

BUSINESSEUROPE



# THE EU AND CHINA

## ADDRESSING THE SYSTEMIC CHALLENGE

A comprehensive EU strategy  
to rebalance the relationship  
with China



## WHO ARE WE ?

BusinessEurope is the leading advocate for growth and competitiveness at the European level, standing up for companies across the continent and campaigning on the issues that most influence their performance.

A recognised social partner, we speak for all-sized enterprises in 35 European countries whose national business federations are our direct members.

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## FOREWORD

The European business community has long been part of China's success story. We have encouraged China's market-oriented reform path, invested in China and championed closer economic engagement with China for years. The EU and China officially established diplomatic relations in 1975, and signed their first trade agreement during the same year that China began its policy of 'reform and opening-up' (改革开放) in 1978. Business engagement followed swiftly since then. Today, the EU is China's most important **trading partner**, while China is the EU's second most important trading partner. Total bilateral trade flows in goods grew to EUR 604.7 billion in 2018, while total trade in services amounted to almost EUR 80 billion in 2017. And there is still plenty of untapped economic potential for both sides.

The Chinese and European economies have **benefitted** tremendously from China's accession to the WTO in 2001. This showcases that rules-based multilateral trade is the best enabler for economic development. The WTO was created as a body governing multilateral rules-based trade that would evolve in parallel to the needs of the modern economy. The lack of WTO reform in recent years, however, coupled with emerging signs of a slowdown or reversal in market-oriented reforms in China has led to level-playing field issues whose impact has grown as China's share of global economy has increased.

This is why the European business community now advocates for a **stronger and fairer economic relationship** between the EU and China. In this paper we outline the potential that closer economic engagement would bring but we also acknowledge and explain the obstacles that undermine this potential. The consolidation of China's state-led economy presents **systemic challenges** that lead to market distortions within China, the EU and on third markets. This undermines the level playing field between European and Chinese businesses. A fairer economic relationship is therefore urgently needed and would best be achieved if China created a true level playing field between domestic and foreign firms and addressed the systemic issues that lead to market distortions.

Recent developments, however, have generated a **renewed sense of urgency** among the European business community that these issues cannot remain unaddressed in anticipation of hopeful improvements. With the objective of a stronger and fairer relationship in mind, **the EU should continue to engage China, while simultaneously taking its own measures to address these challenges.**

Our ultimate **goals** are for the EU to secure a level playing field between the EU and China, mitigate the impact of China's government-induced market distortions, reinforce the EU's own competitiveness, and ensure fair competition and cooperation in third markets.

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# EXECUTIVE SUMMARY

BusinessEurope's paper *The EU and China: Addressing the Systemic Challenge* sets out a strategy on how the EU and China can build a stronger and fairer economic relationship. The paper first demonstrates that there is a shift in the balance of opportunities and challenges in our economic relationship with China (chapter 1). This means that the EU should reconsider how it engages China (chapter 2). As a result, we advance four key objectives that the EU should pursue in order to seize the opportunities within the economic relationship and to address the systemic challenges that China's state-led economic system poses to the EU. Each key objective is also elaborated upon in a dedicated chapter (chapters 3-6). The four key objectives are as follows:

- 1 Secure a level playing field between China and the EU**
- 2 Mitigate the impact of China's government-induced market distortions**
- 3 Reinforce the EU's own competitiveness**
- 4 Ensure fair competition and cooperation on third markets**

This executive summary captures the main messages and recommendations of the paper. The paper's chapters and subchapters include a detailed analysis of the opportunities and challenges and recommends 130 actions on how these four objectives can be achieved.

# 01 CHINA: A SHIFT IN THE BALANCE OF OPPORTUNITIES AND CHALLENGES

## ▶ **EUROPEAN BUSINESS WANTS A STRONGER AND FAIRER ECONOMIC PARTNERSHIP WITH CHINA.**

A stronger relationship with China offers enormous opportunities to European and Chinese businesses. China is already the EU's second biggest trading partner and the EU is China's biggest trading partner. Fair competition between European and Chinese firms would furthermore lead to greater innovation and new opportunities.

## ▶ **NEVERTHELESS, THERE EXIST SEVERE CHALLENGES THAT OBSTRUCT A STRONGER ECONOMIC RELATIONSHIP.** These challenges harm the economic prospects of European businesses and employment in the EU. This is due to the systemic challenges posed by China's state capitalism.

## ▶ **WHAT ARE THEY?** China's state-led system includes direct government control over major parts of its economy including key industries, financing institutions, state-owned enterprises, and softer influence through party cells and the corporate social credit system (CSCS) that will apply to all enterprises. This unique and extensive system of state control and coordination through top-down economic planning increasingly blurs the boundaries between the public and private sector and has given rise to "China Inc." – a structure in which the state dominates all aspects of the economy.

## ▶ **WHY IS THIS A PROBLEM?** This state-led system produces a number of discriminatory outcomes and market distortions, including amongst others a disparity in market access between Chinese and foreign firms, financing advantages for Chinese firms in strategic sectors, cheap land and energy and state guidance and preferential support for selected Chinese industries. The Chinese government often uses measures that promote 'indigenous innovation' to achieve the declared goal of global industrial and technological leadership in key sectors by 2049.

## ▶ **WHY IS IT IMPORTANT NOW?** Profound recent developments have led to a growing awareness among the European business community that these systemic problems are worsening, that we are moving away from their resolution, and that their impact on European business is increasing. This has led to **a renewed sense of urgency** that these problems need to be addressed as a matter of the highest priority.

1. First, instead of reforming its state-led economy into a market economy, signs emerging about China's economic trajectory point to a further consolidation of its state-led economy. The European business community is increasingly concerned that the question is not when China will converge with the global market economy, but if it will converge. A lack of convergence raises serious questions about whether the current rules-based multilateral system can secure a level playing field.

2. Second, China is re-introducing political ideology into its economy instead of sustaining economic reform and liberalisation. The expansion of (the role of) party cells undermines the independence of private companies. The introduction of the corporate social credit system (CSCS) could also in the future undermine the independence of private companies and their commercial decisions.

3. Third, China is for the first time exporting its domestic policy mix because it has the capital and companies to do so, and both are motivated to go overseas. Besides affecting European businesses in China, these distortions increasingly spill over into the European market and third markets and affect fair trade, investment, procurement, competition, and thereby undermine the global liberal economic system.
4. Fourth, China's immense economic growth in recent years means that the impact of these distortions on European businesses is far larger today than when it joined the WTO in 2001. China's share of global GDP grew rapidly from 4% in 2001 to 15.2% in 2017.<sup>1</sup> Similarly, its share of global merchandise trade grew from 4.2% in 2001 to 12.7% in 2018.<sup>2</sup>
5. Fifth, the United States are attempting to force through a resolution of the systemic problems posed by China's state-led economy through a trade conflict with China that is both economic and geopolitical in nature. This also has an impact on the European business community.

► **WHY IS IT DIFFICULT TO ADDRESS?** Alongside European political stakeholders, the EU business community has for years encouraged China's market-based reform path and championed closer economic engagement with China on this basis. The EU has for the same reasons been supportive of China's integration into the global economy. China's transformation into a market economy would by and large address the systemic drivers of its market distortions and result in a greater level playing field. Conversely, China's current consolidation of its state-led economy will likely worsen the systemic problems and their impact on European business.

► **OUR BILATERAL PROSPECTS DEPEND LARGELY ON CHINA.** While our bilateral relationship depends on the engagement of both the EU and China, the prospects for a stronger and fairer relationship which the European business community sees as an ultimate end goal depend largely on whether China can successfully address the growing challenges that European companies face when doing business on the Chinese market or when competing with Chinese companies on the European market and on third markets.

<sup>1</sup> The Global Economy, "[China: Percent of world GDP](#)", 2019.

<sup>2</sup> Own calculations based on [UNCTAD data](#).

## 02 HOW THE EU SHOULD ENGAGE CHINA

The EU needs to reconsider how it engages China in order to achieve the four key objectives we have outlined. In the past, the EU's means of engagement have not produced the desired results. Recent changes within China also prompt the EU to rethink its toolkit. Due to the difficulties outlined above, the EU must reconsider its *modus operandi* towards China and put more emphasis on reciprocity and conditionality.

- ▶ **THE EU MUST RECONSIDER ITS *MODUS OPERANDI* TOWARDS CHINA.** With strong signs of China moving away from market reforms and towards a consolidation of its state-led economy, the European Union cannot wait and see whether China will address these issues and needs to act to defend its interests.
  
- ▶ **WHY SHOULD THE EU RECONSIDER ITS *MODUS OPERANDI*?** In the past, the means through which the EU aimed to achieve its goals vis-à-vis China have often not yielded the desired results. For example, China is still the EU's most restrictive major trading partner, there are still numerous investment barriers and joint venture requirements and China's procurement market is still closed. Consequently, the EU should reconsider the means through which it aims to achieve its *end goals* vis-à-vis China.
  
- ▶ **WHICH LEVELS OF ENGAGEMENT?** The EU should pursue its objectives simultaneously (not sequentially) on the following **three levels**, which will lead to a situation of policy complementarity and enhance the EU's leverage at home and abroad:
  1. **THE MULTILATERAL AND PLURILATERAL LEVEL:** Reforming the WTO and engaging China at WTO level would ideally be the best way to achieve the EU's objectives. The current multilateral rulebook is designed for market economies and does not adequately address the implications of a state-led economy. Unfortunately, attempts to reform the WTO have thus far produced little result, partly due to unanimous decision-making. The EU should also cooperate closely with likeminded partners in plurilateral initiatives to strengthen and reform multilateral economic governance and to restore a global level playing field.
  2. **THE BILATERAL LEVEL:** Engaging China bilaterally is an essential cornerstone in building a stronger and fairer economic relationship between the EU and China. The EU and China should focus on resolving trade and investment barriers through bilateral agreements with the consultation of key stakeholders amongst which the business community. The EU should also encourage China to pursue market-based reforms.
  3. **THE UNILATERAL LEVEL:** If China does not intend to become a liberal market economy, long-standing as well as new economic barriers and market distortions will remain unaddressed through the multilateral and bilateral approaches. As there is frequently a lack of progress on the multilateral and bilateral level, **the EU should simultaneously strengthen its own capabilities** to seize the opportunities and to safeguard our market economy from the negative spill-over effects of government-induced market distortions from China.



► **HOW TO ENGAGE?** The EU should engage China in a much more **reciprocal** and conditional manner, based on our **values, principles, and interests**. The problems highlighted in this paper are much more structural than issue based and addressing them requires a **comprehensive** and **whole-of-government approach** as opposed to an 'issue-based' approach in which problems can be addressed separately. The EU needs to equip itself with the right toolbox to engage China and needs to **update its *modus operandi* in at least five different ways**. The EU should:

1. **ACT SIMULTANEOUSLY:** No single approach will allow the EU to achieve the objectives required to address the systemic challenges presented by China's state capitalism. Therefore, the EU needs to act simultaneously on multilateral, plurilateral, bilateral and unilateral levels as opposed to acting sequentially. Such a strategy will lead to a situation of policy complementarity and enhance the EU's leverage.
2. **ACT UNITEDLY:** European companies and Member States often face a collective action problem. While we would benefit from standing together to achieve maximum leverage, China frequently uses asymmetrical openness and economic diplomacy as tools to undermine our collective action. The EU Member States should find ways to **address China with 'one voice' and act united** for example by moving towards qualified majority voting (QMV) on foreign policy matters in the future. The EU and its Member States should also set up a **mechanism to invest in knowledge sharing and capacity building** on China to achieve information parity and informed decision-making across the EU.
3. **ACT COHERENTLY:** The EU can only achieve its objectives if its policy goals are tailored towards these goals and act in support of and not contrary to them. The EU should elevate its China policy to the highest political priority and adopt a **whole-of-government approach** in which policies are benchmarked on the extent to which they contribute to or undermine our objectives. The EU should also systematically review the implications of the rise of China on the EU through regular and consistent studies.
4. **ACT STRATEGICALLY:** The EU's strategic autonomy and economic sovereignty are being challenged as both China and the USA increasingly mix economics with geopolitics. The EU's current instruments are not designed for a world in which economic, security, and strategic considerations are increasingly intertwined. To stimulate and facilitate a more strategic approach towards China, European business calls on the EU and its Member States to set up an **annual strategic dialogue on China** between the EU, its Member States, the European business community, academia and other key stakeholders. Inspiration could be drawn from the European Commission's Task Force 50 on Brexit.
5. **ACT CONFIDENTLY:** The EU should not shy away from leveraging its economic strength to achieve its objectives. The EU should defend its values, its successful liberal economic system and European interests proactively, enhance the EU's economic diplomacy, and deflect China's sharp power. While the EU has its weaknesses, it wields enormous soft-power and discursive influence. It should better employ these in areas where other means fall short, even if it amounts to making public statements.

## 03 SECURE A LEVEL PLAYING FIELD BETWEEN CHINA AND THE EU

In order to secure a level playing field between China and the EU, reforming the WTO remains a paramount goal. Unfortunately, given the difficulty in achieving reform in recent years, the EU should take complementary measures in the sphere of bilateral trade and investment, in the area of procurement, IPR protection and forced technology transfer, standardisation, e-commerce and energy and climate.

### World Trade Organisation (WTO)

While China's accession to the WTO helped to foster the economic development of China and world trade, China has not changed into an open market economy and there is a list of commitments from China's WTO accession protocol that have not been sufficiently addressed. The gaps and lack of rules in some areas of the WTO trading system mean that the WTO requires urgent modernisation.

- ▶ **WTO REFORM:** The EU should take the lead together with like-minded partners to create comprehensive rules that reign in **industrial subsidies** and discipline the behaviour of **state-owned enterprises**. In this regard, the EU and China should also further intensify discussions in the EU-China joint working group on WTO reform. Other reforms include amongst others introducing flexibilities into the system - both in terms of the negotiating method as well as in the decision-making process - and improving trade policy monitoring and notification procedures for example by introducing penalties for members that fail regarding notification requirements. Lastly, China should take the responsibility it has according to its real level of economic development which means that China can no longer simply be regarded as a developing country.
- ▶ **CHINA SHOULD JOIN EXISTING WTO AGREEMENTS AND THE EU AND CHINA SHOULD COOPERATE IN ONGOING NEGOTIATIONS.** China should first deliver on its longstanding promise to join the Agreement on Government Procurement (GPA). The EU and China should furthermore cooperate to successfully conclude an ambitious plurilateral agreement on e-commerce. Moreover, the EU should engage other WTO members to reprioritise the negotiations on the Trade in Services Agreement (TiSA), and take efforts to strengthen the aspect of sustainability in the WTO context.

### Trade and investment

The potential of a stronger bilateral trade and investment relationship is undermined by numerous trade and investment barriers. The market access barriers that European companies face include both pre-establishment (border measures) restrictions and post-establishment (behind the border) restrictions. In 2018, China surpassed Russia as the EU's most trade-restrictive partner as it now holds the highest stock of recorded trade and investment barriers.<sup>3</sup>

- ▶ **A RECIPROCAL TRADE AND INVESTMENT RELATIONSHIP:** China should make further market access improvements that resemble the enormous advantages China has gained on the European market. These should include trade in goods and services as well as digital trade. At the same time, the EU must take further action to mitigate the negative impact of Chinese state support to Chinese companies by eventually further strengthening the EU's trade defence instruments (TDIs) amongst others.

<sup>3</sup> European Commission, "[Report from the Commission to the Parliament and the Council on Trade and Investment Barriers](#)", 2019.

- ▶ **COMPREHENSIVE AGREEMENT ON INVESTMENT (CAI):** Concluding the negotiations on the CAI before the end of 2020 is a key priority for European business. However, substance should prevail over timing. It is essential that the scope of the agreement is as ambitious as possible. The agreement should remove substantially all investment barriers and effectively protect bilateral investment.

## Procurement

While Chinese companies are often allowed to bid on public procurement tenders in the EU, European businesses are often prohibited to bid on procurement opportunities in China. Several *de jure* and *de facto* barriers hinder European businesses in their access to the Chinese procurement market.

- ▶ **WTO AGREEMENT ON GOVERNMENT PROCUREMENT (GPA):** To achieve balanced market access on public procurement markets, China should join the WTO Agreement on Government Procurement (GPA) as soon as possible on the basis of an acceptable and ambitious accession offer.
- ▶ **AN INTERNATIONAL PROCUREMENT INSTRUMENT (IPI) WITH FURTHER MODIFICATIONS:** The EU should continue to work on the creation of an IPI. The 2016 International Procurement Instrument (IPI) proposal aims to pursue the right objective of encouraging third countries such as China to uphold the principle of balanced market access enshrined in the GPA. However, the proposal requires further modifications, amongst others, to avoid complex price adjustment mechanisms and negative effects on EU companies with international supply chains.
- ▶ **FULL IMPLEMENTATION OF EU PROCUREMENT RULES:** Foreign companies that participate in the EU public procurement market must respect our rules. The European Commission should therefore ensure that contracting authorities and Member States apply the EU 2014 directives more consistently. Additionally, the deletion of Article 85 and 86 of Directive 2014/25/EU should be avoided.

## Intellectual property rights and forced technology transfer

The protection and enforcement of intellectual property rights (IPR) and elimination of forced technology transfers have become a growing priority for European businesses. While some improvements are taking place in selected areas of China's IP landscape, the overall situation remains worrying. The problem is two-fold: on the one hand the Chinese IP framework is still insufficiently developed, and on the other hand existing measures are insufficiently enforced. European businesses therefore call for the creation of a level playing field through adequate IPR protection and eliminating all *de jure* and *de facto* forced technology transfer practices.

- ▶ **IMPROVED ENFORCEMENT WITHIN CHINA:** The EU should strengthen exchanges with Chinese patent and IP offices with a view to securing greater commitments to enforce the stringent IP standards set out at WTO level. China still has important steps to take in improving and enforcing its IP system.

- ▶ **IMPROVED AWARENESS AND ENFORCEMENT WITHIN THE EU:** The EU should also raise awareness among its business community on the common IPR problems within China and address the growing problem of counterfeited and pirated goods entering the EU market. National authorities should have strong and intelligent means to secure effective enforcement of EU IPR law.
- ▶ **TACKLE *DE JURE* AND *DE FACTO* FORCED TECHNOLOGY PRACTICES IN CHINA:** The EU's WTO case on forced technology transfer is an important step in this regard. Litigation matters. But the EU should employ a comprehensive strategy tackling all ways in which forced technology transfers take place. The EU should consider all policy options that could contribute to this objective, including the implementation of the EU Cyber-Diplomacy Toolbox to combat ICT-enabled IP theft.
- ▶ **THE ONUS IS ON CHINA TO TAKE BOLD STEPS:** China should be pressed to eliminate forced technology transfer practices through a mix of legislative, administrative and judicial changes to create a real level playing field. This includes removing discriminatory practices for foreign companies and removing requirements to disclose IP or sensitive business information.

## Standardisation

There are three concerns that may arise with respect to standardisation in China. A first concern is that mandatory Chinese (national, sectoral or local) standards may be used to establish *de facto* barriers to trade. Second, for most standards it is the government who determines which stakeholders, if any, may provide input to the standard. A third concern relates to China's ambition for global leadership in standardisation. The unilateral imposition of Chinese national standards in third countries would result in an unlevel playing field. Combined, these concerns mean that European companies do not enjoy the same access to the Chinese market as Chinese companies to the European market, with possible similar consequences on third markets.

- ▶ **CHINA SHOULD ADHERE TO INTERNATIONAL STANDARDS.** Although China participates proactively in the standard-setting bodies that formulate standards, China often does not implement them. Moreover, Chinese standards should not be used as a trade barrier by establishing a *de facto* mandatory requirement for EU companies when selling their products and services in China.
- ▶ **EUROPEAN COMPANIES SHOULD HAVE FULL RECIPROCAL ACCESS TO PARTICIPATE IN CHINESE STANDARDISATION** on the same footing as Chinese companies can participate in standardisation in the EU (CEN/CENELEC, ETSI or at national level).

## E-commerce

E-commerce has the potential to offer more choice to European consumers as well as to offer new tools for European manufacturers to reach consumers. In 2018, the majority of e-commerce-related parcels circulating in the EU already originated from China.<sup>4</sup> To date, an unacceptable number of Chinese products and services that enter the European market do not fully comply with EU law and safety regulation – most notably but not only in the area of e-commerce.

- ▶ **THE EU MUST ENSURE THAT ONLY EU-COMPLIANT PRODUCTS ENTER THE UNION MARKET:** The EU market surveillance capabilities should be reinforced, and the EU Safety Gate must be further tailored to address these challenges – in particular but not only in the area of e-commerce. EU Member States and the EU should ensure that national authorities are provided with strong and intelligent means to secure effective enforcement of EU law at the European border.
- ▶ **THE EU AND CHINA SHOULD COOPERATE TO CONCLUDE NEGOTIATIONS ON A PLURILATERAL AGREEMENT ON E-COMMERCE:** A future plurilateral agreement on e-commerce should establish binding rules for free, secure and reliable cross-border e-commerce.

## Energy and climate

To achieve our ambition of climate neutrality by 2050, we urgently need international convergence of climate ambitions. For this reason, it is essential that China, being the leading global GHG emitter (28% of the global emissions<sup>5</sup>), takes its responsibility together with the EU and other signatories of the Paris Agreement. While the EU has adopted relatively far-reaching climate policies, there exists a lack of equivalent climate policy measures for industries in China and on third markets – in particular in Africa. The cost burden of climate and environmental policy to China's manufacturing sector is far lower than to the EU's.

- ▶ **STRONG BILATERAL AND MULTILATERAL COOPERATION BETWEEN THE EU AND CHINA IN ACCORDANCE WITH THE PARIS AGREEMENT:** In this regard, the EU and China should for example continue their cooperation in the EU-China Partnership on Climate Change.
- ▶ **SAFEGUARD THE COMPETITIVENESS OF EUROPEAN INDUSTRY FROM 'FREE RIDERS' AND CARBON AND INVESTMENT LEAKAGE:** The EU and EU Member States must fully apply all existing measures within the EU ETS to minimise the risk of carbon and investment leakage. A toolbox of targeted instruments is needed to shield the EU from distortions caused by free riders.
- ▶ **THE EU MUST MINIMISE ITS DEPENDENCY ON CHINESE RAW MATERIALS, IN PARTICULAR RARE EARTHS AND PRECIOUS METALS:** The EU must consider additional measures that proactively mitigate the distortions in competitiveness inflicted by 'free riders' and international regulatory asymmetries.

<sup>4</sup> Wik Consult, "Assessment of EU Parcel Delivery Markets", 2018.

<sup>5</sup> Emissions include CO<sub>2</sub> emissions from fuel combustion only. Data available on the [webpage](#) of the International Energy Agency (2016).

## 04 MITIGATE THE IMPACT OF CHINA'S GOVERNMENT-INDUCED MARKET DISTORTIONS

It is of key importance that the EU takes measures to mitigate the impact of government-induced market distortions on European businesses. The EU should aim to discipline the role of state-owned enterprises, take proactive steps to address the issue of industrial subsidies, engage internationally to try and eliminate overcapacity and take steps in the area of competition policy and state aid.

### State-owned enterprises (SOEs)

Although Beijing announced that the market should play a “decisive” role in allocating resources<sup>6</sup>. President Xi Jinping’s statement that SOEs should become “stronger, better and bigger” stands in sharp contrast to the rhetoric of market-based reform. The conduct of SOEs is growing more problematic because there is a reversal of market-based reforms, an increase of influence of the party on the corporate governance of SOEs, a hike in SOE mega-mergers and a continuation of preferential treatment of SOEs.

- ▶ **THE EU SHOULD DEVELOP AN ‘SOE PRINCIPLE’ TO MITIGATE THE IMPACT OF GOVERNMENT-INDUCED MARKET DISTORTIONS:** An SOE principle entails that EU policies should be designed in such a way that it addresses the market-distortive effects of foreign SOEs. The SOE principle could, for example, be applied in the areas of subsidies, investment and procurement. The EU should also investigate whether this principle could be applied to further policy areas. The Comprehensive Agreement on Investment (CAI) and a potential international procurement instrument should include special provisions on SOEs.
- ▶ **ENSURE ‘COMPETITIVE NEUTRALITY’:** The EU should advocate for the creation of multilateral rules on the competitive neutrality of SOEs. The EU should also encourage China to create a competitive neutrality instrument. Additionally, the EU should study whether and how a European ‘competitive neutrality instrument’ could ensure the competitive neutrality of foreign SOEs on the European market.

### Subsidies

China provides various forms of government support to its industries, particularly in the context of industrial policies such as Made in China 2025. Subsidies can take on several forms, including direct subsidies, government grants, tax benefits and export credits. Direct and indirect subsidies to SOEs have for example amounted to 1.3-1.6% of annual GDP in recent years. The figure of total subsidies is even higher as, in addition to SOEs, private sector firms received about a third of total direct subsidies in 2018. These problems increasingly spill over into the global trading system, including the EU market.

- ▶ **THE EU SHOULD PURSUE MULTILATERAL, PLURILATERAL AND BILATERAL EFFORTS TO DEVELOP NEW DISCIPLINES ON INDUSTRIAL SUBSIDIES AND SOEs.** In this regard, the EU, Japan and the USA should deliver concrete outcomes in their trilateral discussions and consider launching negotiations on a plurilateral agreement on tackling government-induced market distortions. The EU should also intensify discussions on industrial subsidies and SOEs in the EU-China joint working group on WTO reform.
- ▶ **THE EU SHOULD REVERSE THE BURDEN OF PROOF FOR FOREIGN STATE-OWNED ENTERPRISES WITHIN ITS INTERNAL MARKET AND INSTEAD LET THEM PROVE THAT THEY DO NOT RECEIVE DISTORTIVE SUBSIDIES ON THEIR HOME MARKET.** This would be WTO-compliant, and the additional transparency would allow the EU to effectively use its instruments to address the impact of subsidies within its single market.

<sup>6</sup> Central Committee of the Communist Party of China, “*Decision of the Central Committee of the Communist Party of China: The Significance of and Guiding Thoughts on Deepening the Reform Comprehensively*”, 2014.

## Overcapacity

While overcapacity is a global problem, China's industrial policies within the framework of state-led economic planning have been the single largest driver of this problem. A range of policy instruments, including subsidies, contribute to and exacerbate the problem. Although China has acknowledged the problems of overcapacity and initiated plans to tackle them, the results to date have not yet led to a meaningful reduction in overcapacity.

- ▶ **CHINA SHOULD CONTINUE TO TAKE BOLD STEPS TO ELIMINATE OVERCAPACITY.** Reducing government intervention and enhancing reciprocal market access for European and other foreign business would greatly enhance China's ability to overcome problems of overcapacity.
- ▶ **THE EU AND LIKE-MINDED PARTNERS SHOULD PRESS CHINA TO TAKE FURTHER STEPS TO SET AND PUBLISH GOALS TO REDUCE EXCESS CAPACITY THROUGH LEGAL AND MARKET-BASED METHODS AND TO ELIMINATE DUMPING** its overcapacity on foreign markets. The G20 and OECD are excellent fora of engagement and could be an opportunity to explore plurilateral negotiations on eliminating government-induced market distortions.
- ▶ **THE EU SHOULD ALSO MAKE GREATER USE OF ITS TDI TOOLBOX.** The details are covered in the chapter on trade. This includes strengthening TDIs, enhancing transparency tools, ensuring sufficient in-house staff and resources to conduct TDI investigations, as well as a regular fitness check to ensure our TDIs are up to date in addressing the latest types of trade distortions.

## Competition policy and state aid

The EU must find **solutions to mitigate external disturbances** and ensure fair competition in the global context. The EU must use all existing platforms to mitigate the disturbances in competition caused by policies and practices in third countries, including China.

- ▶ **THE EUROPEAN COMMISSION SHOULD IDENTIFY WHETHER THERE ARE SITUATIONS WHERE IT SHOULD PUT MORE WEIGHT ON THE GLOBAL MARKET ENVIRONMENT WHEN ASSESSING MERGERS.** At the same time, the Commission should bear in mind overall market developments as well as competition within the internal market.
- ▶ **THE EU NEEDS TO BETTER ASSESS THE MARKET POWER OF (LEGALLY INDEPENDENT) COMPANIES THAT ARE ASSOCIATED WITH EACH OTHER AND/OR OPERATE IN A COORDINATED MANNER (SINGLE ECONOMIC ENTITY).** A major risk is posed by Chinese acquisitions conducted by formally and legally independent investors who, however, act in a coordinated manner within the framework of the Chinese government's central economic planning. The EU should analyse the risks to competition from increasing Chinese market concentrations and from coordinated action of formally independent undertakings (single economic entity).
- ▶ **THE EU SHOULD STRENGTHEN EU STATE AID RULES TO ADDRESS MARKET-DISTORTING SUBSIDIES OUTSIDE THE EU:** The EU needs to advocate for stronger state aid rules at WTO level and needs to integrate ambitious state aid rules in trade and investment agreements. The EU should also analyse whether it is appropriate to revise EU state aid rules to address market-distorting subsidies outside the EU.

## 05 REINFORCE THE EU'S OWN COMPETITIVENESS

With technologies being increasingly able to influence economic, societal and political outcomes, we are witnessing a clear acceleration of the global innovation race. Despite its many assets, Europe falls behind in this race. The EU's share of the world gross expenditure on R&D has decreased from 25.8% in 2000 to 20% in 2018. Over the same period, China's share has increased from 5% to 21%.<sup>7</sup> The EU must deepen the Single Market, develop an ambitious industrial strategy, invest more in R&D and stimulate digitalisation to maintain its competitive edge.

### A competitive Single Market and ambitious industrial strategy

Businesses continue to experience regulatory and administrative hurdles when doing business in the EU and in the EU Member States. At the same time, China is catching up with the EU in terms of fostering a conducive regulatory business environment. Although the EU ranks higher than China in terms of the overall ease of doing business, on some indicators it is nowadays easier to do business in China than in the EU. In 2018 for example, it was easier (for local companies) to start a business in China than in the EU.<sup>8</sup> To maintain its competitiveness the EU must:

- ▶ **DEEPEN THE SINGLE MARKET:** Regulatory asymmetries make it challenging for companies, in particular start-ups, to develop economies of scale. National regulations must be harmonised as much as possible, while keeping in mind proportionality and necessity principles. This is essential to help provide the domestic base from which new companies can develop economies of scale and compete globally.
- ▶ **DEVELOP A STRATEGIC INDUSTRIAL POLICY:** Instead of developing a dirigiste industrial policy like China, the EU must develop a strategy that aims to improve the framework conditions that incentivise companies of all sizes to invest, innovate and grow.
- ▶ **REGULATION AT EU AND NATIONAL LEVEL SHOULD FOLLOW BETTER REGULATION PRINCIPLES TO MINIMISE REGULATORY AND ADMINISTRATIVE BURDENS.** This will contribute to maintaining our regulatory competitiveness vis-à-vis China, who is steadily catching up.

### Research and innovation

China is becoming a powerhouse in some key areas of research, development and innovation (RDI) and has surpassed the EU in terms of government expenditure on R&D. In 2017, the EU RDI expenditure was equivalent to 2.07% of GDP, while China spent 2.13% on RDI. This figure is even poorer when compared to other third countries such as South Korea (4.55%), Japan (3.20%) or the USA (2.79%).

- ▶ **SCALE UP R&D BUDGETS:** The EU must more ambitiously support private-sector RDI investment in order to reach the EU 3% target and increase the budget of Horizon Europe to at least EUR120 billion.
- ▶ **CREATE THE SKILLS AND JOBS OF THE FUTURE:** Qualified specialists are needed to maintain and improve Europe's competitiveness and its ability to innovate. Currently, there is a shortage of skilled workers, inhibiting the economic growth of the EU in the world economy.

<sup>7</sup> European Commission, "[Science, Research and Innovation Performance of the EU](#)", 2018.

<sup>8</sup> World Bank, "[Doing Business 2019](#)", 2019.



- ▶ **CREATE A 'FIT-FOR-INNOVATION' REGULATORY ENVIRONMENT TO OVERCOME THE 'VALLEY OF DEATH':** Regulatory efficiency and an industry-friendly Horizon Europe will contribute to overcome the 'valley-of-death' between research and the commercialisation of research.
- ▶ **ENHANCE INTRA-EU COLLABORATION:** Because of the rising complexity and interdisciplinary nature of technologies, companies need to collaborate more. The EU must stimulate European partnerships and make them more attractive for companies.
- ▶ **MAINTAIN OPENNESS WHILE REQUIRING RECIPROCAL ACCESS TO FOREIGN RDI PROJECTS AND WHILE PROTECTING SENSITIVE AND CRITICAL RESEARCH DATA:** To achieve the greatest potential societal and economic benefits, research is an area that needs international collaboration to thrive. At the same time, the EU should demand fair access to Chinese RDI projects and more caution is needed to protect sensitive and critical information.

## Digital economy and cybersecurity

Key principles for a healthy digital economy include openness and avoiding protectionism while upholding a global level playing field, protection of intellectual property, privacy and personal data as well as high cybersecurity measures. China's digital strategy presents opportunities but also enormous challenges for European business as China adopted digital protectionist measures and as it is the most restrictive major economy in the area of digital trade.<sup>9</sup> The EU therefore needs to take bold steps to address digital protectionism, to unleash our own digital competitiveness and to enhance our cyber-defence and security capabilities to safeguard our innovations and technologies.

- ▶ **ENHANCE AND INVEST IN THE EU DIGITAL COMPETITIVENESS:** To keep up with the large and dynamic digital markets in China and the USA, EU institutions and Member States need to further develop the European digital market and adapt the legal and regulatory frameworks in the Single Market. The EU and the Member States should invest in key enabling technologies (KETs).
- ▶ **THE EU EFFORTS SHOULD AIM AT ADDRESSING CHINA'S DIGITAL PROTECTIONISM, RESTORING A LEVEL PLAYING FIELD INTERNATIONALLY, AND ADDRESSING THE CYBER-RELATED RISKS AND ABUSES** companies experience within the EU as a result of government-sponsored cyberattacks. Any EU approach, however, should combine pro-competitive policies with tools to address unfair behaviour.
- ▶ **CHINA SHOULD BE HELD TO INTERNATIONAL NORMS AND AGREEMENTS:** While all countries have legitimate concerns about privacy and national security, digital policy measures should be narrowly tailored, reflect international norms, be non-discriminatory and consistent with WTO agreements to which China is a party.

<sup>9</sup> China is the most trade restrictive country on the *'Digital Trade Restrictiveness Index'* that is composed by the European Centre for International Political Economy (ECIPE).

## 06 ENSURE FAIR COMPETITION AND COOPERATION ON THIRD MARKETS

Besides achieving a level playing field in the bilateral economic relationship, extending this level playing field to third markets is of paramount importance for the long-term opportunities of European businesses. The EU Connectivity Strategy is an important step in this regard, and emphasis should be placed on its proper implementation. At the same time, the EU should also try to engage China to ensure its Belt and Road Initiative meets international standards. Securing fair competition on third markets by upholding multilateral economic governance practices is vital.

### EU connectivity

Ambitiously improving the connectivity between the EU and Asia should be a key priority of the EU. Connecting transport, digital, energy and human networks will facilitate bilateral trade for example by cutting transportation costs. This will benefit businesses and consumers in both the EU and China.

- ▶ **THE EU BUDGET FOR CONNECTIVITY MUST BE INCREASED AMBITIOUSLY UNDER THE 2021-2027 MULTIANNUAL FINANCIAL FRAMEWORK (MFF):** In order for the EU to remain competitive globally, the EU must increase the budget available for connectivity programmes such as TEN-T, InvestEU and the EU Strategy on Connecting Europe and Asia.
- ▶ **THE EU AND CHINA SHOULD CONTINUE TO EXPLORE POSSIBLE SYNERGIES BETWEEN THE EU CONNECTIVITY STRATEGY AND THE BELT AND ROAD INITIATIVE (BRI):** The EU should for example further analyse the BRI in its TEN-T Corridor Studies and collaborate with China to conduct studies to determine priority corridors to prevent possible bottlenecks and transport constraints.
- ▶ **THE EU SHOULD BETTER PROMOTE THE EU CONNECTIVITY STRATEGY:** The EU's substantial financial contributions in Asia should be better promoted and the EU should consider rebranding its Connectivity Strategy with a more attractive name such as the '**Marco Polo Strategy**' to complement the existing name. The EU should share expertise and opportunities on connectivity related issues with Member States, and vice versa, so that they can take it into account in their foreign economic diplomacy at national and EU level.
- ▶ **ENSURE RECIPROCAL ACCESS TO THE BRI:** This means that Chinese and other foreign companies are welcome to bid on tenders related to the EU-Asia Connectivity Strategy, but only as long as European construction companies have equal access to Chinese-funded infrastructure projects such as the BRI.
- ▶ **INTENSIFY CONSULTATION AND DIALOGUE WITH BUSINESS AND OTHER STAKEHOLDERS THROUGH THE CREATION OF A BUSINESS ADVISORY COUNCIL:** A structural stakeholder platform should be created that is easily an openly accessible to discuss the implementation of the strategy and to receive valuable input from stakeholders.

### The Belt and Road Initiative

The BRI offers various opportunities for European companies. Besides opportunities for the construction and transport sectors, other sectors such as the banking, consulting and insurance services sectors may also

benefit from BRI. However, these opportunities have by and large not been realised to date because European businesses struggle to become involved. China's rhetoric of a more open, clean and green BRI now needs concrete action.

- ▶ **EUROPE SHOULD ENGAGE CHINA AT EUROPEAN LEVEL AND SPEAK WITH 'ONE VOICE':** Member States should call on China to increase reciprocity, especially in the infrastructure sector, to improve transparency, to prioritise high labour and environmental standards and to ensure debt sustainability.
- ▶ **PROMISES FOR A MORE OPEN, TRANSPARENT, GREEN AND RULES-BASED BRI NOW NEED TO DELIVER CONCRETE RESULTS:** In order to thrive, companies require fair competition and predictable rules surrounding tenders and procurement.
- ▶ **CHINA SHOULD CONSISTENTLY BE URGED TO APPLY INTERNATIONAL STANDARDS IN RELATION TO BRI.**

### Fair competition on third markets

European companies welcome international competition as it fosters development and innovation. All European companies compete internationally within the multilateral governance frameworks established through the WTO, OECD, and other institutions. However, China has engaged in *selective multilateralism*. This means for example that China often deviates from multilateral financing practices and flouts the OECD guidelines, which contributes to the tilting of the international playing field.

- ▶ **THE EU SHOULD WORK TOGETHER WITH PARTNERS TO AIM TO INTEGRATE CHINA FULLY WITHIN THE EXISTING MULTILATERAL FRAMEWORKS:** This includes for example the OECD arrangements on export credits (in particular the International Working Group on Export Credits), the Paris Club and several WTO agreements.
- ▶ **THE EU AND EU MEMBER STATES SHOULD ENCOURAGE CHINA TO CONTRIBUTE TO, IMPLEMENT AND ADHERE TO:**
  - ▶ All decisions, recommendations and guidelines of the **OECD Development Assistance Committee (DAC)**.
  - ▶ All obligations determined by the **OECD Arrangement on Officially Supported Export Credits**.
- ▶ **THERE IS AN URGENT NEED FOR THE EUROPEAN UNION TO DRAW LEVEL WITH FOREIGN DEVELOPMENT INSTITUTIONS.** The EU needs to come par with for example Asian and US development finance institutions (DFIs) in terms of both volume and management capacity for infrastructure finance on third markets, and specifically in Africa.
- ▶ **EU DELEGATIONS ACROSS THE WORLD NEED TO PLAY AN INCREASED ROLE IN CONDUCTING EFFECTIVE ECONOMIC DIPLOMACY.**

# INTRODUCTION

The European business community wants a **stronger and fairer economic relationship** between the European Union (EU) and China that would make it possible to preserve and increase the current level of partnership between our two economies. We believe that reciprocal trade, investment and competition will unleash substantial economic potential. **This potential remains untapped due to the systemic challenges** that China's state capitalism poses to the level playing field between the EU and China, and between European and Chinese firms. Recent profound changes in China generate a new sense of urgency amongst the European business community to redress this issue.

Signs emerging from China about its economic trajectory point towards a further consolidation of its state-led economy over market-oriented reform. This means that the European business community is increasingly concerned that the question is not *when* China will converge with the global market economy, but *if* it will converge. A lack of convergence raises serious questions about whether the current multilateral rulebook can secure a global level playing field.

A lack of World Trade Organisation (WTO) reform over many years has exacerbated this problem. The WTO was created as an institution that would create a global level playing field and evolve in parallel to changing economies. But while national economies and business environments have seen radical change over the past 25 years, the rulebook governing them has remained largely the same.

These simmering issues have reached a boiling point with the eruption of a trade dispute between two of the world's largest economies: the United States (USA) and China. The degree of integration of the world economy means that the trade dispute could have far-reaching consequences for other trading partners, including the EU.

It is against this background that the European business community supports the European Commission's Strategic Outlook on China that the balance of opportunities and challenges presented by China has shifted in recent years.<sup>10</sup> Although the European business community has championed closer economic engagement on the basis of reciprocity for years, this shift leads us now to call on the EU to pursue a strategic reorientation in its relationship with China in order to defend our values, principles and interests.

## The purpose of this strategy paper is:

- ▶ to raise awareness and explain how and where the level playing field between the EU and China is distorted due to China's state-led economy; and
- ▶ to outline concrete recommendations and demands that would lead to a more level playing field in our economic relationship.

<sup>10</sup> European Commission, "[EU-China: A Strategic Outlook](#)", 2019

From a European business perspective, the best way to address the issues outlined in this paper is for the Chinese government to adopt a more hands-off approach and place clear limits to market-distortive interventions that undermine the level playing field. China ought to return to market-oriented reforms and re-embark on the path of convergence with the global market economy in order to preserve and enlarge the benefits of globalisation. The EU and China should work together constructively and with other countries to establish new rules for global market-based governance at multilateral level.

Since progress on these issues is currently stagnating, we advance **four key objectives that the EU should pursue** in order to seize the opportunities within the bilateral relationship while addressing the systemic challenges posed by China's state-led economic system. Each key objective is elaborated in a dedicated chapter. The EU should:

- 1 Secure a level playing field between China and the EU**
- 2 Mitigate the impact of China's government-induced market distortions**
- 3 Reinforce the EU's own competitiveness**
- 4 Ensure fair competition and cooperation on third markets**

The EU should pursue these objectives simultaneously **across the following three levels**, which will lead to a situation of policy complementarity and enhance the EU's leverage at home and abroad:

- 1. The multilateral and plurilateral level:** Reforming the WTO would be the best way to achieve these objectives. The EU should also cooperate closely with likeminded partners in plurilateral initiatives to strengthen and reform multilateral economic governance and to restore a global level playing field.
- 2. The bilateral level:** Engaging China bilaterally is an essential cornerstone in building a stronger and fairer economic relationship between the EU and China.
- 3. The unilateral level:** The EU should simultaneously strengthen its own capabilities to seize opportunities and mitigate the challenges.

Since the challenge presented by China's state-led economy is a systemic one, there is often no single 'smoking gun' or policy to which distortions to the level playing field can be attributed. Rather, China's state-coordinated and controlled economic governance structure of top-down economic planning has a cumulative impact. As such, there are few 'silver bullet' solutions that could singlehandedly achieve these four objectives.

This strategy paper advances **130 detailed recommendations** that, when pursued simultaneously, would contribute to achieving these key objectives. While comprehensive, these recommendations are by no means exhaustive, and are the result of a scoping process that took place across the European business community. This paper and its recommendations are addressed to policy-makers across the European Union and its Member States, though several of them are directly relevant to China.

The paper is structured along six different chapters. The first chapter defines the shift in the balance of opportunities and challenges in the relationship with China. The second chapter advances a comprehensive approach through which the EU should engage China. The third, fourth, fifth and sixth chapters are each dedicated to one of our four key objectives, each with several subchapters that analyse the problems and recommendations that affect these goals.



01

# CHINA: A SHIFT IN THE BALANCE OF OPPORTUNITIES AND CHALLENGES

European business wants a stronger and fairer economic partnership with China. A stronger relationship with China and improved market access would offer enormous opportunities to European and Chinese businesses. China is already the EU's second-biggest trading partner and the EU is China's biggest trading partner. Nevertheless, systemic challenges obstruct a stronger economic relationship and harm the economic prospects of European businesses and employment in the EU. The prospects for a stronger and fairer relationship depend on whether the EU and China can successfully address the severe challenges that European companies face when doing business on the Chinese market or when competing with Chinese companies on the European market and on third markets.

## 1.1. RECIPROCAL TRADE, INVESTMENT AND COMPETITION OFFER ECONOMIC POTENTIAL

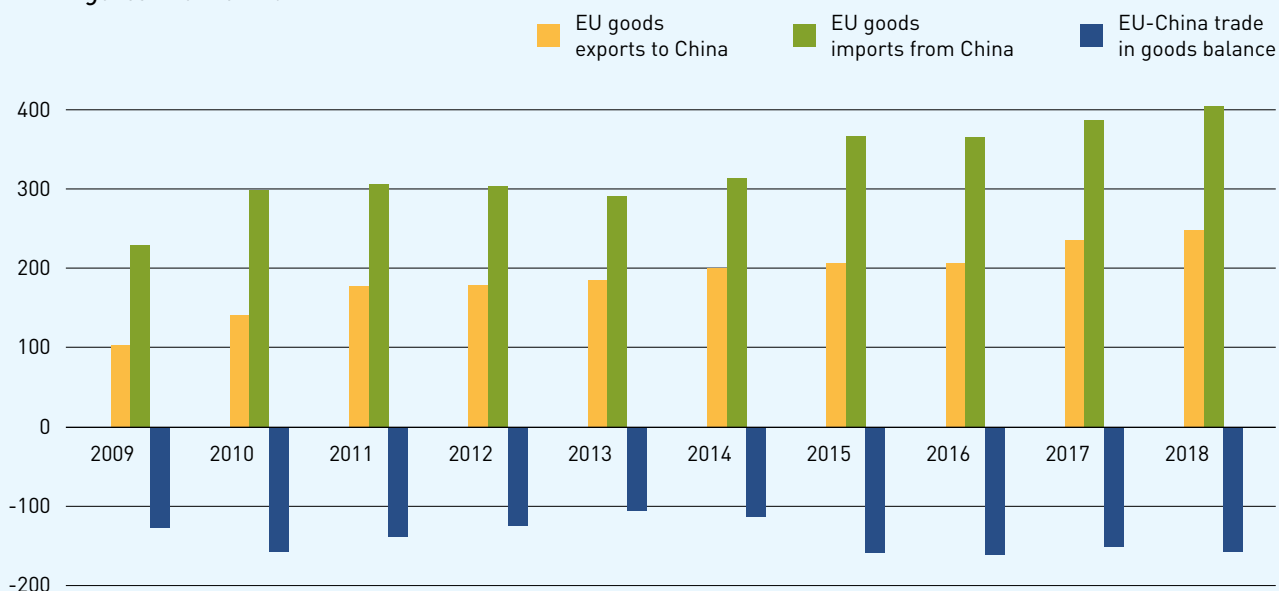
European companies strive for a stronger and fairer economic partnership with China because a closer relationship spurs bilateral trade and investment and stimulates competition, a key driver of innovation.

### Spurring bilateral trade and investment

China offers significant opportunities to European businesses, and vice versa. Bilateral trade and investment flows have been soaring over the last two decades. Total bilateral trade flows have increased from EUR 397.4 billion in 2010 to EUR 604.4 billion in 2018 (see trade chapter for more detailed analysis).<sup>11</sup> European investment flows into China have increased steadily after China's accession to the WTO, from EUR 1.7 billion in 2000, peaking in 2012 at EUR 12.5 billion and gradually declining to EUR 6.1 billion in 2018. Chinese investment flows into the EU have increased from an annual average of EUR 5.76 billion between 2009-2013 to an annual average of EUR 23.5 billion between 2014 and 2018 (see the investment chapter 3.3. for more detailed analysis).<sup>12</sup>

These figures illustrate the opportunities that an even stronger trade and investment relationship would offer to both European and Chinese businesses. Because of these opportunities, European companies are eager to further strengthen economic ties with China and to further open up to rules-based competition with China. After all, free and fair trade stimulates innovation and fosters prosperity.

#### EU-China bilateral trade in goods Figures in billion EUR

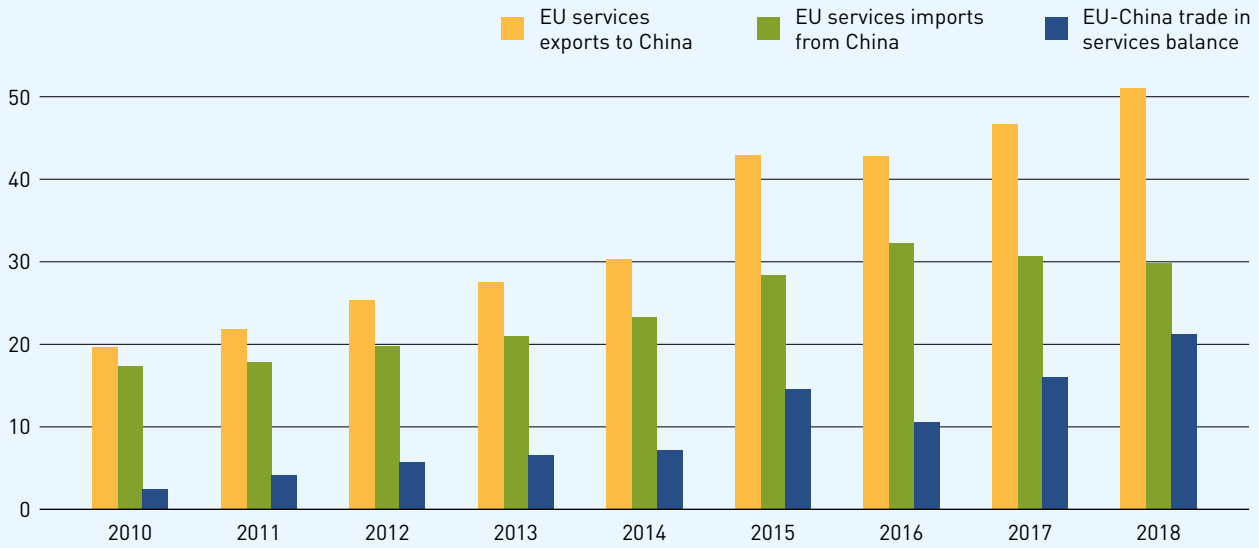


Source: Eurostat, 2019

<sup>11</sup> Eurostat, "International trade in goods – a statistical picture", 2019.

<sup>12</sup> Own calculations based on Rhodium Group data.

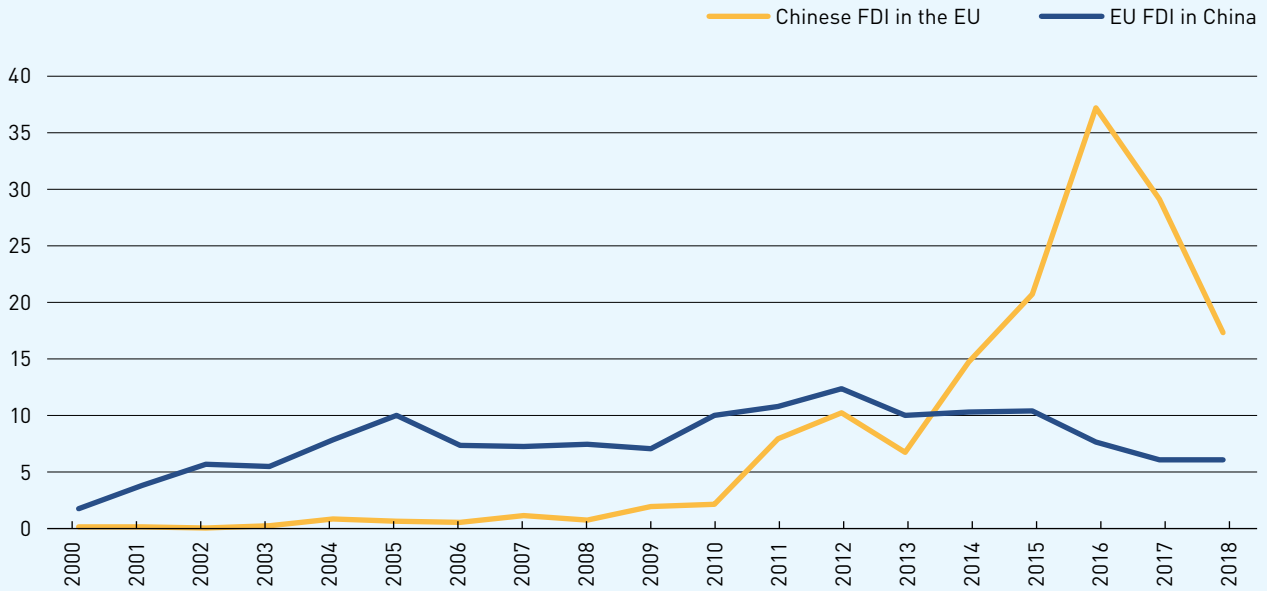
**EU-China bilateral trade in services**  
*In billion euros (data excludes Hong Kong)*



Source: Eurostat, 2019

**EU-China bilateral FDI flows**

*After hitting a record high in 2016, Chinese FDI flows to the EU have declined in 2018 (figures in billion EUR)*



Source: Rhodium Group, 2018



China's healthcare sector is a case in point of such opportunities. Healthy China 2030 underlines the importance of the healthcare sector in China's evolving society, as it disrupts and changes over 200 laws and regulations in the field of intellectual property (IP) laws, regulatory approval, market access, procurement as well as tax and customs. It is a market projected to be worth USD 2.4 trillion by 2030 and currently benefiting from double digit growth. This provides many opportunities for innovative European companies and could also lead to EU-Sino partnerships.

The European business community has for years been encouraging China's market-based reform path and we have been championing closer economic engagement with China on the basis of these reforms. The EU has for the same reasons been supportive of China's integration into the global economy.<sup>13</sup> Besides economic growth, the positive effects of China's successful integration into the world economy would entail welfare and consumer benefits, create important societal linkages, meaning that China could become an anchor for global stability.

### **Competition with China as a driver of innovation**

China aspires to become the global industrial and technological superpower by 2049. As China is moving up the value chain and becoming one of the world's most innovative high-tech countries, the competitive landscape between the EU and China is changing rapidly. In the past, China produced low-cost consumer goods and low-tech manufacturing goods, whereas the EU produced high-tech industrial goods and services. Today, European and Chinese companies are increasingly becoming direct competitors as China's Tier 1 and 2 cities are highly developed and more akin to developed countries. As a result, China today cannot be considered as simply a developing country anymore – as a matter of fact, it is well en route to becoming a technological power in the near-term.

In the 2018 Global Competitiveness Index of the World Economic Forum (WEF), China ranked 28<sup>th</sup> out of 135 countries in terms of the strength of the competitive landscape, an increase of 2 places compared to 2008, and 11 places compared to 2001 when it ranked 39<sup>th</sup>.<sup>14</sup> The sheer size of China's market, the growing economy, increasingly qualified labour force, high rate of information and communications technology (ICT) adoption, infrastructure and rising technological innovativeness are the main contributors to China's strong competitiveness.

In an earlier report, the Joint Research Centre (JRC) estimated that the EU lost 11.4 percentage points of global share in manufacturing value chains between 2000 and 2014 while China's share in global value chains (GVCs) increased by 13.7 percentage points in the same period (see charts). Controlling for demand factors related to the growth of the Chinese market shows that around 40% of the loss of the EU's share in manufacturing GVCs can be attributed to the declined competitiveness of the EU vis-à-vis its main competitors such as China.<sup>15</sup>

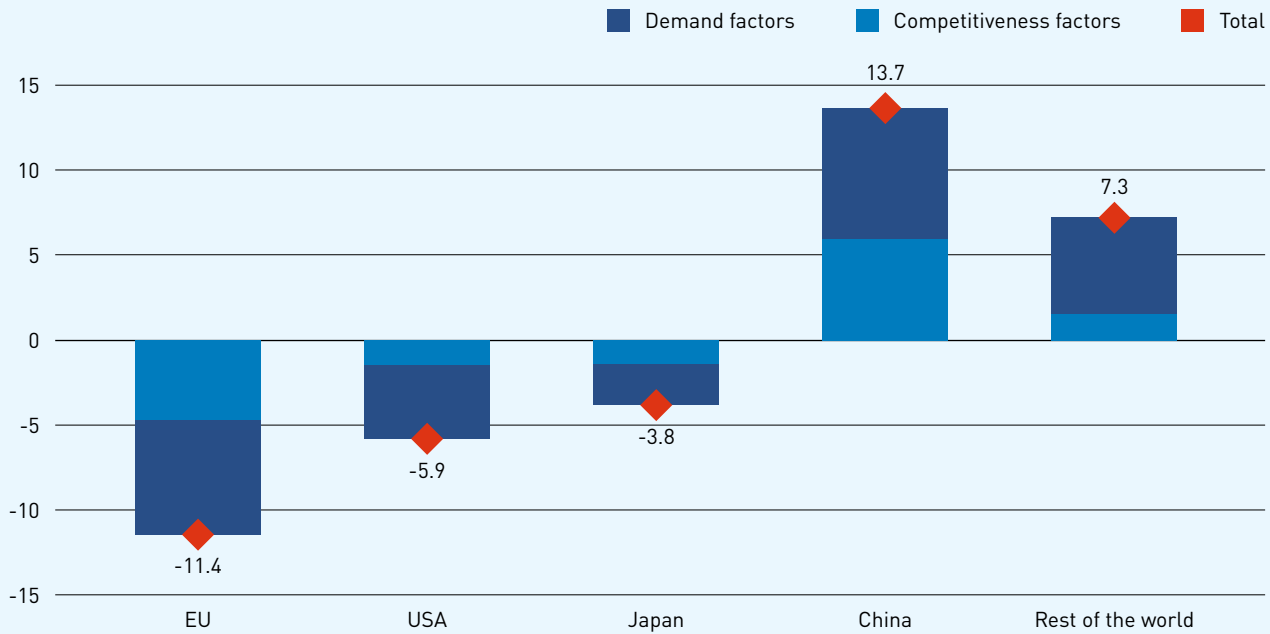
<sup>13</sup> EEAS, "[Commission Working Document: Country Strategy Paper on China](#)", 2002-2006.

