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## **Antitrust in China: The Problem of Incentive Compatibility**

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## Executive Summary

This paper reviews China's recent efforts to enact a competition policy (antitrust) law. We focus on three issues: (1) What is the substance of the proposed law, and how does it differ from existing antitrust law in other countries, (2) How will the law be implemented or enforced, and how will those who must implement this law interpret their mandate, and (3) What will be the likely effects of this law given China's unique history and cultural heritage. We emphasize China's economic, legal and regulatory contexts in which an antitrust law may be enforced. Our central focus is the problem of establishing a substantive and procedural legal framework that is incentive-compatible with economic efficiency and growth.

The policy debate on antitrust within the Chinese government is not public. An unofficial draft of the proposed law was widely circulated outside China in 2003 and was the subject of a public commentary by the American Bar Association. A slightly revised draft was submitted for deliberation to the State Council in March 2004.<sup>†</sup> The changes from the prior draft seem to have chiefly to do with which agency of the government will administer the law. At this time, no further information is available to us. Our comments on the "proposed law" are therefore based on the version that has already circulated.

We find a number of respects in which the draft law could be improved, both to increase its clarity and to make its enforcement more consistent with the goal of achieving improvements in economic efficiency. We also find much merit in the draft, especially its strong focus on reducing anticompetitive practices of state owned enterprises (SOEs) and other government bodies. However, our major difficulty with the new law is that, in the absence of a tradition of reliance on the rule of law, Chinese and foreign enterprises will find it very difficult to rely on the antitrust statute or the actions of the courts in China as a basis for predicting the antitrust liability that might result from various business practices. Therefore, the principal vector by which antitrust law (or indeed any law) affects economic behavior is absent from the Chinese scene. Unless the bureaucracy that enforces the new antitrust law actively pursues a policy of consistent enforcement based on written guidelines, *stare decisis*, or other sources of predictability, the substance of the statute itself will have little significance. That outcome would represent a significant loss for the economic welfare of the Chinese people.

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<sup>†</sup> See comments from Shang Ming, Director of the newly established Antitrust Investigative Office in the Ministry of Commerce, on September 16, 2004, available at <http://big5.china.com.cn/chinese/law/661991.htm>.

# Antitrust in China 2006: The Problem of Incentive Compatibility

Bruce M. Owen, Su Sun and Wentong Zheng\*

## Abstract

This paper reviews China's continuing efforts to enact a competition policy (anti-trust) law. We focus on three issues: (1) What is the substance of the proposed law, and how does it differ from existing antitrust law in other countries, (2) How will the law be implemented or enforced, and how will those who must implement this law interpret their mandate, and (3) What will be the likely effects of this law given China's unique history and cultural heritage. We emphasize China's economic, legal and regulatory contexts in which an antitrust law may be enforced. Our central focus is the problem of establishing a substantive and procedural legal framework that is incentive-compatible with economic efficiency and growth.

The current draft law could be improved, both to increase its clarity and to make its enforcement more consistent with the goal of achieving improvements in economic efficiency. Nevertheless, there is much merit in the current draft, especially its strong focus on reducing anticompetitive practices of state owned enterprises (SOEs) and other government bodies. However, our major difficulty with the new law is that, in the ab-

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sence of a tradition of reliance on the rule of law, Chinese and foreign enterprises will find it very difficult to rely on the antitrust statute or the actions of the courts in China as a basis for predicting the antitrust risks that might result from various business practices. Therefore, the principal vector by which antitrust law (or indeed any law) affects economic behavior is absent from the Chinese scene. Unless the bureaucracy that enforces the new antitrust law actively pursues a policy of consistent enforcement based on written guidelines, stare decisis, or other sources of predictability, the substance of the statute itself will have little significance. That outcome would represent a significant loss for the economic welfare of the Chinese people.

## **I. Introduction**

The Supreme Court of the United States once characterized antitrust law as the ‘Magna Carta’ of free enterprise. In the U.S., where antitrust law is most developed, the law has supported capitalist free enterprise in several ways. First, it has sought to protect customers, both individuals and businesses, against the creation and exercise of undue market power. Second, more controversially, it has often served to protect small, inefficient firms from competition. Third, antitrust law is an aspect of competition policy, which refers to broader public policies that seek to promote private competitive markets as alternatives to state-owned, monopoly, or regulated monopoly, supply sectors. Antitrust law in the United States is also associated with a particular (common law) legal system, one in which predictability of outcome is given high value, much law affecting future nonparties is created by judges, private parties have standing to enforce law, and the major effects of public law enforcement are intended to be deterrent rather than direct. However, antitrust is also practiced in ‘civil law’ jurisdictions, typically by administrative agencies of the executive power, guided by whatever policy aims the current government may have.

In the past more than two decades, China has moved pragmatically from an economic system designed in conformity with Marxist-Leninist-Maoist theory to one in which decentralized competitive markets are permitted to determine many important aspects of economic allocation decisions. These economic reforms have not, generally, been accompanied by corresponding reforms in legal and political systems. One would

expect that a pragmatic policy of increased reliance on capitalist free markets would be accompanied by measures designed to ensure that those markets operate to their maximum potential. This requires, among other things, means of mitigating ‘market failures.’ By market failures, we mean conditions in which decentralized market decision making does not align individual incentives properly with overall economic welfare. In the West, institutions that mitigate market failure include property rights, contract law, and liability systems, as well as antitrust and regulatory laws. Having decided to rely on markets for certain important purposes, presumably China would be wise to adopt either similar legal remedies for market failures or other institutions whose purposes and effects are the same.

Market reforms such as those that have occurred in China are now commonplace around the globe. Developing countries in what used to be called the ‘Third World’ have been pushed to introduce reforms by a variety of forces, chief among them the demise of the Soviet Union and the discrediting of communism as an alternative basis for economic organization. Antitrust is often seen as one of the safeguards required to ensure that free markets serve as a servant of society, rather than its master. Many, even in long-established market economies, view the market as a dangerous mechanism, which must be harnessed and directed to serve social ends. The famous symbol of this perspective is the Depression-era sculpture next to the Federal Trade Commission Building on Pennsylvania Avenue in Washington DC, depicting a heroic male figure reining in a muscular plow horse.

Scholars who follow regulatory reform have noticed, however, that the model of government regulation as a control on the excesses and failures of private markets can be incomplete and misleading. Often, whatever the intent of the regulators may have been, government intervention ends up protecting incumbent sellers rather than consumers, or, more generally, favors politically influential groups. The political forces at work are essentially the same as those that produce tariffs and quotas on imports that threaten domestic producers while benefiting consumers. Further, the tools used by regulators often have unforeseen and unpleasant consequences, and regulations that turn out to have bad effects may be very difficult to change. In consequence, competition policy in developed coun-

tries has frequently been aimed as much at government itself as at private monopolies and cartels. This is seen most vividly in the work of European Commission as it replaces the regulatory interventions of member states in order to promote intra-European markets and competition. The EC has struck down many laws and regulations in member countries that impede imports of goods and services from other member countries, and it has promoted the privatization of state-owned enterprises, such as telecommunications and airlines, so as to produce a set of pan-European competitors in place of national monopolists. Similarly, in the United States, much of the regulatory reform movement that led to the deregulation of trucking, airlines, railroads, banking, professional services and telecommunications in the last thirty years has been motivated and promoted by the antitrust agencies of the U.S. government.

All this has been noted in the market economies. In the developing world, government intervention historically has taken the form of outright ownership of major industries, protectionism, and regulations designed to suppress domestic competition. The first step in reform has been privatization—the sale of government-owned enterprises to private entities. Most often this has happened with little concern for the competitive structure of the post-privatization industry. Examples can be found throughout Latin America, for example, of privatized energy, telecommunications, transport and water companies continuing under private ownership as under-performing monopolies, devoting as much effort to blockading potential competitors as to serving customers efficiently.

