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China's "Socialist Market Economy": A Systemic Trade Issue

EU/China trade relations are intense and rewarding as well as problematic, depending on one's perspective. China is the EU's second trading partner, second only to the US, and the EU is China's first trading partner. However, in goods the EU's 2017 exports are only about 61% (198 billion euros) of EU imports from China and this imbalance seems structural. In services, trade is much less developed, with bilateral EU 2016 exports amounting to a mere 37 billion euro and EU imports at 27 billion euro. Also, the EU foreign direct investment (FDI) in 2016 in China was 178 billion euro – far below what one would expect for such a large and rapidly growing mid-level income country; China's FDI stock in the EU is 44 billion euro. Moreover, FDI flows from the EU to China have slowed to a trickle, and stocks are now growing mainly due to reinvested earnings as repatriation is severely restricted. Focusing on the details,[1] China's industrial tariff protection, though on average only about double the EU rates, is fine-tuned to restrict the imports of many EU comparative advantage goods at six and eight-digit levels. Regulatory aspects of trade, e.g. technical barriers to trade, food and feed rules and inspections (SPS), intellectual property rights (IPRs) – in particular their effective enforcement, etc. – have a chilling or outright restrictive effect on EU exports. EU exported services (aside from retail, which is largely a matter of FDI) are either banned or severely restricted and/or face markets dominated by local State-Owned Enterprises (SOEs) such as insurance and banking.[2] Additionally, China's incoming FDI policies have largely retained their overly restrictive character despite the switch to a negative list. It is therefore a mixed picture at best. There are a few bright spots: the rapid growth of EU food exports to China and the recent average annual growth of goods trade (2013-2017) of 7.6%, both for exports and imports. The usual response of EU trade policy negotiators is, understandably, to insist on lowering the many market access restrictions. More generally, negotiators want reciprocity as China's market access to the EU is incomparably easier and FDI is fairly or complete unrestricted. The current negotiations on a bilateral investment agreement (called CAI) are a litmus test for the EU for far more liberal FDI rules in China as well as market access issues connected with FDI. If the CAI is successfully negotiated, a free trade area is likely to be considered.

This conventional trade policy approach is widely supported for good reason. Nevertheless, 17 years after China joined the World Trade Organization (WTO), it is a necessary but insufficient provision for healthy, future trade and investment relations with China. It should be complemented by addressing the profound systemic issues of the "socialist market economy with Chinese characteristics". In a way, this point is not new. Before becoming a WTO member, China was aware of the need for deep and widespread reforms to transform its planned and heavily state-driven economy into more of a market economy. During the 1990s, China introduced drastic reforms for SOEs including huge lay-offs and reductions in unemployment benefits, and adopted many laws allowing or further facilitating market incentives. The Accession Protocol

1 See J. Pelkmans et al.: Tomorrow's Silk Road - Assessing an EU-China Free Trade Agreement, London 2018, Rowman & Littlefield International.

2 Some specific services have good market access because China needs them, e.g. certain environmental services.

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for China in 2001 specifies a number of additional reforms or actions, coupled with a decade of supervision by a special WTO committee. The EU (as well as other WTO members) has repeatedly asked China to pursue further reforms for a better fit in the world trade system which implicitly – and to some extent explicitly – is based on market economies trading with one another. In the margin, occasional WTO Appellate Body cases have concluded that specific restrictions or practices in China should be brought in line with market conforming practices. Nevertheless, until very recently, no fundamental review of the conformity or compatibility of China's socialist market economy with the WTO and the legitimate trading interests of its members has been undertaken, largely because the EU (and the US and Japan, to name a few) maintained the hope that China would eventually respond to requests in a cooperative manner. This was complicated even further as China repeatedly promised bilateral and multilateral reforms and even produced domestic reform plans, time and again, to little effect other than buying time. In the meantime, China introduced new forms of subtle yet massive interventionism, undermining the credibility of the aforementioned promises. Of course, it is arbitrary to decide at what point numerous piecemeal actions and (largely) fruitless cooperation on such systemic issues are no longer acceptable to WTO partners. In any event, there is little doubt that this moment has now come. This article will attempt to provide a look at the systemic issues at stake and briefly refer to the new, more strategic approach of leading trade partners, including the EU, to address the issues. I will sketch the components of the socialist market economy with Chinese characteristics and examine the substance of the US 301 case on involuntary technology and IPR transfer, now also filed at the WTO with substantive EU support. Finally, I'll briefly discuss China's new industrial policy going back to 2006, which has been thrown into high gear with the massive and ambitious 'Manufacturing Made in China 2025' strategy initiated in 2015 and the large new set of disturbing distortions it has generated.

