in brief...
China's trading success: the role of pure exporter subsidies

China's government provides a wide range of incentives to encourage firms to produce almost exclusively for the foreign market. **Fabrice Defever** and **Alejandro Riaño** analyse the impact of these 'pure exporter subsidies' on both the Chinese economy and the rest of the world – and what would happen if they were removed.

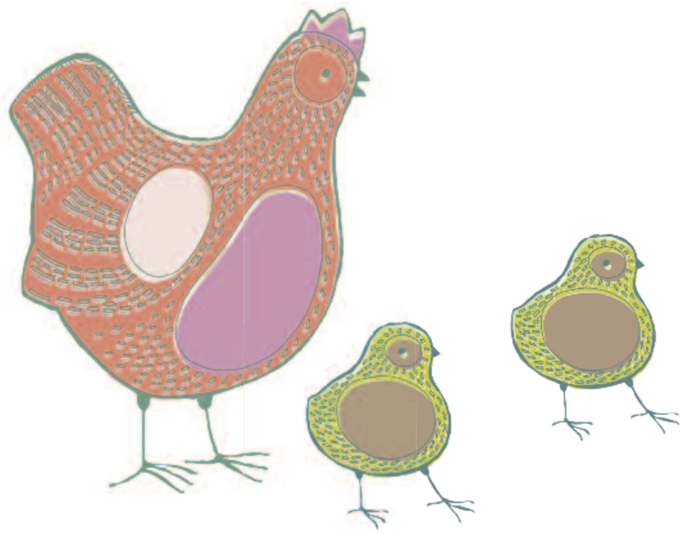
Behind the meteoric rise of Chinese exports in recent years lies an under-appreciated factor: there is a wide range of government incentives aimed at encouraging firms to produce almost exclusively for the foreign market. These incentives – which we call 'pure exporter subsidies' – usually take the form of tax rebates that are conditional on a firm exporting all or most of its production.

For example, until 2008, foreign-owned firms in China that exported over 70% of their production enjoyed a 50% reduction in the corporate income tax rate. By locating in one of the numerous special economic zones, firms could benefit from an even lower rate. Additional benefits included VAT rebates and lower tariffs on imported machinery and intermediate inputs, direct cash subsidies, discounted utility and land rental rates and easier access to finance.

Our research finds that as a direct consequence of these subsidies, over a third of Chinese manufacturing exporters sell more than 90% of their produce abroad. To put this in perspective, fewer than 2% of French exporters and 0.7% of US exporters display such high export intensity (Bernard et al, 2003). Our analysis suggests that China's total spending on these subsidies could be as much as 1.5% of GDP to support such a large number of pure exporters.

Putting strong reliance on encouraging exports while at the same time protecting the domestic market has been a cornerstone of China's transition to a market economy (Naughton, 2007). Since the late 1970s, China has been characterised by a dualistic trade regime in which a system of export-oriented enclaves co-exist with a highly protected domestic economy, a situation described as 'one country, two systems' (Feenstra, 1998).

Ultimately, as a consequence of the use of pure exporter subsidies, Chinese consumers are faced with higher prices while foreign consumers reap the benefits of cheaper subsidised goods. Our evidence suggests that by stopping this type of trade policy, China stands to experience a 3% gain in real income. Without these subsidies, imports from China would become more expensive, which would lead to a 1% loss in real income for consumers in the rest of the world.



China's pure exporter subsidies not only boost exports but also protect domestic firms from foreign competition

There is a wide consensus among economists that export subsidies are not beneficial for an economy – and pure exporter subsidies are no exception. The intuition is that an export subsidy is enjoyed by foreigners who get to purchase subsidised goods at a lower price at the expense of domestic consumers.

But our analysis reveals that besides this detrimental effect (and unlike regular export subsidies), encouraging firms to export most of their production effectively shields domestic producers from tougher international competition. Thus, pure exporter subsidies constitute a mercantilist trade policy, which boosts exports while simultaneously protecting China's local industry.

Although we estimate the overall impact of pure exporter subsidies on China's welfare to be negative, two factors might help to explain their widespread use by the Chinese authorities. First, the subsidies have been instrumental in concentrating a tremendous amount of manufacturing activity in China, which has, in turn, facilitated the massive relocation of surplus labour from rural areas to the cities.

Second, the fact that the subsidies help to shield local producers from foreign competition could contribute to an easing of resistance to other market-oriented reforms. As other researchers have noted, the desire for achieving 'reform without losers' has been a crucial guiding principle underlying China's approach to making the transition to capitalism (Lau et al, 2000).

