

# China's state-owned enterprises and competitive neutrality

Alicia García-Herrero and Gary Ng

## Executive summary

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**AS CHINA'S ECONOMIC** weight continues to grow, so does the global impact of its companies. Chinese state-owned enterprises (SOEs) produce a large share of Chinese goods and services. Given their importance both in China and increasingly globally, it should be measured whether SOEs introduce distortions into markets and how significant those distortions are. Foreign governments negotiating trade or investment deals with China need this information so they can better measure how far China is from offering a level playing field to foreign companies on its domestic market. In this context, competitive neutrality is an important working concept that can be used to assess how far a market is from being a competitive environment.

**THE ORGANISATION FOR** Economic Co-operation and Development defines a framework of competitive neutrality as one in which public and private companies face the same set of rules, and no contact with the state gives competitive advantage to any market participant. Quantifying the concept is difficult, but we provide a preliminary measure of the lack of competitive neutrality in relation to Chinese SOEs. In particular, we focus on debt and tax neutrality and compare the situation for Chinese state-owned and private firms on aggregate and sectoral levels. Our results support the view that China's competitive environment is generally poor. The advantageous position of SOEs in China is true for most economic sectors, though to a variable extent, with the automotive sector one of the furthest away from competitive neutrality.

**A WORKING MEASURE** of competitive neutrality applied in China could help improve the level playing field for foreign companies in China. It could also be applied globally given the very large size and global footprint of Chinese SOEs. The concept could even be introduced in a potential reform of the World Trade Organisation.



### *Recommended citation*

García-Herrero, A. and G. Ng (2021) 'China's state-owned enterprises and competitive neutrality', *Policy Contribution* 05/2021, Bruegel

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# 1 Background

Differential treatment of companies operating in China has long been an issue of concern<sup>1</sup>. It is not only that foreign firms are treated differently from Chinese firms, but also that there is differential treatment of Chinese private firms compared to their state-owned enterprises (SOEs). Foreign investors have long pushed to make the Chinese business environment more equitable. Most recently, this has been a factor in the trade-war negotiations between the United States and China, and in the European Union's December 2020 agreement in principle with China on a Comprehensive Agreement on Investment.

The excessive role of the state in the production of goods and services in China creates a number of major distortions. The impact is increasingly significant on a global level given China's sheer size and the active overseas expansion of its firms (García Herrero and Xu, 2017; García Herrero and Wolff, 2020). There are two main issues. First, in the absence of a level playing field, European firms can find it difficult to compete with local firms in China. Second, even if European firms do not enter the Chinese market, potential distortions created by Chinese SOEs operating globally might have a major impact on the EU single market. In other words, Chinese firms are too big to be ignored, whether in China or in Europe.

Many of the concerns about the behaviour of Chinese SOEs are rooted in the different legal treatment in China of state-owned, Chinese private and foreign companies<sup>2</sup>. Beyond the legal framework, the complex corporate structure of Chinese SOEs<sup>3</sup> and their obligations to the government and to the Chinese Communist Party mean limited public disclosure of information. A good example of this is China's State Secrecy Law, which strictly limits the amount of information that SOEs can share, including with foreign regulators.

More generally, the close relationship between Chinese companies, especially SOEs, and the Chinese government/party make any discussion about the level playing field in China very complex. Furthermore, the difference between SOEs and Chinese private companies – especially in strategic sectors – may be blurred. The process of partial privatisation of Chinese companies since then-premier Zhu Rongji's reforms in the 1990s and the more recent introduction of mixed ownership companies have created additional layers of complexity when trying to classify corporate ownership in China.

One of the basic problems in assessing how level the playing field is how to measure it. Competitive neutrality is an increasingly relevant concept, given the attention it has received from multilateral organisations and US and European trade negotiators with China. This concept was first introduced in Australia in the 1990s and has been formalised and harmonised by the Organisation for Economic Co-operation and Development. The OECD defines competitive neutrality as the regulatory framework within which public and private enterprises face the same set of rules and where no contact with the state gives competitive advantage to any market participant (OECD, 2009; OECD, 2012).

China has shown an interest in applying the concept to itself to maintain market competitiveness (IMF, 2019). Chinese premier Li Keqiang said in 2019 that China would implement competitive neutrality so that “enterprises under all forms of ownership will be treated on an equal footing,” and the concept was the subject of a People's Bank of China/International Monetary Fund conference in 2019<sup>4</sup>.

- 1 The annual position papers of the American and European Chambers in Beijing provide good overviews of such concerns.
- 2 China has improved the legal framework of foreign companies in China with the introduction of a Foreign Investment Law at the end of 2019, under which only those companies in sectors included in China's Negative List for Foreign Investors may be subject to a different legal framework.
- 3 The largest tend to report to the central government through the state-owned Assets Supervision and Administration Commission of the State Council (central SASAC), while there are also provincial SOEs which report to their respective local SASACs.
- 4 See <https://www.imf.org/en/News/Seminars/Conferences/2019/04/19/7th-abc-imf>.

**China's State Secrecy Law strictly limits the amount of information state-owned enterprises can share, including with foreign regulators**

But since then, no apparent progress has been made. From the geopolitical point of view, the heightened tensions between the US and China have caused disruptions. In the negotiations between the EU and China to conclude the Comprehensive Agreement on Investment, the idea of introducing competitive neutrality as a yardstick to evaluate the degree of distortion introduced by SOEs does not appear. It is hard to know if the apparent lack of interest in this concept from China's side reflects the current limited will to implement SOE reform or the lack of straightforward ways to carry out such reform, or even the notion in Chinese policy circles that the concept is too Western for any application to the reality of China's economic system. In any event, whether and how China tackles the uneven playing field in its huge market is important not only for China and the companies operating there but also for the rest of the world.

In this Policy Contribution, we review the concept of competitive neutrality and how it may apply to China. We also provide a workable methodology and apply it to different sectors in China. Finally, we draw conclusions on the relative size and type of distortions and offer some ways forward.

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## 2 Competitive neutrality as a useful tool

The concept of competitive neutrality is underpinned by the idea that resources need to be used effectively within the economy to achieve growth and development. One of the obstacles to achieving competitive neutrality is policies favouring state-owned enterprises over usually more-efficient private firms.

In 2004, the OECD started the first in-depth discussion on how the role of the government affects the way markets function. The public sector may, through subsidies and skewed government procurement rules, enjoy financial advantages over private firms (OECD, 2004). Competitive neutrality would ensure that private and public enterprises operate under the same rules and conditions and thus compete on an equal footing. If they don't, differences should at least be measured so action can be taken to iron out such differences through appropriate policies (OECD, 2009). The idea should then be formalised into national practices and regulation to ensure the level playing field (OECD, 2012). While the meaning of competitive neutrality is clear, measurement of it is less obvious considering the realities in different countries and access to data (OECD, 2012; UNCTAD, 2014).

