China's Mercantilist Subsidies

Beijing supports exporters, Western consumers benefit and the Chinese people lose.

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Washington has accused Beijing of providing at least $1 billion in illegal subsidies to auto firms in China from 2009-11. The two sides began dispute settlement consultations at the World Trade Organization on Sept. 17, and the European Union joined in this week. The case revolves around a variety of export-contingent subsidies—grants, tax preferences and interest-rate subsidies—in apparent violation of WTO rules.

The exact nature of these subsidies has always been murky. It is not widely appreciated that several of them are conditional on firms exporting all or the majority of their output—what we might call "pure-exporter" subsidies. Our latest research at the Nottingham School of Economics offers the first in-depth analysis of the effect of China's pure-exporter incentives on both China and the rest of the world.

Our main finding is that pure-exporter subsidies not only boost exports but, unlike regular export subsidies, also protect China's domestic firms from foreign competition. 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%.

As far back as 2003, just two years after China's accession to the WTO, the European Community posed a polite but prickly question about China's Transitional Review Mechanism on Subsidy Practices: "In certain zones companies are apparently only allowed to locate when they enter obligations to export a certain minimum percentage amount of their production. Can China please explain how such practices are compatible with the obligations arising from the accession protocol?" Article 3 of the WTO's Agreement on Subsidies and

Countervailing Measures explicitly prohibits the use of subsidies contingent upon export performance.

Brussels' curiosity was especially aroused by the case of the Shanghai Foreign Investment Center, where companies exporting the majority of their production were said to benefit from a range of privileges like priority access to infrastructure, loans and land. Firms exporting more than 70% of their production were also exempted from local income tax and obtained a reduced corporate tax.

This is just the tip of the iceberg. Some 90% of exporters in China are foreign affiliates, processing plants or private Chinese firms located in free-trade zones. 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.

As a consequence, one-third of Chinese exporters sell more than 90% of their production abroad. Less than 1% of U.S. exporters sell such a high proportion of their output in foreign markets.

It is incredibly difficult to observe the actual amount of money devoted to these subsidies, but any realistic extrapolation must inevitably conclude that it is enormous. Our quantitative model suggests that pure exporters would receive close to 25% of their value-added in subsidies.

A heavy reliance on encouraging exports while protecting the domestic market has been a cornerstone of China's economic policies during the past two decades. 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. Promoting processing trade enterprises and establishing free-trade zones are geared towards the same objective.

The result is that China has boosted its exports while at the same time making it far less profitable for foreign firms to penetrate its domestic market. Accession to the WTO in 2001 may have led to certain modifications, but the basic philosophy remains intact. Most of the laws and regulations favoring pure exporters still apply today.

Following successive requests by Brussels and Washington in 2003 and 2004, Beijing finally provided in 2006 its first and only subsidy notification for the first 10 years of its WTO membership. Although the notification reported more than 70 subsidy programs, further investigation carried out by the U.S. trade representative showed that hundreds of subsidies, including a large number aimed at pure exporters, had been omitted from the notification.

So after 2006, the EU, the U.S. and other countries stopped questioning and began appealing for countervailing measures. This forced China's hand, leading it to modify its corporate tax law in January 2008, ending the preferential treatment of pure-exporting multinationals. It also scrapped a large umbrella of programs (with names like "China World Top Brand") that doled out subsidies conditional on firms' exporting performance.

Now the issue has become a political football. Republican nominee Mitt Romney suggested last month that the Democrats had "spent 43 months failing to confront China's unfair trade practices." Maintaining the rhetoric, President Obama was quick to declare: "When other countries don't play by the rules we've done something about it. We brought more trade cases against China in one term than the previous administration did in two."

What Messrs. Obama and Romney seem to forget is that these export subsidies have translated into cheap imported products for U.S. consumers. In other words, America's cut-price smartphones and the like are partially paid for by Chinese citizens—taxed by their government to support its export-oriented strategy.

For American politicians, the problem with these subsidies is the resulting competitive pressure on U.S. manufacturing firms, which are in turn prevented from selling in China. From China's perspective, the use of these subsidies has allowed an unprecedented expansion of the Chinese manufacturing sector, which has been instrumental in mobilizing workers from the rural inlands to the industrialized coast.

In a sluggish global economy, however, China will not be able to grow at 10% over the coming decades without redirecting its focus towards its domestic market. Growth must now come from within, and the abandonment of pure exporter subsidies will be a first step in this direction.

The WTO has proved incapable of forcing an end to these subsidies, but policy changes are taking place—albeit slowly. The corporate tax law revision of 2008 and the ditching of the various branding initiatives suggest China is gradually winding down its preferential treatment of pure exporters.

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