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People's Republic of China

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1 INTRODUCTION

In its now two-decade-long transition from a centrally planned to a market economy, the People's Republic of China (PRC) has made remarkable progress in introducing competition to its industries. It recognized that it was essential to build an effective competition policy system so as to create a level playing field for all business enterprises. During this transitional period, industrial policies and inward foreign direct investment (FDI) played a crucial role both in transforming industry and in facilitating the development of competition policy. This chapter reviews the competition policy framework in the PRC with emphasis on its interactions with industrial and FDI policies.

I review existing competition law in the PRC in section 2, focusing in particular on the 1993 Anti Unfair Competition Law, which deals with unfair methods of competition as well as restrictive behavior on the part of public utilities and administrative monopolies, and the 1998 Price Law, which prohibits price fixing, price discrimination, and predatory pricing. I also review the draft antimonopoly law, which has gone through many revisions since the early 1990s and which is likely to be legislated soon. Section 2 also provides information on law enforcement together with detailed cases studies illustrating the current status of competition law enforcement, and public awareness, in the PRC.

Since the start of economic reform and the introduction of an open door policy in 1978, the PRC has vigorously promoted industrial policies. The government strongly believed that, by guiding resource allocation with a 'visible hand,' it could establish industries that were capable of

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competing in international markets while at the same time avoiding the fluctuations that accompany the free play of market forces. During the 1990s, the PRC actively pursued a strategy of building up giant conglomerates and national champions, following the example of the Republic of Korea (Korea). Although the Asian financial crisis led the government to reconsider this strategy, industrial policies remain the guiding force in many economic policies. Section 3 of this chapter examines the interactions between industrial policies and competition policy in the PRC.

Local protectionism is another major obstacle to competition policy development in the PRC. For historical reasons, local governments have had a strong incentive to protect local enterprises from competition from other regions. This has contributed to the duplication of investments and to excess capacity in some industries, and thus the PRC's observed low degree of industrial concentration. Section 4 focuses on the role of regional protectionism in attracting FDI. It gives an example of a car tariff war between Shanghai city and Hubei province to illustrate the prevalence of regional protectionism and its effects on competition and FDI allocation.

Section 5 examines the effects of inward FDI on competition, in particular through two contrasting case studies of acquisitions of domestic brands by multinational enterprises (MNEs). Whereas Unilever and Procter & Gamble have reportedly adopted a 'brand-killing' strategy in relation to the brands they acquired from their local joint venture partners, L'Oréal appears to be committed to the two leading skincare brands it acquired in late 2003 and early 2004. This section also discusses the country's first merger and acquisition (M&A) notification system, set up in 2003 in response to the increase in FDI-related M&As.

In sections 6 and 7 of the chapter I provide some observations on competition and poverty reduction, and offer some concluding remarks.

2 COMPETITION LAW IN THE PEOPLE'S REPUBLIC OF CHINA

The PRC did not have a competition policy until the late 1970s when it started the transition process from a centrally planned to a market economy. Under the traditional central planning system, competition had no role to play either in theory or in practice, and therefore there was no need whatsoever for a competition policy.

In the early 1980s, the PRC moved toward a more decentralized economy. The government permitted the development of a private sector and introduced competition into economic life. There was then a need to set

up rules to govern competition. Currently the main competition laws and regulations in the PRC are the 1980 Provisional Regulations Concerning Development and Protection of the Socialist Competition Mechanism, the 1993 Anti Unfair Competition Law, and the 1998 Price Law. The PRC began drafting a comprehensive antimonopoly law in the early 1990s, but this has not yet been legislated.

The objective of competition policy in the PRC is described in article 1 of the 1993 Anti Unfair Competition Law as being to

safeguard healthy development of the socialist market economy, encourage and protect fair competition, stop acts of unfair competition and to defend the lawful rights and interests of operators and consumers.

The 1980 regulations

The first government document related to competition in the PRC—the Provisional Regulations Concerning Development and Protection of the Socialist Competition Mechanism—was issued by the State Council on 17 October 1980. It stipulates that

in economic activities, with the exception of products managed exclusively by state-designated departments and organizations, monopolization or sole proprietary management of other products is not allowed (article 3).

The contents of the regulations are brief and the regulations were never properly enforced. Nevertheless, even at this early stage of competition policy development, it is apparent that the State Council recognized the need to curb administrative monopolies and regional protectionism. Article 6 states that

competition must be introduced by breaking down regional blockades and departmental barriers. No locality or department is allowed to block the market. No locality or department should impose any ban on the entry of goods made in other places. Localities should ensure that raw material can be transferred out according to state plans and must not create any blockade. Departments in charge of industry, transport, finance and trade must revise any part or parts of their existing regulations and systems which impede competition so as to facilitate competition.

The 1993 Anti Unfair Competition Law

The 1993 Anti Unfair Competition Law, which took effect on 1 December 1993, was the PRC's first competition law.¹ Its goals were to protect competition and prevent unfair trade practices. The promulgation and implementation of this law represented a significant step toward the establishment of a competition policy in the PRC.

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The law proscribed trademark counterfeiting (article 5); restrictions on the use of related products imposed by public enterprises and other legal monopolies (article 6); abuse of administrative power or restraints on free trade among regions by government agencies or their associates (article 7); bribery in business transactions (article 8); deceptive advertising (article 9); obtaining, disclosing, or using trade secrets without the consent of the owner (article 10); predatory pricing (article 11); tied sales (article 12); deceptive sales tactics such as prize draws (article 13); uttering and disseminating false information that would hurt the reputation of a competitor (article 14); and bid rigging (article 15). The prohibited acts can be classified into the following three categories.

- 1 *Deceptive advertising and other business activities involving dishonesty (articles 8, 9, 13, and 14).* Article 8 prohibits bribery in business transactions, especially in the form of kickbacks whereby buyers of commodities are rewarded, in money or materials, in transactions that do not appear in the company books. Article 9 prohibits false or misleading advertising. It extends the liability for false advertising to advertising agencies that are or should be aware of a seller's misrepresentation. Article 13 limits the use of prize draws as a marketing strategy. To be legal, a draw must be conducted honestly and the value of the prize must not exceed CNY5,000. Article 14 outlaws the utterance and dissemination of information intended to injure the reputation of a competitor.
- 2 *Protection of intellectual property rights and trade secrets (articles 5 and 10).* Article 5 offers protection against trademark infringement. It prohibits not only the forgery of trademarks and certificates of quality and origin, but also the use of similar brand identification—brand names, packaging, or designs—that would be likely to confuse the consumer. A fine of 100–300 percent of the value of the illegal gains may be imposed for breaches of the law. Criminal sanctions may also be imposed in accordance with the PRC Trademark Law. Article 10 protects trade secrets, defined as technical and operational information that is not known to the public, that is capable of bringing economic benefits to the owners of the rights, that has practical applicability, and that the owners of the rights have taken measures to keep secret. The law imposes a fine of CNY10,000–200,000 on those who obtain such secrets illegally, or who know or should know that a trade secret was obtained illegally but nevertheless agree to distribute such knowledge to a third party.
- 3 *Antitrust provisions (articles 6, 7, 11, 12, and 15).* Five of the 11 acts prohibited by the Anti Unfair Competition Law can be classified as

antitrust provisions. Article 6 states that 'Public utility enterprises or other business operators that have a legal monopolistic status shall not force others to buy the goods or services of their designated business operators in order to exclude other operators from competing fairly.' Violations may incur fines of CNY50,000–200,000, as well as confiscation of 100–300 percent of the illegally acquired revenue (article 23).

Article 7 addresses the behavior of government officials who coerce customers into buying products from their designated suppliers, stating that 'A local government and its subordinate departments shall not abuse their administrative power to force others to buy the goods of the operators designated by them so as to restrict the lawful business activities of other operators.' It also prohibits blockades of regional competition: 'A local government and its subordinate departments shall not abuse their administrative power to restrict the entry of goods from other parts of the country into the local market or the flow of local goods to markets in other parts of the country.'

Article 11 prohibits predatory pricing. It prevents operators from selling products at below cost in order to drive out competitors—while not spelling out what 'cost' actually means. Article 11 excepts a number of practices from its provisions: the sale of fresh produce; the disposal of products whose period of validity is about to expire, or of overstocked products; seasonal reductions in prices; and the sale of products at reduced prices to pay off a debt, or due to a change in product lines or the closure of the business.

Article 12 provides that, in selling a product, a business operator shall not make a tied sale against the wishes of the buyer, or attach any other unreasonable conditions.

Article 15 prohibits collusion in the tendering process (bid rigging).² Violators can be fined CNY10,000–200,000 depending on the seriousness of the offense (article 27).

