United States International Trade Commission

# China: Description of Selected Government Practices and Policies Affecting Decision-Making in the Economy

Investigation No. 332-492
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# U.S. International Trade Commission

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# U.S. International Trade Commission

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# China: Description of Selected Government Practices and Policies Affecting Decision Making in the Economy

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# Abbreviations, Acronyms, and Definitions

## Frequently Used Abbreviations and Acronyms

| | |
|---|---|
| ADB | Asian Development Bank |
| COE | collective-owned enterprise* |
| EIT | enterprise income tax* |
| FDI | foreign direct investment |
| FIE | foreign-invested enterprise* |
| GDP | gross domestic product |
| MOFCOM | Ministry of Commerce (China) |
| HS | Harmonized System (of tariff classification) |
| HTDZ | High-technology development zone* |
| IP | Intellectual property |
| MOU | Memorandum of Understanding |
| NDRC | National Development and Reform Commission* |
| NPC | National People's Congress (China) |
| OECD | Organization for Economic Cooperation and Development |
| PBOC | People's Bank of China* |
| PRC | People's Republic of China |
| R&D | research and development |
| RMB | Renminbi (China's currency)* |
| S&T | science and technology |
| SASAC | State-owned Assets Supervision and Administration Commission* |
| SOE | state-owned enterprise* |
| USTR | United States Trade Representative |
| VAT | value-added tax* |
| WTO | World Trade Organization |

* These terms are defined below.

## Definitions of Frequently Used Terms

**11th Five-Year Foreign Capital Utilization Plan (Foreign Capital Utilization Plan), 2006–2010:** China's plans for utilizing foreign capital in service of the broader 11th Five-Year Plan. Principal goals of the Plan include encouraging "quality over quantity of foreign investment," foreign investment in high-technology projects, liberalization of FDI in services, and encouragement of FDI in infrastructure and environmentally friendly investments.

**11th Five-Year Plan for National Economic and Social Development (11th Five-Year Plan), 2006–2010:** Chinese central government list of priorities for the upcoming five years, presented to the National People's Congress by the NDRC.

**2006–2020 Medium- and Long-Term National Science and Technology Development Program (S&T Plan):** China's 15-year plan largely geared to foster indigenous innovation.

**Antimonopoly Law:** Bans price-fixing, collusion, excessive market concentration, and other monopolistic practices by private and state-owned businesses. The law also calls for the Chinese government to conduct more formal reviews of foreign purchases of Chinese companies based on their potential to harm national security. Passed in August 2007, the Antimonopoly Law is scheduled to enter into force in August 2008.

**Anti-Unfair-Competition Law:** Promulgated in 1993, the law prohibits price fixing or bid rigging and also addresses many other issues, including bribery, deceptive advertising, coercive sales, appropriation of business secrets, and others, but does not address antitrust issues related to mergers and acquisitions.

**Build-Operate-Transfer (BOT) project:** A system whereby a construction company raises capital to pay for the construction costs of the facility, then recoups its costs and/or additional profits through user fees such as highway tolls, and transfers the project to the government or another owner after a designated time period.

**Business tax:** A tax on the sales of services, including transportation, construction, banking, insurance, postal, telecommunications, recreation, transfer of immovable property, and sale of intangible assets.

**Catalog for the Guidance of Foreign Investment Industries:** Central government catalog of industries, divided into encouraged, restricted, and prohibited categories. Industries in the "encouraged" category receive special tax incentives, and industries in the "restricted" category are limited to investment as joint ventures with Chinese firms.

**China Banking Regulatory Commission (CBRC):** Regulatory authority for banks and financial institutions.

**China Securities Regulatory Commission (CSRC):** Regulatory authority for firms and activities in the securities markets.

**Collective-owned enterprises (COE):** Enterprises whose assets are owned by a collective body of workers, commonly found in the agricultural sector.

**Consumption tax:** Tax based on the price or number of units of tobacco, alcohol, cosmetics, jewelry, fireworks, gasoline, diesel, tires, and motor vehicles. This tax is in addition to the VAT.

**Corporatization:** An interim form of privatization in which state-owned firms are converted into stock companies, whose shares are partially transferred to nongovernmental agents.

**Domestic private enterprises:** Enterprises controlled by "natural persons" who hire workers for profit-making purposes.

**Develop the West program:** Broad central government policy, enacted in different ways by different provinces and localities, but generally leading to more financing for infrastructure projects in the Western provinces. Also called the Go West program, the Western Development Initiative, and other titles.

**Enterprise income tax (EIT):** Income tax law covering all firms based in China except some single proprietorships and partnerships (which are covered by the individual income tax).

**Foreign firms**: Enterprises owned by firms outside of mainland China, Hong Kong, Macau, and Taiwan.

**Foreign-invested enterprise (FIE):** A firm with 25 percent or more investment from outside of China. Until 2008, these firms are covered by a different income tax law than domestic firms.

**Foreign Trade Law:** Passed in 2004, this law applies to foreign trade—the import and export of goods and technologies and trade in services—and the protection of foreign trade-related intellectual property rights.

**High-technology development zone (HTDZ):** A regional development program initiated under the Torch R&D Program in 1991. Enterprises that register in an HTDZ benefit from preferential policies in such areas as taxes and import/export policies.

**Independent municipality:** One of four cities (Beijing, Tianjin, Shanghai, and Chongqing) that are not part of a larger province. These city governments report directly to the central government in Beijing.

**Indicative lending:** Loans made to industry, usually at preferential rates, on the basis of economic or political motives, often without regard to the firms' ability to repay the loan. Also known as directed, or targeted, lending.

**Indigenous innovation:** A key term used in the S&T Plan referring to innovation that originates in China. The term also has been interpreted to mean independent or homegrown innovation.

**Indirect tax:** A tax, such as a sales tax or value-added tax, that is levied on goods or services rather than individuals and is ultimately paid by consumers in the form of higher prices.

**Infrastructure:** Energy, including electric power and natural gas facilities; telecommunications; transport, including roads, seaports, airports, and railroads; and water and sewerage, defined as treatment plants and utilities.

**Joint-stock commercial banks:** Shareholding banks that are smaller than the SOCBs and tend to be better managed. These banks compete with the SOCBs, but tend to stay away from policy lending.

**National and regional commercial banks:** Banks that concentrate on serving the needs of small and medium-size enterprises.

**National Development and Reform Commission (NDRC):** A macroeconomic management agency under the State Council that studies and formulates policies for economic and social development, maintains a balance of economic aggregates, and guides overall economic restructuring in China.

**National People's Congress (NPC)**: China's top legislative institution.

**National policy banks:** Banks responsible for making loans in support of the government's economic growth agenda. They include the China Development Bank, Export-Import Bank of China, and the Agricultural Development Bank of China.

**Nonperforming loans:** Loans that are in default.

**Oversees enterprises:** Enterprises owned by firms in Hong Kong, Macau, and Taiwan

**People's Bank of China (PBOC):** The central bank of China.

**Price Law:** Passed in 1997, the Price Law has provisions against improper pricing behaviors, including price fixing, predatory pricing, and price discrimination.

**Privatization:** The transfer of the ownership of firms within an industry (or entire industries) from the state to the private sector.

**Processing trade:** A pattern of trade in which imports of raw materials or intermediate goods are used to produce goods for export. China has policies for both import duties and value-added tax which favor imports and exports for processing trade. The favored imports are distinguished from "normal" imports and exports in China's customs data.

**Rationalization:** The weeding out of unprofitable firms within an industry so that only the most profitable ones remain.

**Renminbi (RMB):** China's currency (also known as yuan). Unless otherwise stated, the following exchange rates (RMB per U.S. dollar) are used in this report are: 8.2770 (2001); 8.2771 (2002); 8.2772 (2003); 8.2767 (2004); 8.1936 (2005); 8.2603 (2001–2005 average); 7.9723 (2006). Exchange rates are period averages and were obtained from the U.S. Federal Reserve.

**Research and development (R&D):** Based on international standards, R&D is creative work undertaken on a systematic basis to increase the stock of knowledge and the use of this knowledge to devise new applications.

**Sanitary and phytosanitary (SPS) measures:** Regulations established by governments to protect human, animal, and plant life and health, and to help ensure that food is safe for consumption.

**Special economic zone (SEZ):** Geographic area in which foreign investors, and sometimes domestic investors, receive special tax and other incentives for establishing a joint venture or wholly owned business.

**State-owned Asset Supervision and Administration Commission (SASAC):** Government body established in 2003 under the State Council to manage SOE assets and implement SOE reform initiatives.

**State-owned commercial banks (SOCBs):** China's five largest commercial banks whose primary stakeholder is the government of China. They include the Agricultural Bank of China, Bank of China, Bank of Communications, China Construction Bank, and Industrial and Commercial Bank of China.

**State-owned enterprise (SOE):** An enterprise whose assets are owned by the government. These include enterprises whose share of state assets exceeds that of any other single shareholder.

**Township-village enterprise (TVE):** The most common form of collective-owned enterprise, owned by a body of workers in a township-village area, and almost exclusively found in rural settings.

**Value-added tax (VAT):** Tax on the value-added content in production for goods (and repair services) produced in China and on the value of goods imported into China. Most services in China are covered by the business tax rather than the VAT.

# Executive Summary

This is the first in a series of three reports by the U.S. International Trade Commission (the Commission) on U.S.–China trade requested by the Committee on Ways and Means (the Committee) of the U.S. House of Representatives. The Committee requested that this first study describe the practices and policies that China's central, provincial, and local government bodies use to support and attempt to influence decision making in the economy, including the manufacturing, agricultural, and services sectors; the second study is to assess, to the extent possible, the relative impact of these policies on selected sectors; and the third study is to examine the role of these policies in influencing patterns of production and investment in the Asian region.[1]

As requested by the Committee, this report provides a description of government practices and policies in China with respect to the following topics: industrial development; the rationalization and closure of uneconomic enterprises; privatization of state-owned enterprises (SOEs) and private ownership; price coordination; utility rates; taxation; the banking and finance sectors; infrastructure development; research and development; worker training and retraining; and restraints on imports and exports. This report also provides an analysis of the likely impact of the December 2006 policy directive from China's State-Owned Assets Supervision and Administration Commission (SASAC), a directive that outlines the industries the Chinese government considers to be strategically important.

The pace and magnitude of China's economic changes create challenges to understanding the role of the government in firm-level decision making in China's manufacturing, agricultural, and services sectors. Although the extent of government involvement varies by sector in China's economy, the government is less involved than in the past. Moreover, China's economic practices and policies are rapidly changing. For example, in 2007 alone, China's government instituted a new bankruptcy law, a new enterprise income tax law, new banking regulations, a property rights law, an antimonopoly law, and regulations providing for the removal of tax rebates for exports. Also in 2007, the United States and China signed a memorandum of understanding that is intended to eliminate, by

[1] Additional information about the request for this series of reports is provided in app. A.

January 1, 2008, certain Chinese measures challenged by the United States and Mexico at the World Trade Organization (WTO).[2]

China's economic policy and political traditions, as well as continued government intervention in all aspects of the economy, have created substantial ambiguity in the way laws are interpreted and applied in China. In addition, competing lines of political and economic control effectively grant China's provincial and local government authorities significant policy independence under the framework of broader central government policy directives. Thus, the interpretation and implementation of policies and regulations at different levels of government can be inconsistent.

# Summary of Findings

**Industrial development:** China has numerous policies that specify favorable (or unfavorable) treatment for industries. China's current industrial policy focuses on efforts to encourage the growth of industries that can contribute to overall economic expansion and that specialize in more sophisticated products, encourage the use of new or more sophisticated technologies, discourage the use of environmentally damaging or obsolete technologies, and improve productivity and competitiveness. Since 1989, China has classified industries as "encouraged," "restricted," or "to be eliminated." This system of classification—most recently revised in December 2005—is used to determine the financial and tax incentives that industries receive. A parallel classification system is the basis for determining the industries into which China's foreign investment policy seeks to guide investment, for allowing foreign investors to establish joint ventures, and for receiving industrial incentives such as preferential tax rates.

**Rationalization (privatization and closure of uneconomic enterprises) and private ownership:** China's current economic structure reflects both the legacy of central planning and elements of a competitive, modern, and increasingly market-based economy. The central government's rationalization objectives include closing uneconomic enterprises and "corporatizing" certain SOEs. Corporatization in China refers to a partial form of privatization under which SOE assets are converted into corporate shares and partially sold to the public.

[2] On November 29, 2007, the Office of the United States Trade Representative (USTR) announced that the United States signed a "Memorandum of Understanding Between the United States of America and the People's Republic of China Regarding Certain Measures Granting Refunds, Reductions or Exemptions from Taxes or Other Payments." The United States had requested consultations with China under the WTO dispute settlement system with respect to twelve measures. The United States alleged that these measures, in the form of refunds, reductions, and exemptions, were granted on the condition that companies purchase domestic over imported goods or on the condition that they meet certain export performance criteria. After the MOU was signed, the United States and Mexico agreed to suspend their WTO challenges; however, they will not formally withdraw their complaints until all of China's commitments under the MOU are completed. An analysis of the probable impact of China's implementation of the MOU is beyond the scope of this investigation; however, relevant sections of the MOU are noted where appropriate and the full text of the MOU is contained in app. F of this report. See also WTO, "China—Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and other Payments."

**SASAC and its December 2006 policy directive:** SASAC supervises and manages China's SOEs. In its December 2006 directive, SASAC provided, for the first time, insight into the type of industries in which the government will maintain strong ownership positions. The directive identifies a group of "strategic industries," including the following: armament, power generation, petroleum and telecommunications. The directive also identifies a group of "pillar industries," including the following: machinery, automobiles, and information technology. The new policy directs SASAC to maintain at least a 50 percent equity stake in each "strategic industry" firm, as well as in principle "pillar industry" firms.

**Price coordination:** China's central, provincial, and local governments use government-set and government guidance prices for certain goods and services (including certain agricultural commodities such as rice, wheat, tobacco, cotton, vegetable oil, and sugar; pharmaceutical products and medical devices; and energy products such as coal, electricity, natural gas, and oil). Approximately 4 percent of all commodities by volume of sales in China were subject to price controls in 2006. China's central government also restricts to state-trading enterprises the importation of certain goods (including grain, vegetable oil, sugar, tobacco, crude and processed oil, chemical fertilizers, and cotton). China's legacy of central government planning, with a limited framework of competition policy or competition law, has effectively resulted in some monopolistic practices on the part of both SOEs and private firms. China's new Antimonopoly Law is scheduled to enter into force in August 2008. Although the law may address some of these concerns when it is implemented, it does not cover the agricultural sector, government-controlled monopolies, or SOEs. In addition, the new law allows monopoly agreements in certain cases.

**Utility rates:** China's central government sets utility rates to ensure that costs are covered and to either promote or discourage certain industries. Historically, some Chinese industries and sectors have received below-market rates or free electricity, water (especially irrigation water for the agricultural sector), and natural gas. Beginning in 2004, some energy-intensive Chinese industries reportedly were charged significantly above-market rates for electricity and water; a new round of utility price increases for these industries was implemented in 2006 to encourage further resource and environmental conservation. In addition, provincial and local governments offer utility, electricity, and water rate discounts to promote industrial and agricultural development in their localities.

**Taxation:** China's new Enterprise Income Tax (EIT) Law provides a unified tax rate for domestic and foreign-invested enterprises beginning in 2008, thereby abolishing the favorable tax treatment of foreign-invested enterprises and certain other promotional tax policies. The new EIT Law also offers favorable tax treatment for domestic and foreign-invested firms engaged in "encouraged" activities or in geographical regions or projects promoted by the central government. Other key taxation practices and policies identified include selective reduction or elimination of value-added tax (VAT) rebates for exports, and taxes and fees that are inconsistently assessed by provincial and local governments.

**Banking and finance:** China's central government continues to play a significant role in the banking and finance sector. China's central bank sets interest rates; banks are not permitted to determine interest rates based on customer creditworthiness. Chinese banks lend a disproportionate amount of capital to SOEs. This practice of indicative (or directed) lending at favorable interest rates reportedly is unlikely to change soon, in part because Chinese banks do not have in place systems to conduct effective credit-risk analysis of potential borrowers. The inefficiencies of China's banking system have generated large stocks of nonperforming loans. In 2004, the Chinese government provided a $45 billion capital infusion to the banking sector to help service nonperforming loans. The state-controlled China Investment Corporation, created in September 2007, is to channel one-third of its $200 billion investment capital to replenish the capital of the Agricultural Bank of China, which holds large stocks of nonperforming loans, and the China Development Bank.

**Infrastructure development:** China's Western Development program has resulted in a number of practices and policies implemented by central, provincial, and local governments to provide incentives to develop China's western regions. China's 11th Foreign Capital Utilization Plan (2006–2010) was enacted to encourage the use of foreign direct investment in infrastructure projects. In the same time frame, however, new rules governing the licensing of construction and design services firms have made it more difficult for foreign construction, architecture, and engineering design firms to enter China's market.

**Research and development:** China's 15-Year Science and Technology Plan (2006–2020) sets out the country's research and development (R&D) priorities and goals. These include the following: central government-initiated (applied at all levels of government) activities to promote indigenous R&D; government funding of large-scale R&D programs and projects; preferential tax and financing policies to encourage domestic R&D; preferential government procurement policies to support domestic R&D; the development of high-value domestic intellectual property; and the designation of special economic zones that support domestic R&D activities with preferential access to infrastructure, financing, and other services. The plan also seeks to develop domestic technical standards to decrease dependence on foreign technologies and increase the prominence of standards that rely on domestically controlled intellectual property. Incentives offered by local governments, such as tax exemptions and favorable terms for land use and utilities, reportedly are important factors that influence where R&D or production plants are located in China.

**Worker training and retraining:** China's worker training and retraining practices and policies largely support the country's policies of rationalization of SOEs; these practices and policies are used to help manage the large number of workers laid off from SOEs as well as to reduce unemployment stemming from increasing numbers of rural-to-urban migrants. China's central government has also broadened the national social security system and related employee benefits programs. Provincial and local governments bear much of the burden of funding and implementing these programs.

**Restraints on imports and exports:** China's central government has issued regulations since 2004 to restrict or prohibit imports used under the processing trade relief (PTR) program as well as to restrict or prohibit the types of products that can be exported under the PTR program.[3] Other restraints on imports include automatic licensing requirements for certain items and import bans on certain technologies and machinery. Additional

[3] China's processing trade sector involves the importation of products to be used in the production of semi-finished or finished goods solely for export. A processing trade relief program affords duty-free treatment for imported inputs used in the processing trade sector, and VAT rebates upon export of processing trade goods. A significant share of China's foreign trade occurs as processing trade.

restraints on imports include a lack of transparency with respect to customs regulations and burdensome documentation requirements; tariff-rate quotas on certain agricultural products and fertilizer; burdensome and inconsistently applied product certification requirements; government procurement measures that favor domestic products over imports; nontransparent sanitary and phytosanitary standards; and the failure to adopt international standards. China's key restraints on exports include the following: selective reduction or elimination of VAT rebates for exports; export licensing regime; export taxes; restraints on exports of certain apparel; and tying export privileges to environmental performance.

Table ES.1 lists key Chinese government practices and policies identified by the Commission in this report for each of the economic topics described above.

# Information Sources

Because of the difficulties inherent in any effort to review and describe all of China's central, provincial, and local government legislation and practices, the Commission focused on key practices and policies based on information from a wide range of sources. The sources of information included: testimony at the September 6, 2007, public hearing held by the Commission in connection with this investigation and written submissions received in response to the Commission's *Federal Register* notice; U.S., Chinese, and other foreign government sources; nongovernment, business, industry, and academic sources; and factfinding travel to China by Commission staff during August–September 2007.

**Table ES.1** China: Summary of key government practices and policies

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| **Industrial development** | | |
| Establishment of the most recent catalog of industries identified as "encouraged," "restricted," or "to be eliminated." | • Central government | • December 2005 Interim Regulation on Promoting the Adjustment of Industrial Structure and the Guiding Catalog for the Adjustment of Industrial Structure |
| Taxation policies to promote investment in encouraged industries, and to limit and eliminate investment, respectively, in restricted and to be eliminated categories. | • Central government | • December 2005 Interim Regulation on Promoting the Adjustment of Industrial Structure |
| Credit guidance (indicative lending) | • Central government | • 1995 Commercial Bank Law |
| Amendment of the list of industries in which FDI is encouraged, restricted and to be eliminated, to correspond to the current criteria in the Interim Regulations. | • Central government | • December 2005 Interim Regulation on Promoting the Adjustment of Industrial Structure; Guiding Catalog for the Adjustment of Industrial Structure; and Catalog for the Guidance of Foreign Investment Industries |
| Prohibition of exportation or importation of specific products under the processing trade regime, and reductions or rescinding of VAT rebates for exports, to foster more trade in the encouraged industries, and less in the restricted or to be eliminated industries. | • Central government | • Ministry of Commerce and other agencies announcements in 2007 (multiple notices) |
| SASAC directive to clarify the government's policies and intentions regarding "strategic industries" and "pillar industries." | • Central government | • December 2006 SASAC directive |
| Increased access for private firms in previously restricted industries; equal treatment for private firms and SOEs. | • Central government | • State Council Guidelines on Encouraging and Supporting the Development of the Non-Public Sector including Individual and Private Enterprises |
| Western Development program to promote greater investment, better infrastructure, and financing in western provinces, and to restructure rural industry. | • Central government | • Policy outlined in the 10th and 11th Five-Year Plans |
| Research and development (R&D) policies to promote indigenous innovation and to fund programs to achieve scientific breakthroughs. | • Central government | • 2006–2020 Medium- and Long-Term National Science and Technology Development Program (S&T Plans) |

**Table ES.1** China: Summary of key government practices and policies—*Continued*

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| | **Rationalization and private ownership** | |
| | ***SASAC*** | |
| SASAC established to coordinate rationalization efforts. | • Central, provincial, and local government | • 2003 State Council initiative |
| Guiding Opinion on Promoting the Adjustment of State-Owned Capital and the Reorganization of State-owned Enterprise. | • Central, provincial, and local government | • 2006 State Council directive |
| | ***Privatization/Corporatization*** | |
| Privatized firms given legal standing by the Standing Committee of the National People's Congress. | • Central government | • 1993 Corporate Law |
| Various policy announcements strengthening a shareholding-based privatization system. | • Central government | • 1992, 1997 policy statements; CPC 15th Party Congress |
| Government identifies privatization objectives and identifies the need to withdraw from certain sectors; announces intention to diversify the state sector ownership structure; announces plan to provide a source to finance its national social security system. | • Central government | • 1999 Fourth Plenum of the 15th Central Committee |
| Government institutes legal provision to ensure privatized SOEs represented under the law. | • Central government | • 2003 Corporate Law |
| Government establishes framework for how firms could be privatized (corporatized). | • Central government | • 2003 Corporate Law |
| | ***Closure of uneconomic enterprises*** | |
| Government instituted guidelines for bankruptcy procedures. | • Central government | • 1991 Civil Procedures Law |
| Certain provincial and local governments enacted bankruptcy laws to stimulate the practice in their jurisdiction. | • Provincial government | • 1993 Guangdong Provincial People's Congress and Shenzhen Municipal People's Congress |
| Capital Structure Optimization Program. | • Local government | • 1994 (18 municipal governments) |
| New Bankruptcy Law enacted that applied to all forms of enterprises, placed less emphasis on minimizing worker layoffs, and adjusted payment priorities to reflect modern, international practices. | • Central, provincial, and local government | • 2007 Bankruptcy Law |

**Table ES.1** China: Summary of key government practices and policies—*Continued*

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| **Rationalization and private ownership—*Continued*** | | |
| ***Private ownership*** | | |
| Private ownership incorporated into China's constitution in March 1999. | • Central government | • 1999 constitutional amendments |
| Provincial and local governments relax restrictions on private enterprises. | • Provincial and local governments | • Local government private ownership initiatives |
| Constitutional amendment explicitly stating that private property is inviolable. | • Central, provincial, and local | • March 2004 constitutional amendment |
| Central government institutes requirements to local governments, to implement the constitutional amendments that guarantee private property rights. | • Provincial and local governments | • 2005 Guidelines for Encouraging and Supporting the Development of the Non-Public Sector Including Individual and Private Enterprises |
| First law to state that the government recognizes and protects the rights of all market participants equally, placing ownership rights of the state, agricultural collectives, corporations, and individuals on the same legal footing. | • Central, provincial, and local governments | • 2007 Property Law |
| Bankruptcy laws provide a legal means for enterprises to cease operations and dissolve their assets, and provide guidance with respect to handling laid off workers. | • Central, provincial, and local governments | • Bankruptcy Law, 1986, 1996, 2007<br>• 1991 Bankruptcy Guidelines<br>• 1993 local level bankruptcy law |
| **Policies that target prices** | | |
| ***Price controls*** | | |
| NDRC monitors the overall price levels, as well as the prices of major goods and services. It also conducts inspections of prices of products and services such as electricity, grain, fertilizers, drugs, refined oil, and real estate, as well as charges levied on farmers and enterprises, educational fees, medical charges, and taxi fares. | • Central government | • 1998 Price Law<br>• Various measures implemented by NDRC |
| Price controls (fixed and/or guidance prices) on certain agricultural products, including rice, wheat, tobacco, cotton, vegetable oil, silkworm cocoons, and sugar | • Central government<br>• Agriculture | • 2005 State Council No. 1 Document<br>• 2002 Agricultural Law, art. 37 |
| Tobacco, wheat, and rice subject to minimum procurement prices | • Central government<br>• Agriculture | • Notified in China's WTO accession protocol |
| A number of new price and income support policy measures were implemented in 2004 and extended in 2005 to increase grain production and rural incomes. | • Central government<br>• Agriculture | • Reported by the WTO |

**Table ES.1** China: Summary of key government practices and policies—*Continued*

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| **Policies that target prices**—*Continued* | | |
| ***Price controls***—*Continued* | | |
| Price controls on pharmaceutical products. NDRC, the Ministry of Health, and several provincial pricing bureaus have implemented legislation to control prices of medical devices. | • Central and provincial government<br>• Pharmaceutical products and medical devices | • Pharmaceuticals were the only manufactured product subject to government price controls listed in China's WTO accession protocol |
| NDRC sets end-user prices for coal, electricity, natural gas, and oil | • Central government<br>• Utilities | • 1996 Electric Power Law<br>• 2004 Differential Power Price for Energy Intensive Industries<br>• Often no official policy; prices set by negotiation. |
| Central government controls the price of land-use rights. In 2006, the central government doubled land-use fees for new construction projects and set minimum prices for the sale of land for industrial use. Land-use rights controlled by provincial and local governments. | • Central, provincial, and local governments | • China's Constitution and its revisions in 1988, 1993, and 1999 |
| Imports of grain, vegetable oil, sugar, tobacco, crude and processed oil, chemical fertilizers, and cotton restricted to state-trading enterprises. | • Central government<br>• Agriculture | • 2004 Foreign Trade Law |
| Lack of a comprehensive competition law leaves China vulnerable to anticompetitive conduct by private firms and SOEs. 2007 Antimonopoly Law may address some of these concerns, however allows exemptions to the prohibition on monopoly agreements and does not cover the agricultural sector, government-controlled monopolies, and SOEs. | • Central government | • 2007 Antimonopoly Law |
| ***Utility rates*** | | |
| **General utility rate policies** | | |
| NDRC Price Department sets utility rates at sufficient levels to cover full costs, promoting market-based utility rates for economic rationalization of industry. | • Primarily central government; provincial and local governments can propose different rates. | • 1996 Electric Power Law |
| **Electricity** | | |
| Preferential or negotiated electricity rates are sometimes provided by local officials as an incentive to attract firms to set up production in their locality. | • Provincial and local governments | • No official policy; assistance provided on a negotiated basis |
| Higher utility rates charged to discourage certain industries. | • Central government | • 2004 Differential Power Price for Energy-Intensive Industries |

**Table ES.1** China: Summary of key government practices and policies—*Continued*

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| **Policies that target prices**—*Continued* | | |
| ***Utility rates***—*Continued* | | |
| **Water** | | |
| Provides for preferential electricity and water rates to manufacturing firms and preferential water rates for agriculture. | • Provincial and local governments | • 2002 Water Law |
| **Other sector-specific policies** | | |
| Preferential electricity and water rates to manufacturing firms and preferential water rates to agriculture. | • Primarily local governments | • Often no official policy; assistance provided on a negotiated basis |
| NDRC Price Department determines end user prices based on prices of other natural resources, such as natural gas and petroleum. | • Central government | • Natural gas generally regulated by same NDRC departments that regulate electricity |
| Preferential electricity and water rates to manufacturing firms and preferential water rates for agriculture. | • Primarily local | • Often no official policy; assistance provided on a negotiated basis |
| Enterprise income tax (EIT) policies promoting foreign-invested enterprises (FIEs). (See note at end of table.) | • Central government | • 1991 FIE Income Tax Law; FIE incentives to be abolished under the United Enterprise Income Tax Law in 2008 |
| ***Taxation*** | | |
| Enterprise income tax (EIT) policies promoting foreign-invested enterprises (FIEs). (See note at end of table.) | • Central government | • 1991 FIE Income Tax Law; FIE incentives to be abolished under the United Enterprise Income Tax Law in 2008 |
| EIT and VAT policies promoting regional development for less-developed regions. | • Central government | • EIT Laws 1991, 1993, 2008<br>• 2004 VAT reform for northeast region and 2007 reform for central region |
| EIT policies promoting high- and new-technology. | • Central government | • EIT Laws 1991, 2008 |
| EIT rates promoting the export of manufactured goods. | • Central government | • 1991 EIT Law; incentives for manufacturers to be abolished under the United Enterprise income tax in 2008 |

**Table ES.1** China: Summary of key government practices and policies—*Continued*

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| | **Policies that target prices**—*Continued* | |
| | ***Taxation***—*Continued* | |
| EIT and VAT refunds promoting local investment. | • Local governments are allowed to make these concessions within a framework provided by the central government | • EIT Laws 1991, 1993, and 2008<br>• 1994 VAT regulations |
| Local governments may offer additional, and sometimes unauthorized, tax and other incentives to encourage investment and promote growth. | • Provincial and local governments | • No official policy; practice reported by sources |
| Tax laws created by central government, but tax collection, interpretation, and enforcement conducted at provincial and local levels. | • Central, provincial, and local governments | • No official policy; practice reported by sources |
| Different interpretations of the same law may be in use at the same time in different parts of the country. | • Central, provincial, and local governments | • No official policy; practice reported by sources |
| Measures to promote agriculture including reduced EIT and VAT for agricultural products, and elimination of agriculture taxes and tax on land converted from agricultural purposes. | • Central government<br>• Agriculture sector | • EIT Laws of 1991, 1993, 2008<br>• 1994 VAT regulations<br>• 1987 farm land occupation tax |
| | **Policies that target domestic distortions or inefficiencies in the economy** | |
| | ***Banking and finance sector*** | |
| Central government maintains a pervasive role in China's banking system. | • Central government | • 1995 Commercial Bank Law |
| Central government has instructed state-owned commercial banks to reduce the number of local bank branches, and let provincial and rural banks expand service in those markets. | • Central, provincial, and local governments | • 1995 Commercial Bank Law |
| China's banks channel a disproportionate amount of capital to larger SOEs. | • Central government | • 1995 Commercial Bank Law |
| Government bailouts of banks implemented to address the problem of nonperforming loans. | • Central government | • 1995 Commercial Bank Law |
| Government-directed commercial lending practices implemented to address the problem of nonperforming loans. | • Central government | • 2002 Guidelines on the Internal Controls of Commercial Banks |
| Interest rates are set by the People's Bank of China. | • Central government | • 1995 Law on the People's Bank of China |

**Table ES.1** China: Summary of key government practices and policies—*Continued*

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| **Policies that target domestic distortions or inefficiencies in the economy**—*Continued* | | |
| ***Infrastructure development*** | | |
| Western Development program to provide greater financing and infrastructure projects in China's western provinces. | • Broad central government policy, implemented differently by individual provinces and localities | • Policy outlined in the 10th and 11th Five-Year Plans |
| 11th Foreign Capital Utilization Plan includes policy encouraging increased use of FDI for infrastructure projects. | • Broad central government policy, implemented differently by individual provinces and localities | • Policy connected to China's 11th Five-Year Plan |
| Decision to permit more market-based forces to be taken into account in decisions about infrastructure projects. Clarification of the roles of the central versus local governments in infrastructure projects. | • Central government, applies to investment decisions in infrastructure projects | • State Council Decision on Reform of the Investment System |
| Approval of large infrastructure projects that cross provincial boundaries is handled by the central government. Smaller-scale projects are approved by local governments. | • Central, provincial, or local governments, (depending on the size of the project) | • Large projects may be included in the central government's five-year plans. Smaller projects are included in each city's 20-year urban master plan. |
| New rules to clarify licensing of foreign construction firms have made it more difficult for foreign firms to enter the Chinese market, particularly for large projects. | • Central government, applies to all local areas | • Ministry of Construction Decree 113 of 2002; Implemented in 2006 |
| New rules to clarify licensing of foreign architectural and engineering design firms have made it more difficult for foreign firms to enter the Chinese market, particularly for large projects. | • Central government, applies to all local areas | • Ministry of Construction, Decree 114 of 2002; Implemented in 2007 |
| ***Research and development (R&D)*** | | |
| Promoting indigenous innovation. | • Central government initiated, applied at all levels | • Policy outlined in S&T Plan and National S&T Development 5 Year Plans (S&T Plans) |
| Supporting achievement of scientific breakthroughs through R&D funding programs and large-scale projects. | • Central government initiated, applied at all levels | • Policy outlined in S&T Plan and S&T Plans |
| Preferential tax policies to encourage R&D investment, including deduction of 150 percent of R&D expenses from taxable income for domestic and foreign enterprises. (See note at end of table.) | • Central government initiated, applied at all levels | • Policy outlined in S&T Plan and S&T Plans |

**Table ES.1** China: Summary of key government practices and policies—*Continued*

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| **Policies that target domestic distortions or inefficiencies in the economy**—*Continued* | | |
| ***Research and development (R&D)***—*Continued* | | |
| Financing policies to encourage R&D investment, including preferential access to policy and commercial loans and venture capital. | • Central government initiated, applied at all levels | • Policy outlined in S&T Plan and S&T Plans |
| Preferential government procurement policies to support domestic innovation. | • Central government initiated, applied at all levels | • Policy outlined in S&T Plan and S&T Plans |
| IPR and technical standards policies to support domestic innovation | • Central government initiated, applied at all levels | • Policy outlined in S&T Plan and S&T Plans |
| Designation of special economic zones, including high-tech development zones, that receive preferential policies in the areas of land, taxes, import and export policies, funding and loans. | • Central government initiated, applied at all levels | • Policy initiated with the creation of the Torch Program in 1988. |
| ***Worker training and retraining*** | | |
| Social security liabilities, such as pension and related expenses, transferred from SOEs to provincial and local government budgets | • Central government policy, implemented and funded by provincial and local governments | • 1994 Employment Law<br>• 1994 Labor Law, revised 1998 following Conference on Safeguarding the Basic Living Standards of Laid-off Workers in SOEs and their Reemployment<br>• 2002 Circular on Making Further Efforts to Help Re-employment of Xiagang and Unemployed Workers |
| Adoption of active employment policies that largely aim to extend social security coverage to all urban unemployed workers. Key features include preferential reemployment policies to support laid-off SOE workers, employment services and vocational training; expansion of social security system to cover all laid-off SOE workers and urban unemployed; coordinated employment policies for both urban and rural workers | • Central government policy, implemented and funded by provincial and local governments | • 2007 Employment Contract Law<br>• 2007 Employment Promotion Law |
| Promotion of worker training in rural areas | • Central government policy, implemented and funded by provincial and local governments. | • March 2007 policy statement by Premier Wen Jiabao. |

**Table ES.1** China: Summary of key government practices and policies—*Continued*

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| | **Policies that directly affect trade** *Restraints on imports* | |
| Tariffs | • Central government | • 2004 Foreign Trade Law |
| Reduced tariff preferences for imports under processing trade relief (PTR). Some imported products excluded from PTR; other products require deposits before being imported. | • Central government | • Ministry of Commerce and other agency announcements in 2007 (multiple notices) |
| Approximately 740 items currently are subject to automatic import licensing, including certain machinery, electrical equipment, motor vehicles, aircraft, boats and ships, measuring instruments, chemicals, steel and steel products. | • Central government | • 2004 Foreign Trade Law<br>• Regulation on the Administration of the Import and Export of Goods<br>• Administrative Permission Law<br>• Measures for Administration of Automatic Import Licensing for Goods<br>• Various ministerial announcements |
| Tariff rate quotas (TRQs) and import licensing for imports of certain agricultural and fertilizer products. | • Central government | • 2004 Foreign Trade Law<br>• Interim Measures on Administration of Tariff Rate Quota for Importation of Agricultural Products and for Importation of Fertilizers |
| Nontransparent import licensing process. | • Central government | • Interim Measures on Administration of Tariff Rate Quota for Importation of Agricultural Products and for Importation of Fertilizers |
| Restrictions on imports of certain technologies and machinery in order to promote indigenous innovation. | • Central government | • S&T Plan |
| Lack of customs transparency and uneven application of customs regulations. | • Central government | • 2001 Customs Law |
| Burdensome documentation requirements and pre-shipment inspections for imports of used equipment. | • Central government | • 2001 Customs Law<br>• 2002 Law on Import and Export Commodity Inspection |
| Product certification process for imports may be burdensome and expensive for foreign suppliers. | • Central government | • 2002 Regulations for Compulsory Product Certification |
| Government procurement law does not apply to SOEs. Chinese governmental entities are not obligated to include foreign participation for government procurement. | • Central government | • 2003 Law on Government Procurement |

**Table ES.1** China: Summary of key government practices and policies—*Continued*

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| **Policies that directly affect trade**—*Continued* | | |
| ***Restraints on imports***—*Continued* | | |
| Nontransparent sanitary and phytosanitary regulations and practices, including failure to notify the WTO of some SPS measures. Use of nontransparent and non-internationally accepted standards. | • Central government | • 2002 Law on Import and Export Commodity Inspection |
| Antidumping and countervailing duty regime is nontransparent. | • Central government | • 2004 Foreign Trade Law<br>• Antidumping Regulations |
| Reservations on service industries for which China has made WTO accession commitments and for service industries where China made no market access commitments. | • Central government | • None applicable |
| ***Restraints on exports*** | | |
| Certain goods subject to export taxes. | • Central government | • Regulations on Import and Export Tariff. |
| Export licensing regime, including export quotas, export quota bidding, and export licenses. | • Central government | • Foreign Trade Law<br>• Administrative Regulations on Commodity Import and Export |
| Restrictions on exports from companies that violate domestic pollution control regulations. | • Central government | • Environmental Regulatory Notice no. 392, Oct. 8, 2007 |
| Export licenses limit exports of certain textiles and apparel to certain annual quantity thresholds. | • Central government | • Bilateral agreements with the United States (2006) and the European Union (2007) |
| Regulation that restricts exports from companies that violate domestic pollution control regulations to control undesirable export growth. | • Central government | • Ministry of Commerce and Environmental Protection, Agency Environmental Regulatory Notice no. 392 (2007) |

**Table ES.1** China: Summary of key government practices and policies—*Continued*

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| **Policies that directly affect trade**—*Continued* <br> ***Restraints on imports***—*Continued* | | |
| Cancellation and elimination of export VAT rebates to control the growth of China's trade surplus, optimize the commodity structure of its exports, reduce the export of products with high energy consumption, serious pollution, and low value added, promote sustainable economic development, and curb trade friction. | • Central government | • Ministry of Finance announcements (several) 2007 |

Sources: 1994 Employment Law; China Banking Regulatory Commission website; *China Distribution and Trading*, "China's Corporate Income Tax Reform; China Law & Practice, "Beijing's New Rules on Municipal Infrastructure Projects," "Infrastructure Projects," "Private Investment in Urban Utilities," and "Railway Construction in China"; EIU, *Country Commerce: China*; EIU, *Country Finance: China*; ENR, "China's Project Management Rules Have Foreigners Fuming"; Green, "On the Shenzhen Factory Floor, parts 1 and 2"; Howlett, "The Impact of the WTO on China's Construction, Engineering, and Design Industries"; "Invest in China," official Chinese government website; IEA and OECD, China's Power Sector Reforms; Liu, "Planning and Policy Coordination in China's Infrastructure Development"; Ministry of Finance, Ministry of Commerce and General Administration of Customs; Ministry of Water Resources, "Water Resources in China"; Nelson and Quingjum, "The PRC Enterprise Income Tax Law and Its Impact on Listed PRC Companies"; OECD, *China in the Global Economy*, 449; OECD, *International Tax Review*; Ports Law; Primetrica, "Country Profile: China"; State Council's Reply on Rules for Carrying Out National S&T Development Program; Tdctrade.com, Extract from Guide to Doing Business in China; USITC hearing transcript; USITC staff discussions with KPMG officials, September 7, 2007; USITC staff interviews with Chinese and U.S. industry representatives in China, August 29–September 12, 2007; Wang, "China's Active Employment Policies"; Wen Jiabao, "Report on the Work of the Government"; WTO, Committee on Import Licensing, Replies to Questionnaire"; WTO, *Trade Policy Review: China*; *Xinhua News*, "China to Raise Electricity Price for Companies with High Energy Consumption"; "China to Raise Factory Price of Natural Gas"; and "Power Prices Up Due to Higher Coal Prices"; Zhang, "Fiscal Decentralization and Political Centralization in China"; and Zhong and Chen, "Charge Reform in China's Wastewater Treatment Sector."

Note: On November 29, 2007, USTR announced that the United States and China had signed a Memorandum of Understanding (MOU) to settle a U.S. dispute pending against China under the WTO Dispute Settlement Understanding concerning the WTO-consistency of certain Chinese tax practices granting refunds, reductions, or exemptions from taxes or other payments. A copy of the MOU is provided in app. F.

# CHAPTER 1
# Introduction

## Scope and Approach

This is the first in a series of three reports by the U.S. International Trade Commission (the Commission) on U.S.–China trade requested by the Committee on Ways and Means (the Committee) of the U.S. House of Representatives. As requested by the Committee, this report provides a description of practices and policies that central, provincial, and local government bodies in China use to support and attempt to influence decision making in China's economy related to: privatization of state-owned enterprises (SOEs) and private ownership; price coordination; industrial development; the banking and finance sectors; utility rates; infrastructure development; taxation; restraints on imports and exports; research and development; worker training and retraining; and the rationalization and closure of uneconomic enterprises. It also provides the analysis that the Committee requested of the likely impact of the December 2006 policy directive of China's State-Owned Assets Supervision and Administration Commission (SASAC).

The second study in this series is to build on this first study and, to the extent possible, is to assess the relative economic impact on selected sectors of the practices and policies. The third study will examine the role of these policies in influencing patterns of production and investment in the Asian region.[4]

The scope of this report includes current government practices and policies in China. However, China's economic regulatory environment continues to evolve as a result of ongoing structural economic policy changes. Some of these policy changes result from domestic economic reforms stemming from China's opening to the global economy that began in the late 1970s and which still continues, while others reflect commitments China made as part of its December 2001 accession to the World Trade Organization (WTO). As a result, the practices and policies identified and described herein also include draft regulations, policies that have been announced or approved but not fully implemented in

[4] The Commission's second report in this series is to be completed by July 2008, and the third report is to be completed by May 2009. Additional information about the request for this series of reports, including a copy of the letter from the Committee on Ways and Means requesting this series of factfinding investigations, is provided in app. A.

2007, and—to the extent possible—policies that may have recently changed but for which updated information is not yet available.[5]

This report identifies and describes China's current economic regulatory environment at the central, provincial, and local government levels and in the manufacturing, agricultural, and services sectors for the specific economic topics that were requested by the Committee. Descriptions of key practices and policies are provided to the extent that such information is available. A formal assessment of the economic impact of these practices and policies on China's investment, employment, and exports is beyond the scope of this investigation. The discussion of the possible economic effects presented in the report is of a general nature. The magnitude and the direction of the effects described are a function of underlying economic assumptions and the nature of the specific practices and policies.

# Key Practices and Policies

The Committee directed the Commission to examine China's practices and policies with respect to a specific list of economic topics. A brief description of how each has been defined by the Commission for the purpose of this report is presented below.

- **Industrial development:** Practices and policies of China's central government that provide differential treatment to different industrial sectors. Industrial development policies involve the use of government policy decisions—rather than market forces—to determine the country's industrial structure. These policies include favorable treatment to promote certain industries, as well as policies directed at phasing out industries deemed less desirable. China uses policy tools such as price controls, tax incentives or disincentives, and preferential lending to implement its industrial policy decisions. China also classifies industries as "encouraged," "restricted," or "to be eliminated" to determine the preferential financial and tax incentives they receive.

- **Rationalization (privatization and closure of uneconomic enterprises) and private ownership:** China's enterprise ownership reform practices and policies aimed at diminishing government's influence in the economy while relaxing constraints previously imposed on the private sector. Rationalization refers to government policies to reduce the number of unprofitable firms within an industry so that only the most profitable ones remain. Privatization is the transfer of the ownership of firms from the public sector to the private sector. Full privatization in China has been limited to the sale of small, inefficient SOEs. The comprehensive sale of China's SOE assets is characterized more by the conversion of SOEs into share-issuing firms in which the government retains a majority ownership share in the firm. The goals of rationalization are to generate economy-wide benefits by using China's available capital and labor more efficiently,

[5] On November 29, 2007, USTR announced that the United States and China signed a memorandum of understanding (MOU) that is intended to eliminate, by January 1, 2008, certain Chinese measures challenged by the United States and Mexico at the WTO. The United States alleged that these measures, in the form of refunds, reductions, and exemptions, constitute subsidies because they were granted on the condition that companies purchase domestic over imported goods or on the condition that they meet certain export performance criteria. The full text of the MOU is provided in app. F of this report.

creating direct effects on employment but generally indirect effects on investment and trade.

- **Price coordination:** China's central, provincial, and local governments use price controls to increase or decrease the use of a product by producers or consumers by fixing the price of certain products or by limiting the range in which the price of certain goods can fluctuate. Anticompetitive pricing involves firms within an industry jointly agreeing to restrain output to raise prices and earn higher profit. China's legacy of central government economic planning has effectively resulted in many monopolistic practices with no framework of competition policy or competition law to prevent firms from colluding to restrain output in order to raise prices. This report describes China's price control practices and policies for certain goods and services; price controls used by state-trading enterprises; anticompetitive practices in China; and China's new antimonopoly law, which is scheduled to enter into force in August 2008. Price coordination practices and policies can directly or indirectly affect employment, investment, and trade through their effects on industry output.

- **Utility rates:** China's central, provincial, and local governments use a number of policies to set utility rates at levels that ensure profitability for the producers while providing end users with affordable utilities. China's government also uses utility rates to promote or discourage the expansion of certain industries. This report describes China's practices and policies with respect to retail utility rates paid by end users for the provision of electricity, water, and natural gas. Utility rate policies include taxes or assistance to directly increase or decrease the prices paid by end users. By altering utility prices, utility rate policies can have direct effects on industry output that, in turn, can affect employment and trade.

- **Taxation:** China's taxation policies generally have multiple objectives, including: (1) to raise revenue for the government; (2) to encourage or discourage production or consumption of a particular product; and (3) to increase or decrease the use of a particular input in production. China's recent tax reforms, scheduled to take effect in 2008, aim to create a uniform and standard tax system for domestic and foreign-invested enterprises, simplify the tax regime, broaden the tax base, and lower income tax rates. This report describes China's value-added, corporate income, local, and agricultural tax practices and policies. By altering the domestic prices paid by producers and consumers relative to the rest of the world, or relatively within the domestic economy, taxes can affect output, employment, investment, consumption, and trade.

- **Banking and finance sector:** Despite significant economic reforms undertaken since the late 1970s, China's central government continues to maintain a pervasive role in economic decision-making in the banking and finance sector. Some of the market distortions that create obstacles to the establishment of a well-developed capital market in China are overinvestment in SOEs and in specific sectors, overexposure of state-owned commercial banks to nonperforming loans, obstacles to private sector borrowing (especially for small and medium scale enterprises), and inadequate access to nonbank financial institutions. This report describes China's practices and policies related to the financing of industry by China's five state-owned commercial banks, in particular with respect to preferential lending policies and the treatment of nonperforming loans. Overinvestment in SOEs and nonperforming loans leaves less capital available to the most dynamic sectors of China's economy which, in turn, can directly affect economic output.

- **Infrastructure development:** China's 11th Foreign Capital Utilization Plan (2006–2010) specifically calls for building up the country's infrastructure stock as a way to encourage foreign investment. China's principal economic development policies have targeted the country's western, rural areas, aiming for those areas to achieve a level of economic development closer to that of the more urbanized eastern, coastal regions. This report describes China's central, provincial, and local government practices and policies with respect to transportation facilities, electric power, and telecommunications. Improvements in infrastructure generally increase national output, employment, and investment, although the actual effects of infrastructure improvements may differ in specific sectors. Infrastructure improvements also can provide important incentives to attract foreign investment.

- **Research and development:** China's 2006–2020 Medium- and Long-Term National Science and Technology Development Program articulates the central government's policy objectives of promoting indigenous innovation, achieving major scientific breakthroughs in targeted areas, and fostering an enterprise-driven innovation system. This report describes China's central, provincial, and local government practices and policy instruments for achieving these goals. Economic literature reports that developing countries may benefit by shifting from relying on imported technologies to government underwriting to foster domestic R&D capabilities. Successful R&D can improve capital and labor productivity and increase economic output.

- **Worker training and retraining:** China's worker training and retraining programs have been implemented as part of labor market reforms beginning in the mid-1990s. These programs are designed to facilitate the movement of unemployed workers into new jobs to improve economic efficiency, reduce unemployment, and create a more skilled labor force. Specifically targeted are workers who have been laid off as a result of the closure of SOEs and workers migrating from rural areas to cities. This report describes China's central, provincial, and local government policies for worker training and retraining.

- **Restraints on imports and exports:** The major practices and policies China applies to restrain imports are tariffs; restrictions on imports used for processing trade; quantitative restrictions including import licensing, tariff-rate quotas, and import bans; and other nontariff administrative measures. The major practices and policies that China uses to restrain exports are export taxes and quantitative restrictions (export quotas, quota bidding, and licenses), agreements with trade partners to restrict exports of certain textile and apparel products, and export privileges tied to environmental performance. A recent reduction in VAT rebates for exports may also act to discourage exporting. This report describes China's central government policies that directly restrict flows of trade in goods and services by directly raising the price, or reducing the quantity, of imports or exports. These policies alter both consumption and production in the domestic economy, causing shifts in employment, investment, output, and trade flows. Such policies can be used to encourage the development of domestic industries or to restrict trade in certain products for other specific policy objectives.

# Organization of Report

This report has surveyed, assessed, and catalogued a large quantity of information on China's practices and policies. To most effectively present this information, the key practices and policies identified have been grouped based on the nature and effect of the practices and policies. The practices and policies in the three different groups are presented in chapters 3 through 5. Chapter 6 summarizes the views of interested parties.

Chapter 2 describes China's industrial development policy, followed by a description of the rationalization of the state sector (through privatization and closure of uneconomic enterprises), the liberalization of the nonstate sector (through the recognition of private ownership), and the SASAC and its December 2006 directive. China's industrial policy is a comprehensive plan affecting the entire economy and forms the framework for the specific practices and policies discussed in chapters 3–5.

Chapter 3 provides a description of China's practices and policies related to price coordination, utility rates, and taxation. These policy areas directly target prices and largely consist of government controls or taxes designed (1) to limit domestic price movement for a specific good or service; (2) to increase or lower the domestic price of a specific good or service; (3) to generate revenues; or (4) to redistribute those revenues. Since these policies are targeted toward specific products, they are likely to have a narrow expected effect on domestic production and/or consumption of the target goods. They may also have an indirect impact on employment and investment in Chinese industries upstream and downstream from these goods. This report has not quantified these effects.

Chapter 4 describes China's practices and policies related to banking and finance, infrastructure development, research and development (R&D), and worker training and retraining. Reforms of policies in this group generally are designed to address market failures or inefficiencies arising from China's legacy of central government economic planning, and so they share several characteristics. Aimed at distortions in the economy, they tend to improve the allocation of resources and have broad effects across the economy. They affect individual industries indirectly and to varying degrees. The aggregate impact of these policies on national investment, employment, and trade balances is not clear. This report has not quantified these effects.

Chapter 5 provides a description of China's practices and policies related to restraints on imports and exports that directly affect trade flows, including tariffs, tariff exemptions or rebates, quotas, and export taxes and tax rebates for exports. Tariffs and export taxes directly raise the price of importable goods relative to exportable goods in the country imposing them. Import and export quotas directly reduce the quantity of imports and exports, respectively. Trade policies can affect domestic employment and investment. Such reallocation of resources can reduce national output. However, because trade restraints usually are narrowly focused on specific imports or exports, individually they may have no discernible effects on national employment and investment. While trade restraints could affect the composition of China's trade, this report has not quantified their aggregate impact on China's imports, exports, and trade balance.

The remainder of this chapter provides an overview of the information sources consulted during this investigation and a brief description of China's economic decision-making institutions at the central, provincial, and local government levels.

# Information Sources

Information on China's regulatory practices and policies for this investigation was obtained from a number of sources, including written submissions received in response to the Commission's *Federal Register* notice announcing the institution of this investigation;[6] testimony at the public hearing held by the Commission in connection with this investigation on September 6, 2007;[7] and interviews conducted during factfinding travel to China.

Key sources of published information on China's practices and policies were international organizations, including the Asian Development Bank, the Organization for Economic Co-operation and Development, the World Bank, and the WTO; numerous scholarly and peer-reviewed academic publications; business and industry publications; Chinese and English language versions of Chinese Government print documents and information obtained from Chinese Government web sites; and reports by U.S. Government agencies including the Congressional Research Service, the Office of the U.S. Trade Representative (USTR), the U.S. Department of Agriculture, and the U.S. Department of Commerce. Sources cited in the report are fully documented in the Bibliography.

Commission staff conducted factfinding travel to China for this investigation during August–September 2007 to interview government officials at the national, provincial, and local levels who develop and implement the policies and practices addressed in this investigation. Commission staff also interviewed Chinese and foreign industry representatives, representatives of industry associations, and academics. More detailed information on the factfinding travel is provided in appendix E.

# China's Economic Decision-Making Institutions

This section provides an overview of economic decision-making institutions in China. At the conclusion of the first WTO Trade Policy Review of China in 2006, the chairman of the WTO Trade Policy Review Body on behalf of the membership acknowledged "the considerable steps taken by China in reforming its economy" and "commended China's continued trade liberalization."[8] However, the chairman also expressed concerns about transparency in policymaking and trade policy implementation in China, and noted that "although direct intervention by the Government in the economy had declined," Chinese

[6] A copy of the *Federal Register* notice is provided in app. A of this report.
[7] Information on the public hearing is provided in app. B of this report.
[8] WTO, "Concluding Remarks by the Chairperson."

government authorities continue to use "'indirect measures' . . . to 'guide' investment in certain sectors."[9]

## *Central Government*[10]

China has two constitutions—the national constitution, and the constitution of the Communist Party of China (CPC).[11] The leading CPC figures are also leading figures in central government institutions such as the National People's Congress (NPC) and the State Council.[12]

Historical traditions as well as the leading role of the CPC in the government tend to result in a substantial amount of ambiguity in the interpretation of laws in China and how they are to be carried out. Although increasing attention reportedly is being paid to formal law, sources report that parties in China affected by a specific law customarily ask for the most recent interpretation of the law, not what the written letter of the law says.[13] There may be active government policy on a particular topic for years before the policy has been codified into law. In addition, once a law is promulgated, the practical meaning of a law is often determined by administrative regulations issued by the State Council or central government ministries months after the law is passed. Regulations also may be further modified by provincial and local rules and regulations.[14] An example of this situation is China's Antimonopoly Law, which was passed in August 2007 after 13 years of debate.[15] After the passage of the law, fundamental issues, such as whether the law is primarily directed at preventing foreign takeovers of Chinese companies, or whether it may be used to counter the monopoly power of large state-owned enterprises (SOEs), are still matters of uncertainty and debate.[16]

The State Council has substantial power to legislate and regulate. It not only has the power to propose legislation, but it may take direct action through administrative regulation delegated to it by the NPC or its Standing Committee. In the economic sphere, these regulatory powers encompass finance, taxation, customs, banking, and foreign trade. These regulatory powers may be exercised through various documents such as

[9] Ibid.

[10] This section highlights certain features of China's governance that underlie economic policymaking, rather than provides a comprehensive introduction to China's governance. For a brief description of the main institutions of the China's government, see EIU, *China: Country Profile*, 8–15. For an English-language treatise written from the Chinese point of view, see Yang, *Chinese Government*.

[11] All references to China's constitution in this report are to China's national constitution.

[12] The NPC is China's top legislative institution. The State Council leads China's government and is roughly analogous to a cabinet in a parliamentary system. EIU, *Country Profile: China,* 8.

[13] Commission staff interview with government officials, Beijing, September 2, 2007.

[14] Commission staff interviews with government officials, Beijing, August 30, 2007, and September 2, 2007.

[15] China's Antimonopoly Law is discussed in the section on "Price Coordination" in chap. 3 of this report.

[16] *Xinhua News*, "Chinese People Question Effectiveness of Anti-Monopoly Law on SOEs" and "Legislator: China's Anti-Monopoly Law Not to Affect Foreign Investment"; USITC staff interview with government officials, Beijing, August 30, 2007; and USITC staff interview with industry representatives, Beijing, August 31, 2007.

"circulars," "measures," and "temporary measures." In addition, the State Council's Legislative Affairs Committee may interpret legislation and, jointly with the NPC Standing Committee, resolve conflicts between regional laws and State Council regulations.[17]

China's government policies have influenced the behavior of firms and industries since economic reforms began in the late 1970s, although the methods have changed radically and repeatedly, and continue to do so. China has undergone five major government reforms during this time—in 1982–83, 1988, 1993, 1998, and 2003.[18] Each of these reforms reorganized and redrew the major lines of government responsibility, reducing the number of ministries, commissions, and other organs of the State Council from 100 in 1982 to 28 in 2003. Each wave of reform has also attempted to re-draw the boundaries between the government and the SOEs. As a result, SOEs have evolved from being parts of government ministries involved in production activities to something more nearly resembling stand-alone enterprises.

## *Provincial and Local Governments*

The principal levels of government administration in China, in descending order from the central government, include the provincial, prefectural, county, and township levels.[19] The 33 provincial level units include four large municipal areas administered directly by the central government,[20] five autonomous regions, and the special administrative regions of Hong Kong and Macau.

The Constitution and laws of China do not provide a clear demarcation between central and provincial responsibilities.[21] There are multiple relationships of authority and control between lower-level and upper-level bodies. For example, a county-level government agency may rely on the county government for funding and personnel decisions and on the corresponding provincial-level agency for business leadership. At the same time, CPC members in the agency are subject to Party discipline, and the Party makes key decisions about promotion or demotion of key staff. The web of competing lines of control means that provincial and local authorities are often able to pursue substantial policy independence while maintaining that they are acting in a manner consistent with central

[17] Yang, *Chinese Government*, 182; and Commission staff interview with government officials, September 2, 2007.

[18] OECD, *China in the Global Economy*, 15. For additional information see "Historical Overview" in app. C.

[19] The number of administrative units for each level of government, as of the end of 2005, is as follows: provincial level, 33; prefectural level, 333; county level, 2,862; and township level, 41,636. NBS, *China Statistical Yearbook*, 2006. The count of provincial level units does not include Taiwan.

[20] Beijing, Chongqing, Shanghai, and Tianjin.

[21] There are multiple relationships of authority and control between lower-level and upper-level bodies. For example, a county government agency may rely on the county government for funding and personnel decisions and for the corresponding provincial agency for business leadership. At the same time, CPC members in the agency are subordinate to the CPC. OECD, *China in the Global Economy*, 32; and Dong, "Central-Local Relations in China."

government directives.[22] There are differing views on how these competing mandates affect decision making by provincial officials.[23]

Other factors affecting the conditions under which provincial and local governments operate[24] include the tax-sharing reforms of 1994, which increased the central government's share of tax revenue (collected by provincial and local governments)[25] and classified various taxes into central government revenue, provincial and local government revenue, and central-local government shared revenue. This includes central-local government shared revenue from key taxes such as the value added tax, natural resource tax, and negotiable security transactions tax.[26] Beginning in the late 1990s, downsizing and large-scale layoffs in SOEs created challenges for economic development in many localities. Many SOEs were, and continue to be, operated by provincial and local governments rather than the central government. At the same time, social-welfare reforms moved many of the responsibilities for education, health, retirement, and similar functions from the SOEs to provincial and local governments, while the central government began taking a larger share of tax revenue.[27]

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[22] Chinese government official, interview with Commission staff, Beijing, August 30, 2007. The apparent tension between the strong role of the CPC and the relative independence of provincial and local government officials reflects that there can be disagreements between the CPC and government as to the relative importance of different and potentially conflicting priorities; these disagreements often are resolved by the official closest to the scene. Corruption also can cause a divergence between central government priorities and local government actions. Pei, "Corruption Threatens China's Future."

[23] One view is that provincial and local officials place a heavy emphasis on economic growth and sacrifice other objectives to growth maximization. This is further discussed in the section on "Infrastructure Development" in chap. 4 of this report. Research into the likelihood of promotion and termination of provincial-level officials suggests that GDP growth is a high priority for these officials. The pursuit of GDP growth may come at the expense of other social priorities, such as environmental protection or the respect of rural property rights. An alternate view is that provincial and local officials are judged based on how they satisfy multiple central government objectives simultaneously, according to a "balanced scorecard." Industry representative, interview with Commission staff, Beijing, August 31, 2007; Li and Zhou, "Political Turnover and Economic Performance,"1743–62; and academic expert, interview with Commission staff, Beijing, September 6, 2007.

[24] For additional information, see the section on "Taxation" in chap. 3 of this report.

[25] See the discussion of "Taxation" in chap. 3 of this report.

[26] Dong, "Central-Local Relations in China."

[27] For additional information, see the section on "Worker Training and Retraining" in chap. 4 of this report. OECD, *China in the Global Economy*, 33–34.

# CHAPTER 2
# Industrial Development, Rationalization, and Private Ownership

This chapter describes the policies and practices that central, provincial, and local governments in China currently use to support or influence decision making in China's agricultural, manufacturing, and services sectors in the following areas: industrial development, rationalization, and private ownership.

The chapter begins with a description of China's practices and policies related to industrial development, followed by a discussion of China's principal industrial development policy goals and the ways in which these goals are implemented. In most cases, industrial development policy implementation occurs via the practices and policies discussed in more detail in chapters 3 through 5 of this report. Because the ongoing transition from a centrally planned economy to a market economy underlies China's industrial development policy, the second part of this chapter describes the rationalization of state-owned enterprises (SOEs) through privatization[28] and closure of uneconomic enterprises, and the liberalization of the nonstate sector through recognition of private ownership. This part of the chapter also describes the role of China's State-Owned Assets Supervision and Administration Commission (SASAC) and its December 2006 policy directive.

## Industrial Development

Industrial development policy generally refers to government use of policies to directly or indirectly channel resources into specific activities which the government deems important for growth and development.[29] Such policies are often described as the government actively intervening in the market to choose industrial "winners," and to promote their growth through favorable treatment.[30] However, the Chinese concept of industrial development policy is more comprehensive than that. The official documents announcing China's industrial development policy, issued since 1989, describe the broad set of objectives and policies that make up China's plan for a market-oriented transition

[28] The commonly used term for "privatization" in China is "corporatization." Corporatization is discussed in more detail below.

[29] See, for example, Brander, "Rationales for Strategic Trade and Industrial Policy," 23–46.

[30] See, for example, Salvatore, *International Economics*, 275; P. Krugman and Obstfeldt, *International Economics: Theory and Policy*, 287; Brander, "Rationales for Strategic Trade and Industrial Policy," 31; Yamamura, "Caveat Emptor: the Industrial Policy of Japan," 170; and Krugman, "The U.S. Response to Foreign Industrial Targeting," 97.

towards an industrialized economy.[31] Progress on achieving these objectives is reported by the National Development and Reform Commission (NDRC), an economic management agency under the State Council established in 2003 with broad authority for both general economic policymaking and specific administrative decisions regarding the economy.[32]

Within the broad set of objectives that constitute China's industrial development policy, there are a number of policies that specify favorable (or unfavorable) treatment for an industry or group of industries.[33] The details of these policies have changed frequently over time. A policy may target an industry or group of industries as a deliberate matter of national strategy, as a historical legacy of China's economy or as a consequence of the way in which that policy interacts with other policies.[34] Determining which of these purposes underlies specific policies often requires an understanding of the context in which the policy operates and is beyond the scope of this study.

This section first examines China's current industrial development policy objectives, and then discusses the policies used to implement those objectives. Because these are broad, economy-wide objectives, this section focuses on the major policies formulated to achieve them. A more detailed examination of specific policies related to these objectives can be found in later sections of this chapter and in chapters 3 through 5.

The Commission identified nine key practices and policies used in China to carry out industrial development policy at the central government level; many of these policies also are applied at the provincial and local government levels. Key government practices and policies in the economy with respect to industrial development policy are summarized in table 2.1.

## *Industrial Development Policy Objectives*

According to the WTO, China's current industrial development policy emphasizes "strategic adjustment of the industrial structure."[35] This industrial development policy involves (1) structural adjustment of rural industry to strengthen the position of agriculture in the economy; (2) encouragement of industries that can increase economic growth and move China's industry towards specialization in more sophisticated products (e.g., information technology, biotechnology); and (3) encouragement of the use of new

[31] The first explicit official guidelines, "Decision on the Gist of Current Industrial Policy," was issued by the State Council in 1989. The "Outline of the State of Industrial Policy in the 1990s," issued by the State Council in 1994, stated the objectives and specific details for the decade. For a comprehensive summary of official industrial development policy from 1989 until 2000, see Lu, "Industrial Policy and Resource Allocation," 342–360.

[32] NDRC, "Report on the Implementation of the 2006 Plan."