Several countries have taken steps to implement competitive neutrality. A frontrunner is Australia, which underwent a comprehensive reform of the role of the state in the economy in 1990s. Starting from the *Hilmer Report* in 1993, Australia created the environment to inject greater competition into its markets (Commonwealth of Australia, 1993). The framework relied heavily on *ex-ante* components, namely policies governing the operation of state-owned enterprises which gave them an arm's length relationship to government (Brennan, 2019). The key aspects are maintaining neutrality in terms of regulation, debt and tax, while ensuring SOEs achieve commercial rates of return and that loss-making institutions exit the market.

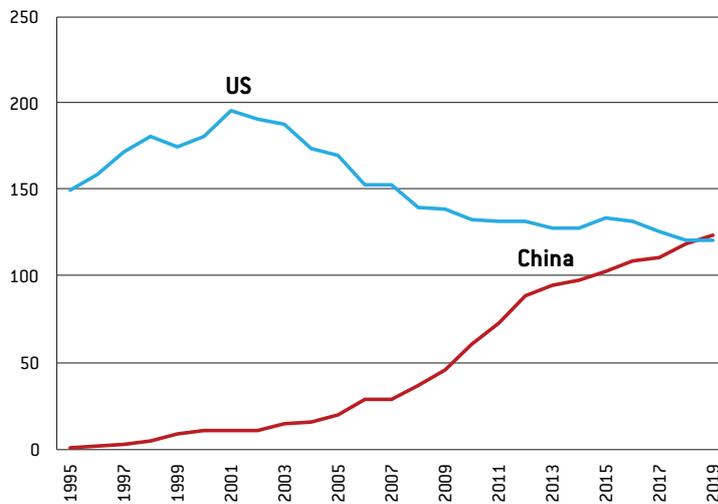
For example, payments should be made to the national treasury as compensation for any regulatory or financial advantages. Australia's Productivity Commission ensures the macro goals are fulfilled through general reporting and communication and the micro targets can be met with flexibility based on sectorial divergence and constraints (Rennie and Lindsay, 2011; Brennan, 2019).

Competitive neutrality is of course different from full-fledged privatisation. In Sweden, for example, the government still has significant corporate holdings, but the concept of competitive neutrality is used to ensure equality among companies and the necessary degree of transparency (Östros, 2019).

While progress has been made in the past few decades on competitive neutrality in developed economies, the state share of the production of goods and services continues to be larger in emerging markets and especially those in transition (OECD, 2017; EBRD, 2020). China clearly stands out. Its state-owned enterprises were valued at \$29 trillion and employed some 20 million people in 2017 (OECD, 2017). Given China's sheer size, a move towards competitive neutrality in China would be significant for both its own development and for the world.

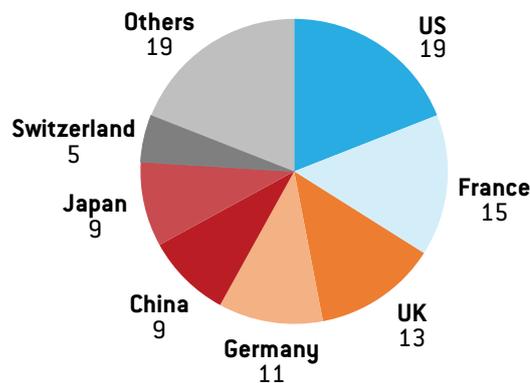
China's potential growth has been decelerating for years and this is bound to continue, pushed by an aging population and decelerating productivity. This calls for more-efficient use of resources. SOEs are less productive and less profitable than other firms, which implies that better resource allocation needs to be centred on the way SOEs are run. In other words, the need for SOE reform in China seems clear (Brennan, 2019). Given that Chinese firms are now the largest in the world, dominating the league table of the Fortune 500, reform of Chinese SOEs will be globally important (Figures 1 and 2).

**Figure 1: Number of firms in Fortune 500**



Source: Bruegel.

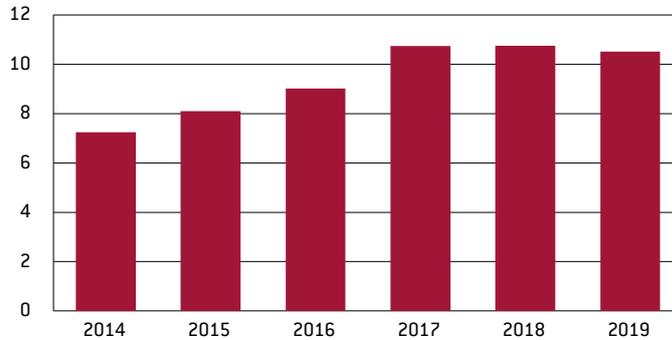
**Figure 2: World's top 100 non-financial multinationals by foreign assets, 2019**



Source: Bruegel based on UNCTAD.

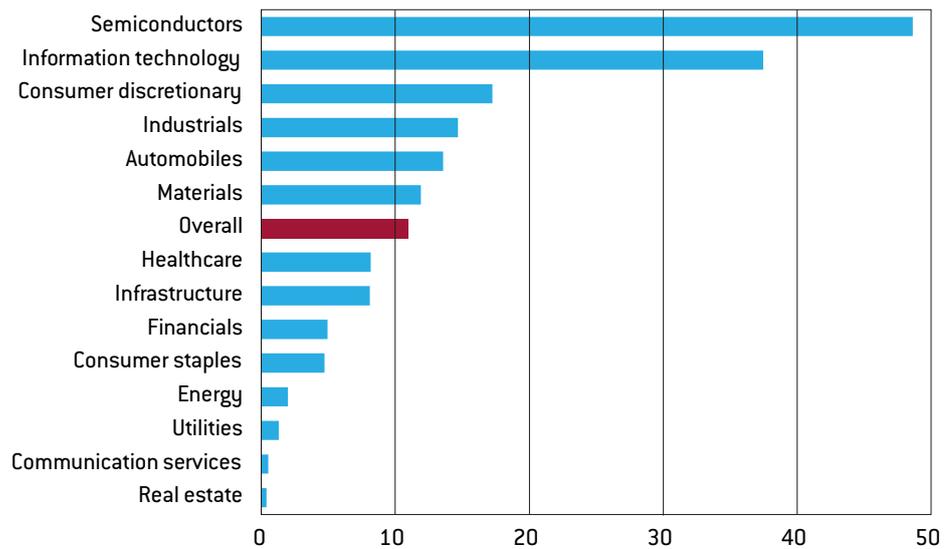
The global importance of pursuing a level playing field in China can be understood from the increasingly large share of the revenues of Chinese companies that come from overseas (Figure 3). From a sectoral perspective, semiconductors and information technology have the largest shares of overseas revenues (Figure 4).

