



THE EU AND CHINA

ADDRESSING THE SYSTEMIC CHALLENGE

A comprehensive EU strategy
to rebalance the relationship
with China

EXECUTIVE SUMMARY



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BusinessEurope is the leading advocate for growth and competitiveness at the European level, standing up for companies across the continent and campaigning on the issues that most influence their performance.

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FOREWORD

The European business community has long been part of China's success story. We have encouraged China's market-oriented reform path, invested in China and championed closer economic engagement with China for years. The EU and China officially established diplomatic relations in 1975, and signed their first trade agreement during the same year that China began its policy of 'reform and opening-up' (改革开放) in 1978. Business engagement followed swiftly since then. Today, the EU is China's most important **trading partner**, while China is the EU's second most important trading partner. Total bilateral trade flows in goods grew to EUR 604.7 billion in 2018, while total trade in services amounted to almost EUR 80 billion in 2017. And there is still plenty of untapped economic potential for both sides.

The Chinese and European economies have **benefitted** tremendously from China's accession to the WTO in 2001. This showcases that rules-based multilateral trade is the best enabler for economic development. The WTO was created as a body governing multilateral rules-based trade that would evolve in parallel to the needs of the modern economy. The lack of WTO reform in recent years, however, coupled with emerging signs of a slowdown or reversal in market-oriented reforms in China has led to level-playing field issues whose impact has grown as China's share of global economy has increased.

This is why the European business community now advocates for a **stronger and fairer economic relationship** between the EU and China. In this paper we outline the potential that closer economic engagement would bring but we also acknowledge and explain the obstacles that undermine this potential. The consolidation of China's state-led economy presents **systemic challenges** that lead to market distortions within China, the EU and on third markets. This undermines the level playing field between European and Chinese businesses. A fairer economic relationship is therefore urgently needed and would best be achieved if China created a true level playing field between domestic and foreign firms and addressed the systemic issues that lead to market distortions.

Recent developments, however, have generated a **renewed sense of urgency** among the European business community that these issues cannot remain unaddressed in anticipation of hopeful improvements. With the objective of a stronger and fairer relationship in mind, **the EU should continue to engage China, while simultaneously taking its own measures to address these challenges.**

Our ultimate **goals** are for the EU to secure a level playing field between the EU and China, mitigate the impact of China's government-induced market distortions, reinforce the EU's own competitiveness, and ensure fair competition and cooperation in third markets.

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INTRODUCTION

The European business community wants a **stronger and fairer economic relationship** between the European Union (EU) and China that would make it possible to preserve and increase the current level of partnership between our two economies. We believe that reciprocal trade, investment and competition will unleash substantial economic potential. **This potential remains untapped due to the systemic challenges** that China's state capitalism poses to the level playing field between the EU and China, and between European and Chinese firms. Recent profound changes in China generate a new sense of urgency amongst the European business community to redress this issue.

Signs emerging from China about its economic trajectory point towards a further consolidation of its state-led economy over market-oriented reform. This means that the European business community is increasingly concerned that the question is not *when* China will converge with the global market economy, but *if* it will converge. A lack of convergence raises serious questions about whether the current multilateral rulebook can secure a global level playing field.

A lack of World Trade Organisation (WTO) reform over many years has exacerbated this problem. The WTO was created as an institution that would create a global level playing field and evolve in parallel to changing economies. But while national economies and business environments have seen radical change over the past 25 years, the rulebook governing them has remained largely the same.

These simmering issues have reached a boiling point with the eruption of a trade dispute between two of the world's largest economies: the United States (USA) and China. The degree of integration of the world economy means that the trade dispute could have far-reaching consequences for other trading partners, including the EU.

It is against this background that the European business community supports the European Commission's Strategic Outlook on China that the balance of opportunities and challenges presented by China has shifted in recent years.¹ Although the European business community has championed closer economic engagement on the basis of reciprocity for years, this shift leads us now to call on the EU to pursue a strategic reorientation in its relationship with China in order to defend our values, principles and interests.

The purpose of this strategy paper is:

- ▶ to raise awareness and explain how and where the level playing field between the EU and China is distorted due to China's state-led economy; and
- ▶ to outline concrete recommendations and demands that would lead to a more level playing field in our economic relationship.

From a European business perspective, the best way to address the issues outlined in this paper is for the Chinese government to adopt a more hands-off approach and place clear limits to market-distortive interventions that undermine the level playing field. China ought to return to market-oriented reforms and re-embark on the path of convergence with the global market economy in order to preserve and enlarge the benefits of globalisation. The EU and China should work together constructively and with other countries to establish new rules for global market-based governance at multilateral level.

¹ European Commission, "[EU-China: A Strategic Outlook](#)", 2019

Since progress on these issues is currently stagnating, we advance **four key objectives that the EU should pursue** in order to seize the opportunities within the bilateral relationship while addressing the systemic challenges posed by China's state-led economic system. Each key objective is elaborated in a dedicated chapter. The EU should:

- 1** ➤ **Secure a level playing field between China and the EU**
- 2** ➤ **Mitigate the impact of China's government-induced market distortions**
- 3** ➤ **Reinforce the EU's own competitiveness**
- 4** ➤ **Ensure fair competition and cooperation on third markets**

The EU should pursue these objectives simultaneously **across the following three levels**, which will lead to a situation of policy complementarity and enhance the EU's leverage at home and abroad:

- 1. The multilateral and plurilateral level:** Reforming the WTO would be the best way to achieve these objectives. The EU should also cooperate closely with likeminded partners in plurilateral initiatives to strengthen and reform multilateral economic governance and to restore a global level playing field.
- 2. The bilateral level:** Engaging China bilaterally is an essential cornerstone in building a stronger and fairer economic relationship between the EU and China.
- 3. The unilateral level:** The EU should simultaneously strengthen its own capabilities to seize opportunities and mitigate the challenges.

