

## FREEMAN BRIEFING

### January 16, 2009

#### Focus on Foreign Firms Obscures Anti-Monopoly Law's Original Intent

China's long-anticipated Anti-Monopoly Law (AML)—the country's first comprehensive legal framework for regulating market competition—finally went into effect in August, 2008.<sup>1</sup> What garnered most attention among overseas analysts was a concern that the AML would be a stalking horse for economic nationalism, particularly the inclusion of a provision in the AML requiring foreign acquisitions of Chinese companies to pass a national security review to ensure that such mergers and acquisitions (M&As) do not harm China's economic security. This raised fears among foreign investors that the AML was designed to restrict their participation in the market and unfairly protect the position of China's state-owned enterprises (SOEs). The subsequent launch of two high-profile cases under the AML involving Microsoft and Coca Cola suggested these fears were well founded.

The Chinese leadership's efforts to harness rising economic nationalism, specifically fears of foreign domination of China's market, in order to overcome local and bureaucratic opposition to the law are highly controversial outside China. However, the rancorous debate over the AML that raged within China for 13 years prior to its passage was not over the issue of foreign competition – in fact, this was one area of rare consensus. On the contrary, the real bone of contention revolved around the original target of the law: local monopolies that have long stood in the path of Beijing's effort to create a truly national market. The fact that in various drafts of the AML provisions prohibiting administrative monopolies were included, deleted, and then finally reinserted in watered-down form underscores the extent of local opposition to central government efforts to combat the problem.<sup>2</sup>

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<sup>1</sup> Unofficial translation of the Chinese Anti-monopoly law is available at <http://www.lawinfochina.com/law/display.asp?db=1&id=6351&keyword=anti,monopoly>.

<sup>2</sup> Administrative monopolies refer to anticompetitive behavior by government agencies at various levels to favor incumbent and/or local enterprises and to protect them from competition. It is often cited as the proximate cause of industrial overcapacity and restricted domestic trade flows.

While focusing on the bugaboo of foreign market domination undoubtedly helped Beijing gain domestic support for the AML there is a danger that this short-term expedient will not only risk foreign investor confidence but will also undermine from the law's original intent. It remains to be seen whether over the longer term Beijing will be able to utilize the AML in order to combat the real source of unfair competition and economic inefficiency: local protectionism and administrative monopolies.<sup>3</sup> Indeed, the 13-year battle over the AML once again highlights China's Achilles heel: unresolved tensions in central-local government relations.

### **Deng's reforms exacerbate problem of local protectionism**

Local protectionism has been a feature of China's economic landscape since ancient times. Divided into 23 provinces, 5 autonomous regions, 4 centrally administrative municipalities, and 2 special administrative regions with vastly differing economic and sociopolitical conditions, it is no wonder China is often described as an amalgamation of small countries. Internal trade barriers are extensive; few companies operate nationally; and nearly every province has its own maker of branded products like washing machines, color televisions, and refrigerators. In 2001, it was reported that China had 120 car manufacturers – and most of them survived on various forms of local protectionism.<sup>4</sup> Local leaders have traditionally ruled their fiefdoms with scant regard to central government directives, observing the age-old maxim: “The Mountains are high, and the emperor is far away.”

One of the unintended consequences of the reforms launched by Deng Xiaoping in the 1980's was to exacerbate the problem of local protectionism. Structurally, the twin effects of decentralization and devolution of economic authority to local governments while at the same time retaining a pricing system that juxtaposed fixed and market prices, led to market conditions that produced contractions between supply and demand in different regions, in turn providing ample arbitrage opportunities and pervasive rent seeking by power holders, speculators, and insiders.<sup>5</sup> Local governments were transformed from purely administrative entities into administrative-cum-economic actors; promotions and professional advancement became linked to the achievement of high investment and

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<sup>3</sup> A Chinese government report issued in 2007 concluded that China does not face imminent risk of monopolies by foreign firms in any industry. See: “No Threat of Foreign Monopoly in Any Industry,” *China Daily*, September 10, 2007

<sup>4</sup> “*China's Local Trade Barrier: A Hard Nut to Crack*”, Beyond Transition, The World Bank Group, (2001).