**Figure 3: Chinese companies, share of revenues from overseas**



Source: Bruegel based on financial statements, WIND. Note: coverage = largest 3000 Chinese onshore listed companies.

**Figure 4: Chinese companies, share of revenues from overseas by sector, 2019**



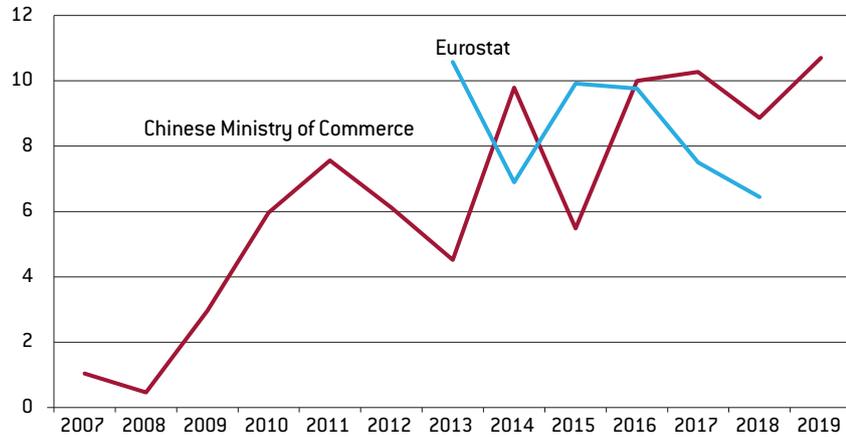
Source: Bruegel based on financial statements, WIND. Note: coverage = largest 3000 Chinese onshore listed companies.

Furthermore, China’s strategy of ‘dual circulation’, which is central to the new Five Year Plan (2021-2025) emphasises ‘internal circulation’, or local production to achieve self-sufficiency in technology (García Herrero, 2020). At the same time, however, ‘external circulation’, which is focused on exports, should support internal circulation. This signals that China wants to reduce the role of international trade in its economy and strengthen its domestic economy. But this does not mean China will be completely detached from the world. Rather, it equates to a ‘hedged integration’ to protect the economy from external volatility, while benefitting from selling into overseas markets. Therefore, European firms are likely to face tougher competition in China without a level playing field.

Beyond corporate revenue and foreign assets, Chinese firms are also influencing the global competitive environment through outward foreign direct investment, including mergers and acquisitions (M&A). This remains very important for the world even though the

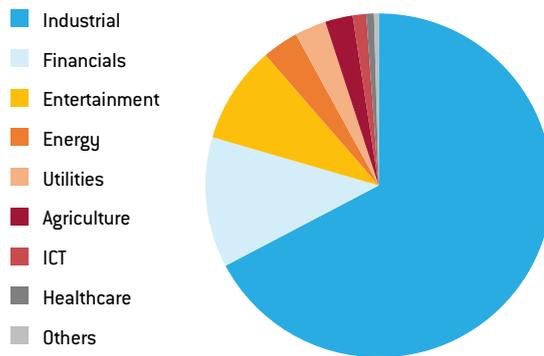
pace of Chinese FDI has slowed down recently partly as a consequence of stricter screening, especially in the west. There is also less appetite from Chinese companies in the context of a plummeting global economy (Figure 5). Europe has long been a popular target for Chinese M&A activity in order to gain market access and technology, especially in industrial-related sectors (Figure 6).

**Figure 5: Chinese direct investment in the EU (\$billions)**



Source: Bruegel based on CEIC, Eurostat. Note: the lines in the chart represent different sources of data.

**Figure 6: Sectoral distribution of Chinese M&A activity in the EU since 2018**



Source: Bruegel based Mergermarket, AEI.

Although enhancing competitive neutrality in China would bring long-term benefits, there is significant resistance. This is understandable given the socio-political reasons for the large presence of SOEs in China and the stabilising role they have long played during economic downturns (García-Herrero and Xu, 2017). Ma (2019) dwelt on the need for local governments to create their own SOEs as they rely on them to fulfil institutional mandates from central government. In other words, Chinese SOEs can be seen as the arm of the state – both central and local – to achieve economic and social goals, whether it is full employment or, more recently, the expansion of Chinese corporations overseas.

There have been attempts to regulate the functioning of SOEs, mainly by allowing the partial listing of SOEs. However, little has been done about their corporate governance. Some proposals exist, such as those of Zhang (2019), who argued that state capital management is by far China’s most important reform as it will ensure equal treatment of all firms by eliminating financial advantages for state-owned enterprises, removing subsidies and preferential policies. Such an approach would be similar to the Australian experience based on the

concept of competitive neutrality. The concept has two main aspects: first to charge prices that fully reflect costs (or in other words to control for a minimum degree of profitability of SOEs) and, second, to ensure neutrality in terms of tax, debt and regulation (Brennan, 2019). From an international perspective, the IMF (2020) offered general principles to ensure a level playing field between SOEs and private firms. In addition, several international organisations have published guidelines, including the OECD and the World Trade Organisation.

But this still leaves the question of how to measure competitive neutrality. Although the OECD provides guidance for policymakers in terms of creating the level playing field, it does not address a core problem of how to measure and compare competitive neutrality in different countries or sectors. For China, the huge share of loss-making SOEs, low returns on commercial investment and the misallocation of credit are all signs of the lack of competitive neutrality (Lardy, 2019).

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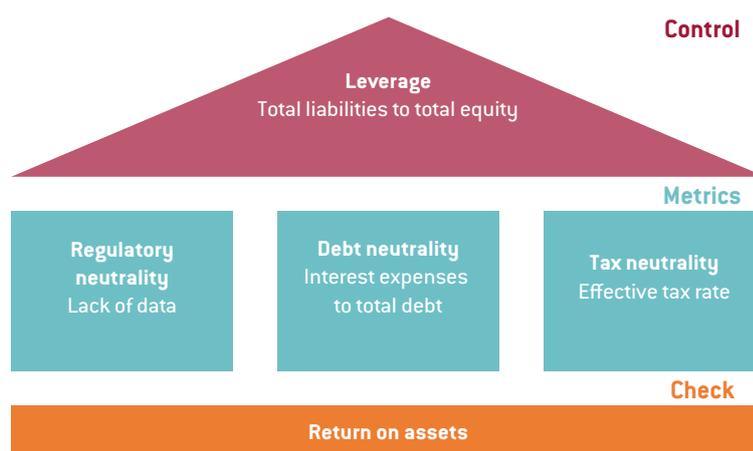
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## 3 Components of competitive neutrality

We provide a preliminary measure of the lack of competitive neutrality for Chinese SOEs. There are many ways in which SOEs can gain advantages over private firms. IMF (2019) described competitive neutrality in financing with regulatory neutrality and debt neutrality in a framework which can be further divided into implicit guarantees, equity financing and credit terms. However, it is difficult to quantify the impact of such benefits. SOEs also benefit from government subsidies. Although direct subsidies can be estimated from the financial statements of listed firms, subsidies can also be handed out in various forms in largely state-owned and national strategic sectors. For example, in China the government has subsidised households that switch from coal to gas or electricity, a measure that can indirectly boost revenues for utilities. However, the benefits for companies, especially in the context of interlaced relationships between SOEs and provincial governments, may not be reflected in financial statements. In addition, firms may not be obligated to pay full dividends to state shareholders. That said, subsidies can vary between sectors and exist in different forms, which makes comparison and measurement difficult.

