



**VAT Rebate Policies
and
China's Rapid Progress up the
Value Chain**

China's VAT Rebate Mechanism

- VAT rebate used to implement government policy
- First goal ('90s): Stimulate exports across the board
 - Spectacularly successful, along with many other initiatives – the “world’s workshop”
- 2006-07: VAT rebate reduction on some 3000 commodities, & complete elimination on over 500, to
 - Reduce pollution
 - Reduce trade friction (dumping charges)
 - Re-direct industrial investment to higher value-added sectors
- VAT rebate re-instatement as part of stimulus program

VAT Impact – Case study

- AB&I Foundry in early '00s
 - China product eating market share (20%+) and severely eroding prices; *Chinese companies profits 100% from VAT rebates*
 - “China Engagement Strategy” decision

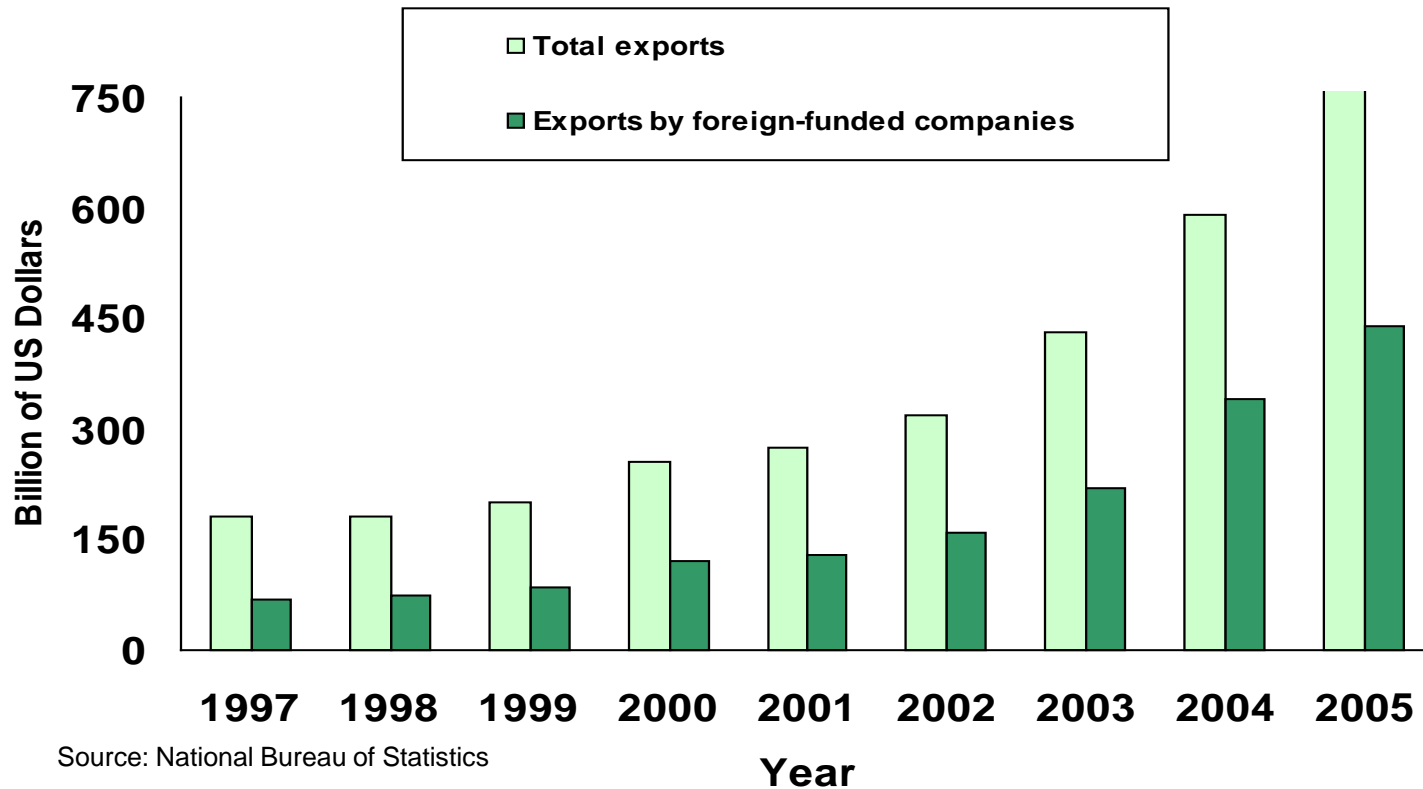
- 2007 VAT Rebate Rollback
 - “The low-margin, low labor commodity game is over. Since our visit [2006], Chinese market share of soil pipe and fittings has been halved in the US. The Chinese manufacturers have lost most/if not all of their rebates and the net effect is a pretty level playing field for us, which we are confident in the fact we can kick ass. The commodity game is over”
Kurt Winter, President, AB&I

