

*The Political Economy of  
Trade Policy in China*

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**WP 10/2000**

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*August 2000*

**MPP Working Paper No. 10/2000 ©**

August 2000

**ISBN: 87-90403-78-9**

**ISSN: 1396-2817**

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## **ACKNOWLEDGEMENTS**

I am grateful to many Chinese scholars for helpful comments and suggestions, particularly my supervisor Prof. Xiong Xingmei (Nankai University), and other oral defense panel members Prof. Xian Guoming and Xue Jingxiao (Nankai University), Zhang Shuguang (Chinese Academy of Social Science), and Wang Linsheng (University of Foreign Trade). Special thanks for the help and advice given by Prof. Robert E. Baldwin (Wisconsin University, Madison). In addition, I wish to thank the Department of Management, Politics and Philosophy, Copenhagen Business School as my host institution of the EU-China Higher Education Program for providing kind support for the research work. In particular, I would acknowledge the great help and suggestive comments of Prof. Lise Lyck and other seminar participants. Nevertheless, all errors are sole responsibility of the author. The views expressed herein are those of the author and should not necessarily reflect those of the Institute of International Economics, Nankai University, and the Department of Management, Politics and Philosophy, Copenhagen Business School.

## ABSTRACT

Most of economists, who prefer either the classical trade theory or the latest emerging new trade theory, adhere to the doctrine of free trade. However, the perplexity between the theoretical ideology and ever-lasting protectionism in reality demonstrates that the political decision-making process of trade policy is often less understood or even ignored. Political economy of trade policy, or simply called endogenous tariff theory, may offer a plausible and decent answer to the dilemma from the perspective of income distribution, rather than economic efficiency.

The paper is basically an analytical-cum-empirical study of trade politics in China, P. R. on the basis of the latest theoretical development of political economy of trade. For this purpose, Chinese trade policies, including trade development strategy, export and import regime, and trade liberalization reform are thoroughly examined so as to yield a comprehensive and far-reaching insight into the political economy of trade policy in China. In Particular, the pattern of trade protection in industrial sectors is studied by cross-sector and time series data to explain its political and economic determinants. Instead of figuring out an optimal trade strategy and reform package for the government, the aim of the study attempts to present a profound understanding to the distorted trade regime and piecemeal trade liberalization process of China, the country never exploited in previous literatures but significantly impacting world trade.

The paper is arranged in five sections. In Section I, the research background, motif, methodology and structure of study are deliberately elaborated. Section II describes an analytical framework of the trade policy decision-making process in China, and then reviews motives, behaviors and performance of main playing roles, namely, the party and central government, domestic interest groups, external pressures of world trade system and foreign governments. A formal revised model of political economy of trade protection, which seems fit to Chinese prevailing political institution, is developed in Section III, and then used as a calibration to produce regression models to estimate determination of industrial trade protection structure in Section IV. Meanwhile, a data bank with the uniform classification standard is established to constitute empirical samples. Finally, in Section V I summarize main conclusions of the study.

The general conclusions of the paper are as follows:

(1) Due to the institutional features of market-preserved authoritarianism and state activism, the party ideology, government preference and national interests are the most crucial factors influencing the decision-making of trade policy in China. Specifically, trade planning, trade flow controlling, export promotion and import substitution, industrial policy, national economic security

and balance of payment are concrete objectives to be pursued. The protection policies of trading rights, automatic import registration, automobile production, grain import and banking service are those typical cases.

(2) Thanks to the gradual political democratization and fast economic growth, more diversified social interests become virtually legitimate and active in a corporatism state, consequently leading to their increasing lobbying and rent-seeking activities for import protection and export preferential policies. Bureaucracy in central executive bodies and local governments, favored in a "clientelism" network culture, appear to be a dominated interest group, while others, mainly composed of domestic enterprises of various kinds, foreign investors, military, and consumers, however only have a marginal or diminishing impact on the decision-making. Such an argument can be demonstrated by case studies on, for example, the policies for protecting telecommunication sector, import quota and licensing requirement, export quota bidding, foreign exchange retention and multiple exchange rates system, antidumping enforcement and anti-smuggling campaign.

(3) With the integration into the world economy, Chinese authority can no longer make final decisions by neglecting the world trade institutional settings and international collective actions as before. The prevailing diplomatic strategy and trade philosophy of foreign governments as well as commercial interest of multinational corporations will impose a more significant external pressure on China to ratchet up her trade liberalization in the context of multilateralism (GATT/WTO), regionalism (APEC) and bilateralism (mainly with the United States). On the other hand, in the long run, China will benefit herself from bargain-induced trade reform by fully integrating into a market-oriented and rules-based world economy.

(4) The trade protection rates (nominal tariff, non-tariff barriers, and effective protection rate) are not only relatively high but quite dispersed as well among 36 Chinese industry sectors, which reflects both national strategic activism and different lobbying capacity of interest groups. The empirical study indicates that those sectors which have the characteristics of higher labor productivity, higher comparative advantage, higher backward linkage, higher labor intensity, higher profits and tax creating, lower value added proportion of public enterprises, and higher consumer goods ratio are usually able to obtain higher nominal and effective protection. Additionally, there is a complementary relation between tariffs and non-tariff barriers. The result of regressions shows that "social concern model" in the literature seems to be more appropriate to explain China's trade protection pattern than "self-interest model". Nevertheless, the social concern herein primarily deals with implementing national interests and industrial policy, rather than mitigating structural adjustment cost and pursuing the equality of income distribution.

As regards policy implications, the study argues that if trade liberalization reform could be viable in the future in China, leaders in the party and central government have to adopt innovative market-oriented trade philosophy and succeed in dismantling obstructions from some interest groups by restructuring political bargain and consensus process in policy-making. Commitments to international agreements and institutional rules in world trade system can provide China with a benchmark and "bicycle effect" for pending reforms.

**Key Words: China, Trade Policy, Political Economy, Trade Protection**

## **I. Introduction**

Most of economists, who prefer either to the classical trade theory or to the latest emerging new trade theory<sup>1</sup>, adhere to the doctrine of free trade. However, the perplexity between the theoretical ideology and ever-lasting protectionism in reality had puzzled them for a long time. It essentially originates from the traditional viewpoint dimension in which economists study on trade policy, namely, the efficiency property of trade policy (Helpman, 1995). It means that if a government pursues economic efficiency or social welfare maximization, all trade policy instruments, whether they be tariffs, export subsidies, quota and licence requirements or voluntary export restraints, should be eliminated. Or in other words, if there exist some trade policy measures, they destined to result in economic distortions and welfare losses under most circumstances.

One plausible answer to the dilemma is the theory of political economy of trade policy that has produced a strand of literature to explain the existence of prevailing trade policy since the late 1970s. Instead of economic efficiency, the theory stresses on income distributional consideration and argues that the political decision-making process of trade policy is often less understood or even ignored. It contends that the real reason for trade interventions is that they are subjectively "created" (supplied) or objectively "needed" (demanded) by the government or some interest groups in society. Given the government objective function and prevailing social interest structure, trade policy should be viewed as a device for income transfers to preferred groups. In other words, it is a sort of "equilibrium price" solved in the political market with the participation of public, authority, interest groups, and foreigners. Therefore, the political economy of trade policy can be simplified as "endogenous tariff theory", in contrast to the traditional theory which looks upon tariff as "exogenous" decided.

On the basis of Mueller's pioneering work on the relation between trade policy and public choice theory, a large number of literatures have emerged in this field (Baldwin, 1982). Early formalizations (Krueger, 1974; Bhagwati, 1971, 1982) emphasized the social welfare loss of endogenous formulation of trade policy by developing the well-known rent-seeking theory, directly unproductive profit-seeking (DUP) theory, and generalized distortion theory, which now constitute the theory of "normative political economy of trade policy" (Baldwin, 1996). More recently, many researchers have concentrated on formally modelling the institutional features of the policy formation process by

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<sup>1</sup> Since late 1970s, a group of trade economists challenged the theoretical orthodoxy by developing so-called "new trade theory" and then agitating "strategic trade policy". A beggar-thy-neighbor policy including export subsidies and tariffs is advocated to extract rent from foreigners on the premise of imperfect competition market structure and increasing returns. Externality is another argument to support governmental border intervention to promote the development in high-tech industries. Although such an aggressive policy is welcomed by the business field and some patriotism politicians, it is still in the acute debate within the academic scope. Many critics argued that new trade theory does not present a strong ground of tracking off free trade.

considering governments, political parties, lobbyists, and elections. These models contribute to enriching the theory of "positive political economy of trade policy" (Baldwin, 1996). As a branch, models of "social concern approach" view the government as a benign shepherd to maximize the "conservative social welfare function" (Corden, 1974) or provide insurance in case of import competition (Eaton and Grossman, 1985; Cassing, Hillman, and Long, 1986; Staiger and Tabellini, 1987). "Self-interest approach" is another branch to relate trade policy to domestic and international politics, given the nature of the government as an "economic man" in pursuit of rationality and selfishness. However, there does not exist a coherent theory to explain trade policy due to the disagreed theory of politics. In specific, Mayer (1984) proposed to regard trade policy as the outcome of majority voting over tariff levels in a direct democracy. Peltzman and Stigler (1971) and Hillman (1982) argued that a tariff rate can be seen the solution of government's trading off political support from interest groups. In the Findley-Wellisz model (1982), a tariff results from non-cooperative game between the interest group lobbying for it and the other opposing it. Alternatively, Magee, Brock and Young (1989) emphasized on the electoral competition between two political parties and therefore tariffs are the Nash equilibrium of a two-stage game among parties, interest groups and public. They also revealed an extreme case called "black hole effect" that almost all of social resources will be exhausted to lobby for a favoured trade policy while tariff rate is finally reduced. Feenstra and Bhagwati (1982) used a tariff formation function with a government that cares about the welfare of general public, and eventually the trade protection demanded by an organized interest group can be lowered to an "efficient" tariff rate than initially sought by "bribery". Finally, a prominent model in the recent political economy literature on trade policy is Grossman and Helpman's (1994) "Protection for Sale" model, which highlights the influence exerted by interest groups on policy makers by means of political contributions. Tariffs are induced in the model to maximize the joint objective function of the government and organized interest groups. With a relatively simple structure, the model yields a clear-cut theoretical prediction that have strong implications for the cross-sector pattern of trade protection. Despite the difference of political institutions and lobbying channels that models rely on, Rodrik (1995) pointed out their similarity in terms of modelling structure and Helpman (1995) presented them in a unified framework that helped to see the key parallel solution in tariff formulas among them. Other literature survey can be referred to the works of Nelson (1988), Hillman (1989), Baldwin (1996), and Pant (1997).

In addition to the theoretical development, there are a vast number of empirical studies that investigate the political-economy determinants of trade protection. Among others, a few eminent examples are Caves(1976), Marvel and Ray (1983), Lavergne (1983), Trefler (1993), and Goldberg and Maggi (1997) to study the protection pattern of tariffs and non-tariff barriers. Other econometric studies are applied to the analysis of voting poll on trade acts in congress (Baldwin, 1976; Baldwin and Magee, 1998) or decision on administrative protection, e.g. anti-dumping and countervailing duties in trade commissions (Finger, Hall and Nelson, 1982). Baldwin (1984) and Rodrik (1995) did a marvellous comprehensive survey of literature reviews in these

aspects. Furthermore, case studies of some sensitive agricultural and industrial sectors, like NBER projects (Krueger, 1996), are also conducted to deepen the understanding to the political economy of trade policy in a non-technical method. Most empirical studies deal with developed countries, especially with U.S., and some have emerged in recent years for developing countries, such as South Korean (Yoo, 1993), Taiwan (Chen and Hou, 1993), and Mexico (Grether, Melo, and Olarreaga, 1999).

Unfortunately, so far there is few study on the political economy of trade policy in the transitional economies. In particular, the research on China, the largest developing country and emerging market in world trade, is still in blank. Unlike the political system of check and balance in western democracy, centralism and authoritarianism still dominate the contemporary Chinese politics in general. However, there also appear some unique traditional characteristics of cultural legacy and new features brought by the reform, such as trends in authority changing from "individual pluralism" into "institutional pluralism" and from personal dictatorship to oligarchical consensus-building, "communist neotraditionalism" shifting from totalitarian mass mobilization to network-based clientelism, "fragmented authoritarianism" shifting from bureaucratic central command through the planning apparatus to interunit bargaining in governance, and "state corporatism" that party-state grants interest-licensing allowing constituent units to organize a limited number of hierarchically ordered and functionally differentiated associations to articulate their interests (Hamrin and Zhao, 1995). From the economic perspective, China seems to emphasize more on exercising comprehensive consensus and moderate authority while trying to preserve the market mechanism by means of institutional incentives and surveillance-coordination system, which can be precisely called "market-preserving authoritarianism" or "market-preserving federalism" (Li and Lian, 1996). These new political and economic configurations make the understanding of Chinese decision-making process more complicated than expected and consequently enrich elements of analyzing the political economy of trade policy in China. In addition, as Shirk (1993) argued, the practical challenge of reforming a communist economy is how to manage politically the major redistributions of funds and power involved in the transition from central planning to market competition. Therefore, the process of economic reform in China should be better observed and understood in terms of political logic. The study on the political economy of trade policy can be accordingly regarded as a case of such an analysis.

Under such a background, the paper attempts to conduct an analytical and empirical study of trade politics in China based on the latest development of political economy of trade policy. Instead of figuring out an optimal trade strategy and reform package for the government, the aim of the study is to present a profound understanding to the distorted trade regime and piecemeal trade liberalization process of China. For this purpose, Chinese trade and industrial policies, including trade development strategy, export and import regime, and trade liberalization reform, are thoroughly examined so as to yield a comprehensive and far-reaching insight into the decision-making of trade policy in China. The paper argues that Chinese trade policy formation is still dominated by party-state leaders' ideological preference and great concern

about national interests. On the other hand, the growth of bureaucratic compartmentalization both in central and local levels and business influence in domestic are eroding the unchallenged authoritarianism of making trade policy. More significantly, external forces, the negotiation on China's accession to WTO in peculiar, are ratcheting up trade liberalization process in China. The commitments to multilateral, regional, and bilateral trade agreements also present Chinese leading reformists with a political vehicle to win over interest groups who will block radical market-oriented reform in the future. The cross-sector and time series empirical study which explains political and economic determinants on the pattern of trade protection in Chinese industrial sectors supports, to a large degree, such arguments presented in the paper.

The following part is arranged for four sections. Section II describes an analytical framework of the decision-making process of trade policy in China, and reviews motives, behaviors and performance of main playing roles, namely, the party and central government, domestic interest groups, external pressures of world trade system and foreign governments. In Section III, a formal revised model of political economy of trade protection, which seems fit to Chinese political institution, is developed and then used as a calibration to produce regression models to estimate the determination of industrial trade protection structure in Section IV. Meanwhile, a data bank with a uniform classification standard is established to constitute empirical samples. Finally, Section V concludes.

## II. The Decision-making Process of Trade Policy in China

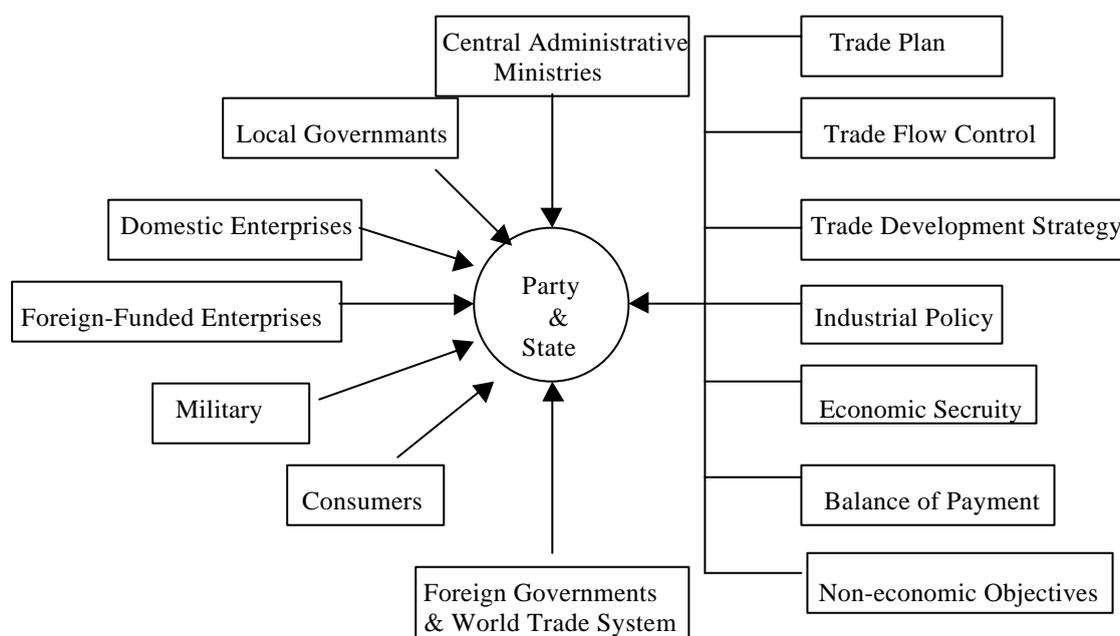
Diagram 1 depicts an analytical framework of the decision-making process of trade policy in China. The central government, *de facto* controlled by the Chinese Communist Party (CCP), dominates in the decision-making of economic policy with its traditional ideology, principles and doctrines developed during past five decades, namely, "balancing in aggregate", "structural adjustment" and "macroeconomic alignment". As far as trade policy is concerned, the "policy targets" inherent in political leaders and techno bureaucracy are specified as trade plan, trade flow control, trade development strategy, industrial policy, economic security, and balance of payment. On the other hand, though not officially recognized and institutionally legitimated, interest groups have become more active since the economic reform. Notably, central administrative ministries and local governments are special kinds of pressure groups in China due to their significant status in the delegated bureaucratic hierarchy. They usually play the role of an agent to lobby or seek rent for their principals, like state-owned enterprises, foreign-funded enterprises, and military, who are affiliated to governmental entities in various forms and bargain with the designated authority in an informal, nontransparent and behind-the-scenes style. Subject to the one-party democracy and legacy of economic planning, interest groups, however, only have marginal impacts on the decision-making of trade policy in general<sup>1</sup>. Finally, with the integration into

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<sup>1</sup> Nevertheless, some commentators argued that if considering the feedback process of policy implementation, domestic interest groups may be able to virtually change the central government's policy under some circumstances. Indeed, there are many examples to illustrate that local governments were

the world economy, China is confronted with more and more demanding challenges of foreign interests, including the rules-based and institutionalized world trade system, international and regional collective actions, and bilateral policy co-ordination in negotiation. The traditional mode of closed decision-making is no longer apt to China under the current circumstance of globalization and regionalization. Basically, diplomatic strategy of foreign governments, trade politics of parties, commercial interest of multinational corporations and public opinion will exert a profound impact on China's policy-making process in three dimensions, namely, China's accession to GATT/WTO, regional trade liberalization arrangement (like APEC), and bilateral trade frictions and talks, particularly with the United States. In what follows, I will elaborate on governmental preference of formulating trade policy, as well as internal and external interest groups' influence on the decision-making process.