Given the lack of conclusive evidence on the degree of competitive neutrality in the Chinese economy, we developed a data-rich approach to measure monetary and fiscal support given to companies (Figure 7). We used leverage as a control measure to show the divergence in leverage for SOEs and private companies. The three key metrics that are deemed important are regulatory, debt and tax neutrality. In reality, it is difficult to quantify regulations and therefore we focus on debt and tax neutrality, which are measured by interest expense-to-total debt and the effective tax rate. Lastly, we followed the Australian approach in measuring return on assets as a check.

**Figure 7: Analysing competitive neutrality**



Source: Bruegel.

On the financial side, the Chinese financial sector is still largely controlled by the state, meaning that banks and other financial institutions also play an important role in the competitive environment companies in China face. Commercial banks are the biggest bondholders in China. As a simple measure of debt neutrality, we calculated how low interest payments may be per unit of debt for a certain SOE compared to a private company within a certain sector.

On tax neutrality, the lack of data on subsidies and other types of benefits prompted us to focus on tax payments, in particular how low the effective tax rate of a certain SOE might be compared to a private company within a certain sector. A generally lower effective tax rate for SOEs is an obvious form of financial support, since it allows companies to retain their earnings and boost returns on assets.

The return on assets is a measurement of the result of the existence or non-existence of comparative neutrality and is an important indicator to assess how efficiently/productively an SOE utilises its resources. If an SOE has received financial support from the government and its profitability is high, it may mean that the support has been well-utilised. The opposite means the government support has not translated into an efficient outcome, which means the subsidies may be better allocated.

## 4 Measuring competitive neutrality in China

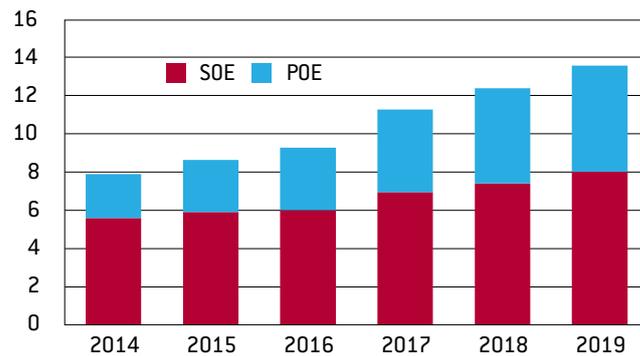
We set out to measure whether there is competitive neutrality between SOEs and privately-owned enterprises (POEs) in China. Foreign firms are not included as it is hard to argue they will enjoy competitive neutrality with local firms if it does not even exist for SOEs and POEs. Our sample includes the 3,000 largest listed non-financial Chinese firms by asset size in both the onshore and offshore markets. Asset size is a more solid measure for the real size and importance of companies, as market capitalisation can be volatile and depends on valuation. The financial sector has a different role in the economy and is beyond the scope of our analysis.

We included not only firms listed on the Shanghai and Shenzhen stock exchanges but

also those listed on overseas venues, including Hong Kong and New York. This extension is essential because some sectors in China, which include huge companies, are heavily dependent on overseas equity financing, such as real estate developers listed in Hong Kong and technology firms listed in the US. Results purely focusing on the onshore market would mean a big part of firms would be neglected.

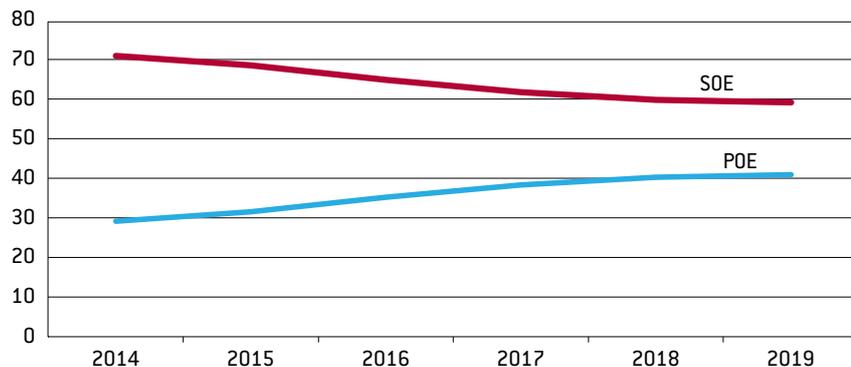
Our data shows asset size has ballooned for listed Chinese firms, which confirms the trend that Chinese firms are gaining more influence in both the domestic market and foreign markets, including the EU (Figure 8). Although the asset size and the share of assets owned by private firms have increased, it does not necessarily mean there is competitive neutrality (Figure 9). Private firms may have grown quicker than SOEs in terms of asset size leading to improved ability to raise funds from the equity market. But most POEs may still need close connections with government to grow, and might not be treated equally to SOEs.

**Figure 8: Listed Chinese firms, asset size by ownership, %**



Source: Bruegel based on financial statements, Bloomberg.

**Figure 9: Assets of listed Chinese firms, share of ownership (%)**

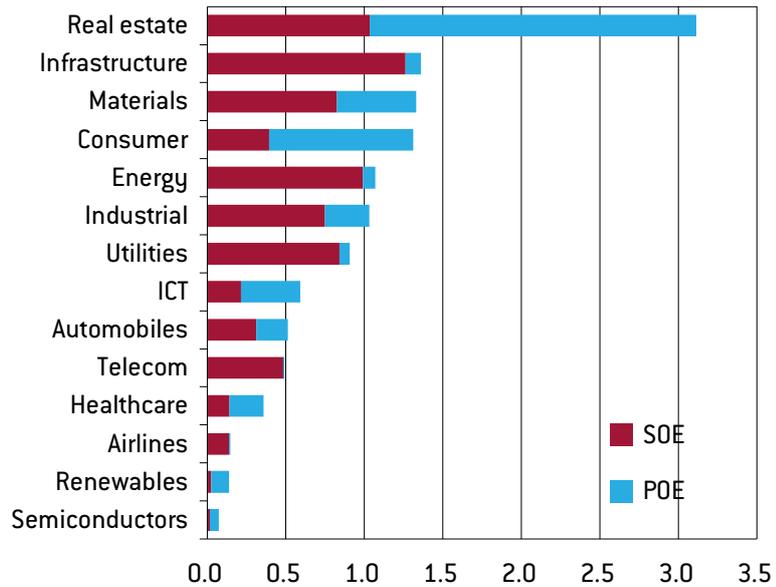


Source: Bruegel based on financial statements, Bloomberg.