- 2009 VAT Re-instatement
 - China quickly gained 5% US market share with huge pricing impact on the whole market
 - “China Engagement Strategy” back on the table

FIEs Major Beneficiaries of VAT Rebates

China has had the highest FDI in the world for a number of years. In 2009, over US\$ 2 billion per week so far (down 17% from 2008).....

Export Ratio of FIEs



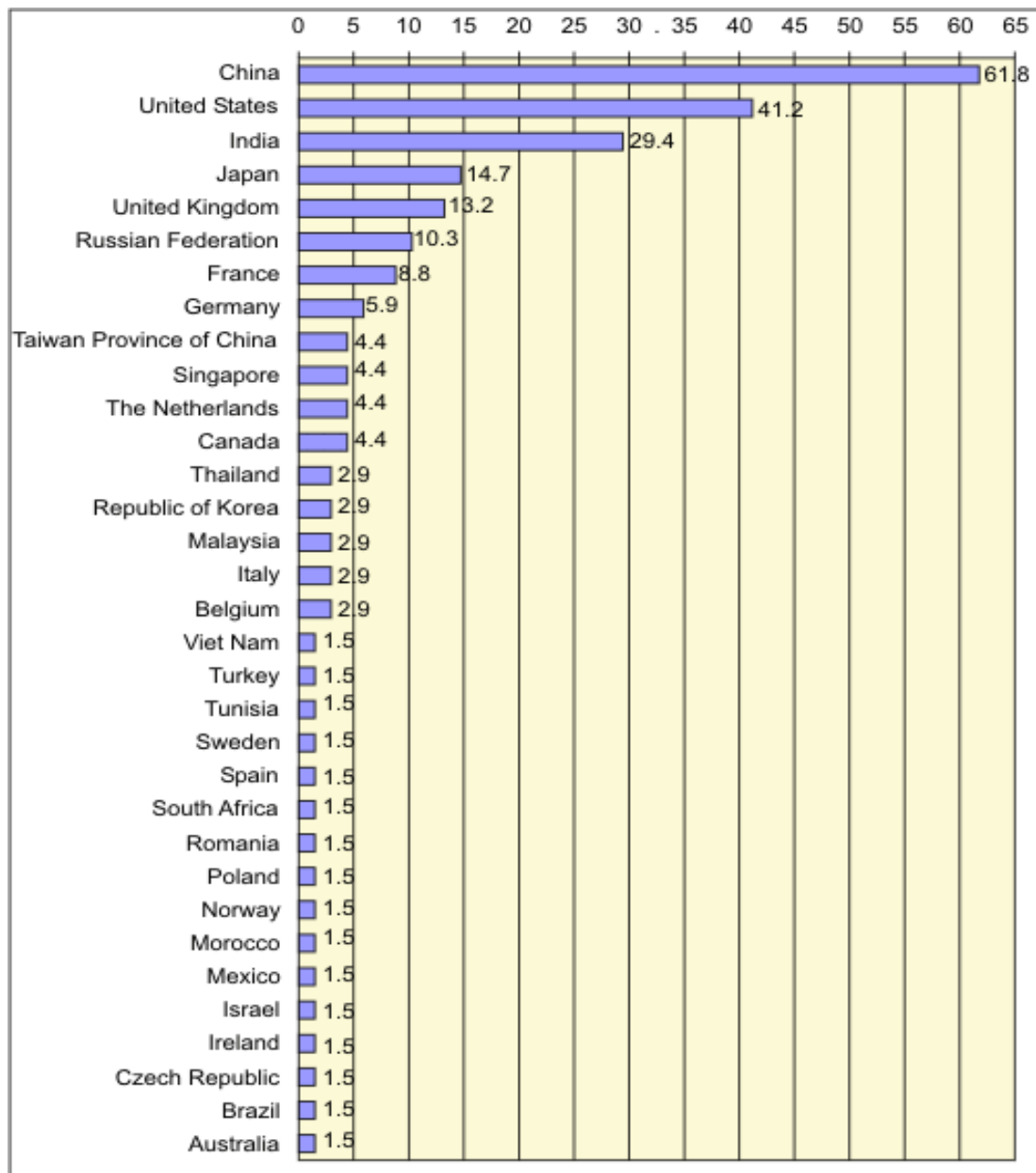
FIE R&D Contribution

Most attractive prospective R&D locations, 2005-2009 –

(% of respondents mentioning the location)

- *750 foreign R&D centers in 2005 (near zero in late 90s)*
- *"Firms now view parts of the developing world as key sources not only of cheap labor, but also of growth, skills and even new technologies"* (Preface to the report)
- **University-industry collaboration on the rise: e.g. Tsinghua University has research contracts with GE, Alcatel, Lucent, P&G, etc.**

Source: UNCTAD, World Investment Report 2005, Transnational Corporations and the Internationalization of R&D.



11th 5-Year Plan, 2006-2010