**Diagram 1. The Decision-making Process of Trade Policy in China: An Analytical Framework**



## **Government Preference and National Interests**

### *Trade Development Plan*

Independence and self-reliance are fundamental principles for making economic development policy in China. In the planned autarky economy, foreign trade could only have a function of balancing the gap between mandatory production and consumption in the fixed price system and must be incorporated into the short, medium and long-term national economic and social development plans or guidelines. Domestic market was isolated from

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sometimes indifferent to orders or circumvent regulations imposed by the central authority.

international market by national trade monopoly and canalization. Exports were considered politically and economically in priority because of long suffering from the shortage of foreign exchanges. Import substitution was encouraged through industrial and trade policies in order to increase the local content of all key manufactured products, capital goods and consumer products in particular.

The picture has been changed since the reform in 1979. Foreign trade based on comparative advantage has been growing at the spectacular rate. It is much attributed to the export promotion of labour-intensive products of which China has abundant resource endowment. However, imports are still formidably limited through a variety of means. Radical trade liberalization reform, in which trade mandatory plan and trade restrictive barriers were reduced to certain degree, only begun in 1992 right after the Chinese Communist Party announced to establish the so-called "Socialism Market Economic System".

The contemporary national trade development program is still a typical way of "state activism" in China. It consists of directives on volume control and structural adjustment. In the Five-year National plan of Economic and Social development and Ten-year National Long-term Target Outlines, the volumes of export and import as well as annual growth rates are specified in concrete number, though they are now only viewed as guided indicators rather than mandatory ones as before. The ultimate goal of volume control is to accelerate economic development because foreign trade has a significantly contribution to GDP growth. Furthermore, the central government succeeds in adjusting trade structure by implementing differential trade policies among sectors. For exports, more preferential treatments have been given to the production of manufactured goods with higher value added ratio, particularly to mechanical and electronic equipment, in order to upgrade quality and increase technological content. Primary goods, mainly including minerals and fuels, are often subject to export restriction to ensure sufficient supply for domestic market and avoid the phenomenon of "immiserizing growth" occurred in other developing countries. On the import side, high-tech software, equipment and key components, as well as raw materials and intermediate products in great shortage are allowed to import in priority by tariff exemption or preference, while imports of general production means, assemble lines, and durable consumer goods are strictly controlled through prohibitive tariffs and quantitative measures. Therefore, it is no surprise to find that China's export commodity pattern has changed much faster than that of import.

### *Trade Flow Control*

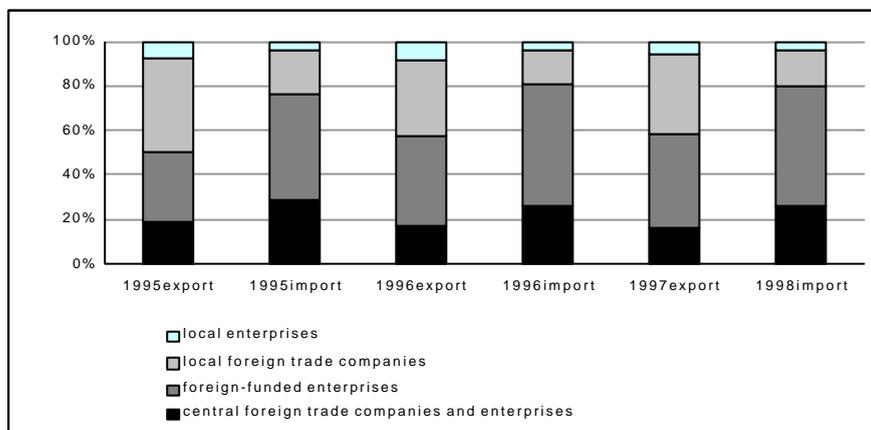
Trade flow control policies, primarily composed of (i) trading rights, (ii) tariffs, non-tariff measures, export tax and license, and (iii) foreign exchange control (discussed in "balance of payment"), are used to implement mandatory or guided trade plans.

#### Trading Rights

Trading rights system defines types and numbers of commercial entities which have the legal right within China to engage in international trade as well as kinds of commodities they can deal in. The aim is said to "maintain the

uniformity of trade regime” and “keep foreign trade in order”. All trade were canalized through 10-16 state specialized trade companies which were responsible for implementing the central plan before 1978 (Lardy, 1992). Although trading rights have been decentralized since the reform, the goods that are of great commercial value to both China and trading partners are still exported or imported principally through central or local state-owned trade companies and enterprises, which account for about 60 percentage in total trade (Diagram 2). By means of approving or abolishing trading rights like adjusting “valves”, the central government is easily capable of controlling trade flows. In addition, trading rights can also be authorised to companies in priority sectors or regions on the preferential basis in order to change export and import structures. According to the Law of Foreign Investment, all foreign-funded companies will automatically be given trading rights when registered.

**Diagrame 2. Foreign Trade Pattern by Ownership in China (1995-97)**



Source: Custom Office, *Chinese Custom Statistics*, 1995, 1996, 1997

In 1997, China has pledged in the trade negotiation of accession to WTO that restriction of trading rights will be completely eliminated and foreigners are allowed to access to China’s internal distribution system over a three-year period. At the end of the transition period, all domestic and foreign companies and enterprises will automatically have trading rights as soon as they register. Nevertheless, the U.S. demand that foreign companies deal directly with Chinese customers or end-users by retail or wholesale instead of being forced to go through intermediary trade companies was denied by the Chinese authority.

In addition, China’s current restrictive approach to license the scope of a business’s operations — defining and limiting the types of goods a company can deal in as well as operations in which it may engage in China — may prove to be a harbinger of restraint on the future expanded trading rights system. According to the revised regime in 1993, import commodities are now divided into four categories subject to the scope license. National trade monopoly and canalization in particular apply to some essential agricultural and industrial products, such as grain, crude oil, fertiliser, cotton, tobacco and cigarettes.

#### Tariffs and other trade tax

As shown in Table 1, until the mid-1990s, China's tariffs were often high enough to preclude most imports. After successive tariff reductions from 1994 to 1998, China has lowered its average import tariff rate to 17 percent and announced to further reduce it to 15 percent in 2000 and 10 percent in 2005<sup>1</sup>. However, the disparity among tariffs still remains large, shown by the standard deviation rates in Table 1. For instance, the tariff rates of sectors in which China is seeking to build her international competitiveness, such as chemicals and motor vehicles, remain extremely high — even to be prohibitive tariffs. On the other hand, the average nominal tariff rate dramatically differs from duty-collected rate because the authority grants preferential tariff rates to some imports, for example, high-technology equipment by special exemptions. Hence, the actual restrictiveness of tariff regime is lessened to a considerable extent. Finally, since 1996, in addition to tariffs, all imports have also been levied on value-added tax (13% or 17%) and part of them are taxed on consumption tax (3-5%).

**Table 1. Tariff Rates and Tariff Structure of China (%)**

	Collected tariff rates	All products			Primary products			Manufactured products		
		Unweighed Mean tariffs	Standard deviation rates	Weighted mean tariffs	Unweighed Mean tariffs	Standard deviation rates	Weighted mean tariffs	Unweighed Mean tariffs	Standard deviation rates	Weighted mean tariffs
1992	4.9	42.9	32.1	40.6	36.2	26.2	22.3	44.9	33.4	46.5
1993	4.3	39.9	29.9	38.4	33.3	24.7	20.9	41.8	31.0	44.0
1994	2.9	36.3	27.9	35.5	32.1	24.3	19.6	37.6	28.8	40.6
1995	2.7	35.6	-	25.0	-	-	-	-	-	-
1996	3.0	23.9	17.6	25.4	25.1	22.1	19.4	23.6	16.0	27.6
1997	2.7	17.6	13.0	18.2	17.9	18.1	20.0	17.5	11.0	17.8
1998	-	17.5	13.0	18.7	17.9	18.6	20.0	17.4	10.8	18.5

Note: Collected tariff rates are ratios of tariff revenue to total imports. Weighted mean tariff is the average of applied rates weighed by product shares in 1995 world imports.

Source: Collected tariff rates estimated from Chinese Statistics Bureau, *Chinese Statistical Yearbook*, 1998; others from World Bank, *World Development Indicators 1999*, CD-ROM

### Non-tariff barriers (NTBs)

Import quota and licensing requirements are core measures of NTBs in China and they, however, have been reduced significantly in the recent trade liberalization reform. The coverage ratio, the index that the value of imports subject to core NTBs accounts for total imports, has lowered from 35% in 1992 to 15% in 1996 and then to 5% in 1998<sup>2</sup>. As shown in Table 2, the commodities still under quantitative restriction include some agricultural products, raw materials, food products, textiles, machinery and equipment, transportation equipment, and heavy industrial products. The restrictions are sometimes overlapped with trading rights (state monopoly and canalization) mentioned above to strengthen import control.

In spite of welcomed removal of trading rights and quotas and license requirements, there are indications that China is trying to erect some new trade

<sup>1</sup> *China's Individual Action Plan on Trade and Investment Liberalization and Facilitation in APEC*, Version 3, 1999, APEC Secretariat, Singapore.

<sup>2</sup> IMF, *Economic Reform in China: A New Phase*, IMF Occasional Paper 114; World Bank, *Chinese Economy: Fighting Inflation and Deepening Reform*, Country Report; *China's Individual Action Plan on Trade and Investment Liberalization and Facilitation in APEC*, Version 3, 1999, APEC Secretariat, Singapore.

barriers to restrict imports. These measures include the new “automatic” import registration requirement, electronic and mechanical product import control measures, new regulations on the administration of medical equipment, pharmaceutical price control regulations, and “buy local” campaign on telecommunications equipment and components. Such measures can be regarded as government plots to avert or minimize the risk in trade liberalization. Some of these measures appear to pose a new *de facto* licensing requirement. Take iron and steel as an example, the automatic registration requirement was carried out at the beginning of 1994 and importers must demonstrate a market need for the goods and prove that they could pay for them. In practice, the import, however, was not "automatically" approved, but rather depended on authority's discretionary criteria and implicit motive of maintaining trade protection that attempted to substitute the original import quota and licence requirement which had been abolished according to Sino-U.S. Market Access Memorandum of Understanding (MOU) signed in 1992. As a result, the import of iron and steel dropped dramatically in 1994.

**Table 2. China's Non-tariff Barriers for Main Import Commodities (1996)**

	State monopoly	Canalization	London Chemical Convention	Import license	Import quota	Price tender	Total
Rice	100.0	0.0	0.0	100.0	0.0	0.0	100.0
Wheat	100.0	0.0	0.0	100.0	0.0	0.0	100.0
Corn	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nongrain crops	50.0	22.9	0.0	72.9	72.9	0.0	0.0
Livestock	0.0	72.7	0.0	72.7	72.7	0.0	72.7
Meat and Milk	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other food products	37.2	0.0	0.0	32.9	31.7	0.0	38.4
Natural resource	46.6	12.8	0.0	0.0	0.0	0.0	59.5
Textiles	0.3	5.7	0.0	12.7	12.7	0.0	12.7
Apparel	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Light manufactures	0.0	9.3	0.0	0.0	0.0	0.0	9.3
Transport industries	0.0	0.0	0.0	35.8	35.8	6.6	42.4
Machinery and equipment	0.0	0.0	0.0	9.2	9.2	20.4	26.4
Basic heavy manufactures	18.7	16.2	0.3	23.5	22.7	0.0	37.7
Service	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total	11.0	7.3	0.1	18.5	16.3	7.4	32.5

Note: Non-tariff barriers are calculated by coverage ratio of imports.  
Source: World Bank (1997)

### *Trade Development Strategy*

Trade development strategy is the policy to stimulate production and trade of some sectors by changing the relative price of exportable and importable goods. By the "multi-indicator method" developed by the World Bank (1987), China's trade development strategy, as Diagram 3 shows, is described as four phases from 1980 to 1998, i.e. “import substitution and marginal export promotion” (1980-1983), “export promotion neutralizing import substitution” (1984-1990), “export promotion and marginal trade liberalization”(1991-1993),

and “trade liberalization” (1994-now). They reveal the central government's strategy of trade and industrial policies for the economic reform.



### Stage I: Import Substitution and Marginal Export Promotion (1980-1983)

China had followed the former Soviet Unions' style in industrialization since 1949 and import substitution had been a longstanding key element in Chinese trade policy until the early 1990s. The traditional import substitution policy differed from the way of other East Asian countries. Stressing on the development of heavy industries, China carried out import substitution through "forward-linkage" that the industrialization was initially fostered from downstream sectors in which China had the least comparative advantages in order to supply capital equipment and intermediate goods for other sectors. On the contrary, the countries in Asian neighbourhood pursued the "backward-linkaged" industrialization, starting from labour-intensive sectors by producing and exporting nondurable consumer goods in which their factors were most richly endowed, and then gradually inducing demands from capital and technology intensive sectors. The wrong strategy China followed for nearly three decades led to high cost of economic inefficiency, bottleneck of essential industrial intermediate goods, shortage of foreign exchanges and consumer goods, and low average wage.

The strategy was changed in 1980 due to the well-known economic reform and open-door policy initiated by Deng Xiaoping. Significantly, exports in labour-intensive sectors, such as textiles, apparel and footwear, boomed once producers could recognize and foresee the "right" relative price in the market. Export incentive policies, however, still seemed to be marginal in terms of the degree of offsetting import substitution. Regional preferential policies, foreign exchange retention system, and secondary foreign exchange market (FEACs, Foreign Exchange Adjustment Centres) were only put into experimental basis.

### Stage II: Export Promotion Neutralizing Import Substitution (1984-1990)

During the second phase, export promotion measures, mainly including the export tax rebate, export subsidy, foreign exchange retention quota and multiple exchange rates system, were formally established and gradually generalized in national wide through the trade reform schemes launched in 1984 and 1988. On the other hand, import trade barriers, quota and licensing requirements in particular, remained high. In addition, real exchange rate was overvalued about 32% in average owing to the hyperinflation in 1985 and 1988, and the discrepancy between official rate and FEACs rate were increasing considerably during the period from 1986 to 1990 (Table 3). Import substitution strategy still prevailed to some extent. According to the three-sector model in trade theory, we call the second stage as "export promotion neutralizing import substitution" or "protected export promotion" that both exportable and importable sectors can be fostered to expand at the expense of non-trade sectors<sup>1</sup>. However, the overall trade orientation at the period was still bias to import substitution in the economy. The argument is strongly verified by the empirical study on the source of economic growth for 12 main industries during the period from 1985 to 1990, which shows that most of sectors witnessed export promotion and import substitution simultaneously<sup>2</sup>.

<sup>1</sup> The World Bank country report (1993b) points out that if considering the dual price system prevailing in the mid of 1980s, China's trade strategy was more likely to be the kind of "de facto import promotion", which was both anti-export-promotion and anti-import-substitution and resulted in import maximization and export minimization. It partly explains China's huge trade deficit in the mid of 1980s.

<sup>2</sup> The methodology of disaggregating the source of economic growth is based on Chenery, Robinson and

**Table 3. Nominal and Real Exchange Rates (US\$/RMB) in China: 1980-1994**

	Official rate	Adjusting rate	Weighted nominal rate	Real official rate	Weighted real rate
1980	1.5	-	1.5	1.5	1.5
1981	1.7	-	1.7	1.82	1.82
1982	1.89	-	1.89	2.02	2.02
1983	1.98	-	1.98	2.10	2.10
1984	2.32	-	2.32	2.15	2.15
1985	2.94	-	2.94	2.76	2.76
1986	3.45	-	3.45	2.93	2.93
1987	3.72	5.47	4.46	2.98	3.57
1988	3.72	6.31	4.86	2.57	3.35
1989	3.77	6.24	4.94	2.34	3.06
1990	4.78	5.81	5.23	3.01	3.29
1991	5.32	5.85	5.74	3.25	3.50
1992	5.51	6.58	6.37	3.14	3.63
1993	5.76	8.41	7.87	2.82	3.86
1994	8.62	-	8.62	4.61	4.61

Notes: 1. Weighted nominal rate= $r \times$  adjusting rate +  $(1-r) \times$  official rate, and r is retention ratio;

2. Real official rate=official nominal rate $\times$ (US wholesale price index/Chinese consumer price index), 1980=100;

3. Weighted real rate=weighted nominal rate $\times$ (US wholesale price index/Chinese consumer price index), 1980=100;

Sources: Official rates, adjusting rates, and weighted nominal rates from World Bank (1993b); price indexes from IMF, *Financial Statistics*, 1980-1994, various issues

Why did the authority take on such a dual incentive structure? It is argued by the paper that the special strategy deals with the political economy of China's economic reform in the mid of 1980s. According to the "convergence school" (Sachs and Woo, 1997), the strategy and perspective of China's economic reform still looked ambiguous and uncertain at the moment. Instead of a reflection of a deliberate and desirable approach of political leadership, the evolutionary, experimental and incremental reforms resulted primarily from lack of consensus over the proper course among senior party leaders and of compromise with some interest groups strongly against reforms. The trade development strategy in the way of "protected export promotion" can be seen as a case evident to the situation. Specifically, new interest groups of export were promoted to grow and also produce spillover effect in the economy, while those inefficient state-owned industrial sectors were still shield from the external competition in the old regime of import substitution. Only on such a condition could economic and trade reforms be politically sustained, otherwise most of public enterprises would go bankruptcy by import shock, the result of which evidently intended to trigger ideological debate and risk in losing the popularity of the reform. Therefore, the dual incentive structure in trade development strategy seemed more politically sustainable and economic viable than radical trade import liberalization, albeit market distortion and corruption.

#### Stage III: Export Promotion and Marginal Trade Liberalization (1991-993)

With the increase of efficiency and competitiveness of Chinese economy, the significant change happened in 1991 when the third stage began. Much bolder trade liberalization was launched to reduce tariff rates, import mandatory

plans, import quotas and licenses. Furthermore, import adjusting duty, export subsidies, and all regulations, guidelines, and policies concerning about import substitution were declared to eliminate. Therefore, the price system turned more sound through trade liberalization and the pattern of production and trade became more “natural” in economic sense than that distortedly man-made in the previous stage. The empirical study on sources of economic growth in 12 industrial sectors during 1990-1994 shows that export promotion remained the dominant contribution in the textile sector, in which China had most comparative advantage, whereas other industries experienced less import substitution promotion than before.