Next, we categorised companies by ownership and sectors. While the line between state-owned and private firms can be blurred in China because many firms have close connections with central or local government, we took the classification from WIND<sup>5</sup> but also checked the ultimate owner for ambiguous cases. For the sectoral classification, we followed Bloomberg's classification and divided firms into 14 key industries. For industrial holdings, we chose the largest sectors in terms of revenues for classification purposes.

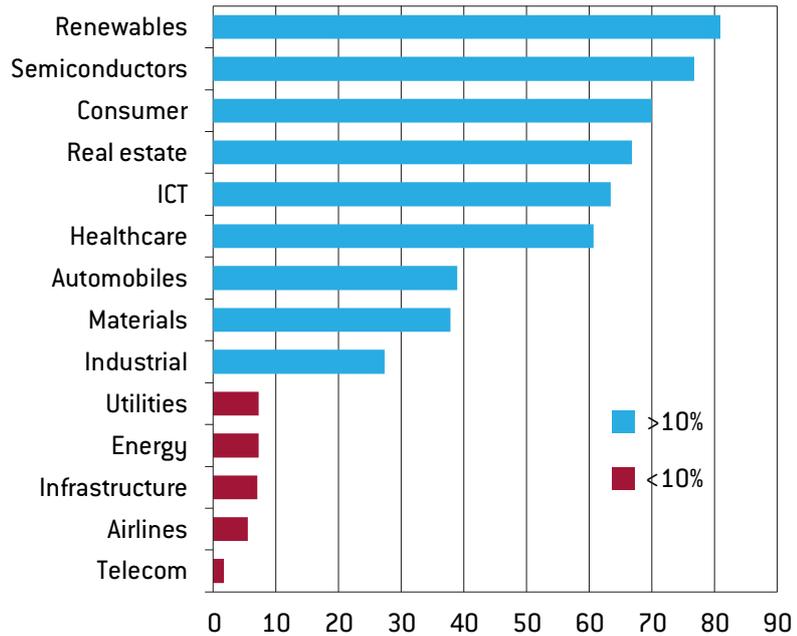
5 WIND is a financial data terminal from China.

**Figure 10: Asset size by sector and ownership, \$ trillions, 2019**



Source: Bruegel based on financial statements, Bloomberg. Note: Chinese listed companies.

**Figure 11: Assets per sector, share held by Chinese private companies**



Source: Bruegel based on financial statements, Bloomberg. Note: Share of assets held by Chinese listed POEs.

General trends, though, could be affected by the different sectoral distribution of SOEs and POEs, coupled by different risk perceptions per sector. To adjust for the impact on our results of such differences, we calculated the financial metrics for the different sectors in our sample. First, we removed the sectors in which SOEs are fully dominant (shares greater than 90 percent) to ensure our selected sectors represent competitive environments for private firms. Thus airlines, energy, infrastructure, telecoms and utilities were excluded from the analysis (Figures 10 and 11).

We used 2014 to 2019 data to calculate leverage ratios, effective tax ratios and average

funding costs, and return on assets by ownership and sector. The leverage ratio is defined as total liabilities over total equity. The effective tax rate is calculated as income tax expense to pre-tax income. The average funding cost is the ratio of interest payments to total debt. We then compared the average of each of the ratios for SOEs and private companies in each sector. Signs of the absence of competitive neutrality are lower effective tax ratios for SOEs and lower funding costs per unit of debt.

In most cases, we calculated an adjusted ratio for POEs excluding real estate. The lack of investment options together with lax mortgage rules have created large property developers in China, generating lucrative returns from quick turnover based on home presales and debt. Such rapid development has helped local governments secure tax revenues from land sales. In other words, while real estate companies are generally POEs (and especially many of the large ones), local governments in particular might consider them strategic, and this skews the overall result.