<sup>14</sup> World Economic Forum, "[Global competitiveness Index 2017-2018](#)", 2018.

<sup>15</sup> Joint Research Centre, "[China: Challenges and Prospects from an Industrial and Innovation Powerhouse](#)", 2019.

**China's increased share in global manufacturing value chains**

*Change in global share in manufacturing value chains (change in percentage points between 2000 and 2014)*



Source: Joint Research Center, "China: Challenges and Prospects from an Industrial and Innovation Powerhouse", 2019.

China's growing technological competitiveness gets European competitors excited about new opportunities. In China, European business perception of China's innovation ecosystem has improved significantly. In 2019, 38% of respondents to the European Union Chamber of Commerce in China (EUCCC) Business Confidence Survey rated China's innovation and research and development (R&D) environment as more favourable than the worldwide average, compared to just 15% in 2016. One of the main drivers of Chinese innovation is the significant sums spent on R&D.<sup>16</sup> Chinese companies are also perceived as becoming more innovative, with 62% of respondents rating Chinese firms as equally or more innovative in 2019. Rather than feeling threatened, many European firms in China regard China's strength in innovation as an opportunity. European businesses welcome healthy competition, as it spurs them to deliver high quality goods and services to consumers, while maintaining the best possible prices. Another reason for their enthusiasm is that European businesses benefit from having more and more innovative Chinese firms in their supply chains.<sup>17</sup>

To fully realise the potential that our bilateral relationship has to offer, it is important that the relationship is reciprocal – that European firms enjoy the same benefits in China that Chinese firms enjoy in the EU, and that European firms are able to compete equally and equitably with Chinese firms on a level playing field. China's emergence in technology is both a source of opportunity for our businesses, and a growing challenge for the future when viewed through the lens of the systemic challenges posed by China's state capitalism – and one which the EU needs to start addressing now. The EU is currently lagging behind in terms of investments in innovation and digitalisation. In order for the EU to maintain its competitiveness, increasing funds and supporting investment to bolster research and innovation and the digital economy should be key priorities for the new European Commission.<sup>18</sup> One important step in that direction is to further develop the European Single Market and eliminate market fragmentation within the EU.

<sup>16</sup> European Union Chamber of Commerce in China, "Business Confidence Survey", 2019, p. 15. Government incentives, low research costs and R&D teams' productivity are all areas in which European businesses feel China compares favourably to other countries. In other areas, such as Internet access and intellectual property rights (IPR) protection, China still has a long way to go. See chapter '5.2. Research and Innovation' in this paper for more detail on R&D spending.

<sup>17</sup> *Ibid.*, pp. 16-17.

<sup>18</sup> See chapter '5.2 Research & Innovation' and chapter '5.3 Digital Economy' for more information.

## 1.2. THIS ECONOMIC POTENTIAL IS UNDERMINED BY THE SYSTEMIC CHALLENGE OF CHINA'S STATE CAPITALISM

The nature of the challenges that prevent a stronger partnership with China are mostly systemic and include *inter alia* the following elements:

- A **state-coordinated and controlled economic governance structure** with formal and informal mechanisms to steer economic outcomes.
- China's state-led system giving rise to **market distortions** and an **unlevel playing field** within China, and increasingly within the EU and within third markets.
- Profound recent changes within China amounting to a **backsliding of market reform efforts**, as well as a **growing impact of market distortions** on European businesses.

When China joined the WTO in 2001 the working hypothesis was that China would reform its state-led economy and eventually become a market economy. This hypothesis was founded, *inter alia*, on China's commitments in its protocol of accession to "allow prices for traded goods and services in every sector to be determined by market forces".<sup>19</sup> In choosing between moving toward becoming a market economy and retaining its state-led economy, China recently opted for greater centralised political control. Signs emerging about China's economic trajectory point to largely decelerated progress towards — or a reversal from — becoming a market economy. The Asia Society Policy Institute's China Dashboard tracks the reform progress of ten policy areas of China's economic reform programme announced in 2013. Data as recent as from autumn 2019 show that reform in five of ten policy areas has regressed since the 2013 plenum (labour, land, cross-border investment, competition and reform of state-owned enterprises), two areas have stalled (innovation and trade) and three areas marked a slight positive trend (fiscal affairs, environment and the financial system).<sup>20</sup> This change in trajectory is highly worrying for European businesses, and requires a major change in working hypotheses when engaging with China. The implementation of China's WTO commitments as well as holding China to account on these have been insufficient. Instead, China's still largely state coordinated and controlled economic governance system has evolved to a system which can be termed as 'China Inc.'<sup>21</sup>

### The features giving rise to 'China Inc.'

'China Inc.' refers to China's state-coordinated and controlled economic governance structure of top-down economic planning in which the boundaries between the public and private sector are blurred.<sup>22</sup> Features of 'China Inc.' include:

1. The Communist Party and state entities, such as the State-owned Assets Supervision and Administration Commission (SASAC), the National Development and Reform Commission (NDRC), the Ministry of Commerce (MOFCOM) and the Ministry of Industry and Information Technology (MIIT) control key components of the Chinese economy. SASAC for instance coordinates all state-owned enterprises (through different SASAC entities at national and local level) while the NDRC, MOFCOM and MIIT control key sectors such as the aerospace, energy, railway, steel, shipbuilding and telecommunications sector. This could be compared to European and national-level authorities that would control and steer all European companies in strategic sectors and their key strategic divisions.<sup>23</sup>

<sup>19</sup> World Trade Organisation, "[Accession of the People's Republic of China](#)", 2001, section 9.1.

<sup>20</sup> Asia Society Policy Institute, "[The China Dashboard](#)", 2019.

<sup>21</sup> Ted Fishman, "[China Inc.: How the Rise of the Next Superpower Challenges America and the Rest of the World](#)", Scribner, 2006; Mark Wu, "[The 'China Inc.' Challenge to Global Trade Governance](#)", Harvard International Law Journal 57:2, 2016.

<sup>22</sup> For a full and detailed explanation of the key features of the concept of 'China Inc.' and its implications, see Mark Wu, "[Testimony before the US-China Economic and Security Review Commission: Hearing on US Companies in China](#)", 2019, pp. 6-7.

<sup>23</sup> See chapter '4.1 State-Owned Enterprises' for more information.

2. Beijing applies top-down economic planning which is coordinated and implemented by powerful state entities such as the NDRC and the Central Financial and Economic Affairs Commission of the Communist Party. As China is increasingly active on the international market, this top-down dirigiste economic planning increasingly causes market distortions in the global market economy.
3. The Party-state also has control over a vast amount of China's financing institutions and the state makes excessive use of subsidies and state-directed investment via Special Purpose Vehicles (SPVs). Through various means and structures of ownership and control, the state can direct credit or tighten credit lines to influence the market and support the implementation of economic objectives in a way that creates unfair advantages for Chinese players. The types of channels used for 'preferential financing' include credit, direct subsidies, and new forms of financing such as government-guided funds.
4. Chinese entities such as SASAC and the Organisational Department control high-level appointments to state-owned enterprises (SOEs), the performance of individual contesters for high-level positions is not only measured by their ability to create economic growth, but also their ability to deliver on Party objectives. This can have an impact that might be difficult to detect on the business decisions of SOEs, particularly regarding procurement or the pursuit of "Buy China" requirements.
5. China's state-capitalism is also evolving in novel ways. The creation of party cells in businesses is a new feature of 'China Inc'. The statement by President Xi Jinping during the 19<sup>th</sup> National Congress of the Communist Party of China in 2017 that the Chinese Communist Party should be deeply integrated within all parts of society has led to an increased politicisation of the business environment. The party cells and the soon-to-come corporate social credit system are part of this view and mark a concerning development for business operations within China.<sup>24</sup> While party cells are not an entirely new idea, their expanded and required role within companies is concerning. Although developments are still at an early stage, companies report being asked to give internal Communist Party cells an explicit role in decision-making.<sup>25</sup> This could undermine the ability of private and foreign companies to make independent decisions in their best interest, and increasingly blurs compliance with Chinese law with political interference.

These formal and informal mechanisms through which the Chinese government can influence economic outcomes mean that problems are much more structural than issue based. For example, China can enter into commitments to prevent forced technology transfer and change its law, but without bringing the entire economic governance system in line in a way that prevents the incidence of technology transfer, forced technology transfer can continue. Without binding and enforceable commitments, it will be very difficult for China's trading partners to verify compliance simply because it is hard to tell which of the many pressure points within China's system of economic governance have led to a specific case of discrimination. This presents significant challenges for European policymakers negotiating agreements that touch only one or few of the elements of China's economic governance, as some outcomes might be difficult to guarantee or enforce.

<sup>24</sup> Financial Times, "[China to include businesses in credit score database plan](#)", 2019.

<sup>25</sup> Washington Post, "[Command and control: China's Communist Party extends reach into foreign companies](#)", 2018.

## 1.3. 'CHINA INC.' LEADS TO MARKET DISTORTIONS AND AN UNLEVEL PLAYING FIELD

The setup of China's system of economic governance produces numerous market distortions and undermines the level playing field between European and Chinese, and state and private enterprises. The origin of this friction lies within the way in which China's state-led economy distorts markets, with a first impact on the Chinese economy, but increasingly also the EU market and other third markets as Chinese companies and capital expand abroad. European businesses are affected in all three domains, as distortions within China also increasingly distort global markets.

### Market distortions in China

The Chinese government's continued heavy intervention in its economy despite its declared objective of transitioning to a more sustainable, market-driven economy means that there are still significant distortions that affect China's economy and foreign businesses alike. While there are numerous specific distortions within the Chinese economy, a recent paper by the Mercator Institute for China Studies (MERICS) and Rhodium Group summarises them into four broad categories.<sup>26</sup>

- 1) COMPETITION-DISTORTING ASYMMETRIES IN TRADE AND INVESTMENT MARKET ACCESS:** the disparity in access between Chinese and foreign firms remains enormous. The consequence of these asymmetries, including post-market entry barriers, serve domestic firms and the state at the expense of Chinese consumers and foreign producers, including those from the EU.
- 2) FINANCING ADVANTAGES:** China's heavily state-led financial system combines political objectives with market considerations. Markets are not the dominant factor in allocating the flow of capital, and by design, China's financial system allocates more weight to the interests of state-favoured borrowing.
- 3) INPUT AND OPERATIONAL COST ADVANTAGES:** China's system also distorts the cost of other inputs. These include cost advantages from under-priced intermediaries (due to subsidies or overcapacity), land and energy, unnaturally low research, development and innovation (RDI) costs thanks to low levels of intellectual property rights (IPR) protection, subsidies, or residual laws encouraging technology transfers, etc.
- 4) STATE GUIDANCE AND PREFERENTIAL BACKING:** a consequence of China's economic system, its commercial policies and industrial policy designs is the avoidance of 'unhealthy' or 'unnecessary' competition. This is particularly made clear in the Made in China 2025 strategy, which promotes selected Chinese industries and players.

### Made in China 2025

*A key example of government-driven market distortions that lead to unfair competition is the Made in China 2025 (MiC 2025) policy. This top-down industrial policy involves hundreds of billions of euros of funding in the form of subsidies, funds and other channels of support to stimulate the development of ten strategic industries. While MiC 2025 could potentially evolve into a project with mutual gains for both Chinese and foreign companies, the current trend appears to go into an opposite direction and European companies are currently deeply concerned about what they see as a 'ringfencing' of China's manufacturing base.*

<sup>26</sup> Rhodium Group and Mercator Institute for China Studies, "[Beyond Investment Screening: Expanding Europe's Toolbox to Address Economic Risks from Chinese State Capitalism](#)", 2019.

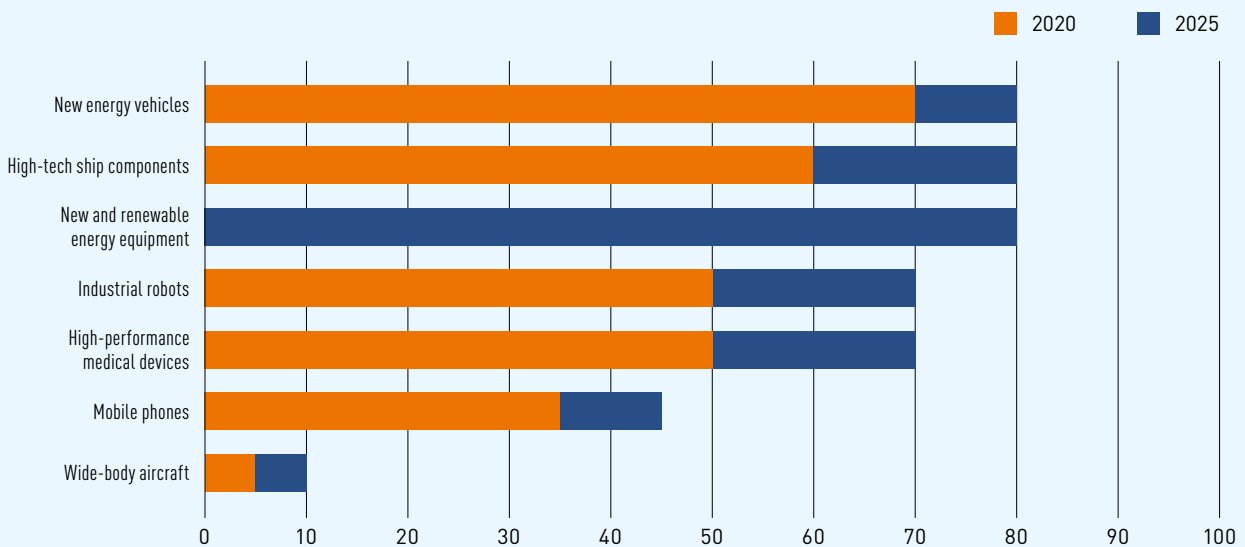
European businesses are concerned because of MiC 2025’s ambitions to promote “indigenous” innovation and facilitate the preferential treatment of domestic companies at the expense of foreign companies.<sup>27</sup> MiC 2025 sets semi-official targets regarding the desired market share of Chinese companies. State documents regarding the implementation of MiC 2025 in the “new energy vehicle” (NEV) sector for example aim at a 70% domestic market share in 2020 and 80% in 2025.<sup>28</sup> Some European businesses therefore regard MiC 2025 as a “ringfencing” of China’s manufacturing base.

A survey conducted amongst European businesses active in China by the EUCCC in 2019 demonstrated that 47% of the respondents that operate in industries covered by the initiative cannot participate in the MiC 2025 initiative.<sup>29</sup> As such, many European businesses perceive the MiC 2025 project as mostly promoting domestic firms to become more competitive at the international level by often restricting foreign companies from participation.

Beijing has employed a variety of policy tools to pursue the MiC 2025 goals, ranging from forced technology transfers in exchange for market access and financial policy, to technology-seeking investments abroad and public-private partnerships. Premier Li Keqiang for example promoted public-private partnerships as a means to raise private funds for the MiC 2025 agenda. According to the China PPP Center (the Chinese government agency for public-private partnership), only 0.7% of all PPP projects included foreign enterprises.<sup>30</sup> This number illustrates the market access obstacles that European businesses face when investing in China.

**Made in China 2025**

Semi-official targets for domestic market share of Chinese products in some sectors (in percentage)



Source: MERICS, 2016.

27 Mercator Institute for China Studies, “Made in China 2025”, 2016.

28 Ministry of Industry and Information Technology, “Interpretation of “Made in China 2025”: Promoting the Development of Clean and New Energy Vehicles”, 2016.

29 European Union Chamber of Commerce in China, “Business Confidence Survey”, 2019. For further information on the implications of MiC 2025 for European business, consult European Union Chamber of Commerce in China, “China Manufacturing 2025”, 2017.

30 Data by the China PPP Center, processed by China Policy, “Embracing the Market on the State’s Terms”, 2019.

## Market distortions impacting the EU

While previously the implications of China's state-led system were mainly noticeable within China's domestic market, as Chinese firms and financing increasingly go abroad and enter the EU, the distortions they are subject to within China also affect the European market. Although not exhaustive, four broad policy areas stand out in which these are increasingly felt within the EU:

- 1) TRADE DISTORTIONS:** distorted prices within China means that a number of products are exported at below market prices, leading to anti-dumping and anti-subsidy measures within the EU.<sup>31</sup>
- 2) INVESTMENT DISTORTIONS:** the acquisition of European companies by Chinese SOEs using subsidised capital or with the explicit objective of commercialising their technology within China.<sup>32</sup>
- 3) PROCUREMENT DISTORTIONS:** when Chinese companies can benefit from subsidised finance, cheaper inputs, and preferential backing from the Chinese state, they are able to tender procurement bids at below market prices.<sup>33</sup>
- 4) COMPETITION DISTORTIONS:** mega-mergers between Chinese SOEs within China and the economic support they receive affect the competitive environment within the European market.

## Market distortions within third markets

The rise of China means that the contradictions between China's system of economic governance and global market-based governance are increasingly felt across borders, particularly in case of overcapacity being pushed into global markets and affecting global prices and the dumping of products below market prices. China's expansion into third markets also means that the contradictions are felt increasingly in areas that go beyond trade and investment.

While many of the challenges first became obvious in trade-related areas, the growing presence and activity of Chinese companies in third markets means that the challenges emanating from China's state-led economic model increasingly spill over into other areas such as investment, procurement, research, defence and security. This is for example the case regarding the Belt and Road Initiative. While the initiative serves a high variety of interests and policy fields, from facilitating trade to stimulating development, the BRI is an important conduit for exporting overcapacities.

China's 'Going Global' strategy is aimed at equipping domestic companies to compete better internationally, as well as at home. Indeed, the consequence of China's strategy of going global means that Beijing's vision of a state-led economic model — alongside the challenges that this poses — is increasingly pushed into other markets. This means that the issues related to China Inc. are being felt more directly outside China and raises important concerns. The chapter on competition on third markets includes an overview of the types of distortions coming from China that affect European businesses in third markets.

Although it is essential that the EU continues to try to solve the trade-related problems that occur in the bilateral relationship with China, it is important that policy-makers understand that there are limits to this strategy given that there are issues that need to be addressed far beyond the trade domain. European business therefore emphasises the urgent need for a comprehensive, multi-faceted and whole-of-government approach to mitigate market distortions and enable European businesses to compete successfully with Chinese companies.<sup>34</sup>

<sup>31</sup> See chapter '3.2 Trade' for more information.

<sup>32</sup> See chapter '3.3 Investment' for more information.

<sup>33</sup> See chapter '3.4 Procurement' for more information.

<sup>34</sup> See chapter '2. How the EU should engage China' for more information.

## How China's opaque legal system and lack of transparency inhibit a level playing field

While China's legal system has developed during the past years, there are several challenges inherent in the legal system that can lead to unfair treatment, a lack of enforcement, or discriminatory outcomes for European business. China's legal system is unique as it represents what its leaders have termed the 'socialist rule of law'. The most striking difference with the Western concept of the rule of law lies in the matter of judicial independence, which is denied in China but essential to the Western concept of the rule of law. China's judicial system is not independent because establishing it implies making the court system a competing authority, which would undermine the supremacy of the Party's authority over the state. Judicial independence is thus regarded as incompatible with the Party-state structure. While the adjudicative independence of China's courts allows them to exercise rulings without interference by other state institutions, the Party's authority is above the state, which allows the Party leadership to generate concerted actions from different branches of the state on issues that are of primary importance to the party.<sup>35</sup> This presents challenges in trying to hold the state accountable due to local protectionism and the court's lack of power vis-à-vis many agents of the Party-state.

The lack of an independent judiciary to enforce the rule of law is a major obstacle for companies to ensure fair and equal treatment before the law. Courts ultimately report to the Central Political and Legal Affairs Commission of the Chinese Communist Party.

A second frequent remark on China's laws is their lack of clarity, or vagueness in wording, that creates confusion among stakeholders over their exact scope and application.<sup>36</sup> This vagueness, however, appears to provide for a degree of flexibility in application that can lead to inconsistent or discriminatory outcomes, not only at the national level but also at local level.

A third issue that is frequently raised by European companies is the insufficient enforcement of existing laws and regulations. This is particularly prevalent in areas in which foreign companies have prevailing interests, such as protecting their intellectual property.<sup>37</sup> The main question in IP protection is: how China can improve its record of enforcement or that adequate compensation is forthcoming in case of violation, so that the law is of consequence? China has made numerous piecemeal improvements in the area of enforcement, though this is still well below adequate.

Finally, the lack of transparency within China's legal system, particularly regarding local regulations, makes it difficult to navigate and understand. A lack of transparency makes it difficult to understand how the legal system works, how predictable it is, and whether the outcomes are the result of a fair process. For example, not all legal rulings are published, which makes it very difficult to detect any formal discrimination between foreign companies and domestic ones (see the graph below).

All this is not to say that China's legal environment is entirely impossible to navigate. Or that foreign companies are unable to do business in China. The number of foreign companies present within China highlights that this is not the case. What it does say, however, is that it provides China with the possibility to marshal resources to facilitate the business environment for companies in sectors in which investment is welcome, or to let companies struggle without guaranteed tools to pursue their rights.

A transparent and clearly structured legal environment would be highly advantageous - first and foremost for China and its economy. It would make doing business in China more efficient and more predictable, and it would also help resolve tensions with its trading partners that emerge from (perceived) discriminatory treatment. There is also a need for China's legal system to evolve more quickly, particularly in view of China's fast evolving economy that sometimes leads to legal gaps.

<sup>35</sup> Ling Li, "Chinese Characteristics of the 'Socialist Rule of Law': Will the Fourth Plenum Cure the Problems of the Chinese Judicial System?", Asia Policy 20, 2015, p. 17.

<sup>36</sup> China's Cybersecurity Law, National Intelligence Law and Foreign Investment Law feature prominently in this regard.

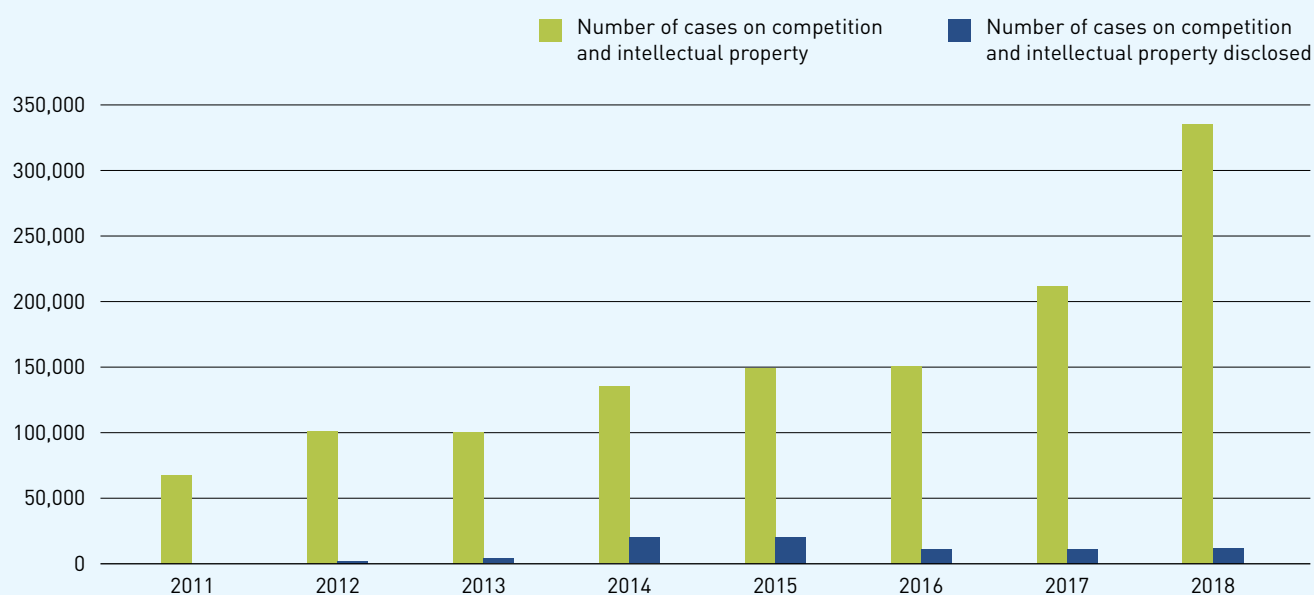
<sup>37</sup> See chapter '3.5 Intellectual Property Rights' and '3.6 Forced Technology Transfer'.



*Attempts to remedy complaints by foreign companies should not lead to ad hoc or anecdotal improvements. Recourse under the law cannot depend on the good will of particular officials. The fact that some foreign companies do extremely well in China and do not face the same set of problems, means that it should be possible for all foreign companies to be treated equally well. Chinese companies in Europe do not face these issues.*

*As highlighted by the EUCCC in their Business Confidence Survey in 2019, "Chinese firms operating in the EU are afforded equal treatment and have clear mechanisms for seeking recourse under the rule of law if they feel they are discriminated against. As China enters its fifth decade of reform and opening up, it is high time that European companies are afforded reciprocal treatment in this respect."<sup>38</sup> The EU has an active role to play in facilitating this and encouraging China to take ambitious steps forward.*

### China's judicial transparency Number of court cases



Source: Rhodium Group, 2019

<sup>38</sup> European Union Chamber of Commerce in China, "Business Confidence Survey", 2019, p. 7.

## 1.4. RECENT PROFOUND CHANGES IN CHINA GENERATE A NEW SENSE OF URGENCY FOR REDRESS

While the existence of market distortions, problems of market access, an unlevel playing field, intellectual property violations, forced technology transfers and others are not new, there has always been a positive agenda of trying to address these issues against the backdrop of integrating China more broadly into the world economy. The accompanying reform that China's integration would bring about would address many of the systemic issues underlying many of these problems. The results of this approach have been mixed, with both positive and negative developments over the years. Recently, however, a number of profound changes in China have led to a greater sense of urgency among European businesses around the need for a comprehensive policy response from the EU that levels the playing field with China, mitigates the effects of market distortions, and enhances our competitiveness, and ensures fair competition and cooperation on third markets. These include, *inter alia*:

- a. Difficulty in implementing the next-generation phase of reform in China means that European business is increasingly concerned that the question is not when China will converge with the global market economy but if it will converge. A lack of convergence or even divergence raises serious questions about whether the current rules-based multilateral system can secure a level playing field.
- b. China's immense economic growth means that systemic differences in economic policy-making have a growing impact on European business. China's share of global gross domestic product (GDP) grew rapidly from 4% in 2001 to 15.2% in 2017,<sup>39</sup> while its share of global merchandise trade grew from 4.2% to 12.7% between 2001 and 2018. Its share of global services trade grew slower, from 2.9% to 4.5% between 2005 and 2018.<sup>40</sup>
- c. China is re-introducing political ideology into the economy instead of sustaining economic reform and liberalisation. The expansion of (the role of) party-cells and introduction of the corporate social credit system are two important developments in this regard that could impact decision-making at business level.
- d. China is for the first time exporting its domestic policy mix because it has the capital and companies to do so and both are motivated to go overseas.<sup>41</sup>
- e. The US Administration is attempting to force a breakthrough on these issues through a trade conflict with China that is both economic and geopolitical in nature. Attempts by both sides towards decoupling and reducing mutual dependence will also affect European business, and any solution in the US-China trade conflict could result in preferential treatment of US companies over EU companies. The EU cannot afford to sit by idly and needs to formulate its own policy.<sup>42</sup>

Consequently, a renewed sense of priority and urgency has taken hold among European businesses over the past few years that if China will not become a market economy, it should at least be held accountable to the rules and principles of a multilateral rules-based system which it joined on that premise. This means that existing multilateral and European rules need to be reformed and new rules should be created that are both binding and enforceable in order to capture all the distortions and level playing field issues that arise from 'China Inc.'

<sup>39</sup> The Global Economy, "China: Percent of world GDP", 2019

<sup>40</sup> BusinessEurope calculations based on [UNCTAD data](#).

<sup>41</sup> See chapter '6.3 Competition on Third Markets' for more information.

<sup>42</sup> Specific recommendations on the EU policy response are formulated in chapter 2.

## The problem of the Corporate Social Credit System

*China's corporate social credit system is now moving into a decisive stage, with full implementation expected by the end of 2020. The system will collect and interpret Big Data using real-time monitoring and processing mechanisms, and the mega-database will then be used to steer business behaviour according to government criteria. Compliance – or lack thereof – with government-defined requirements will increase or decrease a company's rating: higher ratings leading to greater opportunities in public procurement, more favourable credit conditions, shorter waiting times for administrative procedures and/or lower taxation; with lower ratings potentially leading to blacklisting.<sup>43</sup>*

*As the Chinese government seems to move away from hard market access constraints such as investment catalogues, its ability to influence companies appears now to be greater: indeed, the corporate social credit system will create strong incentives for business not merely to comply with legislation but also to fulfil the industrial objectives fixed by the government. While the pros and cons of the system are still up for debate, the risk for companies is clear: on the one hand, the system may increase transparency and induce business to adopt socially and environmentally responsible behaviour; on the other hand, the system – prone as it is to data manipulation and faulty technology – will reduce business autonomy, hinder the success of disruptive models, and threaten proprietary data.<sup>44</sup>*

*Importantly, foreign companies will be integrated within the system and be treated in the same way as their Chinese counterparts. This could lead to a more level playing field: automated data processing can reduce arbitrariness and limit discriminatory practices; moreover, European business – which possess more advanced internal compliance structures – may gain an advantage in relation to Chinese companies. However, the system does mean that foreign companies will be subject to China's industrial policy guidance, which is a point of concern. Furthermore, Chinese companies might be better able to navigate the intricacies of this complex system via their contacts with governmental entities.<sup>45</sup>*

*Another point of apprehension is the detail of some rating requirements, such as the State Administration for Market Regulation's blacklisting mechanism for 'heavily distrusted entities', which makes the system vulnerable to be used for political purposes in trade conflicts. Of great concern, too, are the data elements that will be used to score companies, as well as the weight given to them and the degree of transparency companies will have on the composition of their credit score. It will be difficult to levy complaints against mistakes or wrongdoings within the system without transparency. The scope for abuse and margin of error will likely be huge, and the implications of the corporate social credit system will be enormous regardless of how the system is implemented.*

<sup>43</sup> European Union Chamber of Commerce in China, *"The Digital Hand: How China's Corporate Social Credit System Conditions Market Actors"*, 2019.

<sup>44</sup> Mercator Institute for China Studies, *"China's Social Credit System"*, 2017.

<sup>45</sup> European Union Chamber of Commerce in China, *"The Digital Hand: How China's Corporate Social Credit System Conditions Market Actors"*, 2019.

## 1.5. CHINA HOLDS THE CARDS FOR A BETTER BILATERAL RELATIONSHIP

From a European business perspective, the best way to address the issues outlined in this chapter is for the Chinese government to adopt a more hands-off approach and place clear limits to market-distortive interventions that undermine a level playing field between state and private and domestic and foreign businesses. In practice, this means that China should work constructively with other countries to establish new rules for global market-based governance at WTO level. The direction since at least 2013, however, signals clearly that the Chinese economy is becoming more state-led and features more, not less intervention. At the same time, 'China Inc.' is becoming more sophisticated, making it more difficult to present clear evidence of official breaches of China's commitments at the WTO.

If China does not re-embrace economic liberalisation, marketisation and opening as priorities, its GDP growth will continue to fall and there will be shrinking opportunities for domestic and foreign firms alike. A drop in GDP growth could lead to a reflex towards protectionism and indigenous innovation in order to benefit Chinese firms over foreign firms. China's enormous economic success during the past 40 years, however, is inherently linked to its policy of opening up to the world. Consequently, doubling down on its state-led economy and upending the level playing field for perceived short-term economic gain will only speed up the deceleration of China's economic growth and generate tensions with its trading partners.

It is therefore of utmost importance that the EU continues to engage China in order to try and secure a level playing field within China and globally. This is not least because China's growing international economic engagement means that Chinese companies are able to compete on third markets and within the EU market without any of the restrictions and issues highlighted above, which leads to an unlevel playing field for European business within our home market and on third markets. Areas where there are strong common interests, such as health and health care, should be used as a lever for more market opening on the Chinese side. Both the EU and China have much to gain from increased economic engagement, if this is pursued on a reciprocal basis and on a level playing field.

The prospects for a positive way forward in the EU-China relationship also depend largely on China. Actions that China could undertake that would lead to a fairer and stronger economic relationship with the EU include the following:

- **Create a true level playing field.** China can contribute to a level playing field by eliminating market access barriers for foreign businesses, abolishing joint venture requirements and discriminatory treatment, removing policies of indigenous innovation and 'Buy China' provisions and improving intellectual property protection.
- **Return to market-oriented economic reform.** As the Chinese government outlined in its State Council documents no. 5 and 39,<sup>46</sup> China should eliminate the various market distortions that European companies face within China, on third markets, and increasingly within the EU itself. This would include eliminating market-distorting industrial subsidies and curbing overcapacity.
- **Uphold the rules-based multilateral trading system and engage in meaningful WTO reform.** China's rhetoric of supporting the rules-based multilateral trading system should now be followed by concrete action. China should fully commit and adhere to multilateral economic governance rules and practices by for example joining more WTO agreements and by committing to multilateral financial practices. It should also commit constructively to the creation of new WTO rules and disciplines on industrial subsidies and SOEs.

<sup>46</sup> People's Republic of China, "[Notice on Several Measures on Promoting Further Openness and Active Utilisation of Foreign Investment \[State Council Document No. 5\]](#)" and "[Notice on Several Measures for Promoting Foreign Investment Growth \[State Council Document No. 39\]](#)", 2017.



# 02

## HOW THE EUROPEAN UNION SHOULD ENGAGE CHINA

The EU needs to reconsider how it engages China in order to achieve the four key objectives we have outlined. In the past, the EU's means of engagement have not produced the desired results. Recent changes within China also prompt the EU to rethink its toolkit. Due to the difficulties outlined in the previous chapter, the EU must reconsider its *modus operandi* towards China and put more emphasis on reciprocity and conditionality.

## 2.1 THE EU MUST RECONSIDER THE WAY IN WHICH IT ENGAGES CHINA

For a long time, the EU has engaged China based on the theory of convergence. The policies and instruments that the EU used and the means through which the EU interacted with China were based on the assumption that China would gradually move towards a liberal open market economy. As China is not converging towards a liberal market economy model and instead consolidating its own economic, social and political model, the EU needs to adapt its means of engagement to this new reality. The recent movement towards more state interference in the Chinese economy has furthermore sparked a renewed sense of urgency (see chapter 1.4) and requires a **strategic reorientation** on how to engage China. The European Commission's 'Strategic Outlook' on China that was published in March 2019 is a good first step in this regard.

The European business community has set four end goals (levelling the playing field; mitigating the impact of government-induced distortions; reinforcing the EU's own competitiveness; ensuring fair competition and cooperation on third markets) that could achieve a fairer and stronger relationship with China. None of these goals can be achieved, however, without a broader reform of the EU's means of engagement with China. A **reciprocal and conditional** approach towards China that is based on our **interests, principles** and **values** is essential to seize the opportunities of a tighter economic relationship while off-setting the negative effects of China's state capitalist system.

In order to achieve the four '**end goals**', the EU needs to employ the right '**means**' to achieve these four objectives. In the past, the means through which the EU aimed to achieve its goals vis-à-vis China have often not yielded the desired results. China is still the EU's most restrictive trading partner, there are still numerous investment barriers and joint venture requirements, China's procurement market is still closed, and there are still major concerns about intellectual property (IP) protection and the number of reported cases of forced technology transfers are on the rise. Consequently, the EU should reconsider the way in which it engages China and revisit the policy tools through which the EU aims to achieve its goals vis-à-vis China.

The EU should update its **modus operandi** to ensure a successful and effective China strategy. There are **five means of engagement** that would enable a successful and effective China strategy and that will contribute to achieving the four 'end goals' that are set out in this paper (levelling the playing field; mitigating the impact of government-induced distortions; reinforcing the EU's own competitiveness; ensuring fair competition and cooperation on third markets).

The five means will jointly create the necessary (institutional) framework conditions that will enable the EU to address the existing opportunities and challenges meaningfully. These five enabling factors are not exhaustive, but they will allow the EU to better promote and defend its interests in its economic relationship vis-à-vis China.

**A *modus operandi* embedded in five means of engagement:**

- 1. THE EU SHOULD ACT SIMULTANEOUSLY ON ALL LEVELS**
- 2. THE EU SHOULD ACT UNITEDLY**
- 3. THE EU SHOULD ACT COHERENTLY**
- 4. THE EU SHOULD ACT STRATEGICALLY**
- 5. THE EU SHOULD ACT CONFIDENTLY**

## 2.2 THE EU SHOULD ACT SIMULTANEOUSLY ON ALL LEVELS

To address the consequences of China's move towards a more state-led economy, there is no ready-made strategy or single solution that will likely persuade China to abandon the most problematic aspects of state intervention in the economy. The EU should therefore pursue its objectives simultaneously (not sequentially) through **three levels**. This strategy will lead to a situation of policy complementarity and will enhance the EU's leverage at home and abroad:

- 1. THE MULTILATERAL AND PLURILATERAL LEVEL:** Reforming the WTO and engaging China at WTO level would be the best way to achieve the EU's objectives. The current multilateral rulebook is designed for market economies and does not adequately address the implications of a state-led economy. Nevertheless, attempts to reform the WTO have so far produced little result, partly due to unanimous decision-making. The EU should also cooperate closely with like-minded partners in plurilateral initiatives.
- 2. THE BILATERAL LEVEL:** Engaging China bilaterally is an essential cornerstone in building a stronger economic relationship between the EU and China. On bilateral level, the EU and China should focus on resolving trade and investment barriers in bilateral dialogues on all levels with the participation of key stakeholders such as the business community. The EU should also encourage China to pursue market-based reforms.
- 3. THE UNILATERAL LEVEL:** If China does not intend to become a market economy, long-standing as well as new economic barriers and market distortions will remain unaddressed through the multilateral and bilateral approaches. As there is often an absence of progress on the multilateral and bilateral levels, **the EU should simultaneously strengthen its own capabilities** to seize the opportunities and mitigate the challenges.

The EU should act simultaneously on all three axes – multilateral, bilateral and unilateral – in order to create opportunities and remedy problems as best as possible. While the multilateral and bilateral approaches remain the preferred course of action for European business, these avenues do often not yield the desired outcomes. As there is often an absence of progress on the multilateral and bilateral level, **the EU should also primarily strengthen its own capabilities** to seize the opportunities and mitigate the challenges.

Certain WTO members follow neither the letter nor the spirit of WTO rules and there is an absence of concrete rules in several areas. This requires that the EU bolster its own capabilities to promote and defend an open, fair and market-based world trade system. At the same time, the principle of non-discrimination should be fully respected and promoted.

In the past, the EU has not always followed a strategy of simultaneous engagement on these levels in parallel to achieve its objectives. In the area of international procurement, the EU has for example encouraged China to join the WTO Agreement on Government Procurement (GPA), mostly at WTO level. Since this has not yet materialised and China's public procurement market still remains closed to European companies, the EU should create its own capabilities to encourage third countries to join the GPA and open global public procurement markets (see chapter '3.4 Procurement').

An area in which the EU has pursued action on parallel levels more successfully is industrial subsidies (see chapter '4.2 Subsidies'). At WTO level, the EU engages China in the context of the Agreement on Subsidies and Countervailing Measures (SCM) and in the EU-China bilateral working group on WTO reform. Internationally, the EU also discusses the matter of industrial subsidies at the trilateral meetings with the USA and Japan. Within the EU, the European Commission has recently updated its trade defence instruments to prevent and mitigate the negative effects of foreign state subsidies. The EU should continue to pursue parallel levels simultaneously to achieve its objectives in this area and should also apply this strategy of parallelism in other policy areas.



## 2.3 THE EU SHOULD ACT UNITEDLY

The EU has the largest single market in the world in terms of GDP and is the largest trader of manufactured goods and services. The EU should better **translate Europe's economic strength into political unity and assertiveness**. Only a strong and united Europe can promote its interests and values in the face of a rising world power such as China and growing protectionism.

European companies and European Member States are nevertheless caught up in a **collective action problem**. European companies and EU Member States would benefit from standing together and encouraging China to make necessary reforms. China uses various instruments of leverage such as asymmetrical market openness and selective procurement to undermine our collective action. It is therefore of critical importance for the ability of the EU to act in the face of foreign pressure on individual Member States that the European Council moves from unanimous decision making on foreign policy issues towards **qualified majority voting (QMV)**.

For instance, EU positions regarding a more transparent, open and greener Belt and Road Initiative (BRI) have been watered down as many EU Member States have now endorsed the project. Several EU Member States such as Italy, Portugal and Luxembourg have signed 'memoranda of understanding' with China to cooperate on the initiative. This illustrates the EU's internal divisions and the uncoordinated approach towards China more generally.

The EU will remain vulnerable to Beijing taking advantage of internal divergences as long as a united and coordinated European approach vis-à-vis China is missing. The challenges posed by China's economic and political system cannot be met by any Member State alone. Only a **united and strong Europe** can provide the economic and political leverage to successfully engage and compete with China.

Member States should **invest in knowledge sharing and capacity building on China** at EU and Member State level and **set up an information-sharing mechanism**. One of the drawbacks that undermines unity of action is a disparity in available expert information at different levels of policy and across Member States. A clear understanding of the opportunities and challenges in the relationship with China will help inform better decision-making at all levels.

The EU's **research capacities on China** should also be increased significantly to support informed, intelligent and effective policy-making. Whereas the United States have established a dedicated US-China Economic and Security Review Commission, which publishes comprehensive annual reports and detailed monthly bulletins, comprehensive European studies on China remain scarce. Therefore, resources and research capacities should be enhanced to adequately and systematically analyse the economic, political and security implications of Chinese policies on the EU at regular intervals. The study "China: Challenges and Prospects from an Industrial and Innovation Powerhouse" published by the Joint Research Centre serves as an example of a comprehensive study that should be performed more regularly and systematically.

## 2.4 THE EU SHOULD ACT COHERENTLY

Currently, the policies and instruments of the European institutions are not always tailored to the same objective and not always coherent. To leverage and reinforce our strengths and achieve better outcomes, it is essential to **improve coherence and complementarity between EU policies and instruments** in their application vis-à-vis China and other state-centric economies.

One of the key challenges for the next European Commission, which was also highlighted in the Commission's strategic outlook, relates to action point 8 – identifying **how to fill existing gaps in EU law** in order to fully address the distortive effects of foreign state ownership and state financing on the internal market.

In this regard, one important horizontal principle that the EU should develop in order to remedy market distortions across policy domains is an **'SOE principle'**. This could for example mean a reversal in the burden of proof for foreign SOEs—that they would need to prove compliance with Single Market rules before obtaining market access, that in the future the EU's investment screening mechanism could include special provisions on SOEs and that a future international procurement instrument should also consider a differentiated approach towards SOEs.<sup>47</sup>

Synergies between different policy areas are necessary to create the **leverage** required for EU policies to have the desired impact. This means that a **whole-of-government approach** is needed to tackle the challenges emanating from the pressures that currently threaten global market-based governance. Within the European Commission, the Secretariat-General or the relevant Executive Vice-Presidents have a special responsibility to ensure coherence amongst the relevant EU policy areas. In this regard, the European Commission's Strategic Outlook on China provides a strong foundation for further evolution towards a whole-of-government approach towards China.

<sup>47</sup> See chapter '4.1 State-owned enterprises' for more information on this proposal.

## 2.5 THE EU SHOULD ACT STRATEGICALLY

Europe's **strategic autonomy and economic sovereignty** are being challenged as the USA and China increasingly combine economics and geopolitics. The US National Security Strategy of December 2017 for example includes economics for the first time as part of US national security.<sup>48</sup> Economic and security dimensions have become increasingly interlinked in the strategic rivalry between the EU's two main trade partners. Both China and the USA do not shy away from using their economic power to pursue security and geopolitical objectives.

The linkage between economic and security spheres and the linkage across policy areas are deeply destabilising for the EU as European policies and instruments are not designed for a world in which economic, security and strategic objectives are increasingly blurred.<sup>49</sup> The EU also risks being caught up in the cross-fire between the USA and China and pushed by both partners to choose sides. The geopolitical rivalry between the USA and China therefore poses serious challenges to the EU's strategic autonomy and economic sovereignty. The EU should assess the effects of the blurring of the economic and security dimensions more systematically.

To stimulate and facilitate a more strategic approach vis-à-vis China, European business calls on the EU and EU Member States to set up a **strategic dialogue on China** between the EU Member States, EU institutions and business, with the support of academia and key stakeholders. Inspiration could be drawn from the European Commission's Task Force 50 on Brexit, which allowed the EU to maintain a unified and coherent approach in its negotiations with the United Kingdom. Annual meetings should take place that facilitate greater information exchange between different levels of policy-making and parts of civil society that help underpin a **whole-of-government approach** at EU and Member State level. These could take the form of a high-level dialogue, with specific coordination or working groups that focus on particular issues. This strategic dialogue may also bolster European Commission resources with the information required from business in order to take greater enforcement action. This information is often lacking as companies fear that providing information may lead to retaliation within China.

European Commission President Ursula von der Leyen emphasised in her 'agenda for Europe' that there is an urgent need for a stronger Europe in the world that is "ambitious, strategic and assertive". To realise this objective, **the Multiannual Financial Framework (MFF)** should devote significant resources to the policy areas that ensure a strong geopolitical Europe. In this regard, the MFF should amongst other allocate significant financial resources to research and innovation, to digitalisation and to the EU Connectivity Strategy.

<sup>48</sup> The White House, "[National Security Strategy of the United States of America](#)", 2017.

<sup>49</sup> Bruegel, "[Redefining Europe's economic sovereignty](#)", 2019.

## 2.6 THE EU SHOULD ACT CONFIDENTLY

The EU should act more confidently and should not shy away from **leveraging** its economic strength to achieve its economic objectives. The EU should adopt a **reciprocal and conditional** approach towards China that is based on our **interests, principles and values**.

China has become a more assertive international player. In recent years, China has begun deploying a strategy of **sharp power**, which exemplifies the unprecedented and increasingly sophisticated efforts to influence and intimidate stakeholders outside its borders.<sup>50</sup> This can have the effect of suppressing open debate and influencing policy outcomes. Different from traditional diplomacy, sharp power uses a forceful combination of carrots and sticks to wield influence. Mechanisms of transparency that expose this behaviour as well as mechanisms that foster greater exchange and unity at European level are urgently needed to resist this challenge.

The EU can be more successful in competing internationally by **branding and promoting** its policies better, both on the European market and on third markets. China launched an impressive campaign to promote its policies such as Made in China 2025 and the Belt and Road Initiative. China for example ambitiously promotes the Belt and Road Initiative at Belt and Road Forums that are widely attended by world leaders. While the Belt and Road Initiative and Made in China 2025 are widely known amongst stakeholders and the general public, European policies such as the Connecting Europe Facility and the EU Connectivity Strategy deserve better promotion and branding.

The EU should not hold back in deploying a more self-confident rhetoric both internally and externally and to pursue a coherent presentation of what the EU does. **European interests must be given a clearer voice**. In order for its Connectivity Strategy to be effective, for instance, the EU will have to make sure its strategy and approach are well understood by partners in target regions. A soft launch of the Connectivity Strategy and public diplomacy outreach in third countries are essential in this regard.

The European Commission and other relevant EU bodies should also enhance the EU's **economic diplomacy**. Economic diplomacy has so far mostly been performed by EU Member States. Better European coordination in economic diplomacy would contribute to the promotion of European products and services. In this regard, the EU should for example aim to continue and expand joint business and trade missions. As companies in different European Member States often offer complementary products and services, trade and business missions could for example allow consortia of European business to offer complete 'packages' to foreign clients. Trade and business missions should be organised in close cooperation with businesses and business federations.

### How to move forward

The EU would most likely be more successful at engaging China, strengthening multilateral economic governance, levelling the playing field, remedying market distortions, enhancing its competitiveness and ensuring fair competition and cooperation internationally if the challenges outlined above could be properly addressed. There are a number of key recommendations that, if implemented, would enhance the EU's ability to deliver on these objectives.

As discussed in this chapter, the EU requires a comprehensive, whole-of-government approach in its engagement with China to address the market distortions that flow from its state-led system. It needs to be comprehensive insofar as it should address a range of issues that give rise to market distortions, so that we do not push problems from one part of the 'China Inc.' spectrum to another instead of resolving them. At

<sup>50</sup> The Economist, "[What to do about China's "sharp power"](#)", 2017.

the same time, the EU can only do so by bringing different strands and levels of policymaking together in a coordinated whole-of-government approach.

This is not an easy challenge to address, and the EU should therefore act simultaneously on all three axes – multilateral, bilateral and unilateral – in order to create opportunities and remedy problems as best as possible. While multilateral and bilateral negotiations remain the preferred course of action for European business, the EU should use all existing policy options and simultaneously strengthen its own capabilities in the absence of progress on the multilateral and bilateral level.

To engage China successfully, the EU should **update the *modus operandi* of engagement** from negotiating agreements with provisions that aim to address the legal framework, to one that addresses the challenge of ‘China Inc.’ more comprehensively. This should include clear outlines of what the road to a better bilateral relationship looks like, with **clearly defined and measurable outcomes** and clear enforcement provisions on what remedies and steps can be taken in the event that these outcomes do not materialise. It is important to regularly take stock of progress made and to elevate discussions to a political level in case progress in this area is not forthcoming. In essence, the EU should move into a **conditional and reciprocal relationship** with China so that it can be held to account and we can each engage on our own terms.

This means that the EU should also improve its existing instruments (such as trade defence) and design new instruments to mitigate the effects of market-distortive practices that are inherent to China’s state-led economic system.

In addressing issues related to China’s state-centric system, it is an important priority for European business that the EU does not begin emulating the distortive effects of China’s policies as a way of counterbalancing them. It is therefore crucial for the EU to **preserve and strengthen market-based governance** within the EU. This paper offers a multitude of recommendations on what should be done to achieve this as well as how this may be achieved.

## RECOMMENDATIONS

### 1 THE EU SHOULD ACT SIMULTANEOUSLY ON ALL THREE LEVELS

- 1.1 The EU should pursue parallel tracks to engage China.** As there is no single solution or single path that will allow the EU to achieve its objectives in its relationship with China, the EU should act simultaneously on multilateral, plurilateral, bilateral and unilateral levels to complement efforts and create leverage.
- 1. The multilateral and plurilateral level:** Reforming the WTO and engaging China at the WTO would be the best way to achieve the EU’s objectives, but is also the least likely to yield concrete results in the short term. The EU should also cooperate closely with likeminded partners in plurilateral initiatives.
  - 2. The bilateral level:** Engaging China bilaterally is an essential cornerstone in building a stronger economic relationship between the EU and China.
  - 3. The unilateral level:** As there is often an absence of progress on the multilateral and bilateral level, **the EU should simultaneously strengthen its own capabilities** to seize the opportunities and mitigate the challenges.

## 2 THE EU SHOULD ACT UNITEDLY

- 2.1 The EU Member States should address China with ‘one voice’ and act unitedly.** The EU must also better leverage its economic unity and strength in its relationship with China. Specifically, the European Council should move from unanimous decision-making towards **qualified majority voting (QMV)** on foreign policy matters.
- 2.2 Invest in knowledge sharing and capacity building at EU and Member State level.** One of the drawbacks that undermines unity of action is a disparity in available expert information at different levels and across Member States. A clear understanding of the opportunities and challenges in the relationship with China will help inform better decision-making at all levels. In terms of capacity building, the United States have established a dedicated US-China Economic and Security Review Commission. Such an approach is lacking in the EU.
- 2.3 Define and negotiate clear and measurable outcomes** in the bilateral relationship with China. Although these outcomes are usually defined in terms of legal provisions, a lack of transparency as well as the unique features of the Chinese legal system make a reliance on legal provisions per se a navel-gazing contest. It is therefore important to define the EU’s interests in terms of clear outcomes and ensure that any legal provisions are built around them.

## 3 THE EU SHOULD ACT COHERENTLY

- 3.1 Ensure policy coherence and a whole-of-government approach towards China.** A whole-of-government approach can for example be facilitated by establishing an inter-institutional working group on China.
- 3.2 Design a horizontal ‘SOE principle’.** The EU should apply an ‘SOE principle’ in order to remedy market distortions across policy domains. This could for example mean that the burden of proof is reversed for foreign SOEs, regardless of nationality, that would require additional information to ensure they operate on the basis of market conditions. Policy areas for which this could be considered are amongst others investment screening, public procurement, and subsidies.
- 3.3 Develop and publish an annual tracker or scorecard with key indicators that supports an open and fact-based discussion on the state of play in EU-China relations.** This annual stocktaking exercise would allow the EU and key stakeholders to review the implications of the rise of China more systematically and at regular time intervals and to objectively monitor key developments. This is ever more important in an environment in which transparency and progress within China are increasingly difficult to measure.

## 4 THE EU SHOULD ACT STRATEGICALLY

- 4.1 Secure strategic autonomy and economic sovereignty.** Economic and security dimensions are becoming increasingly interlinked in the strategic rivalry between the EU’s two main trade partners. The EU should more systematically assess the linkage between the economic and security dimensions of the EU’s relationship with China and act proactively to promote and safeguard the EU’s strategic interests.

**4.2 Create a strategic dialogue on China with Member States, EU institutions and key stakeholders.**

This could take the form of a high-level dialogue, with specific coordination or working groups that focus on particular issues. This strategic dialogue may also bolster European Commission resources with the information required from business in order to take greater enforcement action. This could take a similar form to the European Commission's Task Force 50 on Brexit.

**4.3 The Multiannual Financial Framework (MFF) should devote significant resources to the policy areas that ensure a strong geopolitical Europe.**

In this regard, the MFF should amongst other allocate significant financial resources to research and innovation, to digitalisation and to the EU Connectivity Strategy.

**5 THE EU SHOULD ACT CONFIDENTLY**

**5.1 Improve the EU's economic diplomacy.** So far economic diplomacy has mostly been performed by EU Member States. Better European coordination in economic diplomacy would contribute to the promotion of European products and services. It should for example be considered to organise EU trade missions.

**5.2 Act more assertively in protecting market-based governance.** The EU should revisit and enhance its economic diplomacy and make greater use of 'signalling' – identifying and highlighting problems by means of public statements. It is important not to remain silent on important infractions on global market-based governance. This is an important soft-power tool available to the EU that can bolster public debate.

**5.3 Promote EU flagship initiatives with more vigour.** A more ambitious promotion of the EU Connectivity Strategy is key in this regard.

# 03

## SECURE A LEVEL PLAYING FIELD BETWEEN CHINA AND THE EU

In order to secure a level playing field between China and the EU, WTO reform remains a paramount goal. The EU should also take measures to level the playing field in the sphere of bilateral trade and investment, in the area of procurement, intellectual property protection and forced technology transfer, standardisation, e-commerce and energy and climate.



### 3.1. THE WORLD TRADE ORGANISATION (WTO)

The WTO is vital in ensuring free and fair trade, providing the basis for the growth of economies and serving as the backbone of the international system of economic trade governance. While China's accession to the WTO helped to foster the economic development of China and world trade, it has not transformed China into an open market economy. There is also a list of commitments from China's WTO accession protocol that China has not (fully) undertaken. It has not yet acceded to the Agreement on Government Procurement (GPA), still controls prices (e.g. in the area of electricity, raw materials and water) and does not notify trade measures in a full and timely manner.

The current economic asymmetries that exist as a consequence of China's unfulfilled WTO commitments, the WTO's inability to sufficiently enforce existing rules such as those on subsidies, and the deadlock in rulemaking since China joined the WTO have a substantial adverse impact on market economies, including the EU. China's lack of convergence towards the global market economy also raises serious alarms among the European business community since this means that the existing economic asymmetries can only be resolved through WTO reform. Nevertheless, the deadlock in multilateral rulemaking has contributed to doubts on whether WTO reform is possible in the near future, which in turn raises concerns on whether the WTO can ensure fair competition and a global level playing field.

