An Examination of Subsidies to Chinese State-Owned Enterprises (SOEs) in the Context of the WTO Agreement on Subsidies and Countervailing Measures

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Abstract

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Chinese state-owned enterprises (SOEs) have for some time received a large amount of subsidies from both central and local governments. While changes to Chinese SOEs have taken place during the past three decades of reform, some of these subsidies continue. Since China's accession into the WTO, measures adopted by the Chinese government should conform to the multilateral rules system. The question then becomes whether Chinese government support of SOEs is consistent with the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement). But measuring whether China is in compliance with the SCM Agreement is not as straightforward as it initially appears for at least three reasons. First, the term "subsidy" employed in daily language is different from a "subsidy" in the context of the WTO rules. Second, some forms of governmental assistance to Chinese SOEs are designed in a complicated way. Third, Chinese SOE reform is ongoing so that new phenomena emerge especially in terms of the state-enterprise relation. Against such a background, an immediate question should be asked that have SOEs received any subsidies during the SOE reform within the meaning of the SCM Agreement, and if so, what types of subsidies have SOEs obtained? To solve the foregoing questions, this thesis examines the SOE reform, identifies the scope of SOEs and reviews the various assistance provided to SOEs. The thesis then attempts to assess which type of assistance provided by Chinese government constitutes subsidies under the SCM Agreement.

Specifically, this study focuses on seven general types of assistance, because they are contentious in practice and complicated in nature, and they also have far-reaching implications. The seven types of assistance refer to undervalued exchange rate, preferential loan, access to the stock market, debt-equity swap, official export credit, land-use rights and energy subsidies. They are followed by an examination of the other types of assistance that are mainly provided to three industries, namely the iron and steel industry, the auto industry and the electronic information industry, on which state enterprises still have a considerable impact.

Key Words: subsidy, state-owned enterprises (SOEs), assistance, measure, industry

摘要

中国国有企业一度从中央政府与地方政府获得了大量补贴。虽然经过三十年的改革，国有企业已经发生了重大变化，但是部分补贴依然存在。自从中国加入世界贸易组织，中国政府的行为就应当符合这个多边机制的规则。因此，问题便出现了，即中国政府对国有企业的扶持是否符合世界贸易组织《补贴与反补贴措施协定》的相关规则。这个问题并不像它看起来那么直接简单。首先，我们日常生活中所提到的“补贴”不同于世界贸易组织框架下所使用的“补贴”。其次，政府提供给国有企业的某些资助措施是通过一种非常复杂的方式进行的。第三，国有企业改革仍在进行中，新现象不断出现，尤其是政企关系处于持续的调整状态。正是基于这样一个背景，本文所要研究的问题是，在世界贸易组织《补贴与反补贴措施协定》层面上，国有企业在国企改革过程中是否获得了补贴？如果答案是肯定的，国有企业获得了哪些类型的补贴？

为了解决这个研究问题，本文首先回顾国有企业改革历程，然后界定国有企业的范围，总结政府提供给国有企业的资助类型，进而分析这些资助类型是否构成《补贴与反补贴措施协定》意义上的补贴。

本文集中讨论七种资助措施，主要是由于这七种措施在实践中有争议，性质比较复杂，同时影响深远。具体来讲，这七种措施指的是：汇率低估，优惠贷款，公司上市，债转股，官方出口信贷，土地使用权的提供和能源补贴。最后，本文关注其它类型的资助措施，这些措施分别或者同时提供给钢铁，汽车和电子信息三大产业。在这三大产业中，国有企业依然有相当大的影响力。

关键词：补贴 国有企业 资助 措施 产业

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Abbreviations and Acronyms

AB	Appellate Body
ABC	Agricultural Bank of China
AD	Anti-Dumping
AMC	Asset Management Company
BOC	Bank of China
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CCCPC	Central Committee of the Communist Party of China
Central Huijin	Central Huijin Investment Co., Ltd.
China Eximbank	China Export & Import Bank
CIC	China Investment Corporation
CIRRs	Commercial Interest Reference Rates
CISA	China Iron and Steel Association
CSRC	China Securities Regulatory Committee
CVD	Countervailing Duty Investigation
DOC	Department of Commerce
GATT	General Agreement on Tariffs and Trade
ICBC	Industrial & Commercial Bank of China
IPO	Initial public offering
ITO	International Trade Organization
ITC	International Trade Commission
MOF	Ministry of Finance
MOLAR	Ministry of Land and Resources
NBS	National Bureau of Statistics
NDRC	National Development and Reform Commission
NPC	National People's Congress

NPLs	Non-performing loans
OECD	Organisation for Economic Cooperation and Development
PBOC	People's Bank of China
PRC	People's Republic of China
SASAC	State-owned Asset Supervision and Administration Commission
SCM	Subsidies and Countervailing Measures
SHSE	Shanghai Stock Exchange
SETC	State Economic and Trade Commission
SOCBs	State-owned commercial banks
SOCs	State-owned companies
SOEs	State-owned enterprises
STE	State trading enterprise
SZSE	Shenzhen Stock Exchange
TVEs	Township Village Enterprises
WTO	World Trade Organization

Chapter 1 Introduction

It is no secret that both the central and local governments of the People's Republic of China (PRC or China) once provided a large quantity of subsidies in various forms to state-owned enterprises (SOEs).[1] The amount of subsidies to SOEs did not significantly decline until China's accession into the World Trade Organization (WTO).

A brief look at the main items of government revenue from China's statistical yearbooks shows that the amount of annual subsidies for loss-making SOEs was as high as over RMB 30 billion from 1985 to 1999.[2] In fact, the first two items of China's notification to the Committee on Subsidies and Countervailing Measures respond directly to provision of subsidies to SOEs. The first two items are: *Subsidies from Central Budget Provided to Certain SOEs Running at a Loss* and *Subsidies from Local Budget Provided to Loss-Making SOEs*, from 1990 through 1998.[3]

Most forms of subsidy at that time were grants and tax forgiveness, and they were often used for one purpose to maintain the very survival of loss-making SOEs rather than to promote their competitiveness.[4] In accordance with the subsidies notification, China's policy objective and/or purpose of the subsidy are described as: "To promote the structural adjustment of those SOEs running at a loss, and to keep employment by means of promoting rationalization and maintaining stable production and safety of society (as a compensation for the lack of a social security system)".[5]

In essence, the provision of subsidies to SOEs closely relates to both the relationship of the Chinese government to SOEs and the establishment of a market-oriented economy. In this regard, Nicholas Hope comments, "an enterprise sector that functions independently of state subsidies is an essential component of the measures needed for effective management of a modern market economy".[6]

Accompanying the great transformation in the past three decades in China, SOEs and

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[1] See Justin Yifu Lin, Fang Cai and Zhou Li: *State-Owned Enterprise Reform in China*. Hong Kong: The Chinese University Press, 2001, 67-70.

[2] Available at the official website of State Statistics Bureau of China, http://www.stats.gov.cn/.

[3] Annex 5A to the Protocol on the Accession of the People's Republic of China: Notification pursuant to Article XXV of the SCM Agreement. Based on the Notification, the subsidy is not provided to all SOEs running at a loss, but to severe loss-making SOEs due to either fixed price of the products they produce or the increasing cost of exploitation of the resources. Annex 5B to the Protocol indicates that the First Item should be phased out. See Administration of WTO, former Ministry of Foreign Trade and Economic Cooperation (editor): *Compilation of the Legal Instruments on China's Accession to the World Trade Organization*. Beijing: Law Press, 2002, 85-88.

[4] Competitiveness is a strange word for the then Chinese SOEs. To observe China's ailing state enterprises, Edward S. Steinfeld investigated three SOEs in the iron and steel industry, see Edward S. Steinfeld: *Forging Reform in China: the Fate of State-owned Industry*. Cambridge; New York: Cambridge University Press, 1998.

[5] See Annex 5A to the Protocol on the Accession of the People's Republic of China: Notification pursuant to Article XXV of the SCM Agreement. See Administration of WTO, above note 3, 85-88.

[6] Harry G. Broadman (ed.): *Policy Options for Reform of Chinese State-Owned Enterprises: Proceedings of a Symposium in Beijing*, June 1995. Washington, D.C.: The World Bank, 1996.

the economic structure in which SOEs are embedded have shown incredibly new phenomena especially during the past ten years. Moreover, the relationship of SOEs to the government is also changing along with the market-oriented economic reform. Thus, while the term SOEs remains the same, the "connotation" behind SOEs is no longer the same one.

This thesis finds that the continuous rapid growth and change of the Chinese economy in the last ten years has led to several misconceptions about SOEs. From these changes, many general observations and comments are not so appropriate any more. This would include comments such as "highly inefficient SOEs", "loss-making SOEs", "SOEs with heavy debt burdens", "massive governmental intervention into the daily operations of SOEs" and "redundant workers".[7] First and foremost, a large number of SOEs have withdrawn from many competitive industries which resulted in the shrinking of SOEs share in the economy in terms of both numbers and assets, while the number of SOEs in the financial area has increased following the rapid growth of China's capital market. Secondly, different forms of SOEs coexist in current China, including SOEs that have not been corporatized yet and SOEs with the shareholding system,[8] parent companies (SOEs) and daughter companies.[9] Thirdly, there is an important classification of Chinese SOEs based on the level of agencies that act as the investor of SOEs, namely central SOEs and local SOEs. It is also worthwhile noting that although central SOEs have generated tremendous profits over the years, the profits made by SOEs in certain sectors are not as large as their private counterparts. Last but not least, some large SOEs are in monopoly positions, and it is argued that the profits earned by SOEs mainly attribute to their monopolized positions rather than their management capability.[10]

A series of questions arise out of the aforementioned phenomena: How has SOE reform proceeded? What is the role of the state in SOE reform, in particular, how does the state exercise its ownership rights or perform its ownership function? What are SOEs? Have SOEs received any (potential) type of subsidies in the sense of the SCM Agreement in recent years?

The last question is especially meaningful considering that China has been a Member of WTO since December 11, 2001, and thus the WTO rules regulating subsidies should be followed by Chinese government. On the whole, there are two sets of WTO rules governing subsidies for SOEs. One is the general rules embodied in Article VI, XVI of the GATT and the SCM Agreement, and the other is specific rules targeting at

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[7] For a micro-level description of SOEs' performance, see Steinfeld, above note 4

[8] There is a strong argument that the shareholding companies in which the state holds a stake should not be regarded as SOEs Even for the companies where the state is the majority shareholder, they should be categorized as state invested companies (*Guo Jia Tou Zi Gong Si*) or state owned companies (*Guo You Gong Si*) It means that SOEs are read in their narrow sense These arguments will be discussed in Chapter Three

[9] The multi-tier legal entity of SOEs often makes it hard to determine whether the state is the majority shareholder of these daughter companies, let alone granddaughter companies

[10] In practice, these large monopolized SOEs have been increasingly regarded as a symbol of vested interest groups, who only care about their own interests and disregard the shareholders

Chinese SOEs, including Article 10 of the Protocol on the Accession of PRC (the Protocol or China's Accession Protocol) and Paragraphs 43, 44, 45, 46 and172 of the Report of the Working Party on the Accession of China (China's Working Party Report).

With a view to clarifying the main questions pursued by this research and their broad background, this chapter is organized as follows: the first part is a brief introduction to the intellectual debate over the relationship between government and market, since both the government and market are key mechanisms of promoting Chinese economic reform and the prerequisite for deep research into and better understanding of the subsidy rules. Second, the Chapter overviews the remarkable economic reform in China initiated in 1978. The third part of this Chapter discusses the reasons why Chinese SOEs received special treatment in the final accession documents during China's accession process. The main questions of this study are further detailed in the last part, and this Chapter concludes by laying out the structure of the thesis.

1.1 State and Market

The relationship between the state (government) and market is a constant theme with a huge body of literature.[11] As two efficient forms of political and economic organization in the production of power and/or wealth, the state and market differ in their ways of organizing social life.[12] Specifically, the state relies on territoriality, loyalty, exclusivity, monopoly of the legitimate use of force and the consent of its people, especially its most powerful groups; the market depends on functional integration, the relative prices deciding the behaviors of the buyers and sellers, and contractual relationships *etc.*[13]

Since Adam Smith provided the famous metaphor of "the invisible hand",[14] the self-regulating nature of market has been well researched. When John Maynard Keynes challenged the widely accepted classical theory of free market by explaining that in conditions of market failure, government policies were justified.[15] This is, of course, not the final word and the battle between the Classical Economists and the Keynesians seems to be interminable. The Classical Economists including the New Classical Economists continue to point out the shortcomings of the visible hand (government interference), and the Keynesians counter-attack by proving the defects

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[11] See Charles E. Lindblom: *Politics and Markets: the World's Political Economic Systems*. New York: Basic Books, 1977. Joseph E. Stiglitz: *The Economic Role of the State*. Oxford: Basil Blackwell in association with Bank Insinger de Beaufort NV, 1989.

[12] See Robert Gilpin: *The Political Economy of International Relations*. Princeton, N.J.: Princeton University Press, 1987, 10-11.

[13] Ibid.

[14] In his book *the Wealth of Nations,* Smith adopted a daily example to illustrate the simplicity of the principle: It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own self interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages. See Adam Smith (1723-1790): *An Inquiry into the Nature and Causes of the Wealth of Nations*. Oxford: Clarendon Press, 1976.

[15] For more analysis, please refer to John Maynard Keynes (1883-1946): *The General Theory of Employment, Interest and Money*. Basingstoke: Palgrave Macmillan for the Royal Economic Society, 2007. As Keynes's magnum opus, this book was first published in London, 1936.

of the invisible hand (market).

Karl Polanyi stroked the idea of self-regulating market heavily: "The idea of a self-regulating market implied a stark utopia. Such an institution could not exist for any length of time without annihilating the human and natural substance of society; it would have physically destroyed man and transformed his surroundings into a wilderness. Inevitably, society took measures to protect itself, but whatever measures it took impaired the self-regulation of market, disorganized industrial life, and thus endangered society in yet another way".[16] In the end, even a laissez-faire economy itself needs to be enforced by the government. As Joseph E. Stiglitz commented, Polanyi's central theses are as follows: self-regulating markets never work; their deficiencies, embedded in both their internal workings and consequences, are so great that government interventions become inevitable; also, the pace of change is of central importance in determining these consequences.[17]

It turns out that both the government and market are imperfect. Indeed, human history since Adam Smith has been replete with such intellectual debates: someone favors market over government, and vice versa. However, neither has ever acquired the decisive victory in the numerous and various debates. The very general consensus is that both of them are necessary, since neither of them could address adequately the complicated economic activities alone. Such a relatively neutral ground could be found in Mankiw's two of the ten principles of economies: Markets are usually a good way to organize economic activity and government can sometimes improve market outcomes.[18] When the market could not allocate resources efficiently, usually referred to as market failure, or the market fails to distribute the economic prosperity equitably, government can play a role with the aim of improving the market outcomes.[19] The true puzzle in theory may lie in how to balance their roles, or how can they coordinate or interact in the best manner to yield a desirable result. When it comes to a specific country, the specific circumstances faced by that country also constitute variables that affect the balance between the government and the market. For instance, if a country has not established a sound social security system, its government inevitably needs to be proactive.

The reality in recent decades is that market economy is increasingly in a dominant position worldwide, although government intervention is slightly on the rise in the severe global economic crisis.[20] Privatization was the chosen tool to reduce the incentive and scope for the intervention from government in many countries

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[16] See Karl Polanyi *The Great Transformation the Political and Economic Origins of Our Time* Boston, MA Beacon Press, 2001 Originally published New York Farrar & Rinehart, 1944, 3-4

[17] Ibid , in the foreword of this book

[18] See N Gregory Mankiw *Principles of Economics*, 4th edition Mason, Ohio Thomson/South-Western, 2004, 9-11

[19] Ibid

[20] For instance, many countries provided bailout to their auto makers and other measures to stimulate the economy

throughout the late 1980s and the early 1990s.[21] Following the British lead, several countries including Soviet Union and Central and Eastern European countries launched the full or partial privatization of their state-owned economies. Accompanying the general trend of market liberalization and privatization is the persistence of the government's active participation in the economic development in some countries. China's transition from a centrally planned economy to a market economy serves as a good case. It is noticeable that China has adopted a gradual approach to transforming to market economy.[22]

China's practice with respect to how the government and market interact is illustrated herein by a specific yet quintessential example, namely how the Chinese government performs its dual roles as the regulator and owner of SOEs. The reason why SOE in China is seen as such an epitome is that the government has a tradition of controlling the operation of SOEs during its previous planned-economy era. The Chinese government recognizes the necessity to promote the reform of SOEs and comply with WTO rules.[23] The problem is that, even after over thirty years of market-oriented reform, Chinese government of various levels still seems to be prone to provide certain forms of assistance to SOEs or intervene in the management of SOEs.[24] Therefore, numerous controversial issues occur in this area.

On the other hand, the extraordinarily long-lasting multilateral negotiations over the rules governing subsidies and the final ambiguous texts, embody exactly different conceptions towards the tensions between the government and market in adjusting economic activities. Given the fact that China did not participate in the negotiation process for drafting the rules, it is possible that the WTO rules - including the Agreement of Subsidies and Countervailing Measures (SCM Agreement) - creates more tensions in and with China than to pre-existing WTO Members. Again, Chinese SOEs stand as a typical example. For example, noted trade expert John H. Jackson comments: "China's government-owned, or state-operated or owned, enterprises are a big challenge to the system, and it is hard to believe this will not shape some of the thinking about Subsidies. ...One can predict that in a couple of years some of the definitions in the subsidies code will have to be revised, if that is manageable".[25]

Thus, it is extremely challenging to determine the proper extent of the state intervention in the economy and strike a balance between government and market precisely to achieve the economic prosperity and social development. Inevitably, in terms of Chinese SOEs, it is difficult to achieve general agreement on their relation with the government, market and their impact on international trade. Although effort

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[21] See the OECD Policy Roundtables *Competition Policy in Subsidies and State Aid 2001* Available at http //www oecd org/dataoecd/31/1/2731940 pdf

[22] In this connection, China's privatization process is unique

[23] In particular, China struggled to transform its planning economy into a market economy

[24] Admittedly, one cannot ignore the substantial progress that has been achieved since the SOE reform in the 1980s

[25] John H Jackson, 'The Impact of China's Accession on the WTO', in Deborah Cass, Brett Williams & George Barker (eds), *China and the World Trading System Entering the New Millennium* Cambridge, New York Cambridge University Press, 2003, 26

has been made both in the practical and theoretical aspects, a desirable solution has not yet been found. This is an interesting and fundamental question, but unfortunately outside the scope of this research. For purposes of this study, it is just necessary to be aware of such difficulty.

1.2 Economic Development in China Since 1978

Following the intellectual debate over the role of market and government in the economic activities, this part briefly reviews China's macroeconomic development. Such development reflects the interaction between market and government, known as the invisible hand and visible hand, in the scenario of China.

The year 1949 indicated the founding of a new China, the People's Republic of China. Almost 30 years later, Deng Xiaoping's rise to power in 1978 led to the abandonment of Mao's inward-looking economic policies and a beginning of total economic transformation. The changes following Mao's death made the rapid economic development of the next three decades possible. Thus, the historical process of PRC can be generally divided into two phases: one is the pre-reform era from 1949-1978 and the other is the reform era: 1978 to the present.

The reform era officially began at the Third Plenum of the 11th Central Committee of the Communist Party of China (CCCPC) in December 1978, with the launching of the "Reform and Opening Up" policy.[26] This meeting decided to end the horrible class struggle and economically disastrous policies of the earlier phase. The change also required a quick shift of the government's focus to prepare economic development.[27] Subsequently, the Fifth Plenum of the 11th CCCPC in February 1980 confirmed that "the principal contradiction in China is no longer class struggle but the one between the growing material and cultural needs of the people and the backwardness of social production".[28] Therefore, the priority for China at that time was set as development, in line with Deng Xiaoping's brave statement that development is the hard truth.[29]

The immediate problem faced by China was how to achieve the objective of development. China's choice was not the big bang route.[30] Instead, China adopted the philosophy of gradualism: a moderate and gradual approach to economic development.

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[26] The year 1978, a milestone in the history of the PRC, has become an oft-cited number in numerous articles, books and occasions *etc* China also held various activities to commemorate the significant year for Chinese people

[27] Available at http //news xinhuanet com/zilıao/2005-02/05/content_2550304 htm

[28] See Resolution on Several Historical Questions for the CPC since the Founding of PRC Available at http //www gov cn/test/2008-06/23/content_1024934_6 htm

[29] Since then, Chinese economy has undergone remarkable changes China's gross domestic product (GDP) grew fast, with an average rate over 9% from 1978-1995 People's standard of living improved greatly and household savings increased See Nicholas R Lardy *Integrating China into the Global Economy* Washington, D C Brookings Institution Press, 2002, 12 The data given by the World Bank and China National Economic Research Center have a slight difference, but both institutions presented a rate of over 9%

[30] For more information on big bang route, see Joseph E Stiglitz *Globalization and its Discontents* New York W W Norton, 2002, Gérard Roland *Transition and Economics Politics, Markets, and Firms* Cambridge, Mass MIT Press, 2000, Minxin Pei *China's Trapped Transition the Limits of Developmental Autocracy* Cambridge, Mass Harvard University Press, 2006

Deng Xiaoping's famous metaphor "crossing the river by groping for stones"[31] explains the idea, which, in essence, means that policy-makers would solve problems in the course of constant reform step by step.[32]

This gradual process has at times confronted setbacks. The SOE reform is a case in point, since it seemed to lose its direction in the late 1980s and early 1990s after years of adjustments. At that time, a debate over plan-oriented reform and marketed-oriented reform arose among economists and leaders in charge of economic affairs because of the macroeconomic disorder and stagnant SOE reform.[33] On the issue whether China should turn to market or follow strictly the economic ideologies of communism, Deng Xiaoping commented that "it does not matter whether the cat is black or white; as long as it catches the mouse, it is a good cat".[34] This implies again that development was the core, and ideologies should not be a block to the economic development.

Although market was employed as a tool to promote the economic development, it was very difficult to find any breakthrough in urban sectors with SOEs as the main body. Thus, the focus of reform shifted from the urban state sector to the rural sector. Previously, land and other production assets in the rural area were owned by People's Communes (based in townships) and Production Brigades (based in villages), where people had the practice of "eating rice in a shared pot".[35] With the commencement of agriculture reform first in Fengyang County, Anhui Province, the peasants there embraced successful outcome. Then the individual household farming system, also known as household contract responsibility system, spread across the whole country. The grain output reached a historically high level in 1984.[36] To promote the peasants' investment in land, land was contracted to peasant households for farming with three years, and then the contract was extended to 30 years in 1993. Despite some market-oriented measures in the rural economy, land was not privatized in China.

Alongside agricultural restructuring, restrictions on rural industrialization were relaxed.[37] Township Village Enterprises (TVEs) in rural areas developed quickly owing to the success of agricultural reform and the encouragement of the Government. Combining TVEs with private enterprises in 1993, rural industries as a whole produced 36 percent of the national industrial output, making major contributions

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[31] See Bennis So Wai Yip, "Privatization", in Czeslaw Tubilewicz *Critical Issues in Contemporary China* Routledge, Open University of Hong Kong, 2006, Chapter 3

[32] Wang Zhongyu, pervious Minister of State Economic and Trade Commission, once stated that gradualism is the only feasible path for China's enterprise reform in that the accumulated problems and difficulties are long-standing and intractable, and their causes are quite complicated, in Broadman (ed), above note 6

[33] See Jinglian Wu *Understanding and Interpreting Chinese Economic Reform* Thomson/South-Western, 2005, at 62-63

[34] Originally, it was a proverb well known by Chinese

[35] See Chunlin Zhang (2002) *The Interaction of the State and the Market in a Developing Transition Economy the Experience of China* (the first draft of a conference paper) International Seminar entitled *Promoting Growth and Welfare Structural Changes and the Role of Institutions in Asia*, at Santiago, Chile and Rio de Janeiro, Brazil, April 29-May 03, 2002

[36] Ibid

[37] See Bennis So Wai Yip, "Privatization", in Tubilewicz, above note 31, at 53

toward sustaining China's 10 percent annual growth during its transition to a market economy.[38] The policy of opening to the outside world also brought in a number of joint ventures. During this period, it is generally recognized that the achievements of the state sector could not be comparable to those of TVEs and the private sector, which showed the vigor of non-state sectors.

To ensure the sustainable development of non-state sectors under the system of the lingering planned economy, a dual-track system of price emerged in China. Therefore, non-state enterprises obtained raw materials and sold products via a market system, not by the plan of the state. As an approach to market liberalization, the dual-track system had obvious advantages at the earlier stage: it liberalized markets without creating losers and thus was politically appealing, and it enabled efficiency gains while minimizing the numbers of losers from the reform process and did not touch the vested interest groups.[39] For some time, the creative institutional arrangement promoted the economic development of China.[40] But gradually, conflicts between the two systems became obvious and even blocked the economy's progress to a certain extent.[41] Attention was drawn to the sluggish state sector in the urban area again. Different viewpoints occurred correspondingly with regard to how to continue the reform. Some economists argued for the enterprise reform as the main theme, while others advocated for overall and coordinated reform, also named as the integrated reform school.[42]

A strategic and substantial shift occurred in the fourteenth CCCPC in 1992, which was marked by the official declaration of the Central Government for the first time that it aimed to achieve a socialist market economy.[43] It indicated that the long existing planning system in China would be abolished officially. In fact, during his famous Southern Tour in 1992, Deng Xiaoping made clear that market economy is not something that only capitalism can own, and socialism can make use of it to develop the economy as well; however, socialism normally introduced pilot experiment first and then expanded the practice nationwide if the experiment was successful.[44] To evaluate which measure (being capitalistic or socialistic) should be taken, he proposed the judgment rules "three favorables": whether it promotes the growth of the productive forces in a socialist society, whether it increases the overall strength of the socialist state and whether it raises the people's living standards.

Then in 1993, a document with historical meaning "*Decisions on Issues Concerning*

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[38] See Hehui Jin and Yingyi Qian (1998) Public versus Private Ownership of Firms Evidence from Rural China *The Quarterly Journal of Economics*, 773-808

[39] See Stoyan Tenev and Chunlin Zhang with Loup Brefort *Corporate Governance and Enterprise Reform in China Building the Institutions of Modern Markets* Washington D C The World Bank and the International Finance Corporation, 2002

[40] The Soviet Union and Eastern European socialist countries still focused on the reform of the state sector

[41] For a detailed discussion, please refer to Wu, above note 33, at 68-71

[42] Ibid

[43] Available at http //news xinhuanet com/zilliao/2003-01/20/content_697129 htm

[44] Almost each reform in China begins with a pilot test, and then extended to the whole country if the pilot reform shows promising signs

the Establishment of a Socialist Market Economic Structure" was passed by the CCCPC.[45] The reform of industrial SOEs was highlighted in this Decision and new approaches to SOE reform and fiscal policies were established. This CCCPC adopted a reform strategy of "overall advance with key breakthroughs", which meant to push the reform in price, fiscal and taxation system, government finance, foreign exchange control system, the enterprise system and the social security system at the same time.[46] Prior to this Decision, the government had launched the Shanghai Stock Exchange and Shenzhen Stock Exchange in November 1990 and April 1991 respectively to develop the capital market. All of these measures sent a clear signal that China's reform entered into a new stage of overall advance.

The measures taken in the past decade proved to be fairly effective based on GDP performance. Despite Asian Financial Crisis erupting in 1997, China still kept a good record of GDP growth rate. The National Bureau of Statistics (NBS) reported that China's GDP was RMB 12.03 trillion in 2002, RMB 13.58 trillion in 2003, RMB 15.99 trillion in 2004, and RMB 18.31 trillion in 2005.[47] The annual growth of China's GDP was 8% in 2002, 10.0% in 2003, 10% in 2004, and 10.2% in 2005 respectively.[48]

The government showed more trust in the market mechanism. On October 14th, 2003, *Decision on Some Issues concerning the Improvement of the Socialist Market Economy* was adopted at the 3rd Plenary Session of the 16th CCCPC.[49] This decision suggested giving an expanded role to the market in the allocation of resources, enhancing the vitality and competitiveness of enterprises, building up a unified, open, competitive and orderly modern market system, improving the macro-control, administration, and economic legal system and so on.[50]

Take the price fixing system as an example: the catalog stipulated by Chinese government has been amended several times. In 1992, the number of commodities under control was 141. Owing to the revision in 2001, the number of commodities under control was reduced to 13.[51] The 13 broad types of commodities with government-set prices mainly concerned crucial goods, including exclusive tobacco, salt and civil explosive equipment, certain fertilizer, certain medicine, teaching material, natural gas, water supply for hydraulic projects under the direct

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[45] It was adopted at the Third Plenum of the Fourteenth CPC Central Committee in November 1993 Available at http //news xinhuanet com/ziliao/2003-01/20/content_697152 htm

[46] This strategy is advocated by the Integrated Reform School The famous scholars such as Guo Shuqing, Wu Jinglian, Zhou Xiaochuan and Lou Jiwei *etc* supported this idea For the argument of Enterprise Reform as the main theme, Professor Li Yining of Peking University is the chief proponent For details, refer to Wu, above note 33, at 75-85

[47] Available at http //www stats gov cn/tjsj/ndsj/2006/indexch htm

[48] Available at http //news xinhuanet com/fortune/2006-08/31/content_5030050 htm

[49] Available at http //news xinhuanet com/newscenter/2003-10/21/content_1135402 htm

[50] Market is also expected to solve some serious problems and concerns, such as the lower competitiveness of SOEs, the outstanding employment contradictions, the sluggish growth of farmers' income, and the intensified pressures on resources and environment

[51] Available at http //www china com cn/zhibo/2001-07/11/content_8784416 htm Each province has its own local governmental price-fixing catalog, depending on local interests

administration of the central government or inter-provincial hydraulic projects, military supplies, major transportation and postal services, telecommunication business and some specialized services.[52] Some of the items like domestic aviation services were changed from government-set to government-guided. In July 2008, National Development and Reform Commission (NDRC) evaluated whether to revise the price-fixing catalog list.[53]

The reform in China has become more comprehensive in recent years, not just focusing on economic development. In other words, GDP maximization is not extremely emphasized; improving people's livelihood is increasingly highlighted. For instance, the theme of the 16th CCCPC at its sixth plenary session was building a harmonious society. The 17th CCCPC paid more attention to the administrative reform and made public a resolution *Opinions on Deepening Reform of the Administrative System* as well as a *Plan on Institutional Restructuring of the State Council*.[54] The resolution lists the defects associated with the administrative system, such as insufficient change in government functions, excessive administrative interference in micro-economic operations, and relatively weaker social management and public services.[55] Such a resolution exhibits Chinese leaders' willingness to further the reform.

All of the above policies and other measures show, to some extent, the central government's determination to continue the institutional reform and thus strike a better balance between market and government.[56]

1.3 China's Accession to the WTO

Few events in China raised more discussions than China's accession into the WTO throughout the late 1980s and the 1990s. There is a long and convoluted history for China to achieve a seat in the General Agreement on Tariffs and Trade (GATT) and its successor the WTO. The Republic of China was one of the founding contracting parties of the GATT; and when the Chinese Communist Party came to power in 1949, Taiwan or the Kuomintang government withdrew from the GATT several years later for various practical and other complicated reasons.[57] More than thirty years later,

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[52] Available at http //www ndrc gov cn/zcfb/zcfbl/zcfbl2003pro/t20050707_27540 htm

[53] Available at http //www ndrc gov cn/gzdt/t20080822_231895 htm Adjusting the price-fixing catalog is one of the duties and powers of NDRC

[54] They were adopted by the 17th CCCPC at its second plenary session

[55] There are other outstanding problems, such as overlapping functions of government departments, disparities between power and responsibility, and low efficiency Available at http //english mofcom gov cn/aarticle/subject/ncss/lanmua/200803/20080305412675 html

[56] The institutional reform inevitably involves the readjustment of various interest groups, and it will confront huge pressure Thus, the institutional reform not just challenges the determination of the government, but also requires the political wisdom and capabilities

[57] For more details, see Henry Gao (2007) China's Participation in the WTO A Lawyer's Perspective *Singapore Year Book of International Law*, 11, 41-74 In the first footnote, Prof Gao recommends several useful articles concerning China's accession to the WTO, for example, John H Jackson & James V Feinerman (eds) (2001), "China's WTO Accession Survey of Materials", *Journal of International Economic Law*, 4(2), 329-335, Yang Guohua & Cheng Jin (2001), "The Process of China's Accession to the WTO", *Journal of International Economic Law*, 4(2), 297-328, etc

PRC wished to resume "China's" contracting party status of the GATT rather than re-enter the GATT, since it considered Taiwan's withdrawal as illegal and invalid.[58] At the beginning, the Big Three - the US, the European Community and Japan - generally welcomed China's efforts to join the GATT, and the review on China's foreign trade regime ended in 1988.[59] However, following the Tiananmen Square protests in 1989, the evaluation and draft of accession protocol came to a halt and the subsequent negotiating situation became tougher for China.[60] In 1995, the GATT was replaced by WTO and the newly named WTO Accession Working Party completed the accession process. Finally, after another six years, China acceded into the WTO on 11 December 2001.

Simply from the length of time it took China to complete the accession process one can ascertain that China's accession to the WTO was difficult. China's accession was difficult for a variety of political and economic reasons, including China's governing political system, transition to an open economy, political difficulties and even the accidental bombing of the 1999 Chinese Embassy in Belgrade.[61] As importantly, it also took China, a country without any experience to deal with the trade rules, time to fully understand the rules, obligations and commitments regarding several new trade areas, including trade in services, trade-related intellectual property and agriculture.

Here, the focus will be placed on the economic factors. Owing to China's policy of reform and opening up and the subsequent favorable economic growth, goods labeled as "made in China" reached many parts of the world in the 1990s. This concerned other countries in terms of market shares. However, the then existing WTO Members did perceive the extensive opportunities in the huge market of China. Thus, they aimed to get more concession from China and then achieved better access to this market with enormous potential.[62] The conflict between China's reluctance to open too much market and the other WTO Members' request for more market access made the negotiation much tougher. China's dual status as a developing country and economic power also raised a question to the WTO. These conditions made the negotiations move at a slow pace.

Another reason, and perhaps more important, is that some WTO Members have many concerns with the structure and policy settings of Chinese economy that evolved from a formerly planned economy. One of such concerns relates to a large number of SOEs in China. Previously, market structure was not a matter of concern for WTO Members;

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[58] One of the reasons raised by China is that: the founding of the PRC in 1949 did not alter China's status as a subject of international law. The deposed Chiang-Kai Shek regime ceased to represent China as from 1 October 1949. The withdrawal from GATT in the name of China by the authority in Taiwan in 1950 was therefore not legally valid. See Working Party on China's Status as a Contracting Party-China's Foreign Trade Regime-Note by the Secretariat, Spec (88)13/Add.4, 09/12/1988, available at: http://www.wto.org/gatt_docs/English/SULPDF/92260024.pdf.

[59] Wang Yi, *Shiji Tanpan: zai Fuguan/Rushi Tanpan de Rizi li* (Century Negotiations: in the Days Involved with GATT/WTO). Beijing: Zhonggong Zhongyang Dangxiao Chuban she, 2007, 47-54.

[60] Ibid.

[61] See Gao, above note 57, 41-74.

[62] Ibid.

instead, it is conduct of various enterprises that should be subject to behavioral rules.[63] However, existing WTO Members showed more concern with market structure in accession talks with the former centrally planned economies in the 1990s.[64]

In the case of China, it is even pointed out that the progress the Chinese leadership makes in reforming the nation's SOEs is a prism through which to view China's readiness to assume the obligations of membership in the WTO.[65] Such concern was reinforced by Tiananmen Square protests of 1989, which directly led to the Contracting Parties reversing course and holding that China still ignored the market mechanism in favor of central planning, state control and public ownership and state-run enterprises.[66]

Consequently, Chinese SOEs became one of the main targets during the negotiation of China's accession into the WTO. The debate among trade negotiators, governmental and legislative decision-makers during China's accession negotiations displayed fully the standpoints of different groups. One of the groups, called the "hawks", insisted that China remain out of the WTO until China could be seen to have made these necessary reforms, including the selling-off of SOEs, the reform of the legal and administrative systems in China and so on.[67] As a result, China got some special treatment with additional obligations in the WTO system. For example, subsidies to SOEs should be subject to a special specificity requirement,[68] China committed itself to the special safeguard mechanism and China could not enjoy the preferential provisions that are applicable to developing countries *etc.* The WTO rules embrace some basic principles including non-discrimination, transparency and competition.[69] In fact, one of China's accession objectives is to seek an opportunity to promote SOE reform and their competition with international counterparts.[70] It is also regarded as creating an external condition that could not easily be undermined by domestic political resistance.[71]

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[63] See Bernard M Hoekman and Michel M Kostecki *The Political Economy of the World Trading System From GATT to WTO* Oxford University Press, 1995, 111-112

[64] Ibid

[65] See Harry G Broadman, 'a Litmus Test for China's Accession to the WTO Reform of Its State-Owned Enterprises', in Sylvia Ostry, Alan S Alexandroff, and Rafael Gomez (eds), *China and the Long March to Global Trade the Accession of China to the World Trade Organization* Routledge, 2002, Part II, Chapter 5.

[66] See Wang, above note 59, at 47-54

[67] See Ostry *et al* (eds), above note 65, 232

[68] See Art 10 (2) of Protocol For purposes of applying Articles 1 2 and 2 of the SCM Agreement, subsidies provided to state-owned enterprises will be viewed as specific if, *inter alia*, state-owned enterprises are the predominant recipients of such subsidies or state-owned enterprises receive disproportionately large amounts of such subsidies Comments on this Article will be conducted in Chapter Five in detail

[69] See Hoekman and Kostecki, above note 63, 24-32

[70] See Yang & Cheng, above note 58, 297-328 In their paper, they presented five major reasons why China applied to join the GATT/WTO 1), to extend foreign trade, 2), to advance the deepening of economic reform, 3), to participate in international economic affairs and for the formulation of comprehensive trade rules, 4) to resist trade protectionism and 5) to acquire more commercial information

[71] See Shahid Yusuf, Kaoru Nabeshima and Dwight H Perkins, *Under New Ownership Privatizing China's State-Owned Enterprises* Stanford University Press and the World Bank, 2006, 82-86 For economic theory in support of this argument, see Giovanni Maggi and Andres Rodriguez-Clare (1998) The Value of Trade Agreements in the Presence of Political Pressures *Journal of Political Economy*, 106(3) 574-601

1.4 Main Questions and the Structure of the Thesis

Before illustrating the main questions of this thesis, it is first necessary to introduce the current trade remedy measures very briefly. There are three main trade remedies in the WTO legal system: antidumping, countervailing duties (CVD) and safeguards. Two of the trade remedy instruments counter the "unfair" trade practices of exporting countries, and all provide a "safety valve" to sudden increases in trade. Trade remedies function as a means for the government to temporarily exceed specific liberalization commitments under international trading agreements.[72] For instance, antidumping is invoked by the importing countries, when they can prove that products introduced into their market are charged at less than normal value and therefore material injury to their established industry is caused or their domestic industry is threatened.

The other two trade remedial measures, safeguards and CVD, are not as frequently invoked. Unlike other trade remedial measures, safeguards measure is imposed against fair trade. It could be justified, because those imports cause heavy burdens of adjustment of the domestic economic structure resulting from increased imports.[73] Thus, for safeguards, there are quite strict requirements and special procedures in the WTO rules.[74]

Countervailing duties and subsidies involve both the government and companies. Their close connection with government activities makes the issues of CVD and subsidies especially sensitive and delicate. In addition, CVD normally challenges the policies or even some basic economic arrangements taken by a government. It is in this sense that CVD is imposing a certain degree of constraint upon the autonomy of government. On the whole, the action of CVD is a more complicated legal instrument, thereby requiring higher ability to obtain resources.

Along with the increasingly integrated economic communities worldwide, regulating CVD and subsidies has been correspondingly deemed as indispensable for a favorable world trading environment. Admittedly, many unresolved problems and different views still exist relating to both CVD and subsidies.[75] One of the fundamental issues lies in how to distinguish legitimate government activities from trade-distorting subsidies. Major trading nations still maintain their own and often divergent views on the proper role of government involvement with industry.[76] In addition, the meanings

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[72] See Hoekman and Kostecki, above note 63, 161-165

[73] See John H Jackson *the World Trading System Law and Policy of International Economic Relations* Cambridge, Massachusetts and London, England the MIT Press, 1989, 175-179

[74] It must be shown that imports of a product are increasing absolutely or relatively, and such increase is a causal result of unforeseen developments and GATT obligations Of course, these variable concepts contained in the requirement tend to be problematic in practice

[75] See John H Jackson, William J Davey and Alan O Sykes, Jr , *Legal Problems of International Economic Relations Cases, Materials and Text on National and International Regulation of Transnational Economic Relations, 4th edition* ST PAUL, MINN West Group, 2002, 767-827 Also see Gustavo E Luengo Hernandez de Madrid *Regulation of Subsidies and State Aids in WTO and EC Law Conflicts in International Trade Law* Netherlands Kluwer Law International BV, 2007, 7-8

[76] See Jackson, Davey and Sykes, ibid , at 767-768

of some key words in the subsidy and countervailing measures arena are ambiguous, which not just leave the relevant authorities of its Members a wide discretion in launching a CVD investigation and interpreting the key words but also increase the risk and uncertainty of a specific dispute.

Despite the ambiguous rules, there is an obvious trend towards making greater use of CVD in recent years, especially on the products originating from China. For instance, in the 2007 assessment of China's implementation of WTO Commitments, the US-China Business Council (USCBC) made for the first time government subsidies to companies a top ten priority concerns for USCBC members.[77] In fact, 64% of survey respondents assumed they competed with a Chinese firm that receives subsidies.[78] Consequently, more and more CVD investigations have been conducted in the past several years against the products originating from China. The 2008 global financial crisis served to reinforce this trend.

In 2008, 35% of the antidumping investigations (73 among the 208 new investigations) and 71% of the anti-subsidy investigations (10 among the 14 new investigations) involved China, which became the most frequent target of the new initiations of investigations.[79] Among China's major trading partners, the US launched at least half of the CVD investigations against products from China; for instance, 5 of the 10 CVD investigations against China were initiated by the US in 2008. When it came to the year of 2009, the number of CVD investigations against China rose sharply to 10 (see Table 1.1). In fact, US Trade Representative's (USTR) summarized a series of problems associated with China's implementation of commitments in its *2010 Report to Congress on China's Compliance* and ascribed those problems to China's pursuit of industrial policies that rely on excessive, trade-distorting government intervention intended to promote or protect China's domestic industries and SOEs.[80] Thus, there are few signs to show that the anti-subsidy war is going to stop in any time soon.

Table 1.1 CVD Investigation Initiated by the US against PRC[81]

Case Number	Product	Initiation Date
C-570-906	Coated Free Sheet Paper	2006.11.27
C-570-911	Circular Welded Carbon Quality Steel Pipe	2007.7.05
C-570-915	Light-Walled Rectangular Pipe and Tube	2007.7.24
C-570-917	Laminated Woven Sacks	2007.7.25
C-570-913	New Pneumatic Off-the-Road Tires	2007.8.7
C-570-923	Raw Flexible Magnets	2007.10.18
C-570-921	Lightweight Thermal Paper	2007.11.2

[77] Available at http //www uschina org/
[78] Ibid.
[79] Source 2009 press release from the WTO Secretariat reports, available at http //www wto org/english/news_e/archive_e/anti_arc_e htm
[80] See USTR, 2010 Report to Congress on China's Compliance, December 2010
[81] It is worth noting that each CVD investigation against China in the Table 1.1 is accompanied by an anti-dumping investigation

C-570-926	Sodium Nitrite	2007.12.5
C-570-931	Circular Welded Austenitic Stainless Pressure Pipe	2008.2. 25
C-570-936	Circular Welded Carbon Quality Steel Line Pipe	2008.4.29
C-570-936	Citric Acid and Citrate Salts	2008.5.13
C-570-940	Tow Behind Lawn Groomers and Parts Thereof	2008.7.21
C-570-942	Kitchen Appliance Shelving and Racks	2008.8.26
C-570-944	Oil Country Tubular Goods	2009.5.5
C-570-946	Pressed Concrete Steel Wire Strand	2009.6.23
C-570-948	Steel Grating	2009.6.25
C-570-950	Wire Decking	2009.7.2
C-570-953	Narrow Woven Ribbons with Woven Selvedge	2009.8.6
C-570-955	Magnesia Carbon Bricks	2009.8.25
C-570-957	Seamless Carbon and Alloy Steel Standard Line and Pressure Pipe	2009.10.14
C-570-959	Coated Paper Suitable for High-Quality Print Graphics Using Sheet-Fed Presses	2009.10.20
C-570-961	Steel Fasteners	2009.10.22
C-570-963	Sodium and Potassium Phosphate Salts	2009.10.23
C-570-966	Drill Pipe	2010.1.27
C-570-968	Aluminum Extrusions	2010.4.27

Source: http://ia.ita.doc.gov/stats/inv-initiations-2000-current.html

Against such a background, the main goal of this thesis is to explore whether the Chinese government of various levels has provided SOEs subsidies in the course of SOE reform by examining seven typical measures that might constitute subsidies. For sure, there are various forms of assistance provided by the government to SOEs throughout the SOE reform. However, with sufficient data as evidence, it is easy to identify some forms of assistance as subsidies; thus, those kinds of assistance including certain taxes preferences and outright grants will just be mentioned briefly. Emphasis will be placed on the seven measures in that they are contentious in practice and complicated in nature, and they also have far-reaching implications. To enrich and complement the seven measures, this thesis then moves on to examine whether the measures specific to three typical industries - where the state enterprises still have considerable impact- constitute subsidies.

Specifically, the study attempts to answer the following general questions so that the main goal can be achieved: as the owner of SOEs, how does the Chinese government exercise its ownership rights or perform its ownership function? What are the main features of each type of assistance provided by the Chinese government to SOEs? Among the various measures (various types of assistance) examined by this study, which one may be regarded as subsidies in the sense of the SCM Agreement?

The remaining parts of this study proceed as follows. Chapter Two reviews the

existing literature on subsidies and SOEs, and then introduces the main research methodologies adopted by this study.

As mentioned, the precise situation of Chinese SOEs is difficult to fully understand, especially for outsiders. Some may still believe that SOEs are not efficient and have received a huge amount of subsidies, while others argue that SOEs have very good profitability by virtue of a series of reform. Thus, Chapter Three first discusses the SOE reform from the 1950s to the present with a focus on the changing role of the government played in the SOEs. It is followed by an exploration of the scope of SOEs from various standpoints and then a determination of the scope of Chinese SOEs in this study. Defining the scope of SOEs proves to be a problematic issue. Finally, this chapter analyzes the relationship between the government and Chinese SOEs from three perspectives: ownership policies, capital allocations and the way of the government to perform as the owner or investor and the regulator of SOEs.

Chapter Four summarizes seven main measures taken by the Chinese government of various levels to assist SOEs, however, some of the measures are broadly applied, and thus their implications are not limited to SOEs.[82] The seven measures refer to the undervalued exchange rate, preferential loan (whether it is easier for SOEs to get bank loans than other kinds of firms with similar conditions; whether the interest rates of the loans extended by SOCBs to SOEs are lower than the commercial interest rate), access to the stock market, debt-equity swap, official export credit, land-use rights and energy subsidies.

The Chapter then selects three typical industries, namely the iron and steel industry, the auto industry and the electronic information industry, to see how the government at different levels affects SOEs in these industries. The basic reason why these three basic industries are selected is that there still exist typical SOEs in these important industries, especially for the traditional manufacturing industries like the iron and steel industry and the automobile industry. For instance, the subsidies to enterprises in the automobile industry and the forms of subsidies were once striking. In the notification of China to the Committee on Subsidies and Countervailing Measures when applying to join the WTO, both the Third Item and the Fourth Item concern about subsidy programs covering the period from 1994 to 1999 provided to automobile industry.[83] During that period, almost all of enterprises in the automobile industry were SOEs. One program is to give priority to automotive enterprises in obtaining loans and foreign currencies based on their export performance; the other program is giving preferential tariff rates to automotive enterprises based on localization rate of automotive production, and the objective is to promote the localization process of automobile industry in China. Of course, considering the apparent illegal nature of such practice, China committed that those two programs

[82] Measures taken by local governments are also subject to the WTO rules In fact, Article 2(A) (3) of the Protocol emphasizes that "China's local regulations, rules and other measures of local governments at the sub-national level shall conform to the obligations undertaken in the WTO Agreement and this Protocol"

[83] See both Annex 5A and Annex 5B to the Protocol Notification pursuant to Article XXV of the SCM Agreement

would be phased out by 2000.[84]

Chapter Five reviews the evolution of the subsidy rules in the GATT/WTO, and examines relevant articles in the SCM Agreement carefully and some key yet vague terms in particular, including financial contribution, public body, general infrastructure, goods, pass-through of benefit, calculation of benefit, specificity *etc.* It also analyzes articles relating to SOEs subsidies as set forth in the China's Accession Protocol and then overviews Paragraphs 43, 44, 45, 46 and 172 of China's Working Party Report. This Chapter concludes by analyzing the benchmark issues relating to non-market economy when conducting CVD instigations.

Based on the measures categorized in Chapter Four and the key terms and issues clarified in Chapter Five, Chapter Six will make appraisals of the compatibility of those measures with the WTO rules governing subsidies. It also sheds light on the characteristics of those measures.

Chapter Seven concludes by summarizing and reviewing the main points drawn from the introduction and analysis in the previous chapters.

The whole research summarizes and reviews a great many economic issues as well as industrial policies. Much data relating to SOEs has been extracted from yearbooks, governmental reports, and databases *etc.* The very underlying reason lies in the nature of subsidies - the issues addressed by subsidies are at root economic phenomena. To make sound legal analysis, clarifying the framework and mechanism of the relevant economic activities is natural and inevitable. In this sense, this research can be viewed as interdisciplinary. Therefore, to a certain extent, one contribution of this study to the current literature on subsidies can be considered as providing baseline information about subsidies to SOEs in China.

Finally, a brief explanation for the scope of this research is warranted. The author fully understands that the subsidies provided to SOEs are sometimes not solely specific to SOEs but also extend to other types of recipients.[85] Also, it is worthwhile noting that the SCM Agreement, as an annex to the GATT, disciplines only goods, and subsidy rules in the *General Agreement on Trade in Services* (GATS) are not yet well developed yet. For this reason, subsidies involving services (such as in financial sector) are not covered in this study. This research targets only industrial SOEs, namely SOEs in the manufacturing areas.

[84] Ibid
[85] This will be explained furthermore in Chapter Four

Chapter 2 Literature Review

A plethora of literature dealing with issues of SOEs with a focus on Chinese SOEs or of the GATT/WTO rules regulating subsidies exists, but very little of this literature connects these two topics and discusses them with regard to the context of China and the framework of multilateral agreements, let alone in-depth discussion. In this sense, this thesis attempts to address an under-studied issue of great contemporary importance.

To date, there is one key article examining regulation of subsidies to SOEs, namely *WTO Regulation of Subsidies to State-owned Enterprises: A Critical Appraisal of the China Accession Protocol* by Julia Ya Qin.[86] Presuming that Chinese SOEs receive various subsidies from the government, Professor Qin briefly classifies direct or indirect financial assistance to the SOE sector into three general types in accordance with their purposes: (1) subsidies to help sustain and revive loss-making SOEs, such as budget subsidies, bank credits; (2) subsidies to help privatize or restructure SOEs, such as incentives for mergers and acquisitions, repackaging SOEs for foreign direct investment or listing on stock exchanges; (3) and subsidies provided to foster key SOEs.[87] Professor Qin then generally evaluates the trade effects of the three types of subsidies. Professor Qin regards the third type of subsidies provided to key SOEs as problematic since such subsidies promote the competitiveness of a selected group of large SOEs. Consequently, these subsidies may be a source of trade disputes.[88] However, the present study differs from that of Professor Qin's as her focus is on questioning SOE-based specificity test and non-market economy anti-subsidy methodologies,[89] whereas this study intends to summarize various forms of governmental assistance to Chinese SOEs in detail and analyze whether such assistance constitute a "subsidy" in accordance with the SCM Agreement.[90]

For the purposes of the research questions of this thesis, it is necessary to review the literature relating to Chinese SOEs or the GATT/WTO rules governing subsidies. Given the economic nature of both SOEs and subsidies, it is not a surprise that a main body of the existing research on SOEs and subsidies are in the field of economics. It is inevitable that there may be certain difference in law and economics scholarship as

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[86] Julia Ya Qin (2004) WTO Regulation of Subsidies to State-owned Enterprises (SOEs) A Critical Appraisal of the China Accession Protocol *Journal of International Economic Law,* 7(4), 863-919

[87] Ibid According to Professor Qin, key SOEs may be given exclusive or monopoly rights in dealing with specific products, and priority in access to natural resources and other production materials

[88] Ibid

[89] The article also contains a wonderful appraisal of the rules regulating subsidies to SOEs contained in China's Accession Protocol

[90] Professor Qin has, in fact, published another article which addressed WTO rules regulating subsidies and China's industrial policies In that article, she correctly predicted the prevalence of countervailing duties against China in the coming years See Julia Ya Qin (2004) WTO Subsidy Disciplines and China's Industrial Policy Reflections on the First WTO Case against China *Journal of International Economic Law* (Peking University Press), Vol 10, 237-259 (in Chinese)

to certain issues just like the notion of subsidies. Therefore, this literature review necessitates sources from both legal and economic areas.

Furthermore, a considerable portion of the results of the literature review conducted for this thesis actually are integrated in Chapter Three and Chapter Five, particularly in terms of some important data, ideas or opinions.

2.1 Literature Review on SOEs

This part first reviews problems associated with Chinese SOEs and then suggestions for SOE reform. Many noted Chinese economists, such as Jinglian Wu, Yingyi Qian, Chunlin Zhang, Weiying Zhang and Justin Yifu Lin, have thoroughly explored the Chinese SOEs. Other Chinese economy experts, such as Edward S. Steinfeld, Nicholas R. Lardy and Barry Naughton, have also studied China's economy and foreign trade.[91] These doctrinal materials provide a background to observe various issues in relation to Chinese SOEs, especially a basis for this research to determine the proper scope of Chinese SOEs and fully understand the relationship of SOEs with the government.

2.1.1 Problems Facing Chinese SOEs

In this book *Understanding and Interpreting Chinese Economic Reform,* renowned Chinese public intellectual economist Jinglian Wu attributes the problem of SOEs to the state intervention and a lack of efficient mechanism to exercise the ownership right.[92] Similarly, Edward S. Steinfeld argues that the primary problem for Chinese state firms was not that they were state-owned *per se*, but rather that ownership itself failed to function in China (at least before 2000), where the key institutional mechanisms needed to make corporate governance (by extension, property rights) function for complex producers in complex market settings were absent.[93]

Weiying Zhang is critical of state ownership. Among other things, he considers that state ownership was incompatible with market economy and private ownership is an indispensable component for the effective competition and the market economy.[94] In his view, capital and managerial labor markets had a key role in motivating managers

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[91] For instance, Nicholas R. Lardy: *Foreign Trade and Economic Reform in China, 1978–1990.* Cambridge; New York: Cambridge University Press, 1992. Lardy, above note 29; in this book, Nicholas R. Lardy addressed the reasons why China took the gamble to accede into WTO; he also assessed China's pre-WTO trade reforms and implications of China's entry into the WTO to China, US and the world economy. Barry Naughton: *The Chinese Economy: Transitions and Growth.* Cambridge, Mass.: MIT press, 2007.

[92] See Wu, above note 33, at 139-173. This is a comprehensive and authoritative book regarding contemporary economic reform in China, and the Fourth Chapter mainly introduced the SOE reform from 1956 to 2003.

[93] Steinfeld, above note 4. On the whole, this book was a micro-level exploration for the extent to which outside governance institutions in China not only malfunction but also distort the internal operations of the individual firm. Edward analyzed the poor enterprise-level performances of the three steel companies in length: Anshan Iron and Steel, Ma'an Shan Iron and Steel and Shougang, and concluded with a common lesson that rationalizing the firm's external environment or achieving functioning regulatory mechanisms was a precondition to realize a successful internal restructuring, or the efforts for an efficient internal environment only led to chaos.

[94] Weiying Zhang: *Qiye Lilun yu Zhongguo Qiye Gaige* (The Theory of the Firm and Chinese Enterprise Reform). Peking University Press, 1999.

in a market economy with private ownership, while such motivation is absent in a state-owned economy managed by politicians and bureaucrats.[95] Weiying Zhang argues, Chinese experience showed that competition among SOEs often leads to vicious competition (excessive competition) and it is particularly true when the size of the state sector is extensive.[96]

However, Justin Yifu Lin *et al.,* in their book *State-owned Enterprise Reform in China,* challenge the view that treated property rights as the core of SOE reform.[97] The authors believe it was too early for advocators of radical ownership system reform to make the conclusion that "the vagueness in the demarcation of property rights is the root of the problem" for SOEs.[98] The problems associated with SOEs such as the drain of state assets, excessive distribution of wage and other moral hazard *etc.* were mainly caused by the principal-agent issue rather than the property rights issue; also, state ownership was not naturally equivalent to low efficiency. The practice indicates that the property rights reform still could not solve the problems resulting from the separation of ownership and control of SOEs in China. "Focusing on the corporate governance structure issue represents a leap forward in theory",[99] however, corporate governance structures were various and evolved in a path-dependent manner. The authors conclude that it is actually hard to say which manner of corporate governance structure is superior.

In the book *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets,*[100] Chunlin Zhang *et al.* examine the corporate governance issues arising out of the process of insider-centered ownership diversification (the main participants are managers, employees, creditors and outside equity investors) of small and medium-sized SOEs, and the problems associated with listed companies, mostly large and medium-sized SOEs. On this basis, Zhang *et al.* summarize the outstanding problems facing Chinese SOEs from multiple perspectives: first, the structure of state ownership and control of enterprises accounted for to an extent their poor performance, owing to the weak incentives for managers to maximize value and certain protectionist practices from governments. Second, both banks and outside investors were deficient in the capacity and incentives to monitor companies' behavior, and an adequate legal framework was not in place either. In addition, the process of gradual corporatization and ownership diversification resulted in the conflicts between old and new governance structures, where the boards of supervisors might assume largely decorative functions and controlling shareholders often overstepped the bounds of shareholders' meetings and boards of directors in the

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[95] Ibid He applied several models to prove that distortion caused by ownership may induce managers to conduct excessively competitive practices Managers under short-term contracts strived to expand sales revenue and often paid less attention to production costs, since measuring sales revenue is much easier than measuring costs

[96] Ibid Also see János Kornai and Yingyi Qian (eds) *Market and Socialism in the Light of the Experiences of China and Vietnam* Basingstoke [England], New York Palgrave Macmillan, 2009

[97] See Lin *et al* , above note 1, at 133

[98] Ibid

[99] Ibid

[100] Tenev and Zhang, above note 39

situation of listed companies. Lastly, Chinese capital market lacks mature users of financial information including institutional investors and analysts.

The Dramatic Three Decades of Chinese Enterprises (1978-2008) by renowned financial writer Xiaobo Wu [101] recounts influential stories of various Chinese enterprises and the ups and downs of famous entrepreneurs in a very vivid manner.[102] Wu suggests that SOE reform should break the monopoly in that monopoly was totally incompatible with the basic principles of a market economy. He considers the monopoly to severely distort the business environment in China, and believes only a more transparent and equitable environment could create truly competitive modern enterprises.[103]

Another book *Zhongguo Guoyou Qiye Gaige Biannianshi: 1978-2005 (Chinese State-Owned Enterprises Chronicle: 1978-2005)* also provides a multitude of information about the evolution of Chinese SOEs from 1978 to 2005.[104] It is an annual record of SOEs including the macro-economic background, pivotal measures adopted by the government, key theoretical breakthroughs, important documents of policies, regulations and reforms and hot issues.

2.1.2 Suggestions for SOE Reform

As to suggestions for SOE reform, Jinglian Wu proposes four general measures: further reducing the proportion of state equity shares; strengthening internal control system of large enterprises; instituting checks and balances between the owner and the manager; and bringing the State-owned Asset Supervision and Administration Commission (SASAC) into play to exercise shareholder right.[105]

Steinfeld holds the view that true state enterprise restructuring was deferred in China, which threatened to drag down the nation's entire economy and increasingly raised the cost to push forward the reform. To make the property rights exist in real sense, Steinfeld believes that it is necessary to establish basic institutions, such as functioning capital markets, a stable regulatory environment, and enforceable accounting standards.[106]

Justin Yifu Lin *et al.* suggest that "the reform should proceed from eliminating the

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[101] Wu Xiaobo, *Jidang Sanshi Nian Zhongguo Qiye 1978-2008* (Shang) (the Dramatic Three Decades of Chinese Enterprises 1978-2008, Volume One) CITIC, Zhejiang People's Publishing House, 2007, Wu Xiaobo, *Jidang Sanshi Nian Zhongguo Qiye 1978-2008* (Xia) (the Dramatic Three Decades of Chinese Enterprises 1978-2008, Volume Two) CITIC, Zhejiang People's Publishing House, 2008

[102] Strictly speaking, it is not an academic book, while it is quite informative with accurate data and typical examples Plenty of details and comprehensive description of Chinese enterprises including the author's insightful comment not just provide a wonderful orientation to Chinese enterprise development, but also point out the key problems facing Chinese enterprises and their entrepreneurs

[103] Wu, (xia), above note 101

[104] Dicheng Zhang, *Zhongguo Guoyou Qiye Gaige Biannianshi 1978-2005* (Chinese State-Owned Enterprises Chronicle 1978-2005) China Workers' Publishing House, 2006

[105] See Wu, above note 33, at 139-173

[106] Steinfeld, above note 4

unfair competition conditions faced by SOEs".[107] Through theories and empirical evidence in China, they argue that the reform should create a level-playing field for SOEs and other enterprises through the way of eliminating SOEs' social functions and certain policy burdens. Then SOEs should face the competitive market environment and act as genuine enterprises. In sum, Justin Yifu Lin *et al.* hold the view that SOEs in China were imposed with too much burden so that they were lack of the opportunities to compete with other kinds of firms in a fair way. Finally, they lay out the preconditions under which SOEs reform might work well: reallocating the existing stock of assets based on comparative advantage and eliminating unfair competition conditions.[108]

The Organisation for Economic Cooperation and Development (OECD) and World Bank have also paid much attention to SOEs in both OECD countries and non-member countries like China, India and Russia etc.[109] The OECD has published several reports to improve the corporate governance of SOEs existing in many economies, including *Privatising State Owned Enterprises, an Overview of Policies and Practices in OECD Countries (2003), OECD Corporate Governance Principles (Revised 2004), OECD Guidelines on Corporate Governance of State-Owned Enterprises (2005)* and *Corporate Governance of State-Owned Enterprises: A Survey of OECD Countries (2005).*[110] The Guidelines (2005) presented six generally acknowledged guidelines followed by a number of supporting sub-guidelines. The six general guidelines read as follows:

a) The legal and regulatory framework for SOEs should ensure a level-playing field in markets where SOEs and private sector companies in order to avoid market distortions.

b) The state should act as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness.

c) The state and SOEs should recognize the rights of all shareholders and in accordance with the *OECD Principles of Corporate Governance* ensure their equitable treatment and equal access to corporate information.

d) The state ownership policy should fully recognize the SOEs' responsibilities towards stakeholders and request that they report on their relations with stakeholders.

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[107] Lin *et al* , above note 1, at xv

[108] Ibid , 161-174

[109] OECD published the comprehensive report *Governance in China* in 2005 This report aims to address the emerging problems during China's governance reform by looking at different policy sectors in China, such as agriculture, higher education, labour market and social protection, foreign investment, environment, state assets management, protection, collection of statistics, protection of intellectual property rights, banking and tax collection

[110] All of the reports are available in OECD's online databases

e) SOEs should observe high standards of transparency in accordance with the *OECD Principles of Corporate Governance.*

f) The boards of SOEs should have the necessary authority, competencies and objective to carry out their function of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.[111]

The report *Corporate Governance of State-Owned Enterprises: A Survey of OECD Countries (2005)* is comparative research based on a questionnaire circulated in 2003. The comparative report describes the scale and scope of SOEs, outlines the main types of organizing ownership function in the state administration, and reviews the typical features of corporate governance of SOEs in OECD countries (including specific governance problems faced by SOEs).[112]

2.2 Literature Review on Subsidies

Similarly, a large amount of literature exists which deals with subsidies from an economic or legal perspective. Legal analysis includes the negotiation history and the evolution of rules governing subsidies, a definition for subsidies, rationale for disciplining subsidies and interpretation to the key terms in the SCM Agreement, with a special focus on countervailing duties. As to the economic analysis, it normally centers on the impact of subsidies on trade, welfare and competition conditions and the like.

The WTO itself has produced plenty of research on subsidy rules, with the emphasis on negotiation history and how to interpret the SCM Agreement.[113] For instance, the book *The Tokyo Round of Multilateral Trade Negotiations* recorded the details of negotiations in Tokyo Round and provided plenty of original information to understand the drafting and revision of subsidy rules.[114] John Croome's book *Reshaping the World Trading System: A History of the Uruguay Round* introduced the background and traced the history of the Uruguay Round negotiation in detail from the view of an "insider", since the author experienced the negotiation and had the first hand materials.[115]

Books in the field of international trade law just briefly discuss the subsidy rules in one or two chapters.[116] There are a few books concerning trade remedies measures,

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[111] See *OECD Guidelines on Corporate Governance of State-Owned Enterprises* OECD, 2005

[112] See *Corporate Governance of State-Owned Enterprises A Survey of OECD Countries* OECD, 2005

[113] The interpretation of the SCM Agreement is contained in this heavy and comprehensive book *WTO Analytical Index Guide to WTO Law and Practice* Cambridge, UK and New York Cambridge University Press, 2007, 2nd edition It is also available at http //www wto org/english/res_e/booksp_e/analytic_index_e/subsidies_e htm

[114] See Report by the Director-General of GATT *The Tokyo Round of Multilateral Trade Negotiations* WTO, Geneva, April 1979

[115] See John Croome *Reshaping the World Trading System A History of the Uruguay Round* The Hague, London and Boston Kluwer Law International, 1999, 2nd edition

[116] See, for instance, Jackson, Davey and Sykes, above note 75, Simon Lester and Bryan Mercurio (et al) *World Trade Law Text, Materials and Commentary* North America Hart Publishing, 2008, Michael J Trebilcock and

which deal with the substantial and procedural issues relating to subsidies and anti-subsidies by several chapters.[117] For instance, Mavroidis, Messerlin and Wauters produced *The Law and Economics of Contingent Protection in the WTO*[118] which elaborated on the substantial conditions for imposition of countervailing measures and the procedural requirements for the countervailing duty investigation. More specifically, the authors examined three major forms of financial contribution with comments on several key words, such as the meaning of "goods" in the "government provision of goods or services", the term "general infrastructure", the determination of "public body" etc.; and then the analysis of benefit and specificity was followed in length, including the issues of the market benchmark to determine benefit, the determination of benefit, the pass-through of the benefit, distinguishing between the existence of a benefit and the calculation of the amount of subsidy and specific to "certain enterprises" and so on.

There are also several books and articles discussing the countervailing duties.[119] Notably, Marc Benitah focuses on the use of anti-subsidies in his book *the Law of Subsidies under the GATT/WTO System.*[120] Alan O. Sykes challenges the imposition of countervailing duties in that it would often reduce the economic welfare, and suggests an abolition of such laws in *Countervailing Duty Law: an Economic Perspective.*[121]

However, with the rising importance of subsidies in recent years, the term "subsidy" has drawn more and more attention both from academia and practitioners. During the past several years, nearly a dozen of new monographs (including several monographs in Chinese) have appeared, focusing on the rules governing subsidies. Two monographs in English relating to subsidies and state aid adopted a comparative method to compare the relevant rules of WTO and EC.[122] Several monographs in Chinese analyzed the WTO rules and practices in relation to subsidies and discussed the anti-subsidy law of and legal problems faced by China briefly.[123]

Robert Howse *The Regulation of International Trade,* 3rd edition London and New York Routledge, 2005

[117] Rudiger Wolfrum, Peter-Tobias Stoll, Michael Koebele *WTO-Trade Remedies* Leiden, the Netherlands, Boston Martinus Nijhoff Pub , 2008, Edwin Vermulst & Folkert Graafsma *WTO Disputes Anti-dumping, subsidies and Safeguards* London Cameron May Ltd , 2002 (Reprinted, 2005)

[118] Petros C Mavroidis, Patrick A Messerlin, Jasper M Wauters *The Law and Economics of Contingent Protection in the WTO* Cheltenham, UK Edward Elgar, 2008

[119] For instance, James D Southwick (1988) The Lingering Problem with the Specificity Test in United States Countervailing Duty Law *Minnesota Law Review*, 72, 1159, Alan O Sykes (1989) Countervailing Duty Law an Economic Perspective *Columbia Law Review*, 89 (2) 199-263, Marc Benitah *The Law of Subsidies under the GATT/WTO System* The Hague, New York Kluwer Law International, 2001, Konstantinos Adamantopoulos and María J Pereyra *EU Anti-subsidy Law and Practice* London Sweet & Maxwell, 2007 2nd edition

[120] See Benitah, ibid One of the central themes of this book is that the entitlement of Country B's (allegedly affected by a subsidy) recourse against subsidies is attenuated by various explicit and implicit techniques

[121] See Sykes, above note 119, at 199-263

[122] See Luengo Hernandez de Madrid, above note 75 Luca Rubini *The Definition of Subsidy and State Aid WTO and EC Law in Comparative Perspective* Oxford University Press, 2009

[123] See Shan Yi *WTO Kuangjia xia Butie yu Fanbutie Falv Zhidu yu Shiwu* (The Legal System and Practice of Subsidies and Countervailing Measures under WTO) Beijing Law Press, 2009 Gan Ying *WTO Butie yu Fanbutie Falv yu Shijian Yanjiu* (Research on Law and Practice of Subsidies and Countervailing Measures under WTO) Beijing Law Press, 2009 Li Ben *Butie yu Fanbutie Zhidu Fenxi (*Legal perspective on subsidies and countervailing measures) Beijing Peking University Press, 2005

For example, in her monograph *the Legal System and Practice of Subsidies and Countervailing Measures under WTO,* Shan Yi comments on the main problems associated with China's subsidy polices, for instance, structural industrial policy, subsidies to SOEs, export subsidy, regional preferential policies in special economic zones, technical development zones and western development, and tax preferences for foreign invested enterprises.[124]

The following part reviews several topics such as the definition or the common understanding of subsidies, the rationale for disciplining or the effects of subsidies and the approach to regulating subsidies.

