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December 10, 2007

BY HAND DELIVERY

The Hon. David Spooner
Assistant Secretary for Import Administration
U.S. Department of Commerce
14th Street & Pennsylvania Avenue, NW
Washington, DC 20230

Re: *Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise*

Dear Assistant Secretary Spooner:

On behalf of Nucor Corporation, we respond to the Department's request for comments regarding whether and under what circumstances it should consider granting market-economy treatment to individual respondents in antidumping cases involving China.[1] The Department identified three particular issues that it hopes commenters will consider. These include the Department's legal authority to create a market-oriented enterprise test, the administrative feasibility of such a test, and to what extent the Department can rely on non-market economy costs and prices in calculating the dumping margin for individual entities in non-market economies.

As indicated in Nucor's July 5, 2007 response to the Department's last request for comments on this issue, Nucor vigorously opposes any plan for treating individual Chinese respondents as market-oriented. Economic realities in China are such that any plan to do so would be irrational. No participant in an industry or

[1] *Antidumping Methodologies in Proceedings Involving Certain Non-Market Economies: Market-Oriented Enterprise*, 72 Fed. Reg. 60,649 (Dep't Commerce Oct. 25, 2007) (request for comments).

economy exists alone; its actions are affected by the market (or lack thereof) that surrounds it. Given the Chinese government's ownership and control over land, labor, finance and capital, and many companies themselves, it is simply not possible for a Chinese company to be market-oriented.

In the particular case of the Chinese steel industry, it is abundantly clear that no company can possibly be market oriented. Government ownership and control over the industry is simply too great. No player in the industry is free from this ownership and control, or from its effects on the industry as a whole. Thus, as a logical matter, a "market-oriented enterprise" test for Chinese steel producers makes no sense.

In addition to the logical difficulties presented by such a proposal, the three issues that the Department raised in its request for comments all militate against the proposal for a market economy treatment of individual Chinese companies. A test for market-oriented enterprises would embroil the Department in a scheme for which there is no legal authority under the Tariff Act of 1930. Even if permissible, such a test cannot be applied in any way that would not be administratively unworkable, requiring an outlay of staff and resources that the Department simply does not have. Finally, even if instituted, a market oriented enterprise test would be of dubious usefulness, because even an enterprise that "passed" the test would necessarily rely on non-market inputs, such that its own costs could not be used to calculate an accurate dumping margin. Thus, in respect of the three issues stressed in the Department's request for comments, the proposal for market-oriented enterprise treatment fails.

I. ECONOMIC CONDITIONS IN CHINA DO NOT PERMIT THE RATIONAL APPLICATION OF A TEST FOR MARKET ORIENTED ENTERPRISES

China's economy simply has not made sufficient progress toward being market-based for any market-based companies to exist there. Not until China auctions off its state-controlled means of production, and frees land, labor, and capital from government control, will there be any "market-oriented" enterprises in that country. As the Department itself has recognized, "the {Chinese government} still reserves for itself considerable levers of control over the economy and its direction."[2] Further, the U.S.-China Economic and Security Review Commission, it in its most recent report to Congress, concluded that China's efforts to liberalize its economy are slackening.[3]

Chinese companies are generally characterized by high levels of government ownership and palpable indicia of government control. This ownership and control is particularly pronounced in the steel industry, where the government outright owns

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2 Memorandum from Shauna Lee-Alaia et al., Office of Policy, Import Administration, to David M. Spooner, Assistant Sec'y, Import Administration, re: *Anti-Dumping Investigation of Certain Lined Paper Products from the People's Republic of China ("China") – China's status as a non-market economy ("NME")* at 5 (Aug. 30, 2006) ("Lined Paper NME Memo").

3 U.S.-China Economic and Security Review Commission, 2007 Annual Report to Congress , at 20 (Nov. 2007) ("USCESRV Report"), attached as Exhibit 1.

nearly 100% of the top twenty steel producing companies, and where even small producers have significant ties to provincial and local governments. Accordingly, a "market-oriented" steel-making enterprise cannot exist in China, and it would be irrational to test for one's existence.

Moreover, every enterprise in China suffers from the influence of significant, economy-wide distortions that affect prices for inputs and outputs, including governmental control over capital, land, and labor. Even if a Chinese company were, itself, to have no government ownership, and to be free of indicia of government control, that company would still have to operate in a non-market economy. It would necessarily rely on non-market inputs and non-market output prices. This, along with the distorting influence of government ownership and control over capital, land, and labor would render the company's information completely unsuitable for calculating a dumping margin.

Finally, China is not likely to resolve these issues quickly. While the country has made some limited market reforms, it is not accelerating its market liberalization program. Rather, the government appears poised to retrench from even those limited reforms that it has undertaken. Not only would a market-oriented economy test not be suitable for Chinese companies in their present condition, it appears unlikely that such a test could be rationally applied any time in the foreseeable future.

A. The Chinese Government Owns the Country's Steel-Making Enterprises and other Key Enterprises

The Chinese government has identified steel production as a "strategic" or "pillar" industry.[4] The central government's Tenth Five-Year Plan for National Economic and Social Development specifically provides that the "state must hold a controlling stake in strategic enterprises that concern the national economy."[5] This concern is reflected in the actual ownership of China's steel producers.

Eight of China's ten largest companies are wholly owned or controlled by the government. Nineteen of the top twenty Chinese steel producing companies are majority owned or controlled by the government. Within the top twenty steel-making companies, 91 percent of production is state-owned or controlled.[6] Moreover, a closer examination of the major so-called private steel producers reveals significant state ownership in at least seven of the top ten private enterprises.[7] In addition, due to the overlapping ownership interests of the central

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4 USCESRV Report at 20; *see also* Wiley Rein LLP, *Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry* (July 2007) 8-10, ("*Money for Metal*"), attached as Exhibit 2.

5 *See* Gov't of the PRC, *The Tenth Five Year Plan for Nat'l Economic and Social Dev. – People's Republic of China*, available at http://ilo.org/public/english/employment/skills/hrdr/init.chn_1.htm, attached as Exhibit 3.

6 *Money for Metal* at 8-10, attached as Exhibit 2.

7 Wiley Rein LLP, *Government Ownership and Control of China's "Private" Steel Producers* (Oct. 2007), 1, *available at* http://www.wileyrein.com/docs/publications/13322.pdf ("*Government Ownership and Control of China's "Private" Steel Producers*"), attached as Exhibit 4.

Chinese government and provincial and local governments, numerous state actors have vested interests and control over the direction of the individual steel companies and industry as a whole.

The Chinese government also retains substantial ownership interests in the automotive and automotive parts industry, which uses steel as a major input. The Chinese government considers automobile manufacture, like steel, a "heavyweight" industry in which the government must maintain substantial involvement and control.[8] Many of China's large auto parts manufacturers are affiliated with vehicle assembly groups that are owned in part by Chinese local governments. Other unaffiliated auto parts companies are owned directly by the Chinese government, giving these companies access to government loans, equity infusions, and excess retained earnings.[9]

Government ownership of individual companies and industries is pervasive throughout China. The fact that the Chinese government, at all levels, can direct companies and industries to act in ways that maximize tax revenue or employment,

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(Continued . . .)

8 USCESRV Report at 38-39, attached as Exhibit 1.

9 Andrew Szamosszegi, *How Chinese Government Subsidies and Market Intervention Have Resulted in the Offshoring of U.S. Auto Parts Production: A Case Study* at 17, attached as Exhibit 5 ("*Chinese Auto Parts Production Paper*").

rather than further market aims, provides an almost insurmountable hurdle to the application of a market oriented enterprise test.

B. The Chinese Government Exercises Control Over Domestic Enterprises

The Chinese government does not merely passively own the means of production. Indeed, even in those industries where the government lacks significant ownership, it still exercises a significant amount of overt control. In the steel industry, where levels of government ownership are extremely high, these indicia of control are magnified, and preclude the rational application of a market-oriented enterprise test to individual Chinese steel companies.

1. The Chinese Government Controls Industrial Development Through Five-Year Plans

Industrial policy in China is governed by "Five-Year Plans," issued by the Central Committee of the Communist Party of China. These plans set forth which industries, enterprises, and products should be targeted for preferential government support. According to the Chinese government, Five-Year Plans aim to "arrange national key construction projects, manage the distribution of productive forces and individual sector's contributions to the national economy, map the direction of future development, and set targets."[10] In December of 2006, the Chinese

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10 *See* What is the Five Year Plan, *available at* http://www.china.org.cn/english/MATERIAL/157595.htm, attached as Exhibit 6.

government identified both the steel and automobile sectors (a heavy user of steel as an input) as "heavyweight" industries, in which the government will maintain continued, heavy involvement.[11]

The centralized Five-Year Plans for the steel industry specifically prescribe the number and size of steel producers, their location, the type and mix of products that they are permitted to produce, and what technology can be utilized in steel production.[12] Similarly, a recent Five-Year Plan for the automotive industry overtly states the government's objective to "develop a number of vehicle parts enterprises that will realize scale production and edge into the international automobile parts procurement system, and take an active part in international competition."[13] Provincial and local governments exert a similar influence over smaller producers, through their own provincial and local plans. As a result of this web of government direction, China's domestic producers operate in an environment where basic market forces—supply, demand, and comparative advantage—do not exist or apply.

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11 USCESRV Report at 20, attached as Exhibit 1.

12 *See* Steel and Iron Industry Development Policy, Order No. 35 of the National Reform and Development Commission, July 2005, at Art. 20, attached as Exhibit 7.

13 *The Tenth Five Year Plan of the Automotive Industry and its Development*, China Daily, available at http://bizchina.chinadaily.com.cn/guide/industry/industry2.htm, attached as Exhibit 8.

2. Chinese Government Officials Often Act as Senior Officers and Directors of Chinese Companies

The Chinese government also exercises influence and control over domestic companies and industries by installing party members or other government officials as senior officers and directors of Chinese companies. This practice is particularly prevalent in the steel industry. For instance, many directors and supervisors of Maanshan Iron & Steel serve as government officials or as officers in state-owned banks. Even in the so-called private steel companies, many owners, directors, and managers are Communist Party officials.[14] This ensures that the Chinese government will have effective control over the individual companies through direct participation in company management.

3. The Chinese Government Influences Company Decision-Making Through an Extraordinary Range of Subsidies

Further, application of an extraordinary range of subsidies essentially eliminates an individual company's ability to make decisions regarding price, output, sales, and investment in response to market signals. A study of a limited number of Chinese steel companies showed that the Chinese government contributes more than RMB 300 billion (US$ 52 billion) to Chinese steel producers. These subsidies are used as (1) vehicles to carry out government policy, (2) equity infusion and/or debt-to-equity swaps, (3) land-use discounts, (4) incentives for

14 *Government Ownership and Control of China's "Private" Steel Producers* at 4, attached as Exhibit 4.

government-mandated mergers and transfers of ownership, (5) tax incentives, and (6) direct cash grants. For instance, the central Chinese government, in an effort to create several consolidated world-class entities, has directed the consolidation of the steel industry in China by permitting acquisitions at little to no cost and ordering certain state-owned steel companies to offer ownership stakes to other companies.[15] To illustrate, in May 2007, Baosteel, China's second largest steel producer, received a 48.46 percent stake in Xinjiang Bayi Iron & Steel Group at no cost.[16] Such cost-free mergers and acquisitions would be unthinkable in a market situation.

The Chinese government provides many of the same sorts of subsidies to steel-consuming industries, such as the auto parts industry. Similar to the steel industry, the Chinese government has identified the development of the auto parts industry as a matter of national pride; thus, "generous government subsidies have 'force fed' the nascent automotive sector in China."[17] The Chinese government also utilizes these subsidies to lure foreign companies into relocating production facilities to China. In return for this market access, foreign companies are required

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15 *See Money for Metal* at 3, 45, attached as Exhibit 2.

16 *Id.* at 45.

17 *Chinese Auto Parts Production Paper, supra* note 9, at 4, attached as Exhibit 5.

to make technology transfers, establish research and development facilities, and use Chinese-made auto parts in their vehicle assembly operations.[18]

Aside from the steel and auto parts industries, the Chinese government has lavished subsidies on numerous domestic industries, including textiles, petrochemical, high technologies, forestry and paper products, machinery, and copper and other non-ferrous metals.[19] The world trading system is based on the principle that trade must be governed by market forces, not government fiat. The Chinese government, however, has spurned this notion by consciously funneling resources to particular industries and enmeshing itself in the economy as a whole.

C. Chinese Government Control Over Capital, Land, and Labor Distorts the Entire Economy

Above and beyond governmental ownership control over individual manufacturing industries, governmental control over capital, land, and labor serve to render the entire economy's factors of production unrepresentative of their true value. With regard to capital, the government's control over banking and finance permit it to offer subsidized loans and loan forgiveness to favored companies in a manner that does not reflect market principles. Similarly, the government is able to enforce currency controls that distort monetary transactions throughout the entire economy. With respect to land, the government's ownership of all land throughout

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18 *Id.* at 3.

19 United States Trade Representative, *2006 National Trade Estimate Report on Foreign Trade Barriers* 120 (Mar. 2006), attached as Exhibit 9.

the country permits it to offer land and buildings at no cost to favored businesses and industries, while simultaneously restricting the free and efficient movement of business. Finally, all labor in China is subject to government control, leaving China with no real labor market, and severely restricting the rights of both workers and employers to freely and efficiently enter into labor contracts. This permits the government to further subsidize favored industries and businesses while depriving others of access to needed resources.

1. Government Control Over Capital Distorts the FOP of All Chinese Companies

Subsidized loans and debt forgiveness are funneled toward producers with significant state ownership and control. Given the government's control over capital, even if a given Chinese enterprise was itself entirely free of government ownership, government control, and government subsidies, it would still not be market-oriented. The company's costs and prices would be distorted by non-market aspects of other economic sectors.

The Chinese government maintains stringent ownership and control over the country's banking and financial sector, such that these sectors are not reflective of market principles. The central government owns all of China's major banks—the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Agricultural Bank of China—and smaller banking entities are usually owned and controlled by provincial and local governments.

Such state-owned banks make subsidized loans based on political directives from the central or provincial/local governments, representing one of the most widespread forms of subsidy in China.[20] At the government's behest, these "policy loans" are channeled to favored industries, despite indications of uncreditworthiness.[21] For instance, the Tieben Steel project in Jiangsu province resulted in non-performing loans worth billions of yuan.[22]

When Chinese companies default on these loans, state-owned banks forgive the debt and have repeatedly been willing to exchange unpaid debt for shares.[23] Two of China's largest steel producers, Shanghai Baosteel and Anshan, have benefited from this process.[24] The Chinese government, all the while exercising its control over the banking and financial sector, then injects cash into the state-owned banks to relieve insolvency problems resulting from these poor loan decisions.[25]

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20 USCESRV Report at 40, attached as Exhibit 1.

21 *See* Wiley, Rein & Fielding LLP *The China Syndrome: How Subsidies and Government Intervention Created the World's Largest Steel Industry* 25 (July 2006) ("*The China Syndrome*"), attached as Exhibit 10.

22 *See China Gov't Warns of Possible Rebound in Non-Performing Loans*, Asia Pulse, Sept. 20, 2004, attached as Exhibit 11.

23 *See The China Syndrome* at 17, attached as Exhibit 10.

24 *See id.* at 22-23.

25 *See The China Syndrome* at 24. Indeed, according to the Working Policy Report on China's accession to the WTO, "when state-owned enterprises, including banks, provide financial contribution they are doing so as government actors," attached as Exhibit 10. WTO No. G/SCM/118 (Nov. 9, 2005) at 12, attached as Exhibit 12.

Further compounding the government's dominion over the financial sector, China does not permit foreign exchange rates to fluctuate with market forces. Rather, the government maintains significant controls on the FOREX market and on capital account transactions, such that the convertibility of *renminbi* ("RMB") is extremely limited. The People's Bank of China, a government-owned and controlled entity, manages the exchange rate so as to permit only limited fluctuation, which does not reflect the international currency market, or the actual market value of the RMB vis-à-vis other currencies. As a result of China's longstanding policy of deliberately keeping the value of the RMB below its market value, many experts estimate that the yuan is undervalued anywhere from 25 to 50 percent.[26] In effect, this makes exports of Chinese products artificially cheap and acts as a tax on imports to China.[27] As result, neither prices in nor do prices coming out of China reflect the prices available in an open market. The distorting effects of China's governmental control over capital affect every Chinese producer.

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26 *Chinese Auto Parts Production Paper*, *supra* note 9 at 25, attached as Exhibit 5.

27 *See The China* Syndrome at 45-47, attached as Exhibit 10; USCESRV Report at 3, attached as Exhibit 1.

2. Government Control Over Land Distorts the FOP of All Chinese Companies

In addition to government control over China's financial sector, by law, all land in China remains the property of the state or rural collectives.[28] Because all land in China is owned and controlled by the government, no steel company owns the land beneath its factories or the mines from which it obtains coal and iron. Further, the Chinese government provides steel producers use of land at a fraction of its market value.[29] Steel companies are granted land-use rights, usually in heavily subsidized lease agreements. The land-use rights, often classified as normal, depreciable assets, are then booked at their original "cost," amortized on an annual basis, and then carried at the reduced value. Using the annual amortization charge as a proxy for annual rental payments, it becomes apparent that Chinese steel producers reap the benefits of state-owned land at prices far below any market determined rental value. Indeed, it appears that some Chinese steel producers have

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[28] The Property Law of the People's Republic of China, adopted at the Fifth Session of the Tenth National People's Congress on March 16, 2007, promulgated by Order No. 62 by the President of the People's Republic of China on March 16, 2007 and effective as of October 1, 2007. The new property law restates principles found in China's Constitution and Land Law.

[29] *See The China Syndrome* at 21-22 (providing an in-depth discussion of accounting for land-use rights by Chinese steel mills, including Angang Steel Group and Baosteel), attached as Exhibit 10.

been given the right to use the land for free.[30] Without a market for land, it is impossible to have an enterprise fully operating under free market principles.

3. Government Control Over Labor Distorts the FOP of All Chinese Company

The Chinese government controls all labor in China. The rights of workers and companies to freely enter into contracts is severely curtailed. For example, China has only a single, governmentally-controlled labor union. Workers are prohibited from forming independent unions, from striking for better conditions, or otherwise engaging in collective bargaining. Labor mobility is restricted through systems of internal passports and residency papers that prohibits workers from relocating to places with better employment prospects and depresses local wages.

Clearly, the distorting effects of such a restricted labor market extend throughout the entire economy. In particular, they mean that no company's labor costs reflect the market value of that labor. Workers cannot demand or obtain premiums for dangerous work, compensation for overtime, hazardous conditions, or otherwise ensure that their pay is commensurate with the risks, hazards, and characteristics of their work. Simply put, wages in China are not market-based.

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30 *See To Clean Air, Aid Climate, China Looks to End Polluters' Tax Breaks, Other Perks*, The Associated Press, Apr. 27, 2007, attached as Exhibit 13; Tung-Pi Chen, *Emerging Real Estate Markets in Urban China*, 8 Int'l Tax & Bus. Lawyer, No. 78 at 81 (1990-1991), attached as Exhibit 14.

As a result of significant economy-wide distortions in the Chinese markets for capital, land, and labor, there cannot be a "market-oriented" enterprise in China. The Department's own recent analysis of China's economy confirms this.[31] As the Department has found, the Chinese government has control over (1) currency rates, (2) resource allocation, and (3) labor costs, along with the means of production. China also faces institutional weaknesses regarding property rights, bankruptcy, and the rule of law that further distort costs and prices for all businesses participating in the Chinese economy.

D. China is Not Accelerating Market Reforms

The Chinese economy presently lacks indicia of market pressures. Large sectors of the economy are owned and controlled by the government, and government ownership and control over capital, land, and labor affect every company operating in China. Nor is this changing. While China has made limited attempts at market reform, it has not done so quickly, and appears to be retrenching from even those limited reforms that it has made. Rather, as the U.S.-China Economic and Security Review Commission has concluded, "China is unwilling to embrace market-oriented mechanism, because it maintains a preference for authoritarian controls over its economy."[32] Further, the Chinese government has

[31] *See generally* Lined Paper NME Memo.

[32] USCESRV Report at 2, attached as Exhibit 1.

expressed great hesitancy over those reforms that it had enacted, and has only made reforms under pressure from other players in the global economy.[33]

In fact, the central government has recently recommitted itself to continued ownership and control over "pillar" industries.[34] Over 155 of China's largest companies, including nearly all large banking institutions, remain squarely under the control of the government.[35] China continues to grant extensive subsidies to such countries, as well as granting export rebates, tax holidays, and lax enforcement of environmental regulations for favorite industries and enterprises.[36] Finally, the government continues to refuse to permit its currency to fluctuate in accordance with market principles.[37]

The Department has found that the government of China controls the course of the entire Chinese economic environment.[38] No company in China is free of the effects of this control. Until China engages in significant and meaningful economic reforms – including auctioning of state assets, floating its currency, ending pervasive subsidization, and establishing free and open markets for labor and land–

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33 *Id.*

34 *Id.* at 20.

35 *Id.*

36 *Id.* at 19-20.

37 *Id.* at 21.

38 Lined Paper NME Memo at 4.

no "market-oriented" enterprise test can be worth the Department's time and attention.

China appears unlikely to engage in meaningful market liberalization any time in the foreseeable future. Until it does so, the government's stringent control of China's economy will render the Department unable to find a "market-oriented" Chinese enterprise, just as the Department has been unable to find a "market-oriented" Chinese industry at any time in the past. Further, as explained below, such a "market-oriented" enterprise test would be contrary to the Tariff Act, would be administratively unworkable, and would be of dubious utility, given the non-market nature of China's economy.

II. THERE IS NO AUTHORITY FOR A MARKET-ORIENTED ENTERPRISE TEST, SUCH A TEST WOULD BE UNWORKABLE, AND SUCH A TEST WOULD BE OF DUBIOUS USEFULNESS GIVEN CHINA'S ECONOMY

In its October 25, 2007 request for comments, the Department asked commenters to focus on three issues. First, the Department asked for comments on its legal authority to institute a market-oriented enterprise test. Second, the Department asked for comments on the administrative feasibility of such a test. Third and finally, the Department asked commenters to discuss the extent to which the Department can rely on non-market economy costs and prices in calculating the dumping margin for individual entities in non-market economies. Nucor comments in detail on these issues below, and submits that careful consideration of each issue demonstrates that a market-oriented enterprise test is ill-advised.

A. **U.S. Law Does Not Permit a "Market-Oriented" Analysis of Individual Chinese Companies**

The Department's proposal to grant market status to individual Chinese companies is contradicted by the plain language of the 19 U.S.C. § 1677b, as well as by Tariff Act of 1930's overarching command that the Department calculate the most accurate dumping margins possible. First, 19 U.S.C. § 1677b clearly lays out the methodologies that the Department must use to calculate individual margins in a non-market economy, and does not permit the use of market economy methodologies for individual non-market economy respondents. Second, given the economy-wide cost and price distortions present in China, the Department cannot hope to calculate accurate dumping margins based on the costs and prices incurred by individual Chinese producers.

1. Title 19 U.S.C. § 1677b Does Not Permit a Market-Oriented Enterprise Analysis

Title 19 U.S.C. § 1677b sets forth the permissible methods of calculating normal value in antidumping investigations. Subsection (c) of the provision discusses, in particular, the calculation methods appropriate with respect to respondents in non-market economy countries. The law, as written, focuses on a methodology that changes only with the market or non-market nature of each country, and not on the nature of a company or individual respondent. There is nothing in the statute to suggest that the Department is permitted to indulge in a respondent-by-respondent analysis of market orientation.

In fact, Congress, in drafting the Tariff Act, recognized that such a course of action would be futile. The statute's very definition of "non-market economy country" reflects the fact that all sales within such a country are tainted, such that an accurate normal value cannot be calculated on the same basis as in a market economy country:

> The term "non-market economy country" means any foreign country that the administering authority determines does not operate on market principles of cost or pricing structure, so that <u>sales of merchandise in such country do not reflect the fair value of the merchandise</u>.

As the language indicates, once the Department has determined that a country is a non-market economy country, then all sales of merchandise in that country are tainted. A respondent-specific market-oriented enterprise analysis would therefore be useless; all sales in a non-market economy are tainted by the general character of the economy, and the individual purchaser/seller in such an economy cannot change this.

2. A Market-Oriented Enterprise Analysis Would Not Comport with the Department's Mandate to Calculate the Most Accurate Margins Possible

As both the courts and the Department itself have explained on numerous occasions, the overarching purpose of the Tariff Act requires the Department to calculate antidumping margins as accurately as possible.[39] Such accuracy cannot possibly be achieved by application of a market-oriented enterprise test. As the statutory definition of "non-market economy country" makes clear, in such a country, the costs and prices of individual producers are affected by the entire economy's general lack of market values. Even if a producer in a non-market economy purchased all its raw materials from a market economy, and only sold its production in export sales to market economies, the lack of market forces with respect to labor, land, financial institutions, and capital in general would render that company's costs and prices unusable. Simply put, there is no way to accurately calculate dumping margins for a non-market economy producer using market-economy methodologies. The only rational and consistent way to ensure accuracy in the calculation is by resort to the statutorily mandated procedures for non-market economy dumping calculations.

B. A Market-Oriented Enterprise Test is Not Administratively Feasible

In response to its May request for comments on a market-oriented enterprise analysis, the Department received a number of comments from entities in favor of such a test. To the extent that such commenters furnished proposals for such a test,

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39 *See, e.g., Lasko Metal Products v. United States*, 43 F.3d 1442, 1446 ("The Act sets forth procedures in an effort to determine margins 'as accurately as possible.'"); Issues and Decision Memorandum accompanying *Glycine from the People's Republic of China*, 72 Fed. Reg. 58,809 (Dep't Commerce Oct 17, 2007) (final results of antidumping duty administrative review and rescission, in part) at cmt 3.

these proposals fell into two camps. First, a number of commenters proposed that the Department create a rebuttable presumption that all enterprises in China are market-oriented, and require U.S. industry participants to furnish the Department with information rebutting that presumption. Such a "test," if it can even be designated as such, would be completely indistinguishable from granting China market economy status as a whole. The Department has already clearly stated that it does not intend to do this; indeed, China's protocols of accession to the WTO do not envision even the possibility of market-economy status until 2014. It is clear, therefore, that a "test" based on a rebuttal presumption of market orientation is out of the question.

Other commenters in favor of a market-oriented enterprise analysis provided frameworks for tests based on modified versions of the Department's market-oriented industry and/or separate rates tests. However, each of these multi-factor tests would require the Department to invest significant resources in investigating factors of production, indicial of government control, and accuracy and independence of financial reports for what are likely to be multitudes of applicants in every antidumping duty proceeding. The International Trade Administration simply cannot, with the budget, staff, and other resources currently at its disposal, handle such an enormous additional burden. The ITA already has been forced to significantly narrow the number of respondents in administrative reviews and to decline to conduct verifications.

In short, it would be nearly impossible to fashion a market-oriented enterprise test that was streamlined enough so as not to consume significant Departmental resources, and yet expansive and encompassing enough to represent a test that was politically viable and would pass judicial scrutiny. Any market-oriented enterprise test that represented a real attempt to come to grips with the degree to which a particular Chinese company was affected by market, rather than non-market forces, would necessarily be complex and difficult to administer. Compound this by the sheer number of Chinese companies likely to apply for such treatment, and you have all the makings of an administrative nightmare.

C. A Market-Oriented Enterprise Test Would Be of Dubious Utility

Since instituting the "market oriented industry" concept at the time of China's accession to the WTO, the Department has been unable to find a Chinese industry that meets the test's criteria. Given that no market-oriented industries exist within China, it is highly unlikely that any individual company operating within the industry could operate on market principles. Simply stated, no individual producer can function as an island. It must obtain inputs, and it must sell its product. If neither its suppliers nor its home-market purchasers are operating under market forces, the producer's costs and prices will fail to reflect fair value. Even if such a producer purchased all raw materials from a foreign, market economy source, and only sold for export to market economy purchasers, that company would be too enmeshed in the overall Chinese economy to be validly considered market-oriented. The company's access to and use of labor, land, electricity, water, and capital and financial services would all be controlled by the government.

In its October 25, 2007 request for comments, the Department asked specifically that commenters discuss the Department's ability to use individual company information for those inputs that are not "inextricably linked to the broader operating economic environment, *i.e.*, labor, land and capital." In essence, it appears that the Department is suggesting a hybrid approach in which a respondent's own inputs are used for those inputs that are market-based, while surrogates are retained for all non-market inputs. Nucor must counsel against this hybrid approach, as – like any "market-oriented" enterprise analysis -- it is not permitted by the statute, would be administratively unworkable, and is of doubtful utility given the Chinese government's control over finance and capital in China.

First, as described above, the Tariff Act provides a methodology for calculating margins in a market economy, and a methodology for calculating margins in a non-market economy. It does not condone or permit the Department to either adopt a company-by-company analysis, or to use the market-economy methodology with regard to enterprises located in non-market economies. It certainly does not provide the Department with discretion to "mix-and-match" market and non-market methodologies. Any attempt to do so would violate the scheme laid out by the statute.

Second, the Department could not use such a "mix-and-match" strategy without analyzing, on a producer-by-producer basis, which inputs were market based and which were not. It is insufficient to simply declare certain inputs to be "inextricably linked to the broader operating environment," while declaring all other inputs to *not* be so inextricably linked. The Department would, in fact, have to analyze all factors of an individual producer's production, and determine which inputs were market based and which were not. Given the number of Chinese companies who would likely attempt to take advantage of any market-oriented enterprise test, this would quickly swamp the Department's resources. It would be impossible, given the International Trade Administration's personnel and budget, to fairly, thoroughly, and consistently engage in this kind of investigation and analysis.

Third, and perhaps most importantly, *all factors* in a non-market economy are enmeshed due to government influence and control over capital and finance. This is particularly true in the case of China. The central government retains tight controls over foreign exchange and over the banking and financial sectors in China. As a result, no transactions involving the change of currency in China – and thus no transactions whatsoever – are free of the distorting influence of a governmentally controlled economy. Even if a Chinese company were to purchase certain inputs from a market economy source, the prices for these goods would be distorted by the Chinese government's control over the flow of capital. Even were the Department to attempt to determine exactly which inputs of every applicant were "market-based" and which were not, it would not be possible to entirely remove the distortions caused by an applicant's mere presence in a non-market economy.

III. CONCLUSION

The Department should abandon the proposal to institute a "market-oriented enterprise" analysis of individual companies in non-market economies. With respect to Chinese steel producers, there are sufficient indicia of high levels of governmental control over the entire industry to demonstrate that no "market-oriented" steelmaker can exist in China. Further, with respect to the three issues that the Department flagged in its request for comments, the Tariff Act of 1930 does not permit the Department to analyze individual companies in a non-market economy using either a market methodology or a hybrid methodology that pulls from elements of both the market economy and non-market economy dumping methodologies. Any realistic or politically valid attempt to introduce a "market-oriented enterprise" test would subject the Department to heavy administrative burdens, requiring phenomenal resources that the Department simply does not have. Even were the Department to have such resources, a "market-oriented enterprise test would be of limited utility, given the Chinese government's control over important factors of production, including land, labor, and capital. No participant in the Chinese economy can ever be free of all of this distorting influence, rendering all Chinese costs and prices unsuitable for use in calculating accurate dumping margins.

On behalf of Nucor Corporation, we therefore respectfully request that the Department decline to institute and administer a "market-oriented enterprise" analysis for non-market economy producers.

Sincerely,

Alan H. Price /TCB

Alan H. Price
Timothy C. Brightbill

Counsel to Nucor Corporation

Exhibit List

1. Excerpts from U.S.-China Economic and Security Review Commission, 2007 Annual Report to Congress (Nov. 2007)

2. Wiley Rein LLP, *Money for Metal: A Detailed Examination of Chinese Government Subsidies to its Steel Industry* (July 2007)

3. Government of the People's Republic of China, The Tenth Five Year Plan for National Economic and Social Development – People's Republic of China

4. Wiley Rein LLP, *Government Ownership and Control of China's "Private" Steel Producers* (Oct. 2007)

5. Andrew Szamosszegi, *How Chinese Government Subsidies and Market Intervention Have Resulted in the Offshoring of U.S. Auto Parts Production: A Case Study.*

6. What is the Five Year Plan

7. Steel and Iron Industry Development Policy, Order No. 35 of the National Reform and Development Commission (July 2005)

8. *The Tenth Five Year Plan of the Automotive Industry and its Development*, China Daily

9. United States Trade Representative, *2006 National Trade Estimate Report on Foreign Trade Barriers* (Mar. 2006).

10. Wiley, Rein & Fielding LLP *The China Syndrome: How Subsidies and Government Intervention Created the World's Largest Steel Industry* (25 July 2006)

11. *China Government Warns of Possible Rebound in Non-Performing Loans*, Asia Pulse, Sept. 20, 2004.

12. Working Policy Report on China's accession to the WTO, G/SCM/118 (Nov. 9, 2005).

13. *To Clean Air, Aid Climate, China Looks to End Polluters' Tax Breaks, Other Perks*, The Associated Press, Apr. 27, 2007

14. Tung-Pi Chen, *Emerging Real Estate Markets in Urban China*, 8 Int'l Tax & Bus. Lawyer, No. 78 (1990-1991)

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EXHIBIT 1

2007

REPORT TO CONGRESS

of the

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

ONE HUNDRED TENTH CONGRESS
FIRST SESSION

NOVEMBER 2007

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form a complex web of concerns that comprise the overall relationship between the United States of America and the People's Republic of China.

The Commission's conclusions are included in this Executive Summary. At the end of this Summary, the Commission's ten key recommendations are listed. The Commission makes a total of 42 recommendations to the Congress in this Report. Those pertaining to each of the five Report chapters appear at the conclusion of the chapter, and a comprehensive list is provided beginning on page 285.

The United States-China Trade and Economic Relationship

China made progress toward economic reforms in 2007, but only with great hesitancy and, even then, only with the prodding of other nations and the World Trade Organization. China is unwilling to embrace market-oriented mechanisms, such as a freely traded currency, because it maintains a preference for authoritarian controls over its economy. It has not yet, for example, allowed its citizens to freely invest their savings abroad or even in Hong Kong's stock market. Yet China also avoids effective controls where it fears that government intervention might limit economic growth. China continues to refuse, despite repeated promises, to crack down effectively on trademark and copyright piracy of foreign goods sold within China. The central government also has repeatedly resisted calls for it to rein in the extensive government subsides it provides to favored industries, also a violation of free-market principles. Worse still, China formally has adopted a policy of retaining large amounts of the economy—encompassing a dozen industries from information technology and telecommunications to shipping and civil aviation—under direct government ownership and control. As China has adopted and maintained policies designed to support an export-driven growth model, it has amassed the world's largest foreign currency reserves of $1.43 trillion.

Conclusions

The Relationship's Current Status and Significant Changes During 2007

- China's trade surplus with the United States is growing dramatically, due in large part to its financial and economic policies that stimulate exports and discourage imports. China's trade surplus with the United States in goods through August 2007 rose to $163.8 billion, an increase of 14 percent over the $143.3 billion surplus during the equivalent period in 2006. By mid–2007, China had accumulated $1.43 trillion in foreign currency reserves, up from $1.2 trillion in 2006. An estimated 70 percent of those reserves, or about $1 trillion, are invested in dollar denominated assets, mostly U.S. government and corporate bonds.
- Following a five-year phase-in period, China is largely complying with the World Trade Organization's procedures, rules, and regulations, at least on paper. While China has rewritten thousands of laws and regulations, major improvements are still needed in implementation and enforcement. China's performance is notably

weak in the areas of intellectual property protection, maintenance of a market-based currency regime, and compliance with the WTO's prohibitions on export subsidies.

- China's economy remains heavily dependent on manufactured exports to sustain its rapid economic growth and to provide jobs for a rural population moving to urban areas in search of higher pay and benefits. Chinese authorities have not been willing to alter this pattern, even if pushing exports means violating WTO rules or free market principles.
- China's trade relationship with the United States is severely out of balance, with its exports to the United States exceeding its imports by a ratio of more than five to one.
- Beijing has been slow to translate three decades of record economic growth into a better life for all its citizens by enhancing government programs for education, pensions, and health care. Nor has China encouraged financial services reform to allow its citizens to enjoy the benefits of consumer credit and affordable insurance. As a result, Chinese workers save much of their income to enable them to contend with life's vicissitudes and they purchase few imported goods.
- The artificially low value of the renminbi provides a subsidy for Chinese exporters and serves as a hindrance to Chinese importers and consumers.
- China's mercantilist policies are taking a huge toll on small and medium-sized manufacturing facilities and their workers in the United States. While U.S.-based multinationals can transfer and have transferred much of their production to China to serve that market, small and medium-sized manufacturers in the United States are not as mobile. They face the full brunt of China's unfair trade practices, including currency manipulation and illegal subsidies for Chinese exports. This is significant because small and medium enterprises (SMEs) represent 60 percent of the manufacturing jobs in America.

The Control of China's Economy by its Government, and the Effect on the United States

- The push for reform in China's economy in the 1980s and 1990s appears in some cases to have reversed with a renewed use of industrial policies combined with a new class of super state-owned enterprises.
- China's 11th Five-Year Plan emphasizes industrial policy planning for the state-owned sector. The plan heavily promotes the development of value-added industries of a technical nature. The Chinese Communist Party employs a range of tools to accomplish these goals, including the use of subsidies and state-funded R&D centers, promoting foreign direct investment from Western high-tech firms, employing strategies to maximize technology transfers from more-developed economies, infant-industry protection, and directed use of China's state-owned enterprises.

INTRODUCTION

As it prepares to host the 2008 Summer Olympic Games, China is presenting to the world the image of a confident and benevolent world power. But that image stands in contrast to a number of actions by and policies of China's authoritarian government. As a result, Beijing presents enormous challenges for U.S. policymakers who hope to see China move along a path of reform.

Today a prospering China welcomes another year of double-digit growth in its economy and a soaring stock market, and it recognizes that its free market reforms are the engine of its success. However, it is becoming apparent that China's leadership, both in the central government and at the local level, is nervous about the pace and extent of further market-based reforms. In addition, China's leadership continues to avoid political reform by suppressing political dissent and blocking efforts of most groups in the society other than the Communist Party—for example, workers trying to organize and citizens attempting to practice their religion freely.

The Commission has been given the responsibility by Congress to advise it on economic and security policy toward China. Our findings are contained in this, the Commission's fifth major Report to Congress. Contributing to this effort, the Commission held six hearings in Washington DC, and one in Chapel Hill, North Carolina. Commissioners attended three classified intelligence briefings in Washington, DC, and a full day of classified briefings on China's scientific, technological, and military capabilities at Wright-Patterson Air Force Base, Ohio, and are preparing a classified report on those subjects. Commissioners also visited the cities of Beijing, Dalian, and Shenyang in mainland China, as well as Hong Kong; Taipei and Kaohsiung, Taiwan; and New Delhi, India. The Commission contracted for independent research pertaining to topics the Commissioners view as important to consideration of key issues in U.S. policy toward China.

The Commission's conclusions as presented in this Report are a mixture of good news and bad. China has taken a constructive role in reaching agreement among six nations to dismantle North Korea's nuclear weapons production capacity. China has agreed to send a combat engineering battalion to Sudan to help with the U.N.'s peacekeeping and reconstruction activities there, and is showing signs of interest in strengthening its export control system to limit proliferation. China's economic policies have helped lift 200 million of its people out of poverty, and its leaders also have begun to acknowledge the widespread environmental degradation of China's air and water.

Among the problem areas identified by the Commission in 2007 are China's continuing harassment of journalists, bloggers, Internet users, whistleblowers, environmentalists, human rights advocates, and citizens who attempt to disseminate non-official versions of events within China. The costs of such restrictions have become all the more obvious through many recent reports in the Western press about long-standing safety and health concerns of international as well as Chinese consumers who have been exposed to adulterated and dangerous toothpaste, baby formula, and cough syrup. Allowing the Chinese news media to fully report on such domestic scandals earlier might have led to more effective solutions to the problem within China, and controls on exporting tainted products out of China.

Some of the Commission's research during the year involved issues addressed in previous Commission reports, including a number of World Trade Organization compliance problems. China still is not enforcing its own laws against intellectual property theft. As in the past, the problem revolves around China's lax enforcement and its preference for civil fines rather than criminal prosecutions for large transgressions. China also has done little to address repeated complaints from the United States and the European Union about its extensive subsidies to manufacturers. Those subsides include discounts on loans and land, electricity, water, waste treatment, and roads. In some cases, China provides lax environmental and labor law enforcement for favored industries. Tax holidays and rebates on exports also are available for favored industries. China maintains limited market access for American entertainment software, principally movies. Each one of these issues is the subject of a WTO complaint against China by the United States.

The Commission is disappointed that Beijing's efforts to move in the direction of a market economy appear to be slackening. In particular, the government's decision to retain state ownership or control of a large block of the economy is disappointing. In accord with its 11th Five-Year Plan, China has designated a dozen industries, including telecommunications, civil aviation, and information technology, as "heavyweight" or "pillar" industries over which it intends for government to retain control. In addition, 155 of China's largest corporations remain state-owned, including nearly all the nation's largest banks. Much of the economy remains under the Chinese government's strict control. Beijing's provision of subsidies to its pillar industries may damage competitors in other countries—including the United States where companies do not receive such subsidies.

Other Chinese economic policies, especially China's pursuit of energy assets to fuel its economic growth, raise particular challenges. Rather than rely on international oil markets to supply its energy needs as most nations do, China shows a growing reliance on owning oil at the wellhead that easily could cause significant market disruptions if prices continue to stay high and supplies remain tight. In addition, this policy has led China to develop close relationships with countries such as Iran, Sudan, and Burma, and this has made it more difficult for China to cooperate in multilateral efforts to address the human rights issues and other important challenges that these countries pose.

Congress needs to consider the growing unease in Asia about China's militarization and its strategic intentions in the Western Pacific/East Asia region. The Commission examined China's growing military power in classified briefings, in hearings, and during its trips to Asia. The Commission concluded that China is developing its military in ways that enhance its capacity to confront the United States. For example, China has developed the capability to wage cyber warfare and to destroy surveillance satellites overhead as part of its tactical, asymmetrical warfare arsenal. With its highly developed reliance on systems of command, control, communications, computers, intelligence, surveillance, and reconnaissance (C4ISR), the American military is significantly exposed to such attacks. China also could target America's critical infrastructure in a confrontation. In the realm of traditional warfare, China is acquiring the ability to overwhelm the defenses of, and successfully attack, U.S. carrier battle groups.

Creating further uncertainty about China's military and foreign policy intentions is its reluctance to release more details about its military spending. Without such information, Americans are left with little choice but to draw adverse inferences about China's intentions from its focus on cyber warfare and anti-satellite weapons, its construction of two ballistic missile submarines, and its purchase from Ukraine of a former Soviet aircraft carrier. New generations of fighter aircraft, spacecraft, submarines, missiles, and other sophisticated weapons are coming off China's production lines, but China has been reluctant to discuss how its military spending fits into its overall foreign policy goals.

Similarly troubling are the conclusions the Commission reached concerning China's growing reliance on industrial espionage. China continues to supplement its acquisition of new technologies from commercial transfers and direct production partnerships with a large-scale industrial espionage campaign.

China's growing trade surplus with the United States also is worrisome. In the first eight months of 2007, China's trade surplus in goods rose to $163.8 billion, up 14 percent from the same period a year earlier. China's trade surpluses already have helped create the world's largest single pool of foreign currency. United States policymakers are concerned about the China Investment Corporation recently created by the central government. The CIC will manage a portion of China's $1.43 trillion in foreign currency reserves, which thus far have been invested mostly in dollar-denominated bonds. But the record size of China's foreign funds holdings and the fund's rapid growth are raising concerns about the direction of future investments and the impact they could have on the U.S. economy.

China's unwillingness to accelerate the pace of its currency appreciation—or at least to allow the international currency markets to have more influence over the value of the renminbi—remains a major disappointment. Since China announced in July 2005 that it would allow the renminbi to fluctuate within a narrow trading band against a basket of currencies, the renminbi has appreciated less than 10 percent against the dollar. Meanwhile, China's global trade surplus is growing at an ever-faster rate.

The Commission believes that none of these problems is insurmountable and that both governments must work diligently to build the trust and understanding essential to agreements to which the parties will adhere.

have been gaining in importance.[77] "The local sector [SOEs] ... seem to be steadily ... privatized and transformed [with] the local government officials act[ing] more like entrepreneurs," says Dr. Barry Naughton of the University of California/San Diego.[78]

The central government plays a small role in the activities of the local SOEs and instead focuses on several hundred larger firms that Beijing sees as critical to China's future. While local SOEs do employ the majority of the state-owned sector's workforce, the central government controls a disproportionately large share—48.3 percent—of the state-owned sector's assets.[79] The firms that fall in this category are the principal beneficiaries of much of China's industrial policy.[80]

Dr. Naughton quoted a senior Chinese official as saying, "state ownership is appropriate in four sectors: national security, natural monopoly, important public goods or services, and important national resources. In addition, a few key enterprises in 'pillar' (priority) industries and high-tech sectors should be maintained under state ownership."[81] Dr. Naughton testified that "the five sectors of oil, metallurgy, electricity, telecommunications, and military industries represent two-thirds of the labor force and three-quarters of the capital in [the] state sector core."[82]

The largest state-owned firms fall under the Chinese version of a holding company: the State-Owned Assets Supervision and Administration Commission (SASAC). SASAC was created to "manage the [CCP's] efforts to control more effectively China's SOEs, while increasing the SOEs' economic returns and maintaining the political returns to the government."[83] SASAC has jurisdiction over China's best SOEs and has been given explicit instructions to advance a number of the CCP's economic goals.

SASAC's mandate directs it to consolidate its control over larger SOEs and dispose of smaller ones. To accomplish this goal, SASAC divided tens of thousands of SOEs into two groups: those from strategic industries to be owned by the central government and the remainder to be run by provincial and local governments with help from the Ministry of Finance. The smallest and weakest were, in many cases, given to local authorities to shut down or merge. Through restructuring and consolidation, SASAC appears to have pared its list from the original 198 companies to 155 companies.[84]

SASAC has been candid in revealing its plans for China's state-owned enterprises. These include its intentions to provide government subsidies to the "national champions" it intends to create. The "goal of reforming is to reorient state capital away from poorly performing companies in non-crucial areas to priority sectors,"[85] explained Shao Ning, Vice Minister of SASAC.

In December 2006, SASAC and China's State Council jointly announced the "Guiding Opinion on Promoting the Adjustment of State-Owned Capital and the Reorganization of State-Owned Enterprises." The Guiding Opinion identifies seven "strategic industries" in which the state must maintain "absolute control through dominant state-owned enterprises," and five "heavyweight" industries in which the state will remain heavily involved. (See the box below.) *China Daily* and the *Asia Times* estimate that between 40 and 50 of the 155 SASAC-controlled SOEs are engaged in the seven "absolute control" sectors, accounting for 75 percent of SASAC's total assets[86] and as much as 79 percent of SASAC's total profits.[87] They include such highly profitable companies as China Mobile, PetroChina, and Air China. A complete list of these SOEs is included as Appendix VII-C.[88]

INDUSTRIES THE PEOPLE'S REPUBLIC OF CHINA HAS IDENTIFIED AS "STRATEGIC" AND "HEAVYWEIGHT"

Strategic Industries:	Heavyweight Industries:
1) Armaments	1) Machinery
2) Power Generation and Distribution	2) Automobiles
3) Oil and Petrochemicals	3) Information Technology
4) Telecommunications	4) Construction
5) Coal	5) Iron, Steel, and Non-Ferrous metals
6) Civil Aviation	
7) Shipping	

According to China's official news agency *Xinhua*, the "Guiding Opinion proposes 10 actions to promote the reorganization of state-owned enterprises, including stock exchange listing for sound companies and the addition of foreign investors."[89] Other proposed actions include shutting down money-losing companies, reorganizing management in other firms, linking manufacturers to state research institutes, and tightening budget controls.

The announcement indicates that Beijing may be looking to foreign, or "strategic," investors to help China create what economic planners like to call "market socialism." This phenomenon already can be seen at work in the information technology sector to which SASAC attached such great importance. Dr. Zhi Wang, an economist at the U.S. International Trade Commission, recently said that 90 percent of China's high technology exports to the United States are from Foreign Invested Enterprises (FIE), many of which involve joint ventures with Chinese firms.[90] American venture partner companies may be helping a SASAC-targeted industry climb the technology ladder.

Beijing goes to great lengths to hide the fact that many Chinese firms thought to be private are, in fact, SOEs. Many companies in China whose stocks are traded on China's exchanges are in reality SOEs in which the government keeps as much as a 75 percent stake, says Mr. Frederick Jiang, manager of the Ivy Pacific Opportunities Fund. By only listing part of an SOE on domestic exchanges, the Chinese government is able to maintain control of the firm. This association with China's government "often means the companies are assured of maintaining their dominant position,"[91] said Mr. Jiang. Studies have shown that when foreign investment capital is attracted to SOEs through this opaque process, there typically is an increase in their competitiveness. "Foreign capital participation in an SOE is associated with higher innovative activity. . . . There is a positive effect of FDI on SOEs that export, invest in human capital or R&D, or have prior innovation experience."[92]

Of course, at the same time, Beijing isn't anxious to see control of its strongest SOEs pass to foreigners. The State Council reportedly is planning to establish an interdepartmental committee to "scrutinize large-scale mergers or acquisitions of state-owned enterprises by foreign companies." [93]

Another way for Beijing to support companies in SASAC's favored industries is to use government subsidies. SASAC public pronouncements confirm what external studies have already observed: China already is deeply involved in such activity. University of New Haven professor George Haley testified before the Commission that these subsidies are most frequently provided at the provincial and municipal levels in China. They are listed in the box below:

Forms of Provincial and Municipal Government Support for SOEs [94]

1) *Low Cost Loans.* Provincial governments use their influence over the state banks to ensure that SOEs receive low-cost and sometimes free loans that amount to an outright transfer of capital.

2) *Asset Injections.* Provincial and municipal governments transfer assets, such as toll roads and toll bridges, to their SOEs at prices far below market value or replacement costs.

3) *Subsidized Inputs.* Provincial and municipal governments subsidize purchases of equipment, component parts, raw materials, and supplies for SOEs by requiring other SOEs or pressuring their own suppliers to provide these inputs at below-market or even below-cost prices.

4) *Tax Breaks.* Provincial and municipal governments provide tax breaks of various types to their own SOEs. Tax breaks include reduced utility costs, reduced income-based taxes, and reduced general taxes.

5) *Energy Subsidies.* Provincial and municipal governments sell energy and other utilities to their SOEs at below-market prices.

6) *Land Subsidies.* Provincial and municipal governments consolidate land parcels and sell them to their SOEs at below-market prices.

7) *Purchasing SOE Products.* Provincial and municipal governments purchase goods and services from their SOEs at above-market prices, often higher than less well-connected companies' lower bids.

A 2006 European Union report noted these advantages: "China has channeled significant subsidies to favored national industries, in particular companies destined to become national or regional champions. These companies also have benefited from preferential policies such as privileged access to the banking sector. In some cases, such as the automotive and steel sectors, whole sectors benefit from an integrated industrial policy intended to support domestic production and boost exports. China also has developed a taxation system granting tax preferences contingent on the use of local

EXHIBIT 2

MONEY FOR METAL:

A DETAILED EXAMINATION OF CHINESE GOVERNMENT SUBSIDIES TO ITS STEEL INDUSTRY

Prepared for:

The American Iron & Steel Institute
The Steel Manufacturers Association
The Specialty Steel Industry of North America
The Committee on Pipe and Tube Imports

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July 2007

MONEY FOR METAL: A DETAILED EXAMINATION OF CHINESE GOVERNMENT SUBSIDIES TO ITS STEEL INDUSTRY

EXECUTIVE SUMMARY

- The Chinese steel industry is continuing to expand at an unprecedented and seemingly uncontrolled rate. China's steel capacity grew another 20 percent in 2006. Today, experts estimate that China's total steel capacity is already 500 million metric tons or more and will reach as much as 600 million metric tons by year-end 2007.

- This unparalleled expansion is the direct result of the Chinese government's direction and control of the Chinese steel industry, and its bestowal of an extraordinary range of subsidies to Chinese steel producers. The growth of China's steel industry has been both financed and directed by the Chinese government.

- Government ownership of the steel industry is far greater than previously reported. Eight of the ten largest Chinese steel groups are 100 percent owned or controlled by the Chinese government, while 19 of the top 20 groups are majority owned or controlled by the government. In terms of production, 91 percent of the production of the top 20 steel groups is state-owned or controlled. This degree of state ownership allows the government to exert direct control over the steel industry.

- This report identifies more than **RMB 393 billion (US$ 52 billion)** in subsidies granted to Chinese steel producers. These documented subsidies include:

    - **RMB 130.9 billion (US$ 17.3 billion)** in preferential loans and directed credit – The Chinese government uses subsidized loans granted to steel producers to carry out government policy. These policy loans account for the majority of all loans in China, and leading Chinese steel producers have received between 60 and nearly 100 percent of their loans from policy banks. This report details subsidized loans received by 15 major Chinese steel producers.

    - **RMB 141 billion (US$ 18.6 billion)** in equity infusions and/or debt-to-equity swaps – China regularly injects substantial cash subsidies into steel producers, acquiring additional ownership shares in return. The Chinese government has also made widespread use of debt-to-equity swaps since the mid- to late-1990s. At least 37 different Chinese steel companies have benefited, including all of the major producers.

    - **RMB 38.9 billion (US$ 5.1 billion)** in land-use discounts – The physical purchase of land is nearly impossible in China. Instead, the Chinese government provides lease agreements and then transfers land-use rights to the companies for little or no cost. Steel producers enjoy these land-use rights for no charge, or for as little as US$ 0.02 per square foot.

- **RMB 9.5 billion (US$ 1.3 billion)** in government-mandated mergers – The Chinese government is directing consolidation of the steel industry in China by permitting acquisitions for little to no cost. For example, in May 2007, Baosteel, China's second largest steel producer, received a 48.5 percent stake in Xinjiang, worth more than RMB 6 million, at no cost.

- **RMB 2 billion (US$ 258.6 million)** in direct cash grants – Chinese steel producers continue to report outright cash grants, as well as grants for specific steel construction projects, on their balance sheets.

- The actual total subsidy amount is undoubtedly many times larger than this figure because of the limited number of companies reviewed and the partial nature of the data that even these companies reported.

- These subsidies have fueled China's steel industry expansion, resulting in sharp increases in China's steel exports. China moved from becoming a net importer of steel to a net exporter of steel in 2006. In the same year, it became the largest single steel exporting country by volume, up from fifth largest in 2005. China's total finished steel exports surged to 33.8 million tons in the first half of 2007, up nearly 100 percent compared to the same period in 2006.

- The Chinese steel industry has benefited from massive direct and indirect subsidies, many of which violate China's World Trade Organization obligations. The result has been artificial growth of China's steel capacity and production, at the expense of its international competitors, including U.S. companies and their workers.

- The Chinese government should end its policy of control, direction and subsidization of its steel industry. If it does not, the United States and other trading partners should increase efforts to require China's compliance with its WTO commitments and international trade law.

MONEY FOR METAL: A DETAILED EXAMINATION OF CHINESE GOVERNMENT SUBSIDIES TO ITS STEEL INDUSTRY

I. INTRODUCTION

The Chinese steel industry is continuing to expand at an unprecedented and seemingly uncontrolled rate. After an astounding five-year run-up of 170 percent between 2000 to 2005, China's steel capacity grew another 20 percent in 2006. Today, most experts estimate that China's total steel capacity is already 500 million metric tons or more[1] and will reach as much as 600 million metric tons by year-end 2007.[2]

This unparalleled expansion is the direct result of the Chinese government's direction and control of the Chinese steel industry, and its granting of an extraordinary range of subsidies to Chinese steel producers. For years, the Chinese government has owned, directed, and subsidized virtually all aspects of the Chinese steel industry. Even today, China's steel producers operate in an environment where basic market forces – supply, demand, comparative advantage – do not exist or apply, due to the persistent intervention of China's national, provincial, and local governments and the pervasive influence of WTO-illegal subsidies.

The growth of China's steel industry has been both financed and directed by the Chinese government. The Chinese government maintains substantial ownership and control over the steel industry. As documented below, the national, provincial and local governments own majority stakes in almost all of China's major steel producing groups

1 Li Hongmei, *China's 07 Steel Capacity Put At 500M Tonnes*, American Metal Market, June 4, 2007.

2 *Southeast Asian Steel Conference: China's Finished Steel Exports To Fall In 2009, CBI China*, American Metal Market, June 15, 2007 (quoting Jimmy Ding, CBI China, as estimating China's total steel production capacity at 601 million tonnes in 2007 and 642 million tonnes in 2008).

and also hold key decision-making authority over the steel industry. This paper reviews the Chinese government's 9th, 10th and 11th Five-Year Plans, which have dictated the growth and direction of the Chinese steel industry. It also reviews provincial government five-year plans, which contain similarly detailed instructions for particular Chinese steelmakers. As these plans make clear, Chinese steelmakers do not operate according to market forces, and the key strategic and operational decisions are imposed by governmental fiat.

An earlier report, *The China Syndrome: How Subsidies and Government Intervention Created the World's Largest Steel Industry* (July 2006),[3] described the various ways in which the Chinese government provides direct and indirect benefits to the steel industry, including cash grants, land grants, transfers of ownership interests, conversion of debt to equity, debt forgiveness, preferential loans, tax incentives, and other methods. *Money for Metal* further examines these and other forms of subsidies and government intervention, adding new information that has been revealed in the last year. This report also expands upon earlier research through a detailed review of the financial statements of leading Chinese steel producers, including but not limited to Angang, Baosteel, Laiwu, Maanshan, Shougang, and Wuhan. Although financial reporting by these companies remains opaque and elusive, these companies' own documents demonstrate that the Chinese government has provided – and continues to provide – massive amounts of financial assistance to China's steel industry. This assistance benefits the entire range of steel products, including sheet, plate, galvanized, long products, tubular products, and stainless steel products.

[3] Wiley Rein LLP, *The China Syndrome: How Subsidies and Government Intervention Created the World's Largest Steel Industry* (July 2006), *available at*: http://www.wileyrein.com/docs/docs/80.pdf.

A partial compilation, which covers only a handful of the subsidies documented in this report, and including only a limited number of companies, reveals subsidies totaling more than RMB 393 billion (US$ 52 billion). These documented subsidies include RMB 130.9 billion in preferential loans and directed credit; RMB 141 billion in equity infusions and/or debt-to-equity swaps; RMB 38.9 billion in land-use discounts; RMB 9.47 billion in government-mandated mergers; and almost RMB 2 billion in direct cash grants. The actual total subsidy amount is undoubtedly several times larger than this figure because of the limited number of companies reviewed and the partial nature of the data that even these companies reported.[4]

The result of these massive subsidies is that China's steel exports, particularly exports to the United States, are moving upward at an unprecedented rate. In 2005, China moved from becoming a net importer of steel to a net exporter of steel. In 2006, it became the largest single steel exporting country by volume, up from fifth largest in 2005. U.S. imports of finished steel products from China more than doubled in 2006, increasing from 2.3 million tons in 2005 to 5.35 million tons in 2006.[5] This rate of increase has continued in the first half of 2007. U.S. imports from China reached 2.6 million tons in the first half of 2007, an increase of 23.8 percent over the same period in 2006.[6] China's total finished steel exports surged to 33.8 million tons in the first half of

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4 To gain a complete picture of subsidies bestowed upon the Chinese steel industry, it would be necessary to undertake a complete financial analysis of all steel producers for an extended period of time (at least 15 years). This study is limited to only a few Chinese producers for which public financial statements were available. Even for those companies included in the study, financial statements were not available for all fifteen years. Moreover, the study does not encompass possible subsidies that are not readily apparent in the financial statements.

5 U.S. Dep't Commerce, Bureau of Census data.

6 *Id.*

this year, up nearly 100 percent compared to the same period in 2006.[7] With total steel capacity that is now approximately five times larger than the entire North American steel industry, China's exports to the United States and the rest of the world will only increase.

China has not become the world's largest steel producer and exporter by accident, or by operation of free markets and comparative advantage. China has reached its position through a combination of subsidies, mandates, and planned governmental intervention.

7 Li Hongmei, *China Mulling End To All Steel Export Rebates*, American Metal Market, July 16, 2007.

II. CHINESE GOVERNMENT OWNERSHIP AND CONTROL OF THE STEEL INDUSTRY

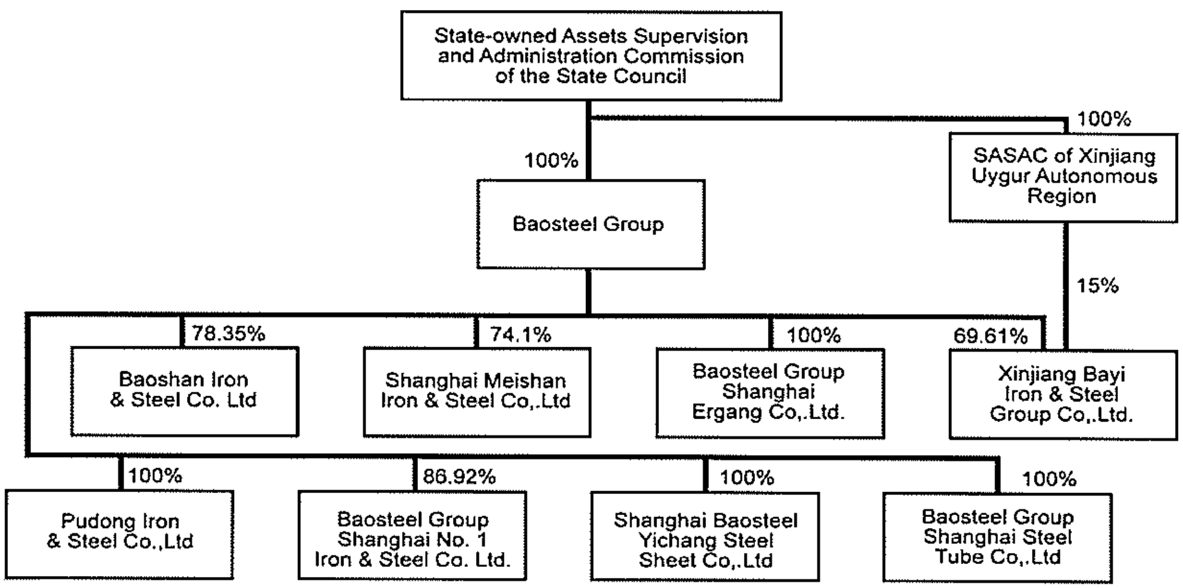
The Chinese government maintains substantial ownership and control over the steel industry. In addition to owning majority stakes in almost all of China's major steel producers, the government retains a high degree of decision-making authority over the steel industry and continues to intervene extensively to direct the course of individual companies. The government's role with respect to steel is set forth in a number of policy directives and incentive programs through which it actively supports the growth and competitiveness of the industry. The Chinese government has implemented its policy of support for the steel industry by providing it with massive subsidies and other forms of assistance, including cash grants, capital infusions, preferential loans, and tax incentives. The result has been the creation of the world's largest steel industry.

A. *Government Ownership*

The Chinese Government's 10th Five-Year Plan for National Economic and Social Development establishes the framework for state ownership of the steel industry by providing that the "state must hold a controlling stake in strategic enterprises that concern the national economy."[8] Because the iron and steel industry is considered a "strategic" or "pillar" industry, the Chinese steel industry remains predominately state-owned, with the government owning the vast majority of shares in almost all of China's major steel producers.

[8] *See* Gov't of the PRC, *The Tenth Five Year Plan for Nat'l Economic and Social Dev.-People's Republic of China, available at* http://ilo.org/public/english/employment/skills/hrdr/init/chn_1.htm.

Most of the top steel producing companies are controlled by a state-owned holding company or "group." For example, Baoshan Iron & Steel Co., the second largest steel producer in China, is 78.35 percent owned by a state-owned holding company, Baosteel Group Corporation, which, in turn, is 100 percent owned by the central government's State-owned Assets Supervision and Administration Commission of the State Council (SASAC).[9] In addition to Baoshan Iron & Steel, Baosteel Group owns and controls other steel-related companies, as well as companies involved in mining, electricity, chemicals, transportation, warehousing, and international trading.[10] As a result of this ownership structure, Baoshan Iron & Steel's ultimate controlling shareholder is the 100 percent central government-owned SASAC.



9 *See, e.g.*, Baosteel 2005 Annual Report at 7. SASAC is the government agency charged with exercising the authority of ownership of China's state-owned enterprises ("SOEs"). The central government SASAC directly controls managerial and board selection and all financial, legal, and corporate structural issues for SOEs. It retains all regulatory power over SOEs and SASACs organized at the provincial and local level. *See generally,* Barry Naughton, *Top-Down Control: SASAC and the Persistence of State Ownership in China* (June 23, 2006), Paper presented at the conference on China and the World Economy, Leverhulme Centre for Research on Globalisation and Economic Policy (GEP), University of Nottingham, *available at* http://www.nottingham.ac.uk/economics/leverhulme/conferences/June06/Naughton.doc.

10 *See id.*

The government uses this ownership structure to manage the financial affairs of individual companies by, for example, mandating the transfer of assets between entities within the holding company to achieve government aims.[11] Additionally, as described in detail below, the government routinely uses its control over the holding company to cross-subsidize assets – *e.g.*, granting steel companies preferential rates for electricity and iron ore from related entities within the holding company. In essence, use of state-owned holding companies allows the government to maintain majority ownership as well as significant control and management over steel companies.

Government control over individual steel companies is further ensured through the two-tier ownership structure of Chinese enterprises, in which the government holds majority shares in most companies while other entities own only a small minority of a separate class of non-tradable shares.[12] The fact that some companies are partially publicly owned is of little consequence due to the lack of rights accorded minority shareholders. Indeed, it is widely recognized that majority shareholders, generally the government, "routinely run roughshod over minority shareholders" and that China's legal system has proven unable to protect minority shareholder rights.[13] As one study re-

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[11] For example, the central government recently requested that state-owned steel mills consolidate their profitable assets under their listed companies. *Anyang Steel to Transfer Assets to Listed Arm*, American Metal Market, June 19, 2007.

[12] *See* James Ahn and David Cogman, *A Quiet Revolution in China's Capital Markets*, McKinsey on Finance at 1 (Summer 2007).

[13] *Corporate Governance Can Drive China's Reform*, The Asian Wall Street Journal, Nov. 22, 2002. *See also* OECD, *Reforming State Asset Management and Improving Corporate Governance: The Two Challenges of Chinese Enterprise Reform* 9 (Feb. 3, 2005) ("The most widespread abuse is asset stripping by controlling 'legal entity' shareholders at the expense of the firm itself and its minority shareholders through abusive related party transactions among firms of the same group, intra-group lending or guarantees, and excessive cash dividends. Indeed, the parent company will typically transfer productive assets to its listed subsidiary, retaining liabilities and redundant staff, and remaining an SOE").

cently concluded, "[t]here is little or no opportunity for minority shareholders to exercise their voice and oppression of minority shareholders is a serious issue in practice."[14]

While the Organization for Economic Co-operation and Development ("OECD") estimates that state-owned enterprises account for 57 percent of total Chinese steel production,[15] this estimate significantly understates actual government ownership. Table 1 below shows the considerable degree of government ownership of the top 20 Chinese steel producers. For the reasons discussed above, the following table focuses on Chinese government ownership of steel companies at the holding company or "group" level.

TABLE 1[16]

OWNERSHIP OF THE TOP TWENTY CHINESE STEEL GROUPS

Rank	Producer	2006 Prod. (Million MT)	Owner/Majority Shareholder	% Govt. Ownership
1	Anshan Benxi (Anben) Group	22.6	Central SASAC* and Liaoning Province SASAC	100.00
2	Shanghai Baosteel Group	22.5	Central SASAC	100.00
3	Tangshan Steel Group	19.1	Hebei Province SASAC	100.00
4	Shagang (Jiangsu Shagang) Group	14.6	Zhangjiagang City SASAC (25%), Shagang Labor Union (30%)[17]	55.00

[14] Jin ZhuYang, *Shareholder Meetings and Voting Rights in China: Some Empirical Evidence*, Int'l Co. and Commercial L. Rev. at 11 (2007).

[15] OECD Directorate for Science, Technology and Industry Steel Committee, *Current Situation of the Chinese Steel Industry*, DSTI/SU/SC(2006)9, at 15 (Apr. 4, 2006).

[16] Ownership and production information contained in Table 1 and Appendix 2 is current through the end of 2006.

[17] Labor unions in China are not independent, but rather controlled by the Chinese Communist Party ("CCP") and are therefore treated as government-controlled entities for purposes of this chart. According to the U.S. State Dep't: "[I]n practice workers were not free to organize or join unions of their own choosing. The All-China Federation of Trade Unions (ACFTU), which was controlled by the CCP and chaired by a member of the Politburo, was the sole legal workers' organization. The trade union law gives the ACFTU control over all union organizations and activities, including enterprise-level unions, and re-

5	Wuhan Iron and Steel Group	13.8	Central SASAC	100.00
6	Jinan Steel Group	11.2	Shandong Province SASAC	100.00
7	Magang Group (parent of Maanshan Steel)	10.9	Anhui Province SASAC	100.00
8	Laigang Group (parent of Laiwu)	10.8	Shandong Province SASAC	91.00
9	Shougang Group Corp	10.6	Central SASAC	100.00
10	Valin Steel Group	9.9	Hunan Province SASAC	100.00
11	Handan Steel Group	7.9	Hebei Province SASAC	100.00
12	Baotou Steel Group	7.5	Inner Mongolia SASAC	64.39
13	Anyang Steel Group	7.0	Henan Province SASAC	100.00
14	Panzhihua Iron & Steel Group	6.8	Central SASAC	100.00
15	Jiuquan Iron & Steel Group	6.6	Gansu Province SASAC	100.00
16	Taiyuan Steel Group	6.3	Shanxi Province SASAC	100.00
17	Tangshan Jianlong Industrial	6.0	Jianlong Iron & Steel Corp.	0.00
18	Liuzhou Steel Group	5.4	Central SASAC (51%)[18] and Guangxi Zhuang SASAC (49%)	100.00
19	Beitai Iron & Steel Group	5.3	Liaoning Province SASAC	100.00
20	Tangshan Guofeng Steel	5.2	China Travel Service (Holdings)[19]	51.00
* State-owned Assets Supervision and Administration Commission of the State Council (SASAC)				

quires the ACFTU to 'uphold the leadership of the Communist Party.' Independent unions are illegal. In some cases the ACFTU and its constituent unions influenced and implemented government policies on behalf of workers; however, the CCP used the ACFTU to communicate with and control workers." U.S. State Dep't, *Country Report on Human Rights Practices 2006, China* Section 6(a) (2007), *available at* http://www.state.gov/g/drl/rls/hrrpt/2006/78771.htm.

18 Liuzhou Steel Group is 51 percent owned by Wuhan Iron & Steel (Group) Corp. ("Wuhan"), which, in turn, is 100 percent owned by the central government SASAC. *See* Appendix 2.

19 Tangshan Guofeng Steel ("Tangshan") is 51 percent owned by China Travel Services (Holdings) Hong Kong Co., which, in turn, is 100 percent owned by the central government SASAC.

As this table demonstrates, eight of the ten largest Chinese steel groups are 100 percent owned or controlled by the Chinese government, while 19 of the top 20 groups are majority owned or controlled by the government. In terms of production, 91 percent of the production of the top 20 steel groups is state-owned or controlled. This degree of state ownership allows the government to exert considerable control over the steel industry and enables the government to direct steel producers to act in ways that further governmental rather than market aims, such as maximizing tax revenue and employment. In addition, as discussed below, the high levels of state ownership make it significantly easier to implement and enforce government policy relating to the steel industry.

Table 1 also demonstrates the degree to which Chinese steel companies are owned by the various levels of the Chinese government: national or central, provincial, and local (county or municipal). Of the top 20 Chinese steel producers, seven are partly or wholly owned by the central government, 13 are partly or wholly owned by a provincial or regional government, and one is partly owned by a local government. Some companies, such as Anben, are jointly owned by the central government and a provincial government, while other steel producers, such as Dongbei Special Steel Group, are jointly owned by multiple provincial governments.

The extensive and overlapping ownership gives each level of government a vested interest in the steel industry. However, this ownership structure often leads to competing interests among the multiple levels of government. For example, a recent industry report indicates that several provinces have disregarded an order from the central government to increase electricity costs for certain industries including steel.[20] In addition, the central government's policy of capacity rationalization and elimination of obsolete capacity has largely been frustrated by provincial and local governments, which have strong, non-market incentives to increase production (*i.e.*, tax revenue and employment). Indeed, many provincial and local government-owned producers have actually increased capacity, in defiance of the central government. Steel production in Hebei Province, the largest steel-producing province in China, increased by 20 percent in 2006 despite the central government's attempt to curb production in that province. In short, the considerable degree of ownership by provincial and local governments, whose decisions are often based on factors such as employment, tax revenue, or corruption rather than market principles, will continue to frustrate even the limited efforts of the central government to pursue such goals as capacity rationalization, elimination of obsolete capacity, and energy efficiency.

While there continues to be debate about whether China is transitioning to a more market-oriented economy, the overwhelming degree of government ownership suggests that market principles will not penetrate China's steel industry to any significant degree in the near future. Because steel has been designated as a strategic industry, the central government has indicated that it plans to retain a strong state influence in the sector.[21] Indeed, as recently as December 2006, the central government SASAC issued the "Guiding Opinion Concerning the Advancement of Adjustments of State Capital and the Restructuring of State-Owned Enterprises," which identified sec-

[20] Vivian Teo, *Beijing Warns Provinces on Power Cost Order*, American Metal Market, Apr. 17, 2007.

[21] *How China Has Made the Steel World Bounce,* Steel Business Briefing Insight, Issue 32, Mar. 1, 2007, at 3.

tors deemed to be critical to the national economy.[22] The measure indicated that the government must maintain strong state control over "pillar" and "backbone" industries such as iron and steel.[23] Additionally, though China has used and continues to need billions of dollars in investment to fund new steel expansion, and because the government has identified iron and steel as a strategic sector of the economy, foreigners are not permitted to own a controlling stake in Chinese steel companies. This largely prevents foreign companies, including U.S. steel producers, from participating in the expansion of the Chinese steel industry and helps consolidate and maintain government control over the industry.

B. *Government Direction and Management of the Steel Industry*

The Chinese government exercises extensive control over the development of the Chinese steel industry not only through its ownership stake but also through a number of policy instruments which afford the government substantial leverage to direct the growth and evolution of the industry. The various levels of government have issued several industrial plans that designate steel as a preferred industry and provide for a wide array of government benefits, including grants, preferential loans, and tax incentives. Additionally, these plans provide for government management of almost every major aspect of China's steel industry and authorize the government to intervene directly and extensively in the steel industry.

All three levels of government maintain separate, and sometimes distinct, policies that impact the steel industry. While these policies are often in concert with one

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22 U.S. Trade Representative, *Nat'l Trade Estimate* at 136 (2007), *available at* http://www.ustr.gov/assets/Document_Library/Reports_Publications/2007/2007_NTE_Report/asset_upload_file855_10945.pdf.

23 *Id.*

another, as detailed below, the numerous policy directives from the various levels of government underscore the often competing interests between the central, provincial, and local governments.

1. *Central Government Policies*

China's central government continues to maintain a high degree of decision-making authority over the management and development of the steel industry. Its policy framework for the steel industry is set forth in the Steel and Iron Industry Development Policy ("Steel Policy") issued by the National Development and Reform Commission ("NDRC") in July 2005. The Steel Policy provides for governmental management and control of almost every aspect of the industry's development, including resource and equipment utilization, regional output levels, quality improvements, technological innovation, investment management, and consolidation. Article 20 specifically provides for the reorganization of China's largest steel producers to create an industry with two 30 million-ton steel groups and several 10 million-ton steel groups by 2010.[24] The policy further prescribes the number and size of steel producers, their location, the type and mix of products that are permitted to be produced, and even minute details relating to the technology that will be used (*e.g.*, size and composition of blast furnaces).

As described in detail in *The China Syndrome*,[25] the Steel Policy also mandates direct government subsidization of the steel industry. Article 16, for example, provides for government support in the form of "tax refunds, discounted interest rates, funds for research and other policy support for major iron and steel projects utilizing newly devel-

[24] Steel and Iron Industry Development Policy, Order No. 25 of the National Reform and Development Commission, July 2005 ("Steel Policy") at Art. 20.

[25] *See The China Syndrome* at 17-18.

oped domestic equipment."[26] The policy also encourages indirect government support by, among other things, restricting foreign investment, discriminating against foreign equipment and technology, and providing various export credits. In short, China's Steel Policy is a primary example of the government's attempt to dictate industry outcomes and involve itself in decisions that should be made by the market.

China's industrial development is also directed and managed by the central government through the following policy instruments:

Five-Year Plans: Issued by the Central Committee of the Communist Party of China, the five-year plans set forth which industries, enterprises, and products should be targeted for preferential government support and specifically enumerate the types of preferences to be provided such industries. According to the government, five-year plans aim to "arrange national key construction projects, manage the distribution of productive forces and individual sector's contributions to the national economy, map the direction of future development, and set targets."[27] These plans serve as economic and industrial instructions for planning agencies, local and provincial governments, banks, and state-owned enterprises.

The 9th Five-Year Plan and 2010 Long-Term Program for National Economic and Social Development called for the government to promote the growth of industries considered to be critical for economic development, such as "pillar industries" (*i.e.*, machinery, electronics, petrochemical, and construction), high-technology industries, and certain basic industries upon which other industries depended (*e.g.*, the steel indus-

[26] Steel Policy at Art. 16.

[27] *See What is the Five Year Plan*, *available at* http://www.china.org.cn/english/MATERIAL/157595.htm.

try).[28] Subsidies granted to the steel industry pursuant to the 9th Five-Year Plan still benefit the Chinese industry today.

The 10th Five-Year Plan for National Economic and Social Development, covering the period from 2001-2005, prescribed "energetically optimizing and improving [the] industrial sector" by enhancing traditional industries with new technologies and intensifying construction of transportation, energy and other infrastructure facilities.[29] According to the plan, these measures were "most important in the energy [and] metallurgy" industries.[30] Thus, in addition to providing for the addition of substantial new steel capacity, the plan also aimed to equip the industry with sophisticated technology and equipment to increase the industry's global competitiveness. It also provided for pervasive government intervention in the economy, stating that the "state must hold a controlling stake in strategic enterprises that concern the national economy" and must also "uphold the dominance of the public sector of the economy [and] let the state-owned sector play the leading role."[31]

Acknowledging the over-building of steel capacity during the 2000-2005 period, the central government's 11th Five-Year Plan (covering the years 2006-2010) focuses on capacity consolidation, along with the creation of new, high-efficiency steel facilities that can compete on a global scale. Specifically, the plan provides for (1) improving the quality of steel products through the acquisition of new technology and equipment and

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28 *See* Lu Ding, *Prospect of Industrial Policy Regime After the WTO*, CPB Nat'l Bureau for Economic Policy Analysis at 7 (2000), *available at* http://www.cpb.nl/nl/research/sector6/afgeronde_projecten/wto/papers/c-indpol-wto.pdf.

29 *See* Gov't of the PRC, *The Tenth Five Year Plan for Nat'l Economic and Social Dev.-People's Republic of China*, *available at* http://ilo.org/public/english/employment/skills/hrdr/init/chn_1.htm.

30 *Id.*

31 *Id.*

(2) consolidating the industry through mergers to create larger and more internationally-competitive steel companies.[32] In other words, the plan acknowledges that China's rapid growth in steel production is not intended for domestic use, but will result in increased exports.

List of Encouraged Industries: The central government's "Catalogue of Key Industries, Products and Technologies the Development of Which is Encouraged by the State" is a planning document that lists key industries and products which are favored by the central government and therefore eligible for preferential treatment. The Catalogue lists "Iron and Steel" as a preferred or favored industry along with dozens of specific steel products.[33] As a result, steel companies are eligible for various tax exemptions and reductions, including a 50 percent income tax reduction for companies that derive more than 70 percent of their revenues from manufacturing a product listed in the Catalogue. The Catalogue also gives provincial and local authorities the discretion to issue policies that help promote the development of these industries.

In 2005, the NDRC issued an updated list entitled the "Directory Catalogue on Readjustment of Industrial Structure." The directory lists 25 types of encouraged projects under the iron and steel category and provides for certain benefits to the steel industry, including new mechanical coking ovens, new rolling and ferroalloy technologies, and assistance in applying automation technology.[34]

32 *11th Five Year Plan for Nat'l Economic and Social Dev.*, Nat'l Dev. and Reform Comm'n.

33 *See, e.g.*, Foreign Affairs Information Portal, *Current Catalogue of Key Industries, Products and Technologies the Dev. of Which is Encouraged by the State (Provisional)* (Approved by the State Council on Dec. 31, 1997), *available at* http://www.bjfao.gov.cn/english/law/003C/144.html.

34 *Directory Catalogue on Readjustment of Industrial Structure* (2005), NDRC Publication No. 40 (Mar. 2, 2005).

Foreign Investment Catalogue: Despite the prohibition on foreign control of steel companies, the central government also maintains a "Catalogue for the Guidance of Foreign Investment Industries," which is issued jointly by the NDRC and the Ministry of Commerce ("MOFCOM"). The catalogue distinguishes between encouraged and discouraged industries, with discouraged industries divided into those where foreign investment is restricted and those where foreign investment is prohibited. Industries that are discouraged are generally those that are not in line with the central government's national economic development goals. Encouraged industries include the "ferrous metallurgical industry" as well as products such as hot-rolled and cold-rolled steel plate.[35] Investors in encouraged industries are eligible for certain government benefits, including tax reductions and duty waivers.[36]

In summary, the central government continues to wield significant control over the direction of the Chinese steel industry through its various policy instruments and other incentive programs. Indeed, the central government recently requested that state-owned steel mills consolidate their profitable assets under their listed companies.[37] Major steelmakers Baosteel and Wuhan Iron & Steel have already done so and Anyang Iron & Steel Group will reportedly transfer assets to its listed arm, Anyang Iron & Steel, in return for 377 million new shares worth US$ 413 million. This is one example of how the central government continues to intervene directly in the steel industry and to manage the financial and other affairs of individual companies.

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35 *See Catalogue for the Guidance of Foreign Investment Industries*, Jan. 7, 2003, *available at* http://www.chinataiwan.org/web/webportal/W5029562/A5120231.html.

36 *Revised Catalogue for the Guidance of Foreign Investment Industries*, Jan. 2005, *available at* http://www.tdctrade.com/alert/cba-e0501a-5.htm.

37 *Anyang Steel to Transfer Assets to Listed Arm*, American Metal Market, June 19, 2007.

2. *Provincial and Local Government Policies*

Provincial and local governments maintain similar control over the steel industry through a wide range of policy instruments. Shandong Province, for example, recently issued "guidelines" for the development of the steel industry in the province.[38] The guidelines include capacity and production targets for crude and finished steel through 2010, including targets for specific steel companies. The guidelines set forth the provincial government's intent to construct a new steel mill with crude capacity of 10 million metric tons and to form a giant steel mill with steel capacity of more than 20 million metric tons.[39] The guidelines even set targets for product mix and energy usage, and establish size requirements for sinter machines, coke ovens and BOFs.[40] These guidelines underscore the extent to which the provincial and local governments continue to direct the expansion of the steel industry.[41]

Provincial and local governments also exert control through regional five-year plans.[42] Similar to the central government's five-year plans, the regional plans establish those industries and products which should be targeted for preferential government support. The five-year plan of almost every province in China establishes the iron and steel industry as a preferred industry and provides substantial government direction for the growth and evolution of the industry. Even Ningxia Province, with the least steel pro-

38 *See The Chinese Steel Industry*, International Iron and Steel Institute, Issue 4, Jan. 2007, at 2.

39 *Id.*

40 *Id.*

41 *Id.*

42 While the following analysis focuses primarily on provincial government policies, local government policies are similar in nature. For example, the Handan City 11[th] Five Year Plan indicates that the city's aim is to "strengthen the four pillar industries of steel, coal, electricity, and construction materials" and to "launch steel-based construction and upgrade the steel industry's overall competitiveness." *Handan City 11[th] Five Year Plan* at 5 and 41.

duction of any province in China, has designated its steel industry a "pillar industry" and states that it will support and encourage the completion of a steel wire production line for Shisuishan Steel & Iron Company as well as improvements to the company's smelting and rolling equipment.[43]

Specifically, in the five-year plans, the provincial and local governments set detailed production and capacity targets for the region as well for individual companies. For example:

- Anhui Province's 11th Five-Year Plan, covering the period 2006-2010, states that a "5 million ton sheet project will be built by Maanshan Iron & Steel Company" and that the same company "will reach 20 million tons in 2010."[44]
- The government of Jiangxi Province intends to "promote competitive steel & iron processing and focus on the construction of [a] 3 million ton sheet project in Xingang."[45]
- The 11th Five-Year Plan for Jilin Province indicates that the provincial government will "accelerate the construction of important projects including Tonghui Steel & Iron Company's 10 million ton steel project."[46]
- The Hubei provincial government states that it will support "steel capacity expans[ion] ... to 22 million tons" by 2010.[47]

Notably, as these examples demonstrate, many provincial and local governments are encouraging the expansion of the local steel industry at the same time that the central government purports to be eliminating obsolete capacity and limiting overall capacity. These policies underscore the often competing interests between the central government's policy of consolidation and elimination of inefficient capacity and the provincial

43 *Ningxia Province 9th Five-Year Plan*.

44 *Anhui Province 11th Five-Year Plan* at 5.

45 *Jiangxi Province 11th Five-Year Plan* at 9.

46 *Jilin Province 11th Five-Year Plan* at 4.

47 *Hubei Province 11th Five-Year Plan* at 11.

and local governments' desire to expand steel capacity for revenue, employment and other factors. It is not surprising, then, that many mills at the local and provincial level have invested in new capacity with the support of local governments but without official approval from the central government.[48]

In addition, provincial governments use the five-year plans to manage product mix and direct certain companies and regions to focus on specific steel products, including sheet, plate, galvanized, bars, tubular, and stainless products. For example:

- The Jiangxi provincial government has directed steel producers in the region to "extend plates and tubular products, develop plates for ships, for boiler furnaces, for pressure vessels, etc; develop high strength low alloy steel tube, replace solid drawn tube with welded tube, and develop welded steel tube for automobiles; and further develop plate spring and cold belt, eliminate hot rolled sheet, ordinary tubular steel, etc."[49]

- The Liaoning provincial government has specified that the "continuous casting ratio will be 72 percent, plates and tubes proportion will be 60 percent, [and] products with high added value will amount to 45 percent."[50]

- The 11th Five Year Plan for the Inner Mongolia Autonomous Region indicates that its goal is to "accelerate steel industry restructuring and implement capacity expansion and rebuilding project of Baotou Steel" and to "improve [the] product mix, including increasing the proportion of medium plate, automobile plate, specialty steel ... and stainless alloy."[51]

Certain provincial governments even dictate which company will produce which product. The Shandong provincial government, for example, has directed that "Jinan Steel company will develop sheet plate ... Laiwu Steel company will focus on the development

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48 *See How China Has Made the Steel World Bounce,* Steel Business Briefing Insight, Issue 32, Mar. 1, 2007, at 3.

49 *Jiangxi Province 10th Five-Year Plan* at 11.

50 *Liaoning Province 9th Five-Year Plan* at 12.

51 *Inner Mongolia Autonomous Region 11th Five-Year Plan* at 10.

and improvement of sectionals ... [and] Qingdao Steel company will put emphasis on wire with light sections."[52]

The provincial five-year plans further specify which technologies should be used in steel production. A recent five year plan issued by the Inner Mongolian government stated that the "metallurgy industry should give priority to Baotou Steel, eliminate lagging open-hearth steelmaking technology and improve ... equipment levels in order to achieve energy saving and consumption reduction."[53] Liaoning Province's Five-Year Plan states that "Angang should ... eliminate the open hearth furnace ... and build modern tipping converters and assorted casters to achieve continuing casting."[54]

Provincial governments also control the development of raw material output and transportation infrastructure to benefit the steel industry. Beijing's provincial government has stated that it will "strictly limit and control the ore mine industry" for the benefit of the steel industry,[55] while another provincial government has pledged to "build more transportation facilities on the coast of northern China to meet demands for iron-ore imports of the steel companies located in north-east China and northern China."[56]

In short, through the five-year plans, provincial governments retain a significant degree of control over all aspects of steel production and development, including output, product mix, technology, raw materials, transportation, and energy. Provincial governments continue to assume a large role in economic development and continue to assert the authority to intervene in economic development at all levels. Such state intervention

52 *Shandong Province 10th Five-Year Plan* at 11.

53 *Inner Mongolia Autonomous Region 10th Five-Year Plan* at 5.

54 *Liaoning Province 9th Five-Year Plan* at 12.

55 *Beijing Province 11th Five-Year Plan* at 45.

56 *Beijing Province 10th Five-Year Plan of Communication.*

is documented and explicitly encouraged in the five year plans. A recent five year plan for Xinjiang Province states that the "regional government should strengthen and improve macro-control by comprehensively using the plan and the financial means to play the role of price and revenue lever, and forming positive macro-control policies to create a favorable macroeconomic environment for the implementation of the plan."[57]

3. *Other Forms of Government Control*

Another method by which the government maintains control over the steel industry is by installing party members or other government officials as senior officers and directors of steel companies. For example, the following directors and supervisors of Maanshan Iron & Steel also serve as government officials or as officers in state-owned banks:

- Zhao Jianming, a director of Maanshan Iron & Steel, also holds the office of Secretary of the Party Committee of Magang.[58]
- Li Kezhang, supervisor of the company, is also Deputy Secretary of the Party Committee of Magang and Chairman of the Labor Union of Magang.[59]
- Wang Xiaoxin is an independent supervisor of the company and has been appointed General Manager of the International Business Department of the China Construction Bank and Deputy President of the China Construction Bank, Anhui provincial branch.[60]
- Jiang Yulin, an independent supervisor of Maanshan Iron & Steel, is also President of the Industrial and Commercial Bank of China, Wuhu branch, and Deputy President of the Industrial and Commercial Bank of China, Anhui Provincial branch.[61]

57 *Xinjiang Province 10th Five-Year Plan* at 26.

58 Maanshan Iron & Steel ("Maanshan") 2004 Annual Report at 34.

59 *Id.* at 35.

60 *Id.*

61 *Id.* at 36.

- Tang Xiaoqing, an independent supervisor of Maanshan Iron & Steel, has served as Director of Finance of the Bank of China, Anhui Province, and is now Deputy President of the Bank of China.[62]

- Dou Qingxun, a supervisor of the company, is also the Deputy Secretary of the Party Committee and Labor Union Chairman.[63]

In fact, in 2003, seven out of 18 directors and supervisors of Maanshan Iron & Steel also served as officials in the Party Committee or as officers in a state-owned bank.[64] Maanshan is not unique in this regard. Angang Steel, for example, has numerous directors who also serve in various levels of the government, including: Liu Jie, Chairman of the company and an alternate member of the 16th Central Committee of the Communist Party of the PRC and a representative in the 10th National People's Congress; and Yang Hua, Vice Chairman of Angang and a member of the Standing Committee of the Party Committee of Angang Holding.[65]

Through direct participation in the decision-making and overall management of steel companies, the government is able to ensure adherence to its policies and maintain substantial control over the direction of the industry. Moreover, having officials of state-owned banks serving simultaneously as directors of major steel companies undoubtedly facilitates the injection of state capital into the companies and facilitates the process of securing government loans. It should be little surprise that in 2004 Maanshan Iron & Steel was the recipient of long term loans worth RMB 1.5 billion, plus EUR 2.1 billion and US$ 165 million from the Industrial and Commercial Bank, the China Construction Bank, and the Bank of China, each of which had representatives in the

62 *Id.*

63 Maanshan 2003 Annual Report at 35.

64 *Id.* at 34-36.

65 Angang New Steel Company Ltd. 2005 Annual Report at 24.

senior leadership of Maanshan at the time the loan was secured.[66] In 2005, Maanshan secured long term loans worth RMB 4 billion, plus EUR 16.6 million and US$ 791 million from the same banks.[67] This is but one example of how the Chinese government exercises its control in multiple, interrelated ways to benefit the steel industry.

C. *Conclusion*

In summary, through its ownership stake, policy instruments, and direct participation in company management, the Chinese government maintains control over the growth and evolution of the steel industry. As discussed in further detail below, the Chinese government exercises its control and implements its policy of support for the steel industry by providing it with massive subsidies and other forms of assistance, including cash grants, capital infusions, land grants, transfers of ownership interests on terms inconsistent with commercial considerations, conversion of debt to equity in steel companies, preferential loans and directed credit, debt forgiveness and inaction regarding non-performing loans, and a variety of tax incentives.

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66 Maanshan 2004 Annual Report at 153.

67 Maanshan 2005 Annual Report at 183-184.

III. CHINESE GOVERNMENT SUBSIDIES TO THE STEEL INDUSTRY

This section of the report details China's various subsidies to its steel industry. A partial compilation, which covers only a handful of the subsidies documented in this report and including only a limited number of companies, reveals subsidies totaling more than RMB 393 billion (US$ 52 billion). As summarized in the table below, these documented subsidies include RMB 130.9 billion in preferential loans and directed credit; RMB 141 billion in equity infusions and/or debt-to-equity swaps; RMB 38.9 billion in land-use discounts; RMB 9.47 billion in government-mandated mergers and almost RMB 2 billion in direct cash grants.

Table 2: Total Documented Chinese Steel Subsidies[68]

Type of Subsidy	Amount (RMB)	Amount (USD)
Loans	130,991,528,889	17,317,301,088
Equity Conversion	141,008,728,000	18,641,591,708
Land Use	38,900,000,000	5,142,645,620
Grants	1,956,399,069	258,639,257
Gov't Mandated Mergers	9,470,000,000	1,251,949,975
Currency Under-valuation	70,862,053,501	9,368,083,010
Tax Benefits	unknown	unknown
VAT	unknown	unknown
Domestic Preference Programs	unknown	unknown
Raw Materials	unknown	unknown

68 Each of these estimates is based on information covering only a small portion of the Chinese steel industry. Conversions are calculated using the exchange rate as of 7/24/2007 (7.5642 RMB/US$ 1).

Electricity	unknown	unknown
Environmental	unknown	unknown
Total	**393,188,709,459**	**51,980,210,658**

The actual total subsidy amount is undoubtedly much greater, and probably several times greater, than the amounts shown in this table and tabulated in this report. For example, the amounts shown for cash grants are based on the financial reports of only nine Chinese steel producers, and the amounts shown for government mandated mergers are based on only two recent merger transactions. In addition, for several large subsidy categories (such as excessive VAT rebates, raw materials, domestic preference programs, electricity and environment), this report does not attempt to quantify the benefits received for the industry as a whole. As a result, the amounts documented in this report only scratch the surface of the actual subsidization amounts.

A. *Cash Grants and Capital Infusions*

The Chinese government's most overt subsidies are its direct cash grants and capital infusions to Chinese steel producers. Though cash grants are becoming less frequent, given their obvious nature as countervailable subsidies, nine Chinese steel producers – including Baosteel, Maanshan, Jinan, and JISCO – reported approximately RMB 2 billion in direct cash grants, "specific construction projects," and similarly earmarked funds on their financial statements. Other companies have also reported receiving direct cash grants from the Chinese government – grants that continue to benefit these companies today.

1. *Description of Types of Grants Offered by China*

Grant subsidies have been, and remain, a favorite tool for China's promotion of its steel industry. The U.S. Department of Commerce reported to the President in 2000 that the Chinese government admitted that it would spend more than US$ 6 billion within several years to upgrade and transform its steel industry.[69] At the time of the announcement, the Chinese Ministry of Commerce stated that the central government would direct local and provincial governments to give the steel industry priority with respect to land use, raw materials, transport, equipment, and water and power supplies.[70]

The Chinese government continues to provide a variety of direct subsidy grants. These subsides include grants for small and medium sized companies, state-owned enterprises operating at a loss, technology and research, export promotion, upgrades and renovation, "outward expansion" of industry, and environmental incentives, to name a few. China's own WTO subsidies notification admits to several programs for small and medium-sized enterprises that provide direct grants. Such programs include funds for supporting technological innovation, development funds, and funds for exploration of international markets.[71] In 2004 alone, China budgeted RMB 1.6 billion for these grants.[72] A substantial portion of these subsidies likely go to favored and state-owned industries, such as China's numerous small and medium sized steel producers.

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69 U.S. Dep't Commerce, *Report to the President, Global Steel Trade: Structural Problems and Future Solutions* at 146 (2000).

70 *Id.*

71 WTO, *New and Full Notification Pursuant to Article XVI:1 of the GATT 1994 and Article 25 of the SCM Agreement*, No. G/SCM/N/123/CHN, at 35-37 (Apr. 13, 2006) (hereinafter "China Subsidies Notification").

72 *Id.*

China has also admitted in reports to the WTO that it continues to offer grants and tax subsidies to state-owned enterprises that are operating at a loss.[73] The government identified the following industries as benefiting from these subsidies: metallurgy, ferrous-metal, machinery, coal, oil, chemical, textile, tobacco, and others.[74] Despite repeated promises to eliminate these subsidies, China has yet to follow through on its commitments.

In addition to offering grants for enterprises operating at a loss, the government provides grants and loans for technology and research.[75] According to a 2004 WTO report, one such program is administered by the Ministry of Finance pursuant to State Council Circular No. 99 of 1987.[76] In 1998, the last year for which data is available for this program, the total amount of payouts under the program was RMB 64.1 billion.[77]

In addition to China's own admissions, other governments have identified actionable direct subsidy grants in the course of trade remedy cases brought against China. In a recent countervailing duty case against China, for example, Canadian authorities identified actionable subsidies in the form of direct cash grants provided by the government to steel and other manufacturing industries for export performance. The Canadian government found benefits to the Chinese steel industry in the form of direct grants to

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73 WTO, Committee on Subsidies and Countervailing Measures, *Transitional Review Mechanism Pursuant to Section 18 of the Protocol of the Accession of the People's Republic of China* ("WTO Transitional Review"), No. G/SCM/Q2/CHN/8 (Oct. 6, 2004).

74 *Id.*

75 *Id.* at Annex 5A.

76 *Id.*

77 *Id.*

enterprises satisfying export criteria as well as grants to enterprises to assist in expanding export sales.[78]

Additionally, in a recent countervailing duty investigation of China, the U.S. government found that the State Key Technology Renovation Project Fund ("Key Technology Fund") offers cash grants for technical upgrades and renovation.[79] The Key Technology Fund was created pursuant to state circular Guojingmao Touzi (1999) No. 886 and operates under the regulatory guidelines contained therein, including the *Measures for the Administration of National Debt Special Fund for National Key Technology Renovation Project,* and state circulars Gujingmao Touzi (1999) No. 122, Guojingmao Touzi (1999) No. 1038, and Guojingmao Touzi (2000) No. 822. According to the U.S. Department of Commerce, the specific purpose of this subsidy program is to promote: (i) technological renovation in key industries, enterprises, and products; (ii) facilitation of technology upgrades; (iii) improvement of product structure; (iv) improvement of quality; (v) supply increase; (vi) expansion of domestic demand; and (vii) continuous and healthy development of the state economy.[80]

Local and provincial governments also provide substantial cash grants to steel producers. These programs are often little more than creatively titled export subsidies. For example, certain funds for "outward expansion" are provided to industries in

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78 Canadian Int'l Trade Tribunal, *Dumping of Certain Carbon Steel and Stainless Steel Fasteners Originating in or Exported From the People's Republic of China and Chinese Taipei and Subsidizing of Certain Carbon Steel and Stainless Steel Fasteners Originating in or Exported from the People's Republic of China and Chinese Taipei*, Nos. 4243-38, 4218-17, AD/1308, CVD/103, at 40-41 (Dec. 21, 2004) (Statement of Reasons and Final Determination). While this case involved steel fasteners, many of the subsidy programs found by the Government of Canada and cited in this paper are granted to manufacturers of other steel products and are also indicative of the types of subsidies granted to both upstream and downstream manufacturers.

79 *Coated Free Sheet Paper From the People's Republic of China,* 72 Fed. Reg. 17,484, 17,491 (Dep't Commerce Apr. 9, 2007) (amended prelim.) ("*Coated Free Sheet*").

80 *Id.*

Guangdong Province for (i) market exploration, (ii) export credit insurance, (iii) loan interest on offshore processing trade projects, (iv) export research and development, (v) responding to antidumping duty cases, (vi) export rebate account loan payments, and (vii) export-oriented enterprises.[81] Steel producers located in the province, including Shaoguan Steel and Guangzhou Steel, likely benefit from this program. Export interest subsidies are also available for enterprises located in Shenzhen or Zhejiang Province.[82] Under this program, RMB 800 million in benefits were to be distributed to eligible companies in 2006.[83] Lastly, local payments are made as incentives and rewards to encourage enterprises to conduct clean production inspections.[84] The program, "Provisional Measures on Clean Production Inspection," went into force in October 2004 and was authorized by Decree No. 16 of the NDRC and the National Administration of Environmental Protection.[85]

2. *Documented Grants Provided to Chinese Steel Producers*

Numerous Chinese steel producers report direct cash grant subsidies in their financial statements. For instance, **Baosteel** reported that it received more than RMB 25 million in government "subsidies" in 2005, in addition to substantial subsidy income in the preceding two years.[86] These cash grants do not appear to be slowing – through

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81 WTO Transitional Review, *Questions from the European Union to China concerning Subsidies and Price Controls*, No. G/SCM/Q2/CHN/24, at 2 (Oct. 20, 2006) ("*EU Subsidies Questions*"); *Guangdong Supports Private Enterprises to Expand Outward*, TDC Trade, Mar. 1, 2004.

82 WTO Transitional Review, *EU Subsidies Questions*, No. G/SCM/Q2/CHN/24, at 2.; *Export Interest subsidy for Shenzhen Enterprises Raised*,: TDC Trade, May 1, 2004.

83 *Id.*

84 The purpose of this program is to provide incentives and rewards (monetary or non-monetary) to encourage enterprises to conduct clean production inspections, with the goal of protecting the environment.

85 *Coated Free Sheet*, 72 Fed. Reg. at 17,497.

86 Baosteel 2005 Annual Report at 46.

the first half of 2006, Baosteel received RMB 21 million in government subsidies.[87] **Maanshan Iron & Steel** reported in its 2003 financial statements that it received more than RMB 276 million in 2003 and RMB 525 million in 2002 in "government subsidies granted for specific construction projects," in addition to "subsidy income for steel export."[88] Additionally, **Jinan** reports that it received direct grants from the "provincial financial office as the technology research and development fund of 2nd national high-tech industry development project."[89] **JISCO** identified almost RMB 300 million in direct subsidies in 1999.[90] Using the U.S. government's subsidy calculation methodology results in a countervailing duty rate of nearly 10 percent for JISCO for grants *alone*. The rate would undoubtedly increase substantially if additional subsidies (*e.g.*, subsidized loans, tax rebates, raw materials procurement) were included.

