BEFORE THE
U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

HEARING ON

CHINA'S INDUSTRIAL POLICY AND ITS IMPACT ON U.S. COMPANIES, WORKERS AND THE AMERICAN ECONOMY

TESTIMONY OF

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INTRODUCTION

Members of the Commission, thank you for the opportunity to appear today. My name is Terence Stewart. I am managing partner of Stewart and Stewart, an international trade law firm that has helped U.S. companies and workers compete in the international marketplace for the last 50 years.

In my testimony today, I will discuss how China has used a variety of tools to grow and transform its economy and to achieve its national security objectives. In areas where China is a net importer and where deficits now prevail, China's leaders clearly aim to reverse the situation and achieve trade dominance in these sectors.

China's local, state, and national governments use a variety of direct subsidies to domestic industries, subsidies and other incentives to attract foreign investors, as well as major state investment of research and development in sectors where it aims to be more competitive.

China has singled out for promotion and development a number of "strategic industries" such as those that involve national security, large and important infrastructures, important mineral resources, important public utilities and public services, and key enterprises in the pillar industries, such as high-technology.

Clearly, these policies have worked for China, as is evidenced by its extraordinary economic growth and its transformation from dependence on imports to the predominant exporter to the world. Data on state-owned enterprises shows strong growth in exports over the last two years in areas such as communications equipment, consumer electronic, and steel.

Among the sectors that have benefitted from these governmental interventions in the market is information technology, steel, manufacturing equipment, tires, and paper.

At the same time, China's policies have contributed to an ever-widening trade gap with the United States. The U.S goods deficit with China was $266.3 billion in 2008 and China accounts for roughly 12 percent of total U.S. trade and one-third of the total U.S. goods trade deficit with the world. China's policies have also raised serious questions in the United States and other countries about whether these policies have distorted trade and led to job losses and economic dislocation.

PERVASIVE NATURE OF GOVERNMENT SUBSIDIES IN CHINA'S ECONOMY

It is well established that the Chinese government at all levels - central, provincial, and local – has long provided a wide range of subsidies to state-owned and state-invested enterprises and, as well, to foreign-invested enterprises to attract investment and obtain technology transfer.

Academics, business groups such as the American Chamber of Commerce in China, government agencies such the Office of the U.S. Trade Representative, the World Trade Organization, and the Commission itself have noted the prevalence of these policies in China. The Commission's 2007 annual report cited low cost loans, asset injections, subsidized inputs, tax breaks, energy

subsidies, land subsidies, and purchasing SOE products as some of the subsidies provided by the Chinese national, state, and local governments.

To date, China's disclosure of its subsidies appears to have been limited. China has submitted only one subsidies notification to the WTO (covering subsidies in existence from 2001 through 2004), and that was not submitted until April 7, 2006, four years after accession. Moreover, the United States, the European Communities, and other countries pointed out that China failed to list numerous subsidies provided at the provincial and local level in that notice.

The United States has brought two WTO actions against Chinese subsidies. One matter was resolved in January 2008, when China agreed to eliminate certain prohibited export and import substitution subsidies that benefitted a wide range of industries in China. The second case was initiated in December 2008 and concerns certain measures offering grants, loans and other incentives to enterprises in China.

Since October 2006, U.S. industries, including paper, steel, tires, textiles, and chemicals, have alleged injury from Chinese subsidies and petitioned for relief in the form of countervailing duties. To date, Commerce has completed 10 countervailing duty investigations concerning China, with three other investigations currently pending.

CHINA'S INDUSTRIAL POLICIES FAVOR SELECTED INDUSTRIES AND STATE-OWNED ENTERPRISES, WITH THE GOAL OF PROMOTING NATIONAL AND GLOBAL CHAMPIONS

That the Chinese government grants domestic subsidies in a variety of forms to SOEs and to foreign-invested enterprises (FIEs) is not in itself surprising or remarkable. What is notable, however, about China's use of subsidies and other incentives is the scale of its subsidy and incentive measures and China's efforts to direct these measures to targeted recipients and industries through the implementation of central government policies.