2.2.1 Definition of Subsidies

In *Regulation of Subsidies and State Aids in WTO and EC Law: Conflicts in International Trade Law,* Gustavo E. Luengo Hernandez de Madrid emphasizes the difficulty and delicacy of regulating subsidies, because it was an issue "tied to the sovereignty of States", and "the most controversial subsidies" were often designed to achieve national objectives rather than securing certain advantages in international trade.[125] Luengo considers one of the most challenging tasks in terms of disciplining subsidies was how to define a common notion of subsidy or state aid.[126]

Luca Rubini's approach to analyzing the notion of subsidy is quite conceptual with much of the focus on jurisprudence.[127] Rubini proposes three basic elements that constituted a minimal subsidy: a) a form of public action; b) the grant of an economic advantage rather than other kinds of advantages; and c) an impact on the competitive process, namely distortion on market competition.[128] Obviously, the latter two elements are quite different from the terms used by the SCM Agreement.

Rubini emphasizes the distinction between scope and justification of the rules on subsidies. He considers three scenarios to consider the scope/justification issue: a) no subsidy, because the measure, as a mere application of the general rule, does not confer an advantage; b) no subsidy, because the measure, even if as a differential treatment, compensates a disadvantage and thus does not really confer an advantage; c) the measure derogates from the norm and grants an advantage, while "it would ultimately be legitimate, or justified" since it could "achieve a recognized laudable objective".[129] There is no subsidy in the first two scenarios, since the situations do not fall within the scope of subsidies; the subsidy in the third scenario is permitted, since it could be justified. The author believes the importance of not conflating the

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[124] Ibid., Shan.
[125] Luengo Hernandez de Madrid, above note 75. Luengo conducted economic analysis on subsidies, examined the evolution of the regulation of subsidies and analyzed the main articles of the SCM Agreement; he also reviewed the regulation of subsidies in the Agreement on Agriculture and introduced the "Foreign Sales Corporations" case in length.
[126] Luengo Hernandez de Madrid, above note 75.
[127] See Rubini, above note 122.
[128] Ibid.
[129] Ibid.

two levels of scope and justification.

In *Privatization and the Definition of Subsidy: a Critical Study of Appellate Body Texturalism,*[130] Richard Diamond provides a conceptual map or structure to analyze the definition of subsidy in the SCM Agreement consisting of five steps. The first step identifies the potential actionable subsidies from the broadest approach, namely government actions that increase producer wealth; the other four steps narrow down the scope of subsidies gradually: exclusion based on nature of recipients (specificity), nature of government action, market competition and effect on competing producers (damage to competing domestic producers is a required element).[131]

Richard H. Snape considers that the term subsidy can be extremely broad, since virtually any government action can affect international trade to a certain extent.[132] The trouble associated with confining subsidies lies in that no general agreement exists as to the proper role of government in complicated and various forms of economic activity. He further states that defining a trade-affecting subsidy has a substantial arbitrary ingredient and any attempt to counter subsidies thus also has an arbitrary element.[133]

William K. Wilcox examines and analyzes the development of the US subsidy law and the changes in subsidy law in the Uruguay Round and the resulting changes in the US subsidy law.[134]

Gagne and Roch, in *The US-Canada Softwood Lumber Dispute and the WTO Definition of Subsidy*[135] examine the criterion of specificity, the condition of financial contribution, the determination and pass-through of benefit by reviewing the complex softwood lumber case; all of which are good reference to this study, since these terms will be explored in depth in Chapter Five.

In the 1980s, subsidies were generally classified as export subsidies and domestic subsidies. The 1979 Subsidies Code made an Illustrative List containing the proscribed export subsidies and permitted export incentives. As to domestic subsidies which do not make overt distinction between goods sold at home and abroad, namely the potentially troublesome subsidies (apart from the subclass of export subsidies), this research by Gary Hufbauer *et al.* made some original observations in terms of nine typical activities, such as the upstream subsidies, pricing natural resources,

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[130] Richard Diamond (2008) Privatization and the Definition of Subsidy a Critical Study of Appellate Body Texturalism *Journal of International Economic Law*, 11(3), 649-678

[131] Ibid, 664-666

[132] Richard H Snape (1991) International Regulation of Subsidies *The World Economy*, 14 (2), 139-164 Richard H Snape discussed the definition of subsidies, the reasons for governments seeking subsidies, the effects of subsidies (mainly about export-promoting subsidies) on other countries as well as the rules of GATT on subsidies from an economist's point of view

[133] Ibid

[134] William K Wilcox (1998) GATT-Based Protectionism and the Definition of a Subsidy *Boston University International Law Journal*, 16, 129-163 In particular, this paper addressed the development of specificity test by introducing the relevant cases in the US court

[135] Gilbert Gagné and François Roch (2008) the US-Canada Softwood Lumber Dispute and the WTO Definition of Subsidy *World Trade Review*, 7(3), 547-572

equity and loans to SOEs,[136] investment incentives and so on.

2.2.2 Rationale for Disciplining Subsidies

In the 1980s, Gary Hufbauer *et al.* addressed the rationale for disciplining subsidies with two specific hypotheses in *Subsidies in International Trade.*[137] The first one, called "falling water level" hypothesis, means that with the significant decline in tariffs and other forms of protection, the remaining trade distortions such as subsidies will have a more apparent effect; and the second one "rising reef" hypothesis implies that subsidies and similar practices may be favored by industrial nations to handle their rising energy prices, slow growth and obsolete equipments and production methods *etc.*

Basically, the legitimacy of regulating subsidy lies on its economic efficiency. However, based on economics, there are so many variables necessary to precisely determine the efficiency of a subsidy (assuming it is possible) that it is quite challenging to do so. These variables may include economies of scale, the presence and importance of learning curves, the presence and scale of externalities, the effects of spillover technology, barriers to entry, union strength, the available supply of key inputs, the amount of research and development required, the possible harm to downstream industries and the stickiness of real wages and so on.[138]

As a legal scholar, Luca Rubini views the effects of subsidy control from two perspectives of trade (particularly in terms of market access) and competition. The connection between domestic subsidies (the author selected "domestic subsidies" as the unit of analysis rather than "subsidies") and market access is twofold: on the one hand, domestic subsidies may offset the effect of a reduced or eliminated tariff and thus frustrate the foreign competitors' market access expectations; on the other hand, domestic subsidies may be a key policy instrument to address market failures or pursue other national policy objectives.[139] Thus, effects of subsidies upon domestic market and international market are placed in conflict.

The connection between subsidies and competition is highly complex, where Rubini conducts welfare analysis and political judgment.[140] Based on a short-term, static and one-perspective-only analysis, the export subsidies reduces the welfare of the subsidizing country and of third countries' exporters, while benefit the consumers and rival domestic industries importing country. To be sure, it is controversial whether

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[136] An example was provided in this subject, if the equity and loan capital for SOEs were earmarked for plant closing, then in the terms by the authors: exports should not be penalized for a socially desirable adjustment policy. See Gary Clyde Hufbauer and Joanna Shelton Erb: *Subsidies in International Trade.* Washington, D.C.: Institute for International Economics, 1984.

[137] Ibid.

[138] See Wilcox, above note 134, at 129-163.

[139] Rubini, above note 122.

[140] Ibid, 42-43. The clarity of the author's comment deserves full citation: The judgment on the desirability of subsidies is a political exercise which depends on which interests (of rivals, consumers, and taxpayers) are considered and which perspective (domestic, global) is taken.

rival domestic industries benefit from the imported-subsidized-products or not Rubini comments that they might suffer but not inevitable for at least two general reasons a) they can "make the most of the competitive pressure and economize its loss and/or divert towards more profitable activities",[141] and b) they can impose the defensive measures like countervailing duties Then Rubini adopts a sophisticated approach to addressing the externalities caused by subsidies and their possible negative economic effect on the competitive process "Consumer welfare objective" was replaced by a "total welfare" approach, because consumers and producers considerably overlap, consumers and taxpayers are the same subject, and consumers may support the employees of the injured companies *etc* All these interested stakeholders including consumers, employees and taxpayers should be considered to fully appreciate the positive and negative externalities of subsidies As to the sophisticated idea of distortion, it can be understood from two consequential steps the effect of the subsidy on the recipient and the ensuring adverse effect on its competitors [142]

Likewise, Alan O Sykes comments on the pros and cons of subsidies [143] And in doing so, he cites research and development subsidies as desirable since they correct some preexisting market failures and tend to improve resource allocation However, subsidies resulting from strategic trade policy may impose costs on other countries, domestic producers receiving subsidies in imperfectly competitive industries may capture monopoly rents in global market, also, certain subsidies reduce the economic welfare of worldwide and the subsidizing country itself, finally, governments may be forced by domestic interest groups to engage in competitive subsidization to match subsidies granted by the subsidizing countries, with the consequence that each nation involved is worse off [144]

2.2.3 The Approach to Regulating Subsidies

Gary Hufbauer *et al* summarize two schools of thought on the scheme for disciplining subsidies the "injury-only" school and the "anti-distortion" school [145] The former believes that a country should not retaliate against foreign subsidies unless those subsidies cause a significant impact on trade, and the remedial measure should be limited to redress that *impact,* since some subsidies may offset preexisting market imperfections The latter holds the view that subsidies *per se* should be retaliated to offset that *subsidy* regardless of its impact on trade, and this School believes the self-regulating market and doubts any potential positive effect of subsidies on trade In essence, the existence of the "injury-only" school and the "anti-distortion" school reflect their different attitudes to market The authors also mention other factors underlying the trade-impact standards, including the differentiation for domestic

[141] Ibid 44-45
[142] Ibid, 49-52
[143] See Sykes, above note 119, at 199-263
[144] Ibid
[145] Hufbauer, above note 136

subsidies and export subsidies, for developing countries, for code signatories and for primary products *etc.*

From an economic perspective, Daniel Brou *et al.* suggest that efficient subsidy rules should strike a balance between policy flexibility and policy rigidity, as weak rules may lead to inefficient use of domestic subsidies for various purposes and rigid rules may inhibit tariff negotiations or induce Member governments to set excessively high tariffs.[146] However, it is worth noting that the authors just focus on a simple economy where only two policy instruments - a trade tariff and a domestic subsidy - are available for Member governments.

2.3 Research Approaches

Three main approaches adopted by this study are historical examination, empirical study and textual and contextual analysis. The following is an explanation to the necessity of each research method.

2.3.1 Historical Examination

Historical examination mainly applies to Chinese SOE reform and the evolution of international rules regulating subsidies. A brief review of the history of Chinese SOE reform is instrumental for this research. Based on the evolution of Chinese SOEs, it would be easier to elaborate the relationship between the government and SOEs. Chinese SOE reform also provides a background for further discussion regarding the scope and classification of SOEs. Similarly, a historical exploration of the GATT/WTO rules regulating subsidies is conducive to a better understanding of the current applicable WTO Agreements.

2.3.2 Empirical Study (Case Studies)

Subsidies are a topic that closely relates to important domestic policies and the practice of international trade. Thus, it is necessary to have a large number of relevant cases and statistics in place first so that they serve as a precondition to understand subsidies to SOEs. As outlined in Chapter One, the comprehensive information with regard to the seven measures (types of assistance provided by the government) and the measures specific to three selected industries is the bulk of this study.[147] Relevant cases and statistics will be collected from the WTO website, Chinese official websites and other authorized websites[148] as well as yearbooks, documents, authorized newspapers or magazines. The cases relating to subsidies and countervailing duties in the WTO are essential references for the legal analysis part of this study. Official documents are also vital to this thesis, since they directly reflect the instructions and

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[146] Daniel Brou *et al.*: The Value of Domestic Subsidy Rules in Trade Agreements. Nov. 2, 2009. Available at: http://www.wto.org/english/res_e/reser_e/ersd200912_e.pdf

[147] It turns out that much time is devoted to searching for relevant information.

[148] One website has to be mentioned here, that is: http://www.worldtradelaw.net.

attitude of the Governments to SOEs.

2.3.3 Textual and Contextual Analysis

The textual and contextual analysis will be used to analyze the key words and articles of WTO Agreements involved in this research. Needless to say, the rationale lies in the fact that WTO is a rule-oriented mechanism. The legal texts matter, and WTO Members should respect and observe the applicable rules; no current negotiation can change the rules in any time soon. The Doha deadlock seems to prove once again that it is increasingly difficult for Member states to agree on any issue. In this context, the way to interpret the current rules and thus strike a delicate balance between the competing interests is extremely important. In addition, no thorough textual interpretation with respect of this specific issue has been conducted yet, and thus this study attempts to fill in such a gap.

A strict textual examination aims to better identify the meanings, objectives, principles and intents of the articles and balance the interests of Members. For instance, in view of the Appellate Body (AB), an interpretative method that attaches the greatest weight to the ordinary meaning of the terms of the treaty is more faithful to the intentions of WTO Members.[149] On the other hand, it is risky to attempt to ascertain the object and purpose of the terms or articles when such object and purpose is not expressed in the text of the relevant articles.

The ordinary meaning of a term is only the starting point for a holistic interpretative exercise. In other words, dictionary is not the sole source of information for determining the meaning of a treaty term in question. Contextual analysis is necessary to establish the meaning of ambiguous terms and complements the limits of purely linguistic inquiry. Reference to a term's immediate and broader context is especially relevant when a term has multiple meanings. Therefore, the plain meaning of the term, its immediate contexts and broad contexts, and the object and purpose of the concerned treaty terms together, constitute the important means to discern the exact meaning of treaty terms.

The task of the panels and AB is to clarify the existing provisions of the covered agreements in accordance with customary rules of interpretation of public international law. In practice, the DSB strictly adheres to the legal texts *per se*.[150] The AB in *Japan - Taxes on Alcoholic Beverages* also emphasized their strict coherence to the text clearly by stating:

> *Article 31 of the Vienna Convention provides that the words of the treaty form the foundation for the interpretive process: 'interpretation must be*

[149] See Claus-Dieter Ehlermann (2003), Reflections on the Appellate Body of the WTO *Journal of International Economic Law*, 6(3), 695-708, also see James Bacchus (2005) Appellators The Quest for the Meaning of And/or *World Trade Review*, 4 (3), 499-523

[150] See Article 3 2 of the DSU

based above all upon the text of the treaty'.[151]

Specifically, the customary rules of interpretation are limited to Article 31 and Article 32 of the 1969 Vienna Convention on the Law of Treaties (VCLT), giving instructions regarding the rules and means of interpretation.[152] The most frequently cited article is Article 31.1 of the 1969 VCLT, which provides that "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose". Likewise, this study will strictly adhere to these interpretative rules.

[151] See Appellate Body Report, *Japan-Taxes on Alcoholic Beverages* (WT/DS8/AB/R), paras.11-12.
[152] For example, Article 31 of the VCLT was referred to by the AB in *US-Gasoline*. See Appellate Body Report, *US-Gasoline* (WT/DS2/AB/R), para.3.

Chapter 3 Chinese SOEs: Reform Process, Scope Exploration and Separation from Government

Since its founding in 1949, the PRC has made various attempts to stimulate and improve the economic system. The market-oriented reforms and modernizations advanced under the leadership of Deng Xiaoping from 1978 onwards, however, represent the country's single greatest achievement towards putting the nation on a path of sustainable economic recovery and growth. The reforms began the transition away from a centrally planned economy and envisaged further market-oriented reforms.[153] Following such a radical departure from traditional communist central planning, economic reforms since that transition can be characterized by gradual and moderate reforms.

An integral part of the transitional process is the change of the corporate sector - the basic economic unit - from a dependent unit in the Lenin Model of State Syndicate to a commercial enterprise.[154] As a pillar of China's national economy, SOEs have significant social and political implications for contemporary China. In addition, SOEs have brought overwhelming influences upon generations of people in China.

This Chapter first reviews the history of SOE reform, which is a prerequisite for better understanding to SOEs. The second section specifies the scope of SOEs in China. The Chapter finally discusses how the government tries to separate the two functions of owners and regulators of SOEs by institutional arrangement and its effect, where the relationship between the government and SOEs can also be observed from three different perspectives.

3.1 SOE Reform

China established a Soviet-style state-owned and state-run enterprise system in the 1950s. For the next few decades, SOEs were subject to continuous intervention and adjustments. After the declaration of the policy of Reform and Opening-up, extensive measures were taken towards SOEs for a new direction. This reform was once regarded as the most challenging part for the whole economic reform of China.[155]

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[153] There is still debate in terms of the nature of Chinese economy This is basically a pragmatic and diplomatic issue The US has regarded China as a non-market economy instead of Soviet-bloc economies since 2007 See "Whether the Analytical Elements of the Georgetown Steel Opinion are Applicable to China's Present-Day Economy" (March 29, 2007) Available at http //ia ita doc gov/download/prc-cfsp/CFS%20China Georgetown%20applicability pdf However, some other countries like Australia have accepted China as a market economy

[154] See Wu, above note 33, at 139

[155] According to the official remarks and documents at that time, the SOE reform was still experiencing a key period which required further breakthrough

Because of the uncertainty and huge risk ahead, even though scholars put forward their various radical or moderate approaches to the SOE reform, the officials still followed a very pragmatic policy of "crossing the river by groping for stones".[156]

Such a long history of Chinese SOE reform together with SOEs' complicated internal structures and significant external impact makes the current situation of SOEs perplexing. If we consider "China's size, diversity, and rapid growth-as well as the complex legacy of its past" as mentioned by China expert Barry,[157] achieving a better understanding of the institutions, economic strategies and current problems in China poses challenges not only to foreign scholars, but also to Chinese observers. With these complexities in mind, the following sections will try to present the Chinese SOE reform in a logical and clear way.

The remaining parts of this section introduce the four phases of SOE reform in China: (1) 1950s-1970s: the establishment of SOEs system; (2) 1980-1992: autonomy oriented reform; (3) 1993-2002: corporatization strategy and ownership diversification; (4) 2003-present: the establishment of State-owned Asset Supervision and Administration Commission (SASAC).

3.1.1 The Establishment of SOEs System

Coming out of civil war, communist government nationalized all privately owned companies and converted them into state-owned and state-run enterprises. Table 3.1 illustrates this phenomenon clearly as private, corporate and joint-ventures did not officially contribute to industrial output.

Table 3.1: Shares of economic sectors in output of industry (%)

	State enterprises	Urban and rural collectives	Private, corporate and joint-ventures
1962	88.9	11.1	0
1965	90.6	9.4	0
1970	87.6	12.2	0
1975	81.2	18.8	0

[156] It is a metaphor for gradualism and pragmatism taken by Chinese policy makers. It is also an approach to economic development of China. There is no precedent for a giant China with socialism to realize a smooth transition to a full-fledged market economy. Therefore, the reform has to move on step by step and adjust continually to the changing circumstances. See Bennis So Wai Yip, "Privatization", in Tubilewicz, above note 31, Chap.3.
[157] See Naughton, above note 91, 10.

1978	77.6	22.4	0

Source: Chinese Statistics Yearbook (various years).

In essence, China's state-owned and state-run enterprises consisted of immense social factories operated directly by the Government.[158] The allocation of all resources (i.e. raw materials, capital, labour, and products distribution) was arranged through central planning.[159] The State owned all the property, inputs, products and production of SOEs and also enjoyed managerial powers. In such a vertically controlled system, SOEs (and their employees) were just like robots. Robots (SOEs) operated mechanically and followed simply the directions from the master (the government). In this regard, the whole nation is just like a "gigantic enterprise" and the individual SOE, as one part of the super enterprise, has no independent legal identity.[160]

SOEs were often referred to as a "unit" (*dan wei*), "small society" (*xiao shehui*) or "mini-welfare state" that could be relied on for one's whole life, because the "unit" provided the "cradle-to-grave" social services to its employees and their families.[161] SOEs guaranteed not just a life-long employment for their workers, known as "iron rice bowl" (*tie fan wan*), but also generous welfare benefits and services. Providing social security was therefore recognized as the typical characteristic of traditional Chinese SOEs.[162] To summarize, SOEs at least assume four functions: first, a political institution, served as a unit of the Party's presence at the grassroots level; second, a level of state administration, performing administrative control representing the party-state; third, a production factory to meet the quota set by the state; and fourth, a state agency to provide a series of social welfare to the employees.[163]

SOEs operated as an employment tool for the State, without consideration to the market, competition or economic efficiency. It was the government, not the market, who regulated and dictated economic activities. The factory director (manager) was responsible for the governmental objectives, and he ensured that the SOE would implement the national economic plan (regardless of the demand of people).[164] Whether the SOE was making a profit or a loss was simply irrelevant to the factory

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[158] The Japanese economist Ryutaro Komiya pointed out in his paper for the China-Japan Economics Symposium held in Okinawa on May 11-14, 1985 that " My impression is that there is no, or almost no, enterprise in China" See Wu Jianjun and Wang Haibo (eds), *Jingji lilun yu jingji zhengce* (Economic Theories and Economic Policies) Beijing Economic Management Press, 1986

[159] See Chunying Xin, Gang Fan *The Role of Law and Legal Institutions in China's Economic Development (1978-1995)* Beijing Law Press of China, 2000, 55

[160] Ibid

[161] See Joe C B Leung and Richard C Nann· *Authority and Benevolence Social Welfare in China* Hong Kong The Chinese University Press, 1995, 56-59

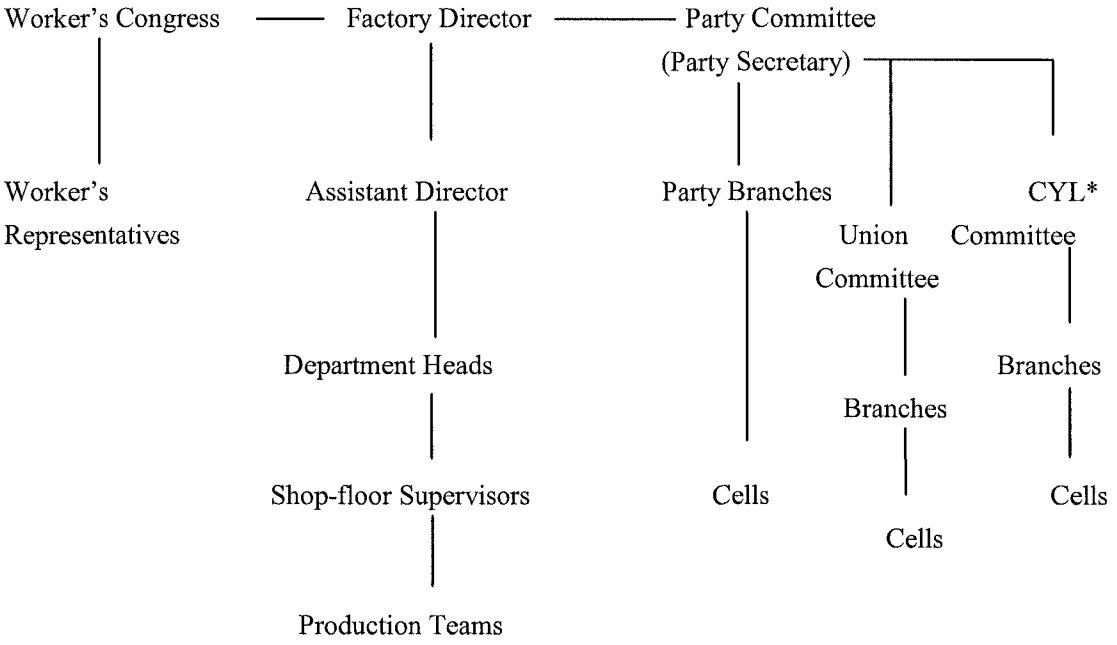
[162] Ibid The "iron rice bowl" refers to a system of job security, such as labor insurance, allowances like subsidies on food, housing, haircuts and transportation, retirement benefits and health care etc., provided by SOEs to their employees

[163] See Zhang, above note 35

[164] For more discussions of firm-level behavior in socialist planned economies, see János Kornai *Economics of Shortage* Amsterdam, New York North-Holland Pub Co , 1980, and *the Socialist System the Political Economy of Communism Princeton*, N J Princeton University Press, 1992

director, as all profits and losses would be directly included in the State's budget. If SOEs ran budget deficits, the State would simply provide additional funds or subsidies from the central budget to ensure that production continued.[165] Figure 3.1 provides a useful illustration of the typical SOEs organisational structure:

Figure 3.1: A Simplified Organizational Structure of a Traditional SOE[166]



*CYL: Communist Youth League

3.1.2 Autonomy Oriented Reform

The original SOEs system confronted several serious problems, including poor performance, complex bureaucracy and inferior competitive ability. Many believed that these problems could be attributed to low incentives of managers and the absence of managerial autonomy and decision making.[167] When economic development in China finally shifted to a more sustainable and economically rational trajectory in the late 1970s, several commentators called for significant reforms of SOEs. One such reformist was the famous economist Sun Yefang, who suggested that the orientation of reform should focus on delegating power to and sharing profit with enterprises. Such reforms, with the main theme of "power-delegating and profit-sharing" [168] (*fangquan rangli*), were taken by the Government.[169]

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[165] See Leung, above note 161, at 56-59. However, it should be noted that in this context, the term of subsidies is just an accepted usage - quite different from the subsidy used in the SCM Agreement.
[166] Ibid., at 58.
[167] See Becky Chiu & Mervyn. K. Lewis: *Reforming China's State-Owned Enterprises and Banks*. Northampton, MA: Edward Elgar Publishing Limited, 2006, 62.
[168] It can also be translated as "delegating power and conceding profit".
[169] Leung, above note 161, at 142.

On May 10th, 1984, the State Council issued the "Tentative Regulation on Further Expanding the Autonomy of Industrial Enterprises Owned by the Whole People". This Tentative Regulation granted SOEs ten types of autonomy rights with the aim of providing incentives and motivation to SOEs and their employees. For instance, if SOEs could meet the plan or contract of the state, then they had the right to decide independently the scope of production and operation, set products prices to a certain extent, decide personnel rights, and make their employment and investment policies.

In 1987, the government also introduced a special form of "power-delegating and profit-sharing" to SOEs. Dubbed the "contract responsibility system", the scheme granted autonomy to SOEs in planning their annual production and in retaining profits for reinvestment. Limited incentives to improve productivity were also given, including allowing SOEs to retain profits that exceed annual revenue based on the production quotas and linking workers' remuneration to productivity.

Further reforms quickly followed, as the *Law of the PRC on Industrial Enterprises Owned by the Whole People* (referred to as "*the Industrial Enterprises Law of 1988*")[170] granted the industrial enterprise owned by the whole people (equivalent to the notation of "state") status as a legal person. Thus, SOEs acquired the power to make their own managerial decisions, to take full responsibility for profits and losses and to practise independent accounting.[171] For example, SOEs were supposed to have autonomy with regard to the policy on labour welfare, personnel, production and investment. Nonetheless, insider control remained prevalent, for instance, SOE executives were still appointed and dismissed by government agencies and enjoyed the same political and economic treatment as government officials or state cadres (*guojia ganbu*).[172] Thus, although the state, as the sole owner, held the property rights of enterprises, the factory director enjoyed the control without little internal checks and balances.

The "*Regulations on Transforming the Management Mechanism of State Owned Industrial Enterprises*" issued by the State Council in 1992 was aimed at furthering the implementation of the *Industrial Enterprises Law of 1988*. This law granted SOEs fourteen types of rights including selling above-quota products, the right to import and export, the right to allocate retention funds, and the right to make decisions on investment. This regulation still followed the autonomy approach, but at the same time it attempted to reduce price controls through the "dual track price system" which allowed SOEs to sell the amount exceeding the annual production quota initially at prices up to 20% above planned prices and then at market prices as of the mid-1980s.

However, the contract system for SOEs was not as successful as for a similar scheme targeting the agriculture. Although most SOEs enjoyed benefits when they were

[170] It was adopted at the First Session of the 7th NPC and promulgated on April 13, 1988, and effective as of August 1, 1988 This Law is still valid, containing 8 chapters and 69 articles

[171] See Article 2 of the Law of the PRC on Industrial Enterprises Owned by the Whole People

[172] Ibid , Article 55

profitable, they were unable to pay the State the required fixed amounts when they sustained losses.[173] Thus, the autonomy approach could not solve the incentives problem, which, on the contrary, violated the owner's rights and interests further. The dilemma is that the government authorized more and more managerial right to SOEs, but SOEs probably would withhold and even embezzle the state-owned assets; finally, the government intervened in the operational activities of SOEs again to tighten the control.

Furthermore, over-staffing remained an unsolved problem. Since China did not have a social security system, SOEs were forced to assist the state in the difficult task of caring for redundant workers. On the other hand, the policy-induced over-staffing enabled SOEs to negotiate with the state and maintained soft budget constraints.[174] The other social welfare benefits provided by SOEs to their employees still existed to various extents, such as housing, health care, child care, retirement income and disability insurance *etc.*

According to Professor Lin, SOEs in the 1990s were still restrained by a series of policy burdens left over from the previous development strategies that put little emphasis on China's comparative advantage.[175] The state had to assist the loss-making SOEs with various kinds of open and hidden subsidies as well as other types of policy protection, since the predicament facing SOEs was a result of the improper industrial policies designed by the state. On the whole, Professor Lin believes that the cause of the inequitable competition environment for SOEs was the extra burdens imposed by the historical legacy of the traditional system and improper reform measures, and thus suggests the elimination of the unfair competition conditions.[176]

During this period, an interesting shift occurred: bank loans increasingly replaced budgetary grants for financing SOEs.[177] This move, which adjusted the allocation of economic interest between the state and SOEs, was accomplished through the resumption or creation of four specialized state-owned banks (The Agricultural Bank of China (ABC), Bank of China (BOC), The People's Construction Bank of China (renamed as the China Construction Bank (CCB) in 1996), and Industrial & Commercial Bank of China (ICBC).)[178] Therefore, subsidies increasingly took the

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[173] See Cindy A Schipani and Junhai Liu (2002) Corporate Governance in China Then and Now *Columbia Business Law Review*, 11

[174] See Lin *et al* , above note 1, at 112-115

[175] Ibid , at 156

[176] Ibid , at 168

[177] See Wenkui Zhang, Dongming Yuan *Zhongguo Jingji Gaige Sanshi Nian Guoyou Qiye Juan* (Three Decades of Chinese Economic Reform From the Perspective of State-owned Enterprise) Chongqing University Press, 2008, 27

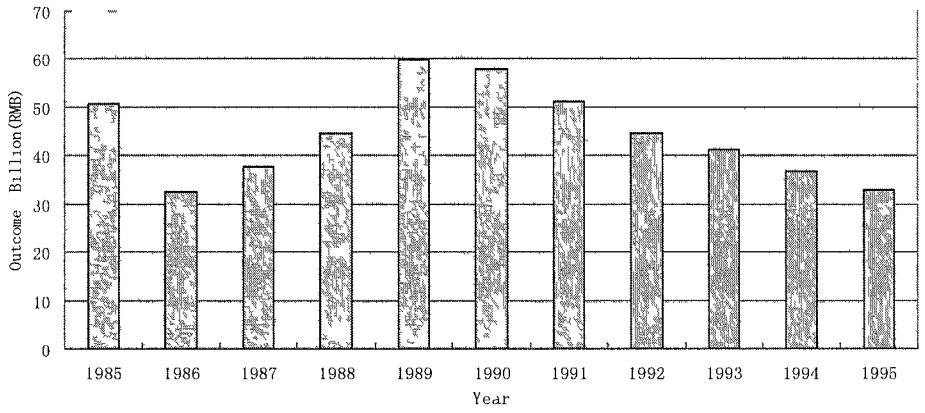
[178] Each of the state-owned banks was originally assigned with a special function ABC undertook financing the rural and agricultural sectors, BOC undertook foreign trade and investment, CCB undertook financing construction and fixed-asset investment, ICBC undertook financing the business activities of SOEs And in the mid-1980s, the business-area restrictions on the specialized banks were loosened See Dali L Yang *Remaking the Chinese leviathan Market Transition and the Politics of Governance in China* Stanford, California Stanford University Press, 2004, 84-91

form not of direct grants from the government but of interest-bearing loans extended by the banks created specifically to fund SOEs.[179] While the replacement of direct government grants is no doubt a step towards market orientation, the bank loans remain "quasi-subsidies" (at the very least) , as the banks provide "policy loans" and cannot foreclose over-due debts.[180] Therefore, it does not matter so much from whence the infusion of capital comes (i.e. from the state budget or the banks) but rather under what terms the capital is extended. Capital is extended on favourable interest rate terms, without the threat of foreclosure or bankruptcy, and under the direction of the government (i.e. if directed by the government, the banks could not refuse to extend the loan due to commercial circumstances). Under such conditions, it is not surprising that the average debt-asset ratio of SOEs climbed to 79.3% by the first half of 1995[181] and correspondingly, triangle debt (inter-enterprise debt) increased rapidly.

3.1.3 Corporatization Strategy and Ownership Diversification

Even with the numerous reforms in the preceding period, SOE performance was still far from satisfactory. In 1985, 9.6% of all within budget industrial SOEs declared losses amounting to RMB 2.7 billion, while in 1995, 44% of such firms were declaring losses, which soared to RMB 40.9 billion.[182] The dramatically high level of subsidization toward SOEs, illustrated in Figure 3.2, provides evidence of the failure.

Figure 3.2: the Amount of Subsidies for SOEs[183]



These losses, of course, can be attributed to various factors, such as the gradual liberalization of input prices, the improper management and the increasing welfare expenditure. Take the welfare expenditure (calculated as operational cost) as an

[179] Steinfeld, above note 4, 19
[180] See Xin and Fan, above note 159, at 71
[181] See Economic Daily, Oct 10, 1995
[182] See Steinfeld, above note 4, 18-22
[183] These data are collected from the web of State Statistics Bureau of China The term SOEs in this figure includes industrial SOEs, commercial SOEs, agricultural SOEs and foreign trade SOEs *etc*

example, the insurance and welfare fund rose rapidly from RMB 7.81 billion in 1978 (14 percent of the total wage bill) to 131 RMB billion in 1992 (33 percent of the total wage bill); The number of retirees leaped prominently from 3 million in 1978 to over 26 million in 1992, and the ratio of employees to retirees decreased from 30:1 in 1978 to only 5.7:1 in 1992, which required much more expenditure.[184]

Since SOEs performed worse after years of autonomy oriented reform, some observers argued that there were institutional defects in the SOEs system.[185] Reflection upon the state ownership was carried out by many economists with extreme caution, including Dong Fureng, since the research and findings would inevitably touch upon a sensitive political issue.[186] Nevertheless, Dong Fureng explicitly suggested that the fundamental obstacle to the success of SOE reform is state ownership, and the reform of SOEs should not avoid the ownership problem. He thus proposed to change the state ownership into a shareholding system.

Governmental officials, led by Deng Xiaoping, adopted the proposal and made an essential change in terms of SOE reform strategy, namely, from autonomy oriented reform to diversity in ownership. This shift aimed to resolve a series of new as well as dogged traditional problems including the erosion of state assets, heavy debt and the inefficiencies.

Ownership diversification and corporatization were both significant moves towards market-oriented reform and embodied the efforts made by the Chinese leadership to improve the performance of SOEs.

Based on "*Decision on Issues Concerning the Establishment of a Socialist Market Economic System*",[187] China attempted to transform SOEs into modern enterprises with clarified property rights, clearly defined responsibility and authority, separation of enterprises from the government and scientific management.[188] The Decision, which stated that SOE reform should "emphasize the institutional innovation of enterprises", was facilitated by the *Company Law* promulgated in November 1993. Promoted by the Decision and the *Company Law*, most large and medium-sized SOEs started the process to corporatize themselves. Under the *Company Law*, much of the welfare sections of SOEs (including clinics, hospitals, schools, and canteens) would be sold off or hereto operated on a commercial basis. This represented a remarkable shift in policy from one of the SOEs being an essential part of the welfare state to becoming essentially operated on commercial terms.

Bankruptcy of SOEs also accelerated during this period. In 1994, China introduced a capital structure optimization programme on a trial basis in 18 cities[189] and was

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[184] State Statistical Bureau, China Statistical Yearbook Beijing Statistical Publishers, 1993, 815-817

[185] See Zhang and Yuan, above note 177, at 48-61

[186] Dong Fureng (1987) *Suoyouzhi Gaige yu Jingji Yunxing Tizhi Gaige* (Ownership Reform and Economic Operational System Reform) The Journal of Graduate School in Chinese Academy of Social Science, the 1st issue

[187] It was adopted by the Third Plenum of the 14th CCCPC in November 1993

[188] In Chinese it means *chanquan mingxi, quanze fenming, zhengqi fenkai, guanli kexue*

[189] The program was based on *Notice of the State Council on the Relevant Issues concerning the Pilot*

subsequently expanded to 56 cities which encouraged SOEs to restructure, merge, spin off the non-productive units such as schools and hospitals, and declare bankruptcy *etc.* This program, the policies from the State Council on M&A and bankruptcies and specific policies from local government together were the driving force for the increasing bankruptcies in the late 1990s.[190] SOEs that could not adapt to the competition would have to go out of business. As the closedown of SOEs would affect adversely the livelihood of millions of workers, redundant workers and their reemployment became a huge burden on all levels of government. Any improper arrangement may intensify the tension between the government and the laid-off workers, thereby causing social unrest. Controversy and debate continued for some time,[191] however people gradually had to accept the notion that the so-called "iron rice bowl" could no longer exist.[192]

At the same time, SOEs were still deteriorating. In 1997, 39.11% of the large and medium-sized SOEs were unable to operate at a profit; the loss of the large and medium-sized SOEs amounted to RMB 66.59 billion and their net profit was RMB 85.65 billion.[193] The loss in 1998 was worse than that in 1997, which rose to RMB 306.65 billion; and the net profit in the same year was only RMB 21.37 billion.[194] Against such a background, a three-year SOEs rescue program (1998-2000)[195] was put forward by the then Premier Zhu Rongji to tackle this pressing problem. This rescue program was deemed as an ambitious goal by many commentators.[196] Following the rescue program, tremendous reform spread across the country in the late 1990s with two features: (1) SOE transformation and restructure; and (2) assistance to viable SOEs.

The slogan of "grasping the large, letting go of the small" (*zhua da, fang xiao*) reflected the core idea of SOE reform in this phase.[197] The term "people in – government out" was also used to refer to the idea of *de facto* privatization for small and medium-sized SOEs.[198] In practice, small and medium-sized SOEs were encouraged to be transformed through selling, auctioning, merging, employee stock ownership and bankruptcy etc.[199] Small and medium-sized SOEs usually existed in

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implementation of Bankruptcy of a State-Owned Enterprise in Some Cities GUOFA [1994] No 59 Available at http //news xinhuanet com/ziliao/2005-03/16/content_2705107 htm

[190] See Li Shuguang (2001), Bankruptcy Law in China Lessons of the Past Twelve Years *Harvard Asia Quarterly*, 5 (1)

[191] Some of the older generations often sighed Oh, heaven! How could our iron rice bowl get broken! Are not we the masters of new China?

[192] Wu, above note 101

[193] These figures were from the MOF Available at http //www hnindustry com/News_View asp?NewsID=10224

[194] Ibid

[195] It was a promise made by Zhu Rongji to resolve the difficulties (*Jie Kun*) of large SOEs

[196] Available at http //www people com cn/GB/shizheng/252/8956/8964/20021030/854064 html

[197] This policy was issued officially at the Fifteenth Party Congress in October 1997 and the Ninth National People's Congress in March 1998 It was also translated as "attaining the larger and releasing the small"

[198] The word "privatization" in Chinese is not used officially Other terms like "transformation of ownership", "restructuring of ownership" are popular

[199] Wu, (Xia), above note 101

the areas where private-sectors were quite active and competitive, such as building materials, chemicals, forestry, food processing, textiles, machinery and commerce.

Another guideline was to provide a variety of assistance to large SOEs. For instance, in order to improve the financial status of selected SOEs, a debt-equity swap plan was carried out in 1999, when four asset management companies (AMCs) were established to take over a portion of the bad debts (non-performing loans) from the four big state-owned commercial banks.[200] By 1999, 601 SOEs had signed debt-to-equity swap deals to get out of financial difficulties, with RMB 459.6 billion in debts converted into shareholding rights owned by banks.[201]

The shareholding system was the dominant institution for large SOEs, which concentrated on major industries and key fields.[202] Well-performing SOEs shall be converted to shareholding enterprises by initial public offerings (IPO).[203] Since SOEs were in a bad situation, it would be difficult for them to list on the domestic and overseas share market. A typical model was designed for IPO: carve out core assets from the original enterprise and restructure them.[204] But the historical burdens such as noncore assets, nonperforming financial claims and redundant workers were left to the original enterprises.[205] Furthermore, it was also discovered that the original enterprise, also called parent enterprise, controlled the listed SOEs and obtained great benefits from listed SOEs.[206] In certain circumstances, such practices even affected the normal operation of listed SOEs.

The Decision on Several Important Issues Regarding Reform and Development of State Owned Enterprises brought forth new requirements for the corporatization of large and medium-sized SOEs.[207] The Decision contained twelve parts concentrating on the problems and some deep-rooted contradictions confronted by SOE reform. It also indicated that SOE reform constituted the central link of the entire economic restructuring and entered a crucial phase of strategic adjustment in the distribution of the state economy. The specific policies and measures in the Decision were helpful to push forward the further reform of SOEs.[208] Some salient problems and concerns were given particular attention, including the excessively high asset-to-liability ratios,

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[200] They are Cinda, Huarong, Great Wall, and Orient respectively

[201] Available at http //english peopledaily com cn/english/200010/13/eng20001013_52487 html

[202] Industries and sectors are classified into four categories industries that are related to national security, industries that are naturally monopolized, industries that supply major products and services for the public, and pillar industries and backbone enterprises in high and new technology sectors See Part Three of The Decision on Several Important Issues Regarding Reform and Development of State Owned Enterprises, adopted at the Fourth Plenary Session of the 15th CCCPC in 1999

[203] Ibid

[204] An alternative was to spin off noncore assets by splitting and reduce redundant workers by early retirement and reemployment This approach took longer, while the carving-out way was faster

[205] See Wu, above note 33, 157

[206] See Jinglian Wu *Shenhua Guoqi Gaige Xuyao Chengqing De Jige Yuanze Wenti* (Clarify Several Key Problems in Terms of Deepening the SOE reform), in *Market Economy Calls for Rule of Law* Beijing SDX Joint Publishing Company, 2007, 33-36

[207] This Decision was adopted at the Fourth Plenary Session of the 15th CCCPC in 1999

[208] For example how to adjust the layout of state economy, how to establish and improve the modern enterprise system, how to strengthen and improve management of enterprises, how to balance SOEs' debts and reduce SOEs' social burdens etc

capital shortage and reduced efficiency. Official rankings were no longer granted to enterprises and their leaders.[209] China's accession into the WTO club in 2001 also created direct external pressure by exposing SOEs to vigorous competition, which served as another impetus to deepen SOE reform.

3.1.4 The Establishment of SASAC

In March 2003, the Chinese government established the SASAC, a ministerial-level special organisation reporting directly to the State Council. The establishment of SASAC meant a shift of ideas, from managing SOEs to only administering the state-owned assets. In theory, this implied a more active retreat of the state from SOEs.

SASAC has a high position in the set-up of State Council and a broad mandate. The mandate mainly includes: first, performing the responsibilities as the investor of the state-owned asset on behalf of the central government; second, drafting laws and regulations regarding state-owned assets; third, managing and restructuring state assets; fourth, dispatching the supervisory board to some large enterprises; and fifth, the appointment, evaluation and removal of the executives of SOEs.[210] Such an arrangement moves forward to reinforce the role of the government as the owner and shareholder of SOEs. It also seems to reconfirm the impossibility of massive privatization during Chinese SOE reform.

The Standing Committee of the 11th National People's Congress (NPC) also adopted *The Law of the PRC on State-Owned Assets of Enterprises* (the Law on State-Owned Assets of Enterprises) on October 28, 2008. The Law on State-Owned Assets of Enterprises, which underwent a 15-year lawmaking process, came into force as of May 1, 2009.[211] Two articles in the law indicate the role of SASAC, and together they provide the legal basis for the position of both central and local SASACs.

> *Article 4.1: The State Council and the local people's governments shall, in accordance with laws and administrative regulations, perform respectively the investor's functions for state-invested enterprises and enjoy the investor's rights and interests on behalf of the state.*
>
> *Article 11.1: The state-owned assets supervision and administration body under the State Council and the state-owned assets supervision and administration bodies established by the local people's governments according to the provisions of the State Council shall perform the investor's functions for*

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[209] See Decision on Several Important Issues Regarding Reform and Development of State Owned Enterprises, adopted at the Fourth Plenary Session of the 15th CCCPC in 1999 The Party must manage and supervise its SOE cadres In the selection of cadres, there should be a two-way system While relying on its own judgment to promote cadres, they should also invite competition from society to compete with Party-selected candidates SOE cadres should no longer be certified only on the basis of the official level

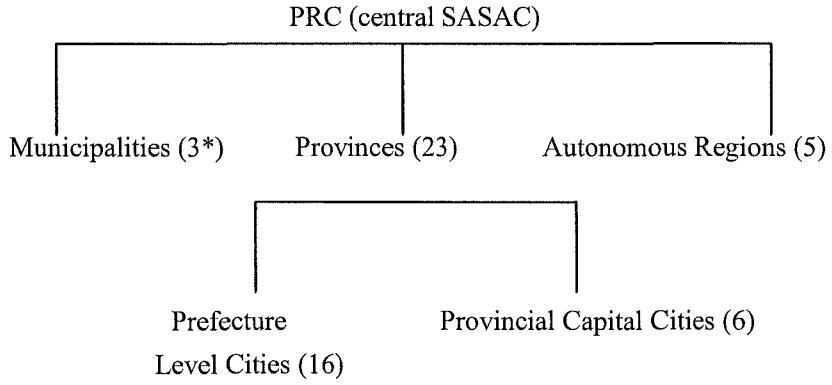
[210] Available at http //www sasac gov cn/n2963340/n2964727/n2974401/2976097 html

[211] This law has been criticized for lots of reasons, like its limited jurisdiction, the dubious identity of SASAC, the unclear wording etc See http //www eeo com cn/ens/Observer/2008/06/30/104814 html

state-invested enterprises on behalf of and upon the authorization of the corresponding people's government.

There are three levels of SASAC. At the top of the structure is the central SASAC. Below it are the provincial-level SASACs, for provinces, autonomous regions (e.g. Xinjiang or Guangxi) and centrally-administered cities (e.g. Beijing or Shanghai). Besides the central SASAC and provincial-level SASACs, there are SASACs established in certain prefectures (*di qu*) and provincially-administered cities. The central directs and supervises the management of local state-owned assets. This structure is illustrated in Figure 3.5.

Figure 3.5: The Administrative Divisions of the Levels of SASAC[212]



* Number of SASAC

Initially the central SASAC managed 196 large SOEs (Central Enterprises). The number was reduced to 150 in March 2008, later to 136 in 2009, and the latest number is 121.[213] The number of these large SOEs will continue to decline, as the objective is to maintain 80~100 large SOEs by central SASAC.[214] According to official account, cutting number is not the aim, but just a first step in state-owned resources optimization. The final aim is to nourish mega-groups with international competitiveness. There are quite a few SOEs under the supervision of local SASAC, while they are relatively small. SOEs under central SASAC, or say central SOEs, are usually large and put in the spotlight.

Central SOEs are expected to focus on important industries and key fields, which may 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. Those industries can be generally categorized into three types.[215]

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[212] Available at http //www sasac gov cn/n1180/n20240/n2454922/2459714 html.
[213] Available at http //www sasac gov cn/n1180/n1226/n2425/index html (last accessed on April 16, 2011)
[214] Attention should be paid to state-owned financial institutions For instance, domestic securities companies, with majority of them invested by the state, are supervised by CSRC Insurance companies are supervised by China Insurance Regulatory Commission Banks including SOCBs are supervised by CBRC
[215] Strategic and important industries mainly belong to non-manufacturing sectors See Paragraph Three in Notice of the General Office of the State Council on Forwarding the Guiding Opinions of the SASAC about Promoting the

Category	Strategic and important industries	Key industries and high-tech industries	Other industries
Specific Industries	Defence, power generation and distribution, oil, coal, telecommunication, civil aviation, public transportation, shipping	Machinery manufacturing, auto, IT, construction, iron & steel, base metals, chemicals, land surveying	Medicine, new materials, agriculture, postal service

Following the principle of "grasping the large, letting go of the small", SASAC promotes the creation of large enterprise groups or business groups (*qiye jituan*)[216] by encouraging mergers in core industries. Usually, a single SOE in China is one part of a large enterprise group or business group (see Figure 3.3 and Figure 3.4). In practice, it is even difficult for SASAC to record which enterprise in a multi-tier enterprise groups can be classified as a SOE. Therefore, large SOEs maintained by SASAC are actually large enterprise groups, which are decreasing in numbers but increasing by scale.

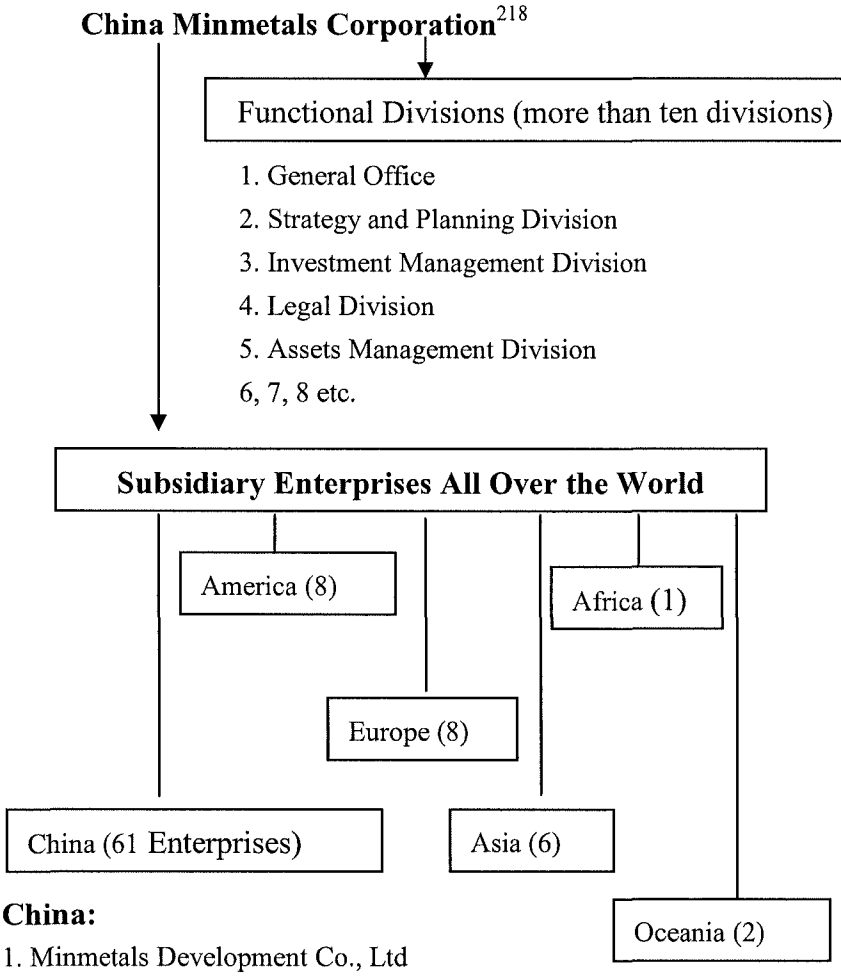
Enterprises groups are mainly formed or expanded by mergers and acquisitions. However, about one third of the central enterprise groups were originally converted from the administrative organs through splitting or changing name.[217] It is such a legacy that made the separation of enterprise management from government operation or influences a challenging task. The disguised various government agencies still could intervene in the firm.

Adjustment of State-owned Capital and the Reorganization of State-owned Enterprises, GUOBANFA [2006]No 97, Dec 5, 2006 Overall, the fields are similar to the Decision made by the 15th CCCPC in 1999 Strategic and important industries mainly belong to non-manufacturing sectors

[216] Business group ("*qiye jituan*" in Chinese) is a very typical economic form, which has some similarities with "chaebol" of Korea and "keiretsu" of Japan The majority of merger decisions among large SOEs in China are made by the governmental officials, or the proposal of merger is encouraged by the government Mergers occasionally result from the initiatives taken by SOEs themselves See Yusuf, above note 71, 96

[217] SASAC *Tansuo yu Yanjiu Guoyou Zichan Jianguan he Guoyou Qiye Gaige Yanjiu Baogao* (2006) (Research and Study. Reports on the Supervision of State-owned Assets and the Reformation of State-owned Enterprises) Beijing China Economic Publishing House, 2007, 624

Figure 3.3: A Simplified Organizational Structure of Enterprise (Business) Groups



China:

1. Minmetals Development Co., Ltd
2. Minmetals Steel Co., Ltd
3. China National Minerals Co., Ltd.
4. **China Minmetals Non-Ferrous Metals Co., Ltd.**
5, 6, 7, etc.

Europe:

Minmetals Japan Corporation

Minmetals South-East Asia Corp. Pte. Ltd.

Minmetals (U.K.) Ltd.

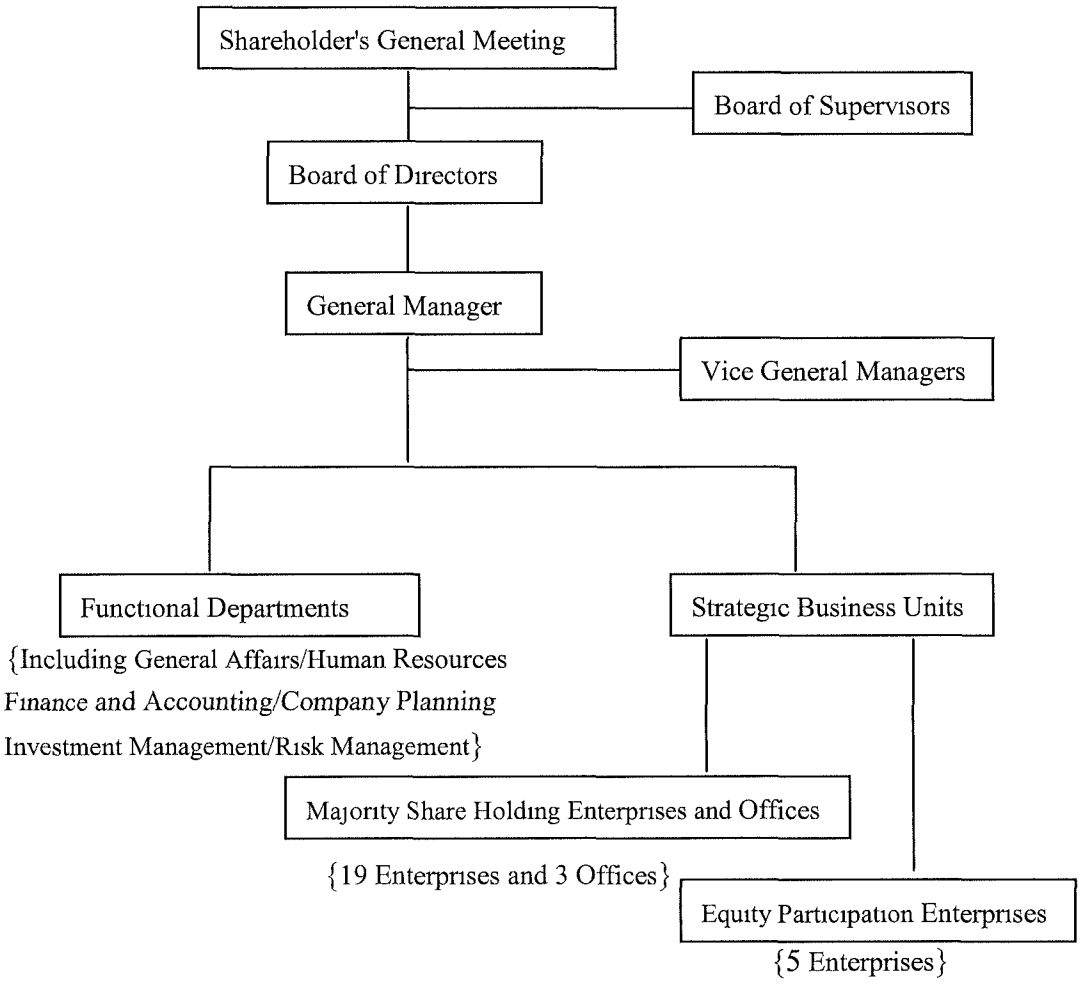
Note:

China Minmetals Non-Ferrous Metals Co., Ltd. is one of the subsidiary enterprises of China Minmetals Corporation; however, as shown in the next figure, China Minmetals Non-Ferrous Metals Co., Ltd. also controlled 19 enterprises as the majority shareholder. The two figures are exactly the epitome of the complicated internal structure of Chinese SOEs.

[218] Available at: http://www.minmetals.com/english/organization.jsp

Figure 3.4: A Simplified Organizational Structure of a modern SOE[219]

China Minmetals Non-Ferrous Metals Co., Ltd.[220]



SOEs that perform well are also encouraged by SASAC to list on the stock exchange market to diversify ownership and raise funds for restructuring activities, while small SOEs are encouraged either to restructure e.g. through mergers and acquisitions and alliances, or to declare bankruptcy. As of 2006, there were 833 listed SOEs in which the state acts as a majority shareholder in the A shares market among 1349 listed companies.[221]

A further step adopted by SASAC relates to how to list. It tended to end the practice of listing only subsidiaries and replace it with full listings, and finally supported the enterprises with good assets or good core assets to realize the overall listing.[222] All

[219] A position of independent director should be established for listed companies, see the Guidelines for the Establishment of Independent Director System by Listed Companies issued by CSRC, ZHENGJIANFA [2001] No 102

[220] Available at http //www cmnltd com 8080/CmnltdWeb/2zzjg jsp

[221] See SASAC, above note 217, at 568 It is worth noting that the number of listed companies rose rapidly As of 2007, there were 1550 listed companies

[222] See Chapter Five in 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, GUOBANFA [2006] No 97, Dec 5, 2006

these measures are in line with the basic principle "make it big, make it strong" produced by SASAC.

During this period, the performance of SOEs showed positive signs. Taking SOEs' good performance as a favorable opportunity, the central government finally initiated the program to remove the social functions from SOEs to various levels of government. Following the notices from the State Council with respect to the separation of central SOEs from performing social functions in 2003 and 2005, central SOEs were pushed forward to transfer the relevant units managing social functions to the government and concentrate on their main business, while some local SOEs may still have certain units to undertake social functions.[223] The State Council took two steps to promote the separation project, probably owing to the complexity and wide impact of this task. In 2003, three central SOEs were selected to conduct a pilot project on the separation of social functions from enterprises, which are: China National Petroleum Corporation (CNPC), China Petroleum and Chemical Corporation (Sinopec) and Dongfeng Motor Corporation in Hubei Province; and the pilot project was basically completed in 2004. The second step took place in 2005: 74 central SOEs were selected and required to complete the separation project in three years.[224] By the efforts of the government to improve the structure of SOEs, most central SOEs have been separated from the social functions.

Since the establishment of SASAC in 2003, two other laws have been amended significantly, which are 1993 Company Law and 1986 Enterprise Bankruptcy Law.[225] These two laws closely connect with SOEs. As a matter of fact, the two laws import a host of articles from the relevant laws of developed countries following the spirit and principles of market-oriented economy.

The amended Company Law entered into force in January 2006, which extended the effects of articles of incorporation, made special provisions on one-person limited liability companies and wholly state-owned companies, and established more discretionary rules instead of compulsory rules. In terms of the liability for debt of companies, it stipulates clearly that "a company shall be liable for its debts to the extent of all of its property; a shareholder of a limited liability company shall be liable to the company to the extent of the capital contribution it subscribes; a shareholder of a company limited by shares shall be liable to the company to the extent of the shares it subscribes".[226]

It is generally accepted that despite certain defects, the Company Law 2006 revealed and facilitated the outcomes of the SOE reform in the recent years. One typical

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[223] See Notice from the Office of the State Council on the Separation of the Second Batch of Central SOEs from Performing Social Functions. GUOBANFA [2005] No. 4, Jan. 14, 2005.
[224] Ibid.
[225] The 1986 Enterprise Bankruptcy Law took effect on October 1, 1988, and according to Article 2 of the law, it was only applicable to traditional SOEs. A striking feature of this expired law is that government approval is required before the bankruptcy could happen.
[226] See Article 3 of the new Company Law (2006).

example is that privileges for companies restructured from traditional SOEs were eliminated.[227] SOEs should follow the principles in the new Company Law rather than the directions and approval from administration, which was a breakthrough for managing SOEs.[228] Furthermore, it is clearly stated that the state as a shareholder is equal to the other shareholders.[229]

Perhaps most notably, the Company Law 2006 adopted a series of provisions to protect the shareholders' rights and enhance their participation. So it is possible that the ownership structure of SOEs will be more diverse, which may be an effective way for achieving better corporate governance in China. Another key issue facilitating the corporate governance is that SOEs face an increasingly more competitive market.

The new Law of the PRC on Enterprise Bankruptcy in lieu of the 1986 Enterprise Bankruptcy Law was put into effect on June 1, 2007.[230] This new law applies to all kinds of enterprises encompassing SOEs. The new law is more market-oriented, with little government interference in the bankruptcy process. One substantial change of this new law is that it gives top priority to the creditors' rights instead of the employers' claims.[231] It changes the previous practices of dealing with the insolvent assets. The new law limits the government intervention in the case of bankruptcy of SOEs. According to Professor Li Shuguang,[232] "the successful enactment of the law could significantly improve China's profile in the WTO, since the law will eliminate some concerns of foreign investors by establishing a legal framework and market environment with credibility, efficiency, assurance and expectation".[233] However, Article 133 stipulates that "any special matter in the bankruptcy of a state-owned enterprise within the term and scope as prescribed by the State Council before the present Law comes into force shall be handled according to the relevant provision of the State Council".[234] Consequently, the policy bankruptcy applied to SOEs until June 2007. Currently, all the enterprises should be subject to the Law of the PRC on Enterprise Bankruptcy.

On the whole, the new laws or the amended laws made much progress and reflected the legislators' good intentions. Nevertheless, that does not guarantee that implementation of the laws is not problematic. Thus, it is apparently necessary to

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[227] For example, Article 75 of Company Law 1993 stipulated There must be five or more sponsors for incorporating a publicly held corporation, while a waiver is granted where a SOE is restructured into a publicly held corporation Such articles were abolished by the Company Law 2006

[228] SASAC, above note 217, at 139

[229] See Article 126, 127 of the new Company Law (2006) It is of course difficult to make sure the full implementation of such articles

[230] The 1986 Enterprise Bankruptcy Law (for Trial Implementation) was abolished simultaneously

[231] See Article 109 an owner of the right to guaranty on the particular assets of the bankrupt may enjoy the priority of right to be repaid by means of the particular assets

[232] He is one of the drafters of the law, and a professor at Beijing's China University of Political Science and Law

[233] Available at http //www atimes com/atimes/China_Business/HI02Cb02 html

[234] The main documents made by the State Council were *Notice of the State Council on the relevant issues concerning the Pilot Implementation of Bankruptcy of a State-Owned Enterprise in Some Cities (1994) and Supplementary Notice of the State Council on the Relevant Issues about the pilot Implementation of the Merger and Bankruptcy of State-owned Enterprises in Some Cities and the Reemployment of Workers (1997)*

distinguish between what the laws provide for and how the laws are practically implemented. For instance, the aforementioned problems SOEs confronted still exist to different extents, i.e.: government interference in enterprise decision-making, poor corporate control and weak governance systems, inappropriate incentive structures of the enterprises.[235]

Chinese SOE reform remains ongoing, while our long story about Chinese SOE reform draws to its close here. A final point is that the above discussions about SOEs include both industrial SOEs (SOEs engaging in manufacturing) and SOEs in service area such as China Telecom, China Mobile and Air China etc. It is difficult to distinguish them since the domestic laws are generally applicable to SOEs in both types of industries. However, in terms of the SCM Agreement annexed to GATT, it just targets on SOEs in manufacturing area. Without specific or additional explanation, SOEs in this study do not contain financial corporations with the state as a majority shareholder or the only shareholder, for instance, the state-owned commercial banks.[236]

3.2 The Scope and Classification of SOEs

Following the SOE reform as illustrated above, this section addresses how to observe SOEs in terms of the scope and classification. A casual reading of SOEs might lead some readers to assume that defining SOEs is easy, for example: the term SOEs, by its definition, refer to enterprises of the state. In practice, however, it is quite hard to find a generally accepted definition for SOEs.

As revealed by OECD when conducting its *2003 Questionnaire on Corporate Governance of State Owned Enterprises*: the most fundamental difficulty was to identify entities that can be regarded as SOEs.[237] OECD members provided various answers as to the classification of SOEs with little homogeneity. For example, in Austria, Netherlands, Italy, Germany and New Zealand, only SOEs belonging to the central state or at federal level are considered; in Greece, only enterprises that are more than 5% state-owned are considered; in Japan, SOEs considered are the "listed government affiliated joint-stock companies"; in Korea, SOEs belonging to the central government are comprised, while the gross assets of the state-owned financial enterprises are excluded when evaluating the total asset value; in Finland, only enterprises totally owned by the state are considered; in Poland, it calculate the data for the Questionnaire based on its 1787 SOEs that are commercial enterprises; in Spain, SOEs taken into account only refer to the ones under the General Direction of the State Assets through the general sub-direction of the state holdings etc.[238] Therefore, different countries have their own recognition to SOEs because of their

[235] See SASAC, above note 217, at 581-590. Chiu, above note 167, at 78-88. Liu Hongru: *Tupo—Zhongguo Ziben Shichang Fazhan zhi Lu* (Breakthrough—the Development of Chinese Capital Market). Beijing: China Financial Publishing House, 2008, 458-460.
[236] In certain cases, it is emphasized that SOEs do not include financial SOEs.
[237] See OECD, above note 112, at 24-27.
[238] Ibid.

unique political, cultural, social and economic conditions and circumstances. It is especially worth noting that, without very cautious comparison, we may not discuss SOEs in the same level or similar meaning.

In terms of China, a previous central planned economy with numerous SOEs, the perplexity of categorizing and defining SOEs is that after a series of transformations outlined in the previous section 3.1, SOEs are a disparate collection differing in their form, size, set-up, operational standards, funding, and so on. In other words, along with the ongoing and long-lasting reform of SOEs, one can still find various kinds of SOEs in China. Apart from the coexistence of various types of SOEs, the tendency of the official document to blur semantic distinctions further increases the difficulty of understanding SOEs. For instance, the privatized firms transformed from SOEs owned by the whole people are usually entitled "nonstate" firms; shareholding SOEs transformed from SOEs owned by all the people connote the partial privatization of those SOEs, and the state still acts as the major shareholder. Just as the Edward Steinfeld commented that the adoption of ambiguous language has been useful for maintaining continuity with the past and promoting huge change in a veil of normality, while it has inevitably caused considerable confusion in terms of enterprise reform including the very basic issue of firm-level categorization.[239]

As introduced in Chapter 2, a plethora of economic literature discusses SOEs, but still, few scholars actually define SOEs *per se*. Even though China's accession documents to the WTO employ the term 'SOEs' frequently, the WTO does not define the term either. Furthermore, there exists certain difference between economics and law relating to how to recognize SOEs. With these complexities in mind, the following part explores and determines the scope of SOEs for this thesis.

3.2.1 Scope of SOEs

This sub-section analyzes the scope of SOEs by comparing opinions obtained from various international organizations and official Chinese documents. The perspectives of international organizations are important reference for the demarcation of SOEs and other companies. The popular views in China, including official and academic views, will also be introduced. Based on all of these opinions, the scope of SOEs that is appropriate for this thesis will be proposed.

3.2.1.1 International Perspectives

Though China is not a member of OECD, its reports are important source of reference. Throughout the *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, the term "SOEs" refers to enterprises where the state has significant control, through full, majority, or significant minority ownership.[240] A question

[239] Steinfeld, above note 4, 10.

[240] See OECD, above note 111, at 11.

relating to the meaning of the term "state" (a country, a province or federal of sub-national levels or government) arises. According to the Oxford Advanced Learner's English-Chinese Dictionary (the 6th Edition), "state" is given six meanings as a noun. There are three meanings which especially require a context in order to determine its specific meaning. The first meaning is "a country considered as an organized political community controlled by one government", the second one is "an organized political community forming part of a country" and the third one is "the government of a country". In accordance with the Guidelines, it is "primarily intended to cover commercial enterprises under central government ownership and federal ownership",[241] so the Guidelines use the "state" in the meaning of "government", including the central government and local government. Therefore, OECD adopts quite a broad definition. As long as the state has a significant minority ownership or higher standard in an enterprise, the enterprise will be viewed as SOEs in the Guidelines. To make sure their wide application, the Guidelines also mention that many of the guidelines are also useful in cases where the state retains a relatively small stake in a company.[242]

In a letter the author wrote to WTO Enquiries at the end of 2007, they replied that state-owned enterprises were government-owned corporations or business entities (e.g., in the UK, telecoms, railways, postal services, before nationalization). This reply is extremely general. Considering that WTO provisions did not employ the term SOEs until China's accession, it is natural that the WTO itself had not given a formal, considered or explicit explanation of the term. In the two famous cases *US-Lead and Bismuth II*[243] and *US-CVD on EC Products*,[244] SOEs, state-owned companies or government owned producers have all been used to indicate preprivatization of steel companies in the United Kingdom and EC, while none of the parties further discussed these terms let alone their potential differences.[245]

3.2.1.2 Chinese Explanations

(i) *Ministry of Finance (MOF)*

It is interesting to note that the Ministry of Public Security, in practice, met difficulty in fully catching the meaning of SOEs, so they requested that MOF make a determination for the state-owned companies/enterprises to ensure the full implementation of a new article added to Criminal Law in 1997.[246] The MOF first

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[241] Ibid
[242] Ibid
[243] See the Panel Report and Appellate Body Report, *US-Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom* (*US-Lead and Bismuth II*), WT/DS138/R, WT/DS138/AB/R
[244] See the Panel Report and Appellate Body Report, *US-Countervailing Measures Concerning Certain Products from the European Communities (US-CVD on EC Products)*, WT/DS212/R, and WT/DS212/AB/R
[245] It is understandable since SOEs *per se* in the two cases are not the key point at all
[246] This article addresses the issue of imposing criminal punishments on the principals and workers of state-owned

acknowledged the significant change of the meaning of "state-owned companies/enterprises" which was often used in the past, owing to the deepening of the SOE reform. Noticing the ambiguity of the various interpretations and classifications in terms of state-owned companies/enterprises and the urgent need to regulate the inconsistent application, MOF undertook the task of interpreting state-owned companies/enterprises. At the same time, MOF emphasized that the determination and classification of state-owned companies/enterprises in the financial work should not be taken as a basis for interpreting the term "state-owned companies/enterprises" mentioned in the Criminal Law.[247]

Nevertheless, MOF suggested two approaches for reference, namely capital structure and shareholder control. Based on capital structure, state-owned companies/enterprises should include:

> *all enterprises owned by the whole people whose ownership rights and interests belong to the state and which are subject to the Industrial Enterprises Law of 1988, and the nonstandard companies established and registered before the promulgation of the Company Law, the exclusively state-owned companies, the limited liability companies and joint-stock companies funded by more than one state-owned entity established and registered after the promulgation of the Company Law.*[248]

As can be observed from its explanation above, MOF holds the view that state-owned enterprises indicate the enterprises registered according to the *Industrial Enterprises Law of 1988*, different from the state-owned companies subject to the *Company Law*.

