

CHINA'S STATE CAPITALISM AND WORLD TRADE LAW

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Abstract Melding the power of the state with the power of capitalism, state-owned and state-controlled enterprises continue to control the commanding heights of the Chinese economy even though market-oriented reforms have led to a rapid expansion of the private sector in China. This article reflects on how China's practice of state capitalism challenges the world trading system and how WTO law, as interpreted by WTO Panels and the WTO Appellate Body (AB), addresses these challenges. The article concludes that the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement) has been interpreted in such a manner that many key features of China's state capitalism could easily be challenged by its trading partners in a WTO-consistent manner. This finding has profound implications for China's domestic economic reforms, especially China's ongoing reforms of its state-owned enterprises and commercial banks.

Keywords: China, countervailing duties, state capitalism, WTO.

I. INTRODUCTION

Despite three decades of extensive state reform and privatization, state capitalism still looms large in many parts of the world.¹ State-owned enterprises (SOEs), development banks, public pension funds, sovereign wealth funds, among many other vehicles of governmental capital, have taken centre stage in the global economy.² The recent global financial crisis seems to have further enhanced the appeal of state capitalism in contrast to the liberal market model.³ In 2005 there was no single SOE among the top 10 firms of the

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¹ I Bremmer, *The End of the Free Market* (Portfolio 2010) 18.

² A Musacchio and SG Lazzarini, 'Leviathan in Business: Varieties of State Capitalism and Their Implications for Economic Performance' (2012) 2 <www.hbs.edu/faculty/Publication%20Files/12-108.pdf>.

³ N Ferguson, 'We Are All State Capitalist Now' *Foreign Policy* (February 2012); LC Backer, 'Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State-owned Enterprises, and the Chinese Experience' (2010) 19(3) *Transnational Law & Contemporary Problems* 3.

Fortune Global 500 list. In 2013, there were three SOEs among the top 10.⁴ A summit of founders and Chief Executive Officers (CEOs) of some of the world's top companies, organized by Harvard Business School, identified state capitalism and its support for 'national champions'—private or state-owned firms chosen to receive government assistance—as being among the ten most important threats to market capitalism.⁵

There is no unitary definition of the term 'state capitalism', despite its widespread use. Some early economists equated state capitalism with government intervention in markets; with central planning; with governments favouring big business and even with the outright expropriation of private property.⁶ More recently, Bremmer distinguishes state capitalism from command economies and free market economies. He defines it as 'a system in which the state functions as the leading economic actor and uses markets primarily for political gain'.⁷ He explains:

Governments use various kinds of state-owned enterprises to manage the exploitation of resources they consider the state's crown jewels and to create and maintain large number of jobs. They select privately owned companies to dominate certain economic sectors. They use so-called sovereign wealth funds to invest their extra cash in ways that maximize the state's profits. In all three cases, the state is using markets to create wealth that can be directed as political officials see fit. And in all three cases the ultimate motive is not economic (maximizing growth) but political (maximizing the state's power and the leadership's chances of survival).⁸

In the same vein, Musacchio and Lazzarini describe state capitalism as being the 'widespread influence of the government in the economy, either by owning majority or minority equity positions in companies and/or through the provision of subsidized credit and/or other privileges to private companies'.⁹

China is a typical example of state capitalism.¹⁰ Market-oriented reforms have enabled China's GDP to grow at an average rate of 9.5 per cent per year and its international trade by 18 per cent in volume terms over the past 30 years. As a result, China is presently the world's second largest national economy, a powerhouse in international trade and a major destination for foreign investment.¹¹ However, China's economic development model is fundamentally different from the Western liberal capitalism model. Melding the power of the state with the power of capitalism, the state-owned

⁴ They are Sinopec Group, China National Petroleum and State Grid. All three are Chinese state-owned enterprises <http://money.cnn.com/magazines/fortune/global500/2013/full_list/>.

⁵ JL Bower, HB Leonard and LS Paine, *Capitalism at Risk: Rethinking the Role of Business* (Harvard Business Review Press 2011) 43–80.

⁶ MN Rothbard, *A Future of Peace and Capitalism* (Allyn and Bacon 1973) 419.

⁷ Bremmer (n 1) 4.

⁸ *ibid* 4–5.

⁹ Musacchio and Lazzarini (n 2) 4.

¹⁰ R Gilson and CJ Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism' (2008) 60 *StanLRev* 1346.

¹¹ WM Morrison, 'China's Economic Conditions' (2012) Congressional Research Service 3.

and state-controlled portions of the economy continue to control the commanding heights of the Chinese economy even though market reforms have led to a rapid expansion of the private sector.¹² Presently, SOEs constitute 80 per cent of the value of the Chinese stock market and the Chinese government is the biggest shareholder in China's 150 largest companies.¹³ In 2013, 95 Chinese firms appeared on the list of Fortune Global 500, compared with 79 in 2012, 69 in 2011, 54 in 2010 and 13 in 2003, and 77 of the 95 firms on the list were SOEs.¹⁴ An OECD study, using data from 2006, estimated that SOEs account for 29.7 per cent of GDP, 40 per cent of fixed investment and employ 40 per cent of the urban labour force in China.¹⁵ Most strikingly, at least partly thanks to the Chinese government's provision of a wide range of financial and regulatory advantages, the SOEs in China seem to have outperformed non-SOEs in the past decade, while the opposite was true in the 1990s.¹⁶ It is now clear that the Chinese government no longer sees state-directed firms as a way-station on the road to liberal capitalism; rather, it is seen as a sustainable model in its own right.¹⁷

China's practice of state capitalism has generated a heated debate regarding the merits of state-led development and the crisis of Western liberal capitalism. Indeed, for the first time since 1850 the global capitalist system is experiencing the rapid rise of a continent-size capitalist power that espouses ideas, institutions, and interests fundamentally different from those of Anglo-American capitalism.¹⁸ It is frequently alleged that China's state capitalism has distorted the Chinese domestic market as well as markets around the world.¹⁹ The challenge is most severe in China's domestic market itself,

¹² Y Deng et al., 'Monetary and Fiscal Stimuli, Ownership Structure, and China's Housing Market' (2011) NBER Working Paper 16871, 20 <<http://www.nber.org/papers/w16871>>.

¹³ A Wooldridge, 'The Visible Hand' (2012) *The Economist* 4; See also US-China Economic and Security Review Commission, 2011 Report to Congress (November 2011) 40. The definition of SOEs is controversial. Official statistics from the Chinese Ministry of Finance define SOEs as including only wholly state-owned companies. In this article, SOEs are defined more broadly to include wholly state-owned SOEs and companies whose majority shares are owned by the Chinese government at various levels (including central, provincial and municipal levels).

¹⁴ Wu Jie, 'Scrutinizing China's Fortune Global 500 Companies'; Guo Qi (14 August 2013) <http://news.xinhuanet.com/fortune/2013-08/14/c_125166671.htm> and <<http://www.sasac.gov.cn/n1180/n1271/n20515/n2697206/15243512.html>>.

¹⁵ JY Lee, 'State Owned Enterprises in China: Reviewing the Evidence' (2009) OECD Occasional Paper <www.oecd.org/dataoecd/14/30/42095493.pdf>. Other estimates are higher, ranging from 30 to 40 per cent or even above 50 per cent of China's economy depending on how the state sector is defined. See DL Scissors, 'State-Owned Enterprises in China': Testimony before the US-China Economic and Security Review Commission (2011).

¹⁶ Xi Li et al, 'A Model of China's State Capitalism' (2012) 2 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2061521>.

¹⁷ A Gabriele, 'The Role of the State in China's Industrial Development: A Reassessment' (2010) 52 *Comparative Economic Studies* 348.

¹⁸ CA McNally, 'Sino-Capitalism: China's Reemergence and the International Political Economy' (2012) 64(4) *World Politics* 765.

¹⁹ EJ Drake, 'Chinese State-Owned and State-Controlled Enterprises: Policy Options for Addressing Chinese State-Owned Enterprises', Testimony before the US-China Economic and

as measures taken by the Chinese government to protect its SOEs have altered the competitive landscape for private enterprises and foreign companies, particularly in high-technology sectors.²⁰ The next frontier is the global market. Since 1999, as an essential part of the government-directed development model, China has adopted the 'Go Global' strategy, the essence of which is to promote the international operations of Chinese firms through outbound direct investment with a view to enhancing their international competitiveness.²¹ Due to the success of the 'Go Global' strategy, in recent years there has been a dramatic increase in Chinese outbound investment and an even larger potential for growth.²² Not surprisingly, at least 80 per cent of all Chinese outbound direct investment has been funded by Chinese SOEs.²³ The close connections between Chinese SOEs and the Chinese government raises concerns that outbound investments decisions have been motivated by political rather than commercial objectives.²⁴ The policymakers in some host countries have thus struggled to balance concerns relating to their national security and trade priorities on the one hand against the promises of inbound investment and employment growth on the other.²⁵

At least for the foreseeable future, the coexistence and competition between state capitalism and liberal capitalism seems to be inevitable. However, some questions arise including how can a fair level playing field in international economic relations be ensured if some companies enjoy various forms of overt or covert support from national governments? And how can legitimate concerns regarding fairness in international trade and investment be prevented from shading into xenophobia and protectionism? This article attempts to approach these questions through the lens of international trade law, embodied in the GATT/WTO system. Part II provides an introduction to the SOE reforms in China during the past three decades and to the various forms of support provided to SOEs by the Chinese government. Part III discusses how WTO law addresses the main features of China's state capitalism and considers the implications of WTO case law for further reforms of the Chinese state sector, with particular emphasis on the role of the SCM Agreement. Part IV provides an overall conclusion.

Security Review Commission (2012); OECD, 'State-Owned Enterprises: Trade Effects and Policy Implications – An Interim Report' (2010) DAF/CA/PRIV(2010) 1.

²⁰ USTR, 2011 Report to Congress on China's WTO Compliance (2011) 61.

²¹ Morrison (n 11) 20; M Silk and R Malish, 'Are Chinese Companies Taking over the World?' (2006) 7 *ChiJIntlL* 112.

²² N Salidjanova, 'Going Out: An Overview of China's Outward Foreign Direct Investment' (2011) US-China Economic and Security Review Commission Staff Research Report 3.

²³ Wooldridge (n 13) 15; MOFCOM, 2009 Statistics Bulletin of Chinese Outward Foreign Direct Investment (2010) 12.

²⁴ J Dean et al, 'China' State Capitalism' Sparks a Global Backlash' *The Wall Street Journal* (16 November 2010) <<http://online.wsj.com/article/SB10001424052748703514904575602731006315198.html>>.

²⁵ DF Gordon, 'The Competitive Challenges Posed by China's State-Owned Enterprises' Testimony before the US-China Economic and Security Review Commission (15 February 2012).

II. UNDERSTANDING CHINA'S STATE CAPITALISM

A. A Brief History of SOE Reforms in China

To grasp the complexity of SOE reforms in China, it is essential to understand the pre-reform institutional environment that SOEs inhabited. After the Chinese Communist Party (CCP) defeated the Nationalist Party and founded the People's Republic of China in 1949, the communist regime discarded the previous market economic order and, emulating the Soviet Union, created a socialist planned economy.²⁶ The new economic structure was, by and large, a replica of the Leninist model of a 'state syndicate', in which state ownership was the sole basis of almost all economic activities.²⁷ Prior to 1978, virtually all firms in China were SOEs and they accounted for 78 per cent of total industrial input and 64 per cent of urban employment. During the period 1975–1980, SOEs accounted for over 84 per cent of new investment in industrial fixed assets.²⁸

In the socialist planned economy era, SOEs were basically production units rather than autonomous profit-seeking corporations. National and local government planning commissions decided what each SOE was to produce, their allocation of materials, capital goods and workers, and how production was to be organized in order to achieve output targets. The output was then sold to the government at a planned price.²⁹ The absence of autonomy and incentives were widely recognized as the central problems facing SOEs in the period prior to reform. Since the historic decision in 1978 to reform and open up the economy, the Chinese government has taken a gradual, experimental and pragmatic approach—known as 'crossing the river by touching the stone'—to bring about the reform of Chinese SOEs.³⁰ This approach is in sharp contrast to the alternative, so-called 'big bang' approach which entails rapid large-scale privatization and which was adopted by the former Soviet Bloc.³¹ SOE reforms were deemed to be necessary in order to reduce economic losses, increase economic growth and raise living standards, from which the Chinese Communist Party (CPP) derives its governing legitimacy.³²

²⁶ ICY Hsu, *The Rise of Modern China* (6th edn, Oxford University Press 2000) 643.

²⁷ Wu Jinglian, 'China's Economic Reform: Past, Present and Future' (2000) 1 Perspectives 5 <http://www.oycf.org/Perspectives2/5_043000/china.htm>.

²⁸ L Brandt, T Rawski and J Sutton, 'China's Industrial Development' in L Brandt, T Rawski and J Sutton (eds), *China's Great Economic Transformation* (Cambridge University Press 2008).

²⁹ B Chiu and M Lewis, *Reforming China's State-Owned Enterprises and Banks* (Edward Elgar Publishing 2006) 61.

³⁰ Xu Chenggang, 'The Fundamental Institutions of China's Reforms and Development' (2011) 49(4) *Journal of Economic Literature* 1076–1151; JY Lin et al, 'Competition, Policy Burdens, and State-owned Enterprise Reform' (1998) 88(2) *American Economic Review* 422–7.