China, India, and the former Soviet republics relied on state-owned enterprises to an even greater degree than Latin American and other developing countries. Within the socialist economies there is a spectrum of national ‘memories’ of market systems and accompanying legal institutions. For example, the market economies of eastern Europe have been more easily restored than those of Russia. China is at the opposite extreme from eastern Europe on this spectrum, partly because China did not have an extensive commercial economy (and associated legal structures) even before the Maoist period. Enterprise in China today remains, if not state-owned, under the active influence of the state. The principal source of competitive private entrepreneurial activity is from coastal provinces in the southeast where special economic zones were first set up more than two

decades ago and local economic controls have been more relaxed, and from foreign direct investors that the central government has permitted to enter domestic markets. A significant part of Chinese domestic production of goods and services still takes place in state-owned enterprises, or SOEs, central or local, and the SOEs still dominate China's key industries. Therefore, efforts to promote the use of competitive market solutions to the production and allocation of goods and services must be aimed chiefly at the operation of SOEs, or recently state-owned enterprises).

We turn next to a brief description of the current structure of the Chinese economy.<sup>1</sup>

## **II. China's Economic and Regulatory Contexts**

Competition policy is not shaped by economic theory alone. The goal, scope, and nature of a country's competition policy is closely tied to the underlying industrial organization and regulatory structure of the country, and is to a large extent determined by the perception of the role of competition by the country's political and economic culture. This is particularly so in the case of China, a country that is undergoing a historic transformation from a centrally planned economy to a market economy. Therefore, to fully understand China's proposed antitrust law, an introduction to China's underlying economic and regulatory structures and the role of competition in China's economy is in order.

### **A. PRE-REFORM ECONOMIC STRUCTURE**

Before 1978, China had a centrally planned economy. In rural areas, farms were organized first as cooperatives, then starting in 1958, as communes. The government's planning agency directed communes to plant particular crops, supplied necessary inputs and collected predetermined quantities of outputs at given prices. Under the commune system, the central planning agency could not arrange everything accurately and effi-

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<sup>1</sup> For detailed analyses of China's economy in the recent decades, see Gregory Chow, *China's Economic Transformation*, (London: Blackwell Publishers, Inc., 2002).



ciently, and farmers had little incentive to work hard. The system proved to be disastrous. Millions died from starvation within three years after the commune system was established. Adjustments were made after the failure of the commune system that allowed farmers to work on their private land, but only to a limited extent, until the current reforms began in 1978.

The inefficiency of central planning was repeated in the industrial sector. All enterprises were state-owned before the 1978 reform. The government set up plans for the production and distribution at all enterprises. The government also set prices for almost all goods and services. Workers were assigned to enterprises by the government and were guaranteed lifetime employment. In order to ‘modernize’ quickly, priority was given to heavy industries and these industries were heavily subsidized. For example, during the Great Leap Forward, launched at about the same time communes were established in rural areas, people were encouraged to build furnaces all over the country to produce iron and steel. Terrible waste resulted.

Before 1978, China’s economy was dominated by the state, and private enterprises played only a negligible role. According to China’s State Statistics Bureau, in 1978, private enterprises accounted for only 0.2% of China’s national industrial-output, while state-owned enterprises and collectively owned enterprises controlled the rest of the economy.<sup>2</sup> With factories being relegated to units of the state productive machinery, there was essentially no need for competition as we know it today. At times the government promoted ‘labor competition’ among factories or productive units in an effort to indoctrinate the populace with communist ideology, but competition motivated by profits was condemned as a symptom of corrupt capitalist systems.

## **B. POST-REFORM ECONOMIC STRUCTURE**

In 1978, Deng Xiaoping initiated economic reforms. Reform started in rural areas where population was more dispersed, the commune system had obviously failed, and some reform experiments had already self-started at the village level. Under the newly estab-

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<sup>2</sup> *Statistical Yearbook of China*, at <http://www.cei.gov.cn> (visited October 28, 2004).

lished household responsibility system, farmers were given much freedom on what to do with their land and got to keep much of what they earned. Then Township and Village Enterprises (TVEs) were formed and collectively owned by the local government. Where they had enough resources and incentives, they grew very quickly to become a significant part of the rural economy and started to compete with the SOEs.

In contrast, the reform of the SOEs has been more difficult. SOEs reflected the central planning perspective of the past and there were various government agencies whose very existence relied on control over the SOEs. The functioning of SOEs is complex, both because of the lack of management training and because of the need to serve social objectives (e.g., employment stability). Major steps were taken to reform SOEs, such as the contract responsibility system introduced in 1987, where SOEs were given much autonomy and could retain profits after paying taxes to the local government. More recently in 1997 SOEs were restructured into share-issuing companies. The price system was also decontrolled with a transition during which a two-tier price system allowed the coexistence of market prices with government-controlled prices for important goods.

In 1992, China significantly accelerated its pace of economic reform after the inspection tour of the southern regions by its paramount leader, Deng Xiaoping. In the fall of 1992, the 14<sup>th</sup> Congress of the Chinese Communist Party officially declared that the central goal of China's economic reform is to establish a 'socialist market economy.' In the following decade, far-reaching reform measures were undertaken to overhaul China's SOE sector, taxation, banking, and foreign currency systems. Private enterprises grew rapidly, and large amounts of foreign investment flowed in.

Now, twenty-five years after the start of economic reform in 1978, China's economic structures have undergone dramatic changes. One of the most significant changes is the decline of the importance of the SOEs and other state-controlled enterprises and the emergence of the country's private sector. According to a national census, among three million enterprises that existed on December 31, 2001, SOEs and enterprises with a con-

trolling share held by the State accounted for 56.2% in capital and 49.6% in annual revenue.<sup>3</sup> In contrast, when the reform first started in 1978, all enterprises were state-owned.

Despite the increasingly important role of the private sector in China's economy, private enterprises in China are mostly small in size. In fact, 99% of the enterprises in China are small or medium size, with most of them funded by private investment.<sup>4</sup> The largest enterprises in China are still SOEs in such industries as electricity, railroads, aviation, telecommunication, and banking, where the state maintains de facto monopolies or dominant firms. According to government statistics, China's small and medium sized enterprises consisted of 55.6% of the country's GDP, 74.7% of industrial production value added, 58.9% of retail sales, 46.2% of tax revenues and 62.3% of exports.<sup>5</sup>

### **C. CHINA'S REGULATORY STRUCTURE**

Understanding China's current regulatory structure is important for understanding China's competition policy, since direct government regulation and competition policy are often deemed alternative ways for government to control the economy, and China's competition policy is being formulated against the backdrop of its current regulatory structure.

At the same time that China's economic structure is undergoing significant changes, the regulatory structure of China is also being transformed to one more compatible with the requirements of a market economy. Since 1978, the Chinese leadership has gradually recognized the harms of undue state interference with the economy, and has undertaken measures to minimize the abuse of the state power while trying to maintain government control in key industries.

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<sup>3</sup> See Section 3 at [http://www.stats.gov.cn/tjgb/jbdwpcgb/qgjbwpcgb/t20030117\\_61467.htm](http://www.stats.gov.cn/tjgb/jbdwpcgb/qgjbwpcgb/t20030117_61467.htm). (visited October 28, 2004).

<sup>4</sup> *Supra* note 2.

<sup>5</sup> See [http://en.ce.cn/Business/Macro-economic/200407/29/t20040729\\_1359090.shtml](http://en.ce.cn/Business/Macro-economic/200407/29/t20040729_1359090.shtml). (visited October 28, 2004).

China's need for government regulation, as the term is understood in Western countries, was created by the devolution of economic power and the emergence of private enterprises since 1978. In the pre-reform era, China's regulation of the economy was modelled after the former Soviet Union and took the form of direct control of the economic activities of the SOEs. For almost every major industry, a corresponding ministry was created within the government to control, manage, and coordinate the production in that industry. There was no need for separate regulatory agencies; the industries were already regulated in the sense that they were directly owned and managed by the state. It was not until after 1978, when China started experimenting with devolving control of SOEs to SOEs themselves, and when a new class of private enterprise emerged, that China faced the issue of devising a regulatory system in the modern sense.