[33] Some of these policies are described later in this chapter, and in chapters 3–5. An assessment of the impact of China's practices and policies on specific sectors (e.g. steel, automobiles, textiles and apparel, copper and brass, and paper) will be provided in a forthcoming USITC report on China (Investigation no. 332-491, forthcoming, July 2008).

[34] For additional discussion, see Lipsey and Lancaster, "The General Theory of the Second Best," 11–32.

[35] WTO, *Trade Policy Review: China,* 114.

**Table 2.1** Industrial development: Summary of key practices and policies, central government

| ***Practices and policies*** | ***Associated laws and regulations*** |
|---|---|
| Establishment of the most recent catalog of industries identified as "encouraged," "restricted," or "to be eliminated." | • December 2005 Interim Regulation on Promoting the Adjustment of Industrial Structure and the Guiding Catalog for the Adjustment of Industrial Structure |
| Taxation policies to promote investment in encouraged industries, and to limit and eliminate investment, respectively, in restricted and to be eliminated categories. | • December 2005 Interim Regulation on Promoting the Adjustment of Industrial Structure |
| Credit guidance (indicative lending) | • 1995 Commercial Bank Law |
| Amendment of the list of industries in which FDI is encouraged, restricted and to be eliminated, to correspond to the current criteria in the Interim Regulations. | • December 2005 Interim Regulation on Promoting the Adjustment of Industrial Structure; Guiding Catalog for the Adjustment of Industrial Structure; and Catalog for the Guidance of Foreign Investment Industries |
| Prohibition of exportation or importation of specific products under the processing trade regime, and reductions or rescinding of VAT rebates for exports, to foster more trade in the encouraged industries, and less in the restricted or to be eliminated industries. | • Ministry of Commerce and other agencies announcements in 2007 (multiple notices) |
| SASAC directive to clarify the government's policies and intentions regarding "strategic industries" and "pillar industries." | • December 2006 SASAC directive |
| Increased access for private firms in previously restricted industries; equal treatment for private firms and SOEs. | • State Council Guidelines on Encouraging and Supporting the Development of the Non-Public Sector Including Individual and Private Enterprises |
| Western Development program to promote greater investment, better infrastructure, and financing in western provinces, and to restructure rural industry. | • Policy outlined in the $10^{th}$ and $11^{th}$ Five-Year Plans |
| R&D policies to promote indigenous innovation and to fund programs to achieve scientific breakthroughs. | • 2006-2020 Medium- and Long-Term National S&T Development Program (S&T Plan) |

*Source:* China Banking Regulatory Commission website; China Ministry of Commerce, Ministry of Science and Technology, and NDRC, "Major Measures to Promote the Adjustment of Industrial Structure" and "Report on the Implementation of the 2006 Plan"; State Council, "Interim Regulation"; SASAC, Commercial Bank Law of China; and WTO, *Trade Policy Review: China*.

or more sophisticated technologies in traditional industries.[36] For traditional industries such as steel, the WTO found that China's industrial development policy emphasizes restructuring to take advantage of economies of scale and avoid "low level, repetitive construction."[37]

In March 2007, the NDRC reported progress in meeting some of these strategic adjustment objectives.[38] Specifically, rural infrastructure has improved (especially roads and water quality), a number of agricultural taxes were abolished, and government support increased for grain production. A number of small firms in steel, aluminum, cement, and coal using outdated and/or highly polluting technologies have been shut down, as well as a number of small mines that did not meet safety requirements. The central government has provided additional funding for research and development (R&D) projects in new technologies, and for projects in western China. More detailed information on China's policies and programs to develop its western region and the R&D sector can be found in the sections on "Infrastructure Development" and "Research and Development" in chapter 4 of this report.

At the same time, the NDRC recognized that many objectives have only been partially achieved. Thus, China's current industrial development policy objectives include the continuation of privatization (corporatization) and rationalization of SOEs, and the closure of SOEs using outdated, energy-intensive, or polluting technologies, especially in industries with excess production capacity such as steel, cement, aluminum, coal, textiles, and paper. China's industrial development policy objectives also emphasize the following: the use of information technology to improve productivity in the steel, building materials, coal, power, petrochemicals, and cement industries; the promotion of high-technology industries, including biopharmaceuticals and other biotech industries, integrated circuits, and telecommunications; the promotion of local high-technology equipment manufacturing; and the development of alternative energy technologies.[39]

## *Industrial Development Policy Instruments*

As the WTO reports, there has been an important change in the government's implementation of industrial development policy, as China has instituted market-oriented reforms. China now relies much less on direct intervention by the state, and much more on indirect policy tools. [40] These tools include trade taxes, domestic policies such as tax incentives or disincentives, "guidance prices," and credit guidance to implement its industrial development policy.[41] The NDRC stated in its November 2007 report that

[36] Ibid.

[37] Ibid. Many of these objectives carry over from 1989, and were originally formulated as a response to the identification of several key problems in China's industrial structure: overcapacity in some manufacturing industries (e.g., traditional heavy industry); underdevelopment in agriculture, energy and raw materials industries, and the transport sector; undercapacity in higher tech industries; inefficiency in geographic distribution of industries; and inefficiency in the organization of firms within industries. Lu, "Industrial Policy and Resource Allocation," 356–57.

[38] NDRC, "Report on the Implementation of the 2006 Plan."

[39] Ibid., 9–10.

[40] WTO, *Trade Policy Review: China,* 60 and 113–14; and Lu, "Industrial Policy and Resource Allocation," 346.

[41] Ibid.

"[w]hen implementing the adjustment of industrial structure, the government should make a full play of the fundamental role of the market in resource allocation. At the same time, the government is to provide guidance through economic, legal and necessary administrative measures."[42]

The State Council classifies industries into three groups: "encouraged," "restricted," or "to be eliminated."[43] The "encouraged" category includes industries that generate domestic R&D,[44] show high expected demand growth, are technology intensive, meet the requirements for environmentally sustainable development, reflect China's comparative advantage, and increase employment opportunities. The restricted category includes industries using production processes or making products that are obsolete, or are not conducive to human safety, energy and resource conservation, and environmental protection; and industries exhibiting redundant construction or significant excess production capacity. The "to be eliminated" category comprises industries using production technologies or making products that are seriously environmentally damaging, waste resources or energy, endanger human safety, fail to meet minimum quality standards, or are obsolete.[45]

The State Council stipulates that financial institutions are to grant loans to support investment projects in the "encouraged" category that are in line with credit granting principles.[46] In addition, these institutions are to refuse examination or approval of any new investment projects in the "restricted" category, and to prohibit any investment in the "to be eliminated" category. China provides credit guidance (also referred to as indicative, or directed, lending) to carry out its industrial development policies. The WTO reported that in 2004, China sought to slow the growth of investment in certain sectors by reducing the lending capability of commercial banks via higher lending rates, open market operations, and lower bank deposit rates. Chinese officials also sent guidance to banks to reduce lending to industries deemed to be at higher risk of failure, including

[42] NDRC, "Major Measures to Promote the Adjustment of Industrial Structure."

[43] Official Chinese documents providing industry classifications date to 1989. "Encouraged" industries at that time included agriculture and agriculture-service industries; selected light industrial and textile products; infrastructure, energy, and raw materials; machinery and electronic industries; other high-tech industries. "Discouraged" industries included those producing low-quality and/or energy-intensive products, and industries which used old technology, pollution-intensive technologies, or inputs in shortage. See Lu, Industrial Policy and Resource Allocations, 356–57. Industry classifications were revised in the December 2005 Interim Regulation, and the supplementary Guiding Catalog for the Adjustment of Industrial Structure. The NDRC stated that both these documents were important measures in meeting China's current needs to upgrade its industrial structure and to achieve the goals in the 11th Five-Year Plan (2006–2010). The Interim Regulation "identifies the targets, principles, direction and priorities of the adjustment of industrial structure, and it also provides the categorizing principles for the Guiding Catalog." See NDRC, "Major Measures to Promote the Adjustment of Industrial Structure"; State Council, "Interim Regulation"; and NDRC, "Industrial Catalog for the Adjustment of the Industrial Structure."

[44] China's R&D practices and policies are described in chap. 4 of this report.

[45] The Guiding Catalog lists 539 products as encouraged, 190 as restricted, and 399 as prohibited or "to be eliminated," across more than 20 industries, such as agriculture, water conservancy, power, transportation, information industry, iron and steel, nonferrous metals, petrochemical industries, building materials, light and textile industries, service industry, environmental and ecological protection, and conservation and comprehensive use of resources. NDRC, "Major Measures to Promote the Adjustment of Industrial Structure," 1.

[46] State Council, "Interim Regulation."

steel, cement, electrolytic aluminum industries, and other industries using older technologies.[47] China's indicative lending policies are described in more detail in the section on "Banking and Finance Sector" in chapter 4 of this report.

Investment projects in the encouraged category are also to be supported by preferential tax policies. Existing investment projects in the restricted category are allowed to continue, but industries are given a fixed time period in which to upgrade their production processes and/or products. In contrast, existing investment projects in the prohibited category are actively discouraged—e.g., by subjecting firms to increased electricity prices or other taxes—in order to eliminate them. Other institutions, such as land management, environmental protection, firefighting, and quality inspection are also directed to cease any relevant procedures for projects in these prohibited categories.[48] Additional detail on China's taxation and utility rate policies can be found in sections on "Taxation" and "Utility Rates" in chapter 3 of this report.

The current objectives of the Interim Regulations are reflected in the 2007 Catalog for the Guidance of Foreign Investment Industries.[49] The catalog lists industries for which FDI is "encouraged," "restricted," and "prohibited."[50] The industries for which FDI is currently encouraged includes, among other things, entries for various types of farm products, fossil fuel-related activities, food processing, many basic chemicals, medicines, artificial fibers, machine-building, telecommunications equipment, automobiles, civil aircraft, electronic equipment, precision instruments, power supply, transport services, residential housing, and environmental technologies. Additional information on China's FDI policies can be found in the sections on foreign-invested enterprises later in this chapter.

The Interim Regulations also have an impact on preferential treatment under China's processing trade regime. Processing trade involves the importation of inputs to be used in the production of semifinished or finished goods solely for export. This type of trade is typically the result of global production chains, in which production processes are split into discrete sequential activities that take place in different countries. China's processing trade policies grant exemptions from duties on imported inputs, and rebates of VAT upon export, to firms involved in processing exports. Additional incentives are given to foreign-invested enterprises located in certain incentive zones and involved in processing

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[47] WTO, *Trade Policy Review: China*, 114.

[48] NDRC, "Major Measures to Promote the Adjustment of Industrial Structure."

[49] NDRC, "Industrial Catalog for Foreign Investment."

[50] Despite the similarity with the industry classifications "encouraged," "restricted," and "to be eliminated" provided in the State Council's Interim Regulation described above, the characters used in the Chinese language for the term "prohibited" are different from the characters used for the phrase "to be eliminated." "Prohibited" refers to activities no longer permitted, such as new investments in certain sectors, while "to be eliminated" refers to activities that are to be phased out, such as production processes that pollute the environment.

trade.[51] China has recently begun rescinding some of this preferential treatment for processing trade. The general tendency of these policies has been to grant the most favorable treatment to high-technology products and the least favorable treatment to natural resource intensive and polluting goods.[52] Adjustment of processing trade and export tax policies is seen by Chinese officials as a way to promote greater value added in exports, to minimize environmental damage, and to restrain the rapid growth of the trade surplus.[53] China's processing trade and related policies are discussed in more detail in the section on "Restraints on Imports and Exports" in chapter 5 of this report.

Underlying all of China's industrial development policies is the restructuring of China's economy to reduce state ownership of firms and allow the growth of the private sector. China recently clarified its policy regarding SOEs owned by the central government in the December 2006 SASAC policy directive.[54] The directive indicated that China's policy of divesting SOEs, begun in the 1990s, is largely over and that the existing holdings now are to be maintained by the government and consolidated. Box 2.1 describes the new SASAC policy direction as a result of the December 2006 directive. SASAC and the December 2006 directive are discussed in more detail in the section on "Rationalization" below.

China has simultaneously continued with reforms that strengthen the private sector and equalize treatment between private enterprises and SOEs. In February 2005, the State Council issued "Guidelines on Encouraging and Supporting the Development of the Non-Public Sector including Individual and Private Enterprises." According to the WTO, these new guidelines increase access for private firms in industries that were previously restricted, including public utilities, financial services, social services, and national defense. They also call for equal treatment of private firms and SOEs, and for a strengthening of property rights. More detailed information on policies relating to private enterprises is provided later in this chapter.

China has a number of policies that favor high-technology products or new products. In addition to most favorable processing trade treatment and the encouragement of certain types of technology-intensive FDI (mentioned above), these policies include government R&D initiatives directed at certain technologies and the continuation of corporate income-tax preferences for high-technology firms that are being phased out for other firms. For more detail on these policies, see the sections on "Taxation" in chapter 3 and "Research and Development" in chapter 4 of this report.

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[51] The effectiveness of some of these policies as incentives over the last ten years is likely to have been limited by nonuniform treatment across firms and products, rebate rate reductions, recurring significant payment arrears, multiple selective withdrawals of rebate privileges across products and over time, and across the board reductions in rebate rates in 2001 and 2004. WTO, *Trade Policy Review: China,* 100–102. For a quantitative analysis, see Chen, Mai, and Yu, "The Effect of Export Tax Rebates on Export Performance," 226–235. See also Ministry of Finance, "Report on the Implementation of the Central and Local Budgets for 2006"; and State Council, "Report on the Work of the Government 2006."

[52] Government official, interview by Commission staff, Beijing, September 5, 2007; Academic expert, interview by Commission staff, Beijing, September 3, 2007.

[53] *Xinhua News*, "China to Maintain Sizeable Trade Surplus for Some Time."

[54] There are also SOEs owned by provincial and other local governments, to be distinguished from the ones mentioned here.

**Box 2.1**
China: SASAC's December 2006 policy directive

In a December 2006 statement, SASAC identified two groups of industries—"strategic industries," for which the government must maintain "absolute control," and "fundamental and pillar industries" or "heavyweight industries," for which the government should maintain "relatively strong control over their principal enterprises. Strategic industries include armaments, power generation and distribution, petroleum and petrochemicals, telecommunications, coal, civil aviation, and shipping. Key firms in these strategic industries account for a large share of the current SASAC portfolio.[a] Pillar industries include machinery and equipment, automobiles, information technology, construction, iron and steel, nonferrous metals, chemicals, mining resources exploration, and science and technology. The role of SASAC and China's policies of rationalization of the state sector are described in greater detail later in this chapter.

Sources: SASAC, "Guiding Opinion"; and Rongrong, "SASAC."

Notes:
[a] USITC staff calculations using data supplied by SASAC indicate that 44 firms in the seven strategic industries account for 75 percent of assets and 79 percent of profits of central government-owned SOEs.

China has traditionally provided lower utility rates to heavy industry and residential users than those charged to light industry and service establishments. However, the central government is attempting to raise electricity rates for certain industries, consistent with recent attempts to discourage certain resource-intensive or polluting industries. NDRC directives have recently sought to raise electricity rates for the electrolytic aluminum, ferroalloy, calcium carbide, caustic soda, cement, and steel industries. However, it is not clear whether these directives have been fully carried out due to resistance from local officials. Additional detail on utility rate policies can be found in the section on "Utility Rates" in chapter 3 of this report.

# Rationalization and Private Ownership

Underlying China's industrial development policies are practices and policies related to rationalization of the state sector (e.g., privatization and the closure of uneconomic enterprises) and liberalization of the nonstate sector (e.g., private ownership). This section describes these practices and policies. It begins by first introducing the structural foundation underpinning China's economy and the role of SASAC in coordinating the government's rationalization measures, in order to provide context for the descriptions of practices and policies that follow.

## *China's Economic Structure*

China's current economic structure reflects both the legacy of central planning and elements of a modern and increasingly market-based competitive system. Despite market-based reforms and nearly three decades of robust economic growth, China's transition from central government economic planning remains ongoing. National, provincial, and local levels of government still own and provide direction to certain domestic enterprises, particularly those industries under SASAC control.[55] China's three

[55] SASAC is discussed in more detail below.

principle economic sectors—the state sector, the nonstate sector, and the collective sector [56] —reflect this distinctive economic market structure, and remain broadly differentiated by their degree of government ownership and influence.

## State Sector

China's state sector consists of SOEs reporting to central, provincial, and local levels of government. SOEs are noncorporate economic units whose assets are owned by the government,[57] and they include enterprises in which the state's share of assets exceeds those of any other single shareholder.[58] In the early phases of China's reforms, SOEs represented the backbone of China's centrally planned economy, [59] and profit-maximization generally was not their primary objective. Rather, many SOEs provided a variety of social services to their employees, such as lifelong employment, free housing or housing assistance, free medical care, and pensions.[60] However, in response to growing competition from the nonstate sector (described below), and to minimize instability that would be caused by wide-scale unemployment,[61] China has instituted several measures to increase managerial autonomy among SOEs.[62] Key regulations include the 1984 Regulations Concerning the Expansion of the Autonomy for State-Owned Industrial Enterprises,[63] the 1993 contract responsibility system, and the 1994 Contract Law.

Although China's central government played an active role in SOE input, output, and price coordination in the early phases of China's reforms, the government's current managerial influence is less comprehensive. It mostly extends to longer-term strategic decisions (e.g., merger and acquisition determinations, lending practices, employment retention levels[64]) and certain operational decisions that may have broader policy implications.[65] Given the implementation of a national unemployment and health insurance system, the creation of publicly funded employment centers,[66] the cutting of SOE payrolls, and the authorization to lay off workers, many SOEs have curtailed the provision of social services that were previously encouraged by the central government.

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[56] Enterprises belonging to the collective sector possess attributes that distinguish them from both state and nonstate sector enterprises. See "collective sector" below for a more detailed description.

[57] NBS, "General Survey Definitions."

[58] Enterprises are only considered state owned if the government's share of assets exceeds that of any other shareholder. However, China's government (at all levels) may also own minority equity shares in nonstate or collective enterprises, as described in more detail below.

[59] Hammer, "The Dynamic Structure of U.S.-China Trade," 6.

[60] Gu, "Beyond the Property Rights Approach."

[61] Tenev et al., *Corporate Governance and Enterprise Reform in China*, 19; and Yusuf et al., *Under New Ownership*, 12.

[62] Industry representatives, interview with Commission staff, September 4–5, 2007.

[63] Yusuf et al., *Under New Ownership*, 55.

[64] Industry representatives, interview with Commission staff, September 4–5, 2007.

[65] Yusuf et al., *Under New Ownership*, 13.

[66] Garnaut et al., "China Restructures," 79.

## Nonstate Sector

China's nonstate sector consists of domestic private and foreign-invested enterprises. Since the late 1970s, China's central government policy has evolved from a position of informal acceptance of this sector to the recognition of this sector's importance for production and technical innovation. In its 11th Five-Year Plan (2006–2010), for example, the central government highlights its support of the sustained growth of the nonpublic sector, given its importance to the national economy.[67]

*Domestic private enterprises*

China currently defines domestic private enterprises as "economic units invested or controlled by natural persons who hire laborers for profit-making activities," and includes certain limited liability corporations, share-issuing firms, private partnerships, and sole proprietorships.[68] These forms of enterprises developed experimentally and in the context of an evolving political, legal, and regulatory environment.

Although the central government has an influence over decision making in domestic private sector firms, the practice does not appear as prevalent as in state and collective sector firms.[69] This influence is more apparent at the provincial and local levels, where the lack of clearly defined property rights has often prompted community businesses to form ties with government officials in an attempt to safeguard business operations, gain access to capital markets, and solve procurement problems.[70] These public–private sector relationships have taken many forms, and include public officials taking positions as paid advisors and board representatives in private sector firms. Moreover, their relationships have often created environments in which local politicians are commonly regarded as patrons of local businesses, rather than as regulators of the local economy.[71] To lessen incentives for forming such public–private relationships, the central government has instituted measures to require local governments to implement constitutional amendments that guarantee private property rights at the local level. Guaranteeing private property rights was one of the fundamental reasons for the State Council's implementation of "Guidelines for Encouraging and Supporting the Development of the Non-Public Sector Including Individual and Private Enterprises" in February 2005.

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[67] NDRC, *11th Five-Year Plan*, May 2006.

[68] NBS, "General Survey Definitions."

[69] World Bank , "China's Emerging Private Enterprises," 10.

[70] Access to capital remains a fundamental problem for private sector enterprises. At the onset of the reforms, access to capital was constrained by state-directed policy banks who typically did not lend to firms that were not SOEs or collective-owned enterprises. Later, with the introduction of commercial banks, financial institutions' lending to private sector enterprises was constrained by a nonexistent national credit rating system, and an absence of credit history with a particular policy bank. For more detail on policy banks and other financial institutions in China, see the section on "Banking and Finance" in chapter 4 of this report. Industry representatives, interview with Commission staff, September 7, 2007.

[71] Garnaut et al., *China's Ownership Transformation*, 13.

*Foreign-invested enterprises*

There are two groups of foreign-invested enterprises (FIEs)—overseas firms (those with funds from Hong Kong, Macau, and Taiwan), and other foreign firms (those with funds from all other countries). To operate in China, FIEs have established three different types of enterprises: wholly foreign-owned enterprises,[72] equity joint ventures (EJVs), or contractual joint ventures (CJVs).[73] Despite the fact that FIEs have formed joint-venture operations with state, nonstate, and collective sector firms, they have been officially categorized as FIEs if the share of foreign or overseas assets exceeds that of any other single shareholder. Although operational influence by governing authorities is limited in FIEs, this influence varies considerably by type of firm, sector, and degree of government ownership.

## Collective Sector

China's collective sector consists of enterprises whose assets are owned by a group of workers.[74] Commonly referred to as collective-owned enterprises (COEs), this sector includes a broad range of enterprises, such as urban collectives, township-village enterprises, village-owned enterprises, and cooperatives.[75] Certain domestic private firms have also registered under this category in order to obtain better access to capital, even though such firms are not owned by their workers.[76]

Given their unique ownership and control mechanisms, COEs are different from enterprises in both the state and nonstate sectors. For example, COEs are predominantly owned by their workers and not the government and, consequently, typically have greater managerial autonomy than SOEs.[77] However, that autonomy often is less prevalent than in private firms, given COE's closer relationships to local governments. Rural-based township-village enterprises, the most common form of COEs, provide local governments with a substantive share of their profits.[78] In return, these government bodies have helped township-village enterprises gain access to credit from local financial

[72] To establish a wholly foreign-owned enterprise, foreign corporations have been encouraged to export at least half of their output, or use technology that the Chinese government deems beneficial for the country. The Oct. 31, 2000 amendment of the 1986 "Law on Foreign Capital Enterprises" changed previous export and technology requirements to "encouragement". WTO, *Trade Policy Review: China*, 130.

[73] EJVs are the most common form of JVs and are basically differentiated from CJVs in their profit distribution system (contrary to CJVs, EJVs profits must be distributed according to ownership stakes); partnership duration (EJVs partnerships typically last between 30 to 50 years, while CJVs are much shorter); and requirements related to capital contributions (CJV foreign partners can withdraw their capital contributions at any time, while EJVs cannot). WTO, *Trade Policy Review: China*, 129.

[74] NBS, "General Survey Definitions."

[75] Jefferson and Singh, *Enterprise Reform in China*, 24.

[76] This phenomenon is reportedly widespread. The World Bank has recently estimated that almost half of all COEs may, in fact, be private enterprises. World Bank, "China's Emerging Private Enterprises," and ADB, *Private Sector Assessment.*

[77] Jefferson and Singh, *Enterprise Reform in China*, 63.

[78] Yusuf et al., *Under New Ownership*, 97.

institutions, impose entry limits on potential competitors, and facilitate communication with higher levels of government. [79]

### China's Changing Economic Structure

All of the sectors identified above have grown throughout China's economic reform period, although their rates of growth have varied. The growth of nonstate sector firms outpaced that of SOEs and, consequently, resulted in noteworthy structural changes.[80] This trend is most pronounced in China's industrial sector. The share of the state sector contribution to China's industrial output declined from about 78 percent in 1978 to 38 percent in 2005, while the nonstate sector share increased from nearly 0 to about 58 percent over the same time period, as shown in figures 2.1 and 2.2.

## *Rationalization of the State Sector*

Rationalization is the weeding out of unprofitable firms within an industry so that only the most profitable ones remain. China's central government has implemented this process through policies such as privatization and the closure of uneconomic enterprises.[81] Although rationalization initiatives increased during the 1990s, they were poorly implemented.[82] To address this issue, SASAC was established in 2003 as the main implementing body of SOE rationalization. This section further describes SASAC and its December 2006 directive, as well as China's main rationalization objectives, which include privatization and the closure of uneconomic enterprises. Key rationalization practices and policies in China are summarized in table 2.2.

### State-Owned Asset Supervision and Administration Commission (SASAC)

SASAC was created to coordinate China's SOE rationalization process through measures such as privatization and bankruptcies, to serve as the central investor in the state sector (by supervising and managing SOE assets),[83] and to consolidate the functions that other

[79] Ibid.

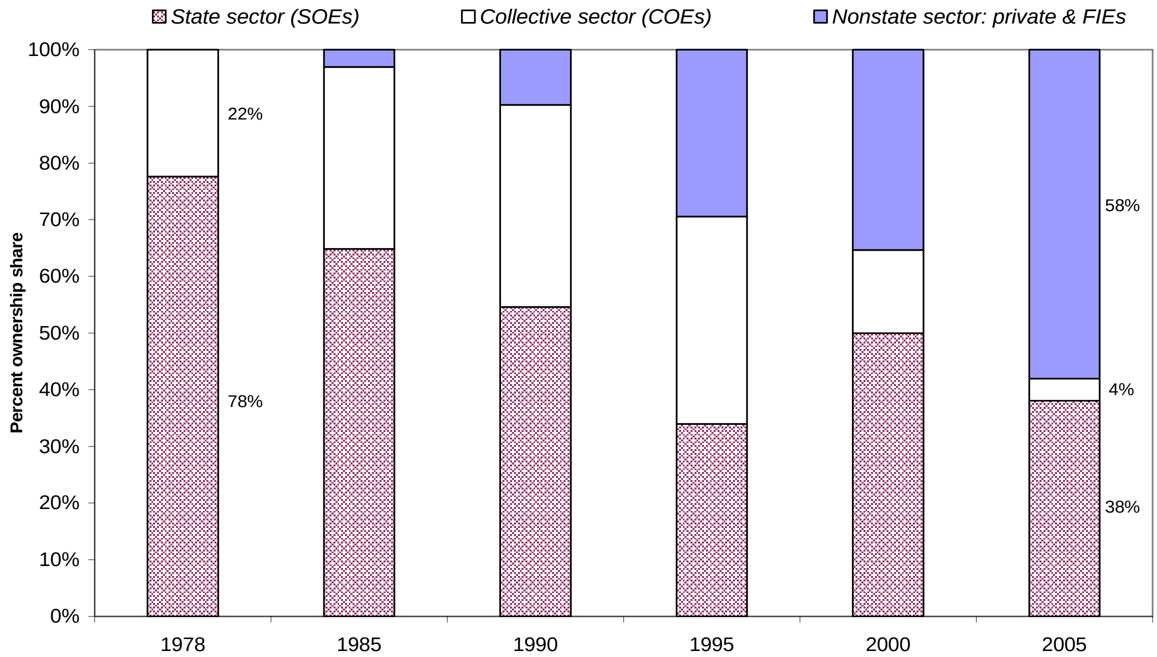
[80] Figures D.1 and D.2 in app. D shows these trends economy-wide. GDP data disaggregated by ownership type are unavailable beyond 2000.

[81] Merger, another important rationalization policy, is not included here because that policy is beyond the scope of this investigation. For additional information, see Keister, *Chinese Business Groups.*

[82] Xu and Lin, "Political Control, Agency Problems, and Ownership Reform."

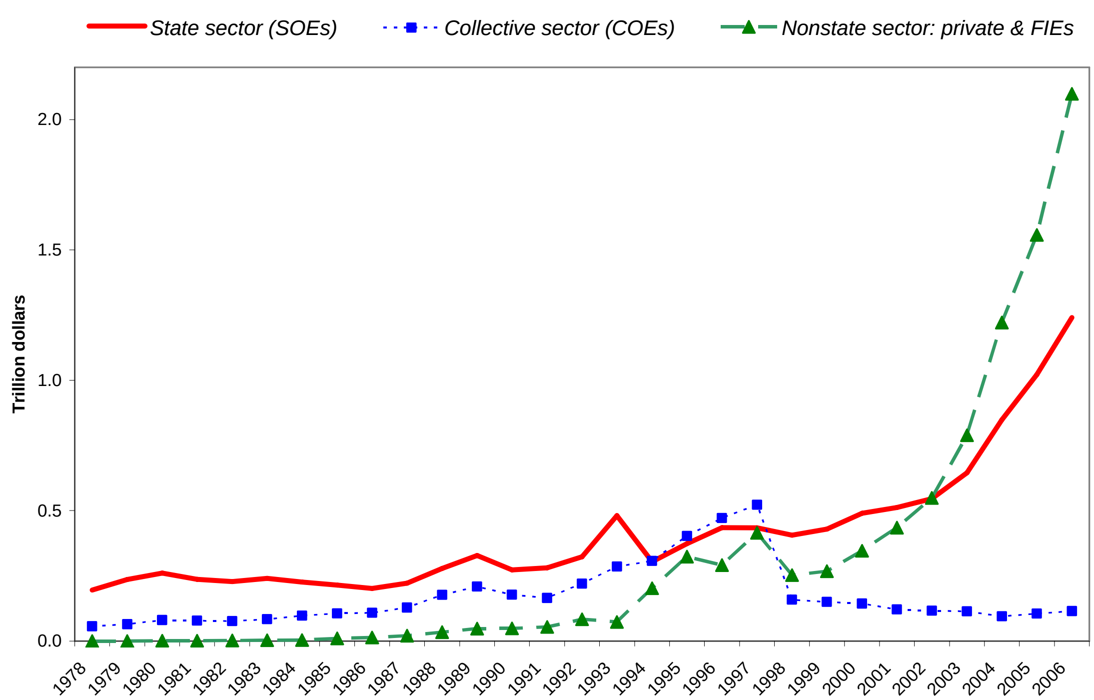
[83] See Article 10 of "Interim Regulations on Supervision and Management of State-Owned Assets of Enterprises" (retrieved from Yusuf et al., *Under New Ownership*, 133); and SASAC, "China State-Owned Assets Management System Reform Entering New Stage."

**Figure 2.1 China: Gross value of industrial output by ownership type, 1978-2005 (percent)**




*Sources:* NBS, *China Statistical Yearbooks* and CEIC.

**Figure 2.2 China: Gross value of industrial output by ownership type, 1978-2005 (trillion dollars)**




*Sources:* CEIC; IMF, *International Financial Statistics* (exchange rates); *and* NBS, *China Statistical Yearbooks*.

**Table 2.2** Rationalization: Summary of key practices and policies

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| | **SASAC** | |
| SASAC established to coordinate rationalization efforts. | Central, provincial, and local government | • 2003 State Council initiative |
| Guiding Opinion on Promoting the Adjustment of State-owned Capital and the Reorganization of State-owned Enterprise. | Central, provincial, and local government | • 2006 State Council directive |
| | **Privatization/Corporatization** | |
| Privatized firms given legal standing by the Standing Committee of the National People's Congress. | Central government | • 1993 Corporate Law |
| Various policy announcements strengthening a shareholding-based privatization system. | Central government | • 1992, 1997 policy statements; CPC 15th Party Congress |
| Government identifies privatization objectives and identifies the need to withdraw from certain sectors; announces intention to diversify the state sector ownership structure; announces plan to provide a source to finance its national social security system. | Central government | • 1999 Fourth Plenum the 15th Central Committee |
| Government institutes legal provision to ensure privatized SOEs represented under the law. | Central government | • 2003 Corporate Law |
| Government establishes framework for how firms could be privatized (corporatized). | Central government | • 2003 Corporate Law |
| | **Closure of uneconomic enterprises** | |
| Government instituted guidelines for bankruptcy procedures. | Central government | • 1991 Civil Procedures Law |
| Certain provincial and local governments enacted bankruptcy laws to stimulate the practice in their jurisdiction. | Provincial government | • 1993 Guangdong Provincial People's Congress and Shenzhen Municipal People's Congress |
| Capital Structure Optimization Program | Local government | • 1994 (18 municipal governments) |
| New Bankruptcy Law enacted that applied to all forms of enterprises, placed less emphasis on minimizing worker layoffs, and adjusted payment priorities to reflect modern, international practices. | Central, provincial, and local government | • 2007 Bankruptcy Law |

*Sources*: ADB, "Private Sector Assessment"; EIU, "China Regulations: New Bankruptcy Law Approved"; Garnaut et al., *China's Ownership Transformation*; Jefferson and Singh, *Enterprise Reform in China;* Li, "SASAC"; Mattlin, "The Chinese Government's New Approach to Ownership"; Naughton, "Claiming Profit for the State: SASAC and the Capital Management Budget"; SASAC, "Guiding Opinion"; World Bank , "China's Emerging Private Enterprises"; WTO, *Trade Policy Review: China*; and Yusuf et al., *Under New Ownership*.

government agencies previously provided.[84] SASAC was established under the State Council to "exercise the government's power of ownership," [85] and it remains administered by central, provincial, and city-level government authorities.[86]

At its inception in 2003, SASAC was given the responsibility of supervising and managing 196 central government administered SOE nonfinancial conglomerates (which represented approximately 159,000 SOEs) whose assets were valued at approximately $832 billion (RMB 6.9 trillion).[87] The combined profits of these SASAC-managed firms accounted for 70 percent of total SOE profits, which in turn generated an estimated 20 percent of the China's central government tax revenue.[88]

SASAC's operating guidelines limit its management of the production and operational activities of state sector firms.[89] However, some of these guidelines also provide SASAC with broader authority to exercise its rights as principal investor.[90] This includes the right to retain SOE dividends (which can hamper managerial investment decisions),[91] impose managerial decisions that may have broader policy implications,[92] and select, evaluate, and remove mangers in the state sector.[93] In practice, however, many of these rights are often not exercised.[94] Parent companies of stock-listed SOEs, as discussed in more detail

[84] Other agencies and departments previously responsible for the management and rationalization of state and collective sector firms include Ministry of Finance, Ministry of Labor, and Social Security, former State Economic and Trade Commission, and CPC Central Enterprise Work Commission. Additional SASAC functions include trading equity, recruiting international management, promoting use of international auditing standards, and divesting social functions (e.g., schooling, health care) from state sector firms. See Green and He, "China's Privatization Ministry?"; Imai, "Explaining the Persistence of State Ownership in China," 12; and Yusuf et al., *Under New Ownership*, 103.

[85] Naughton, "Claiming Profit for the State: SASAC and the Capital Management Budget," 2.

[86] The discussion in this report primarily focuses on centrally government administered SASACs (central SASACs). The central government typically supervises larger state sector firms while provincial- and district-level governments typically supervise smaller state sector firms. Mu, "SOE Bankruptcies Planned," 1–3; and Yusuf et al., *Under New Ownership*, 103.

[87] Many of the holding companies were converted from the former industrial ministries. WTO, *Trade Policy Review: China*, 133; and Naughton, "China's State Sector."

[88] Mattlin, "The Chinese Government's New Approach to Ownership," 9.

[89] See Interim Regulations on Supervision and Management of State-Owned Assets of Enterprises.

[90] This authorizes "investors"—or SASAC since it controls dominating equity stakes—to make firm-level decisions that lie within the scope of "regular investor responsibilities."

[91] SASAC officials reportedly consider this right important to prevent managers from making unprofitable investment decisions with the excess funds. Mattlin, "The Chinese Government's New Approach to Ownership," 13.

[92] Yusuf et al., *Under New Ownership*, 13.

[93] WTO, *Trade Policy Review: China*, 133; and industry representatives, interviews by Commission staff, September 4–5, 2007.

[94] Academics such as Barry Naughton have written about the differences between SASAC's widespread authority and practice in making SOE level employment decisions. While Commission field study interviews confirmed this finding in certain companies, other interviews suggest that SASAC still plays an active role in choosing managers in certain state sector firms. See Naughton, "Claiming Profit for the State," 3.

below, typically have not yet made required dividend payments to SASAC,[95] even as many listed firms have already transferred such payments to their parent companies. To date, SASAC interference in appointing managers reportedly appears to be limited to certain sectors and firms.[96]

As a key component of the rationalization process, SASAC is encouraging its solvent SOEs to list on domestic stock exchanges (through privatization/corporatization), while allowing enterprises with debts exceeding assets to close (through bankruptcy). By August 2005, this process had reduced the number of central SASAC nonfinancial SOE conglomerates from 196 to 168 (or 127,000 firms).[97]

*December 2006 SASAC directive*

One of the most influential policies SASAC has proposed to the State Council was the December 5, 2006 announcement on "Guiding Opinion on Promoting the Adjustment of State-Owned Capital and the Reorganization of State-Owned Enterprises."[98] This directive, for the first time, provided clear insight into the type of industries China's central government considers strategically important. The list of industries includes the following: (1) armaments; (2) power generation and distribution; (3) petroleum and petrochemicals; (4) telecommunications; (5) coal; (6) civil aviation; and (7) shipping (table 2.3).Stated criteria for determining which industries were considered strategically important were based on national security and economic independence interests in maintaining absolute control over infrastructure, key mineral resources, public goods and services, and high- and/or new-technology industries.[99] The 44 large SOE conglomerates that remain fully owned by central SASAC are highly concentrated in this narrow group of sectors.[100] SASAC assets and profits in these 44 conglomerates constitute 75 percent and 79 percent of the central SOEs' total assets and profits, respectively."[101]

[95] SASAC instituted new regulations requiring all SOEs to transfer dividends to SASAC beginning in the first quarter of 2007 in light of the rapid growth in large natural resource and energy sector firms. It is too soon to tell if these regulations have been effectively implemented. *China Daily*, "SOE Dividends Should Go to State Coffers"; Mattlin, "The Chinese Government's New Approach to Ownership," 13; and World Bank, "SOE Dividends: How Much and to Whom?" 13.

[96] Naughton, "Claiming Profit for the State," 3; and industry representatives, interviews Commission staff, September 4–5, 2007.

[97] WTO, *Trade Policy Review: China*.

[98] SASAC, "Guiding Opinion"; and Li, "SASAC."

[99] Li, "SASAC."

[100] Naughton, "China's State Sector, Industrial Policies and the 11th Five Year Plan"; and Mattlin, "The Chinese Government's New Approach to Ownership," 9.

[101] *Xinhua News*, "SASAC."

**Table 2.3** SASAC's December 2006 directive: Industries that are to remain under SASAC influence

| Category description | Industries included | Ownership control | Approximate number of conglomerates |
|---|---|---|---|
| Strategic and key industries | Armaments, power generation and distribution, oil & petrochemicals, telecommunication, coal, civil aviation, shipping | Maintaining at least a 50 percent government equity stake in every firm in industry grouping | 44 |
| Basic and pillar industries | Machinery, automobiles, information technology, construction, steel, base metals, chemicals, land surveying, research and development | Maintaining at least a 50 percent government equity stake in principle enterprises within industry grouping | 70 |
| Other industries | Trading, investment, medicine, construction materials, agriculture, and geological exploration | Maintaining necessary influence by controlling stakes in key companies. In non-key companies, state ownership will be clearly reduced | 50 |

*Sources:* State Council Opinion released May 12, 2006 (app. 1, doc. 18); exclusive Xinhua interview with SASAC Chair Li Rongrong, Dec. 18, 2006, State Council website; reporting on press conference with Li Rongrong explaining the rationale of the policy paper; and Mattlin, "The Chinese Government's New Approach to Ownership."

The December 2006 directive also called for principle companies in "pillar industries" to remain at least 50 percent government-owned. The list of industries in this group is more comprehensive than that for "strategic industries" (table 2.3), and includes the following: automobiles, construction, and information technology.[102] There are approximately 70 large SOE conglomerates under SASAC supervision in this category, whose assets and profits constitute 17 and 15 percent of the central government-administered SOE total assets and profits, respectively.[103]

## Privatization

Privatization is the transfer of the ownership of firms within an industry, or entire industries, from the state to the private sector. While China's broader central government policy encouraged this through the sale of SOEs on domestic stock markets, the

[102] Mattlin, "The Chinese Government's New Approach to Ownership," 16.
[103] *Xinhua News*, "SASAC."

government has never embraced pure privatization as a central policy objective[104] for ideological or other reported reasons.[105] Consequently, the central government has limited full privatization to the sale of relatively small and inefficient SOEs.[106] As an alternative to the comprehensive sale of SOE assets, China has turned to a partial form of privatization, called corporatization,[107] as the preferred medium.

### *Corporatization*

Corporatization is the process through which most of China's state-owned or collective enterprises have been converted into share-issuing companies. Through this process, China's government has typically retained dominant equity stakes, as well as a limited management voice, in the privatized enterprises.[108] Recent studies suggest that while corporatization has had a positive influence on SOE innovation, corporate governance, managerial accountability, and hiring practices,[109] corporatized SOEs have dealt less effectively with labor productivity and excessive debt.[110] This is partially explained by the fact that a portion of corporatized companies' shares (approximately 25 to 33 percent) are still owned and influenced by China's government, and reflects government concerns about managing unemployment and enterprise debt.[111]

China's government unveiled its formal privatization objectives in 1999 after several years of reforms that helped lay the groundwork.[112] At the Fourth Plenum of the 15th Central Committee, it formally identified the need to withdraw its influence from certain

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[104] China's government has consistently ruled out privatization as an option for SOE reform. Mako and Zhang, "Management of China's State-Owned Enterprises Portfolio"; and Mattlin, "The Chinese Government's New Approach to Ownership," 16.

[105] Green, "Two-Thirds Privatization," 2.

[106] This policy initially targeted small, inefficient SOEs. The Fourth Plenum of the CPC 14th Central Committee ultimately included medium-sized SOEs as privatization targets. For a description of the differences between small, medium, and large SOEs, see NBS, *Working Handbook*, 140, and Mako and Zhang, "Management of China's State-Owned Enterprises Portfolio," 42; and Cao et al., "From Federalism," 2; and Xu, et al., "Political Control, Agency Problems, and Ownership Reform," 2–3.

[107] Yusuf et al., *Under New Ownership*, 87–89, 219; Cao, "Chinese Privatization"; Jefferson and Singh, *Enterprise Reform in China*, 107; and Zhu, "China's Corporatization Drive," 29.

[108] Yusuf et al., *Under New Ownership*, 87–89 and 219.

[109] "See Aivaziana, Geb, and Qiu, "Can Corporatization Improve the Performance of State-owned Enterprises"; Jefferson "The Impact of Shareholding Reform on Chinese Enterprise Performance, 1995–2001"; and Yusuf et al., *Under New Ownership*, 217.

[110] Guo and Yao, "Causes of Privatization in China."

[111] Different studies have independently come up with similar estimates of ownership shares (the WTO claims 25 percent, while Stephen Green claims 33 percent). Green, "Two-Thirds Privatization"; and WTO, *Trade Policy Review: China*. For additional information, see the sections on "Banking and Finance Sector Policies" and "Worker Training and Retraining" in chap. 4 of this report.

[112] By October 1992, at the 14th Party Congress, the central government announced a new objective of creating a modern corporate system in its socialist market economy. By 1993, corporatized firms were given legal standing through the "corporate law," by the NPC Standing Committee. In 1997, China's 15th Party Congress placed the shareholding system at the centerpiece of China's enterprise restructuring, providing an unofficial mandate for privatization. Jefferson and Singh, *Enterprise Reform in China*, 107, and Li et al., "The Road to Capitalism," 269.

sectors, diversify the state sector's ownership structure, and provide a source to finance its national social security system.[113] China also amended its Corporate Law in 2003 to ensure that privatized SOEs and other forms of enterprises were fully represented in the law. This new Corporate Law also provided the basic framework from which firms could be privatized and corporatized. Box 2.2 describes stock distribution for corporatized firms.

Under the new law, the split stock system was devised to facilitate the corporatization of firms that still provided social services to its employees.[114] Under this system, the government authorized the division of the company in two parts: the joint-stock company that retained the productive assets, and the parent company that assumed the company's debts, nonproductive assets (e.g., schools, medical clinics), and excess staff.[115] In cases where SOEs no longer performed many social services, the entire company could simply become a joint-stock firm.[116] The amended Corporate Law was subsequently implemented on January 1, 2006.

**Box 2.2** China: Stock distribution for corporatized firms

The current practice of corporatization provides for three different forms of stock distribution. The first involves the distribution of non-tradable state shares to the State Council, which are formerly managed by the national or sub-national branches of SASAC.[a] The second involves a stock issuance to legal persons (LPs) who have the right to sell to other LPs, but not on the stock exchange.[b] These typically account for 30 percent of the companies' newly corporatized stock, and are commonly distributed to the parent company and their employees (sometimes in lieu of wages). The third and final form involves public shares that are tradable, and account for at least 25 percent of the joint stock company's total shares. This form is differentiated by type of buyer. So-called "A shares" are sold to domestic investors in renminbi; "B shares" are sold to foreign investors exchanging on the Shanghai Stock Exchange (in dollar denominated terms) and the Shenzhen Stock Exchange (in HK dollar denominated terms); and "H shares" are sold to foreigners on overseas stock markets. Since many of these non-tradable shares are also owned by state wholly-owned holding companies, or state-controlled nonlisted holding companies, the accumulation of government ownership of these shares is high, reaching 84 percent by 2001 according to one estimate.

*Sources:* Green, "Two-Thirds Privatization"; Liu and Sun, "Identifying Ultimate Controlling Shareholders in Chinese Public Corporations"; WTO, *Trade Policy Review: China*, 135; and Yusuf et al., *Under New Ownership*, 89.

Notes:

[a] Owned by central SASAC or provincial- or city-level SASACs depending on whether the SOE was originally owned by the central, provincial, or local levels of government.

[b] Although these forms of stock were intended to be non-tradable, they could be exchanged outside the open market in a variety of ways, including through agreed sales (where a company, often private, buys LP shares from a state LP shareholder for cash), indirect takeovers, free or judicial transfers (where shares are transferred from one government organization to another or by judicial decision), and/or entrusted shares (where a purchaser buys a controlling share of stocks).

[113] Mako and Zhang, "Management of China's State-Owned Enterprises Portfolio," 36.
[114] Mattlin, "The Chinese Government's New Approach to Ownership," 26.
[115] WTO, *Trade Policy Review: China*, 135.
[116] Ibid.

## Closure of Uneconomic Enterprises

The closure of uneconomic enterprises, which has occurred through government-mandated bankruptcy filings, represents another instrument that China's government has used to satisfy its rationalization objectives. In market-based economic systems, bankruptcy laws govern creditor-debtor relationships,[117] provide efficient mechanisms for reorganizing inefficient enterprises, and help transfer resources out of nonviable areas.[118] Sources report that China's bankruptcy system is inefficient because it is still in the early phases of such reforms and remains encumbered by institutional barriers such as limits on laying off workers.[119] Currently, many resources are lost during bankruptcy procedures, given the lack of a sophisticated secondary market for asset redistribution.[120]

China's most recent Bankruptcy Law entered into effect on June 1, 2007, and sought to remedy problems that persisted from prior legislation and policies[121] by providing a comprehensive approach to bankruptcy that applied to all forms of enterprises. The Bankruptcy Law places less emphasis on minimizing worker layoffs[122] and adjusts payment priorities to reflect current standard international practices (e.g., first, pay all secured claims; second, pay for all secured employee claims; and third, resolve outstanding tax and unsecured payments).[123] For these efforts, the passage of the new law has been considered a milestone in China's market-oriented reform measures.[124] The law is likely to increase foreign investor confidence in their ability to recover invested capital and claims in the event of bankruptcy.[125]

China's 2007 Bankruptcy Law authorizes financial regulators to intervene in financial-service company bankruptcies (such as those for banks), and places greater responsibility on senior management by prohibiting senior managers who had been involved in a bankrupt company from assuming positions of senior responsibility in other companies for three years after bankruptcy.[126] This law also authorizes voluntary bankruptcy filings by the debtor and involuntary bankruptcy filings from the creditor against the debtor, prevents asset transfers to insiders, and recognizes the rulings of foreign courts.[127]

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[117] OECD, "Comparative Overview Of Asian Insolvency Reforms in the Last Decade."

[118] World Bank, "Bankruptcy of State Enterprise in China."

[119] Reasons that China's bankruptcy system has been inefficient include: (1) creditor banks often only recover 3–10 percent of their claims, (2) restructuring alternatives to liquidation remain limited, and (3) secondary markets remain underdeveloped. World Bank, "Bankruptcy of State Enterprise in China."

[120] Industry representatives, interview with Commission staff, September 11, 2007.

[121] The original aim of China's bankruptcy filings also included collective sector firms, although filings in that sector were not as prominent. A history of China's recent bankruptcy laws is provided in app. C.

[122] *Business Week*, "China's New Mantra: Creditors First"; and EIU, "China Regulations: New Bankruptcy Law Approved."

[123] The old policy is to be phased out gradually through a grandfathering provision, with priority given to employee claims incurred before August. 27, 2006. World Bank , *China Quarterly Update*, 19–20.

[124] *Financial Times*, "Struggling China State Companies with Stay of Execution."

[125] Palmer and Rapisadi, "China's New Bankruptcy Law and Its Implication for Doing Business in China."

[126] EIU, "China Regulations: New Bankruptcy Law Approved."

[127] Shuguang, "Bankruptcy Law in China: Lessons of the Past Twelve Years."

Despite its advancements, the 2007 Bankruptcy Law does not apply to 2,116 of China's worst performing SOEs (mostly in the military and mining industries) until 2008.[128] This is largely based on government concerns about the social costs of widespread unemployment.[129] Some sources have expressed concerns about the transparency of the law. For example, China's courts reportedly can decide to accept or reject bankruptcy applications based on undefined criteria.[130] Under "special circumstances" related to the interests of unemployed workers, judicial and government decisions typically favor employee claims.[131] Finally, there is a lack of local, experienced insolvency practitioners and judges to implement such laws, especially in rural China.[132]

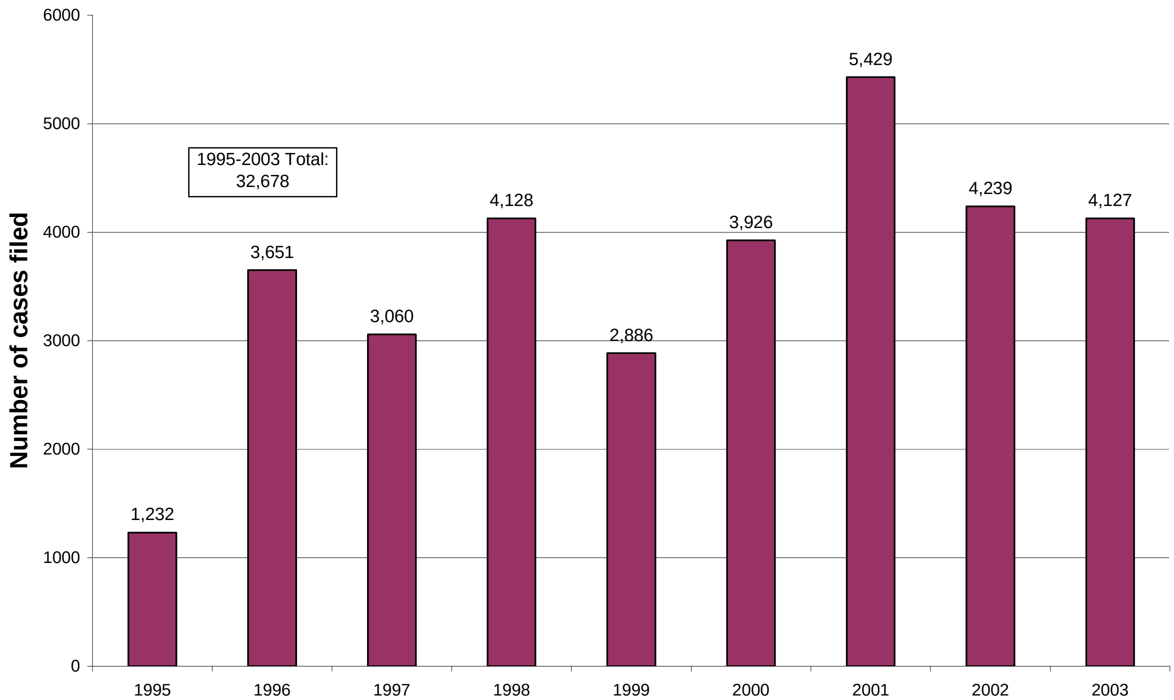
The number of bankruptcy cases in the state sector has fluctuated throughout 1995-2003 from a low of 1,232 in 1995 to a high of 5,429 in 2001 (figure 2.3). The vast majority of these cases were bankruptcy filings by small SOEs that typically employed fewer than 1,000 workers.[133] It is estimated that bankruptcies have been responsible for one-third of the decline in the number of SOEs.[134]

## *Liberalization of the Nonstate Sector*

The liberalization of China's nonstate sector is the counterpart to China's state sector rationalization measures. Liberalization of the nonstate sector also has been a key stimulus behind China's rapid economic growth. Private and foreign-invested firms have flourished under this new system, as evidenced by market entry trends, and the sector's progressively growing shares of GDP, industrial output, employment, exports, and fixed asset investment (see appendix D). The Commission identified several key practices and policies related to private ownership in China, which are summarized in table 2.4.

[128] *People's Daily*, "China to Bail Out Last Group of Money-Losing SOEs."
[129] *Financial Times*, "Struggling China State Companies with Stay of Execution."
[130] EIU, "China Regulations: New Bankruptcy Law Approved."
[131] *Asia Times,* "Foreign Credit Cracks China's 'Iron Rice Bowl'."
[132] *Asia Times,* "Bankruptcy Law to Protect China Investors."
[133] Imai, "Explaining the Persistence of State-Ownership in China," 5.
[134] The number of broadly defined SOEs declined by 107,525, from 253,525 to 146,000, between 1995 and 2003. Over this period, the number of SOE bankruptcy cases amounted to 32,678, or 30.4 percent of the number of SOEs that were rationalized over this period. See Imai, "Explaining the Persistence of State-Ownership in China," 5.

**Figure 2.3 China: SOE Bankruptcy Cases, 1995-2003**




*Sources: Law Yearbook of China* (various years), and Imai, "Explaining the Persistence of State-Ownership in China," 5.

**Table 2.4** Private ownership: Summary of key practices and policies

| ***Practices and policies*** | ***Level of government*** | ***Associated laws and regulations*** |
|---|---|---|
| Private ownership incorporated into China's constitution in March 1999. | Central government | • 1999 constitutional amendments |
| Provincial and local governments relax restrictions on private enterprises. | Provincial and local governments | • Local government private ownership initiatives |
| Constitutional amendment explicitly stating that private property is inviolable. | Central, provincial, and local | • March 2004 constitutional amendment |
| Central government institutes requirements to local governments, to implement the constitutional amendments that guarantee private property rights. | Provincial and local governments | • 2005 Guidelines for Encouraging and Supporting the Development of the Non-Public Sector Including Individual and Private Enterprises |
| First law to state that the government recognizes and protects the rights of all market participants equally, placing ownership rights of the state, agricultural collectives, corporations, and individuals on the same legal footing. | Central, provincial, and local governments | • 2007 Property Law |
| Bankruptcy laws provide a legal means for enterprises to cease operations and dissolve their assets, and provide guidance with respect to handling laid off workers. | Central, provincial, and local governments | • Bankruptcy Law, 1986, 1996, 2007<br>• 1991 Bankruptcy Guidelines<br>• 1993 local level bankruptcy law |

Sources: ADB, "Private Sector Assessment"; EIU, "China Regulations: New Bankruptcy Law Approved"; Garnaut, et al., *China's Ownership Transformation*; Jefferson and Singh, *Enterprise Reform in China;* Li, "SASAC"; Mattlin, "The Chinese Government's New Approach to Ownership"; Naughton, "Claiming Profit for the State: SASAC and the Capital Management Budget"; SASAC, "Guiding Opinion"; World Bank (IFC), "China's Emerging Private Enterprises—Prospects for the New Century"; WTO, *Trade Policy Review: China;* and Yusuf et al., *Under New Ownership*.

## Domestic Private Sector Development

The emergence of China's domestic private sector constitutes one of the most influential aspects of China's overall market-oriented reform strategy, given the sector's robust growth rate.[135] Since the 1990s, the private sector has become the most dynamic element of the domestic economy[136]—attributable, at least in part, to the sector's efficient use of resources and its capacity to create jobs. Figure D.10 in appendix D shows that China's domestic private sector's share of total fixed asset investment ranged from 15-25 percent since 1995. However, the sector's share of bank borrowing—due to residual biases by banks against private-sector lending and a lack of credit history by many private firms—accounted for less than 1 percent of working capital loans in this period.[137] This phenomenon has forced private-sector firms not only to seek alternative sources of capital, but to become more efficient with the limited available resources.

Job creation has also helped explain the private sector's rapid growth, and can be attributed in part to government encouragement of hiring previously laid-off state and collective sector workers in the private sector.[138] The Asian Development Bank (ADB) has estimated that about 24 million new jobs (approximately 26 percent of China's total 92 million new jobs in that period) originated in the private sector between 1997 and 2001 alone. Moreover, the number of new jobs in private sector firms exceeded that of the both the state and collective sectors combined.[139]

Other major practices and policies promoting private sector development include the 2001 streamlining of private firm registration process, and the State Council's 2005 "Guidelines on Encouraging and Supporting the Development of the Non-Public Sector including Individual and Private Enterprises."[140] These guidelines were intended to help private companies gain market access to previously restricted industries, such as those dominated by state monopolies (e.g., public utilities, financial and social services, and national defense equipment).

[135] This growth, however, was unplanned. In the late 1970s, China's policymakers simply revived private business activity in the wake of China's Cultural Revolution as a way to supplement the activities of the state and collective sectors, combat rising unemployment, and minimize economic stagnation. Through three decades of gradual experimentation at the local and sector levels, unpublicized initiatives were taken to stimulate private sector development. These initiatives were subsequently endorsed, and then promoted, by China's central government. World Bank, "China's Emerging Private Enterprises," 7.

[136] Ibid.

[137] Ibid, 17.

[138] ADB, "Private Sector Assessment," 24.

[139] Rawski, "The Political Economy of China's Declining Growth."

[140] WTO, *Trade Policy Review: China*, 18.

*Private ownership*

The importance of private ownership was officially recognized in China's constitution in March 1999.[141] This amendment provided a basis for subsequent changes in the legal, policy, and regulatory environment surrounding private sector firms.[142] Following the adoption of the amendment, local governments began relaxing restrictions on private enterprises.[143] Recognition of the importance of private ownership in China's constitution was further elaborated by means of an amendment promulgated by the central government on March 14, 2004. By explicitly stating that private property was inviolable, and that the individual and private sectors would be protected (in a way that even criminalizes theft from private sector firms),[144] the 2004 law helped clarify and protect ownership rights.[145] To reinforce its official position on the private sector, the government further stated that it "encourages, supports, and guides the development of the nonpublic sectors of the economy." The 2004 amendment also made Communist Party membership available to private entrepreneurs, which increased their ability to influence government policy.[146]

The central government's measures to reinforce the protection of property rights at the local level included the State Council instituting guidelines in February of 2005 to "encourage and support development of the nonpublic sector including individual and private enterprises," which ultimately prompted local governments to better protect private property by amending their own local constitutions.

Private ownership rights of domestic nonprivatized firms were given further support through the passage of China's 2007 Property Law (effective October 1, 2007). For the first time, the law indicated that the government "recognized and protects the legal position and development rights of all market participants equally," thereby placing ownership rights of the state, agricultural collectives, corporations, and individuals on the same level.

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[141] This was done by amending the "private economy is a supplement to public ownership" clause in the Constitution's 11th Article to "the non-public sector, including individual and private businesses, is an important component of the socialist market economy." *China Daily*, "Top Lawmakers Yesterday Overwhelmingly Endorsed China's Landmark Constitutional Amendments"; Guo and Yao, "Causes of Privatization in China," 2; and Qian, "Institutional Foundations for China's Market Transition," 31.

[142] ADB, "Private Sector Assessment," 12.

[143] For example, the Jiangsu provincial government adopted a new policy to give private enterprises equal treatment to state-owned and collective enterprises for registering businesses and granting access to credit through state-owned banks. Also, around the same time, the People's Banks of China issued its Guidelines on Strengthening Credit Support to Efficient SMEs with Sound Credit Stand and Marketable Products, which was intended to help official agencies create departments to serve small to medium-sized private companies' credit needs. Qian, "Institutional Foundations for China's Market Transition," 9. and ADB, "Private Sector Assessment," 16.

[144] EIU, *Country Commerce: China*, 72.

[145] Embassy of the People's Republic of China in the United States of America, "Property Law to Secure Ownership."

[146] The amendment states that the CPC must always represent "the development trend of China's advanced productive forces, the orientation of China's advanced culture and the fundamental interests of the overwhelming majority of the Chinese people." WTO, Trade *Policy Review: China*, 30.

Despite legal advances in securing private ownership in China's constitution, some ambiguity remains with respect to the full legal status of private sector firms. China's law currently states that all land is ultimately owned by the government or agricultural collectives, but that land can be expropriated from private corporations or individuals only when it is in the public interest.[147] Also, private ownership appears to contradict an article in the constitution and civil code that states that socialist public property is "inviolable," though the implications of this remain ambiguous. Finally, verifying land ownership rights is difficult in China, as the country lacks a regional land-registration system, and access to land-transaction records is nearly impossible to obtain.[148] This ambiguity in property rights leaves considerable discretionary scope to government authorities but, like most legal matters in China, these rights are likely to be clarified once interpreted at the local level.[149] Ambiguity over private ownership may continue to hamper private firms' ability to become fully integrated into the economy. This has contributed to domestic private firms' difficulties in accessing loans from principal Chinese banks, gaining miscellaneous administrative approvals, and becoming eligible for tax and other official business incentives.[150] In fact, prior to China's legislation to harmonize taxes, private companies typically faced higher rates than other forms of enterprises operating in China.[151]

## Foreign-Invested Enterprises

The foreign investment environment in China changed drastically with China's 2001 WTO accession.[152] The cumulative effect of China's WTO concessions was to significantly reduce China's trade barriers to imports and inward FDI. Most barriers identified through the accession process were removed in stages over five years, ending in December 2006. Despite this significant opening of China's economy to FDI, the WTO recently noted that Chinese government authorities continue to use "'indirect measures' . . . to 'guide' investment in certain sectors."[153]

Service sector industries have been among the most significant beneficiaries of China's opening to foreign investment, particularly financial and distribution services. Important new benefits for trade in goods included new rules on national treatment, elimination of export subsidies, and reduction of agricultural subsidies.[154] Consequently, FIEs have become a very important part of China's economy. In Shanghai, for example, more than 20,000 FIEs were in operation as of 2003. The combined production output of these companies accounted for more than one-half of the output of industries in Shanghai, and

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[147] Jones Day, "The New PRC Property Law," May 2007, 2–3.

[148] Keliang and Prosterman, "From Land Rights to Economic Boom," and Jones Day, "The New PRC Property Law," 2-3.

[149] Jones Day, "The New PRC Property Law," 2–3.

[150] EIU, *Country Commerce: China*, 72; and industry representatives, interview with Commission staff, August 31, 2007.

[151] State Council "Policy Devil's in the Details."

[152] This section discusses China's current policies toward FIEs, and the implications of those policies for the U.S.-China trade balance. Historical perspective on China's foreign investment policies is provided in app. C.

[153] WTO, "Concluding Remarks by the Chairperson."

[154] Prasad, ed., "China's Growth and Integration in the World Economy," 11.

employed a labor force of about 1.2 million workers. FIEs also accounted for more than one-third of Shanghai's business income tax revenue.[155]

*Implementation of WTO commitments*

As part of its WTO accession and of particular interest to manufacturing sector investors, China committed to implement the WTO Trade-Related Investment Measures (TRIMs) agreement, which prohibits performance requirements for goods-related investment. As a result, China has removed requirements on foreign investors to export a certain share of production, hire certain numbers of Chinese nationals, or source manufacturing inputs from domestic Chinese sources. China also has enacted legal protections for foreign investors' and domestic firms' intellectual property rights, pursuant to its commitments to implement the WTO Trade-Related Intellectual Property (TRIPs) agreement.[156]

China's central government has liberalized its foreign investment policies as outlined in its WTO accession agreement. However, local governments in China may not be supportive of the central government's WTO commitments.[157] Consequently, central government regulations designed to implement those commitments are not always fully implemented at the local level. In addition, central government ministries do not always interpret China's WTO commitments in the same way, leaving significant discretion to provincial and local government authorities in how they implement the central government's decrees.[158] For instance, regulations published by the central government designed to meet China's WTO General Agreement on Trade in Services (GATS) commitments related to distribution rights for foreign-owned firms in 2004 were not always implemented by local governments.[159]

*Government guidance of foreign investment*

In an effort to guide a larger share of FDI into certain desired industries, MOFCOM and the NDRC publish a Catalog for the Guidance of Foreign Investment Industries (Foreign Investment Catalog). The most recent version entered into effect on December 1, 2007.[160] The Foreign Investment Catalog classifies industries as "encouraged," "restricted," or "prohibited" foreign investment industries.[161] Any industry not listed falls into the

[155] "Shanghai Municipality."

[156] For example, see OECD, *China in the Global Economy,* 438–40; and Prasad, ed., "China's Growth and Integration in the World Economy" 11.

[157] Industry representative, interview with Commission staff, Shanghai, September 7 and 11, 2007.

[158] For example, see Subrahmanyan, "China and the WTO."

[159] Refers to the Administration of Foreign Investment in the Commercial Sector Procedures, effective June 1, 2004. Subrahmanyan, "China and the WTO."

[160] Officially, the State Council refers to the 2007 updated catalog as the "Industrial Catalog for Foreign Investment (2007 amendment)."

[161] Order of the State Development and Reform Commission, the Ministry of Commerce of the People's Republic of China, No. 24.

