GGPB
Geneva Global Policy Briefs

N°5/2020

Levelling the Playing Field in EU-China Relations

Pieter VAN VAERENBERGH

Executive Summary

- China is a major trading partner of the EU, but European and Chinese companies do not always compete on equal footing, neither on the EU market, nor on the Chinese market. Particularly, the influence of state ownership and state financing of Chinese companies may be distortive and prompts EU policy responses.
- The European Commssion is actively updating its toolbox of level playing field instruments. It presented an investment screening mechanism framework for the Member States, guidance for European public institutions on third party participation on the EU procurement market, a major overhaul of the anti-dumping calculation methods, and most recently a White Paper on Foreign Subsidies. In reviewing these legal instruments, this policy brief highlights the need for the Commission to carry out a coordinated and streamlined approach in order to aptly define the future of the relations between the EU and China.

China is now the second-biggest trading partner of the European Union (EU), and the EU is China's biggest trading partner. However, the EU internal market is suffering from state-induced action by Chinese State-Owned Enterprises (SOEs). Furthermore, European companies do not have sufficient access to Chinese markets: selective market opening, worrisome lack of transparency, heavy subsidisation of SOEs and private sector companies, and poor protection of intellectual property rights are disadvantageous for European companies active on the Chinese market. In short, China is an important strategic competitor but fails to maintain a level playing field and reciprocate market access commitments.

Against that background, the EU envisages openness to trade and investment based on a level playing field in its trade policy. In the EU-China strategy, the EU employs an assertive, coordinated and proactive approach to strengthen its prosperity and competitiveness. In particular, the Commission aims to "identify how the EU could appropriately deal with the distortive effects of foreign state ownership and state financing of foreign companies on the EU internal market" (Commission 2019a). Importantly, also the EU's new industrial policy, as supported by Member States, foresees the upholding of a global level playing field as one of its central goals (Commission 2020a).

This policy brief outlines current governance issues and recent efforts of the EU to update existing or create new instruments ensuring fair competitive conditions in relation to China. A well-coordinated approach between the various instruments in the Commission's toolbox in trade, competition, investment and procurement policies is thereby essential.

Investment screening

The EU has so far strengthened its toolbox by adopting a framework Regulation for the screening mechanisms of foreign direct investment (FDI), which entered into force in April 2019 and will be fully applied as of October 2020. Member States retain their own screening mechanisms – a possibility of which currently 14 Member States have made use. The Regulation contains EU-wide coordination legislation and aims to safeguard the EU's security and public order regarding purchases by foreign companies. It is a direct reaction to increasing strategic acquisitions made by Chinese SOEs in critical assets, technologies and infrastructure in sensitive sectors, such as the acquisition of the Port of Piraeus in Greece by Chinese investors (Alvarado Garzón 2019, 16-17).

The Regulation prescribes requirements of judicial control, non-discrimination and transparency to the Member States (Art. 3(2)-(5)). State financing of proposed investments, particularly ownership structure or significant funding, is one of the elements that may be considered in the investments screening procedure – however only in as far as these are connected to national security reasons (Art. 4(2)(a) and 9(2)(a)). Furthermore, a cooperation mechanism between Member States and the Commission allows Member States to comment on investments undergoing screening in other Member States and the Commission to formulate non-binding opinions on specific investments which threaten more than one Member State, or undermine a project or programme of interest to the whole EU (Art. 6-8), for instance in the sectors of transport, telecommunications and energy.

In setting out minimum requirements, the Regulation may lead to an increased uniform approach to investment screening, remaining Member States to set up investment screening procedures, or even to an investment screening mechanism on the EU level. Thus far, the national approaches have prevailed, complemented by sectoral mechanisms on the EU level, such as the so-called 'Gazprom clause' in the Gas and Electricity Directive prescribing certification and unbundling requirements as reaction to the dominant position of the Russian energy company Gazprom (Bungenberg & Hazarika 2019, 384-7). In any case, investment screening mechanisms should not grow beyond security reasons, since proper coordination with security policy and competition policy does not necessitate such wide interpretation (BDI 2019, Bertelsmann Stiftung 2019).