Other steel producers have also reported receiving substantial cash grants from the government, including Baotou, Handan, Wuhan, Laiwu, and Shougang.[91] Notably, Baotou and Handan both reported receiving subsidy income as recently as 2006.

B. *Equity Infusions and Conversions*

Equity infusions in the Chinese steel industry take at least two forms. First, there is the familiar straight injection of additional cash into a company, usually in exchange for newly minted shares. As the dominant shareholder in most major steel companies, the Chinese government receives no additional rights when it issues additional shares.

[87] Baosteel 2006 First Half Report at 18.

[88] Maanshan 2003 Annual Report at 144 and 151.

[89] Jinan 2005 Annual Report at 53-54.

[90] JISCO 2000 Annual Report at 52.

[91] *See* Baotou Steel Union ("Baotou") 2006 Annual Report at 3; Handan Steel 2006 First Half Report at 36; Wuhan 1999 Annual Report at 2-3; Laiwu Steel ("Laiwu") 2006 Third Quarter Report at 5; Shougang 2005 Third Quarter Report at 3; Shougang 2003 Annual Report at 33; Shougang 2002 First Quarter Report at 3.

Unless it demands a reasonable commercial return on its investment (in the form of dividends or higher return on sale), the government, in effect, is granting the steel company a straight cash grant. The second form of equity infusion is the debt-to-equity conversion. This popular capitalization technique relieves cash-starved companies of their obligations to repay their massive debts. In exchange for assuming the debt burden, the government receives additional shares in companies they already own. Added together, a review of publicly available financial statements reveals equity grants of at least RMB 141 billion, or nearly US$ 19 billion, over the last ten years.

1. *Description of Equity Infusions Offered by China*

As explained in detail above, the government owns a majority stake in almost all of China's top steel producers. This has been accomplished in large part through the government's ongoing equity infusion scheme, which enables the government to acquire additional ownership shares in steel companies at the same time that it provides substantial cash subsidies to steel producers. Indeed, China regularly uses equity infusions as a grant-giving operation in order to effectuate its economic policy goals.

Equity infusions and other forms of government-backed investment guarantees are well known and expected in China. The US-China Business Council has documented China's use of such tools, including "new infusions of capital," to prop up failing firms.[92] Its report concludes the following:

> The unfortunate reality is that many of these firms have no market potential, and as such, will never take off if exposed to market forces. Time and again, policymakers and managers alike may persuade themselves that each *new infusion of capital is a last supper*, but what everybody knows—

[92] US-China Business Council, *The China Business Review 2000: Free Lunch or Last Supper? China's Debt-Equity Swaps in Context* at 3 (July-Aug. 2000).

> or at least what many managers have come to believe—is that each last supper has been, and will always be, a free lunch. . .[93]

Private investors readily support the use of such non-commercial tools, given the government-guaranteed return on investment. Investors can make a "safe bet" on a Chinese steel producer, knowing that the government will not allow it to fail. As the government's consolidation plan unfolds, the need for a government guarantee increases because, with a few very large firms, a "too big to fail" policy becomes a necessity. Thus, government intervention is a self-perpetuating cycle that becomes more important with time.

2. *Documented Equity Infusions Provided to Chinese Steel Producers*

An examination of public financial statements for China's top steel producers demonstrates the pervasiveness of the equity infusion subsidy scheme. For example, in 2005, **Baosteel** issued five billion ordinary shares.[94] At RMB 5.12 per share, the company raised over RMB 25 billion.[95] Three billion of these shares were purchased directly by Baosteel's 100 percent state-owned holding company, Baosteel Group, resulting in an infusion of more than RMB 15 billion in government cash.[96] Baosteel's financial statements explain that, "upon the completion of new share issuance and asset acquisitions, the company raised its production capacity of crude steel to 20 million tons and established three steel production systems, namely, carbon steel, stainless steel,

93 *Id.* (emphasis added).

94 Baosteel 2005 Annual Report at 32.

95 *Id.*

96 *Id.*

and specialty steel systems."[97] Further, the new share issuance "helped to standardize the Company's governance structure" and thus "won support from the investors and capital market."[98]

It is not surprising that private investors and the capital markets were pleased with Baosteel's share issuance given the government guarantee associated with the sale. The government, through the 100 percent state-owned Baosteel Group, proclaimed publicly that it would (1) retain the shares for a certain window period, (2) not sell its shares for less than RMB 5.63 after the window period, and (3) never own less than 67 percent of the total number of shares.[99] Further, the government stated that it would prevent Baosteel's share price from ever falling below RMB 4.53 in order to "protect the interests of investors."[100] The government would do this by manipulating prices, if necessary, through further injections and/or purchases of public shares on the Shanghai Stock Exchange.[101] Thus, Baosteel successfully increased its production capacity and made acquisitions, all according to government design, with government cash as well as private cash guaranteed by the government.

Maanshan Iron & Steel, another top steel producer, provides a further example of the pervasiveness of the equity infusion subsidy scheme. From 1993 to 1997, the company received government infusions of more than RMB 18 billion – subsidies that still benefit Maanshan today. These equity infusions have also enabled Maanshan to grow substantially over the past 15 years, in line with government policy. Indeed, every

97 *Id.* at 16.

98 *Id.*

99 *Id.* at 110 n.30.

100 *Id.*

101 *Id.*

year the company reiterates that its increases in capacity, consolidation, and acquisitions are all made according to government-established plans. For example, in its 2005 financial statements, Maanshan explains that "[t]he implementation of the Company's master plan for technology reforms and structural adjustments in relation to the Eleventh Five-Year Plan ... was carried out ahead of schedule," including, for example, a thin plate production line with a 5 million ton capacity.[102] Maanshan's current capabilities would not have been possible if not for the government's substantial infusions of cash years ago.

3. *Description of Debt-to-Equity Conversion*

Debt-to-equity swaps are another tool utilized by the Chinese government to prop up state-owned enterprises. In the year 2000 alone, China Daily reported that 37 different Chinese steel companies benefited from debt-to-equity swaps worth a total of RMB 62.5 billion (US$ 7.53 billion).[103] In 1999, the total benefit from debt-to-equity swaps was RMB 27.5 billion.[104]

The debt-to-equity swap is a disguised grant-giving operation. Throughout the 1980s and 1990s, Chinese banks helped implement the economic goals of the government by distributing capital to favored firms and industries.[105] As a result, many of these firms amassed tremendous liabilities and over-invested in capacity expansions, all the while facing declining real returns on investment.[106] The government continues to

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102 Maanshan 2005 Annual Report at 10.

103 *China: Debt-to-equity swaps help steel makers*, China Daily, Mar. 26, 2000, *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=5460.

104 *Id.*

105 US-China Business Council, *The China Business Review 2000: Free Lunch or Last Supper? China's Debt-Equity Swaps in Context* at 1 (July-Aug. 2000).

106 *Id.*

utilize the debt-to-equity swap as a tool to save favored industries that are loaded down with insurmountable debts.[107] Indeed, as of September 2005, the MOFCOM website stated that it would exempt certain state-owned enterprises ("SOEs") from "repayment of non-performing loans, and provide a debt-to-equity swap policy. The policies will support firms' development, make good use of domestic and foreign trade development funds, provide subsidized interest for technical innovation loans, and accelerate infrastructure development."[108]

The debt-to-equity swap also serves as a mechanism to effectuate the government's long-standing policy goals. A report by the US-China Business Council explains that the debt-to-equity swaps are "a sort of response, 16 years later, to the 1984 policy of shifting SOE [state-owned enterprise] financing from direct subsidies to bank loans (bo gai dai)."[109] The idea was to use "market forces," by offering interest bearing loans rather than direct subsidies, in order to increase performance. However, as the report notes:

> [W]hen performance failed to improve—when return on investment actually declines and firms proved unable to repay loans—the conclusion, somehow, was not that market forces were working (as they, indeed, actually were). Few policymakers or enterprise officials would accept the possibility that bo gai dai was doing exactly what it should have done: identify poor performers so that resources could be shifted away accordingly. After all, market forces were not supposed to create losers! Rather than tolerating market outcomes, therefore, decisionmakers [sic] backed away from their own policies. When enterprises could not repay the

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107 *Id.*

108 *See* WTO Transitional Review, *Questions from the United States to China Concerning Subsidies and Price Controls* ("*U.S. Subsidies Questions*"), No. G/SCM/Q2/CHN/14, at 4 (Sept. 29, 2005).

109 US-China Business Council, *The China Business Review 2000: Free Lunch or Last Supper? China's Debt-Equity Swaps in Context* at 2 (July-Aug. 2000).

> bank loans that had replaced direct subsidies, new loans were simply pumped in year after year.[110]

The report explains that Chinese firms and policymakers mistakenly believed that market forces would benefit *all* enterprises regardless of their efficiency.[111] In other words, policymakers did not confront the reality that market forces will, by nature, weed out inefficient enterprises. The report continues:

> What is important to recognize is that some of these beliefs are alive and well in China today, a reality confirmed by the current attitude of many enterprise managers toward debt-equity swaps. Theoretically, the last thing a manager in a market economy should want is a debt-equity swap. After all, equity financing is generally more expensive than debt financing over the long run (otherwise, why would an investor purchase equity if he or she could achieve higher returns by simply putting money in the bank?), and the swap itself is an indicator of default.[112]

In China, however, the debt-to-equity swap is just another source of free capital.[113]

4. *Documented Debt-to-Equity Swaps*

The Chinese government began widespread use of the debt-to-equity subsidy program in 1999.[114] Since then, many of China's largest steel companies have benefited substantially from such swaps.

- A division of **Baoshan Iron & Steel**, Meishan Corp., received a US$ 200 million debt-to-equity conversion in 1999. The China Construction Bank ("CCB"), a government-owned and controlled policy bank, was loaded down with some US$ 30 billion in problem loans.[115] To deal with the debt, China's Finance Ministry provided US$ 1.2 billion to create a state-owned bank asset management company

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110 *Id.*

111 *Id.* at 2-3.

112 *Id.* at 3.

113 *Id.*

114 *China's Bad-Debt Cops Get Going*, Business Week, Oct. 4, 1999.

115 *Id.*

("BAMC") named China Cinda Asset Management Corporation ("Cinda").[116] Cinda, which is completely government owned, controlled, and financed,[117] promptly converted more than US$ 200 million in debt to equity for Meishan Corp.[118]

- Shortly after Meishan's debt-to-equity swap agreement in 1999, Huarong AMC and the China Development Bank completed agreements with three more subsidiaries of **Baosteel.**[119] First, more than RMB 2 billion in debt owed by Baosteel Pudong Steel Co. was converted into equity in the company. Second, a deal was signed with Shanghai No. 1 Iron & Steel Co. for RMB 800 million. Third, an agreement with Baosteel Shanghai No. 5 Steel Co. swapped RMB 500 million of the company's debt for equity. Pursuant to the terms of these agreements, Huarong AMC was to hold most of the equity while the remaining portion would be shared among the AMCs of other creditor banks.[120] The agreements also called on the AMCs and their parent banks to work with the companies to improve their operations. After the debt-to-equity swaps, ratios of liabilities to assets for the Shanghai Baosteel subsidiaries were slashed by 20 percent on average, saving annual loan interest payments of approximately RMB 300 million. Company officials admitted that the deals were necessary because the "companies all have levels of liability considered 'abnormal,' hindering normal operations."[121]

- **Xingang Steel** was established in 2000 through a debt-to-equity swap in which several of China's BAMCs purchased non-performing loans and then injected capital into the steel company.[122]

- **Valin Lianyuan Steel Corp.,** a small producer in Hunan province, successfully converted RMB 740 million in debt to equity in 2000.[123]

- In 2001, **Anyang**, a 100 percent state-owned entity,[124] received a massive equity infusion of RMB 1.7 billion to pay off long-term loans for assets it could not oth-

116 *Id.*

117 *Id.*

118 *Id.*

119 *See China's debt-for-equity swaps proceed despite concern*, Japan Economic Newswire Plus, Nov. 13, 1999.

120 *Id.*

121 *Id.*

122 *Debt-to-Equity Swap Brings Economic Results to Steel Firm*, People's Daily Online, June 7, 2001, http://english.people.com.cn/200106/07/eng20010607_71985.html.

123 *A Remarkable Leap in the Industrial Revitalization of Hunan*, Xinhua News Agency, Oct. 27, 2005.

124 *See* Appendix 2.

erwise pay.[125] Anyang's long-term debts were almost entirely eliminated.[126] At the same time, its shareholder equity increased nearly 80 percent.[127] In other words, when the debts matured and the company was unable to pay, the government stepped in and injected cash. Anyang then paid off the debt, and the financial statements remained healthy. Simply put, one arm of the government paid off the other while the company acquired the assets at no cost.

- In 1997, **Maanshan** benefited from a similar subsidy scheme which continues to benefit the company today.[128] At the time, Maanshan engaged in numerous "projects under construction," including "buildings, plant houses, machine and equipments [sic] and other fixed assets which under [sic] construction or installment."[129] As with Anyang, when Maanshan's loans came due, an equity injection of over RMB 600 million was made and its debts were paid.[130]

These massive infusions benefit the Chinese steel industry today. Recent press reports indicate that the government continues to provide the steel industry assistance in this manner. However, the true extent of this assistance is unknown. The OECD reports that the transactions in China involve "substantial reductions in debt loans in return for restructuring arrangements whose details have not been fully revealed."[131] Indeed, back in 1999, *Business Week* predicted the overall plan "could mark the start of a serious effort by the banks to clear away an estimated $250 billion in bad debt."[132]

C. *Land-Use Rights*

China's steel industry also receives heavily subsidized lease agreements for the land utilized by its massive operations. Based on documented benefits reported in the

125 Anyang 2001 Annual Report at 13-18, 24-25.

126 *Id.* at 13.

127 *Id.*

128 The U.S. Dep't of Commerce would likely use a 15 year average useful life ("AUL") for steel assets. Thus, a debt-to-equity swap in 1997 is still countervailable today.

129 Maanshan 1997 Annual Report at 3.

130 *Id.* at 1.

131 OECD, *Reforming China's Enterprises* at 78 (2000).

132 *China's Bad-Debt Cops Get Going,* Business Week, Oct. 4, 1999.

public financial statements of several major producers, we estimate a total benefit to the Chinese steel industry of at least RMB 38.9 billion (US$ 5.1 billion).

1. *Description of Land Subsidies Offered by China*

Private land ownership, either by individuals or corporations, is prohibited in China.[133] Instead, the Chinese government offers lease agreements or other forms of land-use rights rather than transferring actual ownership.[134] Essentially, the Chinese government assumes the role of landlord by controlling the lease of land to domestic industries. Once the government-granted land-use rights are transferred, the rights are then classified as normal, depreciable assets of the company. The land-use rights are typically listed either as intangible assets or deferred expenses, given a depreciable life-span (usually 50 years), and then used as any other normal asset. For example, land-use rights are routinely used as collateral in securing future financing.[135] As seen in the table below, several of the largest Chinese mills report the use of this accounting method. The land-use rights are booked at their original "cost", amortized on an annual basis, then carried at the reduced value.

133 Memorandum from David M. Spooner, Asst. Sec'y for Import Admin., to Joseph A. Spetrini, Deputy Asst. Sec'y, *re: Antidumping Duty Investigation of Certain Lined Paper Products from the People's Republic of China ("China") – China's Status as a Non-Market Economy*, (Dep't Commerce Aug. 30, 2006).

134 *See* Barry Naughton, *The Assertive Center: Beijing Moves Against Local Government Control of Land*, China Leadership Monitor, No. 20 (Winter 2007).

135 *See, e.g.*, Angang Steel Company Ltd. 2006 Annual Report at 119.

2. *Documented Land Subsidies Provided to Chinese Producers*

Accounting for Land-Use Rights by Selected Chinese Steel Mills[136] [137] [138]

	(RMB 000)	2003	2004	2005	2006
Angang	Cost (original value)	354,200	354,200	354,200	5,638,200
	Depreciation charge for year	7,392	7,107	7,179	57,000
	Accumulated Depreciation	35,534	42,926	50,033	115,000
	Carrying Amount (book value)	311,274	304,167	296,988	5,466,200
Baosteel	Cost (original value)	1,721	1,690	1,305,909	1,334,134
	Depreciation charge for year	31	188	48,798	29,012
	Accumulated Depreciation				
	Carrying Amount (book value)	1,690	1,502	1,257,110	1,305,122
Maanshan	Cost (original value)	1,052,989	1,069,247	1,202,580	1,781,504
	Depreciation charge for year	20,757	21,047	22,207	32,367
	Accumulated Depreciation	168,423	189,179	210,227	232,434
	Carrying Amount (book value)	863,809	859,021	970,146	1,516,703

Using the annual amortization charges as a proxy for annual rental payments, it becomes clear that Chinese steel mills enjoy the use of land at prices substantially below any market-determined value. For example, **Baosteel** – China's second largest steel group with significant operations in Shanghai – booked only RMB 29,012,000 in land-use rights amortization for 2006. In other words, Baosteel apparently valued the cost of using land in Shanghai, plus thousands of acres more throughout China, at approximately US$ 3.6 million in 2006. Similarly, **Angang Steel Group** booked a land-use rights amortization of approximately US$ 7.1 million in 2006 for land used in operations in nearly every region of China, including major urban areas.

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[136] Angang 2003 Annual Report at 93; Angang 2004 Annual Report at 104; Angang 2005 Annual Report at 115; Angang 2006 Annual Report at 119.

[137] Baoshan Iron & Steel Co. ("Baoshan") 2003 Annual Report at 68; Baoshan 2004 Annual Report at 75; Baoshan 2005 Annual Report at 99; Baoshan 2006 Annual Report at 129.

[138] Maanshan 2003 Annual Report at 139; Maanshan 2005 Annual Report at 179; Maanshan 2006 Annual Report at 41.

Furthermore, available information suggests that Angang, along with other steel producers, may have never actually purchased the land-use rights reported in the annual statements. The financial reports indicate that, in some cases, the value and title of these assets, coupled with other property and equipment, were merely transferred from the government to the company at the date of incorporation. For example, references to the "contribution" of at least RMB 226.8 million in land-use rights to Angang Steel are reported as early as 2001.[139] Indeed, Premier Wen Jiabao recently spoke out against "local governments that routinely offer free or cut-rate real estate and utilities to developers looking to set up job-creating businesses, such as steel mills..."[140] Moreover, current land-use processes have evolved from policies where "state agencies, social organizations, and public and private enterprises were able to obtain the right to use land free of charge for indefinite periods of time."[141] Thus, not only does it appear that the Chinese steel industry is receiving the privilege of using land at subsidized rates, it is likely that they were given the right to use the land for free.

Other Chinese steel mills appear to enjoy heavily discounted land use as well. The table below demonstrates reported lease rates for **Baotou Steel**, **Anyang Steel**, and **JISCO**.

139 Angang 2001 Annual Report at 98.

140 *To Clean Air, Aid Climate, China Looks To End Polluters' Tax Breaks, Other Perks*, The Associated Press, Apr. 27, 2007.

141 Tung-Pi Chen, *Emerging Real Estate Markets in Urban China, Int'l Tax & Bus. Lawyer*, No. 78, at 81 (1990-1991).

Land use subsidies to smaller Chinese steel mills [142] [143] [144]

	A	B	C = A*B	D = NPV of C at 10% discount over 50 years	E = 494*B	F = E-D
Company	2005 Reported Cost (RMB per sq. meter)	Land under lease (sq. meters)	Annual cost of lease (RMB)	NPV of lease (RMB)	Estimated purchase price (RMB 494 per sq. meter)	Implied subsidy (RMB)
Baotou	5.00	834,929	4,174,643	41,390,806	412,454,684	371,063,878
Anyang (2004)	1.64	2,975,847	4,880,390	48,388,158	1,470,068,601	1,421,680,442
JISCO	0.64	521,571	333,805	3,309,619	257,656,074	254,346,455
JISCO	1.25	42,095	52,619	521,709	20,795,078	20,273,369
Subtotal						**2,067,364,144**

Company	2005 Reported Cost (USD per sq. meter)	Land under lease (sq. meters)	Annual cost of lease (USD)	NPV of lease (USD)	Estimated purchase price ($60 per sq. meter)	Implied subsidy (USD)
Baotou	$ 0.61	834,929	$ 509,306	$ 5,049,678	$ 50,095,711	$ 45,046,032
Anyang (2004)	$ 0.20	2,975,847	$ 595,169	$ 5,900,995	$ 178,550,842	$ 172,649,847
JISCO	$ 0.08	521,571	$ 41,726	$ 413,702	$ 31,294,260	$ 30,880,558
JISCO	$ 0.15	42,095	$ 6,314	$ 62,605	$ 2,525,718	$ 2,463,113
Subtotal						**$ 251,039,550**

As this table demonstrates, Baotou Steel's 2005 rental fees were RMB 5/m^2 for the 834,929 square meters that its buildings and operations occupied, which equates to the lease of over 200 acres of industrial land for approximately US$ 512,000 in 2005. For Anyang Steel Group, the discount is even greater. In 2004, Anyang reported a land rental fee of RMB 1.64/m^2, meaning that the company leased its industrial land for only US$ 0.02 per square foot in 2004.

In 2004, the state-run newspaper *China Daily* reported the average price of industrial land in China was RMB 494/m^2.[145] Using Baotou Steel as an example, the annual lease payment of RMB 5 per square meter for 50 years is worth RMB 49.57 today.[146] If the same calculation is applied to all three mills and converted to U.S. dollars, the results suggest that they are collectively receiving a subsidy worth over US$ 251

142 Baotou 2005 Annual Report at 26 and 62.

143 Anyang 2004 First Half Report at 13.

144 Jiuquan Iron & Steel Corp. ("JISCO") 2005 Annual Report at 28.

145 *Shanghai Land Prices Rank No 2 In China*, China Daily, Apr. 2, 2004.

146 In order to appreciate the extent of land-use subsidies, it is necessary to compare the net present value (NPV) of the annual lease rates to the reported purchase price of land utilized by the Chinese mills. That is to say, it is necessary to estimate what the value of lease payments made over the course of 50 years (the average length of a lease) would be today.

million. Moreover, if the same methodology is applied to the Chinese steel industry as a whole, the subsidy totals more than US$ 5.1 billion (RMB 38.9 billion).

D. *Government-Mandated Mergers and Transfers of Ownership on Terms Inconsistent with Commercial Considerations*

One of the newer tools used by the Chinese government consists of government-mandated mergers and transfers of ownership. These mergers are being driven by China's 11th Five-Year Plan. Where China previously emphasized growth of unprofitable capacity through grants and equity infusions, it is now emphasizing the creation of several consolidated world-class entities through required mergers and ownership transfers. While the terms of many of these mergers have never been made public, an examination of just two of these mergers demonstrates that they involved RMB 9.47 billion in government subsidies.

1. *Description of Government-Mandated Mergers and Transfers*

As discussed above, consolidation within the Chinese steel industry is a stated focus of the government's Steel Policy. Because so many Chinese steel companies are controlled by government entities, the government can essentially order companies to merge. One common means of doing this is to offer ownership stakes in state-owned steel companies to other, larger steel producers at prices below the market value, or even for free.

2. *Documented Mergers and Transfers*

The China Syndrome described how, in January 2005, **Wuhan Iron and Steel Group** acquired a majority stake in **Ercheng Iron and Steel** *at no cost*, in return for

Wuhan's agreement to merge Ercheng into it.[147] Wuhan received a 51 percent stake in Ercheng, which at the time produced 3 million metric tons of steel a year. At the time, Citigroup valued the assets involved at RMB 2.7 billion.[148]

Consolidation activity has accelerated since that time. Another prominent government-directed merger occurred in May 2007 when **Baosteel** received a 48.46 percent stake in **Xinjiang Bayi Iron & Steel Group** ("Bayi") – *at no cost.*[149] At the time, Xinjiang's assets were worth approximately RMB 6.77 billion.[150]

This transfer was only possible because the Chinese government owns and controls both entities. The Xinjiang government, through the Xinjiang SASAC, owned Bayi, the largest steel producer in Xinjiang.

Bayi produced 3.6 million tons of crude steel in 2006. It intends to increase its crude steel capacity to 5 million tons per year by the end of 2007.[151] Bayi completed a major upgrade of its cold-rolled mill in December 2005[152] and is currently constructing a project that will produce 1.2 million tons of hot rolled steel per year.[153] There are reports

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147 *The China Syndrome* at 22.

148 *China Steel Industry: Capacity Continues to Grow, So Does Surplus*, Citigroup Global Markets, Feb. 21, 2006, at 28, 69.

149 *Regulator Clears Baosteel's Takeover Of Bayi Steel Group,* American Metal Market, June 18, 2007.

150 When Baosteel formally took control of Bayi, it received 48.5 percent of Bayi. It agreed to inject RMB 3 billion into the company, after which its stake would rise to 70 percent. This is an increase of 21.5 percent. If 21.5 percent of Bayi is worth RMB 3 billion, then 48.5 percent would be worth RMB 6.77 billion.

151 Li Hongmei, *Baosteel Takes Formal Control Of Xinjiang Bayi*, American Metal Market, May 17, 2007.

152 Li Hongmei, *Sherman Unit Commissions China Mill Upgrade*, American Metal Market, Dec. 9, 2005.

153 Li Hongmei, *Baosteel Takes Formal Control Of Xinjiang Bayi*, American Metal Market, May 17, 2007.

that Baosteel will inject RMB 3 billion into Bayi, and that its ownership stake will increase to 85 percent at that time.[154]

Significantly, this injection of capital will go into Bayi; it is not payment to the Xinjiang government. Ultimately, the Xinjiang government will continue to hold either an 11 or a 20 percent stake in Bayi, according to reports from different sources.[155] This uncertainty over the extent of the Xinjiang government's share of the company is a further indication of the extent to which the takeover did not comply with normal commercial considerations.

In 2005, **Wuhan Iron & Steel** announced that it was acquiring **Liuzhou Iron & Steel** for US$ 805 million, or approximately US$ 75 per ton of production capacity.[156] As shown above, both Wuhan and Liuzhou are 100 percent government-owned, through various government entities. By way of comparison, other international acquisitions of steel companies in 2005 occurred at prices of US$ 315 to $1,694 per ton of production capacity.[157] Using the next-highest non-Chinese acquisition price in 2005 as a benchmark, the sale of Liuzhou to Wuhan for less than its apparent market value represented a subsidy of at least US$ 644 million to Wuhan.

It is quite likely that transactions of this type will continue to occur. For example, in 2004, the largest specialty steel producer in Northeast China, **Dongbei Special Steel Group Co., Ltd.**, was created through the merger of three "key" SOEs: Liaoning Special Steel Group (*i.e.*, Dalian Iron & Steel Group Co., Ltd.); Fushun Special Steel Group

154 *Id.*

155 *Regulator Clears Baosteel's Takeover Of Bayi Steel Group,* American Metal Market, June 18, 2007; Li Hongmei, *Baosteel takes formal control of Xinjiang Bayi*, American Metal Market, May 17, 2007.

156 PriceWaterhouseCoopers, *Forging Ahead: Mergers And Acquisitions Activity In The Global Metals Industry, 2006* at 3 (2007).

157 *Id.*

Co., Ltd; and Beiman Special Steel Co., Ltd. (major operational assets only).[158] More recently, **Baosteel** has been conducting talks with the government of Inner Mongolia to acquire **Baotou Iron & Steel**, which is owned by the Inner Mongolian government. A Baotou official stated on July 23, 2007, that "[t]he merger can be considered a done deal. Baosteel will take us over, either by paying or getting an asset transfer *free of charge*. It will happen very soon, as our local government is very keen for the merger."[159] The Chinese central government also supports the acquisition.[160] Baotou produced 7.5 million tons of steel in 2006.[161] The lowest international acquisition price for a steel producer not in bankruptcy in 2006 was US$ 533/ton, which ArcelorMittal paid for Sicarsta in December 2006.[162] If Baotou were in fact transferred to Baosteel free of charge, this would represent a subsidy to Baosteel of at least US$ 2.6 billion.

E. *Preferential Loans and Directed Credit*

The government also directs credit to Chinese steel producers in order to effectuate its policy goals. Central, provincial and local governments provide both direct and indirect preferential loans through the state-owned banks. In just the last five years, 15 of China's top steel producers received more than RMB 130 billion in subsidized loans, and the total amount of preferential loans and directed credit is far higher. Experts estimate that the majority of all loans in China are policy (preferential) loans.

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158 *See* CECF Online, *Company Profile*, http://www.constex.com/cn/disp2004.asp?id=63 and http://www.cecf.com.cn/web/en/info/enterprise/detailEnterprise.do;jsessionid=c0a8c00e500a201c3bded14ad9a339fcd0c893f477?enterpriseId=21274289.

159 Li Hongmei, *Baosteel Moves Closer To Takeover Of Baotou Steel*, American Metal Market, July 23, 2007.

160 *Id.*

161 *Id.*

162 PriceWaterhouseCoopers, *Forging Ahead: Mergers And Acquisitions Activity In The Global Metals Industry, 2006* at 7 (2007).

1. *Description of Preferential Loans and Directed Credit*

China's banking system is dominated by the four state-owned banks – the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Agricultural Bank of China – which account for over 60 percent of all loans.[163] Traditionally, these banks have made loans based on political directives from the central or provincial governments, rather than creditworthiness or other market-based factors. These "policy loans" have generally gone to state-owned enterprises and to industries favored by the government, including steel, on preferential, non-commercial terms.[164]

The Chinese government has not hidden its preferential loan policy. As the Department of Commerce noted in its 2000 Report to the President, the Chinese government has publicly stated the amount of discounted loans provided to Chinese steel companies:

> The [Chinese] government recently announced that $6 billion will be spent over the next few years to upgrade and transform the steel industry, with the hope of ensuring its international competitiveness when China enters the WTO. Baoshan, Wuhan, Anshan, and Shougang head the list of steel producers slated to benefit from this assistance. *Nearly $3.4 billion will be in the form of low-interest loans.* It is not clear whether this amount represents the volume of low interest loans or, alternatively, the reduction in interest payments that the government will cover.[165]

163 Luo Ping, China Banking Regulatory Comm'n, *Challenges for China's Banking Sector and Policy Responses*, (New Delhi) (Nov. 14-16, 2003), *available at* http://www.imf.org/external/np/apd/seminars/2003/newdelhi/ping.pdf.

164 *See Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government*, June 1, 2005, http://knowledge.wharton.upenn.edu/index.cfm?fa=printArticle&ID=1202. A recent IMF report concludes that "banks remain exposed to several sectors that are likely over invested, such as steel, cement, aluminum, and construction and, are therefore vulnerable to an economic slowdown and/or consolidation in these sectors." Richard Podpiera, IMF, *Progress in China's Banking Sector Reform: Has Bank Behavior Changed?*, No. WP/06/71, at 11 (Mar. 1, 2006).

165 U.S. Dep't Commerce, Int'l Trade Admin., *Report to the President: Global Steel Trade – Structural Problems and Future Solutions* at 141 (July 2000) (emphasis added).

These preferential policy loans continue to be granted to China's steel producers today. Indeed, China's Steel Policy provides for direct government subsidization of the steel industry, including support in the form of "tax refunds, *discounted interest rates*, funds for research and other policy support for major iron and steel projects utilizing newly developed domestic equipment."[166] The policy also mandates the provision of export credits, restrictions on foreign investment, and discrimination against foreign equipment and technology.[167] For steel projects that utilize domestic equipment, the policy further calls for "policy support in such aspects as taxation, interest subsidy, and scientific research funds."[168] Such projects, therefore, not only receive government loans but also subsidies to pay for the loans, as well as other benefits.

A November 2005 WTO report confirms China's state support to various industries through the banking system "in the form of policy loans, the automatic roll-over of unpaid principal and interest, forgiven and non-performing loans and the selective use of below-market interest rates."[169] In its recent countervailing duty action against China, *Coated Free Sheet Paper*, the Department of Commerce found such loan programs to be countervailable subsidies.[170]

China's policy of preferential loans to favored industries is further evidenced by the devastation these policies have created in its banking system – specifically the high level of non-performing loans and the numerous bailouts of the state-owned banks.

166 Steel Policy at Art. 17 (emphasis added).

167 Article 27 of the Steel Policy, for example, provides that "the State encourages and will provide export credit and other support for enterprises engaged in the production of steel and related production equipment ..."

168 Steel Policy at Art. 17 (emphasis added).

169 WTO Transitional Review, *Chairperson's Report to the Council for Trade in Goods on Transitional Review in China*, No. G/SCM/118, at 12 (Nov. 9, 2005).

170 *Coated Free Sheet*, 72 Fed. Reg. at 17,484.

Standard & Poor estimates that 40 percent of China's state-owned banks' loans – or roughly US$ 800 billion – are non-performing.[171] This debt forgiveness provides a direct subsidy to the recipients in the amount of the debt forgiven. Such high levels of non-performing loans have left the state-owned banks virtually insolvent, forcing the government to repeatedly inject cash into the banks. Indeed, the Chinese government has been forced to provide massive subsidies to the state-owned banks and the state-owned enterprises to which they lent simply to keep them afloat, despite China's contention that these banks and enterprises operate on a commercial basis and are responsible for their own profits and losses. The central government is estimated to have spent more than US$ 250 billion since 1998 to bail out the four primary state-owned banks.[172]

2. *Documented Preferential Loans and Directed Credit*

According to one estimate, policy loans account for nearly 60 percent of all loans.[173] Two of China's top steel producers, **Baosteel** and **Maanshan**, have received between 60 to almost 100 percent of their loans from policy banks.[174] Baosteel funded one-half of the RMB 10 billion cost of a new stainless steel production facility with subsidized loans.[175] Another producer, **Anshan Steel Group**, received RMB 10 billion in

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171 *See Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government*, June 1, 2005, http://knowledge.wharton.upenn.edu/index.cfm?fa=printArticle&ID=1202.

172 *See* WTO Transitional Review, *U.S. Subsidies Questions*, No. G/SCM/Q2/CHN/14, at 3 (Sept. 29, 2005).

173 Luo Ping, *Challenges for China's Banking Sector and Policy Responses*, China Banking Regulatory Comm'n, Nov. 14-16, 2003, *available at* http://www.imf.org/external/np/apd/seminars/2003/newdelhi/ping.pdf.

174 Baosteel 2005 Annual Report at 106 n.28; Maanshan 2004 Annual Report at 148 n.14, 152-153 nn.24-25.

175 China Corporate Culture Web, http://www.ce-c.com.

policy loans from the state-owned China Development Bank.[176] Further, **Handan Iron & Steel Group** received subsidized loans totaling RMB 2.4 billion to fund a 1.3 million ton cold-rolled steel sheet project.[177] Other companies, such as **Baotou Steel**, have reported receiving export financing at below market rates.[178] In 2006, Anshan Steel received export credit totaling US$ 1.05 billion for its exports of high-end products.[179]

Many more Chinese steel producers have been given subsidized loans to carry out Chinese government policy. For instance, Maanshan proclaimed in its financial statements that it "continued with the implementation of the 10th Five-Year Plan" completing major projects including a cold-rolling plant, galvanizing line, a new blast furnace, a coke dry quenching project, a high-speed rod production line, and a coil coating line after receiving over RMB 6 billion in loans at interest rates as low as 0.25 percent from the Bank of China.[180] Maanshan explained that its increase in "long term loans by 107 percent was mainly attributable to the increase in the long term loans for construction" in accordance with the plan.[181]

Baosteel states in its 2005 financial statements that excessive growth and overcapacity are a major problem, echoing the government's 11th Five-Year Plan.[182] To solve this problem, Baosteel explains, "China has strengthened macroeconomic control

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176 Xinhuanet, Sept. 26, 2005, http://finance.sina.com.cn/stock/t/20050926/0829328489.shtml.

177 Stockstar.com, Sept. 2005, http://resource.stockstar.com/info2005/darticle.asp?id=SS,20050921,30269085&column=.

178 *See, e.g.*, 2002 Bautou Annual Report at 57 (noting a US$ 20 million export credit from the China Construction Bank Inner Mongolia Branch).

179 *Anshan Steel Secures 3-Year Funding From China Eximbank*, American Metal Market, Mar. 19, 2007.

180 Maanshan 2004 Annual Report at 10-11, 154 n.25.

181 Maanshan 2005 Annual Report at 185.

182 Baosteel 2005 Annual Report at 25.

over [the] steel industry" which aims to "increase industry concentration led by major enterprise groups."[183] Accordingly, Baosteel *quadrupled* its long-term loans and *quintupled* its short-term loans in 2005, in part for new projects and acquisitions.[184]

Angang received almost RMB 500 billion in long-term loans which were "guaranteed by Angang Holding," Angang's 100 percent government-owned holding company.[185] Finally, Anyang more than tripled its long-term loans in 2005 for construction of a converter-rolling mill.[186]

In the last five years, 15 of China's top steel producers received more than RMB 130 billion in subsidized loans. The average interest rate these companies paid is eight percentage points lower than the commercial rate calculated by the U.S. government in the *Coated Free Sheet Paper* subsidy investigation. The below-market rates enjoyed by Chinese steel producers are due to the pervasive interference in the credit market by the government. The loan subsidies attributable to 2005 total more than RMB 8 billion alone.

F. *Tax Benefits Provided to the Steel Industry*

The central, provincial and local Chinese governments provide a variety of tax exemptions, reductions and credits that directly benefit the steel industry. These programs, detailed below, provide a financial contribution to the steel industry in the form of foregone revenue by the Chinese government. Notably, many of these tax incentive programs were part of the Chinese government's WTO subsidies notification and are the subject of the U.S. subsidy complaint currently pending at the WTO.

183 *Id.*

184 *Id.* at 101 n.18, 106 n.28.

185 Angang 2001 Annual Report at 71.

186 Anyang 2005 Annual Report at 42-46.

1. *China's Tax Policies and Programs*

China's tax policies mandate tax incentives for specified industries, including steel. Article 16 of China's Steel Policy explicitly provides for government support in the form of "tax refunds ... and other policy support for major iron and steel projects."[187] Moreover, China's "Catalogue of Industries, Products, and Technologies To Be Encouraged for Development on a National Level" identifies the steel industry and roughly 30 different steel products as an industry/products to be encouraged. Industries and products identified in the Catalogue receive a wide variety of benefits, including an exemption from Customs duties and VAT on imported equipment used in the production process.[188] In addition, a 50 percent corporate income tax reduction is offered to those companies that derive more than 70 percent of their revenues from manufacturing products listed in the Catalogue.[189]

In support of these policies, the Chinese government has implemented a wide array of programs that provide substantial benefit to Chinese steel companies. Indeed, China's April 2006 WTO subsidies notification identifies more than 45 different tax incentive programs, many of which benefit the steel industry. These programs include measures which provide tax refunds, reductions, and exemptions to (1) enterprises in China that are Foreign Invested Entities ("FIEs") or export-oriented, and (2) enterprises in China that purchase domestic over imported goods.

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187 Steel Policy at Art. 16.

188 *See* Nat'l Dev. Zones, *available at* http://www.cadz.org.cn/en/zgkfq/biao11.htm.

189 *See, e.g.*, Foreign Affairs Information Portal, *Current Catalogue of Key Industries, Products and Technologies the Dev. of Which is Encouraged by the State (Provisional)* (Approved by the State Council on Dec. 31, 1997), *available at* http://www.bjfao.gov.cn/english/law/003C/144.html.

a. Tax Benefits for Export-Oriented Producers and FIEs

- **The Two Free, Three Half Program**: FIEs that are profitable and scheduled to operate not less than 10 years are exempt from income tax in their first two profitable years and pay only half of their applicable tax rate for the following three years.[190] FIEs in the metallurgical industry are automatically eligible for these tax exemptions and reductions.

- **Income tax reduction for export-oriented FIEs**: According to China's subsidies notification, an FIE may continue to pay half of its applicable income tax rate following the expiration of the "Two Free, Three Half Program" if exports constitute 70 percent of the company's sales.[191]

- **Income tax reduction for FIEs based on location**: The government provides a complex system of tax benefits to FIEs operating in Special Economic Areas (SEAs) such as coastal economic zones, export processing zones, and economic and technical development zones. For example:

    - Under Article 7 of the *FIE Tax Law* and Article 71 of *Decree 85*, "productive" FIEs located in the designated economic zones pay income tax at a reduced rate of either 15 or 24 percent.[192] The standard income tax rate for corporations in China is 30 percent, plus a 3 percent provincial income tax.

    - The Jaingsu Yangtze International Metallurgical Industrial Park Zhangjiagang City, an industrial park composed primarily of steel companies, advertises the following tax incentives for foreign-funded manufacturing companies located in the industrial park: the "Two Free, Three Half" program; local income tax exemptions; a VAT exemption for exported products; exemption of VAT and customs duties on equipment used in the manufacturing process; and a full refund of income taxes paid on profit which is reinvested in export-oriented enterprises.[193]

    - The China Association of Development Zones cites additional tax incentives, including: (i) the **Loss compensation schemes** whereby any losses experienced by companies in development zones can be offset through reductions in income taxes for a period of 5 years after the loss is

190 *See Coated Free Sheet*, 72 Fed. Reg. at 17,494.

191 China Subsidies Notification at Art. II, p. 3; *see also* Articles 75(7) and 75(8) of the Rules for Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises; Articles 8 and 9 of the Provisions of the State Council on the Encouragement of Foreign Investment; and Articles 6 and 8 of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises; *see also* United States Consultation Request with China on Export and Domestic Preference Subsidies, Feb. 2007.

192 *See Coated Free Sheet*, 72 Fed. Reg. at 17,494.

193 *See* Investment Guide, Jiangsu Yangtze Int'l Metallurgical Industrial Park.

incurred;[194] (ii) **Regional tax incentives** whereby companies in specified regions, including the "Middle Western Areas," are eligible for a 15 percent reduction in income tax after the original exemption-reduction period is over;[195] and (iii) **Export-oriented tax incentives** whereby taxes are reduced by as much as 50 percent for export-oriented enterprises which export 70 percent or more of their total annual output.[196]

- A 15 percent income tax reduction is granted to FIEs that are engaged in projects encouraged by the State.[197]
- FIEs that establish or expand an export-oriented enterprise or a technologically-advanced enterprise in China are granted an income tax exemption.[198]
- According to China's subsidies notification, FIEs that qualify as technology-intensive or knowledge-intensive and have major products listed in the *Catalogue of High and New Technology Products of China* are eligible for a reduced income tax rate of 15 percent.[199]
- A 40 percent income tax refund is given to FIEs that reinvest profit directly into that enterprise or that use their profit to establish other enterprises with foreign investment.[200]
- Other tax benefits are provided to FIEs that are recognized as high or new technology enterprises or are engaged in research and development.[201]

Moreover, Article 9 of the FIE Tax Law delegates to China's provincial and local governments the authority to provide exemptions and reductions of local income taxes

194 *See* Nat'l Dev. Zones, *available at* http://www.cadz.org.cn/en/zgkfq/biao11.htm.

195 *Id.*

196 *Id.*

197 Article 73(6) of the Rules for Implementation of the Income Tax Law of the People's *Republic of China on Enterprises with Foreign Investment and Foreign Enterprises*; Articles 6 and 7 of the *Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises;* Section XIII of the *Catalogue for the Guidance of Foreign Investment Industries.*

198 Article 81 of the Rules for Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises; Articles 6 and 10 of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises; Article 10 of the Provisions of the State Council on the Encouragement of Foreign Investment.

199 China Subsidies Notification at VI, p. 7.

200 Article 81 of the Rules for Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises; Articles 6 and 10 of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises; Article 10 of the Provisions of the State Council on the Encouragement of Foreign Investment.

201 China Subsidies Notification at VIII, p. 8 and XXVII, p. 31.

for "productive" FIEs. Jiangsu Province, for example, exempts FIEs from local income taxes during the period in which they benefit from the "Two Free, Three Half" program, pursuant to the *Regulations for the Local Income Tax Exemption and Reduction of Jiangsu Province for Enterprises with Foreign Investment.* Xuzhou Province also exempts productive FIEs from local income taxes pursuant to its *Policies for Encouraging Investments of Xuzhou Economic Development Zone.*[202]

b. Domestic Preference Tax Benefits

The Chinese government also provides tax refunds, reductions, and exemptions to certain enterprises on the condition that those enterprises purchase domestic rather than imported goods. In February 2007, the United States requested WTO consultations with China on a number of these domestic preference measures, including the following:

- A VAT refund for enterprises with foreign investment for their purchases of domestic equipment. The purpose of the provision is to "encourage enterprises with foreign investment to use domestic equipment."[203]
- An income tax refund of up to 40 percent for FIEs that purchase Chinese-made equipment rather than imports.[204]
- Preferential tax policies for Chinese enterprises purchasing Chinese-made equipment for the purpose of technological upgrades.[205]

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202 *Policies for Encouraging Investments of Xuzhou Economic Dev. Zone*, July 14, 2004.

203 *See* Circular of the State Administration of Taxation Concerning Transmitting the Interim Measure for the Administration of Tax Refunds to Enterprises with Foreign Investment for Their Domestic Equipment Purchases, GuoShuiFa [1999], No. 171 (Aug. 1999), *available at* http://www.fdi.gov.cn/pub/FDI_EN/default.htm; *see also Coated Free Sheet*, 72 Fed. Reg. at 17,496.

204 *See* Circular of the Ministry of Finance and the State Administration of Taxation Concerning the Issue of Tax Credit for Business Income Tax for Homemade Equipment Purchased by Enterprises with Foreign Investment and Foreign Enterprises, CaiShui [1999], No. 49 (Jan. 1999), *available at* http://www.fdi.gov.cn/pub/FDI_EN/default.htm; Circular of the State Administration of Taxation on Printing and Distributing the Measures Concerning Business Income Tax Credit on the Investment of Enterprises with Foreign Investment and Foreign Enterprises by Way of Purchasing Homemade Equipment, GuoShuiFa [2000], No. 171 (May 18 2000), *available at* http://www.fdi.gov.cn/pub/FDI_EN/default.htm; *see also Coated Free Sheet*, 72 Fed. Reg. at 17,496.

After two rounds of consultations, the United States requested formation of a dispute settlement panel on July 12, 2007.

2. *Documented Tax Benefits to Steel Producers*

Chinese steel companies benefit considerably from these tax incentive programs. Numerous companies, for example, benefit from the "Two Free, Three Half" program granted to FIEs. As **Angang**'s 2006 Annual Report explains, its jointly controlled entity, ANSC-TKS, is "exempt from income tax during its first two profitable years. ... A 50% income tax exemption is granted to ANSC-TKS from the third profitable year to fifth profitable year. No income tax was provided by ANSC-TKS as the year 2006 is the first profitable year of ANSC-TKS."[206] Nor did ANSC-TKS pay income taxes in 2005, as the company failed to make a profit that year.[207] Other steel producers that benefit from this program include TISCO and Hunan Valin.[208]

Chinese steel companies with foreign investment have also been eligible for a reduction in income tax from 33 percent to 15 percent, including the following steel groups or subsidiaries of these groups: Angang, Maanshan, Benxi, Laiwu, Handan Steel, Tangshan, Wuhan, TISCO, and Hunan Valin.[209] For example, certain subsidiaries of **Maanshan** were subject to a preferential income tax rate of only 15 percent in

205 *See* Circular on Distribution of Interim Measures Concerning Reduction and Exemption of Enterprise Income Tax for Investment in Domestically Made Equipment for Technological Renovation, CaiShui [1999], No. 290 (Dec. 8, 1999), *available at* http://www.fdi.gov.cn/pub/FDI_EN/default.htm.

206 Angang Annual Report 2006 at 103.

207 *Id.*

208 *See, e.g.*, Hunan Valin 2005 First Half Report at 28-29.

209 *See* Angang Annual Report 2005 at 99-100; Maanshan 2006 Annual Report at 62, 65; Benxi Interim 2001 Annual Report at 18; Laiwu 2000 Annual Report at 36; Handan Steel 2001 Annual Report at 19; Tangshan 1999 Annual Report at 8; Wuhan 2002 Annual Report at 13; TISCO 2004 Annual Report at 28; Hunan Valin 2001 Annual Report at 14.

2006 (and preceding years) because of foreign investments in the company.[210] According to **Hunan Valin**'s financial statements, pursuant to "File No. 160, 1999 issued by the People's Government of Hunan Province, our company enjoys the preferential income tax policy which states that our company first pays the income tax of 33 percent and then the fiscal department of the province returns 18 percent."[211] Other companies pay even less in income taxes as a result of provincial programs. **Baotou Steel**, for example is eligible for an income tax rate of only 10 percent from 2003 through 2007 as a result of a policy issued by the Department of Finance of the Inner Mongolia Autonomous Region.[212]

Chinese steel producers also benefit from tax incentives granted to enterprises that purchase domestically-produced equipment. **Angang Steel**, for example, states in its financial reports that "[i]n accordance with Guishuifa (2000) No. 13 issued by the State Administration of Taxation on 17 January 2000, the Company enjoyed tax exemption relating to investment in technical development of domestic-produced machinery amounting to RMB 163 million."[213] **Maanshan Iron & Steel** states in its 2006 Annual Report that:

> The amount of 2005 represents a tax concession, approved by the Maanshan City local tax bureau, in respect of the purchases of certain manufacturing plant, machinery and equipment in Mainland China. The tax concession is calculated at 40% of the purchases of such manufactured plant, machinery and equipment in Mainland China in the year of purchases. The amount is deductible in not more than five years ...[214]

210 Maanshan 2006 Annual Report at 62, 65.

211 Hunan Valin 2001 Annual Report at 14.

212 Baotou 2006 Annual Report at 13.

213 Angang Steel Company Limited 2006 Annual Report at 103.

214 Maanshan 2006 Annual Report at 103.

From 2004-2006, **Maanshan** received tax reductions worth RMB 370 million pursuant to this program.[215] Other steel producers have benefited from this program as well. In 2004, **Tangshan** received an income tax credit worth RMB117 million for purchases of domestic-produced equipment, while **Benxi Steel** received a tax credit worth RMB 130 million for its investments in domestic equipment.[216]

Other steel companies have received tax benefits due to their status as high and new technology enterprises. For example, **Hualing Guangyuan Co.**, a subsidiary of Hunan Valin, is a high and new technology enterprise and is therefore exempt from income taxes for two years starting from the first year of profit. Pursuant to this policy, issued by the Science and Technology Bureau of Hunan Province, after the two-year exemption the company is then eligible for a preferred income tax rate of 15 percent.[217] Other companies such as TISCO and Angang have received tax benefits as a result of engaging in research and development promoted by the State. **Angang**, for example, was granted tax exemptions worth RMB 337 million in 2006 as a result of engaging in research and development activities encouraged by the State.[218]

The vast number of tax exemptions, reductions and credits granted to Chinese steel producers by the various levels of the Chinese government have resulted in significant monetary benefits for individual steel producers. As the following table demonstrates, Angang Steel has received more than RMB 1.37 billion in tax benefits over the last 5 years.

215 Maanshan 2006 Annual Report at 103; Manshaan 2005 Annual Report at 95; Manshaan 2004 Annual Report at 71.

216 Tangshan 2004 Annual Report at 2; Benxi Steel 2004 Annual Report at 67; *see also* TISCO 2004 Annual Report at 28.

217 Hunan Valin 2005 First Half Report at 28-29.

218 Angang Steel Company Limited 2006 Annual Report at 103.

Certain Tax Benefits Received By Angang Steel Company[219]

(in millions of RMB)	2002	2003	2004	2005	2006	2002-2006 Total
Investment in technical development of domestic-produced machinery	-	218.98	37.13	24.15	163.00	443.26
Enterprise research and development costs	54.22	67.24	-	96.39	377.19	595.04
Outputs from environmental protection facilities		-	-	-	166.32	166.32
VAT Rebate/Exemption	28.27	5.85	7.29	117.20		158.61
Export tax refund			5.85			5.85
Total	**82.50**	**292.06**	**50.26**	**237.75**	**706.51**	**1,369.07**

G. *Value-Added Tax (VAT) Policies*

The Chinese government also provides subsidies to steel producers through its value-added tax ("VAT") rebate programs. There are at least three types of VAT rebate and exemption programs. These VAT programs are actively managed by the government to encourage production of selected steel products. Moreover, it is also unclear whether Chinese producers even pay the VAT on which they receive rebates.

1. *China's VAT Policies and Programs*

The government operates a VAT and tariff exemption program on imported equipment. The State Council's *Circular on Adjusting Tax Policies on Imported Equipment* (Guofa No. 37) exempts both FIEs and certain domestic enterprises in encouraged industries from paying VAT and tariffs on imported equipment not for resale.[220] The objective of this program is to encourage foreign investment, introduce foreign ad-

219 Angang 2002 Annual Report at 108; Angang 2003 Annual Report at 83 & 131; Angang 2004 Annual Report at 94 & 146; Angang 2005 Annual Report at 99 & 162; Angang Steel Company Limited 2006 Annual Report at 161.

220 Circular of the State Council Concerning the Adjustment in the Taxation Policy of Import Equipment, GuoFa [1997], No. 37 (Dec. 29, 1999), *available at* http://www.fdi.gov.cn/pub/FDI_EN/default.htm; *Coated Free Sheet*, 72 Fed. Reg. at 17,496.

vanced equipment, and upgrade industrial technology. The program was enacted in 1997[221] and was included in the government's subsidy notification to the WTO.[222] The U.S. government has already found this program to be an illegal subsidy and the Department of Commerce has imposed preliminary countervailing duties on imports which benefited from this program.[223]

Certain VAT refunds are also available to companies that operate in specific locations in China. For example, enterprises located in the Economic Development Zone of Hainan enjoy VAT tax preferences.[224] According to the "Preferential Policies Regarding Investment by Manufacturer," high-tech or labor intensive enterprises with an investment of more than RMB 3 billion and more than 1,000 local employees are refunded 25 percent of the VAT paid on domestic sales, the percentage of the tax received by the local government. [225] The subsidy starts the first year the company has production and sales and continues for five years. [226] The U.S. government has already found that program to be an illegal subsidy, and the Department of Commerce has imposed preliminary countervailing duties on imports that benefited from this program.[227]

The VAT subsidy program with the greatest impact is known as the value added tax rebate program, which provides direct payments to steel producers and exporters.[228] The program is conditioned upon export performance. Although characterized as a le-

221 *Id.*

222 Xuhou Guanghaun website, http://www.js.cei.gov.cn/JSfamous/0300016/eguan_hq.htm.

223 *Coated Free Sheet*, 72 Fed. Reg. at 17,496.

224 *Id.*

225 *Id.*

226 *Id.*

227 *Id.*

228 The Provisional VAT Rule replaced rules that had been in place since Sept. 18, 1984.

gitimate VAT rebate system, it is a discriminatory system through which the government decides which products will or will not receive payments upon export. The government periodically amends the rate at which exporters will be compensated, which makes clear that this program is a prohibited export subsidy.

This controversial program has been heavily criticized for years. For example, last year the European Union noted that:

> China appears to be operating a complex system of VAT refunds on exports. This system is not transparent as refunds seem to be given in a discriminatory basis. Discriminatory refunds could make the system a subsidy instrument. It also appears that changes to the VAT rebates are implemented retroactively and apply to companies in free trade zones which should not be subject to VAT.[229]

The United States has expressed its concerns about the discriminatory nature of the program:

> It is our understanding that the State Tax Administration increased value-added tax (VAT) export rebates several times in 1999, up to 17 percent for certain kinds of processed exports, and we see frequent reports to suggest that application of the VAT itself is increasingly uneven and potentially discriminatory.[230]

As these statements underscore, the VAT system with respect to steel products is highly discriminatory, and provides a countervailable subsidy.[231]

China's current VAT system was introduced on January 1, 1994, under the Provisional Rules of the People's Republic of China on Value Added Tax ("Provisional VAT

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229 WTO Transitional Review, *EU Subsidies Questions*, No. G/SCM/Q2/CHN/16, at 5 (July 25, 2006).

230 *See* WTO Transitional Review, *U.S. Subsidies Questions*, No. G/SCM/Q2/CHN/2, at 3 (Oct. 18, 2002).

231 The U.S. Dep't of Agriculture has also published an analysis of how the Government of China accomplishes policy objectives through its manipulation of the VAT and how, in certain circumstances, what the Government of China terms "export VAT rebates" are actually prohibited export subsidies. USDA, *VAT Protections: The Rest of the Story* (Mar. 3, 2007).

Rule") and the accompanying regulations. According to the Provisional VAT Rule, individuals and entities in China who sell goods or render services must pay a VAT upon the sale of their products.[232] The amount of the VAT is equal to the amount of value added by the taxpayer from its production of goods or rendition of services multiplied by the VAT rate. [233] The VAT rate is 17 percent for taxpayers selling most goods, but exported goods are exempt from the VAT. [234] In addition to the VAT exemption applicable to exported goods, taxpayers are entitled to a refund or rebate of the VAT they paid as part of the price for the inputs they purchased and used to produce the exported goods.[235]

VAT export rebate systems can be consistent with the requirements of the WTO Subsidies and Countervailing Measures ("SCM") Agreement and legal under U.S. trade law as long as the exemption or remission of indirect taxes on the production and distribution of exported products does not exceed the indirect taxes levied on the production and distribution of the same products sold in the domestic market.[236] If this requirement

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232 Provisional Regulations of the People's Republic of China on Value-Added Tax at Art. 1, *available at* http://www.zftec.gov.cn/english/PoliciesRegulations/CT/index.shtml.

233 *Id.*

234 *Id.*

235 *Id.* at Art. 25; *How Does The VAT Work In China?*, Mar. 13,2007, at par. D, *available at* http://www.china.org.cn/english/index.htm.

236 The purported purpose of permitting non-excessive rebates of indirect taxes upon exports is to avoid "double taxation," *i.e.*, a tax levied on the inputs into the product and then a tax levied again on the exported product when it enters the country to which it was exported. Article 1 of the SCM Agreement at n.1, and Annex 1, item (g). Prof. Jackson states that the border tax adjustment "reflects a desire to equalize domestic tax treatment on goods consumed domestically, whether domestically produced or imported, and to relieve ... exports of that burden . . . [The approach] has two sides . . . the imposition of an equalizing tax on imported goods, on the one hand, and the revision or exemption from domestic taxes for exported goods, on the other hand." John H. Jackson, *World Trade and the Law of GATT* 295 (Lexis Law Pub. 1969). If the country of export were to collect (and not refund) domestic taxes on exported goods, and such goods subsequently paid domestic taxes as well in the country of import, imported goods would not receive the same domestic tax treatment as domestic-made goods, as they would be subject to double taxation.

is not met, however, the result is a prohibited export subsidy. China's VAT rebate system for exported products has no process to ensure that excessive rebates do not occur. In fact, given its targeted application to a limited number of products and myriad rebate rates, it is in fact a policy tool through which the government promotes the exportation of certain products.

The Chinese government has regularly changed these rebate rates to effectuate its economic policies. For example, in October 2003, the government announced a reduction in the VAT rebate rate for steel products from 15 percent to 13 percent.[237] On March 28, 2005, the government terminated the export tax refund applicable to some steel products under HTS numbers 7203, 7205, 7206, 7207, 7218, and 7224, which cover non-alloy steel and stainless steel in ingots or other primary forms, semi-finished products of non-alloy steel, and stainless.[238] Effective May 1, 2005, the government reduced VAT rebates on all steel products under HTS Chapter 72 to 11 percent.[239]

News articles published contemporaneously with the 2005 revisions to the VAT rebate schedule explain the genesis of the VAT rebates and the subsequent elimination of VAT rebates for some products:

> According to a document issued by the ministry in cooperation with the State Administration of Taxation, China began

[237] Circular of the Ministry of Finance and the State Administration of Taxation on Adjusting the Export Rebate Rates CaiShui [1999], No. 222, at ¶ 4.4 (Oct. 13, 2003), *available at* http://www.fdi.gov.cn/pub/FDI_EN/default.htm.

[238] Circular of the Ministry of Finance and the State Administration of Taxation on the Cease of Export Tax Refund to Such Primary Steel Products as Billet, CaiShui [2005], No. 57 (Mar. 28, 2005), *available at* http://www.fdi.gov.cn/pub/FDI_EN/default.htm. Although CaiShui 57 refers to an "export tax refund," the only applicable export tax refunds are VAT tax refunds and consumption tax refunds. *Export Tax Rebate And Exemption In China, Getting Your Money Back From The Chinese Government*, Global Sources, Aug. 24, 2005. Thus, it is clear that such an export tax refund is a VAT refund.

[239] Ministry of Finance and State Taxation Administration's Notice on Lowering VAT Rebates for Steel Exports, CaiShui [2005], No. 73 (Apr. 27, 2005), *available at* http://www.fdi.gov.cn/pub/FDI_EN/default.htm; China Tax Alert, Deloitte Touche Tohmatsu.

> to offer the tax exemption since 1998 when the prices of China-made steel products were higher than the world market prices, and downstream firms in China imported steel products from overseas in huge quantities, causing great difficulty for domestic steel producers.
>
> That tax privilege has been very helpful in supporting domestic steel firms in turning out steel products in short supply in the country and improving their industrial mix, according to the document. But things have changed in terms of steel trade situation at home and abroad as steel prices in China are lower than that of the world market, and steel production causes too much pollutants, consumes too much energy and other resources, the ministry said.
>
> With permission from China's State Council, or the central government, the two government departments, therefore, decided to call off the tax privilege to ease the country's energy shortage and growing environmental pressure from industrial pollution, according to the document.[240]

On September 14, 2006, the Ministry of Finance, NDRC, MOFCOM, the General Administration of Customs and the State Administration of Taxation jointly announced another major revision to the Chinese VAT export refund policy.[241] According to this revision, the VAT rebate on exports of some products was eliminated; the VAT rebate on exports of other products was reduced; and the VAT rebate on yet other products was increased, in some instances to the full 17 percent, for "some high-tech products encouraged by the State's industrial policies . . . ."[242] The VAT rebate applicable to all ex-

240 *China Scraps VAT Exemption For Export-Oriented Steel Products*, People 's Daily Online, July 1, 2005, http://english.people.com.cn/200507/01/eng20050701_193619.html.

241 Notice of the Ministry of Finance and Four Other Ministries/Administrations Concerning the Adjustment of Export Tax Rebates for Some Commodities and the Enlargement of the Catalogue of Banned Commodities in Processing Trade, CaiShui [2006], No. 139 (Sept. 14, 2006), *available at* http://www.fdi.gov.cn/pub/FDI_EN/default.htm.

242 *Id.*

ports of finished steel products under Chapter 72 of the HTS was reduced to 8 percent for shipments made after December 2006.[243]

The 2006 VAT rebate rate changes were again tailored to manipulate exports to achieve official government policy. Bo Xilai, the Minister of Commerce, stated that the 2006 VAT export refund rate revisions were part of China's effort to address its enormous trade surplus.[244] The 2006 revisions also were designed to raise "the VAT cost for businesses exporting 'high energy consumption and high polluting' products while eliminating or reducing the VAT cost on the exportation of goods that fall under the 'high technology and other encouraged industries.'"[245] The 2006 revisions were also designed to address issues arising from high-volume exports of low value added products from labor-intensive industries that have triggered international trade friction and anti-dumping investigations.[246] In 2007, several additional changes were made to the nominal rates, but the policy motives remained the same. According to industry officials, the changes "ease pressures on the Renminbi and dissuade foreign anti-dumping lawsuits resulting from the mammoth trade surplus."[247]

In addition to the policy motivations behind altering the VAT tax rates, there are other indications that the VAT rebate system can lead to excessive rebates. The rebates appear to be provided on a flat percentage based on the export price of the prod-

243 *Id.*

244 *Revision to the Chinese VAT Export Refund*, LexUniversal, Nov. 13, 2006, *available at* http://www.lexuniversal.com/en/articles/1674.

245 *Id. See also China Adjusts Export Rebates*, Asia Times Online, Sept. 21, 2006; PriceWaterhouseCoopers, *Major Revision To The Chinese VAT Export Refund*, China VAT Alert, Sept. 2006.

246 KPMG, *Export VAT: China's new tool for shaping economic development*, China Alert, Nov. 2006, *available at* http://www.kpmg.com.cn/en/virtual_library/Tax/china_alert/2006/Issue30_1106.pdf; *see also China Adjusts Export Rebates*, China Business, Sept. 21, 2006.

247 *China To Adjust Export Tax Rebate Mechanism*, China Daily, May 14, 2007, *available at* http://www.chinadaily.com.cn/china/2006-07/23/content_647201.htm.

uct. Thus, the amount rebated is tied to the value of the final product, whereas the level of VAT incurred is based on the value of the taxable income. For example, if the VAT rebate is fixed at 13 percent of the value of the finished product, but the VAT collected is only 13 percent of the value of the taxable inputs, then the rebate on exports exceeds the VAT actually incurred by the following formula:

13% * (non-VAT taxable inputs (e.g. labor, capital, overhead)
+ profit earned on the sale of the finished product)

In other words, the VAT rebate exceeds the VAT cost imbedded in the exported product. As such, it is a classic over-rebate of an indirect tax.

In sum, the Chinese Government's VAT rebate program, with rates and availability that vary by product and industry, is a policy tool through which the government selects certain products for export benefits. Moreover, the program appears to provide an excessive rebate beyond the VAT cost, and the government does not have in place any workable program to ensure that rebate payments are not excessive.

H. *Benefits for Purchasing Domestically Produced Inputs and Equipment*

As *The China Syndrome* explained, the Chinese government provides income tax credits and VAT rebates on purchases of domestic inputs, machinery and equipment.[248] Under the SCM Agreement, subsidies for the use of domestic over foreign products are flatly prohibited.[249] The United States included all of these programs in its WTO subsidy case against China.[250]

248 *The China Syndrome* at 34.

249 *See* Annex 1A: *Multilateral Agreements and Goods of the General Agreement on Tariffs and Trade* 1994, Art. 3.1 ("Agreement on Subsidies and Countervailing Measures").

250 United States Consultation Request with China on Export and Domestic Preference Subsidies, Feb. 2007 at 1.

1. *China's Domestic Preference Programs*

In its subsidies notification to the WTO, the Chinese government summarized its program for granting tax credits for the purchase of equipment and machinery produced in China:

> For the technology upgrading projects which are consistent with the state industrial policies of the domestic enterprises, forty per cent of the expenses on purchasing domestically produced equipments shall be deducted from the increment of income tax of that year compared to the previous year.[251]

The same subsidy is available to FIEs that purchase domestically produced machinery and equipment as well.[252] The subsidy is available only to machinery or equipment produced in China; it does not apply to equipment that has been imported and re-sold, or even subject to further manufacturing in China.[253] To receive these benefits, the company requesting the tax credit must file an application with the local tax authority within two months of purchasing the equipment.[254]

The U.S. Commerce Department has found that the tax credit for the purchase of domestically produced equipment by FIEs provides a countervailable subsidy. In the *Coated Free Sheet Paper* investigation, the Department determined that the program provided a financial contribution in the form of revenue foregone by the Chinese government. The amount of the benefit equals the tax savings of the recipient company.[255] Because the program rewards the purchase of domestic over imported products, it is

251 China Subsidies Notification at 67-68.

252 *Id.* at 66.

253 *Id.*

254 *Coated Free Sheet*, 72 Fed. Reg. at 17,495.

255 *Id.*

considered *per se* specific under U.S. law.[256] The Department also preliminarily determined to treat these programs as providing recurring benefits, so that the entire benefit is allocated over sales in the year in which the benefit is received.[257] In its preliminary determination, the Department found that the *ad valorem* benefit from this program alone was 2.98 percent.[258] The Department did not address the identical program for domestic Chinese enterprises (*i.e.*, those with no foreign investment), but the logic of the Department's determination would require exactly the same result, since the programs are generally identical.

In addition, as noted above, the Chinese government refunds the VAT paid on certain domestically produced equipment that is purchased by FIEs.[259] The Commerce Department also preliminarily determined this program to be countervailable for the same reasons as the tax credit program.[260] As with the tax credit program, the Department treated the benefit as a recurring subsidy. The *ad valorem* subsidy amounts for the Chinese producers under this program ranged from 0.35 to 1.45 percent.[261]

2. *Documented Use of Domestic Preference Programs*

Several Chinese steel producers confirm in their financial statements that they have received benefits from domestic preference programs. **Benxi Steel**, for example, noted in its 2004 annual report that it received a reduction in income taxes for purchases of domestic equipment between 1999 and 2001. The total value of the tax

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256 *Id.* Under the SCM Agreement, prohibited subsidies, including subsidies that promote the use of domestic over imported products, are automatically considered "specific." SCM Agreement at Art. 2.3.

257 *Coated Free Sheet*, 72 Fed. Reg. at 17,495.

258 *Id.*

259 *Id.*

260 *Id.*

261 *Id.* at 17,496.

credit was RMB 130.4 million. Because this amount exceeded Benxi's total income tax due, a credit of RMB 100 million was applied to 2004, with the remainder to be applied to 2005.[262]

Similarly, **Maanshan** reported in its 2004 annual report that it had received RMB 110.3 million in tax credits for the purchase of plant machinery and equipment produced in China. The year before, it had received RMB 238.4 million in tax credits for this purpose.[263] Applying the methodology used by the Commerce Department, this program alone would have provided Maanshan with a countervailable benefit of 0.4 percent *ad valorem* in 2004, and 1.5 percent in 2005.

While amounts reported by other companies were smaller, they were also significant; **TISCO**, for example, received a tax credit for purchases of domestically produced equipment of RMB 22.0 million in 2004.[264]

I. *Raw Materials*

In addition to direct contributions to the domestic steel industry, the Chinese government at the national and local levels has undertaken programs to ensure that the steel industry has ready access to material inputs in quantities and at pricing levels that give Chinese steel producers additional unfair market advantages. In an environment where the Chinese government has encouraged the exportation of finished goods in order to ensure inward flows of foreign currency, the government has restricted the exportation of certain goods in order to ensure abundant domestic supply of goods and correspondingly low market pricing for those goods. Moreover, the government has

262 Benxi 2004 Annual Report at 67.

263 Maanshan 2004 Annual Report at 71.

264 TISCO 2004 Annual Report at 28.

made clear its intention to continue to restrict exports of raw materials where this will benefit the steel industry. Article 30 of the Steel Policy specifically states that "[t]he export of such preliminarily processed products as coke, iron alloy, pig iron, waste steel and steel base (ingot) with high energy-consumption and serious pollution shall be restricted ... ."[265]

1. *Metallurgical coke*

For many years, the Chinese central government used a licensing system to restrict the exportation of metallurgical coke – a necessary input for the production of steel in integrated facilities (*i.e.,* blast furnaces). In 2004, the European Union complained that the licensing scheme created significant imbalance in the global market, and demanded that the Chinese government eliminate its program.[266] While the central government agreed to a minimum quantity of coke to be supplied to the EU, the government sought ways to ensure that the licensing scheme stayed in place and was vigorously enforced. For example, the Chinese Ministry of Commerce began enforcing regulations forbidding the trading or selling of metallurgical coke export licenses among Chinese coke producers.[267] Indeed, at the same time that the Chinese government promised to provide a guaranteed quantity of coke to the EU, the government was reducing total exports to a targeted goal of "just 9 million to 10 million tonnes" in 2004 "[i]n order to preserve coke for its booming domestic steel industry."[268]

265 Steel Policy at Art. 30.

266 Philip Shawcross, *Steel Or Coke, The Compass Is Pointing To Asia's Giant: EU Set To Challenge Chinese Licensing*, American Metal Market, May 12, 2004. *See also*, Nancy E. Kelly, *US, EU Protest Chinese Coke Export Controls*, American Metal Market, June 1, 2004.

267 Kit Ling Wong, *Chinese Ministry Issues Warning On Resale Of Coke Export Licenses*, American Metal Market, July 28, 2004.

268 *Id.*

Under continued pressure from the EU and from other trading partners, the Chinese government agreed to end its coke export licensing scheme in 2006.[269] However, while it eliminated a WTO-illegal practice, the central government continued to protect its domestic industry by employing various tax measures to ensure that metallurgical coke stayed in China – including the elimination of tax rebates for exported coke. Indeed, to ensure a plentiful domestic supply of coke, the Chinese government has begun contemplating additional measures – including additional export taxes – to prevent the increased exportation of coke.[270] As a result, Chinese producers continue to enjoy a discount of approximately 15 percent on coke pricing. Whereas the world market price for coke is approximately US$ 171 per ton, Chinese domestic prices stand at approximately US$ 150 a ton. This pricing level, coupled with large quantity reserves, artificially reduces the cost of manufacture for Chinese steelmakers.

2. *Ferroalloys and other nonferrous metals*

Ferroalloys and other metals are used in a variety of ways in steelmaking. Ferroalloys such as ferrosilicon and ferromanganese are used to increase alloy content in steel in order to meet certain metallurgical standards and specifications for particular uses. Other metals such as zinc and chromium are used primarily to coat intermediate level steel goods to become coated steel products (*e.g.*, galvanized steel sheet). In the world market, each of these ferroalloys and non-ferrous metals are sold at high prices – and these prices have increased substantially in recent years.

269 *China Will Control Coke Exports Even After Canceling Coke Export Quota,* Xinhua News Agency, May 16, 2005.

270 *Extra Tax Mulled On Coke Exports*, Xinhua News Agency, Mar. 24, 2007.

In response, the Chinese government has actively sought to restrict the exportation of ferroalloys and non-ferrous metals in order to protect the domestic steelmaking industry. Indeed, as recently as the spring of 2007, the central government has sought to raise the tax rate on exported ferroalloys – now as high as fifteen percent – in order to ensure that the "ferroalloy industry [ ] meets domestic demand in the first place" and to "rein in export[s]."[271] With respect to products such as zinc and other metals that are used in coated steel production, the Government of China has announced that "[a] provisional export tax rate of 10 percent will apply to 30 tax items of steel products such as ...unwrought zinc..."[272] The stated position of the government with respect to the increased export taxes is that they "reduc[e] exports of high energy-consuming and highly polluting products, while encouraging the import of raw energy materials and low-level resource products in an attempt to address China's trade imbalance."[273] However, the main beneficiary of the tax is the domestic steelmaking industry. According to one recent article, the tax is necessary as "controlling exports of zinc and nickel is imperative given domestic demand."[274]

3. *Iron ore*

Along with coke, iron ore is one of the fundamental inputs in integrated steelmaking. The Chinese government has subsidized domestic iron ore production, as well as

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271 *China Expects Ferroalloy Export In 2007 To Reduce*, Steel Guru, *available at* http://www.steelguru.com/news/index/2007/06/06/MjIzMDA%3D/China_expects_ferroalloy_export_in_2007_to_reduce.html.

272 Notification of the Adjustment of the Provisional Tariff Rates for Certain Merchandises, Customs Tariff Comm'n of the State Council (May 21, 2007).

273 *China's Planned Aluminum-Product Export Tax Rebate Reduction Worries Industry*, Resource Investor, May 21, 2007.

274 David Harman, *China To Impose Or Increase Export Tax On Metal Products On June 1*, Resource Investor, May 22, 2007, *available at* http://www.resourceinvestor.com/pebble.asp?relid=32114.

foreign ventures created to obtain iron ore from abroad. Individual companies have received as much as RMB 1.3 billion in subsidies and/or substantial price discounts.

Historically, China has been a resource poor country as it pertains to high-grade iron ore, and has traditionally imported significant quantities of iron ore from countries such as Australia, Brazil, and Indonesia. In 2007, it is estimated that China will import nearly 355 million tons of iron ore.[275] At the same time, China has attempted to improve both the quantity and quality of its domestically sourced ore. According to Chinese press reports, domestic mines produced at least 521 million tons in the first 11 months of 2006 – an increase of 38.2 percent compared to the same period last year.[276] The growth in domestic production of iron ore and the continuous need for foreign-sourced iron ore has led to the institution of numerous subsidy programs to benefit the primary users of iron ore – steel mills.

As part of its transition out of Beijing and into Shanxi province, **Shougang** has worked with the provincial government on a package beneficial to both the company and the province. With the arrival of Shougang, the government of Shanxi Province has pledged to provide the necessary coking coal and iron ore for Shougang's steelmaking operations – presumably free of cost or at highly preferential prices.[277] With respect to foreign sourced iron ore, the government has granted subsidies to local steelmakers to help defray the costs associated with ventures created to obtain iron ore. For example, the government recently awarded RMB 1.30 billion in subsidies to **Jiangsu Shagang**

[275] *China To Import 355 Mln Tons Of Iron Ore Next Year*, Xinhua News Service, Dec. 30, 2006, *available at* http://www.import.net.cn/e/market/html/121477.html.

[276] *Id.*

[277] *Shougang to Set up JV in Shanxi Province*, Steel Business Briefing, Mar. 2, 2006.

Steel Group to support the steel group's iron ore mining project in Australia.[278] Finally, **Angang Steel** has received significant raw material subsidies through its relationship with its government-owned parent. Specifically, Angang Holding, a government-owned entity, has provided guaranteed price discounts to Angang Steel with respect to the steelmaker's purchases of iron ore.[279] According to the company's financial reports, Angang Holding has guaranteed a 10 percent price discount on the average import price paid by Angang for iron ore.

J. *Energy (Electricity)*

Like many of the direct subsidies bestowed on Chinese industries, it is widely known that particular industries, including steel, are eligible for discounted electricity rates in the effort to promote production.[280] While data on the actual rates given to individual companies is unavailable, steel companies' own financial reports as well as other information make clear that the steel industry continues to benefit from electricity at no cost or at rates well below market value.

A comprehensive study on the price of electricity in China published in 2004 concludes that not only are "capital costs of state-owned power plants generally not reflected in electricity prices,"[281] but that "electricity prices in China are highly subsidized and below the average total costs."[282] In other words, prices charged by the Chinese power companies are not sufficient to cover their marginal costs. Indeed, the steel in-

278 *China Jiangsu Over 6 M RMB Of Subsidies To Overseas Investors*, Financial Times, Feb. 15, 2006.

279 Angang Steel Company Limited 2006 Annual Report, at 74.

280 In 2004, Commerce Secretary Donald Evans cited Chinese utility subsidies as an unfair trade advantage. *See* Peter Navarro, *Report of 'The China Price Project'*, at 12 Merage School of Business, University of California-Irvine (Jan. 2007).

281 Pun-Lee Lam, *Pricing Of Electricity In China*, Energy, No. 29, at 287 (2004).

282 *Id.* at 298.

dustry, like many other Chinese industries, was built with the help of subsidized electricity costs. Moreover, because much of the electricity is generated by SOEs, the government continues to use energy prices as a tool of coercion by rewarding companies in line with stated policies with lower rates, and withdrawing preferred rates from those who are not. Recent articles claim that the price of non-compliance with certain government directives may be the loss of electricity altogether.[283]

Steel producers' own financial statements indicate that some companies have been granted the right to use electricity by the government. Chinese electricity subsidies, like land subsidies, are often classified as depreciable assets, which strongly suggests that electricity is transferred to companies by the government as a credit. The government likely awarded companies a certain quantity/value of electricity – most likely at the date of incorporation – which is now simply reduced by the amount of annual use.

Baosteel electricity subsidies (All amounts in RMB)[284]

At Janary 1st 2003	Amortization for the year	At December 31 2003	At Janary 1st 2004	Amortization for the year	At December 31 2004
1,344,244.10	36,114.26	1,308,129.84	1,308,129.84	216,685.56	1,091,444.28

As shown above, Baosteel reported an electricity subsidy ("subsidy for power supply") worth RMB 1,344,244.10 at the beginning of 2003. This amount is depreciated by RMB 36,114.26 and carried at the reduced value of RMB 1,308,129.84. According to Baosteel's 2004 annual report, the end-of-the-year value of RMB 1,308,129.84 was carried over to the beginning of 2004. Again, this value is then depreciated by what is presumably the amount of electricity used, and again is carried over to the beginning of 2005. This highlights the likelihood that electricity credits were given to the Group by

283 *See, e.g.*, *Polluters Must Pay More*, China Daily, June 27, 2007.

284 Baosteel 2003 Annual Report at 68; Baosteel 2004 Annual Report at 75.

the government, and that the credit will continue to benefit the company for many more years.

K. *Environmental Subsidies*

The Chinese government also provides indirect support to its steel industry by failing to enforce basic environmental standards. While a full discussion of environmental subsidies is beyond the scope of this paper, it is important to note that the Chinese steel industry has continued to pollute the environment with little concern for environmental regulations and with little enforcement from the government.[285] As detailed in *The China Syndrome*, the scale of pollution in China is staggering. For example, the Shougang mills in Beijing municipality alone discharge approximately 18,000 tons of particulates into the air each year.[286] Observers from the American Iron and Steel Institute and the Steel Manufacturers Association visiting China in 2005 noted steel mills that apparently lacked standard pollution control devices, such as baghouses, scrubbers, and precipitators. Notably, this was not limited to small producers; one of the mills visited belonged to Jiangsu Shagang, one of the largest producers in China.

A recent World Bank report on pollution in China confirms that the country's pollution woes continue to grow. It found, among other things, that China is now the largest sulfur dioxide emitter in the world[287] – a major air pollutant contributed to by China's

[285] *See The China Syndrome* at 53-55.

[286] David Eimer, *Beijingers Will Need Their Masks; There Are No More "Clear Air" Days*, Financial Times, Oct. 19, 2005.

[287] *Cost of Pollution in China: Economic Estimates of Physical Damage*, The World Bank, Feb. 2007, at xi.

steel producers. The research found that 750,000 people die prematurely in China each year, mainly from air pollution.[288]

L. *Currency Undervaluation*

As large as the subsidies described above are, they are potentially dwarfed by the largest subsidy of all – that bestowed by China's undervaluation of its currency. Because of this government intervention, economists and policymakers worldwide agree that the value of the RMB has remained well below what it would be if the RMB were allowed to float. Recent estimates of the extent of the RMB's undervaluation range from 35 to 56 percent.[289]

As the U.S. Treasury Department has explained,

> The Chinese government's deliberate undervaluation of the renminbi makes U.S. products more expensive to Chinese consumers who therefore purchase fewer of them. Conversely, China's undervalued currency also makes Chinese products cheaper in the United States, and therefore U.S. consumers purchase more of them. The combination is a major contributor to the record high and still growing U.S. trade deficit. The undervalued Chinese currency harms American competitiveness and is also a factor encouraging the relocation of U.S. manufacturing overseas while discouraging investments in U.S. exporting industries.[290]

[288] *Id. See also 750,000 a Year Killed By Chinese Pollution*, Financial Times, July 2, 2007.

[289] *See* M. Goldstein, *A (Lack Of) Progress Report On China's Exchange Rate Policies*, July 2007, (40%); *see also* F. Bergsten, *Testimony Before the Subcommittee on Trade of the House Committee on Ways and Means*, May 2007 (35%); The Economist, *Lost in Translation*, May 2007 (50%); Shanghai Univ. of Finance and Economics, 2006 (35.80%); Nat'l Ass'n of Mfrs., 2006 (40%); Economist Big Mac Index, 2007 (56%); Jeffrey Frankel, *On the Renminbi*, 2004 (36%). The average of these estimates is undervaluation of 42 percent.

[290] *2006 Report to Congress of the U.S.-China Economic and Security Review Comm'n*, 109th Cong., 2d Sess. at 46 (2006).

In 2006, China exported approximately US$ 25 billion in iron and steel. If the RMB was undervalued by 42 percent, China's currency undervaluation provided a subsidy to its steel producers of US$ 9.4 billion in 2006 alone.[291]

[291] Calculated by multiplying the total value of Chinese steel exports by the average rate of currency undervaluation (42%), adjusting for the value of Chinese imports of inputs used in steelmaking. This is only one of many possible ways that China's currency undervaluation could be quantified, and this paper does not endorse a particular approach.

IV. CONCLUSION

As this paper shows, the unprecedented growth of China's steel industry has been both financed and directed by the Chinese government. Indeed, governmental ownership and control of the steel industry in China is far greater than previously reported. When the convoluted ownership structures of China's major steel producers are examined in detail, it becomes apparent that virtually all of the industry remains solidly in governmental hands. More than 90 percent of the country's production remains government owned or controlled. Despite China's claims that it is progressing toward a more market-based economy, nothing could be further from the truth regarding the state ownership and control of the steel industry.

This report has attempted to identify and quantify the extent and amount of Chinese "money for metal" – subsidies to its steel industry. According to these producers' own financial documents, the Chinese government has bestowed at least RMB 393 billion of benefits, in an astonishing array of different programs: outright grants for construction, preferential loans, equity infusions and debt-to-equity swaps, government-mandated mergers, and many others.

It is important to remember, however, that the totals verified in this report only scratch the surface of the actual subsidization amounts. For several of these categories, the subsidies found are for only a handful of producers. And for several large subsidy categories (such as VAT rebates, raw materials, domestic preference programs, electricity and environment), this report does not attempt to quantify the benefits received at all. In short, the subsidies identified and quantified in this report are most assuredly only the tip of the iceberg.

The Chinese steel industry has benefited from massive direct and indirect subsidies, many of which violate China's World Trade Organization obligations. The result has been artificial growth of China's steel capacity and production, at the expense of its international competitors, including U.S. companies and their workers. The Chinese government should end its policy of control, direction and subsidization of its steel industry. If it does not, the United States and other trading partners should increase efforts to require China's compliance with its WTO commitments and international trade law.

APPENDIX 1

SUBSIDIES AND OTHER ASSISTANCE PROVIDED TO CHINA'S LARGEST STEEL PRODUCERS

SUBSIDIES AND OTHER ASSISTANCE PROVIDED TO CHINA'S LARGEST STEEL PRODUCERS

In the most recent ten-year period, many of China's top 20 producers have been the beneficiaries of billions of renminbi worth of WTO-illegal subsidies. The benefits derived from these subsidies have had a major impact on the steel industry in China, and consequently, on global commerce. For entities like the Anben Group, Baosteel, Maanshan, Shougang, the Laigang Group which owns Laiwu Steel, Wuhan Steel, and the Taiyuan Steel Group which owns TISCO, the subsidies have helped create vast steel-making empires – with approximately 98 million tons of steel making capacity for these seven groups alone. The subsidies include the provision of land at less than commercial rates, tax exemptions and other incentives, the provision of loans at extremely low interest rates, credits issued based upon the procurement of domestically produced machinery, and the outright provision of cash grants and infusions. The following section details how all of the various subsidy programs discussed above benefit individual Chinese producers.

A. *Anben Group*

The Anben Iron and Steel Group is currently the largest steel producer in China. The merger of Anshan Steel and Benxi Steel in 2005 created a conglomerate with a rated production capacity of over 22.5 million metric tons per year – nearly 25 percent of the total capacity of all U.S. mills combined. The group controls several large-scale subsidiaries including Angang Steel Co., Ltd., and Bengang Steel Plates Co., Ltd. With respect to Angang Steel, the company has been a major beneficiary of government subsidies in the past several years. In 2006, Angang Steel issued to its parent, Angang Holding, 2.970 billion shares as part of Angang's attempt to acquire all of the equity interest in Angang New Steel and Iron Company Limited ("ANSI").[292] While the issuance of shares in the marketplace is common, what is uncommon is the fact that virtually all of these shares were issued to the *state*. The issuance of restricted shares to the state ballooned Angang's capital reserves from RMB 3.09 billion as of January 1, 2006, to a staggering RMB 12.847 billion at the end of 2006 – a four-fold increase in capital courtesy of the government.

Angang Holding, a government controlled entity, has provided guaranteed price discounts to Angang Steel with respect to the steelmaker's purchases of iron ore – the primary ferrous input in steelmaking.[293] According to the company's annual report, Angang Holding has guaranteed to provide a ten percent price discount on the average import price paid by Angang for iron ore. As the average price is based upon the price "reported to the PRC customs," it is possible that the net effective discount is even larger than ten percent should the company be underreporting its purchase pricing to the customs authorities. In addition to iron ore, Angang obtains needed commodities such as electricity, railway transport services, and water based upon "state pricing,"[294] which as detailed above, are priced at below world market rates.

Angang Steel also enjoys favorable loan terms on its short- and long-term loans – issued in large part by state-owned banks such as the People's Bank of China and the China Construction Bank. The company's short-term loan interest rates decreased from a range of 5.22 to 5.58 percent in 2005 to a range of 4.86 to 5.508 percent in 2006. At the same time, the company's long-term loan interest rates fell from a range of 5.49 to

292 Angang Steel Company Limited 2006 Annual Report at 18-19.

293 *Id.* at 74.

294 *Id.* at 68-70.

6.12 percent in 2005 to a range of 4.941 to 6.12 percent in 2006 for the "Group" and from 5.76 percent in 2005 to 4.941 to 5.76 percent for the "Company".[295] These rates are well below the benchmark rates found by the U.S. Department of Commerce in its countervailing duty investigation of *Coated Free Sheet From the People's Republic of China*.

Finally, the government has subsidized Angang through generous tax relief and credits.[296] The State Administration of Taxation, in accordance with Guoshuifa (2000) No. 13, granted tax exemptions relating to the company's investment in domestically-produced machinery. The Ministry of Finance, in accordance with Caishuzi (2003) No. 244, granted tax exemptions to Angang relating to its research and development activities. The Ministry of Finance also granted tax exemptions to Angang for the company's environmental protection activities. Additionally, according to the provisions of the "Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises," Angang's subsidiary ANSC-TKS did not have to pay any income tax in 2006, as the year represented the company's first profitable year. In fact, ANSC-TKS will be exempt from paying any income taxes in 2007 (assuming it is profitable), and will only have to pay 50 percent of its outstanding tax liability in the three subsequent years (assuming they are all profitable). Additionally, certain of Angang's subsidiaries, including ANSC-TKS, Changchun FAM and TKAS-SSC, are "foreign invested enterprises" and are therefore not required to pay any of three classes of local taxes.[297]

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295 *Id.* at 122.

296 *Id.* at 103.

297 *Id.* at 103.

B. *Baosteel*

1. *Makeup of Baosteel*

As one of the "crown jewels" in China's state-owned industrial complex, Baoshan Iron & Steel (Baosteel) may indeed represent the prototypical state-owned steel company. Baosteel's growing capacity is truly massive; it has been the recipient of a host of government subsidies and tax breaks; its board members are affiliated with state-owned banks; and it benefits from subsidiaries involved in a range of businesses – from used car sales to cargo transport to iron ore. Indeed, the main business and operations statement of Baosteel's controlling shareholder, the Baosteel Group Corporation, notes:

> As a governmental authorized investment vehicle and a state-owned holding company: Manage state-owned assets within the authorized scope set by the State Council; Involved in investments in the following areas: iron and steel manufacturing, metallurgy, mining, non-toxic chemicals, electricity, piers, warehousing, transportation, and steel-related businesses, development and transfer of technologies, technical service and management consulting, imports and exports approved by the Ministry of Foreign Trade & Economic Cooperation (MOFTEC), domestic and international trading where allowed, and its related services.[298]

This statement should come as no surprise. The Baosteel company is 78.35 percent owned by the Baosteel Group, which, in turn, is 100 percent owned by the Chinese government.[299] Moreover, even though Baosteel claims to be a public company, the nine largest shareholders (after the government) account for only four percent of total ownership.[300]

298 Baosteel 2005 Annual Report at 7.

299 *Id.*

300 *Id.* at 6.

2. *Size*

The most recent edition of the International Iron and Steel Institute's "World in Steel Figures" ranked Baosteel as the fifth largest steel-producing company in the world with approximately 22.5 million metric tons of production in 2006.[301] To appreciate the size of this company, the country of South Korea produced 48.5 million metric tons of steel in the same year. In other words, Baosteel single-handedly produced almost half as much steel as the entire country of South Korea.[302] Due to the current consolidation initiative by the Chinese government, the size and operations of Baosteel will only continue to increase. Indeed, recent news articles report the takeover of smaller mills, in addition to joint ventures and partnerships, in Baosteel's effort to increase steel output to between *50 million and 80 million tons* by 2010.[303]

3. *Cash Infusions*

Baosteel has been the recipient of numerous cash infusions in the government's effort to promote the domestic steel industry. The most recent cash infusion assumed the form of the sale of five billion shares of stock. Of the five billion shares sold, three billion were sold directly to the government for over RMB 15.2 billion in proceeds. These proceeds – along with RMB 10.24 billion gained from the sale of the remaining two billion shares – in turn supported a flurry of intra-group activity in the form of asset transfers and acquisitions. Simply put, Baosteel returned the entire RMB 25.4 billion

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301 Int'l Iron and Steel Institute, *World Steel in Figures*, *available at* http://www.worldsteel.org/?action=newsdetail&latest=1&id=198.

302 *Id.*

303 *See, e.g.*, *Shougang Builds 2.5 Million Tpy Flat Steel Plant In Hebei*, American Metal Market, June 22, 2007; *Baosteel, Handan Steel Start Mill Construction*, American Metal Market, June 7, 2007; *Baosteel Given Regulatory Not For Acquisition Of Stake In Bayi*, American Metal Market, June 18, 2007; *Baosteel Inks Alliance Deal With Domestic Steel Maker*, Xinhua online *http://news.xinhuanet.com/english/2007-07/23/content_6419400.htm* (recent articles).

($3.1 billion) in proceeds gained from the stock issuance to the Group in exchange for the steel related assets and operations of associated subsidiaries. This exchange included the physical assets of other steel mills, land, equipment, and even a port. Of course, heavy government investment also served to create a sense of stability for the shareholders who purchased the remaining two billion shares of stock. Beyond these government infusions, Baosteel has received more than RMB 71.5 million in cash subsidies just within the past three years.[304]

4. *Loans*

According to Baosteel's 2005 annual report, the group had over RMB 10.7 billion worth of short-term loans – mostly in the form of unsecured loans – at interest rates ranging from 4.7 percent to 6.3 percent.[305] As a comparison, the U.S. Department of Commerce has estimated that the market rate for short-term loans in China should be approximately 13 percent.[306] The Group's long-term loan portfolio totaled over RMB 16 billion at interest rates as low as 2.125 percent. Given that several of Baosteel's board members are closely affiliated with institutions such as the Bank of China and the Industrial and Commercial Bank,[307] it is not surprising that these banks are large lenders to the Group. These long- and short-term loans are in addition to assorted loans between the Group, the Company, and various other subsidiaries that are often interest free.[308]

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[304] Baoshan 2003 Annual Report at 46; Baoshan 2005 Annual Report at 46; Baoshan 2006 Annual Report at 59.

[305] Baosteel 2005 Annual Report at 101.

[306] *Coated Free Sheet*, 72 Fed. Reg. at 17,492-494.

[307] Baosteel 2005 Annual Report at 9.

[308] *Id.* at 109.

5. *Land and Electricity*

Baosteel has been the recipient of significant land-use grants and electricity subsidies. As discussed previously, it is highly likely that Baosteel has been the recipient of large quantities of land that were essentially transferred to the Company from the local governments at no cost. Because Baosteel was founded almost three decades ago, and because the steel industry has been historically targeted for government-led growth, it has undoubtedly been a beneficiary of free land-use rights. Indeed, it appears that Baosteel – one of China's largest steel producers – paid less than $50,000 for its land *and* electricity for the entire year of 2004.[309]

C. *Shougang Steel*

Shougang Steel, otherwise known as Capital Steel, is one of the flagship steel producers in China and is controlled directly by the central government SASAC. The government's control of the company is most clearly demonstrated in the decision to move the entire steelmaking operations of Shougang out of the western suburbs of Beijing and to neighboring Hebei province,[310] in order to improve Beijing's air quality levels ahead of the 2008 Summer Olympic games.

The interplay between the Chinese government and Shougang is explained in the company's financial reports. In most years since 2000, Shougang has been given direct subsidy income – cash infusions which represent direct and tangible benefits from the Government to a steelmaker.

In addition, Shougang has been the recipient of several tax benefit schemes which have helped reduce the company's tax liability. In the years immediately follow-

309 Baosteel 2004 Annual Report, at 75.

310 *Steel Giant Shougang To Move Out Of Beijing*, Xinhua News Service, Feb. 8, 2005.

ing 2000, Shougang participated in a program whereby the official income tax rate of 33 percent was reduced such that any taxes paid over the 15 percent threshold were refunded back to the company.[311] Shougang's subsidiary Beijing Shoughang Jiahua Building Materials Ltd. ("BSJBML"), an entity with some foreign ownership interests, has been relieved of any tax burden in 2005 and 2006 (if the company earns a profit during both of those two years) and will be required to pay only 50 percent of its tax liability in the subsequent three years in which a profit is realized.[312] In addition, owing to local Beijing government tax relief programs, BSJBML will not be required to pay any local business income tax for the period 2005 to 2009, and will be responsible for only 50 percent of its tax liability from 2010 to 2014.

The Bank of China, a state-owned bank, has issued loans in the amount of RMB 3.2 billion to Shougang. One loan, which matures in November 2013, carries an interest rate of 6.12 percent – well below the benchmark interest rate found by the U.S. Department of Commerce in its countervailing duty investigation of *Coated Free Sheet From the People's Republic of China*.

D. *Laiwu Steel*

With nearly 11 million metric tons of capacity, Laiwu is one of China's largest producers of carbon steel products – primarily long products including rebar and structural steel shapes.[313] Like other Chinese steel producers, Laiwu has enjoyed a broad range of subsidies that have enabled the company to increase its capacity and to oper-

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311 Indeed, according to company filings, Shougang may have been exempt from paying income taxes through calendar year 2004. *See* Shougang 2005 Annual Report at 72.

312 Shougang 2006 First Half Report at 29-30.

313 Arcelor Mittal is seeking regulatory approval to buy a 38 percent stake in Laiwu. Approval has yet to be granted by China's National Development and Reform Commission, and no price has yet been established. *See Arcelor Mittal Expects Nod For Laiwu Soon*, People's Daily Online, Mar. 27, 2007.

ate outside the parameters of normal enterprises. Laiwu has also enjoyed significant tax relief from the State and from the provincial government. Specifically, while Laiwu was required to pay corporate income taxes amounting to 33 percent, official government policy allowed all but 15 percent of that income tax to be refunded back to the company.[314]

Since before 2000, Laiwu steel has enjoyed preferential interest rates on loans issued by government-owned banks – namely the Industrial and Commercial Bank of China, the Bank of China, and the Construction Bank of China.[315] The interest rates from these banks ranged from 4.95 percent to 5.175 percent and covered more than RMB 200 million in secured loans in 2000 and in later years. The value of Laiwu's long-term loans increased to more than RMB 2.3 billion by 2005, with the vast majority being issued by state banks such as the Industrial and Commercial Bank of China and the Bank of China.[316] Even with a substantially larger portfolio of long-term debt, Chinese government banks continued to offer loan packages at favorable rates – from as low as 5.54 percent to 6.12 percent.

Finally, like other companies, Laiwu has received direct subsidy income in the course of its operations. According to the company's 2006 third quarter financial statement, the company received RMB 30 million in the quarter ending September 30, 2006,[317] and an additional RMB 30 million in the period between January 1, 2006 to June 30, 2006 from a fund called the "Yinshanqian District" fund.[318]

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314 Laiwu 2000 Annual Report at 36.

315 *See, e.g.*, Laiwu 2000 Annual Report at 42.

316 Laiwu 2005 Annual Report at 41.

317 Laiwu 2006 Third Quarter Report at 5.

318 Laiwu 2006 First Half Report at 38.

E. *Wuhan Steel*

Wuhan Steel is a large producer of carbon and alloy steel products headquartered in Hubei Province. The company has the capacity to deliver approximately 13.8 million tons of wire rod, structural shapes, and sheet products ever year. Wuhan, the nation's fifth largest producer of steel, is controlled directly by the central government SASAC. Like other SASAC-controlled entities, Wuhan has been the beneficiary of billions of RMB in subsidies and WTO-illegal benefits.

For several years, Wuhan has benefited from a generous tax rebate scheme that placed millions of RMB back into the coffers of the company. During the early part of this decade, Wuhan enjoyed the benefits of tax rebate programs where it was required to pay only 15 percent of the required 33 percent standard income taxes.[319] The extent of the tax savings was demonstrated in the company's financial statement covering the first half of 2000. Due to the 18 percent tax rebate, Wuhan Steel saved over RMB 72.5 million in unpaid taxes – a 20 percent savings in terms of net profit in the first half of 2000 alone.[320]

Wuhan has also been a major beneficiary of loans and grants from the government. During 1999, Wuhan had outstanding loans of RMB 1.127 billion owed to Chinese government-owned banks (Bank of China and the Industrial and Commercial Bank of China).[321] The Bank of China loan, valued at RMB 827 million, was used for the company's silicon electric steel mill;[322] the ICBC loan, valued at RMB 300 million and

319 *See, e.g.*, Wuhan 1999 Annual Report at 21; see *also* Wuhan 2000 Annual Report at 28-29.

320 Wuhan 2000 First Half Report at 5, 14. In 2000, Wuhan received a tax rebate of RMB 145.7 million based upon the reduced income tax rate. *See* Wuhan 2000 Annual Report at 28-29.

321 Wuhan 1999 Annual Report at 22.

322 Wuhan 2000 First Half Report at 13-14.

payable at an interest rate of 6.21 percent,[323] was issued for improvements relating to the company's cold-rolling mill.[324] Several years later, Wuhan embarked on an ambitious set of projects which required significant amounts of capital – all from loans. Between May 2003 and December 2004, Wuhan took out nearly RMB 4 billion in loans from the Bank of China and the Industrial and Commercial Bank of China at interest rates ranging from 5.2155 to 5.49 percent for RMB denominated loans and loans as low as 1.248 percent for yen-denominated loans.[325] The loans all related to steel-making operations and related facilities including: new loans for the improvement of the company's cold rolled steel plant,[326] iron-making coal injection, the company's Number Two and Number Three steelworks, the Number Two hot mill, and other items.[327] Additional loans were taken in 2005 – bringing the company's total outstanding long-term debt to RMB 6.585 billion.[328]

As with other companies, Wuhan has received direct subsidy income from various government agencies. According to the company's 1999 annual report, the company received over RMB 126 million in subsidy income.[329] This income represents nearly 20 percent of the company's total net profit for the calendar year.

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[323] The ICBC *reduced* the interest rate to 5.76 percent on Nov. 22, 2002. *See* Wuhan 2002 Annual Report at 46.

[324] Wuhan 1999 Annual Report at 27.

[325] Wuhan 2004 Annual Report at 53. Some loans were partially financed by offshore banks including the Spanish National Association of Credit and Spanish Central American Bank, but were always balanced by Chinese bank funding.

[326] Wuhan 2003 Annual Report at 53.

[327] *Id.*

[328] Wuhan 2006 First Half Report at 15.

[329] Wuhan 1999 Annual Report at 2-3.

F. *Maanshan*

Maanshan is one of the larger steel producers in China. Its main products include steel plate and sheet, steel sections, and wire rod. In 2006, Maanshan produced 10.9 million tons of crude steel.[330] It continues to add capacity, and plans to produce 20 million tons of steel by 2010.

Maanshan has issued both A and H shares, so that its shares are publicly traded on the Shanghai and Hong Kong stock exchanges. The state, however, continues to own 62.5 percent of the company (as well as 100 percent of the holding company, Magang Group). In 2006, the company had sales of RMB 34.3 billion, and after-tax profits of RMB 2.45 billion.[331]

Like the other major Chinese steel producers, Maanshan has received substantial subsidies from the Chinese government over the past 15 years. In 2006 alone, for example, Maanshan showed RMB 116.6 million in "government subsidies granted for specific projects"[332] and RMB 96.5 million in tax concessions.[333] Maanshan benefited from preferential income tax rates as well.[334] The Maanshan group did not receive any tax credits for purchases of domestic machinery in 2006, but it did receive a credit of RMB 19.9 million in 2005.[335] It also had outstanding bank loans of RMB 16.5 billion at interest rates of 5.76 percent and lower.[336]

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330 Maanshan 2006 Annual Report at 10.