"permitted" category. Encouraged industries receive various incentives,[162] generally including the right for foreign companies to establish wholly foreign-owned subsidiaries.[163] Projects in these industries may also receive lower income tax and larger VAT rebates,[164] may import capital equipment duty-free, and may be allowed to borrow more than other investors in other industries.[165] For restricted industries, foreign investors are generally limited to joint ventures with a Chinese partner, and other restrictions may apply.[166] In addition, it may take longer and be more difficult to get approval for FDI projects for restricted industries, as most projects in this category need approval from the NDRC.[167]

Recent revisions to the Foreign Investment Catalog provided modest changes.[168] Newly encouraged industries include environmentally friendly technologies and modern logistics, all strong markets for U.S. firms. Newly prohibited industries include genetic technologies and information distribution platforms such as movie production, news websites, internet services, and other audio-visual services. Investment in financial futures firms and the construction and operation of electric power grids have been moved from the "prohibited" to the "restricted" category.

Municipalities may also issue their own foreign investment catalogs to guide local FDI decisions by foreign firms. For example, the Shanghai municipal government issued its 2003 Key Industries for Foreign Investments in Shanghai Municipality Catalog enumerating 93 encouraged industries distributed among manufacturing, services, infrastructure and utilities, and agriculture. The Shanghai Municipality simultaneously released the Distribution of Industries with Foreign Investment in Shanghai Municipality Guidelines, which guides foreign investors in specific industries into certain areas of the city.[169] Shanghai's list of encouraged industries was developed in coordination with the central government's list; however, the Shanghai list represents only a subset of "encouraged" industries listed by the central government.

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[162] On November 29, 2007, USTR announced that the United States and China had signed a Memorandum of Understanding (MOU) to settle a U.S. dispute pending against China under the WTO Dispute Settlement Understanding concerning the WTO-consistency of certain Chinese tax practices granting refunds, reductions, or exemptions from taxes or other payments. During the consultations, the United States expressed concerns about the WTO-consistency of tax and other preferences provided by China's FIE income tax law and preferences provided to encourage industries under the Foreign Investment Catalog, among other things. A copy of the MOU is provided in app. F.

[163] Qiao, "Revised Catalogue on Foreign Investment," *Asia Law & Practice*.

[164] VAT rebates are discussed in the section on "Taxation" in chap. 3 of the report.

[165] OECD, *Governance in China,* 44.

[166] Qiao, "Revised Catalogue on Foreign Investment."

[167] OECD, *Governance in China,* 44–5.

[168] The English version can be found at http://en.ndrc.gov.cn. During consultations leading to the November 29, 2007 MOU signed by the United States and China, the United States raised concerns about tax and other preferences provided to encouraged industries under the catalog. China explained that the revised catalog of December 1, 2007 did not reinstate those preferences. See section 3 of the MOU in app. F of this report.

[169] Areas include the Pudong New Area, certain free trade zones, hi-technology parks, and economic and technological development zones. The Guidelines of Shanghai Municipality for Foreign Investment in Industry Circular 2100/03.09.15/SH entered into effect on September 15, 2003.

China's central government has also instituted a system to help provincial and local governments promote investment. Under this system, MOFCOM coordinates investment promotion fairs and other investment attraction activities by local governments to avoid overlapping or competing events. MOFCOM also makes grants from central government resources to support provincial and local governments' efforts to attract FDI.[170]

China's 11th Five-Year Foreign Capital Utilization Plan (Foreign Capital Utilization Plan), 2006–2010, lays out the country's plans for utilizing foreign capital in service of China's broader 11th Five-Year Plan. One principal goal of the Foreign Capital Utilization Plan is to encourage "quality over quantity of foreign investment." The major tasks outlined in the plan include encouraging foreign investment in higher technology projects for a variety of industries, including agriculture, chemicals, automobiles, and electronic information. The plan includes a special emphasis on encouraging foreign investors to transfer technology and invest in Chinese R&D facilities to promote indigenous innovation.[171] The plan also states the need to encourage: additional liberalization of FDI in the service sector;[172] greater FDI in high-technology services; continued FDI in infrastructure; FDI in environmental services; and more attention to resource conservation and the environmentally friendly aspects of FDI projects.[173]

The Foreign Capital Utilization Plan specifies policy measures to support these central government investment priorities, including a new Enterprise Income Tax Law (EIT Law) that provides uniform tax incentives for both foreign and domestic firms, a streamlined foreign investment approval process, new intellectual property laws, and an improved FDI statistical data collection system.[174]

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[170] Circular of the General Office of the Ministry of Commerce on the Establishment of the Reporting System concerning the Investment Attraction Activities within or beyond the Boundary of the People's Republic of China, March 6, 2006.

[171] China's R&D policies and indigenous innovation are discussed in greater detail in the section on "Research and Development" in chap. 4 of this report.

[172] Banking, insurance, securities, telecommunications, distribution, tourism, and logistics services all receive specific discussion in the plan. Transportation, professional services, and construction are mentioned briefly.

[173] Environmental services include environmental protection engineering and pollution control and recycling technology. NDRC, 11th Five-Year Plan on Foreign Capital Utilization.

[174] The new EIT Law is scheduled to enter into force on January 1, 2008. The EIT is described in more detail in the section on "Taxation" in chap. 3 of this report.

# CHAPTER 3
# Price Coordination, Utility Rates, and Taxation

This chapter describes the practices and policies that central, provincial, and local government bodies in China currently use to support or influence decision making in China's agricultural, manufacturing, and services sectors in the following areas: price coordination, utility rates, and taxation.

Practices and policies addressed in this chapter directly target prices, and largely consist of government controls or taxes designed to limit the movement of prices of specific goods in China, to increase or decrease the price of specific goods in China, to generate revenues, or to redistribute those revenues. These policies have differing impacts depending upon whether they are applied to specific products or economy-wide.

## Price Coordination

China's central government controls the prices of certain key goods and services. Price control policies generally are geared toward domestic targets and objectives, such as maintaining the stability of supply and prices, by fixing prices at a set level or by providing minimum and/or maximum levels for prices to restrict price fluctuations to a predetermined range. China's legacy of central government economic planning over the last thirty years effectively resulted in many monopolistic practices with no framework of competition policy or competition law to prevent firms from colluding to restrain output in order to raise prices. China recently passed a long-planned Antimonopoly Law, which is scheduled to be implemented in 2008. China's practices and policies and practices related to both price controls and price collusion, within the framework of competition policy, are summarized in table 3.1.

**Table 3.1** Price coordination: Summary of key practices and policies

| ***Practices and policies*** | ***Level of government and sector where applied*** | ***Associated laws and regulations*** |
|---|---|---|
| NDRC monitors the overall price levels, as well as the prices of major goods and services. It also conducts inspections of prices of products and services such as electricity, grain, fertilizers, drugs, refined oil, and real estate, as well as charges levied on farmers and enterprises, educational fees, medical charges, and taxi fares. | • Central government | • 1998 Price Law<br>• Various measures implemented by NDRC |
| Price controls (fixed and/or guidance prices) on certain agricultural products, including rice, wheat, tobacco, cotton, vegetable oil, silkworm cocoons, and sugar | • Central government<br>• Agriculture | • 2005 State Council no. 1 Document<br>• 2002 Agricultural Law, article 37 |
| Tobacco, wheat, and rice subject to minimum procurement prices | • Central government<br>• Agriculture | • Notified in China's WTO accession protocol |
| A number of new price and income support policy measures were implemented in 2004 and extended in 2005 to increase grain production and rural incomes. | • Central government<br>• Agriculture | • Reported by the WTO |
| Price controls on pharmaceutical products. NDRC, the Ministry of Health, and several provincial pricing bureaus have implemented legislation to control prices of medical devices. | • Central and provincial government<br>• Pharmaceutical products and medical devices | • Pharmaceuticals were the only manufactured product subject to government price controls listed in China's WTO accession protocol |
| NDRC sets end-user prices for coal, electricity, natural gas, and oil | • Central government<br>• Utilities | • 1996 Electric Power Law<br>• 2004 Differential Power Price for Energy Intensive Industries<br>• Often no official policy; prices set by negotiation. Information on electricity, natural gas is provided in the section on "Utility Rates" in this chapter. |
| Central government controls the price of land-use rights. In 2006, the central government doubled land-use fees for new construction projects and set minimum prices for the sale of land for industrial use. Land-use rights controlled by provincial and local governments. | • Central, provincial, and local governments | • China's Constitution and its revisions in 1988, 1993, and 1999 |
| Imports of grain, vegetable oil, sugar, tobacco, crude and processed oil, chemical fertilizers, and cotton restricted to state-trading enterprises. | • Central government<br>• Agriculture | • 2004 Foreign Trade Law |

**Table 3.1** Price coordination: Summary of key practices and policies—*Continued*

| ***Practices and policies*** | ***Level of government and sector where applied*** | ***Associated laws and regulations*** |
|---|---|---|
| Lack of a comprehensive competition law leaves China vulnerable to anticompetitive conduct by private firms and SOEs. 2007 Antimonopoly Law may address some of these concerns, however allows exemptions to the prohibition on monopoly agreements and does not cover the agricultural sector, government-controlled monopolies, and SOEs. | • Central government | • 2007 Antimonopoly Law |

Source: U.S. Department of Commerce memorandum of August 30, 2006, on China's status as a nonmarket economy; WTO, *Trade Policy Review: China*; and USITC hearing transcript, 17 and 47.

## *Price Controls*

Prior to the reforms of the late 1970s, China's central government set prices for almost all goods and services.[175] In 1978, government-priced commodities accounted for 97 percent of total retail sales and 100 percent of the total sales volume of industrial production. The initial price system reform instituted a two-track system under which market prices coexisted with government-controlled prices for some goods and services.[176] Between 1984 and 1988, this two-track system was set up so that firms' output above the government-determined quota could be sold at higher market-determined prices. Efforts to broadly institute market-determined prices began in 1988; however, the central government continued to intervene in price setting in some sectors, including utilities, energy, transportation, and agriculture.[177]

China's 1998 Price Law established two types of price controls: government-set (fixed) prices and government guidance prices (where prices are allowed to fluctuate between a minimum, or floor, and a maximum, or ceiling, value).

In 2001, China's central government abolished 124 price regulations in order to comply with its WTO commitments.[178] In its accession agreement, China agreed not to use price controls to restrict the level of imports of goods or services, and China provided a list of the products and services that remained subject to price controls or government guidance pricing, which were applicable for both state-owned enterprises (SOEs) and private firms.[179] Products and services subject to government-set prices at that time included pharmaceuticals, tobacco, natural gas, edible salt, and certain telecommunications services. Products and services subject to government guidance prices included water, electricity, gasoline, kerosene, diesel fuel, fertilizer, cotton, various grains, vegetable oil,

[175] A primary goal of the government was to make China's economy relatively self-sufficient, but price controls caused widespread distortions in the economy. Owen, Sun, and Zheng, "Antitrust in China 2006," 6. Additional background information is provided in the historical overview included in app. C of this report.

[176] Kennedy, "The Price of Competition," 8.

[177] For example, in 1999, airlines were prohibited from offering air ticket discounts. The ban was lifted in early 2003. Owen, Sun, and Zheng, "Antitrust in China 2006," 14.

[178] The Chinese government issued the Price-Setting Catalog, which freed the prices of most commodities and services that were previously fixed. The number of commodity and service items subject to government-set prices was reduced from 141 in 1992 to 13 in 2001. Kennedy, "The Price of Competition," 8 and 29.

[179] USTR, *2006 Report to Congress on China's WTO Compliance*, 43.

some transportation services, and some professional services.[180] In addition, China agreed that additional products and services would not be added to the list and would work to eliminate price controls then in effect. Also in its WTO accession agreement, China acknowledged providing reduced prices on inputs, such as coal used for electricity generation and crude oil consumed by certain industrial sectors.[181]

## Current Price Control Practices and Policies

The current list of products and services subject to government price controls are published through the *China Economic Herald* and the NDRC website.[182] According to China's central government, approximately 4 percent of all commodities by volume of sales were subject to price controls in 2006.[183] In September 2007, the NDRC announced that it would freeze all government-regulated prices through the end of the year in response to rising inflation.[184]

The NDRC monitors the overall price levels, as well as the prices of major goods and services,[185] and it conducts inspections of prices of products and services such as electricity, grain, fertilizers, drugs, refined oil, and real estate, as well as charges levied on farmers and enterprises, educational fees, medical charges, and taxi fares.[186] The NDRC Price Department is responsible for setting the prices of important commodities and services,[187] setting and adjusting prices and fees administered by the central government, and recommending objectives, policies, and reform plans for price adjustment.[188] The NDRC Department of Price Supervision is responsible for guiding price supervision and inspection, drafting administrative laws and regulations of price supervision, and handling cases involving violations of price-related laws by central government agencies, provincial governments, and SOEs.

While the NDRC administers price controls by setting prices at the national level, adjustments to the prices of some products and services can be made in the provinces by the local bureaus of commodity pricing. In making these adjustments, local governments can take into account factors affecting supply and demand, such as production costs, government policies, prices of related products, and limitations on consumers' purchasing

[180] WTO, *Trade Policy Review: China*, 290–293.

[181] WTO, *Accession of the People's Republic of China*, Annex 5A, and Copper and Brass Fabricators Council, prehearing written submission, August 17, 2007.

[182] The current list is similar to what was included in China's WTO accession agreement. USTR, "2006 Report to Congress on China's WTO Compliance," 43.

[183] WTO, *Trade Policy Review: China*, 126.

[184] The NDRC also charged local governments with monitoring the prices of pork and other meats, eggs, electricity, and other products. *The Washington Post*, "Chinese Government Freezes Some Prices."

[185] The NDRC conducts a monthly survey in 36 cities of the prices for 46 major goods and services, including food and energy products. *China Daily*, "Pork Price Rise Alone Won't Affect CPI Much: Economists."

[186] NDRC, "Report on the Implementation of the 2006 Plan," 6–7.

[187] China has deemed these products and services—which include energy products, pharmaceuticals, and some agricultural products—to be "essential," or of important significance to national economic development and people's livelihoods. Hill, Lee-Alaia, and Norton, "Antidumping Duty Investigation of Certain Lined Paper Products," 49.

[188] NDRC, found at http://en.ndrc.gov.cn/, (accessed September 7, 2007).

power at the local level.[189] This is especially relevant for industrial inputs, such as water, gas, and electricity. Provincial governments also have control over the prices of thermal power, medical services, gardening, education, retirement homes, and entrance fees for tourist sites.[190]

### *Agricultural products*

Price controls, including both fixed and guidance prices, on selected agricultural products are part of China's economic policies geared to maintain agricultural self-sufficiency and to ensure that the country has an adequate supply of food at stable prices.[191] In 2005, China announced that it would continue to directly provide support to grain producers, increase support to farmers, purchase improved crop strains, agricultural machinery, and tools, and follow a minimum purchase price policy for key grains.[192] China's marketing and distribution system is based on a near monopoly by the central government relating to procurement and allocation of select agricultural commodities. For example, key grains are subject to minimum purchase pricing as part of the grain state trading enterprise.[193] As of 2004, tobacco was subject to a centrally set government price, and rice and wheat were subject to a minimum procurement price scheme. In addition to grains, certain other agricultural products, including cotton, vegetable oil, silkworm cocoons, and sugar, are sold at a statutory price because China considers them to be "important reserve materials."[194]

### *Pharmaceutical products and medical devices*

Between 1980 and 2000, the central government controlled the entire range of pharmaceutical prices in China, from manufacturers' sales prices to wholesale and retail prices.[195] Since 2000, China has controlled only the retail prices for prescription drugs that are listed as part of the country's medical insurance system.[196] However, even where market-determined pricing is allowed, the NDRC stipulates that pharmaceutical pricing be not far out of line with production costs.[197] Some pharmaceuticals have fixed prices set by the central government; and others have guidance prices set by the central government, which can be adjusted by provincial governments. In May 2007, the NDRC announced price caps on 1,200 pharmaceutical products.[198]

[189] WTO, *Trade Policy Review: China*, 125–126.

[190] Ibid., 126.

[191] WTO, *Trade Policy Review: China*, 172.

[192] State Council in its No. 1 Document (2005). Ibid.

[193] Grain production, pricing, marketing, and distribution in China are subject to a number of government controls. OECD, "China in the Global Economy: Governance in China," 478.

[194] WTO, *Trade Policy Review: China*, 126.

[195] Pharmaceuticals were the only manufactured product subject to government pricing listed in China's WTO accession protocol.

[196] Interfax China, "China Will Take Various Measures to Strengthen Control Over Drug Prices."

[197] Meng et al., "The Impact of China's Retail Drug Price Control Policy," 186–187.

[198] EIU, *Country Report: China*, June 2007, 20.

The NDRC, the Ministry of Health, and several provincial pricing bureaus have drafted legislation that aims to control the prices of medical devices.[199] Medical devices move from manufacturers, through distributors and hospitals, to end users. With healthcare costs rising in China, the central government's price controls are aimed at limiting profits at the various stages.[200]

### *Energy products*

The NDRC sets end-user prices for coal, electricity, natural gas, and oil.[201] In a gradual fashion, China has somewhat liberalized coal and electricity prices. In 2005, it introduced a coal-electricity price adjustment mechanism, under which the prices of coal for power generation and electricity from coal-fired power plants would fluctuate in response to the changing prices of coal. In 2007, China abolished a two-tiered price system for coal, where prices were set for plan-allocated quotas but market prices were used for demand in excess of the quotas.[202] However, part of what determines the price for commodities such as coal is the resource tax rate charged and, in the case of coal, the prices charged are generally lower than prevailing world prices.[203]

China's wholesale guidance prices for oil are based on the weighted monthly average of spot prices in international markets, and final retail oil prices are allowed to vary by up to 8 percent.[204] However, domestic price changes often do not fully reflect the extent of price changes on international markets; as the price China paid for imported crude oil doubled between 2004 and 2006, prices were not allowed to adjust upward enough and refiners reportedly lost over $5 billion in 2006.[205] As China's dependence on imported oil has increased in recent years, the government's attempt at balancing inexpensive oil for end users with profitability for China's oil companies has become more difficult.[206] For example, in 2007, the NDRC directed China's top two oil refiners to increase supply in certain provinces that had experienced shortages of oil products. China's refiners had recently increased exports of gasoline when fixed domestic retail prices were below international benchmarks, which contributed to the shortages.[207]

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[199] The American Chamber of Commerce, "2007 White Paper," 92–94.

[200] Medical Device and Diagnostic Industry, "Medical Device Regulatory Update."

[201] China's pricing policies with respect to electricity, water, and natural gas are discussed in the section on "Utility Rates" later in this chapter.

[202] Rosen and Houser, "China Energy," 24–25. Coal is the dominant energy source in China, making up about 70 percent of total primary energy consumption in the country.

[203] As a result of the low resource tax rates, natural resource-rich provinces are often some of the poorest in China. Chinese academic, interview with Commission staff, Beijing, China, September 2, 2007.

[204] *China Daily*, "Fuel Price Cuts Spark Debate on Controls."

[205] Rosen and Houser, "China Energy," 21.

[206] Downs, "China," 26–27.

[207] Market Watch, "China Tells Refiners to Increase Oil-Product Supply in Two Provinces." As a result of these price controls, gas prices in China are reportedly 25 percent lower than on global markets. Brian Jones (Foreign Service Officer), interview with Commission staff, Beijing, China, August 31, 2007.

### *Land-use rights*

Separate from price controls on goods and services, Government authorities in China control the price of land-use rights.[208] In China, all land is owned by the state or collective entities.[209] Prices for land-use rights are generally determined at the local level,[210] but the central government, through the Ministry of Land and Resources, monitors land-use prices and makes policy.[211] In 2006, the central government doubled land-use fees for new construction projects and set minimum prices for the sale of land-use rights for industry.[212] In addition, compensation is paid at set prices to holders of land-use rights when they are forced to move for the redevelopment of land for industrial use.[213]

### *State trading*

China maintains some price controls through the use of state trading enterprises as provided under the 2004 Foreign Trade Law (table 3.2). China's WTO accession protocol lists products subject to import through state trading enterprises, including grain, vegetable oil, sugar, tobacco, crude and processed oil, chemical fertilizers,[214] and cotton.[215] The 2004 Foreign Trade Law allowed state trading enterprises to control the importation of certain goods in order to ensure a stable domestic supply, stabilize prices, safeguard food safety, and protect the environment and exhaustible resources. The NDRC directly supervises the State Grain Administration and the State Tobacco Administration,[216] whereas SASAC is responsible for governance and oversight relating

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[208] Also separate from price controls on goods and services is government control of interest rates. China's interest rate policies and practices are described in the section on "Banking and Finance" in chap. 4 of this report.

[209] EIU, *Country Commerce: China,* 40. Law on Land Contract in Rural Areas, March 1, 2003. WTO, *Trade Policy Review: China*, 163.

[210] USITC, hearing transcript, September 6, 2007, 67–68.

[211] The control of land prices has allowed local governments to appropriate land from farmers in order to sell the land-use rights to developers at higher prices to finance urban development. Ding, "Policy and Praxis of Land Acquisition in China," 2.

[212] In order to attract investment, local governments were selling land-use rights for industrial use at very low prices or charging no fee. *People's Daily*, "Minimum Fees Set for Industrial Land." For example, Shanxi province provided land free as an incentive to invest there. Chinese academic, interview with Commission staff, Guangzhou, China, September 6, 2007. Low or reduced prices for land-use rights are available to both private and state-owned enterprises in China. USITC, hearing transcript, September 6, 2007, 149–50.

[213] Sporadic protests in 2005 and 2006 were reportedly in response to, in part, official land grabs, where local authorities either failed to pay or underpaid those with land-use rights when requisitioning land for industrial projects. EIU, *Country Profile: China*, 11–12. Continued events in 2007 have caused the Ministry of Land and Resources to begin a nationwide campaign of enforcement. *China Daily*, "Local Government Blamed for Land Grabs."

[214] In the case of fertilizers, an agricultural input, China has tried to control its production and distribution in order to reduce the prices paid for inputs by farmers. OECD, *China in the World Economy*, 65.

[215] WTO, *Trade Policy Review: China*, 82.

[216] Over the past few years, the State Tobacco Administration has initiated large-scale consolidation in the industry with the goal of creating internationally competitive enterprises. By the end of 2006, there were 31 tobacco manufacturers and 224 cigarette brands in China, down from 185 manufacturers and 1,049 brands in 2001. Wong, "Welcome to Tobacco Country," 10.

to the operations and conduct of SOEs in the agro-food sector, such as the China National Cereals, Oils, and Foodstuffs Corporation and Sinochem (fertilizers, herbicides, etc.).[217]

## *Competition Policy*

China does not have a clearly articulated and comprehensive competition policy in force (a new antimonopoly law, passed in 2007 and scheduled to enter into force in 2008, is described in more detail below). Consequently, anticompetitive conduct by private firms and SOEs in China remains problematic and practices such as localism (in which local governments take anticompetitive actions to prevent entry by firms or products in order to protect local enterprise) continue to occur.[218] Efforts at forming a competition policy in China included the 1993 Anti-Unfair-Competition Law and the 1998 Price Law. The Anti-Unfair-Competition Law prohibited selling goods at below cost, but included a number of exceptions that undermined the intent of the law.[219]

The Price Law was "concerned more with administrative regulation of prices than with competition."[220] It banned collusion and manipulation of market prices and the sale of goods at unreasonably high prices and at prices below cost; it also stipulated penalties for violators.[221] The Price Law specified how prices should be set, taking into account the average cost of production, market supply and demand of related goods and services, and other factors. The Price Law also stipulated that the Chinese government can use price controls for goods and services that are deemed to be important to the development of the national economy, for goods that are in short supply, for natural monopolies, for important public utilities, and for important public welfare services. However, the Price Law also allowed for the government to intervene in market prices and allowed for industry associations that coordinate prices.[222]

In response to the Price Law, in August 1998, the State Economic and Trade Commission, the NDRC's predecessor, directed industrial bureaus and industry associations to coordinate the prices of 21 products and services in response to pervasive deflation that had emerged in China's economy in the late 1990s.[223] With prices falling in many sectors, the Chinese government allowed and encouraged these groups to form price cartels and set "self-discipline prices" using the industries' average costs as the basis for price

[217] OECD, *China in the Global Economy*, 475–6.

[218] Ibid., 362.

[219] For example, exemptions were made for products that were fresh, alive, had almost reached their expiration date, or were overstocked, seasonal, or sold to repay debts, transfer assets, or go out of business. Kennedy, "The Price of Competition," 8.

[220] WTO, *Trade Policy Review: China*, 140.

[221] The Price Law set a higher burden of proof for the authorities than the Anti-Unfair Competition Law and gave similar exemptions. Kennedy, "The Price of Competition," 9–10.

[222] Hill, Lee-Alaia, and Norton, "Antidumping Duty Investigation of Certain Lined Paper Products," 47–48.

[223] Along with increased competition and more market-determined prices in various sectors, the 1997-98 Asian financial crisis played a role in China's deflation by increasing the magnitude of price decreases in sectors such as steel, electronics, and food. Kennedy, "The Price of Competition," 12.

floors.[224] Some local associations attempted to form cartels on their own accord, but most were initiated by national associations. Facing mounting opposition from domestic firms and due to the limited power of industry associations, a regulation issued in November 1998 marked the end of formally sanctioned price cartels.[225]

In China, administrative monopolies, or government-created monopolies, can be found in industries where the government ministries have been converted to industrial associations,[226] in sectors where regulatory agencies have "affiliate companies," and at the provincial and local level where governments have created or maintained barriers to competition from other localities.[227] In April 2001, China issued Rules on Prohibiting Regional Blockades in Market Economic Activities, which aimed at a major form of administrative monopoly in China, where local government agencies deliberately discriminate against products and services provided by firms in other localities, commonly known as regional blockage.[228]

As discussed earlier, production in certain sectors, including electricity, transportation, postal services, and telecommunications, is concentrated in monopolies, near-monopolies, or authorized oligopolies in China.[229] In addition, there have been recent examples of price coordination at the industry level and attempts at enforcement of China's laws against monopolistic practices. In August 2007, the NDRC found that instant-noodle makers had violated price-fixing laws.[230] Antitrust lawsuits filed in the United States in 2005 and 2006 alleged price fixing by Chinese exporters of vitamin C, magnesite, and bauxite.[231]

China began efforts to draft an antimonopoly law as an aspect of broader competition policy in 1994, but the final law was not passed until August 2007. The Antimonopoly

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224 Shipping services, small cars, color televisions, certain steel products, and sugar were among the products and services where cartels were attempted. Kennedy, "The Price of Competition," 19.

225 The regulation set forth that industrial ministries and associations could only monitor price trends and offer suggestions to pricing authorities. After the self-discipline price policy had been rescinded, the Chinese government increased its intervention in the prices of various sectors, including farm vehicles, some steel products, and color televisions. Kennedy, "The Price of Competition," 24.

226 The Chinese government's original intent in organizing industrial associations reportedly was industrial deregulation; but because the major participants in the industrial associations are SOEs and the heads of the associations are often former government officials, the associations often resemble the government ministries that they once were. Owen, Sun, and Zheng, "Antitrust in China 2006," 10.

227 Owen, Sun, and Zheng, "Antitrust in China 2006," 10–12.

228 Owen, Sun, and Zheng, "China's Competition Policy Reforms," 5. An example of a regional blockage in China is for trade in tobacco, which is dominated by provincial firms that try to keep competitors from selling in their province. Chinese academic, interview with Commission staff, Beijing, China, September 2, 2007.

229 USTR, "China," *2007 NTE Report*, 140. In addition, state monopolies will continue to be permitted in "strategic" industries, including the following: military-related manufacturing, petroleum, coal, and civil aviation. *Forbes*, "China Passes Anti-Monopoly Law."

230 EIU, *Country Report: China*, 27.

231 *The Christian Science Monitor*, "China's Grip on Key Food Additive"; and Owen, Sun, and Zheng, "China's Competition Policy Reforms," 22.

Law is scheduled to enter into force in August 2008.[232] In the long period of time before the law was passed, a provisional rule for the prevention of monopoly pricing was issued in 2003, which prohibited the abuse of market dominance and prohibited price coordination.[233] The rules also prohibited government agencies from illegally intervening in price determinations.[234]

The Antimonopoly Law, passed in August 2007, bans price fixing, collusion, excessive market concentration, collective restraints on output, and other monopolistic practices (table 3.2).[235] The law does not cover the agricultural sector and, although the details are not yet clear because implementation regulations have not been published, the legislation appears to apply only to industries that are not "government-stipulated" monopolies;[236] the sectors dominated by state-owned enterprises are to be governed by separate administrative procedures.[237] Exemptions to the prohibition on monopoly agreements are allowed if the agreement is intended to upgrade technology or research and development, improve product quality, raise efficiency, relieve an economic depression, or other scenarios.[238] Administrative monopolies are prohibited from requiring companies to purchase from or deal with favored businesses, discriminating against nonlocal entities, and engaging in other monopoly conduct.[239]

## *Regulatory Environment*

China's current regulatory environment for price coordination practices and policies is presented in table 3.2. These regulations are described by level of government and by economic sector.

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[232] *The Financial Times*, "Foreign Investors Fear China Law to Curb Monopolies." Although the law will go into effect August 1, 2008, it may be some time before China has developed guidelines for the application of the law. USITC, hearing transcript, September 6, 2007, 65–66.

[233] Owen, Sun, and Zheng, "Antitrust in China 2006," 24.

[234] What constitutes illegal versus legal price intervention is not clear. Ibid.

[235] There continue to be unresolved issues with the antimonopoly law, and its impact on foreign firms in China and SOEs is not expected to be clearer for several years. James Zimmerman (Chairman, The American Chamber of Commerce), interview with Commission staff, Beijing, China, August 31, 2007.

[236] *Forbes*, "China Passes Anti-Monopoly Law" and "China Private Oil Firms Urged to Use Anti-Monopoly Law for Guaranteed Supply."

[237] USITC, hearing transcript, September 6, 2007, 17 and 46-47.

[238] WilmerHale, "China Enacts National Competition Law."

[239] Ibid.

**Table 3.2** Price coordination: Key regulatory practices and policies

| Name of law or regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | ***Level of government*** | |
| | **Central government** | |
| Government-set and government guidance prices. | • For a number of products and services, the government sets a price or gives a floor, ceiling or range of prices that is acceptable. | 2001 notification to WTO; updated regularly by NRDC |
| Foreign Trade Law | • Allows the government to restrict imports of certain goods to state trading enterprises in order to ensure a stable domestic supply, stabilize prices, safeguard food safety, and protect the environment and exhaustible resources. | 2004 |
| 2007 Antimonopoly Law | • Bans price-fixing, collusion, excessive market concentration, collective restraints on output, and other monopolistic practices. | Passed in 2007; scheduled to enter into force in Aug. 2008 |
| | **Provincial and local government** | |
| Government-set and government guidance prices | • Provincial and local governments are allowed, in some cases, to make adjustment to central government-set prices. | 2001 notification to WTO; updated regularly by NRDC |
| | ***Economic sector*** | |
| | **Agriculture** | |
| Government-set and government guidance prices | • Tobacco, cotton, vegetable oil, grain, silkworm cocoons, fertilizers, and sugar. | 2001 notification to WTO; updated regularly by NRDC |
| 2004 Foreign Trade Law | • Products restricted to state trading enterprises include grain, vegetable oil, sugar, tobacco, fertilizers, and cotton. | 2004 |
| | **Manufacturing** | |
| Government-set and government guidance prices | • Pharmaceuticals and medical devices. | 2001 notification to WTO; updated regularly by NRDC |
| | **Services** | |
| Government-set and government guidance prices | • Utilities (electricity, water, natural gas, coal); petroleum; telecommunications services; land-use rights. | 2001 notification to WTO; updated regularly by NRDC |
| 2004 Foreign Trade Law | • Products restricted to state trading enterprises include crude and processed oil. | 2004 |

Source: U.S. Department of Commerce memorandum on China's status as a nonmarket economy; WTO, *Trade Policy Review: China*; and USITC hearing transcript.

# Utility Rates

China's central government determines utility rates for different provinces and categories of end users. Provincial and local government authorities also influence utility rate determination, and use favorable utility rate pricing as incentives to attract firms to locate in their regions. For the purposes of this report, utility rates refer to the prices paid by end users for electricity, natural gas, and water (retail price). Although Chinese government officials have discussed the benefits of market based utility rates, they have made clear their intention to maintain authority over certain key utility rates such as electricity.[240] According to one observer, electricity rates in China on average continue to be set at levels slightly below market value.[241] The Chinese government also uses utility rates to promote or discourage the expansion of certain industries and, most recently, to promote energy and natural resource conservation. China's policies and practices for utility rates are described below. China's key practices and policies with respect to utility rates are summarized in table 3.3.

## *Overview of Current Policies*

Government involvement in determining utility rates is a common practice throughout the world. Although rate setting practices vary across countries and even within countries, regulators typically attempt to set utility rates at levels that ensure sufficient profitability for the utility firm while ensuring end users are not charged excessively high prices (table 3.3). Utility rates in China are set by the NDRC Price Department, which sets different price levels for different provinces and categories of end users. Additionally, a number of central, provincial, and local institutions, such as the State Electric Regulatory Commission (SERC) and local pricing bureaus, are involved in advising the NDRC on prices.[242]

The Chinese government uses a number of policies to set utility rates at levels that ensure profitability for the producers while providing end users with affordable utilities.[243] The Chinese government also uses utility rates to promote or discourage the expansion of certain industries. For instance, as indicated below, the government has recently raised utility rates for certain energy-intensive industries.[244] Additionally, China's 11th Five-Year Plan (2006–10) includes specific targets for the conservation of energy and water resources, which demonstrates the government's intention to actively promote natural conservation.[245] Chinese officials have stated that market-determined rates would provide

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[240] *China Daily*, "China Mulls Deregulating Energy Prices," and IEA, *China's Power Sector Reforms*, 55.

[241] Chinese academic expert, interview with Commission staff, Beijing, September 2, 2007.

[242] Rosen and Houser, *China Energy: A Guide for the Perplexed*, 25.

[243] Ibid.

[244] *Xinhua News*, "China to Raise Electricity Price for Companies with High Energy Consumption."

[245] *Xinhua News*, "Resources Conservation Policy Listed in Five-year Plan." The Five–year plans calls for a 20 percent reduction of energy consumption per unit of GDP and 30 percent reduction in water consumption per unit of industrial value added.

**Table 3.3** Utility rates: Summary of key practices and policies

| Practices and policies | Level of government where applied | Associated laws and regulations |
|---|---|---|
| **General utility rate policies** | | |
| NDRC Price Department sets utility rates at sufficient levels to cover full costs, promoting market-based utility rates for economic rationalization of industry. | • Primarily central government; provincial and local governments can propose different rates. | • 1996 Electric Power Law |
| **Electricity** | | |
| Preferential or negotiated electricity rates are sometimes provided by local officials as an incentive to attract firms to set up production in their locality. | • Provincial and local governments | • No official policy; assistance provided on a negotiated basis |
| Higher utility rates charged to discourage certain industries. | • Central government | • 2004 Differential Power Price for Energy-Intensive Industries |
| **Water** | | |
| Provides for preferential electricity and water rates to manufacturing firms and preferential water rates for agriculture. | • Provincial and local governments | • 2002 Water Law |
| **Other sector-specific policies** | | |
| Preferential electricity and water rates to manufacturing firms and preferential water rates to agriculture. | • Primarily local governments | • Often no official policy; assistance provided on a negotiated basis |
| NDRC Price Department determines end user prices based on prices of other natural resources, such as natural gas and petroleum. | • Central government | • Natural gas generally regulated by same NDRC departments that regulate electricity |
| Preferential electricity and water rates to manufacturing firms and preferential water rates for agriculture. | • Primarily local governments | • Often no official policy; assistance provided on a negotiated basis |

Source: IEA and OECD, *China's Power Sector Reforms*; Ministry of Water Resources, "Water Resources in China"; NPC, http://www.china.org.cn/english/government/207454.htm; *Xinhua News,* "China to Raise Electricity Price for Companies with High Energy Consumption"; *Xinhua News*, "China to Raise Factory Price of Natural Gas"; *Xinhua News,* "Power Prices Up Due to Higher Coal Prices"; U.S. and Chinese industry representatives, interviews with Commission staff in China, Aug. 29-Sept. 11, 2007; and Zhong and Chen, "Charge Reform in China's Wastewater Treatment Sector."

more accurate price signals of resource scarcity.[246] But they also have made clear their intention to retain pricing authority for some key utility rates such as the retail price for electricity.[247]

China does not have a unified governmental authority responsible for all energy policy, including pricing. Although the NDRC Price Departmentis ultimately responsible for setting wholesale and retail resource utility rates, a number of other organizations within the national and local governments play some role in setting pricing policy.[248] The NDRC Energy Bureau is responsible for determining the national energy policy, and the

[246] *China Daily*, "China Mulls Deregulating Energy Prices."
[247] IEA, *China's Power Sector Reforms*, 5.
[248] Cunningham, "China's Energy Governance," 2–3.

NDRC Department of Price Supervision is responsible for enforcing China's pricing policy.[249]

## *Electricity*

China's 1996 Electric Power Law sets out the principles of central control of electricity pricing and the setting of electricity prices at a sufficient level to allow cost recovery and profitability for the electric power industry.[250] China's electricity industry is comprised of five large state-owned generation companies and a large number of independent power producers. Transmission and distribution is controlled by the State Power Grid Company in most of the country, while the much smaller China Southern Power Grid Company controls the transmission and distribution facilities in five southern provinces of the country. Both grid companies are state owned. Although a number of these independent power producers are owned by foreign and domestic private investors, many others are owned by provincial and local governments. As of 2006, the independent power producers generated more than one-half of the electricity in China.[251] Key regulatory practices and policies are shown in table 3.4.

### Electricity Pricing Policy by Level of Government

The SERC was established in 2003 to create an independent regulatory agency that would provide unified supervision for the electricity sector. SERC's responsibilities include regulating the electricity markets, establishing electricity trading agreements, developing plans for sectoral reforms, and proposing specific rate changes to the NDRC.[252] Despite a State Council notice in 2005 strengthening SERC's power, SERC does not have the authority to set electricity rates. Thus, SERC's ability to ensure that pricing is based on market criteria, such as cost, rather than political considerations, is limited.[253]

The NDRC Price Department does not establish separate prices for energy transmission and distribution. China's two state-owned grid companies act as the single buyers of electricity from generators and the single sellers of electricity to end users in their respective territories. Generators are generally prohibited from direct transactions with endusers. One source has observed that China's electricity grid suppliers receive less revenue from end users than would be expected given the published rates, based on an analysis of the grid companies' revenues. This suggests that there is significant nonpayment by certain users or that utility rates may be lower than officially reported.[254]

End user pricing is based on a system originally developed in the 1960s under which there are eight categories of end users with three voltage level classifications per category, creating 24 basic categories of users. Each category is assigned a price, which is then

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[249] NDRC, "Main Functions of Departments of the NDRC."
[250] Electric Power Law, Chap. V: Electricity Price and Electricity Fee, arts. 35–6.
[251] Ibid., 33–34.
[252] WTO, *China Trade Policy Review*, 185; and *China Daily*, "Electricity Agency Lacks Power."
[253] IEA and OECD, *China's Power Sector Reforms*, 51 and 95.
[254] Rosen and Houser, *China Energy: A Guide for the Perplexed*, 25.

modified on a provincial and municipal basis.[255] Provincial and local government pricing bureaus may propose rates for different categories to the NDRC.[256] Following a new NDRC policy implemented in 2005, end-user electricity prices may be adjusted to account for variations in the price of coal, but not other fuels.[257] In practice, preferential or negotiated electricity rates are sometimes provided by local officials as an incentive to attract firms to set up production in their locality.[258] In other cases, however, industry representatives report that electricity is provided at fixed rates with no possibility of price negotiations with local government.[259]

This pricing system allows for substantial differentiation in electricity rates among different categories of end users.[260] It is subject to political pressure on both a provincial and national basis as local officials attempt to persuade the NDRC to keep rates as low as possible for industries in their jurisdictions, while generators seek to maintain rates high enough to ensure profitability.[261]

## Electricity Pricing Policy by Economic Subsector

Historically, China's electricity pricing system has provided preferential treatment for heavy industry and the residential sector.[262] This came at the expense of the commercial and nonresidential lighting sectors where electricity prices have historically been relatively high. Additionally, U.S. industry sources report that several Chinese industries, including steel as well as copper and brass, continue to receive preferentially priced or free electricity, resulting in a substantial improvement in their international competitiveness.[263] In recent years, however, the Chinese government has attempted to increase electricity prices for certain categories of users who have traditionally received preferential rates. The Chinese government has cited environmental considerations and economic constraints as the primary motivations for these changes. These attempts to raise electricity rates have met with considerable resistance from provincial and local officials, who maintain a strong interest in providing reduced utility rates to industries operating within their localities.[264]

In 2004, the NDRC instituted a policy of differential power prices for energy intensive industries. Under this policy, higher electricity prices are charged for energy intensive

[255] IEA and OECD, *China's Power Sector Reforms*, 55.

[256] Rosen and Houser, *China Energy: A Guide for the Perplexed*, 25.

[257] *Xinhua News,* "Power Prices Up Due to Higher Coal Prices."

[258] Chinese industry representatives, interview with Commission staff, Huizhou, China, September 7, 2007.

[259] Chinese industry representatives, interview with Commission staff, Zhongshan, China, September 7, 2007.

[260] IEA and OECD, *China's Power Sector Reforms*, 2006, 55.

[261] Rosen and Houser, *China Energy: A Guide for the Perplexed*, 25.

[262] Alan Price (council for The American Iron and Steel Institute and The Steel Manufacturers Association), hearing transcript, September 6, 2007, 149. According to one source, China is the only country in the world in which electricity rates for households generally are lower than rates for most industries, presumably to maintain social stability. Chinese academic, interview with Commission staff, Beijing, September 2, 2007.

[263] Price et al., *Money for Metal,* 75–76; and Copper and Brass Fabricators Council, written submission, 32, August 17, 2007.

[264] IEA and OECD, *China's Power Sector Reforms*, 55.

industries in order to control their growth. In particular, the NDRC targeted the electrolytic aluminum, ferroalloy, calcium carbide, caustic soda, cement, and steel industries. Significant resistance by local officials to implementing these price increases rendered these initial attempts generally unsuccessful. The NDRC responded with further price increases for these sectors in 2006.[265] Additionally, the NDRC sent inspection teams to certain provinces[266] to ensure that these industries paid higher electricity rates, and threatened to punish local officials who resisted implementing this policy.[267]

According to U.S.[268] and Chinese[269] firms operating in China, obtaining favorable utility rates is not as crucial as ensuring continuous and reliable electricity supply. Power shortages greatly increase operating expenses by either necessitating the use of expensive on-site generators or suspending operations until electric service is restored. For guarantees of sufficient electricity supply, these firms must rely on local officials, who have a great deal of latitude in ensuring sufficient supply to favored industries or firms in periods of shortage.[270]

## *Water*

Water utilities in China are dominated by local government-owned water utility companies, although some private domestic and international companies also operate in the sector.[271] By global standards, China has very limited water resources on a per capita basis. This, compounded by the inefficient use of existing water resources and increasing concern about water pollution, has created serious water shortages in certain regions of China. Various levels of government have attempted to use water pricing as one method of rectifying these shortages.[272] Key regulatory practices and policies are shown in table 3.4.

### Water Pricing Policy by Level of Government

As in electricity, the regulatory authority is fragmented for water in China, with several government entities maintaining some degree of authority over the industry, including pricing. The NDRC is responsible for setting the comprehensive water price, which is the average price for industrial, agricultural, governmental, and residential sectors.[273] The Ministry of Water Resources is responsible for developing water pricing regulation

[265] *Xinhua News*, “China to Raise Electricity Price,” October 1, 2006.
[266] Shanxi, Inner Mongolia, Henan, Hunan, Sichuan, Guizhou, Shaanxi and Gansu provinces.
[267] *Xinhua News*, “Gov't Sends Inspection Team to Ensure Differential Power Price.”
[268] U.S. industry representatives, interview with Commission staff, Chongqing, China, September 3, 2007.
[269] Chinese industry representatives, interview with Commission staff, Zhongshan, China, September 7, 2007.
[270] Chinese government official, presentation to Commission staff, Washington, D.C., September 24, 2007.
[271] Lague, “From Murky Waters to Lucrative Deals.”
[272] *Xinhua News*, “Water Rates to Rise as Beijing's Supply Drops.”
[273] *Xinhua News*, “Water Price in Beijing Expected to Go Up This Year.”

recommendations.[274] The Ministry of Construction and local governments both play a role in urban water pricing policy.[275]

Under China's 2002 Water Law, local governments create various quotas for different groups of end users. Under this system, water is provided at a fixed rate until the quota is met. The price becomes progressively higher once the quota has been exceeded.[276] The 2002 law also established the practice that water prices be sufficient to cover the costs of its provision.[277] Several governmental entities, including the State Council, have issued policy papers to ensure that wastewater charges are applied in all cities and are sufficient to cover the full economic costs of treatment.[278] Nevertheless, China's 2005 water prices covered only a portion of the cost of providing water to end users and treating wastewater.[279] To rectify this, China's water authorities have imposed several increases to water rates in recent years.[280] As with electricity, Chinese industry representatives reported that water is provided on a preferential or negotiated basis by local governments in some cases, and in other cases is provided at a fixed price.[281] Preferential water rates may be partly responsible for increased investment in resource intensive industries.[282] Nevertheless, the NDRC has granted authority to local governments to increase water and electricity prices for firms in restricted or to-be-eliminated categories as part of a plan to reduce investment in specific sectors.[283] For example, steel mills targeted for closure in Hebei faced increased electricity prices and stand to face increased water prices or supply disruptions of both electricity and water.[284]

## Water Pricing Policy by Economic Subsector

The agricultural sector receives the lowest cost water on a per unit basis in China's water pricing system. Prices for the provision of irrigation water are neither sufficient for full cost recovery, nor are they based on the amount of water used.[285] In addition, a U.S.

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[274] Ministry of Water Resources, "About MWR."

[275] To illustrate the overlapping role of various Chinese government entities is setting water prices, in 2004–05, the NDRC, the Ministry of Construction, and the Beijing municipal government each announced that they were instituting a water price hike in Beijing during this time period. Wei, "Price Hike Hoped to Save Water"; *Xinhua News*, "China's Water Prices Below the Cost–Minister"; and *Xinhua News,* "Water Rates to Rise as Beijing's Supply Drops."

[276] Water Law, chap. V, arts. 47–49.

[277] Ibid., art. 55.

[278] Lijin and Jining, "Charge Reform in China's Wastewater Treatment Sector."

[279] Collections of payments for water provision, on the other hand, appear to be relatively good, at least in certain localities. World Bank, *Henan Towns Water Supply and Sanitation Project*, 16–17.

[280] *Xinhua News*, "China's Water Prices Below the Cost—Minister."

[281] Chinese industry representatives, interviews with Commission staff, Zhongshan and Huizhou, China, September 7, 2007.

[282] Chinese academic expert, interview with Commission staff, Beijing, China, September 6, 2007.

[283] NDRC news release, "Major Measures to Promote the Adjustment of Industrial Structure," December 22, 2005.

[284] Steel Business Briefing, "Hebei Enforces Power Price Hike for 26 Blacklisted Mills."

[285] World Bank, *China: Country Water Resources Assistance Strategy*, 2002, 12.

industry source reports that some manufacturing firms pay preferential water rates or in some cases are provided water free of charge.[286]

## *Natural Gas*

While natural gas still accounts for a relatively small percentage of total energy consumption in China, its use is expanding rapidly as a result of China's growing chemicals industry and the need to provide a relatively clean source for urban heating and cooking needs, among other things. As with electricity, a steady supply of natural gas is often a more important concern to industries than price.[287] Although a number of international pipeline and liquefied natural gas projects have been proposed and built in recent years, domestic production still accounts for the vast majority of China's natural gas consumption. In addition, China's natural gas pipeline network is fragmented, which restricts China's ability to rely on foreign suppliers. As a result, the price of natural gas in China is not heavily dependent on international market prices. Three large state-owned oil and gas holding companies, China National Petroleum Corporation (CNPC), China Petroleum and Chemical Corporation, and China National Offshore Oil Corporation, dominate China's natural gas distribution market. CNPC is by far the largest in terms of production and reserves.[288] Key regulatory practices and policies are shown in table 3.4.

### Natural Gas Pricing Policy by Level of Government

Most of the regulatory authority over China's natural gas distribution industry resides within the same departments of the NDRC that regulate electricity.[289] Like electricity, the end-user price of natural gas is determined by the NDRC Price Department, and the price varies by province and type of end user.[290] For industrial users and urban electric utilities, the NDRC sets the price based on the prices of other resources, such as petroleum. From this government-set price, a 2005 NDRC policy allows the producers of natural gas to adjust the price they charge to these end users by up to 8 percent.[291]

### Natural Gas Pricing Policy by Economic Subsector

The price of natural gas in China is set higher for residential users than the price for chemical, electric utility, and fertilizer industries. Given this pricing structure, natural gas distribution firms have an incentive to provide natural gas to residential customers first. Indeed, end users in both the chemical industry and the electric utility industry reported having difficulty in obtaining sufficient quantities of natural gas.[292]

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[286] Alan Price (council for The American Iron and Steel Institute and The Steel Manufacturers Association), hearing transcript, September 6, 2007, 145.

[287] U.S. industry representatives, interviews with Commission staff, Chongqing, China, September 3, 2007.

[288] USDOE, EIA, "Country Analysis Brief: China."

[289] Rosen and Houser, *China Energy: A Guide for the Perplexed*, 18–22.

[290] Arruda and Li, *China Energy Sector Survey Part II: The Energy Institutions*.

[291] *Xinhua News*, "China to Raise Factory Price of Natural Gas."

[292] Rosen and Houser, *China Energy: A Guide for the Perplexed*, 22.

### *Regulatory Environment*

China's current regulatory environment for central government utility rate practices and policies is presented in table 3.4.

# Taxation

China's tax laws are promulgated by the central government, although tax collection, interpretation and enforcement are done at the provincial and local levels. While largely geared to raise government revenue, China's tax regime has a number of other policy objectives. China central government has increased certain taxes to encourage environmental conservation, and decreased certain taxes to equalize treatment of domestic and foreign firms, and to encourage investment in less developed parts of the country. Provincial and local governments in China sometimes offer tax incentives to attract firms and investment in their respective regions. This section discusses China's value added tax (VAT), business tax, enterprise income tax (EIT), and agricultural taxes; it also includes discussions of China's tax practices at the central, provincial, and local government levels. China's key practices and policies with respect to taxation are summarized in table 3.5.

### *Overview of China's Tax Regime*

China's current tax regime includes the VAT, a turnover tax on the production of goods; the business tax, a turnover tax covering most services; and the EIT applied to businesses.[293] There are two forms of EIT, one for foreign investment enterprises (FIEs) based on a 1991 law[294] and one for domestic firms based on a 1994 law.[295] The 1994 law established a standard rate for most domestic firms (SOEs, collective enterprises, and private enterprises) of 33 percent, although the actual average rate paid by domestic firms is estimated to be 25 percent.[296] The EIT tax rates for FIEs are generally lower and vary depending on factors such as a firm's length of time in China, location, product produced, agreements with local governments, and percentage of product exported; on average FIEs pay an estimated 13 percent.[297] In 1994, the turnover tax system was also changed, with the VAT broadened substantially to become the core tax for both domestic and foreign enterprises, with the consumption tax and business tax as supplements. [298]

[293] On November 29, 2007, the United States and China signed a MOU related to some of these taxes. See app. F for the MOU text.

[294] Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises, and the associated Rules for the Implementation of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises (entered into force on July 1, 1991).

[295] Interim Regulations on Income Tax for Enterprises (entered into force on January 1, 1994).

[296] Jin, "Explanation on the Draft Enterprise Income Tax Law," and EIU, *Country Commerce: China*, 85.

[297] Average corporate tax rates from EIU, *Country Commerce, China*, 85.

[298] Liu, *Taxation in China*, and D'Amico, "Tax System and Tax Reforms," 7.

**Table 3.4** Utility rates: Key regulatory practices and policies

| Name of law or regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | **Central government** | |
| Electric Power Law | • Chapter V governs electricity price, sets up principle of unified pricing and ensuring price is sufficient to cover costs. | 1996 |
| Scheme for Power Price Reform | • Provides for assistance for residential users. No clear guiding principle or methodology to ensure cost-reflective pricing for this category. | 2003, revised 2005 |
| Coal-electricity price adjustment mechanism | • Allows price of coal-generated electricity for end users to fluctuate with the price of coal. | 2005 |
| Differential power price for energy-intensive industries | • To reduce growth of industries with high energy consumption, the NDRC adopted different electricity prices for 6 industries of electrolytic aluminum, ferroalloy, calcium carbide, caustic soda, cement and steel in 2004. | 2004 |
| Water Law | • Establishes the principle that water prices should be sufficient to cover costs. | 2002 |
| Regulation on the management of water supply prices for water resources project. | • Implements water pricing policy based on principles of cost compensation, rational profit, high price for quality water and fair sharing of cost. Prices to be adjusted according to the cost of water supply and market demand. | 2003 |
| | • Progressive pricing for overconsumption and seasonally adjusted water price, along with a system of basic water price integrated with volumetric water price. | |
| Circular on Enhancing the Collection of Wastewater Treatment Charges and Establishing the Municipal Drainage Discharge System and Common Treatment System | • Requires all cities to collect wastewater charges. Charges for wastewater treatment are to be calculated "based on the volume of water consumption and collected along with the water supply cost." | 1999 |
| Circular on Accelerating the Reform of Urban Water Supply Price | • Attempts to "foster the establishment of charge system for urban wastewater treatment and increase the charge rates to assure the least cost for wastewater service in the long run." | 2002 |
| Circular on Accelerating the Reform of Water Price, Promoting Water Conservation and Protecting Water Resources | • To accelerate the reform of urban wastewater treatment management by applying economic rules and market mechanism. | 2004 |
| Reform of the Monopolized Price Forming Mechanism of Natural Gas | • Abolishes dualistic price mechanism for natural gas which includes both a government set and government adjusted price. New system has only a government adjusted price, which uses a benchmark based on the price of other commodities such as petroleum; price may be adjusted from the benchmark price by as much as eight percent. | 2005 |

Source: IEA and OECD, *China's Power Sector Reforms*; Ministry of Water Resources, "Water Resources in China"; NPC, http://www.china.org.cn/english/government/207454.htm; *Xinhua News,* "China to Raise Electricity Price," "China to Raise Factory Price of Natural Gas," and "Power Prices Up Due to Higher Coal Prices"; Chinese and U.S. industry representatives, interviews with Commission staff in China, Aug. 29-Sept. 11, 2007; and Zhong and Chen, "Charge Reform in China's Wastewater Treatment Sector."

**Table 3.5** Taxation: Summary of key practices and policies

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| Enterprise income tax (EIT) policies promoting foreign-invested enterprises (FIEs). | • Central government | • 1991 FIE Income Tax Law; FIE incentives to be abolished under the United Enterprise Income Tax Law in 2008 |
| EIT and VAT policies promoting regional development for less-developed regions. | • Central government | • EIT Laws 1991, 1993, and 2008<br>• 2004 VAT reform for northeast region and 2007 reform for central region |
| EIT policies promoting high- and new-technology. | • Central government | • EIT Laws 1991, 2008 |
| EIT rates promoting the export of manufactured goods. | • Central government | • 1991 EIT Law; incentives for manufacturers to be abolished under the United Enterprise Income Tax Law in 2008 |
| EIT and VAT refunds promoting local investment. | • Local governments are allowed to make these concessions within a framework provided by the central government | • EIT Laws 1991, 1993, and 2008<br>• 1994 VAT regulations |
| Local governments offer additional authorized tax and other incentives to encourage investment and promote growth. | • Provincial and local governments | • No official policy; practice reported by sources |
| Tax laws created by central government, but tax collection, interpretation, and enforcement conducted at provincial and local levels. | • Central, provincial, and local governments | • No official policy; practice reported by sources |
| Different interpretations of the same law may be in use at the same time in different parts of the country. | • Central, provincial, and local governments | • No official policy; practice reported by sources |
| Measures to promote agriculture including reduced EIT and VAT for agricultural products, and elimination of agriculture taxes and tax on land converted from agricultural purposes. | • Central government<br>• Agriculture sector | • EIT Laws of 1991, 1993, 2008<br>• 1994 VAT regulations<br>• 1987 Farm Land Occupation Tax |

Source: China 2006 WTO submission; *China Distribution and Trading*, "China's Corporate Income Tax Reform; EIU, *Country Commerce: China*; Chinese industry representatives, interview with Commission staff, Hong Kong, Sept. 12, 2007; Green, "On the Shenzhen Factory Floor, parts 1 and 2"; Nelson and Quingjum, "The PRC Enterprise Income Tax Law and Its Impact on Listed PRC Companies"; OECD, *International Tax Review*; Commission staff discussions with KPMG Sept. 7, 2007; WTO, *Trade Policy Review: China*; and Zhang, "Fiscal Decentralization and Political Centralization in China."

China's 1991 and 1994 tax reforms sought both to stem declining central government revenue caused by the shift away from a centrally planned economy and shrinking SOE profits; and to support long-term economic goals of increasing foreign investment, exports, manufacturing, employment, and economic growth. The State Administration of Taxation (SAT) was strengthened, and the tax-sharing system between the national government and provincial governments was introduced. As a result, the central government's revenue has increased at the expense of provincial and local governments since 1994.[299] Under the tax-sharing system, a fixed 75 percent of VAT revenues go to the central government and 25 percent remains with the provincial governments where it was collected, whereas almost all business tax revenues go to provincial governments.[300]

China has recently made major changes to the EIT system to simplify, standardize, and unify the system and to comply with its WTO commitments.[301] Under a new EIT Law, scheduled to take effect January 1, 2008, FIEs and domestic firms will face the same standard tax rate of 25 percent, and will be eligible for the same incentives. The stated goals of the new EIT are creating a uniform and standard tax system for all enterprises, simplifying the tax regime, broadening the tax base, lowering income tax rates, and enforcing tax collection more strictly.[302]

### *VAT and Other Indirect Taxes*

Indirect taxes, including the VAT and the business tax, are China's largest sources of tax revenue.[303] The VAT is assessed on the sale or import of goods, and on repair, replacement, and processing services. Unlike other countries, China does not fully rebate the VAT for exports, and rebate rates are adjusted in response to concerns about export levels.[304] China's VAT is a production-based VAT, and unlike the consumption-based VAT used by many countries, it does not allow firms to deduct their investments in long-

[299] D'Amico, "Tax System and Tax Reforms," 6.

[300] Tax revenue, as a ratio of GDP, rose from 1998-2003, largely due to the 1994 tax reforms and improvements in tax administration that increased compliance. OECD, *China in the Global Economy*, 212.

[301] On November 29, 2007, USTR announced that the United States and China had signed a Memorandum of Understanding (MOU) to settle a U.S. dispute pending against China under the WTO Dispute Settlement Understanding concerning the WTO-consistency of certain Chinese tax practices granting refunds, reductions, or exemptions from taxes or other payments. A copy of the MOU is provided in app. F.

[302] Jin, "Explanation on the Draft Enterprise Income Tax Law."

[303] China also imposes a consumption tax on certain products considered to have a negative effect on the environment (such as disposable wooden chopsticks and wood flooring), or on health (such as tobacco and alcohol), and on "luxury" items (such as cosmetics, skin and hair care products, precious jewelry, and motor vehicles).

[304] In 2006 and 2007, China reduced export VAT refund levels and number of products covered. The government reports that the rebate reductions are targeted toward energy-intensive, polluting, low-tech and low value-added products. Categories include construction materials, base metals and mineral, chemical products, animal and vegetable products, textiles and garments, and electrical and mechanical appliances. PricewaterhouseCoopers, "China Tax/Business," and "China Tax Alert." Export VAT refunds are discussed more fully in the section on "Restraints on Imports and Exports" in chap. 5 of this report.

term capital equipment.[305] Thus, with respect to VAT, capital-intensive industries are at a disadvantage (pay higher taxes) relative to labor-intensive industries.[306]

## VAT

China's standard VAT rate is 17 percent, with a 13 percent rate for some basic goods, and exemptions for some items. The 17 percent rate is estimated to be equivalent to a 23 percent rate under a consumption-based VAT, which is much higher than the rate charged by other countries.[307] In practice, there are a number of rate adjustments, and FIEs are sometimes granted rate concessions.[308] Certain FIEs or firms importing specified items are eligible for VAT exemptions or deductions, including investment projects in industries listed as "encouraged" by the central government, firms importing material to produce items listed in the "High- and New-Technology Products Catalog," integrated circuit producers, and software companies.[309]

FIEs in China may be eligible for a VAT refund on their purchases of domestically-manufactured equipment.[310] The VAT refund policy for domestic equipment purchases was significantly revised in 2006, narrowing the range of firms eligible for the refund while increasing the range of eligible equipment. Firms that qualify include those with "encouraged" project types, FIEs in transportation and real estate, and contractors for offshore oil exploration. Eligible equipment includes equipment and machinery (and accessories and spare parts) for power generation, oil exploration, engineering, and manufacturing.

Changes to the VAT, implemented on a trial basis, reportedly were designed to increase economic growth by changing the VAT from a production-based VAT to a consumption-based VAT. A pilot program began in China's northeast region in 2004 and was expanded to the central region in 2007.[311] The northeast region pilot program covers eight industries (equipment manufacturing, petrochemicals, metallurgy, shipbuilding, automobile manufacturing, agro-processing, military equipment, and high-tech products) which are allowed to deduct VAT paid on purchases of certain fixed assets. This pilot program reportedly is intended to increase investment rates and economic growth, as well as to attract foreign investment and imported technology, increase technological innovation, and upgrade industrial structure in northeastern China, which has been lagging behind southern China.[312] The SAT reportedly intends to extend the reforms to other parts of the country by 2010.[313] Concern about loss of tax revenue however, may slow the reform process, as the VAT change in the northeast reduced revenue by $498

[305] D'Amico, "Tax System and Tax Reforms," 27.
[306] Lin, "Evaluating the VAT in China," 72.
[307] Ibid.
[308] Ibid.
[309] Liu, *Taxation in China*.
[310] KPMG, "Update on the VAT Refund Policy."
[311] The northeast region includes the provinces of Heilongjiang, Jilin, and Liaoning and the port city of Dalian, and the central region includes 26 cities in the provinces of Shanxi, Anhui, Jiangxi, Henan, Hubei, and Hunan. PricewaterhouseCoopers, "Value Added Tax."
[312] Ernst and Young, "VAT Reform in the Northeast Region," 3; KPMG, "Risks and Opportunities in China," 61–67; and PricewaterhouseCoopers, "Value Added Tax."
[313] EIU, *Country Commerce: China*, 97.

million (RMB 4 billion).[314] Changing to a consumption VAT has been estimated to reduce provincial government revenues by 15.5 to 17.0 percent, with greater losses in provinces with more manufacturing.[315] Compensating provincial and local governments for the reduction in revenues would require either an increase in the tax rate or reformulation of intergovernmental transfers.[316]

### Business Tax

Instead of the VAT, a business tax is assessed on sales of services such as transportation, construction, banking, insurance, postal, telecommunications, and recreation.[317] The rate for most services is 5 percent, although some services are assessed at 3 percent or 20 percent.[318] Service providers may be subject to double taxation since business tax is assessed on gross turnover rather than net turnover.[319] Service fees paid to other firms cannot be deducted. The VAT on goods is also not creditable towards business tax; nor is the business tax creditable against VAT payments. The business tax is an important revenue source for China's provincial governments, which receive all of the tax revenue.[320]

## *Enterprise Income Taxes*

Under China's current corporate tax regime, the tax rate for domestic firms is 33 percent. FIEs are covered by a different tax law[321] and most qualify for the preferential 15 or 24 percent rates available in certain locations and industries.[322] Preferential tax treatment for FIEs was designed to attract more foreign investment and develop China's economy.[323] These preferences focused particularly on attracting FIEs that manufacture in China for export. Lower taxes paid by FIEs that export generally leads to an increase in export-oriented investment, and increases relative levels of exports, although some or all the increase in exports may be at the expense of investment and production for the domestic market. Similarly, tax policies favoring FIEs increase investment, employment, and production by FIEs, relative to that of domestic firms.

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[314] Jiang, "VAT in China and its Latest Reform."

[315] Ahmad et al., "Financial Consequences of the Chinese VAT Reform."

[316] Industry representative, interview with Commission staff, Shanghai, September 7, 2007.

[317] A 5 percent business tax also is assessed on the transfer of immovable property and sale of intangible assets.

[318] Services assessed at the 5 percent rate include finance and insurance, hotels, tourism, advertising, consultation, surveying, and packaging. The 3 percent rate applies to transportation, construction, post and telecommunications, culture and sports; and the 20 percent rate applies to entertainment services. Liu, "Taxation in China," 55–56.

[319] Ho et al., "Indirect Taxes."

[320] OECD, *China in the Global Economy*, 208.

[321] China's current policies toward FIEs are described in the section on "Foreign-Invested Enterprises" in chap. 2 of this report.

[322] Liu, *Taxation in China*.

[323] Jin, "Explanation on the Draft Enterprise Income Tax Law."