Realizing the problems associated with the government's interference with the economy, the Chinese government has made a strategic choice to retreat from the 'non-essential' industries such as machinery, electronics, chemicals, and textiles. Those industries do not tend to create conditions of 'natural monopoly,' do not impinge upon national security and public goods, and usually are not regulated in market economies. In several rounds of government restructuring since 1978, China has gradually dissolved the government ministries overseeing those industries and has replaced them with 'industrial associations' representing various interests in those industries.<sup>6</sup>

In industries considered key to China's national security and economic development, such as electricity, petroleum, banking, insurance, railroads, and aviation, the Chinese government has chosen to retain or strengthen its control. In those key industries, the dominant firms remain mostly state-owned. As a result, the government plays a double role: it is both the owner of the major players and the referee, i.e., the regulator. This dual role is now seen as detrimental to the development of China's market economy. Among the steps that have been taken to address this problem, the foremost was to establish sepa-

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<sup>6</sup> Wang Leiming et al., 'Five Comprehensive Government Restructures 1982-2003', Xinhua News (Mar. 6, 2003), available at <http://www.people.com.cn/GB/shizheng/252/10434/10435/20030306/937651.html>. (visited October 28, 2004).

rate regulatory agencies for the key industries and to strip the SOEs in those industries of the regulatory power bestowed upon them in the planned-economy era. In so doing, the Chinese government hopes to separate the government's functions as a player and as a regulator. For example, between 1998 and 2004, China established the Insurance Regulatory Commission, the Banking Regulatory Commission, and the Electric Power Regulatory Commission, which are charged with overseeing the insurance, banking, and electricity industries, respectively. The largest enterprises in those three industries, all state-owned, along with enterprises of other ownership forms that may emerge in the future, are subject to regulation by those new agencies. Additionally, to strengthen government control over SOEs in key industries and to stop the rapid loss of state assets, China in 2003 established the State Assets Regulatory Commission to oversee the operation of state-owned assets by SOEs.

Despite the positive developments in China's regulatory reforms, China's regulatory systems are still beset by abuses of government's regulatory power. The most prominent of those regulatory abuses is the so-called 'administrative monopolies,' i.e., government-created monopolies.

Administrative monopolies are found mostly in three areas. First, in the industries where government ministries have been converted to industrial associations, the industrial associations often sanction anticompetitive practices by their members. Although the government's original intent in organizing those industrial associations was deregulation, in reality many of the industrial associations thus organized are little more than government ministries in disguise. The major participants in those industrial associations are still SOEs subject to the control of the government, and the heads of these associations are often former government officials. Since 1990, amid increasing market competition, many industrial associations adopted industry-wide 'self-disciplinary' prices, functioning as price cartels.<sup>7</sup> To make things worse, this practice was officially sanctioned by the

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<sup>7</sup> For example, faced with growing inventory and price drops, China's nine TV producers held a meeting in southern China in June 2000 to limit TV production and fix prices. The act was not successful and was widely criticized in the media.

government in 1998.<sup>8</sup> Second, in the sectors where the government has retained its regulatory presence, many of the government ministries or regulatory agencies have ‘affiliate companies’ and give preferential treatment to them. This problem is particularly serious at the local level. A good example of this phenomenon is that some local civil affair agencies in charge of issuing marriage licenses require applicants to take pictures only at designated photo shops, which are ‘affiliates’ of the agencies.<sup>9</sup> Third, the governments at provincial and local levels are well known for creating and maintaining barriers to competition from other localities. For example, many local governments force dealers in beer, fertilizer, and medicines to sell only goods that are produced within their own jurisdictions.<sup>10</sup>

Dealing with the problem of administrative monopolies is one of the major goals of China’s proposed antitrust law. Given China’s current regulatory structure, administrative monopolies are seen as posing a far more significant problem to China’s burgeoning market economy than monopolies created by private enterprises.<sup>11</sup> China’s proposed antitrust law tries to tackle this problem by subjecting government ministries and regulatory agencies at all levels to the new antitrust regime. Ambitious as that goal is, it remains an open question whether that is politically feasible. As will be discussed in more detail be-

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<sup>8</sup> State Economic and Trade Commission (‘SETC’), Opinions on Self-Disciplinary Prices Adopted by Some Industries, Aug. 17, 1998, at <http://www.law999.net/law/doc/c001/1998/08/17/00107286.html>. (visited October 28, 2004). Ironically, before its abolishment in the most recent wave of government restructuring, SETC was one of a few government agencies in charge of drafting China’s first antitrust law.

<sup>9</sup> The Forms and Features of Administrative Monopolies and Industry Monopolies, at <http://www.sinolaw.net.cn/zhuanti/fld/fxpl/pl30.htm> (visited May 13, 2001).

<sup>10</sup> *Ibid.*

<sup>11</sup> Anticompetitive behavior by state-owned enterprises is by no means a problem limited to China. SOE’s can engage in certain anticompetitive acts, such as predatory pricing, without the discipline of having to recoup short-term losses with higher prices later. Thus, such behavior is more likely than in the private sector and can continue indefinitely. Sappington, David E.M. and Sidak, J. Gregory, ‘Competition Law for State-Owned Enterprises’, 71 *Antitrust Law Journal* 479-523 (2003).

low, the proposed antitrust enforcement agency will be able to bring antitrust enforcement actions against government agencies of the same or even higher rank. Such an institutional arrangement will inevitably set off power struggles among bureaucrats from different government agencies and among vested interests. Indeed, it is believed that it is this very issue—the relationship between the antitrust enforcement agency and other government agencies—that holds up the drafting process of the proposed antitrust law.<sup>12</sup>

#### **D. CHINA'S AMBIVALENCE TOWARDS COMPETITION**

The scope of China's proposed antitrust law<sup>13</sup> and how strictly the antitrust law will be enforced in practice will depend largely upon the prevailing attitudes in China towards the role of competition in its economic development. Although the doctrine of neoclassical economics that emphasizes free competition has long begun to take hold in China, the attitudes of China's policy-makers toward competition are ambivalent at best. On the one hand, Chinese policy-makers have recognized the problems created by administrative monopolies, and are also awaking to the challenges posed by the acquisitions of domestic businesses by multinational corporations. On the other hand, for the vast majority of China's small and medium sized firms, many Chinese policy-makers doubt whether the proposed antitrust law needs to be strictly enforced or even whether an antitrust law is needed at all.

Administrative monopolies have been subject to extensive criticisms by China's policy-makers and intellectuals. There is a national consensus that more competition needs to be introduced into the industries that are dominated by the state, and some con-

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<sup>12</sup> It is increasingly likely that the antitrust enforcement agency will be housed in the Ministry of Commerce (MOC). MOC is the result of government restructuring that combined several cabinet level agencies in 2002, and is generally considered a powerful ministry, with jurisdiction over China's domestic and international trade. This may give the antitrust enforcement agency considerable power and legitimacy.

<sup>13</sup> The proposed Chinese antitrust law has gone through a series of drafts over the past several years. None of these drafts exists in a citable or official version, especially in English. We comment here on what purports to be a June 2006 draft. It is clear that these drafts are released informally by officials seeking to stimulate comment and discussion.

crete measures have already been taken to achieve that goal. The restructuring of China's telecommunication industry provides an example of China's commitment to promoting competition in state-dominated industries.<sup>14</sup> Meanwhile, Chinese policy-makers are increasingly worried about the acquisition of Chinese businesses by multinational corporations. How to curb the influence of foreign companies and promote the competitiveness of Chinese enterprises has been at the top of China's antitrust policy-makers' agenda.<sup>15</sup>

However, there are fierce debates about whether China really needs an antitrust law for its millions of small and medium sized enterprises, both state-owned and private. The opinion that appears to have gained the upper hand is that for China's small and medium sized enterprises, the problem is not the lack of competition, but too much competition. Chinese policy-makers are very concerned about what they call the 'repetitive investments at low levels' made by small businesses, and have blamed China's small and medium sized companies for engaging in 'suicidal' competition. At times the government even took measures to prohibit some forms of competition that it considered harmful to the national economy. For instance, in 1999, the Bureau of Civil Aviation issued an order

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<sup>14</sup> Before 1994, China's telecommunication industry was monopolized by China Telecom, China's only telecommunication provider. In 1994, the Chinese government formed China Unicom, another telecommunication provider that competed with China Telecom in mobile phone and pager services. In 1999, China Telecom was broken up into two separate entities: China Mobile that provided mobile phone services and a new China Telecom that provided landline services. In the same year, the Chinese governments issued landline licenses to several other newly formed companies to compete with China Telecom. In the next round of restructuring in 2002, China Telecom was further divided and integrated with other telecommunication companies to form two 'competing' landline providers: China Netcom based in Northern China and China Telecom based in Southern China.