Understanding the socialist market economy

The EU has a history of trying to determine what a 'market economy' is and is not, following the formulation of the 1993 Copenhagen criteria which had to be applied to candidate countries for EU membership. Although this alone is problematic enough, it is surely much more difficult to establish a rigorous and factual definition of a 'socialist market economy'. In the Chinese case, what matters most is whether the types and multitude of interventions unduly frustrate trade in goods and services under the WTO given the rules and case law interpretations, the WTO Accession Protocol of China (in 2001), and the reasonable expectations of WTO partners. These could potentially significantly damage the legitimate interests of trading partners. One fundamental expectation of trading partners is that the WTO assumes markets play their role, even if there are many exceptions and even if domestic interventions generate distortions. Drawing the line is not only difficult – and at times even arbitrary – but there are grey areas because the drafters of the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS) simply do not anticipate that non-market economies can be WTO members without switching to a market-based model. The development strategy of China and its insistence on being a 'socialist market economy with Chinese characteristics' have forced WTO partners to focus on the implications and damage caused by China's system, both bilaterally and multilaterally.

Nature of and main interventions in today's Chinese economy

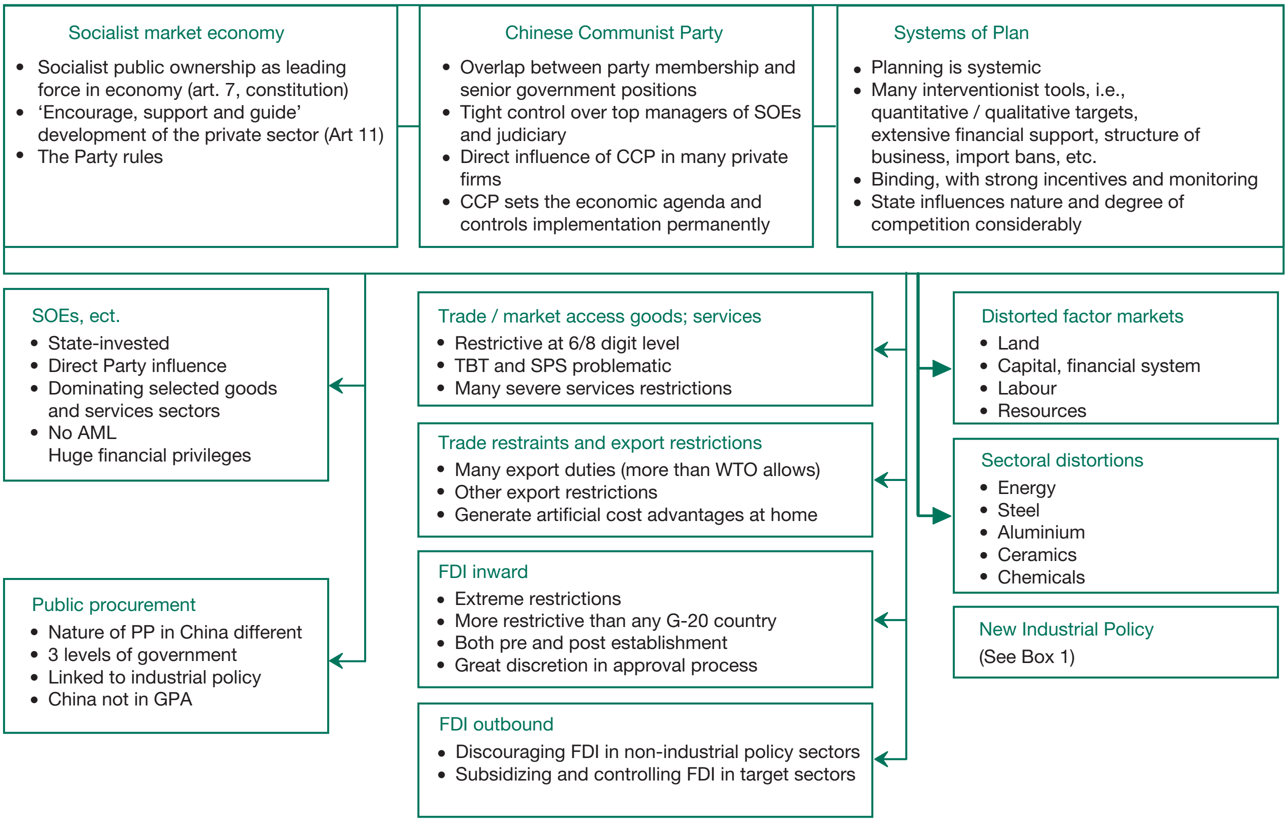
In order to get a comprehensive idea of what today's 'socialist market economy with Chinese characteristics' encompasses, see Figure 1. It may be viewed as a survey of the systemic nature of interventionism, varying over time with the perceived strategic needs of a rapidly developing economy.