China's new EIT Law, adopted March 2007, is to take effect January 2008, and is expected to increase taxes for FIEs (tables 3.6 and 3.8).[324] Under the new law, FIEs and domestic firms will face a standard 25 percent rate and be eligible for the same tax incentives and a number of tax preferences for FIEs will be eliminated. Incentives under the new law include a 20 percent tax rate for small low-profit enterprises; a 15 percent tax rate for high- or new-technology enterprises; tax savings for investments in environmental protection; and lower tax rates for venture capital for investments encouraged by the state.[325] Firms engaged in agriculture, forestry, stock breeding, fishing, and infrastructure projects, and "encouraged enterprises" in central and western China will continue to receive preferential tax rates.[326] Table 3.6 compares the new tax law to the existing law. It should be noted than many of the provisions in the law are not specific and implementation rules have not yet been provided. Reasons cited by the Chinese government for changing the tax system include: reducing tax disincentives for domestic firms vis-à-vis FIEs; promoting environmental protection and social and regional development; promoting industrial upgrades and technological progress; drawing on international tax experience to improve regulations; facilitating and standardizing tax collections; eliminating distorting incentives; and creating a tax system that is appropriate for current needs and level of development.[327]

Many FIEs will likely face a major increase in taxes, phased in over a five-year period, under the new EIT Law. When fully implemented, the EIT changes are expected to increase foreign investors' annual tax costs by $5.5 billion.[328] According to Chinese estimates, FIEs in manufacturing will face tax rates similar to business income tax rates in other countries in the region (estimated to be 26.7 percent) and worldwide (estimated to be 28.6 percent).[329] On the other hand, the income tax rate for service providers is scheduled to decline from 33 percent to 25 percent, thus reducing the current bias which favors manufacturing (particularly for export) over services.[330] The new law is expected to reduce foreign investment growth, although the Chinese government reportedly does not expect the impact to be large.[331] In a 2007 survey of U.S.-China Business Council

[324] On November 29, 2007, USTR announced that the United States and China had signed a Memorandum of Understanding (MOU) to settle a U.S. dispute pending against China under the WTO Dispute Settlement Understanding concerning the WTO-consistency of certain Chinese tax practices granting refunds, reductions, or exemptions from taxes or other payments. In consultations, the United States expressed concerns about the WTO-consistency of preferential tax treatment for FIEs and about certain provisions of the EIT Law. A copy of the MOU is provided in app. F.

[325] For example, firms investing in natural gas will continue to be eligible for tax exemption during their first two profitable years and pay half the normal tax rate in the following three years; some such firms will also pay a lower tax rate of 15 percent in years that follow. *China Daily* "Gov't Will Offer Tax Break to Promote Clean Energy."

[326] For a description of China's use of preferential tax rates as an industrial policy instrument, see the section on "Industrial Development Policy" in chap. 2 of this report.

[327] Jin "Explanation on the Draft Enterprise Income Tax." One area the Chinese have focused on is international firms' use of transfer pricing to reduce tax payments. PricewaterhouseCoopers, "Transfer Pricing Implications of China New Corporate Income Tax Law."

[328] Ibid.

[329] Ibid., and *Taxand Quarterly*, "China," 2.

[330] Taxand Quarterly, "China," 2.

[331] Jin, "Explanation on the Draft Enterprise Income Tax."

**Table 3.6** China's tax laws: Comparison of the new EIT Law to the existing law

| Tax provision | Existing law | New EIT law (see notes at end of table) |
|---|---|---|
| Domestic firm rate | 33 percent except for low-profit firms which face 20 percent rate. | • 25 percent except for low-profit firms which face 20 percent rate |
| FIE rate | 33 percent, but most eligible for lower rates of 15 or 24 percent (see below). | • 25 percent; for firms paying less than 25 percent, the rate will increase 2 percent per year until it reaches 25 percent. At the end of 5 years firms will pay 25 percent unless covered by incentives under the new EIT Law. |
| FIE rate | 15 percent for FIEs in special economic zones, Shanghai Pudong New Area, economic technological development zones. | • Repealed, with 5 year transitional period for existing FIEs |
| FIE high-tech firm rate | 15 percent for companies in high-tech parks. | • Applied to high-tech firms nationwide |
| FIE rate | 24 percent for production FIEs in coastal economic open cities or other developmental areas. | • Repealed, with 5 year transitional period for existing FIEs |
| FIE incentives | Production FIEs: beginning with first profitable year, a 2-year tax holiday followed 50 percent tax reduction for firms investing long term (10 years or longer) in specific zones. | • Phased out, except for high-tech firms for which it will no longer be limited to specific zones. Firms must begin using 2 year tax holiday in 2008 |
| FIE incentives for exports | 50 percent tax reduction if at least 70 percent of total production is for export. | • Repealed |
| FIE incentives for technologically advanced enterprises | 50 percent rate reduction for extended period of 3 years. | • Repealed, with transitional period for existing FIEs |
| FIE incentives for reinvesting profits | FIEs reinvesting profits in the same or new enterprise obtain 40 percent refund on income tax for funds reinvested. Export-oriented and high-tech firms may have the full amount refunded. | • Phased out (details have not been provided on how this phaseout will occur) |
| FIE incentives to purchase local equipment | FIEs may deduct 40 percent of the cost of locally produced equipment to the amount of their increase in income from the previous year. | • Phased out (details have not been provided on how this phaseout will occur) |
| Refund of local portion of income tax | Provincial governments may exempt or reduce taxes for encouraged FIEs. | • Repealed |
| Agricultural incentives | Preferences for agricultural, forestry, stock breeding, fishing, and infrastructure projects. | • Retained |
| Regional incentives | Preferences for "encouraged enterprises" in central and western China (applies to FIEs and domestic firms). | • Retained |

Source: Heidrich and Hausman, "China's New Corporate Income Tax Law"; Deloitte, "International Tax and Business Guide China,"10; and industry interviews with Commission staff, Chonqqing, China, Sept. 5, 2007.

Note: On November 29, 2007, USTR announced that the United States and China had signed a Memorandum of Understanding (MOU) to settle a U.S. dispute pending against China under the WTO Dispute Settlement Understanding concerning the WTO-consistency of certain Chinese tax practices granting refunds, reductions, or exemptions from taxes or other payments. A copy of the MOU is provided in app. F.

Note: New FIEs that had not been granted tax benefits before the new law was passed are to be taxed at 25 percent beginning in 2008.

members, 11 percent of firms said preferential tax rates were highly important in their decision to invest in China, 51 percent said preferential tax rates slightly affected their decision, and 38 percent said preferential tax rates didn't affect their decision at all; almost 70 percent of firms surveyed indicated that the new tax laws that eliminate FIE preferences will not affect their investment decisions.[332]

## *Agricultural Taxes*

Until recently, rural areas in China faced a disproportionate tax burden.[333] However, since 2003, the Chinese government has eliminated a number of taxes and fees levied by local governments on agriculture to reduce the burden on farmers. The agriculture tax was eliminated in 2006.[334] The elimination of the agriculture tax saved farmers about $16.5 billion in 2006.[335] The VAT is the major remaining tax on agriculture, although agricultural goods produced and sold directly by small-scale farmers are exempt. Most other agricultural goods are subject to the lower VAT rate of 13 percent. According to the American Chamber of Commerce, China's rules on the VAT collection "are opaque and applied in an inconsistent and unpredictable manner to agricultural products. Domestic agricultural products are sometimes subject to a lower VAT rate than imported equivalents, which runs counter to China's national treatment obligations."[336] FIEs engaged in agriculture, forestry, and animal husbandry may qualify for EIT tax reductions or exemptions.[337] Under the new EIT Law, domestic firms in these industries also may be eligible for tax reductions or exemptions.[338]

## *Central Government Tax Practices*

The complexity of the Chinese tax system, characterized by local collection and local interpretation of the laws has led to it being called "the world's most fragmented tax regime."[339] Chinese tax laws tend to consist of general frameworks that are clarified in later circulars. The laws often do not deal adequately with the technical aspects of tax and accounting rules, either because officials do not understand the issues needing resolution

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[332] U.S.-China Business Council, Prehearing submission to the USITC, October 16, 2007, 10.

[333] WTO, *Trade Policy Review: China*, xiii.

[334] The agricultural tax rate had been set by local governments; the national average was 15 percent of agricultural income with a limit of 25 percent. An animal slaughtering tax was eliminated in 2003, and a special agricultural tax was eliminated in 2004. D'Amico, "Tax System and Tax Reforms," 11. The special agricultural tax was an extension of the agricultural tax and was imposed on income from agricultural specialties to regulate production income from the agriculture, forestry, animal husbandry, and fishing industries. China has eliminated the special agricultural tax on all products except tobacco leaf. Liu, *Taxation in China*, 309.

[335] Batson, "Politics and Economics: China Tightens Local Oversight."

[336] AmCham-China and AmCham-Shanghai, "2007 White Paper." Agricultural imports are subject to VAT whereas Chinese product sold directly by the farmer is VAT exempt.

[337] In addition to the "2+3" EIT tax exemption/reduction available to other FIEs, these firms may apply to have their taxes reduced by 15 to 30 percent for an additional 10 years. Liu, *Taxation in China*, and D'Amico, Tax System and Tax Reforms," 372.

[338] O'Melveney and Myers, "China Enacts United Enterprise Income Tax Law," 3.

[339] Green, "On the Shenzhen Factory Floor, part 2," 1.

or because they want to maintain ambiguity.[340] Although this provides flexibility within the tax and accounting system; firms can never be assured of full tax compliance.[341]

Tax evasion has been a problem. Increased tax enforcement is a priority under the EIT Law. Sources have estimated that only 45 to 50 percent of China's potential VAT revenue is actually collected.[342] Differing VAT rates for different products, and for firms of different sizes has created opportunities for tax evasion and avoidance, and provides local tax authorities another way to manipulate tax rates.[343] The Chinese estimate that the actual rate of corporate income taxes paid was 13 to 15 percent for FIEs and 25 percent for domestic firms.[344]

Tax avoidance using low transfer pricing to reduce profits was estimated to reduce tax revenue by about $3.8 billion.[345] More than one-third of foreign direct investment (FDI) has been estimated to be from Chinese firms that have sent funds abroad to be reinvested in China in order to qualify for FIE tax preferences.[346] For example, it was estimated that more than one-half of investment reported from the British Virgin Islands was, in fact, capital of Chinese origin.[347] The current EIT Law allows domestic firms to make tax payments based on "deemed profit" rather than actual profit. This provision is sometimes abused, with "deemed profit" much lower than actual profit, thus reducing the tax payments of these firms.[348] According to one source, "so many Chinese companies evaded taxes . . . that the high rate for local firms hardly mattered."[349]

The Chinese government has taken some steps to increase tax compliance. Under the 1994 tax reforms, centrally controlled tax bureaus were set up in each district to prevent manipulation of tax revenue by local governments, and VAT collection was computerized.[350] The SAT has recently been auditing firms to crack down on "falsely issuing and intentionally accepting falsely issued valued added tax special invoices or other deductible invoices; fraudulently obtaining export tax refunds through the adoption of deceptive means; and tax evasion by means of making false accounts, keeping a double set of books and carrying out off balance sheet operations." SAT also plans to "revamp tax levying in areas and regions in which tax levying is comparatively disorderly and where there is a relatively weak foundation of tax administration."[351] The

[340] Chinese industry representatives, interview with Commission staff, Hong Kong, September 12, 2007.

[341] Ibid.

[342] Ahmad et al., "Financial Consequences of the Chinese VAT Reform," 182; Li and Zhou, "Efficiency, Exports and Evasion," 775–78.

[343] Lin, "Evaluating the VAT in China," 72–75.

[344] EIU, *Country Commerce: China*, 85 and Jin, "Explanation on the Draft Enterprise Income Tax."

[345] Hua, "'Loss Making' Foreign Enterprises 'Avoided' RMB30 Billion in Tax Payments," 7.

[346] Lin, "China's Capital Tax Reforms in an Open Economy" 144–45. U.S. Department of State, "2006 Investment Climate Statement—China"; and *Beijing This Month*, "Tax Burdens Equalized."

[347] China Distribution & Trading.

[348] Industry interviews with Commission staff, Shanghai, September 7, 2007.

[349] Leander, "How Big a Bite?"

[350] D'Amico, "Tax System and Tax Reforms in South and East Asia: China."

[351] Xie, "Article by PRC Tax Chief on Faithful Tax Payment."

new EIT Law stresses compliance, including requiring that firms report related-party transactions and how transaction prices are determined.[352]

## *Provincial and Local Government Tax Practices*

China's tax laws are created by the central government, but tax collection, interpretation and enforcement are performed at the provincial and local level.[353] In addition, precedent is not binding so that different interpretations of the same law may be in use at the same time.[354] The varied interpretations of regulations increase the cost of compliance, and create an environment in which businesses cultivate relationships with the tax authorities to receive maximum benefit from tax laws.[355]

The division of tax revenue between the central authority and provincial governments is set by the central government. Some tax revenues go exclusively to the central government, some go exclusively to the province where it is collected, and some are shared between the two levels.[356] Localities below the provincial level must negotiate their income with the provincial governments, and often lack adequate revenues to fund legislative mandates.[357]

Local government authorities may offer tax and other incentives in an effort to increase economic growth, and to increase tax revenues.[358] Localities compete with each other to attract businesses and those with the largest tax base are in the best position to offer tax cuts and incentives. Some of these incentives are provided for in the tax law while others are not. According to one source, "many local governments have granted various unauthorized tax incentives to foreign investors to entice investment."[359] Reported local

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[352] EIU, *Country Commerce: China*, 87. International Tax Review, "Cultural Evolution." Articles 49–56 of the new EIT Law focus directly on the administration of tax collection.

[353] Introduction to the Chinese Tax System, 23. "Tax officials faced with fixed revenue targets may not collect vigorously once the target is met since future targets may be increased." OECD, *China in the Global Economy*, 214.

[354] *International Tax Review,* "Cultural Evolution."

[355] World Bank, PR&EMU, "China Facilitating Investment," 40–41; Rosen, "Behind the Open Door," 61–62; and Chinese industry representatives, interview with Commission staff, Hong Kong, September 12, 2007.

[356] Additional background information on taxation is provided in app. 3.

[357] Martinez-Vazquez, et al, "The Role of Provincial Policies in Fiscal Equalization," 4–5. Since 1994 provincial governments have increased their share of revenues at the expense of lower levels of government at the same time as spending responsibilities for localities increased. Liu, "Regional Completion, Fiscal Reform and Local Governance." Firms with business units in different locations pay their taxes separately in each locality. In order to file consolidated returns and offset losses in one area against profits in another, firms need a waiver but these waivers are not often given. World Bank, PR&EMU, "China Facilitating Investment," 40–41; Rosen, "Behind the Open Door," 61–62; and Chinese industry representatives, interview with Commission staff, Hong Kong, September2007.

[358] The Communist party has used economic growth as the key measure to evaluate local officials for promotions. In order to increase economic growth and tax revenues local governments may encourage or allow business behavior that the central government discourages, such as heavily polluting or very energy intensive industries. *China Distribution and Trading*, "China's Corporate Income Tax Reform."

[359] Ibid.

tax rebates include an EIT tax exemption for five years for a new factory in a poor area and cancellation of VAT collection once revenue goals are reached.[360]

Under the current EIT Law, localities may rebate part, or all, of the 3 percent share of firm income paid to the local government. Under the new EIT Law, beginning in 2008, the 3 percent tax rebate is no longer allowed.[361] In addition to EIT tax rebates, provincial governments may refund a share of their VAT revenue back to the producing firm.[362] Alternatively, the local government may use the tax revenue to provide facilities, goods, or services that benefit firms.

Enforcement, collection efficiency, and officials' knowledge of the tax laws vary among localities. Taxes are set by the central government but collected at the local level (districts) by separate tax collection agencies. EIT taxes for FIEs and for domestic firms are collected separately—a central government tax service collects central and shared taxes, and local tax services collect local taxes.[363] Under current tax law, multinational corporations may be "able to negotiate a very favorable tax package" by negotiating with the local tax officials prior to their decision to build a facility.[364] In addition, "firms may be able to sway local tax authorities to interpret tax laws in ways that disadvantage their competitors."[365] Recently, the central government has put pressure on local tax collection agencies to increase tax revenues; and there are reports of local tax authorities compelling non-FIEs to overstate profits in order to increase tax revenue.[366]

Localities may impose administrative fees to increase their revenues. According to the EIU, "local government finances are chaotic; many regions suffer consistent deficits and have resorted to levying ad hoc charges and fees, sometimes of dubious legality, raising the effective tax burdens."[367] Sub-national governments have gained revenue autonomy by "collecting profits from SOEs, levying administrative changes, collecting penalty and confiscatory income charges, user charges for drilling and so on."[368] In 2004, total taxes and fees paid by businesses, ranged from 3.9 percent of sales costs in parts of southeastern China to 10.6 percent in parts of western China; most of the variation was because of local fees.[369]

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[360] Green, "On the Shenzhen Factory Floor, part 2," 1. Industry interview with Commission staff, Chongqing, China, September 5, 2007.

[361] Heidrich and Hausman, "China's New Corporate Income Tax Law," 3.

[362] Industry interview with Commission staff, Chongqing, September 5, 2007.

[363] According to the OECD, "lack of coordination and communication between the state tax authority and local tax authorities in carrying out their work has resulted in taxpayer complaints about the overlap of work and in considerable duplication of efforts, overlap, and unnecessary compliance and administrative costs." OECD, *China in the Global Economy*, 214. Industry interview with Commission staff, Chongqing, September 5, 2007.

[364] DeSousa, "China Tax and the CEO," 4.

[365] Rosen, "Behind the Open Door," 61.

[366] Academic representative, interview with Commission Staff, Beijing, September 2, 2007.

[367] EIU, "China Risk."

[368] Martinez-Vazquez et al., "The Role of Provincial Policies in Fiscal Equalization Outcomes," 10. According to the World Bank, fees are a bigger problem than taxes (for regional development in China). Businesses remain unclear about the types of fees that can be imposed. World Bank, PR&EMU, "China Facilitating Investment and Innovation," 43.

[369] World Bank, PR&EMU, "China Facilitating Investment and Innovation," 40.

## *Regulatory Environment*

China's current regulatory environment for central, provincial, and local government taxation practices and policies is presented in table 3.7 (the current regulatory environment of the EIT) and table 3.8 (the new EIT scheduled to enter into force January 1, 2008).

**Table 3.7** Taxation: Key regulatory practices and policies

| Name of law or regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | ***Central government*** | |
| | **Enterprise income tax (EIT), current regulatory environment (the new EIT is discussed in table 3.8)** | |
| Separate EIT laws for FIEs (enterprises with foreign investment and foreign enterprises) and domestic enterprises | • Numerous policies to encourage foreign investment by FIEs, particularly those investing in special economic zones. Basic tax rate 33% for most enterprises; however, FIEs engaged in manufacturing are frequently eligible for lower rates and incentives listed below and in table by "Economic Sector." Flexibility in enforcement may create a lower tax rate for FIEs and domestic firms. Revenue shared between central government and local government. | 1991 (FIE EIT Law)<br>1994 (domestic EIT Law) |
| Preferential tax policies for FIEs | • 2-year tax exemption, 3-year 50% tax reduction (production oriented FIEs scheduled to operate for at least 10 years, from first profitable year).<br>• 40% EIT tax refund on profits reinvested directly into the same enterprise, or as capital investment to establish other FIEs. 100% EIT refund for FIE investment in export oriented enterprises or advanced-technology enterprises.<br>• FIEs not established in China but deriving profit, interest, rental, royalty, and other income from sources in China may, since January 2000, pay a reduced EIT rate of 10%; foreign investors in FIEs are exempt from income tax.<br>• Reduced EIT rate of 10%, or exemption, for royalty received for technical know-how in scientific research, exploitation of energy resources, development of communications and transportations industries, agricultural, forestry and animal husbandry production, and development of important technologies. | 1991 |
| Export-oriented FIEs | • 50% reduction in income tax of FIEs exporting 70% or more of the output value, after expiration of income tax exemption/reduction. Export-oriented enterprises in special zones pay 10% tax rate. | 1991 |
| Incentive for FIEs (natural resources) | • Tax incentives including ability to offset profits from one contract against losses incurred in another area for eligible FIEs engaged in the cooperative exploitation of offshore petroleum. | 1994 |
| Incentive environmental | • 5 year exemption or reduction of EIT for enterprises using waste materials as major materials for production. | 1994 |
| Wage cost deductions preferences for FIEs | • FIEs can deduct the full cost of wages, domestic firms cannot deduct the cost of wages above a per person wage cap ranging from $118–145 (RMB 980–1,200) per month. | 1991, 1994 |
| Tax incentives for FIEs locating in certain regions and zones | • Incentives for FIEs locating in border cities, special economic zones, coastal economic open areas, and in economic and technological development zones (Pudong area of Shanghai, Three Gorges of Yangtze River Economic Zone, western region, and poverty-stricken Areas. | 1984–1995 |

**Table 3.7** Taxation: Key regulatory practices and policies—*Continued*

| Name of law or regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | **Central government—*Continued*** | |
| | **EIT—*Continued*** | |
| Tax preferences for locating in western regions (domestic firms, FIEs) | • Reduced EIT rate of 15% for FIEs and domestic firms, in encouraged industries, in western regions, from 2001-2010. Exemption from tariff and import VAT for some imported equipment. EIT exemption for first 2 years and 50% reduction for years 3-5 for FIEs (from first year of profit) and domestic enterprises (from first year of production or operation) newly established in western regions and with 70% of revenues from transportation, electricity, water conservation. Reduced EIT rate of 15% for another 3 years following the expiration of the "2 years exemption and 3 years of 50% reduction" for FIEs in 19 localities in central and western regions in encouraged industries. | 2001 |
| Tax preferences for locating in poverty stricken areas (domestic firms, FIEs) | • EIT exemption or reduction for 3 years for enterprises newly established in certain poverty stricken areas | 1994 |
| Tax preferences for low profit and special businesses | • Preferential tax treatment for firms making little profit, welfare enterprises, township enterprises, providing employment for unemployed people | 1994 |
| | **Provisional regulations on value-added tax (VAT)** | |
| VAT | • VAT rates on the sale of goods and on processing, repair, and replacement services (including imports) range from 0% to 17%. Revenue shared by central and local government. | 1994 |
| VAT reimbursement | • Reimbursement of VAT for imported capital equipment | |
| VAT reimbursement Circular no. 61) | • Reimbursement of VAT for domestic equipment to put it on a par with imported product above | |
| VAT preference for environmental purposes | • Preferential tax treatment for production with integrated utilization of resources. Exemption on VAT on building material products made from waste residues | 1995 |
| | • Preferential tax treatment for other products produced with integrated utilization of resources. (1) Refund on VAT on products produced using resources such as electric power produced from urban waste, and (2) 50% reduced VAT rate on electric power produced with wind power and on some wall building materials. | 2001 |
| VAT trial—northeast region (Circular no. 156) | • Allows firms in certain industries and regions to deduct VAT paid on purchases of certain fixed assets. In northeast region (Heilongjiang, Jilin, Liaoning provinces, and Dalian city), applies to eight industries–equipment manufacturing, petrochemicals, metallurgy, shipping manufacturing, automobiles, agroindustry, military supplies, and high- and new technology. Stated goal is to increase investment in the region. | 2004 |
| VAT trial expansion to central region (Circular no. 75) | • Expands VAT trial to 26 specified industrial cities in the provinces of Shanxi, Anhui, Jiangxi, Henan, Hubei, and Hunan. Stated goal is to increase investment in the regions. Same industries as northeast trial, but also includes excavating and electrical power industries, and excludes shipbuilding and military equipment and materials. | 2007 |
| Exemption of tariff and VAT for imported technology and equipment | • Exemption from tariff and import VAT on equipment imports for encouraged FIE projects. | 1997 |
| | • Exemption from tariff and import VAT on imports of equipments and the technologies, accessories and spare parts imported with the equipments as provided in the contract, for encouraged domestic invested projects. | |

**Table 3.7** Taxation: Key regulatory practices and policies—*Continued*

| Name of law or regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | **Central government—*Continued*** **Other taxes** | |
| Business tax | • Including: communication and transportation, construction (3%); services, transfer of intangible assets, sales of immovable properties (5%); financial services and insurance business (8%). Most of this revenue to local governments. | 1994 |
| Consumption tax | • Excise tax is levied on certain items, notably cigarettes, alcoholic beverages, gasoline, automobiles and “luxury items” with rates from 3% to 45% ($.01– 0.3, or RMB 0.1–0.28) per liter tax on gasoline and diesel). As with VAT, it may be rebated on exports. All revenues go to central government. | 1998 |
| Individual income tax | • Tax based on income received in and outside of China. Includes tax of single proprietors and partnerships. There are deductibles and tax rates range from 5% to 45%. Tax revenue is shared by local and central government. | 1999 |
| Natural resource tax | • Tax on exploitation of minerals. Rates (in RMB/ton except as noted) include: crude oil (8–30); natural gas ( 2–10/cu meter); coal (0.3–5.0); other non metals (0.5–20); ferrous-metal minerals (2–30); nonferrous-metal minerals (0.4–30); solid salt (10–60); liquid salt (2–10). Tax revenue is shared by central and local government. | 1994 |
| City and township land use tax | • Tax rates are set at the local level, typically based on urban area size. Revenue go to local governments. Regional rate exceptions include: “Backward areas” may reduce taxes up to 30% with provincial approval. “Advanced areas” may increase tax but proposed amount must be approved by central government Ministry of Finance. | 1988 |
| | **Taxes for special purposes** | |
| City maintenance and construction tax (CMCT) | • Firms that pay VAT, consumption tax, and or business tax are subject to the CMCT. Rates are 7% in cities, 5% in counties and towns, and 1% in other areas. These rates apply to the amount of tax paid in the VAT, consumption and business taxes and are collected with these. CMCT is not collected on imported goods. Revenue shared by central and local government | 1985 |
| Farm land occupation tax | • Applies to entities occupying farm land for nonfarm purposes. Variable rate based on amount of farm land per person in the area. Revenue goes to local governments. | 1987 |
| Fixed asset investment orientation regulation tax | • Tax suspended since 2000 to encourage investment and economic development. | 2000 |
| Land appreciation tax | • Rate from 20–60%, depending on the appreciation of the property. Revenue goes to local governments. | 1994 |
| | **Non-tax fiscal revenues** | |
| Mining district use fee | • Fees on output of oil and natural gas ranging from 1.0–12.5%; “paid in kind” based on output | 1995 |
| | **Social insurance fees** | |
| Social insurance fees | • All social insurance fees are paid into special social insurance funds. Fees are collected at the provincial level and some provinces may not collect these fees. | |
| Basic pension insurance | • Employers payments not to exceed 20% of wages paid by enterprises. Employees payments not to exceed 8% of wages (withholding). This fee is reported to be 30% of salary paid to an employee in Shanghai Pudong. | 1999 |

**Table 3.7** Taxation: Key regulatory practices and policies—*Continued*

| Name of law or regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | **Central government—*Continued*** | |
| | **Social insurance fees—*Continued*** | |
| Basic medical insurance | • Employers pay 6% of total wages, employees pay 2% of wages (withholding). For non resident workers, insurance contributions can be based on the minimum wage rather than wage paid. Health insurance does not need to be paid in some locations. This fee is reported to be 10% of salary paid to an employee in Shanghai Pudong. | 1999 |
| Unemployment insurance | • Provincial governments may adjust these rates based on local conditions. The basic rate is 2% of total wages paid by employers and 1% of wages (withholding) paid by the employee. This fee is reported to be 1% of salary paid to an employee in Shanghai Pudong. | 1999 |
| Industrial injury insurance | • Depending on the employment risk, 0.5%, 1%, and 2% of wages, paid by the employer, with a average of 1% employer-based floating rates. This fee is not reported for Shanghai Pudong. | 1999 |
| | ***Provincial and local governments*** | |
| EIT reductions/exemptions by regional authorities | • Firms in autonomous regions may, for specific periods, be eligible for EIT exemptions or reductions to the share of the EIT tax received by the provincial government, upon government approval at the provincial level. | 1991 and 1994 |
| Local tax collection agency differs for FIE and domestic firms | • Taxes are collected by different agencies at the local level if FIE or domestic firm. May result in disparate treatment. | 1991 and 1994 |
| Use of deemed income provision | • Small, low-profit firms are allowed to pay taxes on deemed income rather than actual income. It is reported that in some regions most or all domestic firms have been assumed to be small and have substantially underestimated their income and thus paid lower taxes. | 1994 |
| | **Tax collection, enforcement, and incentives** | |
| SAT tax collection | • SAT has local tax bureaus that collect most taxes (those that go in whole or in part to the central government). Tax collection, interpretation, and enforcement are done at the provincial and local levels. This system results in a number of problems for firms, including: differing regional interpretation of regulations (and sometimes within the same region), the need to develop relationships with taxing authorities, increased risk of corruption, and the treatment of firm branches in different locations as different businesses. In addition, a waiver from the tax authorities is required for firms to offset losses in one tax location against profits in another. | 2002 |
| Local government tax collection | • Locally controlled tax collection agencies collect taxes that go solely to local authorities including business, land, and property taxes | Current practice |
| Local fees and tax rates | • While the central government sets all taxes and determines the range, provincial and local governments control the level of some taxes and can charge fees. | Current practice |
| Local government incentives | • Local governments may offer tax and other incentives in an effort to increase economic growth. Local governments have reportedly granted unauthorized tax incentives to FIEs to encourage investment. Local governments may also use tax revenue to provide facilities, goods or services that benefit firms. | Current practice |
| Enforcement | • Tax compliance is enforced at the provincial and local levels. Different interpretations of the same law may be in use at the same time. | Current practice |

**Table 3.7** Taxation: Key regulatory practices and policies—*Continued*

| Name of law or regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | ***Economic sector*** | |
| | **Agriculture** | |
| VAT | • 0% VAT rate for certain agricultural inputs and many agricultural products sold directly by producers. | 1994 |
| FIEs in agriculture, forestry or animal husbandry and in remote underdeveloped areas | • 10 year, 15-30% income tax reduction after expiration of tax exemption/reduction. | 1991 |
| Tax preferences for key leading enterprises in agricultural | • The income of key leading enterprises from planting, animal and fish farming, and preliminary processing of agricultural and forest products may be exempt from income tax. | 2001 |
| Tax preferences for enterprises in forestry | • Income from production of forestry, forestry seeds as well as from preliminary processing of forestry products may be exempt from income tax. | 2001 |
| VAT exemption for grain or oil reserves enterprises | • Sales of grain and edible oil by SOEs which carry reserves of grain and oils for food security purposes are exempted from VAT | 1999 |
| Imports for rotation of grain reserves | • Reduced or no tax on imports of China Grain Reserves Corporation for the purpose of rotation of grain reserves | 2001 |
| | **Manufacturing** | |
| Incentives for FIEs (manufacturing in special economic zones) | • Two year investment tax holiday and a 50% income tax reduction for an additional 3 years for increased investment. FIEs must increase capital at least $60m or at least $15m if 50% increase in capital. Open only to investments in encouraged industries | 1991 |
| Preferential tax policies for FIEs purchasing domestically produced equipment (see note at end of table) | • For certain encouraged investment projects by FIEs, 40% of purchase expenses on domestically produced equipment may be deducted from the increment of income tax of that year compared to the previous year. | 1999 |
| Preferential tax policies for domestic enterprises purchasing domestically produced equipment for technology upgrading | • 40% of purchase expense on domestically produced equipment deducted from the increment of income tax of that year compared to the previous year. | 1999 |
| Preferential tax treatment for casting and forging products; dies products; and numerically controlled machine tool products | • 35% VAT refund on casting and forging products manufactured and sold by certain casting and forging enterprises; 50% VAT refund on dies products manufactured and sold by certain specialized dies manufacturers; 50% VAT refund on numerically controlled machine tool products produced and sold by certain manufacturers. | 2003 (set to expire in 2005, but extended until 2008) |
| | **Services** | |
| VAT vs. business tax | • Many services are covered by the business tax, which has different rates from the VAT and is not deductible | 1994 |
| Banking | • Reduced 15% EIT rate; may be exempt from EIT in the first year and 50% reduction years 2 and 3 | 1994 |
| Technology-related services | • Transfers of technology, technology development, technology consultation services, and technical services may be exempt from business tax | 1994 |
| Agricultural services | • Agricultural technology services and training services may be exempt from business tax | 1994 |
| | **Infrastructure development** | |
| EIT (current) | • Many tax incentives for FIEs that invest in infrastructure development | 1991 |
| Ports, docks | • EIT rate of 15% for Chinese-foreign joint ventures in construction of ports, docks and berths. For firms operating over 15 years, tax exemption for first 5 years, and 50% reduction for next 5 years. | 1991 |

**Table 3.7** Taxation: Key regulatory practices and policies—*Continued*

| Name of law or regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | **Economic sector—*Continued*** | |
| | **Infrastructure development—*Continued*** | |
| Energy, transportation | • Preferential tax policies for FIEs engaged in energy, transportation infrastructure projects. Reduced income tax rate of 15%. | 1991 |
| | **High technology** | |
| Technology-intensive and knowledge-intensive FIEs | • Reduced EIT of 15% for firms with 50% of sales revenue from products listed in the "Catalog of High and New Technology Products of China." | 1991 |
| High- or new-technology FIEs in special zones | • Reduced EIT rate of 15%. Chinese-foreign equity JVs may be exempt from EIT tax in first 2 profitable years. Preferential tax provisions for FIEs in special zones. 50% EIT tax reduction for 3 years after expiration of exemption (exemption and reduction known collectively as "2+3") | 1991 |
| Preferential tax treatment for imported products for scientific and educational purposes | • Exemption from tariff, import VAT, and excise tax on products directly used in scientific research and education and imported by scientific research institutions and schools for nonprofit purposes. | 1997 |
| Preferential tax policies for enterprises transferring technology | • EIT exemption (on income up to about $36,320 for enterprises profiting from technology transfers as well as from providing technology consultation, services and training in the transfer. | 2001 |
| Preferential tax policies for integrated circuit (IC) industry | • IC enterprises may be eligible for the following: 40% EIT tax refund on profits reinvested in IC producing or packaging enterprises; 80% EIT tax refund on profits reinvested in such enterprises in western regions. "2+3" EIT tax exemption/reduction. Exemptions from tariffs and import VAT on certain imports of integrated circuit-producing technology, equipment, and raw materials. | 2000–2002 |
| Incentives for high- and new-tech firms | • Preferential tax policies for enterprises recognized as high- or new-technology enterprises established in the state high-or new-technology industrial development zones | 1991 |
| Incentives for FIEs (high-tech) | • Preferential tax policies for FIEs recognized as high- or new-technology enterprises established in the State high- or new-technology industrial development zones, and for advanced technology enterprises invested in and operated by foreign businesses. | 1991 |
| | • 50% reduction in income tax for first 3 years, commencing with first profitable year. Eligible technologically advanced enterprises that don't qualify for tax incentives offered to FIEs engaged in production. | 1991 |

Source: China 2006 WTO submission; *China Distribution and Trading*, "China's Corporate Income Tax Reform; EIU, *Country Commerce: China*; Chinese industry representatives, interview with Commission staff, Hong Kong, Sept. 12, 2007; Green, "On the Shenzhen Factory Floor, parts 1 and 2"; Nelson and Quingjum, "The PRC Enterprise Income Tax Law and Its Impact on Listed PRC Companies"; *International Tax Review*, "Cultural Evolution"; Commission staff discussions with KPMG Sept. 7, 2007; WTO, *Trade Policy Review: China*; and Zhang, "Fiscal Decentralization and Political Centralization in China."

**Table 3.8** Taxation: Key regulatory practices and policies—China's new EIT Law scheduled to enter into force Jan. 1, 2008

| Name of law or regulatory practice/policy | Description |
|---|---|
| | **Central government** |
| Enterprise income tax law (see note at end of table) | • Unified tax rate of 25% for most firms (domestic and FIEs). The new EIT aims to bring Chinese tax law more into compliance with WTO commitments. Many details of this law are not yet final. |
| Enterprises separated into resident and non-resident (Art. 2) | • Resident enterprises are taxed in China for all firm income, including that outside of China; non-resident enterprises are taxed on income earned in China. Residency is based on the location of "effective management." |
| Small, low-profit enterprises lower rate (Art. 28) | • Reduced 20% rate for small, low-profit firms. |
| Incentives for high tech | • Reduced 15% rate for advanced and new technology eligible enterprises. |
| | • Accelerated depreciation for fixed assets that have a shorter useful life due to advancing technology. |
| Incentives for tech transfer | • May be eligible for exemptions from or reduction of EIT. |
| Incentives for R&D | • Super deductions for expenses incurred in developing new technologies, products, and techniques. |
| Incentives for agriculture | • Firms in agricultural, forestry, animal husbandry, and fisheries industries may be eligible for exemptions from or reduction of enterprise income tax. |
| Incentives for public infrastructure projects | • Firms investing in public infrastructure projects may be eligible for EIT exemption or reduction. |
| Incentives for environmental protection, energy and water savings | • Some share of investments in equipment for environmental purposes or saving energy or water or improving industrial safety will be deductible in the year of the investment. |
| | • Revenue derived from environmental protection, energy, and water conservation products may be eligible for exemptions or reduction of tax. |
| | • Revenue from manufacture of products in line with state industrial policy and manufacture of products using of waste materials may be eligible for exemptions or reduction of tax. |
| Incentives for employing disabled workers | • Additional deduction for employment of disabled and other encouraged workers. |
| | **Provincial and local governments** |
| EIT rebates by regional authorities | • Autonomous government authorities of ethnic autonomous regions can grant an income tax deduction up to the amount of income retained by the region. |
| Local tax collection agency merge FIE and domestic sections | • Local tax collection agencies are to merge sections dealing with FIEs and domestic firms, to foster more similar tax treatment of all firms and reduced tax avoidance by domestic producers. It is therefore expected that tax revenues will not fall much in spite of the reduction of domestic firms' tax rates from 33% to 25%. |
| | **Services** |
| Reduced rate for service providers | • The new EIT stands to benefit firms in the service sector because they have faced a 33% tax rate and were not eligible for most tax deductions under current EIT Law. This should benefit FIEs in particular because they were less likely than domestic service providers to receive benefits granted to small, low-profit firms. |

Source: *Topics in Chinese Law*, "China Enacts Unified Enterprise Income Tax Law," Shanghai, Sept. 7, 2007.

Note: On November 29, 2007, USTR announced that the United States and China had signed a Memorandum of Understanding (MOU) to settle a U.S. dispute pending against China under the WTO Dispute Settlement Understanding concerning the WTO-consistency of certain Chinese tax practices granting refunds, reductions, or exemptions from taxes or other payments. A copy of the MOU is provided in app. F.

# CHAPTER 4
# Banking and Finance, Infrastructure Development, Research and Development, and Worker Training and Retraining

This chapter describes the policies and practices that central, provincial, and local government bodies in China currently use to support or influence decision making in China's agricultural, manufacturing, and services sectors in the following areas: banking and finance sector policies; infrastructure development; research and development; and worker training and retraining. Practices and policies in this group directly target domestic distortions—that is, they aim to reduce economic distortions or inefficiencies in China's economy.

## Banking and Finance Sector

Foreign banks traditionally have had very limited access to China's market. China, under the conditions of its WTO accession agreement, has gradually introduced and phased in market liberalizations since 2001. According to most sources, China is generally meeting its WTO financial services commitments.[370] Nevertheless, foreign firms continue to hold a very small share of China's banking sector, although foreign banks do have significant market share in certain niches related to foreign currency business and trade finance. China's banks continue to channel a disproportionate amount of capital to the country's large SOEs and continue to face the problem of addressing nonperforming loans—many made in support of the government's economic growth agenda to borrowers now unable to repay the debt. China's practices and policies related to the banking and finance sector are summarized in table 4.1.

### *Banking Sector Overview*

The People's Bank of China (PBC) is China's central bank. China's banking system is composed of 19,797 financial institutions including five state-owned commercial banks (SOCBs), joint-stock commercial banks, national and regional commercial banks, and urban and rural credit cooperatives (table 4.2). There are also three national policy banks

[370] China's WTO commitments with respect to the banking and finance sector included a five-year phase-in for banking services by foreign banks. Immediately upon accession, China agreed that it would allow U.S. and other foreign banks to conduct foreign currency business without any market access or national treatment limitations and conduct domestic currency business with foreign invested enterprises and foreign individuals, subject to certain geographic restrictions. The ability of U.S. and other foreign banks to conduct domestic currency business with Chinese enterprises and individuals was to be phased in over a period of two to five years, subject to certain geographic restrictions. China's WTO commitments for the banking and finance sector are described in more detail in box 4.1. USTR, 2006 *Report to Congress on China's WTO Compliance*, 81–2. See also U.S.-China Business Council, "China's WTO Commitments."

**Table 4.1** Banking and finance sector: Summary of key practices and policies

| Practices and policies | Level of government where applied | Associated laws and regulations |
|---|---|---|
| Central government maintains a pervasive role in China's banking system. | • Central government | • 1995 Commercial Bank Law |
| Central government has instructed state-owned commercial banks to reduce their numbers of local bank branches, and let provincial and rural banks expand service in those markets. | • Central, provincial, and local governments | • 1995 Commercial Bank Law |
| China's banks channel a disproportionate amount of capital to large SOEs. | • Central government | • 1995 Commercial Bank Law |
| Government bailouts of banks implemented to address the problem of nonperforming loans. | • Central government | • 1995 Commercial Bank Law |
| Government-directed commercial lending practices implemented to address the problem of nonperforming loans. | • Central government | • 2002 Guidelines on the Internal Controls of Commercial Banks |
| Interest rates are set by the People's Bank of China. | • Central government | • 1995 Law on the People's Bank of China |

Source: China Banking Regulatory Commission website; EIU, *Country Finance: China*; and WTO, *Trade Policy Review: China*.

**Table 4.2** China: Banking institutions by type, quantity, and share of assets, 2006

| Institution | Number of legal entities | Share of assets (percent) |
|---|---:|---:|
| Rural credit cooperatives | 19,348 | 7.9 |
| City commercial banks | 113 | 5.9 |
| Rural cooperative banks | 80 | 1.1 |
| Urban credit cooperatives | 78 | 0.4 |
| Corporate finance companies (see note) | 70 | 0.8 |
| Trust companies (see note) | 54 | 0.8 |
| Foreign financial institutions | 14 | 2.1 |
| Rural commercial banks | 13 | 1.1 |
| Joint-stock commercial banks | 12 | 12.4 |
| Leasing companies (see note) | 6 | 0.8 |
| State-owned commercial banks | 5 | 55.1 |
| Policy banks | 3 | 7.9 |
| Postal savings bureau | 1 | 3.7 |
| Total | 19,797 | 100.0 |

Source: China Banking Regulatory Commission, *2006 Annual Report*, 133 and 149.

Note: The shares of assets held by corporate finance companies, trust companies, and leasing companies are not individually reported, rather the aggregate for the three is reported as 2.4 percent in the category "nonbank financial institutions."

(the China Development Bank, Export-Import Bank of China, and the Agricultural Development Bank of China) responsible for making loans in support of the government's economic policies. Because of their large size, quasi-monopoly status, and perceived stability resulting from government financial backing, the five SOCBs—Agricultural Bank of China, Bank of China, Bank of Communications, China Construction Bank, and Industrial and Commercial Bank of China—dominate China's banking industry, holding 55 percent of the country's total banking assets and 55 percent of deposits in early 2007.[371] By comparison, joint-stock commercial banks[372] hold 12.4 percent of assets and 12.6 percent of deposits, while city commercial banks[373] account for 5.9 percent of both assets and deposits.[374] Foreign banks currently account for just 1.7 percent of total banking assets, and 1.5 percent of loans in China's domestic market.[375] Industry sources reported that China is generally meeting its WTO commitments in the banking sector, and that liberalization has proceeded as agreed.[376] The evolution of China's banking sector reforms and recent reforms are described in box 4.1.

China's central government continues to maintain a pervasive role in the banking sector. Several factors impede commercial practices from being more effectively adopted in China, including political influence in economic decision making at all levels of government, pressure to maintain employment in the banking sector and in other sectors of the economy, and belief that the government will continue to provide bailouts in cases of insolvency. In addition, the networks of China's large banks are so expansive that central government reform efforts often are disregarded at provincial and local levels, where political influence over financial decisions reportedly is more common. This may be one reason why the central government has instructed SOCBs to reduce their numbers of local bank branches and has allowed provincial and rural banks to expand service in those markets.[377]

## *Indicative Lending*[378]

China's banks are widely reported to channel a disproportionate amount of capital to large SOEs, leaving SMEs with limited access to funding. According to industry representatives in China, approximately 70 percent of loans made by the SOCBs are directed toward SOEs.[379] Industry sources state that policy loans at favorable interest rates to certain industries most certainly occur in China, and that complete departure from this practice is unlikely to occur soon.[380] Private enterprise has grown exponentially in

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[371] China Banking Regulatory Commission (CBRC), *2006 Annual Report*.

[372] Joint-stock commercial banks hold a smaller value of assets than the SOCBs, but tend to be more profitable and have lower levels of nonperforming loans. U.S. Department of Commerce, USCS, "China: Banking."

[373] China's 113 city commercial banks are generally responsible for serving the needs of small and medium size enterprises, though their financial viability is uncertain, and management and staff quality are not highly regarded. EIU, *Country Finance: China*, 17.

[374] CBRC, *2006 Annual Report*.

[375] Industry data, provided to Commission staff in Hong Kong, August 2007.

[376] Industry representative, interview with Commission staff, Shanghai, September 7, 2007.

[377] The Bank of China, the China Construction Bank, and the Industrial and Commercial Bank of China all reportedly have scaled back their national branch networks in the past 5 years in an effort to focus on more profitable regions. Industry representative, interview with Commission staff, Shanghai, September 10, 2007.

[378] Indicative lending, in the case of China, includes loans with preferential terms made to certain companies or industries that are considered essential to the government's economic growth agenda.

[379] Industry representative, interview with Commission staff, Beijing, August 2007.

[380] USITC hearing transcript, September 6, 2007, 141–143.

**Box 4.1** China: Evolution of banking sector reforms

Prior to 1979, the People's Bank of China (PBC) held a monopoly in the financial sector. Its chief function was to collect revenue from and allocate investment to SOEs according to government policy. The PBC became China's central bank in 1979, and its commercial bank operations were broken up into the existing SOCBs[a] which were established to serve four key industrial needs; agriculture, construction, heavy industry, and foreign exchange. The SOCBs were eventually allowed to compete across sectors and services, though they maintain strengths in their original customer bases. The China Banking Regulatory Commission (CBRC) was established in 2003 to regulate banks and financial institutions.[b]

Banks play a dominant role in China's financial markets and are the primary source of capital for domestic business operations. Unlike in other, more developed markets where banks typically serve small and medium enterprises (SMEs) and individual consumers, Chinese banks serve as primary financiers across industry with more capital going to the biggest companies. Bank deposits are also the main vehicle for corporate and retail savings—75 percent of China's capital is deposited in its banks, whereas that figure is typically closer to 20 percent in developed countries and 50 percent in other emerging markets. One reason for banks' dominance in the financial system is China's relatively underdeveloped securities markets. Because alternate domestic investment vehicles are not widely available to most Chinese citizens, most household savings are deposited in low-yield savings accounts. Businesses also have few outlets for earnings income. If firms do not reinvest profits, capital is often held in bank accounts. China's tight restrictions on capital outflows further contribute to the high level of bank deposits.

China has introduced new regulations in the past decade intended to address major inefficiencies and shape the financial services sector into something more closely resembling markets in developed countries. China's 1995 Commercial Bank Law requires banks to follow market principles. However, implementation of the laws is inconsistent, especially at the local level. Regulations are generally aimed at commercializing the banking sector, regulating lending, and allowing foreign participation in the market.

China's WTO commitments with respect to the banking and finance sector included a five-year phase-in for banking services by foreign banks. China agreed that, immediately upon accession, it would allow U.S. and other foreign banks to conduct foreign currency business without any market access or national treatment limitations and conduct domestic currency business with foreign invested enterprises and foreign individuals, subject to certain geographic restrictions. The ability of U.S. and other foreign banks to conduct domestic currency business with Chinese enterprises and individuals was to be phased in over a period of two to five years, subject to certain geographic restrictions. "[S]hortly after China's accession to the WTO, the . . . [PBC] issued regulations governing foreign-funded banks, along with implementing rules, which became effective February 1, 2002. The [PBC] also issued several other related measures. Although these measures kept pace with the WTO commitments that China made, it became clear that the [PBC] had decided to exercise extreme caution in opening up the banking sector. . . . China kept up with its commitments regarding the lifting of geographic restrictions on foreign banks conducting domestic currency business with foreign enterprises and individuals and Chinese enterprises. . . . One area in which China fell behind in its WTO commitments involves the establishment of Chinese-foreign joint banks."

Source: Farrell and Lund, "Putting China's Capital to Work," 29; Commission staff interview with industry representatives, Shanghai, September 7, 2007; USTR, 2006 *Report to Congress on China's WTO Compliance*, 81–2; and "WTO, *Trade Policy Review: China*, 209–19.

Notes:
[a] With the exception of the Bank of Communications, which was reclassified as a SOCB in 2006.
[b] According to an industry source, there is some ambiguity regarding the domain of regulatory institutions. The CBRC, PBC, China Securities Regulatory Commission, and China Insurance Regulatory Commission often have overlapping regulatory jurisdictions. Industry representative, interview with Commission staff, Shanghai, September 7, 2007.

the last three decades, and is now responsible for approximately one-half of all industrial output in China.[381] Despite this increased contribution to national output, private enterprises receive only 27 percent of bank loans.[382] The situation for SMEs is even more dramatic. These firms reportedly generate 55 percent of China's GDP and are responsible for 75 percent of the country's employment. However, SMEs receive only 16 percent of bank loans.[383]

One reason China's banks tend to favor loans to SOEs is that, for the most part, banks lack the ability to conduct effective credit-risk analysis on potential borrowers. China's banks have not traditionally based lending decisions on creditworthiness, and do not yet have systems in place to collect credit background information on potential clients.[384] SOEs are perceived to be lower-risk, or at least backed by the government in the event of loan forfeiture; information on creditworthiness of SMEs is not available; and local politicians pressure banks to fund the SOEs. Additionally, SOEs tend to have borrowing histories and established relationships with the SOCBs, reducing their perceived risk. Private firms, including SMEs, are left to find alternate means of financing.[385]

According to central government officials in China,[386] indicative lending no longer occurs. However, industry representatives in China reported that local banks are subject to indicative lending policies as directed by PBC regional offices.[387] These guidelines, which vary by region, indicate which sectors and firms receive priority attention for loans

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[381] Farrell and Lund, "Putting China's Capital to Work," 19.

[382] Ibid., 62.

[383] Ibid., 63.

[384] Unlike in developed economies, China has no national clearinghouse of information on company or individual credit histories and financial records; however, the PBC reportedly maintains some data on borrowers that are in default. Banks can access the information through the CBRC. While some banks—particularly those with foreign investors—are undertaking practices aimed at assessing the risk and financial health of potential loan recipients, financial statements furnished by such companies are often incomplete. Further complicating matters, many businesses in China, including banks, do not adhere to international accounting standards, so financial statements, valuation of assets, and other financial reports, are inconsistent. China is making overtures toward adopting international accounting standards, but any such transition will require time and resources to train industry professionals in those methods. Chinese central government representative, interview with Commission staff, Beijing, August 30, 2007.

[385] Private firms and SMEs typically turn to reinvested earnings, loans from family and friends, and black-market loans, all of which require substantial time commitments to developing and maintaining personal contacts. Black-market loans generally are illegal and typically conducted off-the-record and at high interest rates. Although SMEs and farmers are more frequent borrowers, SOEs sometimes use black-market loans when they cannot meet all their financing needs through official channels. It is estimated that black-market (also referred to as "grey market," or "underground") lending in China may be as high as $100 billion. These loans reportedly account for as much as 33 percent of loans to SMEs, and 55 percent of loans to farmers. Farrell and Lund, "Putting China's Capital to Work," 66; and *The Economist*, "Black-Market Banking."

[386] Chinese government representative, interview with Commission staff, Beijing, August 30, 2007.

[387] Industry representative, interview with Commission staff, Hong Kong, September 11, 2007.

in accordance with the government's industrial development policy. Foreign banks are not required to follow these guidelines.[388]

## *Nonperforming Loans*

The inefficiencies of China's banking system have generated two significant byproducts: an enormous stock of nonperforming loans and a credit shortage for private businesses and SMEs. Throughout China's relatively recent surge of industrial growth, banks—the SOCBs in particular—made many loans in support of the government's economic growth agenda, without regard to the borrowers' ability to repay the debt. Unchecked for more than a decade, the number of nonperforming loans reached a level that threatened the solvency of the banking sector.

The 1996 General Rules on Lending was China's first major piece of legislation designed to address the mounting number of nonperforming loans. This regulation effectively requires the SOCBs to make lending decisions based on creditworthiness rather than political interests.[389] However, a remaining provision in the regulation allows the State Council to suspend that guidance if lending practices are perceived to run contrary to national economic priorities. It is unclear how often and in which sectors that provision is exercised.[390]

According to one report, nonperforming loans accounted for 39 percent of the Bank of China's loan portfolio by 1999, with total nonperforming loans growing to the equivalent of four times China's GDP by 2000.[391] By 2002, the nonperforming loan problem had become unsustainable and the PBC intervened with the new Guidelines on the Internal Controls of Commercial Banks designed to commercialize lending practices. The guidelines called for improving procedures for extending credit and identifying lending risks. The PBC also issued Guidelines on Loan Loss Provisions in 2002, requiring banks to classify new and outstanding loans in a five-tier system, and to conduct quarterly reporting on the status of loans. In 2004, the Government of China provided a $45 billion capital infusion to the Bank of China and China Construction Bank to service their nonperforming loans and to help them remain solvent. The Industrial and Commercial Bank of China received a $15 billion capital infusion in 2005 to help with its nonperforming loans.[392] The state-controlled China Investment Corporation, launched in September 2007 to manage investment of a portion of China's substantial foreign exchange reserves, is to channel one-third of its $200 billion investment capital to replenish the capital of the Agricultural Bank of China, which holds large stocks of nonperforming loans, and the China Development Bank.[393] One industry source estimated that China's government bailout of nonperforming loans ultimately will cost

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[388] Citigroup data on China's banking industry. Provided to Commission staff in Hong Kong, August 2007.
[389] PBC, "Law of the People's Republic of China on Commercial Banks."
[390] According to the Commercial Bank Law, SOCBs are instructed to develop loan policies in accordance with national economic and social development priorities. Losses resulting from such loans are subject to remediation by the State Council. Commercial Bank Law, Arts. 34 and 41.
[391] Lardy, "China's Worsening Debts."
[392] EIU, *Country Finance: China*.
[393] U.S. Government representative, email to Commission staff, November 7, 2007.

the economy $215 billion.[394] According to some sources, government intervention to address nonperforming loans was partially intended to strengthen banks in the face of potential foreign competition resulting from WTO commitments to liberalize the banking sector.[395] China's WTO commitments in the banking sector are described in box 4.1.

Overall, the share of nonperforming loans in China's banking sector has diminished in recent years. Official Chinese data indicate that the SOCBs share of nonperforming loans declined from 31 percent in 2001 to 10 percent in 2005. Since 2001, $150 billion worth of nonperforming loans have been moved from the SOCBs to state-owned asset management firms.[396] Although many banks have made improvements in lending practices, it is likely that the capital infusions from the government and recent increases in total lending are primarily responsible for the banks' dramatically improved balance sheets. Some sources report the added concern that certain loans made after the interventions to improve nonperforming loans, which had the initial effect of diluting the nonperforming loan ratios, will eventually fail to perform, again raising the level of nonperforming loans.[397]

## *Interest Rates*

Interest rates in China are set by the PBC and are fixed against a benchmark rate.[398] In July 2007, the PBC raised the benchmark one-year deposit and lending rates by 0.27 percent to 3.33 percent and 6.84 percent, respectively, representing the third increase of the year.[399] Unlike in market-oriented banking systems, in which banks compete for customers based on creditworthiness and interest rates, banks in China are not permitted to determine interest rates based on the creditworthiness of the customer. As mentioned earlier, China's banks lack the ability to conduct effective credit-risk analysis on potential customers. State bank interest rates are essentially equal to prevailing PBC interest rates. Therefore, less creditworthy SOEs do not pay higher interest rates than more creditworthy borrowers, as would be the case in a more market-based country. This practice works to the detriment of foreign banks with branch networks in China. Foreign banks tend to have more efficient operations than their Chinese counterparts; nevertheless, they have few sources of operating capital beyond deposits collected from customers, which makes it difficult for foreign banks operating in China to compete for business on those terms.[400]

In 2000, China allowed foreign currency deposit and lending rates to be determined by domestic banks,[401] but that practice was rescinded when Chinese currency business was opened to foreign banks in December 2006. In January 2007, reform efforts advanced with the adoption of the Shanghai Interbank Offered Rate (Shibor) as the official

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[394] Farrell et al., "The Promise and Perils of China's Banking System."

[395] EIU, *Country Finance: China*.

[396] Farrell and Lund, "Putting China's Capital to Work," 32.

[397] EIU, *Country Finance: China*.

[398] The PBC currently uses 34 categories of lending rates and specific criteria for their application.

[399] PBC, *China Monetary Policy Report, Quarter Two, 2007*.

[400] Industry representative, interview with Commission staff, Shanghai, September 7, 2007.

[401] Limited to amounts up to $3 million. EIU, *Country Finance: China*, 43.

benchmark rate.[402] As the Shibor is more reflective of prevailing market conditions, this move may be a positive advancement toward interest rate liberalization.

## *Securities Market*

Policies intended to develop the securities markets in China have not resulted in the rapid growth of alternate investment vehicles at either the retail or commercial levels, nor have they succeeded in providing a fresh source of large-scale funding for large, well-performing companies. Some shortcomings in the equity markets are being addressed, particularly concerning the prominence of nontradable shares, but much remains to be done in order to lure major investment.

China's nascent equity and bond markets meet only a small portion of the country's financing needs for industrial growth. The country's two stock exchanges, in Shanghai and Shenzhen, have developed significantly in recent years but certain constraints prevent greater expansion. Approximately two-thirds of the shares on China's domestic stock exchanges are owned by the government and are nontradable, thereby limiting trading to one-third of all stocks. In addition, it has been reported that until recently, China's central government was heavily involved in the selection of companies for the initial public offering process; firms often were chosen for listing not based on company performance, but because of national economic priorities or to relieve banks from lending to companies in default on their loans. The result was a high number of poorly performing firms listed on the domestic stock exchanges. Compounding the problems, the larger and better-performing companies tend to list on international exchanges where they are more likely to raise substantially higher amounts of capital than they would in China's domestic markets. The government severely limited new listings in 2005 and 2006, creating uncertainty in the market. Foreign firms are prohibited from selling and trading A-shares—the class that comprises approximately 99 percent [403] of total market capitalization.

China's corporate bond market is relatively small, with a market capitalization of $18.9 billion in July 2007.[404] This figure amounts to just 1.35 percent of GDP, which is negligible compared to the bond markets in neighboring countries such as South Korea and Malaysia, which amount to 68 and 73 percent of GDP, respectively.[405] The bond market, which is overseen by the China Securities Regulatory Commission (CSRC) and governed by the 1994 Company Law, is closed to foreign investors, and most of the issuing companies have significant government stakes. Market expansion reportedly is constrained by the cumbersome procedures for new issues, which often take 14 to 17 months, as compared to less than one month in most other Asian countries. It is reported that the Chinese government is preparing to overhaul regulations pertaining to corporate bond issues, in an effort to create a more robust market.[406]

As China's securities market has primarily evolved in the past decade, recent legislation in this sector has focused on establishment of institutions and products, and to a lesser

[402] PBC, "New Measure in Establishment of Money Market Base Rate."
[403] EIU, *Country Finance: China*, 80.
[404] Ibid., 102.
[405] Farrell and Lund, "Putting China's Capital to Work," 49.
[406] EIU, *Country Finance: China*, 103.

degree on reform. The most important regulations in this sector include the 2006 Securities Law, the 2006 Company Law, and the 1997 Measures on the Administration of Stock Exchanges.

When large-scale privatization of SOEs occurred in the 1990s, a two-tier system of equity was established. Shares were deemed either tradable and available for purchase on the open market, or nontradable and remained with the original state-affiliated owners. The nontradable shares accounted for approximately two-thirds of all shares, allowing the state to maintain control over business operations,[407] resulting in a lack of liquid capital, lack of confidence in equity markets, and lack of true accountability to shareholders. In 2005, the State Council directed SASAC and the CSRC to develop a plan that would eliminate the two-tier equity structure. China's equity markets are to undergo a significant transformation that is to make all existing nontradable shares publicly tradable over a five-year period beginning in late 2007.[408]

### *Regulatory Environment*

China's current regulatory environment of central government practices and policies for the banking and finance sector is presented in table 4.3.

# Infrastructure Development

China's central government has explicitly targeted infrastructure as a way to simultaneously attract foreign direct investment (FDI) and raise living standards. For the purpose of this report, infrastructure is defined as transportation facilities, electric power, and telecommunications.[409] Infrastructure construction is generally undertaken to enhance economic productivity by lowering costs for producers and consumers. Infrastructure also generally has positive spillovers throughout the economy, which may increase overall growth. China's principal economic development policies have targeted the country's western, rural areas, aiming for those areas to achieve the level of economic development of the more urbanized eastern, coastal regions. China's 11th Foreign Capital Utilization Plan (2006–2010) specifically calls for building up China's infrastructure stock as a way to encourage foreign investment. China's policies and practices related to infrastructure development, and examples of particular projects that flow from those policies, are described below. China's practices and policies related to infrastructure development are summarized in table 4.4.

[407] Ahn and Cogman, "A Quiet Revolution in China's Capital Markets."
[408] Ibid.
[409] This section concentrates on the infrastructure areas most closely related to international trade. A standard definition of infrastructure comprises energy, including electric power and natural gas facilities; telecommunications; transport, including roads, seaports, airports, and railroads; and water and sewerage, defined as treatment plants and utilities. World Bank, *Private Participation in Infrastructure Database.*

**Table 4.3** Banking and finance: Key regulatory practices and policies—central government

| Name of law or regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | **Banking** | |
| Law on Commercial Banks | Requires banking system to adhere to market principles. Dictates application procedures for new banks, and establishes prudential requirements. Requires SOCBs to establish board of supervisors to monitor operations, asset-liability ratios, and increase the value of state-owned assets. | 1995; amended 2003 |
| Law on Regulation and Supervision over the Banking Industry | Designates the CBRC as the regulatory authority for the banking sector. Requires CBRC to monitor risk in banking system and devise early-warning system. Sets levels for requirements such as minimum registered capital, capital adequacy ratios, outstanding loan ratios, etc. | 2004 |
| Guidelines on the Internal Control of Commercial Banks | Requires banks to implement a three-tiered management structure. Directs banks to improve lending procedures and improve risk assessment related to granting new loans. | 2002 |
| Regulations on Administration of Foreign Financial Institutions and its Implementing Rules | Establishes prudential requirements for foreign-funded banks and nonbank financial firms. | 2002 |
| Administrative Rules Governing the Equity Investment in Chinese Financial Institutions by Overseas Financial Institutions | Establishes minimum registered and operating capital requirements for foreign funded or joint-equity banks operating in China. | 2003 |
| General Rules on Lending | Allows banks to become fully commercial enterprises, no longer subject to political pressure. Directs banks to make lending decisions based on profitability, liquidity, and risk avoidance. | 1996 |
| Central Bank Law | Designates the PBC as the country's central bank, with duties and operations similar to the U.S. Federal Reserve. | 1995; amended 2003 |
| Guidelines on Loan-Loss Provisions | Establishes a five-tier loan classification system intended to identify poorly performing loans. Requires banks to submit quarterly reports on status of loans. | 2002 |
| Regulation of the PRC on the Administration of Foreign-funded Banks and its Implementing Rules | Encourages foreign banks to incorporate locally. Foreign banks that do not opt for local incorporation are prohibited from accepting individual deposits less than approximately $121,000 (RMB 1 million). | 2006 |
| Guidelines on Corporate Governance Reforms and Supervision of Bank of China and Construction Bank of China | Launched pilot project to reform the two subject SOCBs into profitable, internationally competitive joint-stock commercial banks with sound business practices. | 2004 |
| Guidelines on Banks' Lending to Small Enterprises | Encourages banks to increase lending to SMEs to the extent that it makes sense from a profitability and risk standpoint. | TBD |

**Table 4.3** Banking and finance: Key regulatory practices and policies, central government—*Continued*

| Regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | **Banking—*Continued*** | |
| Provisional Rules on Administration of Village Banks (licensed microfinance institutions) | Establishes rules for to transform underground microfinance institutions into licensed village banks. Sets guidelines for establishment, loan-making, corporate governance, management, and operations of village banks. | 2007 |
| | **Securities** | |
| Securities Law and Measures on the Administration of Stock Exchanges | Establishes stock exchanges as self-regulatory legal entities approved to engage in securities trading. Designates securities companies as limited liability, and dictates activities in which they may engage. | 1999; amended 2006 |
| Guidelines to Promote Reform, Opening Up and Stable Development of the Capital Market | Identifies goals and policy priorities for reforming the capital market to include addressing non-tradable shares, developing a supervisory framework, developing new financial products, opening the market to foreign investors, and expanding the role of institutional investors. | 2004 |
| Rules on the Establishment of Securities Companies with Foreign Shareholding | Governs establishment of joint-venture securities companies and outlines the scope of business activities in which they may operate. | 2002 |
| Measures on the Administration of Securities Investment Fund Management Companies | Outlines the minimum registered capital required for major and minor shareholders in establishing a fund management company. Foreign shareholders are held to the same minimum as major shareholders (about $36 million, or RMB 300 million), regardless of the size of their stake. | 2004 |
| Interim Measures on the Administration of Securities Investment Funds | Promoted investment funds with the intention of drawing more institutional investors into the market. | 1997 |
| Interim Administrative Measures of Domestic Securities Investments by Qualified Foreign Institutional Investors | Opened capital markets to foreign institutional investors. | 2002 |

Source: *The Asian Banker*, "More Fizz than Bang?"; China Banking Regulatory Commission website; EIU, *Country Finance: China*; and WTO, *Trade Policy Review: China*.