- Shift foreign trade from “quantitative to qualitative growth”
 - “We regard the enhancement of independent innovation capability as the central link and will promote market-oriented & enterprise-led innovation”

Ma Kai, Minister of NDRC

- Key policy Shift: Develop technology-led sectors and high-value capabilities, while maintaining the manufacturing base
 - **Increase R&D spending from 1.3% of GDP in 2005 to 2% by 2010 and 2.5% by 2020**
 - **4% of GDP on education**
 - **150% deduction for qualified R&D expenditures**
 - Targets include biotechnology, nanotechnology, renewable energy, etc.
 - IC research – nano circuits and smaller
 - Biomedicine - Major biotech centers in Beijing and Tianjin, etc.
 - Civil aircraft
 - Satellite applications
 - New materials
 - Tax equalization between FIEs and domestic firms, but

Investment Catalog Comparison

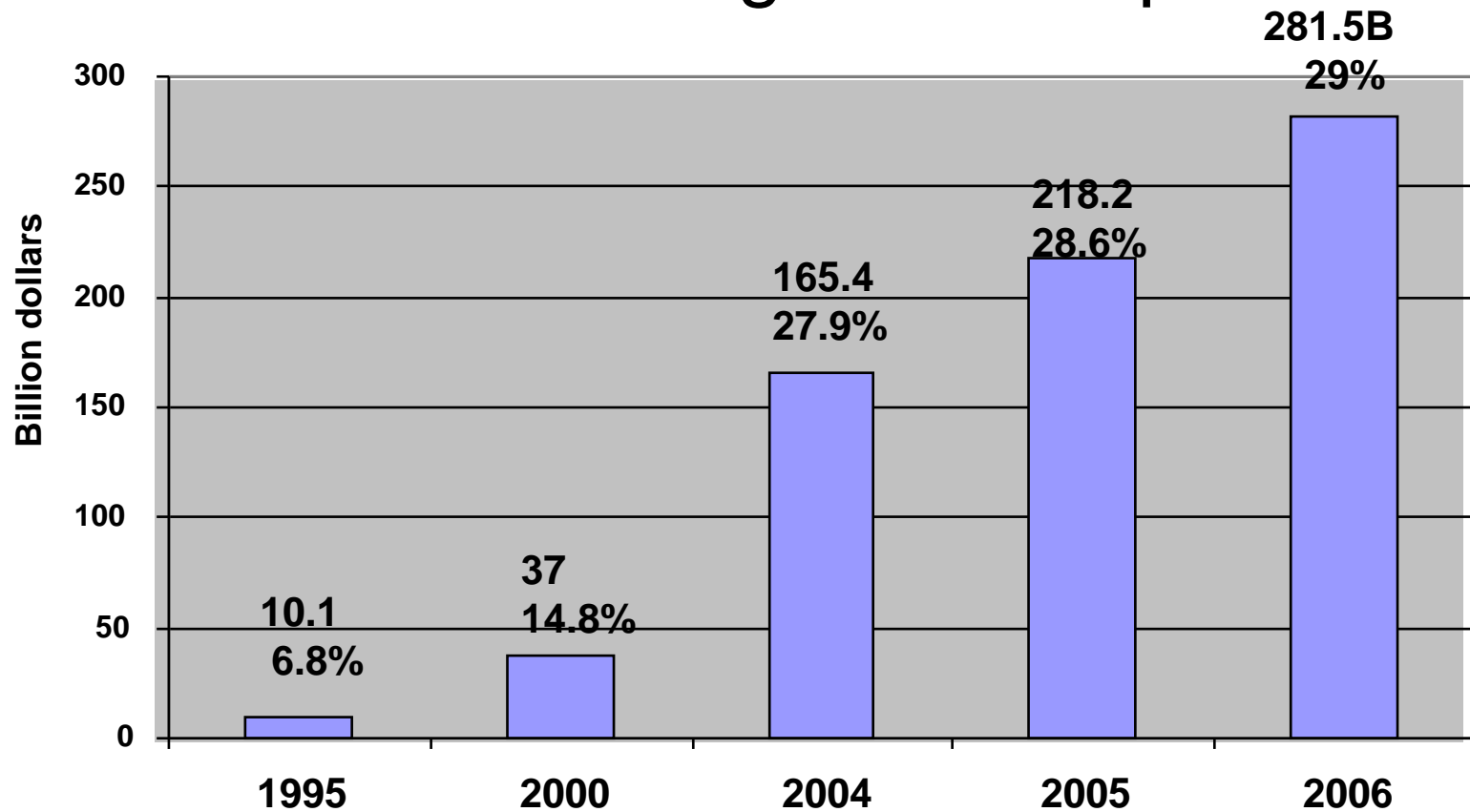
Table 1 Comparison of the entries of the old and new versions “Catalogue for the Guidance of Foreign Investment Industries”

