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An Assessment of China's Trade System

China's trade system has a reputation for high tariff rates, complicated nontariff barriers, and strict controls. But our aggregate measures of the costs of protection suggest that Chinese trade protection is not extreme when compared with that of Japan or South Korea.[1] This result contradicts popular wisdom. In this chapter, we will attempt to show why.

Import Tariffs: High Rates, Multiple Reductions and Exemptions, and a Narrow Base

In 1994, China still maintained a system of high tariffs. Despite prior reductions, nominal tariffs remained high, at an average of nearly 36 percent—about 30 percentage points higher than most developed countries and 15 to 20 percentage points higher than many developing countries in Asia. In 1994, some 6,350 tariff lines were enumerated. Goods with rates below 10 percent represented 11.2 percent of total lines, while goods with rates above 30 percent represented 44.1 percent of the total. In all, 598 goods had rates above 80 percent. Goods with high tariffs included durable consumer goods (sedans, limousines, motorcycles, air conditioners, videocassette recorders, etc.) and nondurable luxury goods (cigarettes, wine, cosmetics, etc.). If the tariff rates on these items were

1. See Sazanami, Urata, and Kawai (1995) for Japan and Kim (1996) for South Korea. We compare tariff and nontariff barriers, consumer surplus ratios, and import penetration for China, Japan, and South Korea in chapter 3 of this book.

strictly enforced and if value-added and consumption taxes were imposed on top of the tariffs, then the gross tariff plus tax on such imports would exceed 100 percent and sometimes reach 400 percent.

However, duties were not strictly enforced. In some cases, when excessively high tariffs on intermediate goods created import shortages, the government announced a lower ''provisional tariff rate.'' By 1994, some 282 tariff lines could be imported under a reduced provisional tariff.

Furthermore, the government implemented tariff reductions and exemptions on a large scale. In 1994, 19 categories of imported goods qualified for reduced or zero tariffs, as shown in table 4.1. These measures covered about 43 percent of China's total imports, reducing tariff revenues by nearly $10 billion.

Meanwhile, the rapid growth of China's processing trade (trade in goods that are imported, processed, and then reexported) was also shrinking the proportion of imports subject to duty payments. Chinese firms conduct two main types of processing activities: (1) import processing with material provided exclusively by foreign clients who are in turn customers for the finished products and (2) import processing with some materials provided by domestic firms. Goods imported for approved processing activities are treated by the customs authorities as bonded imports. They are not subject to the payment of tariffs or other taxes.[2] Despite the loss in revenue, the government encourages processing trade because it creates employment, utilizes excess industrial capacity, and earns foreign exchange. In 1994, bonded imports amounted to $47.6 billion, about 41.1 percent of total imports (table 4.2).

Together, these relief measures mean that out of total imports of $115.7 billion in 1994, only $18.3 billion were dutiable goods (about 16 percent of total imports). Total tariffs of $3.17 billion were collected on the $18.3 billion of dutiable imports, indicating an actual average tariff rate of 17.3 percent. Although the average tariff rate declined to 23 percent in 1996, from 36 percent in 1994, the share of inward processing in total imports rose to 44.9 percent in 1996. Meanwhile, collected tariff revenue reached $3.5 billion, mainly because some tariff reduction and exemption policies were eliminated. Another factor may have been that for those goods not subject to a reduction or exemption before 1996, a lower tariff rate may have induced higher imports and, if the increases were high enough, higher tariff revenues.

Of the 25 products selected for this study, three had tariff rates above 80 percent: sedans, motorcycles, and air conditioners. These are luxury consumer durable goods, often purchased by public ministries or state enterprises. Despite high tariff rates, they constitute a significant portion of