**Table 4.4** Infrastructure development: Summary of key practices and policies

| Policies and practices | Level of government where applied | Associated laws and regulations |
|---|---|---|
| Western Development program to provide greater financing and infrastructure projects in China's western provinces | • Broad central government policy, implemented differently by individual provinces and localities | • Policy outlined in the 10th and 11th Five-Year Plans |
| 11th Foreign Capital Utilization Plan includes policy encouraging increased use of FDI for infrastructure projects | • Broad central government policy, implemented differently by individual provinces and localities | • Policy connected to China's 11th Five-Year Plan |
| Decision to permit more market-based forces to be taken into account in decisions about infrastructure projects. Clarification of the roles of the central versus local governments in infrastructure projects. | • Central government, applies to investment decisions in infrastructure projects | • State Council Decision on Reform of the Investment System |
| Approval of large infrastructure projects that cross provincial boundaries is handled by the central government. Smaller-scale projects are approved by local governments. | • Central, provincial, or local governments, (depending on the size of the project) | • Large projects may be included in the central government's five-year plans. Smaller projects are included in each city's 20-year urban master plan. |
| New rules to clarify licensing of foreign construction firms have made it more difficult for foreign firms to enter the Chinese market, particularly for large projects. | • Central government, applies to all local areas | • Ministry of Construction, Decree 113, issued Sept. 2002, implementing regulations issued March 2006 |
| New rules to clarify licensing of foreign architectural and engineering design firms have made it more difficult for foreign firms to enter the Chinese market, particularly for large projects. | • Central government, applies to all local areas | • Ministry of Construction, Decree 114 of 2002; Implementing regulations issued Jan. 1, 2007 |

Sources: *China Law & Practice,* "Beijing's New Rules on Municipal Infrastructure Projects," "Infrastructure Projects," "Private Investment in Urban Utilities," and "Railway Construction in China"; *ENR*, "China's Project Management Rules Have Foreigners Fuming"; Howlett, "The Impact of the WTO on China's Construction, Engineering, and Design Industries"; "Invest in China," official Chinese government website; OECD, *China in the Global Economy,* 449; Liu, "Planning and Policy Coordination in China's Infrastructure Development"; Ports Law; Primetrica, "Country Profile: China"; and WTO, *Trade Policy Review: China*.

## *Central, Provincial, and Local Government Practices*

The central, provincial, and municipal governments have distinctly different roles regarding infrastructure development in China (tables 4.4 and 4.5). Government bodies at all levels are responsible for planning new projects, finding appropriate finance, and overseeing the construction and architectural design firms. The actual construction is carried out either by state-owned, private, or foreign-owned firms.

**Table 4.5** China: Government roles in infrastructure development

| | Planning | Financing | Implementation |
|---|---|---|---|
| National arterial expressways | Ministry of Construction and National Development and Reform Commission | Ministry of Construction | Provincial departments of communications |
| Provincial highways | Provincial departments of communications | Provincial governments | Provincial departments of communications |
| Railways | Ministry of Railways and National Development and Reform Commission | Ministry of Railways | Ministry of Railways |
| Local railways | Provincial governments | Provincial governments | Provincial governments |
| Power plants | Central government (indicative master planning only) | Power enterprises | Power enterprises |
| Power transmission | Central government (master planning only) | China Power Grid Co. and China Southern Grid Co. | China Power Grid Co. and China Southern Grid Co. |
| Urban water and sanitation | Municipal governments | Municipal governments and utilities companies | Municipal governments and utilities companies |
| Urban bus transport | Municipal governments | Municipal governments and bus transport companies | Municipal governments and bus transport companies |
| Urban mass rail transit system | Municipal governments, subject to approval of National Development and Reform Commission | Municipal governments | Municipal governments |

Source: Reprinted from Liu, "Planning and Policy Coordination in China's Infrastructure Development," app. table 3.

Infrastructure planning by the central government is coordinated by the NDRC. These high-level policy bodies work together with the Ministry of Finance (MOF) and the People's Bank of China (PBC),[410] to ensure budgeting and finance for large projects. They also coordinate with sector-specific ministries on large infrastructure projects with significant national impact, such as the Three Gorges Dam, national highways and railways, and rural electrification projects. Depending on the project, relevant ministries may include the Ministry of Communications, Ministry of Railways, Ministry of Construction, Ministry of Information Industry, Ministry of Land Resources, State Environment Protection Administration, and Civil Aviation Administration.[411]

SASAC,[412] as the agency that owns and controls many of the SOEs in the transportation and energy sectors, is also involved in infrastructure planning.[413] Annual infrastructure

[410] The PBC is described in more detail in the section on "Banking and Finance" elsewhere in this chapter.

[411] Liu, "Planning and Policy Coordination in China's Infrastructure Development."

[412] SASAC, and its role in China's economy, is described in greater detail in chap. 2 of this report.

[413] Naughton, "Strengthening the Center, and Premier Wen Jiabao."

spending in China increased from $180 billion in 2004 to $275 billion in 2006, just under 10 percent of GDP. By far the largest shares of spending were for electricity and heating and for highway transportation, which accounted for 40 percent and 35 percent, respectively, of total infrastructure spending in 2007.[414]

In 2004, the State Council announced its Decision on Reform of the Investment System, meant to permit more market-based factors into decisions on infrastructure investment, and to clarify the respective roles of the central and local governments. The decision encouraged local governments to attract private capital into local infrastructure projects, so long as existing laws did not specifically prohibit private sector participation. Incentives such as concessionary financing were permitted to attract private sector investment, and private investors were encouraged to arrange private sector bank financing.[415] The new rules also streamlined approval of foreign investment projects, particularly those involving "large-scale fixed asset investment in infrastructure, transport, and manufacturing."[416]

Municipal and provincial level governments plan and carry out urban infrastructure projects whose scope is contained within a single province or local area. One example is Liaoning province's "One Line—Five Points" ports project. Liaoning is upgrading five ports in the province (Dalian, Yinkou, Jinzhou, Huludao, and Dandong) as a central piece of a broader effort to attract FDI from heavy industry and large equipment manufacturing companies that depend on easy access to modern port facilities.[417] Local government projects are ostensibly planned in accordance with each city's 20-year urban master plan. In many cities, however, the planning process is hampered by the rapid population growth that many Chinese cities have experienced in recent years, often making the urban master plans obsolete before their infrastructure targets can be met. At the same time, many mayors have instituted significant infrastructure programs as a way to entice FDI, and thus contribute to local economic growth, often without closely coordinating with the city's master plan.[418]

A city mayor's job performance and promotion potential are largely dependent on his or her success at achieving GDP growth,[419] so local government officials have strong incentives to favor infrastructure investment, which is more likely to boost GDP in the short-term during the construction phase than other forms of expenditures, and to help attract FDI, leading to longer term GDP growth.[420] The planning process is primarily driven by the local mayor, for whom infrastructure development is a way to fulfill the parallel goals of providing public service and boosting economic growth. Even local government officials are often uncertain about the roles and responsibilities of different

[414] Includes expenditures for transportation, electricity, heating, urban water supply, sanitation, information transmission, computers, and software. It is not possible to exclude the latter two categories from the data. Data from the NBS as reported by CEIC database, http://www.ceicdata.com/.

[415] Liu, "Planning and Policy Coordination in China's Infrastructure Development."

[416] OECD, *China in the Global Economy*, 442.

[417] Government representative, interview with Commission staff, Shenyang, September 4, 2007.

[418] Liu, "Planning and Policy Coordination in China's Infrastructure Development."

[419] Industry representative, interview with Commission staff, Hong Kong, September 11, 2007; and OECD, Working Party on Environmental Performance.

[420] OECD, "China," *OECD Economic Surveys*, 205.

government bodies involved in infrastructure planning and development, which include municipal, suburban district and town government agencies, and quasi-state-owned investment companies.[421]

Under the central government's decentralization policy, local governments must fund or finance new infrastructure, a requirement that may conflict with another central government policy that prohibits government bodies from engaging directly in commercial functions. In most cases, this results in a situation where the municipal government becomes the major shareholder in an investment company that finances infrastructure projects. That company raises funds through local bank loans or project-specific local taxes.[422] The municipality of Chongqing, for example, established nine separate government-owned investment groups to raise capital for infrastructure projects. Financing largely relied on commercial bank loans, but the groups also issued bonds, and local construction companies financed projects from operating funds or bank loans, in a build-operate-transfer (BOT) structure.[423] Typical projects include subway lines, water and wastewater treatment facilities, and local highways.[424]

Beijing is not only China's capital, but one of four large cities that are independent municipalities (not part of a province) reporting directly to the central government. Beijing municipal infrastructure has been the subject of international discussion as a result of the upcoming 2008 Olympic Games to be held in China. Local infrastructure priorities for Beijing's municipal government are outlined in text box 4.2.

In a similar municipal infrastructure initiative in the late 1990s, the Beijing municipal government established a public-private company to build a new ring road. The new company took complete responsibility for all aspects of the financing and contracting process, and the 65 km highway project was finished under budget and two years ahead of schedule.[425] Other municipal governments have used such public-private companies to handle infrastructure, particularly airports, but with less success. By 2005, for example, the Yangtze River Delta area surrounding Shanghai will have 18 airports, leading to a density of 0.8 airports per 10,000 square kilometers).[426]

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[421] China Metropolitan Infrastructure Management: Initial Stock Taking."

[422] Liu, "Planning and Policy Coordination in China's Infrastructure Development."

[423] Industry representative, interview with Commission staff, Chongqing, China, September 4, 2007; and China Metropolitan Infrastructure Management, *Discussion Paper*. Under a BOT arrangement, a construction company raises capital to pay for the construction costs of the facility, then recoups its costs and/or additional profits through user fees such as highway tolls, and transfers the project to the government or another owner after a designated time period.

[424] Due to the off-budget nature of the funding, however, it is not clear that the fiscal liabilities incurred by local governments are sustainable over the long term. Liu, "Planning and Policy Coordination in China's Infrastructure Development." Participants in a roundtable discussion of stakeholders in Chongqing's infrastructure development policies echoed major concerns about the availability of financing for important projects. China Metropolitan Infrastructure Management, *Discussion Paper*.

[425] OECD, "China," *OECD Economic Surveys*, 186.

[426] By contrast, in the United States, airport density is 0.6 per 10,000 square kilometer. A similar overcrowding of airports has occurred in the Pearl River Delta in southern China. Throughout China, smaller airports have had difficulty attracting airlines due to overcapacity; and a 2001 survey showed that 90 percent of China's 143 airports lost money. OECD, "China," *OECD Economic Surveys,* 186.

**Box 4.2** Beijing municipal government infrastructure priorities: Beijing's 11th Five-Year Program goals for 2006–2010

In Beijing, the local government's Municipal Commission of Development and Reform is responsible for infrastructure development planning, among other responsibilities. In Beijing's own 11th Five-Year Plan, the city government has presented its plans for infrastructure development during 2006-2010, focusing on optimizing the city's space layout and support for the 2008 Olympic Games. The stated priorities include:

- Construction of a comprehensive traffic system, including both urban public transportation, primarily in the form of new subway lines, and intercity and intracity transport, including new highways, expressways, and regional railways.
- Improvements to the energy supply system, including construction of new electric power generating plants, together with additions to the transmission and distribution networks, and increased natural gas supplies in Beijing from both domestic and foreign sources.
- Guaranteeing the city's water supply, by speeding up construction of Beijing's segments of the South-North Water Diversion Project, and improving the city's drainage and wastewater treatment networks, and constructing additional wastewater treatment plants and sewage networks.
- Secondary priorities include additional broadband communication, digital television, and Internet networks, new fire-control resources around the city, increasing green space around Beijing, and renovating existing infrastructure facilities.

Source: Beijing Municipal Commission of Development and Reform, "The 11$^{th}$ Five Year Programme."

Local governments have also begun to use private concessions and BOT projects to finance infrastructure development. Under this system, a private company finances the project costs and recoups its investment through the collection of user fees, most popularly for wastewater treatment, solid waste disposal, and public transportation. The Ministry of Construction issued nationwide rules for such concessions to private investors in the water, gas, heating, public transport, and water and waste-management operations. Although the rules are perceived to be friendlier to Chinese than to foreign investors, the private concession process has been successful in increasing available funding for infrastructure investment in early test cases.[427] Companies reported participating in concession financing for both highway and bridge projects, with funding raised from banks, outside investors, or the company's own internal capital.[428]

The NDRC reportedly may be attempting to reassert control over infrastructure planning by the provincial governments. According to one source, approximately 6 percent of the projects reviewed by the NDRChave been rejected and sent back to the provinces for correction since new central government review provisions entered into force in

[427] Liu, "Planning and Policy Coordination in China's Infrastructure Development."
[428] Industry representatives, interviews with Commission staff, Chongqing, September 4, 2007.

November 2006.[429] Projects reportedly were rejected because local governments exceeded their authority (approving midsize reservoirs or limited-access highways), failed to follow procedures properly (approving individual coal mines without a regional coal industrial development plan in place), or had extravagant standards (such as roadways with overly wide roadbeds). The NDRC has announced its intentions to send projects back to the province for reconsideration if it disagrees with the need for the project, which will certainly add delays to the investment approval process, and could signal increasing central government involvement with the details of new infrastructure investment.[430]

## *Sector-Specific Practices and Policies*

The creation of special economic zones (SEZs) and related economic and technological development zones (ETDZs) have been an important vehicle for attracting FDI into manufacturing in China.[431] While these zones offer special tax incentives to foreign firms, they also frequently offer superior infrastructure compared to the facilities available outside of the SEZs, such as reliable electric power and natural gas supplies, improved roads, and easier airport and seaport connections.[432] Financing rules for the construction of new infrastructure facilities for the zones vary both by province and within provinces. For example, there is a special infrastructure fund to which firms within the Hainan SEZ contribute, but foreign firms are exempt from fees paid to the fund. Firms in SEZs that are involved in production receive a preferential 15 percent income tax rate, which is also extended to FIEs involved in infrastructure development including port or harbor construction, energy, or transport. The Chinese government also encourages BOT projects related to infrastructure, particularly in the SEZs.[433]

A primary goal of China's 11th Five-Year Plan is the building of a "new socialist countryside."[434] This focus on the economic development of the rural areas includes a number of infrastructure projects targeted specifically at the agriculture sector, including construction of water conservation facilities, safe drinking water supplies, new roads, and methane production facilities.[435] In 2007 alone, China's central government established plans to build or upgrade 300,000 km of rural roads to facilitate local transport in rural areas, and to upgrade ferries and bridges to better protect certain areas from natural disasters. The Ministry of Communications will continue to invest heavily in extending the road network of the western and central regions of the country. About 260,000 km of roads have recently been built or upgraded in rural areas, dramatically improving local transport for 30 million people living in 30,000 villages.[436]

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[429] Naughton, "Strengthening the Center, and Premier Wen Jiabao."

[430] Ibid.

[431] Additional information on SEZs is provided in the section on "Research and Development" elsewhere in this chapter.

[432] Industry representatives, interviews with Commission staff, Chongqing, September 3–5, 2007; and H.E. Song Deheng, "Special Economic Zones and Economic Growth in China.

[433] EIU, *Country Finance China*.

[434] "Key Points of the 11th Five-Year Guidelines."

[435] WTO, *Trade Policy Review: China*, 124.

[436] Chinese government official web portal, January 3, 2007, http://english.gov.cn/2007-01/03/content_486565.htm, accessed September 25, 2007.

On a smaller scale, the government has also provided funds for irrigation projects, research, and construction of agricultural high-technology parks.[437] Some of this funding goes directly to assist farmers in local infrastructure improvements. In the citrus producing areas near Chongqing, for example, the government provides funding to farmers to help build reservoirs, irrigation pipe systems, and road systems to help get products to market. The funding applies to materials only, with farmers supplying their own labor.[438]

Within this broad outline that applies to all types of infrastructure development, policy differences apply to particular infrastructure areas, such as telecommunications, electric power, ports or highways. The provision of telecommunications networks in China, for example, has taken place in an essentially free market, although the central government continues to control the telecommunications service providers. China's central government actively worked to attract multinational companies to the industry during the 1980s and 1990s, with a specific policy on "providing market access in return for technology."[439] More recently, Chinese telecommunications equipment firms such as Huawei and ZTE have become much more competitive, both within China and internationally. The central government is the majority owner of all six principal Chinese telecommunications service providers, although most of the firms have minority foreign ownership, and four of them are listed on stock exchanges in China, Hong Kong, and New York.[440]

China's central government has identified a list of key transport infrastructure projects for the 11th Five-Year Plan (table 4.6). New railway development was a feature of China's 10th Five-Year Plan (2001–2005), which included plans to invest approximately $42 billion (RMB 350 billion) in new railways. To guide the process, the Ministry of Railways issued the Administration of Railway Construction Procedures, which took effect in October 2003. The procedures outline the conditions for foreign investment, the bidding process, quality and safety control, and other essential components of railway construction.[441]

China's Ministry of Construction manages overall national port administration, including policy formulation.[442] The principal applicable legislation is the 2004 Ports Law. This

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[437] WTO, *Trade Policy Review: China*, 124.

[438] Industry representative, interview with USTIC staff, Chongqing, China, September 4, 2007. The funding is directed to farmers in two ways: either directly from the government to the villages, or through a juice processing company, which passes it on to the farmers. Estimates of funding levels were not available.

[439] Li, "China's Telecom Industry on the Move."

[440] WTO, *Trade Policy Review: China*, 231; and Primetrica, "Country Profile: China."

[441] Finder, "Railway Construction in China."

[442] Before 2001, some of China's ports were governed directly by the central government through the MOC, others jointly by the MOC and local governments, and others were governed entirely by the local government. WTO, *Trade Policy Review: China*, 244-45.

**Table 4.6** China: Priority transportation infrastructure projects, 11th Five-Year Plan, 2006–2010

| Project | Description |
|---|---|
| Railways | Six passenger railways, including one between Beijing and Shanghai; five inter-city railways, including one between Beijing and Tianjin; and the upgrading of five existing railways including one between Datong and Qinhuangdao. |
| Highways | 14 expressways, including one from Beijing to Hong Kong and Macau. |
| Ports | Transit systems for the transportation of coal and imported oil, gas and iron ore, and containers, transport systems at 12 seaports including those in Dalian, Tianjin, and Shanghai; coal transit and storage bases in eastern and southern China. |
| Shipping | The third-phase project for dredging the deepwater channel at the mouth of the Yangtze River, the course at the mouth of the Pearl River to the sea, channel dredging in the Yangtze and Pearl river valleys, and the Beijing-Hangzhou Canal; and acceleration of port construction along inland rivers. |
| Airports | Expansion of 10 airports including those in Beijing, Shanghai and Guangzhou; relocation of the two airports in Kunming and Hefei; and upgrading of airports in central, western and northeastern China to accommodate flights on feeder lines. |

Source: Government of China, National People's Congress

law encourages both domestic and foreign investment in port construction and operations. The Ports Law requires consideration of geographical distribution in the planning of new ports, and calls for such planning to be coordinated between the central government and the relevant provincial government, local government, autonomous regions, and military organs, with plans submitted to the State Council in charge of transportation for comments.[443] The 2004 implementing Regulations on Administration of Port Operation detailed the requirements for licensing of port operators, safety standards, and other operating rules.[444] Foreign investors have purchased minority shares of a number of port operation companies in China, but are not permitted to own majority shares.[445] Under reforms started in 2001, responsibility for port operations belongs to local governments, each of which designates a port administration authority to implement regulations and handle daily port operations.

The 2004 Administration of Concessions for Urban Utilities Procedures sets requirements for provincial governments to select new utility projects, which also need to be approved by the relevant municipality, city, or county governments. For large-scale projects, approval by the Ministry of Construction is also required. The Ministry of Construction takes on a guiding role at the national level, provincial government bodies do the same role within their own provinces, and the local level government actually implements the projects.[446] Foreign investment in electric power utilities is coordinated by the Service Trade Division of the Foreign Investment Administration, an agency of MOFCOM.[447] The State Electricity Regulatory Commission (SERC) is China's electric power regulator and is responsible for proposing laws, drafting regulations and reform plans, and

[443] Ports Law 4500/03.06.28, Articles 8-9.
[444] WTO, *Trade Policy Review: China*, 244-45.
[445] Industry representative, interview with Commission staff, Hong Kong, September 10, 2007.
[446] Yuan, Jianan and Qin Yu, "National Rules to Regulate Urban Utility Concessions."
[447] Arruda and Li, "China Energy Sector Survey Part II."

monitoring prices, market operations, enforcing standards, settling disputes, and managing other regulatory concerns.[448] Effective December 1, 2007, China is to allow foreign investment in construction and management of electric power grids.[449]

The centerpiece of China's efforts to increase electric power generation is the Three Gorges Dam project on the Yangtze River, which was completed in July 2007.[450] Among other effects, the Three Gorges project stands to lead to significantly greater integration of China's national electricity grids, in order to fully utilize the electric power produced by the dam, leading in turn to greater economic productivity in other areas of the economy.[451]

## *Western Development Program*

The central government's Western Development program[452] sets overall policy targets for infrastructure development in the provinces of western China (Chongquing, Gansu, Guangxi, Guizhou, Inner Mongolia, Ningxia, Qingha, Shaanxi, Sichuan, Tibet, Xinjiang, and Yunnan).[453] Support for infrastructure development in ETDZs in the central-western region is a primary goal of Beijing's plans for the region, through both direct assistance and loans for infrastructure construction projects.[454] In its discussion of Western development in the 11th Five-Year plan, the NDRC highlighted faster infrastructure development of railways, trunk highways, branchline airports and inland waterways. The plan also envisions establishing manufacturing bases in the western region that will take advantage of these new infrastructure resources.[455]

Several central government ministries have enacted specific policies in support of the Western Development program. In January 2002, for example, the China's State Administration of Taxation published a notice announcing special incentives for foreign investment in the 12 designated western provinces. Projects with a scheduled lifespan of more than 10 years in the postal services, power, radio and television, transport, or water resources industries are eligible for tax incentives that have only been available to manufacturing firms in the eastern part of the country, namely a two-year income tax holiday, followed by a 50 percent reduction in income taxes for three years.[456]

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[448] Ibid. China's electricity pricing practices and policies are described in the section on "Utility Rates" in chap. 3 of this report.

[449] Foreign investors are prohibited from owning majority stakes in joint ventures of power grids. *Wall Street Journal*, "China Opens Power-Grid Investment."

[450] The dam has 26 hydropower generators, adding 18,200 MW to China's generation capacity at an estimated cost of $23 billion, and the forced relocation of approximately 1.3 million people. In September 2007, the Chinese government announced that an additional 4 million people would likely be relocated, due to problems with the dam. Wright, "Power's On, Final Segment's Under Way as Three Gorges Forges Forward"; and *Xinhua News*, "China Warns of Environmental 'Catastrophe' from Three Gorges Dam."

[451] Bottelier, USITC hearing transcript, 131.

[452] Also identified variously as the "Western Region Development Strategy," the "Go West program," the "Open Up the West" program, and other titles.

[453] "Basic Facts about the Western Region." Office of the Leading Group for Western Region Development of the State Council. Website.

[454] Liu, "Planning and Policy Coordination in China's Infrastructure Development."

[455] NDRC, "Report on the Implementation of the 2006 Plan."

[456] EIU, *Country Finance China*, 78.

MOFCOM, in cooperation with the China Development Bank, has offered loans of approximately $1.8 billion (RMB 15 billion) for infrastructure construction in the West, as part of a broader plan to attract investment to the region.[457] Actual implementation of particular projects is carried out by provincial and municipal governments.

China's central government has also published a Catalog of Advantageous Sectors for Foreign Investment in the Central and Western Regions. The identified sectors enjoy the same preferential treatment as those in the "encouraged" section of the Catalog for the Guidance of Foreign Investment Industries, and lean heavily toward infrastructure development. Identified industries include infrastructure projects in agriculture, water conservancy, ecology, transport, energy, municipal administration, environmental protection, minerals, tourism and resource development.[458]

The nature of the Western Development program, which depends upon implementation by the provincial and local governments, makes it difficult to find statistics on actual spending associated with the program. Chinese officials estimated that as of 2005, approximately $73 billion (RMB 600 billion) had been spent on infrastructure projects as part of the initiative.[459] This program also has influenced the World Bank's Country Partnership Strategy with China, which serves as a basis for the World Bank's work in China for 2006–2010. That plan, released in 2006, focuses in part on poverty reduction, inequality, and social exclusion, through increasing access to basic infrastructure services in China's rural areas.[460] In the western province of Xinjiang alone, the central government reported that as of early 2003, it had spent approximately $8.5 billion (RMB 70 billion) in infrastructure investment, including highways, power plants, dams, and telecommunications facilities.[461]

The independent municipality of Chongqing[462] has realized extensive benefits from the Western Development program. That program has resulted in a significant inflow of resources directed to infrastructure development in the past 10 years, with the goal of enhancing Chongqing's manufacturing sector and improving its transport links to the rest of the country. According to Chongqing's municipal Party secretary, the central government contributed approximately $1.9 billion (RMB 16 billion) to the municipal budget between 1999 and 2002, and the mayor claimed that this government investment in key projects had attracted an additional $12 billion (RMB 100 billion) to infrastructure, construction, and environmental protection projects in Chongqing.[463] In interviews, several Chinese and foreign firms cited Chongqing's status as a municipality under direct control of the central government as an important factor in the city's infrastructure

[457] Ministry of Commerce, Circular on "Implementing the Project of Encouraging Investment in Central-Western Region."

[458] OECD, *China in the Global Economy,* 449.

[459] In 2003, the central government also launched a development plan for the Revitalization of the Northeast and Other Old Industrial Bases, but that plan was focused primarily on increasing employment and stabilizing worker pensions, rather than on construction of new infrastructure facilities. *China Economic Quarterly*, 125.

[460] World Bank, *Country Partnership Strategy for the People's Republic of China*.

[461] Goodman, *China's Campaign to "Open Up the West,"* 56.

[462] Chongqing was separated from Sichuan province in 1997. As an independent municipality, Chongqing (a city) effectively has the status of a province in its relationship to the central government.

[463] Cited in Goodman, *China's Campaign to "Open Up the West,"*142.

building efforts, saying that this status, combined with the Western Development program, facilitated access to significant funding for such projects.[464]

## *State-Owned and Foreign-Owned Enterprises in Infrastructure Development*

New infrastructure projects in China are developed by construction, architectural, and engineering design firms, so policies impacting access to construction contracts by foreign and domestic firms are key to understanding the process of infrastructure development. Infrastructure facilities are generally funded by the Chinese government, but those facilities (dams, bridges, highways, railway lines) are designed and built by SOEs, wholly foreign-owned firms, and joint ventures.[465] Wholly foreign-owned firms generally face several important restrictions in competing for infrastructure construction contracts, as discussed later in this section. For technically difficult projects, it is common for both FIEs and SOEs to work together. Most often in those cases, foreign firms perform some or all of the architectural and engineering design work, and Chinese firms provide construction services.[466] Foreign engineering firms are frequently used for projects for which Chinese firms do not have the technical skills.[467]

The central government, through the Ministry of Finance, is primarily responsible for contract awards for large projects funded by the central government. Public invitation (a form of open tendering) is required for procurement of items exceeding approximately $242,000 (RMB 2 million) for construction projects as of 2004, or approval by the Ministry of Finance when the public invitation process is not used. In cases of procurement below the prescribed thresholds, the method of procurement is decided by the procuring entity in accordance with the law.[468]

Smaller projects generally are funded and administered by the provincial governments, with each province following its own procedures. One firm in Chongqing reported that 40

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[464] Industry representatives, interviews with Commission staff, Chongqing, China, September 3–5, 2007. As of 2006, 20 new bridges were planned for the coming decade in Chongqing, many of them illustrating new technology and design work, and creating a strong market for multinational construction firms. There were only five bridges in Chongqing in 1997. Cho, "China's Great Expansion Fuels Boom in High-Profile Designs"; and industry representative, interview with Commission staff, Chongqing, September 4, 2007.

[465] There appear to be few if any private, domestic firms in the infrastructure construction industry.

[466] Industry representatives, interviews with Commission staff, Chongqing, China, September 4, 2007, and Beijing, August 30 and September 5, 2007.

[467] Industry representative, interview with Commission staff, Beijing, China, September 5, 2007. For instance, construction of the 25.5 km Shanghai-Chongming Expressway, in progress as of August 2007, involves a technically difficult twin-tunnel project. The tunnels were designed by Shanghai Tunnel Engineering and Rail Transit Design and Research Institute (China), supported by Third Harbour Engineering Investigation and Design Institute (China), the Halcrow Group (UK) and Parsons Brinckerhoff (Asia office of a U.S.-based company). The contractor, China-based Shanghai Tunnel Engineering, turned to Bouygues Travaux Public (France) for technical support, and Germany's Herrenknecht handles the contract to supply tunnel-boring machines and other equipment components. Reina, "World's Biggest Borers Begin Digging New Chinese Link."

[468] WTO, *Trade Policy Review: China*, 95–7.

percent of its work was offered through a bidding process, with the remainder offered directly to the company by the local government. Both foreign and Chinese firms noted that the bidding process was competitive, with firms winning less than half of the contracts on which they placed bids. Contract awards generally take three factors into account: technology (the technical expertise of the company and approval of the design), economic factors (financial soundness and reliability of the company), and commercial factors (the price of the bid, but also provisions made for the welfare of the workers and social stability). A company's local ties and local knowledge are reportedly another factor in the bid award process, although there is significant competition for contracts between provincial-based companies and large central government-owned SOEs.[469]

China's current rules for the participation of foreign construction and engineering/design firms in the Chinese market were established in 2002 by Ministry of Commerce Decrees 113 and 114.[470] The rules permit wholly foreign-owned firms to operate in China's construction and engineering design industries for the first time, and permit joint ventures with foreign majority ownership to operate in this sector. Under the March 2006 implementing regulations for Decree 113, construction licenses are to be approved by the provincial government, with approvals needed from both the provincial Department of Commerce and the construction authorities.[471] However, wholly foreign-owned construction firms are limited to contracts on projects fully funded by foreign investors; projects funded by international financial institutions with contracts awarded by competitive bidding; projects where foreign investment is 50 percent or more of the total cost; and technically complex projects that Chinese firms cannot execute independently. In addition, foreign contractors are required to establish a local presence in China, either as a wholly foreign-owned firm or as a joint venture.[472]

Under the January 2007 implementing regulations for Decree 114 (engineering design services), foreign-invested design firms applying for Grade A qualifications are approved by the State Council (central government) and firms applying for Grade B qualifications are approved by provincial or municipal governments.[473] Licenses are granted at the local level but, once granted, are valid for operations in all of China.[474] At least one global construction firm reported a shift to significantly more projects outside of the Beijing and Shanghai areas, and under the control of provincial and local governments, as a result of the new decrees.[475]

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[469] Industry representatives, interviews with Commission staff, Chongqing, September 4, 2007; and Beijing, September 5, 2007.

[470] Howlett, "The Impact of the WTO on China's Construction, Engineering, and Design Industries." The 2002 decrees reversed a prior decree (Decree 32) permitting foreign construction firms to operate in China only on a project-by-project basis. *ENR*, "China Should Reconsider How It Builds for the Future."

[471] The current rule is Ministry of Construction Circular no. 76, issued March 29, 2006. Howlett, "The Impact of the WTO on China's Construction, Engineering, and Design Industries."

[472] Tuchman, "Business Rules Are Changing for Contracting in China"; and industry representative, interview with Commission staff, Beijing, September 5, 2007.

[473] Grades A and B are not defined in this regulation. Regulations on Administration of Foreign-Invested Construction and Engineering Service Enterprises, Decree of the Ministry of Construction and the Ministry of Commerce, no. 155.

[474] Industry representative, interview with Commission staff, Beijing, September 5, 2007.

[475] Tulacz and Rubin, "The Industry Searches for a Swift Turnaround."

Establishment under Decree 113 involves registered capital requirements that vary according to the license grade, maintenance of a minimum staff of 200 to 300 professionals and 12 to 20 project managers in China, with minimum residency requirements of three months per year for foreign technical and staff managers. Under Decree 114, 25 percent of a minimum staff of 80 persons must be foreigners, key foreign personnel must reside in China at least six months of each year, and foreign firms are required to collaborate with a Chinese design firm that must be party to contracts which may include sensitive project pricing details.[476] Sources reported that these employment restrictions have led most foreign firms to conclude that establishment of a wholly foreign-owned foreign enterprise is not economically feasible, and that foreign firms had greater effective access to the Chinese market under the old system of project-by-project licensing.[477] Many global construction and engineering firms that are not already established in China are now unable to obtain licenses for construction and design services, and are primarily limited to consulting, conceptual design work, and project management services.[478] Even if permitted, foreign firms have reported that they would be unlikely to seek to offer actual construction services, as it is more cost effective to hire local Chinese firms for that aspect of large projects.[479]

Several additional restrictions remain on foreign firms' participation in infrastructure industries, although China has been reducing barriers to FDI in both telecommunications and transport services in line with its WTO accession commitments.[480] In the electric power sector, China's Catalog for the Guidance of Foreign Investment Industries (Foreign Investment Catalog)[481] classifies seven types of power generation projects as "encouraged" for future investment.[482] Majority Chinese ownership is required only for the construction of nuclear plants; all other "encouraged" projects allow 100 percent foreign ownership. However, China's central government still plays a significant role in determining the terms of investment in electricity generation, including the power plants' location, the type of generators to be established, and the prices that can be charged. Foreign investment in the construction and operation of conventional coal-fired power plants of an installed capacity of less than 300,000 kW remains "restricted." China's

[476] Kosowatz, "International Work: New Rules Threaten Global Firms in China"; and Howlett, "The Impact of the WTO on China's Construction, Engineering, and Design Industries."

[477] Industry representatives, interviews with Commission staff, Beijing, August 30 and September 5, 2007, and Chongqing, China, September 4, 2007.

[478] Industry representative, interview with Commission staff, Chongqing, September 4, 2007.

[479] Industry representatives, interviews with Commission staff, Beijing, August 31 and September 6, 2007.

[480] WTO, *Trade Policy Review: China*.

[481] The Foreign Investment Catalog is described in more detail in the section on "Foreign-Invested Enterprises" in chap. 2 of this report. The catalog classifies industries as "encouraged," "restricted," or "prohibited" for the purpose of determining eligibility for foreign investment incentives.

[482] These projects include: construction and management of thermal-power plants with single generators of a capacity of at least 300,000 kW; construction and management of power plants using clean coal-burning technology; heat; natural gas; hydropower; nuclear power; or new resources (geothermal, solar, wind, tide, etc.). China's electricity pricing practices and policies are described in the section on "Utility Rates" in chap. 3 of this report.

central government prohibits foreign investment in the construction and operation of power transmission and distribution networks.[483]

### *Regulatory Environment*

China's current regulatory environment of central government practices and policies for infrastructure development is presented in table 4.7. As stated and described above, China's central government infrastructure development policies are implemented differently by provincial and local governments.

## Research and Development

China's R&D policy priority is to become an innovation-oriented society by 2020 through implementation of the 2006–2020 Medium- and Long-Term National Science and Technology (S&T) Development Program (the S&T Plan). The priorities of the S&T Plan are to promote indigenous (Chinese-origin) innovation, to achieve major scientific breakthroughs in targeted areas, and to foster an enterprise-driven innovation system. Key policy objectives include reducing China's reliance on foreign technology, creating high-value domestic intellectual property (IP) and technical standards based on that IP, greatly increasing research and development (R&D) expenditures in strategic areas, and promoting increased R&D by enterprises through preferential tax, finance and government procurement policies, and special development zones. China's practices and policies related to R&D are summarized in table 4.8

### *Overview of China's R&D Policy Priorities at the Central Government Level*

China has emerged as a large and growing R&D hub. R&D expenditures and the ratio of those expenditures to GDP (R&D intensity) have grown rapidly over the last 10 years. According to one source, China's R&D intensity increased from 0.6 percent in 1996 to 1.4 percent in 2006; and R&D expenditures grew from about $5 billion (RMB 40 billion) in 1996 to $38.5 billion (RMB 300 billion) in 2006.[484] Through this steady and substantial increase in R&D funding, China plans to become an "innovation-oriented" society by 2020.[485]

[483] WTO, *Trade Policy Review: China*.

[484] TLAG, *China's Industrial Subsidies Study: High Technology*. The OECD, which calculates R&D spending on purchasing power parity terms, estimated that China would become the world's second largest R&D spender in 2006, behind the United States and ahead of Japan. OECD, "China Will Become World's Second Highest Investor in R&D."

[485] *Xinhua News*, "Innovation Tops Hu Jintao's Economic Agenda"; OECD, *OECD Reviews of Innovation Policy*, 48; and The Levin Institute, *Industrial Innovation in China*, Appendix.

**Table 4.7** Infrastructure development: Key regulatory practices and policies

| Regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | **Central government** | |
| Ministry of Construction Opinion on Accelerating the Marketization of the Urban Utilities Industry | • Details the process for privatization of urban utilities through a concession/tendering process. | 2002 |
| Construction Law | • Outlines basic construction rules including licensing, building permits, project supervision, and qualifications for construction firms. | 1998; a new draft Construction Law was issued in 2004, but there is no indication that the new law has been enacted. |
| Administrative Measures on Concession Arrangements for Municipal Public Utilities | • New rules formally allowing private investors to operate water, gas, heating, public transport and water and waste-management operations. | 2004 |
| Administration of Incorporation of Foreign-Invested Construction and Engineering Companies, Ministry of Construction, Circular no. 76 | • Delegates review of foreign-invested construction and engineering design firms to the provincial authorities, so that all applications do not need to be approved by the Ministry of Construction. | 2006 |
| Interim Provisions of Construction Project Design of Foreign Enterprises, Ministry of Construction Circular no. 78 | • Only conceptual design from foreign designers is permitted unless formal collaboration is performed with a Chinese design firm. | 2004 |
| Ministry of Construction, Decree 113, Regulation on Administration of Foreign Investment Construction Enterprises | • New rules outlining the procedures to permit licensing of foreign-invested construction firms in China. | 2002 |
| Provisions on the Administration of Foreign Invested Construction Engineering Services Enterprises | • Implementing regulations for Decree 113, above, including registered capital and minimum staffing requirements. | 2004 |
| Ministry of Construction Circular no. 159 | • Clarification of implementing regulations for Decree 113 on foreign-invested construction firms, includes details regarding personnel requirements and track record requirements applicable to foreign construction firms. | 2004; amplified by a supplement in 2005 |
| Ministry of Construction and Ministry of Foreign Trade and Economic Cooperation Decree no. 114 | • New rules to clarify licensing of foreign construction engineering design firms. | 2002 |
| Detailed Rules for the Implementation of the provision on Administering Foreign-invested Construction Engineering Design Enterprises, Ministry of Construction and MOFCOM Circular no. 18 | • Implementing regulations for Decree 114, above. | 2007 |
| Supplementary Provisions of the Provisions on the Administration of Foreign-funded Construction and Engineering Design Enterprises, Ministry of Construction and MOFCOM Decree no. 122 | • Supplement to Decree 114 outlining rules for foreign invested construction and engineering design firms that apply only to firms based in Hong Kong and Macao under the CEPA agreement. | 2004 |
| Regulations on Administration of Foreign-Invested Construction and Engineering Service Enterprises, Ministry of Construction and MOFCOM Decree no. 155 | • Permits foreign firms to establish construction-related services, particularly survey, cost consultancy, and tendering. | Scheduled to enter into force Mar. 26, 2007 (but entry into force may have been delayed). |

**Table 4.7** Infrastructure development: Key regulatory practices and policies—*Continued*

| **Regulatory practice/policy** | **Description** | **Year of entry into force** |
|---|---|---|
| | **Central government—***Continued* | |
| Trial Measures Concerning Construction Project Management , Ministry of Construction Circular no. 200 | • Requires a firm to have a license in one of the five areas (tendering, design, construction, cost consulting, surveying, or supervision) to provide project management or construction management services for construction projects. | 2004 |
| Measures for the Administration of Pilot Program for Indirect Investment in Infrastructure Projects with Insurance Funds, issued by the China Insurance Regulatory Commission | • Permits insurance companies to invest funds in infrastructure projects in China through investment funds, as outlined in the regulation. | 2006 |
| Implementing "the Project of Encouraging Investment in Central-Western Region," MOFCOM Circular no. 530 | • Details on implementing the policy to encourage development in China's western regions, including enhanced support of infrastructure construction in state-level Economic and Technological Development Zones and special funds for the promotion of foreign trade in the region. | 2006 |
| Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises<br><br>Rules for the Implementation of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises<br><br>State Council Circular no.13 of 1999 | • Preferential tax policies for foreign-invested enterprises engaged in energy, transportation infrastructure projects. The income tax of foreign-invested enterprises engaged in energy and transportation infrastructure projects such as harbor and wharf projects may be levied at the reduced rate of 15 percent. | 1999 |
| Rules for the Implementation of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises (2001–04) | • Preferential tax policies for Chinese-foreign equity joint ventures engaged in port and dock construction may receive a reduced income tax rate of 15 per cent; where the period of operations is 15 years or more, these firms may be exempt from income tax for the first 5 years of profitability, then receive a reduction of 50 percent for years six through ten. | 2001–04 |
| Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises; and Rules for the Implementation of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises (2001–04) | • Preferential tax policies for enterprises with foreign investment established in SEZs (excluding Shanghai Pudong area) | 2001–04 |
| Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises; and Rules for the Implementation of the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises. (2001–04) | • Preferential tax policies for FIEs established in Pudong area of Shanghai, with special consideration for construction of infrastructure projects, and for projects meant to last 30 years or more | 2001–04 |
| Ministry of Finance Circular no.034 (2001–04) | • Preferential tax policies for enterprises with foreign investment established in the Three Gorges of Yangtze River Economic Zone. | 1995 |
| Catalog for the Guidance of Foreign Investment Industries | • Designates certain industries as "encouraged," "restricted," or "prohibited" for FDI, including electric power, an important industry for infrastructure | 2005 |
| Catalog of Advantageous Sectors for Foreign Investment in the Central and Western Regions | • Designates encourage industry for FDI in the central and western regions of China | 2000 |

**Table 4.7** Infrastructure development: Key regulatory practices and policies—*Continued*

| Regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | **Provincial and local government** | |
| Beijing: Concessions for Urban Infrastructure Procedures | • Lays out procedures for private investment by foreign and domestic companies in large urban infrastructure projects, including Build-Operate-Transfer, Transfer-Operate-Transfer, and concessions | 2003 |
| | **Services** | |
| Ports Law | • Administration, planning and construction of ports, including foreign investment in ports | 2004 |
| Regulations on Administration of Port Operations | • Implementing regulations for the Ports Law, above | 2004 |
| Administration of Railway Construction Procedures, Ministry of Railways | • Outlines railway project management, bidding process, quality control and safety provisions | 2003 |
| Highway Law | • Outlines highway project management, planning, and supervision provisions. | 1998, revised 2004 |
| Telecommunications Regulations (Ministry of Information Industry) | • Sets principles and requirements for telecommunications network construction, licensing, telecommunications security, and other industry standards. | 2000 |

Source: *China Law & Practice, "*Beijing's New Rules on Municipal Infrastructure Projects," "Infrastructure Projects," "Private Investment in Urban Utilities," and "Railway Construction in China"; *ENR*, "China's Project Management Rules Have Foreigners Fuming"; Howlett, "The Impact of the WTO on China's Construction, Engineering, and Design Industries"; "Invest in China," official Chinese government website; OECD, *China in the Global Economy,* 449; PRC Ports Law 4500/03.06.28; Primetrica, "Country Profile: China"; WTO, *Trade Policy Review: China*; and Liu, "Planning and Policy Coordination in China's Infrastructure Development."

**Table 4.8** Research and development: Summary of key practices and policies

| Practices and policies | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| Promoting indigenous innovation | • Central government initiated, applied at all levels | • Policy outlined in S&T Plan and National S&T Development 5 Year Plans (S&T Plans) |
| Supporting achievement of scientific breakthroughs through R&D funding programs and large-scale projects | • Central government initiated, applied at all levels | • Policy outlined in S&T Plan and S&T Plans |
| Preferential tax policies to encourage R&D investment, including deduction of 150 percent of R&D expenses from taxable income for domestic and foreign enterprises (see note) | • Central government initiated, applied at all levels | • Policy outlined in S&T Plan and S&T Plans |
| Financing policies to encourage R&D investment, including preferential access to policy and commercial loans and venture capital | • Central government initiated, applied at all levels | • Policy outlined in S&T Plan and S&T Plans |
| Preferential government procurement policies to support domestic innovation. | • Central government initiated, applied at all levels | • Policy outlined in S&T Plan and S&T Plans |
| IPR and technical standards policies to support domestic innovation | • Central government initiated, applied at all levels | • Policy outlined in S&T Plan and S&T Plans |
| Designation of special economic zones, including high-tech development zones, that receive preferential policies in the areas of land, taxes, import and export policies, funding and loans. | • Central government initiated, applied at all levels | • Policy initiated with the creation of the Torch Program in 1988. |

Source: China's September 2007 replies in the WTO to questions by the United States; State Council, "State Council's Reply on Rules"; and WTO, Committee on Subsidies and Countervailing Measures, *China*.

Note: On November 29, 2007, USTR announced that the United States and China had signed a Memorandum of Understanding (MOU) to settle a U.S. dispute pending against China under the WTO Dispute Settlement Understanding concerning the WTO-consistency of certain Chinese tax practices granting refunds, reductions, or exemptions from taxes or other payments. A copy of the MOU is provided in app. F.

## Promotion of Indigenous Innovation

The S&T Plan's focus on "indigenous innovation" responds to the perception among China's policymakers that the opening up of the economy to FDI has not led to the improvement of domestic innovation capabilities. [486] Chinese policymakers express the concern that foreign technologies dominate in high-tech products, relegating China to a

[486] The Chinese phrase for indigenous innovation may also be translated as independent or homegrown innovation. Although it has been interpreted potentially as a regression to "techno-nationalist" strategies of self-reliance from the Maoist period, Chinese government officials stress the country's commitment to participation in the global innovation system. Cao, Suttmeier, and Simon, "China's 15 Year Science and Technology Plan," 40; Chinese government official, interview with Commission staff, Beijing, September 4, 2007.

costly and low-value role in global production networks.[487] Until recently, China has relied largely on importing new technologies or equipment embodying new technologies, licensing, and attracting FDI as a means of advancing technological know-how.[488] The S&T Plan sets as a goal a substantial reduction in China's reliance on foreign technology.[489] It calls for foreign technology import regulations to limit repeat purchases and imports of obsolete foreign technologies; it also calls for regulations to require an assessment of whether imported foreign technologies can be absorbed and re-innovated.[490] On November 2, 2007, MOFCOM issued a Catalog of Technologies Whose Imports Are Banned, which reportedly identifies 126 types of technologies subject to import restrictions for various reasons, including accelerating the establishment of domestic industries.[491]

To foster indigenous innovation, the S&T Plan promotes the creation of high-value domestic IP and the establishment of technical standards that rely on domestic IP. Similarly, MOFCOM's 11th Five-Year Plan (2006–2010) on Promoting Trade through Science and Technology seeks to expand the export of domestic products with IP ownership, to foster large global companies with high-tech products and famous brand-names, and to strengthen innovation through the adoption and modification of imported technologies.[492] Central and local government officials also are increasingly active in establishing specific measures to support the creation of domestic IP including funding for the development of brand-names, technical assistance in the preparation of patent applications and the identification of unpatented foreign technologies for exploitation by Chinese companies, and funding to defend patent infringement cases brought against Chinese companies.[493]

In the area of technical standards, China has adopted a policy of fostering the development of product standards for a range of electronics products including cellular

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[487] Academic representatives, interview with Commission staff, Beijing, September 6, 2007. For example, a Chinese newspaper article recently pointed out that due to a lack of core technologies, Chinese firms pay foreign patent holders 20 percent of the price for Chinese-made cell phones and 30 percent for computers. Serger and Breidne, "China's Fifteen-Year Plan," 147.

[488] The United States reportedly is the third largest source of technology purchases behind the European Union and Japan. Tektra, "China Increasing Technology Transfer/Import and Co-operations in R&D." U.S. willingness to sell technology to China appears to be negatively impacted by firms' reported experience that technology brought to China is often reverse engineered, cloned, and disseminated widely to domestic competitors. Industry officials, interviews by Commission staff, Beijing and Shanghai, August 31, and September 7, 2007; Dewey Ballantine LLP. Posthearing submission to the USITC, September 20, 2007, 1–2.

[489] China calculates the level of reliance on foreign technology as a ratio of foreign technology purchases to gross expenditure on R&D plus foreign purchases. The current level of reliance on foreign technologies is about 39 percent. Whalley and Zhou, "Technology Upgrading and China's Growth Strategy to 2020," 10.

[490] WTO, Council for Trade in Goods, "Questions from the United States to China," 2.

[491] Ibid.

[492] China's National IP Strategy, recently completed and pending before the State Council, also focuses on the need to improve IP protection and domestic inventive capacity. Chinese Government official, interview by Commission staff, Beijing, September 4, 2007.

[493] MOFCOM, "Sichuan: IP Office Emphasizes Development of Patent Application," August 24, 2007; MOFCOM, "Beijing Publicizes Measures to Encourage Innovation," August 20, 2007; and MOFCOM, "More Gov't Support for Firms in IPR Disputes," September 11, 2007.

telephones, digital televisions, integrated circuits, wireless devices, and video discs.[494] This standards-setting push is intended to decrease dependence on foreign technologies, and increase the prominence of standards that rely on domestically controlled IP, and thereby to increase royalty payments to domestic IP owners.[495] Multinational corporations (MNCs) report that Chinese standards-setting processes often are opaque, non-centralized and closed to foreign participation.[496]

Standards setting initiatives have been supported by the Ministry of Science and Technology's (MOST) "863" High-Technology R&D funding program; at least 29 standards have resulted from this support.[497] One of the highest profile efforts has been the central government's support for TD-SCDMA—a third-generation (3G) cellular telephony standard jointly developed by Chinese and foreign companies—with R&D funding and preferential financing for domestic firms.[498] The government's 2006 policy decision to declare TD-SCDMA a national standard and schedule its roll out so that 3G phones may be used during the 2008 Olympics is expected to be a major test of the success of China's standards- setting efforts.[499]

## Achievement of Scientific Breakthroughs

The S&T Plan also aims to achieve major scientific breakthroughs to address development needs and spur domestic innovation. It identifies key priorities in 11 areas; particular priorities in the agriculture, manufacturing, and services areas are identified below (box 4.3). It also identifies 17 major government- funded engineering and science "megaprojects,"including projects in the areas of large-scale integrated circuit manufacturing, large aircraft development, manufacturing technologies, and nanotechnology. To achieve these scientific breakthroughs, the S&T Plan commits China to increase total R&D expenditures from the current 1.4 percent of GDP to 2.5 percent of GDP, the average for OECD countries, by 2020. It also commits to a GDP growth rate exceeding 7.5 percent annually until 2010 and then 7 percent until 2020, implying massive increases in R&D expenditures to reach 2.5 percent of GDP in 2020.[500] China's R&D funding programs are a critical channel for this planned increase in investment. The main R&D funding programs, subject matter areas, and program funding levels are described in table 4.9.

These R&D funding programs can point to historical successes, for example, in the areas of nuclear defense and space technologies.[501] China's government R&D support for products or technologies for the commercial market reportedly has been less successful. For example, substantial government funding of R&D in nanotechnology—through MOST's high-technology R&D, basic research, and other programs (table 4.9)—has

[494] Technical standards foster the development of technologies by ensuring that different components or products are able to operate together.

[495] Linden, "China Standard Time," 1–2.

[496] Dewey Ballantine LLP, Posthearing submission to the USITC, September 20, 2007, 1; industry official, interview with Commission staff, Shanghai, September 7, 2007.

[497] Suttmeier et al., "Standards of Power?" 13.

[498] Ibid., 18.

[499] Industry official, interview by Commission staff, Beijing, August 31, 2007.

[500] Whalley and Zhou, "Technology Upgrading and China's Growth Strategy to 2020," 8–9.

[501] Cao, Suttmeier, and Simon, "China's 15 Year Science and Technology Plan," 40.

**Box 4.3** China's 15-Year S&T Plan: Priority subjects in agriculture, manufacturing, IT and services, and megaprojects

**Agriculture**
Crop germoplasms
Livestock, poultry and aquatic products disease prevention
Downstream processing, storage and shipping of agricultural products
Biomass development and utilization
Ecological safety in agriculture and forestry
Ecologically sound fertilizer and pesticide products
Multifunctional farming equipment
Applying computer technology to farming operations
Modern dairy farming

**Manufacturing**
Basic spare parts and standard components
Digitized and intelligent design and manufacturing
Process industry greening and automation
Recyclable iron and steel processes and equipment
Marine engineering technologies and equipment
Basic raw and semifinished materials
Informatic functional materials and devices
Key materials and engineering for military production

**IT and Services**
IT for supporting service industries and large-scale application software
Next-generation internet technologies and services
High-performance computing
Sensor networks and intelligent processing
Digital media content platforms
High-definition, large-screen, flat panel displays
Information security for core applications

**Megaprojects**
Advanced numeric-controlled machinery and basic manufacturing technology
Control and treatment of AIDS, hepatitis, and other major diseases
Core electronic components, high-end universal chips, and basic software
Drug innovation and development
Extra-large-scale integrated circuit manufacturing technologies
Genetically modified new-organism variety breeding
High-definition Earth observation systems
Large, advanced nuclear reactors
Large aircraft
Large-scale oil and gas exploration
Manned aerospace and Moon exploration
New-generation broadband wireless mobile telecommunications
Water pollution control and treatment
Development and reproductive biology
Nanotechnology
Protein science
Quantum research

Source: Levin Institute, "Excerpts from the 15-Year Plan," App. 85-117.

**Table 4.9** China: Main R&D programs, focus, and funding

| Program | Subject matter focus | 2001–05 funds allocated by central government (dollars) |
|---|---|---|
| National High-Technology R&D 863 Program | Supports R&D in the fields of IT, advanced materials, biotechnology and agricultural technology, advanced manufacturing and automation, energy, resources and environment, and marine, space and laser technologies. Although most projects appear to be in the fields of biotechnology, IT, and advanced manufacturing, the marine, space, and laser programs involve military R&D, specific funding and project information is not available for these programs. | $2.4 billion |
| National Natural Science Fund | Supports basic and applied research in the natural sciences: math and physical sciences, chemical, life, earth, engineering, information and management sciences. Most funding directed to life sciences and engineering. | 1.3 billion |
| Key Technologies R&D Program | Supports R&D in the fields of agricultural processing and biotechnology, key manufacturing technologies, IT and high-technology industries, environment, traditional Chinese medicine, and social development. Most funding directed to agriculture and biotechnology. | 763 million |
| National Basic Research R&D 973 Program | Supports basic and applied research in agriculture, energy, information, environment, population and health, materials, and synthesis. Most funding directed to population and health. | 484 million |
| Innovation Fund for Small, Technology-Based Firms | Product development support in areas of electronics and IT, biotechnology, materials, automation, environment and energy for technology-based SMEs. Most projects in the field of IT. | 315 million |
| Agricultural Science and Technology Transfer Fund | Support for agricultural technology generation, transfer and application. | 169 million |
| National New-Products Program | Publication of annual list of new products that contain self-owned intellectual property rights, have high export potential, replace import products, are made primarily with domestic parts or that adopt international standards for support through grants and other policies. | 84 million |
| Spark | Support of R&D and S&T education for rural economies, advanced technologies for township enterprises, the improvement of labor conditions and skills, and the creation of sustainable agricultural technologies. | 60 million |
| Torch | Development support in areas of new materials, biological and medical technology, electronic information, integrated light and electronics and their machinery, new and efficient energy, and environmental protection. Creation and support of HDTZs. | 36 million |

Source: NBS and MOST, *China Statistical Yearbook on S&T*; Liu and Lundin, "Toward a Market-Based Open Innovation System"; Seong and Popper, *Strategic Choices in Science and Technology*; and MOST, "Innovation Fund for Technology-Based SMEs."

spurred significant increases in scientific publications but only limited success in the commercialization of nanotech products.[502] Chinese policymakers generally have concluded that the links between academic research and enterprises are weak and that enterprises must play a more central role in R&D and innovation activities.[503]

## Fostering Enterprise-Driven Innovation

The S&T Plan focuses on reforms of China's R&D system so that domestic enterprises play a greater role and the government a smaller role in R&D and innovation. In practice, it is difficult to capture the evolving roles of enterprises and government in the financing and direction of R&D.[504] Moreover, although there reportedly is agreement among Chinese policymakers that the innovation practices of domestic firms are weak, the S&T Plan does not address the role of foreign firms in R&D and innovation in China.

The S&T Plan identifies policy interventions in the areas of taxes, financing and funding, and government procurement to promote R&D and innovation in domestic enterprises (box 4.4). In April 2006, the State Council issued a list of 99 additional supporting measures that it considers necessary for implementation of the S&T Plan.[505] The tax incentives will modify measures adopted in the 1990s that are perceived to have been ineffective in stimulating domestic R&D investments.[506] For example, although prior rules permitted enterprises to "deduct" 150 percent of R&D expenses from taxable income, the deduction only applied to profitable enterprises that increased their R&D expenses 10 percent over the previous year. New rules will permit the deduction without requiring profitability or a 10 percent increase and will allow it to be carried forward for five years. New tax rules also will move the value-added tax (VAT) from a production-type to a consumption-type to permit the deduction of capital expenses, as well as provide more- favorable tax terms for venture capital that invests in high-technology small and medium-sized enterprises (SMEs).[507]

[502] According to the Chinese Academy of Science (CAS), funding totaled $160 million in 2006 and, according to industry analysts, $250 million in 2005 and $197 million in 2004. CNS-UCSB, "Innovation or Imitation?"

[503] Academic representatives, interviews by Commission staff, Beijing, September 5 and 6, 2007; Lu, "An Analysis of the Characteristics of China's Innovation System," 39–41.

[504] The enterprise sector's share of total R&D expenditures is reported to have risen from one-third to more than two-thirds of total expenditures in the last 10 years. However, the change results in large part from the conversion of government research institutes into SOEs. Moreover, most enterprise R&D is conducted by SOEs; of the 50 Chinese companies with the largest R&D expenditures in 2006, more than 80 percent were state-owned. Thus, Chinese statistics appear to understate the role of government in the direction and financing of R&D. Serger & Breidne, "China's Fifteen-Year Plan for Science and Technology," 139, 158; and Lu, "An Analysis of the Characteristics of China's Innovation System," 40.

[505] State Council of the PRC, "State Council's Reply on Rules for Carrying Out National S&T Development Program."

[506] Whalley and Zhou, "Technology Upgrading and China's Growth Strategy to 2020," 15.

[507] Ibid., 15–16. See also table 4.10 and the section on "Taxation" in chap. 3 of this report.

**Box 4.4** China: Main policy tools identified in the S&T Plan

**Tax policies**

- More generous deduction of R&D expenses from taxable income
- Accelerated implementation of consumption value-added taxes (VAT) to allow for capital expenditure deduction
- Custom duties and import-related VAT removed for imports of R&D products
- Accelerated depreciation of R&D apparatus and facilities
- Preferential tax policies, such as favorable taxation terms for venture capital, to promote development of new products, new technologies, high-tech enterprises, and SMEs

**Funding and finance policies**

- Policy banks to provide loans to R&D-focused enterprises, finance imports and exports, and support agricultural technology application and industrialization
- Commercial banks encouraged to provide loans based on government guarantees and provide discounted interest rates
- Encourage venture capital investment with government funding, policy bank, and commercial loans
- Encourage independent innovation and restrict indiscriminate importation of duplicative foreign technologies
- Special funding to support the absorption, assimilation, and re-innovation of imported technologies
- Special funding of key technologies for major industries and the use of national development projects as a vehicle for enhancing innovation capabilities
- Create favorable environment for overseas stock exchange listings
- Facilitate establishment of overseas R&D centers with foreign exchange and financing support

**Government procurement policies**

- Encourage independent innovation through government purchases of domestic products or technologies
- Implement government procurement policy that gives priority to technologies and equipment with domestically developed IPR
- Funding support to enterprises that purchase domestic technologies and equipment

Source: Levin Institute, "Excerpts from the 15-Year Plan," App. 85–11; and Whalley and Zhou, "Technology Upgrading and China's Growth Strategy to 2020."

The S&T Plan also identifies financing, funding, and government procurement measures to promote R&D and demand for domestic products. In the area of financing and funding, policy banks are instructed to increase R&D lending and commercial banks are encouraged to do so with government guarantees and discounted interest rates. In the area of government procurement, government agencies have issued implementing measures that establish an accreditation process so that domestic innovative products may be certified and given procurement priority in key national projects (box 4.4).

The S&T Plan does not address the role of foreign firms in China's R&D policies, despite the fact that there are reportedly more than 1,000 foreign R&D centers in China (up from only a handful ten years ago).[508] In the past, the government has encouraged the establishment of foreign R&D centers with beneficial tax policies, including a deduction for R&D expenses like that provided to domestic enterprises. However, MNCs generally do not identify government policies as a major impetus for decisions to invest in China; they report that proximity to a large market of customers and to production facilities, and reduced labor costs including for scientists and engineers, are more important motivators.[509] By contrast, decisions about where to locate an R&D or production plant within China are reportedly influenced by the incentive packages offered by local governments–such as favorable terms for land use and utilities and corporate tax exemptions–as well as the qualifications of the local labor pool.[510]

The S&T Plan's focus on indigenous innovation may suggest fewer incentives for foreign investment in the future. Some Chinese policymakers articulated skepticism about the positive "spillover effects" of foreign R&D and high-tech manufacturing.[511] Policy measures such as the unification of tax rates between foreign and domestic companies[512] are viewed as crucial for promoting indigenous innovation and a central role for domestic enterprises in China's R&D system.[513]

## *Overview of R&D Policies at the Regional and Local Government Levels*

Levels and main performers of R&D activities vary greatly throughout China's regions and provinces. China can be separated into three regions: east, central, and west, for purposes of describing R&D spending at the regional level.[514] The eastern region—which includes Beijing, Shanghai and Guangdong—is the hub for R&D activities. In 2005, the eastern region accounted for 72 percent of total R&D expenditure ($22 billion), followed

[508] *International Financial News*, "The MOFCOM Report: R&D Centers of Multinational Companies Accelerated Pace into China."

[509] Walsh, "Foreign High-Tech R&D in China," 250. Industry officials, interviews by Commission staff, Beijing and Shanghai, August 31, September 7 and 10, 2007.

[510] Industry officials, interviews by Commission staff, Beijing and Shanghai, August 31, September 7 and 10, 2007.

[511] Some assert that foreign R&D "crowds out" domestic activities because it is isolated from local R&D performers and channels of innovation, and captures the best human resources. Industry official, interview by Commission staff, Beijing, August 30, 2007; and Serger & Breidne, "China's Fifteen-Year Plan for Science and Technology," 146.

[512] See the section on "Taxation" in chap. 3 of this report.

[513] Academic representative, interview by Commission staff, Beijing, September 6, 2007.

[514] The Eastern region includes the following 13 provinces and municipalities: Liaoning, Jilin, Heilongjiang, Shangdon, Fujian, Hainan, Beijing, Tianjin, Hebei, Guangdong, Shanghai, Jiangsu, Zheijiang. The central region includes the provinces of Anhui, Henan, Hubei, Hunan, Jiangxi, and Shanxi. The seven provinces and municipalities of Chongqing, Gansu, Guizhou, Qinghai, Shaanzi, Sichuan, and Yunnan and the autonomous regions of Guangxi, Inner Mongolia, Ningxia, Tibet, and Xinjiang form the western region.

by the central region at 15 percent ($4.5 billion), and the western region at 13 percent ($3.9 billion).[515]

A similar regional profile exists for the distribution of R&D projects under the Torch and Spark programs set up by the central government and implemented at the regional and local levels.[516] In 2005, China's eastern region conducted 60 percent of the Torch and Spark projects, the middle region performed 25 percent, and the remaining 15 percent of projects were done in the west.[517] The Western Development program is intended to address some of these disparities by fostering greater investment and R&D activities in China's western region.[518]

At the municipal level, Beijing leads in R&D expenditures with nearly $463 million, or 16 percent of the total national R&D expenditure in 2005.[519] Beijing hosts the Chinese Academy of Sciences (CAS), China's premier academic institution, 78 universities and over 16,000 high-tech enterprises.[520] Beijing has in place a number of policies to encourage the establishment of foreign and domestic R&D centers including preferential tax policies, the right to bid on tenders for large municipally funded science and technology projects, and financial assistance to cover patent costs. Shanghai, Tianjin and Guangzhou similarly have measures in place to encourage the establishment of high-technology enterprises and R&D centers including corporate income tax rebates, reduced land-use prices, and R&D grants.[521]

China's designation of different types of special economic development zones (SEZs) is an important policy instrument in the regional and local development of R&D capabilities.[522] At present, there are more than 200 central government-approved development zones including: 53 high-tech development zones (HTDZs); 54 economic and technical development zones (ETDZs); 15 trade free zones; 58 export processing zones; 14 frontier economic cooperation zones; and 33 other types of development zones. An additional 1,346 development zones have been approved by provincial governments.[523]

HTDZs, the primary approach used by MOST to facilitate the Torch R&D funding program, are located in almost every province and city in China (figure 4.1). High-tech enterprises located in an HTDZ benefit from preferential policies in such areas as reduced corporate income tax rates (from 30 to 15 percent) with additional reductions in the initial

[515] NBS and MOST, *China Statistical Yearbook on Science and Technology,* 18–19.

[516] These programs are described in table 4.9.

[517] NBS and MOST, *China Statistical Yearbook on Science and Technology,* 280–81.

[518] The Western Development program is described in more detail in the section on "Infrastructure Development" elsewhere in this chapter.

[519] NBS and MOST, *China Statistical Yearbook on Science and Technology,* 18–19.