The importance of an effective and uniform FDI screening mechanism is illustrated by the fact that FDI stocks held by third country investors amount to €6,295 billion and provide 16 million direct jobs in the EU. In addition, the unprecedented public health crisis caused by the COVID-19 pandemic moved the EU to issue specific guidelines to protect critical assets and technology, as public health is one of the grounds on which Member States may screen FDI and impose mitigating measures or prevent merger or acquisition transacions at all (Commission 2020b).

Government procurement

As one of the key achievements of the internal market, the EU established a single market for public procurement with the unique feature of being open to domestic and foreign bidders alike. The EU's open procurement market is worth €2.4 trillion annually and represents 14% of the EU's GDP (Commission 2019a). As the first deliverable outcome of the EU-China strategy, the EU has published guidelines in July 2019 on the participation of third-country bidders and goods in the EU procurement market. The guidelines provide public buyers with direction on how to evaluate third-country offers, especially by clarifying abnormally low-priced offers and the requirement to respect security, labour and environmental standards (Commission 2019b). The Commission provides also assistance to public buyers in the EU in evaluating individual offers. The guidelines ensure fair competition, high quality tenders and a level playing field in public procurement markets. They do not, however, allow for foreign subsidies to be fully taken into account. The guidelines accentuate the new EU Public Procurement Directive, which were adopted in February 2014 and are applied since April 2016. The new rules modernised public procurement by cutting red tape, strengthening the position of small and medium-sized enterprises, ensuring value for money public purchases, giving the EU's principles of transparency and equal treatment a central place, and promoting quality-based procurement where social and environmental considerations and innovation aspects are central evaluation criteria.

At the same time, European bidders on the Chinese procurement market suffer from lack of transparency, national establishment requirements, "Buy Chinese" strategies, price preferences and other discriminatory practices. These barriers exist particularly on markets where EU companies are highly competitive such as transport equipment, telecommunications, power generation, medical equipment and construction services. The Commission, seeking to adopt a more offensive stance on these practices, presented an amended proposal for the establishment of an EU

Université de Genève | Bvd du Pont d'Arve 40 - CH 1211 Genève 4 | Tél. +41 22 379 84 90
Website: www.ceje.ch | To contact the editor : ceje@unige.ch

mechanism for an International Procurement Instrument (IPI) in January 2016. It aims to promote reciprocity and opening up procurement opportunities for EU companies in third countries (Commission 2016). The mechanism would allow for investigations by the Commission against discriminatory practices on foreign procurement markets, initiation of consultations to remedy such practices, and restrictions of access of the third country's companies, goods and services to the EU procurement market if necessary. The proposal has been criticised for its complex price adjustment mechanisms (Business Europe 2020).

On the multilateral level, the EU promotes accession by China to the Government Procurement Agreement (GPA) in the World Trade Organization (WTO), in order to ensure reciprocity and balanced rights regarding public procurement. A Chinese bid matching the level of market opening of current GPA countries is necessary to that extent (BDI 2019).

Competition policy

The EU's antitrust policy instruments apply without discrimination to all economic operators on the internal market, irrespective of their origin. The current rule framework does not allow the Commission and national competition authorities to specifically take into account market-distorting practices or targeted state support to SOEs that are active on the EU's internal market. The effects of restraints of competition by foreign export cartels are nonetheless felt on the internal market. The extraterritorial reach of EU antitrust rules is limited to situations where there is a tangible, direct and predictable impact on the internal market (so-called 'effects doctrine'); mere agreements on prices on the foreign market are not. Furthermore, Chinese SOEs often have to be considered to exercise sovereign rights, rather than being economic undertakings, consequently escaping competition rules. Problematic also is the fact that several independent Chinese SOEs are acting in a coordinated manner on the internal market in the framework of centrally planned corporate networks. The Commission has been reluctant to calculate together market shares of several SOEs when investigating potential abuse of a dominant position, particularly because this approach would mean that all these cooperation forms between Chinese SOEs would fall out of the scope of the cartel rules (Müller-Ibold 2020, 259-260). A case-by-case approach should be adopted. The Commission also looks into improving case detection and speed up investigations (Commission 2020a).