Based on the shareholder control, MOF was of the view that an enterprise in which the state holds more than 50% of the shares shall be state-owned companies/enterprises. For an enterprise, in which the state holds relatively more shares, it depends on specific standards[249] to decide whether it is a state-owned company/enterprise; the reason is that the shareholder structure and the controlling position in such a state-owned company/enterprise is relatively complicated.[250] In terms of shareholder control, the scope of state-owned companies/enterprises proposed by MOF is narrower than the one suggested by OECD. Taking account of the distinction between SOEs and state-owned companies made by MOF, the scope covered by SOEs is even much narrower.

(11) *National Bureau of Statistics (NBS)*

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companies, enterprises and public institutions as well as the principals of the superior authorities thereof for disrupting the management order of companies or enterprises, which are favorable for better cracking down the behaviors encroaching on state-owned assets and creating a good economic order

[247] See Opinions of the Ministry of Finance on the Determination of State-owned Companies/Enterprises CAIQIHAN [2003] No 9, April 23, 2003

[248] Ibid

[249] MOF recommended that the specific standards should be put forward after very serious research

[250] Ibid

According to the *Main Economic Indicators of All Industrial Enterprises of the Statistical Yearbook* by NBS in 2004, most registered enterprises[251] with state ownership or state-owned assets could be SOEs, wholly state-owned companies, state-holding enterprises, state owned joint-operation enterprises, or joint state-collective enterprises.

NBS has actually made a detailed and narrow determination of enterprises when conducting statistics. State-owned enterprises, originally known as state-run enterprises (or state enterprises) with ownership by the whole society, are non-corporation economic entities registered in accordance with the *Regulation of the PRC on the Management of Registration of Legal Enterprises*.[252] In addition, the entire assets of SOEs are owned by the state. Based on the explanation of NBS, three features of SOEs are noted. First, SOEs are not corporations while have the status of legal entities, which were once named socialist commodity production and operation units. Second, SOEs have only one investor, namely the state or the whole people in PRC and the enterprises themselves do not enjoy the ownership but just the rights to possess, utilize and dispose of the property that the state has authorized them to operate and manage.[253] Third, the factory director, also called manager, assumes overall responsibility for the work of the enterprise and occupies the central position in the enterprise;[254] all shareholders bear limited responsibility for the enterprise according to the Company Law of the PRC.

Therefore, it provides a very narrow definition for SOEs; on the other hand, that is exactly the features of traditional SOEs introduced in the first section. The above three characters also distinguish traditional SOEs from any other corporation with the state as a shareholder.

On the whole, SOEs only consist of traditional SOEs based on the analysis of NBS. Such a determination has been supported not just by the above explanation made by MOF, but also by the statement in the Trade Policy Review by China (sees the following part).

(iii) *Trade Policy Review by China*

According to the official statement Chinese government made in the Trade Policy Review of China in 2006, China's economic regime has undergone substantial

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[251] Different kinds of enterprises shall register in different registration authorities According to Article 6 of Company Law of the People's Republic of China (2005), "when a company is to be established, an application for registration of its establishment shall be submitted to the company registration authority" According to Article 4 of Measures of the People's Republic of China for the registration of Partnership Enterprises, "The administrative department for industry and commerce shall be the registration organ of partnership enterprises"

[252] Explanatory notes on main statistical indicators of the China Statistical Yearbook, National Bureau of Statistics

[253] For corporations, they are enterprise legal person and have independent corporate property and enjoy corporate property rights, for the shareholders, they enjoy the rights and interests such as gaining benefits from their assets, making major decisions and selecting managerial personnel See Wang Baoshu and Cui Qinzhi *Principles of China's Company Law*, 3rd edition Social Sciences Academic Press, 2006, 28-29

[254] See Article 7 and 45 of the Law of the PRC on Industrial Enterprises Owned by the Whole People

changes.[255] First and foremost, after 27 years of reform since the *Law on Industrial Enterprises Owned by the Whole People* was promulgated in 1988, China has no mandatory production plan for state-owned enterprises. All state-owned enterprises are in a free position to operate on a commercial basis, running the business, engaging in decision-making and being responsible for profits and losses on their own. They have to compete with more and more other kinds of companies (individual industrial and commercial households, private enterprises, FIEs *etc.*) emerging in the market, and if they could not gain profitability, they are required to declare bankruptcy. Secondly, more than 50 percent of state-owned companies (SOCs) originally registered according to the *Industrial Enterprises Law of 1988* have been re-registered according to the *Company Law*. China also commented that in the future, the great majority of state-owned enterprises will be registered according to the *Company Law*.[256]

Just like the interpretations made by MOF and NBS, the documents about China's Trade Policy Review have clearly distinguished SOEs from SOCs, which are quite similar to the difference between traditional SOEs and reformed SOEs adopting the shareholder system.

(iv) *The Law of PRC on State-Owned Assets of Enterprises*

The *Law of PRC on State-Owned Assets of Enterprises* in 2008 was formulated mainly for value maintenance and appreciation of state assets. Considering that the substantial reform of SOEs in the past ten years has been mainly regulated by various policies and limited regulations, the emergence of this law is remarkable. The fact that corruption has been very serious in the restructuring, merger and acquisition, property transactions, capital operations construction projects of large SOEs, can also partly be attributed to the lack of enforceable laws.[257] Thus, to a certain extent, it fills the gap of laws regulating the SOE reform.

For the first time, this law employs the concept of state-invested enterprise rather than state-owned enterprises. The significant change of terms indicates the emphasis on investment and capital structure. Article 5 defines the term "state-invested enterprise", which reads as follows:

> *Article 5 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.*

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[255] See Trade Policy Review Report by the People's Republic of China WT/TPR/G/161, March 17, 2006

[256] See the (IV) State-owned enterprises (SOEs), in the Trade Policy Review People's Republic of China, Minutes of Meeting WT/TPR/M/161/Add 1, June 15, 2006

[257] It is commonplace to read headlines of newspapers about corrupted presidents from SOEs Even after *the Law on the State-Owned Assets of Enterprises* was released, the corruption seems still serious

In this context, the term "state-invested enterprises" has a significantly general spectrum, which naturally contain traditional SOEs, the limited liability companies and joint-stock companies funded by state-owned entities aforementioned. For a wholly state-owned enterprise or company, the state is the sole investor; for a company, the state should have a stake in it, irrespective of the forms and size of investment made by the state. Briefly speaking, as long as the state has a stake in the company, it can be regarded as a state-invested enterprise. Although different wording is used, state-invested enterprises can be recognized as the broadest SOEs.

In effect, the adoption of the term "state-invested enterprises" in place of state-owned enterprises/companies reflected a shift of attitude of the state toward the enterprises in which it has a stake. The state is also an investor, trying to be equal with other kinds of investors. What owned by the state are the rights and interests derived from investment by the state rather than the enterprises *per se*.

It can be observed that MOF, NBS, Trade Policy Review by China and *the Law of PRC on State-Owned Assets of Enterprises* aforementioned all distinguish SOEs from SOCs. According to those interpretations, the widely-used term SOEs just comprise SOEs in the narrow sense. One basic criterion is the law registered by the legal entities: *Industrial Enterprises Law of 1988*, or *the Company Law*. These distinctions are worth noting, because it means that the authority realized and emphasized the difference; the information including data about SOEs provided by the Chinese authorities probably is limited to traditional SOEs; also, it reflects the diversification of "SOEs" in the new period; and they will have an impact upon certain legal analysis.

However, some official documents issued by the State Council or SASAC refer to the SOEs and SOCs collectively as state-owned and/or state-controlled enterprises[258] or SOEs. Thus, the ambiguity about SOEs cannot be underestimated. It has to be admitted that the number of such official documents are limited, especially in recent ten years. The following five important documents affecting directly the process of SOE reform are the typical examples, which do not make a distinction between SOEs and SOCs. They are: 1) *Interim Regulations on Supervision and Management of State-owned Assets of Enterprises* issued in 2003;[259] 2) *Opinion on State-owned Assets Supervision and Administration Commission on Regulating the SOE reform* released in 2003; [260] 3) *Opinion on State-owned Assets Supervision and Administration Commission on Further Regulating the SOE reform* issued in 2005;[261] 4) *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*

[258] Another translation of the term is state-owned and state-holding enterprises

[259] See Interim Regulations on Supervision and Management of State-Owned Assets of Enterprises, Order of the State Council No 378, May 13, 2003

[260] See Opinion on State-owned Assets Supervision and Administration Commission on Regulating the SOE reform, forwarded by the General Office of the State Council, GUOBANFA [2003], No 96

[261] See Opinion on State-owned Assets Supervision and Administration Commission on Further Regulating the SOE reform, forwarded by the General Office of the State Council, GUOBANFA [2005], No 60

the Reorganization of State-owned Enterprises in 2006;[262] and 5) *Opinions of the State Council on the Pilot Implementation of the State Capital Operating Budget* released in 2007, which has been amended and then integrated into *the Law of PRC on the State-Owned Assets of Enterprises*.[263]

(v) *Scholars*

In a classical book, *Industrial Reform in China: Past Performance and Future Prospects*, the writers make an emphasis on categories of enterprise in China: those township-and village-run enterprises (TVNEs) engaged in joint ventures with foreign enterprises are officially classified as "other enterprises"; similarly, those SOEs issuing shares, i.e. joint stock companies, are also regarded as "other enterprises".[264] The authors consider it necessary to keep in mind those complexities when review the structural transformation of the Chinese economy.[265] Obviously, they notice the changes of SOEs and do not regard SOEs issuing shares as SOEs any longer. So they adopt the narrow way to interpret SOEs.

Ye Lin holds the idea that SOEs should be classified into two kinds: traditional SOEs and shareholding SOEs (SOCs), while obviously, both of them are SOEs.[266] The distinction is necessary because they are subject to different controlling system and pursue different objectives. The shareholding structure is a better choice for SOEs.[267]

Wang Yuben[268] believes that SOEs should just mean traditional SOEs.[269] A strict distinction should be made between SOEs and state-owned companies in which the state holds majority or minority ownership. He argues that SOEs and the other companies are subject to different laws; SOEs, a term originated from the planned economy, has its specific meaning in current China. Such a practice, according to him, is conducive to guarantee the further reform of SOEs and reduce unnecessary misunderstanding. Gan Wenxiao holds a similar viewpoint.[270]

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[262] See 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, GUOBANFA [2006]No 97, Dec 5, 2006

[263] See Opinions of the State Council on the Pilot Implementation of the State Capital Operating Budget, GUOFA [2007] No 26, Sep 8, 2007

[264] See Keijiro Otsuka, Deqiang Liu, and Naoki Murakami *Industrial Reform in China Past Performance and Future Prospects* Oxford Clarendon Press, 1998

[265] Ibid , at 7

[266] See Ye Lin Chonggou Qiye Guoyou Zichan Chuziren Baohu de Falv Zhidu (Restructure the Legal System for Protecting the Investor of State-owned Assets of Enterprise), in *A Collection of the EU-China International Symposium on Corporate Governance in SOEs Corporate Governance Ownership and Goals in SOEs* Beijing Law Press China, 2006, 59-79

[267] Ibid

[268] Wang Yuben is a Law Professor at Capital University of Economic and Business

[269] Wang Yuben (2002), Guoyou Qiye Bu Dengyu Guoyou Konggu Qiye (SOEs are not the Same Concept as State Holding Companies) *Economic Science*, the 5th issue

[270] Gan Wenxiao (2006) the Legal Explanation of SOEs in Paragraph 46 of the WPR Available at http //www iolaw org cn/showNews asp?id=16803

3.2.1.3 Scope of SOEs for This Study

Taking account of various perspectives on the scope of SOEs, it is clear that the international organizations take a broad scope of SOEs, while the Chinese authorities adopt a narrow scope of SOEs and make a distinction between SOEs and SOCs. In recent ten years, only very limited official documents generally refer to SOEs and SOCs as state-owned and/or state-controlled enterprises. Such conflicts about the scope of SOEs will definitely affect the understanding of SOEs in China. This is further compounded by the piecemeal approach to the SOE reform which leads to the coexistence of various forms of SOEs.

This research adopts the broad scope of SOEs. Such an interpretation is similar to the approach suggested by OECD. That is to say, unless otherwise stated, SOEs comprise all enterprises where the state has full, majority or significant minority ownership. On the other hand, it is worth noting that SOEs in China normally indicate traditional SOEs. For China, the change of corporate governance structure, from SOEs to SOCs, reflects the positive outcome of the long-lasting SOE reform.

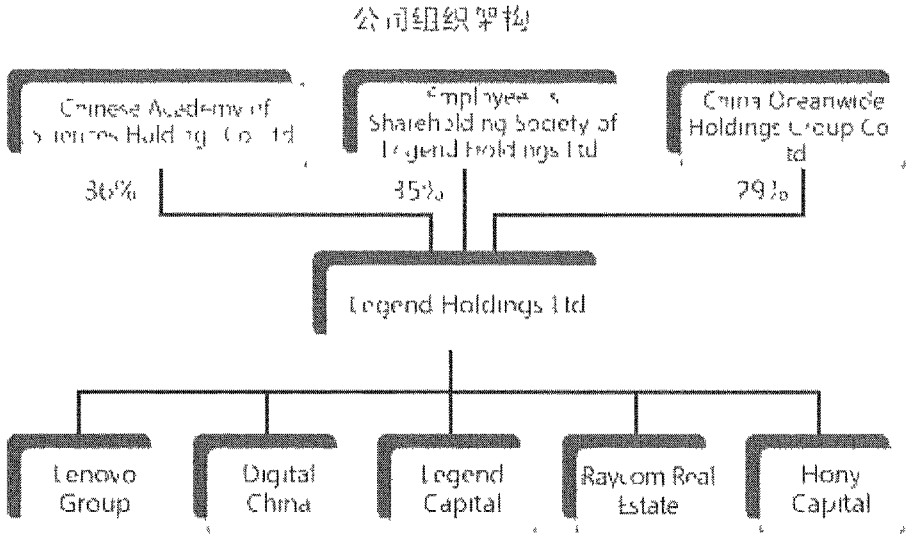
There are two main reasons for choosing a broad scope for SOEs here. First and foremost, in terms of the interaction between the state and market, state ownership is the most key factor rather than the form of enterprise that determines the difference between SOEs and other companies. The form of enterprises may have an impact on the decision-making process, set-up of the enterprise and certain rights and obligations. Moreover, different structures may affect the efficiency of enterprises or companies, but efficiency is not the determining factor in this situation. Put in other words, little relevance could be observed between efficiency and SOEs when defining SOEs. It would not be appropriate to regard efficient SOEs with modern shareholding structure as non-SOEs.

More importantly, the main questions this thesis aims to discuss require a broad way to understand SOEs. The main questions were not designed for the broadest way, since the State has little effect on companies that it has an insignificant minority ownership. The problem with the narrow way is that it limits the form of the enterprise and excludes the SOEs registered as corporations. There are only a few traditional SOEs left after many years of corporatization reform, and it is thus meaningless to just study the interaction between the State and the traditional SOEs while omitting the major part - the shareholding SOEs (SOCs). Therefore, for the purpose of this thesis, it also needs to adopt a broad scope for SOEs rather than the broadest way and the narrow way.

Notwithstanding the tradition that the term SOEs is widely used in various texts, the author considers that it is more appropriate to use specific terms to avoid misunderstandings such as traditional SOEs, SOCs or state-invested enterprises.

3.2.1.4 Conclusions

Thus, this thesis takes the view that SOEs include traditional SOEs as well as SOCs in which the state acts as the controlling shareholder through full, majority, or significant minority ownership. In reality, it is easy to discern central SOEs that are under the management of SASAC and SOEs that are subject to central ministries and commissions. Companies directly owned by provincial and municipal government or local SASAC may also be easily confirmed as SOEs. However, companies invested by those SOEs and the subsidiaries thereof may not be easily classified. In particular, most listed SOEs have multi-hierarchical ownership structures. For example, the question whether Legend Holdings Ltd., (its corporate structure is shown in the following picture)[271] is a SOE does not have an obvious answer, which requires a calculation of the shares held by the government or public bodies. When it comes to Lenovo Group, the mere fact that it is registered in Hong Kong makes it a foreign-investment enterprise based on the laws in China. However, suppose that this fact does not exist, it turns out to be difficult to decide whether it is a SOE or not, 41.5% of whose shares are owned by Legend Holdings.



However, when it is necessary to interpret the nature of a specific enterprise under certain complicated circumstances, relevant factors should be weighed first and then a judgment could be reached. Tracking ownership structure of the largest shareholder of enterprise is the basic approach to identifying the real owner.

[271] http //www legendholdings com cn/intro_en asp

3.2.2 SOE and STE

It is also worth noting that state trading enterprise (STE) is totally different from SOE. On the whole, the GATT did not require the contracting parties to accept any particular obligations about property ownership, with an exception of Article XVII of GATT 1947 - State Trading Enterprises. Article XVII sets out that the purchases or sales of STE involving imports or exports should be based on commercial considerations and Members should notify their state trading enterprises (STEs) to the WTO annually. However, to quote from the explanation of the WTO, "the WTO does not seek to prohibit or even discourage the establishment or maintenance of state trading enterprises, but merely to ensure that they are not operated in a manner inconsistent with WTO principles and rules".[272]

The first paragraph of Article XVII defines what a State trading enterprise is. Specifically, it refers to three types of enterprises:

(I) "State enterprises" (that is, owned and operated by the State) ;

(II) Enterprises granted special privileges by the State (for example a subsidy or subsidy equivalent); and

(III) Enterprises granted exclusive privileges (i.e. a monopoly in the production, consumption or trade of certain goods).

The results of the Uruguay Round of multilateral trade negotiations include the Understanding on the Interpretation of Article XVII of GATT 1994. One of the main features of the Understanding is the "working definition of State trading enterprise" contained in paragraph 2 of the text, which reads:

> *governmental and non-governmental enterprises, including marketing boards, which have been granted exclusive or special rights or privileges, including statutory or constitutional powers, in the exercise of which they influence through their purchases or sales the level or direction of imports or exports.*

Three fundamental elements are identified in this "working definition":

(I) a governmental or non-governmental entity, including marketing boards;

(II) the granting to the enterprise of exclusive or special rights or privileges; and

(III) a resulting influence, through the enterprise's purchases or sales, on the level or direction of imports or exports.[273]

The third element goes to the heart of what the regulation of State trading in the WTO:

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[272] See "the regulation of state trading under the WTO system", http://www.wto.org/english/tratop_e/statra_e/statrad.htm.

[273] See Technical Information on State Trading Enterprises, available at: http://www.wto.org/english/tratop_e/statra_e/statra_info_e.htm

the potentially distorting effects on international trade of the operations of STEs. That is exactly what SCM Agreement strives to achieve as well. The WTO explains:

> *Once again, it must be emphasized that an enterprise need not be State owned, nor need it have a monopoly position, in order to be covered by Article XVII and subject to WTO rules on STEs. The important criteria are that it enjoys exclusive or special rights or privileges, and that in the exercise of these rights and privileges it influences imports or exports by its buying and selling activities.*[274]

With respect to SOEs, the core concept of SOEs, by definition, requires that such enterprises should be owned or controlled by the state. SOEs normally do not enjoy exclusive or special rights or privileges in the course of trade; any other type of company, in the same industries with SOEs, also has the right to conduct import or export activities. Therefore, SOEs are quite different from STEs, although they may have certain intersections.

In contemporary China, it cannot be disputed that there are still quite a few SOEs. However, the concept of STEs is mentioned less frequently, and in practice, it is even difficult to find such enterprises.[275]

3.2.3 Classification of SOEs

Having discussed various perspectives on the scope of SOEs in the previous section, this sub-section classified the broad SOEs by different factors with a view to observing SOEs thoroughly and clearly.

Based on the form of SOEs, the first type of classification is traditional SOEs and shareholding SOEs (SOCs). Traditional SOEs can be changed into SOCs if they are corporatized. One of the purposes of SOE reform in China is to transform the traditional SOEs into SOCs to achieve good corporate governance. It is of importance to note that there is a distinction in Chinese between the terms "SOEs" and "SOCs", namely "*Guoyou Qiye*" and "*Guoyou Gongsi*", while in English both of them may be generally named as SOEs.

There is also a distinction between wholly state-owned enterprises, majority SOEs and significant minority SOEs. Considering the multi-tier legal entity system of SOEs, SOEs may be classified as parent companies, daughter companies and granddaughter companies and even more.

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[274] Ibid

[275] China currently conducts trade mainly through STEs on the exportation of crude oil, processed oil, coal, tungsten, antimony and silver, and on the exportation of rice, corn and cotton These STEs are independent, responsible for their own gains and losses, and make their export decisions based on factors such as supply/demand and price in the domestic and international markets The overview of the export quotas and the qualification requirements of exporting enterprises are available at the MOFCOM website See I Trade Policies and Practices by Measure, (vii) State Trading in the WT/TPR/M/161/Add 1, 15 June 2006

According to the factor whether a SOE is listed, there are listed SOEs and non-listed SOEs. As a rule, SOEs as parent companies remain unlisted, and SOEs as daughter companies or granddaughter companies go listed, which also represent the good assets of the whole enterprise group. Nonetheless, the trend is that the whole enterprise group is listed to realize the overall listing.

SOEs can also be categorized as central SOEs and local SOEs depending on their direct owners. Articles by Prof. Qian Yingyi examine and compare three types of ownership of firms: "private ownership", "local government ownership", and "state ownership" (i.e., national government ownership). The distinction between "state ownership" and "local government ownership" reflects diverse ownership forms inside the government hierarchy in countries like China, where there are not only national government-owned "national public firms," but also local government-owned (or other types of lower level government agency-owned) "local public firms".[276] SOEs are (national government-owned) national public firms, and most of them were present during the planning era.

SOEs can be sorted by the criterion of competitiveness: competitive SOEs and non-competitive SOEs based on the nature of industries.[277] For the competitive SOEs, the state will retreat gradually; for the non-competitive SOEs, the state may strengthen its controlling stake.

Using excludability and rivalry as two characteristics,[278] Professor Mankiw divides goods into four categories: private goods, public goods, common resources and natural monopolies such as fire protection, cable TV and uncongested toll roads.[279] Accordingly, SOEs can be grouped in these four areas. More and more SOEs in China have got monopolies in their areas, especially in the crucial areas like coal, electricity, and telecommunication etc. On the other hand, a number of SOEs have retreated from highly competitive fields.

For purposes of discussion, traditional SOEs in China have similar meaning with pre-reform SOEs; shareholding SOEs in China can also be named as reformed SOEs, or SOCs (state-owned companies). Although traditional SOEs have decreased significantly through the long-lasting reform, traditional SOEs and shareholding SOEs still coexist in China.

3.3 The Separation of Government's Roles as Owners and Regulators of SOEs

The role of government or state in the SOE reform is a problematic yet very basic

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[276] Jiahua Che and Yingyi Qian (1998) Insecure Property Rights and Government Ownership of Firms *The Quarterly Journal of Economics*, MIT Press, 113(2), 467-496

[277] Xu Xiaosong *Guoyou Qiye Zhili Falv Wenti Yanjiu* (Research on Legal Issues Relating to Governance in SOEs) China University of Political Science and Law Press, 2006, 6-9

[278] (a) Is the good excludable? Can people be prevented from using the good? (b) Is the good rival? Does one person's use of the good diminish another person's enjoyment of it?

[279] Mankiw, above note 18, at 218-219

issue, which can be observed clearly in the first section. Specifically, this section focuses on the dual roles played by the government in SOEs.

On the whole, the transformation of Chinese economy from a planned economy to a market economy including SOE reform is basically a top-down approach, mainly driven by the Chinese Central Government. During this process, the central government and local government often act as both referee and player in the economy; actually, one of the objectives of the SOE reform is to separate the role of the state as the owner of SOEs and the other role as the regulator. In essence, the core issue in the SOE reform is to clarify the relationship between the government and SOEs, which is also highly conducive to good corporate governance.

Before any further elaboration, a short detour is necessary to review the background of the government's role in enterprises from a global perspective. In the 1980s and 1990s, there was a trend for privatization around the world. To quote from Nikolaos, "this trend is by no means confined to developed countries. Privatization has spread like wildfire in the underdeveloped countries of Africa, the stagnant economies of Latin America, and even the impressive 'tigers' of Asia."[280] During the long debate over the position or function of market and state in the economy, the market system finally convinced more people with its virtues highly emphasized by a majority of scholars and officials.[281] State ownership is generally regarded by the economists as inefficient, which could not be compatible with the market economy.[282] That is why most of the countries or regions in the world established and maintained the market economy system. In England, the privatization of SOEs was driven by the New Conservatism or Thatcherism, which is generally based on the virtues of the free market.[283] However, massive privatization has never been embraced by China.

From 1950s to 1980s, the mainstream for the economic approach was how to increase output and how to invigorate SOEs under the framework of public ownership or state ownership. In the 1990s, several official documents made it clear that China would build a Socialist Market Economy with a mixed ownership.[284] To date, China has almost finished its transitional process changing from a central-planned economy to a

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[280] See Nikolaos Zahariadis *Markets, States, and Public Policy Privatization in Britain and France* The University of Michigan Press, 1995, 1 Also see, for example, Raymond Vernon (ed), *The Promise of Privatization* New York Council on Foreign Relations, 1988, William Glade (ed), *Privatization of Public Enterprises in Latin America* San Francisco ICS for the International Center for Economic Growth, 1991, and V V Ramanadham (ed), *Privatization in Developing Countries* London and New York Routledge, 1989

[281] See Zhang and Yuan, above note 177, at 12-13

[282] Andrei Shleifer (1998) State versus Private Ownership *Journal of Economic Perspectives*, 12 (4) 133-150 For sure, such a proposition is still debatable as commented in literature review part (Chapter 2)

[283] Specifically speaking, there are four pillars accounting for the privatization in England government activity is viewed with suspicion, Conservatives have a deep distrust of SOEs, Conservatives have hostility toward unions, particularly the ones in the public sector, Conservatives support the free market on moral grounds See Zahariadis, above note 280, at 58-60

[284] One of the most important documents is Decision of the CCCPC on Some Issues concerning the improvement of the Socialist Market Economy Adopted at the 3rd Plenary Session of the 16th CPC Central Committee on Oct 14th 2003

market economy.[285]

The following part elaborates the role of the state in SOEs from three different perspectives: (1) ownership policies, (2) capital allocations and (3) the way to perform as the owner or investor and regulator. The last two perspectives may slightly overlap in the capital allocation, because how to perform as the owner will unavoidably relate to the financial issues.

3.3.1 Ownership Policies

State ownership has been placed in a commanding position since Communist Party of China (CPC) adopted Marxism-Leninism as its theoretical guidance, which could be manifested by many provisions in the Constitution of PRC. For example, Article 7 stipulates that the state-owned economy, also called the socialist economy under ownership by the whole people, is the leading force in the national economy.[286] Orthodox Marxism is characterized by distinguishing socialism from capitalism in terms of a planned economy and a market economy. Deng Xiaoping radically broke such boundaries between socialism and capitalism by claiming that "social practice is the only criterion of seeking truth". Gradually, more practices departed from the orthodox Marxism; still, China theoretically follows the Marxism, a living Marxism and socialism with Chinese characteristics. Even though the report of Jiang Zemin at the 14th National Congress of CPC in 1992 called for the establishment of a socialist market economy with a mixed ownership, it still emphasized the dominant position of state ownership in such a system.

In theory, state ownership means that the ownership is shared by the whole people. Nevertheless, in practice, the state assets in the traditional SOEs or the state shares in the shareholding SOEs have to be held by certain agencies. According to one careful study of a sample of 1105 enterprises, state control including control by state wholly owned holding companies or state-controlled non-listed holding companies in 2001 reached 84% of the total.[287]

There are mainly four kinds of agencies in China: certain central ministries or commissions, central SASAC, local ministries or commissions and local SASAC.[288]

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[285] In Adam Smith's great book, *An Inquiry into the Nature and Causes of the Wealth of Nations* in 1776, he described how people interacted in the market economy systematically for the first time and concluded that the participants in the economy were motivated by self-interest and the invisible hand of the market guided the self-interest into promoting general economic well-being While for US and EU, they have their own standards for measurement respectively See Adam Smith (1723-1790), *An Inquiry into the Nature and Causes of the Wealth of Nations* Oxford Clarendon Press, 1976

[286] See Article 7 of the Constitution of PRC 1982 The state-owned economy, namely, the socialist economy under 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

[287] See Yusuf, above note 71, at 89 For details, see Guy S Liu and Sun Pei (2003) Identifying Ultimate Controlling Shareholders in Chinese Public Corporations An Empirical Survey *Asia Programme Working Paper* 2, the Royal Institute of International Affairs, London, Guy S Liu and Sun Pei (2005) "China's Public firms How Much Privatization" In Stephen Green and Guy S Liu (eds) *Exit the Dragon? Privatization and State Control in China* Malden, MA Blackwell Publishing, 2005

[288] Research Center of SHSE *Report of Corporate Governance in China (2006) Corporate Governance of State*

Take the listed SOEs for example, the state shares of 38 SOEs are held by the central ministries or commissions (such as Ministry of Commerce, MOF, Ministry of Science and Technology, and Ministry of Education), 129 SOEs held directly by the central government, 152 SOEs by local ministries or commissions and 268 by local government, which are shown in the following table 3.2:

Table 3.2: Listed SOEs Classified by the Majority Shareholder[289]

Types of the Majority Shareholders / Quantity/ Proportion	State Shares				Non State Shares	
	Central Ministries or Commissions	Central SASAC	Local Ministries or Commissions	Local SASAC	Natural Persons	Collective Enterprises
Quantity (Companies)	38	129	152	268	221	23
Proportion (%)	4 57	15.52	18 29	32 25	26 59	2 77
Total Assets (RMB 100 Million)	20 77	122 58	26 19	33 14	17 09	38 40

In 1997, the famous economist Xiao Zhuoji, who has insights into quite a few key theoretical problems with respect to Chinese economic development and reform, argued in the People's Daily: "the dominance of public ownership should be measured by both 'quantity' and 'quality', but the latter is more important. It is not accurate to use quantity as the criterion of the judgment as people usually do".[290] The restructuring of SOEs into various non-public sectors was exactly a practice that moved toward a quality-oriented direction.

As to how the policy of ownership has changed, it can be observed explicitly through four amendments (1988, 1993, 1999 and 2004) to the Constitution of the PRC enacted in 1982 (before the 1982 Constitution, there were 1954, 1975 and 1978 Constitution in the history of the PRC). Since the private or non-public modes of production contributed a lot to the whole economy, new understandings of their roles in the whole structure of socialist economy were written into the Constitution. Accordingly, these amendments are not concerning state ownership but the changing position of private economy in the national economy.

The following Table 3.3 shows the gradual change of the state's attitude towards private economy or non-public sector in the economy system, which is placed in an increasingly favourable position. Along with the amendments are the subtle change of the relationship between the state and SOEs. As has been illustrated in the previous sections, a large amount of small and medium-sized SOEs were restructured and appeared in other forms or bankrupted directly. Only certain large SOEs or SOEs in sectors vital to the national economy or national security still keep a controlling stake;

Holding Listed Companies Fudan University Press, 2006

[289] Source Ibid

[290] Xiao Zhuoji (1997) The Major Breakthrough of Ownership Theory, a report in the People's Daily

after share structure reform, state shareholders will still keep their controlling position in certain sectors.[291]

Table 3.3: Amendments to the Constitution of PRC 1982[292]

The Constitution of PRC 1982: Article 11	The individual economy of urban and rural working people, operating within the limits prescribed by law, is a complement to the socialist public economy. The state protects the lawful rights and interests of the individual economy. The state guides, assists and supervises the individual economy by administrative control.
Amendments (1988) to the Constitution of PRC: A new paragraph of Article 11	The 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. The state protects the lawful rights and interests of the private sector of the economy, and exercises guidance, supervision and control over the private sector of the economy.
Amendments (1999) to the Constitution of PRC: Article 11	The non-public sector, including self-employed and private business, within the domain stipulated by law, is an important **component** of China's socialist market economy. The state shall **protect** the lawful rights and interests of the self-employed and private enterprises, and exercise guidance, supervision and management over them according to the law.
Amendments (2004) to the Constitution of PRC Article 11.2	The state protects the lawful rights and interests of the non-public sectors of the economy, including individual and private sectors of the economy. The state **encourages, supports** and guides the development of the non-public sectors of the economy, and exercises supervision and control over the non-public sectors according to law.

3.3.2 Capital Allocations

In 1983, for the first time, SOEs were required to pay enterprise income tax and regulation tax instead of transferring all their profits to the state.[293] It was known as breaking up the "sharing rice pot" (*da guo fan*) and invigorating SOEs. When the contracting system was established in 1986, the new policy of "tax payments for profit delivery" was displaced by the contract management responsibility system. The basic principle of the contracting system was "fixing the basic quota, guaranteeing the remittance, retaining what exceeds the quota, and making up what falls short of the quota".[294] It was another measure which aimed to promote the profit motives of SOEs. All these measures were supposed to improve the financial relationship between the state and SOEs as introduced by the tax policies and regulations, with the underlying objective of enlarging the budget revenue.

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[291] Available at: http://english.peopledaily.com.cn/200506/18/eng20050618_190980.html
[292] Available at: http://www.lawinfochina.com.easyaccess1.lib.cuhk.edu.hk/Law/list.asp
[293] See Zhang and Yuan, above note 177, at 25-27.
[294] Wu, above note 33, at 147.

For purposes of establishing a modern enterprise system and properly adjusting the profit distribution between the state and enterprises, the 1994 tax reform required that SOEs pay income tax to the state at a unified rate 33%, and retain any other profits. Following the fiscal and taxation system reform of 1994, most SOEs were exempted from paying dividends (profits after tax) to the state. According to Section 4.1 - Change SOEs' Profit Distribution System of the *Adoption of a Dual-System Regime for Taxation*, the majority of wholly state-owned enterprises registered before 1993 are exempted temporarily from paying the profit after tax. This policy was based on the consideration that profits paid by some SOES at that time were extremely low.[295] However, such a "temporal" practice was not repealed until 2007. In the internal system of SOEs, listed SOEs paid dividends to their minority shareholders and the controlling shareholder, namely their non-listed parent companies, and their parent companies retained all profits rather than passing them to the state.[296]

The policy of no dividends to the state was changed along with the huge profits made by SOEs (see the following two tables showing the income and profit earned by SOEs). In fact, the practice of no dividends was regarded as one of the reasons for excessive and even wasteful investment, ultimately leading to vicious competition. In some cases, SOEs with good performance used their huge profits to benefit their management and employees, who could get higher salaries than the average, cash bonus and other welfare.

Scholars increasingly suggested abolishing such a practice. Governmental officials also began to realize that as a shareholder of SOEs, the state should enjoy the rights and interests derived from SOEs; therefore, the state should collect dividends, or it would be meaningless to be a shareholder.[297] On the other hand, no dividends mean SOEs can achieve privileges from its owner. The World Bank also recommended large SOEs to pay dividends to central government.[298] The State Council issued an order *Opinions of the State Council on the Pilot Implementation of the State Capital Operating Budget* in 2007, which was incorporated into the *Law of State-Owned Assets* in 2008.

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[295] State Council's Decision on Adoption of a Dual-System Regime for Taxation, GUOFA [1993] No 85, issued on December 15 1993

[296] World Bank policy note (2005) *SOE Dividends How Much and to Whom?* Available at http //www worldbank org cn/english/content/SOE_En_bill pdf

[297] Available at http //www ce cn/xwzx/gnsz/gdxw/200606/11/t20060611_7295180_1 shtml

[298] The large SOEs overseen by SASAC made net profits of 299 billion RMB during the first half of 2005 and 400 billion RMB in 2004, according to the report of World Bank The World Bank said a sound dividend policy for China's SOEs could enhance the efficiency of re-investments by SOEs and improve the overall allocation of public financial resources, and corporate sector saving including those by SOEs is a key contributor to China's high rates of saving and investment Available at http //english peopledaily com cn/200602/12/eng20060212_242002 html

Table 3.4 Income and Profit of SOEs[299]

Year	Income (Trillion RMB)	Profit (Trillion RMB)	Ratio of Profit to Income
2002	8.53	0.38	4.5%
2005	11.5	0.90	7.8%
2007	18	1.62	9%
2008	21.05	1 18	5.6%
2009	22.51	1.34	5.9%

(Source: Websites of MOF, SASAC and NBS.)

Table 3.5 Income and Profit of Central SOEs[300]

Year	Income (Trillion RMB)	Profit (Trillion RMB)	Ratio of Profit to Income	Ratio of Profit of central SOEs to that of all SOEs[301]
2002	3.36	0.24	7%	63.16%
2005	N/A	0.64	N/A	71.11%
2007	9.84	0.99	10%	61.11%
2008	11.5	0.64	5.6%	54.24%
2009	14.35	0.94	6.6%	70.15%

(Source: Websites of MOF, SASAC and NBS.)

The state capital operating budget system carries out budget administration of the income and expenditures of state-owned capital.[302] It required that enterprises with state capital shall turn over the proceeds to the state, which contain the profits, bonuses and dividends, income from the transfer of state-owned property (including state-owned shares) of an enterprise, income from the liquidation of a wholly state-owned enterprise and other income. Accordingly, the state should be responsible for some kind of expenditure, the capital expenditure, (arranged according to the requirements of the industrial development plan, adjustment of the layout and structure of the state-owned economy and development of the state-owned enterprises as well as the needs for the national strategies and security), expense expenditure (making up the costs and expenses for the reform of state-owned enterprises, etc.) and other expenditure.

This new system means that SOEs need to not only pay the enterprise income tax to the state, but also turn over certain of their profits to the state. For shareholding SOEs, the state can enjoy the dividends as a shareholder; for the traditional SOEs, the state can benefit in other forms from their commercial activities. On the other hand, the

[299] According to MOF, SOEs here in their annual report exclude financial SOEs in China

[300] According to MOF, the central SOEs here in their annual report refer to both SOEs under the management of SASAC and SOEs subject to the 82 central ministries and commissions

[301] It is obvious that most profits of the SOEs came from the central SOEs, while most profits of the central SOEs was contributed by the limited monopolized companies like PetroChina, Sinopec, CNOOC, China Mobile, China Telecom, Baosteel, China Shenhua, China Aluminum and the State Grid Available at http //www atimes com/atimes/China_Business/II26Cb02 html

[302] See Article 58 of The Law of on State-Owned Assets of Enterprises

bodies performing the investor's functions on behalf of the state will enjoy the decision about how to use the profits from state-owned capital.

Such a system shifts the profits allocation and corporate investment from the individual enterprise to SASAC and other departments or bodies which perform the investor's functions for SOEs on behalf of the corresponding people's government. On the other hand, it makes the financial relationship between the state and SOEs clearer. It is an independent system in parallel with the national budget system, which means that if the fund for SOEs comes from the operating budget system of state-owned assets, it is both reasonable and lawful. A latest example is that, SASAC has just infused a fund from state capital operating budget to five electricity generation SOEs, whose facilities were destroyed by the terrible Sichuan Earthquake; the purpose of the fund injection was to assist the electricity generation SOEs in their efforts to recover construction in the area struck by the earthquake.[303]

3.3.3 The Way to Perform as the Owner and Regulator

There are three typical ways for the state to exercise the ownership rights. The traditional type is a decentralized model or sector model, where SOEs are subject to relevant sector ministries or line ministries; the second type is a dual model, where both the sector ministries and a central entity are responsible for SOEs; and finally it is the centralized model, in which the ownership function is performed by one main ministry or entity.[304]

As discussed in the previous section, an absolute centralized organization was presented by the structure of Chinese SOEs in the 1960s, while the absolute centralized organization prevalent during that period is different from the centralized model. Specifically, the state was once the only owner and regulator of SOEs when Chinese economy was dominated by public ownership. It is the state as a whole rather than one ministry or entity at the central level that manages SOEs.

Decades later, the state has tried to separate the administration from the daily management and operation of SOEs with a variety of models in the late 1980s. An important attempt at the central level to separate the management function of government from state assets oversight was in 1988, when the central government established the National State Asset Administration Bureau (NSAAB).[305] However, the transfer of ownership functions from line ministries to the NSAAB and MOF met strong resistance from line ministries; and the comprehensive ministries such as the State Economic and Trade Commission (SETC) and State Economic Restructuring Commission, could not reach a consensus either. During the government reorganization in 1998, a compromise was made that most line industries were

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[303] Available at: http://www.eeo.com.cn/Politics/beijing_news/2009/02/20/129886.shtml

[304] See OECD, above note 112, at 42-68.

[305] It was under the guidance of the MOF and reported to the State Council directly. See Tenev and Zhang, above note 39, 25.

merged into SETC with their ownership functions transferred to different comprehensive ministries, and NSAAB was dissolved.[306] Therefore, the efforts to separate the regulatory and ownership functions failed. The main drawback associated with the sector model is that it makes the clear separation of the ownership function from regulatory function of the state quite difficult.

Before the corporatization reform, it was the state, as the single owner, who owned all the assets of SOEs. In essence, the corporatization reform introduced the shareholding system, where the state was supposed to be just one of the shareholders of corporatized SOEs. Such a system was embodied in the Company Law 1993. As suggested by OECD in 2005, the state should act as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness.[307]

In effect, the results in China have seldom been very successful. The objective of clearly separating government administration from enterprise management is still regarded as an outstanding challenge. For a long time even after the corporatization reform, the state still acted as both the owner and regulator now and then. It is proved once again that the task of demarcating and clarifying the roles of investor (owner) and managers is by no means easy.

However, the founding of SASAC in 2003 may have made some difference. As an agency empowered to perform the functions and responsibilities of the owner of state-owned assets on behalf of the state in a unified manner, it aims to separate the government's social and public management functions from the role of the investor of the state-owned assets. The broad power and rights bestowed upon SASAC shows the firm determination of the central government to uphold this new institutional framework. One point to note under this framework is that a key objective of SASAC is to perform the responsibilities as an investor of SOEs and protect the state-owned assets. It is reported that "the establishment of SASAC and the promulgation and implementation of *Statute for the Supervision and Management of Corporate State-owned Assets* (tentative) means that the reform of state-owned assets management system of China achieved significant breakthrough and entered a new stage".[308]

In theory, the state now focuses on its role as the regulator for SOEs and the whole national economy, and the role as the owner of SOEs is delegated to SASAC or other bodies. It is generally recognized that the basic role of SASAC is to perform its ownership function. Such an arrangement has been confirmed by Article 6 of the *Law of State-Owned Assets* in 2008.

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[306] Ibid.
[307] See OECD, above note 111.
[308] Available at: http://www.sasac.gov.cn/n2963340/n2964727/n2974401/2976097.html

Article 6: The State Council and the local people's governments shall, according to law, perform the investor's functions, based on the principles of separation of government bodies and enterprises, separation of the administrative functions of public affairs and the ownership functions of state-owned assets, and non-intervention in the legitimate and independent business operations of enterprises.

For shareholders in a corporation, they are entitled to enjoy their shareholders' rights in proportion to their shares and obligated to transfer ownership of their investment to the company. If SASAC, representing the state as a shareholder, invests in corporations, SASAC also enjoys the shareholder's rights, like collecting dividends. On the whole, the different roles of state to act as a regulator and its representatives as investors have been stipulated relatively clear in the form of law for the first time since the establishment of SOEs system.

Nevertheless, whether such a functional division will be effective is up to the future practice. There are two direct challenges. First, SASAC could be a tool for implementing certain auxiliary administrative functions, like the environmental issues, social policy and sanitary policies. Second, SASAC may treat SOEs in an administrative manner.

3.4 Conclusion

This Chapter illustrated and analyzed Chinese SOEs from different perspectives. It finds that SOEs' size, structure, efficiency and other aspects are continuously changing, especially with the number of SOEs constantly shifting. Moreover, SOEs are complicated, considering their large numbers and diversities, their intertwinement with financial reform of China, and their crucial meaning to China. SOEs can be understood better in the context of Chinese economic reform taking into account the characteristics of Chinese economy, like its huge scale, its unique history and its economic and political structure.

By and large, the overall reform of SOEs is market-oriented. For instance, budgetary grant to SOEs was superseded by bank loans, and bank loans are increasingly commercial. The ownership right of the state is further clarified. In particular, SASAC started to collect dividends from SOEs in 2007 to exercise its ownership right.

For the small and medium-sized SOEs, it is obvious that government favoritism is fading; for large SOEs, the government intends to promote their survival capability in the unfettered global competition by various ways to accelerate such process. Although governmental intervention into SOEs has been reduced significantly compared to the early 1990s or 1980s and SOEs have been increasingly subject to the principles of market including relevant market-oriented laws, the unnecessary interference into SOEs still exists.

Chapter 4 Chinese SOEs: Case Studies

On the basis of a systematical introduction to and an exploration of the scope of Chinese SOEs in the previous chapter, this chapter addresses measures adopted by the Chinese government which may be construed as privileges for Chinese SOEs. At first glance, these measures seem to have the potential to constitute subsidies, but the situation is more complex and some measures taken by the government do not actually fall within the scope of a "subsidy" within the meaning of the SCM Agreement. What is more, some measures taken by private bodies which may initially deem out of the scope of the SCM Agreement actually might be included within the scope of a "subsidy". Apart from the pliable nature of the concept of subsidies, subsidies *per se* appear in diverse forms, some of which are easy to observe, however, others may be disguised in various forms.

With these complexities in mind, this chapter selects and focuses on the major blurred or controversial measures relating to Chinese SOEs. Such measures are not easily identified as subsidies, because the causal chain in question is not obvious and it is also a complicated exercise to decide whether the measures at issue could be attributed to the government. On the other hand, some direct measures such as tax preferences, capital infusion and outright grants, are quite easily determined to be subsidies.[309] For this reason, these types of subsidies will not be further discussed.

This Chapter is organized into two main parts. The first part examines seven general measures taken by the government which may affect several industries.[310] As will be illustrated, these kinds of measures are not limited to one SOE or those SOEs in only one industry. On the contrary, they can influence at least most SOEs and even other forms of enterprises such as wholly foreign owned enterprises, joint-equity enterprises and private companies *etc.*

In the second part, three selected industries are discussed further: the iron and steel industry, the auto industry and the electronic information industry. Specific measures that may just impact one of these industries will be covered in this part. A basic orientation to the development of the three industries in China is also necessary.

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[309] In fact, SOEs were imposed higher enterprise income tax for long in China than foreign-invested enterprises The privileges enjoyed by the foreign legal and natural persons in China are named as "super national treatment"

[310] The first measure among the seven measures, undervalued exchange rate, is the allegations by the US of the devaluation of Chinese RMB It is a controversial issue especially whether it could be deemed as a subsidy, which has been discussed extensively in recent years See Robert W Staiger and Alan O Sykes (2008) Currency Manipulation and World Trade, NBER Working Paper No W14600, Aaditya Mattoo and Arvind Subramanian (2008) Currency Undervaluation and Sovereign Wealth Funds A New Role for the World Trade Organization, World Bank Policy Research Working Paper 4668

The first reason for selecting the above three industries is that there exist typical SOEs in these basic industries, especially for the traditional industries like the iron and steel industry and the automobile industry. Secondly, they are key sectors in the overall industrial system, namely, pillar industries which make phenomenal contribution to the national economy. The third reason is that these industries usually involve a wide range of governmental policies, considering that they have a long supply chain and provide a great number of jobs.[311] Last, these industries are the potential areas for more disputes in the framework of WTO.[312] For instance, the iron and steel industry has been problematic in the international trade for a long period.[313] Over the past several years, the United States and some other countries have initiated more and more countervailing duty investigations against China. And many investigations target on the iron and steel products, for instance, the DOC has made a few notices of initiation of countervailing duty investigation (CVD), including: *Circular Welded Carbon Quality Steel Pipe from the PRC*;[314] *Light-Walled Rectangular Pipe and Tube from the PRC*;[315] *Circular Welded Carbon Quality Steel Line Pipe from the PRC*;[316] and *Pre-Stressed Concrete Steel Wire Strand from the PRC*.[317]

4.1 General Measures

The general measures include undervalued exchange rate, preferential loans (the easy access to commercial bank loan and lower interest rate), access to the stock market, debt-equity swap, official export credit, land-use rights and energy subsidies. These measures have been applied generally by the Chinese government. They are summarized from the measures in favor of SOEs adopted by Chinese government of various levels during the SOE reform, the measures specified in countervailing duty investigations against China by its trading partners, the official reports, proposed bills by the US representatives or senators and relevant academic works and so on.

Take the countervailing duty investigations conducted the US as an example; several programs have frequently been considered as countervailable in their preliminary determinations, including provision of inputs for less than adequate remuneration (hot-rolled steel, water, electricity, land *etc.*), preferential lending (government policy lending program, loans provided pursuant to certain programs[318] and loan guarantees

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[311] Probably, this is why many governments have adopted stimulus plans to make sure the survival of their auto sectors in the financial crisis

[312] As of writing, there have been 17 cases relating to the automotive sector Available at http //www wto org/english/tratop_e/dispu_e/dispu_subjects_index_e htm#automobiles

[313] For example, the US launched its famous 201 investigation in June 2001, and imposed definitive safeguard measures upon about 10 kinds of steel products, which made lots of countries responded immediately in a protective manner Since the creation of WTO, there have been 30 disputes focusing on iron and steel products Available at http //www wto org/english/tratop_e/dispu_e/dispu_subjects_index_e htm#steel

[314] 72 Federal Register 36663 (July 5, 2007)

[315] 72 Federal Register 40281 (July 24, 2007)

[316] 73 Federal Register 23184 (April 29, 2008)

[317] 74 Federal Register 29670 (June 23, 2009)

[318] According to the investigation report, preferential loans are provided pursuant to certain industrial policies, Northeast Revitalization Program or five-year plans

from government-owned and controlled banks *etc.*), a series of provincial/local subsidy programs[319] and tax subsidies to FIEs in specially designated geographical areas and so on.

The primary aim of this chapter is to make the social and economic context of each measure as clear as possible, and the technical issue of whether these measures constitute subsidies in the sense of the SCM Agreement will be analyzed in Chapter Six. Admittedly, for some measures, ascertaining the objective and unbiased standard or facts is almost an impossible task.

4.1.1 Undervalued Exchange Rate

China's exchange rate policy is an extremely debatable issue. Expressions of various approaches to China's exchange rate policy can be seen in the burgeoning literature and relevant governmental documents. The reason it is discussed here is mainly due to the fact that over the past few years several bills have been proposed and debated in the US Congress which would allow the US to treat the undervaluation of a foreign currency as a countervailable subsidy.[320] Moreover, "a foreign currency" in those bills implicitly indicates the RMB owing to China's high trade surplus.

Given the contentious nature of the debate, it is not surprising that various opinions coexist. The supporters of those bills believe it is the undervaluation of RMB that promotes the export of a large amount of Chinese products into the US The counterargument holds that exchange rate plays a very limited role in balancing international trade,[321] and China's trade surplus can be attributed to three factors: China's economic structure, adjustments in the location of international production, and the international monetary system.[322] Furthermore, whether the devaluation of a currency is conducive to gaining trade advantage in the long run deserves more demonstration, and the particular circumstance matters for such a judgment.

In some regards, China has significantly reformed its exchange rate. The People's Bank of China (PBOC) issued its landmark Announcement on Reforming the RMB

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[319] The alleged programs are various, including provincial level grants to loss-making SOEs, funds for "outward expansion" of industries, "famous brands" program *etc.*

[320] The proposals by US representatives or senators can be observed in the following bills in the 110th Congress (2007-2008): H.R. 2942 (Currency Reform for Fair Trade Act of 2007), S. 1607 (Currency Exchange Rate Oversight Reform Act of 2007) and S. 1677 (A Bill to Amend the Exchange Rates and International Economic Coordination Act of 1988 and for Other Purposes, also cited as Currency Reform and Financial Markets Access Act of 2007). All these bills are available at this web: http://www.govtrack.us/.

[321] Two examples relating to the limited role of exchange rate: the appreciations of the deutsche mark and Japanese yen against US dollar do not necessarily result in less trade surplus.

[322] Wu also highlighted that China decided to reform its foreign exchange in a controlled manner and in a gradual fashion, while simply moving the exchange rate in the absence of corresponding economic restructuring policies would only hurt China's economy and thus the global economy, since China is one of its driving force. See Wu Xiaoling, "China's Exchange Rate Policy and Economic Restructuring", in Morris Goldstein and Nicholas R. Lardy (eds.), *Debating China's Exchange Rate Policy*, Peter G. Peterson Institute for International Economics, 2008, 355-362.

Exchange Rate Regime in 2005.[323] Pursuant to this Announcement, starting from July 21, 2005, China will reform the exchange rate regime by moving into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies.[324] Since then, the RMB has no longer been pegged to the US dollar and the RMB exchange rate regime has been slightly more flexible. As is well known, the RMB exchange rate has significantly appreciated since 2005: the exchange rate of the US dollar against the RMB was adjusted to RMB 8.11 per US dollar on July 21, 2005; it is about RMB 6.82 in the first half year of 2009.[325]

Furthermore, in theory, the determination of equilibrium exchange rate is also very complicated. There are several theories and their variations relating to equilibrium exchange rate: different forms of Purchasing-Power Doctrine, Fundamental Equilibrium Exchange Rate (FEER) which is one derivative of General Equilibrium Model, Natural Real Exchange (NATREX) and Behavioral Equilibrium Exchange Rate (BEER) etc.[326] Needless to say, different theories produce different outcomes about the equilibrium exchange rate. Therefore, another challenging problem is how to determine the proper exchange rate. Consequently, it is uncertain whether there exists the currency manipulation.[327] The accused currency manipulation could only be suspected rather than substantiated, due to the lack of positive evidence.

Put the factual issues and economic theories aside first, the fundamental legal issue whether the manipulation of a currency is subject to the jurisdiction of WTO is already very questionable. A report by the US Congressional Research Service, *Currency manipulation: The IMF and WTO* on January 27, 2009, analyzed and compared the composition of the term "subsidy" and "exchange rate" but ended up with few similarities.[328] The report then concluded that "currency manipulation would not appear to qualify under the WTO definitions" and the existing WTO rules, because of its adoption of the GATT rules without fundamental change, have not been adjusted to reflect the reality of international finance.[329] On the contrary, the Articles of Agreement of the International Monetary Fund (IMF) explicitly prohibit manipulating currency, but even if China were violating this Articles, the IMF has no enforcement capability.[330]

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[323] See Announcement No. 16 [2005] of the PBOC on Reforming the RMB Exchange Rate Regime.
[324] Ibid.
[325] The daily figure is available at the website of the PBOC: http://www.pbc.gov.cn/huobizhengce/huobizhengcegongju/huilvzhengce/renminbihuilvjiaoyishoupanjia.asp.
[326] Zhu Tuohua, *Renminbi Huilv Wenti Yanjiu* (On the Exchange Rate of Chinese Renminbi). Beijing: the People's Press, 2007, 3-20.
[327] The similar point is also supported by other articles. For instance, see Bryan Mercurio & Celine Sze Ning Leung (2009): Is China a "Currency Manipulator"?: The Legitimacy of China's Exchange Regime Under the Current International Legal Framework. *The International Lawyer*, 43(3): 1257-1300, which states "no estimation method can authoritatively conclude that the RMB is misaligned (not to mention precisely stating the extent of misalignment)".
[328] See Jonathan E. Sanford: *Currency Manipulation: The IMF and WTO*. Congressional Research Service Report for Congress (May 8, 2008), www.fas.org/sgp/crs/misc/RS22658.pdf.
[329] Ibid.
[330] Ibid. In any event, it is not even clear that China violates the IMF Articles. See Mercurio & Leung, above note

4.1.2 Preferential Loans

Preferential loans are a common item in the CVD investigations against China. Broadly speaking, preferential loans mean that SOEs receive privileges when getting loans from the banks owned or controlled by the state. This measure is also quite disputable, which can be analyzed from two points. The first point is whether it is easier for SOEs to get bank loans than other kinds of firms under similar conditions; and the second one is whether the loan interest rates to SOEs extended by state-owned commercial banks (SOCBs) are lower than other commercial loan interest rates.

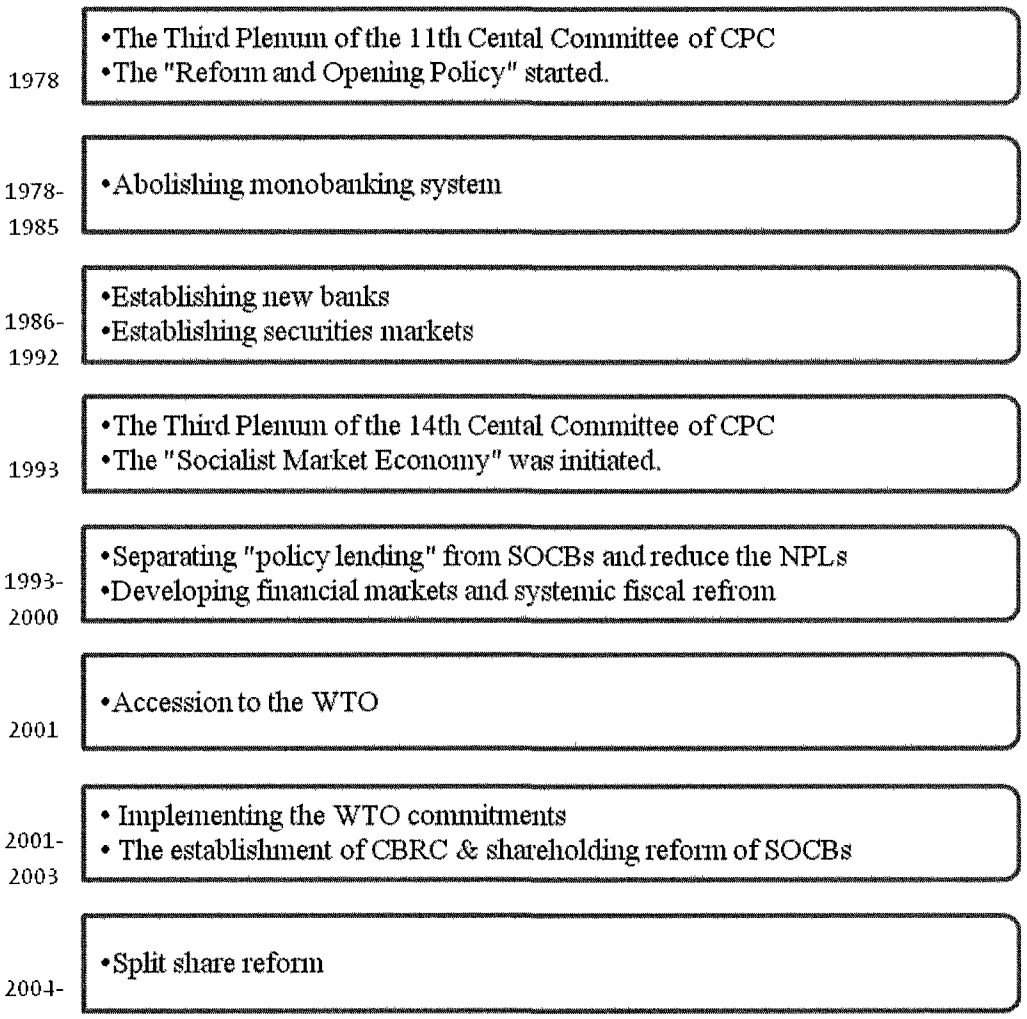
One key element for understanding this measure is time. Along with the reform of Chinese banking system, incredible changes to SOCBs have occurred. Two decades ago, SOEs did face little constraint on getting loans from banks, and the loans extended by banks were usually named as policy loans.[331] China's banking system has undergone substantial improvement in the course of a market-oriented financial reform during the past two decades, especially the last decade.

The following figure shows the process of how China's banking system has been reformed since 1978. Although there is no clear line between these periods, China's accession into the WTO in conjunction with the disposal of a large amount of non-performing loans (NPLs) accumulated by the banks turned over a new page for the further reform of the banking system.

327, at 1257-1300.

[331] The details with regard to policy loans have been discussed in Chapter Three

Figure 4.1 the Banking Reform in China



To better understand the measure at issue, the historical track of the banking system reform in China is illustrated briefly as follows:

Similarly to SOEs, the reform strategy for banking system has also adopted a gradual or incremental approach. China's banking system has played a much more important role in the Chinese economy in terms of size relative to its stock markets. The ratio of China's bank credit to GDP (1.11) was higher than even the German-origin countries (with a weighted average of 0.99) in 2002.[332]

Before 1978, the banks were subordinated to the central government, whose major function was to implement the credit plan and cash plan designated by the authority.[333] China's central bank PBOC was structured according to the nationwide

[332] See Franklin Allen *et al.* (2005): Law, Finance, and Economic Growth in China. *Journal of Financial Economics*, 77, 57-116.
[333] See Wai Chung Lo, "A Retrospect on China's Banking Reform" in Hung-Gay Fung and Kevin H. Zhang (eds.),

administrative hierarchy, with branches established at the provincial, municipal and county levels (such a banking system is characterized as a 'monobank').

As mentioned in Chapter Three, to replace direct budgetary grants to SOEs, four specialized banks were resumed or established in the late 1970s and early 1980s to finance SOEs, however, the banks were obliged to serve the state in the way of providing policy lending to SOEs. The four banks were totally owned by the state at the beginning, therefore named as state-owned commercial banks.[334] Up to then, a two-tier banking system had been formed with the PBOC playing the role of central bank. SOEs during this period were especially famous for their soft budget constraints and easy access to soft lending.

The year 1993 is a historic year in the Chinese history for the financial system reform because it represents a substantial shift towards market mechanism. The State Council made a decision to separate policy lending from commercial lending with a view to transforming the SOCBs into genuine commercial banks.[335] Subsequently, three policy banks were established in 1994 to concentrate on policy lending. To supplement the SOCBs and encourage competition in the commercial banking sector, a few shareholding banks were created in the 1990s, like the Bank of Communications, China Everbright Bank, China Minsheng Bank, China Merchants Bank, Shenzhen Development Bank, etc.[336]

As the Asian financial crisis erupted in 1997, the Chinese government held the First National Financial Conference and advanced the financial reform with a series of decisive measures, including the capital injection to the SOCBs, disposal of massive NPLs and the adoption of a fifth-grade loan classification system to enhance the risk awareness of banks.[337] Then ownership and institutional reforms were initiated following the Second National Financial Conference in February, 2002. The SOCBs were reorganized into joint-stock commercial banks with the introduction of overseas strategic investors. Central Huijin Investment Co., Ltd. (Central Huijin) [338] established in December 2003, currently acts as the controlling shareholder of SOCBs (see Table 4.1 below) as a real "principal" in the newly restructured SOCBs. Central Huijin, previously rendered in English as the "China SAFE Investment Limited", is

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Financial Markets and Foreign Direct Investment in Greater China. M.E. Sharpe, 2001, 38-53.

[334] They are The Agricultural Bank of China (ABC), Bank of China (BOC), The People's Construction Bank of China (renamed as the China Construction Bank (CCB), and Industrial & Commercial Bank of China (ICBC).

[335] See Decision on Issues Concerning the Establishment of a Socialist Market Economic System, adopted by the Third Plenary of the 14th CCCPC in November 1993.

[336] See Wai Chung Lo, "*A Retrospect on China's Banking Reform*" in Fung and Zhang (eds.), above note 333, at 38-53.

[337] See Liu Chunhang, "*Reform of State-Owned Commercial Banks: from Disposing of Non-Performing Assets to Institutional Reform*", in Wang Mengkui (ed.): *China in the Wake of Asia's Financial Crisis.* Routledge, 2009, 84-97.

[338] Central Huijin is an investment company wholly owned by the PRC government and was established with the approval of the State Council under the Company Law. Central Huijin was controlled by the State Administration of Foreign Exchange before September 2007.

controlled by China Investment Corporation (CIC)[339] after September 2007. The members of Central Huijin's Board of Directors and Board of Supervisors are appointed by and are accountable to the State Council directly, and Central Huijin does not conduct any other business or commercial activity with its focus on exercising the investor's functions.[340] According to the introduction of Central Huijin at its official website, it does not intervene in the day-to-day business operations of the companies in which it has a stake.[341]

Table 4.1 The Shares Held by Central Huijin in the SOCBs

As of June 30, 2009

SOCBs	Type	Date of the investment by Central Huijin	Ratio of Shares Held by Central Huijin
ICBC	Joint-stock company	April 22, 2005	35.41%
BOC	Joint-stock company	Dec. 30, 2003	67.53%
CCB	Joint-stock company	Dec. 30, 2003	48.23%
ABC	Joint-stock company	Oct. 29, 2008	50 00%

Source: the official website of Central Huijin.

Shortly after shareholding reform, CCB (in 2005), BOC (in 2006) and ICBC (in 2006) were floated on domestic and international capital markets and diversified their ownership structure. The ABC is not floated yet as of the end of 2009.[342] The reform of the SOCBs has achieved remarkable outcomes which can be observed from their main financial indicators (see Table 4.2 below).

Table 4.2 Main Financial Indicators of the SOCBs (2009)

	Return on Assets (%)	Return on Equity (%)	NPLs Ratio (%)	Provision Coverage Rate (%)	Capital Adequacy Ratio (%)
ICBC	1.20	20.14	1.54	164.41	12.36
BOC	0.97	16.44	1.52	151.17	11.14
CCB	1.10	20.9	1.50	175.77	11.70
ABC	0.82	20.53	2.91	105.37	10.07

Source: Annual reports of ICBC, BOC, CCB, and ABC.

Hence, SOCBs, the nationwide or regional commercial banks, in conjunction with other forms of banks are expected to provide commercial lending. For the last decade, these commercial banks including the SOCBs have formally adopted new corporate management structures including modern risk controls, external auditors, centralized

[339] China Investment Corporation was established on September 29, 2007 with the issuance of special bonds worth RMB 1 55 trillion by the Ministry of Finance Central Huijin was merged into CIC as its wholly-owned subsidiary company in September 2007 CIC is not a common investment bank, since, in essence, the fund it manages is the sovereign wealth fund of China See http //www china-inv cn/cicen/index html

[340] Top executives' roles of Central Huijin were assumed by government officials See Peng Yuanyuan *the Chinese Banking Industry Lessons from History for Today's Challenges* Routledge, 2007, 9

[341] See http //www huijin-inv cn/hjen/aboutus/aboutus_2008 html?var1=About

[342] It is reported that ABC is ready to get listed in the next few years Available at http //finance sina com cn/stock/t/20090117/04535772845 shtml

loan committees, and independent supervisory agencies.[343] The SOCBs also introduced financial indicators such as economic value added (EVA) and risk-adjusted return on capital (RAROC) and more market-based incentives in human resources management.[344] They are subject to the Commercial Banking Law of 1995 (Revised in 2003). In accordance with Article 4 of the Commercial Banking Law of 2003, these commercial banks shall make their own decisions and assume the risks independently[345]:

> *Commercial banks shall work under the principles of safety, fluidity and efficiency, with full autonomy and assume sole responsibility for their own risks, profits and losses, and with self-restraint.*
>
> *Commercial banks shall carry out business in accordance with laws free from any interference by entities or individuals.*
>
> *Commercial banks shall bear civil legal liabilities independently with all their properties as legal persons.*

Article 41 of the Commercial Banking Law[346] further emphasizes the independence of the commercial banks: "*No entity or individual may coerce a commercial bank into granting loans or providing guarantee. A commercial bank shall have the right to refuse any entity or individual to force it to do so.*"

Nevertheless, Article 34 of the Commercial Banking Law of 2003[347] seems to counteract at least slightly the independency of the commercial banks as it states that commercial banks are supposed to lend under the guidance of the state policies.

In terms of improvements in the external environment, a critical event in the banking system in 2003 was the establishment of China Banking Regulatory Commission (CBRC), which was designed to take over the supervisory role of PBOC.[348] The official initiation of CBRC is to improve the efficiency of bank supervision and to support PBOC to focus on the management of macro economy and currency policy. To date, CBRC has formulated and released hundreds of rules and regulations, such as the "*Directives on Corporate Governance and Relevant Supervision of State-Owned Commercial Banks*", "*Management Measures for Capital Adequacy*

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[343] See Jonathan Anderson (2006): Five Persistent Myths about China's Banking System. *The Cato Journal*, 26(2), 243-250.
[344] See Liu, above note 337, at 84-97.
[345] See Article 4 of the Commercial Banking Law of 2003.
[346] See Article 41 of the Commercial Banking Law of 2003.
[347] See Article 34 of the Commercial Banking Law of 2003: Commercial banks should carry out their loan business upon the needs of national economy and the social development and under the guidance of the state industrial policies.
[348] According to its website, CBRC is responsible for "the regulation and supervision of banks, AMCs, trust and investment companies as well as other deposit-taking financial institutions. Its mission is to maintain a safe and sound banking system in China". Available at: http://www.cbrc.gov.cn/english/home/jsp/index.jsp.

