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# **Study of the Value Added Tax System In China For Agricultural Products**

A Global Broad Based Initiative Study

- ❖ DTB Associates LLP
  - ❖ Larkin Trade International LLC
  - ❖ Ag Risk Management LLC
  - ❖ Daniel Sumner and Hyunok Lee
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# **STUDY OF THE VALUE ADDED TAX SYSTEM IN CHINA FOR AGRICULTURAL PRODUCTS**

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## **Executive Summary**

China maintains a value added tax (VAT) system for most commercial transactions, including those for agricultural products. The nominal VAT on domestically produced agricultural products is zero for farm level production, 13 percent for first stage processed products, and 17 percent for value added products.

The basic structure for the payment of the VAT at various stages of the marketing chain is:

$$\text{Tax Paid} = \text{Output Tax} - \text{Input Tax}$$

where output tax is the seller's price (or "amount") multiplied by the applicable VAT rate (e.g. 13 percent or 17 percent), and where the input tax is the VAT tax from the special VAT invoices or import invoices obtained during production by the seller, plus any deemed deductions allowed if the purchase is from an agricultural producer. ("Deemed deductions" are deductions calculated on the basis of the imputed VAT payment in cases where no payment was required.)

These input tax deductions, especially the deemed deduction allowance, result in effective VAT rates on domestically produced products far below the rates paid by equivalent imports. For the sale of products by agricultural producers, the effective VAT rate would be zero based on China's VAT regulations. The effective VAT on the sale of first stage processed products, referred to as primary processors in this report, is significantly reduced from the nominal rate of 13 percent through a series of deductions.

The most important of these deductions is a deemed deduction of 13 percent on the sale of products by primary processors. This deduction is provided under the rationale that the producer has paid a full 13 percent VAT on the sale of his products, when in fact, he is provided a complete VAT exemption. Similarly, value added agricultural products in China are provided a series of deductions, explained in the report, that result in an effective VAT significantly below the nominal VAT rate of 17 percent.

While domestically produced agricultural products receive significant deductions from nominal VAT charges, agricultural imports must pay the full VAT rates of either 13 or 17 percent. This places imported products at a significant price disadvantage relative to domestically produced product.

As explained in the report, the basic formula for determining the level of VAT discrimination on imported products is as follows:

$$\text{Farm level product VAT discrimination} = 13 \text{ percent}$$

This would include wheat, feed grains, unprocessed fruit, unprocessed almonds, unprocessed potatoes, eggs in shell and ginseng. The VAT discrimination is 13

percent because the imported product is assessed a full 13 percent VAT charge at the time of import, after which it is assessed VAT charges identical to those that domestic primary products are charged as they move through the processing and marketing chain.

For first stage processed products, the level of VAT discrimination is defined as follows:

Primary Processing VAT Differential = 13% - Effective VAT at Primary Processing Level  
for Chinese Domestic Entities

This formula would cover products such as processed beef, pork and poultry products. The VAT differential will be the 13 percent VAT charge on imports minus the VAT charged at the primary processing level, because imported meat products have already been processed, and therefore cannot take the deductions Chinese entities are allowed to take at the primary processing level.

For value added processed products, the level of VAT discrimination is defined as follows:

VAT Differential = 17% - (Effective VAT at Primary Processing Level + Effective VAT at  
Value Added Level)

This formula would cover products such as dairy and most potato products. The VAT differential is 17% minus charges at the primary processing and value added level, because imported value added products do not need to go through these two stages of processing in China, and thus cannot deduct the input taxes Chinese domestic entities are allowed to deduct at the primary processing and value added levels.

It can be seen that the highest level of VAT discrimination in absolute terms falls on bulk commodity shipments such as grain, soybeans, etc., the next highest level falls on meat products, and the lowest level of VAT discrimination in absolute terms accrues to dairy and potato processed products.

