China, State Capitalism and the World Trading System

1.1 Introduction

On 10 November 2001, China finally joined the World Trade Organization (WTO) after a marathon accession negotiation stretching 15 years.1 Fast forwarding 20 years, China has emerged as the largest trader in the world, yet the world trading system is in crisis, with its dispute settlement system in paralysis and its latest negotiation round – the Doha Round – languishing for most of the past decade. Some observers argue that the triumph of China and the decline of the WTO are not mere coincidence but deeply correlated. According to them, China manipulated its trade practices through its state capitalism model to get where it is today, and this is exactly what precipitated the crisis at the WTO, because its rules are ill-equipped to deal with China’s practices which violate the spirit but not necessarily the letter of the world trade law, thus leading to the collapse of its dispute settlement and negotiation functions.

As we write this book, this narrative remains the most popular in the trade law circle, with some key WTO Members, particularly the United States, pushing for reforms of the multilateral trade rules. The United States, under the Trump administration, vehemently criticised the WTO for being ‘incapable of fundamentally changing [China’s] trade regime that broadly conflicts with the fundamental underpinnings of the WTO system’.2 The Biden administration has largely maintained this position. In a recent speech, the United States Trade Representative (USTR) Katherine Tai criticised ‘China’s lack of adherence to global trading rules’


and failure to make ‘meaningful reforms to address the concerns’ about ‘its state-centered economic system’. The European Union (EU) shared the United States’ concerns by labelling China’s ‘state-capitalist model’ and associated ‘unfair trade practices’ as the fundamental challenge for the world trading system. To address these concerns, the two Members, along with Japan, issued a series of joint statements calling for the strengthening of the WTO rules on state owned enterprises (SOEs) and industrial subsidies.

The popularity of this narrative is not hard to understand as it combines all of the right elements: the economic rise of China, its practice of state capitalism and the decline of the world trading system. Yet, having the right elements can only guarantee a nice story, not the correct answer. The biggest flaw of the narrative is that it mistakes correlation with causation. As we will unpack in this book, the full story of the interactions between China’s state capitalism and the world trading system is much more nuanced than this simplistic narrative. As a matter of fact, concerns over the potential incompatibilities between China’s unique economic system and the rules of the multilateral trading system are not new. As soon as China applied to return to the General Agreement on Tariffs and Trade (GATT), the predecessor of the WTO, the Members noticed the problems and carefully crafted China-specific rules to tackle them in the final accession package. Upon its accession, China initially made a conscientious effort to reform its economic system, especially its SOEs, in the direction of more market-orientation

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as aligned with the requirements of WTO rules. However, as time went by, China’s reform process stalled and even went into reverse gear over the past decade. But this does not necessarily mean that the existing WTO rules are useless in dealing with China’s state capitalism. If anything, the degree of marketisation in China today is certainly much higher than it was 20 years ago, when China first joined the WTO, and even more so than 36 years ago, when China sought its return to the multilateral trading system. Thus, the extensive discussions on China’s state capitalism that took place during the accession negotiation, including the problems with state control of the economy and the solutions worked out by existing WTO Members and China together, are highly relevant today.