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## 5 Main findings

### 5.1 Clear signs of lack of competitive neutrality

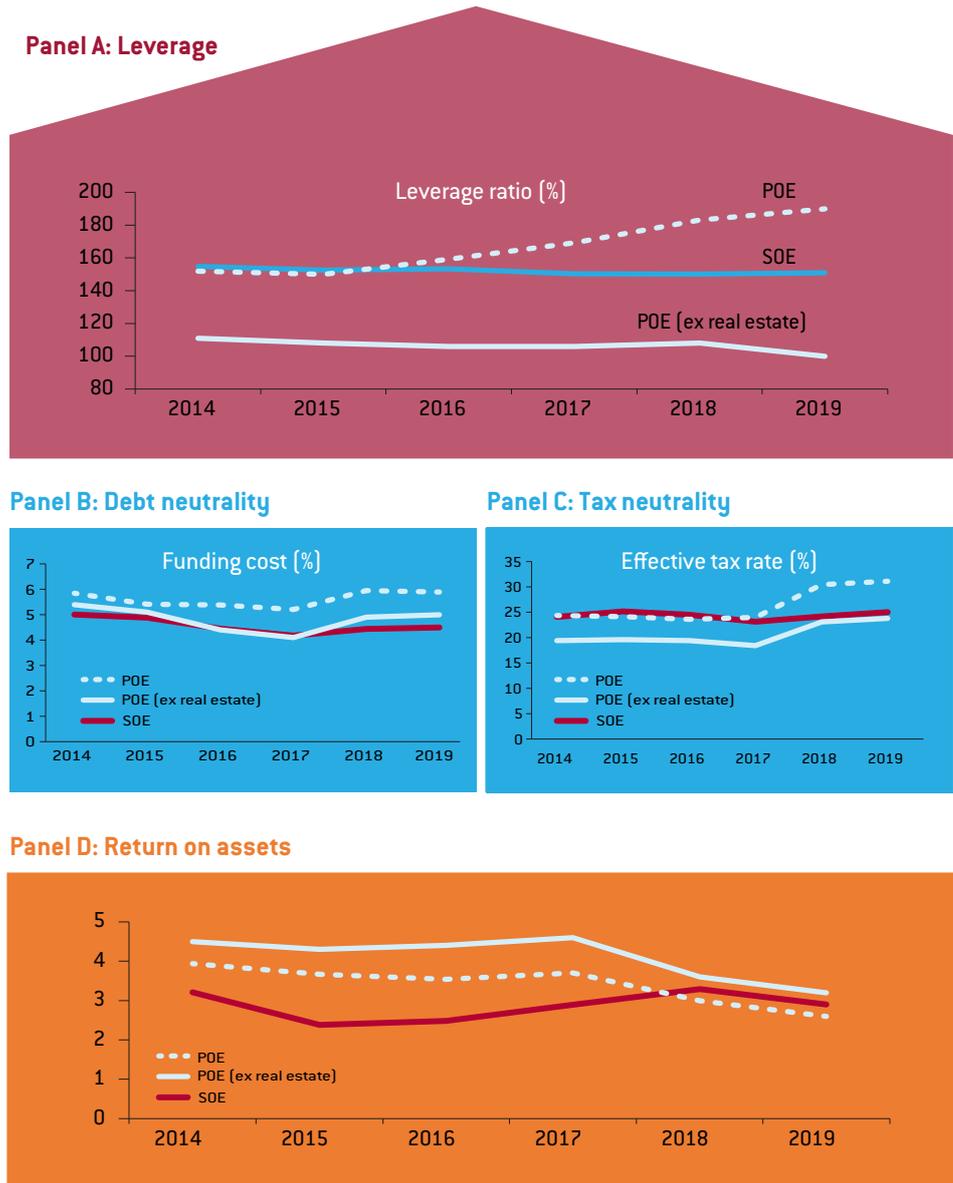
Our results support the view that China's competitive environment is poor, with conditions tending to favour SOEs. On leverage, POEs find it harder to borrow money and the gap with SOEs in this respect widened in 2019 (Figure 12, panel A). In previous years, Chinese regulators became more wary of financial risks and started to deleverage the economy, but progress was paused sometimes because of the need for short-term economic growth. Under this on-and-off deleveraging campaign, the leverage ratio for SOEs remained largely stable at 151 percent in 2019. For the private sector, overall leverage is greater than that of SOEs, but is mainly down to the overwhelming importance of real-estate developers among the largest private companies in China. These real-estate companies are by far the most leveraged across all sectors. When real estate is excluded, the leverage ratio for POEs declined from 108 percent in 2014 to 100 percent in 2019.

As for the cost of funding, the implicit interest rate on the cost of debt is generally higher for POEs than SOEs (Figure 12, panel B). Between 2015 and 2017, funding costs declined sharply for all firms as the government tried to support growth and ease overcapacity problems, but such lax liquidity conditions have not been felt equally by SOEs and POEs. The latter have suffered from widening funding costs compared to SOEs. The reasons for this are the greater difficulty for POEs to access liquidity and the much worse market perception as they cannot count on an implicit guarantee from the government. Even in the most leveraged sector, real estate, private firms still pay more per unit of debt than SOEs.

However, the trend in terms of tax looks different. Real estate developers are being heavily taxed, leading to an increase in the overall tax burden for private firms. If we exclude real estate, the effective tax rate has been consistently lower for private firms than for SOEs (Figure 12, panel C). But the situation has changed since 2018, with POEs starting to pay higher tax rates, closer to the level paid by SOEs.

In addition, the return on assets (ROA) has been higher for private firms than state-owned enterprises until recently (Figure 12, panel D). Part of the reason for this could be the tougher stance towards the real estate sector, but it is also true that the ROA has fallen more sharply for the rest of the private sector. For SOEs, the improvement could be an indicator of a more centralised approach to resource allocation with a stronger focus on SOEs. Decelerating economic growth and geopolitical tensions could have made the Chinese government more convinced of the need to create national champions in different fields.

**Figure 12: Results for SOEs and POEs**



Source: Bruegel based on financial statements, Bloomberg. Notes: Leverage ratio is computed by dividing total liabilities by total equities. Funding cost = interest expense over total debt.

### 5.2 Competitive neutrality is lacking in most sectors but with major differences

From a sectoral perspective, private firms cannot borrow as much as SOEs in most sectors, as measured by leverage (Figure 13). Real estate continues to be an outlier with an exceptionally high leverage ratio versus state-owned counterparts. However, the situation is worst for renewables, healthcare and ICT – the sectors with relatively high private ownership levels.

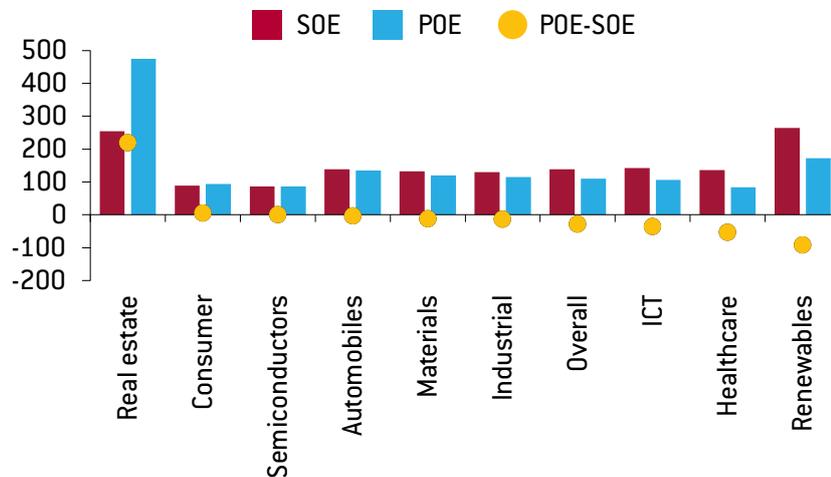
In terms of the funding costs and effective tax ratios for different sectors, SOEs tend to pay lower effective tax rates than private firms in most cases (Figure 14). Consumer goods and semiconductors are the only two exceptions. For consumer goods, one of the underlying reasons could be the continuous push by the Chinese government for a consumption-based economy, which needs the support of private firms. For semiconductors, the development of new technology and innovation clearly needs private firms, which are often more efficient.

On potentially subsidised cost of funding, SOEs seem to have a clear advantage in all sectors except semiconductors. This might be explained by the strategic importance of the semiconductor sector and the large pool of public resources made available under Chinese innovation programmes and the various special funds that specifically target semiconductors. In other words, in highly strategic sectors, private companies seem to be well supported by the government.

Lastly, return on assets seems to be lower for private firms in most sectors. But the ROA for POEs is slightly better than for SOEs in the renewables, industrial and materials sectors. The slower growth environment and the bias towards SOEs have clearly caused challenges to POEs in competing fully with SOEs in most sectors.