In the meantime, a new wave of protectionism has taken hold across the world. In the WTO's 20<sup>th</sup> monitoring report on trade-restrictive measures taken by G20 countries, the WTO notes a significant increase in the number and coverage of trade-restrictive measures.<sup>51</sup> The United States government is currently one of the most vocal WTO members questioning the viability of the multilateral trading system it once helped to create and has taken unilateral measures to attempt to bridge these gaps. As a result, the multilateral trading system is currently facing its deepest crisis since its inception due to these enduring problems and the pressure from the USA to achieve a breakthrough in resolving them.

More than two decades after the organisation was created, it is clear that the multilateral system needs to be renewed and made relevant again. While national economies and business environments have evolved substantially during this period, the rulebook governing them has remained largely the same. The pledges that the EU made to safeguard and promote the multilateral rules-based system and the reassurances that President Xi Jinping made at the 2017 World Economic Forum in Davos now need to be followed by concrete action.

#### Reforming the WTO

To strengthen the multilateral trading system, it is essential to achieve progress in terms of negotiating new rules that are adapted to today's global trading environment. This requires exploring possibilities under existing rules as well as updating and reinforcing the rulebook of the WTO.

In June 2018, in the context of the 7<sup>th</sup> annual EU-China high-level economic and trade dialogue, the EU and China decided to establish a working group to discuss and cooperate on proposals to reform the WTO in a way that is able to meet challenges and develop rules to ensure a global level playing field, such as on industrial subsidies. The first meeting took place in October 2018. This joint working group should be actively used to discuss key issues such as industrial subsidies, state-owned enterprises and reform of the dispute settlement pillar of the WTO.

<sup>51</sup> World Trade Organisation, "[Report on G20 Trade Measures \[Mid-October 2018 to Mid-May 2019\]](#)", 24 June 2019. In terms of the number of measures introduced, G20 economies implemented 20 new trade-restrictive measures during the period, including tariff increases, import bans and new customs procedures for exports. The trade coverage of import-restrictive measures during the period is estimated at USD 335.9 billion. This is the second highest figure on record, after the USD 480.9 billion reported in the previous period (mid-May 2018 to mid-October 2018). Together these two periods represent a dramatic spike in the trade coverage of import-restrictive measures. The stable trend identified up to July 2018 has been replaced with a steep increase in the trade coverage of import-restrictive measures.

China published a position paper on WTO reform, covering for example industrial subsidies, special and differentiated treatment of developing countries and dispute settlement.<sup>52</sup> European business shares the same principles that China touches upon but does not share how China ‘translates’ these principles into practical reform proposals. The following paragraphs set out the key priorities for European business regarding WTO reform and discuss how the WTO should be updated to take into account the implications of a state-centric economy such as China.

### **Industrial subsidies and SOEs**

Currently, there is a lack of coherent and comprehensive rules in the area of subsidies – beyond export subsidies – and the role of SOEs. Regarding subsidies, the major challenge in disciplining government support comes from the fact that government support can take a wide variety of forms and that there is currently a lack of transparency in the way that government support programmes are implemented. Therefore, anti-subsidy rules should be reformed to become stricter while also being sufficiently flexible to address the extremely diverse forms of government support and the lack of transparency in implementation. The concept of prohibited subsidies should be expanded to cover the most fundamental trade and competition distortions, including all subsidies to a sector benefitting from systemic state support. WTO subsidy rules need to address systemic state-led promotion of domestic industries and effective remedies must be created to enforce new anti-subsidy rules.

#### **Means of government support that currently are poorly addressed in WTO rules:**

- **State support granted through intermediate state-owned enterprises and semi-private operators.** *There is currently a lack of comprehensive rules on state-owned enterprises and semi-private operators that grant state support on behalf of the state or that channel state subsidies to the end beneficiaries at their own discretion.*
- **State support granted to establish or invest in new operations in third countries.** *Mergers and acquisitions by Chinese companies on foreign markets that are backed by government (financial) support distort the market.*
- **State guarantees.** *Explicit and implicit financial guarantees by the state for companies distorts the market. Companies that have a state guarantee can often offer products below the market price, leading to market distortions.*
- **Systemic state support programmes.** *WTO subsidy rules do not address state-led plans that promote an array of domestic industries, or even single sectors. Current WTO rules generally only address subsidies to specific producers of a single product. This needs to change as it does not reflect the magnitude of today's distortions.*<sup>53</sup>

Secondly, the growth and influence of SOEs in recent years is not yet sufficiently matched by equivalent regulatory disciplines to capture market-distorting behaviour. Some subsidies granted to SOEs are already captured by the WTO Agreement on Subsidies and Countervailing Measures (SCM). When SOEs themselves grant subsidies, the SCM Agreement captures them through the concept of a “public body”. However, the concept of a public body has been interpreted too narrowly, allowing a number of SOEs to avoid application of the agreement. Therefore, it is necessary amongst others to clarify what constitutes a public body and how to assess whether a member exercises meaningful control over the given enterprise.

<sup>52</sup> Ministry of Commerce, “China’s Position Paper on WTO Reform”, 2018.

<sup>53</sup> AEGIS Europe, “Reform of the WTO for a global level playing field”, 2019.

BusinessEurope calls on the EU to address this issue through multiple channels. Firstly, as agreed at the 21<sup>st</sup> EU-China summit, both sides should discuss the issue of industrial subsidies in the EU-China joint working group on WTO reform. While this is a reassuring initial step, the discussions need to lead to concrete deliverables which can be enforced.

Simultaneously, the EU should further intensify the trilateral meetings with the USA and Japan on the issue of industrial subsidies and SOEs. The EU should also strive to open the discussion to like-minded countries, for example by considering integrating these topics into broader negotiations on a plurilateral agreement on government-driven market distortions under the framework of the WTO.

### **Notification of subsidies and technical barriers to trade**

The shortcomings of the current system are evident when it comes to the notification of subsidies and technical barriers to trade (TBTs). Although the WTO Agreement on Subsidies and Countervailing Measures (SCM) requires members to notify their subsidies, the poor level of compliance has led to situations where many WTO members have provided incomplete notifications. Although China has progressed from making no notification at all to making some notifications, the 2018 WTO Trade Policy Review on China demonstrated that notifications remain incomplete – e.g. official expenditure figures of support programmes and subcentral data are often missing.<sup>54</sup>

Within the current WTO notification system, it is impossible to oblige Member States to submit comprehensive and complete notifications in a timely manner. For this reason, rule-making should focus on creating incentives for WTO members to comply with their notification obligations and on promoting regulating transparency in subsidies and TBTs. An improved process for notifications would be a stepping stone to creating better rules defining the use of legitimate and illegitimate subsidies in pursuit of fairer global trade. In this regard, the EU should amongst others promote its joint communication to the WTO General Council, dated 27 June 2019, on ‘procedures to enhance transparency and strengthen notification requirements under WTO agreements’.

Trilateral discussions held between the EU, the USA and Japan explore ideas to address this issue. European business suggests considering the reversal of the burden of proof, meaning that it should lie with the WTO member that fails to notify a subsidy. Another option would be the introduction of penalties for WTO members that fail to notify measures that have an impact on trade.

### **Dispute settlement system**

The dispute settlement pillar of the WTO is vital to check and correct the implementation and enforcement of rules by all WTO members. The current blockage of Appellate Body appointments undermines the operation of the WTO dispute settlement system as a whole.

The dispute settlement system has provided major benefits to business and consumers and is an essential element of the WTO. While imperfect and in need of reform, it should be improved as opposed to destroyed. Behind every trade dispute there are companies that rely on clear, stable and enforceable rules. All WTO members should therefore act responsibly and find a solution that can prevent ‘the law of the jungle’ in international trade.

Until an agreement in the WTO is reached, countries should also look at alternative dispute settlement solutions, as the European Commission is currently proposing. To safeguard the Appellate Body, a coalition of WTO members, including the EU and China, have submitted a joint proposal to the General Council of the WTO with concrete changes to overcome the current deadlock in the Appellate Body.<sup>55</sup>

<sup>54</sup> World Trade Organisation, “[Trade Policy Review: China](#)”, 2018.

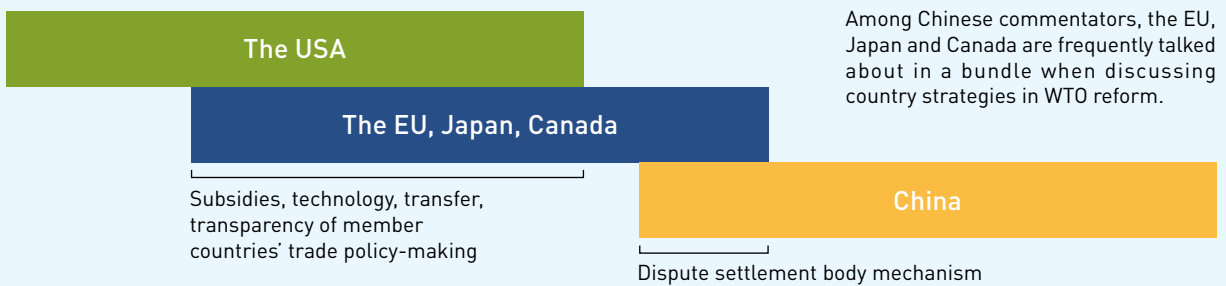
<sup>55</sup> For further information about the joint proposal, please consult: World Trade Organisation, “[Communication from the EU, China, Canada, India, Norway, New Zealand, Switzerland, Australia, South Korea, Iceland, Singapore and Mexico to the General Council](#)”, 2018.

**Special and differentiated treatment**

European business believes that development is a core priority of the WTO and that special and differential treatment for developing countries should be safeguarded. At the same time, this also means that further developed WTO members have to take the responsibility they have according to their real development status. This is particularly applicable to China which, despite being the world’s second largest economy and one of the largest trading powers globally, often demands a special and differential treatment that is normally reserved for the developing and least developed economies.

European companies support the European Commission’s assessment that “China can no longer be regarded as a developing country.”<sup>56</sup> China has become “a key global actor and leading technological power. Its increasing presence in the world, including in Europe, should be accompanied by greater responsibilities for upholding the rules-based international order, as well as greater reciprocity, non-discrimination, and openness of its system.”<sup>57</sup> The EU should therefore cooperate with China to reform the WTO, while insisting that China complies with its commitments and actively contributes at a level that is proportional to its current economic and technological development as this is not a black-and-white issue. For this reason, objective criteria should be implemented to assess the developing country status.

**An analysis of the perceptions of Chinese scholars of country positions on WTO reform**



**Analysis**

Chinese scholars believe that the EU, Japan and Canada share the same common ground as the USA in almost all WTO reform issues except for the dispute settlement mechanism.

Despite these three countries’ overall support for constructive WTO reform, Chinese commentators believe that the three might lower their ambition for WTO reform to a targeted discussion on subsidies out of concern that the USA might otherwise withdraw from the WTO.

**China’s response**

Chinese scholars warn about the threat of the EU, Japan and Canada forming an alliance with the USA to establish a new trade order that would exclude China and means abandoning the WTO. They base themselves on progress between the USA and the EU in their trade negotiations.

They advise the Chinese government to join the Japan-led CPTPP and expedite RCEP negotiations to hedge against the risks of exclusion.

Source: PolicyCN, 2019

56 European Commission, “EU-China: A Strategic Outlook”, 2019, p. 1.  
57 Ibidem.

## China and WTO agreements

### **Agreement on Government Procurement (GPA)**

*It is of utmost importance that China joins the GPA on the basis of an acceptable accession offer soon. After China has presented several unacceptable offers in the past, it will have to be assessed whether a new, revised Chinese offer tabled in October 2019 will overcome the shortcomings of the earlier offers. The necessity to reach an acceptable Chinese offer should be treated as a key priority in any further contacts of the EU with China from now on. The EU should encourage China to deliver on its promise to join the GPA as soon as possible and work towards substantially and meaningfully opening its procurement market to foreign bidders. See chapter '3.4 Procurement' for more information.*

### **E-commerce**

*A future agreement on e-commerce should establish binding rules for free, secure and reliable cross-border data transfer. Legal localisation requirements, such as those included in China's new Cybersecurity Law, should be minimised, and the freedom of businesses to decide whether and what data are transferred should not be curtailed. The transfer of or access to source codes should not be a market access requirement for software. Here – as well as for cross-border data transfer – existing rules on data protection and security that are in conformity with WTO law are to be respected. European companies would welcome an agreement that facilitates electronic transactions and improves enforcement of local product safety rules. See chapter '3.8 E-commerce' for more information.*

### **Environmental Goods Agreement (EGA)**

*China is a world leader in the manufacture and sales of clean-energy technologies. Along with the EU, both countries are well placed to lead support to reinvigorate discussions on the EGA. The aim of such an agreement must be to reduce and eliminate tariffs on key environment-related products, open up markets for environmental services, and develop common standards and labeling for environmental products. This will help to achieve environmental and climate protection goals, such as energy and resource efficiency, and controlling air pollution, while avoiding new bureaucratic customs procedures.*

## Plurilateral efforts to enhance market-based governance

While WTO reform would be the most beneficial route to restore the global level playing field, plurilateral options to enhance market-based governance should also be considered as building blocks towards strengthening the multilateral system.

### **Trade in Services Agreement (TiSA)**

The EU should furthermore reprioritise and conclude negotiations on the TiSA. This is a plurilateral agreement aiming to liberalise trade in services, and should include an annex on transparency and provisions on data flows and data localisation. The agreement is being negotiated on a non-MFN (most favoured nation) basis, meaning that only signatories will be able to benefit from it. However, TiSA has an open structure, meaning that more WTO members could join the agreement in the future (see chapter '3.2 Trade' for more information).

### **Eliminating government-induced market distortions**

While the agreement on Subsidies and Countervailing Measures (SCM) attempts to restrict the use of subsidies, there are numerous market distortions beyond subsidies that can distort global markets. Without a framework to restrict government-induced market distortions, government interventions in certain economies might create distortions and trigger reactions in other economies. The EU should explore possible frameworks on how to address these together with likeminded partners.<sup>58</sup>

<sup>58</sup> This recommendation is explored in greater detail in chapter 4.3 on overcapacity.

**DEMANDS**

**6 WTO REFORM.** WTO reform and the effective implementation of existing rules play a key role in reducing activities that distort competition. In this context, the focus should be on updating the rules on subsidies; introducing flexibilities into the system, both in terms of the negotiating method and on the decision-making process; improving trade policy monitoring and notification procedures by for example introducing penalties for members that fail regarding notification requirements; clarifying the role of state-owned enterprises; strengthening the role of the WTO Secretariat; setting new rules for clarity and transparency of export credits; and setting up joint complaints in the WTO dispute settlement system. We support the EU proposals to address these issues by, for example, reversing the burden of proof on notifications.

**7 THE EU SHOULD ENCOURAGE CHINA TO JOIN THE FOLLOWING EXISTING WTO AGREEMENTS AND ENGAGE MEANINGFULLY IN ONGOING NEGOTIATIONS:**

**7.1 Agreement on Government Procurement (GPA)**

It is a key priority that China joins the GPA on the basis of an ambitious and acceptable accession offer as soon as possible. Additionally, there should be a stronger role for the WTO Secretariat in monitoring and enforcing (with penalties for non-compliance) the WTO GPA rules and in building more structured interactions with the business community.

**7.2 Negotiations on an agreement on e-commerce**

Any agreement should establish binding rules for free, secure, and reliable cross-border data transfer. Legal localisation requirements should be minimised, and the freedom of businesses to decide whether and what data is transferred should not be curtailed. The transfer of or access to source codes and algorithms should not be a market access requirement for software. Tariffs on electronic transmissions should also be permanently abolished.

**7.3 Negotiations on the Environmental Goods Agreement (EGA)**

China is a world leader in the manufacture and sales of clean-energy technologies. Along with the EU, both countries are well-placed to revive the discussions on the EGA.

**8 NEGOTIATIONS ON THE TRADE IN SERVICES AGREEMENT (TISA):** This is a plurilateral agreement aiming to liberalise trade in services, and should include an annex on transparency, e-commerce, and provisions on data flows and data localisation. The agreement is being negotiated on a non-MFN basis, meaning that only signatories will be able to benefit from it. However, TISA has an open structure, meaning that more WTO members could join the agreement in future.

**9 INTENSIFY DIALOGUE IN THE EU-CHINA JOINT WORKING GROUP ON WTO REFORM:** The working group should address key issues regarding WTO reform such as industrial subsidies, state-owned enterprises and dispute settlement. The EU should encourage China to take up its responsibility for the functioning of the multilateral trade system.

- 10 THE EU SHOULD EMPHASISE THAT ALL WTO MEMBERS SHOULD TAKE THEIR RESPONSIBILITIES ACCORDING TO THEIR REAL ECONOMIC STATUS AND LEVEL OF DEVELOPMENT.** The EU should cooperate with China to reform the WTO, while insisting that China actively contributes at a level that is proportional to its current economic and technological development. This means that China can no longer be considered a developing country in the same way that it has been within the WTO.
- 11 THE EU SHOULD BETTER HOLD CHINA TO ACCOUNT REGARDING COMPLIANCE WITH WTO RULES.**<sup>59</sup> This involves first and foremost sharing and exchanging with likeminded partners on China's conduct. Where possible, the EU should bring cases at the WTO in order to improve the implementation and enforcement of China's WTO commitments. The EU's case against forced technology transfers is an excellent example in this regard.
- 12 THE EU SHOULD CONTINUE TO ADVOCATE TO ENHANCE TRANSPARENCY AND STRENGTHEN NOTIFICATION REQUIREMENTS UNDER WTO AGREEMENTS.** In this regard, the EU should amongst others promote its joint communication to the WTO General Council, dated 27 June 2019, on 'procedures to enhance transparency and strengthen notification requirements under WTO agreements'. It is essential to improve the compliance with existing notification commitments and to agree on new ones, especially on subsidies. We would like to see these efforts further supported by all WTO members. Sanctions for a lack of transparency or a failure to notify could be explored in this regard.

<sup>59</sup> See chapter 1.2. for more analysis on this issue.

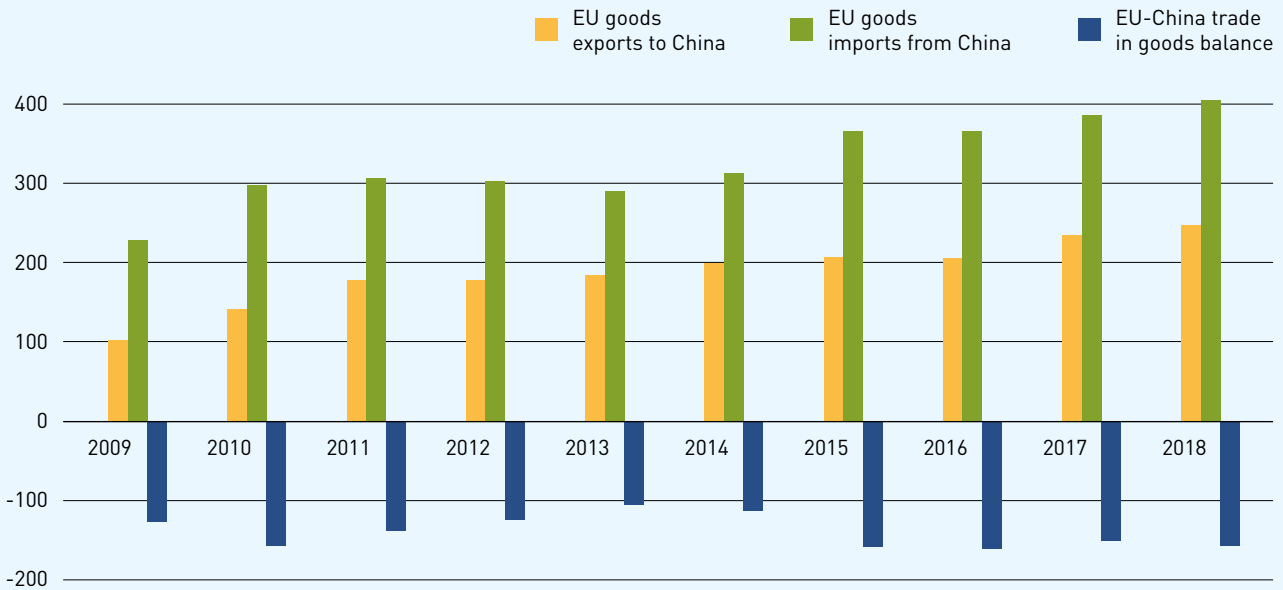
### 3.2. TRADE

#### Trade in goods

Trade flows between the EU and China are dominated by trade in goods. The EU exported EUR 209.8 billion of goods to China in 2018 and imported EUR 394.8 billion of goods from China, resulting in a trade deficit of EUR 185 billion. Exports of goods to China have grown slightly from EUR 170 billion in 2015 to EUR 210 billion in 2018.<sup>60</sup> China is the EU’s second most important trade partner with the value of bilateral trade flows amounting to EUR 604.7 billion in 2018, behind the USA (EUR 674.1 billion). While China is the EU’s second most important trade partner, the EU is China’s most important trade partner.

Nevertheless, the bilateral trade relationship is affected by numerous trade irritants. These include *inter alia* China’s mercantilist focus on export-driven growth, state ownership and control of both state-owned enterprises and private firms, floods of low-cost lending directed towards traditional manufacturing and high-tech industry, lower social and environmental standards, legal and non-administrative practices to compel foreign companies to transfer technologies. Persistent market access barriers to the Chinese market have been on top of the list of concerns for the European business community for years. The ‘composite trade liberalisation index’ (CTLI), which measures the change in China’s imports of a selection of highly protected goods and services, shows that there is a lack of trade liberalisation and even some backsliding in the manufacturing and services sectors.<sup>61</sup>

**EU-China bilateral trade in goods**  
 Figures in billion EUR



Source: Eurostat, 2019

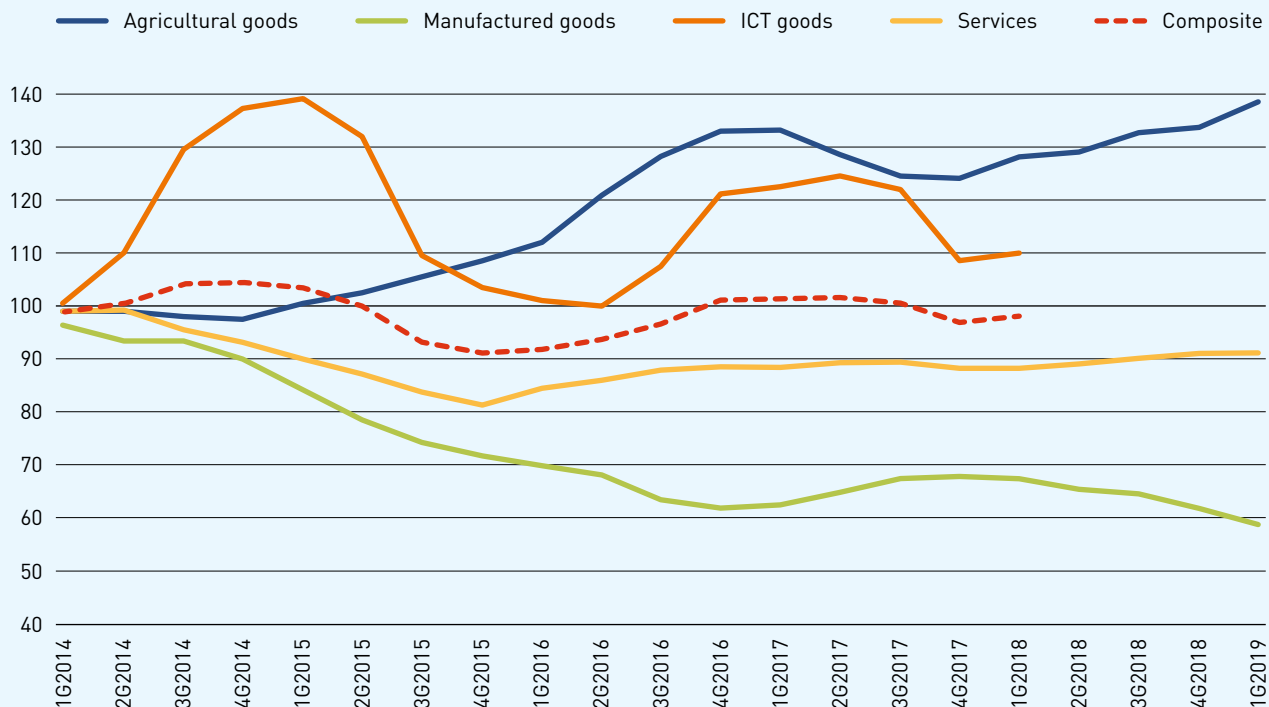
<sup>60</sup> Eurostat, “International trade in goods – a statistical picture”, 2019.

<sup>61</sup> Asia Society, “The China Dashboard: Trade Policy Reform”, 2019.



### China's Composite Trade Liberalisation Index

Import-to-GDP ratios of selected goods and services (>100=higher import levels) / By 4qma, Index value (4Q2013=100)



Source: Bloomberg, Rhodium Group, 2019

The trade relationship between the EU and China is further complicated by the escalation of the trade conflict between the USA and China, which destabilises the world economy and international trade. A solution of the conflict that includes the elimination of the additional tariffs imposed by the USA and China is therefore in the interest of the EU. However, any agreement between these two parties should not alter the level playing field to the detriment of the EU or other third countries. A deal that would include managed trade, discriminatory rules, market distortions or breaches of WTO law would imply significant damages upon the multilateral trading order.

#### Market access barriers

China is currently the EU's most trade-restrictive partner. In 2018, China surpassed Russia as the country with the highest stock of recorded trade and investment barriers, with 37 barriers impeding European companies in their exporting to and investing in China. Russia is the EU's second most restrictive trade partner with 34 barriers currently in place. Analysis also shows that overall behind-the-border measures (234) are more important than traditional border measures (191). China also occupies the first place in terms of behind-the-border measures (25), followed by Russia (18) and Brazil (15).<sup>62</sup>

Many European companies report operating difficulties that remain unique to China.<sup>63</sup> Doubts on whether China is truly committed to simplifying its administrative environment and creating a level playing field continue to deepen. Cumbersome regulations and vaguely worded laws – often subject to arbitrary interpretation – continue to pose a range of challenges.

<sup>62</sup> European Commission, "Report on Trade and Investment Barriers", 2019.

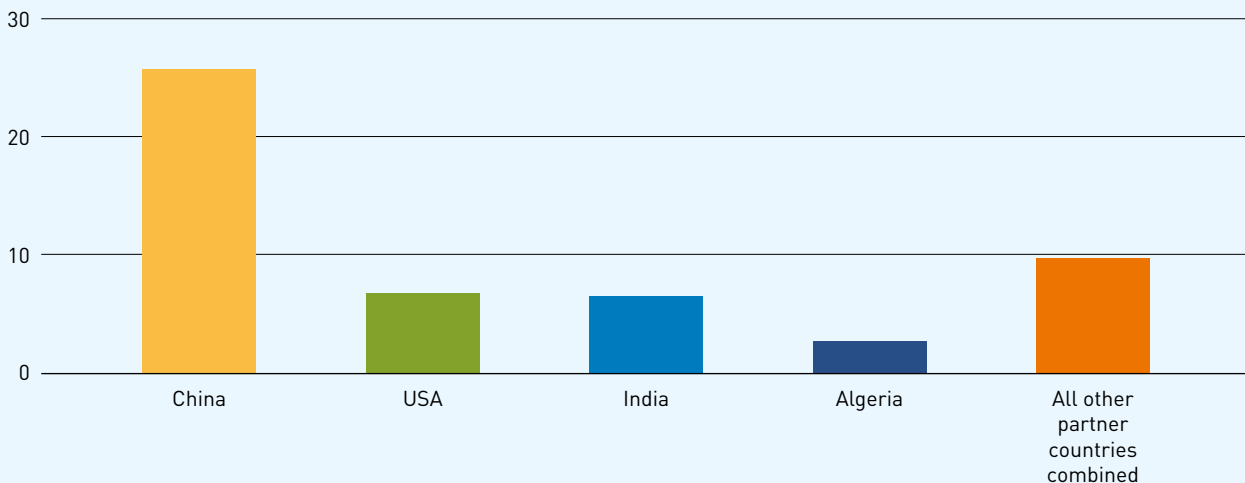
<sup>63</sup> European Union Chamber of Commerce in China, "Business Confidence Survey", 2017.

China resorted to four new trade and investment barriers in 2018. When estimating the economic impact of these four new barriers, analysis shows that these barriers could affect EU exports of up to EUR 25.7 billion. China’s Cyber Multi-Level Protection Scheme (also called Cyber-MLPS) is an example of a behind-the-border measure that was recorded in 2018. This draft legislation, for example, increases the administrative burden on foreign companies by requesting additional testing and certification requirements and further complicates access to standardisation bodies for foreign companies. The European Commission Directorate-General for Trade (DG Trade) estimates that this regulation alone could affect the entire ICT and electronics sector, in which EU exports are valued at EUR 24.9 billion.<sup>64</sup>

Explicit barriers such as long-held equity caps and licensing restrictions handicap foreign companies as they seek to build market share in China. Major progress on licensing and certification is a priority for European business as many still face unwarranted restrictions on their ability to operate in China. Even in those areas where limited access is provided, European business finds complex procedures that in practice make business establishment impossible. Thus, wider sectoral access for licensing and certification must be delivered, and the process for securing them must be signposted and streamlined.

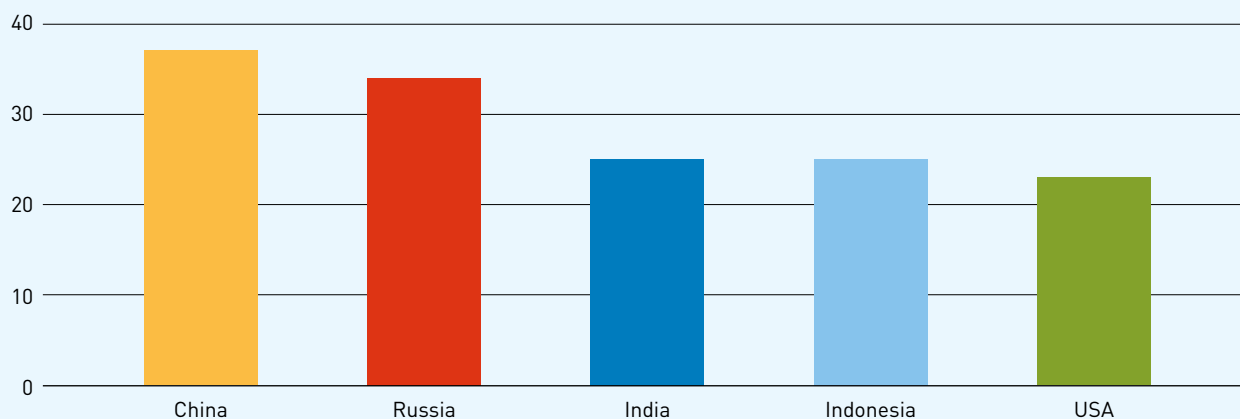
There are also many implicit barriers, from the frequent use of informal notifications of sensitive policy changes (‘window guidance’ in banking, for example) and insufficient lead time before new policies take effect. These practices create uncertainty about regulatory compliance and drive up costs for European companies. Furthermore, the presence of European businesses in China is often contingent on complex and constraining arrangements such as joint ventures with Chinese state-owned companies and many sectors are still closed to real competition.

**In 2018 alone, EUR 25 billion of EU trade flows were affected by new Chinese barriers**  
*EU trade flows affected by new barriers reported in 2018 (in billion euros)*



Source: European Commission, “Report on Trade and Investment Barriers 2018”, 2019

<sup>64</sup> European Commission, “[Report on Trade and Investment Barriers](#)”, 2019, pp. 14-15.

**China is the most restrictive trade partner of the EU***Overall stock of trade and investment barriers per country in 2018*

Source: European Commission, "Report on Trade and Investment Barriers 2018", 2019

**Reciprocity and national treatment**

In bilateral and multilateral negotiations, the EU should focus more on reciprocity in addition to national treatment. European companies operating in China want to be treated in a similar fashion as Chinese companies are treated in the EU. Advocating solely for national treatment for European companies in China could entrench the lack of a level playing field.

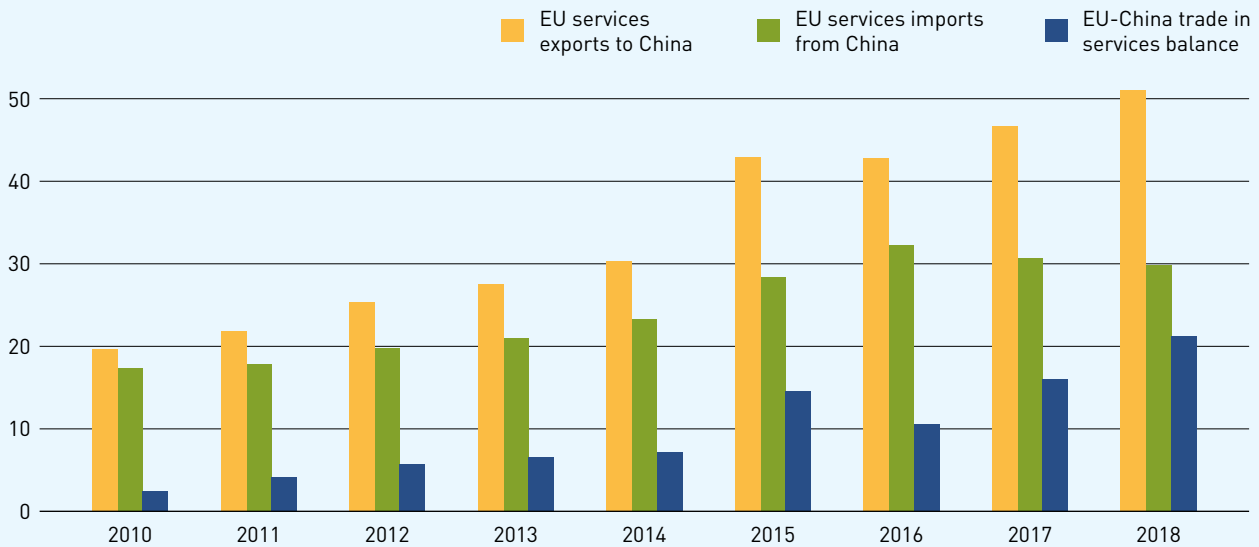
The 2019 EUCCC Business Confidence Survey reported that 45% of the respondents experienced unequal treatment of foreign-invested companies, with the most frequently cited areas of discrimination being market access (43%), administrative issues (28%) and communication with the government (26%). Chinese companies that operate in the EU are afforded equal treatment and have clear access to recourse under the rule of law if they feel they are being discriminated against. It is high time that European companies are afforded reciprocal treatment in this respect.<sup>65</sup>

**Trade in services**

The value of bilateral trade in services between the EU and China reached EUR 80.8 billion in 2018 in terms of balance of payments (BoP). Although total EU exports in services increased significantly from EUR 19.6 billion in 2010 to EUR 51 billion in 2018, bilateral trade between the EU and China remains dominated by trade in goods. In 2018, only 19.5% of all EU exports to China consisted of trade in services, significantly lower than the European average to the rest of the world (32% of total EU exports is in trade in services).<sup>66</sup> The relatively low value of exports in services to China indicates that European companies experience significant challenges when exporting services to China.

<sup>65</sup> European Union Chamber of Commerce in China, "[Business Confidence Survey](#)", 2019.<sup>66</sup> Own calculations based on Eurostat, "[International Trade in Services](#)", 2019.

**EU-China bilateral trade in services**  
*In billion euros (data excludes Hong Kong)*



Source: Eurostat, 2019

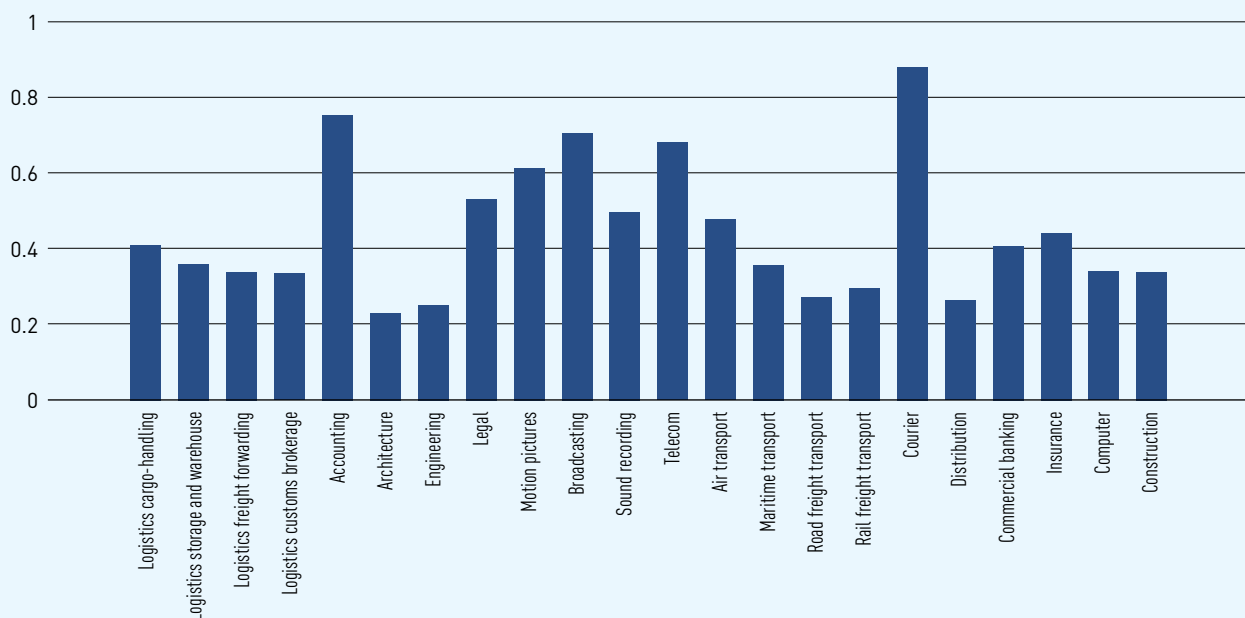
**Chinese policies and practices restricting trade in services**

The services sector in China remains relatively closed to foreign companies. This can be illustrated by China’s relatively low ranking on the OECD Services Trade Restrictiveness Index (STRI). Out of the 22 sectors covered in the STRI in 2019, the level of restrictiveness in trade in services in China is relatively higher than the average global restrictiveness in all but three sectors. Architecture services, rail freight services and engineering services are the three sectors in which China scores relatively better than other countries. All other services sectors are relatively more closed. The telecommunications services, postal and courier services and motion services sectors are particularly restricted to foreign investors as they are subject to Chinese ownership requirements or included in Beijing’s Negative List.<sup>67</sup>

Loosening market restrictions in services is a key priority for European companies. In addition to legal restrictions on foreign entities, *de facto* barriers, such as low regulatory transparency and visa restrictions, are also impeding foreign companies when operating in China’s services sector.

<sup>67</sup> Organisation for Economic Co-operation and Development, “[Services Trade Restrictiveness Index: The People’s Republic of China](#)”, 2019.

**Chinese services sectors are often restricted to foreign companies**  
*China's score on the OECD's Services Trade Restrictiveness Index (per sector)*  
*(0 = open; 1 = closed)*



Source: OECD 2018

**Positive developments but also backsliding**

China has made some progress in terms of opening up domestic services markets and making reforms. State Council Documents No. 5 and State Council Document No. 39 included pledges to improve market access for foreign companies in the services sectors. Additionally, the revision of the Negative List (see chapter '3.3 Investment') in June 2018 included timelines for gradually lifting equity caps in certain financial services. At the 2019 G20 summit in Osaka, Xi Jinping furthermore announced that the 2019 revision of the Negative List will further loosen market access restrictions in services.<sup>68</sup> This new Negative List has become effective in July, but the reduction in restrictions has not met the expectations. Nevertheless, European business applauds China's efforts to open up the services sector and calls on China to continue opening its services market to foreign enterprises and to deliver tangible improvements that also tickle down to the lower levels of government.

Several negative developments have however diminished some of the progress that has been made regarding removing market access restrictions. Despite some positive reforms, European companies have therefore not necessarily experienced significant progress in operating in China's services sector. Even within the same sector, market openings in some areas can be diminished by tightening in a different area. For instance, within the legal services sector 23% of European business experienced market openings. This opening was diminished as an equal amount of European business in the legal services sector (23%) experienced market closing.<sup>69</sup> Moreover, these industries provide services to other companies operating on China's market, thereby indirectly having a negative impact on the operations of other foreign companies.

<sup>68</sup> China Daily, "Xi unveils plans for greater opening-up", 2019.

<sup>69</sup> European Union Chamber of Commerce in China, "Business Confidence Survey", 2019.

### **Higher emphasis on services**

In future dialogues with China, the EU should emphasise the need for stronger liberalisation of China's services sector. European companies call on the EU to highlight services at all relevant platforms, for example at EU-China summits. The Comprehensive Agreement on Investment (CAI) should aim to liberalise investment in the services sector, and should deliver concrete results in a timely fashion.

European business furthermore strongly calls on the EU to advocate internationally to revive negotiations on the Trade in Services Agreement (TiSA). Revamping negotiations on TiSA is essential to strengthen rules and improve market access for trade in services. The negotiations should cover all sectors substantially and an agreement should include provisions on transparency, data localisation and the movement of natural persons working in services.<sup>70</sup>

### **Trade defence instruments (TDI)**

Effective trade defence instruments – including anti-dumping and anti-subsidy measures – are essential tools for Europe's manufacturing industry. China remains one of the EU's most market-distorting trading partners.<sup>71</sup> In order to protect European companies against unfair trade practices such as illegal subsidies and to achieve a level playing field, the EU must stand up for a reciprocal approach from China and make trade rules more effective and enforceable. The European business community welcomes the 2018 modernisations of the EU's trade defence instruments but identifies a need for further enhancement of the instrument and a need for a stronger application and implementation of its provisions, with due consideration for the various interests of EU industry and importers.

There are several mechanisms that the EU can apply to use the trade defence instruments more effectively and with a faster and more resolute response.

First, while in the current TDI legislation it is sufficient to prove "*threat of injury*" to initiate an anti-dumping case, the European Commission has shown a clear preference to take action only if EU producers prove to have suffered actual "*material injury*" in the form of a very low or negative profitability. In some situations, this approach can come too late since industry will either have already stopped producing or will have changed its production operations in view of the obvious risk of being undercut in prices by Chinese imports. A substantial change in the assessment of the existence of a *threat of injury* and of *material injury* is required to ensure that a right remedy is adopted at a right time.

Second, the EU legislation entitles the Commission to open anti-dumping, anti-subsidy and anti-circumvention investigations cases on its own initiative (*ex officio*) without a complaint from the industry. This possibility has only rarely been used in the EU. The Commission should therefore more often use its right to initiate investigations *ex officio* in view of the vast evidence of Chinese dumping, subsidies and circumvention practices. This will particularly help small and medium-sized enterprises (SMEs) who do not possess the resources to prepare a trade defence complaint by themselves.

Third, it is crucial that the TDIs provide the same level of protection against dumped imports from third countries as the former analogue country approach – without putting the burden of proof on the shoulders of the European industry. The European industry is still facing non-transparent markets and regulatory framework conditions in third countries. Given this "black box" situation, the European Commission – together with the Members States – need to establish own information sources to gather robust and independent market intelligence.

<sup>70</sup> For more detail on this recommendation, see chapter 3.1 on the WTO.

<sup>71</sup> In the last ten years, the EU has imposed 41 anti-dumping/countervailing duties on China while China has only imposed 12 on the EU. Source: World Trade Organisation, "[Summary and Status of G-20 trade and trade-related measures since October 2008](#)", 2019.

Fourth, the application of a new methodology in anti-dumping investigations resulted in a significant increase in the workload of the Commission's anti-dumping service. At the same time, the staff constraints remained the same. It is imperative in this regard that next to market intelligence, the staff of the Directorate H, Trade defence, of DG Trade is significantly increased as well.

Moreover, the Commission applies a very high threshold to evaluate the complaint and requires that very detailed evidence and data are provided by private companies. This makes it very difficult, especially for SMEs, to launch an anti-dumping complaint. Consequently, the European business community believes that a complaint should contain prima facie evidence only, as in line with EU regulation.

Finally, TDI measures should undergo a regular fitness check to ensure that they are up to date in addressing the latest types of trade distortions. This is necessary as there are ongoing attempts by actors to circumvent TDI measures imposed by the Commission. Therefore, it is crucial that collaboration between the authorities is enhanced to capture these illegal practices. In that respect, the contribution of the European Anti-Fraud Office (OLAF) should be further sought and encouraged to identify and tackle circumvention practices.

The EU should furthermore consider to develop tools to address distortions both in the area of services trade and in relation to trade in goods that are not 'imported' (e.g. means of transport such as ships) but injure EU producers. For instance, shipbuilding is one manufacturing sector in which overcapacity, subsidisation and government interventions lead to injurious pricing practices and other trade distortions that create unfair competition for European shipyards. Regrettably traditional trade defence measures imposed at the border are *de facto* not applicable to shipbuilding because ships are not 'imported' in the common customs sense known for most other products (i.e. permanent entry into commerce of the affected economy) and are rarely produced in large series (it is hence difficult to establish a 'like product' and calculate the related dumping margin on it). So far, there are therefore no effective trade defence instruments to address these distortions,<sup>72</sup> and there are gaps in both WTO and EU law which need to be addressed and filled.<sup>73</sup> The creation of new instruments should be considered here.

## Digital trade

Digital trade concerns the entire economy, not only the ICT sector. It is conducive to services and e-commerce and, at the same time, a major enabler and value-adding factor to traditional manufacturing. Data flows are inextricably linked with digital trade. Research conducted by the McKinsey Global Institute in 2016 indicates that global cross-border data flows have multiplied by a factor of 45 between 2005 and 2014, jumping from 4.7 Tbps to 211.3 Tbps.<sup>74</sup> The same report also shows the important role of data flows in the increase of global GDP. Compared to a scenario where no digital trade takes place, econometric research indicates that global flows of goods, foreign direct investment (FDI) and data have increased the current global GDP by roughly 10%, accounting for USD 7.8 trillion. Data flows alone account for USD 2.8 trillion of this effect.

At the same time, new trade barriers are emerging. Digital protectionism, such as investment restrictions, restrictions on cross-border data flows and forced data localisation are a growing concern for the European business community.<sup>75</sup> China is by far the most restrictive major economy in digital trade. The Digital Trade Restrictiveness Index (DTRI) shows that "China applies sweeping regulatory measures in all aspects of digital trade, including trade in digital goods and services, investment in the information and communications technology (ICT) sector, as well as the movement of data and ICT professionals."<sup>76</sup> On a scale varying between 0 (completely open) and 1 (virtually closed), China's score comes in at 0.7, putting it far ahead of the number two, Russia, with a score of 0.46. By comparison, the European Union has a score of 0.21. In order to address the barriers as well as skewed openness to digital trade, there are several policy measures that should be taken to address these challenges.<sup>77</sup> The EU should advocate for effective standards in digital trade that go hand in hand with trade liberalisation.

<sup>72</sup> Long running efforts to establish a legally binding global regime amongst shipbuilding nations under OECD-sponsored negotiations have so far not succeeded. Nor can tangible results be expected in this domain in the foreseeable future despite the best efforts of the EU.

<sup>73</sup> AEGIS Europe, "[WTO Reform: The Business Case \[Annexes\]](#)", 2019; AEGIS Europe, "[WTO Reform: The Policy Case](#)", 2019; European Union Chamber of Commerce in China, "Shipbuilding Working Group Position Paper", 2019.

<sup>74</sup> McKinsey & Company, "[Digital Globalisation: The New Era of Global Flows](#)", 2016.

<sup>75</sup> See chapter '5.3 Digital Economy and Cybersecurity' for more detail and recommendations on how to tackle digital protectionism.

<sup>76</sup> European Centre for International Political Economy, "[Digital Trade Restrictiveness Index](#)", 2018.

<sup>77</sup> For an overview of common barriers to digital trade as well as detailed recommendations on how to address them, see BusinessEurope, "[BusinessEurope's views on Digital Trade](#)", 2017.

## DEMANDS

- 13 THE EUROPEAN BUSINESS COMMUNITY ASKS CHINA TO MAKE SIGNIFICANT MARKET ACCESS IMPROVEMENTS.** Market access improvement should reciprocate the enormous advantages China has gained on the European market. China should abolish before the border barriers, for example joint venture and localisation requirements, and behind the border barriers such as opaque licencing and certification procedures.
- 14 CHINA SHOULD CREATE A TRANSPARENT, RULES-BASED AND PREDICTABLE REGULATORY ENVIRONMENT AS THIS WILL ENCOURAGE INVESTMENT AND JOB CREATION.** China should abide by the rule of non-discrimination, transparency and predictability and ensure a level playing field for foreign companies operating on the Chinese market and on China's export markets. Transparent and rules-based trade helps companies trust that their decisions to invest and trade have certain predictable consequences in any given business environment. To this end, China should for example publicly publish legislative reforms and ensure consistent implementation at all levels of government.
- 15 FOREIGN-INVESTED COMPANIES AND TRADERS IN CHINA SHOULD BE PROVIDED RECIPROCAL TREATMENT IN ADDITION TO PRE-ESTABLISHMENT AND POST-ESTABLISHMENT NATIONAL TREATMENT.** Chinese companies that operate in the EU are afforded equal treatment and have clear access to judicial process under the rule of law if they feel they are being discriminated against. It is high time that European companies are afforded reciprocal treatment in this respect. European companies operating in China want to be treated similarly as Chinese companies are treated in the EU, so as to avoid competitive advantages on the part of Chinese companies.
- 16 THE EU SHOULD FULLY APPLY AND FURTHER STRENGTHEN ITS TRADE DEFENCE INSTRUMENTS (TDIs).** A lack of subsidy transparency in China undermines a company's ability to provide the necessary evidence of 'material injury' in anti-subsidy cases. DG Trade must have sufficient staff and stronger in-house information resources to gather robust and independent market intelligence to fill this gap. By more accurately recording trade-distorting subsidies, the EU would be able to launch more anti-subsidy, dumping and circumvention cases. TDI measures should undergo a regularly fitness check to ensure that they are up to date in addressing the latest types of trade distortions.
- 17 THE EU SHOULD EXAMINE THE SCALE AND POSSIBLY DEVELOP TOOLS TO ADDRESS DISTORTIONS BOTH IN THE AREA OF SERVICES TRADE AND IN RELATION TO TRADE IN GOODS THAT ARE NOT "IMPORTED" (E.G. MEANS OF TRANSPORT SUCH AS SHIPS) BUT INJURE EU PRODUCERS.** So far, there are therefore no effective trade defence instruments to address these distortions and there are gaps in EU law which need to be addressed and filled. The creation of new instruments should be considered here.
- 18 THE EU SHOULD ADVOCATE INTERNATIONALLY TO REVAMP THE NEGOTIATIONS ON A PLURILATERAL TRADE IN SERVICES AGREEMENT (TISA).** Strengthening the international rulebook on and stimulating trade in services is essential for businesses to operate smoothly in an international trade environment in which trade in services is increasingly becoming more important.



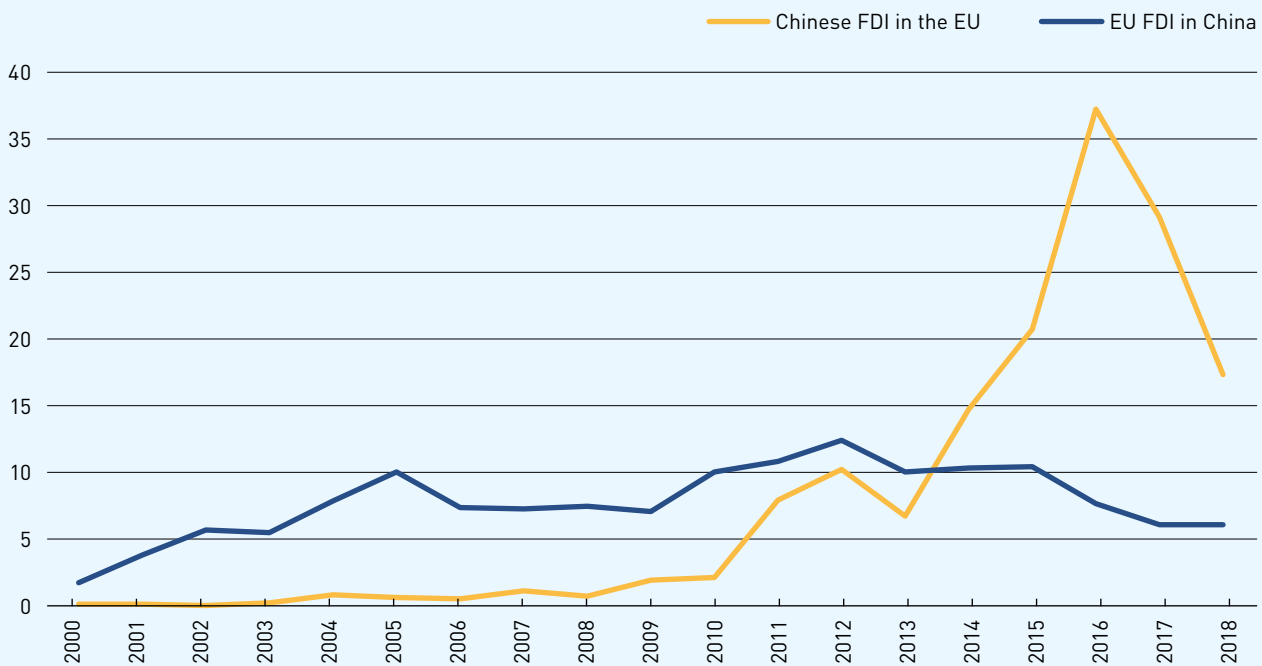
- 19 THE EU FREE-TRADE AGREEMENTS (FTAs) HELP TO SECURE MARKET-BASED GOVERNANCE AND SHOULD INCLUDE STRONG RULES AND PROVISIONS IN ISSUE AREAS IN WHICH MULTI-LATERAL RULES ARE LIMITED.** For example, the EU should spread strong standards in digital trade that go hand in hand with trade liberalisation. These chapters should have ambitious disciplines that tackle barriers to digital trade and ensure cross-border data flows and limit data localisation. Disciplines on SOEs and subsidies also pave the way for a plurilateral or multilateral consensus.
- 20 THE EU ALSO NEEDS TO RAPIDLY EXPAND WORK WITH LIKE-MINDED PARTNERS** towards agreements on privacy, data localisation and cyber standards, as well as free and safe data flows.
- 21 IT IS IMPORTANT FOR THE EU TO START A DIALOGUE WITH CHINA ON EXPORT CONTROLS AND IMPORT RESTRICTIONS.** In particular, there is a need to clarify China's evolving legal framework on export control of dual-used goods as EU companies have important legal concerns regarding their exports from China all over the world (e.g. the notion of 'deemed exports' is too vague).
- 22 A POTENTIAL TRADE DEAL BETWEEN THE USA AND CHINA MUST NOT BE AT THE EXPENSE OF THIRD COUNTRIES OR THE INTERNATIONAL COMMUNITY.** The EU should emphasise in its dialogues with the USA and China that a potential bilateral trade agreement between the USA and China must abide by WTO rules such as non-discrimination.