Rate of Commercial Banks" and "*Methods for Internal Control Assessment of Commercial Banks*" *etc.*[349]

Interest rates liberalization is quite sensitive for the Chinese banks, since even a tiny adjustment will have a significant impact on profits of the banks. The PBOC set the lending and deposit rates of banks with little room for fluctuation in the past. In 2004, PBOC removed the ceiling on bank lending rates yet imposed a binding floor on lending rates, and retained a binding ceiling on deposit rates, and the rates should not be set based on the nature or the size of the firms. It means that the banks can decide their lending and deposit rates with much freedom. The PBOC has long discussed its intention to establish the pricing mechanism of the deposit and lending rates based on market supply and demand and make the market play a dominant role in financial resource allocation. Since 2004, measures relating to market-based interest rate reform have been adopted gradually, and major moves may be taken toward liberalization.[350]

According to a recent report by the World Bank entitled "Formal versus Informal Finance: Evidence from China", firms using formal bank finance[351] grow faster than those financed from alternative channels. The positive association between bank finance and growth is not driven by the firms that government instructs the banks to lend to, in other words, government help in obtaining bank finance (15% of their overall sample firms report that they received help) has no impact on firm performance.[352]

The foregoing introduction provides a background to understand the issue of preferential loans, including government ownership of banks, regulatory environment of the banking system, and interest rates liberalization. Again, time matters here, since SOEs experienced a series of changes dramatically in the 1990s. Until late 1990s, the number of SOEs did not decline obviously. The absolute majority of the firms in China were SOEs. Thus, it is inevitable that they are the major recipients of bank loans. Also, the banking reform, initiated in 1993, pushed further in the direction of commercialized banks gradually. Before the banking reform, the application for loan is more a formality. Therefore, it is meaningless to discuss this issue in a blurred period, like 1990s.

In fact, it has to be admitted that the first issue whether SOEs have easier access to

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[349] Source: the official website of CBRC.

[350] For more about the progress on land market reform, please refer to Academy of Economy and Resources Management of Beijing Normal University: Zhongguo Shichang Jingji Fazhan Baogao 2008 (A Report on the Development of China's Market Economy 2008). Beijing: Beijing Normal University Publishing Group, Sep., 2008, 159-167.

[351] Bank Finance includes local commercial banks and foreign commercial banks.

[352] See Meghana Ayyagari, Asli Demirgüç-Kunt and Vojislav Maksimovic: *Formal versus Informal Finance: Evidence from China*. The World Bank, Policy Research Working Paper 4465, 2008. The World Bank adopted a detailed firm level survey data on 2400 firms across 18 different cities in China to explore how the financing patterns, both formal and informal, vary across different types of firms across cities and regions.

bank loans than other firms under similar conditions is extremely facts intensive. Although it is often reported that SOEs have less trouble to apply for a loan than private firms in China, such a statement is too general with little evidence.

When it comes to the last decade, SOEs have retreated from a number of competitive industries. The amount of SOEs has been reduced dramatically, especially for the small and medium-sized SOEs. It should be noted that many existing SOEs have been performing better and better. Such a comparison faces another challenge, that is, how to define similar conditions for SOEs and private firms. Many factors exist, such as different industries, different size of companies, different credit standing *etc.,* and SOEs in the recent decade have advantages over private firms in terms of the above factors. Given those huge changes and complex factors, it is understandable that most of the bank credit has been diverted to companies in the state and listed sectors.

It is observed that the Chinese commercial banks do not discriminate against private borrowers *per se* but do discriminate against small borrowers, including smaller SOEs, without visible cash flow.[353] The Chinese commercial banks actually prefer to lend to large and established private players, and they even compete aggressively for such lending business.[354] According to the Economic Observer on July 28 2008, a professional Chinese finance newspaper, a manager from the corporate business department of one SOCB said that large SOEs were still their most important customers, because projects were relatively guaranteed (more importantly, they all had group guarantees), and the risks of breaches of contract were relatively low.[355]

As to whether the loan interest rates to SOEs provided by SOCBs are lower than commercial loan interest rates, there are a few technical problems. First, it is necessary to determine the nature of SOCBs, that is to say, whether they are public bodies. The second issue is how to define the commercial loan interest rate in China.

4.1.3 Access to the Stock Market

The development of China's stock market can be described in three stages: the emergence of the stock market (1978-1992) along with the launch of economic reform, the formation and initial development of national stock market (1993-1998) with the adoption of Securities Law as the landmark event, and the further regulation and development of the stock market (1999-now) along with the establishment of China Securities Regulation Committee (CSRC).[356] The development of the stock market has facilitated direct funding of firms in China, which also has promoted the reform of

[353] See Anderson, above note 343, 243-250. The most cited reason for the banks' unwillingness to make loans to smaller firms is their inability to price capital in a differentiated manner.
[354] Ibid.
[355] See Kang Yi and Liu Wei: *State-Owned Chinese Firms Face Credit Drought Risks*. 378 Economic Observer, 3 (July 28 2008). Available at: http://www.eeo.com.cn/ens/Industry/2008/08/01/108947.shtml.
[356] See CSRC, *Zhongguo Ziben Shichang Fazhan Baogao* (China Capital Markets Development Report). China Financial Publishing House, 2008, 1-21.

SOEs. Banks in China are prohibited from investing in non-financial companies, which resulted in companies having very limited channels to finance. Therefore, in this sense, the stock market was a natural choice for facilitating the funding of firms.

On November 26, 1990, the Shanghai Stock Exchange (SHSE) was established officially, as China's first stock exchange.[357] This was quickly followed by Shenzhen Stock Exchange (SZSE) on December 1, 1990.[358] In the early years of China's stock market, the administrative authorities believed that the basic function of the stock market was to raise capital for enterprises, especially for SOEs facing severe capital shortage. Thus they adopted the opinion that "the stock market should serve SOEs".[359] First, SOEs were given priority in IPO (initial public offering) approval to raise funds and get out of financial difficulty; Second, stock prices were often manipulated to raise more funds for companies with listing qualifications, and then they can enjoy high premiums in IPO.[360]

Under a top-down listing quota system, the former State Planning Commission (SPC) set the annual financing plan for state enterprises in the State Plan after comprehensive balancing, and the SPC was also lobbied by ministries and provincial governments.[361] The total amount of allocated quotas for share issuance throughout China was 5 billion in 1993.[362] When local governments selected the companies to be listed, they tended to first consider local SOEs that urgently needed capital infusion, or were socially or economically important, which created a bias against other types of companies.[363] To an extent, getting listed at that time was viewed as a privilege and a fund-raising mechanism owned by Chinese SOEs. For the non-state firms, they had to rely on the informal means of funding, which are expensive yet insufficient. In 1998, CSRC made a notice to further and strongly support the listing of large and medium-sized SOEs.[364] The notice is short but clear: apart from 512 key local SOEs, the 512 key central SOEs should also be given priority if they are qualified to be listed so as to support the reform and development of large and medium-sized SOEs.

The authorities' perception of the function of the stock market was changing. Some officials of CSRC commented that strengthening the shareholding system by listing aimed to develop a diversified ownership structure that would enhance the enterprise

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[357] Available at: http://www.sse.com.cn/sseportal/ps/zhs/sjs/jysjs.shtml.
[358] Available at: http://www.szse.cn/main/aboutus/bsjs/bsjj/.
[359] To be more specific, it means that the government policies boost the stock market and then SOEs grab the money relying on the policies not their own performances. A famous economist, Zhang Weiying, is the first person who made a famous comment that Chinese stock market was turned into a paradise for rent seeking. And soon this metaphor was echoed by the majority.
[360] See Wu, above note 33, 242-244.
[361] See Carl E. Walter and Fraser J. T. Howie: *Privatizing China: Inside China's Stock Markets*, 2nd edition. John Wiley & Sons (Asia) Pte Ltd., 2006, 109-110.
[362] See Fang Liufang (1995): *China's Corporatization Experiment.* Duke Journal of Comparative & International Law, 5, 149-269.
[363] See Tenev and Zhang, above note 39, 75.
[364] See Notice of CSRC Concerning the Strong Support for the Listing of Large & Medium-Sized SOEs (1998).

autonomy.[365] With further improvement of the stock market, it has been regarded a key forum to pursue better corporate governance of SOEs.[366]

Along with the decline of SOEs in numbers and the substantial increase of other types of firms, the structure and players of Chinese stock market have changed considerably. Most importantly, the quota system directed by the government was eliminated, and approval system was adopted accordingly. It is the 1999 Securities Law that significantly changed the candidate selection process for public listing. Securities firms have a broad scope to identify and develop listing candidates and the issuers have the right to choose their own security firms independently.[367] Rules relating to the issuing and trading of shares are generally applicable to both state shares and non-state shares. And CSRC plays a more passive role in reviewing listing application materials, and their focus shifts to make sure the full compliance of listing candidates with relevant laws and regulations.[368]

The listing procedure has been further amended by the Securities Law (2006). For the IPO, the issuer has to be underwritten and recommended. It is reflected by Article 11:

> *An issuer shall, in its application for public issuance of stocks or convertible corporate bonds by adopting underwriting in accordance with the law, or an application for public issuance of other securities for which the recommendation system shall be adopted as specified by laws and administrative regulations, engage an institution qualified for recommendation, as its sponsor.*[369]

To summarize, before the adoption of the Securities Law in 1999, large and medium-sized SOEs were often explicitly favored by the government in terms of listing. The government issued a series of policies in support of the shareholding structure reform of SOEs as well as their funding. Ultimately, governmental intervention has declined gradually, and such process is accompanied by newly instituted laws and regulations.

4.1.4 Debt-Equity Swap

The debt-equity swap is a relatively short-term economic scheme that occurs at a specific period, and will cease functioning when its designated tasks are fulfilled. The adoption of debt-equity swap program in China in the end of 1990s was a tough

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[365] See Walter and Howie, above note 361, at 47.
[366] For more details, see Research Center of SHSE, above note 288.
[367] See Art. 22 of Securities Law of PRC (1999). However, limitations are still evident. There were 29 major securities firms at that time and a securities firm could only have a maximum of four recommendations each year. For the company, it had to go through a restructuring process for at least one year before its IPO is successfully launched.
[368] See Walter and Howie, above note 361, at 109-110.
[369] See Art. 11 of Securities Law of PRC (2006).

decision in a tough environment. As the preceding chapter on Chinese SOE reform has illustrated, SOEs were undergoing a difficult time in the 1990s and the SOEs sector and banking system in China were believed to stay on the verge of collapse.[370]

At that time, the sudden emergence of Asian financial crisis in 1997 alarmed China, but also a great opportunity to reflect its large amount of NPLs and the financial vulnerabilities, especially the serious banking risks thereof. The State Council responded quickly with a high-level National Financial Conference, which decided to launch a series of reforms in financial and banking system.[371] The NPLs were correlated with SOEs closely, however, SOEs had little capability to pay back its huge volume of debts and the banks lacked the resources to deal with the NPLs themselves. One year later, China adapted the asset management company (AMC) model officially to address the NPLs.[372]

(I) Operation of AMCs in China

The AMCs in China were modeled on other jurisdictions' experiences, including Finland, Japan, Sweden and the US. AMCs can be run by private organizations or public bodies. State-run AMCs become an inevitable choice in China, since a public owned AMC would not cause problems such as determining transfer prices.[373] Furthermore, it is hard to imagine that certain private organs in China could resolve such huge NPLs.

This policy was expected to accomplish three things: resolve the NPLs for the SOCBs to prevent financial turbulence; relieve SOEs' huge debt burden; and accelerate the establishment of a modern enterprise system.[374] However, it has to be admitted that this policy may introduce a greater moral hazard problem to state banks and state enterprises.[375]

The typical feature of China's AMCs is bank-specific. On April 20, 1999, the State Council created Cinda AMC as a pilot project to acquire the bad assets from the China Construction Bank.[376] In October 1999, the other three AMCs were established: the Orient AMC for the Bank of China, Great Wall AMC for the Agricultural Bank of

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[370] Steinfeld, above note 4, 258.
[371] Available at: http://cpc.people.com.cn/GB/64162/64165/72301/72320/4981373.html.
[372] See James R. Barth, Zhongfei Zhou, Douglas W. Arner, Berry F.C. Hsu, Wei Wang (eds.), *Financial Restructuring and Reform in Post-WTO China*. Kluwer Law International, 2007, 129-132. Using intermediaries such as AMCs to solve the State commercial bank NPLs problem was recommended as early as 1993 by Zhou Xiaochuan, Wu Xiaoling *etc.*
[373] See Lou Jianbo, *China's Troubled Bank Loans: Work Out and Prevention*. Kluwer Law International, 2001?
[374] See Notice of the State Economic and Trade Commission (SETC) and PBOC on Several Problems relating to the Debt-Equity Swap on July 30, 1999.
[375] See Yingyi Qian and Jinglian Wu, "China's transition to a Market Economy: How Far across the River?" in Nicholas Hope (ed.), *How Far across the River: Chinese Policy Reform at the Millennium?* Stanford University Press, 2003, 31-64.
[376] See Notice of the PBOC, etc. on Establishing China's Cinda AMC No.33 (1999). Beijing, General Office of the State Council, 4 April 1999.

China and the Huarong AMC for the Industrial and Commercial Bank of China. The MOF injected each of the four AMCs with RMB 10 billion.[377] The four AMCs are state-owned financial institutions managing and disposing NPLs, with their own independent legal entities and local branch offices established in certain cities.[378]

Generally speaking, the conversion procedure for dealing with the NPLs can be completed by three steps: the AMCs took over the non-performing assets from the big four banks to certain SOEs, and then the AMCs exchanged the debts for the equity of SOEs; finally the AMCs dissolved the bad debts and achieved their maximum value by auction, biding and various other methods.[379] The biggest challenge here is how the AMCs absorbed the bad debts in an efficient way, or the heavy debt burden has to be taken by the fiscal funds. In other words, taking over NPLs from banks is not the aim, since this step does not ensure that bad assets will be recycled, restructured or managed rather than warehoused.[380]

According to the Notice on Several Problems relating to the Debt-Equity Swap issued by the State Economic and Trade Commission (SETC) and PBOC on July 30, 1999, the AMCs only handled the bad debts of SOEs emerged before 1996 which were created mainly by national policy. It also indicated that the NPLs after 1996 were left to banks themselves, since they were required by the Commercial Banking Law 1995[381] to bear the credit risks of their lending.[382] However, there was an exception for some extremely important SOEs which confronted severe difficulty. Their debts would be tackled even though they emerged in 1996, 1997 and 1998.[383]

This policy targeted 521 key SOEs designated by the state or industrial SOEs established during the seventh plan (1986-1990) or the eighth plan (1991-1995), or the first two years of the ninth plan (1996-2000); furthermore, they must prove that they have the potential to make profits after the debt-equity swap.[384] Through negotiations with local government, SOEs and relevant governmental departments, the State Council selected 601 SOEs, among which 508 SOEs joined the debt-equity swap program.[385]

In the end of 1999, the total assets of SOEs including the state-controlled enterprises

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[377] See Notice of the PBOC, etc. on Establishing China's Huarong, Great Wall and Orient AMC No.66 (1999). Beijing, General Office of the State Council, 21 July 1999.
[378] See Section 2, Asset Management Company Regulations. State Council Decree 2000, No. 297. Beijing, 10 November 2000.
[379] Ibid, Section 3, 4 and 5. Hu Yuancheng: *Guoyou Qiye Zhai Zhuan Gu yu Ziben Jiegou Youhua* (Debt-equity swap of SOEs and optimal structure). Tsinghua University Press, 2004, 62-65.
[380] See Lou, above note 373, at 111.
[381] See Article 4 of the Commercial Banking Law, which has been amended in 2003.
[382] See Zhongfei Zhou: *Banking Laws in China*. Kluwer Law International, 2007, 3. N. Lardy, China's Unfinished Economic Revolution. New York, Brookings Institution Press, 1998, 91-92.
[383] See Notice of SETC and PBOC on Several Problems relating to the Debt-Equity Swap on July 30, 1999.
[384] See Notice of SETC and PBOC on Several Problems relating to the Debt-Equity Swap on July 30, 1999. This document, actually, prescribes a list of five substantial requirements relating to the selection of SOEs.
[385] See "Financial Asset Management Companies", Almanac of China's Finance and Banking 2001. Beijing, Editorial Board of Almanac of China's Finance and Banking, 2001, 49, in Barth *et al.* (eds.), above note 372, 164.

amounted to about RMB 8047.17bn and the total debt was RMB 4949.50bn; hence the debt-asset ratio was as high as 61.98%.[386] By the end of June 2005, the four AMCs converted the bad debt amounting to RMB 376.9bn it absorbed into the equity.[387] By this way, the four AMCs also contributed significantly to the decline in the ratio of NPLs. For instance, the ratio of NPLs was only 15% in 2004.[388]

According to China's State-Owned Assets Supervision and Administration Yearbook (2006), the task of debt-equity-swap was almost completed in 2005. As of 2005, among all the 561 SOEs approved by the State Council joining the debt-equity swap program, 447 SOEs registered as new companies and 80 SOEs terminated the operation of debt-equity swap, which together amounted to 93.9% of the approved SOEs.[389]

(II) The Example of CCB and Cinda AMC

The following part illustrates the example of Cinda AMC buying CCB's debt, to see how this program operates in China specifically.[390]

Shortly after the Cinda AMC was created, CCB sold NPLs of RMB 250bn to it in 1999. Cinda AMC paid by issuing 10-year bonds (annual interest rate 2.25%) with a value of RMB 247bn, and another RMB 3bn was paid by cash.

CCB launched the shareholding reform in early April 2003, setting up a leading group in charge of the coordination and arrangement for the shareholding reform throughout the bank. On June 25, 2004, CCB and Cinda signed the Agreement on the Transfer of Suspicious Loans. According to this agreement, CCB sold suspicious loans of RMB 128.9bn to Cinda and transferred loss loan of RMB 56.9bn without consideration.

One year later, China Construction Bank Corporation was registered on Sep.17, 2004. Central Huijin held 85.228% of the total shares as the controlling shareholder, and China Jianyin Investment Limited[391] held 10.653% as the second major shareholder. By virtue of the NPLs transfer agreement with Cinda AMC and the cash infusion of Central Huijin representing the State Council, shareholders' equity of CCB in 2004 was RMB 194.74bn compared to RMB 186.23bn in 2003.[392]

It then became the task of Cinda AMC to deal with the bad assets taken from CCB. Just like other AMCs, the Cinda AMC took various ways to improve the quality of the

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[386] See Hu, above note 379, at 1.
[387] See China's State-Owned Assets Supervision and Administration Yearbook (2006).
[388] See Loren Brandt and Xiaodong Zhu, "China's Banking Sector and Economic Growth", in Charles W. Calomiris (ed.): *China's Financial Transition at a Crossroads*. Columbia University Press, 2007, 86.
[389] See China's State-Owned Assets Supervision and Administration Yearbook (2006).
[390] Source of the figures used in this example: the websites of CCB and Cinda.
[391] Jianyin is an investment company wholly owned by the PRC government as approved by the State Council.
[392] The data is based on the Annual Report 2004 of China Construction Bank Corporation. Available at: http://www.ccb.com/cn/uploads/1-30.1118994252200.pdf.

bad assets. For CCB, according to the figures in 2008, its shareholder structure changed a lot by introducing foreign shareholders: only 48.17% of its shares were held by Central Huijin and 8.85% by China Jianyin Investment Limited.[393]

4.1.5 Official Export Credit

Broadly defined, an export credit implies that a foreign buyer of exported goods or services can defer payment over a period of time.[394] Export credit support may be provided by an exporter's bank, financial institutions including the export credit agencies (ECAs) or even private companies guided by the governments.[395] Such export credits took place to satisfy the need of the government to promote exports and partly correct the market failure in the private trade finance sector; because the private sector is reluctant to cover certain risks in some buying countries, especially political risks associated with a large size of transaction.[396] Generally speaking, there are supplier credit (the credit is extended by the exporter) and buyer credit (the exporter's bank or other financial institutions lends to the buyer or his bank). Based on their maturity, there can be the short-term credits (usually below two years), medium term (between two and five years) and long-term credits (more than five years).[397]

There are very limited norms to regulate the export credit globally. In addition to the OECD Arrangement on Officially Supported Export Credits (OECD Arrangement), Item (j) and item (k) of Annex I (Illustrative List of Export Subsidies) to the SCM Agreement are related to export credits support. Paragraph 2 of item (k) establishes an exception to the prohibited export credits based on the OECD Arrangement.

In response to the formidable challenges from the global financial crisis, WTO Director-General Pascal Lamy urged governments to support their ECAs to close the liquidity gap in trade finance.[398] However, it is not easy to distinguish WTO-compatible export credits support from the prohibited export credits. To understand the WTO rules relating to export credits, it is first necessary to know about the OECD Arrangement.

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[393] See Changes in Share Capital and Particulars of Shareholders, from the Annual Report 2008 of China Construction Bank, at 88

[394] It is set forth in the OECD Handbook on Export Credits relied on by the EC in *Korea-Commercial Vessels* See Panel Report, *Korea-Measures Affecting Trade in Commercial Vessels* (*Korea-Commercial Vessels*), WT/DS273/R, para 7 316

[395] For instance, Coface in France and Atradius in the Netherlands are private companies, acting as the agents of the government

[396] See Malcolm Stephens *The Changing Role of Export Credit Agencies* Washington, D C International Monetary Fund, 1999, Delio E Gianturco *Export Credit Agencies the Unsung Giants of International Trade and Finance* Westport, Connecticut Quorum Books, 2001

[397] See Jian-Ye Wang *et al* , *Officially Supported Export Credits in a Changing World* Washington, D C International Monetary Fund, 2005, 44

[398] See General Council of the WTO, Informal Meeting of Heads of Delegation, "Lamy Warns Trade Finance Situation 'Deteriorating'" (November 12, 2008), Available at http //www wto org/english/news_e/news08_e/gc_dg_stat_12nov08_e htm

(I) Export Credit in the OECD Arrangement

The OECD Arrangement has become an international practice and also an important international agreement in the field of export credits. The OECD Arrangement "seeks to foster a level playing field for official support ... in order to encourage competition among exporters based on quality and price of goods and services exported rather than on the most favorable officially supported financial terms and conditions".[399] To this end, the OECD Arrangement places limitations on the terms and conditions of export credits that benefit from official support. In particular, two types of official support (government-backed support for an export credit) are identified: official financing support and pure cover.

The genesis of the OECD Arrangement was to bring order to official export financing, especially the interest rate subsidies.[400] OECD Arrangement was negotiated and formalized in 1978. It is neither a treaty nor an OECD Act, but a so-called gentlemen's agreement among its Participants of indefinite duration.[401] The Participants to the OECD Arrangement modify the rules regularly, but the basic framework is unchanged. As of the writing, the latest version is OECD Arrangement 2009.[402]

According to Article 5 (scope of application) of the OECD Arrangement 2009, official financing support includes: direct credits/financing (where the loan is extended by the government of the exporter) and refinancing or interest rate support. Another type of official support - pure cover - refers to the provision of insurance and guarantees with no official financing support. When the Participants provide official financing support for fixed rate loans, they shall apply the relevant Commercial Interest Reference Rates (CIRRs) as minimum interest rates, which is constructed on the basis of government bond yields plus a fixed margin at a particular time. The reason that CIRRs are designed is to correspond to commercial interest rates for "first-class" borrowers.[403] The OECD Arrangement prescribes five principles for the establishment of CIRRs.[404]

(II) Policy banks in China

Official export credits in China are connected with the policy banks. Three policy banks were established in 1994 to undertake the task of providing "policy loans" in accordance with the state objectives and industrial policies.[405] They were also

[399] See Article 1 of the OECD Arrangement 2009.
[400] See Janet West, the Export Credit Arrangement 1978-2008. Available at: http://www.oecd.org/dataoecd/17/24/40594872.pdf
[401] See Article 2 of the OECD Arrangement 2009.
[402] Available at: http://webdomino1.oecd.org/olis/2009doc.nsf/Linkto/NT00000BE6/$FILE/JT03259737.PDF
[403] See Article 15 of the OECD Arrangement 1998.
[404] See Article 19 of the OECD Arrangement 2009: Minimum Interest Rates under Official Financing Support.
[405] The three policy banks are: China Development Bank, China Export & Import Bank and Agricultural Development Bank of China.

designed to reduce moral hazard by separating policy lending from commercial lending and push forward the overall financial reform.[406]

As to the main functions of the three policy-oriented banks in China, they concentrate on lower-interest-rate loans, and long-term policy-oriented business loans to specifically designated clients and business targets.[407] In accordance with the ninth item (loans from the state policy banks) under the notification of China to the WTO in 2001, loans from China Development Bank are mainly directed to infrastructure constructions in energy, transportation, telecommunications and water conservancy, resources development in the middle and western parts of China, as well as technology renovation of some enterprises; loans from Agricultural Development Bank of China are mainly provided for purchase and storage of agricultural and side-line products, forestry construction and water conservancy development; and loans from China Export & Import Bank (China Eximbank) are mostly directed to guarantee for export credit of commercial banks, and a small part is for direct export credit.[408] On the whole, the policy objective of this subsidy is to adjust investment structure as reported by China.[409]

Among the three policy banks in China, the business activities of China Eximbank focus on export credit and some other kinds of international loans.[410] China Eximbank was established as a financial company; nevertheless, its status is similar to ECAs in some OECD countries. It is worth noting that China Eximbank is fully owned by the Chinese government and under the direct leadership of the State Council.

The export credit operated by China Eximbank contains export seller credit and export buyer credit. In 2008, the newly signed export seller credit by China Eximbank amounted to RMB 135.533bn with an actual loan disbursement adding up to RMB 130.04bn; the newly signed export buyer credit amounted to USD 4.934bn with an actual loan disbursement of USD 2.673bn.[411] No details of its loans such as the interest rate, loan amount and repayment period are available at its Annual Report in 2008.

Confronting the volatile and complicated financial situation, the State Council decided to promote the reform of policy banks in the Third National Financial

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[406] Li Yang (editor in chief): *China's Banking & Financial Markets: the Internal Research Report of the Chinese Government*. John Wiley & Sons (Asia) Pte Ltd, 2007, 87.
[407] Ibid.
[408] See Annex 5A to the Protocol: Notification pursuant to Article XXV of the SCM Agreement. See Administration of WTO, above note 3, 95-96.
[409] Ibid.
[410] Available at: http://english.eximbank.gov.cn/. Headquartered in Beijing, the Bank now has over ten domestic business branches and representative offices as well as three overseas representative offices in South Africa (Representative Office for Southern & Eastern Africa), Paris and St. Petersburg.
[411] See the Annual Report of China Eximbank in 2008. Available at: http://www.eximbank.gov.cn/annual/2008.shtml.

Conference in January 2007.[412] The objective is to commercialize the operation of policy banks, which means that the policy banks should take full responsibility for their own risks, losses and profits. However, the objective cannot be realized immediately, thus the policy banks may still have to undertake the policy objectives set by the Chinese Government. According to the Annual Report of China Eximbank in 2008, it combined the concessional and non-concessional credits and then reduced the policy-business-related loss successively.[413]

4.1.6 Provision of Land-use Rights

Before analyzing the policies of land-use rights relating to SOEs, this part first reviews the land ownership in China quite briefly. With regard to the land ownership, the 1982 Constitution of the PRC provides that all land in cities is owned by the State (guojia suoyou) and land in the rural and suburban areas is collectively-owned (*jiti suoyou*), which are called as the socialist public ownership of land. The 1982 Constitution prohibits the buying, selling and transfer of land by organization or individual through unlawful means.[414]

In 1988, a major development in land law occurred, with Article 2 of *Amendments (1988) to the 1982 Constitution of PRC*, for the first time making the land-use rights generally transferable:

> *The fourth paragraph of Article 10 of the Constitution, which provides that "no organization or individual may appropriate, buy, sell or lease land or otherwise engage in the transfer of land by unlawful means", shall be amended as: "No organization or individual may appropriate, buy, sell or otherwise engage in the transfer of land by unlawful means. The right to the use of land may be transferred in accordance with law".*[415]

Following the constitutional amendment relating to land, the land-related rights were also amended in the 1988 Land Administration Law (LAL), which replaced the 1986 Land Administration Law. 1988 LAL provides that the right to use state-owned or collectively-owned land may be transferred in accordance with law. The system of paid-for use for state-owned land (or translated as use by payment of consideration) is established in the 1988 LAL.[416] Therefore, the land should not be used for free based on the land-related provisions.[417]

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[412] Available at: http://news.xinhuanet.com/fortune/2007-01/21/content_5631738.htm.
[413] Available at: http://www.eximbank.gov.cn/annual/2008.shtml.
[414] See Article 10 of the 1982 Constitution.
[415] See Amendment to the Constitution of the People's Republic of China, adopted at the First Session of the Seventh National People's Congress on April 12, 1988.
[416] See Article 2 of the 1988 LAL.
[417] The only exception is that "appropriation of state-owned land use right by the state within the scope prescribed by law is excluded" according to Article 2 of the 1988 LAL.

In 1998, Ministry of Land and Resources (MOLAR) issued a provisional regulation on the allocated land-use right during the reform of SOEs with a view to supporting the SOE reform and promoting the implementation of using state-owned land by payment of consideration.[418] In summary, there are mainly four methods used to deal with land-use rights during the succeeding reform of SOEs: appropriation or allocated land-use rights (*hua bo*), which was a common way before the 1988 LAL; leasing; buying or granted land-use rights (*chu rang*); and converting land-use rights into equity. When the land-use right is involved in the reform of SOEs, the previous allocated land-use right should be leased or sold to the new enterprises in most cases. However, the practices in land-use rights vary significantly by localities depending on their regional factors.[419]

In response to the *Decision of CCCPC on Several Important Issues Regarding Reform and Development of SOEs,*[420] MOLAR also issued a document entitled "*Opinions on Strengthening Land Resource Management and Promoting Reform and Development of SOEs*"[421] in 1999. The Opinions stipulated that the pre-reformed SOEs (traditional SOEs) can use the previous land allocated to them, and the reformed SOEs (shareholding SOEs) can use the land in the form of allotment, if the land use falls within the Catalogue of Allocation of Land, which mainly contains the land for governmental and military use. For instance, for those energy, transportation, and irritation facilities with government support, the land-use right may be provided by allocation.[422] Some reformed SOEs can still use the land by the way of allocating upon certain conditions for the purposes of reducing the burden of SOEs.[423] The usual conditions are: land in use must be assessed, and any extra land must be returned to the government; the land use could not be changed nor leased to others without the permission of the relevant agency; and land-use tenure is usually set for between 5 and 10 years, depending on the land use.[424]

In the year 2003 and subsequent years, a series of laws and regulations were stipulated with a consistent emphasis on the fair and open transaction of land-use rights. Regulation on the Agreement-Based Assignment of State-Owned Land-Use Right was implemented in 2003, which aimed to strengthen the transaction methods with regard to land-use right.[425] In 2004, the State Council issued a Decision on

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[418] See the Provisional Regulation on the Management of Allocated Land-Use Right during the Reform of SOEs. MOLAR [1998] No. 8, March 1, 1998.

[419] See Ross Garnaut, Ligang Song, Stoyan Tenev, and Yang Yao: *China's Ownership Transformation: Process, Outcomes and Prospects*. International Finance Corporation and the World Bank, 2005, 81-86.

[420] It was adopted at the Fourth Plenary Session of the 15th CCCPC in 1999.

[421] See Circular of Ministry of Land and Resources on Printing and Distributing <Opinions on Strengthening Land Resource Management and Promoting Reform and Development of SOEs>, GUOTUZIFA [1999] No.433, November 25, 1999.

[422] See the Catalogue of Allocation of Land. MOLAR [2001] No. 9, October 18, 2001.

[423] See Circular of MOLAR on Printing and Distributing <Opinions on Strengthening Land Resource Management and Promoting Reform and Development of SOEs>, GUOTUZIFA [1999] No.433, November 25, 1999.

[424] See Garnaut *et al.*, above note 419, at 81-86.

[425] See Regulation on the Agreement-Based Assignment of State-Owned Land-Use Right. MOLAR [2003] No. 21, June 11, 2003.

Deepening the Reform of Rigorous Land Management, which required the promotion of distributing the land resources by market.[426]

4.1.7 Energy Subsidies

Generally speaking, energy contains coal, oil, electricity, natural gas, nuclear energy, renewable sources and so on.[427] *Oxford Advanced Learner's Dictionary of Current English* defines energy very briefly: "3[U] a source of power, such as fuel, used for driving machines, providing heat".[428] It affects the national economic security and sustainability, numerous downstream industries, environment protection and the living standards of individuals. Its crucial importance is self-evident. For purposes of the thesis, this section focuses only on policies relating to potential energy subsidies (mainly reflected by energy price).

Energy subsidy is construed broadly by relevant organizations. For instance, the study by International Energy Agency (IEA) in 1999 defined it as "any government action that concerns primarily the energy sector that lowers the cost of energy production, raises the price received by energy producers or lowers the price paid by energy consumers".[429] The common types of energy subsidies include direct financial transfers, preferential tax instruments, trade instruments, and energy-related services provided directly by government at less than full cost.

The difference between the IEA and the SCM Agreement in terms of how to read energy subsidies is obvious. The focus in the SCM Agreement is subsidies to producers rather than consumers, in that production subsidy tends to reduce producers' incentives to minimize costs and then result in less efficient operation and sub-optimal investment.

China is now the world's second-largest energy producer and consumer.[430] On the whole, the energy sector in China is controlled or monopolized by SOEs. Given its pivotal importance, sensitive position and higher risks, it is a very common practice of the other countries to leave the energy sector under the guidance and regulation of the

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[426] See the Decision on Deepening the Reform of Rigorous Land Management by the State Council GUOFA [2004] No 28, 2004 For more information, please refer to Academy of Economy and Resources Management of Beijing Normal University *Zhongguo Shichang Jingji Fazhan Baogao 2003* (A Report on the Development of China's Market Economy 2003) Beijing International Economics and Trade Press, Feb , 2003, 99-111, Academy of Economy and Resources Management of Beijing Normal University, above note 350, 97-114

[427] Article 2 of the Energy Conservation Law of the PRC (2007) has defined the term "energy" "energy" as used in this Law refers to coal, petroleum, natural gas, biomass energy, electric power, heat power and other resources from which useful energy can be derived directly or through processing or transformation

[428] Sally Wehmeier, *Oxford Advanced Learner's Dictionary of Current English*, the 6th edition Oxford University Press, 2000

[429] IEA, World Energy Outlook 1999 Insights Looking at Energy Subsidies-Getting the Prices Right, 1999

[430] It is predicated by IEA in its annual report "world energy outlook (2008 Edition)" that fast-growing China will displace the US as both the world's biggest polluter this year and the largest energy consumer by 2010, based on current trends

State.[431] The difference is that energy price in China was highly influenced by the state, since no fully functioning market system existed. The market-oriented reform of energy pricing mechanism is continuing, yet the prices of some categories of energies are not fully based on the supply and demand of market.

(I) A Report on Energy Subsidies

The discussion on energy subsidies starts with a report by the Alliance for American Manufacturing on January 8, 2008, named as *Shedding Light on Energy Subsidies in China: an Analysis of China's Steel Industry from 2000-2007.*[432] According to this report, massive government energy subsidies fueled China's transformation into the world's largest producer and exporter of steel. By comparing Chinese and world prices for thermal coal, coking coal, natural gas and electricity, the author of this report calculated that the Chinese steel sector received US dollar 27.11 billion in energy subsidies from 2000 through the middle of 2007.[433]

China Iron and Steel Association (CISA) responded immediately. CISA labeled the report on energy subsidies provided by Chinese government to boost its steel industry as "completely groundless".[434] According to the CISA, it is, in no way, inappropriate for the government to offer domestic steel mills subsidies for closing down some of them with obsolete capacity, and subsidies for technology upgrades with respect to energy conservation and environmental protection.[435]

(II) Policy Tendency

To grasp the gist of various arguments about China's energy subsidies, the following part addresses the energy-related policy. Energy conservation has been established as a basic national policy of China, and it is also emphasized by *the Outline of the Eleventh Five-Year Plan for National Economic and Social Development of the People's Republic of China* (the 11th Five-Year Plan) covering the years from 2006 to 2010.[436]

In 1997, China enacted the Energy Conservation Law1997; revised in 2007, the newly-amended Energy Conservation Law highlights the rational use of energy and

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[431] It is only over the past decade that privatization followed by liberalization of former national energy monopolies has opened up increasingly competitive national and then regional markets in energy.
[432] Available at: http://www.americanmanufacturing.org.
[433] The methodologies adopted by this report are questionable. However, it is not the task of this study to analyze the flawless data collection and data analysis here.
[434] Available at: http://news.sina.com.cn/c/2007-08-06/223812336705s.shtml; or http://www.resourceinvestor.com/News/2007/8/Pages/U-S--Report-on-Chinese-Steel-Industry-Subsidies.aspx. According to the CISA statement, fixed-asset investment in China's iron and steel industry increased 8.4% to RMB 125.16 billion ($20.08 billion) in the first six months of this year, 82.1% of which was self-raised by enterprises, with the remaining 17.9% raised from bank loans and foreign investment.
[435] Ibid. It is interesting to note that CISA even argued it was common practices for other governments, including the US government, to offer subsidies to domestic steel industry at its earlier development.
[436] Both the Chinese and English versions are available at http://ghs.ndrc.gov.cn/15ghgy/t20060529_70793.htm.

energy conservation through six sections in detail.

This Energy Conservation Law also proposes various measures to conserve the energy and protect the environment, one of which is to provide subsidies to the eligible projects. For example, Article 61 provides that the State supports the popularization and use of energy-saving lighting instruments and other energy-saving products through subsidies. Moreover, Article 65 provides that the State should give guidance to financial institutions so that they increase the credit support to energy conservation projects, and offer preferential loans to qualified projects for research and development in energy conservation, manufacture of energy saving products and innovation of energy conservation technologies etc.

Renewable Energy Law of China was adopted by the NPCSC in 2005 and went into effect in January 2006, which, to an extent, revealed the determination of the central government to develop renewable energy and improve the domestic structure of energy. The final objective of this Law is to maintain a sustainable economic and social development. Financial discounts and tax preferential policies are suggested to foster the renewable energies.[437] However, renewable energy subsidies themselves may be legally vulnerable. Whether the subsidies will pass through to the SOEs in iron and steel industry should be analyzed based on positive evidence.

In respect of the monopoly and price-setting issues in energy sector, the 11th Five-Year Plan advocates deepening the reform of monopoly sectors and improving pricing mechanisms, including the prices for provision of water, electricity, oil and land sectors.[438]

The white paper "China's Energy Conditions and Policies" mentions that on the basis of properly handling the relations among various interest groups and taking full account of the acceptability of all social sectors, the Chinese government has advanced energy price reform in a vigorous yet steady way; also, it gradually establishes a pricing mechanism that is able to reflect resource scarcities, changes in market supply and demand, and environmental costs.[439]

Admittedly, energy pricing mechanism is a very complicated and also a delicate issue in China. Each slight move involves various interests groups and massive social

[437] See Article 25 and 26 of the Law of Renewable Energies: Article 25: Financial institutions may offer favorable loans with financial discounts for renewable energy development and utilization projects, which are listed in the renewable energies development guidance catalogue and also meet the credit requirements (another version of translation: Financial institutions may offer preferential loans with financial interest subsidy to projects for exploitation of renewable energy that are listed in the national development guidance catalogue of the renewable energy industry and meet the requirements for granting loans.). Article 26: The state shall adopt a tax preferential policy for projects that are listed in the renewable energies development guidance catalogue (another version of translation: The State grants preferential taxation to projects listed in the development guidance catalogue of the renewable energy industry. The specific measures in this regard shall be formulated by the State Council.).

[438] See Chapter 31 and 34 of the 11th Five-Year Plan.

[439] See the part Advancing Price Mechanism Reform in the White Paper "China's Energy Conditions and Policies" (2007), issued by the Information Office of the State Council of the People's Republic of China.

implications. In the area of coal, however, market competition has been introduced into the production and distribution process. The price of coal depends to a large extent on the market supply and demand. The fact that numerous coal corporations and small mines with quite different levels of productivity spread in China is conducive to the establishment of market mechanism.

Overall, the Government has improved the pricing mechanism of oil and natural gas to reflect changes in the international market prices as well as the domestic market in time. The following parts discuss electricity and oil sectors respectively in detail.

(III) Electricity

The electricity (power) mechanism in China has been reformed or adjusted many times since the 1980s. In January 1993, the following five regional electricity supply groups were established: North China Electricity Group; East China Electricity Group; Northeast China Electricity Group; Central China Electricity Group; and Northwest China Electricity Group.[440] These regional groups consolidated both the electricity grids and the power generation plants within their own regions. All of the regional electricity supply groups were the wholly-owned subsidiaries of the State Power Corporation of China.[441]

In the early 2002, the State Council formulated the *Scheme of Electricity System Reform*,[442] with a view to breaking up the monopoly, separating the governmental function from the electricity enterprises' management and constructing an open and proper electricity market. Specifically, two of the major measures relate to segregation of the power plants from the grids and implementation of the price bidding for uploading electricity.[443] Subsequently, five major power generation groups were established: China Huaneng Group (Huaneng), China Datang Corporation (Datang), China Huadian Corporation (Huadian), China Guodian Corporation (Guodian), and China Power Investment Corporation (CPIC).[444] In December 2002, the State Grid Corporation of China (SGCC) and China Southern Power Grid Co., Ltd. (CSG) were established respectively.[445] These corporations constitute the basic framework of China's current electricity industry.

In 2003 and the subsequent years, a series of policies have been taken to promote the electricity price reform. The General Office of the State Council issued the *Circular*

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[440] Not all provinces were included by the five groups, for example, Guangdong and Shandong were not covered.

[441] See Notice regarding Establishing State Power Corporation of China by the State Council. GUOFA [1996], No. 48, December 7, 1996.

[442] See *Scheme of Electricity System Reform* issued by the State Council. GUOFA [2002] No.5, February 10, 2002.

[443] Ibid.

[444] See the State Planning Commission's *Approval on the Restructure Scheme of Dividing the Assets of the State Power Corp relating to the Electricity Generation.* JIJICHU [2002] No.2704, December 3, 2002. Also, each of the big five corporations should not control more than 20% market share in each regional market.

[445] See http://www.sgcc.com.cn/ywlm/gsgk-e/gsgk-e/gsgk-e1.shtml and http://eng.csg.cn/topic.php?channelID=1&topicID=1.

on Printing and Distributing the Scheme of Electricity Price Reform, which proposed the long-term goal of the price reform: (1) to have uploading price, transmission price, distribution price, and terminal retail price separated; (2) to make sure power generation price and retail price determined by market demand and supply forces; and (3) to regulate the transmission price and distribution price by the government with a transparent price formulation mechanism.[446]

The retail prices of power supply are the area where most of the potential disputes originate from. However, the retail prices vary among provinces and industries depending on factors like cost of producing electricity and the way to use electricity. In accordance with Articles 7 and 8 of the *Provisional Administrative Rules on Retail Electricity Price* issued in 2005 by NDRC, the retail prices should be gradually categorized into five major types: large-scale industrial prices, general industrial and commercial prices, residential price, agricultural irrigation price in poverty-stricken counties and agricultural price; as the objective of the reform, the electricity prices will be classified into three kinds: residential use, agricultural use and commercial and industrial use.[447] Generally speaking, the users in the same category are provided with the same treatment; still, there are several exceptions. For instance, differential electricity prices are applicable to the high energy consuming industries.[448] Currently, the residential electricity price in China is much lower. Any slight rise in residential price will impose much burden on households. Thus, the power generation companies often run at loss in this category. The profit earned by power generation companies and grid companies mainly attribute to the higher industrial and commercial prices.

Article 27 of the *Provisional Administrative Rules on Retail Electricity Price* sets out two principal mechanisms for price adjustment: periodical adjustment and adjustment contingent upon uploading price.[449] Periodical adjustment is conducted mainly owing to the need of reflecting the change of coal price and transportation cost.

On the whole, government administrative functions and enterprises' management have been separated in the electricity industry, so has power production from power transmission. The electricity price reform in China is still going on, and its ultimate goal is to make sure that electricity generation and selling prices are eventually formed by market competition, with the electricity transmission and distribution

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[446] See Circular on Printing and Distributing the Scheme of Electricity Price Reform GUOBANFA [2003] No 62, July 9, 2003

[447] See Circular on Implementation Measures Concerning the Electricity Price Reform by NDRC, with its three appendices the *Provisional Administrative Rules on Uploading Electricity Price*, the *Provisional Administrative Rules on Transmission and Distribution Electricity Price*, and the *Provisional Administrative Rules on Retail Electricity Price* FAGAIJIAGE [2005] No 514, March 28, 2005

[448] See Circular on Resolving Problems with regard to Electricity Price on East China Grid FAGAIJIAGE [2004] No 1039, June 8, 2004 In this Circular, the six high energy consuming industries are electrolytic aluminum, iron alloy, calcium carbide, sodium hydroxide, cement, and iron and steel The encouraged and permissible sectors in these six industries are subject to normal large-scale industrial users' price, while the restricted and eliminated sectors in these six industries are subject to higher electricity price

[449] Ibid

prices supervised and controlled by the State.

(IV) Oil

Broadly speaking, oil includes crude oil and product oil such as gasoline, diesel, and aviation kerosene, aviation gasoline refined from crude oil. In fact, the crude oil price in China is now determined by the enterprises themselves with a reference to the international market price.[450] For product oil prices, both government-fixed prices and government-guided prices are applicable.[451] On May 31, 2009, the NDRC issued a notice to raise the product oil prices based on the new oil pricing mechanism.

Chinese government conducted a series of splitting and restructurings in an attempt to break up the monopoly situation. There exist now three big oil companies. In effect, it is obvious that the oil industry still has a high degree of monopoly. The three oil giants are: China National Petroleum Corporation (CNPC), China Petroleum and Chemical Corporation (Sinopec) and China National Offshore Oil Corporation (CNOOC). All of them were restructured in 1998 to improve their corporate governance. Soon these three corporations made their initial public offerings.

A Case: Cash Infusion to Sinopec

It was reported in 2008 that the Government probably had ratified Sinopec's application for cash infusion.[452] The final decision and the specific amount were not available at the websites yet.[453] Then it would be the third time the Government made cash infusion to Sinopec. The first time was on Dec. 29, 2005 with RMB 10bn, and the second was on Dec. 26, 2006 with RMB 5bn. The cash infusion has not only caused national wide debate,[454] but also resulted in potential disputes, namely not complying with the SCM Agreement or other WTO agreements. The subsequent problem is whether the oil is provided to manufacturing companies at lower price; if lower prices of oil could be confirmed, it might be considered as subsidies to the other companies as well.

However, the story behind the cash infusion is complicated. Sinopec, with its focuses almost exclusively on refining, argued that it must buy most of the oil it processed from other companies at global prices (relatively higher prices). After refining that oil, Sinopec sells the gasoline and other fuels it produces to Chinese consumers at prices

[450] See the Measures for the Administration of Oil Prices (trial), which has just been issued by NDRC in May 2009. It aims to improve the oil pricing mechanism and regulate the oil pricing acts.
[451] Ibid. According to Article 5, government-guided prices shall be applicable to the wholesale price and retail price of gasoline and diesel, and prices of gasoline and diesel supplied to wholesale enterprises, railway and transportation industries or other special users.
[452] Available at: http://www.cs.com.cn/ssgs/02/200802/t20080225_1376845.htm.
[453] Available at: http://www.ce.cn/cysc/ny/shiyou/200803/01/t20080301_14692476.shtml.
[454] Someone argued that this cash infusion was similar to "robbing the poor to the rich", considering Sinopec has earned lots of profits.

capped by the government, which are too low to cover its cost.[455] Therefore, Sinopec believes that it is exactly the low-price policy of the central government makes it suffer a big loss.

The central government confronts a dilemma. The Consumer Price Index (CPI) in 2007 is continuing to rise and has reached an 11-year high.[456] According to the figure from NBS, CPI was up by 7.1 percent in January over the same month last year.[457] To maintain social and economic stability, the Government had to check high inflation with a series of measures. Against such a background, the Government vowed not to raise State-capped oil product prices in the short term.

It is almost a commonplace for SOEs in the energy sector to cry for higher price and pressure the government to raise the energy prices. Furthermore, it is not a secret in China that these monopoly SOEs providing oil, gas, electricity and water always treat their employees very well regardless of the gain or loss of the enterprises. For instance, the average pay for their employees is much higher than that in many private firms or other kinds of SOEs.

In summary, the seven measures taken by the Chinese government which may constitute subsidies have all now been illustrated. The remainder of this Chapter intends to observe three industries and make further analysis in terms of governmental assistance.

4.2 **Three Industries**

The three industries refer to the iron and steel industry, the automobile industry and the electronic information industry. They will be examined at length in this part, especially how they are guided or affected by different levels of government. The measures taken by the government towards these industries may contain policy guidance, tax reduction, cash infusion and general measures as discussed in the previous part.[458]

Among all the measures for the three industries, policy guidance is the core issue. Some specific preferential measures such as tax reduction, loan preferences and other governmental support, may have been mentioned in the texts of the relevant policies. These policies, as record evidences, show the relationship between the government and the three industries directly. However, these policies are inherently changeable and abstract.[459] In addition, they usually contain quite general provisions without specific implementation and enforcement mechanisms, that is to say, they neither

[455] Sinopec plans to produce 42 MLN tons of oil in 2008, available at (latest visiting time March 2, 2008):
[456] Available at: http://news.xinhuanet.com/fortune/2007-12/11/content_7229589.htm.
[457] Available at: http://www.stats.gov.cn/english/newsandcomingevents/t20080219_402463161.htm.
[458] The general measures will not be discussed again in this part.
[459] The government faces little constraint on changing the policies, considering the simple procedure and loose requirements for policy making.

formulate the supervision provisions on its implementation nor prescribe any consequence for non-compliance.

The first policy document that this part attempts to examine is the 11th Five Year Programme, with a focus on the paragraphs addressing the selected three industries. The 11th Five Year Programme covered the years from 2006 to 2010. The Programme is comprehensive and covers various issues closely relating to China's further development. Specifically, it contains the following large themes: guiding principles and development objectives, construction of socialist new villages, industrial structure optimization and upgrading, service industry, regional development, resource efficiency and environment, science and education, structural reform, trade and foreign investment, construction of socialist harmonious society, construction of democratic politics, construction of socialist culture, national defence, and mechanism for implementation.[460]

Section One of Chapter Thirteen "optimize the development of metallurgy"[461] places emphasis on domestic consumption, energy conservation and control on overcapacity. It also encourages reorganization of enterprises. Section Two of Chapter 11, entitled as "lift the auto industry",[462] gives much weight to the development of independent intellectual property right, and encourages the development and use of energy-saving and environment-friendly autos with new fuel and M&A of auto enterprises.

Just like the first two industries, Section one of Chapter 10, "enhance the electronics information manufacture",[463] provides general aspirations and orientations in terms of the future development of this industry. It emphasizes the development of core sub-industries, key technologies and extension of the industrial chain. It encourages establishment of the industry base of software, microelectronics and optical electronics.

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[460] See *Outline of the Eleventh Five-Year Plan for National Economic and Social Development.*

[461] The original text: Depend mainly on domestic consumption, strive to resolve the issue of overcapacity, control the new production capacity in the iron and steel industry, speed up the elimination of obsolete technologies, equipment and products, and enhance the level and quality of iron and steel products. Promote the development of cyclic economy in the iron and steel industry, and exert the enterprises' function of manufacture, energy conversion and waste treatment. Encourage the inter-regional restructuring of enterprises into large groups, and form several enterprises with international competitiveness. Build the Caofeidian (曹妃甸) iron and steel base, based on the relocation of urban enterprises and elimination of obsolete capacity of Shougang Group. Make full use of low-grade iron ore.

[462] It provides that: strengthen the independent innovation of the auto industry; accelerate the development of auto engine, auto electronics, key assembly and parts with independent intellectual property right. Make backbone enterprises play a positive role; enhance the market shares of passenger autos with independent brand. Encourage the development and use of energy-saving and environment-friendly autos with new fuel. Guide the merger and acquisition of enterprises through competition and achieve certain enterprises with production capacity of million.

[463] This section reads as follows: Develop core industries vigorously such as integrated circuit, software and new components, focus on the cultivation of information industries including electro-optical communication, wireless communication, high-performance computer and network device, build the industry base of software, microelectronics and optical electronics and promote the emergence of industrial chain of electronics based on the general trend of digitalization, networking and intelligentization. Develop the key technologies in the information industry, boost the capabilities of innovation and competitiveness and extend the industrial chain.

The following part turns to the important policies and cases specific to each of the three industries.

4.2.1 Iron and Steel Industry

The iron and steel industry is an important and basic industry in the national economy, especially for a rapidly developing country like China. There are thousands of products in this industry, and they can be classified generally as pig iron, ferrous alloys, steel, stainless steel, flat-rolled products, hot-rolled bars and rods, angles, shapes and sections, wire and hollow drill bars and rods etc.[464]

The massive industrial/manufacturing and construction projects in China have a huge demand for iron and steel, since they are necessary materials of various other industries in the economy such as household appliances, vessels, traffic, railway, military industry and new industries. So both the Central and local government have put much emphasis on this industry to achieve the goal of building a modern industrialized country. For the local government, iron and steel industry contributes a lot to the GDP growth rate and the employment, which provide strong incentives for local government to place emphasis on this industry.

China has become the world's largest iron and steel consumer, also a big producer, exporter and importer of iron and steel.[465] Since 2005, China has been a net export country of iron and steel, along with its overall steel production larger than the consumption.[466] It in part explains why the iron and steel industry is frequently attacked by AD/CVD investigations. The following Table 4.3 showed the change of the import and export of rolled steel from 2001 to 2007 (rolled steel is a major part of the import and export of iron and steel in China).

Table 4.3 Annual Volume and Value of Import and Export of Rolled Steel[467] in China

Unit / Year	Volume: 10,000 metric tons		Value: US Dollar Million	
	Import	Export	Import	Export
2001	1722	474	8,963	1,865
2002	2449	545	12,366	2,183
2003	3723	681	19,916	3,105
2004	2937	1412	20,787	8,334

[464] Each of the products has its own tariff line, which is different from country to country and also subject to slight changes almost every year. For example, the Office of Customs Tariff Commission of the State Council and Tariff Department of Ministry of Finance of PRC compile jointly Customs Tariff of import and Export of the People's Republic of China each year.

[465] See the Plan for Adjusting and Boosting the Iron and Steel Industry, released on March 20, 2009. Another source is China Iron and Steel Association.

[466] However, the situation in the end of 2008 and in 2009 changed dramatically owing to the impact from the severe global financial crisis: both the export and import of iron and steel decreased remarkably.

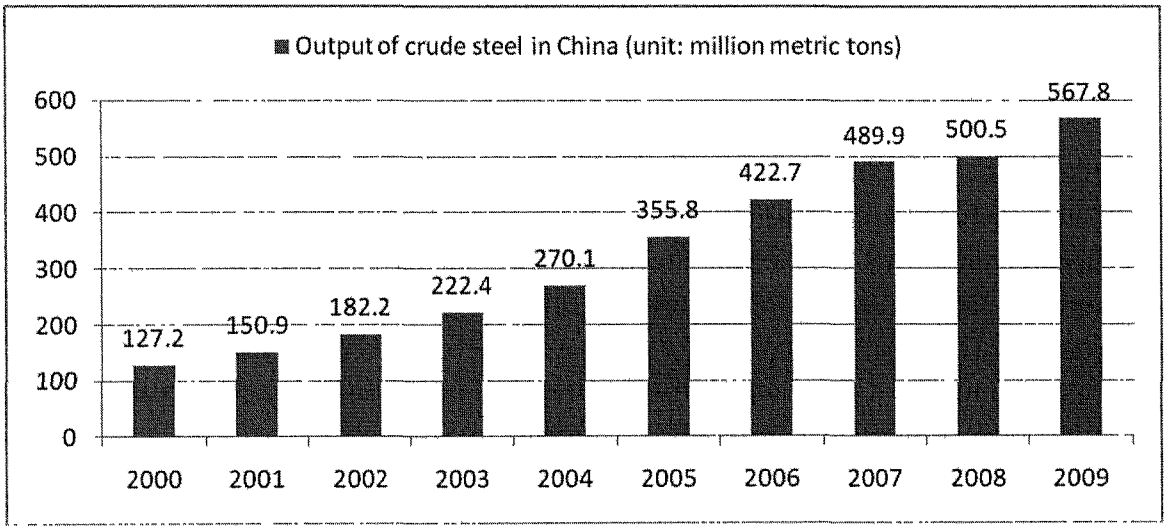
[467] Rolled steel does not include Billet, Crude Forgings, Pig Iron and Spiegeleisen.

2005	2582	2052	24,608	13,080
2006	1850	4298	19,828	26,243
2007	1687	6265	20,553	44,133

Source: the official website of National Bureau of Statistics.

The output of crude steel in china has been the first in the world for over ten years, with 500.5 million metric tons in 2008, 489.9 in 2007, and 355.8 million in 2005[468], nevertheless these impressive figures look less remarkable considering China's huge population of more than 1.3 billion (see the following Figure 4.2).

Figure 4.2 Annual Output of Crude Steel in China[469]



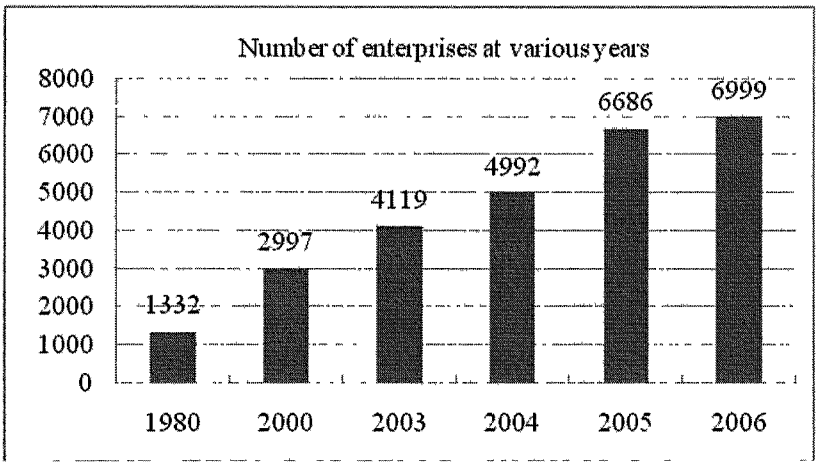
China still has a large amount of steel enterprises which own outdated capacities with high energy consumption and heavy pollution. The technologies and equipment in most existing small steel mills even some large steel enterprises are obsolete, resulting in more energy consumption and heavier pollution. The other serious issues include the excessive blind investment, unreasonable industrial structure and the lack of natural resources *etc.*[470]

Both the number of productive enterprises of iron and steel and the growth speed of the enterprises are remarkable in China. For instance, there were about 1332 productive enterprises of iron and steel in 1980, and 2997 productive enterprises in 2000; however, the number of the enterprises rose rapidly to 6686 in 2005 and 6999 in 2006.[471] As a consequence of the expansion, the production capacity of enterprises of iron and steel is much larger than the practical production needs. On average, gross

[468] More figures are available at: http://www.worldsteel.org/?action=stats_search.
[469] Source: http://www.worldsteel.org.
[470] The steelmakers in China, now the largest buyer of iron ores, have to import large amount of iron ores to meet their production. The steelmakers, led by the China Iron and Steel Association, negotiated with miners Rio Tinto, BHP Billiton and Vale each year.
[471] See the part of the Basic Statistics of Iron and Steel Industry China, available at China Steel Yearbook 2007, compiled by the editorial board of China Steel Yearbook.

output value is also increasing year by year.

Figure 4.3 the Number of Iron and Steel Enterprises in China[472]



Over 50% of the iron and steel enterprises in China are state owned. As of June 2009, there are six enterprises which are selected as the central enterprises under the direct supervision of SASAC: Angang Steel Company Limited (Angang for short), Baoshan Iron and Steel Co., Ltd. (Baosteel for short), Panzhihua Iron and Steel (Group) Company (Pansteel for short), Wuhan Iron and Steel (Group) Corporation (WISCO), China Minmetals Corporation (Minmetals) and Sinosteel Corporation (Sinosteel).[473] It is worth noting that Pansteel was a traditional SOE, owned by the whole people incorporated under the Industrial Enterprises Law of 1988; Pansteel had just been restructured as a modern company in the end of 2009 with its registered capital RMB 5 billion totally contributed by SASAC, and hence Pansteel is a wholly State-Owned company.[474]

4.2.1.1 Guiding Policies Related to Iron and Steel Industry

There are now two major national policies for the iron and steel industry that are effective in China. One is the *Development Policies for the Iron and Steel Industry* (2005) and the other is the *Plan for Adjusting and Boosting the Iron and Steel Industry* (2009). The provisions regarding direct or indirect assistance to enterprises will be selected and analyzed.

(i) Development Policies for the Iron and Steel Industry

[472] Source: China Steel Yearbook.

[473] Minmetals and Sinosteel are very special, because they a non-productive steel corporation which do not produce steel. For example, Sinosteel's core businesses are: developing and processing of metallurgical mineral resources, trading and logistics of metallurgical raw materials and engineering technical service and equipment manufacturing.

[474] Sichuan Panzhihua Municipal Administration for Industry and Commerce issued the business license for enterprise's legal person to Pansteel, which was renamed as Panzhihua Iron and Steel Group Co., Ltd. The restructuring aimed at the full listing of Pansteel. Available at: http://www.pzhsteel.com.cn/NewsCenter/readnews.aspx?NewsID=020430082

On July 20 2005, the NDRC issued an order *Development Policies for the Iron and Steel Industry* (or the Iron and Steel Industrial Policy 2005) so as to guide the sound development of the iron and steel industry. This development policy was produced in an attempt to solve several serious problems constraining this industry, including lower technology content, structural contradictions and investment overheating. Thus it sets forth clearly that the focus of developing the iron and steel industry shall be placed on technical upgrading and structural adjustment.

The development policy contains 9 chapters, and it basically constitutes a comprehensive instruction to the domestic iron and steel industry. Chapter II *Industrial Development Planning* and Chapter III *Adjustment of Industrial Layout* are very abstract, indicating some long-term plans and emphasizing on developing in a sound, sustainable and harmonious manner. Chapter IV *Industrial Technical Policies* is relatively specific. In this chapter, a host of requirements are listed to develop a recycling economy and improve the environment. It also explicitly requires enterprises to eliminate backward working techniques, products and technologies according to the requirements of the provisions on environmental protection.

For purposes of locating possible governmental assistance, two articles in this chapter are especially worth noting. The first one is Article 16, which encourages the use and development of local-content equipments: *We should support and organize the implementation of equipment localization of the iron and steel industry, enhance the research and development as well as designing and manufacture levels of major technical equipment of our iron and steel industry. For crucial iron and steel projects that are based on newly developed home-made equipments, the State should provide policy supports in taxation, interest rate assistance, scientific R&D funds and so on.*

And the other one is Article 18, which also put emphasis on the use of home-made equipments: *The policies for imported technologies and equipment: enterprises are encouraged to use home-made equipment and technologies and reduce import. For any equipment or technology that cannot be produced domestically or fails to meet the demand and, thus, must be introduced from abroad, the introduced equipment or technology should be advanced and practical. We should organize and implement the localized production for the equipments that have a great and extensive demand.*

As can be observed, the above two articles show that the government will support certain projects upon certain conditions. For instance, the state shall grant enterprises using home-made equipment and technologies discounted interest rate and scientific research funds. Notwithstanding the contents embodied in the policy, whether and how the government of various levels would implement the policy is not clear.

(ii) The Plan for Adjusting and Boosting the Iron and Steel Industry

To deal with the impact of the global financial crisis upon the iron and steel industry, the State Council released the *Plan for Adjusting and Boosting the Iron and Steel Industry* (or the Iron and Steel Industrial Policy 2009) on March 20, 2009.[475] The plan had received in-principle approval over the State Council's executive meeting on January 14, 2009.

The Plan, designed for 2009-2011 period, includes five parts: the status quo of and the situation to be coped with by the industry, guidelines, basic principles and goals, key tasks, policies and measures as well as implementation of the Plan.

Totally 12 policies and measures for adjusting and boosting the industry were proposed by the Plan. They read as follows:

1. adjustment of the import and export tariff rates for some products,
2. implementation of the fair trade policy,
3. increase of investment in technical advancement and technical renovation,
4. improvement of the exit mechanism for obsolete production capacity,
5. improvement of the restructuring policy,
6. revision of industry policy at an appropriate time,
7. improvement of the standard for steel used in construction projects,
8. coordinating the development among steel and the relevant industries,
9. maintaining the implementation of flexible financing policies,
10. implementing the outward-oriented strategy,
11. establishing the industrial information disclosure system
12. giving full play to the functions of the industrial associations.

The above Item 3, 5, 9 and 10 seem to be legally vulnerable if they were implemented by relevant governmental organizations. In particular, the outward-oriented strategy in Item 10 highlights that the approval procedure for projects should be simplified, and the policies for the credit, foreign reserve, finance and tax and import and export of personnel should be improved. The strategy also supports the pivotal companies doing business overseas and exploiting resources. Obviously, it does not mean to encourage the simple export of iron and steel products.

4.2.1.2 Policies of Local Government

In a northern province surrounding Beijing, Hebei Province, there are nearly 20 iron and steel enterprises with various levels of production capabilities. The number may be striking, while only TangShan Iron & Steel Company and HanGang Company could produce more than 5 million metric tons of crude steel per year. To a large extent, the situation of iron and steel enterprises in Hebei is an epitome of the whole country: large in number but small in size and backward in technology. Nevertheless,

[475] Available at: http://www.gov.cn/zwgk/2009-03/20/content_1264318.htm

for the different levels of government in Hebei Province, the importance of the tax revenue from and the employment supported by these enterprises is evident.

Under such a context, Hebei Provincial Government and the SASAC of Hebei Province have responded actively to the central policies by issuing detailed policies tailored to their own needs and situations. For example, *Overall Implementation Program of Structural Adjustment of Iron and Steel Industry of Hebei Province* was enacted following the issuance of the Iron and Steel Industrial Policy 2005.[476] Just as what the title has indicated, the primary goal of this Implementation Program is to optimize the whole industrial structure by adjusting structures of the products, the technologies and equipments.

Another important policy issued by Hebei Province is the *Implementation Opinion on Further Strengthening the Elimination of Backward Production Capability* in April 2010.[477] Similarly, this Implementation Opinion is formulated to implement the suggestions in the policy issued by NDRC two months earlier in the same year.[478] Two points need to be made here: first of all, this policy focuses on many high-pollution industries including electricity, coal, iron and steel, cement, nonferrous metal, coke, paper making, tanning, and printing and dyeing; secondly, the State Council has issued a series of consistent policies to address the increasing pressure of prohibiting pollution by closing the high-pollution and high-emission firms with obsolete production capabilities.[479] When it comes to the situation in Hebei Province, three industries, namely the iron and steel, electricity and coal, as the main industries of Hebei Province, need to undertake more tasks of eliminating obsolete production capability. For instance, the specific task for iron and steel industry is to eliminate the backward production capability amounting to 14.4 million ton. To encourage the relevant enterprises, the Implementation Opinion also offers to give support to the enterprises and their districts completing the tasks as scheduled in terms of funds for technological upgrading, funds for energy conservation and emission reduction, approval and record of investment projects, development and utilization of land and credit and financing *etc.*

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[476] It is very hard to find the original text of this Implementation Program even though the author has tried various sources. Luckily, a summary of the Implementation Program is available.

[477] See Implementation Opinion on Further Strengthening the Elimination of Backward Production Capability issued by Hebei Province. JIZHENG [2010] No. 52, April 9, 2010.

[478] See Notice of the State Council on Further Strengthening the Elimination of Backward Production Capability. GUOFA [2010] No. 7, February 6, 2010.

[479] These policies are: the Decision of the State Council on Promulgating and Implementing the Interim Provisions on Promoting the Industrial Restructuring, GUOFA [2005] No. 40; the Catalogue for Guiding Industrial Restructuring formulated by NDRC in 2005; the Notice of the State Council on Issuing the Comprehensive Working Schemes on Energy Conservation and Emission Reduction, GUOFA [2007] No. 15; the Notice of the State Council on Ratifying and Forwarding the Several Opinions of NDRC and Other Departments on Curbing Overcapacity and Redundant Construction in Some Industries and Guiding the Sound Development of Industries, GUOFA [2009] No. 38; and the plans for restructuring and revitalizing industries including iron and steel, nonferrous metal, light industry, textile, *etc.* issued in 2009.

4.2.1.3 Case Studies: Restructuring (Merge & Acquisitions)

As discussed above, the steel enterprises in China are large in number but quite small in size. Take the figures in 2004 as an example: there were as many as 4992 steel mills in 2004 according to the China Iron and Steel Industry Yearbook 2005, while only 4 of them could produce over 5 million tons of crude steel per year, and 24 of them could produce 3 million tons or more per year.[480] The percentage of the first four steel enterprises' combined output in China's total output in 2004 was 18.52%[481]. In stark contrast to China's low industry concentration and low output capability of a single enterprise, the percentage of the first four enterprises' combined output in their own national total output worldwide in 2004 was: US 61.29%, Japan 75.17%, Russia 66.89%, EU (15 countries) 72.59%, and Korea (two enterprises) 79.55%;[482] the top producer of crude steel worldwide in 2004 was: Arcelor 46.90 million tons (mmt), Mittal 42.84mmt (it acquired Arcelor in 2006 and became the current Number One producer: ArcelorMittal), Nippon Steel 31.41mmt, JFE 31.13mmt, POSCO 31.05mmt and Baosteel Group 21.41mmt.[483]

It is exactly the aforementioned fragmentary structure that makes the SASAC promote the restructuring of iron and steel SOEs.[484] It seems that the market mechanism has very limited impact on the small size of steel mills in China, although the competition is very intense. On the other hand, local government has a deep-rooted tradition to intervene in this industry; and the fact that some local governments take their iron and steel enterprises as a cornerstone for tax revenue affects the market-oriented M&A. However, the scattered nature of the iron and steel enterprises is a serious barrier to enhance the overall competitiveness of Chinese iron and steel industry. That explains why the Chinese Central Government highlights the necessity to promote the intra-industry consolidation and promotes the improvement and implementation of restructuring policy.[485] Therefore, the restructuring for iron and steel enterprises is more government-oriented than market-oriented in China. In this sense, the restructuring practice can be seen as the merge and acquisitions with Chinese characteristics.

To be specific, the Government encourages the substantial restructuring, regional restructuring and cross-region restructuring. To enhance the international competitiveness of steel enterprises, the central government has long required the

[480] Available at the China Iron and Steel Industry Yearbook 2005.
[481] Source: China Iron and Steel Association, available at: http://www.chinaisa.org.cn/
[482] Ibid.
[483] Source: the International Iron and Steel Institute (IISI), available at: http://www.worldsteel.org/?action=storypages&id=330.
[484] The Chairman of SASAC, Li Rongrong once responded to the press that in China, the industries like iron and steel industry are troubled by low concentration, a constraint to their competitiveness in the global market; therefore the pressing task is to enhance the concentration and promote competition of those industries. Available at: http://www.sasac.gov.cn/n1180/n1549/n1600/n1765/6513799.html.
[485] See the Development Policies for the Iron and Steel Industry (2005) and the Plan for Adjusting and Boosting the Iron and Steel Industry released on March 20, 2009.

closure of small iron and steel mills, the obsolete ones or the unlawful ones that could not meet the environmental standards. During this process, local government has much initiative to urge the restructuring of their local iron and steel companies especially the small ones that would be forced to close, or the local government may lose an important source of revenue. Needless to say, such measures taken by the local government, to a certain extent, counter the effect of the policies from central government.