Since the challenge presented by China's state-led economy is a systemic one, there is often no single 'smoking gun' or policy to which distortions to the level playing field can be attributed. Rather, China's state-coordinated and controlled economic governance structure of top-down economic planning has a cumulative impact. As such, there are few 'silver bullet' solutions that could singlehandedly achieve these four objectives.

This executive summary captures the main messages and recommendations of the paper. The paper's chapters and subchapters include a detailed analysis of the opportunities and challenges and include **130 detailed recommendations** which, when pursued simultaneously, would contribute to achieving these key objectives. While comprehensive, these recommendations are by no means exhaustive, and are the result of a scoping process that took place across the European business community. This paper and its recommendations are addressed to policy-makers across the European Union and its Member States, though several of them are directly relevant to China.

The paper is structured along six different chapters. The first chapter defines the shift in the balance of opportunities and challenges in the relationship with China. The second chapter advances a comprehensive approach through which the EU should engage China. The third, fourth, fifth and sixth chapters are each dedicated to one of our four key objectives, each with several subchapters that analyse the problems and recommendations that affect these goals.

01 CHINA: A SHIFT IN THE BALANCE OF OPPORTUNITIES AND CHALLENGES

▶ **EUROPEAN BUSINESS WANTS A STRONGER AND FAIRER ECONOMIC PARTNERSHIP WITH CHINA.**

A stronger relationship with China offers enormous opportunities to European and Chinese businesses. China is already the EU's second biggest trading partner and the EU is China's biggest trading partner. Fair competition between European and Chinese firms would furthermore lead to greater innovation and new opportunities.

▶ **NEVERTHELESS, THERE EXIST SEVERE CHALLENGES THAT OBSTRUCT A STRONGER ECONOMIC RELATIONSHIP.** These challenges harm the economic prospects of European businesses and employment in the EU. This is due to the systemic challenges posed by China's state capitalism.

▶ **WHAT ARE THEY?** China's state-led system includes direct government control over major parts of its economy including key industries, financing institutions, state-owned enterprises, and softer influence through party cells and the corporate social credit system (CSCS) that will apply to all enterprises. This unique and extensive system of state control and coordination through top-down economic planning increasingly blurs the boundaries between the public and private sector and has given rise to "China Inc." – a structure in which the state dominates all aspects of the economy.

▶ **WHY IS THIS A PROBLEM?** This state-led system produces a number of discriminatory outcomes and market distortions, including amongst others a disparity in market access between Chinese and foreign firms, financing advantages for Chinese firms in strategic sectors, cheap land and energy and state guidance and preferential support for selected Chinese industries. The Chinese government often uses measures that promote 'indigenous innovation' to achieve the declared goal of global industrial and technological leadership in key sectors by 2049.

▶ **WHY IS IT IMPORTANT NOW?** Profound recent developments have led to a growing awareness among the European business community that these systemic problems are worsening, that we are moving away from their resolution, and that their impact on European business is increasing. This has led to **a renewed sense of urgency** that these problems need to be addressed as a matter of the highest priority.

1. First, instead of reforming its state-led economy into a market economy, signs emerging about China's economic trajectory point to a further consolidation of its state-led economy. The European business community is increasingly concerned that the question is not when China will converge with the global market economy, but if it will converge. A lack of convergence raises serious questions about whether the current rules-based multilateral system can secure a level playing field.

2. Second, China is re-introducing political ideology into its economy instead of sustaining economic reform and liberalisation. The expansion of (the role of) party cells undermines the independence of private companies. The introduction of the corporate social credit system (CSCS) could also in the future undermine the independence of private companies and their commercial decisions.

3. Third, China is for the first time exporting its domestic policy mix because it has the capital and companies to do so, and both are motivated to go overseas. Besides affecting European businesses in China, these distortions increasingly spill over into the European market and third markets and affect fair trade, investment, procurement, competition, and thereby undermine the global liberal economic system.
4. Fourth, China's immense economic growth in recent years means that the impact of these distortions on European businesses is far larger today than when it joined the WTO in 2001. China's share of global GDP grew rapidly from 4% in 2001 to 15.2% in 2017.² Similarly, its share of global merchandise trade grew from 4.2% in 2001 to 12.7% in 2018.³
5. Fifth, the United States are attempting to force through a resolution of the systemic problems posed by China's state-led economy through a trade conflict with China that is both economic and geopolitical in nature. This also has an impact on the European business community.

► **WHY IS IT DIFFICULT TO ADDRESS?** Alongside European political stakeholders, the EU business community has for years encouraged China's market-based reform path and championed closer economic engagement with China on this basis. The EU has for the same reasons been supportive of China's integration into the global economy. China's transformation into a market economy would by and large address the systemic drivers of its market distortions and result in a greater level playing field. Conversely, China's current consolidation of its state-led economy will likely worsen the systemic problems and their impact on European business.

► **OUR BILATERAL PROSPECTS DEPEND LARGELY ON CHINA.** While our bilateral relationship depends on the engagement of both the EU and China, the prospects for a stronger and fairer relationship which the European business community sees as an ultimate end goal depend largely on whether China can successfully address the growing challenges that European companies face when doing business on the Chinese market or when competing with Chinese companies on the European market and on third markets.

