

# Regulating Procurement of State Enterprises in China

*-current status and future policy considerations*

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## 1 Introduction

While procurement of state enterprises is posing a significant challenge to WTO rules<sup>2</sup>, in particular, those on public procurement, it is also an important issue in domestic law, especially in those countries with large state sector such as China. This is mainly because state enterprises in these countries, as major spenders of public money and the primary channel of state investment, should, in principle, subject their purchases to domestic regulation to ensure value for money and transparency.

Although the main objective of the international rules (non-discriminatory treatment of foreign products, services and suppliers) and that of domestic procurement regulations (value for money) are different, it can be argued that both international and domestic procurement regimes need to consider carefully the adequate approach to regulating procurement of state enterprises. This is particularly so when there is a need for the domestic regulations to be integrated into the international regime.

China is now fully committed to join the Agreement on Government Procurement of

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<sup>2</sup> See Wang, P. "Coverage of the WTO's Agreement on Government Procurement: Challenges of Integrating China and other Countries with a Large State Sector into the Global Trading System" (2007)10 *Journal of International Economic Law* 887-920

the WTO (GPA).<sup>3</sup> However, China has so far declined to offer any state enterprise for GPA coverage albeit significant interest from existing GPA Parties. While the coverage of procurement of state enterprises remains a contentious issue of China's GPA accession negotiation, it is important to assess (section 2 below) the *current status*, i.e. the extent to which such procurement is subject to domestic procurement law since China has denied such procurement is regulated domestically.<sup>4</sup>

Furthermore, in the case of China, it is also important to consider the domestic factors demanding procurement of state enterprises to be regulated in a coherent and consistent manner *in the future* as at present, the international obligations are often ignored and the coverage of domestic procurement law is limited. These factors, as further discussed in section 3 include the need to achieve value for money; the need to fight against the corruption of state enterprises managers; and the need to address the issue of local protectionism.

It is argued that even if procurement of state enterprises is completely excluded from China's GPA coverage (which is unlikely), there are still enough domestic incentives and legal practices for considering, as a future reform, a more coherent approach to regulating such procurement in domestic law.

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<sup>3</sup> See Wang, P. "Accession to the Agreement on Government Procurement: the Case of China" Chapter 3 in *The WTO Regime on Government Procurement Recent Developments and Challenges Ahead* S. Arrowsmith and R. Anderson (eds.)(CUP: forthcoming 2011); Wang, P. "China's accession to the WTO Government Procurement Agreement - challenges and the way forward" (2009)12(3) *Journal of International Economic Law* 663-706; Wang, P. "China's Government Procurement Policy at a Crossroad", December 2008 (Policy Paper), available at [www.nottingham.ac.uk/law/pprg](http://www.nottingham.ac.uk/law/pprg). Anderson, R. "China's accession to the WTO Agreement on Government Procurement: Procedural Considerations, Potential Benefits and Challenges, and Implications of the On-going Negotiation of the Agreement" (2008) 17 *Public Procurement Law Review* 161.

<sup>4</sup> See China's replies to the Checklist of Issues for Provision of Information Relating to Accession to the GPA in September 2008, not yet published.

## **2 Procurement of State Enterprises in Domestic Law**

According to China's *Law of Legislation*, the hierarchy of legal instruments in Chinese legal system is at first level national laws enacted by the National People's Congress (NPC); at the second level Implementing Ordinances and Administrative Regulations enacted by the State Council; and at the third level Ministerial Orders/Regulations/Measures adopted by Ministries, as well as Local Regulations enacted by Provincial People's Congress. At present, procurement of state enterprises is regulated at both the first and the third level. It is also noteworthy that a number of state enterprise groups have adopted their own firm-level procurement rules on the basis of national laws. These measures at various levels with different legal authority will be discussed in turn below.

### **2.1 Procurement of state enterprises under national laws**

Procurement of state enterprise is clearly outside of the definition of government procurement provided by the Government Procurement Law in Article 2. It defines government procurement as "all the purchasing activities conducted using fiscal funds by state organs at all levels, institutions and social organizations when the goods, construction and services concerned are listed in the Centralized Procurement Catalogue or value of which exceeds the respective Prescribed Procurement Thresholds for goods, construction or services as applicable". Since the state enterprises are arguably not procuring with fiscal funds and normally not classified as "state organs", "institutions" or "social organizations".

However, on the other hand, procurement of state enterprises is *de facto* covered by

the *Tendering Law*--the national law applies to all tendering activities, public or private.<sup>5</sup> In other words, procurement of state enterprises is not regarded as “government procurement” under Chinese law, but remains subject to tendering rules established by procurement law. The significance of this situation is that procurement of state enterprises is not subject to procurement rules as a distinctive category or due to the special characteristic of state enterprises. This is in contrast with the approach in other legal system such as the EU where public undertakings operating in certain utility sectors are covered as a specific category by the procurement regulation.

The *Tendering Law* defines its coverage through a combination of general and specific coverage. While Article 2 of *Tendering Law* provides that it should apply to “all tendering activities” within the territory of China, Article 3 of *Tendering Law* further requires that procurement of construction projects including procurement of relevant services (land inspection, design) and procurement of important equipments and materials used in such projects must go through tendering procedure if the construction project is “[i] concerning public interests or public security such as large infrastructure, public utility and etc.; or [ii] fully or partially financed by state-owned or state-borrowed fund; or [iii] financed by loans or aid from international organizations or foreign governments”.

While procurement of state enterprises will certainly fall under the general coverage of the *Tendering Law* (Article 2) if tendering procedure is employed in such process, the extent to which works procurement of state enterprises will also fall under the narrower compulsory requirements for tendering (Article 3) is not entirely clear. It is not clear what

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<sup>5</sup> For the interaction and potential conflicts between the Government Procurement Law and the Tendering Law see Wang, P. “China’s Evolving Legal Framework on Public Procurement” (2004)(6) *Public Procurement Law Review* 285-318

constitute “public interests”. Although two examples were given (large infrastructure or utilities), they are seemingly not exclusive. It is not clear whether “state-owned fund” refers to only further investment from the government account or it also includes fund owned by the state enterprise itself. It is not clear either whether “state-borrowed fund” refers only to money borrowed by the government such as the Treasury bond or it also includes money borrowed by the state enterprise from commercial banks.

However, Article 3 of the *Tendering Law* does contain a built-in mechanism for further clarifications, i.e. detailed scope and threshold of those projects subject to the compulsory tendering requirement shall be promulgated by the State Development and Reform Commission (SDRC, the former State Planning Commission) with the approval of the State Council. The *Provision on the Scope and Threshold of Construction Projects subject to Tendering Requirements* is approved by the State Council on 4 April 2000 and enacted by the SDRC on 1 May 2000. Four relevant terms mentioned in Article 3 of the *Tendering Law* are further defined in the Provision.

“Infrastructure projects concerning public interests or public security” include [i] energy projects such as coal, petrol, natural gas, electricity, new energy and etc.; [ii] transportation projects such as railway, highway, pipe, waterway, aviation and etc.; [iii] post and telecommunication projects such as post, telecommunication centre, information network and etc.; [iv] water resources projects such as flood control, watering, preservation of water and soil, hydroelectric power centre and etc.; [v] city facility projects such as road, bridge, subway, tramway, waste control, public parking and etc.; [vi] echo environment protection projects; [vii] *other infrastructure projects*. (Article 2)

“Public utility projects concerning public interests or public security” include [i] municipal infrastructure projects such as supply of water, electricity, gas, heat and etc.; [ii] projects involving technology, education and culture; [iii] sports and tourism projects; [iv] projects involving public health and social benefit; [v] commercial housing projects; [vi] *other public utility projects*. (Article 3)<sup>6</sup>

“Projects invested by state-owned fund” include [i] projects financed by budgetary fund; [ii] projects using special designated construction fund administrated by the Treasury; [iii] *projects using state enterprises or institutions own fund, and over which the investor of state asset has de facto control*. (Article 4)

“Projects financed by state-borrowed fund” include [i] projects using fund raised by the state through issuing treasury bond; [ii] projects using fund raised through loans taken or guaranteed by the state; [iii] projects using state policy loans; [iv] *projects using loans taken by the investing party authorized by the state*; [v] *projects using loans taken by the procuring entity but specially approved by the state*. (Article 5)

The threshold is 2 million Yuan (around 130 thousand Pounds) for a single construction contract, 1 million Yuan for a single procurement contract of important equipments and materials, only half a million Yuan for a single related service contract. If the overall investment of the project exceeds 30 million Yuan, all contracts involved should be conducted through tendering disregarding their individual value.