The 1993 Anti Unfair Competition Law provides for criminal penalties only in the cases of trademark infringement (article 21) and bribery (article 22). Even the hard-core collusive behavior of bid rigging does not attract a criminal penalty under the 1993 law, although it does under the Public Tendering Law of the People's Republic of China, which took effect in January 2000.

The State Administration for Industry and Commerce (SAIC) is the administrative body responsible for enforcing the 1993 Anti Unfair Competition Law.³ It has branches throughout the country at the provincial, city, and county levels, and had over 61,000 staff nationwide in 2002. All

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SAIC branches have investigative power. They can issue warnings and take corrective measures, including imposing fines and suspending business licenses.

SAIC is under the State Council and has a long tradition of protecting market order even under the traditional central planning system. The Fair Trade Bureau created within SAIC in 1994 has three divisions, responsible for preventing unfair trade practices, investigating monopolies, and consumer protection. SAIC's other duties include administration of business licenses, registration of trademarks, and enforcement of related laws such as the Trademark Law and the Advertising Law.

Table 4.1 contains information on SAIC's enforcement activities during 1995–2002. Although the majority of the cases listed in the table involve trademark infringements or trade secrets, SAIC has also been active in combating antitrust violations. In 1995 SAIC handled 194 antitrust cases. The figure has continued to rise since then, reaching as high as 2,208 in 2001 and 1,547 in 2002. A large number of these cases involved public utilities, with bid rigging constituting another main component. The sharp rise in the number of such cases in recent years reflects the increased attention SAIC has paid to fighting the abuse of administrative power and restrictive practices by public utilities. In 2001, it launched a nationwide campaign specifically to counter such practices. In 2002, the State Council launched its own campaign to break down sectoral monopolies and regional blockades, and combat other anticompetitive acts (Wang 2001). As a consequence, the number of administrative monopoly cases rose substantially in 2000 and reached a record high of 137 cases in 2001. The number of cases involving public utilities increased from 432 in 1999 to 785 in 2000, then more than doubled to 1,614 in 2001 before declining to 1,089 in 2002. Other types of antitrust violations have experienced a similar pattern, except for predatory pricing, which accounts for 30–40 cases per year.⁴

During the decade since the introduction of the 1993 Anti Unfair Competition Law, SAIC has issued over 70 administrative explanations to local SAIC branches giving specific guidance on law enforcement. In the area of international cooperation, it has established cooperative relationships with over 20 competition agencies from other countries (Gan 2003). In addition, it has conducted various competition advocacy activities to raise public awareness of competition policy. The State Council promoted SAIC from vice-ministerial to ministerial level in 2001, further strengthening its authority and position.

While the enforcement record of SAIC is impressive, one point worth noting is that most of the cases it has dealt with have involved administra-

Table 4.1 PRC: Competition cases handled by SAIC, 1995-2002 (no.)

Type of case	1995	1996	1997	1998	1999	2000	2001	2002
Consumer protection/business dishonesty	709	2,160	2,441	1,756	2,651	4,260	6,841	8,490
Infringement of trademark/trade secret	4,361	8,856	9,296	9,698	11,011	14,525	15,575	18,454
Antitrust violations	194	264	261	281	603	1,154	2,208	1,547
Abuse of administrative power	22	38	13	10	10	56	137	88
Restrictions by public utilities	55	102	94	131	432	785	1,614	1,089
Predatory pricing	10	59	32	19	26	39	31	43
tied sales	91	42	85	44	84	64	110	139
Bid rigging	16	23	37	77	51	210	316	188
Removing/concealing/destroying illegal assets	24	108	46	35	43	21	29	29
Other cases	-	-	2,847	2,876	3,891	6,093	10,718	12,331
Total number of cases	5,288	11,388	14,891	14,646	18,199	26,053	35,371	40,851
Total amount of illegal gains (CNY million)	419.1	738.2	843.9	648.1	1,230.0	1,906.1	3,358.9	3,080
Value of confiscations & fines (CNY million)	36.8	85.4	107.8	195.0	144.7	269.2	472.1	499.5
No. of cases transferred to judicial system	35	104	5	n.a.	n.a.	n.a.	n.a.	11

n.a. = not available.

Source: SAIC.

tive measures, with only a tiny percentage turned over to the judicial system. This indicates the heavy reliance of competition law enforcement on administrative channels.⁵

In addition to the national Anti Unfair Competition Law, many provinces and major cities have their own laws and regulations designed to counter unfair competition.⁶ For example, price fixing was first prohibited by Guangdong province under implementing regulations on unfair competition. Beijing enacted an Anti Unfair Competition Law in 1994, shortly after the promulgation of the national law. To date, over 20 provinces and cities in the PRC have enacted similar laws and regulations, some of them simply detailed guidelines for implementing the national law (Kong 2001: 15). Sectoral regulations such as the 2000 Telecommunications Ordinance of the People's Republic of China also incorporate competition-related provisions.

The 1998 Price Law

Five years after the promulgation of the Anti Unfair Competition Law, the government enacted another important piece of competition legislation, the 1998 Price Law. The main objective of this law, which came into effect on 1 May 1998, is to fight price fixing and predatory pricing. Article 14 declares the following practices to be unfair and illegal: conspiracies aimed at controlling market prices that result in damage to other operators and/or consumers; predatory pricing; and price discrimination.⁷ The penalty for violating the provisions of the 1998 Price Law can be as high as five times the illegal gains. In extremely serious cases, business licenses can be suspended. However, no criminal penalties can be imposed.

The Price Law is a good complement to the Anti Unfair Competition Law in that it specifically outlaws price cartels, which the 1993 law did not do. It also makes up for the failure of the 1993 law to provide a definition for 'cost' in its predatory pricing provisions: the Price Law defines 'cost' as referring to production and operational costs (article 8). A provision on discrimination against particular business operations is designed to prevent monopolies from using a price squeeze strategy to drive competitors out of related markets. The 1993 law contains similar provisions on discrimination against particular business operations.⁸

Responsibility for enforcing the Price Law rests with the State Development and Reform Commission (SDRC) and its price administration agencies at the provincial, city, and county levels. This enforcement system was very inexpensive to set up as the SDRC and its local branches

were already in place; it was this body that had been responsible for setting the prices of virtually all commodities during the central planning era.⁹ Although detailed data on the SDRC's law enforcement record are not available, it is clear that it has not been as busy as SAIC, partly due to the differences in the nature of the violations covered by the two laws. The SDRC has, however, been tested by some price-fixing cases that have drawn national attention, such as a cartel in color television sets (Box 4.1). Enforcement activity by local SDRC branches has also been reported. For example, in July 2000 the Beijing Price Bureau successfully broke an agreement among nine licensed travel agencies in Beijing to collectively set minimum prices on package trips to several Southeast Asian destinations.¹⁰

An important lesson that can be drawn from the case of the color television cartel is that the government needs to do more to raise public awareness of the Price Law. The TV manufacturers involved in the price cartel initially did not realize that their agreement was illegal, and even a high-ranking official in the Ministry of Information Industry was not aware that they had violated the Price Law. Other firms have been similarly caught out.¹¹ Better competition advocacy would certainly improve the effectiveness of competition law in the PRC.

Moreover, the occurrence of price wars and subsequent closure of some firms does not necessarily mean that competition is excessive or vicious. On the contrary, it may be an indication of a market system that is functioning well and of improvements in efficiency as less-efficient players are driven out of the market. One does of course also need to be aware of the danger of predatory behavior. But in any case, it should be the law, rather than self-regulation on the part of the players, that deals with any instances of anticompetitive conduct.

The draft antimonopoly law

The PRC's existing competition laws focus primarily on unfair competition. They do not deal with monopolization, abuse of a dominant position, or M&As. In 1994, the government announced its intention to promulgate an antimonopoly law to supplement the provisions of the Anti Unfair Competition Law. The drafting group formed in May 1994 consisted of officials from the State Economic and Trade Commission and SAIC. The antimonopoly law they prepared has been revised several times, based on the suggestions of scholars from international organizations such as the Organisation for Economic Co-operation and Development (OECD), the World Bank, the United Nations Conference on Trade and Development,

Box 4.1 A case study of a color television cartel

The television industry underwent six price wars during the period 1996–2000, with several leading manufacturers experiencing losses in 2000 (Lee and Chan 2002). On 9 June 2000, at a summit held in Shenzhen, the top managers of nine TV manufacturers agreed to form an alliance to address the problems in the industry.