² The Global Economy, "[China: Percent of world GDP](#)", 2019.

³ Own calculations based on [UNCTAD data](#).

02 HOW THE EU SHOULD ENGAGE CHINA

The EU needs to reconsider how it engages China in order to achieve the four key objectives we have outlined. In the past, the EU's means of engagement have not produced the desired results. Recent changes within China also prompt the EU to rethink its toolkit. Due to the difficulties outlined above, the EU must reconsider its *modus operandi* towards China and put more emphasis on reciprocity and conditionality.

- ▶ **THE EU MUST RECONSIDER ITS *MODUS OPERANDI* TOWARDS CHINA.** With strong signs of China moving away from market reforms and towards a consolidation of its state-led economy, the European Union cannot wait and see whether China will address these issues and needs to act to defend its interests.

- ▶ **WHY SHOULD THE EU RECONSIDER ITS *MODUS OPERANDI*?** In the past, the means through which the EU aimed to achieve its goals vis-à-vis China have often not yielded the desired results. For example, China is still the EU's most restrictive major trading partner, there are still numerous investment barriers and joint venture requirements and China's procurement market is still closed. Consequently, the EU should reconsider the means through which it aims to achieve its *end goals* vis-à-vis China.

- ▶ **WHICH LEVELS OF ENGAGEMENT?** The EU should pursue its objectives simultaneously (not sequentially) on the following **three levels**, which will lead to a situation of policy complementarity and enhance the EU's leverage at home and abroad:
 1. **THE MULTILATERAL AND PLURILATERAL LEVEL:** Reforming the WTO and engaging China at WTO level would ideally be the best way to achieve the EU's objectives. The current multilateral rulebook is designed for market economies and does not adequately address the implications of a state-led economy. Unfortunately, attempts to reform the WTO have thus far produced little result, partly due to unanimous decision-making. The EU should also cooperate closely with likeminded partners in plurilateral initiatives to strengthen and reform multilateral economic governance and to restore a global level playing field.
 2. **THE BILATERAL LEVEL:** Engaging China bilaterally is an essential cornerstone in building a stronger and fairer economic relationship between the EU and China. The EU and China should focus on resolving trade and investment barriers through bilateral agreements with the consultation of key stakeholders amongst which the business community. The EU should also encourage China to pursue market-based reforms.
 3. **THE UNILATERAL LEVEL:** If China does not intend to become a liberal market economy, long-standing as well as new economic barriers and market distortions will remain unaddressed through the multilateral and bilateral approaches. As there is frequently a lack of progress on the multilateral and bilateral level, **the EU should simultaneously strengthen its own capabilities** to seize the opportunities and to safeguard our market economy from the negative spill-over effects of government-induced market distortions from China.

► **HOW TO ENGAGE?** The EU should engage China in a much more **reciprocal** and conditional manner, based on our **values, principles, and interests**. The problems highlighted in this paper are much more structural than issue based and addressing them requires a **comprehensive** and **whole-of-government approach** as opposed to an 'issue-based' approach in which problems can be addressed separately. The EU needs to equip itself with the right toolbox to engage China and needs to **update its *modus operandi* in at least five different ways**. The EU should:

1. **ACT SIMULTANEOUSLY:** No single approach will allow the EU to achieve the objectives required to address the systemic challenges presented by China's state capitalism. Therefore, the EU needs to act simultaneously on multilateral, plurilateral, bilateral and unilateral levels as opposed to acting sequentially. Such a strategy will lead to a situation of policy complementarity and enhance the EU's leverage.
2. **ACT UNITEDLY:** European companies and Member States often face a collective action problem. While we would benefit from standing together to achieve maximum leverage, China frequently uses asymmetrical openness and economic diplomacy as tools to undermine our collective action. The EU Member States should find ways to **address China with 'one voice' and act united** for example by moving towards qualified majority voting (QMV) on foreign policy matters in the future. The EU and its Member States should also set up a **mechanism to invest in knowledge sharing and capacity building** on China to achieve information parity and informed decision-making across the EU.
3. **ACT COHERENTLY:** The EU can only achieve its objectives if its policy goals are tailored towards these goals and act in support of and not contrary to them. The EU should elevate its China policy to the highest political priority and adopt a **whole-of-government approach** in which policies are benchmarked on the extent to which they contribute to or undermine our objectives. The EU should also systematically review the implications of the rise of China on the EU through regular and consistent studies.
4. **ACT STRATEGICALLY:** The EU's strategic autonomy and economic sovereignty are being challenged as both China and the USA increasingly mix economics with geopolitics. The EU's current instruments are not designed for a world in which economic, security, and strategic considerations are increasingly intertwined. To stimulate and facilitate a more strategic approach towards China, European business calls on the EU and its Member States to set up an **annual strategic dialogue on China** between the EU, its Member States, the European business community, academia and other key stakeholders. Inspiration could be drawn from the European Commission's Task Force 50 on Brexit.
5. **ACT CONFIDENTLY:** The EU should not shy away from leveraging its economic strength to achieve its objectives. The EU should defend its values, its successful liberal economic system and European interests proactively, enhance the EU's economic diplomacy, and deflect China's sharp power. While the EU has its weaknesses, it wields enormous soft-power and discursive influence. It should better employ these in areas where other means fall short, even if it amounts to making public statements.