China's VAT system results in some level of discrimination on virtually all imported agricultural products. This discrimination is in violation of World Trade Organization (WTO) rules. Article III.2 of the General Agreement on Tariffs and Trade provides that imported products from WTO members "shall not be subject, directly or indirectly, to internal taxes or internal charges of any kind in excess of those applied, directly or indirectly, to like domestic product." A central conclusion of this study is that the VAT charges applied to imported agricultural products are in excess of those applied to domestic products. In addition, China's VAT policies are also in violation of commitments made in its WTO Protocol of Accession, and may also be in violation of GATT Article XVII rules related to state trading.

Econometric analysis was conducted to determine the trade impact of removal of that portion of VAT import charges determined to be discriminatory. Removal of discriminatory VAT charges would have a positive impact on U.S. exports to China of all products included in the study except soybeans, where there would be a small decline in U.S. exports. That decrease would be offset by increases in U.S. exports of soybean oil and soybean meal. The increase in U.S. exports would be particularly significant for corn, beef, pork, poultry and soybean oil.

## **I. General Background on Value Added Tax Systems**

A value added tax (VAT) is an incremental tax on the value added to a product by an individual or firm at each point in the marketing chain. Under the simplest VAT system, each individual or firm in the chain of supply, from producer to retailer, charges a VAT on their sale and deducts from this amount the VAT paid on their purchases. The effect of offsetting the VAT on purchases against the VAT on sales is to impose a tax on the value added at each point in the marketing chain.

The VAT on products produced in China is basically either 13 percent or 17 percent, depending on whether the product produced is at an initial or value added stage of processing. By assessing an incremental tax on the value added at each point in the marketing chain, the Chinese government should in theory capture the entire 13 percent or 17 percent VAT from the point of initial production to the final retail sales stage.

A VAT system differs from a sales tax system, under which taxes are normally charged only at the point of final sale to consumers. While the final price including tax that the consumer pays for the product should be the same under both systems, the VAT system imposes the actual collection of the tax across the entire marketing chain, while the sales tax “backloads” the tax payment on the consumer at the final retail point of sale.

Following is a simple example that illustrates the operation of a 1) no tax, 2) sales tax and 3) value added tax system.

### *No Tax*

- A wristwatch manufacturer spends \$100 on watch components and uses those materials to make a watch.
- The watch is sold wholesale to a watch retailer for \$120, leaving a profit of \$20.
- The watch retailer then sells the watch to a consumer for \$150, making a profit of \$30

### *10% Sales Tax*

- A watch manufacturer spends \$100 on components and uses those materials to make a watch.
- The watch is sold wholesale to a watch retailer for \$120, leaving a profit of \$20.

- The retailer prices the watch at \$150 at the retail level, and charges the consumer \$165 ( $\$150 + (150 \times 10\%)$ ). The retailer pays the government \$15 and keeps \$30 as profit.

### *10% Value Added Tax*

- The watch manufacturer pays \$110 for his raw materials, and the seller of the raw materials pays the government \$10.
- The manufacturer charges the retailer \$132. The manufacturer pays the government \$2 (he has added value of \$20, multiplied by 10%) and keeps \$20 as profit.
- The retailer charges the consumer \$165. The retailer pays the government \$3 (he has added value of \$30, multiplied by 10%) and keeps \$30 as profit.

Note that in both the sales tax and value added tax example, the final price to the consumer is the same (\$165) and the taxes collected by the government are the same (\$15).

## **II. Background on China's VAT for Agricultural Products**

### **A. Legal and Regulatory Background**

Prior to December 2008, the primary regulation used in determining the calculation of the VAT for agricultural products was the "Interim Regulation on the VAT of the People's Republic of China", issued on December 13, 1993. On November 10, 2008, the Chinese government issued Decree No. 538, which replaced the December 13, 1993 VAT regulations.<sup>1</sup> Although Decree No. 538 is now the operative regulation with respect to operation of the VAT in China, it contains only relatively minor substantive changes with respect to the VAT on agricultural products, compared to those contained in the December 1993 regulation and its subsequent modifications.

Article 15 of Decree No. 538 is particularly relevant to the VAT analysis conducted in this study, since it exempts "all self produced agricultural products sold by agricultural processors", and provides for other partial exemptions for the commercial transaction of agricultural products in various parts of the marketing chain.