However, the remaining average tariff rate and non-tariff coverage ratio were still high, namely, 43% and 51% respectively in 1992 (World Bank, 1993b), if compared to the international level. More importantly, the restrictiveness and distortion of foreign exchange control system were not alleviated and kept unfavourable to exporters. The overvalue of real exchange rate, about 44% in average (Table 3), harmed exports. Additionally, export licensing requirement and export tax were consolidated in enforcement to relieve domestic export competition in disorder.

#### Stage IV: Trade Liberalization (1994-now)

To establish the “socialism market system” and quicken the process of access to WTO before the deadline, China came to a new phase in 1994 when she started the more radical trade liberalization. As shown in Diagram 3, a number of measures were taken to meet internal targets as well as external requirements. Not only has the average level of trade barriers been consecutively reduced, but the structure has been adjusted to tend to be “trade neutrality” as well. Producers, therefore, can calculate their input and output at international prices and substitute capital and intermediate goods into cheaper labours in production. More significant reform occurred to the foreign exchange system. The current account was completely liberalized in 1997, which made China eventually meet the IMF’s standard of eliminating foreign exchange control. Meanwhile, the dual exchange rate system was abolished by merging into a unified, managed and floated rate in 1994, and it actually depreciated RMB nearly 50 percent in official rate.

In short, during past five decades, China's trade development strategy has evolved from stumbling trade to promoting trade, from inward-looking orientation and outward-looking orientation, from anti-comparative-advantage to pro-comparative-advantage, from forward-linkage with supply effect to backward-linkage with demand effect, from price distortion to price correction (“making price right”), and from quantitative control to tariff protection. The benign evolution of trade development strategy leads to the improved economic performance. Table 4 indicates that economic growth, saving and investment, efficiency and productivity, exports, and foreign exchange reserve all improved significantly with the change of strategies. On the other hand, trade liberalization process notably follows a piecemeal and roundabout way instead of a radical and direct approach. With transitional cost, the sectors of import substitution were provisionally protected, partially compensated and structurally adjusted to weaken their strong oppositions to market-oriented trade reform.

**Table 4. Economic Performance for China's Trade Development Strategies**

	Phase I 1980-1983	Phase II 1984-1990	Phase III 1991-1993	Phase IV 1994-1997
Real GDP growth (%)	1.75	7.34	9.72	10.05
Real GDP per capita growth (%)	0.36	5.76	8.36	8.87
Domestic saving rate (%)	32.4	36.7	40.3	40.6
Domestic investment rate (%)	33.7	36.2	38.1	40.0
Capital-output ratio	0.28	0.29	0.32	0.35
TFP growth (%)	2.28	1.40	2.90	n. a.
TFP's share in GDP growth (%)	30.2	14.9	27.6	n. a.
Export growth (%)	7.49	16.0	14.0	19.3
Manufactured export growth (%)	12.6	21.3	17.7	21.2
Share of manufactured export (%)	53.7	64.2	79.9	85.4
Foreign exchange reserve growth(%)	-	17.7	31.4	65.5

Notes: 1. Real GDP and real GDP per capita are estimated in the price level of 1978.

2. Domestic saving rate=(GDP-government consumption-resident consumption)/GDP

Domestic investment rate=(fixed capital investment+inventory)/GDP

3. Capital-output ratio=fixed capital inventory/GDP

4. TFP, total factor productivity, is estimated in Solow's method.

5. Foreign exchange reserve excludes gold.

6. n. a., data unavailable; -, estimation not applicable

Sources: TFP during 1980-1983 from Li Jingwen and D. Jogensen (1993), eds. *Productivity and Economic Growth in US, China and Japan*, Beijing: Chinese Social Science Academy Press; TFP during 1984-1994 from World Bank (1996), *Chinese Economy: Fighting Inflation and Deepening reform*, the County Report; Other indicators are calculated by the author based on the data from *Chinese Statistics Yearbook* (1998), State Statistical Bureau

What's China's trade development strategy in the future? There is no official announcement or explanation. Trade liberalization seems to be the mainstream in the governmental long-term reform strategy. However, there are two points that should be mentioned when we observe recent policy initiatives of the authority. First, China attempts to take advantage of "home market effect" to extract foreign monopolistic rent, when noticing the fact that radical import liberalization has negative effects on some national pillar industries since the market share of the goods both imported and produced by foreign investors has risen astonishingly fast during recent years. Secondly, the authority is more convinced of the great importance to accelerate the development of high-tech industries to maintain international competitiveness in globalization. Both of the new policy keynotes arouse the feasibility of taking "strategic trade policy" — the policy advocating selective activism to extract foreigners' economic rents, or to harness technological and scale externality in domestic economy — for China.

For the profit-shifting argument, based on the empirical study by the author (1996), infant sectors like chemical fabrics, non-ferrous metal, transportation equipment and telecommunication should be protected in moderate degree to foster production and potential export by taking advantage of scale economy and "learning-by-doing" effect. For the externality argument, it is necessary to subsidize high-tech industries such as microelectronics, bioengineering and new materials, in which China has acquired predominant competitiveness to some extent in the international arena. The aggressive policy will accelerate China to form industrial complexes in these sectors and ultimately lead to national specialization.

## *Industrial Policy*

In China, the industrial policy is officially explained as the policy to “develop key industrial sectors, foster infant industries, limit entry to declining and superfluous sectors, and correct market distortion and failure.” The nature of industrial policy, therefore, is usually systemically differential among industries rather than functional for the market. It means that co-ordinating investment and choosing winners seem to be the priority objective of the policy.

In the early 1980s, the industrial policy looked like a hodgepodge with confused signals in the result of interest balance among the Commission of Economic Planning, local governments and other central administrative ministries. Then it came to be a *de facto* therapy of economic tightening in the late 1980s when the so-called “order and rectification” policy was carried out to copy with severe macroeconomic instability. Only in 1994, right after the Chinese Communist Party announced to establish the “socialism market economy”, was a formal industrial policy guideline, *National Industrial Policy Outline in 1990s*, formulated and then revised in the following years. Notably, in the outline, three tradable sectors — electronic equipment, petrochemicals, and automobile, and one non-tradable sector — construction were selected as pillar industries. Based on the outline, the authority soon formulated the *Directory of National Industrial Policy in the Fifth Five-year Plan* and *Directory of Industrial Investment for Foreign-funded Enterprises*.

In the current industrial policy with the feature of non-neutral incentive, trade policy only plays in a secondary and supplementary role, if compared to major measures like investment, credit, and material distribution policy. Exports are promoted all the time through a variety of preferential policies, even during the “order and rectification” period. Import policies differ a lot among sectors and periods. For instance, the final products of strategic sectors are protected by prohibitive tariffs as well as quota and licensing requirement, while intermediate inputs for those sectors can be given lower rate and even some import subsidies. Though levied on high tariffs in principle, capital imports are normally offered exemption or preference in practice to support production in key sector and construction projects. Also, some sectors are selected to protect on the ground that excessive imports could hinder the development of domestic industry. In short, import policy has to be differentiated among sectors to serve industrial policy.

The disperse protection structure results in over-investing and over-entry in downstream industries in which local governments and affiliated enterprises have great commercial interests, and therefore, the ambitious plan of the central government to re-organize industrial structure often fails. Automobile industry is a typical example. Despite the rapid growth and technological accomplishment, it still faced several systemic and structural problems, such as geographic fragmentation, incompetence of scale production, underdevelopment of component sectors, and lack of international competitiveness, much due to the inefficient industrial policy in 1980s (World Bank, 1993a). The value added of automobile manufacturing turned to be negative if calculated on the basis of international prices. In addition, as shown in Table 5, the high trade protection

and compulsory regulation of local content results in tremendous welfare loss in the auto industry — 11% of the total sale revenues, and consumers, whose welfare loss accounts for 7% of total sales revenue, are main losers. To solve the problem, the authority issued *Automobile Industrial Policy* in 1994 in order to achieve international cost and quality in the coming years.

**Table 5. The Welfare Effect of China's Auto Industry Policy (1994 as the Baseline)**

	Consumer loss (100 million Yuan)	Consumer net loss (100 million Yuan)	Producer loss (100 million Yuan)	Producer net loss (100 million Yuan)	Total net welfare loss (100 million Yuan)	Net welfare loss per auto (Yuan)
Trucks	337.1	30.0			30.0	4140
Passenger cars	171.5	20.9	24.1	3.0	23.9	12383
Sedan cars	265.6	34.1	70.8	20.8	54.9	21931
Total	774.2	85.0	94.9	23.8	108.8	9316
complete vehicles						
Parts and components	n.a.	n.a.	104.4	24.7	n.a.	n.a.
Efficiency loss(100 million Yuan)		48.5				
Dislocation loss(100 million Yuan)						133.5

Notes: Total net welfare loss is the sum of consumer net loss and producer net loss. Efficiency loss is the sum of producer net loss in producing complete vehicles and auto components. Dislocation loss is the sum of consumer net loss and efficiency loss.

Source: Author's estimation (1998)

### *National Economic Security*

Given the political ideology confrontation and vulnerable economic power in the history, China regards national security as the symbol of independence and sovereignty. According to *The Law of Foreign Trade* (1994), any export and import harming to health, culture, environment and other public interests will be prohibited. Moreover, a few strategic sectors are also limited or restricted so as to establish or accelerate domestic development. Agricultural and financial sectors are two typical cases.

#### Agricultural sector

Currently, grain, cotton, wool, and sugar are agricultural goods listed in import control directory and only specialized state-owned trade companies are entitled to deal in such commodities and strictly follow national mandatory plans and import quotas. In parallel to the officially declared target saying that "the self-reliance ratio will not be lower than 95% and net import will not exceed 5% of domestic consumption", grain imports, for example, are now limited by tariff-rate quotas (TRQs, 3%), and out-of-quota tariff rates are as high as more than 100%. In addition, all grain imports must be canalized through public trade companies.

From the viewpoint of comparative advantage, there are no relatively abundant resource endowments for China to produce grain to feed her people because 22 percent of population in the world rely on only seven percent of cultivated land and water source on the earth<sup>1</sup>. Domestic grain price has risen dramatically since the price reform in the 1980s and overall exceeded the

<sup>1</sup> Information Office of State Council (1996), *White Paper on Grain in China*

international market price level since 1994. However, price increase didn't stimulate the growth of grain production, which shows that China is being gradually lost her advantage in grain production due to the dynamic industrialization.

Why does Chinese authority still cling to the autarky policy of grain? The main reasons can be explained in following aspects:

(a) The grain policy is not only an acute economic issue, but also a crucial political matter when taken account of some unforgettable historical lessons, such as the starvation before liberation, trade embargo by western countries in the era of Cold War, famine disaster in the late of 1950s, unemployment in rural areas, and challenging task of poverty alleviation in the contemporary national social development plan.

(b) As a rule approved by some industrialized countries, with the economic development and structural change, agriculture in China will inevitably change from the sector taxed to support other industry into that to be supported by other industry. Owing to the increasing family disposable income, reduced Engel's Coefficient and structural change of food consumption, trade protection on grain could be more endured by the public in China.

(c) The empirical study shows that the prospect of grain production in China is not so optimistic if considering factors like regional market segment, low commercializing ratio, obsolete agricultural technology, high reserve cost, population mobility, and redistribution to low-income people, although grain production seems to be stable during the past years. In addition, skeptics also question whether China is able to afford to import a large amount of grain by the scarce foreign exchanges.

(d) The self-reliance grain policy also reflects the authority's conservative vision and attitude towards the prospect of international grain market, especially to Prof. Brown's (1995) deliberately exaggerated argument that "who will feed China in next century". The authority reaffirmed the policy to conciliate the panic caused by "China's threat to world grain market".

(e) The autarky policy can help to stabilize domestic price level due to the fact that there exists high correlation between grain price index and retail (consumer) price index in both urban and rural areas. Meanwhile, external price fluctuation in the international grain market can be effectively isolated in order to facilitate domestic price reform in a sound and smooth way.

(f) Adhered to trade protection policy, the government hopes to enhance average income of farmers whose annual earnings still primarily come from grain production in most rural regions. It will undoubtedly serve to reduce income unequal distribution between rural and urban areas, improve the term of trade between agricultural and industrial goods, and eventually alleviate poverty in countryside and achieve the social justice.

The result of CGE model simulation for China's grain policy indicates that given the current agricultural policy the "natural" self-reliance ratio inclines to drop in the future and there will be great welfare loss and higher on-border protection rates needed to counteract low international prices if the targeted self-reliance ratio (95%) is to be maintained (Yang and Huang, 1997b). Will China's traditional grain policy be changed in the near future? The answer will depend partly on the negotiation of China's accession to WTO, because

according to the provision of WTO, only so-called “green box” measures can be used to support agricultural production, and it also partly on the ideological change of policy makers, for instance, into a academic popularized proposition of “food-exchange-food” within agricultural sector.

#### Financial sector

The of liberalization of financial services has been gradually progressive because of the nature of political and economic sensitivity as well as the attempt to keep it in harmony with the speed and process of overall economic reform. The government is currently applying a number of restrictive laws and arbitrary regulations in terms of the extent and conditions of market access. Foreign banking service providers, for instance, complain that they are only allowed to operate under selective “experimental” licenses with strict operational requirements, limits on the forms of establishment for entry, and restrictions on the geographic scope of activities. In line with her efforts to join the WTO, China has begun to allow greater foreign participation in banking services on a trial basis. For example, the State Council followed up on plans announced in January 1996 to allow foreign banks in Shanghai's Pudong area to conduct local currency transactions on a restricted trial basis. Foreign financial institutions, however, still needed approval for new representative offices and branches, which was granted on a discretionary, case-by-case basis. The scope of activities for these banks and branches was limited largely to business denominated in foreign currencies, essentially carving out the entire domestic market and leaving only international trade related business. In the most recent offer submitted to WTO, China proposed to eliminate, upon accession, all geographic restriction on the establishment of foreign banks and further to relax limits on local currency operation.

The liberalization process by a self-imposed "experimental, step-by-step approach" inflects the authority's ambivalence towards opening banking industry. On the one hand, China has to make commitments to opening her financial market because they are dispensable part of Protocol for access to WTO. Foreign banks can not only provide capital inflows for China to sustain her high economic growth but also carve out an intermediate for China to raise fund in international capital market. Moreover, the modern commercial banking system in China can be established by both learning from experience and benefiting from externality of foreign banks in terms of operation, management, technology and human resource.

On the other hand, the central government holds a cautious attitude towards financial liberalization when taking account of following considerations:

(a) Hasty financial liberalization may cause overheating in economy and subsequently destabilize the macroeconomy, which is the lesson that the government draws from the disorder in domestic financial market occurred in 1993-994. It reminds the authority of that “financial liberalization must keep steps with the economic development, financial deepening, foreign trade, competence of financial industry and surveillance capacity”.

(b) Most of state-owned commercial banks are running in the bad performance according to the international standard, largely attributed to historical "policy loans" in low interest rates to inefficient public enterprises as well as the loose internal operation system. The unperforming loan ratio of four

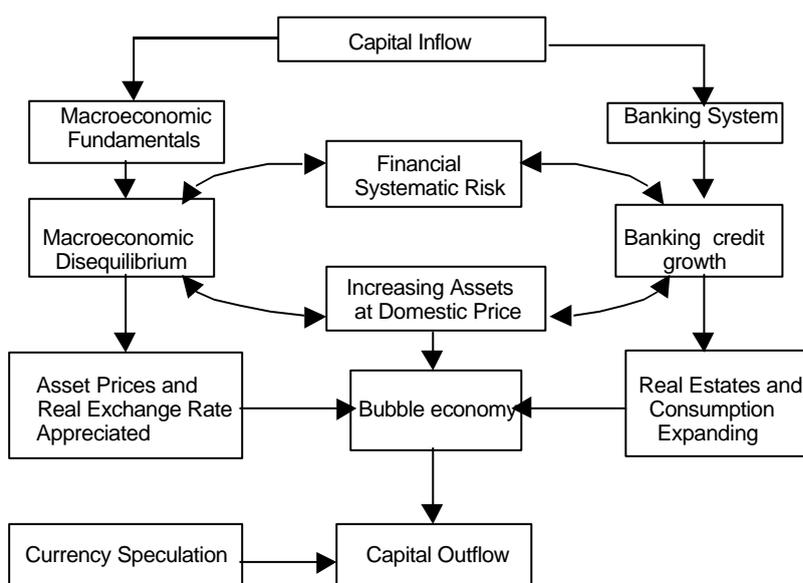
largest commercial banks is officially said to be 20-25% and even as higher as 30-40% estimated by some international financial agencies<sup>1</sup>. Hence, the government decided to postpone radical liberalization in order to give the domestic banking system a buffer to restore efficiency and competitiveness.

(c) According to the Barsel Agreement (1983), the central bank in host country is responsible for supervising foreign-funded banks and their branches in the collaboration with its partners in home countries. The surveillance system and institutional capacity of the People's Bank of China (PRC, China's central bank), however, are still comparatively immature and vulnerable so that it needs a transitional period to formulate rules and consolidate management.

(d) The loans of foreign banks to joined-ventures, which are regarded as equivalence of external debt in China, have increased significantly in recent years and become the largest share in local foreign debts. Some loans were transferred to domestic enterprises in various disguised ways, and a considerable portion of them were invested in real estates and security. All these phenomena make the central government more alert to risk management of foreign debts by limiting the market access of foreign banks.

(e) Finally, China's ambitious reform of capital account liberalization by the end of 2000 was unexpectedly deferred by the financial turmoil of East Asia in 1997-1998. The financial liberalization process turns to be sluggish when the government realizes that foreign banks and their off-shore business are one of sources for speculative attack to local currency. Indeed, shown in Diagram 4, the banking system is the principal media of financing short-term foreign capital into real estate and bonds market and then induces the overheating of a bubble economy. Therefore, it is no surprise for Chinese authority to tighten regulation on capital flows and put foreign banks in scrutiny in recent years.

**Diagram 4. Financial Crisis for East Asia: Causes**



Source: Author's compilation.

<sup>1</sup> "China Issues in Focus: China's Banking Structural Reform ", *Morgan Stanley Dean Witter*, Morgan Stanley Asia Limited, 1998/4/27; Goldenman Sachs, Morgan Stanley (Asia), NOMURA Singapore Limited.

Nevertheless, the steps by the PRC to crack down on unauthorized foreign exchange transactions resulted in disruption of the operations of foreign banks to some extent.