There are several points are noteworthy. First of all, the scope of “infrastructure projects” and “public utility projects” concerning public interests or public security are

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<sup>6</sup> It is noteworthy that the term “public utility” used in this Provision and therefore in the *Tendering Law* seems different from the term used in EC public procurement directives.

arguably wide enough to cover all such projects since the ambiguous term “other infrastructure (public utility) projects” is used at the end.

Secondly, state-owned fund includes fund owned by the procuring state enterprise. However, it is interesting to note that an extra condition is imposed for such projects financed by the state enterprise itself to be covered, i.e. the investor of the state asset (the government, institution or state enterprise which owns the procuring state enterprise) has *de facto* control over the project. The criteria of the existence of *de facto* control are not clear. Neither is the intention of this extra requirement. It seems suggesting that only when the government has effective control over the project, through funding or other practical means if the state enterprise finances the project by itself, should the project be subject to compulsory tendering.

Thirdly, it remains unclear to what extent a project financed by loans from commercial banks taken by a state enterprise is covered. Article 5 of the Provision suggests that only those loans “authorized” or “specially approved” by the government will count as “state-borrowed fund”. However, such authorization or approval is arguably merely an internal administrative procedure and not an objective criterion to define the scope of coverage of a legal instrument.

Nevertheless, it can be argued that read in conjunction with the subsequent clarification, the scope of the *Tending Law* with respect to construction projects subject to the compulsory tendering requirement, are arguably very wide and could potentially catch a large proportion of works and related procurement of state enterprises. Even so, procurement of supplies and services by a state enterprise which is not associated with any

construction projects, for example, procurement of accounting services by a state car company, might not be covered by the *Tendering Law* if the enterprise decides not to use tendering procedure. All ministerial regulations enacted to implement the *Tendering Law* arguably share the same limitation with respect to their coverage vis-à-vis procurement of state enterprises.

## **2.2 Procurement of State Enterprises under Ministerial Regulations**

A number of ministerial regulations have explicitly addressed the issue of procurement of state enterprises. These ministerial regulations can be broadly divided into five categories according to the nature and the enacting authority: [i] regulations on works procurement enacted by the Ministry of Construction [ii] regulations on procurement of large infrastructure and projects funded by state investment adopted by SDRC; [iii] regulations on international tendering of machinery and electrical equipment enacted by the Ministry of Commerce and its predecessor MOFTEC; [iv] various regulations on the procurement and investment of state enterprises enacted by the State Economic and Trade Commission (SETC) and its successor State-owned Assets Supervision and Administration Commission (SASAC); [v] the regulation on the procurement of state-owned financial enterprises promulgated by the Ministry of Finance (MOF). These regulations will be discussed in turn below.

### *2.2.1 Regulations on Construction Procurement Enacted by the Ministry of Construction*

The Ministry of Construction adopted on 30 December 1992 the *Measure on the Administration of Tendering for Procurement of Works in Construction Projects*. Article 2



of the Measure provides that “the works in any construction project involving building, modification, expansion or technical improvement invested by any government agency, public (state-owned and collective-owned) enterprise or institution have to be procured through tendering in accordance with this Measure except in cases where tendering procedure is not appropriate”.<sup>7</sup> It can be argued that this provision has in fact subject almost all works procurement of state enterprises to tendering procedure disregarding the source of the fund and the nature of the project.

However, the 1992 *Measure on the Administration of Tendering for Procurement of Works in Construction Projects* was later repealed by the Ministry of Construction in 2001. Its replacement, the *Measure on the Administration of Tendering for Procurement of Works in Construction Projects of House Building and Municipal Basic Infrastructure* promulgated by the Ministry of Construction on 1 June 2001, has taken a slightly different (narrower) title and omitted the explicit reference to procurement of state enterprises. Article 1 of the new Measure makes it clear that its legal base includes the *Tendering Law*. Without specifying covered procuring entity, Article 3 simply provides that all house building (including the construction of affiliated facilities, decoration and install of pipes and equipments) and municipal infrastructure projects (involving city road, public transportation, supply of water, electricity, gas and heat, drain, gardening, waste, flood control and etc.) have to be procured through tendering procedure if the overall investment of the project exceeds 30 million Yuan or the value of any single contract exceeds 2 million Yuan.

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<sup>7</sup> Ministry of Construction, *Measures on the Administration of Tendering for Procurement of Works in Construction Projects*, 30 September 1992, repealed, Chinese version available at <http://www.cin.gov.cn/law/depart/2000110617-00.htm>.

This approach to coverage is similar to that of the Tendering Law, i.e. it is not the (public) nature of the procuring entity but the nature of the project that would determine whether tendering procedure should be followed. Therefore, for example, even a commercial house building project invested by a private company above the threshold will have to be conducted through competitive tendering. Certain procurement of state enterprises, namely those involving house building and city infrastructure, will probably also fall under the coverage of this Measure, for example, the project of a state enterprise to build houses for its own employees using its own fund.

However, given the wide interpretation of the compulsory coverage of the Tendering Law, it can be argued that the scope of the Measure adopted by the Ministry of Construction is actually included in the scope of the Tendering Law. This is because “public utility projects concerning public interests or public security” already include, *inter alia*, “municipal infrastructure projects” such as supply of water, electricity, gas, heat and etc. and “commercial housing projects”.

### *2.2.2 Regulations on Procurement of Large Infrastructure and State Invested Projects adopted by SDRC*

Even before the enactment of *Tendering Law*, procurement of large infrastructure projects by state enterprises funded or monitored by the state had already been subject to tendering requirements contained in a specific SDRC regulation on large infrastructure projects-- the *Provisional Regulation on Application of Tendering in Large and Medium Sized National Infrastructure Construction Projects, 1997*.

The Tendering Law was drafted by the SDRC and therefore accommodated most

previous ministerial regulations adopted by the SDRC. A number of implementing ministerial regulations have been enacted by the SDRC and sometimes jointly with other ministries. However, these regulations are mainly to provide further guidance as to the technical issues arising from the implementation of the Tendering law such as the composition of the bid assessment committee. None of them has been particularly designed to regulate procurement of state enterprises although a large proportion of works procurement of state enterprises falls under their coverage in accordance with the scope identified above anyway.

On the other hand, the SDRC, as the investor on behalf of the State, has also promulgated regulations on procurement project using state investment or subsidy. The *Interim Measure on the Administration of Projects Receiving Investment and Interest Subsidy from Central Budget* entered into force on 1 August 2005 provides in Article 26 that any project receiving investment or interest subsidy and valued more than 5 million Yuan should be conducted through tendering procedure. The main receivers of such subsidy include state enterprises and local governments. The significance of this provision is that it has arguably extended the compulsory coverage of the *Tendering Law* to cover non-construction related projects although in practice construction projects still account for the majority of such projects receiving budgetary subsidy.<sup>8</sup>

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<sup>8</sup> Article 4 of the Interim Measure provides that the selected projects should be for public interest or public basic infrastructure; protection or improvement of eco environment; promotion of the social and economic development of less developed region; promotion of technology advancement and industrialization of high tech; or other qualified projects according to relevant rules.