03 SECURE A LEVEL PLAYING FIELD BETWEEN CHINA AND THE EU

In order to secure a level playing field between China and the EU, reforming the WTO remains a paramount goal. Unfortunately, given the difficulty in achieving reform in recent years, the EU should take complementary measures in the sphere of bilateral trade and investment, in the area of procurement, IPR protection and forced technology transfer, standardisation, e-commerce and energy and climate.

World Trade Organisation (WTO)

While China's accession to the WTO helped to foster the economic development of China and world trade, China has not changed into an open market economy and there is a list of commitments from China's WTO accession protocol that have not been sufficiently addressed. The gaps and lack of rules in some areas of the WTO trading system mean that the WTO requires urgent modernisation.

- ▶ **WTO REFORM:** The EU should take the lead together with like-minded partners to create comprehensive rules that reign in **industrial subsidies** and discipline the behaviour of **state-owned enterprises**. In this regard, the EU and China should also further intensify discussions in the EU-China joint working group on WTO reform. Other reforms include amongst others introducing flexibilities into the system - both in terms of the negotiating method as well as in the decision-making process - and improving trade policy monitoring and notification procedures for example by introducing penalties for members that fail regarding notification requirements. Lastly, China should take the responsibility it has according to its real level of economic development which means that China can no longer simply be regarded as a developing country.
- ▶ **CHINA SHOULD JOIN EXISTING WTO AGREEMENTS AND THE EU AND CHINA SHOULD COOPERATE IN ONGOING NEGOTIATIONS.** China should first deliver on its longstanding promise to join the Agreement on Government Procurement (GPA). The EU and China should furthermore cooperate to successfully conclude an ambitious plurilateral agreement on e-commerce. Moreover, the EU should engage other WTO members to reprioritise the negotiations on the Trade in Services Agreement (TiSA), and take efforts to strengthen the aspect of sustainability in the WTO context.

Trade and investment

The potential of a stronger bilateral trade and investment relationship is undermined by numerous trade and investment barriers. The market access barriers that European companies face include both pre-establishment (border measures) restrictions and post-establishment (behind the border) restrictions. In 2018, China surpassed Russia as the EU's most trade-restrictive partner as it now holds the highest stock of recorded trade and investment barriers.⁴

- ▶ **A RECIPROCAL TRADE AND INVESTMENT RELATIONSHIP:** China should make further market access improvements that resemble the enormous advantages China has gained on the European market. These should include trade in goods and services as well as digital trade. At the same time, the EU must take further action to mitigate the negative impact of Chinese state support to Chinese companies by eventually further strengthening the EU's trade defence instruments (TDIs) amongst others.

⁴ European Commission, "Report from the Commission to the Parliament and the Council on Trade and Investment Barriers", 2019.

- ▶ **COMPREHENSIVE AGREEMENT ON INVESTMENT (CAI):** Concluding the negotiations on the CAI before the end of 2020 is a key priority for European business. However, substance should prevail over timing. It is essential that the scope of the agreement is as ambitious as possible. The agreement should remove substantially all investment barriers and effectively protect bilateral investment.

Procurement

While Chinese companies are often allowed to bid on public procurement tenders in the EU, European businesses are often prohibited to bid on procurement opportunities in China. Several *de jure* and *de facto* barriers hinder European businesses in their access to the Chinese procurement market.

- ▶ **WTO AGREEMENT ON GOVERNMENT PROCUREMENT (GPA):** To achieve balanced market access on public procurement markets, China should join the WTO Agreement on Government Procurement (GPA) as soon as possible on the basis of an acceptable and ambitious accession offer.
- ▶ **AN INTERNATIONAL PROCUREMENT INSTRUMENT (IPI) WITH FURTHER MODIFICATIONS:** The EU should continue to work on the creation of an IPI. The 2016 International Procurement Instrument (IPI) proposal aims to pursue the right objective of encouraging third countries such as China to uphold the principle of balanced market access enshrined in the GPA. However, the proposal requires further modifications, amongst others, to avoid complex price adjustment mechanisms and negative effects on EU companies with international supply chains.
- ▶ **FULL IMPLEMENTATION OF EU PROCUREMENT RULES:** Foreign companies that participate in the EU public procurement market must respect our rules. The European Commission should therefore ensure that contracting authorities and Member States apply the EU 2014 directives more consistently. Additionally, the deletion of Article 85 and 86 of Directive 2014/25/EU should be avoided.

Intellectual property rights and forced technology transfer

The protection and enforcement of intellectual property rights (IPR) and elimination of forced technology transfers have become a growing priority for European businesses. While some improvements are taking place in selected areas of China's IP landscape, the overall situation remains worrying. The problem is two-fold: on the one hand the Chinese IP framework is still insufficiently developed, and on the other hand existing measures are insufficiently enforced. European businesses therefore call for the creation of a level playing field through adequate IPR protection and eliminating all *de jure* and *de facto* forced technology transfer practices.

- ▶ **IMPROVED ENFORCEMENT WITHIN CHINA:** The EU should strengthen exchanges with Chinese patent and IP offices with a view to securing greater commitments to enforce the stringent IP standards set out at WTO level. China still has important steps to take in improving and enforcing its IP system.