³¹ MX Pei, *China's Trapped Transition: The Limits of Developmental Autocracy* (Harvard University Press 2006) 22.

³² Li et al (n 16) 9.

The actual reforms passed through three broad phases.³³ The first phase ran from the mid-1980s until the mid-1990s. Inspired by the success of the household responsibility system in the rural reforms in the early 1980s, the first phase focused on increasing enterprise autonomy and incentivizing SOE managers to meet performance targets by allowing them to retain profit. First, a 'dual-track approach' let SOEs produce beyond their quotas, sell the excess at market prices, and keep the proceeds as corporate profits, with the government continuing to set quotas.³⁴ Later, a 'contract responsibility system' was introduced for most small and medium-sized SOEs, under which SOE managers signed contracts with the government giving them the right to run day-to-day operation, while the firm remained a state asset. Profits were shared between the enterprises and the state in accordance with the terms of the contract.³⁵ There is evidence that SOEs made some productivity gains as a result of these firm-level reforms.³⁶ However, these reforms were soon viewed as inherently flawed and inadequate to deal with new problems. For example, the 'dual track' approach allowed administrative interference and created incentives for arbitraging between planned and market prices.³⁷ It increased the pervasiveness of corruption in China.³⁸ Similarly, the contract responsibility system did not solve the short-termism of management behaviour. Because the contracts were usually easy to realize when firms performed well but hard to implement when firms could not meet the contractual performance targets, managers were able to exploit their effective control over SOE assets at the expense of the state, damaging firms' long-term development.³⁹ Due to increasing competition from the private sector, including foreign-invested enterprises and township and village enterprises, SOEs stacked up huge losses.⁴⁰ During 1978–1993, the share of net industrial output generated by SOEs decreased sharply, even though virtually none closed during this period. About 40 per cent of SOEs were loss-makers in 1994 and their debt-to-equity ratio increased to 200 per cent. These developments put substantial pressure on government revenue, its fiscal burdens and banking stability.⁴¹

³³ Deng (n 12) 9; S Green and GS Liu, 'China's Industrial Reform Strategy: Retreat and Retain' in S Green and GS Liu (eds), *Exit the Dragon? Privatization and State Control in China* (Blackwell Publishing 2006) 16.

³⁴ Deng, *ibid* 9.

³⁵ Li Wei, 'The Impact of Economic Reform on the Performance of Chinese State Sector Enterprises: 1980–1989' (1997) 105(5) *Journal of Political Economy* 1080–1106.

³⁶ MM Shirley and C Xu, 'Empirical Evidence of Performance Contracts: Evidence from China' (2001) 17 *Journal of Law, Economics and Organization* 168–200.

³⁷ Green and Liu (n 33) 17.

³⁸ W Li, 'Measuring Corruption under China's Dual-Track System' (2002) <<http://faculty.darden.virginia.edu/liw/papers/measuring-corruption.pdf>>.

³⁹ YY Qian, 'Enterprise Reform in China: Agency Problems and Political Control' (1996) 4(2) *Economics in Transition* 427–47.

⁴⁰ SM Li, SH Li and WY Zhang, 'The Road to Capitalism: Competition and Institutional Change in China' (2000) 28 *Journal of Comparative Economics* 269–92; YZ Cao, YY Qian and BB Weingast, 'From Federalism, Chinese Style to Privatization, Chinese Style' (1999) 7 *Economics in Transition* 103–31.

⁴¹ Li (n 16) 9.

The second phase of SOE reforms commenced after the historic Southern tour of Deng Xiaoping in 1992, when the goal of China's economic reform became the establishment of a socialist market economy. The Third Plenary Session of the Fourteenth Central Committee of the Communist Party of China (CCCCP) announced the *Decision on Issues Regarding the Establishment of a Socialist Market Economic System*. The Decision required SOEs to be modern enterprises characterized by 'clear property rights, well-defined power and responsibility, separation of enterprise from government, and scientific management'.⁴² In practice, corporatization was seen as a means of achieving the reform goals set by the CCP. The first general Chinese Company Law was enacted in order to provide for the incorporation of SOEs in 1994. Thereafter, newly corporatized SOEs proliferated all over the country.⁴³ In 1999, a CCP decision adopted at the Fourth Plenary Sessions of the Fifteenth CCCPC, outlined a clear road map to transform SOEs into competitive modern corporations. First, it provided that a corporate governance structure providing checks and balances between the owner and the manager should be at the core of the enterprise system. Second, it required that whilst a minority of SOEs should remain state monopolies, the rest should actively develop into corporations with multiple equity-holders, including non-state equity investment. Third, it encouraged well-performing SOEs to become listed on domestic or overseas stock markets.⁴⁴

Along with corporatization, at the core of the reforms to SOEs in the 1990s was the central government policy of 'nurturing the large and letting the small go', a reference to a policy of concentrating the government's resources on the larger SOEs, while relaxing state control over smaller SOEs.⁴⁵ The central government explicitly pursued the strategy of retaining state control of 500–1000 large SOEs in strategic sectors. At the same time, the Chinese government retreated from labour-intensive competitive sectors such as textiles, building materials, food processing, and electronics.⁴⁶ Many small and medium-sized SOEs were assessed for reorganization, bankruptcy, debt write-offs, merger into partnerships, leasing, contractual operation, or sales.⁴⁷ After this round of reform, the SOEs were streamlined and their advantageous position was further reinforced in the upstream and strategic industries.

⁴² Decision on Issues Regarding the Establishment of a Socialist Market Economic System, para 1(2) <<http://finance.ifeng.com/opinion/jjsh/20090906/1199906.shtml>>.

⁴³ LY Zhang, 'The Roles of Corporatization and Stock Market Listing in Reforming China's State Industry' (2002) 32 *World Development* 2031.

⁴⁴ Decision on Several Important Issues Regarding Reform and Development of SOEs, paras 5(3) and 7(3) <<http://cpc.people.com.cn/GB/64162/71380/71382/71386/4837883.html>>. JL Wu, *Understanding the Interpreting Chinese Economic Reform* (Thomson Higher Education 2005) 155–8.

⁴⁵ M Mattlin, 'Chinese Strategic State-Owned Enterprises and Ownership Control' (2010) 4(6) *BICCS Asia Paper* 8.

⁴⁶ Green and Liu (n 33) 2.

⁴⁷ Deng (n 12) 10.

The third phase of SOE reforms started in 2003, and focused on reforming property rights and corporate governance in large SOEs.⁴⁸ Chinese Company Law and Chinese Securities Law were revised to achieve more congruence between Chinese law and practice and that of countries with more developed capital markets.⁴⁹ One key reform was the establishment of the State Assets Supervision and Administration Commission (SASAC), a quasi-governmental, ministerial-level agency operating directly under the State Council, to oversee the management of the SOEs. Prior to the creation of the SASAC, many analysts pointed to the absence of an ultimate owner of SOEs as a key problem.⁵⁰ Theoretically the state, on behalf of all the Chinese people, formally owns SOE assets, but it is not readily apparent who represents the state. In reality, control rights and residual cash-flow rights were not clearly defined and invariably dispersed among multiple bureaus, each with different interests to pursue.⁵¹ As a result, no single entity was ultimately responsible for an SOE's performance. The SASAC was primarily designed to fulfil the state's ownership function, combining the administrative functions previously carried out by various government agencies. The Law on State-owned Assets of Enterprises in 2008 formally recognizes the SASAC as an 'investor' and assigns the SASAC the legal rights and duties of a shareholder, holding SOE shares on behalf of the State.⁵² As an investor, the SASAC enjoys an owner's equity rights and assumes legal liabilities under Chinese Company Law but it does not intervene directly in SOE operations, so that the ownership rights are separated from those of management.⁵³ Chinese leaders and SASAC officials have repeatedly emphasized that the SASAC must not meddle in the business operations of SOEs.⁵⁴

The establishment of the SASAC contains both centralizing and decentralizing features. On the one hand, the principle of local control over local SOEs was clarified and institutionalized by clearly separating central, provincial and municipal SOEs and handing control over them to SASAC offices at respective jurisdictional levels.⁵⁵ On the other hand, the SASAC serves as a unitary holding company for those key central SOEs that have been selected by the government to be China's national champions and future top global companies. When it was established in 2003, 196 central SOEs were under

⁴⁸ *ibid* 11.

⁴⁹ JV Feinerman, 'New Hope of Corporate Governance in China?' (2007) *China Quarterly* 590–612; JH Liu and KB Pibler, 'Corporate Governance of Business Organizations in the People's Republic of China: The Legal Framework after the Revision of the Company Law in 2005' (2010) 1–48 <<http://ssrn.com/abstract=1695888>>.

⁵⁰ DC Clarke, 'Corporate Governance in China: An Overview' (2003) 14 *China Economic Review* 494.

⁵¹ H Sheng and N Zhao, *China's State-Owned Enterprises: Nature, Performance and Reform* (World Scientific Publishing Company 2012) 267.

⁵² Chapter 2 of PRC Law on State-Owned Assets of Enterprises.

⁵³ Chiu and Lewis (n 29) 122.

⁵⁴ LM Hou, 'SASAC Chief says that the SASAC will not be SOEs' Popo and Boss' <<http://money.163.com/08/0810/16/4J0FN4U002510B6.html>>.

⁵⁵ Mattlin (n 45) 8.

the management of the SASAC, out of a national total of nearly 120,000. Under the oversight of SASAC, by July 2013 that number was reduced to 114, as the smaller and less competitive firms were absorbed by the larger ones.⁵⁶ Although not large in number, the size and importance of central SOEs to the national economy in many respects surpass that of all the other SOEs combined. In 2009, the central SOEs accounted for roughly 40 per cent of total non-financial SOE assets, 60 per cent of sales and over 70 per cent of total profits.⁵⁷ Their listed subsidiaries represent around one-third of the entire valuation of the Chinese domestic stock exchange.⁵⁸ This makes the SASAC 'the world largest controlling shareholder'.⁵⁹

The SASAC has a broad mandate that includes drafting laws and regulations regarding state-owned assets, managing and restructuring state assets so that their value develops positively, hiring and firing executives of SOEs under its supervision and pushing forward further reforms of SOEs.⁶⁰ Though there have been doubts over whether the SASAC is always able to exercise its authority effectively, the SASAC is a very powerful state agency and since its establishment the SASAC has been pushing forward SOE reforms aggressively.⁶¹

As mighty leviathans of the Chinese planned economy, Chinese SOEs were long depicted as 'industrial dinosaurs', 'muscle-bound goons' or the 'relics of a failed economic experiment', and characterized as possessing a lack of managerial flair, little concern for profit, low employee motivation and mobility and a tendency to maximize corporate size.⁶² After the extensive reforms of the past two decades, Chinese SOEs have evolved from being parts of government ministries involved in production activities to legally stand-alone enterprises that are empowered to make their own managerial, operational and production decisions. It is unrealistic today to uphold the simplistic and pessimistic view of Chinese SOEs as industrial and commercial dinosaurs fit only for dismemberment or bankruptcy. Modern corporate governance systems have been established in Chinese SOEs, some of which can rival the best private companies in the world. Many SOEs have vastly

⁵⁶ See the most recent updated list of central enterprises at <<http://www.sasac.gov.cn/n1180/n1226/n2425/index.html>>.

⁵⁷ Deng (n 12) 21.

⁵⁸ Mattlin (n 45) 9.

⁵⁹ Boston Consulting Group, 'SASAC: China's Megashareholder' (2007) <https://www.bcgperspectives.com/content/articles/globalization_strategy_sasac_chinas_megashareholder/>.

⁶⁰ SASAC, Main Functions and Responsibilities of SASAC <<http://www.sasac.gov.cn/n1180/n3123702/n3123717/n3162319/index.html>>.

⁶¹ B Naughton, 'SASAC Rising', China Leadership Monitor No 14 <http://media.hoover.org/sites/default/files/documents/clm14_bn.pdf>; CE Walter and FJT Howie, *Red Capitalism* (John Wiley & Sons 2012) 189–91.

⁶² J Hassard et al, 'China's State-Owned Enterprises: Economic Reform and Organizational Restructuring' (2010) 23(5) *Journal of Organizational Change Management* 501; J R Woetzel, *Reassessing China's State-Owned Enterprises* (July 2008) McKinsey Quarterly 1.

improved their financial performance in the past decade and have proactively engaged in global partnerships and acquisitions.⁶³

B. SOEs and the Chinese Party-State

One core task of SOE reforms in China is the separation of government functions from enterprise management. Following the reforms, Government officials are asked not to intervene in the day-to-day business operations of SOEs.⁶⁴ Nevertheless, the management of SOEs continues to be influenced by policy considerations. To understand the behavioural logic of Chinese SOEs in both national and international markets, it is enlightening to look at the incentives offered to corporate executives in central SOEs.⁶⁵

The leaders of central SOEs are appointed in accordance with a highly institutionalized sharing arrangement between the CCP and the SASAC. The top positions in 54 key central SOEs, including the chairman of the board of directors, chief executive officer and party secretary, are appointed and evaluated directly by the Central Organization Department (COD) of the CCP.⁶⁶ These SOE executives hold ministerial rank and many are members or alternates of the powerful Central Committee of the CCP.⁶⁷ Deputy positions in these 54 enterprises, and appointments and evaluations of top executives in the remaining central SOEs, are made by the SASAC, usually with inputs from various party organs and ministries involved in supervising relevant business operations and are subject to approval by the State Council.⁶⁸ Still, the COD wields tremendous power behind the scenes and is the real decision maker when it comes to making senior personnel.⁶⁹ The *Interim Provisions on the Management of Executives in Central SOEs*, issued jointly by the Central Committee of CCP and the State Council in December 2009, enshrines the principle of 'absolute control of the (SOE) executives by the party (CCP)'.⁷⁰ In short, the CCP and the SASAC are able to ensure their control over China's

⁶³ A Musacchio and F Flores-Macias, 'The Return of State-Owned Enterprises' (2009) *Harvard International Review* 5.