The Commission will develop new rules on antitrust policy to ensure a level playing field between European and Chinese competitors, particularly when it comes to subsidised SOEs whose financial power gives them an unfair head-start over European competitors. The Commission initiated public consultations for a new antitrust tool based on three pillars: vigorous enforcement of existing competition rules, possible ex ante regulation of digital platforms, and a possible new competition tool to deal with structural competition problems the current rules cannot capture properly.

Furthermore, calls have been raised to ensure stricter application of EU merger control against Chinese companies, and at the same time relaxing certain merger control rules for European companies.

The current Merger Control Regulation does not allow the Commission to intervene against the acquisition of a European company solely on the grounds that the buyer benefitted from foreign subsidies. The use of financial state resources may already be considered by the Commission (Art. 2(1)(b)), but the focus of analysis is on the structure of competition in the market. The Commission wants to introduce a provision allowing national regulators to intervene in competition-distorting takeover deals involving state-backed companies at inflated prices or undercutting strategies (Commission 2019a). Such system would allow for corrections in merger decisions that would be in conflict with trade policy objectives of the EU. This could also be done through broadening the scope of 'legitimate interests' that allow rejection or mitigations of mergers beyond security, media and financial services rules (Art. 21(4)) – in as far as this would have any impact in practice (Bertelsmann Stiftung 2019).

Another proposal is to shift the burden of proof on the Chinese company to prove that it is not backed by state subsidies, rather than on the Commission proving the opposite is true. In any case, if takeovers financed through subsidised SOEs are scrutinised thoroughly, this must be done based on transparent information on ownership structure and sources of financing by an adequately staffed EU inspection body (BDI 2019).

The Commission has been called to consider the risks on competition from coordinated action by formally independent Chinese undertakings in line with China's central economic planning (Business Europe 2020). In the EDF/CGN merger decision in the nuclear energy sector, the turnover of all Chinese state-owned energy companies was added together to calculate the EU merger thresholds, rather than the individual company's turnover. This conclusion supports the stance that Chinese SOEs are ultimately controlled by central authorities and means that Chinese SOEs may have to notify mergers faster, so that the Commission may exert merger control.

On the other hand, after blocking the Alstom/Siemens mega-merger in the rail transport sector and investigating the Tata/ThyssenKrupp merger in the steel sector, some Member States are pushing a reform of EU competition rules to create so-called 'European champions' that face competition with Chinese SOEs. This could be done by including consideration of closing lead markets, longer time-frames, disinvestment requirements, or even appeal mechanisms against Commission decisions (Bertelsmann Stiftung 2019).

Extraterritorial application of state aid rules to subsidies outside the EU has been proposed, too. Such extraterritorial application could lead to scrutiny over Chinese aid granted to companies active on the EU market including subsidised takeovers of EU companies. The introduction of so-called 'matching clauses' allowing EU state aid rules to be used when foreign state aid distorts competition in the EU has also been considered (BDI 2019). However, both proposals would blur the line with anti-subsidy rules. More generally, the EU is carrying out a fitness check of the 2012 State aid modernisation package, railways guidelines and the short-term export credit insurance communication and a public consultation on proposal to amend General Block Exemption Regulation.

The Commission has enabled Member States to make use of state aid flexibilities by adopting a Temporary Framework to support the economy in the context of the coronavirus outbreak (Art. 107(3)(b) TFEU), and approved a list of state aid measures adopted by the Members States to support their economy and help mitigate the social-economic impact of the pandemic (Art. 107(2)(b) TFEU).