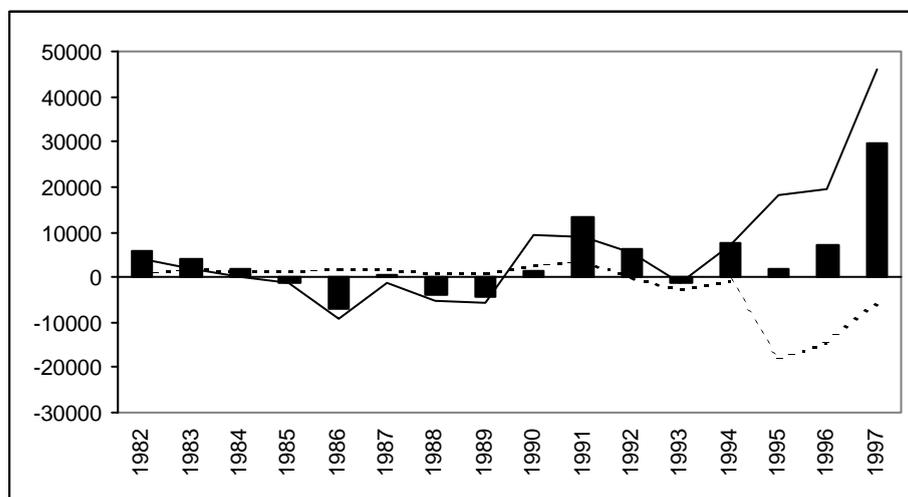
### *Balance of Payment*

Maintaining balance of payment is one of fundamental principles for China's trade policy. Essentially, foreign exchanges are only used for imports of key technology and equipment, scarce intermediate goods, and some consumer necessities. China states that she will try to fulfil balance of payment by export promotion rather than reducing imports. However, like other countries, China's trade policy also roots in the trade philosophy of "new mercantilism", which implies that

- (a) Trade deficit in the long run should be corrected by any means;
- (b) Exports are positive whereas imports are negative; and
- (c) Imports will depend on exports.

As shown in Diagram 5, the balance payment of current account is evidently associated with four macroeconomic cycles<sup>1</sup> from 1982-1997 and particularly, trade deficit in the late 1980s and early 1990s were soon corrected by tightening the economy. In addition, with the structural change in industrialization, service trade has been more in deficit during recent years and it could be one of reasons that the authority is unwilling to offer substantial concessions in service for foreigners.

**Diagram 5. Balance of Payment for China: Time Series ( Million US\$, 1982-1997)**



Notes: The solid line for balance payment of commodity trade, the dotted line for service trade, and the columns for current account balance

Source: IMF, *International Financial Statistics Yearbook*, 1982-1998

Balance of payment is also essential to the accumulation of foreign exchange reserve, which is usually considered as the relatively scarce resource

<sup>1</sup> They are 1982-1986, 1986-1990, 1991-1993, 1994-1997.

for China because of currency inconvertibility. The estimation of import function with error-correction model indicates the strong relation between import volumes and foreign exchange reserve (IMF, 1994), which explains the reason why the government controls imports by considering the growth of reserve.

Foreign exchange control of current account had been strictly held until China accomplished IMF Clause 8(2) (3) (4) to become a member “without foreign exchange restriction” in 1996. Yet, it is “conditional” current account liberalization because only sale and purchase of foreign exchanges are permitted, and domestic companies are not allowed to own their bank accounts in foreign exchanges. The authority also carried out some provisional measures to prevent capital flight, particularly during the financial crisis of East Asia.

## **Domestic Interest Groups**

### *Central Administrative Ministries*

The decision-making power of trade policy in China is substantially delegated to administrative body, namely, the State Council, instead of the legislative — the People’s Congress, though all trade laws and regulations have to be ratified by the Congress. Diagram 5 illustrates the organizational structure of a complex set of trade policies administered by a range of occasionally overlapping ministers and agencies. The Standing Committee of State Council is the the supreme in the executive hierarchy, but it is often subordinated to the Central Finance and Economic Leading Group of the Chinese Communist Party, a joint commission of the Politbureau and State Council, composing of only a few senior party leaders and in charge of all crucial economic issues in China. The parallel structure reflects the dominate leadership of the party as the "principle" and its delegation relationship with the government as the "agent". In general, there is a vice prime minister delegated to take responsibility of foreign trade and several ministries or bureaus will share powers in the decision-making. The most important organizations are the Ministry of Foreign Trade and Economic Co-operation (MFTEC), mainly taking charge of negotiating international trade agreement and formulating national trade policy, the State Planning Commission (SPC), the institutional legacy of economic planning system, and the State Economic and Trade Commission (SETC), focusing on trade management reforms in state-owned foreign trade companies and enterprises.

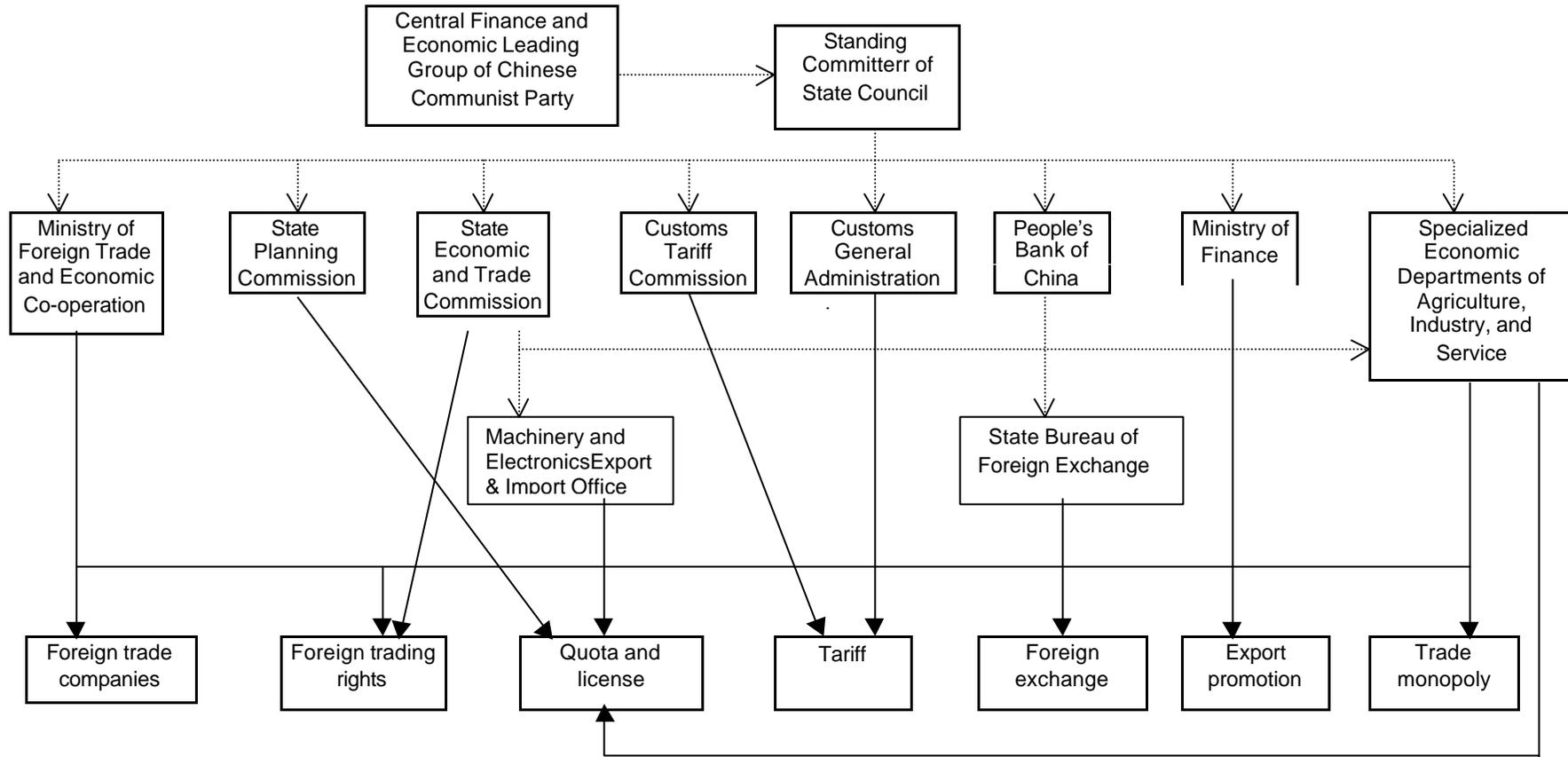
In lack of a single and integrated department responsible for making trade policies, ministries concerned have to reach a flexible consensus through comprehensive discussion, coordination and bargain. In China, it is called *guikou* (proper channel) and *zhengchuduomen* (a policy made by several institutions) and in other words, named as “participatory bureaucracy” or “institutional pluralism”. Bureaucratic fragment in the overlapping power-sharing system occasionally result in disputes and conflicts among administrative bodies and they have to escalate problems to senior politicians in higher hierarchy for to decide. Self-centered sense of different ministries is much attributed to their “natural” administrative functions, official promotion system,

special benefit from the regulated industry and enterprises, and even corruption with bribery. Finally, it is still a black box in the bureaucratic coordination and bargain arena. Once the policy is formulated, it is often stated as "common sense of consensus" and no further public debate is allowed.

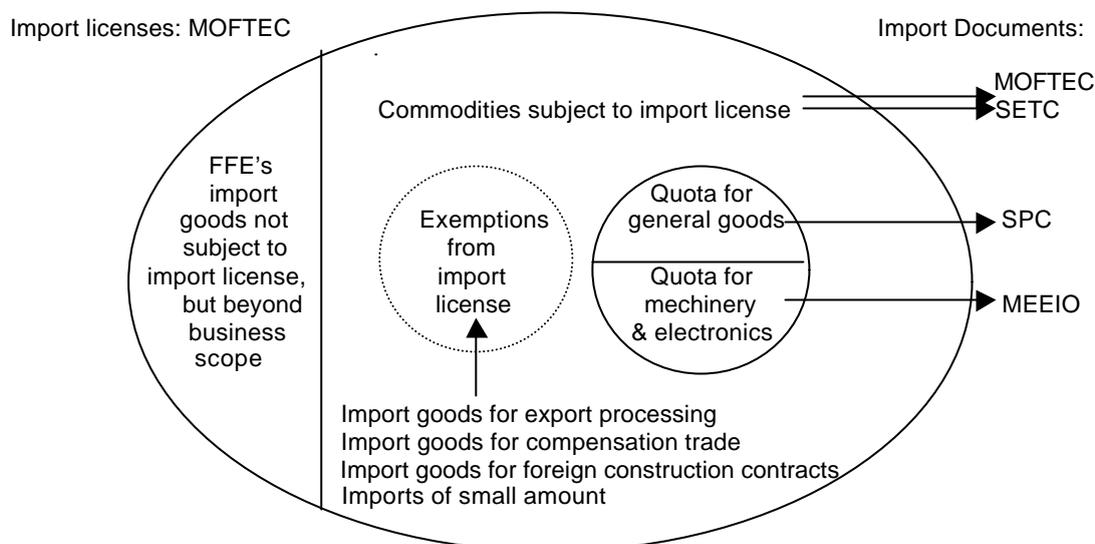
Diagram 6 also shows how central administrative ministries specifically interact with one another in different trade policy measures. The typical case is import quota and license. As shown in Diagram 7, import quotas are divided into those of general commodities and machinery and electronic products. General commodities cover key agricultural and industrial materials that are deemed to essential to China's economy and people's livelihood and their quotas are decided by the State Planning Commission (SPC) in the negotiation with various specialized ministries or bureaus, state-owned enterprises and trading companies. Once import "demand" is determined, SPC allocates quotas that are eventually distributed nation-wide to end-users and administered by local branches of SPC agencies. The Machinery and Electronics Export and Import Office, led by the State Economic and Trade Commission (SETC), is responsible for coordinating and administering imports of mechanic and electronic equipment. Moreover, the Ministry of Foreign Economic and Trade Co-operation (MOFTEC) uses import documents (licenses) to exercise an additional, nation-wide system of control over some other imports. Many products are subject to both quotas and import licensing requirements. For these products, after permission has been granted by other designated agencies for importation, MOFTEC must decide whether to issue a license, and it claims that import licenses are issued automatically once other agencies have approved an import.



**Diagram 6. The Organizational Structure of China's Trade Administration**



**Diagram 7. The Import Quota and Licensing Requirement in China**



Source: Author's compilation

Concerning other policy measures, there are similar cases for interministerial negotiations and coordinations. For example, tariff reduction initiatives in international trade agreement negotiation by MOFETC must be ratified by the Custom Tariff Commission (CTC) whose principal responsibility is to defend national sovereignty of tariff. In addition, tariff concession of sensitive sectors may be opposed by the ministries or bureaus concerned at the excuse of safeguarding national economic security or protecting infant industries. The Ministry of Information Industries (including telecommunication), for instance, fiercely objected to opening China's monopolized telecommunication market to foreign investors, which made MOFETC waveringly submit China's schedule to WTO Parties. In the field of anti-dumping, SETC and MOFETC should independently conduct investigation that whether there exist dumping and material injury to the industry concerned, and the final outcome must be approved by CTC. Also, in recent years, MOFETC hoped to promote exports by means of more preferential export tax rebate, but the initiative inherently collide with the goal of the Ministry of Finance — to increase public revenue in the transitional period and eventually balance government budget in 2000. Only after the financial crisis in East Asia were export tax rebate rates of some products adjusted higher to alleviate domestic economic deflation. Finally, the People's Bank of China set the currency stability as the priority during the financial turmoil, while MOFETC and other industrial ministers complained export stagnation due to the real appreciation of RMB.

### *Local Governments*

The relation between central government and local government is one of most subtle issues in China. Since the reform, more and more decision-making powers have been decentralized to local authorities, particularly in fiscal

respect. Policy work conference enfranchises provinces in the policy-making process and offers local governments equal formal representation as ministries (Shirk, 1993). Local governments in different levels now have their own economic and social development plans parallel to the central government's. A newly-coming-on national policy usually arouses their great concerns about income distribution and social justice among regions. They also care of the responsibilities that must be taken for local constituencies. As far as trade policy is concerned, the central-local relation and local-local relation are depicted in Table 6. The following part will deal with aspects listed in the table.

**Table 6. Local Authorities' Influence on Trade Policy**

	Export promotion policies	Import preferential policies	Import restriction policies
Central-local relation	Foreign trade responsibility contract	Industrial policy	Trade liberalization
Local-local relation	Foreign exchange retention & adjustment; Regional policy	Regional policy	Investment policy related to imports

Source: Author's compilation

#### Foreign trade responsibility contract

Foreign trade responsibility contract system was formally carried out in national wide in 1988 in order to reduce the increasing fiscal loss that were incurred by export subsidies of the central government. To encourage local governments to share self-disciplined responsibility, the reform changed the traditional vertical trade administration structure (*tiaotiao*) into provincial autonomy (*kuaikuai*). Under the new system, local governments would sign responsibility contract with the central government, including the basic amount of foreign exchange revenues, foreign exchange remittance, and export subsidy. More importantly, local governments would afford all export subsidies to local foreign trade companies that would be delinked from national foreign trade corporations in Beijing. The new policy took effect in the short run by improving economic performance and curtailing export subsidy loss, but later led to the serious regional segmentation and local protectionism during the late 1980s. To implement trade contracts, provinces set up various forms of interregional barriers, such as transport license, export embargo and resource tax, to block outflow of production materials. A large number of anecdotal evidences were found during the period, among which the most famous were "cotton war", "wool war", "tobacco war", "silk war", and "tea war". In addition, exports were in intensive competition with dumping price (Yang, Zhu, and Sheng, 1998). As a result, export subsidies continued to increase and reached the historical peak in 1989. Trade responsibility contract was finally abolished in 1994.

#### Foreign exchange retention and dual exchange rates system

Foreign exchange retention system, which allowed trade companies to retain the certain percentage of foreign exchange revenue and sell them at more preferential rate in the swap market, was initiated at the very beginning of economic reform to promote exports. In the early stage, the retention ratio was formulated on the regional basis, tilting to certain provinces in the southeast

China and minority autonomous municipalities. Other provinces then complained about “unfairness” of the reform. The central government subsequently revised it into the policy on the industrial basis in 1991, which actually led to multiple exchange rates. But it didn't eliminate regional segment and unfair competition as expected, because most of inland provinces, where resource-intensive industries were given much lower retention rates to discourage their exports, were still losers for the new policy. The problem prevailed until the foreign exchange retention system was repealed in 1994.

Although the foreign exchange adjusting system was established in 1980 to accommodate the retention system mentioned above, the true swap market (FEACs) in national wide didn't appear until 1986. However, since then, interregional transaction of retained foreign exchanges was still occasionally hindered due to institutional flaw, technical incompatibility and more importantly, reluctance of local government to meet market demand from outside provinces. The negative effects in such a provisional regime were eventually eliminated when a unified and managed floating exchange rate system and national foreign exchange electronic transaction market were established in 1994.

#### Import restriction and local investment policy

Local authorities have been entitled to invest on their own favourite projects since 1985. Unfortunately, local projects sometimes didn't fall in accord with guidelines or directives made by the State Planning Commission because of the distorted price system and different profit rates. The game between SPC and local governments usually occurred in assembled industries, such as durable consumer products (colour TV, refrigerators, bicycle, etc). The central government often worried about reduplicate investment, over-capacity and disorder competition in those sectors, while local authorities attempted to capture alluring short-term profits as soon as possible. Though imports of assemble line and key equipment were limited by quota and licensing requirement as well as foreign exchange restrictions, they were still available to local enterprises through a variety of informal channels under the acquiescence of local governments. A typical case is import of refrigerator compressors, half of which were not given the authorized permission of import licenses in 1988. Ultimately, the central government could only resort to issuing production licenses in order to shut down some non-eligible factories.

#### Preferential Import and import liberalization policy

Local governments will respond differently to national import policy due to their distinguished industrial competitiveness. The empirical study of revealed comparative advantage (RCA) for 30 provinces in China shows that the provinces in the coast area have the advantage of producing capital goods and consumer goods, while the provinces in the middle and west areas dominate in producing mining and intermediate products. As regards preferential import policy, enterprises in the coast region benefit a lot from the regulation on processed trade and compensation trade, which now account for more than 50% of total trade in China, because imports of intermediate goods to re-export production are tariff-exempt and license-exempt. The preferential treatment particularly applies to those “enclaves”, say, Special Economic Zones, tax-free zones, and export zones in coastal cities. On the other hand, the import goods given preferential treatment are just substitute of products in which the

provinces in the middle and west region most specialize. They are complaining that the preferential import policy for processed trade, a sort of rent-creating supplied by the central government, is harmful to the economic development of the impoverished inland provinces and should be abolished. However, the policy still remains in valid because of the strong commercial interest pursued by coastal provinces and joint-ventures.