⁶⁴ WY Li and L Putterman, 'Reforming Chinese SOEs: An Overview' (2008) 50 *Comparative Economic Studies* 353–80.

⁶⁵ KE Brodsgaard, 'Politics and Business Group Formation in China: The Party in Control?' (2012) *China Quarterly* 626.

⁶⁶ B Naughton, 'SASAC and Rising Corporate Power in China' (2008) *China Leadership Monitor* No 24, 2.

⁶⁷ Walter and Howie (n 61) 187.

⁶⁸ LW Lin and CJ Milhaupt, 'We Are the National Champions: Understanding the Mechanisms of State Capitalism in China' (2011) *The Centre for Law and Economic Studies Working Paper* No 409, 38 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1952623>.

⁶⁹ A Szamoszegi and C Kyle, 'An Analysis of State-Owned Enterprises and State Capitalism in China' (2011), Report to US–China Economic and Security Review Commission 76; MX Pei, 'The Dark Side of China's Rise' *Foreign Policy* (March 2006) <http://www.foreignpolicy.com/articles/2006/02/17/the_dark_side_of_chinas_rise>.

⁷⁰ Para 3(1) of *Interim Provisions* <http://www.comac.cc/rfzy/zczd/201108/12/t20110812_449071.shtml>.

most powerful business groups by virtue of their power to appoint and remove its top management.⁷¹

The COD and the SASAC have developed a sophisticated performance evaluation system for top executives of central SOEs.⁷² In both annual and triennial evaluations, their performance—and their rewards and career prospects—are gauged by referring to a range of indicators.⁷³ Financial performance, though an important indicator accounting for 50 per cent of the evaluation, is not the sole criterion. ‘Political qualities’, ie, how well SOE executives adhere to CCP priorities and government directions, is also an important evaluation criterion.⁷⁴

SOE executives therefore face two sets of incentives. On the one hand, they want the SOEs they manage to be profitable because their evaluations are based on the firm’s financial performance. On the other hand, their career paths are ultimately determined by the CCP which is equally, if not more, concerned with how well the executives respond to the government directions and carry out the goals of the state. A top SOE executive judged unresponsive to the CCP policies risks not being promoted, or even demoted, at the end of his three-year term even if the SOE performs well.⁷⁵ These dual criteria for evaluating SOE top executives—to deliver profits and serve the government interests—are often in alignment. It is reasonable to assume that a commercially successful SOE is often in the best interests of its owner, the Chinese government. However, where an SOE’s financial interests and state goals are in conflict, the incentive schemes strongly encourage compliance with state interests rather than the financial interests of the company and of other non-state shareholders.⁷⁶

Research has shown that state goals dominate SOE executive decision-making. Nie and his colleagues found that winning political promotion is more important than financial compensation in shaping executive behaviour.⁷⁷ Since the majority of top positions at key central SOEs are at vice-ministerial rank, SOE leaders usually hope to be transferred to senior positions in government bureaucracies or party organs so that they could subsequently be promoted even further.⁷⁸ There is also evidence that the turnover of top executives in listed Chinese SOEs is significantly less closely related to financial performance indicators than in other listed firms.⁷⁹ In 2008, when global fuel

⁷¹ Walter and Howie (n 61) 193; R McGregor, *The Party: The Secret World of China's Communist Rulers* (Harper Perennial 2011) 49.

⁷² Provisional Measures Concerning the Integrated Evaluation of the Top Management Teams and Managers of the Central Enterprises, CCP Organization Department Doc No 17 (2009).

⁷³ *ibid* art 4.

⁷⁴ *ibid* art 9 and 10.

⁷⁵ Deng (n 12) 16.

⁷⁶ Szamosszegi and Kyle (n 69) 79.

⁷⁷ Yang Ruilong, Wang Yuan and Nie Huihua, ‘The Promotion Mechanism of ‘Quasi-officials’: Evidence from Chinese Central Enterprises’ (2013) GuanLi ShiJie <<http://cfos.ruc.edu.cn/Article/UploadFiles/201304/2013040112405165.pdf>>.

⁷⁸ *ibid*.

⁷⁹ ZY Zhao, ZS Yang and CE Bai, ‘The Empirical Study of the Effect on the Top Management Turnover in China’s Listed Companies’ (2007) *Journal of Finance Research* 76–89.

prices were skyrocketing, Sinopec Corp, a large Chinese SOE, duly complied with the government's decision to maintain low gasoline prices and, as a result, racked up huge losses.⁸⁰ In 2009, the Chinese government's fiscal stimulus measures required significant amounts of lending by state-owned banks and investments by SOEs. Deng found that bank lending went primarily to SOEs which subsequently used those funds to invest in real estate. The banks lent stimulus money without the due diligence typically used, and the SOEs paid more for their acquisitions than non-SOEs who purchased otherwise identical properties.⁸¹ It was also reported that the Aluminum Company of China (Chinalco) was hand-picked by the Chinese government to acquire significant stakes in an Australian mining company Rio Tinto; its funding was directly approved by the State Council and its CEO was promoted to a State Council position days after the final deal was negotiated.⁸² These examples indicate that Chinese SOEs, especially central SOEs, are more than a purely financial investment for the Chinese party-state. The SASAC, as the organizational manifestation of the Chinese party-state in its role as a controlling shareholder, seeks to maximize a range of benefits—extending from state revenues to technological prowess and from soft power abroad to regime survival at home—rather than maximizing shareholder value alone.⁸³

C. Identification of Strategic and Pillar Industries

On December 5, 2006, the SASAC issued its *Guiding Opinion on Promoting the Adjustment of State-Owned Capital and the Reorganization of State-Owned Enterprises* (the Guiding Opinion).⁸⁴ This set out a major policy of promoting the concentration of state-owned capital in major industries and on key fields, enhancing the controlling power of the state-owned economy and underlining its leading role. Major industries and key fields mainly include industries concerning national security, major infrastructure and important mineral resources, industries that provide essential public goods and services, as well as key enterprises in pillar and high-tech industries.⁸⁵ The former SASAC chairman Li Rongrong has clarified the different roles of SOEs in strategic, pillar and other industries. According to Li, strategic industries relate to national security and are key to the national economy. They cover seven industries: defence, electric power and grid, petroleum and petrochemical,

⁸⁰ Szamoszegi and Kyle (n 69) 46.

⁸¹ Deng (n 12) 7.

⁸² McGregor (n 71) 58–61.

⁸³ Lin and Milhaupt (n 68) 46; See CE Bai, JY Lu and ZG Tao, 'The Multitask Theory of State Enterprise Reform: Empirical Evidence from China' (2006) 96(2) *American Economic Review* 354.

⁸⁴ 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 (No 97 [2006] of the General Office of the State Council, 5 December 2006).

⁸⁵ *ibid.*

telecommunications, coal, civil aviation and shipping.⁸⁶ The state would maintain absolute control in these strategic sectors, either through sole ownership or by having an absolute controlling stake, and state-owned assets should be increased.⁸⁷ By comparison, the state has a notably smaller role in basic and pillar industries, which include equipment manufacturing, the auto industry, information technology, construction, iron and steel, non-ferrous metals, chemicals, surveying and design and technology. In this group, the state must maintain an absolute or conditional relative controlling stake, and the influence of state ownership should be enhanced even if the amount of state capital is reduced.⁸⁸ Other industries include trading, investment, medicine, construction materials, agriculture and geological prospecting, in which the state should maintain the necessary degree of influence by holding a controlling stake in leading enterprises in some influential sectors, although the number of SOEs in these sectors should be clearly reduced.⁸⁹

The identification of strategic and pillar industries appears to have been made on an ad hoc basis. On the one hand, as Naughton pointed out, even though the machinery equipment industry as a whole is recognized as a pillar industry, some subsectors of that industry are clearly not considered to be so in practice.⁹⁰ On the other hand, from time to time, newly emerging industries have been identified as new strategic or pillar industries. For example, China's State Council unveiled the '12th Five-Year Development Plan for National Strategic Emerging Industries' in July 2012. The plan identified seven strategic emerging industries, namely, the energy-saving and environmental protection industry, the new-generation information technology industry, the biology industry, the high-end equipment manufacturing industry, the new energy auto industry, the new energy industry and the new material industry. The State Council aims to make the first three pillar industries and last four guiding industries in China by 2020.⁹¹ In the light of the role assigned to state ownership in strategic and pillar industries by the SASAC, SOEs will necessarily play a vital role in developing these strategic emerging industries going forward.

D. State Support of SOEs: Sources of Competitive Advantages

Several possible sources of market distortions can arise as a result of the competitive advantages that some SOEs have over non-state enterprises.

⁸⁶ The level of state ownership in the banking sectors is comparable to that of China's strategic industries. The SASAC did not name banking sector as strategic because the banking sector in China is subject to a separate regulatory regime. See Deng (n 12) 23.

⁸⁷ SASAC, 'The State Sector Shall Keep Absolute Control over Seven Industries' <http://www.gov.cn/ztlz/2006-12/18/content_472256.htm>.

⁸⁸ *ibid.*

⁸⁹ *ibid.*

⁹⁰ B Naughton, 'State-Owned Enterprises in China' (2011) Testimony before the US-China Economic and Security Review Commission.

⁹¹ State Council, the 12th Five-Year Development Plan for National Strategic Emerging Industries, Guofa [2012] No 28, 9 July 2012.

Such advantages are not necessarily based on better performance, superior efficiency, better technology or superior management skills but are merely government-created.⁹² These advantages can be roughly classified into financial, regulatory and other forms of advantage.⁹³

1. Financial advantages

a) Tax reductions and exemptions

The Chinese government has used lower tax rates to reward SOEs and subsidiaries for undertaking investments, procuring goods and services, and performing other activities that market incentives alone would not support.⁹⁴ For example, the US regulatory filings of Chinalco showed that the firm benefited from a RMB 92.4 million tax credit for purchasing certain domestic equipment in 2008.⁹⁵

b) Direct subsidization

Another form of benefit conferred upon SOE subsidiaries is the direct transfer of funds through grants or capital injections. One example is the Chinese government's grant of RMB 50.9 billion to Sinopec Corp to cover the company's losses in 2008.⁹⁶

c) Low-cost capital from state-controlled banks

Despite changes in the legal framework which are ostensibly aimed at pushing the state-owned commercial banks towards more commercially oriented lending patterns, China's state-owned commercial banks continue to favour SOEs and make loans to them on preferential terms.⁹⁷ *The Economist* reported that Chinese SOEs borrow from state-owned banks at below-market rates of only 1.6 per cent, compared to the 4.7 per cent interest rate charged to private companies.⁹⁸ Other benefits include writing off loans that SOEs are unable to repay or continuously rolling over the principal.⁹⁹ In 2009 approximately 85 per cent of China's \$1.4 trillion in bank stimulus loans went to SOEs.¹⁰⁰ This preference persisted despite generally low levels of profitability or even

⁹² A Capobianco and H Christiansen, 'Competitive Neutrality and State-Owned Enterprises: Challenges and Policy Options' (2011) OECD Corporate Governance Working Paper No 1, 11.

⁹³ J Nakagawa, 'Regulatory Harmonization through FTAs and BITs: Regulation of State Owned Enterprises (SOEs)' (2012) SIEL Working Paper No 2012/55, 3.

⁹⁴ Szamoszszegi and Kyle (n 69) 45.

⁹⁵ *ibid.* The programme was later discontinued in response to a WTO investigation into China's tax regime.

⁹⁶ *ibid.* 20.

⁹⁷ Walter and Howie (n 61) 25.

⁹⁸ Wooldridge (n 13) 15.

⁹⁹ JY Qin, 'WTO Regulation of Subsidies to State-owned Enterprises (SOEs) – A Critical Appraisal of the China Accession Protocol' (2003) 7(4) JIEL 876.