### 2.2.3 *Regulations on international tendering of machinery and electrical equipment enacted by the Ministry of Commerce and its predecessor MOFTEC*

Procurement of mechanical and electrical equipments by government agencies, public institutions and state enterprises has been required to go through domestic tendering before applying for import license since 1985.<sup>9</sup> The initial intention was to ensure there would be no domestic substitute for the imported mechanical and electronic equipments.<sup>10</sup> However, since 1992, the objective of the tendering regulation has changed: procurement of mechanical and electrical equipments has been required to go through international competitive tendering with a view not only to encourage domestic suppliers to compete with foreign firms but also, and mainly, to take advantage of the better value offered by the international market.<sup>11</sup>

Over the last two decades, MOFTEC and its successor the Ministry of Commerce have enacted a number of regulations to ensure competitive tendering open to international suppliers in procurement of mechanical and electrical equipments. The latest version is the *Implementing Measure on International Tendering in Procurement of Mechanical and Electronic Products* (hereinafter the “*Tendering Regulation on M&E products*” which was enacted by the Ministry of Commerce on 1 November 2004 and entered into force on 1 December 2004. Its legal base is the *Tendering Law*. It provides in Article 2 that “the regulation applies to all international tendering proceedings in procurement of mechanical and electronic products conducted in the territory of China”. Article 8 further clarifies that

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<sup>9</sup> [http://www.trade.gov.cn/chinese/4G\\_web/Germany/php/show.php?id=17019](http://www.trade.gov.cn/chinese/4G_web/Germany/php/show.php?id=17019), visited on 17 July 2006.

<sup>10</sup> Tian, Jingbin, ‘Public Procurement in China: The Way Forward’(2001)10 *Public Procurement Law Review* 207, at208.

<sup>11</sup> News release of the Ministry of Commerce,

<http://www.mofcom.gov.cn/aarticle/bb/200508/20050800276713.html>, visited on 17 July 2006.

procurement subject to compulsory international tendering requirements includes procurement of mechanical and electrical products from abroad in [i] projects that concern public interests or security, such as large infrastructure, public utility and etc.; [ii] projects invested wholly or partly by state-owned or state-borrowed fund; [iii] projects funded by loans or aids from international organizations or foreign governments; [iv] **government procurement**<sup>12</sup>; [v] other procurement required by laws or administrative regulations.

The scope of the “*Tendering Regulation on M&E products*” is defined in a style similar to that of its legal base--the *Tendering Law*. It can be argued that the definition of terms such as “public interests” and “state-owned fund” contained in *Provision on the Scope and Threshold of Construction Projects subject to Tendering Requirements* should also apply. Since the coverage of “*Tendering Regulation on M&E products*” is not limited to construction project or related goods and services, procurement of mechanical and electrical products not related to any construction project by a state enterprise will also fall under the regulation.<sup>13</sup>

It is noteworthy that the “*Tendering Regulation on M&E products*” contains procedural rules of tendering similar to that in the *Tendering Law* as well as a chapter on bid challenge—the issue not addressed by the *Tendering Law* itself.<sup>14</sup>

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<sup>12</sup> It is noteworthy that the term “government procurement” is used here in parallel with other “public” projects. Even though the definition of “government procurement” provided in the *Government Procurement Law* is a narrow one, there is undoubted overlap between government procurement and other three “public” procurement projects listed above. It is suggested that this approach reflects the general misunderstanding about government procurement among Chinese bureaucrats, namely the term “government procurement” only means procurement under the administrative authority of the MOF and its local offices, which at present mainly include purchase of office equipments and vehicles.

<sup>13</sup> Contract valued under 1 million Yuan is exempted together with 10 other type of contracts not suitable for tendering such as purchase of old products, purchase with more than 50% discount and so on. Article 9 of *Tendering Regulation on M&E products*.

<sup>14</sup> The issue of bid challenge has not been explicitly address in the *Tendering Law* itself but dealt with by a ministerial regulation adopted by the SDRC later: *Measure on Handling Complaint Arising from the Tendering Activities in Construction Projects* (SDRC Order No.11, entered into force on 1 August 2004)

The significance of the tendering regulation on procurement of mechanical and electronic products should not be estimated. According to the news release of the Ministry of Commerce, during the period Tenth Five Years Plan (2000-2005), the overall value of procurement of mechanical and electronic equipments through competitive tendering is estimated as over 870 billion Yuan.<sup>15</sup> There is not statistics showing how much of these contracts value has been awarded by state enterprises, but it is noteworthy that the value of Chinese government procurement in 2004 is only 200 billion Yuan.

#### 2.2.4 *Regulations on the procurement and investment of state enterprises enacted SETC and SASAC*

##### 2.2.4.1 SETC Regulations

The State Economic and Trade Commission (SETC) promulgated a number of rules on the procurement of state enterprises through ministerial orders:

[i] The *Provisional Regulation on the Administration of Procurement of Supplies by State-owned Industrial Enterprises*, was promulgated on 1 April 1999 and entered into force on 1 May 1999.<sup>16</sup> Its objective is to regulate and supervise the purchasing behaviour of state-owned industrial enterprises, and to prevent the loss of state assets (Article 1). While it applies to state-owned industrial enterprises, it also applies “in principle” to state enterprises operating in other sectors such as “transportation, construction, exploration, commerce, foreign trade, post and telecommunication, water resources, technology and etc.”(Article 27).

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<sup>15</sup>*Supra.* n. 11.

<sup>16</sup> Ministerial Order No 9.

The regulation has only 29 Articles sorted in 6 chapters: general provision, decision making, procurement through comparing quality and price, price control, quality control, liability and bonus. It requires that the decision of procurement of major supplies (referring to main materials and other subject involving large sum of money) should be made by collective decision of the management (Article 5). “Unless only one supplier is available or the business operation of enterprise demands so, the enterprise should, in the procurement of major supplies, compare the quality, price offered by two or more suppliers and their reputations, then purchase from the better one” (Article 9). The qualification of the supplier should be inspected (Article 10). “When the conditions for tendering are met, the enterprise should, in the procurement of large amount of raw materials, infrastructure, major equipments in technology innovation projects, or procurement of other supplies involving a significant sum of money, use tendering procedure *as far as possible*.” (Article 11)

It can be argued that the *Provisional Regulation on the Administration of Procurement of Supplies by State-owned Industrial Enterprises* is more an internal administrative guideline than a procurement regulation in legal sense. This is because first of all, although the regulation was enacted close to the promulgation of the *Tendering Law*, it contains no provisions on the publication of contract opportunities, solicitation, submission and assessment of tenders and does not differentiate open and selective tendering. Secondly, its objective is not to achieve value for money but to strengthen the administrative supervision and prevent corruption. Thirdly, the majority of the provisions focus on the internal decision making process, price and quality control. Tendering

procedure is not even a mandatory requirement and only to be conducted “*as far as possible*” when conditions are met. It is also noteworthy that procurement of services is arguably outside of the scope of this regulation.

[ii] The SETC also developed a number of regulations on using tendering procedure in the procurement of technical improvement and technical innovation projects which aimed at improving the technology and productivity of state enterprises. Although these regulations were not explicitly addressed to state enterprises, in practice, it was the state enterprises that carried out such projects. These regulations include the *Opinion on the Tendering in State Key Technical Improvement Projects during the Ninth Five Year Plan* (SETC Decree No.847 1996, enacted and enter into force on 17 April 1996 ); the *Measure on the Administration of Tendering in State Key Technical Improvement Projects* (SETC Investment Decree No. [1999] 262, enacted and enter into force on 7 April 1999) ; the *Notice on Strengthening the Supervision of Technical Improvement Projects using Funds Raised by Treasury Bonds* (SETC Investment Decree No. [1999]1162, issued on 30 November 1999) ; the *Measure on the Administration of Tendering in State Technical Innovation Projects* (SETC Order No. 40, enacted on 29 October 2002, and enter into force on 1 December 2002) .

