

LEGAL IMPLICATIONS OF THE DEEPENED REFORM OF  
CHINESE STATE-OWNED ENTERPRISES: WHAT CAN BE  
EXPECTED FROM RECENT REFORMS?

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## LEGAL IMPLICATIONS OF THE DEEPENED REFORM OF CHINESE STATE-OWNED ENTERPRISES: WHAT CAN BE EXPECTED FROM RECENT REFORMS?

CHE Luyao

### *Abstract*

*A new round of State-Owned Enterprise (hereinafter “SOE”) reform contains the clear purpose of integrating SOEs into the market while maintaining their strength in contributing to the economic development of China. This raises the question of how the reform will utilize relevant legal instruments and what changes in legal arrangements can be expected. Regarding the internal market, the reform may deeply incorporate SOEs into the market and devise the ways in which the state manages SOEs to be more market-oriented. As for the global market, the changes in the domestic market can further coordinate China’s state sector with the existing international economic order.*

*Keywords: State-Owned Enterprises (SOEs), SOE Reform, public entities, out-of-country benchmarks, non-market economy (NME) status*

### I. INTRODUCTION

It is now more than three-and-a-half decades since China launched its ambitious program of undertaking economic reform. Central to China’s economic reform has consistently been the reform of state-owned enterprises (“SOEs”). Undeniably, SOEs have contributed remarkably to China’s economic development, as they have been able to pursue long-term goals in line with public interests.<sup>1</sup> However, SOEs must be subject to progressive reforms in order to overcome their inherent weakness and meet the requirements of constantly changing economic and social surroundings. After entering the second decade of the twenty-first Century, SOEs are currently faced with new challenges, highlighting the urgency of a new round of reform.

From a purely economic perspective, the major economic concern of the new round of reform is the economic efficiency and the capacity of innovation of SOEs. Since China first launched its economic reform in the late 1970s, the economic efficiency of SOEs has increasingly improved.<sup>2</sup> However, according to various economic indicators, SOEs are still characterized by their underperformance in productivity

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<sup>1</sup> See *How Can China Sell off Its Government-Owned Companies?*, CHINA ECON. REVIEW (June, 10, 2014), <http://www.chinaeconomicreview.com/SOE-reform-sale-ownership-japan-lessons-adapt-china-context>.

<sup>2</sup> See e.g., BARRY NAUGHTON, *THE CHINESE ECONOMY: TRANSITION AND GROWTH* 3-8 (2007).

and innovation compared with some non-state actors.<sup>3</sup> While the concern of the competitiveness of SOEs is mainly purposed at a micro level, the demands of reform can also be observed at a macro level. In the current stage of economic development, the optimization of the structure of national economy is recognized as being of vital importance to the further development of the Chinese economy. Besides, the unoptimistic circumstances of the external market, namely the global economic recession since 2008, further dictates the urgency of China to find a solution to existing and potential difficulties.

Besides the aforementioned economic incentives, the necessity of deepened reform is augmented by several regulatory and legal concerns. Because China's economic reform has been policy-oriented, laws and regulations have been introduced under certain policies to meet specific needs. Therefore, rules governing SOEs and other market entities are rarely codified but are generally separately stipulated in different laws and regulations. This calls for coordinating and unifying laws and regulations. From the angle of the outside world, successful reform may help Chinese SOEs and Chinese economy to be further coherent with the international economic order. For example, because of the extensive state sectors, China and Chinese companies have frequently been subject to contingent measures under the WTO, including anti-dumping duties and countervailing duties. In addition, further SOE reform is also urgent because of social and political reasons, such as the necessity of fighting against corruption and the abuse of managerial power.<sup>4</sup>

Several important documents have been issued under such historical circumstances. In September 2015, the Central Committee of the Communist Party of China, along with the State Council, released a long-awaited literature entitled *Guideline for the Deepened Reform of State-Owned Enterprises* ("the Guideline").<sup>5</sup> The Guideline proposes a series of relatively comprehensive initiatives for further invigorating Chinese state-owned enterprises, integrating them into the market economy, whilst striving to maintain the advantage of SOEs. Following the release of the Guideline, the *Several Opinions Concerning the Reform and Completion of State-Owned Assets*

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<sup>3</sup> See Langi Chiang & Victoria Ruan, *Inefficient SOEs Lack Profit Focus: Earlier Reforms Failed to Address the Core Problem of Low Productivity Among SOEs*, S. CHINA MORNING POST (Apr. 04, 2014), <http://www.scmp.com/business/china-business/article/1464205/inefficient-soes-lack-profit-focus>.

<sup>4</sup> See Liu Zhifeng (刘智峰), *Guoyou Qiye Fubai Xianxiang de Sanda Weihai* (国有企业腐败现象的三大危害) [*Three Major Harms of the Corruption of SOEs*], QIAN XIAN (前线) (Mar. 3, 2015), <http://www.bjcx.org.cn/qxweb/n189763c637.aspx>.

<sup>5</sup> See Zhonggong Zhongyang, *Guowuyuan guanyu Shenhua Guoyou Qiye Gaige de Zhidao Yijian* (中共中央、国务院关于深化国有企业改革的指导意见) [Guideline by the Central Committee of the Communist Party of China and the State Council for the Deepened Reform of State-Owned Enterprises] (promulgated by Cent. Comm. of CPC & St. Council, Aug. 24, 2015, effective Aug. 24, 2015) (Chinalawinfo).

*Administrative System* was issued by the State Council in November 2015.<sup>6</sup> The *Thirteenth Five-Year Guideline*, which was passed by the Fourth Session of the Twelfth National People's Congress in March 2016, further confirmed the initiatives that were formulated in previous documents.<sup>7</sup>

Both the mass media and scholars are concerned with whether the new round of SOE reform will mark a significant change in China's economic development, but mainly focus on purely economic issues. However, the purposes of SOE reform cannot be achieved absent certain legal mechanisms. The question of how the reform will utilize relevant legal instruments, and what changes in legal arrangements can be expected is thereby raised.

This paper intends to answer this question through observing both the internal and the external markets. It respectively explores the impacts on the legal framework of China's internal market and the legal implications of China's participation in the global market. The paper argues that, regarding the internal market, the newly proposed reform has the potential to deeply incorporate SOEs into the market and make the ways in which the state manages SOEs to be more market-oriented. In terms of China's participation in the global market, the changes in the domestic market can help protect SOE competitors and the Chinese government from being questioned and challenged by other countries.

