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Policy Choices for China's Trade Liberalization

Throughout this study, we have sought to depict China's trading system as it existed in 1994. We now turn to the policy implications of this analysis and point out ways to improve China's trading system and reduce the costs that protection imposes on the economy. More specifically, we recommend that China reduce the average tariff rate to 15 percent by the year 2000, a goal to which China already committed in 1995. Since that goal was set, China has undertaken numerous reforms. However, recent reforms have been more incremental than systemic, leaving the principal challenges of trade liberalization essentially the same, though perhaps marginally more manageable. Our four principal recommendations follow.

Continue to Reduce Statutory Tariff Rates and Strengthen Control Over Import Levies, Deductions, and Exemptions

Our calculation shows that tariff revenue in 1994 for the products that we studied should have exceeded 80 billion yuan; receipts, however, were only about 33 percent of that amount, or about 27 billion yuan. To minimize this gap between statutory and effective tariffs and to reduce the average effective tariff rate to 15 percent by the year 2000, China reduced statutory tariffs from 35.9 percent in 1994 to 23 percent in 1996 and to 17 percent in 1997. In addition, detailed data on actual tariff revenue for each good are now collected to determine the effective tariff rates on all imported goods, and further statutory tariff cuts will be based on these effective rates.

The key to attaining the 15 percent average effective tariff target may be to increase control over import levies, deductions, and exemptions, so that the government can retain a greater share of expected tariff and nontariff revenues. In 1996, realized tariff revenues were higher than in 1994 despite a 13 percentage point reduction in the nominal tariff rate. Together, lower statutory tariff rates and tighter border controls would make smuggling and other ways to circumvent the trade regime less profitable and more risky (see appendix D), and China would be well on its way to reducing its average effective tariff rate to 15 percent by 2000.

Further Deregulate the Trading-Rights Regime

China still maintains tight controls on trade in specific goods (trading companies controlled the trade of 12 goods in 1994) and denies trading rights to many firms, including most firms with foreign capital. These import controls impose significant transaction costs and other losses associated with constrained competition.

Officials should further increase the number of designated trading companies in sectors still subject to limits, loosen the quotas used to implement this system, and reduce the number of goods subject to designated trading. Thereafter, the goal should be to phase out the designated-trading-company system. Important in this sequencing is that firms with trading privileges will have the best opportunity to adjust to structural changes in the market.

Reduce the Number of Goods Subject to Import Quotas and Licensing

Import quotas and licensing are still common in China. Although the number of firms that engage in foreign trade has increased significantly in recent years, China's inefficient import-licensing regime still excludes many firms from trading internationally. The current system should be replaced with a system in which firms only register once to engage in foreign trade and do not have to seek numerous other approvals as well.

Chinese import administrators still distribute import quotas to specific regions and sectors. Consequently, some regions and sectors are privy to unfair benefits. Not surprisingly, higher administrative costs have emerged alongside those benefits. This inefficient and unfair system should be replaced with a market-oriented system, such as a quota-auction scheme. An auction system would not only mitigate unfair benefits and high administrative costs but would also increase fiscal revenues.

Unify Trade Policy and Administration to Achieve a Rational Trade Incentive System

China's current import administration system is far from transparent even to most Chinese. Central and local governments, progressive and parochial ministries, and various departments within given ministries each have different interests and objectives in administering the trade system. The lack of uniformity leads to inefficiency, imposes high administrative costs, and reduces tax revenues. Perversely, this system discriminates against honest, law-abiding Chinese enterprises.

Reforming China's trade administration should be a first-order concern. Trade administration should be centralized to a much greater degree, and far fewer agencies should be involved. This fourth recommendation is essential to achieving the first three steps set out above and to establishing a system that punishes illegal trade and rewards the law-abiding with lower average tariffs and transaction costs.

Beyond the Year 2000

So far, our policy recommendations have focused on achieving China's goal of 15 percent average tariffs by 2000. However, because China is transitioning to a market-oriented economy, the impact of trade liberalization goes far beyond, socially and economically, that goal for 2000. One of the obstacles to further trade liberalization is the feared impact on workers. However, the major labor market problems have domestic roots, such as inefficient state enterprises. Trade liberalization that forces domestic industries to become competitive will help to solve, not worsen, the problem. For example, the number of jobs lost because of liberalization is estimated to be about 35 million (30 million in the agricultural and 5 million in the industrial sector) under the worst-case scenario. This is a modest number in an economy the size of China's. Again, we emphasize that we are working with a static model of the costs and benefits from trade liberalization. Dynamic effects, which could dramatically increase the measured benefits, are not considered. If the market structure changes from monopolistic to competitive in the course of trade liberalization, for example, the number of jobs could increase by about 40 percent from the preliberalization level (assuming that the number of jobs changes as the proportion of production changes; see appendix A).

The other concern is that trade liberalization may destroy domestic industries and cause social instability. Opponents to free trade argue that trade liberalization will replace domestic products with inexpensive imports and stifle domestic enterprise. However, our illustrative calculations point out that, if markets become more competitive because of trade liberalization (i.e., regulations are loosened and monopolistic practices ended), domestic output often increases rather than decreases (see appendix E). This will not be true for all industries in China, but for many the potential gains from trade liberalization are substantial when coupled with more competitive markets. Beyond 2000, China's trade regime should be liberalized in the context of energetic domestic competition policies. That combination will maximize the benefits from trade liberalization and minimize the costs.