<sup>15</sup> The *Wall Street Journal* reported, on the eve of China's then-expected enactment of the antitrust law, that many multinational corporations feared that they would become the law's first targets. Rebecca Buchman, 'China Hurries Antitrust Law', *Wall Street Journal*, June 11, 2004, page A7.



prohibiting airlines from offering air ticket discounts, citing the adverse effect of price competition on the healthy development of the airline industry.<sup>16</sup>

Therefore, there are tensions between China's determination to fight administrative and foreign monopolies and its unwillingness to take on its small and medium sized enterprises. Most likely, those tensions will be reflected in the enforcement of the anti-trust law. Besides these tensions, the government may also be concerned about the loss of a policy tool. Lacking effective macroeconomic policy tools to fine-tune the economy, China's economic policy makers tend to micromanage the economy by directly controlling the scale of investment at the local level (for example, by ordering local governments and banks not to approve new investment proposals and loan requests). This is likely to undermine the proposed antitrust law.

Another concern may be the impact of competition on the survival of SOEs that employ many workers. The problem here is that pensions and other social security programs have been funded and administered in the past by the SOEs, and there is as yet no mechanism to supply such benefits to former employees of defunct SOEs. For example, large and failing SOEs often receive 'policy loans' from state-owned banks at low interest rates that are often not expected to be repaid, while small private enterprises face much difficulty in financing, paying much higher interest rates (sometimes plus the cost of side payments to bank officials). If such subsidies become targets of antitrust, then there is a policy problem that cannot be resolved by the competition authority acting alone.

### **III. China's Legal Context**

The current legal system in China was created mainly to serve political purposes. The passage and enforcement of laws have been largely at the discretion of the Communist Party through its own political leadership and organizational structure. When political needs change, laws change. For example, the Constitution was changed several times to

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<sup>16</sup> However, the ban on discount air tickets was frequently ignored by the airlines, and the ban was finally lifted in early 2003.

suit the need for new policy directions. Most recently, in 1998 the Constitution was revised to protect the rights of private enterprises, and in early 2004 it was amended to protect individual private property rights. Since the economic reforms started in 1978, some reforms of the legal system have taken place. Within the Party's organizational structure and in the legislature, the National People's Congress, indirect elections have been used to a large extent. The National People's Congress has also gradually increased its independence. In rural areas, direct elections have been conducted at the village level for more than a decade.

The focus of China's legislature in most of the past twenty years has been on economic laws, most notably contract law, bankruptcy law, corporate law, foreign investment law, securities law, and the like. These laws have provided a framework under which market activities are facilitated, transaction costs are reduced and disputes may be resolved. However, economic behavior and expectations cannot be and have not been changed by passing laws alone. Both the enforcement agencies and adjudicating body are under direct control of the political leadership at all levels of the government, and there are serious deficiencies and often corruption in enforcement. People are still used to conducting economic activities through social networks. Moreover, judges and lawyers are not well trained. This situation, however, is improving, as the government is pushing for legal reform and the role of lawyer has gradually become more important and professional in recent years.

From an economic perspective, law is a potentially powerful tool for aligning the economic incentives of individuals with the conditions required for economic efficiency.<sup>17</sup> This tool works by its influence on the expectations of economic agents concerning the future consequences of their economic decisions. Individual agents form expectations about future events based on information available at the time a decision is made. One dimension of such expectations is the legal significance of decisions that the agent may make, or that others may make in reaction to that decision. The decision to en-

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<sup>17</sup> Bruce M. Owen, 'Imported Antitrust', 21 *Yale Journal on Regulation* 441 (2004) spells out this point in greater detail.

ter into a contract for the purchase of goods to be delivered in the future, for example, obviously depends in part on the role that the legal system will play in the event of various contingencies, both those contemplated in the contract and those not contemplated. Other things equal, if the legal system's reaction to any contingency is difficult to predict, the risk associated with any given contract will increase, and a higher expected return will be required to make the contract worth that risk. Thus, if the legal system provides a predictable set of contract enforcement remedies, more contracts will be entered into than otherwise, increasing output, social welfare and economic growth. In the antitrust area, to use a more relevant example, entry by firms seeking to compete with an SOE will be more likely than otherwise if the entrants expect the competition agency to protect them effectively from potential predatory responses from the SOE.

In addition to reducing the risks associated with economic activity, the legal system can mitigate market failures, often more effectively than direct regulation of economic activity. Competition law is a leading example. Monopolies, cartels, and practices associated with them are a source of market failure; their reduction improves economic efficiency. Antitrust law can reduce this cost to society by imposing higher expected costs on behavior whose effect is to reduce economic efficiency. For example, the prospect of having to disgorge, with significant probability, some multiple of the unlawful gains from price fixing will deter some price fixing. The prospect that a proposed merger transaction will be challenged by the government upon review will prevent some inefficient transactions from being proposed.<sup>18</sup> Both of these desirable effects occur only if the behavior of the enforcement agency in reaction to a given business decision is reasonably predictable. Predictability by its nature constrains the discretion of the government and the courts, reducing their discretionary power.

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<sup>18</sup> In its congressional submission for fiscal year 2001, the U.S. Department of Justice Antitrust Division writes that the deterrence effect 'is perhaps the single most important outcome of the Division's work.' For detailed analysis, see Philip Nelson and Su Sun, 'Consumer Savings from Merger Enforcement: A Review of the Antitrust Agencies' Estimates,' 69 *Antitrust Law Journal* 921-960 (2002).

## A. THE LAWMAKING PROCESS

Under China's Constitution, the highest state power is bestowed upon the National People's Congress ('NPC') and its permanent body, the Standing Committee of the NPC.<sup>19</sup> The Constitution also states that the NPC and its Standing Committee exercise the legislative power of the state.<sup>20</sup> The NPC convenes for a Plenary Session once each year, and when the NPC is not in session, the Standing Committee performs most of the general legislative functions. Under the NPC are seven special committees, each charged with overseeing legislation in a specific area such as foreign affairs, judiciary, education, and finance.

The lawmaking process in China involves three steps: drafting, approval, and promulgation. The drafting of most of the high-profile or controversial bills is usually done by the Commission for Legislative Affairs ('CLA') under the NPC. After a legislation effort is initiated, a 'drafting group' will be formed within the CLA to research and formulate a first draft of the bill. The draft is then sent to the relevant special committees of the Standing Committee for comments. Comments are also invited from other governmental bodies, political organizations, selected members of the academic community and in some cases, foreign consultants. The draft is then modified if necessary. Controversial bills—like the proposed antitrust law—usually will go through several rounds of drafting and modifications before they can be finally submitted to the NPC for approval.

Other state organs, including the State Council, i.e., the executive branch of the government, the Supreme People's Court, the Supreme People's Procuratorate, and the Central Military Commission, also have the authority to draft and submit bills directly to the NPC.<sup>21</sup>

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<sup>19</sup> Chinese Constitution, Art. 57 (1982)  
<http://english.people.com.cn/constitution/constitution.html> (visited October 28, 2004).

<sup>20</sup> *Ibid.*, Art. 58.

<sup>21</sup> The draft antitrust law in discussion was a work product of joint efforts by several government agencies under the State Council.

The approval stage of the lawmaking process is relatively simple. After a bill reaches the NPC, it can be approved by the NPC either by its Plenary Session or by its Standing Committee. By the time a bill reaches the floor of the NPC, its approval is guaranteed. Despite the progress China has made in recent years in strengthening the role of the NPC in the legislating process, the NPC is still essentially a rubber stamp for the purpose of approving bills. Most of the bargaining among various interests affected by the proposed bills is done in the drafting or pre-drafting stage. After a bill is approved by the NPC, the President signs a Presidential Order promulgating the new law. Again, it is always the case that the President signs the bill into law.