Most of these regulations had been enacted before the entry into force of the Tendering Law, which contain merely a brief requirement of tendering without providing detailed procedures or even differentiating open and selective tendering. In contrast, the 2002 *Measure on the Administration of Tendering in State Technical Innovation Projects* has provided some detailed practical guidance for procuring state enterprises as to how to



procure through tendering procedure. These include, for example, criteria for using selective tendering instead of open tendering<sup>17</sup> (Article 7); the content of the notice of intended procurement, the designated media to advertise such notice and the time limit (Article 8); the content of the solicitation document (Article 10); bid opening, assessment and award of the contract (Article 17-23).

It is noteworthy that both the 1999 *Notice on Strengthening the Supervision of Technical Improvement Projects using Funds Raised by Treasury Bonds* and the 2002 *Measure on the Administration of Tendering in State Technical Innovation Projects* contain “buy national” policy.

Article 3 of the 1999 *Notice on Strengthening the Supervision of Technical Improvement Projects using Funds Raised by Treasury Bonds* provides explicitly: “[P]urchasing domestically produced equipments should be encouraged. If domestically produced equipments can satisfy the need of the project, the procurement **must** be conducted through domestic tendering; ...in international tendering [for all or parts of equipments not available domestically], *preference shall be given* to equipments jointly manufactured by the foreign bidder in collaboration with domestic enterprises. No government department, unit and individual is allowed to designate any particular supplier for the procuring enterprise, and *no provision discriminating against domestic bidders shall be set up.*” The terms “domestically produced equipment” and “domestic enterprise” are not further defined. It is not clear whether foreign invested enterprises or joint ventures established in China (a Chinese juristic person according to Chinese law) and their

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<sup>17</sup> The selective tendering procedure may be used in circumstances that : [i] intellectual property or trade secrets are involved; [ii] national security is concerned; [iii] bidder’s number is limited; or [iv] otherwise provided by other state regulations.

products would qualify as “domestic”.

Article 15 of the 2002 *Measure on the Administration of Tendering in State Technical Innovation Projects* provides that “bidders shall be enterprises or other organizations that are **domestically registered juristic person**”. Since according to the company law, foreign invested enterprises or joint ventures registered in China according to Chinese law are Chinese juristic person, these enterprises would arguably be allowed to bid as “domestic” bidders.

On the surface, these provisions are overtly discriminating against foreign products and suppliers. However, judging from the last sentence of Article 3 of 1999 *Notice on Strengthening the Supervision of Technical Improvement Projects using Funds Raised by Treasury Bonds*(**no provision discriminating against domestic bidders shall be set up**), it can also be argued that the real intention of the regulator is not to discriminate against foreign suppliers and products, but to prevent government officials and managers of state enterprises from favouring foreign suppliers after being bribed and discriminating against domestic suppliers. This argument is based on the background that such “reverse discrimination” against domestic suppliers due to corruption has been causing serious problems.

Nevertheless, the legality of these provisions is questionable taken into consideration the subsequent commitments undertaken by China upon WTO accession further discussed in the previous policy paper, in particular, the commitment that government shall refrain from influencing procurement of state enterprises and state enterprises shall procure only based upon commercial considerations.

[iii] After the entry into force of the Tendering Law, the *Tendering Law* and previous SETC regulations were reemphasized in the *Basic Rules on the Establishment of Modern Enterprise Regime and Strengthening Administration in State-Owned Large and Medium Enterprises* drafted by the SETC and promulgated by the Secretariat of the State Council on 28 September 2000.<sup>18</sup>

In the chapter on cost calculation and control, it requires that procurement of supplies for the production of state enterprises must be conducted through comparing quality and price strictly in accordance with the 1999 *Provisional Regulation on the Administration of Procurement of Supplies by State-owned Industrial Enterprises* (Article 35). In the chapter of financial and account administration, it also requires that “all procurement in projects of infrastructure or technical improvement must be conducted through tendering strictly in accordance with the *Tendering Law*, the *Provision on the Scope and Threshold of Construction Projects subject to Tendering Requirements* and the *Notice on Strengthening the Supervision of Technical Improvement Projects using Funds Raised by Treasury Bonds*”(Article 44). No further implementing measure was provided.

It can be argued that the *Basic Rules on the Establishment of Modern Enterprise Regime and Strengthening Administration in State-Owned Large and Medium Enterprises* is also just an administrative guideline instead of a “regulation” in legal sense conferring rights and obligations. It merely emphasized the previous SETC regulation and the *Tendering Law* should be followed.

[iv] The *Measure on the Administration of Fixed Assets Investment Project of*

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<sup>18</sup> Chinese version available at <http://www.sasac.gov.cn/gzjg/qygg/200408100320.htm>.

*Industrial and Commercial Enterprises* was promulgated by SETC through Ministerial Order 39 on 29 October 2002, and entered into force on 1 December 2002. A related regulation on challenge procedure regarding the procurement of these projects has been enacted on 7 January 2003.

Article 4 of the Measure provides that “procurement of technology (including construction design), equipments (including materials), building and installation works and other goods and services, shall be conducted through tendering if such procurement occurs in a fixed assets investment project of a industrial and commercial enterprise that [i] concerning public interests or public security such as large infrastructure, public utility and etc.; or [ii] fully or partially financed by state-owned or state-borrowed fund; or [iii] financed by loans or aid from international organizations or foreign governments”. The Measure also contains detailed procedural rules and criteria on open and selective tendering as well as handing of complaint.

The scope of the measure is defined in a way similar to that of the *Tendering Law*. Two differences are: the procuring entities are limited to “industrial and commercial enterprises”; the scope of covered procurement is arguably wider and not limited to construction related goods and services. However, the wording of Article 4 of the Measure is ambiguous. The term “industrial and commercial enterprise” is not further defined, and it is not even clear whether the term cover private enterprises as well as state enterprises.<sup>19</sup> It is not clear either to what extent the term “fixed assets investment” also includes non-construction related services.

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<sup>19</sup> Although it can be argued that most enterprises involved in projects funded by the state or concerning public interests should be state enterprises anyway.

A more serious problem is that the relationship between the *Measure on the Administration of Fixed Assets Investment Project of Industrial and Commercial Enterprises* and other previous SETC regulations such as those on procurement of state-owned industrial enterprises and technical improvement and innovation projects is not clear. There is arguably a significant overlap since for example, procurement of a new production line by a state-owned car manufacturer might be classified as both a technical improvement project and a fixed assets investment. Although such clash between different regulations is arguably less significant since the *Measure on the Administration of Fixed Assets Investment Project of Industrial and Commercial Enterprises* is the only one contains the most detailed procedural rules and other previous SETC regulations are only about principle, the uncertainty and ambiguity of the legal framework originated from a single authority, and the lack of a unified, principled approach to the procurement of state enterprises is nevertheless regrettable.

#### 2.2.4.2 SASAC regulations

The single most detrimental factor to the significance of all above-discussed SETC regulations is arguably that SETC as a government organ has ceased to exist. During the restructuring of Chinese central government—the State Council- in 2003, the SETC was abolished, but the Ministers of SETC together with all its stuff and administrative structure have been entrusted to set up a new central government ministry State-owned Assets Supervision and Administration Commission (SASAC).<sup>20</sup>

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<sup>20</sup> National People's Congress, "Decision on Approving the Reform Proposal of State Council Organs", *People's Daily*, 11 March 2003.

In strict legal sense, the SASAC is not the successor of the SETC but a newly established government organ. Although, in practice, the SASAC has been viewed as the *de facto* successor of the SETC because of the continuity of leadership and staff and the fact that SASAC is also in charge of the supervision of state assets in state enterprises, the validity of previous SETC regulations on procurement of state enterprises discussed above is still in serious question from a legal perspective. It is noteworthy that certain previous SETC regulations are still available in the policy, law and regulation sector of the new official website of SASAC and other government website on procurement.<sup>21</sup> It is also reported that in a conference held on 29 March 2006, one SASAC provincial (Fujian province) office stated that the main focus of this year's work would be the establishment of a mechanism of ensuring procurement of large amount of supplies by state enterprises under the control of the provincial government to be conducted through tendering.<sup>22</sup> However, without confirmation from new legal instruments adopted by the SASAC, the legality of SETC regulations remains uncertain.