## II. LEGAL IMPLICATIONS OF CHINA'S INTERNAL MARKET REGULATION

Recently proposed initiatives for deepened reform are embedded with the pursuance of "clearly defined property rights", "unambiguous division of rights and responsibility", "separation between the government and enterprises", and "scientifically managed and modernized corporative system".<sup>8</sup> Conceivably, the achievement of these purposes requires rationalized legal underpinnings. The paper addresses three folds of changes in legal arrangements that the new round of reform may employ to achieve these purposes: the reform

<sup>6</sup> See Guowuyuan guanyu Gaige he Wanshan Guoyou Zichan Guanli Tizhi de Ruogan Yijian (国务院关于改革和完善国有资产管理体制的若干意见) [Several Opinions of the State Council Concerning the Reform and Completion of State-Owned Assets Administrative System] (promulgated by St. Council, Oct. 25, 2015, effective Oct. 25, 2015) (Chinalawinfo).

<sup>7</sup> See Zhonghua Renmin Gongheguo Guomin Jingji he Shehui Fazhan di Shisan ge Wunian Guihua Gangyao (中华人民共和国国民经济和社会发展第十三个五年规划纲要) [The Thirteenth Five-Year Guideline of the People's Republic of China for the National Economic and Social Development] (promulgated by Nat'l People's Cong., Mar. 17, 2016, effective Oct. 25, 2015) § 11 (Chinalawinfo).

<sup>8</sup> See Zhonggong Zhongyang, Guowuyuan guanyu Shenhua Guoyou Qiye Giage de Zhidao Yijian (中共中央、国务院关于深化国有企业改革的指导意见) [Guideline by the Central Committee of the Communist Party of China and the State Council for the Deepened Reform of State-Owned Enterprises] (promulgated by Cent. Comm. of CPC & St. Council, Aug. 24, 2015, effective Aug. 24, 2015) § 1(1) (Chinalawinfo).

relies fundamentally on the conversion of SOEs towards commercial entities; on this basis, SOEs may independently exercise their property rights, thereby facilitating their participation in the market competition; meanwhile, the role of the state in SOE governance would be further modernized that of a shareholder.

*A. The Legal Nature of SOEs: from State Organs to Commercial Entities*

As proposed in a series of reform initiatives, the new round of SOE reform aims to allow and provide SOEs the opportunity to complete a transformation from state organs to commercial entities that are subject to market conditions. This paper contends that, from a legal perspective, the transformation ultimately relies on two legal arrangements, namely the independent legal personality and the abolition of privileges provided to SOEs.

An independent legal person is one with the full capacity to be engaged in legal relationships, exercising rights and performing corresponding obligations. The legal personality of a SOE as a commercial entity is based on the fact that the SOE is established under commercial law. A recently proposed division between “for-profit” SOEs and welfare-providing (“for-welfare”) SOEs can further pave a way for the vast majority of SOEs to be converted into modernized legal persons. If the 2015 Guideline is implemented, all SOEs will fall within either the scope of “for-profit” SOEs or “for-welfare” SOEs.<sup>9</sup> As the pursuance for commercial profits has been clearly set as the sole purpose for their operation, it is rather unnecessary for “for-profit” SOEs to maintain administrative features, and thus, an independent personality would do nothing harmful to their purpose.

In addition to independent legal personality, the process in which SOEs gradually become commercial entities has been closely associated with the gradually abolition of privileges and rights exclusively provided to SOEs. For instance, SOEs once enjoyed exclusive rights to undertake importing and exporting, but these rights gradually opened to all other entities in the 1990s.<sup>10</sup> Through the abolition, commercial law that equally applies to all types of market entities would eventually become the main sources of the rights of SOEs, and SOEs would be less subject to administrative regulations and orders.

Such a transformation in the legal nature of SOEs is underlined by a certain historical context. SOEs were once a combination of administrative bodies and productive units under a centrally-planned

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<sup>9</sup> *Id.*, § 2(4).

<sup>10</sup> See Ross P. Buckley & Weihuan Zhou, *Navigating Adroitly, China's Interaction with the Global Trade, Investment, and Financial Regimes*, 9(1) E. ASIA LAW REVIEW 1, 11-12 (2015).

economy, receiving governmental instructions and constituting an integral part of the national economy.<sup>11</sup> Since the early stage of economic reform, an unclear separation between entrepreneurial and administrative issues has been often described as a weakness of SOEs. The rationale for this criticism is that, only when business decisions of a SOE can be made independently from administrative commands or interventions, can the SOE acquire sufficient capacity to immediately and flexibly respond to various market signals. With the progress of gradually introducing a competitive market, it became increasingly necessary for SOEs to maintain a certain degree of managerial power in order to adapt to the constantly changing conditions of the market economy.<sup>12</sup> However, arguably, a fundamental conversion into commercial entities cannot be achieved unless SOEs are invested within full capacity of entering into legal relationships and faced with the same market conditions as competitors. The necessity for SOEs to acquire full legal personality and be put in a competition environment is thereby highlighted.

### *B. Property Rights of SOEs: from State-Owned Properties to Enterprises' Properties*

Possessing independent legal personality means that a SOE can correspondingly enjoy property rights. For a long time, without a clear stipulation by law, it has been controversial whether properties of SOEs belong solely to the enterprises or also to the state.<sup>13</sup> Arguably, recent reforms make it increasingly clear that the ownership of property rights should be exclusively attributed to SOEs, rather than the state.<sup>14</sup>

The controversy originated from the preliminary stage of economic reform, when all Chinese SOEs were wholly owned by the state. As a distinction between state property and SOEs' property in that circumstance was unnecessary, SOEs' properties were often tangled up or even equated with state-owned properties. For instance, the *Decision of the Standing Committee of the Fifth National People's*

<sup>11</sup> See Ma Wen-kuei, *Industrial Management in China: How China's Socialist State-Owned Industrial Enterprises Are Managed*, PEKING REV. (Feb. 26, 1965), at 20-23, <https://www.marxists.org/subject/china/peking-review/1965/PR1965-09k.htm>.