¹⁰⁰ Wooldridge (n 13) 7.

the uncreditworthiness of some SOEs and more rapid growth in other segments of the Chinese economy. As a result of the bias toward SOEs in bank lending, the private sector receives a relatively small share of credit from the formal financial sector in China and has come to rely on private financing mechanisms.¹⁰¹

2. Regulatory advantages

SOEs are often not subject to the same costly regulatory regimes as private companies, resulting in their enjoying lower operating costs than their private competitors.¹⁰² Examples of such preferential treatment include exemptions from antitrust enforcement and bankruptcy rules, preferential access to raw materials, favourable dividend policies, and preference in government procurement.¹⁰³

a) Monopolies

Some Chinese SOEs are granted exclusive rights over the activities that they are mandated to pursue. As discussed above, the state sector is mandated to control strategic and pillar industries and in these sectors, both domestic and foreign private capital is severely restricted and Chinese SOEs enjoy de facto exemption from antitrust enforcement.¹⁰⁴ The office of the United States Trade Representative (USTR) has found that 'China has added a variety of restrictions on investment that appear designed to shield inefficient or monopolistic Chinese enterprises from foreign competition'.¹⁰⁵

b) Captive equity

SOEs equity is generally 'locked in', ie control of an SOE cannot be transferred as easily as would be the case in privately-owned firms. Under the State-owned Asset Law of Enterprises, transfer of state shares requires the prior approval of the SASAC or its local office, even with respect to transactions over which it does not have veto power as a shareholder under Chinese Company Law.¹⁰⁶ Some Chinese courts have held that contracts for the transfer of state-owned shares without prior approval are not enforceable or invalid, despite their being consistent with Chinese Company Law.¹⁰⁷ The inability to transfer ownership

¹⁰¹ KS Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (Cornell University Press 2002) 10. ¹⁰² Capobianco and Christiansen (n 92) 6.

¹⁰³ The Economist, *The State Advances* (6 Oct 6 2012).

¹⁰⁴ S Lubman, 'China's State Capitalism: The Real World Implications' *The Wall Street Journal* (1 March 2012). ¹⁰⁵ USTR (n 20) 68.

¹⁰⁶ Art 53 of the State-Owned Assets Law of Enterprise of China.

¹⁰⁷ See eg *Zhang Buo v Beijing Jing Gong Garments Group Co Ltd*, Civil Case No 2985, Beijing Intermediate People's Court (20 May 2009); *Hunan Zheqin Group Co Ltd v Chengdu*

rights results in a number of advantages for SOEs. First, because they are not subject to the threat of takeovers, SOEs can generate losses for a long period of time without fear of bankruptcy.¹⁰⁸ Second, SOEs are more inclined to engage in anti-competitive (and rarely profitable) exclusionary pricing strategies which might result in losses due to the below-cost pricing without fear of falling stock prices.¹⁰⁹

c) Favourable dividend policy

A State Council decision in 1994 exempted Chinese SOEs from paying dividends through much of the 1990s and 2000s, partly to allow them to repair their balance sheets but also because of resistance from politically influential SOE managers.¹¹⁰ This practice changed in 2007 when the State Council launched a reform that aimed to collect dividends from central SOEs and put them into a State Capital Management Budget on a pilot basis. Currently, Chinese central SOEs are paying 5–15 per cent in dividends, which is a much lower dividend payout ratio than is common in other firms.¹¹¹ This favourable dividend policy gives SOEs an advantage over current and potential competitors by keeping their cost of capital low.

d) Preferential access to raw materials and other inputs

The Chinese government supports its SOEs and other domestic manufacturers by ensuring that they have adequate supplies of low-priced raw materials, often at below market prices.¹¹² In addition, China has imposed various export restrictions on raw materials and rare earth elements, even though China is the largest source of many of these materials. This causes problems of supply for manufacturers in other countries, and results in Chinese companies—such as

Yinghua Investment Co Ltd, Civil Case No 6, Huaihua City Intermediate People's Court (27 May 2009).

¹⁰⁸ Whether the Enterprise Bankruptcy Law of China should apply to SOEs used to be a controversial topic. The debate delayed the promulgation of China's Enterprise Bankruptcy Law for many years. The new Enterprise Bankruptcy Law, enacted in 2006, applies to all SOEs except 2000 SOEs which are specifically singled out by the State Council. See <<http://finance.sina.com.cn/g/20060828/07252860205.shtml>>.

¹⁰⁹ TC Brightbill, Testimony before the US–China Economic and Security Review Commission (2012).

¹¹⁰ N Borst, 'SOE Dividends and Economic Rebalancing' (11 May 2012) <<http://www.piie.com/blogs/China/?p=1258>>.

¹¹¹ The average dividend payout for mature and established industrial firms in the US is 50–60 per cent. The average dividend for SOEs in five developed economies was 33 per cent. The Chinese SOEs that are listed in Hong Kong pay an average dividend of 23 per cent. See World Bank, 'Effective Discipline with Adequate Autonomy: The Direction for Further Reform of China's SOE Dividend Policy' (2009) 12–35.

¹¹² OECD Steel Committee, 'A NAFTA Perspective on the Impact of SOEs on the Global Steel Market' (2012) 13 <<http://steelnt.org/new/20120531.pdf>>.

those in the state-dominated steel industry—having an unfair competitive advantage.¹¹³

e) Government procurement

The Chinese government operates a substantial government procurement market which it uses to support SOEs and create national champions in key industries.¹¹⁴ A recent study by the European Chamber of Commerce estimates the public procurement market in China to be more than 20 per cent of its national GDP (ie, \$1.07 trillion).¹¹⁵ However, this lucrative market is largely closed to foreign invested companies. It has been estimated that 43 per cent of Chinese government investment-related procurement and 79 per cent of government consumption expenditure were made through state-owned or state-controlled enterprises.¹¹⁶ There are several reasons for the substantial advantages enjoyed by SOEs in Chinese government procurement market. First, China has not yet acceded to the WTO's Government Procurement Agreement and the PRC Government Procurement Law requires that the Government should purchase domestic goods, projects and services.¹¹⁷ Second, procurement is often conducted by local government, which may be predisposed to favour local SOEs. This is not only because the management of local SOEs usually has close relations with local government decision-makers, but also because local SOEs contribute revenues to local coffers and the government has a vested interest in their success.¹¹⁸ Third, once an SOE has obtained a government procurement contract, it is likely to conduct any related subcontracting through other SOEs.¹¹⁹

In addition to these financial and regulatory advantages, Chinese SOEs may also benefit by having access to government information or data which are not available to their private competitors, or are only available to a limited extent.¹²⁰

It should be emphasized that the benefits enjoyed by SOEs as a result of their particular relationship to the state have been eroded as a result of the extensive SOE reforms.¹²¹ In addition, following its accession to the WTO, other WTO

¹¹³ B Karapinar, 'Export Restrictions and the WTO Law: How to Reform the 'Regulatory Deficiency' (2011) 45(6) JWT 1141.

¹¹⁴ USTR (n 20) 63–4.
¹¹⁵ European Union Chamber of Commerce in China, 'European Business in China Position Paper' (2012/2013) 70 <<http://european-chamber.com.cn/en/chamber-publications>>.

¹¹⁶ Szamosszegi and Kyle (n 69) 58–9.

¹¹⁷ Art 10 of PRC Government Procurement Law. China committed to joining the WTO Government Procurement Agreement as part of its WTO Accession in 2001, but the terms of its GPA membership are still under negotiation. See WTO, China Announces Next Step in Joining Government Procurement Agreement <http://www.wto.org/english/news_e/news12_e/gpro_18jul12_e.htm>.

¹¹⁸ CE Bai et al, 'Local Protectionism and Regional Specialization: Evidence from China's Industries' (2003) 1–35 <<http://www.wdi.umich.edu/files/publications/workingpapers/wp565.pdf>>.

¹¹⁹ Szamosszegi and Kyle (n 69) 57.

¹²⁰ Capobianco and Christiansen (n 92) 7.

¹²¹ Hassard et al (n 62) 511.

members, either through bilateral dialogues or through WTO litigation, have successfully persuaded China to remove many of the policies and measures that have afforded SOEs special advantages. For example, the WTO Appellate Body recently upheld a Panel finding that China had violated several of its WTO commitments by imposing export restrictions on raw materials, including bauxite, coke and zinc.¹²² The 2013 US–China Strategic and Economic Dialogue specifically addressed Chinese SOE dividend reform and Chinese negotiators agreed to increase the number of SOEs that pay dividends, as well as to increase the amount of dividends actually paid.¹²³

III. STATE CAPITALISM AND THE LAW OF THE WORLD TRADE ORGANIZATION

Even before its accession to the WTO, the existence of a large number of SOEs in China was perceived as being fundamentally incompatible with the world trading system.¹²⁴ The Chinese government's prominent economic role a decade after it joined the WTO throws doubt on expectations that WTO membership would cause China to pull back from market interventions.¹²⁵ It is thus necessary to examine what WTO rules are relevant to confront China's state capitalism and to what extent these rules are effective in curbing it.

It is important to note that when China acceded to the WTO in 2001 it agreed to be bound by a large number of special rules that elaborate, expand, modify or deviate from the provisions of the general WTO Agreements. These China-specific rules are set out in the WTO Accession Protocol (the Protocol) and in the more than 140 paragraphs of the Report of the Working Party on the Accession of China.¹²⁶ As an integral part of the WTO Agreements, the China-specific rules contained in China's accession commitments are enforceable through the WTO dispute settlement

¹²² WTO Appellate Body Report, *China—Measures Related to the Exportation of Raw Materials Restrictions* (30 Jan 2012) WT/DS394/AB/R.

¹²³ Joint US–China Economic Track Fact Sheet of the Fifth Meeting of the US–China Strategic and Economic Dialogue (7/12/2013) <<http://www.treasury.gov/press-center/press-releases/Pages/jl2010.aspx>>.

¹²⁴ G Hufbauer, 'China as an Economic Actor on the World Stage: An Overview' in F Abbott (ed), *China in the World Trading System: Defining the Principle of Engagement* (Kluwer Law International 1998) 50; See also JH Jackson, 'The Impact of China's Accession on the WTO' in D Cass, B Williams and G Barker (eds), *China and the World Trading System* (Cambridge University Press 2003) 26.

¹²⁵ HB Malhotra, Chinese Communists Keeping Hands in All Pockets (30 November 2011) <<http://www.theepochtimes.com/n2/business/chinese-communists-keeping-hands-in-all-pockets-151064.html>>.

¹²⁶ Protocol on the Accession of the People's Republic of China, WT/L/432 (10 November 2001). JY Qin, "'WTO-Plus' Obligations and Their Implications for the WTO Legal System: An Appraisal of the China Accession Protocol' (2003) 37(3) JWT 483.

processes.¹²⁷ These disciplines put additional constraints on the activities and financial situation of China's SOEs.

A. The Ownership-Neutral Philosophy of the World Trading System

The post-World War II international trading system is based on rules and principles that often assume the existence of a market-oriented economy where enterprises make decisions on the basis of economic factors rather than government directives.¹²⁸ Still, the WTO does not prescribe any particular economic system for its members and states with non-market economies have been accepted into the GATT/WTO membership.¹²⁹ In addition, most GATT/WTO rules address governments only in their role as regulator of economic activities. Little is said about government participation in economic activities through SOEs. Indeed, the GATT/WTO does not impose on members any particular obligations with respect to property ownership.¹³⁰ A WTO member is free to establish and maintain SOEs if it wishes to do so.

There are several reasons for the WTO's ownership-neutral position. First, as Qin points out, a basic principle of public international law is that each state has the sovereign right to choose freely its own political, social and economic system. States still hold divergent views as to the proper roles of the government and the state-owned sector in the national economy and finding the right mix of public and private ownership remains a challenge for many countries.¹³¹ Second, governments may instruct SOEs to engage in numerous forms of business practice that discriminate against foreign goods and services and possibly undermine the GATT/WTO commitments.¹³² Such restrictive practices may include being the exclusive importer/exporter of a product, using government funds for subsidizing domestic production and trade, and controlling product standards, etc. However, such practices are not restricted to entities that are owned or controlled by the state. Besides, the underlying sources of such trade distortion are usually the special rights and privileges which are enjoyed by SOEs.¹³³ Thus public ownership is not what matters. The regulatory focus should be on the behaviour of those SOEs which are granted

¹²⁷ WTO Appellate Body Report, *China—Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products*, WT/DS363/AB/R (21 December 2009) paras 133–140.

¹²⁸ WJ Davey, 'Article XVII GATT: An Overview' in T Cottier and P Mavroidis (eds), *State Trading in the Twenty-First Century* (the University of Michigan Press 1998) 21.

¹²⁹ JH Jackson, *The World Trading System: Law and Policy of International Economic Relations* (MIT Press 1997) 328.

¹³⁰ PC Mavroidis and T Cottier, 'State Trading in the Twenty-First Century: An Overview' in Cottier and Mavroidis (n 128) 3.

¹³¹ EU Petersmann, 'GATT Law on State Trading Enterprises: Critical Evaluation of Article XVII and Proposals for Reform' in Cottier and Mavroidis (n 128) 72. ¹³² Qin (n 99) 899–900. ¹³³ *ibid.*

special rights and privileges.¹³⁴ Finally, from a practical point of view, how capital should be formed and whether or not SOEs should be dismantled are fundamental choices of domestic policy making. International law cannot, nor should it, prescribe such basic choices if it is to remain effective.¹³⁵ Accordingly, it is suggested that the WTO law should not take sides by prescribing basic choices related to the organization of its members' economy and remain neutral as regards questions concerning the formation and ownership of capital, whether private or public.¹³⁶

Based on this reasoning, WTO disciplines contain few rules specifically relating to SOEs. With respect to trade in goods, GATT Article XVII sets out the basic disciplines concerning state trading firms, but Article XVII does not refer to the ownership of such entities.¹³⁷ Similarly, although the SCM Agreement expresses a preference for privatization in developing countries, it does not impose any obligation regarding SOEs.¹³⁸ Of course, whether the ownership-neutral philosophy of the GATT/WTO permits it to respond effectively to all the challenges posed by SOEs is a debatable issue.