But while adverse economic conditions linger in developed countries, there is mounting pressure for China to re-orient its economy towards its domestic market – a sentiment that was echoed in the twelfth five-year plan unveiled by the Central Committee of China's Communist Party in 2010.

At the same time, complaints by the United States, the European Union and other members of the World Trade Organization have also resulted in China scrapping various subsidies to pure exporters, most notably their favourable treatment by the corporate income tax code. Our study indicates that this is indeed the right path for China to follow.

This article summarises 'China's Pure Exporter Subsidies' by Fabrice Defever and Alejandro Riaño, CEP Discussion Paper No. 1182 (http://cep.lse.ac.uk/pubs/download/dp1182.pdf).

Fabrice Defever and **Alejandro Riaño** are at the University of Nottingham. Defever is a research associate in CEP's globalisation programme.

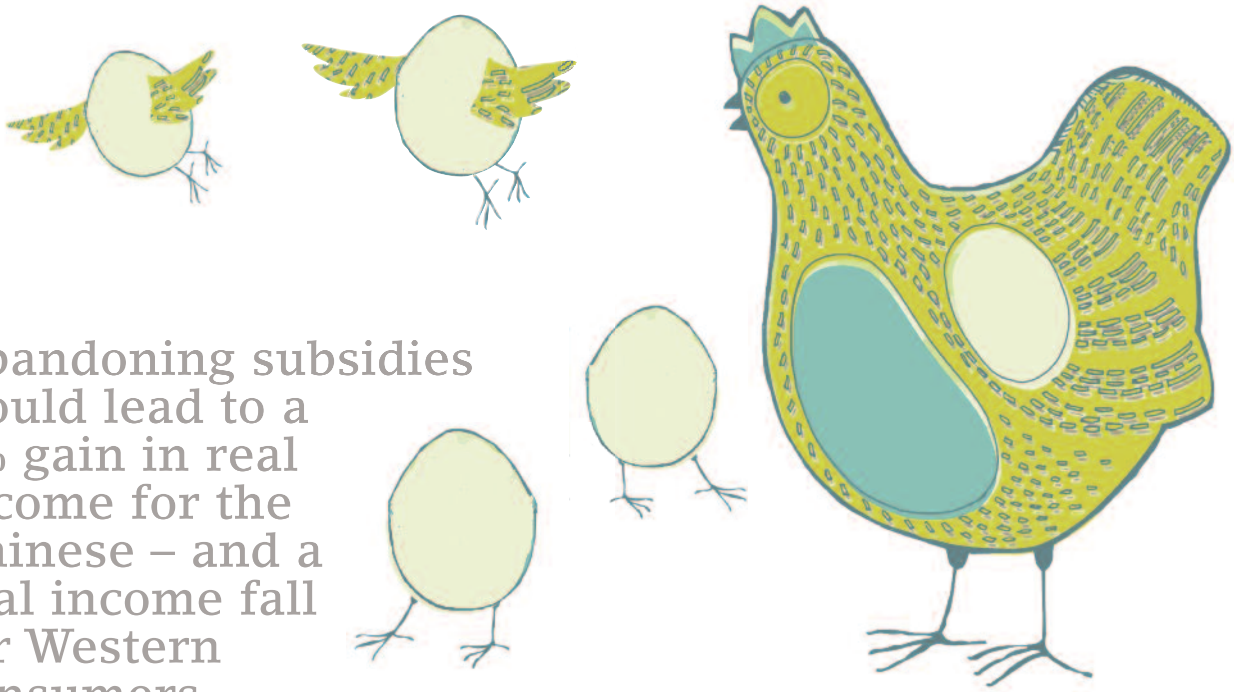
Further reading

Andrew Bernard, Jonathan Eaton, Bradford Jensen and Samuel Kortum (2003) 'Plants and Productivity in International Trade', *American Economic Review* 93: 1268-90.

Robert Feenstra (1998) 'One Country, Two Systems: Implications of WTO Entry for China', manuscript, University of California, Davis (http://www.econ.ucdavis.edu/faculty/fzfeens/pdf/onecountry.pdf).

Lawrence Lau, Yingyi Qian and Gerard Roland (2000) 'Reform without Losers: An Interpretation of China's Dual-Track Approach to Transition', *Journal of Political Economy* 108: 120-43.

Barry Naughton (2007) *The Chinese Economy: Transitions and Growth*, MIT Press.



Abandoning subsidies would lead to a 3% gain in real income for the Chinese – and a real income fall for Western consumers