One goal of China's industrial policy is to favor and promote certain state-owned enterprises into national and global "champions." In the 2008 trade policy review of China, the WTO Secretariat described the shift in China's industrial policy toward favored sectors and SOEs as follows.

> "Direct intervention in the economy remains the main approach of industrial policy. Nonetheless, <u>there has been a shift towards the use of various other policy tools to channel resources into certain activities that the Government believes are important for China's continued growth and development</u>. In addition to tariffs and other border tax measures, tax incentives, and subsidies, these tools include 'guided' credit, various 'catalogues' identifying sectors eligible for incentives, as well as restricted or prohibited activities, various forms of 'guidance' including section-specific 'industrial development policies' (e.g. for steel, automobiles, and cement), and price controls."

CHINA'S ELEVENTH FIVE-YEAR PLAN AND RELATED GUIDELINES TARGET CERTAIN DESIGNATED STRATEGIC AND PILLAR INDUSTRIES FOR DEVELOPMENT AND PROMOTION

SOE Restructuring

In 2006, China issued its Eleventh Five-Year Plan for the period 2006-2010. The Plan provided a general outlook for economic growth that aims to "further strengthen China's industrial sectors and foster the growth of a more highly-developed, knowledge-based economy." China's Plan "proposed to accelerate the transformation of the economy from being 'resource dependent' to 'innovation driven.'"

China implements its industrial policy through its control of SOEs, particularly through direct control of the largest and most dominant SOEs by the State-owned Asset Supervision and Administration Commission (SASAC), which is responsible for managing government assets and reform of central-level non-financial SOEs. As noted by the WTO Secretariat, SOEs under SASAC management "accounted for 40% of total SOE assets in 2006, and earned 60% of total profits." USTR has noted that it is "evident that the Chinese government {is} intent on heavily intervening in the commercial decisions of state-owned enterprises, including decisions related to their strategies, management and investments."

Specific guidance regarding SOEs was provided in December 2006 by the National Development and Reform Commission (NDRC) when it issued a guiding opinion on state-owned assets restructuring. The opinion states that SASAC's state-owned assets should concentrate on "important industries and key areas" (*i.e.*, strategic industries). The opinion then explained that the "important industry and key areas" shall "mainly include industries that involve national security, large and important infrastructures, important mineral resources, important public utilities and public services, and key enterprises in the pillar industries and high-tech industries." The opinion calls for the administrative agencies to promulgate catalogues and to lay down specifics as to which sectors shall be subject to absolute control or relative control by SOEs. "Absolute" and "relative" control are not defined; but it is generally understood that absolute control means control by majority ownership; and relative control means another controlling position short of majority ownership.

On December 18, 2006, Li Rongrong, Chairman of the NDRC, delivered a speech in which he clarified the guiding opinion. Chairman Li stated that the Government should maintain absolute control over SOEs involved in "important industries and key areas" in the interest of China's security and economic livelihood. These "important industries and key areas" include seven industries: defense, electric power and grid, petroleum and petrochemical, telecommunications, coal, civil aviation, and shipping. Li said that NDRC's policy was to increase the overall state-owned assets in these industries, to optimize their structure, and to develop some of the key enterprises into world top tier enterprises.

For SASAC-controlled SOEs in the sectors of defense, petroleum, natural gas and some other important natural resources exploration, electric power and grid, and basic telecommunication infrastructure, the Government would maintain sole ownership or absolute control. For their subsidiaries, and for SASAC-controlled SOEs in civil aviation and the shipping industry, the

Government will maintain majority ownership. For downstream petrochemical products distribution and retail and for telecommunication valued-added services, the SASAC will seek private and foreign investment to diversify ownership structure.