### 3.3. INVESTMENT

Over the last decade annual Chinese foreign direct investment (FDI) flows into the EU have increased rapidly from EUR 700 million in 2008 to peaking at EUR 37 billion in 2016. Although Chinese investment flows dropped to EUR 17.3 billion in 2018, they nevertheless vastly exceed European FDI flows into China, which amounted to EUR 6.1 billion in 2018. China has also exceeded the EU in terms of total outstanding FDI stock. Cumulative Chinese FDI in the EU reached EUR 149.3 billion in 2018 while the total stock of EU FDI in China equalled EUR 138.3 billion.<sup>78</sup>

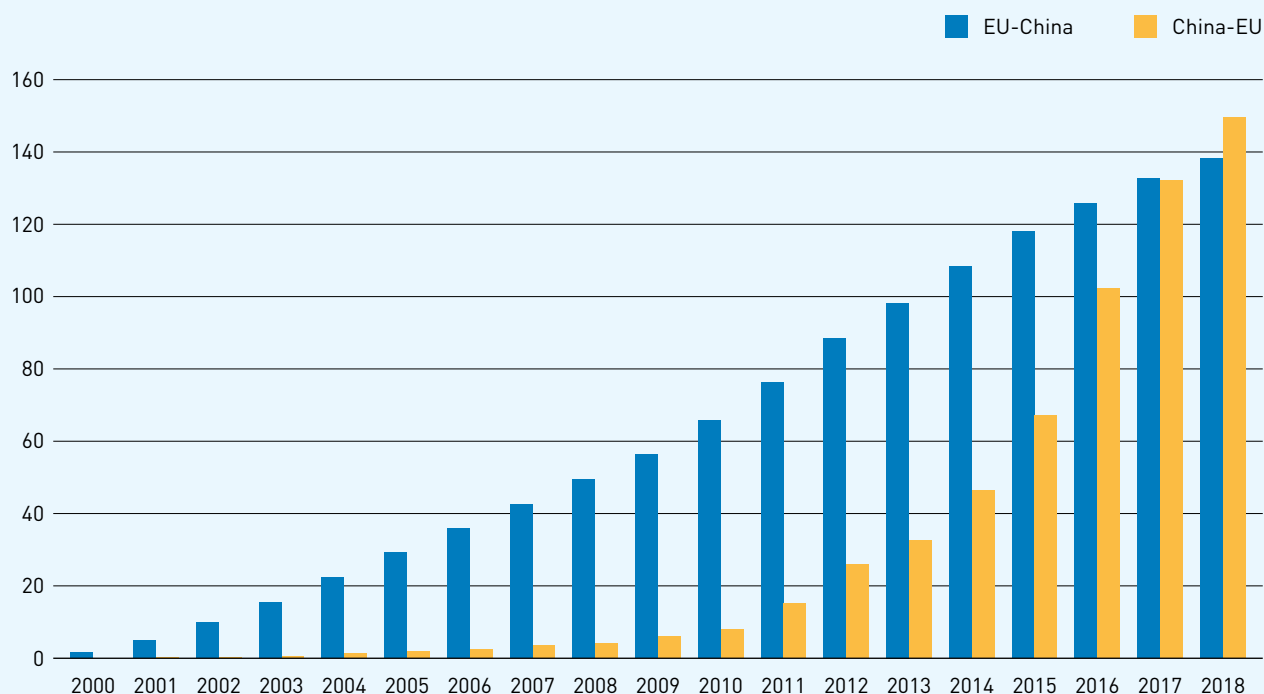
#### EU-China bilateral FDI flows

After hitting a record high in 2016, Chinese FDI flows to the EU have declined in 2018 (figures in billion EUR)



Source: Rhodium Group, 2018

<sup>78</sup> Rhodium Group and Mercator Institute for China Studies, 2019.

**EU-China bilateral FDI stock***Cumulative Chinese FDI in the EU has now exceeded European FDI in China (figures in billion EUR)*

Source: Rhodium Group. Data represents the cumulative value of annual direct investment transactions, including greenfield projects and acquisitions that result in significant ownership control (>10% of equity).

The five year consecutive drop of EU FDI into China can partly be attributed to the high barriers to investment that are present in China. The restrictive market access that European businesses experience can be illustrated by the fact that China still ranked 59<sup>th</sup> out of 62 countries in terms of openness to FDI in the 2018 OECD FDI Regulatory Restrictiveness Index.<sup>79</sup> There is currently a lack of a level playing field in the area of investment as the EU is open to Chinese investments, but the Chinese market is highly restricted.

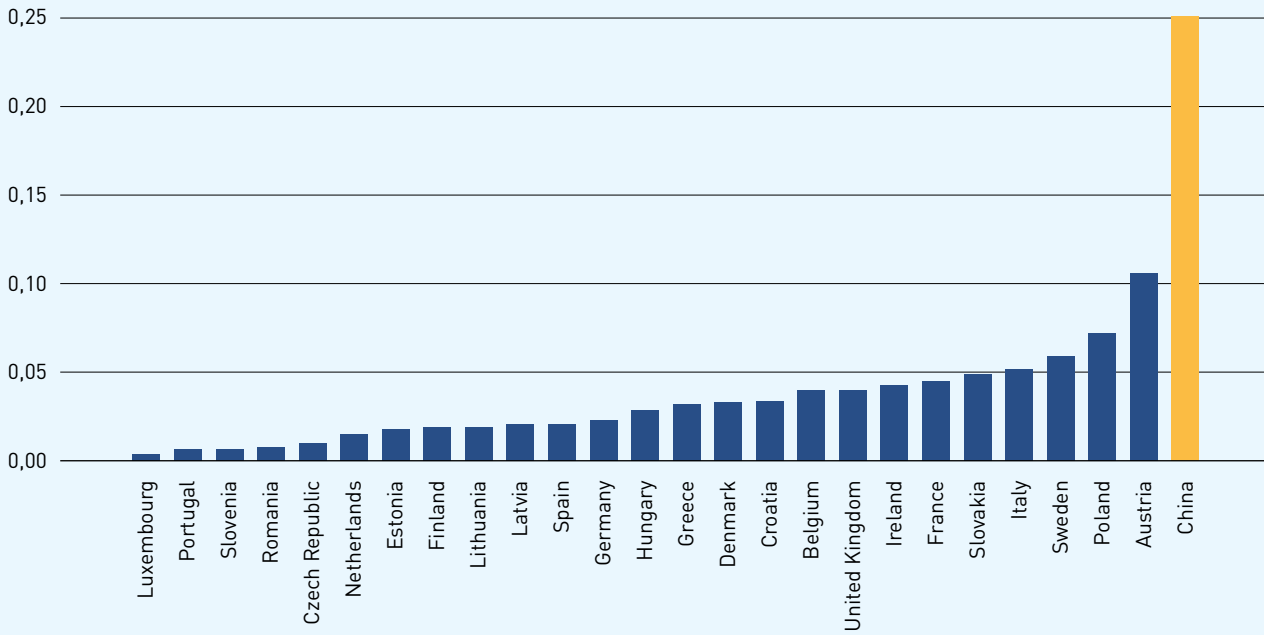
Likewise, China ranked 100<sup>th</sup> out of 180 countries that were assessed in the Heritage Foundation's Economic Freedom Index. China scores particularly low on the 'investment freedom' indicator as Beijing applies restrictive foreign investment policies that protect inefficient SOEs.<sup>80</sup> Thus, while the EU market is in essence open to foreign investors, the Chinese market is relatively closed to European investment.

<sup>79</sup> A score of 1 equals maximum restrictiveness. See Organisation for Economic Co-operation and Development, "[FDI Regulatory Restrictiveness Index](#)", 2018.

<sup>80</sup> The Heritage Foundation, "[Index of Economic Freedom: China](#)", 2019.

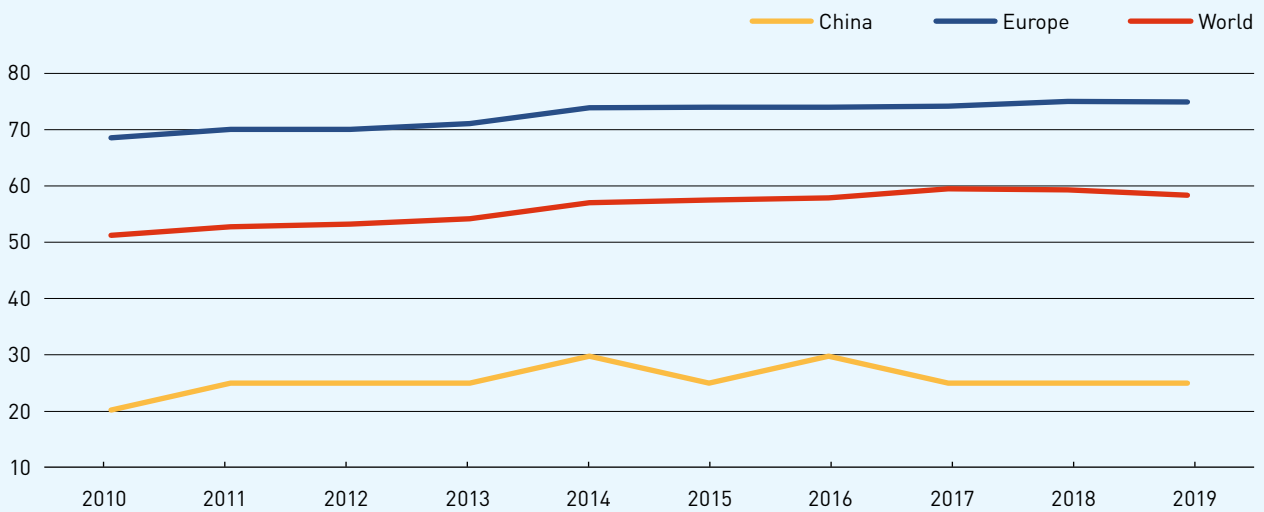
**FDI Regulatory Restrictiveness Index**

FDI restrictiveness is an OECD index gauging the restrictiveness of a country's foreign direct investment (FDI) rules by looking at four main types of restrictions: foreign equity restrictions; discriminatory screening or approval mechanisms; restrictions on key foreign personnel and operational restrictions. Implementation issues are not addressed and factors such as the degree of transparency or discretion in granting approvals are not taken into account. The index here shows the total and nine component sectors taking values between 0 for open and 1 for closed.



Source: OECD, 2019

**China's investment freedom score is barely improving**  
 100 = total freedom, 0 = totally restricted



Source: The Heritage Foundation, 2019

## Pre- and post-establishment restraints

When investing in China, European businesses are confronted with 'pre-establishment' and 'post-establishment' restraints on foreign investment.

Pre-establishment restraints include amongst others market entry restrictions, burdensome approval procedures, equity caps, and cases of forced technology transfer. Market access restraints are primarily laid down in the National Negative List on Foreign Investment (officially called the 'Special Administrative Measures on Access to Foreign Investment') and the FTZ Negative list on Foreign Investment (officially called the 'Free Trade Zone Special Administrative Measures on Access to Foreign Investment') which are issued by the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM).

In June 2018, Beijing improved market access for foreign companies when it updated the National Negative List on Foreign Investment, reducing the number of restricted sectors on the negative list from 63 to 48.<sup>81</sup> These have been further cut back to 40 restricted sectors in July 2019. The FTZ Negative List was also renewed in 2019, reducing the number of restricted sectors from 45 to 37.<sup>82</sup> In several sectors foreign ownership caps were raised or removed. In the automotive sector, for example, equity caps on new energy vehicles (NEVs) were completely removed in 2018 and foreign ownership requirements will furthermore be lifted on commercial vehicles in 2020 and on passenger cars in 2022.<sup>83</sup>

However, the recent market openings have been contradicted by increasing market access restrictions in other sectors as many markets in which European companies are highly competitive remain largely closed. A business survey by the EUCCC demonstrates that while some sectors, such as the cosmetics, automotive and financial services sectors, have opened up, other sectors, such as the pharma and IT/telecom sectors, have also seen partial closures. The improved market access has furthermore been diminished as some sectors that have been removed from the Negative List for Foreign Investment remain on the Negative List for Market Access.<sup>84</sup> Moreover, in many of the sectors that have been opened state-run monopolies are so entrenched that it will be difficult for foreign companies to gain a market entry and to compete (railways, power grids, etc.).

In addition to market access restrictions recorded in the Negative List, foreign investors are often obliged to meet restrictive equity requirements or forced to establish a joint venture when entering the Chinese market. For example, while the majority of German investors in the Chinese automotive sector were forced to invest their capital in minority stakes, most Chinese investors in the European automotive sector have a controlling majority stake.<sup>85</sup>

Secondly, companies are confronted with various post-establishment restraints regarding foreign investments in China. Post-establishment barriers include the existence of explicit and implicit policies and practices that result in discriminatory treatment of foreign investors. In 2018, 35% of European businesses were confronted with administrative obstacles and 30% experienced discretionary enforcement of rules and regulations when operating in China.<sup>86</sup>

Furthermore, European investors in China face hurdles in gaining access to funding in China. On the one hand, European businesses are explicitly excluded from many financial support programmes as some programmes specifically target domestic companies and indigenous innovation. On the other hand, foreign businesses that operate in China have difficulty in obtaining financial services because they are often indirectly excluded since local businesses are preferred as they have closer relationships with local banks.

<sup>81</sup> United States Information Technology Office, "[NDRC and MOFCOM Releases New Negative List](#)", 2018.

<sup>82</sup> Xinhua, "[China Focus: China opens more sectors to foreign investment with new negative lists](#)", 2019.

<sup>83</sup> Reuters, "[China further eases foreign investment curbs](#)", 2018.

<sup>84</sup> European Union Chamber of Commerce in China, "[Business Confidence Survey](#)", 2019.

<sup>85</sup> MERICS & Rhodium Group, "[EU-China FDI: working towards reciprocity in investment relations](#)", 2018.

<sup>86</sup> European Union Chamber of Commerce in China, "[Business Confidence Survey](#)", 2018.

## The Foreign Investment Law

On 15 March 2019, Beijing furthermore adopted the new Foreign Investment Law (FIL). The law requires foreign investments to be awarded 'national treatment' except when the Negative List of the Catalogue Guiding Foreign Investment in Industry states otherwise. Additionally, the new law aims to tackle the problems linked to forced technology transfers. The law for example prohibits Chinese authorities from using administrative means to force foreign investors to transfer technology.

The FIL addresses some key concerns of private and foreign investors, but there remain various questions as to what extent the FIL will lead to tangible improvements in investment conditions in China. Firstly, the FIL contains many vaguely formulated clauses that lack detail. Moreover, it remains vague in terms of enforcement as its enforcement will depend implementation provisions that are yet to be adopted. This is a concern particularly regarding the regional and local enforcement of the law. The provisions banning forced technology transfer are also unclear. Whereas the FIL prohibits authorities from using administrative means to force investors to transfer technology, this does not prevent non-administrative means to force investors to transfer technology. Lastly, the law still distinguishes between 'domestic' and 'foreign' companies. This does not contribute to the equal treatment of businesses regardless of their origin.

In general, the Foreign Investment Law has the potential to contribute to creating a better investment climate for businesses in China. For this to be true, however, it is essential that Chinese authorities enforce the law at all levels of government and that the government delivers on its promises to provide national treatment to foreign businesses and respect intellectual property. Moreover, as long as Chinese policies such as MiC 2025 include concrete targets for domestic market share for Chinese companies, European business remains concerned to what extent FIL and other market openings will yield tangible improvements.

## How to move forward

### **Comprehensive Agreement on Investment (CAI)**

The best way to improve EU-China relations is by negotiating and concluding the CAI before the end of 2020. This would give the right signal to European companies that China's market remains open for business, and also creates the predictability companies need to make their investment decisions. However, substance should prevail over timing as an ambitious agreement would resolve a lot of the issues that have been raised by the European business community. Both sides must strive to liberalise all sectors substantially, eliminate pre- and post-establishment restrictions to investment and tackle both *de jure* as well as *de facto* barriers to investments. The agreement must also include provisions on industrial subsidies and state-owned enterprises (for example by opening up markets that are now only open to SOEs and by considering how to handle SOEs in investor-to-state disputes related to the investment agreement). The resulting negative list for FDI in China should be as short as possible since many sectors are still completely or partially restricted to foreign investment.

For the CAI to deliver concrete results for business, it is essential that it does not only include ambitious clauses on market access for goods and services, technology transfer and free movement of capital, but also on fair and equitable treatment, investor-to-state and state-to-state dispute settlement and sustainable development. The successful conclusion and implementation of the CAI would also give a positive incentive to consider opening free-trade negotiations in the future if the right conditions prevail.

### **Investment screening**

On 5 March 2019, the European Council adopted a regulation establishing a framework for the screening of foreign direct investment into the EU. We welcome the fact that the new screening regulation clearly

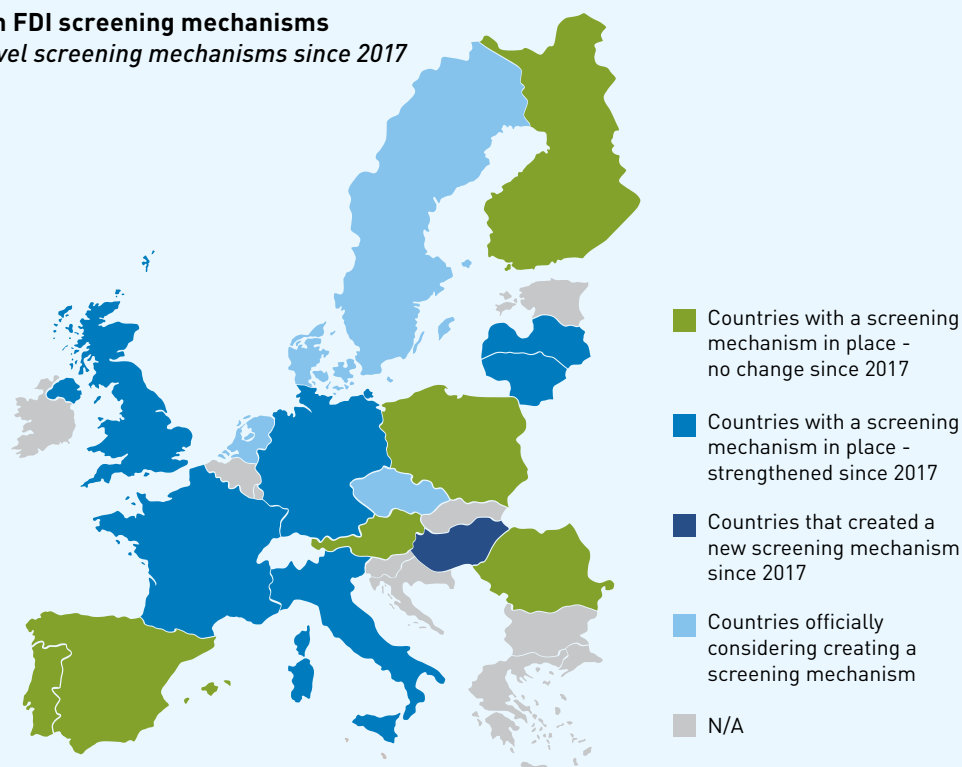
emphasises that the EU remains an open investment environment and welcomes Chinese FDI. This point is crucial, as FDI is a major contributor to the creation of jobs and growth in the EU.<sup>87</sup> Screening mechanisms can still be improved as mechanisms currently differ between Member States. The EU and EU Member States must therefore strive to ensure a coherent and compatible application of the EU investment screening framework and respect minimal EU standards for their national control mechanisms.

Notwithstanding the non-discriminatory principles of the investment screening regulation, its provisions could particularly apply to a substantial amount of Chinese investment. In a report on Chinese investments into the EU, Rhodium and the Mercator Institute for China Studies demonstrated that the provisions of the screening regulation to a large extent apply to Chinese investment into the EU. The FDI screening framework requires special scrutiny for investments that: 1) have been designated as sensitive sectors, 2) have been made by state-owned enterprises and other directly or indirectly state-controlled entities or 3) fall under a foreign state-led programme or project. Accordingly, 83% of Chinese merger and acquisition transactions into the EU could potentially fall under intensified scrutiny.<sup>88</sup>

In 2018, 46% of the Chinese mergers and acquisitions into the EU fell into the designated sensitive sectors, including for example the defence, transport and communications sectors, but also the “freedom and pluralism of the media”. Secondly, over the past years, 50-60% of the value of Chinese investments into the EU originated from SOEs or other Chinese companies that were directly or indirectly controlled by the Chinese government. In 2018, 41% of the value of Chinese merger and acquisition transactions into the EU were made by SOEs.

Thirdly, 58% of the number as well as the value of Chinese investment flows into the EU were directed at sectors that are targeted by the state-led programme Made in China 2025.<sup>89</sup>

### Overview of European FDI screening mechanisms Changes in national-level screening mechanisms since 2017



Source: MERICS and Rhodium Group, 2019

<sup>87</sup> See European Commission, “*Trade for all: Towards a more responsible trade and investment policy*”, 2015: “...inward investment is responsible for employing 7.3 million people in the EU”, p. 9.

<sup>88</sup> Rhodium Group and Mercator Institute for China Studies, “*Chinese FDI in Europe*”, 2019.

<sup>89</sup> *Ibidem*.

**EU information portal on investment screening**

An EU information portal on investment screening will contribute to a transparent and predictive investment climate that facilitates and stimulates foreign investment into the EU.

The attractiveness of the EU as a destination for investment may suffer from market fragmentation as a result of divergent national investment screening mechanisms and the lack of centrally available information about the functioning of national screening mechanisms. While the new investment screening regulation requires Member States to submit an annual report regarding inward FDI and to establish a national contact point in the field of FDI, these measures do not necessarily contribute to the harmonisation of information and may actually reinforce national divergences regarding information processing about screening mechanisms. Additionally, the mechanism does not guarantee that information is shared publicly or that information regarding the functioning of the FDI mechanisms is publicly accessible to foreign investors. The information that is currently publicly available is very limited. Gaps regarding the availability as well as the quality of information have a negative effect on attracting foreign investment. Higher transparency will contribute to a stable and predictive investment climate.

Therefore, the EU should establish an EU information portal on investment screening, allowing the public and foreign investors to assess the functioning of national screening mechanisms at a central European level. An EU information portal on investment screening should contain a comprehensive overview of the respective national investment screening frameworks and the relevant implications of screening procedures on investment decisions.



**DEMANDS**

- 23 CONCLUDE THE NEGOTIATIONS ON THE COMPREHENSIVE AGREEMENT ON INVESTMENT (CAI) BEFORE THE END OF 2020.** Concluding the negotiations on CAI is a key priority for European business. However, substance should prevail over timing and negotiations should be concluded only if the agreement is sufficiently ambitious. Both sides should therefore strive for an ambitious and far-reaching agreement that eliminates substantially all pre- and post-establishment market access barriers for goods and services and ensures national treatment of foreign investors. Additionally, the CAI should include strong enforcement measures and provisions on state-owned enterprises.
- 24 ENCOURAGE CHINA TO FURTHER ELIMINATE ALL PRE- AND POST-ESTABLISHMENT RESTRAINTS ON FOREIGN INVESTMENT.** While Chinese investors have access to the European market, European investors do not have equal access to the Chinese market. The EU should engage with China to level the playing field by eliminating pre- and post-establishment restraints on investment.
- 25 ENCOURAGE CHINA TO CLARIFY THE FOREIGN INVESTMENT LAW WITH APPROPRIATE IMPLEMENTATION AND ENFORCEMENT MECHANISMS.** The Foreign Investment Law has the potential to improve the business environment in China for foreign investors by furthering the prevalence of equal treatment with home-grown firms and strengthening the protection of intellectual property rights. However, businesses require further clarity on implementation of the law to ensure that it delivers concrete and enforceable results on the ground. The law remains vague on enforcement and on issues with potentially broad connotations such as the national security review.
- 26 EU MEMBER STATES SHOULD IMPLEMENT AN INVESTMENT SCREENING MECHANISM, ENSURE A COHERENT APPLICATION OF THE EU INVESTMENT SCREENING FRAMEWORK AND RESPECT MINIMAL EU STANDARDS FOR NATIONAL CONTROL MECHANISMS IN ORDER TO AVOID MARKET FRAGMENTATION.** This should go hand in hand with creating better market intelligence capabilities for both the European Commission as well as the EU Member States. Moreover, enhanced collaboration between the EU and the Members States is key.
- 27 ESTABLISH AN EU INFORMATION PORTAL ON INVESTMENT SCREENING.** Currently, there is a lack of transparent, harmonised and publicly available information regarding national FDI screening mechanisms. As information is collected on a Member State level, this might reinforce national divergences and hinder inward FDI. The attractiveness of the EU to foreign investors benefits from more transparent and centrally available information. For this reason, the Commission should consider establishing an EU information portal on investment screening to facilitate investment into the EU. However, information that is considered confidential by companies should be excluded.

### 3.4. PROCUREMENT

The value of the EU public procurement market has been estimated at EUR 2.4 trillion,<sup>90</sup> accounting for approximately 14% of EU GDP in 2017.<sup>91</sup> The EU has globally been a strong advocate for the opening of public procurement markets. Accordingly, the EU has significantly opened its 2.4 trillion public procurement market through multilateral and bilateral agreements. According to data that the Chinese authorities provided to the WTO, the total annual value of government procurement was RMB 3.11 trillion in 2016 (EUR 460 billion), accounting for 4.2% of GDP. A total of 95% takes place at local level.<sup>92</sup> The relatively low total value of the procurement market and the discrepancy between central and local procurement is explained by the fact that some areas, such as large central infrastructure projects that are conducted by SOEs, are not covered in this number.

While Chinese companies are allowed to bid on public procurement tenders in the EU,<sup>93</sup> European businesses are often prohibited to bid on procurement opportunities in China.<sup>94</sup> On a bilateral level, the EU has integrated ambitious chapters on procurement in several free-trade agreements, such as the Comprehensive Economic and Trade Agreement (CETA) with Canada. On a multilateral level, the EU has strongly promoted the establishment of the plurilateral Agreement on Government Procurement (GPA) through the WTO. China promised to access the GPA ‘as soon as possible’ when it joined the WTO in 2001. To this day, however, China has not yet acceded to the GPA. Besides the fact that China is not a member of the GPA, several *de jure* and *de facto* barriers hinder European businesses when wishing to access the Chinese procurement market.

#### **De jure barriers**

Whereas the EU’s public procurement market is regulated through the EU public procurement directives and in addition through plurilateral and bilateral agreements, China is not a member of the GPA, nor has it integrated procurement in any of its bilateral trade agreements. China’s procurement market is regulated through two domestic laws: the Tendering and Bidding Law (TBL) and the Government Procurement Law (GPL).

Both laws include numerous *de jure* barriers that exclude European businesses from the Chinese procurement market or highly limit access for European bidders. Several aspects of the GPL result in market distortions. Article 10 of the GPL, for example, contains a ‘buy Chinese’ clause which prescribes that “domestic goods, construction and services shall be procured for government procurement”.<sup>95</sup> What is more, a clear definition of what constitutes domestic goods and companies is currently lacking. This causes uncertainty for European businesses active in China as it is, for example, often unclear whether goods and services that are produced locally, by foreign-invested enterprises (FIEs), qualify for consideration. Moreover, state-owned enterprises conduct most of Chinese procurement and certain procurement projects, such as the EUR 32.7 billion Three-Gorges dam, were excluded from TBL and GPL rules.

Likewise, FIEs who wish to participate in a bid for a procurement opportunity under the TBL are often required to obtain a licence. Although the TBL does not explicitly state that domestic companies should receive a preferential treatment, it is in line with the government’s general goal to enhance ‘indigenous innovation’. Regional regulations that fall under the scope of TBL sometimes explicitly exclude foreign bidders. Article 23 of the Regulations of Tianjin Municipality on Patent Protection for example states that for “government procurement and other procurement where financial funds are used, products with indigenous patents shall be considered first. When indigenous innovation products with patent rights enter the market [...] the government shall begin to procure or order these products”.<sup>96</sup> It is imperative that these *de jure* barriers are reduced and that Chinese and European businesses have reciprocal access to each other’s procurement markets.

<sup>90</sup> European Commission, “*Factsheet on the International Procurement Instrument*”, 2019.

<sup>91</sup> European Commission, “*Single Market Scoreboard: Public Procurement*”, 2018.

<sup>92</sup> World Trade Organisation, “*Trade Policy Review: China*”, 2018.

<sup>93</sup> However, because China is not a member of the WTO GPA and because China and the EU do not have an FTA, a Chinese bidder, as any other bidder from a third country which has neither signed the GPA nor a bilateral FTA with the EU, does not have secured access to procurement procedures in the EU and may be excluded under Article 85 of Directive 2014/25/EU.

<sup>94</sup> See the ‘Belt and Road Initiative’ and the ‘Competition on Third Markets’ chapters for procurement challenges that occur outside China on third markets.

<sup>95</sup> People’s Republic of China, “*Government Procurement Law*”, 2002.

<sup>96</sup> Standing Committee of Tianjin People’s Congress, “*Regulations of Tianjin Municipality on Patent Promotion & Protection*”, 2011, article 23.

## De facto barriers

Besides these *de jure* barriers to foreign bidders on the Chinese market, there are also *de facto* barriers to procurement opportunities for European businesses. The European Chamber of Commerce in China demonstrated that European businesses face several *de facto* barriers in China.<sup>97</sup> These include amongst others the non-transparent procurement system and the unpredictable enforcement of regulation. The selection and award criteria for example are often unclear. The existence of two parallel systems of procurement (TBL and GPL) and the inconsistencies between the systems cause further confusion amongst European businesses.

### Barriers to European companies on the Chinese procurement market

"European companies face many hurdles when operating on China's procurement market." On the other hand, the EU procurement market is open to Chinese companies.

Exclusion of certain projects from GPL or BTL

- Three Gorges Dam (USD 37.3 billion)
- China's high-speed rail network

National establishment

Existence of two systems: GPL and BTL

Buy Chinese provisions

 *de jure*

 *de facto*

Lack of transparency

Discriminatory enforcement

Source: European Commission, "IPI factsheet", 2019, and own additions

<sup>97</sup> European Union Chamber of Commerce in China, "European Business in China 2018/2019: Position Paper", 2018.

## The EU's public procurement market

Besides efforts to open third-country procurement markets for European companies, the EU should also ensure that foreign companies that participate in the EU's public procurement market respect our rules. The legislative framework in the EU was updated in 2014, when Directives 2014/25/EU, 2014/24/EU and 2014/23/EU were adopted. These directives require contracting authorities to award contracts according to the principle of the most economically advantageous tender (MEAT), allowing contracting authorities to take both quality and costs into account, by for example applying price-quality ratio and life-cycle costing and by setting ambitious social and environmental standards.

European business is concerned as Member State authorities do not consistently apply and enforce these directives. National and local contracting authorities have much discretion to apply tender criteria, and in practice award contracts are often based on the lowest price rather than quality criteria. The EU should ensure that contracting authorities apply the directives as consistently as possible. The European Commission services should proactively support contracting authorities to implement the directives to facilitate the shift towards sustainable procurement.

The 'Guidance on the participation of third country bidders and goods in the EU procurement market' issued by the European Commission in July 2019 is a useful tool for contracting authorities. The guidance reminds authorities that bidders from countries which are not part to the WTO GPA nor to an FTA have no secured access to the EU's public procurement market.

The 2014 directives also require contracting authorities to review and optionally reject 'abnormally low tenders'. This allows contracting authorities to ensure a level playing field when for example subsidised state-owned enterprises offer an uncompetitive abnormally low tender. Contracting authorities should be encouraged and supported to review, and when necessary reject, abnormally low tenders more consistently in accordance with Art. 69 of Directive 2014/24 and Art. 84 of Directive 2014/25. European companies must be prevented from being discriminated against by dumping offers from subsidised companies.

## How to move forward

### **WTO Agreement on Government Procurement (GPA)**

While China proposed to become a member of the GPA "as soon as possible" when it joined the WTO, negotiations are still ongoing. It is of utmost importance that China joins the GPA on the basis of an acceptable accession offer as soon as possible. China has presented six accession offers that were considered unsatisfactory by the current GPA members, as the market access offers that the Chinese proposed were not equivalent to the level of openness granted by the current GPA members. It will have to be examined very carefully whether the new revised Chinese offer that was tabled in October 2019 will overcome the shortcomings of the previous offers and whether this latest offer will grant acceptable market access to Chinese procurement markets equalling the opening volume granted by the current GPA members.

Open public procurement markets provide a win-win opportunity for both Chinese and European suppliers. The EU should prioritise China's accession to the WTO's GPA under acceptable conditions and strive for a balanced and reciprocal access to procurement markets, elimination of substantially all barriers to procurement markets and equal opportunities for domestic and foreign suppliers. As the accession of China to the WTO GPA has moved forward very slowly, from now on the call for accession should become a key priority in any future contacts of the EU with China. Although a timely accession is important, it is even more important that there is a maximum level of ambition and that there are sufficiently strong enforcement provisions and available resources should China's accession not deliver in practice.

It is important that a revised offer aims to eliminate the policies and practices that allow for the preferential treatment of domestic suppliers such as the 'buy Chinese' provisions in China's GPL. As European procurement markets are considerably open at central and subcentral level, a Chinese GPA offer should also cover both central and subcentral levels. Any deal should also apply to state-owned contracting authorities (e.g. China Railways) – which are major customers for European industry. As the provisions of the GPA contain important safeguards regarding transparency, non-discrimination and legal remedies, an acceptable accession offer – i.e. a coverage similar to the coverage of the other GPA members – would significantly improve current shortcomings related to transparency and administrative practices.

While details of the recent Chinese accession offer of October 2019 are not yet public, it has to be criticised that the previous Chinese GPA offer which dated from 2014 was still limited to the procurement of goods, works and services conducted with fiscal funds by state organs, public institutions and social organisations (approximately 10% of the market). By contrast, it completely leaves out the procurement of large infrastructure and public utility projects, e.g. power generation and supply, sewage, water supply and public transportation (approximately 90% of the market).<sup>98</sup> It will have to be assessed very carefully whether the revised Chinese offer will overcome the shortcomings of the previous offer.

### **International Procurement Instrument (IPI)**

European business supports an open procurement market and welcomes EU measures that aim to open global procurement markets and encourage more partners to join the WTO GPA. The proposed International Procurement Instrument (IPI) pursues the right objective of enforcing the principle of balanced market access enshrined in the WTO GPA and creating leverage to encourage partners to join the GPA by enabling the European Commission to investigate discrimination against EU companies on procurement markets in third countries. However, the revised proposal of the Commission of 2016 requires several amendments in order to avoid negative implications.

Firstly, the Commission should avoid that the IPI leads to increased administrative burden and higher implementation costs for contracting national authorities Member State who are already struggling to consistently implement the current procurement rules such as the 2014 directives. The 2016 proposal already provides that price adjustment measures shall only apply to contracts with an estimated value equal to or above EUR 5,000,000 exclusive of value-added tax. Negotiating that threshold would also ensure that smaller contracting authorities with less procurement resources and knowledge will not be impacted.

Secondly, the proposed evaluation by procurement authorities of the European content of tenders may create some practical difficulties and uncertainties. It could even backfire and penalise EU businesses with diversified supply chains. For this reason, the EU should abstain from establishing a mechanism that would assess the origin of an offer by applying the proposed 'rules of origin' method. The proposed rules of origin method will often lead to complex investigations and could cause new administrative burden and new legal uncertainties for EU businesses and contracting authorities. The IPI would be more effective and less cumbersome if the price adjustment measures would for example apply to legal entities established in or controlled by a legal entity based in the third targeted country – removing any difficulties linked to the calculation of the share of content from this third country (Article 8, (1)).

Thirdly, we also need an instrument that can leverage the existing rules enshrined in the EU procurement directives. Although Article 85 and 86 of Directive 2014/25 have not often been used in practice, it is important that these articles – enabling contracting authorities to exclude tenders with a majority of foreign content – are maintained.

<sup>98</sup> European Construction Industry Federation, European International Contractors and European Dredging Association, "[Joint voting recommendations for the amended proposal for a "market access" regulation](#)", 2018.

Lastly, the proposed price adjustment mechanism is excessively complex and it is not clear whether the proposed price penalty for tender evaluation will be sufficiently effective to address actors such as state-owned entities who are also driven by policy agendas. Accordingly, the proposed IPI provisions regarding the price penalty need to be revised. It might also be reflected as to whether special provisions on state-owned enterprises could be designed to also include a full exclusion of a state-owned enterprise from a third country which did not sign any opening agreement with the EU and has been identified as a country with discriminatory policies and practices in place against EU companies.

## DEMANDS

- 28 THE EU SHOULD URGE CHINA TO SUBMIT A REVISED AND CLEARLY MORE AMBITIOUS GPA ACCESSION OFFER.** It is essential that China joins the GPA on the basis of an acceptable accession offer as soon as possible. While six previous offers presented over many years were clearly not acceptable for the current members of the GPA, China recently tabled another revised offer at the end of October 2019. It will have to be assessed very carefully whether this latest offer overcomes the diverse shortcomings of the previous offers. The call for Chinese accession should be treated as a key priority in any high-level contacts between the EU with China from now on. The offer must eliminate substantially all *de jure* and *de facto* barriers that currently lead to the preferential treatment of domestic suppliers over foreign suppliers.
- 29 IMPROVE OPENNESS IN PUBLIC PROCUREMENT MARKETS.** The draft International Procurement Instrument aims to pursue the right objective of enforcing the principle of balanced market access enshrined in the GPA and creates leverage to encourage partners to join the GPA. However, an international procurement instrument must avoid negative effects such as a higher bureaucratic burden for contracting authorities, legal uncertainties for EU companies, complex price adjustment mechanisms and negative effects on EU companies with international supply chains. Therefore, the 2016 proposal requires further modifications and should also include special provisions on SOEs.
- 30 ENCOURAGE CONTRACTING AUTHORITIES AND EU MEMBER STATES TO APPLY THE EXISTING EU PUBLIC PROCUREMENT RULES MORE VIGOROUSLY.** The Commission should ensure that contracting authorities and Member States apply the EU directives more consistently and, when necessary, proactively support contracting authorities to meet their obligations under the 2014 EU directives. Contracting authorities should for example be further encouraged to award contracts to the Most Economically Advantageous Tender (MEAT), which allows the contracting authority to take into account not only price, but also quality, by for example applying life-cycle costing.
- 31 PREVENT THE DELETION OF THE PRINCIPLES CURRENTLY ENSHRINED IN ARTICLE 85 AND 86 OF DIRECTIVE 2014/25/EU.** The EU public procurement framework allows contracting authorities to reject any offer for a supply contract where the proportion of the products originating in third countries exceeds 50% of the total value of products constituting the tender. This article has been enshrined in the EU public procurement framework since 2004. In the 2016 IPI proposal, however, the European Commission proposes to delete these articles. There is a risk that if these articles are deleted, companies from third countries that are not a member of the GPA or do not have an FTA with the EU will have unrestricted access to the EU's procurement market.

- 32 NATIONAL CONTRACTING AUTHORITIES SHOULD BE ENCOURAGED TO SCREEN THE PARTICIPATION OF FOREIGN ENTITIES IN EU-FUNDED PROJECTS THAT ARE VITAL TO THE SECURITY AND PUBLIC ORDER OF THE EU AND SHOULD BE ENCOURAGED TO CONSIDER THE APPLICATION OF ARTICLE 85 OF DIRECTIVE 2014/25/EU IN THESE CASES.** The application of Article 85 should for example be considered in cases when foreign entities participate in projects related to critical and/or strategic infrastructure and technology, or in tenders that would allow access to sensitive EU information. Similar to the investment screening mechanism, Member States should be encouraged to share information on foreign entities bidding on EU-funded tenders in projects that are vital to the EU security and public order.
- 33 FULLY IMPLEMENT AND FURTHER IMPROVE THE RULES ON 'ABNORMALLY LOW TENDERS'.** The rules on 'abnormally low tenders' may be shaped more effectively in the future. This includes assessing the option to place the burden of proof on the bidding candidate whose offer has been rejected as abnormally low. Special attention could be given to tenders that are submitted by SOEs. In particular, more stringent investigation obligations should apply to contracting authorities, with the support of the European Commission's services.
- 34 STRICTLY OBSERVE TRANSPARENCY REQUIREMENTS WHEN AWARDING CONTRACTS IN THE EU AND EFFECTIVELY ENFORCE EU LAW.** The transparency requirements applicable to public contracts under the EU law must be strictly observed. This means, in particular, that public contracts subject to tendering requirements must not be concluded through inadmissible "direct awards".

### 3.5. INTELLECTUAL PROPERTY RIGHTS

As China's economy continues to grow and mature, the protection and enforcement of intellectual property and forced transfer of technology have become a growing priority for European businesses. The overall picture of the Chinese intellectual property landscape is mixed – while some improvements are taking place in selected areas, the overall situation nevertheless remains worrying with respect to most intellectual property rights (IPRs). The problem is twofold: on the one hand the Chinese IP framework is still insufficiently developed, and on the other hand existing measures are insufficiently enforced. In addition, practices of forced technology transfer are still on the rise and the spectrum through which it takes place is complex and requires a comprehensive response. China's economic clout and ambitious industrial policies such as Made in China 2025 also include a strategic approach to IPR and incentivise developments in high-tech fields.<sup>99</sup> In this context, European businesses urge the creation of a level playing field through adequate IPR protection, elimination of practices of forced technology transfer and strong enforcement of the recently signed agreement on Geographical Indications (GIs).<sup>100</sup>

#### IPR violations in China

Intellectual property violations in China take place in various ways, including trade in counterfeited goods, copyright piracy, forced technology transfer, forced patent licensing and IP infringement. Consequences are prejudicial to European companies, result in substantial losses of revenue and diminished brand value, and spark health and safety concerns. The Chinese legal framework possibly facilitates these violations to the extent that Chinese laws (i) are insufficiently evolved to protect IP adequately, (ii) in some cases deliberately facilitate technology transfer practices and (iii) still lack clear, strong and compulsory enforcement and remedies.

Despite the efforts and recent reforms, the Chinese legal framework still fails to address the pressing situation with ongoing IP infringement, in such a way that it could effectively reduce the continuous pressure of IP infringements. Although the European pharmaceutical industry is encouraged by recently proposed policies and initiatives to improve IPR protection within its sector, detailed implementation rules are yet to be published. In general, however, it is the desire of the European business community that effective IPR protection is applied to all sectors to an equally high standard.

According to the latest data, China remains the EU's number one priority country regarding IP violations due to longstanding problems of protection and enforcement. More than 80% of the seizures of counterfeit and pirated goods come from China.<sup>101</sup> In recent years, the digital revolution has aggravated the situation, as the proliferation of online trading platforms provides wider and easier access to Chinese counterfeit and pirated products at the global level. The measures taken by the Chinese government do not appear to be adequate to face the rise of new technologies and the growing scale of infringements.<sup>102</sup> While the European business community welcomes progress made to date, the Chinese IPR system is still a cause for concern and there are areas that require further improvement and effective action.

<sup>99</sup> European Commission, "[Report on the protection and enforcement of intellectual property rights in third countries](#)", 2018, p. 7.

<sup>100</sup> European Commission, "[Landmark agreement will protect 100 Geographical Indications in China](#)", 2019.

<sup>101</sup> *Ibidem*, pp. 8-9 for a summary of the specific IPR-related problems faced by European businesses in China.

<sup>102</sup> *Ibidem*, p. 7



## Some figures on trade in counterfeit goods

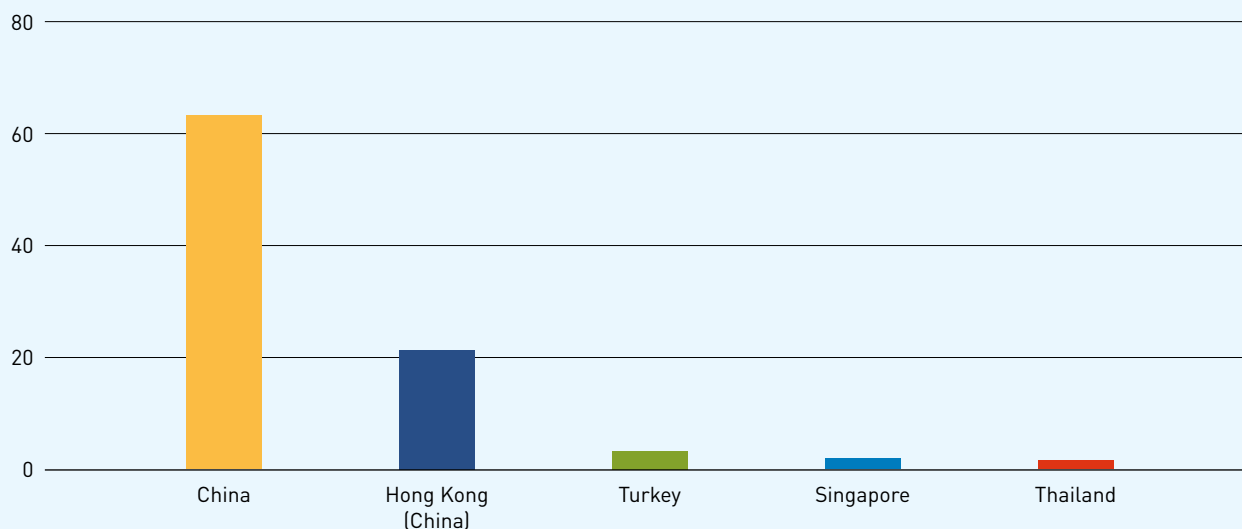
IPR violations in China also create challenges within the EU. Trade in counterfeit goods is a key concern in this regard. In 2016, international trade in counterfeit and pirated products represented up to 3.3% of world trade, compared with an estimate of up to 2.5% of world trade in 2013. This equates to a total value of USD 509 billion from which USD 239 billion, or 47% of world exports of fake goods, is exported from China.<sup>103</sup> For the EU, total counterfeit imports amounted to 6.8% of total EU imports (versus 5% in 2013), equivalent to EUR 121 billion. A 2019 OECD-EUIPO study also shows that more than 80% of counterfeit goods seized by customs in the EU originated from China and Hong Kong (China).<sup>104</sup>

In terms of the mode of transport, between 2014 and 2016, an average of 57% of all seized counterfeit goods were sent by post and 12% by express courier services. In the same period, small parcels accounted for 69% of customs seizures of IP-infringing products, against 63% for the 2011-2013 period.<sup>105</sup> Small parcels, boosted by the rise of e-commerce, is the most popular method of shipping illicit products.<sup>106</sup>

It is essential that the EU tackles these problems. Harmonised measures specifically aimed at preventing and combating online IPR infringements should be adopted at EU level, keeping in mind the roles of different stakeholders in the online environment and allowing for adaptations to a rapidly developing technological landscape.

### Most fake goods originate from China

*Top provenance economies of fakes, as a percentage of total seizures*



Source: OECD, 2013

<sup>103</sup> OECD/EUIPO, "[Trends in Trade in Counterfeit and Pirated Goods](#)", 2019.

<sup>104</sup> *Ibidem*.

<sup>105</sup> *Ibidem*.

<sup>106</sup> See chapter '3.8 E-commerce' for more information.

**DEMANDS FROM THE EU**

- 35 STRENGTHEN THE EXCHANGE AND COOPERATION WITH CHINESE AUTHORITIES TO IMPROVE THE ENFORCEMENT OF IPR IN CHINA.** This should include strengthening international cooperation between European and Chinese IP offices within several frameworks (i.e. within IP5, TM5 and ID5), as well as within the EU-China customs network. Chinese IP offices should be encouraged to adopt international standards of examination. At international meetings (such as the IP5, TM5 and ID5, bilateral meetings, and technical cooperation programmes), the EU should press Chinese authorities to respect and enforce the stringent IP standards set out at WTO level (in the Agreement on Trade-Related Aspects of Intellectual Property (TRIPS)). Lastly, the EU should ensure the strong enforcement of the recently signed **Agreement on Geographical Indications (GIs)**.
- 36 RAISE AWARENESS WITHIN THE EU ON THE WORKINGS OF CHINA'S IPR SYSTEM AS WELL AS THE MOST PROBLEMATIC ISSUES REGARDING IP ENFORCEMENT IN CHINA.** European companies should better understand the Chinese patent and trademark system in order to successfully navigate the Chinese market. At the same time, they should be made fully aware of the risks regarding IPR enforcement in China, particularly the risks of trademark squatting. European consumers should also be made aware of the consumer risks linked to the high number of counterfeit and pirated products available online and mostly originating from China, including goods delivered in small parcels.
- 37 IMPROVE THE ENFORCEMENT OF IPR WITHIN THE UNION FOR IMPORTED PRODUCTS.** First, national authorities should be provided with stronger and more intelligent means (as well as adequate training) to secure effective enforcement of EU IPR law vis-à-vis goods originating from China which arrive into the EU territory in great numbers. Second, major Chinese and other global platforms active in the EU should be required by the EU to make commitments concerning the notice and removal of counterfeit and pirated goods and should also provide necessary information to assist infringed parties in cases of IP infringements. The EU should further develop a world-class IP system by promoting strong IP protection.

**RECOMMENDATIONS TO CHINESE AUTHORITIES. THEY SHOULD:**

- 38 REVIEW, UPDATE AND IMPROVE CHINA'S LEGISLATION ON IP PROTECTION WHERE NEEDED.** First, we ask the Chinese government to introduce specific legislation on the protection of trade secrets. Second, the Chinese government could complete the review and updating of Chinese patent and copyright legislation. Third, it could review and update trademark legislation and practice, and in doing so provide better protection of foreign entities against trademark squatters. Here the Chinese government could (i) recognise the well-known establishment of a trademark outside China and (ii) deny co-existence of trademark free riders with pre-existing foreign trademarks.<sup>107</sup>
- 39 SIGNIFICANTLY IMPROVE THE ENFORCEMENT OF IP PROTECTION IN CHINA.** We call on the Chinese government to strengthen their efforts to tackle IP infringement and enforcement challenges. The current level of IP enforcement is still too weak and needs to be improved. This should include efforts to achieve consistent and uniform IPR protection across China and eliminate existing divergent judicial interpretations by local courts from the Supreme People's Court.

<sup>107</sup> For more information, see IAM Media, "[Case alert - Hugo Boss Trademark Management GmbH v Britain Boss International Co Ltd](#)", 2018. The implication here is that Chinese courts should begin acknowledging the well-known reputation of EU trademarks in cases where a similar Chinese mark is challenged. In other words, they should assess the reputation of an EU trademarks having in mind its long-standing reputation in the EU or worldwide.

- 40 REFORM CHINA'S UTILITY MODEL PATENT PRACTICE AND DESIGN MODEL LEGISLATION.** China would benefit from reforming the utility model patent practice. This could be achieved by aligning the assessment of utility model patents and invention patents as far as prior art and inventive steps are concerned. Second, we would call on the Chinese government to reform the design model legislation to extend the lifetime of design protection to a level similar to that of other important jurisdictions. In the EU a design patent protection lasts for 25 years while in China this protection is only granted for 10 years.
- 41 IMPROVE RECOGNITION OF FOREIGN EVIDENCE AND INCREASE COMPENSATION IN IP LITIGATION.** The enforcement of IP rights would benefit substantially from improving the recognition of foreign evidence and simplifying procedures for foreign companies in IP litigation. Second, increasing compensation in litigation would also help to deter infringements. This should go hand in hand with lowering the burden of proof for IP owners to provide evidence on IP infringements and receive compensation, as well as a strict enforcement of the rulings regarding compensation.
- 42 HARMONISE THE CHINESE NATIONAL CLASSIFICATION SYSTEM FOR GOODS AND SERVICES WITH THE INTERNATIONAL CLASSIFICATION SYSTEM.** This would be of dual benefit as greater alignment would allow Chinese companies to operate more seamlessly on international markets, while foreign companies could operate more seamlessly on the Chinese market.

### 3.6. FORCED TECHNOLOGY TRANSFER

European companies are increasingly subject to practices of forced technology transfer in China. The number of reported cases of forced technology transfer in order to maintain market access has doubled from 10% in 2017 to 20% in 2019. Alarming, 63% of all cases reported by European businesses highlight that this happened within the last 2 years, with 25% of those cases currently taking place.<sup>108</sup> These developments occur despite official government pledges to prohibit this type of activity.<sup>109</sup> Improved market access in certain sectors in China's revised Negative List for investment and the adoption of the Foreign Investment Law (see chapter '3.3 Investment') have not (yet) led to a more favourable situation overall regarding forced technology transfer. Ending practices of forced technology transfer is a key priority for European businesses. These circumstances have led the EU to lodge a WTO case against China's measures on forced technology transfer on 1 June 2018.<sup>110</sup>

Forced technology transfer occurs in multiple ways. The EU's case at the WTO outlines at least 17 laws and measures through which China imposes technology transfer. While the EU is right in targeting China's legal framework, China's ecosystem of measures that directly and indirectly induce forced technology transfer goes beyond the legal dimension. Transfers can happen both on a legal and voluntary basis (such as Chinese outbound foreign direct investment) and on a forced or involuntary basis. Efforts to tackle them comprehensively must similarly include an approach that addresses this ecosystem broadly. The myriad of ways that lead to forced technology transfer can be categorised as follows:

- ▶ **Soft enforcement of intellectual property rights.** Despite the efforts and the recent reforms, China's legal and enforcement framework still fails to address the pressing situation in China with ongoing IP infringement by many parties. The framework is therefore still underdeveloped and not adequate. China's IP framework therefore continues to passively enable and facilitate IP infringement.
- ▶ **Market access restrictions and conditionality.** In China, access to several sectors is restricted for foreign investors and feature joint venture requirements in which foreign companies are permitted a minority stake only. Although they may not be directly endorsed by the Chinese government, the existence of such joint venture requirements restricts market access and tilts the commercial playing field so that it enables Chinese firms to include extra-commercial conditions to forming a joint venture, including technology transfer requirements.
- ▶ **Technology licensing agreements.** In technology licensing agreements between non-Chinese licensors and Chinese licensees, licensors cannot restrict licensees from making improvements to the licensed technology or from using the improved technology as all improvements belong to the party making the improvements. In addition, Chinese implementing regulations on Chinese-foreign equity joint ventures permit the Chinese licensee the legal right to continue using the technology after the licensing term has expired.<sup>111</sup>
- ▶ **Government licencing requirements.** Government licencing requirements require companies to obtain approval before they can conduct certain business activities. For instance, companies are often required to disclose detailed product and process information as part of licensing procedures. The relatively opaque nature of the licensing process enables the transmission of intellectual property without a clear paper trail that could be used to challenge IP theft. Chinese legal provisions, which theoretically prohibit such practices, are either vaguely worded or not clearly enforced.<sup>112</sup>

<sup>108</sup> This figure is an average across all sectors. European companies' responses show that forced technology transfer occurs more in high-value, cutting-edge industries, such as chemicals and petroleum companies (30%), medical devices (28%), pharmaceutical companies (27%) and automotive companies (21%). See European Union Chamber of Commerce in China, "[Business Confidence Survey](#)", 2019, pp. 30-31.

<sup>109</sup> See People's Republic of China, "[Foreign Investment Law](#)", 2019, of which Article 22 stipulates that "no administrative department or its staff member shall force any transfer of technology by administrative means".

<sup>110</sup> For a good summary of the laws and measures identified to mandate forced technology transfer, please consult European Union, "[Request for Consultations on China: Certain Measures on the Transfer of Technology](#)", 2018.

<sup>111</sup> Mannheimer Swarteling, "[Technology Licensing Legislation in China: WTO Commitments \(TRIPS\)](#)", 2018.

<sup>112</sup> US-China Economic and Security Review Commission, "[How Chinese Companies Facilitate Technology Transfer from the United States](#)", 2019, p. 8.

- **Commercial espionage.** This includes cyberespionage efforts that originate from Chinese (government) entities. These are well documented.<sup>113</sup> Cyberespionage typically involves digital intrusions that extract commercially valuable business information. China's 2017 Cybersecurity Law presents a new challenge in the fight against forced technology transfer in China by requiring companies to store, disclose and make their source codes and commercially sensitive data available in a way that other countries do not. This makes them vulnerable to theft.

## How to move forward

Technology transfers can be acceptable in deals with Chinese firms provided that they operate in a legal and non-discriminatory manner and are based on voluntary, non-pressurised commercial decisions. In all other cases, these practices prevent beneficial competition, clearly undermine multilaterally agreed rules and are clear obstacles to enter third-country markets.

Forced technology transfer is likely to remain a major problem in the years ahead. Although China made a political commitment in 2018 to prohibit forced technology transfer, between 2017 and 2018 the number of reported cases of technology transfer doubled and remained equally high in 2019. European business is concerned that activities stimulating involuntary technology transfer are likely to grow as China seeks to further develop its high-tech industries as described in its Made in China 2025 industrial strategy.<sup>114</sup> Although China's Foreign Investment Law contains provisions prohibiting forced technology transfer through administrative measures, this law is still vaguely worded, enforcement measures still look inadequate and the law may include loopholes as it excludes non-administrative means of tech transfer.<sup>115</sup>

The challenge of forced technology transfer is immense. The enforcement of WTO legislation and domestic IPR and investment laws remains key, as is the closing of other loopholes through which technology can be transferred involuntarily or on a non-commercial basis. China's declared industrial policy goals such as Made in China 2025, economic incentives and the multiple avenues through which forced technology transfer takes place mean that tackling one symptom of forced technology transfer might lead to an increase in other means. Success in combating forced technology transfer therefore requires a comprehensive and coherent response across the entire spectrum in which it takes place. The commercial value associated with technology transfer makes this a key priority for European businesses.

### DEMANDS FROM THE EU

- 43 **OPPOSE ALL POLICIES AND PRACTICES THAT REQUIRE ACCESS TO OR THE TRANSFER OF INTELLECTUAL PROPERTY.** The EU should strongly condemn Chinese policies and practices that require access to or the transfer of intellectual property as a precondition for market access. This also means opposing requirements to transfer source codes. The EU should work closely with China and within the framework of the WTO to address IP concerns, and particularly the practice of forced transfer of technology. The EU should clarify with the Chinese authorities that these practices undermine multilaterally agreed rules and are clear obstacles for innovative companies to enter the Chinese market.
- 44 **ENSURE THAT EU COMPANIES ARE REMUNERATED BY CHINESE COMPANIES FOR THE USE OF STANDARD ESSENTIAL PATENTS.** European companies that hold patents for technologies that are essential for the functioning of certain standards (standard essential patents) should be remunerated by Chinese companies that widely use these technologies without paying adequate royalties. Legal measures that permit the right to use technology after the expiry of the licensing term should be addressed, as they worsen this problem.

<sup>113</sup> European Centre for International Political Economy, "Stealing Thunder", 2018, p. 14.

<sup>114</sup> See the text box on Made in China 2025 in chapter 1.3 for more information.