331 *Id.* at 65.

332 Maanshan 2006 Annual Report at 70.

333 *Id.* at 121.

334 *Id.* at 102.

335 *Id.* at 103.

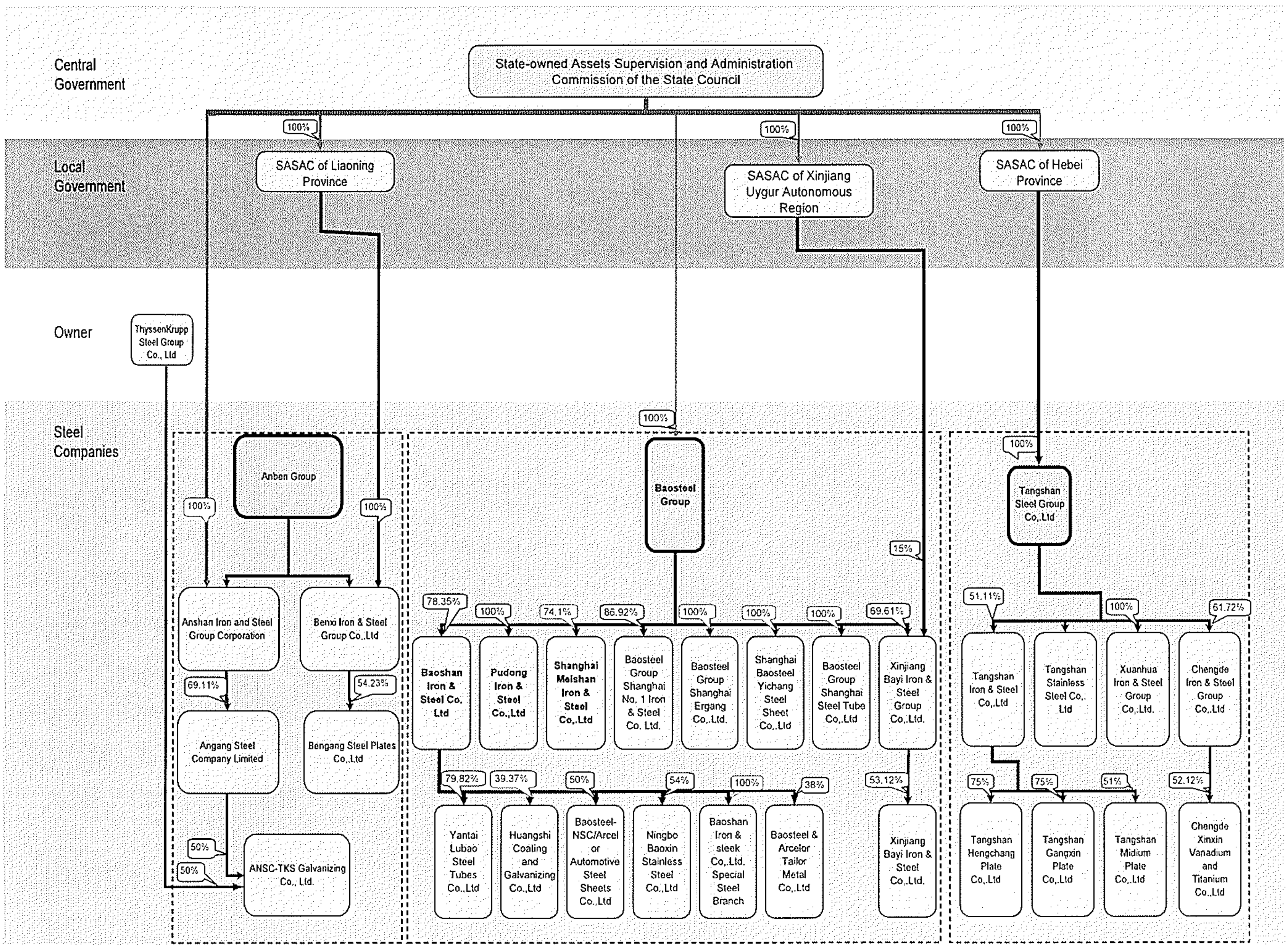
336 *Id.* at 128.

The following summarizes the types and amounts of subsidies Maanshan has received over the last decade. The amounts are indicative rather than comprehensive; nonetheless, they indicate the magnitude of the support Maanshan has received from the Chinese government:

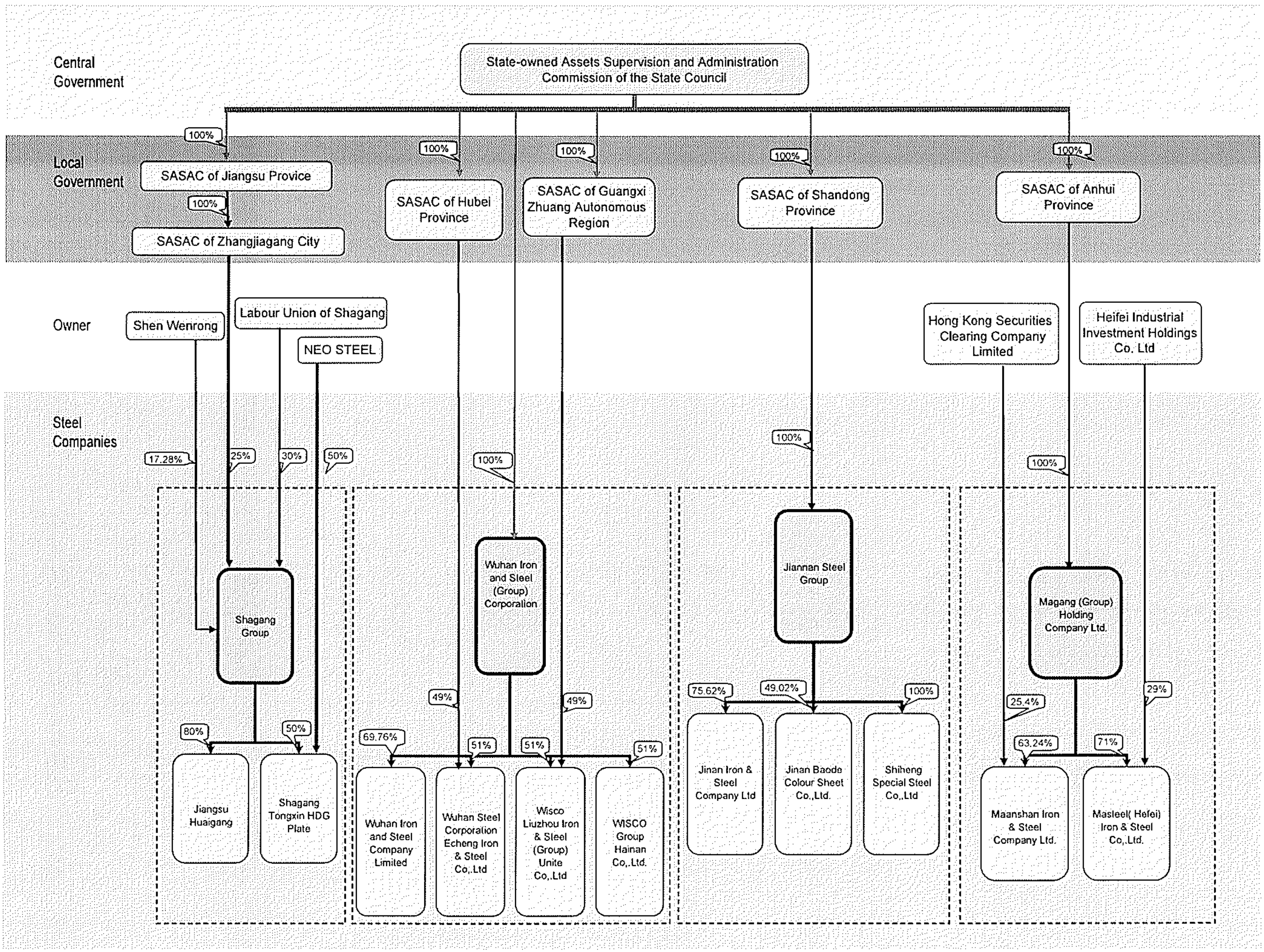
- grants for construction projects: RMB 801 million
- subsidy income for exports
- equity infusions: RMB 18 billion
- debt-to-equity conversions: RMB 600 million
- policy loans at preferential interest rates: RMB 6 billion
- tax credits for purchases of Chinese-made machinery: RMB 3.699 billion
- income tax reductions and exemptions.

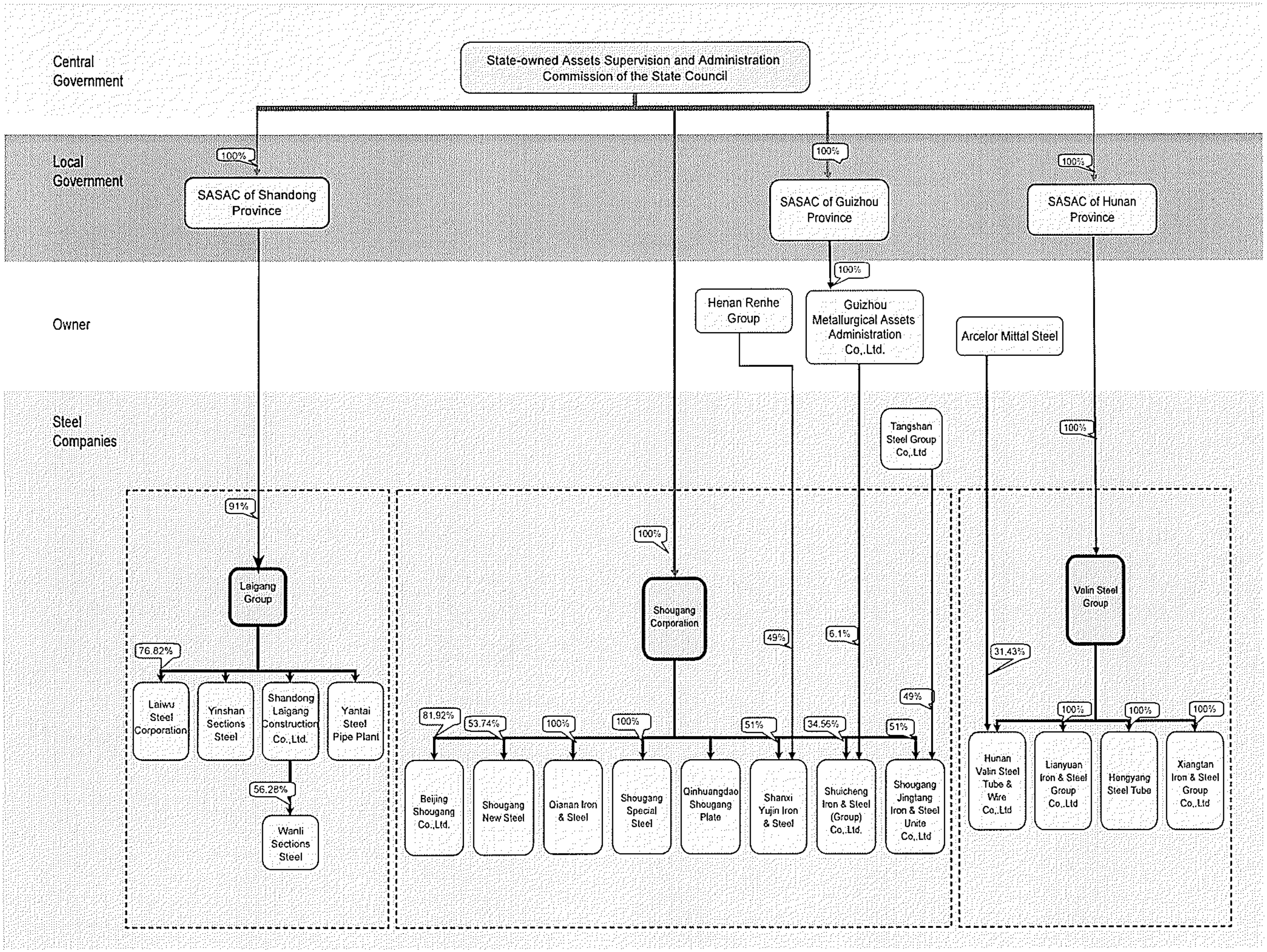
APPENDIX 2

OWNERSHIP FLOWCHART
FOR CHINA'S TWENTY LARGEST STEEL GROUPS

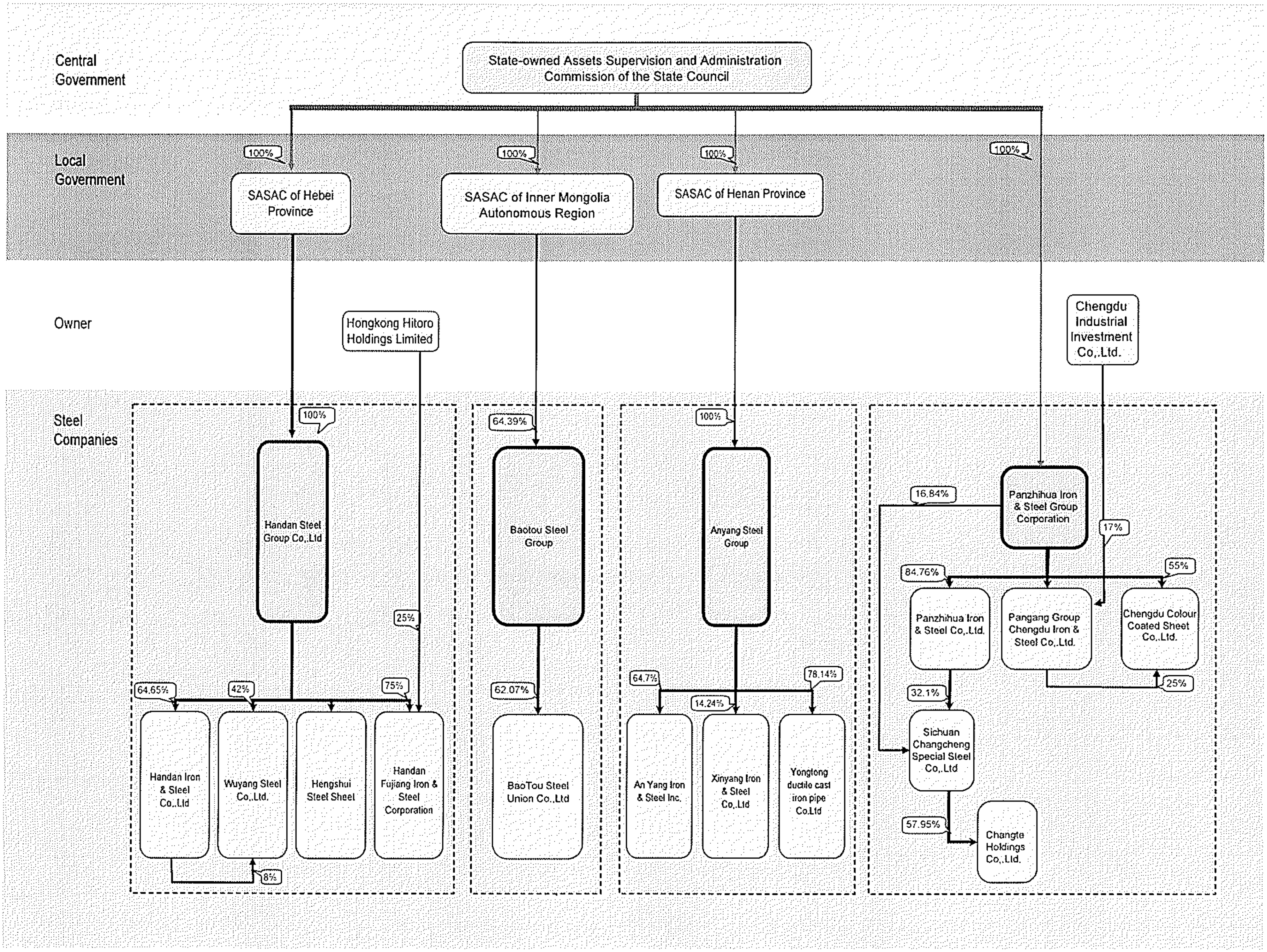


Central Government
Local Government
Owner
Steel Companies
State-owned Assets Supervision and Administration Commission of the State Council
100%
SASAC of Liaoning Province
100%
SASAC of Xinjiang Uygur Autonomous Region
100%
SASAC of Hebei Province
ThyssenKrupp Steel Group Co., Ltd
Anben Group
100%
100%
Anshan Iron and Steel Group Corporation
Benxi Iron & Steel Group Co.,Ltd
69.11%
54.23%
Angang Steel Company Limited
Bengang Steel Plates Co.,Ltd
50%
50%
ANSC-TKS Galvanizing Co., Ltd.
100%
Baosteel Group
15%
78.35%
100%
74.1%
86.92%
100%
100%
100%
69.61%
Baoshan Iron & Steel Co. Ltd
Pudong Iron & Steel Co.,Ltd
Shanghai Meishan Iron & Steel Co.,Ltd
Baosteel Group Shanghai No. 1 Iron & Steel Co. Ltd.
Baosteel Group Shanghai Ergang Co.,Ltd.
Shanghai Baosteel Yichang Steel Sheet Co.,Ltd
Baosteel Group Shanghai Steel Tube Co.,Ltd
Xinjiang Bayi Iron & Steel Group Co.,Ltd.
79.82%
39.37%
50%
54%
100%
38%
53.12%
Yantai Lubao Steel Tubes Co.,Ltd
Huangshi Coaling and Galvanizing Co.,Ltd
Baosteel-NSC/Arcelor Automotive Steel Sheets Co.,Ltd
Ningbo Baoxin Stainless Steel Co.,Ltd
Baoshan Iron & steek Co.,Ltd. Special Steel Branch
Baosteel & Arcelor Tailor Metal Co.,Ltd
Xinjiang Bayi Iron & Steel Co.,Ltd.
100%
Tangshan Steel Group Co.,Ltd
51.11%
100%
61.72%
Tangshan Iron & Steel Co.,Ltd
Tangshan Stainless Steel Co.,Ltd
Xuanhua Iron & Steel Group Co.,Ltd.
Chengde Iron & Steel Group Co.,Ltd
75%
75%
51%
52.12%
Tangshan Hengchang Plate Co.,Ltd
Tangshan Gangxin Plate Co.,Ltd
Tangshan Midium Plate Co.,Ltd
Chengde Xinxin Vanadium and Titanium Co.,Ltd

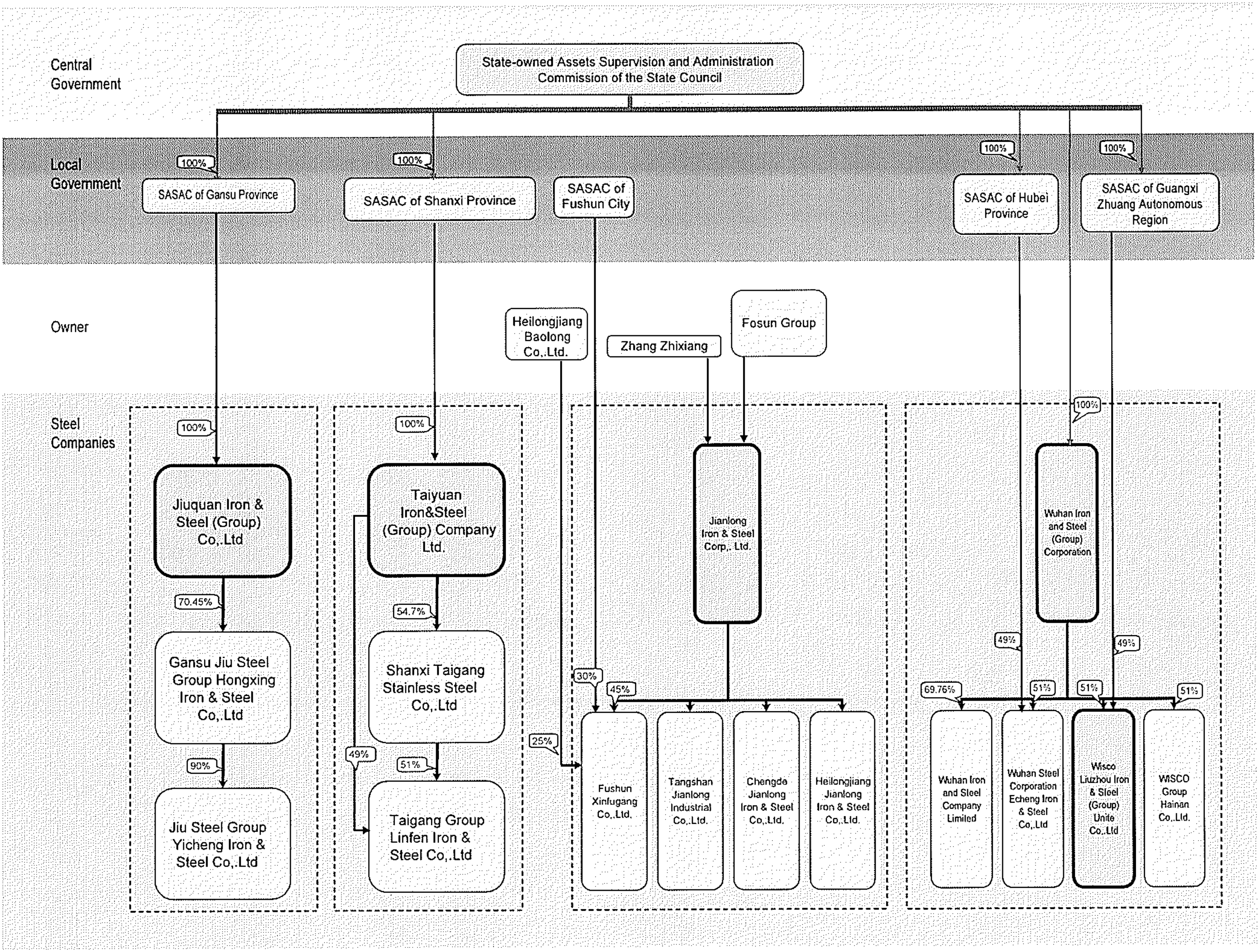

Central Government
Local Government
Owner
Steel Companies
State-owned Assets Supervision and Administration Commission of the State Council
100%
SASAC of Jiangsu Provice
100%
SASAC of Zhangjiagang City
SASAC of Hubei Province
SASAC of Guangxi Zhuang Autonomous Region
SASAC of Shandong Province
SASAC of Anhui Province
Shen Wenrong
Labour Union of Shagang
NEO STEEL
Hong Kong Securities Clearing Company Limited
Heifei Industrial Investment Holdings Co. Ltd
17.28%
25%
30%
50%
Shagang Group
80%
50%
Jiangsu Huaigang
Shagang Tongxin HDG Plate
Wuhan Iron and Steel (Group) Corporation
49%
69.76%
51%
51%
49%
51%
Wuhan Iron and Steel Company Limited
Wuhan Steel Corporation Echeng Iron & Steel Co,.Ltd
Wisco Liuzhou Iron & Steel (Group) Unite Co,.Ltd
WISCO Group Hainan Co,.Ltd.
Jiannan Steel Group
75.62%
49.02%
100%
Jinan Iron & Steel Company Ltd
Jinan Baode Colour Sheet Co,.Ltd.
Shiheng Special Steel Co,.Ltd
Magang (Group) Holding Company Ltd.
25.4%
63.24%
71%
29%
Maanshan Iron & Steel Company Ltd.
Masteel(Hefei) Iron & Steel Co,.Ltd.



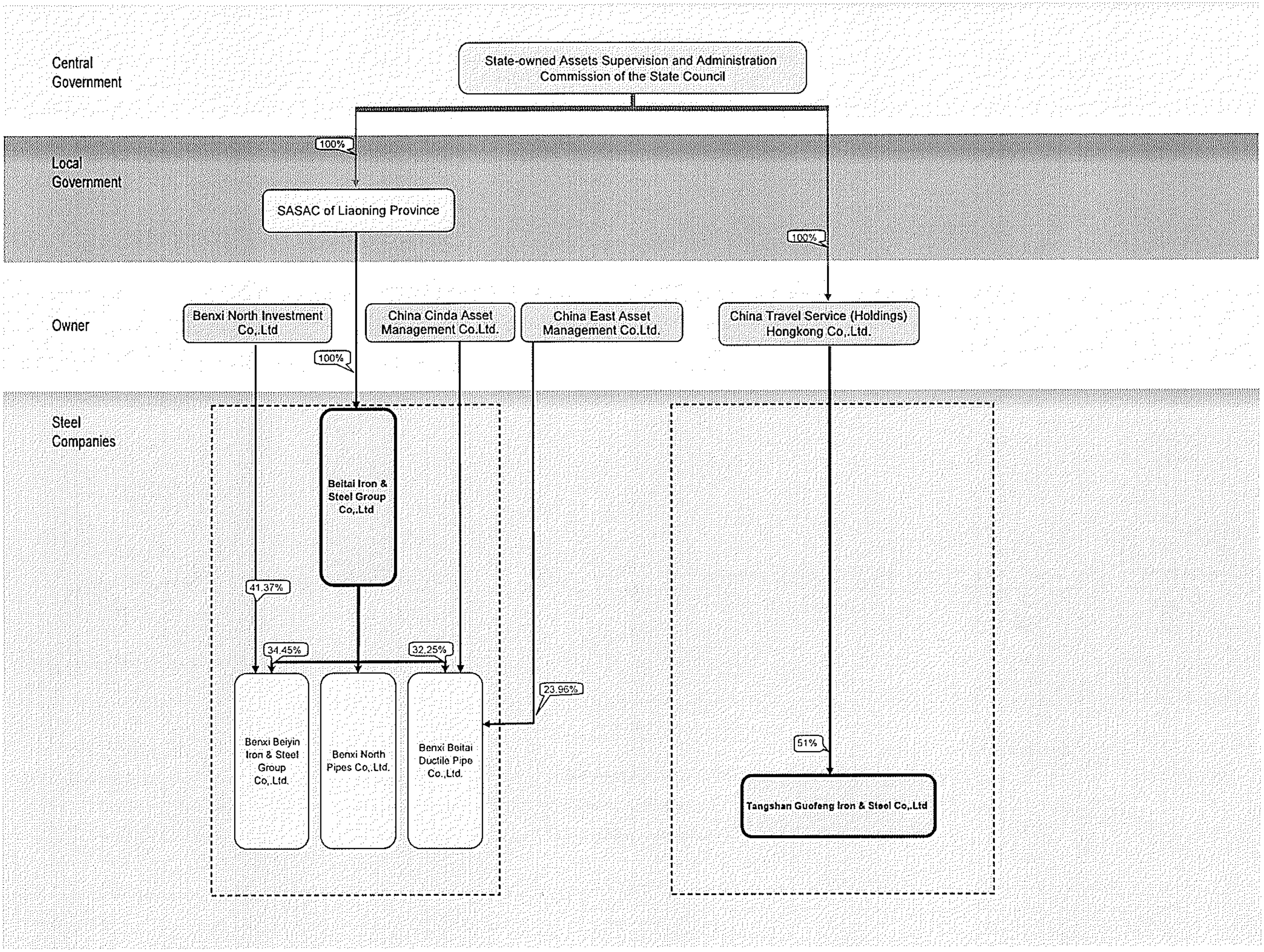
Central Government
State-owned Assets Supervision and Administration Commission of the State Council
Local Government
100%
SASAC of Shandong Province
100%
SASAC of Guizhou Province
100%
SASAC of Hunan Province
Owner
Henan Renhe Group
100%
Guizhou Metallurgical Assets Administration Co,.Ltd.
Arcelor Mittal Steel
Steel Companies
Tangshan Steel Group Co,.Ltd
100%
91%
Laigang Group
76.82%
Laiwu Steel Corporation
Yinshan Sections Steel
Shandong Laigang Construction Co,.Ltd.
Yantai Steel Pipe Plant
56.28%
Wanli Sections Steel
100%
Shougang Corporation
49%
6.1%
49%
81.92%
53.74%
100%
100%
51%
34.56%
51%
Beijing Shougang Co,.Ltd.
Shougang New Steel
Qianan Iron & Steel
Shougang Special Steel
Qinhuangdao Shougang Plate
Shanxi Yujin Iron & Steel
Shuicheng Iron & Steel (Group) Co,.Ltd.
Shougang Jingtang Iron & Steel Unite Co,.Ltd
Valin Steel Group
31.43%
100%
100%
100%
Hunan Valin Steel Tube & Wire Co,.Ltd
Lianyuan Iron & Steel Group Co,.Ltd
Hengyang Steel Tube
Xiangtan Iron & Steel Group Co,.Ltd



Central Government
State-owned Assets Supervision and Administration Commission of the State Council
Local Government
100%
SASAC of Hebei Province
100%
SASAC of Inner Mongolia Autonomous Region
100%
SASAC of Henan Province
100%
Owner
Hongkong Hitoro Holdings Limited
Chengdu Industrial Investment Co,.Ltd.
Steel Companies
100%
Handan Steel Group Co,.Ltd
25%
64.65%
42%
75%
Handan Iron & Steel Co,.Ltd
Wuyang Steel Co,.Ltd.
Hengshui Steel Sheel
Handan Fujiang Iron & Steel Corporation
8%
64.39%
Baotou Steel Group
62.07%
BaoTou Steel Union Co.,Ltd
100%
Anyang Steel Group
64.7%
14.24%
78.14%
An Yang Iron & Steel Inc.
Xinyang Iron & Steel Co,.Ltd
Yongtong ductile cast iron pipe Co.Ltd
Panzhihua Iron & Steel Group Corporation
16.84%
17%
84.76%
55%
Panzhihua Iron & Steel Co,.Ltd.
Pangang Group Chengdu Iron & Steel Co,.Ltd.
Chengdu Colour Coated Sheet Co,.Ltd.
25%
32.1%
Sichuan Changcheng Special Steel Co,.Ltd
57.95%
Changte Holdings Co,.Ltd.



Central Government
State-owned Assets Supervision and Administration Commission of the State Council
Local Government
100%
SASAC of Gansu Province
100%
SASAC of Shanxi Province
SASAC of Fushun City
100%
SASAC of Hubei Province
100%
SASAC of Guangxi Zhuang Autonomous Region
Owner
Heilongjiang Baolong Co,.Ltd.
Zhang Zhixiang
Fosun Group
Steel Companies
100%
Jiuquan Iron & Steel (Group) Co,.Ltd
70.45%
Gansu Jiu Steel Group Hongxing Iron & Steel Co,.Ltd
90%
Jiu Steel Group Yicheng Iron & Steel Co,.Ltd
100%
Taiyuan Iron&Steel (Group) Company Ltd.
54.7%
Shanxi Taigang Stainless Steel Co,.Ltd
49%
51%
Taigang Group Linfen Iron & Steel Co,.Ltd
Jianlong Iron & Steel Corp,. Ltd.
30%
45%
25%
Fushun Xinfugang Co,.Ltd.
Tangshan Jianlong Industrial Co,.Ltd.
Chengde Jianlong Iron & Steel Co,.Ltd.
Heilongjiang Jianlong Iron & Steel Co,.Ltd.
100%
Wuhan Iron and Steel (Group) Corporation
49%
49%
69.76%
51%
51%
51%
Wuhan Iron and Steel Company Limited
Wuhan Steel Corporation Echeng Iron & Steel Co,.Ltd
Wisco Liuzhou Iron & Steel (Group) Unite Co,.Ltd
WISCO Group Hainan Co,.Ltd.



Central Government
State-owned Assets Supervision and Administration Commission of the State Council
100%
Local Government
SASAC of Liaoning Province
100%
Owner
Benxi North Investment Co,.Ltd
China Cinda Asset Management Co.Ltd.
China East Asset Management Co.Ltd.
China Travel Service (Holdings) Hongkong Co,.Ltd.
100%
Steel Companies
Beitai Iron & Steel Group Co,.Ltd
41.37%
34.45%
32.25%
23.96%
Benxi Beiyin Iron & Steel Group Co,.Ltd.
Benxi North Pipes Co,.Ltd.
Benxi Beitai Ductile Pipe Co.,Ltd.
51%
Tangshan Guofeng Iron & Steel Co,.Ltd

EXHIBIT 3

Report on the Outline of the Tenth Five-Year Plan for National Economic and Social Development (2001)

(Delivered at the Fourth Session of the Ninth National People's Congress on March 5, 2001)

Zhu Rongji

Premier of the State Council

Notes:

1. News dispatches are embargoed until the conclusion of today's meeting.

2. The official version of this speech in Chinese will be released by the Xinhua News Agency.

Fellow Deputies,

Beginning this year, China will implement the first five-year plan for the new century. The Proposal of the CPC Central Committee for the Formulation of the Tenth Five-Year Plan for National Economic and Social Development was adopted at the Fifth Plenary Session of the Fifteenth CPC Central Committee. The Proposal defined objectives, guiding principles and major tasks for China's national economic and social development during the next five years. In the spirit of the Proposal and on the basis of opinions solicited from all sectors of society, the State Council has drawn up the Outline of the Tenth Five-

Year Plan for National Economic and Social Development (Draft) of the People's Republic of China. On behalf of the State Council, I now make my report to you and present the Outline (Draft) for your consideration and also for comments from members of the National Committee of the Chinese People's Political Consultative Conference.

I. Review of National Economic and Social Development During the Ninth Five-Year Plan Period

Over the past five years, the people of all ethnic groups worked hard together, blazed new trails with a pioneering spirit, and obtained great achievements in all fields of endeavor under the leadership of the Communist Party of China.

The national economy experienced sustained, rapid and sound development, and overall national strength continued to grow.In the five years, China's GDP increased by an average annual rate of 8.3% and reached 8.9404 trillion yuan in 2000. The mission of quadrupling the per capita GNP of 1980 has been overfulfilled. As the economy continued to grow and economic performance improved, national revenue in 2000 reached 1.338 trillion yuan, an average increase of 16.5% annually. The output of major industrial and agricultural products now stands in the front ranks of the world's economies, and commodity shortages were by and large eliminated. Progress was made in industrial restructuring. The quantities of grain and other major agricultural products we are capable of producing increased noticeably, marking a historic change from a long-term shortage of agricultural products to a basic balance in their total supply and demand, with even a surplus during good harvest years. Good results were achieved in eliminating outmoded industrial production capacity, reducing excess production capacity and upgrading technology in key enterprises. Information technology and other new and high-tech industries grew rapidly. Marked success was achieved in infrastructure development, alleviating bottlenecks in energy, transportation, communication, and raw and processed materials.

Economic restructuring was extensively carried forward, and a socialist market economy was preliminarily established.Significant advances were made in the establishment of a modern corporate structure in large and medium-sized state-owned enterprises. Most key state enterprises became corporations, and a considerable number of them were listed on stock markets inside or outside China. There was a marked reduction of losses and increase of profits in enterprises, and total profits from state-owned industrial enterprises and from the industrial enterprises with a controlling share held by the state reached 239.2 billion yuan in 2000, an increase of 190% over the 1997 figure. The objectives of reforming large and medium-sized state-owned enterprises and turning around loss-generating operations within three years were basically attained. At the same time that public sectors of the economy further developed, private and individual sectors also grew rapidly. The market system continued to improve, and the supply of capital, technology and labor expanded rapidly. The basic role of the market in the allocation of resources was noticeably enhanced. The system of finance and taxation continued to improve. Banking reform was accelerated. Major progress was made in the reform of the urban housing system, the social security system and government institutions. The state macro-regulation system was further strengthened.

We opened wider to the outside world, and the pattern of all-round opening took basic shape.Reform of the foreign trade system steadily progressed, and the internationally-oriented economy grew rapidly. The total volume of China's imports and exports reached US$474.3 billion in 2000, with exports accounting for US$249.2 billion, a rise of 69% and 67%

respectively over the 1995 figures. The mix of exports improved, and the proportion of electromechanical products and high-tech products increased. The spheres of activity open to foreign businesses were gradually widened, and the investment environment was improved. Foreign investment was increased and better utilized. More than US$289.4 billion in foreign funds were put to use during the past five years, an increase of 79.6% over the period of the Eighth Five-Year Plan. China's foreign exchange reserves totaled US$165.6 billion at the end of 2000, US$92 billion more than in 1995.

People's living standards continued to improve, and generally people began to lead a relatively comfortable life.In 2000 the per capita net income of rural dwellers and the per capita disposable income of urban residents reached 2,253 yuan and 6,280 yuan respectively, increasing by 4.7% and 5.7% annually in real terms. There was abundant supply of commodities; the level of consumption continued to rise, and the total volume of retail sales of consumer goods increased by an average annual rate of 10.6%. Housing, telecommunications, electricity and other aspects of living conditions for both urban and rural residents improved considerably. Personal savings deposits of residents increased by more than 100% over the past five years. The value of stocks, bonds and other financial assets increased rapidly. The number of people below the poverty line in rural areas decreased drastically. The objectives set in the seven-year plan to help 80 million people get out of poverty were basically attained.

The development of science, technology and education was accelerated, and other social undertakings progressed in a comprehensive way.The March 1986 Program to stimulate the development of high technologies was implemented successfully. A number of major results were achieved in the fields of aeronautics and astronautics, information technology, materials science, bioengineering and other high technologies. New advances were made in basic and applied research. The transformation of applied research institutes under government departments into enterprises has been basically accomplished, and restructuring of other research institutes has been carried out in a comprehensive way. The process of getting scientific and technological achievements to the market and applying them in production was accelerated. Progress was made in strengthening various types of education at all levels. Initial success was achieved in fulfilling the objectives of making nine-year compulsory education basically universal in the country and eliminating illiteracy among young and middle-aged people. Major progress was made in the reform of the management system of higher education. The increase of university and college enrollment was widely appreciated by the general public. New advances were made in population management and family planning. Great efforts were made in ecological conservation and environmental protection. Culture, public health, sports and other social undertakings continued to develop. Successive results were achieved in building a clean and honest government and in the struggle against corruption. The administration of all facets of public security was improved. New progress was made in improving socialist spiritual civilization, democracy and the legal system. Continuing progress was made in modernizing national defense and the armed services.

During the Ninth Five-Year Plan period, the Chinese government resumed its exercise of sovereignty over Hong Kong and Macao, and historic progress was made in the great cause of peaceful reunification of the motherland. Since the return of Hong Kong and Macao to the embrace of the motherland, the principle of "one country, two systems" and the basic laws of the two regions have been implemented in a comprehensive way. Outstanding achievements were made in the work of the governments of the special administrative regions. Social stability and economic development were secured in Hong Kong and Macao.

With the fulfillment of the Ninth Five-Year Plan, we attained the strategic objectives for the second stage of China's modernization drive, which laid a solid foundation for undertaking the Tenth Five-Year Plan and moving on to the third stage. This constituted a great achievement in China's socialist modernization drive and a new milestone in the progress of the Chinese nation.

These tremendous achievements in economic and social development during the Ninth Five-Year Plan period were hard-won victories over numerous difficulties. We successfully coped with the challenges posed by unexpected international events. We protected ourselves from the impact of the Asian financial crisis. We controlled inflation during the initial stage of the Ninth Five-Year Plan and curbed deflation in the middle and late stages. We also conquered severe floods and droughts. We attained these achievements thanks to the timely and correct policy decisions made by the CPC Central Committee with Comrade Jiang Zemin at its core in the face of numerous problems and difficulties and to the concerted efforts of the people throughout the country. On behalf of the State Council, I would now like to pay my highest respects to the people of all ethnic groups. You have all been working hard and making contributions in your own fields of endeavor. I also wish to express our sincere thanks to our compatriots in Hong Kong Special Administrative Region, Macao Special Administrative Region, Taiwan, as well as to overseas Chinese who have shown their concern and support for the development and reunification of the country.

During the implementation of the Ninth Five-Year Plan, we have accumulated a wealth of experience in improving macro-economic management and regulation to meet the requirements for developing a socialist market economy.

First, we have solved problems blocking our advance by stimulating economic development.Development is the fundamental principle. In the face of various social problems, we have always made economic development the central task and adopted effective measures to promote a sustained, rapid and sound development of the national economy, thus providing a foundation for handling other problems properly. Meanwhile, we adhered to the principle of "doing two jobs at once and attaching equal importance to each". We increased our efforts to improve socialist spiritual civilization, democracy and the legal system, and this has created a good political and social environment and provided a strong impetus for economic development.

Second, we made timely adjustments to the macro-control policy in accordance with the changing economic situation.In dealing with inflation, we paid attention to ensuring sustained expansion of the economy and a successful "soft-landing". In curbing deflation, we adhered to the principle of boosting domestic demand, resolutely enforced a proactive fiscal policy, and improved various policies and measures in the course of experience. We issued additional national bonds and expanded investment on the one hand, and we appropriately increased the income of the medium- and low-income urban residents and encouraged more consumption on the other, thus stimulating economic growth. We also adopted such measures as raising the export tax rebate rate and cracking down on smuggling in order to expand exports, achieve a balance of international payments, and keep the value of RMB stable. We implemented prudent monetary policies, adjusted interest rates and adopted many other measures to support economic growth. At the same time, we regulated the monetary supply, guided the direction of credit, and guarded against and reduced financial risks.

Third, we integrated the expansion of domestic demand with economic restructuring.In view of the over-productivity in the general processing industries, investments from national bonds were mainly put into infrastructure development. Investment in agriculture, science, technology and education was also increased, and support was rendered for technological upgrading in enterprises. We made use of the surplus production capacity in the capital goods industry to accomplish some large undertakings we had been wanting to but were unable to do for years. By so doing, we stimulated economic growth and increased the stamina for further economic development.

Fourth, we balanced reform, development and stability.Under complicated and difficult conditions, instead of coming to a halt, reform pressed forward vigorously and in an orderly manner, giving a powerful impetus to economic development. In the meantime, attention was paid to adjusting the magnitude of reform to the tolerance of the people. When economic restructuring and deepening reform unavoidably touched deep-seated interests, great attention was paid and various policies and measures were adopted to safeguard the fundamental interests of the general public. Vigorous efforts were made to implement re-employment projects and ensure that laid-off workers receive their basic living expenses and retirees their old-age pension payment on time and in full. The farmers' surplus grains were purchased without restriction at a protective price. All these measures helped to safeguard social stability and achieve sustained economic growth.

While fully affirming our achievements, we are clearly aware that there are still numerous problems in our economic and social life. The principal problems are as follows: inappropriate industrial structure and non-coordinated development of local economies; low overall quality of the national economy and low competitiveness in the international market; imperfections in the socialist market economy and conspicuous systematic factors hampering the development of productive forces; a comparatively backward state of science, technology and education, and relatively weak innovative ability in science and technology; a shortage of important resources such as water and petroleum and the deterioration of the ecological environment in some regions; growing employment pressure, slow income increase of farmers and some urban residents, and an increasing income gap; considerable disorder in some areas of the market economy; frequent occurrences of grave accidents; serious corruption, extravagance and waste, formalism and bureaucratism; and poor public order in some localities. The causes for these problems are rather complicated, but they are not unrelated to shortcomings and errors in our work. We must pay great attention to them and take further steps to solve them.

II. The Objectives and Guiding Principles of the Tenth Five-Year Plan

Looking ahead at the situation at home and abroad at the beginning of the 21st century, it can be said that the next five to ten years will be an extremely important period for China's economic and social development. The worldwide new scientific and technological revolution is progressing rapidly with great momentum. The economic globalization trend is gaining strength. Many countries are actively restructuring their industries, and our neighboring countries are accelerating their development. This international environment presents a severe challenge and a historic opportunity for us to strive to catch up and achieve development by leaps and bounds. At home, we are at a crucial juncture in economic restructuring, and reform is in a very difficult period. Our entry into the World Trade Organization will bring us a number of new problems. We are facing many arduous tasks. Many deep-seated problems need to be solved. All this requires us to seize the opportunity and accelerate development. At the same time, there are many favorable conditions for our national economy to achieve rather rapid development over a fairly long period.

In light of the situation and tasks facing us during the Tenth Five-Year Plan period, the Outline sets forth the main targets for economic and social development in the next five years as follows: maintain a fairly rapid growth rate in the national economy, achieve noticeable success in the strategic restructuring of the economy, and make marked improvement in the quality and benefits of economic growth to lay a solid foundation for doubling the 2000 GDP by 2010; make significant progress in establishing a modern corporate structure in state-owned enterprises, increase the soundness of the social security system, improve the socialist market economy, and open wider to the outside world and strengthen cooperation with other countries; expand avenues of employment, increase the income of urban and rural residents steadily, improve people's material and cultural standards of living, and improve ecological conservation and environmental protection; accelerate the development of science, technology and education, further improve the quality of the Chinese people, and achieve marked progress in improving spiritual civilization, democracy and the legal system.

The Outline of the Tenth Five-Year Plan embodies the following major guiding principles.

Making Development the Central Theme. We stress a balance between high growth rate and good economic returns and attaining fairly rapid growth by improving economic returns. Sound economic growth must be based on strong market demand and good economic returns. This is a fundamental principle. Based on an overall analysis of conditions in all sectors of the economy, we have set the target for the average annual economic growth rate in the Tenth Five-Year Plan period at around 7%. Though slightly lower than the actual growth rate of the Ninth Five-Year Plan period, it is still fairly high. Arduous efforts have to be made to attain this target through better economic performance. However, as there exist some uncertainties both at home and abroad, we have to leave some leeway when defining our target. This will help people focus on restructuring and improving economic returns, and also help prevent overheating of the economy and redundant development.

Concentrating on economic restructuring. We have already reached the point where we cannot further develop the economy without making structural adjustments. Under the old economic structure and its crude manner of growth, products will not be marketable, and it will be impossible to sustain resources and preserve the environment. We must adjust the economic structure in developing the economy and maintain a relatively rapid growth in structural adjustments. In the next five years, efforts should be intensified to adjust the patterns of economic development between different industries, between different regions, and between urban and rural areas, with emphasis on the industrial structure. We should stabilize and strengthen agriculture as the foundation of the economy, accelerate industrial reform, reorganization, upgrading and optimization, vigorously develop the service industry, accelerate efforts to base the national economy and society on information, and continue to reinforce the infrastructure.

Making reform and opening up and technological progress the driving force. The success of both economic development and structural adjustment depends on institutional, scientific and technological innovation. In the next five years, we must unswervingly pursue reform, open China wider to the outside world, and break down the institutional obstacles to the development of productive forces. This will provide a strong impetus for economic and social development. In addition, we have to give priority to the development of science, technology and education, further implement the strategy of developing

China through science and education, invigorate science and technology, train more skilled personnel, and better integrate science, technology and education with the economy.

Making improvement of the people's living standards the basic starting point. Raising the people's living standards in both urban and rural areas is the basic goal of our economic development and a crucial factor for expanding domestic demand and stimulating sustained economic growth. We must give priority to raising the people's living standards. To accomplish this we must create more jobs, increase personal income, distribute income more equitably, improve the social security system, and ensure a more comfortable life for the people.

Coordinating economic development with social development. We should make great efforts to improve socialist spiritual civilization, democracy and the legal system, balance reform, development and stability, accelerate development of various social undertakings, and ensure social stability. We need to pay close attention to and solve issues of population, resources and the ecological environment, take further steps to implement the strategy of sustainable development, and stimulate coordinated economic, social and environmental development.

The Outline for the Tenth Five-Year Plan emphasizes its strategic, macro-economic and policy characteristics. It contains fewer specific targets and sets more tentative ones adjustable to structural changes. The Outline focuses on key development areas and the settlement of major problems, orients our efforts, and presents corresponding policies and measures. It stresses that the role of market mechanisms should be fully exercised in the implementation of the Plan, and that economic levers, economic policy and legislation be further employed in the government's macro-control. In the process of formulating the Plan, we need to encourage more participation by all elements of society, thus making it a process of giving full scope to democracy, absorbing all useful ideas, and reaching agreement among all sides.

III. Strengthening Agriculture as the Foundation of the Economy and Striving to Increase Farmers' Income

Agriculture, rural areas and farmers are of great importance to the reform, opening up and modernization drive. During the period of the Tenth Five-Year Plan, we need to give top priority to implementing the Party's basic rural policy, strengthening agriculture as the foundation of the economy and increasing farmers' income. We must focus on the following aspects of this work:

Accelerating restructuring of agricultural production and the development of the rural economy.This is the fundamental way to improve economic returns in agriculture and increase farmers' income. While effectively protecting the cultivated land and stabilizing our grain production capacities, we need to restructure the patterns of farming, focusing on improving strains, quality and economic returns. We need to accelerate the development of animal husbandry, forestry and aquaculture. We need to adjust the patterns of agricultural production appropriately in different regions, taking into account their local comparative advantages. Agricultural production needs to be developed in light of local characteristics, and scale of economy and specialization need to be developed to raise the proportion of production marketed. Great efforts need to be exerted to promote the industrial management of agricultural production, to support leading enterprises, and to spread the practice of farmers working with companies or producing crops on a contract basis. We need to develop industries for processing, storing and transporting agricultural products and keeping them fresh in order to gain better returns from intensive processing of agricultural products. Town and township enterprises need guidance in restructuring, technological progress and institutional innovations. Small towns and cities need to be expanded; their economies need to be made prosperous; and steady progress needs to be made in urbanization in order to increase job opportunities and sources of income for farmers. We need to work diligently to reinvigorate agriculture through science and education. We need to strengthen the research, development and application of biotechnology, information technology and other high and new technologies, and spread the use of improved strains and advanced technologies. Great efforts need to be made to stimulate the industrialization of agriculture by applying agricultural science and technology. We need to improve the socialized service system for agriculture. Market information systems for agricultural products need to be established and standards and inspection procedures need to be formulated to ensure food safety and quality. In restructuring agriculture, we need to proceed in light of local conditions and follow the principles governing the development of the market, and we need to protect farmers' right to independence in production and operation and refrain from pressure and coercion.

Actively promoting the reforms in rural areas.While keeping the system of stable, long-term land contracts as a foundation, areas where conditions permit should be encouraged to explore a land operation rights transfer system. In light of the new situation in grain production and distribution, we need to continue to deepen the reform of the grain distribution system. While increasing the central grain reserves appropriately, the main grain-consuming areas should accelerate the pace of market-oriented grain distribution, and their need for grain should be met by establishing long-term and stable purchase and sale relations with the main grain-producing areas and by renewing and regulating the central grain reserves. The relevant departments in the main grain-producing areas should continue to adhere to the three policies of purchasing surplus grain from farmers without limit at protective prices, of having state-owned grain purchase and wholesale businesses sell grain at a profit, and of ensuring closed operation of grain purchase funds and the reform of state-owned grain purchase and wholesale businesses. These departments need to purchase surplus grain from farmers without limit at protective prices, and they will continue to receive funds from the central treasury to make full use of their superiority in grain production. This will expand the grain market for the main grain-producing areas and promote a reasonable rise in grain prices. This will also be conducive to adjusting the agricultural structure in the main grain-consuming areas and broadly increasing farmers' incomes. Basic farmland should be protected, and conversion of cultivated land to non-agricultural land without authorization will never be allowed. This is where we draw the line. The system of administrative fees and taxes in rural areas needs to be reformed by abolishing all administrative fees imposed exclusively on farmers, such as contributions to township and village public accumulation funds and at the same time by raising the current rates of agricultural tax and special agricultural product tax where it is appropriate. This is a sound policy for safeguarding the legitimate rights and interests of farmers and reducing their burden. Reform needs to be accelerated with a review of the experience gained from pilot projects in Anhui Province. As a result of the reform of taxes and administrative fees, it will be necessary to decrease the number of the administrative bodies and employees in towns and townships, and reduce the number of village and group functionaries receiving government subsidies. It will be necessary to dissolve or merge some townships and towns where conditions permit. We need to continue to deepen the financial reform in rural areas and actively seek a financial system that helps stimulate rural economic development. It is necessary to accelerate the reform of the management system for rural credit cooperatives in light of local conditions. It is of particular importance to clearly establish ownership, exercising better control over rural credit cooperatives by bringing them within the legal person framework, and hold individuals responsible for preventing and defusing financial risks. Adhering to their mission of serving agriculture, rural areas and farmers, rural credit cooperatives must strengthen their operation and management, and expand their roles as the dominant financial force in rural areas and as the financial link between farmers. The Agricultural Bank of China and other financial institutions should also give more support to agriculture and the rural economy. The reform of rural supply and marketing cooperatives should be deepened.

Stepping up the construction of agricultural and rural infrastructure.More investments need to be made to accelerate the harnessing of big rivers and lakes. No time can be lost in constructing pivotal projects on major rivers and reinforcing decaying reservoirs to improve their flood-control, flow-management and storage capabilities. Great efforts need to be made to upgrade the water conservancy projects in large irrigated areas, and farmers need to be encouraged to play a more active role in building irrigation and water conservancy projects. We should do a good job in water and soil conservation. Efforts to build national commodity grain bases and quality agricultural product bases need to be intensified to stimulate comprehensive agricultural development. We need to continue to increase the construction of power grids, telecommunications, radio and television installations, roads and water supply facilities in rural areas to improve the production, living and marketing conditions there.

Continuing to fight poverty in rural areas.Although the seven-year plan to help 80 million people out of poverty has been basically fulfilled, it will be an arduous task for a long time to bring about a fundamental change for the better in poverty-stricken areas. We need to intensify our efforts to fight poverty and priority needs to be given in our anti-poverty endeavor to ethnic minority areas in central and western China, the old revolutionary base areas, border areas and destitute areas. Assistance to the poor needs to continue to be development-oriented. More funds need to be put into anti-poverty efforts in every possible way. We need to expand the scale of programs that provide jobs as a form of relief and support efforts in poverty-stricken areas to improve the infrastructure.

IV. Energetically Optimizing and Improving Industrial Structure

Readjusting and improving industrial structure is the key to the strategic restructuring of the economy. We must stress the following aspects.

Enhancing traditional industries with high, new and advanced technologies.We need to pay close attention to the restructuring and reform of traditional industries. In these industries enterprises are the main entities, and they should be directed by the market and supported by technological advances. The following measures should be taken. First, we need to increase product variety, improve product quality, save on energy, reduce waste, prevent and control pollution, and increase productivity. These measures are most important in the energy, metallurgy, chemical, machinery, automobile, building materials, construction, textile and light industries. Support should be given to a number of key enterprises for technological renovation to improve their technology and equipment. Second, we need to speed up development of universal, key and accessory technology that can stimulate structural advancement by depending on both domestic innovation and imported technology. We need to stimulate equipment manufacturing and design and build complete plants of large, advanced and highly-efficient equipment urgently needed in China. Third, in major industries, we need to encourage the establishment of a number of large companies and enterprise groups through stock listing, merging, association and reorganization. Such companies and groups need to have their own intellectual property rights, core products and a strong central leadership, and they should become key players and pillars in industrial readjustment and advancement. Fourth, we need to support and promote renovation of old industrial bases, fully utilizing their strong foundation and concentration of talent to raise their production levels. The cities and large mining areas which depend on the exploitation of mineral resources should develop other industries to substitute for mining in light of local condition. At the same time, we need to take economic, legal and necessary administrative measures to continue closing down plants and mines that produce shoddy goods, waste resources, cause serious pollution, or operate under unsafe conditions. Outmoded and surplus production capacity needs to be abandoned or reduced. Relocation and reconstruction of these outmoded facilities will be prohibited. Enterprises that have been in the red for long with little hope of recovery and whose debts surpass assets should be allowed to go bankrupt, and mines with exhausted resources should be closed. We should take the initiative to facilitate and gradually standardize the channels for encouraging such enterprises to quit the market.

Developing new and high-tech industries, and using information technology to stimulate industrialization. In accordance with actual situations, we need to selectively stimulate development of new and high-tech industries such as information technology, bioengineering and materials science. We need to lend support to important high-tech projects, such as high-speed, wide-band information networks, key integrated circuits and new-type carrier rockets in order to strengthen China's new and high-tech industries on an overall as well as individual basis. We need to expand the manufacturing of information technology products, develop the ability to manufacture all components of integrated systems, and enhance our capability for independent development. We also need to develop the software industry, strengthen the development of the information infrastructure, and apply digital and network technologies extensively in the technical development, production and marketing activities of enterprises, and in public services and government administration, so that industrialization and the information revolution go hand in hand.

Intensifying construction of water conservation, transportation, energy and other infrastructural facilities and attaching great importance to strategic issues concerning resources. Lack of water resources is a serious limitation on the economic and social development of our country. We need to put water conservation high on our work agenda, establish a rational system for management of water resources and a rational pricing mechanism, comprehensively adopt water conservation technologies and measures, develop water-efficient industries, and raise the entire society's awareness of water conservation. Prevention and control of water pollution should be strengthened. We should improve sewage treatment and utilization. We need to expedite the planning and building of projects to divert water from the south to the north. In transportation, we need to build highways, railways, ports, channels, airports and pipelines in order to establish a comprehensive modern transportation system that is unimpeded, safe and convenient. Energy, oil in particular, is of strategic importance. Domestic development and production of oil can no longer keep pace with the needs of the country's economic and social development, resulting in an increasing imbalance between oil supply and demand. Therefore, we need to take all possible measures to conserve and substitute for oil, accelerate exploration and exploitation of oil and natural gas resources, and make effective use of overseas resources. We need to institute a system for preserving strategic resources such as oil as soon as possible. We need to vigorously carry forward the renovation of large coal mines, construct highly productive and efficient mines, and place special emphasis on the development and utilization of clean coal technology. While making full use of existing power-generating capacity, we need to develop hydroelectric power and build large-scale thermal power plants near coal mines, reduce small thermal power stations, and moderately develop nuclear power. We should strengthen the construction and upgrading of power grids in urban and rural areas and work to complete nationwide network. We should further reform the power management system, gradually allow power plants and grids to operate separately, and institute bidding for the power supply. Emphasis should be placed on the development of all types of new energy.

Accelerating development of the service industry.This is an important avenue for stimulating economic restructuring and increasing employment. Actively developing modern services, such as information services, banking, accounting, consulting and law, will help raise the overall quality of the service industry. Up-to-date management and technology should be applied to renovate traditional service sectors, such as internal and foreign trade, transportation and municipal services, to improve their quality and efficiency. Services for urban consumers, such as real estate, community services, tourism, catering services, entertainment and fitness services need to be expanded. We need to deepen reform and adopt necessary policies and measures to create an environment favorable for the development of the service industry.

V. Implementing the Strategy for Developing the Western Region to Promote Coordinated Progress of Different Areas

Carrying out the strategy for western-region development to accelerate the development of the central and western regions is a major step taken to achieve the strategic goals of the third stage of the country's modernization drive. During the Tenth Five-Year Plan period, we need to place emphasis on key projects for a good beginning of the program. Construction of infrastructure and protection of the ecological environment should take priority, and we should strive for major breakthroughs within five to ten years. At the same time, we hope to develop science, technology, and education considerably.

We must focus on a number of major projects of strategic significance, such as the transmission of natural gas and electricity from western to eastern regions and the planned Qinghai-Tibet Railway. We need to give priority to protecting, economizing and exploiting water resources through careful planning and rational allocation in order to ensure better utilization of water. We need to steadily proceed with major projects for protecting natural forests in light of local conditions, returning cultivated land to forests or pastures, preventing and controlling desertification, and protecting grassland. Great attention should be paid to the ecological self-regeneration capacity. We should connect these projects to form an ecological green belt in the western region. We need to vigorously improve education to train professionals and workers much needed in various fields. We need to increase investment in scientific and technological development. Localities should cultivate individualized local economies by adjusting and optimizing their industrial system, and by strengthening agriculture and by accelerating the transformation of resource advantages into economic advantages. In developing the western region, we need to begin work at places along major transportation routes, such as the Eurasian Continental Bridge, the Yangtze River, and the routes in the southwestern part of the country leading to the sea. Major cities connected by such lines should serve as economic centers and play leading roles in the development of their adjacent areas. We should particularly foster the economic zones along the Tongguan-Lanzhou-Urumqi line, the upper reaches of the Yangtze River, and the Nanning-Guiyang-Kunming line to promote development of the surrounding areas.

The State Council has already promulgated a number of policies and measures to support the development of the western region. The state will invest more in the west and increase transfer payments from the national budget to local budgets there. However, people in the western region should rely primarily on their own efforts and hard work over the long haul. We need to accelerate reform and opening up and create a sound investment environment to attract more funds, technology and human resources from home and abroad to the western region. We also need to increase the exchange of cadres.

The central region should make use of its regional advantages and its comprehensive advantages of resources to accelerate its pace of economic growth. It should focus on areas with main water and land transportation lines, make full use of the role of major cities and actively foster new loci of economic growth and new economic belts. It should consolidate and develop agriculture and continue to strengthen construction of infrastructural facilities and ecological projects. It should step up efforts to upgrade traditional industries with high, new and advanced technologies and raise its technological level and competitiveness.

The eastern coastal region should be oriented towards both the domestic and international markets. Priority tasks are to accelerate scientific and technological progress and innovation, to develop industries applying high and new technology, and to develop the internationally-oriented economy to improve its general performance and its competitiveness in the international market. Areas where conditions permit should take the lead in modernization. The eastern region should strengthen its economic and technological cooperation with the central and western regions by various means to support and stimulate their economic development and to increase its own flexibility for structural adjustment and economic growth at the same time.

VI. Implementing the Strategy of Developing China Through Science and Education and Vigorously Tapping Human Resources

This is an important component of the Outline as well as an important guarantee for accomplishing the various tasks during the next five years.

Stimulating scientific and technological progress and innovation to give a strong impetus to structural readjustment and economic development.First, we need to vigorously conduct strategically significant high technology research, strive to make breakthroughs in some key technological fields that have a direct bearing on economic lifelines and national security, improve our innovative capability, and accelerate the application of high and new technology in production. Second, technological support needs to be provided for the upgrading of traditional industries. We need to concentrate on making technological progress in the processing and converting of agricultural products, manufacturing equipment, conserving water and energy, and finishing textiles. We also need to accelerate the application of high and new technology in traditional industries. Third, we need to strengthen basic research and applied basic research and improve our ability to make sustained progress in scientific and technological innovation. We need to strengthen pioneering and interdisciplinary research in key fields of the basic sciences. We have to increase basic research in selected fields where we have been doing well and which have a great bearing on development, and we have to strive to make fresh progress in the important fields of genomics, information technology, nanoscience, ecology and geoscience. We have to facilitate the integration of natural and social sciences and promote the development of management science. Emphasis should be placed on the development of philosophy and other social sciences and the advances of theoretical innovation.

We need to accelerate the reform of the structure of scientific disciplines and technological fields and promote the closer connection of science and technology with the economy. Efforts to develop a state system to stimulate innovation need to be increased, and enterprises should be encouraged to play an important role in technological progress and innovation. We need to continue to encourage research institutes engaged in technological development to merge with enterprises or be turned into enterprises, push forward the reform of non-profit research institutes, and establish a number of research institutes that can exert international influence. We need to develop agencies providing scientific and technological services. We need to improve the venture capital investment mechanism, establish a growth enterprise market, and support small and medium-sized enterprises in technological innovation. The state and the society need to invest more in science and technology. Great efforts have to be made to build national key laboratories.

Persisting in the appropriate development of future-oriented education to serve national economic and social development.In developing education, we should meet the needs of modernization, the world and the future, and concentrate on improving quality-oriented education to ensure that students improve in terms of their moral qualities, intellectual ability, physical fitness and aesthetic appreciation. We need to consolidate the achievements of making nine-year compulsory education basically universal in the country and eliminating illiteracy among young and middle-aged people, accelerate the expansion of senior secondary school education and higher education, and develop high-level programs in selected universities and disciplines. Great efforts have to be made to develop vocational education and training and to establish an educational system featuring the integration of vocational education with general education. We need to develop adult education and various forms of continuing education and gradually establish a system of lifelong education. Great emphasis should be placed on children's early education. Information technology needs to be used to develop long-distance education. In light of the needs of economic and social development, we need to continue to revise the educational structure and organization, optimize the division of disciplines, update teaching materials, reform the curriculum, examination and evaluation systems, improve the methods and quality of instruction, strengthen moral education, especially for young people, improve ideological and political work, recruit a strong corps of capable teachers, and raise the ideological and professional levels of teachers.

We need to deepen the reform of the systems for operating schools and managing education. We need to allow institutions of higher learning to make operating decisions according to law, and to continue the transformation to a system of independent operation of support services in universities and colleges. We need to encourage and help all sectors of society to run schools, and we need to exercise oversight over their operation. In light of new conditions following the reform of taxes and fees in rural areas, county governments should be responsible for overall planning of spending for elementary education. Measures must be implemented to guarantee the coordinated payment of teachers' salaries. The state and society need to invest more in education. More transfer payments and investment in special projects from the central and provincial financial departments have to be provided for education in poverty-stricken areas and areas inhabited by ethnic groups. We need to improve the systems of scholarships, grants and loans to support students, and we need to take effective measures to curb arbitrary charges levied by schools.

Making efforts to implement the strategy of tapping human resources, and focusing on the important tasks of training, attracting and utilizing talented people.In light of the overall interests of the modernization drive and long-term development, we need to train and nurture a contingent of leading cadres who are highly competent, who persist in taking the socialist road with Chinese characteristics, who have a good understanding of political theory and a pioneering spirit, who have mastered modern science and culture and acquired managerial expertise, and who are well-experienced. We need to train and cultivate a contingent of specialized, high quality public servants who are honest, industrious and eager to serve the people, and a contingent of professional personnel and enterprise managers who have advanced technological and managerial knowledge and innovative ability and meet the needs of economic and social development. We need to attach importance to training leading scholars in frontier disciplines and improving the scientific qualifications and working skills of the entire labor force. We need to deepen the reform of the personnel system; establish and improve the methods by which professionals are recruited, examined, evaluated, transferred, motivated and supervised; and formulate a mechanism that encourages talented people to emerge in large numbers and to make full use of their talent. We need to establish and improve the human resources market and protect intellectual property rights in accordance with the law. We need to attract and employ highly qualified professional personnel from abroad, and encourage students studying overseas to come back to work in China or serve their country in other appropriate ways.

VII. Further Deepening Reforms and Opening Wider to the Outside World

To gradually bring the system of socialist market economy to completion and to stimulate structural readjustment and economic growth, we will press ahead with reforms and open wider to the outside world.

Deepening the reform of state-owned enterprises to enable them to compete as equals in the market economy.The key issue in this regard is to accelerate the establishment and improvement of a modern corporate structure. We need to encourage large and medium-sized state-owned enterprises to adopt the share-holding system and to change their operating procedures by listing their shares on the stock market, setting up joint ventures with foreign investors, or holding each other's shares. The state must hold a controlling stake in strategic enterprises that concern the national economy and national security, but not necessarily in others. We need to energetically explore effective ways to manage state assets. The legal person system of governance for enterprises must be fully developed and implemented. The supervision and control of state-owned enterprises in particular need to be established and strengthened, and the role of the board of supervisors needs to be fully developed. Enterprises need to further reform their personnel, labor and income distribution systems in order to improve the mechanisms that provide incentives and restraints and to strengthen scientific management. In the course of readjusting the industrial structure, we must adhere to the principles of "advancing in some aspects while retreating in others" and "focusing on certain tasks while putting others aside" and promote strategic readjustment of the overall arrangement of the state-owned sector of the economy. We need to continue to relax control over small and medium-sized state-owned enterprises to enhance their vitality. More efforts need to be made to separate the functions of government from those of enterprises, and the functions of government need to be transformed to reduce administrative oversight and approval. Chambers of commerce, trade associations and other such intermediary agencies are encouraged to play appropriate roles. We need to further reform the management systems of industries such as electricity, railways, civil aviation and telecommunications, and introduce a mechanism for competition. The reforms need to improve the relations between the government and enterprises so as to meet the requirements of a socialist market economy. The ownership system needs to be further improved. We need to uphold the dominance of the public sector of the economy, let the state-owned sector play the leading role, develop various forms of collective undertakings, and support, encourage and guide the healthy development of private and individual sectors of the economy.

Overhauling and regulating market order, and expanding the market system.This is an urgent task to ensure normal operation of the economy and an important measure to strengthen the socialist market economy. We must improve laws and regulations concerning markets and enforce the law strictly. We need to improve oversight mechanisms and employ advanced technology to improve market supervision. We must persist in cracking down on criminal activities such as producing and marketing fake and shoddy goods, tax evasion, tax fraud, obtaining foreign currency through deception, and smuggling. We need to overhaul the construction market, reorganize and standardize the financial order, strengthen financial discipline, tighten audit supervision, standardize the operation of intermediary agencies, break up monopolies by departments or industries, eliminate regional barriers, and improve management and supervision of industrial safety. We need to oppose local protectionism. We need to establish as soon as possible and improve an integrated national market system that is standardized and encourages fair competition. We need to focus our efforts on the development of markets for production factors, especially capital, foster work ethics that stress honesty and trustworthiness, and accelerate the establishment and improvement of a nationwide credit system.

Enhancing macro-control, and deepening reform of the finance, taxation, banking and investment systems.We need to gear our macroeconomic policies to the changing economic situation. In the near future we will continue to implement a proactive fiscal policy to increase investment and stimulate consumption. We need to conduct financial affairs according to the law, strengthen tax collection and management, and improve supervision of government financial affairs. We will step up the reform of replacing fees with taxes and the reform of the budget system, improve the tax system, and adjust and improve the system of fiscal expenditures in order to gradually set up a public finance framework compatible with a socialist market economy. While expanding domestic demand and checking the trend of deflation, we need to be on guard against possible overheated economic growth and inflation. We will continue to implement a prudent monetary policy and regulate money supply in timely fashion to keep the Renminbi stable. We need to carry out a comprehensive reform of the wholly state-owned commercial banks in the light of modern banking principles and bring the role of the policy banks into full play. We need to develop medium-sized and small banking institutions, standardize and improve the securities market, and safeguard the interests of investors. We need to expand the insurance industry, improve supervision of financial institutions, implement a system of strict evaluation of financial operations and management, implement a system of accountability, improve financial services and the quality of financial assets, and guard against and defuse financial risks. We also need to deepen the reform of the investment system, adopt a system under which legal persons are responsible for all investment projects, a public bidding system, a project supervision system, and a contract management system, and strengthen the mechanisms for restraining investment.

Doing a better job in opening to the outside world in the light of economic globalization.First, we should lose no time in preparing for China's entry into the World Trade Organization and fulfilling our tasks in the transitional period. We need to take effective measures to change the methods of government administration and enhance the competitiveness of Chinese enterprises. We need to deepen the reforms in order to establish a system of foreign trade and economic cooperation compatible with international norms and suitable to domestic conditions. We need to step up the work of revising relevant laws and regulations. We also need to train professionals who are well acquainted with regulations governing international trade. Second, we need to expand import and export trade, with emphasis on the export of high-quality goods and technology. We need to optimize the mix of export commodities by expanding the share of high and new technology products, raising the technological content and added value in traditional commodities exported in large quantities, and expanding the scale of the service sector. We need to standardize the regulation of processing industries and increase the value-added increment of such trade. We need to vigorously promote market diversification and open new markets for our exports. In import trade we need to emphasize advanced technology, key equipment and important raw and processed materials that are urgently needed in China. We need to take an active part in multilateral trading partnerships and international and regional economic cooperation. Third, we need to make better use of foreign funds. We need to open up the service sector to foreign investment step by step. We need to encourage foreign investors, especially transnational corporations, to invest in high-tech industries and infrastructure, and encourage them to set up research and development centers in China and to participate in the restructuring and renovation of state-owned enterprises. We need to support eligible enterprises to become listed on overseas stock markets and further improve the investment climate. We also need to explore new ways to utilize more foreign investment, such as acquisition, merger, risk investment, investment funds, and investment in securities. We should actively encourage foreign businessmen to invest more in the central and western regions. We should continue to manage the special economic zones and the Pudong New Area well. Fourth, we need to implement a "going outside" strategy, encouraging enterprises with comparative advantages to make investments abroad, to establish processing operations, to exploit foreign resources with local partners, to contract for international engineering projects, and to increase the export of labor. We need to provide a supportive policy framework to create favorable conditions for enterprises to establish overseas operations. We also need to strengthen supervision and prevent the loss of state assets.

VIII. Constantly Raising Living Standards and Improving the Social Security System

It is an important task for the government in the next five years to raise living standards substantially and gradually enable the people to lead a more comfortable life.

Improving the social security system at a faster pace.This is a major issue concerning reform, development and stability. We need to ensure that basic living allowances for laid-off workers from state-owned enterprises and basic pensions for retirees are paid in full and on time. At the same time, we need to accelerate the formation of a social security system that is independent of enterprises or institutions and supported by funds from diversified sources, and that provides standardized safeguards and society-wide services. In addition, we need to conduct meticulous pilot projects aimed at improving the social security system in urban areas. We need to improve the basic old-age insurance system for workers in urban areas, combining contributions from enterprises and institutions with personal accounts. We also need to improve the unemployment insurance system and gradually incorporate the basic cost-of-living allowances for workers laid off by state-owned enterprises into unemployment insurance. We need to strengthen the system of subsistence allowances for urban residents and take good care of those in dire need. We need to improve the basic medical insurance system for workers in urban areas and carry forward the reform of medical institution and the system for distributing medicines. Institutional employers with available resources are encouraged to set up supplementary old-age and medical insurance programs for their employees and more fully utilize commercial insurance. We must see to it that there are reliable sources and a stable flow of funds for social security, and that these funds are efficiently operated under a strict management mechanism. We need to develop other social security programs, such as social welfare, charities, job placement for demobilized servicemen and social mutual aid. We must safeguard the legitimate rights and interests of women, juveniles, senior citizens and the handicapped; and we need to support the various programs to help the handicapped.

Expanding employment by all possible means.During the Tenth Five-Year Plan period, we face the demanding task of expanding employment. While maintaining a fairly high growth rate for the economy, we must develop labor-intensive industries that have comparative advantages, especially service businesses that can provide large numbers of jobs. We also need to encourage the development of collective, private and individual businesses to create more jobs. We need to improve the infrastructure of communities and expand community services. We need to set up a flexible employment system to provide more forms of employment. We need to help people change their ideas about employment and encourage them to start their own businesses or find jobs for themselves. We need to make greater efforts to develop the labor market, improve employment services, expand vocational training, and form market-oriented employment mechanisms.

Increasing income of urban dwellers, especially those with low incomes.We need to establish a wage payment system, a minimum wage system, and a mechanism for adjusting the minimum wage as the economy grows. Government financial departments at all levels need to ensure that the salaries of government employees and pensions for retirees are paid in full and on time, and gradually increase salaries in accordance with the principle of feeding the people first, then building the country. We need to deepen the reform of the system of income distribution. We should adhere to the principle of giving priority to efficiency with due consideration to fairness. We need to implement an income distribution system in which distribution according to work is the leading principle and other factors are taken into consideration, and we need to include capital, technology and other economic factors in the distribution of economic rewards. We must raise salaries of senior managers and senior technical professionals in state-owned enterprises to fully reflect their contributions and annual salaries may be introduced on a trial basis for them. At the same time we must enforce strict restraint and supervision to prevent those who do poor work from getting high salaries even if the performance of their enterprises is dissatisfactory. There must be penalties for those who are not qualified or even guilty of malfeasance. Stock options may also be initiated on a trial basis for leading executives and key technical professionals in state-controlled companies listed on the stock market, but state assets must not be transferred to individuals. We need to tighten the control and supervision over income distribution in monopoly industries, standardize the distribution of social wealth, and strengthen the regulatory function of tax collection over income distribution to prevent the gap in income distribution from becoming too wide.

Adjusting the consumption pattern and improving the environment for consumption.Efforts should be made to improve housing and transportation conditions for both urban and rural residents. We need to build more affordable and functional housing and establish a system to ensure an adequate supply of low rent housing. We need to energetically develop public transportation. We need to improve urban landscaping and develop infrastructures in urban and rural areas.

More efforts should be made to improve the living environment of urban and rural residents. We need to develop preventive medical care for communities, improve public health services in rural areas, and expand public-oriented sports facilities.

IX. Continuing to Implement the Strategy of Sustainable Development

We need to better coordinate the development of population, resources and the environment, and place more emphasis on the implementation of the strategy of sustainable development.

Adhering to the basic state policy on family planning.We must work hard to sustain the low birth rate and improve prenatal and postnatal care. We need to devote more effort to the management of family planning in rural areas and among the floating population. We should establish awards for family planning and continue to hold leaders of local Party and government organizations responsible for work in this regard. Legislation on population and family planning must be accelerated. We need to expand care for senior citizens.

Protecting natural resources and using them properly.We need to protect and make proper use of valuable resources such as fresh water, farmland and energy in accordance with the law. We must gradually establish a system of reserves for strategically important mineral resources and ensure their safe supply. We need to strengthen the comprehensive development, utilization and conservation of marine resources. We need to increase our recycling of resources in order to utilize our resources more effectively. We need to improve the system of paying compensation for the use of natural resources. We must safeguard the rights and interests of the state as the owner of mineral and other resources. We must improve laws and regulations in this regard, and strengthen law enforcement.

Improving ecological conservation and strengthening environmental protection.Greater efforts need to be exerted to complete projects to protect natural forests, such as those along the upper reaches of the Yangtze River and the upper and middle reaches of the Yellow River. We need to intensify work on the Northeast, North and Northwest China Shelter Forest Projects and similar projects on the middle and lower reaches of the Yangtze. We need to do more to protect natural grasslands. We need to step up our efforts to prevent the karst from becoming stony desert. No time can be lost in bringing under control the sources of sand storms affecting the area around Beijing and Tianjin. We need to continue our efforts to control and treat water pollution in important river valleys, regions and sea areas. We need to treat pollution and do more landscaping in large and medium cities with the aim of noticeably improving the quality of the environment there. We also need to pay due attention to prevention and control of environmental pollution in rural areas. We need to improve environmental, meteorological and seismological monitoring to help prevention and reduction of natural disasters.

X. Promoting Spiritual Civilization, Improving Democracy and the Legal System, and Strengthening National Defense

Vigorously promoting socialist spiritual civilization.We need to follow the principle of "doing two jobs at once and attaching equal importance to each." We need to consolidate and strengthen the guiding role of Marxism and educate the people in Marxism-Leninism, Mao Zedong Thought and Deng Xiaoping Theory. We need to promote patriotism, collectivism and socialism. We need to continue education of our cadres in the important principle of "Three Represents" (The Communist Party of China represents the requirement to develop advanced productive forces, an orientation towards advanced culture, and the fundamental interests of the overwhelming majority of the people in China.) and foster the spirit of studying hard, being politically-minded, and being honest and upright. Our cadres should have a correct outlook on the world and life and have correct values. We need to work hard to foster ideas and ethics appropriate for a socialist market economy. We need to administer the country in accordance with moral principles as well as the law. We need to disseminate scientific knowledge, combat ignorance and superstition, and encourage healthy lifestyles. We need to further develop various cultural undertakings, such as literature and art, journalism and publishing, and radio, film and television. We should adhere to the principles of serving the people and socialism and of "letting a hundred flowers blossom and a hundred schools of thought contend." We need to produce more and better cultural and intellectual works. We need to maintain the correct orientation of public opinion, and place strong emphasis on the establishment and management of new information media. We need to build more libraries, cultural centers, science and technology centers, museums, archives, and recreation centers for juveniles and senior citizens. Mass participation activities should be continued to promote cultural and ethical progress. We need to deepen reform of the system for managing cultural undertakings, improve the economic policies concerning cultural undertakings, and promote the development of industries related to culture. We need to organize and standardize the cultural market and persist in the fight against pornographic and other illegal products.

Energetically improving socialist democracy and the legal system.We need to develop a socialist democratic political system, govern the country according to the law, and make China a socialist country ruled by law. We need to press ahead with reform of the political system; implement democratic elections, decision-making, management and supervision; protect the extensive rights and freedoms of the people as prescribed by law; and respect and guarantee human rights. We need to continue to strengthen the legislative and supervisory role of the People's Congress, and expand the role of the Chinese People's Political Consultative Conference in political consultation, democratic supervision, and administration and deliberation of state affairs. We need to bring the legal system into line with a socialist market economy. Governments at all levels must conscientiously subject themselves to the supervision of the people's congresses at corresponding levels and consult with the CPPCC. They must govern in accordance with the law and be strict in performing official duties. We need to deepen the reform of the judicial system, strictly enforce laws, and administer justice impartially. We need to put greater efforts into combating corruption and building a clean government. We need to strengthen legal education and raise the awareness of law among all citizens. We need to strengthen development of legal infrastructures, and improve the qualifications of procuratorial, judicial and public security officers.

We need to make further efforts to implement the Party's policy on ethnic groups, adhere to and build upon the system of the autonomy of ethnic minority regions, and develop socialist relationships among all ethnic groups characterized by equality, unity and mutual assistance. As part of our efforts to develop the western region of China, we need to give more support to accelerate the all-round economic and social development of the areas inhabited by ethnic minorities, and strive for common prosperity and progress of all ethnic groups. We need to implement the Party's policy on religions in a comprehensive manner, protect the people's freedom of religious belief, administer religious affairs in accordance with the law, and help the various religions adapt to socialist society. We need to conscientiously implement the Party's policy on affairs concerning overseas Chinese and bring their role into full play in the modernization drive and the great cause of peaceful reunification of the country.

We need to better safeguard social stability and correctly handle conflicts among the people in the new era. We should pay close attention to correspondence from the people and their personal visits. We need to improve public order through comprehensive measures and crack down on criminal activities that pose a threat to social order and national security. We must use legal means to combat ethnic separatist activities, religious extremist forces, violent and terrorist activities, cults, and illegal activities carried out under the guise of religion. We need to continue our campaign against the Falungong cult, and further expose and condemn the anti-human, anti-social and anti-science nature of the cult, which has become a tool for domestic and overseas forces hostile to our socialist government. We need to mete out severe punishment to the small number of criminals while making unremitting efforts to unite, educate and rescue the vast majority of people who have been taken in.

Strengthening national defense and building up the armed services.This is an important guarantee for the security of the state and the success of the modernization drive. As we focus our efforts on developing the national economy, we must also strengthen our national defense and increase our defense capabilities. We need to strengthen ideological and political work among servicemen, ensure the absolute leadership of the Party over the armed forces, and guide the development of the armed forces in the correct direction. We need to work conscientiously to implement the military strategy of active defense in the new era; persist in reform and innovation; strengthen the armed forces through science and technology, with an emphasis on quality and thrift; run the armed forces by law; and streamline the armed forces in a Chinese way in order to build a more modernized, standardized revolutionary army. We need to raise the people's awareness of the importance of national defense and improve the mobilization system. We need to strengthen defense-related scientific research, reform and restructure science, technology and industry related to national defense, develop new weapons and equipment, utilize modern technology, especially high technology to improve the defense capabilities and combat effectiveness of the armed forces, and ensure their preparedness for any contingency.

Fellow Deputies,

As we enter the new century, we will continue to adhere to the principle of "one country, two systems" and the basic laws of Hong Kong and Macao special administrative regions. Economic cooperation and exchanges of the mainland with Hong Kong and Macao should be strengthened. We will render full support to the chief executives and governments of Hong Kong and Macao in their efforts to govern the regions in accordance with the law, and defend the long-term prosperity and stability of Hong Kong and Macao.

An early settlement of the Taiwan issue and the accomplishment of national reunification are the shared aspirations of the entire Chinese nation and an enormous task we are now facing. We will continue to follow the basic principles of "peaceful reunification" and "one country, two systems" and the eight-point proposal put forward by President Jiang Zemin. We will, together with the vast majority of our compatriots in Taiwan, resolutely put a stop to any separatist attempt and do our utmost to achieve peaceful reunification. We will adhere to the one China principle, continue to push for cross-Straits dialogue and negotiations on that basis, and promote economic, cultural and personnel exchanges between the two sides. We are confident that with the unremitting efforts of all Chinese people, the great cause of national reunification will surely be accomplished at an early date.

In the face of an international situation characterized by growing political multipolarization and economic globalization, we will, as always, pursue an independent foreign policy of peace, develop friendly relations and cooperation with all countries on the basis of the Five Principles of Peaceful Coexistence, and strive for a long-term peaceful international environment and good relations with our neighbors. China will take an active part in international affairs and make fresh contributions to the maintenance of world peace, the promotion of international cooperation, the achievement of common development, and the establishment of a peaceful, stable, just and reasonable new international political and economic order.

Fellow Deputies,

The year 2001 is the first year into the new century and the first year for the implementation of the Tenth Five-Year Plan. To ensure a good beginning for this endeavor, it is crucial to act in the spirit of the Fifth Plenary Session of the Party's Fifteenth Central Committee and its conference on economic work, and do all aspects of this year's work well. We need to adhere to the policy of expanding domestic demand and continue to follow a proactive fiscal policy and a prudent monetary policy. We will issue 150 billion yuan of long-term treasury bonds, and invest the ensuing revenue in projects under construction and development projects in the western region. We will raise staff salaries of government organizations and institutions at an appropriate rate. We will also increase the earnings of urban residents with low incomes. We need to put strengthening agriculture as the foundation of the economy and increasing farmers' incomes on the top of our economic agenda, and take effective measures to solve outstanding agricultural and other problems presently facing rural areas. We need to consolidate and build on our achievements in the reform of state-owned enterprises, and pay special attention to establishing a modern corporate structure, transforming operational mechanisms and intensifying scientific management. We need to quicken preparation for accession into the World Trade Organization. We need to improve the social security system, create more jobs by various means, and raise people's living standards. An important and pressing task is to make great efforts in reorganizing and standardizing the order of the market economy. We need to promote spiritual civilization and improve democracy and the legal system. We need to continue to handle the relationship between reform, development and stability properly, improve all facets of public security and maintain social stability. We fully support Beijing's bid to host the Olympic Games. We need to make overall plans by taking all factors into consideration and avail ourselves of the favorable circumstances in order to sustain our forward momentum in economic and social development.

Fellow Deputies,

We have already entered the 21st century and started to march toward the strategic objectives of the third stage in the modernization drive. No difficulties or hardships can deter we Chinese people in our pursuit of success. Let us rally closely around the Party Central Committee with Comrade Jiang Zemin at its core, hold high the great banner of Deng Xiaoping Theory, adhere to the Party's basic line, and follow the guidance of the important principle of the "Three Represents". Let us bestir ourselves and work diligently toward the objectives set forth in the Tenth Five-Year Plan for the establishment of a strong, prosperous, democratic, and culturally advanced modern socialist country!

EXHIBIT 4

Government Ownership and Control of China's "Private" Steel Producers

Wiley Rein LLP

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OCTOBER 2007

Government Ownership and Control of China's "Private" Steel Producers

By Alan H. Price, Timothy C. Brightbill, Christopher B. Weld and D. Scott Nance

October 2007

The Chinese government continues to exert substantial ownership and control over the Chinese steel industry, including the purportedly private steel producers. As demonstrated in *Money for Metal: A Detailed Examination of Chinese Government Subsidies to Its Steel Industry*, 19 of the top 20 Chinese steel groups are majority owned or controlled by the government, with 91 percent of the production of the top 20 steel groups state-owned or controlled.[1]

In response to *Money for Metal*, however, some have argued that the Chinese steel industry is becoming increasingly private and that the government's influence on the industry has been overstated. For example, the Chairman of China's Chamber of Commerce of Metals, Minerals and Chemicals Importers & Exporters recently stated that claims of substantial government direction and control over the steel industry is a "very, very big misunderstanding" and that China's "steel industry has developed over the last several decades along the path of [a] market economy."[2] He stressed that "China has been making great efforts in developing the non-state-owned sector" and that "almost 40% of total production [in China's steel industry] is contributed by the private sector."[3] Indeed, numerous steel producers in China claim to be privately owned. A recent industry report claims that production from the top ten "privately-owned" mills reached 50 million metric tons in 2006.[4]

However, a closer examination of the so-called top ten private steel producers in China reveals that many of these producers are substantially owned and controlled by the Chinese government and/or are subject to substantial government intervention. The attached ownership chart demonstrates that the state maintains a significant ownership share in at least seven of the top ten private firms. These so-called private producers with government ownership stakes include the Shagang Group; Fushun Xinfugang Co., Ltd., a subsidiary of Jianlong Iron and Steel; Nanjing

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1 *See Money for Metal: A Detailed Examination of Chinese Government Subsidies to Its Steel Industry*, at 8-11, available at http://www.wileyrein.com/docs/publications/13202.pdf.

2 *Marketization Process of China's Steel Industry and Trade*, Chan Horan, Chairman of China's Chamber of Commerce of Metals, Minerals and Chemicals Importers & Exporters, September 18, 2007, AMM China Summit Conference, Arlington, Virginia.

3 *Id.*

4 *China's Top Ten Private Mills*, Steel Business Briefing Analytics, China, September 11, 2007, at 3.

Iron & Steel Company United Co., Ltd.; Rizhao Iron & Steel Group Co. Ltd.; Jiangsu Yonggang Group Co., Ltd.; and Sichuan Chuanwei Group Co., Ltd. Other private producers appear to be substantially influenced by government policies, subsidies, and other forms of manipulation.

For example, the Chinese government owns 40 percent of **Nanjing Iron & Steel United Co., Ltd.** ("NISCO United"). According to the Chinese Iron and Steel Association, NISCO United was founded in August 2003 as a joint venture on the basis of investments by Nanjing Iron & Steel Group Co., Ltd. (40 percent), Shanghai Fosun High-tech Co., Ltd. (30 percent), Shanghai Fosun Industrial & Investment Co., Ltd. (20 percent), and Shanghai Guangxing Sci-tech Development Co., Ltd. (10 percent).[5] The Fosun Group is a large privately-owned conglomerate, giving the illusion that NISCO United has been privatized. However, Nanjing Iron and Steel Group Co. Ltd. is a 100 percent state-owned enterprise ("SOE") owned by the Jiangsu Province State Asset Supervision and Administration Commission ("SASAC").[6] At the time of the merger, all the steel making assets and subsidiaries of Nanjing Iron and Steel Group were merged into the new subsidiary, NISCO United.

As a result, while the state-owned Nanjing Iron and Steel Group Co. Ltd. has no steel making assets of its own, it retains a 40 percent share of NISCO United. Thus, even though the majority share of NISCO United is owned by a private company, the Chinese government has a substantial ownership share and is able to exercise considerable management and control. This is but one example of how substantial government ownership and control has been obscured by the creation of intermediate owners.

Significant Chinese government ownership is also present in **Jiangsu Shagang Group**, which is billed as the largest private steel enterprise in China and the country's fourth largest steel producer.[7] The firm was formed in 1975 as a village enterprise,[8] and changed its name to Jiangsu Shagang Group in 1995. The firm's ownership status changed in 2001, during a period of asset stripping management buyouts in the Chinese steel industry. Approximately 17 percent of the firm was purchased by the plant general manager and 25 percent of the firm was sold to the Jiangsu SASAC. An additional 23 percent went to the company's labor union, which is controlled by the Chinese Communist Party,[9] and almost 35 percent went to the "employees of

5 *See* http://www.steelhome.cn/english/introduction.html.

6 All provincial SASAC's report to the central government SASAC.

7 *See SBB Analytics China* (September 11, 2007) at 7; "Shagang in talks to buy rival producer," *China Daily* (September 20, 2007) at http://www.china.org.cn/english/business/225157.htm.

8 Liu Weiling and Diao Ying, "Man of Steel," *China Daily* (August 13, 2007).

9 *See Money for Metal* at 8-9 ("Labor Unions in China Labor unions in China are not independent, but rather controlled by the Chinese Communist Party ("CCP") and are therefore treated as government-controlled entities for purposes of this chart. According to the U.S. State Dep't: "[I]n practice workers were not free to organize or join unions of their own choosing. The All-China Federation of Trade Unions (ACFTU), which was controlled by the CCP and chaired by a member of the Politburo, was the sole legal workers' organization. The trade union law gives the ACFTU control over all union organizations and activities, including enterprise-level unions, and requires the ACFTU to 'uphold the leadership of the Communist Party.' Independent unions are illegal. In some cases the ACFTU and its constituent unions influenced and implemented government policies on behalf of workers; however,

Shagang." That same year, the firm doubled its capacity by acquiring a German mill and reassembling it in China. In 2006, it acquired Huaigang, a specialty steel producer whose ownership has at various times included the municipal government of Huai'an, the provincial government of Jiangsu, and the Nanjing Iron & Steel Group, which is owned by the Jiangsu Province SASAC.[10] In short, even China's largest privately owned producer is substantially state-owned, and appears to have received capital inflows from the state in the same year it doubled its capacity.

Jiangsu Yonggang was China's 48th largest steel producer in 2005 and is considered the ninth largest private steel mill in China.[11] Its website indicates that its main steel producing entity is Jiangsu Lianfeng Industrial Stock Co., a joint stock company.[12] However, it appears that a significant portion of the company's ownership remains in the hands of state-controlled entities. Jiangsu Yonggang was formed in 1984 by the local village enterprise and the Nanfeng County Supply and Marketing Corporation, which is owned by the Jiangsu Province SASAC.[13] It later jointly invested in a new rolling line with the China Shipbreaker Co., another firm wholly owned by the provincial SASAC. As a result, despite its disparate first line of ownership, ultimate ownership of the group continued to rest with the Jiangsu SASAC and the village, as shown in the attached chart. As part of a restructuring in 1998, Jiangsu Yonggang established Jiangsu Lianfeng Industrial Stock Co., with a portion of its shares ultimately transferring to management.[14] However, even after this restructuring, state-owned entities continue to have a majority ownership in Jiangsu Yonggang Group and the Group, in turn, continues to maintain majority ownership in Jiangsu Lianfeng Industrial Stock Co.

The Chinese government exerts considerable control and direction even over those companies that appear to be truly controlled by private investors. From 2001-2003, the state-owned **Hebei Jinxi Iron & Steel Corporation** underwent a restructuring that included a management buyout and an investment by the Pioneer Iron & Steel Group of Hong Kong.[15] In December 2003, Hebei Jinxi announced its intentions to sell shares in Hong Kong.[16] Despite the IPO, Hebei Jinxi is almost entirely owned by the China Oriental Group, a firm owned primarily by Wellbeing

the CCP used the ACFTU to communicate with and control workers." U.S. State Dep't, *Country Report on Human Rights Practices 2006, China* Section 6(a) (2007), *available at* http://www.state.gov/g/drl/rls/hrrpt/2006/78771.htm.")

10 *See* http://www.huaigang.com/about1.asp.

11 *See SBB Analytics China* (September 11, 2007) at 3,8.

12 *See* http://www.yong-gang.com/english/fazanlicheng.htm; and http://www.yong-gang.com/english/zhidu.htm.

13 *See* http://www.yong-gang.com/english/fazanlicheng.htm.

14 *See* http://www.yong-gang.com/english/fazanlicheng.htm; and http://www.yong-gang.com/english/zhidu.htm.

15 *See* http://www.chinaorientalgroup.com/english/gsjj.asp.

16 *See* "Jinxi Iron & Steel Plans Hong Kong IPO; Hires Bankers (Update5)," *Bloomberg.com* (December 16, 2003) at http://quote.bloomberg.com/apps/news?pid=10000080&sid=a3Q9DY1txZUY&refer=asia#.

Holdings Limited (42.82 percent) and the Pioneer Iron & Steel Group (28.11 percent).[17] Wellbeing Limited and another minor shareholder are controlled by Mr. Han Jingyuan, the chairman of Hebei Jinxi prior to its restructuring. Ms. Chen Ningning, the 36-year old owner of the Pioneer Iron & Steel Group, is the grandchild of Mr. Lu Dong, who was China's metallurgy minister in the 1960s and 1970s.[18] Mr. Han and Ms. Chen are currently chairman and vice chairman of China Oriental Group, respectively.[19]

Though the government holds no ownership interest in the firm, it is clear from a recent proxy battle between Mr. Han and Ms. Chen that even private steel producers are significantly influenced by government policy mandates. According to company management, China Oriental has "focused, in line with PRC government policies, on improving its competitive edge by enhancing its product mix and production efficiency."[20] Management further noted that "China Oriental will continue to maintain its strategic position and diversify its product mix in line with PRC government policies."[21] And, assuming that these private steel companies toe the party line, the rewards are substantial. Proxy documents indicate that the privately-owned steel mill continues to benefit from government largesse, including an RMB 145 million loan from the local government at an interest rate equal to China's official deposit rate,[22] subsidy income,[23] a reduced effective tax rate due to the firm's status as a foreign invested firm,[24] and the provision of industrial facilities for less than market value.[25]

The Chinese government also exerts direction and control over private steel companies through its ties to company management. Numerous owners, directors and managers of privately-owned steel companies are Community Party officials. For example, Mr. Zhang Zhixiang, who owns the majority of Jianlong Iron & Steel Group, is a delegate to China's National People's Congress ("NPC").[26] Wang Shoudong, the chairman of Shandong Taishan Steel, another private steel

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17 *See* "China Oriental Group Company Limited Response document in relation to the unsolicited voluntary conditional offers by Macquarie (Hong Kong) Limited on behalf of Smart Triumph Corporation," (August 17, 2007) (hereafter, "CNOG proxy response") at 157. The Jinxi company union owns 16 percent of Wellbeing. See CNOG proxy response at 29.

18 Robin Kwong, "Princeling Chen on track," *The Australian* (August 21, 2007).

19 It is unclear how these individuals acquired the capital to obtain their ownership shares. Nor is it clear whether state entities were involved in financing the acquisition of these shares.

20 *See* CNOG proxy response at 17.

21 *Id.* at 37.

22 *Id.* at 121. The deposit rate in Chin is several percentage points lower than the official borrowing rate.

23 *Id.* at 123.

24 *Id.* at 127 to 128. China's tax rate is 30 percent, while the local tax rate is three percent. The group's effective tax rate in 2006, due to the various tax preferences, was 17.1 percent (210,886 / 1,233,236 = 17.1 percent).

25 *Id.* at 152. For example, China Oriental leases a 62,016 square meter industrial complex in Tangshan, Heibei Province, for RMB 46,510 **per year** ($5,867 at the 2006 RMB-dollar exchange rate). The contract went into effect in 2003.

26 *See* http://www.hurun.net/detailen3.people38.aspx.

company, is described by the *China Daily* as an NPC deputy.[27] Guo Guangchang, an owner of Jianlong Iron & Steel Corp., Ltd., was a member of the 9th Chinese People's Political Consultative Conference ("CPPCC") National Committee and the 10th NPC.[28]

Finally, the fact that a steel company raises funds in Hong Kong or is based in Hong Kong does not necessarily support a finding of private ownership. Indeed, while certain private steel companies, such as China Oriental Group, raise funds in Hong Kong either through share offerings or through purchases by Hong Kong entities, it is well known that Chinese government capital has been frequently diverted through Hong Kong in order to access the preferential tax rates available to foreign-invested firms. Additionally, China Travel Service (Holdings), Ltd., a Hong Kong-based company, is the majority owner of **Tangshan Guofeng Iron & Steel Co., Ltd.** (considered the third largest private steel company in China). China Travel Service, however, is 100 percent owned by the central government SASAC.[29] Thus, the ultimate ownership and control of offshore (principally Hong Kong) private investment funds with stakes in Chinese steel firms may lie with the Chinese government.

In summary, the Chinese government exerts considerable ownership and control over the steel industry, including China's so-called private producers. The government owns substantial ownership shares in many of the private producers, exercising very visible control over these companies. In other instances, the government's role is less visible, though it nonetheless maintains considerable control and direction through ties to company management, subsidies, and other forms of manipulation and coercion.

* * *

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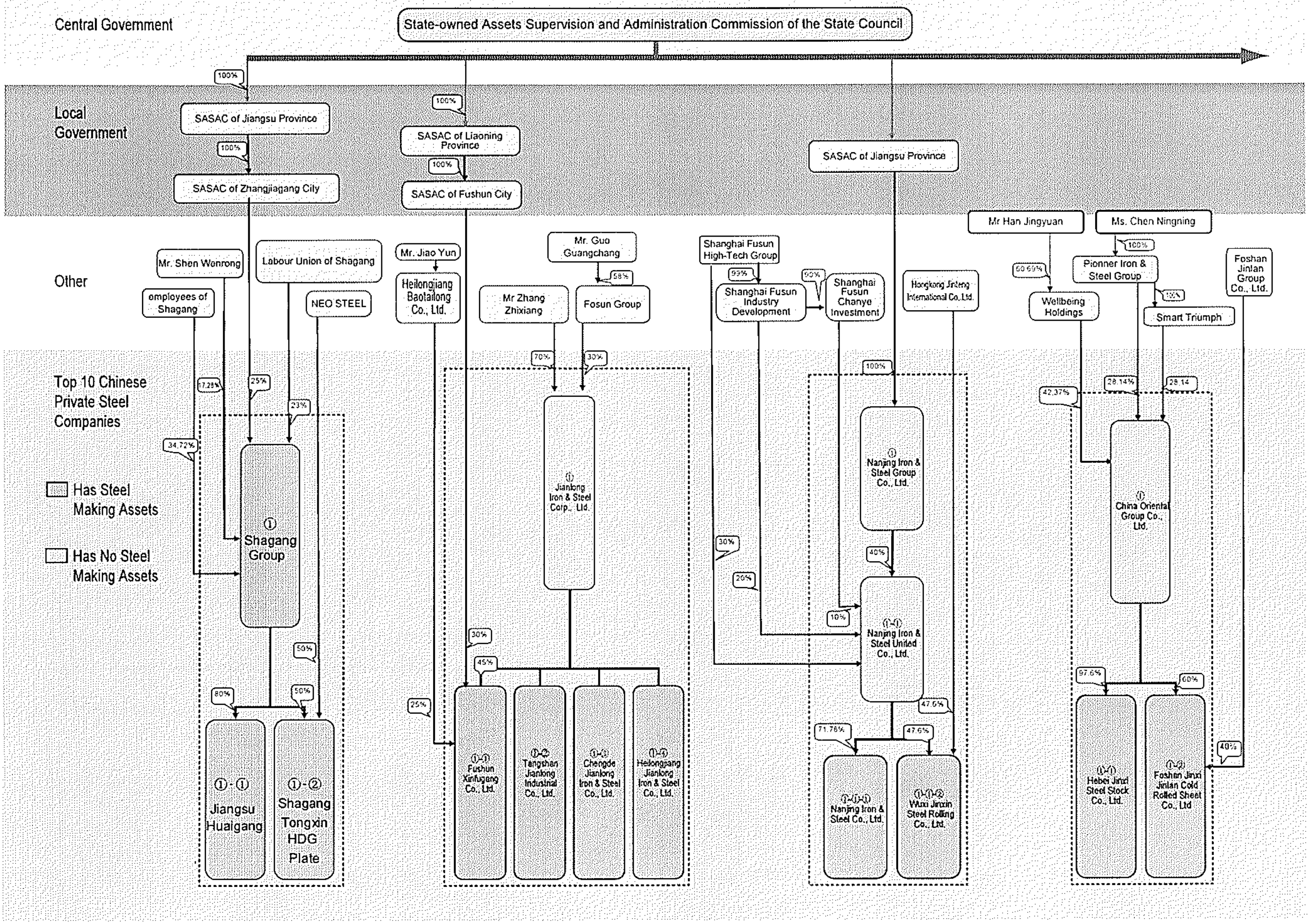
27 *See* http://www.chinadaily.com.cn/bw/2007-03/26/content_835905.htm.

28 *See* http://www.chinavitae.com/biography/Guo_Guangchang/full.