<sup>12</sup> See Qian Weiqing (钱卫清), *Guoyou Qiye Gaige Falü Baogao* (国有企业改革法律报告) [The Legal Report of SOEs' Reform] 59 (2004).

<sup>13</sup> See Xu Xiaosong (徐晓松), *Lun Guoyou Qiye Gongsizhi Gaige zhong de Chanquan Wenti* (论国有企业公司制改革中的产权问题) [Property Rights Issue in Transferring the State-Owned Enterprises to Corporation], 2 ZHENGFA LUNTAN (政法论坛) [TRIBUNE OF POLITICAL SCIENCE AND LAW] 13, 14 (2000).

<sup>14</sup> See Zhonggong Zhongyang, *Guowuyuan guanyu Shenhua Guoyou Qiye Gaige de Zhidao Yijian* (中共中央、国务院关于深化国有企业改革的指导意见) [Guideline by the Central Committee of the Communist Party of China and the State Council for the Deepened Reform of State-Owned Enterprises] (promulgated by Cent. Comm. of CPC & St. Council, Aug. 24, 2015, effective Aug. 24, 2015) § 1(2), para. 3 (Chinalawinfo) (stating that "implementing the property rights and operational autonomy of enterprises according to law" is one of the principles guiding the reform).

*Congress on State-Owned Properties in Closed Enterprises and Stopped and Suspended Projects* adopted on March 6, 1981 uses the term “state-owned properties” to refer to all properties in closed SOEs and halted projects that were undertaken by SOEs during national economic adjustment, including “factory sites, raw materials, fuels, and products”.<sup>15</sup>

However, such a non-distinction between the property ownership of SOEs and the state is incompatible with a basic principle of property law in a market economy, which requires property rights to be exercised exclusively. It was once argued that when the state authorizes SOEs to manage themselves, it only transfers certain functions of property rights to SOEs, and meanwhile maintains remaining functions.<sup>16</sup> In this view, the exclusive nature of property rights is not undermined, for the state and SOEs respectively maintain different functions of the same property.<sup>17</sup> Although this argument seemed sound under certain historical period, it has shown its weakness after the commencement of developing mixed-ownership enterprises. If a SOE operates fully as a market entity, the rights of the state, as an investor of SOEs, originate from its activity of investment, rather than the existence of properties in the SOE. Accordingly, the object of the rights is not one of property but is one of investment. In this sense, the term “SOEs” is somehow misleading: because the state does not actually own the properties in a SOE but instead enjoys certain interests and benefits resulting from its investment in the SOE. Furthermore, while many SOEs have diversified the sources of their shares, the state is no longer the sole contributor of the enterprises but often performs on an equal footing with other private investors, and it is obviously unreasonable to analogously claim that private investors maintain property rights over an enterprise’s properties.

Recent SOE reform has drawn an increasingly clear boundary between the property rights of the state and those of SOEs. In the *Enterprises State-Owned Assets Law*, it is stipulated that SOEs have the rights to “possess, utilize, profit from, or dispose of their movable property, immovable property and other property in accordance with

<sup>15</sup> See Guanyu Fangzhi Guanting Qiye he Tingjian Huanjian Gongcheng Guojia Caichan Zaoshou Sunshi de Jueyi (关于防止关停企业和停建缓建工程国家财产遭受损失的决议) [Decisions on State-Owned Properties in Closed Enterprises and Stopped and Suspended Projects] (promulgated by the Standing Comm. Nat’l People’s Cong., effective Mar. 6, 1981) (Chinalawinfo).

<sup>16</sup> See Yu Nengbin (余能斌) & Li Guoqing (李国庆), *Guoyou Qiye Chanquan Falü Xingzhi Bianxi* (国有企业产权法律性质辨析) [On Legal Nature of Property Right of State Enterprises], 5 ZHONGGUO FAXUE (中国法学) [CHINA LEGAL SCIENCE] 80 (1994).

<sup>17</sup> See Wang Liming (王利明), *Lun Gufenzhi Qiye Suoyouquan de Er'chong Jiegou: yu Guo Feng Tongzhi Shangque* (论股份制企业所有权的二重结构——与郭锋同志商榷) [On the Dual Structure of the Ownership at Shares Enterprises: A Deliberation with Comrade Guo Feng], 1 ZHONGGUO FAXUE (中国法学) [CHINA LEGAL SCIENCE] 47 (1989).

laws, administrative regulations and their Articles of association”.<sup>18</sup> As the rights to “possess, utilize, profit from, or dispose” contain all the functions of property rights, it is manifested that the property rights in SOEs are attributed exclusively to enterprises, rather than to the state.

The conversion from state-owned properties to enterprises’ properties can result in a two-fold consequence. On the one hand, the state would be no longer titled to possession, utilization, usufruct, and disposition of properties of SOEs under the *Property Law*.<sup>19</sup> On the other hand, this may allow SOEs to escape from the scope of state organs, and therefore the state may bear no joint responsibility for any legal or contractual breach by SOEs.

*C. The Nature of the Right Enjoyed by the State SOE Governance:  
from an Administrator to a Shareholder*

Although the state is no longer entitled to the ownership of properties after investing property into a SOE, it is unquestionable that the state still enjoys certain rights in the operation of SOEs. Therefore, after figuring out that a SOE is the sole subject of its property rights, it is worth further elucidating the nature of the rights that are actually exercised by the state in its legal relationship with the particular SOEs. This paper submits that, once accomplishing its investment in certain SOEs, the state maintains shareholder rights under the *Company Law*. Relevant governmental agencies, on behalf of the state, thereby influences SOE governance by exercising shareholder rights, rather than implementing administrative measures. This actually means a conversion in the role of the relevant agency from traditional administrator role into that of a shareholder, and more fundamentally, a shift in the paradigm of the state-to-market relationship.

The role of the state in the corporate governance of SOEs has lacked an accurate legal status, owing to constantly changing policies of reform, but the newly released reform initiatives, including the *Guideline for the Deepened Reform of State-Owned Enterprises*, the *Several Opinions Concerning the Reform and Completion of State-Owned Assets Administrative System*, and the *Thirteenth Five-Year Guideline*, may help the state find a more accurate legal position under Chinese commercial law. A new approach for state-assets management formulated in the Guideline, namely the capital-focused

<sup>18</sup> See *Qiyue Guoyou Zichan Fa* (企业国有资产法) [State-Owned Assets of Enterprises Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 28, 2008, effective May 1, 2009) art. 16 (Chinalawinfo).