B. State Trading Enterprises

The original parties to the GATT were aware of the danger that some Member governments might create SOEs in order to circumvent their obligations under the GATT. At the same time, those parties could not agree on imposing greater restrictions on SOEs than on private enterprises.¹³⁹ Consequently, only a few provisions in the WTO Agreements explicitly address SOEs. The most important is Article XVII of the GATT 1994. Article XVII:1(a) requires that State Trading Enterprises (STEs) shall act in a manner consistent with the general principles of non-discriminatory treatment under the GATT. Article XVII:1(b) requires that STEs shall make any purchases or sales solely on the basis of commercial considerations. Article XVII is intended to ensure that members do not use STEs to escape or circumvent their GATT obligations.¹⁴⁰

The implications of Article XVII for SOEs are limited. First, Article XVII is applicable only to STEs, a term which has never been clearly defined in the

¹³⁴ BM Hoekman and P Low, 'State Trading: Rule Making Alternatives for Entities with Exclusive Rights' in Cottier and Mavroidis (n 128) 329.

¹³⁵ T Cottier and P Mavroidis, 'Conclusions: The Reach of International Trade Law' in Cottier and Mavroidis (n 128) 400.

¹³⁶ *ibid* 397.

¹³⁷ Qin (n 99) 900.

¹³⁸ Art 27.13 of the SCM Agreement.

¹³⁹ Xuejun Xie, 'WTO Rules on State-Owned Enterprises and Implications for Chinese SOE Reforms' (2002) 3(6) Perspectives <http://www.oycf.org/oycfold/http://docs/Perspectives/18_093002/WTO_Rules.htm>.

¹⁴⁰ WTO Appellate Body Report, *Canada—Measures Relating to Export of Wheat and Treatment of Imported Grain*, WT/DS276/AB/R (30 August 2004) para 85.

GATT.¹⁴¹ A working definition was developed during the Uruguay Round for the purpose of notifying the WTO of such enterprises:

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.

Significantly, this definition covers a private enterprise that receives some special rights or privileges that can influence the level or direction of trade.¹⁴² On the other hand, SOEs are excluded from the definition unless they have a special right or privilege and they influence the level or direction of trade through their purchases or sales.¹⁴³ The special right or privilege granted need not be a monopoly position.¹⁴⁴ When China acceded to the WTO in 2001, China was obliged to allow all enterprises in China to trade in all goods by 11 December 2004, except for those specified in Annex 2 of the Protocol.¹⁴⁵ By virtue of a special national treatment clause in the Protocol, this right to trade is also extended to all foreign individuals and entities, which have either invested in or are registered in China.¹⁴⁶ Thus only a limited number of Chinese SOEs may be labelled as STEs under the WTO law.

Second, the coverage of Article XVII:1 is fairly limited. It is unclear whether the obligation of STEs to 'act in a manner consistent with the general principles of non-discriminatory treatment under the GATT' refers only to most-favoured nation treatment of trade with other countries or also national treatment of imported and like domestic goods. In several GATT disputes, Panels have ruled in favour of the narrower interpretation.¹⁴⁷ In addition, in *Canada–Wheat*, the Appellate Body concluded that Article XVII:1(a) sets out an obligation of non-discrimination and that Article XVII:1(b) clarifies the scope of that obligation.¹⁴⁸ The Appellate Body rejected the US argument that XVII:1(b) establishes a separate, general competition-law-type obligation on state trading enterprises to follow 'commercial considerations' in all of their purchases and sales.¹⁴⁹ As a result, Article XVII:1 allows STEs to act in an anti-competitive manner insofar as such action does not violate the obligation of non-discrimination.¹⁵⁰

However, although the general thrust of Article XVII of the GATT 1994 is weak, Chinese SOEs are not able to benefit from such weakness. The Protocol extends the WTO disciplines concerning STEs to all Chinese SOEs, regardless of whether they engage in export or import trade.¹⁵¹ The Protocol requires the

¹⁴¹ WTO, Technical Information on State-Trading Enterprises <http://www.wto.org/english/tratop_e/statra_e/statra_info_e.htm>.

¹⁴² Qin (n 99) 901. ¹⁴³ Petersmann (n 132) 80.

¹⁴⁴ WTO (n 141).

¹⁴⁵ Art 5.2 of the China's Accession Protocol.

¹⁴⁶ JY Qin, 'Trade, Investment and Beyond: The Impact of WTO Accession on China's Legal System' (2007) *China Quarterly* 726.

¹⁴⁷ Petersmann (n 132) 80–1.

¹⁴⁸ WTO Appellate Body Report, *Canada–Wheat* (n 140) para 145.

¹⁴⁹ *ibid.*

¹⁵⁰ Nakagawa (n 93) 6.

¹⁵¹ Qin (n 99) 884.

Chinese government to ensure that all SOEs operate according to market economy principles and also requires it not to meddle with the autonomous operation of SOEs. Specifically, it provides that:

China would ensure that all state-owned and state-invested enterprises would make purchases and sales based solely on commercial considerations, eg, price, quality, marketability and availability, and that the enterprises of other WTO Members would have an adequate opportunity to compete for sales to and purchases from these enterprises on non-discriminatory terms and conditions. In addition, the Government of China would not influence, directly or indirectly, commercial decisions on the part of state-owned or state-invested enterprises, including on the quantity, value or country of origin of any goods purchased or sold, except in a manner consistent with the WTO Agreement.¹⁵²

C. The SCM Agreement and Countervailing Duties against China

1. The SCM Agreement and China's WTO Accession Protocol

In a market economy the only way a government can affect trade through SOEs that do not enjoy monopoly rights is through the provision of subsidies.¹⁵³ It has long been recognized that while subsidies are widely used by governments to promote national policy objectives, they may have adverse effects on the interests of other countries involved in international trade.¹⁵⁴ Countervailing duty (CVD) laws are designed to provide relief to domestic industries that have been materially injured, or are threatened with material injury, by imported goods that have been subsidized by a foreign government or other public entity. The relief provided takes the form of an additional import duty on the subsidized imports.

The SCM Agreement, which supplements the relevant provisions of Articles VI and XVI of the GATT, sets out obligations, rights and remedies regarding government subsidies of goods and the imposition of CVDs on subsidized imports. By virtue of the Protocol, China agreed to be fully subject to the general WTO disciplines on subsidies upon its accession. Key to the WTO subsidy disciplines is the definition of a subsidy. In accordance with Article 1.1 of the SCM Agreement, a subsidy shall be deemed to exist if two distinct elements are present: (i) a financial contribution by a government or any public body, by which (ii) a 'benefit' is conferred. To put it differently, this 'captures situations in which something of economic value is transferred by a

¹⁵² Report of the Working Party on the Accession of China, WT/ACC/CHN/49 (1 October 2001) para 46.

¹⁵³ F Roessler, 'State Trading and Trade Liberalization' in MM Kostechi (ed), *State Trading in International Markets* (Macmillan 1982) 264.

¹⁵⁴ B Kyle and RW Staiger, 'Will International Rules on Subsidies Disrupt the World Trading System?' (2006) 96 *AmEconRev* 877-95.

government to the advantage of a recipient'.¹⁵⁵ Moreover, to be subject to the disciplines of the SCM Agreement, the subsidy must be specific.¹⁵⁶

A financial contribution is defined as a direct transfer or potential direct transfer of funds, forgoing government revenue otherwise due—such as tax credits, and the provision of goods and services other than general infrastructure, or purchase of goods by the government.¹⁵⁷ The case law shows that the Appellate Body has endorsed a broad interpretation of these three different kinds of financial contributions.¹⁵⁸ For example, as to the direct transfer of funds and liabilities, in *Japan–DRAMs Countervailing Duties* the Appellate Body indicated that the term 'funds' encompassed not only 'money' but also financial resources and other financial claims more generally.¹⁵⁹ Consequently, debt forgiveness, the extension of loan maturity, and an interest rate reduction are all considered direct transfers of funds within the meaning of Article 1.1(a)(1)(i) because the financial position of the borrower is improved.¹⁶⁰

To be labelled a subsidy under the SCM Agreement, the financial contribution should confer a 'benefit'. Whereas the financial contribution element focuses on the government and the public body, when determining whether there is a benefit the focus shifts toward the recipient of the contribution.¹⁶¹ In *Canada–Aircraft*, the Appellate Body found that a government financial contribution confers a benefit if the financial contribution makes the recipient 'better off' than it would otherwise have been, absent the contribution, and that the market place provides an appropriate basis for such a comparison.¹⁶² In this connection, Article 14 of the SCM Agreement prescribes the conditions under which government provision of equity capital, loans and loan guarantees, or goods and services or purchase of goods can be considered as conferring a benefit.

Specificity is not a constitutive element of a subsidy, but it is a necessary condition if that subsidy is to be subject to the disciplines of the SCM Agreement.¹⁶³ Only subsidies that are specific to certain enterprises, ie, an enterprise or industry or enterprises or industries that are known and particularized, rather than being generally available throughout the economy

¹⁵⁵ WTO Appellate Body Report, *US–Final Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada*, WT/DS257/AB/R (19 January 2004) para 51.

¹⁵⁶ Art 1.2 of the SCM Agreement.

¹⁵⁷ Art 1.1(a)(i) of the SCM Agreement.

¹⁵⁸ J Wouters and D Coppens, 'An Overview of the Agreement on Subsidies and Countervailing Measures' in KW Bagwell, GA Bermann and PC Mavroidis, *Law and Economics of Contingent Protection in International Trade* (Cambridge University Press 2010) 15.

¹⁵⁹ WTO Appellate Body Report, *Japan–Countervailing Duties on Dynamic Random Access Memories from Korea*, WT/DS336/AB/R (17 December 2007) para 250.

¹⁶⁰ *ibid*, para 251.

¹⁶¹ WTO Appellate Body Report, *Canada–Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R (20 August 1999) para 156.

¹⁶² *ibid*, para 157.

¹⁶³ Art 1.2 of the SCM Agreement.

of a WTO Member, are countervailable.¹⁶⁴ The rationale for the specificity requirement reflects the view that only specific financial contributions can lead to trade distortion.¹⁶⁵ The SCM Agreement targets, first of all, ‘*de jure* specificity’, ie, situations in which the subsidy is explicitly limited to certain enterprises. When seeking to determine if there is *de jure* specificity the focus is on whether only certain enterprises are eligible for the subsidy while the access to that subsidy is limited for other enterprises.¹⁶⁶ In addition, an apparently non-specific subsidy may be *de facto* specific and thus also be subject to the disciplines of the SCM Agreement. Article 2.1(c) lists four factors that can be taken into consideration when determining whether a subsidy is *de facto* specific.¹⁶⁷

Once it has been determined that there is a specific subsidy for the purposes of the SCM Agreement, a traffic light metaphor is then used in order to categorize subsidies. Export subsidies and import substitution subsidies are principally prohibited by their very nature because of their direct trade-distorting effect, and so are given a ‘red’ light.¹⁶⁸ Prohibited subsidies are also presumed to be specific.¹⁶⁹ All other subsidies are actionable subsidies (a ‘yellow’ light), meaning that they can be challenged or countervailed if they cause adverse effects. At present, no type of subsidy qualifies for a ‘green’ light under the SCM Agreement.¹⁷⁰

An importing Member can unilaterally impose CVDs to offset the adverse effects of the subsidy in its domestic market.¹⁷¹ In a unilateral action, CVDs may only be imposed pursuant to an investigation conducted in accordance with the procedural and substantive obligations provided for by the SCM Agreement. This investigation should determine the existence of three substantive elements: (1) the existence of a specific subsidy; (2) injury to the domestic industry producing the like product; and (3) a causal link between the subsidized import and the injury.¹⁷²

The Protocol contains a number of special provisions which are only applicable to China. Article 14 provides that, when determining the amount of a benefit, the prevailing conditions of the SCM Agreement in the domestic market of the WTO member seeking to defend itself should be used as a benchmark. Section 15(b) of the Protocol, however, explicitly authorizes

¹⁶⁴ WTO Appellate Body Report, *United States – Definitive Anti-Dumping and Countervailing Duties on Certain Products from China* (‘US–Anti-Dumping and Countervailing Duties’) WT/DS379/AB/R (11 March 2011) para 373.

¹⁶⁵ PC Mavroidis, *Trade in Goods* (Oxford University Press 2012) 549.

¹⁶⁶ WTO Appellate Body Report (n 164) para 368. ¹⁶⁷ Art 2.1(c) of the SCM Agreement.

¹⁶⁸ Art 3 of the SCM Agreement. ¹⁶⁹ Art 3 and 2.3 of the SCM Agreement.

¹⁷⁰ Three categories of subsidies were non-actionable before 2000. However, the category of green light subsidies expired at the end of 1999. R Howse, ‘Do the World Trade Organization Disciplines on Domestic Disciplines Make Sense? The Case for Legalizing Some Subsidies’ in Bagwell, Bermann and Mavroidis (n 158) 85–102.

¹⁷¹ M Matsushita, TJ Schoenbaum and P Mavroidis, *The World Trade Organization: Law, Practice and Policy* (Oxford University Press 2006) 336. See also art 10, fn 35 of the SCM Agreement.