- ▶ **IMPROVED AWARENESS AND ENFORCEMENT WITHIN THE EU:** The EU should also raise awareness among its business community on the common IPR problems within China and address the growing problem of counterfeited and pirated goods entering the EU market. National authorities should have strong and intelligent means to secure effective enforcement of EU IPR law.
- ▶ **TACKLE *DE JURE* AND *DE FACTO* FORCED TECHNOLOGY PRACTICES IN CHINA:** The EU's WTO case on forced technology transfer is an important step in this regard. Litigation matters. But the EU should employ a comprehensive strategy tackling all ways in which forced technology transfers take place. The EU should consider all policy options that could contribute to this objective, including the implementation of the EU Cyber-Diplomacy Toolbox to combat ICT-enabled IP theft.
- ▶ **THE ONUS IS ON CHINA TO TAKE BOLD STEPS:** China should be pressed to eliminate forced technology transfer practices through a mix of legislative, administrative and judicial changes to create a real level playing field. This includes removing discriminatory practices for foreign companies and removing requirements to disclose IP or sensitive business information.

Standardisation

There are three concerns that may arise with respect to standardisation in China. A first concern is that mandatory Chinese (national, sectoral or local) standards may be used to establish *de facto* barriers to trade. Second, for most standards it is the government who determines which stakeholders, if any, may provide input to the standard. A third concern relates to China's ambition for global leadership in standardisation. The unilateral imposition of Chinese national standards in third countries would result in an unlevel playing field. Combined, these concerns mean that European companies do not enjoy the same access to the Chinese market as Chinese companies to the European market, with possible similar consequences on third markets.

- ▶ **CHINA SHOULD ADHERE TO INTERNATIONAL STANDARDS.** Although China participates proactively in the standard-setting bodies that formulate standards, China often does not implement them. Moreover, Chinese standards should not be used as a trade barrier by establishing a *de facto* mandatory requirement for EU companies when selling their products and services in China.
- ▶ **EUROPEAN COMPANIES SHOULD HAVE FULL RECIPROCAL ACCESS TO PARTICIPATE IN CHINESE STANDARDISATION** on the same footing as Chinese companies can participate in standardisation in the EU (CEN/CENELEC, ETSI or at national level).

E-commerce

E-commerce has the potential to offer more choice to European consumers as well as to offer new tools for European manufacturers to reach consumers. In 2018, the majority of e-commerce-related parcels circulating in the EU already originated from China.⁵ To date, an unacceptable number of Chinese products and services that enter the European market do not fully comply with EU law and safety regulation – most notably but not only in the area of e-commerce.

- ▶ **THE EU MUST ENSURE THAT ONLY EU-COMPLIANT PRODUCTS ENTER THE UNION MARKET:** The EU market surveillance capabilities should be reinforced, and the EU Safety Gate must be further tailored to address these challenges – in particular but not only in the area of e-commerce. EU Member States and the EU should ensure that national authorities are provided with strong and intelligent means to secure effective enforcement of EU law at the European border.
- ▶ **THE EU AND CHINA SHOULD COOPERATE TO CONCLUDE NEGOTIATIONS ON A PLURILATERAL AGREEMENT ON E-COMMERCE:** A future plurilateral agreement on e-commerce should establish binding rules for free, secure and reliable cross-border e-commerce.

Energy and climate

To achieve our ambition of climate neutrality by 2050, we urgently need international convergence of climate ambitions. For this reason, it is essential that China, being the leading global GHG emitter (28% of the global emissions⁶), takes its responsibility together with the EU and other signatories of the Paris Agreement. While the EU has adopted relatively far-reaching climate policies, there exists a lack of equivalent climate policy measures for industries in China and on third markets – in particular in Africa. The cost burden of climate and environmental policy to China's manufacturing sector is far lower than to the EU's.

- ▶ **STRONG BILATERAL AND MULTILATERAL COOPERATION BETWEEN THE EU AND CHINA IN ACCORDANCE WITH THE PARIS AGREEMENT:** In this regard, the EU and China should for example continue their cooperation in the EU-China Partnership on Climate Change.
- ▶ **SAFEGUARD THE COMPETITIVENESS OF EUROPEAN INDUSTRY FROM 'FREE RIDERS' AND CARBON AND INVESTMENT LEAKAGE:** The EU and EU Member States must fully apply all existing measures within the EU ETS to minimise the risk of carbon and investment leakage. A toolbox of targeted instruments is needed to shield the EU from distortions caused by free riders.
- ▶ **THE EU MUST MINIMISE ITS DEPENDENCY ON CHINESE RAW MATERIALS, IN PARTICULAR RARE EARTHS AND PRECIOUS METALS:** The EU must consider additional measures that proactively mitigate the distortions in competitiveness inflicted by 'free riders' and international regulatory asymmetries.

⁵ Wik Consult, "Assessment of EU Parcel Delivery Markets", 2018.

⁶ Emissions include CO₂ emissions from fuel combustion only. Data available on the [webpage](#) of the International Energy Agency (2016).

04 MITIGATE THE IMPACT OF CHINA'S GOVERNMENT-INDUCED MARKET DISTORTIONS

It is of key importance that the EU takes measures to mitigate the impact of government-induced market distortions on European businesses. The EU should aim to discipline the role of state-owned enterprises, take proactive steps to address the issue of industrial subsidies, engage internationally to try and eliminate overcapacity and take steps in the area of competition policy and state aid.

State-owned enterprises (SOEs)

Although Beijing announced that the market should play a “decisive” role in allocating resources,⁷ President Xi Jinping’s statement that SOEs should become “stronger, better and bigger” stands in sharp contrast to the rhetoric of market-based reform. The conduct of SOEs is growing more problematic because there is a reversal of market-based reforms, an increase of influence of the party on the corporate governance of SOEs, a hike in SOE mega-mergers and a continuation of preferential treatment of SOEs.