<sup>19</sup> See *Wuquan Fa* (物权法) [Property Law] (promulgated by Nat’l People’s Cong., Mar. 16, 2007, effective Oct. 1, 2007), art. 51 (Chinalawinfo). See also Shi Jichun (史际春), *Guanyu Faren Caichan Quan yu Gudong Quan de Falü Guiding Chuyi* (关于法人财产权与股东权的法律规定刍议) [On Property Rights and Shareholder Rights of Enterprises], 6 FAZHI YU SHEHUI FAZHAN (法制与社会发展) [LAW AND SOCIAL DEVELOPMENT] 40, 43 (1995).



approach, coincides with the shift in the role of the state. The Guideline proposes to “promote a transition in the function of state-owned assets supervision and administration agencies by adopting a capital-based management approach”.<sup>20</sup> Specifically, it says that a state-owned assets supervisory and administrative agency should accurately position itself as a contributor of shares of SOEs under the law.<sup>21</sup> Relevant expressions in the Several Opinions by the State Council coincide with the Guideline.<sup>22</sup> Therefore, the capital-focused approach can be deemed as an affirmation that the nature of the rights enjoyed by the state is one of shareholder’s rights based on the activity of investing capital, rather than through the existence of assets in an enterprise. This is to say, the state has shareholder rights under relevant clauses in the *Company Law*, including proportional returns and benefits based on the assets it invested,<sup>23</sup> and the rights to participate in management, such as making major decisions and overseeing the executive levels.<sup>24</sup>

Performing the role as a shareholder means that the relationship between the state and the management level of a SOE will become a delegation relationship under the *Company Law*. The role of the state would basically resemble one of a private contributor of a company.<sup>25</sup> It is evident that the new round of reform would take radical steps to limit the managerial power of the state-owned assets supervision and management agencies and let them devolve their administrative power upon the managerial level of SOEs. Specifically, the Guideline requires supervision and management agencies to “scientifically draw a boundary between the ownership of state-owned capitals and management right”, and the supervision and management agency should not interfere in SOEs’ making decisions on their own.<sup>26</sup>

<sup>20</sup> See Zhonggong Zhongyang, Guowuyuan guanyu Shenhua Guoyou Qiye Giage de Zhidao Yijian (中共中央、国务院关于深化国有企业改革的指导意见) [Guideline by the Central Committee of the Communist Party of China and the State Council for the Deepened Reform of State-Owned Enterprises] (promulgated by Cent. Comm. of CPC & St. Council, Aug. 24, 2015, effective Aug. 24, 2015) (Chinalawinfo).

<sup>21</sup> *Id.*

<sup>22</sup> See Guowuyuan guanyu Gaige he Wanshan Guoyou Zichan Guanli Tizhi de Ruogan Yijian (国务院关于改革和完善国有资产管理体制的若干意见) [Several Opinions of the State Council Concerning the Reform and Completion of State-Owned Assets Administrative System] (promulgated by St. Council, Oct. 25, 2015, effective Oct. 25, 2015) (Chinalawinfo).

<sup>23</sup> See e.g., Gongsì Fa (公司法) [Company Law] (promulgated by the Standing Comm. Nat’l People’s Cong., Dec. 29, 1993, amended Mar. 1, 2014), art. 4, 166 (Chinalawinfo).

<sup>24</sup> *Id.* art. 103, 105.

<sup>25</sup> See Mariana Pargendler, *State Ownership and Corporate Governance*, 80 FORDHAM L. REV. 2917, 2923 (2012).

<sup>26</sup> See Zhonggong Zhongyang, Guowuyuan guanyu Shenhua Guoyou Qiye Giage de Zhidao Yijian (中共中央、国务院关于深化国有企业改革的指导意见) [Guideline by the Central Committee of the Communist Party of China and the State Council for the Deepened Reform of State-Owned Enterprises] (promulgated by Cent. Comm. of CPC & St. Council, Aug. 24, 2015, effective Aug. 24, 2015) (Chinalawinfo).

Besides, SOEs are conferred with the right to contribute in and become shareholders of various types of enterprises.<sup>27</sup>

Delegating administrative power to SOEs does not necessarily mean that the state would give up its influence in SOE governance. Rather, through exercising its rights as a shareholder, the state is expected to enhance its capacity to influence the operation of SOEs based on market conditions. The state decides basic layout of the industries, identifies key and strategic industries, and correspondingly makes national strategies for further economic development. These initiatives can be implemented through deciding specific projects in which the state as a shareholder should invest and make decisions in SOE governance through exercising the states' shareholder rights. Accordingly, the state is able to ensure that SOEs operate in line with the goal of economic development through a non-administrative way that does not undermine market conditions.

Similar to the changes in the legal status of SOEs' properties, the shift of the state's role towards an agency of shareholder is not an unexpected change but is consistent with a series of previous reforms. Before SOE reform, SOEs directly received administrative orders and implemented productive plans; SOEs had no ground to make their own decisions to operate the enterprises. Correspondingly, the role of the government was once as the manager of all SOEs, in charge of making the major decisions for all SOEs.

With the progress in which SOEs gradually gained independent legal personality under commercial law, the role of the government inevitably had to change as to adapt and allow SOEs to exercise their managerial autonomy. The idea of introducing a nation-wide shareholding system and developing a mixed-ownership economy was set in stone during the Third Plenary Session of the Sixteenth Central Committee, during which the development of mixed-ownership was announced to be "the most important form for the realization of public ownership".<sup>28</sup> Afterwards, a symbolic change was the establishment of the State Assets Supervision and Administration Commission ("SASAC"), which introduced a national-level shareholding system, where SASAC, on behalf of the state as a shareholder, became positioned at the top of a vertical shareholding system.<sup>29</sup> However, to a certain degree, the state maintained the power to intervene in a SOE's commercial decision-making by directly exercising its administrative authority. This contributed to the hybrid role of state as

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<sup>27</sup> *Id.*, § 13.