It is possible that local governments have given incentives to the relevant enterprises or companies so that the enterprise or company would like to be a part of the merger and acquisition activity. Admittedly, the policies at the local level lack transparency, which makes it hard to find what exactly the incentives are. In effect, the Iron and Steel Industrial Policy 2009 requires explicitly that favorable policies necessary for restructuring including preferential tax policy should be established. However, few details about the favorable policies are available.

NDRC etc. (totally eight departments) issued the joint "*Notice on Controlling Total Output, Eliminating Obsolete Technologies, Accelerating Structural Adjustment of Iron and Steel Industry*" in June 2006. According to this notice, it aimed to solve the serious challenges domestic iron and steel industry has faced for long, like the blind investment, the intense competition and the decreasing industrial consolidation *etc.* Following this Notice, many provinces and cities like Shandong and Jiangsu promulgated their own notices to implement the suggestions from the Central Government. In 2007, 11 major M&A of steel enterprises occurred in China and such M&A even accelerated in 2008.[486]

Hebei Iron & Steel Group (HBIS) was a typical result of government-oriented M&A in 2008.[487] The whole process is promoted by the Hebei Provincial Government and the SASAC of Hebei Province. After the restructure, HBIS owns eleven subsidiaries like TangShan Iron & Steel, HanGang Company, XuanGang Company, ChengGang Company, WuGang Company and HengBan Company etc, among which TangShan Iron & Steel and HanGang Company are two big companies. As of the writing in April 2010, HBIS is the second largest iron and steel enterprise in terms of total output in China.

In recent two years, both the domestic and global situations for Chinese iron and steel companies have seriously deteriorated. The salient problems are the roaring price of imported iron ore and the excessive low-level production capacity. In addition, the development of China's iron and steel industry has been facing more and more constraints of energy, water, electricity supply and transportation, and the increasing cost resulting from environmental protection.

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[486] Available at: http://www.mysteel.com/tg/gnzs/2008/11/27/090634,1908916.html
[487] Its official website is http://www.hebgtjt.com/lists.jsp?pid=17.

4.2.2 The Auto Industry

The auto industry has been confirmed as one of the pillar industries of the national economy in China's first auto industry plan *Policy on Development of Automotive Industry* promulgated in 1994. In effect, the auto industry is highlighted by most nations, owing to its long industrial chain, high relevance with other industries, its promotion of mass-production techniques, guarantee of more jobs and strong stimulus to the consumption demand.[488]

China's auto industry was established in the early 1950s and its overall technology and production capability remains far behind the levels of US, Japan and Germany. Upon accession to the WTO, China liberalized the domestic auto market and the applicable tariff rate fell by three-quarters. At that time, some observers believed that the vulnerable Chinese auto market would be swamped with world-class auto companies and that the domestic producers would be driven out of the market.[489] In reality, however, the effects on the larger joint venture car producers have been regarded as modest.[490]

Despite the auto industry's rapid growth in recent years, the old problems such as unreasonable industrial structure, low technical level, weak capability of independent development and imperfect consumption policies still stand out.[491] The new issues of energy conservation, environmental protection and urban traffic congestion also emerge to be the bottleneck of auto industry's further development.

The unreasonable structure can be easily observed by the following figures. In 2006, as many as 2751 auto firms existed in China according to the China Automotive Industry Yearbook 2007. Of that, 1407 auto firms were large and medium-sized, which accounted for 92.27% of the total value.[492] Thus, the remaining 1344 auto firms accounted for less than 8 percent of total production. In total, 435 auto firms were reported to be loss-making.[493]

There were 691 SOEs in 2006, including the enterprises where the state has significant control.[494] 215 SOEs were loss-making, with the amount as high as about RMB 4 billion.[495] Currently, only two SOEs in the auto industry are under the direct

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[488] To solve the dramatic decline in car sales in the global financial crisis, most governments have offered stimulus package for their auto sectors. It is the importance of auto industry that makes the governments believe the necessity of bailouts.

[489] Lardy, above note 29, at 111-113.

[490] Ibid.

[491] See the Plan on Adjusting and Revitalizing the Auto Industry, promulgated by the General Office of the State Council on January 14th, 2009.

[492] Zhongguo Qiche Gongye Gongsi (China Automotive Industry Corporation) (ed.): *China Automotive Industry Yearbook 2007*. Beijing: China Machine Press.

[493] Ibid.

[494] Available at China's Auto Market Almanac (2006-2007).

[495] Ibid.

supervision of central SASAC. They are the China First Automobile Works (FAW) Group Corporation in the City of Changchun, Jilin Province and Dongfeng Motor Corporation in Hubei Province. Dongfeng, formerly known as Second Automotive Works, was established in 1969 and once had a leading position in the domestic auto industry. Shanghai Automotive Industry Corporation (Group) ("SAIC" for short) was established in the 1950s. SAIC is a local company, but it is called as one of the top 3 auto corporations in China. In 2007, the revenue earned by FAW amounts to USD 29.52 billion, Dongfeng USD 24.70 billion and SAIC USD 25.29 billion.[496]

4.2.2.1 Guiding Policies

(i) Policy on Development of Automotive Industry

In order to conform to the WTO rules and adjust the structure of auto industry, *Policy on Development of Automotive Industry* was adopted at the executive meeting of NDRC and soon approved by the State Council in May 2004 (Policy 2004). Accordingly, the first auto industry plan *Policy on Development of Automotive Industry* (Policy 1994) became null and void.

The Policy 2004 contains 13 chapters and 78 provisions. It puts much emphasis on environmental protection, the research and development capability and technological innovation capability of auto makers. Another basic objective of the Policy 2004 is to optimize the structure of the auto industry, and this can be reflected in Art. 4: *the structural adjustment and reorganization of the auto industry shall be promoted to expand the large-scale benefits of enterprises, improve the centralization of the industry and avoid the scattering, disorder and low-level repeated construction.*

Two articles in the Policy 2004 involve measures to financially support the auto industry: Article 7 and Article 31. Specifically, Article 7 provides that "*The state shall render support in tax policies to the research and development activities conforming to the technical policy*". Article 31 stipulates that "*For those enterprises undertaking the production of auto components and parts, which can support several independent enterprises that undertake the production of the whole vehicles and which enter into the international system of procurement of automobile components and parts, the state shall support them in priority in such aspects as the introduction of technology, technological transformation, financing and merger and reorganization, etc.*". The determination of the Government to promote the favorable development of automobiles can be observed to a certain extent here. The innovation ability of automobile companies is given much priority.

(ii) The Policies for Automobile Trade

The Policies for Automobile Trade was adopted at the executive meeting of the

[496] Source: China Enterprise Confederation; China Economic Review's China Business Guide (2009). Hong Kong: China Economic Review Pub., 2008.

Ministry of Commerce in August 2005. Its direct target is to achieve the brand sale and services of automobiles and improve the functions and the system concerning the sale and post-sale services of automobiles and second-hand automobiles. Then by 2010, a group of automobile trade enterprises with their own strength, and a coordinated development between the automobile and the automobile industry could be established. It has eight chapters, which mainly contain the sale of automobiles, circulation of second-hand automobiles and automobiles components, discarding of automobiles and foreign trade of automobiles. Article 44 emphasizes that "*The automobile industrial association shall intensify the industrial self-discipline and establish a competitive and orderly foreign trade order regarding automobiles and the relevant products*".

These two articles seem to have certain connection with the governmental assistance. The first one is Article 34: *We should improve the measures for the administration of subsidy funds for the discarding and renewal of old automobiles and encourage the discarding and renewal of old automobiles.* The second one is Article 41: *We should support the foreign trade development of automobiles and the relevant products by using the central foreign trade development funds.*

(iii) The Plan for Adjusting and Boosting the Auto Industry

In response to the impact of the global financial crisis upon the auto industry, the State Council laid down the *Plan for Adjusting and Boosting the Auto Industry*, which received in-principle approval on January 14, 2009.[497]

The Plan, designed for 2009-2011 period, includes five parts, namely the status quo of and the situation facing the industry, guidelines, basic principles and goals, main tasks, policies and measures as well as implementation of the Plan.

Totally 11 policies and measures for adjusting and boosting the industry were proposed by the Plan, which read in the relevant parts:

1. To reduce the purchase tax on passenger vehicles,
2. To implement the program for bringing autos to rural areas,
3. To accelerate the retirement and update of old and used cars,
4. To sort out and revoke the unreasonable provisions restricting the purchase of autos,
5. To promote and regulate the auto consumption credit loans,
6. To standardize and promote the development of the second-hand vehicle market,
7. To accelerate the construction of the urban road traffic system,
8. To improve the auto enterprise reorganization policies,
9. To make more investments in technological progress and innovation,
10. To popularize the use of energy-saving and new-energy autos,

[497] Available at: http://www.chinalaw.gov.cn/article/xwzx/szkx/200901/20090100127441.shtml.

11. To implement and improve the Auto Industry Development Policies.

In the above measures, only Item 8 and 9 seem to be legally vulnerable. Nevertheless, it does not mean that the other measures totally conform to the WTO rules. It depends on the application of the measures in specific circumstances.

4.2.2.2 Policies of Local Government

The China First Automobile Works (FAW) Group Corporation in Jilin Province is an important SOE with a relatively long history in PRC. With the enthusiasm and efforts of all the people, FAW was created in 1953 as the first automobile works in this newly born country. For quite a long period, it was also the largest automobile works in China, which produced China's first Liberation truck and the first Red Flag car.

However, like other domestic automobile enterprises, it faced an increasingly more competitive market after China's accession to the WTO. Although it was in the list of Fortune Global 500 companies and it has improved thoroughly along with the whole economic reform since 1978, FAW posted a net loss of RMB 570 million (equivalent to USD 68.9 million) for the first quarter of 2005.[498]

On May 13, 2005, the government of Jilin Province issued an administrative order which laid out 50 measures trying to help FAW out of the trouble. The measures included guaranteed supply of energy, special treatment on land use, encouraging purchase of FAW cars, separating its social function, granting aid for technological development and so forth. In this administrative order, it also gave a hint that FAW still have a burden of social functions, which indicates that it was not restructured totally. Whether the above measures could change the company's current situation is questionable. But it seems that these measures may not be consistent with the rules of WTO regulating subsidies. Two more similar policies are presented as follows:

In January 2009, the municipal government of Changchun City in Jilin Province issued a document that the autos of FAW shall be put in a priority in terms of governmental procurement.[499] For the registration of FAW autos in the Changchun City, there will be no charge of test fees and verification fees. Also, local enterprises are encouraged to buy the FAW products, when they plan to update their equipments.[500]

The Plan for Adjusting and Boosting the Auto Industry of Anhui Province was published on May 12, 2009.[501] Like the Changchun City's government, Anhui Government requires that the autos produced in Anhui shall be purchased in terms of

[498] Available at: http://www.cbiz.cn/NEWS/showarticle.asp?id=2328.

[499] Available at: http://auto.sohu.com/20090108/n261634539.shtml.

[500] Ibid.

[501] Available at: http://www.ahxf.gov.cn/shownew.asp?ID=98241.

governmental procurement. The social organizations, enterprises and residents are encouraged to buy the autos produced in Anhui Province, which will be given preferential treatment regarding the bridge tolls, highway-user fees, insurance fees, passenger transport fares etc. Another feature of this Provincial Plan is to encourage syndicate and restructuring among provincial auto enterprises.

4.2.2.3 Case Studies: Bankruptcy of a Large Auto SOE

China Auto Corporation (*Zhong Qi*) was once a central SOE under the direct supervision of SASAC. It was declared to go bankrupt in 2007 by the Beijing First Intermediate People's Court according to the Law of the PRC on Enterprise Bankruptcy.[502] China Auto Corporation, once an important SOE, underwent the long history of SOE reform. In the late 1990s, it was in a terrible condition because of high debt and terrible corporate governance. In the end, it could not maintain its daily operation and cope with its increasing debt. This is a typical example that even large SOEs may be threatened by bankruptcy, needless to say other SOEs.

4.2.2.4 Case Studies: Export Credit for Chery

Chery Auto Co., Ltd. was created in 1997 by five of Anhui Province's local state owned investment companies with an initial capitalization of RMB 3.2 billion.[503] Chery Auto, one of China's largest automakers, has proved itself to be a successful independent Chinese brand. Chery's total sales also fell in 2008 in the context of a sharp slowdown in Chinese car sales. Its plan to go listed in A-share Market in 2008 was delayed as well.

Chery Auto signed with China Eximbank a strategic cooperation agreement worth RMB 10bn in December 2008 so as to support Chery for its upgrading of export products and export of major technology and equipment [504] as well as its "going-global" efforts.[505] Considering the global financial crisis and the fact that Chinese auto industry has come to a critical development stage, the signing of the agreement offered crucial support for Chery to overcome the economic downturn.

According to China Eximbank, the lending showed its response to the policy of increasing input and stimulating domestic demand set out by the State Council and the Central Committee of CPC, marking a new phase in the cooperation between China Eximbank and Chery Auto.[506]

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[502] Available at: http://finance.people.com.cn/GB/6594134.html.
[503] Available at: http://www.cheryinternational.com/company-overview.
[504] However, how the money has been or will be used is disputable. John Bonnell, a Singapore-based analyst at JD Power, the auto consultancy commented that this was a way for the government to support Chery. Money that would have gone to export support now goes to product development, and the money could also be spent in other ways to support the domestic business. Available at: http://www.ftchinese.com/story_ce.php?storyid=001023549.
[505] Available at: http://www.eximbank.gov.cn/annual/2008/2008nb37.shtml.
[506] Available at: http://www.eximbank.gov.cn/annual/2008/2008nb37.shtml.

4.2.3 Electronic Information Industry

The electronic information industry is a newborn industry in China. Still, China is the world's largest producer of most types of electronics including personal computers, mobile phones, DVD players, refrigerators, third-generation mobile telecommunication, digital TV manufacture, software and integrated circuits.[507] Most of the electronic manufacturers are located in the Pearl River Delta and the Yangtze River Delta, Chengdu and Wuhan (known as Optics Valley of China)[508] are also expected to develop their electronic information industry.

The electronic information industry has basically achieved sustainable and rapid development. The sales income from electronic information industry grew at an average rate of 28% on a year-on-year basis from 2001 to 2007.[509] The export amount of electronic information products was as high as USD 521.8 billion in 2008, which accounted for 36.5% of the total export amount in foreign trade of China.[510] In 2009, the export value of electronic information products declined to USD 457.2 billion.[511]

Lenovo has to be mentioned here for its trailblazing success in the electronic information industry.[512] However, considering that its registration place is in Hong Kong, Lenovo Group Limited, the famous computer maker, is not a domestic company but a foreign-invested enterprise based on the legal concept of foreign-invested enterprises formulated by Chinese laws. As early as in 1994, Hong Kong Lenovo has gone public on the Hong Kong Stock Exchange with the stock code 00992.[513]

Only two companies in the electronic information industry are under the direct supervision of Central SASAC, which are China Potevio Co., Ltd (China Potevio)[514] and China Electronics Corporation (CEC).[515] China Potevio was established on July 23, 2003 in Beijing, focusing on information technology (IT) equipment manufacturing and service. CEC is the largest state-owned IT Company in China, which merged with China Great Wall Computer Group in 2005.[516] It was established

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[507] Source: http://www.cena.com.cn/

[508] The State Optoelectronic & Information Industry Base is also located in Wuhan East Lake Hi-Tech Development Zone, available at: http://english.wh.gov.cn/html/Development_Zone/

[509] See The Plan on Adjusting and Revitalizing the Electronic Information Industry, issued by the General Office of the State Council.

[510] However, in the second half of 2008, the export growth of electronic information products slowed down, the growth speed of sales income saw a dramatic decrease.

[511] See Report on the Operation of Electronic Information Industry in 2009, available at http://www.miit.gov.cn/n11293472/n11293832/n11294132/n12858462/13009463.html

[512] The obvious example is that Lenovo stunned the business world in 2004 by announcing its plan to acquire IBM's personal computer operations for $1.25bn.

[513] Available at: http://www.hkexnews.hk/listedco/listconews/advancedsearch/search_active_main.asp.

[514] It was born out of China Posts and Telecommunications Industry Corporation, which has the longest history in China's telecommunication industry. Its website: http://www.potevio.com/en/index.aspx.

[515] Its website: http://www1.cec.com.cn/english/cec.asp.

[516] Available at: http://www1.cec.com.cn/ce26.asp.

in 1989 and originated from the former Ministry of Electronics Industry as a result of government restructuring.

4.2.3.1 Policies

Like the revitalization plans for iron and steel industry and the auto industry, the State Council laid down the *Plan on Adjusting and Revitalizing the Electronic Information Industry*, which received in-principle approval by the State Council's executive meeting on February 18, 2009.[517]

The Plan includes five parts, namely the status quo of and the situation facing the industry, guidelines, basic principles and goals, main tasks, policies and measures as well as implementation of the Plan. Totally 7 policies and measures for adjusting and boosting the industry were recommended by the Plan, which are:

1. Implementing the measures for expanding domestic demand,
2. Increasing the investment of the state,
3. Providing more policy support,
4. Improving the investment and financing environment,
5. Supporting the M&A and restructuring of superior enterprises,
6. Further exploring the international market,
7. Strengthening the building of the independent innovation ability.

In the above items, Item 3, 4 and 5 could involve possible governmental support for electronic information industry. As can be noticed, the intra-industry restructuring policy affects both the iron and steel industry and the auto industry.

With regard to Item 1, the subsidy program "home appliances go rural" is a case in point, since it stimulates rural consumption effectively. As a pilot program, it is limited to three big provinces in agriculture: Shandong, Henan and Sichuan.[518] If one rural family buys the designated brands of a maximum of two color TV sets, two refrigerators and two mobile phones from December 2007 through May 2008, this family can enjoy a 13% tax rebate.[519] Later on, this scheme is expanded nationwide, and the products are also enlarged including computer, washing machine, water heater, microwave oven and induction cooker.[520] In fact, MOFCOM and MOF together have set up a special information system to continue the program "home appliances go rural".[521]

It is worth noting that Item 6, namely exploring the international market, involves the preferential export refund policies to some electronic information products, export credit insurance in supporting the export of electronic information products, and the

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[517] Available at: http://www.gov.cn/zwgk/2009-04/15/content_1282430.htm.
[518] Available at: http://www.chinadaily.com.cn/bizchina/2009-02/02/content_7439036.htm; http://jdxx.zhs.mofcom.gov.cn/index.shtml. Peasants are very surprised at such rebate program and they even comment that: this is exactly like free food falling from the sky!
[519] Ibid.
[520] Available at: http://jdxx.zhs.mofcom.gov.cn/admin/news.do?method=view&id=42161362
[521] The official website for this program: http://jdxx.zhs.mofcom.gov.cn/index.shtml.

export credit support for small and medium electronic information enterprises.

Another policy scheme is led by the Ministry of Information Industry and China Development Bank, which aims to promote the electronic information industry development and information technology application. They promulgated the Temporary Measure on the Loan by China Development Bank in 2006. The loans are classified as medium/long-term loans and short term loans; the interest rate is implemented according to the interest rate policy decided by the PBOC.[522]

4.2.3.2 Policies of Local Government

A few provincial governments have responded immediately to the *Plan on Adjusting and Revitalizing the Electronic Information Industry* by announcing their own plans. These local plans usually follow the central plan closely with slight changes.

For instance, Anhui Province issued a notice to further accelerate the growth of electronic information industry in February 2009.[523] This Notice highlights the meaning of electronic information industry to the industrial structure of Anhui Province and then places it in an advanced and pivotal position. The striking part of the Notice made by the Government of Anhui Province is that it suggests various financial institutions offer credit loan support to firms in the electronic information industry.

Beijing Municipal Government also released its *Implementation Program on Adjusting and Revitalizing the Electronic Information Industry* in 2009. Beijing regarded the electronic information industry as its strategic and backbone industry. In accordance with the Implementation, the Beijing Municipal Government should support the technological transformation of the enterprises, structural adjustment of the industry, independent research and development and the general infrastructure building for industrial parks *etc.* by various funding forms such as grant, interest rate assistance, capital fund injection, follow-up investment and rewards and so on. This Implementation places emphasis on small and medium-sized electronic information firms with the preferential policies made for them.

4.3 Conclusion

To conclude, the first part of this Chapter introduced and analyzed seven general measures, including exchange rate, preferential loans, and access to the stock market, debt-equity swap, official export credit, land-use rights and energy subsidies. These measures relate to either the basic economic system or certain

[522] See the Temporary Measure on the Loan by China Development Bank for the Electronic Information Industry Development and Information Technology Application, China Development Bank [2006] No.160. The original text is available at http://www.westlawchina.com/main.php?a=0&l=cn.
[523] The original text is available at http://www.westlawchina.com/main.php?a=0&l=cn.

crucial economic policies designed by Chinese government. That is exactly why both subsidy and anti-subsidy are sensitive issues in the international trade arena.

From the standpoint of the relationship between state and market, these measures show that the Chinese government has much impact on the economic activities. In particular, the state exerted huge influence by making policies in the areas where the market does not function or could not work effectively, such as the land system and certain energy issues. Chapter Six will examine whether these measures conform to the rules of the SCM Agreement.

The second part discussed three selected industries with very specific examples. As illustrated above, these industries are not only typical, where large SOEs still exist, but also key sectors in the national economy. In fact, the iron and steel industry and the auto industry are traditional industries, fully reflecting the structural and historical problems that are urgent for the government to address, including the obsolete production capability, excessive investment, and all-inclusive structure of both large and small enterprises lacking specialized production and competitiveness. That partly explains why the state is prone to intervene in these industries. Likewise, whether there exist specific measures that are not consistent with the rules of the SCM Agreement is the task of Chapter Six.

Chapter 5 WTO Rules Regulating Subsidies: Overview and Review

Chapter Three provides an overview of SOE reform and a few ways to define the scope of SOEs in China. Chapter Four summarizes seven measures adopted by Chinese governments to assist SOEs or even affect the whole national economy. Before attempting to determine whether these measures are consistent with the WTO rules regulating subsidies, it is first necessary to review and examine the relevant rules carefully. This Chapter thus focuses on the regulation of subsidies.

Subsidy *per se* is a household word, since it is closely connected with individuals, households and companies on the micro level and with countries or regions on the macro level. Take China as an example, different levels of governments may provide different forms of subsidies (*bu tie*) to individuals in various occasions. For instance, when the pork supply in 2007 was severely scarce and its price soared sharply, governments provided subsidies to pig farmers to ensure the basic supply of pork for consumers.[524] In addition, another example is if it is extremely hot in the southern area of China in summer, workers in that area will be given certain subsidies by the local governments on the basis of their salary. Furthermore, minor subsidies are also offered to low-income groups in cities and to college students with tuition fee trouble. Measures such as these assistance subsidies are generally utilized by every country in the world.

Moving on to the agricultural sector, subsidies are quite persistent. Several developed trading powers like the US, Canada, the EU and Japan have provided large subsidies to their agriculture for quite a long period and made little headway in reducing their generous subsidies despite many rounds of negotiations.[525] In the Ministerial Declaration at the Doha Development Round negotiations, the aims for the agriculture area are still very basic but challenging: substantial improvements in market access; reductions of, with a view to phasing out, all forms of export subsidies; and substantial reductions in trade-distorting domestic support.[526]

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[524] See: http://english.peopledaily.com.cn/200706/04/eng20070604_380616.html. Pig production stays in a state of dramatic fluctuation mainly because of the regulatory measures, rising prices in pig feeds and the possible outbreak of diseases *etc.* Contrary to the scarcity of pork in 2007, there was a growing pig surplus in 2008. However, this measure has been challenged by US, who questioned China's pork subsidies in a letter posted on the website of WTO. Agricultural subsidy is a complicated issue and a red-hot debate with a long history. There was a growing pig surplus in 2008. Pig production stays in a state of dramatic fluctuation.

[525] See Kevin C. Kennedy (2001): *Reforming Farm Trade in the Next Round of WTO Multilateral Trade Negotiations*. 35(6) Journal of World Trade 1061-1079.

[526] For details, see Ministerial Conference, Doha Ministerial Declaration, WT/MIN (01)/DEC/1, Nov. 20, 2001, paras. 13 and 14. In fact, one of the many reasons for Doha's deadlock goes to the expansion of negotiation into agricultural subsides, an extremely sensitive area for many developed countries. For instance, it is reported that EU faced protects in any move towards disciplining its farm subsidies, see

In September 2008, as the subprime mortgage crisis accelerated, the US government offered a series of market interventions to help particular firms, including the astonishing $700 billion proposal, which was designed for stimulating economic growth and inspiring confidence in the financial markets.[527] While the sales of General Motors and Chrysler plunged in the fall of 2008, their industry leaders sought and received $25 billion in federal loan guarantees, which was the first bailout. Then they asked Washington for a second bailout to make sure their simple survival.[528] Many other nations also generously funded bail-out packages; for instance, in China, the State Council invested RMB 4,000 billion ($581.8bn) over two years.[529] Likewise, in a stimulus package, India's central bank injected $60.2bn into the financial system to boost liquidity and Indian Government planned $4bn of extra spending in the fiscal year of 2008 to revive fading economic growth.[530]

From the literal aspect, *Oxford Advanced Learner's Dictionary of Current English* defines the term subsidy as "money that is paid by a government or an organization to reduce the costs of services or of producing goods so that their prices can be kept low".[531] According to *Longman Dictionary of Contemporary English*, a subsidy means "money that is paid by a government or an organization to make prices lower, reduce the cost of producing goods *etc.*".[532] *Shorter Oxford English Dictionary* defines the word "subsidy" as "help, aid, assistance"; or "a grant or contribution of money; one granted by the state or a public body *etc.* to keep down the price of a commodity, service, *etc.*".[533] Thus, dictionary definitions suggest that the intent of a subsidy is to have the effect of lowering the prices of products.[534]

From an economic viewpoint, one notable scholar defined the term "subsidy" to refer to "anything the government does which alters the producer's costs or revenues in a favorable direction".[535] Thus, a subsidy normally indicates the transfer by the government of something of value or economic resources to a producer which increases the producer's profitability or benefits. Subsidies tend to be extremely

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http://www.nytimes.com/2010/02/02/world/europe/02farm.html.

[527] The revised bailout package intended to bolster the ailing US financial system finally won approval on 3 Oct. 2008. It became the most expensive government intervention in history. See: http://www.nytimes.com/2008/10/04/business/economy/04bailout.html?hp; http://edition.cnn.com/2008/BUSINESS/10/03/us.bailout.deal.markets/index.html.

[528] See: http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_crisis/auto_industry/index.html?scp.

[529] See: http://finance.people.com.cn/GB/1037/8306806.html. The fiscal stimulus plan focuses on infrastructure and aims at boosting domestic consumption.

[530] See: http://www.nowpublic.com/tech-biz/indian-government-unveils-4bn-econmic-stimulus-plan. http://www.expressindia.com/latest-news/After-rate-cuts-govt-plans-4-bn-spending-boost/395684/.

[531] Sally Wehmeier (ed.), *Oxford Advanced Learner's Dictionary of Current English*, the 6th edition. Oxford University Press, 2000.

[532] Essex Harlow (ed.), *Longman Dictionary of Contemporary English,* 3rd edition. Longman Group Ltd 1995.

[533] Angus Stevenson (ed.): *Shorter Oxford English Dictionary*, 6th edition. Oxford University Press, 2007, Vol. 2, 3087.

[534] The term "subsidy" defined by dictionaries is closely related to products and services. In China, the term "subsidy" (*bu tie*) is widely used in various occasions.

[535] Robert E. Hudec (1996): Difference in National Environmental Standards: the Level-Playing-Field Dimension. *Minnesota Journal of Global Trade*, 5(1), 15.

pliable from the political perspective: once the helping hand of government becomes conspicuous, the "subsidy" objections would be elicited irrespective of the form that the help takes; therefore, Hudec commented that the political perception of subsidies was primarily a matter of visibility.[536]

Apparently, subsidies can be used frequently in various contexts. The recipient may be an individual or a company or group of persons or companies in different industries. It seems that recipients get certain good in contrast with no assistance at all. The abovementioned examples share another common characteristic: the money or other kinds of assistance is provided by governments. Therefore, the word "subsidy" used in our daily life has quite general and vague meanings, which can be all-embracing. In a broad sense, "virtually every government action can be regarded as a subsidy for someone, and virtually all such actions can affect international trade."[537] So defining the term "subsidy" will by no means be an easy task. It is not surprising that there was no general common ground on the legal definition of a "subsidy" until the Uruguay Round negotiation.

The following section is a general introduction to the evolution of subsidies rules during its negotiation history. Then it analyzes the definition of subsidies and examines the key specificity test and classification of subsidies *etc.*, especially some controversial and vague terms such as public bodies, provision of goods and pass through of benefit.

5.1 The Rules of Subsidies from Havana Charter to Uruguay Round

After the World War II, many western leaders realized the need to create a new world political and economic system to maintain peaceful development and prevent mistakes concerning economic policies. In 1944 the leaders convened the famous Bretton Woods conference, where the charters for the International Monetary Fund and the International Bank for Reconstruction and Development were established.[538] They also considered the necessity of setting up an international organization relating to trade. Nonetheless, they did not tackle the problems in the trade area, probably owing to the fact that the Bretton Woods conference was under the aegis of ministries of finance not ministries responsible for trade issues.[539]

5.1.1 Havana Charter

In 1945, the US, the strongest economy in the post-war world, and British took the

[536] Ibid.
[537] See Snape, above note 132, at 140.
[538] See Lester *et al.*, above note116, at 66.
[539] See Jackson, above note 73, 31-32.

initiative and negotiated for a corresponding institution on trade on a bilateral basis, the International Trade Organization (ITO), where they produced a pamphlet entitled *Proposals for Expansion of World Trade and Employment.*[540] The pamphlet was amended in successive conferences from 1946 to1948 in London, New York, Geneva and Havana. In the early 1948, the Havana conference completed the ambitious final draft of ITO.[541]

It was expected that the ITO would be approved by the US Congress. However, the US Congress did not approve the ambitious ITO, mainly because the composition of Congress had shifted to a stance less liberal on trade matters and less internationally oriented.[542] The congressional committee also indicated that the legislation enacted in 1945 did not authorize the president to sign an agreement for an organization, but just authorized agreements for the purposes of reducing tariffs and other restrictions concerning trade.[543]

Although ITO never materialized, the provisions on subsidies contained in the Havana Charter were almost entirely incorporated into the GATT.[544] Havana Charter established the multilateral framework for subsidies for the first time. Four articles in Chapter IV (Articles 25 to 28) dealt with subsidies.[545] Article 25 (Subsidies in General) contained the general obligation for ITO Members to notify the extent and nature of the subsidization that they granted or maintained in written form; Articles 26 (Additional Provisions on Export Subsidies) regulated export subsidies, which would be prohibited when they resulted in the sale of such a product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market; Article 27 (Special Treatment of Primary Commodities) and Article 28 (Undertaking regarding Stimulation of Exports of Primary Commodities) dealt with primary products.[546]

5.1.2 Subsidies in the GATT 1947

The preparation of the GATT was intertwined with that of the ITO charter. At the conference in Geneva from April to October, 1947, the negotiators were conducting three major parts at the same time.[547] One part continued the preparation for the ITO; the other two parts devoted to a multilateral agreement to reduce tariffs and a draft for

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[540] See Kenneth W. Dam, *the GATT Law and International Economic Organization.* Chicago and London: the University of Chicago Press, 1970, 10-11.
[541] See Lester *et al.*, above note116, 66-67.
[542] Ibid. The Congress was Republican-dominated after the 1948 election, but the presidency was controlled by the Democratic hands.
[543] See Jackson, above note 73, 33.
[544] Luengo Hernandez de Madrid, above note 75, 37.
[545] Ibid, 39-40.
[546] Ibid. Also see Section C, Chapter IV of *Final Act of the United Nations Conference on Trade and Employment: Havana Charter for an International Trade Organization.*
[547] See Jackson, above note 73, 32-33.

"general clauses" of tariff obligations respectively.[548] The latter two parts formed the basic framework of the GATT, which was supposed to be subordinated to the ITO.

When the Havana conference drew to a close with the completion of the GATT, the US and other countries desired to have the GATT accepted and implemented as soon as possible.[549] For many practical reasons, a "Protocol of Provisional Application" (PPA) was signed by eight nations to apply the GATT "provisionally on and after 1 January 1948" in late 1947; the remaining members of the twenty-three original members of GATT would sign later.[550] Through the PPA, GATT was applied as a treaty. It is worth noting that PPA provided an exception to implement Part II of the GATT "to the fullest extent not inconsistent with existing legislation", while Part II prescribed most principal substantive obligations.[551]

Article VI and Article XVI of the GATT contained general rules governing subsidies. Article XVI of GATT in 1947 included only one paragraph (XVI: 1) originally from the Havana Charter, which required Contracting Parties to perform the duty of notification if subsidies inconsistent with this article exist.[552]

When the failure of ITO was a definite fact in 1955, Article XVI was modified and enriched to include more specific provisions, and then four paragraphs were added; hence, this Article consisted of two sections: Section A: Subsidies in General; Section B: Additional Provision on Export Subsidies.[553] Among the new paragraphs, there are two key obligations (paragraph 3 and 4) which treat primary and non-primary products differently; finally, the amendments were accepted only by certain industrialized nations of GATT.[554] For the first time, Interpretive Notes to Article XVI was added in Annex I of the GATT.[555]

5.1.3 The Subsidies Code from Tokyo Round Negotiation

Upon the conclusion of Kennedy Round in June 1967, the GATT's annual session in November in the same year decided to initiate a further round of trade negotiations to solve the problems in the dynamic trade field.[556] After a long preparation, the Meeting of Ministers in Tokyo from 12 to 14 September 1973 officially launched the

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[548] Ibid.
[549] See Jackson, above note 73, at 34.
[550] Ibid, at 34-37.
[551] Ibid. For instance, Part II deals with customs procedures, quota, subsidies, antidumping duties and national treatment. For the other two parts, Part I contains most favored treatment and and tariff concession legislation; and Part III stipulates procedural issues.
[552] See Jackson, Davey and Sykes, above note 75, at 773.
[553] Ibid.
[554] Therefore, developing countries interpreted it as discrimination against their trade and did not endorse this section of the Article. See Trebilcock and Howse, above note 116, at 264.
[555] See Ad Art. XVI, in Annex I to GATT 1947 entitled "Notes and supplementary provisions".
[556] After a short economic recession, monetary disturbances, growing inflation, rising unemployment and protectionist pressures created lots of problems for governments; see Report by the Director-General of GATT, above note 114, at 2.

multilateral trade negotiations leaving the specific tasks to the Trade Negotiations Committee. Unlike the previous negotiations, the Tokyo Round addressed both tariff measures and non-tariff measures extensively; hence it was regarded as the most ambitious negotiation up to that time. At the outset, the Tokyo Round comprised six Groups and a few Sub-Groups; later, a seventh Group, described as the Framework Group, was set up in 1976.[557] The fourth Sub-Group in the third Group addressed subsidies and countervailing duties.[558]

At that time, European Economic Community, Japan and the US shared about two thirds of world trade among them. If the Big Three could not reach an agreement on certain major issues, no agreement could be reached among all the participants.[559] In December 1967, a GATT Working Party had been established to study countervailing duties, subsidies and other export incentives. However, the Working Party never met owing to the differences on its terms of reference between then European Economic Community and the United States: the former was just interested in a possible code on countervailing duties, while the latter insisted on both subsidies and countervailing duties covered.[560] In the Tokyo Round (1973-1979), substantive negotiations on subsidies did not begin until 1978; further intensive bilateral and plurilateral negotiations led to the completion of the text of *Agreement Concerning the Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement* (Subsidies Code).[561]

The main reason why the subject of subsidies in the GATT underwent a long and tortuous negotiating process lies in the deep-rooted divergences of position between then European Economic Community and the United States, which made any attempt at compromise impossible over the first several years of the negotiations. Their conflicts were embodied in the final Subsidies Code, which was divided into two tracks. Track I dealt with the adoption of countervailing duties by the Contracting Parties and introduced the corresponding procedure, and Track II focused on the governments' obligations to restrict the use of trade-distorting subsidies.[562] Also, the Subsidies Code was adopted mostly by OECD countries and by a small number of developing countries, less than twenty-five Contracting Parties in total, so it was not a multilateral agreement, but a plurilateral one.[563]

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[557] Ibid, at 8-9.
[558] Ibid.
[559] Ibid, at 16-17.
[560] Ibid, at 54.
[561] Ibid, at 56.
[562] See Trebilcock and Howse, above note 116, at 264. For details relating to the two tracks, please refer to Luengo Hernandez de Madrid, above note 75, at 65-74.
[563] See the list of acceptances of Tokyo Round agreements in *Analytical Index of the GATT* (WTO, 1995), 1147-50. Just like the amendments to GATT in 1955, the Code could not strike a balance between the conflicts of interests from different countries.

As regards the contents in the Tokyo Round, a principal difficulty was to draw a distinction between subsidies granted by government for valid economic and social policies and those having distorting effect on world trade and depriving other countries of legitimate trade opportunities.[564] Also, it was difficult to define a subsidy, since there was no common ground on subsidies and how to deal with them.[565] In the end, the Tokyo Round left the definition of "subsidies" open.

Apart from the above difficulties, it is vague about "material injury" in the Subsidies Code. The US Tariff Act of 1930 did not require "material injury" as a condition for imposing countervailing duties and thus did not conform to the requirement of GATT Article VI: 6(a). Many participants were against the practice of the US and therefore, the acceptance of the "material injury" was the crux of the negotiations.[566] Most nations at that time treated subsidies other than export subsidies as their national matters or internal policies and aimed to secure a binding requirement on imposing countervailing duties, while US insisted that rules on countervailing duties should only be addressed if an agreement to discipline subsidies was more generally reached.[567]

As can be observed, such a negotiation history reveals the process of compromise of different interests, especially among the Big Three; and, to be sure, the evolution of subsidy-related provisions also shows to us how the subsidy rules are formulated and amended in more details.

5.1.4 The SCM Agreement from Uruguay Round

Launched in 1986 with more than 120 participating countries, the Uruguay Round was the most ambitious Round to date and resulted in the creation of the WTO.[568] The Uruguay Round concerned the detailed work on many non-tariff measures, and covered virtually every sector of world trade, such as services, intellectual property and investment etc. It is not an over-exaggeration to state that the 1994 WTO Agreement is arguably the most important worldwide agreement since the UN Charter of 1945.[569] It contains 29 Agreements and Understandings listed in the 4 Annexes and includes 28 further Ministerial Decisions, Declarations and 1 Understanding.

Subsidies were one of the subjects that required revision in this negotiation, because the inoperability of its provisions had been evident since the adoption of the Subsidies

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[564] See Report by the Director-General of GATT , above note 114, at 53.
[565] Ibid., at 54.
[566] Ibid., at 58-59.
[567] See Trebilcock and Howse, above note 116, at 264.
[568] See Jackson, Davey and Sykes, above note 75, 227-230.
[569] Ernst-Ulrich Petersmann: *International Trade Law and the GATT/WTO Dispute Settlement System*. London, Boston: Kluwer Law International, 1997.

Code in Tokyo Round in 1979.[570] It did not define some of the most important concepts, for instance, "serious prejudice", "material injury" and "subsidy". It also failed to respond to both the rules concerning subsiding and countervailing measures adequately. The United States even commented that the Subsidies Code was a source of conflict rather than an instrument for objective arbitration of differences between contracting parties.[571]

By and large, except the US, the other countries viewed the industrial subsidies as legitimate instrument of domestic policies.[572] Nevertheless, in the end, the negotiation result in the Uruguay Round reflected the concern of the US, which generally considered the use of subsidies as illegitimate distortions to international trade.[573] To achieve a balance, the use of countervailing duty was also regulated by a series of procedures.

In the early period of the Uruguay Round negotiation, a long list of issues was made as a framework for further discussions among participants, and it was amended regularly by the Secretariat to reflect the progress. The issues focused on both subsidies (principals and approaches, including 8 separate points; definitions and concepts related to subsidies, 11 points; disciplines on subsidies, as least 14 points; and measurement of the amount of a countervailable subsidy, just one point but fundamental) and countervailing measures (determination of the existence of material injury, definition of sale, initiation and conduct of countervailing duty investigations, imposition and duration of countervailing measures, and two other topics).[574] There were another ten points discussing the differing views on special rules toward developing countries and on dispute settlement.[575]

The traffic light approach, namely the three-category classification of subsidies, was suggested in the Secretariat list, and it was developed further by European Community, Columbia and Switzerland with various proposals.[576] Not all the ideas contained in the proposals were accepted, but later, "the three-category concept proved critical to developing a balanced approach to the Uruguay Round subsidy negotiations".[577] Recommendations based on the three-category classification by the Chairman of the subsidies negotiating group, Michael Cartland, "provided a flexible, logical and quite detailed framework"[578] for the governments to discuss more easily and clearly. The subsequent negotiations followed this framework and put more details into the three categories: prohibited subsidies, subsidies that could be exempt

[570] Luengo Hernandez de Madrid, above note 75, at 84.
[571] See Croome, above note 115, at 61.
[572] See Trebilcock and Howse, above note 116, at 262.
[573] Ibid.
[574] Ibid.
[575] Ibid.
[576] Ibid, at 62.
[577] Ibid.
[578] Ibid.

from countervailing action and non-prohibited but countervailable or otherwise actionable subsidies.[579] The actionable subsidies probably can be challenged if they are believed to cause adverse effects, that is, serious prejudice, injury or nullification and impairment of benefits. In addition, the participants raised quite a few different themes for the actionable subsidies, such as the prevention of circumvention of duties, whether a "sunset clause" is necessary, whether the key terms including "domestic industry" and "major proportion" should be laid down more precisely etc.[580]

In the beginning of 1990, Chairman Michael Cartland and the Secretariat developed a single draft text to bring the previous work to a conclusion. The text was circulated informally and later proved sufficiently acceptable as a basis for further negotiation.[581] The text was redrafted several times before the Brussels meeting to solve the differences. Cartland commented that the suggested amendments were often proposed by some and rejected by some others, and the possibilities for progress at the technical working level had been exhausted, thus it could only be handled at political level.[582]

Finally, a subsidy agreement in Uruguay Round was adopted to take place of the Subsidies Code in Tokyo Round with substantial progress, known as Subsidies and Countervailing Measures Agreement. For the first time, it provided a definition of subsidy. It introduced a vital element: the "specificity" test; and it also adopted the approach of three-category classification of subsidies. The term of "specificity" is crucial in the new Agreement, since only specific government actions will be subject to the disciplines contained in the SCM Agreement. Article XXVII of the SCM Agreement also made special arrangement for the developing countries in terms of using subsidies, for instance, Paragraph One states that: Members recognize that subsidies may play an important role in economic development programmes of developing country Members.[583]

As to the relationship between the SCM Agreement and the GATT 1994, first of all, the SCM Agreement is an annex to the GATT 1994. Second, both the SCM Agreement and the GATT 1994 are integral parts of the WTO, which is a single treaty instrument accepted by the WTO Members as a "single undertaking"; the former shall prevail in the event of a conflict.[584]

Given the specific problems caused by subsidies for primary products in the previous negotiation rounds, a separate group was arranged to deal with agricultural products

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[579] Ibid, at 171-172.
[580] Ibid.
[581] Ibid, at 175-176.
[582] Ibid.
[583] See Article XXVII of the SCM Agreement.
[584] See Appellate Body Report, *Brazil-Measures Affecting Desiccated Coconut* (WT/DS22/AB/R), para. B (WTO Agreement: An Integrated System) in IV Applicability of Article VI of the GATT 1994.

(*Committee on Trade in Agriculture*).[585] Therefore, the SCM Agreement focuses on non-primary products relevant to GATT, not covering many issues in agriculture.[586]

Nonetheless, the SCM Agreement is not static; the dynamic internal trade and the closer and closer economic interdependency between States on a worldwide scale, not just enhance the necessity to "regulate the granting of subsidies at the international level", but also call for the further negotiation and revise of the subsidies rules.[587] The Negotiating Group on Rules of WTO has already been directed by Members in Doha meeting to clarify and improve disciplines under the AD and SCM agreements, while preserve the basic concepts, principles and effectiveness of those Agreements.[588] As a reference, the following table summarizes all the trade negotiation rounds since the inception of GATT:

GATT/WTO Trade Rounds[589]

Year	Place/Name	Subjects Covered	Participating Economies
1947	Geneva	Tariffs	23
1949	Annecy	Tariffs	13
1951	Torquay	Tariffs	38
1956	Geneva	Tariffs	26
1960-61	Geneva (Dillon Round)	Tariffs	26
1964-67	Geneva (Kennedy Round)	Tariffs and anti-dumping duties	62
1973-79	Geneva (Tokyo Round)	Tariffs, non-tariff measures, 'framework' agreements	102
1986-94	Geneva (Uruguay Round)	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO, etc.	123
2001-	Doha(Doha Round)	Agriculture, services, market access for non-agricultural products, trade-related aspects of intellectual property rights, relationship between trade and investment, interaction between trade and competition policy, transparent in government procurement, trade facilitation, WTO rules, trade and	142 as of 26 July 2001

[585] Luengo Hernandez de Madrid, above note 75, at 85; Also see Croome, above note 115, 92-99, at 199-255.
[586] Agreement on Agriculture (AoA) only refers to certain primary products; hence, primary products excluded from the AoA are still covered by the SCM Agreement.
[587] See Luengo Hernandez de Madrid, above note 75, at 3.
[588] See TN/RL/W/213, 30 Nov. 2007. The Negotiating Group on Rules issued the Draft Consolidated Chair Texts of the AD and SCM Agreement first on 30 Nov. 2007, which caused great debates and conflicts.
[589] Source: WTO, *Understanding the WTO* (WTO, Geneva, 2005), 16; Ministerial Conference, Doha Ministerial Declaration, WT/MIN (01)/DEC/1, Nov. 20, 2001; and the website of WTO.

		environment, electronic commerce, technical cooperation and capacity building, and least-developed countries etc.	

5.2 Analysis of Subsidies in the SCM Agreement

The following section explores subsidies as prescribed by the SCM Agreement. Briefly speaking, there must be two elements within the meaning of SCM Agreement, which are "financial contribution by a government or any public body" (or its alternative: income or price support in the sense of Article XVI of the GATT 1994) and "benefit" respectively.[590] As will be noted, each element has its own specific and comprehensive meanings.

The SCM Agreement defines subsidies as follows:

Article 1 Definition of a Subsidy

1.1 For the purpose of this Agreement, a subsidy shall be deemed to exist if:

(a) (1) A financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where:

(i) A government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);

(ii) Government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);

(iii) A government provides goods or services other than general infrastructure, or purchases goods;

(iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments;

***or** (a) (2) there is any form of income or price support in the sense of Article XVI of GATT 1994;*

***and** (b) A benefit is thereby conferred.*

1.2 A subsidy as defined in paragraph 1 shall be subject to the provisions of

[590] It also can be deemed to have four factors: financial contribution, any public body, benefit, the causation between the financial contribution and the benefit.

Part II or shall be subject to the provisions of Part III or V only if such a subsidy is specific in accordance with the provisions of Article 2.

5.2.1 Financial Contribution

Financial contribution is the first and foremost element of subsidies. In essence, it is one type of governmental actions. Broadly speaking, the governmental actions may refer to financial transfers, taxation, monetary policies, industrial policies, border trade measures, and regulatory measures *etc.* These forms of governmental actions giving economic advantage do not necessarily mean that a subsidy can be confirmed. In light of the wording of Article 1 in the SCM Agreement, only governmental actions that constitute financial contributions can be regarded as subsidies.

The Panel in *US-Export Restraints* further defined the meaning of governmental action by introducing the element financial contribution: "By introducing the notion of financial contribution, the drafters foreclosed the possibility of the treatment of any government action that resulted in a benefit as a subsidy".[591] Otherwise, there would be no need for the existence of financial contribution since "all government measures conferring benefits, *per se*, would be subsidies".[592]

The Panel in *US-Export Restraints* further stated "the negotiating history of Article 1 confirms our interpretation of the term 'financial contribution'. This negotiating history demonstrates, in the first place, that the requirement of a financial contribution from the outset was intended by its proponents precisely to ensure that not all government measures that conferred benefits could be deemed to be subsidies." [593] The Panel also stressed that many participants in the negotiations consistently maintained that only government actions constituting financial contributions should be subject to the multilateral rules on subsidies and countervailing measures.

The rationale for selecting financial contribution as a criterion is that some kinds of governmental actions are necessary for sustaining the operation of economic activities, especially when these actions may not be trade-distorting or harmful. Also, when the market fails, it is inevitable for the government to manage the situation and remedy the failures and deficiencies of the market. In effect, it is common that governments nowadays often intervene in economic activities, with various objectives such as providing the regulatory framework for the national economy, adjusting the macroeconomic environment, and providing general benefit to its citizens and so

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[591] Panel Report, *US-Measures Treating Export Restraints as Subsidies (US-Export Restraints)*, WT/DS194/R, para. 8.38.
[592] See Appellate Body Report, *US-Countervailing Duty Investigation on Dynamic Random Access Memory Semiconductors (DRAMs) from Korea (US-Countervailing Duty Investigation on DRAMs)*, WT/DS296/AB/R, para.114.
[593] See Panel Report, *US-Export Restraints*, above note 591, para. 8.65.

on.[594]

In *Canada - Aircraft*, the Panel concluded that "the object and purpose of the SCM Agreement could more appropriately be summarized as the establishment of multilateral disciplines 'on the premise that some forms of government intervention distort international trade, or have the potential to distort international trade'."[595] Therefore, financial contribution was introduced to the SCM Agreement primarily to make a distinction between legitimate internal policies and protectionist market distortions; and then fewer legitimate internal policy decisions might be countervailable.[596] It is of course a difficult task to draw a line between fair international trade practices and legitimate sovereignty actions.

When it comes to the types of financial contribution, Article 1.1(a) (1) of the SCM Agreement defines a list of governmental measures that constitute a financial contribution. A question naturally arises in terms of whether the list is an illustrative one or exhaustive. The answer is that it should be considered exhaustive; otherwise, the definition of subsidy in article 1 of the SCM Agreement would lose its intended purpose. The introductory provision of Article 1 states that "for the purpose of this Agreement, a subsidy shall be deemed to exist if', its ordinary meaning indicates an exhaustive list; and the text of Article 1.2 " A subsidy as defined in paragraph 1" also supports this view.[597]

The Panel on *US-Export Restraints* also held this view: "Obviously, Article 1 as ultimately adopted incorporates the requirement of a financial contribution by a government or other public body as a necessary element of a subsidy. The submissions by participants to the negotiations suggest that the proponents' purpose behind including this element was to limit the kinds of government actions that could fall within the scope of the subsidy and countervailing measure rules. In other words, the definition ultimately agreed in the negotiations definitively rejected the approach espoused by the United States of defining subsidies as benefits resulting from any government action, by introducing the requirement that the government action in question constitute a "financial contribution" as set forth in an exhaustive list." [598]

Next question relates to how to read the concept of financial contribution itself. The Panel on *US-Export Restraints* noted that if the concept of financial contribution were about effects rather than existence or nature of government actions, the concepts of

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[594] Government may also provide assistance to persons, to service sectors, to agriculture and so on, while in this thesis we will focus on industries or enterprises, which are the primary objects of the SCM Agreement as well as the main target of international trade conflicts.

[595] Panel Report, *Canada-Measures Affecting the Export of Civilian Aircraft (Canada-Aircraft)*, WT/DS70/R, para. 9.119.

[596] Wilcox, above note 134, at 129-163.

[597] See Wolfrum *et al.*, above note 117, at 428.

[598] Panel Report, *US-Export Restraints*, above note 591, para. 8.69.

benefit and specificity would be the sole determinants of the scope of the SCM Agreement, which was not the intended purpose and object of the SCM Agreement.[599] In this respect, financial contribution is only concerned with its existence and nature, leaving the issue of effect to the other element of a subsidy, namely benefit.

5.2.1.1 How to Interpret "Public Bodies"

In light of the wording of Article 1.1(a)(1) of the SCM Agreement, the financial contribution must be provided by "a government or any public body within the territory of a Member (referred to in this Agreement as "government")".[600] So it indicates that either a government or any public body may provide a financial contribution. A private body may also provide financial contribution on condition that it is entrusted or directed by a government.[601] Therefore, three kinds of entities can be clearly identified as potential providers of subsidies in accordance with the SCM Agreement.

As to the term "government", the *Black's Law Dictionary* defines "government" as, *inter alia*, "the regulation, restraint, supervision, or control, which is exercised upon the individual members of an organized jural society by those invested with authority".[602] There is little disagreement about its scope, which covers not only central/federal government institutions but also sub-national governments, local/ municipal authorities, and even other public agencies such as, inter alia, agencies or institutions subordinated to the state.[603]

The term "public body", however, is not as clear as "government". Its scope seems to be quite vague. There is little textual guidance on the meaning of this term. In the latest case *United States-Definitive anti-dumping and countervailing duties on certain products from China (US-AD/CVD on Certain Products from China),* one of the main legal issues goes to the scope of "public body" in Article1.1 (a)(1) of the SCM Agreement, namely whether the term "public body" requires to exercise functions of a governmental or public character; in particular, whether SOEs are public bodies in the sense of the SCM Agreement.[604] The Panel in the *US-AD/CVD on Certain Products from China* holds that "governments", "public bodies" and "private bodies" constitute a complete universe of all potential actors; since SOEs do not fall into the ordinary meaning of the term "private body" and do not match with the term of "government",

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[599] Ibid., paras.8.38, 8.42.
[600] See the chapeau of Article 1.1(a)(1) of the SCM Agreement.
[601] See Article 1.1(a)(1)(iv) of the SCM Agreement. In essence, this paragraph is intended to ensure that governments do not evade their obligations under the SCM Agreement by using private bodies as proxies. Thus, it is an anti-circumvention provision.
[602] See *Black's Law Dictionary.* West Publishing Co., 1990, 695.
[603] See Wolfrum *et al.*, above note 117, at 429.
[604] See Panel Report, *United States-Definitive Anti-Dumping and Countervailing Duties on Certain Products from China* (*US-AD/CVD on Certain Products from China*), WT/DS379/R, 8.3-8.41.

SOEs should not be excluded from the scope of "public bodies".[605] The problem with such logic is that there is no clear line between public bodies and private bodies. Grey area exists owing to their inevitable intersection or overlap, for instance, there may be entities called as semi-public bodies or semi-private bodies. In addition, the SCM Agreement mentions "governments", "public bodies" and "private bodies" explicitly as potential providers of subsidies, while it shows no exhaustive sign. This means that other kinds of entities just like the semi-private bodies may provide subsidies.

The following part explores the plain meaning of public bodies. The dictionary meanings of the word "public" includes: "of, concerning, or affecting the community or the people; capitalized in shares of stock that can be traded on the open market; connected with or acting on behalf of the people, community, or government",[606] "of or pertaining to the people as a whole; belonging to, affecting or concerning the community or nation", as "carried out or made by or on behalf of the community as a whole; authorized by or representing the community",[607] and "provided, especially by the government, for the use of people in general; connected with the government and the services it provides" *etc.*[608] Many other dictionaries share similar definitions about the word "public", which involves the government or affects the people as a whole. The word "body" may refer to "an artificial person created by legal authority; a corporation; an officially constituted organization, an assembly, an institution, a society".[609] The problem is that dictionary definitions suggest a rather broad range of potential meanings for the composite term "public body". Thus the concept of "public body" is still quite vague, and it could refer to a number of different concepts encompassing a variety of entities. In particular, it is silent about the question whether the composite term "public body" refers to entities vested with and exercising governmental authority. Owing to the vagueness of its concept, a public company listed in the stock market can also be categorized as public bodies, solely based on the dictionary meaning of "public".

Some may argue that the conjunction "or" in the phrase "a government or any public body" indicates similar meanings or even functional equivalents, while others argue that it expresses distinct and different meanings for the two connected terms.[610] Unfortunately, both arguments based on the conjunction "or" are undermined by the dictionary meanings of "or", since the term "or" has several different meanings including those held by both arguments.[611]

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[605] Ibid., para.8.68. The Panel also cites various dictionary meanings in support of its standpoint.
[606] *Free Dictionary Online* (accessed Nov. 1, 2010) <http://www.thefreedictionary.com>.
[607] Stevenson (ed.): *Shorter Oxford English Dictionary*, above note 533, Vol. 2, 2394.
[608] Sally Wehmeier (ed.), *Oxford Advanced Learner's Dictionary of Current English*, the 6th edition. Oxford University Press, 2000.
[609] Stevenson (ed.): *Shorter Oxford English Dictionary*, above note 533, Vol. 1, 261.
[610] See Panel Report, *US–AD/CVD on Certain Products from China*, above note 604, 8.3-8.41.
[611] See *Free Dictionary Online* (accessed Nov. 1, 2010) <http://www.thefreedictionary.com> and Sally Wehmeier (ed.), *Oxford Advanced Learner's Dictionary of Current English*, the 6th edition. Oxford University Press, 2000.

The AB also recognizes the limitations of dictionary definitions, "dictionaries are important guides to, not dispositive statements of, definitions of words appearing in agreements and legal documents".[612] Thus, for the AB, dictionary definition is only a starting point for determining the precise meaning of a treaty term. In accordance with the customary rules of interpretation codified in the VCLT,[613] apart from the plain meaning of the term in question, the immediate and broad context in which the treaty term is used should be considered carefully.

Article 1.1(a)(1)(iv) of the SCM Agreement serves as a closely relevant, and perhaps the most important context, which states that: *a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments.* This paragraph identifies the instances where a seemingly private act conducted by a private body may be attributable to a government for purposes of determining whether there has been a financial contribution. Particularly noteworthy is the wording that a private body is entrusted or directed by a government or public body "*to carry out*" a function. In effect, the key terms "entrust" and "direct" have been discussed in length in cases such like *US – Export Restraints*[614] and *US-Countervailing Duty Investigation on DRAMs.*[615] The *US – Export Restraints* Panel explained "it follows from the ordinary meanings of the two words 'entrust' and 'direct' that the action of the government must contain a notion of delegation (in the case of entrustment) or command (in the case of direction)."[616] The AB in the *US-Countervailing Duty Investigation on DRAMs* emphasized the plain meanings of the verbs "entrust" and "direct" unambiguously convey a sense of authority exercised over someone.[617] The same AB concluded "a finding of entrustment or direction, therefore, requires that the government give responsibility to a private body - or exercise its authority over a private body - in order to effectuate a financial contribution".[618]

By virtue of subparagraph (iv) in the Article 1.1(a)(1) of the SCM Agreement and the relevant interpretations contained in panel and appellate body reports, it is clear that the verbs "entrust" and "direct" require the giving of responsibility and duty to or exercise of authority over a private body. It means that a government or a public body should first own certain authority and it is particularly true for public bodies. In the

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[612] See Appellate Body Report, *US-Continued Dumping and Subsidy Offset Act of 2000* (WT/DS217/AB/R), para 248

[613] See Article 31 1 of VCLT

[614] See Panel Report, *US-Export Restraints*, above note 591.

[615] See Panel Report, *US-Countervailing Duty Investigation on Dynamic Random Access Memory Semiconductors (DRAMs) from Korea (US-Countervailing Duty Investigation on DRAMs),* WT/DS296/R, Appellate Body Report, *US-Countervailing Duty Investigation on DRAMs* (WT/DS296/AB/R)

[616] See Panel Report, *US-Export Restraints*, above note 591, para 8 29

[617] See Appellate Body Report, *US-Countervailing Duty Investigation on DRAMs*, above note 592, para 111

[618] Ibid., para 113

absence of authority, it is hard to imagine that a public body could entrust or direct a private body to carry out certain functions. Therefore, the term "public body" in the sense of Article 1.1(a)(1) of the SCM Agreement is not extended to any entities that involve the government or affect the people as a whole; rather, it is limited to entities with certain authority.

As recognized by the AB in *US–AD/CVD on Certain Products from China,* subparagraph (ii) also lends support to the proposition that a public body connotes an entity vested with certain governmental authority.[619] Subparagraph (ii) relates to the revenue foregone or not collected including tax, and such action involves the exercise of governmental authority in that it is an integral part of the sovereign function.[620] This kind of financial contribution can be provided by public body, thus, public body should, first of all, possess or exercise such governmental authority.

Another related contextual background is Article I:3(a) of the *General Agreement on Trade in Services* (GATS). The first task is to examine whether GATS can be considered as a context of the SCM Agreement. Pursuant to Article II:2 of *Agreement Establishing the World Trade Organization* (*WTO Agreement*), Annexes 1, 2 and 3, including Annex 1A - *Multilateral Agreements on Trade in Goods* and Annex 1B - *General Agreement on Trade in Services and Annexes*, are integral parts of it.[621] It means that the agreements covered by Annex 1, 2 and 3 together constitute the *WTO Agreement*, and in this sense, GATS and the SCM Agreement are linked. Furthermore, Article I:3(a) of GATS connects Article 1.1(a)(1) of the SCM Agreement and the term "public body" in respect of the texts. Article I:3(a) of GATS reads as follows:

> *"Measures by Members" means measures taken by: (i) central, regional or local governments and authorities; and (ii) non-governmental bodies in the exercise of powers delegated by central, regional or local governments or authorities.*

Both articles deal with the providers of certain measures affecting trade among countries. That is an important similarity. Specifically, "governments and authorities" respond to governments in Article 1.1(a)(1) of the SCM Agreement, and the plain meaning of the term "non-governmental bodies" indicates that it includes not just public bodies and private bodies, but also entities or grey areas that exist between public and private bodies.[622]

Therefore, Article I:3(a) of GATS is a relevant to interpreting the term "public body"

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[619] See Appellate Body Report, *US–AD/CVD on Certain Products from China* (WT/DS379/AB/R), 296-297.
[620] Ibid.
[621] The agreements and associated legal instruments included in Annexes 1, 2 and 3 (hereinafter referred to as "Multilateral Trade Agreements") are integral parts of this Agreement, binding on all Members.
[622] In particular, there is no clear line between the activities of public and private bodies, and thus gray areas exist.

contained in the SCM Agreement.[623] Article I:3(a) of GATS states clearly that for measures taken by non-governmental bodies, they should be in the exercise of powers delegated governments and authorities. Similarly, the term "public body" in Article 1.1(a)(1) of the SCM Agreement should be interpreted as having certain governmental authority or functions of a governmental character.

Having concluded that "public body" in Article 1.1(a)(1) of the SCM Agreement should exercise functions of certain governmental authority, the remainder part discusses whether SOEs , including SOEs in financial area, are public bodies or not. First of all, ownership in a company does not mean control the company, let alone governmental authority delegated to the company. Put differently, government ownership is not sufficient, in itself, to determine that an entity is controlled by the government or even a "public body" in the sense of Article 1.1(a)(1) of the SCM Agreement. Other decisive factors ought to be considered to determine the level of control by the government over the company, such as the composition of the managing and supervisory board, the setting up of instructions for day-to-day activities, the adoption of important business strategies and investment plans and the approval of other reports *etc.*[624] Similar understanding is supported by Article XXVIII:(n)(ii) of GATS, and it defines "control" in the following way: a juridical person is "controlled" by persons of a Member if such persons have the power to name a majority of its directors or otherwise to legally direct its actions.[625]

As explained by the AB in *US-AD/CVD on Certain Products from China,* this proposition is also upheld by Articles 4, 5 and 8 of the International Law Commission's Articles on *Responsibility of States for Internationally Wrongful Acts* (ILC Articles), namely, authority to perform governmental functions is a core feature of the term "public body".[626] The key problem is whether the ILC Articles can be regarded as relevant rules of international law applicable in the relations between the parties in accordance with Article 31(3)(c) of the *VCLT.* The answer provided by the AB in *US-AD/CVD on Certain Products from China* is positive. As the same AB commented, both Articles 4, 5 and 8 of ILC Articles and Article 1.1 (a)(1) of the SCM Agreement involve the question of attribution of conduct to a state, and it is in this sense that they are relevant. Second, ILC Articles reflect customary rules of

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[623] Article 31.2 and 31.3: "2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes: (a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty; (b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty. 3. There shall be taken into account, together with the context: (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation; (c) any relevant rules of international law applicable in the relations between the parties.

[624] These decisive factors are listed in the book *WTO-Trade Remedies* adopting an article-by-article commentary approach. See Wolfrum *et al.*, above note 117, at 429.

[625] See Article XXVIII: (n)(i) of GATS.

[626] See Appellate Body Report, *US–AD/CVD on Certain Products from China*, above note 619, 304-311. The commentary on Article 5 states that state participation in its capital or ownership of its assets is not decisive criterion for the purpose of attribution of the entity's conduct to the state.

international law to some extent – one source of international law in Article 38(1) of the Statute of the International Court of Justice.[627]

According to the Panel in the *Korea-Commercial Vessels*, "an entity will constitute a 'public body' if it is controlled by the government (or other public bodies). If an entity is controlled by the government (or other public bodies), then any action by that entity is attributable to the government, and should therefore fall within the scope of Article 1.1(a) (1) of the *SCM Agreement*".[628] The Panel regarded 100 per cent government ownership as "a situation that is highly relevant to and often determinative of government control".[629] The Panel in the *Korea-Commercial Vessels* listed much evidence to support its conclusion that KEXIM is a public body, such as KEXIM is 100 per cent owned by GOK or other public bodies; the operations of KEXIM are presided over by a President (Article 9(1) of the KEXIM Act) appointed and dismissed by the President of the Republic of Korea; the annual KEXIM Operation Programs need the Ministerial approval; GOK enjoys extensive control over the parameters within which KEXIM must operate *etc.*[630] Those evidences show that KEXIM is controlled by the government from various aspects and hence it is a public body, while the conclusion made by the Panel just emphasizes a limited part of those evidences, namely governmental ownership. Rephrased differently, the conclusion is not a corollary of all the evidences in this case; it ignores a series of factors in the specific case, and defines the term public body just by one of those factors, namely percentage of shares held by the government. Thus, the Panel's conclusion in the *Korea-Commercial Vessels* is not convincing. Admittedly, the government ownership is an important factor, while definitely it should not be the single factor to determine whether an entity is a public body.

In effect, the US DOC suggested a broad examination of "five factors" in its countervailing duty investigation to determine whether SOEs can be viewed as public bodies: (1) government ownership; (2) the government's presence on the entity's board of directors; (3) the government's control over the entity's activities; (4) the entity's pursuit of governmental policies or interests; and (5) whether the entity is created by statute.[631] Proposing five factors to decide whether an entity is a public body is rational, while it becomes irrational if the authorities put too much emphasis on one factor, or even make decisions solely on one factor. No single factor above can define a public body precisely and properly, given the complicated structure and nature of

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[627] Ibid.

[628] See Panel Report, *Korea-Commercial Vessels*, above note 394, para.7.50.

[629] Ibid., para.7.353. The Panel also said that: We find further evidence of government control of KAMCO in the fact that government-appointed officials on the Management Committee are responsible *inter alia* for formulating KAMCO's operational policy and service plan, and assuming non-performing assets (Article 14 of the KAMCO Act).

[630] Ibid., para.7.50.

[631] See US DOC: *Final Affirmative Countervailing Duty Determination: DRAMs from the Republic of Korea*, June 23, 2003; also US DOC: *Issues and Decision Memorandum for the Final Affirmative Countervailing Duty Determination: Laminated Woven Sacks from the PRC*, June 16, 2008.

entities other than governmental bodies.

As to SOEs in China, they are quite complicated as discussed in length in Chapter Three. A simple term SOE could not reveal the changing and various situations hiding behind enterprises in which the state has a stake. For instance, the use of the term SOEs in place of "state enterprises" or "state firms" reveals the change of SOEs' position and characteristic. In Chinese, state enterprise (guoying qiye) means the enterprise is operated and managed by the state, while state-owned enterprise indicates that the enterprise is invested by the state.[632] Such a change can be traced back to amendment of the Constitution. Article 8 of the Amendment (1993) to the Constitution of the PRC reads that: "State-owned enterprises have decision-making power with regard to their operation within the limits prescribed by law. State-owned enterprises practice democratic management through congresses of workers and staff and in other ways in accordance with law".[633] Before the Amendment (1993), Article 16 of the Constitution 1982 reads as follows[634]:

> *State enterprises have decision-making power with regard to operation and management within the limits prescribed by law, on condition that they submit to unified leadership by the State and fulfill all their obligations under the State plan. State enterprises practice democratic management through congresses of workers and staff and in other ways in accordance with law.*

Traditional SOEs discussed previously evolved from the state enterprises as mentioned in Article 16 of the Constitution 1982. In essence, state enterprises, belonging to the centrally planned economy, were just an executive instrument of the state plan; they should meet the obligations as required by the state plan; they pursue similar objectives with the state *etc.* Hence, there is no doubt that state enterprises can be regarded as public bodies in the sense of the SCM Agreement. On the other hand, the stark distinction between traditional SOEs and state enterprises, to an extent, makes it inappropriate to presume that SOEs are public bodies.

As an investor in traditional SOEs, the behaviors of the SASAC or other governmental ministries should also be subject to *the Industrial Enterprise Law of 1988.* Most enterprises wholly owned by the government aim at doing business and gaining benefits rather than "performing (with a degree of discretion) functions of governmental character (regulate, restrain, supervise, or control the conduct of private citizens)", especially when the government intends to gain the return on equity.[635]

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[632] The use of state-invested enterprises reflects more directly the change of ideas: those enterprises are just invested by the state not operated or managed by the state. It implies that the state should not intervene in the operation of the state-invested enterprises.

[633] See Article 8 of the Amendment (1993) to the Constitution of the PRC.

[634] See Article 16 of the Constitution 1982.

[635] Appellate Body Report, *Canada-Dairy,* WT/DS103/AB/R, WT/DA113/AB/R, para. 97.

Their pricing and production decision and other daily operational activities are generally independent of the state. Also, SOEs are under the discipline of the *Law on Enterprise Bankruptcy*; if they could not fit well in the competitive market, it is natural for them to go bankrupt. From the historical point, one primary aim of the long-lasting enterprise reform in China is to separate the government from the enterprise, with the establishment of SASAC mechanism as a typical example. SASAC, acting as the representative of the state, exercises the responsibilities and rights of an investor in SOEs. At least, traditional SOEs in China should be presumed non-public bodies, which can be rebutted.

