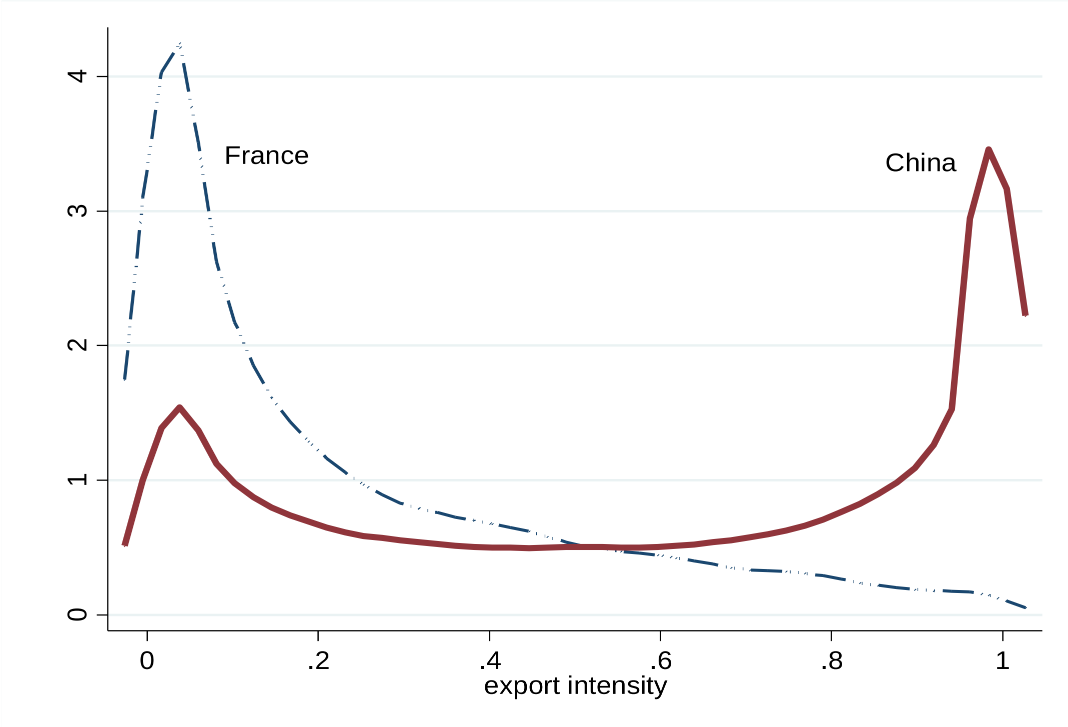
China’s Pure Exporter Subsidies: Protectionism by Exporting.

On September 17, 2012 the United States requested consultations with China concerning a wide range of export-contingent measures -- grants, tax preferences and interest-rate subsidies— totaling at least US$1 billion, in apparent violation of the World Trade Organization’s (WTO) Agreement on Subsidies and Countervailing Measures, China’s accession Protocol and article XVI of the GATT. The EU joined the consultations shortly after on September 28.

Although the nature of China’s subsidies has always been murky, an issue that the US, the EU, Canada and other countries have repeatedly raised at the WTO over the last decade, it is not widely appreciated that several of these subsidies are conditional on firms exporting all or the majority of their output. These are what we would call ‘pure-exporter subsidies’.

Figure 1: kernel density of export intensity in France and in China.



As a result of these policies, a large number of manufacturing firms in China export all or almost all of their production. Between 2000 and 2006, more than a third of Chinese manufacturing exporters sold 90% or more of their output abroad. In contrast, as can be seen in Figure 1, less than 2% of French exporters display such high export intensity; similarly, Bernard et al. (2003) report a corresponding figure of 0.7% for US exporters.

In our latest research article "China's Pure Exporter Subsidies", we provide the first in-depth analysis of the economic implications of pure exporter subsidies for China and the rest of the World. We show that pure-exporter subsidies not only boost exports but, unlike regular export subsidies, also protect China's domestic firms from foreign competition.