2. For policy regulations governing the processing trade, see Shino-Hong Kong International Co. (1989).

Table 4.1 Import tax exemptions and reductions in 1994

Exemption for . . .	Approved by . . .
Goods used in SEZs	Local governments and their authorized departments
Goods used in SEZs (half exemption)	SPC, MOF, the Tariff Policy Commission of the State Council, the Bureau of SEZ, and GAC
Economic development regions along coastal areas	Relevant provincial governments
Economic and technical development regions along coastal areas	Local governments and their authorized departments
Goods using foreign-government loans	MOFTEC
Goods using international loans	MOFTEC and the loan managing department of the People's Bank of China
Donations by overseas Chinese and the European Union	Provincial governments, the Overseas Chinese Bureau of the State Council, the Office of the State Council for Taiwanese Issues, State Council's office of electromechanical goods import/export control, and GAC
Donations by international and foreign governments	MOFTEC, MOF, PBC, SPC, SSTC, SEC, the State Family Planning Commission, MOH, MOA, and the Chinese Red Cross
Equipment and technology for the joint exploration of oil	The Chinese Ocean Oil Corporation and GCA
Equipment for technical importation	The State Economic and Trade Commission
Equipment for key national projects	Relevant to the key national project, commissions, and provincial governments
Equipment for broadcasting	MORFT
Merchandise imported by foreign firms investing in China	MOFTEC, the local bureaus of the economic and trade commission, and the state and local commercial and industrial bureaus
Equipment for compensating and processing trade	Relevant to MOFTEC or its local authorities
Hotel appliances for foreign investment or loan projects	National Bureau of Tourism, MOFTEC, and SPC
Barter trade with the former Soviet Union and former Soviet East European countries	MOFTEC
Apparatus for educational and scientific purposes	GAC and local customs authorities
Special permission for the particular case	The State Council and the Administrative Office of the State Council
Devices for disabled imported by organizations for disabled	MOIA, the Foundation for the Disabled, GAC, and local customs authorities

GAC: General Administration of Customs
MOA: Ministry of Agriculture
MOF: Ministry of Finance
MOFTEC: Ministry of Foreign Trade and Economic Cooperation
MOH: Ministry of Hygiene
MOIA: Ministry of Internal Affairs
MORFT: Ministry of Radio, Film, and Television
PBC: People's Bank of China
SEC: State Education Commission
SEZs: Special Economic Zones
SPC: State Planning Commission
SSTC: Science and Technical Commission

Table 4.2 Bonded goods imported for processing and reexport by China, 1987-95

	1987	1988	1989	1990	1991	1992	1993	1994	1995
Value of bonded goods imported for processing and reexport (billions of dollars)	10.2	14.7	16.4	18.7	25.0	31.5	36.4	47.6	58.4
Percentage of total imports	24	27	28	35	39	39	35	41	44

Source: General Administration of Customs, *Customs Statistics Yearbook*, 1987-95.

dutiable imports and an important source of tariff revenue. Two products selected for study have tariff rates of zero (wheat and ammonium phosphate). For these products, import controls are administered indirectly by state plans for grain and fertilizer. Consequently, both goods are protected with nontariff barriers of 72.4 percent. We also assigned a tariff rate of zero to color televisions because an overwhelming proportion are imported through duty-free foreign exchange stores. In addition, we assigned provisional tariff rates of 15 percent, 7 percent, and 8 percent, respectively, to color-television tubes, microcomputers, and videocassette recorders, because the government permits low provisional tariffs for designated industrial users of these commodities, within a prescribed import volume.

Import Approval: Designated Trading Agents and High Transaction Costs

Before 1994, China's import approval system largely operated under the umbrella of its state-planned economy. Two prominent and enduring features of that system are designated trading agents and high transaction costs. Under the designated trading agent system, only a limited number of firms can import and sell products in the domestic Chinese market. Firms become designated trading agents either by assignment from central government ministries in Beijing or by capturing part of the import quotas that are distributed from Beijing to districts or industries. Most of these quotas cannot be obtained through market competition—competitive bidding is still uncommon.

China currently administers two types of import approval procedures, based on the purpose of importation. Imports for processing trade are subject to a simplified import approval procedure: Any enterprise that has a contract with a foreign corporation for a processing activity approved by MOFTEC or its subordinates and that is registered with the customs office is permitted to import goods without having to deal with designated trading agents or pay high transaction costs.

However, goods imported for purposes other than the processing trade are subject to the standard import approval procedure, which involves designated trading agents and high transaction costs. The government retains control over imports by authorizing trading rights and using the designated agents to enforce quotas and other nontariff barriers. The government uses nontariff barriers to centralize the management of imports of strategic commodities while diversifying the management of imports for most goods. Table 4.3 summarizes the 1994 nontariff barriers for the goods included in this study.