The SASAC is entrusted with the task to represent the investor's interest of the State in state enterprises. It mainly supervises non-financial state enterprises directly affiliated to Chinese central government, and provides guidance to local government regarding the supervision of state enterprises under local government control. This arguably means that the SASAC cannot directly regulate state enterprises under the control

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<sup>21</sup> For example, Basic Rules on the Establishment of Modern Enterprise Regime and Strengthening Administration in State-Owned Large and Medium Enterprises drafted by the SETC and promulgated by the Secretariat of the State Council on 28 September 2000 available at <http://www.sasac.gov.cn/gzjg/qygg/200408100320.htm>. All SETC regulation mentioned above available at <http://www.cntc.gov.cn/zcfg/index.html> administrated by organs of SDRC.

<sup>22</sup> [http://www.chinabidding.com.cn/zbw/zxzx/zxzx\\_show.jsp?op=op\\_browse&record\\_id=901208](http://www.chinabidding.com.cn/zbw/zxzx/zxzx_show.jsp?op=op_browse&record_id=901208), visited 19/06/2006.

of regional (provincial) governments.

So far the SASAC has enacted only one regulation of investment which is related to procurement of state enterprise: *Provisional Measure on the Supervision and Administration of Investments of Central Enterprises* (SASAC Ministerial Order No. 16, promulgated on 28 June 2006 and entered into force on 1 July 2006). The investment in this regulation refers to investment in fixed assets, purchase of property or ownership and long term stock investment (Article 3). It mainly requires that central enterprises (non-financial state enterprises affiliated to the central government and under the supervision of SASAC defined in Article 2) should make yearly plan regarding their investment and report the plan to SASAC (Article 7-11). And certain investment of central enterprises and major issue arising therein should be approved by the SASAC in advance, for example, investment in non-major business by state wholly owned enterprises with no board of directors.

However, unlike the previous SETC regulation on fixed asset investment, the SASAC *Provisional Measure on the Supervision and Administration of Investments of Central Enterprises* does not mention how such investment should be conducted. There is no provision regarding the procurement method or transparency requirements. No reference has been made to competitive tendering procedure or the *Tendering Law*. It can be argued that this either suggests that previous SETC regulations are still in force or the SASAC has no intention to regulate procurement of state enterprises in such a detailed manner as SETC.

### 2.2.5 *The Regulation on Procurement of Financial State Enterprises enacted by the MOF*

As explained above, the portfolio of SASAC only covers non-financial state enterprises controlled by the central government. Financial state enterprises have traditionally been under the supervision of the Ministry of Finance (MOF). In 2001, the MOF promulgated *Several Rules on Strengthening the Administration of Centralized Procurement of Financial State Enterprises* ([2001] No. 209, promulgated and entered into force on 20 September 2001).

It defines financial state enterprises as “commercial banks, policy banks, insurance companies, financial assets administration companies, stock broker companies, investment trust companies and other financial enterprises that are wholly owned by the state or the controlling shareholder is the state (Article 2). The term “centralized procurement” refers to “purchase or rental of large amount of supplies, works or services by financial state enterprises” (Article 3). However, Article 5 further provides that any contract of [i] armoured vehicle and other vehicle, office building; [ii] surveillance system; [iii] computer network and related equipments, ATM machines, bill-counter, printer, photo-copier, air-conditioner; or [iv] other items designated by the authority valued more than 1 million Yuan must be awarded through centralized procurement. This list contained in Article 5 gives rise to the question whether procurement of other construction works and in particular, procurement of services is actually covered although Article 5(4) suggests that the authority (MOF) may expand the scope of covered procurement at its discretion.

Such centralized procurement of financial state enterprises are required to be conducted, in principle, through open or selective tendering according to the *Tendering*



*Law.* On the other hand, it is noteworthy that if the open tendering has failed to produce successful bid or under other special circumstances and after reporting to financial authorities, financial state enterprises are allowed to use other procurement methods such as competitive negotiation, request for quotation and single source procurement (Article 10). However, no detailed procedures regarding how to use these alternative procurement methods have been provided.

The brief provision on alternative procurement methods available to financial state enterprises is arguably significant. This is because (open and selective) tendering has been the only theme of other national laws and ministerial regulations applying to procurement of state enterprises discussed above. According to the lessons learned from other public procurement regime which regulating procurement of state enterprises such as the EC Utility Directive, the commercial nature and business operation of state enterprises does demand more flexible procurement methods than tendering. By utilizing these alternative procurement methods, while maintaining certain degree of transparency, the flexibility needed by certain project of state enterprises may be achieved. This is an arguably better approach comparing to “tendering or nothing”.

It is also noteworthy that state policy banks are required in general to “buy national”: if they need to purchase “foreign products”, a certificate produced by specialized technical department proving that domestic products can not satisfy the need must be filed first (Article 13). As further discussed in the previous policy paper, the legality of this provision is arguably questionable, especially when state policy banks are viewed in this regulation as financial state enterprises instead of government agencies, since China has undertaken

that the government will refrain from influencing procurement of state enterprises and state enterprises shall procure only based upon commercial considerations.

### **2.3 The Initiative of State Enterprise Groups for Procurement Regulations**

It is noteworthy that there has been a trend in recent years for state enterprise groups to adopt internal procurement rules that apply to affiliated enterprises and institutions. Most notably, China Petrochemical Corporation (Sinopec Group) and State Grid Corporation of China (SGCC) have promulgated comprehensive procurement regulations with a view to strengthen the control over hundreds of affiliated state enterprises and institutions operating at national and local level (Sinopec Group, *Regulation on the Administration of Tendering in Construction Projects*, enacted and entered into force on 23 December 1999; SGCC, *Measure on Administration of Tendering*, enacted and entered into force on 7 December 2004).

Although according to the *Law of Legislation*, these regulations adopted by state enterprise groups should not be regarded as parts of domestic law, in practice, they have been classified as “national legislation” or “ministerial regulation” in the database of regulations<sup>23</sup>. Indeed, the format of these regulations is similar to that of ministerial regulations. And as further discussed below, some provisions are certainly conferring rights and obligations upon private parties. This is arguably because both the Sinopec Group and the SGCC enjoy special privilege (oligopoly/natural monopoly) in the respective sector they operate and have a status as “quasi-ministry”.<sup>24</sup>

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<sup>23</sup> Article 82 of the *Law of Legislation*. See for example, the database of regulations at [www.chinabidding.com.cn](http://www.chinabidding.com.cn) certified by the Ministry of Commerce.

<sup>24</sup> The SGCC was transformed from part of former Electricity Ministry.

The Sinopec Group 1999 *Regulation on the Administration of Tendering in Construction Projects* provides that the Tendering Law is the legal base and it is similar in format to other implementing regulations of the Tendering Law adopted by other provincial governments and central government ministries. The scope of covered procurement is limited to procurement of construction works and related equipments, materials and services (Article 2). The threshold is 3 million Yuan for a single construction contract which is 1 million Yuan higher than, therefore arguably inconsistent with, the threshold set up in SDRC 2000 *Provision on the Scope and Threshold of Construction Projects subject to Tendering Requirements*. It does not specify covered procuring entity but provides that the Group headquarter will be in charge of the administration of tendering in construction projects of the whole group; as to fix assets investment project, procuring entity may, upon the approval and under the guidance of the headquarter, procure through tender by itself (Article 3).