Concerning import liberalization reform, local governments are very sensitive to reduction of tariff and NTBs on the industries which are of great importance to local budget revenue and employment. In lack of an adequate social security system, local governments are likely to bear the bulk of financial burdens from the massive lay-offs of state-owned enterprises, which were approximately 10 percent of total urban labour force just in 1998<sup>1</sup>. The problem is peculiarly acute in the Northeast China where local authority is complaining a lot about import competition in capital-intensive industries, like iron and steel, electronic appliance, and automobile sectors.

### *Domestic Companies and Enterprises*

With the modernization and democratization, domestic enterprises witness the historical change of free expression of their commercial interests from a informal, scattered, and implicit fashion to a formal, associated, and explicit style, though such an expression should always be legitimate, cautious and occasionally cracked down by the authority. Industrial associations and trade chambers report member enterprises' opinions, advices, and complainings to the designed ministries or local governments. However, to a large extent, as official or semi-official organizations in a corporatism state, they are still under the control and scrutiny of the authority, and therefore they differ from the counterparts in western countries with the function of active professional lobbying and rent-seeking. Some trade chambers are delegated to allocate export quotas and licenses and co-ordinate export prices among member companies. In general, a trade chambers is manipulated by several leading public trade companies and enterprises in the industry.

Most lobbying activities happen between individual enterprise and central ministry or local agency with regulatory authority over its business by means of behind-the-scene persuasion, complaint, and exchange. They are private, secretive affairs, just like policy making itself. In addition, there are a few formal venues, for instance, policy consultant conferences, hearings, and work report meetings, for enterprises to influence the policy formation to less extent. The validity of rent-seeking much depends on the nature and status of enterprises and their network (*guanxi*) with competent officials. In specific, there are acute differences between public enterprises and private enterprises, large-and-medium enterprises and small-scale enterprises, bad-performance enterprises and good-performance enterprises, large tax remittance enterprises and small tax payment enterprises, coastal enterprises and inland enterprises, upstream industrial enterprises and downstream enterprises, high-tech enterprises and labour-intensive enterprise, and domestic enterprises and foreign-funded

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<sup>1</sup> State Commission for Restructuring Economic Systems (SCRES, 1997), *China's Tariff Policy in Transition*, Beijing.

enterprises. The case study on export quota bidding reform of magnesium during 1993-1996 indicates that both state-owned trade companies and foreign-funded enterprise were favoured by the exclusive access to a large portion of quotas, while many small companies, most of which were private or township enterprises, were apparently biased. Another case conducted in the fieldwork is about import quota policy of cotton in 1997. To protect cotton production in Xinjiang as import substitution, MOFTEC suddenly imposed restrictive quota on cotton imports and it immediately stirred the fierce opposition of domestic textile enterprises and joint ventures in the southeast provinces. Finally, the authority gave in.

Among all forms of enterprises, state-owned enterprises (SOEs) should be singled out to emphasize on. Although the importance of SOEs in Chinese economy has been steadily declined since the reform, they still dominate a number of pillar industries, most of which are capital-intensive sectors that China has comparative disadvantage, and exercise significant monopoly over most of service sectors. Due to soft budget constraint and poor management in the history, more than half of SOEs are now running in red. The recent challenge for SOEs comes from massive lay-offs in the governmental structural adjustment reform. Under such circumstances, SOEs have turned to be the most important obstacle to trade liberalization. They tend to "walk on one leg" and deal with the authority directly, and therefore, both central and local governments are often confronted with "blackmailing" of some SOEs.

Traditionally, when faced to unfair import competition, domestic firms had been contained by the authority or informationally ignored due to the lack of legal channels until *China's Foreign Trade Law*(1994) and *Regulations on Anti-dumping and Countervailing Duty* (1996) were issued. The procedure of quasi-judicial administrative protection provides Chinese enterprises a legal, fast-track, and effective platform to counteract unfair foreign competition. In late 1997, China launched her first antidumping investigation case — against Canadian, Korean and U.S. newsprint producers. Finally, MOFTEC announced a preliminary determination that newsprint from above three countries had been dumped in China at margins of up to 79 percent below domestic prices. On an interim basis, importers of newsprint from three countries must post cash guarantees equal in value to the margin assessed against it. The unilateral action temporarily relieved the severe import shock to domestic paper industry running in red, and more importantly presented a demonstration effect for others in the future.

### *Foreign-funded Enterprises*

Traditionally and currently, foreign-funded enterprises (FfEs) have a unique status in Chinese economy. They have been given many preferential treatments in the realm of income tax system, investment regulation, trade policy and financial arrangement. Compared with other developing countries, there are fewer compulsory obligations on export ratio, local content, and equity ratio requirement for them. The Chinese authority eagerly expects foreign direct investment (FDI) to accelerate economic growth, increase employment, upgrade technology and human resource, and induce benign competition in

domestic market. In the local level, contracted FDI and actual inflow are regarded as main standards to evaluate the political performance of leading officials. As shown in Table 7, FDI has the significant impact on industrial output, fixed capital investment, manufactured exports, and employments in China. The situation applies to coastal cities in particular. Hence, foreign investors are usually able to take full advantage of internal competitions among regions to bargain with local officials for more preferential treatments and better business environment that they can provide.

**Table 7. FDI's Impact on China's Economy (1991-1995)**

	1991	1992	1993	1994	1995
Actual FDI inflow (billions of US\$)	4.4	11.2	27.5	33.8	37.5
FDI's share in total domestic investment (%)	4.5	8	13.6	18.3	25
FFEs' exports (billions of US\$)	12.1	17.4	25.2	34.7	46.6
Share of FFEs' exports in total (%)	17	20.4	27.5	28.7	31.3
Share of FFE's industrial output in total (%)	5	6	9	11	13
Employments in FFEs	4.8	6	10	14	16
Share of tax revenue from FFEs in total (%)	...	4.1	...	...	11.2

Note: ..., data unavailable

Source: Databank of MOFTEC, Chinese State Tax Bureau, UNTCAD, and World Bank

Since 1993, with the increasing volume and changing structure of FDI, the market penetration ratio of products made by joint-ventures has jumped off, and a large number of public enterprises have been merged or acquired by multinational corporations. Some local officials and entrepreneurs, united by academics, charged the situation partly on the preferential policies to which foreigners had been offered. To smooth social panic, the central government was determined to adjust the policy towards FDI in order to provide a fair playground for both joint-ventures and domestic enterprises. In 1996, a new policy to phase out tariff exemption for material and capital equipment imports of joint-venture was announced. As a result, contracted foreign investment, the indicator to symbolize future business investment in China, declined steeply during the following years. It was said that a move to impose normal tariffs on foreign investors was raising project costs to commercially unacceptable levels. In 1997 and 1998, the financial crisis in East Asia aggravated the dooming situation. To boom aggregate demand and relieve the deflation, in the late 1997 China declared a reversal of course on her planned two-year phase-out of tariff exemption and the previous preferential treatment for foreign investors were almost restored.

### *Military*

Like other developing countries, military (the People's Liberation Army, PLA) has its particular and eminent status in Chinese politics and economy. Since the national defence reform in the mid of 1980s, the budget expenditure on military has been cut considerably to support economic development. As a sort of financial compensation, military forces were permitted to establish their own affiliated companies and given many preferential fiscal and trade policies. For example, all export products made by these enterprises were allowed to retain full foreign exchange revenues. It is estimated that the total value added of

army-affiliated companies accounted for about two percentage of GDP at the early of 1990s and they provided more than 60 thousand employment opportunities for non-military staff. Some of the military's businesses were respectable while others were patently illegal, such as smuggling and hoarding. Unfortunately, the illegal activities engaged by military with their special background became more and more severe in recent years. In particular, smuggling was so rampant in some coastal regions that it led to the nullification of custom administration, tariff revenue loss, prevailing grey market, and import shock to key industries, like crude oil sector. Civilian businesspersons complained that PLA enterprises enjoyed unfair advantages and senior politicians were concerned over corruption and moral degeneration in military. In August 1998, the central government launched an ambitious program to standardize regulatory enforcement as part of an anti-smuggling campaign. Meanwhile, all of companies in relation with military were forced to completely separate from business within a definite time period and the expense would be entirely compensated by a lump-sum financial transfer through tax revenues. The resolute decision ended the controversial history of military's involvement in the commerce during the past two decades.

#### *Other Social Interest Groups*

##### Consumers

Obviously, Chinese consumers could benefit a lot from trade liberalization with low price and high quality. The CGE model stimulation shows that most residents will increase their welfare and real consumption through different trade liberalization packages and they should be more welcomed by consumers in higher income class (Yang and Huang, 1997a). However, Chinese consumers have traditionally been very weak in the political process and therefore have few impact on the decision-making of trade policy. Although there exist some semi-official organizations, like the Chinese Consumers Association, their function has nothing to do with representing and articulating interest of consumers to lobby trade policy. Finally, the well-known "free-rider problem" (Olson, 1965), heterogeneity among Chinese consumers, and their psychological ambivalence to trade liberalization also nullify their collective force to influence the trade policy formation.

##### Farmers

Despite the fact that they account for approximately 80 percent of the total population in China, farmers seem never to play any significant role in the authority's decision-making. They are scattered widely in geographical sense and hardly organized. They are normally depressed and poorly educated to understand the intellectual meaning of trade liberalization.

##### Union

As a quasi-official association led by the party and state, the nature of Union in China is totally distinct from that in western countries. Lobbying for protection from import shock, increasing wages and asking for better working conditions are never seen as in the agenda.

## Foreign Interests and Commitments to World Trade System

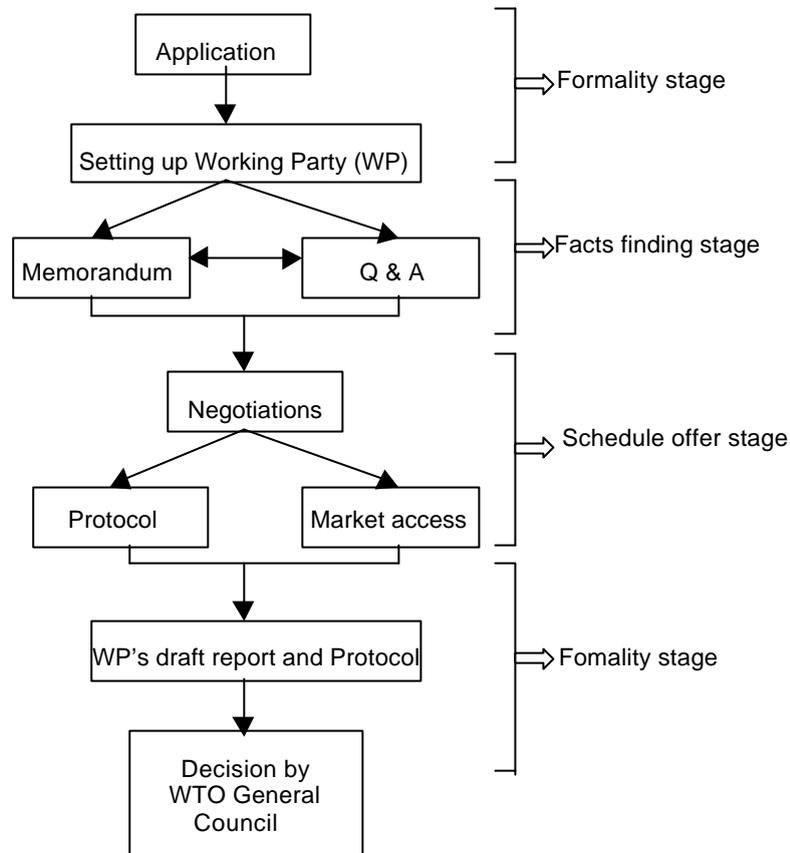
### *Multilateralism: World Trade System and China's Accession to WTO*

Since 1986 when China submitted her application to GATT, to meet requirement of the membership has been the most important external factor to influence her traditional closed-style decision-making process. In the early years, China hoped to be given permanent MFN or GPS status by renewal the membership in GATT so as to increase the market access to developed countries when the new protectionism was prevailing in 1980s. The government also expected to solve bilateral trade disputes with main trade partners in multilateral dispute settlement framework. Furthermore, the isolation from the world trade system seemed to mismatch China's political status in international affairs and her market-oriented economic reform. Although China was quite disappointed and humiliated at unsuccessful accession to GATT before WTO was established in 1994, she didn't close the door to negotiations. The most important reason is that new Chinese leaders are determined to conform international rules, persist open-door policy and follow market-oriented economic reform. They are more politically bold and charismatically wise than elder politicians and strategically anchor China's future in the globalization and international policy coordination. The principles of world trade system — transparency, fair and impartial judicial practices, peaceful settlement of disputes, the rule of law — are those leaders hope to advance in China and worldwide.

On the other hand, main WTO contracting parties, U.S. and EU in particular, changed their attitudes and strategies to China's application after the Tiananmen Square Incident in 1989. Besides political ideology confrontation, they also intended to concentrate more on demanding commercial issues. Specifically, they tried to seize the opportunity to enable China to accelerate economic reforms which hopefully resulted in transforming her political system. In other words, the process of accession to GATT/WTO is able to ratchet up Chinese internal reform and keep reformists' bicycle going on. In addition, they wanted to lock-in China in a rules-based international trade system and keep her from disturbing the managed trade order as a free rider. The commitment to institutional rules can be regarded as an *ex ante* chain set on China to prevent market disruption and system friction. Finally, the GATT/WTO negotiation being an opener, they sought to prey China's emerging huge market as much as possible to obtain a protocol on the commercially meaningful basis. The United States also took full advantage of negotiation to comprehensively settle bilateral trade disputes with China, her second largest trade partner with trade deficit.

According to the accession process depicted in Diagram 8, Table 8 reviews the detailed time schedule of China's accession to GATT/WTO. There are four phases that are dealt with as follows for China's exhausted journey.

**Diagram 8. WTO Accession Procedure**



Source: Author's compilation on WTO (1999), *Technical Note on the Accession Process*. WT/ACC/7, note by the Secretariat; Michalopoulos (1999), *WTO Accession for Countries in Transition*, WTO Internal Achieve.

**(a) Factual examination and institutional reforms**

On the basis of *the Memorandum on the Foreign Trade Regime* presented by the Chinese delegation in 1987, China's economic and trade legal regimes were examined and inquired by GATT contracting parties, and in particular the areas of inconsistency with GATT agreement were identified. To meet the member qualification of "non-planned economy", three rounds of comprehensive economic and trade reforms were carried out in 1984-87, 1988-90, and 1991-1993, covering issues of ownership system, price system, trading rights, trade mandatory plan, export subsidy, foreign exchange, etc. With such reforms Chinese authority gradually enacted the laws, developed the institutions and applied the policies that enabled her to conform to the fundamental rules and disciplines of GATT. Finally, in early 1992 the Chinese Communist Party clarified the goal to establish the "socialism market economy".

**(b) Negotiations and suspension**

After the submission of revised the Memorandum in 1993, the process moved on to negotiate the terms of accession related to GATT rules, goods and service. China's intinial schedule of "offers" for market access was focused on tariffs and then broadened to cover non-tariff barriers, intellectual property, and

a small number of service sectors requested by main contracting parties. After signing *The Sino-U.S. Memorandum on Market Access*, China launched her unprecedented import liberalization by reducing tariffs and quantitative measures in 1992. The government also completed another round of massive import reforms, including current account liberalization and elimination of dual foreign exchange rates, before the deadline to finalize the renewal GATT membership by the end of 1994. In spite of significant macroeconomic and trade reforms, China could still hardly meet the demanding requirement of main parties, who requested that China should access to GATT as a "developed country". Under such impending circumstances, China delivered an ultimatum to main parties, saying that the negotiation had to be finished by the deadline time. Unfortunately, it failed and China furiously declared the negotiation would not resume unless she was invited by contracting parties.

**Table 8. The Timetable of China's Accession to GATT/WTO**

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
<b>Working Party meetings</b>	*July, application	*Mar., established *Oct.	*Feb. *Apr. *June *Sept.	*Feb. *Mar. *Apr. *Dec.	*Sept.		*Feb. *Oct. *Dec.	*Mar. *May *Sept.	*Mar. *July *Dec.	*July	*Mar. *Nov.	*Mar. *May *Aug. *Dec.	*Apr. *July	
<b>Memorandum</b>		*Feb.	*Dec.					*May *Sept.						
<b>Q &amp; A</b>		*Nov.	*Mar.								*Mar. *Apr.		*July	
<b>Data and annex</b>														
Price control										*July		*July		
Agriculture									*June		*Apr.			
Tariff							*Feb. *Oct.	*Mar.	*May			*Oct.	*Apr.	
NTBs								*Mar.		*July		*May *July		
Service								*Apr.						
Export										*July		*Feb.		
Subsidy												*July	*Apr.	
Others										*7		*June *Dec.	*Apr. *May	
<b>Concession</b>														
Goods									*Sept.					
Service									*Apr. *Sept.	*Oct.	*Dec.	*Nov.		
<b>WP's draft protocol</b>									*Dec.			*Mar. *May		
<b>WP's draft report</b>									*Dec.			*May.		

Source: Author's compilation on WTO(1998), *The People's Republic of China's Accession to the World Trade Organization*, Non-Attributable Background Note, and *Technical Note on the Accession Process*, Annex 1, Status of Working Party Accessions: China. WT/ACC/7, WTO Secretariat, 10 March, 1999.

### (c) Restarting negotiation and bargain process

After one-year suspension in the Working Party talk and harsh Sino-U.S. trade war on market access and intellectual property right protection, the negotiation resumed by main parties' invitation in 1995. However, it became extremely stumbling and exhausting because the new offer requested by contracting parties were alternatively based on the issues reached in the Uruguay Round, particularly including tariff bounds, agriculture commitments, a large number of service schedules. Trade talks proceeded in a go-and-stop style during the following years, much depending on the China-U.S. economic

and diplomatic relation. Nevertheless, there was some progress of China's commitments in trading rights, agriculture, and piecemeal opening domestic service markets.

(d) Accelerating negotiation and approaching the final stage

Obviously, China accelerated the negotiation with WTO contracting parties since the early of 1999 because she was worried that the requested offer would be more demanding if new round of multilateral trade negotiation duly started in Seattle at the end of year. Except for a short interval due to U.S. bombing Chinese embassy in Belgrade, the bilateral trade negotiation was going on in a constructive approach, and eventually, on November 15, a major watershed marked in China-U.S. relation. According to the agreement, China made substantial concessions on agriculture, information technology products, and telecommunication, banking, and insurance sectors. In addition, during past weeks, some exhilarating breakthroughs had occurred both to China and the world as well. On May 19, the China-EU market access agreement was reached, which can be seen as another vital step to break the deadlock of trade negotiations between China and major WTO Working Parties. On 25 May, the US House of Representatives, after fierce debate and lobbying, voted to approve Permanent Normal Trade Relations (PNTR) with China. Hopefully, the U.S. Senate is also supposed to endorse PNTR when it votes on the matter in the coming weeks. These historical events have now brought China ever closer to the WTO membership than before. But much work remains to be done. Importantly, China must come to terms on bilateral market access agreements with several countries including Costa Rica, Ecuador, Guatemala, Mexico and Switzerland. The Working Party on China's accession must also complete its load of procedure and secretarial work.