Li further stated that, in addition to the seven strategic industries, the Government would maintain a strong control position (*i.e.*, 30%-50% equity ownership) for key enterprises in the basic and pillar industries, which include equipment manufacturing, auto, information technology (IT), construction, iron and steel, non-ferrous metals, chemicals, and surveying and design. For these pillar industries, SASAC will reduce its share of state-owned assets, but will increase its economic influence and guiding role. Specifically, SASAC-controlled SOEs are directed to become key enterprises and play a leading role in the equipment manufacturing, auto, IT, construction, steel, and non-ferrous metal industries. It has been estimated that 40-50 of the SOEs controlled by SASAC are in the strategic industry category and account for 75 percent of SASAC's total assets and up to 79 percent of SASAC's total profits.

USTR has repeatedly expressed concerns about China's increasing use of industrial policies to promote SOE dominance in selected industry sectors and create national champions. For instance, USTR's 2008 compliance report noted that U.S. companies had pointed to an array of Chinese polices "promoting and protecting 'pillar industries.'"

Investment Guidelines

China furthers its industrial policy goal of creating national champions by controls on investment. As noted by the WTO Secretariat, China's Eleventh Five-Year Plan "proposed to accelerate the transformation of the economy from being 'resource dependent' to 'innovation driven.'" The scope of China's reinvestment plans was evident in the Secretariat's description, which covered more than 20 industries, including 539 encouraged categories, 190 restricted categories, and 300 prohibited categories (which are to be eliminated gradually or within a specific time frame).

With respect to foreign investment, in November 2006, China issued a policy titled Guideline for Utilizing Foreign Investment for the 11th Five-year Period (2006-2010) which signaled that China intended to continue its policy of attracting foreign investment. The key themes of that guideline include establishing a unitary regulatory system for both foreign and domestic companies and attracting foreign investment that helps with upgrading technology-intensive industries.

The Provisions on Guiding Foreign Investment Direction set out the basic regulations concerning foreign direct investment (FDI) in China. In general, they classify foreign investment projects into four categories: encouraged, permitted, restricted, and prohibited. The current Catalogue for the Guidance of Foreign Investment Industries entered into force on December 1, 2007. The Catalogue lists industries that are encouraged, restricted, and prohibited; if a project is not within these categories, it is permitted. The FDI Catalogue provides guidance on foreign investment in China's designated "strategic" and "pillar" industries.

USTR has expressed concerns about China's investment polices that signal that SOEs "should absolutely control, or at least maintain a 'strong controlling position' over broad swaths of its industry – in sectors such as equipment manufacturing, automobiles, iron and steel."

Another investment-related concern raised by USTR and U.S. companies is China's new anti-monopoly law which took effect in August 2008. While the new law is an improvement on China's previous competition law, the U.S. government and companies have questioned whether the new law will be applied to favor domestic companies and restrict investment by foreign companies. In a recent instance that may raise concern about China's application of the anti-monopoly law to restrict foreign investment, China rejected the $2.4 billion bid of Coca-Cola to acquire China's largest juice maker, China Huiyuan Juice Group.

SELECTED EXAMPLES OF CHINA'S INDUSTRIAL POLICIES THAT FAVOR DESIGNATED INDUSTRIES: STEEL AND AUTOS

Steel

The substantial extent of government subsidies to the Chinese steel industry has been well documented in a number of research studies. For example, one study found that a wide range of subsidies benefited the Chinese steel industry, including cash grants, land grants, transfers of ownership interest on terms inconsistent with commercial considerations, conversion of debt to equity in steel companies, debt forgiveness and inaction regarding non-performing loans, preferential loans and directed credit, tax incentives, targeted infrastructure development, manipulation of raw material prices, and manipulation of the value of the Chinese RMB.

According to the Commission, the result of such substantial government intervention has been "a dramatic increase in steel output in China, so far exceeding even China's skyrocketing domestic steel consumption that huge overcapacity has resulted." In its 2007 annual report, the Commission succinctly summarized the effects of China's steel policy –a huge increase in steel production capacity to become the world's largest steel producer and transformation from a net steel importer to a net steel exporter.