<sup>115</sup> See chapter '3.3 Investment' for more information about the FIL.

- 45** **CONSIDER ALL POSSIBLE POLICY OPTIONS TO COMBAT ICT-ENABLED IP THEFT.** This should include the implementation of the EU Cyber Diplomacy Toolbox, and should also cover the theft of trade secrets or other confidential business information that provides competitive advantages to companies or commercial sectors.
- 46** **RAISE AWARENESS AMONG EUROPEAN COMPANIES OF THE VARIOUS RISKS THAT COULD RESULT IN FORCED TECHNOLOGY TRANSFER WHEN THEY DECIDE TO ENTER THE CHINESE MARKET.** The practices that result in the transfer of technology emerge from a spectrum of issues that go beyond conditional market access. In order to safeguard their intellectual property, companies should have access to information to prevent the forced and/or involuntary transfer of IP.

#### RECOMMENDATIONS TO CHINESE AUTHORITIES. THEY SHOULD:

- 47** **ELIMINATE POLICIES AND PRACTICES THAT RESULT IN AN INVOLUNTARY TRANSFER OF TECHNOLOGY.** In practice this means primarily eliminating discriminatory practices for foreign companies. In order to achieve this, a holistic approach should be adopted that includes legislative changes, as well as bringing administrative and judicial decision mechanisms in line. China's Foreign Investment Law (FIL) is a good step in this regard, though it still needs to be implemented. The Chinese government also ought to remove restrictions on technology transfer agreements in Chinese Contract Law (see Article 329) and the Supreme People's Court judicial interpretation on litigation issues relating to technology contract disputes (2004) to align them with the positive changes in the technology import-export restrictions. European companies should also be allowed to license IP on market-based and freely negotiated terms.
- 48** **REMOVE IP DISCLOSURE REQUIREMENTS FOR FOREIGN COMPANIES.** China should remove IP disclosure requirements and preferences based on national origin that are laid down in laws, regulations, standards, certifications and procurement processes. At the same time, requirements to publish sensitive business information when conducting business in China should be eliminated.
- 49** **INCREASE THE QUALITY OF NATIONAL PATENTS AND UTILITY MODELS GRANTED IN CHINA BY INSTALLING A STRICTER EXAMINATION PROCEDURE.**
- 50** **ALLOW EUROPEAN COMPANIES TO INDEPENDENTLY APPLY FOR AND OBTAIN ANY AND ALL LICENCES FOR INVESTMENT AND OPERATION IN CHINA.**

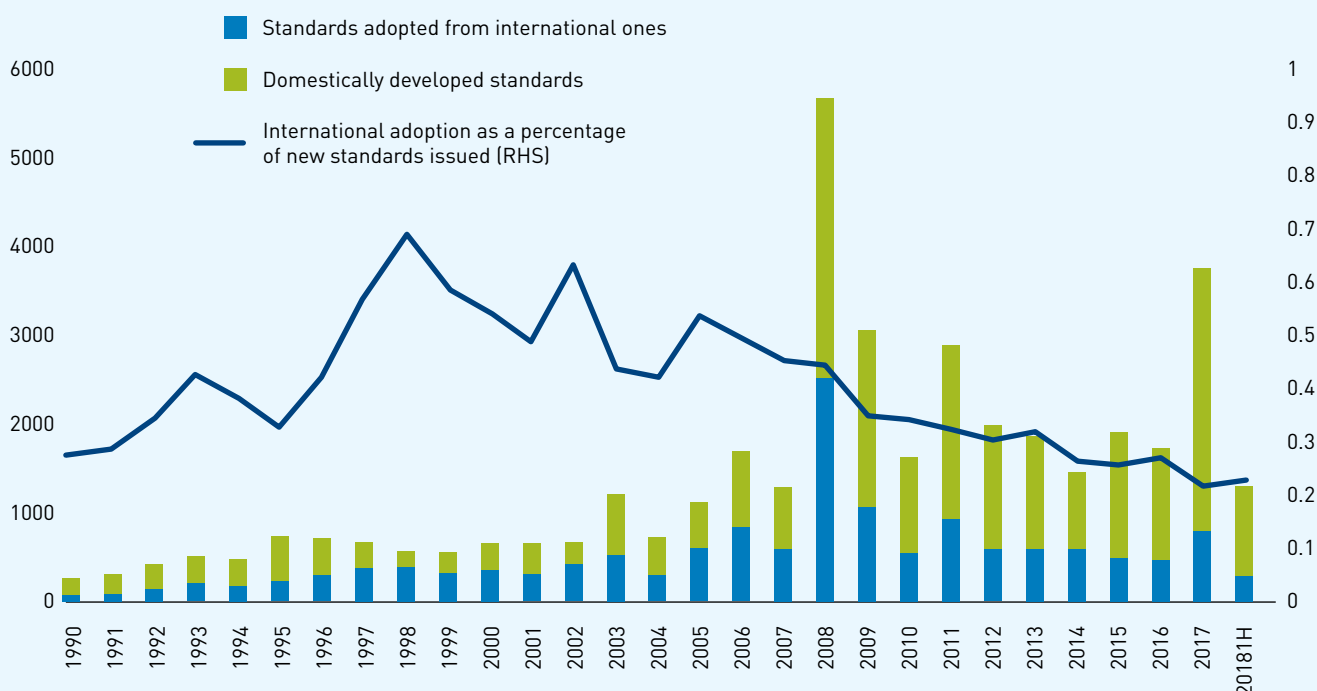
### 3.7. STANDARDISATION

Standardisation is generally understood as a voluntary consensus among industry on technical matters or processes which allows, *inter alia*, for enhanced interoperability or safety. Standards can be set at a national, EU or global level. At the global level, standards are set in international standardisation organisations such as most notably the ISO (International Organisation for Standardisation) and IEC (International Electrotechnical Commission). These standards are generally proposed on the initiative of a (national) standardisation organisation, which receives these from its stakeholders. The Chinese government aims to actively deploy standards as a tool to realise industrial upgrading, supporting in particular sectors included in Made in China 2025 (discussed in chapter 1.3). China also specifically anticipates standardisation leadership in the digital area through the 'China Standards 2035' initiative which involves artificial intelligence, the Internet of Things, 5G and big data. China has also become very active within the ISO and IEC.

#### Problem

There are three concerns that may arise with respect to standardisation in China. A possible first concern is that mandatory Chinese (national, sectoral or local) standards may be used to the detriment of non-Chinese companies, establishing a *de facto* barrier to trade. China actively participates in the development of international standards to facilitate access to foreign markets. Domestically, however, China often uses national standards with national content diverging from international standards or adds additional national requirements to the international standard. The chart below shows a clear downward trend in China's adoption of standards from international standards, with the figure falling from around 45% in 2008 to between 20-25% today.

**National Standards in China, by origin 1990-2018**  
Number of standards, percent (RHS)



Source: Standardization Administration of China, retrieved by the Rhodium Group.

A second concern relates to the governance of Chinese standardisation. While China's new standardisation law entered into force in 2018 with the aim of enhancing market relevance of Chinese standards, for most standards it is the government who determines which stakeholders/companies, if any, may provide input. The process is therefore fundamentally different from standardisation processes in the EU and the USA, which is mainly driven by industry. Furthermore, standards in China are seldom available in English, which makes it hard for European companies to know the requirements that they need to meet on the Chinese market. When no public standards are available, companies are also obliged to publish their company standard, which could lead to a potential leakage of trade secrets.

A third potential concern relates to China's ambition for global leadership in standardisation. While the development and use of global standards is voluntary, a less voluntary uptake of Chinese standards may result from unilateral imposition of national standards in third countries. This seems to be the case in the Belt and Road Initiative (discussed in chapter 6.2. of this paper), initially mainly in the transport/construction sector, but increasingly also for example in the area of 5G ('Digital Silk Road').<sup>116</sup>

This results in an unlevel playing field, where European companies do not enjoy the same access to the Chinese market as Chinese companies to the European market. This needs to be a prioritised policy objective for the EU to ensure that technical content in standards used on the Chinese market are consistent with the international standard applied in the area and that the standard, if not identical to the international standard, is easily accessible in English.

## DEMANDS

- 51 EUROPEAN COMPANIES SHOULD HAVE FULL RECIPROCAL ACCESS TO PARTICIPATE IN CHINESE STANDARDISATION** on the same footing as Chinese companies can participate in standardisation in the EU (CEN/CENELEC, ETSI or at national level).
- 52 CHINESE STANDARDS SHOULD NOT BE USED AS A TRADE BARRIER** by establishing a *de facto* mandatory requirement for EU companies when selling their products and services in China, especially when it relates to requirements that go beyond interoperability. There should be adherence to international standards to the largest possible extent - which is something we also advocate for EU standards. We fully support constructive participation of China in ISO/IEC.
- 53 IEC TESTS SHOULD BE ACCEPTED IN CHINA IF THE CHINESE GB-STANDARDS ARE IDENTICAL.** The scopes of international certification schemes could be extended, for example with the IEC Conformity Assessment for Electrotechnical Equipment and Components (IECEE CB) scheme which is an international system for mutual acceptance of test reports and certificates for electronics. In addition, the principles of mutual recognition with no additional testing should be implemented as advocated by the IECEE. We furthermore feel that no factory inspection should be necessary, when a company is certified to ISO 9001 (2000 version).
- 54 ACCESS TO CHINESE STANDARD ESSENTIAL PATENTS SHOULD BE GRANTED ON FAIR, REASONABLE AND NON-DISCRIMINATORY (FRAND) TERMS.** FRAND terms are general principles that allow for licensing on reasonable terms to standard essential patents for those who do not own the patent. Where standards are developed by Chinese standardisation organisations, access should be granted on the basis of these internationally recognised principles.

<sup>116</sup> Mercator Institute for China Studies, "*China's Digital Rise: Challenges for Europe*", 2019, p. 22: "China's long-term goal is to change the global landscape of technological competition by defining and exporting their own standards for all emerging industries, thereby ensuring that Chinese products and services are not obstructed by standards set by another country."



### 3.8. E-COMMERCE

Over the past years, there has been an increased presence in Europe of major online e-commerce platforms and e-retailers from other parts of the world – from China in particular. Alibaba and its B2C platforms such as AliExpress are gaining demand from European consumers and are building their distribution hubs in various EU countries to reinforce their presence. In 2018, a significant amount of e-commerce-related parcels circulating in the EU already originated from e-retailers in China as can be seen in the table below.<sup>117</sup>

Chinese e-commerce platforms and other third-country platforms have the advantage of offering more choice to European consumers as well as offering new tools for European manufacturers to reach consumers. As new e-commerce platforms are investing in Europe, this will translate into the growth of jobs and the economy.

It is essential that all foreign companies – including Chinese companies – operate according to the same rules and legal standards as European companies. This means that Chinese companies who offer their products and services on the European market through e-commerce must comply with EU law – e.g. product compliance, consumer rights, taxation and customs, intellectual property, waste management, etc.

#### E-retailer country of origin of most recent cross-border purchases

Most recent online purchases in	were ordered from an e-retailer in		
Denmark	Germany (22%)	China (20%)	United Kingdom (15%)
The Netherlands	China (36%)	Germany (18%)	United Kingdom (10%)
Sweden	China (24%)	Germany (21%)	United Kingdom (17%)
Germany	China (41%)	United Kingdom (15%)	Austria (5%)
Luxembourg	Germany (71%)	France (12%)	United Kingdom (5%)

Source: WIK-Consult, "Development of Cross-border E-commerce through Parcel Delivery", 2019. Data is based on a survey commissioned by DG GROW of over 8,000 consumers across the EU. Respondents were asked to consider the following question: "Thinking of your most recent purchase from an online shop or a seller on an online marketplace in a country other than the one you currently live in, where was the online shop or seller located?". The survey was conducted in every EU Member State; however, for purposes of brevity, this table only includes the top five countries in EU27 by proportion of individuals who purchased online in 2018 according to [Eurostat](#).

#### Chinese e-commerce products are often non-compliant with EU law

EU consumer protection laws impose a number of obligations on products circulating in the EU. These include amongst others rules related to their safety, labelling, marketing, environmental footprint and health effects. EU law also bans a number of goods and components due to their hazardous effects. One of the similar traits of foreign e-commerce platforms is the fact that through them millions of small packages carrying low-value goods enter the European market. These packages are often non-compliant with EU law as they are covered in tape, with no or little information on the goods contained herein, no return address and often ticking the customs declaration as a 'gift'.

With consumers increasingly 'importing' goods via e-commerce platforms, the risks associated with consumer wellbeing, the environment as well as the risks on fair competition increase substantially. To date, an unacceptable number of products and services offered through e-commerce platforms and originating from China do not comply with EU law.

<sup>117</sup> WIK-Consult, "Development of Cross-border E-commerce through Parcel Delivery", 2019, p. 50.

A simple product search in some of these marketplaces shows that much of the pre-contractual information imposed by European consumer law (e.g. on withdrawal rights, burden of proof, delivery, guarantee periods, remedies) is often omitted. In 2018, the Danish Consumer Council found that 21 out of 39 checked cosmetics bought on wish.com, a US-based e-commerce giant with a majority of Chinese traders behind it, did not contain information on ingredients or outright contained substances forbidden in the EU.

European companies invest a high amount of legal and financial resources to be able to comply with the 50+ items of EU contractual mandatory information to be given to consumers before the purchase is agreed. European companies expect that all non-EU competitors comply with the same rules. For example, under the Waste Electrical and Electronic Equipment Directive, European companies placing certain goods on the EU market are under the obligation to take waste back or pay fees that cover the waste removal. Chinese companies, who are one of the biggest exporters (41%) of computer devices worldwide, are however not obliged to pay this fee.<sup>118</sup>

### **Example: mobile phone chargers ordered from Chinese e-commerce platforms do not comply with EU law and safety standards**

*In 2016, the Netherlands Food and Consumer Product Safety Authority warned consumers that 24 out of 41 mobile phone chargers that were tested on compliance with EU safety standards carried the risk of heating up, melting or exploding. Alarmingly, all chargers that were directly imported from e-commerce platforms in China and included in the sample proved to be non-compliant with EU law.<sup>119</sup>*

## **How to move forward**

### **Plurilateral agreement on e-commerce**

A future plurilateral agreement on e-commerce should establish binding rules for free, secure and reliable cross-border e-commerce. An e-commerce agreement should aim to facilitate electronic transactions for example by recognising electronic signatures and by ambitiously removing customs duties on electronic transactions.

High and global standards of consumer protection should also be set with the aim of protecting consumers from dangerous goods and preventing unfair competition to manufacturers that spend resources complying with strict product safety standards. In this regard, a future plurilateral agreement on e-commerce should ensure closer cooperation on enforcement of local products safety rules. Such provisions will provide national authorities with a better legal basis to enforce product safety requirements towards manufacturers – most of them located in China – that are sending non-compliant goods to customers in Europe.

Regarding data transfer, legal localisation requirements, such as those included in China's new Cybersecurity Law, should be minimised, and the freedom of businesses to decide whether and what data is transferred should not be curtailed. The transfer of or access to source codes and technology transfer should not be a market access requirement. Here – as well as for cross-border data transfer – existing rules on data protection and security that are in conformity with WTO law are to be respected.

The agreement should establish a cooperation mechanism between the parties to solve any issues that might come up and ensure the respect and implementation of the rules agreed. Moreover, the European and Chinese authorities should set up a cooperation framework to control that existing rules on data protection and security are in conformity with the WTO rules and are fully respected.

<sup>118</sup> World's Top Exports, "[Computer Device Exports by Country](#)", 2019.

<sup>119</sup> Nederlandse Voedsel- en Warenautoriteit, "[Onderzoek elektrische USB-laders](#)", 2016.

**Improve market surveillance capabilities**

It is essential that the EU strengthens its market surveillance capabilities to ensure that only EU-compliant products are made available on the Union market. Currently, diverging working methods and diverging levels of effectiveness between market surveillance authorities make it hard to raise efficiency and efficacy through scale effects, information exchange, orchestrated priority actions and mutual learning. This situation reinforces exploitation of the weakest links in enforcement by rogue economic operators, legal uncertainty and dissimilar treatment of similar cases in different parts of the Union.

While the challenges regarding market surveillance are particularly relevant in the area of e-commerce, it is important to emphasise that these problems go beyond e-commerce and also apply to 'traditional' imports of goods. This means that the EU should improve its market surveillance capabilities in general to ensure that that all products and goods that enter the Union market are EU-compliant - no matter in what way the product enters the market.

In this regard, BusinessEurope finds that there should be a continued focus on capacity of national market surveillance authorities, both in terms of expertise and resources to do physical checks. It is also important that the EU Safety Gate is further tailored to address the challenges of e-commerce. The EU Safety Gate (formerly known as RAPEX) is designed to exchange information about goods presenting a serious risk that are manufactured in the EU or imported from third countries and sold in the EU. It is a success story of EU consumer protection. Notably, in 2017, 53% of the 2201 alerts of unsafe products notified in the system came from China. In 2018, China was again the country of origin for 53% (1,191) of the alerts, an identical share to the one registered in the previous year.<sup>120</sup>

Products that are sold directly into the EU via e-commerce may not emerge through the Safety Gate, since market surveillance authorities often have limited capacity to intercept and check products that are sold to consumers via online shops. The percentage of products coming from China that present a serious risk therefore is likely higher than the number of notifications the Safety Gate suggests.

SWEEPS, the coordinated actions taken from different national consumer protection authorities (via the ECC network) to evaluate respect of EU law in targeted sectors has so far not been used regarding non-EU websites.

**DEMANDS****55 THE EU AND CHINA MUST COOPERATE IN THE PLURILATERAL NEGOTIATIONS ON E-COMMERCE.**

To this end, it is important that the EU and China contribute to delivering an ambitious plurilateral agreement on e-commerce that facilitates electronic transactions and improves enforcement of local product safety rules (see chapter '3.1 WTO').

**56 EU MEMBER STATES AND THE EU SHOULD ENSURE THAT THE RELEVANT NATIONAL AUTHORITIES ARE PROVIDED WITH STRONG AND INTELLIGENT MEANS TO SECURE EFFECTIVE ENFORCEMENT OF EU LAW VIS-À-VIS E-COMMERCE PACKAGES.**

A comprehensive strategy must be designed to enforce EU law and detect non-compliant packages (often originating from China). In this regard, the EU Safety Gate could be further tailored to better address the challenges in e-commerce but also in other areas. Market surveillance efforts should focus on products that present the biggest risk to consumers.

<sup>120</sup> European Commission, ['Questions and answers on the Safety Gate for dangerous products'](#), 2019.

**57** **THE EU SHOULD FOCUS ON THE ENFORCEMENT OF EU PRODUCT RULES TOWARDS PRODUCTS AND ECONOMIC OPERATORS THAT PRESENT THE BIGGEST RISK TO USERS.** This would really harvest the risk reduction intended by EU legislation and ensure a level playing field for European companies. Such enforcement is in the hands of national market surveillance authorities. The capacity of national market surveillance authorities should therefore be adequate, both in terms of expertise and resources to do physical checks.

**58** **ENCOURAGE AND ASSIST MEMBER STATES IN USING THE POWERS OF THE NEW CONSUMER PROTECTION COOPERATION REGULATION - ALLOWING FOR THE TAKING DOWN OF WEBSITES WHICH SEVERELY BREACH EU CONSUMER LAW.** The EU should make use of the EU SWEEP instrument (joint enforcement action) carried by the ECC-network towards non-EU e-commerce websites. This also means developing measures to alert against dangerous and non-compliant goods also for consumers (bottom-up source).

**FURTHERMORE, THE EU SHOULD:**

**59** **INVITE MAJOR CHINESE AND OTHER GLOBAL PLATFORMS TO MAKE COMMITMENTS CONCERNING NOTICE AND TAKING DOWN OF NON-COMPLIANT GOODS;**

**60** **PROMOTE AWARENESS OF AUTHORITIES AND CONSUMERS REGARDING THE IMPLICATIONS OF BUYING PRODUCTS ON NON-EU WEBSITES;**

**61** **LOOK FOR SOLUTIONS REGARDING WASTE MANAGEMENT WHICH ALSO TAKE ACCOUNT OF NON-EU BASED WEBSITES TARGETING EUROPEAN MARKETS;**

**62** **WORK FURTHER ON IMPROVING VAT COMPLIANCE OF FOREIGN COMPANIES THAT EXPORT TO THE EU OR ARE ESTABLISHED IN THE EU.**

### 3.9. CLIMATE AND ENERGY

European businesses stand behind the EU ambition of net-zero greenhouse gas (GHG) emissions to reach the objectives of the Paris Agreement.<sup>121</sup> Reaching climate neutrality by around mid-century, as the Intergovernmental Panel on Climate Change (IPCC) Special Report and the European Commission's 2050 climate strategy consider is necessary to limit average global temperature increases to 1.5°C, will fully depend on meeting a set of crucial framework conditions and relation actions on both the European and global level. One of the conditions that will allow European businesses to achieve the ambition of climate neutrality is the necessary international convergence of global climate ambitions. For this reason, it is essential that China, being the leading global GHG emitter (28% of the global emissions),<sup>122</sup> takes its responsibility together with the EU and other signatories of the Paris Agreement to implement the goals of the agreement.

To work effectively towards the convergence of global climate ambitions, European business supports the high-level EU-China Partnership on Climate Change. In this regard, we welcome the commitment made by both sides at the 2019 EU-China summit to intensify bilateral cooperation on the basis of the 2018 joint "Leaders' Statement on Climate Change and Clean Energy". Continued bilateral and multilateral cooperation in the field of climate change and clean energy is pivotal to ensure that both sides deliver on their commitments made in the Paris Agreement. The EU and China must continue their exchanges on regulatory best practices in the field of carbon markets and renewable energy. At the same time, both sides should make use of the EU-China Partnership on Climate Change to converge ambitions and seek to harmonise regulations. EU-China cooperation on developing a Chinese emissions trading system (ETS) is a positive development in this regard.<sup>123</sup>

The goal of climate policy convergence has not been achieved yet. While the EU has adopted relatively far-reaching climate policies in the industrial sector, there is a lack of equivalent climate or other environmental policy measures for industries in China. The cost burden of climate and environmental policy to China's manufacturing sector is far lower than the EU's. Moreover, China's industries are less efficient in greenhouse gas emissions compared to the EU and several Chinese investment projects lead to uncontrolled exploitation of natural resources and deforestation, also on third markets such as Africa.

#### Regulatory asymmetries

Whereas Europe's energy-related CO<sub>2</sub> emissions continued to fall by 1.3% in 2018, they rose globally by 1.7% to hit a new record due to sharp increases in China (2.5%), the United States (3.1%) and India (4.8%).<sup>124</sup> Even with current climate pledges by major economies, which are less ambitious than Europe's, there are many uncertainties as to how they aim to achieve these targets. For example, whereas the EU's Nationally Determined Contributions (NDCs) provided comprehensive economy-wide emission targets based on absolute reductions, the NDCs by China are based on carbon intensity (emissions per unit of GDP). This means China's absolute GHG emissions are still on the rise as more new coal-fired capacity is added to the grid, and it is unclear when its absolute emissions will peak.<sup>125</sup> Furthermore, as the USA are currently in the process of withdrawing from the Paris Agreement - they have submitted a formal notice of their intention to withdraw on 4 November 2019 - and as the USA are abolishing their national Clean Energy Plan, it remains to be seen whether the USA will reach their targets.

One field in which there still exists a lack of equivalent climate policy is carbon trading systems. The EU emission trading system (ETS) is far wider in scope and ambition than any other system in the world. In recent years several non-EU countries announced intentions to establish carbon pricing systems or have already done so, in the form of either a carbon trading system or carbon taxes. However, the carbon trading systems come in different shapes and sizes. In China, a nation-wide ETS is currently being created but it will

<sup>121</sup> BusinessEurope, "European Business views on a competitive energy & climate strategy", 2019.

<sup>122</sup> Emissions include CO<sub>2</sub> emissions from fuel combustion only. Please consult International Energy Agency, "Key World Energy Statistics", 2019.

<sup>123</sup> European Commission, "Emissions trading: European Commission and China hold first policy dialogue", 2018.

<sup>124</sup> International Energy Agency, "Global Energy & CO<sub>2</sub> Status Report", 2019.

<sup>125</sup> China also provided USD 36 billion of financing in 2018 for coal plants outside the country. Please consult Institute for Energy Economics and Financial Analysis, "China at a Crossroads", 2019.

initially only cover its power sector. Other sectors, which unlike the power sector are subject to international competition, will be excluded when the system starts. Therefore, even though the EU ETS includes some provisions to protect trade-exposed energy-intensive industries from unequal international competition with less ambitious countries, the risk of investment and carbon leakage remains a real concern.

## **Safeguard European competitiveness**

The effects on industries and businesses of enforcing strong European climate or other environmental policies has to be closely monitored in relation to the competitiveness situation. The best solution obviously would be if international standards and policy measures were used globally, or if Chinese and European policy measures were similar, but as long as that is not the case, a discussion on how to handle distortions in competition has to be initiated. As a first step, the EU and the EU Member States must fully implement, at the national level, the measures provided for in the reformed EU ETS in order to minimise the risk of carbon and investment leakage. Secondly, it is pivotal that the EU continues its climate diplomacy, contributing to a global 'race to the top' by actively supporting and cooperating with third countries such as China to work towards achieving the goals of the Paris Agreement. Thirdly, when third countries do not deliver on their obligations under the Paris Agreement or if asymmetrical climate policies lead to distortions in competition, the EU must consider additional safeguards that proactively mitigate the distortions in competition inflicted by 'free riders' and international regulatory asymmetries.

## **Better engagement of the private sector**

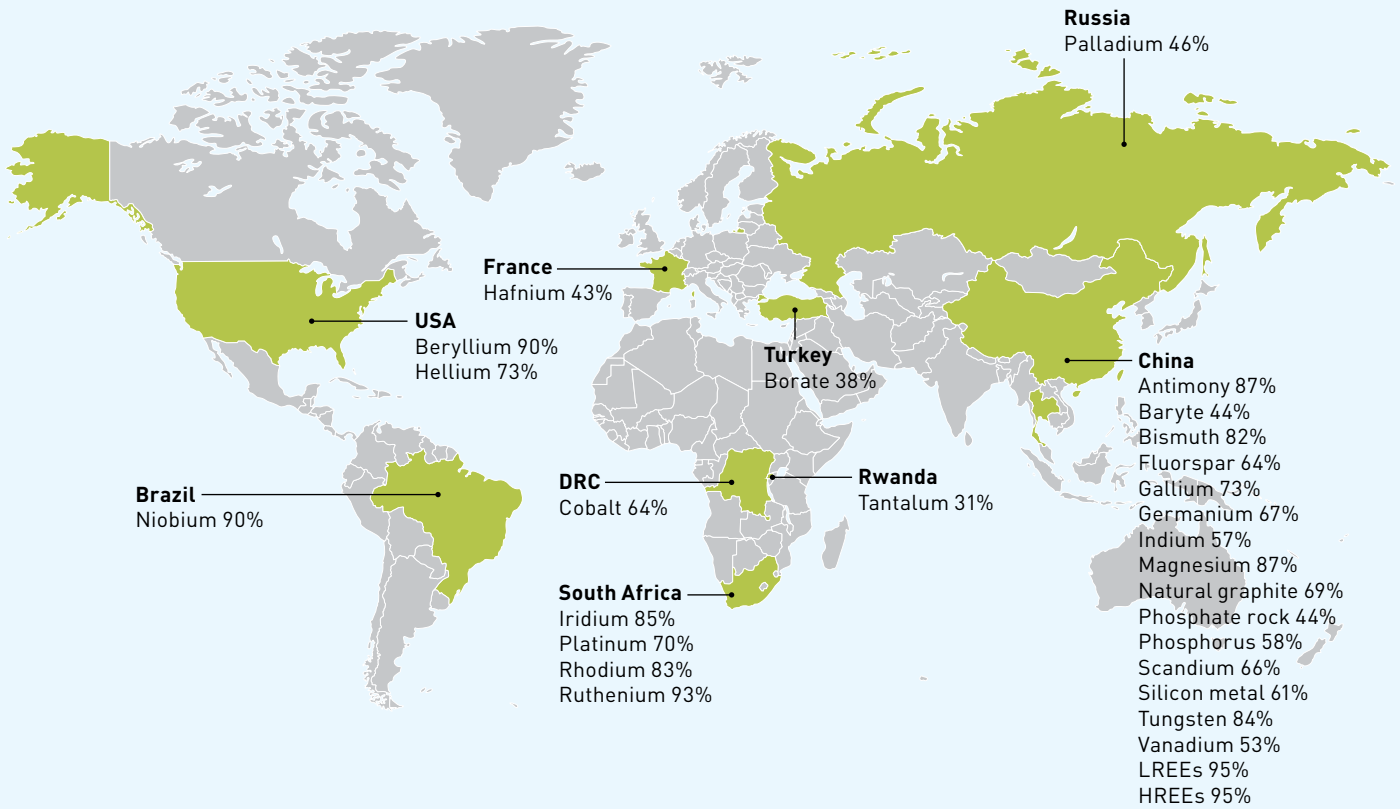
The EU and China need to engage the private sector more actively in their bilateral cooperation to forge synergies between private innovation and the growing demand for clean technology and products in both the EU and China. To achieve the goals of the Paris Agreement, the EU and China need solutions to, amongst others, improve energy, carbon and resource efficiency, waste management and environmental performance (greenhouse gases, air, water and solid waste). In this regard, European business welcomes that the 2019 'Joint Statement on the implementation of the EU-China energy cooperation' has deepened and intensified the annual EU-China Energy Dialogue. The private sector should be engaged more actively in this process for example through facilitating complementary business interactions to exchange innovative technologies that will contribute to achieving our respective climate goals.

## **Raw materials**

The industrial dimension of the energy transition puts Europe in front of a potential threat: shifting the EU's dependency from fossil fuels to a new dependency on raw materials might lead to a new dependency on China as the vast majority of the rare earths and precious metals are sourced from China. An assessment by the European Commission on critical raw materials (CRMs) shows that China is the main supplier for 15 out of 38 CRMs.<sup>126</sup> Therefore, the EU needs to ensure that efforts towards building EU strategic value chains take these potential threats of dependency into account.

<sup>126</sup> European Commission, "Study on the review of the list of Critical Raw Materials", 2017.

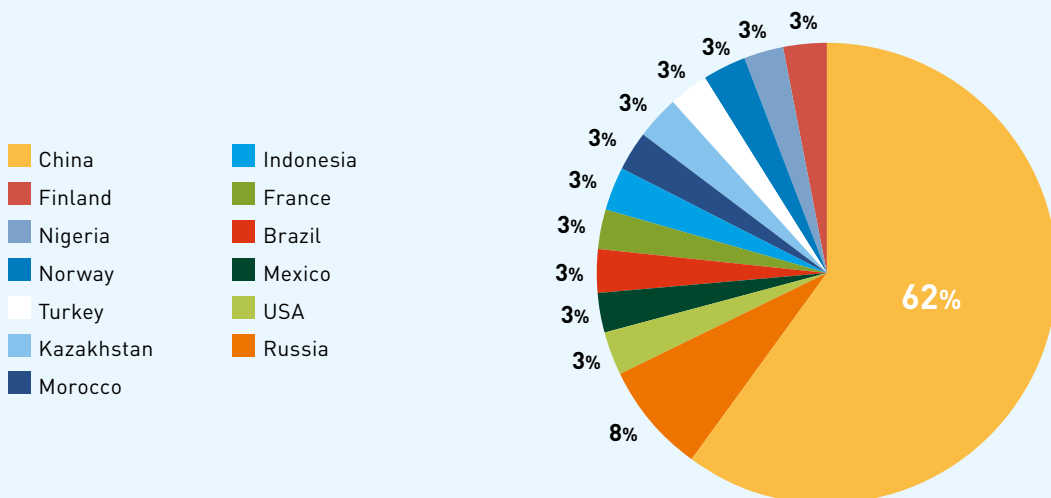
**Countries accounting for the largest share of global supply of critical raw materials**



Source: European Commission, «Study on the review of the list of critical raw materials», 2017

**China is the main supplier of critical raw materials to the EU**

Figure based on number of critical raw materials (CRMs) supplied out of total 37 CRMs (average from 2010-2014)



Source: European Commission, "Study on the review of the list of critical raw materials", 2017

## DEMANDS

- 63** **STRONG BILATERAL AND MULTILATERAL COOPERATION BETWEEN THE EU AND CHINA IN ACCORDANCE WITH THE PARIS AGREEMENT.** The EU and China should continue to deepen and intensify their cooperation in order to reach the targets of the Paris Agreement. Both sides should engage in strong international climate diplomacy and climate advocacy to spark an international 'race to the top'. The EU should make sure that the Chinese method of calculating greenhouse gas emissions is comparable to enable transparent monitoring and verification.
- 64** **THE EU MUST FULLY APPLY THE EU EMISSION TRADING SYSTEM (ETS) AND BETTER PROTECT EUROPEAN INDUSTRY.** The EU and EU Member States must fully apply all existing measures within the EU ETS to minimise the risk of carbon and investment leakage. Additionally, sectors facing international competition need strong protection under the EU ETS, including but not limited to free allocation and indirect cost compensation, if other major economies do not face similar costs and regulatory burdens.
- 65** **THE EU MUST FURTHER IMPROVE ITS TOOLBOX TO SAFEGUARD THE COMPETITIVENESS OF EUROPEAN INDUSTRY FROM 'FREE RIDERS' AND DISTORTIONS CAUSED BY INTERNATIONAL REGULATORY ASYMMETRIES.** The EU must study the distortive effects of third-country climate policies on the competitiveness of the EU and assess the possible policy alternatives, amongst which trade-related measures, to ensure a level playing field and to prevent carbon and investment leakage.
- 66** **THE EU MUST MINIMISE ITS DEPENDENCY ON CHINESE RAW MATERIALS, IN PARTICULAR RARE EARTHS AND PRECIOUS METALS.** The EU undergoes an energy transition from a dependency on fossil fuels to a dependency on alternative clean energy sources, such as certain raw materials. As a vast amount of rare earths and precious metals are sourced from China, the EU should diversify its supply of rare earths and precious metals to avoid creating an unnecessary dependency on China for its raw materials supplies. At the same time, the EU should ensure that it has access to the Chinese market (e.g. no export restrictions in China for raw materials for European companies).







04

## MITIGATE THE IMPACT OF CHINA'S GOVERNMENT- INDUCED MARKET DISTORTIONS

It is of key importance that the EU takes measures to mitigate the impact of government-induced market distortions on European businesses. The EU should aim to discipline the role of state-owned enterprises, take proactive steps to address the issue of industrial subsidies, engage internationally to try and eliminate overcapacity and take steps in the area of competition policy and state aid.

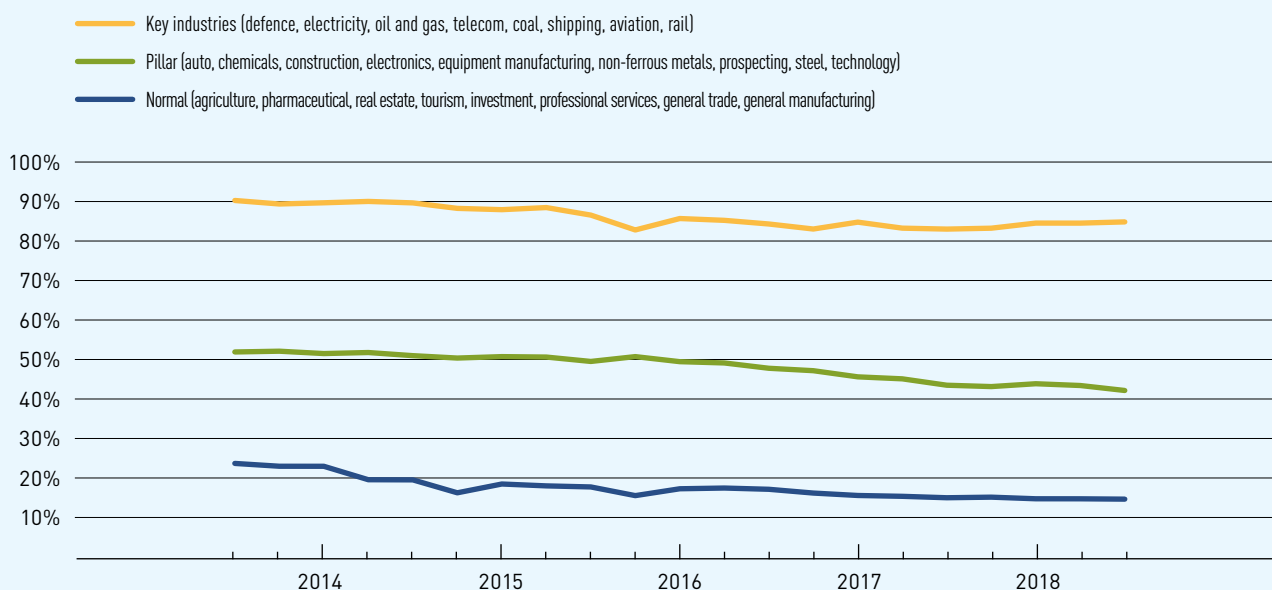
## 4.1. STATE-OWNED ENTERPRISES (SOEs)

After an overall reform was initiated in 1978, Beijing drastically reformed its SOEs running up to China's WTO accession in 2001. China closed, reorganised, merged and privatised many of its SOEs, laying off 40 million employees between 1998 and 2003.<sup>127</sup> Nevertheless, attempts to make SOEs more market-oriented have been diminished by deeper integration within the Communist Party and a further reliance on SOEs to control the economy and coordinate the party's long-term strategy. China is dependent on SOEs as their dividends form a major source of government income and as SOEs contribute to social and political objectives, employing over 60 million people.

Today, 14% of the 3,485 companies listed in China are SOEs.<sup>128</sup> These SOEs account for 40% of total market capitalisation and 54% of total revenue of listed enterprises. In the industrial sector, only 5% of the total number of industrial enterprises are SOEs, but they account for 28% of total Chinese industrial assets and for 18% of annual total industrial profit.<sup>129</sup> In key strategic industries, SOEs enjoy an even larger market share. In 2018, the share of SOE revenues in key strategic industries for example accounted for around 85% of total revenue.<sup>130</sup> In its latest review of the Chinese economy, the WTO said the state retained a majority share in all but one of China's 100 largest publicly listed companies.<sup>131</sup> Consequently, SOEs remain an integral part of the Chinese economy.

### Chinese SOEs have up to 90% of market share in key industries

*SOE shares of revenue in normal versus officially identified special industry categories, amongst listed companies (in percentage)*



Source: Asia Society, 2019

<sup>127</sup> Clingendael, "EU-China Investments: Barriers to Market Access in China", 2018.

<sup>128</sup> SOEs are defined as having more than 20% government ownership.

<sup>129</sup> Asia Society Northern California and Rhodium Group, "Missing Link: Corporate Governance in China's State Sector", 2018.

<sup>130</sup> Asia Society Policy Institute and Rhodium Group, "China Dashboard: State-Owned Enterprise", 2019.

<sup>131</sup> World Trade Organisation, "Trade Policy Review: China", 2018.

While private and foreign companies are effectively banned from many state-controlled industries, Chinese SOEs enjoy privileges provided by the government, posing a serious threat to fair competition. While most European industries are open to Chinese investors, many Chinese industries are dominated by SOE monopolies and closed to foreign private companies. This causes a lack of reciprocity the consequences of which European companies suffer from.

### The lack of market-based reform and increasing party influence

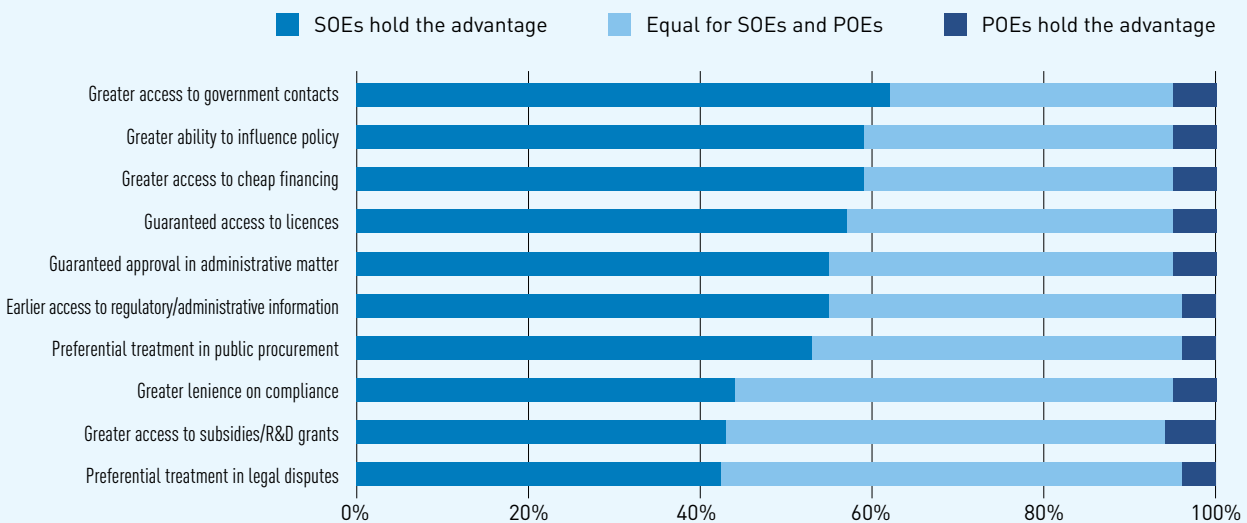
Beijing has repeatedly announced market-oriented reforms of its economy. At the Third Plenum in 2013, Beijing announced comprehensive reform plans which would allow the market to play a “decisive” role in allocating resources.<sup>132</sup> These statements were welcomed by the European business community as it seemed that Beijing was willing to tackle the underlying causes of market distortions such as the inefficient allocation of resources to SOEs.

However, the rhetoric of market-based reforms stands in sharp contrast to the reality as SOEs are growing bigger and stronger. In 2003, the State Assets Supervision and Administration Commission (SASAC) was established to regulate and manage the central SOEs. Instead of breaking state-owned monopolies and improving market competition, the SASAC announced in 2006 that the state should have “absolute control” over the armaments, power generation and distribution, oil and petrochemicals, telecommunications, coal, aviation and shipping industries.

A key concern to European business is whether Chinese SOEs make investment and corporate decisions based on political and strategic considerations or on commercial and market considerations. In fact, political considerations have continued to influence SOE behaviour, threatening the ability of Chinese SOEs to act in accordance with commercial considerations. The Party controls and influences SOEs through various means and measures. The most obvious form of state influence is through state ownership of SOEs. In 2017, there were around 174,000 companies in which the Chinese government, through special purpose vehicles, had a minority or majority shareholding.

### SOEs have the upper hand in most areas of doing business

Which type of firm holds the advantages in the following areas in your sector?



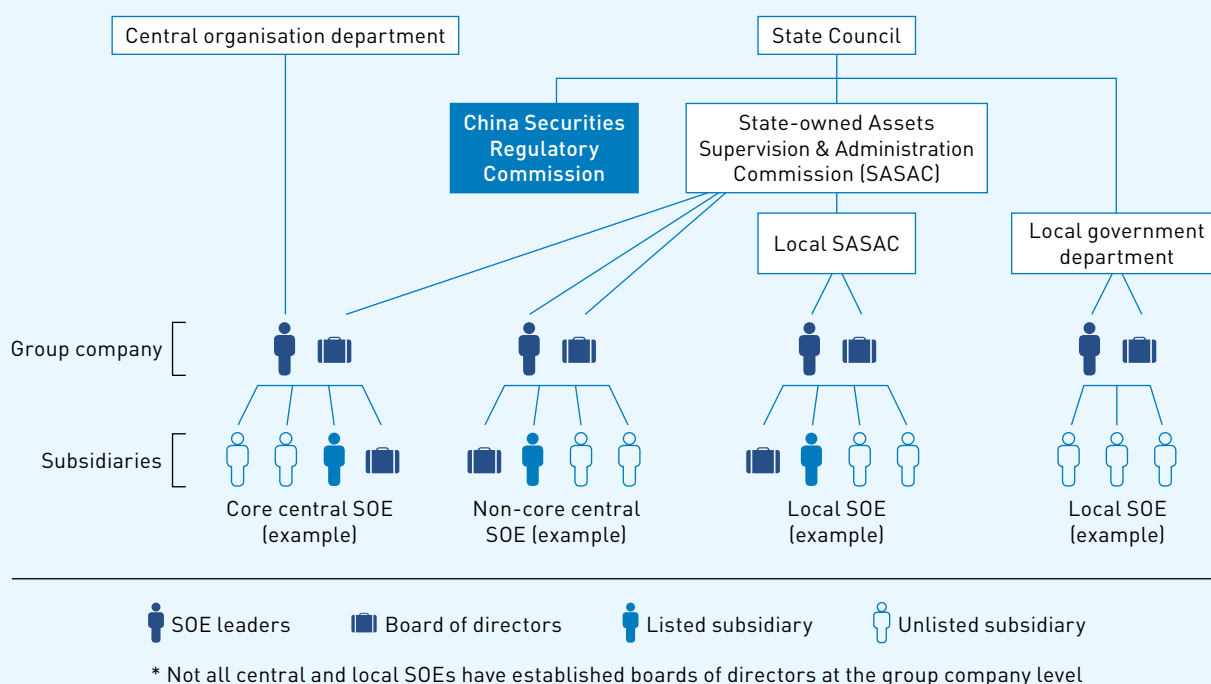
Source: European Chamber of Commerce in China, “Business Confidence Survey 2019”

132 Communist Party of China, “Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform”, 2014.

Besides having ownership over the SOEs, the government also exercises control through its influence over the corporate governance of SOEs. Central and local branches of the government's SASAC are for example responsible for personnel appointments. Because SASAC appoints the board of directors of central SOEs, appointments are politically motivated. After all, the board of directors is responsible for safeguarding and managing state assets and therefore it is problematic to ensure commercial and competitive neutrality.

Moreover, President Xi Jinping has initiated several party building efforts to further increase the influence of the Party within SOEs. The Guiding Opinions on SOEs adopted in 2015 included provisions that embedded the Party as the "political core" in the governance structures of SOEs. During the 19<sup>th</sup> Party Congress in 2017, the Party Constitution was further amended to include a sentence emphasising that the Party Central Committee should "play a leadership role" in SOE decision-making. Statements by President Xi, in which he calls for "stronger, better and bigger" SOEs, illustrate the fact that SOEs will remain a fundamental element of the Chinese economy.<sup>133</sup>

### SOE organisational structure and position in China's administrative hierarchy



Source: Asia Society, 2018

### Mega-mergers leading to unfair competition

European companies increasingly experience unfair competition as a result of Chinese policies that initiated a series of SOE mergers. In the 2013 Guiding Opinion on Accelerating the Promotion of Mergers and Reorganisations of Enterprises in Key Industries, Beijing aimed to "foster a number of large enterprise groups that are competitive at the international level."<sup>134</sup> The rationale behind the mergers is to improve the financial performance of SOEs, create internationally competitive 'national champions' and concentrate state ownership – allowing for greater state control. Xi Jinping stated that "SOEs should keep growing bigger and stronger, and arguments against SOEs, or for small SOEs, are wrong and one-sided".<sup>135</sup>

<sup>133</sup> China Daily, "Xi calls for furthering SOE reform", 2017.

<sup>134</sup> Ministry of Industry and Information Technology, "Guiding Opinion on Accelerating the Promotion of Mergers and Reorganizations of Enterprises in Key Industries", 2013.

<sup>135</sup> China Policy, "Embracing the Market on the State's Terms", 2019.

Annual central SOE mergers increased from an average of two mergers between 2012 and 2014 to six central SOE mergers in 2015 and five mergers in 2016.<sup>136</sup> As a result of the mergers, the average asset size of industrial SOEs increased from RMB 923 million in 2008 to around RMB 2.3 billion in 2017.<sup>137</sup> Beijing for example aims to consolidate China's fragmented steel sector so that the top 10 producers account for 60 per cent of steel production, up from 35 per cent now. In this regard, China Baowu Steel Group plans to acquire a majority stake in Magang Steel to strengthen its international competitiveness. The acquisition would create a group whose combined production would have exceeded that of the entire US steel industry last year.<sup>138</sup>

### Case study: the reversal of SOE reform in the shipbuilding industry

*Since 'reform and opening-up' was initiated in 1978, China has made significant progress in reforming its state-owned enterprises. The government privatised inefficient SOEs and closed many unprofitable companies. In this context, China's shipbuilding monopoly was split between China Shipbuilding Industry Company (CSIC) and the China State Shipbuilding Company (CSSC) in the 1990s.*

*However, in October 2019 this reform was reversed as China's State-Owned Assets Supervision and Administration Commission announced it had approved the merger of the two biggest state-owned shipbuilders CSIC and CSSC, paving the way for a new mega-company with 21 percent of global sales.<sup>139</sup> The new state enterprise will be called China Shipbuilding Group Corp.*

*The merger restores the previous organisational structure for China's state-owned shipbuilding operations and is a solid move to strengthen the earning ability of the state-owned enterprise sector. The merger aims to allow the two companies to compete against established rivals in South Korea and Europe.*

*Given the fact that the sector has been listed as a "key industry" in Made in China 2025, given the two action plans released in December 2018, and given the active participation of the government in the process, it is evident that the merger is driven by the government and follows clear industrial policy objectives. Indeed, it allows Beijing to better, more effectively and directly manage the sector so to achieve global dominance for what concerns the production of liquefied natural gas carriers, luxury cruise liners, icebreakers, and offshore engineering equipment.<sup>140</sup>*

European policy-makers should be cautious about interpreting recent SOE reforms as a sign of privatisation and liberalisation. Instead, European policy-makers should anticipate further SOE mergers and increased political control, making it increasingly difficult for private companies to compete with Chinese SOEs across the world.

Mega-mergers and state monopolies threaten to undermine the global market-based economy. Moreover, the negative effects generated by these offensive policies extend beyond the Chinese border as European businesses also face unfair competition with SOEs on the European internal market and on third markets. Government support allows SOEs to acquire foreign businesses and foreign technology and to bid on procurement tenders at uncompetitive prices.<sup>141</sup> It is essential to determine how mega-mergers – particularly those involving state-owned corporations – should be regulated and how the EU could deal with SOE mergers to secure fair competition.

The policies and practices behind 'bigger and better' SOEs undermine the principles of a market economy that prevent high market concentrations and ensure competition. While private companies need to adhere strictly to anti-trust laws, SOEs are exempted, creating significant market distortions both in China as well

<sup>136</sup> European Council on Foreign Relations, "Big is beautiful? State-owned enterprise mergers under Xi Jinping", 2016.

<sup>137</sup> Ross Garnaut, Ligang Song and Cai Fang (edd.), "China's 40 Years of Reform and Development 1978-2018", ANU Press, 2018.

<sup>138</sup> Financial Times, "China steel groups merger set to exceed US output", 2019.

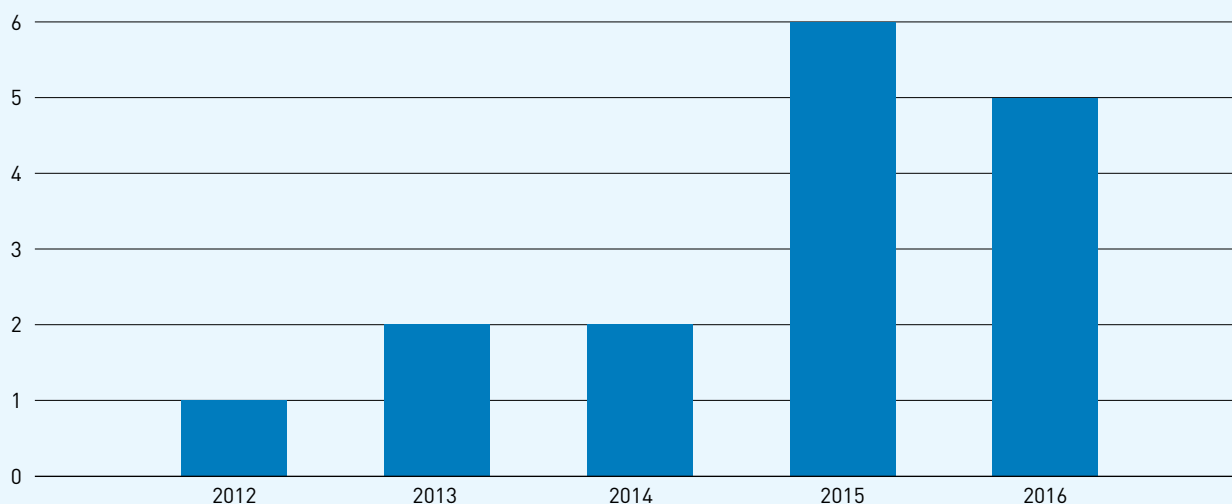
<sup>139</sup> The Maritime Executive, "Beijing Gives Green Light for CSSC-CSIC Merger", 2019.

<sup>140</sup> China Daily, "Two Shipbuilders mull mergers", 2019.

<sup>141</sup> US-China Economic and Security Review Commission, "SOE Megamergers Signal New Direction in China's Economic Policy", 2018.

as on third markets. To ensure fair competition, China should strictly enforce its anti-trust laws on SOEs and prevent monopolies.

### A spike in central SOE mergers Number of mergers



Source: European Council on Foreign Relations, 2017

## Subsidies and privileged access to funding

European companies also face unfair competition because SOEs often receive state subsidies and have better access to funding. Many SOEs receive government support or have easy access to state bank loans, which enable Chinese SOEs to offer products below market prices and causes overcapacity. This leads to unfair competition the consequences of which private and foreign-owned businesses suffer from. Rules regulating government subsidies can furthermore be circumvented as the Chinese government can use SOEs as an intermediary to channel public funds and subsidies to SOE subsidiaries or other 'independent' enterprises.<sup>142</sup>

Compared to private companies, former SOEs continue to benefit from government support after they have been privatised. A study using a comprehensive dataset from China demonstrated that SOEs have easier access to low-interest loans from Chinese state-owned banks than private companies. Moreover, privatised SOEs continue to receive lower interest rates and more subsidies than enterprises that have never been state-owned.<sup>143</sup>

## Politically motivated private enterprises

The EU should consider that Chinese state interference in the market goes beyond state-controlled SOEs. Think tanks have warned against the danger of setting rigorous rules for Chinese SOEs, while leaving room for politically connected Chinese private firms to distort the market.<sup>144</sup> Firstly, politically connected private companies may receive government support which leads to unfair competition. In this way, European companies experience a competitive disadvantage when competing with such state-aided firms.

<sup>142</sup> Ru Ding, "Public Body' or Not: Chinese State-Owned Enterprises", *Journal of World Trade* 48:1, 2014.

<sup>143</sup> Ann Harrison et al., "Changing the tiger's stripes: reform of Chinese state-owned enterprises in the penumbra of the state", 2019.

<sup>144</sup> Bruegel, "How to handle state-owned enterprises in EU-China investment talks?", 2017.

Secondly, decisions by politically connected Chinese private firms risk being made on the grounds of political motives rather than commercial objectives. This may for example be the case when the members of boards of directors of private companies are also members of the Communist Party or closely aligned to the Party.

Thus, solely targeting SOEs in the Comprehensive Agreement on Investment and other bilateral and international negotiations leaves room for other forms of state interference through businesses. The EU should therefore demand broad definitions of state owned enterprises and avoid that loopholes occur. In other words, instead of solely focusing on state ownership, the EU should carefully consider how China's state-led institutional framework gives some Chinese companies an unfair advantage over European companies (see chapter '1. China').<sup>145</sup>

## Distortions induced by Chinese SOEs on the Single Market

The Chinese government's continued heavy intervention in its economy despite its declared objective of transitioning to a more sustainable, market-driven economy means that there are still significant distortions that affect China's economy and foreign businesses alike. This also has distortive effects on the European market in the following four ways:

- 1. TRADE DISTORTIONS:** distorted prices within China means that several products are exported at below market prices, leading to anti-dumping and anti-subsidy measures within the EU.<sup>146</sup>
- 2. INVESTMENT DISTORTIONS:** the acquisition of European companies by Chinese SOEs using subsidised capital or with the explicit objective of commercialising their technology within China.<sup>147</sup>
- 3. PROCUREMENT DISTORTIONS:** when Chinese companies can benefit from subsidised finance, cheaper inputs, and preferential backing from the Chinese state, they are able to tender procurement bids at below market prices.<sup>148</sup>
- 4. COMPETITION DISTORTIONS:** mega-mergers between Chinese SOEs within China and the economic support they receive affect the competitive environment within the European market.

## How to move forward

Global governance is at a crossroads to determine how industrial subsidies and SOEs should be regulated to maintain free and fair economic growth and development. Instead of moving to a more market-based economy, Beijing remains convinced that SOEs are an essential element of China's socialist 'market' economy and the broader development agenda. European business does not argue that all SOEs should be privatised. Rather, state-owned enterprises should not enjoy discriminatory privileges and state-owned and privately owned companies should both adhere to strong competition laws.