Trade defence instruments

A strengthened EU toolbox must also include a focus on the EU's Trade Defence Instruments (TDI). China's massive overcapacities in the steel sector have flowed over into the EU single market at dumping prices. Two recent legislative changes amended the EU's Basic Anti-Dumping Regulation against these developments. In December 2017, a new dumping margin calculation method for countries with significant state-induced market distortions was introduced (Art. 2(6a)(b)). This country-neutral methodology was a reaction to the lapse of the temporary rules in China's Accession Protocol to the WTO and in practice targets Chinese imports. This is evidenced by the first (and thus far only) country report on China prepared by the Commission containing information on macro-economic aspects and sector-specific distortions to be used in anti-dumping investigations (Commission 2017). Under the new methodology, if the Commission finds domestic prices unreliable due to significant state distortions, it will use other benchmarks reflecting undistorted costs of production and sale (Art. 2(6a)(a)). This methodology may well be WTO-inconsistent (Huyghebaert 2019), but the WTO Panel charged with the review of the EU's rules suspended its activities on the request by China in June 2019 and consequently the authority of the Panel lapsed after 12 months of inactivity in June 2020 (DS516). New interpretations of the term 'particular market situation' may not bring salvation either (DS529).

In May 2018, the EU further modernised its anti-dumping legal framework. Amongst others, it (partially) removed the 'lesser-duty-rule' applied in the EU. This rule allows to impose duties at such level as to eliminate the injury to the EU industry, rather than on the (higher) margin of dumping. The EU will no longer apply this beneficial rule, in case raw material distortions exist (Art. 7(2a)). Further changes include the consideration of future social and environmental costs, and a target price with at least a 6% profit margin. The 2018 modernisation package of the EU's trade defence instruments also carried out various procedural changes to make anti-dumping investigations more efficient (Müller 2018).

The EU's Basic Anti-Subsidy Regulation was equally updated by the 2018 modernisation package, leading amongst others to a complete abolition of the 'lesser-duty-rule' (Art. 12(1)). Nonetheless, the current anti-subsidy rules do not capture all potential effects of foreign subsidies or support by third countries. The EU therefore supports a reform of the global rules on industrial subsidies at the WTO – it is a top priority of the EU to push China into committing to stronger disciplines on industrial subsidies. Particularly, the EU focusses on improved transparency and subsidies notifications, disciplines to better capture SOEs, and disciplines of the most trade-distortive types of subsidies (European Union 2018). It could also implement a shift in the burden of proof – where it is up to SOEs to prove they did not benefit from subsidies – either based on the general WTO rules (Business Europe 2020) or the China-specific legal basis (Bungenberg and Van Vaerenbergh 2020).

Another pressing problem surrounds the unworkable definition of a 'public body', which makes it hard for the Commission to capture Chinese SOEs as subsidy-granting entities. As China rapidly builds production capacities in other countries through its Belt and Road Initiative, the Commission imposed anti-subsidy measures on goods which enjoyed state support from the Chinese government to third countries and therefore have effect on the EU internal market (Crochet & Hegde 2020). Procedurally, a further increase in efficiency of the procedure would be useful, more ex officio powers of the Commission, as well as an evidentary shift of the burden of proof (Bertelsmann Stiftung 2019).

Recent amendments of trade defence rules may have rendered the framework more resilient to addressing new challenges in an increasingly sophisticated Chinese subsidy scheme. However, several challenges remain, such as action against dumped or subsidised services as an upcoming problem for which new instruments must be created (BDI 2019). However, the GATS does not contain a provision on trade remedies equivalent to Art. VI GATT mandating the development of such instrument.

White Paper on Foreign Subsidies

Responding to regulatory gaps in the existing instruments in the EU's toolbox, the EU opted to design policy proposals for new instruments that focus explicitly on the effect of foreign subsidies as such. To that extent, in June 2020, the Commission adopted a White Paper on Foreign Subsidies, presenting three possible new tools to level the playing field as regards foreign subsidies (Commission 2020b). The White Paper is understood to focus primarily on Chinese investments and acquisitions. After public consultations, it would be converted into a legal instrument by June 2021.