<sup>5</sup> 张明, “历史视中的中国地方保护主义”, (Chinese Local Protectionism from a Perspective of History), 南京政治学院, 经济研究, 2008年5月第6卷第期

economic growth rates. Enterprising administrators, in search of political advancement or monetary gain, blurred the lines between commerce and government. As a result, many administrators were motivated to put local interests above the broader national goals mandated by the central government and advance their careers through the pursuit of unchecked growth.<sup>6</sup> As such, the power holders became “economic warlords” who sliced the Chinese economy into “economic fiefdoms” at the provincial and local government levels.<sup>7</sup> Economic barriers, known as “bamboo walls and brick ramparts” were erected between provinces – designed to impede outflows of undervalued raw materials and to block inflows of overvalued finished products, keeping the excess locally. Local governments employed a range of administrative and economic means to engage in such protectionism.

### **Impenetrable “bamboo walls and brick ramparts”**

Between 1984 and 1990, the Chinese press reported on some one hundred “trade wars” between provinces involving fifty different commodities.<sup>8</sup> There were even reports of armed patrols preventing the exports of one region entering another.<sup>9</sup> Some provinces stipulated that local hotels and restaurants could only sell local produce. Arbitrary tariffs were placed by provincial authorities on goods traveling from province to province, making transportation costs for goods moving within China frequently higher than those on Chinese goods bound for international markets. As a result, price differentials between regions were wide – a bottle of Beijing’s Yanjing beer that cost the equivalent of 18 cents in the Chinese capital would cost \$1.00 in Sichuan Province, for example. Other areas supported local enterprises through preferential tax breaks and provision of credit capital, as well as rigging procurement bids for government projects to favor local firms.

As the market became increasingly dysfunctional, conflict between central and local authorities also emerged; local rent-seeking was effectively robbing the state of much-needed revenue. Battles over strategic Category 2 commodities – e.g. cotton, tobacco and silk – were a direct attack on central prerogatives, as national state-owned enterprises (SOEs) are supposed to receive, as a priority, a significant share of such commodities.<sup>10</sup> Decentralization and deregulation also

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<sup>6</sup> Economic Warlords: How De Facto Federalism Inhibits China's Compliance with International Trade Law and Jeopardizes Global Environmental Initiatives.

<sup>7</sup> Poncet, Sandra, “*The Fragmentation of the Chinese Domestic Market: Peking Struggles to put an end to regional protectionism*”, China perspectives, October 2004

<sup>8</sup> *ibid*, “Export Protectionism”, p. 87

<sup>9</sup> *supra* 10, p. 20

<sup>10</sup> *supra* 10, p. 21

undermined Beijing's efforts to balance regional growth, and contributed to the growing income disparity between regions and provinces.

To address the ill effects of decentralization, the central authorities began a program of recentralization in the 1990s, including comprehensive tax reforms launched in 1994. As part of this drive, the State Council Legislative Affairs Office had already created an Anti-Monopoly Working Group to look into the problem of local monopolies and unfair competition in 1987. Draft "Interim Regulations Against Monopoly and Improper Competition" were circulated but faced opposition from vested interest groups and those who believed that laws to regulate monopoly actions were not necessary at that stage of China's economic development. Monopoly regulations, they argued, could only arise in advanced market economies where large-scale monopolies, oligopolies and cartels exist. As a result, a "Law Against Improper Competition" was passed without reference to local monopolies in 1993.

In 1994, the legislative plan for the Eighth National People's Congress (NPC) included a mandate to draft a separate law to address monopolies. It would take another 13 years to fill that mandate and have the NPC approve a final law. Although anti-trust provisions were contained in the Commercial Banking Law issued in 1995; the Price Law issued in 1997; and the Procurement and Bidding Law issued in 1999; as well as in various ad-hoc administrative regulations, lack of comprehensive anti-monopoly rules, a clear enforcement mechanism, and ineffective implementation left the chaotic situation at the local level largely unchanged.

### **WTO accession refocuses attention on the AML**

China's preparation for entry into the World Trade Organization (WTO), particularly its commitment to national treatment and non-discrimination among firms, refocused attention on the outstanding problem of local protectionism and administrative monopolies. In 2001, the State Council issued "Rules on Prohibiting Regional Blockades in Market Economic Activities," and the NPC announced that China would issue an AML in preparation for entry into the WTO. In 2002, the NPC announced that efforts would be made to "break up trade monopolies and regional blockades, promoting free circulation of commodities and the elements of production in a nationwide market," and to "establish a unified, open, competitive, and orderly modern market system."<sup>11</sup>

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<sup>11</sup> "DRC Recommendations Regarding Breaking Up Local Protectionism," *Zhongguo Jingji Shibao*, August 6, 2003