¹⁷² Art 11.2 of the SCM Agreement.

a departure from the Article 14 guidelines and allows WTO Members to use the so-called 'non-market economy (NME) methodologies' to calculate the amount of a subsidy granted by the Chinese government. Section 15(b) of the Protocol reads:

The importing member may 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 benchmarks.

Clearly, section 15(b) permits an importing member to resort to alternative benchmarks in order to calculate the amount of a subsidy if it finds that the prevailing conditions in China are inappropriate to be used as such. As the Appellate Body commented, this 'affords importing WTO Members investigating Chinese imports additional flexibility in the methodology used to identify and measure subsidy benefits'.¹⁷³ The provision necessarily presumes that the extensive governmental intervention and less developed market conditions in China may not always offer appropriate market benchmarks against which to calculate the amount of a subsidy. Section 15(b) of the Protocol has two peculiar characteristics. First, this brief text lacks both substantive and procedural detail to guide members in practice. The implementation of this provision seems to be left entirely to the discretion of the importing member.¹⁷⁴ For example, what factors should an importing member consider when judging the appropriateness of prevailing conditions in China? How should it choose alternative benchmarks when Chinese benchmarks are found to be inappropriate in the relevant proceedings? The failure to specify necessary conditions when authorizing the use of alternative benchmarks runs the risk of permitting the abuse of what could be a powerful protectionist tool. Second, and partly due to the first characteristic, such alternative benchmarks may always be used by other WTO Members, regardless of the actual conditions within the Chinese economy.¹⁷⁵ This is in sharp contrast to the special anti-dumping provisions in the Protocol, which expressly stipulate that the use of NME anti-dumping methodologies will not be applicable to Chinese exports from 2016.¹⁷⁶

In addition, Section 10.2 of the Protocol prescribes a special SOE-based specificity test. It reads:

For purposes of applying Article 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.

If the Chinese government explicitly permits only SOEs or its favoured enterprises to have access to a subsidy, then that subsidy is *de jure* specific.

¹⁷³ WTO Appellate Body Report (n 164) para 436 and fn 401.

¹⁷⁵ *ibid* 904.

¹⁷⁴ Qin (n 99) 903.

¹⁷⁶ Art 15(d) of China's WTO Accession Protocol.

In WTO case law, it is usually much more difficult to determine whether a subsidy is de facto specific. Under the Protocol, however, the difficult weighing and balancing exercise under Article 2.1(c) of the SCM Agreement is reduced to a finding of one of the two conditions in section 10.2 of the Protocol. This will make it easier to find that a subsidy provided to an SOE by the Chinese government is specific.¹⁷⁷

D. The US–Anti-Dumping and Countervailing Duties Case

Even though the Protocol allows importing members to resort to special rules when imposing CVDs against Chinese goods, it is only since 2004 that China has become a target of CVD investigations and only since 2005 that effective countervailing measures have been put in place.¹⁷⁸ Traditionally, the US refused to apply CVD laws to NMEs such as China, largely as a result of a 1984 determination by the Department of Commerce (USDOC) that there was no adequate way to measure market distortions caused by subsidies in an economy that is not based on market principles.¹⁷⁹ The turning point came in 2006 when the USDOC announced that it had initiated a CVD investigation into China with respect to coated free-sheet paper.¹⁸⁰ To support its decision, the USDOC reasoned that the rationale used to prevent CVD law from applying to nonmarket economies in *Georgetown Steel* in 1984 no longer held true for modern-day China.¹⁸¹ The Chinese paper manufacturers sought an injunction from the US Court of International Trade claiming that the USDOC was prohibited by the *Georgetown Steel* ruling from conducting CVD investigations against NMEs such as China.¹⁸² The Court of International Trade declined to issue the injunction on jurisdictional issues but cast doubt on China's claim that the USDOC is prohibited from applying CVD law to NMEs.¹⁸³ Although CVDs were not imposed in the Coated Free-Sheet Paper case because the US International Trade Commission made a negative final determination on injury, it opened a 'Pandora's Box' of CVD petitions and impositions of CVDs on Chinese goods. As of September 2012, a total of

¹⁷⁷ Drake (n 19).

¹⁷⁸ D Ahn and J Lee, 'Countervailing Duty against China: Opening a Pandora's Box in the WTO System?' (2011) 14(2) JIEL 346.

¹⁷⁹ Carbon Steel Wire Rod from Czechoslovakia, Final Negative Countervailing Duty Determination, 49 Federal Register 19, 370, 19, 371 (7 May, 1984).

¹⁸⁰ Notice of Initiation of Countervailing Duty Investigations: Coated Free Sheet Paper from the People's Republic of China, Indonesia and the Republic of Korea, 71 Federal Register 68, 546 (27 November 2006).

¹⁸¹ USDOC, Countervailing Duty Investigation of Coated Free Sheet Paper from the People's Republic of China—Whether the Analytical Elements of the Georgetown Steel Opinion are Applicable to China's Present-Day Economy (29 May 2007).

¹⁸² *Government of the People's Republic of China v United States*, 483 F Supp 2d 1274 (Ct Intl Trade 2007).

¹⁸³ *ibid* 1282. The court said that the Georgetown Steel court only affirmed USDOC's decision not to apply CVD law to the NMEs in question in that particular case and recognized the continuing broad discretion of the agency to determine whether to apply CVD law to NMEs.

24 countervailing measures were in force against China. In 2009 alone, the USDOC initiated ten countervailing duty investigations regarding Chinese products.¹⁸⁴ In response to this flood of CVD investigations against Chinese goods, the Chinese government brought the US before the WTO dispute settlement body (DSB) in 2009 and the Appellate Body issued its report in March 2011.¹⁸⁵ The Appellate Body report clarified several important issues relating to the imposition of CVDs on Chinese goods and it has profound implications for counteracting China's state capitalism.

1. SOEs and state-owned commercial banks (SOCBs) as 'public bodies'

In *US–Anti-Dumping and Countervailing Duties*, the Panel was confronted with the issue of whether Chinese SOEs and SOCBs are 'public bodies'. This determination is important because, if SOEs and SOCBs were regarded as public bodies, then any provision of goods or services by SOEs and SOCBs to other market entities would be regarded as a 'financial contribution' and potentially fall within the ambit of the SCM Agreement. The Panel interpreted the term 'public body' in Article 1.1(a)(1) of the SCM Agreement as 'any entity controlled by a government'. The Panel considered government ownership to be highly relevant and potentially dispositive evidence of government control. Since the Chinese SOEs and SOCBs at issue were majority-owned by the Chinese government, the Panel sided with the USDOC that they were 'public bodies'.¹⁸⁶

The Appellate Body rejected the notion that the mere fact of governmental majority control is sufficient to render a state-controlled entity 'public body'. Rather, it saw the concept of 'public body' as sharing certain attributes with the concept of 'government'. The Appellate Body emphasized that a 'public body' within the meaning of the SCM Agreement must be an entity that possesses, exercises or is vested with governmental authority.¹⁸⁷ To make such a determination, investigating authorities should engage in a careful evaluation of the core features of the entity concerned and its relationship with government, having regard, in particular, to whether the entity exercises authority on behalf of the government.¹⁸⁸ In any case, apart from an express delegation of authority in a legal instrument, the mere fact that a government is the majority shareholder of an entity is unlikely to be sufficient to establish the necessary possession of governmental authority.¹⁸⁹

Undoubtedly, the Appellate Body's interpretation of 'public body' has narrowed the range of what entities might be considered to be such.¹⁹⁰ However, it is important to note that its ruling addressed only the *manner* of the

¹⁸⁴ Ahn and Lee (n 178) 346. ¹⁸⁵ WTO Appellate Body Report (n 164). ¹⁸⁶ *ibid* para 278.

¹⁸⁷ *ibid* para 317. ¹⁸⁸ *ibid* para 319. ¹⁸⁹ *ibid* para 318.

¹⁹⁰ E Vermulst, 'Concurrent Trade Defense Investigations in the EU, the EU's New Anti-subsidy Practice against China, and the Future of Both' (2012) 11(3) WTR 530.

Panel and the USDOC's examination of Chinese SOEs and it was not handing down a final verdict on the legal nature of Chinese SOEs more generally. In other words, the Appellate Body did not rule out the possibility that Chinese SOEs might be viewed as 'public bodies' in future CVD investigations if, besides majority government ownership, there was additional evidence showing that the Chinese government exercises meaningful control.¹⁹¹ As the Appellate Body commented:

In our view, the evidence that *a government exercises meaningful control over an entity and its conduct* may serve, in certain circumstances, as evidence that the relevant entity possesses governmental authority and exercises such authority in the performance of governmental functions.¹⁹²

It will be very interesting to watch the application of the Appellate Body's 'public body' legal standard to Chinese SOEs in future trade disputes. As has been seen in Part II above, Chinese SOEs have undergone extensive reforms in the past three decades. They are today fundamentally different from their predecessors, which were essentially arms of state bureaucracy and as such were not separate from the political or administrative authorities. Post-reform Chinese SOEs now enjoy a large degree of autonomy and have responsibility to make business decisions in accordance with market conditions. Administrative interference in the day-to-day management of the SOEs is prohibited by law. Financial performance weighs heavily in the annual and triennial evaluations of SOE executives, which in turn determines their remuneration and career prospects. Modern corporate governance structures have been established which rival the best Western corporations.¹⁹³ Many SOEs are also listed in domestic and international stock markets and comply with the rigorous supervision standards which stock market regulators require. All the evidence confirms that the 'new' Chinese SOEs should be viewed differently from their predecessors. At the same time, however, there should be no denying that the relationship between Chinese SOEs and the Chinese government is unique and vastly different from the conventional expectation of government-enterprise relationship in the Western world. Significantly, the CCP has retained inviolate power to appoint and remove SOE executives. This mechanism has created strong incentives for executives to comply with CCP diktats. Indeed, in much of the literature they are called 'quasi government officials' because many successful SOE executives have been promoted to senior positions in government bureaucracies or party organs.¹⁹⁴

In *US–Anti-Dumping and Countervailing Duties*, the Appellate Body emphasized that a 'public body' determination involves a careful evaluation of the core features of the entity concerned and its relationship with government, having regard, in particular, to whether the entity exercises

¹⁹¹ WTO Appellate Body Report (n 164) para 318.

¹⁹³ Musacchio and Flores-Macias (n 63).

¹⁹² *ibid.*

¹⁹⁴ Brodsgaard (n 65) 641.

authority on behalf of government.¹⁹⁵ Suppose that the USDOC had not *solely* relied on the Chinese government's majority ownership of the SOEs under investigation, but instead focused on evaluating the core features of these SOEs and their relationship with the Chinese government as advised by the Appellate Body, what conclusion might the USDOC have drawn from such an analysis?

It is immediately clear that the legal standard formulated by the Appellate Body to evaluate whether or not an entity is a 'public body' is quite ambiguous.¹⁹⁶ What is governmental authority? How can it be determined whether or not an entity possesses, exercises or is vested with governmental authority? In reality, is it possible for an investigating authority to show that a government exercises meaningful control over a company when it has not expressly mandated that company to perform certain functions and has avoided giving any other indicia?¹⁹⁷ Given the fact that the CCP controls the appointment of all major SOE executives and that SOE executives have incentives to follow government policy decisions, could it be concluded that an SOE possesses, exercises or is vested with governmental authority solely on this basis? If not, what additional factors should be looked at? The Appellate Body suggests that such an analysis should pay particular regard to whether the entity *exercises* authority on behalf of government. Does this mean that being vested with governmental authority itself would not be sufficient? Should whether the functions or conduct be of a kind that is ordinarily classified as governmental in the legal order of the relevant WTO Member be a relevant consideration?¹⁹⁸ Since Chinese SOEs at different levels (eg, central SOEs and local SOEs, different industries and different stages of SASAC-led reform) have different relationships with the Chinese government, a case-by-case analysis of each relationship seems to be required. As the burden of proof rests with the investigating authority, one may wonder if the 'public body' determination is an excessively burdensome test.¹⁹⁹

Admittedly, the Appellate Body's public body analysis, as it now stands, leaves some uncertainties. It would be much more straightforward, as some have suggested, to regard all sorts of government-controlled bodies, including SOEs that could easily be used by a government to channel or generate a financial contribution as 'public bodies'. Such a categorization is neither a problem nor wrongful because if CVDs were to be imposed, other conditions—such as 'benefit' and 'specificity'—must also be met.²⁰⁰ However, I would argue that many criticisms of the Appellate Body's analysis are not well

¹⁹⁵ WTO Appellate Body Report (n 164) para 319.

¹⁹⁶ M Cartland, G Depayre and J Woznowski, 'Is Something Going Wrong in the WTO Dispute Settlement?' (2012) 46 *JWT* 1011; J Pauwelyn, 'Treaty Interpretation or Activism? Comments on the AB Report on *United States – ADs and CVDs on Certain Products from China*' (2013) 12 *WTR* 235, 236. ¹⁹⁷ *ibid* 1010.

¹⁹⁸ A Dukgeun, 'United States – Definitive Anti-Dumping and Countervailing Duties on Certain Products from China' (2011) 105(4) *AJIL* 764.

¹⁹⁹ Cartland et al (n 196) 1010.