There are a number of occasions where the Sinopec Regulation confers upon the Tendering Administration Office under the Group headquarter regulatory authority normally born by government departments. For example, the office may rule on bid challenges (Article 8); all suppliers that wish to bid for construction contracts of the Group have to register with the office and pass the qualification inspection first (Article 23); the office has the power to terminate any tendering process or annul the award of contract if irregularities from the part of procuring entity or bidders are found; it also has the power to impose fines and other administrative sanctions (Article 41).

It is noteworthy that although Sinopec Group 1999 *Regulation on the*

*Administration of Tendering in Construction Projects* does not contain any buy national policy as such, its Article 34 provides that “...***under the same conditions, preference should be given to bidders which is affiliated to the Group.***” What constitute “the same conditions” is not further clarified in the regulation. It is not clear whether the “condition” means the price level, the quality or the combinations of both; or how much difference, for example in price, between two bid would be omitted. Nonetheless, it can be argued that this provision has left the procuring entity considerable discretion to favour fellow members of the Group while discriminate against any other outside (domestic or foreign) suppliers.

On the other hand, SGCC 2004 *Measure on Administration of Tendering*, although also based upon the *Tendering Law*, has some distinctive features. It applies to “[i] the SGCC head office and its subsidiaries; [ii] regional grid companies, provincial electricity companies and units under their control; [iii] any unit the controlling shareholder of which is the SGCC; [iv] other enterprises and institutions directly affiliated to the SGCC; [v] other units entrusted to be administered by the SGCC” (Article 2). Other companies with the SGCC as a shareholder may choose to follow the Measure. The covered procurement is defined as including construction procurement such as procurement of works, related services (design, exploration, inspection) and related supplies (equipments and materials) with the same threshold provided in SDRC 2000 *Provision on the Scope and Threshold of Construction Projects subject to Tendering Requirements*; “***as well as non-construction procurement*** valued more than 200 thousand Yuan such as procurement of equipments, office supplies and services.

The provision on coverage in the SGCC regulation deserves special consideration. This is because it provides, for the first time, a way to define the coverage of procuring state enterprises as well as a comprehensive coverage of procurement including construction, goods and services. Comparing to other domestic regulations introduced above in chapter 4 most of which only cover certain type of procurement or projects, this is quite unusual.

In contrast with Sinopec Group 1999 *Regulation on the Administration of Tendering in Construction Projects*, SGCC 2004 *Measure on Administration of Tendering* is cautious on conferring any administrative authority on SGCC institutions. With respect to any breach of the rules, it provides that penalties should be given by “the administrative authority with proper jurisdiction”.

The procurement regulations of Sinopec and SGCC are not isolated incidents. There are many more such regulations or internal rules adopted by state enterprise groups albeit in different forms. This initiative of state enterprise groups to adopt procurement regulations has arguably demonstrated that there exists domestic consensus among government and state sector stakeholders regarding the benefits for procurement of state enterprises to be regulated, although the extent and method of such regulation may considerably vary from different perspectives.

Nevertheless, the significance of state enterprises’ internal procurement regulations should not be underestimated. It is common in China that regulation comes later than practice. The procurement regulations of state enterprises with assets worth more than

1000 billion Yuan are certainly influential.<sup>25</sup> It can be argued that the trial of this kind can prepare state enterprises for future reform and increase the confidence of the government to incorporate such an approach into the domestic law.

### **3 Domestic Incentives for Regulating Procurement of State Enterprises**

Having taken into consideration of the current status of domestic regulations regarding procurement of state enterprises, it is now time to look at the future. Any domestic reform or adjustment for implementing international obligations in this area can only be achieved, through the exploration and education of potential incentives and benefits which justify the regulation of procurement of state enterprises. These incentives shall include at least the following.

#### **3.1 Value for Money**

Chinese state enterprises remain vitally important in national economy. They not only occupy strategically important sectors such as the utilities, defence and raw materials but also are the major spender of public fund including state budgetary investment fund, fund raised through treasury bond and loans from state-owned banks. The establishment of new state enterprises or expanding the capacity of existing state enterprises have been the major means for the government to invest in basic infrastructure. For example, the overall planned investment of 9 state enterprises under the control of Fujian provincial government (including, *inter alia*, a coal company, a petrochemical company, a shipbuilding company, a textile company and a transportation company) in 2006 alone accounts for 5 billion Yuan involving 100 projects with around half of the money from state enterprises own fund and

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<sup>25</sup> By the end of 2005, SGCC accumulated a total asset of RMB1176.7 billion Yuan.

the other from bank loans.<sup>26</sup>

Therefore, there is a strong argument that such a significant proportion of public spending should be conducted in a regulated, transparent and efficient way aiming at value for money. Subject such purchase to procurement rules is certainly a proved way forward. Therefore, value for money is the first and most important incentive for procurement of state enterprises to be regulated in a transparent, legalized but flexible manner.

In fact, it has already been recognized by Chinese government organs that modern procurement methods, especially competitive tendering, can save money. It is noted in a *Notice on Further Promoting Tendering* issued by the SETC on 18 January 1999 that “[T]endering has played an important role in not only construction projects but also in procurement of equipments, through which social resources have been allocated effectively. Tendering is an important component of a market system, *an important economic instrument* to supervise state assets and *to regulate procurement and investment of [state] enterprises*. Tendering has significant role in helping state enterprises participate the market competition, *make savings in investment*, minimize risks and transform business operation mechanism.”

According to the news release of the Ministry of Commerce, during the period of Seventh to Ninth Five Years Plan (1985-2000), the rate of savings achieved through tendering in procurement of mechanical and electronic products has been estimated as respectively: 16.95% of 18 billion Yuan (1985-1990); 15.5% of 48 billion Yuan (1991-1995); 16.8% of 223.6 billion Yuan (1996-2000). Although procurement of state

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<sup>26</sup> [http://www.chinabidding.com.cn/zbw/zxzx/zxzx\\_show.jsp?record\\_id=1004662](http://www.chinabidding.com.cn/zbw/zxzx/zxzx_show.jsp?record_id=1004662), visited on 19/06/2006.

enterprises is only a (though major) part, the average saving rate should remain the same and constantly more than 15% over the fifth years is arguably quite impressive. It is also reported that through centralized procurement via tendering procedure, in 2005, the Zibo Mining Enterprises Group (a local state enterprises group) has managed to save 13.7 million Yuan, 13% of annual spending in procurement of supplies alone.<sup>27</sup> Recent reports also indicate that state enterprises are indeed using central purchasing agencies established under the Government Procurement Law to conduct their procurement although they are not obliged to with a view to achieve value for money.<sup>28</sup>

### **3.2 Fight against Corruption**

It is suggested that the original intention of applying tendering to construction projects of state enterprises was to deter the abuse of growing managerial autonomy.<sup>29</sup> One of the major forms of such abuse is corruption. For example, it is reported that some managers of state enterprises have used public fund to apply to investor migration, gamble, seek profit in stock market and in particular, have taken bribery or favoured relatives in procurement supplies and construction. In 2004, Sichuan Province alone has received 2890 reports of corruption incidents involving state enterprises' managers and 425 individuals have been punished.<sup>30</sup> It is reported that "roughly two-thirds of the fugitives were senior executives of state-owned enterprises [and] between US\$ 8.75 billion and US\$ 50 billion were

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<sup>27</sup> <http://www.sasac.gov.cn/gyqydt/dfdt/200607060174.htm>, visited on 19/06/2006.

<sup>28</sup> [http://www.ccg.gov.cn/dfcg/dfdt/201011/t20101116\\_1416775.shtml](http://www.ccg.gov.cn/dfcg/dfdt/201011/t20101116_1416775.shtml), reporting a local state-owned public transport company in Jing Zhou, Hu Bei province purchased buses through the local government procurement agency applying government procurement rules and achieved significant savings, visited in January 2011.

<sup>29</sup> Tian, Jingbin, 'Public Procurement in China: The Way Forward'(2001)10 *Public Procurement Law Review* 207, at 208.