According to MOFTEC's 1994 trade policy document Provisional Regulations for the Management of Import Commodities, imports of 12 types of goods are controlled by designated trading agents: wheat, crude oil, refined-oil products, fertilizers, natural rubber, rolled-steel final products, timber, plywood, wool, polyacrylonitrile fiber, cotton, and tobacco. Only a few state-run designated trading companies are authorized to import these goods; other firms can only purchase the imports from these agents. Of the 25 goods selected for this study, 10 are managed by designated trading agents: wheat, crude oil, gasoline, diesel oil, ammonium phosphate, natural rubber, rolled-steel final products, plywood, wool, and synthetic fibers.

Quota and license administration is another type of import approval procedure. In 1994, three groups of imports were regulated by quota and licensing. These were:

- Electromechanical goods. Quotas were imposed on electromechanical imports because the government decided that developing domestic production of these goods was more important than meeting the market demands for these goods at the world price. Imports of electromechanical goods that compete with industries selected for accelerated development are administered under a ''catalog of specific electromechanical products.'' In 1994, 171 tariff lines of electromechanical goods were listed in this catalog. In addition, 10 other product categories (comprising 196 tariff lines) in the electromechanical group were subject to quotas designed to promote industrial restructuring (e.g., automobiles, motorcycles, and color televisions). Certification from the State Council's Office of Electromechanical Goods Import/Export Control must be obtained to import these goods (MOFTEC 1994a).
- Nonelectromechanical goods. In 1994, 26 types of nonelectromechanical goods (356 tariff lines) were also subject to quota regulations (crude oil, wool, timber, plywood, etc.). Certification from the State Planning Commission is required to import these goods.
- Other regulated goods. In 1994, to monitor the import of certain important commodities, the State Planning Commission brought nine categories of goods (comprising 361 tariff lines) under a so-called ''automatic

Table 4.3 Nontariff restraints for 25 imports in 1994

	Managed by authorized companies	Quota or register	Import license	Other nontariff barriers
Food				
Sugar	No	Quota[a]	License from MOFTEC deputy[b]	Commodity inspection Plant inspection Food inspection
Wheat	Yes	Quota[a]	License from MOFTEC	Commodity inspection Plant inspection Food inspection
Rapeseed oil	No	Quota[a]	License from MOFTEC deputy	Commodity inspection Plant inspection Food inspection
Beverages				
Soft drinks	No	Quota[a]	License from provincial COFTEC[c]	Food inspection
Inedible raw materials				
Plywood	Yes	Quota[a]	License from provincial COFTEC	Commodity inspection and plant inspection
Wool and wool tops	Yes	Quota[a]	License from deputy of MOFTEC	Quarantine
Synthetic fiber	Yes	Quota[a]	License from provincial COFTEC	Commodity inspection
Crude oil	Yes	Quota[a]	License from MOFTEC deputy	Commodity inspection
Natural rubber	Yes	Quota[a]	License from MOFTEC deputy	Commodity inspection
Synthetic rubber	No	Quota[a]	License from provincial COFTEC	
Fossil-fuel products				
Gasoline	Yes	Quota[a]	License from MOFTEC deputy	Commodity inspection
Diesel oil	Yes	Quota[a]	License from MOFTEC deputy	Commodity inspection
Chemicals				
Ammonium phosphate	Yes	Quota[a]	License from MOFTEC deputy	Commodity inspection
Plastics	No	Register[d]		Commodity inspection
Manufactured goods				
Rolled-steel final products	Yes	Register[d]		Commodity inspection
Copper and copper products	No	Register[d]		Commodity inspection
Aluminum and aluminum products	No	Register[d]		
Transportation equipment				
Motorcycles	No	Quota[e]	License from MOFTEC deputy	Commodity inspection
Autos (sedans)	No	Quota[e]	License from MOFTEC deputy	Commodity inspection
Miscellaneous manufactured goods				
Color television	No	Quota[e]	License from MOFTEC deputy	Commodity inspection
Videocassette recorders	No	Quota[e]	License from MOFTEC deputy	Commodity inspection
Air conditioners	No	Quota[e]	License from MOFTEC deputy	Commodity inspection
Microcomputers	No	Quota[e]	License from MOFTEC deputy	Commodity inspection
Color tubes	No	Quota[e]	License from MOFTEC deputy	Commodity inspection
Program-controlled switchboards	No			

a. Nonelectromechanical.
b. MOFTEC is the Ministry of Foreign Trade and Economic Cooperation. Deputy refers to the individual who was dispatched to the entry point by the MOFTEC.
c. COFTEC is the Commission of Foreign Trade and Economic Cooperation.
d. Other regulated.
e. Electromechanical.

registration equipment'' (rolled-steel products, copper, aluminum, paper, cosmetics, etc.). Certification from the State Planning Commission is also required to import these goods.