When it comes to state-owned companies (SOCs) or reformed SOEs, it is even more difficult to take them as public bodies.[636] Most official documents referred to the reformed SOEs as SOCs so as to distinguish between SOCs and SOEs. For SOCs with the state as the one of the two or more shareholders, SASACs have the right to propose candidates for directors and supervisors to the (general) shareholders' meeting; for SOEs or state wholly owned companies, SASACs have the right to appoint and remove the relevant senior managers.[637] A conspicuous feature of Chinese SOEs including SOCs is their multi-tier structure, for instance, one SOC is partly invested by other larger SOEs which are also invested by SOEs. In this sense, the term SOE is misleading, because it is normally invested by other SOEs rather than the governmental bodies. Pursuant to the Company Law, SASACs or SOEs as shareholders of SOCs should focus on their rights and duties just like other investors or shareholders.

Therefore, unless there is evidence to show that governmental bodies have factual and effective control over Chinese SOEs, Chinese SOEs should be presumed as non-public bodies. As analyzed previously, ownership should not be taken as the single factor to decide whether SOEs are public bodies, especially in the case of Chinese SOEs where such ownership is not held by the state directly.

5.2.1.2 Types of Financial Contribution

Considering that the elaborate list of various forms of financial contribution is exhaustive, it is of more importance to examine each type very carefully. Obviously, if a measure at issue does not meet any type as set forth in the exclusive and exhaustive list, there would be no subsidy. Hence, every analysis with regard to determining the existence of a subsidy needs to start with the examination of the types of financial contribution and its only alternative: any income or price support. If a

[636] Following the corporatization strategy and the property rights reform of SOEs in the past two decades, the majority of traditional SOEs have adopted the shareholding system. SOCs register according to the requirements of the *Company Law*. Based on the shares owned by the state in SOCs, there can be state wholly owned companies, SOCs with the state as the majority shareholder, and SOCs with the state as significant or insignificant minority shareholder.

[637] See Article 22 of the Law on State-Owned Assets of Enterprises.

detailed classification is made here, five types of financial contribution can be derived from the four paragraphs of Article 1.1(a) (1) of the SCM Agreement. The list of types of financial contribution is analyzed in the following part.

(i) Direct Transfer of Funds (e.g. grants, loans, and equity infusion)

Such a contribution may take various forms, including not only grants, loans, and equity infusion, but also interest rate support, corporate bond purchases, debt-equity swaps, investments, corporate debt forgiveness.[638] The Panel on *Brazil-Aircraft (Article 21.5-Canada II)* considered that certain payments by the government made in the form of redeemable bonds constituted direct transfers of funds[639]; In *Canada - Aircraft,* the Panel concluded that TPC (Technology Partners Canada) contributions constituted direct transfers of funds.[640]

(ii) Potential Direct Transfer of Funds or Liabilities (e.g. loan guarantees)

Potential direct transfer of funds often takes the form of loan guarantees or insurance programmes. In *Brazil-Aircraft*, the Panel stated that "a 'potential direct transfer of funds' exists only where the action in question gives rise to a benefit and thus confers a subsidy irrespective of whether any payment occurs", and that "the existence of a 'potential direct transfer of funds' does not depend upon the probability that a payment will subsequently occur".[641] Liabilities means a financial obligation, so its transfer should be from the recipient to the government, or it does not make sense in this context.

(iii) Government Revenue Foregone or Not Collected

Two questions arise from this type of financial contribution. First, how do understand government revenue; and secondly, how to determine the situation where such revenues would have been collected but for the government action. There is no definition of government revenue in the SCM Agreement, while it is reasonable to include the taxes, duties and other compensation the state normally receives. For instance, the government has the entitlement to raise revenue through import duties, which naturally constitute a part of the government revenue source; the Panel in *Canada-Autos* concluded that:[642]

Through the import duty exemption, Canada has ignored the "defined,

[638] Wolfrum *et al.*, above note 117, at 430.
[639] See Panel Report, *Brazil-Aircraft (Article 21.5-Canada II)*, WT/DS46/R, para.5.22.
[640] See Panel Report, *Canada-Aircraft,* above note 595, para. 9.306.
[641] See Panel Report, *Brazil - Export Financing Programme for Aircraft (Brazil-Aircraft),* WT/DS46/R, paras 7.67-7.72.
[642] See the Appellate Body Report, *Canada-Certain Measures Affecting the Automotive Industry (Canada-Autos),* WT/DS139/AB/R, para. 91.

normative benchmark" that it established for itself for import duties on motor vehicles under its normal MFN rate and, in so doing, has foregone "government revenue that is otherwise due".

However, not all forgoing of government revenue could be considered as a financial contribution. Such forgoing normally has reasonable grounds. For instance, the Interpretive Note 1 to the SCM Agreement indicates that certain remission of duties or taxes for exported products should be exceptional, which reads as follows:

In accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which accrued, shall not be deemed to be a subsidy.

The rationality underlying such exceptions is simple: products exported into foreign markets will be subject to import duties and indirect taxes, while they have been taxed in the internal market. Hence, such an exemption actually avoids the additional burden of double taxation imposed on the exported products.

As to the second question, it relates to a comparison between two situations: the situation affected by the governmental measure and the situation that would have been in the absence of forgoing of government revenue that is due. It is an important factor that the government revenue foregone is due, as the AB on *US-FSC* commented:[643]

Under Article 1.1(a) (1) (ii), a 'financial contribution' does not arise simply because a government does not raise revenue which it could have raised. It is true that, from a fiscal perspective, where a government chooses not to tax certain income, no revenue is 'due' on that income. However, although a government might, in a sense, be said to 'forego' revenue in this situation, this alone gives no indication as to whether the revenue foregone was 'otherwise due'. In other words, the mere fact that revenues are not 'due' from a fiscal perspective does not determine that the revenues are or are not 'otherwise due' within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement.

Simply speaking, the normal tax system would have received the revenue but for the occurrence of the governmental measure. Or, the government is entitled to collect such revenue under the normal cases, while its new and usually

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[643] See Appellate Body Report, *US-Tax Treatment for 'Foreign Sales Corporations' (US-FSC) (Article 21.5-EC II)*, WT/DS108/RW2, para. 88.

temporary measure gives up such entitlement.

(iv)Provision of Goods or Services and Purchase of Goods

This paragraph contains two distinct transactions that have the potential to provide a financial value or increase the revenue of the enterprises artificially: one is the provision of goods or services other than general infrastructure by the government; the other is the purchase of goods by the government.[644]

The key to understanding this form of financial contribution is the term "goods", which can be interpreted narrowly or broadly.[645] Black's Law Dictionary, for example, defines "goods" as "tangible or movable personal property other than money; especially articles of trade or items of merchandise ‹goods and services›".[646] The *US-Softwood Lumber* Panel mentioned: "in our view, the sentence 'goods or services other than general infrastructure' refers to a very broad spectrum of things a government may provide. The fact that the only exception provided for in subparagraph (iii) is general infrastructure reinforces our view concerning the unqualified meaning of the term goods as used in this provision."[647] Thus, the *US-Softwood Lumber* Panel adopts a quite broad reading of the term goods. The same Panel concluded that "there is no basis in the text of the SCM Agreement to limit the term 'goods' to tradable products with a potential or actual tariff line, we consider that standing timber, trees, are goods in the sense of Article 1.1(a)(1)(iii) SCM Agreement."[648] As Canada refused to consider trees as goods by citing domestic law, the AB in *US-Softwood Lumber* stated that the concepts of "personal" and "real" property were creatures of municipal law that are not reflected in Article 1.1(a) (1) (iii) itself.[649] That is to say, the manner in which the municipal law of a WTO Member classifies an item cannot, in itself, be determinative of the interpretation of provisions of the WTO covered agreements.[650]

Concerning the term "infrastructure", *Oxford Advanced Learner's Dictionary of Current English* defines infrastructure as "the basic systems and services that are necessary for a country or an organization, for example buildings, transport, water and power supplies and administrative systems".[651] EU mentioned in a document submitted in 1989 that governmental actions in the non-trade related areas including

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[644] See Appellate Body Report, *US-Final Countervailing Duty Determination with respect to Certain Softwood Lumber from Canada* (*US-Softwood Lumber IV*), WT/DS257/R, para. 53.
[645] It seems that few legal issues in the CVD disputes go to the term "services". It is probably because of the fact that the SCM Agreement deals with trade in goods.
[646] *Black's Law Dictionary*. West Publishing Co., 1990, 701. See also *New Shorter Oxford English Dictionary*. Oxford: Clarendon Press, 1993, 1116 ("Saleable commodities; merchandise, wares; [in singular] a type of merchandise").
[647] See Panel Report, *US-Preliminary Determinations with respect to Certain Softwood Lumber from Canada (US-Softwood Lumber III)*, WT/DS236/R, para. 7.23.
[648] Ibid., para. 7.29.
[649] See Appellate Body Report, *US –Softwood Lumber IV*, above note 644, para. 65.
[650] Ibid.
[651] Sally Wehmeier, *Oxford Advanced Learner's Dictionary of Current English*, the 6th edition. Oxford University Press, 2000.

the general infrastructure "may have an effect on the economy of a country, and thus on the international economy, but they are not normally subsidies, because they merely contribute to setting the terms and conditions of a country's economic and business environment. Therefore they do not alter the competitive position of firms".[652] The Panel in *US-Softwood Lumber* also emphasized that the only explicit exception from "goods or services" was general infrastructure rather than natural resources, and the same Panel further concluded that "if the drafters had wanted to exclude other items such as natural resources or non-tradable goods, they would have also explicitly excluded such 'goods or services'".[653] As commented by the Panel in *US-Softwood Lumber*, this paragraph is intended to ensure that the term financial contribution is not interpreted to mean only a money-transferring action, but also encompasses an in-kind transfer of resources, with the exception of general infrastructure.[654] Nonetheless, if the infrastructure is not of a general nature, it would also be regarded as goods or services.[655]

(v) Payments to a Funding Mechanism or Entrustment or Direction of Private Bodies

Payments to a funding mechanism or entrustment or direction of private bodies help to counter circumvention where a financial contribution is made by the government or public bodies through a private party. Although five requirements can be derived from this type, namely, (i) a government "entrusts or directs"; (ii) "a private body"; (iii) "to carry out one or more of the type of functions illustrated in" subparagraphs (i)-(iii) of Article 1.1(a)(1); (iv) "which would normally be vested in the government" and (v) "the practice, in no real sense, differs from practices normally followed by governments", the key requirement here in terms of interpretation should be the terms "entrust" and "direct".[656] Basically, the two words indicate the proximate causal relationship between the measure of the government or public bodies and the action of the private body.

Concerning entrustment and direction, the *US – Export Restraints* Panel explained "it follows from the ordinary meanings of the two words 'entrust' and 'direct' that the action of the government must contain a notion of delegation (in the case of entrustment) or command (in the case of direction)."[657] The *US – Export Restraints* Panel also found that "both the act of entrusting and that of directing therefore necessarily carry with them the following three elements: (i) an explicit and affirmative action, be it delegation or command; (ii) addressed to a particular party;

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[652] These non-trade related areas also include education, social welfare, culture and health etc. see MTN.GNG/NG10/W/31, November 27, 1989, p8.
[653] See Panel Report, *US-Softwood Lumber III,* above note 647, paras. 7.25-7.26.
[654] Ibid.
[655] See Appellate Body Report, *US-Softwood Lumber IV*, above note 644, para. 60. See also *US-Softwood Lumber III,* above note 647, paras 7.23-7.24.
[656] See Panel Report, *US-Export Restraints*, above note 591, para. 8.25.
[657] Ibid., para. 8.29.

and (iii) the object of which action is a particular task or duty."[658] The same Panel concluded that neither entrustment nor direction could be said to have occurred without any of these three elements.

The *US-Countervailing Duty Investigation on DRAMs* Panel further reasoned "Although the plain meaning of entrustment and direction requires that something must be delegated to someone, or that someone must be commanded to do something, the plain meaning of those terms does not require that such someone or something must necessarily be specified in great detail".[659]

(vi) The Alternative of Financial Contribution: Income or Price Support

The concept of income or price support is not a kind of financial contribution. The connector "or" between Article 1.1(a) (1) and 1.1(a) (2) makes it clear that income or price support can replace a financial contribution as its alternative.

Income or price support is regulated under Article XVI: 1 GATT 1947 as a specific form of the general concept of a subsidy, which operates directly or indirectly to increase exports or reduce imports of any product.[660] Income or price support relate mainly to governmental measures in the agricultural sector, which encompasses a variety of measures aiming either at stabilization of domestic prices for agricultural goods, or at maintaining certain levels of income of agricultural producers.[661]

So far, this type has not been used by the DSB in any dispute. However, its importance and potential application should not be ignored.[662] Gustavo Luengo held the view that it is possible to regard export restriction as a form of income support. He made an example that: providing that product A is a key input for product B, an export restraint on product A may reduce its domestic price, thereby lowering down the cost of product B.[663] Thus, the producers of product B, benefiting from the lower prices of its key input, could compete better both in the domestic and international markets through such restraint, which could be deemed as income support. In any event, there are at least two problems associated with such a view. The first one is that export restraint *per se* may have legitimate reason, or could be justified. The second one is that it is uncertain whether a specific export restraint on certain product could reduce its price, to put it differently, the causal link between an export restraint and a lower price of the product involved is unclear, which depends on other factors such as

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[658] Ibid.
[659] Panel Report, *US-Countervailing Duty Investigation on DRAMs*, above note 615, para. 7.35.
[660] See Article XVI: 1 of GATT 1947.
[661] Wolfrum *et al.*, above note 117, at 445.
[662] It is argued that the use of this alternative may trigger the "Pandora's Box", with the consequence that many government measures may be regarded as conferring benefits, and hence, subsidies. See Luengo Hernandez de Madrid, above note 75, 119-123.
[663] Ibid.

the change of domestic demand of the product, the amount of the product produced, and the substitutability of the product and so forth.

To conclude, when evaluate whether a subsidy exists or not, the first and foremost step is to examine whether the government action or measure falls within the six types discussed above. If the measure constitutes a financial contribution or income or price support, then it is meaningful to continue to analyze the other elements based on the first confirmative evaluation.

5.2.2 Benefit

The second distinct element for a subsidy in the sense of the SCM Agreement is "benefit", which is the causal result of the financial contribution or income or price support. The short sentence "A benefit is thereby conferred" as used in Article 1.1(b) implies several factors for consideration. First, what is the meaning of the term "benefit"? The second issue is how to determine the existence of a benefit. And third, the verb "confer" which is used in passive form, in conjunction with the adverbial phrase "thereby", emphasizes conferral of the benefit to the recipient. According to the Webster's Third New International Dictionary, "thereby" means: 1). By that {judges in every state shall be bound~-US Constitution}: by that means: in consequence of that {paid cash, ~ avoiding interest charges}; 2). Connected with that: with reference to that; 3). Chiefly Scot: beside that: nearby: about that.[664] In the context of Article 1.1(b), the first explanation "by that" meets the term "thereby" most, which indicates the causal link between the financial contribution or income or price support and benefit. The following is a detailed analysis to the issues relating to the "benefit" in Article 1.1(b).

5.2.2.1 Meaning of Benefit

Article 1 does not define the term "benefit" or set out any criterion for determining the conferral of a benefit. In *Canada-Aircraft*, the AB confirmed the methodology that subsidies provided by Article 14 are valued as the benefit to the recipient rather than the cost to the government.[665] At the outset of the report, the AB mentioned the dictionary meaning of "benefit" as "advantage", "gift", "profit", or more generally "a favorable or helpful factor or circumstance", and then considered the following factors.[666] First, logic dictates that a "benefit" must go to a recipient, and therefore

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[664] See Philip Babcock Gove (editor in chief) and the Merriam-Webster editorial staff: *Webster's Third New International Dictionary of the English Language*. Springfield, Mass.: Merriam-Webster, c2002, at 2372.
[665] See Appellate Body Report, *Canada-Measures Affecting the Export of Civilian Aircraft (Canada-Aircraft)*, WT/DS70/AB/R. Para 155 further explained "This explicit textual reference to Article 1.1 in Article 14 indicates to us that benefit is used in the same sense in Article 14 as it is in Article 1.1. Therefore, the reference to 'benefit to the recipient' in Article 14 also implies that the word 'benefit', as used in Article 1.1, is concerned with the 'benefit to the recipient'".
[666] Ibid.

the focus of this inquiry should be on the recipient, and not on the granting authority. Second, the guidelines in Article 14 follow the benefit-to-the-recipient way. Furthermore, the structure of Article 1.1 as a whole confirms that the element "financial contribution" as set out by Article 1.1(a) indicates the cost to government, whereas the term "benefit" under Article 1.1(b) focuses on the recipient. Finally, the word "benefit" implies some kind of "comparison". It is often emphasized by the panel or the AB that the marketplace provides an appropriate basis for comparison in determining whether a benefit has been conferred.

According to Draft Consolidated Chair Texts of the AD and SCM Agreement issued in 2007, "A benefit is conferred when the terms of the financial contributions are more favorable than those otherwise commercially available to the recipient in the market, including, where applicable, as provided for in the guidelines in Article 14.1".[667] Take one service item in the financial market as an example, if one or two manufacture companies receive a loan on below-market interest rate granted by or a guarantee by the government, a benefit will naturally be conferred. Nevertheless, if the interest rate or the guarantee is similar with the one offered by a private investor in similar circumstances, then a benefit should not be deemed to exist.

Further elaboration can be found in Article 14 of the SCM Agreement, which sets forth guidelines for calculating the amount of a subsidy in terms of the benefit to the recipient.[668] The four guidelines listed also clarify the identification of benefit in the form of cases. The first three guidelines consider the commercial market as a benchmark in a straightforward way, while the fourth case employs the wording "prevailing market conditions" to determine "the adequacy of remuneration" rather than the commercial market benchmark.

According to Article 14(a), government provision of equity capital shall not be considered as conferring a benefit, unless the investment decision can be regarded as inconsistent with the usual investment practice (including for the provision of risk capital) of private investors in the territory of that Member.

Article 14(b) and (c) of the SCM Agreement indicate exactly the immediate example discussed above.[669] Article 14(b): a loan by a government shall not be considered as conferring a benefit, unless there is a difference between the amount that the firm receiving the loan pays on the government loan and the amount the firm would pay on a comparable commercial loan which the firm could actually obtain on the market; Article 14(c): a loan guarantee by a government shall not be considered as conferring

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[667] See TN/RL/W/213, 30 Nov. 2007. The Negotiating Group on Rules issued the Draft Consolidated Chair Texts of the AD and SCM Agreement first on 30 Nov. 2007. Available at: http://www.wto.org/english/tratop_e/rulesneg_e/rules_chair_text_nov07_e.htm.

[668] See Art. 14 (a) of the SCM Agreement.

[669] See Art. 14 (b) and (c) of the SCM Agreement.

a benefit, unless there is a difference between the amount that the firm receiving the guarantee pays on a loan guaranteed by the government and the amount that the firm would pay on a comparable commercial loan absent the government guarantee.

Article 14(d) of the SCM Agreement: the provision of goods or services or purchase of goods by a government shall not be considered as conferring a benefit unless the provision is made for less than adequate remuneration, or the purchase is made for more than adequate remuneration.[670] It is similar with the approach of the first three paragraphs: the pure government intervention will not constitute a subsidy in the SCM Agreement, unless a benefit is thereby conferred.

Therefore, to prove the existence of a benefit, a commercial market benchmark should be considered to make a comparison between the treatment a firm receives from the government measure and what would have been offered in normal market circumstances. However, it is not clear what kind of commercial market or market can be regarded as appropriate benchmark. Theoretically, there can be undistorted or perfect market which does not exist in real world and the existing market. And the existing market may refer to in-country real market, out-of-country real market or world market.[671]

The texts of the SCM Agreement do not clarify this issue; instead, they even send competing signals about the type of the market. The first two guidelines - Article 14 (a) and (b) of the SCM Agreement - seem to adopt an existing market rather than a perfect market by the reference to "usual investment practice of private investors" and "actually obtain on the market" respectively. The third guideline, Article 14 (c), is ambiguous about the nature of the market, which just mentions "a comparable commercial loan". It seems that both an existing market and a perfect market would work for the third guideline when making a comparison with a loan guarantee offered by a government. The fourth guideline, namely Article 14 (d) of the SCM Agreement, is very special about the market benchmark in terms of its use of "prevailing market conditions...in the country of provision or purchase", which means that an in-country existing market is selected as the benchmark.

When it comes to the cases adjudicated by the panels and the Appellate Body, it is common to find inconsistent opinions. In *Brazil-Aircraft,* the Panel considered it evident that the "market" to which reference must be made is the commercial market, i.e. a market undistorted by government intervention.[672] The Panel is silent about the exact meaning or criteria of the undistorted market. Considering the overwhelming

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[670] See Art. 14 (d) of the SCM Agreement, which also says that "The adequacy of remuneration shall be determined in relation to prevailing market conditions for the good or service in question in the country of provision or purchase (including price, quality, availability, marketability, transportation and other conditions of purchase or sale)".

[671] See Zheng Wentong (2010): The Pitfalls of the (Perfect) Market Benchmark: the Case of Countervailing Duty Law. *Minn. J. Int'l L.* 19 (1), 1-54.

[672] See Panel Report, *Brazil - Aircraft (A21.5)* (WT/DS46/RW/2), para.5.29.

presence of the government in economic activities, it is more appropriate to consider that an ideal standard is adopted here. In practice, the investigation authorities will enjoy wide discretion in deciding on the meaning of the so-called undistorted market.

Interestingly, Brazil in the *Brazil-Aircraft*[673] proposed a pattern of comparison when determining the material advantage. Brazil compared its PROEX payments with the export credit terms available with respect to competing products from other Members (Canada in this case). The Panel of course denied such a proposition on the grounds that this type of comparison has no textual support in the SCM Agreement and such an interpretation would also produce absurd results that do not conform to the object and purpose of the SCM Agreement.[674]

Such an ideal standard for the undistorted market, however, is not recognized by some other panel or Appellate Body reports. For instance, neither the Panel nor the AB in the long-running dispute between the US and Canada concerning the softwood lumber required a perfect market as the benchmark for comparison; on the contrary, they rejected the undistorted-market approach. It is worth noting that the discussions of those reports relating to softwood lumber are limited to the meaning and essence of market in the Article 14 (d) of the SCM Agreement, which may not be proper to refer to the market as used in other provisions.

In the view of the Panel in *US-Softwood Lumber III*, the "prevailing market conditions" of Article 14 (d) of the SCM Agreement do not mean a theoretical market free of government interference as the US seems to be advocating; the market conditions should be those that are actually existing in the country and faced by the recipient of the financial contribution.[675] The Panel further explained the meaning of the market in conjunction with the term "prevailing" that:[676]

> *Article 14 (d) of the SCM Agreement provides that the 'prevailing' market conditions in the country of provision of the goods are to form the basis for the comparison. The ordinary meaning of the term "prevailing" market conditions is the market conditions 'as they exist' or 'which are predominant'. Considering that the only qualifier used to the 'market conditions' in question is that they be 'prevailing', we are of the view that the text of Article 14 (d) SCM Agreement does not in any way require the 'market' conditions to be those of a hypothetical undistorted or perfectly competitive market.*

The Panel and the AB in *US-Softwood Lumber IV* agreed with the Panel in

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[673] Panel Report, *Brazil-Aircraft*, above note 641, paras.7.21-7.24.
[674] Ibid., paras.7.25-7.26.
[675] See Panel Report, *US-Softwood Lumber III*, above note 647, paras.7.50-7.52.
[676] Ibid., paras.7.50.

US-Softwood Lumber III that the text of Article 14 (d) of the SCM Agreement did not explicitly refer to a pure market, or to a market undistorted by any government intervention.[677] The Panel in *US-Softwood Lumber IV* also held that Article 14 (d) of the SCM Agreement implied the use of in-country prices as the benchmark for determining adequacy of remuneration.[678]

The AB acknowledged that "prices of similar goods sold by private suppliers in the country of provision are the primary benchmark that investigating authorities must use when determining whether goods have been provided by a government for less than adequate remuneration";[679] nonetheless, it held a different view about the type of the existing market with the Panel. The AB in *US-Softwood Lumber IV* pointed out that the phrase "in relation to" is not limited to "in comparison with" as interpreted by the panel; instead, it is similar to the phrases "as regards" and "with respect to", implying a broader sense of "relation, connection, reference".[680] Therefore, the AB held that "the use of the phrase 'in relation to' in Article 14(d) suggested that the drafters did not intend to exclude any possibility of using as a benchmark something other than private prices in the market of the country of provision".[681] In brief, the Panel endorsed the use of in-country market prices while the AB upheld the use of both the in-country and out-of-country market prices.

5.2.2.2 Recipient of the Benefit

The benefit can only exist where there is a beneficiary or recipient. According to the Panels and the AB in *Canada-Measures Affecting the Export of Civilian Aircraft*, a "benefit" can be said to arise only if a person, natural or legal, or a group of persons, has in fact received something, which implies that there must be a recipient.[682]

In *US-Countervailing Measures on Certain EC Products,* the US argued that a company and its shareholders should be separated as the Panel in *Canada-Measures Affecting the Export of Civilian Aircraft* admitted a clear dividing line between a firm and its owners. The Panel rejected this idea by concluding that:

> *for the purpose of the benefit determination under the SCM Agreement, no distinction should be made between a company and its shareholders, as together they constitute a producer, a natural or legal person that may be the "recipient" of the benefit to be assessed. Any artificial distinction*

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[677] See Panel Report, *US-Final Countervailing Duty Determination with respect to Certain Softwood Lumber from Canada (US-Softwood Lumber IV)*, WT/DS257/R, para.7.9; and Appellate Body Report, *US-Softwood Lumber IV,* above note 644, para.87.
[678] See Panel Report, ibid., paras.7.48-7.51.
[679] See Appellate Body Report, *US-Softwood Lumber IV*, above note 644, para.90.
[680] Ibid., para.89.
[681] Ibid.
[682] See Appellate Body Report, *Canada-Aircraft,* above note 665, para. 154.

between owners (shareholders) and company ignores the relationship between a company and its owners, and it is this relationship that changes upon privatization.[683]

The AB in *US-Countervailing Measures on Certain EC Products* observed that it would be possible to confer a benefit on a recipient company by providing a financial contribution to its owners/shareholders.[684]

5.2.2.3 Conferral of the Benefit

The AB in *Canada-Measures Affecting the Export of Civilian Aircraft* stated that "The ordinary meaning of the word 'confer', as used in Article 1.1(b), bears this out. 'Confer' means, *inter alia*, give, grant or bestow. The use of the past participle 'conferred' in the passive form, in conjunction with the word 'thereby', naturally calls for an inquiry into *what was conferred on the recipient*".[685]

Imagine such a case, the government showed its intent to provide certain assistance to a company, like a preference loan or exemption of duties, but such intent was not transformed into practice because of various constraints or unexpected occasions. It is clear no actual advantage (benefit) was conferred to the company (the recipient) by the government. In this context, the detection of a benefit is not sufficient to prove that a benefit has been conferred to the recipient.

However, Article 1.1 (b) SCM does not appear to require that the benefit, once made legally available to the recipient, must have been consumed by the recipient following its conferral, either wholly or in part, in order for a subsidy to be found to exist.[686] The key point is that the recipient has access to the benefit, and the benefit will be consumed by the recipient when necessary.

5.2.2.4 Pass-Through of Benefit

The term "pass-through of benefit" (it is also mentioned as "pass-through of subsidy") cannot be found in the text of the current SCM Agreement. In practice, it is common that benefit conferred on one entity has been passed on, in full or in part, to another entity, typically a downstream producer. Cases like that touch upon the issue of pass-through of benefit. Several cases addressed by the DSB have involved this issue. The Panel in *US-Softwood Lumber IV* described the pass-through problem as "where the subsidies at issue are received by someone other than the producer of the

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[683] See Panel Report, *US-Countervailing Measures on Certain EC Products* (WT/DS212 /R), para 7.54.
[684] See Appellate Body Report, *US-Countervailing Measures on Certain EC Products* (WT/DS212/AB/R), para. 117-119.
[685] See Appellate Body Report, *Canada-Aircraft,* above note 665, para. 154.
[686] Wolfrum *et al.*, above note 117, at 450.

investigated product, the question arises whether there is subsidization in respect of that product."[687]

Some argued that probably benefit for the downstream producer can be found to exist; the rationale is that the latter entity is also enjoying the benefit and consequently, is also a recipient of the subsidy.[688] However, this issue is associated with many problems, and thus should not be read simply. For instance, suppose the upstream producer or the input producers receive subsidies, questions arise as to whether the input producers are related to the producers of the subject merchandise; whether the input producers provide its products to independent downstream producers totally based on the commercial principle; how to calculate the amount of benefit that is passed through and the benefit that is received by the input producers, since it is very hard to get information about the subsidy bestowed on the upstream producers, whose products are not subject to the investigation and so on.

Actually, the Draft Consolidated Chair Texts of the AD and SCM Agreement issued in 2007 has added a paragraph in Article 14 of the SCM Agreement probably to clarify the uncertainties relating to the pass-through of benefit, which reads as follows:[689]

> *For the purpose of Part V, where a subsidy is granted in respect of an input used to produce the product under consideration, and the producer of the product under consideration is unrelated to the producer of the input, no benefit from the subsidy in respect of the input shall be attributed to the product under consideration unless a determination has been made that the producer of the product under consideration obtained the input on terms more favourable than otherwise would have been commercially available to that producer in the market.*[690]

Nevertheless, a final decision in terms of whether the benefit has been passed through to the subject merchandise should be made on a case-by-case basis. The landmark case discussing this issue is *US-Softwood Lumber IV.* Pre-privatization subsidies to SOEs also relate to the pass-through of benefit, which can be found in the two famous and long-lasting cases: *US-Lead and Bismuth II*[691] and *US-CVD on EC Products.*[692]

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[687] See Panel Report, *US-Softwood Lumber IV*, above note 677, para. 7.85.
[688] See Wolfrum *et al.*, above note 117, at 451-452.
[689] See TN/RL/W/213, 30 Nov. 2007. The Negotiating Group on Rules issued the Draft Consolidated Chair Texts of the AD and SCM Agreement first on 30 Nov. 2007. Available at: http://www.wto.org/english/tratop_e/rulesneg_e/rules_chair_text_nov07_e.htm.
[690] Where, however, it has been established that the effect of the subsidy is so substantial that other relevant prices available to the producer of the product under consideration are distorted and do not reasonably reflect commercial prices that would prevail in the absence of the subsidization, other sources, such as world market prices, can be used as the basis for the determination in question.
[691] See *US-Lead and Bismuth II,* above note 243.

The Panel and the AB in the *US-Softwood Lumber IV* made a pass-through analysis in detail.[693] The basic fact is that several Canadian provincial governments established stumpage programs, which mean the governments conferred on private timber harvesting companies the right to harvest standing timber (non-subject product). Owing to those stumpage programs, the US DOC imposed countervailing duty in respect of certain softwood lumber (the subject product) imports from Canada. The DOC believed that the benefit received by the tenured logs harvesters/sawmills, automatically, passed through to the lumber manufacturers and lumber remanufacturers for further processing.

The AB summarized the pass-through issue as "whether a Member is required to analyze whether the subsidy conferred on products of certain enterprises in the production chain was 'passed through', in arm's length transactions, to other enterprises producing the countervailed product",[694] and reasoned "it would not be possible to determine whether countervailing duties levied on the processed product are in excess of the amount of the total subsidy accruing to that product, without establishing whether, and in what amount, subsidies bestowed on the producer of the input flowed through, downstream, to the producer of the product processed from that input".[695] The AB concluded that the investigating authority must establish that the benefit on input products is passed through to producers of the processed product in order to impose countervailing duties.[696]

The AB in the *US-Softwood Lumber IV* classified the situations at issue into two types: (i) a tenured timber harvester/sawmills sells at arm's length some or all of the logs to unrelated sawmills for processing into lumber; and (ii) a tenured timber harvester processed logs it harvests into lumber and sells at arm's length some or all of the lumber it produces to unrelated lumber remanufacturers.[697] It is necessary to conduct the pass-through analysis for the first situation, irrespective of whether the tenured timber harvester owns a sawmill or not, and the underlying rationale is that the benefit are initially attached to logs rather than the softwood lumber subject to the investigation. There is no need to conduct the pass-through analysis in the second situation, since both the lumber (primary softwood lumber) produced by sawmills and the one (remanufactured softwood lumber) produced by remanufacturers are subject products. However, if the transaction in the first situation is not operated at arm's length, or the entities engaging in the transactions are not unrelated, it is not necessary

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[692] See *US-CVD on EC Products,* above note 244.
[693] See Appellate Body Report, *US-Softwood Lumber IV*, above note 644, para. 75.
[694] Ibid., para. 124.
[695] Ibid., paras. 128, 139-141.
[696] Ibid., para. 146. For further comments, please refer to Marc Benitah (2002), "Softwood Lumber: Exact Significance of the Recent Canadian Victory before the WTO and Prospects in the Context of the Pending Second Lumber Case", *the Estey Centre Journal of International Law and Trade Policy*, 3(2), 346-356; Niels Jenson and Joan Fitzhenry (2004). "Countervailing Duties and the Pass-Through of Subsidies: Canadian Lumber and the Australian Position". *International Trade Law & Regulation*, 10(6).
[697] See Appellate Body Report, *US-Softwood Lumber IV*, above note 644, paras. 155-166.

to conduct the pass-through analysis.

In the *US-Lead and Bismuth II* dispute, the US specifically determined that transactions between BSC, GKN, and UES were conducted at arm's length[698] and fully reflected commercial considerations paying fair market value[699]. Nonetheless, the US found that a company's sale of a business or productive unit does not alter the effect of previously bestowed subsidies and that disposed assets take a portion of the benefits with them when they travel to their new home. Therefore, the pre-privatization financial contributions to the then state-owned BSC had "passed through" to the private entity.[700] The European Communities were of the view that when a private buyer purchases a company or assets thereof in an arm's-length transaction at fair market value, the price paid necessarily values and incorporates within the transaction any subsidy previously conferred.[701] If the subsidy increases the value of the company, so will it increase the price that the purchaser must pay; the payment of market price thus necessarily precludes the notion that any "benefit" would have "passed through" to this new private owner as a basic matter of economics.[702]

The panels and the AB also held that if a company was purchased at arm's length and for fair value, there was no economic basis for claiming that the buyer, or the business or productive unit purchased, received a "benefit" by virtue of the past financial assistance that the seller received.[703] To convey benefit, the seller would effectively have had to sacrifice income by agreeing to a price lower than fair market value; consequently, the benefit of a subsidy does not and cannot pass through to the buyer in an arm's-length sale at fair market value.

The Panel in *US-Countervailing Measures on Certain EC Products* expressed similar idea in an explicit fashion with the report of the Panel in *US – Lead and Bismuth II:*

> *Privatizations at arm's-length and for fair market value must lead to the conclusion that the privatized producer paid for what he got and thus did not get any benefit or advantage from the prior financial contribution bestowed upon the state-owned producer. While Members may maintain a rebuttable presumption that the benefit from prior financial contributions (or subsidization) continues to accrue to the privatized producer, privatizations at arm's-length and for fair market value is sufficient to rebut*

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[698] Arm's-length transaction: a transaction between two unrelated and unaffiliated parties; a transaction between two parties, however closely related they may be, conducted as if the parties were strangers, so that no conflict of interest arises. See Bryan A. Garner (ed.): *Black's Law Dictionary*, West Publishing Co., a Thomson business 8th Ed, 2004.
[699] Ibid. Fair market value: the price that a seller is willing to accept and a buyer is willing to pay on the open market and in an arm's length transaction; the point at which supply and demand intersect.
[700] See *US-Lead and Bismuth II*, above note 243, paras. 6.39-6.42.
[701] Ibid., paras.6.32-6.38.
[702] Ibid.
[703] Ibid., paras.6.71-6.74.

such a presumption.[704]

In the *US-Countervailing Measures on Certain EC Products,* the AB held that privatization at arm's length and for fair market value "may", but not "must", result in extinguishing the benefit. "Indeed, we find that there is a rebuttable presumption that a benefit ceases to exist after such a privatization. Nevertheless, it does not necessarily do so ···It depends on the facts of each case."[705]

5.3 The Concept of "Specificity"

Not all subsidies are problematic in the SCM Agreement, since it introduced the specificity test to separate "good" domestic subsidy from "bad" one. Specificity is a crucial concept for the regulation of subsidies. Briefly speaking, only specific subsidies might be subject to the countervailing duties in accordance with the SCM Agreement (all the prohibited subsidies are regarded as specific subsidies automatically and artificially). Therefore, to determine whether a subsidy should be subject to the disciplines of prohibited subsidies, actionable subsidies or non-actionable subsidies, it is necessary to undertake a specificity test first.

The main point of the specificity requirement is to exclude broadly-based general welfare programs, such as aid to the poor, from regulation.[706] Normally, such general programs serve as important governmental tools for conducting legitimate public policies. In other words, government assistance that is both generally available and widely distributed throughout within the jurisdiction of the granting authority is probably acceptable, and thus should not be countervailed.

The Panel in *US-Export Restraints* further explains the purpose of this concept: "While the object and purpose of the Agreement clearly is to discipline subsidies that distort trade, this object and purpose can only be in respect of 'subsidies' as defined in the Agreement. This definition, which incorporates the notions of 'financial contribution', 'benefit', and 'specificity', was drafted with the express purpose of ensuring that not every government intervention in the market would fall within the coverage of the Agreement".[707] On the whole, the term 'specificity' and the other two factors were designed to determine the legitimacy of subsidies and limit the potential

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[704] The Panel also stated that "Furthermore, since the fair market value paid for the state-owned producer is deemed to include the market value of the benefit received, the Panel considers that the privatization transaction for fair market value includes the repayment to the government, as the shareholder of the state-owned producer, of the subsidy as valued by the market at the time of privatization" See Panel Report, *US-Countervailing Measures on Certain EC Products* (WT/DS212 /R), para 7 82

[705] See the Appellate Body Report, *US-Countervailing Measures on Certain EC Products* (WT/DS212/AB/R), para 127 Therefore, they reversed the Panel's conclusion that Once an importing Member has determined that a privatization has taken place at arm's-length and for fair market value, it must reach the conclusion that no benefit resulting from the prior financial contribution (or subsidization) continues to accrue to the privatized producer

[706] Lester *et al* , above note116, at 427

[707] Panel Report, *US-Export Restraints*, above note 591, para 8 63

abuse of countervailing duties.

The original text of Article 2 provides that:

Article 2 Specificity

2.1 In order to determine whether a subsidy, as defined in paragraph 1 of Article 1, is specific to an enterprise or industry or group of enterprises or industries (referred to in this Agreement as "certain enterprises") within the jurisdiction of the granting authority, the following principles shall apply:

(a) Where the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises, such subsidy shall be specific.

(b) Where the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions[708] governing the eligibility for, and the amount of, a subsidy, specificity shall not exist, provided that the eligibility is automatic and that such criteria and conditions are strictly adhered to. The criteria or conditions must be clearly spelled out in law, regulation, or other official document, so as to be capable of verification.

(c) If, notwithstanding any appearance of non-specificity resulting from the application of the principles laid down in subparagraphs (a) and (b), there are reasons to believe that the subsidy may in fact be specific, other factors may be considered. Such factors are: use of a subsidy programme by a limited number of certain enterprises, predominant use by certain enterprises, the granting of disproportionately large amounts of subsidy to certain enterprises, and the manner in which discretion has been exercised by the granting authority in the decision to grant a subsidy.[709] In applying this subparagraph, account shall be taken of the extent of diversification of economic activities within the jurisdiction of the granting authority, as well as of the length of time during which the subsidy programme has been in operation.

2.2 A subsidy which is limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority shall be specific. It is understood that the setting or change of generally applicable tax rates by all levels of government entitled to do so shall not be deemed to be a specific subsidy for the purposes of this

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[708] Objective criteria or conditions, as used herein, mean criteria or conditions which are neutral, which do not favor certain enterprises over others, and which are economic in nature and horizontal in application, such as number of employees or size of enterprise.

[709] In this regard, in particular, information on the frequency with which applications for a subsidy are refused or approved and the reasons for such decisions shall be considered.

Agreement.
2.3 Any subsidy falling under the provisions of Article 3 shall be deemed to be specific.
2.4 Any determination of specificity under the provisions of this Article shall be clearly substantiated on the basis of positive evidence.

Specific subsidies within the meaning of Article 2 of SCM are subject to the disciplines in Part II (Prohibited Subsidies), Part III (Actionable Subsidies) or Part V (Countervailing Measures). There are four general kinds of specificity: selected enterprise, industry, region and prohibited subsidies which are deemed to be specific automatically (contingent upon export performance or the use of domestic over imported products). It is worth noting that "any subsidy falling under the provisions of Article 3 shall be deemed to be specific", which is set forth explicitly by Article 2.3. The rationale for this strict discipline is based on the presumption that such subsidies have strong and direct trade-distorting effects.

However, it is criticized that the language used in Article 2 (specific to an enterprise or industry or group of enterprises or industries) gives one the distinct impression that the drafters have avoided specificity in the specificity test for the same reason that any concrete definition of a subsidy had been avoided.[710]

5.3.1 Enterprise and Industry Specificity

The Chapeau of Article 2.1 provides that, to determine whether a subsidy is deemed specific if it is limited to "certain enterprises" within the jurisdiction of the granting authority, several conditions, namely the principles set out in subparagraphs (a), (b) and (c), shall apply. The term "certain enterprises" refers to "an enterprise or industry or group of enterprises or industries".

Two forms of specificity are identified first by Article 2.1, namely enterprise specificity and industry specificity. The term "enterprise" is clearer than "industry", and the latter has left much room for further interpretation. Thus, it is an interesting and also key issue in respect of how to define "industry".

To begin with, it is worth noting that the term of "industry" could be "expanded or narrowed in light of the specific circumstances of the case".[711] In *US-Softwood Lumber IV,* the Panel introduced the definition of industry from the *Shorter Oxford English Dictionary*: "a particular form or branch of productive labour; a trade, a manufacture", and then indicated that the common practice to refer to industries is by the type of products they produce, not on the basis of specific goods or

[710] See Wilcox, above note 134, at 129.
[711] Luengo Hernandez de Madrid, above note 75, 137.

end-products.[712] The same Panel rejected Canada's arguments that specificity should be determined at the product level (on the basis of specific end-products) and explained, because of the similarity and the relatedness of the output products, even when an industry (e.g., steel, textiles, telecommunication, and autos) produces a broad range of specific end-products, it still remains an industry or group of industries within the meaning of Article 2.1 of the SCM Agreement.[713] The Panel in US-Upland Cotton considered that the concept of an industry relates to producers of certain products and the breadth of this concept may depend on several factors in a given case; an industry or a group of industries may be generally referred to by the type of products they produce.[714]

With regard to the issue of a group of enterprises or industries, the word "group" normally refers to "a number of people or things regarded as forming a unity or whole on the grounds of some mutual or common relation or purpose, or classed together because of a degree of similarity".[715] The Panel in *US-Softwood Lumber IV* reasoned that industries should produce "sufficiently similar products in order to be considered as a 'group' of industries".[716]

The definition of domestic industry provided by Article 16.1 of the SCM Agreement, to an extent, provides a relevant and broad context[717] to understand the term "industry". Article 16.1 of the SCM Agreement, entitled Definition of Domestic Industry, reads as follows:

> For the purposes of this Agreement, the term "domestic industry" shall, except as provided in paragraph 2, be interpreted as referring to the domestic producers as a whole of the like products or to those of them whose collective output of the products constitutes a major proportion of the total domestic production of those products, except that when producers are related[718] to the exporters or importers or are themselves importers of the allegedly subsidized product or a like product from other countries, the term "domestic industry" may be interpreted as referring to the rest of the producers.

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[712] See Stevenson (ed.): *Shorter Oxford English Dictionary*, above note 533, Vol. 1, 1167.
[713] See Panel Report, *US-Softwood Lumber IV*, above note 677, paras. 7.120-7.121.
[714] See Panel Report, *US – Upland Cotton* (WT/DS267/R), para. 7.1142.
[715] See Stevenson (ed.), above note 533, at 1371.
[716] See Panel Report, *US-Softwood Lumber IV*, above note 677, paras. 7.120-7.121.
[717] VCLT 1969, Article 31.1: A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
[718] For the purpose of this paragraph, producers shall be deemed to be related to exporters or importers only if *(a)* one of them directly or indirectly controls the other; or *(b)* both of them are directly or indirectly controlled by a third person; or *(c)* together they directly or indirectly control a third person, provided that there are grounds for believing or suspecting that the effect of the relationship is such as to cause the producer concerned to behave differently from non-related producers. For the purpose of this paragraph, one shall be deemed to control another when the former is legally or operationally in a position to exercise restraint or direction over the latter.

Thus, domestic industry used in Article 16.1 generally refers to domestic producers as a whole of the like products with certain exceptions. Article 16 is found in the Part V of the SCM Agreement and this part deals with the adoption of countervailing duties where national interests are adversely affected. However, the term "industry" in Article 2 nevertheless just refers to the field of granting a subsidy. Given that difference, the definition of "domestic industry" in Article 16 should not be considered as the same with the "industry" in Article 2.[719]

5.3.2 De Jure Specificity and De Facto Specificity

Specificity can be grouped into *de jure* specificity and *de facto* specificity. Subparagraphs (a) and (b) of Article 2.1 provide standards to identify whether *de jure* specificity exists or not. For *de jure* specificity, textual analysis of the measure (policies, regulations, legislations etc.) at issue will suffice. It goes without saying that these policies, regulations, legislations etc. should be valid and able to be implemented.[720]

Under subparagraph (b) of Article 2.1, specificity shall not be deemed to exist for a subsidy, if certain elements are met: (1) the eligibility is automatic, (2) the criteria or conditions are strictly adhered to by the granting authority, and (3) the criteria or conditions are clearly spelled out in the law or other official document so as to be capable of verification.[721]

Footnote 2 to Article 2.1 (b) defines the standards for the existence of "objective criteria or conditions". The criteria or conditions includes (1) impartial, (2) favor certain companies over others, and (3) economic in nature and horizontal in application. The footnote lists two examples: number of employees and size of enterprises. The other objective and neutral criteria may also be applicable, given that the connector "such as" is used in the text of footnote 2 to Article 2.1 (b).[722]

Under the introductory sentence of subparagraph (c) of Article 2.1, there are reasons to believe that the subsidy may nevertheless be found to be in fact (*de facto*) specific, even though some legislations appear to be general and have the appearance of non-specificity resulting from the application of paragraphs (a) and (b). Four factors are listed to evaluate whether *de facto* specificity exists. The four factors shall be regarded as alternative rather than cumulative. The Panel in *US-Softwood Lumber IV* explained as follows, "The use of the verb 'may' rather than 'shall', in our view, indicates that if there are reasons to believe that the subsidy may in fact be specific, an authority may want to look at any of the four factors or indicators of specificity. We

[719] For more details, please refer to Luengo Hernandez de Madrid, above note 75, at 132-137.
[720] In China, for instance, some policies are not put into practice, which are just policies in text.
[721] See Article 2.1 (b) of the SCM Agreement.
[722] See footnote 2 to the SCM Agreement.

note the difference in language between Article 2.1 (c) SCM Agreement and, for example, Article 15.4 SCM Agreement...if the drafters had wanted to impose a formalistic requirement to examine and evaluate all four factors mentioned in Article 2.1 (c) SCM Agreement in all cases, they would have equally explicitly provided so as they have done elsewhere in the SCM Agreement."[723]

In the dispute *EC-DRAMS*, the Panel stated that a funding program had a limited use (only 6 of 200 potential companies), and among these, one company Hynix, had employed 41% of the funds, which revealed that such a program was *de facto* specific.[724]

When subparagraph (c) of Article 2.1 is applied, "account shall be taken of the extent of diversification of economic activities within the jurisdiction of the granting authority, as well as of the length of time during which the subsidy programme has been in operation".[725] In some developing countries with poor diversification of economy, it is probable that there is only one enterprise or a little more in certain region. Even the jurisdiction of the granting authority provides subsidies to all the enterprises, still, only one or several enterprises can get it. Therefore, unlike the economy with rich diversification, in such cases the number of enterprises does not matter and subsidies should be regarded as generally available.

5.3.3 Regional Subsidies

Specificity concerning regional subsidies connects with the "jurisdiction of the granting authority". Regional specificity is set forth in Article 2.2 of the SCM Agreement. Subsidies granted by the central government on a generally available basis within the country are not specific. However, central government subsidies which are limited to a region are specific, even if generally available throughout that region.

Likewise, subsidies provided by a regional government, e.g. a province, a state or a county, which are made generally available within the region are not specific. If subsidies by a regional government are limited to certain enterprises within a designated geographical region, such subsidies should be considered as specific subsidies. The phrase "certain enterprises" in this paragraph is also a collective expression that is equivalent to "an enterprise or industry or group of enterprises or industries".

In practice, there are quite a few economic development zones or industrial parks in cities to achieve intensive development. Many enterprises are located within such a

[723] Panel Report, *US-Softwood Lumber IV*, above note 677, para.7.123.
[724] See Panel Report, *EC-DRAMS* (WT/DS299/R), paras.7.216-7.230.
[725] See Subparagraph (c) of Article 2.1 of the SCM Agreement.

designated geographical region. If subsidies are provided to all enterprises in the designated geographical region, a question of whether it is specific arises. Also, how if most companies of the cities are established in the designated geographical region?

These questions are partly addressed in a latest case *US-AD/CVD on Certain Products from China*. The parties disagree as to the scope of "certain enterprises" for specificity in the sense of Article 2.2 of the SCM Agreement to exist.[726] China argues that, it means a subsidy in dispute is limited to subset of enterprises located within a designated geographical region. The US contends that such limitation of subsidies is on a purely geographic basis. The Panel in this case supports the argument raised by the US by considering Article 8.2 of the SCM Agreement as a most relevant context.[727] The text of Article 8.2 (b) shows that, a subsidy to a disadvantaged region is specific in spite of being non-specific within the region in question.[728] Thus, the specificity in Article 2.2 of the SCM Agreement is based on one single basis: geographical limitation. If a subsidy is limited to a subset of the territory within the jurisdiction of the granting authority, then specificity arises under Article 2.2 of the SCM Agreement irrespective of the breadth of enterprises or industries in this designated region.

5.4 The Classification of Subsidies

On the basis of specificity, subsidies can be classified as specific subsidies and non-specific subsidies. Specific subsidies are generally categorized as prohibited subsidies[729] and actionable subsidies, and non-specific subsidies are non-actionable subsidies. However, certain specific subsidies which "meet all the conditions"[730] provided in Article 8.2 (a), (b) or (c)[731] are also non-actionable subsidies.

According to the traffic light approach, the category of prohibited subsidies is called a red light, which is never allowed. The category of actionable subsidies is faced with a yellow or amber light and the category of non-actionable subsidies a green light.

5.4.1 Prohibited Subsidies

Prohibited subsidies are regarded as distorting international trade and affect other countries' interests adversely. Consequently, prohibited subsidies are singled out and subject to the strictest disciplines. According to Article 3, prohibited subsidies contain two types: export subsidies and domestic content or import substitution subsidies.

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[726] See Panel Report, *US-AD/CVD on Certain Products from China*, above note 604, 9.125-9.128.
[727] Ibid., 9.129-9.135.
[728] Ibid.
[729] All prohibited subsidies are deemed to be specific automatically.
[730] See Article 8 of the SCM Agreement.
[731] For short, (a) means assistance for research; (b) assistance to disadvantaged regions; (c) assistance to promote adaptation of existing facilities to new environmental requirements.

Article 4 is the procedural requirement for challenging these subsidies in the red category, which is quite fast (around seven months) to put an end to the adverse effects caused by the prohibited subsidies.[732]

5.4.1.1 Export Subsidies

Export subsidies refers to "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance".[733] *De jure* export contingency is demonstrated on the basis of the words of the relevant legislation, regulation or other legal instrument.[734] *De facto* export contingency is demonstrated on the evidence available "tied to actual or anticipated exportation or export earnings".[735] The Uruguay Round negotiators sought to prevent circumvention of the prohibition against subsidies contingent in law upon export performance by stipulating subsidies contingent in fact upon export performance.[736]

De jure export contingence is clarified by the Panel in *Canada-Certain Measures Affecting the Automotive Industry ('Canada-Autos'):* "export contingency in law, in our view, must refer to the situation where one can ascertain, on the face of the law (or other legal instrument), that export contingency exists. In other words, an examination of the terms of the underlying legal instruments of the subsidy in question would suffice to determine whether or not export contingency in law exists."[737] The Panel explains further that it does not mean "the terms of the law must - as Canada suggests - 'expressly provide' that the subsidy is contingent upon export performance, but rather, that the existence of export contingency can be demonstrated on the basis of the law or other relevant legal instrument, without reference to external factual elements. "[738]

With respect to the demonstration of *de facto* export contingency, it is necessary to examine whether there exists a relationship of conditionality or dependence "between the grant of the subsidy and the anticipated exportation or export earnings".[739] The Panel in *Canada-Aircraft* stated that "whether the facts demonstrate that such TPC assistance would not have been granted to the regional aircraft industry but for anticipated exportation or export earnings".[740] The Panel in *Canada-Aircraft* then concluded: "the closer a subsidy brings a product to sale on the export market, the greater the possibility that the facts may demonstrate that the subsidy would not have

[732] See Article 4 of the SCM Agreement. Also, Luengo Hernandez de Madrid, above note 75, 182.
[733] See Article 3 of the SCM Agreement.
[734] See the Appellate Body Report, *Canada-Aircraft,* above note 665, para.167.
[735] See footnote 4 to the SCM Agreement.
[736] See the submission of the European Communities during the negotiators of the SCM Agreement, entitled "Elements of the Negotiating Framework" (MTN.GNG/NG10/W/31).
[737] See Panel Report, *Canada-Certain Measures Affecting the Automotive Industry ('Canada-Autos'),* WT/DS139/R and WT/DS142/R, para.10.179.
[738] Ibid.
[739] See Panel Report, *Canada-Aircraft,* above note 595, para. 9.331.
[740] Ibid., para. 9.332.

been granted but for anticipated exportation or export earnings."[741]

Based on footnote 4 to the SCM Agreement, the AB in *Canada-Aircraft* examined three elements relating to this standard: (1) the granting of a subsidy; (2) "tied to", which emphasizes that a relationship of conditionality or dependence must be demonstrated; (3) anticipated exportation or export earnings is expected, which should be gleaned from an examination of objective evidence. It is necessary to establish each of the three substantive elements in footnote 4.[742] Further, the Panel in *Australia - Automotive Leather II* established a standard of "close connection" between the grant or maintenance of a subsidy and export performance.[743]

In addition to the "contingency" standard illustrated above, Annex I to the SCM Agreement contains an "Illustrative List of Export Subsidies", which includes eleven types of export subsidy. It is explicit that the list is an illustrative one not exhaustive, whose basic function is to establish that export subsidies exist in certain defined circumstances.[744]

Another important issue relates to the mandatory and discretionary distinction developed by the dispute settlement practice of the GATT/WTO over the years. Under this mandatory/discretionary distinction, if legislation mandates a violation of GATT/WTO obligations, then the legislation as such, rather than a specific application of that legislation, is considered to be inconsistent with those obligations.[745] If the legislation is discretionary, there is the possibility that the legislation as applied violates the GATT/WTO obligations.

When examining Brazil's claim against the relevant legal instruments as such of supporting Canadian civil aircraft industry, the Panel on *Canada-Aircraft Credits and Guarantees for Regional Aircraft* further explained its consequential order of analysis in terms of applying the mandatory and discretionary distinction: first, it would examine each of the programmes at issue based on their legal texts to see if they mandated a benefit, and, if the answer is yes, it would move on to examine whether that subsidy is contingent upon export performance, thereby constituting a prohibited subsidy within the meaning of Article 3.1(a) of the SCM Agreement.[746]

5.4.1.2 Domestic Content Subsidies (Import Substitution Subsidies)

Domestic content subsidies, or import substitution subsidies are a category of

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[741] Ibid., para. 9.339.
[742] See Appellate Body Report, *Canada-Aircraft,* above note 665, paras 166-170.
[743] See Panel Report, *Australia-Automotive Leather II* (WT/DS126/R), para. 9.55.
[744] See Lester *et al.*, above note 116, at 440.
[745] See Panel Report, *US-Export Restraints*, above note 591, para. 8.4.
[746] See Panel Report, *Canada-Aircraft Credits and Guarantees for Regional Aircraft* (WT/DS222/R), paras. 7.56-7.59.

prohibited subsidies that aim at reducing imports of products from other countries with the aim to favor domestic production.[747]

In *Canada-Autos*, the Panel found that "contingency" under Article 3.1(b) extended only to *de jure* contingency and not to *de facto* contingency. In reaching this conclusion, the Panel relied on the fact that Article 3.1(a) referred explicitly to both subsidies contingent "in law or in fact", while Article 3.1(b) did not contain such an explicit reference; in particular, the Panel recalled that the AB in *Japan-Alcoholic Beverages* emphasized that "omission must have some meaning".[748] Therefore, the Panel opined that "the omission of the words 'in law or in effect' from Article 3.1(b) was deliberate and that Article 3.1(b) extends only to contingency in law".[749]

The AB reversed this finding and believed that other contextual aspects except Article 3.1(a) should be examined, for instance, Article III: 4 of the GATT 1994. It also held that "a finding that Article 3.1(b) extends only to contingency 'in law' upon the use of domestic over imported goods would be contrary to the object and purpose of the SCM Agreement because it would make circumvention of obligations by Members too easy".[750] Relied on the above reasons, the AB stated that words absent from Article 3.1(b) did not necessarily mean that Article 3.1(b) extends only to *de jure* contingency.[751]

5.4.2 Actionable Subsidies

Actionable subsidies are specific subsidies which cause "adverse effects to the interests of other Members".[752] These subsidies *per se* should not be viewed as illegal, unless they have caused negative trade effects. The rationale is that these subsidies are not designed to affect the flow of international trade, which put more emphasis on domestic industries rather than on exportation or the use of domestic over imported goods. Article 7 of the SCM Agreement establishes the procedural measures that can be used against the subsidies in the amber or yellow category.[753] This procedure is much longer than that of the prohibited subsidies (around 16 months) to make sure that there would be enough time to examine whether the adverse effect exists or not.

Three circumstances are given to explain the adverse effects in accordance with Article 5 of the SCM Agreement: (a) injury to the domestic industry of another Member; (b) nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994 in particular the benefits of concessions bound

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[747] Luengo Hernandez de Madrid, above note 75, 154.
[748] See Panel Report, *Canada-Autos*, above note 737, para. 10.221.
[749] Ibid.
[750] See the Appellate Body Report, *Canada-Autos*, above note 642, para. 142.
[751] Ibid., paras.139-143.
[752] See Article 5 and 6 of the SCM Agreement.
[753] Ibid., Article 7.

under Article II of GATT 1994; (c) serious prejudice to the interests of another Member.

As to (a) injury to the domestic industry of another Member, there are two key words that need to be interpreted: injury and domestic industry. It is a complicated exercise to determine the precise meaning of the two terms. This study will conduct a brief rather than detailed analysis of these two terms here. Footnote 11 to the SCM Agreement explains that the phrase "injury to the domestic industry" is used here in the same sense as it is used in Part V.[754] According to Article 15.7 of and Note 45 to the SCM Agreement, the term injury means a material injury or threat to a domestic industry, or a material retardation of the establishment of that industry.[755]

Footnote 13 clarifies that "the term 'serious prejudice to the interests of another Member' is used in this Agreement in the same sense as it is used in paragraph 1 of Article XVI of GATT 1994, and includes threat of serious prejudice".[756] The AB in *US-Lamb* noted that the standard for "serious prejudice" is higher than that of "material injury".[757] Pursuant to Article 15.1 of the SCM Agreement, the determination of "injury" to the domestic industry must be based on positive evidence and involve an objective examination of two factors. Specific procedures for developing information on serious prejudice are set out in Annex V to the SCM Agreement.

5.4.3 Non-actionable Subsidies

Non-actionable subsidies are regarded as non-harmful to the other countries, which does not trigger much international concern. Non-actionable subsidies regulated by Article 8, existed for a period of five years, from the entry into force of the WTO Agreement.[758] Therefore this Article expired on 31 December 1999, and it has not been extended as of the writing. The failure to renew the provision in part might have been the result of the Seattle Ministerial Conference debacle that took place around this time.[759] Its procedural requirement for the subsidies in the green category is set out by Article 9 of the SCM Agreement. It is initiated by consultations, and the parties are supposed to reach a mutually agreed solution within a period of 60 days; or the case can be referred to the SCM Committee, who will determine whether there exists any adverse effect in 120 days.

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[754] Footnote 45, in Part V: Under this Agreement the term "injury" shall, unless otherwise specified, be taken to mean material injury to a domestic industry, threat of material injury to a domestic industry or material retardation of the establishment of such an industry and shall be interpreted in accordance with the provisions of this Article.

[755] See Luengo Hernandez de Madrid, above note 75, 166-167.

[756] Article 6 of the SCM Agreement explains "serious prejudice" in extensive detail, which contains 9 paragraphs. For further exploration, see Lester *et al.*, above note 116, at 442-446; Jackson, Davey and Sykes, above note 75, 727-737.

[757] See the Appellate Body Report, *US-Lamb* (WT/DS/AB177/R), para. 124.

[758] See Article 31 of the SCM Agreement.

[759] See Lester *et al.*, above note 116, at 447.

Since the non-actionable subsidies have lapsed and not been renewed, it is plausible to conclude that this provision has no legal effect any more. If it is proved that these kinds of subsidies have caused adverse effects on other WTO Members, then theoretically they may be countervailed by WTO Members.

The following table summarizes the articles in the SCM Agreement regulating each category of subsidies and the time periods for them:[760]

	Red category-prohibited subsidies	Amble category -actionable subsidies	Green category-non-actionable subsidies
Substantial requirement	Article 3	Article 5 and 6	Article 8
Procedural requirement	Article 4	Article 7	Article 9
Consultation	30 days	60 days	60 days
Panel	90 days	120 days	120 days (the SCM committee)
Appellate Body	30/60 days	60/90 days	N/A
Adoption of the report	30 days	30 days	N/A

5.5 Rules in China's Accession Protocol on SOEs Subsidies

This section turns to the subsidy rules contained in China's Accession Protocol. China acceded to the WTO pursuant to the terms set out in the Protocol on December 11, 2001. As provided for by Article 1(2) in Part I of the Protocol, the Protocol is an inseparable part of the WTO Agreements:[761]

> *The WTO Agreement to which China accedes shall be the WTO Agreement as rectified, amended or otherwise modified by such legal instruments as may have entered into force before the date of accession. This Protocol, which shall include the commitments referred to in paragraph 342 of the Working Party Report, shall be an integral part of the WTO Agreement.*

Among the 18 provisions in Part I of the Protocol, only Article 10 - General Provisions - deals with subsidies.[762] According to Article 10(1) of the Protocol, China shall undertake the obligation of notifying any subsidy within the meaning of Article 1 of the SCM Agreement in its territory. Article 10(3) of the Protocol provides that

[760] Source for this table: the SCM Agreement and Luengo Hernandez de Madrid, above note 75.
[761] See Part I of the Protocol.
[762] For more details, please refer to Qin, above note 86, 863-919.

China shall eliminate all export subsidy programs upon accession. Article 10(2) in the Protocol regulates the subsidies to SOEs with substantial requirements; in particular, it sets out new criteria of viewing subsidies to SOEs as specific. This paragraph reads as follows[763]:

> *For purposes of applying Articles 1.2 and 2 of the SCM Agreement, subsidies provided to state-owned enterprises will be viewed as specific if, inter alia, state-owned enterprises are the predominant recipients of such subsidies or state-owned enterprises receive disproportionately large amounts of such subsidies.*

5.5.1 State Ownership as a New Specificity Test

Article 10(2) of the Protocol, different from the specificity principles set out in Article 2 of the SCM Agreement, seems to establish a new specificity test in terms of SOEs subsidies in China. In the introductory clause to Article 2.1 of the SCM Agreement, it identifies two forms of specificity: enterprise specificity and industry specificity, including an enterprise or industry, or a group of enterprises or industries. However, it is still unclear concerning how to define a group. As mentioned in the preceding part dealing with the concept of "specificity", the Panel in *US-Softwood Lumber IV* reasoned that industries that produce sufficiently similar products should be considered as a "group" of industries. Another issue arises immediately: the usage of "sufficiently similar products" is so vague and general that a "group" of industries is still ambiguous. So far, the SCM Agreement and relevant cases have not established a clear criterion of defining a group of enterprises or industries. However, it is clear that the products should be "sufficiently similar". For instance, industries producing disparate products cannot be categorized a group of industries.

One essential question is, therefore, whether this Article sets forth a new criterion for defining a group of enterprises or industries as specificity: state ownership.[764] It is explicit from the wording of Article 10(2) that SOEs are viewed as a type or a group, and as a whole, they can be viewed as meeting the specificity when they receive subsidies. Following a strict textual reading, "state ownership" establishes a standard of grouping enterprises or industries.

Based on thorough and detailed reasoning, Prof. Qin concludes by saying that the SOE-based specificity test in China's accession documents departs from the ownership-neutral philosophy of the world trading system.[765] In accordance with Prof. Qin, the ownership-neutral position is reasonable on the following grounds: (1) The

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[763] See Article 10(2) of the Protocol.
[764] Qin, above note 86, at 886.
[765] Ibid. Such a criterion is strongly criticized by Julia Ya Qin by saying that it is a rather curious departure from the principled ownership-neutral philosophy.

position is legally consistent with the requirements of international law; (2) The position could be understood from a historical perspective; (3) More important to the position is its underlying economic rationale.[766] Thus, WTO documents have never used the word "ownership", with the only exception of China's accession documents. Since this argument proposed by Prof. Qin with elaborate analysis is quite convincing, no more analysis is conducted in this section.

5.5.2 How to Understand SOEs in This Article

In fact, this Article contributes greatly to clarifying the controversy over the term "public bodies" in the meaning of Article 1.1(a) (1) of the SCM Agreement, in particular, whether SOEs can be viewed as public bodies. Based on the plain meaning of this Article, it is clear that SOEs are deemed as the potential recipients of subsidies rather than the granting bodies. On the other hand, if SOEs were regarded as public bodies, this Article would be redundant. Just as Prof. Qin commented, on the whole, the objective of China's Accession Protocol is to require or encourage SOEs to operate solely on commercial basis in the marketplace just like its private counterparts, and this is consistent with the tenet of Article XVII of GATT 1994 on state trading enterprises.[767]

Since the Protocol is an integral part of the WTO Agreement and Article 10 (2) of the Protocol is highly relevant to Article 1 of the SCM Agreement, Article 10 (2) of the Protocol serves as an important context for determining the meaning of "public body". Apparently, treating SOEs as public bodies is against the intent of the parties to the Protocol as well as the plain meaning of the text. A consistent interpretation indicates that SOEs as a whole could not be understood as "public bodies" in the SCM Agreement.[768]

In the practice of CVD investigations, the US DOC has frequently examined two kinds of common programs: grants to loss-making SOEs and the provision of certain inputs for less than adequate remuneration by SOEs. It is evident that SOEs are regarded as recipients in the former program while granting bodies in the latter one. It does not make much sense to shift the status of SOEs in a similar environment. A practical explanation for placing SOEs in such conflicting roles may be that - the number of loss-making SOEs has been reduced significantly, and many SOEs have enhanced their competitiveness; however, a considerable number of viable SOEs do not export but provide goods or services to other types of firms. Thus it is impossible for the investigating authorities to impose countervailing duties on such SOEs,

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[766] Ibid.

[767] See "the Appellate Body and the Meaning of 'Public Bodies'", available at: http://worldtradelaw.typepad.com/ielpblog/2011/03/index.html

[768] It is possible that certain SOEs resemble the characteristics of public bodies. In such situations, a final decision should be made on a case-by-case basis.

especially for those in the upstream industries. Ultimately, an alternative approach to restraining those competitive SOEs is to take them as public bodies. Once SOEs are deemed as public bodies, whether inputs provided by SOEs are set at reasonable prices or for less than adequate remuneration is just a technical issue leaving much discretion to the investigating authorities.

Another related and important issue is the scope of SOEs in this Article. It is more appropriate to view the SOEs in the Protocol as traditional SOEs rather than shareholding SOEs (SOCs); both traditional SOEs and SOCs have been discussed in Chapter Three.

First, during China's negotiation with the existing WTO Members before December 2001, most Chinese SOEs were traditional SOEs. Although China was striving to promote the SOEs reform and establish a market-oriented mechanism in the 1990s, the objective could not be effective in a short period. It indicates that the majority SOEs remained traditional SOEs. In such a situation, it is highly impossible even for the drafters of the Protocol to take SOEs employed in this Article as SOCs.

Secondly, as mentioned above, the aim and purpose of this Article is to make sure that traditional SOEs operate based on commercial considerations like private firms. Although the State is the shareholder of both traditional SOEs and shareholding SOEs or SOCs, SOCs differ from SOEs significantly. The conversion of SOEs to SOCs, however, exactly reflects the effort of Chinese governments to reduce the government interference in SOEs and promote the operation of modern corporations in China. In terms of corporate governance including decision-making process, the difference between SOCs and other kinds of companies is much slighter than that between traditional SOEs (register under *the 1988 Industrial Enterprise Law*) and other companies. For instance, SOCs, especially those floated on the stock market, face the threat of takeover and bankruptcy, and strictly follow market principles as opposed to traditional SOEs which may not operate solely based on commercial considerations. Such difference thus makes a special specificity test for SOCs redundant.[769]

Third, the official statement in the Trade Policy Review of China clearly distinguishes SOEs from SOCs.[770] It shows that China does not intend to take SOEs as a broad concept. In the academic discussion, one can decide the scope of SOEs based on various grounds, while in terms of interpreting a treaty article, focus should be the plain meaning, the context and the purpose and aim of the article etc.

Admittedly, the meaning of a treaty term should not be decided simply by reference to

[769] It is worth noting that, a specificity test based on ownership is arguably inconsistent with the principles of the WTO. For more information, see section 5.5.1 of the thesis.
[770] See the (IV) State-owned enterprises (SOEs), in the WT/TPR/M/161/Add.1, 15 June 2006.

the label given under the domestic legal instruments of each WTO Member.[771] The AB in *US-Softwood Lumber IV* also considers that the way a WTO Member's municipal law classifies an item cannot, on its own, be determinative of the interpretation of provisions of the WTO covered agreements.[772] On the other hand, it means that the definitions and usages of municipal law are, at least, of great reference to the interpretation of WTO treaty terms.