29 *See Money for Metal,* Appendix 2.

Ownership of China's Top Ten "Private" Steel Producers



Ownership of China's Top Ten "Private" Steel Producers (cont'd)

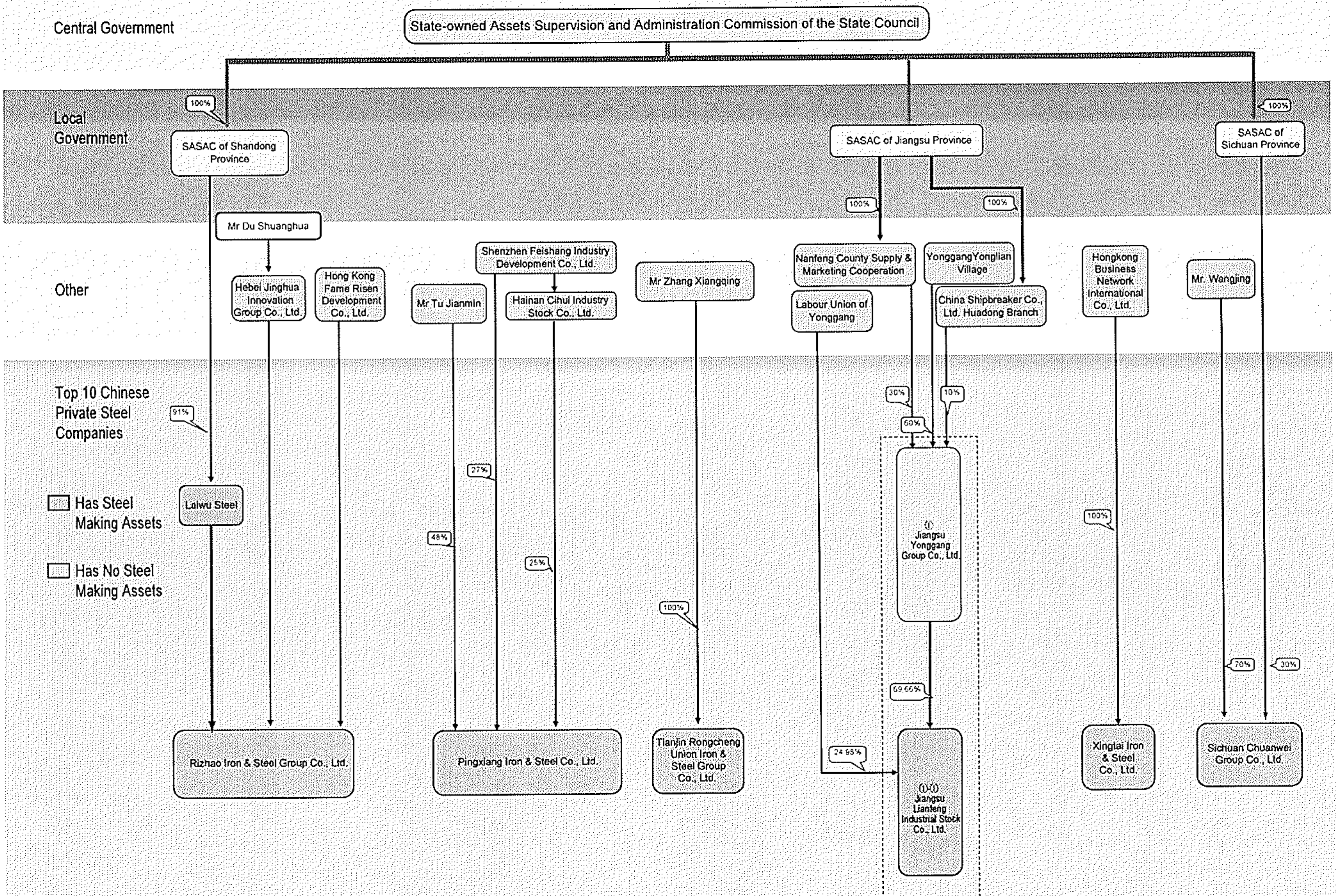


EXHIBIT 5

HOW CHINESE GOVERNMENT SUBSIDIES AND MARKET INTERVENTION HAVE RESULTED IN THE OFFSHORING OF U.S. AUTO PARTS PRODUCTION: A CASE STUDY[1]

Andrew Szamosszegi

EXECUTIVE SUMMARY

- The Chinese government is actively using numerous subsidies and direct market intervention to fuel the growth of its automotive and auto parts industries. In addition to these subsidies and other direct incentives conferred by the central and provincial government policies, the Chinese government has conditioned the entry of U.S. companies into its market, and the granting of production licenses, on technology transfers to the Chinese industry, the establishment of research facilities in China, and the replacement of imported parts with domestic parts.
- U.S. automotive companies have been drawn to China in order to access the growing Chinese market (by being the "first" in the officially promoted automotive industry), and in order to capitalize on these subsidies and financial incentives provided by national and local governments. This has led U.S. auto makers and auto parts companies to invest heavily in China, to transfer their technology and intellectual property, and to promise to source auto parts from China.
- The Chinese government is transforming its once-backward automotive industry into a global auto and parts export powerhouse, and maintains a comprehensive automotive industrial policy spelling out how this will occur. These auto industry promotion policies have been tremendously successful for China. China's exports of auto parts and vehicles are expanding approximately 30 percent per year. In the first quarter of 2007, China passed Germany to become the second largest parts supplier to the United States.
- China requires U.S. automakers with operations in China to buy their parts in China as a condition of granting production licenses. U.S. automakers have complied, despite the fact that China's requirement is

[1] The author wishes to thank the American Iron and Steel Institute and the Steel Manufacturers Association for their financial support of this paper. The views expressed herein solely reflect those of the author.

WTO-illegal. In response to these Chinese requirements and subsidy programs, major auto producers such as GM, Ford, and Chrysler have promised to increase even further their already substantial purchases from parts makers in China.

- Having now obtained U.S. technology and assistance, recent Chinese government policies are now aimed at building auto and auto part exports. In particular, the government is heavily promoting and subsidizing domestic firms and brands, encouraging the creation of homegrown technologies, and creating auto export manufacturing bases. China has begun producing the Chery for shipment to the United States, and has entered a joint venture to produce SUVs in Tijuana, Mexico, and then ship them duty-free to the United States.
- For example, the Chinese government announced in August 2006 that it was establishing eight export manufacturing bases to facilitate the overseas expansion of China's auto industry. China has also announced plans to offer low-interest loans to its domestic automakers to lift their share of the market and promote local brands.
- Based upon this analysis, Chinese government incentives have played a primary role in the growth of automotive production and the relocation of auto parts production to China.
- In addition, Chinese government subsidies designed to relocate automotive production to China have had multiple adverse effects on various U.S. industries. These subsidies have injured U.S. workers and parts suppliers and have forced a massive relocation overseas. U.S. industries that supply the automakers, such as the steel industry, have also been injured by these subsidies through the loss of demand for input products.

"The auto industry represents a country's overall economic strength. The government should provide vigorous support."

Zhang Ji, Deputy Director of the Department of Import and Export of Machinery and Electronic Products, Ministry of Commerce

I. BACKGROUND

The Chinese government is actively using numerous illegal subsidy programs and other forms of direct market intervention to accelerate the growth of its automotive and auto parts industries. In addition to subsidies and other direct incentives conferred by the central and provincial government policies, the Chinese government has limited the entry of U.S. companies into its market, and the granting of auto production licenses in China. Before U.S. companies can gain market access, China requires them to make technology transfers to the Chinese industry, to establish research and development facilities in China, and to use auto parts made in China in their vehicle assembly operations.

U.S. companies have responded by making massive commitments to manufacturing in China in the last five to ten years. Delphi has invested half a billion dollars in China during the past decade and now imports more than $100 million annually from China. GM has a joint venture in China and has transferred important technology aimed at upgrading Chinese vehicle and parts production. Ford and Chrysler have made commitments to Beijing to purchase increasing amounts of parts from China in the coming years.

In less than twenty years, China has gone from a country with an extremely small and undeveloped automotive (including auto parts) sector to the third largest automobile producer in the world. Today, China is the second largest supplier of automotive parts to the United States, with $1.936 billion in sales in the first quarter of 2007. This amount is up 27.4 percent from a year ago. By 2007, China is expected to produce as many as 10 million automobiles,[2] which would place it second to the United States in total production.

The Chinese auto sector's rate of development far surpasses a normal, free market growth rate. How is this so? The answer lies in the actions of the

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2 King and Wood, *China: Auto industry policy,* International Financial Law Review (Feb. 2007), *available at* http://www.iflr.com/?Page=10&PUBID=33&ISS=23342&SID=673168&TYPE=20 (last accessed on July 17, 2007).

Chinese government to "grow" its automotive and auto parts manufacturing production capacity.[3] Generous government subsidies have "force fed" the nascent automotive sector in China, resulting in spectacular growth rates. China's industrial policy in the automotive sector has nothing to do with free trade, comparative advantage, or playing by the rules. It is a China's national ambition to be a leading exporter of auto and auto parts, and to transfer production of cars and parts from the United States to China.[4]

Chinese auto parts producers are not the only subsidy recipients in the industry. U.S., European, and Japanese auto parts manufacturers have been lured abroad by the Chinese government's limitless largesse. For years, the Chinese government has favored foreign firms over indigenous manufacturers in order acquire the investment and capital necessary to jump start the domestic auto industry.[5] The domestic auto parts industry in China was highly fragmented, technologically underdeveloped, and undercapitalized. Left on its own, it would not have been capable of developing world-class parts for world-class cars for many years. To overcome these obstacles, the Chinese authorities offered massive subsidies to major U.S., European, and Japanese automotive and auto parts companies to locate manufacturing in China. Indeed, the government has used the "carrot" of automobile manufacturing expansion rights to attract foreign technology transfer and investment in Chinese auto part manufacturing.

Faced with the inherent limitations of its auto parts industry, the Chinese government has embarked on a comprehensive and multi-faceted program of development. The goal of this growth is not merely to service the domestic market: the Chinese government has identified auto part *exports* as one of its priorities.

China's efforts to expand auto parts exports already are paying dividends. As is evident in Exhibit 1, exports of auto parts to the United States have

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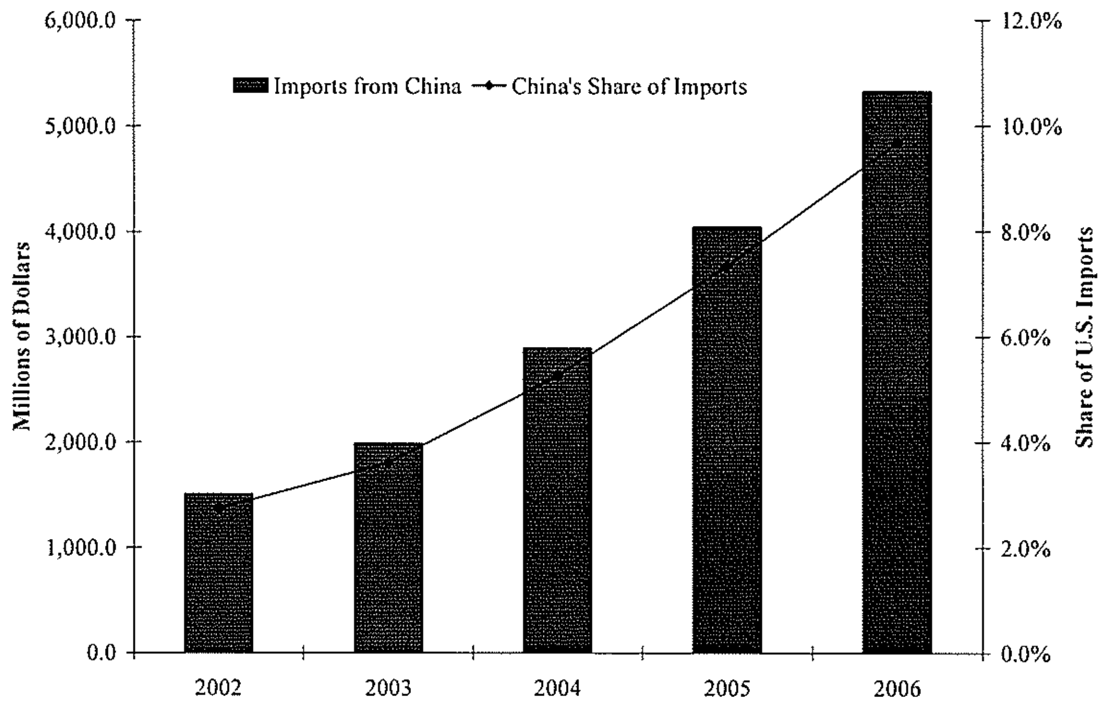
3 The central government has not been the only source of encouragement and largesse. Local governments in China have also played an major role in the development of the Chinese automotive industry. *See* Eric Thun, *Changing Lanes in China—Foreign Direct Investment, Local Governments, and Auto Sector Development* (Cambridge University Press, 2006) (hereafter, "Thun").

4 Cathy Chen, *The genes of China's auto industry are changing*, China Automotive Review (Jan. 2006) (hereafter "Chen 2006"). In the same interview, Deputy Director Zhang stated, "{Automobiles} add to the dignity of a nation...When Chinese-made cars drive on freeways in developed countries, the status of China as a great nation will be further elevated. We must therefore make quality automobiles."

5 *See* Witman Liao, *New unified corporate income tax system to become effective in 2008*, China Automotive Review (May 2007).

exploded in the past four years. The value of parts imports from China, as well as the China's share of imports, more than tripled between 2002 and 2006. According to press reports, China passed Germany in the first quarter of 2007 to become the second largest national supplier of automotive parts to the United States.[6]

Exhibit I: U.S. Imports of Auto Parts and Vehicle Bodies from China (Value and Share)



Data cover NAICS codes 33621, 33631-33639.
Source: USITC Trade Dataweb at http://dataweb.usitc.org.

In 2005, for the first time, China achieved a net surplus in auto parts trade.[7] As shown in Exhibit 2, China's automotive exports to the world expanded at a

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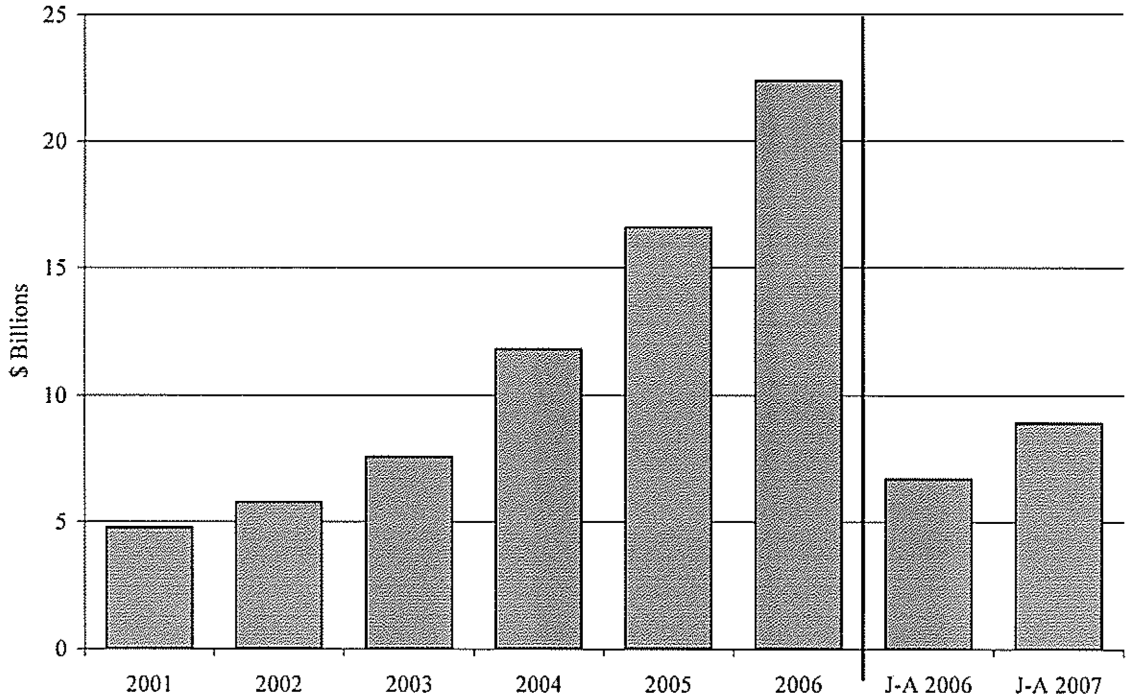
6 *China becomes 2nd largest exporter of auto parts to US*, China Daily (June 10, 2007), *available at* http://eg2.mofcom.gov.cn/aarticle/chinanews/200706/20070604766978.html (last accessed on July 18, 2007).

7 Andrew Batson, *China's Rise as Auto-Parts Power Reflects New Manufacturing Edge*, Wall Street Journal Online (Aug. 1, 2006), *available at* http://online.wsj.com/article/SB115439653395623010.html?mod=hps_us_pageone (last accessed on July 18, 2007).

compound annual growth rate of 36 percent from 2001 to 2006 and are on pace to reach nearly $30 billion in 2007.

Exhibit 2: Chinese Exports of Automotive Vehicles and Parts (HS 87)



Source: China General Administration of Customs/SAFE.

II. CHINA RELIES ON PROHIBITED SUBSIDIES TO ACCELERATE ITS INDUSTRIAL DEVELOPMENT

To achieve its industrial goals, the Chinese government has offered large subsidies to encourage foreign manufacturers to locate in China and to encourage domestic production of products that would otherwise be imported. According to WTO and U.S. countervailing duty rules, an illegal subsidy exists if a government provides a financial benefit to a recipient, and if that benefit is specific or contingent on export performance. These subsidies can come in a variety of forms. A subsidy exists if a government provides direct financial support through grants, low interest loans, loan guarantees, or other mechanisms. A subsidy can also exist if government favors a domestic industry through tax breaks or by providing goods and services at below-market prices. A subsidy also exists if the government delegates to other organizations the task of subsidizing a favored industry. This type of subsidy is referred to as entrustment or direction.

The massive levels of Chinese subsidies pose a substantial threat of harm to U.S. industries. For years prior to its entry into the WTO, the Chinese government brazenly subsidized its favored industries, rewarding them for export performance. These programs were a blatant violation of the rules that apply to all 150 member countries of the WTO. Although China committed to eliminating many of its programs by year-end 2001, many of the programs in fact remain in existence.

China ended some of these WTO-illegal programs reluctantly, and only after the United States and other trading partners complained to the WTO. In January 2007, the United States filed a case before the WTO challenging some of China's subsidy programs.[8] The U.S. case covers the following types of subsidies routinely carried out by China to increase exports and/or reduce imports from the United States and other countries:

- Income tax reductions and refunds available to companies that satisfy certain export performance requirements;
- Value-added tax (VAT) exemptions available to companies that satisfy certain export performance requirements;
- Tariff exemptions available to companies that satisfy certain export performance requirements;
- Discounted lending rates available to companies that satisfy certain export performance requirements;
- Exemptions from mandatory worker benefit contributions available to companies that satisfy certain export performance requirements;
- Income tax refunds available to companies that purchase Chinese-made equipment and accessories rather than imports;
- VAT refunds available to companies that purchase Chinese-made equipment and accessories rather than imports;[9]

According to the Office of the U.S. Trade Representative, these subsidies unfairly benefit numerous Chinese industries. Indeed, in a 2007 review of

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8 *See* Dispute Panel, *China-Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and Other Payments*, WT/DS358 (Feb. 2007).

9 *Id.*

Chinese subsidies, the U.S. Department of Commerce found that the Chinese government continued to use a variety of subsidy programs, including: grants, policy-directed discounted loans and other credit benefits from state-owned banks, income-tax benefits to foreign invested firms,[10] value-added tax (VAT) and duty exemptions, and domestic VAT refunds for firms in special economic zones.[11] [12]

The WTO subsidies case has now preceded through two rounds of consultations and, in a sign that other countries recognize the trade-distorting effects of these subsidies, the consultations between China and the United States have been joined by Australia, Canada, the European Communities, Japan, and Mexico.[13] On July 12, 2007, the United States formally requested a dispute settlement panel on twelve Chinese subsidy programs.

In sum, the automobile and parts industries in China receive substantial monetary and operational benefits from numerous, interrelated Chinese government policies that aim to increase Chinese production, increase Chinese exports, and reduce import shares in China's domestic market. To achieve its industrial goals for the auto and parts industries, the Chinese government has offered major subsidies to foreign auto parts manufacturers to locate in China, and extended benefits to a favored few indigenous producers that it has selected for world class development.

III. U.S. AUTOMAKERS HAVE TRANSFERRED TECHNOLOGY AND PARTS PRODUCTION TO CHINA IN EXCHANGE FOR PRODUCTION LICENSES

The level of technological development and production capacity that exists in China today did not develop internally. Though China has produced

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10 Foreign-invested firms are firms operating in China that have a significant share of direct investment. Direct investment, as opposed to portfolio investment, indicates foreign share large enough to bestow some level of managerial control upon the foreign partner in the venture.

11 *See Coated Free Sheet Paper From the People's Republic of China*, 72 Fed. Reg. 17,484 (U.S. Dep't Commerce, Apr. 9, 2007) (amended prelim. aff. det.).

12 In an explicit admission that its VAT rebate scheme inflates exports from China, China's Ministry of Finance recently announced the elimination of VAT rebates on exports of 2,831 products in order "to suppress overheated export growth and ease trade frictions between China and its trade partners." *See China to adjust export rebate policy on 2,831 commodities*, Xinhua News Agency (June 20, 2007), *available at* http://english.people.com.cn/200706/20/eng20070620_385830.html (last accessed July 18, 2007).

13 *See* Dispute Panel, *China-Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and Other Payments*, WT/DS358 (Feb. 2007).

cars for decades, the industry was woefully underdeveloped and technologically backward through the early to mid-1990s. For example, Volkswagen blueprints created in Germany had to be simplified before being sent to Chinese supplier firms.[14] GM also found initially that its suppliers were unable to handle complex designs.[15] That is obviously no longer the case today, as PIERS trade data indicates GM imported $145.3 million of Chinese produced parts between April 2006 and March 2007.

To quickly develop its automotive sector, the Chinese government relied on major foreign auto producers, including U.S. producers. Beijing's strategy was to trade market access in China for technology, and the automakers readily obliged. According to one account,

> {T}he central government would announce that it was going to approve one final assembly JV, and foreign firms, desperate not to be locked out of one of the last great auto markets, would claw over one another to get the contract. When a second auto JV was created in Shanghai, for example, two years were spent negotiating with four prospective partners—General Motors, Toyota, Nissan, and Ford and then, once GM was chosen from these four, another year and a half was taken to negotiate the JV agreement. GM wanted to build cars in China, it was willing to pay in order to do so, and it did.[16]

Once in China, GM and other U.S. automakers provided technology and know-how to upgrade the Chinese parts and vehicle industries. Soon after, these companies began using Chinese-produced parts instead of U.S. parts in their China-produced vehicles. After that, they began using Chinese parts in their U.S. vehicle assembly operations.

This cycle of offshoring parts production to China has been accelerated by official Chinese pressure to localize procurement and transfer technology more rapidly. China's auto parts industry is now advanced enough to achieve a trade surplus in automotive trade, and private Chinese firms are now exporting completed vehicles. Though U.S. automaker deals with Beijing got them into the

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14 Eric Thun, *Industrial policy, Chinese-style: FDI, regulation, and dreams of national champions in the auto sector*, Journal of East Asian Studies (Sept.-Dec. 2004) at n. 85.

15 *Id.* at n. 82. Thun notes that GM negotiated with both the local government and the central government, and negotiated in fear that China would turn to Ford if the joint venture agreement could not be hammered out satisfactorily.

16 *Id.*

Chinese market, China's Eleventh Five Year Plan makes clear that the cycle will not be complete until Chinese companies control both parts production and vehicle manufacturing in China.

IV. CHINA'S FIVE-YEAR PLANS HAVE DIRECTED THE GROWTH OF CHINA'S PARTS AND VEHICLES INDUSTRIES

The development of an export-oriented automotive industry in China, including parts and finished vehicles, is a national goal that is promoted at various levels of government in a variety of ways. In the minds of Chinese government planners, the development of the automotive industry into an export powerhouse is a matter of national dignity. As noted by Deputy Director Zhang, "Automobiles are in a way different from other merchandises. Automobile export adds to the dignity of a nation."[17] This goal has been pursued through three tools of industrial policy: imports substitution, technology appropriation, and subsidization, with U.S. vehicle and parts producers playing a central role in bringing China's national goals to fruition.

The Chinese automotive industry was established in the 1950s with the help of Russian aid.[18] The industry has always been viewed as a strategic industry worthy of promotion under a series of five-year plans, but development did not begin in earnest until the late 1980s, well after Chairman Deng Xiaoping shifted the course of China's economy from purely planned to socialism with Chinese characteristics, a formulation that allowed for a combination of capitalist and planned economic development.

In 1987, the government began to encouraging joint ventures with foreign auto producers and adopted a trade policy aimed at nurturing domestic parts production. This new policy included compulsory licensing of imports and new production facilities.[19] In the 1991 five-year plan, Beijing referred to the automotive industry as a "pillar industry" that would power China into the

17 Cathy Chen, *The genes of China's auto industry are changing*, China Automotive Review (Jan. 2006).

18 Richard F. Doner, Gregory W. Noble, and John Ravenhill, *Industrial Competitiveness of the Auto Parts Industries in Four Large Asian Countries: The Role of Government Policy in a Challenging International Environment*, World Bank Policy Research Working Paper 4106 (Dec. 2006) at 37 ("World Bank Study").

19 *Id.*

twenty-first century.[20,21] The government's Automotive Industry Policy (AIP) in 1994 continued to encourage foreign direct investment and protectionism to further the development of the Chinese automotive industry.[22] The policy also required investors to establish research and development (R&D) capabilities in China, manufacture high tech automotive products in China, acquire foreign exchange through exports, and favor Chinese parts and components.[23] The government mandated domestic parts production, requiring 40 percent local content at start up for passenger car production, with this local content requirement increasing to 60 percent by the second year and 80 percent by the third year.[24] The impact of these policies accelerated as China was preparing to join the WTO, as GM and Toyota agreed to transfer technology and nurture local parts suppliers in return for production licenses.[25] As discussed below, GM has been a major conduit of technology and a demand driver for the Chinese parts industry.

The auto parts industry remains a major focus of Chinese economic policy in the twenty-first century. The auto parts industry in China has been deemed a priority industry under the most two recent national Five Year Plans and continues to receive special policy guidance through special auto industry plans drafted in consultation with the domestic industry.[26] The 10th Five Year Plan for the Automotive Industry concluded in 2005, and therefore included the initial years of China's membership in the WTO. That plan called for the production levels to reach one million vehicles per year and encouraged consolidation.

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20 Irina Aervitz, *The Driving Force Behind the Automotive Sector in China and Russia: The Role of the State in Technology Appropriation*, Unpublished Dissertation, Miami University (2007) at 41 ("Aervitz Dissertation").

21 Chinese provinces also seek to develop local auto industries. According to Thun, 22 out of 30 Chinese provinces and municipalities in 1996 designated the local auto industry as a key area for economic growth. *See* Thun at 43.

22 Wayne Xing, *China to issue adjustment to Auto Industry Policy*, China Automotive Review (Nov. 2006).

23 Aervitz Dissertation at 76-77.

24 Aervitz Dissertation at 67. Aervitz notes that this import substitution policy not only led to higher levels of domestic production at the expense of imports, but also advanced the technological capabilities of the Chinese parts industry.

25 World Bank Study at 38.

26 *See, e.g.*, Cathy Chen, *The inside story on the 11th Five-Year Plan*, Chinese Automotive Review (Oct. 2006).

The 11th Five Year Plan for the Automotive Industry runs through 2010. In this plan, the Chinese government, apparently impatient with the export-readiness of the current industry, expresses its strong desire to Sinocize the domestic automotive and parts industry. The goal is to create more Chinese brands and intellectual property.

Continued special treatment for auto parts on the behalf of the Chinese government is laid out in the most recent Five Year Plan for the automotive industry, dated June 28, 2004 ("Automobile Industry Development Policy No. 8 decree of the State Development and Reform Commission of the People's Republic of China").[27,28] One of the plan's stated main objectives is to "develop a number of vehicle parts enterprises that will realize scale production and edge into the international automobile parts procurement system, and take an active part in international competition".[29] According to a summary of the plan published by China Daily, the national newspaper that serves as a voice of the ruling Communist Party, five to 10 large auto parts corporation groups will emerge, and they will be competitive internationally. Twenty percent of their total production will be exported. The top 3 will hold 70 percent market share.[30]

Article 31, Chapter 8 of the auto five year plan lays out specific incentives granted by the state to promote auto parts production: *"directing social funds to flow into automobile parts production* . . . The State gives preferential treatment to parts production enterprises which can supply parts to several independent

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27 State Development and Reform Commission of the People's Republic of China, *Automobile Industry Development Policy No. 8 decree* (June 18, 2004), *available at* http://www.tdctrade.com/report/reg/reg_040601.htm (last accessed on July 18, 2007).

28 The prior Five Year Plan for the Auto Industry, published in June 2001, also identified the development of the auto parts industry as a major goal, and identified a number of actions to be taken to achieve that goal. *See The Tenth Five Year Plan of the Automotive Industry and its Development*, China Daily (hereafter "Auto Five Year Plan"), *available at* http://bizchina.chinadaily.com.cn/guide/industry/industry2.htm (last accessed on July 18, 2007). *See also* Mark Santucci, *The Auto Parts Industry in China is Set to Take Off*, eAutoPortal.com (July 9, 2002), *available at* http://www.eautoportal.com/News/China-article-ii.asp (last accessed on July 18, 2007).

29 *The Tenth Five Year Plan of the Automotive Industry and its Development*, China Daily (hereafter "Auto Five Year Plan"), *available at* http://bizchina.chinadaily.com.cn/guide/industry/industry2.htm (last accessed on July 18, 2007).

30 *10th Five-Year Plan*, China Daily (Apr. 18, 2006), *available at* http://www.chinadaily.com.cn/bizchina/2006-04/18/content_570425.htm (last accessed on 7/18/2007).

complete vehicle production enterprises and participate in the international automobile parts procurement system."[31]

Article 51 of Chapter 8 of the five-year plan stipulates that only "approved" projects are permitted to go through the state-supervised procedures for land requisition, and to receive benefits such as loans from State-owned banks, tax exemptions with Customs, stock floating and listing with SEC, and enterprise registration. In other words, the Chinese government provides generous incentives to approved auto parts production expansion, while denying support to unapproved projects.

After joining the WTO, Chinese authorities recognized that many of their protection and promotion polices violated WTO rules, and adjusted the language of their pronouncements on the auto and parts industries. According to one researcher seeking information on the government's role in accelerating the inflow of foreign auto technology, "The interviewees also refused to discuss a number of issues especially related to the 'shadow' role of the Chinese government in the development of the sector, which may manifest itself in financial assistance for R&D purposes to the state-owned auto makers." [32] Nevertheless, sub-national authorities who take their cues from the central government on issues of industrial targeting have made substantial investments in the automotive industry. At the sub-national level, in the so-called special economic zones, the available financial incentives are discussed more openly.[33]

China has not deviated from its policy and financial support of the domestic auto and parts industry. Though official policy pronouncements are more discreet, official reports in the Chinese press and from other sources clearly indicate that joining the WTO has not changed China's government directed industrial policies.[34] According to a recent World Bank study on the auto and parts industries in four Asian countries:

> The Chinese government retains a serious industrial policy, and debates in the Chinese-language press reveal a strong and wide consensus in favor of supporting national firms and brands; the

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31 *Automobile Industry Development Policy No. 8 decree,* ch. 8, art. 31.

32 Aervitz Dissertation at 77 and 87. At n. 94, Aervitz makes clear she is referring to state financial support.

33 Aervitz Dissertation at 128.

34 *See* Chen (2006) for Deputy Director Zhang Ji's discussion of Africa, Vietnam, and India.

> only question is how fast to push the transition away from dependence on foreign companies.[35]

To underscore this point, the Chinese government announced in August 2006 that it was establishing eight export manufacturing bases to facilitate the overseas expansion of China's auto industry.[36] In June 2006, the Chinese government announced plans to offer low-interest loans to its domestic automakers to lift their share of the market and promote local brands.[37]

V. CHINA'S SUBSIDIES AND INCENTIVE PROGRAMS FOR AUTOMOTIVE AND AUTO PART PRODUCERS

The subsidies for China's auto parts industry exist in various guises and developed from various national and sub-national sources. China has coordinated these subsidies with other industrial policy tools to accelerate the creation of a parts industry that can supply the majority of parts to both foreign and homegrown automobile producers at home and abroad.

A. The Chinese Government Ties Local Auto Parts Purchasing to Auto Assembly Expansion and New Product Approvals

Until its entry into the WTO, the Chinese government had specific local content requirements that forced foreign auto manufacturers to locate parts production in China. More recently, the Chinese government has replaced explicit domestic content requirements with more subtle forms of "persuasion."

One of the most effective methods of shifting parts production from other countries to China is to make approvals of auto assembly operations contingent upon the purchase of local parts. The automobile assembly industry in China is showing signs of expanding too rapidly, with consequent over-capacity.[38] In order to better control the expansion rate, the Chinese government has taken

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35 World Bank Study at 41.

36 *China: Government plans eight auto export bases*, just-auto.com (Aug. 17, 2006), *available at* http://www.just-auto.com/article.aspx?id=88729&lk=s (last accessed on July 18, 2007).

37 Brian Schwartz, *Shanghai aims to be China's Detroit*, Asia Times Online (Oct. 12, 2006), *available at* http://www.atimes.com/atimes/China_business/HJ12Cb01.html (last accessed July 18, 2007).

38 *See Auto industry facing grave overproduction in next five years: official*, People's Daily Online, (Nov. 15, 2005), *available at* http://english.peopledaily.com.cn/200511/15/eng20051115_221220.html (last accessed July 18, 2007).

steps to limit the number of licenses granted for final automobile assembly. Accordingly, the awarding of a license to expand auto production capacity in China is extremely valuable.

To gain licensing approval, foreign automakers seeking to expand production in China also are required to file product feasibility studies with the central government that spell out localization (local parts purchase) levels. According to an official of the National Development and Reform Commission (NDRC), the central government agency that takes overall charge of the national economy, the foreign automakers are expected to fulfill localization requirements.[39] In other words, the Chinese government is accomplishing via non-tariff barriers the very goals that it previously achieved with WTO-inconsistent tariff measures. For the automakers, success in the Chinese market for finished vehicles, including the ability to introduce new models, is contingent upon their substituting parts made in the United States and other countries with parts made in China. Such brazen import substitution contradicts commitments made by China in its WTO accession negotiations, and also provides an income support – a prohibited subsidy – to parts makers in China.

As is evident from the following examples, localization pressures have had their intended effects:

- Press reports indicate that GM has committed to purchasing $10 billion annually in Chinese produced auto parts by 2009.[40] By 2005, Buicks manufactured in China by GM's joint venture already had an 80 percent local content ratio.[41]

- Ford is reported to also have made at least US$ 3 billion in commitments to buying substantial quantities of Chinese produced parts for export to Ford plants worldwide.[42] The Wanxiang Group, China's largest

39 Witman Liao, *Foreign joint venture partners urged to fulfill contract commitments*, China Automotive Review (Mar. 2007).

40 Lindsay Chappell, *China ups auto parts to U.S., but Mexico is top shipper*, Automotive News (Feb. 27, 2007), *available at* http://www.plasticsnews.com/china/english/automotive/headlines-arc2.html?id=1172276211 (last accessed July 18, 2007).

41 *GM posts record first-half China sales*, China Daily Online (June 6, 2005), *available at* http://www.chinadaily.com.cn/english/doc/2005-07/06/content_457715.htm (last accessed on July 17, 2007).

42 *Ford Motor*, Asian Automotive Newsletter, No. 84 (Dec. 2006) at 2.

indigenous auto parts supplier, has reported an agreement with Visteon, whereby it will supply the former Ford auto parts affiliate with substantial volumes of auto parts. Visteon reportedly has 21 plants in China.[43]

- DaimlerChrysler also has stated that it intends to buy more auto parts from China.[44]

- Toyota agreed to expand local parts purchases in order to secure a production license from the government.[45]

In order to continue receiving subsidies and other benefits, the major automakers routinely agree to the desires of the Chinese government. One recent example is the reaction of the automakers to a WTO case against China jointly filed by the U.S. and E.U. governments in March 2006 against a new Chinese policy that was, in effect, a localization requirement. China, which collects information on all the parts used in assembled vehicles, decided to double the tariff (to approximately 28 percent) on imported parts and components if their value in an assembled vehicle exceeded certain thresholds.[46] A Dispute Settlement panel was formed on January 29, 2007 to hear the U.S. and EU complaints, as well as complaints lodged by the government of Canada.[47] China ultimately agreed to postpone this new law for two years, but only after holding high level meetings with the CEOs of BMW and DaimlerChrysler

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43 Lindsay Chappell, *China ups auto parts to U.S., but Mexico is top shipper* (Feb. 27, 2007), *available at* http://www.plasticsnews.com/china/english/printer_en.html?id=1172276211 (last accessed on July 17, 2007).

44 U.S. Department of Commerce, *Report on Automotive Sector* (2004), available at http://www.ita.doc.gov/td/auto/international/staffreports/Chinamarket2004.pdf (last accessed on July 18, 2007); Witman Liao, *Foreign joint venture partners urged to fulfill contract commitments,* Chinese Automotive Review (Mar. 2007).

45 World Bank Study at 38.

46 *See* United States Trade Representative, *United States Files WTO Case Against China Over Treatment of U.S. Auto Parts,* (Mar. 20, 2006), *available at* http://www.ustr.gov/Document_Library/Press_Releases/2006/March/United_States_Files_WTO_Case_Against_China_Over_Treatment_of_US_Auto_Parts.html (last accessed July 18, 2007).

47 Constitution of the Panel Established at the Requests of the European Communities, the United States, and Canada, *China – Measures Affecting Imports of Automobile Parts,* WT/DS339/9, WTDS340/9, & WT/DS342/9 (07-0421) (Jan. 2007), *available at* http://www.rieti.go.jp/wto-c/070320/070320-2.pdf (last accessed July 18, 2007).

Northeast Asia. These meetings produced commitments to increase local parts purchases by $274 million and $740 million respectively.[48]

B. There is Substantial (Local) Government Ownership in the Auto Parts Industry, Which Ensures Access to Preferential Financing

Government ownership remains prevalent in the Chinese auto parts industry. Many of the large auto parts manufacturers are affiliated with the large vehicle assembly groups in China, who in turned are owned in part by local governments. Other unaffiliated auto parts companies benefit from government ownership directly. For example, the Wanxiang Group, the largest auto parts manufacturer in China, is owned in part by the municipal government of Xiashan.

Government ownership provides numerous benefits to Chinese automotive companies. Among the most important, government ownership is a virtual guarantee of access to capital, either in the form of loans, additional equity infusions, or excess retained earnings. As the U.S. Department of Commerce recently found, virtually all capital in China is allocated by government-owned or controlled banks.[49] Not surprisingly, these banks regularly favor companies in which there is government ownership. Indeed, most foreign auto parts companies enter the Chinese market by forming joint ventures with local and regional governments. This marriage provides the joint venture with Government equity capital, as well as near-guaranteed access to cheap and preferential bank loans.

As noted above, the Chinese government ensures that "social funds" flow into the auto parts sector, and aggressively seeks way to direct capital in its direction. For example, the Chinese government has allowed the Wanxiang Group to form its own investment company, thus ensuring that the company has a ready supply of cheap capital. Such investment companies are almost unheard of in China. The investment company bestows substantial advantages. In fact,

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48 *See* Witman Liao, *Foreign joint venture partners urged to fulfill contract commitments*, China Automotive Review (Mar. 2007).

49 *See Coated Free Sheet Paper From the People's Republic of China*, 72 Fed. Reg. 17,484 (U.S. Dep't Commerce, Apr. 9, 2007) (amended prelim. aff. det.).

on its website, Wanxiang boasts that companies that become part of its Group will obtain access to the type of preferential financing that it enjoys.[50]

If a financially troubled company is not state-owned or controlled, the local or regional government is likely to step in. For example, the state-owned Yoncheng Coal was ordered to bail out one of China's largest bearings manufacturers, Luoyang Bearing, when the latter found itself in serious financial trouble.[51] According to one Chinese business executive, this transaction should not be mistaken for "a real business transaction, that it is not." This is the Chinese government instructing a profitable state-run business to take over an unrelated but troubled state-run business. By this way Luoyang Bearing continues to operate."[52]

Chinese governments advance industrial policy goals for the auto parts industry through their ownership interests in major auto producers, the same companies that have formed joint ventures with U.S. and other foreign automakers. China's three largest auto manufacturers, First Automotive Works (FAW), Shanghai Auto Industry Corporation (SAIC), and Dongfeng Motor Corporation, have been favored by the central government for decades, and many other automakers are government owned.[53]

- FAW began as a state-owned enterprise in the 1950s. Today, the FAW Group is one of the largest state-owned enterprises in China and has joint ventures with Volkswagen and Toyota.[54]
- Dongfeng was formed by the central government by grafting employees and equipment from FAW.[55] Dongfeng remains an SOE and has joint ventures with Citroen and Nissan.
- Local governments also play a major role in the Chinese industry. For example, SAIC was "essentially a division of the municipal government" when it was formed, and the Shanghai government

50 "All projects are backed by the full faith and credit of the Government of the City of Xiaoshan, and qualify for special tax treatment." WanXiang American Corporation, *Investment Opportunities, available at* http://www.wanxiang.com/invest.html (last accessed on July 17, 2007).

51 *China's Luoyang Bearing Acquired by Yongcheng Coal*, eBearing News (Dec. 20, 2004), *available at* http://www.ebearing.com/news2004/122001.htm (last accessed on July 17, 2007).

52 *Id.*

53 Thun at 62, n. 56.

54 Aervitz Dissertation at 95, n. 149; Thun at 69.

55 Thun at 173.

has exerted its influence into every aspect of SAIC's behavior.[56] SAIC's board of directors, which includes three government officials, reports to the Shanghai Municipal Asset Management Committee, which is headed by Shanghai's mayor.[57] SAIC is a joint venture partner of GM and Volkswagen.

- The company Chery is owned by the Anhui provincial government.[58]
- Brilliance Automotive is owned by the Liaoning provincial government.[59]
- The Beijing Automotive Industry Company (BAIC) is owned by the municipal government and has a joint venture with Jeep.[60]
- Tianjin Automotive Industry Corporation (TAIC) and Guangzhou Automotive Industry Corporation (GAIC) are also under the control of municipal governments.[61]

Many of China's automakers, especially those owned by local governments, appear to benefit from preferential (*i.e.*, cheap) financing as well.[62] Local governments' interest and support is driven in large measure by employment and potential tax revenue from automotive ventures.[63]

C. The Chinese Government Provides Tax Incentives and Other Subsidies

56 Thun at 103 and 117. SAIC also had ownership interests in auto parts suppliers. The Shanghai municipal government created a Localization Office to oversee the localization of parts production to Shanghai. *See* Thun at 110-112.

57 Thun at 261.

58 Jean Wang, *China's New Automobile Policy Fails to Comply with Its WTO Commitments*, Berkeley Electronic Press (2005) at 7.

59 *Id.*

60 Thun at 154. Beijing Jeep has since been renamed BeijingBenz-DaimlerChrysler Automotive Ltd. (BBDC).

61 Yasheng Huang, *Economic Fragmentation and FDI in China*, Davidson Institute Working Paper No. 374 (Aug. 2004) at 24.

62 Alysha Webb, *In China, automakers play by different rules*, Automotive News (June 20, 2007).

63 *Id.*; IBM Business Consulting Services, *Inside China: The Chinese view their automotive future* (2005) at 10, 13 & 17 ("IBM Study").

China's tax incentives are numerous and apply in a variety of economic zones and localities. This paper focuses on just one location, China-Singapore Suzhou Industrial Park (SIP), which was founded as a joint undertaking by the governments of Singapore and China.[64] The SIP is home to massive levels of foreign investment from parts producers, including Delphi. Other special zones also seek to encourage FDI in autos and parts,[65] and special economic zones other than SIP provide similar tax incentives.[66]

1. *Income tax reductions and refunds available to companies that satisfy certain export performance requirements;*

The web site of the SIP contains information on various "competitive preferential policies" and "incentives for enterprises in export processing zones."[67] The incentives for foreign-invested manufacturers include:

- Preferential corporate income tax of 15 percent and exemption of local income tax of three percent;
- Two-year tax exemption and three-year 50 percent tax reduction for enterprises "with an operation period of over 10 years;"
- Ten percent preferential income tax rates after the tax holiday for enterprises that export 70 percent of output;
- Further income tax reductions for firms who reinvest profits to raise invested capital or establish new facilities that operate for at least five years;[68]

64 *See* Suzhou Industrial Park, *Background*, http://www.sipac.gov.cn/english/sipprofile/t20040218_4479.htm (2004) (last accessed on July 17, 2007).

65 *See, e.g.*, Zhou Wanfeng, *Auto exhibition in August City to focus on development of vehicles, parts, China Daily—HK Edition* (May 9, 2001). Shenyang's Mayor Chen Zhenggao expected the auto industry to become the city's leading "pillar industry" during the 10th Five-Year Plan period. He promised "to spare no efforts to enhance the collaboration with famous foreign auto firms and increase the production capability of the current joint ventures, which is key to the development of auto sector."

66 Irina Aervitz, *China's extra special zones, Online Asia Times* (Sept. 12, 2006).

67 *See* Suzhou Industrial Park, *Competitive Preferential Policies*, http://www.sipac.gov.cn/english/Investment/t20050329_11068.htm (2004) (last accessed on June 4, 2007); Suzhou Industrial Park, *Incentives for Enterprises in Export Processing Zone*, http://www.sipac.gov.cn/english/Investment/t20050329_11070.htm (2004) (last accessed on June 4, 2007).

- Preferential 10 percent tax rates on dividend, interest, rental, royalty, and other incomes earned by the foreign-invested enterprise.[69]

2. *Value-added tax (VAT) refunds and exemptions available to companies that satisfy certain export performance requirements;*

- VAT exemptions are available to foreign-invested enterprises (and other enterprises with export rights) who export at least 50 percent of output;[70] and
- Higher rebates exist for exported goods (including cars and car parts) that are encouraged by the government, and those rebate levels were not reduced in 2004, when the government reduced rebates to other industries because of budgetary pressures.[71,72]
- In SIP, the VAT *is exempted on all* exports.[73]
- The Provincial State Tax Bureau has assured SIP that the tax bureau supports efforts to develop SIP by special policies in "export rebate, exemption and reduction, etc."[74]

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68 The government refunds forty percent of the income tax paid on the reinvested profit. For export-oriented industries, all of the income tax paid on the reinvested profit is refunded.

69 *See* Suzhou Industrial Park, *Competitive Preferential Policies,* http://www.sipac.gov.cn/english/Investment/t20050329_11068.htm (2004) (last accessed on July 18, 2007).

70 *See, e.g.,* LehmanBrown, *VAT Rebate Rate Cut,* http://www.lehmanbrown.com/Newsletters/Insights/insights_newsletter_November 12th_2003.htm#1 (last accessed July 18, 2007); Global Sources, *Export Tax Rebate and Exemption in China – Getting Your Money Back from the Chinese Government,* http://www.globalsources.com/TNTLIST/2005/0805/DZRA_TAXREBATEMAIN.HTM (last accessed on July 18, 2007).

71 *See* Lehman Brown, *VAT Rebate Rate Cut,* http://www.lehmanbrown.com/Newsletters/Insights/insights_newsletter_November 12th_2003.htm#1 (last accessed July 18, 2007).

72 *See China reforms export tax rebate system,* http://www.chinadaily.com.cn/en/doc/2003-10/14/content_271988.htm (Oct. 14, 2003) (last accessed July 18, 2007).

73 *See* Suzhou Industrial Park, *Incentives for Enterprises in Export Processing Zone,* http://www.sipac.gov.cn/english/Investment/t20050329_11070.htm (2004) (last accessed on June 4, 2007).

74 Suzhou Industrial Park, *Provincial State Tax Bureau Promises Full Support for SIP Growth,* http://www.sipac.gov.cn/english/news/t20060306_14109.htm (Mar. 2, 2006) (last accessed on July 18, 2007).

3. *Tariff exemptions available to companies that satisfy certain export performance requirements*

- According to the SIP web site, the government exempts import duties and import related taxes on imported machinery used for production, construction, and maintenance in export processing zones.

4. *Additional VAT refunds available in export processing zones*

- VAT is refundable on purchases of domestic machinery, equipment, raw materials, spare parts, components, packing materials, and construction materials.

- VAT is refundable on water, power, and gas purchased by firms producing for export.[75]

A partial list of automotive parts suppliers with facilities in Suzhou Industrial Park appears below.

Firm	Approximate Opening Date
Delphi Saginaw Steering (Suzhou) Co., Ltd.,	May-07
Metaldyne (Suzhou) Co., Ltd.	May-07
Tyco Electronics (Souzhou)	Jun-06
Montaplast Automotive System (SIP) Co., Ltd.	May-06
Trico Automotive System (Suzhou) Co., Ltd.	May-06
Suzhou United Plastics Technololgy Co., Ltd.	Apr-06
Tesa Adhesives Company	Dec-05
Georg Fischer Automotive (Suzhou) Co. Ltd.	Oct-05
PKC Auto Circuit (Suzhou) Co., Ltd.	Oct-05
Siegel Robert Automotive Company	Sep-05
Bosch Technology Center	Apr-05
Akebono Braking System Company	Nov-04
Hydro Aluminum (Suzhou) Co. Ltd.	May-05
Bosch Automotive (Suzhou)	Jun-05
Haldex Automotive Products (Suzhou) Co., Ltd.	Jun-05
AGC Flat Glass (Suzhou) Co., Ltd.	Apr-04

75 *See* Suzhou Industrial Park, *Incentives for Enterprises in Export Processing Zone*, http://www.sipac.gov.cn/english/Investment/t20050329_11070.htm (2004) (last accessed on June 4, 2007).

Hitachi Auto Parts (Suzhou) Co., Ltd.	
Delphi Electronics (Suzhou) Co., Ltd.	Nov-96
Source: http://www.sipac.gov.cn/english.	

D. Other Investment Incentives

In its bid to attract world-class auto parts manufacturers, the Chinese government provides a number of other investment incentives. For example, Article 41 of the Five Year Auto Plan states that new investment in auto parts manufacturing does not require State approval. This stands in stark contrast to any new investment in auto assembly, which can only go forward if State approval is granted. Foreign auto parts producers are also exempt from the 50 percent ownership limit placed on joint ventures in the production of finished vehicles.[76]

In addition, if located in an export zone, foreign investment in auto parts production is exempted from the general provision in China that limits foreign ownership to 50 percent. Such incentives have benefited companies such as Robert Bosch GmbH of Germany (the world's largest auto parts company)[77], Delphi Corporation[78] (the largest auto parts manufacturer in the United States), the PKC Group of Finland, Georg Fischer Group of Switzerland, and Akebono of Japan, all of which have invested heavily in auto parts production in China. Bosch, for example announced in December 2006 that it planned to double its

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[76] The 50 percent limit can apparently be modified if the vehicle producer is export oriented. For example, Honda holds a 65 percent share in its joint venture with GAIC, which was approved by the government because all of its output will be exported. *See* IBM Study at 17; State Development and Reform Commission of the People's Republic of China, *Automobile Industry Development Policy No. 8 decree* (June 28, 2004), *available at* http://www.tdctrade.com/report/reg/reg_040601.htm (last accessed July 18, 2007).

[77] Andrew Batson, *China's Rise as Auto-Parts Power Reflects New Manufacturing Edge*, Wall Street Journal Online (Aug. 1, 2006).

[78] *Id.*

investment in China, by spending almost $800 million by 2008.[79] Delphi was an early investor in the SIP, establishing its first facility there in 1996.[80]

E. The Chinese Government Provides R&D Incentives and Requires Companies to Invest in R&D in China

Chapter 3, Article 12 of the Auto Five Year Plan states: "the State supports research, development and production of automobile electronic products, boosts the automobile electronic industry, and speeds up the application of electronic and information technology in automobile products . . ."

A recently published "Adjustment" to the Auto Five Year Plan specifically focuses on efforts to increase R&D in China. To that end, the Chinese government provides tax incentives for R&D expenditures. In addition, the government requires that any newly-approved auto project include a commitment to invest $60 million in R&D. Delphi, for example, while in the midst of bankruptcy in the United States, nevertheless has announced an investment of $50 million in an R&D center to be located in Shanghai.[81] Given that R&D is the type of high value-added activity in which developed countries like the United States are still competitive, the expenditure of this level of China is hard to understand, absent government intervention.

F. Duty Protection and Quotas

Besides granting direct financial support, the Chinese governmental authorities go to great lengths to provide a favorable business environment for auto parts production. For example, Chapter 11 of the Auto Five Year Plan cited import substitution as a major goal. Although China's duties on parts were recently reduced from 28 percent to approximately 10 percent, even the lower level still leaves Chinese duties significantly higher than U.S. duties on the same products. Nevertheless, China sought to offset the WTO-required duty

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79 Business Development Asia, *China*, 49 Asian Automotive News Letter 1 (Dec. 2006), *available at* http://www.bdallc.com/news/Auto/pdf/Asian%20Auto%20Newsletter%20Dec%202006.pdf (last accessed on July 18, 2007).

80 Suzhou Industrial Park, *Delphi Announces Plans for New China Facility* (Feb. 27, 2004), http://www.sipac.gov.cn/english/2004y/t20061130_18272.htm (last accessed on July 18, 2007).

81 Craig Simons, *Delphi's China Operation Offers Tough Lessons For U.S. Manufacturing*, COX Newspapers Washington Bureau (Mar. 5, 2006).

reductions on parts with plans to increase tariffs when parts imports in a given vehicle line exceeded a certain threshold. Moreover, China allegedly maintains a system of import quotas on autos and key auto parts.[82] These tariffs and quotas on parts encourage foreign investment and import substitution in violation of WTO rules.[83]

G. China's Undervalued Exchange Rate Provides an Incentive to Export

The Government of China has undertaken a sustained policy of accumulating foreign reserves in order to maintain an undervalued exchange rate. Numerous experts estimate the level of undervaluation of the yuan at anywhere from 25 to 50 percent. China has accumulated more than one trillion dollars in foreign exchange ($1.16 trillion through Feb. 2007),[84] and by most accounts the vast majority of China's foreign currency holdings are in U.S. dollars.

China's purchases of dollars to maintain the weak yuan constitute a subsidy because it provides a price/income support to Chinese exports who receive more yuan for their dollar-based exports than would otherwise be the case. The weak yuan also makes Chinese exports cheaper in foreign markets, and U.S. products more expensive in China, than would be the case if the yuan were fairly valued. Investors' recognition that the yuan is overvalued has led to increased foreign investment levels in China because once the yuan is valued properly, the foreign currency value of foreign-owned assets in China will rise substantially. The yuan profits generated in China by foreign-owned assets will also be worth more in currencies such as the dollar, providing a further incentive to auto parts producers to invest in China.

V. CASE STUDIES

A. Delphi and Visteon are Reducing Their U.S. Operations While Expanding in China, Where They Have Received Substantial Government Support

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82 *See Auto Product Import to Exceed US$10 Billion This Year,* Xinhua News Agency, *available at* http://www.chinawithqfii.com/news.htm#News12 (last accessed on July 18, 2007).

83 *See Chinese auto industry profits rise 46%,* Online Asia Times (Feb. 8, 2007), http://www.atimes.com/atimes/China_Business/IB08Cb03.html (last accessed on July 18, 2007).

84 *China Reserves and Currency Liquidity*, International Monetary Fund (July 17, 2007), available at http://www.imf.org (last accessed on July 18, 2007).

U.S. auto parts producer Delphi has been under pressure due in part to slower sales and domestic competition faced by the company's biggest customer, General Motors (GM). Delphi sought filed for bankruptcy in October 2005, but non-U.S. subsidiaries were not included in the U.S. filing.[85]

In contrast, Delphi's operations in China are growing substantially. As noted, Delphi opened a facility the SIP in 1996. Delphi's Annual Report for 2004 lists 14 Chinese subsidiaries, suggesting that the firm vigorously pursued Chinese subsidies. According to the SIP website, Delphi operates 14 joint ventures and wholly owned foreign owned enterprises in China.[86] By 2004, Delphi also had eight technology transfer agreements with China, a technical center, and a training center.[87] In April 2005, Delphi established its fifteenth Chinese firm, Delphi Electronics Suzhou, bringing its total investment in China to $500 million.[88]

The joint venture is Delphi's preferred method of organizing production in China. By teaming up with a local or regional government development authority, Delphi gains access to substantial tax and infrastructure benefits, and, potentially, cheaper capital.

Delphi is now a major importer of auto parts and components from China. PIERS data covering April 2006 to March 2007 indicate that the Delphi Corporation directly imported $104.3 million from China, while exporting $65.6 million to China. China's vast array of subsidies, technology appropriation, and import substitution policies will certainly result in even higher levels of imports and lower levels of exports than would be the case without Chinese industrial policies.

Visteon, a major U.S. parts producer spun off from Ford, is also a major player in China. According to recent information, 20 percent of Visteon's

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85 *See* Motion for Order Under 11 U.S.C. § 365 and Fed. R. Bankr. P. 6006 Authorizing Rejection of Certain Executory Contracts with General Motors Corporation, *In re Delphi Corporation, et al.*, Case No. 05-44481 (RDD) (Mar. 31, 2006) at 7.

86 Suzhou Industrial Park, *Delphi Announces Plans for New China Facility*, http://www.sipac.gov.cn/english/2004y/t20061130_18272.htm (Feb. 27, 2004) (last accessed on July 18, 2007).

87 *Id.*

88 Suzhou Industrial Park, *Grand Opening of Delphi Electronics Suzhou*, at http://www.sipac.gov.cn/english/2004y/t20050428_18282.htm (Feb. 28, 2004) (last accessed on July 18, 2007).

purchases are from China.[89] Yanfeng Visteon Automotive Trim Systems, a 50-50 joint venture between local-government-owned Shanghai Automotive Industry Corp (SAIC), was China's fifth largest parts maker in revenue terms in 2005.[90]

B. China's Largest Auto Parts Company, Wanxiang Group, Receives Substantial Local and National Government Support

The recent history of the Wanxiang Group provides a compelling case study of the level of government incentives supplied by the Chinese government to the auto parts industry. The Wanxiang Group is the largest automotive parts producer in China. In 2006, the company had total sales of 30 billion yuan ($3.8 billion),[91] making it China's largest auto parts supplier.[92] While Wanxiang often is portrayed as one of the most successful examples of privately-owned business development in China, in reality the Group is closely affiliated with the municipal government of Xiashan (its home town) in the province of Hangzhou.[93] Indeed, Wanxiang advertises joint venture opportunities with the municipal government of Xiashan on its website. Another report identifies the local government as a prominent shareholder of Wanxiang Bearings, a major auto parts manufacturer within the Wanxiang Group.

With the aid of the Chinese government, Wanxiang has grown rapidly. To strengthen in technology base, it has begun to aggressively seek failing Western auto parts suppliers. Wanxiang has acquired stakes in Universal

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89 *Visteon to buy more auto-parts in China*, Supplier Business (Mar. 1, 2007), *available at* http://www.supplierbusiness.com/news_endpoint.asp?id=3436&search=true&a=s&c=Visteon&d=1&k=0&l=d&j=1 (last accessed on July 18, 2007).

90 *China's Wanxiang Group top auto part supplier by sales revenue in 2005 – CAAM*, AFX News Limited (June 23, 2006), *available at* http://www.forbes.com/home/feeds/afx/2006/06/23/afx2835438.html (last accessed on July 18, 2007).

91 *Wanxiang Group Record Annual Revenue 30 Billion Yuan*, bearing.com, http://www.bearing.com.cn/read_news.php?type=zwxw&id=15814 (Mar. 9, 2007) (last accessed on July 18, 2007).

92 *China's Wanxiang Group top auto part supplier by sales revenue in 2005*, CAAM, AFX News Limited (June 23, 2006), *available at* http://www.forbes.com/home/feeds/afx/2006/06/23/afx2835438.html (last accessed on July 18, 2007).

93 *See, e.g., Hurun Report 2004 China Rich List-Top 20* at p. 2 (Autumn 2004) (noting that the shareholding of the "former town and village enterprise: had been restructured").

Automotive Industries, Inc., a U.S. maker of brakes, Driveline Systems LLC, an axle manufacturer located near Rockville Illinois, Rockford Powertrain, as well as other companies in the U.S. and Europe.[94]

Wanxiang is able to expand and buy U.S. technology by using the resources of its financial arm, Wanxiang Capital Co., Ltd. This investment company, which is the only one of its sort that has been approved by the Bank of China,[95] provides Wanxiang with a ready source of capital. In addition, contrary to banking regulations in most of the Western world, Chinese banking regulations impose no restrictions upon Wanxiang Capital lending to affiliated companies. One of the carrots that the Wanxiang Group holds out to potential acquisition targets is that membership in the group entails the same financial benefits of other Group members.[96]

C. GM Has Been a Major Source of Technology for the Chinese Industry

GM has played a prominent role in developing the Chinese automotive industry. GM established a 50-50 joint venture with SAIC in 1997. GM's investment amounted to approximately one billion dollars.[97] But perhaps more important for the Chinese vehicle and parts industry was GM's contribution to the technological development of China. GM's CEO Jack Smith was desperate to secure the joint venture with SAIC, even if it meant transferring modern technology.[98] Once GM won the heated competition for the joint venture, it took more than a year to iron out supplier agreements and other details. As part of the GM-SAIC joint venture agreement, GM was required to create an R&D facility in China. This operation, the Pan Asia Technical Automotive Center (PATAC), has 900 employees. GM also transferred process technology to China. According to one student of the Chinese and Russian auto industries,

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94 Peter Wonacott, *China Investing in Rust-Belt Companies,* Wall Street Journal, *available at* http://www.wanxiang.com/wallstreet.html (last accessed on July 18, 2007).

95 Wanxiang Capital is the "only capital company of enterprise group approved by the People's Bank of China." *Wanxiang Finance Company Introduced,* China Taiwan Network (Aug. 10, 2004), *available at* http:/big5.chinataiwan.org/web/webportal/w5266253/A23141.html (last accessed July 18, 2007).

96 *Id.*

97 Aervitz Dissertation at 90.

98 Terry McCarthy, *The China Drive,* Time Asia (May 22, 2000), *available at* http://www-cgi.cnn.com/ASIANOW/time/magazine/2000/0522/china.the_china_drive.html (last accessed on July 18, 2007).

> The SGM North factory is exceptionally automated. For example, the robots in the body shop put all components together and check the fit and the correctness of all dimensions. SGM also has an intricate multistage coating procedure that incorporates several layers of paint and layers against corrosion. The plant has an automated stamping press. The SGM North factory manufactures technology intensive components: engines, transmission, etc. Furthermore, SGM exports auto components abroad, which indicates a certain extent of technological sophistication.[99]

Despite all this, GM's attempt to secure a license to produce smaller vehicles aimed at the average Chinese consumer was delayed.[100] To add insult to injury, the design of one of GM's early small car releases in China, was allegedly copied by one of China's local-government-owned companies, Chery.[101] The Chery QQ is outselling the GM offering in China and is currently being exported as well.[102]

Evidence of the technological sophistication of Chinese parts production is evident in GM's high levels of imports from China. According to data from PIERS, GM imported $145.3 million from China in the twelve months through March 2007. This total excludes the use of Chinese-made parts and components purchased from Delphi, as well as parts and components imported into Canada for U.S.-bound finished vehicles. For example, engines produced by GM's joint venture are exported to Canada and used in the Chevrolet Equinox, a decision driven by excess capacity at the engine production facilities of GM's joint venture in China.[103] Apparently, that excess capacity in China continues to exist because the Chinese engine continues to power the Equinox in 2007.

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99 Aervitz Dissertation at 91.

100 Terry McCarthy, *The China Drive*, Time Asia (May 22, 2000), *available at* http://www-cgi.cnn.com/ASIANOW/time/magazine/2000/0522/china.the_china_drive.html (last accessed on July 18, 2007).

101 Jianxi Luo, *The Growth of Independent Chinese Automotive Companies*, Discussion Paper Draft, International Motor Vehicle Program, MIT (May 6, 2005) at 30-31, *available at* http://imvp.mit.edu/downloads/The%20Growth%20of%20Independent%20Chinese%20Automotive%20Companies-05.06.pdf (last accessed on July 18, 2007).

102 *Id.* at 31-32.

103 Bill Visnic and Brian Corbett, *GM Begins Engine Export to N. America*, Wardsauto.com, http://waw.wardsauto.com/ar/auto_gm_shanghai_begins_2/ (Nov. 1, 2003) (last accessed on July 18, 2007).

VII. CONCLUSION

U.S. automakers and auto parts suppliers have made massive investments in China in order to take advantage of the tremendous subsidies and financial incentives offered by the Chinese government.

China, in turn, has used these subsidies and incentives to jump-start its own weak automotive industry. It has required U.S. companies to transfer technology, to invest in R&D in China, and to use Chinese parts in their China-based vehicle assembly operations. As a result, China has leapfrogged other countries to become the second largest parts supplier to the United States.

The rush to China has been driven by WTO-illegal subsidies and incentives. These Chinese government incentives have played a primary role in the growth of automotive production and the relocation of auto parts production to China. These subsidies have also caused injury to U.S. workers and parts suppliers, as well as input suppliers such as steel producers.

EXHIBIT 6

What Is the Five-Year Plan

Adjust font size:

The Five-Year Plan for National Economic and Social Development, or the Five-Year Plan, mainly aims to arrange national key construction projects, manage the distribution of productive forces and individual sector's contributions to the national economy, map the direction of future development, and set targets. From 1949 to 1952, the economy was in its so-called recovery period. In 1953, the central government implemented its first five-year plan. Except for a period of economic adjustment between 1963 and 1965, a total of ten five-year plans have been made and implemented to date. The five-year plan for 2006-2010 is called the 11th Five-Year Development Guidelines.

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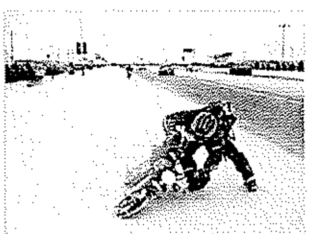

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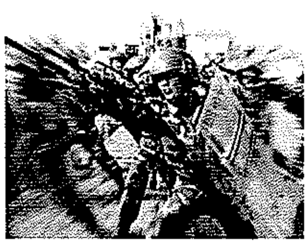

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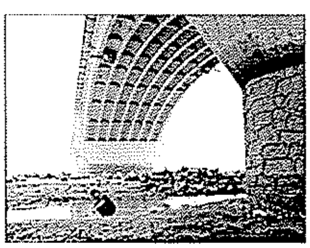
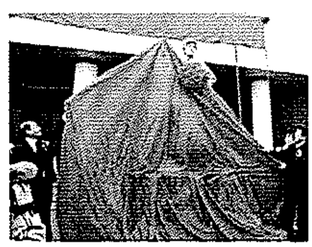
Death toll from cyclone in Bangladesh rises to 3,113

The China syndrome



Drought leaves 3.2 mln short of drinking water

Misses 'light the passion' for the Olympic Games



Memorial opened to commemorate Mao's 2nd wife

Paris Hilton avoids family hotel chain in Shanghai

EXHIBIT 7

Development Policies for the Iron and Steel Industry

Promulgation date:	07-08-2005
Effective date:	07-08-2005
Department:	NATIONAL DEVELOPMENT AND REFORM COMMISSION
Subject:	INDUSTRY & COMMERCE ADMINISTRATION

Order of the National Development and Reform Commission
(No. 35)

The Development Policies for the Iron and Steel Industry, which were adopted at the executive meeting of the State Council, are hereby promulgated upon the consent of the State Council and shall come into force as of the date of promulgation.
Attachment: Development Policies of the Iron and Steel Industry

Director of the National Development and Reform Commission: Ma Kai
July 8, 2005

Attachment: Development Policies for the Iron and Steel Industry

The iron and steel industry is an important basic industry of the national economy, a supporting industry to realize the industrialization and an industry intensive in technologies, capital, resources and energy, whose development requires a comprehensive balancing of all kinds of external conditions. China is a big developing country with a comparatively big demand of iron and steel in the economic development for a long time to go. China's production capacity of iron and steel has ranked the first place in the world for many years. However, there is a large gap between us and the international advanced level in terms of the technological level and material consumption of the iron and steel industry, and thus the focus of development shall be put on technical upgrading and structural adjustment. In order to elevate the whole technical level of the iron and steel industry, promote the structural adjustment, improve the industrial layout, develop a recycling economy, lower the consumption of materials and energy, pay attention to the environmental protection, enhance the comprehensive competitiveness of enterprises, realize the industrial upgrading and develop the iron and steel industry into an industry with international competitiveness that may basically satisfy the demand of the national economy and social development in terms of quantity, quality and varieties, we have formulated the development policies of the iron and steel industry according to the relevant laws and regulations and the domestic and international situations the iron and steel industry faces so as to guide the sound development of the iron and steel industry.

Chapter I Aim of the Policy

Article 1 According to the requirement of our country's economic and social development and the situation of resources, energy and environmental protection, the production capacity of iron and steel shall maintain at a reasonable scale, which may be specifically resolved in the relevant planning. The comprehensive competitiveness of iron and steel industry may reach the internationally advanced level so that China may become a large country in iron and steel production and with world-wide competitive.

Article 2 By the year 2010, by means of structural adjustment of products, the proportion of good iron and steel products shall have been elevated considerably, the majority of products shall have basically satisfied the development requirements of most industries in the national economy such as construction, machinery, chemical industry, auto-mobiles, household appliances, vessels, traffic, railway, military industry and new industries.

Article 3 By means of organizational and structural adjustment of the iron and steel industry, we may expand the scale of those backbone enterprise groups with comparative advantages by means of acquisition and reorganization so as to elevate the industrial concentration. By 2010, the number of iron and steel smelting enterprises shall have been considerably reduced and the production capacity of the iron and steel enterprise groups that rank top 10 in the domestic market shall have covered more than 50 % of the national total production capacity; by 2020, the proportion shall have reached more than 70%.

Article 4 By means of layout adjustment of the iron and steel industry, by 2010, the unreasonable layout shall have been changed; by 2020, a comparatively reasonable industrial layout that complies with the supply of resources and energy, allocation of traffic and transportation, supply and demand of the market and environmental capacity shall have been formed.

Article 5 According to the concept of sustainable development and recycling economy, we should elevate the comprehensive level of environmental protection and resource utilization, and should save energy and lower consumption. We should elevate the comprehensive utilization capacity of waste gases, water and rubbishes to the largest possible extent, strive for the goal of realizing "zero discharge" and establish iron and steel factories of the recycling type. The iron and steel enterprises shall develop the business of generating power by using remnant heat and energy. An iron and steel associated enterprise with the production scale of more than 5 million tons shall strive for the goal of having more than enough power to support itself and providing the surplus to outsiders. By 2005, the comprehensive energy consumption for each ton of steel shall have been lowered to 0.76 ton of standard coal, the comparable energy consumption for each ton of iron shall have been lowered to 0.70 ton of standard coal and the water consumption for each ton of steel shall have been lowered to less than 12 tons in the whole industry; by 2010, the corresponding index shall have been lowered to 0.73 ton of standard coal, 0. 685 ton of standard coal and less than 8 tons of water, respectively; by 2020, the corresponding index shall have been lowered to 0.7 ton of standard coal, 0.64 ton of standard coal and less than 6 tons of water, respectively. That is, in the coming 10 years, the iron and steel industry shall, on the precondition that the total consumption of water resources decreases and the total energy consumption increases by a small margin, and realize a proper development in total quantity.

Article 6 By the end of 2005, all the wastes as discharged by iron and steel enterprises shall have met the standards of the state and local provisions, and the total discharge volume of major wastes shall have met the controlling index as verified by the local environmental department.

Chapter II Industrial Development Planning

Article 7 The state guides the iron and steel industry to develop in a sound, sustainable and harmonious manner through the development policies and the mid- and long-term development policies of the iron and steel industry. The mid- and long-term development policies of the iron and steel industry shall be formulated by the National Development and Reform Commission (hereinafter referred to the NDRC) in collaboration with other relevant departments.

Article 8 An enterprise group with a production capacity of more than 5 million tons in 2003 may, according to the state mid- and long-term development planning of the iron and steel industry and the overall planning of the city where it is located, formulate the planning of its own, which shall be implemented upon the approval of the State Council or the NDRC after making necessary cohesion and balancing efforts. The specific construction projects of the planning are not required to be subject to the examination and approval or verification of the NDRC, but shall be organized and implemented by the enterprise itself after such formalities for examination and approval of land, environmental protection, security and credit have been handled, and shall be reported to the NDRC for archival filing according to the relevant provisions.

Article 9 The development of any other iron and steel enterprise shall also meet the requirements of the development policies and mid- and long-term development planning of the iron and steel industry.

Chapter III Adjustment of Industrial Layout

Article 10 For the adjustment of industrial layout, we should take such conditions as mineral resources, energy, water resources, traffic and transportation, environmental capacity, market allocation and overseas resources into account in a comprehensive manner. For the layout adjustment of the iron and steel industry, we shall not separately establish any new iron and steel associated enterprise, independent iron-smelting or steel-smelting factory as a general principle. It's not encouraged to establish any independent steel-rolling factory. We should, on the basis of those established enterprises that meet relevant conditions and in combination with merger and relocation, carry out reform and expansion in those regions with such comparative advantages as water resources, raw materials, transportation and market consumption. We should combine new increase of production capacity with elimination of backward production capacity and shall not, as a general rule, substantially expand the production capacity.
In the important regions of environmental protection, the regions in serious short of water, the urban district of big cities, the iron and steel smelting and production capacity shall not be expanded any more. Those enterprises established within the districts shall, in combination of the adjustment of organizational structure, equipment structure and product structure, cut production and move to other places so as to meet the requirements of environmental protection and resource economization.

Article 11 Taking bulk ores, energy, resources, water resources, transportation condition and the domestic and overseas market into account, the large-scale iron and steel enterprises shall be mainly located along the coastal areas. The iron and steel enterprises in inland regions shall, in combination with the local market and bulk ore resources, determine their production according to the mines available, and shall regard the sustainable production as the main factor for consideration other than strive for any expansion of production scale.
There are abundant resources of iron mines in the Anshan-Benxi region in north-east China, which is near the production bases of coal and has a certain condition of water resources. According to the development strategy of vitalizing the old north-east industrial base, the iron and steel enterprises in this region shall, according to the requirements of associated reorganization and establishing a top-quality production base, eliminate the backward production capacity so as to build up a large enterprise group with international competitiveness.
As the region of North China is in short of water resources and the production capacity thereof is low and excessive, we should, according to the ecological requirements of environmental protection, put the focus on structural adjustment, carry out merger and reorganization, strictly control the continuous over-increase of production factories and expansion of production capacity. We should relocate the Capital Steel Corporation and the reorgane it with the iron and steel industry of Hebei Province.
The steel material market in North China has a big potential. However, the layout of iron and steel enterprises thereof are over-intensified and thus, the large backbone enterprises with comparative advantages within this region may, in combination of the adjustment of organizational structure and product structure, elevate their production concentration and international competitiveness.
As the central-southern region has abundant water resources and desirable water transportation, the south-east coastal regions shall make full use of the advantage of deep waters and good harbors to

build up large iron and steel associated enterprises in combination with the industrial reorganization and the relocation of urban steel factories.

There are abundant water resources in the west-south regions, and in the Panzhihua-Xichangarea has a large storage capacity of iron mines and coal resources but with inconvenient transportation. The key backbone enterprises established shall improve their equipments, adjust the variety structure, develop high-value-added products, determine the production capacity according to the sustainable supplying capacity of bulk ores rather than blindly pursue the increase of quantity.

As the west-north region is in short of bulk iron ores and water resources, the backbone enterprises established shall put the focus on satisfying the requirement of local regional economic development other than pursue the expansion of production scale, and shall make good use of the mineral resources in neighboring countries.

Chapter IV Industrial Technical Policies

Article 12 In order to guarantee the industrial upgrading of the iron and steel industry, realize the sustainable development and prevent any low-level repetitive construction, we hereby prescribe the equipment level, the technical and economic indexes and the requirements of access into the iron and steel industry as follows, which the enterprises shall make efforts to meet by way of technical innovation:

The building areas for agglomeration machines shall be 180 sq meters or above; the height of coke-oven carbonization rooms shall be 6 meters or above; the available volume of blast furnaces, 1,000 cubic meters or above; the nominal volume of converters, 120 tons or above; and the nominal volume of electronic furnaces, 70 tons or above.

For the iron and steel projects as constructed in deep water harbors along the coast, the available volume of blast furnaces shall be more than 3, 000 cubic meters; the nominal volume of converters shall be more than 200 tons, and the production scale of steel shall be 8 million tons or above. The technical and economic indexes for iron and steel associated enterprises shall be: the comprehensive energy consumption for each ton of steel in the procedure of blast furnaces shall be less than 0.7 ton of standard coal and that in the procedure of electronic furnaces shall be less than 0.4 ton of standard coal; the water consumption for each ton of steel in the procedure of blast furnaces shall be less than 6 tons, and that in the procedure of electronic furnaces shall be less than 3 tons. The recycling utilization rate of water shall be 95% or above. The other iron and steel enterprises shall reach the average level of key large/medium-sized iron and steel enterprises in respect of energy consumption in working procedures.

For any iron and steel construction project, we should economize our use of land and strictly carry out the administration of land. The relevant departments shall make efforts to accomplish the revision work of land use indexes for iron and steel factories and the standard of building coefficient.

Article 13 All production enterprises shall reach the local and state standards of waste discharge. The controlling index of total discharging volume of major wastes from construction projects shall be strictly implemented according to the provisions of the Appraisal Document (Form) of Environmental Influence as approved. Any enterprise, which exceeds the scope as prescribed by the waste discharging index and the total volume as verified, shall be stopped from carrying out its operations.

For those projects that are newly initiated, the blast furnaces shall be synchronously equipped with pressure recovery turbine (TRT) devices and coal injection devices; the coke oven shall be synchronously equipped with coke dry quenching devices and with filtering devices as well as gas desulfurizing devices for the coke ovens. The coke ovens, blast furnaces and converters shall be synchronously equipped with gas recovering devices. The electronic furnaces shall be equipped with smoke and dust recovering devices.

Enterprises shall, according to the requirements of developing a recycling economy, establish a comprehensive treatment system for waste water and residue, adopt the technologies of drying quenching cokes, technologies for the recovery and utilization of gas from coke ovens, blast furnaces and converters, power generation by jointly using gas and steam, TRT of blaster furnaces, evaporative cooling, technologies for the recovery and re-utilization of such energy and resources as smoke, dust and waste residue, so as to elevate the utilization efficiency of energy and the recovery and utilization rate of resources and to improve the environment.

Article 14 We should accelerate the cultivation of initial innovation capacity of the iron and steel industry, support enterprises to establish the institutions for development and scientific research of products and techniques. We should enhance the capacity of development and innovation, develop the working techniques, equipment techniques and products with the self-owned intellectual property right. We should support enterprises to follow up, research, develop and adopt such frontier techniques in the production procedures of iron and steel as continuous strip casting and melting reduction.

Article 15 Enterprises shall actively adopt such advanced techniques and equipment as feeding concentrated materials into furnaces, oxygen-enriched coal spraying, iron pretreatment, large-sized blaster furnaces, converters and electronic furnaces with superpower, ex-furnace refining, continuous casting, continuous rolling and controlling rolling and controlling cooling.

Article 16 We should support and organize the implementation of equipment localization of the iron and steel industry, enhance the research and development as well as designing and manufacture levels of major technical equipment of our iron and steel industry. For a major iron and steel project that is based on home-made equipment as newly developed, the state shall grant policy supports in such aspects as taxation, discounted interest rate and scientific research funds.

Article 17 We should accelerate the elimination and prohibition of such backward working techniques and equipment as newly-built sintering with indigenous method, indigenous carbonization (including improved carbonization), melting iron and refining steel, hot agglomeration mines, blaster furnaces with a volume of 300 cubic meters or below (except for the special factories of iron pipe casting), converters with the nominal capacity of 20 tons or below, electronic furnaces with the nominal capacity of 20 tons or below (except for the mechanic casting or the production of high-alloy steel), tight rolling sheet mills, roughing mill for ordinary steel, blank medium-sized rolling mills, three-roller Lotus medium plate rolling mills, double due wire mills, row small-sized millers, hot narrow strip rolling mills, assembling units of hot rolling seamless pipes with diameter below 76 centimeters and intermediate frequency furnaces. Enterprises in the iron and steel industry shall strictly observe the Catalog of Repetitive Construction as Prohibited in the Field of Industry and Commerce and the Catalog of Backward Production Capacity, Working Techniques and Products to Be Eliminated as amended by the state at the opportune moment, or eliminate backward working techniques, products and techniques according to the requirements of the provisions on environmental protection.

Article 18 The policies of imported technologies and equipment: enterprises are encouraged to use home-made equipment and technologies and reduce import. For any equipment or technology that cannot be produced domestically or fails to meet the demand and, thus, shall be introduced from abroad, the introduced equipment or technology shall be advanced and practical. For the equipment in large number, we should organize and implement the localized production thereof from now on. Enterprises are prohibited from adopting any second-handed backward production equipment of iron and steel at home or abroad that has been eliminated.

Article 19 Enterprises of special steel shall make an effort towards conglomerated and specialized production and management.They are encouraged to adopt the working techniques with short workflow and that use waste steel as raw materials. Enterprises of special steel are discouraged to adopt any working procedure that involves the use of blaster furnaces and electronic furnaces and with high consumption and serious pollution. Enterprises of special steel are encouraged to carry out research, develop and produce special steel for the use of the military industry, bearing, gears, models, heat resistance, cold resistance and corrosion resistance, etc. so as to enhance the product quality and technical level.

Chapter V Adjustment of the Organizational Structure of Enterprises

Article 20 The iron and steel enterprises are encouraged to develop into groups and carry out strategic reorganization by way of alliance between mighty enterprises, merger and reorganization, mutual shareholding, etc. so as to reduce the number of iron and steel production enterprises and realize the structural adjustment, optimization and upgrading of the iron and steel industry.
Where possible, large-scale enterprise groups are supported and encouraged to carry out trans-regional alliance and reorganization. By 2010, two enterprise groups with the production capacity of 300 million tons and several particularly large enterprise groups of international competitiveness with the production capacity of several hundred million tons shall be established.
All the large iron and steel enterprises shall carry out stock reforms and are supported to get listed in the stock market. All kinds of social capital including private capital are encouraged to participate in the reorganization of the iron and steel enterprises as established by means of stock purchase and merger and acquisition so as to promote the adjustment of capital structure and organizational innovation thereof.

Article 21 The state supports large iron and steel associated enterprises with good conditions and that have been formed by alliance and reorganization to expand the production scale in a proper manner by way of structural adjustment and industrial upgrading and to enhance the production intensification. Such enterprises will be given policy support in such aspects as segmentation of the major and minor, resettlement of personnel and social security.

Chapter VI Investment Management

Article 22 The state shall carry out the necessary administration on the investors' economic activities of all economic types in the domestic iron and steel industry and the investment of domestic enterprises in the overseas iron and steel field. The investment in any iron and steel project shall be subject to the examination and approval or verification of the NDRC according to the relevant provisions.

Article 23 For the construction of such projects as iron smelting, steel smelting and steel rolling, the proportion of self-owned capital of enterprises shall reach 40% or above.
To start an iron and steel project, an enterprise shall, apart from meeting the requirements of such laws and regulations of the state on environmental protection and safety production, have comparably strong capital strength, advanced technologies and management capability as well as stable, reliable external conditions such as perfect marketing networks, water resources, raw materials of bulk ores, coal, and power energy, and transportation, etc. which shall have been basically carried into effect.
Where an iron and steel enterprise invests in the construction of any cross-region iron and steel associated enterprise project, if it is an enterprise of common steel, the steel production thereof in the previous year shall reach 5 million tons or more; thief it is an enterprise of special steel, the production thereof shall reach 0.5 million or more. Where a non-iron-and-steel enterprise invests in any iron and steel associated enterprise project, it shall have the capital strength and comparatively high public creditworthiness. An asset assessment shall be carried out to the enterprise's registered capital. the bank concerned shall provide a credit certification, and the relevant accounting firm shall provide a performance report. Where possible, the form of bidding invitation shall be adopted to choose the project owner.
Any overseas iron and steel enterprise that invests in the iron and steel industry of China shall have

intellectual property right and techniques of its own and its production of common steel in the previous year shall reach 10 million tons or above or the production of special high-alloy steel shall reach 1 million tons. An overseas non-iron-and-steel enterprise that invests in the iron and steel industry of China shall have a strong capital strength and comparatively high public creditworthiness, and shall provide an asset assessment report as produced by a bank and an enterprise performance certification as produced by an accounting firm. Where an overseas Chinese enterprise invests in the domestic iron and steel industry, it shall implement the investment in combination with the reform and relocation of domestic iron and steel enterprises and shall not establish any new business site. For any foreign investment in the iron and steel industry of China, foreign investors are not allowed to have a controlling share, as is the general principle.

Article 24 For any project that fails to comply with the development policies for the iron and steel industry and hasn't been subject to examination and approval or where the examination and approval thereof fails to comply with the relevant provisions, the department of state land and resources shall not handle the formalities for land use and the department of industry and commerce shall not accepts its registration, the administrative department of commerce shall not approve its contract and constitution, the financial institution shall not provide any loan or give credit support in any other form, the customs shall not handle the formalities for tax refund of imported equipment, the department of quality supervision shall not issue any production permit, and the department of environmental protection shall not examine or approve the appraisal document of environmental influence on the project or issue any license of waste discharge.

Article 25 To grant mid- and long-term loans for the fixed-asset investment to the projects of iron smelting, steel smelting and steel rolling, a financial institution shall comply with the development policies for the iron and steel industry, and strengthen their risk management. For any fix-asset investment loan granted to any project of iron smelting, steel smelting and steel rolling with newly increased production capacity, the relevant reply, verification or archival documents as produced by the NDRC shall be required to be provided.

Article 26 Where an enterprise makes an initial public offering of stocks or seeks any financing in the securities market, the funds as raised shall be invested in the iron and steel industry, and shall comply with the development policies for the iron and steel industry. The investment document for the raised funds as produced by the NDRC shall be provided to the administrative department of securities.

Article 27 The state encourages the enterprises that engage in the production of iron and steel and equipment manufacture to export the technologies and set equipment of metallurgy with domestic advantages by way of integrating processing with trade or integrating techniques with trade and shall grant supports in aspect of export credit, etc..

<u>(Article 27 Should read: The state encourages and will provide export credit and other support for enterprises engaged in the production of steel and related production equipment to trade or transfer technology by **exporting** superior domestic technologies and metallurgical equipment sets.)</u>

Chapter VII Policy of Raw Materials

Article 28 The mineral resources shall belong to the state. The state encourages large-scale iron and steel enterprises to carry out the exploration and development of such resources as iron mines. For the exploration of mines, a mining license shall be legally obtained. A mining construction project of iron resources with a storage capacity of 50 million tons or more shall be subject to the verification or examination and approval of the NDRC. At the same time, we should do a good job in such environmental protection work as the planning of mines, safety production and re-claiming of land, conservation of water and top soil, and the filing of underground coal mines. Any unauthorized collection or unrestrained digging is prohibited. As for any unauthorized collection or unrestrained digging that hasn't gone through the legal procedures of examination and approval, the department of state land and resources shall revoke the mining right and stop the illegal mining.

Article 29 According to the practical situation that China has few rich mines but many poor mines, the state encourages enterprises to develop the selection technologies of low-grade mines and make full use of domestic poor mineral resources. The department of state land and resources shall intensify the exploration of mineral resources, protect mineral resources and give necessary punishments to and carry out rectification on any unauthorized collection or unrestrained digging.

Article 30 We should, according to the principles of making their advantages complement each other and achieving the win-win situation, intensify the international cooperation regarding overseas mineral resources. We should support those large backbone enterprise groups to establish overseas production and supplying bases of iron mines, chrome ore mines, manganese mines, nickel ore mines, waste steel and coking coal, etc. by way of setting up solely-funded enterprises, joint-equity enterprises, contractual enterprises and purchase of mineral resources. For such important raw materials and auxiliary materials as bulk ores and coke as needed by the enterprises in coastal areas, the state encourages them to solve it by way of overseas market.
The iron and steel industrial association shall do a good job in the industrial self-discipline and coordination and stabilize the raw material market both at home and abroad. Where two or more domestic enterprises are engaged in vicious competition for overseas resources, the state may adopt administrative coordination to hold alliance or select one of them to make investment so as to avoid vicious competition. The relevant enterprises shall be subject to the administrative coordination of the state.
The export of such preliminarily processed products as coke, iron alloy, pig iron, waste steel and steel base (ingot) with high energy-consumption and serious pollution shall be restricted and the tax refund for export of these products shall be decreased or canceled.

Chapter VIII Economical Use of Steel

Article 31 The whole society shall set up the consciousness of using steel in an economical and scientific manner. It is encouraged to use renewable materials as a substitution and to recover wasted steel so as to reduce the quantity of steel as used.

Article 32 The departments of construction shall organize the revision and improvement of the designing norms and standards for the use of construction steel so as to reduce the coefficient of steel use under the precondition of ensuring safety.The departments of design shall, according to the designing norms and standards, carry out their designs and incorporate the economical and thrifty products as developed and researched into the standardized design in a timely manner.

Article 33 It is encouraged to research, develop and use new materials of good performance, low costs and low consumption to substitute steel.

Article 34 The iron and steel enterprises are encouraged to produce high-strength steel and corrosion resisting steel, elevate the strength and service term of steel and lower the quantity of steel as used. We should lower the steel consumption by means of popularizing such steel varieties as hot rolling strip reinforcing bar at or above Grade III (400mpa) , the high-strength steel plates for all kinds of purposes, and h-steel, etc.
We should elevate the corrosion resistance and service term of steel by means of applying the oil well pipes and pipeline steel plates capable of resisting the corrosion of hydrothion and carbon dioxide, steel plates and structural steel capable of resisting the corrosion of atmosphere, and fire-resisting steel.

Article 35 With the increase of the number of iron and steel products in the market and the recycling quantity of waste steel as well, we should decrease the proportion of iron ores and increase the proportion of wasted steel.

Chapter IX Other Matters

Article 36 Consultation, designing and construction entities that engage in the iron and steel industry shall observe the present industrial policies. The relevant industrial associations shall establish a mechanism of self-discipline and mutual supervision. For any violation of the present industrial policies, the person and entity as held responsible shall be given punishments by relevant departments such as the NDRC, the Ministry of Construction and the State Administration of Industry and Commerce, etc. according to the relevant provisions.
The present industrial development policies are the basic requirements for the iron and steel industry. All relevant departments and industrial associations may formulate and revise the relevant technical norms and standards according to the present industrial policies.

Article 37 We should regulate the market order and maintain the market steadiness. The iron and steel enterprises are encouraged to establish a long-term strategic alliance with users, stabilize the supply and demand relations, enhance the processing and distribution capacity of steel, and extend the services thereof.

Article 38 We should give full play to the functions of the industrial associations. The industrial associations shall establish and improve a periodical information publication system and an industrial early-warning system in respect to the supply and demand of the iron and steel market, production capacity and technical and economic indexes, shall report the industrial trend to the administrative department of government and set forth policy suggestions in a timely manner, coordinate the significant matters regarding industrial development, intensify the industrial self-discipline and offer guidance to the enterprise development.

Article 39 The present industrial policies are published upon the authorization of the State Council and shall be observed by all the administrative departments of the people's governments. For any construction entity or administrative entity which violates the present policies for industrial development, such departments as supervision, investment, land, industry and commerce, taxation, quality inspection, environmental protection, commerce, finance and securities supervision shall investigate into the violations and fix responsibilities to the violator.

Article 40 The NDRC shall organize the relevant departments to formulate and revise the development policies for the iron and steel industry, report it to the State Council for approval and supervise the implementation thereof.

Notes:
1. The term "the iron and steel industry" as mentioned in the present Development Policies covers: the selection of iron mines, manganese mines and chromium mines and working techniques and relevant supporting techniques such as agglomeration, carbonization, iron alloy, carbon products, fire-resisting materials, iron smelting, steel rolling and metal products.
2 The term "trans-regional investment" refers to the investment across different countries, provinces, autonomous regions or municipalities directly under the Central Government.
3. The term "overseas enterprises" includes the enterprises that have been registered abroad or in the regions of Hong Kong, Macao or Taiwan.

钢铁产业发展政策

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国家发展和改革委员会令

（第35号）

《钢铁产业发展政策》业经国务院常务会议讨论通过，经国务院同意，现予以发布，自发布之日起施行。

附：钢铁产业发展政策

国家发展和改革委员会主任：马凯

二00五年七月八日

附：

钢铁产业发展政策

钢铁产业是国民经济的重要基础产业，是实现工业化的支撑产业，是技术、资金、资源、能源密集型产业，钢铁产业的发展需要综合平衡各种外部条件。我国是一个发展中大国，在经济发展的相当长时期内钢铁需求较大，产量已多年居世界第一，但钢铁产业的技术水平和物耗与国际先进水平相比还有差距，今后发展重点是技术升级和结构调整。为提高钢铁工业整体技术水平，推进结构调整，改善产业布局，发展循环经济，降低物耗能耗，重视环境保护，提高企业综合竞争力，实现产业升级，把钢铁产业发展成在数量、质量、品种上基本满足国民经济和社会发展需求，具有国际竞争力的产业，依据有关法律法规和钢铁行业面临的国内外形势，制定钢铁产业发展政策，以指导钢铁产业的健康发展。

第一章　政策目标

第一条　根据我国经济社会发展需要和资源、能源及环保状况，钢铁生产能力保持合理规模，具体规模可在规划中解决。钢铁综合竞争能力达到国际先进水平，使我国成为世界钢铁生产的大国和具有竞争力的强国。

第二条　通过产品结构调整，到2010年，我国钢铁产品优良品率有大幅度提高，多数产品基本满足建筑、机械、化工、汽车、家电、船舶、交通、铁路、军工以及新兴产业等国

民经济大部分行业发展需要。

第三条　通过钢铁产业组织结构调整，实施兼并、重组，扩大具有比较优势的骨干企业集团规模，提高产业集中度。到 2010 年，钢铁冶炼企业数量较大幅度减少，国内排名前十位的钢铁企业集团钢产量占全国产量的比例达到 50%以上；2020 年达到 70%以上。

第四条　通过钢铁产业布局调整，到 2010 年，布局不合理的局面得到改善；到 2020 年，形成与资源和能源供应、交通运输配置、市场供需、环境容量相适应的比较合理的产业布局。

第五条　按照可持续发展和循环经济理念，提高环境保护和资源综合利用水平，节能降耗。最大限度地提高废气、废水、废物的综合利用水平，力争实现"零排放"，建立循环型钢铁工厂。钢铁企业必须发展余热、余能回收发电，500 万吨以上规模的钢铁联合企业，要努力做到电力自供有余，实现外供。2005 年，全行业吨钢综合能耗降到 0.76 吨标煤、吨钢可比能耗 0.70 吨标煤、吨钢耗新水 12 吨以下；2010 年分别降到 0.73 吨标煤、0.685 吨标煤、8 吨以下；2020 年分别降到 0.7 吨标煤、0.64 吨标煤、6 吨以下。即今后十年，钢铁工业在水资源消耗总量减少和能源消耗总量增加不多的前提下实现总量适度发展。

第六条　在 2005 年底以前，所有钢铁企业排放的污染物符合国家和地方规定的标准，主要污染物排放总量应符合地方环保部门核定的控制指标。

第二章　产业发展规划

第七条　国家通过钢铁产业发展政策和中长期发展规划指导行业健康、持续、协调发展。钢铁产业中长期发展规划由国家发展和改革委员会会同有关部门制定。

第八条　2003 年钢产量超过 500 万吨的企业集团可以根据国家钢铁产业中长期发展规划和所在城市的总体规划，制定本集团规划，经国务院或国家发展和改革委员会进行必要衔接平衡后批准执行。规划内的具体建设项目国家发展和改革委员会不再审批或核准，由企业办理土地、环保、安全、信贷等审批手续后自行组织实施，并按规定报国家发展和改革委员会备案。

第九条　其它钢铁企业的发展也必须符合钢铁产业发展政策和钢铁工业中长期发展规划的要求。

第三章　产业布局调整

第十条　钢铁产业布局调整要综合考虑矿产资源、能源、水资源、交通运输、环境容量、市场分布和利用国外资源等条件。钢铁产业布局调整，原则上不再单独建设新的钢铁联合企业、独立炼铁厂、炼钢厂，不提倡建设独立轧钢厂，必须依托有条件的现有企业，结合兼并、搬迁，在水资源、原料、运输、市场消费等具有比较优势的地区进行改造和扩建。新增生产能力要和淘汰落后生产能力相结合，原则上不再大幅度扩大钢铁生产能力。

重要环境保护区、严重缺水地区、大城市市区，不再扩建钢铁冶炼生产能力，区域内现有企业要结合组织结构、装备结构、产品结构调整，实施压产、搬迁，满足环境保护和资源节约的要求。

第十一条　从矿石、能源、资源、水资源、运输条件和国内外市场考虑，大型钢铁企业应主要分布在沿海地区。内陆地区钢铁企业应结合本地市场和矿石资源状况，以矿定产，不谋求生产规模的扩大，以可持续生产为主要考虑因素。

东北的鞍山-本溪地区有比较丰富的铁矿资源，临近煤炭产地，有一定水资源条件，根据振兴东北老工业基地发展战略，该区域内现有钢铁企业要按照联合重组和建设精品基地的要求，淘汰落后生产能力，建设具有国际竞争力的大型企业集团。

华北地区水资源短缺，产能低水平过剩，应根据环保生态要求，重点搞好结构调整，兼并重组，严格控制生产厂点继续增多和生产能力扩张。对首钢实施搬迁，与河北省钢铁工业进行重组。

华东地区钢材市场潜力大，但钢铁企业布局过于密集，区域内具有比较优势的大型骨干企业可结合组织结构和产品结构调整，提高生产集中度和国际竞争能力。

中南地区水资源丰富，水运便利，东南沿海地区应充分利用深水良港条件，结合产业重组和城市钢厂的搬迁，建设大型钢铁联合企业。

西南地区水资源丰富，攀枝花-西昌地区铁矿和煤炭资源储量大，但交通不便，现有重点骨干企业要提高装备水平，调整品种结构，发展高附加值产品，以矿石可持续供应能力确定产量，不追求数量的增加。

西北地区铁矿石和水资源短缺，现有骨干企业应以满足本地区经济发展需求为主，不追求生产规模扩大，积极利用周边国家矿产资源。

第四章　产业技术政策

第十二条　为确保钢铁工业产业升级和实现可持续发展，防止低水平重复建设，对钢铁工业装备水平和技术经济指标准入条件规定如下，现有企业要通过技术改造努力达标：

建设烧结机使用面积 180 平方米及以上；焦炉炭化室高度 6 米及以上；高炉有效容积 1000 立方米及以上；转炉公称容量 120 吨及以上；电炉公称容量 70 吨及以上。

沿海深水港地区建设钢铁项目，高炉有效容积要大于 3000 立方米；转炉公称容量大于

200吨，钢生产规模800万吨及以上。钢铁联合企业技术经济指标达到：吨钢综合能耗高炉流程低于0.7吨标煤，电炉流程低于0.4吨标煤，吨钢耗新水高炉流程低于6吨，电炉流程低于3吨，水循环利用率95%以上。其它钢铁企业工序能耗指标要达到重点大中型钢铁企业平均水平。

钢铁建设项目要节约用地，严格土地管理，有关部门要抓紧完成钢铁厂用地指标和建筑系数标准修订工作。

第十三条　所有生产企业必须达到国家和地方污染物排放标准，建设项目主要污染物排放总量控制指标要严格执行经批准的环境影响评价报告书（表）的规定，对超过核定的污染物排放指标和总量的，不准生产运行。

新上项目高炉必须同步配套高炉余压发电装置和煤粉喷吹装置；焦炉必须同步配套干熄焦装置并匹配收尘装置和焦炉煤气脱硫装置；焦炉、高炉、转炉必须同步配套煤气回收装置；电炉必须配套烟尘回收装置。

企业应根据发展循环经济的要求，建设污水和废渣综合处理系统，采用干熄焦，焦炉、高炉、转炉煤气回收和利用，煤气-蒸汽联合循环发电，高炉余压发电、汽化冷却，烟气、粉尘、废渣等能源、资源回收再利用技术，提高能源利用效率、资源回收利用率和改善环境。

第十四条　加快培育钢铁工业自主创新能力，支持企业建立产品、技术开发和科研机构，提高开发创新能力，发展具有自主知识产权的工艺、装备技术和产品。支持企业跟踪、研究、开发和采用连铸薄带、熔融还原等钢铁生产流程前沿技术。

第十五条　企业应积极采用精料入炉、富氧喷煤、铁水预处理、大型高炉、转炉和超高功率电炉、炉外精炼、连铸、连轧、控轧、控冷等先进工艺技术和装备。

第十六条　支持和组织实施钢铁工业装备本地化，提高我国钢铁工业的重大技术装备研发、设计、制造水平。对于以国产新开发装备为依托建设的钢铁重大项目，国家给予税收、贴息、科研经费等政策支持。

第十七条　加快淘汰并禁止新建土烧结、土焦（含改良焦）、化铁炼钢、热烧结矿、容积300立方米及以下高炉（专业铸铁管厂除外）、公称容量20吨及以下转炉、公称容量20吨及以下电炉（机械铸造和生产高合金钢产品除外）、叠轧薄板轧机、普钢初轧机及开坯用中型轧机、三辊劳特式中板轧机、复二重式线材轧机、横列式小型轧机、热轧窄带钢轧机、直径76毫米以下热轧无缝管机组、中频感应炉等落后工艺技术装备。

钢铁产业必须严格遵守国家适时修订的《工商领域制止重复建设目录》、《淘汰落后生产能力、工艺和产品的目录》，或依照环保法规要求，淘汰落后工艺、产品和技术。

第十八条　进口技术和装备政策：鼓励企业采用国产设备和技术，减少进口。对国内不能生产或不能满足需求而必须引进的装备和技术，要先进实用。对今后量大面广的装备要组织实施本地化生产。

禁止企业采用国内外淘汰的落后二手钢铁生产设备。

第十九条　特钢企业要向集团化、专业化方向发展，鼓励采用以废钢为原料的短流程工艺，不支持特钢企业采用电炉配消耗高、污染重的小高炉工艺流程。鼓励特钢企业研发生产国内需求的军工、轴承、齿轮、工模具、耐热、耐冷、耐腐蚀等特种钢材，提高产品质量和技术水平。

第五章　企业组织结构调整

第二十条　支持钢铁企业向集团化方向发展，通过强强联合、兼并重组、互相持股等方式进行战略重组，减少钢铁生产企业数量，实现钢铁工业组织结构调整、优化和产业升级。

支持和鼓励有条件的大型企业集团，进行跨地区的联合重组，到 2010 年，形成两个 3000 万吨级，若干个千万吨级的具有国际竞争力的特大型企业集团。

大型钢铁企业均要进行股份制改造并支持其公开上市，鼓励包括民营资本在内的各类社会资本通过参股、兼并等方式重组现有钢铁企业，推进资本结构调整和机制创新。

第二十一条　国家支持具备条件的联合重组的大型钢铁联合企业通过结构调整和产业升级适当扩大生产规模，提高集约化生产度，并在主辅分离、人员分流、社会保障等方面给予政策支持。

第六章　投资管理

第二十二条　国家对各类经济类型的投资主体投资国内钢铁行业和国内企业投资境外钢铁领域的经济活动实行必要的管理，投资钢铁项目需按规定报国家发展和改革委员会审批或核准。

第二十三条　建设炼铁、炼钢、轧钢等项目，企业自有资本金比例必须达到 40%及以上。

建设钢铁项目除满足环保生态、安全生产等国家法律法规要求外，企业还必须具备较强的资金实力、先进的技术和管理能力，以及健全的市场营销网络，水资源、矿石原料、煤炭和电力能源、运输等外部条件要稳定可靠和基本落实。

钢铁企业跨地区投资建设钢铁联合企业项目，普钢企业上年钢产量必须达到 500 万吨及以上，特钢企业产量达到 50 万吨及以上。非钢铁企业投资钢铁联合企业项目的，必须具有

资金实力和较高的公信度，必须对企业注册资本进行验资，银行提供资信证明，会计事务所提供业绩报告，有条件的通过招标方式选择项目业主。

境外钢铁企业投资中国钢铁工业，须具有钢铁自主知识产权技术，其上年普通钢产量必须达到1000万吨以上或高合金特殊钢产量达到100万吨。投资中国钢铁工业的境外非钢铁企业，必须具有强大的资金实力和较高的公信度，提供银行、会计事务所出具的验资和企业业绩证明。境外企业投资国内钢铁行业，必须结合国内现有钢铁企业的改造和搬迁实施，不布新点。外商投资我国钢铁行业，原则上不允许外商控股。

第二十四条　对不符合本产业发展政策和未经审批或违规审批的项目，国土资源部门不予办理土地使用手续，工商管理部门不予登记，商务管理部门不批准合同和章程，金融机构不提供贷款和其它形式的授信支持，海关不予办理免税进口设备手续，质检部门不予颁发生产许可证，环保部门不予审批项目环境影响评价文件和不予发放排污许可证。

第二十五条　各金融机构向炼铁、炼钢、轧钢项目发放中长期固定资产投资贷款，要符合钢铁产业发展政策，加强风险管理，向新增能力的炼铁、炼钢、轧钢项目发放固定资产投资贷款需要项目单位提供国家发展和改革委员会出具的相应的项目批复、核准或备案文件。

第二十六条　企业申请首次公开发行股票或在证券市场融资，募集资金投向于钢铁行业，必须符合钢铁产业发展政策，并需向证券监管部门提供由国家发展和改革委员会出具的募集资金投向的文件。

第二十七条　国家鼓励钢铁生产和设备制造企业采用工贸或技贸结合的方式出口国内有优势的技术和冶金成套设备，并在出口信贷等方面给予支持。

第七章　原材料政策

第二十八条　矿产资源属国家所有。国家鼓励大型钢铁企业进行铁矿等资源勘探开发，矿山开采必须依法取得采矿许可证。储量5000万吨及以上铁矿资源的开采建设项目必须经国家发展和改革委员会核准或审批，同时做好矿山规划、安全生产以及土地复垦、水土保持、地下矿井回填等环境保护工作，禁止乱采滥挖行为。未经合法审批手续乱采滥挖的，国土资源部门要收回采矿权，停止非法开采行为。

第二十九条　根据我国富矿少、贫矿多的资源现状，国家鼓励企业发展低品位矿采选技术，充分利用国内贫矿资源。国土资源部门要加大矿产资源勘探力度，保护矿产资源，对滥采乱挖行为，要给予必要处罚和进行整顿。

第三十条　按照优势互补、互利双赢的原则，加强与境外矿产资源国际合作。支持有条

件的大型骨干企业集团到境外采用独资、合资、合作、购买矿产资源等方式建立铁矿、铬矿、锰矿、镍矿、废钢及炼焦煤等生产供应基地。沿海地区企业所需的矿石、焦炭等重要原辅材料，国家鼓励依靠海外市场解决。

钢铁协会要搞好行业自律和协调，稳定国内外原料市场。国内多家企业对境外资源造成恶性竞争时，国家可采取行政协调方式，进行联合或确定一家企业进行投资，避免恶性竞争。企业应服从国家行政协调。

限制出口能耗高、污染大的焦炭、铁合金、生铁、废钢、钢坯（锭）等初级加工产品，降低或取消对这些产品的出口退税。

第八章　钢材节约使用

第三十一条　全社会要树立节约使用钢材意识，科学使用，鼓励用可再生材料替代和废钢材回收，减少钢材使用数量。

第三十二条　建设部门要适时组织修订和完善建筑钢材使用设计规范和标准，在确保安全的情况下，降低钢材使用系数。

设计部门要严格按照设计规范和标准进行设计，把研发的经济、节约型产品及时纳入标准设计。

第三十三条　鼓励研究、开发和使用高性能、低成本、低消耗的新型材料，替代钢材。

第三十四条　鼓励钢铁企业生产高强度钢材和耐腐蚀钢材，提高钢材强度和使用寿命，降低钢材使用数量。

通过推广Ⅲ级（400mpa）及以上级别热轧带肋钢筋、各类用途的高强度钢板、h型钢等钢材品种，降低钢材消耗。

开发应用抗硫化氢、抗二氧化碳腐蚀的油井管和管线钢板、耐大气腐蚀钢板和型钢、耐火钢等产品，提高钢材的耐腐蚀性和钢材使用寿命。

第三十五条　随着市场保有钢铁产品数量增加和废钢回收量增加，逐渐减少铁矿石比例和增加废钢比重。

第九章　其它

第三十六条　咨询、设计、施工单位从事钢铁业活动，必须遵守本产业政策。相关行业协会要建立自律机制，互相监督。违反本产业政策规定的，由国家发展和改革委员会、建设部、工商管理总局等有关部门根据规定对责任人、责任单位进行处罚。

本产业发展政策是对钢铁行业的基本要求，各有关部门和行业协会可根据本产业政策制定和修订有关技术规范和相关标准。

第三十七条　规范市场秩序，维护市场稳定。鼓励钢铁企业与用户建立长期战略联盟，稳定供需关系，提高钢材加工配送能力，延伸钢铁企业服务。

第三十八条　发挥行业协会的作用，行业协会要建立和完善钢铁市场供求、生产能力、技术经济指标等方面信息定期发布制度和行业预警制度，向政府行政部门及时反映行业动向和提出政策建议，协调行业发展的重大事项，加强行业自律，引导企业的发展。

第三十九条　本产业政策由国务院授权发布，各政府行政管理部门都应遵守。对违反本产业发展政策的建设单位和行政单位，各级监察、投资、土地、工商、税务、质检、环保、商务、金融、证券监管等部门要追究其责任。

第四十条　钢铁产业发展政策，由国家发展和改革委员会组织有关部门制定、修订报国务院批准，并监督执行。

注：

1、本产业发展政策所称钢铁产业的范围包括铁矿、锰矿、铬矿采选，烧结、焦化、铁合金、炭素制品、耐火材料、炼铁、炼钢、轧钢、金属制品等各工艺及相关配套工艺。

2、跨地区投资指跨国、跨省、自治区、直辖市。

3、境外企业包括国外和在香港、澳门、台湾地区注册的企业。

EXHIBIT 8

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BIZ GUIDE

Industry Overview

Auto Industry

10th Five -Year Plan Foreign Investment WTO Commitments

The Tenth Five-Year Plan of the Automotive Industry and its Development

I. The Tenth Five-Year Plan of the automotive industry

According to the 10th Five-Year Plan, the general guidelines for developing the automotive industry in China during the period (2001-2005) is to meet the ever-increasing needs of the domestic market through opening up and accelerating 'self-development." The development of relevant spare parts will be regarded as the basis and economy cars will be the focus of development. The country will try to hasten product adjustments and upgrades. Large corporations will serve as the backbones, which will be helpful in realizing the optimization of the structure of the automotive industry and achieve mass production.