Figure 1 shows clearly how pervasive and intrusive interventionism is in China today. Only by studying this general systemic picture does one begin to realise that a casuistic approach of identifying specific (e.g. sectoral interventions) or a particular distortion (for example, at the provincial level), or a case of specific discrimination (of foreign enterprises, products or services) fails to address the deep seated problematic nature of the socialist market economy. Conversely, it helps to explain why specific piecemeal liberalisation, usually under conditions, often has little or no impact in markets and leaves trading partners and foreign enterprises in China disappointed. Figure 1 largely speaks for itself. The top layer of the figure displays the fundamentals of the socialist market economy, as defined in the Chinese constitution and in the constitution of the Chinese Communist Party (CCP).[3] The system of plans is crucial, still today. It is allowing or even imposing many interventionist tools that are binding – something that goes against the very nature of a market economy, but is frequently ignored outside China. It is enforced quite effectively via incentives (and party promotions), tight monitoring and informal or financial sanctions. Even more worrying is the strict control the CCP exercises over the top appointments in the larger SOEs.[4] Under Xi Jinping, CCP representatives serve as observers or members of the board in both SOEs and private firms, in order to check and promote the implementation of the relevant segments of the planning. There are hundreds of sectoral and horizontal plans in addition to those at provincial and local levels. Some 150,000

3 The CCP has its own parallel constitution.

4 And in the judiciary!

Figure 1
Socialist market economy with Chinese characteristics



Source: Author's compilation.

firms have CCP board members already and the number is rapidly increasing. The Chinese elite already tend to have well-developed network connections which has the effect of blurring the distinctions between private and state-owned firms. Moreover, private firms cannot easily exercise their rights as courts capable of taking such action do not exist.[5] This also means, of course, that foreign investors have no genuine recourse on state-driven or plan-inspired interventions, even when seen as unfair or damaging policy reversals. The constitution is clear in stressing that public ownership is dominant (Article 6). Even in the interesting reform strategy of November 2013 (3rd Plenum) with 60 reform proposals ('let the market play the decisive role'), the decision affirms that 'public ownership plays a dominant role' and 'is the foundation of the socialist market economy'. 'Reforms' in China typically refer to the rebalancing of the economy (e.g. towards services, away from heavy industry and from assembly to more value-added in value chains which implies a shift towards advanced sectors), rather than rebalancing the role of the state and that of markets.[6]

The left side of Figure 1 specifies two core instruments of the state: SOEs and public procurement. The position of SOEs is powerful and their influence is enormous. They are used as essential tools for a range of policy interventions whilst there are many indications that motives such as profit-seeking and productivity increases over time are secondary at best. Where SOEs (e.g. in steel and aluminium, and some other sectors) are making losses or even turn into 'zombie firms', they rarely go bankrupt; instead, the state (at central, provincial and local levels) explicitly encourages and supports mergers. The state then absorbs the losses, managing the shedding of labour and only eventually raising productivity. Such approaches are not what markets would realise (even when there is a social plan for workers): competitors

5 Stronger, chapter 75 of the 13th plan (2016 – 2020) is about building a "rule of law China", yet, it emphasises "… we will strengthen the Party's leadership over legislative work …". Quoted from European Commission: Commission Staff Working Document on significant Distortionsl in the Economy of the People's Republic of China for the Purposes of Trade Defence Investigations, SWD(2017) 483, Brussels, 20 December 2017, p. 11.