First, SOEs should not enjoy discriminatory privileges. This chapter explained how low interest rates on state loans, favoured procurement bids and accelerated administrative approvals are just a few examples of how Chinese SOEs enjoy discriminatory benefits at the expense of private companies. These practices hurt the private sector and therefore the innovativeness and competitiveness of the Chinese economy. In Europe, such discriminatory privileges are forbidden through strong state aid rules.

Secondly, SOEs should adhere to strong state aid and competition rules. A strong competition policy that also applies to SOEs will foster innovation, stimulate the development of new technologies and lead to cost-effective prices that benefit consumers. The current surge in mega-mergers in China is an example of

<sup>145</sup> See chapters 1.2 and 1.3 for a description of China's state-led economy and its impact.

<sup>146</sup> See chapter '3.2 Trade' for more information.

<sup>147</sup> See chapter '3.3 Investment' for more information.

<sup>148</sup> See chapter '3.4 Procurement' for more information.



how the lack of strong competition rules on SOEs in China has an enormous distortive impact on competition - not only in China, but also in Europe and on third markets.

### **The EU should develop an 'SOE principle'**

Since SOEs form a dominant part of China's economy and form one of the main avenues through which these distortions are felt within the European market, the EU should develop an 'SOE principle' to mitigate the impact of government-induced market distortions through SOEs. This entails that EU policies should be designed in such a way that they address the market-distortive effects of foreign SOEs.

Since it would be very difficult to distinguish the market behaviour of one firm from another, the EU should reverse the burden of proof for foreign SOEs, whether from China or elsewhere. This would capture the company segment that is most likely to benefit from or behave in distortive ways while ensuring that EU action would be compliant with WTO rules on non-discrimination. At the same time, it would avoid unduly burdening private enterprises and ensure the European economy remains firmly open for market-based players.

This principle can be applied in at least three ways in order to mitigate the distortive effects outlined above:

- ▶ **Subsidies:** the EU could reverse the burden of proof for foreign state-owned enterprises within the internal market and instead let them prove that they do not receive subsidies on their home market. This measure would overcome issues of transparency while being compatible with the WTO's non-discrimination principle.
- ▶ **Investment:** the EU could include additional provisions on foreign SOEs in a future revision of its investment screening mechanism. The Canadian model already includes provisions for SOEs and serves as a good example of how this can be implemented in practice.
- ▶ **Procurement:** the EU could include provisions in rules on 'abnormally low tenders' that devote special attention to tenders that are submitted by foreign SOEs.

The EU should examine whether an SOE principle of this kind could be applied to more policy areas in order to mitigate the distortive effects of foreign SOEs on the European single market.

### **Work with like-minded countries and consider commencing plurilateral negotiations**

BusinessEurope strongly supports the trilateral meetings between the EU, the USA and Japan on the market distortions caused by industrial subsidies and state-owned enterprises. The EU should strive to expand working with more like-minded partners in relevant international fora, such as the G20, to tackle market distortions created by SOEs.

European business calls on the EU to consider commencing negotiations on a plurilateral agreement under the WTO to mitigate government-driven market distortions. Such an agreement could for example tackle the market-distortive effects of state-owned enterprises and industrial policies. Addressing the market-distortive practices of SOEs through negotiating a global rulebook would not only mitigate the distortive effects of foreign-owned state enterprises but would also make European state-owned companies more efficient. Negotiations on a plurilateral agreement should be open to all WTO members and the EU should proactively engage all members.

Additionally, the EU and China should intensify the discussions within the EU-China joint working group on WTO reform with the aim of discussing international rules on SOEs and industrial subsidies. It is essential that the WTO reform addresses the market distortions caused by the practices of SOEs in the global economy.

### **Ensure 'competitive neutrality'**

According to the United Nations Conference on Trade and Development (UNCTAD), *competitive neutrality* is the recognition that significant government business activities which are in competition with the private sector should not have a competitive advantage or disadvantage simply by virtue of government ownership and control.<sup>149</sup>

The EU should advocate internationally for the creation of rules on the competitive neutrality of state-owned enterprises. The EU should in particular encourage China to create and implement measures to ensure the competitive neutrality of state-owned enterprises. UNCTAD conducted a study on competitive neutrality in China.<sup>150</sup> UNCTAD concluded that Chinese SOEs receive preferential treatment. As a result, private companies face disadvantages and imbalances in economic terms both in industries in which there exists a natural monopoly as well as in competitive industries. The report by UNCTAD recognises that SOE reform is complex and difficult to achieve and made recommendations on how the Chinese government can improve competitive neutrality. Accordingly, China should amongst others:

1. Further deepen political and economic reform. In this regard, it is important that the boundaries between the market and the government are redefined;
2. Implement a stronger competition policy that also applies to state-owned enterprises;
3. Apply a high level of anti-monopoly enforcement in the field of administrative monopolies.

The EU should furthermore study whether, and if so how, it should create a 'competitive neutrality instrument'. A competitive neutrality tool should aim to offset unfair advantages and market distortions resulting from government ownership and ensure a level playing field between private and foreign state-owned companies on the European internal market.

A competitive neutrality instrument could for example allow stakeholders to file complaints with a dedicated agency in the event that 'neutral' competition is suspected to be breached. When the foreign SOE's behaviour is found to distort 'neutral' competition, consultations should be held with the goal of rectifying the market-distortive practices of the state-owned enterprise in question.<sup>151</sup> If consultations do not lead to the required reforms, SOEs that do not operate in accordance with competitive neutrality principles should be disciplined through an enforcement mechanism. Australia has a competitive neutrality instrument which could be used as a source of inspiration for a potential European neutrality tool.<sup>152</sup> A competitive neutrality tool could potentially contribute to bolstering a market-based economy and a level playing field between foreign state-owned companies and privately owned companies.

### **Ambitious provisions on SOEs in the CAI**

The Comprehensive Agreement on Investment should include ambitious provisions on curbing the market-distortive effects of SOEs. The investment agreement with China should for example contain provisions on SOEs on at least the following dimensions: a clear definition and broad scope; removal of market access barriers in industries and sectors that are dominated by SOEs; general obligations and rights; specific disciplines on trade-distortive practices by SOEs; provisions to improve transparency; and rules regarding enforceability and dispute settlement.

<sup>149</sup> See definition provided by United Nations Conference on Trade and Development, "[Competitive Neutrality](#)".

<sup>150</sup> United Nations Conference on Trade and Development (UNCTAD), "[UNCTAD Research Partnership Platform. Competitive neutrality and its application in selected developing countries](#)", 2014.

<sup>151</sup> Mercator Institute for China Studies, "[Evolving Made in China 2025](#)", 2019.

<sup>152</sup> For more information, see United Nations Conference on Trade and Development, "[Competitive Neutrality and its Application in Selected Developing Countries](#)", 2014.

## DEMANDS

- 67** **ALL FUTURE INVESTMENT AND TRADE AGREEMENTS, INCLUDING THE COMPREHENSIVE AGREEMENT ON INVESTMENT, MUST INCLUDE AMBITIOUS PROVISIONS ON STATE-OWNED ENTERPRISES.** The EU should be careful not to limit the scope of provisions covering SOEs to ownership thresholds or the number of members of the board of directors appointed by the government. SOEs should be defined broadly to include all enterprises that are owned, controlled, or influenced, directly or indirectly, by a foreign government. The EU should avoid a narrow definition of SOEs as private companies or hybrid forms of SOEs may also be benefitting from state assistance or be influenced by political motives. The CAI should aim to remove substantially all market access barriers in sectors and industries that are dominated by SOEs.
- 68** **THE EU SHOULD DEVELOP AN 'SOE PRINCIPLE' TO MITIGATE THE IMPACT OF GOVERNMENT-INDUCED MARKET DISTORTIONS THROUGH SOES.** This is because SOEs form a dominant part of China's economy and form one of the main avenues through which these distortions are felt within the European market. This entails that EU policies should be designed in such a way that they address the market-distortive effects of foreign SOEs. One step would be to demand increased accounting transparency for state-owned enterprises in order to determine whether they operate based on market conditions and identify instruments to enforce this obligation. By increasing transparency, this would enable the EU to effectively apply its state aid and anti-subsidy rules. The SOE principle could, for example, be applied in the areas of subsidies, investment and procurement. The EU should investigate whether this principle could be applied to further policy areas.
- 69** **THE EU SHOULD PROMOTE AND STIMULATE 'COMPETITIVE NEUTRALITY'.** The EU should advocate internationally for the creation of rules on the competitive neutrality of SOEs. The EU should also encourage China to create measures to ensure the competitive neutrality of SOEs. Additionally, the EU should study whether, and if so how, a European 'competitive neutrality instrument' should be created to ensure the competitive neutrality of foreign SOEs on the European market. A competitive neutrality tool should aim to offset market distortions and unfair advantages resulting from foreign state ownership and ensure a level playing field between foreign state-owned companies and private companies on the European market.
- 70** **THE EU SHOULD COOPERATE WITH LIKE-MINDED COUNTRIES TO TACKLE MARKET DISTORTIONS CREATED BY SOE.** The trilateral discussions between the EU, the USA and Japan on industrial subsidies and state-owned enterprises are a welcome first step in this regard. The EU should furthermore strive to open the discussion to like-minded countries, for example by considering commencing negotiations on a plurilateral agreement on government-driven market distortions under the framework of the WTO.
- 71** **THE EU AND CHINA SHOULD INTENSIFY DISCUSSIONS ON INDUSTRIAL POLICIES AND STATE-OWNED ENTERPRISES IN THE EU-CHINA JOINT WORKING GROUP ON WTO REFORM.** The EU and China should for example cooperate to address the market-distortive effects of SOEs in the WTO reform.

## 4.2. SUBSIDIES

China provides a range of government support for its industries, particularly in the context of its 5-year plans and industrial policies such as Made in China 2025. State subsidies are an important part of China's industrial policy, which it employs not only to stimulate innovation in key sectors, but also to achieve objectives such as sustaining unprofitable industries.

Subsidies can take several forms, including direct subsidies, government grants, tax benefits, cheap access to land and capital below market prices. And while the scale and value of China's subsidies is hard to measure in full, one analysis of publicly available data shows that direct and indirect subsidies to SOEs have amounted to 1.3-1.6% of annual GDP in recent years. This includes direct subsidies (+/- 0.3% of GDP), artificially cheap credit (+/- 0.5% of GDP) and delayed payments by SOEs to their suppliers which represents a significant indirect subsidy (+/- 0.6% of GDP) when taking into account the interest payable if the total outstanding amount had to be borrowed.<sup>153</sup> SOEs here abuse their market power to effectively create free loans. The WTO Trade Policy Review on China also assesses the level of direct financial support for SOEs. In 2016, around 3,000 SOEs listed in the Shanghai and Shenzhen stock exchanges received government support, totalling RMB 123.215 billion, an increase from RMB 89,421 billion in 2014.<sup>154</sup>

### Example: China's shipbuilding sector

*A recent study on the shipbuilding sector showcases the impact of China's subsidies on domestic and global markets.<sup>155</sup> The study estimates that the amount of government support to Chinese domestic shipbuilding companies between 2006 and 2013 equates to RMB 550 billion/USD 90 billion, with the lion's share going to entry subsidies, followed by production subsidies and investment subsidies. According to the study, this has boosted China's domestic investment and entry by 270% and 200% respectively, and increased its global market share by 40%, creating sizeable distortions.*

It is, however, important to note that not all direct subsidies are made out to SOEs: listed private-sector firms received about a third of total direct subsidies in 2018.<sup>147</sup> Although export credits are not subsidies, the way in which China uses them has the impact of a subsidy, since it allows China to provide loans to foreign buyers of Chinese goods in order to create markets. According to US Export-Import Bank data, China has the world's largest export credit system, and it provides more funding to support its exports each year than the three next countries in the list combined.<sup>156</sup>

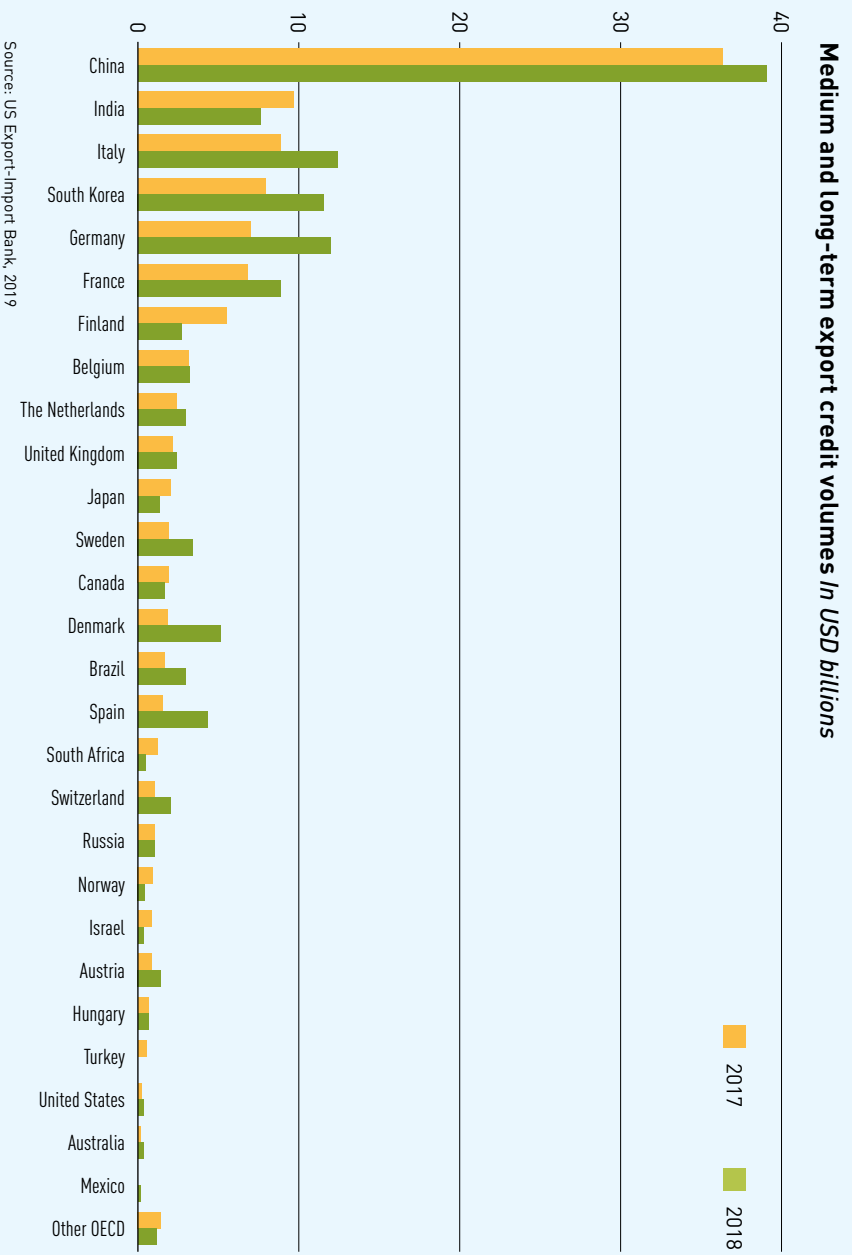
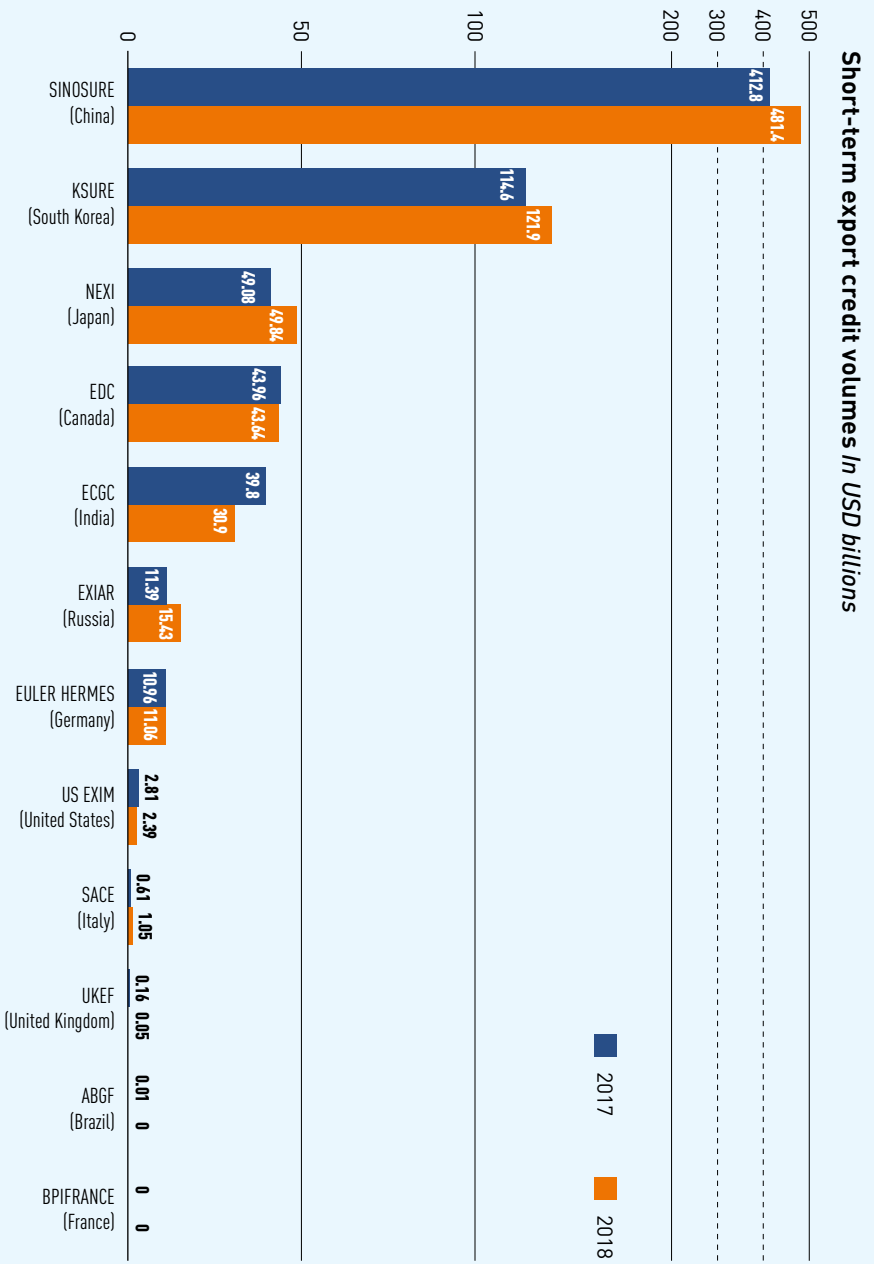
<sup>153</sup> Gavekal Dragonomics, "The Size of State Subsidies", 2019.

<sup>154</sup> World Trade Organisation, "Trade Policy Review: China", 2018, p. 89. Companies that received financial support are mainly from the chemical, automobile, excavation and steel industries.

<sup>155</sup> Vox CEPR, "Industrial Policy: Lessons from China", 2019.

<sup>156</sup> Gavekal Dragonomics, "The Size of State Subsidies", 2019.

<sup>157</sup> US Export-Import Bank, "Reports on Global Export Credit Competition", 2018 and 2019.



### **The consequences of China's direct and indirect subsidies are significant**

- 1. First and foremost, subsidies divert resources away from other, more productive parts of China's economy. China would benefit greatly from eliminating most of its industrial subsidies and indirect subsidies as its economy would grow more sustainably and robustly.*
- 2. Second, they create market distortions because they lead to artificially lower prices, create artificial demand and allow companies to grow beyond what they would be able to under market conditions.*
- 3. Third, subsidies can also lead to overcapacities and the dumping of products below market prices, which places enormous downward pressure on affected industries globally.*
- 4. Fourth, subsidies significantly distort fair competition, because foreign firms which do not receive subsidies see their profits dwindle and their market shares erode.*

Although various forms of state aid have caused market distortions in China, these problems also increasingly spill over into the global trading system, including the EU. This is due to China's growing economy as well as the increasing internationalisation of its companies. Some of the effects include unfair competition for European companies on third markets from subsidised competitors, dumping of subsidised products on our internal market, subsidised procurement bids that result in abnormally low tenders, as well as acquisitions of European companies by subsidised entities. While there is already a broad awareness of these consequences, the exact scale of these problems is less well known. Further research on the consequences on our internal market would be useful to evaluate which measures would be most effective to address them.

### **How to move forward**

Tackling the challenges posed by state subsidies on foreign markets such as China is not easy. A lack of transparency within the Chinese economy means that it is hard to assess whether and to what extent a company receives subsidies. It is important that the EU and other like-minded partners continue to encourage China to rein in direct and indirect industrial subsidies for its own benefit and that of its trading partners.

Nevertheless, relying on a single approach is unlikely to produce significant results in the short term. As the challenges and possible solutions are intertwined, they require a comprehensive approach. Solutions should be simultaneously pursued with China, at WTO level through trilateral cooperation with the USA and Japan, and in the EU.<sup>158</sup> An improved process for the notification of subsidies at the WTO would ultimately be an important stepping stone to creating better rules defining the use of legitimate and illegitimate subsidies in pursuit of fairer global trade and to reduce market distortions. The EU should work with like-minded partners to consider adopting more binding requirements on notifications, including penalties for non-compliance and a strong role of the WTO Secretariat in monitoring and enforcement.

<sup>158</sup> See chapter '3.1 World Trade Organisation' for more information.

**DEMANDS**

- 72 INTRODUCING NEW RULES AND DISCIPLINES ON SUBSIDIES SHOULD BE A KEY PRIORITY IN MULTILATERAL EFFORTS ON WTO REFORM.** In this context, the focus should be on updating the rules on subsidies, improving trade policy monitoring and notification procedures, clarifying the role of state-owned enterprises, strengthening the role of the WTO Secretariat, and setting up joint complaints in the WTO dispute settlement system. We support the EU's proposals to address these issues by, for example, reversing the burden of proof on notifications.
- 73 TRILATERAL COOPERATION BETWEEN THE EU, THE USA AND JAPAN TO DEVELOP RULES AND DISCIPLINES ON INDUSTRIAL SUBSIDIES SHOULD LIKEWISE CONTINUE IN PARALLEL TO THE ABOVE.** To move ahead with the agreed objectives of delivering concrete measures, it is essential that market-distorting practices are addressed. The results from these discussions should be used to launch plurilateral efforts to negotiate agreements on tackling market distortions and disciplining subsidies in parallel to multilateral negotiations at the WTO. This could also act as a stepping stone to a future multilateral agreement.
- 74 THE EU SHOULD ENGAGE CHINA BILATERALLY THROUGH THE JOINT EU-CHINA WORKING GROUP ON WTO REFORM TO STRENGTHEN INTERNATIONAL RULES ON INDUSTRIAL SUBSIDIES.** European business welcomes the fact that both the EU and China have already committed to this work in the joint statement of the 21<sup>st</sup> EU-China summit in April 2019.
- 75 THE EU SHOULD APPLY THE 'SOE PRINCIPLE' IN TACKLING SUBSIDIES, AND REVERSE THE BURDEN OF PROOF FOR FOREIGN STATE-OWNED ENTERPRISES WITHIN ITS INTERNAL MARKET AND INSTEAD LET THEM PROVE THAT THEY DO NOT RECEIVE SUBSIDIES ON THEIR HOME MARKET.**<sup>159</sup> A lack of transparency in some countries means that EU investigative authorities face difficulties when trying to find enough evidence to prove that foreign companies have obtained subsidies in their home market. By placing the burden of proof on foreign SOEs, the assumption is that they receive subsidies at home unless they can prove otherwise. This measure would overcome issues of transparency while also being compatible with the WTO's non-discrimination principle. Since SOEs tend to receive a very large share of subsidies, this measure would allow the EU to address a very large part of the subsidy problem without disproportionately affecting all businesses. The non-discrimination principle also does not prevent the EU from differentiating between itself and foreign firms, since it already enforces an internal state aid framework. We invite the European Commission to explore and discuss this proposal in greater detail.
- 76 THE EU SHOULD CARRY OUT AND PUBLISH A STUDY ON HOW SUBSIDIES PROVIDED TO CHINESE COMPANIES IMPACT THE EU INTERNAL MARKET AND EUROPEAN COMPANIES.** This study should aim at identifying and measuring potential adverse impacts and breaches to EU law and analysing potential unfair competition.

<sup>159</sup> See chapter '4.1 State-owned enterprises' for a more detailed explanation of the SOE principle.

### 4.3. OVERCAPACITY

China's industrial policy of state-led economic planning has led to overcapacity in several sectors of the economy. While subsidies are one of the most important drivers of China's overcapacity, a range of other policy instruments also contribute to and exacerbate this problem. Research to date shows that eight upstream industries in China that are most affected by overcapacity are: steel, electrolytic aluminium, cement, chemicals, refining, flat glass, shipbuilding, and paper and paper board.

Nevertheless, this does not imply that Chinese overcapacity exists only in upstream sectors or that their impact is limited to upstream sectors. Shipbuilding is a downstream sector in which Chinese overcapacity also has a strong impact. The world shipbuilding industry is historically characterised by cyclicity, strong government intervention (particularly in Asia) and overcapacity.<sup>160</sup> Between 2002-2007 the EU28+Norway maintained an average level of shipbuilding production (measured in million compensated gross tonnage (CGT)) of 4.5 million CGT per year, while China averaged 3.8 million CGT per year. During the peak years of the financial crisis between 2008-2011, shipbuilding production in the EU28+Norway adjusted downward, whereas Chinese production went up and peaked at over 19 million CGT. Between 2011-Q1 2019, the production of the EU28+Norway went down to an average of 2.2 million CGT per year whereas China averaged 14 million CGT per year.<sup>161</sup> The overcapacity in the shipbuilding sector has meant that shipyards have had to accept loss-making orders to fill production facilities, with the resulting losses leading to new government interventions to save shipyards from bankruptcy and reducing the capital needed to invest in clean and safe technology. Overcapacity in shipbuilding has also had knock-on effects on the shipping sector, by reducing the value of existing fleets, and creating incentives to purchase new ships which leads to additional capacity and lower price levels.

While comparable data is generally hard to find, data between 2008 and 2014 show that in six upstream sectors for which comparative data were available overcapacity increased substantially, and in some cases more than doubled. An argument often heard within Chinese circles is that the collapse in international demand is one of the main reasons why overcapacity grew so much during this period. Nevertheless, both capacity and production of these materials increased significantly during this period, including those which do not really lend themselves to be traded internationally due to their low price and high trade costs, like cement. Although a drop in global demand might have meant that more capacity was not utilised in some sectors, the figures for the sectors below and their pre-existing overcapacity in 2008 point to domestic drivers as their main source.

China has acknowledged the problems of overcapacity and initiated plans to tackle it through so-called supply-side structural reform. This set of policies is meant to reduce distortions in the supply side of the economy and upgrade the industrial sector. Nevertheless, the results to date have not yet led to a meaningful reduction in overcapacity.

<sup>160</sup> See the subsidies chapter (4.2.) for an example of Chinese government support for the shipbuilding sector. See also OECD, "[Imbalances in the Shipbuilding Industry and Assessment of Policy Responses](#)", 2017; and OECD, "[Workshop on factors impacting costs and distorting the shipbuilding market](#)", 2018.

<sup>161</sup> SEA Europe based on IHS Fairplay data





### The development of overcapacity in China between 2008-2014: an increase

Overcapacity		Capacity (in mio. t)	Production (in mio. t)	Utilisation rate (in %)	2008 vs. 2014 (2015) Scale of overcapacity (in mio. t)
Steel	2008	644	512	80	132
	2014	1140	813	71	327
Electrolytic aluminium	2008	18.1	13.2	78	4.9
	2015	38.1	28.9	76	9.2
Cement	2008	1870	1420	76	450
	2014	3100	2250	73	850
Refining	2008	391	314	80	77
	2014	686	456	66	230
Flat glass	2008	650	574	88	76
	2014	1046	831	79	215
Paper and paperboard	2008	89	80	90	9
	2014	129	108	84	21

Source: European Union Chamber of Commerce in China, "Overcapacity in China: an impediment to the Party's reform agenda", 2014

While China is not the only country in the world with issues of overcapacity, its overcapacity in the steel sector in 2014, for example, stood at twice the total annual consumption of steel in the EU.<sup>162</sup> So while global initiatives such as the Global Forum on Steel Excess Capacity is a good platform to tackle this issue in the steel industry, the systemic drivers of China's overcapacity as well as new industrial plans such as Made in China 2025 risk overcapacities being created in other sectors in the future, unless these drivers themselves are addressed.

The box below contains an overview of the most important drivers of overcapacity in addition to subsidies. It exposes the difference between policy efforts, which on the one hand try to reduce overcapacity, and China's industrial policy on the other hand, which leads to overcapacity. A lack of alignment between the central government and local governments, including the duplication of industrial policies, also contributes to overcapacity. While the problem of overcapacity is acknowledged by the Chinese government, its policies have also aimed at keeping input prices low in order to stimulate secondary sectors, particularly heavy industry.<sup>163</sup>

#### Drivers of overcapacity in China

1. Local protectionism and the fragmentation of industries that is driven by regionalism
2. Weak enforcement of regulations
3. Low input prices due to government policies
4. A fiscal system that encourages local governments to attract excessive investment
5. Widespread availability of inexpensive technology
6. Environmental, health and safety (EHS) standards and laws that are not fully implemented
7. A philosophy of market share vs. profitability

Source: European Union Chamber of Commerce in China, "Overcapacity in China: An Impediment to the Party's Reform Agenda", 2016

<sup>162</sup> European Steel Association, "European Steel in Figures", 2018.

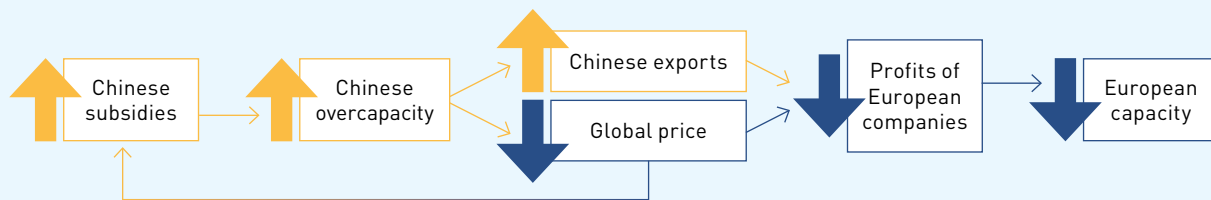
<sup>163</sup> European Commission, "Working Document on Significant Distortions in the Economy of the People's Republic of China for the purposes of trade defence investigations", 2017, p. 19.

## The impact of overcapacity on China and the global economy

Overcapacity has a significant impact on China's economy. Besides the misallocation and waste of resources, affected industries are beset by a range of issues. Their profitability is severely hampered, meaning that they are unable to muster the capital required to invest in R&D and pursue innovation. Affected companies struggle to move up the value chain, and instead further increase their capacity to try and grow their market share and improve their competitive situation. This vicious circle is a major obstacle to curbing overcapacity.<sup>164</sup>

China's overcapacity also has a strong impact on the global economy, depressing global prices, eroding profits of European companies and reducing European capacity. This has led to several anti-dumping cases within the EU as well as repeated calls by affected industries for the EU to take stronger measures to fend off the effects of overcapacity. The effects and their causal relationship are shown in a simple illustration below.

### Impact of overcapacity on global economy



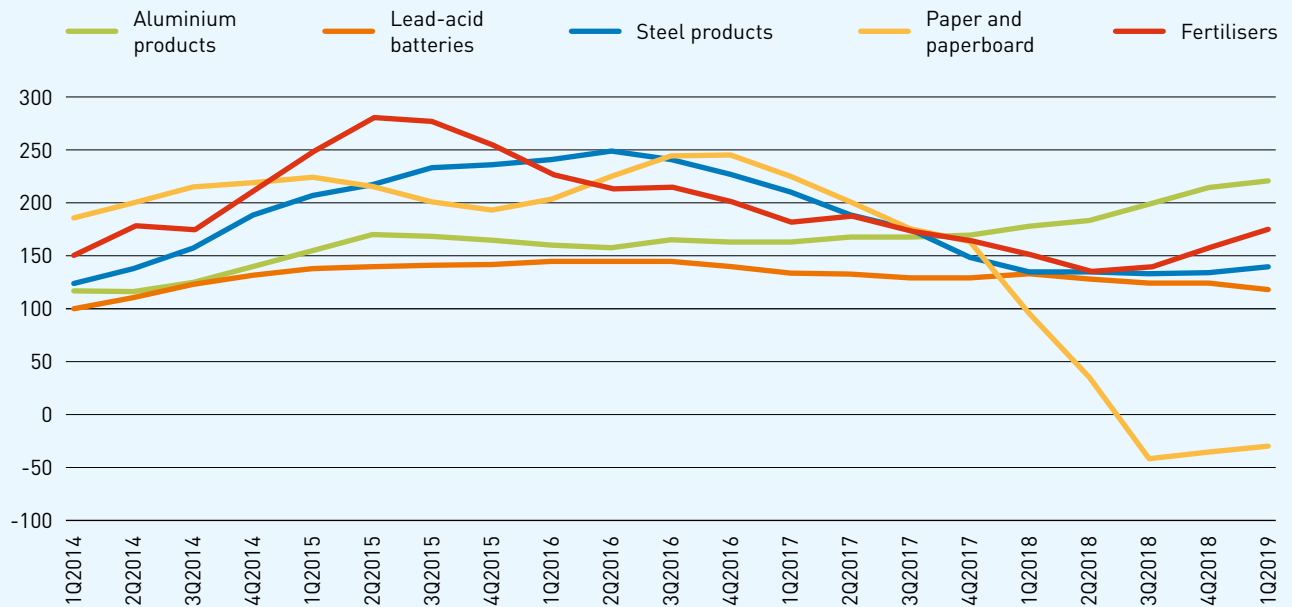
Trade data from China also reflects the exports of Chinese overcapacity. Quarterly data since 2014 show that China's net exports in overcapacity sectors have increased substantially by volume since 2012. Although comparative data on overcapacity is limited and not fully available up to 2019, the three sectors for which overcapacity and trade data are available show that the build-up in overcapacity correlates with a substantial growth in exports in steel (241% of 2012 levels by Q1 2016), paper & paperboard (203% of 2012 levels by Q1 2016) and aluminium (160% of 2012 levels by Q1 2016). While steel and paper & paperboard volumes both peaked in 2016 and decreased since then, aluminium exports have continued to grow. In the first quarter of 2019 steel exports dropped to 140% of 2012 levels, paper & paperboard dropped to -30% of 2012 levels, whereas aluminium grew to 221% of 2012 levels.

The growth in net exports of aluminium corresponds to a substantial increase in China's production of aluminium, as is shown in the aluminium case study below. Since joining the WTO in 2001, China's production in aluminium grew from 13% of global production to 56% – or more than half – of global production in 2018. When comparing global production with the latest year for which Chinese overcapacity figures are available (2015), Chinese overcapacity in aluminium in 2015 was as high as 34% of aluminium production by the rest of the world. While this is only one example for which comparative data are available, it would be generally useful to know which sectors, upstream or downstream, are currently or likely to be affected similarly in order to formulate appropriate policy responses.

<sup>164</sup> European Union Chamber of Commerce in China, *Overcapacity in China: An Impediment to the Party's Reform Agenda*, 2016.

### Trade and overcapacity

Change in China's net exports in overcapacity sectors by volume by four-quarter rolling sum, index value (4Q2012=100)



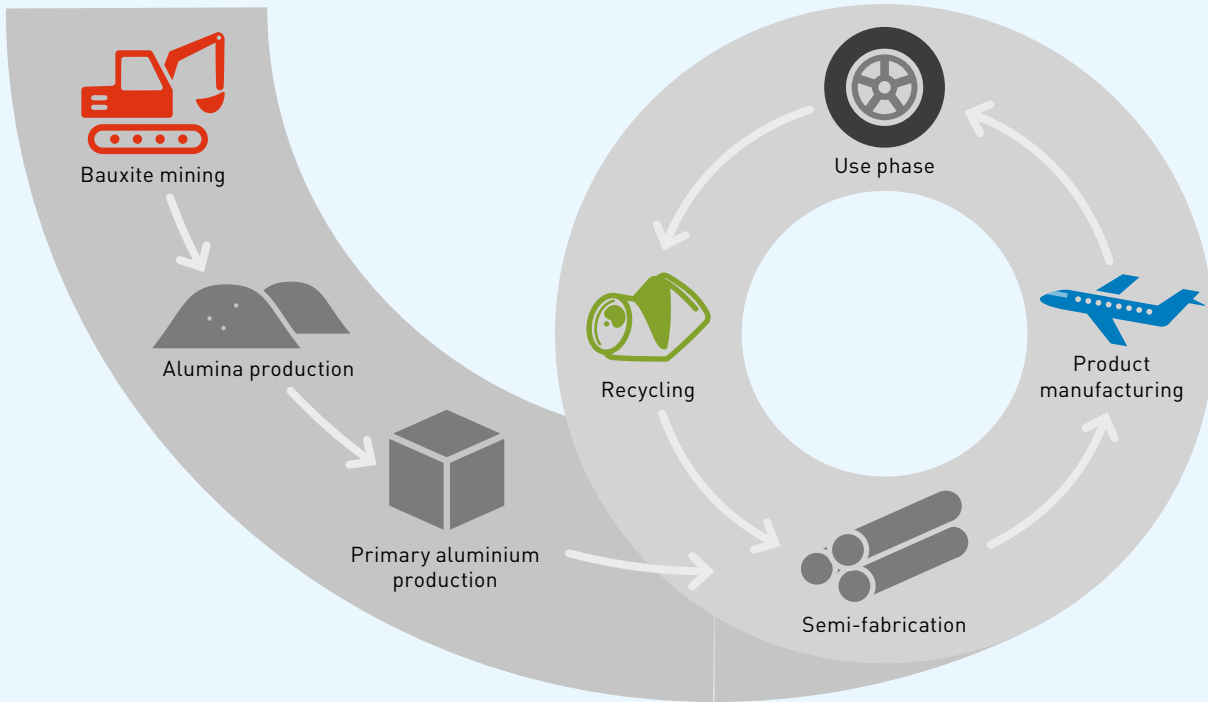
Source: Asia Society Policy Institute China Dashboard, 2019

### Case study: the aluminium sector

In January 2019, the OECD published a report “Measuring distortions in international markets: the aluminium value chain”. The study demonstrates that Chinese state support has contributed to the development of aluminium overcapacity in China. The OECD has established that of the up to USD 70 billion subsidies provided over 2013-2017 to 17 international companies examined, 85% went to 5 companies – all of them Chinese.

The aluminium value chain can be broadly divided into upstream (up to the primary production, i.e. aluminium smelting) and downstream (production of semi-fabricated products).

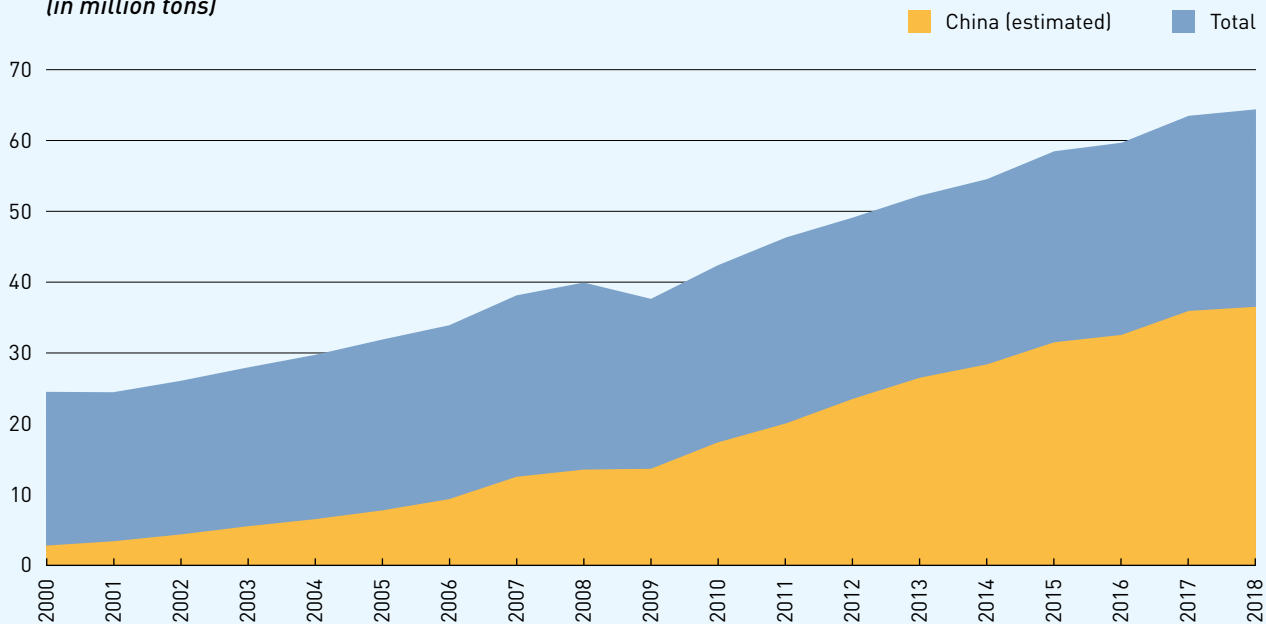
**An overview of the aluminium value chain**



Source: European Aluminium

In 2000, China stood for 10% of global primary aluminium production. By 2018 this figure rose to 53%. In parallel, Chinese primary aluminium overcapacity reached 10 million tons in 2017. For comparison, European Union’s production of primary aluminium stands at 2.2 million tons – nearly 5 times less. Chinese overcapacity in semi-fabricated products has been multiplied by 4 since 2008.<sup>165</sup>

**Global production of primary aluminium**  
*(in million tons)*

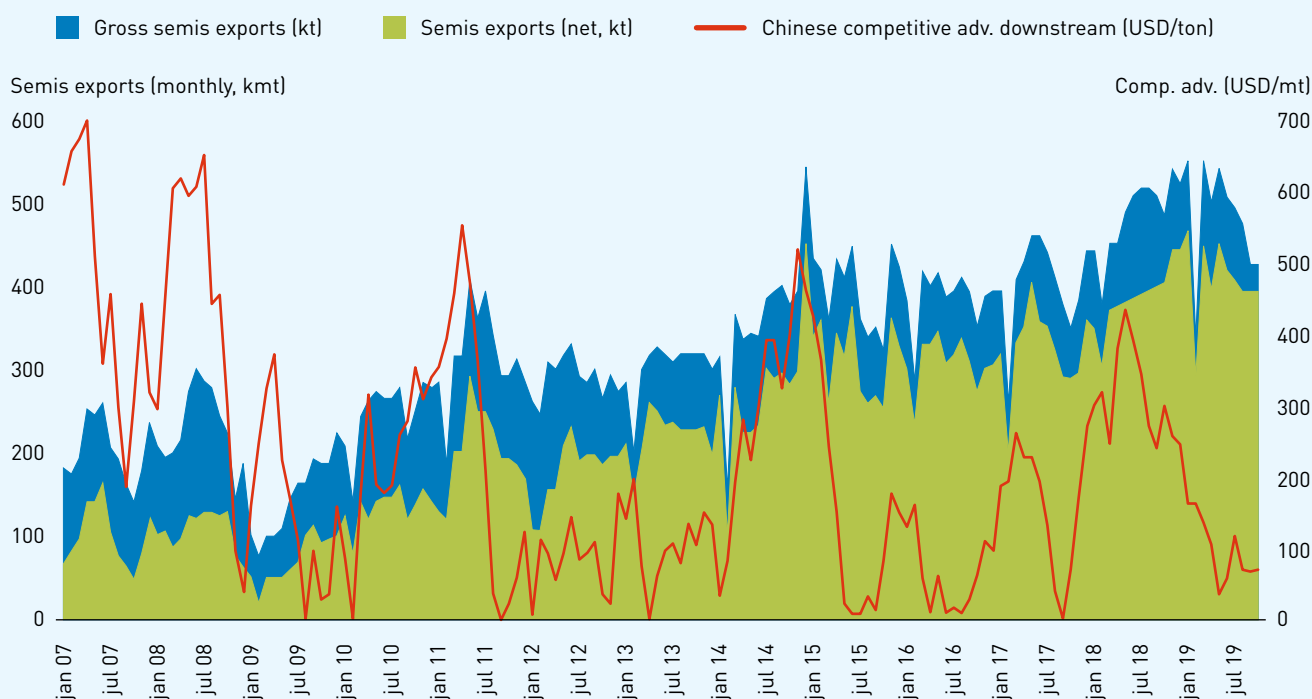


Source: International Aluminium Institute, 2019

Aluminium, as oil, is globally priced. The price of aluminium has experienced a decline since 2011. In the European Union and North America, this price decline corresponded to a fall in the profitability of aluminium producers and led to aluminium smelter closures. However, despite higher input costs in China, Chinese aluminium-producing firms appeared not to have been affected and showed solid profit margins. This suggests the use of state intervention stimulating company profits and leading to capacity growth in China. It also contributes to the vicious circle of overcapacity further depressing global prices and hurting company profitability even further. While no figures are readily available in this case study, we can assume that it would also have consequences on employment in the EU.

Overcapacity makes primary aluminium cheaper domestically in China, thus benefitting development of Chinese downstream industries that use these products as inputs. Lower production costs for semi-fabricated products have in turn translated into lower export prices that have made China more competitive in most segments of the market. This is equally true for exports of products containing aluminium, for example car wheels, bicycles and shower curtains. Such exports are detrimental to aluminium demand outside China, further challenging market balances and global prices, as well as manufacturing value chains outside China.

### Exports of semi-finished aluminium products out of China continue at record levels



Source: Norsk Hydro calculations based on Chinese customs and multiple journalistic sources, 2019

According to the OECD report, the non-market forces that drive overcapacity include a wide range of state intervention, which might help explain the persistence of overcapacity in the aluminium industry. At a broad level, this includes all policies that directly or indirectly favour increases in capacity that are not market-driven, either by encouraging the construction of new smelters or preventing the retirement of older ones:

- **Financial support provided by SOEs (to SOEs).** The provision of financial support appears to be prevalent in the Chinese aluminium industry. Subsidies, and subsidised bank loans in particular, prevent the exit of less productive firms hit by shocks. In the OECD study, Chinese aluminium SOEs have attracted the vast majority of all financial support provided to sampled companies, although two large private firms also benefitted from support from state-owned banks. State influence in China is especially evident in the area of financing, with companies able to borrow from banks and other state-owned financial institutions on terms that are much more favourable than those available on private markets. State enterprises thus play a role as both recipients and providers of support in China.
- **Input subsidies provided by SOEs (to SOEs).** For example, Chinese SOEs provide inputs such as coal, alumina, or electricity to other companies at below-market prices. However, it is difficult to identify the specific policies underlying these sorts of practices due to the opaque relationship between the government and companies in China.
- **Targeted policies supporting exports of downstream products.** Chinese policies, on the one hand, discourage exports of primary aluminium while on the other hand, they encourage exports of downstream products through VAT rebates for exports. This has negative impact throughout the value chain on importing markets like the EU due to lower demand for locally manufactured products.

## How to move forward

Overcapacity, while not a new or uniquely Chinese phenomenon, occurs predominantly in China. China's overcapacity is driven by various reasons, and government attempts to curb it have produced limited results. At the same time, new industrial policies such as Made in China 2025 risk creating overcapacities in additional sectors, unless the drivers of overcapacity are addressed properly. The impacts are manifold, both on China and the global economy. The EU, China and other trading partners should therefore work together to do their utmost to eliminate the drivers of overcapacity.

There are also several barriers to addressing overcapacity that make it harder to move forward and effectively tackle the issue. These include local subsidies and protectionism, whereby local governments want to attract investment and grow their GDP. The threat of social unrest also looms large in provinces where industries mired in overcapacity are a major source of employment. Most importantly, however, the way in which the government continues to intervene in the economy from multiple angles makes any singular policy effort difficult and requires a broad effort.

Reducing government intervention and enhancing reciprocal market access for European and other foreign business would greatly enhance China's ability to overcome problems of overcapacity. It would contribute to China's declared objective of transitioning to a more sustainable, market-driven economy as highlighted in the 'Decision on Some Major Issues Concerning Comprehensively Deepening the Reform' in 2013.<sup>166</sup> The EU and other governments should continue to engage with China in order to help China in eliminating its overcapacity. The EU should move in parallel, however, to prevent and mitigate the negative consequences on European business and develop plurilateral efforts to develop rules to restrict government-induced market distortions.

<sup>166</sup> Communist Party of China, "[Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform](#)", 2014.

**DEMANDS**

- 77 THE EU SHOULD ENGAGE CHINA TO TAKE FURTHER STEPS TO SET AND PUBLISH GOALS TO REDUCE EXCESS CAPACITY THROUGH LEGAL AND MARKET METHODS AND TO STOP DUMPING ITS OVERCAPACITY ON FOREIGN MARKETS.** Otherwise there is a risk that this overcapacity knocks out entire industries in Europe and ultimately leads to trade defence measures and other policies. While China has undertaken efforts to restructure its overcapacities in steel, the country remains the largest exporter of those overcapacities in absolute terms.
- 78 THE EU SHOULD ALSO CONTINUE ENGAGING IN PLURILATERAL DIALOGUES LIKE THE G20 AND OECD GLOBAL FORUM ON STEEL EXCESS CAPACITY.** The G20 is the political forum where outreach efforts to eliminate overcapacity can best be deployed. It is unfortunate, however, that China withdrew from the Global Forum on Steel Excess Capacity on 23 October 2019. As a major contributor to steel overcapacity, China should be encouraged to re-join the forum. The EU should also take a leading role to ensure that the OECD forum makes concrete progress and adopts binding commitments to remove market-distorting policies that contribute to excess capacity.
- 79 THE EU SHOULD ENGAGE LIKEMINDED PARTNERS IN ORDER TO LAUNCH PLURILATERAL NEGOTIATIONS ON ELIMINATING GOVERNMENT-INDUCED MARKET DISTORTIONS.** This should be done in parallel to other bilateral and multilateral efforts to address the issue of overcapacity. A plurilateral approach of this kind could help bind members to new rules on government-induced market distortions, something which is lacking in the current WTO framework.

## 4.4. COMPETITION AND STATE AID

### Competition policy

The lack of a level playing field poses a serious challenge for European companies as Chinese companies do not play under the same rules, leading to unfair competition. As discussed, this does not only negatively impact European businesses competing in China, but it also affects the level playing field in the EU Single Market and in third markets. In order for European companies to remain competitive at a global level, the EU should put in place a smart implementation of EU competition rules to ensure that effective competition between companies exists that contributes to job creation, growth and investment. It should also address the global challenges which businesses are facing in order to boost their and the EU's overall competitiveness.<sup>167</sup>

### The role of competition policy and merger control

European business supports a strong competition policy. We clearly recognise the fundamental role that well-functioning competition rules play in the Single Market and in a market-oriented economy, both in terms of limiting distortions and ensuring efficiency and innovation by protecting consumer choice and allowing competitors to enter new markets. Furthermore, EU competition policy is one of the few areas where the EU has extra-territorial teeth.

EU merger policy as such does not prevent the creation of large companies but its impact in influencing companies' strategic decisions should not be underestimated. Even though the vast majority of concentrations subject to EU merger control are cleared unconditionally (90% of all mergers), various transactions have also been abandoned and notifications withdrawn, possibly in view of a likely prohibition or significant remedy requirements.<sup>168</sup>

In recent debates, the suggestion has been made that relaxing EU merger review conditions is necessary to allow for greater European market concentrations in the context of increasing global and Chinese competition. Allowing greater European market concentrations would however not necessarily mean that European companies would be better able to compete with Chinese giants. After all, Chinese companies – in particular SOEs – would continue to benefit from state subsidies and many Chinese companies would still be protected from foreign competition on their domestic market through various market access barriers.

The EU Merger Regulation, relevant notices and guidelines, and the existing body of case law and practice, give the Commission enough discretion to identify all the competitive constraints that merging firms face and any changes to the substantive test and other provisions in the Merger Regulation would create new uncertainties, nullifying some of the well-established case law, and increase existing discretion. This would be inappropriate in view of the legally sub-optimal procedures under the EU Merger Regulation with limited external and internal controls. Instead, the Commission should explore how EU competition policy can adapt to developments on global markets and where necessary change relevant notices and guidelines.

### Evolving markets and market definitions

Regarding the definition of markets, overall the Commission defines geographic markets correctly, setting the right framework to assess competitive constraints from outside the EU. However, the Commission should identify on the basis of objective and transparent criteria, whether there are situations where it should put more weight on the global market environment when assessing certain concentrations, while bearing in mind overall market developments as well as competition within the internal market. For example, in cases where the merging parties compete outside the EU and where third-country competitors do not (yet) have business activities or revenues in the EU, enough consideration should be given to the global market environment. By not properly taking the global market environment and dynamics into account and by focusing too much on

<sup>167</sup> For more information, see BusinessEurope, *"Improving EU Competition and State Aid Policy"*, 2019.

<sup>168</sup> BusinessEurope, *"Improving EU Competition and State Aid Policy"*, 2019.



immediate effects in the EU, or on narrow geographical markets, the Commission may put EU companies at a disadvantage, preventing them from achieving greater scale and technological leadership which enables them to compete at global level. It should also be explored whether the Commission is sufficiently flexible when appraising efficiencies from mergers.

## **Analysing and offsetting competition distortions**

In the Commission's strategic outlook on the EU-China relationship, the Commission announced they should assess how to fill existing gaps in EU law with regard to the distortive effects of foreign state ownership and state financing in the internal market. This has become even more relevant in the light of recent mega-mergers of Chinese SOEs (see chapter '4.1 State-owned enterprises').

It is key that the Commission monitors and analyses the competitive risks from the recent increase in market concentrations in China and the implications on the competitive landscape, as discussed in the chapter on SOEs, as well as the impact of any foreign government support that could be granted. The average asset size of industrial SOEs increased from RMB 923 million in 2008 to around RMB 2,300 million in 2017.<sup>169</sup> The EU needs a granular effective monitoring system to evaluate the potential competitive risks of increasing market concentrations and concentrated foreign control of industries.

The Commission should take account of the various forms of public subsidies (e.g. export subsidies, loans, funding of state-owned companies, etc.) that companies from outside the EU enjoy. These subsidies are most relevant when assessing both markets' dimensions (as they may allow companies from outside the EU to sell globally, while EU companies often cannot, thereby giving the impression of the market being smaller) and market players' power on the same markets (as companies benefitting from public subsidies might consequently have much stronger market power). A bottom-up fact-finding exercise, with the help of company information, would be key to build a picture of the situation and should be implemented immediately.

## **State Aid**

State subsidies, market protection and unfair trade practices that infringe market-based principles give an unfair competitive advantage to competing firms. To counter this, the EU needs effective state aid control. In the EU, we need more coherent application of the rules at national level. At international level, we need strengthened rules to address market-distorting subsidies, including indirect industrial subsidies in the form of tax cuts, cross-subsidisation, cheap sovereign loans to state-owned enterprises and/or inflated procurement prices paid by local public authorities.

EU state aid rules have usually arranged for a level playing field within the EU, without ensuring also a level playing field for EU companies competing worldwide. The existence of a so-called "*matching clause*" in some situations (e.g. the Research, Development and Innovation framework) aims at compensating for the distortive third-country subsidy. However, this clause has never been applied, because there is a lack of data regarding aid granted by third countries to competitors. This reinforces the need for a fact-finding exercise, as stressed above. In any event, support received by competitors from non-EU countries should not only be considered in the context of the level of aid granted to the EU firm (as covered by the matching clause) but more generally to achieve an accurate assessment of the overall competitive environment.

Work needs to be done to improve the scope and implementation of relevant WTO rules and the Commission should address this issue in the context of free-trade agreements. The global situation should also be particularly taken into account in the context of cluster policy, and particularly the fact that other regions of the world, like the USA, India and China have very supportive cluster policies.

<sup>169</sup> Ross Garnaut, Ligang Song and Cai Fang (edd.), "*China's 40 Years of Reform and Development 1978-2018*", 2018.

## DEMANDS

**80 THE EU MUST ENSURE A SMART IMPLEMENTATION OF EU COMPETITION RULES THAT PROTECTS CONSUMERS WHILST ENSURING THAT EU COMPANIES CAN ALSO COMPETE AT GLOBAL LEVEL.**

At the same time, the EU should ensure that the administrative and procedural framework of EU competition proceedings is sufficiently speedy, transparent and proportionate.

**81 THE COMMISSION SHOULD IDENTIFY WHETHER THERE ARE SITUATIONS WHERE IT SHOULD PUT MORE WEIGHT ON THE GLOBAL MARKET ENVIRONMENT WHEN ASSESSING MERGERS.**

At the same time, the Commission should bear in mind overall market developments as well as competition within the internal market. By not properly taking the global market environment and dynamics into account and by focusing too much on immediate effects in the EU, or on narrow geographical markets, the Commission may put EU companies at a disadvantage, preventing them from achieving greater scale and technological leadership which enables them to compete at global level.