The State Council, as the executive branch of the government, has broad power to enact administrative regulations, with or without legislative grant of authority. The rule-making process at the State Council is not subject to a uniform code of conduct, as China has yet to have a law setting out the procedures administrative agencies need to follow when making regulations.<sup>22</sup> The ministries, commissions, and departments under the State Council usually draft regulations in their respective areas, and send the proposed regulations to the State Council for approval. Not surprisingly, the rules thus enacted often lack scientific and legal bases.

Under Chinese law, the people's congresses at the provincial and local levels, if approved by the State Council, have the authority to pass local regulations applicable within the geographical limits of their jurisdictions. As a general rule, those local regulations cannot contradict laws passed by the NPC or regulations enacted by the State Council.

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<sup>22</sup> The Administrative Litigation Law, adopted in 1989, is often mistakenly translated as 'Administrative Procedure Law.' Actually, the Administrative Litigation Law of 1989 concerns only judicial review of administrative actions, and does not deal with the rulemaking and adjudication processes followed by administrative agencies. However, efforts to adopt an administrative procedure law have been underway since 2002.

## **B. ENFORCEMENT**

The law enforcement power in China is shared among the Public Security Bureaus, the People's Procurators, and the various government agencies charged with overseeing the implementation of regulatory policies. Law enforcement bodies in China are granted much greater power than those in western countries, and their actions usually are not subject to effective judicial review.

The Public Security Bureaus at all levels are responsible for maintaining public order, fighting crimes, and conducting criminal investigations. Criminal cases, after being initiated by the Public Security Bureaus, are transferred to the People's Procurators for prosecution. The People's Procurators enjoy much greater prosecutorial power than their counterparts in Western countries. Notably, the People's Procurators have the authority to issue arrest warrants, whereas such power is usually exercised by courts in most Western countries. Chinese law also provides for preliminary hearings in which the People's Procurators can move the People's Courts to establish probable cause *ex parte* (without the presence of the defendants or their counsel). Moreover, the prosecution is allowed to appeal an acquittal by a lower court to a higher court. There is no such doctrine as 'double jeopardy' in Chinese law.

The various government agencies charged with implementing the government's regulatory policies have the authority to enforce statutes and regulations in their respective areas. This kind of law enforcement is most pertinent to the proposed antitrust law, since the enforcement of the antitrust law will mostly be carried out by a government agency, i.e., the antitrust enforcement agency. Since China's enactment of the Administrative Litigation Law ('ALL') in 1989, the administrative actions of government agencies in certain categories have been subject to judicial review by the People's Courts. The effect of the ALL, however, is limited. Among the problems with the ALL frequently cited by commentators are the narrow scope of the judicial review, the convoluted proce-

dures for judicial review, and the bias in favor of the government in judicial review of administrative actions.<sup>23</sup>

### **C. THE JUDICIARY**

Under the Chinese Constitution, the judicial power of the country belongs to the People's Courts at all levels.<sup>24</sup> China has a centralized, four-tier court system: one Supreme People's Court at the national level, thirty Provincial High Courts at the provincial level, almost four hundred Intermediate People's Courts at the prefecture level, and more than three thousand Primary People's Courts at the local level. Civil and criminal cases can be first brought in the People's Courts at any of the four levels, depending on the importance of the case. However, no matter where a case is first brought, it can be appealed only once, to the People's Court at the immediate higher level.

Although the Chinese Constitution states that the People's Courts shall exercise their judicial power independently, in practice there is no institutional guarantee of judicial independence. In China the judiciary is not intended to be an institution that checks and balances the other branches of the government; instead, the judiciary, along with everyone else, is expected to 'follow the leadership' of the Communist Party and the governments at all levels.

Until recently, Chinese judges had been selected primarily from the pool of retired military officers. Judges generally have no legal training or experience. As a result, the judiciary had been ill-equipped to handle complicated cases. In 1995, China enacted the Judges Law, which establishes minimum qualifications for judges and provides for selection of new judges through public examinations. With the implementation of the Judges Law, it is expected that the overall education level of Chinese judges will improve. However, it remains in doubt whether Chinese judges, most of whom are not

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<sup>23</sup> For more details on China's judicial review of administrative actions, see Chris X. Lin, 'A Quiet Revolution: An Overview of China's Judicial Reform', 4 *Asian-Pacific Law & Policy Journal* 9 (June 2003).

<sup>24</sup> Chinese Constitution, *supra* note 17, Art. 123 (1982).

trained in economics, will be competent to handle antitrust cases to be brought under the proposed antitrust law. This is of course a problem almost everywhere in the world where antitrust enforcement is subject to review by courts of general jurisdiction.

#### **D. LEGAL INTERPRETATIONS AND STARE DECISIS**

China operates under a civil law system, where there is no formal place for ‘judge-made’ law. In China’s civil law tradition, the People’s Courts conduct the judicial proceedings by applying statutes to the particular facts of the cases. If ambiguity arises, judges are expected to refer to the acceptable, codified forms of legal interpretations or to seek legal interpretations from higher government authorities.

In China, the authority to interpret law is shared by the Standing Committee of the NPC, the State Council, the Supreme People’s Court, and the Supreme People’s Procurator. The Standing Committee of the NPC has the ultimate authority in interpreting the Constitution and other national legislation. The State Council and its subordinate ministries, commissions, and agencies have the authority to interpret laws in areas other than adjudications and legal procedures, while the Supreme People’s Court can interpret legal issues concerning court proceedings. The Supreme People’s Procurator is also allowed to interpret questions involving the specific application of statutes and decrees with regard to prosecutorial proceedings.<sup>25</sup>

Although the Supreme People’s Court has the power to interpret laws relating to court proceedings, its legal interpretation cannot be cited by other courts and does not serve the function of precedents in common law countries. There is no such principle as ‘stare decisis’ in Chinese law. This means that potential litigants cannot base expectations of what courts will do in a particular factual circumstance on prior decisions in similar circumstances. Indeed, there is no mechanism for doing so—judges do not write detailed opinions that are published. Expectations about the behavior of courts are thus difficult to form.

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<sup>25</sup> See Li Wei, ‘Judicial Interpretation in China’, 5 *Willamette Journal of International Law and Dispute Resolution* 87 (1997).



## IV. China's Antitrust Laws

### A. CURRENT COMPETITION POLICY

China already has a Law for Countering Unfair Competition, promulgated in 1993.<sup>26</sup> For example, its article 12 prohibits tie-in sales against the wish of a buyer. Article 15 prohibits price fixing or bid rigging. But the Law also addresses many other issues, including bribery, deceptive advertising, coercive sales, appropriation of business secrets, etc. It is very common for new antitrust laws in developing countries to focus on such consumer protection issues. In the parlance of economics, relationships between buyers and sellers are sometimes beset by opportunistic behavior that may be difficult for the competitive market to correct, whether because of asymmetric information or because particular buyer/seller pairs do not expect to meet again. Similarly, certain contracts or contractual terms, even those that promote economic efficiency, may strike people as unfair. Examples include so-called 'victimless crimes,' unilateral refusals to deal and certain tying arrangements. Condemnations and restrictions of such market behavior may have great popular appeal. In societies that are skeptical of the legitimacy of competitive markets, such practices often illustrate the popular or ideological basis for the skepticism. Monopolies and price fixing are but items on the list of potential market abuses, and it is not surprising to see consumer protection regulations incorporated into and even dominating so-called competition laws.<sup>27</sup> Also, advanced developed countries often have similar consumer protection regulations, but are more likely to have delegated their enforcement to specialized agencies.

China's 1993 law is too simplistic compared to the antitrust laws and competition policy guidelines in countries with more antitrust experience. It is hardly enough to deal

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<sup>26</sup> For the text of this law, see <http://apecweb.apec.org.tw/doc/China/Competition/cncom2.html>.

<sup>27</sup> See, e.g., Costa Rica, *Law on Promotion of Competition and Effective Defense of Consumers* (Law No. 7472) (1995); Jamaica, *Fair Competition Act* (1993), both in Organization of American States, *Inventory of Domestic Laws and Regulations Relating to Competition Policy in the Western Hemisphere* (Washington, OAS, 2002).

with a broad range of competition issues. For example, it does not address antitrust issues related to mergers and acquisitions, which are an important part of antitrust policy in the developed countries.