<sup>30</sup> <http://www.sasac.gov.cn/dfgzdt/200504180077.htm>, visited on 10/06/2006.



supposedly brought out of the country in recent years”.<sup>31</sup>

Chinese leaders have recognized that “anti-corruption and building a clean government is an important strategic mission.”<sup>32</sup> Although China has undertaken a number of measures to more effectively detect and punish corruption (such as the penal regime and disciplinary system), it is suggested that more attention should be paid to “reviewing areas prone to corruption, eliminating opportunities for corruption and creating conditions conducive to ethical behaviour”.<sup>33</sup> It can be argued that procurement of state enterprises is no doubt one of the areas “prone to corruption” and a principled approach to regulating such procurement would considerably limit discretion of state enterprises managers therefore reduce the “opportunities for corruption”.

It has also been recognized by Chinese government authorities and state enterprises that employing modern procurement method, in particular competitive and transparent tendering procedure, in the procurement of state enterprises is an important instrument to restrict the discretion of the management and therefore, to prevent the occurrence of corruption. In a speech titled “how to improve the capacity of state enterprises to prevent corruption” delivered by the Disciplinary Chief of SASAC on 8 September 2005, it is recognized that a system and relevant procedural rules should be put into place with respect to important business operations of state enterprises such as, *inter alia*, ***investment and procurement*** in order to minimize uncertainty and avoid

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<sup>31</sup> OECD, Governance in China, Chapter 3, available at [http://www.oecd.org/document/32/0,2340,en\\_2649\\_37405\\_35340704\\_1\\_1\\_1\\_37405\\_00.html#HTO](http://www.oecd.org/document/32/0,2340,en_2649_37405_35340704_1_1_1_37405_00.html#HTO)

<sup>32</sup> President Hu Jintao’s speech to mark the 85th anniversary of the party’s founding , <http://news.bbc.co.uk/1/hi/world/asia-pacific/5131978.stm>, visited on 15/07/2006.

<sup>33</sup> OECD, Policy Brief: China’s Governance in Transition, September 2005, available at [http://www.oecd.org/LongAbstract/0,2546,en\\_2649\\_201185\\_35312076\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/LongAbstract/0,2546,en_2649_201185_35312076_1_1_1_1,00.html) .

disproportionate discretion.<sup>34</sup>

There are also cases of state enterprises themselves have promulgated procurement regulations or set up procurement mechanism in order to prevent corruption. For example, China Railway Communication Co., Ltd. (China Railcom) has promulgated “Rules on Procurement Administration” see further explained above; the state major car manufacturer Dongfeng Company has sent disciplinary officer to monitor the tendering procedure in procurement of equipments and construction projects.<sup>35</sup>

### **3.3 Integration of Domestic Market and Battle against Local Protectionism**

Local protectionism or localism has been a major obstacle in the development of Chinese style “socialist market economy”. While in western economies enterprises compete on a comparatively non-protectionist and commercial basis in unified and free internal markets, Chinese enterprises have to face a fragmented and entrenched national market with significant officially-built-up internal barriers between different regions.

The causes of this problem are arguably twofold. Firstly, for more than three decades, the priority of China’s industrial development policy had been national defence instead of industrial growth on the basis of efficiency. As the result of such policy, China has a system of duplicated and fragmented geographical location of manufacturing industry. It is argued that after a half-century of inefficient industry allocation, subsidization and elaborate trade protections to counterbalance inefficiencies, local protectionism is entrenched in China in a way not found in the comparatively unified Western nations’

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<sup>34</sup><http://www.sasac.gov.cn/gzwwgk/ldjj/hdh/hdhzyjh/200509230076.htm>, visited on 10/06/2006

<sup>35</sup> <http://www.sasac.gov.cn/rdzt/zt0031/zyqybx/200509210014.htm>, visited on 10/06/2006.

internal markets.<sup>36</sup>

Secondly, the management of Chinese state enterprises has always been a multi-tier structure: with the central government controlling large national state enterprise groups and local (provincial) government controlling locally established state enterprises as well as local subsidiaries of national companies. The new state asset management system established in 2003 has succeeded this decentralized approach. The relationship between the SASAC and its branches within the provincial government is merely “guidance and supervision” instead of direct administration.<sup>37</sup> The regional (provincial and municipal) governments still have a significant say in the important decision making of state enterprises under their control. For example, the annual investments plan of local subsidiary of central government controlled China Petrochemical Corporation (Sinopec Group) has to be approved by State Assets Supervision and Administration Commission of (Fujian) provincial government.<sup>38</sup> The influence of local government over state enterprises, even local subsidiary of a national companies, also relies on the fact that a large proportion of such enterprises’ funding come from loans granted by local branches of state commercial banks that are under the control or influence of local government. This approach has arguably provided the tool for local government to require state enterprises under their control to serve local interests, for example, to “buy local” in their procurement.

As public procurement has been an important non-tariff barrier in the international trade, government procurement, especially procurement of state enterprises, has arguably

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<sup>36</sup> Tiefer, C. “Sino 301: How Congress Can Effectively Review Relations with China after WTO Accession” (2001) 34 *Cornell International Law Journal* 55, at 70.

<sup>37</sup> Article 2 of SASAC 2006 “Interim Measure on Guidance and Supervision of Local State Assets Management”, SASAC Ministerial Order [2006] No. 15, enacted on 7/4/2006, entered into force 7/5/2006.

<sup>38</sup> [http://www.chinabidding.com.cn/zbw/zxzx/zxzx\\_show.jsp?record\\_id=1004662](http://www.chinabidding.com.cn/zbw/zxzx/zxzx_show.jsp?record_id=1004662), visited on 19/06/2006.

been a significant barrier of internal trade in China, in other words, a weapon of local protectionism. It is reported that a giant construction company located in Shanghai submitted a reasonable bid for a warehouse construction contract in another province but lost and the reason for the loss is “When a local enterprise is desperate for orders, [said an executive of the Shanghai company], the local government will naturally give it priority... the chances for a non local company to win a public bid are very small.”<sup>39</sup>

The problem of using public procurement, in particular procurement of state enterprises, to reinforce the “regional block”—barrier to cross-region internal trade has also been highlighted in the State Council *Regulation on Forbidding Regional Block in Economic Activities in the Market* (State Council Order No. 303, enacted and entered into force on 21 April 2001). Measures adopted by local governments or organizations authorized by them of the nature of a regional block identified by the regulation include, *inter alia*, [i] “require, through any means, any unit or individual only to purchase locally-manufactured products or services provided by local enterprises”(Article IV:1); [ii] “apply different technical specifications, inspection criteria or other discriminatory measure to non-local products or services in order to restrict the entry of non-local products or services into local market”(Article IV:4); [iii] “restrict participation of non-local enterprises to local tendering process through setting up discriminatory qualification criteria or contract award criteria, or holding up contract information and etc.”(Article IV:6). Three out of seven measures addressed are directly related to public procurement. This has arguably reflected the importance of public procurement regulation in the battle against local protectionism.

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<sup>39</sup> Trish Saywell, “China's City Limits”, *Far E. Econ. Rev.*, Oct. 14, 1999,

Legal instruments employed to ensure the integration of domestic market arguably include both competition law and public procurement law.<sup>40</sup> With the Chinese anti-trust law likely to exclude state enterprises from its coverage<sup>41</sup>, a nationwide, unified, principled approach to regulating procurement of state enterprises is more important to ensure the integration of domestic market.