In sum, although it is more suitable to treat the SOEs in the Protocol as traditional SOEs, it does not affect the thesis to define SOEs in a broad way. The direct implication is that subsidies for shareholding SOEs are not subject to the special specificity test, since it is designed for SOEs in the traditional sense.

5.6 Rules in China's Working Party Report on SOEs

Paragraph 172 of China's Working Party Report has mentioned SOEs together with Article 1.1 (a) of the SCM Agreement. The original text reads as follows:

> *Some members of the Working Party, in view of the special characteristics of China's economy, sought to clarify that when state-owned enterprises (including banks) provided financial contributions, they were doing so as* ***government actors*** *within the scope of Article 1.1(a) of the SCM Agreement. The representative of China noted, however, that such financial contributions would not necessarily give rise to a benefit within the meaning of Article 1.1(b) of the SCM Agreement. He pointed out that China's objective was that state-owned enterprises, including banks, should be run on a commercial basis and be responsible for their own profits and losses. The Working Party took note of this commitment.*

Focusing on the first sentence of paragraph 172, it seems that state-owned enterprises (including banks) could be regarded as public bodies. However, such a reading is quite problematic. First of all, the first half sentence implies that "financial contributions" in the scope of Art.1.1 (a) of the SCM Agreement could be provided by entities other than "governments or public bodies", while such a logic is inconsistent with Art.1.1 (a) of the SCM Agreement, which clearly stipulates that financial contributions could only be provided by "a government or any public body".[773] There is another possibility that the first half sentence has already indicated that state-owned enterprises (including banks) are "governmental actors" (probably, an equivalent to "governments or public bodies"), however, such assumption is arbitrary without any

[771] See Appellate Body Report, *US-Corrosion-Resistant Steel Sunset Review* (WT/DS244/AB/R), footnote 87 to para.87.
[772] See Appellate Body Report, *US-Softwood Lumber IV*, above note 644, para. 65.
[773] There are special cases that financial contributions are provided by a private body, while the precondition is that a government entrusts or directs such private body. Such entrustment and direction almost could be deemed as order from the government.

proper reasons and also makes the second half of the sentence redundant. In fact, the representative of China sent a signal that it was highly impossible for SOEs to provide financial contribution, since they should and will operate on a commercial basis.

More importantly, the foregoing analysis of Article 1.1 of the SCM Agreement and Article 10 of the Protocol leads to the conclusion that SOEs are not public bodies. Thus, treating SOEs as governments or public bodies is in serious conflict with the meaning of public bodies in the sense of Article 1.1 of the SCM Agreement.

Secondly, the representative of China states that state-owned enterprises (including banks) should operate on a commercial basis and make commercial decisions, since they have to bear all the losses induced by their commercial decisions and behaviours on their own. Therefore, it is very clear that the reply of the representative of China shows that state-owned enterprises (including banks) are not public bodies or government actors.

Paragraphs 43, 44, 45 and 46 of China's Working Party Report also set out general requirements in terms of SOEs in China. On the whole, these paragraphs emphasize that Chinese SOEs should operate under market conditions. For instance, purchases and sales made by SOEs should be based solely on commercial considerations as provided in the WTO Agreement; Chinese government would not influence commercial decisions on the part of SOEs in a direct or indirect way. In sum, these paragraphs require SOEs to behave just like private companies, especially when Chinese SOE reform moves further.

5.7 The Link between Countervailing Duty Investigation and Non-Market Economy Status

The frequent trade frictions between China and its major trading partners in recent years have brought to the fore the issue of non-market economy again. The term non-market economy was originally termed "state-trading countries" and then "centrally planned economies" indicating a group of countries such as the Soviet Union and Central and Eastern European countries adopting the central planning system rather than the market mechanism for economic activities.[774] At present, there is no general agreement among countries about what constitutes non-market economy, and it is difficult to even imagine a consensus either.[775] For long, the notion of non-market economy and its controversy were mainly connected to anti-dumping

[774] The term non-market economy has been criticized for its subjective nature; such emotional appraisal should not be a substitute for legal and economic arguments in terms of international trade relations. See Alexander Polouektov (2002): Non-Market Economy Issues in the WTO Anti-Dumping Law and Accession Negotiations: Revival of a Two-tier Membership? *Journal of World Trade*, 36(1), 1-37.

[775] For instance, the US and EU have set forth very different standards in determining whether a country is a "market economy" or not.

investigation in practice.[776] However, when the US Department of Commerce (DOC) altered its long-standing practice of not applying countervailing duty (CVD)[777] law to non-market economy countries in November 2006, the core of the argument has turned to both the anti-dumping, CVD law and non-market economy.[778] Such change naturally incurred much debate over the connection between the CVD law and non-market economy, especially in terms of increasing trade remedy measures against products originating from China.[779]

In effect, since the DOC applied the CVD investigation on Coated Free Sheet (CFS) Paper from China at the end of 2006,[780] nearly thirty CVD investigations together with concurrent anti-dumping investigations against products from China have been initiated by the DOC.[781] The intensity of the CVD investigation is highly unusual given its record of very limited initiation. The question of whether the CVD law could be applied to China which is treated as a non-market economy in terms of the anti-dumping investigation has been raised by China in almost every CVD investigation against it.[782] An overview of the reports on the CVD disputes between China and the US shows that the common arguments from the Chinese side are: first, the relevant sections of the Trade Act of 1974 demonstrate that the DOC does not have the authority to apply CVD law to non-market economies;[783] second, the fact that DOC applied the anti-dumping and CVD laws simultaneously on Chinese products constitutes double counting, thus double remedies; third, the DOC has conceded that it is difficult and meaningless to discern subsidies in non-market economies, where the market forces and allocation of resources are severed almost completely by the massive involvement of the state, and the pervasive use of external

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[776] There is plenty of literature on this issue, see Polouektov, above note 774; Jiangyu Wang (1999): A Critique of the Application to China of the Non-Market Economy Rules of Antidumping Legislation and Practice of the European Union. *Journal of World Trade*, 33(3), 117-145; Silke Melanie Trommer (2007): Special Market Economy: Undermining the Principles of the WTO. *Chinese Journal of International Trade*, 6(3), 565-599; Helena Detlof, Hilda Fridh (2007): The EU Treatment of Non-Market Economy Countries in Anti-dumping Proceedings. *Global Trade and Customs Journal*, 2, 265–281; Gary N. Horlick and Shannon S. Shuman (1984): Nonmarket Economy Trade and US Antidumping/Countervailing Duty Laws. *International Lawyer*, 18 (4), 807, to name but a few.

[777] In accordance with Article 10 of the SCM Agreement and footnote 36 thereto, the term "countervailing duty" shall be understood to mean a special duty levied for the purpose of offsetting any subsidy bestowed directly or indirectly upon the manufacture, production or export of any merchandise, as provided for in paragraph 3 of Article VI of GATT 1994.

[778] See Georgetown Steel Corp. v. United States, 801 F. 2d 1308 (Feb. Cir. 1986).

[779] There has already been much literature in this area especially in Chinese, see Longyue Zhao and Yan Wang, Trade Remedies and Non-Market Economies: Economic Implications of the First US Countervailing Duty Cases on China (Policy Research Working Paper 4560 of World Bank). Commission of the European Communities: Commission Staff Working Document on Progress by the People's Republic of China towards Graduation to Market Economy Status in Trade Defence Investigations, Brussels, 19/09/2008, SEC (2008) 2503 Final. Also, Xu Quan (2008), Meiguo Fan Butie Fa Shiyong Tanxi (Analysis of the Application of US CVD law to the Non-Market Economy). *Fa Shang Yanjiu* (*Studies in Law and Business*), 1(123). Bagen Bai (2009), Meiguo Fanbutie Fa Nengfou Shiyong yu Fei Shichang Jingji (Whether the CVD Law of the US Can be Applied to Non-Market Economy). *Journal of International Economic Law*, 16 (4), 153-179 (in Chinese).

[780] Available at: http://trade.gov/press/press_releases/2006/paper_china2_112106.asp. NewPage Corporation (OH) is the petitioner for this investigation. DOC completed its preliminary and final affirmative determination in 2007.

[781] Available at http://ia.ita.doc.gov/stats/inv-initiations-2000-current.html.

[782] See the issues and decision memorandum for the final determination in the CVD investigation of a series of subject products from the People's Republic of China, available at http://ia.ita.doc.gov/frn/summary/prc/prc-fr.htm.

[783] The relevant sections normally refer to section 701, 731, 751 and 771 of the Trade Act.

benchmark in determining subsidies by the DOC further proves such difficulty.

In response, the DOC normally contends that: first, the Congress has granted it the general authority to conduct CVD investigations against any country, which of course includes non-market economies; second, the DOC has broad discretion in determining whether it can apply the CVD law to imports from non-market economies, irrespective of whether any anti-dumping duties are imposed. Specifically, there are substantial differences between the traditional non-market economy, or the Soviet-style economies and the non-market economy of China nowadays;[784] and China's present-day economy allows the application of CVD law to imports from China, although it is still a non-market economy preserving a significant role for the state in the economy.[785] It seems that both sides have their strong arguments.[786] A question arises out of the above arguments. Even if the American legislations explicitly allow the CVD investigations against non-market economies, do such legislations and practices conform to the relevant WTO rules?

Against this background, this section intends to examine the relationship between the CVD investigation and non-market economy with China as a case in point within the legal framework of the WTO Agreements including China's Accession Protocol and also shed light on the surrogate country method.[787] To do so, this section first explores the legal source of the surrogate country method against the non-market economy in anti-dumping investigation, namely the special methodology to calculate the dumping margin. The following part may use the special methodology, alternative benchmark, external benchmark and surrogate country method exchangeably. It is followed by an examination of the interpretation of non-market economy. This section then moves to the issue of the link between CVD and non-market economy and focuses on Article 15(b) of the Protocol to see whether the CVD can be applied to China as a non-market economy, which, ultimately, turns out to be a specious question. Phrased differently, there is no legal barrier for the use of CVD against a non-market economy in terms of the WTO Agreements. Instead, the true problem lies in the concurrent use of a special methodology in the anti-dumping and CVD investigation against the same products from a non-market economy, as it most likely

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[784] The US stated in the CVD investigation of CFS Paper that "the Soviet-style economies at that time made it impossible to apply these criteria because they were so integrated as constitute, in essence, one large entity. In such a situation, subsidies could not be separated out from the amalgam of government directives and controls." See the CVD investigation of Coated Free Sheet (CFS) Paper from PRC made by US-Whether the Analytical Elements of the Georgetown Steel Opinion are Applicable to China's Present-Day Economy, March 29, 2007.

[785] Ibid.

[786] It is not the main purpose of this paper to evaluate the merits of those arguments, thus no more comment is made here in order to focus upon the primary question of this paper. Still, it may be informative to note the decision rendered by the US Court of International Trade in the case *GPX International Tire Corp. v. United States:* "the DOC may have the authority under the statutory scheme to apply CVD law and anti-dumping law simultaneously to products of non-market economy country, but only if such an application included methodologies to safeguard against this substantial potential for double counting, which does not occur when net value and US price are calculated based on data from the same country-the market economy approach". See the case *GPX International Tire Corp. v. United States,* available at http://www.cit.uscourts.gov/slip_op/Slip_op10/10-84.pdf.

[787] The Protocol is deemed as an inseparable part of the WTO Agreements. See Part I of the Protocol.

results in double counting. This section further argues that the gist among all the issues is the precondition for the adoption of a special methodology in the course of CVD investigation against China, which is "special difficulties" as employed in Article 15 of the Protocol, rather than non-market economy. Finally, the key term "special difficulties" relating to the CVD investigation will be analyzed combined with the famous softwood lumber case between the US and Canada.

5.7.1 Legal Source for the Special Methodology in Anti-Dumping Investigation

The special methodology can be understood by comparing it to the normal methodology used in the anti-dumping investigation. The normal methodology means that the normal value usually should be determined through the following three ways: (1) comparable price of "like product" in home market; (2) comparable price of like product exported to a third country; (3) constructed price composed of cost of production, administrative, selling and other costs, plus the reasonable profit etc., which has been prescribed clearly in the relevant articles of General Agreement on Tariffs and Trade (GATT) 1994.[788]

In the current trade practice, it is the non-market economy status that enables the investigating authorities of the importing country to adopt a special methodology, that is, the investigating authorities have the right of disregarding the "normal value" in the domestic market of the exporting country as an appropriate benchmark for comparison when calculating the dumping margin between "normal value" and export price. In such cases, the investigating authorities enjoy much discretion and flexibility and usually select a surrogate country that has a market economy with approximately the same level of GNP per capita and use its domestic price as an alternative benchmark.[789] Such an approach normally makes it much easier to determine the existence of dumping and obtain a greater margin. That is why the special methodology associated with the non-market economy status is preferred by any investigating authorities if they have the initiative or pressure to protect their own domestic industries. Thus, it is clear why the non-market economy issue has drawn much attention in global trade.

The legal source for using special methodology to establish the normal value in the anti-dumping investigation can be found in Paragraph 1.2 of Ad Article VI of Annex I to GATT 1994, which reads as follows:

> *2. It is recognized that, in the case of imports from a country which has* ***a complete or substantially complete monopoly of its trade*** *and where* ***all domestic prices are fixed by the State, special difficulties*** *may exist in*

[788] See Art. VI: 1 of GATT 1994, Art. 2.1 and Art. 2.2 of the Anti-Dumping Agreement.
[789] In effect, to find a proper surrogate country is an almost impossible task. The determination of comparability based merely on GNP per capita is too simplistic to be appropriate. See Horlick and Shuman, above note 776, at 808.

determining price comparability for the purposes of paragraph 1, and in such cases importing contracting parties may find it necessary to take into account the possibility that a strict comparison with domestic prices in such a country may not always be appropriate.[790]

This brief interpretative note was added in the GATT Review Session of 1954-1955 owing to a proposal by the former Czechoslovakia to address a special problem of determining comparable prices in the country whose trade is operated by a state monopoly.[791] In practice, the Treasury Department of the US launched its first traceable anti-dumping investigation (*Bicycles from Czechoslovakia*) against a centrally planned economy in 1960 and adopted the practice of using the domestic or export prices of similar goods from non-Communist market countries.[792] Gradually, such a short interpretative note became an important trade policy instrument against not just state trading economy but also non-market economy for the investigating authorities in terms of anti-dumping cases.

As to the text of the interpretative note, it is the term "special difficulties" rather than "non-market economy" that is employed and emphasized. Two factors should be present if "special difficulties" may be deemed to exist in comparing domestic prices with exporting prices: firstly, the exporting contracting party has a complete or substantially complete monopoly of its trade; and (2) all domestic prices of the exporting contracting party are fixed by the State. In other words, without either of the two factors, "special difficulties" and the ensuing special methodology should not be applied. As is evident from its wording, the precondition for "special difficulties" and the subsequent use of discriminatory treatment is extremely high, considering the use of "monopoly of trade" and "all domestic prices...fixed by the state". Article 2.7 of Part I of the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 ("Anti-Dumping Agreement") has reiterated that such provision should be maintained without prejudice.[793] However, the standards are so high that almost no present-day economy could satisfy such two factors.

When it comes to China and its accession Protocol, the term "non-market economy" can be found in the legal text directly.[794] Article 15(d) of the Protocol, containing three sentences, implies that the importing WTO Members should establish the criteria for market economy in their domestic law. If China could not meet these criteria, they can take China as a "non-market economy" and adopt an alternative benchmark in the application of CVD investigation based on Article 15(a) (ii) of the

[790] See Ad Note to GATT 1994, Article VI: 1 in Annex I to GATT 1994.
[791] Polouektov, above note 774.
[792] See Horlick and Shuman, above note 776.
[793] See Article 2.7 of Part I of the Anti-Dumping Agreement: This Article is without prejudice to the second Supplementary Provision to paragraph 1 of Article VI in Annex I to GATT 1994.
[794] See the first sentence of Article 15(d) of Protocol: Once China has established, under the national law of the importing WTO Member, that it is a market economy, the provisions of subparagraph (a) shall be terminated provided that the importing Member's national law contains market economy criteria as of the date of accession.

Protocol. Article 15(a) of Protocol[795] deals with the way to determine price comparability in the course of anti-dumping investigation. In particular, Article 15(a) (ii) of the Protocol indicates that the price comparison is not required to be based on a strict comparison with the prices or costs in China's market as long as China could not clearly show the prevalence of market economy conditions in the industry. Nevertheless, such an automatic procedure to take China as a non-market economy thus adopting the special methodology, in any event, shall expire 15 years after the date of China's accession, which means that the special methodology in the course of anti-dumping investigation shall be terminated in 2016.[796]

5.7.2 "Special Difficulties" in GATT and the Non-Market Economy

In accordance with Article 15(d) of the Protocol,[797] each importing Member should provide its criteria for market economy in its national law if the importing Member purports to treat China as a non-market economy. As to the criteria or definition of "non-market economy" contained in the national law of the importing Member, the Protocol itself gives no specific indications. Therefore, it leaves huge discretion to the importing Members to formulate the criteria for market economy.

However, as discussed above, the term "special difficulties" in Paragraph 1.2 of Ad Article VI of GATT 1994 deals with the use of alternative benchmark in the anti-dumping investigation. While there is no clear textual guidance on the similarities and differences between "special difficulties" and "non-market economy" in the framework of the WTO Agreements, one common background for "special difficulties" and "non-market economy" can be drawn from the relevant articles employing the two terms, that is, both terms serve as the precondition for the use of special methodology in the anti-dumping investigation. Such a critical point shared by them makes it possible to take the "special difficulties" as a context for interpreting "non-market economy".[798] In this connection, when interpreting the standards for

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[795] See Article 15(a) of the Protocol: In determining price comparability under Article VI of the GATT 1994 and the Anti-Dumping Agreement, the importing WTO Member shall use either Chinese prices or costs for the industry under investigation or a methodology that is not based on a strict comparison with domestic prices or costs in China based on the following rules: (i) If the producers under investigation can clearly show that market economy conditions prevail in the industry producing the like product with regard to the manufacture, production and sale of that product, the importing WTO Member shall use Chinese prices or costs for the industry under investigation in determining price comparability; (ii) The importing WTO Member may use a methodology that is not based on a strict comparison with domestic prices or costs in China if the producers under investigation cannot clearly show that market economy conditions prevail in the industry producing the like product with regard to manufacture, production and sale of that product.

[796] See the second sentence of Article 15(d) of the Protocol.

[797] See Article 15(d) of the Protocol.

[798] See Article 31.1 of VCLT: A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. Also Article 31.2 and 31.3: "2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes: (a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty; (b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty. 3. There shall be taken into account, together with the context: (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; (b) any subsequent practice in the application of the

non-market economy established by the importing Member, the criteria for "non-market economy" should be prone to those for "special difficulties" rather than an ideal market, even though the criteria may not be necessary to be tantamount to those for "special difficulties". If the criteria for "non-market economy" are interpreted as slightly different from a standard market economy, then there is high possibility that such interpretation is not consistent with the meaning and purposes of the WTO Agreements.

Take the US standards for market economy as an example to illustrate the interpretation of non-market economy. The US criteria are extracted from *19* ***U.S.C.*** *Sec.* ***1677,*** which read as follows[799]:

> *(18) Non-market economy country.*
>
> *(A) In general. The term "non-market economy country" means any foreign 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.*
>
> *(B) Factors to be considered. In making determinations under subparagraph (A) the administering authority shall take into account--*
>
> *(i) The extent to which the currency of the foreign country is convertible into the currency of other countries; [,]*
>
> *(ii) The extent to which wage rates in the foreign country are determined by free bargaining between labor and management,*
>
> *(iii)The extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country,*
>
> *(iv) The extent of government ownership or control of the means of production,*
>
> *(v) The extent of government control over the allocation of resources and over the price and output decisions of enterprises, and*
>
> *(vi) Such other factors as the administering authority considers appropriate.*

As can be observed easily, there are six factors to be considered when determining the non-market economy status. Each factor starts with the word "extent", which means that every factor can range from one end to the other end. Such vague description inclines to give the investigating authority quite broad discretion. Nonetheless, at least one point for interpretation should be followed: the six factors should be read in

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treaty which establishes the agreement of the parties regarding its interpretation; (c) any relevant rules of international law applicable in the relations between the parties.

[799] See 19 U.S.C. Sec. 1677.

conjunction with the two conditions constituting special difficulties in Article VI of GATT 1994: complete or substantially complete monopoly of its trade, and all domestic prices fixed by the State; that is to say, the scenario created collectively by the standards of the six factors should be approximate to that of the special difficulties.

5.7.3 Whether the Special Methodology for CVD could be Used Against Non-Market Economy

In essence, the question of whether the special methodology for CVD can be applied against non-market economy is similar to the frequent and hot debate between the US and China about the application of CVD to non-market economy. The reason is that once China is treated by the DOC as a non-market economy in practical investigations, the special methodology is adopted accordingly. However, it may be misleading for China to put too much attention and resource on the issue of non-market economy instead of the special methodology.[800] For China, the final pursuit in terms of the CVD investigation is the termination of using special methodology, thus the recognition of market economy status is only a means to the end. Unfortunately, as analyzed below, there is the risk that even China is recognized as a market economy, the adoption of a special methodology for CVD investigation is still possible.

The explicit mention of special methodology or alternative benchmark for CVD could be observed in Article 15(b) of Protocol on the Accession of People's Republic of China, which says that:

> *In proceedings under Parts II, III and V of the SCM Agreement, when addressing subsidies described in Article 14(a), 14(b), 14(c) and 14(d),* ***relevant provisions*** *of the SCM Agreement shall apply; however, if there are* ***special difficulties*** *in that application, the importing WTO Member may then use methodologies for identifying and measuring the subsidy benefit which take into account the possibility that prevailing terms and conditions in China may not always be available as appropriate benchmark. In applying such methodologies,* ***where practicable****, the importing WTO Member should adjust such prevailing terms and conditions before considering the use of terms and conditions prevailing outside China.*

In this paragraph, the term "special difficulties" occurs again. On first reading, the logic of this paragraph is clear: the term "special difficulties" serves as the precondition for the use of special methodology or alternative benchmark. What is

[800] It has already been a commonplace for readers to notice news about how China requested the recognition of market economy treatment and applauded such recognition by some of its trading partners. Take one piece of news as an example, "China still striving for 'market economy' status from EU", available at http://news.xinhuanet.com/english/2009-05/21/content_11415493.htm.

more, even there existing special difficulties, the use of alternative benchmark should first adjust the prevailing terms and conditions in China as long as it is practicable.

Therefore, the key condition for the use of special methodology in the course of CVD investigation is the existence of "special difficulties" in applying relevant provisions of the SCM Agreement. It turns out that no answer could be given as to the question of whether the special methodology for CVD investigation could be applied against non-market economy or not in the WTO Agreements. Put differently, there is no direct link between the application of CVD investigation including the use of special methodology and the non-market economy. The only precondition for the adoption of special methodology is the "special difficulties".

For sure, one can make a theoretical comparison between the standards of special difficulties as employed in Article 15(b) of Protocol and the criteria for non-market economy as set forth by the importing Members. If the standards for "special difficulties" were higher than those for non-market economy, the special methodology for CVD might not be used against non-market economy. It implies that there may be no special difficulties for the investigating authorities to determine the subsidies in a non-market economy, thus it is not necessary to adopt the special methodology in the process of CVD investigation.

If the standards for "special difficulties" were lower or they had equivalent standards, the special methodology for CVD could be used against non-market economy and even market economy. That is, in the context of WTO Agreements, the importing WTO Members have the right to use the special methodology for CVD against non-market economy and even market economy, as long as the standards for non-market economy are higher (or stricter) than those for "special difficulties". Thus, the special methodology for CVD may be used against non-market economy and even market economy. The final outcome, to a large extent, depends on how special difficulties are to be read.

Article 15(d) of Protocol further corroborates the finding that there is no direct relation between the application of CVD investigation including the use of special methodology and the non-market economy. Pursuant to Article 15(d) of Protocol, there is no doubt that the special methodology for anti-dumping could be used against non-market economy in the WTO Agreements. Article 15(d) of Protocol mentions that "once China has established ...that it is a market economy, the provisions of subparagraph (a) shall be terminated" in the first sentence and "should China establish ...that market economy conditions prevail in a particular industry or sector, the non-market economy provisions of subparagraph (a) shall no longer apply to that industry or sector" in the last sentence. Subparagraph (a) indicates the use of special methodology in the anti-dumping investigation. The fact that Article 15(d) does not mention a single word of the subparagraph (b) which is about the provisions of

adopting the special methodology in the CVD investigation, offers the plausible explanation that the use of special methodology for CVD does not depends on whether China is a non-market economy, which is quite different from anti-dumping.[801] On the other hand, considering Article 15(d) of Protocol sets the maximum period for the use of special methodology in terms of anti-dumping investigation, the silence of Article 15(d) about the subparagraph (b) may imply another potential risk: there is no time limit for the use of special methodology for purposes of CVD investigation if the "special difficulties" exist.

Admittedly, the treatment of market economy matters for China in terms of anti-dumping investigation. In particular, if China could be recognized as a market economy by more trading partners before 2016, the Chinese enterprises would receive normal treatment in calculating the dumping margin earlier. Also, it is confirmed by the US Court of International Trade that the concurrent use of special methodology in the CVD and anti-dumping investigations leads to double counting and is thus an extra punitive duty on the same imported products. This is because the special methodology for anti-dumping duty (using a subsidy-free normal value in a surrogate country) has taken account of the effect of subsidies on the subject goods, while at the same time the CVD is collected on the same subject goods to effectively counteract the effect of subsidization again.[802]

5.7.4 "Special Difficulties" in Art.15 (b) of Protocol

Based on the aforementioned analysis, the immediate problem is how to understand the term of "special difficulties". The brevity of the text on special difficulties causes a series of problems. Does it have the same meaning or scope as the "special difficulties" used by Paragraph 1.2 of Ad Article VI of GATT 1994? The next issue is how to understand its nature. For example, can it be construed as an obligation imposed on the investigating authorities? Or is it just a limitation to the right of the investigating authorities' use of special methodologies? Or is it simply a burden of proof that should be imposed on the investigating authorities or China in proceedings?[803] Another interpretative issue is what the standard for "practicable" is.

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[801] Based on the text of Article 15(d), the CVD in this Article does not mean all the types of financial contribution covered by the SCM Agreement; it only applies when "addressing subsidies described in Article 14(a), 14(b), 14(c) and 14(d)".

[802] The Chief Judge Jane A. Restani in the *GPX International Tire Corp. v. United States* reasoned that "the DOC compares a subsidy-free constructed normal value (essentially using information from surrogate countries) with the original subsidized export price to calculate the anti-dumping margin… thus, the margin is greater than it would be if subsidies were reflected on both sides of comparison". See the case *GPX International Tire Corp. v. United States,* available at: http://www.cit.uscourts.gov/slip_op/Slip_op10/10-84.pdf.

[803] It is the investigating authorities who intend to assert the existence of "special difficulties"; so they should put forward sufficient evidence to make a *prima facie* evidence (a presumption). See "In line with the practice of various international tribunals, the Appellate Body has endorsed the rule that the party who asserts a fact, whether the complainant or the respondent, is responsible for providing proof thereof. The burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence", which is Available at: http://www.wto.org/english/tratop_e/dispu_e/disp_settlement_cbt_e/c10s6p1_e.htm#txt1

This Provision also offers an open question on how to adjust the prevailing terms and conditions.

The rules are designed to make the trade environment more sound and predictable. Too much ambiguity and flexibility will endanger the integrity and credibility of the WTO legal system. The importance of interpretation is self-evident. Since its inception, the WTO Dispute Settlement Body (DSB) has adhered to the customary rules of interpretation of public internal law including relevant articles of VCLT. Based on Article 31.1 of the VCLT, "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose",[804] the plain and ordinary meaning of the terms should always be examined carefully, and their context, the object and purpose of the treaties should be considered as well. Thus, the way to read the "special difficulties" in Article 15(b) of Protocol should also follow such rules.

In so far as the WTO Agreements and the cases adjudicated by the DSB, Paragraph 1.2 of Ad Article VI of GATT1994 and the *US – Softwood Lumber IV* can provide certain clues to understand the "special difficulties" in Article 15(b) of China's Accession Protocol on the basis of their respective similarities with the context of "special difficulties". The remaining parts thus concentrate on the two sources.

The starting point is the plain meaning of "special difficulties" in Article 15(b) of the Protocol. The term "special difficulties" does not indicate general, ordinary or normal difficulties, whose standard, by implication, is definitely higher than usual "difficulties", or the word "special" is meaningless here and redundant.[805] Apart from the ordinary meaning of "special difficulties", the context should be considered. Here, "special difficulties" in Art. 15(b) of Protocol refers to the difficulties in applying provisions of the SCM Agreement relevant to Art. 14(a), 14(b), 14(c) and 14(d), which involves how to determine whether benefit exists in the four cases: government provision of equity, a loan by a government, a loan guarantee by a government and the provision of goods or services or purchase of good by a government. Even for the above four situations, the standards of "special difficulties" may be slightly different, depending on the type of market chosen for comparison.

Basically, there can be two types of market: a perfect or near-perfect market (the undistorted-market approach) and the market-as-is approach.[806] In the view of the Panel in *US - Softwood Lumber III*, the "prevailing market conditions" of Article 14 (d) of the SCM Agreement do not mean a theoretical market free of government

[804] See Article 31.1 of VCLT.

[805] The word "special" as an adjective has five meanings; the relevant meaning is "not ordinary or usual; different from what is normal". See Sally Wehmeier, *Oxford Advanced Learner's Dictionary of Current English*, the 6th edition. Oxford University Press, 2000, at 1240.

[806] See Zheng, above note 671, 1-54. Prof. Zheng explained that the justifications made by the DOC for findings of market distortion (and then choice of alternative benchmark) were undermined by its circular reasoning and inconsistency with rudimentary economic principles.

interference as the US seems to be advocating; the market conditions should be those that are actually existing in the country and faced by the recipient of the financial contribution.[807] The Panel in *US-Softwood Lumber IV* also held that Article 14 (d) of the SCM Agreement implied the use of in-country prices as the benchmark for determining adequacy of remuneration.[808]

Obviously, both Article VI of GATT1994 and Article 15(b) of China's Accession Protocol employ the same term "special difficulties". As discussed previously, "special difficulties" in Article VI of GATT 1994 indicates the unusual difficulties in determining the normal value of the exported products in the course of AD investigation, while "special difficulties" in Article 15(b) of the Protocol means the difficulties in calculating the amount of a subsidy in terms of the benefit to the recipient in four situations as listed by Article 14 of the SCM Agreement. It probably makes sense that the identical terms in the WTO Agreements have different meanings if they are used in totally different contexts. Take the "like products" as an example. While it appears in the GATT provisions approximately 16 times[809], the general statement is that the meaning of "like products" is likely to vary from one provision to another. The Panel in the *Japan-Taxes on Alcoholic Beverages* held that its meaning should be determined in conjunction with the criteria for "likeness"[810] on a case-by-case basis, which was upheld by the AB. However, Prof. Hudec believed that it is the different policy contexts that make the differences in meaning exist and even identifiable.[811]

Still, one similarity for the two same terms "special difficulties" used in anti-dumping and CVD investigations respectively is that, the market is considered as affected or distorted by the government. The four situations in Article 14 of the SCM Agreement depend on the terms and conditions of domestic market; if the market is fully operating, such determination of benefit may face little difficulty provided that other necessary information is best available. In this sense, the "special difficulties" in applying the four situations have a high relevance to the context of "special difficulties" in Article VI, which also depends on the market conditions. Thus, given the extremely high standards for "special difficulties" employed in Article VI, the criteria for "special difficulties" in Art. 15(b) of Protocol should also be high.

In the enduring case of *US – Softwood Lumber IV,* the surrogate country value issue

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[807] See Panel Report, *US-Softwood Lumber III*, above note 647, paras.7.50-7.52.
[808] See Panel Report, *US-Softwood Lumber IV*, above note 677, paras.7.48-7.51.
[809] Robert E. Hudec, "Like product": the Differences in Meaning in GATT Articles I and III. Originally published in Thomas Cottier & Petros Mavroidis (eds.), *Regulatory Barriers and the Principles of Non-Discrimination in World Trade Law*, University of Michigan Press, 2000, at 101-123.
[810] The criteria usually contain: (1) the product's properties, nature and quality, and its end-uses; (2) consumers' tastes and habits; and (3) the product's tariff classification. See the Panel Report, *Japan-Taxes on Alcoholic Beverages* (WT/DS8, 10, 11/R), para. 6.21-6.22.
[811] See Hudec, above note 809.

was discussed in depth.[812] The last situation (provision of goods or services or purchase of good by a government) involving the special difficulties is highly similar to that in this case. The US DOC argued that most timbers were owned by Canadian provincial governments, the price charged to harvest the timber (the "stumpage fee") was impossible to be a market price. The DOC believed that the private sector price was affected significantly by the large public sector, thus it compared the "price" paid for provincial stumpage fee with private stumpage prices in the United States, while Canada was strongly against such analysis and required that the benchmark should be prices in the market of the country of provision according to Articles 1.1(b) and 14(d) of the SCM Agreement.

The Panel and the AB of *US-Lumber IV* summarize three detailed circumstances for using an alternative benchmark, with particular emphasis on the prudent and restrictive use of alternative benchmark other than domestic prices: (1) where the government is the only supplier of the particular goods in the country (hereinafter referred to as "only supplier of particular goods");[813] (2) where the government administratively controls all of the prices for those goods in the country (hereinafter as "government controls all prices");[814] and (3) the government's role in providing the financial contribution is so predominant that it effectively determines the price at which private suppliers sell the same or similar goods ("government's predominant role").[815] However, the AB of *US- Softwood Lumber IV* does not encourage such use of alternative benchmark; they believe it should be very limited.[816] In accordance with the AB of *US- Softwood Lumber IV*, even though the above three circumstances exist, it is also possible that the private prices in the country of provision may be used as appropriate benchmark unless the distortion of prices could be proved:[817]

> *We emphasize once again that the possibility under Article 14(d) for investigating authorities to consider a benchmark other than private prices in the country of provision is very limited. We agree with the United States that "the fact that the government is a significant supplier of goods does not, in itself, establish that all prices for the goods are distorted". Thus, an allegation that a government is a significant supplier would not, on its own, prove distortion and allow an investigating authority to choose a benchmark other than private prices in the country of provision. The determination of whether private prices are distorted because of the government's predominant role in the market, as a provider of certain goods, must be made on a case-by-case basis, according to the particular*

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[812] See Panel Report, *US-Softwood Lumber IV,* above note 677; Appellate Body Report, *US-Softwood Lumber IV,* above note 644.
[813] See Panel report, ibid., para.7.57.
[814] Ibid.
[815] See Appellate Body report, *US–Softwood Lumber IV*, above note 644, para.98.
[816] Ibid., para.102.
[817] Ibid.

facts underlying each countervailing duty investigation.

In sum, in the view of the AB of *US- Softwood Lumber IV,* the fundamental principle is that the use of an alternative benchmark in determining price comparability shall be extremely limited. The importing Members should use the private prices in the exporting Members' markets when possible.

Considering the high relevance of the case to the special difficulties in applying CVD, the three circumstances for use of alternative benchmark summarized by the Panel and AB of *US-Softwood Lumber IV* should be of important reference value to the understanding of "special difficulties" in Article 15(b) of Protocol. It is probably fair to say that the three circumstances for the use of alternative benchmark summarized in *US-Softwood Lumber IV* can be applied in the case of "special difficulties" in Article 15(b) of Protocol.

A more far-reaching implication of the case *US - Softwood Lumber IV* is that for a market economy like Canada, it is still possible that an alternative benchmark is adopted by the importing Members. Although the final finding in the case *US - Softwood Lumber IV* is in Canada's favor, there is the possibility that the US DOC applies the special methodology against a market economy in the future practice. A dangerous trend is that as long as a certain number of state-owned enterprises exist, special difficulties are deemed to exist.

In fact, in a recent case *US-AD/CVD on Certain Products from China,* Article 15 of China's Accession Protocol is mentioned but not applied. The panel in *US-AD/CVD on Certain Products from China* stated that, neither China nor the US invoked the specific provisions contained in Article 15(b) of China's Accession Protocol, and its application would raise a number of interpretative issues with no existing jurisprudence.[818] Taken together, the Panel did not make findings under Article 15(b) of China's Accession Protocol, and its analysis focuses on Article 14 of the SCM Agreement.[819] Thus, this case offers little indication to the application of Article 15 of China's Accession Protocol.

Another related question is how to understand the nature of "special difficulties", for instance, is it an obligation imposed on the investigating authorities or a limit to a right? Originally, this question comes from a discussion on the worldtradelaw.net.[820] No matter whether the Protocol can create obligations on other WTO members,[821] the

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[818] See Panel Report, *US-AD/CVD on Certain Products from China*, above note 604, para.10.12.

[819] Ibid.

[820] Henry Gao raised the question: does the Accession Protocol create legal obligations for China only, or does it create legal obligations for other WTO members as well? Or, do other WTO members also undertake commitments as a result of China's accession commitments? Available at: http://worldtradelaw.typepad.com/ielpblog/

[821] Such discussion could be very lengthy. Since it is not necessary to be answered here, this part will not delve into the details. For further reading, please see the discussions initiated by Henry Gao on the worldtradelaw.net; Julia Ya Qin, the Challenge of Interpreting "WTO-Plus" Provisions, available at

precondition-"special difficulties" actually totally can be regarded as a limit to the right of the investigating authorities in adopting an alternative benchmark. Consider the process of using alternative benchmark: first, the investigating authorities conceive the terms and conditions in China as "special difficulties"; they could not find appropriate benchmark in China; on such basis, they have to turn to the alternative benchmark. It is clear that the existence of "special difficulties" is both a natural and integral part of exercising the right to alternative benchmark. A reasonable explanation for the use of benchmark is to show the existence of "special difficulties". Such exhibition or demonstration can also be regarded as a prerequisite for the use of alternative benchmark.

For the standards of the term "practicable" and how to "adjust such prevailing terms and conditions", they actually remain to be two open questions. There are few sources that can be used as reference yet. The investigating authorities may demonstrate from an opposite perspective that it is "impracticable" to adjust the prevailing terms and conditions in China.

5.7.5 Conclusion

In the framework of the WTO Agreements, the status of non-market economy is closely connected with the use of special methodology in the anti-dumping investigation, while there is no direct link between the use of special methodology in the CVD investigation and the non-market economy. Practically speaking, this means that when China is treated as a market economy, as long as there is evidence to show the existence of "special difficulties" in determining the amount of subsidies, the special methodology may still be adopted by the investigating authorities in the course of CVD investigation.

Still, from China's perspective, the benefit of being recognized as a market economy before the year 2016 is obvious: the normal value of the goods exported by Chinese firms should be determined based on Chinese prices or costs for the relevant industry rather than a surrogate country value. Even though China could not be recognized as a market economy, the special methodology for calculating the dumping margin shall expire in 2016. Also, if China could not get the market economy treatment before the year 2016, the concurrent use of special methodology against the same subject goods from China results in double counting and then double remedies, unless the investigating authorities adjust the calculation method.

Therefore, the meaning of a market economy recognition in international trade mainly matters for the anti-dumping investigation.[822] Also, even if some WTO Members still

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http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1428976; Steve Charnovitz, Mapping the Law of WTO Accession, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=957651.

[822] For sure, if a fully competitive market mechanism with the necessary institutional support from the government

do not grant the market economy status in the year 2016 and afterwards, the special methodology against Chinese products should be terminated in any event. In terms of the CVD investigation, the focus should be the interpretation of "special difficulties" as employed by Article 15(b) of China's Accession Protocol rather than the market economy. The status of market economy or non-market economy does not have direct influence on the use of a surrogate country value by the investigating authorities. If the term "special difficulties" is simplified as the existence of certain SOEs or public sector in the relevant industries, the external benchmark in the course of CVD investigation may be adopted easily. The clarity of the term "special difficulties" and then the predictability and security of certain WTO rules finally hinge on the future decisions rendered by the DSB.

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could operate in China, it would be a blessing for most Chinese. Nevertheless, the proper boundary between the market and government is a fundamentally challenging problem for any economy. Since the global financial crisis erupted in 2008, a feasible solution to this problem has been even more pressing.

Chapter 6 Whether Measures are Consistent with the WTO Rules Regulating Subsidies

While Chapter Four summarized the major and contentious measures taken by the Chinese government towards SOEs,[823] and introduced specific measures relating to three industries in which typical SOEs still exist, Chapter Five concentrated on the WTO rules regulating subsidies in length, with particular attention paid to some key yet ambiguous terms and paragraphs and the relationship of the CVD investigation to the non-market economy status. In turn, this Chapter will analyze whether the measures reviewed in Chapter Four constitute these measures constitute subsidies under the WTO.

Before any effort to examine whether the disputed measures are in compliance with the WTO rules, however, we must also note that consideration should be given to a prerequisite factor: the cut-off time. The cut-off time indicates the date on which the WTO rules can be applicable to the relevant Member. More specifically, this means that even certain measures which constitute subsidies, but occurred and expired before the cut-off date, they should not be subject to the jurisdiction of the SCM Agreement.

The legal source for determining the cut-off date is the Protocol, with Article 2 of Part III reading as follows: *This Protocol shall enter into force on the thirtieth day following the day of its acceptance.*[824] China's accession day into the WTO is December 11, 2001.[825] With nothing in the Protocol indicating that WTO rules including China's accession documents are retroactive, it can be assumed that December 11, 2001 can be regarded as a proper cut-off date for the application of WTO rules to China. Though the cut-off date decides when the WTO Agreements - including the SCM Agreement - are applicable to China, there may be exceptions if such measures involve the pass-through of a benefit.

6.1 General Measures

This Chapter deals in turn with the following issues: undervalued exchange rate, preferential loans (the easy access to commercial bank loan and lower interest rate),[826] access to the stock market, debt-equity swap, official export credit, land-use rights

[823] Some measures not just involve SOEs but also affect other types of companies, such as the undervalued exchange rate and preferential loans.
[824] See Part III of the Protocol.
[825] Available at: http://www.wto.org/english/thewto_e/acc_e/completeacc_e.htm#chn.
[826] The two issues relate to the preferential loan can be described as: whether it is easier for SOEs to get bank loans than other kinds of firms with similar conditions; whether the interest rates of the loans extended by SOCBs to SOEs are lower than the commercial interest rate.

and energy subsidies.

The subsequent analysis towards each measure is two-tiered because of the logic embedded in the determination of subsidies: first, whether the measure involves financial contribution, in other words, whether the measure falls within one of the seven types of financial contribution; second, whether a benefit is thereby conferred. To determine whether a subsidy is actionable, a specificity test will also be conducted. In the circumstances of export subsidies and import substitution subsidies, the factor of "specificity" is assumed to exist automatically.

It should be noted, however, it is neither the purpose of this study nor possible for this study to pinpoint the amount of any subsidy, considering that the determination of financial contribution and the calculation of the amount of benefit require a vast amount of specific data including proprietary official information. Thus the legal analysis focuses on the question of whether these measures constitute subsidies or not. Such analysis and the subsequent conclusion are preliminary since it is based on limited facts best available.[827]

6.1.1 Undervalued Exchange Rate

The debates concerning China's exchange-rate policy from political, economic or legal perspectives have been extensive in recent years, and the relevant discussions can easily be found in the burgeoning literature.[828] For instance, Mattoo and Subramanian argue that "an undervalued exchange rate is both an import tax and an export subsidy and is hence the most mercantilist policy imaginable".[829] Staiger and Sykes, however, question the notion that exchange rate misalignments are in violation of WTO commitments, namely, forming a tariff increases or export subsidies.[830] Mercurio and Leung comprehensively assess the legitimacy of China's exchange-rate regime under the public international law, the Articles of Agreement of the IMF and both Article XV of the GATT and the SCM Agreement of the WTO and confirm its

[827] In practice, it even takes the sophisticated governmental agencies and experienced law firms years to gain the detailed and accurate facts and figures as evidence related to subsidies. Furthermore, certain substantial figures can only be obtained by authorization of relevant agencies and companies and used as proprietary information. Therefore, the thesis will not try to accomplish such impossible task of gathering all the relevant data, and the analysis focuses more on the nature and extent of the measures at issue.

[828] For instance, see Wayne M. Morrison & Marc Labonte: China's Currency: An Analysis of the Economic Issues. Congressional Research Service Report for Congress (October 1, 2010), www.fas.org/sgp/crs/row/RS21625.pdf. Also see Marc Benitah (2003): China's Fixed Exchange Rate for the Yuan: Could the United States Challenge It in the WTO as a Subsidy? (corrected version), available at: http://www.asil.org/insigh117.cfm; Erik Denters (2003): Manipulation of Exchange Rates in International Law: The Chinese Yuan, available at: http://www.asil.org/insigh118.cfm; M. Ulric Killion (2004): China's Foreign Currency Regime: the Kegan Thesis and Legalification of the WTO Agreement. *Minnesota Journal of International Trade*, 14, 43-90; Raj Bhala (2008): Virtues, the Chinese Yuan, and the American Trade Empire. *Hong Kong Law Journal*, 38, 183-253; Goldstein and Lardy (eds.), above note 322.

[829] See Mattoo and Subramanian, above note 310. More similar views were also expressed; see A Survey of Views Regarding Whether Exchange-Rate Misalignment is a Countervailable, Prohibited Export Subsidy Under the Agreements of the World Trade Organization (WTO) (hereinafter Survey of Views), April 2007, www.faircurrency.org/presscenter/survey_of_views0407.pdf.

[830] See Robert W. Staiger and Alan O. Sykes (2010): 'Currency Manipulation' and World Trade. *World Trade Review*, Cambridge University Press, 9(4): 583-627.

consistency with all the applicable rules without any modification.[831] Article XV of GATT deals with the exchange arrangements issues, but there is still no jurisprudence or decision of a competent WTO body on Article XV.[832] In fact, Paragraph 1 of Article XV indicates that exchange action is within the jurisdiction of IMF.[833] For purposes of this thesis, I will focus on the examination of whether the undervalued exchange rate can be considered a subsidy within the meaning of the SCM Agreement.

As illuminated in Chapter Four, it is not an easy task to make a proper appraisal of whether China is depreciating the RMB. I would assume, however, that the RMB is undervalued, and then evaluate whether an undervalued exchange rate constitutes a subsidy.[834] Thus, the following legal analysis is premised on such a condition that the RMB is undervalued.

6.1.1.1 Whether a Financial Contribution Exists

Succinctly stated, to be deemed as an actionable subsidy within the meaning of the SCM Agreement, a measure needs to satisfy three criteria simultaneously: financial contribution, benefit and specificity.[835] As to whether the undervalued exchange rate can be viewed as a subsidy, the first question is whether the undervalued exchange rate could meet the requirement of financial contribution. Exchange rate, in nature, is an exchange action rather than a trade action, and it relates to currency convertibility and capital movement in the international monetary and capital markets.[836] A state has the freedom to manage its currency regime based on domestic objectives, and exchange rate regulation naturally falls within the scope of national autonomy even in an era of increasingly high degree of economic interdependence.[837]

In essence, exchange rate can be viewed as a regulatory power vested in a sovereign state so that the state can regulate its macroeconomic policies without excessive outside intervention.[838] Despite the pliability of the definition of subsidy, forms of governmental regulation giving economic advantages are not considered as subsidies;

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[831] See Mercurio & Leung, above note 327, at 1257-1300.

[832] See Paragraph 1 of Article XV of GATT 1994: The Contracting Parties shall seek co-operation with the International Monetary Fund to the end that the Contracting Parties and the Fund may pursue a co-ordinated policy with regard to exchange questions within the jurisdiction of the Fund and questions of quantitative restrictions and other trade measures within the jurisdiction of the Contracting Parties.

[833] See Mercurio & Leung, above note 327, at 1257-1300. See also Deborah E. Siegel (2002): Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreement. *The American Journal of International Law*, 96 (3):561-621. It is not impossible that a new mechanism is designed to solve the problem, for example, the cooperation of IMF and WTO.

[834] It is more appropriate for economists to solve the problem whether RMB has been undervalued.

[835] The detailed interpretation about these rules is provided in Chapter Five.

[836] See Mercurio & Leung, above note 327, at 1257-1300.

[837] Ibid. See also Gilpin, above note 12, 118-168. Under a regime of flexible exchange rates following the Jamaica conference, the fundamental problem is the clash between the national autonomy and independence in economic matters and the interest of international economic stability.

[838] See Survey of Views (Views of Bacchus and Shapiro). In no event should this mean that domestic exchange-rate policy makers ignore the spillover effects of their decisions upon other economies. To limit the detrimental effects of self-centered domestic macroeconomic policies, extensive policy coordination among economies is definitely necessary.

the traditional forms under the general expression "financial contribution" are fiscal policies, such as governmental spending and taxation.[839] It is logically appropriate to preclude the general regulatory power from financial assistance. As the Panel in *US - Export Restraints* noted, the introduction of the element "financial contribution" and its alternative "price or income support" is exactly to foreclose the possibility of treating any governmental action that results in a benefit as a subsidy.[840]

The following part proceeds to examine whether the undervalued exchange rate entails any specific form of financial contribution as listed in Article 1.1(a) (1) of the SCM Agreement. Obviously, it does not involve a direct or a potential direct transfer of funds and not relate to government revenue. The undervalued exchange rate does not require something of value from the government because of a transfer of currencies to the recipients.[841]

As to the form of provision of goods or services or purchase of goods, it is clear that the undervalued exchange rate cannot be deemed as "goods".[842] The argument that it is a service of converting US dollars into RMB provided by the Chinese government[843] is also untenable. The conversion of a foreign currency into a domestic currency can be conducted by most normal financial bodies in addition to governmental bodies,[844] and the exchange-rate policy is essentially a macroeconomic arrangement maintained by the government.[845] Such an arrangement simply manages "exchange rate fluctuations through the purchase or sale of currencies",[846] which does not involve the transfer of economic resources or advantages to any specific exporters. In effect, its public nature makes it similar to general infrastructure (economic infrastructure) provided by the government.

Furthermore, the undervalued exchange rate has no relation with income or price support as set forth in Article XVI:1 of GATT, which primarily targets at agricultural products to stabilize domestic prices of agricultural products or maintain certain levels of income for agricultural producers.[847]

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[839] See Rubini, above note 122, at 92-94.
[840] See Panel Report, *US-Export Restraints*, above note 591, para. 8.38.
[841] See Survey of Views (Views of Bacchus).
[842] Goods refer to tangible or movable personal property other than money.
[843] See Survey of Views (Views of Hartquist and Magnus).
[844] See Article 7, 24-26 of Regulation of the PRC on Foreign Exchange Administration (2008), Order of the State Council [2008] No.532, Aug. 5, 2008. This Regulation is an amendment to the Regulation of the PRC on Foreign Exchange Administration, Order of the State Council [1997] No. 211, Jan. 14, 1997.
[845] As the representative of China stated in paragraph 29 of WPR: State Administration of Foreign Exchange ("SAFE") was under the auspices of the People's Bank of China (PBOC), and was the administrative organ empowered to regulate foreign exchange (forex). Its main functions were to monitor and advise on balance-of-payments and forex matters. SAFE was also required to draft appropriate regulations and monitor compliance. He further noted that domestic and foreign banks, and financial institutions could engage in forex business, with the approval of the PBOC".
[846] See Mercurio & Leung, above note 327, at 1257-1300.
[847] See Article XVI of GATT 1947. See also Killion, above note 828, 43-90. It is difficult to link the pegged yuan to a direct benefit to the industry in the form of payments and price supports.

6.1.1.2 Whether a Benefit is Thereby Conferred

The three factors constituting a subsidy are cumulative. Hence, when there is no requisite financial contribution in the case of the undervalued exchange rate, it is normally not necessary to discuss whether a benefit is thereby granted. To discuss this issue thoroughly, this part continues to examine whether the factor "benefit" can be established owing to the undervalued exchange rate.

The claim that Chinese exporters receive a benefit is mainly supported by the following arguments: (1) US dollars or other foreign currencies are valued at higher rate and the recipients receive more RMB than that with a market-driven exchange-rate regime;[848] (2) the undervalued exchange rate lowers labor costs for Chinese producers and thus make their products more competitive in the global market and earn a distinct advantage;[849] and (3) Chinese exporters do not face the hedge risk caused by currency fluctuations.[850] The core problem here whether benefit is conferred mainly hinges upon market elasticity and production structure.[851] Market prices tend to adjust to exchange-rate regimes, thus benefits may not be conferred.[852]

With respect to the first argument, the exporters may get more RMB in terms of quantity, while the RMB is relatively cheaper. Thus, the key element is the value of the RMB gained by the exporters; for sure, it is equal to the value of the US dollars or other foreign currencies based on a given exchange rate. In this sense, no benefit exists. Second, an undervalued exchange rate may improve the trade competitiveness for a state. Still, it does not mean that exporters can get more benefit.[853] In addition, the critical reason for China's low cost of labor is largely attributable to its abundant supply of labor; the relatively low cost labor in China is its temporary competitive advantages in international trade.[854] Third, even if Chinese exporters do not need to face hedging costs, they have to handle other risks including inflation risks and interest rate risk associated with a fixed exchange rate regime.[855]

6.1.1.3 Specificity

Specificity in Article 2 means the subsidy is specific to an enterprise or industry or group of enterprises or industries. It is quite difficult to take currency undervaluation as actionable subsidies, because currency undervaluation just cannot pass the test of

[848] See Survey of Views (Views of Wiley Rein & Fielding).
[849] See Mercurio & Leung, above note 327, at 1257-1300. This argument is maintained by most critics of China's exchange-rate regime.
[850] Ibid.
[851] See Dukgeun Ahn (2010): Is the Contemporary Chinese Exchange-Rate Regime WTO-Legal? Available at: http://www.voxeu.org/index.php?q=node/4867.
[852] For a rigorous analysis about the element of benefit, see Robert W. Staiger and Alan O. Sykes (2010): 'Currency Manipulation' and World Trade. World Trade Review, Cambridge University Press, 9(4): 583-627.
[853] Just as the reason given by Mercurio: "an increase in sales volume at lower unit prices does not necessarily lead to an increase in profit". See Mercurio & Leung, above note 327, at 1257-1300.
[854] Because of effects of the one-child policy and the consequent shortage of labor, labor costs in China have already shown rising signs.
[855] See Mercurio & Leung, above note 327, at 1257-1300.

specificity. The most important reason is that currency undervaluation does not just affect a group of enterprises or industries; instead, it has an extensive impact on all the individuals, companies and other entities directly or indirectly. As a macroeconomic regime, its effect is, of course, not limited to exporters, producers or importers. In any event, the undervalued exchange rate is not devised selectively for any special enterprise or industry. The diversity and breadth of the recipients further indicate that undervalued currency is broadly available throughout the economy; therefore, an undervalued exchange rate is non-specific.

It is also frequently claimed that currency undervaluation constitutes export subsidies, thus it is specific automatically. Export subsidies indicate subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, while it is also obvious that currency undervaluation affects anyone that has the need to exchange currencies. It is not specially designed for export; put differently, there is no relationship of conditionality or dependence between the grant of the subsidy and the anticipated exportation or export earnings.[856] Furthermore, the Illustrative List of Export Subsidies annexed to the SCM Agreement does not involve the exchange rate at all. At most, Item (j) of the Illustrative List of Export Subsidies mentions "exchange risk programmes, at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes", however, the undervalued exchange-rate policy cannot be deemed as an exchange risk program where the costs and losses analysis is not economically meaningful.[857]

In the light of the forgoing analysis, the undervalued exchange rate cannot satisfy any of the three basic requirements for the existence of a subsidy. It is thus impossible to consider the undervalued exchange rate as subsidies in the sense of the current SCM Agreement.[858]

6.1.2 Preferential Loans

Two issues relating to preferential loans are discussed in Chapter Four: first, whether it is easier for SOEs to get bank loans than other kinds of firms under similar conditions; second, whether the loan interest rates to SOEs extended by SOCBs are lower than other commercial loan interest rates.

Changes in Chinese banking system have been significant in the past decades. Owing to the Asian financial crisis and China's accession into the WTO, the Chinese government took a series of critical policies to accelerate the market-oriented

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[856] For a detailed analysis about the broader initiatives related to China's undervalued exchange rate, see Mercurio & Leung, above note 327, at 1257-1300.

[857] See Marc Benitah (2003): China's Fixed Exchange Rate for the Yuan: Could the United States Challenge It in the WTO as a Subsidy? (Corrected version), available at: http://www.asil.org/insigh117.cfm.

[858] To quote from Dukgeun Ahn: "This issue appears to be a kind of 'political question' in the WTO system, rather than a legal problem to be judged by the dispute settlement system. Therefore, litigation of this issue is unlikely to produce proper solutions. Accordingly, the US and China should find other more 'politically' attuned forum, such as G20 meeting, more suitable to resolve this conflict." See Ahn, above note 851.

financial reform. Although there is no such thing as a clear line to distinguish between two periods, China's accession into the WTO can roughly be viewed as a turning point in the financial reform.[859] Thus, with China's acceding into the WTO as the dividing line, this measure of preferential loans can be analyzed from two periods.[860]

With respect to the first issue, the answer is probably positive for both periods, that is, SOEs have easier access to bank loans. Before China joined the WTO, it is well known that, subject to direct and indirect interference from the government, SOCBs extended policy loans to SOEs. In effect, SOCBs once were treated as a "secondary budget" of the government to allocate capital to SOEs.[861] A noteworthy fact is that SOEs at that time were the majority among various types of firms.

After China became a member of the WTO, the reason for a positive answer is that usually SOEs are large and the banks prefer large firms rather than smaller firms.[862] Nonetheless, that is the decision made by the banks themselves based on the benefit and cost analysis, even without intervention by the government. For instance, among the many factors affecting SOCBs' credit decisions, SOCBs only give very limited consideration to industrial policies. The financial status, the prospect of and the guarantee or mortgage provided by the potential client (irrespective of its ownership structure), and the macroeconomic outlook of the concerned industry are all taken into account.[863] Thus, it has little connection with subsidies, unless the interest rate of the loans extended by the banks is lower than the commercial interest rate. The mere condition that SOEs have easier access to bank loans does not involve any form of financial contribution.

The second question is whether the interest rates of the loans extended by SOCBs to SOEs are lower than the commercial interest rate. First of all, it is necessary to determine whether the loans from SOCBs are commercial or not. As illuminated previously, after China's accession into the WTO along with a series of crucial banking reform measures such as the capital injection, the establishment of four AMCs to remove the accumulated NPLs, the corporatization of SOCBs and the introduction of institutional investor *etc.*, the operation of SOCBs has been commercialized to a high extent. The external supervision over SOCBs has been strengthened as well: they are subject to the Commercial Banking Law of 2003, the Company Law and the Securities Law *etc.*, and the CBRC was established to enhance the supervision of SOCBs and the other banks.[864]

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[859] As discussed in Chapter Four, China's accession into the WTO in conjunction with the capital injection and the disposal of a large amount of NPLs established a new milestone in the course of Chinese financial reform.

[860] Also, the date on which China acceded to the WTO is the cut-off time.

[861] Peng, above note 340, at 12-17.

[862] As explained in Chapter Four, projects of large firms like SOEs are relatively guaranteed and the risk of default is low.

[863] This answer is from SOCBs during the on-site verification for the CVD investigation against Coated Free Sheet Paper from China. This can also be confirmed by response to loan application documents (grant or refusal) issued by SOCBs.

[864] Despite the progress, it does not preclude the possibility that in practice, some transactions of SOCBs may be

When it comes to the essence of SOCBs, it is difficult to categorize them as public bodies. Let us start with the current majority shareholder of SOCBs, namely Central Huijin, which held 35.41% shares of ICBC, 67.53% of BOC, 48.23% of CCB and 50.00% of ABC as of June 2009.[865] Central Huijin is expected to focus on its functions as an investor and not interfere in the daily operations of SOCBs. However, the status and nature of Central Huijin is vague and confusing. It was established as a commercial company incorporated under the Company Law, while its current chair, vice chairman and general manager all had official titles before they joined Central Huijin. For instance, its current chair is Lou Jiwei, acting as China's former Deputy Minister of Finance and former Deputy Secretary-General of the State Council. Also, the board of directors and board of supervisors of Central Huijin are appointed by the State Council directly. If it is deemed a governmental entity, it is in fact registered as a company with its business scope as follows: to accept the authorization of the State to make equity investments in state-owned major financial enterprises. Considering the close connection of its senior management personnel with the government, it is fair to say that Central Huijin has the form of a company, while it is controlled by its controlling company CIC[866] and may be affected by the state. In this case, the positive signal is that both CIC and Central Huijin have been attempting to operate in a normative and transparent manner.

To summarize, Central Huijin, the majority shareholder of SOCBs, may be treated as a public body, namely an instrumental body of the state. Even if Central Huijin is regarded as a public body, SOCBs could not be categorized as public bodies mainly on the following grounds. First, the standard corporate structure has been adopted by all the SOCBs and the SOCBs are disciplined by the relevant commercial laws.[867] Second, the ownership of SOCBs held by Central Huijin is around 50% let alone 100%. As analyzed in Chapter Five, governmental ownership including the majority governmental ownership is only one important but not decisive factor to consider whether entities at issue are controlled by the government or not. Third, SOCBs are commercial banks subject to the direct supervision of PBOC and CBRC. Even if certain entities like SOCBs are controlled by the government, it does not necessarily follow that those entities are delegated with functions of governmental authority or public characters associated with public bodies.[868] The old days when the government seriously interfered in the operation of SOCBs are gone.

Even if it occurs that certain local governments may push for higher lending to their local commercial projects, central government agencies including PBOC and CBRC

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affected by certain governmental officials in a manner inconsistent with the written law.

[865] Source: the official website of Central Huijin, http://www.huijin-inv.cn/.

[866] Central Huijin is a wholly-owned subsidiary of China Investment Corporation (CIC). CIC also registered as a company with a corporate structure as required by the Company Law. The current chairman of CIC is Lou Jiwei, China's former Deputy Minister of Finance and former Deputy Secretary-General of the State Council. The general manager of CIC is Gao Xiqing, former vice chairman of China's National Council for Social Security Fund.

[867] It also partly explains why SOCBs could float on the HK Stock Exchange successfully.

[868] This proposition that public bodies in the SCM Agreement are connected with certain governmental authority has been discussed in Chapter Five in detail.

push for better credit practices and transparency, which may restrict the potential interference from local governments.[869] One may also argue that Article 34 of the Commercial Banking Law of 2003 states that commercial banks should "carry out their loan business upon the needs of national economy and the social development and under the guidance of the state industrial policies",[870] and it implies that the SOCBs are subject to the state industrial policies. However, guidance does not mean requirement, thus this article gives much room for SOCBs to make their own lending decisions. In addition, the state industrial policies *per se* are generally discretionary in nature,[871] so it is inappropriate to argue that SOCBs are seriously affected by industrial policies. As mentioned above, SOCBs take many factors into consideration when making lending decisions, and they may attach little weight to industrial policy.

Therefore, generally speaking, SOCBs should be treated as commercial banks. Loans from SOCBs should be presumed to be commercial in the sense that SOCBs are commercial entities. This conclusion, however, does not preclude the possibility that in practice certain transactions conducted by SOCBs may be affected or even interfered by some governmental entities at various levels.

Having concluded that SOCBs are commercial banks, the next question is whether the interest rate extended by SOCBs to SOEs is lower. For sure, it is basically impossible to solve this problem in abstract. Nevertheless, it is helpful to observe the practice conducted by the US, a frequent user of CVD measure. In the CVD investigations, the DOC of the US first selects an external benchmark and then compares the interest rate in China with that on a foreign country market. The reason for using an external benchmark is that the DOC deems the Chinese banking system as controlled and managed by the government. Normally, the DOC concludes that the rate extended by SOCBs in China is lower, and a benefit is thereby conferred to SOEs or other enterprises or certain industries at issue.

Put the debate (whether the Chinese banking system is controlled by the government or affected by the market forces) aside first, the apparent logical loophole is that even if the loan interest rates to certain enterprises and industries are similar in China, while on the whole, they may be lower than that on a foreign market.[872] It means that preferential loans are not confined to SOEs, but expanded to any enterprise or industry that is subject to CVD investigation. It also implies that the specificity test designed by the SCM Agreement is circumvented by selecting an external market.

On the other hand, when an external benchmark is selected, it does not matter whether

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[869] See Jonathan Anderson, China's New Banking System in W. John Hoffmann and Michael J. Enright (eds.): *China into the Future: Making Sense of the World's Most Dynamic Economy*. John Wiley & Sons (Asia) Pte. Ltd., 2008, 163-212.

[870] See Article 34 of the Commercial Banking Law.

[871] Analysis on the nature of certain industrial polices is conducted in length in the following part.

[872] It is normal that loan interest rates to various enterprises and industries are similar in China, but they are lower than that on a foreign market. This source is from the interview of the author at Scott Liu and Associates and the check of a large amount of first-hand documents in 2009.

the domestic loan interest rates are similar or not.[873] As long as the interest rate in question is lower than the selected benchmark, then the benefit can be proved. Taken together, the use of an external benchmark can escape two key elements of an actionable subsidy: benefit and specificity.

6.1.3 Access to the Stock Market

Prior to the adoption of the Securities Law in 1999, it is clear that SOEs enjoyed absolute priority in IPO, however, the broader context is that SOEs were the majority of Chinese firms at that time. Along with the SOE reform and the improvement of China's stock market, the other types of firms other than SOEs increasingly have more chances to acquire listing qualifications. A majority of listed companies in China, however, are still SOEs, for instance, as of 2006, the state acts as a majority shareholder in 833 listed SOEs among 1349 listed companies in the A shares market.[874]

To determine whether easier access to the stock market provides a subsidy to SOEs, the first step is to examine whether a financial contribution exists within the meaning of Article 1.1 of the SCM Agreement. First of all, easier access to the stock market is not related to the (direct or potential direct) transfer of funds from the government or public bodies. Obviously, it is totally different from the foregoing government revenue or provision of goods.

At most, a claim may be made that easier access to the stock market encompasses provision of services to SOEs. This argument is untenable in that the stock market is a basic and fundamental instrument for the functional operation of the capital market, and thus access to the stock market (whether it is easy or difficult) is an institutional arrangement rather than a normal service. Stated differently, the establishment of a stock market is crucial "software" for the national economy; thus, to a large extent, access to the stock market can be regarded as access to a general infrastructure in the economic system.

In essence, easier access to the stock market can also be viewed as a regulatory measure dealing with listing rules.[875] No financial resource is transferred to the recipients from the government or any public body. Thus, it is highly improbable to conclude that there exists financial contribution, one of the two key factors constituting a subsidy.

Assuming arguendo that a financial contribution exists, the second step is an enquiry in terms of whether easier access to the stock market confers a benefit upon the

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[873] A closely related question is whether Article 14(b) of the SCM Agreement permits an external benchmark and rejects the in-country interest rates, and if so, under what circumstances. This issue has been addressed by the Panel in a recent case: *US–AD/CVD on Certain Products from China*, above note 604.

[874] SASAC, above note 217, at 568.

[875] As analyzed in Chapter Five, not every governmental action giving a benefit could be regarded as a subsidy in the sense of the SCM Agreement.

recipients. The key aspect of this measure is that when SOEs have easier access to the stock market compared with private firms, especially when they enjoy an absolute priority, they could get a higher level of funding from the capital market. If the listing rules were equal to all types of potential application companies for floatation on the stock market, there would be no extra advantage for SOEs.

One assertion that SOEs receive benefit, may be based on the assumption that SOEs could get more favorable terms and conditions in relation to the listing process than those actually available for other participants in the market. Indeed, it is apparent that they would gain considerable advantages through such a process. Imagine how many potential shareholders exist in a country with a population of more than 1.3 billion. Nevertheless, it is quite difficult, if not totally impossible, to calculate the specific amount of such kind of benefit earned by listed SOEs.

As to the specificity test, the measure faces certain legal barrier that has to be overcome. Based on the Protocol, there is a special standard for traditional SOEs since it sets forth a new criterion for defining a group of enterprises or industries as specificity: state ownership.[876] If traditional SOEs account for the majority of entities that have easier access to the stock market, this measure then can be deemed specific. On the other hand, if this measure mainly targets on shareholding SOEs adopting the modern corporate governance structure, the specificity requirement is not matched.

Therefore, it is easy to affirm that no financial contribution can be found in this measure. Since the three elements (financial contribution, benefit and specificity) are cumulative for actionable subsidies, the easier access of SOEs to the stock market cannot be deemed as a subsidy in the sense of the SCM Agreement.

Even though this practice of favoring SOEs and discriminating other types of firms in the capital market is evident, it is equally evident that the SCM Agreement could do little about such practice. The change and ultimate removal of such practice mainly depends on the institution building relating to capital market as well as the determination and vision of the Chinese governmental leaders to realize sustainable development of the market-oriented economy. The positive aspect is that such practice has been curtailed considerably along with the development of the capital market reform.

6.1.4 Debt-Equity Swap

This scheme, designed by the then Chinese leaders, known as a rescue package to both SOEs operating at a loss and SOCEs with huge NPLs, is highly vulnerable to CVD investigation. The details of this scheme have been discussed in Chapter Four. The following is a legal analysis of this measure in light of three key elements constituting specific subsidies: financial contribution, benefit and specificity.

[876] As elaborated in Chapter Five, it is more appropriate to view the SOEs in the Protocol as traditional SOEs rather than shareholding SOEs (SOCs).

6.1.4.1 Whether a Financial Contribution Exists

The first and foremost relevant issue is to consider whether there exists a financial contribution in the process of debt-equity swap. As illustrated, the AMCs took the bad assets from the banks incurred by SOEs incorporated in this scheme, and then exchanged the debts into equity of SOEs or dissolved the bad debts by auction, bidding and other methods.

Apparently, it is not easy for the AMCs or any other pertinent entities to recover those bad debts; the return on equity of most SOEs in the short term is probably low. Put differently, this scheme means that AMCs provide certain assistance (at least certain convenience) to loss-making SOEs. If the AMCs forced the designated SOEs to repay the debt directly, there is a high possibility that the SOEs would go into bankruptcy. The subsequent question is that, in such a situation, whether assistance provided by AMCs constitutes financial contribution. Also, how could AMCs survive? The nature of AMCs and the source of their operating funds offer explanations to these questions.

As indicated in Chapter Four, unlike usual financial companies, AMCs are state-owned financial institutions created with clear policy objectives. The operating fund of the AMCs was injected by MOF from national revenue; and the amount of the initial cash injection was RMB 10 billion for each AMC. With the support of the original large capital injection by MOF, the AMCs can survive even in very unfavorable circumstances. They are executive tools of the government to solve the NPLs and forestall a financial crisis. In this sense, AMCs are vested with governmental authority. Thus, AMCs can be regarded as public bodies, and they provided assistance to SOEs covered by the scheme. It is worth noting that present-day AMCs have achieved their transformation upon the completion of their policy tasks, and they basically operate on a commercial basis.