This book challenges the conventional wisdom that the existing WTO rules are inadequate to address China’s state capitalism, particularly the market-distortive conduct of Chinese SOEs supported by industrial policies and subsidies. Our key argument is that China’s WTO-plus obligations, coupled with the general rules on subsidies, can be applied to tackle these problems. This argument is advanced not only through a detailed analysis of the relevant general WTO rules, but also a thorough examination of the evolution of China’s SOE reforms, especially fresh insights from the latest phase, and a critical review of the WTO-plus obligations in China’s WTO accession package. The latter review shows that these China-specific rules were not intended to mandate a systemic change of China’s economic model, but merely to tackle select aspects of the Chinese system. Thus, the concerns with China’s state capitalism model were more specific than systemic, contrary to the above-mentioned narrative that has dominated the debate about China and the world trading system. Through these discussions, this book also expounds the challenges posed by state intervention, SOEs and non-market economies (NMEs) to the multilateral trading system and the relationship between WTO rules and state intervention, the nature of rules on subsidies and other market-distorting practices. Moreover, to strengthen our argument, this book critically examines the efficacy of new sets of rules advanced in recent free trade agreements (FTAs), particularly the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and some major post-CPTPP agreements such as the China–EU Comprehensive Agreement on Investment (CAI). We argue that, compared with these new rules, China’s WTO-plus obligations remain more rigorous in many substantive aspects.
Based on the above analyses, a major policy recommendation of this book is that WTO Members should continue to resort to the WTO dispute settlement system to challenge China’s state capitalism using existing rules. This book provides detailed guidelines on how to make this litigation strategy more fruitful. New WTO rules, if needed, can be developed only via multilateral negotiations. Here, the ongoing discussion on WTO reform provides a good opportunity to engage China, especially in view of President Xi’s recent announcement that China would be willing to engage in discussions on issues relating to SOEs and subsidies, which are the key elements in its state capitalism model. While the details for such discussions are still being worked out, the negotiations can only be successful if certain rules of engagement, as outlined in this book, are followed. Of course, as it takes time to negotiate the new rules, WTO litigation based on existing rules remains the best option, at least for now and for some time to come.

Finally, while this book focuses on China (for good reasons), most of its analysis is not limited to China alone. Instead, issues such as the challenges of SOEs for global trade and governance, the applicability of WTO rules to SOEs and the development of multilateral and regional approaches to tackling SOE-related issues are all systemic problems in international trade regulation. Accordingly, this book offers a valuable source for future studies, policymaking and trade law practice not only in relation to China but also the development of the world trade rules more generally.

1.2 State Capitalism, State-Owned Enterprises and China

As an evolving concept, ‘state capitalism’ has developed new meanings in the globalised world. Nowadays, it is no longer accurate to equate state capitalism with purely planned or command economies, or bluntly contrast it with free market capitalism. Most economies have undergone some degree of market opening and domestic reforms in pursuit of economic growth. A more nuanced definition of state capitalism, thus, refers to the magnitude of government involvement in business activities depending on ‘state ownership stake in or significant influence over’ the

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business sector. While state capitalism takes different forms in different economies, a common feature pertains to the extensive role that SOEs have been playing in consolidating and expanding state capitalism.

The mounting challenges posed by SOEs to the world economy are widely documented. The Organization for Economic Co-operation and Development (OECD), in particular, has taken a range of initiatives to explore these challenges and the regulatory approaches to address them. The starting point is to treat SOEs as a global issue because many economies other than China maintain a significant state sector. As observed by the OECD, the underlying problem arises from the non-commercial behaviour and conduct of SOEs driven by political or policy motives rather than commercial interests. Such behaviour and conduct is typically enabled by a wide spectrum of unfair competitive advantages given to SOEs, ranging from subsidies and preferential financing to privileged access to information, regulatory advantages, protected monopolistic positions and other forms of government support. As SOEs increasingly compete with privately-owned enterprises (POEs) in home and foreign markets, their privileged position and anti-competitive practices lead to significant market distortions and undermine the interests of POEs, particularly those of trading partners.

When it comes to China, it is widely observed that, despite the rapid growth of the private sector and the progressive liberalisation in China, SOEs remain one of the principal mechanisms of Chinese state capitalism. In fact, China’s ongoing SOE reform has strengthened rather than weakened state capitalism through the growing influence of the state and

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9 See generally Kurlantzick, State Capitalism, n. 8, 29–47.
12 Ibid., 27.
13 Ibid., 28–30.
the Communist Party of China (CPC or Party) on Chinese firms, especially SOEs.\textsuperscript{16} The control of SOEs by the state/Party is not necessarily problematic, at least not under the rules of the WTO. However, combined with other factors, such control could and often does result in anti-competitive effects. One such factor concerns a range of state support conferring significant competitive advantages on Chinese SOEs through direct and indirect subsidies, preferential regulatory treatment and exemptions, etc. These problems are further exacerbated by China’s unique economic model, which treats SOEs as the primary economic agents of the state and the main instrument for implementing industrial and other national policies.\textsuperscript{17} Frequently, the state combines large SOEs that are already market leaders individually to create behemoth national champions in disregard of antitrust concerns.\textsuperscript{18} In addition to squeezing competitors out of the relevant Chinese market,\textsuperscript{19} SOEs have also been used as a vehicle to restrict market access to China by foreign competitors and expand China’s presence in foreign markets through aggressive bids and other means, often with the financial backing of the Chinese government.\textsuperscript{20} Moreover, state/Party controls not only create such anti-competitive effects but also tend to sustain those effects by preventing markets from self-correcting through the confluence of factors such as vertical policy actions, administrative monopoly and preferential support for SOEs.\textsuperscript{21} Accordingly, these practices not only raise concerns about competition in general but also pose mounting challenges to the multilateral trading system, as they undermine the conditions of competition