- ▶ **THE EU SHOULD DEVELOP AN ‘SOE PRINCIPLE’ TO MITIGATE THE IMPACT OF GOVERNMENT-INDUCED MARKET DISTORTIONS:** An SOE principle entails that EU policies should be designed in such a way that it addresses the market-distortive effects of foreign SOEs. The SOE principle could, for example, be applied in the areas of subsidies, investment and procurement. The EU should also investigate whether this principle could be applied to further policy areas. The Comprehensive Agreement on Investment (CAI) and a potential international procurement instrument should include special provisions on SOEs.
- ▶ **ENSURE ‘COMPETITIVE NEUTRALITY’:** The EU should advocate for the creation of multilateral rules on the competitive neutrality of SOEs. The EU should also encourage China to create a competitive neutrality instrument. Additionally, the EU should study whether and how a European ‘competitive neutrality instrument’ could ensure the competitive neutrality of foreign SOEs on the European market.

Subsidies

China provides various forms of government support to its industries, particularly in the context of industrial policies such as Made in China 2025. Subsidies can take on several forms, including direct subsidies, government grants, tax benefits and export credits. Direct and indirect subsidies to SOEs have for example amounted to 1.3-1.6% of annual GDP in recent years. The figure of total subsidies is even higher as, in addition to SOEs, private sector firms received about a third of total direct subsidies in 2018. These problems increasingly spill over into the global trading system, including the EU market.

- ▶ **THE EU SHOULD PURSUE MULTILATERAL, PLURILATERAL AND BILATERAL EFFORTS TO DEVELOP NEW DISCIPLINES ON INDUSTRIAL SUBSIDIES AND SOEs.** In this regard, the EU, Japan and the USA should deliver concrete outcomes in their trilateral discussions and consider launching negotiations on a plurilateral agreement on tackling government-induced market distortions. The EU should also intensify discussions on industrial subsidies and SOEs in the EU-China joint working group on WTO reform.
- ▶ **THE EU SHOULD REVERSE THE BURDEN OF PROOF FOR FOREIGN STATE-OWNED ENTERPRISES WITHIN ITS INTERNAL MARKET AND INSTEAD LET THEM PROVE THAT THEY DO NOT RECEIVE DISTORTIVE SUBSIDIES ON THEIR HOME MARKET.** This would be WTO-compliant, and the additional transparency would allow the EU to effectively use its instruments to address the impact of subsidies within its single market.

⁷ Central Committee of the Communist Party of China, “*Decision of the Central Committee of the Communist Party of China: The Significance of and Guiding Thoughts on Deepening the Reform Comprehensively*”, 2014.

Overcapacity

While overcapacity is a global problem, China's industrial policies within the framework of state-led economic planning have been the single largest driver of this problem. A range of policy instruments, including subsidies, contribute to and exacerbate the problem. Although China has acknowledged the problems of overcapacity and initiated plans to tackle them, the results to date have not yet led to a meaningful reduction in overcapacity.

- ▶ **CHINA SHOULD CONTINUE TO TAKE BOLD STEPS TO ELIMINATE OVERCAPACITY.** Reducing government intervention and enhancing reciprocal market access for European and other foreign business would greatly enhance China's ability to overcome problems of overcapacity.
- ▶ **THE EU AND LIKE-MINDED PARTNERS SHOULD PRESS CHINA TO TAKE FURTHER STEPS TO SET AND PUBLISH GOALS TO REDUCE EXCESS CAPACITY THROUGH LEGAL AND MARKET-BASED METHODS AND TO ELIMINATE DUMPING** its overcapacity on foreign markets. The G20 and OECD are excellent fora of engagement and could be an opportunity to explore plurilateral negotiations on eliminating government-induced market distortions.
- ▶ **THE EU SHOULD ALSO MAKE GREATER USE OF ITS TDI TOOLBOX.** The details are covered in the chapter on trade. This includes strengthening TDIs, enhancing transparency tools, ensuring sufficient in-house staff and resources to conduct TDI investigations, as well as a regular fitness check to ensure our TDIs are up to date in addressing the latest types of trade distortions.

Competition policy and state aid

The EU must find **solutions to mitigate external disturbances** and ensure fair competition in the global context. The EU must use all existing platforms to mitigate the disturbances in competition caused by policies and practices in third countries, including China.

- ▶ **THE EUROPEAN COMMISSION SHOULD IDENTIFY WHETHER THERE ARE SITUATIONS WHERE IT SHOULD PUT MORE WEIGHT ON THE GLOBAL MARKET ENVIRONMENT WHEN ASSESSING MERGERS.** At the same time, the Commission should bear in mind overall market developments as well as competition within the internal market.
- ▶ **THE EU NEEDS TO BETTER ASSESS THE MARKET POWER OF (LEGALLY INDEPENDENT) COMPANIES THAT ARE ASSOCIATED WITH EACH OTHER AND/OR OPERATE IN A COORDINATED MANNER (SINGLE ECONOMIC ENTITY).** A major risk is posed by Chinese acquisitions conducted by formally and legally independent investors who, however, act in a coordinated manner within the framework of the Chinese government's central economic planning. The EU should analyse the risks to competition from increasing Chinese market concentrations and from coordinated action of formally independent undertakings (single economic entity).
- ▶ **THE EU SHOULD STRENGTHEN EU STATE AID RULES TO ADDRESS MARKET-DISTORTING SUBSIDIES OUTSIDE THE EU:** The EU needs to advocate for stronger state aid rules at WTO level and needs to integrate ambitious state aid rules in trade and investment agreements. The EU should also analyse whether it is appropriate to revise EU state aid rules to address market-distorting subsidies outside the EU.