Module 1 addresses in general distortions caused by foreign subsidies to a beneficiary established or active in the EU internal market. In an ex post review of the impact of foreign subsidies, the Commission or investigating authorities may initiate ex officio investigations and impose redressive measures. The analysis includes an EU interest test, which may shift the balance in favour of allowing the foreign subsidy if it aligns with the EU's policy objectives. Expanding beyond the anti-subsidy rules, foreign subsidies provided for goods and agricultural products would not be covered by Module 1, but foreign subsidies to services investments and other financial flows would. Similarly, the consideration of foreign subsidies is not constrained to security concerns, as under the investment screening procedures.

Module 2 is a specific instrument regarding foreign subsidies directly or indirectly facilitating the acquisition of EU targets. The Commission envisages a mandatory notification system initiating ex ante review of takeovers which may lead to the prohibition of the transaction. This may lead to parallel, yet separately conducted, procedures under Module 2 and the Merger Control Regulation, but complements the existing rules by allowing proceedings solely based on foreign subsidisation.

Module 3 is another specific instrument that ensures that foreign subsidies can be addressed properly in individual public procurement procedures. Recipients of distortive foreign subsidies would be excluded from the specific tender process, or even from all future public procurement procedures for up to three years.

Conclusion

In line with its EU-China strategy, the EU is actively updating its toolbox of procurement, competition, trade and investment instruments to remain competitive on the global market and ensure a level playing field between European and foreign companies. The Commission thereby makes sure that existing rules are updated and, in addition, that new rules are created to fill regulatory gaps. It is important that a coordinated approach is rolled out, using the strength and purpose of the various trade policy tools to their fullest extent. Today more than ever, this is necessary for the EU, which has integrated the twin challenges of digital and ecological transitions with industrial policy (Commission 2020a).

Any new policy tool that is developed may prompt Chinese reaction. It is therefore essential for the Commission to consider how new policy approaches might be received and mirrored by China. Such considerations may arise for instance with regard to easing the antitrust mechanisms, and is now also voiced with regard to the significant distortions methodology and massive granting of subsidies in the EU in the verge of the COVID-19 pandemic.

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About the author

Pieter Van Vaerenbergh is research associate and PhD candidate at Saarland University, Germany. He completed his basic law studies at Ghent University, Belgium and pursued an LL.M. degree in international and European law from the Europa-Institut at Saarland University, Germany. Currently, he conducts PhD research in the field of international and European economic law, particularly on green trade remedies. His research interest and publications focus on EU trade defence instruments, international dispute settlement in trade and investment matters, and sustainable international trade law.

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Founded in 1963, the *Centre d'études juridiques européennes* (CEJE) is the leading Research Centre in EU Law within the Law Faculty of the University of Geneva. Under the direction of Prof. Christine Kaddous, Jean Monnet Chair *ad personam*, the CEJE is committed to developing high quality courses, training programmes and research activities on issues related to European Integration and Policies, the EU's role on the International scene as well as in Regional and Global Governance. In 2017, the CEJE was awarded the Jean Monnet Centre of Excellence label and is launching a number of new activities, chief among them being the GGPB Series.

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Levelling the Playing Field in EU-China Relations
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GGPB N°5/2020

Publications in the Series should be cited as:
AUTHOR, TITLE, Geneva Global Policy Brief No ./YEAR [URL]

Pieter VAN VAERENBERGH, Levelling the Playing Field in EU-China Relations, Geneva Global Policy Brief No 5/2020, pp. 1-7.

ISSN 2624-8603

Université de Genève | Bvd du Pont d'Arve 40 - CH 1211 Genève 4 | Tél. +41 22 379 84 90
Website: www.ceje.ch | To contact the editor : ceje@unige.ch