Entries Involved	The 2007 Amended Version			The 2004 Amended Version		
	<u>Encouraged</u>	Restricted	Prohibited	<u>Encouraged</u>	Restricted	Prohibited
Mining industry	9	8	3	11	6	2
Pharmaceutical manufacturing	16	6	2	16	6	2
Non-metal mineral manufacturing	20 ✓	--	--	9	--	--
General machinery manufacturing	19 ✓			7	3	--
Special equipment manufacturing	71 ✓	3	1	42	3	--
Traffic & transport equipment manufacturing	26 ✓	1	--	17	--	--
Chemical materials and chemical products manufacturing	26	10	--	25	7	--
Communication equipment, computer and other electronic equipment manufacturing	35 ✓	2	--	30	1	--
Manufacturing of instruments & meters, culture and machinery for office purpose	18 ✓	--	--	8	--	--
...
Total	351 ✓	87	40	257	78	35

Source: Zero2IPO Research Center **(37% inc.)** **(12% inc.)** **(14% inc.)**

Shift to High Tech is Already Well Under Way

Growth of High Tech Exports



Transition to a Private Sector

Unit: 100 million RMB

Year	# State-Owned & Holding Co's. (% Change)	# Private Enterprises (% Change)	State-Owned Output Value (% Change)	Private Output Value (% Change)	State-Owned Employment (% Change)	Private Employment (% Change)
1998	64,737	10,667	33,621	2,083	37,477,800	1,608,000
2002	41,125 (-36%)	49,176 (+360%)	45,179 (+35%)	12,951 (+500%)	24,236,300 (-35%)	7,329,000 (+356%)
2006	24,961 (-39%)	149,736 (+204%)	98,910 (+119%)	67,240 (+419%)	18,040,000 (-25%)	19,710,100 (+170%)

Source: Statistical yearbook, 2007

- # SOE's declined by 60%, employment by over 50% (But output value went UP!)
- 14 fold increase in # of private companies, with similar employment growth
- Private sector employment gains identical to SOE employments losses

“So in 30 years we have gone from ‘sold in China’ to ‘made in China’ to ‘designed in China’ to ‘dreamed up in China.’”

Thomas Friedman, *The World is Flat*



Thank you. Please feel free to call if you
have questions

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