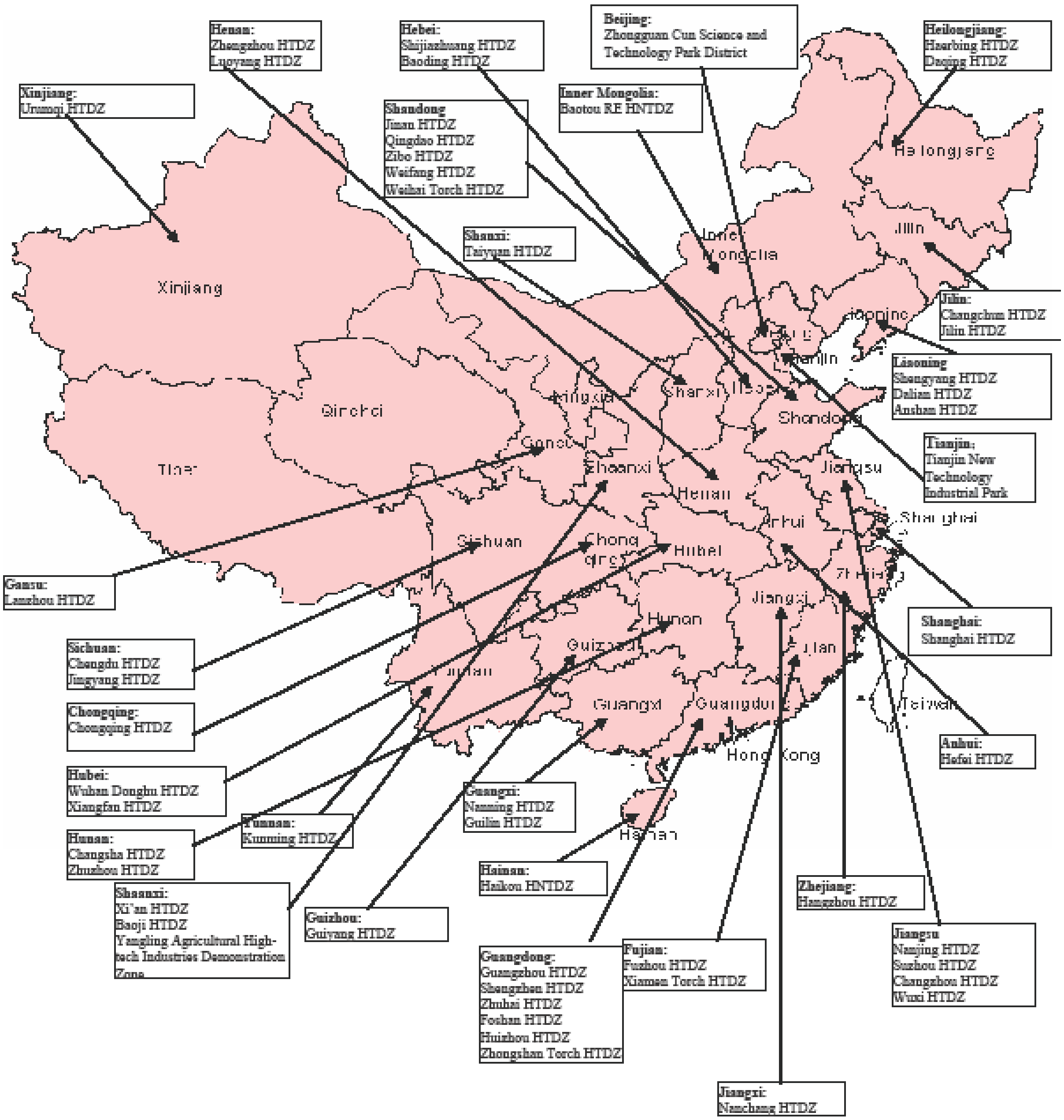
[520] Ibid., 282–83.

[521] Additional information on provincial and local government policies is provided in table 4.10.

[522] Sigurdson, *Technological Superpower China*, 215.

[523] Lan, "Chinese Policies on New and High-Tech. Industries." For additional information, see the sections on "Restraints on Imports and Exports" in chap. 5 of this report.

**Figure 4.1** China High-Tech Development Zones, 2007




**China's High-Technology Development Zones (HTDZs)**

years, tax reductions for firms adopting advanced technology, streamlined procedures for imports and exports, financing and grants, and loans for land and construction.[524]

ETDZs and science parks, located in all of China's provinces, also play a substantial role in China's R&D activities.[525] Beijing's Zhongguancun Science Park (Z-Park) dubbed the "Silicon Valley of China" is the country's largest science park. Z-Park hosts 39 universities, the CAS, and about 18,000 companies. It attracts investment by offering special incentives to tenants, such as corporate tax reductions, reduced land-development fees, and personnel training and management programs.[526] Similarly, Tsinghua Science Park, the only commercially owned science park in China, hosts leading MNCs, domestic companies, and startup enterprises, including those in the "returned students' pioneer park," where students who return from overseas receive special incentives from the central government to start up a new business including free space for at least one year.[527] Preferential policies in the area of land, taxes, and R&D equipment support enterprises in this Park. Enterprises also may obtain high-level services, including improved access to venture capital and financing channels, personal connections that ease transaction costs, and daily opportunities for knowledge sharing between individuals and enterprises in an environment where IP reportedly is respected.[528]

Chinese policymakers reportedly anticipate future changes in the policies applicable in SEZs. The unification of tax rates applicable to foreign and domestic firms, combined tax and trade policy adjustments to curb exports,[529] and the policies favoring domestic innovation all are thought to impact the policy landscape for foreign firms in SEZs.[530] Also under consideration is the possible elimination of SEZs in the coastal areas to encourage more widespread economic development through SEZs in the central and western parts of the country.[531]

## *Regulatory Environment*

China's current regulatory environment of R&D practices and policies is presented in table 4.10. Practices and policies are described for the central government, including central government practices by sector, and for provincial and local governments.

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[524] Walsh, "Foreign High-Tech R&D in China," 45; and CBBC, "Trade & Investment Zones."

[525] Hsiung, "An Evaluation of China's Science & Technology System and its Impact on the Research Community," 32.

[526] See Z-Park official website. "Special Incentives," and table 4.10.

[527] See Tsinghua Science Park official website, http://www.thsp.com.ch, and Science park official, interview by Commission staff, Beijing, September 7, 2007.

[528] Ibid.

[529] For additional information, see the sections on "Taxation" in chap. 3 and "Restraints on Imports and Exports" in chap. 5 of this report.

[530] Lan, "Chinese Policies on New and High-Tech Industries."

[531] Academic representative, interview by Commission staff, Beijing, September 5, 2007.

**Table 4.10** Research and development: Key regulatory practices and policies identified

| Name of law or regulatory practice/policy | Description | Date of entry into force |
|---|---|---|
| | **Central government** | |
| | ***Preferential Tax Policies*** | |
| Preferential tax policies for technology- and knowledge-intensive FIEs | • Reduced tax rate of 15 percent for FIEs that are technology- and knowledge-intensive and whose products are listed in the Catalog of High and New Technology Products | 1995 |
| Preferential tax policies for R&D of domestic enterprises | • Domestic enterprises permitted to deduct 150 percent of actual R&D expenses for new products and technologies from taxable income for that year when expenses have increased by 10 percent or more from previous year | 1996 |
| Preferential tax policies for R&D of FIEs | • FIEs permitted to deduct 150 percent of actual R&D expenses conducted in China from taxable income for that year when expenses have increased by 10% or more from previous year | 2000 |
| Preferential tax policies for enterprises transferring technology | • Income tax exemption for enterprises profiting from or providing technology transfer services where the net income of the enterprise is less than $36,000; where income is more than this amount, the exceeding part is taxed at the regular rate. | 2001 |
| Preferential tax policies for FIEs purchasing domestically produced or "homemade" equipment (see note at end of table) | • FDI in the encouraged category and FIEs can deduct 40% of the expense of domestically produced equipment purchased to upgrade existing equipment. Domestic equipment purchases also may be eligible for VAT refunds and refund of local taxes. | various |
| Preferential tax policies for domestic enterprises purchasing domestically produced equipment (see note at end of table) | • Domestic enterprises can deduct 40 percent of expense of equipment purchased for technology and equipment upgrading. | 1999 |
| Preferential exemption of tariff and import VAT for imported technologies and equipments (see note at end of table) | • Tariff and import VAT exemptions for equipment imported for encouraged FDI and domestic projects, as well as for producing products in the Catalogue of State New and High Technology Products. | 1997 |
| Preferential tax treatment for enterprises in special economic zones | • Reduction of tax liability for enterprises in high-technology, economic development, coastal economic and other special economic zones. | 1991 |
| Preferential tax treatment for reinvested profits of FIEs | • Refund of income tax paid on reinvestment for organization and expansion of advanced technology or export-oriented FIEs. | 1991 |
| Preferential tax treatment for FIE royalties | • Reduction of income tax rate to 10 percent for royalties received by FIEs for the supply of technical know-how. | 1991 |
| Preferential exemption from payment of certain worker expenses | • Certain export and technologically-advanced enterprises exempt from payment of certain worker expenses | 1986 |

**Table 4.10** Research and development: Key regulatory practices and policies identified—*Continued*

| Name of law or regulatory practice/policy | Description | Date of entry into force |
|---|---|---|
| | **Central government—*Continued*** | |
| Preferential tax treatment for imported products for scientific and educational purposes | • Tariff, import VAT and excise tax exemptions for products used in scientific research and education and imported by institutions and nonprofit schools. | 1997 |
| Preferential tax policies for scientific research institutions under transformation | • Scientific research institutions that convert to enterprises exempt from taxes for five years from conversion. | 2003 |
| Preferential tax policies for foreign R&D centers | • Qualified R&D centers established by FIEs may obtain: waiver of customs duty and import VAT for equipment imported for internal use; waiver of business tax on income derived from transfer of self-researched and developed technology; and deduction of R&D expenses from income tax. | 2000 |
| | ***Funding Support*** | |
| Funds for supporting technological innovation of SMEs | • Preferential funding for science and technology projects of SMEs in the form of grants and loan interest discounts. | 1999 |
| Brand development fund | • Financial supports for brand development and promotion activities. Similar and implementing programs at the provincial and local government levels. | 2006 |
| Export contingent support for famous name brand products | • Preferential funding for R&D projects, assistance in establishing R&D centers, and support for technology to strengthen famous brand exports. Similar and implementing programs at the provincial and local government levels. | 2006 |
| Go global (fund for brand development) | • Funding to support restructuring of textile industry, technology innovation and brand development. | 2006 |
| Provisional measures for the administration of the specific project funds for R&D in the integrated circuit industry | • Chinese IC firms may receive grants equal to 50 percent of R&D expenditures. IC Fund provided $18 million (RMB 150 million to 27 companies for 29 projects in 2005. | 2005 |
| R&D Funding Programs | • R&D funding programs including: 863 National High Technology R&D Program; National Natural Science Fund, Key Technologies R&D Program; National Basic Research R&D 973 Program; Innovation Fund for Small Technology-Based Firms; Agricultural Science and Technology Transfer Fund; National New Products Program; Torch and Spark Programs. | various |
| | ***Measures Relating to the S&T Plan*** | |
| Implementing measures for the S&T Plan | • Itemized table identifies the agencies, subject matter, time frame for completion and persons responsible for the implementation of 99 measures required to support the S&T Plan. | 2006 |
| Several opinions of MOF and NDRC regarding the use of R&D funds as venture capital | • Framework for experimental project to use government R&D funds for venture capital financing. | 2007 |
| Policy bank support for major national scientific and technological projects | • Policy banks to strengthen their financial support of independent innovation and projects designated in the S&T Plan. In March 2006, China Development Bank announced it would provide MOST with $6 billion in policy loans to support major R&D programs. | 2006 |

**Table 4.10** Research and development: Key regulatory practices and policies identified—*Continued*

| Name of law or regulatory practice/policy | Description | Date of entry into force |
|---|---|---|
| | **Central government—*Continued*** | |
| Trial measures for the administration of the accreditation of national independent innovation products | • Measures establish an accreditation process so that domestic innovative products are certified and given government procurement priority in key national projects. | 2006 |
| Development zones to foster innovation | • Policies such as the promotion of independent innovation, domestic IP and standards and venture capital financing to be implemented in the development zones. | 2007 |
| Opinions guiding the conduct of aid work for the safeguard of intellectual property rights (State Intellectual Property Office) | • IP legal aid centers to be set up around the country providing IP conflict resolution and litigation services, funding support for legal fees in foreign IP cases, IP feasibility studies and technology transfer support and other IP services. | 2007 |
| | **Provincial and local government** | |
| Shanghai provisions encouraging the establishment of R&D organizations | • Implements the 2000 R&D MOFTEC circular and sets additional benefits including: customs duty and import VAT waived for royalties on imported software; customs duty waived for certain articles brought in by staff of R&D centers, deduction of R&D expenses against taxable income, refund of fees relating to land use and real estate transactions, improved customs clearance services and more effective protection of IPRs of R&D centers. | 2000 |
| Beijing Municipality policies encouraging the establishment of scientific and technology research and development organizations | • Certified organizations may be entitled to benefits including: exemption from customs duty and VAT for imported equipment, exemptions from business and enterprise income tax; income tax deduction for half of the increase in R&D expenses; right to bid on tenders for municipal S&T projects; and subsidies to cover patent costs. | 2002 |
| Zhongguancun Science Park policies on the development of new and high-tech industries | • Includes policies on attracting talented people; reduction and exemption of corporate income tax, business tax, business VAT; tariff preferences; special funds for the development of enterprises in the park; and other preferential policies and services. | various |
| Tsinghua Science Park policies encouraging development of software and integrated circuit (IC) industries | • Preferential policies in the areas of investment, funding, tax, export facilitation, personnel, procurement and IPR protection to support development of software and IC industries. | various |
| Tianjin Municipality tentative provisions encouraging foreign investment in the research, development and industrialization of high and new technology projects | • Preferential treatment available for FDI in R&D includes exemption from enterprise tax and tax on technology transfer services. | 2000 |
| Tianjin Economic Technological Development Area (TEDA) policies promoting development of high and new technology industries | • Provides grants to support R&D and the establishment of R&D centers; land for R&D facilities may also be made available at favorable prices. | 2006 |
| Guangzhou City provisions encouraging foreign investors to establish headquarters | • R&D centers set up by foreign investors may obtain recognition as headquarters and obtain financial incentives, land grants, preferential tax policies, and discounted rates for public utilities. | 2006 |
| Shishi City of Fujian province brand building Incentives | • Financial awards for companies with well-known brands recognized by the State Administration of Industry and Commerce or Administration of Quality Supervision, Inspection and Quarantine | 2006 |

**Table 4.10** Research and development: Key regulatory practices and policies identified—*Continued*

| Name of law or regulatory practice/policy | Description | Date of entry into force |
|---|---|---|
| | **Provincial and local government—*Continued*** | |
| Ningbo City key industry technological development fund | • Fund assists key industries, including electronic information, new materials, auto parts and machinery production, in their technological upgrading and development of famous brands | 2006 |
| Shenzhen policies to support independent innovation, industries, intellectual property and talent | • Policies include: R&D aid fund for leading enterprises in strategic industries, construction aid for laboratories and R&D centers and aid for industrialization of research.<br>• Industrial policies include preferential support for FIEs, and enterprises in the IC, software, logistics, finance, venture investment, processing and utilities industries. Intellectual property policies include subsidies for patent applications and patent grants. | various |
| | ***Economic sectors***<br>**Agriculture** | |
| Outlay for S&T training of youngster farmers | • Appropriation for S&T training of youngster farmers. | 1999 |
| Assistance for popularization of agricultural technologies | • Funding for agricultural technology projects that can serve as a model to other areas. | 1999 |
| Assistance for actualizing agricultural technology | • Funding to the rights holders of new agricultural technologies to accelerate technological achievements in agriculture, forestry, water conservation and irrigation and to improve the capacity of agricultural innovation. | 2001 |
| Funding for national key construction projects on water and soil conservation | • Funding to assist irrigation, water and soil conservation projects in rural areas. | 1983 |
| | **Manufacturing** | |
| Policies to assist the steel industry | • Tax refunds, discounted interest rates and R&D funds for major iron and steel projects using newly developed domestic equipment. | various |
| Industrial Policy for the Automobile Industry | • FIEs must have their own patents, trademarks, product development and manufacturing technology and sales and finance channels. Manufacturers of completely built up autos must have Chinese partner with at least 50 percent equity. R&D tax deductible. | various |
| Policies to assist the steel industry | • Tax refunds, discounted interest rates and R&D funds for major iron and steel projects using newly developed domestic equipment. | various |
| Industrial Policy for the Automobile Industry | • FIEs must have their own patents, trademarks, product development and manufacturing technology and sales and finance channels. Manufacturers of completely built up autos must have Chinese partner with at least 50 percent equity. R&D tax deductible. | various |

**Table 4.10** Research and development: Key regulatory practices and policies identified—*Continued*

| Name of law or regulatory practice/policy | Description | Date of entry into force |
|---|---|---|
| | ***Economic sectors—Continued*** | |
| | **Manufacturing—*Continued*** | |
| Preferential tax policies for integrated circuit (IC) industry | • Refunds of income tax paid on reinvestment; VAT refund for enterprises selling independently designed IC protects or IC products with self-owned intellectual property rights and tariff and import VAT exemption for imported equipment and apparatus for producing IC by an accredited IC enterprise. | various |

Source: PRC, *WTO Subsidies Notification*, April, 2006; PRC, *Subsidies Replies to Questions Posed by the United States*, September 2007; State Council's Reply on Rules for Carrying Out National S&T Development Program; TLAG, *China's Industrial Subsidies Study: High Technology*, April 2007; TLAG, *China's Laws, Regulations and Practices in the Areas of Technology Transfer, Trade-related Investment Measures, Subsidies and Intellectual Property Protection which Raise WTO Compliance Concerns*, September, 2007; NCTO, *China Subsidies Review*, September, 2007; and Tdctrade.com, *Extract from Guide to Doing Business in China;*. Shenzhen, "Invest Shenzhen," 2007.

Note: On November 29, 2007, USTR announced that the United States and China had signed a Memorandum of Understanding (MOU) to settle a U.S. dispute pending against China under the WTO Dispute Settlement Understanding concerning the WTO-consistency of certain Chinese tax practices granting refunds, reductions, or exemptions from taxes or other payments. A copy of the MOU is provided in app. F.

# Worker Training and Retraining

China uses worker training and retraining programs as a policy instrument to move unemployed or underemployed workers from less efficient to more efficient industries to increase worker productivity and, consequently, firm output. China's initial worker training and retraining programs began in the late 1990s as part of a prototype social security system for workers laid off as a result of SOE reforms; these initial programs more closely resembled job counseling and referral programs than specific training programs. Since 2003, China's central government has adopted an active employment policy focused on expanding social security support to all registered unemployed workers in cities to combat increasing urban unemployment, as well as providing worker training and retraining programs. Most recently, central, provincial, and local government employment policies also have focused on rural social programs such as vocational training and other efforts to help mitigate the rural-to-urban migration that exacerbates urban unemployment. Key practices and policies with respect to worker training and retraining used in China are summarized in the table 4.11.

## *Overview of China's Labor Market and Policies*

Worker training and retraining programs are one component of China's labor policy as the country moves from a highly rigid labor market under a centrally planned economy to a more flexible labor market increasingly operating on market-based principles. Pressure to expand worker training and retraining programs for China's urban workers is likely to increase as rural-to-urban migration increases with unskilled rural workers seeking jobs in the cities, particularly along China's eastern coast.

**Table 4.11** Worker training and retraining: Summary of key practices and policies

| Practices and policies identified | Level of government and sector where applied | Associated laws and regulations |
|---|---|---|
| Social security liabilities, such as pension and related expenses, transferred from SOEs to provincial and local government budgets | • Central government policy, implemented and funded by provincial and local governments | • 1994 Employment Law<br>• 1994 Labor Law, revised 1998 following Conference on Safeguarding the Basic Living Standards of Laid-off Workers in SOEs and their Reemployment<br>• 2002 Circular on Making Further Efforts to Help Re-employment of Xiagang and Unemployed Workers |
| Adoption of active employment policies that largely aim to extend social security coverage to all urban unemployed workers. Key features include preferential reemployment policies to support laid-off SOE workers, employment services and vocational training; expansion of social security system to cover all laid-off SOE workers and urban unemployed; coordinated employment policies for both urban and rural workers | • Central government policy, implemented and funded by provincial and local governments | • 2007 Employment Contract Law<br>• 2007 Employment Promotion Law |
| Promotion of worker training in rural areas | • Central government policy, implemented and funded by provincial and local governments | • March 2007 policy statement by Premier Wen Jiabao. |

Sources: 1994 Employment Law ; Wen, "Report on the Work of the Government"; and Wang, "China's Active Employment Policies."

China's total population of approximately 1.3 billion in 2005 can be divided roughly into 745 million rural and 562 million urban residents (57 and 43 percent, respectively).[532] At year-end 2005, China estimated its total work force at 758 million, composed of approximately 485 million rural workers and 273 million urban workers (64 and 36 percent, respectively).[533] Of China's 485 million rural workers, roughly 150 million have been traditionally estimated to be surplus labor.[534] Of the 273 million urban workers, nearly 65 million were employed in state-owned units.[535] Registered urban unemployed numbered approximately 8.4 million.[536] The sectoral composition of the work force in 2005 was 45 percent in agriculture (340 million), 24 percent in manufacturing (181

[532] The *China Statistical Yearbook* gives China's population as 1,307,560,000 at yearend 2005. NBS and MOST, *China Statistical Yearbook*, table 4-1.

[533] NBS and MOST, *China Statistical Yearbook*, table 5-1. The "total work force" cited is the category "total number of employed persons."

[534] Brooks and Tao, "China's Labor Market Performance and Challenges," 1–5. Surplus labor (rural hidden unemployment) is defined as low-productive employment regardless of working time. Ibid., 14.

[535] NBS and MOST, *China Statistical Yearbook*, table 5-1.

[536] Ibid.

million), and 31 percent in services (274 million).[537] Employment and unemployment categories in China are described in box 4.5.

Worker training and retraining programs in China are largely directed toward the manufacturing sector. This focus on manufacturing sector workers is a result of the predominance of heavy industry SOEs in the Chinese economy and SOE reforms carried out particularly during 1998–2002 that resulted in a large number of laid-off SOE employees. Although the SOE reform policy was initiated by the central government, provincial and local governments have been essentially responsible for its funding and implementation, in turn leading to variation in program results due to regional differences in available resources.[538]

## *Central Government Policies*

Before the late 1990s, China's SOEs focused predominantly on heavy and manufacturing industries. Those industries provided not only lifetime job tenure but also social benefits such as housing assistance, education, health-care, and retirement pensions.[539] China's 1994 Enterprise Law and 1994 Labor Law (revised in 1998) started the country's reform transition from tenured employment to contract employment. Those reforms led to a major downsizing of SOEs and consequent worker layoffs numbering in the tens of millions, heaviest during the 1998–2002 period.[540] With no nationwide unemployment system in place, the central government at that time took over the social safety net obligations that previously had been the responsibility of the SOEs. Although the central government has since proceeded to institute a nationwide social security system designed to cover all urban unemployed workers, Premier Wen Jiabao pledged as recently as March 2007, that the central government would continue the SOE reform toward contract employment and will also continue to relieve SOEs from their obligations to provide social benefits.[541]

[537] Ibid.

[538] Some of the SOEs hardest hit initially in 1999 were in the textiles, coal mining, armaments production, and machinery manufacturing industries. The provinces where the laid-off SOE workers were most numerous were in the northeast (Liaoning, Jiln, Heilonjiang) and the central region (e.g., Henan, Hubei, and Hunan) and, to a lesser extent, in Sichuan in the southwest, Shaanxi in the northwest, and Anhui and Jiangxi on the eastern coast. Bidani et al., "Evaluating Job Training in Two Chinese Cities."

[539] Dong, "China's Urban Labor Market Adjustment."

[540] In testimony before the USITC, Pieter P. Bottelier put the labor force contraction during the SOE reform at roughly 45 million workers, although he said roughly two-thirds of these reentered the labor force while the remaining one third became early retirees. USITC hearing transcript, September 6, 2007, 154. According to the OECD, SOE employment declined approximately 40 percent from 1998 through 2003. State and collective enterprises controlled by local governments restructured more rapidly than the central government during this period, with over 85 percent of the decline in SOEs coming below the provincial level, mostly at county level. OECD, "China," *OECD Economic Surveys*, 29 and 94–102.

[541] Wen, "Report on the Work of the Government."

**Box 4.5** China: Employment and unemployment categories

Different employment and unemployment categories—signaling different benefits—have emerged and evolved with China's SOE reforms. Three key categories are described below.

Workers at SOEs that were retained "on post" were considered "overstaffed" or redundant. These individuals continued to receive pay and related benefits; they also might be reassigned to work in other positions.

Workers at SOEs that were laid-off became "off post" SOE workers, a category known by the Chinese term "xiagang" or "Xia Gang." These individuals technically remained SOE employees while seeking alternate employment with the help of the firm's reemployment service center, explained below in further detail.

Another category includes the registered urban unemployed. This classification evolved reflecting the societal constraints of China's household registration system that recognizes only those individuals officially authorized to live in a city as eligible for urban unemployment services.

Source: Zhang, "Urban Xiagang, Unemployment and Social Support Policies," 3–6

## Reemployment Service Centers

China's first worker training and retraining programs arose from central government efforts to fashion a prototype social security system for the vast number of SOE workers laid off during the peak 1998–2002 period of SOE reform.[542] This prototype social security system offered the services of Reemployment Service Centers (RSCs);[543] official certification of unemployed status and administration of necessary documents; and guaranteed funding for the RSCs.[544] However, workers in agricultural or other collective-owned enterprises were not covered under the RSC program because of limited government funds and a low policy priority.[545] The RSC program was scheduled to expire at the end of 2001; however, a number of provinces extended the program until all RSCs were finally closed in 2003.[546] Additional background information on RSCs is provided in appendix C.

Despite the work of the RSCs, laid-off SOE workers proved difficult to reemploy due to common characteristics of many of the workers, such as their generally more advanced

[542] At the end of 2002, there were approximately 27 million of these workers, shed largely from manufacturing industries. Zheng, "Labor Market Policies in China."

[543] Additional historical information about RSCs is provided in app. C.

[544] Funding was typically not forthcoming from the central government, leaving funding the responsibility of the provincial and local governments and the downsizing SOEs. Ibid. The RSC program was adopted in May 1998 based on a 1993 program developed by the Shanghai municipal government. Other major policy approaches used to address laid-off SOE workers included early retirement for employees within five years of legal retirement, and severance payments to induce workers to accept voluntary separation. Dong, "China's Urban Labor Market Adjustment," 4–9.

[545] Giles, Park, and Fang, "Reemployment of Dislocated Workers in Urban China" and Zheng, "Labor Market Policies in China." RSC funding reportedly came one-third from the government budget, one-third from the firm, and one-third from the unemployment insurance fund, originally established in the 1950s and last revised in the later 1990s, although these latter benefits varied by region because some companies did not pay into the funds, for example, where employers and workers agreed to evade the social security system to give workers more cash up front. Baker McKenzie LLP, interview by Commission staff, Shanghai, September 11, 2007.

[546] Giles and Cai, "Reemployment of Dislocated Workers in Urban China."

age, minimal formal education, and lack of marketable skills.[547] Retraining programs to address these problems by teaching new skills, however, were often met with resistance from these workers.[548]

## Urban Employment Policies

Starting in 2003, China's central government instituted a more active employment policy in response to the unprecedented increase in urban unemployment resulting from the SOE reform.[549] This policy targets five areas: (1) job creation, generated through macroeconomic policies and growth; (2) a preferential reemployment policy, supporting laid-off SOE workers and the urban unemployed that prove particularly difficult to reemploy; (3) employment services and vocational training, intended to match worker skills with those in demand by businesses; (4) standardization of SOE downsizing, designed to better guide the relocation of redundant workers; and (5) inauguration and expansion of the social security system, aimed at covering all laid-off SOE workers and urban unemployed entitled to basic benefits.[550]

In 2007, China's Ministry of Labor and Social Security (MOL) cited initial progress in these five areas as a result of its active employment policy.[551] Macroeconomic policies targeted at job creation are reported to have increased urban employment from 7.3 million workers annually during the 1998–2002 period to nearly 10 million workers

[547] Typical examples cited include men in their 50s and women in their 40s, the general inability of women to take up reemployment in construction or other laborer jobs, employees in poor health, education only up to the junior middle-school stage, and upwards of three-quarters of such workers being classified as unskilled.

[548] Smyth, Qingguo, and Wang, "Labour Market Reform in China's State-Owned Enterprises," 42–72. One survey found some workers preferred taking early retirement to accepting reemployment, some collected their unemployment benefits while working informally (i.e., "moonlighting"), and other surveys found that many displaced state-sector employees have a strong preference for returning to employment in the state sector, often turning down available jobs as being below their expectations and at times disdaining private sector work on principle, calling it "inferior."

[549] "Circular by [the] CCCPC [sic] and the State Council on Making Further Efforts to Help Re-employment of Xiagang and Unemployed Workers," issued following a major national conference in September 2002 to address the deterioration in the urban unemployment situation. Zhang, "Urban Xiagang, Unemployment and Social Support Policies"; and Zheng, "Labor Market Policies in China."

[550] Zheng, "Labor Market Policies in China"; and Zhang, "Urban Xiagang, Unemployment and Social Support Policies," 10. Zhang reports the ten policy instruments as (1) [tax] reduction and exemption policies, (2) micro-credit policies, (3) social security subsidizing policies, (4) employment assistance policies, (5) policies on separating subordinate [SOE] business from core business, (6) employment service policies, (7) fiscal input policies, (8) social security policies, (9) downsizing policies, and (10) community platform policies. Whereas the new national social security system applies in principle to all urban workers (it does not currently apply to rural areas), its "implementation is not at all uniform." Portability of benefits remains a significant unresolved problem where different provinces provide different preferences, such as housing subsidies and pension insurance. Representative of Baker McKenzie LLP, interview with Commission staff, Shanghai, September 11, 2007.

[551] Wang, "China's Active Employment Policies."

annually during 2003–06. China's reemployment policies have provided microcredits[552] and tax reduction or exemptions for displaced workers who start their own businesses as entrepreneurs, granted funding to enterprises that reemploy laid-off workers, and have created subsidized public posts for over 5 million people.[553]

Public employment services have been established in more than 90 percent of communities and more than 70 percent of townships during the 2003–06 period.[554] Since 2003, the MOL reports that these employment agencies have provided free employment services to over 50 million laid-off workers and rural laborers. These agencies have reportedly organized reemployment training for 11 million laid-off and unemployed workers, of which 60 percent are said to have found subsequent employment. In 2006, the central government reported that it had begun implementing an employment program to develop labor skills of rural laborers, with approximately 8 million rural workers participating in vocational training.[555]

The International Labor Organization (ILO) reported that, at the end of 2004, there were 23,300 job centers in China provided by central government agencies, plus an additional 10,500 job centers run by other agencies at provincial and local government levels.[556] Resembling more job counseling centers than strictly job training and retraining programs, the ILO reported that these centers offer vocational guidance, skills testing, and job placement services to job seekers, as well as information about labor and social security laws, regulations, and policies for both job seekers and employers. China's central government contends that its active employment policies have helped stabilize the registered urban unemployment rate, although others contend that significant unreported unemployment or underemployment exists.[557] The Chinese government reported that its active employment policies are resulting in a more controlled and organized migration of rural workers to the cities, and that it has started providing worker training to rural-to-urban migrants.[558]

In March 2007, Premier Wen Jiabao stated that the central government would continue to deepen SOE reforms by continuing to relieve SOEs of their obligation to operate social

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[552] Microcredits and microfinance refer to credit services (including services provided by nongovernmental organizations, credit unions, nonbank financial intermediaries, and commercial banks) provided to small ("micro") enterprises. These services are provided either to individuals or groups, ranging from personal microcredit, to small enterprise support and rural finance. World Bank, "Micro-finance and Other Credit Mechanisms."

[553] One such example given was the creation of public jobs as street corner crossing guards. Representatives of Liaoning Provincial Development and Reform Commission, interview with Commission staff, Shenyang, China, September 4, 2007.

[554] Wang, "China's Active Employment Policies."

[555] Ibid.

[556] Hansen, "The Role Of Public Employment Services in the Delivery of Career Guidance."

[557] At year-end 2005, official registered urban unemployment was 8.4 million people (4.2 percent). Yan, "China's Employment Policies and Strategies." Researchers constructing internationally comparable measures of unemployment estimated that the unemployment rate in five major cities was closer to 14.0 percent, from which they estimated further that the unemployment rate grew from 6.1 to 11.1 percent among permanent urban residents from 1996 through September 2002. Fleischer and Tao Yang, "China's Labor Market," 26–27. Others have estimated actual unemployment rates in China at roughly double the official rate. Social and Economic Policy Institute. "Overview of Current Labour Market Conditions in China."

[558] Wang, "China's Active Employment Policies."

programs for workers.[559] He also stated that the Chinese government has sought to strengthen the social safety net for workers by establishing employment and reemployment policies to create jobs, particularly for workers laid off from SOEs, through various channels such as increased vocational and technical training; such programs have a particular focus on households with no employed resident.[560]

China's central government has reported that it will continue to develop new legislation to broaden the country's social security system and related employee benefits programs. For example, after more than two years of deliberation, the NPC Standing Committee passed the Employment Contract Law (ECL) in June 2007; the law is scheduled to take effect on January 1, 2008. The ECL will supersede certain provisions of employment contracts and company rules concerning a number of workplace issues.[561]

The Standing Committee passed the Employment Promotion Law on August 30, 2007. The law is to take effect January 1, 2008. Overall, the law aims to coordinate employment policies in urban and rural areas, providing part of the legal underpinning for the active employment policy being developed by the central government.[562] Included in the legislation is a provision that 2 percent of union funds are to be used for worker training programs.[563] The law is to regulate, in a uniform fashion, existing employment preferences and benefits, although if implementing regulations fail to specify the preferences, then no benefit is available. The implementing regulations are being drawn up by provincial and local governments and, consequently, different regional locations are likely to have different regulations.[564]

## *Provincial and Local Government Policies*

The impact of the central government's employment policies has varied significantly by region. Policies were less successful where resources were inadequate, particularly in economically depressed provincial and local governments and in SOEs that had insufficient resources to carry out worker training and retraining programs. According to one academic expert, official systems for state-run unemployment insurance "do not necessarily work" because all social security and safety net payments remain legally a local government responsibility.[565] The results of several major MOL reemployment

[559] Wen, "Report on the Work of the Government."

[560] This focus on securing at least one job for zero-employment households was emphasized in discussions with Commission staff. Interview by Commission staff, Liaoning Provincial Development and Reform Commission, Shenyang, September 4, 2007.

[561] These include company rules, collective bargaining, individual employment contracts, fixed term v. open term contracts, probationary period, training contracts, noncompetition restrictions, liquidated damages, summary dismissal of an employee, collective dismissals, protected categories of employees, termination payments, unlawful termination, and temporary agency workers, among others. Baker & McKenzie LLP, "Employment Contract Law Is Passed."

[562] Baker & McKenzie LLP, "Employment Promotion Law Is Passed," 3; *China View*, "China's Legislature Deliberates Draft Law on Employment Promotion"; and *China Daily,* "China Drafts Law to Ease Employment Pressure," February 26, 2007.

[563] Representatives of Baker McKenzie LLP, interview with Commission staff, Shanghai, September 11, 2007.

[564] Ibid.

[565] USITC hearing transcript, September 6, 2007, 154. Professor Bottelier noted that the central government may provide some supplemental funding in dire cases such as social unrest.

campaigns since 1994 have varied from province to province on the basis of age, gender, and educational background of the workers.[566]

Academic experts reported that the successful implementation of worker training and retraining programs remain a significant challenge for China, and that Chinese officials need to address worker training on a variety of levels.[567] They pointed out that China's rural-to-urban migrants typically are introduced into the urban workforce through employment in the service sector. These experts noted that, whereas universities provide high-tech training and others may attend business schools to learn entrepreneurial skills to start their own business, training in basic social skills in addition to work skills also may be necessary for unskilled rural workers to adapt to urban jobs such as nurses or chefs.

Chinese cities with abundant resources reportedly provide worker training and retraining programs. Box 4.6 describes worker training programs in Nanjing and in Shanghai municipality.

## Effectiveness of Worker Training Programs in Two Chinese Cities

An evaluation of job training in two Chinese cities found that the quality of training programs varied widely according to the training institutions.[568] In the northwest city of Shenyang (Liaoning province), a one-month training program was taught largely through the local labor bureaus and provided training in such areas as computer skills, cooking, beauty services, and sewing skills. In the central city of Wuhan (Anhui province), a more ambitious training program was taught largely at institutions of higher learning such as upper schools, colleges, and universities, with courses lasting approximately three months or more in such areas as computer skills, business management, cooking, repair work, and driving. The evaluation of the effectiveness of these two programs concluded that there was no greater likelihood of reemployment in Shenyang, although earnings increased for those who were reemployed. In contrast, there was a greater likelihood of reemployment after training in Wuhan, but there was no observed increase in earnings.[569]

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[566] Zeng, "China's Employment Challenges and Strategies after the WTO Accession."
[567] Representatives of Tsinghua University School of Public Policy and Management, interview with Commission staff, Beijing, September 6, 2007.
[568] Bidani et al., "Evaluating Job Training in Two Chinese Cities."
[569] Ibid.

**Box 4.6** China's provincial and municipal government training programs

Provincial and local governments often have significant leeway in determining how central government policies and programs are implemented. Below are illustrative examples of worker training and retraining programs formulated at the provincial and municipal level in response to central government policy.

***Worker training programs in Nanjing***

One example of current retraining efforts is a website operated by the China Construction Training Network which provides retraining information for regional Chinese job markets. The Labor Department of Nanjing announced, for example, its tenth procurement contract for vocational skills training for unemployed workers, issued on August 14, 2007. This training is to be provided free to newly laid off as well as already registered urban unemployed workers, offering training for posts in fields such as business, computers, health care, construction, and teaching.

***Worker training programs in Shanghai municipality***

In cities with more abundant resources, subsidies for worker training and retraining programs have also been more abundant. In Shanghai, for example, such training programs are available to unemployed workers, migrant rural workers, university graduates, as well as already employed or other approved workers. The person applies to the local labor bureau, selects from approximately 140 study possibilities, and pays for the training course, if approved. The government reimburses the cost either wholly or partially depending on how well the person proves their qualification with their new skills. Some 40,000 people participated in these programs in Shanghai in 2005. Nationwide, 26 million people are reported to have pursued training programs during 2001-06, funded largely by the central government although administered by the provincial and local governments. This training benefits a large number of workers who have migrated from rural to urban areas.

Source: Baker McKenzie LLP, interview with Commission staff, Shanghai, China, September 11, 2007, and China Construction Training Network.

## *Programs for the Agricultural Sector*

In October 2005, the CPC Central Committee stated that rebalancing the economy was a prime economic objective. To move toward this objective, targets were set for 2020, including efforts to help narrow the urban-rural and regional development gaps, improve income distribution, increase employment, and establish a social safety network covering both urban and rural regions.[570] In March 2007, Wen Jiabao stated that the central government will promote training in needed practical skills and development of human resources for rural workers.[571] These will include increased training of farmers in subjects such as scientific techniques for growing crops, raising livestock, and developing aquaculture products, as well as finding off-farm rural employment.[572]

[570] World Bank, *China Quarterly Update*, 15.

[571] Wen, "Report on the Work of the Government."

[572] The 11th Five-Year Plan (2006–10) includes policies aimed at more equitable growth between the rural and urban areas. Two key policies addressed rural education policy and rural health care. Free rural education for the nine years of compulsory education was reported to be implemented in 2007, three years ahead of the schedule approved by the 11th Five Year Plan, as was the rural health care insurance program which aims to subsidize health care costs for up to a goal of 80 percent of China's rural residents at the county level. World Bank, *China Quarterly Update*, 14–15.

## *Regulatory Environment*

China's current regulatory environment of central, provincial, and local government practices and policies for worker training and retraining is presented in table 4.12.

**Table 4.12** Worker training and retraining: Key regulatory practices and policies

| Regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | **Central government** | |
| Safeguarding the Basic Living Standards of Laid-off Workers in SOEs and their Reemployment. | • Central government policy to formulate a social security system to support SOE workers laid off as a result of SOE reform started as part of the 1994 Enterprise Law. The reform transfers social security obligations for these workers from SOEs (the central government) to provincial and local governments which, in turn, must develop and fund the variety of programs that result from the law's mandate. | 1998 |
| Circular on Making Further Efforts to Help Re-employment of Xiagang and Unemployed Workers | • Central government revision of the 1998 SOE social security system that revises and expands these benefits (such as contributions paid for pension, medical, unemployment insurance) to include not just SOE workers but also registered urban unemployed workers. One-third of the funding is to come one-third from provincial or local governments, one-third from the SOE, and one-third from the employee. | 2002 |
| Employment Contract Law | • Regulates aspects of employment contracts and company rules governing employee practices. Implementing regulations reportedly forthcoming by year-end 2007; provincial and local governments implement the law, often leading to significant regional variations in effect. | 2008 |
| Employment Promotion Law | • Makes existing employment preferences and benefits more uniform. Provincial and local governments also are drafting implementing regulations; likely to lead to significant regional variations in effects. | 2008 |
| | **Provincial and local government** | |
| The following are several illustrative examples of local level implementation of central government laws requiring worker training and retraining programs: | | |
| Shanghai Municipality Textile Reemployment Service Center | • Provided retraining for unemployed textile workers. Reemployment training classes in subjects such as computer techniques, accounting, cooking, and sewing skills. | Late 1980s |
| Shanghai Municipality Training and Retraining courses | • Provides approximately 140 courses of study, if approved, for unemployed workers, rural migrants living in the city, university graduates, and employed or other approved workers. Applicant pays for course, and is reimbursed, in whole or in part, by the local government upon proof of his/her qualification. | 2005 |
| Nanjing Labor Department: Vocational Skills Training | • Training is to be provided free to newly laid-off as well as already registered urban unemployed workers, offering training for posts in fields such as business, computers, healthcare, construction, and teaching. | 2007 |

Sources: Baker & McKenzie LLP. "Employment Promotion Law is Passed"; China Construction Training Network website; Dong, "China's Urban Labor Market Adjustment"; Representatives of Baker McKenzie LLP, interview with Commission staff, Shanghai, Sept. 11, 2007; Zeng, "China's Employment Challenges and Strategies after the WTO Accession"; and Zhang, "Urban Xiagang, Unemployment and Social Support Policies;

# CHAPTER 5
# Restraints on Imports and Exports

This chapter describes the policies and practices that central, provincial, and local government bodies in China currently use to support or influence decision making in China's agricultural, manufacturing, and services sectors with respect to restraints on imports and exports. China's main restraints on foreign trade include restrictions and reduced incentives for export processing (exports produced using imported inputs afforded duty-free treatment); tariff-rate quotas on certain agricultural products and fertilizer; a lack of transparency with respect to customs regulations and burdensome documentation requirements; the administrative burden associated with an automatic import licensing regime; burdensome and inconsistently applied product certification requirements; government procurement measures that favor domestic products over imports; nontransparent sanitary and phytosanitary standards; the administrative burden associated with an export licensing regime; export taxes; restraints on exports of certain apparel; and export privileges tied to a firm's environmental performance.

China's main laws covering international trade in goods include the 2004 Foreign Trade Law, the 2001 Customs Law, the 2005 Regulations on Import and Export Tariff, and numerous other laws and regulations. China also has numerous laws and regulations with respect to international trade in services. These laws and regulations are not specifically analyzed in this report. The discussion of services in this report focuses primarily on China's market access commitments for trade in services. China's practices and policies with respect to restraints applied to imports and exports are summarized in tables 5.1. (restraints on China's imports) and 5.2 (restraints on China's exports).

## Imports of Goods

The principal restraints on imports into China are tariffs; restrictions on imports used for processing trade; quantitative restrictions including import licensing, tariff-rate quotas (TRQs), and import restrictions; and other nontariff barriers including lack of customs transparency, restrictions on imports of used equipment, product certification requirements, government procurement practices, sanitary and phytosanitary measures, and nontransparent antidumping regulations.

### *Tariffs*

China's simple average MFN applied tariff was 9.9 percent ad valorem in 2006, but for agricultural products the average was 15.7 percent and for nonagricultural products trade it was 9.0 percent.[573] China's trade-weighted average tariff rate was 4.7 percent in 2005, the most recent year for which data are available: 15.4 percent for agricultural products

[573] WTO, *China's Tariff Profile*.

**Table 5.1** Restraints on imports: Summary of key practices and policies

| **Practices and policies** | **Associated laws and regulations** |
|---|---|
| | **Central government** |
| Tariffs | • 2004 Foreign Trade Law |
| Reduced tariff preferences for imports under processing trade relief (PTR). Some imported products excluded from PTR; other products require deposits before being imported. | • Ministry of Commerce and other agency announcements in 2007 (multiple notices) |
| Approximately 740 items currently are subject to automatic import licensing, including certain machinery, electrical equipment, motor vehicles, aircraft, boats and ships, measuring instruments, chemicals, steel and steel products. | • 2004 Foreign Trade Law<br>• Regulation on the Administration of the Import and Export of Goods<br>• Administrative Permission Law<br>• Measures for Administration of Automatic Import Licensing for Goods<br>• Various ministerial announcements |
| Tariff rate quotas (TRQs) and import licensing for imports of certain agricultural and fertilizer products. | • 2004 Foreign Trade Law<br>• Interim Measures on Administration of Tariff Rate Quota for Importation of Agricultural Products and for Importation of Fertilizers |
| Nontransparent import licensing process. | • Interim Measures on Administration of Tariff Rate Quota for Importation of Agricultural Products and for Importation of Fertilizers |
| Restrictions on imports of certain technologies and machinery in order to promote indigenous innovation. | • S&T Plan (see the discussion of "Research and Development" in chap. 4 of this report) |
| Lack of customs transparency and uneven application of customs regulations. | • 2001 Customs Law |
| Burdensome documentation requirements and pre-shipment inspections for imports of used equipment. | • 2001 Customs Law<br>• 2002 Law on Import and Export Commodity Inspection |
| Product certification process for imports may be burdensome and expensive for foreign suppliers. | • 2002 Regulations for Compulsory Product Certification |
| Government procurement law does not apply to SOEs. Chinese governmental entities are not obligated to include foreign participation for government procurement. | • 2003 Law on Government Procurement |
| Nontransparent sanitary and phytosanitary regulations and practices, including failure to notify the WTO of some SPS measures. Use of nontransparent and non-internationally accepted standards. | • 2002 Law on Import and Export Commodity Inspection |
| Antidumping and countervailing duty regime is nontransparent. | • 2004 Foreign Trade Law<br>• Antidumping Regulations |
| Reservations on service industries for which China has made WTO accession commitments, and for service industries where China made no market access commitments. | • None applicable |

Source: Ministry of Finance, Ministry of Commerce and General Administration of Customs; WTO, Committee on Import Licensing, Replies to Questionnaire"; and WTO, *Trade Policy Review: China*.

**Table 5.2** Restraints on exports: Summary of key practices and policies

| Practices and policies | Associated laws and regulations |
|---|---|
| **Central government** | |
| Certain goods subject to export taxes. | • Regulations on Import and Export Tariff. |
| Export licensing regime, including export quotas, export quota bidding, and export licenses. | • Foreign Trade Law<br>• Administrative Regulations on Commodity Import and Export |
| Regulation that restricts exports from companies that violate domestic pollution control regulations | • Environmental Regulatory Notice no. 392, Oct. 8, 2007 |
| Export licenses limit exports of certain textiles and apparel to certain annual quantity thresholds. | • Bilateral agreements with the United States (2006) and the European Union (2007) |
| Regulation that restricts exports from companies that violate domestic pollution control regulations to control undesirable export growth. | • Ministry of Commerce and Environmental Protection, Agency Environmental Regulatory Notice no. 392, Oct. 8, 2007 |
| Cancellation and elimination of export VAT rebates to control the growth of China's trade surplus, optimize the commodity structure of its exports, reduce the export of products with high energy consumption, serious pollution, and low value added, promote sustainable economic development, and curb trade friction. | • Ministry of Finance announcements (several) 2007 |

Source: China Ministry of Finance, Ministry of Commerce and General Administration of Customs; WTO, Committee on Import Licensing, Replies to Questionnaire"; and WTO, *Trade Policy Review: China*.

and 4.2 percent for nonagricultural products.[574] China's value-added tax (VAT) is also assessed on imports.[575] According to the WTO, China applies lower tariffs to sectors in which China has an apparent comparative advantage, such as labor-intensive farm products.[576]

[574] China's 2005 trade-weighted tariff rate probably reflects duty-free treatment of products covered by the WTO's Information Technology Agreement and other WTO tariff concessions. The effective tariff rate may actually be lower because of tariff preferences in free-trade agreements and unilateral Chinese policies; duty-free treatment for imported inputs for assembly of exported products under the processing trade relief regime as well as in export processing zones and free-trade zones; and in-bond exemptions for imported machinery as an incentive for foreign direct investment.

[575] The VAT is discussed in the section on "Taxation" in chap. 3 of this report. For imports, the VAT is applied on the value of the good (customs value) plus the applicable customs duty. See Liu, *Taxation in China*, 318.

[576] WTO, *Trade Policy Review: China*, 168.

## *Restrictions on Processing Trade Imports*

China's processing trade sector involves the importation of inputs to be used in the production of semi-finished or finished goods solely for export. [577] China's processing trade relief (PTR) program affords duty-free treatment for imported materials and production machinery used by firms involved in processing trade production, and VAT rebates upon export of processing trade goods. A significant share of China's foreign trade occurs under the PTR program. In 2006, processing trade accounted for about one-half of the value of China's total imports and about 40 percent of China's exports.[578]

China's central government has issued regulations since 2004 to restrict or prohibit imports used under the PTR program, as well as to restrict or prohibit the types of products that can be exported under the PTR program.[579] These PTR program restrictions and prohibitions have been applied to encourage the processing trade sector to become more globally competitive; to increase indigenous[580] innovation in China; and to decrease processing trade activities that consume high amounts of energy, generate high levels of pollution, and produce low-value-added goods.[581]

Beginning in 2006, China excluded products of animal origin, minerals, mineral fuels, certain chemicals, copper products, nickel products, other base metal products and certain miscellaneous manufactures from the PTR program.[582] In April 2007, China tightened its auditing and scrutiny of processing trade companies. In July 2007, China made numerous tariff lines, covering mainly plastics, fabrics, textile materials, furniture, and rough metal products, subject to PTR program restrictions and prohibitions.[583] Firms importing these restricted items were required to make a cash deposit between 50 and 100 percent of the potential customs duty and VAT on the materials and to export finished products within certain time frames. However, these new restrictions were not applied to companies operating within certain customs supervised areas, such as export processing zones or free trade zones, but this still resulted in a substantial portion of processing trade

[577] In China, an import or export must be declared as "processing" at Customs. Chinese trade statistics record two types of processing imports and exports: customs regime 14, "processing and assembly," where the foreigner retains ownership of imported inputs (and exports made therefrom); and customs regime 15, "processing with imported inputs," where the importer acquires ownership of imported inputs (and exports made therefrom). Both "processing and assembly" and "processing with imported inputs" can be performed by either Chinese- or foreign-owned firms.

[578] Global Trade Information Services, China Customs trade data, trade regime, 2006.

[579] In 2004, China prohibited 305 products (HS 8-digit level) from being imported or exported under the PTR program. Another 30 products (HS 10-digit level, mainly steel-related) were added to the list of prohibited products under the PTR program in early 2005, and alumina and ferro-alloy products were added to the list of later that year. WTO, *Trade Policy Review: China*, 103.

[580] China's indigenous innovation policies are discussed in the section on "Research and Development" in chap. 4 of this report.

[581] Ministry of Commerce, "Circular Concerning Reinforcing the Administration of Processing Trade."

[582] Ministry of Finance, "Circular on Adjusting the Export Rebate Rate" and PricewaterhouseCoopers, "Processing Trade Prohibitions," *China Customs & Trade News*, December 2006.

[583] Ministry of Commerce and General Administration of Customs, "Promulgating List of Commodity Restricted for Processing Trade."

activities being subject to the new measures. Furthermore, processing trade companies in the central and western regions, where there is relatively little processing trade activity, were less adversely affected because they were only required to establish a bank account at a designated bank as a guarantee, but no cash deposit was required.[584] In September 2007, following complaints from some provincial and local governments, [585] the central government relaxed the requirement for cash deposits for enterprises importing restricted items in the eastern region to allow for bank guarantees based upon credit lines to be used in lieu of cash deposits.[586]

## *Quantitative Restrictions*

China uses quantitative restrictions, including an import licensing regime and import restrictions, to restrain imports and to accomplish certain economic policy goals. China has notified the WTO of three import licensing regimes: import licensing, automatic import licensing, and TRQs. [587]

### Import Licensing and Automatic Import Licensing

China's import licensing regime appears to continue the policies it imposed prior to its WTO accession. It is regulated under the Foreign Trade Law, the Regulation on the Administration of the Import and Export of Goods, the Administrative Permission Law, and the Measures for Administration of Automatic Import Licensing for Goods. [588] Licensing is predominately applied to products covered by China's commitments under international conventions, such as for products that may be used in weapons of mass destruction, chemicals used to produce narcotics, ozone-depleting substances, and endangered species.[589]

China requires automatic import licensing for certain products for which the central government seeks to monitor import levels. Approximately 740 items currently are subject to automatic licensing, including certain machinery, electrical equipment, motor vehicles, aircraft, boats and ships, measuring instruments, chemicals, steel and steel products. [590] Applicants must apply for licenses, which are valid for a limited period of

[584] Deloitte, "New Curbs on Processing Trade Relief (PTR)."

[585] The adjustment in the regulations came in response to complaints from some eastern provincial and local governments, as well as lobbying by the Hong Kong government, that the July 2007 regulations requiring cash deposits added unduly to the burden of Chinese processing trade exporters. Such Chinese exporters were already facing rising raw materials costs and the abolishment of export incentives in the form of export VAT rebates. Li, "China Delays Curbs on Exporters"; and Hong Kong industry officials, interviews with Commission staff, Hong Kong, September 10 and 11, 2007.

[586] Ministry of Commerce, "Ledger Margin Method of Payment Notice"; and Hong Kong industry officials, interview with Commission staff, Hong Kong, September 11, 2007.

[587] WTO, *Trade Policy Review: China*, 80.

[588] Tdctrade.com, *Foreign Trade Law of the People's Republic of China*; and WTO, *Trade Policy Review: China*, table AII.2, 265.

[589] WTO, *Trade Policy Review: China*, 78.

[590] Ibid., 79.

time, and receive the license in order to import.[591] China issued a catalog of products subject to automatic licensing in December 2006, which was modified in March 2007 and May 2007, eliminating from automatic licensing a large number of products that were not subject to tariffs.[592]

## Tariff-Rate Quotas

China maintains TRQs on imports of certain agricultural and fertilizer products.[593] TRQs limit imports by subjecting overquota imports to higher import tariffs, in addition to the requirement of a license to import.[594] Table 5.3 shows China's imports under TRQs, by volume and by fill rates, for January–July 2007:

**Table 5.3** China's tariff rate quota regime: Import volumes and fill rates, January–July 2007

| Products | Import volume (tons) | Fill rate (percent) |
|---|---|---|
| cotton | 1,400,000 | 156.6 |
| nitrogen-phosphorous-potassium fertilizers | 920,000 | 26.7 |
| sugar | 690,000 | 35.5 |
| diammonium phosphate | 540,000 | 7.8 |
| rice | 260,000 | 4.9 |
| wool | 200,000 | 69.7 |
| wheat | 80,000 | 0.8 |
| maize (corn) | 10,000 | 0.1 |
| wool tops | 10,000 | 12.5 |
| urea | 0 | 0.0 |

Source: WTO, Committee on Market Access, "Communication from China," 3.

[591] Applications for automatic import licenses must be submitted to entities authorized by MOFCOM, including the MOFCOM Bureau of Quota and License Affairs, corresponding departments in the provincial government, and 16 local MOFCOM Special Commissioner's offices (for products including photographic products, textile and clothing products, some alcohol products, agricultural products, and waste and scrap metals); MOFCOM, corresponding departments in the provincial government, and 16 local MOFCOM Special Commissioner's offices and the designated Office of Import and Export of Machinery and Electronic products in other central government ministries and commissions (for products including machinery, engines and air conditioners); and the MOFCOM Bureau of Quota and License Affairs, and MOFCOM departments in the provincial government (for products including petroleum and chemical and related products). WTO, *Trade Policy Review: China*, 80.

[592] Ministry of Commerce and the General Administration of Customs, Announcement no. 113, December 10, 2006; Ministry of Commerce and the General Administration of Customs, Announcement no. 14, March 10, 2007, and Announcement no. 43, May 20, 2007; and WTO, Committee on Import Licensing, "Communication from the People's Republic of China."

[593] Most of the products China subjects to TRQs also are also subject to the limitation that significant shares of both imports and exports are reserved for state-trading enterprises and price controls. These limitations are described in more detail See the section on "Price Coordination" in chap. 3 of this report.

[594] Interim Measures on Administration of Tariff Rate Quota for Importation of Agricultural Products (issued by MOFCOM and the NDRC), and the Interim Measures on the Administration of Tariff Rate Quota for Importation of Fertilizers (issued by the former State Economic and Trade Commission and the General Administration of Customs). WTO, *Trade Policy Review: China*, 77.

China's practices in administering certain TRQs are an issue of concern for certain trading partners. On July 17, 2007, MOFCOM announced, without further explanation, the suspension of all wool imports even though the official quotas for 2007 were far from being filled.[595] China's central government reportedly issues initial quota and above-quota licenses to domestic entities but does not make public announcement of the volume, timing, or applicable tariff rate, thus resulting in a lack of transparency in the licensing process and the operation of the TRQ.[596]

### Import Restrictions

China bans or restricts imports of certain technologies and machinery.[597] Banned items are prohibited from importation, and restricted items are subject to import licensing. In November 2007, China issued a new catalog of banned and restricted technologies in order to implement aspects of China's S&T Plan related to promoting the development of indigenous innovation.[598] The new catalog seeks to restrict certain imports and to guide Chinese companies to import advanced and appropriate technologies to promote their assimilation and use for domestic innovation. The catalog lists 126 technologies in 19 industries.[599]

## *Other Types of Nontariff Barriers*

### Customs Transparency

Practices at China's ports of entry by customs authorities, particularly with regard to product classification and other regulatory interpretations, result in lengthy delays in customs clearance. In addition, the information required by China's customs authorities located in the provinces varies considerably.[600] Misinterpretations may result in higher import duties and fees while lengthy delays at customs facilities may result in customers shifting from imported to domestic sources of supply, as the foreign supplier may be perceived as being unreliable. Some U.S. exporters report long delays by Chinese

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[595] Ministry of Commerce officials confirmed to Australia that 110,000 metric tons (MT) of the raw wool quota (287,000 MT) was unfilled and that 70,000 MT of the wool top quota (80,000 MT) was unfilled. The Honorable Warren Truss MP, Minister for Trade, Australia, "China Wool Quota Talks Remain Positive," media release, August 13, 2007.

[596] WTO, Committee on Agriculture, "Questions to China."

[597] According to the WTO, China notified the WTO of its import prohibitions under Article XX at the HS 8-digit level; the latest notification was made in December 2004; Chinese authorities provided the WTO with data on import prohibitions and other restrictions for 2005 for the 2006 WTO *Trade Policy Review* of China. WTO, *Trade Policy Review: China*, 75.

[598] The S&T Plan is discussed in greater detail in the section on "Research and Development" in chap. 4 of this report. Ministry of Commerce, "Catalog of Banned and Restricted Technology Imports," Order no. 7, 2007, October 23, 2007.

[599] WTO, Council for Trade in Goods, "Questions from the United States to China," 2.

[600] American Association of Exporters and Importers, written submission to the USITC, August 17, 2007, 1.

customs authorities in approving import entries, and also note that customs clearance may be held up because of unpublished regulations.[601]

### Restrictions on Imports of Used Equipment

China imposes burdensome documentation requirements for foreign exporters of used equipment shipped to China. Rather than accept verification from well-known third party agencies, as is the common practice elsewhere in the world, China requires a preshipment inspection by a Chinese official in the exporting country. The expense of this inspection report can be greater than the value of the equipment.[602]

### Product Certification

China requires tests and certification for some products under regulations promulgated under the State Bureau of Quality Control Inspection and Quarantine (now the General Administration of Quality Supervision, Inspection, and Quarantine).[603] Product certification may be burdensome to exporters because of the product testing expense, delays in getting products into the Chinese market, and the need to meet Chinese product specifications.

Under China's product certification system, products that meet China's quality and safety standards receive the China Compulsory Certificates (CCC) mark and then may be sold in the Chinese market.[604] In January 2007, China issued a new list of products requiring the CCC mark, totaling 320 products.[605] Concerns expressed by U.S. industry about China's product certification practices are: (1) only Chinese laboratories are authorized for conducting the product tests; (2) there is no provision for accepting third-party testing outside of China and foreign exporters to China face long delays because of the lack of third party testing availability;[606] (3) the process is expensive;[607] (4) Customs enforcement in China is inconsistent with regard to the requirement for the CCC mark;[608] (5) for many electrical items, the CCC mark system accepts only products built to

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[601] Ibid., 2, and Society of the Plastics Industry, written submission to the USTR, September 17, 2007, 3–4.

[602] Society of the Plastics Industry, Inc., written submission to the USTR, September 17, 2007, 3–4.

[603] State Bureau of Quality Control, Inspection, and Quarantine, Order no. 5, "Regulation Concerning Management of Compulsive Product Certification," (effective May 1, 2002).

[604] The 2002 Regulations for Compulsory Product Certification requiring CCC marks became fully operative in August 2003.

[605] Products covered by the CCC mark include low-voltage electrical apparatus; welding machines; IT products; motor vehicle tires; latex and emulsion products; fire protection service; solvent coatings; cable and wire; fractional horse-power motors; household and similar electrical appliances; lighting apparatus; safety glasses; telecommunications terminal equipment; security and protection products; toys; switches (for circuits, installation protective or connection devices); electric tools; audio and video equipment; motor vehicles and safety parts; agricultural machine products; medical devices; and wireless local-area networks.

[606] USTR, "China," *2007 NTE Report*, 94.

[607] National Electrical Manufacturers Association, written submission to the USTR, September 5, 2007.

[608] Ibid.

Chinese national standards or other standards that preclude many products built to U.S. requirements;[609] and (6) the CCC regulations appear to be trade restrictive on several sectors, including automobiles.[610]

## Government Procurement

China is currently not a signatory to the WTO Agreement on Government Procurement (GPA), although China committed in 2006 to begin formal negotiations to join the GPA no later than December 31, 2007.[611] China reportedly has used government procurement regulations to favor domestic products over imports as a means to encourage local innovation.[612] China's Government Procurement Law does not apply to purchasing by SOEs.[613] Although foreign firms sell some products to central, provincial, and local governments in China, Chinese governmental entities are not obligated to include foreign participation for procurement. Moreover, China's Government Procurement Law states that procurement is to be conducted to facilitate the government's goals of economic and social development.[614]

## Sanitary and Phytosanitary Measures

China, like most other countries, maintains numerous laws, regulations, and practices regarding sanitary and phytosanitary (SPS) measures, in order to protect human, animal, and plant life and health, and for food safety. Some of China's SPS measures result in no or limited imports, as well as rejected imports, thus restraining trade. Exporters to China report being adversely affected by a lack of transparency in many of the numerous laws, regulations, and practices.[615] The lack of transparency includes China's failure to notify the WTO of some SPS measures. Also a concern among trading partners is China's maintenance of its own norms, rather than adopting international conventions regarding food and agriculture.

China has a policy enforcing zero tolerance of certain pathogens and growth hormones in meat and poultry products,[616] and China frequently rejects products because of contamination or additives in other products. This has resulted in China banning or

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[609] Ibid.

[610] WTO, Committee on Market Access, "Communication from the European Communities," 2–3.

[611] USTR, "The U.S.-China Joint Commission on Commerce and Trade."

[612] Chinese industry representative, interview with Commission staff, Shanghai, China, September 7, 2007, and U.S. Chamber of Commerce, *Issues of Importance to American Business in the U.S.-China Commercial Relationship*, 21.

[613] WTO, *Trade Policy Review: China*, 60.

[614] Ibid., 96–7.

[615] WTO, Committee on Sanitary and Phytosanitary Measures, *Report to the Council for Trade in Goods on China's Transitional Review*.

[616] U.S. Chamber of Commerce, *Issues of Importance to American Business*, 49. The zero tolerance requirements for certain pathogens is cited as Standardization Administration of China and General Administration of Quality Supervision, Inspection, and Quarantine of the People's Republic of China National Standard on Fresh and Frozen Poultry Products (GB16869-2005), 2005, effective January 1, 2006, as noted in WTO, Committee on Sanitary and Phytosanitary Measures, *Report to the Council for Trade in Goods on China's Transitional Review*, 2.

suspending imports of a number of products from various countries. Recent examples of import bans or suspensions include:

- Bananas (dried) from the Philippines (August 2007);[617]
- Fish and other aquatic products from Indonesia (August 2007);[618]
- Chicken and pork products (July 2007) and pork products (August 2007) from certain U.S. processing plants;[619]
- Beef from the United States (December 2003), based in part on concerns about bovine spongiform encephalopathy (BSE).[620]

Specific U.S. concerns about access to China's market for beef include China's sanitary packaging requirements, China's requirements for export certificates,[621] and China's limits on animal age and product range which the United States cites as inconsistent with international standards.[622]

Other SPS measures China applies to restrict imports include:

- China's restrictions on the type of materials used in food packaging and food-contact materials sold in the Chinese market. Under the Food Hygiene Law regulations, new materials may be added to the list of approved materials by petitioning the Ministry of Health; however, the regulations do not specify the procedures for obtaining approvals for new materials;[623]
- China's plant regulatory system restricting plant imports reportedly goes beyond International Plant Protection Convention recommendations;[624]
- China's ban on imports of beef from the EU, where China's interpretation of the World Organization for Animal Health guidelines precludes imports from the EU; and

[617] Information on the duration of the ban was not available. Go, "Banana Chip Exports Seen to Drop by 10%."

[618] The statement issuing the ban described it as "temporary," but gave no indication when imports could resume. *Reuters*, "China Bans Indonesian Fish Imports on Health Fears."

[619] George Reynolds, "US Urges China to Lift Pork and Poultry Ban," MeatProcess.com (July 17, 2007) http://www.meatprocess.com/. According to another source, China's "standards are regularly used to randomly stop the import of U.S. poultry products at the port of entry." U.S. Chamber of Commerce, *Issues of Importance to American Business*, 49.

[620] China banned imports of U.S. beef following the discovery of BSE in a Canadian-born cow in the state of Washington in late 2003. In late May 2007, the World Organization for Animal Health classified the United States as a "Controlled Risk" region for BSE. Controlled Risk is the second highest safety rating.

[621] R-CALF United Stockgrowers of America, written submission to the USITC, August 17, 2007, 7.

[622] USDA, FAS, *China Livestock and Products Annual Report 2007*.

[623] Restrictions issued under China National Standard GB 9685-2003, issued by the Ministry of Health. Society of the Plastics Industry, Inc., written submission to the USTR, September 17, 2007, 6-7.