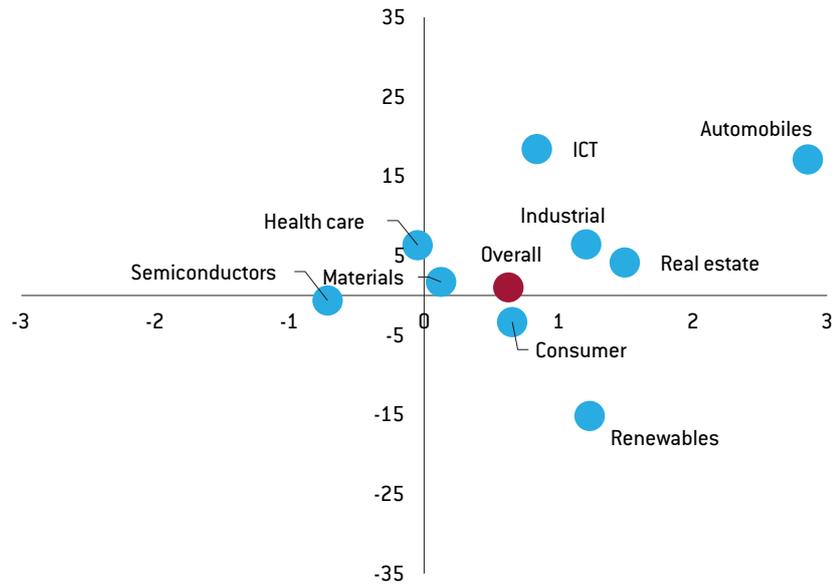
Therefore, general and sectoral trends point to private firms being unable to leverage as much as SOEs and, even with a lower leverage ratio on average, they still have higher funding costs. The notable exception is the real-estate sector. Arguments are often heard in China that the lower tax and debt burden of SOEs means they can support the economy throughout the cycle by creating jobs during bad times, for example. These arguments, which might be valid for social stability reasons, are hardly relevant when measuring competitive neutrality. In other words, while there may be good reasons for the different treatment of SOEs and POEs, the degree of such unequal treatment remains significant. Measuring this can help gauge the distortions that such policies create in China in terms of the lack of a level playing field. This is not only important for POEs but also for foreign companies operating in China. The slower growth environment, with sharp declines in POE returns on assets, has now made it difficult for POEs to compete with SOEs in most sectors. Consumer and renewables are the sectors in which POEs are relatively well positioned to compete with SOEs. The fact that these sectors have relatively higher levels of private ownership shows that a lesser presence of state-owned players can enhance competitive neutrality for private firms.

**Figure 13: Chinese listed firms, leverage ratio by sector and ownership, %, 2019**



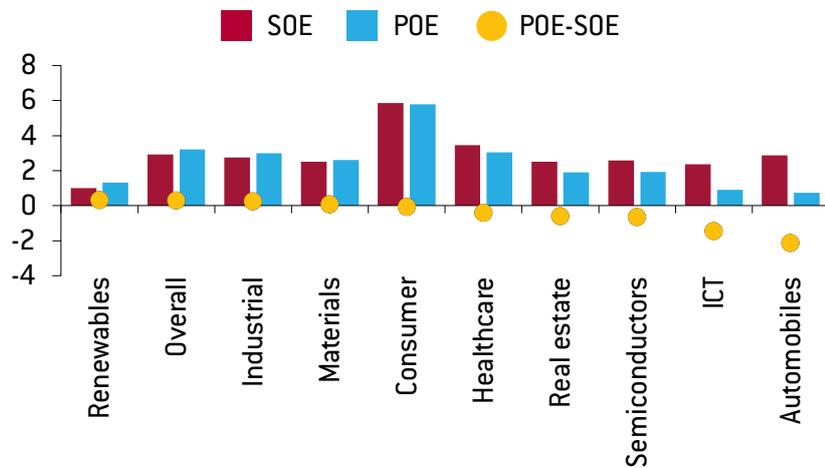
Source: Bruegel based on financial statements, Bloomberg. Notes: Leverage ratio is computed by dividing total liabilities by total equities.

**Figure 14: SOEs, POEs, divergence in effective tax rates and interest rates (values of POE – SOE, 2019)**



Source: Bruegel.

**Figure 15: Chinese listed firms, return on assets by sector and ownership, %**



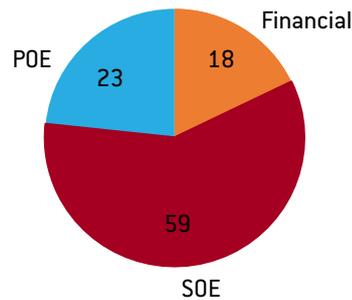
Source: Bruegel based on financial statements, Bloomberg.

### 5.3 Global implications

The lack of competitive neutrality in China has significant consequences for companies operating in the Chinese market but also beyond. One way to look at the global impact is to look into the global relevance of Chinese firms, especially SOEs. Most Chinese companies on the Fortune 500 list are indeed SOEs, and the proportion is even higher for financial companies compared to non-financial corporations (Figure 16).

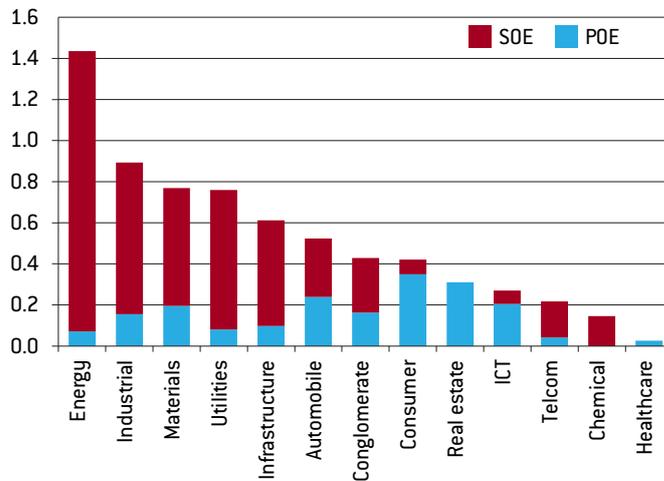
Beyond the general dominance of SOEs among the largest companies in China, and globally, the sectors with the largest revenues are generally those fully dominated by SOEs, such as energy, utilities and infrastructure (Figure 17).

**Figure 16: Chinese Fortune 500 firms by revenue, %, 2019**



Source: Bruegel.