Some antitrust elements are also seen in more specialized laws. For example, in the Commercial Banking Law passed in 1995, Article 9 stipulates that banks should not engage in improper competition. However, it is not clear what ‘improper’ means. The Price Law also has some provisions prohibiting price manipulations.

Because of the need to address some emerging competition issues in the absence of a full antitrust law, some provisional rules have been promulgated. Two recent such rules stand out.

The first is Provisional Rules for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors (effective April 12, 2003). These provisional rules apply only to foreign companies. Article 12 describes the documents to be submitted to relevant government agencies if pre-merger notification is required. Article 19 lays out the four conditions under which pre-merger notification is required: (1) one merging party’s annual sales is above 1.5 billion RMB (approximately \$180 million); (2) the foreign party has acquired more than 10 other domestic companies in related industries in the past year; (3) one merging party’s market share in China is above 20%; (4) post-merger market share is above 25%. Article 20 describes how a hearing is conducted when the authority thinks the merger will impede competition. Article 21 lays out five conditions relating to merging parties’ assets, sales, and market shares inside China under which mergers outside China should be reported to China’s Ministry of Foreign Trade (now part of the Ministry of Commerce) and the State Industry and Commerce Administration. Article 21 is especially interesting because for the first time it allows China to intervene in mergers

outside China.<sup>28</sup> It is not clear whether there has been such intervention. The U.S. and the E.U. commonly require review of mergers among foreign firms that trade within their respective jurisdictions.

The other prior rule is Provisional Rules for Prevention of Monopoly Pricing (effective November 11, 2003), issued by the State Development and Reform Commission. The Rules prohibit the abuse of ‘market dominance’ and infer it through ‘market share in the relevant market, substitutability of relevant goods, and ease of new entry.’ However, it does not specify how relevant market is defined or how the inference of market dominance can be actually made. The Rules also prohibit price coordination, supply restriction and bid rigging. The Rules prohibit government agencies from illegally intervening in price determinations. However, what would be legal price intervention is not clear. The Rules are also unclear on prohibitions of below-cost-pricing and price discrimination and could lead to excessive government intervention when there is not a competition issue.

The vagueness of China’s pre-existing law is hardly unusual. Most competition laws are written in general terms. Notably, the U.S. Sherman Act contains the following fundamental provisions, which are incapable of being interpreted literally:

**§ 1 Sherman Act, 15 U.S.C. § 1**

Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding \$10,000,000 if a corporation, or, if any other person, \$350,000, or by imprison-

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<sup>28</sup> Mergers outside China that may impact China’s market significantly are not unusual given that China has become a major market for many foreign companies. For example, in 1996, Germany’s Mannesmann and Italy’s Italmimpianti, makers of specialized pipes for oil drilling, merged into a monopoly. The technology was suitable for developing countries only and China was the main buyer. Because the main market was outside Europe, merger notification was not required by the European Commission. See Eleanor M. Fox, ‘International Antitrust and the Doha Dome’, 43 *Virginia Journal of International Law*, 911-922 (2003).

ment not exceeding three years, or by both said punishments, in the discretion of the court.

**§ 2 Sherman Act, 15 U.S.C. § 2**

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding \$10,000,000 if a corporation, or, if any other person, \$350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

These clauses are no less vague than many provisions of China's draft competition law. The details and the definitions are left to be developed by courts and enforcement agencies. In the West, this permitted a revolution in the accepted interpretation of competition law during the second half of the last century, despite the absence of change in the statutes. This was accomplished through the informal diffusion of economic learning through the legal profession and the judiciary; arguably it could not have been accomplished through formal legislation. The common law model is hardly the only one that can be applied to the task of creating a system that is both predictable and flexible, however. For example, an administrative agency can develop policies and procedures which, if made public and followed consistently, can provide guidance equivalent to case law, and in the case of antitrust arguably more responsive to new learning and better-informed by the progress of science. The role of the Department of Justice/Federal Trade Commission *Merger Guidelines* serves such purposes in the U.S., even though it has no binding force even on the behavior of prosecutors, much less on courts.

## B. CHINA'S PROPOSED ANTITRUST LAW

In this subsection, we offer some specific comments on China's draft antitrust law.<sup>29</sup> At the outset it is necessary to observe that the proposed law does not reflect adequately the current state of economic understanding of the benefits that can arise from effective competition policy. On the other hand, the proposed law clearly contemplates reliance on administrative rather than judicial machinery as its primary enforcement mechanism, and calls for the enforcement agency to issue detailed rules and regulations to implement the law. In the end, given China's legal environment described above, it is these rules and their enforcement that will matter most. It would be inappropriate to evaluate the proposed law as if it were, as it would be in the U.S., a set of instructions intended for the judiciary to interpret.

The ongoing policy debate on antitrust within the Chinese government is not transparent, though sometimes there are media reports giving updates on the status of the draft. Some earlier drafts were circulated within small circles for comments at various stages. An unofficial draft of the proposed law was widely circulated outside China in 2003 and was the subject of a public commentary by the American Bar Association (ABA). A slightly revised draft was submitted for deliberation to the State Council in March 2004.<sup>30</sup> A subsequent April 8, 2005 revised draft received further comments by

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<sup>29</sup> We are in agreement with much of the commentaries on the draft law undertaken by the American Bar Association, and we do not belabor points that we believe the JSABA has covered adequately. *Joint Submission of the American Bar Association's Sections of Antitrust Law and International Law and Practice on the Proposed Anti-Monopoly Law of the People's Republic of China* (hereinafter 'JSABA'), July 15, 2003, <http://www.abanet.org/intlaw/divisions/regulation/chin715II.pdf> (visited on October 28, 2004), *Joint Submission of the American Bar Association's Sections of Antitrust Law, Intellectual Property Law and International Law and Practice on the Proposed Anti-Monopoly Law of the People's Republic of China*, May, 2005, <http://www.abanet.org/antitrust/comments/2005/05-05/commentsprc2005woapp.pdf> (visited on July 23, 2006), and the July 2005 *Supplement*, <http://www.abanet.org/antitrust/comments/2005/07-05/abaprcat2005-2final.pdf> (visited on July 23, 2006).

<sup>30</sup> See comments from Shang Ming, Director of the newly established Antitrust Investigative Office in the Ministry of Commerce, on September 16, 2004, available at <http://big5.china.com.cn/chinese/law/661991.htm>. (visited October 28, 2004).

the ABA. Several more rounds of revisions were undertaken before a recent draft was submitted to the NPC's Standing Committee for its first review in June 2006.<sup>31</sup> These revisions appear to have incorporated some comments made by various parties including the ABA and the earlier published version of our paper.<sup>32</sup> Our comments below are thus updated from our 2005 paper to reflect changes in the June 2006 draft ("the current draft").

### **1. Efficiency objective.**

The objective of competition law, from an economic point of view, should be to improve continuously the economic welfare of society by increasing the output of goods and services that can be produced with available resources—in a word, to improve economic efficiency. The use of competitive market processes has proven an effective way to achieve this objective, both in China and elsewhere. Antitrust law seeks to promote the use of competitive markets (in place of, for example, SOEs or private monopolies) as a means to the end of improved efficiency. To be sure, virtually every country that has competition policy also has non-efficiency objectives, often objectives that would, if pursued, reduce social welfare. A society may very well decide to make such sacrifices as part of the political compromises necessary to maintain stability and consensus among its component interests.<sup>33</sup> But a decision to sacrifice economic welfare for some political objective probably should be made explicitly and narrowly at the legislative level, rather than delegated to enforcement agencies or courts. Otherwise, those in charge of enforcing the law will be faced, without adequate statutory guidance, with contradictory instruc-

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<sup>31</sup> The NPC Standing Committee members have made many interesting comments on this draft during their first review. See <http://www.npc.gov.cn/zgrdw/common/zw.jsp?label=WXZLK&id=350218&pdm=110106> (visited on July 23, 2006).

<sup>32</sup> See Owen et al., *supra* note \*.

<sup>33</sup> But, for a defense of the proposition that economic efficiency should not be sacrificed to political or other non-deontological goals, see Louis Kaplow and Steven Shavell, *Fairness Versus Welfare* (Cambridge, MA: Harvard Univ. Press, 2002).

tions, the practical effect of which may be to delegate too much discretion and legislative power to the bureaucracy.