6 Paraphrased from European Commission, op. cit., p. 12.

who do better, foreign or domestic, have no chance to expand their market share. Even when SOEs are not operating on a loss, consolidation is often aggressively encouraged in order to lay the groundwork for investments in new products, additional and new R&D, and even foreign investments for technology acquisition. SOEs dominate certain goods and services sectors, actually pre-empting competition from foreign investors. Suspicions of tacit collusion are widespread as the AML (competition law) does not apply to SOEs; and the encouraged mergers are not subjected to merger control. Chinese public procurement law has a very different history than that of Europe, in that its initial purpose was to instill budget discipline throughout the public sector in China.[7] It was not considered a market issue. When entering the WTO, China promised to join the GPA, the Government Agreement on Public Procurement; despite six offers, however, other GPA partners could not be convinced and therefore this giant market did not open to foreign bidders.

The central column of Figure 1 is about trade and investment. It is striking to see that restrictiveness is everywhere, even in outward FDI, which is still subject to an approval system, something that is undoubtedly conflicting with a market economy. The approval system is linked to foreign exchange controls and to explicit targets for FDI in acquiring foreign technology and IPRs like patents and trademarks (brands). Trade in goods and even more in services is restricted by China, and it has remained mostly closed.[8] FDI into China is even more restricted:[9] until 2014, China was more restrictive in incoming FDI than any other country in the OECD FDI restrictiveness index (including all G-20 countries and several developing countries known to be restrictive). This index for China has held constant since 2006. In 2016, the index went down a little but it is still more restrictive than other BRICs, let alone OECD countries. Moreover, the index is based on verifiable measures, and therefore ignores the informal pressures from and discretion of Chinese officials that businesses from many countries have been complaining about for decades. Such discretion is used to force foreign investors to transfer technology and align industrial policy measures where relevant. These pressures come on top of the obligation in many sectors to conclude a joint venture with a Chinese partner which cannot be controlled by the outside investor and in which the Chinese partner conducts the negotiations with the government(s). The recent announcement by Xi Jinping himself that wholly-owned subsidiaries will become possible in a range of sectors would be a significant policy reversal but European business in China remains sceptical for the moment. Finally, China employs a battery of export restraints, such as export duties,[10] export licences, export bans and quotas. Support for exports consists of variable VAT rebates, among other things. In export finance and credit insurance, China is not a partner of the OECD system and this has led to considerable complaints by international business in third markets (e.g. in Africa and elsewhere) where Chinese companies can undercut bids by other companies due to a lack of disciplinary action.

The right-hand column is about distorted factor markets and sectoral distortions of two kinds: traditional sectors and ten advanced sectors, some of them significant. The distortions in factor markets are often considerable: free land for many SOEs, capital markets or the entire financial systems completely controlled by SOEs and residual restrictions, capital markets used for support measures and many others.[11] This also applies to the sectoral distortions of the five sectors specified.[12] The sectoral distortions have to be assessed in conjunction with those generated by the more horizontal ones in the top layer of Figure 1, with the distortions generated by the system of SOEs, and those generated by the financial system. The box on the new industrial policy will be discussed below.

The case on involuntary technology transfer including IPRs

One long-standing complaint about the Chinese system for incoming FDI (if permited at all) is the combination of compulsory joint ventures with Chinese companies and involuntary technology and/or IPRs transfer. Since the Chinese entry into the WTO, a formal obligation to transfer technology as a condition for incoming FDI is forbidden. The involuntary transfer is now arranged in two partly overlapping ways. In the first route, an application for FDI by a foreign company induces informal pressure signalled by Chinese officials, but without any papers or emails involved. Given the discretionary power of the officials and the de facto impossibility to assure one's rights or object to violations of the WTO, foreign companies face a major dilemma – they can either bow out of the huge Chinese market or they must give up control of their valuable technology, trade secrets and/or IPRs. Many firms see no way other than to condone the involuntary transfer.

The second route is to form a joint venture (JV) with a Chinese partner. The partner – as majority owner – conducts the negotiations with the administration. Usually this occurs without the foreign company. The JV is told – again, infor-

7 See J. Pelkmans et al., op. cit.
8 Ibid., chapters 6, 8, 9, 10, 11 and 13.
9 Ibid., chapter 15.
10 In 2017 statutory export duties for 102 tariff lines, up to 50%, and another 179 tariff lines (8 digits) for interim duties, down from 314 (in 2015), after China lost WTO cases on the matter e.g. because the Accession protocol limits the number of export duties to 80. See WTO: Trade Policy Review China, 2018, pp. 61-65.
11 See European Commission, op. cit., chapters 9, 11, 12 and 13.
12 Ibid., chapters 10, 14, 15, 16 and 17.

mally – via the partner that technology transfer is expected and the partner is typically not prepared to move without this promise. If the partner is already in the same goods market, there is moreover the risk that other subsidiaries will start producing on the basis of the transferred technology and that the JV will sooner or later be ended as well. There are documented cases that show that the restrictions in this area might be intensified, too, once the technology is mastered.