**82 IMPROVE MERGER PROCEEDINGS.**

Merger control proceedings before the European Commission take a long time and are disproportionately burdensome. Excessive information and document consultation must be reduced to a manageable level and the often lengthy pre-notification meetings should not be the rule. There should be a proper due process and effective checks and balances in the system. Internal checks should involve a complete and impartial re-examination of both the procedural and the substantive aspects of a case and access to these bodies should not be limited as this prevents them from being an effective impartial arbiter throughout the proceedings. Existing checks and balances should be strengthened and institutionalised. This should not lead to longer procedures.

**83 THE EU MUST FIND SOLUTIONS TO MITIGATE EXTERNAL DISTORTIONS AND ENSURE FAIR COMPETITION IN THE GLOBAL CONTEXT.**

The EU must use all existing platforms to mitigate the disturbances in competition caused by policies and practices in third countries, including China. This assessment should both address disturbances in the the EU Single Market as well as on external third markets. DG Competition, the European Competition Network (ECN), the Council of the EU's 'Working Party on Competition' and all other relevant actors should actively work together to assess whether our existing instruments are adequate and effective where actions by third countries are causing market distortions. There should also be consistency between different EU policies so that they converge towards common objectives.

**84 THE EU NEEDS TO BETTER ASSESS THE MARKET POWER OF (LEGALLY INDEPENDENT) COMPANIES THAT ARE ASSOCIATED WITH EACH OTHER AND/OR OPERATE IN A COORDINATED MANNER (SINGLE ECONOMIC ENTITY).**

A major risk is posed by Chinese acquisitions conducted by formally and legally independent investors who, however, act in a coordinated manner within the framework of the Chinese government's central economic planning (in particular SOEs). In such a case, European competition authorities should diagnose and combat market power. The competition law instruments should be used to address this new global challenge. To this end, the EU should monitor and analyse the risks to competition from increasing Chinese market concentrations, also taking into account that formally independent undertakings may operate in a (state-influenced) coordinated manner (single economic entity).

- 85** **EU RULES ON HORIZONTAL COOPERATION SHOULD ENCOURAGE COMPANIES TO COLLABORATE TO CARRY OUT JOINT RESEARCH AND DEVELOPMENT AND TECHNOLOGY DEVELOPMENT, ACHIEVE OBJECTIVES OF OTHER EU POLICIES, OR MAKE MORE EFFECTIVE BIDS FOR CONTRACTS.** Especially in the age of Industry 4.0, joint research projects or collaborations through industry platforms play an important role. Consortia of companies would be eligible for tender, enabling it to bid for the larger contracts that have become more and more regular. The Commission should therefore give clear guidance on how companies can enter into such arrangements in order to compete more effectively without falling foul of competition rules.
- 86** **THE EU SHOULD STRENGTHEN EU STATE AID RULES TO ADDRESS MARKET-DISTORTING SUBSIDIES OUTSIDE THE EU:** Work needs to be done to improve the scope and implementation of relevant WTO rules and the Commission should address this issue in the context of free-trade agreements. The Commission should continue its active work on making trade agreements with substantive provisions on state aid, also with a view to enforcing them. These are important steps towards better subsidies control which takes the global dimension into account.
- 87** **THE EU MUST ENSURE THAT STATE AID POLICY SUPPORTS INVESTMENT IN LARGE RESEARCH AND INNOVATION PROJECTS THAT CONTRIBUTE TO GROWTH, JOBS AND EU GLOBAL COMPETITIVENESS:** This will allow European companies to effectively compete on the global (digital) markets. In addition, the promotion of so-called IPCEIs (“Important Projects of Common European Interest”), joint projects in key technologies such as microelectronics, battery cell production or the “low-carbon industry” requires a broader approach and faster approval.

# 05

## REINFORCE THE EU'S OWN COMPETITIVENESS

With technologies increasingly able to influence economic, societal and political outcomes, we are witnessing a clear acceleration of the global innovation race. Despite its many assets, Europe is falling behind in this race. The EU is losing its relevance on innovation for the benefit of the Chinese market. The EU's share of the world gross expenditure on R&D had decreased from 25.8% in 2000 to 20% in 2018. Over the same period, China's share has increased from 5% to 21%.<sup>170</sup> The EU must deepen the Single Market, develop an ambitious industrial strategy, invest more in R&D and stimulate digitalisation to maintain a competitive edge.

## 5.1. A COMPETITIVE SINGLE MARKET AND AMBITIOUS INDUSTRIAL STRATEGY

A supportive business environment is crucial for providing a basis for the creation and expansion of firms. The EU only ranks 29<sup>th</sup> on average in terms of the overall ease of doing business (compared to 8<sup>th</sup> for the USA and 46<sup>th</sup> for China).<sup>171</sup> Although the EU still ranks higher than China in terms of the overall ease of doing business, the EU is steadily losing its competitive position in comparison to other major economies. Completing the Single Market (in particular its digital aspects), a strong industrial policy and reducing the regulatory and administrative burdens for business are essential to provide the domestic base from which new companies can develop economies of scale to compete globally.

### The *renaissance* of the Single Market

The EU's competitiveness in the global economy stems from internal competition and efficiency gains in a well-functioning, open and harmonised EU Single Market. The free movement of capital, goods, services, people and data on the Single Market not only enhances the competitiveness of the EU, but also generates economic leverage, both to the EU as a whole and to its members individually. However, there are numerous data pointing to lack of integration and the potential still unused (2.28% of EU GDP in services, or 1.8% of EU GDP with full application of the mutual recognition principle in goods).<sup>172</sup>

One issue that showcases the lack of Single Market integration is that European start-ups struggle to scale up their business operations across the EU. It is highly complicated to expand and grow in the EU as the Single Market remains scattered in certain areas. In comparison to other major economies such as the USA and China, the EU performs poorly with regards to high-growth firms that have reached a USD 1 billion market value within a short time frame from start-up - the so-called 'unicorns'. The EU has not matched other regions when it comes to developing such firms, with the number of unicorns founded since 2010 amounting to only 29 in the EU, compared to 139 in the USA and 81 in China. Moreover, the average value of EU unicorn firms is USD 2.1 billion, only about half that in China (USD 4 billion) and the USA (USD 3.6 billion). This illustrates the challenges that the EU has with scaling up its enterprises.

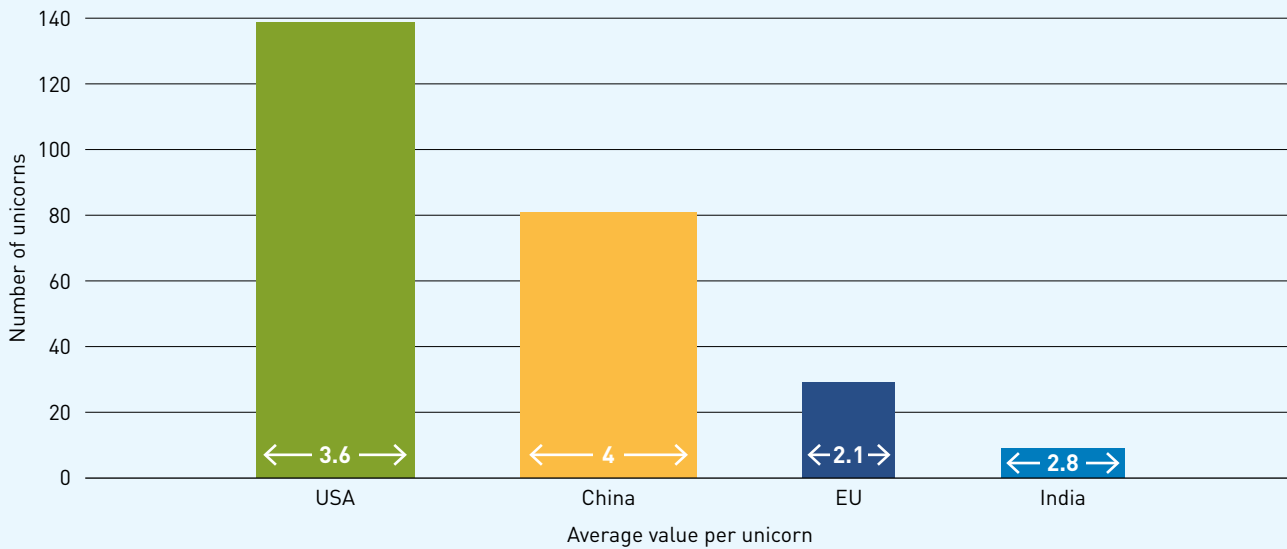
Completing the EU Single Market is pivotal, to create economies of scale and to compete successfully with our main competitors such as China. The EU should therefore put the completion of the Single Market back on top of the EU agenda.

<sup>170</sup> European Commission, "[Science, Research and Innovation Performance of the EU](#)", 2018.

<sup>171</sup> World Bank, "[Doing Business 2019: Training for Reform](#)", 2019.

<sup>172</sup> European Parliament, "[Contribution to Growth: European Digital Single Market](#)", 2019.

**Number and average value of unicorns by region**  
 Width shows average valuation of unicorns (in billion USD billion)



Data until November 2018. Source: CB Insights and BusinessEurope, 2018

## An ambitious industrial strategy

A more pro-active approach is necessary. This does not mean that Europe should become inward-looking or become more like China by applying a *dirigiste* industrial policy. Europe must not enter a new era of interventionism where the state 'picks the winners', thereby limiting and hindering other business action and competition as a whole.

Instead, the EU should concentrate its efforts on improving the framework conditions that incentivise companies of all sizes to improve their performance, ability to scale, invest and safeguard the EU's economic resilience. Furthermore, it needs to foster industrial cross-border cooperation and networks around value chains that are key to the EU's industrial competitiveness and strategy autonomy. For instance, the work around microelectronics, batteries, low-carbon industries, hydrogen or cybersecurity is important to position the EU in areas of key technologies. This more strategic approach should pave the way for a pooling of public and private resources, including investment, at the critical phase of moving technologies from labs to first industrial deployment and commercialisation. This is the moment when public support may be necessary to fill the financial gap to overcome market failures. In this way, the EU can equip itself to compete successfully with China and other countries in the context of an increasing competitive global economy.

## Reducing regulatory and administrative barriers

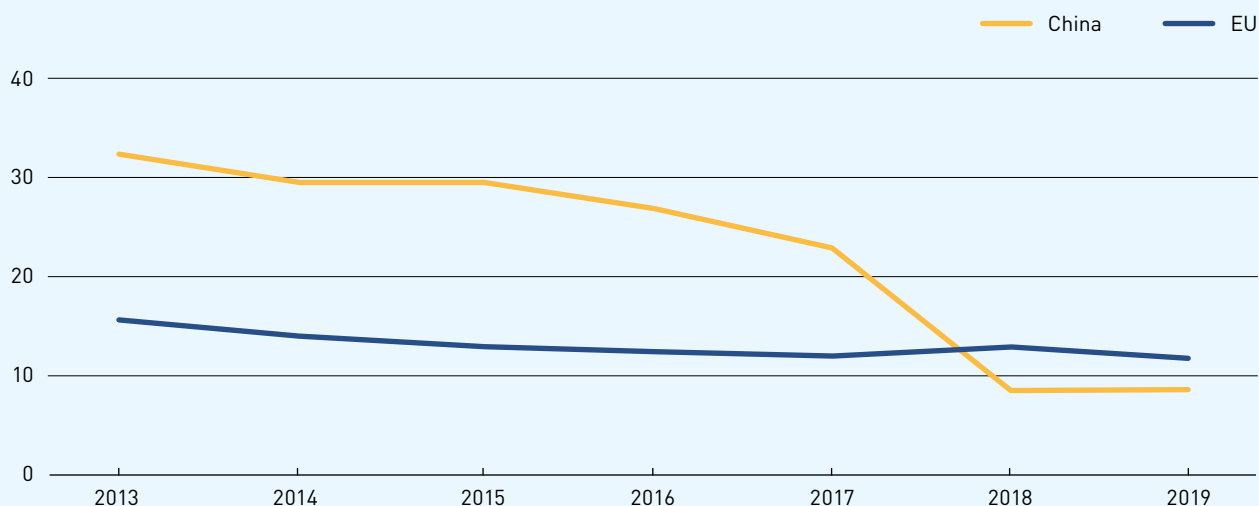
Businesses continue to experience regulatory and administrative hurdles when doing business in the EU and in the EU Member States. Administrative complexity, regulatory heterogeneity and different approaches, for example, in consumer protection, cause barriers to trade and burdens for European businesses, while reducing choices for consumers. At the same time, China is rapidly catching up with the EU in terms of fostering a conducive regulatory business environment, potentially impacting the EU's long-term competitiveness.

While China's business environment is strongly confined by barriers such as forced technology transfer and a distortive state aid system, in some areas it is nowadays easier to do business in China than in the EU. The ease of starting a new business is one key indicator of the overall ease of doing business in an economy. While China's competitive landscape has made rapid advancements in terms of time and costs required to start a business, the EU can do more for a conducive business environment. In 2019, China ranked 27<sup>th</sup> out of 190 economies in terms of the ease of starting a business, while the EU only ranked 65<sup>th</sup>.<sup>173</sup>

The days required to start a business in China have declined from 29.4 days in 2014 to 8.6 days in 2019. In the EU, the days required to start a business in the EU have only declined from 13.6 days in 2014 to 11.9 days in 2019.<sup>174</sup>

### China has exceeded the EU with regard to time required to start a business

*Time required to start a business (days)*



Source: World Bank, 2019

Within the EU, regulations furthermore differ across national borders. This regulatory heterogeneity damages the EU's ability to foster a dynamic business environment which allows companies to benefit from economies of scale. Revisiting the example of the ease of starting a business, it takes 3.5 days to start a business in the Netherlands, whereas the same process takes 37 days in Poland.<sup>175</sup> Similarly, the number of procedures required to legally start and formally operate a business also vary significantly amongst EU Member States. In Sweden, there are 3 procedures on average to be completed when starting a business, while that number is three times higher in Germany as there exist 9 procedures on average. When it comes to actual implementation of EU Single Market rules and administrative practices, it is even more complex.

Meanwhile, China has introduced a single form for entrepreneurs to obtain a business licence, an organisation code and tax registration. Beijing furthermore streamlined the company registration process and launched portals for online company registration, simplifying the procedures for starting a business and fostering a more dynamic business environment.<sup>176</sup> It is essential for European businesses that the EU does not lag behind in this regard. However, in practice it remains challenging to obtain a business license and requires companies to engage with multiple government departments through a convoluted process.

<sup>173</sup> World Bank, "[Doing Business 2019: Training for Reform](#)", 2019.

<sup>174</sup> World Bank, "[Time required to start a business](#)", 2019.

<sup>175</sup> World Bank, "[Doing Business 2019: European Union report](#)", 2019.

<sup>176</sup> World Bank "[Doing Business 2019: China report](#)", 2019.

The EU must enhance its regulatory environment to maintain regulatory competitiveness. The better regulation principles should, for example, be applied more consistently to prevent high administrative and regulatory burdens for companies, in particular SMEs.

## DEMANDS

- 88 DEEPEN THE EU SINGLE MARKET.** This is essential to help provide the domestic base from which new companies can develop economies of scale and compete globally. This is essential also to further integrate markets for goods and services, including logistics and network services, and ensure a barrier-free framework that helps wide-scale roll-out of digital technologies. Consistent policy-making is necessary so that decisions do not hinder digitalisation and, likewise, choices on digital do not undermine the Single Market freedoms.
- 89 DEVELOP A MORE STRATEGIC EU INDUSTRIAL POLICY.** Business and public authorities will need to collaborate to support and co-invest more intensively in strategic areas for Europe's future global competitiveness and strong autonomy in critical technologies and infrastructure. In that regard, the work on strategic value chains by the Strategic Forum on Important Projects of Common Europe Interest (IPCEI) should be further developed, in clear and transparent process. The EU's industrial policy should aim to improve the framework conditions that incentivise companies of all sizes to invest, innovate and grow.
- 90 REGULATION AT EU AND NATIONAL LEVEL SHOULD FOLLOW BETTER REGULATION PRINCIPLES TO MINIMISE REGULATORY AND ADMINISTRATIVE BURDENS.** Compared to China and the USA, the EU is steadily losing ground in terms of regulatory competitiveness. Competitiveness proofing, including an SME test and full use of the innovation principle, must be an integral part of the ex-ante impact assessment for all legislative proposals.
- 91 EUROPEAN BUSINESS CALLS ON THE EU AND EU MEMBER STATES TO HARMONISE NATIONAL REGULATIONS AS MUCH AS POSSIBLE, WHILE KEEPING IN MIND THE PROPORTIONALITY AND NECESSITY PRINCIPLES.** Regulatory asymmetries make it challenging for companies, in particular start-ups, to develop economies of scale. The EU and the EU Member States must harmonise regulations as much as possible and based on better regulation principles, or otherwise rely on the mutual recognition/country of origin application. This should go hand in hand with facilitating business start-ups and stimulating company expansion.
- 92 THE EU SHOULD STRENGTHEN THE IMPLEMENTATION AND ENFORCEMENT OF LEGISLATION BEHIND OR – IF NECESSARY – AT THE EU BORDER.** EU companies comply with stricter regulations and standards, while products coming from abroad do not always comply with the same rules. Improving implementation and enforcement would also advance the level playing field.



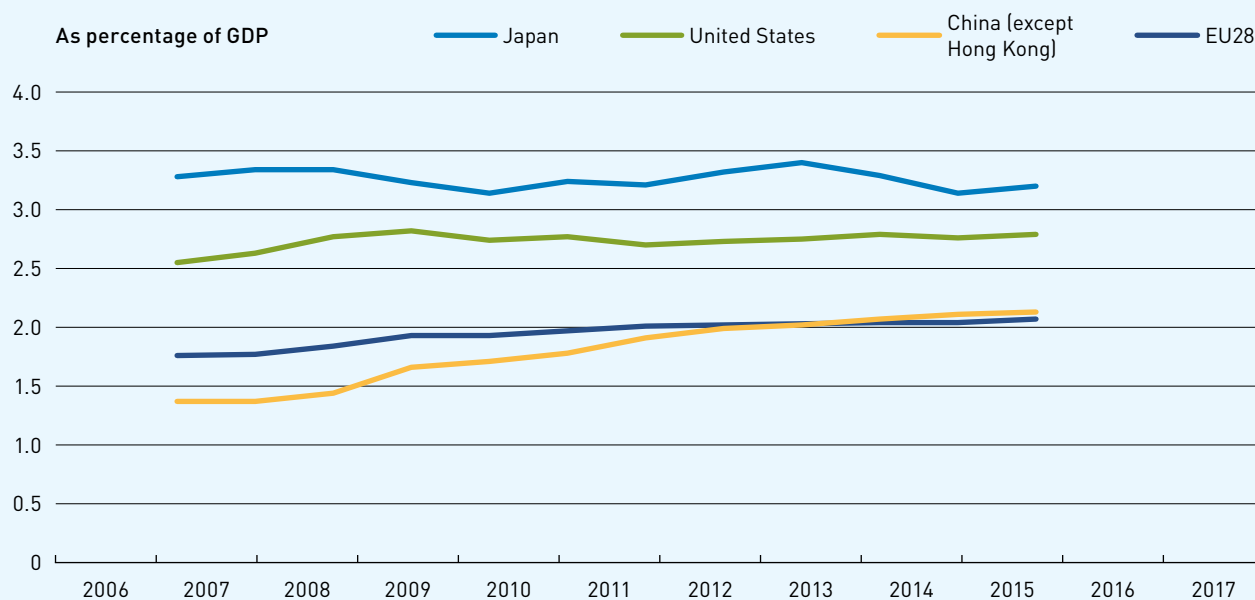
## 5.2. RESEARCH AND INNOVATION

With technologies being increasingly able to influence economic, societal and political outcomes, we are witnessing a clear acceleration of the global innovation race. Despite its many assets, Europe is falling behind in this race. On the other hand, China is becoming a powerhouse in some key areas of research, development and innovation.

Gross expenditure on R&D within the EU was equivalent to 2.07% of total GDP in 2017. This figure is disappointing when compared to other countries such as South Korea (4.55%), Japan (3.20%), the USA (2.79%). In terms of R&D intensity (R&D expenditure as percentage of GDP), China spends 2.13% of its GDP on research and development, which is relatively equal to the EU's R&D intensity.<sup>177</sup>

### China nowadays outspends the EU in terms of expenditure on R&D

Gross domestic expenditure on R&D (GERD), 2006-2017



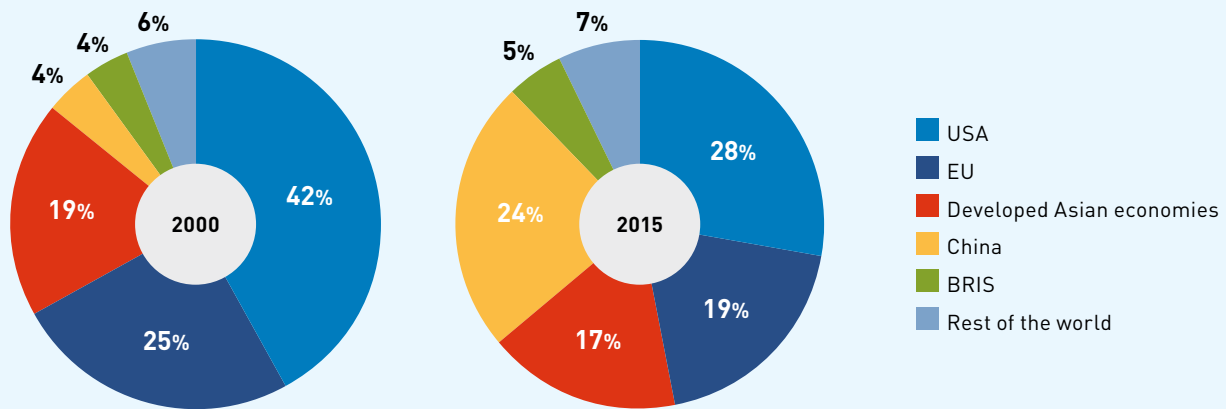
Source: World Bank, 2019

However, the EU is losing its relevance on innovation for the benefit of the Chinese market. The EU's share of the world gross expenditure on R&D had decreased from 25.8% in 2000 to 20% in 2018. Over the same period, China's share has increased from 5% to 21%. As of today, the EU accounts for less than one fifth of the world's business investment in R&D, whilst China accounts for 24%.<sup>178</sup>

<sup>177</sup> Eurostat, "R&D expenditure in the EU increased slightly to 2.07 of GDP in 2017", 2019.

<sup>178</sup> European Commission, "Science, Research and Innovation Performance of the EU", 2018.

**World business enterprise expenditure on R&D**



Developed Asian economies refer to Japan, South Korea, Singapore and Taiwan / BRIS refers to Brazil, Russia, India and South Africa  
 Source: European Commission, 2018

Raising EU public funds and making EU framework programmes (FPs) for research and innovation more attractive for European companies, drafting and implementing a ‘fit-for-innovation’ regulatory framework, developing and attracting skilled people, enhancing collaboration and cooperation with international partners are essential elements in order for the EU to remain competitive.

**More and smarter public funding**

One of the main concerns for European business is that the EU might fall behind and that China’s RDI expenditure will outperform the EU’s expenditure. Therefore, there is an urgent need for the EU to scale up public spending on RDI to realise the EU objective of allocating 3% of GDP to research and development.<sup>179</sup>

The EU should, for example, ambitiously increase the budget of EU framework programmes for research and innovation. The FPs play a crucial role in leveraging investment, boosting innovation and funding excellent research. While the FPs only make up for a small proportion of the total public investment in RDI in the EU - about 10% of public R&D investment,<sup>180</sup> they are decisive for companies’ investment decisions. According to the European Commission, each euro invested through Horizon Europe, the 9<sup>th</sup> FP, can potentially generate a return ranging from €10 to €11 over the same period (2021-2027).

In June 2018, the European Commission proposed a total budget allocation of EUR 94 billion to Horizon Europe. Whilst this budget proposal represents a raise of 29% from Horizon 2020, the European business community calls for matching the strong policy ambition with an equally ambitious budget, increasing the financial envelope to at least EUR 120 billion (in constant prices). Anything below is considered neither sufficient to address the EU’s innovation deficit, nor for competing with other third countries such as China.<sup>181</sup> Public funding is a vital piece in the RDI puzzle, with evidence that government funding in RDI crowds in private-sector funding and stimulates total investment on RDI. In this regard, European business welcomes that European Commission President Ursula von der Leyen called on the European Parliament to “significantly modernise” the EU budget for RDI in the new Multiannual Financial Framework in order not to fall behind on our competitors – most notably the USA and China.<sup>182</sup>

<sup>179</sup> For more detailed policy recommendations, see BusinessEurope, “*BusinessEurope views on maximising the impact of EU research and innovation programmes*”, 2017.  
<sup>180</sup> European Commission, “*Key findings from the Horizon 2020 Interim Evaluation*”, 2017.  
<sup>181</sup> For more policy recommendations, see BusinessEurope, “*BusinessEurope comments on Horizon Europe*”, 2018.  
<sup>182</sup> European Commission, “*Speech by European Commission President Ursula von der Leyen in the European Parliament plenary on the occasion of the presentation of her College of Commissioners and their programme*”, 2019.

## Better stimulate business to perform and fund RDI

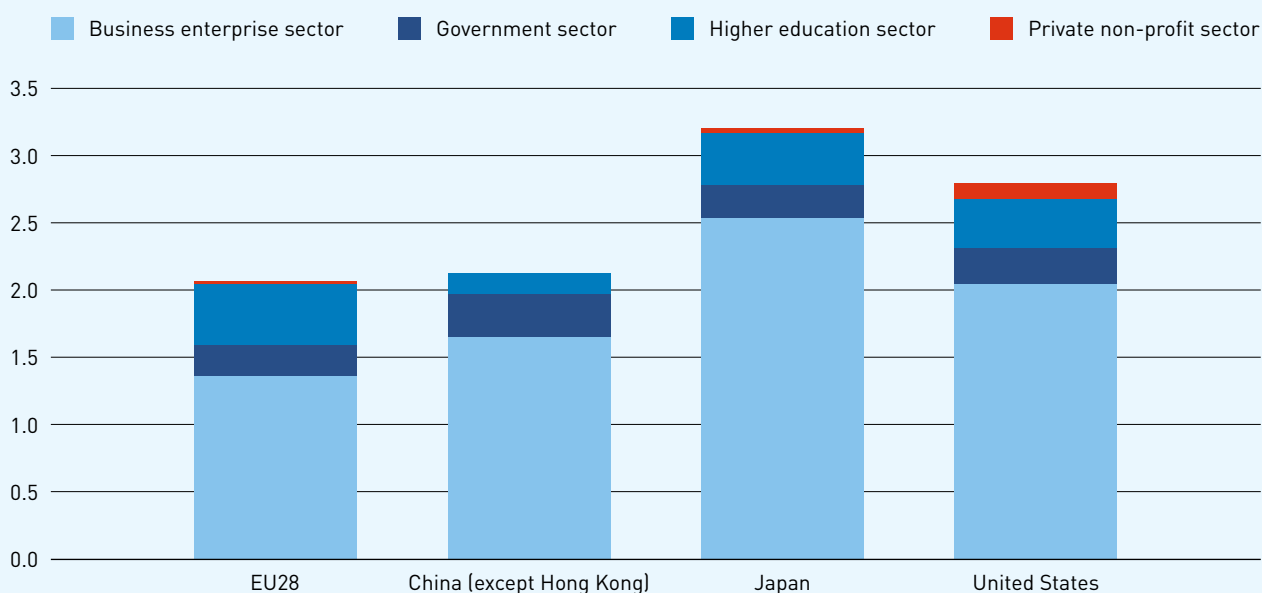
The participation of businesses in RDI projects is of pivotal importance for the successful commercialisation of innovations. However, China is currently outperforming the EU both in terms of business performance of R&D (which can be funded by the public sector) and business funding of R&D (which can be performed by non-business entities). In 2017, 66% of all R&D activities within the EU were performed by the business enterprise sector, equalling a value of 1.36% of GDP. However, business performance was significantly higher in China (1.65%) and the USA (2.04%) and was even higher in other countries such as South Korea (3.62%) and Japan (2.53%).<sup>183</sup>

The Chinese business sector is not only performing more R&D, but also funding more R&D than European companies. Although the distinction between the public and the private sector is highly blurred in China, Eurostat data illustrate that in 2016, 76% of all R&D costs in China were financed by the business sector, while in the EU only 57% of all R&D expenditure is funded by the business sector.<sup>184</sup>

For the EU to remain competitive, it is essential to stimulate business expenditure on RDI and business funding of RDI as much as possible as business is the main driving force to translate research into innovative products. The EU should engage the private sector more vigorously to speed up efforts in overcoming the 'valley of death' – the gap between the research work and the commercialisation phase.

In doing so, EU programmes should be made attractive to companies. To reach this objective, more emphasis should be put on the "Global Challenges and European Industrial Competitiveness" pillar and key-enabling technologies (KETs). These are the essential technology building blocks which underpin Europe's global leadership in various industries. In light of their relevance and in response to Made in China 2025, companies call for more budget and targeted policies for KETs.

**Gross domestic expenditure on R&D by performance per sector, 2017**  
(Percentage relative to GDP)

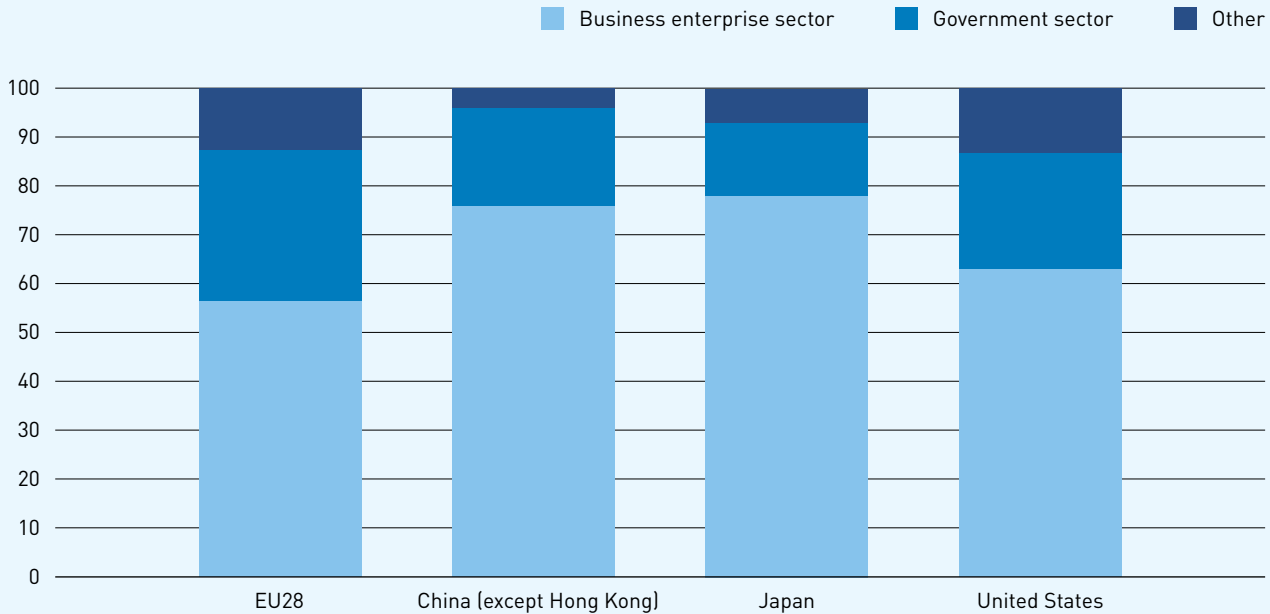


Source: Eurostat, 2019

<sup>183</sup> Eurostat, "R&D Expenditure", 2018.

<sup>184</sup> *Ibidem*.

**Gross domestic expenditure on R&D by source of funds, 2016**  
 (% share of total)



Source: Eurostat, 2019

### “Fit-for-innovation” regulatory framework

Innovation depends on many systemic factors, including the incentives and obstacles set by the existing regulatory framework.

Regulation is an important aspect of investment and planning for companies, because it guarantees stability and certainty. For instance, it was a well-designed regulation which pushed Europe to technology and market leadership in the early years of mobile telephony. However, if Europe wants to be competitive and develop its ‘third way’ of regulating new technologies, it needs to support an innovative regulatory framework. At this date, China’s technological and economic footprint grows, and so is its influence in shaping rules and attracting RDI investment.

In this perspective, the EU is equipped with one of the largest and most advanced regulatory architectures in the world, with the Single Market being one of the EU’s biggest success stories. At the same time, the diversity and complexity of this regulatory landscape runs the risk of stifling the ability of companies to innovate in certain situations, and therefore pushes companies to develop their RDI projects outside of Europe.

To encourage companies to make RDI investment in Europe, the EU should aim at fostering innovation when drafting and implementing new regulation. From a positive narrative for emerging technologies to full implementation of the innovation principle, from a closer involvement of industrial stakeholders to the adoption of innovative regulatory tools (e.g. sandboxes for RDI and innovation deals), EU companies believe that the EU could do a lot to foster innovation through regulation.

## Skilled people

European companies have difficulties in finding talented technical staff for RDI. Around 40% of European employers have difficulties in finding people with the skills they need to grow and innovate, creating substantial problems for recruiting and consequently major bottlenecks in companies' capacity to develop new offerings and businesses.<sup>185</sup> This strongly and adversely impacts Europe's RDI performance, as companies are more relaxed to invest outside of Europe, where the best universities and students are.

While the competence for the content of teaching and the organisation of education and training schemes lies with Member States, the EU business community believes that the EU could support national efforts to propose academic programmes that are designed to provide the skills required by companies. For instance, the EU should guide Member States to provide students with a basic understanding of business and digitalisation courses to be implemented at primary and secondary education level. Industrial PhD programmes should be strongly promoted, mobility encouraged, and future-proof vocational training supported.

In all these areas, the EU has a great potential to help Member States with joint goals, common tools for transparency, shared best practices and recognition of skills and qualifications. This would ultimately reduce the skills gap and bring Europe into a more comfortable position in the 'war for talent'.

## Intra-EU collaboration

Over the last years, the conversion of knowledge into innovative products, technologies, applications and services has become more complicated and has therefore pushed companies to collaborate with other entities (e.g. universities, research and technology organisations (RTOs), other companies, etc.) when developing their RDI projects.

The USA and China have long understood the potential of collaboration for RDI deployment, and have particularly supported knowledge clusters, such as the Silicon Valley and Shenzhen. In its 'Outline for a national Medium and Long-term programme for Science and Technology Development' (2006-2020), China set out its agenda on RDI, which – among its many objectives – also plans to expand international and regional science and technology cooperation and exchanges, so as to create an ecosystem able to encourage mass innovation and entrepreneurship.

Whilst the EU has a few but strong knowledge clusters (e.g. cyber-valley in the German state of Baden-Württemberg or the Brainport Eindhoven in the Netherlands), the EU community considers the EU should do more to foster collaboration. The objective should be to speed up efforts to overcome the 'valley of death' and the gap between the demonstration and commercialisation phases.

Horizon Europe's industrial pillar should for example be strengthened by, amongst others, enhancing public-private partnerships and joint technology initiatives and simplifying participation procedures to make European partnerships more attractive for companies. Also, to support industry scale-up and technology diffusion, a European approach to and shared vision of technology infrastructures is key.

<sup>185</sup> European Commission, "[Communication: A new skills agenda for Europe](#)", 2016.

## Third-country participation

Europe does not lack ideas. However, European front runners are often bought up by non-EU competitors – all along with their know-how, copyright and patents. We can explain this phenomenon in two ways: from an ‘internal perspective’, the necessary scale-up funding is missing and the Single Market should be further deepened. From an ‘external perspective’ targeted foreign industrial strategies and a distorted unlevel playing field play a role.<sup>186</sup>

While European RDI projects and funds are often open to third-country participants, China’s RDI projects and funds are mostly closed to foreign applicants. China’s National Medium- and Long-Term Programme for Science and Technology Development (MLP) promotes “indigenous innovation”, benefitting China’s domestic companies at the expense of foreign businesses. This could present a long-term challenge for foreign companies in China, whose products within supply chains may be substituted and whose access to the Chinese market may be challenged. The EU should encourage China to open its research and development projects equally to domestic and foreign parties to improve reciprocity.

The Horizon Europe programme sets out rules for third-country participation. International collaboration with countries that have a strong track record on science and innovation, such as China, is key. At the same time, it is important that partnering countries show similar levels of commitment as the EU to co-funding and access to funding, as well as to respecting and enforcing intellectual property rights.

More caution is also required regarding open research cooperation and open access to data with respect to critical industries. While acknowledging the potential benefits of making research data from public-sector research more widely available, caution is needed to avoid leakage of critical or sensitive research data. Open access to RDI projects and open access to data should not apply by default. Tailor-made approaches may be required, in which public and private partners contractually agree on a voluntary and case-by-case basis how data access should be managed.

### DEMANDS

**93 SCALE UP R&D BUDGETS AND SUPPORT PRIVATE-SECTOR RDI INVESTMENT IN ORDER TO REACH THE EU’S 3% TARGET.** To boost RDI, artificial intelligence and digital technologies, as well as protecting intangible assets, the post-2020 EU budget (MFF) must scale up public spending on RDI. The EU must ambitiously bolster Horizon Europe, the InvestEU programme and other initiatives that provide loans and guarantees to public and private RDI investors.

**94 INCREASE THE BUDGET OF HORIZON EUROPE.** The EU’s funding of Horizon Europe should be increased to at least **EUR 120 billion** (in constant prices). To leverage private investment and to address the EU’s innovation deficit in the context of the acceleration of the global tech race, 60% of Horizon Europe’s budget should be allocated to the ‘Global Challenges and European Industrial Competitiveness’ pillar. The EU should design a more ambitious programme to reflect that research, development and innovation are genuine EU priorities. In this context, a particular emphasis on KETs would make Horizon Europe more attractive to companies.

<sup>186</sup> European Political Strategy Centre, “*Rethinking Strategic Autonomy in the Digital Age*”, 2019.

- 95** **CREATE A ‘FIT-FOR-INNOVATION’ REGULATORY ENVIRONMENT TO OVERCOME THE “VALLEY OF DEATH” BETWEEN RESEARCH AND COMMERCIALISATION.** Regulatory efficiency and an industry-friendly Horizon Europe will contribute to the potential of commercialising research and innovation. In the framework of the better regulation agenda, the EU should fully implement the ‘innovation principle’ across the whole policy cycle. An important step to achieve this would be to make the use of the ‘innovation tool’ in the impact assessment process for all relevant new EU legislation mandatory, and at the same time give guidance on the relation between the innovation and the precautionary principles. Also, the EU should engage more proactively with stakeholders (including through regulatory sandboxes and innovation deals) to ensure EU legislation fosters innovation. Finally, there is a need for faster decision-making in order to avoid long legislative processes, e.g. the translation of documents into multiple languages.
- 96** **ENSURE THE SKILLS AND JOBS OF THE FUTURE BY INVESTING IN TRAINING AND EDUCATION.** Qualified specialists are needed to maintain and improve Europe’s competitiveness and its ability to innovate. Currently, there is a shortage of skilled workers, inhibiting the economic growth of the EU in the world economy. The EU should invest in education, including life-long learning and vocational education and training, to increase the quantity of qualified workers in all relevant areas, particularly in the fast-moving areas of technical and digital professions.
- 97** **ENHANCE COLLABORATION BY SUPPORTING EUROPEAN PARTNERSHIPS AND MAKING THEM MORE ATTRACTIVE FOR COMPANIES.** Because of the rising complexity and interdisciplinary nature of technologies, companies need to collaborate more. Also, the need to respond to societal challenges pushes companies to collaborate further and more often with new partners and sectors. While market forces should be the main drivers of R&D collaboration, the EU should play a role in fostering collaborative projects. The EU should for example support collaborative efforts by companies, by allocating the budget to partnerships and collaborative calls according to their technology content, objectives and expected impact. The business community should be consulted when designing policies to promote and improve future public-private partnerships.
- 98** **MAINTAIN OPENNESS AND COOPERATE WITH INTERNATIONAL PARTNERS IN RDI PROGRAMMES WHILE REQUIRING RECIPROCAL ACCESS TO CHINESE FUNDED RDI PROJECTS AND PROTECTING SENSITIVE AND CRITICAL RESEARCH DATA.** To achieve the greatest potential societal and economic benefits, research is an area that needs international cooperation to thrive. An open Horizon Europe, based on the principle of fair participation meaning fair access, will leverage a wider pool of talent, expertise, experience and resource to deliver better results. At the same time, the EU should demand fair access to Chinese R&I projects and more caution is needed to protect sensitive and critical research data. When European companies face discriminatory restrictions to third-country RDI markets, the EU should engage this third country to open its RDI market. As a measure of last resort and with the purpose of encouraging the third country to open its RDI markets, the EU should consider restricting access to the European RDI market for companies from the restrictive third country.

### 5.3. DIGITAL ECONOMY AND CYBERSECURITY

The EU's efforts should simultaneously improve the EU's digital competitiveness and strengthen European cybersecurity at home, while aiming to address digital protectionism in China.

On enhancing its competitiveness, the EU's efforts should aim at improving the EU's 'digital competitiveness'. The IMD World Digital Competitiveness Ranking measures the capacity and readiness of 63 economies to adopt and explore digital technologies as a key driver for economic transformation in business, government and wider society (100 = the most competitive, 0 = the least competitive). China climbed from the 38<sup>th</sup> position on the ranking in 2014 to the 22<sup>nd</sup> position in 2019. In its jump, China overtook the EU in terms of digital competitiveness in 2019 (China scored 84.3 points and the EU scored 82.2 points).<sup>187</sup> The EU must therefore significantly step up its efforts to remain a leading player in the digital economy.

Regarding digital protectionism, the EU should encourage China to abandon its digital restrictive policies and practices.<sup>188</sup> China is for example extremely restrictive in the area of digital trade. The Digital Trade Restrictiveness Index (DTRI) created by the European Centre for International Political Economy (ECIPE) measures to what extent countries restrict digital trade (0 = open; 1 = closed). This index shows that China is the most restricted country in digital trade in the world with a score of 0.70. The EU ranks 37<sup>th</sup> with a score of 0.21.<sup>189</sup>

Key principles for a healthy digital economy include openness and avoiding protectionism while upholding a global level playing field, protection of intellectual property, privacy and personal data as well as high cybersecurity measures. Governments should oppose digital protectionism, data localisation requirements and forced source code disclosure in return for market access, as these undermine the digital economy's global nature as well as business integration in global value chains. China's new data protection law should be carefully assessed to see whether it delivers on these goals. The global dimension of the digital economy also means that international standards, upholding cybersecurity and fair public procurement rules are ever more important.

Digital protectionism can be exploited to gain 'network effects' and create 'winner takes all' models. The asymmetries in market openness that accompany digital protectionism therefore create several risks and problems for European business. China has several policies in place to exploit these asymmetries.<sup>190</sup> Digital protectionism is one of the biggest economic and political challenges for European companies, as China intends to develop policies to open new growth markets amid a continuing economic slowdown and to achieve global leadership and self-reliance in the digital economy. At the same time, the EU should address the cyber-related risks and abuses companies experience as a result of government-sponsored cyberattacks.

The EU can only succeed in a digital world economy if it combines pro-competitive policies with tools that contribute to a global level playing field, address unfair behaviour, and tools that ensure cybersecurity.

<sup>187</sup> Own calculations based on IMD World Competitiveness Center, "[IMD World Digital Competitiveness Ranking](#)", 2019.

<sup>188</sup> See chapter '3.2 Trade' under sub-heading 'digital trade' for more information.

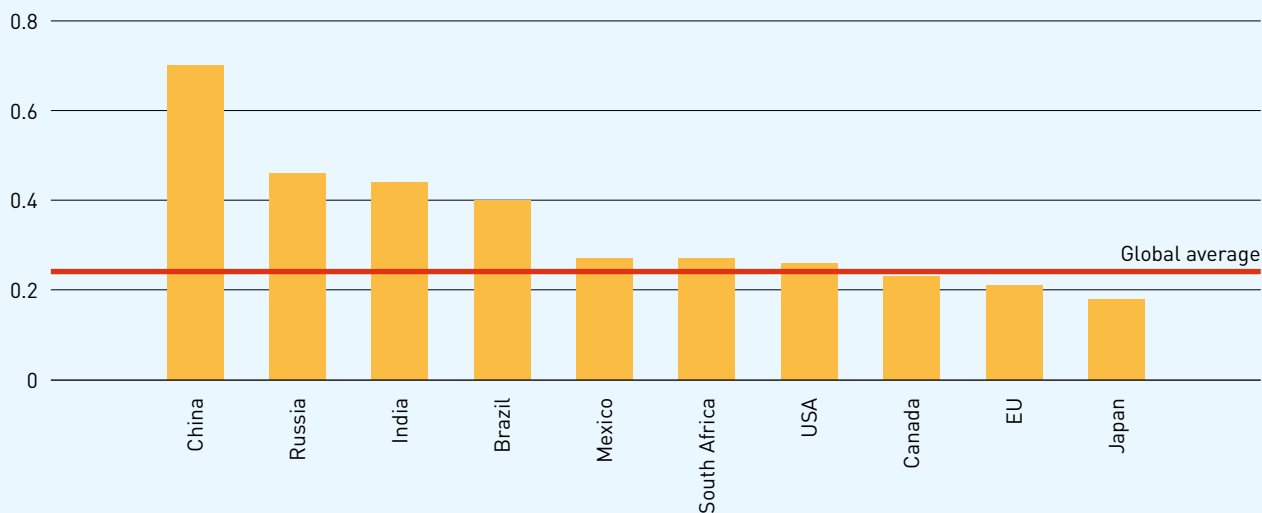
<sup>189</sup> European Centre for International Political Economy (ECIPE), "[Digital Trade Restrictiveness Index](#)", 2018.

<sup>190</sup> Mercator Institute for China Studies, "[China's Digital Rise: Challenges for Europe](#)", 2019, p. 44.



### China is the most restricted country in digital trade

Digital Trade Restrictiveness Index (1 = completely closed, 0 = completely open)



Source: European Centre for International Political Economy, 2017

## Within Europe

The right mix of enhancing our digital economy and deterring unwanted behaviour relies on a mix of pro-competitive policies and steps to address our vulnerabilities.

### Unlocking the EU's digital competitiveness

Europe needs a true digital transformation to increase its global competitiveness and deliver growth and jobs. If successful, Europe could see a gross added value worth EUR 1.25 trillion between 2015 and 2025 in manufacturing alone. To the contrary, if we fail to turn the digital transformation to our advantage, the potential losses can be up to EUR 600 billion by 2025 – the equivalent of losing over 10% of the EU industrial base.<sup>191</sup>

To achieve real 'digital competitiveness', the EU needs to enable businesses to reach their potential in the digital era, allowing innovation opportunities and providing legal predictability. The EU should invest in key enabling technologies such as artificial intelligence (AI), robotics, quantum computing, semiconductors, microelectronics and others. The EU also needs to invest in the digital skills of the workforce, as well as to foster trust through cybersecurity measures and knowledge through research, development and testing. Modern and efficient infrastructure is the starting point of a digitised economy, and a coordinated EU-wide cybersecure deployment of 5G and ultra-fast broadband networks are vital for this. And as the digital economy is increasingly borderless, the EU needs to provide leadership in shaping the global rules-based system that supports business integration through global value chains.<sup>192</sup>

5G is the catalyst of the next phase of this ongoing digital revolution. It will connect billions of machines and enable new technologies, such as: automation, robots, block chain, sensors, Internet of Things (IoT), AI, smart cities, future mobility, industry 4.0, financial services, content services, public services, eHealth. Moreover, 5G will result in more rapid innovations in nanotechnologies/advanced materials and micro-electronics. 5G will also have a major impact on cybersecurity. BusinessEurope welcomes the European Commission

<sup>191</sup> Compared to the 2015 baseline scenario in Roland Berger, *"The Digital Transformation of Industry"*, 2015.

<sup>192</sup> See BusinessEurope, *"Our Digital Ambition: priorities for 2019-2024"*, 2019.

recommendation on the cybersecurity of 5G networks and believes there are a number of actions that the EU and Member States can take to facilitate the roll-out of 5G while taking adequate measures to prevent harmful forces from undermining these opportunities or damaging trust.<sup>193</sup>

Artificial intelligence is another collection of technologies that offers tremendous potential for business transformation while helping us answer many of societal challenges. AI technologies are forecast to add up to USD 15 trillion to the global economy by 2030. It could support industry 4.0 and build on strengthening our world-class manufacturing sector through improving supply chain communication, harnessing data and cutting waste to answer developing consumer and business needs. It can support smarter cities through more efficient water supply, waste collection, lighting and indoor heating systems. AI has the ability to fight resource inefficiency faster through streamlining energy infrastructure and maintenance of supply. Healthcare is already being improved through AI to assist diagnosis and treatment of our ageing population taking strains off our health systems. The EU could for example invest in the healthcare infrastructure and in AI in the life science sector. China is increasingly becoming more competitive in this area as it is for example strongly incentivising digitisation and the development of AI solutions for its ageing population through the Chinese New Generation Artificial Intelligence Development Plan. The European business community has many recommendations that will enable the EU to take advantage of the opportunities provided by AI.<sup>194</sup>

Without the correct legal framework, the full potential of AI and the societal goals which it could deliver, will not be achieved. This represents a global competitive challenge. As other regions such as China race forward with a large market and relatively relaxed conditions within which to experiment, their technological leaps could be greater and faster as a result. Europe faces a choice, get the balance between open innovation and societal protection correct, or accept and welcome a future where it will be commonplace for a great number of sectors to buy superior AI solutions from third countries to achieve their ambitions.

### **Cybersecurity**

Improving our cybersecurity is also an important part in achieving the EU's digital transformation and fostering trust in our digital economy. At present, European businesses are increasingly falling victim to large-scale cyber-attacks stemming from non-EU countries aimed at misappropriating sensitive business information such as trade secrets and intellectual property. As a result, individual companies suffer irrecoverable damage.

Without effective legal means to mitigate cyber-related risks, the EU industry as a whole will see its competitiveness impaired and incentives to engage in innovation undermined. Damages resulting from cyber-enabled theft have been estimated at 0.41% of EU GDP, or EUR 55 billion.<sup>195</sup> Cyber-enabled theft is a global problem, and could affect our economic growth well into the future. Many EU Member States are grappling with the fast-paced increase in cyber threats, interconnectedness and lack of a European response.

Available evidence shows that China is among the major culprits in cyberespionage and that companies are frequently targeted. Known state-sponsored attacks target businesses almost as frequently as government institutions.<sup>196</sup> The EU lags behind in taking measures to detect and address industrial espionage and is behind other developed economies when it comes to protecting its IT environments. Alarm bells are sounding across the European business community as the risks are set to increase exponentially over time with the increased connectivity in IoT devices and greater reliance on digitisation of business processes. Indeed, developments in cloud computing could mean that an entire connected business, including equipment settings, operational schedules and production details, can be copied and pasted, stolen and handed over to a competitor within a few years.<sup>197</sup>

<sup>193</sup> See BusinessEurope, "[Cybersecurity of the 5G Ecosystem](#)", 2019.

<sup>194</sup> See BusinessEurope, "[Artificial Intelligence Recommendations](#)", 2019.

<sup>195</sup> Center for Strategic and International Studies, "[Net Losses: Estimating the Global Cost of Cybercrime](#)", 2014. The cost figure covers the year of the study, and could differ for other years.

<sup>196</sup> Mercator Institute for China Studies, "[China's Digital Rise: Challenges for Europe](#)", 2019, p. 40.

<sup>197</sup> European Centre for International Political Economy, "[Stealing Thunder](#)", 2018, p. 7.

Member States and the EU are considering their relationship with and strategy on China in the digital domain as tensions have recently reached a boiling point. The EU recently passed its Cybersecurity Act and created the European Union Agency for Cybersecurity (ENISA) which are key to face digital threats. However, they do not address cyber-attacks sponsored by third states targeting technologies, trade secrets and other confidential industrial information. The Cybersecurity Act will nevertheless lead to cybersecurity schemes that define minimum cybersecurity requisites. Once these schemes have been developed, companies in Europe will be able to declare the conformity of their products and services with these schemes in order to demonstrate vis-à-vis potential buyers that these products and services fulfil certain cyber-security measures. Additional measures are necessary, however, to deter cyberespionage from Chinese entities. Likewise, high-level political declarations between states can be toothless initiatives: only three years after the 'Obama-Xi Cyber agreement' for example, Apple/Amazon chips were hacked to spy on the US government.<sup>198</sup>

Most hacks occur through critical infrastructure such as broadband networks. According to MERICS, "the lack of nationwide standards for IoT devices, cheap and low-quality products from China pose a security risk to Europe, as has been shown in the past. The spread of unsecured Chinese devices is thought to have contributed to a massive increase in Distributed Denial-of-Service (DDoS) attacks in Europe."<sup>199</sup> The EU is now moving towards fully rolling out 5G and Member States are already contemplating how to do this safely. BusinessEurope welcomes the EU's proposal to agree on a coordinated approach regarding the security of 5G networks.<sup>200</sup> So far, however, no decision has been fully taken as how to fend off Chinese interference. Some Member States are more concerned with public security while others are wary of Chinese retaliation. The long-term damages from Chinese actions in this area are slowly being understood however, and companies are pushing governments more than ever before to find a solution. Even though risks of Chinese interference exist, Europe should continue to uphold its values and principles. This includes that the admission or exclusion of a company from our digital infrastructure must be based on transparent justifiable criteria (e.g. a combination of technical, economic, political and judicial considerations). In particular, the same (very high) security criteria must apply to all companies – regardless of their geographical origin.

The right mix of enhancing our digital economy and deterring unwanted behaviour relies on a mix of pro-competitive policies and steps to address our weaknesses. While the right mix of security measures such as security by design in the Cloud, IoT and 5G architecture, IoT certification and strong encryption are good examples of how cyber-resilience could be strengthened, these are very expensive solutions and will never be fully effective without an accompanying strategy to deter hostile actors. In other words, in the cyber-world defence is much harder than offence. Effective and pre-emptive policy responses should therefore be considered that prevent cyber-issues from emerging.

## Within China

### **China's objectives and policy measures**

China is pursuing a comprehensive digital strategy in order to unlock key drivers of economic growth. While in theory this could create business opportunities for domestic and foreign enterprises alike and hence, for both the Chinese and European economies, the objectives and policy measures adopted in support of China's digital strategy present enormous challenges for European business in their current form.

First, the Communist Party's dual objective of increasing control over all aspects of society and the economy means that digital policies are designed with this objective in mind.<sup>201</sup> This leads to an increasingly sophisticated and tailored approach of government interference into independent management and investment decisions. The quest for control also seriously undermines the protection of intellectual property, as China's Cybersecurity Law requires that companies hand over source codes and algorithms and forces them to store data within China, and proactively requires them to justify reasons for transferring data overseas.<sup>202</sup>

<sup>198</sup> Bloomberg, "[The Big Hack: How China Used a Tiny Chip to Infiltrate U.S. Companies](#)", 2018.

<sup>199</sup> Mercator Institute for China Studies, "[China's Digital Rise: Challenges for Europe](#)", 2019, p. 39.

<sup>200</sup> See BusinessEurope, "[Cybersecurity of the 5G Ecosystem](#)", 2019.

<sup>201</sup> The Independent, "[China national congress: Xi Jinping signals spread of state control over all aspects of people's lives](#)", 2017.

<sup>202</sup> This is a barrier for investment into China for many multinational companies, particularly for those sectors with technical and international supply chains for which it is essential that companies can easily and efficiently share data.

Second, China's pursuit of self-reliance and autonomy results in several discriminatory policies. A key objective includes industrial and economic upgrading, a relatively benign goal if it was pursued transparently and under fair conditions in which foreign businesses could participate as equal stakeholders. However, core elements of the Made in China 2025 strategy and the Digital Silk Road strategy outline "indigenous innovation" criteria aimed at excluding foreign companies from supply chains while simultaneously pursuing ambitious semi-official global market share targets of up to 70% in some sectors. This approach undermines fair competition and creates a zero-sum dynamic which leads to protectionist outcomes. A case in point is that China ranks first on the Digital Trade Restrictiveness Index.<sup>203</sup> Besides undermining a level playing field within China, the global market share targets also raise concerns about fair competition on third markets and on the European market.

Third, China's ambitious economic targets paired with the discriminatory policies outlined above lead to a number of problematic outcomes for European business. On the one hand, China employs a host of support measures for domestic companies, using government support, regulations and financing to ensure it achieves its digital strategy. This may include privileged access to procurement markets, exemption from or delayed implementation of regulations, preferred access to capital markets, bank loans, or investment from state-backed venture capital funds.<sup>204</sup> On the other hand, foreign businesses experience the flipside of the coin by being blocked from China's digital infrastructure, being prevented from accessing China's generous digital support programmes, facing discriminatory procurement practices, while experiencing forced technology transfers, data localisation requirements and theft of intellectual property.