Following is a list providing a chronological inventory of China's active VAT laws and regulations as they relate to agricultural products.<sup>2</sup>

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<sup>1</sup> State Council Decree No. 538 of January 1, 2009 replaced State Council Decree No. 134 of January 1, 1994, and consolidated all VAT related changes in regulations occurring from 1994 to 2008.

<sup>2</sup> Annex II includes a full inventory of these regulations, as well as now inactive Chinese VAT regulations.



**TABLE 1**  
**China's Active VAT Laws and Regulations**

Ref. No.	Date Issued	Name	Date Implemented	Notes
1	12/25/93	Explanatory Notes on the Levying Scope of Value-Added Tax on Some Goods [No. 151, 1993]	12/25/93	Article 1 ended on 4/30/06
2	12/28/93	Provisions for Some Specific Questions on Value-Added Tax [ No. 154,1993]	12/28/93	Effective
3	06/15/95	Notice of the Ministry of Finance and the State Administration of Taxation [No. 52, 1995]	07/01/95	Effective
4	10/06/95	Circular of the State Council on Lowering the Rates of Tax Refund for Export [Guo Fa No. 29, 1995]	01/01/96	Effective
5	06/29/99	MOF & SAT Circular on VAT Exemption for Staple Crops Enterprises [Caishui No. 198, 1999]	06/01/99	Effective
6	07/19/99	Notice of the State Administration of Taxation on Some Issues Concerning the VAT Invoice Issued by the Grain Company [Guo Shui Ming Dian No. 10, 1999]	07/19/99	Effective
7	08/18/99	Notice of the State Administration of Taxation on Some Issues Concerning the VAT Management of the State Owned Grain Company [Guo Shui Han No. 560, 1999]	08/18/99	Effective
8	07/12/01	Circular of the Ministry of Finance and the State Administration of Taxation on Exemption of VAT for the Feed Grains [Cai Shui No. 121, 2001] Article II was been replaced by Guo Shui Han [2004] No. 884	08/01/01	Article II was abolished in 2004.
9	07/20/01	Notice of the Ministry of Finance and the State Administration of Taxation on the VAT Exemption on Some Agricultural Production Means [No.113, 2001] (Chinese w/ English Summary)	08/01/01	Effective
10	08/07/01	Notice of the Ministry of Finance and the State Administration of Taxation on the VAT Exemption for Soybean Meal [No.30, 2001]	08/07/01	Effective
11	11/15/01	Circular of Income Tax Exemption for Leading Agricultural Enterprises by the State Administration of Taxation [No.124, 2001]	01/01/01	Effective
12	01/09/02	Notice of the Ministry of Finance and State Administration of Taxation on Increasing the Deductible VAT Rate of Agricultural Products	01/09/02	Effective
13	04/04/05	Notice on Opening Testing Chain-store Operations of Agricultural Products [Shangjianfa No.1, 2005]	04/04/05	Effective
14	06/30/05	The response from State Administration of Taxation to Shanghai Taxation Bureau about the question on	06/30/05	Effective

Ref. No.	Date Issued	Name	Date Implemented	Notes
		applicable VAT rate on dairy products such as milk with micro-elements. [Guoshuihan No. 676, 2005]		
15	05/11/07	Interim Regulations on Extending the Scope of VAT Credit in the Central Region” State Finance Circular [Cai Shui No. 75, 2007]	07/01/07	Effective
16	12/14/07	Circular on Abolishing Export Tax Refunds for Raw Grains such as Wheat and Powders [Cai Shui No.169, 2007]	12/14/07	Effective
17	06/24/08	Notice of the Ministry of Finance and the State Administration of Taxation concerning the Relevant Tax Policies for the Farmers’ Professional Cooperatives [Cai Shui No.81, 2008]	07/01/08	Effective
18	11/10/08	Interim Regulations of the People’s Republic of China on Value-Added Tax, State Council Decree No. 538	01/01/09	Effective
19	12/18/08	Detailed Rule for the Implementation of the Interim Regulations of the People’s Republic of China on Value-Added Tax	01/01/09	Effective
20	1/19/09	The notice of adapting the low VAT rate (13%) for some items and levying VAT by using some simple and practical methods [Cai Shui No. 9, 2009]	01/01/09	Effective
21	11/21/08	Primary Processing of Agricultural Products in the Scope of Enterprise Income Tax Preferential Policy (Provisional) (Edition 2008)	01/01/08	Effective

As noted, Item 18, the “Interim Regulations of the People’s Republic of China”, implemented on January 1, 2009 (Decree No. 538), and Item 19, the “Detailed Rule for Implementation of the Interim Regulation, also implemented on January 1, 2009, are the key regulations with respect to the current operation of the VAT on agricultural products in China.