The US 301 case, which is based on a hearing and numerous documents, careful analyses of Chinese acts, business reports and academic literature, investigates whether China's pre-establishment FDI regime is unreasonable or discriminatory and whether the Chinese actions may harm American IPRs, innovation or technology development. It has five specific chapters. One analyses the Chinese government's use of foreign ownership restrictions (such as joint ventures and equity caps) coupled with administrative licensing and an approval process. It further examines whether these lead to pressures or requirements for (involuntary) technology transfer from US companies to Chinese entities. A second chapter investigates whether US companies who intend to license technologies (etc.) to Chinese companies are forced to do so on non-market based terms that favour Chinese recipients.

The third chapter is about Chinese outbound FDI and verifies whether the Chinese government directly and unfairly facilitates the systematic investment in, and acquisition of, US companies and assets by Chinese entities, to obtain cutting edge technologies and generate large-scale technology transfer in industries deemed important by state industrial plans. And fourthly, two chapters are dedicated to cyber intrusions into US commercial networks on a massive scale, hence exploiting unauthorised access to trade secrets, technical data, negotiation positions, etc., and other policies where suspicions persist but which have not been further investigated; in this case, e.g. on standardisation, the application of the AML and aggressive talent acquisitions far above market rates. The chapters are abundantly documented and carefully analysed and the conclusions lead to the confirmation of the queries and extensive damage to US companies and to long-run US competitiveness. The case has been moved to the WTO via a request for bilateral consultations.

Meanwhile, the EU and Japan have declared that – despite their rejection of the unilateral nature of the 301 provision in the 1974 US Trade Act – they support the substance of the case. It should be observed that this relatively specific form of illegitimately undermining the comparative advantages of companies from the trilateral economies is a clear manifestation of the systemic issues generated by the 'socialist market economy with Chinese characteristics'.

China's new industrial strategy

China's extremely rapid growth has been fuelled by a reliance on heavy industries, massive low-skilled assembly work in many special zones (as the final point of global and East Asian value chains) and an extremely high investment / savings (instead of consumption) rate. As a consequence (and typical for communist countries), services were neglected or barely developed. Trade in a relatively open world economy and targeted FDI in the special zones were crucial to these developments. This growth model was already running out of steam by the time China joined the WTO. Today, this is even more the case as the infinite supply of labour from the Chinese countryside is gradually shrinking.

For good reasons, therefore, China has decided to emphasise more local consumption for citizens, the steady development of services (which has since passed the 50% of GDP benchmark) and a decisive shift to (more) advanced industrial sectors inside global value chains as well as for stand-alone competition in the domestic market. The emergence of a new industrial policy focusing on seven advanced sectors was announced in 2006. By 2015, this matured into a massive and full-fledged industrial strategy, called "Manufacturing Made in China 2025".[13] The strategy is incredibly ambitious, seemingly justifying equally ambitious efforts to do anything to make it successful. For lack of space, Box 1 summarises the important features of this strategy. The profound concerns of trading partners are less about the aims – even though aiming for dominance in some advanced world industries hardly invites enthusiasm from other countries – but more about the instruments, their scale, the overt discrimination, and the lack of transparency and reciprocity.

The amount, omnipresence, and preparedness of funding are amazing but also worrying. China's reporting on subsidies to the WTO has long been neglected. Recently, China has begun to provide details of subsidy programmes, but only partially, rarely with figures and only dealing with the period before China 2025.[14] There are telling (yet, incomplete) descriptions of subsidies in China,[15] but most subsidies assume forms that are hard to detect without official reporting, e.g. soft loans and privileged finance. The vehicle of investment funds has quickly taken prominence: by the end of

13 The following is based on J. Wuebbeke et al.: Made in China 2025, The making of a high-tech superpower and consequences for industrial countries, MERICS Papers on China No. 2, Mercator Institute for China Studies, December 2016; European Union Chamber of Commerce in China: China Manufacturing 2025, Putting Industrial Policy Ahead of Market Forces, Beijing 2017, available at www.europeanchamber.com.en; and specifics of the US 301 case (as in section 2.2) and in the lengthy report of the European Commission, op. cit.