In addition to subsidies, China's steel policy protects the Chinese steel industry through restrictions on foreign investment. Article 23 of China's Steel and Iron Industry Development Policy (issued in July 2005) provides that foreign investors may not hold a controlling share in a Chinese steel company. Moreover, China's steel policy requires foreign investors to transfer proprietary technology. In addition to subsidies, USTR summarized a number of other aspects of China's steel policy that favor domestic companies and concluded, "China's steel policy is also striking because of the extent to which it attempts to dictate industry outcomes and involve the government in making decisions that should be made by the marketplace. It prescribes the number and size of steel producers in China, where they will be located, the types of products that will and will not be produced, and the technology that will be used."

Autos

China designated the auto industry as a pillar industry targeted for development. The Commission noted in its 2006 annual report that China views the promotion of the auto industry as a "fundamental step in achieving the technologically advanced industrial base it seeks to develop." Under China's Industrial Policy for the Automobile Industry, there is a "50% foreign-ownership restriction in vehicle manufacturing, including completely built up units, automobiles for special use, agricultural transport vehicles, and motorcycles." As noted by the Secretariat, "When establishing a foreign-invested automotive manufacturing joint venture, the place of origin of technology must be registered with the competent authorities (e.g., the provincial departments of the MOFCOM or the NDRC)."

The effect of China's auto policies has been a dramatic increase in production capacity and expanded exports. "China's auto production is on a fast roll. China's auto output has nearly quintupled since 2001, and China is expected to become the world's largest producer in 2009. Half the world's auto industry expansion has recently occurred in China. China achieved a surplus in auto parts in 2005. That surplus grew 83 percent in 2007 and has been increasing at an even faster rate in 2008," according to the Commission in its 2008 annual report.

China Trade Data Demonstrates That China's Industrial Policies of Subsidies and Investment Controls Have Resulted in Expanded Exports in Many Industry Sectors

In addition to steel and autos, there are a variety of instances where China's industrial support policies have effectively targeted sectors in which China has experienced a trade deficit and either sharply curtailed that deficit or turned the deficit into a surplus over time. Through strategic investments and support to these industries, China has been able to stem or even reverse areas of weakness in their trade balance.

For example, in the steel industry, China consistently ran trade deficits with the rest of the world each year from 1995 through 2004. After years of government support, China was able to reverse this deficit, and it ran a surplus in its steel trade for the first time in 2005. That surplus has increased each year since, reaching nearly $67 billion in 2008.

In the auto industry, while China still runs an overall trade deficit, it is remarkable that the deficit has not grown sharply in light of China's surging domestic demand for automobiles and the challenges of overcapacity and dampened demand faced by the automotive industry in the rest of the world. Over the past five years, while China's auto imports have doubled in value, their exports have nearly quadrupled.

INCENTIVES FOR FOREIGN INVESTMENT IN CHINA

Income Tax

Since the beginning of China's reform and opening up, the government has relied heavily on preferential income tax treatment to attract foreign investors. Before the current enterprises income tax became effective on January 1, 2008, China had in place a dualist system for corporate income tax, applying a special income tax law to foreign invested enterprises (FIEs). The FIE income tax law allowed favourable tax treatment for FIEs. Most well known is the so-called "two free, three half" policy, which exempted manufacturing FIEs from paying income tax for the first two years starting from the year when the company registered a profit, and allowed a 50% tax reduction for the subsequent three years. Other incentive tax policies included allowing FIEs to deduct their R&D expenses from their taxable income and allowing an income tax credit for purchasing domestic equipment. Under China's new Enterprise Income Tax Law (effective January 1, 2008), China unified its income tax system, applying the same rate of 25% to all enterprises, including FIEs, except for enterprises subject to a five-year "grandfathering" period. However, tax incentives for enterprises engaged in high-tech and new technology activities continue to be subject to a preferential tax rate of 15%.