The State Council's research arm, the Development Research Center, issued a report in 2003, which found that Beijing, Shanxi, Anhui, and Yunnan were among the most the protected cities and provinces; and tobacco, food and beverages, pharmaceuticals, agriculture, construction, and post and telecom, among the most protected industries. The DRC report concluded:

*The problem of local protectionism is not only still serious, furthermore the protectionism continues to take on new forms, changes take place in what the protectionism covers . . . the scope of protectionism continues to grow. Local protectionism impedes the free circulation of goods and essential elements on a nationwide scale, weakening the functions and effectiveness of the market mechanism . . . and from the long-term perspective, is bound to seriously harm the overall sound development of China's national economy and the achievement of general reform goals, and it has now reached a point where we must make a serious effort to resolve it.<sup>12</sup>*

And yet, due to entrenched local government and bureaucratic opposition, it would take another four years of arduous negotiations before a comprehensive national AML would be passed by China's legislature.

### **Issues contested during the drafting of China's AML**

The drafting of China's AML took place against the backdrop of an historic transition from a command to a market economy and amidst fierce debate over the scope and speed of that transition. The final draft of the AML reflects the compromises made between the central authorities and vested interest groups on a number of hotly contested issues.

#### **"Malignant" Competition**

For a government whose overriding concern is ensuring stability, free market competition that can result in factory closures and unemployment is obviously a risky proposition. Whereas the ideal of market competition is an aspirational goal in the West, it has been the subject of fierce debate in China. The Chinese media has hyped the issue of "malignant" competition—blaming China's food and product scandals and industrial accidents on "excessive" competition that has forced producers to cut costs and lower safety standards. Such fears were used by critics to question whether China really needed a law to promote further

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<sup>12</sup> Ibid.

competition. Concerns over stability have led the government to support anti-competitive actions in the past and exemptions in the AML indicate that they will continue to do so in the future. Whereas in the United States collusion among firms is an unpardonable sin for competition policy, the AML makes such activity not only permissible, but encouraged as market conditions warrant. For example, in order to ensure market stability, the AML provides an exemption for agreement among competitors that occurs to “mitigate, in economic recession, severe decrease of sales volume or excessive overstocks.”<sup>13</sup>

### The Role of China’s SOEs

The reform of China’s SOEs, which include national, provincial and local government-owned firms, is connected to the larger ideological debate over public versus private ownership in China and has long been a drawn-out battle between reformers and conservatives. On the one hand, the AML was aimed at breaking the monopolistic power of the SOEs and opening up markets to private firms, including foreign multinationals. On the other hand, China was seeking to maintain state control of “strategic” sectors of the economy and to shield SOEs in these sectors from competition. The protracted process of seeking to reconcile these two contradictory goals was one of the main reasons for the delay in passage of the AML.

In the 1990s, public complaints over SOE abuse of their monopolistic power as well as preparation for competition from multinationals following entry in the WTO prompted calls for reform, including the passage of anti-trust legislation. In 2005, China allowed private enterprises market entry to a number of sectors previously off limits. However, in 2006 the government announced seven “strategic” industries that would continue to be controlled by SOEs. The breadth of these strategic industries and the loophole created for SOE domination therein raise significant questions for the efficacy of the AML. While SOE-controlled sectors are nominally subject to the AML, therefore, it remains unclear how well the law will be enforced against firms in the public sector. According to one government-sponsored Chinese survey, more than half of those polled believed that the AML would have little impact on improving prices or services in the monopolistic operations of SOEs.<sup>14</sup>

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<sup>13</sup> Unofficial translation of the Chinese Anti-monopoly law is available at <http://www.lawinfochina.com/law/display.asp?db=1&id=6351&keyword=anti,monopoly>.

<sup>14</sup> “Chinese People Question Effectiveness of Anti-Monopoly Law on SOEs,” *Renmin Ribao*, September 13, 2007

## Administrative Monopolies

Despite reforms aimed at separating China's SOEs from the powerful ministries that used to run them, many remain either directly or indirectly controlled by government agencies; eliminating economic interference by these agencies has proved difficult. Such behavior compels public firms to act in anticompetitive ways, and erects market barriers against the entry of private domestic and foreign firms. For example, in 1999, the Bureau of Civil Aviation issued regulations preventing airlines from offering air ticket discounts in order to prevent price competition from harming the development of the industry. Other agencies continue to compel the use of products or services from SOEs either currently or formerly affiliated with them. And, despite attempts to combat local protectionism, agencies and governments at the local level continue to restrict market entry to firms from other regions—known as “regional blockades.”