14 See WTO, op. cit.

15 See e.g. European Commission, op. cit., various chapters; see also J. Wuebbeke et al., op. cit.

Box 1

China's new industrial strategy: Manufacturing Made in China 2025

- Targeting steeply rising market shares towards 2025
- Host of interventions in China
- Interventions for targeted acquisitions (for high-tech companies)
- Found in ten advanced industries
  1. New generation ICT
  2. Computerised machines and robots
  3. Space and aeronautics industry
  4. Maritime equipment and high-tech
  5. Advanced railway roll. stock/equipment
  6. New (non-carbon) energy vehicles
  7. Energy equipment
  8. Agricultural machines
  9. New materials
  10. Bio-pharma & high-tech medical devices
- Key concepts:
  a. Indigenous innovation
  b. Self-sufficiency
  c. International capacity cooperation (JVs abroad, learning new technology)
  d. Acquisition drive abroad
  e. Massive interventionism with staggering funding

2015, some 780 such funds existed, with 300 of them set up in 2015 under China 2025.[16] These funds dispose of no less than 294 billion euro and are largely or entirely state-owned. Their market-orientation is very doubtful. Their task is simply to promote what is targeted and in sectoral or provincial plans. How can EU companies, operating under a strict EU state aid regime, compete in China in the presence of such massive non-market funding? The funds play a significant role in high-tech acquisitions in the US and the EU, but they are not really private market driven funds. The take-over of US machine maker AIXTRON implied a network of no less than 16 investment vehicles, largely state-owned, including only a few firms; similarly, in the takeover attempt of the radio frequency power segment of the Dutch semiconductor firm NXP by JAC capital, state interests were equally opaque.[17] Questions have also been raised in the huge takeover of Syngenta (39 billion euro).

16 European Union Chamber of Commerce, op. cit., pp. 17 and further.

17 But unravelled in the detailed flowcharts on both cases in J. Wuebbeke et al., op. cit., p. 51 and p. 53.

Conclusion

The 'socialist market economy with Chinese characteristics' has turned into a systemic trade and investment issue both bilaterally and multilaterally. The hope that WTO membership would eventually transform China into a market economy with distortions that would gradually become tolerable and negotiable has not borne out. Partners are continuously reassured that the blend of state capitalism with some market properties, e.g. sharp price competition in retail, will undergo reforms, like the impressive 60 reform packages that rolled out in November 2013. But the reforms that do take place have more to do with the need to rebalance the growth model than with the need to rebalance the role of the state against that of markets. Moreover, discrimination against foreign companies and lack of reciprocity in trade and FDI is deeply engrained in the system. Trade and investment with China is not only severely restricted, with few genuine changes over time, but competition inside China and with Chinese firms in world trade is negatively affected by massive interventionism, on a field that is anything but 'level'. When contesting these fundamentals, China is likely to resist whilst offering marginal reforms. Anti-dumping cases will not effectively address the systemic nature of the offenses. Anti-subsidy approaches may be more appropriate but too partial and incidental for the systemic issue to be solved. Concluding the CAI is also appropriate and helpful to some extent but both the US experience for a decade now and the EU experience in addressing pre-establishment and post-establishment market access and reciprocity has not seen much – if any – concrete progress. For these and other reasons, the US, the EU and Japan (trilaterals) decided to join forces in order to form wider coalitions for WTO reform that would better address the systemic issues China has engendered. Given the tensions in the world trading system and in the corporate world with respect to these issues, the alternative will be either selective trade wars, or targeted exclusions of Chinese firms – be it via FDI screening more focused on economic damage, though a dangerous slippery slope, or via a case-by-case application of reciprocity. The EU favours the cooperative route and has recently agreed with China on the establishment of a joint task force on WTO reform. How effective this task force will be is anybody's guess. Even with willing countries reforming the WTO, this can only be a short-term solution; however, there are likely to be some partners in the WTO who are not so willing. For that reason alone, one should expect more emphasis on FDI screening (and shed the naivety about Chinese high-tech acquisitions) and on anti-subsidy cases as a very partial and inadequate response to the socialist market economy which inflicts considerable negative spillovers on the EU and other foreign businesses and can occassionally directly undermine the very foundation of the EU advanced sectors.