Value-Added Tax (VAT)

In general, China applies a 17 percent VAT for selling goods or providing taxable services. VAT preferential treatment is another incentive tool, mostly used to reduce costs for technology renovation for FIEs, thus encouraging them to adopt advanced technology in their local operation. For example, China had allowed a VAT exemption to FIEs when they purchased equipment either locally or from overseas. This policy, however, was abolished in December 2008 when China introduced its new VAT code.

In more general terms, the fact that China has a system that relies on indirect taxes, such as the VAT, is itself an incentive to foreign investment due to the disparate treatment accorded direct and indirect taxes in world trade. Under GATT/WTO rules, indirect taxes, such as VAT and excise taxes, are adjustable at the border, while direct taxes, such as income taxes, are not. These rules allow countries that have indirect tax systems to (1) impose indirect taxes, such as the VAT, on incoming imports, and (2) provide a rebate of the tax on outgoing exports. However, the same treatment is not accorded to countries, such as the United States, that rely primarily on direct tax systems. In other words, under the GATT/WTO rules, indirect taxes are adjustable at the border, direct taxes are not. China is one of the 153 countries that imposes a VAT and allows rebates of VAT on exports. Based on 2007 data, the VAT disadvantage to U.S. producers and exporters as a result of China's use and application of VAT is estimated to have been as high as $52 billion. Given the disparate treatment of indirect and direct taxes under current trade rules, China's VAT gap may be viewed as a $52 billon incentive for U.S. producers to move to China.

China also uses VAT export rebates as a tool to adjust and control trade flows. China imposes a standard VAT rate of 17 percent on goods domestically produced or imported and grants VAT

rebates upon export, but the rate of the rebate is generally less than the VAT rates actually paid. Periodically, China adjusts the rate of the VAT rebate applied to particular products in order to, *inter alia*, "meet industrial development goals, and control exports of certain products," as well as to "rein in out-of-control expansion of production capacity in particular sectors."

General Policy Shift

In general, the Chinese government has reduced some of its broadly applicable preferential policies in recent years, and has been trying to create a unitary system for both domestic and foreign-invested companies. In addition to adopting a unitary tax system, the State Council in 2006 established a national minimum price for land used for industrial purposes that applies equally to domestic and foreign companies. On the other hand, in order to expedite procedures, the Central Government has delegated foreign investment approval authority to provincial governments for projects below RMB100 million. It appears that the Chinese government has determined that, given the fast growth of China's domestic market, access to the domestic market itself will provide a sufficient incentive for foreign investors. In this respect, it is notable that China has often required that foreign companies, as a condition for access to the Chinese market, provide technology transfer to Chinese producers.

Misaligned Currency

China's undervalued currency effectively acts as an incentive for foreign companies to invest in China because the cost of foreign investment and establishing operations in China is cheaper for the foreign company than it would be if the Chinese currency operated under market forces.

Local Preferential Policies

Although the Central Government has been reducing preferential policies, local governments are still providing incentives to foreign investment. For example, the Ningbo Municipality Authority in 2005 awarded government assistance to large foreign-invested projects. Projects with foreign investment over US$5 million are entitled to a cash award ranging from RMB 30,000 to RMB 120,000, depending on the size of the investment.

China's 2009 Stimulus Package Includes Preferences for Favored State-Owned Enterprises and Designated Industries

To combat the worldwide economic slowdown, on November 9, 2008, China announced a RMB 4 trillion (US$585bn) economic stimulus plan for the next two years (2009-2010). The size of the stimulus plan is equivalent to 14 percent of China's GDP. The Chinese Government hopes that the stimulus plan will enable China to maintain an annual growth rate of 8 percent over the 2009-2010 period. Economic growth for the fourth quarter of 2008 was 6.8 percent and the growth estimate for 2009 was 7.2 percent without the stimulus package. It is not clear how much of the stimulus comprises spending not previously planned, but it has been estimated that new spending is roughly equivalent to 5-7 percent of GDP. A total of RMB 1.18 trillion will be

supplied by the Central Government in FY 2009 and 2010, and it is estimated that this will drive up China's fiscal deficit to 3 percent of GDP in 2009.