A strong reliance on encouraging exports while at the same time protecting the domestic market has been a cornerstone of China's transition into a market economy (see e.g. Naughton, 2007). Since the late 1970s, China has been characterized by a dualistic trade regime in which a system of export-oriented enclaves coexist with a highly protected domestic economy; a situation that Feenstra (1998) described as "one country, two systems."

Ultimately, Chinese consumers are faced with higher prices while foreign consumers reap the benefits of cheaper subsidized goods. We show that eliminating these subsidies would improve welfare in China by 3% while reducing welfare in the rest of the World by 1%.

Which firms benefit from these subsidies?

The large number of widely spread pure exporter subsidies (some of them quite short-lived) makes them extremely difficult to keep track off in a systematic manner. However, we are able to identify three types of firms which were more likely to receive preferential treatment under the laws and regulations effective in China between 2000 and 2006, conditionally on them exporting most of their production. These include **Foreign-invested Enterprises (FIEs),** establishments devoted to export processing activities, i.e. **Processing Trade Enterprises (PTEs)**, and private-owned firms located within **Free Trade Zones (FTZs).**

Table 1 presents the statutory corporate income tax rates that applied for different types of firms between 1991 and 2008, perhaps one of the clearest examples of a policy instrument favoring pure exporters.

> China's corporate income tax law in place between 1991 and 2008 stated that the standard corporate income tax rate for Chinese-owned firms operating in China was 30%. However, FIEs exporting more than 70% of their production faced a lower income tax rate of just 15%. Additionally, if these firms happened to be located in a FTZ, they would see their income tax rate further reduced to 10%. Moreover, in all FTZs, Chinese-owned enterprises exporting more than 70% of their production faced a 10% corporate income tax rate, regardless of their ownership structure or trade regime under which they operated.

Table 1: China's corporate Income tax rate, 1991-2008.

	National Tax Rate	Free Trade Zone (FTZ)	
		Special Economic Zones	Coastal Development Zones
Export/sales ratio			
	Foreign-Invested Enterprises (FIE)		
Below 70%	30%	15%	24%
Over 70%	15%	10%	10%
	Production Enterprises		
Below 70%	30%	15%	15%
Over 70%	30%	10%	10%

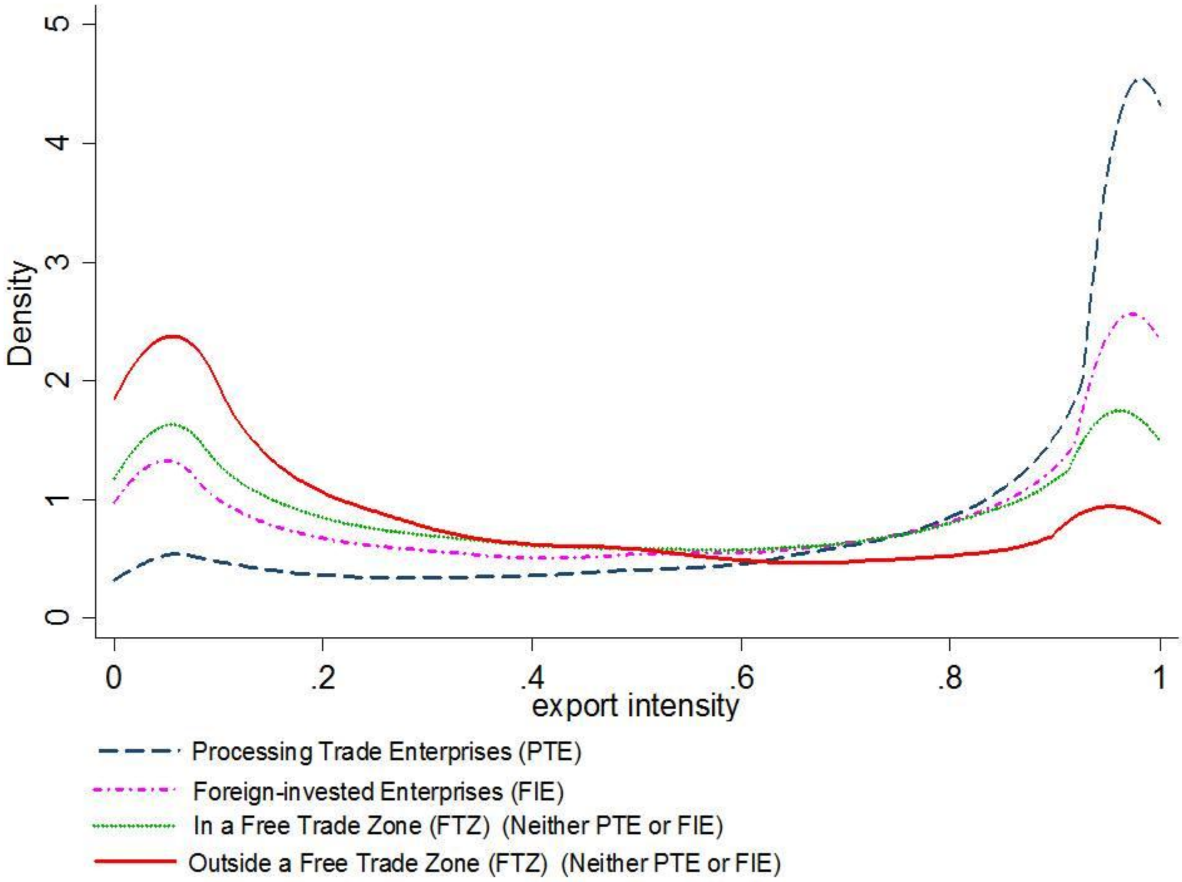
Another example is the Processing Trade Enterprises (PTEs), which face a strict control over their domestic sales. These enterprises are allowed to import inputs duty free as long as they are not used for domestic consumption. If any output is sold in the domestic market, firms must promptly pay the tariffs and value-added taxes on the imported materials. More importantly, they must obtain approval from both the provincial commerce authorities and customs for an import licence. Failing to do so translates into a penalty ranging from 30 to 100 percent of the declared value of the imported materials and parts.