Translations or summaries of all of these regulations are contained in Annex II of this study.

Chinese government agencies and their responsibilities with respect to development, implementation and enforcement of VAT policies are listed below.

- State Council of People’s Republic of China (Responsible for the approval of these regulations)
- Ministry of Finance of People’s Republic of China (Responsible for the draft of these regulations)
- State Administration of Taxation (Responsible for the implementation of the regulations in China)

- Ministry of Commerce of People’s Republic of China (Participate in promoting the regulations in commercial sector)
- General Administration of Customs of People’s Republic of China (Responsible for the implementation of the regulations during import & export)
- Ministry of Agriculture of People’s Republic of China (Participate in drafting and discussing the regulations)

## **B. Structure of the VAT in China**

As noted in Section I, the VAT is an incremental tax system, under which taxes are assessed at different points in the marketing chain based on the value that is added to the product. Referring to Decree No. 538, the Interim Regulation of the People’s Republic of China on the Value Added Tax, the basic structure for the tax paid under the Chinese VAT is the “output tax” minus the “input tax.”<sup>3</sup> “Output tax” is defined in the regulation as the sellers’ price (or “amount”) multiplied by the tax rate, while “input tax” is the VAT sellers have paid during the process of production.<sup>4</sup>

$$\text{Tax Paid} = \text{Output Tax} - \text{Input Tax}$$

Applying this basic concept to the simple example of the wristwatch in Section I, if the retailer’s sales price for the wristwatch before tax is \$162, the VAT is 10%, and the purchase price of the wristwatch from the wholesaler is \$132, then the VAT paid by the retailer will be \$3.

$$\text{Tax Paid} = (\$162 * .10) - (\$132 * .10)$$

$$\$3 = \$16.20 - \$13.20$$

However, China’s VAT laws are in practice considerably more complicated than the example above, and include a series of exemptions and deductions that significantly reduce the VAT burden for the domestic producer and processor of agricultural products.

## **III. A More Detailed Look at the VAT Transaction Process In China**

Prior to reviewing the VAT transaction process at specific levels of the marketing chain, and the relevant laws and regulations, it is important to understand in general terms how the VAT in China is calculated and paid in practice. Following is a brief and general description of the process and the role of the buyer and seller in that process:

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<sup>3</sup> Decree No. 538, the Interim Regulation of the Peoples Republic of China on the Value Added Tax, January 1, 2009. Article 4.

<sup>4</sup> Decree No. 538, the Interim Regulation of the Peoples Republic of China on the Value Added Tax, January 1, 2009. Articles 5 and 8.

1. The seller calculates and charges the VAT to the buyer, which is referred to as the output tax;
2. The buyer pays the VAT as part of the total amount paid to the seller, and the VAT amount paid is referred to as the input tax (should equal the output tax the seller calculated and charged);
3. The seller determines the amount to be paid to the tax authorities which is the input tax paid to the seller by the buyer minus allowable input tax deductions the seller incurred in the production of the product; and
4. The seller submits the final calculated VAT payment to the tax authorities.