The stimulus package appears to have increased investment in China. The National Statistics Bureau released statistics on March 11, 2009 that showed that, for the first two months of 2009, total investment increased by 30 percent (after adjustment for inflation). Bank loans for the first two months of 2009 was RMB 2.6 trillion. In comparison, total bank loans for 2008 were RMB 4.9 trillion. MOFCOM data, however, show that, comparing January 2008 and January 2009, foreign direct investment (FDI) declined by US$7.5 billion (32.67 percent).

Policies for Industries Covered by the Stimulus Package

Prior to the NPC's annual plenary session in March 2009, the State Council decided, in general, that ten major industries would be covered in the stimulus package and laid out the general policies to be followed when funneling funds to these industries. The ten major industries include steel, auto, textile and apparel, equipment manufacturing, ship manufacturing, electronics and information technology, light industry, petrochemical, non-ferrous metals and logistics. The broad measures to be used to assist these industries include: (1) reducing tax burdens; (2) allowing more access to financial resources; (3) providing RMB100 billion and other financial support to promote R&D; and (4) facilitating industrial structure adjustments and upgrading, as well as encouraging merger and restructuring to create large companies.

With respect to concerns that the new stimulus plan would add too much new capacity to the specified industries, Vice Chairman Zhang explained that the package funds would not be used for investment in the processing industry and duplicative projects. Instead, the focus would be on promoting social welfare, or "three-rural" projects. Investments will flow primarily to infrastructure projects, ecosystem and environment protection, energy saving and emission reduction projects, and be used to cover costs for structural adjustment, technology renovation, and modification of economic development patterns.

Industry	Policies
Auto industry	Implement the new energy strategy, commercialize electric cars and key components, allocate central fiscal funds to support energy saving cars and cars using new energy in middle to large cities; subsidize consumption; encourage early retirement of old cars; reduce consumption tax for cars to 5%
Steel industry	Control the total output, retire old technologies, merger and restructuring, support technology renovation, optimize geographical allocation
Textile and apparel	Increase export VAT rebate from 14% to 15%
Ship making	Stabilize demand, control new capacity development, push forward structure adjustment, improve the overall competitiveness of large ship makers, speed up renovation, develop high value added ship manufacturing capacity, develop marine engineering equipments manufacturing capacity

Industry	Policies
Equipment manufacturing	Promote domestic manufacturing capacity for key technical equipments, encourage structural adjustment; support merger among the key equipment manufacturing companies to create a large enterprise group with the capacity to engage in international operation and financing capabilities; accelerate and improve products standards setting; and foster the development of a modern manufacturing service industry for the sector
Electronics and information technology	Optimize industrial structure, ensure the stable development of the key enterprises in the industry, develop self innovation capacity, achieve break-through in key technologies, enhance software development capacity, foster the creation of economic driving engine in the telecommunication equipments, information service and technology sector
Light industry	Expand consumption and supply, improve trade facilitation, and maintain overseas market shares
Petrochemical	Upgrade the industry and establish a national refined oil strategic reserve system
Non-ferrous metals	Stabilize and expand domestic and overseas markets; support exports of deep processed, high value-added, and high-technology products; support technology renovation; encourage enterprises restructuring; improve raw material supply security; develop recycling capacity; develop national reserve systems for some of the non-ferrous metals; and adjust VAT rebate structure
Logistics	Promote commercialized and specialized logistics services; promote merger and restructuring to create large and globally competitive logistics companies; promote logistics services in energy, mineral, auto, agricultural products, medical device industries; and promote international logistics and tariff bond logistics capacities

Source: Chinanews; available at http://www.chinanews.com.cn/cj/gncj/news/2009/02-25/1578916.shtml.