## **2. Definition of monopoly.**

A good example of this problem is the current draft's stated objective and definition regarding 'monopoly.' Along with other more efficiency-oriented clauses, the current draft defines monopoly as activities that damage 'the legitimate interests of other business operators.' Like the rest of the objectives set out, this is rather vague. But it could be (and often is, elsewhere) interpreted as an instruction to do the very opposite of seeking competition. The object of competitive behavior, from the point of view of firms that engage in it, is to take business away from competitors, and thus to harm them. Inefficient firms are thus driven from the market, or reduced to a more efficient size. Competition policy cannot seek to preserve inefficient competitors, because to do so harms consumers. Thus, the law should not be interpreted to include the right of any business to be protected from competition.<sup>34</sup>

Also, a monopoly is perhaps better defined as a condition of a market than as a list of activities. (In the U.S., both monopolization and 'attempted' monopolization are statutory offences, but in practice only monopolies achieved through unlawful actions are held unlawful. Monopoly achieved through superior efficiency is not unlawful.) A monopoly that results from continued success in serving consumers should not be condemned, but rather encouraged.

Finally, the current draft includes price fixing in the definition of monopolization. While a price fixing agreement indeed seeks to establish an effective monopoly, there are substantial policy differences between the treatment of a single-firm monopolist and a cartel. In particular, price fixing agreements are almost always harmful to consumers, whereas single-firm monopolies are often beneficial or at least unavoidable. This definition may lead to unnecessary confusion of the two concepts, which most countries have found it useful to keep separate.

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<sup>34</sup> See JSABA discussion of definitions at 10-14.

### **3. Agreements among enterprises.**

The current draft has reflected various parties' comments, including ours, on the broad prohibitions of all agreements in earlier drafts and now outlaws agreements specifically among competitors. However, the current draft is not clear on how the vertical contracts will be analyzed. It is still important to note that contracts that are vertical (between firms and their suppliers or distributors) are seldom anticompetitive, and can be treated separately with less danger of deterring competitive behavior beneficial to consumers. The current draft still provides for exemptions that are permitted by the review process. As in earlier drafts, the provision exempting agreements among competitors to mitigate the effects of slow sales and large inventories during economic downturns is too broad, economically unsound and likely to hurt consumers.

### **4. Presumption of lawfulness.**

The draft law, as noted above, contemplates a European-style competition regime wherein all competitive activity is automatically unlawful, except where specifically permitted by regulation (as with the EU 'block exemption' system, which is to be phased out) or exempted in a case-by-case review. In general, this is indistinguishable from a centrally-planned and controlled economy. Even if guided by a modern understanding of how markets and competition can serve the interests of consumers, this approach is likely to be unwieldy and to impose daunting delays and barriers in the path of competitive initiatives. A better approach may be to permit anything that is not specifically forbidden, with published guidelines for information and penalties for deterrence.

### **5. Market definition.**

Some earlier versions of the draft law defined the term 'market' solely in geographic terms. Markets have important product dimensions as well as territorial dimensions, as described in the *United States Department of Justice/Federal Trade Commission 1994*



*Merger Guidelines*.<sup>35</sup> The current draft now has expanded the scope of the market to include the product dimension.

## **6. Per se versus rule of reason.**

Use of the word ‘monopoly’ in the section concerned with ‘agreements’ may create unnecessary confusion. The distinction is between multi-firm behavior and unilateral behavior. Anticompetitive agreements generally require, as a necessary condition for causing consumer harm, that the parties create or attempt to create an economic monopoly. More substantively, monopolies and many agreements among competitors must be assessed individually, based on their effects on economic welfare, but some agreements among competitors can safely be proscribed ‘per se.’ These distinctions are especially useful because they permit fine tuning of the mechanism of deterrence. Unless antitrust enforcers are to attempt to examine every transaction in the economy, deterrence is the principal vector by which antitrust (and most other) laws achieve their effects on economic behavior. Deterrence of anticompetitive behavior, however, has a dark side: inadvertent deterrence of efficient behavior. The deterrent effect of a law or regulation is affected by the probability of detection and successful prosecution (itself a function of enforcement resources), the firm’s understanding of the law, and the penalties expected to result from successful prosecution. Very effective deterrence of anticompetitive behavior will also deter pro-competitive behavior if the law is unclear to private decision-makers or if private decision-makers anticipate frequent errors by prosecutors and judges.<sup>36</sup>

## **7. Publication of decisions.**

An earlier draft states that “the enforcement authority *should* publish its decisions,” a requirement that makes sense only if the published opinions are intended (as they should

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<sup>35</sup> The *Merger Guidelines* may be found at [http://www.usdoj.gov/atr/public/guidelines/horiz\\_book/hmg1.html](http://www.usdoj.gov/atr/public/guidelines/horiz_book/hmg1.html) (visited October 18, 2004). Market definition is discussed in Section 1.

<sup>36</sup> See generally, Kenneth Heyer, ‘A World of Uncertainty: Economics and the Globalization of Antitrust’, U.S. Dept. of Justice, EAG working paper 04-11 (Washington, U.S. Dept. of Justice, 2004).

be) to influence future behavior of business firms, as discussed above in connection with deterrence. Publication of decisions and the reasoning behind them, however, is a necessary but not sufficient condition for effective deterrence. It is also necessary to have a rule that serves the purpose, in a common law system, of ‘stare decisis.’ That is, the enforcement authority must to some extent be bound by its prior decisions and reasoning. If prosecutors (or courts) can decide each case without regard to the ways in which similar facts have been analyzed and treated in the recent past, private firms have no basis to form expectations about the consequences of their actions. The effect of this is to increase the risks of doing business, thus discouraging investment by ruling out investment projects that do not have a sufficiently high expected return to compensate investors for taking on the risk of (erroneous) antitrust prosecution. The current draft has changed this language to that “the enforcement authority *may* publish its decisions.” This subtle change seems to reflect a reluctance of the Chinese government to commit to full disclosure of its future antitrust decisions, which is not helpful for private firms attempting to form expectations about the antitrust authority’s actions.

## **8. Concentration thresholds.**

The current draft includes presumptive thresholds for holding a dominant market position, based on what economists call ‘concentration ratios:’ a single firm with more than 50 percent of the market, or the top two firms with more than two-thirds of the market, or three firms with more than three-quarters of the market. The specific thresholds are of course arbitrary, as are similar thresholds in other jurisdictions, but they may nevertheless be useful in the context of deterrence. In some earlier drafts, the rules are also ambiguous. If the largest three firms in a market have over  $\frac{3}{4}$  of the market, and individual shares of 70%, 3% and 2%, are all three regarded as dominant firms? Suppose each has 25% percent: is each a dominant firm? Neither result would make much sense. The current draft has added a provision that each firm’s market share has to be at least 10% for it to be considered a dominant firm. This to some extent solved the problem in the first scenario, but not the second one. Most jurisdictions have adopted the HHI approach to measuring concentration, and most jurisdictions define dominance (or ‘market power’) in terms of a

specific minimum market share, such as 35%, for the leading firm, plus the existence of barriers to entry.

### **9. Monopoly pricing.**

The draft law forbids monopolistic pricing, which is contrasted with ‘normal’ pricing. This is unlikely to be a useful provision for two reasons. First, every enterprise in a competitive market system should be encouraged to strive to achieve a monopoly or dominant position through superior customer service, lower costs, and innovation. The primary incentive motivating such behavior is the prospect of earning higher profits. This provision, by denying the prospect of rewards from competitive effort, could act to reduce or eliminate the incentive to compete. Second, as a practical matter the calculation of the difference between an actual ‘monopolistic’ price and a hypothetical ‘normal’ or competitive price is daunting, and where it has been attempted in the West (e.g., in regulated industries), it has consumed vast resources and proved ineffective or worse. The current draft similarly proscribes ‘predatory’ pricing by a dominant firm, defined as pricing below ‘cost.’ The tendency in the academic literature has been to emphasize the difficulty of designing an appropriate and operational definition of ‘cost’ for this purpose, and to point out the possible incentive of enterprises to avoid vigorous price competition for fear of erroneous prosecution. U.S. courts in recent years have emphasized the rarity of circumstances in which predatory pricing is likely to be profitable.