The nine manufacturers who took part in the summit were Konka, Skyworth, TCL, Rova, Hisense, Xococo, Jinxing, Panda, and Westlake, who together account for more than 80 percent of the domestic color TV market. The PRC's leading manufacturer, Changhong, did not participate. The agreement reached at the summit covered three areas: research and development (R&D) cooperation in developing new products and a digital technology standard for the industry; joint efforts to promote exports to other countries; and the setting of minimum prices for TVs sold domestically.

The third element is clearly a price cartel agreement. The manufacturers jointly announced that the retail prices of 21-inch, 25-inch, 29-inch, and 34-inch color television sets would henceforth be at least CNY1,050 (\$127 at the current official rate of CNY8.27/\$1), CNY1,700 (\$206), CNY2,600 (\$310), and CNY4,200 (\$500) respectively. *Beijing Youth Daily* reported that the alliance also planned to cut production for the domestic market by 15–20 percent. This would amount to a reduction of about two million television sets (*China Daily*, 25 June 2000, 11 August 2000). According to the manufacturers, the prescribed minimum was so low that any TV sold at a lower price would have to be of very poor quality.

It appears that the TV manufacturers were not aware that their collective action would violate the 1998 Price Law. The managers of some of the companies openly defended their decision, saying that collective action was needed to end the losses caused by the price wars in the industry. The State Development and Planning Commission (SDPC)—which is now the SDRC—had to make it publicly clear that their acts were indeed a breach

and Asia-Pacific Economic Cooperation, and from countries such as Germany, the United States, Japan, Korea, and Australia.

The most recent version of the law that is publicly accessible was drafted in 2002. It has eight chapters containing 58 articles. The chapters cover price fixing, predatory pricing, price discrimination, refusal to deal, tied sales, exclusive dealing, resale price maintenance, M&As, administrative monopolies, the establishment of a competition authority, legal liability, and so on, accompanied by both civil and criminal remedies. (A detailed table of contents for the draft law is given in Appendix A4.1.) The

of the law. An SDPC official criticized the alliance as a monopoly in disguised form, and said that the SDPC would investigate the case intensively.¹² But Konka for one fought back, saying that the price floor set by the alliance was sufficient only to cover production costs. The company's executive vice-president, Liang Rong, pointed out that the cost of producing a television set included such things as materials, labor, overheads, taxes, after-sales services, and employee training fees, as well as the company's spending on R&D. 'Sales under the floor price, or production costs, should be regarded as unfair competition,' he said (*China Daily*, 25 June 2000).

A high-ranking official in the Ministry of Information Industry, which supervises the sector, seemed to take the industry's side; on the same day that the summit was held, he stated that the formation of such an alliance was a sign of the maturing of the color TV sector, indicating the 'healthy development of the industry via self-protection, self-discipline, and voluntary cooperation.'¹³ But on 3 August 2000, after meeting with the nine producers, the SDPC and the Ministry of Information Industry jointly declared that while there was nothing wrong with the manufacturers discussing long-term issues affecting the industry as a whole, setting minimum prices nevertheless violated the 1998 Price Law.¹⁴

No formal action has been taken against the manufacturers, perhaps because of the internal problems that quickly developed within the alliance. Only a day after its establishment, the Nanjing-based company, Panda, reportedly priced one of its models at CNY600 (\$72.30), lower than the floor price set by the alliance. According to An and Yang (2002), the alliance had agreed to impose a fine of CNY500,000 on any manufacturer that violated the agreement, but this rule was never implemented. Supermarket statistics also indicate the failure of the agreement: there was an actual increase in the number of color TV sets sold after the alliance declared it would limit production and raise prices (*China Daily*, 25 June 2000).

latest draft of the antimonopoly law was submitted to the State Council's Legislative Affairs Office in March 2004 and has been placed on the legislative agenda of the current National People's Congress (which ends in 2007).

The coverage of the draft law is quite comprehensive and generally in line with international standards.¹⁵ However, one major area, namely the provisions on legal liability, has aroused debate. Chapter 7 of the draft law spells out the maximum penalties for violations of the law: CNY5 million for price fixing, CNY10 million for abuse of a dominant market position

and for non-compliance with merger control decisions, and so on. However, it fails to specify the basis for imposing a specific penalty for any given violation. Is the penalty supposed to be equal to the illegal gains? Can multiple damages be imposed? Economic principles tell us that for laws to have a deterrent effect, the penalty needs to be greater than the illegal gains from the violation (because the probability of detecting a violation is less than 1).¹⁶ Unlike the 1993 Anti Unfair Competition Law and 1998 Price Law, which both allow multiple damages and thus are consistent with the economic principles for an optimal penalty, the draft anti-monopoly law has yet to explicitly incorporate the notion of a deterrent effect.¹⁷

A distinct feature of the PRC's draft antimonopoly law is that it deals explicitly with administrative monopolies. Chapter 5 identifies four types of administrative monopoly: forced transactions, regional blockades, sector/industry monopolies, and forced joint activities that restrict competition. Administrative monopolies are rooted in the traditional central planning system and will continue to be extremely difficult to tackle.

The two types of administrative monopoly that are most prevalent in the PRC are regional blockades (discussed in more detail in section 4) and sectoral monopolies. One illustration of the latter is found in the telecommunications industry as documented by Sheng and Zhang (2000). Telecommunications services were provided by one giant monopoly, the Ministry of Posts and Telecommunications, until the early 1990s. In 1994, China Unicom, a new service provider jointly established by the Ministry of Electronics, Ministry of Electricity, and Ministry of Railroads, entered the telecommunications markets with the authorization of the State Council. The industry thus became a duopoly between China Unicom and the dominant incumbent, which was also the industry regulator.

According to Sheng and Zhang (2000), the Ministry of Posts and Telecommunications adopted several anticompetitive practices shortly after the entry of China Unicom in order to defend its monopoly position. The new entrant was required to apply to the ministry for permission to operate in any of the PRC's many geographic markets. By delaying consideration of its applications, the ministry could ensure that China Unicom's newly developed infrastructure could not be put to use for some time. The ministry also set up administrative barriers, and charged unreasonable interconnection rates for access to its network. It made it difficult for the new entrant to obtain critical resources such as telephone numbers, airwave frequencies, and satellite channels, occasionally disconnected services to China Unicom's customers, and employed other restrictive business practices such as predatory pricing and cross-subsidization.

3 LINKAGES BETWEEN COMPETITION POLICY AND INDUSTRIAL POLICY

Since the start of its open door policy in the late 1970s, the PRC has persistently pursued targeted industrial policies. Industrial policy objectives are embedded in the country's FDI, science and technology, education, land use, and taxation policies. According to Jiang (2002a: 49), the central government issued more than 80 comprehensive industrial policies between 1978 and 1997, pertaining to virtually every government department and every industry. She divided these industrial policies into four categories: policies designed to reform the industrial landscape; those containing interventionist measures; policies that supported particular industries and enterprises; and those that restricted certain industries and enterprises.¹⁸

Jiang (2002a) identified three stages of policy development.¹⁹ During the first stage, from the late 1970s to the mid-1980s, the PRC's industrial policies promoted competition, by encouraging the entry of new firms (particularly in non-state sectors), by introducing competition among existing enterprises, and by relaxing price controls. In the second stage, from the mid-1980s to the mid-1990s, the country's industrial policies limited competition. They restrained the establishment of new small and medium-sized enterprises, restricted competition between rural and state-owned enterprises (SOEs), and provided preferential treatment to large SOEs. In the third stage, which began in the mid-1990s, industrial policies have both promoted and limited competition: they have been used to promote competition in monopolistic industries, but they have also been used to rescue SOEs that were facing difficulties.

Jiang's characterizations of the effects of industrial policies on competition are fairly sensible. Until the mid-1990s, the PRC's policy-makers regarded industrial policies as the cure for virtually every economic problem and as the key to long-term economic development. Whenever a shortage or surplus occurred in the marketplace, or competition was judged to be 'excessive' (as seen by price wars or a large number of loss-making enterprises), the public expected the government to step in and correct the situation with 'proper' industrial policies.

During the early stage of economic reform (late 1970s to mid-1980s), a primary goal of the government was to improve the performance of enterprises by introducing competition—relaxing price controls, removing entry barriers, and so on. On the whole these measures worked well, significantly boosting enterprise performance. However, during that period—and indeed until the mid-1990s—the market mechanism was regarded as supplementary to central planning. As competition intensified

in the domestic industry, the government was faced with new problems such as the duplication of investments and the crowding out of large SOEs by small-scale, mostly non-state-owned, new entrants. To combat these 'problems,' the government introduced new industrial policies. The second stage in Jiang's analysis thus corresponds roughly to a correction period for industry. After a period of consolidation, during which order was restored and industrial activity slowed, a new round of stimulatory industrial policies was launched.