### **3.4 Facilitating the Improvement of Public Procurement Legal Framework**

The evolution in China's public procurement framework has arguably passed three phases marked respectively by the enactment of the *Tendering Law* (2000), the *Government Procurement Law* (2003) and the implementing regulations for the *Government Procurement Law* and *Tendering Law* (2004-present). On the one hand, more and more detailed technical rules such as time limits, formalities of important documents, tender evaluation criteria and procedure and review handling procedure have been provided over the time. However, on the other hand, the main issue of Chinese public procurement legal framework--the conflict between *Government Procurement Law* and *Tendering Law* with respect to coverage and the inconsistency of the institutional framework—has not yet been effectively addressed. The recently established inter-ministerial coordination mechanism can hardly be an adequate remedy for such an overt conflict of rules.<sup>42</sup> The fundamental problem of Chinese public procurement regime, namely the fragmentation of rules and institutional tension as the result of the co-existence of two pieces of primary public

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<sup>40</sup>OECD, "Governance in China", see Chapter 12 "Competition Law and Policy in China", available at [http://www.oecd.org/document/32/0,2340,en\\_2649\\_37405\\_35340704\\_1\\_1\\_1\\_37405,00.html#HTO](http://www.oecd.org/document/32/0,2340,en_2649_37405_35340704_1_1_1_37405,00.html#HTO)

<sup>41</sup> *Ibid.*

<sup>42</sup> See Wang, P. "China's Evolving Legal Framework on Public Procurement" (2004)(6) *Public Procurement Law Review* 285-318.

procurement legislation, remain.

Regulating procurement of state enterprises is only one but important aspect of the evolving Chinese legal framework of public procurement. It can be argued that a principled approach to regulating procurement of state enterprises would pave the way for the reform of public procurement regime in general. The advantages of such an approach include:

[i]Such an approach might provide a solution for the embarrassing status of *Tendering Law* .

The *Tendering Law* is not a piece of public procurement legislation *per se*. It regulates tendering activities in both public and private procurement. The *Government Procurement Law* has tried to restrict its application to tendering procedure in procurement of construction (not including procurement of related supplies and services) after the attempt to “swallow” it failed. However, evidence from the new regulations adopted by the SDRC jointly with other ministries shows that institutions behind the implementation of the *Tendering Law* have tried to expand its coverage to procurement of construction-related goods and services in government procurement. Nevertheless, the status of *Tendering Law* as the first national legislation in the area of procurement is embarrassing and modification is ultimately necessary.

Regulations of procurement of state enterprises are closely linked to *Tendering Law* and its implementing regulations. It would be an ideal way forward if the *Tendering Law* is, after necessary amendment, designated to regulate procurement of state enterprises, while the *Government Procurement Law* governs the procurement of government departments and public bodies (social organizations and institutions in Chinese term). The demarcation

line between the scopes of two national laws will no longer be the nature of the procurement projects which is ambiguous and inconsistent, but the nature of the procuring entity. This is in fact proposing a legislative framework similar to the EU public procurement Directives, i.e. one Directive covers the procurement of works, goods and services by public sector, the other Directive covers all procurement of utilities. It can be argued that this approach can better serve the need of procuring public undertakings and state enterprises for more flexible and adequate rules. In the Chinese context, such a structure will arguably enable the *Tendering Law* to walk out of the fear of being swallowed by the *Government Procurement Law* and find its own justifiable and legitimate regulatory purpose. The fact that the application of the *Tendering Law* at present is concentrating in procurement of large infrastructure by state enterprises supervised by the SDRC reinforces such argument and should arguably make the transformation relatively easier.

[ii] Such an approach might provide a way to circumvent the “deadlock” of institutional tension which has impeded the reform of public procurement regime.

The fight for “administrative territory” between government agencies entrusted with the task to supervise the implementation of two conflicting pieces of primary procurement legislation, namely SDRC and MOF, has been the single most significant obstacle for Chinese public procurement legal framework to move forward. A reform starting from the regulation of procurement of state enterprises might arguably provide a way to circumvent such institutional tension.

Chinese government ministries involved in the regulation of procurement of state enterprises include SDRC (large infrastructure and state investment), Ministry of

Construction (urban utility construction), former SETC and new SASAC (state assets management of non-financial state enterprises), Ministry of Commerce (imports of mechanical and electronic products), as well as the Ministry of Finance (procurement of financial state enterprises). The “duel” between SDRC and the MOF for the position of leading authority of overall public procurement regime is less apparent so far as regulating procurement of state enterprises is concerned. The main interest of the Ministry of Finance with respect to procurement of state enterprises is arguably limited to financial state enterprises. Therefore, the coordination between different government ministries for a principled approach to regulating procurement of state enterprises should be arguably easier than designating a single authority for the overall supervision of government procurement. It is suggested that the SDRC, as the investor of the State, and the SASAC, as the manager of state assets can jointly take the leading role in developing such an approach. Once the “territories” of different ministries are successfully divided in this area, in particular, if the function of the *Tendering Law* is transformed as suggested above, the tension between different ministries should be largely defused.

#### **4 Conclusion**

Based the above discussion, it can be safely argued that procurement of state enterprises, especially their procurement of works, construction-related supplies and services and mechanical and electronic products, is to a large extent regulated in Chinese law not only by the primary national legislation on tendering activities (the *Tendering Law*) but also by a number of Ministerial Regulations as well as state enterprises’ internal rules.

However, it is noteworthy that most of these regulations are not designed to



regulate procurement of state enterprises. Their scope of coverage is defined mostly in accordance with the nature of the procurement projects instead of the procuring entity. In that sense, regulating procurement of state enterprises is more like a “by-product” of these regulations. The exceptions are the SETC regulation on procurement of industrial state enterprises and the MOF regulation on procurement of financial state enterprises the scope of which is defined primarily according to the procuring entity instead of the nature of the procurement project. However, the former is arguably too brief to be classified as a procurement regulation and the latter only applies to financial state enterprises and the scope of its covered procurement is not entirely clear.

It can be argued that these domestic laws and regulations adopted and supervised by different government ministries have constitute a “complex net” instead of a coherent legal framework for procurement of state enterprises. Certain procurement project, for example, the procurement of a new water cooling system by a state chemical company to be used in a new factory being built, could arguable qualify, at the same time, as the procurement of construction-related equipment therefore subject to the *Tendering Law* and its implementing regulations adopted by the SDRC; or as a technical innovation project subject to SETC regulations; or as a procurement of electronic equipment subject to the Ministry of Commerce regulations. This has arguably made it difficult for a state enterprise to comply with the rules. In practice, what happens is that the state enterprise will choose to comply with the rules enacted by the authority to which it has applied for funding or subsidy. Another solution is to use the state-owned procuring agency which has been recognized by all those authorities including SDRC, SETC and Ministry of Commerce

such as the China National Tendering Centre for Mechanical and Electronic Equipment established by the SDRC. However, these practical solutions are no substitute to a principled approach to regulating procurement of state enterprises.

It is also noteworthy that tendering has been the main, most of the time the only, means of procurement provided by the above-mentioned domestic regulations. This is arguably because the *Tendering Law* has not offered any alternative procuring methods and the overwhelming goal of such regulation is to strengthen administrative supervision and to restrict discretion of the procuring entity (negotiation is strictly forbidden). How to enable the state enterprise to procure efficiently bearing in mind their commercial environment is not the priority. Furthermore, no provision on new electronic procurement has been included in these regulations although in practice, there have trials of such kind explained above by state enterprises.

In light of the above, and the need to comply with China's WTO commitments and potential GPA obligations discussed in the previous policy paper, it is desirable that a new approach to regulating procurement of state enterprises is necessary. The beneficiaries of the new approach include not only the government but also state enterprises. By adopting a principled approach, state enterprise can avoid legal uncertainty, complexity and disproportionate rigidity of existing regulations. Through consolidating existing rules and on that basis, developing suitable disciplines as well as guidelines (for example, a clear guidance on when and how to use more flexible modern procurement methods such as framework agreement, dynamic purchasing system and electronic reverse auction.), the regulatory burden of state enterprises will arguably be reduced instead of increased. At the

same time, the state enterprise will have a legal support and justification to help resist the arbitrary interference of the government.

The current paper only points out the direction of future policies in this area. More research needs to be done regarding a detailed road map.