<sup>28</sup> Zhonggong Zhongyang Guanyu Wanshan Shehui Zhuyi Shichang Jingji Tizhi Ruogan Wenti de Jueding (中共中央关于完善社会主义市场经济体制若干问题的决定) [Decision of the Central Committee of the Communist Party of China on Some Issues concerning the Improvement of the Socialist Market Economy] (promulgated by Cent. Comm. of CPC, effective Oct. 14, 2003) (Chinalawinfo).

<sup>29</sup> See Ming Du, *China's State Capitalism and World Trade Law*, 63(2) INT'L & COMP. L.Q. 409, 416 (2014).

both an administrator exercising governmental authority and a shareholder possessing relevant rights under commercial law.<sup>30</sup>

Deepened reform increasingly requires reducing the administrative nature of the state in SOE governance. On the one hand, as SOEs are major competitors in key and pillar industries, they can inherently be benefitted more from their economic strength than administrative privileges, which makes it unnecessary for them to be administratively instructed. On the other hand, rigid administrative orders may deter SOEs from operating positively in response to various changes in the market and discourage non-state investors from actively contributing to mixed-ownership enterprises.

### III. IMPACTS ON CHINA'S PARTICIPATION IN THE INTERNATIONAL ECONOMIC SYSTEM

The proposed reform would not only impact China's internal market regulation but also affect China's involvement in various international regimes. The existing international economic order, especially the world trading system, embodies a clear value orientation of protecting private competitors in the market and preventing governments from intervening in the market. Therefore, the existence of China's extensive state sector often results in tensions between China and the existing international economic order, which has been majorly developed and advocated by Western countries.

This section argues that the new round of SOE reform may help further coordinate China's unique economic system with the existing international economic order. The coordination can be observed on both micro and macro levels. Regarding SOEs from a micro perspective, separate SOEs possessing independent legal personality and operating as purely commercial entities, may be less difficult to be exempt from the scope of public entities. In terms of the macro level, which concerns the Chinese economy or the whole industries where SOEs are predominant, deepened reform may help Chinese competitors to satisfy the conditions of a market economy. Accordingly, on both levels, the reform has the potential to nullify the legal grounds for other countries to resort to discriminatory legal arrangements in dealing with SOE competitors from China.<sup>31</sup> As it is impossible to investigate all the aspects of legal environment that

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<sup>30</sup> See Li-Wen Lin & Curtist Milhaupt, *We Are the (National) Champions: Understanding the Mechanisms of State Capitalism in China*, 65(4) STAN. L. REV. 697, 734 (2013).

<sup>31</sup> E.g., the anti-dumping authority in the EU has frequently sort to apply the third-country approach in calculating dumping margins and determining anti-dumping duties (ADs) against manufacturers from China on the ground that market conditions do not prevail in certain industries in China. See Appellate Body Report, *European Communities — Definitive Anti-Dumping Measures on Certain Iron or Steel Fasteners from China*, WT/DS397/AB/R (Jul. 15, 2011) [hereinafter *EC-Iron Fasteners*]. This issue will be addressed in detail in following sections in this paper.

China is faced with in its external market, this paper mainly adopts relevant instruments and disputes in the WTO regime as examples.

### A. The Recognition of Public Entities

Western countries, prominently the US, have striven to recognize Chinese SOEs as “public entities” in anti-subsidy investigations in order to impose countervailing duties (“CVDs”) to neutralize the cost advantages of these Chinese enterprises resulting from their strong governmental association.<sup>32</sup> Whether such a practice is justifiable under the WTO framework has constantly been controversial and consistently triggers conflicts between China and countries that have frequently initiated anti-subsidy investigations into Chinese products.<sup>33</sup> According to the *Agreement on Subsidies and Countervailing Measures* (“SCM Agreement”), which is the main source governing subsidization in the WTO system, a subsidy is defined as “a financial contribution granted by a government or public body, in which a benefit is conferred”.<sup>34</sup> While the concept of “government” is quite clear, the scope of “public body” is rather vague, especially when considering that various SOEs are owned and controlled by the state but essentially operate as commercial entities. In practice, SOEs might provide prominent advantages to other commercial enterprises by granting the latter favorable terms and conditions in contracts. This drives the investigating authorities of several WTO Members to identify SOEs as public entities, in order to successfully conclude that the interests conferred in such a scenario are those of a subsidy and impose CVDs accordingly.<sup>35</sup>

While a robust definition of public body is absent from the SCM Agreement, the practice of WTO dispute settlement has provided more specific interpretations on whether SOEs can be recognized as public entities under the *SCM Agreement*. In *US — Anti-Dumping and Countervailing Duties (China)*, China made significant efforts to systematically challenge a few methodologies that have been frequently applied by Department of Commerce of the United States (“USDOC”) in anti-subsidy and anti-dumping investigations against products from China.<sup>36</sup> One essential claim by China was over the

<sup>32</sup> Thomas J. Prusa & Edwin Vermulst, *United States—Definitive Anti-Dumping and Countervailing Duties on Certain Products from China: Passing the Buck on Pass-Through*, 12 *WORLD TRADE REV.* 197, 198 (2013).

<sup>33</sup> See Investigation Memorandum, C-570-907 (Mar. 29, 2007), available at <http://ia.ita.doc.gov/download/prc-cfsp/CFS%20China.Georgetown%20applicability.pdf>.

<sup>34</sup> Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1869 U.N.T.S. 14., art. 1.1.

<sup>35</sup> See Liu Shan (刘珊), *Zhongguo Guoyou Qiye Butie Ruogan Falv Wenti Tanjiu* (中国国有企业补贴若干法律问题探究) [*Legal Issues on Subsidies to Chinese State-owned Enterprises*] (Apr. 25, 2010) (unpublished Master dissertation, East China University of Political Science and Law), 8-9.