In October 1992, at the 14th Congress of the Chinese Communist Party, the PRC decided to replace its traditional approach in which the market was supplementary to central planning with one aimed at establishing a socialist market economy. Gradually the market mechanism has been recognized as an alternative, and possibly much better, means to overcome economic problems. Nowadays, the most competitive industries in the PRC, such as home appliances and textiles, are those that experienced the most turmoil and excessive competition during the past two decades.

Nevertheless, industrial policies continue to play a very important role. In particular, the promotion of large-scale enterprises remains an important part of central government policy. Influenced by the approach of Korea, the PRC regarded the establishment of large conglomerates as the best way for domestic enterprises to obtain economies of scale and compete with MNEs both domestically and in international markets. It also saw M&As as an effective vehicle to absorb and transform loss-making SOEs.²⁰ In 1991 and again in 1997, the State Council selected a 'national team' of 120 large enterprise groups, primarily from industries considered to be of strategic importance, to receive special treatment from the government.²¹ To enhance their competitiveness, these 'national champions' were granted tariff protection, special rights to engage in international trade, access to foreign technology, 'easy loans' from state-owned banks, and other preferential treatment.²²

Although the Asian financial crisis, and its effects on Korea in particular, led the PRC to reconsider its original approach, establishing large domestic enterprises has remained a top priority for the government. Not surprisingly, many of the large-scale M&As that have taken place in recent years have been government managed. For example, in a government-ordered merger in 2002, the Civil Aviation Administration of China forced nine domestic airlines under its direct control to form three super groups: China National Aviation and China Southwest became subsidiaries of Air China; Yunnan Airlines and China Northwest became subsidiaries of China Eastern; and China Northern and Xinjiang Airlines

became subsidiaries of China Southern. Because the mergers were carried out through administrative transfers, the super groups obtained the assets of the regional carriers for free.

In another example, under its 10th five-year plan for the auto industry (2000–05), the government decided to encourage 100 small automobile manufacturers to merge with the three giants: First Automotive Works Corporation, Dongfeng Automobile Company, and Shanghai Automobile Group. In 2002, First Automotive Works bought a majority stake in Tianjin Xiali Ltd in the largest M&A transaction in domestic auto-manufacturing history. This acquisition was more market oriented than the airline transactions in that First Automotive Works actually purchased 51 percent of Tianjin Xiali's stock (Global M&A Research Center 2003: 393–7).

Industrial policy and the delay in enacting antimonopoly legislation

As mentioned earlier, the PRC began drafting an antimonopoly law in the early 1990s. While there are many reasons for the long delay in enacting this legislation, the pursuit of industrial policy has been one factor holding back the effort to set up a comprehensive competition law.

Views on the need to introduce an antimonopoly law in the PRC differ. One view holds that it is too early to enact such a law because the PRC is still in the early stage of building a market system and its markets are not well developed. The issue for most industries in the PRC is not high concentration, but rather the reverse: major firms have not yet attained economies of scale, and so action against monopolies is largely irrelevant (Yang 2002). A related position held by many government officials is that the government should actually continue to encourage the formation and development of large enterprise groups and promote economies of scale so as to enhance the international competitiveness of domestic enterprises. The introduction of an antimonopoly law would work against these goals (Li and Ma 2002). Both of these views seem to equate competition policy with a bias against bigness.

Advocates of antimonopoly legislation, meanwhile, hold that the enactment of an antimonopoly law is not only consistent with, but also necessary for, enhancing the competitiveness of large enterprises, especially SOEs. According to this view, only through fair market competition where efficient firms survive and prosper and inefficient ones exit the marketplace can large domestic enterprises really grow and become competitive (Wang 2004; Kong 2001: 259). The proponents of this view believe that creating and maintaining a level playing field, as opposed to protecting domestic enterprises, benefits all firms.

A more pessimistic view holds that the most crucial issue facing the PRC today is the fight against administrative monopolies, a problem that will not be resolved by a single piece of antimonopoly legislation. The proponents of this view maintain that the administrative monopolies inherited from the traditional central planning system can only be dealt with through further economic reform and the PRC's transformation into a true market economy (Li and Ma 2002).

Promulgating an antimonopoly law is now at the top of the agenda for the National People's Congress. However, even with such a law in place, conflicts between competition policy and industrial policy are likely to occur. For example, in evaluating the competition effects of a merger, the government is likely to take into account its desire to encourage large enterprise groups and promote national champions. Also, in situations involving competition between domestic firms and foreign investors, protection of domestic players may continue to carry some weight. The challenge for the competition law enforcement agency will be to demonstrate that it can deal with such conflicts.²³ In the author's view, it is extremely important for the PRC to establish a truly independent enforcement agency with sole responsibility for enforcing competition law. If, instead, the task of enforcing the antimonopoly law rests on the shoulders of an existing agency that has traditionally been charged with promoting industrial policy, then it will be more difficult to guarantee the full implementation of competition policy and its non-interference with industrial policy.

4 LOCAL PROTECTIONISM AND COMPETITION

Local protectionism is prevalent in the PRC. It has taken such forms as imposing taxes on commodities made in other provinces (Box 4.2), banning exports to other regions of locally made raw materials that are of high quality or in short supply,²⁴ or even preventing law enforcement officers from dealing with local firms that counterfeit the brands of other regions (Lin 2001). With the move toward fiscal decentralization since 1978, local governments have had a strong incentive to shield local firms and protect their tax base. The desire to guarantee local employment is another economic as well as political incentive for local government officials. Throughout the 1990s, local governments competed to attract FDI, even adopting protective measures that would ensure the profitability of locally based foreign firms.

Local protectionism leads to market fragmentation and thus to low regional specialization. The eight-firm concentration ratios reported in Table 4.2 are consistent with widespread local protectionism in the PRC.

Box 4.2 A case study of protection in the local auto industry

The city of Shanghai and the province of Hubei are the PRC's two leading car manufacturing bases. In 1984 Volkswagen, the German auto manufacturer, set up a 50:50 joint venture with a consortium of domestic partners led by the Shanghai Automotive Industrial Corporation to produce Santana passenger cars in Shanghai. In 1992, Automobiles Citroën of France and Dong Feng Motor Corporation of the PRC set up the Dong Feng Citroën Automobile Company in Wuhan, the capital of Hubei, to produce and sell Fukang passenger cars.

In mid-1998, Shanghai introduced local regulations to protect its Santana sedans. The municipal government slapped extra licensing fees and sales taxes on consumers who bought cars made outside Shanghai, thereby adding some CNY80,000 (\$9,600) to the already high prices of such cars.²⁵ This badly affected the Fukang; in the first half of 1999, Dong Feng Citroën sold only 24 cars in Shanghai whereas Shanghai Volkswagen sold 6,400 Santanas.

In swift and severe retaliation, Hubei began levying taxes on consumers who bought Santanas rather than the locally made Fukang. Taxes included irrigation construction fees (abolished long ago by the central government) and a dubious CNY70,000 (\$8,400) levy to 'help loss-making SOEs overcome their difficulties.' As a result, the price of a Santana in Wuhan rose to CNY326,000 (\$39,000)—nearly double its usual price of CNY172,000 (\$20,700).

Both Shanghai's and Hubei's regulations on car purchases came into being despite a 1990 directive from the State Council banning such restrictions on interprovincial trade. A spokesperson for the Machinery Industry Department of Hubei claimed that the province had been forced to issue the restrictions because 'everyone else does the same.' It is indeed true that, with more than 120 car-makers nationwide, nearly every locality that boasts an auto plant applies restrictions to outside manufacturers in order to keep its own local champion afloat.

Unable to enforce regulations among competing localities, the central government decided to take the PRC's three leading car-makers under its protection and support the creation of a mainland-style auto *chaebol*. The chosen three included the two companies at the center of the Shanghai–Hubei car war—Shanghai Automotive Industrial Corporation and Dong Feng Motor Corporation—as well as First Automotive Works, which is based in Jilin province. In late January 2000, Shanghai announced that it would scrap its protective licensing fees and, from 19 January 2000, throw open its market to outside manufacturers.

Source: *Asia Times Online*, 15 January 2000.

Although the degree of concentration has generally increased since 1995, very few industries have a concentration ratio above 50 percent, and for most the ratio is below 20 percent.