[624] WTO, Committee on Sanitary and Phytosanitary Measures, "Communication from the European Communities," 3.

- China's reliance on end-product testing of food imports where the standard is set much lower for certain pathogens than is allowed for in international conventions.

### Antidumping Duties

China maintains 101 outstanding antidumping duty orders covering 34 products as of November 13, 2007. [625] In addition, China has 9 suspension agreements in effect.[626] Under the WTO agreements, including Article VI of GATT 1994, a country may impose antidumping duties on imports of a good when it finds that the export price of imports of the good is less than the "normal value" of the good and such imports cause or threaten to cause material injury to a domestic industry or materially retard the establishment of a domestic industry. The United States has raised questions in WTO forums about China's antidumping regime, including with respect to the transparency of the regime, margin calculations, a lack of access to documents filed by domestic parties, and a lack of sufficient opportunity to present and rebut arguments.[627]

## Imports of Services

Restraints on China's imports of services or foreign investment in services (services delivered through the channel of direct investment) include limited coverage for service industries for which China has made WTO accession commitments and bans or restrictions for service industries where China made no market access commitments. Restrictions and prohibitions on foreign investment in China's service industries were recently listed in the Industrial Catalog for Foreign Investment.[628] China's 2004 Foreign Trade Law and other regulations address China's WTO services obligations and commitments. China imposes restraints on imports of services by:

- excluding certain sectors from its WTO Accession General Agreement of Trade In Services (GATS) Schedule of Concessions;[629]
- for sectors in its GATS schedule, limiting certain modes of operation through horizontal commitments, leaving certain modes of delivery of services "unbound" (i.e., not binding its commitments), and placing restrictions on participation, such as requiring joint ventures with domestic partners, or limiting equity participation;[630] and

[625] These measures are implemented pursuant to China's 2004 Foreign Trade Law and the Antidumping Regulations. WTO, *Trade Policy Review: China*, 83, citing the Foreign Trade Law and the Anti-Dumping Regulations (promulgated by Decree No. 328 of the State Council on November 26, 2001, and amended on March 31, 2004).

[626] WTO, Committee on Anti-Dumping Practices, "Semi-Annual Report Under Article 16.4 of the Agreement: China"; Ministry of Commerce, "Bisphenol A Notice of Anti-Dumping Injury," 2007 Notice no. 68, August 29, 2007; and Ministry of Commerce, "Methyl Ethyl Ketone from Japan, Taiwan, and Singapore: Notice of Preliminary Ruling," 2007 Notice no. 67, August 8, 2007.

[627] WTO, "Questions from the United States to China."

[628] NDRC, "Industrial Catalog for Foreign Investment"

[629] WTO, *Trade Policy Review: China*, 208–209.

[630] Ibid., table AIV.2, 298.

- requiring foreign participants to meet certain capital thresholds;[631]

Sources reported a number of concerns regarding foreign market access for services in China. For example, in banking, equity limits on acquisitions result in foreign banks having to develop their own branch networks placing them at a disadvantage with domestic banks that already had branch networks in place before China's WTO accession.[632] China's requirement for mandatory automobile collision insurance, which can only be provided by domestic insurance companies, forces foreign insurance providers to partner with a domestic company in order to gain access to this portion of the market.[633] In construction services, recently issued circulars on licensing regulations have resulted in foreign construction engineering service firms being unable to obtain class A licenses because they cannot develop the required work experience in China under the previous set of regulations (those that existed prior to decree 114 issued in 2007). Without the license, foreign construction engineering firms cannot readily develop the work experience required for the license to work on large projects that are currently open for bids, so these firms will have to spend several years developing their work experience before applying for the license, therefore they are precluded from class A work for several years.[634]

# Exports of Goods

The major practices and policies that China uses to restrain exports are export taxes and quantitative restrictions (export quotas, quota bidding, and licenses, agreements with trade partners to restrict exports of certain textile and apparel products, and export privileges tied to environmental performance). A recent reduction in VAT rebates for exports may also discourage exporting. China's restraints on exports of goods are described below. Key regulatory practices and policies are shown in table 5.5.

## *Export Taxes*

China applies export taxes to a limited number of products under the Regulations on Import and Export Tariff. China uses export taxes to deter exports and conserve exhaustible resources,[635] to promote the development of the certain industries and, according to the WTO, to "implicitly subsidize domestic downstream processing."[636] Many of the products subject to export taxes are raw materials, giving Chinese producers an incentive to export processed or finished products instead of raw materials. Global

[631] Ibid., AIII.9, 294.

[632] Banking is discussed in more discussion in the section on "Banking and Finance" in chap. 4 of this report.

[633] Foreign industry representatives, interview with Commission staff, Chongqing, September 3, 2007.

[634] See discussion in the section on "Infrastructure Development" in chap. 4 of this report.

[635] WTO, *Trade Policy Review: China*, 44.

[636] Ibid., 99.

competitors may face higher raw material costs if these export taxes are levied on raw materials for which China is an important global supplier.[637]

The list of products subject to export taxes is revised annually. Few products were subject to export taxes after 2003; however, since late 2006 China has expanded the number of products subject to export taxes.

Effective January 1, 2007, China's tariff schedule listed approximately 100 different products with export tax rates ranging from 20 to 40 percent. Some recently announced export tax increases include:

- In November 2006, China imposed export taxes on approximately 100 products in order to lower energy consumption, reduce pollution, and curtail exports of certain natural resource commodities.[638] The list of products included rare earth, metallic and other minerals (10 percent export tax); coal, coke, crude oil, and other energy products (5 percent export tax); certain primary nonferrous metal products (15 percent export tax); certain iron and ferroalloy products and a number of miscellaneous products (10 percent export tax).
- In May 2007, again to reduce energy consumption, pollution, and certain natural resource exports, China raised the export tax on a number of steel and certain natural resource products (from 0 to 5 percent); on other steel products, rare earths, and nonferrous metal products (from 0 to 10 percent); and of steel inputs including coke, as well as other specialized metal raw materials (from 5 or 10 percent to 15 percent).[639]
- Seasonal export taxes of 20 percent and 10 percent were levied on exports of phosphate and hydroxyapatite from June–December 2007 to ensure that adequate supplies would be available for the domestic market.[640]
- A 15 percent tax on exports of nonalloyed aluminum profiles, bars, and rod was levied in August 2007 to reduce energy consumption, pollution, and industrial commodity exports.[641]

[637] Copper and Brass Fabricators Council, written submission to the USITC, August 17, 2007, 26–28; Norandal U.S.A., Inc., written submission to the USTR, September 17, 2007, 10–14; and American Iron and Steel Institute, written submission to the USTR, September 17, 2007, 15–16.

[638] Ministry of Finance, "The State Council Tariff Regulations Committee on the Reorientation of Some of the Goods: Import and Export Tentative Tax Notice," Tax Authority 30, October 27, 2006.

[639] Ministry of Finance, "Recently China Will Adjust Its Tariff Rates for Imports and Exports of Some Commodities," May 21, 2007; and General Administration of Customs Notice no. 22, 2007, May 30, 2007.

[640] Ministry of Finance, "China Will Impose Export Tariffs on DAP and Phosphate Rock from June 1, 2007," May 11, 2007.

[641] Ministry of Finance, "China's Recent Adjustment of the Tariff on Aluminum Products," July 19, 2007. 2007).

- In August 2007, China announced a new tax on exports of crude oil owned by foreign parties under Sino-foreign cooperative exploitation contracts for marine oil.[642] Neither the rate nor the reason were specified.

## *Quantitative Restrictions on Exports*

China's quantitative restraints include export licensing (export quotas, quota bidding,[643] and licenses), agreements with trade partners to restrict exports of certain textile and apparel products, and, recently, export privileges tied to environmental performance. These restraints are discussed below.

### Export Licensing

Export licenses are permission from the government to export a specific product over a specific period of time. China' export licensing regime includes export quotas, export quota bidding, and export licenses. These practices appear to be a continuation of policies enacted prior to its WTO accession and can be found in its 2004 Foreign Trade Law[644] and Administrative Regulations on Commodity Import and Export. The main policy objectives of China's export licensing regime, quotas, and quantitative restraints include: protecting against supply shortages; to prevent the exhaustion of natural resources; meeting national security or public needs; fulfilling international commitments; and monitoring exports.[645] The list of products subject to export quotas, export quota bidding, and licenses in China appears below. The list of products requiring export quotas and/or licenses recently has been expanded:[646]

- **Export quotas and licenses**: corn, rice, wheat, cotton, lumber, live cattle (to Hong Kong and Macao), pigs (to Hong Kong and Macao), live chickens (to Hong Kong and Macao), silk and silkworm cocoons, coal, coke, crude oil, refined oil, rare earths, antimony and antimony products, tungsten and tungsten products, zinc ore, tin and tin products, and white silver. Beginning in June 2007, indium and molybdenum were added to the list. Export quotas are generally reserved for state-trading enterprises.[647]

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[642] Ministry of Finance and General Administration of Customs, Bulletin no. 20, 2007, July 4, 2007.

[643] Export quota bidding generally involves firms bidding for a portion of a quota allocation.

[644] Tdctrade.com, Hong Kong Trade Development Council, *Foreign Trade Law of the People's Republic of China*, May 31, 2004.

[645] WTO, *Report of the Working Party on the Accession of China*, 32.

[646] Ministry of Commerce, the General Administration of Customs Notice No. 100, 2006, "2007 Export License Management Directory of Goods and the 2007 Border Trade Export Permit Small Cargo Directory Management," December 22, 2006.

For information on the quota levels, see Ministry of Commerce, Announcement No. 90 2006, "On the Total Volume of Export Quota of Agricultural Products, Industrial Products and Silk Product in 2007," October 30, 2006.

[647] Ministry of Commerce, the General Administration of Customs Notice no. 54, 2007, "Indium and Molybdenum Export Quota License Management," June 11, 2007.

- **Export quota bidding and licenses**: Lin lin (rush) grass and grass products, silicon carbide, fluoride stones (powder), slippery stones (powder), light-weight burned magnesium, bauxite, licorice and licorice products.[648]
- **Licenses**: Live cattle (for markets outside of Hong Kong and Macao), pigs (for markets outside of Hong Kong and Macao), live chickens (for markets outside of Hong Kong and Macao), chilled and frozen beef, chilled and frozen pork, chilled chicken meat, frozen chicken, ozone-depleting substances, paraffin, platinum (export processing trade), zinc and zinc-based alloys, certain rare metals, electric fans, automobiles (including complete sets of parts), chassis, bicycles, motorcycles (including all-terrain vehicles), motorcycle engines, and tractors. China announced an export license requirement for natural sand beginning in March 2007.[649] China announced export license requirements for certain steel products covering 83 HS codes in April 2007.[650]

China subjects a number of raw materials, many of which are specialized metals used in a variety of industries, to exports quotas despite the fact that China is a leading global producer of many of these products. The United States has expressed the concern that these quotas may increase the prices of these raw materials on the international market, effectively providing raw materials for China's domestic end users at below world market prices.[651] The EU has expressed concerns about China's export quotas applied to nonferrous metals, chemical industry raw materials, coke, rare earths, and raw hides and skins.[652]

## Restraints on Exports of Certain Textiles and Apparel

Following the expiration of the Miltifiber Arrangement on January 1, 2005,[653] China reached agreements with the United States and the EU to limit its exports of certain textiles and apparel to certain annual quantity ceilings. Under these agreements, China issues export licenses[654] and allocates a portion of the ceiling levels specified in the agreements through a bidding process to Chinese exporters. The U.S.–China agreement

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[648] WTO, *Trade Policy Review: China*, 106.

[649] Ministry of Commerce and General Administration of Customs, Announcement no. 26, 2007.

[650] Deloitte, *Tax News*.

[651] WTO, China's Transitional Review Mechanism, "Communication from the United States."

[652] WTO, Committee on Market Access, "Communication from the European Communities."

[653] The Multifiber Arrangement (MFA) governed world trade in textiles and apparel from 1974 through 2004. At the heart of the MFA were a set of bilateral agreements between developed-country importers, such as the United States, and developing-country exporters such as China. The MFA did not apply to trade among developed countries. U.S. Department of Agriculture, Economic Research Service, "The World Bids Farewell to the Multifiber Arrangement," *Amber Waves*, February 2006, 1.

[654] WTO, *Trade Policy Review: China*, 108–109.

entered into force on January 1, 2006, and is to expire December 31, 2008.[655] The EU–China agreement also entered into force in 2006, and was scheduled to expire January 1, 2008. On October 9, 2007, the EU and China announced a new agreement under which China would continue to issue licenses for exports to the EU and would provide certain license data to the EU for monitoring of import levels, with that arrangement covering all of 2008.[656]

### Export Privileges Tied to Environmental Performance

China issued a new regulation in October 2007 that restricts exports from companies that violate domestic pollution control regulations to control undesirable export growth.[657] Such growth has generated illegal discharge of pollutants, sewage, and increased pressure on resources and the environment. The priority sectors cited in this regulation are metallurgy, chemical, cement, textile, and light industry. Companies violating domestic pollution control regulations may lose their ability to export through denial of export licenses and quota allocations for up to three years.[658]

## *Reduction or Elimination of VAT Rebates on Exports*

China generally provides for a partial rebate of the VAT[659] incurred on raw materials or components either imported into China or purchased locally when products are exported. Recently, China continued its policies of reducing rebates for exports.[660] Since September 2006, China has reduced or eliminated VAT export rebates for a wide range of products in order to support the central government policy goals of controlling the growth of China's trade surplus and reducing international trade friction; optimizing the commodity structure of its exports; reducing exports of products that have high energy

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[655] The United States and China established agreed levels for certain cotton, wool, man-made fiber, silk blend and other vegetable fiber textiles and textile products, produced or manufactured in China and exported to the United States during three one-year periods in accordance with the *Memorandum of Understanding (MOU) between the Governments of the United States of America and the People's Republic of China concerning Trade in Textile and Apparel Products*, signed and dated November 8, 2005, and paragraph 242 of the Report of the Working Party for the Accession of China to the WTO, which allowed for transitional safeguard measures due to actual or imminent increase in market share or volume of imports from China. See *Memorandum* and 70 Fed. Reg. 74777-74779 (December 16, 2005).

[656] European Commission, "EU and China Decide on Textile Import Monitoring System for 2008."

[657] Ministry of Commerce and Environmental Protection Agency, "On Strengthening Export Enterprises," Environmental Regulatory Notice no. 392, October 8, 2007.

[658] Ibid.

[659] China's VAT is described in the section on "Taxation" in chap. 3 of this report.

[660] During 1994–2006, China restraints on export VAT rebates included partial VAT rebates, rebate reductions, very long lags in rebate payments to exporters, multiple withdrawals of rebate privileges, both for broad swaths of products and for particular products, and major reforms in the system in 2001 and 2004. WTO, *Trade Policy Review: China*, 100–102.

and resource consumption and generate high pollution levels; and promoting sustainable economic and social development.[661]

Key recent policy adjustments under China's new VAT export rebate policy are:

- September 2006: cancelled the VAT export rebate for certain nonmetallic products (e.g., coal, natural gas, olefin, bitumen, silicon, arsenic, stone materials, etc.), metallic ceramics, certain pesticides, leather, certain batteries, and other miscellaneous products; reduced the VAT export refund rates on a number of metallic, ceramic, and other products;[662]
- April 2007: cancelled the VAT export rebate for 83 steel products, reduced the rebate rate to 5 percent for 76 other steel products; and
- June 2007: Undertook measures covering 2,831 specific commodities, including

  (1) eliminated the VAT export rebate for 553 "high energy consuming, high polluting, and scarce resource-consuming" products, including leather, chlorine, dyes and other chemical products, certain industrial chemicals, certain fertilizers, metal carbide and activated carbon products, certain lumber and one-time-use wooden products, unalloyed aluminum poles and other certain nonferrous processed metal goods, certain ships and boats; the refund rates for these products ranged from 5 to 13 percent;

  (2) reduced the VAT export refund rate by 2 to 8 percentage points for 2,268 products that might potentially be involved in trade disputes, including certain electronic machinery, apparel, shoes, hats, luggage and bags, toys, plastics, rubber and rubber products, certain chemicals, certain base metals and products thereof, bicycles, motorcycles and certain automobiles, vegetable oils; and

  (3) exempted peanuts and certain art work from being subject to the VAT upon export.[663]

## *Regulatory Environment*

China's current regulatory environment of central government practices and policies that act to restrain imports and exports is presented in table 5.4.

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[661] "Circular of the Ministry of Finance, the National Development and Reform Commission, the Ministry of Commerce, the General Administration of Customs and the State Administration of Taxation on Adjusting the Export Rebate Rate for Some Commodities and Supplementing the Prohibitive Catalog for the Processing Trade," no. 139, September 14, 2006; "Supplementary Circular of Ministry of Finance, General Administration of Taxation on Relevant Issues Adjusting Tax Refund Rate of Some Commodities," no. 145, September 29, 2006; Ministry of Finance, State Administration of Taxation, "Steel Export Tax Rebate Notice" no. 64, April 9, 2007; and Ministry of Finance and the State Administration of Taxation, "Notice Regarding the Adjustment in Export Reform Rate for Certain Commodities," no. 90, June 18, 2007.

[662] PriceWaterhouseCoopers, "Major Revision to the Chinese VAT Export Refund," *China VAT Alert*, September 2006.

[663] Deloitte, "China Export Rebate Policy; and Ernst & Young, "China Further Reduces VAT Refunds on Export Goods."

**Table 5.4** Restraints on imports and exports: Regulatory environment

| Regulatory practice/policy | Description | Year of entry into force |
|---|---|---|
| | **Central government (general trade-related)** | |
| Foreign Trade Law | • Main law covering international trade | 2005 |
| Customs Law | • Governs customs and related matters | 2001 |
| Regulations on Import and Export Tariff | • Contains tariff schedule | 2004 |
| | ***Imports*** | |
| Processing trade: Adjusting the Export Rebate Rate for Some Commodities and Supplementing the Prohibitive Catalog for the Processing Trade," Circular no. 139 (Ministry of Finance, NDRC, the Ministry of Commerce, the General Administration of Customs and the State Administration of Taxation) | • Lists products prohibited from the processing trade relief program. | 2006 |
| Processing trade: Processing trade restrictions product catalog, Notice no. 44, (Ministry of Commerce and General Administration of Customs) | • Details 1,853 commodity codes added to the list of restricted products in the processing trade relief program. Enterprises importing restricted materials must now pay increased cash deposits ranging from 50 to 100 percent of the MFN tariff rate and VAT. Currently 2,247 commodity codes covered in the Restricted Catalogue. Does not apply to EPZs, FTZs, or other customs supervised zones. | 2007 |
| Licensing: Promulgating commodity catalog prohibited for the processing trade, Notice no. 17 ( Ministry of Commerce, General Administration of Customs, and State Environmental Protection Administration) | • Lists products prohibited from importing, exporting, or both importing and exporting, under the processing trade relief program. Prohibited products are treated as general trade, and subject to customs duties and VAT. Does not apply to EPZ, FTZ, or other customs supervised zones. | 2007 |
| Licensing: Promulgating the list of commodities under automatic import licensing administration, Announcement no. 14 (Ministry of Commerce and General Administration of Customs) | • A new list of commodities that require automatic import licensing; 338 products were removed from the list leaving 700 or so items on the list. | 2007 |
| Licensing: Ministry of Commerce and General Administration of Customs, Announcement no. 43 | • Eliminates 32 items required to be licensed under the automatic import licensing administration. | 2007 |
| Licensing: Ministry of Commerce and the State Administration of Taxation on announcing the catalog of commodities under the Import License Management in 2007, Announcement no. 99 | • Covers 10 Chinese 8-digit HS tariff codes but 57 products. The products covered are ozone-damaging chemicals. | 2007 |
| Licensing and tariff-rate quotas: Ministry of Commerce, State Development and Reform Commission, Notice no. 4 | • Products include certain grains (wheat, maize, and rice), vegetable oil, sugar, tobacco, crude oil and processed oils, chemical fertilizer, wool, and cotton | 2003 |
| Regulations for Compulsory Product Certification | • Establishes a list of products which require China Compulsory Certificate (CCC) mark | 2003 |

**Table 5.4** Restraints on imports and exports: Key regulatory practices and policies, central government—*Continued*

| Regulatory practice/policy | Description | Date of entry into force |
|---|---|---|
| | ***Exports*** | |
| Export tariffs: Regulations on Import and Export Tariff, and General Administration of Customs, Announcement no. 75 | • The State Council Tariff Commission decides which products are subject to export tariffs. Customs administers the decision. | 1992 and 2007 |
| Export VAT rebates: On Adjusting the Export Rebate Rate for Some Commodities and Supplementing the Prohibitive Catalog for the Processing Trade," Circular no. 139 (Ministry of Finance). This announcement also covered processing trade and is listed in imports above. | • Lists products prohibited from the processing trade relief program | 2006 |
| Export VAT rebates: Notice Regarding the Adjustment in Export Reform Rate for Certain Commodities, no. 90, (Ministry of Finance and the State Administration of Taxation) | • Lists goods no longer eligible for export VAT rebates (553 products), goods entitled to reduced export VAT rebate rates (2,268 products), and goods entitled to VAT-free exports (i.e., not subject to an output VAT charge upon export). | 2007 |
| Export licensing: Ministry of Commerce and General Administration of Customs, on promulgating license administration on exports of certain steels | • Requires export licenses for certain steel products | 2007 |
| Export licensing administration: Export License Management Directory of Goods and the 2007 Border Trade Export Permit Small Cargo Directory Management, Notice no. 100, (Ministry of Commerce and General Administration of Customs) | • Lays out the export licensing administration for 2007, including export licenses, export quotas, export quota bidding, and export state trading. | 2007 |
| Environmental Regulatory Notice no. 392, Oct. 8, 2007 | • Restrictions on exports from companies that violate domestic pollution control regulations | 2007 |

*Source:* China Ministry of Finance, Ministry of Commerce and General Administration of Customs; and WTO, *Trade Policy Review: China*.

# CHAPTER 6
# Summary of Positions of Interested Parties

In its June 27, 2007, *Federal Register* notice for this investigation,[664] the Commission invited interested parties to appear at the public hearing held for this investigation on September 6, 2007, and to provide written submissions in lieu of, or in addition to, participating in the hearing. Five interested parties testified at the Commission's September 6, 2007, public hearing. A summary of the views of those interested parties is presented below.

In addition to inviting public comments for the purpose of this report, the Commission's June 27 *Federal Register* notice also invited "testimony or written submissions, identifying the industries, products, or services in which Chinese government policies and interventions are prevalent and in which leading U.S. exports have not penetrated the Chinese market, as well as public comments regarding the sectors that are perceived to be the primary drivers of the U.S.-China trade deficit." Such information is to be used for a second report the Commission is preparing on China involving sector- and industry-based case studies requested by the Committee of Ways and Means (*China: Governmental Policies Affecting U.S. Trade in Selected Sectors*, Investigation 332-491, forthcoming).[665]

## Pieter P. Bottelier, School of Advanced International Studies, The Johns Hopkins University

In testimony, Pieter Bottelier stated that China used to have a large bilateral trade surplus with the United States and, to a lesser extent with the European Union, "but a relatively balanced overall current account until the second half of 2004."[666] He stated that "China's overall trade surplus since 2004 is of a structural nature and is likely to grow in the years ahead. It appears to be related . . . to domestic economic imbalances, especially high investment rate in manufacturing sector, and high profitability levels that fuel the investment." He reported that China's domestic imbalances and trade surplus are "mutually reinforcing," and stated that "China needs more forceful action to address the domestic and foreign trade imbalances."

[664] A copy of the *Federal Register* notice can be found in app. A.

[665] A copy of the letter from the Committee on Ways and Means of the U.S. House of Representatives requesting this report and two other reports on China is provided in app. A.1.

[666] This quote and the other quotes in this section are from Pieter P. Bottelier, testimony before the U.S. International Trade Commission, September 6, 2007.

Mr. Bottelier contended that China is a competitive global economy. He stated that China's exchange rate is undervalued, but he also stated that he does "not believe that this [undervaluation] is the root cause of China's trade surplus with the United States or with the world." He noted that China's trade surplus is more related to China's productivity growth, efficient financial intermediation, and declining logistics costs as a result of the country's investment. Mr. Bottelier stated his belief that "China is becoming a very efficient producer," and that most observers "have underestimated the extent to which sheer productivity growth is underlying the dynamics of what's going on in China today. He also stated that Chinese exporters are now able to increase their prices and still increase their profitability and not show domestic excess capacity because "China's market share in so many products globally has become so large that the larger exporters amongst them are beginning to work as market price leaders. They were always price takers. Now the Chinese, the larger exporters amongst them are beginning to be price leaders."

Mr. Bottelier stated that the sectors most responsible for China's widening trade surplus are steel and steel products, heavy machinery, apparel, and electronics and other light manufactures. He also stated that China has acknowledged overinvestment in sectors including steel and nonferrous metals. He observed that "China has learned how to use the whole world to use, to absorb in a way its excess capacity." The enterprises responsible for the growing trade surplus are not SOEs, but rather domestic private enterprises, foreign-investment companies, and joint ventures. He stated that "[t]he vast majority of companies in China are private companies, mostly domestically owned private companies," that "[n]inety percent of all companies now are private companies in China . . . subject to very fierce market competition, that "[t]here's very little state support or state protection" in China's globally competitive industries, and that "60 percent of Chinese exports is done by foreign invested corporations."

According to Mr. Bottelier, other factors, such as the China's privatization of urban housing and the privatization of SOEs, have generated cash flow to help finance China's investment boom. He stated that China's import-substitution policies also were a significant contributor to China's global trade surplus because such policies reduce China's need to import inputs and other goods that were traditionally imported.

Mr. Bottelier said that China's use of subsidies has changed over the years: "I think the notion that the Chinese state still completely controls everything that goes on in the Chinese economy is completely wrong. Also that the Chinese state is distributing subsidies left, right and center I think may have been true at some point in the past. It's certainly not true anymore today." He contended that the practice of accumulating nonperforming loans as a way of providing subsidies to SOEs ended in 2002 after Chinese officials recapitalized the banks. "I don't think that we can point since 2002 to further significant accumulation of nonperforming loans, which was a disguised way of subsidizing industry in China. These are arguments of the past. They are no longer arguments of the present." He argued that, in recent years, "[t]he Chinese state has relied more on competition than on subsidies to promote certain industries." He acknowledged that China may still employ subsidies, but also stated that "these are all relatively insignificant factors relative to the phenomenal productivity increase."

Mr. Bottelier also reported that China's central government does not control economic decision making at the provincial and local levels. "China is not controlled by Beijing, it's controlled by provincial governments, county governments, municipal governments who may have an incentive framework and a set of objectives that doesn't exactly coincide with the Beijing set of objectives."

# The American Iron and Steel Institute and the Steel Manufacturers Association

The American Iron and Steel Institute (AISI) is composed of 31 member companies, including integrated and electric furnace steelmakers, and 130 associate and affiliate members who are suppliers to or customers of the steel industry. AISI's member companies represent approximately 75 percent of both U.S. and North American steel capacity. The Steel Manufacturers Association (SMA) is a trade association for scrap-based electric arc furnace steelmakers. The SMA is composed of 39 North American companies that operate 125 steel plants and employ approximately 40,000 people; the SMA also has six international steel company members in countries outside of North America.

In their written submission[667] and hearing testimony, [668] AISI and SMA stated that the extent of government ownership of China's steel industry is far greater than previously reported. They report that 8 of the 10 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. Even where shares of Chinese steel producers are publicly traded, the government commonly continues to own a controlling interest, and the scale of government ownership is often disguised through a complicated web of holding companies. [669] Extensive government ownership also makes it difficult to compare the profitability of Chinese companies to foreign counterparts because it is very hard to get financial information on Chinese enterprises. [670]

According to AISI and SMA, although China faces the same global iron prices as do U.S. producers (about $80 per ton), Chinese producers "turn around and sell the finished product for the price of the raw materials and yet they show a profit on the books." [671]

AISI and SMA identified in their written submission the following government policies and practices in China to encourage steel production:

- Central, provincial, and local government involvement in decision making in steel industries;

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[667] AISI and SMA, written submission (prehearing brief), August 20, 2007.

[668] Alan H. Price, Wiley Rein, LLP, on behalf of the AISI and SMA, testimony before the U.S. International Trade Commission, September 6, 2007.

[669] Ibid., and AISI written submission (prehearing brief), August 20, 2007.

[670] Alan H. Price, Wiley Rein, LLP, on behalf of the AISI and SMA, testimony before the U.S. International Trade Commission. September 6, 2007.

[671] Ibid.

- Preferential loans and directed credit;
- Equity infusions and/or debt-to-equity swaps for Chinese steel companies;
- Use of land at little or no cost;
- Government-mandated mergers, permitting acquisitions at little or no cost;
- Slow movement on closure of uneconomic plants, with closure often just a reorganization of assets rather than an actual reduction in industry size; and
- Direct cash grants for specific steel construction projects.

## The Copper and Brass Fabricators Council

The Copper and Brass Fabricators Council (Council) is a trade association of nineteen companies, accounting for over 80 percent of U.S. production of semifabricated copper and copper-alloy products. In its written submission, the Council stated that its member companies are under increasing competitive pressure over the last five or six years, particularly due to the emergence of China since its WTO accession in December 2001.[672] Council data shows that U.S. production of semifabricated copper and copper-alloy products decreased from 3.8 million tons in 2000 to 3.2 million tons in 2006, a decline of 16.2 percent.[673] The Council contends that the decline was caused by (1) escalating raw material costs caused by the surge of scrap exports to China; (2) a surge in imports of semifabricated copper and copper-alloy products into the United States; and (3) the erosion of the U.S. copper and brass mills' customer base in the United States.[674] By contrast, production of the same products in China has expanded significantly over the same time period. The Council states that China's industrial sector is transitioning a large number of small-scale producers into large-scale professional enterprises.[675]

According to the Council, the Chinese copper and brass mill industry is not developing through market forces.[676] Instead, the government is implementing a comprehensive plan to encourage the development of copper and brass production instead of importing from the United States and other established producers. In December 2006, the State Assets Supervision and Administration Commission (SASAC) issued a directive that identified the nonferrous metals sector, including the copper and brass industry, as one of the key industries in which central SOEs should become "heavyweights," and state capital must play a leading role. According to SASAC's Chairman, Li Rongrong, the targeted industries "are the vital arteries of the national economy and essential to national security."[677]

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[672] Copper & Brass Fabricators Council, written submission (prehearing brief), August 17, 2007, 1.
[673] Ibid., 5.
[674] Ibid.
[675] Ibid., 9.
[676] Ibid., 2.
[677] Copper & Brass Fabricators Council, written submission (posthearing brief), September 20, 2007, 3.

The Council identified in its written submissions[678] certain government policies and practices in China to encourage copper and brass production, including:

- Undervaluation of the Chinese currency;
- Creation of "pillar industries" by SASAC, which encourages strong SOEs (discussed above);
- Government coordination of sufficient supplies of key inputs in cooper and brass production at the lowest prices;
- Investments with government money in foreign copper mines;
- Encouraging foreign investment with advanced technology;
- Preferential loans and directed lending ("policy-driven" loans) to SOEs;
- Loan forgiveness;
- Indirect subsidies through infrastructure development;
- Grants;
- Exemptions from taxes or preferential tax rates; (e.g., reduced taxes when purchasing Chinese-made capital equipment and 50 percent reduction in income tax rates for key industries meeting established production criteria);
- Lowering of tariffs on imports of raw materials and advanced technology equipment;
- Raising tariffs on exports of raw materials (e.g., 10 percent export taxes in 2005 and 2006 on copper scrap, blister, and cathode);
- Land grants or reduced land costs for SOEs, which have never been repaid;
- Subsidies for utilities and energy resources; and
- Related party transactions at non-arm's length prices for assets transferred from Chinese government-owned parent companies to copper and brass fabricators.

The Council urges the Commission to select the copper and brass sector as a sector for further study in the second of three China investigations requested by the House Ways and Means Committee.[679]

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[678] Ibid., 1, 5; Copper & Brass Fabricators Council, written submission (prehearing brief), August 17, 2007, 13-16, 18-23, 26-45.

[679] Ibid., prehearing brief, 2.

## Dewey Ballantine

Dewey Ballantine LLP is a U.S.-based international law firm. In its written submissions[680] and in hearing testimony,[681] representatives of Dewey Ballantine focused on conditions of competition in China and on China's draft antimonopoly law.

Dewey Ballantine acknowledged that China had consulted with many countries while drafting its antimonopoly law, but stated "there's no consensus among these countries that China has been consulting with about what competition policy ought to consist of." Dewey Ballantine expressed several concerns about China's draft antimonopoly law and the extent to which the new law will reduce legal uncertainties and facilitate doing business in China, particularly with respect to the definition of market dominance, intellectual property rights (IPR) practices, and exemptions to the law.

Dewey Ballantine stated that the way China has defined market dominance in the antimonopoly law was problematic because the definition includes practices that are considered standard commercial practices in the United States. "The way the Chinese law defines dominance is they would draw an inference of dominance if a company has half of a relevant market. They also draw an inference of dominance if two companies have two-thirds of a relevant market or three companies have three-quarters of a relevant market."[682]

Dewey Ballantine also expressed concerns about certain provisions concerning IPR protection in the draft antimonopoly law, particularly in light of focus on promoting indigenous innovation in China's 2006–2020 15-Year Science and Technology Plan.[683] Specifically, Dewey Ballantine stated that the "refusal to deal" provision in draft law "might be interpreted to apply to a situation in which a company with proprietary technology of some kind refused to license that to a Chinese enterprise," whereas "the U.S. position vis-à-vis intellectual property rights is that to provide an incentive for innovation it's necessary to allow innovators to have a monopoly if they have a protected IP, a patent or whatever, and that there's no such thing as charging too high a price or refusing to license."[684]

[680] Dewey Ballantine LLP, written submission (prehearing brief), August 16, 2007 and written submission (posthearing brief), September 20, 2007.

[681] Thomas Howell, Dewey Ballantine LLP, testimony before the U.S. International Trade Commission. September 6, 2007.

[682] Ibid.

[683] China's R&D policies, the 15-Year Science and Technology Plan, and the promotion of indigenous innovation are discussed in the section on "Research and Development" in chap. 4 of this report.

[684] Howell, testimony before the U.S. International Trade Commission; and Dewey Ballantine written submission (prehearing brief).

Dewey Ballantine also stated that not all sectors of China's economy dominated by SOEs appear to be governed by the antimonopoly law. Many sectors, including the agricultural sector and sectors controlled by SASAC,[685] reportedly are to be exempt from the law.[686] Dewey Ballantine noted that, "[s]tate ownership is not WTO illegal, but there's a general sense since the beginnings of the GATT that state ownership or state intervention in the market could be problematic."[687]

In testimony, Dewey Ballantine described some of the means by which China is addressing the issue of excess industrial capacity and overinvestment in certain sectors, stating that competition would be the best policy for dealing with these issues. They also noted that it would be difficult to obtain firm-level capacity and utilization data for Chinese enterprises.[688]

Dewey Ballantine testified that there continues to be disproportionate bank lending to China's SOEs, and reported that "a lot of politicized lending [is] still occurring." They also reported that many investment incentives favor foreign-invested enterprises, and that domestic complaints are forcing China's government to offer comparable benefits to domestic enterprises.[689] Finally, Dewey Ballantine testified that policy implementation in China varied from region to region, and that "there are many different policies that are implemented at the regional level that are inconsistent with what the central government wants." They particularly commended Shanghai for reducing obstacles for foreign enterprises.[690]

## National Electrical Manufacturers Association (NEMA)

NEMA is a trade association that represents 430 large, medium, and small businesses that manufacture products used in the generation, transmission and distribution, control, and end use of electricity. NEMA states that it promotes safety in the manufacture and use of electrical products, and provides a forum for the standardization of electrical equipment.[691]

In its written submission to the Commission, NEMA included a copy of its comments of September 5, 2007, to the USTR regarding China's compliance with its WTO commitments. NEMA expressed its concerns about product certification practices in China[692]:

- The process of obtaining China's Compulsory Certification (CCC) mark is expensive, customs enforcement with respect to the CCC mark is inconsistent, and it is unclear as to whether the CCC mark is actually needed.

[685] SASAC, a Chinese government agency created to manage certain SOEs, is described in more detail in chap. 2 of this report. SASAC has identified a number of key industries in which the Chinese government is to retain a majority ownership share.
[686] Howell, testimony before the U.S. International Trade Commission.
[687] Ibid.
[688] Ibid.
[689] Ibid.
[690] Ibid.
[691] NEMA, "About NEMA," http://www.nema.org/about/.
[692] Product certification is discussed in more detail in chap. 5 of this report.

- The national treatment China affords to non-Chinese electrical products often requires goods to be built either to Chinese national standards or standards that, in some cases, do not include products built to U.S. requirements.
- China requires exemptions for non-CCC inputs that are to be included as part of exported finished goods.
- China has redundant product testing requirements and refuses to accept data from internationally recognized laboratories.[693]

# The Ranchers–Cattlemen Action Legal Fund, United Stockgrowers of America (R-CALF USA)

R-CALF USA is a national organization that represents more than 15,000 U.S. cow/calf producers and independent stockers and feeders in 47 U.S. states on domestic and international trade and marketing issues. In its written submission, [694] R-CALF USA stated that China does not currently import large amounts of fresh, frozen, or chilled cuts of beef from the United States because of Chinese health and safety concerns related to BSE. [695] Consequently, most U.S. beef exports to China are lower-value offal and variety meats. However, even without China's BSE-related restrictions on U.S. beef, it was not clear to R-CALF USA how much larger U.S. beef exports to China would be because of China's focus on increasing domestic production.[696]

R-CALF USA stated that cattle and beef production in China grew significantly from 2000 to 2007, helping China to grow in importance as a global cattle and beef producer. Less than 0.03 percent of China's domestic beef demand is satisfied by imports. [697] In testimony, a representative of R-CALF USA stated that, in 2000, it was anticipated that China's beef demand would far exceed its beef production; instead, "the real surprise is . . . [Chinese producers] have managed to ramp up their domestic production in a much larger degree than what was ever imagined."[698] According to R-CALF USA, one reason that China has been able to increase its cattle and beef production significantly is "because of active government programs that encourage and support domestic production while shielding it from international competition."[699]

R-CALF USA further stated that "aggressive government policies in China to encourage investment, production and exports, and to discourage imports, may help China rise as a major producer and exporter of beef," particularly in light of the cost advantages Chinese producers have over U.S. producers. [700] In testimony, R-CALF USA stated that U.S.

[693] NEMA, written submission (posthearing brief), October 10, 2007.
[694] RCALF-USA, written submission (prehearing brief), August 17, 2007.
[695] China banned imports of U.S. beef following the discovery of BSE in a Canadian-born cow in the state of Washington in late 2003.
[696] Eric Nelson, chair, R-CALF USA Trade Committee, testimony before the U.S. International Trade Commission. September 6, 2007.
[697] R-CALF USA, written submission, August 17, 2007.
[698] Eric Nelson, chair, R-CALF USA Trade Committee, testimony before the U.S. International Trade Commission. September 6, 2007.
[699] R-CALF USA, written submission (prehearing brief).
[700] Ibid.

producers are “very sensitive to small changes in supply,” and expressed the concern that any future displacement of U.S. beef exports to third-country markets by Chinese beef exports would probably have an adverse impact on U.S. beef producers.[701]

R-CALF USA identified in its written submission[702] the following government policies and practices in China to encourage cattle and beef production:

- Abolition of agricultural taxes for the cattle and beef production sector since 2004;
- Preferential tax rates for cattle producers in western Chinese provinces through 2010;
- Subsidized grain prices to ensure adequate feed supplies;
- Market intervention to keep corn prices low in order to discourage exports and ensure adequate domestic feed supply;
- Technical training for cattle producers in techniques of artificial insemination to improve the country’s genetic stock for cattle;
- Low to zero tariffs on bovine semen and breeding stock to encourage imports and improve breeding stock;
- Government-financed infrastructure programs to improve feedlots and slaughterhouses in east-central China and assist cattle producers to build a competitive cattle and beef production industry in the region, as well as targets for infrastructure investment that ensure that at least 10 percent of investment in agricultural infrastructure is related to cattle production;
- Numerous preferential government policies directed at the cattle and beef production sector, including preferential access to land and utilities at discounted rates, access to credit and debt forgiveness from state-owned banks at favorable terms, price controls, and other tax and production subsidies;
- Non-science-based health and safety standards designed to restrict imports; and
- Undervaluation of the Chinese currency.

[701] Nelson, testimony before the U.S. International Trade Commission, September 6, 2007.
[702] R-CALF-USA, written submission (prehearing brief).

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# APPENDIX A
# About This Report

# About This Report

On May 29, 2007, the U.S. International Trade Commission (the Commission) received a request from the House Committee on Ways and Means (the Committee) under section 332(g) of the Tariff Act of 1930 (19 U.S.C. 1332(g)) that the Commission prepare three reports relating to U.S.-China trade. In its letter, dated May 23, 2007, the Committee noted that it had earlier, in a letter dated September 21, 2006, requested that the Commission prepare three reports relating to U.S.-China trade. In its May 23, 2007 letter, the Committee requested that the Commission augment the September 21, 2006 letter by adding two more components to its investigation in order to provide an in-depth assessment of the causes of the U.S.-China trade imbalance and whether and to what extent China uses various forms of government intervention to promote investment, employment, and exports. The first report under the revised schedule is to be delivered 7 months after receipt of the letter and the second and third reports, 14 and 24 months after receipt of the letter, respectively. This is the first of the three reports requested by the Committee in its May 23, 2007 letter.

# Congress of the United States
## U.S. House of Representatives

COMMITTEE ON WAYS AND MEANS

1102 LONGWORTH HOUSE OFFICE BUILDING
(202) 225-3625

Washington, DC 20515-6348

http://waysandmeans.house.gov



May 23, 2007

The Honorable Daniel R. Pearson
Chairman
U.S. International Trade Commission
500 E Street, S.W.
Washington, D.C. 20436

Dear Mr. Chairman:

The U.S. trade deficit in goods with China grew astronomically for the sixth consecutive year in 2006, reaching a record high of $233 billion. The size and persistent nature of this deficit raises serious questions about its causes, including to what extent the deficit is driven by government interventions in the Chinese economy. In particular, the People's Republic of China (PRC) maintains numerous policies, including subsidies, aimed at promoting investment, exports, and employment. Those policies appear to have a direct role in exacerbating the U.S.-China trade imbalance, and a deleterious effect on the health of our domestically-based manufacturers, service providers, and farmers.

Therefore, on behalf of the Committee on Ways and Means of the United States House of Representatives, under the authority of section 332(g) of the Tariff Act of 1930, I request that the Commission augment the Committee's letter of September 21, 2006, by adding two more components to the fact-finding investigation to provide an in-depth assessment of the causes of the U.S.-China trade imbalance, and whether and to what extent the PRC uses various forms of government intervention to promote investment, employment, and exports. To make these additional requests manageable, additional time is allotted to complete the tasks, as specified below. I expect to supplement this request with additional questions, including ones related to the functioning of China's labor market.

**Study I**

Study I should describe and where possible, quantify the practices and policies that central, provincial, and local government bodies in the PRC use to support and attempt to influence decision making in China's manufacturing, agricultural and services sectors, and by individual firms.

Study I should include, but not be limited to, chapters describing government policies and interventions related to: (1) the privatization of State-owned enterprises and private ownership; (2) price coordination; (3) industrial development, particularly policies that target specific industries; (4) the banking and finance sectors, including policies and interventions to promote indicative lending and on the treatment of non-performing loans; (5) utility rates; (6) infrastructure development; (7) taxation; (8) restraints on imports and exports; (9) research and development; (10) worker training and retraining; and (11) the rationalization and closure of uneconomic enterprises. The study should include an analysis of the likely impact of a recently announced policy directive from the PRC's State-Owned Assets Supervision and Administration Commission (SASAC), which raises serious concerns about PRC interventions in a number of sectors. The Commission is requested to deliver this first report no later than 7 months from the receipt of this letter.

**Study II**

Study II will build on Study I by comprehensively cataloguing and where possible, quantifying the government policies and interventions described in Study I in specific sectors. Study II should include case studies on sectors where leading U.S. exports have not penetrated the Chinese market, and on sectors which are the primary drivers of the U.S.-China trade deficit. Study II should also include case studies on sectors where government policies and interventions are prevalent, including the semiconductor, telecom, banking, textiles and apparel, steel, automotive parts and aircraft sectors. In addition, the ITC should seek public comment and input from other government agencies on other sectors that should be included as case studies. Where applicable, the case studies should identify how PRC policies and actions are exacerbating existing global overcapacity in specific sectors.

Study II substantially overlaps with a current investigation under section 332(g) being undertaken by the Commission on *U.S.-China Trade: Driving Factors and Impediments*. The ongoing study should be combined with Study II, consistent with the focus discussed above. The Commission is requested to deliver Study II no later than 14 months from the receipt of this letter.

**Study III**

In addition, I request that the Commission combine two requested studies under section 332(g), also related to U.S.-China trade. One Study, *U.S.-China Trade: Implications of U.S.-Asia Pacific Trade and Investment Trends* will describe changes in U.S.-Asia trade. The second Study, *U.S.-China Trade: Implications of China's Deepening Integration with the Global Economy* will assess how two global trends, the fragmentation of production processes, and the growth in foreign direct investment flows are contributing to the growth in the U.S. trade deficit with China. The combined report – Study III – should analyze the role of PRC policies, including subsidies and other interventions in spurring changes in patterns of production and investment in the Asia region. In addition, to the extent that the Commission finds that China serves as a production platform for other Asian countries, I request that the Commission identify the specific products for which it serves as a production platform, whether other Asian countries have ceased production of those products, and whether the composition and levels of U.S. trade with the other Asian countries have changed. I also request that the Commission analyze the growth in the U.S. trade deficit with other leading Asian trading partners, such as Japan and Korea, and the reasons for this growth.

As part of this combined Study, I also request that the Commission examine the impact of foreign-invested firms in bilateral trade between the United States and China. The Study should examine what percentage of foreign-invested firms' production supply and serve the Chinese market and what percentage supplies the U.S. and other global markets. As part of that examination, the Commission should examine the profitability of foreign-invested firms both as to their operations in serving the Chinese market and in their export activities. The Commission is requested to deliver the combined Study no later than 24 months from receipt of this letter.

It is the Committee's intent to make studies available to the public in their entirety. Therefore, the reports should not contain any confidential business or national security classified information.

Sincerely,

Charles B. Rangel
Chairman

**COMMITTEE ON WAYS AND MEANS**

**U.S. HOUSE OF REPRESENTATIVES**
**WASHINGTON, DC 20515**

Received @ ER - #084 on 10/2/06

September 21, 2006

The Honorable Daniel R. Pearson
Chairman
U.S. International Trade Commission
500 E Street, S.W.
Washington, DC 20436

Dear Chairman Pearson:

As you know, there has been dramatic growth in trade between the United States and China in recent years. According to official U.S. data, U.S. merchandise exports to and imports from China grew by 153 percent and 144 percent, respectively, between 2000 and 2005. China became the fourth largest market for U.S. exports and the second largest source of U.S. imports in 2005. By 2003 China had also become the sixth largest destination for U.S. foreign direct investment (FDI) among developing economies. Global FDI in China is closely linked to growth in China's trade with the United States. According to Chinese official data, foreign-invested enterprises accounted for 67 percent of Chinese exports to and 53 percent of Chinese imports from the United States in 2005. More than three-quarters of these exports and nearly half of these imports were processing trade - imports of intermediate goods to be assembled in China ultimately for re-exportation.

China's rapid growth and development over the last two decades have been fueled by its promotion of a more market-oriented economy, including more liberalized trade and freer foreign investment flows. However, there has been extensive debate about the causes of the recent growth in U.S.-China trade, particularly exports from China, and the extent to which this growth is driven by market forces or by Chinese domestic policies, such as discriminatory taxes or targeted loans. Analyzing U.S.-China trade growth would involve determining the key sectors accounting for such growth and assessing the relative roles of trade, investment, and domestic policies in fueling that growth. A deeper understanding of U.S.-China trade growth would require closer examination of China's processing trade with the United States and the world, the role FDI plays in that trade, and the effect of that interrelationship on the magnitude and composition of trade flows between China and the United States. Finally, U.S.-China trade growth should be evaluated in the larger context of U.S.-Asian trade because of the integral economic linkages that trade and FDI have created between China and other Asian countries.

Therefore, on behalf of the Committee on Ways and Means of the United States House of Representatives, under authority of section 332(g) of the Tariff Act of 1930, I request that the Commission institute three consecutive fact-finding investigations to provide an in-depth assessment of the U.S.-China trade and investment relationship and the U.S.-Asian trade and investment relationship, considering both historical and current trends. The details of these three investigations are specified in the following paragraphs.

Study I will analyze the principle trends and patterns in trade and foreign direct investment between Asian and Pacific countries and the United States and their implications for the U.S.-China trade relationship. This study will include a discussion of the main factors influencing these trends; an in-depth examination of the industries that have had a major effect on trade and investment patterns in recent years; and, if required, formal quantitative analyses that may help to explain these trends and provide an assessment of the reliability of the data used in each analysis. This study will also review the relationship between international trade and foreign direct investment, the trade and investment policies in the major countries of the region, and their effect on economic activity both on a global scale and within the Asian and Pacific region. The Commission is requested to deliver the first report no later than 12 months from receipt of this letter.

Study II will investigate the driving factors behind the rapid growth in U.S.-China trade, including identification of the key industries, products, and services that account for the rapid growth in U.S. exports to and imports from China; assessment of the role of U.S. and Chinese government trade and investment policy, special FDI and other incentives, and private ownership in explaining this growth; comparison of these findings with factors underlying the growth of U.S. and Chinese trade with the world; and review of China's role in the U.S. trade deficit and the importance of adjusting both U.S. and Chinese trade data to account for trade passing through Hong Kong. This study will also provide in-depth case studies of selected industries, products, and services to further illustrate the relative roles of comparative advantage, trade and foreign investment policy, private sector development, business practices, and other relevant domestic policies in explaining the growth of U.S.-China trade. The Commission is requested to deliver the second report no later than 18 months from receipt of this letter.

Study III will provide an in-depth examination of China's integration with the global economy through processing trade and FDI, and its implications for U.S.-China trade and investment. This study will include an analysis of: the extent of processing trade in China's total trade with the United States and the world and the industry characteristics (e.g., scale, capital-intensity) that influence its extent and pattern; the importance of FDI in China from the United States and other countries and the role of FDI in U.S.-China processing trade; qualitative and quantitative analysis of the joint impact of FDI and processing trade on the volume and composition of U.S.-China trade flows. The study will also: identify the leading areas of investment by sector, industry, product, leading source countries, and major types of FDI; and review the relevant trade, foreign investment, and domestic policies affecting FDI. The Commission is requested to deliver the third report no later than 24 months from receipt of this letter.

It is the Committee's intent to make these reports available to the public in their entirety. Therefore, the reports should not contain any confidential business or national security classified information.

Best regards,

Bill Thomas

Bill Thomas
Chairman

## INTERNATIONAL TRADE COMMISSION

**[Investigation No. 731–TA–894 (Review)]**

## Certain Ammonium Nitrate From Ukraine

### Determination

On the basis of the record[1] developed in the subject five-year review, the United States International Trade Commission (Commission) determines, pursuant to section 751(c) of the Tariff Act of 1930 (19 U.S.C. 1675(c)) (the Act), that revocation of the antidumping duty order on certain ammonium nitrate from Ukraine would be likely to lead to continuation or recurrence of material injury to an industry in the United States within a reasonably foreseeable time.

### Background

The Commission instituted this review on August 1, 2006 (71 FR 43516) and determined on November 6, 2006 that it would conduct a full review (71 FR 67366, November 21, 2006). Notice of the scheduling of the Commission's review and of a public hearing to be held in connection therewith was given by posting copies of the notice in the Office of the Secretary, U.S. International Trade Commission, Washington, DC, and by publishing the notice in the **Federal Register** on December 15, 2006 (71 FR 75579). The hearing was held in Washington, DC, on April 17, 2007, and all persons who requested the opportunity were permitted to appear in person or by counsel.

The Commission transmitted its determination in this review to the Secretary of Commerce on June 19, 2007. The views of the Commission are contained in USITC Publication 3924 (June 2007), entitled *Certain Ammonium Nitrate from Ukraine: Investigation No. 731–TA–894 (Review).*

Issued: June 20, 2007.

By order of the Commission.

**Marilyn R. Abbott,**

*Secretary to the Commission.*

[FR Doc. E7–12427 Filed 6–26–07; 8:45 am]

BILLING CODE 7020–02–P

[1] The record is defined in sec. 207.2(f) of the Commission's Rules of Practice and Procedure (19 CFR § 207.2(f)).

## INTERNATIONAL TRADE COMMISSION

**[Inv. No. 337–TA–546]**

## In the Matter of Certain Male Prophylactic Devices

### Order

This investigation was instituted on August 5, 2005, based on a complaint filed on behalf of Portfolio Technologies, Inc., of Chicago, Illinois. 70 FR 45422. The complaint, as amended and supplemented, alleged violations of section 337 of the Tariff Act of 1930, as amended, 19 U.S.C. 1337, in the importation into the United States, the sale for importation, and the sale within the United States after importation of certain male prophylactic devices by reason of infringement of claims 1–27, 31–33, and 36 of U.S. Patent No. 5,082,004. The respondents named in the investigation are Church & Dwight Co., Inc., of Princeton, New Jersey (''C&D''); Reddy Medtech, Ltd., of Tamil Nadu, India; and Intellx, Inc., of Petoskey, Michigan.

On June 30, 2006, the presiding administrative law judge (''ALJ'') issued a final initial determination (''ID'') in which he ruled that there is no violation of section 337 of the Tariff Act of 1930, as amended. He found that certain valid claims were infringed, but concluded that there was no domestic industry under the economic prong of the domestic industry requirement. All parties petitioned for review of various parts of the final ID.

On September 29, 2006, the Commission determined to review the issues of claim construction, infringement, invalidity due to anticipation, and domestic industry, and requested briefing on these issues and certain subissues. 71 FR 58875 (Oct. 5, 2006). On December 5, 2006, the Commission determined to affirm in part, reverse in part, and remand in part the final ID. Among other things, the Commission reversed the ALJ's finding of no domestic industry under the economic prong. The Commission also determined to extend the target date for completion of the investigation until June 5, 2007. The date was subsequently moved to June 21, 2007, by an unreviewed ID.

On March 19, 2007, the ALJ issued his remand ID (''IDR''), in which he ruled that there is a violation of section 337 based on the infringement of certain valid claims and the finding that there is a domestic industry. In further briefing before the Commission, all parties claimed error.

Having examined the parties' submissions and the record in this proceeding, it is hereby *ordered* that —

(1) The ALJ's finding of violation of section 337 is reversed;

(2) The ALJ's finding that the accused products infringe certain claims of U.S. Patent No. 5,082,004 is reversed;

(3) The ALJ's finding that the Twisted Pleasure product fails to meet the thickness limitation of claims 22 and 25 of the asserted patent is reversed;

(4) The ALJ's finding that C&D waived its argument that claim 31 of the asserted patent is invalid as anticipated by the prior art is reversed;

(5) The ALJ's finding that claims 1, 6, and 9 of the asserted patent are invalid in view of the prior art are reversed;

(6) The IDR is vacated except where consistent with the determination of the Commission;

(7) The motion of the Office of Unfair Import Investigations to file its reply out of time is granted;

(8) The investigation is terminated with a finding of no violation of section 337;

(9) The Secretary shall serve a copy of this Order and the Commission Opinion in support thereof, as soon as it is issued, upon each party to the investigation; and

(10) The Secretary shall publish notice of this order and termination of the investigation in the **Federal Register**.

Issued: June 21, 2007.

By order of the Commission.

**William R. Bishop,**

*Acting Secretary to the Commission.*

[FR Doc. E7–12400 Filed 6–26–07; 8:45 am]

BILLING CODE 7020–02–P

## INTERNATIONAL TRADE COMMISSION

**[Investigation No. 332–492]**

## China: Description of Selected Government Practices and Policies Affecting Decision-Making in the Economy

**AGENCY:** United States International Trade Commission.

**ACTION:** Institution of investigation and scheduling of public hearing.

**SUMMARY:** Following receipt of a request on May 29, 2007, from the Committee on Ways and Means of the U.S. House of Representatives (Committee) for a series of three reports under section 332(g) of the Tariff Act of 1930 (19 U.S.C. (332(g)) on U.S.-China trade, the Commission instituted investigation No. 332–492, China: Description of Selected

Government Practices and Policies Affecting Decision-Making in the Economy, for the purpose of preparing the first report.

**DATES:** August 17, 2007: Deadline for filing requests to appear at the public hearing.

August 17, 2007: Deadline for filing pre-hearing briefs and statements.

September 6, 2007: Public hearing.

September 20, 2007: Deadline for filing post-hearing briefs and statements and other written submissions.

December 29, 2007: Transmittal of Commission report to the Committee on Ways and Means.

**ADDRESSES:** All Commission offices, including the Commission's hearing rooms, are located in the United States International Trade Commission Building, 500 E Street, SW., Washington, DC. All written submissions should be addressed to the Secretary, United States International Trade Commission, 500 E Street, SW., Washington, DC 20436. The public record for this investigation may be viewed on the Commission's electronic docket (EDIS) at *http://www.usitc.gov/secretary/edis.htm.*

**FOR FURTHER INFORMATION CONTACT:** Project leaders James Stamps (202–205–3227 or *james.stamps@usitc.gov*) or John Fry (202–708–4157 or *john.fry@usitc.gov*) for information specific to this investigation. For information on the legal aspects of this investigation, contact William Gearhart of the Commission's Office of the General Counsel (202–205–3091 or *william.gearhart@usitc.gov*). The media should contact Margaret O'Laughlin, Office of External Relations (202–205–1819 or *margaret.olaughlin@usitc.gov*). Hearing-impaired individuals may obtain information on this matter by contacting the Commission's TDD terminal at 202–205–1810. General information concerning the Commission may also be obtained by accessing its Internet server (*http://www.usitc.gov*). Persons with mobility impairments who will need special assistance in gaining access to the Commission should contact the Office of the Secretary at 202–205–2000.

## Background

In its May 23, 2007, letter, the Committee noted that it had earlier, in a letter dated September 21, 2006, requested that the Commission prepare three reports relating to U.S.-China trade. In its May 23, 2007 letter, the Committee requested that the Commission augment the September 21, 2006, letter by adding two more components to its investigation in order to provide an in-depth assessment of the causes of the U.S.-China trade imbalance and whether and to what extent China uses various forms of government intervention to promote investment, employment, and exports. The Committee indicated that it may supplement its request with additional questions, including questions related to the functioning of China's labor market. The Committee also allotted more time to the Commission to submit its reports, with the first report under the revised schedule to be delivered 7 months after receipt of the letter and the second and third reports, 14 and 24 months after receipt of the letter, respectively.

This notice announces institution of an investigation related to preparation of the first report described in the Committee's May 23, 2007, letter. The Commission will issue notices concerning investigations that relate to preparation of the second and third reports at a later date. In its letter the Committee also expanded the scope of ongoing Commission investigation No. 332–478, U.S.-China Trade: Implications of U.S.-Asia-Pacific Trade and Investment Trends. The report in that investigation will be the third in the series of three reports, and the Committee has extended the transmittal date to May 29, 2009.

As requested by the Committee, in its first report the Commission will describe and where possible quantify the practices and policies that central, provincial, and local government bodies in China use to support and attempt to influence decision making in China's agricultural, manufacturing and services sectors, and by individual firms. The Commission's report will include, but not be limited to, chapters describing government policies and interventions related to: (1) The privatization of state-owned enterprises and private ownership; (2) price coordination; (3) industrial development, particularly policies that target specific industries; (4) the banking and finance sectors, including policies and interventions to promote indicative lending and on the treatment of nonperforming loans; (5) utility rates; (6) infrastructure development; (7) taxation; (8) restraints on imports and exports; (9) research and development; (10) worker training and retraining; and (11) the rationalization and closure of uneconomic enterprises. The Committee also requested that the Commission include an analysis of the likely impact of a recently announced policy directive from China's State-Owned Assets Supervision and Administration Commission, which the Committee indicated raises serious concerns about China's interventions in a number of sectors.

As requested by the Committee, the Commission will provide its first report to the Committee by December 29, 2007.

## Public Hearing

A public hearing in connection with this investigation and report will be held at the U.S. International Trade Commission Building, 500 E Street SW., Washington, DC, beginning at 9:30 a.m. on September 6, 2007. Requests to appear at the public hearing should be filed with the Secretary, no later than 5:15 p.m., August 17, 2007, in accordance with the requirements in the ''Written Submissions'' section below. In the event that, as of the close of business on August 17, 2007, no witnesses are scheduled to appear at the hearing, the hearing will be canceled. Any person interested in attending the hearing as an observer or nonparticipant may call the Secretary to the Commission (202–205–2000) after August 17, 2007, for information concerning whether the hearing will be held.

The Commission is also interested in receiving public comments, through hearing testimony or written submissions, identifying the industries, products, or services in which Chinese government policies and interventions are prevalent and in which leading U.S. exports have not penetrated the Chinese market, as well as public comments regarding the sectors that are perceived to be the primary drivers of the U.S.-China trade deficit.

## Written Submissions

In lieu of or in addition to participating in the hearing, interested parties are invited to submit written statements and briefs concerning this investigation. All written submissions, including requests to appear at the hearing, statements, and briefs, should be addressed to the Secretary to the Commission. All pre-hearing briefs and statements should be filed not later than 5:15 p.m., August 17, 2007; and all post-hearing briefs and statements and all other written submissions should be filed not later than 5:15 p.m., September 20, 2007. All written submissions must conform with the provisions of section 201.8 of the Commission's Rules of Practice and Procedure (19 CFR 201.8). Section 201.8 requires that a signed original (or a copy so designated) and fourteen (14) copies of each document be filed. In the event that confidential treatment of a document is requested, at least four (4) additional copies must be filed, in which the confidential information must be deleted (see the following paragraph for further information regarding confidential business information). The Commission's rules authorize filing submissions with the Secretary by facsimile or electronic means only to the extent permitted by section 201.8 of the rules (see Handbook for Electronic Filing Procedures, *http://www.usitc.gov/secretary/fed_reg_notices/rules/documents/handbook_on_electronic_filing.pdf*). Persons with questions regarding electronic filing should contact the Secretary (202–205–2000 or *http://www.usitc.gov/secretary/edis.htm.*

Any submissions that contain confidential business information must also conform with the requirements of section 201.6 of the Commission's Rules of Practice and Procedure (19 CFR 201.6). Section 201.6 of the rules requires that the cover of the document and the individual pages be clearly marked as to whether they are the ''confidential'' or ''non-confidential'' version, and that the confidential business information be clearly identified by means of brackets. All written submissions, except for confidential business information, will be made available for inspection by interested parties.

In its request letter, the Committee stated that it intends to make the Commission's reports available to the public in their entirety, and asked that the Commission not include any confidential business information or national security classified information in the reports that the Commission sends to the Committee. Any confidential business information received by the Commission in this investigation and used in preparing this report will not be published in a manner that would reveal the operations of the firm supplying the information.

Issued: June 21, 2007.

By order of the Commission.

**Marilyn R. Abbott,**

*Secretary to the Commission.*

[FR Doc. E7–12428 Filed 6–26–07; 8:45 am]

**BILLING CODE 7020–02–P**

## DEPARTMENT OF JUSTICE

### Notice of Lodging of Consent Decree Under Comprehensive Environmental Response, Compensation and Liability Act

Notice is hereby given that on June 15, 2007, a proposed Consent Decree in *United States* v. *Beehive Barrel and Drum, Inc. d/b/a Cascade Cooperage, Inc.* (D. Utah), C.A. No. 2:04–CV–00570 (TC), was lodged with the United States District Court for the District of Utah, Central Division.

In this action, the United States seeks response costs incurred and to be incurred by the Environmental Protection Agency (''EPA''), pursuant to Section 107 of the Comprehensive Environmental Response, Compensation and Liability Act, as amended (''CERCLA''), 42 U.S.C. 9607, in connection with the Service First Barrel and Drum Site, located in Salt Lake City, Utah. The United States also seeks punitive damages for non-compliance with a unilateral administrative order issued to the Estate of Stanley Pope and Stanco Enterprises, L.C. pursuant to Sections 106(b) and 107(c)(3) of CERCLA, 42 U.S.C. 9606(b), 9607(c)(3), and civil penalties for Bryan Pope's and S.R.P. Gifting Trust's failure to answer EPA's information requests pursuant to Section 104(e) of CERCLA, 42 U.S.C. 9604(e). Defendants Estate of Stanley Pope, Bryan Pope, S.R.P. Gifting Trust and Stanco Enterprises have resolved the United States' response cost claims, punitive damages claims and civil penalties claims through this Consent Decree.

The settlement is based on a documented inability-to-pay analysis. Based upon the analysis, EPA determined that the Rossomondo Defendants had the financial ability to pay the proceeds from a sale of the Diatect Stock owned by the Estate to reimburse EPA for the EPA's response costs that were incurred in connection with the clean-up of the Site. Defendants Estate of Stanley Pope and Stanco Enterprises, L.C. will pay $2,500 in punitive damages to settle their liability for failure to comply with a unilateral order. Defendants Bryan Pope and S.R.P. Gifting Trust will pay $7,500 in civil penalties for failure to respond to EPA's information requests.

The Department of Justice will receive, for a period of 30 days from the date of this publication, comments relating to the proposed Consent Decree. Comments should be addressed to the Assistant Attorney General for the Environment and Natural Resources Division, and either e-mailed to *pubcomment-ees.enrd@usdoj.gov* or mailed to P.O. Box 7611, U.S. Department of Justice, Washington, DC 20044–7611, and should refer to *United States* v. *Beehive Barrel and Drum, Inc. d/b/a Cascade Cooperage, Inc.,* DOJ Ref. No. 90–11–3–08170.