<sup>36</sup> See Appellate Body Report, *US — Anti-Dumping and Countervailing Duties (China)*, WT/DS379/AB/R (Mar. 11, 2011) [hereinafter *Anti-Dumping*].

method in which the USDOC determined that various Chinese SOEs, including state-owned commercial banks (“SOCBs”), were public bodies.<sup>37</sup> In making these decisions, the USDOC relied on a rule of “*per se* majority ownership test”, which means the fact that the state is a majority shareholder of a SOE is self-sufficient in establishing that the SOE is a public entity.<sup>38</sup> China contended that the USDOC recognized several SOEs as public bodies purely relying on a “*per se* majority ownership test” but failed to examine other relevant factors. The Panel defied China’s argument on the basis that the term “public body” should be understood as “any entity controlled by a government”.<sup>39</sup> However, the Appellate Body overturned the decision of the Panel through affirming two other approaches used to determine what is necessary in identifying a public entity.

Firstly, in the instances where a legal instrument expressly delegating governmental authority to an entity exists, it can be straightforward to establish that the entity concerned is a public entity. An example of such a statutory delegation can be found in the Chinese *Commercial Banking Law*, where its Article 34 explicitly requires commercial banks in China to “conduct their business of lending in accordance with the needs of the national economic and social development and under the guidance of the industrial policies of the State”.<sup>40</sup> The Appellate Body accordingly found that the SOCBs concerned in this case should be deemed to be public bodies.<sup>41</sup>

Secondly, without a statutory delegation of authority, the public entity test may be more complex and rather difficult to conduct. The difficulty is augmented when it comes to a SOE, as the entity presents some features suggesting that it is a public body and other features suggesting that it is a private body.<sup>42</sup> According to the Appellate Body, the aim of a public entity test is not to examine the structure, but to evaluate whether the entity concerned is actually vested with governmental authority and whether it practices such authority. Therefore, the majority ownership by the state does not suffice on its own to demonstrate that the entity subject to investigation is a public body.<sup>43</sup> The Appellate Body further found that the USDOC did not provide sufficient evidence to show that the entities were meaningfully controlled by the government and actually exercised governmental functions. On this ground, the Appellate Body ruled that the USDOC

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<sup>37</sup> *Id.*, ¶ 282.

<sup>38</sup> *Id.*, ¶ 277.

<sup>39</sup> *Id.*, ¶ 278.

<sup>40</sup> See *Shangye Yinhang Fa* (商业银行法) [Commercial Banks Law] (promulgated by Standing Comm. Nat’l People’s Cong., May 10, 1995, amended on Aug. 29, 2015) art. 34 (Chinalawinfo).

<sup>41</sup> See *Anti-Dumping*, *supra* note 36, ¶ 355.

<sup>42</sup> *Id.*, ¶ 318.

<sup>43</sup> *Id.*, ¶ 317.

had failed to establish that SOEs other than SOCBs were public entities.<sup>44</sup>

Nevertheless, the Appellate Body did not offer specific guidance that can help investigating authorities conduct a public entity test properly. As Wu suggests, the decision of the Appellate Body may imply that a multi-factor inquiry to evaluate the extent to which the entity possesses government authority is necessary.<sup>45</sup> Prusa and Vermulst point out that if the USDOC shift its focus on examining whether an entity actually possesses, exercises, or is vested with governmental authority, respectively examining more factors in its public entity test, it may succeed in establishing that the entity is a public entity.<sup>46</sup>

Conceivably, the new round of SOE reform may help Chinese SOEs become more compliant with relevant rules in the SCM Agreement. Once SOEs are clearly categorized into two groups, namely “for-profits” and “for-welfare”, little controversy of the nature of Chinese SOEs will remain in disputes concerning subsidies and countervailing measures. SOEs for public welfare, with certain delegation of power and governmental functions, may be recognized as SOEs. However, with a clearly defined nature, these “for-welfare” SOEs will no longer serve the purpose of strengthening the competitiveness of Chinese enterprises, and therefore there is less likelihood for them to offer other enterprises that are engaged in international trade favorable conditions and thereby trigger subsidy investigations.

In terms of “for-profits” SOEs, they may be more easily exempt from the scope of public entities, provided the WTO continues to pursue the two methods that have been identified in the Appellate Body Report in *US — Anti-Dumping and Countervailing Duties (China)* to determine the nature of specific SOEs. The first method to identify public entities, which concerns the formal delegation of governmental power by law, may hardly be applied. As mentioned before, once SOEs are fundamentally converted into commercial subjects under business law, they will no longer enjoy legal privileges and possess relevant governmental functions. Therefore, it will be difficult to find that a “for-profit” SOE is empowered by law to exercise governmental functions and thereby to establish such a SOE as a public entity under the SCM Agreement.

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<sup>44</sup> *Id.*, ¶ 355.

<sup>45</sup> See Mark Wu, *The WTO and China's Unique Economic Structure*, in *REGULATING THE VISIBLE HAND?: THE INSTITUTIONAL IMPLICATIONS OF CHINESE STATE CAPITALISM* 338 (Benjamin L. Liebman & Curtis J. Milhaupt eds., 2016).

<sup>46</sup> See Thomas J. Prusa & Edwin Vermulst, *United States—Definitive Anti-Dumping and Countervailing Duties on Certain Products from China: Passing the Buck on Pass-Through*, 12 *WORLD TRADE REVIEW* 197, 227-28 (2013).

While applying the second approach, namely the functional approach that cares about whether an entity is actually empowered with governmental functions, it is similarly difficult to recognize a for-profit SOE as a public entity. The Appellate Body in the *US — Anti-Dumping and Countervailing Duties (China)* case made it clear that majority ownership by the state cannot be deemed as the decisive factor in identifying a public entity.<sup>47</sup> This makes it difficult to establish that SOEs are public entities relying on the fact that the state is the major contributor and shareholder of these enterprises. Although a detailed guidance for determining SOEs is absent from the Appellate Bodies' Report, it can be argued that the more market-driven a SOE becomes, the less possible it is for the WTO to recognize that the SOE is a public entity.

Based on the analysis above, it is reasonable to say that the reform initiatives may help minimize the gap between the understandings on the scope of public entity by Western countries and China. It is worth mentioning that the issue of public entities not only exists in the area of anti-subsidy, but can also be found in various contexts in which SOEs appear as a participant in the market. For example, China is currently making effort to become a signatory of the Government Procurement Agreement under the WTO, but consistency exists in the attitudes between China and Western countries towards the list of the entities that undertake public procurement.<sup>48</sup> While China tends to include less SOEs within the scope, Western countries tend to insist that more SOEs should be listed.