Recent empirical studies on the effects of local protectionism on regional economies in the PRC have come up with mixed findings. Young (2000) provides anecdotal evidence of a rise in local protectionism during the reform era, especially in the 1980s, and presents statistical evidence of declining regional specialization. Naughton (1999), on the other hand, finds evidence of increasing regional specialization between 1987 and 1992. More recently, Bai et al. (2005) use more comprehensive statistical methods to find evidence of local protection of industries with a high tax-plus-profit margin and a high degree of state ownership. They also find that the degree of regional specialization has been increasing since the mid-1980s, after an earlier decrease. Nevertheless, the case study of the auto industry presented in Box 4.2 demonstrates that regional protectionism was prevalent even in the late 1990s, despite the revised trend.

The central government has long been trying to prohibit regional protectionism. This was the intention of article 6 of the State Council's Provisional Regulations Concerning Development and Protection of the Socialist Competition Mechanism, issued as early as 1980. Enforcement of these regulations over the past two decades has, however, been poor. Perhaps the passage of an antimonopoly law, especially the provisions on administrative monopolies, will allow regional barriers to trade and competition to be torn down more effectively.

Possibly even more important than external forces such as enforcement are internal incentives on the part of localities. In June 2004, nine provinces in southern PRC joined the Macao and Hong Kong, China special administrative regions to form the Pan Pearl River Delta regional trading block.²⁶ This was an encouraging development given that the sole goal of the agreement was to break down trade barriers and build a vast common market for the 11 member regions. The formation of this trading block was driven by increasingly intense competition between the Pearl River Delta region (consisting of Guangdong province and the Macao and Hong Kong, China special administrative regions) and the Yangtze River Delta (consisting of the city of Shanghai and the provinces of Zhengjiang and Jiangsu in eastern PRC).

5 FOREIGN DIRECT INVESTMENT AND COMPETITION

A major factor affecting the degree of competition in the PRC is the massive inflow of FDI over the past two decades. Since the PRC adopted an

Table 4.2 PRC: Eight-firm concentration ratios in selected manufacturing industries, 1995 and 2000 (%)

Industry	1995	2000
Food processing	5.3	7.5
Food production	9.9	13.1
Beverage production	8.6	20.4
Tobacco processing	33.0	54.0
Textiles	2.8	6.6
Garments & other fiber products	3.8	9.3
Leather, furs, & related products	2.9	n.a.
Timber & straw products	5.7	n.a.
Furniture manufacturing	5.4	n.a.
Papermaking & paper products	5.3	10.9
Printing & recorded medium products	5.1	n.a.
Educational & sporting products	8.1	n.a.
Petroleum processing & coking	44.9	82.8
Chemical materials & products	11.3	7.9
Pharmaceutical products	11.8	28.8
Chemical fibers	37.6	13.8
Rubber products	18.3	36.4
Plastic products	3.6	6.0
Non-metal mineral products	2.4	6.1
Ferrous metals	30.2	39.5
Non-ferrous metals	13.3	10.3
Metal products	4.6	9.5
Ordinary machinery	6.5	9.9
Equipment for special purposes	6.2	11.7
Transport equipment	20.9	28.9
Electrical equipment & machinery	8.8	30.8
Electronic & telecommunications equipment	14.7	23.1

n.a. = not available.

Source: China Statistics Press (1997, 2002).

open door policy in the late 1970s, and particularly since 1993 when Deng Xiaoping made his famous tour of the south, inward FDI has been a driving force for increased competition in the PRC. The presence of foreign-invested companies has greatly changed the landscape of competition for almost every industry.

Table 4.3 contains information on the presence of foreign firms in various manufacturing industries. As can be seen, in 2002 foreign-invested enterprises accounted for over 30 percent of total sales in many industries. The ratio was over 50 percent in industries such as leather and fur products and cultural and sporting goods, and as high as 74 percent in electronic and telecommunications equipment. In most industries the foreign presence has increased since 1995, highlighting the trend toward increased competition from foreign firms in the domestic market.

However, entry into the PRC has been far from free for foreign investors. They are subject to numerous government regulations, including the requirement to abide by the central government's *Catalog Guiding Foreign Investment in Industry* (MOFTEC 2003). This catalog divides industries into those that are 'prohibited,' 'restricted,' 'allowed,' and 'encouraged' in terms of their openness to FDI.²⁷ Depending on the amount of investment, every new project involving foreign investment must be approved by either the provincial/regional government concerned or the Ministry of Foreign Trade and Economic Cooperation (MOFTEC, which became the Ministry of Commerce in 2003).

The government has also set requirements for the mode of foreign entry. Until the mid-1990s, joint ventures were the main mode of entry for FDI, driven by the PRC's desire to have local partners learn about advanced foreign technology. It was only in the late 1990s—in fact, in the lead-up to the PRC's accession to the World Trade Organization (WTO) in January 2002—that the PRC allowed wholly foreign-owned enterprises to operate in the country, and permitted foreign firms to acquire domestic firms through new FDI inflows. The government has actively used local content requirements as a means to foster the backward linkage effects of FDI, through vertical technology transfers to local suppliers, for example.

The presence of FDI has affected industrial structures in the PRC through two channels. First, increased competition from foreign companies—often equipped with superior technology and management—has driven inefficient local firms out of the market, increasing the degree of industrial concentration. Second, foreign firms have become the dominant players in important industries—automobiles, mobile phone production, chemical products such as detergents and cosmetics, and soft drinks—by merging with or acquiring leading domestic enterprises.

Table 4.3 PRC: Ratio of foreign-invested enterprise sales to industry sales, 1995–2002 (%)

Industrial sector	1995	1997	1999	2001	2002
Food processing	21.2	23.6	24.0	24.6	25.9
Food production	30.5	35.0	37.7	41.8	40.7
Beverage production	26.2	25.5	27.7	30.6	30.9
Tobacco processing	0.6	0.9	0.8	0.7	0.5
Textiles	17.9	18.7	21.3	21.8	21.7
Garments & other fiber products	50.8	44.9	49.2	46.8	45.5
Leather, furs, & related products	54.1	50.1	58.2	54.4	53.2
Timber & straw products	27.3	27.1	32.6	29.6	25.8
Furniture manufacturing	30.7	29.8	42.8	46.6	47.2
Papermaking & paper products	17.0	19.6	28.3	33.0	32.8
Printing & recorded medium products	18.3	20.8	31.1	34.6	33.8
Cultural & sporting goods	50.7	49.3	60.6	60.3	60.0
Petroleum processing & coking	1.4	4.1	5.4	9.0	9.9
Chemical materials & products	12.6	14.2	18.8	21.7	22.2
Pharmaceutical products	18.3	20.3	21.8	22.0	21.7
Chemical fibers	12.7	17.5	33.3	21.0	25.4
Rubber products	25.0	23.1	33.2	36.2	39.0
Plastic products	33.0	33.0	42.0	44.0	42.0
Non-metal mineral products	11.4	11.5	16.1	19.3	19.2
Ferrous metals	6.2	4.0	6.5	7.9	7.6
Non-ferrous metals	12.5	11.8	13.2	11.8	12.6
Metal products	26.6	30.0	35.5	36.8	37.2
Ordinary machinery	14.5	16.1	20.7	22.6	24.0
Special purpose equipment	9.0	10.5	14.4	18.9	20.2
Transport equipment	25.2	22.8	29.6	31.5	32.6
Electrical equipment & machinery	24.2	27.2	32.2	33.8	33.6
Electronic & telecommunications equipment	60.8	62.5	69.5	73.8	73.9

Source: State Statistics Bureau (various years).

Box 4.3 A case study of local brand acquisitions by Unilever and P&G

In early 2002 a bitter row erupted between Unilever, the consumer goods multinational, and Shanghai Toothpaste Factory (STF), a well-known domestic company, over a brand agreement for Zhonghua toothpaste. Zhonghua has been the best-selling toothpaste brand in the PRC for decades. In 1993, Unilever and STF signed an agreement giving Unilever the sole right to manufacture, market, and sell the Zhonghua brand in the PRC. The agreement had an unlimited term, subject to trademark renewal every 10 years. The key condition for renewal was that the total production volume in the last year of the agreement should be higher than that in the first year.

As the end of the first 10-year period approached, STF told Unilever that it wanted to end the agreement and take back the brand because it had 'suffered bad treatment at Unilever's hand' (*China Daily*, 16 January 2002). STF had already taken back another brand of toothpaste leased to Unilever—Maxam—in 2000. Unilever (China) Limited responded that, far from shelving the product, it had given it more attention than it deserved. The company claimed to have spent a considerable sum on developing the Zhonghua brand—on average 53 percent of its annual advertising and promotion budget in the oral category—and pointed out that production of the toothpaste had risen to 40,000 tons in 2002 compared with 35,000 tons in 1993. Unilever also said it had invested in new packaging for the Zhonghua brand and had launched a promotional campaign in August 2001 to boost sales (*China Daily*, 16 January 2002).