### **China's Cybersecurity Law**

China's Cybersecurity Law came into effect on 1 June 2017. This is complemented by the Guidelines of the Cyberspace Administration of China (CAC) which deals specifically with cross-border data flows as well as several further acts of primary law, such as the Cryptography Law, and secondary legislation such as the Provisions for Cybersecurity Vulnerabilities Management. All these are wide in scope and require companies to adapt constantly to new legislative requirements. The scope of China's cybersecurity legislation is far-reaching. It entails targeting Internet security, protection of public and private information, cryptography, safeguarding digital sovereignty, smart home security and response reporting. It applies domestically but also on foreign markets. While many parts are similar to the EU directive on the security of Network Information Systems (NIS) and the General Data Protection Regulation (GDPR) in terms of incident reporting and consent to process data, certification procedures mean foreign companies have to disclose trade secrets for certain higher tiered equipment. The levels of tiering are still unknown and yet to be fully implemented. There is a concern that local companies will be treated with more lenient rules than foreign ones. This would be unfair compared to the EU's GDPR or Cybersecurity Act. Data localisation rules also oblige companies to prove that data being transferred abroad are necessary and that they perform security assessments prior to the transferral of any data, which further restricts the free flow of data.<sup>205</sup> This also restricts the possibility to fully harness the potential of new technologies, such as machine learning, for which huge quantities of data are essential to provide for precise predictions (e.g. predictive maintenance).

China's Cybersecurity Law places onerous restrictions on commercial encryption products that could adversely impact billions of euros in cross-border trade. Provisions in the new Cybersecurity Law and related measures that include broad data residency requirements and restrictions of cross-border data flows, trade-inhibiting security reviews and requirements for ICT products and services, forced transfer of technology, and broad requirements for data sharing and technical assistance raise serious concerns for companies with global operations. These measures will add costly burdens, restrict competition and may decrease product safety.

They also underscore the asymmetry between the access that Chinese companies enjoy on other markets and the access foreign companies have in China. For example, Chinese companies are generally able to fully own

<sup>203</sup> See chapter '3.2 Trade' under sub-heading 'digital trade' for more information.

<sup>204</sup> Mercator Institute for China Studies, "[China's Digital Rise: Challenges for Europe](#)", 2019, p. 16.

<sup>205</sup> *Ibidem*, pp. 23-24.

and control data centres and cloud-related services in Europe with no foreign equity restrictions or technology transfer requirements, and they can do so under their brand name and without any need to obtain a license. By contrast, such access is impossible for foreign cloud companies operating in China.

All countries have legitimate concerns about privacy and national security, but China is the principal country addressing these concerns by often requiring foreign companies to transfer their technology and to surrender their brand and operating control in order to do business. Requirements that are claimed by Chinese authorities to be neutral and non-discriminatory are instead having the effect of excluding foreign competitors who cannot meet them because of technology transfer, encryption and other requirements.

## DEMANDS

### Enhancing our digital competitiveness:

**99 ENHANCE AND INVEST IN THE EU'S DIGITAL COMPETITIVENESS.** To keep up with the large and dynamic digital markets in China and the USA, EU institutions and Member States need to further develop the European digital market and adapt the legal and regulatory frameworks in the single market. The size of the domestic market is a decisive factor for the international competitiveness of digital business models. In this regard, the EU should invest in key enabling technologies such as artificial intelligence, robotics, quantum computing, and others.

**100 INCREASED INVESTMENT IN DIGITAL INFRASTRUCTURE.** High-performance networks are key to the success of digitisation. Member States must also take a concerted approach to the security of 5G networks and their roll-out. They should encourage telecommunications providers to assess the strategic nature and cybersecurity of the equipment they use in 5G roll-out particularly for the most sensitive communications networks, namely defence ministries and secure networks for government communications.<sup>206</sup> This would require horizontal requirements for the suppliers of network equipment to ensure security along the value chain.

### Enhancing our cybersecurity:

**101 PURSUE A EUROPEAN APPROACH TO EUROPEAN CYBERSECURITY SCHEMES.** Rather than taking uncoordinated steps to be the first-in-class, EU Member States should coordinate their efforts to ensure that products and services on the European single market are cyber-resilient. To this end, a speedy and industry-driven development of cybersecurity schemes under the EU Cybersecurity Act is needed to develop standards against which the cybersecurity level of products and services can be declared. Priority should be given to developing an EU cybersecurity scheme on 5G infrastructure components.

**102 THE EU SHOULD ALSO PROMOTE AND PROTECT ITS CYBER DEFENCE INDUSTRY IN ORDER TO SAFEGUARD OUR INNOVATION FROM CYBERATTACKS AND CYBERESPIONAGE.** Public and private investments are needed to stimulate European cyber-defence businesses and start-ups. This is increasingly needed as the risk of state and non-state cyber-attacks and cyberespionage is growing.

<sup>206</sup> A one-sided focus on 5G risks being too narrow in scope. As more or less all traffic is offloaded to the fixed network, it is of equal importance that the backbone networks, consisting of optical fiber, are safe and secured. In particular, nodes must be protected and deployed in a way that enables robust communications. This is not the case today, leaving important parts of the network open for intrusion.

- 103 USE OUR STRENGTHS IN DIGITISATION.** The EU needs to become better at exploiting specific strengths, such as the strong demand for security and data protection. This can be achieved in part by upholding secure supply chains for core digital technologies and devising bottom-up strategically effective and autonomous digital policies to support them.<sup>207</sup> Cybersecurity and a high level of data protection must be turned into a competitive advantage in global competition.
- 104 IDENTIFY WHAT LEGAL OPTIONS EXIST TO ENHANCE THE PROTECTION OF THE EU AGAINST FOREIGN CYBER-THREATS.** To develop our capacities to deter and prevent state-funded cyber-espionage, the European Commission should launch a study to determine what legal options exist to deter states engaged in supporting, enabling, tolerating or neglecting the prevention of cyberattacks or cyber-intrusions and to hold them accountable when attacks or intrusions occur. The new EU sanctions regime to counter cyberattacks is a good step.
- 105 DEVELOP A DIPLOMATIC TOOLBOX TO DETER INSTANCES OF CYBERESPIONAGE:** As a pro-active response to the export of China's strategic industrial policy, European policy-makers should review their own European and Member State level powers to deter actors from carrying out cyberespionage. The European Commission could then coordinate possible actions and when they can legally be used and in what way. Going forward the Commission could coordinate Europe's response. This would ensure Europe has a full face answer to cyberattacks across the region in order to deter this wide-scale and growing issue.
- 106 THE EU SHOULD SPEAK UP MORE FREQUENTLY IN A COORDINATED MANNER THROUGH PUBLIC STATEMENTS AND FOLLOW-UP ACTIONS** to indicate that it will regard state-sponsored cyberattacks against EU companies as anti-competitive trade measures and therefore take measures when justified. Such signalling might discourage state-sponsored attacks targeting EU firms. Alternative non-legislative measures such as diplomatic action or economic retaliation could be considered to apply pressure on non-cooperative states.
- 107 THE EU SHOULD SEEK INTERNATIONAL SUPPORT IN TACKLING CYBERSECURITY ISSUES AND ENGAGE THROUGH INFORMATION-SHARING PLATFORMS FOR LIKE-MINDED PARTNERS THAT TRACK CYBERATTACKS** and pool resources to better adapt to developing trends and threats.

<sup>207</sup> Digital transformation needs to be addressed properly. Europe needs incentives for a large-scale migration to more secure standards. A low-hanging fruit is enabling of the latest Internet protocol called IPv6. Europe is falling short in terms of IPv6 users. Despite the fact that IPv6 include IPSec, which provides confidentiality, authentication and data integrity, telecom operators in Europe are lagging behind in adopting IPv6, leaving their customers to less secure solutions and less interoperability. Furthermore, it hampers the uptake of IoT. The public sector could lead the way by enabling IPv6 in all public services.

**Addressing digital protectionism:**

- 108 CHINA'S ICT MEASURES SHOULD BE NARROWLY DEFINED, REFLECT INTERNATIONAL NORMS, BE NON-DISCRIMINATORY AND CONSISTENT WITH WTO AGREEMENTS TO WHICH CHINA IS A PARTY.** They should not unnecessarily impose nationality-based conditions or restrictions on the purchase, sale or use of ICT products and services by commercial enterprises.
- 109 THE EU SHOULD ENCOURAGE CHINA TO COMMIT TO INTERNATIONAL STANDARDS IN THE DIGITAL ECONOMY.** This would also benefit Chinese companies seeking to access global markets. At the same time, foreign companies must be able to participate equally and reciprocally in standardisation work in China in the same way as Chinese companies can engage in standard setting in the EU (CEN/CEELEC, ETSI or at national level).
- 110 THE EU SHOULD SET UP A FORMAL MECHANISM TO ADDRESS CYBERSECURITY-RELATED ASPECTS WITH CHINA** in order to address our concerns. One of the objectives should be to press China to address commercial espionage outside and within its borders.



06

## ENSURE FAIR COMPETITION AND COOPERATION ON THIRD MARKETS

Besides achieving a level playing field in the bilateral economic relationship, extending this level playing field to third markets is of paramount importance for the long-term opportunities of European businesses. The EU's Connectivity Strategy is an important step in this regard, and emphasis should be placed on its proper implementation. At the same time, the EU should also try to engage China to ensure its Belt and Road Initiative meets international standards. Securing fair competition on third markets by upholding multilateral economic governance practices is vital.



## 6.1. EU CONNECTIVITY STRATEGY

Connectivity networks and business competitiveness are closely linked. Fostering European connectivity and improving the connectivity between the EU and the rest of the world are of essential importance. A well-functioning EU-wide transport infrastructure network is important to connect European regions and for the proper functioning of the EU internal market. Improving intra-European transport and infrastructure networks contributes to the competitiveness of the EU. Ambitiously improving the connectivity between the EU and Asia should be a key priority of the European connectivity strategy. Connecting transport, digital, energy, and human networks will facilitate bilateral trade by for example cutting transportation costs. This will benefit businesses and consumers in both the EU and China.

### The EU-Asia Connectivity Strategy and the EU-China Connectivity Platform

On 19 September 2018 the European Commission and the High Representative of the Union for Foreign Affairs and Security Policy adopted the joint communication ‘Connecting Europe and Asia – Building blocks for an EU strategy’.<sup>208</sup> This connectivity strategy promotes Europe’s engagement with its Asian partners through a sustainable, comprehensive and rules-based approach to connectivity, exploiting the existing and planned EU networks. The strategy aims to decrease the investment gap in connectivity by engaging private investors, national and international institutions and multilateral development banks.

European business welcomes the joint statement of the 21<sup>st</sup> EU-China summit in April 2019 as it included promising elements for forging synergies between the EU Strategy on Connecting Europe and Asia and the EU Trans-European Network for Transport (TEN-T) on the one hand, and China’s Belt and Road Initiative on the other hand. These synergies will further be discussed in the EU-China Connectivity Platform. European business calls on the EU and China to consider such synergies in close dialogue with business and other stakeholders.

### Larger investments in connectivity within the EU

EU connectivity starts at home. Even today, passenger transportation between two European capitals can be extremely difficult due to the poor availability of quality infrastructure. China is able to offer projects under non-market conditions to meet the infrastructure needs of the most Eastern and Southern European countries.<sup>209</sup> Unless the EU mitigates the impact of China’s government-induced distortions within the Single Market and enables sustainable alternatives, Member States might be incentivised to work with Chinese companies for infrastructure projects under unfair conditions. Consequently, this could lead to an erosion of confidence and hinder the call for ‘speaking with one voice’. The EU should also cooperate closely with key partners in the region such as Turkey, the Balkans and the Eastern Partnership to improve the connectivity with and within the EU’s neighbouring regions, ultimately stimulating the growth of trade and investment.

Currently, there is an investment deficit with regard to connectivity investments within the EU. This threatens the EU’s competitiveness vis-à-vis China and other competitors. The completion of the TEN-T core network will require approximately EUR 750 billion until 2030.<sup>210</sup> Italy for example – as a major exporter and a Mediterranean hub – needs to speed up shipments and to reduce an infrastructural gap at a cost level estimated of around EUR 70 billion per year (roughly 4% of GDP).<sup>211</sup> The completion of TEN-T should therefore remain a key priority.

European businesses support the European Commission’s proposal to renew the Connecting Europe Facility (CEF II) beyond 2020 under the new Multiannual Financial Framework. While CEF II by itself is not the only solution to Europe’s transport investment challenge, its renewal marks an important step towards reaching our future infrastructure needs. European business is however concerned that the budget dedicated to transport infrastructure has been reduced by 8% compared to the current CEF programme in terms of real

<sup>208</sup> European Commission, “*Connecting Europe and Asia: Building blocks for an EU strategy*”, 2018.

<sup>209</sup> See chapter ‘1.3 China Inc.’ for an overview of the types of distortions that affect these projects.

<sup>210</sup> European Commission, “*Delivering TEN-T*”, 2017.

<sup>211</sup> Confindustria, “*Italy, Europe and China: Recommendations for a new cooperation strategy*”, 2019.

value (i.e. adjusted to inflation).<sup>212</sup> As transport is one of the main enablers of economic growth and prosperity, the EU should abstain from reducing the CEF II budget. In fact, the budget should rather be increased. EU-wide multimodal transport infrastructure is needed for the EU's overall competitiveness and proper functioning of the internal market.

The EU should also bolster other funds that contribute to TEN-T and European connectivity in general. These include amongst others the InvestEU fund, the European Fund for Strategic Investment (EFSI) and the European Structural and Investment Funds (ESIFs). For the EU to remain competitive globally, it is essential that the EU budget for these connectivity funds is increased ambitiously under the new MFF.

## Larger investments in connectivity outside the EU

The Asia Development Bank has estimated that Asian economies need EUR 1.3 trillion a year worth of infrastructure investment until 2030 to maintain Asia's growth momentum and address the climate change challenge. This illustrates the enormous potential that European companies have on the Asian market. However, in comparison to China, the EU lags behind in funding the high infrastructural investment needs on Asian markets. The EU should make more funds available to support the connectivity strategy, leveraging private and commercial funds and investments.

The EU Strategy on Connecting Europe and Asia needs to be adequately funded. The EU's connectivity strategy – targeting not only Asia but the entire world – is funded by the EU external action budget. This budget has been increased to EUR 123 billion for the period 2021-2027, including an investment framework that amounts to up to EUR 60 billion. To put this into perspective, the total EU external action budget of EUR 123 billion roughly equals the amount that one individual Chinese bank, the China Development Bank, has already invested in loans to the Belt and Road Initiative.<sup>213</sup> There is a strong need to increase the EU budget for connectivity, while avoiding that this leads to massive public debts such as in China.

Besides the external action budget, the EU has several other financial means to finance its connectivity strategy. These include the Investment Facility for Central Asia, the Asian Investment Facility and the European Fund for Sustainable Development (EFSD). The EU should make more use of innovative, smart and multi-dimensional funding mechanisms and 'blending' to support its connectivity strategy. A successful funding strategy would leverage private investment in connectivity projects.

## Promoting the EU connectivity strategy

Only increasing the connectivity budget will however not necessarily lead to more successful connectivity projects in third countries. It is also essential that the EU promotes its connectivity strategy. This could partly be achieved through better branding. By bringing the EU initiatives together under a single, simple brand such as, for example, the **'Marco Polo Strategy'**, the EU could better promote its Connectivity Strategy. It is essential that the Connectivity Strategy is not only promoted by the European institutions in Brussels, but also by Member States and Member State representations in third countries. A more holistic approach is needed in this regard. The EU Connectivity Forum in 2019 was a good step in the right direction, but more needs to be done.

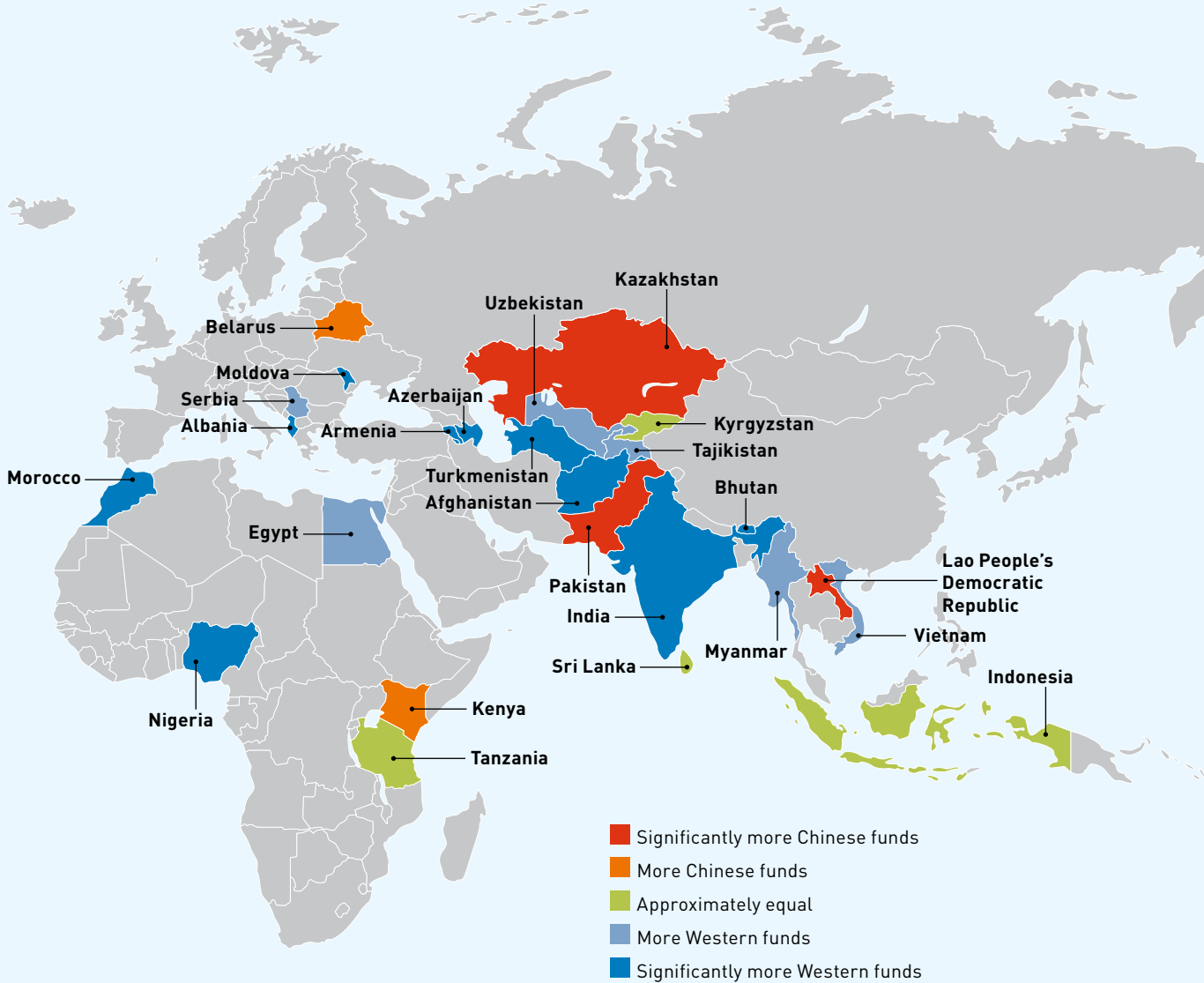
The EU is already one of the world's greatest donors and financial contributors to local development. The EU must ensure that funding and investment that fall under the scope of the EU Connectivity Strategy are adequately branded as such and are well communicated to EU Member States and companies. This is often not the case. According to the Bertelsmann Stiftung, Western countries outspend China in terms of FDI and official development assistance (ODA) flows in most countries in the 'Belt and Road region'.

<sup>212</sup> BusinessEurope, *"Transport infrastructure: The Connecting Europe Facility and the Trans-European Transport Network"*, 2018.

<sup>213</sup> European Institute for Asian Studies, *"Note of Comment on 'Connecting Europe and Asia'"*, 2018.

China only significantly outspends the West in Kazakhstan, Pakistan and Laos. At the same time, Western countries significantly outspend China in Afghanistan, Armenia, Azerbaijan, India, Morocco and Nigeria.<sup>214</sup> The perception, however, is vastly different. Therefore, the EU should communicate more clearly that it is a massive investor in third countries.

**Comparison between Chinese and Western official financial flows to various countries**



Source: Bertelsmann Stiftung, 2019

214 Bertelsmann Stiftung, "Was der Westen entlang Chinas neuer Seidenstrasse Investiert", 2019.

The financial contributions, however, are not branded using terminology that speaks to the imagination and is linked to a wider strategic narrative that covers EU values and interests. As a result, the EU struggles to bring attention to its instruments and companies are not always aware of existing opportunities.

It is essential that the strategy and approach to connectivity are well understood by partners in the region. A soft launch of the connectivity strategy and public diplomacy outreach with partners including Japan, Indonesia and other South and Southeast Asian countries would contribute to building bases for partnership. For example, the EU and India both focus on rules and normative aspects of connectivity, which is a good starting point for future cooperation. And Japan with its two continents, two oceans approach, is a major actor on connectivity in Asia and an important potential partner for the EU.

### Promoting high standards

As transport networks and business competitiveness are closely linked, European business encourages this cooperation, whilst emphasising that any form of cooperation should abide by the principles of market rules, transparency, open procurement, a level playing field, fair competition and high standards. Businesses view the joint statement of the 21<sup>st</sup> EU-China summit as reflecting the EU's values and international values. The real challenge lies in implementing these values and principles. Moreover, European businesses do not yet see the promises that China made at the 21<sup>st</sup> EU-China summit and at the 2019 Belt and Road Forum reflected in current Belt and Road projects. The EU should therefore continue to urge China to implement the principles of market rules, transparency, sustainability, open procurement, a level playing field, fair competition and high standards in their Belt and Road projects.

### Prevent possible transport bottlenecks and constraints resulting from the BRI

Lastly, the EU should prepare European transport corridors to facilitate the potential increase of traffic generated by China's economic growth and the Belt and Road Initiative. A study prepared by the European Parliament Directorate-General for Internal Policies for the TRAN Committee in 2018 assessed the opportunities and challenges for EU transport arising from the BRI.<sup>215</sup> European businesses support the recommendation from the study that "the TEN-T Corridor Studies [of the European Commission] should be reviewed periodically to take account of developments in the BRI and other relevant third-country initiatives". Additionally, to foster synergies with the BRI, the EU should use the EU-China Connectivity Platform to initiate EU-China joint studies to determine priority corridors analogous to those prepared for TEN-T. In this regard, the 'Joint Study on Sustainable Railway-based Comprehensive Transport Corridors between Europe and China' is a positive development.

### Engaging the private sector

The effectiveness of the EU connectivity strategy would benefit from structural input from the private sector and other stakeholders. Therefore, the European External Action Service (EEAS) should consider establishing a **Business Advisory Council** that will allow key stakeholders to discuss the implementation of the strategy and contribute to the strategy. Public-private partnerships should play an increasingly important role as they can enable a faster and more flexible delivery of transport projects. EU companies should also receive more information from the EEAS on how to benefit from EU funds related to the Connectivity Strategy.

<sup>215</sup> European Parliament, "[The new Silk Route – opportunities and challenges for EU transport](#)", 2018.

## DEMANDS

- 111 THE EU BUDGET FOR CONNECTIVITY MUST BE INCREASED AMBITIOUSLY UNDER THE 2021-2027 MULTIANNUAL FINANCIAL FRAMEWORK (MFF).** In order for the EU to remain competitive globally, the EU must increase the budget available for connectivity programmes such as TEN-T, InvestEU and the EU Strategy on Connecting Europe and Asia. Inside the EU, these funds include amongst others CEF II, the InvestEU fund and the European Fund for Strategic Investments (EFSI). Funding instruments that cover connectivity projects outside the EU and that should be bolstered include amongst others the Investment Facility for Central Asia and the Asian Investment Facility.
- 112 THE EU SHOULD BETTER DEMONSTRATE AND COMMUNICATE ITS EXISTING FINANCIAL CONTRIBUTIONS AND INVESTMENTS AND REBRAND THE CONNECTIVITY STRATEGY WITH A MORE ATTRACTIVE NAME SUCH AS THE 'MARCO POLO STRATEGY'.** The EU is already one of the world's greatest donors and financial contributors to local development but struggles to bring this to the attention of the public as the strategy suffers from a lack of effective branding and promotion. By bringing the EU initiatives together under a single, simple brand such as the 'Marco Polo Strategy', the EU could better achieve the aims of its Connectivity Strategy and make companies aware of the existing opportunities.
- 113 PROMOTE THE EU CONNECTIVITY STRATEGY IN THIRD COUNTRIES.** The EU will have to make sure that its strategy and approach to connectivity are well understood by partners in different regions. A soft launch of the connectivity strategy and public diplomacy outreach in partners including Japan, India and Southeast Asian countries will contribute to build bases for partnership.
- 114 THE EU SHOULD ONLY ALLOW FOREIGN COMPANIES TO EU-FUNDED CONNECTIVITY TENDERS WHEN EUROPEAN COMPANIES HAVE EQUAL ACCESS TO FOREIGN-FUNDED CONNECTIVITY TENDERS.** This means that foreign companies are welcome to bid on tenders related to the EU-Asia Connectivity Strategy, but only as long as European construction companies have equal access to foreign-funded infrastructure projects such as the BRI. The EU should ensure that such a measure would be legally feasible and that it would also have the objective to maintain the openness of connectivity projects as much as possible. Moreover, the EU should advocate for ambitious market access improvements in the exchanges and activities of the EU-China Connectivity Platform.
- 115 FOCUS ON IMPLEMENTATION AND FLEXIBILITY.** Businesses regard the EU-Asia Connectivity Strategy as comprehensive and a good reflection of the EU's values. The real challenge lies in implementation, particularly the funding of connectivity initiatives. The EU will have to make sure that different actors including Member States, financing institutions and the private sector are also integrated under this umbrella. The EU should continue to make more use of innovative, intelligent funding mechanisms and blending to leverage private investment.
- 116 TRANS-EUROPEAN (AND NATIONAL) INFRASTRUCTURE MUST BE SIGNIFICANTLY IMPROVED AND EXPANDED TO REMAIN COMPETITIVE.** EU connectivity starts at home. Remaining regulatory, administrative and technical barriers within the EU need to be removed to ensure necessary access to infrastructure facilities, inter-connections, inter-operability and to create an investment-conducive regulatory and financial framework.

- 117 THE EU SHOULD ADDRESS THE BELT AND ROAD INITIATIVE IN ITS TEN-T CORRIDOR STUDIES AND COLLABORATE WITH CHINA TO CONDUCT STUDIES TO DETERMINE PRIORITY CORRIDORS TO PREVENT POSSIBLE BOTTLENECKS AND TRANSPORT CONSTRAINTS.** The TEN-T corridor studies should be reviewed periodically to take account of developments in the BRI and other relevant third-country initiatives in order to prevent the emergence of bottlenecks and constraints resulting from the potential increase of traffic generated by the BRI. More generally, TEN-T policy should become more outward-focused to take explicit account of such initiatives.
- 118 INTENSIFY CONSULTATION AND DIALOGUE WITH BUSINESS AND OTHER STAKEHOLDERS THROUGH THE CREATION OF A BUSINESS ADVISORY COUNCIL.** The connectivity strategy is a good first step. However, the EU should extend its outreach to businesses and other stakeholders, particularly in the field of confidence building for small companies in relation to the available opportunities and to make sure the EU's connectivity approach is well understood. The EEAS should for example create a structural stakeholder platform that is easily and openly accessible to discuss the implementation of the strategy, to receive valuable input from business, and to share knowledge to increase the effectiveness.
- 119 IN ORDER FOR DIFFERENT EUROPEAN ACTORS TO HAVE A MORE COHERENT FOREIGN ECONOMIC DIPLOMACY, THE EU SHOULD SHARE EXPERTISE AND OPPORTUNITIES ON CONNECTIVITY-RELATED ISSUES WITH MEMBER STATES, AND VICE-VERSA, SO THAT THEY CAN TAKE IT INTO ACCOUNT IN THEIR FOREIGN ECONOMIC DIPLOMACY AT NATIONAL AND EU LEVEL.** Trade promotion activities are largely a national competence, and it would be useful if the EU and Member States shared their intelligence on connectivity with each other.

## 6.2. THE BELT AND ROAD INITIATIVE

The Belt and Road Initiative (BRI) was launched by President Xi Jinping at the start of his tenure in 2013. The initiative has become China's most important foreign policy strategy through which it aims to connect the Eurasian continent from China to Europe. During the past three years, BRI projects have focused primarily on land and maritime infrastructure investment, construction, railways and roads, automobile, real estate, e-commerce, and electricity networks.

The strategy underlines China's push to take a larger role in global affairs through the creation of a China-centred hub and spokes trading network. The plan's long-term geopolitical objective is to make the Eurasian continent under Chinese leadership an economic and trading area that rivals the transatlantic one. At present China holds just over USD 3 trillion in foreign exchange reserves, has a growing but slowing economy coupled with overinvestment during the global financial crisis, which produced growing levels of overcapacity in a number of industrial sectors. Consequently, China wants to expand its outbound investment, open up foreign markets for its companies, export its overcapacity abroad and foster political influence.

Estimations of the size of Chinese investment flows for the BRI vary according to different sources. MOFCOM states that the average investments in the BRI add up to about USD 15 billion annually.<sup>216</sup> MERICS estimates that China has in total invested more than USD 70 billion into BRI-related infrastructure projects between 2013 and 2018.<sup>217</sup> Chinese financial institutions also claim to fund the programme by attributing all their investments in BRI-related sectors – ranging from ports and dams to LNG carriers – to be contributing to the initiative. The China Development Bank (CDB) for example stated to have provided over USD 190 billion for BRI projects since 2013. While China has demonstrated its willingness to lend substantial amounts of capital, China is beginning to realise that the funding requirements of the BRI will exceed its capacity to finance it. Therefore, Beijing is now trying to mobilise multilateral development banks and raise private-sector funding to make up for the funding shortfall.

### Opportunities for European business

The volume of funds committed to date present a clear opportunity for business. According to the Asian Development Bank, there continues to exist an annual infrastructure investment gap of USD 459 billion in Asia.<sup>218</sup> The BRI contributes to meeting Asia's large infrastructure investment needs, and while Chinese companies are competitive in the construction and transport sector, European companies are well positioned and globally recognised for their quality and expertise. European companies, including SMEs, are world leaders in developing environmentally friendly, resource-efficient and sustainable products and building materials.

Besides the construction and transport sectors, infrastructure development opens up a number of opportunities for European logistics providers who transport goods. As rail transport is faster than maritime cargo and cheaper than air cargo, logistics providers estimate that rail transport will grow from 5% to 10% of all transport between Europe and Asia during the next few years, complementing existing links. A number of service sectors also see opportunities in the BRI, including banking, consulting, insurance, digital and legal services. There are also other sectors, including the chemical industry, which supply raw materials that end up in trains, cars and other building materials. Europe is competitive in these areas and several European companies supply both European and Chinese companies and stand to benefit no matter who implements the BRI.

<sup>216</sup> The Diplomat, "China's Belt and Road: A Reality Check", 2019.

<sup>217</sup> Mercator Institute for China Studies, "Mapping the Belt and Road Initiative: this is where we stand", 2018.

<sup>218</sup> This is because Asia's developing countries spend only about USD 881 billion a year on infrastructure, well below an estimated need of USD 1.34 trillion per year from 2016 until 2030. See Asian Development Bank, "Closing the Financing Gap in Asian Infrastructure", 2018.

## Barriers for European business

These opportunities have by and large not been realised to date for a number of reasons. The Chinese government clearly sets the strategy and focus of the initiative and employs a deals-based model as opposed to a rules-based model to implement BRI projects. Instead of using transparent public tenders and allowing fair competition for projects, China provides non-competitive funding, which falls foul of OECD guidelines, brings together consortia of subsidised Chinese state-owned enterprises, and uses various means of economic diplomacy to convince foreign governments to take on BRI projects.

A 2018 survey amongst European businesses active in China demonstrated that 45% of the businesses do not see any opportunities in participating in the BRI. The survey furthermore demonstrated that many European companies are excluded from participating in the BRI because of preferential treatment of Chinese contractors, insufficient information available regarding potential projects and a lack of transparency in public procurement and tendering.<sup>219</sup>

Out of all contractors participating in Chinese-funded BRI projects, 89% are Chinese companies, 7.6% are local companies (companies headquartered in the same country as where the project was taking place), and 3.4% percent are foreign companies (non-Chinese companies from a country other than the one where the project was taking place). In comparison, out of the contractors participating in projects funded by the multilateral development banks, 29% are Chinese, 40.8% are local, and 30.2% are foreign. Moreover, less than 1% of projects have so far been financed by multilateral development banks.<sup>220</sup> As long as the CDB and China Eximbank finance projects are tied to Chinese content requirements, it will not be possible for European companies to participate on an equal footing.

### An example of China's deals-based approach to connectivity

*China's deal-based approach can be illustrated by a rail project in Malaysia that was executed in the context of the BRI. China convinced the Malaysian government to resume a Chinese rail project in Malaysia by reducing the costs of the project from USD 20 billion to only USD 10.7 billion after the project was suspended over political concerns regarding the high price and excessive debt Malaysia would be settled with.<sup>221</sup> This example not only illustrates the high costs of projects that China is willing to pay to increase its influence abroad, it also raises questions of whether BRI projects are solely based on commercial prices. After all, a sudden price reduction of 50% seems commercially impossible. This example furthermore demonstrates that it is highly challenging for European companies to outbid Chinese SOEs in a public tender.*

Another important issue for European companies is the lack of information and transparency surrounding the BRI. There is no official portal or database of BRI projects (in English), and European companies have largely been unable to find information on how to get involved unless they have been approached directly by a Chinese consortium.

<sup>219</sup> European Union Chamber of Commerce in China, "Business Confidence Survey", 2018.

<sup>220</sup> Centre for Strategic and International Studies, "China's Belt and Road Initiative: Five Years Later", 2018.

<sup>221</sup> New York Times, "China Yields on Malaysia Rail Project as Global Infrastructure Program is Re-Examined", 2019.



## China's rhetoric of a more open, clean and green BRI now needs concrete action

China has embarked on an active promotion campaign in the hope that more countries and stakeholders will support the flagship initiative. China hosted dozens of world leaders during the Second Belt and Road Forum (BRF) in Beijing in April 2019. At the forum, Xi Jinping promised that the BRI will be open, green and clean. A joint statement released after a meeting of the participating government leaders emphasised the need for high-quality projects, encouraged multilateral cooperation mechanisms under BRI and called for the participation of developed countries. The EU abstained from participating as a bloc, although several EU Member States sent representatives to the BRF.

European business calls on China to translate the rhetoric about an open, clean and green BRI into concrete action, to provide more information to foreign stakeholders, to increase transparency and to involve European business at an earlier stage of BRI project development. Moreover, BRI tendering processes must be made fully transparent and open to foreign contractors and should also respect high-level technical standards.

### How to move forward

European business encourages Europe to engage China and the BRI on a European level. Unfortunately, European responses to the BRI have only partially been harmonised. On the one hand, the EU has developed a common position, officially welcoming the BRI with a number of caveats.<sup>222</sup> The EU recognises that when done in the right way, and carefully evaluated, more investment in cross-border infrastructure links would unleash growth potential with broad-based benefits. But the EU stresses that to make the BRI an open initiative and to link it with the EU, it should adhere to market rules as well as EU and international norms and standards. The EU also calls for an open and inclusive approach, non-discriminatory procurement, and more transparency. Multilateral frameworks like the Asia-Europe Meeting (ASEM) and the Asian Infrastructure Investment Bank (AIIB) could be used to realise this. The EU has also emphasised economic, fiscal, climate and environmental sustainability as key criteria to bear in mind when assessing the vitality of infrastructure projects. European business encourages the EU to continue these united efforts and voice European concerns in a coordinated fashion.

On the other hand, the EU has also been divided as several EU Member States have endorsed the project. Twelve EU Member States and five Western Balkan states joined the BRI under the '17+1' cooperation format. However, Chinese investments in Central and Eastern EU Member States have remained low. In 2018, only 2 % of all Chinese FDI into the EU were invested in Eastern European Member States.<sup>223</sup>

The 17+1 format and the fact that several other EU Member States, such as Italy, Portugal and Luxembourg, have participated in the BRI illustrates the EU's internal divisions regarding the BRI and the EU's uncoordinated approach towards China more generally. The lack of an orchestrated approach towards the BRI has subsequently allowed China to take advantage of divisions within the EU. For instance, growing Chinese influence has led to internal division in the EU on important foreign policy decisions concerning China. Some EU Member States that received sizeable Chinese FDIs, watered down or vetoed European positions on contentious Chinese actions with regards to human rights or the South China Sea. The EU will remain vulnerable to Beijing taking advantage of internal divergences as long as a coordinated European approach is missing.

<sup>222</sup> European External Action Service, "[Belt and Road Forum: EU Common Messages](#)", 2017.

<sup>223</sup> In this statistic, Eastern EU Member States include Austria, Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia. Please consult Rhodium Group and Mercator Institute for China Studies, "[Chinese FDI in Europe](#)", 2019.

## DEMANDS

- 120 EUROPE SHOULD ENGAGE CHINA AT THE EUROPEAN LEVEL AND SPEAK WITH 'ONE VOICE'.** The EU Member States should speak with 'one voice'. Member States should call on China to increase reciprocity, especially in the infrastructure sector, improve transparency, prioritise high labour and environmental standards and ensure debt sustainability. Europe should be united on this issue and develop a 'coordinated approach' in order to exert a maximum level of influence.
- 121 PROMISES FOR A MORE OPEN, TRANSPARENT, GREEN AND RULES-BASED BRI NOW NEED TO DELIVER CONCRETE RESULTS.** In order to thrive, companies require fair competition and predictable rules surrounding procurement. Surrendering these principles in favour of a deals-based approach advanced by China could undermine the EU's interest. Tenders have to respect the principles of the rule of law and transparency and abide by international technical, environmental and social standards. As long as CDB/Exim finance projects are tied to Chinese content requirements, it will not be possible for European companies to participate.
- 122 CHINA SHOULD CONSISTENTLY BE URGED TO APPLY INTERNATIONAL STANDARDS IN RELATION TO THE BRI.** The BRI can help to ensure that – in areas such as financial services, the environment and public procurement – long established standards are used, which will decrease technical barriers to trade, facilitate trade flows and allow for a greater variety of organisations to become involved in the BRI. In cases where international standards have not been developed, the European Commission should work urgently with Europe's leading companies to help set new standards and embed them at the international level.
- 123 COMPANIES NEED TO BE INVOLVED AT AN EARLIER STAGE OF BRI PROJECT DEVELOPMENT.** Companies need to do their due diligence, assess whether projects make commercial sense, whether they should co-finance projects, and share their insights and expertise. This is difficult when they are involved when the project has already been set. Foreign companies also need the same access to state funds that Chinese companies have to conduct feasibility studies and to ensure that there is sufficient funding behind a project so that they can actually be paid for providing their services.

## 6.3. COMPETITION ON THIRD MARKETS

### Background

Emerging in 1999, the 'Going Global' strategy sought to bid farewell to the Mao-era mindset of self-reliance, urging Chinese firms to take advantage of booming world trade to invest in global markets. The first years of 'Going Global' coincided with China's 2001 admission to the WTO. From the outset, the 'Going Global' strategy was about nurturing Chinese "dragon heads" (national champions) to become globally competitive multinational firms. The vast expansion of Chinese state-owned companies on third markets in the last decade was facilitated by a sophisticated state-coordinated subsidy programme in combination with exclusive targeted political support by the Chinese government and the Chinese policy banks, especially China Eximbank.

All companies, whether they are from the United States, Europe or elsewhere, compete internationally within the multilateral governance frameworks established through the WTO, OECD, and others. The ability to compete furthermore relies on notions of free markets.

China's selective multilateralism, however, frequently distorts fair competition and the level playing field for European companies. China's growing international activity and the reaffirmed commitment to its state-driven economy means that market distortions have increasingly spilled over onto third markets and policy domains that go beyond trade and investment, a challenge for which remedies do not yet fully exist.

### State-backed companies compete on world markets with privately run companies

As Chinese companies set up subsidiaries abroad, participate in procurement bids and infrastructure projects, and acquire foreign firms, the power of state-backing on China's home market is increasingly felt to the detriment of privately run companies.

China's state-coordinated engagement on third markets is most obvious in headline-grabbing infrastructure deals in developing countries, and in particular in Africa. China has recognised the opportunities in Africa and is showing great interest in African markets. Chinese companies act with high speed and risk appetite – also because of government support. China is now the largest investor in many African countries. To compete, the EU should support European companies by facilitating risk reduction, financing and support European private-sector projects in Africa on the basis of market principles.

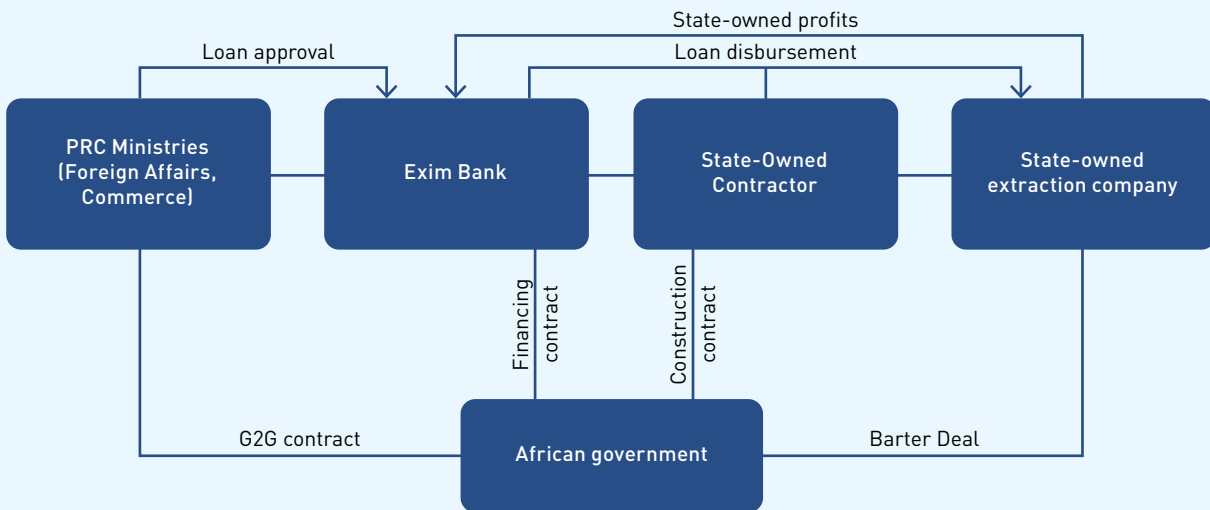
China has a clear focus on exporting African resources. A large part of Chinese investment in Africa goes into transport, energy and raw materials. The Chinese investment in transport and energy is often used to extract and export raw materials. The Chinese commodity deals with third-country governments are often tied to other projects, i.e. infrastructure (Angola Model) – which are mostly executed by Chinese companies.

The Chinese government directly or indirectly intervenes in every step of the model (see figure 'Chinese state coordination of infrastructure delivery in Africa'). Chinese ministries negotiate package deals with governments and oversee approving project investment. Partner governments conclude the financing contracts of government-to-government ('G2G') package deals with China Eximbank, while construction and/or extraction contracts and licenses are for example negotiated with China's state-owned enterprises (SOEs) under the supervision of the respective Chinese ministries. After signing, China Eximbank disburses loans directly to the SOEs, which in turn revert their profits to the bank, allowing for future direct contracting.

The model of a **G2G contract** regularly includes tax, tariff and visa exemption, reducing the costs of imported labour, equipment and material. The **financing agreement** sets the rules of procurement to ensure execution by Chinese companies via direct contracting and enables a fast mobilisation of funding. The **construction contract** allows companies to implement their own standards and rules thus reducing compliance costs, while the **Barter Deal** grants preferential licensing, resource discounts and tax exemptions.

Furthermore, there is a risk of excessive public debt in developing countries as a result of some large Chinese loans that go beyond the debt-carrying capabilities of some developing countries. In turn, excessive debt will lead to negative effects such as unfavourable macroeconomic conditions and the excessive dependence on a single investor.

**Chinese state coordination of infrastructure delivery in Africa**

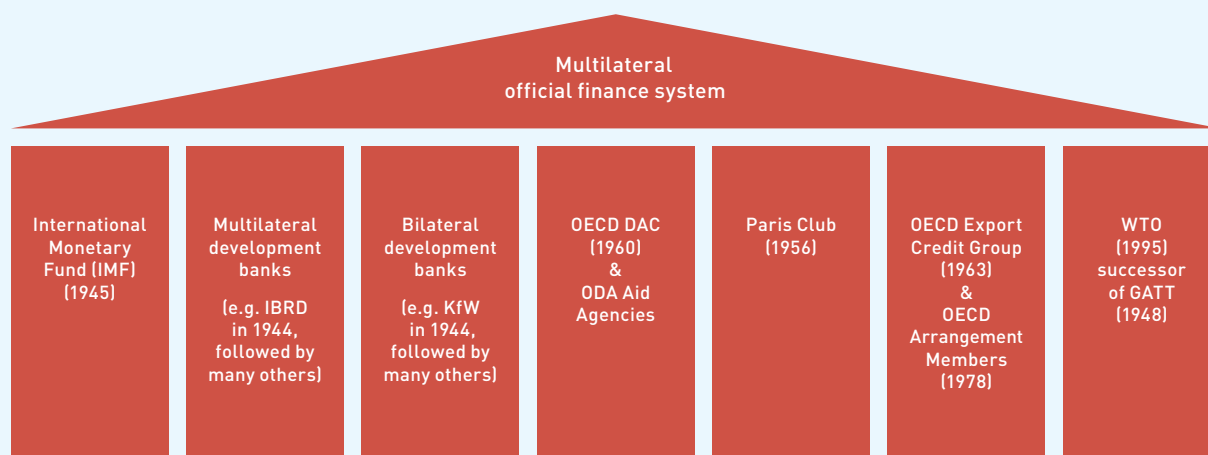


Source: EIC, 2019

**Deviation from multilateral financing practices**

China’s selective approach to multilateralism means that Beijing is sometimes reluctant to adhere to the multilateral financial architecture, as displayed in the illustration ‘seven pillars of the multilateral official finance system’. The global framework includes: detailed regulations for development finance, official export credits, financial and technical assistance for countries in debt distress and debt rescheduling for developing countries to major creditor countries on a multilateral basis rooted in the Paris Club.

## Seven pillars of the multilateral official finance system



Source: Mudde, 2018

China continues to ignore the multilateral consensus on export and development finance and, unlike OECD countries, does not yet make a clear distinction between official development aid and officially supported export credits. China's financial loans are highly non-transparent and they do not adhere to the rules of the OECD Development Assistance Committee (DAC) and the OECD export credit reporting system. Its practices include amongst others:

- **Minimum risk or market-based premiums** for officially supported export credits adopted by the OECD to comply with WTO regulations **do not apply** to China. China can easily undercut pricing from OECD export credit agencies (ECAs) and create competitive advantages for Chinese (construction) companies. China's Sinosure is for example highly opaque about its pricing.
- **Minimum interest rates** for officially supported export credits do not apply to Chinese official finance. Neither do relevant OECD minimum interest rates to safeguard the WTO obligation – so-called commercial interest reference rates (CIRRs).
- **Terms and conditions** of export credits regarding the repayment profile, maximum credit periods, maximum grace periods, maximum support for local costs and minimum down payments (15%) **do not apply** to China.
- **China is not a member of the OECD DAC.** Therefore, China's development loans risk lacking transparency and may not be in line with ODA standards and practices on concessionality. China would have to use substantially higher subsidy funds to meet international aid requirements.<sup>224</sup>

## Standards is one of the ways through which the level playing field is distorted

Besides direct state support, there are also other issues that further erode the level playing field. China's approach to standard setting is one important factor.<sup>225</sup> China actively participates in the development of international standards to facilitate access to foreign markets. Domestically, however, China often uses national standards with diverging national content from international standards or adds additional national

<sup>224</sup> *Ibidem*.

<sup>225</sup> See chapter '3.7 Standardisation' for more information.

requirements to the international standard. China also often imposes its national standards unilaterally in third countries through initiatives such as the Belt and Road Initiative, but increasingly also in the area of 5G ('Digital Silk Road'). Consequently, the application of Chinese standards instead of international standards does not only create problems and trade barriers for foreign companies active on China's domestic market, but also on third markets.

## Consequences of unfair competition

There are several drivers that have facilitated essential competitive advantages for Chinese companies outside the international lending framework apart from export subsidies. As a result, these companies may offer services at dumped prices. Factors in favour of this practice are amongst others low wages, lax regulations and preferential treatment. The Chinese price for export services is linked to protectionist measures for the domestic Chinese market (Chinese exporting companies are often exempted from VAT). This has helped Chinese companies to create monopolies on foreign markets. Over the past ten years for example, Chinese contractors have tripled their international market share from 7% to 21%.<sup>226</sup>

In 2018, McKinsey stated in a report that Chinese companies expand their activities outside their value chains once they have established market presence. This means for instance that construction companies become active in ICT, manufacturing companies participate in the farming industry and mining companies are advancing in the energy sector. These companies serve as market entry facilitator, diplomatic leverage and as resource supplier for domestic production. According to McKinsey, Chinese companies generate a profit margin of more than 20%. Profit margins of this size are highly unusual, especially on international and national construction markets.<sup>227</sup>

For European international contractors the above-mentioned alleged profit margins represent a serious obstacle in the realisation of infrastructure projects financed by multilateral or bilateral development banks where Chinese bidders often undercut their international rivals by 20% or more. Borrowers of European development financial institutions (DFIs) and multilateral development banks (MDBs) often choose Chinese contractors based on the lowest price. The fact that bid prices offered by Chinese contractors usually lie below the direct costs indicates that high profits generated via projects under tied Chinese financing agreements are "re-invested" to distort competition in international open tenders. As a consequence, Chinese contractors have gained ground in international open competitive tenders while being cross-financed through subsidies, supported by high returns on G2G contracts and exempted from taxes and tariffs. In this context, there have been reports of bidding practices that undermine conventional bidding standards: several Chinese companies participate in the bidding procedure with differently priced bids. After the closest bid has won, the winning company contracts its Chinese competitors for the execution of project works. This type of behaviour leads to a heavy distortion of competition and to project cost explosion via price undercutting.<sup>228</sup>

The main consequence of China's approach to internationalisation as described above is that they lead to unfair competition between private companies and Chinese state-backed companies, or SOEs. It tilts the level playing field in such a way that the global market share of European firms is lower than it would be in the absence of such practices. Significantly for certain sectors, China's approach to industrial subsidies also generates enormous overcapacities that depress global prices in these sectors, which puts great pressure on companies in those sectors to remain profitable.<sup>229</sup> China's Belt and Road Initiative is to a large degree a culmination of the various issues highlighted above, and requires an adequate response by European policy-makers in order not to shut out European companies out of important global markets. The EU Connectivity Strategy is an important step in this regard.<sup>230</sup>

<sup>226</sup> Engineering News-Record, "[Top 250 International Contractors Statistics](#)", 2019.

<sup>227</sup> McKinsey & Company, "[Dance of the lions and dragons: How are Africa and China are engaging, and how will the partnership evolve?](#)", 2017.

<sup>228</sup> The Rhodium Group, "[Leveraging the Chinese State Against Foreign Firms: Rail and Beyond](#)", 2019.

<sup>229</sup> See chapter '4.2 Subsidies' and '4.3 Overcapacity' for more information.

<sup>230</sup> See chapter '6.1 EU connectivity' and '6.2 the Belt and Road Initiative' for more information.

While European companies welcome international competition, domestic economic support, mercantilist policies, flouting of OECD guidelines and state-led contract negotiations all contribute to tilt the international playing field. To restore a level playing field, China should therefore rein in (discriminatory) industrial subsidies, further open up its home market, adhere to OECD guidelines on financing, and let Chinese companies compete for contracts on their own merits.

## DEMANDS

**124 THE EU SHOULD WORK TOGETHER WITH PARTNERS TO AIM TO INTEGRATE CHINA FULLY WITHIN THE EXISTING MULTILATERAL FRAMEWORKS.** The EU and EU Member States should call upon China to implement and adhere to multilateral arrangements such as those under the OECD, the Paris Club and WTO agreements such as the GPA that would restore the level playing field in the area of standards, official financing, procurement and investment. The EU should work with China and other OECD members to fully implement the existing global standards for export and project financing and develop future standards in line with the OECD consensus.

**125 THE EU AND EU MEMBER STATES SHOULD CALL UPON CHINA TO IMPLEMENT AND ADHERE TO:**

**125.1** All decisions, recommendations and guidelines of the **OECD Development Assistance Committee (DAC)**. Chinese development loans do not meet the minimum concessionality levels that the OECD-DAC applies to tied aid – 50% for least developing countries (LDCs) and 35% for other countries –, meaning that China would have to use substantially higher subsidy amounts to meet international aid requirements.

**125.2** All obligations determined by the **OECD Arrangement on Officially Supported Export Credits**. China is the global leading provider of export credits, supporting Chinese exporters with generous financing terms that are not available to European exporters and to other OECD countries that are bound to strict OECD rules on export financing. The terms and conditions of their export credits are opaque, and China should commit to transparency on the terms they offer their exporters. China should particularly implement and adhere to the work being done in the international working group on export credits.

**126 WHEN THIRD COUNTRIES DO NOT FOLLOW OECD FINANCING RULES AND PRACTICES, TO THE EXTENT LEGALLY POSSIBLE, THE EU AND EU MEMBER STATES SHOULD DECLARE COMPANIES FROM THAT SPECIFIC COUNTRY INELIGIBLE FOR PARTICIPATION IN INFRASTRUCTURE TENDERS FINANCED FROM EU OFFICIAL DEVELOPMENT ASSISTANCE (ODA).** The EU institutions and Member States should only untie European ODA to other OECD and non-OECD countries on a reciprocal basis. Reciprocity should be fully transparent and verifiable, and it must be ascertained that untied aid is not *de facto* tied. Along the lines of the European Investment Bank Transport Lending Policy Point 96 and 97,<sup>231</sup> the EU should also consider withdrawing the credit lines or co-funding grants benefitting third countries engaging in unfair trade practices.

<sup>231</sup> European Investment Bank, "*Transport Lending Policy*", 2011, whose article 97 mentions that the EIB "will check (...) for the existence of any outstanding issues concerning (i) Intellectual Property Rights, (ii) potential breaches of trade agreements and, (iii) as far as possible, the risk of distortions caused by anti-competitive practices (including, inter alia, state aid, direct subsidisation, injurious or below-cost pricing ...) in the producer country or in the shipyard concerned. The Bank will not finance shipping projects where such satisfaction cannot reasonably be obtained."

**127 AS THE WORLD'S LARGEST DONOR, THE EU AND ITS MEMBER STATES SHOULD REBALANCE THE SECTORAL OFFICIAL DEVELOPMENT ASSISTANCE (ODA) PORTFOLIO AND PUT A STRONGER EMPHASIS ON THE INFRASTRUCTURE SECTOR, AND ESPECIALLY ON TRANSPORT AND WATER.**

OECD statistics for the year 2018 show that these two crucial infrastructure sectors account for only around 10% of the European ODA to Africa. Comparable figures for Japan, China and South Korea lie at almost 50%. The EU needs to take measures to make European development assistance more visible to stakeholders and citizens in recipient countries. Lastly, the EU must invest in the technology needs of developing countries (for example 5G) and invest in private sector development.

**128 THE EU SHOULD PROVIDE ADDITIONAL FLEXIBLE GUARANTEES FOR EUROPEAN COMPANIES UNDER THE NEW EXTERNAL INVESTMENT PLAN IN THE NEXT MULTIANNUAL FINANCIAL FRAMEWORK.**

European companies lead in providing sustainable long-term solutions but on many third-country markets they face increasing pressure from state-owned companies from emerging actors, with whom they cannot compete on a price basis. The creation of more flexible instruments to support the ability of EU companies to compete in third countries, especially vis-à-vis Chinese enterprises, is essential.

**129 THERE IS AN URGENT NEED FOR THE EUROPEAN UNION TO PERFORM ON PAR WITH ASIAN OR US DEVELOPMENT FINANCIAL INSTITUTIONS (DFIS), EXIM BANKS AND POLICY BANKS, AID AGENCIES, ETC. IN TERMS OF BOTH VOLUME AND MANAGEMENT CAPACITY FOR INFRASTRUCTURE FINANCE ON THIRD MARKETS – IN PARTICULAR IN AFRICA.**

A more streamlined and versatile financing institution on EU level, capable of combining European development and export finance and thus of matching the performance of Asian and US institutions, could work alongside European DFIs and Export Credit Agencies and aggregate existing financial capacity and technical expertise. It is of utmost importance that the European Union is committed to a fundamental reform of the OECD consensus on export credit to create a level playing field but also to make the consensus more attractive for non-OECD countries to join the arrangement.

**130 EU DELEGATIONS ACROSS THE WORLD NEED TO PLAY AN INCREASED ROLE IN CONDUCTING EFFECTIVE ECONOMIC DIPLOMACY.**

This includes communicating and promoting European strategies, funds, and mutual education on third-country needs and what could be offered by EU policies and European companies to satisfy them.





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