#### *B. The Determination of the Prevalence of Market Conditions*

Some discriminatory measures applied by Western countries are justified on the grounds that China's economy or a whole industrial sector in China is not an area where market conditions prevail. After determining that the economy is not under market conditions, an investigating authority may use economic indicators external to China's market to evaluate and thereby impose relevant measures. Two circumstances in which China is subject to the determination of the prevalence of market conditions are addressed here, namely: the application of out-of-country benchmarks that the US authority often applies in anti-subsidy investigations and the recognition of non-market economy status used by the EU authority in anti-dumping measures.

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<sup>47</sup> See *Anti-Dumping*, *supra* note 36, ¶ 317.

<sup>48</sup> See Wang Ping, *China's Accession to the WTO Government Procurement Agreement: Challenges and The Way Forward*, 12 J. OF INT'L ECON. L. 663 (2009).

### 1. Out-of-Country Benchmarks

The application of “out-of-country” means that, in determining the amount of the benefits conferred from a subsidy, the investigating authority resorts to benchmarks from outside of the country where the producers subject to investigation come from, precluding any consideration of actual conditions in the domestic market.<sup>49</sup> Out-of-country benchmarks are utilized on the ground that, in an industry wherein the state sector is so extensive that may distort the market, the domestic price of products may not reliably reflect the market price.<sup>50</sup> Not surprisingly, because the application of out-of-country benchmarks in anti-subsidy investigations may potentially neglect all comparative advantages of Chinese producers, it constitutes another controversial issue concerning China’s state ownership.

The application of out-of-country benchmarks may be justifiable under the *SCM Agreement*, in which its Article 14(d) stipulates that “the adequacy of remuneration shall be determined in relation to prevailing market conditions for the good or service in question in the country of provision or purchase”.<sup>51</sup> Although very implicitly, the provision indicates that the evaluation of the conditions “in the country” is premised on the notion that there exist “prevailing market conditions” that have not been distorted. Where the in-country private market prices are unreliable due to government-caused market-distortion, an investigating authority may be permitted to refer to conditions outside the domestic market under Article 14 (d).

Accordingly, the question of whether the application of out-of-country benchmarks is justifiable is determined by whether the state’s influence in certain industries results in market-distortion.<sup>52</sup> In practice, the question is if the fact that state ownership is predominant, on its own, suffices the requirement for establishing that a market is distorted. In *US — Anti-Dumping and Countervailing Duties (China)*, the Panel and the Appellate Body respectively examined the USDOC’s practice in precluding in-country benchmarks when calculating several types of benefits from subsidization and constructing out-of-country benchmarks to estimate the amount of these benefits. For instance, in the consideration of the benchmarks for input prices of steel products sold by Chinese SOEs, the Panel pointed that evidence indicating that the government was the predominant supplier is sufficient, on its own, to establish market-distortion.<sup>53</sup>

<sup>49</sup> See Du, *supra* note 29, at 438-42.

<sup>50</sup> See e.g., Appellate Body Report, *United States — Definitive Anti-Dumping and Countervailing Duties on Certain Products from China*, ¶ 470, WT/DS379/AB/R (Mar. 11, 2011).

<sup>51</sup> See Agreement on Subsidies and Countervailing Measures, *supra* note 34, art. 14(d).

<sup>52</sup> See Zheng Wentong, *The Pitfalls of the (Perfect) Market Benchmark: The Case of Countervailing Duty Law*, 19 Minn. J. OF INT’L ECON. L. 1, 22 (2010).

<sup>53</sup> See Panel Report, *United States — Definitive Anti-Dumping and Countervailing Duties on Certain Products from China*, ¶ 10.61, WT/DS379/R (Oct. 22, 2010).



The Appellate Body upheld the Panel's findings but added a point that, although the private price is likely to be distorted when the role of SOEs is predominant in a market, a case-specific analysis is still required.<sup>54</sup> In the present case, because of the fact that 96.1 per cent market share of the hot-roll steel was maintained by SOEs, it could be assumed that the predominance of the government would affect the market price through its own pricing strategy.<sup>55</sup> In such an instance, evidence of factors other than market share owned by SOEs is rather insignificant in the determination of market-distortion.<sup>56</sup>

In short, the Panel and Appellate Body formulated a principle that state ownership is the most decisive factor to establish that a market is distorted. Although other factors should also be taken into account on case-specific grounds, they carry less weight than evidence of predominant state ownership. This is to say, unlike the criteria for determining whether SOEs are public bodies, which concerns the actual function of separate SOEs, the determination of market distortion mainly relies on a structural approach.

The recently proposed reform may help decrease the likelihood of a foreign investigating authority using out-of-country benchmarks to conduct an anti-subsidy investigation against Chinese products. The reform aiming to develop mixed-ownership will result in a change in the proportion of state ownership in certain industries. With such a structural change, the monopolistic position of SOEs will remain in fewer industries.

Besides, according to *US — Anti-Dumping and Countervailing Duties (China)*, factors other than ownerships are also expected to be examined, although to a limited extent, by an investigating authority. It should be noted that, because of the limitation of negotiations, the WTO does not have the same purpose of regulating the competitive market as competition law does. Therefore, it only defies state intervention that can distort the global market, rather than preventing commercial tycoons from decreasing market competition.

Accordingly, it can be reasonably argued that if SOEs operate as purely commercial entities and are subject to the law of the market, an industry where their role is dominant may be considered as an industry where market conditions are prevalent. This is because the influence of SOEs on its industry is no longer governmental distortion but is simply a consequence of market competition.

## 2. Non-Market Economy Status

“Non-market economy” (“NME”) usually refers to an economy where market conditions do not prevail. This concept is particularly

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<sup>54</sup> See *Anti-Dumping*, *supra* note 36, ¶ 441.

<sup>55</sup> *Id.*, at ¶ 455.