During the fourteen-year negotiation, GATT/WTO parties and China have discussed a number of crucial issues that substantially impact on Chinese protective trade regime and policy. They include:

(a) the issues about China's economic and trade system, covering planned economic system, planned price system and dual price system, foreign exchange control and dual exchange rates system, trading rights and trade monopoly, state-owned enterprise reform, export subsidies;

(b) the issues of policy uniformity and transparency, such as trade mandatory plan, import quota and licensing requirements, preferential policies of Special Economic Zones, regional and industrial policies, custom regulations and standards, and information availability of laws, regulations, and data;

(c) the issue of China's accession to GATT/WTO as a developing or developed country;

(d) the issues on foreign companies' market access to China, including tariffs reduction and binding, import quota and license, import substitution directive, industrial policy, restrictions in agriculture and service, intellectual property rights protection, national treatment of investment, and GATT/WTO plural agreements; and

(e) the issues of China's market disruption in world market, ranging from selective safeguard clause and GATT/WTO mutual non-applicable clause to antidumping, countervailing duty, and quantitative restriction of China's exports.

Indeed, both China and main WTO contracting parties would be losers if they denied China's accession to WTO as a developing country. The GTAP model simulation shows that China's real GDP, welfare, and trade will decrease dramatically in 2005 compared to those of the base year 1992, much due to the restrictive export quotas imposed on textiles. For U.S. and EU countries, they cannot benefit from China's huge and growing home market, which will accordingly lose many employment opportunities, and consumers have to pay higher cost for the imports of labour-intensive goods. Their term of trade will also deteriorate (Yang, 1996).

### *Regionalism: China and APEC*

Basically, APEC, NAFTA and EU are three largest markets for China's exports and imports. In particular, China has intended to prefer more to briskly involving into all-dimensional economic cooperation in the Asia-Pacific region. It is not only because China has meaningfully commercial stakes in the dynamic Asia-Pacific region, but also because APEC provides China with an accessible track of implementing her regional trade strategy to ferment a favourable surrounding for the sake of domestic reforms.

First and foremost, exports to and imports from Asia-Pacific countries account for more than half of China's total trade, because her main trade partners all dwell in the region. Hence, the meaningful commercial interest of market access to and dependence on technology-intensive imports from Asia-Pacific countries get China spurred to anchor her trade policy in APEC, the only regional economic cooperation organization in which she participates now. Second, APEC seems to be an efficient diplomatic vehicle for China in pursuit of her responsibility in the globe as a shepherd for developing countries and this motive is far beyond the trade liberalization and facilitation. Third, APEC already has evolved into a substantial geo-political dialogue platform, where Chinese leaders are able to have routine meetings with those of other nations. Fourth, APEC is very likely to be a sub-optimal means substituting for long denied accession to GATT/WTO. It offers China a midway approach for fully integration into the world trade system. China can also discuss a number of essential bilateral trade issues in the APEC arena. She will be faced with fewer aggressive external pressures from other members than contracting parties in WTO. In short, China has little to lose and much to gain in APEC.

China has a very clear and confirmed vision for APEC that it should keep to its nature as an economic forum and focus on promoting the regional economic cooperation. In other words, the function of APEC is only a consultative and consensual decision-making entity, and it is neither a venue for trade negotiation and bargaining, nor an obligatory agreement which relies on the drafting and ratification by all participants of legally binding international agreements or treaties. In essence, APEC is a loosely-structured and minimized-institutional organization. The willingness for China's regional cooperation with others doesn't have any hint of transferring sovereignty, deepening far-reaching integration and pursuing extensive institutionalization.

China's vision of APEC leads to her gradually developed strategy toward it. Firstly, China attaches great importance to the unique way of collaboration,

which is so-called "APEC approach" and defends it at any rate to be the "cornerstone" and "right" direction for the organization. The main elements of the approach include: (i) adherence to mutual respect, equality, mutual benefit; (ii) recognition of diversity; (iii) flexibility and pragmatism; (iv) gradual progress and openness; (v) consensus; and (vi) unilateralism and voluntariness. Secondly, China is opposed to having an inward-looking, fortress-like and beggar-thy-neighbour organization in the Asia-Pacific and endorses the notion of "open regionalism" that APEC should be oriented to their own region as well as the rest of the world.

During the past decade, China has done the utmost to devote herself to APEC trade liberalization by initiatives and contributions. For instance, she has considerably and successively reduced trade and investment barriers on the voluntary and piecemeal basis. In 1995, her "down payment" in the Osaka Summit presented a meaningful demonstration for the following Manila Action Plan of APEC (MAPA) — reduction of average tariff rate from 40% to 23%, which was greatly welcomed and praised by other members. However, she also cautiously kept the balance of the concessions between APEC and GATT/WTO.

It is undoubted that to a significant degree, the eventual direction that APEC takes will be influenced by the leadership exercised or not exercised by the developed members, particularly the United States. With the increasing intention to the Asia-Pacific Rim, the U.S. foreign policy to APEC will have more conflicts with and squeeze on China, since both parties hold different vision and strategy to the commonly-interested region.

For the United States, APEC is not an end in itself but a means to achieve a series of foreign policy goals, incorporating U.S. economic, political, and security interests. They are reflected in President Clinton's proposed "New Asia-Pacific Community". U.S. politicians never give up their dream to attain such an established goal, albeit setback and boycott by its partners in Asia.

APEC has special meanings for U. S. trade policy. Firstly, APEC turns to be a tool for the U.S. seeking to "ratchet up" multilateral trade, catalyze worldwide trade liberalization, and facilitate future negotiations. It can be shown by three specific American accomplishments in APEC, namely, to finish and accelerate the Uruguay Round, to launch the new Millennium round of world trade negotiation, and to stimulate multilateral sector negotiations on liberalization of information technology products and services (e.g. telecommunication). Secondly, APEC can offer the U.S. an experimental yard to seek regional agreement on proposals which have been considered in the GATT/WTO but can not yet be adopted there. The notable examples in this regard are trade facilitation programs, competition policy, deregulation, public procurement, and market access to some service sectors. Finally, for the U.S., APEC is a short-cut for market penetration because her three largest trading partners, half of the ten vital Big Emerging Markets she identified, and two largest trade partners she has trade deficit with are all APEC members. By and large, in American perspective, regionalism in the Asia-Pacific, is complementary to her ultimate goal of trade multilateralism.

With the ideology of New Asia-Pacific Community and mission of trade policy, the primary strategy of the U.S. to APEC has been to institutionalize

APEC to be a free trade area on an evolutionary basis. In addition, the U.S. is making efforts to push forward the modality, formality and comparability of APEC trade liberalization programs. The U. S. government also tried to propose the methods of "APEC-plus", "flexible consensus", and "critical mass" to ratchet up those members whom she considers as "pulling the leg" in APEC. By all means, the U.S. needs APEC evolve to be an organisational maturity to serve her broader goal of free trade. The second strategy is that trade and investment liberalization and facilitation have been the priority goals for the U.S. since APEC was founded. Contrary to slow, flexible and unilateral way of some developing members, the U.S. pointed out that implementing the trade liberalization elements of the agenda successfully will require close adherence to three guiding concepts called the "three C's" — comprehensiveness, comparability, and consultation, which can be seen as a typical step for the U.S. to strive APEC to be a rule-based and formalized community. Thirdly, U.S. perennially stresses the importance of reciprocal trade concessions and has rejected accepting the notion that APEC liberalization must rest solely on unconditional MFN basis, worrying that that unconditional extension would not only give other countries a free ride on American concessions but also provides insufficient incentives for non-members to undertake comparable liberalization measures.

In short, China has shown her great intention and energy to favour regionalism in the Asia-Pacific in the wake of economic globalization and holds the vision and strategy of APEC beyond the trade liberalization. The motive and approach she has pursued in APEC, however, are still undergoing evolutionary change and will be challenged by other superpowers in the region. More importantly, the paper argues that the Chinese future policy towards APEC will greatly rely on the political leaders' ideology of understanding the true nature of regional cooperation in diplomacy.

#### *Bilateralism: Sino-U.S. Trade Relation*

Trade issue is one of core disputes in Sino-U.S. bilateral relationship. The trade disputes cover a number of areas, mainly including issues on China's accession to WTO, Normal Trade Relations (formerly called MFN status) with China, U.S. large trade deficit with China, Chinese export subsidies, Chinese prisoner products export, China's satellite launching business, market access of key agricultural, industrial and service products to China, intellectual property right protection in China, U.S. export control of high-tech products to China, U.S. antidumping and countervailing duty to Chinese exports, and China's textiles export quotas and "illegal" transshipment. Apparently, the bilateral trade negotiation had a significant impact on trade policy decision-making of Chinese authority. During past decades, the most essential achievement of bilateral trade talks are *China-U.S. Memorandum of Market Access* (1992) and *China-U.S. Bilateral WTO Agreement* (1999). Meanwhile, intensive trade frictions and nearly-occurred trade wars broke out due to the disputes on market access and intellectual property rights protection in 1991, 1994 and 1995. To a great extent, they accelerated the process of China's opening domestic market and

establishing a functioning system to protect intellectual property rights, which has become part of China's nation-wide campaign to combat piracy.

For China, the trade policy to U.S. anchors in the fundamental diplomacy so-called "constructive strategic partnership" with U.S. since American market is of great importance to China in terms of labour-intensive product exports, technology imports, and investment financing. China also tries to tactically seek the balance between trade issues and other hot disputes with U.S., say, human rights, Taiwan independence, Tibet autonomy, and nuclear proliferation.

The basic American trade policy towards China is part of Clinton Administration's strategy of "comprehensive engagement" with China. It will serve U.S. government to create a peaceful, stable and prosperous Asia-Pacific region, promote political and economic liberalization within China, integrate China into the global rules-based trading system, and pursue U.S. commercial interests. In particular, a sound trade agreement will open Chinese markets to U.S. exports, and give American domestic industries stronger protection against "unfair" trade practices because China is now the fourth largest American trade partner. Hence, to win these benefits, a bilateral agreement with China must be commercially meaningful, addressing American major concerns in a detailed, enforceable and rapid way. In return, U.S. will offer China the permanent Normal Trade Relation status and support her endeavour to join the WTO.

The U.S. trade policy towards China strongly roots in her long evolved trade philosophy of "new reciprocity" (overall reciprocity) and trade strategy of "stick-and-carrot". The U.S. government paid great attention to countries with larger bilateral trade surplus with U.S., to those with larger and faster-growing economies, and to those she thought with higher trade barriers. These patterns of behavior do not appear to vary by presidential administration. To American trade officials, all kinds of "lateralism", whether they be multi, uni, bi, tri or plurilateral, are good as long as foreign trade barriers can be reduced.

The policy is also influenced by the political policy-making procedure and structure in America and demands of a variety of domestic special interest groups. For example, the bipartisan struggle often gives an inconsistent trade policy to China. The executive administration is likely to be pro China in trade issues while the Capitol always plays a role of stumbling stone. The U.S. Trade Representative Office seems to be more aggressive to China than other administrative bodies. More importantly, exporters, primarily composed of agricultural producers, industrial multinational corporations, and key service suppliers are actively lobbying for reaching and passing a bilateral trade agreement with China, while import competing sectors, Union, and human right activists are opposed it. As a consequence, U.S. trade policy to China is probably best considered as a manifestation of competing interests in which no single goal predominates, and special interest groups may only hold sway on particular issues.

### **III. Model**

There are few formal models to describe the political economy of China's trade policy in the literature. Branstetter and Feenstra (1999) derived a model drawing on Grossman and Helpman (1994) with the feature of empirically

estimable government objective function and they viewed the political process of trade liberalization in China as trading off the social benefits of increased trade and foreign direct investment against the losses incurred by state-owned enterprises. However, due to the nature of trade policy that is exclusively made by the central government, it seems unrealistic for the model to be theoretically developed and empirically test on the cross-region basis, albeit the limited economic integration among Chinese provinces which they argued.

Instead, in this part, I attempts to formulate a formal model of the political economy of trade protection, which is fit to Chinese political system, in order to depict the decision-making process of trade policy mainly from the supply side. The specific-factor model and government objective function in the particular form are core of the new model. More importantly, contrary to the study of Branstetter and Feenstra, the model is developed and can also be applied to empirical study on the cross-industry basis that looks more reliable in practice.

Commodity market and factor market are supposed to be in perfect competition structure and infinite supply elasticity is for production factors. The international price is considered as exogenous. Like other models, the “free rider” problem of interest groups' lobbying is ignored. Finally, trade policy is only available policy vehicle for the government and there are no differences between tariff and non-tariff barriers. According to Renaud (1989), the structure of political economy model should include following elements:

- (a) parties in the decision-making process;
- (b) the interest function of parties;
- (c) the parties' influence on policy makers;
- (d) policy tools;
- (e) binding institutional constraints for parties; and
- (f) the equilibrium solution of policy.

In the demand side, all labours (in the number of L) in the economy will participate in the policy-making process. Each preference is supposed to be homogenous and the quasi-linear utility function of representative individual is:

$$u(x) = x_0 + \sum_{i=1}^n u_i(x_i) \quad [1]$$

$x_0$  is the consumption of numeraire commodity and its international and domestic price are fixed as one.  $x_i$  is the consumption of commodity  $i$ ,  $i=1, 2, \dots, n$ , and  $n$  is the number of tradable goods. Normally,  $u_i(0) = 0$ ,  $u_i' > 0$ , and  $u_i'' < 0$ .

$p_i$  and  $p_i^*$  are set as the price in domestic and foreign market respectively.  $p_i^*$  is an exogenous variable and  $p_i = p_i^* + t_i$  while  $t_i$  is tariff plus non-tariff barriers or subsidy equivalence.

With the individual demand function  $x_i = D_i(p_i)$  and [1], the direct and indirect utility function be deduced as  $u(x) = V(p, I) = I + \sum_{i=1}^n u_i(D_i(p_i)) - \sum_{i=1}^n p_i D_i(p_i)$ , while  $I$  and  $p = (p_1, p_2, \dots, p_n)$  are income expenditure and price vector. Obviously, the consumer surplus, which is defined as  $S(p)$ , equals to  $\sum_{i=1}^n u_i(D_i(p_i)) - \sum_{i=1}^n p_i D_i(p_i)$ .

In the supply side, following the assumption proposed by Grossman and Helpman (1994), I suppose that only labour is needed for producing the numeraire good 0 and both input-output coefficient and wage rate ( $w$ ) are one. To produce non-numeraire goods requires labour and at least one specific factor. On the assumption of free labour mobility among sectors, their wage rate is also one. The return of specific factor,  $\mathbf{p}_i$ , depends on the price of commodity  $i$ ,  $p_i$ , so that  $\mathbf{p}_i = \mathbf{p}_i(p_i)$ . According to the Hotelling Theorem, we know that the production function of good  $i$   $y_i(p_i) = \mathbf{p}_i'(p_i)$ .

Foreign trade results from the gap between domestic demand and supply so that the net import  $M_i = LD_i - y_i$  and net tariff revenue is

$$R(p) = \sum_{i=1}^n t_i M_i = \sum_{i=1}^n t_i [LD_i(p_i) - y_i(p_i)] \quad [3]$$

Suppose that tariff revenue will be distributed equally to each labour by means of government income transfer. Hence, an individual's total income is composed of three parts — labour wage, return of specific factors, and transfer of tariff revenue.

$$I = 1 + \sum_{i=1}^n s_i \mathbf{p}_i(p_i) + \sum_{i=1}^n t_i [D_i(p_i) - \frac{1}{L} y_i(p_i)] \quad [4]$$

Here  $s_i$  represents an individual's share in the total specific return for producing good  $i$  and  $\sum_{j=1}^L s_{ji} = 1, i=1, 2, \dots, n$ . With [4] and indirect utility function

$V(p, I) = I + S(p)$ , the individual's interest function, which includes supplier surplus and consumer surplus, can be written as

$$V(p, I) = 1 + \sum_{i=1}^n s_i \mathbf{p}_i(p_i) + \sum_{i=1}^n t_i [D_i(p_i) - \frac{1}{L} y_i(p_i)] + \sum_{i=1}^n u_i [D_i(p_i)] - \sum_{i=1}^n p_i D_i(p_i) \quad [5]$$

The individual's objective is to maximize his interest function.

Next, we turn to consider another crucial and special policy maker — the central government. Its interest function  $G$  can be obtained as [6] by weightedly summing up returns of all individuals.

$$G = \mathbf{b}(w) [L + \sum_{i=1}^n \mathbf{q}_i(z_i) \mathbf{p}_i(p_i)] + \sum_{i=1}^n t_i [LD_i(p_i) - y_i(p_i)] + L \{ \sum_{i=1}^n u_i [D_i(p_i)] - \sum_{i=1}^n p_i D_i(p_i) \} \quad [6]$$

In other words,  $G$  is regarded as the social welfare function for the authority and the objective of the government is to maximize it. Two parameters in [6], namely  $\mathbf{b}$  and  $\mathbf{q}_i$ , are particularly noteworthy here.  $\mathbf{b}$  represents the weight of factor incomes to the sum of net tariff transfer and consumer surplus. Generally speaking,  $\mathbf{b} \geq 1$ , which indicates that the government usually pay more attention to the interest of producers than consumers. The reason is due to either governmental short-term policy targets on tax revenue, economic growth, etc., or the "free rider" problem of consumers' lobbying.  $\mathbf{b}$  also depends on the distribution of specific factors among all labours. Specifically, the more even the distribution is, the more  $\mathbf{b}$  tends to 1. We mark all exogenous variables influencing  $\mathbf{b}$  as  $w$  and so  $\mathbf{b} = \mathbf{b}(w)$ .

The parameter  $q_i$  shows weights that the government endows to different sectors in the objective function. In general,  $q_i \geq 1$ . From the perspective of political supply, it implies that the government prefers to favour some “strategic” sectors based on its ideology and deliberated targets, or from the perspective of political demand, it shows sectoral distinctive lobbying capability which is close related to the industrial characteristic. Similarly, we mark all exogenous variables that influence  $q_i$  as  $z_i$  and therefore  $q_i = q_i(z_i)$ .