05 REINFORCE THE EU'S OWN COMPETITIVENESS

With technologies being increasingly able to influence economic, societal and political outcomes, we are witnessing a clear acceleration of the global innovation race. Despite its many assets, Europe falls behind in this race. The EU's share of the world gross expenditure on R&D has decreased from 25.8% in 2000 to 20% in 2018. Over the same period, China's share has increased from 5% to 21%.⁸ The EU must deepen the Single Market, develop an ambitious industrial strategy, invest more in R&D and stimulate digitalisation to maintain its competitive edge.

A competitive Single Market and ambitious industrial strategy

Businesses continue to experience regulatory and administrative hurdles when doing business in the EU and in the EU Member States. At the same time, China is catching up with the EU in terms of fostering a conducive regulatory business environment. Although the EU ranks higher than China in terms of the overall ease of doing business, on some indicators it is nowadays easier to do business in China than in the EU. In 2018 for example, it was easier (for local companies) to start a business in China than in the EU.⁹ To maintain its competitiveness the EU must:

- ▶ **DEEPEN THE SINGLE MARKET:** Regulatory asymmetries make it challenging for companies, in particular start-ups, to develop economies of scale. National regulations must be harmonised as much as possible, while keeping in mind proportionality and necessity principles. This is essential to help provide the domestic base from which new companies can develop economies of scale and compete globally.
- ▶ **DEVELOP A STRATEGIC INDUSTRIAL POLICY:** Instead of developing a dirigiste industrial policy like China, the EU must develop a strategy that aims to improve the framework conditions that incentivise companies of all sizes to invest, innovate and grow.
- ▶ **REGULATION AT EU AND NATIONAL LEVEL SHOULD FOLLOW BETTER REGULATION PRINCIPLES TO MINIMISE REGULATORY AND ADMINISTRATIVE BURDENS.** This will contribute to maintaining our regulatory competitiveness vis-à-vis China, who is steadily catching up.

Research and innovation

China is becoming a powerhouse in some key areas of research, development and innovation (RDI) and has surpassed the EU in terms of government expenditure on R&D. In 2017, the EU RDI expenditure was equivalent to 2.07% of GDP, while China spent 2.13% on RDI. This figure is even poorer when compared to other third countries such as South Korea (4.55%), Japan (3.20%) or the USA (2.79%).

- ▶ **SCALE UP R&D BUDGETS:** The EU must more ambitiously support private-sector RDI investment in order to reach the EU 3% target and increase the budget of Horizon Europe to at least EUR 120 billion.
- ▶ **CREATE THE SKILLS AND JOBS OF THE FUTURE:** Qualified specialists are needed to maintain and improve Europe's competitiveness and its ability to innovate. Currently, there is a shortage of skilled workers, inhibiting the economic growth of the EU in the world economy.

⁸ European Commission, "Science, Research and Innovation Performance of the EU", 2018.

⁹ World Bank, "Doing Business 2019", 2019.

- ▶ **CREATE A 'FIT-FOR-INNOVATION' REGULATORY ENVIRONMENT TO OVERCOME THE 'VALLEY OF DEATH':** Regulatory efficiency and an industry-friendly Horizon Europe will contribute to overcome the 'valley-of-death' between research and the commercialisation of research.
- ▶ **ENHANCE INTRA-EU COLLABORATION:** Because of the rising complexity and interdisciplinary nature of technologies, companies need to collaborate more. The EU must stimulate European partnerships and make them more attractive for companies.
- ▶ **MAINTAIN OPENNESS WHILE REQUIRING RECIPROCAL ACCESS TO FOREIGN RDI PROJECTS AND WHILE PROTECTING SENSITIVE AND CRITICAL RESEARCH DATA:** To achieve the greatest potential societal and economic benefits, research is an area that needs international collaboration to thrive. At the same time, the EU should demand fair access to Chinese RDI projects and more caution is needed to protect sensitive and critical information.

Digital economy and cybersecurity

Key principles for a healthy digital economy include openness and avoiding protectionism while upholding a global level playing field, protection of intellectual property, privacy and personal data as well as high cybersecurity measures. China's digital strategy presents opportunities but also enormous challenges for European business as China adopted digital protectionist measures and as it is the most restrictive major economy in the area of digital trade.¹⁰ The EU therefore needs to take bold steps to address digital protectionism, to unleash our own digital competitiveness and to enhance our cyber-defence and security capabilities to safeguard our innovations and technologies.

- ▶ **ENHANCE AND INVEST IN THE EU DIGITAL COMPETITIVENESS:** To keep up with the large and dynamic digital markets in China and the USA, EU institutions and Member States need to further develop the European digital market and adapt the legal and regulatory frameworks in the Single Market. The EU and the Member States should invest in key enabling technologies (KETs).
- ▶ **THE EU EFFORTS SHOULD AIM AT ADDRESSING CHINA'S DIGITAL PROTECTIONISM, RESTORING A LEVEL PLAYING FIELD INTERNATIONALLY, AND ADDRESSING THE CYBER-RELATED RISKS AND ABUSES** companies experience within the EU as a result of government-sponsored cyberattacks. Any EU approach, however, should combine pro-competitive policies with tools to address unfair behaviour.
- ▶ **CHINA SHOULD BE HELD TO INTERNATIONAL NORMS AND AGREEMENTS:** While all countries have legitimate concerns about privacy and national security, digital policy measures should be narrowly tailored, reflect international norms, be non-discriminatory and consistent with WTO agreements to which China is a party.