²⁰⁰ *ibid*.

founded, and at the same time underestimated the systemic implications of the alternative interpretative approaches which they suggest.

To begin with, the Appellate Body approach recognizes the possibility that modern SOEs may be run as genuine commercial enterprises and operate on a level playing field with private enterprises. If so, SOEs should not be treated differently simply because they are majority-owned by a government. Second, if SOEs were labelled as ‘public bodies’ without a careful evaluation of their core features, any goods and services provided by an SOE to other enterprises would be automatically considered as a ‘financial contribution’. Though this determination will not necessarily lead to an imposition of CVDs, one may argue that the rights of WTO Members owning SOEs under the SCM Agreement are diminished by this interpretation. This is especially the case for China. If all Chinese SOEs were considered as ‘public bodies’, then the first prong of the subsidy definition would be automatically fulfilled. Consider also that when determining the existence of ‘benefit’, the second prong of the subsidy definition, investigating authorities frequently refer to out-of-country benchmarks. In practice, such comparisons invariably result in a finding that benefit exists. The point is that the imposition of CVDs on China would be easier than it should be if the investigating authority could dispense with the public body analysis. It may well be that an implicit anti-public ownership position is built into the ‘new’ approach, as suggested by some WTO commentators. By requiring the investigating authority to examine the nature of SOEs, the Appellate Body has demonstrated impressive sensibility not to take a rigid position on a politically delicate issue. Such political sensibility is necessary to maintain the Appellate Body’s legitimacy as the gatekeeper of the multilateral trading system.

Finally, the legal standard formulated by the Appellate Body is not an insurmountable barrier for national investigating authorities to find that some SOEs are ‘public bodies’. At the panel stage, China argued that the USDOC should conduct the factual five-factor analysis it had applied in certain prior investigations, in particular in *Korea–DRAMs*, in order to determine whether entities were public bodies.²⁰¹ The five factors that the USDOC had used were: (i) government ownership; (ii) government presence on the board of directors; (iii) government control over activities; (iv) pursuit of governmental policies or interests; and (v) whether the entity was created by statute. The USDOC applied the five-factor analysis to Chinese SOEs in at least two investigations, but could not reach a conclusion due to insufficient evidence on the record. Some suggested the USDOC’s five-factor analysis to be an acceptable formula for fleshing out the Appellate Body’s ‘governmental authority’ test.²⁰²

²⁰¹ WTO Panel Report, *US–Anti-Dumping and Countervailing Duties*, WT/DS379/R, para 8.101.

²⁰² TJ Prusa and E Vermulst, ‘United States – Definitive Anti-Dumping and Countervailing Duties on Certain Products from China: Passing the Buck on Pass-Through’ (2013) 12 WTR 227–8.

No matter how the Appellate Body's legal standard will be applied in practice going forward, any evaluation of Chinese SOEs is likely to reveal a mixed picture. Some characteristics of Chinese SOEs may suggest that government control is manifold and that it does exercise meaningful control over them. Such evidence may permit an inference that the SOEs in question exercise governmental authority. This is especially the case with regard to central SOEs directly under the supervision of the SASAC. Other evidence may suggest that they share many similarities to private enterprises. The investigating authority must evaluate and give due consideration to all relevant characteristics of the SOE in question before reaching a conclusion.

This view may be reinforced by the fact that the Appellate Body endorsed the Panel's treatment of Chinese SOCBs as 'public bodies', given the scope and extent of control over them exercised by the Chinese government.²⁰³ In contrast to its dealing with SOEs, the Panel's determination with regard to the SOCBs goes beyond the fact that the Chinese government is a majority shareholder. Rather, the determination is based on a comprehensive consideration of a few relevant factors including (i) the near-complete state ownership of the banking sector in China; (ii) Article 34 of the Commercial Banking Law, which states that banks are required to carry out their loan business according to the needs of the national economy and social development and under the guidance of state industrial policies; (iii) recorded evidence indicating that state-owned commercial banks still lack adequate risk management and analytical skills; and (iv) the fact that during the investigation, the USDOC did not receive the evidence necessary to document in a comprehensive manner the process by which loans were requested, granted and evaluated.²⁰⁴ In addition, research reports by the OECD and IMF, as well as excerpts from the Bank of China's Global Offering, also support the conclusion that the Chinese banking sector is meaningfully controlled by the Chinese government.²⁰⁵ Still, it is not apparent why these facts demonstrated that SOCBs are exercising governmental authority. For example, a lack of business flair, as illustrated by inadequate risk management and analytical skills and poor loan-making practices, has little to do with whether the SOCBs are exercising governmental authority. Article 34 of the Commercial Banking Law is a very general statement and its implications for the SOCBs' loan business are not clear. The conclusion to be drawn from the Appellate Body's determination of the nature of SOCBs is simply that determining whether an entity is a 'public body' requires something more than there being government majority ownership. What additional evidence is needed, however, is not entirely clear at present and the Appellate Body seems to enjoy a large degree of discretion when doing so.

²⁰³ WTO Appellate Body Report (n 164) para 355.

²⁰⁵ *ibid* paras 350–351.

²⁰⁴ *ibid* para 349.

2. Specificity

In *US–Anti-Dumping and Countervailing Duties*, the controversies concerning the determination of specificity related to whether the SOCBs preferential lending to the tyre industry amounted to *de jure* specificity under Article 2.1(a), and whether the provision of land-use rights amounted to regional specificity under Article 2.2 of the SCM Agreement. With regard to the first specificity determination, the Appellate Body found that several planning documents at central, provincial and municipal levels of government identified the tyre industry as being one of the ‘encouraged projects’ and that all SOCBs were instructed to provide financing to that industry.²⁰⁶ In response to the government plans, both SOCBs and Chinese policy banks provided preferential loans to tyre producers, pursuant to the government policies as set out in the planning documents. Therefore, the lending by SOCBs to the tyre industry, and in particular to those producers who were identified specifically in the planning documents, was considered to be *de jure* specific.²⁰⁷

The reasoning of the Appellate Body raises some interesting questions. First, arguably both the SCM Agreement and the WTO case law fail to provide sufficient guidance on what degree of specificity is required.²⁰⁸ In *US–Upland Cotton*, the Panel held that non-specific subsidies are subsidies which are broadly available throughout an economy, in contrast to specific subsidies to which access is limited to a ‘sufficiently discrete segment’ of an economy as to constitute ‘certain enterprises’.²⁰⁹ Still, how big can ‘certain enterprises’ be without being perceived as being ‘broadly available’? In *US–Anti-Dumping and Countervailing Duties*, in addition to the tyre industry, the central planning catalogue has identified 539 ‘encouraged industries’ spanning 26 broad sectors of economic activity. The Appellate Body refused to consider whether all of these constituted ‘certain enterprises’, considering such an analysis to be unnecessary.²¹⁰ This is questionable. As Prusa and Vermulst point out, even if the tyre industry was identified as one of the encouraged projects and received subsidies, this does not necessarily indicate specificity. The focus of the inquiry should be whether the tyre producers under investigation receive more subsidies than other sectors identified in the Chinese government’s planning documents.²¹¹ This is because subsidies provided under the same instruments may be regarded as ‘broadly available’. In order to meet the specificity requirement, there must be evidence that tyre producers have access to certain subsidies not enjoyed by others sectors.

Second, China raised an important point that access to SOCB loans was not limited to the industries which were listed in the planning documents as being

²⁰⁶ *ibid* para 400.

²⁰⁷ *ibid*.

²⁰⁸ Wouters and Coppens (n 158) 29.

²⁰⁹ WTO Panel Report, *United States–Subsidies on Upland Cotton*, WT/DS267/R (8 September 2004) para 7.725.

²¹⁰ WTO Appellate Body Report (n 164) para 395.

²¹¹ Prusa and Vermulst (n 202) 229.

in the 'encouraged category' since the 'permitted' industries, which are not included, were also beneficiaries of such loans. Because the Panel did not make any findings on this point, the Appellate Body rejected China's argument on evidential grounds.²¹² China's assertions, if true, would certainly strengthen the argument that the subsidies were not specific and that the Appellate Body would be required to analyze whether enterprises in the 'encouraged' category enjoyed, *de jure* or *de facto*, access to subsidies that were unavailable to enterprises in the 'permitted' category.

These arguments lead to a perplexing question. If the specificity threshold is set at too high a level to be met, is there not a risk that in a country such as China, where there are many recipients of subsidies, those subsidies are even less likely to be countervailed? It may be precisely because of this concern that the Appellate Body has imposed an 'easier' specificity threshold than conventionally might have been expected. This shows the complexity of applying the SCM Agreement to a state capitalism country where the government retains a significant role in resource allocation.

As regards the second issue, the USDOC had determined that the provision of land-use rights to the Aifudi Company was regionally specific because the land was physically located in an industrial park within the jurisdiction of the Huantai County. The Panel found there to be no separate policy for land in the industrial park. If land was to be for industrial use, this had to be in accordance with the general industrial land policy which was applied uniformly both inside and outside the industrial park. In addition, the Panel found that the USDOC had failed to assess whether the provision of land-use rights in the industrial park constituted a 'distinct regime'—for instance, by virtue of price differences—compared with the land-use rights outside the industrial park.²¹³ The Appellate Body agreed with the Panel and rejected the USDOC's determination that the land-use rights in question were regionally specific.

Given that the Chinese government is the ultimate owner of all land, any time an enterprise obtains land-use rights anywhere in China it receives a financial contribution from a government. How to determine specificity in relation to the provision of land-use rights is likely to be a salient issue in future SCM disputes involving China. In this regard it should be noted that in *Coated Sheet Paper* case, and in the absence of cooperation from the Chinese Government, the EU made a positive specificity determination based on the following series of facts: (i) some provisions of the government's paper-making plan set out specific rules on industrial layout by stating what types of papermaking industries were to be established in various geographic regions of the country; (ii) there was evidence that the papermaking industry was an 'encouraged industry'; (iii) there was no functioning market for

²¹² WTO Appellate Body Report (n 164) para 385.

²¹³ *ibid* para 416.

land in China; (iv) the was evidence from cooperating exporting producers that land was allocated to them for their papermaking projects.²¹⁴ In evaluating the amount of the benefit conferred, an out-of-country benchmark was used and it turned out to be higher than the Chinese domestic land price.²¹⁵ The EU's analysis is likely to be referred to in future CVD investigations concerning China.

3. Market distortion and out-of-country benchmarks

In *US–Anti-Dumping and Countervailing Duties*, the Appellate Body specifically dealt with the issue of how to calculate the amount of benefit to the SOEs from the subsidies. Normally, in-country private prices in the country where the goods are provided should be used to determine whether any benefit exists. However, in-country private prices may be distorted due to the predominance of the government as a supplier in the market. Faced with such a scenario, the Appellate Body reaffirmed its earlier decision in *US–Softwood Lumber VI* that the SCM Agreement allows investigating authorities to discard in-country private market prices in favour of out-of-country price benchmarks if it can be showed that in-country private market prices are distorted and that alternative out-of-country benchmarks are related to prevailing market conditions in the country under investigation.²¹⁶ The Appellate Body then held that the Chinese government's predominant role and extensive intervention distorted the commercial lending market such that Chinese domestic interest rates were not appropriate benchmarks to determine the existence and amount of benefit associated with the Renminbi (RMB)-dominated loans from SOCBs.²¹⁷ Similarly, the Panel determined that China's provision of land-use rights to the producers investigated for an inadequate remuneration constituted a countervailable subsidy.²¹⁸ The Panel found that in-country private prices were not an appropriate basis of comparison when determining whether a benefit existed because all land was owned by some level of government in China and land prices were distorted by the significant role that the government had in the market by prohibiting private land ownership.²¹⁹

This ruling by the Appellate Body raised two key questions. First, when are in-country prices so distorted that they cannot be used as proper benchmarks for the calculation of the benefit? Second, if existing in-country private prices are rejected, what alternative benchmarks might be used as proxies for the counterfactual undistorted market?

²¹⁴ Council Implementing Regulation 452/2011, Coated Fine Paper from China, Official Journal of the European Union (OJ) 2011 L128/18 (definitive countervailing duty) paras 252–258.

²¹⁵ *ibid.* ²¹⁶ WTO Appellate Body Report (n 164) para 446. ²¹⁷ *ibid* para 509.

²¹⁸ WTO Panel Report (n 201) para 10.82. ²¹⁹ *ibid* paras 10.76–10.82.

a) Market distortion analysis

As regards the first question, the Appellate Body made it clear that the decision should be made by evaluating the role of the government in the market as a provider of the same or similar goods or services. If the government is a *significant* supplier, this fact alone cannot justify a finding that prices are distorted. Evidence pertaining to factors other than government market share is needed to prove distortion. However, where the government is the *predominant* supplier, it is likely that private prices will be distorted because the government's own pricing strategy can affect the prices charged by private providers for the same goods, though a case-by-case analysis is still required.²²⁰ In both instances, the investigating authority would have to reach its conclusion based on all the available evidence, including evidence regarding factors other than government market share.²²¹ Applying this test to the facts of the case, the Appellate Body found that Chinese SOE suppliers produced 96.1 per cent of all of the products in question in China, all of which were majority-owned by the Chinese government.²²² The Appellate Body considered that this fact made it likely that the Chinese government, as the predominant supplier, had the market power to affect the pricing of private providers for the same goods, and induce them to be in alignment with government prices.²²³ Since the in-country private prices are very likely to be distorted, the Appellate Body concluded that it was appropriate to use out-of-country prices, in this case the world market prices as reported in an international industry publication, as the benchmark from which to calculate the amount of benefits received by the enterprises under investigation.