In addition, an import license issued by MOFTEC or one of its subordinate bodies is required to import either of the first two types of goods. These import licenses are issued at three levels: by MOFTEC, local deputies of MOFTEC, and the local (provincial or municipal) Commission of Foreign Trade and Economic Cooperation (COFTEC). To sum up, among the 25 imported goods that we study, seven require a ''certificate of import quota for electromechanical products'' from the State Council's Office of Electromechanical Goods Import/Export Control, 13 require a ''certificate of import quota for ordinary commodities'' from either the State Planning Commission or its subordinate bodies, four require a ''certificate of import registration for specific products'' from the State Planning Commission, and 20 require an ''import license'' from MOFTEC or COFTEC (see tables 4.1 and 4.3).

The various import approval procedures are costly. In addition, there are the expenses of commodity inspection, quarantine, sanitary inspection, customs declarations, etc. Mismanagement is also costly: an electronic data network has not yet been established among the authorities that supervise and control imports and the efficiency of these authorities is relatively low. These measures contribute to the high transaction costs for goods imported into China. Although demand conditions and high tariff rates may have contributed to the gap, the deterrent effect of high transaction costs may help to explain why, in 1994, import quotas for many goods were not filled.

Government Administration: Overlapping Authority and Multiple Objectives

In China, both the central and local governments administer imports. Many central-government departments have deputies at the local level. This bureaucratic structure, coupled with the trend toward decentralization, has led to a joint administration of import policy by central and local authorities. Moreover, at both the central and local levels, more than one department has a voice in shaping import policy. This multiplicity of actors has led to conflicts and contradictions (see box 4.1 for the roles of each agency).

For example, China's tariff rates are principally drafted by the State Council's Committee on Tariff Regulations, but in practice many departments participate, including the State Economics and Trade Commission, the Ministry of Finance, MOFTEC, the State Planning Commission, the State General Administration of Taxation, and the General Administration of

Box 4.1 Role of economic ministries and offices in trade affairs

1. State Planning Commission
Distributes ''nonmechanical products quotas'' and issues ''import automatic register certification.''

2. Tariff Policy Commission of the State Council
Responsible for tariff policy and adjusting tariff rates.

3. Office of Electromechanical Goods Import/Export Control under the State Council
Distributes ''electromechanical products quotas'' and issues ''electromechanical products import certifications.''

4. Ministry of Foreign Trade and Economic Cooperation (MOFTEC)
Issues ''import/export licenses'' to firms with quotas and approves import processing contracts.

5. General Administration of Customs
Supervises import/export controls, collects customs duties (based on policies and rates set by the Tariff Policy Commission of the State Council) and other taxes and fees, prevents smuggling, and compiles customs statistics.

Customs. In addition, the ministries of various industries and local governments insist on having a voice in issues that affect their particular interests.

As for quantitative restrictions, the State Planning Commission, MOFTEC, and the State Commission of Economics and Trade have the decisive roles. However, as with the creation of tariff policy, the various industrial ministries, local governments, and even designated trading companies play an active role in the process. Local authorities participate in the distribution of import quotas, and the General Administration of Customs and local customs authorities collect import taxes and enforce quantitative restrictions.

The central government has multiple objectives in designing its import policies: raising employment, promoting infant industries, fostering economic growth, keeping prices down, acquiring better technology, and maintaining a reasonable current account position. At the same time, it seeks to fulfill trade agreements and collect much-needed revenue from tariffs, value-added taxes, and consumer taxes. To complicate matters, the many central-government departments overseeing foreign trade do constant battle over administrative power, staff positions, and the dispensation of chartered rights and favored treatment.