### **A. China's Agricultural Producer**

Article 2.2.a of Decree No. 538 sets the nominal VAT rate at 13 percent for food grains and vegetable oil. Article 2.2.e further stipulates that the VAT rate shall be 13 percent on "other goods prescribed by the State Council." A notice from the Ministry of Finance and State Administration of Taxation, and an administrative arm of the State Council, dated November 19, 2009, provides that all agricultural products are subject to the 13 percent VAT tax.<sup>5</sup> Notice No. 52, dated June 15, 1995, and still in effect, provides further clarification as to the definition of agricultural products, essentially including all agricultural products as subject to the 13 percent VAT rate.<sup>6</sup>

Article 15 of Decree No. 538 provides a full exemption from payment of the VAT for "self produced agricultural products sold by agricultural producers." Notice No. 52 of June 15, 1995 provides clarification as to the definition of an "agricultural producer," as "farmers . . . engaged in planting and reaping, or breeding and raising of animals or fish". Notice 52 reiterates what was first established in State Council Decree No. 134 of January 1, 1994, that agricultural producers are exempt from payment of the VAT.

As noted in the section above on the collection of VAT charges, in China the VAT is paid by the buyer to the seller as part of the total sales price at the point of sale.<sup>7</sup> This means that, in the absence of the VAT exemption provided to agricultural producers by virtue of Decree No. 538, the merchandiser, wholesaler or primary processor would have to pay the 13 percent VAT to the producer as part of the overall sales price at the time the producer sold the product.

It should also be noted that Decree No. 113, of August 1, 2001, entitled "Notice of Ministry of Finance and the State Administration of Taxation on the VAT Exemption on Some Agricultural Means" (see Item 9 in Table 1), provides for a VAT exemption on the sale of certain inputs to farmers. Inputs specifically mentioned include seed, pesticides, herbicides, agricultural machinery and some fertilizers.

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<sup>5</sup> See Item 20 in Table 1. The Notice of Adapting the Low VAT Rate (13%) for "Some Items." Part One.

<sup>6</sup> See Item 3 in Table 1.

<sup>7</sup> Decree No. 538, the Interim Regulation of the Peoples Republic of China on the Value Added Tax, January 1, 2009. Article 19.

The full VAT exemption in the transaction between the agricultural producer and merchandiser or processor means that no VAT is paid when the merchandiser or processor purchases agricultural products from the farmer.

## **B. China's Agricultural Processor**

Article 8 of Decree 538 provides for a series of VAT deductions for “taxpayers” who purchase product from suppliers. In the case of agricultural products, the purchasing “taxpayer” may be a merchandiser, wholesaler or first stage processor (e.g. a feed mill or slaughter house).

Recall the basic model for the assessment of VAT charges mentioned earlier in this report, where:

$$\text{Tax Paid} = \text{Output Tax} - \text{Input Tax}$$

In the case of the merchandiser, wholesaler or first stage processor, the VAT would be collected and then paid at the time he sells the product purchased from the farmer or the product in processed form to the next stage in the marketing chain. At that point of sale, Article 8 of Decree 538 establishes deductions that are subtracted as input taxes.

What are the deductions provided for in Article 8 of Decree 538? First, and most importantly, Article 8.3 provides that “the input tax is calculated on the basis of the agricultural product purchase price as indicated on the purchase invoice at a deduction rate of 13 percent.” In other words, in calculating the input tax paid, the primary processor is allowed to deduct 13 percent of the purchase price of the product from his VAT payment calculation, on the assumption that the producer has paid the full 13 percent nominal VAT to the agricultural producer, when in fact, the producer has paid no VAT at all. As demonstrated in product specific examples provided later in this report, the effect of this deduction is to significantly decrease the VAT charged by the merchandiser, wholesaler or primary processor at his point of sale. The assumption that a 13% VAT is paid to the producer in the calculation of the effective VAT at the next marketing stage, when in reality no VAT is paid by the producer, is referred to in this report as the “deemed” or “imputed” VAT.<sup>8</sup>

In addition to the deduction provided for the imputed 13 percent VAT, Article 8.4 of Decree 538 establishes a specific 7 percent deduction for transportation costs incurred by the merchandiser, wholesaler or primary processor.