More national technical centers will be set up to enhance technique-innovation and production-development abilities. Market surroundings will be improved and management based on the legal system will be strengthened to promote fair competition. Greater efforts will be made to try to exert comparative advantages and enhance China's overall competitive ability in the world market.

1. The automotive industry's main tasks during the 10th Five-Year period

(1) China will promote strategic reorganization of the automotive industry and provide support and direction to cooperations between influencial corporations. Powerful corporations will be encouraged and supported to develop further and become bigger and stronger. Distribution of resources will be optimized and a pattern of large automobile corporation groups will be established. A supplementary system of auto parts manufacturing will also be developed to improve competitive ability.

(2) Step by step, China will enhance the independent ability to develop and spread new products,techniques, materials and energy sources actively to encourage the advancement of techniques, accelerate development of the automotive industry and upgrade automobile products.

(3) High and new technologies will be employed to develop key automobile spare parts, which will gain either a comparative advantages or larger developmental potential. Efforts will be made to enhance the country's ability to develop new products and strengthen the competitive ability to realize the simultaneous development of spare parts with whole vehicles and take part in the international division of labor.

(4) A perfectly functioning modern marketing system and sourcing network will be developed to make use of the resources reasonably and efficiently and to provide the consumer with all-round services.

(5) The country will bring out its comparative advantages and strengthen cooperation with foreign corporations in economy and technique to cultivate its own exceptional products in the automotive industry. Efforts will be made to extend the international market and promote the exporting of China-made automobile products.

2. The automotive industry's main targets

Based on the objectives of the 10th Five-Year Plan from the above-mentioned tasks, China's automotive industry will achieve the following goals by 2005.

(1) Output volume: The annual output of motor vehicles in China will be around 3.20 million, 1.1 million of which will be cars. The industrial added value of motor vehicles in China will total 130 billion yuan (US$15.66 billion), accounting for about 1 percent of the Gross Domestic Product. The domestic need for automobiles will nearly be satisfied. Income from automobile and spare-parts exports will account for 8 percent of the total.

(2) The structural adjustment of corporations: Two to three large automobile corporation groups with a competitive world ability will come into being. The sales and after-sales-services systems of such companies, which reflect international standards, will be established. More than 70 percent of the domestic market share will be held by the corporations and some of their products will be exported. Five to 10 large auto spare-parts corporation groups with a preliminary competitive world ability will also appear and 70 percent of the domestic market share will be held by the top three groups. The corporations' spare-parts export value will account for 20 percent of the total sales value. Three to four motorcycle corporation groups, also with a competitive world ability, will also be established.

(3) The adjustment of product structure: The purpose of the adjustment is to increase the number of cars among allmotor vehicles and heavy and specialized vehicles among the total number of loading vehicles. The amount of diesel-loading vehicles and light-diesel passenger cars will also be boosted, and all mid-sized vehicles will be equipped with diesel engines.

While the production of diesel cars and mini vehicles will be launched, the number of gas-fueled buses and taxis will also be increased. By 2005, the total numberof cars will top 35 percent from 29.2 percent in 2000. The number of diesel vehicles will climb to about 35 percent from 29.7 percent in 2000. Vehicles powered by substitute fuels will account for more than 2 percent of the total. The systematic and modularized ability of spare-parts and increase the number of high-tech spare parts with added value. The export volume of spare parts will also be increased. At the end of the 10th Five-Year Plan, gas vehicles with carburetors will no longer be produced.

(4) The adjustment of technical structure: By the end of the 10th Five-Year Plan, the performance and quality of automobiles and key spare parts will reach the level of similar products in the world. The details are as follows:

i. Product safety will be improved greatly. All new large and mid-sized passenger cars and heavy-duty vehicles will be equipped with an anti-lock braking system (ABS); the number of cars with ABS and airbags will also be boosted. Equipped with features designed to minimize damages in head-on collisions, new cars and mini passenger cars will also be fitted with technology reducing the impact of side collisions.

ii. In non-diesel vehicles, electric, closed-loop fuel-supply systems will be popularized and three-level catalyzed transformation fittings will be introduced;, burning with thin air, changeable gas levels and straight spraying within the cylinder will also be widespread. Diesel vehicles will be equipped with oxygenized catalyzed transformation fittings, and added-pressure techniques, middle cooling and shared diesel-engine rails will also be adopted.

Gas emissions in new cars, light and mini vehicles, large and mid-sized passenger cars and mid- to heavy-duty vehicles will meet Euro II emissions standards, and some mid- to top-grade cars, as well as large and mid-sized top-grade passenger cars will meet Euro III standards. Gas emissions in four-wheel agricultural vehicles will also be gradually improved and equipped with multiple cylinders that meet Euro I standards. Gas emissions standards of various vehicles produced around 2010 will reach the international level.

iii. The utilization coefficient of non-diesel vehicles will be improved. Gas consumption per every 100 miles will also be decreased by an average 10 percent. The reduced consumption levels of cars and light vehicles will range between 5-10 percent and the corresponding figure for mid and heavy vehicles will be 10-15 percent. The number of automobiles powered by a substitute fuel will rise so that auto fuel need and supply in China can be optimized.

iv. At the end of the Tenth Five-Year Plan, two to three of the nation's whole vehicle-development centers will be set up. Chinese corporations must play a major role in the development of loading vehicles. The development of cars can be realized via a cooperation between Chinese and foreign corporations, and China should be capable to develop economical cars with independent intellectual property rights that can compete in the world market. Six to eight national development centers for spare parts will be also be set up to meet the need of expanding whole-vehicle manufacturers.

II. The development of the domestic automotive industry

According to the National Bureau of Statistics, the total number of auto-manufacturing corporations in China was 5,228 in 2000. Among them 119 were whole-vehicle producers, 780 were re-equipped-vehicle producers and 143 were motorcycle producers. Staff members totaled about 1,465,000 and the net value of fixed assets was about 163.3 billion yuan. By the end of 2000, total assets were valued at about 564.2 billion yuan. The annual output of the entire automobile-manufacturing industry was about 2,069,000 units in 2000 with a sales volume of 2,089,000, ranking eighth in the world. The number of finished products in storage totaled 186,000 at the end of 2000 with a total output value of 371 billion yuan and sales value of 391 billion yuan.

Among the 119 whole-vehicle producers, there were nine corporations whose individual output totaled more than 100,000 units (total output was 1,652,000, accounting for 79.9 percent of the total); four corporations had an individual output of more than 200,000 (total output was 1,090,000, accounting for 52.7 percent of the total). Corporations with an individual output of more than 100,000 units were FAW Group, with an annual output of 424,000; Shanghai Volkswagen Automotive Co Ltd, with 253,000; Dong Feng Motor Corp, with 211,000); Chang'an Automobile Co Ltd, with 203,000; Beijing Automotive Industry Group Co, with 125,000; Hafei Motor Co Ltd, with 122,000; Liuzhou Wuling Automobile Co Ltd, with 112,000; Changhe Airplane Industry Co, with 103,000; and Tianjin Automotive Industry Corporation, with 102,000.

Among the 2,069,000 automobiles produced in 2000 63.1 percent were passenger vehicles. Detailed information regarding the sales and production of different vehicles is as follows:

1. Heavy-loading vehicles: There are 19 corporations in total with an output and the sales volume of 82,000 and 83,000 units respectively. The market share of five corporations – Dong Feng Motor Corp, FAW Group Corporation of China, Sichuan Automobile Co, Shanxi Automobile Co and Chongqing Automobile Co -- is 97.1 percent. FAW's market share is 58.9 percent.

2. Middle-loading vehicles: There are 11 corporations in total with an output and sales volume of 154,000 and 163,000 units respectively. FAW's and Dong Feng's market shares are 47.4 and 46.6 percent respectively.

3. Light-loading vehicles: There are 46 corporations in total with an output and sales volume of 391,000 and 397,000 units respectively. Beijing Automotive's market share is 25.2 percent, ranking first among its domestic counterparts.

4. Mini vehicles: There are 11 corporations in total with an output and sales volume of 138,000 and 132,000 units respectively. Liuzhou Wuling's market share is 41.7

percent, ranking first among its domestic counterparts. Chang'an Automobile is in second place with a market share of 31 percent.

5. Large passenger cars: There are 14 corporations in total with an output and sales volume of 7,953 and 7,743 respectively. Dong Feng's and Liaoning Huanghai's total market share is 36.8 percent, with an output and sales volume of over 1,000 units each.

6. Mid-sized passenger cars: There are 17 corporations in total with an output and sales volume of 36,000 units. FAW's market share is 34.2 percent, ranking first its domestic counterparts. Dong Feng, Jiangsu Yaxing, Changzhou Changjiang and Liaoning Huanghai also have relatively high market shares.

7. Light passenger cars: There are 51 corporations in total with an output and sales volume of 248,000 units. FAW, Yue Jin Co and Hefei Jianghuai Co are the top three companies in terms of market share.

8. Mini passenger cars: There are eight corporations in total with an output and sales volume of 408,000 and 420,000 units respectively. Hafei Motor Co Ltd's market share is 27.3 percent, ranking first among its domestic counterparts. The second is Chang'an Automobile Co Ltd, whose market share is 24.6 percent, followed by Changhe Airplane Co at 21.5 percent.

9. Saloon cars: There are 13 corporations in total with an output and sales volume of 605,000 and 613,000 respectively. Shanghai Volkswagen Automotive Co Ltd's market share is 36.3 percent, ranking first among its domestic counterparts. The second is FAW , whose market share is 18.2 percent, followed by Tianjing Automotive Industry Corporation at 14.7 percent. Shenlong ranks fourth with a market share of 8.5 percent followed by Chang'an at 7.7 percent. Major market brands include the Santana, XiaLi, Jetta, FuKang and Chang'an Aotuo.

In 2002, the automotive industry's output was 3.4774 million units -- an increase of 38.5 percent over the previous year. From that figure, loading vehicle, passenger car and Saloon output was 1.2453 million, 0.9171 million and 1.0624 million units respectively -- an increase of 35, 27.2 and 52.8 percent respectively over the previous year.

From January to November 2002, the total production value in the automotive industry reached 624.929 billion yuan, climbing 32.87 percent over the same period in 2001; sales value and profits amounted to 611.808 billion and 40.806 billion yuan respectively -- up 33.25 and 68.2 percent over the same period in the previous year.

During January-May 2003, the output volume of the automotive industry was 1.7756 million units -- a hike of 32.1 percent over the previous year. From that figure, loading vehicle, passenger car and Saloon output was 0.5078 million, 0.4323 million and 0.7242 million units respectively -- rising 0.9, 11.9 and 105 percent respectively over the same period in 2002.
During January-February 2003, the production value of the automotive industry totaled 118.6 billion yuan calculated at the current value -- an increase of 56 percent over the same period in 2002.

EXHIBIT 9

USTR 2006
National Trade
Estimate Report
on Foreign
Trade Barriers

CHINA

TRADE SUMMARY

The U.S. goods trade deficit with China was $201.6 billion in 2005, an increase of $40 billion from $161.9 billion in 2004. U.S. goods exports in 2005 were $41.8 billion, up 20 percent from the previous year. Corresponding U.S. imports from China were $243.5 billion, up 24 percent. China is currently the 4th largest export market for U.S. goods.

U.S. exports of private commercial services (i.e., excluding military and government) to China were $7.2 billion in 2004 (latest data available), and U.S. imports were $5.6 billion. Sales of services in China by majority U.S.-owned affiliates were $3.8 billion in 2003 (latest data available), while sales of services in the United States by majority China-owned firms were not available in 2003 ($321 million in 2002).

The stock of U.S. foreign direct investment (FDI) in China in 2004 was $15.4 billion, up from $11.5 billion in 2003. U.S. FDI in China is concentrated largely in the manufacturing, wholesale, and mining sectors.

Since joining the WTO in December 2001, China has taken steps to implement its numerous WTO commitments. With most of China's key commitments scheduled to be phased in fully by December 2004, this past year provided a first critical glimpse at what to expect of China as a WTO member with its full range of commitments in place. At this point, however, China's implementation work is still incomplete. While China has made important progress in implementing specific commitments and in adhering to the ongoing obligations of a WTO member, there are still serious problems in some important areas, especially in the enforcement of intellectual property rights (IPR). Many of the shortfalls in China's WTO compliance efforts seem to stem from China's incomplete transition from being a state-planned economy. China has not yet fully embraced the key WTO principles of market access, non-discrimination and national treatment, nor has China fully institutionalized market mechanisms and made its trade regime predictable and transparent. Although China implemented some key reforms, it continued to use an array of industrial policy tools in 2005 to promote or protect favored sectors and industries, and these tools at times collide with China's WTO obligations.

The Administration utilized high-level engagement, expert-to-expert discussions and WTO mechanisms to address the problems that arose and, in particular, initiated a comprehensive new strategy for obtaining improvements in China's IPR enforcement. Many of these efforts culminated in a meeting of the Joint Commission on Commerce and Trade (JCCT) in July 2005, co-chaired by Vice Premier Wu Yi on the Chinese side and Secretary of Commerce Gutierrez and United States Trade Representative Portman on the U.S. side. That meeting achieved measured progress on a range of concerns, but it fell short of realizing the many win-win outcomes of the previous JCCT meeting, held in April 2004. Nevertheless, China did agree to take several specific actions in support of its WTO commitment to significantly reduce IPR infringement levels, to initiate technical consultations with WTO members to accelerate its efforts to join the WTO Government Procurement Agreement and to schedule telecommunications and insurance dialogues to discuss market access issues in those sectors. While U.S. stakeholders generally hold the view that China's economic reforms have improved the climate for U.S. exporters and investors, serious challenges remain, and many U.S. businesses are still not able to maximize their opportunities in the Chinese market. Areas that continue to generate significant problems include inadequate enforcement of laws, particularly in the IPR area, industrial policies, services, agriculture and an overall lack of transparency in the regulatory environment.

In the IPR area, while China has made noticeable improvements to its framework of laws and regulations, the lack of effective IPR enforcement remains a major challenge. Building on its engagement with China at the April 2004 JCCT meeting, the United States took several aggressive steps in 2005 in an effort to obtain meaningful progress. First, the United States conducted an out-of-cycle review under the Special 301 provisions of U.S. trade law. At the conclusion of this review in April 2005, the Administration elevated China to the Special 301 "Priority Watch" list and set forth a comprehensive strategy for addressing China's ineffective IPR enforcement regime, which included the possible use of WTO mechanisms, as appropriate. The United States immediately began to pursue this strategy during the run up to the July 2005 JCCT meeting, and China subsequently agreed to take a series of specific actions designed to increase criminal prosecutions of IPR violators, improve enforcement at the border, combat piracy of movies, audio visual products and software, address Internet-related piracy and assist small and medium-sized U.S. companies experiencing China-related IPR problems, among other things. Because lack of transparency on IPR infringement levels and enforcement activities in China has hampered the United States' ability to assess the effectiveness of China's efforts to improve IPR enforcement since the April 2004 JCCT meeting, the United States also submitted a transparency request to China under Article 63.3 of the TRIPS Agreement in October 2005. The U.S. request, made in conjunction with similar requests by Japan and Switzerland, seeks detailed information from China on its IPR enforcement efforts over the last four years.

China has also increasingly resorted to industrial policies that limit market access by non-Chinese origin goods or rely on substantial government resources to support increased exports. The objective of these policies seems to be to support the development of Chinese industries by effectively mandating local content of products that are higher up the economic value chain than the industries that make up China's current labor-intensive base, or simply to protect less-competitive domestic industries. In 2005, examples of these industrial policies are readily evident. They include the issuance of regulations on automotive parts tariffs that discourage the use of imported parts, the telecommunications regulator's interference in commercial negotiations over royalty payments to intellectual property rights holders in the area of 3G standards, the pursuit of unique national standards in many areas of high technology that could lead to the extraction of technology or intellectual property from foreign rights holders, draft government procurement regulations mandating purchases of Chinese-produced software, a new steel industrial policy that calls for the state's management of nearly every major aspect of China's steel industry, continuing export restrictions on coke, and excessive government subsidization benefiting a range of domestic industries in China. Some of these policies may raise concerns with respect to China's WTO commitments in the areas of market access, national treatment, subsidies disciplines and technology transfer, among others.

In the area of services, concerns in many sectors remain, largely due to arbitrary and non-transparent policies, delays in the issuance of regulatory measures, and China's use of entry threshold requirements that exceed international norms. Indeed, Chinese regulatory authorities continue to frustrate efforts of U.S. providers of distribution, direct selling, franchising, insurance, construction and engineering, telecommunications and other services to achieve their full market potential in China.

In the area of agriculture, while the United States was able to reach agreement on and initial a Memorandum of Understanding in July 2005 to facilitate cooperation on animal and plant health safety issues and improved U.S. access to China's markets for agricultural commodities, agricultural trade with China remains among the least transparent and predictable of the world's major markets. Capricious practices by Chinese customs and quarantine officials can delay or halt shipments of agricultural products into China, while sanitary and phytosanitary (SPS) standards with questionable scientific bases and a generally opaque regulatory regime frequently bedevil traders in agricultural commodities.

Transparency concerns cut across sectors, as China's various regulatory regimes continue to suffer from systemic opacity, frustrating efforts of foreign – and domestic – businesses to achieve the potential benefits of China's WTO accession. Although China has taken steps to improve transparency across a wide range of national and provincial regulatory authorities, particularly at the Ministry of Commerce (MOFCOM), many other ministries and agencies have made less than impressive efforts to improve their transparency.

Overall, while China has a more open and competitive economy than 25 years ago, and China's WTO accession has led to the removal of many trade barriers, there are still substantial barriers to trade that have yet to be dismantled. The central government continues to implement industrial policies and protect noncompetitive or emerging sectors of the economy from foreign competition. In many sectors, import barriers, opaque and inconsistently applied legal provisions, and limitations on foreign direct investment often combine to make it difficult for foreign firms to operate in China. In addition, some ministries, agencies and government-sponsored trade associations have renewed efforts to erect new technical barriers to trade. Meanwhile, many provincial governments at times have strongly resisted reforms that would eliminate sheltered markets for local enterprises or reduce jobs and revenues in their jurisdictions, although they have also supported market access for other foreign investors that do not pose a threat to local vested interests.

If China is to complete the implementation of its WTO commitments and institutionalize market-oriented reforms, it will need to eliminate mechanisms that allow government officials to intervene in the Chinese economy in a manner that is inconsistent with market principles. Despite its remarkable transformation over the past quarter century, China continues to suffer from its command economy legacy. As a result, Chinese economic policy-making often operates in a way that prevents U.S. businesses from achieving their full potential in the China market. As U.S. expectations shift from the establishment of basic regulations and implementation of specific WTO commitments to measurable improvements in market access for U.S. products and services, there will be decreasing tolerance for Chinese efforts to protect domestic industries.

In early 2006, the Administration completed a USTR-led interagency "top-to-bottom" review of the United States' China trade policy. Recognizing the importance of the United States' trade relationship with China and the challenges that confront the United States in that relationship, the Administration issued a report concluding that the United States is entering an important new phase in its relationship with China. While U.S. trade policy for the past 20 years had been focused principally on encouraging market-based reforms and bringing China into the international trading system, the report explained that the end of China's transition period as a new WTO member was drawing near, and it recommended that U.S. trade resources and priorities should be readjusted to meet new challenges. Specifically, in addition to strengthening the United States' current focus on China's WTO compliance and adherence to international norms, the report urged that more focus be put on ensuring that: (1) the bilateral trade relationship offers more balanced opportunities and is equitable and durable; (2) U.S. trade policymaking is more proactive and informed by more comprehensive information regarding China's economic trends and developments and stronger coordination within the Executive branch and between the Executive and Congressional branches; (3) China participates more fully in the global trading system as a responsible trading partner; and (4) the U.S. remains an active and influential economic and trading power in the Asia Pacific region. Based on the results of the interagency review, the Administration committed to take a series of actions to help ensure that the United States is best positioned to meet its key China trade objectives. Among other things, the Administration committed: (1) to expand USTR's trade enforcement capacity; (2) to expand USTR's capability to obtain and process comprehensive, forward-looking information about the U.S.-China trade relationship; (3) to expand U.S. trade resources in Beijing; (4) to strengthen interagency coordination and the Executive-Congressional partnership on China trade; and (5) to increase coordination with other trading partners on China trade issues. The Administration also committed to strengthen, expand and increase the effectiveness of the U.S.-China dialogue on needed structural economic reforms and numerous specific issues, such as standards and SPS issues, China's subsidies practices, financial services, telecommunications services, labor, environmental protection, and transparency and the rule of law, among other issues.

IMPORT REGULATION

Prior to its WTO accession in December 2001, China restricted imports through high tariffs and taxes, quotas and other non-tariff measures, and restrictions on trading rights. Beginning in 2002, its first year in the WTO, China significantly reduced tariff rates on many products and the number of goods subject to import quotas, expanded trading rights for Chinese enterprises, and increased the transparency of its licensing procedures. Since then, China has continued to make progress by implementing tariff reductions on schedule, phasing out import quotas and expanding trading rights for foreign enterprises and individuals, although some serious problems remain, such as China's tariff treatment of imported automotive parts.

Trading Rights

Prior to its WTO accession, China restricted the types and numbers of entities with the right to trade. Only those domestic and foreign firms with trading rights could import goods into, or export goods out of, China. Restrictions on the type and number of firms with trading rights contribute to systemic inefficiencies in China's trading rights system and create substantial incentives to engage in smuggling and other corrupt practices.

Liberalization of China's trading rights system had been proceeding gradually since 1995. The pace accelerated in 1999 when MOFCOM's predecessor, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), announced new guidelines allowing a wide variety of Chinese firms with annual export volumes valued in excess of $10 million to register for trading rights. In August 2001, China extended this regulation to allow foreign-invested firms to export their finished products. Import rights of foreign-invested firms were still restricted to the importation of inputs, equipment and other materials directly related to their manufacturing or processing operations. Firms and individuals without trading rights, including foreign-invested firms with a manufacturing presence in China seeking to import products made outside of China, were required to use a local agent.

In its WTO accession agreement, China committed to substantial liberalization in the area of trading rights. Specifically, China committed to eliminate its system of examination and approval of trading rights and to make full trading rights automatically available to all Chinese enterprises, Chinese-foreign joint ventures, wholly foreign-owned enterprises and foreign individuals, including sole proprietorships, within three years of its accession, or by December 11, 2004, which was the same deadline for China to eliminate most restrictions in the area of distribution services. China further committed to expand the availability of trading rights pursuant to an agreed schedule during the first three years of its WTO membership.

Although China did not fully adhere to the agreed phase-in schedule in some instances, it has put in place a registration system implementing the required liberalization of trading rights, both for Chinese enterprises and for Chinese-foreign joint ventures, wholly foreign-owned enterprises and foreign individuals, including sole proprietorships. This liberalization is reflected in China's revised Foreign Trade Law, issued in April 2004 by the National People's Congress. It provides for trading rights to be automatically available through a registration process for all domestic and foreign entities and individuals, effective July 1, 2004, almost six months ahead of the scheduled full liberalization required by China's accession agreement. In June 2004, MOFCOM issued implementing rules setting out the procedures for registering as a foreign trade operator. U.S. companies have reported few problems with the new trading rights registration process, although China's slow progress in implementing related distribution services commitments has made these new rights less meaningful for some U.S. companies.

In December 2004, as required by its WTO accession agreement, China also ended its practice of granting import rights or export rights for certain products – steel, natural rubber, wools, acrylic and plywood – only to designated enterprises. Any domestic or foreign enterprise or individual can now trade in these products.

Consistent with the terms of China's WTO accession agreement, the importation of some goods, such as petroleum and sugar, is still reserved for state trading enterprises. In addition, for goods still subject to tariff-rate quotas such as grains, cotton, vegetable oils and fertilizers, China reserves a portion of the in-quota imports for state trading enterprises, while it committed to make the remaining portion (ranging from 10 percent to 90 percent depending on the commodity) available for importation through non-state traders. In some cases, the percentage available to non-state traders increases annually for a set number of years.

Meanwhile, China has not yet implemented its trading rights commitments insofar as they relate to the importation of books, newspapers and magazines. Under the terms of China's accession agreement, China's trading rights commitments apply fully to books, newspapers and magazines, as they are not among the products for which China reserved the right to engage in state trading. As a result, trading rights for books, newspapers and magazines should have been automatically available to all Chinese enterprises, Chinese-foreign joint ventures, wholly foreign-owned enterprises and foreign individuals as of December 11, 2004. Nevertheless, China continues to wholly reserve the right to import books, newspapers and magazines to state trading enterprises.

China has also not yet implemented its trading rights commitments insofar as they relate to the importation of pharmaceuticals. Even though China's accession agreement creates no exception for pharmaceuticals, and trading rights should have been automatically available to foreign pharmaceutical companies as of December 11, 2004, China still requires foreign pharmaceutical companies to hire Chinese importers to bring their finished products into the country (and it also requires them to sell their finished products through Chinese wholesalers).

Import Substitution Policies

Throughout the 1990s, China gradually reduced formal import substitution policies. In its WTO accession agreement, China committed that it would not condition import or investment approvals on whether there are competing domestic suppliers or imposes other performance requirements. In anticipation of this commitment, China enacted legal changes in 2000 and 2001 to eliminate local content requirements for foreign investments. Under the prevailing rules, however, investors are still "encouraged" to follow some of the formerly mandated practices. Instances in which the Chinese Government has reportedly pursued import substitution or similar policies are described below.

Corporate Tax Deductions to Foreign-Invested Firms

The State Administration for Taxation (SAT) in May 2005 issued Circular No. 488/2005 that allows foreign-invested firms to deduct the costs of domestic-manufactured equipment from their corporate income taxes. According to the notice, equipment manufactured in China is eligible for the tax deduction but equipment assembled in China from imported parts is not eligible.

Automotive Parts

Before China's WTO accession, China's automobile industrial policy offered significant advantages for foreign-invested factories using high-levels of local content. In 2001, in anticipation of China's new obligations as a WTO Member, the State Economic and Trade Commission (SETC) issued Bulletin No.13, which provided that the preferential policy for automobile localization rates would be cancelled upon China's WTO accession. However, U.S. automobile manufacturers reported that some local government officials continued to require local content and cited the old automobile industrial policy's standards. China also committed to issue a revised automotive industrial policy within two years of its WTO accession, or by December 11, 2003, but missed this deadline. In May 2004, China issued a new automobile industrial policy. It included provisions discouraging the importation of auto parts and encouraging the use of domestic technology. It also included a number of vague provisions, such as in the area of complete knocked-down automotive kits, whose implementation will warrant close scrutiny.

In 2005, China issued measures implementing the new automobile industrial policy. One problematic measure is the *Measures on the Importation of Parts for Entire Automobiles*, which was issued by the National Development and Reform Commission (NDRC) in February 2005 and became effective in April 2005. These new rules require manufacturers in China to register the parts they use in the assembly of new automobiles, and if the number or value of imported parts exceeds specified thresholds, China's General Administration of Customs will apply the tariff rate assessed a complete automobile on each of the various imported parts rather than the tariff rate applicable to an individual part. China's bound and applied tariff rates for complete automobiles are significantly higher than the tariff rates for imported auto parts. The new rules appear to improperly condition tariff treatment on local content and to result in the imposition of a tariff on automotive parts in excess of the bound rate.

Steel

China issued a new Steel and Iron Industry Development Policy in July 2005. Although many aspects of this new policy have not yet been implemented, it still includes a host of objectives and guidelines that raise serious concerns. For example, this policy appears to discriminate against foreign equipment and technology imports. Like other measures, this policy encourages the use of local content by calling for a variety of government financial support for steel and iron projects utilizing newly developed domestic equipment. Even more troubling, however, it calls for the use of domestically produced steel-manufacturing equipment and domestic technologies whenever domestic suppliers exist, apparently in contravention of the commitment in China's accession agreement not to condition the right of investment or importation on whether competing domestic suppliers exist.

Semiconductors

China's 10th Five-Year Plan calls for an increase in Chinese semiconductor output from $2 billion in 2000 to $24 billion in 2010. In pursuit of this policy, China has attempted to encourage the development of China's domestic integrated circuit (IC) industry through, among other things, discriminatory VAT policies. In particular, through a series of measures, China has provided for the rebate of a substantial portion of the 17 percent VAT paid by domestic manufacturers on their locally produced ICs. China, meanwhile, charged the full 17 percent VAT on imported ICs, unless they were designed in China. After bilateral meetings on this issue failed to yield a change in China's policy, in March 2004, the United States filed the first and to date only WTO case against China. In the ensuing consultations, China signaled its willingness to discuss a possible resolution. In July 2004, the United States and China reached a settlement in which China agreed to immediately cease certifying new Chinese IC manufacturers or products as eligible for the VAT rebate and to issue the necessary regulations to eliminate the VAT rebate entirely by November 1, 2004, with an effective date no later than April 1, 2005. China also agreed to repeal the relevant implementing rules that had made VAT rebates available for ICs designed in China but manufactured abroad by September 1, 2004, with an effective date no later than October 1, 2004. China followed through on each of these agreed steps in a timely manner, and the two sides notified the WTO in October 2005 that their dispute had been satisfactorily resolved. Nevertheless, the United States continues to monitor closely new financial support that China is making available to its domestic producers for consistency with the WTO Subsidies Agreement's disciplines.

Fertilizer

In 2001, China began exempting all phosphate fertilizers except diammonium phosphate (DAP) from the VAT. DAP, a product that the United States exports to China, competes with other phosphate fertilizers produced in China, particularly monoammonium phosphate. Both the United States Government and U.S. producers have complained that China has employed its VAT policies to benefit domestic fertilizer production.

Telecommunications Equipment

There have been continuing reports of Ministry of Information Industry (MII) and China Telecom adopting policies to discourage the use of imported components or equipment. For example, MII has reportedly still not rescinded an internal circular issued in 1998 instructing telecommunications companies to buy components and equipment from domestic sources.

Tariffs and Other Import Charges

Under the terms of its WTO accession, China committed to substantial annual reductions in its tariff rates, with most of them taking place within five years of China's WTO accession. The largest reductions took place in 2002, immediately after China acceded to the WTO, when the overall average tariff rate fell from over 15 percent to 12 percent.

China's post-WTO accession tariff rates are "bound," meaning that China cannot raise them above the bound rates without "compensating" WTO trading partners, i.e., re-balancing tariff concessions or, in accordance with WTO rules, being subject to withdrawal of substantially equivalent concessions by other WTO members. "Bound" rates give importers a more predictable environment. China may also apply tariff rates significantly lower than the WTO-required rate, as in the case of goods that the government has identified as necessary to the development of a key industry. For example, China's Customs Administration has occasionally announced preferential tariff rates for items that benefit key economic sectors, in particular for the automotive, steel and chemical industries.

China's WTO accession commitments are having a dramatic effect on tariffs for many products of interest to the United States. As in prior years, China implemented its scheduled tariff reductions for 2005 on schedule. These tariff reductions further increased market access for U.S. exporters in a range of industries, as China continued the process of reducing tariffs on goods of greatest importance to U.S. industry from a base average of 25 percent (in 1997) to 7 percent over a period of five years, running from January 1, 2002, while it made similar reductions throughout the agricultural sector (see the Agriculture section below). The reductions made on January 1, 2005, involved a range of sectors, including motor vehicles and motor vehicle parts, office machinery, large appliances, furniture and chemicals, and contributed to another significant increase in U.S. exports, which rose approximately 17 percent from January through September 2005, when compared to the same time period in 2004.

In one of its more significant tariff initiatives, China continued its participation in the Information Technology Agreement (ITA), which requires the elimination of tariffs on semiconductors and semiconductor manufacturing equipment, computers and computer parts, software, telecommunications equipment, computer-based analytical instruments and other information technology products. China began reducing and eliminating these tariffs in 2002 and continued to do so in the ensuing years, achieving the elimination of all ITA tariffs on January 1, 2005, as tariffs on ITA products dropped to zero from a pre-WTO accession average of 13.3 percent. U.S. exports of ITA goods continued to perform well in 2005, as they were projected to exceed $5 billion by the end of the year, although they did decrease by 12 percent from January through September 2005, when compared to the same time period in 2004.

China also continued its timely implementation of another significant tariff initiative, the WTO's Chemical Tariff Harmonization Agreement. U.S. chemical exports covered by this agreement increased by 36 percent from January through September 2005 and were projected to reach $5.8 billion by the end of the year, well above 2004's healthy total of $4.7 billion.

Meanwhile, exports of some bulk agricultural commodities have increased dramatically in recent years, particularly cotton and wheat, while exports of soybeans continued to perform strongly, totaling $1.2 billion for the first nine months of 2005. Exports of forest products such as lumber performed strongly, increasing by 26 percent for the first nine months of 2005, with a projected year-end total of $477 million. Fish and seafood exports, after having increased from $119 million in 2001 to $135 million in 2002, and then to $176 million in 2003 and $258 million in 2004, rose by another 41 percent in the first nine months of 2005 and were projected to reach $363 million by the end of the year. Meanwhile, exports of consumer-oriented agricultural products increased by only 4 percent from January through September 2005, when compared to the same period in 2004, although they were still projected to exceed $500 million by the end of the year.

However, China still maintains high duties on some products that compete with sensitive domestic industries. For example, the tariff on large motorcycles will only fall from 60 percent to 45 percent. Likewise, most video, digital video and audio recorders and players still face duties of around 30 percent. Raisins face duties of 35 percent.

Tariff Classification

Chinese customs officers have wide discretion in classifying a particular import. While foreign businesses might at times have benefited from their ability to negotiate tariff classification into tariff categories with lower import duty rates, lack of uniformity makes it difficult to anticipate border charges.

Recent foreign and joint venture auto manufacturing entrants to the Chinese market complain about disparate treatment under tariff classification rules. They are less able than domestic manufacturers and the early joint venture entrants to assemble cars with locally manufactured components, and their knock-down kits imported for assembly in China are more likely to be classified as complete vehicles than are the kits imported by domestic manufacturers and the early joint venture entrants.

Customs Valuation

In January 2002, shortly after acceding to the WTO, China's Customs Administration issued the *Measures for Examining and Determining Customs Valuation of Imported Goods*. This measure addressed the inconsistencies that had existed between China's customs valuation methodologies and the Agreement on Customs Valuation.

The Customs Administration subsequently issued the *Rules on the Determination of Customs Value of Royalties and License Fees Related to Imported Goods*, effective July 2003. This measure was intended to clarify provisions of the January 2002 measure that address the valuation of royalties and license fees. In addition, by December 11, 2003, China had issued a measure on interest charges and a measure requiring duties on software to be assessed on the basis of the value of the underlying carrier medium, meaning, for example, the floppy disk or CD-ROM itself, rather than based on the imputed value of the content, which includes, for example, the data recorded on a floppy disk or CD-ROM.

Nevertheless, China has not uniformly implemented these various measures. U.S. exporters continue to report that they are encountering valuation problems at many ports. For example, even though the January 2002 and July 2003 measures provide that imported goods normally should be valued on the basis of their transaction price, meaning the price the importer actually paid, nearly four years later, many Chinese customs officials are still improperly using "reference pricing," which usually results in a higher dutiable value. In 2005, China appeared to continue its efforts to eliminate the use of "reference pricing," although it still occurs at many ports.

In addition, some of China's customs officials are reportedly not applying the provisions in the January 2002 and July 2003 measures as they relate to software royalties and license fees. Following their pre-WTO accession practice, these officials are still automatically adding royalties and license fees to the dutiable value (for example, when an imported personal computer includes pre-installed software), even though China's July 2003 measure expressly directs them to add those fees only if they are import-related and a condition of sale for the goods being valued. While some improvement appears to have taken place with regard to the valuation of royalties and license fees since the issuance of the July 2003 measure, that measure has not led to uniform, WTO-consistent implementation by China's customs officials in this area.

Beginning in 2004, U.S. exporters also complained about the Customs Administration's handling of imports of digital media that contain instructions for the subsequent production of multiple copies of products such as DVDs. The Customs Administration has been inappropriately assessing duties based on the estimated value of the yet-to-be-produced copies.

Rules of Origin

In September 2004, nearly three years after China acceded to the WTO, the State Council finally issued the regulations intended to bring China's rules of origin into conformity with WTO rules for import and export purposes. These regulations took effect on January 1, 2005, although necessary implementing rules are still being drafted. Nevertheless, importers have not reported problems stemming from inappropriate application of rules of origin.

Border Trade

China's border trade policy continues to generate MFN and other concerns. China provides preferential import duty and VAT treatment to certain products, often from Russia, apparently even when those products are not confined to frontier traffic as envisioned by Article XXIV of GATT 1994. China addressed some of these concerns in 2003 when it eliminated preferential treatment for boric acid and 19 other products. Nonetheless, it appears that large operators are still able to take advantage of border trade policies to import bulk shipments across China's land borders into its interior at preferential rates. In addition, U.S. industry reports that China continues to use border trade policies to provide preferential treatment for Russian timber imports, to the detriment of U.S. timber exporters.

Antidumping, Countervailing Duty and Safeguard Measures

Since acceding to the WTO, China has emerged as a significant user of antidumping measures, with a total of 67 antidumping measures covering 19 countries currently in place and 42 antidumping investigations in progress. China continued to actively apply its antidumping law in 2005, initiating several new investigations, four of which involved U.S. exports. Chemical products remain the most frequent target of Chinese antidumping actions.

Most of the rules and regulations used by MOFCOM to conduct its antidumping investigations were issued as provisional measures by MOFCOM's predecessor agencies – MOFTEC and the State Economic and Trade Commission – shortly after China acceded to the WTO. While these measures generally represent good-faith efforts to implement the relevant WTO commitments and to improve China's pre-WTO accession measures, they also contain vague language, have gaps in areas of practice and allow inordinate discretion. Meanwhile, China's handling of antidumping investigations and reviews continues to raise concerns in key areas such as transparency and procedural fairness. Concerns with transparency, including access to information, are especially acute with regard to the injury portion of investigations.

To date, China has not initiated a countervailing duty investigation. China's only safeguard measure was removed at the end of 2003 after being in place for less than two years.

The Supreme People's Court has issued a judicial interpretation covering the review of antidumping and other trade remedy decisions. To date, however, judicial review of these types of decisions remains untested.

In one antidumping investigation involving imports of kraft linerboard from the United States, following an affirmative final determination and the imposition of antidumping duties in September 2005, the affected U.S. exporters filed for administrative reconsideration with MOFCOM in which it raised concerns with various aspects of the final determination, particularly the injury finding. Immediately after the United States notified China that it also intended to commence dispute settlement at the WTO, MOFCOM issued a decision repealing the antidumping order.

Non-Tariff Barriers

China's WTO accession agreement obligated China to address many of the non-tariff barriers it had historically used to restrict trade. For example, China is obligated to phase out its import quota system, apply international norms to its testing and standards administration, remove local content requirements, and make its licensing and registration regimes transparent. At the national level, China made progress following its WTO accession in reforming its testing system, revising regulations requiring local content, and improving overall regulatory transparency, including in the licensing area. Despite this progress, however, as China's trade liberalization efforts moved forward, some non-tariff barriers remained in place and others were added.

Four years after China's WTO accession, many U.S. industries complain that they face significant non-tariff barriers to trade, which are discussed in more detail in various sections below. These barriers include, for example, regulations that set high thresholds for entry into service sectors such as banking, insurance and telecommunications, selective and unwarranted inspection requirements for agricultural imports and the use of questionable sanitary and phytosanitary measures to control import volumes. Many U.S. industries have also complained about China's manipulation of technical regulations and standards to favor domestic industries.

Import Quotas

In the past, China often did not announce import quota amounts or the process for allocating import quotas. China set import quotas through negotiations between central and local government officials at the end of each year. Import quotas on most products were eliminated or are scheduled for phase-out under the terms of China's WTO accession. China's accession agreement required China to eliminate existing import quotas for the top U.S. priority products upon accession and phase out remaining import quotas, on industrial goods such as air conditioners, sound and video recording machines, color TVs, cameras, watches, crane lorries and chassis, and motorcycles, by January 1, 2005. While China's post-WTO accession import quota system was beset with problems, China did fully adhere to the agreed schedule for the elimination of all of its import quotas, the last of which China eliminated on January 1, 2005.

Tariff-Rate Quotas

In 1996, China claimed to have introduced a tariff-rate quota (TRQ) system for imports of wheat, corn, rice, soy oil, cotton, barley, and vegetable oils. The quota amounts were not publicly announced, application and allocation procedures were not transparent, and importation occurred through state trading enterprises. China later introduced a TRQ system for fertilizer imports. Under these TRQ systems, China places quantitative restrictions on the amount of these commodities that can enter at a low "in-quota" tariff rate; any imports over that quantity are charged a prohibitively high duty.

As part of its WTO accession commitments, China was to establish large and increasing TRQs for imports of wheat, corn, rice, cotton, wool, sugar, vegetable oils, and fertilizer, with most in-quota duties ranging from 1 percent to 9 percent. Each year, a portion of each TRQ is to be reserved for importation through non-state trading entities. China's accession agreement sets forth specific rules for administration of the TRQs, including increased transparency and reallocation of unused quotas to end-users that have an interest in importing.

For the first two years after China's WTO accession, China's implementation of its TRQ systems generated numerous complaints from foreign suppliers, with the most serious problems being lack of transparency, sub-divisions of the TRQ, small allocation sizes and burdensome licensing procedures. Repeated engagement by U.S. officials led regulatory and operational changes by NDRC for shipments beginning January 1, 2004. Key changes included the elimination of separate allocations for general trade and processing trade, the elimination of certain unnecessary licensing requirements, and the creation of a new mechanism for identifying allocation recipients. In 2004, improvements in NDRC's TRQ administration became evident, although transparency continued to be problematic for some of the commodities subject to TRQs into 2005.

While NDRC was implementing the systemic changes in 2004, exports of some bulk agricultural commodities from the United States showed substantial increases, largely due to market conditions. In particular, despite some continuing problems with NDRC's handling of the cotton TRQs, U.S. cotton exports totaled a record $1.4 billion in 2004. In addition, U.S. wheat exports totaled $495 million in 2004, as the TRQ allocations for wheat did not appear to act as a limiting factor. In 2005, U.S. cotton exports totaled $1.4 billion, while U.S. wheat exports declined significantly to $78 million. The drop in U.S. wheat exports was due to higher production and lower prices in China, which reduced China's overall import demand.

Meanwhile, the administration of China's TRQ system for fertilizer, handled by SETC and subsequently MOFCOM, has suffered from systemic problems since China's WTO accession. By 2005, this system was still operating with insufficient transparency, and administrative guidance still seemed to be affecting how the allocated quota was used. U.S. fertilizer exports to China have declined throughout the post-WTO accession period, due in part to the continuing problems with MOFCOM's administration of the fertilizer TRQ system and in part to increasing subsidization – and resulting overcapacity – of China's domestic fertilizer industry. U.S. fertilizer exports to China have gone from $676 million in 2002 to $459 million in 2003 to $306 million in 2004. In 2005, U.S. fertilizer exports to China remained stable, as the figures for

January through September 2005 showed a slight decrease, totaling $210 million as compared to $215 million during the same period in 2004.

Import Licenses

In the early 1990s, China began to reduce substantially the number of products subject to import licensing requirements. With its WTO accession in December 2001, China committed to the fair and non-discriminatory application of licensing procedures. Among other things, China also committed upon its WTO accession to limit the information that a trader must provide in order to receive a license, to ensure that licenses are not unnecessarily burdensome, and to increase transparency and predictability in the licensing process.

MOFTEC issued new regulations and implementing rules to facilitate licensing procedures shortly after China's accession to the WTO. However, license applicants initially reported that they have had to provide sensitive business details unnecessary for simple import monitoring. In some sectors, importers also reported that MOFTEC was using a "one-license-per-shipment" system rather than providing licenses to firms for multiple shipments. MOFTEC began to allow more than one shipment per license in late 2002 following U.S. interventions, without modifying the measure authorizing the "one-license-per-shipment" system. In December 2004, MOFCOM issued revised licensing procedures for imported goods. Among the changes, import licenses no longer have quantitative restrictions, provisions related to designated trading were removed, and provisions allowing more than one license per shipment and an "under or over provision" for overloaded or short shipments were added.

In May 2005, after Chinese steel producers negotiated contracts with major foreign iron ore suppliers, the Chinese government began imposing new import licensing procedures for iron ore without prior WTO notification. Even though the WTO's Import Licensing Agreement calls for import licensing procedures that do not have a restrictive effect on trade, China reportedly restricts licenses to 48 traders and 70 steel producers and has not made public a list of the qualified enterprises or the qualifying criteria used. While the Chinese government maintained that it did not impose any qualifying criteria, it did acknowledge that two organizations affiliated with the Chinese government, the China Steel Industry Association and the Commercial Chamber for Metals, Minerals and Chemicals Importers and Exporters, had been discussing a set of rules regarding qualifying criteria such as production capacity and trade performance.

China's inspection and quarantine agency, the State Administration of Quality Supervision and Inspection and Quarantine (AQSIQ), has also imposed inspection-related requirements that have led to restrictions on imports of some U.S. agricultural goods. In particular, two AQSIQ measures issued in 2002 require importers to obtain a Quarantine Inspection Permit (QIP) prior to signing purchase contracts for nearly all traded agricultural commodities. QIPs are one of the most important trade policy issues affecting the United States and China's other agricultural trading partners.

AQSIQ sometimes slows down or even suspends issuance of QIPs at its discretion, without notifying traders in advance or explaining its reasons, resulting in significant commercial uncertainty. Because of the commercial necessity to contract for commodity shipments when prices are low, combined with the inherent delays in having QIPs issued, many cargoes of products such as soybeans, meat and poultry arrive in Chinese ports without QIPs, creating delays in discharge and resulting in demurrage bills for Chinese purchasers. In addition, traders report that shipment quantities are often closely scrutinized and are at risk for disapproval if considered too large.

Some improvements were made to the QIP system in 2004 following repeated U.S. engagement, both bilaterally and at the WTO. In June 2004, AQSIQ issued Decree 73, the *Items on Handling the Review and Approval for Entry Animal and Plant Quarantine*, which extended the period of validity for QIPs from three months to six months. AQSIQ also began issuing QIPs more frequently within the established time lines. Nevertheless, a great deal of uncertainty remains even with the extended period of validity, because a QIP still locks purchasers into a very narrow period to purchase, transport and discharge cargoes or containers before the QIP's expiration, and because AQSIQ continues to administer the QIP system in a seemingly arbitrary manner.

Meanwhile, traders are hesitant to press AQSIQ for change because they would risk falling out of favor. Many traders would at least like AQSIQ to eliminate the quantity requirements that it unofficially places on QIPs. These quantity requirements have been used often by AQSIQ during peak harvest periods to limit the flow of commodity imports. Eliminating this requirement would make the QIP system more dependent on market forecast.

In 2005, the QIP system underwent little improvement. AQSIQ officials continued to insist that the QIP system ensures that an adequate number of examiners are on duty at ports when shipments arrive to certify and inspect them for quality and quantity. The United States, with support from other WTO members, has questioned the scientific basis for the QIP system and has maintained that it serves as an unjust and overly restrictive barrier to trade.

INTERNAL POLICIES

Taxation

In April 2001, the National People's Congress Standing Committee passed long-awaited changes to the tax collection law, designed to standardize and increase the transparency of China's tax procedures. The State Council issued detailed regulations for the implementation of this law in September 2002. As part of a broader campaign to "rectify market order" and eliminate inter-provincial barriers to domestic commerce, the Chinese central government also implemented measures to prevent local governments from applying tax treatment that discriminated in favor of locally owned firms.

In order to narrow the widening urban-rural income gap, the Central Committee of the Communist Party of China and the State Council issued Document No. 1 of 2004, which instructed the governments at all levels to reduce the agricultural tax rate of 8.4 percent by 1 percent in 2004, along with the removal of all taxes on special farm produce except for tobacco. Document No. 1 also calls for further reductions in the agricultural tax rate until it is totally eliminated within five years. Where fiscally feasible, governments were also called upon to reduce or eliminate agricultural taxes more quickly. In December 2005, China announced that agricultural taxes would be abolished nationwide effective January 1, 2006.

Foreign investors, including those who have used investment as an entry point to the Chinese domestic market, have benefited from investment incentives, such as tax holidays and grace periods, which allow them to reduce substantially their tax burden. Domestic enterprises have long resented rebates and other tax benefits enjoyed by foreign-invested firms, and these benefits may be gradually phased out. Plans to unify the enterprise income tax laws, which impose higher rates on domestic as compared to foreign enterprises, have been postponed due to policy differences within the central government, and are not expected to take effect before 2007.

Application of China's single most important revenue source – the VAT, which ranges between 13 percent and 17 percent, depending on the product – continues to be uneven. Importers from a wide range of sectors report that, because taxes on imported goods are reliably collected at the border, they are sometimes subject to application of a VAT that their domestic competitors often fail to pay. As discussed above (in the section on Import Substitution Policies), the United States was successful in obtaining China's agreement to remove discriminatory VAT policies favoring domestically produced semiconductors. China's selective exemption of certain fertilizer products from the VAT has also operated to the disadvantage of imports from the United States.

China retains an active VAT rebate program for exports, although rebate payments are often delayed. In 2003, China announced the reduction of VAT rebates for exports by three percentage points partly in response to foreign complaints about an under-valued RMB. Although State Administration of Taxation officials reportedly plan to eliminate rebates eventually in order to increase tax revenues, China has continued this practice in order to spur domestic economic growth. In December 2004, for example, the Ministry of Finance (MOF) and the State Administration of Taxation issued a circular announcing an increase in the VAT rebate rate from 13 percent to 17 percent for the export of certain IT products, including integrated circuits, independent components, mobile telecommunication equipment and terminals, computers and periphery equipment, and numerical-controlled machine tools. In 2005, China adjusted the ratio of the share of the export VAT refund burden between the central and local governments, from 75-25 to 92.5-7.5. China also halted refunds for some products in high demand domestically in order to discourage their export. For example, China eliminated a 13 percent VAT rebate for exports of steel billets and ingots, although it maintained VAT rebates of 11 percent to 13 percent for more processed steel products.

Meanwhile, China continues to consider fundamental reform of its VAT regime from production-based to consumption-based, which began with a pilot program in the Northeast. This reform reportedly may be extended nationwide as early as this year.

China's 1993 consumption tax system continues to raise concerns among U.S. exporters. Because China uses a substantially different tax base to compute consumption taxes for domestic and imported products, the tax burden imposed on imported consumer goods ranging from alcoholic beverages to cosmetics to automobiles is higher than for competing domestic products.

Standards, Technical Regulations and Conformity Assessment Procedures

In its WTO accession agreement, China committed that it would ensure that its regulatory authorities apply the same standards, technical regulations and conformity assessment procedures to both imported and domestic goods and use the same fees, processing periods and complaint procedures for both imported and domestic goods. China also committed that, in order to eliminate unnecessary barriers to trade, it would not maintain multiple or duplicative conformity assessment procedures and would not impose requirements exclusively on imported products. China further committed to ensure that its standards developers, regulatory authorities and conformity assessment bodies operated with transparency and allowed reasonable opportunities for public comment on proposed standards, technical regulations and conformity assessment procedures.

In anticipation of these commitments, China devoted significant energy to reforming its standards and testing and certification regimes prior to its WTO entry. In April 2001, China merged its domestic standards and conformity assessment agency and entry-exit inspection and quarantine agency into one new organization, AQSIQ. Chinese officials explained that this merger was designed to eliminate discriminatory treatment of imports, including requirements for multiple testing simply because a product was imported rather than domestically produced. China also formed two quasi-independent agencies administratively under AQSIQ: (1) the Certification and Accreditation Administration of China (CNCA), charged with the task of unifying the country's conformity assessment regime; and (2) the Standardization Administration of China (SAC), responsible for setting mandatory national standards and unifying China's administration of product standards and aligning its standards and technical regulations with international practices and China's commitments under the WTO Agreement on Technical Barriers to Trade (TBT Agreement).

In January 2002, China began the task of bringing its standards regime more in line with international practice with AQSIQ's issuance of rules designed to facilitate China's adoption of international standards. China subsequently embarked on the task of reviewing all of its existing 21,000 technical regulations to determine their continuing relevance and consistency with international standards. In November 2005, China reported that as of October 2005 it had nullified 1,416 national standards as a result of this review.

Nevertheless, in a number of sectors, including autos, auto parts, telecommunications equipment, Internet protocols, wireless local area networks (see the "WAPI" section below), radio frequency identification tag technology, audio and video coding, whiskey and other distilled spirits, and fertilizer, concern has grown as China has pursued the development of unique technical requirements, despite the existence of well-established international standards. These China-specific standards, which sometimes appear to lack a sound basis, could create significant barriers to entry into China's markets because of the high cost of compliance for foreign companies.

The lack of transparency in China's standards development process also troubles many foreign companies. The vast majority of standards-setting bodies are not fully open to foreign participation, in some cases refusing membership to foreign firms and in other cases refusing to allow companies with majority foreign ownership to vote. In some cases, foreign firms are allowed non-voting observer status, but are required to pay membership fees far in excess of those paid by the voting members. Nevertheless, in 2005, some U.S. companies concluded that China had begun to make steady progress in reforming its standardization system by strengthening its links with standards-setters in other countries and by moving its standards regime into closer conformity with international practice.

China's designated standards notification authority, MOFCOM, has been notifying proposed technical regulations and conformity assessment procedures to WTO members, as required by the TBT Agreement. Almost all of these notified measures have emanated from AQSIQ or SAC, however, and generally have not included measures drafted by other agencies. Lack of meaningful comment periods is also an issue. In many other cases, Chinese regulatory authorities provided insufficient time to consider interested parties' comments before a regulation was adopted.

Despite China's commitment to apply the same standards and fees to domestic and imported products upon its accession to the WTO, many U.S. industries have complained about China's manipulation of technical regulations and standards to favor domestic industries. In fact, SAC issued a strategy report in September 2004 promoting China's development of standards and technical regulations as a means of protecting domestic industry as tariff rates fall. At the sub-national level, importers have expressed concern that local officials do not understand China's WTO commitments and apply arbitrary technical regulations and standards to protect local industries. These problems are compounded by the fact that coordination between AQSIQ and its new affiliated bodies, CNCA and SAC, is lacking, as is coordination between these bodies and China Customs and other ministries and agencies, at both the central and local government levels, with responsibilities relating to technical regulations and standards.

China's new "China Compulsory Certification" (CCC) mark system took full effect on August 1, 2003, following a transition period that lasted for fifteen months. The new CCC mark replaces the old "Great Wall" and "CCIB" marks and is now required for more than 130 product categories, such as electrical machinery, information technology equipment, household appliances and their components.

In 2005, as in prior years, U.S. companies continued to complain that the regulations lack clarity regarding the products that require a CCC mark. They also have reported that China is applying the CCC mark requirements inconsistently and that many domestic products required by AQSIQ's regulations to have the CCC mark are still being sold without the mark. U.S. companies in some sectors further complained that certification remains a difficult, time-consuming and costly process. The process involves on-site inspection of manufacturing facilities outside of China, the cost of which is borne by producers. In addition, small and medium-sized U.S. companies without a presence in China find it particularly burdensome to apply for CCC mark exemptions, such as for replacement and re-export, because China requires the applications to be done in person in the Beijing offices of CNCA. China also continues to require the CCC mark for products that would no longer seem to warrant mandatory certification, such as low-risk products and components.

Meanwhile, to date, China has granted well over one hundred Chinese enterprises accreditation to test and certify for purposes of the CCC mark. Despite China's commitment that qualifying minority foreign-owned (upon China's accession to the WTO) and majority foreign-owned (two years later) joint venture conformity assessment bodies would be eligible for accreditation and would be accorded national treatment, China so far has not granted accreditation to any foreign-invested conformity assessment bodies. As a result, exporters to China are often required to submit their products to Chinese laboratories for tests that have already been performed abroad, resulting in greater expense and a longer time to market.

In other conformity assessment contexts, some importers report discriminatory treatment and uneven enforcement of technical regulations and standards. For example, foreign companies' products can only be tested at certain laboratories. Limited testing and certification capacity means that evaluations sometimes take much longer than international best practice would suggest appropriate. As testing and certification capacity expands to meet this demand, U.S. companies with multi-country operations worry that inexperienced laboratories might make negative determinations that would have global consequences for the company.

Meanwhile, redundant testing requirements continue to trouble U.S. companies, particularly in cosmetics, new chemicals, pharmaceuticals, medical equipment, cellular telephones and other telecommunications products, consumer electronic products and automobiles. For example, China often requires telecommunications and information technology equipment to be tested and certified to the same electro-magnetic compatibility requirements by both MIC and CNCA. In December 2004, SAC created technical committees to develop standards for testing environmental equipment, genetically modified organisms, and new plant and animal varieties, suggesting that foreign companies may soon see additional requirements in these industries as well.

U.S. companies also cite problems with a lack of transparency in the certification process, lack of coordination among standards bodies, burdensome requirements and long processing times for licenses. Some companies have also expressed concern that their intellectual property will be released to competitors when they submit samples of high-technology products for mandatory quality testing. Technical committees that evaluate products for licensing and certification are generally drawn from a pool of government, academic and industrial experts that companies fear may be too closely associated with their competitors. In some cases, laboratories responsible for testing imported products are affiliated with domestic competitors, making the possibility of intellectual property being released more likely.

WAPI

A particularly significant example of China's development of unique technical requirements, despite the existence of well-established international standards, arose in May 2003, when China issued two mandatory standards for encryption over Wireless Local Area Networks (WLANs), applicable to domestic and imported equipment containing WLAN (also known as Wi-Fi) technologies. These standards, which were scheduled to become fully effective in June 2004, incorporated the WLAN Authentication and Privacy Infrastructure (WAPI) encryption technique for secure communications. This component of the standards differed significantly from internationally recognized standards. China sought to enforce the use of WAPI by providing the necessary algorithms only to a limited number of Chinese companies. U.S. and other foreign manufacturers would be compelled to work with and through these companies, some of which were competitors, and provide them with technical product specifications. Following high-level bilateral engagement, AQSIQ, SAC and CNCA jointly announced in April 2004 that China would suspend indefinitely its proposed implementation of WAPI as a mandatory wireless encryption standard, that it would instead work to revise its WAPI standard, taking into account comments received from Chinese and foreign enterprises, and submit it for consideration as an international standard with appropriate international standards setting bodies addressing wireless encryption for computer networks generally. The WAPI standard is currently under consideration by ISO/IEC for adoption as an international standard, and a decision will likely be made in 2006.

On December 30, 2005, MOF, NDRC and MII jointly issued the *Opinions for Implementing Government Procurements of Wireless Local Areas Network.* This measure seems to require all government agencies, quasi-government bodies and government-affiliated organizations, when procuring WLAN and related products using fiscal funds, to give priority to WAPI-compliant products. This measure took effect on February 1, 2006.

Encryption and Decryption Technologies

China generally prohibits foreign-developed encryption and decryption technologies. In the past, this prohibition has not applied to software and hardware for which encryption is only an incidental feature. However, in December 2003, China dramatically changed this precedent with the issuance of standards on encryption for WLAN, which have since been suspended, as discussed in the WAPI section above.

Enhanced Versatile Disc (EVD) Systems

In February 2005, MII announced the issuance of *Technical Standards for Enhanced Versatile Disc Systems*. The recommended, non-compulsory technical standards announced by MII consist of three parts, governing EVD discs, document systems, and data and soundtrack coding for surround-sound speakers. According to MII, these standards will be applicable to the development of chips, software and core parts of EVD players, and will unify the technical standards of the disc and player industries.

The team leader of China's EVD Standards Working Group reportedly stated that the EVD standards will become a technical barrier protecting the domestic industry, reduce the expensive digital versatile disc (DVD) royalty fees domestic firms are currently charged, break the monopoly of foreign DVD firms and provide China with leverage in the international market.

Chemicals

In September 2003, China's State Environmental Protection Administration (SEPA) issued a regulation requiring manufacturers and importers of new chemicals to apply to SEPA's Chemical Registration Center (CRC) for approval and to provide extensive test data to substantiate the physical properties, consumer safety and environmental impact of the new chemical. U.S. industry's primary concerns are that CRC has not been able to make decisions on the approval of new chemicals in a timely manner and that the governing rules and testing requirements are not transparent and accessible. SEPA's CRC acknowledges receipt of more than 40 completed applications for new chemicals since October 15, 2003. According to the most recent information available from CRC, approximately 10 of these applications have been approved. U.S. industry notes that a number of applications have been pending well beyond the 120-day timeline set forth in the regulation. U.S. industry also complains of shifting requirements and implementation changes, such as recently expanded eco-toxicity testing requirements, which mandate that certain eco-toxicity testing, particularly fish eco-toxicity and bio-degradation studies, be carried out in one of six SEPA-accredited laboratories in China. These accredited laboratories have all been established since mid-2004 in response to the September 2003 regulation, and U.S. industry fears that if inexperience leads one of these new labs to declare a product unsafe, it could affect sales globally. China's lack of a low-volume exemption, meaning an exemption where trade in a given chemical falls below an annual volume threshold, also appears to hinder the importation of U.S. chemicals, particularly for high value specialty chemicals sold in small quantities.

Hazardous Substances

In response to the European Union's *Directive on the Restriction of the Use of Hazardous Substances* (EU RoHS Directive), which is scheduled to go into effect on July 1, 2006, China's MII has issued a draft regulation, the *Management Methods for Pollution Prevention and Control in the Production of Electronic Information Products* (China RoHS), which would, like the EU RoHS Directive, ban the use of lead, mercury, cadmium, hexavalent chromium, PBB and PBDE in electronic products. However, at present, this draft regulation is much narrower in scope than the EU RoHS directive, affecting only electronic information products. It is expected that MII will eventually include other types of products and possibly restrict other substances. MII reportedly views a China RoHS regime as an opportunity for China to engage in a new phase of technology innovation with the rest of the world. MII's current goal is to make the China RoHS regime effective early next year.

U.S. industry has been working with MII to improve the draft China RoHS regulation and harmonize it with the EU RoHS regime, with some progress in the area of maximum tolerated thresholds. However, U.S. industry continues to be concerned that harmonization between the EU RoHS and China RoHS regimes will not be achieved, particularly in the areas of marking and labeling, test methods, material declarations and compliance schemes, where the China RoHS regime is overly burdensome and will likely result in significant added expenses and delays without any apparent added benefit to society.

Scrap Recycling

Scrap exports from the United States to China exceed $2 billion annually, making scrap one of the United States' largest exports to China by value. In late 2003, China's AQSIQ issued a notice requiring overseas scrap material exporters to register with AQSIQ. The stated purpose of the new requirement was to better monitor the entry of scrap shipments into China reportedly due to high occurrences of receiving dangerous waste and illegal material in past shipments from overseas. It was not until May 2004 that AQSIQ issued the implementing rules. These rules established registration procedures, including an application deadline of July 1, 2004, and set substantive requirements. In response to U.S. and other WTO members' concerns that the application period was too short, AQSIQ extended the application deadline to August 1, 2004, allowed companies who submitted incomplete applications to supplement required documents and extended the new requirement's effective date from November 1, 2004 to January 1, 2005.

In 2004, AQSIQ made public on its website the names of overseas exporters approved to ship scrap to China in two postings, the first in mid-October and the second at the end of December, only days before the new registration would take effect. In total, about 85 percent of worldwide applicants were granted approval, including hundreds of U.S. exporters. AQSIQ indicated that it would notify applicants that were not approved and that these exporters would be able to apply again six months after receiving notice of their rejection.

On July 29, 2005, AQSIQ posted Bulletin No. 103/2005 on its website, announcing the resumption of the review and approval of registration applications for scrap imports. According to the bulletin, as of August 1, 2005, scrap suppliers must wait three years to reapply for registration if they are denied eligibility. An AQSIQ notice dated December 30, 2005, reports that an additional 260 company registrations had been approved, including 55 U.S. companies.

Meanwhile, U.S. scrap exporters continue to experience problems related to inconsistent and unexplained rejections of licenses, confusing requirements imposed with little or no notice, and rejections of shipments at the point of entry. Problems are also being encountered within the United States as a result of pre-inspection requirements imposed by the Chinese authorities and conducted by Chinese-authorized inspectors at the shipment origin point.

Scrap Waste

In December 2004, China's President Hu Jintao signed Presidential Order No. 31, publishing the amended *Law for the Prevention of Solid Scrap Waste Pollution*, which went into effect in April 2005. According to this law, firms manufacturing, selling and importing items listed in the mandatory reclamation catalogue must recycle these items, and it is illegal to import scrap waste as component materials that cannot be rendered safe. Depending on the particular item, items that can be safely used as component materials are subject to either restricted import procedures or automatic licensing procedures. The State Administration of Environment Protection (SEPA) is charged with coordinating with MOFCOM, NDRC, China Customs and AQSIQ to design, adjust and publish the catalogues of imported solid scrap waste subject to the restricted or automatic licensing regimes. SEPA and MOFCOM, meanwhile, are responsible for reviewing and issuing licenses for the items subject to restricted import procedures.

Medical Devices

Although China is moving toward greater use of quality systems and utilization of Good Manufacturing Practice audits for medical devices, it still requires outdated type-testing (batch testing) for medical devices. Quality systems audits address product safety and efficacy in a more rigorous manner than type-testing. As a result, requiring firms that have undergone internationally recognized quality systems audits to also be type-tested is redundant and does not provide any additional safety benefits, while it adds unnecessary costs and delays in getting needed medical device products to Chinese patients.

Certain electro-medical devices also face redundant testing by two different agencies, the State Food and Drug Administration (SFDA) and AQSIQ, which administers the "CCC" mark for electrical safety. Both agencies perform virtually identical product tests and factory inspections prior to registration, but they do not recognize the results of one another's tests and inspections. The U.S. medical devices industry reports that this redundancy adds significant time and costs to bringing a new technology to market in China without providing any additional safety benefits.

A similar concern exists for imported pacemakers, which are scanned by AQSIQ upon clearing customs. This review adds unnecessary delay and costs to the distribution of these pacemakers, without providing any additional safety benefits, as pacemakers are re-scanned and re-calibrated by the hospital before implantation into patients.

Sanitary and Phytosanitary (SPS) Measures

In 2005, China's general lack of transparency remained a problem. China either failed to notify or belatedly notified to the WTO numerous SPS measures, resulting in measures that were adopted without the benefit of comments from other interested WTO members. In addition, in some cases, the adopted measures were overly burdensome, appeared to lack a scientific foundation, or raised significant national treatment concerns. U.S. engagement with China at the WTO and bilaterally, including through the provision of technical assistance, has generated some improvements in China's compliance with its WTO transparency obligations. At the same time, however, various U.S. agricultural exports continued to be subjected to unnotified entry, inspection and labeling requirements or faced unwarranted import bans. The most problematic of China's SPS measures are described below.

Bovine Spongiform Encephalopathy (BSE)-Related Bans on Beef and Low-Risk Bovine Products

In December 2003, China and other countries imposed a ban on U.S. cattle, beef and processed beef products in response to a case of BSE found in the United States. Since that time, the

United States has repeatedly provided China with extensive technical information on all aspects of its BSE-related surveillance and mitigation measures, internationally recognized by the OIE as effective and appropriate, for both food safety and animal health. After two years, China still has not provided any scientific justification for continuing to maintain its ban, nor has it identified any of the administrative and regulatory steps necessary to lift the ban. China finally sent a technical team to the United States in October 2005 to gather information on the United States' surveillance and mitigation measures, but no further progress took place during the remainder of the year.

At the same time that it banned U.S. cattle, beef and processed beef products, China also banned low-risk bovine products, i.e., bovine semen and embryos, protein-free tallow and non-ruminant feeds and fats, even though they are deemed tradable based on OIE guidelines regardless of a country's BSE status. After numerous bilateral meetings and technical discussions in 2004, including a visit to U.S. bovine facilities by Chinese food safety officials, China announced a lifting of its BSE-related ban for low-risk bovine products in late September 2004. However, China conditioned the lifting of the ban on the negotiation of protocol agreements setting technical and certification parameters for incoming low-risk bovine products. In November 2004, U.S. and Chinese officials finalized and signed protocols that would enable the resumption of exports of U.S.-origin bovine semen and embryos, contingent on facility certification by China's regulatory authorities, as well as a resumption of exports of U.S.-origin non-ruminant feeds and fats. In July 2005, China finally announced the resumption of trade in bovine semen and embryos, following certifications for 52 U.S. facilities made earlier in the year. However, trade in U.S.-origin non-ruminant feeds and fats did not resume, as China's regulatory authorities were insisting on a series of onerous, detailed and unnecessary information requirements that are not consistent with OIE guidelines and contrast sharply with U.S. requirements. As a result of further negotiations in December 2005, export certificates were finalized, and trade was expected to resume in early 2006. Meanwhile, trade in protein-free tallow had not resumed by the end of 2005, as U.S. and Chinese officials had not reached agreement on provisions of a protocol.

Avian Influenza (AI)

In February 2004, China imposed a nationwide ban on U.S. poultry in response to cases of low-pathogenic AI found in Delaware. Throughout 2004, the U.S. provided technical information to China on the U.S. AI situation, and in August 2004 a high-level Chinese delegation conducted a review of the status of AI eradication efforts in the United States. In December 2004, China lifted its nationwide ban on U.S. poultry, leaving in place a ban only for the states of Connecticut and Rhode Island. In early 2005, following the announcement of low-pathogenic AI found in the state of New York, China did not impose a nationwide ban. Instead, demonstrating progress in following OIE guidelines, China imposed a ban limited to poultry from the state of New York. As part of its ongoing dialogue with China's AQSIQ on AI, the United States has presented epidemiological information in support of its request for China to lift the current import bans on poultry products from Connecticut, Rhode Island and New York.

Wheat

The 1999 U.S.-China Agricultural Cooperation Agreement established an agreed level of TCK fungus tolerance in U.S. wheat, and China no longer routinely blocks U.S. wheat exports from the Pacific Northwest on the basis of the TCK fungus. Nevertheless, China has imposed a maximum residue level (MRL) for selenium that is more stringent than the international standard and threatens U.S. wheat exports to China. In addition, China has imposed an MRL for vomitoxin in wheat in the absence of any international standard. Although these measures are problematic, U.S. exports of wheat to China appeared to be unaffected by them in 2005. The drop in U.S. wheat exports in 2005 was attributable to other factors (as discussed in the "Tariff-Rate Quotas" section above).

Zero Pathogen Standards

China enforces zero tolerance standards for certain pathogens in raw meat and poultry products – standards that have resulted in the de-listing of several U.S. meat and poultry facilities. These standards appear to be enforced inconsistently. For some of the pathogens, a zero tolerance is not achievable because certain pathogen levels are unavoidable and do not result in unacceptable risk to consumers. These standards were developed by the Ministry of Health (MOH) and are enforced by AQSIQ. It does not appear that the Chinese authorities apply these standards equally to domestic products. Non-transparent enforcement of these standards has caused minor export disruptions since 2003.

The United States has worked with the Chinese authorities to re-list the affected facilities. It also continues to press China to revise its pathogen standards based on sound science and to adopt modern testing methodologies. Based on actions taken by the Chinese authorities in December 2005, it is expected that zero pathogen standards will become a more significant issue in 2006.

Distilled Spirits

China maintains a mandatory standard on distilled spirits that sets maximum limits on naturally occurring substances, know as superior alcohols or fusel oils, which result from the production process. However, the Joint UN FAO/WHO Expert Committee on Food Additives, like U.S. regulators of alcohol, has recognized that superior alcohols are safe for human consumption.

Food Additive Standards

Another problematic area involves China's overly restrictive food additive standards. China continues to block many U.S. processed food products from entering the Chinese market by banning certain food additives that are widely used in other countries and have been approved by the World Health Organization. The most recent example is China's proposed *Hygienic Standard for Uses of Food Additives*, notified to the WTO in July 2005 so that WTO members could comment on it.

This proposed technical regulation is 237 pages long and covers dozens of residues and additives for nearly 1,000 commodities. In some cases, it employs domestic nomenclature rather than internationally recognized technical terms, making it difficult to assess the impact that it would have on specific products. The United States recently submitted detailed comments on the proposed technical regulation and asked China to delay adoption of it until a thorough review could take place.

Fire Blight

Since 1994, China has refused to act on the United States' market access request for California plums, allegedly due to phytosanitary concerns regarding fire blight. In June 2005, the WTO Appellate Body report in *Japan - Measures Affecting the Importation of Apples* made clear that these concerns are unwarranted for imports of mature symptomless fruit. In December 2005, following further U.S. interventions, China formally approved the market access request for California plums.

Biotechnology Regulations

In January 2002, the Ministry of Agriculture (MOA) issued new rules implementing June 2001 regulations on agricultural biotechnology safety, testing and labeling. The product most affected by these rules was soybeans, while corn and other commodities were also potentially affected. However, the rules did not provide adequate time for completion of required safety assessments before their effective date of March 20, 2002. In response to U.S. interventions, China issued interim rules, which allowed trade to continue while authorities carried out safety assessments of biotechnology products. These interim rules were extended twice and were set to expire in April 2004. In December 2003 talks, MOA officials promised that permanent approval of Round-up Ready soybeans would be completed at least 60 days before expiration of the interim rules in order to prevent any trade disruption. China followed through on this promise and approved Round-up Ready soybeans, along with two cotton events and two corn events, in February 2004. Two months later, China issued final safety certificates for four additional corn events and seven canola events. China issued a formal safety certificate for another corn event later in 2004, leaving only one corn event still awaiting final approval. During the July 2005 JCCT meeting, MOA issued the final safety certificate for the remaining corn event.

Other U.S. concerns with China's biotechnology regulations remain. Areas of concern include limited timelines for submission of products, lack of clarity on assessment requirements for stacked (multiple trait) products and, at times, duplicative and unprecedented testing requirements. The United States is also concerned with the apparent lack of coordination of the development of biotechnology policy in China.

Food Labeling

The U.S. processed food industry has registered concerns with a number of standards and labeling requirements on its exports to China. The meat industry in particular is concerned that labeling regulations issued in late 2002 contain several requirements that go beyond those of any other country. They assert that these requirements are unnecessary and costly.

Agricultural importers and importers of processed foods are also concerned about measures requiring labels for products containing transgenic material, such as soybeans and corn. The June 2001 biotechnology regulations issued by MOA require labeling of bulk commodities, but implementation has been limited and sporadic. Future implementation of these measures remains uncertain.

The distilled spirits industry is concerned that China will require its products to comply with all existing food labeling requirements. The industry believes that some of these requirements are inappropriate. For example, China requires distilled spirits product labels to include a bottling date. Under international practice relating to wines and spirits, however, the date of manufacture (production or bottling date) is not required. As many spirits products consist of a blend of spirits that are aged for varying periods, a single "date of manufacture" is often not possible to specify, would not represent the actual age of the product, and would confuse consumers regarding the actual age of the product. China also requires the labels of distilled spirits products to include a list of ingredients, even though the original ingredients (e.g., corn, wheat, rye and barley) are completely transformed and are no longer present after distillation. Furthermore, China maintains typeface specifications and translation requirements that are inconsistent with international standards.

EXPORT REGULATION

Export Licenses and Quotas

Over the last several years, China has progressively reduced the number of products requiring some type of export license. In 2005, China continued this trend, as it freed up three more categories of products from this requirement (man-made jade, satin and some kinds of silk). However, 47 categories of products (totaling 316 items at the 8-digit tariff level) are still subject to various types of export licenses. Products requiring export licenses include some grains, cotton, livestock, raw materials and metals, lethal chemicals and food products. In addition, China occasionally imposes new export licensing requirements on strategically sensitive commodities.

For some products, such as blast furnace coke and fluorspar, the export licensing system raises strong concerns under WTO rules that generally prohibit export restrictions. Export licenses for these two products are accompanied by export quotas and at times have required the payment of high export license fees beyond the administrative costs of administering an export license system.

In 2004, China's export restrictions on blast furnace coke, a key steel input, began to have a significant, adverse effect on U.S. integrated steel producers and their customers. The United States began to raise its concerns with China's coke export restrictions during high-level meetings in Washington in April 2004. The United States urged China to eliminate the practice of using export restrictions, not just for coke but also for other products. In late July 2004, China raised the 2004 quota allotment for coke to 12.3 million MT, and it indicated that it would eventually raise the quota to the 2003 level of 14.3 million MT.

Shortly thereafter, MOFCOM also issued an urgent notice reiterating that the sale of export licenses was illegal. In the ensuing months, with the increased supply of Chinese coke and the crackdown on the sale of export licenses, the export prices for Chinese coke declined significantly. U.S. industry was also able to obtain a substantially larger quantity of Chinese coke in 2004 than it had in 2003.

In May 2005, consistent with earlier indications from China, an NDRC official stated publicly that China would eliminate the coke export quota system as of January 1, 2006. A MOFCOM official also noted that while WTO rules allow member countries to impose quotas on exports under certain circumstances, the rules simultaneously require restrictions on domestic consumption, which had not been done to date. In November 2005, when MOFCOM announced the 2006 export quota levels for agricultural, industrial and textile products, coke was absent from the list. MOFCOM later indicated that coke would still be subject to an export quota, except the export quota would now be administered by the NDRC, not MOFCOM. The reason given for the switch in coke export quota administration is that NDRC is responsible for administrating industrial products that have significant influence on the national economy. In early December 2005, the NDRC released a list of 2006 coal export quotas, but did not include coke. In late December 2005, the NDRC finally issued the coke export quota, set at 14 million MT for 2006.

China has imposed quotas and high license fees on exports of fluorspar since before it acceded to the WTO, apparently with the objective of supporting China's domestic users of fluorspar, which face no comparable restrictions. China has refused to modify its practices in this area, despite repeated U.S. requests.

In December 2004, in an apparent effort by China to manage the export growth of textile and apparel products in response to concerns from its trading partners as the January 1, 2005 deadline for removal of global textile quotas drew near, China announced plans to impose export duties on certain categories of textile and apparel products. In February 2005, MOFCOM issued rules imposing automatic licensing requirements for textile exports to the United States, the European Union and Hong Kong. Subsequently, China suspended the licensing requirements only to restore similar measures in June 2005 and July 2005 after the United States imposed safeguards on certain categories of textile imports from China. China claimed the measures were needed to avoid uncertainty among Chinese textile exporting firms, to encourage exports of high value added items and to avoid rent seeking in license distributions. Under the June 2005 measures, MOFCOM, China Customs and AQSIQ jointly issued and made adjustments to a catalogue of subject items, listed by tariff codes, destination countries and regions, implementing periods and total licensed export quantities of subject items. Included in the catalogue were textile products subject to foreign safeguard actions or those subject to temporary quantitative regulation in accordance with bilateral agreements. In November 2005, USTR and MOFCOM signed a memorandum of understanding (MOU), under which China agreed to limit export growth rates in 34 categories of textiles, representing approximately 40 percent of bilateral trade in textiles, through 2008. The United States in turn agreed to dismiss all pending China-specific textile safeguard investigations and agreed to exercise restraint in invoking safeguards for categories of textiles falling outside the MOU. The United States and China also established an Electronic Visa Information System (ELVIS) Arrangement to monitor trade in the affected products.

China also requires export licenses on products that are the subject of antidumping duties in a foreign market. As was initially the case in 2005 for textile exports subject to safeguard limitations in the United States, the central government has often delegated responsibility for issuing these licenses to quasi-governmental industry associations formed to take the place of the ministries that governed production during the earlier central planning era. Foreign investors report that the industry associations are using the power to issue export licenses to force companies to participate in association-supported activities. For example, the steel producers' industry association will not issue an export license to any company that does not contribute to its antidumping defense funds.

Export Subsidies

China officially abolished subsidies in the form of direct budgetary outlays for exports of industrial goods on January 1, 1991. China agreed to eliminate all subsidies prohibited under Article 3 of the WTO Agreement on Subsidies and Countervailing Measures, including all forms of export subsidies on industrial and agricultural goods, upon its accession to the WTO in December 2001.

A general lack of transparency makes it difficult to identify and quantify possible export subsidies provided by the Chinese government. China's subsidy programs are often the result of internal administrative measures and are not publicized. Sometimes they take the form of income tax reductions or exemptions that are *de facto* contingent on export performance. For example, the Chinese government announced in 2005 that it would provide financial and export credit assistance for automobile manufacturers with domestically owned intellectual property rights and noted that MOFCOM is selecting 100 Chinese auto or auto parts manufacturers to be designated as "state-level auto and part exporters" for financial support. In addition, according to a 2002 OECD report, foreign-invested enterprises exporting 70 percent or more of their output in a given year are eligible for a 50 percent tax reduction in that year even after the expiry of the normal tax holiday. China's subsidy programs can also take a variety of other forms, including mechanisms such as credit allocations, low-interest loans, debt forgiveness and reduction of freight charges. U.S. industry has alleged that subsidization is a key reason that Chinese exports are undercutting prices in the United States and gaining market share. Of particular concern are China's practices in the textiles industry as well as in the steel, petrochemical, high technology, forestry and paper products, machinery and copper and other non-ferrous metals industries.

U.S. subsidy experts continue to seek more information about several Chinese programs and policies that may confer export subsidies. Their efforts have been frustrated in part because China has failed to make any of its required subsidies notifications since becoming a member of the WTO three years ago. At the July 2005 JCCT meeting and in formal meetings at the WTO, China committed to submit its long-overdue subsidies notification by the end of 2005. China did not meet this deadline.

Since shortly after China acceded to the WTO, U.S. corn exporters began to complain that China was subsidizing its corn exports. In 2002 and 2003, it appeared that significant quantities of corn had been exported from China, including corn from Chinese government stocks, at prices that may have been 15 percent to 20 percent below domestic prices in China. As a result, U.S. corn exporters were losing market share for corn in their traditional Asian markets, such as South Korea and Malaysia, while China was exporting record amounts of corn. In 2004, however, trade analysts began to conclude that, because of several economic factors, including changes in the relationship between domestic prices and world prices, China was trending toward becoming a net importer of corn. One result appeared to have been that China's exports were largely made on a commercial basis in 2004 and 2005, although concern remains regarding the operation of China's VAT rebate system for corn.

INTELLECTUAL PROPERTY RIGHTS (IPR) PROTECTION

China has undertaken substantial efforts to implement its commitment to overhaul its legal regime to ensure the protection of intellectual property rights in accordance with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). Those efforts have fallen short in some respects, particularly with regard to criminal liability for copyright piracy and trademark counterfeiting. In other areas, China has done a relatively good job of revising its legal regime. However, China has been much less successful in enforcing its laws and regulations and ensuring the effective IPR enforcement required by the TRIPS Agreement. With U.S. industry reporting no significant reduction in IPR infringement levels in 2005, IPR enforcement remains problematic. Counterfeiting and piracy in China remain at epidemic levels and cause serious economic harm to U.S. businesses in virtually every sector of the economy.

Throughout 2005, the United States continued to place the highest priority on improving IPR enforcement in China, taking several aggressive steps in an effort to obtain meaningful progress in this area. First, the United States conducted an out-of-cycle review under the Special 301 provisions of U.S. trade law. At the conclusion of this review in April 2005, the Administration elevated China to the Special 301 "Priority Watch List" and set out a comprehensive strategy for addressing China's ineffective IPR enforcement regime, including the possible use of WTO mechanisms, as appropriate. The United States immediately began to pursue this strategy during the run up to the July 2005 JCCT meeting, and China subsequently agreed to take a series of specific actions designed to increase criminal prosecutions of IPR violators, improve enforcement at the Chinese border, counter piracy of movies, audio visual products and software, address Internet-related piracy, and appoint an IPR ombudsman to serve as a point of contact for U.S. companies, particularly small and medium sized U.S. companies experiencing China-related IPR problems. After concluding that lack of transparency is a serious barrier to a more complete understanding of key deficiencies in China's IPR enforcement system, the United States also submitted a transparency request to China under Article 63.3 of the TRIPS Agreement in October 2005. The request, made in conjunction with similar requests by Japan and Switzerland, seeks detailed information from China on its IPR enforcement efforts over the last four years.

The United States is committed to working constructively with China to significantly reduce IPR infringement levels in China and continues to devote extra staff and resources, both in Washington and in Beijing, to address the many aspects of this problem.

At the same time, the United States remains prepared to take whatever action is necessary and appropriate to ensure that China develops and implements an effective system of IPR enforcement, as required by the TRIPS Agreement.

Legal Framework

In anticipation of its accession to the WTO, China began modifying the full range of IPR laws, regulations and implementing rules, including those relating to patents, trademarks and copyrights, in an effort to comply with the TRIPS Agreement. By the end of 2001, China had completed amendments to its patent law, trademark law and copyright law, along with regulations for the patent law and regulations addressing computer software protection and the protection of layout designs of integrated circuits. After it acceded to the WTO, China issued regulations for the trademark law and the copyright law. China also issued various sets of implementing rules and judicial interpretations in the patent, trademark and copyright areas. In addition, China issued regulations and implementing rules covering specific subject areas, such as integrated circuits, computer software and pharmaceuticals. Many of the legal changes made by China represent major improvements that have moved China generally in line with international norms in most key areas. More work needs to be done, however, particularly with regard to administrative and criminal enforcement. In addition, new legislation may be required in certain "cutting edge" areas like Internet copyright protection.

In the trademark area, some progress was made in 2004 on the recognition of foreign well-known marks. More than a year after the issuance of implementing rules on well-known marks, a handful of foreign marks has been recognized as well-known. In addition, in June 2005, the Trademark Administration circulated draft amendments to its *Regulations on the Timely Transfer of Suspected Criminal Cases in the Enforcement of Administrative Law*, which are designed to provide guidance to provincial administrations for industry and commerce in facilitating effective trademark enforcement and protection.

With regard to copyright protection over information networks, in November 2004, the National Copyright Administration of China and MII jointly organized a hearing on draft implementing rules known as the *Draft Measures for Administrative Protection of Copyright on the Internet*. The Chinese authorities issued these rules in final form in April 2005. The rules require Internet service providers to take remedial actions to delete contents that infringe on copyrights upon receipt of a complaint from the right holder, or face administrative penalties ranging from confiscation of illegal gains to fines of up to RMB 100,000 ($12,000). In September 2005, China circulated a more important Internet-related measure for public comment, the draft *Regulations on the Protection of Copyright Over Information Networks*, with the goal of issuing the final version in 2006. This development is a concrete step in line with China's April 2004 JCCT commitments to improve protection of electronic data while China continues its preparations for accession to the WIPO Internet-related treaties – the *WIPO Copyright Treaty* and the *WIPO Performances and Phonograms Treaty*.

Although China is not obligated under WTO rules to accede to the WIPO Internet-related treaties, the United States considers these treaties to reflect international norms for providing copyright protection over the Internet. These treaties entered into force in 2002 and have been ratified by many developed and developing countries. While China's existing regulations and implementing rules do address certain copyright issues related to the Internet, and China is in the process of drafting further revisions, the United States has urged China for some time to accede to the WIPO Internet-related treaties and fully harmonize its regulations and implementing rules with them. These steps are important as a means for preventing China's Internet environment from becoming a "safe harbor" for piracy, especially in light of the rapidly increasing number of Internet users in China, most of whom have broadband access. At the April 2004 JCCT meeting, China agreed to ratify and implement the WIPO Internet-related treaties as soon as possible.

At the July 2005 JCCT meeting, the United States obtained China's commitment to submit the legislative package necessary for China's accession to the WIPO Internet-related treaties to the National People's Congress by June 2006.

In furtherance of China's April 2004 JCCT commitment to increase border measures protecting against the import and export of infringing products and to make it easier for rights-holders to secure effective enforcement at the border, the Customs Administration issued the *Regulations on Customs Protection of Intellectual Property Rights*, which went into effect in March 2004. The Customs Administration subsequently issued implementing rules for these regulations, effective July 2004. These regulations and implementing rules addressed the duties of the Customs Administration and improved guidance on the implementation of the customs IPR recordal mechanism. In other areas, however, the regulations and implementing rules lacked clarity or could have benefitted from further changes, such as with regard to the storage and disposition of infringing goods and the transferal of cases for possible criminal prosecution. Meanwhile, in September 2004, the Customs Administration issued new regulations on administrative penalties in the customs context, the *Implementing Regulations for the Imposition of Administrative Penalties by the General Administration of Customs*, effective November 2004. In an apparent improvement over the prior regulations, these new regulations do not impose a "knowledge" requirement before penalties can be imposed. However, the new regulations provide for fines not to exceed 30 percent of the value of the goods confiscated, or RMB 50,000 ($6,000), whichever is lower. In contrast, the prior regulations allowed for fines up to the full value of the goods confiscated. The fines allowed under the new regulations are also lower than those imposed by other Chinese agencies focusing on domestic IPR infringement. At present, the effectiveness of these various regulations and implementing rules remains in doubt, as exports of counterfeit and pirated goods from China are increasing, facilitated by trading rights liberalization and the rapid growth of Internet usage and e-commerce.

The United States has urged China to pursue additional legislative changes to improve the legal framework supporting enforcement, particularly in the area of criminal enforcement. For example, the criminal enforcement legal framework could be improved through the removal of various evidentiary and liability thresholds, the "for profit" requirement in the copyright area, the "identical trademark" requirement and the distinction between individual and enterprise liability. Among these issues, China's high thresholds for criminal liability (i.e., the minimum values or volumes of infringement deemed criminal by authorities) pose a particular problem.

Despite efforts at reform, these thresholds remain so high that they have the effect of insulating commercial infringers' retail sales and other significant commercial activities involving counterfeit and pirated goods from criminal penalties. China's legal framework has thus created a "safe harbor" that protects a large group of commercial infringers and operates to deprive the criminal enforcement authorities of needed information regarding the sources of counterfeit and pirated goods.

The United States also remains concerned about weaknesses in China's legal framework that encourage or support counterfeiting and piracy. Some of these weaknesses have facilitated the establishment of Chinese companies under the false appearances of foreign companies, the squatting of foreign company names, designs and trademarks, and the theft of trade secrets.

In addition, restrictions on market access for legitimate movies, music, software and books and built-in delays in the marketing approval system for pharmaceuticals have created incentives for counterfeiting and piracy that are difficult to address through the existing legal framework.

Enforcement

IPR infringement in China in 2005 continued to affect products, brands and technologies from a wide range of industries, including films, music, publishing, software, pharmaceuticals, chemicals, information technology, consumer goods, industrial goods, food products, medical devices, electrical equipment, automotive parts and clothing, among many others. This situation not only has had an enormous economic impact, but also presents a direct challenge to China's ability to regulate many products that have health and safety implications for China's population and, given the increasing amount of counterfeit and pirated products being exported from China, for others around the world.

The United States places the highest priority on addressing IPR enforcement problems in China, and since 2004 it has devoted additional staff and resources, both in Washington and in Beijing, to address these problems. While a domestic Chinese business constituency is increasingly active in promoting IPR enforcement, it is clear that there will continue to be a need for sustained efforts from the United States and other WTO members, along with the devotion of considerable resources and political will by the Chinese government to IPR enforcement, if significant improvements are to be achieved on this front. At present, however, China's IPR enforcement efforts remain hampered by the challenges of coordination among Chinese government ministries and agencies, local protectionism and corruption, high thresholds for initiating investigations and prosecuting cases, and inadequate and non-transparent administrative penalties.

At the April 2004 JCCT meeting, China announced a comprehensive action plan on IPR enforcement that included five major commitments, for which the results have been mixed. First, and most importantly, China agreed that it would significantly reduce IPR infringement levels. Nevertheless, IPR infringement in China remains rampant, and IPR infringement levels reported by U.S. industry have not improved. Second, China committed that it would take steps by the end of 2004 to increase penalties for IPR violations by subjecting a greater range of violations to criminal investigation, applying criminal sanctions to the import, export, storage and distribution of pirated and counterfeit products and applying criminal sanctions to on-line piracy. China did take some steps to increase penalties for IPR violations, as China's Supreme People's Court and Supreme People's Procuratorate issued a judicial interpretation in December 2004 redefining the criteria for commencing criminal prosecutions and reaching criminal convictions. Nevertheless, while this judicial interpretation has generated improvements, it did not address deficiencies in China's criminal law still in need of correction. Third, China committed to crack down on IPR violators by conducting nation-wide enforcement actions and increasing customs enforcement actions. Vice Premier Wu launched this crack down at the time of the Xiamen China International Fair for Investment and Trade in August 2004. However, a lack of transparency hinders an assessment of the disposition of any ensuing enforcement and customs actions. Fourth, China committed to improve protection of on-line works by ratifying and implementing the World Intellectual Property Organization (WIPO) Internet-related treaties as soon as possible, and by extending an existing ban on the use of pirated software in government offices. Although China has not yet ratified the WIPO Internet-related treaties, the Chinese government did extend its ban on the use of pirated software in government offices. Fifth, China committed to launch a national IPR education campaign. China followed through on this commitment by launching a national public awareness campaign to educate the Chinese public on IPR protection, which included radio and television programs, newspaper inserts, awards and national and local level training programs. The campaign also included the introduction of a television program, "Intellectual Fortune," which is broadcasted in 20 provinces nationwide, the publication of an English language inserts in the China Daily English-language newspaper on intellectual property, and radio broadcast programs, among other targeted efforts. The long-term impact of these efforts continues to be evaluated.

In early 2005, the United States conducted an out-of-cycle review under the Special 301 provisions of U.S. trade law. At the conclusion of this review in April 2005, the Administration elevated China to the Special 301 "Priority Watch List" and set forth a comprehensive strategy for addressing China's ineffective IPR enforcement regime, which included the possible use of WTO mechanisms, as appropriate.

The United States immediately began to pursue this strategy during the run-up to the July 2005 JCCT meeting, as the United States sought to strengthen the commitments that China had made at the April 2004 JCCT meeting and to obtain China's commitment for greater involvement of its police authorities in IPR enforcement matters. China subsequently agreed to: (1) increase criminal prosecutions for IPR violations relative to the total number of IPR administrative enforcement cases; (2) reduce exports of infringing goods by issuing regulations to ensure the timely transfer of cases for criminal investigation; (3) improve national police coordination by establishing a coordinating group in the Ministry of Public Security responsible for overall research, planning and coordination of all IPR criminal enforcement to ensure a focused and coordinated nationwide enforcement effort; (4) enhance cooperation on law enforcement matters with the United States by immediately establishing a bilateral IPR law enforcement working group focusing on the reduction of cross-border infringement activities; (5) expand an ongoing initiative to aggressively counter piracy of movies and audio-visual products; (6) complete its program ensuring that only licensed software is used by all central, provincial and local government offices by the end of 2005 and extend this program to enterprises in 2006; (7) fight software end-user piracy by declaring that it is considered to constitute "harm to the public interest" and therefore is subject to administrative penalties nationwide and criminal penalties in appropriate circumstances; (8) establish an IPR ombudsman in the Chinese embassy in Washington to assist U.S. companies, particularly small- and medium-sized companies, experiencing IPR problems, (9) develop measures to rid trade fairs of fake goods; (10) join the WIPO Internet-related treaties in 2006; and (11) clarify the December 2004 Judicial Interpretation to make clear that its criminal thresholds apply to sound recordings and that exporters are subject to independent criminal liability.