To summarize, in the course of debt-equity swap, the AMCs assisted the designated SOEs by not collecting the debts directly or immediately. Furthermore, when the equity converted from debts shrunk sharply, the AMCs suffered huge losses. Therefore, in essence, the debt-equity swap can be regarded as a form of debt forgiveness with various extents to the designated SOEs, which is the first type of financial contribution: direct transfer of funds.

6.1.4.2 Whether a Benefit is Thereby Conferred

It is difficult to say that the designated SOEs get a benefit or advantage from this scheme, if one considers how the bad debts were caused. In accordance with the Notice by SETC and PBOC, the scheme mainly covered the bad debts that emerged before 1996 and those bad debts were created by national policy.

Thus, the bad debts were not caused by the SOEs themselves but the national policy. The Chinese government intended to reduce the bad debts to promote financial reform

and independent operation of SOEs. Put another way, the earlier national policy created bad debts for SOEs and then years later, the high-level decision makers decided to take the bad debts away through new national policy. If these bad debts were not removed, it would be an additional obligation for the SOEs. The debt forgiveness just means that these additional obligations imposed on SOEs were finally eliminated. Therefore, it is difficult to conclude that the designated SOEs get any real benefit during such a process.

However, there was an exception in this scheme - the AMCs also took bad debts emerged in 1996, 1997 and 1998 from some extremely important SOEs. These bad debts were not caused by national policy. So these bad debts should be undertaken by the relevant SOEs themselves. Naturally, the relevant SOEs received substantial benefit when their debts were converted into equity by the AMCs. Together with the existence of financial contribution, one may conclude that the relevant SOEs got subsidies.

The debt-equity swap scheme continued to exist for almost ten years. It is worth noting that some conversions took place before 2001. At that time, China was not a member of the WTO yet, which indicates that the WTO Agreements including the SCM Agreement should not be applicable to China. Nonetheless, if there is evidence to show that the benefit to the relevant SOEs continued to exist after China's accession to the WTO, then subsidies could be deemed to exist.

6.1.4.3 Specificity Test and Comment

In this scheme, the selected SOEs are traditional SOEs; one of the aims of the swap program is to support the conversion of traditional SOEs into shareholding SOEs. Thus, the new specificity test designed for Chinese SOEs by the Protocol can be applied in this circumstance. Based on the new specificity test, subsidies to those selected SOEs are specific, since all recipients in the debt-equity swap scheme are traditional SOEs.

The debt-equity swap program adopted by the Chinese government is meaningful for SOCBs' further adjustment as well as SOEs' survival and transformation. If it was not the bailout by the Central Government, it would be almost impossible for SOCBs themselves to dismantle the extremely high debt-asset ratio, let alone their subsequent commercial operation or reform. The performance of the financial sector deteriorated in the late 1990s and the rate of return on assets of SOCBs fell from 1.4% in 1985 to only 0.2% in 1997.[877] In order to maintain long-term financial stability and sustainable economic growth, the Chinese government at that time had little alternative but to "intervene" in the financial system including the initiative in launching financial reform program.

[877] See Nicholas R. Lardy, "When Will China's Fiscal System Meet China's Needs?" in Nicholas Hope (ed.), above note 375, 67-70.

As Lardy commented, "the development of a modern, commercially oriented financial system in China is an important precondition for sustaining fast economic growth and moving decisively toward a market economy".[878] He also mentioned, "Whether or not China's accession into the WTO could result in improved efficiency depends on the further transformation of the financial system, especially whether SOCBs could operate on a commercial basis".[879] Thus, he recommended structural reform that could end policy lending by commercial banks.

6.1.5 Official Export Credit

In principle, official export credit is prohibited by the SCM Agreement. The reason is that subsidized official export credits would cause a large risk to normal trade flows. Two items of Annex I (Illustrative List of Export Subsidies) to the SCM Agreement have elaborated the official export credit support: item (j) and item (k). Item (j) deals with export credit guarantee or insurance programmes and prescribes that premium rates should not be inadequate to cover the cost to the government, namely the "cost to the government" approach:

> *(j) The provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programmes, of insurance or guarantee programmes against increases in the cost of exported products or of exchange risk programmes, at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes.*

Item (k) deals with the grant of export credits and the payment of the costs with the purpose of securing "a material advantage in the field of export credit terms"; it also describes conditions under which official financing support is prohibited. And the second paragraph of item (k) is the so-called "safe haven":

> *(k) The grant by governments (or special institutions controlled by and/or acting under the authority of governments) of export credits at rates below those which they actually have to pay for the funds so employed (or would have to pay if they borrowed on international capital markets in order to obtain funds of the same maturity and other credit terms and denominated in the same currency as the export credit), or the payment by them of all or part of the costs incurred by exporters or financial institutions in obtaining credits, in so far as they are used to secure a material advantage in the field of export credit terms.*
>
> *Provided, however, that if a Member is a party to an international undertaking on official export credits to which at least twelve original Members to this Agreement are parties as of 1 January 1979 (or a*

[878] Ibid.
[879] Lardy, above note 29, at 130.

successor undertaking which has been adopted by those original Members), or if in practice a Member applies the interest rates provisions of the relevant undertaking, an export credit practice which is in conformity with those provisions shall not be considered an export subsidy prohibited by this Agreement.

As noted previously, most loans from China Eximbank are directed to guarantee the export credit of commercial banks in China, and a small part is for direct export credit. In terms of the export credit provided by China Eximbank, the first relevant question is whether China Eximbank is a public body. A comparison can be made with another bank engaging in export credit, KEXIM wholly owned by the Government of Korea, since they are quite similar in many aspects. KEXIM was determined by the Panel in the *Korea-Commercial Vessels* as a public body.[880] Just as KEXIM, China Eximbank, fully owned by the Chinese government and under the direct leadership of the State Council, probably can be viewed as a public body in conjunction with the other characteristics. Therefore, export credit by China Eximbank can be regarded as the official export credit.

The ninth item in the notification of China to the WTO in 2001 involves loans from the state policy banks, however, China did not make any commitment about the time limits of this item: *Duration of the subsidy and/or any other time-limits attached to it: 1991--* .[881] Furthermore, this item was not listed as subsidies to be phased out in Annex 5B. Therefore, in line with the Protocol and its annexes, it seems that China has reserved the right to offer official export credits whenever it intends to do so.

However, Article 10(3) of China's Accession Protocol provides for that "*China shall eliminate all subsidy programmes falling within the scope of Article 3 of the SCM Agreement upon accession*".[882] The reference to "all subsidy programmes" means that it does not allow any exception in the situation of prohibited subsidies (including both export subsidies and import substitution subsidies). For instance, if the terms and conditions of official export credits offered by China Eximbank could be categorized as export subsidies in Item (k) of Annex I to the SCM Agreement, such practice violates China's obligations under the SCM Agreement. Thus, there exists an obvious conflict between China's Accession Protocol and Item (k) of Annex I to the SCM Agreement. As a result, the final conclusion about the official export credit in China probably depends on the interpretive approach.

6.1.6 Provision of Land-use Rights

Just like the measure of debt-equity swap, the favorable policies regarding the

[880] See Panel Report, *Korea-Commercial Vessels*, above note 394, para.7.50.
[881] See Annex 5A to the Protocol: Notification pursuant to Article XXV of the SCM Agreement. See Administration of WTO, above note 3, 95-96.
[882] See Article 10(3) of the Protocol.

provision of land-use rights to SOEs mainly emerged in the late 1990s, when SOEs were trapped in an extremely difficult situation. However, those obvious land-related privileges for SOEs have gradually decreased. In particular, a series of policies and regulations have been released since 2003 with a view to improving the land market environment.[883]

6.1.6.1 Whether a Financial Contribution Exists

The unique characteristics of land make it easier to exclude most types of financial contribution, especially those forms relating to capital injection or loan. A financial contribution not only means a money-transferring action, but also exists in case of provision of goods or services, which can be valued and represent a value to the beneficiary. Apparently, the provision of land-use rights resembles one form of financial contribution: provision of goods or services. In the case of China, the mechanism of public ownership of land indicates that any provision of land-use rights to companies or households is a transfer from government of different levels to private bodies. Just like standing timber is provided as a good for the stumpage program in the dispute *US-Softwood Lumber,*[884] land is provided by the Chinese government in this situation.[885]

The problem is that, based on dictionary definitions, land is neither a good nor a service. According to Black's Law Dictionary, the term "goods" refers to "all things, including specially manufactured goods, that are movable at the time of identification to a contract for sale and future goods. The term includes the unborn young of animals, growing crops, and other identified things to be severed from real property...".[886] Some dictionary defines the term "goods" as "personal property having intrinsic value but usually excluding money, securities, and negotiable instruments".[887] In essence, land is real estate or real property as opposed to personal property.[888] So land does not fall into the category of goods, "tangible or movable personal property, other than money", as defined by dictionaries.[889] In other words, strict adherence to the ordinary

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[883] For instance, Regulation on the Agreement-Based Assignment of State-Owned Land-Use Right, MOLAR [2003] No. 21, June 11, 2003; Decision on Deepening the Reform of Rigorous Land Management by the State Council, GUOFA [2004] No. 28, 2004.

[884] The Panel in *US-Softwood Lumber III* does not agree with Canada's proposition that the right to take the trees from the Crown land is different from the government selling the trees as such. Instead, the Panel in *US-Softwood Lumber III* considers that there are a number of ways in which the government may be providing timber, by auctioning off the trees as such, by entering into short term tenure agreements or by concluding long term tenure or licence agreements. The conclusion of tenure or licence agreements is one way for the government to supply timber. When the government enters into a contract with a harvesting company whereby it allows this company to exercise this right and to cut the trees, it is in fact supplying trees, standing timber, to such companies. See Panel Report, *US-Softwood Lumber III,* above note 647, para. 7.16.

[885] However, it is disputable whether land can be categorized goods. For instance, Canada argues that even if one were to accept that the issuance of harvesting rights by the provincial governments is equal to the provinces making standing timber available to the loggers, this still does not qualify as the "provision" of a good. See Panel Report, *US-Softwood Lumber III,* above note 647, para. 7.17.

[886] See Bryan A. Garner (ed.): *Black's Law Dictionary.* West Publishing Co., 1990, 701.

[887] *Webster's Ninth New Collegiate Dictionary.* Markham: Merriam-Webster, 1991, 527.

[888] Personal property means movable property, as distinguished from real estate. Available at: http://www.thefreedictionary.com/personal+property.

[889] See Panel Report, *US-Softwood Lumber III,* above note 647, paras. 7.21-7.23.

meaning of goods means that land could not be regarded as "goods" as sets forth by Article 1.1(a) (1) (iii).

However, as generally recognized by AB, dictionary definitions are not determinative of the precise meaning of a treaty term. This is especially true when a term has multiple meanings. In addition, the AB considers that the concepts of "personal" and "real" property are creatures of municipal law, and such concepts could not be reflected in Article 1.1(a) (1) (iii) itself.[890] In this sense, the AB does not accept such the classification of personal and real property adopted by municipal laws. That is also why, in the dispute *US-Softwood Lumber IV*, Canada's argument that standing timber should be defined as personal property rather than "goods" is rejected by AB.

The immediate context of a treaty term in question always matters. The term "goods" is used in the context of "provision of goods or services other than general infrastructure". If one considers such a context, the term "goods" could be interpreted even more broadly. The use of "other than general infrastructure" could be iterated as: unless the subject matter is general infrastructure, the provision of subject matter should fall into the category of providing goods or services. Land is usually not considered as general infrastructure, but as natural resources deriving from the environment. In this regard, the comment made by the Panel in *US-Softwood Lumber* reinforces such a reading: the only exception from "goods or services" was general infrastructure rather than natural resources.[891] In effect, no wording in the text of the SCM Agreement provides any "exception for the right to exploit natural resources".[892] Following the above logic, it is highly possible that provision of land-use rights constitutes a financial contribution in the form of provision of goods other than general infrastructure.

Therefore, the question of whether the provision of land-use rights to SOEs is a financial contribution in the form of providing goods or services other than general infrastructure, seems to depend on how to interpret Article 1.1(a) (1) (iii) of the SCM Agreement. However, based on a contextual reading, there is a high possibility that land is categorized goods.

In fact, even if land is not regarded as goods, one may also argue that in this situation, it is land-use right that is provided. Land-use right is ascertainable in value and can be transferred, thus it can represent a value to the beneficiary. In this circumstance, the provision of land-use right is equivalent to direct transfer of funds.

6.1.6.2 Whether a Benefit is Thereby Conferred

In accordance with the above discussion, the provision of land-use rights in this program can be viewed as a financial contribution. Thus, the next step is to examine

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[890] See Appellate Body Report, *US-Softwood Lumber IV*, above note 644, para. 65.
[891] See Panel Report, *US-Softwood Lumber III,* above note 647, paras. 7.25-7.26.
[892] Ibid.

whether a benefit is conferred.

A preliminary issue is whether China has a land market independent of the governmental "interference". Disagreement still exists. The supporter would argue that governmental interference is totally different from government management of land, which is crucial for the sustainable use of limited and scarce land. The opponent would enumerate relevant evidence to argue that the sale of land-use rights in China is not conducted in accordance with market principles.

The government, as a party to the land-use rights agreement, sells land-use rights to the other party. It tends to be questionable whether the method of setting the price could reflect market principles. Nevertheless, the key issue is whether SOEs obtain their land-use rights at the price lower than market value, that is to say, whether the government provides land-use rights for less than adequate remuneration. According to Article 14(d) of the SCM Agreement, a benefit exists only when provision of goods by government is made for less than adequate remuneration. The subsequent question is how to make such comparison so as to decide whether a benefit is conferred to SOEs.

There are at least two approaches to considering whether there is a benefit. The first approach is to compare the transaction price at issue with the domestic private prices and the second one is to use an external benchmark to conduct such comparison.

The first approach is the normal method adopted in AD/CVD investigations, while it seems unavailable in this context, since the public ownership of land in China means that the land-use rights are all supplied by different levels of government. In other words, the government is the only supplier of the particular goods (land) in the country.[893] For such a circumstance, it is a persuasive point to argue that domestic market would be distorted as a result of the government's significant involvement in the land market.[894] Thus, the second approach needs to be adopted. As prescribed by Article 15(b) of the Protocol, special difficulties exist and make the prevailing terms and conditions in China not an appropriate benchmark for calculating the benefit. There is a procedural requirement that, the importing WTO Member should, where practicable, adjust such prevailing terms and conditions before using an external benchmark. However, the ambiguous wording of "where practicable" leaves much discretion to the importing WTO Member. So when deciding whether benefit exists, the importing country can use an alternative benchmark other than domestic prices of land-use rights transactions.[895]

In China's case, however, there are some situations where the existence of benefit is evident. As discussed in Chapter Four, the Opinions issued by MOLAR in 1999

[893] See Panel report, *US-Softwood Lumber IV*, above note 677, para.7.57.
[894] In the case *US-Softwood Lumber IV*, the Appellate Body commented that even though the government is the only supplier of the particular goods in the country, it is not necessarily that private prices are distorted. The problem is that if the government is the single supplier, it is hardly to find private prices for the subject particular goods.
[895] This has been discussed in length in Chapter Five.

provides that traditional SOEs can use the previous land allocated to them for free, and some shareholding SOEs can still use the land by allocation upon certain conditions. For the other kinds of firms, they normally get the land-use rights by granting, leasing or conversion into equity. The fact that, the land-use rights are provided free of charge substantiates the existence of benefit. The problem is that most of those practices occurred before 2001; thus, like the case in debt-equity swap, the analysis with regard to pass-through of a benefit is necessary.

6.1.6.3 Specificity Test and Comment

Even assuming, arguendo, that the government has provided subsidies to SOEs in terms of land-use rights, it does not necessarily mean that such subsidies meet the requirement of specificity. For land-related program solely in favor of traditional SOEs, it is easy to categorize such program as specificity in accordance with the new specificity test designed for traditional SOEs by China's Accession Protocol.

For shareholding SOEs, also the majority of SOEs, the special specificity test based on state ownership is not applicable. In effect, it is the specificity test prescribed by Article 2 of the SCM Agreement that matters for shareholding SOEs. These shareholding SOEs probably represent a wide variety of industries, and it is difficult, if not impossible, to regard such subsidies as specific. In reality, if some local governments offer more favorable land-related policies to SOEs and these SOEs happen to be in one group of industries (industry specificity) or locate within a designated region (regional specificity), these policies may constitute subsidies that are specific.

The provision of land-use rights in China is vulnerable to countervailing duties, mainly because of its public ownership of land. The subsidy rules are established and interpreted with market principles and private ownership of land as the guidelines. Under conventional wisdom, it is not easy to argue that China has maintained a fair and transparent land market on the basis of public ownership of land.[896] However, it is a tough task to reconcile the direct contradiction between China's public ownership of land and the WTO rules regulating subsidies. For China, a country under the leadership of the communist party, such a mechanism for land is a fundamental arrangement; and it is out of the question that they could significantly change the public ownership of land in any time soon. Consequently, the provision of land-use rights will be a frequent target of the countervailing duty investigations against China. In essence, this serious conflict in terms of land system reflects the confrontation between a state-oriented mechanism and an international rules system oriented by market. It raises further complicated questions such as: can the WTO push its Members to change their fundamental economic system intertwined with social and

[896] On the other hand, China has accelerated the land market reform along with the rapid development of real estate market. For more about the progress on land market reform, please refer to Academy of Economy and Resources Management of Beijing Normal University, above note 350, at 97-114.

political system? Is WTO just a forum for the pursuit of national commercial interests?

6.1.7 Energy Subsidies

In terms of energy subsidies in China, there can be two perspectives to understand this issue. The first one is that subsidies are provided to energy SOEs and these subsidies then may be passed through to downstream manufacturers; the second one refers to a situation that energy SOEs provide energy to their downstream manufacturers for less than adequate remuneration. In practice, the provision of electricity by SOEs is often covered by CVD investigations initiated by the US authority.

For the first type, it is not difficult to determine whether energy SOEs get subsidies from the government. Two interesting and relevant issues are discussed: entities providing the subsidies to energy SOEs and the pass-through of subsidies to downstream producers respectively.

Assuming arguendo that subsidies exist, there is a possibility that those subsidies may be provided by SASAC through the state capital operating budget rather than the state.[897] In china, most energy SOEs are subject to the supervision of SASAC. In this situation, SASAC provides financial assistance, usually in the form of capital infusion, to the energy SOEs as their shareholder or owner, which should be distinguished from the subsidies provided by the state involving national revenue. The differences are apparent: first, SASAC acts as the shareholder or owner of the energy SOEs rather than a governmental body; secondly, and perhaps more importantly, the state capital operating budget in China comes from dividends paid by central SOEs to their shareholder or owner: SASAC. If the financial assistance is provided by the state to energy SOEs, and a benefit is thereby conferred, there is little doubt that energy SOEs receive subsidies from the state.

A subsequent problem is whether the subsidies are passed through to the downstream manufacturers especially the exporters, if yes, a CVD investigation is possible. Hence, a pass-through analysis will be necessary, if the energy SOEs receiving subsidies are unrelated with the downstream manufacturers and their transactions are operated at arm's length; otherwise, the investigation authorities may presume that the subsidies have been passed through to the downstream manufacturers.[898]

The following part discusses the second understanding of energy subsidies in detail, namely the provision of electricity by energy SOEs to their downstream manufacturers for less than adequate remuneration. Considering the fact that there are

[897] For instance, through the state capital operating budget, SASAC injected capital to five power plants, whose branches in Sichuan confronted huge losses in the terrible Sichuan Earthquake in 2009.
[898] Whether a pass-through analysis is required or not has been discussed thoroughly in the part of Pass-through of Benefit in Chapter Five, based on several prior cases adjudicated by the DSB.

various types of energy and each type of energy bears certain resemblances to others, this subsection focuses on electricity. Also, in practice, electricity (or power) price is much more problematic than the other types of energy. In the comment part, the oil price and the oil companies will also be incorporated.

6.1.7.1 Whether a Financial Contribution Exists

The second understanding assumes that energy SOEs provide financial contribution in the form of provision of electricity. Financial contribution should be provided by a government, any public body or a private body directed or entrusted by a government. However, SOEs could not be presumed public bodies as demonstrated in Chapter Five, so it is lack of rationale to regard energy SOEs as the entities providing financial contribution.

To further this discussion, the remaining part examines whether the provision of electricity for less than adequate remuneration constitutes a form of financial contribution. Electricity prices, categorized in different types, are quite complicated in China as discussed in Chapter Four; thus the determination of adequate remuneration is not easy. However, the key threshold issue is whether the provision of electricity falls into one of the seven forms of financial contribution. It is easy to preclude several forms of financial contribution, including the direct transfer of funds, potential direct transfer of funds, government revenue foregone or not collected.

The claim that provision of electricity could be deemed as provision of goods or services and purchase of goods does not withstand scrutiny. Obviously, it is difficult to regard electricity *per se* as a service. And electricity is quite different from ordinary goods.[899] Goods are "tangible or movable personal property, other than money", as defined by Black's Law Dictionary and adopted by the Panel Report of the *US-Softwood Lumber* case.[900] Electricity is not tangible, but it is movable through special devises.

Electricity is regarded as essential infrastructure by many countries and regions such as Canada, Australia, Brazil and European Union *etc.*, as confirmed in their official websites.[901] In accordance with the definition provided by *Shorter Oxford English Dictionary*, infrastructure refers to "the foundation or basic structure of an undertaking the installations and services (powers, sewers, roads, housing, etc.) regarded as the economic foundation of a country".[902] The World Bank in its report considered infrastructure as covering a complex of distinct sectors that represent a

[899] Electricity is not contained by Harmonized Commodity Description and Coding System (HS) including the explanatory note to HS heading.
[900] See Panel report, *US-Softwood Lumber IV*, above note 677, para.7.57.
[901] Available at their own websites:
http://www.neb-one.gc.ca/clf-nsi/rnrgynfmtn/nrgyrprt/nrgnfrmtnprgrm/nrgnfrmtnprgrm-eng.html;
http://www.era.wa.gov.au/2/293/50/infrastructure.pm; http://www.aneel.gov.br/area.cfm?idArea=262&idPerfil=13;
http://ec.europa.eu/energy/index_en.htm.
[902] Stevenson (ed.): *Shorter Oxford English Dictionary*, above note 533, Vol. 1, 1380.

large share of an economy, and classified infrastructure into two types.[903] One refers to economic infrastructure that includes the long-lived engineered structure, equipment, facilities, and the services they provide that are used in economic production and by households; the other is social infrastructure, which indicates an equally important yet very different set of issues and often encompasses education and health care.[904] Specifically, the first type of economic infrastructure means public utilities (power, piped gas, telecommunications, water supply, sanitation and sewerage, solid waste collection and disposal), public works (major dam and canal works for irrigation, and roads), and other transport sectors (railways, urban transport, ports and waterways, and airports).[905] Thus, power (or electricity) is clearly considered as an economic infrastructure by World Bank in its report.

Indeed, it is much more appropriate to say that electricity is categorized as "general infrastructure" on several grounds. First, it is hard to imagine a household living in the modern society without electricity; while one could not get it from any normal shop or super market. Second, its generation, distribution and transmission rely on the establishment and maintenance of relevant pipelines, and a series of coordination among the stakeholders; once these basic infrastructures are ready, the sale of electricity is possible. Such a process is like a road, a widely accepted type of general infrastructure. Furthermore, the electricity-related companies may run below cost if the households live in remote mountains or in a quite scattered way; in this case, it is rational for the companies to refuse the provision of electricity to those households from the point of making profits, while it is not proper taking account of the right of individuals to enjoy the basic service in modern society, and thus the involvement of government is necessary to make sure the stable provision of electricity at a reasonable price.

For the aforementioned reasons, it is inappropriate to regard electricity as goods or services; in effect, its characteristics make it general infrastructure. Therefore, provision of electricity should not be taken as a type of financial contribution. The analytical logic for oil subsidies is similar to that for electricity, so it will not be repeated here. The "benefit" and "specificity" analysis is similar to the logic in the measure provision of land-use rights, so it is also omitted.

6.1.7.2 Comment

The above analysis actually shows the difficulties in determining the existence of energy subsidies in the sense of the SCM Agreement. In particular, the second understanding is untenable. At most, it may be possible to demonstrate that certain subsidies are provided by the state to energy SOEs, and then the subsidies are passed through to downstream manufacturers.

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[903] World Bank: *World Development Report 1994: Infrastructure for Development.*
[904] World Bank: ibid.; *World Development Report 1993: Investing in Health.*
[905] Ibid.

In fact, a salient problem afflicting China's economy is the monopoly of SOEs in certain industries other than very limited sectors closely connected to national security. For instance, the electricity generation industry is controlled by five SOEs and the oil industry by three giants in China as mentioned in Chapter Four. Their monopoly position is protected by the newly issued Anti-Monopoly Law (AML) on August 30, 2007. Because of their pivotal position in the national economy and the potential governmental intervention into this industry, it is not impossible to argue that these energy SOEs are directed or entrusted by the government to provide financial contribution to other producers.[906]

In terms of the anti-monopoly review for a concentration of business operators, the new Law does not make a distinction between domestic and foreign investors except two circumstances. One of the exceptions involves the monopoly of certain SOEs; specifically speaking, the AML provides an exemption for SOEs in sectors that affect the national economic lifeline and state security or sectors in which exclusive operation and exclusive sale are implemented.[907] Energy including the electricity and oil is probably categorized as one sector that affects the national economic lifeline because of their fundamental importance in modern economies. Therefore, it is highly possible that the AML will not be applicable to the monopolistic practices by energy SOEs including the five power plants and the three oil giants.

In response to the question whether SOEs are in a monopoly position, Li Rongrong, previous Chairman of SASAC commented that the AML law was against monopolistic behaviour rather than monopolized corporations, which may not manipulate the market; he further stated that monopolized SOEs shall not monopolize the market.[908] In his view, the extent of concentration is too low rather than high; and expanding the scale of SOEs through concentration will contribute to their market competitiveness.

Theoretically, monopoly other than monopolistic behaviour may not cause serious problems to the national economy. It is not unusual to find large monopolized corporations worldwide. The problem relating to China is that an effective regulatory mechanism for monopolized SOEs is absent. If there is no strict supervision over the behaviors of SOEs, how can one expect that the monopolized SOEs will not monopolize the market? In this connection, the monopoly of SOEs including the energy SOEs is problematic.

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[906] The WTO jurisprudence shows a high requirement for the demonstration of direction or entrustment. It should be noted that certain energy may be regarded as general infrastructure.

[907] See Article 7 of the Anti-Monopoly Law of PRC. First Paragraph of Article 7: With respect to the industries that hold controlling position in the State-owned economy, control the lifeline of the national economy, and are related to the national security, and the industries that implement exclusive or monopoly distribution in accordance with the law, the State protects the lawful operation activities of the business operators in the aforesaid industries, moreover, the State supervises and regulates, in accordance with the law, the said operators' operation conducts and the prices of their services and commodities, so as to protect the interests of consumers and promote technological advancement.

[908] http://www.sasac.gov.cn/n1180/n1549/n1600/n1765/6513799.html

6.2 Three Industries

Among all the measures designed for the three industries covered by this research, policy guidance is highly emphasized in that Chinese government has issued a series of industrial policies to guide and develop its industrial sector.[909] In effect, some problematic measures probably are caused by industrial policies.

Chinese government releases various policies in a relatively frequent way with an aim to promote the growth of the national economy. There are policies for the whole national economy or local economy, and policies specific to certain industries; there are fiscal policies, monetary policies, trading policies. In particular, the well-known five-year plan in China serves as a tradition to provide a comprehensive outline and a general guideline for the country's development in the next five years.[910] Provinces or municipalities also tailor their five-year plans to needs and conditions of their jurisdictions.

The current five-year plan is a legacy from the centrally-planned economy. In the planned economy or the Soviet-style economy, all aspects of the national economy were governed by extensive five-year plans designed and administered by the central government. They were mandatory in nature. By contrast, in the era of market-oriented economy, China's embrace of such a five-year plan mainly retains a symbolic meaning. The plan shifted from being mandatory in nature to indicative by the 1990s.[911]

The US argued that central level five-year plans should be considered a central-government policy or program adopted and implemented at the provincial and municipal levels through their own five-year plans.[912] Such allegation ignores a basic characteristic of the plans, that is, both the five-year plans at the central and local level are general policy orientations and non-binding. The texts are so general and abstract that they cannot be implemented without further guidance. In addition, there is no penalty for nonperformance of these orientations.

In fact, the 11th Five Year Programme, covering the years from 2006 to 2010, selected the word "programme" (*Gui Hua*) instead of "plan" (*Ji Hua*).[913] The wording of planning is also abandoned from the ministries or commissions, for instance, the State Planning Commission became the State Development Planning Commission in 1998 and is now known as the National Development and Reform Commission.[914]

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[909] China is often cited as a case in point when it comes to industrial policies.
[910] The first Five-Year Plan in China dated back to 1953.
[911] See Kenneth Lieberthal, *Governing China: from Revolution through Reform*. New York, London: W.W.Norton & Company, 2004, at 259-261.
[912] See Panel Report, *US–AD/CVD on Certain Products from China*, above note 604, paras. 9.47- 9.48.
[913] This Programme was effective in March 2006. It contains 14 Parts and 48 Chapters, and provides an ideal orientation for the national economic and social development. Although the final part deals with the implementation issue in general terms, it places great emphasis on the function of market mechanism. For some aspirations, both the market-oriented and incentive-oriented mechanisms are established.
[914] It is dubbed as the "little State Council".

Virtually, no part of the Chinese economy operates in accordance with a national planning document.[915]

Such seemingly slight change in wording of the title revealed again the nature of the 11th Five Year Programme: an indicative forecast rather than a mandatory quantitative target.[916] The 11th Five Year Programme, on the whole, draws a big picture of governmental programs to ensure the rapid and sustainable economic growth in the long period. As commented by Barry Naughton in this regard, the recommendations in the 11th Five Year Programme are so broad and abstract that they cannot be implemented and enforced without further specific policies.[917]

It is worthwhile noting that the Panel and AB in the *US-AD/CVD on Certain Products from China* acknowledged that several planning documents, at central, provincial and municipal levels of government, taken together, singled out one industry or specific enterprises, thus certain measure at issue, for instance, loan to one industry, was specific.[918] There are at least two problems associated with such an analysis. First, those multiple policy planning documents at various levels are indicative or discretionary rather than mandatory. Second, those documents have a wide coverage and encourage the development of different industries in China; they do not specially target at certain enterprises or industries. Thus, an intended selection of certain industry and abandonment of other industries from various planning documents is against the aim and purpose of each document.

As examined in Chapter Four, both the central government and local governments put forward industrial policies for the three industries. The first and foremost problem is to examine whether these policies are mandatory or discretionary. Therefore, apart from other measures, the following sections will first analyze the relevant policies for the three industries to make a mandatory and discretionary distinction, and such distinction has already been employed in both GATT and WTO cases over the years.

6.2.1 Iron and Steel Industry

6.2.1.1 Policies Analysis

Both the Iron and Steel Industrial Policy 2005 and 2009 share the same objective of achieving the industrial upgrade, while the former emphasizes its aim of guiding the sound development of the iron and steel industry and the latter proposes some counter-measures to cope with the severe financial crisis erupted in 2008. As explained in Chapter Four, the industrial policies in favor of outward-oriented strategy

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[915] One exception may be some state-initiated infrastructure projects. See Kenneth Lieberthal, above note 911, at 259-261.

[916] See Michael J. Enright, China's Economy into the Future, in Hoffmann and Enright (eds.), above note 869, at 23-29.

[917] See Barry Naughton (2005): the New Common Economic Program: China's Eleventh Five Year Plan and What It Means. *China Leadership Monitor*, 16.

[918] See Appellate Body Report, *US-AD/CVD on Certain Products from China*, above note 619, paras.394-397.

are problematic. For the policy guidance, a potential problem is whether the policies are "as such" subsidies.

Following the logic of the Panel in the *Canada-Export Credits and Loan Guarantees for Regional Aircraft*, it is first necessary to consider the relevant legal requirements of the applicable provisions of the WTO Agreement to the policies that will be examined; then the mandatory/discretionary distinction is applied and it is followed by the policies under review.[919] With regard to the Iron and Steel Industrial Policy 2005, it has two overt articles that support the use of domestically-made equipment and reduce the use of imported ones.[920] Quite obviously, such articles are against the obligations as set out in Article 3.1(b) of the SCM Agreement. For the Iron and Steel Industrial Policy 2009, it puts great emphasis on the financing support to key enterprises, for instance, the provision of interest rate assistance if necessary. Clearly, financing support to key enterprises is quite vulnerable to subsidy rules.

The next problem is whether these policies are mandatory or not. As to the Iron and Steel Industrial Policy 2005, even though two problematic articles adopt the imperative mood, for instance "the State should provide policy supports in taxation, interest rate assistance, scientific research funds and so on" and "we should organize and implement the localized production for the equipment that has a great and extensive demand" to improve the capacity of domestic iron and steel industry, the terms are too general to be implemented. It is hard, if not impossible, for various levels of government to abide by and implement the ambiguous and abstract wording of the two articles. These vague "plans or designs" in and of themselves without specific implementing guidance cannot grant a benefit and thereby a subsidy to the iron and steel enterprises. Put another way, the "plans or designs" just reflect some written aims and objectives or even aspirations, and they are indicative forecasts for the future, accompanied by proposing measures in a general way. According to the official response of China in the WTO, the iron and steel industry development policy just outlined opinions of the government towards development of the sector, and the policy was not compulsory in itself.[921]

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[919] See 5.4.1 Prohibited Subsidies in Chapter Five; also see the Panel Report, *Canada-Aircraft Credits and Guarantees for Regional Aircraft* (WT/DS222/R), paras. 7.56-7.59.

[920] See the original text of Article 16: *We should support and organize the implementation of equipment localization of the iron and steel industry, enhance the research and development as well as designing and manufacture levels of major technical equipment of our iron and steel industry. For crucial iron and steel projects that are based on newly developed home-made equipments, the State should provide policy supports in taxation, interest rate assistance, scientific R&D funds and so on.* The text of Article 18: *The policies for imported technologies and equipment: enterprises are encouraged to use home-made equipment and technologies and reduce import. For any equipment or technology that cannot be produced domestically or fails to meet the demand and, thus, must be introduced from abroad, the introduced equipment or technology should be advanced and practical. We should organize and implement the localized production for the equipments that have a great and extensive demand.*

[921] In its response, China also argued that there was no government's interference in commercial decisions of enterprises. See Part IV. Trade Policies by Selected Sectors, (3) energy (ii) Iron and Steel, in the WT/TPR/M/161/Add.1, 15 June 2006.

The Iron and Steel Industrial Policy 2009 is more general; likewise, it cannot be a binding requirement for central and local governments to observe without necessary detailed rules. In effect, these objectives can be accomplished by various approaches.

To be sure, the policies reveal the willingness of the government to support the iron and steel industry, however, considering that no specific and operable measure is formulated and enforced, it is highly impossible to maintain that these policies are mandatory. Solely based on the texts of the policies in question, it is almost impossible for the two polices to require a conferral of benefit in practice and, hence, no subsidization to the iron and steel enterprises could be provided.

To conclude, the two policies are discretionary rather than mandatory. In other words, the policies do not mandate the establishment and operation of any program or measure in violation of the SCM Agreement, so it would be inappropriate to conclude that the policy "as such" is inconsistent with the subsidy rules. Nonetheless, their discretionary nature does not exclude the possibility that these polices as applied may be inconsistent with the SCM Agreement.

6.2.1.2 Restructuring

As illustrated previously, the current restructuring for iron and steel enterprises in China is mainly driven by different levels of government for their respective reasons. During the restructuring process, the government may offer various incentives to relevant enterprises to encourage their restructuring. At the central level, this task is promoted by SASAC, while such restructuring is usually executed by the provincial and municipal governments at the local level.

For the incentives provided by SASAC, the entity performing the ownership function of SOEs, it is more appropriate to regard such incentive as behaviors of a shareholder rather than governmental behaviors.[922] It may be problematic for the incentives offered by local governments.

6.2.2 The Auto Industry

Three major auto industrial policies are introduced in Chapter Four, with particular attention to articles that may be inconsistent with the subsidy rules. As to the Policy 2004 and Plan 2009, some articles seem to involve governmental assistance. For instance, Article 7 in Policy 2004 mentions tax support to the research and development activities; Article 31 in Policy 2004 requires the government to provide financing and other support to enterprises dealing with auto components and parts. With regard to Policy for Automobile Trade, Article 34 provides that the measures of managing subsidy funds for the discarding and renewal of old automobiles should be improved.

[922] This issue has been discussed previously in 6.1.7 Energy Subsidies.

Plan 2009 is basically an outline, which emphasizes the technological progress and innovation and the use of energy-saving and new-energy autos. A salient point of Plan 2009 is that it introduces a 50% reduction of the purchase tax for vehicles 1.6 liters and lower. This purchase tax reduction supports the sales of certain cars, stimulates the domestic consumption and boosts the domestic auto industry, but it is not inconsistent with the subsidy rules. The reason is that it targets on consumers directly and benefits consumers generally, irrespective of the auto makers.

Similarly, the policies for the auto industry are discretionary rather than mandatory. To avoid repetition, the analysis is omitted here. Greater emphasis is placed on the measures from the local governments and the case studies.

Local governments adopt favorable measures for local auto enterprises by their local regulations or documents, such as special treatment on land-use right, aid for technological development, guaranteed supply of energy and separation of social functions. Since these kinds of measures for the local auto industry have been analyzed as the general measures, it is not repeated here.

One special favorable measure shared by both governments of Changchun City and Anhui Province is the exemption of fees and other charges (including test fees, verification fees, bridge tolls and highway-user fees *etc.*) from the users of their local autos. This measure is special mainly because the privileges are enjoyed by the consumers rather than the producers. Still, there is a high possibility that such benefit may be shared by the local auto producers. By comparison, if the exemption of fees and other charges were generally available to all types of autos, no auto manufacturers could have got comparable advantage.

The first step is to examine whether a specific form of financial contribution can be found. It is evident that these fees are part of the sources of government revenue. These fees would be charged by local governments but for their policies supporting the purchase of their local autos. Consequently, a part of the government revenue disappears. Furthermore, the forgoing of such revenue is not based on objective or justifiable reasons. Therefore, a conclusion can be drawn from the above analysis that the exemption of fees and other charges probably constitutes a form of financial contribution: government revenue foregone or not collected.

There is little doubt that the exemption of fees and other charges has conferred a benefit on the recipient, namely the purchasers of the local autos. Such privileges come from the policy documents of local governments, and thus they cannot be obtained from the commercial market at all. The problem is that the financial contribution is given to the purchasers rather than the auto manufacturers. In other words, though the benefit can be confirmed, the benefit is actually enjoyed directly by the purchasers who choose local autos.

To determine whether a subsidy exist in the sense of the SCM Agreement, the relevant question is whether the financial contribution has conferred a benefit to manufacturers of autos. Therefore, a subsequent enquiry is whether the benefit received by the local auto purchasers has any positive impact on the auto manufacturers. Like what the Panel on *Brazil-Aircraft (Article 21.5 - Canada II)* concluded: whether the financial contribution conferred a benefit to producers of regional aircraft, as opposed merely to supplier of financial services, depended upon the impact of PROEX III on the terms and conditions of the export credit financing available to purchasers of Brazilian regional aircraft.[923]

Given the fact that the exemption of fees and other charges benefits the purchasers of local autos and improves the terms and conditions that local auto manufacturers could offer when selling autos, thereby increasing their chances of securing the contract, a *prima facie* case can be established that it confers a benefit on local auto manufacturers. Suppose that, local consumers have strong preferences towards foreign brands of autos, or local autos are not qualified or excellent enough in certain aspects, the exemption may not be appealing for local consumers. Thus, if there is positive evidence to demonstrate that local autos benefit from the exemption of fees and other changes, it is safe to conclude that local autos receive subsidies by this favorable measure.

6.2.3 Electronic Information Industry

A subsidy program known as "home appliances go rural" is introduced in Chapter Four. This initiative is generally applauded for boosting rural consumption. Also, domestic consumption has for long been expected to assume greater importance in economic development than export.[924] Fifteen prominent Chinese manufacturers, including Haier, Hisense and Changhong, participate in the rebate program.[925] The manufacturers for each type of products are selected by a transparent bidding process.[926] In this scheme, the tax rebate is not given to home appliance manufacturers, instead, it goes to rural families who finally purchase the designated home appliances. In other words, the subsidy is enjoyed by poor rural families. Thus, quite obviously, such subsidy program is not inconsistent with the subsidy rules.

With regard to the local policies, the credit loan support to firms in the electronic information industry in Anhui Province is problematic. Likewise, various funding forms such as grant, interest rate assistance, capital fund injection, follow-up investment and rewards offered the Beijing Municipal Government is vulnerable to

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[923] See Panel Report, *Brazil-Aircraft (Article 21.5-Canada II)*, above note 639, para.5.28.
[924] Available at: http://www.nytimes.com/2008/02/21/business/worldbusiness/21iht-yuan.1.10263714.html
[925] Ibid.
[926] China National Electronics Import & Export Corporation is responsible for the bid business. More information about the bid is available at: http://www.ceiec.com.cn/news/view.aspx?id=514.

the subsidy rules.

Considering that the analytical logic for policies enacted by the central government for the electronic information industry is similar to those for the iron and steel industry and the auto industry, detailed policy analysis of the electronic information industry is omitted in this part.[927]

6.3 Conclusion

Among the seven measures, the measure undervalued exchange rate cannot meet any of the three elements that constitute actionable subsidies in the context of the SCM Agreement. The measure that SOEs had easier access to the stock market cannot be categorized as subsidies either. Although the biased listing rules are formulated by the government to benefit SOEs, these rules are regulatory measures not covered by the notion of financial contribution.

As to the measure preferential loans (whether it is easier for SOEs to get bank loans than other kinds of firms with similar conditions; whether the interest rates of the loans extended by SOCBs to SOEs are lower than the commercial interest rate) and the measure official export credit, in deciding the question of whether interest rates extended by SOCBs and China Eximbank constitute financial contributions, the nature of SOCBs and China Eximbank matters. Moreover, in the determination of a benefit, both measures highly depend on the type of the selected comparison benchmark to decide whether the interest rates are lower or not. Taking the commercial interest rate in China as the benchmark probably is different from the interest rate on the international market or other countries, thereby having a different impact on the interest rates provided by SOCBs and China Eximbank. In practice, China is often regarded as a non-market economy, and then it is probable that an external benchmark is adopted by the investigating authorities. An external benchmark makes it easier to determine the existence of a benefit. Owing to the wide discretion enjoyed by the investigating authorities to choose certain external benchmark, they naturally tend to select a benchmark with a higher interest rate.

Among all the seven measures, the scheme debt-equity swap is most vulnerable to the discipline of the subsidy rules. Apart from meeting the two elements financial contribution and benefit, this measure is specific to important SOEs with a huge amount of bad debts, thus satisfying the specificity requirement as well. This scheme has terminated upon the completion of the debt-equity swap scheme. Nevertheless, if there is evidence to show that benefit continues to exist, this measure still can be challenged.

The last two measures - the provision of land-use rights and energy subsidies, relate to special "products" (both land and energy are so special that they even could not be

[927] The relevant texts contained in the policies are listed in Chapter Four.

categorized as goods). To a large extent, the question of whether these two measures can be considered as subsidies is subject to the interpretative approach.

In respect of the three industries, local governments in China normally incline to intervene in the operation of these key industries by protective measures. Such intervention is based on several counts. First, they serve as an important source of governmental revenue, as part of the taxes paid by their local large enterprises in the key industries goes to the pocket of local governments. Secondly, the contribution of local large enterprises to local GDP would enhance the cadre's performance. Also, the local unemployment rate might be lowered down. However, policies released by the central government normally concentrate on the environment impact, energy consumption, excessive production capacity, the overall competitiveness of certain industries, the promotion on new technologies and upgrade of the industrial structure *etc*. Nonetheless, policies released by the government at both central and local levels reveal exactly the government's intervention into or macro regulation of the industrial development. As examined previously, these policies contain provisions that are not in conformity with the WTO rules regulating subsidies. Given that these policies are discretionary rather than mandatory, they cannot be considered inconsistent with the WTO rules governing subsidies "as such".

In both the auto industry and electronic information industry, there is a trend that the subsidy goes to consumers directly. Such subsidy schemes benefit the consumers directly and stimulate domestic consumption. However, some subsidy programs are problematic, considering that they restrict the access to subsidy to consumers that purchase local products.

Chapter 7 Conclusion

The Chinese central government places great emphasis on the fundamental importance of SOEs to China. During the past three decades, Chinese SOEs have undergone a series of reforms. On the whole, the reform of Chinese SOEs is driven by the central government in cooperation with local governments through various policies and a very limited number of laws.[928]

Admittedly, there are multiple underlying rationales for the SOE reform. In essence, it is an inevitable trend, since the whole Chinese economy has been transforming from a planned-economy - which created a large quantity of typical SOEs - to a market-oriented economy. However, the most direct reason goes to the deteriorating performance of SOEs in the 1990s, which once were on the verge of collapse, thereby endangering the whole economy. That also explains why several substantial reforms, including the large-scale withdrawal of small and medium-sized SOEs from the competitive industries and the ownership diversification of SOEs, took place in the 1990s.[929]

Given SOEs' vital importance, it is natural for one to consider that the government tended to offer a helping hand to the underperforming SOEs. Even if the Chinese government did not intend to directly provide huge financial rescue to SOEs in danger, it seems that they had few alternative at that time. The problem is that, with too much assistance from the government, certain kinds of assistance may not be congruent with the WTO rules governing subsidies. Yet, on the whole, Chinese SOEs have experienced substantial changes during the last ten years, which therefore saw a decline of previous governmental subsidies to SOEs. To quote from OECD, "with improved governance and other reforms, SOEs are, in some ways, operating more like private-sector firms".[930]

In fact, the primary goal of this research is to review the various assistance provided by the Chinese government to SOEs in the course of SOE reform, and find out which types of assistance may constitute subsidies. This study focuses on seven major types of assistance (or measures) and the other types of assistance that are specifically provided to three industries, namely the iron and steel industry, the auto industry and the electronic information industry, on which SOEs still have a considerable impact. As to this research question, the reasoning presented by the previous chapters leads to the basic and general findings of this study: there is a high possibility that some measures taken by the Chinese government to assist SOEs are inconsistent with China's obligations under the WTO rules regulating subsidies with the SCM

[928] This is exactly a top-down process.

[929] The initiation of the shareholding mechanism for SOEs, one significant strategic move, accelerated the reform process.

[930] OECD: *OECD Economic Surveys: China.* Volume 2010/6. Paris, February 2010, 109.

Agreement as the main body, while many other measures could not be considered as subsidies in the sense of the SCM Agreement.

The above general findings can be supported and complemented by a series of specific conclusions. Thus, the remaining part will summarize the main points of the whole research, which ultimately serve the primary research question.

First, notwithstanding the long-lasting efforts in regulating the government's role as the owner of SOEs, the separation of the government's role as the owner and regulator of SOEs is still not clear enough. It is especially true at the local government level.

Second, a very important point of this study relates to the scope of SOEs in China. The scope of SOEs can be enlarged or narrowed depending on the selected criteria but it is still difficult to reach consensus on this issue. It is even more difficult when the boundary between SOEs and private enterprises is becoming increasingly blurred.

The third point involves the nature of SOEs, in particular, whether SOEs can be considered as public bodies. Generally speaking, SOEs in China, at least the majority of them, should not be regarded as public bodies in the sense of the SCM Agreement.

Fourth, despite the possible difficulty of distinguishing between the two behaviors, the assistance provided to SOEs can be attributed to the SASAC (the owner or shareholder of SOEs) or the government (the regulator of SOEs). Such a distinction implicates that it may be inappropriate to regard the financial assistance from the SASAC as subsidies, especially if the SASAC acts properly as the owner or shareholder of SOEs.

Fifth, based on the changing characteristics of the relationship between SOEs and the state along with the SOE reform, subsidies to SOEs in China can also be categorized into three different historical periods: the typical planned economy era; from reform and opening up in the late 1970s to December 2001 when China joined the WTO; and from China's accession into the WTO until now. In practice, the rules of the SCM Agreement cannot be used retroactively against the subsidies provided to SOEs before China's accession into the WTO, while the rules could still be applicable, if it could be proved that the prior subsidies have been passed through to and enjoyed by the enterprises even after the year 2001.

Finally, this thesis is a review on the seven general measures and the measures specific to the three selected industries. All of these measures have been analyzed in conjunction with the WTO rules regulating subsidies in Chapter Six.

7.1 Partial Separation of the State's Role as the Owner and Regulator of SOEs

The establishment of SASAC in China is a mechanism to separate the role of the state as the owner, investor or shareholder and regulator of SOEs. There are three levels of

SASAC, which can be named as central SASAC, provincial SASAC and municipal SASAC; normally, both the provincial SASAC and municipal SASAC are referred to as local SASACs. As discussed previously, the SASAC is empowered by *the Law on State-Owned Assets of Enterprises* to perform the "investor's functions for state-invested enterprises on behalf of and upon the authorization of the corresponding people's government"[931] in a unified manner.

However, the SASAC model is not generally applied in China. The role of acting as the owner or shareholder of SOEs is still shared by the SASAC and certain ministries or commissions. Put differently, there are now four kinds of entities that perform the owner functions of SOEs: certain central ministries or commissions, central SASAC, local ministries or commissions and local SASACs. It is exactly in this sense that the separation of the government's roles of the owner and regulator of SOEs is incomplete.

When it comes to the central SOEs, the SASAC model has worked fairly well so far. Specifically, for the central SOEs subject to the central SASAC, the ownership function is exercised by central SASAC on behalf of the central government; and the regulatory function is performed by the government. Likewise, local SASACs representing local governments operate in a similar way. As the data indicated, central SOEs possess the majority of the total assets of SOEs in China.[932] The major profits earned by SOEs are contributed by central SOEs as well.[933]

7.2 The Scope of SOEs

It is uncontested that the present-day SOEs are quite different from the SOEs in the centrally planned economy era. As clarified in Chapter Three, the long-lasting SOE reform has produced various kinds of enterprises. Some new features of enterprises in which the state has a stake blur the boundaries between SOEs and other types of enterprises. Thus, to have an accurate understanding of the present-day SOEs, it is necessary to identify the scope of SOEs.

To recall from Chapter Three, SOEs registered under the Industrial Enterprise Law of 1988 are traditional SOEs. These SOEs are the heritage of the centrally planned economy. Such traditional SOEs still exist nowadays, while their number is much smaller. They share three basic features: first, they are not corporations, instead, they are just factories that acquire the status of legal entities;[934] second, they have only one owner, namely the state; and third, the factory director leads a central position in the enterprise.

Following the corporatization strategy and the property rights reform of SOEs in the

[931] See Article 11.1 of the Law on State-Owned Assets of Enterprises.
[932] This comment is based on the tables and figures in Chapter Three.
[933] Ibid.
[934] See Article 2 of the Law of the PRC on Industrial Enterprises Owned by the Whole People.

past two decades, the majority of traditional SOEs have adopted the shareholding system. Most official documents referred to the reformed SOEs as state-owned companies (SOCs) so as to distinguish between SOCs and SOEs. SOCs register according to the requirements of the *Company Law*. Based on the shares owned by the state in SOCs, there can be state wholly owned companies, SOCs with the state as the majority shareholder, and SOCs with the state as significant or insignificant minority shareholder. In effect, such distinction is meaningful in terms of their structural differences. Pursuant to the *Law on State-Owned Assets of Enterprises* just effectuated in May 2009, the board of supervisors of SOCs should be set up in accordance with the *Company Law*, and that of SOEs (traditional SOEs) should be appointed by SASACs.[935] Also, for SOCs with the state as one of the two or more shareholders, SASACs have the right to propose candidates for directors and supervisors to the (general) shareholders' meeting; for SOEs or state wholly owned companies, SASACs have the right to appoint and remove the relevant senior managers.[936]

Generally speaking, there can be three approaches to defining the scope of SOEs. The narrow approach only takes traditional SOEs as SOEs. The broadest one considers any state-invested enterprises as SOEs. That is to say, as long as the state has a stake in the enterprises or companies, they can be categorized as SOEs. In accordance with the broad approach, SOEs refer to both traditional SOEs and SOCs where the state has full, majority or significant minority ownership.

As illustrated in Chapter Three, the broad approach is adopted by this research. The reason is that even though SOCs and traditional SOEs have different structures or forms, they share a common feature that the state has a stake in them as an investor. It is the state ownership and its impact that matter for SOCs and traditional SOEs, rather than the form. Also, it is the very special role of the state in state-invested enterprises that makes them different. A series of peculiar problems arise out of state-invested enterprises, precisely because of the special nature of state and its special role in the enterprises. For the purposes of this study, it is the state ownership that makes the issue of subsidies and SOEs more complicated and be of more research value. Hence, the approach to determining the scope of SOEs should not be limited by the form and the narrow approach should not be adopted.

It is inappropriate to adopt the broadest scope either. If the state has insignificant minor ownership in certain state-invested enterprises, its impact is so minimal that the special characteristic of the state as a shareholder can be negligible. Those special problems associated with state-invested enterprises on which the state has a significant impact may not be problems for such enterprises. The problems include, for instance, the impact of the state ownership on the company, the delicate relationship between the state as a controlling or significant shareholder and the minority shareholders, the possibility of equitable treatment of all shareholders, the

[935] See Article 19 of the Law on State-Owned Assets of Enterprises.
[936] Ibid, Article 22.

role of stakeholders in corporate governance *etc.* Therefore, it is not necessary to regard all state-invested enterprises as SOEs.

To avoid misunderstandings, it is further pointed out here that the meaning of changes in form of SOEs (from traditional SOEs to SOCs) should not be underestimated or even ignored in terms of China's long-lasting SOE reform. Its objective is exactly to embrace the shareholding mechanism and adopt modern corporate governance structure, thereby boosting SOEs' competitiveness.

Given the fact that the SCM Agreement annexed to GATT only disciplines goods, this study focuses on SOEs in the manufacturing area rather than SOEs in service area. To summarize, SOEs in this research indicate manufacturing enterprises where the state has significant impact, through full, majority, or significant minority ownership, irrespective of their forms.

In practice, it is quite difficult to identify whether an enterprise is a SOE or not, especially if it is one part of a large enterprise group. With the efforts of SASAC to make SOEs bigger and stronger, the emergence of large enterprise groups has become increasingly salient in China in recent years. The structure of a large enterprise group is multi-tiered, which usually contains the parent company, daughter company and granddaughter company *etc.* In light of the multi-tier enterprise groups, to determine whether an enterprise is a SOE or not, it is probably necessary to calculate the shares held by the state in one enterprise if it is a part of a large multi-tier enterprise group.

7.3 The Nature of SOEs

With respect to the nature of SOEs, the relevant question here is whether SOEs can be deemed as public bodies in the sense of Article 1.1(a)(1) of the SCM Agreement. Based on the elaborate discussion in Chapter Five, the term "public body" shares certain attributes with the concept of "government" in the SCM Agreement, and refers to entities that possess, exercise or are vested with governmental authority.[937] Thus, public bodies should have certain governmental authority or functions of a governmental character.

As discussed previously, state enterprise, operated and managed by the state, were just executive instruments of the state plan. Those kinds of enterprises pursued similar objectives with the state and they were under the absolute control of the state. Hence, they can be regarded as a public body or even a governmental entity.

However, SOEs in China should not be presumed as public bodies in the sense of the SCM Agreement. In effect, SOEs show a stark contrast with state enterprises. Owned by the state but not operated by the state, SOEs are market players following market principles, rather than executive branches of the huge state machine. The long-lasting SOE reform has significantly changed the function(s) of SOEs, the majority of which

[937] Also see Appellate Body Report, *US–AD/CVD on Certain Products from China*, above note 619, para. 317.

operate for commercial profits rather than other political, administrative or cultural functions.[938] Social function has been removed from central SOEs by the government, while there is no clear indication that it has been separated from the local SOEs as well. Along with the removal of non-economic functions previously undertaken by traditional SOEs and SOEs' pursuit of good corporate governance, they have little bargaining power with the government when they run at a loss. If they could not survive in the competitive market, they have few alternative choices but to go bankrupt in accordance with the Bankruptcy Law. To further regulate the behavior of the state as the investor of SOEs, the state has established the SASAC system to separate the government's roles as the owner or investor of SOEs.

In particular, the debacle of "old three committees" *(Lao San Hui)* including party committee, employee representatives congress and trade union, and the establishment of "new three meetings" *(Xin San Hui)* including shareholders' meeting, board meeting, supervisory board meeting in the internal structure of shareholding SOEs, significantly reduced the impact of the party on SOEs and thus upheld the establishment of a good corporate governance.

7.4 Distinguishing the Exercise of Ownership Rights and Regulatory Function

As summarized in previous chapters, the government has for long provided various types of assistance to SOEs. Under such a context, SOEs have been perceived by the public as getting a large amount of preferential treatment.

A threshold problem is that the assistance from the government can be categorized into two types since the establishment of SASAC: one type refers to the situation that the assistance is from SASAC as the owner of certain SOEs; the other type means the assistance is provided by the government as the regulator. For years, China has attempted to establish a mechanism to separate the roles of the state as the owner or shareholder and regulator of SOEs. So far, the SASAC system has worked well for the central and local SOEs subject to it. As the body performing the investor's functions on behalf of the corresponding government, SASAC enjoys the return on assets, participation in major decision-making, selection of managers and other investor's rights to the state-invested enterprises.[939] The Law on the State-Owned Assets of Enterprises explicitly stipulates that SASAC shall not intervene in the business activities of enterprises other than performing the investor's functions in accordance with the law.[940] When attending the shareholders' meeting, the shareholder representative(s) appointed by SASAC enjoy(s) the rights to make proposals, present opinions and exercise the voting right following the instructions of

[938] As illustrated in Chapter Three, SOEs or state enterprises in the era of centrally planned economy had four basic functions: 1) a political institution, served as a unit of the Party's presence at the grassroots level; 2) a level of state administration, performing administrative control representing the party-state; 3) a production factory to meet the quota set by the state; and 4) a state agency to provide a series of social welfare to the employees.
[939] See Article 12 of the Law on State-Owned Assets of Enterprises.
[940] Ibid, Article 13.

SASAC. In particular, SASAC should be responsible for the maintenance and increment of the value of state-owned assets, and they should prevent the loss of state-owned assets.[941] Maximizing the value of state-owned assets is in fact deemed as the core responsibility of SASAC – the owner or shareholder of SOEs.

The point to be made here is that, it is possible to view SASAC as an owner or shareholder of SOEs with specified rights and obligations. If the "governmental assistance" is offered by SASAC, such assistance can be considered as the behavior of an owner or shareholder. Although such kind of assistance may be rare in practice, its special nature should not be ignored. More importantly, it is inappropriate to regard such assistance as subsidies within the meaning of Article 1 of the SCM Agreement on two grounds. First, the assistance from SASAC is the right and/or obligation of an owner or shareholder. It is in this sense that the assistance has little difference from that of shareholders and owners of other kinds of companies. Secondly, the state capital operating budget is not the central budget, but a parallel to the central budget; and the establishment of the state capital operating budget system makes it possible that SASAC provides monetary input to SOEs in an independent manner.[942] One problem is that the state capital operating budget system was just initiated in 2007, thus it may take time for the system to function efficiently.

This perspective can be applied to several kinds of measures taken by SASAC, including the remission of dividends, restructuring promoted by SASAC, and other supporting measures to large SOEs by SASAC.[943] Those measures may benefit SOEs, while those benefits are provided by their shareholders or owners; it is in this sense that such measures cannot be taken as subsidies within the meaning of the SCM Agreement.

For SOEs whose ownership rights are still exercised by ministries, commissions or local governments, it is difficult to identify who provides assistance to those SOEs. Put differently, there is no mechanism that separates the role of owner of the government from its role of regulator. Nor does the capital of those SOEs have an independent budget system. Thus, the distinction of the source of assistance for those SOEs will not be applicable.

On the other hand, if the assistance is provided by the state rather than SASAC, irrespective of the entities that exercise the ownership rights of SOEs, the assistance can be deemed as subsidies provided that the two elements of "financial contribution"

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[941] Ibid, Article 14 and 15. However, Barry argued that in the early years of its mandate, SASAC probably would be plagued by multiple and inconsistent objectives: combine regulatory and ownership authority. It is because the transformation cannot be achieved overnight. See Naughton, above note 91, 318-319.

[942] It could be concluded that the financial relationship between the government and SOEs in China is now adjusted by the taxation and the state capital operating budget systems, while the state capital operating budget system is still in a trial stage.

[943] Considering the fact that exemption of dividends from SOEs had existed for long, dividends that were exempted before the establishment of SASAC could be considered as subsidies to SOEs. As discussed in Chapter Three, this practice of no dividend to the State ended in 2007. However, it might be of interest to note that for a long time, the enterprise income tax rate of SOEs was much higher than that of foreign enterprises. Such situation was changed by the new Enterprise Income Tax Law adopted in 2007.

and "benefit" are met.

7.5 Subsidies to SOEs in China at Three Different Periods

During the first period, namely the era of centrally planned economy from the 1950s to the 1970s, state-run enterprises running at a loss received a large amount of subsidies from both the central and local budget. The underlying logic is that state-run enterprises are branches of the state, and they execute the orders issued by the state. State enterprises were required to hand over all their profits to the state at that time, and the state financed SOEs by budgetary grants. Such financial arrangement between SOEs and the state matched with the concept of "soft budget constraints" proposed by János Kornai. The subsidies received by the then SOEs actually indicate these budgetary grants. Considering that SOEs were integrated into the state and their special financial relationship during the planned economy, those so-called subsidies were essentially different from the subsidies regulated by the WTO rules. SOEs were executive branches of the giant state machine, in stark contrast to the market-oriented corporations or modern enterprises.

When it comes to the second period, the "Reform and Opening Up" policy was initiated by the then Chinese leaders. Some reform measures were of course targeted at the soft budget constraint in an attempt to remove the defects associated with it. From the outset, with the previous practice of transferring all their profits to the state abolished, SOEs were required to pay enterprise income tax and regulation tax. Later in the late 1980s, the contracting system was adopted which demanded a basic quota from enterprises; the income above the quota could be retained by enterprises. Those measures aimed to motivate sluggish SOEs, since the measures allowed enterprises to keep more income if they have better performance. At the same time, direct government grants were replaced by bank loans. However, those bank loans were regarded as policy loans similar to quasi-subsidies. The reason was simple: the bank loans were extended to SOEs under the direction of the government (especially the local government) and SOEs did not even face the threat of foreclosure or bankruptcy. The local government supported SOEs mainly on the grounds that SOEs undertook various social functions and employed redundant workers, which of course lent a helping hand to the governments. A large number of laid-off workers would definitely caused huge pressure for the local government, owing in part to the potential of social unrest.

The situation has changed considerably in the 1990s. Along with the deepening of SOE reform and financial reform, most SOEs adopted the shareholding system[944] and the banks operated more independently and paid more attention to the commercial risks. With the wake-up call of the Asian financial crisis to China's leadership in 1997, the reform in the financial market was accelerated substantially. For instance, a series

[944] The measures taken by the government towards SOEs have been discussed in detail in Chapter Three.

of important measures including the removal of a large amount of accumulated NPLs, the establishment of four AMCs, capital injection and efforts for good corporate governance *etc.* were adopted. However, these measures *per se* reveal precisely the massive government intervention into the financial system and SOEs. As a matter of fact, the measures including the preferential loans, easier access to the stock market, and debt-equity swap all emerged during this period. In particular, the measure debt-equity swap was a direct result of the massive financial reform in the wake of the Asian financial crisis. Various direct "subsidies" provided to SOEs during the first two periods lead to the general perception that SOEs receive massive assistance from the government, especially when SOEs were struggling to survive.

The third period started from China's accession into the WTO. Since then, more and more banks have been floated on the stock market; a large portion of ill-performed SOEs have exited by various ways, and the existing SOEs have increasingly concentrated on important industries and key fields. The SASAC system was also created in this period. Owing to the policy of "grasping the large, letting go of the small" in the course of SOE reform, the number of SOEs has declined sharply, while SOEs, especially the central SOEs, are extremely large in scale. Overall, this policy, to a large extent, has also resulted in the shrinking of SOEs in China. With the accumulated effect of the previous significant changes, commercial banks have shown extraordinary performance, especially the SOCBs. SOEs have earned good profits with the central SOEs as typical examples.[945] Correspondingly, a series of laws and regulations have also been instituted or amended to adapt to the new circumstances.

During this period, SASAC has played an active role in exercising the ownership right of SOEs subject to its supervision. The government has been attempting to shift its focus on the regulatory function. However, an increasingly striking problem with regard to SOEs in this period is that most large SOEs are in a monopolized position in their own industries. They may not receive subsidies from the government any more, while the monopolized position means privileges for those SOEs, especially when effective supervision mechanism is absent.

7.6 The Seven Measures of the Government

The seven general measures as summarized in Chapter Four include the undervalued exchange rate, preferential loans (whether it is easier for SOEs to get bank loans than other kinds of firms with similar conditions; whether the interest rates of the loans extended by SOCBs to SOEs are lower than the commercial interest rate), access to

[945] The issue of SOEs making profits is controversial, since it is believed by some observers that the large, centrally SOEs regained profitability, in part due to their protected market positions rather than their improved competitiveness. See Naughton, above note 91, 308; Also, a recent report from OECD considers that, this impressive profitability improvement mainly goes to a relatively small number of central SOEs, and it has not been even across all state controlled firms. For instance, the largest gains occurring at the upper end of the distribution - from 1998 to 2007, 90% of the improvement in returns was generated by the top 30% of SOEs. See OECD: *OECD Economic Surveys: China*. Volume 2010/6. Paris, February 2010, 112.

the stock market, debt-equity swap, official export credit, land-use rights and energy subsidies. Again, it is noted that there are various measures taken by the Chinese government towards SOEs, and the main reason why only those seven measures are selected is that they are complicated in nature and contentious in practice.

It is untenable to take the two measures "undervalued exchange rate" and "access to the stock market" as subsidies, since the relevant governmental actions cannot be categorized as financial contributions. In essence, the policies and rules in question with regard to the two measures are regulatory measures, which do not fall within the traditional scope of financial contribution. Also, the measure of undervalued exchange rate cannot meet the specificity requirement. A new legislation that imposes a remedy against undervalued exchange rate could remove the current legal constraints in a single stroke, while such legislation may face more essential challenges to conform to the WTO principles. Although the measure - access to the stock market - fails to meet the elements of subsidies, the fact that SOEs have easier access to the stock market and thus one more source to funding in comparison with the private firms is a serious distortion to China's capital market.

For the two measures - preferential loans and official export credit, two issues have significant impact on the question of whether they constitute subsidies. The first one is the nature of entities providing loans, which are SOCBs and China Eximbank respectively. If the SOCBs and China Eximbank are determined as public bodies or even governmental entities, there is a possibility that a financial contribution exists; if they are regarded as commercial banks, a financial contribution could occur only when they are directed or entrusted by the government. As argued previously, SOCBs could not be categorized as public bodies, but China Eximbank can be viewed as a public body. The other issue is the element of benefit. To a large extent, the determination of benefit is subject to the selected comparison benchmark. Given the non-market economy status attached to China and the high possibility of selecting an external benchmark, it is technically easier for the investigating authorities to choose a benchmark with a higher interest rate. However, even for a generally recognized market economy, it is also possible that an external benchmark will be applied to its certain product market if there are special difficulties to use domestic benchmark.[946]

As analyzed in Chapter Six, there is a high possibility of considering the measure debt-equity swap as providing subsidies to SOEs incorporated into the debt-equity swap scheme. In terms of the measures of the provision of land-use rights and energy subsidies, the interpretative approach could make a huge difference. From a quite broad perspective, land and electricity can be interpreted as "goods" in the SCM Agreement. However, strictly following the wording in Article 1 of the SCM Agreement, they may not be covered by the "goods" in the SCM Agreement. The energy SOEs subject to SASAC may receive fund injection from the state capital

[946] See the softwood lumber dispute between Canada and the US in Panel report, *US-Softwood Lumber IV*, WT/DS257/R and Appellate Body report, *US-Softwood Lumber IV*, WT/DS257/AB/R.

operating budget; in this situation, it is inappropriate to consider such capital injection as subsidies.[947] Moreover, for the energy subsidies received by energy SOEs, it is possible that these subsidies have been passed through to downstream manufacturers.

7.7 The Measures Specific to the Three Industries

The detailed introduction to the development of and major SOEs in the three selected industries (the iron and steel industry, the auto industry and the electronic information industry) in Chapter Four reveals the close interaction between the Chinese government and those SOEs. In particular, the first two industries once were strongly supported by the government through industrial policies and favorable allocation of various resources. Comparing the industrial policies designed for the three industries at different periods, it turns out that the latest policies have few articles that are inconsistent with the WTO rules regulating subsides, while it is normal to find many articles of the earlier policies that are apparently inconsistent with the subsidies rules. Also, the local governments, through their local policies, tend to intervene in the industries so as to maintain their local large SOEs survive or be in a better position in the competition. In essence, these policies are not mandatory but discretionary. In practice, this means that these policies could be in violation of the subsidy rules "as applied" rather than "as such".

7.8 Concluding Remarks

When studying "subsidies" to SOEs, the author fully perceived the complexities of Chinese SOEs, the pliable nature of subsidies, the uncertain implications of subsidies and the flexibilities associated with interpreting legal terms. This study also reveals the apparent tension between Chinese practices and the WTO rules. For instance, the Chinese government needs policy space including financial assistance to solve problems caused by SOEs, however, such space is constrained by the rules regulating subsidies. On the other hand, certain kinds of assistance provided by the Chinese government to SOEs including the biased listing rules could not be subject to the regulation governing subsidies.

To figure out the specific issues relating to subsidies to SOEs, this research focuses on descriptive analysis and case analysis. It is interesting to analyze other measures that are not covered by this research, including environmental protection projects and research and development assistance.[948] It also deserves further thought to study how the WTO balances various conflicts between state-centric economy and rules created based on traditional market economy, how to understand the relationship between the accession documents and the WTO Agreements and whether it is necessary to identify exceptional circumstances for allowing subsidies including the severe financial crisis, to name a few.

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[947] This issue has been discussed in 7.3.

[948] These projects or measures are increasingly relevant since the non-actionable subsidy clause expired.

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