Evidence from firm-level data

By matching firm-level data from the Annual Survey of Manufacturing Firms with custom-based export transactions for the period 2000-2006, we are able to identify FIEs and PTEs as well as private firms located in Free Trade Zones. Altogether, these three types of firms account for 90 percent of the exporters in our data. These three types of exporters may benefit from a wide array of subsidies that are conditioned on them exporting all or most of their production. Conversely, firms located outside a FTZ and which are neither FIEs nor PTEs, constitute only 10 percent of all exporting firms.

Figure 2 shows the distribution of export intensity across the three groups of firms described above and of firms located outside a FTZ and which are neither FIEs nor PTEs. Pure exporters are more prevalent among PTEs, while FIEs and firms located in a FTZ exhibit a greater degree of bimodality. The export intensity for the residual group of firms displays a majority of firms selling a small share of their output abroad, the more common pattern documented for manufacturing firms in other countries (closer to France's export intensity distribution shown in Figure 1).

Figure 2: Export Intensity Distribution by Firm Type and Location.



A new form of protectionism

By attracting multinational affiliates and compelling them to export all of their production, China has protected its low-productivity domestic companies from competition while simultaneously boosting exports. The Promotion of processing trade enterprises and the establishment of FTZ are geared towards the same objective. In contrast, a standard export subsidy, allows exporters to expand at the expense of the domestic firms inducing exit of the least productive firms serving only the domestic market.

Our work shows how pure-exporter subsidies contribute to this strategy by boosting exports while simultaneously protecting the least efficient, domestically-oriented firms. Furthermore, our analysis shows that Chinese consumers are adversely affected by the use of pure-exporter subsidies; their aggregate expenditure falls because they need to finance the subsidy, while facing lower consumption variety and higher prices due to the protection that the subsidy provides to low-productivity firms. For consumers in the rest of the World, on the other hand, these pure exporter subsidies have resulted in a greater variety of cheaper imported products. Eliminating these subsidies will improve the welfare of Chinese consumers while increasing the price of consumer goods elsewhere.

One of the main goals of the Twelfth Five-Year Plan unveiled in October 2010 is to redirect China's focus towards its domestic economy emphasizing growth based on domestic consumption. Abandoning pure exporter subsidies will be an important first step in this direction.

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