Finally, Article 8.1 of Decree 538 provides a general allowance for deduction of input tax amounts as contained on the “special VAT invoice.” The special VAT invoice is a document that is provided in the transaction of products from buyer to seller (examples

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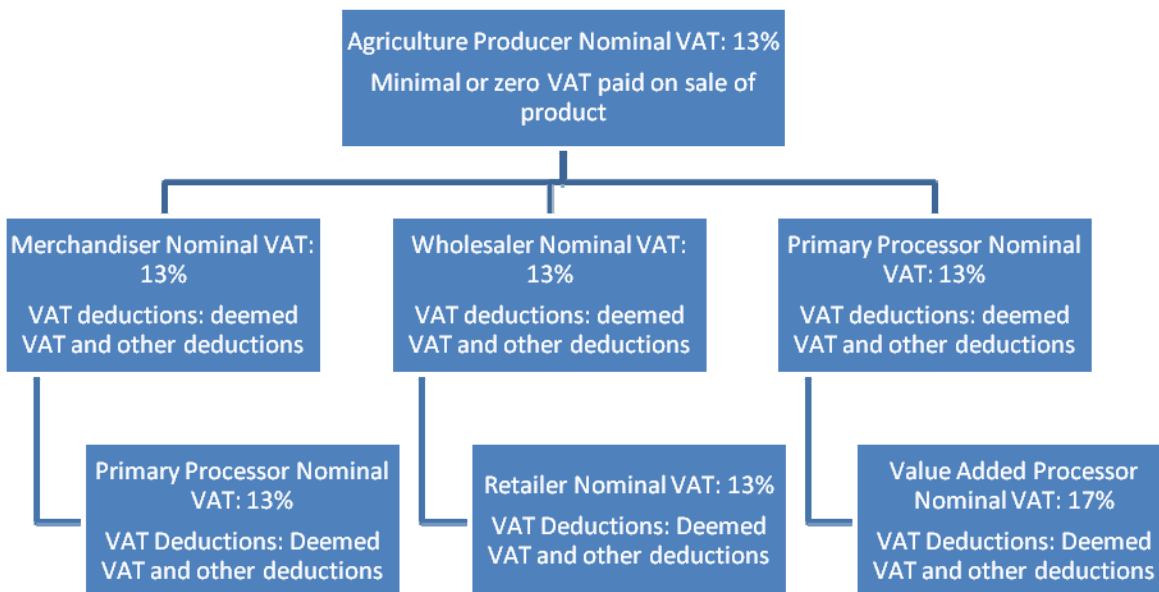
<sup>8</sup> In the case of the transaction between the agricultural producer and primary processor, a “purchase invoice” is obtained from the local taxation office, and the procurement price from the producer is provided by the processor. That procurement price then becomes the basis for the 13 percent deduction of the deemed or imputed VAT.

of the special VAT invoice are provided in the commodity reports in Annex III). At the time of sale by the merchandiser, wholesaler or primary processor, the cost breakdown on the special invoice becomes the basis for applying VAT deductions of 13 or 17 percent on a full range of operating costs, including but not limited to gasoline or other power related costs, packaging costs and depreciation of machinery.<sup>9</sup>

The nominal VAT paid by primary processors is the same nominal VAT as that paid by producers; 13 percent of value added. Primary processors includes first stage processing operations such as feed mills, flour mills and slaughter houses. Examples of a value added processor are dairy processing facilities producing cheese or milk powder and potato processors producing potato chips. Value added processors fall outside the scope of Notice No. 52 implemented on July 1, 1995 (see Item 3 in Table 1), "Notice of the Ministry of Finance and State Administration of Taxation," and for this reason are subject to a 17 percent rather than 13 percent VAT.

The flowchart below depicts VAT charges as an agricultural product makes its way through the marketing chain in China.