Local governments, likewise, have multiple objectives. They lobby for chartered rights and other concessions to spur the local economy, raise employment, and boost local revenue. At the same time, they must carry out responsibilities delegated by the central government. Corruption often comes into play, with local governments and influence peddlers exploiting privileges and even engaging in illicit trade.

Conflicting objectives have been most pronounced in tariff reduction and exemption policy, processing-trade administration, and the control of smuggling. Given the complicated nature of import policy at all levels in China, it is useful to examine the operational mechanisms for dealing with these three areas.

Tariff Reduction and Exemption Policy

Since 1993, the central government has been trying to dismantle its tariff reductions and exemptions system to increase public revenue and lower the average statutory tariff. To smooth the transition, China has gradually repealed tariff reductions and exemptions and established grace periods for some industries. However, this approach has prompted those local governments and authorities that benefit most from reductions and exemptions (in league with affected domestic and foreign firms) to lobby the central government for longer grace periods. When grace periods are extended, local authorities often bring more production on-line. Meanwhile, those local authorities and industries with fewer tariff reductions and exemptions grumble that they are put at a disadvantage. They pressure the central government either to grant them more reductions and exemptions or to quickly dismantle the whole system.

Imports for Processing Trade

Illicit diversion of imports into the domestic market often accompanies the processing trade. Diversion reduces public revenue and erodes the effectiveness of quotas and licenses. In response, the central government has proposed a series of deterrent measures, such as intensified monitoring of imports and exports. But local governments oppose tighter surveillance, for fear that it will interfere with export-oriented activity. MOFTEC has nevertheless pushed ahead with its antidiversion campaign. To this end, the General Administration of Customs initiated a system of ''prior deposits'' to ensure that high-risk imports were indeed processed for reexport. Under this system, tariffs were deposited when goods were imported and refunded when the processed goods were exported. This put a financing and administrative burden on legitimate processing firms. In 1995, after much deliberation, the central government proposed a ''desk account'' system, by which the customs office would collect taxes on imported goods that are not exported after processing without raising the cost to firms that legitimately reexport their imported components and raw materials after processing. The jury is still out as to whether this compromise measure solved the import diversion problem.

Smuggling

The control of smuggling has long been a high priority, with all levels of government declaring their enthusiasm for enforcement measures. However, the incentives for smuggling remain strong, thanks partly to high protective barriers (see appendix D). To cite some extreme examples, the estimated profit rate on smuggled cigarettes exceeds 200 percent, while on smuggled sedans the figure is above 150 percent. Some local authorities actually sympathize with the smugglers. They plead for mercy on their behalf and even acquit smugglers who are caught red-handed, because smuggling only reduces central government revenue and does not have a direct impact on local interests. Furthermore, these local authorities may be the recipients of bribes. The central government periodically initiates nationwide crackdowns. But often when smugglers are apprehended, they are merely fined and set free, and the fines are even lower than the legitimate tariffs and taxes in certain cases.

In this atmosphere, smuggling thrives. In many situations, law-abiding importers operate at a competitive disadvantage to smugglers, and this prompts the expansion of illicit trading behavior. Available statistics show that the amount of confiscated smuggled goods in 1995 exceeded 10 billion yuan ($1.2 billion). Attempts have been made to curtail this activity. For example, in 1994, more than 2,000 smuggled automobiles were seized by customs. The central government has decreed strict measures to enforce the ban against sedan smuggling, such as requiring annual automobile inspections and certified import documents when registering an automobile with the motor vehicle administration. Theoretically, therefore, it is almost impossible for smuggled automobiles to escape detection. Yet, these measures have not succeeded in curbing automobile smuggling, partly because the smugglers enjoy the protection of some local authorities.

Conclusion

Our aggregate measures of the costs of protection are perhaps on the low side. Multiple trade regulations have created huge economic rents. Loose law enforcement encourages illegal trade and corruption to take place. Also, domestic business practices, including trade barriers among regions, probably add to the total cost of protection (Rosen 1996). If these additional barriers are added to our costs, the costs of protection in China might exceed those in South Korea or Japan. Also, dynamic effects are more important in China than in South Korea or Japan, because the Chinese economy has been centrally planned and dominated by monopolies for so long. Therefore, in the long run, the benefits of trade liberalization will exceed its costs by far.