The proposed Consent Decree may be examined at the Office of the United States Attorney, 185 South State, Ste. 400, Salt Lake City, Utah 84111; and U.S. EPA Region 8, 1595 Wynkoop Street, Denver, Colorado 80202. During the public comment period, the proposed Consent Decree may also be examined on the following Department of Justice Web site, *http://www.usdoj.gov/enrd/Consent_Decree.html.* A copy of the proposed Consent Decree may be obtained by mail from the Consent Decree Library, P.O. Box 7611, U.S. Department of Justice, Washington, DC 20044–7611 or by faxing or e-mailing a request to Tonia Fleetwood (*tonia.fleetwood@usdoj.gov*), fax number (202) 514–0097, phone confirmation number (202) 514–1547. In requesting a copy of the Consent Decree from the Consent Decree Library, please enclose a check in the amount of $6.75 (25 cents per page reproduction costs), payable to the U.S. Treasury.

**Robert D. Brook,**

*Assistant Section Chief, Environmental Enforcement Section, Environment and Natural Resources Division.*

[FR Doc. 07–3147 Filed 6–26–07; 8:45 am]

**BILLING CODE 4410–15–M**

## DEPARTMENT OF JUSTICE

### Notice of Lodging of Consent Decree Between the United States of America and the City of New Haven, MO Under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)

Under 28 CFR 50.7, notice is hereby given that on June 15, 2007, a proposed Consent Decree (Consent Decree) with Defendant the City of New Haven, Missouri (New Haven) in the case of *United States* v. *the City of New Haven, Missouri,* Civil Action No. 4:06CV01429–ERW, has been lodged in the United States District Court for the Eastern District of Missouri.

This Consent Decree resolves the United States' claims against New Haven under Section 107 of CERCLA, 42 U.S.C. 9607, for the recovery of response costs incurred by the United States in connection with releases of hazardous substances at or from the Old City Dump Site, operable unit three of the Riverfront Superfund Site, located in New Haven (OU3). Under the decree, New Haven agrees to implement the remedy selected by the United States Environmental Protection Agency (EPA) for OU3 and pay $19,500 of EPA's response costs for OU3, based on New Haven's limited ability to pay. Pursuant to the decree, the United States covenants not to sue or take administrative action against New Haven for OU3, as well as for operable

# APPENDIX B
# Public Hearing

# CALENDAR OF PUBLIC HEARING

Those listed below appeared as witnesses at the United States International Trade Commission's hearing:

| | |
|---|---|
| **Subject:** | China: Description of Selected Government Practices and Policies Affecting Decision Making in the Economy |
| **Inv. No.:** | 332-492 |
| **Date and Time:** | September 6, 2007 - 9:30 a.m. |

Sessions were held in connection with this investigation in the Main Hearing Room (room 101), 500 E Street, S.W., Washington, D.C.

**ORGANIZATION AND WITNESS:**

Johns Hopkins University
School of Advanced International Studies (SAIS)
Washington, D.C.

**Pieter P. Bottelier**, Senior Adjunct Professor of China Studies

Dewey Ballantine
Washington, D.C.

**Thomas R. Howell**, Partner

The Ranchers-Cattlemen Action Legal Fund –
United Stockgrowers of America ("R-CALF USA")
Billings, MT

**Eric Nelson**, Chair, R-CALF USA Trade Committee

**ORGANIZATION AND WITNESS:**

Wiley Rein LLP
Washington, D.C.
on behalf of

The American Iron and Steel Institute
The Steel Manufacturers Association

**D. Scott Nance**, International Trade Consultant,
Wiley Rein LLP

**Alan H. Price** ) – OF COUNSEL

Kelley Drye Collier Shannon
Washington, D.C.
on behalf of

The Copper and Brass Fabricators Council

**Warren E. Bartel**, Chairman, The Copper and Brass Fabricators Council; *and* Senior Vice President, Luvata

**Joseph L. Mayer**, President, The Copper and Brass Fabricators Council

**David A. Hartquist** )
) – OF COUNSEL
**Jeffrey S. Beckington** )

# APPENDIX C
# Historical Overview of China's Economic Reforms

# Historical Overview of China's Economic Reforms

This appendix presents historical information on China's economic reforms. It begins with brief background on China's economic development prior to the reform era, and then discusses in more detail the post-1978 reform era. The discussion of reforms includes information on transitions in government leadership, general government reforms, SOE reforms (including corporatization and bankruptcy), the expansion of private ownership, and foreign investment reforms.

## Historical Background Prior to 1978[703]

The People's Republic of China was founded in 1949 under Mao Zedong and the PRC Communist Party. The Maoist regime began a campaign of nationalization of industry and collectivization of agriculture, originally following models from Stalin's Soviet Union but gradually adapted into Chinese forms. The combination of policies under Maoism led to a significant accumulation of both physical capital and human capital through improved education which caused economic growth to accelerate compared to the previous period. Nonetheless, growth was uneven due in part to periodic political upheaval and radical economic experimentation. The Great Leap Forward (1958–1960) attempted rapid industrialization through labor-intensive, small-scale technology in rural areas, such as backyard steel furnaces, and sought to forcibly organize small-scale rural collectives into larger communes. The aftermath of this attempt to transform the economy from the top down, combined with years of low harvests, subsequently led to widespread famine. The first stages of China's 1966–68 Cultural Revolution misallocated much of China's human capital by removing intellectuals, government officials, and managers suspected of ideological disloyalty and assigning them agricultural labor.

[703] Principal references for this section include USITC, *Assessment of the Economic Effects on the United States of China's Accession to the WTO*, 1999, Appendix F.

# Historical Developments of the Reform Era[704]

The deaths of CPC chairman Mao Zedong and Premier Zhou Enlai (the first generation of CPC leadership) in 1976 began a transition period that created the conditions for subsequent economic reforms. The broad trend of China's economic reforms has been to gradually separate firms from government, permit nongovernmental firms to emerge, and to broaden the role of markets and prices in economic decision making. At the same time, China's government continued to maintain control over significant sections of the economy. Market channels and traditional planning coexisted under a two-track economic system.[705] This caused the share of the economy subject to direct government control to gradually decline over time. One indicator of this was the decline in the share of urban employment accounted for by SOEs, COEs,[706] and cooperative enterprises even though the absolute level of such employment continued to rise. Most urban Chinese are now employed by various types of private enterprises, domestic corporations, foreign-funded entities, or are self-employed.[707]

# Second Generation Reforms (1978–1989)

The second generation of CPC leadership is associated with Deng Xiaoping, and is generally considered to be the beginning of the reform era. Highlights of this period included: (1) the introduction of the "rural responsibility system" in agriculture and the "corporate responsibility system" in industry, both of which allowed enterprises to retain a share of output and make profit-oriented decisions, and (2) the "open-door policy," which expanded roles for private enterprise, foreign direct investment, and the establishment of special economic zones (SEZs) beginning in 1980.

The structure of the Chinese government was reformed twice during this period.[708] During 1982–83, the number of organs of the State Council was reduced from 100 to 61, with corresponding cuts in the number of staff at both central and lower government

[704] This historical overview covers the period from approximately 1978 onward. It is organized primarily according to the generational transitions in CPC governance (1978–1989, 1999–2002, 2002–present). This division has not been followed rigidly, however. Matters pertaining to foreign investment, discussed under the "second generation," and privatization and bankruptcy, discussed under the "third generation," have been kept together even when certain developments took place outside of the time period indicated.

[705] Barry Naughton coined the widely used term "growing out of the plan" in 1984 to describe China's government planning that kept the size of the central government's material allocations fixed in absolute terms while allowing markets for goods to grow up around them. Naughton, *Growing Out Of the Plan*, 8–9.

[706] Collective enterprises are discussed in more detail in the "market reform" section in chapter 2. They are generally smaller, rural-based enterprises which are formally controlled by their employees. There is a substantial overlap between the categories of "collective enterprises" and "township and village enterprises." Employment trends are further described in app. D.

[707] *China Statistical Yearbook* (2006), table 5-4, and USITC staff calculations. Available employment data generally do not cover rural areas.

[708] OECD, *Governance in China*, 15.

levels. The number of economic management departments also declined. In 1988, the number of State Council organs and staff members, which had grown in the previous five years, was again reduced. This period marked the beginning of the separation of government agencies from profit-making (state-owned) enterprises, as well as increased separation of the CPC and the state.

China began implementing reforms within the state sector in the mid-1980s. In 1984, SOE reforms focused on rewarding managers for specific improvements in performance. In 1988, legislation on SOEs made the state an owner of stand-alone enterprises, rather than exercising direct administrative control of production.[709]

In the late 1970s, individual businesses were allowed to begin to operate in activities in which the state and collective sectors were not involved. The December 1978 Plenum of the CPC's 11th Central Committee emphasized individual incentives. The contract responsibility system devolved economic management in agriculture to households, including rural households which specialize in non-agricultural activities. State Council regulations in 1981 defined a category of urban private businesses with a single proprietor, capped at eight employees.

By the mid-1980s, China began to allow larger privately-owned enterprises employing more than eight people to operate. These enterprises were formally recognized by the government through registration and regulation beginning in 1988. The new regulations recognized private firms in the form of single proprietorships, partnerships, and limited liability companies. Some of these firms were established by the leasing of state or collective enterprises to individuals. In some localities as many as 50 percent of COEs were leased to private entrepreneurs. The Chinese government continued to consider private ownership as largely a supplement to state ownership and planned activity.[710]

## *Foreign Investment*

From the early years of economic reform, beginning with the 1978 Law on Chinese-Foreign Joint Ventures, the Chinese government has looked to foreign investors to help China achieve its economic development goals. The State Council promulgated several regulations during 1986 specifying the incentives available to foreign investors and the rights and obligations of FIEs. The Joint Venture Law was first extended to wholly foreign-owned firms in 1989.[711] Over the years, China's engagement with foreign firms has changed character, reflecting the growth of the Chinese domestic market, the evolution of Chinese economic policies, and global economic factors. FIEs currently play a vital role in China's trade balance, as both employers and trading companies.

During the early years of economic reform (1978 through the 1980s), the Chinese government encouraged foreign manufacturing investment focused primarily on assembly and re-export (processing trade).[712] China established the first five SEZs in the southeastern areas of the country with special tax and other incentives (Shenzhen, Zhuhai and Shantou, all in Guangdong Province; Xiamen in Fujian province; and all of Hainan

[709] Yusuf et al., *Under New Ownership*.
[710] IFC, *China's Emerging Private Enterprises*.
[711] Rosen, *Behind the Open Door,* 21.
[712] Processing trade is described further in chap. 5 of this report.

province).[713] In 1984, 14 additional cities were opened to foreign investment, all on the eastern coast.[714] Successive openings extended from Shenzhen up the Pearl River Delta and from the Yangtze River Delta near Shanghai and westward along the Yangtze River.[715] The Shanghai Pudong New Zone was founded in 1990, and investment in the Pudong Zone received special preferential policies not extended even to the SEZs at that time. These preferential policies included reduced customs duties and income tax, and permission for foreign investors to open financial institutions and establish service sector businesses.[716] The gradual pace of the economic opening allowed China to slowly introduce foreign investment into the Chinese economy, bringing foreign capital, technology, and modern business practices.[717]

# Third Generation Governance (1989–2002)

The third generation of CPC leadership is associated with Jiang Zemin, who became Communist Party chairman in 1989. The movement toward reform accelerated after Deng Xiaoping's "trip to the south" in January 1992, which highlighted the successes of foreign-invested enterprises and Chinese private enterprises. Shortly thereafter, the number of private enterprises grew rapidly. The government developed its first strategy for transition to a market economy in 1993, with increasing emphasis on building market-supporting institutions and the rule of law. Under Jiang, the slogans of "socialist market economy"[718] and "Deng Xiaoping theory" were adopted to recognize the permanent nature of the reforms.

Private ownership and the rule of law were incorporated into China's Constitution in March 1999. By 2002, CPC ideology had added Jiang's "thought of the three represents," which had the practical effect of admitting private businesspersons into the ranks of CPC leadership. Highlights of the third generation period include the opening of stock markets (1989), the beginning of the Three Gorges Dam project (1993), a major reform of the tax system (1994), the reversion of Hong Kong (1997) and Macao (1999) to Chinese rule, and China's accession to the WTO (2001).

The third-generation period saw two major overhauls of government structure.[719] In 1993, government was restructured for a "socialist market economy." The number of State Council organs, which had grown back to 86, was reduced to 59. Macroeconomic supervision and control was strengthened, and enterprises were further separated from government bodies. A civil service system was established with formal retirement and

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[713] Additional information on SEZs is provided in the section on 'Research and Development" in chap. 4 of this report. The first four SEZs were established in 1980, with Hainan added in 1988.

[714] The 14 cities are Dalian, Zinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai. "China in Brief: Opening to the Outside World."

[715] "China in Brief: Opening to the Outside World" and OECD, *Governance in China*, 438.

[716] "China in Brief: Opening to the Outside World" and Lardy, *Foreign Trade and Economic Reform in China*, 42–3.

[717] Prasad, "China's Growth and Integration in the World Economy," 2.

[718] Adopted at the 14th CPC in 1992.

[719] OECD, *Governance in China*, 15.

promotion processes and age limits for employees. In 1998, reduction of the bureaucracy continued, with the number of ministries and commissions downsized to 29.

## *Privatization and Corporatization*

Corporatization in China has been the process by which state, or collective enterprises, have been converted into stock companies. This process has been considered more ideologically palatable in China than privatization because (1) the government typically retains dominant equity stakes,[720] (2) accompanying reforms have typically resulted in fewer job losses, and (3) public and private shareholders have a common interest in the long-term vitality of the enterprises.[721] Box C.1 highlights some of the implications of China's continued strong ownership stakes in SOEs.

As with many of China's reforms, corporatization started with experimental reforms of state and collective enterprises in provinces such as Guangdong, Shandong, and Sichuan.[722] In Guangzhou, the capital of Guangdong, the city government stood at the forefront of the corporatization, by allowing private ownership of newly corporatized small- and medium-size SOEs engaged in infrastructure, real estate, tourism, foreign trade and marketing for state-run research institutes.[723] Such sub-national initiatives were subsequently authorized and later promoted by the national government.[724]

By October 1992, at the 14th CPC Congress, the national government announced a new objective of creating a modern corporate system in its socialist market economy. By 1993, corporatized firms were given legal standing through the "corporate law," by the NPC Standing Committee. In 1997, the 15th CPC Congress placed the shareholding system at the centerpiece of China's enterprise restructuring,[725] providing an unofficial mandate for corporatization.[726]

## *Bankruptcy Policy*

From the founding of the People's Republic of China in 1949 until 1986, China did not have a codified bankruptcy law. Through administrative orders, inefficient enterprises running into severe debt were closed, suspended, consolidated, or directed to change their product lines. Some were even forced into automatic bankruptcy, circumventing any form of formal legal procedures. After the implementation of market reforms in 1978, policymakers revisited the bankruptcy issue, and introduced a trial law at the 6th NPC Standing Committee in 1986. The fact that bankruptcy could only apply to China's state sector enterprises (as identified in Article 2) narrowed the scope of the new law, and,

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[720] Yusuf et al., *Under New Ownership*, 87–89 and 219.

[721] Xu, Zhu, and Lin", Political Control, Agency Problems, and Firm Performance," 3.

[722] Qian, "Institutional Foundations for China's Market Transition," 31; and Guo and Yao, "Causes of Privatization in China" 2.

[723] EIU, "The Operating Environment: State Role in the Economy," February 16, 2007.

[724] Guo and Yao, "Causes of Privatization in China," 2.

[725] Jefferson, *Enterprise Reform in China*, 7.

[726] Ibid., and Li et al., "The Road to Capitalism," 1.

**Box C.1** Implications of China's continued dominance in SOE equity shares

There are direct and indirect implications of China's government continued strong ownership stakes in SOEs:

First, the government can maintain operational influence over corporatized enterprises. Therefore, corporatized state sector firms continue to derive benefits from their close associations to official decision makers by taking measures to reduce their corporate tax payments (e.g., software industry), restraining competition in the domestic market (e.g., consumer electronics), and restraining imports (e.g., steel industry).

Second, nonstate minority shareholders have limited control over government mismanagement because their ability to bring a legal claim is restricted, courts are unlikely to rule in their favor, and majority shareholders are not required to abide by such legal judgments. Although minority shareholders can appoint outsiders to the board of directors, powers of these directors are limited. In the face of other directors appointed by the government in SASAC and state-dominated holding companies, their influence is even more diluted.

Third, the government-appointed management in the majority of corporatized SOEs is replaced infrequently, even in cases of inappropriate decision making. New managers have been selected from a small pool of candidates that have been pre-selected by the CPC.

Finally, China's government also exerts indirect influence. For example, by 2000, the China Securities Regulations Commission (CSRC) had the authority to approve new listings and determine the stock exchange on which company shares would be listed. Some accounts suggest that China's government, through the CSRC, creates unfavorable conditions for domestic private companies to list on local stock exchanges. Prior to listing on stock exchanges, CSRC has been encouraging private firms to first acquire major stakes in corporatized SOEs and only sell the consolidated assets after satisfying CSRC requirements.

Sources: Green, "Two-Thirds Privatization"; Yusuf et al., *Under New Ownership*, 90, 132, 224; and Chinese central government representatives, interview with Commission staff, September 4, 2007.

more importantly, represented a monumental departure from a centrally planned system which prevented SOEs bankruptcy. By 1991, China's central government instituted the guidelines for China's bankruptcy procedures in the Civil Procedures Law, and the Supreme Court issued its first bankruptcy interpretation through several official opinions. By 1993, progressive provincial and local governments enacted their own bankruptcy laws to stimulate the practice in their jurisdiction. These included the Guangdong Provincial People's Congress and the Shenzhen Municipal People's Congress. [727]

Despite the identified policy reforms between 1986 and 1994, bankruptcies rarely occurred. This dramatically changed following the creation of the special Capital Structure Optimization Program in 1994 which applied to industrial SOEs in 18 cities.[728] The program prioritized employee claims over creditor claims. For example, it earmarked revenue generated from the liquidating debtor's land use rights to fund the rehabilitation of workers and ensure social facilities were assumed by the municipality. While this reform climate encouraged SOE bankruptcies, it posed problems for state-owned Chinese banks, which were often the exposed creditors. On average, these banks retrieved only 3 to 10 percent of the loan book value from bankrupt SOEs. As a result, through April 1994,

[727] Li, "Bankruptcy Law in China: Lessons of the Past Twelve Years."
[728] World Bank, "Bankruptcy of State Enterprise in China."

the Chinese government allocated $5.9 billion (RMB 49.3 billion) as subsidies to state-owned banks, and allowed them to write off $27.0 billion (RMB 223.8 billion) of bad loans. [729]

Despite increases in SOE bankruptcies as a result of policy changes, the judicial system was ill-equipped to manage bankruptcy cases involving private and foreign companies. Accounting and asset appraisals were inaccurate, and foreign investors in joint ventures had little guidance and inadequate protection in bankruptcy proceedings. Partially as a result of such experiences, a new bankruptcy law was drafted in 1995 that would apply to state enterprises, nonstate enterprises, and natural persons. China's current Bankruptcy Law went into effect on June 1, 2007.[730]

# Fourth Generation Governance (2002–present)

The fourth generation of CPC leadership is associated with CPC chairman and President Hu Jintao and Premier Wen Jibao. Many of the most important institutions for the governance of Chinese economic policy took their present form during government reforms at the beginning of this period (see below). Characteristic slogans of this period are "building a harmonious society" and (since the 17th CPC Congress of October 2007) the "scientific outlook on development." These ideas reflect the increasing emphasis of policy on addressing rural-urban and coastal-inland disparities in income and economic growth, as well as a progressively more technocratic approach to economic policymaking.

Small firms, which account for the majority of China's private sector enterprises, initially flourished in the absence of strong legal protection, given their ability to self-finance and rely upon an interdependent group of founding members. However, unclear private ownership rights and administrative restrictions have impeded many private firms' growth potential. For example, their limited access to capital, particularly for bank loans, inhibited growth and even pressured many private enterprises to register as state or collective sector firms.[731] This situation has also prompted many to establish close links with local bureaucracies in their search for patrons. To address these issues, and help sustain the rapid growth exhibited by the private sector over the past three decades, China's government recently instituted a series of policies aimed at codifying private ownership, such as through the February 2005 "Guidelines on Encouraging and Supporting the Development of the Non-Public Sector including Individual and Private Enterprises."[732]

The government overhaul in 2003 saw a number of important new forms of economic management.[733] These included the establishment of the State-owned Assets Supervision and Administration Commission (SASAC); the formation of the National Development and Reform Commission (NDRC) as the successor to the State Development and Planning Commission; the creation of the Ministry of Commerce (MOFCOM) by the

[729] *People's Daily*, "China to Bail Out Last Group of Money-Losing SOEs."
[730] *Economist*, "Euthanasia for Companies." China's current bankruptcy law is described in more detail in chap. 2 of this report.
[731] ADB, *Private Sector Assessment: People's Republic of China*
[732] The guidelines are described in more detail in chap. 2 of this report.
[733] OECD, *Governance in China*, p. 15.

merger of two previous agencies; and the establishment of the China Banking Regulatory Commission (CBRC). The 2007 Property Law represents a further step in establishing and codifying the increasing role of private enterprise in the Chinese economy.[734]

[734] See Jones Day, "The New PRC Property Law." SASAC and the NDRC are described in more detail in chap. 2 of this report.

# APPENDIX D
# China's Structural Economic Changes

# China's Structural Economic Changes

Changes in China's ownership structure have been central to the country's ongoing transition from a centrally-planned to market economy. Based on data collected from China's National Bureau of Statistics [735] and estimates conducted by the Asia Development Bank,[736] these trends have unfolded throughout China's economy, in areas such as the country's industrial, trade, and investment sectors, as well as China's labor market.

### *GDP and Industrial Sector*

In 1978, approximately 60 percent of China's GDP and 80 percent of its prominent industrial sector originated from SOE production.[737] The remainder derived from production in the collective sector. As China had not yet authorized private sector activity or opened its markets to foreign trade, the private and foreign-invested sectors accounted for an insignificant part of national production levels at that time. While official data from that time is either unavailable or unreliable, some have estimated that the private sector's contribution to GDP was less than 1 percent in 1978.[738]

Since the mid-1980s, increasing competition brought about by government policy and the emergence of the nonstate sector has helped stimulate economic activity throughout the China's economy. Compound annual growth in the nonstate sector of 27 percent between 1990 and 2000 dramatically outpaced the 15 percent growth in the state sector during the same period (Table D.1). Since growth rates from the nonstate sector have outpaced those from the state sector, the economy has undergone considerable restructuring (figure D.1). While the absolute value of SOE output has risen and continues to dominate China's economy (figure D.2), the state sector's GDP share fell from 58 percent in 1978 to 37 percent in 2000 (figure D.1).

[735] NBS, *China Statistical Yearbooks* (1990–2007).
[736] ADB, "Private Sector Assessment—People's Republic of China."
[737] NBS, *China Statistical Yearbooks* (1990–2007).
[738] Lau, "The Chinese Economy After the Sixteenth Party Congress," May 2, 2003, retrieved from Yusuf et al., *Under New Ownership*, 5.

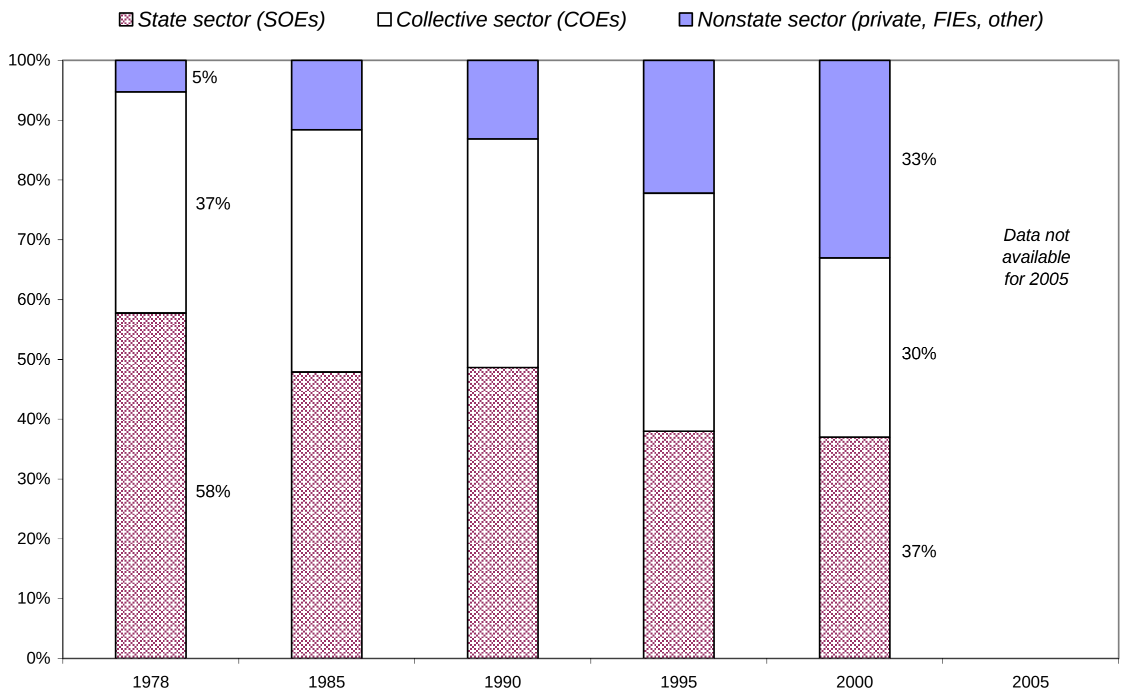
**Table D.1** China: GDP by ownership sector, 1985–2005

| | 1985 | 1990 | 1995 | 2000 | 2005 | Compound annual growth 1990–2000 |
|---|---|---|---|---|---|---|
| | *billion dollars* | | | | | *percent* |
| GDP | 305 | 388 | 700 | 1,080 | 2,234 | 17 |
| State sector (SOEs) | 146 | 189 | 266 | 400 | * | 15 |
| Collective sector (COEs) | 124 | 149 | 279 | 324 | * | 14 |
| Nonstate sector (private, FIE, other) | 35 | 51 | 156 | 356 | * | 25 |

Sources: Asia Development and NBS, *China Statistical Yearbooks*.

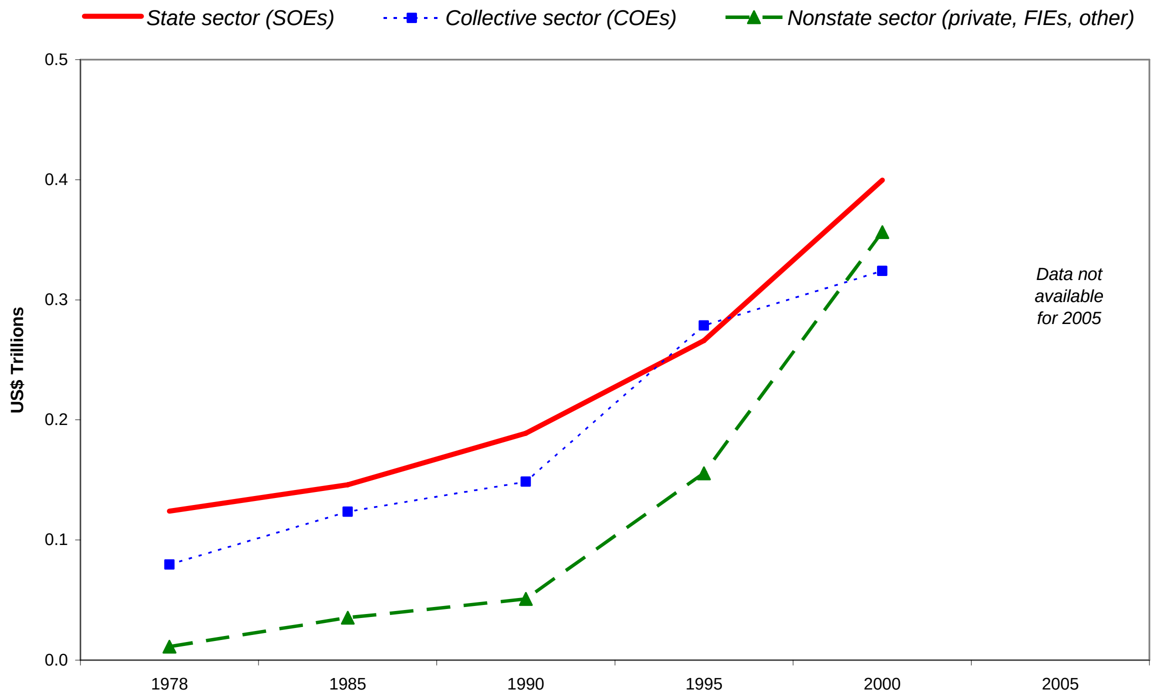
Notes:
* Data unavailable

**Figure D.1 China: GDP by ownership type, 1978-2000 (percent)**




*Source:* ADB.

**Figure D.2 China: GDP by ownership type, 1978-2000**
**(US$ Trillions)**

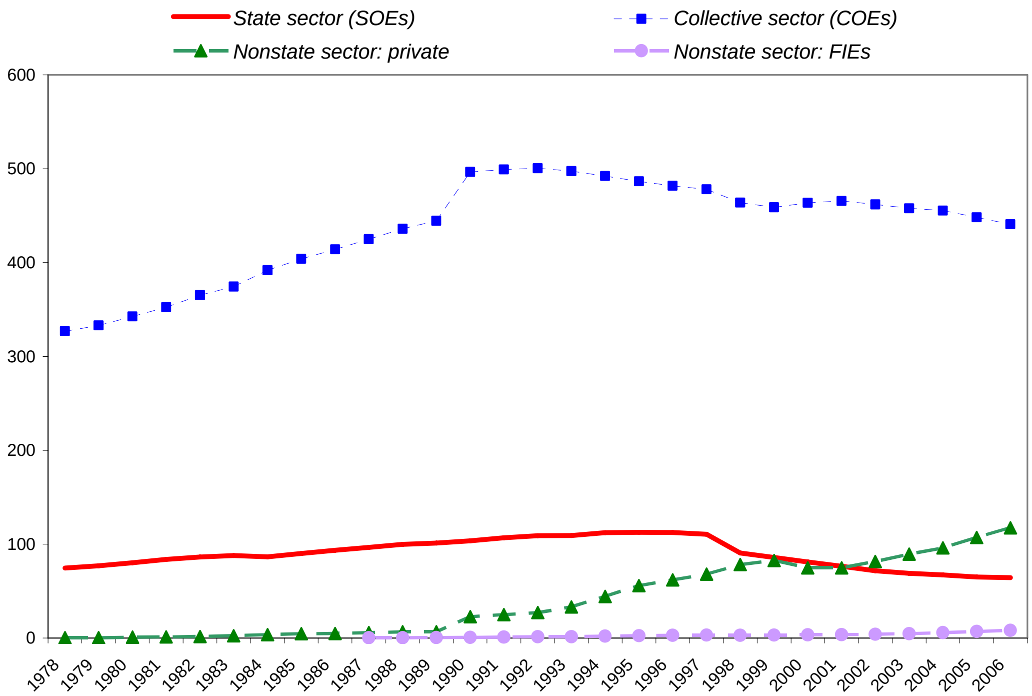



*Sources:* ADB and IMF, *International Financial Statistics* (for U.S. dollar / RMB exchange rates).

Changes to China's labor market have also unfolded during the country's economic restructuring. For example, the rapid GDP growth exhibited by the nonstate sector, as well as the growth in the number of nonstate firms, attracted former state and collective sector workers who were either laid off, looking for higher wages or seeking alternative employment opportunities (figure D.3).[739] Moreover, the number of nonstate enterprises in China's industrial sector grew faster than any other form of enterprises since 1978, bringing the number of industrial domestic private and FIEs firms above the number of state sector firms by 2003 (figure D.4).

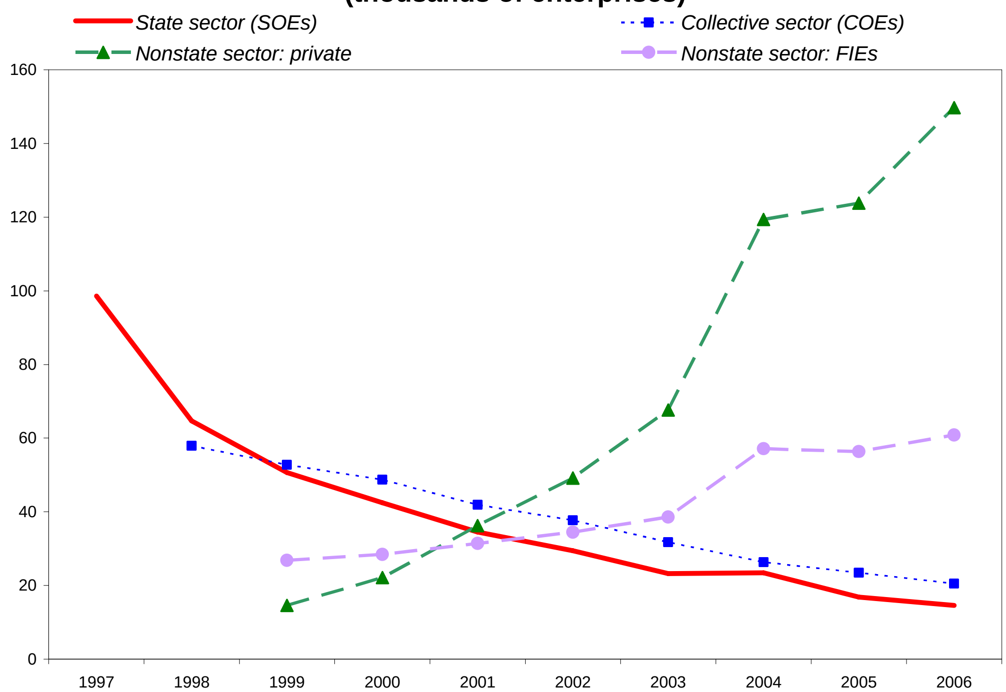
[739] Yusuf et al., *Under New Ownership*, 8, 77; and ADB, "Private Sector Assessment," 7.

**Figure D.3 China: Employment by ownership type, 1978-2006 (millions of people)**




*Sources:* National Bureau of Statistics, China Statistical Yearbooks and CEIC.

**Figure D.4 China: Number of industrial sector enterprises, 1997-2006 (thousands of enterprises)**

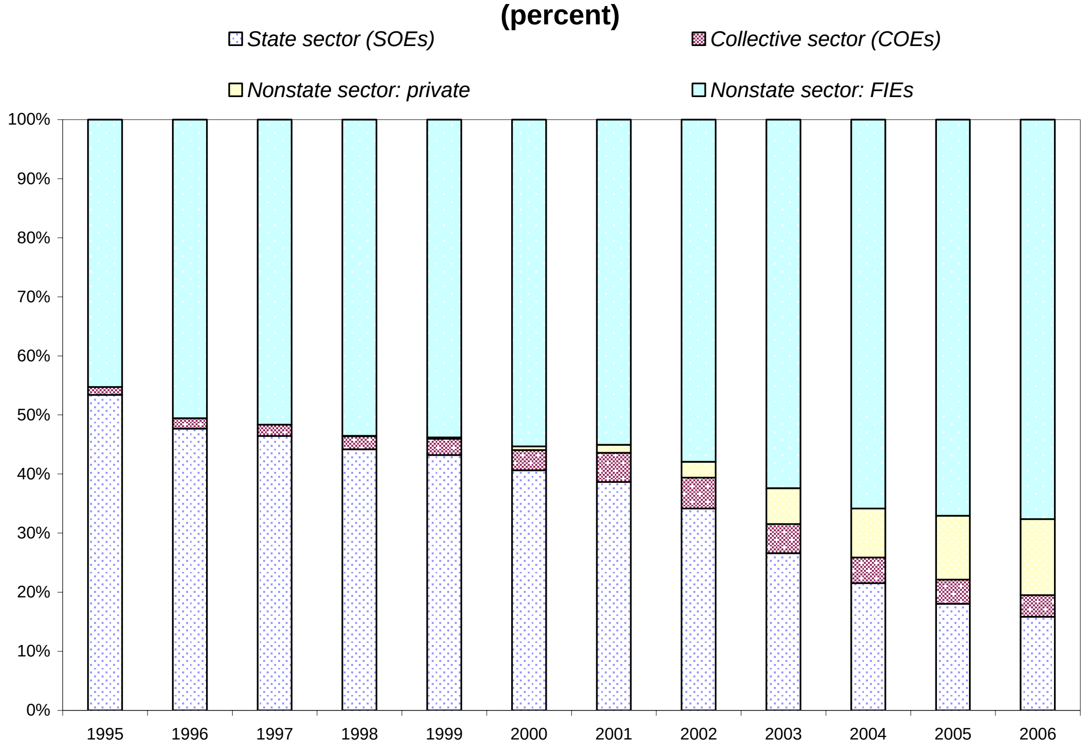



*Sources: NBS,* China Statistical Yearbooks *and CEIC.*

## *Trade*

In the late 1970s, China's economy was relatively closed and the limited trade it conducted was undertaken by SOEs and COEs. As China implemented economic reforms, its share of world trade has grown from approximately 1 percent in 1979 to 6–7 percent by 2004.[740] With this growth, and the related economic restructuring that simultaneously took place, the composition of China's trade also fundamentally changed. While official data on the composition of China's trade flows is only available from 1995, figures D.5 through D.9 show structural changes that unfolded during that period vis-à-vis China's trade with the United States. The most prominent bilateral trend is the growing share of trade originating from or destined for FIEs and private enterprises in China. This trend also is reflected in China's broader trade with the world.

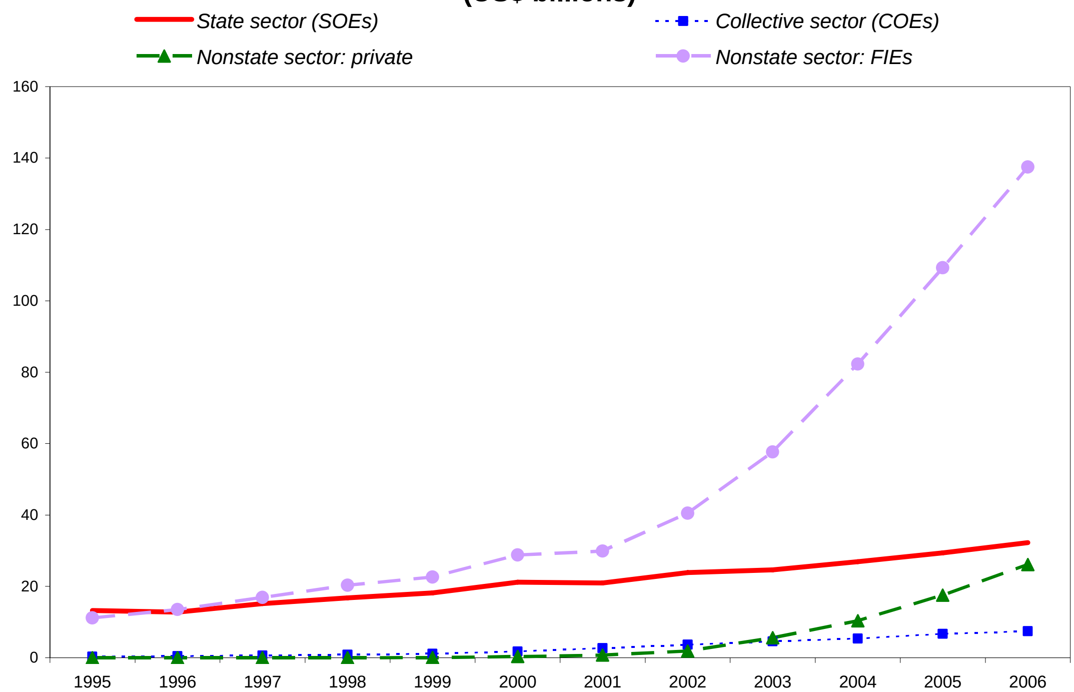
**Figure D.5 China: Exports to the United States by ownership type, 1995-2006 (percent)**




*Source:* China Customs.

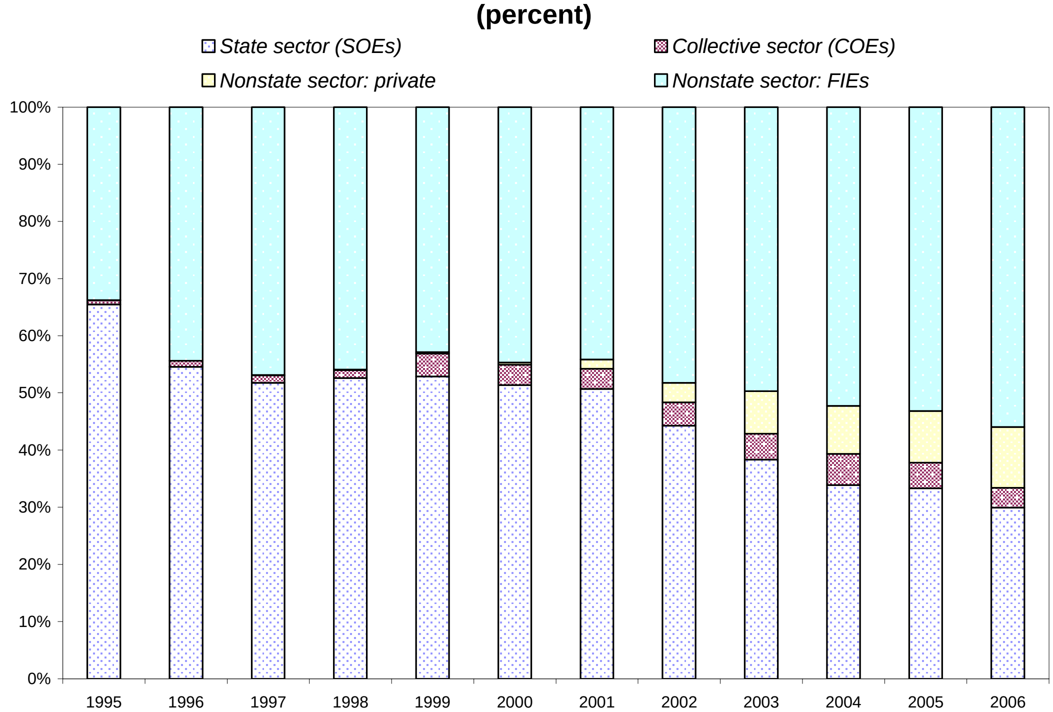
[740] Marquez and Schindler, "Exchange-Rate Effects of China's Trade," 1; Prasad and Rumbaugh, "China's Growth and Integration into the World Economy," 2004; and WTO, *Trade Policy Review: China*, 133.

**Figure D.6 China: Exports to the United States by ownership type, 1995-2006 (US$ billions)**



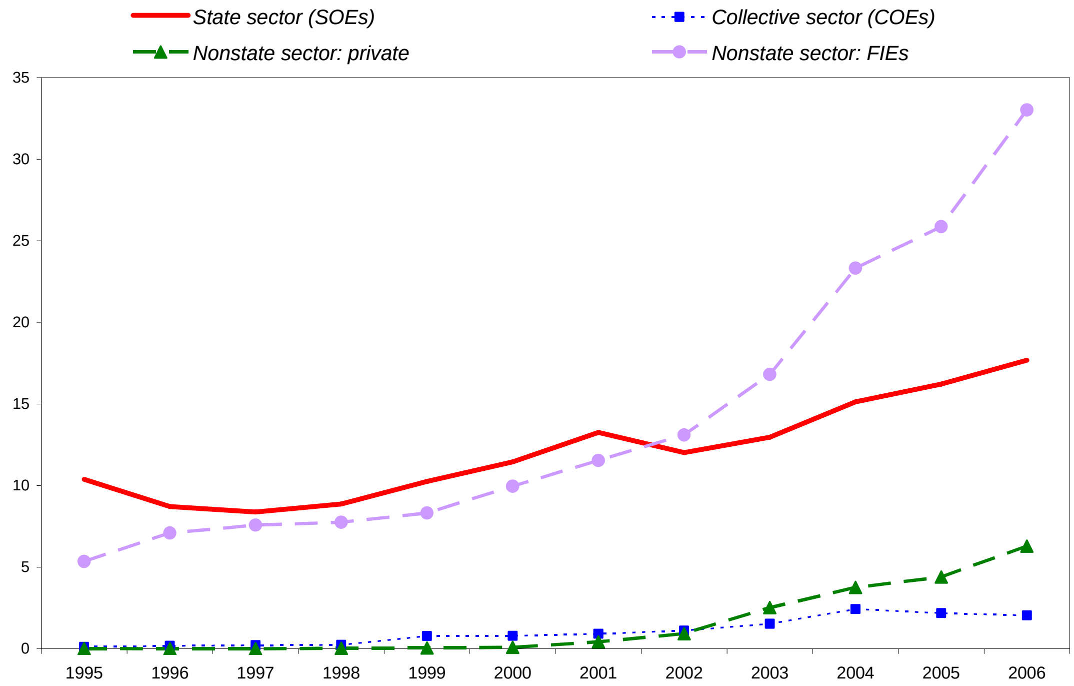

*Source:* China Customs.

**Figure D.7 China: Imports from the United States by ownership type, 1995-2006 (percent)**



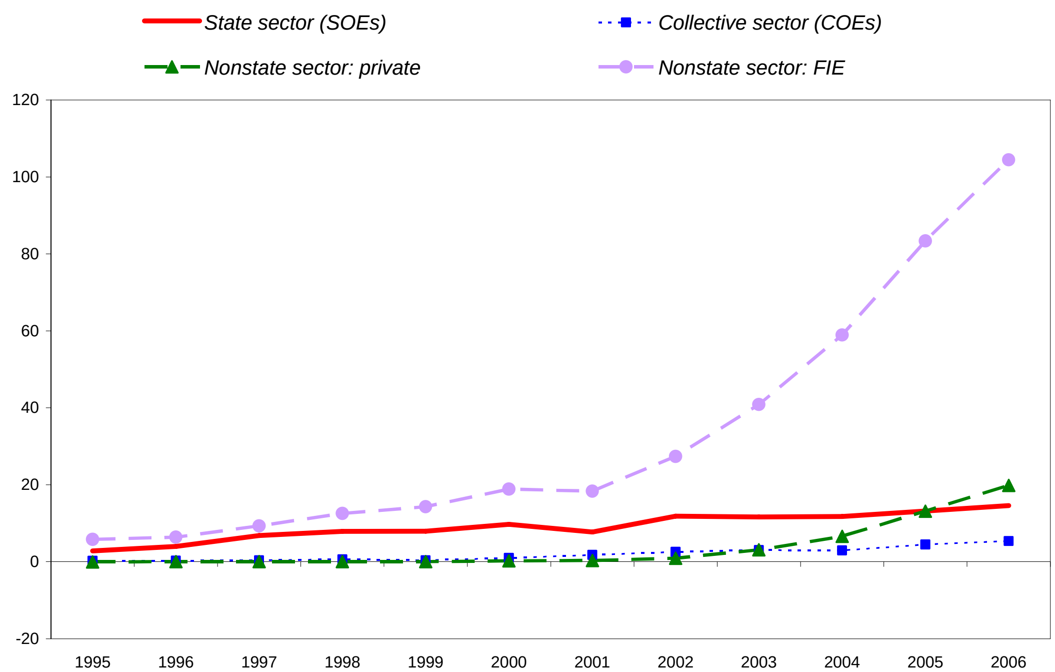

*Source:* China Customs.

**Figure D.8 China: Imports from the United States by ownership type, 1995-2006 (US$ billions)**




*Source:* China Customs.

**Figure D.9 China: Trade balance with the United States by ownership type, 1995-2006 (US$ billions)**




*Source:* China Customs.

The prominence of the nonstate sector is attributable to its considerably faster growth rates in both exports and imports, relative to the state sector. Consequently, nonstate sector firms have shouldered a progressively larger share of trade with the United States since 1995. This restructuring of China's bilateral trade flows takes on added significance when considering the large and growing trade surplus the country is running with the United States which, according to Chinese statistics, amounted to $144 billion in 2006.[741]

### *Fixed Asset Investment*

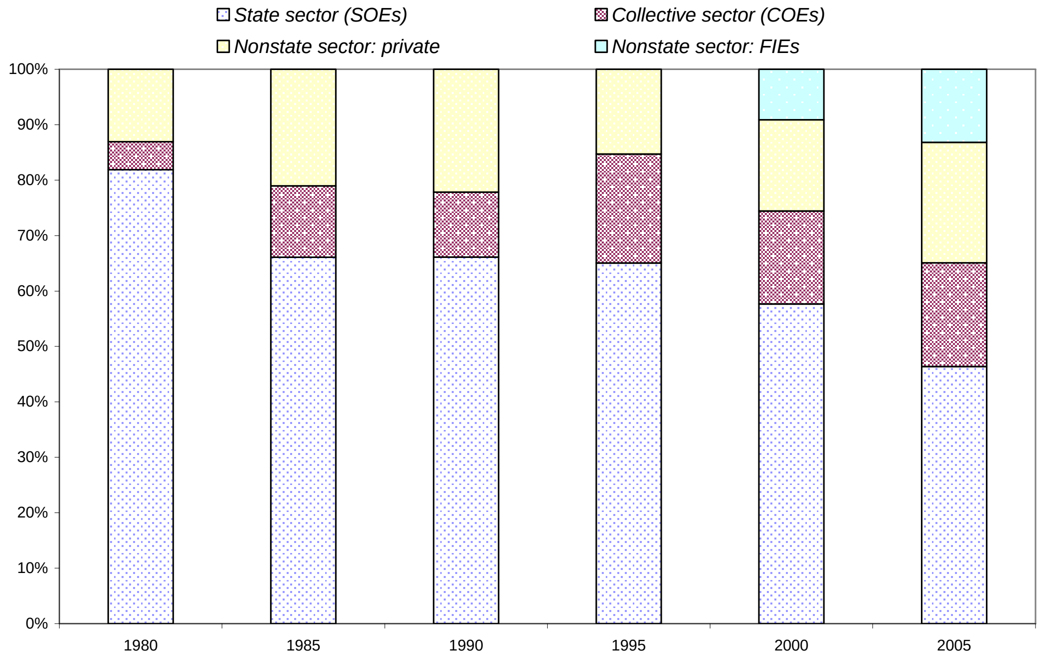
Fixed asset investment is officially defined as the monetary value of construction activities, fixed assets purchases, and related fees.[742] Since the early phases of the reform movement, the state sector has accounted for the vast majority of fixed asset investment in China. However, with the gradual introduction of private and foreign enterprises into the market, fixed asset investment from nonstate sector firms has grown faster than in state and collective firms. Between 1980 and 2005, nonstate sector firms exhibited a 27 percent compound annual growth rate in fixed asset investment, compared to only 16 percent in the state sector.[743] The consequence of these differing growth rates is that state sector firms now account for less than half of China's overall fixed asset investment (figures D.10 and D.11).

[741] Based on China Customs trade data. Although not identical to U.S. data, China's data were used in order to analyze the ownership composition of export and import flows. The most notable explanation for the difference lies in the fact that trade flowing through Hong Kong are included in U.S. data. See Ferrantino and Wang, "Accounting for Discrepancies in Bilateral Trade: The Case of China, Hong Kong, and the United States," 2005.

[742] NBS, *China Statistical Yearbook - 2005*, 255.

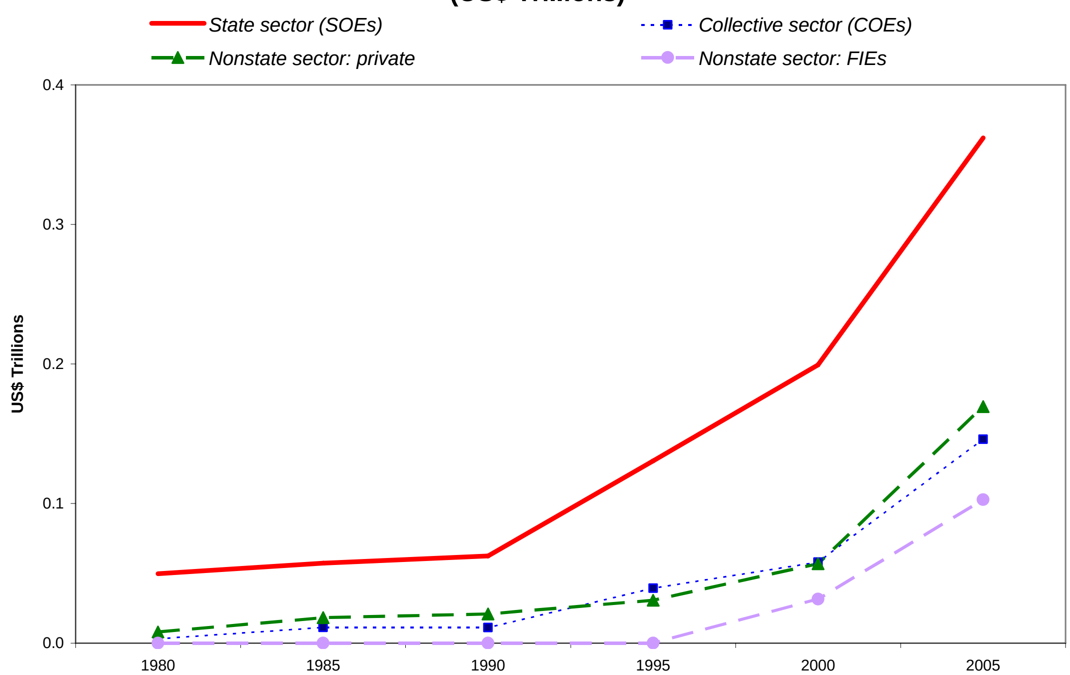
[743] Based on ITC staff estimates from official fixed asset investment information compiled from the *China Statistical Yearbook(s)*, via the CEIC database.

**Figure D.10 China: Fixed asset investment by ownership type, 1980-2005**




*Sources:* National Bureau of Statistics, *China Statistical Yearbooks* and CEIC.

**Figure D.11 China: Fixed asset investment in China by ownership type, 1980-2005 (US$ Trillions)**




*Sources:* National Bureau of Statistics, *China Statistical Yearbooks*, International Monetary Fund, *International Financial Statistics* (exchange rates), and CEIC.

# APPENDIX E
# Factfinding Travel for This Investigation

# Factfinding Travel for This Investigation

Commission staff conducted factfinding travel to China for this investigation during August–September 2007 to interview government officials at the national, provincial and local levels who develop and implement the policies and practices addressed in this investigation. In addition, staff met and gathered information from academics, selected Chinese and foreign industry representatives, and representatives of industry associations that are impacted by these policies and practices. Commission staff traveled to three municipalities (Beijing, Chongqing, and Shanghai), two provinces (Liaoning in the northeast and Guangdong in the south) and the city of Hong Kong (figure E.1). The travel plan was designed to provide geographic and industrial diversity while at the same time providing representative examples of Chinese enterprises.

In total, staff conducted approximately 60 meetings which included 14 government agencies or organizations, 9 industry associations, 5 groups of academics, and 32 companies. The companies covered a wide range of industries, including steel, auto parts, textiles and apparel, banking, computers, electronics assembly, appliances, research and development, and agriculture. These firms were often able to help prioritize the impact of national, provincial, and local policies and practices that currently exist. The goal of fieldwork was also to gather information for another Commission study (*China: Governmental Policies Affecting U.S. Trade in Selected Sectors*, Investigation 332-491, forthcoming) requested by the House Ways and Means Committee on the effect of policies and practices on selected sectors.

E-4

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BANGLADESH
MYANMAR
LAOS
THAILAND
VIETNAM
MONGOLIA
CHINA
NORTH KOREA
SOUTH KOREA
JAPAN
PHILIPINES
Atbassar
Astana
Qaraghandy
Balqash
L. Balkhash
Irtysh
Novosibirsk
Novokuznetsk
Krasnojarsk
Bratsk
L. Baykal
Irkutsk
Ulan Ude
Chita
Khabarovsk
Amur
Bishkek
Alma Ata
Hovd
Uliastay
Altay
Ulaanbaatar
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Karamay
Urumqi
Hami
Korla
Kashi
Xinjiang
Hotan
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Yumen
Islamabad
Amritsar
New Delhi
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Qinghai
Xining
Lanzhou
Gansu
Ningxia
Yinchuan
Nei Mongol
Hohhot
Baotou
Beijing
Tianjin
Hebei
Shijiazhuang
Taiyuan
Shanxi
Huang
Jinan
Shandong
Taian
Qingdao
Zhengzhou
Kaifeng
Henan
Xian
Shaanxi
Heilongjiang
Qiqihar
Jixi
Harbin
Jilin
Changchung
Fuxin
Liaoning
Shenyang
Benxi
Dalian
Pyongyang
Seoul
Pusan
Sea of Japan (East Sea)
Yellow Sea
Nagasaki
Jiangsu
Nanjing
Hefei
Anhui
Shanghai
Hubei
Wuhan
Yangtze
Mianyang
Chengdu
Sichuan
Chongqing
Zigong
Yueyang
Changsha
Hunan
Hangzhou
Ningbo
Zhejiang
Nanchang
Jiangxi
Wenzhou
East China Sea
Fuzhou
Fujian
Taipei
T`ai-chung
T`ai-nan
Taiwan
Kao-Hsiung
Xiamen
Guizhou
Guiyang
Dukou
Kunming
Yunnan
Guangxi
Nanning
Guangdong
Guangzhou
Shantou
Hong Kong
Haiphong
Hanoi
Haikou
Hainan
Hue
South China Sea
Manila
Nagpur
(Calcutta) Kolkata
Dhaka
Mandalay
Salween
Vishakhapatnam
Bay of Bengal
Madras
Rangoon
Vientiane
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# APPENDIX F
# U.S.–China November 29, 2007 Memorandum of Understanding on Certain Chinese Subsidies

**Memorandum of Understanding Between the United States of America and the People's Republic of China Regarding Certain Measures Granting Refunds, Reductions or Exemptions from Taxes or Other Payments**

Whereas the United States of America ("United States") filed requests for consultations with the People's Republic of China ("China") on 2 February 2007 and 27 April 2007 pursuant to Articles 1 and 4 of the World Trade Organization (WTO) Understanding on Rules and Procedures Governing the Settlement of Disputes, Article XXII:1 of the WTO General Agreement on Tariffs and Trade 1994, Articles 4 and 30 of the WTO Agreement on Subsidies and Countervailing Measures, and Article 8 of the WTO Agreement on Trade-Related Investment Measures, regarding certain measures granting refunds, reductions or exemption from taxes or other payments (DS358);

Whereas the United States and China held constructive consultations in Geneva on 20 March and 22 June 2007;

The United States and China have agreed as follows:

1. During the consultations, the United States described its concerns about the WTO-consistency of tax preferences provided under:

(a) the *Circular of the Ministry of Finance and the State Administration of Taxation Concerning the Issues of Tax Credit To Enterprise Income Tax for Purchase of Domestically Produced Equipment by Enterprises with Foreign Investment and Foreign Enterprises*, CaiShuiZi [2000] No. 49, issued on 14 January 2000, and the *Circular of the State Administration of Taxation on Printing and Issuing the Measures On Tax Credit To Enterprise Income Tax for Purchase of Domestically Produced Equipment by Enterprises with Foreign Investment and Foreign Enterprises*, GuoShuiFa [2000] No. 90, issued on 18 May 2000; and

(b) the *Circular on Printing and Issuing the Interim Measures on Credit and Exemption of Enterprise Income Tax for Investment in Domestically Made Equipment for Technological Renovation*, CaiShuiZi [1999] No. 290, issued by the Ministry of Finance and the State Administration of Taxation on 8 December 1999.

In this regard, China has explained that legal instruments of at least equal legal stature to the circulars identified in sub-paragraphs (a) and (b) above, will contain provisions stating that these circulars are repealed, and will be issued by the competent authorities, by 31 December 2007, effective no later than 1 January 2008. China confirms that the tax preferences under the circulars identified in sub-paragraphs (a) and (b) above will not be reinstated.

2. During the consultations, the United States described its concerns about the WTO-consistency of tax preferences provided under:

(a) Article 9 of the *Provisions of the State Council on the Encouragement of Foreign Investment*, GuoFa [1986] No. 95, issued on 11 October 1986 (hereinafter "*State Council Provisions*"); Article 6 of the *Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises*, Order No. 45, promulgated on 9 April 1991 (hereinafter "*FIE Income Tax Law*"); and Article 75, paragraph 1, section 8 of the *Rules for the Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises*, Decree No. 85, issued by the State Council on 30 June 1991 (hereinafter "*FIE Income Tax Implementing Rules*");

(b) Article 8 of the *State Council Provisions*; Article 6 of the *FIE Income Tax Law*; and Article 75, paragraph 1, section 7 of the *FIE Income Tax Implementing Rules*; and

(c) Article 10 of the *State Council Provisions*; Articles 6 and 10 of the *FIE Income Tax Law*; and Article 81 of the *FIE Income Tax Implementing Rules*.

China confirms that, effective 1 January 2008, the *Enterprise Income Tax Law of the People's Republic of China*, Order No. 63, promulgated on 16 March 2007 (hereinafter "*Enterprise Income Tax Law*"), repeals the *FIE Income Tax Law*. In addition, China has explained that legal instruments to be issued by, and made effective no later than, 1 January 2008, will contain provisions stating that the *FIE Income Tax Implementing Rules* are repealed. With the abolition of the *FIE Income Tax Law* and the *FIE Income Tax Implementing Rules*, Articles 8, 9 and 10 of the *State Council Provisions* will no longer be valid. China has further explained that, in accordance with its schedule of administrative regulations revision, Articles 8, 9 and 10 of the *State Council Provisions* will be eliminated by a legal instrument no later than 1 January 2009. The legal instruments repealing the *FIE Income Tax Implementing Rules* and Articles 8, 9 and 10 of the *State Council Provisions* will be issued by the competent authorities and be of at least equal legal stature to the legal instruments being repealed. China confirms that the tax preferences under the legal provisions identified in sub-paragraphs (a), (b) and (c) above will not be reinstated.

3. During the consultations, the United States described its concerns about the WTO-consistency of tax and other preferences provided under:

(a) Article 7 of the *FIE Income Tax Law*; Article 73, paragraph 1, section 6 of the *FIE Income Tax Implementing Rules*; and Section XIII of the *Catalogue of Encouraged Foreign Investment Industries* (hereinafter "*Encouraged Catalogue*") within the *Catalogue for the Guidance of Foreign Investment Industries*, Order [2004] No. 24, issued by the National Development and Reform Commission and the Ministry of Commerce on 30 November 2004 (hereinafter "*Catalogue*"); and

(b) the *Circular of the State Council Concerning the Adjustment in the Taxation Policy of Imported Equipment*, GuoFa [1997] No. 37, issued on 29 December 1997; and Section XIII of the *Encouraged Catalogue*.

In this regard, China has explained that, in accordance with its economic and social development, it revised the *Catalogue* on 31 October 2007, which revision will take effect as of 1 December 2007. China confirms that Section XIII of the *Encouraged Catalogue* dated 30 November 2004 will not be reinstated.

4. During the consultations, the United States described its concerns about the WTO-consistency of the *Enterprise Income Tax Law*, including Articles 25, 28, 31 and 57 thereof. China has explained that these provisions do not provide for the offering of any income tax preference contingent upon the use of domestic over imported goods or upon export performance. China has further explained that, notwithstanding the fact that Article 57 of the *Enterprise Income Tax Law* authorizes the continuation of certain income tax preferences beyond 1 January 2008, it will not be implemented or applied so as to introduce or permit the continuation of the income tax preferences being repealed by virtue of the actions described in paragraphs 1 through 3 of this Memorandum of Understanding. These limitations will be made explicit under fully authoritative legal measures, and will be effective, no later than 1 January 2008.

5. During the consultations, the United States described its concerns about the WTO-consistency of an exemption for certain foreign-invested enterprises from payments to the State for worker allowances, provided under Article 3 of *State Council Provisions*.

China has explained that, at the time the State Council promulgated the *State Council Provisions*, Article 11 of the *State Council Regulations on Labor Management in Sino-Foreign Joint Ventures*, GuoFa [1980] No. 199 (26 July 1980), required foreign-invested enterprises to make such payments to the State. China has confirmed, however, that because this requirement was eliminated by the *State Council Decision on Abolition of Certain Administrative Regulations Promulgated Prior to the End of 2000*, Order No. 319 (6 October 2001), the exemption provided under Article 3 of the *State Council Provisions* is no longer operative. China confirms that Article 3 of the *State Council Provisions* may no longer serve as a legal basis to exempt foreign-invested enterprises from making payments required by Chinese law, regulation, or other official measure.

6. During the consultations, the United States described its concerns about the WTO-consistency of value-added tax (VAT) refunds provided under the *Circular of the State Administration of Taxation on Printing and Issuing the Interim Measures for the Administration of Tax Refund to Enterprises with Foreign Investment for the Purchase of Domestically Produced Equipment*, GuoShuiFa [1999] No. 171, issued on 20 September 1999, and the *Circular of the State Administration of Taxation and National Development and Reform Commission on Printing and Issuing the Interim Measures for the Administration of Tax Refund for the Purchase of Domestically-Produced Equipment in Foreign Investment Projects*, GuoShuiFa [2006] No. 111, issued on 24 July 2006.

In this regard, China has stated that these circulars do not create a preference, either in law or on a *de facto* basis, for the use of domestic over imported goods in connection with purchases of domestically-produced equipment when viewed in relation to the *Circular of the State Council Concerning the Adjustment in the Taxation Policy of Imported Equipment*, GuoFa [1997] No. 37, issued on 29 December 1997, in connection with purchases of imported equipment. China has confirmed that, in implementing the above-mentioned legal instruments as well as any new legal instruments that affect the operation of the above-mentioned legal instruments, it will ensure that imported equipment receives VAT treatment under terms and conditions no less favorable than those applicable to domestically-produced equipment.

7. The United States and China agree to communicate in a timely manner with respect to the implementation of the actions described above, including provision of related new legal instruments.

8. This Memorandum of Understanding is without prejudice to the rights and obligations of the United States and China under the WTO Agreement.

Done in Geneva, on XX November 2007, in two copies in English and Chinese respectively, each text being equally authentic.

| | |
|---|---|
| For the Government<br>of the United States of America | For the Government<br>of the People's Republic of China |