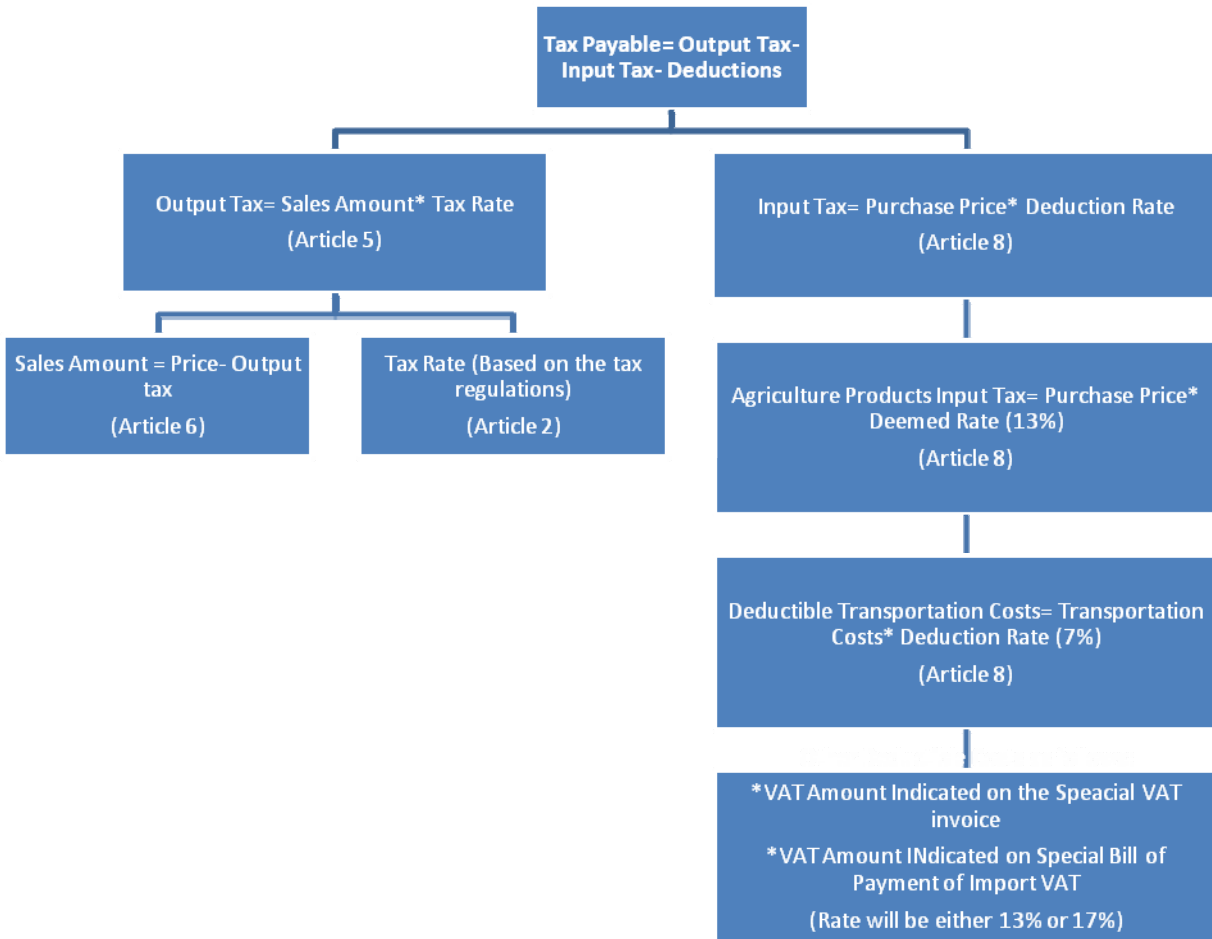
**Flow Chart 1**  
**Application of the VAT on Agricultural Products in China**



The following flow chart provides details on the application of the VAT upon sale of agricultural products by marketing entities other than producers.

<sup>9</sup> Note that labor is not to be included as deductible in the VAT calculation. LTI confirmed in discussions with Chinese government authorities that labor is not included as a deductible cost in the VAT calculation, by virtue of Decree 538, Article 1.

**Flow Chart 2**  
**VAT Charges on Agricultural Products**



**C. How the VAT Works in Practice: Wheat Example**

The “effective VAT” is defined in this study as the VAT actually applied in a sales transaction, as opposed to the nominal VAT of 13 percent or 17 percent that is applied to agricultural products. Following is an abbreviated example of the calculation of the VAT for wheat and wheat flour produced and marketed in China.

The cost and profit breakdown for wheat and other products examined in Annex III of this report were obtained in person to person interviews or online research.