By the end of 2005, China had already taken several steps to implement these commitments. Nevertheless, the overall results of China's efforts remain unclear, largely because of transparency problems associated with IPR enforcement activities in China. For example, China will not make public the enforcement decisions made by administrative authorities. China has issued statistics that appear to show some increase in enforcement activities, but there is no evidence of any significant corresponding reduction in IPR infringement levels. In October 2005, the United States submitted a request to China under the transparency provisions of Article 63 of the TRIPS Agreement, in conjunction with similar requests by Japan and Switzerland, seeking to clarify China's efforts to improve IPR enforcement.

A detailed review of the three different mechanisms for IPR enforcement provided for by China's IPR laws and regulations – enforcement by administrative authorities, criminal prosecutions and civil actions for monetary damages or injunctive relief – is set forth below.

Administrative Enforcement

Although the central government continues to promote periodic anti-counterfeiting and anti-piracy campaigns, and these campaigns in the short term result in high numbers of seizures of infringing materials, they are largely ineffective. For one thing, the cases subsequently brought by the administrative authorities usually result in artificially low fines because the administrative authorities often do not treat the infringing goods as having the value of the genuine articles, but rather establish value based on the price charged for the counterfeit or pirated goods. In addition, evidence showing that a person was caught warehousing infringing goods is not sufficient to prove an intent to sell them, and as a result the administrative authorities will not even include those goods in the value of the infringing goods when determining the fine amounts.

The lack of deterrence from the fines is compounded by the fact that the administrative authorities rarely forward an administrative case on to the Ministry of Public Security for criminal investigation, even for commercial-scale counterfeiting or piracy. Statistics provided by China confirm this fact. In 2004, only 96 out of 51,851 administrative trademark cases (approximately 0.2 percent) and 101 out of 9,691 administrative copyright cases (approximately 1.0 percent) were transferred for criminal prosecution. These statistics showed no improvement over 2001, when the corresponding statistics similarly indicated very low transfer rates of 0.2 percent for administrative trademark cases and 1.5 percent for administrative copyright cases. As a result, infringers continue to consider the seizures and fines simply to be a cost of doing business, and are usually able to resume their operations without much difficulty.

At the 2005 JCCT meeting, as discussed above, China committed to increase the number of criminal IPR prosecutions relative to the number of administrative IPR cases. Since then, China has prepared and made available for public comment draft rules to facilitate the transfer of administrative cases for criminal enforcement. The United States has submitted written comments on these draft rules, which were expected to be finalized by the end of 2005. China is working separately on draft rules for the transfer of customs cases for criminal enforcement.

Meanwhile, China's administrative enforcement efforts have also failed to put an end to open and notorious IPR infringement at trade fairs, retail markets and wholesale markets throughout China. The United States has urged China to step up efforts at retail markets such as the "Silk Street" market in Beijing and wholesale markets such as Xiangyang in Shanghai, Yiwu in Yiwu City, and Lowu in Shenzhen. At major trade fairs, exhibitors displaying infringing goods in the past have escaped with only non-deterrent administrative penalties. China pledged to address the trade fair problem as part of its July 2005 JCCT commitments, and it is expected to issue final measures designed to improve administrative IPR enforcement at trade fairs, including provisions enhancing on-site complaint centers at major fairs, in early 2006.

The Customs Administration developed an action plan in mid-2004 calling for increased enforcement over exports of infringing goods, in conformity with China's April 2004 JCCT commitments. Currently, China's share of U.S. seizures of exports of counterfeit and pirated goods remain very high, although mid-year 2005 U.S. Customs and Border Patrol seizure data did show a modest decrease in seizures of infringing imports from China as compared with the same period in 2004, both in terms of aggregate value and percentage of total seizures.

Criminal Enforcement

In the view of the United States and U.S. industry, the most critical steps for China to take in improving its IPR enforcement are in the criminal area. Effective criminal enforcement is a core WTO obligation, and it offers the deterrence needed for China to begin to handle the rampant IPR infringement hurting both foreign and domestic enterprises. For this reason, the United States sought and obtained at the April 2004 and July 2005 JCCT meetings commitments by China to apply criminal sanctions to a wider range of IPR-infringing activities, to increase the penalties for IPR violations, to increase the number of criminal prosecutions for IPR violations, to reduce exports of infringing goods through the timely transfer of cases for criminal investigation, to improve national police coordination, and to ensure that its criminal thresholds apply to sound recordings and that exporters are subject to independent criminal liability.

There are some reports that the number of criminal prosecutions in China has increased in certain types of cases, but lack of transparency makes it difficult to confirm the existence, extent or significance of any improvement. Criminal prosecutions remain very rare in relation to administrative cases, and they have not created an adequate deterrent for IPR infringers. U.S. companies also continue to complain that, in most regions of China, the police are either not interested in pursuing counterfeiting and piracy cases or simply lack the resources and training required to investigate these types of cases effectively. Moreover, even when IPR violations are referred for criminal enforcement, the actual prosecution of IPR crimes frequently requires coordination among a relatively large number of agencies at the national and local levels.

Coordination remains problematic, however, with different agencies using different standards to determine whether criminal conduct exists and some agencies apparently unwilling or unable to work together.

Civil Enforcement

In part because of the ineffectiveness of the administrative and criminal enforcement mechanisms in China, particularly in the copyright area, there has been an increase in the number of civil actions being brought for monetary damages or injunctive relief. Most of the civil actions have been brought by Chinese rights-holders. This increased use of civil actions has coincided with an increasing sophistication on behalf of China's IPR courts, as China continues to make efforts to upgrade its judicial system. These efforts are still in progress, however. U.S. companies still complain about local protectionism and have also found that most judges lack necessary technical training and that court rules regarding evidence, expert witnesses, and protection of confidential information are vague or ineffective. In addition, in the patent area, where enforcement through civil litigation is of particular importance, a single case still takes several years to complete, rendering the damages provisions adopted to comply with China's TRIPS Agreement obligations less meaningful.

SERVICES BARRIERS

Until China's entry into the WTO, China's service sectors were among the most heavily regulated and protected sectors of the national economy. Foreign service providers were largely restricted to operations under the terms of selective "experimental" licenses. However, both as a matter of policy and as a result of its WTO commitments, China decided to significantly liberalize foreign investment in its service sectors. At present, the market for services, underdeveloped due to historical attitudes and policies, has significant growth potential in both the short and long term.

China's WTO commitments are designed to provide meaningful access for U.S. service providers. In its accession agreement, China committed to the substantial opening of a broad range of service sectors through the elimination of many existing limitations on market access, at all levels of government, particularly in sectors of importance to the United States, such as banking, insurance, distribution, telecommunications and professional services. These commitments are far-reaching, particularly when compared to the services commitments of many other WTO members.

China also made certain "horizontal" commitments, which apply to all sectors listed in its services schedule. The two most important of these cross-cutting commitments involve acquired rights and the licensing process. Under the acquired rights commitment, China agreed that the conditions of ownership, operation and scope of activities for a foreign company, as set out in the respective contractual or shareholder agreement or in a license establishing or authorizing the operation or supply of services by an existing foreign service supplier, will not be made more restrictive than they were on the date of China's accession to the WTO.

In other words, if a foreign company had pre-WTO accession rights that went beyond the commitments made by China in its services schedule that company could continue to operate with those rights. In the licensing area, prior to China's WTO accession, foreign companies in many sectors did not have an unqualified right to apply for a license to operate in China. They could only apply for a license if they first received an invitation from the relevant Chinese regulatory authorities, and even then the decision-making process lacked transparency and was subject to inordinate delay and discretion. In its accession agreement, China committed to licensing procedures that were streamlined, transparent and more predictable.

At present, many challenges remain in securing the benefits of China's services commitments. While China continued to keep pace nominally with the openings required by its WTO accession agreement, it frequently maintained or erected terms of entry that were so high or cumbersome as to prevent or discourage many foreign suppliers from gaining market access. For example, despite some progress, excessive capital requirements continue to restrict market entry for foreign suppliers in many sectors, such as insurance, banking, securities, non-bank motor vehicle financing, asset management, direct selling, franchising, freight forwarding and telecommunications, among others. In addition, in sectors such as insurance and legal services, branching restrictions have been put into effect that call into question commitments made by China in its services schedule. In other sectors, particularly express delivery and construction services, problematic proposed or final measures continue to threaten to take away previously acquired market access rights.

Progress was made on some fronts in 2005. For example, the licensing process in many sectors continued to proceed in a workman-like fashion, although national treatment concerns remain, particularly in the banking and insurance sectors. The *Administrative Licensing Law*, which took effect in July 2004, has also increased transparency in the licensing process, while reducing procedural obstacles and strengthening the legal environment for domestic and foreign enterprises.

Insurance Services

In its WTO accession agreement, China agreed to phase-in expanded ownership rights for foreign companies, for the most part during the first three years of China's WTO membership. Upon China's accession to the WTO, foreign life insurers were to be permitted to hold 50 percent equity share in a joint venture; within two years of accession, foreign property, casualty and other non-life insurers were to be permitted to establish as a branch, joint venture or a wholly foreign-owned subsidiary; and, within three years of accession, or by December 11, 2004, foreign insurers handling large scale commercial risks, marine, aviation and transport insurance, and reinsurance were to be permitted 51 percent foreign equity share in a joint venture (with the right to establish as a wholly foreign-owned subsidiary within two more years). China further agreed that all foreign insurers would be permitted to expand the scope of their activities to include group, health and pension lines of insurance by December 11, 2004. In addition, China agreed to eliminate geographic restrictions on all types of insurance operations by December 11, 2004.

Shortly after China acceded to the WTO, the China Insurance Regulatory Commission (CIRC) issued several new insurance regulations, including ones directed at the regulation of foreign insurance companies. These regulations implemented many of China's commitments, but they also created problems in three critical areas – capitalization requirements, transparency and branching. In particular, China's capitalization requirements were significantly more exacting than those of other populous countries, and they limited the ability of foreign insurers to make necessary joint venture arrangements. The regulations also continued to permit considerable bureaucratic discretion and to offer limited predictability to foreign insurers seeking to operate in China's market.

With regard to branching, China scheduled a commitment to allow non-life firms to establish as a branch in China upon accession and to permit internal branching in accordance with the lifting of China's geographic restrictions. China further agreed that foreign insurers already established in China that were seeking authorization to establish branches or sub-branches would not have to satisfy the requirements applicable to foreign insurers seeking a license to enter China's market.

China's regulations regarding foreign insurers' branching rights, however, remain vague, and CIRC has so far insisted that non-life insurers that are already in the market as a branch and that wish to branch or sub-branch cannot do so unless they first establish as a subsidiary, a costly condition. Further complicating this issue, CIRC has apparently waived this requirement for at least one foreign non-life insurer, but has not explained how or whether other foreign insurers could apply for this waiver.

In May 2004, CIRC took steps to address concerns related to China's high capitalization requirements by issuing the *Detailed Rules on the Regulations for the Administration of Foreign-Invested Insurance Companies*. These rules lowered capital requirements for national licenses from RMB 500 million ($60 million) to RMB 200 million ($24 million) and for branch offices from RMB 50 million ($6 million) to RMB 20 million ($2.4 million). These changes have been welcomed by some U.S. insurers, but others still consider them to be too high. The rules also streamlined licensing application procedures and shortened approval times, although some procedures remain unclear. Meanwhile, the rules did not adequately address branching rights, as many aspects of this issue remain vague.

By December 2004, in accordance with its WTO commitments, China lifted all of its geographic restrictions on foreign insurers. China also took steps in 2005 to permit foreign insurers to offer health and group insurance as well as pension/corporate annuities and increased the 50 percent ceiling on foreign ownership of joint venture insurance brokerages to 51 percent.

With all geographic restrictions removed and most business scope restrictions lifted in 2005, the operations of foreign insurers in China continued to grow. Foreign insurer premium income more than doubled, increasing from $1.2 billion in 2004 (representing 2.3 percent of total premium income) to $4.3 billion in 2005 (representing 6.9 percent of total premium income). While foreign insurers still had a relatively low share of the national market, in some areas market share was increasing more quickly. According to the most recently available figures from CIRC, in 2004, the 37 foreign insurers present in China (a figure that rose to 40 in 2005) held a 15.3 percent market share in Shanghai and an 8.2 percent market share in Guangzhou.

However, despite these developments, U.S. and other foreign insurers are concerned that apparent discrimination in branching approvals may limit their ability to expand. In practice, it appears that established Chinese insurers are being granted new branch approvals on a concurrent basis, meaning more than one branch at a time. In contrast, foreign insurers so far have only received approvals on a consecutive basis, meaning one branch at a time. Meanwhile, a number of U.S. investors have taken significant minority equity stakes in major Chinese insurance companies as a means of accessing China's insurance market.

Banking Services

As part of its WTO accession agreement, China agreed to allow foreign banks to conduct local currency business with Chinese companies two years after its WTO accession and with Chinese individuals five years after accession, or by December 11, 2006. China also committed to opening four new cities every year where foreign banks could engage in local currency operations. All non-prudential market access and national treatment restrictions on foreign banks are to be lifted by December 11, 2006.
Under regulations issued in December 2001, foreign banks must meet stringent criteria such as having gross assets of $20 billion when opening new branches in China. Although China reduced capital requirements for foreign bank branches in December 2003, they remained excessively high, increasing local capital costs for foreign banks. Foreign bank branches must also place 30 percent of their operating capital in interest bearing assets designated by the People's Bank of China (PBOC). Foreign bank branch current assets (cash, local bank demand deposits, and PBOC deposits) must continue to be greater than 25 percent of customer deposits. In addition, the ratio of customer deposits in foreign currency to domestic foreign currency assets may not exceed 70 percent, an increase from the 40 percent-level mandated previously. China calculates prudential rations and limits based on the local capital of foreign bank branches rather than on the global capital base of the bank, although more lenient rules apply in authorized cities in the northeastern and western regions of China.

China also continues to have strict limitations on foreign banks' participation in local currency operations, which are regulated by the PBOC. These restrictions are being gradually relaxed, but local currency transactions with individuals remain prohibited until December 11, 2006. Restrictions on the rights of foreign banks to raise RMB in the interbank market also inhibit the ability of foreign banks to build RMB loan portfolios necessary for profitable operations in China. Meanwhile, although foreign currency business with any customer, foreign or domestic, is now freely permitted, only a limited number of foreign banks are allowed to do forward foreign exchange contracts.

In December 2003, the Chinese Government increased the stake a single foreign investor can take in a Chinese bank from 15 to 20 percent, with a total 24.9 percent allowed for all foreign investors. The United States and other WTO members have objected to these limitations, as China did not schedule any limitation on the percentage of foreign ownership in these banks when it acceded to the WTO.

Nevertheless, since the increased ownership limitations went into effect, a number of foreign investors have taken significant equity stakes in Chinese banks, including three of the four large state-owned banks. In the case of the Shenzhen Development Bank, a foreign investor has been allowed to take a controlling interest. Two of the foreign-invested banks have successfully listed on the Hong Kong stock exchange and more are expected in the near future.

By October 2005, despite high capital requirements and other impediments, 173 foreign banks, including a number of U.S. banks, reportedly had branches or representative offices in China, although only major banks have been large enough to satisfy the application requirements. In addition, the business that foreign banks were most eager to pursue in China – domestic currency – had expanded tremendously, although China's regulatory authorities continued to shield domestic banks from foreign competition in some areas, such as by limiting product innovation by foreign banks. According to the PBOC and CBRC, the domestic currency business of U.S. and other foreign banks grew rapidly in the first two years after China's WTO accession, even though the banks' clients were then limited to foreign-invested enterprises and foreign individuals. Following the PBOC's December 2003 announcement that foreign banks would be permitted to conduct domestic currency business with Chinese enterprises subject to previously permitted geographic restrictions, the growth in U.S. and other foreign banks' domestic currency business accelerated. The total assets of foreign banks in China reportedly had reached $84.5 billion by October 2005, representing approximately 2 percent of the total banking assets in China. In some coastal cities, the share was higher. For example, in Shanghai, foreign banks' assets reportedly represented 12.4 percent of total banking assets.

Securities Services

Pursuant to the terms of China's WTO accession agreement, foreign securities firms were to receive the right to form joint ventures for fund management upon China's accession to the WTO in December 2001, while joint ventures for securities underwriting were to be permitted within three years after accession.

The China Securities Regulatory Commission issued regulations on the establishment of joint venture fund management companies and securities underwriting by Chinese-foreign joint ventures shortly after China's WTO accession. China's decision to limit foreign partners to a minority stake of these joint ventures (49 percent for fund management and 33 percent for securities trading), however, continues to limit their appeal to leading foreign firms and only a handful of joint ventures have been formed. In addition, China continues to limit the security underwriting joint ventures to underwriting A-shares and to underwriting and trading government and corporate debt, B-shares and H-shares.

Since December 2002, China has allowed Qualified Foreign Institutional Investors (QFIIs) to trade in A-shares via special accounts opened at designated custodian banks. However, stringent criteria currently make it difficult for foreign institutions to qualify as QFIIs, while other requirements limit the extent to which QFIIs can trade in A-shares.

Motor Vehicle Financing Services

China's WTO accession agreement required China to allow foreign non-bank financial institutions to provide motor vehicle financing immediately upon its accession in December 2001 and without any limits on market access. As a result of persistent U.S. engagement with China, both bilaterally and at WTO meetings, China issued regulations in October and November 2003 allowing foreign non-bank financial institutions to provide motor vehicle financing. The capital requirements set by these regulations are relatively high, with minimum registered capital at RMB 300 million ($36 million), and minimum paid-in capital at RMB 500 million ($60 million). In January 2004, CBRC granted licenses for one U.S. auto company and two other foreign auto companies to set up non-bank motor vehicle financing institutions. CBRC granted licenses for other foreign auto companies later in the year as well. In August 2004, the PBOC and CBRC jointly issued the *Administrative Rules on Auto Financing*, which became effective in October 2004. These rules set forth administrative requirements and risk management rules for extending auto loans in China and allowed the licensed companies to actually begin operations.

Financial Information Services

In its WTO accession agreement, as discussed above, China committed that, for the services included in its Services Schedule, the relevant regulatory authorities would be separate from, and not accountable to, any service suppliers they regulated, with two specified exceptions. One of the services included in China's services schedule – and not listed as an exception – is the "provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services."

Nevertheless, China has still not established an independent regulator in the financial information services sector. Xinhua, the Chinese state news agency, is both a major market competitor of, and the regulator of, foreign financial information service providers in China. As problems with Xinhua's regulation of this sector mounted in 2005, U.S. and other foreign financial information service providers began to call for the establishment of an independent regulator.

Wholesaling Services and Commission Agents' Services

In its WTO accession agreement, China committed to provide national treatment and eliminate market access restrictions for foreign enterprises seeking to provide wholesaling and commission agents' services and related services, such as repair and maintenance services, through a local presence within three years of China's accession (or by December 11, 2004), subject to limited product exceptions. In the meantime, China agreed to progressively liberalize its treatment of these services pursuant to a set schedule. The phase-in of these services was supposed to start with minority foreign-owned joint ventures by December 11, 2002, followed by majority foreign-owned joint ventures by December 11, 2003.

Shortly after acceding to the WTO, China fell behind in its implementation of the required progressive liberalization, as foreign enterprises continued to face a variety of restrictions. It was not until mid-2004, following high-level U.S. engagement that China began to take steps to liberalize. At that time, MOFCOM issued regulations providing national treatment and eliminating market access restrictions on joint ventures providing wholesaling services and commission agents' services. These regulations also established a timetable for extending this liberalization to wholly foreign-owned enterprises on December 11, 2004.

While these regulations were welcome, MOFCOM was very slow to implement them, and it still has not implemented them fully. Initially, MOFCOM did not issue any guidance regarding how its approval system would operate, and the application process remained opaque. In most instances, the application process turned into a protracted negotiation, as the central and local approving authorities were still in the process of determining the appropriate procedures and documentation requirements. When approvals were issued, moreover, the central and local approving authorities imposed a variety of restrictions, such as limits on the scope of products that could be distributed and limits on the specific services that could be supplied. Registered capital requirements have also varied.

In addition, through the first six months of 2005, the Chinese authorities rarely issued approvals for existing enterprises seeking to expand their business scope to include wholesale distribution, in part because the Chinese authorities were sorting our historical tax treatment and Free Trade Zone (FTZ) issues. The Chinese authorities did issue some approvals for the establishment of new wholesale distribution enterprises, but this route did not make business sense for many enterprises already established in China.

By June 2005, the Chinese authorities had begun to make progress in resolving many of the problems that had plagued the application and approval process, including how it would handle the tax and FTZ issues that had stalled many enterprises' applications. In July 2005, MOFCOM and the General Administration of Customs (Customs Administration) issued the Circular on Issues Concerning the Trade Administration of Bonded Zones and Bonded Logistics Parks, which clarified the handling of applications from enterprises located in FTZs. At the July 2005 JCCT meeting, China also committed to improve the transparency of the application and approval process. Consistent with this commitment, in September 2005, MOFCOM issued the Application and Approval Guidelines for Foreign Investments, which clarify many aspects of the application and approval process. Since then, some improvements have taken place in the application and approval process, although U.S. industry continues to have concerns with regard to continuing product and services restrictions. U.S. industry is also concerned about the uncertainty created by the provision in the April 2004 regulations that allows the local approving authorities to withhold wholesale (and retail) distribution license approvals when, as is the case in most cities, urban commercial network plans have not yet been formulated. This provision could operate as a de facto restriction on the operations of foreign wholesalers (and retailers).

One area that requires clarification from the Chinese authorities involves the distribution of books, newspapers and magazines. While the April 2004 regulations purport to allow foreign enterprises to obtain the right to distribute books, newspapers and magazines in China, other measures appear to restrict this right.

For example, the *Administrative Measures on the Subscription of Imported Publications*, issued by the General Administration of Press and Publications in September 2004, appear to restrict the distribution of imported publications by subscription to state trading enterprises. While China has since confirmed that foreign enterprises are now permitted to distribute books, newspapers and magazines in China, it has not provided a justification for the measure that restricts the distribution of imported publications by subscription to state trading enterprises.

In 2005, China began to implement several measures designed to implement its commitment to allow the distribution of automobiles by foreign enterprises, including the *Implementing Rules for the Administration of Brand-Specific Automobile Dealerships,* the *Policies for Automobile Trade* and the *Measures for the Administration of the Distribution of Used Vehicles.* However, under these rules, foreign cars face more, not fewer, restrictions, especially in the area of dealerships. For example, foreign automobile manufacturers are required to delegate the operations of its distribution network to either a domestic firm or a newly created firm. Moreover, prior to December 11, 2006, foreign investors cannot hold more than 49 percent of any new dealership if it already owns thirty or more dealerships. Dealerships, post-sales service and supply of parts are all restricted to delegated operators.

Meanwhile, China has delayed the implementation of its commitments with regard to the distribution of pharmaceuticals, despite the fact that the exception for pharmaceuticals contained in China's accession agreement expired as of December 11, 2004. Although the April 2004 regulations indicated that separate regulations would be issued for the pharmaceuticals sector, China has not issued any further regulations and has continued to require foreign pharmaceutical companies to sell their finished products through Chinese wholesalers (after hiring Chinese importers to bring their finished products into the country). China reportedly decided in the last half of 2005 to begin accepting applications from foreign pharmaceutical companies for wholesale (and retail) licenses under the April 2004 regulations and the State Food and Drug Administration's *Rules on the Management of Drug Business Licenses.*

Retailing Services

In 1999, the Chinese government broadened the scope for foreign investment in the retail sector. New regulations encouraged the entry of large international retailers (such as hypermarkets and warehouse-style stores) into China. China's subsequent WTO commitments were designed to further expand the ability of foreign retailers to enter the market through a much wider range of modalities. Smaller retail operations, some large retail operations, gas stations and even car dealerships may be wholly foreign-owned within three to five years of China's December 2001 WTO accession, although certain types of large retail operations may still face ownership limitations.

As in the area of wholesaling and commission agents' services, China fell behind in its implementation of the required progressive liberalization of retailing services shortly after acceding to the WTO, as foreign enterprises continued to face a variety of restrictions.

China only began to take steps to liberalize in mid-2004, when MOFCOM issued regulations providing national treatment and eliminating market access restrictions on joint ventures providing retailing services. These regulations also established a timetable for extending this liberalization to wholly foreign-owned enterprises on December 11, 2004.

Many of the same problems that plagued the application and approval process for wholesaling and commission agents' services in 2005 also arose in the area of retailing services. While improvements took place throughout the year, U.S. industry continues to have concerns, particularly with regard to the provision in the April 2004 regulations allowing the local approving authorities to withhold retail distribution license approvals when, as is the case in most cities, urban commercial network plans have not yet been formulated.

Meanwhile, it appears that China may not be fully implementing its commitment to allow foreign enterprises to sell gasoline at the retail level. Although China's retail services commitments initially did not apply to processed oil, as it was one of the excepted goods under China's services schedule, that exception expired on December 11, 2004, and by that time China committed to permit wholly foreign-owned enterprises to operate gas stations. However, according to some recent reports, China is now claiming that gas stations fall under the chain store provision in its services schedule, which applies to "those chain stores which sell products of different types and brands from multiple suppliers with more than 30 outlets" and permits only joint ventures with minority foreign ownership.

Franchising Services

As part of its services commitments, China committed to permit the cross-border supply of franchising services immediately upon its accession to the WTO. It also committed to permit foreign enterprises to provide franchising services in China, without any market access or national treatment limitations, by December 11, 2004. In December 2004, MOFCOM issued new rules governing the supply of franchising services in China, the *Measures for the Administration of Commercial Franchises*, effective February 2005. These rules raised a number of concerns. Of particular concern is a requirement that a franchiser own and operate at least two units in China for one year before being eligible to offer franchises in China. The business models of many U.S. franchising companies, including some large hotel chains, are adversely affected by this requirement because they do not own and operate units, instead relying exclusively on franchisees to distribute goods and services. The rules also impose high capital requirements and require broad and vague information disclosure by franchisers, with uncertain liability if these disclosure requirements are not met.

Sales Away From a Fixed Location

In 1998, China banned all direct selling activities (or sales away from a fixed location) activities after some foreign and domestic firms used direct selling techniques to operate fraudulent pyramid schemes and other less-than-legitimate operations disguised as direct selling to bilk participants. No U.S. firms were implicated in these schemes. Meanwhile, some large U.S. and other foreign direct selling firms were allowed to continue operating in China after altering their business models. In its WTO accession agreement, China committed to the resumption of direct selling activities by December 2004.

In September 2005, nine months overdue, the Chinese authorities issued the measures designed to implement China's direct selling commitments – the *Measures for the Administration of Direct Selling* and the *Regulations on the Administration of Anti-Pyramid Sales Scams*. These measures contained several problematic provisions. For example, one provision outlaws practices allowed in every country in which the U.S. industry operates – reportedly 170 countries in all – by refusing to allow direct selling enterprises to pay compensation based on team sales, where upstream personnel are compensated based on downstream sales. The United States has pointed out that China could revise this provision to permit team-based compensation while still addressing its legitimate concerns about pyramid schemes. Other problematic provisions include a three-year experience requirement that only applies to foreign enterprises, not domestic ones, restrictions on the cross-border supply of direct selling services and high capital requirements that may limit smaller direct sellers' access to the market. These measures also forbid foreigners from working as salespersons or as trainers for salespersons.

Express Delivery Services

Beginning in December 2001, the State Postal Bureau (together with MOFTEC and MII) issued restrictive measures that could have jeopardized market access that foreign express delivery firms (which were then required to operate as joint ventures with Chinese partners) enjoyed prior to China's accession. These measures threatened to curtail the scope of operations of foreign express delivery firms licensed prior to China's accession to the WTO, despite China's horizontal commitment on acquired rights. Specifically, a measure issued in December 2001 required firms wishing to deliver letters to apply for entrustment with China Post. A second measure, issued in February 2002, extended China Post's monopoly on letters by creating weight and rate restrictions on letter deliveries by private firms. Following high-level U.S. interventions, in September 2002, a third measure eliminated the weight and rate restrictions on letter deliveries and streamlined the entrustment application procedure. Two major U.S. express delivery firms subsequently applied for and obtained entrustment certificates from China Post.

In July 2003, however, China circulated draft amendments to its postal services law that generated two immediate concerns among U.S. companies. First, the draft amendments purported to give China Post a monopoly over the delivery of letters under 500 grams, which would have constituted a new restriction on the scope of activities of existing foreign-invested express delivery companies, contrary to China's horizontal acquired rights commitment. Second, the draft amendments did not address the need for an independent regulator.

In September, October and November 2003, China circulated new sets of draft amendments. While each set of draft amendments included a different definition of the China Post monopoly, the most recent draft amendments continued to provide China Post with a monopoly on letters weighing less than 500 grams. They also included other problematic provisions. For example, they appeared to create a new, more burdensome licensing process, and they seemed to require express couriers to pay a percentage of their revenue from the delivery of letters into a universal service fund.

In April 2004, following high-level U.S. engagement urging China not to cut back on the scope of activities that foreign-invested express delivery companies had been licensed to provide prior to China's WTO accession, Vice Premier Wu Yi committed that old problems, like the weight restriction, would not resurface as new problems. In July 2004, however, the State Council circulated another set of draft amendments to the postal services law. Despite Vice Premier Wu's commitment, these draft amendments continued to include a weight restriction, now reduced from 500 grams to 350 grams and did little to address other U.S. concerns. A new but still problematic set of draft amendments was reportedly circulating within China's ministries and agencies and to select domestic enterprises in early 2006, as U.S. engagement continued.

Construction, Engineering, Architectural and Contracting Services

Since before China's WTO accession, U.S. construction, engineering and architectural firms and U.S. contractors have enjoyed a relatively cooperative and open relationship with the Chinese government. These firms have operated in the Chinese market through joint venture arrangements and have been less affected by regulatory problems than other service sectors. Nevertheless, they have also faced restrictions. It has been difficult for foreign firms to obtain licenses to perform services except on a project-by-project basis. Foreign firms have also faced severe partnering and bidding restrictions.

In September 2002, the Ministry of Construction and MOFTEC jointly issued Decrees 113 and 114, which opened up construction and related construction design services to joint ventures with majority foreign ownership and, two years ahead of schedule, wholly foreign-owned enterprises. At the same time, however, these decrees created concerns for U.S. and other foreign firms by imposing new and more restrictive conditions than existed prior to China's WTO accession, when they were permitted to work in China on a project-by-project basis pursuant to Ministry of Construction rules. In particular, these decrees for the first time required foreign firms to obtain qualification certificates, effective October 1, 2003. In addition, these decrees for the first time required foreign-invested firms supplying construction services to incorporate in China, and they impose high minimum registered capital requirements and foreign personnel residency requirements that are difficult for many foreign firms to satisfy. In consultation with U.S. industry, the United States, in a high-level intervention, pressed its concerns about Decrees 113 and 114 and sought a delay before the decrees' problematic requirements would become effective. In September 2003, the Ministry of Construction agreed to extend the implementation date from October 1, 2003 until April 1, 2004 so the concerns of foreign firms could be analyzed further.

In April 2004, Decree 113 went into effect. However, in September 2004, the Ministry of Construction and MOFCOM issued Circular 159, which permitted foreign providers of construction services and related construction engineering design services to continue operating on a project by-project basis until July 1, 2005, effectively extending the effective date of the incorporation-related requirements. With the expiration of Circular 159 in July 2005, however, U.S. and other foreign companies now face a great deal of uncertainty as they seek to participate in projects in China.

In September 2005, the Ministry of Construction and MOFCOM circulated draft *Regulations on the Administration of Foreign-Invested Construction Service Enterprises* for public comment. These draft regulations call for the Chinese authorities to begin accepting applications from foreign-invested enterprises on December 1, 2006. While the draft regulations bring clarity to the application and approval process, they fail to address foreign companies' concerns regarding high capital requirements and recognition of foreign credentials. They also create obstacles and delay for foreign companies by establishing a complicated grading system for construction service enterprises.

Meanwhile, in late November 2004, the Ministry of Construction issued the *Provisional Measures for Construction Project Management* (known as Decree 200), which became effective on December 1, 2004. Among other things, Decree 200 appears to preclude the same company from providing construction services and related construction engineering design services if it also provides project management services on the same project. This aspect of the decree raises concerns because U.S. companies often provide all of these services in combination when working on a project in a foreign market.

Finally, a number of restrictions continue to apply to foreign providers of engineering and architectural services. Foreign firms cannot hire Chinese nationals to practice engineering and architectural services as licensed professionals. Currently, Chinese engineering and architectural firms must approve and stamp all drawings prior to construction. China also sets extremely low design fees, rather than letting the market set prices, while China does not have adequate lien laws to protect the rights of engineering and architectural firms from non-payment. There have also been instances in which U.S. engineering and architectural firms have had to pay Chinese domestic taxes on designs prepared in the United States for Chinese projects.

Transportation and Logistics Services

The transportation and logistics sector has in the past faced severe regulatory restrictions, high costs, dominance by government-invested agents, and limitations on permitted activities. The multiple government bodies responsible for this sector include the Ministry of Communications, the Ministry of Railways, MOFCOM, NDRC and the Civil Aviation Administration of China. Overlapping jurisdictions, multiple sets of approval requirements and opaque regulations hinder market access. In some areas, domestic firms have also used government connections and investments to monopolize the sector.

Nevertheless, like China's own reform policies, China's WTO commitments support a broad opening of the transportation and logistics sector to foreign services providers, to be phased in over time. Foreign firms should be able to invest freely in warehousing, road freight transport, rail freight transport and freight forwarding companies within three to six years after WTO accession, depending on the sector.

In July 2002, MOFCOM's predecessor, MOFTEC, issued a *Notice on Establishing Foreign-Invested Logistics Companies in Trial Regions*. This notice allows foreign-invested logistics companies (with up to 50 percent foreign ownership and registered capital of $5 million) to establish in several designated cities. U.S. firms have expressed concern about the high capital requirement and the 50 percent cap on foreign ownership, which may conflict with China's WTO commitments for certain types of logistics services.

In November 2002, China issued regulations allowing majority foreign ownership of road transportation firms, as it was required to do within one year of its WTO accession. China was also obligated to issue regulations allowing majority foreign-owned joint ventures to enter the fields of packaging services, storage and warehousing, and freight forwarding one year after its accession; it issued timely regulations allowing 75 percent foreign-owned joint ventures in these fields.

China took a significant step in July 2004 to increase market access for U.S. passenger and cargo carriers by signing a landmark amendment to the aviation agreement with the United States. The amended agreement will more than double the number of U.S. airlines operating in China and will increase by five times the number of flights providing passenger and cargo services between the two countries over the next six years. The agreement also allows each country's carriers to serve any city in the other country, provides for unlimited code-sharing between them, expands opportunities for charter operators, and eliminates government regulation of pricing as of 2008. U.S. passenger and cargo carriers have since obtained additional routes and increased flight frequencies, as envisioned by the agreement.

Similarly, in late 2003, China took steps to liberalize the maritime services sector despite having made no WTO commitment. The United States and China signed a far-reaching, five-year bilateral maritime agreement, which will give U.S.-registered companies the legal flexibility to perform an extensive range of additional shipping and logistics activities in China. U.S. shipping and container transport services companies, along with their subsidiaries, affiliates and joint ventures will also be able to establish branch offices in China without geographic limitation.

In April 2005, AQSIQ issued the *Criteria for the Classification and Assessment of Logistics Firms*. Under this measure, AQSIQ uses a firm's business and financial situation, equipment, operating infrastructure, management, services provided, and human resource information as of the time of its business license application in order to classify the firm into one of three broad categories, i.e., transport, warehouse or multi-service, for regulatory purposes.

Some firms have criticized this measure as creating "hastily formulated standards" that inappropriately restrict the business scope of logistics firms and have also complained about unnecessary and burdensome requirements. In addition, freight forwarding firms are concerned about not being included in one of the three logistics business categories, particularly because it may prevent their participation in relevant standards-setting activities.

Telecommunications

In its WTO accession agreement, China made important commitments in the area of telecommunications services. It agreed to permit foreign suppliers to provide a broad range of services through joint ventures with Chinese companies, including domestic and international wired services, mobile voice and data services, value-added services, such as electronic mail, voice mail and on-line information and database retrieval, and paging services. The foreign stake permitted in the joint ventures is to increase over time, reaching a maximum of 49 percent for most types of services. In addition, China agreed to eliminate all geographical restrictions within two to six years after its WTO accession, depending on the particular service sector.

Importantly, when it acceded to the WTO, China also accepted key regulatory principles from the WTO Reference Paper. As a result, China became obligated to separate the regulatory and operating functions of MII (which had been both the telecommunications regulatory agency in China and the operator of China Telecom) upon its accession and to implement its regulations in an impartial manner. Since China's accession, MII has spun-off China Telecom, which now competes in the market with other telecom operators. While the formal separation of regulator and operator has occurred, evidence of continued MII influence over operational decisions of the telecom operators (e.g., relating to personnel, corporate organization and standards) suggests that regulatory independence is far from complete. The current regulator, MII, is not structured as an independent entity as it still bears the responsibility to help develop China's IT and telecom manufacturing industries.

China is also obligated to adopt pro-competitive regulatory principles, such as transparent licensing, cost-based pricing and the right of interconnection, which are necessary for foreign-invested joint ventures to compete against established operators. China appears laggard in implementing these commitments, however. For example, there is no sign that "major suppliers" in China have made their interconnection arrangements public. With practically no foreign participation in the market, it has been difficult to assess compliance with such commitments. This very lack of foreign participation, however, is indicative of a licensing regime that has not been conducive to foreign investment, in part due to lack of transparency.

China's *Regulations on Foreign-Invested Telecommunications Enterprises* went into effect January 1, 2002. These regulations define registered-capital requirements, equity caps, requirements for Chinese and foreign partners, and licensing procedures. The regulations stipulate that foreign-invested telecommunications enterprises can undertake either basic or value-added telecommunications services. Foreign ownership may not exceed 49 percent in the case of basic telecommunications services (excluding wireless paging) and 50 percent in the case of value-added services (including wireless paging, which is otherwise categorized as a basic service). The entire process of forming a Sino-foreign joint venture for basic services pursuant to the new regulations is believed to be lengthy, lasting on average 9 to 12 months. While China committed to giving foreign applicants freedom to choose potential joint venture partners, it appears that MII is interpreting requirements regarding technical qualifications to effectively exclude all but incumbent operators, foreclosing additional competition in the market. For foreign operators interested in offering international services, requirements to use a gateway operated by a state-owned operator appear excessive and unjustified. The capitalization requirement established for new entrants, which exceeds $200 million, is another major impediment to market access. There appears to be no justification for such a requirement, particularly for companies interested in leasing, rather than building facilities, while specific licensing terms for resale-based operators do not appear to exist. Meanwhile, MII continues to process applications very slowly for the few foreign-invested telecommunications enterprises that have attempted to satisfy MII's licensing requirements. The results have been predictable: no new joint ventures appear to have been formed in the basic telecom sector since China introduced the January 2002 regulations.

At times, MII has also changed applicable rules without notice and without transparency. For example, in February 2003, MII announced a reclassification of certain basic and value-added telecommunications services effective April 1, 2003. No public comment period was provided. This move limited the ability of U.S. firms to access China's telecommunications market because basic services are on a slower liberalization schedule and are subject to lower foreign equity limits and higher capitalization requirements.

Little progress has been made in opening the market for value-added services, such as Internet service and content providers. MII announced moves toward convergence in voice, video and data services in 2000, but China considers information content sensitive, so foreign companies face significant barriers in the Internet services sector. Although more foreign companies are registering ".com.cn" websites in China, these sites are still often blocked, which hinders companies' abilities to maintain a stable Internet presence. The requirement that Internet service providers (ISPs) must provide user login information and transaction records to authorities upon request, without clear guidelines as to the circumstances and situations that warrant such actions, raises concerns about consumer privacy and prevention of data misuse. Meanwhile, even though China has now completed its fourth year of WTO membership, the United States is aware of only one application for a license to provide value-added services that has completed the MII licensing process. That license was awarded to a Chinese-Korean joint venture in 2005.

Foreign equity investment limitations for ISPs and Internet content providers (ICPs) mirror the timetable for value-added services in China's WTO accession agreement (30 percent upon accession, 49 percent within one year after accession and 50 percent within two years after accession). However, ICPs must still win the approval of MII and/or local telecom administrations depending on the geographic coverage of their services before they can receive foreign capital, cooperate with foreign businesses, or attempt domestic or overseas stock listings. Their services, including even simple commercial websites, are also subject to excessive capitalization requirements that bear little relation to any legitimate licensing goals.

In 2004, a draft of the long-awaited Telecommunications Law began to circulate among Chinese ministries and agencies. If China takes the initiative, this law could be a vehicle for addressing existing market access barriers and other problematic aspects of China's current telecommunications regime. The current status and content of this legislation is unclear, despite repeated U.S. efforts to obtain this information.

Meanwhile, even though China committed in its WTO accession agreement that further liberalization of this sector would be discussed in the current round of WTO negotiations, China has yet to make an improved services offer. With the modest telecommunications commitments made by China in its WTO accession agreement having so far failed to facilitate effective market entry for foreign firms, further liberalization, bound through the current round of WTO negotiations, appears critical to improving market access prospects for this sector.

On-Line Services

Chinese authorities routinely filter Internet traffic entering China, focusing primarily on the content they deem objectionable on political, social or religious grounds. In 2002, China lifted filters on most major western news sites. Nevertheless, since then, foreign news websites have periodically been blocked, as happened, for example, for several weeks during the 16th National Congress of the Communist Party of China in 2003. More generally, according to a Harvard University study published in 2002, China had still blocked 19,032 sites on multiple occasions. In addition to blocking sites related to Taiwan, the Falun Gong spiritual movement, Tibetan and Uighur support groups and human rights organizations focusing specifically on China, the study states that China repeatedly blocked university alumni homepages such as MIT's homepage, various church and other religious-themed sites and search engines such as Alta Vista. Changes to Internet filtering can occur without warning or public explanation. For example, the popular Internet search engine Google was blocked completely in China for a few weeks starting in late August 2002. When Google became available again in September 2002, its "cached pages" feature remained blocked; that feature had previously allowed users in China to access "snapshots" of some web pages that were otherwise blocked in China. All of these practices remained prevalent in 2005. Few, if any, websites related strictly to economic and business matters, however, are blocked.

Internet content restrictions for ICPs, electronic commerce sites and application service providers located in China are governed by a number of measures, not all of which are public. Some of these measures restrict who may report news and place limits on what exactly may constitute news. The most important of these measures was issued in September 2000 and updated in September 2005. In addition to interfering with news reporting in the traditional sense, this measure may provide a basis for Chinese authorities to interfere with the normal business reporting operations of non-news organizations, such as multinational corporations, if they use the Internet to keep clients, members, their headquarters and other interested parties informed about events in China.

In March 2002, the Internet Society of China, a nominally private group affiliated with MII, established a "Public Pledge on Self-Discipline for the China Internet Industry." Signatories commit to "refrain from producing, posting or disseminating pernicious information that may jeopardize state security and disrupt social stability, contravene laws and regulations and spread superstition and obscenity." Reportedly, 130 major Internet portals have since signed the pledge.

Audio-Visual Services (Including Film Imports)

China's *Regulations on the Administration of Audio-Visual Products and Regulations on the Management of Film* went into effect on February 1, 2002. They are designed to bring more order and transparency to the film and audio-visual industries, with an eye to moving toward greater commercial efficiency in accordance with domestic reform efforts and China's WTO commitments. Despite these positive moves, China's desire to protect the revenues earned by the state-owned movie and print media importers and distributors, and China's concerns about politically sensitive materials, result in continued restrictions on foreign providers of audio-visual services. For example, distribution of sound recordings, videos, movies, books and magazines remains highly restricted. In addition news services remain wary that the Chinese government will impose new restrictions on their activities. Inconsistent and subjective application of censorship regulations further impedes market growth for foreign and domestic providers alike.

China issued a number of regulations in 2004 that should lead to expanded market access in the audio-visual services sector, although many restrictions remain. In July 2004, the State Administration for Radio, Film and TV (SARFT) issued the *Rules for the Administration of China-Foreign Cooperation in Filmmaking*. According to these rules, licenses are required for both the joint Chinese-foreign filmmaking cooperative and the cooperating domestic partner. In October 2004, SARFT and MOFCOM issued the *Provisional Rules on the Access Requirements for Film*. These rules cover film production, distribution, screening and imports by domestic firms, and film production and screenings involving foreign firms. All firms engaged in these businesses are subject to SARFT licensing. Foreign firms are allowed to form joint ventures and cooperative firms engaged in film production, technology and equipment. Joint ventures or cooperative firms must have at least RMB 5 million ($600,000) of registered capital, and foreign capital cannot make up more than 49 percent of the total share. In October 2004, SARFT and MOFCOM issued the *Provisional Rules on the Administration of China-Foreign Joint Venture and Cooperative TV Program Production Firms*. These rules establish a minimum registered capital requirement of RMB 2 million ($240,000) for joint ventures and cooperative firms and mandate a share of no less than 51 percent for domestic partners. In February 2005, SARFT issued a circular placing further restrictions on foreign partners and requiring two-thirds of the programs of a joint venture or cooperative firm to have Chinese themes. Finally, in August 2005, the State Council issued a directive stating that non-public capital cannot be used to establish or operate a news agency, newspaper, publishing house, radio station, or TV station. The directive also stated that radio and television signal broadcasting and relay station, satellite and backbone networks are closed to non-public capital.

China began importing foreign films on a revenue-sharing basis in 1994. The Chinese government limits the number of foreign films allowed to enter China. China allowed in only ten foreign films annually through much of the 1990s, but more recently allowed in 20 foreign films annually on a revenue-sharing basis under its WTO commitments. However, China treats its WTO commitment as a ceiling, rather than a floor, which artificially increases demand for pirated products. Although China is also obligated to open theaters and film distribution to foreign investment, currently there are only two authorized distributors of foreign films, the state-owned China Film Distribution Company and Huaxia. Furthermore, lengthy censorship reviews by Chinese authorities delay the arrival of legitimately imported foreign films on Chinese movie screens. When the films do make it to the screen, they have sometimes been subject to blackout viewing periods during national holidays. China's large black market for foreign films continues to grow because these market access restrictions not only create a demand for pirated DVDs in the absence of legitimately licensed films, but also diminish the incentive for foreign investment in movie theaters (which is currently limited to a minority stake). Rights holders who comply with Chinese law must forego marketing legitimate products, leaving the demand for movies to be satisfied almost entirely by pirates. Some progress was achieved in 2004, when MOFCOM approved a U.S.-invested film distribution joint venture and took steps to shorten the time required to bring films to market.

Meanwhile, China is reportedly in the process of formulating a policy to support its weak cartoon industry. According to several reports, in June 2005, SARFT began circulating a draft measure providing that only domestically produced cartoons could be broadcast during prime-time viewing hours and that advertisements shown during this period should be used to finance the production of domestic cartoons. The draft measure also reportedly forbids the introduction of foreign cartoons under the disguise of domestic cartoons as well as cartoons that are jointly made with foreigners.

Tourism and Travel Services

Immediately following China's WTO accession in December 2001, China issued new travel agency administration regulations, the *Regulations on the Administration of Travel Agencies*, which were designed to make it easier for large foreign travel and tourism service providers to participate as minority partners in the operation of full-service joint venture travel agencies handling foreign inbound tourism. China subsequently issued the *Provisional Measures for the Establishment of Foreign-controlled and Wholly Foreign-funded Travel Agencies*, effective July 2003, which for the first time expressly allowed both foreign-controlled joint ventures and wholly foreign-owned enterprises. Under this measure, these travel agencies were allowed to engage in foreign inbound tourism through the establishment of offices in five major foreign tourist destinations in China – Beijing, Shanghai, Guangzhou, Shenzhen and Xian. Foreign-controlled travel agencies must have an annual worldwide turnover in excess of $40 million, and wholly foreign-funded travel agencies must have an annual worldwide turnover in excess of $500 million. For both types of travel agencies, there is also a local registered capital requirement of RMB 4 million ($480,000).

In November 2003, Germany's Touristic Union International (TUI) signed a letter of intent with the China Tourism Agency to form the first joint venture travel agency controlled by a foreign interest since China's WTO accession. Japan Airlines subsequently established the first wholly foreign-funded travel agency.

In February 2005, China issued a measure lowering the minimum registered capital requirement for foreign-controlled and wholly foreign-owned travel agencies from RMB 4 million ($480,000) to RMB 2.5 million ($300,000), which had been required as of December 11, 2004, by its WTO accession agreement. It also lifted all remaining geographical restrictions on the establishment of foreign-controlled and wholly foreign-owned travel agencies, nearly three years in advance of the schedule set forth in its WTO accession agreement.

Foreign firms continue to be restricted from competing in the Chinese outbound tourist market. In addition, China requires all travel agents, airlines and other booking entities to use or connect into China's nationally owned and operated computer reservation system when booking airline tickets. Foreign computer reservation companies can only provide reservations by connecting with the Chinese system. The total number of non-immigrant visas issued to Chinese wishing to travel to the United States rose from approximately 263,000 in FY 2004 (October 1, 2003-September 30, 2004) to more than 326,000 in FY 2005 (October 1, 2004-September 30, 2005), a 24 percent increase. Most of this increase is accounted for by a resumption of normal travel patterns following the containment of the SARS outbreak in China in 2003.

Beginning on January 15, 2005, eligible Chinese nationals wishing to visit the United States temporarily for business (B-1) or tourism (B-2) could be issued visas that were valid for 12 months and multiple entries. The previous maximum validity for U.S. visas issued for these purposes was six months and multiple entries.

Meanwhile, holders of official Chinese passports, nearly 23,000 of who were issued U.S. visas in 2004, are required to use China's state-owned airlines or their code-share partners. Most of these individuals are employees of state-owned enterprises, who would not be considered government employees in most countries. This represents a significant loss of business for U.S. airlines.

Education and Training Services

China faces a shortage of qualified teachers and clearly needs educators in inland regions. However, the Ministry of Education (MOE) continues to restrict participation by foreign educators and trainers. China permits only non-profit educational activities that do not compete with the MOE-supervised nine years of compulsory education, thereby inhibiting much-needed foreign investment in the education sector. In April 2000, MOE also banned foreign companies and organizations from offering educational services via satellite networks.

In June 2004, the Ministry of Education issued the *Implementing Rules for China-Foreign Cooperative Education Projects*. Although formulated to implement the *Regulations on China-Foreign Cooperation in Running Schools*, issued in September 2003, the rules allow foreign educators to participate only in certain activities, including education offering academic certificates, supplementary education and pre-school education. These activities cannot take the form of activities at actual educational institutions.

Foreign universities may set up non-profit operations. However, they must have a Chinese university host and partner to ensure that programs bar subversive content and localize imported information.

Meanwhile, China's training market is unregulated, which discourages potential investors from entering the market.

Legal Services

Prior to its WTO accession, China maintained various restrictions in the area of legal services. It prohibited representative offices of foreign law firms from practicing Chinese law or engaging in profit-making activities with regard to non-Chinese law. It also imposed restrictions on foreign law firms' formal affiliation with Chinese law firms, limited foreign law firms to one representative office and maintained geographic restrictions. Chinese law firms, on the other hand, have been able to open offices freely throughout China since 1996.

As part of its WTO accession, China agreed to lift quantitative and geographical restrictions on the establishment of representative offices by foreign law firms within one year after accession. In addition, foreign representative offices are to be able to engage in profit-making business, to advise clients on foreign legal matters and to provide information on the impact of the Chinese legal environment, among other things. They also are to be able to maintain long-term "entrustment" relationships with Chinese law firms and to instruct lawyers in the Chinese law firm as agreed between the two law firms.

The State Council issued the *Regulations on the Administration of Foreign Law Firm Representative Offices* in December 2001, and the Ministry of Justice issued implementing rules in July 2002. While these measures removed some market access barriers, they also generated concern among foreign law firms doing business in China. In many areas, these measures were ambiguous. For example, it appeared that these measures created an economic needs test for foreign law firms that want to establish offices in China, which would raise concerns regarding China's compliance with its GATS commitments. The measures also seemed to take an overly restrictive view of the types of legal services that foreign law firms may provide. In addition, the procedures for establishing a new office or an additional office were unnecessarily time-consuming. For example, a foreign law firm may not establish an additional representative office until its most recently established representative office has been in practice for three consecutive years. Foreign attorneys also may not take China's bar examination, and they may not hire registered members of the Chinese bar as attorneys.

Although a number of U.S. and other foreign law firms have been able to open a second office in China, little progress has been made on the other problematic aspects of these measures, particularly the economic needs test, the unreasonable restrictions on the types of legal services that can be provided and the unnecessary delays that must be endured when seeking to establish new offices. These obstacles continue to prevent foreign law firms from participating fully in China's legal market.

Accounting and Management Consultancy Services

Prior to China's accession to the WTO, foreign accounting firms could not choose their own Chinese joint venture partners freely or enter into contractual agreements that could fully integrate these joint ventures. Upon its accession to the WTO, China agreed to allow foreign accounting firms to partner with any Chinese entity of their choice. China also agreed to abandon the prohibition on foreign accounting firms' representative offices engaging in profit-making activities. In addition, China agreed that foreign accounting firms could engage in taxation and management consulting services, without having to satisfy the more restrictive requirements on form of establishment applicable to new entities seeking to provide those services separately.

The Chinese Institute of Certified Public Accountants, a government body under MOF, has made progress in modernizing accounting in China. In 2002, MOF released four newly revised auditing statements covering inter-bank confirmation, capital verification, accounting estimates and the audit of commercial bank financial statements. Furthermore, MOF has been active in standardizing accounting procedures across a wide range of topics including investments, inventories, cash flow statements, and fixed assets. The Chinese Securities Regulatory Commission, meanwhile, requires a listed company to appoint a certified international CPA firm to conduct audits on prospectuses and annual reports in accordance with international standards.

Despite these positive changes, pervasive problems remain. Differing accounting regulations limit the comparability of data, and the accounting practices followed by many domestic firms do not meet international conventions.

Advertising Services

In the past, foreign firms had been restricted to representative offices or minority ownership of joint-venture operations. As part of its WTO accession commitments, however, China agreed to allow majority foreign ownership of joint venture advertising companies by December 11, 2003, and wholly foreign-owned subsidiaries by December 11, 2005.

In March 2004, the State Administration of Industry and Commerce (SAIC) and MOFCOM issued rules governing joint venture, cooperative and wholly foreign-owned advertisement firms. To establish branches, a firm must have paid in full its registered capital and have at least RMB 20 million ($2.4 million) in annual advertising revenue. Foreign firms are currently limited to a 70 percent share of joint venture and cooperative firms. Implementing rules, effective January 1, 2005, subsequently allowed wholly foreign-owned advertising firms to conduct business in China.

Advertising in China is still governed by China's 1995 Advertising Law, which is enforced by SAIC. Among other things, the law bans messages "hindering the public or violating social customs." The law is also subject to interpretation by SAIC, which must approve all advertising campaigns. One additional difficulty for foreign advertising firms, as well as foreign manufacturers, is that China has strict regulations prohibiting comparative advertising as well as any advertising with claims about the relative superiority of one brand over another. Marketing strategies that are successful in some other countries are therefore illegal in China.

Movement of Professionals

Generally, there are no special entry restrictions placed on U.S. professionals who wish to work in China, such as doctors or engineers. However, like other foreign professionals, they must receive approval from the Foreign Experts Bureau. Prior to arrival, a prospective American job applicant may be asked to provide notarized copies of his or her professional credentials and a summary of past work experience. The credentials will be used by the employer to file for a "foreign experts residency permit" for the American employee. Once the "foreign expert" permit is authorized, the prospective employee can request a work visa (a "Z" visa) from a Chinese embassy or consulate. If the prospective employee arrives in China on a visitors' visa (an "L" visa) prior to commencing employment, the prospective employee is usually asked to depart China prior to starting work, and to apply for the appropriate work visa from a foreign entry point (usually Hong Kong). Local employers are responsible for all employment or income tax and other withholdings for these "foreign experts" while they are employed in China. Recent press reports indicate that the government is considering measures to liberalize access by issuing "permanent resident" visas to long-time foreign residents of China. Meanwhile, for long-term foreign residents in China, the government is liberalizing access by replacing the "Residence Card" with the "Permanent Resident Visa."

INVESTMENT BARRIERS

Foreign investors continue to show great interest in China despite significant obstacles. According to the United Nations Conference on Trade and Development, China received $60.3 billion in FDI in 2005, about 0.5 percent under the 2004 figure but still making China the third largest destination for FDI after the United States and the United Kingdom. Investors in China continue to confront a lack of transparency, inconsistently enforced laws and regulations, weak IPR protection, corruption and an unreliable legal system incapable of protecting the sanctity of contracts. In 2005, U.S. companies highlighted the inadequate supply of qualified management-level human resources and local protectionism as two new areas of concern, and noted that China's performance in both areas had deteriorated since 2004.

China's leadership has reaffirmed its commitment to "further open" China to investment and to continue movement toward a rules-based economic system. Meanwhile, foreign (and domestic) companies have continued to report high profitability in 2005, indicating that challenges to doing business in China have been largely surmountable. Nonetheless, faster progress toward removing investment barriers could spur even more investment, particularly in new, higher value-added manufacturing and services.

Investment Requirements

In addition to taking on the obligations of the WTO Agreement on Trade-Related Investment Measures, China committed in its WTO accession agreement to eliminate export performance, local content and foreign exchange balancing requirements from its laws and regulations and not to enforce any contracts imposing those requirements. China also agreed that it would no longer condition investment (or import) approvals on those requirements or on requirements such as technology transfer and offsets.

In anticipation of these commitments, China revised its laws and regulations on foreign-invested enterprises in an attempt to eliminate WTO-inconsistent requirements relating to export performance, local content and foreign exchange balancing as well as technology transfer. China also revised "Buy China" policies that regulated procurement of raw materials and fuels, and removed requirements that joint ventures and wholly foreign-owned enterprises submit production/operation plans to Chinese authorities. However, some measures continue to "encourage" technology transfer, without formally requiring it. U.S. companies are concerned that this encouragement will in practice amount to a requirement in many cases, particularly in light of the high degree of discretion provided to Chinese government officials when reviewing investment applications. In addition, according to U.S. companies, some Chinese government officials still consider factors such as export performance and local content when deciding whether to approve an investment or to recommend approval of a loan from a Chinese bank, which is often essential to the success of an investment project.

Foreign investors remain wary of potential investment-related practices that would be inconsistent with WTO rules. In their experience, central government commitments to WTO-compliant measures often do not translate into provincial practices.

Investment Guidelines

Foreign investment inflows continue to be controlled and channeled toward areas that support national development objectives. China has adjusted its investment guidelines a number of times over the last several years. The revisions have confused potential investors and added to the perception that the investment guidelines do not provide a stable basis for business planning. Uncertainty as to which industries are being promoted as investment targets and how long such designations will be valid undermines confidence in the stability of the investment climate. The most recent catalogue of investment targets took effect January 1, 2005, replacing the April 2002 catalogue. Like its predecessor, it lists sectors in which foreign investment would be encouraged, restricted or prohibited. Investment in unlisted sectors is considered to be permitted.

Sectors in which China encourage investment include those in which China believes that it could benefit from foreign assistance or technology, such as construction and the operation of infrastructure facilities. In addition, the April 2002 catalogue had implemented elements of openings in sectors to which China committed in its WTO accession agreement, including banking, insurance, petroleum extraction, value-added telecommunications, and distribution. The January 2005 catalogue opens television program production and movie production to foreign investors by allowing minority participation in joint ventures. It also adds production of certain components for large-screen color projection tubes, automobile electronics, industrial boilers and the manufacture of compact disc media to the list of encouraged investments, which benefit from duty-free import of capital equipment and VAT rebates on inputs.

Over the past several years, China has also introduced incentives for foreign investment in certain encouraged sectors. For example, China introduced incentives for investments in high-technology industries, such as a measure issued in November 1999 that provided foreign-invested enterprises a tax deduction for contributions to non-affiliated research and development or educational institutions. In December 2001, China announced comprehensive new incentives for investment in the less-developed central and western parts of the country. Other tax incentives include a reduction of income taxes for foreign-invested enterprises in targeted regions and special economic zones as well as for foreign-invested enterprises engaged in certain industries, such as machinery or construction.

The government also announced a series of measures in August 1999 that began to decentralize authority for approving investments and to create new incentives for investments in key sectors and geographic regions. These guidelines also expanded the authority of provincial-level governments to approve foreign-invested projects. The current rules, set forth in measures issued by the State Council in July and October 2004, significantly expanded provincial governments' approval authority. Under these measures, only project proposals in "encouraged" and "permitted" sectors valued above $500 million, and those in "restricted" sectors valued above $50 million, require NDRC review and State Council approval.

Meanwhile, the Chinese government restricts foreign investment projects in sectors not in line with "the needs of China's national economic development." In these sectors, foreign firms must form a joint venture with a Chinese company and restrict their equity ownership to a minority share in order to invest in the Chinese market.

Beginning in 2004 and continuing through 2005, the government employed a series of restrictive measures to cool what it considered an overheating economy. Some of these measures attempted to restrict further domestic and foreign investment in certain sectors, like real estate and steel. In the case of steel, the new measure – China's July 2005 steel policy – treats foreign investors more strictly. In particular, the new steel policy restricts foreign investment in a number of ways. For example, it requires that foreign investors possess proprietary technology or intellectual property in the processing of steel. Given that foreign investors are not allowed to have a controlling share in steel and iron enterprises in China, this requirement would seem to constitute a *de facto* technology transfer requirement, in conflict with the commitment in China's accession agreement not to condition investment on the transfer of technology. This policy is also troubling because it attempts to dictate industry outcomes and involves the government making decisions that should be made by the market. The policy also prescribes the number and size of steel producers in China, where they will be located, the types of products that will and will not be produced, and the technology that will be used.

This high degree of government direction and decision-making regarding the allocation of resources into and out of China's steel industry is not only inconsistent with the spirit of China's obligations as a member of the WTO, but raises concerns specifically because of the commitment that China made in its WTO accession agreement that the government would not influence, directly or indirectly, commercial decisions on the part of state-owned or state-invested enterprises.

China also prohibits foreign investment in certain sectors. Citing national security interests, China bans foreign investment in news agencies, radio and TV broadcasting stations and networks, radio and TV programming, film production and screening, and the publication, importation and wholesale distribution of press and audio-visual products. The production of arms by foreign investors is also prohibited, as is the mining and processing of certain minerals. U.S. investors have expressed particular concern about China's prohibition of investment in the production and development of plant seeds that are a product of biotechnology.

Other Investment Issues

Venture Capital

Regulations that took effect in March 2003 replaced earlier regulations permitting the establishment of foreign-invested venture capital firms, including wholly foreign-owned enterprises, aimed at funding high-technology and new technology startups in industries open to foreign investment. The March 2003 regulations lower capital requirements, allow these firms to manage funds directly invested from overseas, and offer the option of establishing venture capital firms under an organizational form similar to the limited liability partnerships used in other countries.

Meanwhile, regulations that took effect in April 2001 permit foreign private equity firms subject to limits on corporate structure, share issuance and transfers, and investment exit options. These same regulations, however, bar all domestic and foreign securities firms from the private equity business.

Investment exit problems, especially the difficulty of listing on China's stock exchanges, coupled with the bureaucratic approvals required to list overseas, have limited interest in establishing China-based venture capital and private equity investment. As a result, most foreign venture capital and private equity investments in China are actually housed in offshore investment entities, which, as with other offshore FDI, can be transferred without Chinese government approval.

The Chinese government issued new regulations for domestic venture capital firms in the fall of 2005, and implementing rules are expected to be issued in 2006. It is unclear if these measures will allow foreign firms choosing to operate onshore to take advantage of the incentives offered to domestic firms.

Holding Companies

There has been some relaxation of restrictions on the scope and operations of holding companies, although minimum capital requirements normally make them suitable only for corporations with several sizeable investments to manage. Holding companies may manage human resources across their affiliates and also provide certain market research and other services. However, some restrictions on services provided by holding companies and on holding companies' financial operations and ability to balance foreign exchange internally will remain even after full implementation of China's WTO commitments. Profit and loss consolidation within holding companies also remains prohibited.

Access to Capital Markets

Foreign-invested enterprises in China remain largely unable to access domestic and international stock markets, to sell corporate bonds, to accept venture capital investment, to sell equity, or to engage in normal merger, acquisition and divestment activity. Foreign exchange transactions on the capital account can be concluded only with case-by-case official review, and approvals are subject to very tight regulatory control. These barriers to capital market access were not addressed by China's WTO accession agreement.

China has begun to experiment with liberalization, such as the opening of domestic stock markets to listings by foreign-invested firms. Through the Qualified Foreign Institutional Investor (QFII) program, foreign securities firms can gain limited access to the RMB-denominated A share market by applying for QFII status with the Chinese government. As of December 2005, 32 foreign firms had been granted QFII status, and 31 of them had been issued QFII investment quotas totaling $5.645 billion.

GOVERNMENT PROCUREMENT

In accordance with the terms of its WTO accession agreement, China agreed to conduct its government procurement in a transparent manner and to provide all foreign suppliers with equal opportunity to participate in procurements opened to foreign suppliers. China also committed to become an observer to the WTO Agreement on Government Procurement (GPA), which it did in May 2002, and to table an offer and initiate negotiations for membership in the GPA "as soon as possible." In the interim, China agreed that all of its central and local government entities would conduct their procurements in a transparent manner, as reflected in its WTO accession agreement. China also agreed that, if procurement were opened to foreign suppliers, it would provide MFN treatment by allowing all foreign suppliers an equal opportunity to participate in the bidding process.

While China has still not initiated GPA negotiations, it did promulgate its first Government Procurement Law in July 2002. In part, this was a response to the need to separate purchases by "state-owned enterprises," which China had agreed in its WTO accession agreement would be made on a commercial basis, from "government procurement." China also agreed that the government would not influence the commercial decisions of state-owned enterprises, although in practice this has not consistently been the case.

The Government Procurement Law, which became effective on January 1, 2003, attempts to follow the spirit of the GPA and incorporates provisions from the United Nations Model Law on Procurement of Goods. However, the law also directs central and sub-central government entities to give priority to "local" goods and services, with limited exceptions. China envisions that this law will improve transparency, reduce corruption and lower government costs. The law is also seen as a necessary step toward reforming China's government procurement system in preparation for China eventually becoming a Party to the GPA. In August 2004, MOF issued implementing rules stipulating that procurement of foreign goods, works and services, which are allowed in exceptional circumstances, are subject to review and approval by MOF.

MOF also issued measures in August 2004 covering bidding procedures, publication of information and the handling of complaints related to government procurements. The rules on bidding procedures require all government procurements over a certain amount to be conducted through public bidding. According to the 2004 catalogue for central-government financed government procurement, the threshold for public bidding is RMB 1.2 million ($144,000). To be eligible to participate, suppliers must be domestic and provide "domestic goods and services." MOF is reportedly formulating the criteria for "domestic goods and services." The rules on publication of information require procuring entities and their agencies to make public all necessary information through media outlets designated by MOF. These rules define this information as statutes, data and other materials concerning government procurements, and also require the disclosure of detailed information concerning bid invitations and bidding. The rules on the handling of complaints require MOF and local finance administrations to respond to complaints from suppliers regarding the conduct of procurements. Suppliers may apply for administrative review of a ruling or file an administrative suit in court.

Meanwhile, beginning in 2003, U.S. companies expressed concerns about implementing rules on government software procurement being drafted by MOF. At a time when China's already large software market was projected to grow by more than 50 percent annually, the initial draft of these rules reportedly contained guidelines mandating that central and local governments – the largest purchasers of software in China – purchase only software developed in China to the extent possible. In October 2004, MOF issued a notice seeking input from foreign enterprises regarding the software procurement rules being drafted. Although no actual draft of those rules was included, it appeared that MOF was taking a very restrictive approach in defining "domestic products." The United States and U.S. industry were concerned not only about U.S. software exporters' continuing access to China's large and growing market for packaged and custom software – $7.5 billion in 2004 – but also about the precedent that could be established for other sectors if China proceeded with MOF's proposed restrictions on the purchase of foreign software by central and local governments. At the July 2005 JCCT meeting, China took note of the United States' strong concerns and indicated that it would indefinitely suspend the drafting of implementing rules on government software procurement.

Finally, at the July 2005 JCCT meeting, China agreed to commence "technical discussions" with the United States and other WTO members in preparation for the initiation of negotiations to join the GPA. The first round of technical discussions between China and the United States was scheduled to take place in February 2006.

ELECTRONIC COMMERCE

China has experienced dramatic growth in Internet usage since 1999. According to the 16th Internet survey recently published by the China Internet Network Information Center (CNNIC) in July 2005, the number of people in China with access to the Internet was approximately 103 million, an increase of 10 percent year on year, second only to the United States in terms of total users. Falling personal computer prices and the arrival of devices tailored for the Chinese market will further expand Internet access.

China has also experienced a dramatic increase in the number of electronic businesses established. An estimated 78 percent of all Chinese websites are now operated by "enterprises" and 5 percent by "businesses." By the end of June 2005, there were roughly 677,500 registered websites in China. Of this total, there were 622,534 domain names registered under ".cn". However, despite these developments, only 11 percent of Chinese "enterprise" websites and 45 percent of Chinese "business" websites offer "e-commerce services." Nevertheless, China is experiencing rapid development of on-line business such as search engines, network education, on-line advertisements, audio-video service, paid e-mail, short message, on-line job hunting, Internet consulting and on-line gaming.

The Chinese government recognizes the potential of electronic commerce to promote exports and increase competitiveness and has made some progress toward establishing a viable commercial environment. However, some Chinese ministries with responsibility for electronic commerce have excessively regulated the Internet, thereby stifling the free flow of information and the consumer privacy needed for electronic commerce to flourish. Content is still controlled and encryption regulated, as discussed more fully above (in the "Online Services" section).

A number of technical problems also inhibit the growth of electronic commerce in China. Rates charged by government-approved Internet service providers make Internet access expensive for most Chinese citizens. Slow connection speeds are another problem, although this is changing as broadband connections become more readily available. In 2005, nearly 53 percent of China's Internet users had broadband connections, representing an increase of 15 percent over 2004, and China Telecom is now reportedly the world's largest DSL operator. There are now more than 30 million broadband subscribers in China. China surpassed Japan in 2004 as the country with the second most broadband lines after the United States. At the same time, Internet penetration remains relatively low in China, so there is still significant room for growth.

Other impediments to Chinese businesses and consumers conducting online transactions include the paucity of credit payment systems, consumer reluctance to trust online merchants, the lack of secure online payment systems and inefficient delivery systems. China has also yet to develop a legal framework conducive to the rapid growth of electronic commerce. Laws recognizing the validity of "e-contracting" tools and stressing the importance of online privacy and security have been proposed, but not yet issued. Despite these obstacles, however, a large and growing percentage of Chinese Internet users reportedly have made online purchases.

In a positive development, China passed E-signature legislation in August 2004, which became effective on April 1, 2005. China is also in the process of drafting data privacy legislation.

ANTICOMPETITIVE PRACTICES

China continues to struggle with economic inefficiencies and investment disincentives created by local protectionism, pricing practices and preservation of industry-wide monopolies. Anticompetitive practices in China take several forms. In some cases, industrial conglomerates operating as monopolies, near monopolies or authorized oligopolies (as in the telecommunications industry) may have been allowed to fix prices, allocate contracts and in other ways restrict competition among domestic and foreign suppliers. In addition, regional protectionism by provincial or local authorities often blocks efficient distribution of goods and services inside China. These practices may restrict market access for certain imported products, raise production costs and restrict market opportunities for foreign-invested enterprises in China. There are several existing laws and regulations in China addressing competition matters. However, these measures are largely ineffective due to poor national coordination and inconsistent local and provincial enforcement. China is drafting a new anti-monopoly law that could be adopted by late 2006.

Since November 2002, regulations have allowed foreigners to purchase traded and non-traded (or designated state) shares of Chinese enterprises. In addition, regulations that took effect in April 2003 specify procedures for foreign acquisition of and merger with domestic enterprises. These regulations require pre-merger notification and allow for examination of antitrust considerations in some cases. By requiring approval of all owners of the Chinese enterprise, the regulations implicitly prohibit hostile takeovers. The thresholds for notification are also not straightforward, leaving open the possibility of abuse by officials or domestic competitors. Domestic competitors have the power under the regulations to call for public hearings on prospective mergers.

China also issued regulations in November 2002 addressing the use of foreign investment to reorganize state-owned enterprises. These reorganizations, however, require extensive approvals and the agreement of the state-owned enterprise's labor union. These requirements have limited the appeal of this type of investment.

OTHER BARRIERS

Transparency

In its WTO accession agreement, China committed to publish all laws, regulations and other measures that relate to trade matters, including those that affect imports, and generally to provide a reasonable period for commenting on them before implementation. China also agreed to establish or designate an official journal for the publication of these trade-related measures. In addition, China agreed to provide a copy of new trade-related laws, regulations and other measures to the WTO Secretariat in Geneva, translated into one or more of the WTO's official languages (English, French and Spanish) no later than 90 days after implementation. China further agreed to create various enquiry points for its WTO trading partners and foreign businesses to obtain information about these measures.

Various government-owned specialty newspapers routinely carry the texts of government regulations, implementing rules, circulars and announcements. Many government ministries also publish digests or gazettes containing the texts of these measures, both in written form and on their websites. In addition, there has been a proliferation of online news and information services that routinely offer up-to-date news about and texts of new laws and regulations. Some services even provide legal-quality English translations by subscription. However, many measures that do not rise to the level of ministry-issued regulations or implementing rules continue to remain unavailable to the public. China's ministries routinely implement policies based on internal "guidance" or "opinions" that are not available to foreign firms. Experimental or informal policies and draft regulations, in addition, are regarded as internal matters and public access is tightly controlled.

While positive in some respects, the sheer number of outlets through which trade-related measures are published complicates the ability of interested parties to track their development and issuance. In late 2002, China designated the China Foreign Economic and Trade Gazette as the official journal for this purpose. Published by MOFCOM and replacing the MOFCOM Gazette, it came out on a trial basis in October 2002 and as an official publication in January 2003. However, this journal does not carry draft measures for public comment, nor does it consistently carry trade-related measures developed by ministries and agencies other than MOFCOM. The establishment or designation of a single comprehensive journal would enhance the ability of WTO members to track the drafting, issuance and implementation of trade-related measures. Furthermore, the use of a single journal to request comments on proposed trade-related measures, as envisioned in China's WTO accession agreement, would facilitate the timely notification of comment periods and submission of comments.

In December 2001, the State Council issued regulations explicitly allowing comment periods and hearings. However, many of China's ministries and agencies continued to follow the practice prior to China's accession to the WTO. The ministry or agency drafting a new or revised law or regulation will normally consult with and submit drafts to other ministries and agencies, Chinese experts and affected Chinese companies. At times, it will also consult with select foreign companies, although it will not necessarily share drafts with them. As a result, only a small proportion of new or revised laws and regulations have been issued after a period for public comment, and even in these cases the amount of time provided for public comment has generally been short.

In 2004, some improvements took place, particularly on the part of MOFCOM, which began following the rules set forth in its *Provisional Regulations on Administrative Transparency*, issued in November 2003. Those rules could potentially serve as a model for other ministries and agencies seeking to improve their transparency. Nevertheless, basic compliance with China's notice-and-comment commitment continued to be uneven, both in 2004 and 2005. For example, China did not provide for public comment on major trade-related laws and regulations, such as the April 2005 *Measures on the Importation of Parts for Entire Automobiles*. In the area of intellectual property rights, however, a number of ministries and agencies circulated proposed measures for public comment in 2005.

Meanwhile, China's ministries and agencies continue to have a much better record when it comes to making new or revised laws and regulations available to the public. In accordance with State Council regulations issued in December 2001, which require the publication of new or amended regulations thirty days before their implementation, almost all new or revised laws and regulations have been available (in Chinese) soon after issuance and prior to their effective date, an improvement over pre-WTO accession practice. Indeed, these laws and regulations are often published not only in official journals, but also on the Internet. At the same time, however, China continues to lag behind in its obligation to provide translations of these laws and regulations.

U.S. industry continues to report instances where Chinese companies are provided unofficial guidance by Chinese regulators, guidance which is usually unavailable to foreign entities. In some cases, Chinese officials provided unpublished documents to interested parties, but this dissemination was ad hoc and based more on personal connections than formal procedures.

MOFCOM's predecessor, MOFTEC, in late 2001, established an enquiry point to provide information on new trade and investment laws, regulations and other measures. Other ministries and agencies have also established formal or informal, subject-specific enquiry points. Since the creation of these various enquiry points, U.S. companies have generally found them to be responsive and helpful, and have generally received timely replies.

Legal Framework

Laws and Regulations

Laws and regulations in China tend to be more general and ambiguous than in other countries. While this approach allows the Chinese authorities to apply laws and regulations flexibly, it also results in inconsistency and confusion in application. Companies often have difficulty determining whether their activities contravene a particular law or regulation.

In China, regulations are also promulgated by a host of different ministries and governments at the central, provincial and local levels, and it is not unusual for the resulting regulations to be at odds with each other. Even though finalized regulations are now routinely published in China, they often leave room for discretionary application and inconsistencies, either through honest misunderstanding or by design. Indeed, government bureaucracies have sometimes been accused of selectively applying regulations. China has many strict rules that are often ignored in practice until a person or entity falls out of official favor. Governmental authorities can wield their discretionary power to crack down on foreign or disfavored investors or make special demands on them simply by threatening to crack down.

This lack of a clear and consistent framework of laws and regulations can be a barrier to the participation of foreign firms in the Chinese domestic market. A comprehensive legal framework, coupled with adequate prior notice of proposed changes to laws and regulations, and an opportunity to comment on those changes, would greatly enhance business conditions, promote commerce and reduce opportunities for corruption. The U.S. Government has provided technical assistance, at the central and local levels of government in China, in an effort to promote improvements in China's legislative and regulatory drafting process. In its WTO accession agreement, China committed to establish tribunals for the review of all administrative actions relating to the implementation of trade-related laws, regulations, judicial decisions and administrative rulings. These tribunals must be impartial and independent of the government authorities entrusted with the administrative enforcement in question, and their review procedures must include the right of appeal. To date, little information is publicly available regarding the frequency or outcomes of review before these tribunals.

China also committed, at all levels of government, to apply, implement and administer all of its laws, regulations and other measures relating to trade in goods and services in a uniform and impartial manner throughout China, including in special economic areas. In connection with this commitment, in 2002, China also established an internal review mechanism, now overseen by MOFCOM's Department of WTO Affairs, to handle cases of non-uniform application of laws. The actual workings of this mechanism remain unclear, however.

Commercial Dispute Resolution

Both foreign and domestic companies often avoid seeking resolution of commercial disputes through the Chinese courts, as skepticism about the independence and professionalism of China's court system and the enforceability of court judgments and awards remains high. There is a widespread perception that judges, particularly outside of China's big cities, are subject to influence by local political or business pressures. Most judges are not trained in the law and/or lack higher education, although this problem decreases at the higher levels of the judiciary.

At the same time, the Chinese government is moving to establish consistent and reliable mechanisms for dispute resolution through the adoption of improved codes of ethics for judges and lawyers and increased emphasis on the consistent and predictable application of laws. The Judges' Law, issued by the Standing Committee of the National People's Congress in 1995, requires judges to have degrees in law or in other subjects where they have acquired specialized legal knowledge, and permits judges appointed before the law's implementation who do not meet these standards to undergo necessary training. In 1999, the Supreme People's Court began requiring judges to be appointed based on merit and educational background and experience, rather than through politics or favoritism. In 2002, the Supreme People's Court issued rules designating certain higher-level courts to hear cases involving administrative agency decisions relating to international trade in goods or services or intellectual property rights. According to the Supreme People's Court, China's more experienced judges sit on the designated courts, and the geographic area under the jurisdiction of each of these designated courts has been broadened in an attempt to minimize local protectionism. The rules provide that foreign or Chinese enterprises and individuals may bring lawsuits in the designated courts raising challenges, under the Administrative Litigation Law, to decisions made by China's administrative agencies relating to international trade matters. The rules also state that when there is more than one reasonable interpretation of a law or regulation, the courts should choose an interpretation that is consistent with the provisions of international agreements to which China has committed, such as the WTO rules.

Despite initial enthusiasm, foreign observers have grown increasingly skeptical of the China International Economic and Trade Arbitration Commission (CIETAC) as a forum for the arbitration of trade disputes. Some foreign firms have obtained satisfactory rulings from CIETAC but other firms and legal professionals have raised concerns about restrictions on the selection of arbitrators and inadequacies in procedural rules necessary to ensure thorough, orderly and fair management of cases.

Finally, in cases where the judiciary or arbitration panels have issued judgments in favor of foreign-invested enterprises, enforcement of the judgments has often been difficult. Officials responsible for enforcement are often beholden to local interests and unwilling to enforce court judgments against locally powerful companies or individuals.

Labor Issues

In recent years, China has expanded the scope of its national labor laws and regulations so they now cover most, though not all, key labor areas. Even with these changes, China does not adhere to certain internationally recognized labor standards, such as the rights of freedom of association and collective bargaining. In addition, critics allege that China's household registration system is equivalent to a form of forced or compulsory labor, and there are many reports indicating that China does not enforce its laws and regulations concerning minimum wages, hours of work and occupational safety and health. There are also persistent concerns about the use of prison labor and child labor.

The Chinese government is slowly developing nationwide pension, unemployment insurance, medical insurance and workplace injury insurance systems that require substantial employer contributions. These systems are still rudimentary and characterized by serious funding shortfalls, in part due to widespread non-compliance among domestic firms. There is also inconsistent application and enforcement of labor regulations between Chinese-owned enterprises and foreign-invested enterprises.

The cost of labor, especially unskilled labor, is low in much of China. The existence of a large pool of surplus rural workers, many of whom seek work in urban areas, helps to keep unskilled wages low. Some companies offering substandard wages and working conditions have experienced shortages of unskilled labor. Where competition for workers is intense and the supply limited, as in the case of technical, managerial and professional staff in China's coastal areas, wages can be higher. However, restrictions on labor mobility distort labor costs. China is gradually easing restrictions under the country's household registration system, which has traditionally limited the movement of workers within the country, in part due to the recognition that labor mobility is essential to the continued growth of the economy.

In 2005, the China National Textile and Apparel Council established the Committee for the Promotion of Corporate Social Accountability System for Chinese Textile Enterprises (CSC9000T). Reportedly, increasing numbers of Chinese firms have realized the importance of social accountability, but remain confused about the various foreign corporate social accountability standards and certifications bodies that exist. The council formed CSC9000T to formulate Chinese corporate social responsibility standards to promote among Chinese firms. The standards are based on relevant Chinese legislation and regulations and reference international practices. To date, 160 council members have adopted these standards. This year, the committee will focus its efforts on promoting the adoption of these standards, conducting surveys on standards implementation, increasing communication with international buyers and providing training opportunities.

Corruption

Many people expected that China's entry into the WTO, which mandated a significant reduction in tariffs, would in turn reduce incentives for smuggling-related corruption. While WTO membership has increased China's exposure to international best practices and resulted in some overall improvements in transparency, corruption remains endemic. Chinese officials themselves admit that corruption is one of the most serious problems the country faces, and China's new leadership has called for an acceleration of the country's anti-corruption drive with a focus on closer monitoring of provincial-level officials. According to the most recently available information from Chinese state media sources, in 2004, Chinese prosecutors caught more than 42,000 officials for corruption and other offenses, reflecting a rise of one percent from 2003. Official graft was a leading offense, with prosecutors recovering a total of RMB 3.8 billion ($456 million) of misappropriated and embezzled funds.

In July 2004, China implemented a new *Administrative Licensing Law*. This law is designed to increase transparency in the licensing process, an area that has long served as a source of official corruption. This law seeks to ensure the reasonable use of administrative licensing powers, to protect the interests of corporations and individuals, and to promote efficient administrative management by requiring government agencies to set up special offices for issuing licenses and to respond to applications within 20 days. It is too early to judge the effectiveness of this law. While some reports suggest that it has resulted in the removal of many unnecessary administrative licensing requirements, some agencies have been reluctant to implement the law and have continued to administer their licensing powers in ways that appear to conflict with the requirements of the law.

China issued its first law on unfair competition in 1993, and the central government continues to call for improved self-discipline and anti-corruption initiatives at all levels of government. While the central government in recent years has pledged to begin awarding contracts solely on the basis of commercial criteria, it is unclear how quickly and to what extent the government will be able to follow through on this commitment. U.S. suppliers complain that the widespread existence of unfair bidding practices in China puts them at a competitive disadvantage. This dilemma is less severe in sectors where the United States holds clear technological or cost advantages. Corruption nevertheless undermines the long-term competitiveness of both foreign and domestic entities in the Chinese market.

Land Issues

China's constitution specifies that all land is owned in common by all the people. In practice, agricultural collectives, under the firm control of local Communist Party chairmen, distribute agricultural land to the rural poor, while city governments distribute land for residential and industrial use. The State and collectives can either "grant" or "allocate" land use rights to enterprises in return for payment of fees. Enterprises granted land-use rights are guaranteed compensation if the State asserts eminent domain over the land, while those with allocated rights are not. Granted land-use rights cost more, not surprisingly, than allocated rights. However, the law does not define standards for compensation when eminent domain supercedes granted land-use rights. This situation creates considerable uncertainty when foreign investors are ordered to vacate. The absence of public hearings on planned public projects, moreover, can give affected parties, including foreign investors, little advance warning.

The time limit for land-use rights acquired by foreign investors for both industrial and commercial enterprises is 50 years. A major problem for foreign investors is the array of regulations that govern their ability to acquire land-use rights. Local implementation of these regulations may vary from central government standards, and prohibited practices may occur in one area while they are enforced in another. Most wholly-owned foreign enterprises seek granted land-use rights to state-owned urban land as the most reliable protection for their operations. Chinese-foreign joint ventures usually attempt to acquire granted land-use rights through lease or contribution arrangements with the local partners.

China's current rural land law, which took effect in 2003, gives peasants fixed contracts for periods of 30 to 50 years, and permits peasants to exchange or rent out their land-use rights while their use contract remains in force. There is no immediate prospect for changing from land-use rights to direct ownership of rural land. However, since 2004, the leadership has pressed for sturdier land rights for farmers along with stricter controls over the legal process for converting farmland from agricultural to industrial or residential use. Local governments are no longer supposed to expropriate land for commercial use, as farmers are now supposed to be able to negotiate a compensation price for land directly with commercial users. However, implementation of these provisions lags.

EXHIBIT 10

THE CHINA SYNDROME: HOW SUBSIDIES AND GOVERNMENT INTERVENTION CREATED THE WORLD'S LARGEST STEEL INDUSTRY

Prepared for:

The American Iron & Steel Institute
The Steel Manufacturers Association
The Specialty Steel Industry of North America
The Committee on Pipe and Tube Imports

American Iron and Steel Institute

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THE COMMITTEE ON PIPE AND TUBE IMPORTS

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EXECUTIVE SUMMARY

China has the world's largest steel industry. Indeed, in 2005, China made more steel than the next four largest producers combined. From 2000 to 2005, China's steel production increased by over 170 percent, as the Chinese industry added capacity at a furious rate. Between 1998 and 2005, China's steel exports more than quadrupled, as China established itself as one of the world's leading exporters. This explosive growth in both production and exports would not have been possible without the support of the Chinese government.

The structure of the Chinese steel industry reflects the Chinese government's ongoing role. The Chinese steel industry continues to be primarily state-owned. The Chinese government intervenes directly and extensively in the steel industry, and retains a high degree of decision-making authority over its development. China's new Steel Policy specifically provides for continued direct subsidization of the steel industry in the form of tax refunds, discounted interest rates, and other preferential policies. The policy also provides various forms of indirect support, such as restrictions on foreign investment. The policy makes consolidation of the industry a priority, and in fact, there have been several well-publicized mergers of state-owned producers in the last year.

The ways in which the Chinese government provides direct and indirect benefits to the steel industry include:

Cash grants. China's subsidies notification to the World Trade Organization indicates that it continues to provide cash grants to a number of enterprises. For example, the Chinese government provides steel producers with cash grants to defray costs for raw materials and energy.

Land grants. The Chinese government provides steel producers with land at a fraction of its market value.

Transfers of ownership interests on terms inconsistent with commercial considerations. Shares in state-owned steel producers have been transferred to other state-owned producers at prices well below their market value. This has enabled producers to acquire new facilities and expand production at a low or even no cost.

Conversion of debt to equity in steel companies. Chinese steel producers owe billions of dollars to state-owned banks and asset management companies. In many cases, the asset management companies and banks have converted non-performing loans into shares in steel producers in an effort to reduce the producers' debt loads. Two of China's largest steel producers, Shanghai Baosteel and Anben, benefited from this process.

Debt forgiveness and inaction regarding non-performing loans. State-owned banks and asset management companies have also simply forgiven billions of dollars in bad debts owed by Chinese steel producers. They have also declined to press for payment in cases where market-oriented lenders would have taken action to collect on loans.

Preferential loans and directed credit. The state-owned banks have loaned the Chinese steel industry billions of dollars at preferential interest rates at the behest of the Chinese government. These low-cost loans funded a substantial portion of the industry's capacity expansion between 2000 and 2005.

Tax incentives, including a variety of income tax exemptions and reductions. These tax benefits are available to and used by a variety of steel producers, including those with foreign investment, those located in Special Economic Areas and specific regions, and firms that produce for export.

Targeted infrastructure development. The Chinese government has built industrial parks, technology parks, and similar areas which provide steel producers with access to sophisticated facilities at reduced costs. These developments also commonly provide their tenants with tax advantages.

Manipulation of raw material prices. The Chinese government has used export restrictions on coke and scrap to reduce the cost of these inputs for Chinese producers. The Chinese government also has attempted to use import license schemes and intervention in price negotiations to control prices for imported iron ore, although its most recent efforts were signally unsuccessful.

Manipulation of the value of the Chinese RMB. China has a longstanding policy of deliberately keeping the value of the RMB below its market value. This has the effect of making exports of Chinese steel and products containing steel artificially cheap, while effectively imposing a tax on imports from the United States.

The Chinese government has implemented other measures that provide the industry with indirect support, such as import barriers and barriers to foreign investment. The latter, in particular, may have prevented the industry from undergoing the sort of consolidation and closure of facilities that foreign majority ownership might trigger. China also has failed to enforce its environmental and labor laws fully. Taken together, these policies provide the Chinese steel industry with yet another artificial advantage in international competition.

THE CHINA SYNDROME:
HOW SUBSIDIES AND GOVERNMENT INTERVENTION CREATED THE WORLD'S LARGEST STEEL INDUSTRY*

INTRODUCTION

Since 1990, the Chinese steel industry has expanded at a phenomenal rate to become the largest in the world. Over this period, China has gone from being a net importer of steel to a net exporter. This change would not have been possible without the conscious and persistent support of the Chinese government. This report describes and analyzes the various ways in which the Chinese government has supported the unprecedented expansion of the Chinese steel industry.

The explosive growth of the Chinese steel industry has enormous ramifications for the global economy. It affects the markets of steel producers in other countries directly, as well as the availability and prices of iron ore, coke and coal, shipping, and other inputs used by steelmakers and others. China's increased steel supply also affects the competitive position in world markets of manufacturers using steel in China versus manufacturers in other countries. Finally, the growth of the Chinese steel industry has profound implications for the world's environment.

Subsidies and the Chinese Steel Industry

The Chinese steel industry in its present form is the direct product of massive subsidies and other support provided by the Chinese government. The Chinese government intervenes directly and extensively in the steel industry, and retains a high degree of decision-making authority over its development. China's new Steel Policy specifically provides for continued direct subsidization of the steel industry in the form of tax refunds, discounted interest rates, and other preferential policies. The policy also provides various forms of indirect support, such as restrictions on foreign investment. The

* The authors would like to thank Tom Danjczek, Mindy Fleishman, David Hartquist, Roger Schagrin, Terry Stewart, and all the others who provided invaluable advice, comments, and information for this paper.

Steel Policy, as discussed in detail below, is a clear and unassailable example of the Chinese government's management of nearly every major aspect of China's steel industry.

The Chinese government has implemented its policy of support for the steel industry by providing the industry with massive subsidies and other forms of assistance, including:

- Transfers of ownership interests on terms inconsistent with commercial considerations;
- Conversion of debt to equity in steel companies;
- Grants to pay for energy and raw materials;
- Debt forgiveness and inaction regarding non-performing loans;
- Tax incentives, including a variety of income tax exemptions and reductions for Foreign Invested Entities, firms in Special Economic Areas, and firms that produce for export;
- Targeted infrastructure development, including government subsidies to build and finance industrial parks;
- Control over raw material prices and exports, including import licensing schemes to control the price of iron ore and export restrictions on coke;
- Manipulation of the value of the Chinese RMB to make Chinese exports artificially cheap;
- Preferential loans and directed credit, including "policy loans" to favored state-owned enterprises on non-commercial terms;
- Import barriers, including high tariffs and other practices that discriminate against foreign equipment and technology; and
- Barriers to foreign investment.

The result of this pervasive Chinese government support has been the creation of the world's largest steel industry in a form far different from what the market would have created. These policies and actions by the Chinese government have distorted world trade severely and have imposed tremendous economic costs on other countries, especially the United States. While subsidization of the Chinese steel industry is far from the only cause of the huge trade deficit of the United States with China, it represents the type of behavior the Chinese government has engaged in with respect to dozens of other industries. This analysis describes how the Chinese government has made one favored industry artificially competitive in world markets while disadvantaging market-oriented producers around the globe, including those in the United States. The massive manipulation of markets by the Chinese government has substantially impaired the anticipated benefits of China's WTO accession and has severely distorted global markets.

Chinese Subsidies and the WTO

Many of these forms of assistance – including export subsidies, domestic content subsides, and selective preferential bank financing – appear to violate China's WTO obligations under the Agreement on Subsidies and Countervailing Measures ("Subsidies Agreement"). Many of the subsidies also violate the commitments China made in its WTO accession agreement, wherein China committed to eliminating immediately all subsidies prohibited under Article 3 of the Subsidies Agreement – a commitment it has failed to honor.

China has also failed to comply with its obligation to provide detailed information about its subsidy programs to the WTO on an annual basis. In fact, until recently, China had failed to make any of its required subsidy notifications since becoming a member of the WTO, despite repeated requests by the United States and other WTO member countries that China do so.[1] According to the U.S.-China Economic and Security Review Commission, "this lack of transparency compounds the difficulties in addressing China's complex and pervasive system of subsidies."[2]

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1 *See 2005 Report to Congress of the U.S.-China Economic and Security Review Commission*, at 38 (Nov. 2005).

2 *Id.* at 38-39.

In April 2006, China finally filed its first subsidies notification with the WTO, identifying more than 75 types of subsidies.[3] The notification provided a great deal of detail regarding tax incentives provided by the Chinese government, and somewhat less detail regarding various types of grants. Somewhat surprisingly, the notification confirmed that China continues to provide a broad range of subsidies contingent on export performance, even though such subsidies are specifically prohibited by the WTO Subsidies Agreement.[4]

The notification included no discussion whatsoever of major categories of subsidies provided by the Chinese government, including transfers of ownership on terms inconsistent with commercial considerations; conversion of bad debts owed to state-owned banks into equity in the borrowing enterprise; government direction of credit through the state-owned banks; so-called "policy loans" at preferential interest rates; and the forgiveness of debts by state-owned banks. Not surprisingly, the notification does not discuss manipulation of the value of the RMB or government control over raw materials.

Information regarding the various subsidies provided to the steel industry by the Chinese government is not readily available. This makes it difficult for the United States and other WTO members to confirm that China is complying with its WTO obligations. This paper catalogs the information currently available. Any truly thorough examination of the role of subsidies in the creation and expansion of the Chinese steel industry would depend upon the ability to obtain accurate information directly from the Chinese government – information the Chinese government has not made public.

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[3] World Trade Organization, *New and Full Notification Pursuant to Article XVI:1 of the GATT 1994 and Article 25 of the SCM Agreement*, No. G/SCM/N/123/CHN (Apr. 13, 2006) (hereinafter "China Subsidies Notification").

[4] *See* Annex 1A: *Multilateral Agreements and Goods of the General Agreement on Tariffs and Trade* 1994, art. 3.1 ("Agreement on Subsidies and Countervailing Measures").

THE CHINESE STEEL INDUSTRY

A steel industry has existed in China since ancient times. The current Chinese steel industry, however, is very much a product of recent government decisions. The Chinese government continues to own the overwhelming majority of the steel industry, and to control it directly and indirectly through a number of methods.

The Government's Creation of the Chinese Steel Industry

When the Chinese Communist Party came to power in 1949, the Chinese steel industry had been decimated by 15 years of war. Although China was an overwhelmingly rural and agrarian country, the new leadership, under Mao Zedong, gave priority to the establishment of the steel industry. The government funneled massive resources into the construction of new mills, consistent with the then-prevalent Stalinist model of development, with its emphasis on heavy industry. The apogee of this effort was reached in 1958 with the onset of the "Great Leap Forward," when Chairman Mao proclaimed that China would double its steel production over the course of a single year. This led to the widespread establishment of small steel mills – the so-called "backyard blast furnaces" – in towns and villages throughout China. The project was of course an economic, technological, and environmental disaster.

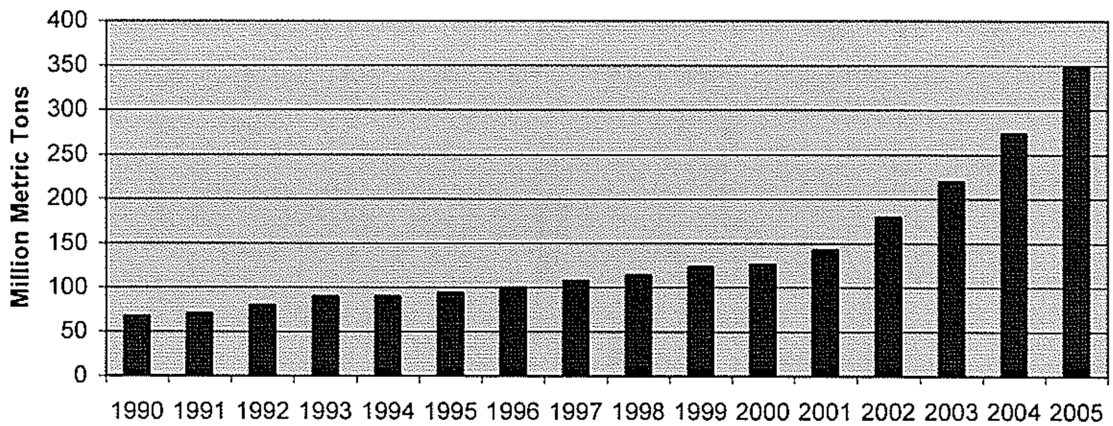
China subsequently returned to a more traditional approach to developing its steel industry, as the state continued to pour billions of dollars worth of resources into new steel mills. As a result of this investment, China emerged by the late 20th century as a major steel producer. In 1990, the first year for which reliable international statistics are available, China was the world's fourth largest producer. In that year, it produced 67.2 million metric tons of steel, compared to 88.6 million metric tons in the United States and 110.3 million metric tons in Japan.[5]

The Chinese steel industry grew steadily throughout the 1990s, as the government continued to devote a disproportionate share of resources to it. Production skyrocketed between 2000 and 2005, as the Chinese government directed massive

5 International Iron and Steel Institute, http://www.worldsteel.org/?action=archivedsteellist2.

amounts of capital into the steel industry. By 2005, China was by far the world's largest steel producer, with production of 349.4 million metric tons and accounting for more than 30 percent of global steel production.[6] The following chart shows the explosive growth in Chinese steel production between 1990 and 2005.[7]

CHART 1
CHINESE STEEL PRODUCTION, 1990 - 2005



Exports of Chinese steel have followed a similar trend. In 1998, China exported only 5.9 million tons of steel.[8] By 2005, this amount had more than quadrupled, to 27 million tons.[9]

The Structure of the Chinese Steel Industry

The Chinese steel industry is marked by two notable characteristics: the very large number of steelmaking enterprises and the degree of government ownership. As recently as 2000, there were 1,045 companies in China producing steel, of which only

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6 International Iron and Steel Institute, *World Steel in Figures 2005* 3 (2006).

7 International Iron and Steel Institute, http://www.worldsteel.org/?action=archivedsteellist2.

8 International Iron and Steel Institute, *Steel Statistical Yearbook 2005* 73 (2005).

9 International Steel Statistics Bureau, *Steel Statistics in the News*, available at http://www.issb.co.uk/.

34 produced more than one million tons per year.[10] More recent estimates indicate there are as many as 800 steel mills in China, but only 16 have the capacity to produce more than 5 million tons per year.[11] There has been some consolidation in the industry, and the China Iron and Steel Association, the official trade association of the Chinese industry, states that it has over 50 "medium and large" members. Nonetheless, experts predict that, after consolidation, China will still have over 100 different significant steel producers.[12]

Fragmentation of the Chinese Steel Industry

The degree of fragmentation in the Chinese steel industry is apparent from the production quantities of the major Chinese producers. Although China has the world's largest steel industry, in 2004 only one Chinese producer, Shanghai Baosteel, ranked among the world's ten largest producers. Only two Chinese producers, Shanghai Baosteel and Anshan (now Anben), produced more than 10 million tons in that year, while eight reached that level in 2005. In 2005, 25 Chinese producers ranked in the top 80 in the world.[13] Yet these producers accounted for less than 40 percent of total Chinese production. The following table shows the ten largest Chinese producers and their production in 2004 and 2005.[14]

TABLE 1
MAJOR CHINESE STEEL PRODUCERS

Producer	2005 Production (Million MT)	2004 Production (Million MT)
Shanghai Baosteel	23.8	21.4
Anben	18.4	16.8
Tangshan	16.1	7.7

10 Qingfeng Zhang, *A Comparison of the United States and Chinese Steel Industries*, 3 Perspectives No. 6 (2002).

11 David Lague, *China's Small Steel Mills Feel Heat*, International Herald Tribune, May 25, 2005, *available at* http://www.iht.com/articles/2005/05/24/business/steel.php.

12 *Id.*

13 International Iron and Steel Institute, *World Steel in Figures 2005,* at 2 (2005).

14 *Id.*; Steel Business Briefing, *China's Steel Industry* (2006).

Wuhan	12.0	9.3
Jiangsu Shagang	10.5	7.6
Shougang	10.4	8.5
Jinan	10.4	6.9
Laiwu	10.3	6.6
Maanshan	9.6	8.0
Panzhihua	6.2	6.0

The Chinese government has recognized the negative aspects of this fragmentation, and thus a central focus of the Steel Policy is consolidation. The move to consolidate has picked up speed with the recent mergers of Chinese steel companies, including: Wuhan and Liuzhou (numbers 18 and 52 in world production, respectively); Anshan and Benxi (19 and 37); and Tangshan and Xuangang (12 and 68). Wuhan also acquired Echeng Steel, as discussed below, at no cost, while Tangshan acquired Chengang Steel as well.[15]

The Chinese steel industry is also fragmented geographically. While steel production is concentrated in the northeast, no province accounts for more than 18 percent of China's annual production.[16] Moreover, several provinces have annual production of less than 5 million metric tons per year. The following table shows annual production of finished steel in China, by province, in 2005.[17]

15 *Improved Steel Price Outlook*, FinanzNachrichten, April 19, 2006, available at http://www.finanznachrichten.de/nachrichten-2006-04/artikel-6303473.asp.