There is now a growing concern that foreign enterprises may soon dominate all of the country's industries, and that domestic firms will be driven out of business. The potentially negative consequences of foreign acquisitions for domestic brands is illustrated by the case of a leading domestic brand of toothpaste that is allegedly being 'killed off' by the foreign MNE that bought it (Box 4.3). In contrast, two acquisitions by L'Oréal of prominent brands in the skincare industry were apparently not motivated by the desire to freeze out a competing brand (Box 4.4).

Merger controls and FDI policy

Since the late 1990s, and especially since the PRC's accession to the WTO in early 2002, foreign investors have been keen to merge with or acquire domestic enterprises. In 2002, its first year as a WTO member, the PRC

But STF disagreed. 'Unilever did not manage to push the sales higher till almost the end of the first decade. Nevertheless, we are determined to take back the Zhonghua brand. Zhonghua is a national brand name, with a long history; we must protect it,' said a top manager (*China Management Daily*, 22 November 2001). In 2003 Unilever and STF finally settled their dispute, with STF agreeing to renew the contract for the Zhonghua brand name. One of the conditions of the contract was that Unilever would give the brand a leading position among its product lines (*Southern Daily*, 22 September 2004). Some reports suggest that Unilever's compliance with this condition, and its recent national campaign to promote the brand, is part of a damage control effort to change its negative image among domestic consumers of being a 'domestic brand killer' (*Beijing Modern Commerce Daily*, 29 September 2004).²⁸

Another multinational, Procter & Gamble (P&G), has also been accused of 'freezing' a local brand. In 1994, P&G set up a joint venture with Beijing Second Daily Cosmetic Factory to produce and sell Panda detergent. The Beijing firm was given a 35 percent share of equity in the joint venture in return for access to its manufacturing facilities and the Panda brand name. Panda was among the three best-selling detergent brands in the PRC when the joint venture was launched, but today it is hard to find it in the shops. In September 2000, the Beijing firm bought back the brand. But by that time its position in the market had been reduced to almost nothing whereas P&G's own brand, Tide, had become a family name. In six years, production of Panda detergent had dropped from 60,000 to 4,000 tons (*China Daily*, 16 January 2002).

overtook Japan to become the most active M&A market in Asia. Foreign companies spent \$13.9 billion between January and November 2002 on purchasing domestic firms, up 180 percent over the \$4.9 billion spent in 2001 (US-China Business Council 2003). M&As are an important vehicle for foreign investors to gain a strategic position in the domestic market; they offer immediate access to distribution channels, customers, and domestic companies with great potential.²⁹

In response to the rapid emergence of FDI-related M&As, the government set up an M&A notification/evaluation system in March 2003, the first of its kind in the country.³⁰ The purpose of the Interim Provisions on Mergers with and Acquisitions of Domestic Enterprises by Foreign Investors is to

promote and regulate foreign investors' investment in the PRC and the introduction of advanced technology and management experiences from abroad,

Box 4.4 A case study of the acquisition of a local brand by L'Oréal

L'Oréal, one of the world's leading manufacturers of beauty products, recently reached agreement to take over two leading domestic brands in the PRC: Mininurse, which it acquired in December 2003, and Yue-Sai, which it acquired in January 2004. L'Oréal has been exploring the PRC market since the 1980s. In 1996 it set up a joint venture in Suzhou city in the eastern province of Jiangsu to produce cosmetics by Maybelline, the large American company it had purchased. L'Oréal faces stiff competition in the PRC from such well-known companies as P&G, Estee Lauder, Avon, Unilever, and Shiseido.

Mininurse is among the three leading skincare brands in the PRC. A mass-market brand based on the quality and affordability of its products, Mininurse is distributed through some 280,000 outlets found throughout the PRC. Its market share was 5 percent in 2003. The acquisition was L'Oréal's first in the PRC market, and included a manufacturing facility in Yichang city in Hubei province. Paolo Gasparini, general manager of L'Oréal China, said: 'Mininurse complements L'Oréal's brand portfolio perfectly and enables us to move more quickly into the Chinese consumer skincare market' (L'Oréal News Release, 11 December 2003). An important condition of the agreement was that the creator of Mininurse, Li Zhida, must not engage in the skincare business in the future.³¹

L'Oréal's acquisition of Mininurse was followed a month later by the acquisition of Yue-Sai Cosmetics, a company founded by Chinese-American TV celebrity Yue-Sai Kan. She had set up a factory in Shen-

improve the utilization of foreign investment, rationalize allocation of resources, ensure employment, and safeguard fair competition and national economic security (article 1).

Article 3 stipulates that as a general rule M&As

shall not create excessive concentration, eliminate or hinder competition, disturb social and economic order or harm public interests.

The provisions require investors to notify MOFTEC (now the Ministry of Commerce) and SAIC if any of the following thresholds are met for an M&A directly involving a domestic enterprise (article 19):³²

- 1 the business turnover of a party to the merger or acquisition in the domestic market in the current year exceeds CNY1.5 billion (approximately \$182 million);

zhen to produce her eponymous brand of cosmetics, promoted as being specifically designed for Chinese women's skin. By 1996 Yue-Sai had become the leading brand in the PRC, with surveys showing that brand name recognition was especially high among city women (*China Daily*, 7 August 2001). Yue-Sai had 18 sales offices and over 800 outlets in 240 of the PRC's largest cities prior to the transaction. In 2000, the brand accounted for 26 percent of the color cosmetics market and 17 percent of the skincare market (*China Daily*, 30 October 2000). In 2003, Yue-Sai reported sales of almost 38 million euros (\$47 million) (*China Daily*, Hong Kong edition, 28 January 2004). But the brand has faced increased competition since the mid-1990s when foreign competitors realized the PRC's market potential and launched large-scale marketing campaigns.

In 1998, Yue-Sai formed a joint venture with multinational fragrance and cosmetics firm Coty Inc. to produce up to 60 million units of cosmetics and skincare products per year in Shanghai. Yue-Sai Kan said that she hoped Coty's backing would help her brand survive even if other domestic brands were eventually overwhelmed by foreign giants (*China Daily*, 26 October 1998).

When L'Oréal purchased Yue-Sai in 2004, Gasparrini affirmed the company's intention to look after the valued brand:

Yue-Sai, a symbolic brand for the Chinese women of today, will naturally slot into L'Oréal's portfolio ... The brand strengthens the group's leadership in make-up and facial skincare. The group's technological input will enable Yue-Sai to win new market share (L'Oréal news release, 26 January 2004).

- 2 the foreign investors have merged with or acquired more than 10 domestic enterprises in aggregate in the relevant industry in the PRC within one year;
- 3 the market share of a party to the merger or acquisition in the domestic market has reached 20 percent; or
- 4 the market share of a party to the merger or acquisition in the domestic market will reach 25 percent as a result of the transaction.

The 2003 provisions are the most comprehensive set of M&A regulations in the PRC to date. Although they apply to FDI-related M&As only, and fall short of international standards from a technical viewpoint, their establishment nonetheless represents a milestone in antitrust development. They are the first set of official rules ever in the PRC to adopt an antitrust approach to the regulation of M&As.³³

Report of the State Administration for Industry and Commerce

In early June 2004, after a year-long investigation, SAIC released a report entitled *The Competition-restricting Behavior of Multinational Companies in China and Countermeasures* (SAIC 2004). This report, the first of its kind in the country, stated that some MNEs commanded obviously dominant positions in their industries and were using their advantage to curb competition. It accused several multinationals of attempting to limit competition through strategies such as predatory pricing, exclusive dealing, tied sales, and M&As. The report specifically mentioned Microsoft and Eastman Kodak, which both denied any wrongdoing.³⁴

In the case of Kodak, SAIC drew attention to the agreement signed in 1998 between Kodak, the SDRC, the State Economic and Trade Commission, and MOFTEC under which Kodak undertook to invest a total of \$2 billion in acquiring all of the country's domestic imaging factories, except those of Lucky Film. On its part, the government agreed not to allow the establishment of any other joint venture in the imaging sector between 1998 and 2000. In response to the SAIC report, Kodak released a statement saying that the company had never done anything to circumvent the normal processes of market competition. However, insiders say that the agreement gave Kodak three golden years to develop its market in the PRC free from foreign competition. Kodak now has over 50 percent of the market. Fujifilm, Kodak's nearest rival, had 48 percent of the market until 1998, but by 2003 its share had dropped to 15 percent as a result of Kodak's rapid progress (*China Business Weekly*, 8 June 2004).

