Thornhill Capital

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Government Subsidies and the Home-Court Advantage, Part I

What's made China the export powerhouse it is today is that it's able to produce its goods cheaper than anyone else, or on a scale in which smaller countries find it difficult to compete. Most assume that this lower cost of goods is due to an inherent in-country economic benefit of cheaper labor, as well as less expensive infrastructure costs, such as electricity and water. And that's, for the most part, true. However, Chinese government subsidies for many industries have allowed many companies to produce their goods at an artificially low cost.

A subsidy is a direct or indirect transfer of resources from the government to a producer or exporter. In other words, a subsidy exists if there's a financial contribution or price support by the government where a benefit is conferred.

According to a study performed by Capital Trade Incorporated and submitted to the US-China Economic and Security Review Commission, a financial contribution can be

- a direct transfer of funds, such as a grant, loan, or equity infusion;
- a potential direct transfer of funds, such as a loan guarantee;
- foregoing or not collecting revenue that is otherwise due, as with tax credits or deductions from taxable income;
- providing goods and services other than general infrastructure; or
- purchasing goods.

In the above examples, foreign companies may benefit from these subsidies in a number of ways:

- The interest rate on the loans they receive may be less than comparable commercial-rate loans.
- The government buys shares at a higher price than other investors or invests in a company in which other investors

would not invest.

- The government forgives principal and/or interest.
- The tax paid by the company is less than that paid by a comparable company without a tax program.
- The goods or services provided are at costs below prevailing market conditions.
- Government-provided assistance replaces some of the corporate obligations of the company.
- Export transport or freight costs are less than domestic transport or freight costs.
- The terms for the products or services produced are more favorable for export than for domestic consumption.

A Lack of Transparency

Not all subsidies are easy to spot. They're not transparent. For example, municipal and local governments routinely provide water and electricity to companies whose products are exported, thereby allowing a company to manufacture its products at an artificially low cost. In addition, the government can subsidize a company by providing low or free rent. It can also provide land at no cost or at a price substantially below market value. All these methods for subsidizing a company lack transparency and are difficult to substantiate. But the end result is still the same. Due to government subsidies, China is able to manufacture goods at a price that makes the manufactured products of other countries uncompetitive.

In addition to subsidies, many provinces and municipalities relax enforcement of labor laws and environmental standards for companies in key

economic sectors. These subsidies are very difficult to document, yet they give Chinese companies a substantial economic advantage.

One of the most difficult subsidies to document are loans by China's banks to state-owned enterprises (SOEs). According to Peter Navarro, a professor of economics and public policy at the Paul Merage School of Business, University of California, Irvine, these loans are often issued at little or no interest rate and without expectation of repayment. Many of these SOEs are in heavy industries, such as petroleum and steel, and employ a great number of people. As a result, the government is loath to allow them to go bankrupt, even if they lose a great deal of money, because of the loss of jobs and social unrest that would ensue.

The Home-Court Advantage

In what's considered by many to be a subsidy, China uses a value-added tax (VAT) rebate system for export industries.

> A value-added tax is a form of consumption tax where the seller charges the VAT to the buyer and then pays this tax to the government.

In China, a VAT tax is imposed in the domestic production and distribution process. However, in many cases, the government simply collects and then rebates this tax for exports. In other cases, exporting firms are simply exempt from the tax. These practices create an uneven playing field in that the VAT rebate acts as an export subsidy and therefore violates World Trade Organization (WTO) rules, which prohibit export subsidies.

Subsidies make Chinese firms more competitive in the world market. Since China joined the WTO in 2001, government subsidies have annually

financed over 20 percent of the expansion of the country's manufacturing capacity. These subsidies give China the ability to not only be competitive, but to also dominate markets in which it has no labor-cost advantage. In solar, steel, glass, paper, and auto parts, Chinese labor was 2 to 7 percent of production costs. Imported materials and energy accounted for the remainder of the manufacturing cost. Yet the cost of Chinese auto parts was substantially below that of other industrialized countries with equally efficient manufacturing processes!