16 Steel Business Briefing, *China's Steel Industry* (2006).

17 *Id.*

TABLE 2
CHINESE STEEL PRODUCTION BY PROVINCE

Province	2005 Production (Million MT)	Percent	Province	2005 Production (Million MT)	Percent
Hebei	64.64	17.42%	Nei Monggul	7.48	2.02%
Jiangsu	43.28	11.66%	Fujian	7.3	1.97%
Liaoning	32.06	8.64%	Zhejiang	7.17	1.93%
Shandong	30.09	8.11%	Guangxi	5.15	1.39%
Shanghai	19.64	5.29%	Yunnan	4.8	1.29%
Tianjin	16.61	4.48%	Jilin	4.79	1.29%
Hubei	15.86	4.27%	Gansu	4.52	1.22%
Guangdong	13.66	3.68%	Shaanxi	3.37	0.91%
Shanxi	13.41	3.61%	Xinjiang	3.22	0.87%
Henan	13.37	3.60%	Chongqing	2.95	0.79%
Sichuan	11.73	3.16%	Heilongjiang	2.32	0.63%
Anhui	11.42	3.08%	Guizhou	2.15	0.58%
Jiangxi	10.18	2.74%	Qinghai	0.48	0.13%
Beijing	9.66	2.60%	Hainan	0.15	0.04%
Hunan	9.61	2.59%	Ningxia	0.09	0.02%
Total	371.16				

This degree of geographic fragmentation demonstrates, among other things, the extent to which the Chinese steel industry reflects the desire of provincial governments to have a steel industry, whether or not such an industry is economically viable. Indeed, as Ian Christmas, Secretary-General of the International Iron and Steel Institute, noted, "{e}ach region within China wishes to have its own steel industry."[18] As discussed below, local governments frequently pressure local banks to provide low-cost loans to lo-

18 *The Challenges Ahead for Steel*, http://www.worldsteel.org/?action=programs&id=37&about=1.

cal steel companies to expand facilities. This has resulted in a significant expansion of capacity in inland China, mostly in the form of fairly small mills, far from China's major markets and from the ports used to import iron ore in particular.[19]

Government Ownership

The second striking characteristic of the Chinese steel industry is the extent to which it remains state-owned, with state-owned enterprises accounting for 57 percent of total production.[20] The Chinese government owns majority stakes in almost all of China's major steel producers. The following table shows the state's ownership interest in the ten largest Chinese producers.[21] Even after consolidation, the expectation is that the Chinese government will continue to own a majority stake in nearly all of the "top 100" producers.[22]

TABLE 3:
ESTIMATED GOVERNMENT OWNERSHIP OF CHINESE STEEL COMPANIES

Producer	Government Ownership (%)
Shanghai Baosteel	85.41%
Anben	64.70%
Wuhan	75.81%
Shougang	81.19%
Maanshan	62.50%
Tangshan	61.31%
Jiangsu Shagang	0.00%
Jinan	76.60%
Laiwu	78.01%
Panzhihua	55.37%

19 *Id.*

20 OECD Directorate for Science, Technology and Industry Steel Committee, Current Situation of the Chinese Steel Industry DSTI/SU/SC(2006)9 (Apr. 4, 2006) (hereinafter CURRENT SITUATION OF THE CHINESE STEEL INDUSTRY).

21 *See* http://www.corporateinformation.com.

22 *China's Small Steel Mills Feel Heat.*

The Chinese government is comprised of three distinct levels: national, provincial, and local (county or municipal). Ownership of shares in a steel company may lie with any one of these levels.[23] Government ownership of steel companies gives each level of government a vested interest in the industry, as well as the ability to direct steel producers to act in ways that further governmental rather than market aims, such as maximizing employment and tax revenues. Moreover, government decisions at each level can greatly benefit steel producers. For example, in January 2005, the Government of Hubei Province transferred 51 percent of the ownership of Ercheng Iron & Steel, a local steel producer, to Wuhan at no cost. In this way, Wuhan acquired some three million tons of new capacity at a cost of $0 per ton.[24]

Future Expansion

Despite the enormous recent increases in capacity, it appears that the Chinese steel industry will continue to expand. The Chinese government has officially stated that it intends to have the Chinese steel industry reduce capacity slightly. China had approximately 414 million tons of steel-making capacity in 2005,[25] and expects that capacity to fall to 400 million tons in 2010.[26] To accomplish this reduction, the Chinese government plans to remove about 55 million tons of obsolete steel-making capacity from production.[27]

However, at the end of 2005, 70 million tons of new steel making capacity was already under construction in China, and another 80 million tons of capacity was planned.[28] This indicates that, even if China in fact closes the full 55 million tons of capacity targeted, capacity would actually increase to at least 429 million tons with the

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23 *See* Organization for Economic Cooperation and Development, *Capacity Expansion in the Global Steel Industry* 8 (2005).

24 Citigroup, *China Steel Industry* 28 (2006).

25 OECD Directorate for Science, Technology and Industry Steel Committee, *Current Situation of the Chinese Steel Industry*, DSTI/SU/SC(2006)9, at 20 (Apr. 4, 2006) (hereinafter "No. DSTI/SU/SC(2006)9 (Apr. 4 2006)").

26 *Id.* at 2.

27 *Id.*

28 *Id.* at 20.

completion of projects currently underway. This total would rise to 509 million tons if all planned projects are completed.

Despite the Chinese government's announced intention to decrease capacity, individual Chinese producers continue to plan additional capacity. In 2004-2005, the Chinese government approved a $2.5 billion plant expansion for Maanshan Iron & Steel Company as well as a $2 billion expansion for stainless-steel maker Tauyuan Iron and Steel. In addition, China's largest producer, state-owned Baosteel, announced plans for a new facility in Guangdong that will have an annual output of 20 million tons. Each project apparently involves significant levels of government support.[29] The American Iron and Steel Institute estimates that the state-owned steel companies accounted for roughly $6 billion in capital expansion expenditures in 2002 alone – much of the capital presumably from the state.[30]

The fact that these mills are adding so much capacity at a time when China already suffers from overcapacity indicates that these investments are driven by government planning, not market forces. Indeed, despite calls to curb production as a result of growing excess capacity, these capacity expansions continue unabated even as steel profits plunge – by 74.6 percent year-on-year during the first two months of 2006.[31] Moreover, according to the China Iron and Steel Association, its 66 member steelmakers saw net profit decrease by 10.6 percent in 2005, with the net profit margin rate declining from 8.1 percent to 6.5 percent.[32] Such margins are well below 2005 global margins for steelmakers and constitute inadequate financial returns in what was likely the peak of the global steel cycle – further evidence that steel developments in China are not driven by market forces.

29 Letter from the American Iron and Steel Institute to Gloria Blue re: China's Compliance with its WTO Commitments, at 6 (Sept. 6, 2005).

30 Written Statement for the Record of the American Iron and Steel Institute on United States-China Economic Relations Submitted to the House Committee on Ways and Means, 3 (Nov. 3, 2003).

31 *Chinese Steel Profits Plunged 74.6% in Jan/Feb*, Steel Bus. Briefing, Mar. 30, 2006.

32 No. DSTI/SU/SC(2006)9, at 11 (Apr. 4, 2006).

Government Management of the Steel Industry

China's central government maintains a high degree of direction and decision-making authority over the development and management of the steel industry. The government has issued a number of industrial plans which specifically designate steel as a preferred industry and provide for a wide array of government benefits including grants, preferential loans and tax incentives. In addition, these plans provide for government management of nearly every major aspect of China's steel industry, and permit – even mandate – the government to intervene directly and extensively in the steel industry.

China's Steel Policy

In July 2005, the National Development and Reform Commission ("NDRC") issued China's new Steel and Iron Industry Development Policy ("Steel Policy"), which outlines the government's comprehensive policy for the steel industry. As a whole, the policy provides for the government's management of China's steel industry, including resource and equipment utilization, regional concentration of output, quality improvements, technological innovation, investment management, and consolidation. Article 20 specifically provides for the strategic reorganization of China's largest steel producers to create an industrial structure with two 30 million-ton steel groups and several 10 million-ton steel groups by 2010.[33] The policy further prescribes the number and size of steel producers, where they will be located, the types of products that are allowed to be produced, and minute details relating to the technology that will be used (*e.g.*, size and composition of blast furnaces).

As described in detail below, the Steel Policy mandates direct government subsidization of the steel industry. For example, Article 16 specifically provides for government support in the form of "tax refunds, discounted interest rates, funds for research and other policy support for major iron and steel projects utilizing newly devel-

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[33] Steel and Iron Industry Development Policy, Order No. 25 of the National Reform and Development Commission, July 2005, ("Steel Policy") at art. 20.

oped domestic equipment."[34] The policy also calls for indirect support by, among other things, restricting foreign investment, discriminating against foreign equipment and technology, and by providing various export credits. In short, China's Steel Policy is a primary example of the government's attempt to dictate industry outcomes and involve itself in decisions that should be made by the market.

The Five-Year Plans

China's industrial development is also directed and managed by the central government through its Five-Year Plans. Issued by the Central Committee of the Communist Party of China, the Five-Year Plans establish the broad parameters defining which industries, enterprises, and products should be targeted for preferential government support. According to the government, Five-Year Plans aim to "arrange national key construction projects, manage the distribution of productive forces and individual sector's contributions to the national economy, map the direction of future development, and set targets."[35]

The 10th Five Year Plan for National Economic and Social Development, covering the period 2001-2005, calls for "energetically optimizing and improving [the] industrial sector" by, among other things, enhancing traditional industries with new technologies and intensifying construction of transportation, energy and other infrastructure facilities.[36] According to the plan, these measures are "most important in the energy [and] metallurgy" industries.[37] The plan further calls for the "establishment of a number of large companies and enterprise groups through stock listing, merging, association and reorganization."[38] It also provides for the continued and pervasive role of the government in the economy, stating that the "state must hold a controlling stake in strategic enterprises that concern the national economy" and must also "uphold the dominance of

34 *Id.*, art. 17.

35 *See What is the Five Year Plan, available at* http://www.china.org.cn/english/MATERIAL/157595.htm.

36 *See The Tenth Five Year Plan for National Economic and Social Development-People's Republic of China, available at* http://www.logos-net.net/ilo/195_base/en/init/chn_1.htm.

37 *Id.*

38 *Id.*

the public sector of the economy [and] let the state-owned sector play the leading role."[39]

China's new 11th Five Year Plan, covering the period 2006-2010, offers more of the same and is designed to "optimize and upgrade industrial structures."[40]

List of Encouraged Industries

The central government's National Planning Commission periodically issues a "Catalogue of Key Industries, Products and Technologies the Development of Which is Encouraged by the State." Essentially, this planning document lists key industries and products which are favored by the central government and therefore eligible for preferential treatment. The Catalogue lists "Iron and Steel" as a preferred or favored industry along with dozens of specific steel products.[41] As a result, steel companies are eligible for various tax exemptions and reductions, including a 50 percent income tax reduction for companies that derive more than 70 percent of their revenues from manufacturing a product listed in the Catalogue. In addition, the Catalogue gives local authorities the discretion to issue policies that help promote the development of these industries.

Foreign Investment Catalogue

The government also maintains a "Catalogue for the Guidance of Foreign Investment Industries" which is issued jointly by the NDRC and the Ministry of Commerce ("MOFCOM"). The catalogue distinguishes between encouraged and discouraged industries, with discouraged industries further broken down into those where foreign investment is restricted and those where foreign investment is prohibited. Industries that are discouraged are generally those that are not in line with the central government's national economic development goals. Encouraged industries include the "ferrous metallurgical industry" as well as products such as hot-rolled and cold-rolled steel plate.[42]

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39 *Id.*

40 *See* Key Points of the 11th Five-Year Guidelines, http://www.china.org.cn/english/20061h/160403.htm; *see also* Changes in Five-Year Plans' Economic Focus, http://www.china.org.cn/english/2005/Nov/148163.htm.

41 *See, e.g.,* Foreign Affairs Information Portal, *Current Catalogue of Key Industries, Products and Technologies the Development of Which is Encouraged by the State (Provisional)* (Approved by the State Council on Dec. 31, 1997), http://www.bjfao.gov.cn/english/law/003C/144.html.

42 *See Catalogue for the Guidance of Foreign Investment Industries*, Jan. 7, 2003, http://www.chinataiwan.org/web/webportal/W5029562/A5120231.html.

Investors in encouraged industries are eligible for certain government benefits, including tax reductions and duty waivers.[43]

43 *Revised Catalogue for the Guidance of Foreign Investment Industries*, Jan. 2005, http://www.tdctrade.com/alert/cba-e0501a-5.htm.

DIRECT GOVERNMENT SUBSIDIES TO THE STEEL INDUSTRY

The Chinese steel industry would probably be a fraction of its current size without direct aid from the Chinese government. The Chinese government created the infrastructure of the Chinese steel industry, and has spent billions of dollars directly on it. Direct government assistance comes in the form of grants and other direct payments to Chinese steel producers, an undervalued RMB, and government intervention to control raw material and energy prices. In addition, the state-owned banks have forgiven billions of dollars in loans to steel producers and have repeatedly been willing to exchange unpaid debt for shares. As with other manufactured products, the Chinese government has a panoply of tax incentives that encourage production of exports.

Documenting Chinese subsidies to the steel industry is a difficult task. According to USTR, "a general lack of transparency makes it difficult to identify and quantify possible ... subsidies provided by the Chinese government. China's subsidy programs are often the result of internal administrative measures that are not publicized."[44] Efforts to collect information about Chinese subsidy programs have been further frustrated because, until recently, China has failed to make any of its required subsidy notifications, a key requirement of the WTO Subsidies Agreement. Despite its flagrant disregard for international norms, China has paid no consequences for its "hide-the-ball" approach on subsidies.

Notwithstanding the lack of transparency, it is clear that the Chinese government plays a substantial role in assisting its steel industry. Indeed, direct subsidies are an integral part of China's Steel Policy. Article 16 of the policy specifically provides for government subsidies in the form of "tax refunds, discounted interest rates, funds for research and other policy support for major iron and steel projects utilizing newly developed domestic equipment." China's stated commercial policies further confirm preferential government treatment, especially for state-owned enterprises ("SOEs"). As of September 2005, for example, the MOFCOM website reportedly states that it will exempt certain SOEs from "repayment of non-performing loans, and provide a debt-to-

[44] United States Trade Representative, *2006 National Trade Estimate Report on Foreign Trade Barriers* 120 (Mar. 2006) (hereinafter "*Mar. 2006 NTE*").

equity swap policy. The policies will support firms' trans-regional development, make good use of domestic and foreign trade development funds, provide subsidized interest for technical innovation loans, and accelerate infrastructure development."[45]

Not surprisingly, in a recent report on foreign trade barriers, USTR singled out Chinese subsidies to its steel industry as of particular concern, stating:

> [Subsidies] take the form of income tax reductions or exemptions that are *de facto* contingent on export performance. ... China's subsidy programs can also take a variety of other forms, including mechanisms such as credit allocations, low-interest loans, debt forgiveness and reduction of freight charges. ... *Of particular concern are China's practices in the textiles industry as well as in the steel*, petrochemical, high technology, forestry and paper products, machinery and copper and other non-ferrous metals industries."[46]

As part of the WTO's transitional review of China, member countries have confirmed ongoing Chinese industrial subsidies:

> Based on available information, it appeared that China continued to provide tax incentives and preferential bank financing to producers of agricultural and industrial goods that were contingent upon export or the use of domestic over import goods, despite a clear commitment by China four years ago to eliminate all prohibited subsidies upon its accession to the WTO. It also appeared quite clear that China continued to provide subsidies to loss-making state-owned enterprises, despite making statements to this Committee in 2002 that these subsidies had been eliminated in 2001 ...[47]

[45] *See* World Trade Organization, *Transitional Review Mechanism Pursuant to Section 18 of the Protocol on the Accession of the People's Republic of China, Questions from the United States to China Concerning Subsidies and Price Controls*, No. G/SCM/Q2/CHN/14, at 4 (Sept. 29, 2005) (hereinafter "*WTO No. G/SCM/Q2/CHN/14* (Sept. 29, 2005)").

[46] Mar. 2006 NTE at 120. (emphasis added).

[47] World Trade Organization, *Chairperson's Report to the Council for Trade in Goods on Transitional Review of China*, No. G/SCM/118, at 3 (Nov. 9, 2005) (hereinafter "*WTO No. G/SCM/118* (Nov. 9, 2005)".

Government Grants to the Steel Industry

The Government of China continues to provide a number of direct government grants to the steel industry, including cash grants, energy and raw material grants, and land grants.

Cash Grants

In 2000, the Chinese government announced that it would spend $6 billion over several years to upgrade and transform its steel industry.[48] The actual amount spent is believed to be much greater. At the time of the announcement, the Chinese Ministry of Commerce stated that the central government – in administering key investment projects – would likely direct local and provincial governments to give the steel industry priority with respect to land use, raw materials, transport, equipment, and water and power supplies.[49]

China's WTO subsidies notification identifies several programs for small medium-sized enterprises ("SMEs") that may be providing direct grants to steel producers. These include funds for supporting technological innovation, development funds, and funds for exploration of international markets.[50] Because of the number of small steel producers in China, a substantial portion of these subsidies could go to steel producers. In 2004 alone, China budgeted RMB 1.6 billion for these grants.[51]

Cash grants are also provided by the government to promote increased exports of steel products. In a recent countervailing duty case brought against China, Canadian authorities identified actionable subsidies in the form of direct grants provided by the Government of China to steel and other manufacturing industries for export performance. The Canadian government cited benefits to the steel industry in the form of direct

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48 U.S. Department. of Commerce, *Report to the President, Global Steel Trade: Structural Problems and Future Solutions* 146 (2000).

49 *Id.*

50 China Subsidies Notification at 35-37.

51 *Id.*

grants to enterprises satisfying export criteria as well as grants to enterprises to assist in expanding export sales.[52]

In addition, China continues to offer grants and tax subsidies to state-owned enterprises which are operating at a loss.[53] In reports to the WTO, the Chinese government has identified the following industries as benefiting from these subsidies: metallurgic, ferrous-metal, machinery, coal, oil, chemical, textile, tobacco, and others.[54] China has promised to eliminate these subsidies on numerous occasions, but has yet to follow through on its commitments. In 2000, pursuant to Annex 5B of the Protocol of Accession to the WTO, China committed to eliminating "subsidies provided to certain state-owned enterprises which are running at a loss."[55] During China's 2002 transitional review, the Chinese representative informed the WTO that these subsidies had been eliminated in 2001. However, subsequent Chinese press reports indicate that the government was working to eliminate these subsidies by 2005[56] – with still no sign that these subsidies have ceased.

Energy and Raw Material Grants

The government also provides grants in the form of assistance with energy, raw material and other input costs. According to a March 2006 Steel Business Briefing report, the Beijing-headquartered steel company, Shougang, recently signed an agreement with the Shanxi government in northern China to help restructure the steel industry in that province. Shougang is expected to assist in the ongoing restructuring and up-

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52 *Statement of Reasons Concerning the Making of a Final Determination With Respect to the Dumping of Certain Carbon Steel and Stainless Steel Fasteners Originating in or Exported From the People's Republic of China and Chinese Taipei and the Making of a Final Determination With Respect to the Subsidizing of Certain Carbon Steel and Stainless Steel Fasteners Originating in or Exported From the People's Republic of China and Chinese Taipei*, Nos. 4243-38, 4218-17, AD/1308, CVD/103, at 40-41 (Dec. 24, 2004) (hereinafter "*Canada Statement, Nos. 4243-38, 4218-17, AD/1308, CVD/103* (Dec. 24, 2004)"). While this case involved steel fastners, many of the subsidy programs found by the Government of Canada and cited in this paper are granted to manufacturers of other steel products and are also indicative of the types of subsidies granted to both upstream and downstream manufacturers.

53 *See* World Trade Organization, *Transitional Review Mechanism Pursuant to Section 18 of the Protocol of the Accession of the People's Republic of China*, No. G/SCM/Q2/CHN/8 (Oct. 6, 2004) (hereinafter " *WTO No.* G/SCM/Q2/CHN/8 (Oct. 6, 2004)").

54 *Id.*

55 *Id.*

56 *Id.*

grading of the region's steel industry. In return, the provincial government has pledged to provide the necessary coking coal and iron ore for Shougang's steelmaking operations – presumably free of cost.[57] In addition, the Chinese government grants subsidies to Chinese steel companies to help defray costs derived from overseas steel input operations. The Chinese government recently granted Jiangsu Sha Steel Group 1.3 billion RMB in subsidies for its iron mine project in Australia.[58]

The government also provides raw materials and other inputs at no cost or below market cost. Water, for example, a scarce commodity in most of China, was provided free by the state until recently. Now, water costs as little as $0.16 per cubic meter in China (compared with $2.50 in the United States), reflecting neither the cost of delivery nor the scarcity of the water.[59]

Land Grants

Chinese steel companies continue to benefit from land grants or reduced land costs provided by the government. In a recent countervailing duty case involving steel fasteners from China, the Canadian government found that certain companies located in Special Economic Areas pay reduced long-term land use fees for land on which factories are located.[60] Beyond this, by law, all land in China remains the property of the state. Without a market for land, it is impossible to determine whether Chinese steel producers are paying market rates for their land. Shanghai Baosteel, the largest Chinese producer, shows deferred expenses of 1.689 million RMB, or about $200,000, for "transfer price for land use rights & site formation fee."[61] The fee for 2004 was 187,724 RMB.[62] If this figure in fact represents the company's long-term cost for land, it would appear to be far below any market value. For the whole industry, below-market rents

57 Shougang to Set Up Steel JV in Shanxi Province, Steel Bus. Briefing, Mar. 2, 2006.

58 *China Jiangsu Offering Over 6 M RMB of Subsidies to Overseas Investors*, Financial Times, Feb. 15, 2006.

59 Tom Miller, *Water Crisis Needs Market-Driven Solution*, China Econ. Q. (Feb. 13, 2006).

60 *Canada Statement, Nos. 4243-38, 4218-17, AD/1308, CVD/103*, at 41 (Dec. 24, 2004).

61 Shanghai Baosteel, Annual Report 75 (2004).

62 *Id.*

for land represent a subsidy worth tens of millions of dollars to the Chinese steel industry per year.

Transfers of Ownership

As part of its role in directing the consolidation and restructuring of the steel industry – as set out in China's Steel Policy – the Chinese government has encouraged and even induced various mergers and acquisitions within the steel industry through cash grants and grants of ownership interest. For example, in January 2005, Wuhan Iron and Steel Group was offered a 51 percent stake in Ercheng Iron and Steel *at no cost*, to encourage the merger. Ercheng had crude steel output of 3 million metric tons and profit of 20 million RMB in 2004.[63] The contribution of profitable assets at no cost is a clear subsidy.

Debt-to-Equity Swaps

Debt-to-equity swaps are another tool utilized by the Chinese government to prop up state-owned enterprises through direct government infusions of cash. This tool serves essentially as a grant-giving operation. Since 2000, 37 different Chinese steel companies have benefited from debt-to-equity swaps worth at least $8.4 billion as part of the government's plan to restructure and consolidate the steel industry.[64] Two of China's largest steel producers, Shanghai Baosteel and Anshan, both benefited from this process. In both cases, non-performing loans to the company were transferred from state-owned banks to state-owned bank asset management companies ("BAMCs"). The BAMCs then exchanged the debt for shares in the companies. The OECD reported that these transactions involved "substantial reductions in debt loads in return for restructuring arrangements whose details have not been fully revealed."[65]

63 Citigroup Global Markets, *China Steel Industry: Capacity Continues to Grow, So Does Surplus*, 28, 69 (Feb. 21, 2006).

64 *See* Letter to Gloria Blue, *supra* at 5; China's Iron/Steel Industry to See M&A Activity, Asia Times Online, Aug. 24, 2005.

65 Organization for Economic Cooperation and Development, *Reforming China's Enterprises*, at 78 (2000).

Similarly, Xingang Steel was established in 2000 through a debt-to-equity swap in which several of China's BAMCs purchased non-performing loans and then injected capital into the steel company.[66] Other, smaller producers have also benefited; in 2000, for example, Valin Lianyuan Steel Corp., a small producer in Hunan province, successfully converted RM740 million in debts into equity.[67]

These massive cash infusions continue to benefit the Chinese steel industry today. More importantly, recent press reports indicate that the government continues to provide the steel industry assistance in the form of cash grants and debt-to-equity swaps. The *Asia Times Online* reports that China's iron and steel companies have benefited in the amount of 11.19 billion yuan from debt-to-equity swaps as part of the government's plan to restructure and consolidate the steel industry in the years leading up to 2005.[68]

Debt Forgiveness and Inaction Regarding Non-Performing Loans by State-Owned Banks

Another form of direct government assistance to the steel industry is the forgiveness of or inaction regarding non-performing loans by China's state-owned banks. This provides a direct subsidy to the recipients in the amount of the debt forgiven. WTO members have raised concerns regarding China's "automatic roll-over of unpaid principal and interest, forgiven and non-performing loans, and the selective use of below-market interest rates."[69] These forms of assistance were cited as direct financial contributions provided by China's state-owned banks to Chinese industry.

The Government of China continues to channel financing to preferred industries, including steel, based on policy considerations instead of market-based factors. The result is a high level of non-performing loans and repeated bailouts of China's state-

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66 *See* Debt-to-Equity Swap Brings Economic Results to Steel Firm, People's Daily Online, June 7, 2001, http://english.people.com.cn/200106/07/eng20010607_71985.html.

67 A Remarkable Leap in the Industrial Revitalization of Hunan, Xinhua News Agency, Oct. 27, 2005.

68 China's Iron/Steel Industry to See M&A Activity, Asia Times Online, Aug. 24, 2005.

69 *WTO No. G/SCM/Q2/CHN/8*, at 3 (Oct. 6, 2004).

owned banks. Loans are generally classified as non-performing when the borrower fails to pay interest and principal according to the original terms of the loan.[70] Standard & Poor's estimates that 40 percent of China's state-owned banks' loans – or roughly $800 billion – are non-performing.[71] Other estimates indicate that "borrowers may default on as much as half of [the] loans issued by state banks."[72]

Under China's Northeast Revitalization Program, industries in the country's industrial northeast region are benefiting from debt forgiveness on a large scale. As detailed above, much of China's steel is produced in this region. Under this program, China has carried out "strategic restructuring and technical transformation of key enterprises in the areas of oil, petrochemical, iron and steel, automotive, shipbuilding and aircraft products manufacturing sectors in Northeast China in a bid to establish production bases of advantage industries."[73]

The high level of non-performing loans is evidence that state-owned banks continue to loan to enterprises, including steel companies, that are uncreditworthy and that would not meet normal market-based credit terms. The Tieben steel project in Jiangsu province, for example, resulted in non-performing loans worth billions of yuan.[74] The staggering level of non-performing loans has left the state-owned banks virtually insolvent. As a result, the Chinese Government has been forced to repeatedly inject cash into these banks; in 2003, the government recapitalized the Bank of China and the China Construction Bank with an injection of $45 billion of reserves.[75] To date, the cen-

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70 *See* Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government, June 1, 2005, http://knowledge.wharton.upenn.edu/index.cfm?fa=printArticle&ID=1202 (hereinafter "Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government").

71 *Id.* Statistics released by China's Banking Regulatory Commission indicate that in the first half of 2004, China's major state-owned banks held more than $200 billion in non-performing loans – an undoubtedly conservative estimate given the unreliability of the Commission figures and because the figure likely does not include the billions of dollars of non-performing loans the state-owned banks have sold to state-owned asset management companies. *See* China Gov't Warns of Possible Rebound in Non-Peforming Loans, Asia Pulse, Sept. 20, 2004. For example, in June 2004, the Bank of China and the China Construction Bank sold nearly 280 billion yuan ($33.7 billion) in non-performing loans to a state-owned asset management company.

72 Craig Simons, *The People's Bank*, Newsweek, Dec. 6, 2004, at 37.

73 *WTO No.* G/SCM/Q2/CHN/14, at 2 (Sept. 29, 2005).

74 *China Gov't Warns of Possible Rebound in Non-Performing Loans*, Asia Pulse, Sept. 20, 2004.

75 *See* Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government.

tral government is estimated to have spent more than $250 billion since 1998 to bail out the four primary state-owned banks.[76] Standard & Poor's estimates that these banks will require an additional $190 billion in the next several years just to stay afloat.[77]

The steel industry is, of course, not the only beneficiary of China's lax credit policies. However, the Chinese steel industry could not have added capacity on the scale it did between 2000 and 2005 absent massive loans. Without access to the records of the state-owned banks, asset management companies, and other lenders, it is impossible to know the full extent to which the Chinese steel industry has benefited from the Chinese government's willingness to tolerate non-performing loans. Given the industry's level of borrowing, though, it is reasonable to conclude that the benefit to the industry runs into the billions of dollars.

Preferential Loans and Directed Credit from State-Owned Banks

China's banking system is dominated by the four state-owned banks – the Industrial and Commercial Bank of China, the Bank of China, the China Construction Bank, and the Agricultural Bank of China – which account for over 60 percent of all loans.[78] Traditionally, these banks have made loans based on political directives from the central or provincial governments, rather than creditworthiness or other market-based factors. These "policy loans" generally have gone to state-owned enterprises and to industries favored by the government, including steel.[79] Currently, state-owned enterprises account for 25 percent of China's GDP, but receive over 65 percent of loans from state-owned banks.[80] Moreover, the government has channeled its finances to preferred in-

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76 *WTO No. G/SCM/Q2/CHN/14*, at 3 (Sept. 29, 2005).

77 Brian Bremmer, *The Great Bank Overhaul: Can a Chinese Bank Be A Model for Heroic Reform?*, Business Week, Aug. 22, 2005.

78 Luo Ping, *Challenges for China's Banking Sector and Policy Responses* (Nov. 14-16, 2003).

79 *See* Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government. A recent IMF report concludes that "banks remain exposed to several sectors that are likely over invested, such as steel, cement, aluminum, and construction and, are therefore vulnerable to an economic slowdown and/or consolidation in these sectors." Richard Podpiera, *Progress in China's Banking Sector Reform: Has Bank Behavior Changed?*, No. WP/06/71, at 11 (Mar. 1, 2006).

80 *See* Reform of China's Banks, Burdened by Bad Loans, Is Priority for Government.

dustries at extremely low, non-market interest rates.[81] These preferential loans, granted on non-commercial terms to inefficient state-owned companies, have subsidized the steel industry and have given the industry an unfair advantage on the market.[82]

Today, both private and state-owned Chinese steel companies continue to have access to subsidized financing from state-owned banks that have a strong incentive to lend to preferred industries such as steel. Indeed, China's Steel Policy specifically provides for export credits for steel companies. Article 27 of the policy states:

> The state encourages and will provide export credit and other support for enterprises engaged in the production of steel and related production equipment to trade or transfer technology by exporting superior domestic technologies and metallurgical equipment sets.

Moreover, a WTO report issued in November 2005, summarizing the findings of member countries with respect to China's obligations under its accession agreement, identifies state support to various industries through the banking system, mainly "in the form of policy loans, the automatic roll-over of unpaid principle and interest, forgiven and non-performing loans and the selective use of below-market interest rates."[83] Member countries concluded that China continues to provide "preferential bank financing to producers of agricultural and industrial goods, despite a clear commitment by China four years ago to eliminate all prohibited subsidies upon its accession to the WTO."[84] The report singles out China's Northeast Revitalization Program, finding that China's state-owned banks continue to extend "subsidized financing for large-scale investment projects in China which were designed to increase the competitiveness of state-owned enterprises, particularly in the Northeast, in industries such as oil and gas,

81 According to Morgan Stanley, "prices on a variety of financial instruments" – including interest rates, bank credit lines and bond prices – "are tightly controlled by leadership decisions made at the highest levels of the Chinese government." *See* Stephen S. Roach, *Inside the China Debate*, at 2 (Morgan Stanley 2006).

82 These state-owned banks are, in essence, acting as the government when they provide loans. Indeed, according to the Working Party Report on China's accession to the WTO, "when state-owned enterprises, including banks, provide financial contribution they are doing so as government actors." Thus, to the extent that the loans are being provided on preferential or below market rates, they constitute a subsidy. *See WTO No. G/SCM/118* (Nov. 9, 2005) at 12.

83 *Id.*

84 *Id.* at 3.

petrochemicals, iron and steel, and ship-building."[85] Furthermore, the WTO cites a report on the MOFCOM website claiming that the Dalian Branch of the Export-Import Bank would provide RMB 5 billion in export credits to companies in northeast China to enter global markets. According to the report, MOFCOM states that, since November 2003, "low-cost credit provided by the bank has saved the enterprises [RMB] 150 million interest."[86]

That China's non-commercial lending practices continue today, despite its assurances to the contrary, has been asserted by numerous WTO members. In a September 2005 WTO communication, for example, the U.S. delegation concluded that:

> Bank lending on terms inconsistent with commercial consideration has continued unabated and government bailouts of the banks have grown over time in frequency and magnitude. Since 1998, these banks collectively have reportedly benefited from repeated government capital injections and non-performing loan purchases in excess of $250 billion.[87]

The U.S. delegation further stated that:

> [S]tate-owned banks continue to make policy-driven loans that are not commercially justified, and when those loans fail, the loans are written-off and passed to the asset management companies to be dealt with. The recent inauguration of Huida Asset Management Ltd., set up to specifically deal with the non-performing loans of the state-owned People's Bank of China is one such example.[88]

In its 2005 report to the U.S. Congress, the U.S.-China Economic and Security Review Commission determined low and no-cost financing to be "one of the most pervasive forms of subsidies in the Chinese economy."[89] It stated:

> This system of 'policy lending' whereby capital is allocated for political or strategic reasons using subsidized interest rates and other noncommercial terms arguably amounts to a massive government subsidy for Chinese firms that is

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85 *Id.*

86 *Id.*

87 *WTO No. G/SCM/Q2/CHN/14*, at 3 (Sept. 29, 2005).

88 *Id.*

89 *2005 Report to Congress of the U.S.-China Economic and Security Review Commission*, at 39.

used both to bolster their operations and to fund acquisitions.[90]

Chinese steel companies have benefited significantly from subsidized loans. For example, in 2005, the state-owned China Development Bank agreed to provide Anshan Steel Group (now Anben) with RMB 10 billion (US$1.2 billion) in preferential policy (i.e., subsidized) loans.[91] The same year, Handan Iron & Steel Group received interest-subsidized loans from the government worth RMB 2.4 billion (US$300 million) to fund a 1.3 million ton cold-rolled steel sheet project.[92] In 2005, Baosteel, China's largest steel producer, funded one-half of the RMB 10 billion cost of a new stainless steel production facility with subsidized loans from state-owned banks.[93]

Subsidized loans are playing a major role in capacity expansion in the Chinese steel industry for small as well as large producers. In December 2005, the Export-Import Bank of China – a bank that extends export credits under the direct leadership of the government – signed an agreement with Hunan Valin Steel & Iron Group for $619 million to support its exports and its overseas operations.[94] Valin had already obtained RMB 3.0 billion in discounted loans in 2002. As a result of these discounted loans, production at Valin was projected to reach 9 million tons in 2005, so that it can no longer be considered a small producer.[95]

China's policy of subsidizing the acquisition of strategic assets by state-owned enterprises was highlighted in the recent dispute over the attempted takeover of Unocal Corp. by the Chinese oil company Cnooc Ltd. Cnooc's loan package was heavily subsidized and included a $6 billion loan from a state-owned bank as well as a $7 billion loan from its parent company, China National Offshore Oil (100 percent owned by the

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90 *Id.*

91 Xinhuanet (September 26, 2005), *available at* http://finance.sina.com.cn/stock/t/20050926/0829328489.shtml.

92 *See* Stockstar.com (September 21, 2005), *available at* http://resource.stockstar.com/info2005/darticle.asp?id=SS,20050921,30269085&column=.

93 China Corporate Culture Web, http://www.ce-c.com.

94 Briefing – Asia Banking, Asia Pulse (Dec. 21, 2005).

95 *See* A Remarkable Leap in the Industrial Revitalization of Hunan.

government).[96] The loan from its parent company consisted of $2.5 billion at zero interest and $4.5 billion at 3.5 percent interest per year. All interest payments would have been waived if Cnooc's credit rating fell below a certain level – hardly the terms that would accompany a commercial loan in a free market.

Finally, in the recent steel fasteners case, the Canadian government found actionable subsidies in the form of preferential loans and loan guarantees by the Government of China. Specifically, the Canadian authorities found the existence of preferential interest rates and financing terms provided, either directly by the Government of China or indirectly through financial institutions, to companies satisfying certain export-contingent criteria. They also found that loans provided to certain manufacturers, including steel companies, satisfying export-contingent or other criteria are being guaranteed by the Government of China or other state-run financial institutions.[97]

China's policy of preferential loans to favored industries is further evidenced by the devastation these policies have created in its banking system – specifically the high level of non-performing loans detailed above and the numerous bailouts of the state-owned banks. Indeed, the Chinese government has been forced to provide massive subsidies to the state-owned banks and the state-owned enterprises to which they lent simply to keep them afloat, despite China's contention that these banks and enterprises operate on a commercial basis and are responsible for their own profits and losses. As noted above, in 2003 the central government injected $45 billion into the Bank of China and the China Reconstruction Bank from its foreign reserves.[98] In May 2005, the central government injected another $15 billion of foreign exchange reserves into the Industrial and Commercial Bank of China, which in April 2005 had acknowledged that approximately 20 percent of its loans were non-performing.[99]

96 *See* Cnooc Drops $18.5 Bln Unocal Bid Amid U.S. Opposition, Bloomberg, Aug. 2, 2005; *see also* Statement of Carolyn Bartholomew, Commissioner, U.S.-China-Economic and Security Review Commissioner, before the U.S.-China Relations Seminar (July 14, 2005).

97 *Canada Statement, Nos. 4243-38, 4218-17, AD/1308, CVD/103*, at 40-41 (Dec. 24, 2004).

98 *WTO No. GSCM/Q2/CHN/8*, at 3 (Oct. 6, 2004).

99 *WTO No. G/SCM/Q2/CHN/14*, at 4 (Sept. 29, 2005).

Tax Incentives Provided to the Steel Industry

The central, provincial, and local Chinese governments provide a variety of tax exemptions, reductions, and credits which directly benefit the steel industry. This is the one area for which the recent Chinese subsidies notification to the WTO provides some detail. These programs, detailed below, provide a financial contribution to the steel industry in the form of foregone revenue by the Chinese government.

China's Tax Policies

China's tax policies mandate tax incentives for specified industries, including steel. Article 16 of China's Steel Policy specifically provides for government support in the form of "tax refunds ... and other policy support for major iron and steel projects." Moreover, China's Catalogue of Industries, Products, and Technologies To Be Encouraged for Development on a National Level identifies the steel industry and roughly 30 different steel products as an industry/products to be encouraged. Industries and products identified in the Catalogue receive a wide variety of benefits, including an exemption from Customs duties and VAT on imported equipment used in the production process.[100] In addition, a 50 percent corporate income tax reduction is offered to those companies that derive more than 70 percent of their revenues from manufacturing products listed in the Catalogue.[101]

As described in greater detail below, China's tax policies also provide incentives for export-oriented production and for Foreign Invested Entities.

Tax Incentives for Firms in Special Economic Areas

The Government of China provides a complex system of tax and other financial incentives to manufacturers operating in Special Economic Areas (SEAs) such as Special Economic Zones (SEZs), High Technology Industrial Development Zones, Export Processing Zones, free ports, bonded zones, and the like. These SEAs promote investment with unique tax packages and other incentives, many of which benefit the steel industry. The incentives generally include significant reductions or exemptions in

100 *See* National Development Zones, http://www.cadz.org.cn/en/zgkfq/biao11.htm.

101 *See, e.g.*, Foreign Affairs Information Portal, *Current Catalogue of Key Industries, Products and Technologies the Development of Which is Encouraged by the State (Provisional)* (Approved by the State Council on Dec. 31, 1997), http://www.bjfao.gov.cn/english/law/003C/144.html.

national and local income taxes, land use fees, import and export duties, and priority treatment in obtaining basic infrastructure services.[102] The government has also created special incentives for projects involving export-oriented investments and for certain industries including steel.[103]

For example, the Jiangsu Yangtze International Metallurgical Industrial Park in Zhangjiagang City, an industrial park composed primarily of steel companies, advertises the following tax incentives for foreign-funded manufacturing companies: a corporate income tax exemption in the first two profit-making years and a 50 percent reduction in the third-to-fifth profit-making year; local income tax exemptions; a VAT exemption for exported products; exemption of VAT and customs duties on equipment used in the manufacturing process; and a full refund of income taxes paid on profit which is reinvested in export-oriented enterprises.[104]

Other industrial parks and development zones offer even more attractive tax packages. One high-tech industrial park boasts tax-free status for the first five years, starting from the day of registration, followed by a 50 percent reduction in income tax for the second five-year period. The same park offers a 25 percent refund of paid VAT for 7 years and an exemption from operations taxes for the first 3 years, starting from the day of registration.[105] Such benefits are indicative of those granted to steelmakers in similar parks.

China's subsidies notification identifies preferential tax policies for enterprises recognized as high or new technology enterprises established in the high or new technology industrial development zones. Enterprises located in such areas pay a 15 percent income tax rate and are exempt from income tax for their first two years.[106]

The China Association of Development Zones cites additional tax incentives, including the following:

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[102] *See* U.S. & Foreign Commercial Service and U.S. Department of State, Doing Business in China: A Country Commercial Guide for U.S. Companies, ch. 6, Investment Climate (2005).

[103] *Id.*

[104] *See* Investment Guide, Jiangsu Yangtze International Metallurgical Industrial Park.

[105] *See* Investment Promotion, *Baotou National Rare Earth Hi-Tech Industrial Development Zone*, http://www.rev.cn/en/pre.htm.

[106] China Subsidies Notification at 10.

- **Loss compensation schemes** whereby any losses experienced by companies in development zones can be offset through reductions in income taxes for a period of 5 years after the loss is incurred.[107]

- **Regional tax incentives** whereby companies in specified regions, including the "Middle Western Areas," are eligible for a 15 percent reduction in income tax after the original exemption-reduction period is over.[108]

- **Export-oriented tax incentives** whereby taxes are reduced by as much as 50 percent for export-oriented enterprises which export 70 percent or more of their total annual output.[109]

The amounts of such subsidies can be substantial, if not huge. Hangzhou Iron & Steel Co., for example, reported that one of the company's subsidiaries received subsidies worth RMB 1.14 million from the Ningbo Daxie Development Finance & Tax Bureau.[110]

Tax Benefits for Foreign Invested Entities

The Chinese government provides a variety of tax exemptions and reductions for Foreign Invested Entities (FIEs) that are export-oriented. Indeed, China's subsidies notification identifies no fewer than nine different tax programs that benefit enterprises with foreign investment.[111] According to China's Income Tax Law, enterprises invested in and operated by foreign businesses that export more than 70 percent of their annual output receive a 50 percent reduction in corporate income taxes after the period income tax exemption has expired.[112] Thus, export-oriented FIEs receive an income tax exemption in the first two profit-making years and an income tax reduction of 50 percent in

107 *See* National Development Zones.

108 *Id.*

109 *Id.*

110 Hangzhou Iron & Steel Co., Ltd., Annual Report (2005) (in Chinese only).

111 *See* China Subsidies Notification at 1-17.

112 Rules for the Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, art. 75 (7), http://www.fdi.gov.cn/resupload/epdf/e00081.pdf.

the following three years. After the five year period, an export-oriented FIE may be eligible for additional tax reductions depending on its location.[113]

FIEs that are not export-oriented are also eligible for corporate income tax reductions, depending on their location and industry. Article 7 of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises provides in part:

> The income tax on enterprises with foreign investment established in Special Economic Zones, foreign enterprises which have establishments or places in Special Economic Zones engaged in production or business operations, and on enterprises with foreign investment of a production nature in Economic and Technological Development Zones, shall be levied at the reduced rate of fifteen percent.
>
> The income tax on enterprises with foreign investment of a production nature established in coastal economic zones or in the old urban districts of cities where the Special Economic Zones or the Economic and Technological Development Zones are located, shall be levied at the reduced rate of twenty-four percent.[114]

Additional tax incentives provided to FIEs include:

- A refund of either 100 percent or 40 percent of the income tax paid on the amount reinvested (depending on whether the reinvestment was in an export-oriented business) for FIEs that reinvest their profits in their China-based business.[115]
- An exemption from a 5 percent business tax that typically applies to technological transfers such as intangible assets, patents, and copyrights.
- A VAT rebate on purchases of domestic machinery and equipment by FIEs.

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113 *Id.*

114 Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, art. 7, http://www.fdi.gov.cn/resupload/epdf/e00088.pdf.

115 *Id.* art. 10.

- An income tax exemption or reduction for dividends, interest, rents, franchising fees and other forms of income derived from sources in China by FIEs.

Tax Benefits for Specific Regions

Tax benefits are also available for enterprises located in specific regions. China's subsidy notification identifies special tax benefits for enterprises located in, among others, the western regions and poverty stricken areas.[116] Steel producers in various regions, such as Baotou Iron & Steel Group, have benefited from such programs.[117]

Tax Subsidies Identified as Actionable by the Canadian Government

In a recent countervailing duty case involving carbon steel and stainless steel fasteners from China, the Canadian government identified numerous tax credits, refunds, and exemptions granted by various levels of the Chinese government to the steel industry. These subsidies, which were found to be actionable, included:

- Reduced rate of tax on corporate income for companies that have a significant volume of export sales.
- Exemption from and further reduction of income tax for companies operating in special economic areas during a designated start-up period (usually five years).
- Eligibility of companies located in Special Economic Areas (SEAs) for rebate of corporate income tax paid when profits are re-invested within the SEA.
- Exemption or reduction of sub-provincial income taxes for certain foreign invested enterprises located in SEAs.
- Exemption of duties and taxes on imported machinery and other inputs for use in production of subject merchandise.

116 China Subsidies Notification at 18-19.

117 *See* Inner Mongolia Local Taxation Service Center, http://www.nmds.gov.cn.

Subsidized Targeted Infrastructure Development

Special Economic Areas and Industrial Parks

The Chinese government subsidizes the steel industry by financing and building, in whole or in part, industrial parks and other Special Economic Areas (SEAs). An investment guide for Jiangsu Yangtze International Metallurgical Industrial Park in Zhangjiagang City highlights the purpose and purported virtues of these industrial parks.[118] This particular park was approved by the government of Jiangsu Province in 2003 and is primarily dedicated to the steel industry. The park is located on 40 square kilometers close to the Yangtze River's deep-water coastline. There are currently 27 foreign-owned companies, including POSCO and Hyosung from South Korea, and 40 Chinese companies, including Shangang and other steel companies. The park "seeks to establish the first 10 million ton metallurgical industrial base and the biggest steel sheet production based in Jiangsu province with the annual sales 9.5 billion US$ in 5 years and 15 billion US$ in ten years."[119] In 2005, the annual production capacity of the park was expected to be 12.5 million tons of raw steel and 10 million tons of rolled steel.

The industrial park offers "complete infrastructure facilities," presumably financed and built by the provincial government. The investment guide boasts completed and ready to deliver water supply (tap, industrial, and soft water), water drainage, sewage, power supply, steam supply, road networks, telecommunication systems, fuel gas (with natural gas transported from western China), industrial gas (such as oxygen nitrogen, argon and helium), and leveled land plots. According to the guide, twelve 10,000-ton level wharfs have been built on the Yangtze River and another seven are under construction. The guide also states that "manufacturing projects, which are in accord with the general design of Yangtze International Metallurgical Industrial Park and industry guide will enjoy various fiscal support provided by the Administrative Commission of the Park."

Additional services promised to investors include:

- "Maximum preference" on land use and price;

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118 *See* Investment Guide, Jiangsu Yangtze International Metallurgical Industrial Park.

119 *Id.* at Brief Introduction of Metallurgical Industrial Park.

- Water and power supplied to the facilities;
- Financial services, including the provision of working capital in a timely manner. A company can get a loan from the bank by mortgaging the land use right of the state-owned land it receives;
- Port services, including round-the-clock Customs service for certain products;
- Living communities for foreign investors which include medical treatment and education facilities. The park includes a foreign language school offering primary and secondary education. Children of overseas investors are promised priority in enrollment; and
- Consultation and/or training for foreign investors in the applicable laws, regulations and policies, and preparation of all necessary documents and materials for setting up and registering the enterprise.

The Jiangsu Yangtze Industrial Park is not alone in providing incentives to industrial enterprises to promote growth. Industrial parks are sprouting up throughout the country offering similar benefits. For example, a park in Baotou promises, among other things, financial support, a loan guarantee fund, a guaranteed water supply, a "special zone rate for electricity," and a steam production facility.[120] An industrial park devoted almost exclusively to the steel industry, Baoshan International Steel Logistics and Service Park, is expected to be completed in 2006.[121] The park is expected to attract over 500 international steel manufacturing, services, and trading companies and will likely offer similar incentives to those described above.

Finally, the Canadian government has identified Special Economic Area incentives as actionable subsidies. It found that certain incentives were "[a]vailable to [steel] manufacturers operating in regions such as economic and technical development zones, export processing zones, bonded zones and high-technology industrial devel-

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120 Investment Promotion, *Baotou National Rare Earth Hi-Tech Industrial Development Zone*.

121 *See generally*, Shanghai Municipal Government website, http://www.shanghai.gov.cn.

opment zones."[122] It identified the following benefits, either granted outright or contingent on export performance: special land use and investment exemptions, and preferential costs of services and infrastructure provided by government agencies or state-owned enterprises.[123]

The Northeast Revitalization Program

The Government of China has undertaken an industrial revitalization program which provides "potentially unfair advantages to businesses locating to or operating in Northeast China."[124] Starting in 2003, China's central government has carried out a plan to resuscitate the old industrial base in the three northeastern provinces of Heilongjiang, Jilin, and Liaoning, aiming to build the region into a world-class industrial base.[125] Together, these provinces account for about 10 percent of China's steel production.[126]

As described by China's State Property Commission, under this program China is executing a "strategic restructuring and technical transformation of key enterprises in the areas of oil, petrochemical, iron and steel, automotive, shipbuilding and aircraft products manufacturing sectors in Northeast China in a bid to establish production bases of advantage industries."[127] One of the stated aims of the program at the outset was to increase the competitiveness of Anshan Iron and Steel.[128] In support of the Northeast Revitalization Program, the central government has offered preferential policies and financial support to industry, including tax incentives and low-interest rate financing.[129]

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122 *Canada Statement, Nos. 4243-38, 4218-17, AD/1308, CVD/103*, at 40-41 (Dec. 24, 2004).

123 *Id.*

124 *WTO No. G/SCM/Q2/CHN/14*, at 2 (Sept. 29, 2005).

125 China's Old Industrial Base Eyes Bright Future With Ambitious Plan, People's Daily Online, http://english.peopledaily.com.cn/200401/09/print20040109_132185.html.

126 *See* Table 2, *supra*.

127 *WTO No. G/SCM/Q2/CHN/14*, at 2 (Sept. 29, 2005).

128 SASAC Announces Timetable for SOE Restructuring in Northeast, Business Alert – China, Jan. 1, 2004.

129 *See* China's Old Industrial Base Eyes Bright Future With Ambitious Plan.

Government Intervention in Raw Material Prices

China lacks adequate domestic supplies of many of the key raw materials that are necessary for steel production, especially iron ore and steel scrap. To remedy this situation, the Chinese government is implementing a deliberate strategy of locking up long-term supply through a combination of subsidized foreign investments and long-term contracts with foreign suppliers. The effect of this strategy has been to drive up prices for these inputs worldwide. Now that China has established itself as an indispensable customer of the major raw material suppliers, though, the Chinese government is threatening to cap import prices of iron ore, a key input. China also restricts exports of coke, another major input, keeping its domestic price artificially low.

The Chinese Government and Raw Materials for Steel

Until the economic reforms of the past two decades, the Chinese government controlled all domestic prices in China, including prices for iron ore and coke. In many ways, the actual price levels were irrelevant, as China's steel mills produced according to a central plan rather than in response to the market. The government no longer directly controls prices for steel inputs, but it does affect them in ways that have the end result of making iron ore and coke available to Chinese producers at prices below what they would otherwise be.

As explained above, the Chinese government continues to own a majority of the Chinese steel industry. China's largest iron ore producers, including Anshan Mining Co. and Shoudu (Capital) Mining Co., are primarily state-owned. In addition, iron ore producers are part of larger corporate groups that also produce steel. All of these assets were originally 100 percent state-owned, and were "contributed" to enterprises. Even after the economic reforms of the 1980s and 1990s, the enterprises were never required to pay for these assets. In this way, the Chinese steel industry was essentially given not just China's domestic iron ore reserves, but the equipment needed to exploit those reserves. This original gift continues to provide huge benefits to the Chinese steel industry, as it has not incurred the significant capital costs associated with the development and exploitation of iron ore reserves.

Because iron ore producers are normally linked to steel producers, relatively little iron ore in China is actually traded. Steel producers can assign their internal iron ore supplies a lower price than would occur in a free market, because neither the steel producers nor the iron ore suppliers incurred the capital costs associated with the discovery and ownership of iron ore reserves. Moreover, because both the iron ore producers and the steel producers are mostly state-owned, the Chinese government can ensure that domestic iron ore prices are set at levels that ensure the profitability of steel producers and, as importantly, the continuing expansion of the steel industry. In this way, the Chinese government and the Chinese steel industry can manipulate the price of this key input to their mutual advantage.

The government also seeks to manipulate the price of iron ore and other raw materials through import licensing schemes. In May 2005, for example, the Chinese government began imposing new import license procedures for iron ore. China reportedly restricted licenses to 48 traders and 70 steel producers and failed to make public a list of the qualified enterprises or the qualifying criteria used – violations of the WTO Import Licensing Agreement.[130] It did so in an attempt to control the price of iron ore and insulate this critical raw material from market forces.

Government Intervention in Import Negotiations

Although China is the world's largest producer of iron ore, by tonnage, Chinese iron ore reserves have a relatively low iron content. This has forced China to import large quantities of iron ore, primarily from Australia, Brazil, and India. In 2004, China imported 208 million tons, or slightly less than one-third of total world imports. Imports for full year 2005 exceeded 275 million tons, and should exceed 300 million tons by 2006. Iron ore imports in the first two months of 2006 were 51.5 million tons, an increase of 37 percent from the previous year.[131] The Chinese steel industry is heavily dependent on imported iron ore. Accordingly, a sharp increase in iron ore prices would have an immediate negative effect upon the industry.

The Chinese government exhibited its willingness to intervene in international markets on behalf of its steel industry when precisely such a sharp increase appeared likely in the early part of 2006, as Chinese steel producers began negotiations with Aus-

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130 United States Trade Representative, *2005 Report to Congress on China's WTO Compliance* 25 (Dec. 11, 2005).

131 China May Trim List of Domestic Iron Ore Importers, Dow Jones, Mar. 15, 2006.

tralian and Brazilian iron ore suppliers. Initially, the Chinese government attempted to control the negotiations by limiting participation to a single Chinese steel producer, Shanghai Baosteel. The avowed purpose of this move was to impose discipline on the Chinese industry in the negotiations.[132] Some sources subsequently reported that China would effectively cap imported iron ore prices by refusing to approve import permits for shipments above the cap price ($54/ton for Australian ore and $70/ton for Brazilian ore).[133] The Chinese government also indicated that it was considering reducing the number of importers allowed to bring iron ore into China so that it could exert greater control over iron ore imports.[134] The Chinese government made its goal clear in a statement by the Ministry of Commerce and the National Development and Reform Commission, as an official stated that:

> {I}ron ore was the main raw material of steel and iron production, price of iron ore was directly related to the development of steel industry and all sectors of national economy. China's steel industry was in a very difficult position that cost was rising, profit was decreasing and price of iron ore was increasing again. The Chinese government had taken measures to further enhance the control to the utilization of imported iron ore, accorded with national industrial policies, supported eliminating and outdated system and restrained over-fast growth of production capacity of iron ore. The unreasonable demand for iron ore will be further reduced. Chinese government will pay close attention to the negotiation process of iron ore price, and take necessary measures to avoid damaging interests of the nation and enterprises if price set is unreasonable and unacceptable to China.[135]

Ultimately, the Chinese government's attempts to limit iron ore price increases were unsuccessful, as the Chinese producers agreed to price rises of 19 percent for iron ore lumps and fines (although the price for pellets dropped).[136] Nonetheless, the Chinese government is planning to "strengthen its monitoring" of iron ore imports "in a move expected to increase pressure on miners as they seek to finalize yearly supply

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132 China Assoc: Only Baosteel to Hold Iron Ore Price Talks, Dow Jones Newswire, Feb. 22, 2006.

133 China Caps Iron-Ore Prices Daily Telegraph, Mar. 7, 2006.

134 China May Trim List of Domestic Iron Ore Importers, Dow Jones, Mar. 15, 2006.

135 MOFCOM and NDRC Highly Concerned with the Long-Term Iron Ore Price Negotiation in 2006, http://english.mofcom.gov.cn/aarticle/newsrelease/significantnews/200603/20060301691985.html.

136 CVRD, Rio Tinto Also Settle Iron Ore Prices with China, *The Tex Report* (June 23, 2006).

contracts with steelmakers."[137] From these steps, it is plain that the Chinese government has acted aggressively to limit increases in iron ore prices – increases that are largely the result of the rapid expansion of the Chinese steel industry itself.

Subsidization of Iron Ore Investments

The Chinese government's support of the steel industry with respect to raw material supplies is not limited to direct and indirect controls over prices. The explicit policy of the Chinese government is to assist the Chinese steel producers in securing sources of overseas supply through investments.[138] To ensure access to iron ore supplies, the Chinese government and Chinese companies have negotiated investments in a number of iron ore projects worldwide. Most of these projects involve the development of mines, although some concern existing facilities, with much of the investment subsidized by the government. Indeed, the Chinese government recently granted Jiangsu Shagang Steel Group 1.3 billion RMB in subsidies for its iron mine project in Australia.[139] Additional projects, with their estimated capacities, include:

- Extension Hill, Western Australia, Australia (5 million MT/year)
- Labrador, Canada (10-12 million MT/year)
- Camarines Norte, Philippines (unstated)
- Musan, North Korea (10 million MT/year)
- Koolan Island, Western Australia, Australia (0.3 million MT/year)
- Lao Cai, Vietnam (1.5-3 million MT/year)
- Pilbara, Western Australia, Australia (800 million MT total reserves)
- Capitan, New Mexico, USA (unstated)
- Minnesota, USA (unstated)
- Koolanooka, Western Australia, Australia (5 million MT/year)

137 China Introduces New Measures to Monitor Iron Ore Imports, SteelDay, Mar. 15, 2006.

138 Steel Policy, art. 30.

139 *China Jiangsu Offering Over 6 M RMB of Subsidies to Overseas Investors*, Financial Times, Feb. 15, 2006.

- Chita, Russia (10 million MT/year)
- Wheelarra, Western Australia, Australia (12 million MT/year)
- Pilbara, Western Australia, Australia (5-10 million MT/year)

Taken together, these investments could give Chinese companies, and their government owners, direct control over more than 62 million tons per year of iron ore production. This would represent control of nearly nine percent of world trade in iron ore, which totaled 715 million tons in 2005. By way of comparison, the United States produced 55 million tons of iron ore in 2005 and imported 13.0 million tons.[140]

In addition, the Chinese government has begun discussions with the government of Orissa state in India regarding the development of iron mines in Orissa, although no definite projects have been undertaken. India is a major supplier of iron ore to China. Similarly, China Minmetals, the state-owned metals trading company, has begun discussions on a joint venture in Brazil with Brazilian ore producer CVRD. Four Chinese steel producers have proposed a joint venture with BHP Billiton for the mining of iron ore in Australia.

China's long-term strategy is to establish significant control over its foreign sources of iron ore. Chinese companies are preparing to invest up to $8 billion in mines in Australia alone – much of this capital presumably from state-owned banks on preferential, non-commercial terms.[141] Half of these investments are expected to be in iron mines. The Chinese metals industry currently has "some kind of involvement" with suppliers providing 25 percent of current iron ore imports, and intends to raise that percentage to 50 percent.

Chinese companies have also sought to tie up iron ore supply by concluding long-term contracts with iron ore suppliers. The world iron ore market is dominated by three companies – BHP Billiton (Australia), CVRD (Brazil), and Rio Tinto (Great Britain, but with mining operations throughout the world) – which collectively control over 70

140 United States Geological Survey, *Mineral Commodity Surveys-2006*, at 86 (2006).

141 As noted previously, the Chinese government recently granted Jiangsu Sha Steel Group 1.3 billion RMB in subsidies for its iron mine project in Australia. *China Jiangsu Offering Over 6 M RMB of Subsidies to Overseas Investors*, Financial Times, Feb. 15, 2006.

percent of world seaborne iron ore trade. These producers periodically negotiate with the major iron ore consumers to set prices for the next year. Chinese customers have been pressing CVRD in particular, however, to agree to long-term contracts. As the largest buyers of iron ore, the Chinese users have significant negotiating leverage. The Chinese ore buyers do not have to act alone; Chinese government officials have noted that "{m}arket forces ought to dictate prices of iron ore, used in the making of steel, but the Chinese Government can't help but 'take an interest' in how it is priced."

In addition to negotiating with the three largest suppliers, Chinese consumers have also concluded long-term contracts with other, smaller suppliers around the world.

- BHP Billiton has agreed to sell to a consortium of four Chinese steel producers 12 million MT of iron ore per year for 10 years.
- Portman Ltd. of Australia is sold out through 2006 because of orders from China.
- Chinese companies are seeking to buy the entire output of Murchison Metals Ltd. of Australia.
- Hebei Wenfeng Iron and Steel has signed a contract with Fortescue Metals of Australia to purchase 2 million MT of iron ore per year over a 20 year period.

This strategy of using investments and long-term contracts to ensure a steady supply of iron ore would not be possible without the continuing support of the Chinese government. Indeed, the efforts of the Chinese steel industry to secure long-term sources of supply simply represent one facet of China's overall drive to secure the raw materials its economy needs, but which the country lacks.

Government Restrictions on Exports of Raw Materials

The Chinese government also indirectly keeps the prices of certain key raw materials for steel production low by placing restrictions on the exportation of those materials. The best-known case involves coke, which is an essential input into making steel using the traditional blast furnace. In 2004 and 2005, China imposed a quota on exports of coke of 14.3 million metric tons. By contrast, China's coke production in 2004 was 208 million metric tons. This caused the price for coke exported from China to rise to artificially high levels[142] and had a "significant, adverse effect on U.S. integrated steel producers and their customers."[143]

The export restrictions on coke provide a benefit to the Chinese steel industry in two distinct ways. First, as a matter of basic economics, increasing the supply of an input without increasing demand will cause the price of the input to drop. By keeping the domestic supply of coke artificially high, the Chinese government keeps its domestic price artificially low. At the same time, the export restrictions make Chinese coke more expensive for foreign steel producers, reducing their competitiveness vis-à-vis the Chinese industry. In late June 2005, for example, Chinese steel producers were paying only $139 per metric ton for coke, while foreign steel producers were paying $220 per metric ton for the same coke.[144] In this way, the Chinese government's control over coke exports provides the Chinese industry with a double advantage.

The Chinese government has made it clear that it intends to continue to restrict exports of raw materials where this will benefit the steel industry. Article 30 of the Steel Policy states specifically that "{t}he export of such preliminarily processed products as coke, iron alloy, pig iron, waste steel and steel base (ingot) with high energy-consumption and serious pollution shall be restricted ... ."[145] Despite complaints from its trading partners, China will continue to impose restrictions on the export of key steel-making raw materials to keep domestic prices low.

Government Controls Over Energy Prices

The Chinese government also controls energy prices. The National Development and Reform Council sets prices for both natural gas and electricity. In the absence of a market, it is impossible to know what prices for electricity, natural gas, and

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142 World Trade Organization, *China's Transitional Review Mechanism: Communication of the United States*, No. G/MA/W/71, at 3 (Sept. 6, 2005).

143 United States Trade Representative, *2004 Report to Congress on China's WTO Compliance* 33 (2004).

144 World Steel Dynamics, *Steel Thermometer #24*, at 15 (June 30, 2005).

145 Steel Policy, art. 30.

other forms of energy in China would be. However, "China's pricing structure for energy resources and utilities has been criticized for causing artificially-low prices ... ."[146]

The Chinese steel industry benefits from low prices for both electricity and natural gas, if indeed Chinese steel producers pay for utilities at all. There have been reports that, for electricity in particular, local authorities, which control local utilities, may not charge favored enterprises for electricity, or charge them reduced rates. Because energy accounts for a substantial portion of the cost of producing steel, this represents a sizable benefit to Chinese steel producers.

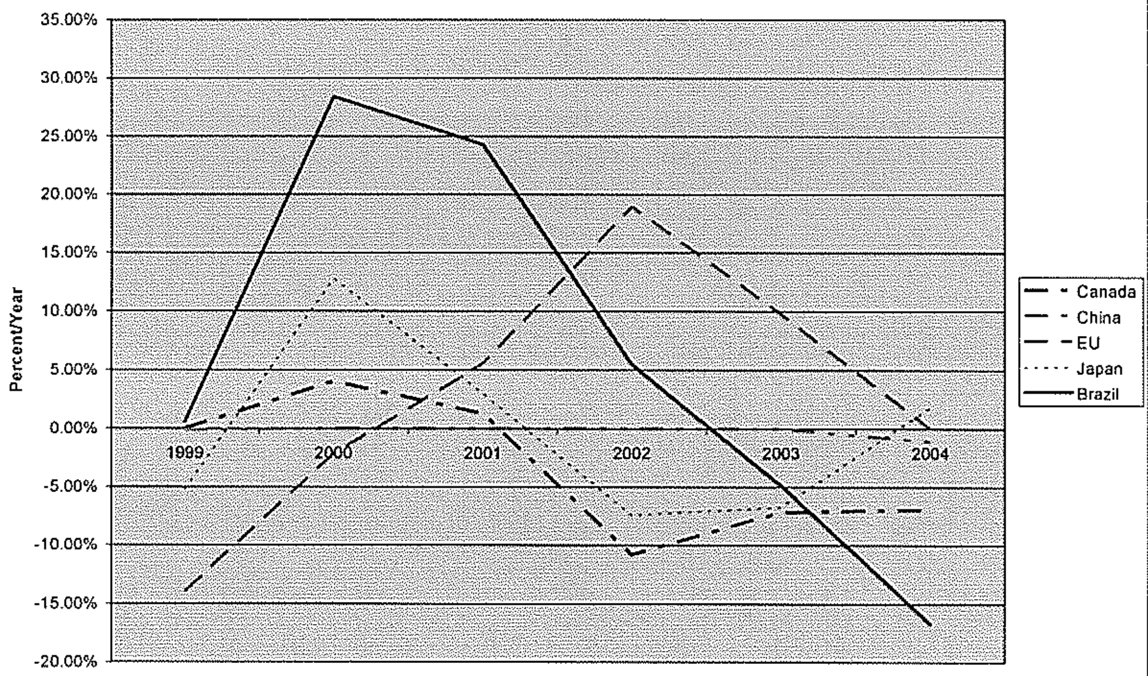
Currency Manipulation

It is impossible to overstate the benefit the Chinese government's manipulation of the value of the RMB provides to Chinese steel producers. Although the U.S. government has thus far declined to make a formal finding of manipulation, there can be no doubt that China actively manages the value of the RMB to benefit Chinese exporters, including the steel industry. Between February 2002 and March 2006, the U.S. dollar fell in value by an average of 15 percent against all currencies. Over that period, the dollar declined by an average of 24 percent against the euro and other industrialized country currencies, but by only about 1.6 percent against the Chinese RMB.[147] The following chart shows the how other currencies have moved up and down vis-à-vis the dollar, while the value of the Chinese RMB has remained remarkably steady. This startling difference reflects the impact of currency manipulation by China.

[146] China to Raise Retail Electricity Prices, Forbes, Mar. 2, 2006.

[147] Federal Reserve Statistical Release, Foreign Exchange Rates, *available at* http://www.federalreserve.gov/releases/h10/Hist/.

CHART 2
CHANGES IN EXCHANGE RATES, 1999 - 2005



China has made vague promises to allow the RMB to float across a wider range. On July 21, 2005, China raised the peg for the yuan from 8.28 to 8.11. This represented only a 2 percent revaluation, which was too small to have a measurable effect on trade. Although China has announced plans to value the RMB against a basket of currencies, the RMB still tracks the dollar quite closely. In March 2006, the RMB was trading at a rate of 8.04RMB/dollar. The preceding chart shows how the Chinese government has manipulated the value of the RMB to minimize its fluctuation vis-à-vis the U.S. dollar. By comparison, the currencies of other major trading partners of the United States have fluctuated significantly.

To keep the RMB's value down, the Chinese government must make enormous purchases of U.S. dollars, usually in the form of U.S. government bonds. The Chinese government's purchases of U.S. dollars and other securities are currently averaging about $200 billion per year. These purchases amount to fully 9 percent of China's GDP. Chinese government purchases of dollars and other securities create an effective 27 *percent* subsidy on China's exports.[148] This subsidy gives Chinese exports of steel a huge advantage in world markets. At the same time, an undervalued RMB makes imports, including steel imports, more expensive. In this way, China's manipulation of its currency subsidizes the Chinese steel industry in two different but complementary ways.

[148] P. Morici, *The Doha Round: No Help for America's Trade Deficit?* 21 (2006), available at http://www.morici-dohareport.org/NoHelpForAmericasTradeDeficit.pdf.

INDIRECT GOVERNMENT SUBSIDIES TO THE STEEL INDUSTRY

In addition to direct subsidies, the Chinese government has implemented a number of policies and programs that provide its steel industry with more indirect but nonetheless concrete benefits. These include barriers to imports and foreign investment.

Import Barriers

China has traditionally restricted imports through a variety of means, including high tariffs and taxes, quotas and other non-tariff measures, and restrictions on trading rights.[149] While China has made some progress in removing restrictions in these areas, according to USTR, "bureaucratic inertia and a desire to protect sensitive industries" has prevented substantial progress.[150]

China's recently released Steel Policy mandates practices which discriminate against foreign equipment and technology imports by encouraging the use of domestic products when competing domestic suppliers exist. Article 16 of the policy provides for government support in the form of "tax refunds, discounted interest rates, funds for research and other policy support for major iron and steel projects utilizing newly developed domestic equipment." Article 18 sets forth the government's policy on the "Import of Technology and Equipment" and states:

> Enterprises are encouraged to use domestic equipment and technology and reduce imports. For equipment and technology that must be imported due to the lack of domestic ability to produce such or due to insufficient domestic supply, such equipment and technology must be modern and practical.

China also restricts imports of raw material and other steel inputs to control prices. For example, as discussed above, China has recently blocked iron ore imports above a price cap to restrict the spot price of iron ore.[151] Moreover, in May 2005, the Chinese government began imposing new import license procedures for iron ore.

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149 United States Trade Representative, *2005 National Trade Estimate Report on Foreign Trade Barriers* 74 (Mar. 2005).

150 *Id.*

151 *See* China caps iron-ore prices: Report, The Daily Telegraph, Mar. 7, 2006.

China reportedly restricted licenses to 48 traders and 70 steel producers and failed to make public a list of the qualified enterprises or the qualifying criteria used – in violation of China's WTO obligations.[152]

Not surprisingly, in its most recent annual report on foreign trade barriers, USTR concluded that there are substantial barriers to trade in China that have not been dismantled.[153] Specifically, USTR found that:

> China has also increasingly resorted to industrial policies that limit market access by non-Chinese origin goods or rely on substantial government resources to support increased exports. The objective of these policies seems to be to support the development of Chinese industries by effectively mandating local content of products that are higher up the economic value chain than the industries that make up China's current labor-intensive base, or simply to protect less-competitive domestic industries.[154]

These policies are likely in contravention of China's WTO accession agreement in which China committed not condition the right of investment or importation on whether domestic suppliers exist.[155]

The report further found that import barriers, opaque and inconsistently applied legal provisions, and limitations on foreign direct investment combine to make it difficult for foreign firms to operate in China.[156] Finally, USTR concluded that the central government continues to implement industrial policies and protect noncompetitive or emerging sectors of the economy from foreign competition.[157]

Barriers to Foreign Investment in the Steel Industry

The Chinese Government strictly regulates investment by foreign firms within China and prohibits foreign companies from owning majority stakes in most Chinese en-

[152] United States Trade Representative, *2005 Report to Congress on China's WTO Compliance*, at 25 (Dec. 11, 2005).

[153] *See Mar. 2006 NTE* at 93

[154] *Id.*

[155] *Id.* at 98.

[156] *Id.* at 94.

[157] *Id.*

terprises. Article 23 of China's Steel Policy explicitly forbids foreign companies from owning a controlling stake in Chinese steel producers, stating: "[f]or any foreign investment in the iron and steel industry of China, foreign investors are not allowed to have a controlling share."[158] Foreign investment that is permitted is channeled toward areas that support national development objectives; foreign investment not in line with these development objectives is restricted or prohibited.[159]

Restrictions on Foreign Investment in the Steel Industry

China's Steel Policy restricts foreign investment in a number of additional ways by mandating certain requirements as conditions for investing, with added restrictions placed on foreign investors. Article 23 of the policy includes investment requirements for certain production levels in the previous year, self-financing of 40 percent or above, modern technology and management, developed supply and distribution networks, transportation, and water and power resources. These requirements appear to apply only to domestic companies seeking to operate in cross-regional domestic steel operations, while foreign companies must meet these requirements for any investment in China. Moreover, Chinese companies only need to meet a 5 million ton previous year quantity threshold for investments in common steel and a .5 million ton threshold for investments in specialty steel. The corresponding thresholds for foreign companies are 10 million tons and 1 million tons. Additionally, Article 23 prohibits foreign companies from investing in new business sites and limits participation to reform or relocation of existing enterprises.

China's Steel Policy also requires that foreign investors possess proprietary technology or intellectual property in the processing of steel. Given that foreign investors are not allowed to have a controlling stake in Chinese steel companies, this amounts to a *de facto* technology transfer requirement. As noted above, the policy also appears to discriminate against foreign equipment and technology imports by encourag-

158 Steel Policy, art. 23. In addition, Luo Bingsheng, Secretary General of the China Iron and Steel Association recently stated that "Foreigners taking a controlling stake in our major steel mills is against our iron and steel development policy. We have a batch of competitive steel mills, which can play an important role in the restructuring of the industry." China to Shut Small Steel Mills, Urge Mergers, Reuters, Mar. 5, 2006.

159 *See Mar. 2006 NTE* at 150.

ing the use of domestic equipment and by providing for a number of government financial supports for steel projects utilizing newly developed domestic equipment.

Chinese Tax Policies as a Barrier to Foreign Investment

China's tax policies also serve as barriers to foreign investment. China's Value Added Tax (VAT) – the country's single most important revenue source which ranges from 13 to 17 percent – continues to be applied in a manner that provides an unfair benefit to certain Chinese industries. According to USTR, "importers from a wide range of sectors report [that they are] subject to application of a VAT that their domestic competitors [in China] often fail to pay."[160] Indeed, numerous foreign manufacturers have cited the arbitrary application of the VAT and VAT rebates as an indirect subsidy aimed at limiting import competition from U.S. and other foreign products and giving price-advantage to Chinese products.[161] As recently as March 2006, the China Iron and Steel Association (CISA) reports that the government is considering exempting the VAT for the steel product tolling business to discourage imports.[162] According to CISA, the exemption would be designed to assist domestic steelmakers, who have seen a decline in profits during the past several months.[163]

In addition, China's consumption tax system is an area of concern among exporters to China and may constitute an import substitution subsidy. Because China uses a different tax base to compute consumption taxes for domestic and imported products, the tax burden imposed on a wide range of imported goods is higher than for competing domestic products.[164] In fact, importers may pay twice as much as they would if the tax were assessed at the same rate as for Chinese products, putting U.S. imports at a severe disadvantage vis-à-vis their Chinese competition.[165]

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160 *Id.* at 107.

161 Letter to Gloria Blue, *supra* at 14.

162 China Considers Exempting Value-Added Tax on Steel Product Tolling Business, Interfax, Mar. 29, 2006.

163 *Id.*

164 *Mar. 2006 NTE* at 107.

165 *See* United States Council for International Business, *Statement re: Submission to the United States Trade Representative (USTR) on China's Compliance With its WTO Commitments* 11 (Sept. 6, 2005).

Other Barriers

Finally, USTR cites additional barriers to investment that plague China, including a "lack of transparency, inconsistently enforced laws and regulations, weak IPR protection, corruption and an unreliable legal system incapable of protecting the sanctity of contracts."[166]

[166] *Mar. 2006 NTE* at 149.

STRUCTURAL SUBSIDIES TO THE STEEL INDUSTRY

In addition to direct and indirect assistance, the Chinese government also provides support to the Chinese steel industry through broader policies and practices. Prominent among these are the Chinese government's failure to enforce environmental and labor laws. In each case, China has relatively tough laws on the books, but declines to enforce them.

Weak Environmental Regulation

On paper, China's environmental laws are relatively stringent. In practice, the laws are often laxly enforced. Environmental enforcement in China is primarily the responsibility of local governments – the same local governments that often own controlling shares in local steel producers and that look to those producers to provide employment and tax revenues. Given this, it is no surprise that Chinese government organs have repeatedly allowed the steel industry to continue to pollute.[167]

In an attempt to reassert central control over environmental enforcement, the State Environmental Protection Administration (SEPA) recently announced that it was launching a concentrated investigation of industries that are major polluters, including the steel industry.[168] Among the firms named specifically as a subject of investigation was Xingtai Iron and Steel Corp.[169] SEPA also stated that it was investigating Nanjing Steel, which launched an expansion project without performing the required environmental impact assessment.[170] Meanwhile, the official Xinhua News Agency released a detailed report in 2005 regarding a steel mill built on illegally obtained land in Henan Province that violated environmental standards by discharging untreated wastes directly into a nearby reservoir – a reservoir designed to provide water to Beijing and Tianjin.[171]

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167 *See* SEPA Begins New Onslaught on Polluters, Including Petrochemical and Metals Producers, Metals Weekly (Feb. 10, 2006).

168 *Id.*

169 *Id.*

170 *Id.*

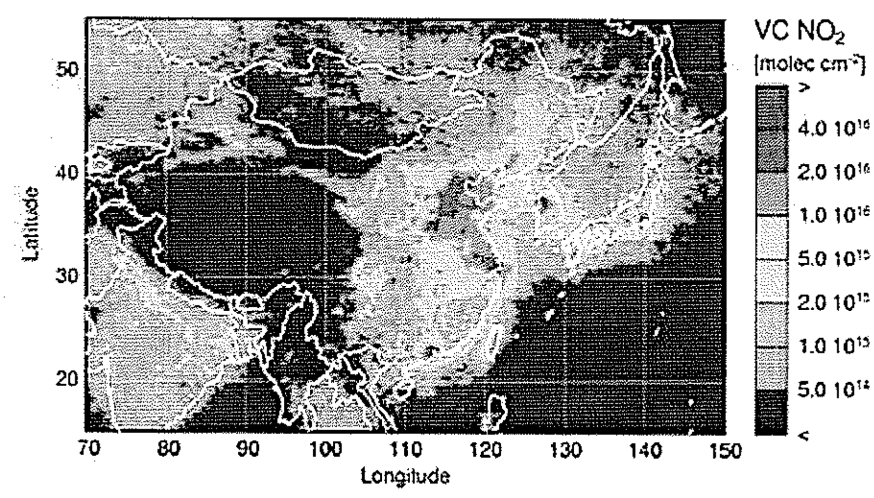
171 Elaine Kurtenbach, *China Ups Environment Spending; Report Says Steel Plant Severely Polluting Major Water Project,* Associated Press Worldstream, Mar. 29, 2005.

Despite the publicity given this initiative, the widespread expectation is that the Chinese steel industry will continue to pollute the environment with little concern for environmental regulations. The scale of pollution is staggering; the Shougang mills in Beijing municipality alone discharge approximately 18,000 tons of particulates into the air every year.[172] Observers from the American Iron and Steel Institute and the Steel Manufacturers Association visiting China in 2005 noted steel mills that apparently lacked any standard pollution control devices, such as baghouses, scrubbers, and precipitators. This was not limited to the smallest producers; one of the mills visited belonged to Jiangsu Shagang, one of the largest producers in China. A major problem is the continued use of small (40 ton or less) basic oxygen furnaces that are typically antiquated and lack any environmental control features.

The concentration of pollution in China closely tracks the location of the steel industry. As discussed above, China's steel industry is concentrated in the eastern part of the country, and especially in Hebei, Jiangsu, Liaoning, and Shandong provinces. As the following chart shows, this is also where concentrations of a major pollutant, nitrogen dioxide, are located. Moreover, these concentrations doubtless reflect the presence of other major pollutants, such as sulfur dioxide and particulates, as well.

CHART 3

EMISSIONS OF NITROUS OXIDES IN CHINA



[172] David Eimer, *Beijingers Will Need Their Masks; There Are No More "Clean Air" Days,* Financial Times, Oct. 19, 2005.

The lack of effective environmental regulation for the Chinese steel industry is having profound effects on the world's environment. By some measures, China is responsible for 25 percent of worldwide emissions of particulates. The Chinese steel industry is a major contributor. China has also emerged as the world's second greatest emitter of greenhouse gases.[173] The expansion of the steel industry, and its demand for electricity produced in large part by heavily polluting coal-fired generating plants, is a major cause.

The Chinese steel industry is less energy efficient than the steel industries in the United States, the European Union, and other developed countries. As discussed above, it also generally does an inadequate job of controlling emissions of pollutants. By its policies that fuel the artificial expansion of the steel industry, the Chinese government is forcing the transfer of steel production to high-polluting facilities in China from relatively low-polluting facilities in the rest of the world. China benefits economically from the increased production, but the whole world – including China – loses because of the increased pollution and greenhouse gas emissions for which the Chinese steel industry is responsible.

Labor Laws and Worker Safety

Workers in China are regularly denied basic labor rights and remain largely unprotected by the weak enforcement of China's existing labor law and policies. China's labor law prohibits workers from organizing independent unions and does not provide for the right to strike. There is only one trade union in China, the All China Federation of Trade Unions, which is essentially an extension of the Communist Party in workplaces. Many workers lack minimal health and safety protections and adequate wages.[174]

Without the right to organize independently, Chinese steelworkers lack effective ways to resolve labor issues in the workplace. Moreover, workers who organize labor

173 Pan Jiahua, *China and Climate Change: The Role of the Energy Sector*, Science & Dev. Network Policy Briefs, June 2005, http://www.scidev.net/dossiers/index.cfm?fuseaction=policybrief&policy=64&dossier=4.

174 *See* Human Rights Watch, *Human Rights and the 2008 Olympics in Beijing*, http://www.hrw.org/campaigns/china/beijing08/labor.htm.

protests and demonstrations may face severe government repression.[175] For example, a crackdown carried out by local police in October 2005 against protesting workers from the Chongqing Steel Plant resulted in two deaths, a 70 year old woman and a 50 year old woman, and dozens more injured. The police crackdown was the result of a series of demonstrations by several thousand steelworkers who were laid off from the plant without compensation in August 2005, following the company's bankruptcy. Several of the protest leaders were detained.[176] In 2003, independent metalworkers' representatives at the Ferro Alloy Factory in Liaoyang were arrested for their part in a peaceful workers' protest over unpaid wages and benefits and then charged with "illegal assembly" and "subversion of state power." Two of the representatives, including Yao Fuxin, were sentenced to prison terms of up to seven years.[177] Others labor leaders have been detained or sent to forced labor camps without trial.

In its most recent annual human rights report, the State Department confirmed China's poor labor record, concluding that China restricts "labor rights, including freedom of association, the right to organize and bargain collectively, and worker health and safety."[178] It noted that "[p]rotests by those seeking to redress grievances increased significantly" in 2005 and were often suppressed violently by Chinese security forces.[179] It also found that although Chinese law permits collective bargaining, this right is largely illusory.[180]

In addition, the State Department made the following findings:

- China has no comprehensive policy to combat child labor.

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175 *See Id.*

176 China Labour Bulletin, *Two Women Reportedly Killed, and Three Workers' Leaders Detained, During Police Crackdown on Mass Protests*, Oct. 14, 2005, *available at* http://www.china-labour.org.hk/public/contents/news?revision_id=17749&item_id=17748.

177 International Metalworkers' Federation, *"Release Yao Fuxin and Xiao Yunliang"*, Jan. 28,2005 *available at* http://www.imfmetal.org/main/index.cfm?id=47&l=2&cid=10661; UAW, *China Has Jailed Many Labor Activists*, *available at* http://www.uaw.org/action/china/free03.html.

178 United States Department of States, *China: Country Reports on Human Rights Practices, 2005*, at 1, *available at* http://www.state.gov.

179 *Id.*

180 *Id.* at 30.

- China has no national minimum wage (although individual provinces and cities often have local minimum wages).
- Wage arrearages to employees are common.
- Rules regulating the number of hours worked per week and overtime were regularly violated in 2005. Specifically, "in the manufacturing sector, compulsory overtime reportedly was common, often without overtime pay" and "factories routinely falsified overtime and payroll records."[181]
- The "poor enforcement of occupational health and safety laws and regulations continued to put workers' lives at risk."[182] According to official Chinese statistics, a total of 5,986 workers died in coal mines in 2005. In addition, there were reports of serious accidents in which miners were killed when mine managers forced them to continue working under unsafe conditions.[183]
- Many factories that used harmful materials or processes not only failed to protect their workers against the ill effects of such materials or processes, but failed to inform them of the hazards and denied their claims for compensation when they fell ill or were otherwise injured.

The State Department is not alone in finding gross inadequacies in China's labor record. Freedom House, a prominent human rights and pro-democracy organization, reports that:

> Freedom of assembly and association is severely restricted. ... Independent trade unions are illegal, and enforcement of labor laws is poor. All unions must belong to the state-controlled All China Federation of Trade Unions, and several independent labor activists have been jailed for their advocacy efforts. Collective bargaining is legal in all industries, but it does not occur in practice.[184]

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181 *Id.* at 31.

182 *Id.*

183 *Id.*

184 *Freedom in the World China* (Freedom House 2005), *available at* http://www.freedomhouse.org.

Other human rights organizations have documented labor abuses in China, including being forced to work overtime without pay; denying women the right to paid maternity leave; denying workers pay for sick leave and denying their legal right to national holidays; and illegally denying workers health insurance and then terminating those that are injured on the job.[185]

[185] National Labor Committee, *Wal-Mart in China: What They Don't Want Us to Know*, 2005, *available at* http://www.nlcnet.org.

CONCLUSION

Under true market conditions, China would undoubtedly have a large and diverse steel industry. It would not have a steel industry that has grown to account for a staggering 31 percent of total world steel production. The Chinese steel industry in its current form is the creation of the Chinese government. It has benefited from massive direct and indirect subsidies, many of which violate the WTO Subsidies Agreement, China's obligations under its WTO accession agreement, or both. These subsidies are likely to continue unabated as the Chinese government recently adopted an official policy that requires it to continue to provide the steel industry with massive subsidies.

The consequences of these actions have been profound. The growth of the Chinese steel industry has been at the expense of its international competitors. The Chinese steel industry's expansion is simply one component of an overall strategy that has resulted in the displacement of production in dozens of steel consuming industries from the United States to China, at the cost of hundreds of thousands, if not millions, of American jobs. Because the Chinese steel industry emits more pollutants and greenhouse gases than the steel industries in the United States and other countries, subsidization of the Chinese steel industry has had a negative impact on the environment. The economic stability and security of the United States, and the health of the global environment, demand that the Chinese government end its policy of subsidization of the Chinese steel industry.

EXHIBIT 11

http://www.atimes.com

China

China warns of surge in bad loans, hurting reform

BEIJING - Government officials and scholars have again warned that China's banking sector should keep alert to prevent rebound of non-performing loans (NPLs) rate through reckless lending.

The high rate of non-performing loans used to disturb Chinese banks for a long time. But the banks made major progress in their campaigns to reduce non-performing assets from last year to the first half of this year. Statistics released by the China Banking Regulatory Commission, the watchdog agency or the banking industry, show that last year, the non-performing loans of China's banking industry according to the five-category classification standard dropped 7 percentage points to account for 17.8% of all loans by the end of 2003. In the first half of this year non-performing loans at China's major banks - the four State-owned commercial banks and the 11 joint-stock banks further dropped by 4.44 percentage points from the end of last year to 1.66 trillion yuan (US$200 billion), or 13.32% of their total lendings, at the end of June.

The four state-owned lenders held 1.52 trillion yuan (US$183 billion) of the total, or 15.59% of their loan portfolios. The four banks are the Industrial and Commercial Bank of China, the Bank of China (BOC), the China Construction Bank (CCB) and the Agricultural Bank of China.

However, the problem is again exposed recently.

Speaking at the 2004 Chinese Business Summit on September 12, Vice-Chairman of the CBRC Li Wei said the non-performing loans rate of banks is facing a trend of rise. Thanks to write-off and auction of the non-performing loans of the Bank of China and China Construction Bank, the non-performing loans rate of all national commercial banks declined further to 13.3% by the end of June 2004. However, this positive momentum has ended, he said, adding that by early September, the non-performing loans rate of China's banking industry has rebounded to 14.65%.

CBRC said the major reason for the fast decline of NPLs last year and in the first half of this year was massive disposals at the BOC, the CCB and the Bank of Communications, one of the joint-stock lenders that is undergoing a major restructuring.

The BOC and CCB, which were chosen at the end of last year by the Chinese Government for a pilot joint-stock reform and received a combined US$45 billion recapitalization, sold nearly 280 billion yuan (US$33.7 billion) in NPLs to a State-owned asset management company in June.

Despite the massive NPL disposals, the CBRC said its task of reducing both outstanding NPLs and the NPL ratios at major banks this year has got more difficult as the "loans to some suspended or canceled projects will create a new batch of bad loans."

The government has ordered tight credit curbs and land controls this year on overheated sectors such as steel, cement and aluminum, trying to slow down the rapid growth in fixed investment and bank loans starting from the latter half of last year.

A big number of steel and cement plants as well as many other fixed asset projects like economic development zones and shopping malls have reportedly been ordered to stop construction.

Analysts have expressed worries such administrative measures will not solve the problem, although they have had some immediate effect on slowing down fixed investment and bank loans.

The increase in non-performing loans was a consequence of overheating investment since last year. In 2003, total loans of China's banking system increased by 21%, and the growth rate was even faster for many joint-stock commercial banks. Most of the new loans went to rapidly expanding manufacturing, real estate and housing mortgage sectors.

The fast increase lasted until the first quarter of 2004, and the government began to intervene in the second quarter to slow down the loan growth and limit excessive investment. Statistics show that the loan growth fell from 24% in August 2003 to 14% in June 2004. This figure may also be misleading if the big amounts of non-performing loans written off and auctioned by the Bank of China and China Construction Bank were considered. After adjustment for this factor, the annual loan growth in June 2004 would approach 18%.

It is not difficult to see that large quantities of loans went to overheating industries in the past period. To cool down the overheating industries, no new loans should be granted to the industries. Accordingly, the projects using bank loans, say the typical Tieben case, a big steel project in east China's Jiangsu province that has been stopped, may be halted. This single project caused non-performing loans amounting to billions of yuan.

Aside from administrative intervention to cool down investment overheating, systematic problem is probably a deeper rooted problem. For a long time, China's banks, particularly the Big Four State-owned banks, are to some extent administrative organs, instead of being real commercial banks, for which their operators are government officials in real sense, instead of being bankers, and their position is in real sense secondary treasury or cashier of the government, instead of monetary financial enterprises. If banks could not be independent from the administrative system and administrative forces, it is impossible to improve corporate governance.

Central bank governor Zhou Xiaochuan used to say that the nature of the reform of state-owned commercial banks is reform of state-owned enterprises. China's reform of state-owned enterprises has undergone the two phases of severing from the government, and establishment of modern enterprise system. In the same way, reform of the state-owned commercial banks will first have to separate themselves from the government and put an end to administrative intervention.

China has adopted mainly two approaches to handle non-performing loans of banks: one is the traditional approach of injecting capital and disposing of non-performing loans, and the other approach is to create new derivative products, i.e. letting in strategic investors and selling non-performing assets in packages. Nowadays, the second approach has made a substantial progress. At the end of last year, Huarong put on auction 25 billion yuan worth of non-performing assets, attracting such bidders as Citigroup, JP Morgan, Goldman Sachs, UBS Warburg, and Morgan Stanley. In August this year, Cinda put on sale 15.7 billion yuan worth of non-performing assets, attracting the participation of Goldman Sachs, Merrill Lynch and Credit Suisse First Boston.

Anyway, the best way to avoid non-performing loans is to prevent them from the origin. With regard to this, Chinese authorities seem to have pinned the hope on share holding transformation of banks. As the supervisor to state-owned banks, CBRC has raised four gals and seven standards that serve as the general requirements for the current reform of banks.

The seven standards cover very specific requirements on non-performing assets rate and non-performing loans rate. Authoritative sources in the banking sector pointed out that share holding reform of banks should be pushed forward gradually. It is believed that the non-performing loans rate will be much lower in two or three years.

The question is whether or not the share holding transformation will work? Many aspects are involved and it is difficult to answer this question, but there is one clear point, that is, it's not an easy thing to reduce the non-performing loans by a great margin within a short period.

CBRC Chairman Liu Mingkang said recently that banking reform should not be isolated, and it depends on the general environment whether or not it will succeed. Improvement of general environment, however, is a gradual progress.

(Asia Pulse/XIC)

EXHIBIT 12

WORLD TRADE ORGANIZATION

G/SCM/118
9 November 2005

(05-5259)

Committee on Subsidies and Countervailing Measures

CHAIRPERSON'S REPORT TO THE COUNCIL FOR TRADE IN GOODS ON TRANSITIONAL REVIEW OF CHINA

1. The Committee on Subsidies and Countervailing Measures undertook the fourth transitional review of China pursuant to Paragraph 18 of the Protocol on the Accession of the People's Republic of China (WT/L/432) at its regular meeting on 27 October 2005.

2. Annex 1A to the Protocol requires China to submit information on the following to this Committee: "Pricing Policies": (a) "application of existing or any other price controls and the reason for their use"; and (b) "pricing mechanisms of China's state trading enterprises for exported products". China submitted a notification in this respect on 26 October 2005, which has been circulated in document G/SCM/N/135.

3. Members had submitted questions in the context of the transitional review. These can be found in documents G/SCM/Q2/CHN/12 (European Communities), G/SCM/Q2/CHN/13 (Japan), G/SCM/Q2/CHN/14 (United States) and G/SCM/Q2/CHN/15 (Canada, Mexico and the United States).

4. The statements made at the meeting of 27 October 2005, at which the transitional review was Item F of the agenda, are reflected in the minutes of the meeting, which will be circulated as document G/SCM/M/54. The relevant paragraphs, which reflect the statements made and the discussion at the meeting, are annexed.

Excerpt from the minutes of the regular meeting of the Committee on Subsidies and Countervailing Measures held on 27 October 2005, to be circulated as document G/SCM/M/54.

F. TRANSITION REVIEW UNDER PARAGRAPH 18 OF THE PROTOCOL OF ACCESSION OF THE PEOPLE'S REPUBLIC OF CHINA TO THE WORLD TRADE ORGANIZATION

1. The Chairperson recalled that Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization provided that all subsidiary bodies, including this Committee, "which have a mandate covering China's commitments under the WTO Agreement or [the] Protocol shall, within one year after accession, review, as appropriate to their mandate, the implementation by China of the WTO Agreement and of the related provisions of [the] Protocol." China was to provide relevant information in advance of the review, including information specified in Annex 1A to the Protocol. China could also raise issues relating to any reservations under Section 17 or to any other specific commitments made by other Members in the Protocol, in subsidiary bodies which have a relevant mandate. This Committee had to report the results of the review promptly to the Council for Trade in Goods. Review was to take place after accession in each year for eight years, with a final review in year 10 or at an earlier date decided by the General Council.

2. The Chairperson noted that there were no procedures set out in the Protocol for the conduct of the transition review, except that China was to provide relevant information in advance of the review. In this regard, Annex 1A specified that China was requested to provide information on the following to this Committee in accordance with Article 18.1 of its Accession Protocol: "Pricing Policies": (a) "application of existing or any other price controls and the reason for their use"; and (b) "pricing mechanisms of China's state trading enterprises for exported products". China's notification, received on 26 October 2005, had been circulated as document G/SCM/N/135. Written questions and comments had been submitted in the context of this transitional review by the European Communities (G/SCM/Q2/CHN/12), Japan (G/SCM/Q2/CHN/13), the United States (G/SCM/Q2/CHN/14) and Canada, Mexico and the United States (G/SCM/Q2/CHN/15). Before proceeding to these questions, the Chairperson opened the floor for any general comments.

3. The delegate of the United States said that the WTO was in the midst of its fourth annual transitional review of China's efforts to implement the commitments that it made in its Protocol of Accession to the WTO. In the United States' view, the transitional review remained an important and useful mechanism serving both the interests of China and the interests of other WTO Members. The transitional review mechanism provided Members with the opportunity to seek clarifications regarding China's policies and practices. China, in turn, had the opportunity to clarify its policies and practices with the goal to prevent misunderstandings that could lead to trade frictions. The transitional review mechanism also allowed Members to convey to China their views, expectations and concerns regarding China's efforts to comply with its WTO obligations. China then had the opportunity to explain its views and to inform Members about how it had addressed their expectations and concerns. In other words, the transitional review mechanism was an important and useful exercise in transparency, one of the fundamental principles underlying the WTO Agreement.

4. The purpose of the transitional review before this Committee was to review, on an annual basis, China's progress on implementing its obligations under its Protocol of Accession and the SCM Agreement. Unfortunately, as Members neared the end of China's fourth year as a Member of the WTO, it remained nearly impossible to evaluate the extent to which China's subsidies regime was in compliance with WTO disciplines. Despite assurances China had given before the Council for Trade in Goods during the transitional review conducted in 2003 China had still not provided its long-overdue subsidy notification as required by Article 25 of the SCM Agreement. In addition, more than one year ago, the United States had submitted a request to China under Article 25.8 of the SCM

Agreement seeking detailed information on a number of subsidy programmes that had come to its attention (G/SCM/Q2/CHN/9). Article 25.9 stated that questions that a Member receives under Article 25.8 shall be answered as quickly as possible and in a comprehensive manner. The programmes subject to the questions posed by the United States under Article 25.8 supported a wide range of industries in China including forest products, textiles, semi-conductors and agriculture. China, however, still had not provided any responses to that request. The absence of a timely response was troubling.

5. Even more troubling were the subsidy programmes that China appeared to maintain, as demonstrated by the growing number of questions that the United States and other Members had posed to China, both through the transitional review mechanism and under Article 25.8 of the SCM Agreement. Members continued to see evidence of government support that China had committed to eliminate. Based on available information, it appeared that China continued to provide tax incentives and preferential bank financing to producers of agricultural and industrial goods that were contingent upon export or the use of domestic over imported goods, despite a clear commitment by China four years ago to eliminate all prohibited subsidies upon its accession to the WTO. It also appeared quite clear that China continued to provide subsidies to loss-making state-owned enterprises, despite making statements to this Committee in 2002 that these subsidies had been eliminated in 2001 as China had indicated it would do in Annex 5 to its Protocol of Accession. In past transitional reviews before this Committee, China had dismissed as baseless the claims of the United States that these subsides continued, arguing that multiple media reports and websites were unreliable. One new source could now be added to the long and varied list of publicly available sources describing China's continued subsidization of loss-making state-owned enterprises, the OECD's *2005 Economic Survey of China*. The United States again urged that China provide information on these subsidies.

6. The delegate of the United States stated that it also appeared quite clear that the Chinese Government continued to provide massive subsidies to state-owned banks and the state-owned enterprises to which they lent, despite China's contention that these banks and enterprises operated on a commercial basis and were responsible for their own profits and losses. For example, China claimed during last year's transitional review that the Government's $45 billion capital infusions into the Bank of China and the China Construction Bank in 2003 constituted investments, not subsidies, but this claim was exceedingly difficult to accept in light of those banks' financial performance in the previous five years, which had been characterized by repeated capital injections by the Government and bad-debt transfers to government-owned asset management companies. It seemed clear that the Government was not seeking to invest in investment-worthy companies either in December 2003 or in prior years. Rather, the Government was trying to keep the banks afloat and the loss-making state-owned enterprises they supported, regardless of cost. An example of the type of lending that could result from these large and repeated infusions had received widespread attention recently when a state-owned oil and gas company had sought to acquire a foreign competitor. Two state-owned banks had offered what appeared to be billions of dollars of preferential financing to facilitate the acquisition. Even though the acquisition had not take place, the United States found it objectionable that the terms and conditions under which the financing was apparently offered were inconsistent with commercial considerations. It was difficult to reconcile the terms and conditions of this financing with China's repeated claim that banks in China now extended loans on a purely commercial basis and operated free from government influence and control. The United States was very concerned about what these offers of non-commercial financing said about how credit was allocated in China.

7. The United States also understood that state-owned banks were extending subsidized financing for large-scale investment projects in China which were designed to increase the competitiveness of state-owned enterprises, particularly in the Northeast, in industries such as oil and gas, petrochemicals, iron and steel and ship-building. In the United States' view, continued intervention by the Chinese Government in this manner thwarted the development of institutionalized market mechanisms in China. It also made little sense from an economic restructuring point of view

for the Government to support continued production by firms of products that were the primary cause of the region's problems. Resources should be flowing out of and away from large inefficient state-owned enterprises in heavy industries to support the growth and development of small and medium-sized enterprises and new industries. Unfortunately, the bank financing to state-owned enterprises in the Northeast was doing exactly the opposite, frustrating a more efficient allocation of scarce resources and sustaining obsolete state-owned enterprises that continued to drain resources from the region and the rest of China's economy. While the United States did not take issue with China's goal of revitalizing the Northeast region, it had grave concerns with the significant subsidization the pursuit of those objectives entailed and with the potential adverse trade effects resulting directly or indirectly from this subsidization.

8. The delegate of the United States considered that similar concerns applied as well to China's recently released iron and steel industry development policy ("Steel Policy") and were highlighted in the joint submission from Canada, Mexico and the United States for this transitional review (G/SCM/Q2/CHN/15). This Steel Policy detailed a series of objectives and initiatives for managing the development of China's state-owned steel enterprises. These objectives and initiatives included a broad range of very specific directives which demonstrated the government's intention to intervene directly and extensively in key sectors of the economy, such as steel. In particular, the Steel Policy prescribed the number and size of steel producers in China, where they would be located, the types of products that would and would not be produced and the technology that would be used. Subsidies were an integral part of the Steel Policy. In particular, Article 16 of the Steel Policy specifically provided for state support in the form of tax refunds, discounted interest rates, research and development and other policy support from major iron and steel projects utilizing newly developed domestic equipment. The United States agreed with the goal of an efficient rationalized steel industry envisioned by China's new steel policy but was concerned about the implementation of this initiative to the extent that it relied on import substitution measures, dictated industry outcomes, and involved governments making decisions that should be made by the market place. The likely outcome of the Steel Policy was more inefficiency and not less and greater distortions in world steel production and trade. While the United States was aware that the steel policy might be intended in part to address China's ballooning production capacity and China's recent emergence as a net steel exporter, it had been the United States' experience that subsidy-driven industrial policies rarely resulted in expeditious or market restructuring. Rather, they created a significant market distortion and exacerbated trade frictions.