### **10. Price discrimination.**

The draft law proscribes price discrimination, by a dominant enterprise, between like customers. Economists generally view price discrimination as a device to extract additional surplus from customers, but not necessarily as harmful to economic efficiency. In some circumstances, as when demand in a market is too small to support even one firm charging a uniform price, price discrimination may be necessary to permit even a single firm to exist. Similar remarks apply to prohibitions in the draft law on tying, exclusive dealing, refusals to deal, and the like. Practices such as these that are either ambiguous in their effects, or legitimate competitive activity easily mistaken for the opposite, should be

evaluated in terms of their effects on consumer welfare in particular cases, rather than condemned per se.

## **11. Mergers.**

The draft law provides for agency review of proposed mergers, acquisitions, and joint ventures, a very useful device to avoid anticompetitive concentration without the messy complication of ex post disassembly of a consummated transaction. Unfortunately, the current draft applies to all consolidations rather than just consolidations of competing firms. The effect could be to unnecessarily increase the delays associated with obtaining agency clearance for mergers with little or no potential for anticompetitive effects, including many beneficial mergers.

The current draft attempts to set out a list of the information required to be submitted by enterprises proposing to consolidate. The list is unduly vague and may preempt a more thoughtful and detailed information request from the enforcement agency, tailored to the circumstances of the particular transaction.

The current draft provides a limit on the time the agency can take to make a decision regarding a proposed transaction. This is a valuable provision. In some countries businesses complain that review periods are too long or even open-ended, and that opportunities for corruption are created by the process.

The factors for consideration of a proposed transaction include the effect on ‘other business operators’ and the effect on ‘the development of the national economy and public interest.’ These criteria are either subject to abuse by competitors or too vague to be useful in predicting which transactions will be disapproved. It will be very important for the enforcement agency to set out clearer and more specific criteria.

## **12. Administrative monopoly.**

The current draft contains an entire chapter of prohibitions on anticompetitive activity by government agencies. For the reasons explained above, these may be the most important provisions in the law. However, the sweeping condemnation of monopolistic and anti-

competitive behavior by government agencies provides no guidance to those decision makers who must decide whether necessary or otherwise legitimate functions of government, which incidentally have an anticompetitive effect, should nevertheless be permitted. An example is environmental regulations that have the effect of increasing the minimum efficient size of enterprises. It would be helpful to give decision makers some guidance, such as net improvements in consumer welfare, when such conflicts arise.

### **13. Enforcement Authority**

Previous drafts proposed the establishment of an Enforcement Agency under the State Council. There had been speculations that such an Enforcement Agency would be created within an existing ministry, most likely the Ministry of Commerce. Many were concerned that such an agency would not have enough authority to investigate other government agencies suspected of abusing their administrative power to limit competition, especially if such agencies are ministries at a higher level in the government bureaucracy.

The current draft proposes another authority besides an Enforcement Agency proposed in earlier drafts: an Antimonopoly Commission at the cabinet level that conducts policy research, oversees the work of the Enforcement Agency, and coordinates work on major cases. A cabinet level Antimonopoly Commission will have more clout, which is much needed to combat administrative monopolies arising from other ministries acting as or for interest groups. However, it is not clear why the Enforcement Agency cannot be part of the Antimonopoly Commission, rather than part of an existing ministry. This proposed dual structure is strikingly reminiscent of the very unfortunate experience in Brazil, where three antitrust agencies were created, resulting in widespread complaints of delays and other impediments to commercial transactions for which antitrust review was required. Given the frequently observed turf wars among some Chinese government agencies and the waves of restructuring of government agencies in recent years aimed at reducing such inefficiencies, it would be unwise to create dual enforcement authorities.

The current draft makes the compromise that monopolistic activities subject to the antimonopoly law that are also within the scope of other regulatory agencies' investigative power based on other laws and administrative regulations shall be investigated by those

other agencies and these other agencies report the results to the Antimonopoly Commission. The enforcement agency investigates such matters only when they are not investigated by other agencies. As a formal matter, this reflects U.S. legal doctrine, which holds regulatory agencies responsible for including competition policy concerns among the factors to be considered in making regulatory decisions. That doctrine has seldom been useful in overcoming resistance to competition by regulated firms. If regulatory capture is a serious source of administrative monopoly in China, then such delegation is troubling.

#### **14. Penalties.**

The draft law provides for fines for enterprises that engage in agreements to limit competition and other offences. In earlier drafts, these fines were stated in terms of a fixed cash range, with no indexing for inflation and no criteria for determining the size of the fine within the specified range. Optimal deterrence requires fines that, on the margin, balance the gains to society from the deterrence of inefficient behavior against the loss to society from inadvertent deterrence of efficient behavior. While these calculations may often be impractical, the enforcement agency or the court should be instructed to be guided by such considerations. In the current draft, fines are stated in terms of a percentage of sales. The current draft also provides reduced penalty for voluntarily assisting the enforcement authority's investigation in monopolistic agreement cases, which is similar to the amnesty provision adopted by other jurisdictions in recent years, especially with respect to cartels. There are minor differences, though. For example, the lead antitrust offender is often not qualified for amnesty in most other jurisdictions.

Interestingly, the penalties for government agencies and officials who engage in anticompetitive behavior include not merely injunctive relief but demotion or termination for individuals and, where appropriate, criminal prosecution. It is quite unusual for competition laws to contain such provisions; more commonly government agencies and officials are held immune from antitrust prosecution. China obviously takes this problem very seriously.

In some earlier drafts, private parties who are victims of anticompetitive activities are given a right to petition the People's Court for relief and damages. Damages include

actual loss plus the defendant's profit, plus the plaintiff's legal expenses. This provision apparently permits recovery of damages in excess of actual loss, and thus serves the same purpose as the corresponding U.S. treble damage provision. Effective deterrence requires a penalty in excess of the anticipated gains from anticompetitive activity because the probability of a successful legal action by injured parties (especially customers) is far from certain. The correct multiple doubtless varies according to the circumstances. This provision has been reduced to a mere statement that offenders shall take responsibility for civil liability in the current draft. However, the amount of fines specified in the draft law seems to be sufficient to serve as a deterrent.

The current draft is unclear regarding structural remedies, such as dissolution of monopolies or divestiture of anticompetitive acquisitions. Such power exists in agencies and courts in the West, but is very rarely used. In China, where the structure of SOEs continues to present competitive problems, such remedies have been addressed in the past through legislation.

### **15. Judicial review.**

Private parties are given the right to judicial review if they are not satisfied with the Enforcement Agency's decisions. In the context of China's current legal system, discussed above, it remains unclear whether this right increases or decreases the predictability of the process and therefore the potential for promotion of economic efficiency and growth. It is not clear what level of the Court will handle such appeals or whether the Court's decision will be final.

### **16. Intellectual property rights and Enforcement of Guidelines**

The draft law states clearly that an intellectual property right is not to be regarded as a per se unlawful monopoly. Beyond that useful provision, the current draft provides little guidance to officials who must decide whether a particular business practice constitutes an 'abuse' of an intellectual property right. As with mergers, this area must be the subject of detailed guidelines from the enforcement agency. And, indeed, the current draft does allow the enforcement agency to issue such guidelines, rules, and regulations covering

not just intellectual property but its entire subject matter jurisdiction. It would be even more useful if the law required the enforcement agency and the People's Court to be bound by such regulations.

## **V. CONCLUSION**

The salient feature of China's antitrust law is that it is designed to reduce the anti-competitive conduct of government agencies. Given China's present economic structure and its ambition to rely on competitive markets for future economic growth, this is a valuable feature of the proposed law. On the other hand, the draft law has two potentially serious flaws: a lack of focus on economic efficiency as the primary goal of competition, and therefore of competition law, and an apparent lack of awareness of the powerful economic effects of law-influenced expectations on private incentives. These flaws have the potential to leave on the table, unexploited, much of the long term gain from adoption of a competition law. Both flaws can be remedied, however, by thoughtful and consistent enforcement of the law by an enforcement agency well-informed on matters of microeconomics and imbued with sufficient political clout to merit the attention of economic decision makers, both in the SOEs and in the domestic and foreign private sectors..