\textsuperscript{17} See William Kovacic, ‘Competition Policy and State-Owned Enterprises in China’ (2017) 16(4) \textit{World Trade Review} 693, 704.


\textsuperscript{20} See Kovacic, ‘Competition Policy and State-Owned Enterprises in China’, n. 17, 705.
that the WTO is designed to maintain. Therefore, they put to the test the adequacy and efficacy of WTO rules in coping with Chinese state capitalism.

1.3 International Regulation of State-Owned Enterprises

The challenges posed by SOEs entail two essential policy responses. Competitive neutrality, as the first response, seeks to constrain preferential treatment or the privileged position of SOEs so as to remove their competitive advantages and level the playing field vis-à-vis POEs. This approach requires not only rules to deal with subsidies and other preferential treatment enjoyed by SOEs but also rigorous competition laws and enforcement more broadly. Competition policies and enforcement, including competitive neutrality, vary considerably across jurisdictions, and harmonisation among different economic, political and social systems can hardly be achieved in any near future. In the case of China, its competition law and enforcement have largely failed to constrain the competitive advantages and anti-competitive practices of Chinese SOEs. Therefore, while competitive neutrality is a key element to address the ‘SOE problems’, it is also imperative to discipline the market-distortive behaviour and conduct of SOEs directly.

The second response tackles the market-distortive behaviour and conduct of SOEs, especially when engaged in commercial activities that harm the interests of foreign competitors. The scope of these disciplines hinges on how SOEs are defined and enforcement requires access to detailed information about SOEs, the support they receive from

23 See García-Herrero and Ng, ‘China’s State-Owned Enterprises and Competitive Neutrality’, n. 22.
26 See OECD, State-Owned Enterprises as Global Competitors, n. 10, 83–95.
governments, etc., which in turn calls for rules on transparency and disclosure.27 At the same time, however, the legitimate needs of governments to use SOEs for public policy objectives are also generally recognised.28 This means that international disciplines on SOEs are necessarily subject to exceptions and exemptions so as to save the policy space needed by governments.

This book does not discuss competition rules in trade agreements but focuses on disciplines on the behaviour and conduct of SOEs. The general WTO rules that apply to all Members do not define SOEs and provide only limited disciplines. While we acknowledge that the existing WTO rules are not perfect in this regard, especially the general agreements of the WTO, we do believe in the potential of several China-specific rules in its accession package which have been strikingly underutilised to date. Given the broad coverage of these rules, they can be applied to address the major problems associated with China’s state capitalism such as non-commercial behaviour of Chinese SOEs, the supportive industrial policies and subsidies they receive and state intervention in the market more broadly. However, to unleash the full potential of these rules, WTO Members need to invoke these rules to challenge the relevant Chinese laws and practices via litigation. As shown in past cases, WTO litigation can not only build a body of jurisprudence that clarifies the scope of the China-specific obligations but also push China to undertake systemic adjustments.29 Without recourse to the dispute settlement system, the potential of these obligations and their impact on China will only remain tenuous. It follows that the conventional narrative about the inadequacy or ineffectiveness of the existing WTO rules is untenable and misleading.

As noted in the Introduction, we are aware of the efforts by some WTO Members to explore new approaches to regulate SOEs in FTAs such as the CPTPP and the CAI. However, these rules do not add much new to the existing rules in China’s WTO accession package. While China’s engagement with the EU on the negotiations of the CAI and its recent request for entry into the CPTPP are a good sign of its

28 See e.g. OECD, State-Owned Enterprises as Global Competitors, n. 10, 19; OECD, Guidelines on Corporate Governance of State-Owned Enterprises, n. 10, 12–13.
willingness to accept more international disciplines on SOEs, trade negotiators will need to rethink the efficacy of the CPTPP/CAI rules on SOEs.