Taking autos and auto parts as an example, according to the Office of the United States Trade Representative, the Chinese government provided auto and auto parts manufacturers, between 2009 and 2011, more than $1 billion in subsidies. Autos and auto parts have been an increasing focus of the Chinese government, and between 2002 and 2011, China's exports of autos and auto parts increased more than nine-fold, from $7.4 billion to $69.1 billion, catapulting China from the world's sixteenth largest to the fifth largest autos and auto parts exporter.

Some may argue that giving consumers access to cheaper parts is good. After all, given the same quality, most, if not all, of us would choose the cheaper priced product. That works for consumers. However, on a micro level, the production of autos and auto parts in the United States is a key component of our nation's manufacturing base. In 2011, for example, manufacturers in the United States produced over $350 billion worth of autos and auto parts. Typically, this sector accounts for about 5 percent of the US GDP and 16 percent of all durable goods shipments. It also employed, as of July 2012, over 800,000 American workers. The sale of autos and auto parts by Chinese companies at artificially low prices jeopardizes many of these jobs, as well as has a direct impact on the American economy.

The reason that China's goods are priced so low, compared to those produced by other industrialized countries, is not only because of China's cheaper labor rate. It's also, as we mentioned, because of government subsidies. In 2000, according to the *Harvard Business Review*, labor-intensive products constituted 37 percent of all Chinese exports. By 2010, they fell to 14 percent. Yet China's exports continued to grow. The difference was government subsidies, which now allowed China to produce technologically advanced products and undercut unsubsidized foreign manufacturers. In 2011, the United States imported 560 percent more technologically advanced products from China than it exported.

The Harvard Business Review gives two examples of how government subsidies can create a dominant global position for the product that's subsidized. In 2000, China was a net importer of steel, with 13 percent of world imports and 16 percent of global output. By 2007, it became the world's largest producer, consumer, and exporter of steel. During this same period, government energy subsidies to China's steel industry totaled $27 billion. Today China produces half the world's steel, which sells for 25 percent less than US or European steel, even though China has no technological advantages.

In a second example, China became the world's largest paper producer, selling its paper at a substantial discount to both European and US paper. This was largely the result of $33 billion in government subsidies to paper manufacturers from 2002 to 2009. With a similar subsidy package, foreign firms would be much more competitive against Chinese companies and experience increased output, exports, workers' earnings, and enhanced growth. Inversely, without these subsidies, China would experience a decline in its economy.

Promises Broken

In 2000, prior to China joining the WTO, member nations informed China that subsidies were not permitted among WTO member nations and that they would have to discontinue this practice. China, eager to gain entry to the WTO, promptly agreed. According to Usha C. V. Haley, professor of management and director of the Robbins Center for Global Business and Strategy at West Virginia University, and George T. Haley, professor of marketing and director of the Center for International Industry Competitiveness at the University of New Haven, the WTO requires annual notification from members on subsidies they maintain. However, until April 13, 2006, there was a total lack of compliance on the part of China, as it failed to acknowledge subsidies to domestic producers.

Finally, on that date, China identified seventy-eight subsidy programs that existed from 2001 to 2004. However, it ignored WTO directives that dictate that members should provide sufficient information *to enable other members to evaluate the trade effects to understand the operation of notified subsidy programs*. Instead, China's report simply stated that several central government ministries and agencies distributed and monitored subsidies, and extensive legislation in China supported these subsidies. No data were provided for anyone to assess the trade effects of any subsidy or the amount of the subsidy. China's notification focused almost entirely on subsidies to foreign-invested enterprises (FIEs).

A foreign-invested enterprise (FIE) is a legal structure that permits a company to set up its business in a foreign country.

China's notification, therefore, ignored subsidy programs supported by

provincial and municipal governments, favorable lending policies by commercial banks, financial preferences for SOEs, providing electricity at below-market rates, and other forms of subsidies that reduced the financial burden on industry.

In Part II, I'll discuss how subsidies affect various Chinese industries as well as the private sector.

References for the data and information contained within the above material can be found in *Conducting Business in the Land of the Dragon* by Alan Refkin and Scott Cray.

Alan Refkin

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