The Appellate Body's ruling clearly shows that the market benchmark which it envisages is an undistorted or pure market.²²⁴ Implicitly or explicitly, this assumes that governments do not normally intervene in market activities.²²⁵ The ruling also assumes that government or government-affiliated entities will never price their goods or services at market rates and so if the government provides a majority, or a substantial portion, of the market in question, private prices will be distorted and out-of-country benchmarks should be sought. The possibility that the government might be operating on the basis of market-determined terms is completely ignored. Even though the Appellate Body said that it would review the decision on the basis of the all the available evidence, it stopped short of indicating what additional evidence would be considered and how the presumption of market distortion could be overturned in trade disputes.²²⁶

²²⁰ WTO Appellate Body Report (n 164) para 441.

²²¹ *ibid* para 443.

²²² *ibid* para 455.

²²³ *ibid*.

²²⁴ WT Zheng, 'The Pitfall of the (Perfect) Market Benchmark: the Case of Countervailing Duty Law' (2010) 19 *Minnesota Journal of International Law* 23.

²²⁵ DK Tarullo, 'Beyond Normalcy in the Regulation of International Trade' (1987) 100 *HarvLRev* 550.

²²⁶ Zheng (n 224) 27.

A more fundamental question arises from the undistorted market paradigm. Clearly, not all government intervention should be considered market-distorting: there has to be scope for regulation, for example. But how can legitimate government intervention be distinguished from illegitimate government intervention that should be countervailed? In *US–Anti-Dumping and Countervailing Duties*, the Appellate Body drew a distinction between a government’s role in implementing monetary policy on the one hand, and market distortions that may result from governmental participation and intervention in the commercial market, on the other.²²⁷ It rejected Chinese domestic interest rates as appropriate benchmarks against which to determine the existence and amount of benefit associated with the RMB-dominated loans from SOCBs. In other words, it thought that the Chinese government’s control of its banking sector somehow ‘crossed the line’. The real issue is where, precisely, the line actually is.

The Appellate Body’s decision is based on several characteristics of the Chinese banking sector, including (i) the government’s predominant role and its influence on interest rates, as evidenced by various publications by outside institutions; (ii) the fact that lending rates in China were largely undifferentiated, with most loans being made at rates close to the government-set benchmark rates, which is evidence that market forces were not operating and that banks still lacked adequate risk management and analysis skills; (iii) that foreign banks in China were subject to the same governmental controls as domestic banks, and finally, (iv) that privately owned Chinese banks account for a very small percentage of total lending.²²⁸ Even if all these allegations were true, it is difficult to see how each of these factors, separately or cumulatively, had any effect on the interest rates in question and, in particular, how these factors caused RMB’s interest rates to be lower than they would otherwise have been. The Appellate Body took the view that there was no specific requirement in the SCM Agreement that investigating authorities must show that government prices were artificially low in order to reject in-country prices. It simply *believed* that these factors, taken together, distorted the Chinese commercial lending market.²²⁹

b) Out-of-country benchmark

As discussed above, the problem with the market distortion analysis stems from the wide latitude granted to investigating authorities to conduct an essentially free-wheeling analysis. This problem is further exacerbated by the same latitude granted to investigating authorities to choose alternative benchmarks. The essential reason why investigating authorities can choose an out-of-country benchmark is to enable them to ‘replicate reliably market

²²⁷ WTO Appellate Body Report (n 164) para 498.

²²⁹ *ibid* paras 506 and 508.

²²⁸ *ibid* para 503.

conditions prevailing in one country on the basis of market conditions prevailing in another country and that appropriate adjustment would need to be made to avoid in particular the countervailing of comparative advantage'.²³⁰ In *US–Anti-Dumping and Countervailing Duties*, the Panel was confronted with the question of how to select a proper benchmark for Chinese land-use prices. The Panel agreed with the USDOC that prices for certain industrial property in Bangkok and adjacent provinces in Thailand might serve as a proper benchmark. In selecting the out-of-country benchmark, the USDOC took into consideration a number of factors, such as per capita Gross National Income (GNI), population density, the types of land transactions and the type of land at issue (land in industrial zones), etc.²³¹

Because land is by definition not traded across borders and because its value is largely determined by its location and by the uses to which it may be put, it is almost impossible to replicate the prevailing market conditions for land in one country by referring to land values in another, which has its own—and different—physical, social, political and economic environment. The Panel recognized that this is difficult from a practical point of view.²³² However, the Panel reasoned that the task of an investigating authority is to do its best to identify a benchmark that approximates to the market conditions that would prevail in the absence of the distortion. In order to do so, the authority must conduct a reasoned analysis based on factual information, selected and adjusted as necessary in order that it might be as comparable as possible to such market conditions. Nevertheless it remains to be explained why the factors considered by the USDOC are appropriate to indicate what the correct price of land might be in another country, as it is well known that appropriate adjustments for considerations of this nature are extremely difficult to make and are subject to manipulation in ways that can favour domestic interest groups.²³³

In *US–Anti-Dumping and Countervailing Duties*, the Appellate Body seems to demand reasonable rationale from WTO Members when they use out-of-country benchmarks. In calculating the benefit associated with RMB-denominated loans from Chinese SOCBs, the USDOC constructed a proxy—a multi-currency regression model based on per capita GNI and institutional quality—as a proper benchmark. China challenged the legality of the benchmark, arguing that the USDOC had not provided any coherent explanation why these factors made the proxy a proper benchmark. As the Panel blindly accepted the USDOC position without rigorous analysis, the Appellate Body held that the Panel had violated its obligation to perform an 'objective assessment of the matter' under Article 11 of the DSU. The Panel

²³⁰ WTO Appellate Body Report (n 155) paras 108–109.

²³¹ WTO Panel Report (n 201) para 10.165. The finding was not appealed.

²³² *ibid* para 10.184.

²³³ AO Sykes, 'The Questionable Case for Subsidies Regulation: A Comparative Perspective' (2010) 2 *Journal of Legal Analysis* 505.

was obliged to engage in a critical and searching review of whether the reasons put forth by the investigating authority could justify the proxy that it constructed, including testing the adequacy and reasonableness of the determination in the light of other plausible alternative explanations.²³⁴ The practical effect of the ruling should be to impose a level of discipline on the use of out-of-country benchmarks that investigating authorities might not have otherwise considered to exist.²³⁵ In future disputes, the construction of a proper out-of-country benchmark will likely be an issue for debate. It must be stressed that this controversy does not meaningfully restrict the USDOC's ability to impose CVDs using an out-of-country benchmark. It only requires the USDOC to provide more support for the methodology it uses to construct its benchmark.

E. Implications for Chinese state capitalism

While reducing or eliminating state ownership in the Chinese economy may be a desirable goal, it will be a very difficult goal to achieve in the near future. The SOEs and SOCBs are tools used by the government to develop China's economy, carry out macroeconomic stimulus, and increasingly to secure economic security and advance economic interests abroad.²³⁶ In the foreseeable future, the Chinese government will continue to offer substantial support and protection to strategic industries and will maintain a pivotal role in the allocation of capital to both private and state-owned enterprises.²³⁷

Although not every governmental act that distorts trade can be considered a subsidy, the SCM Agreement is nevertheless broad in scope and wide open for interpretation by the WTO adjudicating bodies.²³⁸ The additional disciplines embodied in the Protocol further strengthen the disciplines on the Chinese government. The Appellate Body ruling in *US–Anti-Dumping and Countervailing Duties* in some ways puts into question the very means by which the Chinese government regulates the national economy. Whether SOEs are 'public bodies' for the purpose of applying the SCM Agreement remains an open question. However, as has been analysed above, it is not unlikely that some SOEs in some cases may be regarded as public entities in future SCM disputes. The Chinese government still uses extensive governmental planning and industrial policies to rationalize investment and guide economic development. It turns out that such planning has made the specificity requirement much easier to meet than expected. Significantly, the Appellate Body did not specify the evidentiary standards that must be met before investigating authorities can reject in-country private market prices. Nor did it set out the evidentiary standards for alternative benchmarks to be considered in

²³⁴ WTO Appellate Body Report (n 164) para 523.

²³⁵ Prusa and Vermulst (n 202) 199–200.

²³⁷ Drake (n 19).

²³⁶ Szamosszegi and Kyle (n 69) 83.

²³⁸ Wouters and Coppens (n 158) 33.

relation to prevailing market conditions in the country under investigation. The Appellate Body leaves those two important decisions largely to the discretion of the investigating authorities. As a result, there appears to be a policy of considering all loans made by Chinese commercial banks to any of the industries featured in government planning documents to be countervailable subsidies.²³⁹ These rulings are likely to have significant long-term consequences for the use of CVDs against China.

The principal findings of the Appellate Body report were quickly followed by other WTO Members. The EU completed its first ever CVD investigation against China in May 2011. Unsurprisingly, the final ruling showed substantial similarities to the *US–Anti-Dumping and Countervailing Duties* Appellate Body report.²⁴⁰ The EU Commission concluded that Chinese SOCBs and policy banks are ‘public bodies’; that the interest rates of SOCBs and land prices in China are distorted to the extent that resort to out-of-country benchmarks is necessary.²⁴¹ It can be expected that the Appellate Body ruling in *US–Anti-Dumping and Countervailing Duties* has laid the groundwork for WTO Member states’ future CVD investigations on Chinese exports.

The ruling has profound implications for the further reform of Chinese SOEs as well as the banking sector. In order to avoid being categorized as ‘public bodies’, SOEs need to be genuine commercial entities making independent business decisions and competing with private enterprises on an equal footing. It is not a problem that the Chinese government remains the majority shareholder. However, SOEs should not be vested with or exercise government authorities. Otherwise, all other companies which have made purchases from such SOEs will face the potential threat of CVD investigations. It should be noted that the Appellate Body ruling is in fact consistent with the Chinese government’s SOE reform objectives. Over the years, China’s SOE reforms have been conducted on the principle of separating government administration from enterprise management and separating ownership from management. The Chinese government is thus well advised to use the Appellate Body ruling as an incentive to push forward further SOE reforms. The more daunting task concerns Chinese SOCBs and policy banks. In view of the approach taken by the Appellate Body to the indicators determining that China’s commercial lending market is distorted, it seems that without far-reaching reforms of the whole financial system, including allowing private capital to form commercial banks and enhanced market access for foreign banks, out-of-country benchmarks will be used for a long time to come. So far, the extent to which the Chinese government is committed to substantial reform of its rigid financial system remains uncertain.²⁴²

²³⁹ Dukgeun (n 198) 764.

²⁴¹ *ibid.*

²⁴² F Allen et al, ‘China’s Financial System: Challenges and Opportunities’ (2011) <<http://www.nber.org/papers/w17828>>.

<http://www.nber.org/papers/w17828>.

IV. CONCLUSION

Over the past three decades, the Chinese government has strived to move from a command economy to a market economy. Extensive economic reforms have produced an unparalleled economic miracle in China. However, it is important to understand that the Chinese political economy system, generally known as ‘state capitalism’, remains fundamentally different from Western liberal market capitalism. One key feature of China’s state capitalism is that the Chinese government, directly or indirectly, controls a large number of powerful SOEs, especially in strategic and key sectors. The Chinese government has strengthened these SOEs by streamlining them, professionalizing their management and demanding that they take responsibility for their own balance sheets. Many of the reforms have been quite successful and many Chinese SOEs have emerged as powerful modern enterprises playing significant economic and political roles in both the domestic market and the global market. However, in order to foster these ‘national champions’ and develop them into internationally competitive modern enterprises, the Chinese government has granted them a range of fiscal and regulatory advantages. The resulting perception of unfair trade has undermined international trade and investment relations between China and other WTO Members.

This article has addressed the question of how WTO law deals with China’s state capitalism. After canvassing China’s extensive SOE reforms in the past 30 years, the conclusion is that the relationship between Chinese SOEs and the Chinese party-state presents a mixed picture. To a very large extent, Chinese SOEs are independent market entities who are confronted with competition from Chinese domestic private enterprises and foreign-invested enterprises. In addition, the benefits conferred on SOEs have been consistently eroded as a result of extensive market-oriented reforms. Bilateral and multilateral economic dialogues and WTO litigation have further persuaded China to remove measures that provide SOEs with competitive advantages. Increasingly, Chinese SOEs are becoming similar to genuine commercial entities and their government-provided competitive advantages are disappearing. However, the Chinese government still retains a strong influence over SOEs.

In view of the complicated nature of the government–enterprise relationship in China, it is important to conceptualize Chinese SOEs properly. In this connection, the WTO case law, especially the recent *US–Anti-Dumping and Countervailing Duties*, has demonstrated that WTO Agreements are remarkably flexible when addressing the challenges posed by China’s state capitalism. Indeed, the WTO rules have been interpreted in such a manner that many key features of China’s state capitalism could easily be challenged by its trading partners in a WTO-consistent manner. This article has also identified several gaps in the reasoning of the Appellate Body in *US–Anti-Dumping and Countervailing Duties* and has suggested that such gaps should be filled in future WTO dispute settlements.

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