1.4 The Structure of This Book

The summary provided in this chapter not only provides a background for our detailed discussions in this book but also maps our core arguments, which will be unfolded in the subsequent chapters as follows:

In Chapter 2, we trace the contours of China’s SOE reform since 1978, when the reform and opening up policy was first adopted. We divided the four decades of reform into five phases, where the first two phases focused on ensuring the survival of SOEs by granting them operational autonomies, first at the firm level and then at the managerial level. China did not have much choice for the initial phases of the reform, as the old system of central planning was obviously not working, as proven by the dilapidated state most SOEs were in as they emerged from the Cultural Revolution before Deng Xiaoping took power in 1978. The third phase of the reform was premised on the philosophy that SOEs should be made profitable, which saw the adoption of corporatisation strategies for the ones deemed promising and privatisation of the ones deemed unviable. It is interesting to note that this wave of privatisation took place in the decade after Deng’s famous Southern Tour and also coincided with the final stretch of China’s WTO accession. It could be argued that the privatisation efforts helped to dispel potential concerns over the sincerity of China’s economic reform and paved the way for China’s final accession. The fourth phase of the reform covered the first decade after China’s accession to the WTO, where the earlier trajectories were continued, as we can see in the efforts to continue the market-oriented reform for SOEs with plans of commercialisation and modernisation. At the same time, a worrying trend also started to emerge during this period, when the government launched various campaigns to create national champions. This trend was not only inherited but also amplified as we enter the new era of ‘Socialism with Chinese Characteristics’, where SOEs, strengthened by the previous rounds of reforms, started to squeeze out private firms in various forms. At the same time, the CPC has also stepped up its efforts to enhance its influence in SOEs by launching aggressive drives to build Party cells in these entities to enhance Party control in the current round/phase of SOE reform. This goes against the direction of market-oriented reform in previous phases, and it is no
wonder that this phase also saw the rise of the narrative that WTO rules are ill-equipped to handle China’s state capitalism, a claim that we debunk in Chapter 3.

In Chapter 3, we deflate the myth that China’s state capitalism is a new problem, with an extensive review of how such concerns were discussed and addressed during China’s WTO accession. Drawing from the negotiation records in the Report of the Working Party on China’s accession, we demonstrate that WTO Members were well aware of the potential clashes between WTO rules and China’s state capitalism since the very beginning. Yet, contrary to those who argue that state capitalism is inherently incompatible with the WTO, the Members believed that practical solutions could be found to minimise the inconsistencies between WTO rules and China’s trade practices. Thus, they meticulously identified specific aspects of the Chinese system that might undermine its WTO commitments and carefully crafted surgical solutions to address these problems in WTO-consistent ways. Such an approach is much better than the one demanding a complete overhaul of China’s economic system, as it not only minimises the resistance of China but also ensures that the problematic areas are fully addressed. Thus, the theory that the accession negotiation failed to address the problems presented by China’s state capitalism is unconvincing. Instead, the practical approach adopted in the negotiation demonstrates the faith among WTO Members in the ability of the WTO to act as a neutral forum for countries with different economic systems to interact with each other, which is the topic that we explore further in Chapters 4 and 5.