¹⁰ China is the most trade restrictive country on the '[Digital Trade Restrictiveness Index](#)' that is composed by the European Centre for International Political Economy (ECIPE).

06 ENSURE FAIR COMPETITION AND COOPERATION ON THIRD MARKETS

Besides achieving a level playing field in the bilateral economic relationship, extending this level playing field to third markets is of paramount importance for the long-term opportunities of European businesses. The EU Connectivity Strategy is an important step in this regard, and emphasis should be placed on its proper implementation. At the same time, the EU should also try to engage China to ensure its Belt and Road Initiative meets international standards. Securing fair competition on third markets by upholding multilateral economic governance practices is vital.

EU connectivity

Ambitiously improving the connectivity between the EU and Asia should be a key priority of the EU. Connecting transport, digital, energy and human networks will facilitate bilateral trade for example by cutting transportation costs. This will benefit businesses and consumers in both the EU and China.

- ▶ **THE EU BUDGET FOR CONNECTIVITY MUST BE INCREASED AMBITIOUSLY UNDER THE 2021-2027 MULTIANNUAL FINANCIAL FRAMEWORK (MFF):** In order for the EU to remain competitive globally, the EU must increase the budget available for connectivity programmes such as TEN-T, InvestEU and the EU Strategy on Connecting Europe and Asia.
- ▶ **THE EU AND CHINA SHOULD CONTINUE TO EXPLORE POSSIBLE SYNERGIES BETWEEN THE EU CONNECTIVITY STRATEGY AND THE BELT AND ROAD INITIATIVE (BRI):** The EU should for example further analyse the BRI in its TEN-T Corridor Studies and collaborate with China to conduct studies to determine priority corridors to prevent possible bottlenecks and transport constraints.
- ▶ **THE EU SHOULD BETTER PROMOTE THE EU CONNECTIVITY STRATEGY:** The EU's substantial financial contributions in Asia should be better promoted and the EU should consider rebranding its Connectivity Strategy with a more attractive name such as the '**Marco Polo Strategy**' to complement the existing name. The EU should share expertise and opportunities on connectivity related issues with Member States, and vice versa, so that they can take it into account in their foreign economic diplomacy at national and EU level.
- ▶ **ENSURE RECIPROCAL ACCESS TO THE BRI:** This means that Chinese and other foreign companies are welcome to bid on tenders related to the EU-Asia Connectivity Strategy, but only as long as European construction companies have equal access to Chinese-funded infrastructure projects such as the BRI.
- ▶ **INTENSIFY CONSULTATION AND DIALOGUE WITH BUSINESS AND OTHER STAKEHOLDERS THROUGH THE CREATION OF A BUSINESS ADVISORY COUNCIL:** A structural stakeholder platform should be created that is easily and openly accessible to discuss the implementation of the strategy and to receive valuable input from stakeholders.

The Belt and Road Initiative

The BRI offers various opportunities for European companies. Besides opportunities for the construction and transport sectors, other sectors such as the banking, consulting and insurance services sectors may also

benefit from BRI. However, these opportunities have by and large not been realised to date because European businesses struggle to become involved. China's rhetoric of a more open, clean and green BRI now needs concrete action.

- ▶ **EUROPE SHOULD ENGAGE CHINA AT EUROPEAN LEVEL AND SPEAK WITH 'ONE VOICE':** Member States should call on China to increase reciprocity, especially in the infrastructure sector, to improve transparency, to prioritise high labour and environmental standards and to ensure debt sustainability.
- ▶ **PROMISES FOR A MORE OPEN, TRANSPARENT, GREEN AND RULES-BASED BRI NOW NEED TO DELIVER CONCRETE RESULTS:** In order to thrive, companies require fair competition and predictable rules surrounding tenders and procurement.
- ▶ **CHINA SHOULD CONSISTENTLY BE URGED TO APPLY INTERNATIONAL STANDARDS IN RELATION TO BRI.**

Fair competition on third markets

European companies welcome international competition as it fosters development and innovation. All European companies compete internationally within the multilateral governance frameworks established through the WTO, OECD, and other institutions. However, China has engaged in *selective multilateralism*. This means for example that China often deviates from multilateral financing practices and flouts the OECD guidelines, which contributes to the tilting of the international playing field.

- ▶ **THE EU SHOULD WORK TOGETHER WITH PARTNERS TO AIM TO INTEGRATE CHINA FULLY WITHIN THE EXISTING MULTILATERAL FRAMEWORKS:** This includes for example the OECD arrangements on export credits (in particular the International Working Group on Export Credits), the Paris Club and several WTO agreements.
- ▶ **THE EU AND EU MEMBER STATES SHOULD ENCOURAGE CHINA TO CONTRIBUTE TO, IMPLEMENT AND ADHERE TO:**
 - ▶ All decisions, recommendations and guidelines of the **OECD Development Assistance Committee (DAC)**.
 - ▶ All obligations determined by the **OECD Arrangement on Officially Supported Export Credits**.
- ▶ **THERE IS AN URGENT NEED FOR THE EUROPEAN UNION TO DRAW LEVEL WITH FOREIGN DEVELOPMENT INSTITUTIONS.** The EU needs to come par with for example Asian and US development finance institutions (DFIs) in terms of both volume and management capacity for infrastructure finance on third markets, and specifically in Africa.
- ▶ **EU DELEGATIONS ACROSS THE WORLD NEED TO PLAY AN INCREASED ROLE IN CONDUCTING EFFECTIVE ECONOMIC DIPLOMACY.**

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