Lu Fu, a professor at the China University of Political Science and Law, said that the report showed that the PRC urgently needed a complete set of laws on monopolistic practices and unfair competition (*China Business Weekly*, 8 June 2004). He argued that while continuing to welcome foreign investment, the PRC should learn more about the potentially negative effects of the presence of multinational giants and take steps—such as passing antimonopoly legislation and revising the 1993 Anti Unfair Competition Law—to prevent them from employing anticompetitive practices. He is not the only one to be concerned about the potential for MNEs to abuse their market power in the PRC; some scholars expressed the view, even before SAIC issued its report, that the new antimonopoly law should be used to check the monopoly power of transnational corporations (Wang 2002: 230).³⁵

Given that it specifically targets MNEs and was issued by the sole enforcer of the 1993 Anti Unfair Competition Law, the SAIC report has made many multinationals in the PRC uneasy.³⁶ Foreign investors are deeply concerned about whether they will be treated in the same way as

domestic players after an antimonopoly law is promulgated.³⁷ It is perhaps unfortunate that two of the country's most powerful government agencies, SAIC and MOFTEC, have each targeted foreign investors recently, and especially prior to the introduction of antimonopoly legislation—SAIC with its report and the ministry with merger regulations that apply exclusively to foreign investors. Given recent developments, it may take some time, or even some noteworthy cases, for the enforcement agency of the antimonopoly law (whoever it turns out to be) to convince the world that the PRC's competition laws do apply equally and fairly to all players.

6 COMPETITION, DEVELOPMENT, AND POVERTY

The 'economic miracle' of the past two decades has greatly raised the standard of living in the PRC. According to the World Bank, the proportion of the population living on \$1 or less per day declined from 33 percent in 1990 to 16 percent in 2000. This rapid reduction in poverty is undoubtedly associated with increased economic freedom for individuals and enterprises, improved flows of trade and resources among regions, and the introduction of competition to domestic sectors.

However, the process of poverty reduction has been accompanied by some practices that have limited competition. For instance, due to limited labor mobility and restrictions on residence inherited from the central planning period, attracting outside capital has been of critical importance in developing local economies. The prevalence of regional protectionism stems directly from local governments' desire to boost their local economies and increase the living standards of residents. Like protectionism in international markets, this phenomenon can be dealt with primarily through two approaches: interregional collaboration to abolish trade barriers; and more effective implementation of existing laws prohibiting regional blockades and protectionism.

One should note, however, that public awareness of competition issues is very low in the poorer regions of the country, where law enforcement is also lacking. Business operators in poor areas may act to maximize their short-run profit at the expense of the long-term development of the local economy. Of the three bid-rigging cases SAIC reported to the OECD Global Forum on Competition in 2001, for example, two concerned school construction projects, one in Changding county in Fujian province and the other in Lichuan county in Jiangxi, one of the poorest provinces in the country (Wang 2001). It is encouraging that SAIC has been targeting this type of violation. Local government officials need to understand

that competition law is enforced not just to ensure fair competition, but also as an important means to reduce poverty and promote the long-term development of local economies.

7 CONCLUSION

The PRC has made significant progress over the past decade in setting up an antitrust system. The passage of the 1993 Anti Unfair Competition Law and the 1998 Price Law, together with active law enforcement, laid a solid foundation for creating and maintaining a level playing field for competition in the PRC. The enforcement effort of SAIC is to be applauded. After a decade of deliberation and numerous revisions, it appears that the PRC is finally willing and ready to enact a comprehensive antimonopoly law.

Industrial policies have had direct and significant effects on industrial structure and the degree of competition in the PRC over the past two decades. From the late 1970s to the mid-1990s, the government vigorously pursued industrial policies. While the pursuit of such policies has cooled since the 1997 financial crisis, and especially since the PRC acceded to the WTO in 2002, industrial policies remain an important policy instrument for the government, particularly in major sectors such as airlines and automotives, as recent M&A activity illustrates. The long delay in passing an antimonopoly law is related to the government's fear that the business conglomerates it has nurtured through its targeted industrial policies may be adversely affected by such legislation.

Another major driving force in antitrust development over the past two decades has been inward FDI, which has had a huge impact on industrial structure, firm conduct, and the degree of competition in the PRC. On the one hand, FDI has contributed to market fragmentation as regional governments competed to attract foreign capital and technology, causing duplication of investments in many sectors. Local governments have even erected regional trade barriers to protect foreign-invested enterprises in their regions. On the other hand, the presence of foreign enterprises has seen less-efficient local enterprises driven out of business, leading to a rapid increase in the level of industrial concentration. Moreover, MNEs have been actively merging with or acquiring local firms, to get quick access to their distribution channels, customer base, and so on. FDI-related M&As have been particularly common since the PRC acceded to the WTO in 2002, and began to allow foreign investors to combine with domestic enterprises in early 2003.

The presence of foreign enterprises prompted the PRC to establish a merger control regime, albeit applying to FDI-related transactions only.

The 2003 Interim Provisions on M&As marked a milestone in the development of an antitrust system in the PRC. One can predict that the interplay of FDI policy and competition policy, and the accompanying interaction among foreign and domestic firms, will continue to be a primary factor shaping industrial structure, firm conduct, and performance in the PRC for years to come.

With a general antimonopoly law likely to be in place within the next two years, the PRC will soon have a fairly complete set of competition laws. Law enforcement will then be the biggest challenge facing the country. One difficult task will be to tackle the administrative monopolies inherited from the old central planning system, which have proven to be extremely resilient throughout the entire economic reform era. As illustrated by the case studies in this chapter, sectoral monopolies and regional protectionism will continue to pose enforcement problems for the new competition agency.³⁸ With regard to regional blockades, the recent formation of the Pan Pearl River Delta alliance with the sole goal of breaking down regional trade and investment barriers is an encouraging development. There is good reason to expect that similar common markets will be formed among other regional economies as interregional competition intensifies further, and as regional governments realize the full extent of the damage caused by interregional trade wars.

Another major challenge for the PRC will be to deal with the potential conflicts between industrial policy and competition policy. Although industrial policies will become less important as the PRC fulfills its WTO obligations in the years to come, they remain deeply rooted in government regulations. The 2003 M&A provisions, for instance, take the clear stand that competition policy is secondary to industrial policy.³⁹ The industrial policy mentality may also influence the enforcement of competition laws in the PRC, including the antimonopoly law even if it does not explicitly incorporate industrial policy concepts. In addition, the recent SAIC report has created great concern among foreign investors. It will be interesting to see how the government balances fair competition on the one hand against protection of domestic enterprises on the other.

For all of the above reasons, it is crucial for the PRC to set up a powerful and independent competition authority. The competition authority should have the power and capability to combat administrative monopolies, and should therefore not be affiliated to any existing government ministry or agency. Ideally it would be placed directly under the State Council to guarantee that it has the real authority to challenge administrative monopolies.⁴⁰

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In addition, to ensure that competition law is enforced without interference from other government policies with potentially conflicting objectives, the competition authority should be separated from those agencies that have had responsibility for implementing the country's industrial and FDI policies in the past. There needs to be a clear recognition that having the will and intent to implement competition rules fairly and equally is a different matter from being seen to apply the rules fairly and equally. Because of such factors as asymmetric information, the competition authority's methods of dealing with given cases will never be perfectly observable to outsiders. If in addition the agency is charged with a dual role that requires it to implement potentially conflicting policies, its independence may be compromised in the public mind.⁴¹ While it may be costly to set up a new competition agency, the PRC's policy-makers should be aware that competition laws are the fundamental rules of the game for a market economy and that the benefits of investing in institution building should not be underestimated.

Other important factors for an effective antitrust system include capacity building, competition advocacy, and development of a culture of fair competition. Overall, the PRC has much to learn from the experiences of other countries, particularly those in East Asia.⁴² Perhaps the most valuable lesson concerns the importance of a truly independent competition authority. In Japan, for instance, the conflict between the Fair Trade Commission, which administrates competition policy, and the Ministry of International Trade and Industry (now the Ministry of Economy, Trade and Industry), which implements industrial policy, has impeded the enforcement of competition law (Sanekata and Wilks 1996). The PRC should fully explore its late-mover advantage in competition policy development and should not repeat the mistakes other countries have made, particularly in institutional design.