In Chapters 4 and 5, we explore the utility of different WTO rules in disciplining market-distortive behaviours of SOEs and subsidies that enhance their competitive advantages, with some being more promising and others less so. The less promising ones are discussed in Chapter 4, including GATT rules on import monopolies, state trading enterprises (STEs), transparency, and anti-dumping (AD) measures. In our view, these rules are all of limited utility, albeit for different reasons: the rules on import monopolies and STEs are quite narrow in terms of the coverage of policy instruments and the prescribed obligations, the transparency obligation is rather toothless, while the ability to use AD measures to deal with market distortions due to state intervention has been curtailed by the Appellate Body (AB) in recent cases. Of course, this does not mean that all WTO rules are useless. Instead, as discussed in Chapter 5, great potential can be found in China-specific rules on pricing and the commercial behaviour of SOEs, coupled with WTO rules on
subsidies both in the original Agreement on Subsidies and Countervailing Measures (SCM Agreement) and further elaborated in China’s WTO Accession Protocol. In particular, in response to the argument that WTO subsidy rules have been rendered ineffective by the AB’s interpretation of the term ‘public body’, we argue that the utility of the provision has been rehabilitated by the AB’s subsequent decision in US – Countervailing Measures (China) (Article 21.5). Moreover, even the original ‘authority-based’ test is no longer an insurmountable hurdle due to the backtracking of China’s SOE reform in recent years, which resulted in more micro-management by the Party and state in the management of SOEs. Thus, the best way to tackle China’s state capitalism is through WTO litigation based on existing rules discussed in this chapter. That said, we are aware of the different views and proposals of some key Members in favour of the development of new rules on SOEs. Their approaches to advancing such new rules, particularly through various regional initiatives such as the CPTPP, are discussed in Chapter 6.

Chapter 6 provides a critical evaluation of the new rules on SOEs developed in international trade and investment agreements, with the CPTPP as the leading example. Despite its reputation as a ‘twenty-first century high-standard trade agreement’, we argue that the SOE rules in the CPTPP do not add much to the existing rules in the WTO and are less rigorous than China’s WTO-plus obligations discussed in Chapter 5. In particular, the scope of the covered entities under the CPTPP tends to be narrower, while its rules on commercial considerations, non-discrimination, and subsidies do not go beyond the obligations crafted for China in its accession package. Moreover, the rigour of these CPTPP rules is further reduced by the inclusion of extensive exemptions and exceptions that allow CPTPP governments to carve out sub-central SOEs and schedule non-conforming measures. This chapter then examines some major post-CPTPP trade and investment agreements with significant rules on SOEs including the EU–Japan FTA, the EU–Vietnam FTA, the United States–Mexico–Canada Agreement (USMCA) and the CAI. As one of China’s latest international agreements, the CAI is also the first treaty where China agreed to SOE rules outside the WTO. Again, the main substantive obligation here – the one on commercial considerations – simply repeats the existing obligation in China’s WTO accession package. While all of the FTAs discussed in this chapter should be praised for setting new and higher standards of transparency, they do not resolve the longstanding problem of enforcement – the most challenging issue under the WTO’s transparency regime. By the end of this
chapter, we have set out all the materials and analysis to support our core policy recommendations focusing on litigation and negotiation in the WTO, which are elaborated in Chapter 7.

Drawing on our analysis in the previous chapters, Chapter 7 is dedicated to a more focused discussion on how to tackle China’s state capitalism in the WTO. The first option is utilising existing WTO rules, especially those China-specific provisions, to bring cases against China, which so far has not happened. This is partly due to the perception that WTO litigation does not work against China, an argument which we refute by referring to China’s good compliance record with WTO decisions. At the same time, we do agree that a more strategic approach should be taken in bringing such cases and proceed to suggest the types of cases that should be brought and how the evidentiary burden could be met. The second option is through trade negotiations. While bilateral negotiations such as the US–China Phase One deal do not really work, there is great potential in multilateral negotiations. Here, we caution against those advocating the exclusion of China in such rule-making efforts and argue that China should be engaged to make the negotiation fruitful. To make the discussions more productive, we also suggest certain guidelines to make sure that China will be more constructively engaged. Hopefully, with President Xi’s recent statement that China would be willing to engage in WTO reform discussions on SOEs and subsidies, coupled with the more widespread use of subsidies by Western governments during the COVID-19 pandemic, more common ground can be found between China and the other major players in the system in the pursuit of more advanced rules on SOEs and subsidies.

In the conclusion, Chapter 8 sets out the main findings and suggestions from the preceding chapters, and tries to gaze into the future even though we do not have a crystal ball. Only time will tell which of our predictions turn out to be true but, regardless of the outcome, we hope that our book has made some modest contribution towards the understanding of the multi-faceted challenges presented by China’s state capitalism to the multilateral trading system and in turn helps strengthen the WTO, an institution that we have both served and deeply believe in.