Finally, we assume that tariff or non-tariff barriers (of tariff equivalence) are only policy instrument available to the central government. Several propositions and deductions are then attained as follows. Regretably, all proof procedures are omitted due to the format of short paper.

**Proposition 1.** To maximize the government’s objective function, the optimal protection rate should be

$$\hat{t}_i = (bq_i - 1) \frac{y_i}{(-M_i)} \geq 0 \quad [7]$$

$M_i$  is the slope of import demand function.

**Deduction 1.** When  $bq_i = 1$ , particularly,  $b = q_i = 1$ , the government will pursue free trade policy.

**Proposition 2.** The magnitude between the individual’s expected optimal protection rate  $\tilde{t}_i$  and governmental optimal rate  $\hat{t}_i$  relies on the discrepancy between  $bq_i$  and  $s_i L$ . That is

- (1) if  $bq_i < s_i L$ ,  $\hat{t}_i < \tilde{t}_i$ ;
- (2) if  $bq_i > s_i L$ ,  $\hat{t}_i > \tilde{t}_i$ ; and
- (3) if  $bq_i = s_i L$ ,  $\hat{t}_i = \tilde{t}_i$ .

**Deduction 2.** When specific factors are equally distributed among the labours in sector  $i$ , free trade policy will prevail in the sector.

**Proposition 3.** The more parameter  $b$  (the weight of factor incomes to the sum of tariff revenue transfer and consumer surplus) or  $q_i$  (the weight endowed to different sectors) is, the higher optimal tariff rate  $\hat{t}_i$  will be. That is

$$\frac{d\hat{t}_i(b)}{db} > 0, \quad \frac{d\hat{t}_i(q_i)}{dq_i} > 0.$$

**Deduction 3.** *Caeteris paribus*, the more  $q_i$  tends, the more  $p_i$ ,  $y_i$ , and  $p_i$  will be, but the less  $x_i$  and  $M_i$  are. That is

$$\frac{dp_i}{dq_i} > 0, \quad \frac{dy_i}{dq_i} > 0, \quad \frac{dp_i}{dq_i} > 0, \quad \frac{dx_i}{dq_i} < 0, \quad \frac{dM_i}{dq_i} < 0.$$

**Proposition 4.** Subject to the binding condition of (1)  $t_i \leq t_i^*$  (binding tariff requirement) or (2)  $\bar{M}_i - d t_i \geq m^* L_{X_i}$  (minimum import requirement), the new optimal protection rate will turn to be (1)  $\hat{t}_i = \min\{\hat{t}_i, t_i^*\}$  or (2)  $\hat{t}_i = \min\{\hat{t}_i, \frac{1}{d}(\bar{M}_i - m^* L_{X_i})\}$ , where  $t_i^*$  is exogenous binding tariff rate and  $\bar{M}, d$ , and  $m^*$  represent autonomous net import, sensitivity coefficient of net import to tariff change, and exogenous minimum ratio of import to domestic consumption respectively.

**Proposition 5.** When the government has a trade talk (cooperatively) with a foreign country (\*), as long as the negotiating procedure allows both sides to choose from the outcomes that are efficient from their own perspective, the equilibrium can be obtained to satisfy:

$$\hat{t}_i - \hat{t}_i^* = (\mathbf{b}q_i - 1) \frac{y_i}{(-M_i)} - \frac{I_i - \mathbf{a}_L}{a + \mathbf{a}_L} \frac{y_i^*}{(-M_i^*)}$$

where  $I$  is a dummy symbolizing that the industry  $i$  is represented by a lobby,  $\mathbf{a}_L$  is the share of population that owns specific factors, and  $a$  represents the foreign government's weight of welfare relative to political contribution in its governmental objective function (Grossman and Helpman, 1994).

The revised model in the paper can explain the trade policy formation in the country with political characteristic of democratic-centralism. The individual utility function and income function reflect democratic participation of all labours, while the governmental objective function, distinguished from that in western countries, reveals the central government's preference on welfare distribution ( $\mathbf{b}$ ) and industrial strategy ( $q_i$ ) in terms of "activism" and "nationalism". The political pressure of interest groups is still "marginal" and lobbying or rent-seeking activities are rather implicit. It is reflected by the parameter  $q_i$  in the model. The proposition extended to include exogenous binding conditions and cooperative trade talk will further fit to China's current situations in multilateral, regional, and bilateral trade negotiations. Significantly, the political equilibria of tariff formula in the model, namely Proposition 1, coincides with the unified framework that is proposed by Helpman (1995) to compare different political economy approaches explaining trade policy. However, the model still needs being modified and extended by considering lobbying cost, free rider problem, sequential game between interest groups and the central government, and feedback to external bids.

## IV. The Empirical Study of Political Economy of Industrial Protection Pattern in China

### Dependent Variables

In lack of enough price comparison data, only "single index" method is used to estimate trade protection rates in China, including nominal tariff rate, frequency ratio of non-tariff barriers, and effective protection rate. They will be

dependent variables for the following empirical models. Technical notes of three protection rates can be found in Appendix.

### *Tariffs*

Although the simple average tariff rate lowers from 43% in 1992 to 18% in 1998 and the weighted average tariff rate is reduced from 41% to 19% during the same period (Table 1), there still exists great dispersion among tariff lines, which indicates the implicit trade distortion in China. In 1998, the deviation coefficient of tariffs for all products, primary products and manufactured products are 74%, 104% and 62% respectively. For industrial goods<sup>1</sup>, nominal tariff rates of 36 sectors in China are listed in Table 9. The deviation coefficient of them are 72%, 80%, and 70% in 1992, 1994 and 1996 respectively.

There is significant discrepancy between nominal tariff rate and tariff collected rate because of complex and arbitrary tariff exemption system. For example, the nominal tariff rate in 1997 is 18% while the collected tariff rate is only 3%. However, tariff collected rates for industrial sectors are unavailable due to limited information. Finally, as Table 9 shows, tariff reductions in lines are gradual and piecemeal, varying on the arbitrary basis.

### *Non-tariff barriers (NTBs)*

The “frequency ratio”, the ratio of the number of tariff lines subject to one or more than one NTBs to the total number in the category, is used to represent the restrictiveness of NTBs. In addition, NTBs are estimated by two methods of measures, namely “hard core” (only import quota and license) and “all” instruments. Table 10 shows that the average frequency ratio lowers from 37% in 1994 to 31% in 1996 for “all” NTBs and from 10% to 5% for “hard core” NTBs during the same period. Some imports, say, beverage, tobacco, chemical fabrics, and transportation equipment, are usually restricted by higher NTBs, quantitative measures in particular, than others. The third feature of NTBs, shown by the Pearson test, is that they are complementary to tariff protection. Particularly there exists the strong positive correlation (0.55) between tariffs and quantitative restriction measures.

### *Effective protection rate (EPR)*

EPR is calculated by value added in Balassa approach (1971) in order to consider the effect of intermediate goods to reflect the overall degree to which economic resource is distortedly allocated. As shown in Table 11, EPRs of 36 Chinese industrial sectors are much higher and more disperse than nominal tariff rates. Tariff escalation generally has raw material and intermediate product sectors negatively protected while overwhelmingly stimulates downstream production of consumer goods and capital goods. The average of EPR drops significantly from 81% in 1992 to 45% in 1996, but the deviation coefficient keeps almost unchanged to be around 100%. Moreover, the fact that nominal tariff rate and EPR are highly correlated in the time series shows

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<sup>1</sup> Industrial products include all manufactured products and some primary products.

that the government can implement the plan of resource allocation in the economy through the prevailing tariff regime<sup>1</sup>.

**Table 9. Nominal Tariff Rates by China's Industrial Sectors (%)**

	1992	1994	1996
01 Mining of coal	18.1	14.3	5.5
02 Extraction of crude oil and natural gas	20.6	16.9	7.8
03 Mining of ferrous metals	0.0	0.0	0.0
04 Mining of non-ferrous metals	6.5	4.1	2.6
05 Mining of non-metallic minerals	30.3	26.3	7.8
06 Logging and related activities	12.5	7.5	4.4
07 Food products	49.5	44.3	36.9
08 Beverage	103.7	100.0	57.9
09 Tobacco	150.0	145.0	70.0
10 Textiles	71.3	57.5	31.0
11 Apparel and other fabric articles	88.4	75.4	41.9
12 Leather and feather products	72.4	55.2	42.3
13 Wood products	41.6	22.4	19.8
14 Furniture	75.7	66.1	44.4
15 Paper and paper products	35.4	27.7	22.3
16 Printing and publishing	16.0	12.0	10.2
17 Stationery, sports and entertainment goods	56.3	47.8	39.0
18 Petroleum refineries and coking	16.5	13.4	8.1
19 Basic industrial chemicals	27.2	23.2	14.3
20 Drugs and medicines	22.3	18.1	11.2
21 Chemical synthetics and fabrics	78.3	61.8	33.1
22 Plastic products	36.9	30.7	21.3
23 Rubber products	42.3	35.5	24.9
24 Non-metallic manufactures	49.8	40.5	25.8
25 Iron and steel	13.9	13.5	9.0
26 Non-ferrous manufactures	16.9	15.0	9.8
27 Metal products	39.6	34.0	18.9
28 General machinery	31.2	25.2	16.5
29 Specialized machinery	21.2	19.4	14.6
30 Transport equipment	67.6	64.4	35.7
31 Electric machinery and apparatus	40.0	30.1	21.1
32 Electronic and communication equipment	43.5	34.8	22.8
33 Scientific instruments and office equipment	40.9	31.2	23.5
34 Other manufacturing not else classified	56.5	49.3	31.5
35 Electricity, heating and water	3.0	3.0	3.0
36 Coal gas	15.0	12.0	6.0
Mean	43.7	36.5	23.3
Standard deviation	31.3	29.3	16.3
Deviation coefficient	71.6	80.3	70.0

Source: Author's calculation

<sup>1</sup> The Pearson test shows the correlation is as high as 0.92 in the sample years.

**Table 10. Frequency Ratios of Non-tariff Barriers by China's Industrial Sectors (%)**

	1994		1996	
	Quota & license	all	Quota & license	all
01 Mining of coal	0.0	62.5	0.0	50.0
02 Extraction of crude oil and natural gas	7.7	7.7	0.0	7.1
03 Mining of ferrous metals	0.0	100.0	0.0	100.0
04 Mining of non-ferrous metals	0.0	10.7	0.0	7.1
05 Mining of non-metallic minerals	11.0	36.3	0.0	11.4
06 Logging and related activities	60.9	69.6	0.0	95.0
07 Food products	4.0	93.6	4.8	96.5
08 Beverage	43.3	86.7	40.0	90.0
09 Tobacco	83.3	83.3	33.3	66.7
10 Textiles	1.9	36.6	0.7	8.4
11 Apparel and other fabric articles	11.2	11.2	0.0	11.3
12 Leather and feather products	0.0	25.9	0.0	7.4
13 Wood products	18.1	33.7	0.0	82.2
14 Furniture	0.0	0.0	0.0	0.0
15 Paper and paper products	8.3	67.4	0.0	39.7
16 Printing and publishing	0.0	0.0	0.0	0.0
17 Stationery, sports and entertainment goods	0.0	10.3	0.0	12.4
18 Petroleum refineries and coking	17.1	28.6	20.0	28.6
19 Basic industrial chemicals	9.1	18.2	5.7	15.1
20 Drugs and medicines	0.0	79.1	0.0	76.2
21 Chemical synthetics and fabrics	88.1	92.7	30.2	93.2
22 Plastic products	12.1	31.0	10.9	12.5
23 Rubber products	0.0	0.0	0.0	0.0
24 Non-metallic manufactures	0.0	0.0	0.0	0.0
25 Iron and steel	1.4	82.2	0.0	85.9
26 Non-ferrous manufactures	0.7	48.6	0.0	45.3
27 Metal products	0.0	18.6	0.0	15.6
28 General machinery	8.9	39.1	7.3	34.3
29 Specialized machinery	2.5	30.2	0.3	36.3
30 Transport equipment	33.3	41.9	27.7	32.8
31 Electric machinery and apparatus	3.5	21.2	2.2	17.5
32 Electronic and communication equipment	22.1	40.7	13.8	25.1
33 Scientific instruments and office equipment	10.9	22.3	4.8	9.2
34 Other manufacturing not else classified	0.0	0.7	0.0	3.5
35 Electricity, heating and water	0.0	0.0	0.0	0.0
36 Coal gas	0.0	0.0	0.0	0.0
Mean	10.1	36.5	5.3	30.6

Source: Author's calculation

**Table 11. Effective Protection Rates by China's Industrial Sectors (%)**

	1992	1994	1996
01 Mining of coal	13.7	9.5	-2.1
02 Extraction of crude oil and natural gas	19.6	15.7	5.1
03 Mining of ferrous metals	-26.0	-22.2	-14.2
04 Mining of non-ferrous metals	-8.5	-10.2	-6.5
05 Mining of non-metallic minerals	36.2	32.6	-0.2
06 Logging and related activities	6.1	-0.4	-0.6
07 Food products	176.2	161.0	143.1
08 Beverage	256.8	252.7	139.3
09 Tobacco	219.4	214.6	100.0
10 Textiles	157.9	126.3	63.5
11 Apparel and other fabric articles	220.2	196.0	109.2
12 Leather and feather products	197.4	142.4	121.4
13 Wood products	58.9	8.5	26.7
14 Furniture	204.8	190.1	128.3
15 Paper and paper products	67.3	50.6	46.7
16 Printing and publishing	-6.9	-8.2	-2.5
17 Stationery, sports and entertainment goods	107.7	94.7	96.4
18 Petroleum refineries and coking	53.9	43.7	26.9
19 Basic industrial chemicals	38.1	32.5	19.7
20 Drugs and medicines	18.4	12.9	6.4
21 Chemical synthetics and fabrics	174.1	135.4	69.6
22 Plastic products	38.4	31.0	30.0
23 Rubber products	90.6	76.2	59.5
24 Non-metallic manufactures	97.7	78.4	50.5
25 Iron and steel	13.0	15.5	11.4
26 Non-ferrous manufactures	27.3	26.1	17.4
27 Metal products	103.5	87.6	44.8
28 General machinery	53.3	41.4	27.2
29 Specialized machinery	17.5	20.0	19.5
30 Transport equipment	151.8	149.7	79.5
31 Electric machinery and apparatus	87.2	60.3	44.0
32 Electronic and communication equipment	80.4	63.8	41.6
33 Scientific instruments and office equipment	64.9	47.0	39.1
34 Other manufacturing not else classified	118.9	105.8	71.0
35 Electricity, heating and water	-12.9	-9.4	-2.6
36 Coal gas	-0.7	-2.8	-3.5
Mean	81.0	68.6	44.6
Standard deviation	77.5	71.6	45.0
Deviation coefficient	104.5	0.96	0.99

Source: Author's calculation

High and stable dispersion of different protection rates arouses an essential question concerning the political economy of trade policy in China—what kinds of political and economic factors determine such a diversified industrial protection pattern and trade liberalization packages? Based on the revised theoretical model, the study attempts to find out a number of plausible independent variables (vectors of  $w$  and  $z_i$ ) that have an impact on two key parameters —  $b$  and  $q_i$ , which then further influence trade protection rates. Therefore, cross-sectoral trade protection rates can be estimated by the following the reduced-form econometric model:

$$\begin{cases} T_i = T_i(\mathbf{b}, \mathbf{q}_i) \\ \mathbf{b} = \mathbf{b}(\mathbf{w}) \\ \mathbf{q}_i = \mathbf{q}_i(z_i) \end{cases}$$

Four empirical models are proposed as follows in hypothesis to explain the determinants of trade protection rates in the Chinese industry. For each model, the basic idea, independent variables, expected signs and economic explanation will be specified.

## Regression Models

### *National Interest Model*

In this model, trade policy is regarded as a public good to serve for the national or social interests, which have often been described in the “social concern approach”. There are two plausible national interests for the Chinese central government. One is to fulfil so-called “national strategy”, including industrial policy to foster the development of pillar sectors, open-door policy to promote international competitiveness, and policy to maintain economic security and balance of payment. Another one could be to pursue income redistribution among labours and other related targets, for example, achieving social equity, reducing structural adjustment cost, alleviating poverty, and safeguarding the interest of low-income workers. Independent variables for two sub-models are listed in Table 12 and 13.

**Table 12. National Interest Model: Sub-model A — National Strategy**

Variables	Definition	Expected Sign	Explanation
Value added ratio	The ratio of value added to gross value	+	Encouraged by industrial policy
Labour productivity	The ratio of value added to employee number	+	Encouraged by industrial policy
Backward linkage coefficient	See Appendix	+	Trade development strategy of export promotion; Supply-induced effect
Forward linkage coefficient	See Appendix	-	Trade development strategy of import substitution; Demand-induced effect
Competitiveness indicator	The ratio of net export to the sum of export and import	-	Normally, lower protection for high competitive sectors; Intra-industry trade theory
Concentration of foreign exchanges	The ratio of sectoral import to total import	+?	Maintaining balance of payment; Scarcity of foreign exchanges
Dummy variable	1 for key sectors specified in official documents, 0 for others	+	Encouraged by industrial policy
Non-tariff barriers	Frequency ratios	Uncertain	

### *Interest Group Rent-seeking Model*

The model hypothesizes that trade policy is a political product demanded by various kinds of interest groups and the government is ready to respond it by sale of protection. But other interest groups who are negatively affected by the

policy will be opposed to it by similar sort of lobbying. Finally, there comes to an political equilibrium among interest groups. The model is frequently called "self-interest approach" in the literature. Independent variables of the model are listed in Table 14.

**Table 13. National Interest Model: Sub-model B — Income Distribution**

Variables	Definition	Expected Sign	Explanation
The share of low-income workers	The ratio of low-income workers to all employees	+	
The share of low-skilled workers	The ratio of low-skilled workers to all employees	+	Achieving social equity;
The share of workers over 50 years old	The ratio of workers over 50 ages to all employees	+	Reducing structural adjustment cost;
The share of low-educated workers	The ratio of workers without higher education to all employees	+	Alleviating poverty;
Average annual income	The ratio of total annual salary income to the employee number	-	Safeguarding the interest of low-income workers
The share of sectoral employment	The ratio of the workers in a sector to all employees	+	

**Table 14. Interest Group Rent-seeking Model**

Variables	Definition	Expected Sign	Explanation
The number of companies	The total number of companies or enterprises with independent accountability	uncertain	Index for seller concentration; positive sign in the adding machine model (Caves, 1976), but negative sign in the pressure group model (Olson, 1965; Pincus, 1975)
Export ratio	The ratio of export to gross output	-	Lerner Theorem; Pass-through Coefficient Theory
Import penetration ratio	The ratio of import to domestic consumption	+?	Normally higher protection for import shock; Exceptional case in Grossman and Helpman's model (1994)
Capital intensive ratio	The ratio of fixed capital (excluding depreciation) to the number of employees	-	Index for the force of Union; Higher marginal revenue of capital, specific factor dedicated to lobbying
Tax and profit	The annual tax and profit revenue submitted to the government	+	Fiscal policy and public finance
The share of state-owned enterprises	The ratio of value added of state-owned enterprises to sectoral gross value added	+	Ideological preference; Bad performance; Vulnerable competitiveness
Sino-foreign equity ratio	The ratio of Chinese registered capital to foreign investment	+	Indicator for the role of foreign-funded enterprises; Olarreaga (1998)
Geographic concentration	See Appendix	uncertain	Index for local governments; Positive sign in Pincus (1975), but negative in Caves (1976)
Consumption ratio	The ratio of resident and social consumption to total output	-	Index for consumers; Collective action dilemma for consumers' lobbying; Strong opposition by intermediate product users

### *Hybrid Model*

The model will combine all independent variables in national interest model and interest group rent-seeking model in the regression to examine the significance and stability of determinants in both short and long run.