9. With regard to the area of countervailing measures, the delegate of the United States commended China for taking an important step in notifying its countervailing duty laws and regulations. The United States had had an active and on-going exchange with China regarding these laws and regulations and was encouraged by the transparency that such an exchange promoted. His delegation looked forward to China's written responses to its most recent set of follow-up questions (G/SCM/Q1/CHN/57). The United States remained concerned that China's current countervailing duty regulations lacked sufficient detail to make clear to interested parties what procedures the administrative authority would follow and conduct in countervailing duty cases.

10. The delegate of the United States said that one final area addressed in his delegation's submission for this transitional review involved price controls. In this regard, the United States had asked a series of questions seeking clarification or updates regarding the pricing of coal, rice, steel, copper scrap, fertilizer and water.

11. The delegate of the United States concluded by saying that the United States' chief concern at the time of this year's transitional review emanated from China's continuing and seemingly growing use of subsidies, including prohibited subsidies. When coupled with China's on-going failure to submit a subsidy notification required of every WTO Member and answers to the questions posed by the United States under Article 25.8, this raised serious questions about how committed China was to

meeting its obligations under its Protocol of Accession and the SCM Agreement. The United States appreciated the difficulties and sensitivities inherent in many of the steps that China had to take to honour its WTO obligations. However, other Members faced similar challenges. He therefore urged China to take immediate action to demonstrate its commitment to the WTO subsidy disciplines. The first step should be the submission of China's long-overdue subsidy notification and of answers to the Article 25.8 questions which the United States had submitted in 2003.

12. The delegate of Japan stated that his delegation totally agreed with the view of the United States on the importance of the transitional review mechanism in the WTO system. As reflected in the written questions submitted by his delegation (G/SCM/Q2/CHN/12), Japan was interested in getting answers with regard to two aspects of China's position in the subsidies area. The first aspect was the notification of subsidies. While the subsidy notifications required by Article 25 of the SCM Agreement were of great importance for the purpose of improving transparency, China had not yet provided any further subsidy notification after its accession to the WTO. With reference to a statement by China at last year's Committee meeting that it was internally collecting information for its subsidy notification, he asked China to indicate the timing of its full subsidy notification. Second, Japan was interested in China's VAT refund scheme for copper. The Japanese industry, especially the smelting copper industry, had serious concerns on this VAT refund scheme. If, as China had stated, the refund scheme was WTO-consistent, any detailed information or documents would be greatly appreciated in order that Japan could explain the scheme to its industry and allay the industry's concerns regarding this scheme. In light of statements made last year by China that it was reviewing the refund scheme and considering its possible abolition, he asked whether there had been further developments in this regard.

13. The delegate of Canada shared the views of the United States and Japan on the importance of the transitional review mechanism. Canada also shared the concerns expressed by Japan, the United States and the European Communities, in writing, regarding the failure of China to fulfil its obligations by providing a new and full notification of its subsidies. Canada therefore encouraged China to provide such a notification as soon as possible. Canada was participating in this transitional review mechanism with a joint submission with Mexico and the United States regarding China's Steel Policy announced last July (G/SCM/Q2/CHN/15). Given the importance of China's steel production, this new policy could have repercussions on the world market, including Canada's industry and markets. Canada's concerns were centred on the degree of intervention of the Chinese Government in the direction and decision-making of its steel industry, and Canada questioned the compliance of such intervention with the commitments undertaken by China in the Accession Working Party Report. Canada was therefore looking forward to receiving clarifications from the Government of China on the issues raised in the submission.

14. The delegate of the European Communities fully supported the statements made by the United States, Japan and Canada and shared all the concerns they had expressed. He appealed to China to strictly comply with its obligations resulting from the WTO membership, particularly in the area of subsides, including the provision of the long-outstanding subsidy notification. He hoped that at the present meeting China would provide meaningful replies to questions posed by the European Communities and other Members. While he realized that China, according to the agreed procedures, had no obligation to supply written replies, it would already be very helpful to have a room document with the properly prepared answers.

15. The delegate of Mexico stated that like the previous delegations, Mexico was concerned about the Steel Policy of China and was also expecting the notifications on subsidies which China should have presented. His delegation looked forward to receiving answers from China to the questions asked jointly by Canada, Mexico and the United States on China's Steel Policy.

16. The delegate of China stated that while he had taken note of the comments and concerns raised by Members with regard to the issue of China's subsidy notification, in previous years his delegation had repeatedly stressed the enormous difficulties facing China in the information-gathering process for the preparation of such a notification. China was firmly committed to the principle of transparency in this regard. The serious practical problems and difficulties raised by the preparation of the subsidy notification had been recorded during the accession negotiations in the Working Party Report and had also been recognized by many Members in this Committee. During the last three years, China had been educating and training officials in relevant government agencies and mobilizing them to review through hundreds of pieces of regulations, department rules and policies to examine whether they were relevant to the SCM Agreement. This process had so far concentrated on the central government level. Questions raised by Members on some specific policies and measures, including the questions raised by the United States under Article 25.8 of the SCM Agreement, were all taken into account in this internal information-gathering process. There had been intense discussion on all the technical details of the information gathered to determine whether particular measures fell within the scope of the notification obligation, in view of the fact that the SCM Agreement required only notification of subsidy programmes which were specific, as defined by the Agreement. As a result of these efforts of the last years, China was now in the process of finalizing a draft of its subsidy notification, which at this stage was still in Chinese. China would submit this notification without prejudice to its position as to whether the policies and programmes to be notified were subsidies or whether they were specific, as defined in the SCM Agreement. Subject to inter-agency procedures and translation, which was extremely important and required absolute accuracy to reflect exactly what the policies were and to avoid misunderstanding, China was prepared to submit the full subsidy notification to the Committee before the end of this year. With this notification China would like to clarify as much as possible its policy in this regard and reiterate its strong commitment to the fundamental WTO principle of transparency to which China had always adhered since its accession.

17. The delegate of China stated that on some of the questions raised by Members in their written questions, for example with respect to developments in the financial sector, China had strong reservations as to whether they fell within the mandate of this Committee or whether they were subsidies or specific. However, in a spirit of co-operation and professionalism, China had in the past few years provided information with regard to the reform process of China's banking and financial sector and would continue to do so at the present meeting. The delegate of China also pointed to the fact that some Members had repeatedly raised the same questions, which had disturbed China's internal efforts to gather the information necessary for the submission of a subsidy notification. On some of these questions, Members would find relevant information in the minutes of previous Committee meetings. Some of the questions posed by Members had only arrived at China's Permanent Mission very shortly in advance of the meeting, which had caused great difficulties for China in preparing comprehensive and detailed answers. Nevertheless, in a spirit of co-operation and transparency, China had made every effort to coordinate the relevant competent authorities to address these questions.

18. The delegate of China then proceed to answer specific questions submitted by the delegations of Canada, the European Communities, Japan, Mexico and the United States.

Countervailing duty legislation

19. Regarding China's laws and regulations on countervailing measures, the delegate of China noted that the Foreign Trade Law, revised on 6 April 2004, which had been referred to by a Member as not being notified, had been notified to the Committee on 22 November 2004 (document G/SCM/N/1/CHN/1/Suppl.4). While there were no "Anti-Subsidy Regulations" in China, it was possible that the Member had used this term to refer to the regulations of the People's Republic of China on countervailing measures, which had been revised on 31 March 2004 and which China had

notified on 18 October 2004 (document G/SCM/N/1/CHN/1/Suppl.3). In addition to the above laws and regulations, China's existing laws and regulations on countervailing measures included: (1) provisional rules for initiation of countervailing investigations, (document G/SCM/N/1/CHN/1/Suppl.1), which had come into force on 13 March 2002; (2) provisional rules on questionnaires in countervailing investigations (document G/SCM/N/1/CHN/Suppl.1), which had come into force on 15 April 2002; (3) provisional rules for the conduct of public hearings in countervailing duty investigations (document G/SCM/N/1/CHN/1/Suppl.1), which had come into force on 13 March 2002; (4) provisional rules for on -the-spot verifications in countervailing investigations (document G/SCM/N/1/CHN/1/Suppl.1), which had come into force on 15 April 2002; and (5) rules on investigations and determinations of industry injury for countervailing measures (document G/SCM/N/1/CHN/1/Suppl.2), which had entered into force on 15 January 2003. As the newly promulgated regulation was still under translation, China would notify it to the Committee once the translation was finished.

VAT refund scheme for imports of copper raw materials

20. The delegate of China stated that China had provided detailed information on the VAT rebate scheme for copper raw materials in last year's transitional review mechanism of this Committee. Considering the crucial importance of copper on national economy and national security, the purpose of this VAT refund scheme was to improve the technology and management of the copper refinery industry. China's imports of copper raw material only accounted for a small proportion of the world's total trade in copper and would not distort the international market. At present, the policy was under review.

Preferential tax treatment of foreign-owned enterprises

21. With regard to the preferential tax treatment of foreign invested enterprises, the delegate of China considered that such preferential treatment of foreign investment was a common practice internationally and was not specific in nature, as defined in the SCM Agreement. Detailed information on the preferential tax treatment of foreign investment was already contained in Annex 5 of China's Accession Protocol. To remain consistent with the existing notification, and to clarify further China's policies, China would include this detailed information on preferential tax treatment for foreign investments in its forthcoming subsidy notification. Some of the specific provisions in the existing legislation were also being examined in the context of China's tax reform, which was currently under preparation. A major step to be taken in this reform was to unify the income tax system for domestic enterprises and enterprises with foreign investment, following the principles of fair competition and national treatment. In that process, consistency of China's tax policies with the SCM Agreement would also be stressed and observed.

Measures applied by local governments

22. The delegate of China stated that there were great difficulties in collecting relevant information on policies applied at various levels of local government in China. However, the available information indicated that the supportive policies of China's local governments referred to by a Member were of two types. First, in order to promote and harmonize the economic development of under-developed areas and raise their agricultural productivity, local governments formulated policies to enhance the reconstruction of the agricultural infrastructure, to subsidize the introduction of new species, to promote new technology and technical training, to purify and upgrade the local superior species and to establish service systems, such as the prevention and cure for plant diseases and insect pests, the information supply system, the quality standard and testing systems, etc. Second, some policies of local governments might be supporting the small and medium enterprises (SMEs), to explore international markets, such as supporting SMEs to attend overseas exhibitions, to acquire certifications from various quality or environmental management systems, to advertise and market

overseas, to organize training and seminars as well as to bid for overseas projects. Such measures to support SMEs were widely adopted by many Members. The delegate of China pointed out that the reimbursement of export credit insurance fees referred to by a Member in its questions was not contingent on export performance.

Northeast revitalization policies

23. The delegate of China stated that the policy of revitalization of the former industrial regions in Northeast China had been adopted in 2003, and mainly included the following practices: first, to start pilot projects on the perfection of urban and township social security systems in the Northeast area. Second, to expedite the bankruptcy process of the state-owned enterprises. Third, to reform investment systems in the Northeast to simplify and transfer to the lower levels, the process for the review and approval of investment projects. These policies were not so-called industrial policies, which might favour certain industries, but formed part of a general policy meant to deepen the reform of the investment system and to establish the urban and township social security systems and thus speed up China's transformation to a market economy. With regard to the two examples of the revitalization programme raised by a Member, the delegate of China stated that the policy on the strategic restructuring and technical transformation of key enterprises in areas such as oil, petrochemical and iron in Northeast China, carried out by the Commission of State-Owned Assets Administration, was just a guideline focussing on the reform and reconstruction of the central enterprises and was not mandatory. The enterprises were free to take their own decisions on their operations. Regarding the example mentioned by a Member of the provision by branch of the Export-Import Bank of RMB 5 billion of export credits to companies in Northeast China, the delegate of China stated that the applicable interest rates were in conformity with the OECD Arrangement on Officially Supported Export Credits and that these export loans were not only granted to the enterprises in the Northeast but were granted to enterprises all over the country under the same conditions.

Financial sector reform

24. The delegate of China stated that although her delegation did not consider that this Committee was the right venue to discuss China's ongoing financial sector reform, she would provide information in the interest of transparency. China currently was engaged in a fundamental reform of its financial system, including simultaneously: (1) the continuation of the reform of the stock-holding system of the commercial banks, such as the Bank of China, the Construction Bank of China, the Industrial and Commercial Bank of China (ICBC) and the Bank of Communication; (2) encouraging the commercial banks to attract strategic investment; (3) reform of the rural credit agencies; (4) strengthening of administration with regard to the provision of social credit; (5) improvement of the payment and settlement system; and (6) combating money laundering. All these policies would create a solid commercial environment for the commercial banks in China.

25. The reform of the stock-holding system of the commercial banks mainly involved two aspects, financial restructuring and the improvement of corporate governance. Financial restructuring included resolution of the problem of non-performing loans and the introduction of certain paid-in capital. Thus, as an example, she explained that the People's Bank of China had acquired ICBC's doubtful loans and transferred them to the financial assets management companies by inviting public bidding. According to the regulations on the financial assets management companies, these companies were not banks, but state-owned financial institutions to acquire, manage, and dispose of the non-performing loans of the state-owned banks. The bidding prices offered by the financial assets management companies were reasonable and close to the real price of the non-performing loans. On the other hand, in April 2005 Huijin Investment Company had invested $15 billion into ICBC. China's financial supervisory organs strictly supervised and examined ICBC in order to secure this paid-in capital and its reasonable re-pay.

26. The delegate of China stated that while the financial restructuring was under way, the state-owned commercial banks were improving their corporate governance mainly by two means. First, establishing a separate and healthy operation and function of the shareholders meeting, board of directors and board of the supervisors and enhancing the effective monitoring and coordinated development of the three boards. Second, diversifying the shareholding structure. For example, the Construction Bank of China had introduced Bank of America and Asia Financial Shareholding Company as its strategic investors. These commercial banks were also seeking to become listed. As the state-owned commercial banks were now transformed into shareholding commercial banks by means of the reform of their stockholding systems, they had become the real market players which were profit-oriented with the maximization of the shareholders' interest as the goal of their operation. Therefore, the reformed state-owned commercial banks would issue loans in a market-oriented manner consistently with the principle of cost efficiency. Meanwhile, China was also making efforts to develop the capital market, which would result in the decline of the proportion accounted for by banks in the financing of enterprises. The Government was also experiencing a change of role in the administration of the banking sector during the process of the reform of these state-owned commercial banks stockholding system. The Government did not intervene in the operation and business decisions of the reformed banks, but focused on the macro aspects, such as the establishment of the financial market and the supervision system, financial stability and the prevention and handling of financial crises.

State-owned enterprises

27. The delegate of China stated that the subsidies provided to certain state-owned enterprises which were running at a loss, as listed in Annex 5(b) of China's Accession Protocol, had been phased out in 2001. The subsidy programme had not been included in the Government's budget since 2001. The Chinese Government had never made the statement referred to in the news report cited by a Member. The attempted acquisition by a Chinese state-owned enterprise referred to by a Member involved a business decision based on commercial considerations made by the enterprises and the banks. In China, state-owned commercial banks and state-owned enterprises operated as independent market players, bearing full responsibilities of their own interests and losses. They were eligible and able to negotiate and sign the financing contract according to their own risk evaluation. In this respect, she stated that the allegation that a loan to a state-owned enterprise in the energy sector referred to by a Member was inconsistent with commercial considerations was not verified. To grant a loan not based on commercial considerations was not consistent with China's requirements in the reform of state-owned commercial banks and other state-owned enterprises. China was very disappointed to see that this acquisition attempt of the Chinese company based on commercial considerations had not, in return, been treated by the other party in accordance with commercial considerations.

Price controls

28. The delegate of China stated that the Law of the People's Republic of China on Pricing did not contain a termination date or expiration date of China's pricing administration policy and that during the past year China had not issued new laws, regulations or other measures to eliminate or reduce the price controls listed in Annex 4 to its Protocol of Accession. Among the products subject to the state guidance pricing list in Annex 4, the prices of grains, cotton and vegetable oil referred to the base price of the bidding and auction through which the government sold its reserves of these products. Regarding the products covered by Annex 4, changes had occurred in 2001 in that except for oil used by the army, the prices of lamp-kerosene, naphtha, and fuel oil in China were not subject to state guidance pricing anymore, and were now determined by the market. Therefore, these products should be deleted from Annex 4.

29. The delegate of China then provided information on particular goods and services subject to state guidance pricing. Processed oil was a scarce resource of crucial importance to the national economy and people's lives. With regard to fertilizer, she said that at present, the fertilizer distribution system in China was based on the market mechanism under the administration of the government. China was presently establishing a pricing system on silkworm cocoons which was mainly market-oriented under the government administration. China's transportation service charges had not changed. With regard to charges for professional services and charges for commission agents' services, she stated that because China's professional services market was still in the initial stage of its development, the degree of marketization was rather low. This explained why the Government had to establish criteria and determine the scope of fluctuation of the services charges, while the exact charge of each service provided by the service provider was determined by the two parties themselves. Regarding charges for settlement, clearing and transmission services of banks, she said that the service situation in China had now further improved, as foreign banks had gradually entered into the Chinese market. At present, with the exception of RMB basic settlement services, which were closely related to the general public, most of the charges of the bank services were open to be decided by the market. With respect selling prices and renting fees of residential apartments, she stated that prices of low-price residential apartments meant for the low income residents were still subject to state guidance pricing, whereas prices of other commercial residential apartments were decided by the market.

30. The delegate of China stated that China had not adopted any new price control measures during the past year on products and services not included in Annex 4, including steel and steel-based scrap, copper and copper-based scrap.

31. In accordance with China's existing pricing laws and policies, the price of coal was now determined in the market through negotiations between the suppliers and demanders. China's long-term development plan with respect to coal, electricity power and natural gas was reflected in documents that provided overall guidance rather than mandatory instructions. The State Development and Investment Corporation was engaged in many industries, including the energy sector. Its operations were completely based on market considerations and in this respect this company was not different from other enterprises.

32. Regarding the new pricing policy for electricity, the delegate of China stated that by the end of last year the National Development and Reform Committee had adopted a policy which provided for the price of electricity to be adjusted in light of the price of coal. According to this new policy, the price of electricity per kilowatt had been raised by 2.5 cents RMB in April 2005.

33. The delegate of China stated that the purpose of the reform of China's pricing policy on tap water was to address the problems of the lack of water resources in China, to save water, to enhance the efficiency of water usage and to improve the sustainable development of the water resources. In recent years, the reform on pricing policies of the tap water had produced a significant effect. From 2002 to 2004, the per capita senior residents usage of water had declined by approximately 10 per cent. The major policy measures envisaged as part of the further reform of the pricing policy of tap water, were to enlarge the scope of collecting the water fees and to raise the price standard to a reasonable level; to gradually raise the tap water price for water construction projects; to reasonably adjust the water price to the urban citizens; to try and take the disposal fee as the priority in reform; to reasonably decide the price of the re-used water; and sixth, to reform the calculation of the price of water.

34. The delegate of China said that since 2004 the price of grains, including rice, had been liberalized. The fertilizer and grains protection fee was consistent with China's commitment in its WTO Accession Protocol. In recent years, the acquiring price of grain in China had been decided mainly by the markets. The Government established the lowest acquiring price to protect the income

of the farmers only when the decline in the grain market had been too significant. However, since 2004, the market price of grain had been higher than the acquiring price set by the Government and the lowest acquiring price had therefore not been used.

35. With respect to fertilizer, China had adopted policies aiming to further develop the productivity of fertilizer production in China, to enhance the distribution of fertilizer and to enhance the reserves of fertilizer. In order to stabilize the grain market China had adopted measures to adopt the lowest acquiring price on the grain, to encourage different kinds of enterprises to enter the market and acquire the grain, and to enhance the market evaluation of the price on grain. These policies applied to the following products: grain, wheat and corn.

Steel policy

36. Regarding China's recently announced Steel Policy, the delegate of China stated that in light of the changed situation and market requirements of China's steel and ore industry, China had issued a steel and ore industry development policy in July 2005. The Steel Policy mainly aimed at strengthening the whole industry through encouraging advanced techniques, structure adjustments, better distribution, system reform and changes of growing method. The policy provided for overall guidelines and did not involve compulsory regulations for individual enterprises. It provided that the Chinese Government would encourage strategic convergence of the steel and ore industry with methods such as merging and acquisition, restructuring and mutual holdings. Market rules played a major role during the merger and acquisition practice, so that each party could benefit from these processes. Banks and firms operated on their own following the market mechanism. Because of the nature of the Steel Policy as an overall guideline, the Chinese Government never demanded any specific bank service providing for firms during the merger and acquisition process. Regarding the question raised on the provisions contained in Articles 16 and 18 of the Steel Policy, the delegate of China stated that her delegation had already provided information in the transition review which had taken place in the Import Licensing Committee. She stressed that since the guidelines had been formulated, the Chinese Government had not provided any government support in any form for the use of domestic equipment.

37. The Chairperson welcomed the announcement by China that it would shortly submit a subsidy notification.

38. The delegate of the European Communities stated that the need to repeat certain questions was due to the lack of sufficiently detailed answers from China. In this respect, he reiterated his delegation's interest in knowing the exact legal provisions pursuant to which the VAT refund was applied and in detailed information on how the system worked. Regarding the issue of preferential tax treatment of foreign-owned enterprises, he pointed out that Article 75(7) of the Rules for the Implementation of Income Tax of the People's Republic of China clearly provided that companies that exported more than 70 per cent of their production would receive the benefit of 50 per cent reduction of the company tax. He again asked China to indicate whether this provision still existed, whether or not it had been eliminated, and how it was compatible with the obligations of the SCM Agreement. The European Communities considered this to be a prohibited subsidy, which was specific by its very nature, even if available to all companies. His delegation was looking forward to China's subsidy notification. If this preferential tax programme was mentioned in that notification, this would enable his delegation to ask written questions and receive written answers.

39. With respect to the question of whether banking issues were within the competency of this Committee, the delegate of the United States said that as a general matter it was widely recognized that state-owned banks were, in essence, acting as the government when they were providing loans and that, to the extent that those loans were preferential or below market rates, that constituted a subsidy. He drew attention to certain paragraphs in the Working Party Report on China's accession.

Paragraph 172 stated that "when state-owned enterprises, including banks, provide financial contribution they are doing so as government actors within the scope of Article 1.1(a)". Paragraph 173 stated that "Members of the Working Party have identified state support through the banking system, notably government-owned banks in the form of policy loans, the automatic roll-over of unpaid principle and interest, for given and non-performing loans and the selective use of below-market interest rates". The Report also stated that China was attempting to make government-owned banks operate on a commercial basis. Thus the issues that were discussed in the Working Party were the very same issues which Members continued to discuss in this Committee in the context of this transitional review mechanism.

40. The delegate of the United States echoed the views of the European Communities regarding the issue of tax benefits contingent upon exports. It was somewhat disturbing to hear China's response that tax benefits that were provided only to exporters were widely available, and therefore were not specific, when in fact, according to the SCM Agreement, benefits that were contingent upon export performance were deemed specific. These tax benefits that were contingent upon export were prohibited subsidies and the United States looked to their termination in the near future.

41. With respect to the statement of the delegate of China that the Government no longer intervened in bank operations and was only concerned about the macro environment and about macro policy design, he recalled that when the Committee discussed the Northeast revitalization programme in 2003 and when the point was made that many of the bad debts of the state-owned enterprises in that region were being forgiven, the Chinese delegate had responded by saying that the settlement of those bad debts was a matter between the banks and the state-owned enterprises and that the Government was not involved. The Chinese delegate had basically stated that the banks recognized that the loans would not be repaid and were negotiating with the state-owned enterprises for any kind of cash repayment or any non-cash payment that the banks could extract from them. In light of that response, he wondered why those banks would continue to lend to the various state-owned enterprises that they had just had problems with in terms of these bad debts. In the absence of government intervention, it was hard to explain why a commercial bank would negotiate or settle bad debts with state-owned enterprises and then proceed to lend new money to them.

42. The delegate of Japan agreed with the European Communities that China's response with regard to the VAT refund scheme for copper raw materials was not satisfactory because of its lack of detail. Japan expected China to provide detailed documentation on this scheme. He hoped that in its forthcoming subsidy notification China would as soon as possible provide all the information presented at this meeting in accordance with the agreed standard format.

43. The delegate of Canada stated that the task of delegates and interpreters would be simplified if China could make it answers available in writing. His delegation looked forward to China's subsidy notification.

44. The delegate of Mexico reserved the right to have responses from China in writing and to raise further questions, especially in respect of the Steel Policy.

45. The delegate of China stated that he did not have much to add to the lengthy responses provided by his delegation. Thus for example, with regard to the follow-up question of the European Communities on specific provisions of China's existing legislation, his delegation had already indicated in its earlier intervention that these provisions were currently being examined in the context of China's tax reform and that China's forthcoming subsidy notification would contain information on China's preferential tax treatment of foreign investment. His delegation had taken note of the issues raised in the follow-up questions and comments of various delegations and would take them into consideration in preparing China's subsidy notification.

46. The delegate of the United States rephrased his earlier question with respect to benefits that are contingent upon export. It was the understanding of the United States that there were several Chinese tax programmes that were contingent upon exportation and which his delegation therefore considered to be prohibited subsidies. He asked China if it would accept the interpretation that benefits received that were contingent upon exportation were specific and were export subsidies. The delegate of the United States also reiterated his question on the issue of whether or not there continued to be government involvement in the decisions of state-owned commercial banks. He recalled in this respect that during the transitional review conducted in 2003 when the United States had raised questions about debt forgiveness that was benefiting large state-owned enterprises in the North-east region, the delegate of China had responded that the debt forgiveness being granted to the state-owned enterprises was part of a private settlement negotiated between the banks and those enterprises. If one took that as given, it was very hard to explain why the same banks would continue to lend to the same enterprises to finance projects involving the upgrading the technology of those enterprises. Thus the question was how those banks could continue to loan to the state-owned enterprises in the North east region if in fact the Government did not intervene in the banks' decisions and operations.

47. The delegate of the European Communities stated that he concluded from the statement of the delegate of China that the specific provision which he had mentioned regarding preferential tax treatment of foreign investment was still in force.

48. The delegate of China said that he was not in a position at this stage to respond to the specific question raised by the United States because of language difficulties he had not been able to catch details of the question and that he would refer this question to his authorities.

49. The Committee took note of the statements made.

50. The Chairperson noted that the Protocol of China's accession to the WTO did not contain guidelines regarding the report to be provided by the Committee on the transitional review. Following the review conducted at the meeting in November 2004, her predecessor, acting on his own responsibility, had prepared a brief factual report with references to the documents concerned and attaching the portion of the minutes of the meeting which related to the transitional review. She proposed that the Committee follow the same procedure again this year.

51. The delegate of China said that his delegation did not consider it necessary to attach the relevant portion of the minutes of this meeting to the report but that it was not opposed to following the previous practice of the Committee.

52. The delegate of the United States, the European Communities and Japan stated that the relevant portion of the minutes of this meeting relating to the transitional review should continue to be attached to the report submitted to the Council for Trade in Goods.

53. The Committee agreed to proceed as proposed by the Chairperson.

EXHIBIT 13

abcNEWS

China to Act on Pollution, Warming Gases

To Clean Air, Aid Climate, China Looks to End Polluters' Tax Breaks, Other Perks

By ALEXA OLESEN

The Associated Press

BEIJING

Premier Wen Jiabao pledged Friday to help clean China's air and water and combat global warming by phasing out tax breaks and discounts on land and electricity for highly polluting industries.

"More work on energy conservation and emissions reduction is urgently required to deal with global climate change," Wen said. "Our country is a major coal producer and consumer, and reducing polluting emissions is a responsibility we should bear."

China's coal habit has made it a major contributor to greenhouse gases, mainly carbon dioxide, which scientists say contribute to global warming.

China accounted for 15 percent of the world's greenhouse gases in 2000, second only to the United States' 21 percent, but the fast-growing Chinese economy is expected to surpass the U.S. in emissions in the next couple of years.

China's 3-decade-old boom has left waterways and coastlines polluted by industrial and farm chemicals and domestic sewage. Towns are littered with garbage and construction waste, and its cities are enveloped in smog.

"We must clearly recognize that the situation the nation faces regarding energy conservation and emissions reduction is still quite grim," Wen said at a meeting of other top government leaders, in a speech posted on the government Web site.

He noted that China has failed to meet earlier goals to reduce emissions and conserve energy.

It committed itself to cutting 20 percent of its energy use for every unit of gross domestic product by 2010, but last year it failed to meet the first phase a 4 percent reduction. Instead, energy use fell by only 1.2 percent. Sulfur dioxide and other polluting emissions, meanwhile, are supposed to fall by 10 percent by 2010, but last year they rose slightly.

In his speech, Wen took aim at local governments that routinely offer free or cut-rate real estate and utilities to developers looking to set up job-creating businesses, such as steel mills or chemical plants. The premier said the government would "clean up and rectify preferential policies that give land and electricity discounts or tax breaks to energy-intensive or highly polluting industries."

He didn't lay out further details of the plan or say when it would be implemented.

Despite such central government mandates, Beijing often has difficulty ensuring that conservation initiatives are enforced at the local level, where many officials reap the rewards of China's rapid industrialization at the expense of the environment.

"The question is how are they actually going to implement it?" asked Elizabeth Economy, an Asia specialist at the Council on Foreign Relations in New York. "What exactly will they put in place to make it more difficult for local bank officials to approve those local steel plants, small coal mines and concrete factories?"

Wen also said China should work harder to create a system whereby polluters pay for environmental damage they cause, and enterprises investing in clean energy are rewarded. He also called for continued price reforms on natural gas, heating fuel and water to encourage energy conservation, without giving a timeframe for price increases.

China is a signatory to the Kyoto Protocol on reducing greenhouse gases, but as a developing nation it is exempt from its mandatory cutbacks.

Consultant Peter Fusaro, of New York's Global Change Associates, said China's clean-up campaign is motivated by the spotlight of the 2008 Olympics, to be held in Beijing, a growing grass-roots environmental movement in China and increasing media attention on China's pollution problem.

"It's not great to be the biggest polluter in two years," Fusaro said. "That's not going to help them attract business."

AP correspondents Charles J. Hanley and Sarah DiLorenzo in New York contributed to this report.

On the Net:

Chinese Central Government Official Web Portal: http://www.gov.cn/

EXHIBIT 14

INTERNATIONAL TAX & BUSINESS LAWYER

VOLUME 8

1990-1991

Emerging Real Estate Markets in Urban China

by
Tung-Pi Chen†

I. Introduction

The law governing the ownership of land in China has recently begun another fundamental transformation in urban areas. Where only forty years ago feudalism prevailed, and where a decade ago all land was communally owned, the land reforms now under way are part of the general transformation of the centrally planned economy into - "socialist commodity economy," relying increasingly on market mechanisms for the efficient allocation of resources. In 1987, the Thirteenth National Congress of the Communist Party of China (CPC) called for the establishment of a socialist market system that would include markets for such essential factors of production as funds, labor, and real estate.[1] Indeed, the foundation of a real estate market has begun to develop in urban China, with the introduction of payment for the use of land and the legitimation of trade in land use rights. These reforms, however, are far from complete, and commodity interests in land are still relatively rare in the country as a whole. The reforms are most advanced in the Special Economic Zones (SEZs) and coastal cities where foreign investment is concentrated.[2] Nevertheless, trends clearly point toward their expansion throughout the country.[3]

† Professor of Law, Queen's University, Kingston, Canada. LL.B. National Taiwan Univ., 1959; M.C.L. Columbia, 1963, LL.M. Yale, 1965; J.S.D. Yale, 1968. The author wishes to acknowledge and thank the Social Sciences and Humanities Research Council of Canada for financial assistance, and his assistant, Casper Sinnege.

1. The report adopted by the Communist Party National Congress declared: "The Socialist market system should include not only a commodity market for consumer goods and for means of production but also markets for other essential factors of production such as funds, labour, technology, information and real estate." Zhao Ziyang, *Advance Along the Road of Socialism With Chinese Characteristics*, BEIJING REV., Nov. 9-15, 1987, at 23, 35.

2. *See* Ge Di Tudi Shi Yong Quan You Chang Chu Rang, Zhuan Rang Li Fa Qing Kuang [A Survey of Legislation on the Compensated Transfer and Assignment of Land Use Rights] (July 1989) (unpublished paper prepared by the PRC State Land Administration Bureau) [hereinafter Legislation Survey] (on file at the offices of the *International Tax & Business Lawyer*).

3. One third of urban areas are experimenting with the reforms. Wang Jiafu & Huang Minchuan, *On the Legal System of Compensatory Transfer of Land Use Rights*, FAXUE YANJIU [Legal Research], 1988, No. 3, at 54, 56.

This paper will review the practical implications of urban land reforms, especially in the SEZs and coastal cities, and clarify Chinese land administration systems for prospective foreign investors. As the new urban land regime comes to increasingly resemble Western systems of regulated private property rights, the Chinese government, which remains officially committed to Marxist principles, must elaborate the ideological justification of its policies. The paper will conclude by examining the emerging market-oriented nature of the new land system and its implications.

A. Historical Review

Every dynasty and regime that has ruled China has emphasized the importance of land as the key to a strong and prosperous state.[4] The current communist regime is no exception. Current reforms in urban areas are based on reforms first introduced in the countryside. Before the establishment of the People's Republic of China (PRC) in 1949, virtually all rural land was concentrated in the hands of feudal landlords and rich farmers. Most peasants were mere tenant farmers and had no land of their own. Thus, it was by advocating a "land to the tiller" policy that the communist party gained popular support and came to power.[5] As in the Russian Revolution,[6] the Chinese Agrarian [Land] Reform Law [hereinafter Land Reform Law][7] was among the first pieces of legislation enacted by the new regime.[8] Article 1 of this law declared: "The land ownership system of exploitation by the landlord class shall be abolished and the system of peasant land ownership shall be introduced in order to set free the rural productive forces, develop agricultural production and thus pave the way for New China's industrialization."[9] Specifically, article 30 provided for the recognition of the land then in the hands of peasants and farmers as their private property: "After agrarian reform is completed, the People's Government shall issue title deeds and shall recognize the right of all land owners to manage, buy, sell or rent out land

4. For an historical review of Chinese land systems before the Communist reforms, see SUN JIAN QING, ZHONGGUO LIDAI TUDI ZHIDU DE YANJIU [A Historical Study of China's Land Systems] (2d ed. 1982); WANG WENJIA, ZHONGGUO TUDI ZHIDU SHI [The History of Chinese Land Systems] (2d rev'd ed. 1981).

5. They had promulgated a series of laws implementing this policy in the areas they occupied before 1949. *See*, Chen Shoushan, *The Land Law System*, ZHONGGUO TUDI [China Land], 1985, No. 4, at 14, 15.

6. Butler, *Land Reform in the Chinese Soviet Republic*, in THE LEGAL SYSTEM OF THE CHINESE SOVIET REPUBLIC 1931-1934 77 (W. Butler ed. 1983).

7. The Agrarian [Land] Reform Law (promulgated June 30, 1950), *reprinted in* A. BLAUSTEIN, FUNDAMENTAL LEGAL DOCUMENTS OF COMMUNIST CHINA 276 (1962) [hereinafter Land Reform Law].

8. The earliest Chinese land reform legislation however, dated back to December 1928 when the revolutionary regime of the Chinese Soviet Republic adopted a Land Law at Jinggangsan. *See* Butler, *supra* note 6, at 90.

9. Land Reform Law, *supra* note 7, art. 1.

freely."[10] The peasants' right to own land was subsequently guaranteed in the 1954 Constitution.[11]

The early PRC legislation had abandoned the socialization of land, the cornerstone of Bolshevik land policy, in favor of peasant ownership. However, since private ownership of land was inconsistent with the fundamental Marxist creed of public ownership, the Chinese communists soon began organizing collective farms.[12] Through the co-operative movement, private ownership of rural land was, with the exception of very small private plots around the peasants' houses, completely transformed into collective ownership.[13]

Mao Zedong's Great Leap Forward of 1957 continued the process of collectivizing land. As part of the overall plan to consolidate communism, the agricultural co-operatives were amalgamated into the much larger People's Communes.[14] Private property was largely eliminated as houses, domestic animals and "tools for private economic activities" were turned over to the communes.[15] Private ownership of land was completely eliminated, including the small private plots previously permitted during the co-operative stage.[16]

While rural land was being collectivized, land in urban areas was brought under state ownership.[17] This transformation in land ownership was achieved in two ways. One was the confiscation of land left behind by the previous Kuomintang government.[18] The other was through the policy of socialist transformation begun in 1953.[19] Under the latter method, private enterprises controlling much of the remaining urban land were first forced into joint state-private enterprises. The central government completed nationalizing these joint enterprises by the end of 1956.[20] These two processes simultaneously completed the consolidation of urban land in the hands of the state.

Thus, unlike the Soviet Union where the state has claimed exclusive title to *all* land and allocates its perpetual use to various users,[21] in China, as in

10. Land Reform Law, *supra* note 7, art. 30. It has been estimated that forty to fifty percent of China's arable land was redistributed in this way to the benefit of sixty to seventy percent of the rural population. A. DONNITHORNE, CHINA'S ECONOMIC SYSTEM 37 (1967).

11. PRC Const. of 1954, art. 8, *reprinted in* A. BLAUSTEIN, *supra* note 7, at 8.

12. J. TSAO, CHINA'S DEVELOPMENT STRATEGIES AND FOREIGN TRADE 14 (1987).

13. *Id.*

14. For a discussion of the communes, see M. MARSHALL, ORGANIZATIONS AND GROWTH IN RURAL CHINA 46-47 (1985).

15. *Id.* at 47.

16. *Id.*

17. *See* V. LIPPIT, THE ECONOMIC DEVELOPMENT OF CHINA 109-10 (1987).

18. *Id.* at 109.

19. *Id.* at 110.

20. *Id.*

21. *See* The USSR Land Law, arts. 3, 8-9, Chinese translation in the State Planning Commission, State Land Administration, 1 GUOTU FAGUI XUANBIAN [Selections on Land Laws (Foreign Countries)] 398-99, 401 (Peking University ed., 1983).

North Korea,[22] the state has claimed title only to urban and industrial land, leaving rural land with the collectives. The Chinese system resembles the Romanian land system in which the state had similarly retained title to urban and industrial land and transferred ownership of rural areas to the tillers.[23] The current Constitution clearly enunciates the principle of public ownership of land in China: "Land in the cities is owned by the state. Land in the rural and suburban areas is owned by the collectives . . . . No organization or individual may appropriate, buy, sell or unlawfully transfer land in other ways."[24]

B. Traditional System: Administrative Allocation

Under the prior system of strict public ownership, land was clearly not treated as a commodity; it could not be sold, leased, mortgaged or inherited.[25] Instead, land in urban areas was bureaucratically distributed through a two-step administrative allocation process (*xingzheng huabo*),[26] emulating the standard form of Soviet land utilization.[27] In the first step, the economic planning authorities approved the enterprise,[28] and in the second, the local land administration bureaus appropriated the required land for the users.[29] Through this process, state agencies, social organizations, and public and private enterprises were able to obtain the right to use land free of charge for indefinite periods of time.[30] Thus, except for the fact that these rights were inalienable, it seems that the user received rights of virtual ownership while the state retained only nominal title.

22. *See* The Land Law of the Democratic Republic of Korea, arts. 10-11, State Planning Commission, State Land Administration, 1 GUOTU FAGUI XUANBIAN [Selections on Land Laws (Foreign Countries)] 422, 424 (Peking University ed. 1983).

23. J. HAZARD, COMMUNISTS AND THEIR LAW 157 (1969).

24. PRC Const. art. 10 (December 4, 1982), *reprinted in* 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 4-500. Article 80(3) of the General Principles of Civil Law, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 19-150, contained provisions virtually identical to those of the Constitution. Moreover, before its recent amendment, article 2 of the Law of the People's Republic of China on Land Management also was very similar to the Constitution in this regard. Zhonghua Renmin Gongheguo Guowuyuan Gongbao [State Council Gazette], July 10, 1986, No. 17, at 531, *translated in* 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 14-715, *translated, as amended, in* Foreign Broadcast Information Service, Daily Report—China (FBIS-CHI), No. 89-021, Feb. 2, 1989, at 39 [hereinafter Land Administration Law].

25. PRC Const. art. 10, *reprinted in* 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 4-500.

26. The administrative land allocation process is codified in the Provisional Rules Regarding the Approval Process of State Land Use Development (promulgated on Nov. 22, 1988 by the State Land Administration), ZHONGGUO TUDI, 1989, No. 3, at 4.

27. For Soviet land use method, see J. HAZARD, *supra* note 23, at 155.

28. Wu Gaosheng, *On Some Important Points in The Land Management Law*, ZHONGGUO FAXUE [Legal Science in China], 1986, No. 6, at 56, 59.

29. *Id.*

30. Wu Gaosheng, *supra* note 28; Chen Shoushan & Pan Mingcai, Guan Yu Wo Guo Cheng Shi Tudi Shi Chang Wen Ti de Si Kao [Some Thoughts on Our Country's Land Market] 3 (March 1988) (unpublished paper in Chinese) (on file at the offices of the *International Tax & Business Lawyer*).

This system of urban land allocation, modeled after the Soviet system, suffered from the shortcomings typical of a non-market allocation process. Gratuitous and perpetual land use, with its lack of cost discipline, tended to foster waste, inefficiency, and rigidity.[31] Because users could obtain land free of cost, they demanded, and were frequently granted, far more land than they needed.[32] In order to satisfy the needs of these land users, municipal governments requisitioned large amounts of land from rural collectives.[33] Although the user was required to pay a nominal fee to the state for the requisitioning of the land, this money was allocated back to the user by the state as part of the approval and establishment of the construction project. At any rate, because most state enterprises "ate from the same big pot" of state funds, especially before the introduction of the urban economic structural reforms in 1984,[34] the enterprises remained indifferent to the costs of land use.[35] Consequently, China, which has much less than the average arable land per capita in the world,[36] lost one million hectares of agricultural land in 1985.[37] As land could be obtained for free, it was not only requisitioned from rural and suburban areas in excessive quantities,[38] but it was also frequently underutilized, or even left idle.[39]

General economic inefficiency seemed to be exacerbated by the prohibition against land transfers: misallocated land could not efficiently be reallocated to more productive employment. In actuality, however, transfers did take place through certain legal loopholes,[40] and enterprises that urgently

31. For a general discussion on the flaws of the existing system, see Chen Shoushan & Pan Mingcai, *supra* note 30, at 2-5.

32. *Id.*

33. *See* Ma Xiangcong, *On Land Law*, in ZHENGZIH YU FALU [Law & Politics], 1987, No. 3, at 44, 46. The Land Administration Law, *supra* note 24, arts. 2, 21-36, discusses the process and fees for requisitioning. *See infra* note 70 and accompanying text.

34. For the introduction of the urban economic structural reforms in 1984, see "Decisions of the Central Committee of the Communist Party of China on Reform of the Economic Structure," adopted by the Twelfth Central Committee of the CPC at its Third Plenary Session on Oct. 20, 1984, *reprinted in* BEIJING REV., Oct. 29, 1984, Documents.

35. *See* Chen Shoushan & Pan Mingcai, *supra* note 30, at 2.

36. The State Land Administration estimates that agricultural land in China has only ninety-three million hectares of cultivatable land. It makes up just about 10% of the total land mass and amounts to 0.093 hectares per person. This is less than half the 1952 figure and much lower than the world average of 0.33 hectares per person. *See* Huang Guodong & Ma Lixin, *Quota System Planned to Limit Use of Farmland*, China Daily, Oct. 21, 1988, at 1, *reprinted in* FBIS-CHI, No. 88-204, Oct. 4, 1988, at 27.

37. *Id.* It is estimated that fifteen million hectares have been lost in the last thirty years. *Id.*

38. According to the State Land Administration, land requisitioned by the state for the expansion of industry and urban areas totalled more than 857,000 hectares during the 1981-85 period. FBIS-CHI, No. 89-132, July 12, 1989, at 41.

39. *See* Ma Xiangcong, *supra* note 33.

40. Two loopholes, the transferring of land through the transfer or lease of buildings and the exchange of land use rights for joint venture shares, have become quite popular. *See, e.g.*, Zhou Niannian & Huang Weilin, *The Existing Land Use System Must Be Reformed—A Report on the Conference on the Compensated Use of Urban Land*, JINGJI GUANLI [Economic Management], 1989, No. 1, at 28-30, *translated in* FBIS-CHI, No. 89-066, Apr. 7, 1989, at 40, 42; The Law of the PRC on Joint Ventures Using Chinese and Foreign Investment, art. 5, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 6-500 [hereinafter Joint Ventures Law].

needed land often illegally leased or purchased it at high black market prices.[41] As a result, those enterprises given desirable land were blessed with windfall profits, while others were placed at a competitive disadvantage. The poor economic productivity caused by these market distortions was naturally reflected in the overall low level of profits.[42]

The low state enterprise earnings indirectly affected government revenues. The system of gratuitous allocation of land also funneled government funds directly into urban infrastructure development. By the end of 1986, for example, the government of Shenzhen SEZ had allocated eighty-two square kilometers of land, charging between one and twenty-one yuan per square meter.[43] The cost of developing this land was 13.5 billion yuan,[44] 6.7 billion of which had to be borrowed from banks.[45]

Moreover, the rigid inalienability of the traditional system of land use rights did little to facilitate foreign investment. Currently, the usual way for a foreign investor to acquire land in China is through a Chinese partner who agrees to contribute the land use rights as its share in the joint venture.[46] But since the Chinese partner cannot mortgage or otherwise transfer its land, such contributions cannot be used as security for financing. Thus, it is predominantly the foreign investor's capital contribution that is at risk in case of default. Moreover, in the absence of a real estate market, the valuation of the land rights the Chinese partner contributes are arbitrary at best, to the chagrin of the foreign negotiators.[47]

II. FIRST PHASE OF REFORM: PAYMENT FOR LAND USE

Recognizing the defects of the traditional economic system, the PRC initiated broad rural and urban reforms, beginning with improvements in land management. In addition, learning from the success of the "rural household production responsibility contract system"[48] introduced in 1979,

41. *See* Wei Qixiu, *The Compensated Land Use System Should Also Be Applied to Urban Land Already Administratively Allocated by the State*, ZHONGGUO TUDI, 1989, No. 7, at 29.

42. Between twenty and twenty-five percent of state enterprises are reported to be losing money. *See* Zheng, *Bankruptcy Laws of the People's Republic of China*, 19 VAND. J. TRANSNAT'L. L. 683, 685 (1986).

43. *See* Chen Shoushan & Pan Mingcai, *supra* note 30, at 3-4.

44. The Chinese basic currency unit equals US$0.21 at official rates and about US$0.17 on the black market.

45. *See* Chen Shoushan & Pan Mingcai, *supra* note 30, at 4.

46. A Chinese joint venturer's investment "may include the right to the use of a site provided for the joint venture during the period of its operation." Joint Ventures Law, *supra* note 40, art. 5.

47. *See* Gelatt, *Legal and Extra-legal Issues in Joint Venture Negotiations*, 1 J. CHINESE L. 217, 233 (1987); Surrey, Fishburne & Chaudhri, *Joint Ventures in China: the First Water Stop*, 21 TEX. INT'L L.J. 221, 248-49 (1986).

48. *See* Yan Ruizhen, *On China's Agricultural Responsibility System*, JINGJI LILUN YU JINGJI GUANLI [Economic Theory and Business Management], 1984, No. 3, at 34, *translated in* Joint Publication Research Services (JPRS), CAG-84-026, at 11, 13.

whereby farmers paid for the use of land under a contract with the collectives, China adopted the intermediate system of "payment for land use allocation" (*tudi piyong*) in urban areas.[49] This system was first introduced in the foreign investment sector nationwide, and then in the SEZs and the economic and technological development zones of other coastal cities.[50] It has since been extended to many other urban areas.[51]

The first pieces of legislation that incorporated the intermediate system requiring payment for the use of urban land were the Law of the PRC on Joint Ventures Using Chinese and Foreign Investment [hereinafter Joint Ventures Law][52] and its subsequent implementing regulations.[53] These regulations establish another two-step land allocation process. The first step is an administrative process like that found in the traditional system, whereby joint venture enterprises apply to the local land management authorities for land allocation.[54] In the second step, the authorities grant the land use rights by means of a contract.[55] Under this contract, the state transfers the land to the user for a fixed period, upon the payment of a fee.[56] This marks the beginning of the separation of "use" from "ownership"[57] and the development of leasehold rights in China. Rather than handing over virtual ownership to the user, as in the traditional system of pure administrative allocation, the state derives income from its land[58] and retains a reversionary interest.[59] Similar to the traditional system, however, the land use rights remain inalienable.[60]

49. In this paper, the first phase of reform is referred to as the "intermediate" system to distinguish it from the traditional (*xingzheng huabo*) system and from the second phase of the reform which is the "new" system discussed *infra* in Part III. All three systems exist concurrently in China today.

50. Legislation Survey, *supra* note 2.

51. *Id.*

52. Joint Ventures Law, *supra* note 40. The law provides that if the right to the use of the site is not taken as part of the Chinese joint venturer's investment, the equity joint venture shall pay the Chinese Government for its use. *Id.* art. 5.

53. Regulations for the Implementation of the Law of the PRC on Joint Ventures Using Chinese and Foreign Investment, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 6-550 (Sept. 20, 1983) (promulgated by the State Council). "The standard for a site use fee shall be set by the people's governments of the province, autonomous region or municipality directly under the central government where the joint venture is located. . . and shall be filed with the Ministry of Foreign Economic Relations and Trade and the state department in charge of land." *Id.* art. 49.

54. "Any joint venture requiring the use of a site shall file an application with local departments of the municipal (county) government in charge of land and obtain the right to use a site only after securing approval and signing a contract." *Id.* art. 47.

55. *Id.*

56. *See* Wang Jiafu & Huang Mingchuan, *supra* note 3, at 54, 56-57.

57. For the concept of separation of "use" from "ownership," see Part V of this paper, *infra* page 45.

58. Shenzhen collected between 1 and 21 yuan/m^2. In 1986 it allocated 8 km^2 of land and recovered 14 million yuan. *See* Qi Mingshen, *Implementing Payment for Use of Urban Land to Develop Funds for City Development*, ZHONGGUO TUDI KEXUE [China Land Science] 1988, No. 4, at 11.

59. *See* Wang Jiafu & Huang Mingchuan, *supra* note 3.

60. *Id.*

Based on the Joint Ventures Law and its implementing regulations, many cities in the SEZs and coastal areas subsequently introduced similar legislation requiring not only foreign invested enterprises but all domestic Chinese enterprises[61] to pay for the use of newly granted land rights.

The duration of land use rights differs among jurisdictions. In Dalian and Tianjin it is simply determined by "the requirements of the particular project."[62] Most other jurisdictions, however, specify a maximum term of fifty years.[63] Those users who require the land for periods in excess of the maximum may seek an extension by renewal of the contract.[64] Since it will be some time before any land use rights issued under this system expire, it is too early to tell how difficult it will be to obtain extensions. Chinese officials invariably express confidence that such extensions will merely be a matter of formality, subject only to the negotiation of a new land use fee.[65]

The fees charged by the various jurisdictions for land use rights under this system depend on the use and location of the land. However, the fees are sometimes arbitrary and invariably much too low.[66] The base rates charged on land use by domestic Chinese enterprises are negligible and the maximum rates are not very much above the base.[67] This situation exists because the enterprises cannot absorb the cost of land use fees themselves and because, under the irrational state pricing structure, they usually cannot pass increased production costs on to consumers. As might be expected, foreign enterprises

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61. *Id.*

62. Regulations for Land Management of the Tianjin Economic and Technological Development Zone (ETDZ), art. 9, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 92-012; Measures of the Dalian ETDZ on the Administration of Land Use, art. 7, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 83-012.

63. Except for the Regulations for the Administration of Land Use in the Xiamen SEZ, art. 6, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 76-503, which sets a sixty-year maximum period, the Provisional Measures on the Administration of Land Use for Economic Development and Construction in Beihai Municipality, art. 12, *id.* ¶ 82-013, the Trial Measures of the Guangzhou ETDZ on Land Management, art. 12, *id.* ¶ 85-023, the Implementation Measures of Ningbo Municipality for the Administration of Land Use for Sino-Foreign Joint Equity Ventures, art. 10, *id.* ¶ 88-009, and the Provisional Regulations of the Shandong ETDZ on Land Management, art. 12, *id.* ¶ 96-103, all set a fifty-year maximum period.

64. Interview with knowledgeable Chinese officials (August 1989).

65. The author learned this in interviews in August 1989 with Chinese officials who predicted that the current land users will be given the right of first refusal of the new land use contract, subject to the negotiation of a new fee.

66. For example, Fushun, the first city to charge domestic enterprises for land use, levied fees ranging from .20 to .50 yuan/m^2 with a spread of only 1.5 times between the base and the maximum rate. *See* the 1985 Fushun Implementation Measures for the Collection of Land Use Fees (in Chinese) (on file at the offices of the *International Tax & Business Lawyer*). For a study on Fushun's experience in levying land use fees, see Zhou Cheng, Bi Baode, Zhou Yi-gen, Liu Junyan & Zhao Long, *Payment for Land Use in Urban Areas is a Must*, JINGJI LILUN YU JINGJI GUANLI [Economic Theory and Economic Management], 1987, No. 6, at 65.

67. *See supra* note 66. For low fees and small differentials between base and maximum rates, see also the Guangzhou example in Qi Mingshen & Gao Xiangjun, *On the Practice of and Enlightenment from Compensated Use of Land in Guangzhou*, at 19 (publication source cannot be identified) (on file at the offices of the *International Tax & Business Lawyer*).

pay considerably more than domestic Chinese enterprises.[68] But even these higher fees are inadequate to overcome the problems of the system of administrative land allocation still predominant in urban China. Since the fees cover only a fraction of development costs, the drain on government funds continues.

The introduction of fees for fixed periods of land use (*tudi piyong*) is an improvement on the traditional system of administrative land allocation. The newer system, however, is still limited in its application and routinely plagued by the problems associated with the continued inalienability of land use rights. Many of the inefficiencies and abuses associated with the rigidity of the old system thus remain.[69]

The Land Administration Law of 1986[70] was an administrative attempt to address the continuing problem of land abuse. Article 3 declared: "People's governments at all levels shall implement a policy of fully recognizing the value of and rationally using land, and shall practice overall planning, strengthen management, protect and develop the land's resources and prevent the indiscriminate seizure of cultivated areas and the misuse of land."[71] Although the law provided that those abusing land would be subject to the stiff sanctions of forfeiture, fines and disciplinary action,[72] violations continued to be common. In 1987 alone, 168,000 such cases were reported in eleven provinces and a few additional cities.[73] It is estimated that the number of cases could be as high as 400,000 in all of China.[74]

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68. Guangzhou, for example, charges domestic enterprises between ¥0.50 and ¥4.00/m^2 annually, depending on location, while foreign enterprises in that city pay between ¥2.00 and ¥70.00/m^2 annually. *See* Qi Mingshen & Gao Xiangjun, *supra* note 67. Incentives in the form of lower land use fees for foreign invested "export enterprises" and "technologically advanced enterprises" are provided in the State Council Regulations Concerning Encouragement of Foreign Investment, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 13-509, and some subsequently issued local implementing regulations. *See* Cohen and Valentine, *Foreign Direct Investment in the PRC: Progress, Problems and Proposals*, 1 J. OF CHINESE L. 161, 197-98 (1987).

69. Guangzhou tried to cope with the large number of violations of this rule by grandfathering all land use rights that had been assigned without state approval. This at least brought them under the payment system and redirected black market rents into the state treasury. *See* Guangzhou Experimental Measures for Levying Urban Land Use Fees, art. 10, in TUDI SHIYONG ZHIDU GAIGE CANKAO WENJIAN ZILIAO XUANBIAN [Selected Documents and Materials on Reforms of the Land Use System] 66, 67 (Guangdong State Land Administration Bureau ed. 1988).

70. Land Administration Law, *supra* note 24.

71. Land Administration Law, *supra* note 24, art. 3.

72. *Id.* art. 47.

73. *See* Du Yinghua, *Improving the Management System, Strengthening Law Enforcement Measures*, Fazhi Ribao [Legal System Daily], Dec. 20, 1988, at 3.

74. *Id.*

III. Second Phase: Assignable Land Use Rights

In calling for the introduction of a "socialist market system," the Thirteenth CPC National Congress[75] pointed the way to a more fundamental solution to the problems of the Chinese land system. Implementing such a system would require not only that the duration of land use rights be defined and that they be paid for, but also that they be assignable. The new "payment for assignable land use rights system" (*tudi shiyongquan juanrang*) was thus introduced. It was a breakthrough that could lead to the establishment of a real estate market in urban China.

Because of the urgency of the need, this system was introduced in the Shenzhen SEZ as early as the fall of 1987, before the enabling legislation was adopted in 1988 and before the Central Government regulations were in place two years later.[76] Shenzhen thus sold assignable land use rights for land that was to be used for housing developments.[77] Other cities also invited tenders for land development.[78]

In January 1988, Shenzhen[79] and Shanghai,[80] within a few days of each other, promulgated China's first regulations creating a system of assignable land use rights. In February, Hainan Province[81] and its capital city, Haikou,[82] both promulgated similar regulations. These four jurisdictions were soon followed by Guangzhou[83], Fuzhou[84], Shandong,[85] Xiamen,[86]

75. *See* Zhao Ziyang, *supra* note 1.

76. For the Shenzhen experience see *supra* note 43. For the enabling legislation and regulations, *see infra* notes 92 and 94.

77. Shenzhen tender documents (in Chinese) (on file at the offices of the *International Tax & Business Lawyer*).

78. Shanghai invited tenders for the development of a 1.29 hectare piece of land called Lot No. 26 on March 22, 1988. The tender documents (English translation on file at the offices of the *International Tax & Business Lawyer*) provide that the successful tenderer would obtain the legal right to use the land for a [fifty year] term expiring September 30, 2038. *See infra* note 115. Several other cities soon followed this example. In September, 1988, the City of Fuzhou in Fujian Province leased twelve pieces of land totalling fifteen hectares. Nine of them, in the city center, were intended for the development of commercial high-rise buildings. The leases for these pieces of land were for eighty years. One plot, intended for residential high-rise construction, was to be leased for ninety years, and another, to be used for burial plots was leased for ninety-nine years. FBIS-CHI, No. 88-177, September 13, 1988, at 43. These long leases were not based on regulations but on a legal circular issued by the local government.

79. Regulations of the Shenzhen SEZ on Land Management, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 73-500 (Jan. 3, 1988) [hereinafter Shenzhen regulations].

80. Measures of Shanghai Municipality on the Compensatory Transfer of Land Use Rights, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 91-034 (Nov. 29, 1987) [hereinafter Shanghai regulations].

81. Hainan Land Management Measures, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 96-200 (Feb. 13, 1988) [hereinafter Hainan regulations].

82. Haikou City, Granting and Assigning Leaseholds for Value Provisions, 2 CHINA LAW AND PRACTICE, No. 3, at 23 (1988) (the Chinese version of the provisions is on file at the offices of the *International Tax & Business Lawyer*).

83. Measures of the Guangzhou ETDZ on the Compensatory Transfer and Assignment of Land Use Rights, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 85-035 (March 4, 1988) [hereinafter Guangzhou regulations].

Tianjin[87] and several others.[88] As of June of 1989, thirteen localities had adopted the new land use rights system.[89]

Strictly speaking, every one of these local regulations was initially illegal. Until recently, when they were amended, both the 1986 Land Administration Law[90] and the 1982 Constitution[91] forbade the sale and transfer of interests in land. The Constitution was appropriately amended only in April 1988. The revised version states: "No organization or individual may appropriate, buy, sell or unlawfully transfer land in other ways. *The right to use land may be assigned in accordance with the provisions of the law.*"[92] The National People's Congress similarly amended the Land Administration Law in December 1988[93] to accommodate the local developments.

These developments culminated in the State Council proclamation of two administrative decrees. On May 19, 1990 the State Council adopted the Provisional Regulations of the PRC Governing the Grant and Transfer of Use Rights in State Owned Urban Land [hereinafter the State Council Land Use Rights Regulations],[94] and the Provisional Measures for the Control of Large Scale Land Development and Management by Foreign Investors, [hereinafter the State Council Large Scale Land Development Measures] which officially institutionalized the land use rights system.[95] These developments reflect the common Chinese practice of experimental lawmaking: once the central authorities are satisfied with the local experience, the central laws are amended or enacted accordingly.

84. Fuzhou Decree on Compensatory Granting of Three Parcels of Municipal Owned Land, Decree on Compensatory Granting of State Owned Land, *see supra* note 78; Legislation Survey, *supra* note 2, at 2-3.

85. Shandong Province, Developing an Export Oriented Economic Provisions, 2 CHINA LAW AND PRACTICE, No. 7, at 16 (1988).

86. Xiamen, Leasehold Assignment Procedures, 2 CHINA LAW AND PRACTICE, No. 6, at 21 (1988).

87. Tianjin ETDZ Administration of the Granting and Assigning of Lease Provisions, 2 CHINA LAW AND PRACTICE, No. 7, at 19 (1988) [hereinafter Tianjin regulations]; Tianjin ETDZ Granting and Assignment of Leaseholds Implementing Procedures, 3 CHINA LAW AND PRACTICE, No. 5, at 25 (1989).

88. While the various local regulations vary slightly in their details, all establish the same general procedure for the acquisition and transfer of land use rights. *See* Legislation Survey, *supra* note 2.

89. *Id.*

90. Land Administration Law, *supra* note 24.

91. *See supra* note 24 and accompanying text.

92. PRC Const. art. 10 (amended April 12, 1988), *reprinted in* 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 4-500 (emphasis added).

93. Land Administration Law, *supra* note 24, art. 2.

94. For the law and the scope of its application, see Fazhi Ribao [Legal System News], May 31, 1990, at 2. The law is applicable to both domestic and foreign investors. *See* FBIS-CHI, No. 90-104, May 30, 1990, at 52.

95. The law governs only large scale development of land and infrastructures in the SEZs, open coastal cities and ETDZs by foreign investors. For the law and the scope of its application, see Fazhi Ribao, May 31, 1990, at 2.

A. *The Process*

The new assignable land use rights system is modeled after that of Hong Kong,[96] whereby the state retains ownership of the land and leases out the land use rights. The process used to accomplish this is the reverse of that under the intermediate system of "payment for land use allocation" (*tudi piyong*).[97] Under that system, the prospective user initiated the process and the approval of the investment project preceded the allocation of the land. Under the new system, however, the state first parcels land to be developed and prepares a draft granting contract accordingly; detailed construction plans are approved afterward.[98] The draft contract is prepared in accordance with state economic plans and municipal development requirements.[99] It is then offered to prospective developers and users either by negotiation, by invitation to tender, or by open auction, depending on the circumstances.[100]

Both Chinese and foreign[101] enterprises may submit detailed development proposals.[102] The municipal (county) land administration bureau then enters into a contract with the successful applicant who is thereupon required to pay a land transfer fee (*tudi churangjin*),[103] register its land use rights[104] and obtain a land use certificate.[105] The developer is required to complete the project and is entitled to retain the land use rights for the period specified in the contract.[106]

As in Hong Kong,[107] the government imposes terms and conditions as covenants on the lessee and the assignee in order to effect land development according to its land use planning.[108] The lessee may still mortgage or otherwise assign the land.[109]

96. *See* Note, *Hong Kong Property Title and the Joint Declaration*, 21 TEX. INT'L L.J. 529 (1986).

97. *See supra* note 49 and accompanying text.

98. *See* Wang Jiafu & Huang Mingchuan, *supra* note 3, at 57-59.

99. *Id.*

100. *See infra* part III.B.

101. The Shanghai regulations require that foreign enterprises be registered in a country that maintains diplomatic relations with China and has established a commercial representative office there. Shanghai regulations, *supra* note 80, art. 4.

102. According to a survey by the State Land Administration, 31.4% of the parcels of land was acquired by foreign invested enterprises. *See* Legislation Survey, *supra* note 2, at 10.

103. *See infra* part III.C.

104. *See infra* part III.D.

105. *See* Wang Jiafu & Huang Mingchuan, *supra* note 3, at 57-59.

106. *See infra* parts III.E. and III.F.

107. *See* Ta Shanshi, *The Hong Kong System of Granting of Land*, SHANGHAI FANGDI [Shanghai Lands and Houses], 1987, No. 1, at 23.

108. *See infra* part III.G.

109. *See* the Shanghai regulations, *supra* note 80, arts. 26, 35; the Shenzhen regulations, *supra* note 79, art. 19.

B. Selection of the Transferee

Whether the government proceeds by negotiation, tender, or auction depends primarily upon the type of project that it has planned for the site.[110] Negotiations are entered into for the development of public interest projects to provide facilities for education, defense, and utilities.[111] Tender is the preferred method for other major construction projects where the details of the development plans and the reputations of the developers are important considerations, and where the government consequently does not wish to be bound to award the contract to the highest bidder.[112] Auction has been employed where land is to be used for general commercial purposes, such as shopping centers and hotels, and for other general commercial use where profit is the main consideration.[113] Shanghai, however, does not have any provision for the auction of land use rights,[114] and the first project under its new regulations was initiated through the tender process.[115]

C. Payment

Once the transferee has been chosen, the contract is signed and payments are made in accordance with the agreement.[116] There are two direct payments, as well as a number of other charges and taxes.[117] The main direct fee is the initial payment, tantamount to capitalized rent, called the "land use transfer fee" (*tudi shiyong churang fei*), the "land price" (*tudi jiage*) or the

110. *See* Shenzhen Land Administration System Reform Office, Basic Measures for the Reform of the Shenzhen SEZ Land Administrative System 13-14 (unpublished paper on file at the offices of the *International Tax & Business Lawyer*).

111. If negotiation is the chosen means of offering the land use right, then interested parties may apply for information about the specific requirements of the project. The parties must then submit documents including their credentials and a letter of intent containing their construction plan and the proposed amount and method of payment. *Id.* The land administration bureau is then obliged to respond within a specified period. *E.g.*, Shanghai regulations, *supra* note 80, art. 16(3) (the Municipal Land Bureau must respond within thirty days of receiving the letter of intent); Guangzhou regulations, *supra* note 83, art. 10(3) (the Land Management Department of the Land Administrative Commission must respond within seven days).

112. If this is the chosen method of offering the land use rights, interested parties can find the detailed development conditions in the tender documents and draft contracts issued by the local authorities. In Shanghai, the only contract offered by tender to date was won by a foreign company. *See infra* note 115. In Shenzhen, however, Chinese developers have prevailed. *See* Shenzhen SEZ, Invitation for and Submission of Bids for Land Sale Tentative Procedures, 2 CHINA LAW AND PRACTICE, No. 2, at 21 (1988). For different methods used by various localities in granting land use rights, see Legislation Survey, *supra* note 2, at 10.

113. *See supra* note 110.

114. The Shanghai regulations provide that, "[t]he Municipal Land Bureau may adopt such methods as bilateral agreements and invitations for tenders when transferring land use rights." Shanghai regulations, *supra* note 80, art. 14.

115. *See* Shanghai Land Administration Bureau, Tender Documents (Lot No. 26 in Shanghai Hongqiao ETDZ) (Mar. 22, 1988) (English translation on file at the offices of the *International Tax & Business Lawyer*).

116. Wang Jiafu & Huang Mingchuan, *supra* note 3, at 57.

117. *See infra* part III.I.

"granting price" (*churang jin*).[118] It may be paid all at once or by installments.[119] As in Hong Kong,[120] a small annual "land use fee" (*tudi shiyong fei*) is also payable as a token reminder that the state retains title to the land and that the user has only a leasehold interest.[121]

As a substantial secondary market for land use rights has not yet developed, and since the state has a monopoly in the primary market, it would seem that the authorities have considerable flexibility in determining the amounts of these fees. For example, in 1987, the Shenzhen government by negotiation sold land use rights to 5,000 square meters of land for only 200 yuan/m^2 (US\$54/m^2).[122] When Shanghai recently issued land use rights to 1.29 hectares of land by tender, however, the transfer fee amounted to more than 8,000 yuan/m^2.[123] The stated policy, however, is to charge only moderate prices in order to attract investment, particularly in manufacturing and residential projects.[124]

D. Registration

In 1987, pursuant to articles 9, 10 and 14 of the Land Administration Law before amendment, the State Land Administration Bureau issued two sets of rules for the establishment of land survey and registration schemes in all localities.[125] Again, local governments in the Special Economic Zones and coastal cities are leading the way. Most areas, however, have yet to establish such a system.

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118. *See* Yang Fan, Zhang Jun, Wang Jian & Li Yan, *Several Problems Regarding Compensatory Transfer of Land Use Rights*, JINGJI CANKAO [Economic References], May 9, 1988, at 4.

119. *See, e.g.*, a Shenzhen model land use contract, para. 2 (in Chinese) (on file at the offices of the *International Tax & Business Lawyer*).

120. Ta Shanshi, *supra* note 107, at 33.

121. The Guangzhou regulations state: "Land use fees refer to fees collected by the State as it exercises its ownership rights over the land . . . ." The annual fee in Guangzhou will be brought down to a uniform rate of 2 yuan/m^2 over the next ten years. Guangzhou regulations, *supra* note 83, art. 32. Shanghai charges a uniform fee of 1 yuan/m^2, with a minimum annual payment of 1,000 yuan. Shanghai regulations, *supra* note 80, art. 22.

122. Shenzhen Land Administration Reform Office, *Basic Approach Towards Land Administration Reform*, ZHONGGUO TUDI, 1988, No. 4, at 13. In 1987, under this new system, the Shenzhen govenrnment sold five pieces of land totalling 0.16 km^2, receiving a thirty-five million yuan one-time payment. Qi Mingshen, *supra* note 58, at 11. This was two and one-half times the amount they had been able to collect under the intermediate system. In 1988, Shenzhen auctioned land use rights and projected receipts of more than one hundred million yuan while their infrastructure development cost was eighty million yuan. Qi Mingshen, *supra* note 58, at 11.

123. *The Emerging Real Estate Market in China*, Renmin Ribao (Overseas) [People's Daily], Nov. 14, 1988, at 3. This was for the auction of Lot No. 26 on July 8, 1988. The transfer fee for the package was US\$28 million, or US\$2,170/m^2, the equivalent of US\$8.78 million per acre. For transfer fees received by various localities, see Legislation Survey, *supra* note 2, at 10-11.

124. Interview with Chinese officials in Shanghai and Shenzhen (June 1988).

125. These two rules are entitled: The Urban and Rural Land Survey and Recording Rules and The Nationwide Land Registration Rules. *See* Urban and Rural Land Survey and Recording Rules and the Nationwide Land Registration Rules (State Land Administration Bureau 1987).

Shenzhen[126] was the first to adopt rules for land registration, followed by Shanghai[127] and other localities. According to these measures, users must register their newly acquired land use rights within a specified period.[128] Moreover, as in the Torrens system,[129] title in land becomes effective and a legal interest is thus created only once it has been registered.[130] Buildings and land are registered separately, the former with the local building construction authority,[131] and the latter with the local land administration agency.[132] Bureaucratic jealousy and confusion in property registration inevitably result.

E. Conditions of the Contract

Finally, in order to perfect their land use rights, users must fulfill the conditions and covenants specified in the contract. Chinese land use contracts invariably contain extensive conditions and covenants not typically found in Western lease agreements. These provisions include not only legal descriptions of the land and the duration of use, but also terms detailing permitted use, building height, size and location, site coverage, and areas of greenery.[133] These provisions normally run with the land and bind not only the original grantee of the use rights but also subsequent assignees and lessees.[134] Such detailed provisions take the place of the zoning and subdivision control legislation normally found in Western systems.[135] The Standing Committee of the National People's Congress has recently adopted the PRC

126. Detailed Implementing Rules of the Shenzhen SEZ on Land Registration and the Issue of Certificates, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 73-547 (March 8, 1988) [hereinafter Shenzhen Registration Rules].

127. Shanghai, Registration of Transfers for Value of Leaseholds Implementing Rules (promulgated Oct. 12, 1988), 3 CHINA LAW AND PRACTICE, No. 5, at 24 (1989); Shanghai Notarization of Transfers for Value of Leaseholds Implementing Rules (promulgated Oct. 12, 1988), 3 CHINA LAW AND PRACTICE, No. 5, at 25 (1989).

128. In Shenzhen, land use rights must be registered with the Land Bureau within thirty days of the signing of the land use contract. A fine of ten yuan per day is imposed if the contract is not registered within the specified period. Shenzhen Registration Rules, *supra* note 126, arts. 26(6), 28.

129. For an excellent explanation of the Torrens system, see T. MAPP, TORRENS' ELUSIVE TITLE: BASIC LEGAL PRINCIPLES OF AN EFFICIENT TORRENS' SYSTEM (1978).

130. Registration is evidenced by land use certificates. For example, the Shenzhen Registration Rules provide that, "Land ownership rights and land use rights shall be verified by land certificates. Legally verified land ownership rights and land use rights shall be protected by State [sic] law and no unit or individual shall infringe upon these rights." Shenzhen Registration Rules, *supra* note 126, art. 3.

131. *See, e.g.*, Shenzhen City, Urban and Rural Housing Registration Certification Issuance Procedures, 2 CHINA LAW AND PRACTICE, No. 3, at 21 (1988).

132. *See* Chen Min, Chen Lianghua & Xu Jiming, *Several Measures for the Registration and Certification of Use Rights in State-Owned Land*, SHANGHAI FANGDI, 1987, No. 3, at 14.

133. *See, e.g.*, Shanghai Tender Document, *supra* note 115, at 5-14.

134. *See* Shenzhen regulations, *supra* note 79, art. 23; Shanghai regulations, *supra* note 80, art. 29.

135. Interview with a Chinese official at the State Land Administration Bureau (May 1988). Zoning and subdivision control legislation is rarely seen in Chinese localities.

Urban Planning Act, effective April 1, 1990.[136] The implementing regulations have yet to be promulgated by the central and local governments.

F. Duration

The duration of the lease, like that if the land use rights obtained under the intermediate system discussed previously, varies in accordance with the jurisdiction and the nature of the project.[137] An important consideration is the degree of control that the state wishes to exert over land development. It must be remembered that China remains officially committed to the Marxist ideal of public ownership. Long leases would limit the state's ability to redirect the use of the land while short ones enable them to put an early end to any undesirable uses. Long leases would also deprive the government of the benefit of rising land values.[138] However, the lease must be long enough to allow users to amortize their capital investments and reap a reasonable profit.

Jurisdictions have chosen various lengths for their leases. The first two jurisdictions to implement the new system of land use (Shanghai and Shenzhen) set the maximum period at fifty years.[139] The Hainan regulations, however, set the maximum lease period at seventy years.[140] The Guangzhou regulations, adopted a month later, originally set a maximum period of fifty years, but this has recently been extended to seventy years as well.[141] Tianjin followed a similar course.[142] In September 1988, the City of Fuzhou in Fujian Province by a legal circular stretched the leasing periods to eighty years for commercial development, ninety years for residential high-rise construction, and ninety-nine years for burial plots.[143] By a subsequent decree,[144] the city followed the practice of most localities in setting the maximum lease period at seventy years. This happened to be in line with the State Council Land Use Rights Regulations promulgated subsequently.[145]

136. For the Act, see Fazhi Ribao, Dec. 30, 1989, at 2.

137. *See* Legislation Survey, *supra* note 2, at 6.

138. These two considerations prompted the Crown to cease the practice of granting very long leases in Hong Kong. *See* Note, *supra* note 96, at 532.

139. The Shanghai regulations specify a maximum period of fifty years for most purposes other than industrial developments, which are limited to forty years, and recreational projects, which are limited to twenty years. Shanghai regulations, *supra* note 80, art. 8. The Shenzhen regulations, promulgated within two days of those of Shanghai, stipulate that the maximum period shall be determined in accordance with the requirements of the project, not to exceed fifty years. Shenzhen regulations, *supra* note 79, art. 16.

140. Hainan regulations, *supra* note 81, art. 22.

141. Guangzhou regulations, *supra* note 83, art. 5; Renmin Ribao (Overseas), Aug. 14, 1989, at 1.

142. Tianjin regulations, *supra* note 87, art. 9; Renmin Ribao (Overseas), Aug. 9, 1989, at 1.

143. *See supra* note 78. For a general survey of the leasing period among various localities, see Legislation Survey, *supra* note 2, at 6-7.

144. The Fuzhou Measures for Compensated Grant and Transfer of Use Rights in State-Owned Land, art. 7, proclaimed May 8, 1989, and reprinted in JINGJI YU FALU [Economy and Law, Hong Kong], 1990, No. 2, at 32.

145. *See supra* note 94, art. 12.

During the whole period of the contract, the holder of the land use certificate is entitled to the land use rights. There are provisions, however, for expropriation on payment of "appropriate compensation."[146] Since the primary market is completely monopolized by the state and since the secondary market is likely to remain very thin for some time, it may be very difficult to determine what will be considered fair or "appropriate" compensation.

G. *Assignability*

The major breakthrough in China's urban land reform is the development of assignable land use rights, facilitating sale, exchange, mortgage, gifts and inheritance. All land regulations, however, place some restrictions on assignment.[147] Thus in the Shanghai regulations,[148] and perhaps also in those of Hainan,[149] the original purchaser of the land use rights must complete the capital investments undertaken in the original granting contract before they will be permitted to assign the rights for the remainder of the land use period. The Shenzhen regulations require only that twenty-five percent of the contracted investment be paid before the use rights may be assigned.[150] These provisions are an understandable attempt to curtail speculation in land use rights—an activity that would no doubt be highly lucrative in these rapidly growing economic zones.

Unfortunately, these restrictions may also inhibit the development of the market for land use rights. The more recent Guangzhou regulations wisely refrain from imposing any such restrictions, as land use regulations and lease contracts usually already call for the assignee to complete the project and comply with the covenants stipulated in the original contracts.[151] So long as the development conditions and covenants are fulfilled, state approval is not required and assignments can be effected by registration.[152] Partial assignments, however, may require approval, as in subdivision control legislation present in some Western land systems.[153]

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146. *See, e.g.,* Shanghai regulations, *supra* note 80, arts. 42-44.

147. *See* Legislation Survey, *supra* note 2, at 8-9.

148. Shanghai regulations, *supra* note 80, art. 26.

149. It is not perfectly clear whether the Hainan regulations require that the original transferee satisfy the conditions of the contract. The wording may be interpreted as permitting transfer subject only to the condition that *someone* satisfy them. The regulations provide: "*Subject to compliance with the relevant conditions*, a land user that has acquired land use rights through the government's compensatory transfer system may assign the land use rights . . . ." Hainan regulations, *supra* note 81, art. 24 (emphasis added).

150. Shenzhen regulations, *supra* note 79, art. 20.

151. *See* Guangzhou regulations, *supra* note 83, art. 16. *See also supra* note 109.

152. For the procedures for the assignment of land use rights, see Guangzhou regulations, *supra* note 83, arts. 15-28.

153. For example, the Shanghai regulations require approval for all partial assignments. Shanghai regulations, *supra* note 80, art. 26. However, the Guangzhou regulations expressly provide for partial assignment without prior approval unless otherwise stipulated in the original contract. Guangzhou regulations, *supra* note 83, art. 15.

H. Reversion and Extension

At the end of the contracted land use period, all rights to the land, together with any buildings on it, revert to the state.[154] The land use contract may stipulate that the developer must either clear away or dismantle certain equipment and buildings or pay clearing fees.[155]

All the new land use regulations, like those establishing the intermediate payment for land use allocation (*tudi piyong*) system,[156] provide for the extension of the land use period.[157] Most contemplate that such an extension would be effected through the negotiation of a new contract, upon the payment of a new fee.[158] The requirement that a new contract be formed would seem to imply that new investment undertakings may be required as well, although this is not at all certain. The key appears to be in the payment of a new transfer fee. Since the expectation is that renewal should be relatively straightforward under the intermediate system, the same should be true of this new system. The recent Guangzhou Land Use Regulations confirm this.[159]

I. Fees and Taxes

As discussed earlier,[160] one of the key features of the reforms, is the payments for land use: land transfer fees and annual land use fees. There are, in addition, a number of other fees and taxes that are levied on land and land transactions. A brief review of these levies will indicate that they are not dissimilar to those found in market economies.

As in most other civil law countries, the first transaction tax usually encountered is the stamp duty (*yinhua xue*).[161] It is charged upon the making of all legal documents, including land contracts (at 0.1% of the contract value) and certificates (at the flat rate of ¥5 per document). Foreign invested

154. *See e.g.* Shanghai regulations, *supra* note 80, art. 41.
155. *Id.*
156. *See supra* note 70 and accompanying text.
157. *See* Legislation Survey, *supra* note 2, at 6.
158. Interview with knowledgeable Chinese officials (August 1989).
159. "If the party with title to the land use rights wishes to continue to use the land after the expiry of the land use term, an application for an extension of the term of usage may be submitted to the Administrative Commission six months before the expiry of the term and, following its approval, a new transfer contract based on the current price of land use rights shall be signed with the Administrative Commission." Guangzhou regulations, *supra* note 83, art. 36.
160. *See supra* part III.C, page 24.
161. The State Council Provisional Rules on Stamp Duty, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 31-712 [hereinafter Provisional Rules on Stamp Duty].

enterprises, which are required to pay Consolidated Industrial and Commercial Taxes,[162] however, are exempt.[163] Failure to pay the stamp duty is punishable by fines.[164]

Another transaction tax is the contract tax (*qi xue*),[165] which resembles land transfer taxes in other jurisdictions. It is levied on all contracts for the assignment of land use rights and, in some localities,[166] also on the original transfer from the state. The rate, based on the Contract Tax Law of 1950,[167] is six percent of either the purchase price or, in the case of a gift or exchange, the current value.[168]

All urban real estate in China, not only that acquired under the newly reformed land system, is subject to taxes analogous to property taxes in other countries. Thus, buildings owned by domestic Chinese enterprises or individuals are subject to the Urban Building Tax at the rate of 1.2% of current value.[169] Land in the hands of domestic enterprises or individuals is taxed at rates ranging from ¥0.30/m^2 to ¥6/m^2 in small towns,[170] and from ¥0.50/m^2 to ¥10.00/m^2 in large cities.[171] Foreign invested enterprises pay taxes both on buildings and land use rights under the 1950 Urban Real Estate Tax regulations.[172] Under these regulations, the building tax is one percent and the land tax is 1.5% of the average price of similar properties in the vicinity.

All these taxes are relatively low and are in forms familiar to Western businesses. Of greater concern is whether substantial capital gains taxes will be imposed on land holdings in China. So far, no central law imposes such a

162. *See* A.J. EASSON & LI JINYAN, TAXATION OF FOREIGN INVESTMENT IN THE PEOPLE'S REPUBLIC OF CHINA 103-10 (1989).

163. *Foreign Enterprises Exempt From the Stamp Tax*, Renmin Ribao (Overseas), Aug. 8, 1989, at 1.

164. Provisional Rules on Stamp Duty, *supra* note 161, art. 13.

165. See the Shanghai regulations, *supra* note 80, arts. 45-46, which refer to the Detailed Rules for the Implementation of the Provisional Regulations of Shanghai Municipality on Contract Tax.

166. For example, Guangzhou charges a 2.5% "management fee" on transfer and assignment prices and 3% on the current value of a gift or exchange. Guangzhou Measures, *supra* note 83, art. 30.

167. Zhongyang Renmin Zhengfu Faling Huibian 1949-50 [Compendium of the Central People's Government 1949-50], art. 5, (Law Publishing House 1982).

168. *See* Shanghai regulations, *supra* note 80, art. 5(1). Compare with the Hong Kong Lease Assignment Tax of three percent, *see* Note, *supra* note 96, at 533.

169. Provisional Regulations on Real Estate Tax, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 39-505. Since implementing regulations have yet to be enacted, it is unclear how the property is to be assessed in the absence of an established real estate market.

170. Provisional Regulations of the PRC Governing Land Use Tax in Cities and Towns, art. 4, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 39-509 (1988). These taxes, with the lowest base rate starting at ¥0.30/m^2 and ranging to ¥10.0, do not adequately reflect the great variety of land values. As such, they do not provide much incentive for domestic enterprises to make the best use of their land.

171. *Id.*

172. Provisional Regulations Governing the Urban Real Estate Tax, art. 6, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 39-500.

tax. Some localities nonetheless charge capital gains "fees" on assignments,[173] though under the constitutional practice, only the central government has power to levy taxes.[174] The city of Haikou charges a twenty percent "fee" on profits from the assignment of land use rights.[175] Guangzhou levies a capital gains "fee" on a progressive scale, starting at fifteen percent and going up to a maximum of fifty percent.[176] Shenzhen and Shanghai do not charge such "fees." Whether there should be a capital gains tax on property is currently a matter of contention. The prevailing view among officials[177] is that such a tax is not necessary since profits are already captured by other taxes.[178]

J. *Nature of the New Reform*

The new land system improves on the traditional administrative and intermediate systems by creating a more fiscally realistic allocation process and by expanding the land use rights created under it. The user's rights to possess, use and derive profits from land are protected by law. These rights are, however, limited to surface rights only. All underground natural resources and objects are invariably reserved for the state.[179] The ability to dispose of land use rights by assignment and mortgage has also been established.[180] Also, as discussed previously,[181] assignment by private agreement is now subject only to fairly reasonable planning and anti-speculation conditions. These

173. *See* Hainan regulations, *supra* note 81, arts. 17, 27. The CCH translation renders the term *zengzhi xue* as "value added tax" but notes that "capital gains tax" is also a possible translation. The Guangzhou regulations impose "value added fees" (*zengzhi fei*) at progressive rates up to fifty percent of the capital gain. Guangzhou regulations, *supra* note 83, art. 33.

174. Interview with the State Council Bureau of Legal Affairs (June 1990). However, the Constitutional provisions are silent as to whether the local government has taxation authority.

175. Haikou Provisions, *supra* note 82, art. 28.

176. Guangzhou regulations, *supra* note 83, art. 33. The increments are as follows: 15% tax if the capital gain is 100% or less of the original price; 30% on any portion of capital gain between 100% and 200%; 40% on the next 100% increment; and 50% on any increment over 300%. *Id.*

177. Interviews with officials at the State Council Bureau of Legal Affairs (August 1989).

178. *See* the Consolidated Commercial and Industrial Tax, referred to in the Shanghai regulations. Shanghai regulations, *supra* note 80, art. 48. See also the income tax laws concerning foreign enterprises, discussed in T. GELATT & T. CHANG, CORPORATION AND INDIVIDUAL TAXATION IN THE PRC (2d ed. 1987).

179. *See, e.g.*, Shanghai regulations, *supra* note 80, art. 3; Guangzhou regulations, *supra* note 83, art. 3; Hainan regulations, *supra* note 81, art. 19. This differs from common law principles, whereby tenants in fee simple are entitled to all mines and minerals under their land. R. MEGARRY, MANUAL OF THE LAW OF REAL PROPERTY 570 (4th ed. 1969). The distinction is, however, attenuated by the fact that most common law jurisdictions have encroached on the fee simple mineral rights by various statutes or by reservations contained in the grants of public land that vest specific mineral rights in the state. *See* R. MEGARRY & H. WADE, THE LAW OF REAL PROPERTY 71 (4th ed. 1975).

180. *See, e.g.*, Shanghai regulations, *supra* note 80, art. 2(2); Shenzhen regulations, *supra* note 79, art. 19.

181. *See supra* part III.G, page 30.

rights are proprietary in nature and come very close to resembling the full rights of ownership.[182]

Property ownership, as defined in the General Principles of Civil Law, comprises the "rights of an owner, according to the law, to possess, use, reap benefit from and dispose of his own property."[183] Only the limit on the duration, therefore, prevents the land use rights from encompassing the complete rights of ownership. Moreover, these limits are being increasingly relaxed. The fifty-year maximum adopted by Shanghai and Shenzhen in early 1988 was subsequently lengthened to seventy years in most localities,[184] and nationwide according to the State Council regulations.[185] In addition, although it may be premature, all signs indicate that obtaining extensions of the original leases will become a matter of course.[186]

The reform of the urban land system and the introduction of real estate markets in China are clearly under way. Trends established by the local laws indicate that the contracts are becoming increasingly flexible as the government replaces direct control with regulation and tax incentives, giving the land user a significant measure of proprietary rights.

The advantages of this system compared with the old are manifest: rigidity, waste and inefficiency have been replaced with flexibility, prudence and productivity. Assignability makes possible the voluntary transfer of land to more productive uses. The clearer definition and increased protection of proprietary interests in land will enable planning and encourage long term investment by land users while the ability to mortgage these interests will facilitate the growth of the capital markets needed to fund such investments.[187]

IV. Transition to the New System

The majority of urban land remains under the old administrative allocation system of free and perpetual use, and to a much lesser extent the intermediate system of payment for land use allocation.[188] In order to provide a legal

182. Most Chinese commentators are of the view that land use rights under the new system are not mere contractual rights but are also proprietary in nature. *See, e.g.*, Jin Liqi & Xu Ming, *On Land Management Rights*, ZHONGGUO FAXUE, 1989, No. 1, at 59; Cai Zhilong, *Some Legal Questions on Compensated Land Use Rights*, ZHONGGUO FAXUE, 1989, No. 3, at 69.

183. General Principles of Civil Law, *supra* note 24, art. 71.

184. *See supra* part III.F, page 28.

185. *See supra* note 145 and accompanying text.

186. Interviews with officials at the State Bureau of Land Administration (May 1988) and at the State Council Bureau of Legal Affairs (August 1989).

187. *See also* Wang Jiafu, "On China's Compensatory Transfer of Land Use Rights System," speech delivered at the World Peace through Law Conference, Beijing, China, April 1990 (on file at the offices of the *International Tax & Business Lawyer*).

188. *Id.* The new assignable land use rights system is currently applicable in selected urban areas for experimentation. *See* the State Council Regulations, *supra* note 94, art. 51. It is also applicable in SEZs, open coastal cities and ETDZs. *See* the State Council Large Scale Land Development Regulations, *supra* note 95, art. 18.

framework for the eventual transition of all land in China from the old administrative system (*xingzheng huabo*) and the intermediate payment system (*tudi piyong*) into the new assignable system (*tudi shiyongquan juanrang*), the State Council has adopted two pieces of legislation.

The first, the Provisional Regulations of the PRC Governing Land Use Tax in Cities and Towns [hereinafter Tax Regulations], were effective November 1, 1988.[189] As previously discussed,[190] it imposes an annual tax on land use ranging from 0.26 yuan/m^2 in townships and industrial and mining areas to 10 yuan/m^2 in large cities. In addition, the law provides that provincial governments may raise these rates "appropriately" in developed areas.[191] These taxes are meant to replace the annual land use fees being collected in some localities under both the intermediate and the new systems and to provide incentives for enterprises nationwide either to make more efficient use of the land themselves under the traditional system, or to join the new system and assign its use to other enterprises that can employ it more efficiently.[192]

The second piece of legislation, the Provisional Regulations Governing the Grant and Transfer of Use Rights in State Owned Urban Land[193] is designed to facilitate the new system of compensatory assignments of land use rights. The State Council adopted the draft regulations just ten days after the Tax Regulations, but did not promulgate them until nearly two years later[194] because of jurisdictional disputes within the State Council.[195] The regulations that became effective on the date of their promulgation contained a chapter with transitional provisions whereby enterprises already possessing land under the old administrative system could enter into contracts with the

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189. Provisional Regulations of the PRC Governing Land Use Tax in Cities and Towns, 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 39-509 (Sept. 27, 1988) [hereinafter Tax Regulations].

190. *See supra* notes 170-71 and accompanying text.

191. Tax Regulations, *supra* note 189, art. 5.

192. Interview with knowledgeable Chinese officials (August 1989).

193. *See State Council's 14th General Meeting Adopts in Principle the Provisional Regulations on Urban State Land Use Rights Transfer and Assignment*, Renmin Ribao (Overseas), July 23, 1988, at 1.

194. *See supra* note 94 and accompanying text.

195. The jurisdictional dispute concerns the question of which ministry within the State Council is to collect this fee and administer the new system. The Ministry of Construction argues that land administration cannot be separated from the administration of construction and development projects, for which they are responsible. According to a Chinese official at the State Council Bureau of Legal Affairs interviewed by the author in August 1989, the State Land Administration contends that urban land administration should not be separated from rural land administration, for which they are responsible. The jurisdictional dispute is not fully settled in the newly proclaimed State Council Regulations. *See supra* note 94, arts. 7, 25. The author was advised by a State Council legal official in June 1990 that it will be resolved in the forthcoming organic regulations of the State Council.

The enactment of the tax law was not delayed because there was no dispute as to who would be responsible for administering it. Article 13 of the provisional tax regulations provide that those regulations are to be interpreted by the Ministry of Finance and that implementing measures, to be adopted by provinces, autonomous regions and the three municipalities directly under the central government, must be reported to the Ministry of Finance for the record. Tax Regulations, *supra* note 189, art. 13.

state that would delimit their land use rights and make them assignable, thereby bringing them into the new system.[196] Fully implementing this "carrot and stick" legislative scheme would therefore likely advance the development of the real estate market called for by the Thirteenth CPC National Congress in 1987.

One could hardly expect that so radical a transformation should proceed easily. The taxes imposed and fees collected for land use in localities experimenting with both the intermediate and the new reforms are so low that they may provide only a weak incentive for bringing land under the new system.[197] Increases in the land use tax can only occur in coordination with more general economic reforms, such as pricing and enterprise deregulation. This presents a formidable challenge for the foreseeable future.

In the meantime, Hainan's transition strategy may provide a temporary solution. It plans to bring all perpetual land use rights now under the traditional and intermediate systems into the new one by redefining their duration and applying a fee to them.[198] Units holding land acquired under the old systems will be allowed to assign their newly defined land use rights and keep half of the assignment profits.[199]

Recent events within China have dramatized the stress presented by economic liberalization. In view of these events, one cannot help but question the regime's commitment to continuing modernization in general and reform in urban land systems in particular. On June 9, 1989, in the very speech in which he congratulated the army on its efforts on behalf of the state in Tiananmen Square, Deng Xiaoping reaffirmed his resolve to continued economic reform:

> Is our basic concept of reforms and openness wrong? No. . . . [W]e must continue to persist in integrating a planned economy with a market economy. There cannot be any change in this policy. In practical work we can place more emphasis on planning in the adjustment period. At other times, there can be a little more market regulation, so as to allow more flexibility. The

196. *See* the State Council Land Use Rights Regulations, *supra* note 94, ch. 7, especially art. 45. The State Council regulations however contain no provision regarding the transformation of the intermediate payment system (*tudi piyong*) into the new system. This may be because the intermediate system is already an improvement on the old system and the regulations' transitional provisions would become applicable when the use period under the intermediate system expires.

197. *See supra* notes 121 and 170-72 and accompanying text for the applicable tax rates.

198. The Hainan regulations provide:

> State land occupied by organs, groups, enterprises, public institutions, the armed forces or individuals before the promulgation of these Measures shall also be subject to the implementation of the system of compensatory usage of land for specified periods of time. . . . If any of the above-mentioned land user units or individuals conduct compensatory assignment of land use rights, it shall report the details to the State Land Bureau. . . and shall carry out assignment procedures in accordance with the law. Of the land price payment collected on the assignment . . . 50% shall be paid to the municipal or county finance organ. . . .

Hainan regulations, *supra* note 81, art. 25.

199. *Id.*

> future policy should still be an integration of planned economy and market economy. What is important is that we should never change China into a closed country.[200]

Deng continued, saying that "[i]f there is any inadequacy to talk about, then I should say our reforms and openness have not proceeded well enough."[201] Recent developments in the real estate field include the American company MGM's acquisition of a seventy year lease on 1.9 square miles of land in Tianjin to build an industrial park,[202] and Guangzhou's plans to lease seven plots of downtown land totalling 10.4 acres.[203] These developments indicate that the Chinese leadership does indeed want real estate markets in urban China to emerge as a vehicle for attracting foreign investment.

V. THEORY AND IMPLICATIONS

The transition from the traditional method of state bureaucratic land management to a system in which land use rights trade in a commodity market was as innovative ideologically as it is economically. The key to making the development of a commodity market ideologically consistent with socialist concepts of public ownership was the recent theoretical discovery that "use and management" could be separated from "ownership." The use/ownership distinction is a result of the ideological dilemma the government faces in trying to adhere both to socialism and to commodity economics. On one hand they must remain committed to "the four cardinal principles";[204] on the other hand, they are committed to economic modernization and the development of an economy in which not only consumer goods, but factors of production such as labor and land trade as commodities.[205]

This twist in the socialist perspective is achieved by the Chinese authorities in two steps. The Chinese economy must pass through a stage of capital accumulation (if not capitalism) before the material conditions of true socialism can be attained.[206]

In the report to the Thirteenth CPC National Congress, General Secretary Zhao Ziyang thus proclaimed:

> Our Party has already made a clear and definite statement on this question: China is now in the primary stage of socialism. . . . We must proceed from this

200. FBIS-CHI, No.89-122, June 27, 1989, at 8, 10 (English translation).

201. *Id.*

202. *Tianjin Signs Biggest Foreign Investment Project*, Renmin Ribao (Overseas), Aug. 9, 1989, at 1. It is estimated that the completion of the project will cost MGM approximately US$3 billion.

203. *China to Lease Seven Sites in Guangzhou to Foreigners*, Asian Wall Street Journal Weekly, Aug. 21, 1989, at 10.

204. These four principles are: (1) Adherence to the Socialist Road, (2) the Dictatorship of the Proletariat, (3) the Leadership of the Communist Party and, (4) the Guidance of Marxism-Leninism-Mao Zedong thought. *See* PRC Const. preamble, *reprinted in* 1988 China Laws For Foreign Business (CCH Austl. Ltd.) ¶ 4-500; *Deng Xiaoping on Upholding the Four Cardinal Principles and Combating Bourgeois Liberalization*, BEIJING REV., July 16-19, 1989, at 20-22.

205. Zhao Ziyang, *supra* note 1.

206. *Id.* at 26-27.

> reality and not jump over this stage. Under the specific historical conditions of contemporary China, to believe that the Chinese people cannot take the socialist road without going through the stage of fully developed capitalism is to take a mechanistic position on the question of the development of the revolution, and that is the major cognitive root of Right [sic] mistakes. On the other hand, to believe that it is possible to jump over the primary stage of socialism, in which the productive forces are to be highly developed, is to take a utopian position on this question, and that is the major cognitive root of Left [sic] mistakes.[207]

Such high authority permitted both Chinese lawyers and economists to assert in 1988[208] what Adam Smith asserted in 1776:[209] that a clear definition of property rights is necessary to provide adequate incentives for investment and individual initiative.

The Chinese have thus conceded that the old administrative practice of gratuitous allocation of perpetual land use rights erred in not allowing the factors of production to be circulated.[210] What was needed was a conceptual system of property rights encouraging the efficient circulation of productive resources, while maintaining some semblance of socialism. The separation of "use" from "ownership" accomplished this. As stated by a prominent economist in the Party's theoretical journal, "[t]he fact that we have come to realize the possibility of separation between ownership rights and operational rights of the enterprises under ownership by the whole people should be taken as a theoretical breakthrough."[211]This was the innovation that permitted the whole range of reforms from the household responsibility contract to the establishment of the foundations of real estate markets under the new land administration system in urban areas.

If the economic reforms proceed as promised by Deng Xiaoping, and if the land use system continues in the present direction, foreign and domestic

207. *Id.* at 25-26.

208. Zhou Qiren, *Land System: Valid Property Rights, Long Term Tenancy, and Paid Transfer*, JINGJI CANKAO [Economic References], Nov. 2, 1988, at 4, *translated in* FBIS-CHI, No. 88-226, Nov. 23, 1988, at 41, 42.

See also, Song Tingming, *Public Ownership, Profit Mechanisms, Contract Responsibility System*, Renmin Ribao, Feb. 27, 1989, at 6, *translated in* FBIS-CHI, No. 89-043, Mar. 7, 1989, at 30, 31: "[N]o one can change the law that people are born to seek their own economic interests. One can only bow to it."

209. "It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own interest." A. SMITH, THE WEALTH OF NATIONS 14 (Random House Ed. 1937). This radical departure from Marxist ontology is not being accepted easily by the Chinese authorities who continue, especially after the events in Tiananmen Square, to denounce "bourgeois liberalism" and consumerism.

210. *See* Zhou Quiren, *supra* note 208.

> In the past, our system was to a very great extent under the condition that possessing something equalled owning it. Factories had large numbers of machines and equipment but they were not used or transferred; land was occupied but was not fully used or sold. This is because society did not recognize the right to sell, and returns were not protected.

Id. at 42.

211. Xiao Liang, *A Decade of Ownership Study and Reform in Retrospect*, QIUSHI [Seeking Truth], 1988, No. 11, at 22, *translated in* FBIS-CHI, No. 89-010, Jan. 17, 1989, at 48.

Chinese investors alike may look forward to the development of vigorous real estate markets in urban China.

The use of land in China will naturally remain subject to rigorous control by the state. Indeed, Deng's speech foreshadows "more emphasis on planning in the adjustment period."[212] However, unrestricted land use rights have never existed, even in the West. In modern Western cities, land regulation is, if anything, more extensive than that existing in China currently. Only the most libertarian deny that some measure of social control over the use of such an essential commodity as land is desirable.[213] The problem is to strike a balance between the autonomy of the individual and the interests of the community.[214]

From this point of view, the emerging urban land system in China is not fundamentally different from what is common in the West: land will be managed and operated on a decentralized basis by more or less autonomous individuals and corporate economic agents, subject to the planning requirements of the state. What distinguishes the two systems is their differing points of departure. In the West, where land has long been privately owned, the state exerts control by regulation; in China, where the point of departure is state ownership, similar results are achieved in a more proprietary manner—through the use of leasing contracts. Of course, the balance struck in the end may be quite different. In an excellent comparative study of Soviet and American land use regulation, Professor John Hazard considers the balance between community and individual interest.[215] He notes that privately owned land in the United States, where the balance is in favor of the private owner, is being subjected to more restraints in the interest of community welfare.[216]

Western property markets and Western economies in general have been relatively prosperous under such regimes of regulated property rights. Perhaps, with a similar system, China can hope to achieve equal results. In fact, with the controlled duration of land use rights in China, the state effectively imposes limited accumulation of wealth in property markets by individuals and, by doing so, better preserves the public interest than could an unlimited free market regime of land ownership. It is for this reason that, although the gap between Chinese and Western land use systems is narrowing, the Chinese system can hope to achieve even better results.

212. *See supra* note 200, at 10.

213. *See, e.g.*, R. NOZIC, ANARCHY, STATE, AND UTOPIA 3-9 (1974).

214. Of course, there is a very great difference in the underlying reasons for striking this balance. Whereas in Western liberal democracies, the autonomy of the individual is an end in itself, Chinese authorities view it mainly as a means of invigorating the economy. *See supra* note 34, documents VI-VII.

215. Parker School of Foreign and Comparative Law, Soviet Legal Institutions: A Manual for Comparison 73 (J. Hazard, ed. 1988) (unpublished course materials, Columbia University) (on file at the offices of the *International Tax & Business Lawyer*).

216. *Id.*