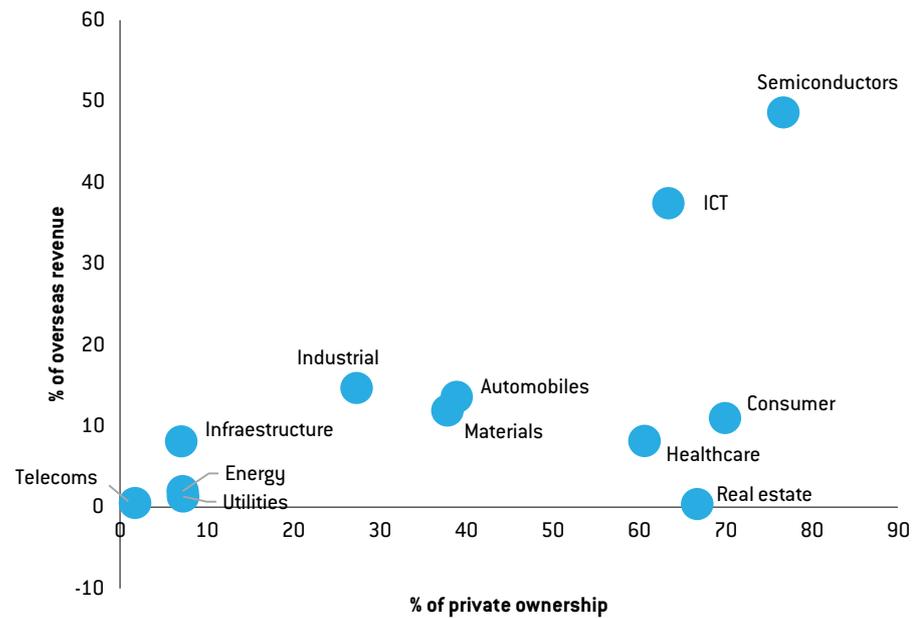
**Figure 17: Chinese Fortune 500 firms, revenues by sector, \$ trillions, 2019**



Source: Bruegel.

Meanwhile, Chinese firms in the ICT, industrial and auto sectors earn relatively high proportions of their revenues overseas (Figure 18). These sectors are among those that lack competitive neutrality the most, based on our measurement of distance to competitive neutrality. Given the role of European automakers in China, this is an important point to take into account as the uncompetitive environment, which very much favours state-owned automakers must be hurting foreign competitors, including those from Europe. On the one hand, China is the largest automobile market in the world and Europe has a large car manufacturing sector. On the other hand, the growing importance of electric vehicles and the early moves that China has taken to develop the sector could mean future comparative advantages in batteries, although big hurdles still exist in semiconductor chips.

**Chart 18: Chinese listed firms, share of overseas revenue and private ownership (2019)**



Source: Bruegel based on financial statements, Bloomberg, WIND. Note: Renewables not included due to lack of data.

## 6 Policy suggestions

We have shown that – unsurprisingly – competitive neutrality is lacking in China. Various measures could be put in place to improve the competitive environment in China, without going to the extreme of privatisation.

Above all, it is important to identify the sectors that suffer from competitive neutrality issues and those that should be characterised as natural monopolies/oligopolies. Once the subgroup of sectors is identified, both *ex-ante* and *ex-post* measures are needed to ensure a level playing field for different companies. Extending the list of exempted sectors for national security reasons would of course defeat the purpose of the exercise.

Fundamental *ex-ante* concepts include tax, debt and regulatory neutrality. For the first two, the ability to calculate the implicit subsidy and to make it known through appropriate disclosure rules is key. For regulatory neutrality, China’s ultimate goal of socialism with Chinese characteristics might make legal and regulatory equalisation particularly difficult to achieve. This also means that ensuring competitive neutrality on other aspects (tax and debt neutrality) becomes even more important.

In this context, a number of external forces might be brought to bear in order to persuade Chinese policymakers to act on SOE reform, and more specifically work towards the objective of competitive neutrality. The most obvious venue is the World Trade Organisation (WTO), but this would require major stakeholders to work on a reform so that WTO members would have an obligation to create a level-playing field. Quantitative evidence on the lack of competitive neutrality could help support anti-dumping duties on China on the basis of the existence of subsidies or subsidy-equivalent support, such as fiscal or financial support, as we have shown in our working definition of competitive neutrality (through the fiscal and debt equivalence concepts).

Beyond the WTO, negotiations between the US and China on trade beyond the Phase 1

**The sheer size of Chinese companies implies that China's acceptance of competitive neutrality would improve the competitive environment globally**

deal, will require much more than China agreeing to import volume targets. The concept of competitive neutrality, which was high on the list of potential solutions at the beginning of the negotiations and is clearly supported by the IMF, may come to the forefront again.

The deal reached between the EU and China on the Comprehensive Agreement on Investment should be another important channel via which a workable concept of competitive neutrality can be proposed.

Finally, the sheer size of Chinese companies and the rate of their overseas expansion imply that China's acceptance of competitive neutrality principles would improve the competitive environment globally, and not only in China. China's expansion overseas also includes foreign direct investment, whether greenfield or acquisitions. China's lack of a competitive environment is exported overseas through these channels, especially when it comes to the very large Chinese companies on the global market.

Unless the competitive environment in China improves, through the concept of competitive neutrality or other means, foreign governments may decide they must use their own policies to protect the competitive environment in their own market, and possibly globally. Trade policies – especially antidumping duties – are one potential though partial response. Competition policies and a better dispute resolution framework are fundamental. Still, no policies can be more effective than China improving the competitive landscape in its own market, which makes the potential adoption of competitive neutrality in China's treatment of SOEs particularly appealing<sup>6</sup>.

Beyond the WTO, and the bilateral negotiations between the US and China and the EU and China, the Organisation for Economic Co-operation and Development probably offers the least aggressive, but possibly very effective way, for China to improve its competitive environment and implement SOE reform. By becoming a member of the OECD and adhering to its principles of corporate governance and competitive neutrality, China could achieve the right result without the impression that it has been subject to foreign pressure.

In any event, China would be the main beneficiary of improvements to its competitive environment, especially given the clearly stated objectives of ensuring technology upgrading and self-reliance, as stated in the Fifth Plenum of the 19th Central Committee of the Chinese Communist Party (CCP)<sup>7</sup>. The two objectives tend to be mutually exclusive unless a very competitive environment is guaranteed. Otherwise, incumbents will be protected, making it harder to move up the technology ladder in a cost-effective way.

All in all, implementing the concept of competitive neutrality seems like a relatively easy way out – compared to full-fledged SOE reform and privatisation – of China's long-standing competition problems, which have pushed down potential growth. As growth problems become more acute, the need for a solution will become more urgent, but also potentially more costly compared to acting sooner.

6 The European Commission (2020) published a white paper on foreign subsidies, offering a set of different tools for this.

7 See [http://www.xinhuanet.com/2020-10/29/c\\_1126674147.htm](http://www.xinhuanet.com/2020-10/29/c_1126674147.htm).

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