### *Trade Liberalization Model*

The model attempts to study guidelines of China's cross-industry tariff reduction schedule in GATT/WTO, APEC and Sino-US trade negotiations. Besides the independent variables listed above, basic tariffs (1992), historical tariffs (previous year), and frequency ratio of NTBs are also considered in the regression. The relation between tariff reduction rates and historical tariffs are expected to be positive because foreign governments have long been exerting great pressure on the Chinese authority to dramatically cut her high tariff peaks.

### **Technique and Data**

The Ordinary Least Square (OLS) method is used for regressions whose econometric function is in the general linear form as

$$TPR_i = a_0 + \sum_{k=1}^n a_k PV_{i,k} + m_i$$

where TPR represents dependent variables (nominal tariff rate, frequency ratio of NTBs, effective protection rate, or tariff reduction rate), PV is an independent variable vector including political and economic indicators of industrial sectors,  $a_0$  and  $a_k$  are intercept and regression coefficient respectively.  $m_i$  symbolizes the residual. Subscript  $i$  and  $k$  represent different sector and independent variable.

To estimate empirical models, data of three years (1992, 1994, 1996) are collected from various Chinese official source and international organizations and aggregated up to 36 industrial sectors according to the Chinese Industrial Classification Standard. The descriptions of data source and technical explanation are illustrated in the Appendix.

The estimation on the national interest model, interest group rent-seeking model, and trade liberalization model are based on annual cross-sector samples. For the hybrid model, the methodology of "pooling data", which merges the data of cross-sector and time series together, is also used to study the long-term effect, besides annual estimates likewise. To avoid the problem of multilinearity and freedom degree in the hybrid model and trade liberalization model, the "backward method" of OLS is employed to eliminate those independent variables with low and minimum T-test value successively until all remained variables have the controlled significant level. All independent variables are supposed to be in linear and non-logarithmic form and exogenous to various protection rates.

## Results

### *National interest model*

The empirical test of the national interest model A — “national strategy” shows that the adjusted  $R^2$  is relatively high (0.66-0.87) to well explain the determinant of annual nominal protection rate. The labour productivity and backward linkage coefficient have their expected signs and significant level as well, but their influence fades gradually during the period from 1992 to 1996. The competitiveness index also hold the significant level, but the sign is opposite to the expected, which indicates a distinct characteristic of China’s trade protection regime that those industrial sectors with comparative advantages are more protected. “Hard core” NTBs are shown to be complementary rather than substitute to nominal tariff protection, while the coefficients of “all” NTBs are not in the significant level. Other independent variables have insignificant T-test values, no matter they have expected or unexpected signs.

The result of estimate on annual effective protection rate is basically similar except that the backward linkage coefficient loses its significance and the value added ratio holds significance but with the unexpected sign. In addition, the adjusted  $R^2$  is lower than that in the above test, dropping to approximately 0.5, which implies that there are yet other unspecified political and economic factors to explain the disperse effective protection rates in the industry.

The regression result of the national interest model B — “income redistribution” is surprisingly disappointed. The adjusted  $R^2$  of the estimate on both nominal tariffs and effective protection rates are relatively low (0.4-0.5). More significantly, only the share of low educated workers has the both expected sign and significant level. Though having positive signs, the share of employment, and the index of Union force or employment pressure, doesn’t pass through the threshold value of T-test. The rest of independent variables all hold unexpected signs. Therefore, the empirical test shows that China’s trade policy doesn’t seem to provide the function for redistributing income, reducing poverty, and promoting social justice. It is uniquely distinguished from many studies on western countries where trade protection is very likely to be the effective policy to reduce structural adjustment cost and safeguard low wage community. The possible reasons could be that the nature of Union in China is substantially different and the authority may prefer to use other direct policy tools, like income and food subsidy, to achieve such social targets.

### *Interest group rent-seeking model*

Primarily, the explanation competence of the empirical test of interest group rent-seeking model is inferior to that of national strategy model. As far as nominal tariffs are concerned, not only is the adjusted  $R^2$  relatively low (the maximum is 0.6), but most of independent variables have an insignificant level. For nominal protection rate, the significant determinant factors are tax and profit (expected sign), the share of state-owned enterprises (unexpected sign but in decreasing trend), and the consumption ratio (expected sign). The geographic concentration index shows the positive sign and, however, in an insignificant

level, probably due to the similar regional industrial structure in China. Other variables are neither significant nor signally stable in the annual regression. In particular, some variables, like the number of companies, export ratio, and import penetration ratio, which are usually used in other empirical literatures, seem invalid to explain the case of China.

As regards NTBs, F-test is so low that two annual regressions cannot pass through the critical value. No independent variables with stable significance level are found except that quantitative restrictions (hard core NTBs) are occasionally effected by the geographic concentration index in 1992 and 1994 and consumer ratio in 1996. It shows that interest groups have little influential stake on the policy-making of NTBs because the administrative protection is usually discretionary and autonomously controlled by the executive bureaucracy.

For effective protection rates, the result is quite analogous to that of nominal tariffs. The consumption ratio appears to be most essential factor to determine sectoral EPR, which fits well the fact that China's industrial and trade policy have long favoured heavily protecting domestic consumer goods production. The result, however, also shows that the positive coefficient is reducing gradually in recent years, demonstrating the bold and resolute trade liberalization reform by the central government. Tax and profit creating as well as the share of state-owned enterprises have the significant impact on EPRs in 1992 and 1994, but it is soon lost in the case of 1996.

#### *Hybrid model*

With the backward methodology in regression, the variables which remain in all annual estimates with significant T-value on nominal tariffs are labour productivity, competitiveness index, tax and profit, and "hard core" NTBs. For the case of effective protection rates, they are labour productivity, competitiveness index, and consumption ratio. Hence, most of remained independent variables are those significant in the national strategy model. Meanwhile, the adjusted  $R^2$  for the hybrid model is only slightly higher than that of national strategy model, showing the marginal effect of interest groups' rent-seeking.

When pooling the data to get larger samples, we are able to obtain a general view of the determination of trade protection pattern in the long term, as listed in Table 15. Those sectors which have the characteristics of higher labor productivity, higher comparative advantage, higher backward linkage, higher labor intensity, higher profits and tax creating, lower value-added proportion of public enterprises and higher consumer goods ratio usually obtain higher nominal and effective protection. Again, there is a complementary relation between tariffs and non-tariff barriers. These conclusions are basically parallel to the empirical results mentioned above. Next, the dummy variable of key sectors appears to be significantly positive to explain EPR. The fact that coefficients of time dummy variables, though insignificant, decrease in years indicates the trade liberalization process occurred in China. Finally, the adjusted  $R^2$  is high for the regression on nominal tariff, but it is relatively lower for EPR, which leaves further question to study.

**Table 15. The Determination of Nominal Tariff Rates and Effective Protection Rates of China's Industrial Sectors: "Pooling the Data" Method**

Independent variables	Nominal protection rate	Effective protection rate
Intercept	16.27 (1.13E-07)	-168.07 (-2.99E-07)
Labour productivity	0.0003*** (3.58)	0.0006*** (3.02)
Backward linkage coefficient	26.22* (1.70)	21.66 (0.36)
Forward linkage coefficient	5.08 (1.55)	6.08 (0.57)
Competitiveness index	11.71*** (4.05)	27.41*** (2.52)
Export ratio	0.07 (1.54)	0.20 (1.19)
Import penetration ratio	0.07 (1.24)	0.28 (1.22)
Capital intensity	-0.0001** (-2.20)	-0.0002 (-0.82)
Tax and profits	0.02 (0.82)	-
The share of state-owned enterprises	-0.31*** (-3.13)	-0.81** (-2.15)
Sino-foreign equity ratio	0.002 (0.79)	-0.004 (-0.48)
Consumption ratio	0.35*** (4.15)	1.36*** (4.19)
Hard core NTBs	0.74*** (9.82)	-
Dummy variable (Key sector=1)	2.31 (0.71)	25.39** (2.09)
Dummy variable (1992=1)	-9.89 (-6.86E-08)	224.19 (3.99E-07)
Dummy variable (1994=1)	-22.32 (-1.55E-07)	197.50 (3.52E-07)
Dummy variable (1996=1)	-32.00 (-2.22E-07)	168.00 (2.99E-07)
Adjusted R <sup>2</sup>	0.83	0.57
F-value	28.68***	8.86***
Samples	108	108

Note: T-value in parenthesis, \*\*\* for 1% significant level, \*\* for 5% significant level, \* for 10% significant level

Source: Author's estimation

### *Trade liberalization model*

Again, with the backward method, the empirical test shows that in 1994 the lower reduction in tariffs goes to those sectors with higher competitiveness index, concentration ratio of foreign exchange, and capital intensity. It reflects some traditional principles that the government adheres to when taking trade reforms — maintaining sector comparative advantages, balance of payment, and import substitution strategy by protection. Moreover, high NTBs still remained to strengthen tariff protection, the phenomenon criticized by the World Bank (1993b) as a redundancy regime. On the contrary, the trade reform in

1996 looks rather radical than before, since the tariffs of sectors with the feature of higher labour productivity and higher share of state-owned enterprises are notably reduced. In addition, the historical tariffs of 1994 have a remarkable positive impact on tariff reduction rates, which indicates increasing external pressures from main trade partners on trade talks, especially in the negotiation of China's accession to WTO.

## V. Conclusions

The study on the political economy of trade policy in China is important because it helps to understand the decision-making process of the Chinese government in the new era and particularly to have an insight into protection structure as well as some major public policy debates, such as auto industrial policy, aukarty agricultural policy, service deregulation and liberalization, and China's accession to GATT/WTO. It is also conducive to broaden case study of the political economy of trade policy to a missed huge country. Yet, much further work is needed in the future to collect information through fieldwork and interviews and improve the research methodology, model and data. The main conclusions drawn from the paper are:

(1) Due to the institutional features of market-preserved authoritarianism and state activism, the party ideology, government preference and national interests are the most crucial factors influencing the decision-making of trade policy in China. Specifically, trade planning, trade flow controlling, export promotion and import substitution, industrial policy, national economic security and balance of payment are concrete objectives to be pursued. The protection policies of trading rights, automatic import registration, automobile production, grain import and banking service are those typical cases.

(2) Thanks to the gradual political democratization and fast economic growth, more diversified social interests become legitimate and active in a corporatism state, consequently leading to their increasing lobbying and rent-seeking activities for import protection and export preferential policies. Bureaucracy in central executive bodies and local governments, favored in a "clientelism" network culture, appear to be a dominated interest group, while others, mainly composed of domestic enterprises of various kinds, foreign investors, military, and consumers, however only have a marginal or diminishing impact on the decision-making. Such an argument can be demonstrated by case studies on, for example, the policies for protecting telecommunication sector, import quota and licensing requirement, export quota bidding, foreign exchange retention and multiple exchange rates system, antidumping enforcement and anti-smuggling campaign.

(3) With the integration into the world economy, Chinese authority can no longer make final decisions by neglecting the world trade institutional settings and international collective actions as before. The prevailing diplomatic strategy and trade philosophy of foreign governments as well as commercial interest of multinational corporations will impose a more significant external pressure on China to ratchet up her trade liberalization in the context of multilateralism (GATT/WTO), regionalism (APEC) and bilateralism (mainly with the United States). On the other hand, in the long run, China will benefit herself from

bargain-induced trade reform by fully integrating into a market-oriented and rules-based world economy.

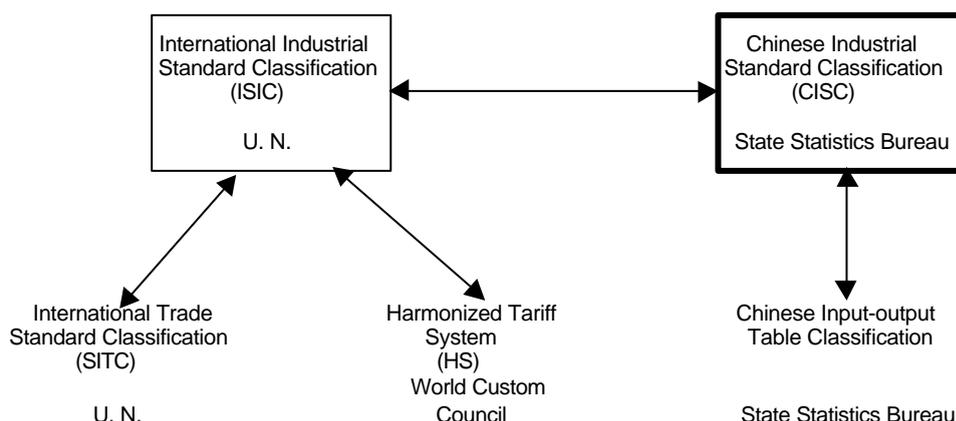
(4) The trade protection rates (nominal tariff, non-tariff barriers, and effective protection rate) are not only relatively high but quite dispersed as well among 36 Chinese industry sectors, which reflects both national strategic activism and different lobbying capacity of interest groups. The empirical study indicates that those sectors which have the characteristics of higher labor productivity, higher comparative advantage, higher backward linkage, higher labor intensity, higher profits and tax creating, lower value added proportion of public enterprises, and higher consumer goods ratio are usually able to obtain higher nominal and effective protection. Additionally, there is a complementary relation between tariffs and non-tariff barriers. The result of regressions shows that “social concern model” in the literature seems to be more appropriate to explain China’s trade protection pattern than “self-interest model”. Nevertheless, the social concern herein primarily deals with implementing national interests and industrial policy, rather than mitigating structural adjustment cost and pursuing the equality of income distribution.

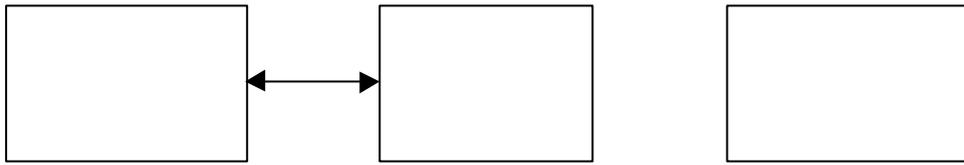
As regards policy implications, the study argues that if trade liberalization reform could be viable in the future in China, leaders in the party and central government have to adopt innovative market-oriented trade philosophy and succeed in dismantling obstructions from some interest groups by restructuring political bargain and consensus process in policy-making. Commitments to international agreements and institutional rules in world trade system can provide China with a benchmark and “bicycle effect” for pending reforms.

### **Appendix: Technical Notes on Data**

In order to establish a data bank for the empirical study, the new Chinese Industrial Standard Classification (CISC), which has been used by *China’s Statistics Yearbook* since 1994, is selected as the benchmark for processing data. With fine-tuning it covers 36 industrial sectors. Data on tariffs, non-tariff barriers, input-output table, exports and imports, and sectoral economic indicators are collected from various Chinese official sources and international organizations. Diagram 9 illustrates the concordance of various classification standards by which the data of different sources are disaggregated. Notably, the International Industrial Standard Classification (ISIC) is used as a pivot for the concordance with trade flow (SITC) and trade barriers (HS).

**Diagram 9. Concordance of Classification Standards**





Nominal tariff rates of industrial goods are re-aggregated and calculated on the basis of four-digit HS tariff lines in *Regulation on Import Tariff and Export Duty of the People's Republic of China* (1992, 1994, 1996). To compute effective protection rates, the tariffs of six agricultural sectors are also re-aggregated and calculated.

The frequency ratios of non-tariff barriers (NTBs) are estimated from *Regulation on Import and Export Measures of the People's Republic of China* (1992, 1994, 1996/97). NTBs are divided into "hard core" and "all" measures in the study. The former are quantitative measures, namely, import quotas and licenses, while the latter further covers automatic import registration, import tender, import inspection requirement, plant and veterinary import quarantine standards, food sanitary inspection, and medical inspection certificate.

The definition of effective protection rate follows Balassa's (1971) approach, ignoring the effect of indirect tax rate and non-tradable goods. According to Fukasaku and Lecomte (1996), input-output coefficients in the formula are re-adjusted to obtain those in the free trade regime. The direct consumption matrix (42 sectors  $\times$  42 sectors) is re-calculated based on the 89 $\times$ 89 basic flow matrix derived from *China's Input-output Table* (1992) with some fine-tunings of the classification criterion. Forty-two sectors include six agricultural sectors and 36 industrial sectors. Service sectors are omitted because there is almost no tariff levied on service imports in China.

The export and import data of 36 sectors in 3-digit (SITC 3) are re-aggregated and calculated on the basis of the United Nations' COMTRADE data bank, via the website of the International Trade Centre (<http://www.itc.org>).

Some sectoral economic indicators, such as value added ratio, labour productivity, number of companies, tax and profit, capital intensity, proportion of state-owned enterprises, are quoted or simply estimated from *China's Statistics Yearbook* in various issues. The competitiveness index, concentration of foreign exchanges, export ratio, and import penetration ratio are calculated on the basis of exports, imports, output data. The formula of geographic concentration index follows the method proposed by Trefler (1993) and is computed by the data in *China's Industrial Statistics Yearbook* and *China's Statistics Yearbook* in various issues. The Sino-foreign equity ratio and all data concerning labour market are calculated from *The Third Round General Industrial Investigation of the People's Republic of China* (1995). The backward and forward linkage indexes, and consumption ratio are computed from the 42 $\times$ 42 input-output matrix previously mentioned. Their formulas are defined in economics of input-output.

Finally, the dummy variables for key industrial sectors are set based on a series of official documentation, such as *China's Industrial Policy Outline* (1992), *National Industrial Policy Scheme in Nineties* (1994 and 1996), and *National Plan of Economic and Social Development* (1996).

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