<sup>56</sup> *Id.*

important in the context of anti-dumping under the WTO framework, because it constitutes an exceptional situation for the normal methodology in determining dumping margins and imposing anti-dumping duties. Article VI of the *General Agreement on Tariffs and Trade* principally requires the calculation of the normal value of a product to be based on the price charged in the home market of the product or its production cost.<sup>57</sup> However, WTO Members are allowed to use an alternative methodology to process an investigation against producers in an economy that is identified as an “NME”.<sup>58</sup> Usually, as an alternative to the usual method to calculate normal value, a similar product from a third country where the market prevails may be used as a sample to estimate the normal value of the importing product.<sup>59</sup>

This mechanism was established and once applied to regulate economies that adopted a Soviet-style economic system, where a market price is absent.<sup>60</sup> However, some Western countries, especially the US and EU countries, have frequently sought to apply the instruments designed for NMEs against products from China. The EU and the US believe that, as China could intentionally create its advantage through low prices and cause its domestic companies to enjoy a more advantageous position in global competition by means of its special economic model, the NME methodology is necessary to be adopted as a safeguard.<sup>61</sup> However, according to Chinese scholars, by allowing an investigating authority to choose a surrogate country, the application of the NME methodology increases the discretion of investigating authorities and undermines the predictability of anti-dumping proceedings.<sup>62</sup> Besides, the NME methodology may ignore the inherent comparative advantage in costs as a natural result of the market rather than the intervention of the government.<sup>63</sup>

Central to the tension between China and the traditional capitalist regimes, such as the EU and the US, is whether the application of the NME methodology in anti-dumping proceedings against producers

<sup>57</sup> See General Agreement on Tariffs and Trade art. 6, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, 1869 U.N.T.S. 183, 33 I.L.M. 1167.

<sup>58</sup> *Id.*, art. 1(2).

<sup>59</sup> See Yanning Yu, *Rethinking China's Market Economy Status in Trade Remedy Disputes after 2016*, 8 ASIAN J. WTO & INT'L HEALTH L. & POL'Y 77, 83 (2013).

<sup>60</sup> See Francis Snyder, *The Origins of the “Nonmarket Economy”: Ideas, Pluralism and Power in EC Anti-dumping Law about China*, 7 EUR. L. J. 369, 374-75 (2001).

<sup>61</sup> See K. William Watson, *Will Nonmarket Economy Methodology Go Quietly into the Night?: US Antidumping Policy Toward China after 2016*, 763 CATO INST. POLICY ANALYSIS 1, 13-14 (2014).

<sup>62</sup> See Liu Liquan (刘立权) & Fan Chenyu (范陈玉), *Woguo Feishichang Jingji Diwei de Yuanqi, Weihai yu Duice* (我国非市场经济地位的缘起、危害与对策) [*The Origin, Negative Effects and Strategies of China's Non-Market Economy Status*], 462 SHANGCHANG XIANDAIHUA (商场现代化) [MKT. MODERNIZATION MAGAZINE] 13, 14 (2006).

<sup>63</sup> See Ji Ma, *Challenge the Non-Market Economy Methodology Taken by EU and US against China in WTO Anti-dumping Area*, 13 (June 10, 2012) (unpublished Ph.D. dissertation, Peking University School of Transnational Law).

from China is consistent with WTO rules.<sup>64</sup> Since the EU has frequently applied its anti-dumping instruments against manufacturers from contemporary China, in July 2009, China has requested consultations with the European Communities (“EC”) concerning Article 9(5) of the Basic AD Regulation and the determination and imposition of ADs on imports of certain iron or steel fasteners from China.<sup>65</sup>

*EC-Iron Fasteners* did not directly provide any analysis on the criteria to establish an NME. However, it limited the flexibility for Members to apply the NME methodology to a very limited extent. The EU’s argument that its application of NME approach is justifiable because all Chinese manufacturers involved were closely associated together as to constitute a single entity.<sup>66</sup> Accordingly, the Appellate Body examined if there is a legal basis supporting that all manufacturers from China could be deemed as a single entity.<sup>67</sup> Appellate Body’s Report noted that the EU is not entitled to presume that all the exporters and suppliers in an NME constitute a single entity, because such a presumption actually places the burden of proof on the exporters and suppliers, rather than on the investigating authorities.<sup>68</sup>

The Appellate Body went further as to examine whether the test formulated by the EU serves as an appropriate criterion for judging whether the state and the exporters in an NME can be considered as a single entity. According to the findings by the Appellate Body, among the five requirements formulated in Article 9(5) of the Basic AD Regulation, only one of them, which is Article 9(5)(c), is directly related to the structural relationship between the state and the suppliers.<sup>69</sup>

Arguably, the China’s SOE reform has been constantly in parallel with the gradual formation and completion of a market mechanism. With the progressive abolition of privileges of SOEs, SOEs have been gradually faced with the same type of market conditions that other non-state actors face. Ultimately, SOEs have to function as market entities that operate in the market on equal footing with other competitors in the market. Therefore, the reform may help certain industries in China more easily qualify an NME status in future practice.

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<sup>64</sup> See *EC-Iron Fasteners*, *supra* note 31, ¶ 2.

<sup>65</sup> *Id.*, ¶ 1-2.

<sup>66</sup> *Id.*, ¶ 361.

<sup>67</sup> *Id.*, ¶ 363-370.

<sup>68</sup> *Id.*, ¶ 364.

<sup>69</sup> *Id.*, ¶ 378. See also Council Regulation 1225/2009, art. 9(5), 2009 O.J. (L 343) 51, 63 (EC), [http://trade.ec.europa.eu/doclib/docs/2010/april/tradoc\\_146035.pdf](http://trade.ec.europa.eu/doclib/docs/2010/april/tradoc_146035.pdf).

#### IV. CONCLUSION

Faced with urgent needs in both economic and social grounds, China has recently released several documents proposing a new round of SOE reform. This paper has explored the legal implications of the proposed reform by assessing the potential changes in legal arrangements in both internal and external markets.

The paper has found that, regarding the internal market regulation, even more SOEs may be converted into purely commercial entities and entitled to independent property rights. The state may influence SOE governance through performing its shareholder rights, rather than rigidly interfering in the operation of SOEs by exercising its administrative authority.

In terms of the influences of the newly proposed reform on China's participation in the global market, as SOEs may largely operate as commercial entities, they can more easily escape from the scope of public entities. Also, as the relationship between the state and the market becomes more market-oriented, it becomes increasingly difficult to establish that the Chinese economy is not subject to market conditions. In short, successful reform may help relieve the tensions between China and Western countries where the doctrine of free-market capitalism prevails, and thereby the coherence between China and the international economic order will be further advanced.