NOTES

- 1 An English version of the law can be found at <www.apeccp.org.tw/doc/China.html>.
- 2 It is worth noting that the Anti Unfair Competition Law does not prohibit price cartels (price fixing) in general, even though almost all of the competition laws of other countries consider such cartels to be per se illegal. This omission was fixed in the 1998 Price Law.
- 3 The People's Courts also play a role in enforcing the law.
- 4 The tendency of firms to rely heavily on price competition, as opposed to non-price competition (advertising, quality, research and development, serv-

- ice), may account for the seemingly large number of predatory pricing cases in the PRC compared with other countries (see, for example, Xie 2001).
- 5 This approach is not confined to competition law; reliance on administrative channels is also common in other areas of law enforcement, such as the enforcement of intellectual property rights.
 - 6 Two additional laws that support national competition legislation, but that are not discussed in detail in this chapter, are the Law of the People's Republic of China for Protecting Consumers' Rights and Interests, promulgated in 1993, and the Public Tendering Law of the People's Republic of China, enacted in 1999. The latter law covers bid rigging in more detail than the 1993 Anti Unfair Competition Law.
 - 7 The law also prohibits conduct such as spreading rumors about price hikes, attracting business through deceptive pricing, and so on.
 - 8 The Law of the People's Republic of China on International Trade, promulgated in 1994 and revised in April 2004, prohibits predatory pricing and bid rigging in the context of international trade (articles 32 and 33).
 - 9 Exactly why a separate enforcement agency was chosen for the Price Law, rather than getting the SAIC to do the job, is unknown.
 - 10 For instance, the agencies set a minimum charge on a one-week trip to Thailand at CNY3,900, compared with as low as CNY2,800 before the agreement was reached. See Kong (2001: 188–9) for more details.
 - 11 On 20 January 2000, the Chinese Automobile Industry Association publicized a decision by 10 domestic automobile manufacturers not to fight a price war. However, because they did this more discretely than the color TV manufacturers, the case did not receive as much media attention (*China Daily*, 3 August 2000).
 - 12 Under the Price Law and the Anti Unfair Competition Law, manufacturers who manipulate market prices can be fined CNY30,000–300,000 (\$3,600–36,000), and any illegal income can be confiscated.
 - 13 See 'Cooperation started among the nine domestic color TV producers' at <<http://www1.people.com.cn/GB/channel3/22/20000609/97046.html>> [in Chinese].
 - 14 See Li Jialu, 'Price cutting behavior since the color TV summit' at <<http://www1.people.com.cn/GB/channel3/22/20000809/180077.html>> [in Chinese].
 - 15 Jung and Hao (2003) provide a comprehensive evaluation of the draft anti-monopoly law, especially from a legal perspective.
 - 16 See Becker (1968) and Posner (1977). The treble damage system of US antitrust law, for instance, is consistent with these basic economic principles.
 - 17 The administrative surcharges imposed under Japan's Antimonopoly Act used to be based on the idea of 'confiscation of illegal gains.' Japan is currently planning to change this arrangement to one that imposes multiple damages. See Lin (2005) and Fair Trade Commission of Japan (2004) for further details.

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- 18 Jiang (2002a: Table 1) provides a detailed description of the various measures included in the industrial policy framework.
- 19 See also Jiang (1996) for a comprehensive study of the PRC's industrial policies from the late 1970s to the mid-1990s, from both a theoretical and practical perspective.
- 20 In 1987, it was made clear at the 13th Congress of the Chinese Communist Party that small SOEs could be sold to collectives and individuals. In 1994, the government began to conduct mergers of large and medium-sized enterprises in 100 pilot cities.
- 21 These industries included electricity generation, coal mining, automobiles, electronics, iron and steel, machinery, chemicals, construction materials, transport, aerospace, and pharmaceuticals. See Nolan (2001) for a detailed study.
- 22 In the mid-1990s, as part of a reform of the country's innovation system, many R&D centers affiliated with ministries or other government agencies were transferred to members of the national team. The goal was to enhance their R&D capacity as well as to overcome the entrenched problem of research projects not being motivated by the actual needs of the market simply because so many R&D centers were not linked to real business entities.
- 23 Some scholars say that one important reason for the long delay in introducing antitrust legislation is competition among the present enforcement agencies—SAIC, the SDRC, and the Ministry of Commerce (which took over the task of drafting the antimonopoly law in 2003)—to gain the power to enforce the general antimonopoly law (Neumann and Guo 2003).
- 24 Watson, Findlay, and Du (1989) cite the 'wool war' and the 'silk war' of the mid-1980s as examples of local governments trying to keep raw materials within the locality in order to favor local manufacturers.
- 25 Because PRC auto-makers tend to be overstaffed and produce on a small scale, a few years ago the prices of domestically produced cars were two to three times higher than the world average. Large domestic manufacturers relied on import tariffs of 80–100 percent to maintain their profitability. However, import tariffs have been declining since the PRC's accession to the WTO in early 2002.
- 26 The nine provinces were Fujian, Jiangxi, Hunan, Guangdong, Hainan, Sichuan, Guizhou, Yunnan, and the Guangxi Zhuang Autonomous Region. The 11 regions together account for 47 percent of the economy and more than half of foreign trade.
- 27 The catalog has been revised several times—most recently in 2002 after the PRC entered the WTO—becoming increasingly less restrictive. According to the 2002 version, prohibited industries include certain financial services, air transportation, media, and electricity transmission.
- 28 In addition to Zhonghua and Maxam, Unilever acquired four other local brands in the PRC during the 1990s in the fields of detergent, tea production, and ice cream. Most have either struggled or disappeared (*Beijing Modern Commerce Daily*, 29 September 2004).

- 29 In 2001, for example, Emerson took over Avansys, the entire electronic wing of Huawei Technologies, a leading telecommunications supplier in the PRC, for \$750 million in cash, making it the largest M&A deal between a private domestic company and a foreign investor to date. In the banking sector, Hong Kong and Shanghai Bank spent \$62 million to purchase an 8 percent stake in Shanghai Bank in January 2002, thus becoming the first foreign bank to own a stake in a state-owned domestic bank (Global M&A Research Center 2003).
- 30 The English version of the regulations can be found at <<http://bizchina.china-daily.com.cn/guide/law/law05.htm>>.
- 31 See *China Youth Daily*, 12 December 2003. A similar condition was contained in the agreement with Yue-Sai Kan; see *Yangcheng Wuanbao* [*Yangcheng Evening Paper*], 10 February 2004.
- 32 A different set of thresholds applies to off-shore M&As that affect domestic markets.
- 33 According to private sources, the Ministry of Commerce has received and approved many merger applications from foreign investors since the regulations were issued, but has not challenged any of them.
- 34 *China Daily*, Hong Kong edition, 18 June 2004. Microsoft stated that the company's conduct in the PRC was in line with PRC laws and regulations (*China Daily*, 2 June 2004).
- 35 Other scholars are less worried about the presence of foreign companies in the PRC, arguing that the dominant market share of foreign firms as a whole, rather than of a single firm, does not necessarily imply monopoly in PRC markets (see, for example, Jiang 2002b). Also, according to SAIC data, less than 10 percent of the cases dealt with by SAIC have involved foreign firms.
- 36 Abbott B. 'Tad' Lipsky, a partner with Latham & Watkins LLP in Washington DC, said that 'there are going to be a lot of foreign investors losing sleep until economic and procedural rationality and proportional remedy are established as the organizing principles of Chinese antitrust' (*Global Competition Review*, 2 July 2004, <www.globalcompetitionreview.com/news/news_print.cfm?item_id=1825>).
- 37 An anonymous official of the National People's Congress recently said that the PRC's antimonopoly law would 'definitely treat all enterprises equally' (*China Daily*, 2 June 2004).
- 38 One major difficulty for SAIC in enforcing the 1993 Anti Unfair Competition Law has been interference from local governments, which on many occasions have tried to prevent its staff from investigating firms in their localities (SAIC 2002).
- 39 Lin (2004) argues that the incorporation of competition provisions in the 2003 M&A provisions places an additional constraint on the set of permissible mergers *within* the traditional industrial policy framework. Under the regulations, even mergers that would enhance competition are not allowed if they would violate industrial policy as stipulated in the *Catalog Guiding Foreign Investment in Industry* (MOFTEC 2003).

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- 40 However, it has been reported that in the latest draft of the antimonopoly law, submitted to the State Council in secrecy, the article on setting up an independent competition authority directly under the State Council has been dropped. It is not clear whether SAIC, the Ministry of Commerce, or some other agency will be responsible for enforcing the antimonopoly law (*China Daily* 29 June 2004, <www.chinadaily.com.cn/English/doc/2004-06/29/content_343701.htm>).
- 41 See Chen and Lin (2002) for a discussion of the informational problem associated with the dual role in the context of competition policy in Hong Kong, China's telecommunications industry.
- 42 For a discussion of the implications of East Asian experiences for competition policy in the PRC, see Lin (2005).

*Appendix A4.1 PRC: Table of contents of the draft antimonopoly law,
February 2002^a*

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a Translated from the original by the author.