According to Qinghua University Professor Wang Baoshu, the AML involved the vested government interests, “so China's antimonopoly legislation has always been resisted, more or less, by certain sectors and government departments.”<sup>15</sup> Resistance to the AML by powerful local and bureaucratic interest groups was evidenced by the fact that prohibitions on administrative monopolies included in the 2002 draft law were removed in the 2005 draft. Although provisions concerning administrative monopolies were reinserted in the final draft in 2007, their “force was weakened quite significantly,” according to Professor Wang.<sup>16</sup>

The compromise reached on the issue of administrative monopolies underscores the weak hand Beijing continues to hold against powerful local interest groups. It is against this background that the central authorities began to seize upon rising economic nationalism—playing up fears of foreign domination of China's markets—in order to overcome resistance and gain support for the AML.

## The Rise in Economic Nationalism

In the past several years, amid rising concerns over the “downsides” of China's economic development—an increasing income gap, regional disparities, corruption, environmental degradation—fundamental questions have been raised about China's future development path. A group of intellectuals known as the “New Left” have found a great deal of public support for their critique of

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<sup>15</sup> “Qinghua Professor Wang Baoshu Criticizes Anti-Monopoly Law,” *Caijing*, September 2, 2007

<sup>16</sup> *Ibid.*

China's market reforms. The New Left first came to prominence with their criticism of SOE reform, particularly the perceived injustice of the privatization process and the corruption it engendered. They have also been critical of financial liberalization, particularly the sale of banks to foreigners, warning of "economic colonization" and the loss of economic sovereignty; and helping to fuel the rise of popular economic nationalism—or "economic patriotism" as the Chinese media terms it.

Foreign companies have been the main casualty of the "economic security" debate, with Carlyle Group and Goldman Sachs among others finding themselves mired in protracted negotiations over the purchase of Chinese companies. In a sign that the leadership was clearly listening to and eager to harness the debate for its own purposes, in September 2006 regulations were issued that strengthened the government's oversight of mergers and acquisitions (M&As), adding two more state agencies—and a mountain of red tape—to the approval process. And, by selling the AML as legislation necessary to combat foreign domination of China's markets, the central authorities were able to garner significant public support for its passage, even over the objections of vested local government interests. In the June 2007 draft of the AML a provision was added requiring foreign acquisitions of Chinese companies to pass a national security review to ensure that such M&A's do not harm China's economic security.

### **Is China's Anti-Monopoly Law Anti-Foreign?**

Foreign firms certainly have cause for concern about how China's AML will be implemented in practice. The first target of the law was Microsoft, which faced complaints over the ubiquity of its operating system and other applications (despite the fact that, due to the rampant piracy of its products in China, legal copies of Microsoft's products account for only a fraction of China's overall market for such software) and Coca-Cola's attempt to acquire Chinese juice maker Huiyuan remains mired in controversy. According to one poll some 80 percent of respondents are opposed to the sale of a "national brand" to a foreign company. This does not augur well for future M&As.

Notwithstanding, China is not the only country to require a national security review for certain M&As. The United States, Germany and France are among the countries that review M&As for national security purposes. The Chinese authorities also sought advice from foreign experts and agencies in the drafting of the AML and solicited opinions from foreign business organizations on the drafts. While foreign firms are currently in the unfortunate position of having

been put in the spotlight by the law it would, however, be wrong to conclude that the law is anti-foreign.

As with any other anti-trust legislation, China's AML was not formulated in a vacuum and must be viewed within the particular political, economic and legal constraints the drafters had to work with. Focusing on foreign firms was politically expedient and certainly helped Beijing gain domestic support for the AML with the goal of creating a true national market. Such a market would benefit not only Chinese firms of scale, but also those from other economies. However, an over-emphasis on the dangers of foreign competition, while a useful expedient, is a double-edged sword that could easily swamp the ultimate target of the AML. Relying on the expedient over the longer term will not only risk global confidence in the China market but will also fail to combat the real source of unfair competition and economic inefficiency: local protectionism and administrative monopolies.

If that becomes the case, the tortured process that led to the AML could yield a market that remains fractured, without the efficiency and other economic gains earned through competition from foreign firms. That would be a destination 180 degrees from the one intended by China's leadership when the AML began its odyssey 13 years ago,

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