## 1. Wheat Producer

**Table 2**  
**Wheat Producer: Effective VAT for Wheat**

VAT Paid by Wheat Producers					
Costs of Production is 58% of Sales Amount					Profit 42%
Seed 10.56%	Machinery 39.89%	Fertilizer 37.54%	Pesticide 3.87%	Other 8.14%	
Cost as a Percentage of Sales Amount = Total Cost multiplied by component costs					
$.58 * .1056 = .0612$	$.58 * .3989 = .2314$	$.58 * .3754 = .2177$	$.58 * .0387 = .0224$	$.58 * .0814 = .0472$	0.42
VAT Rate					
VAT: 0%	VAT: 0% <sup>10</sup>	VAT: 0%	VAT: 0%	VAT: 0%	N/A
VAT Multiplied by Component Cost					
$.0612 * 0\%$	$.2314 * 0\%$	$.2177 * 0\%$	$.0224 * 0\%$	$.0472 * 0\%$	N/A
Effective VAT Rate					
0%	0%	0%	0%	0%	N/A

By virtue of the fact that VAT charges on all producers is zero, the effective VAT for wheat producers is therefore zero.

## 2. Flour Mill

**Table 3**  
**Wheat Flour Miller: Effective VAT**

Basic market information obtained on prices and costs for a wheat flour mill:

1. The purchase price of the wheat: RMB 1,580/ton
2. The packaging cost: RMB 120/ton
3. The power cost: RMB 42/ton
4. The depreciation cost: RMB 28/ton
5. Other costs (including management cost and repairing cost): RMB 140/ton
6. The exchange for one ton of wheat to flour was one ton of wheat = 0.846 ton of flour + 0.154 ton of wheat bran
7. The selling price at that time for flour was RMB 2262/ton and for 0.846 ton flour was RMB 1,913.65.
8. The selling price at that time for wheat bran was RMB 1,380/ton and for 0.154 ton wheat bran was RMB 212.52.

<sup>10</sup> The fertilizers and machinery used for agricultural production are all VAT free. See details in Article 1 of Item 4 in the Notice No. 113 of the Value Added Tax Exemption on Some Agricultural Production Means released by Ministry of Finance and State Administration of Taxation in 2001.



VAT Paid by Flour Mill					
Cost 99.81%					Profit 0.19%
Purchase of wheat 82.72%	Packaging 6.28%	Power 2.2%	Depreciation 1.47%	Other 7.33%	
Cost as a Percentage of Sales Amount = Total Cost multiplied by Component Percentage					.0019
.9981*.8272 =.8256	.9981*.0628 =.0627	.9981*.022 =.022	.9981*.0147 =.0147	.9981*.0733 =.073	
Deductible VAT Rate					
13%	17%	17%	17%	0%	N/A
VAT Deduction Amount = VAT Rate multiplied by Cost as a Percentage of Sales Amount					
.1073	.0107	.0037	.0025	0	N/A

Recall that the basic formula for calculation of the effective VAT is as follows:

$$\text{VAT Paid} = \text{Output Tax Paid} - \text{Input Tax}$$

Output Tax = .13x (This is the 13% VAT rate multiplied by the sales amount.)

Input Tax = .13\*.8272y (This is the 13% deemed VAT rate multiplied by the wheat purchase price as a percentage of total mill costs.)

Power Costs Deduction = .17\*.022y (This is the 17% deemed VAT rate multiplied by the cost of power as a percentage of total mill costs.)

Packaging Costs Deduction = .17\*.0628y (This is the 17% VAT rate multiplied by the cost of packaging as a percentage of total mill costs.)

Depreciation Costs Deduction = .17\*.0147y (This is the 17% VAT rate for depreciation of machinery multiplied by the depreciation cost as a percentage of total cost.)

Where x is the sales price (or "sales amount") of RMB 1913.65, and y is the purchase price plus costs of processing the wheat that is subject to VAT deductions. The purchase price of the wheat is RMB 1580. The additional costs of processing the wheat into flour that are VAT deductible are 230 RMB. Therefore, y = RMB 1910.

Following is the calculation of the effective VAT for wheat flour. All of the commodity reports contained in Section 3 follow this basic model.

$$1. \text{ VAT Paid} = .13x - [(.13(.8272*y)) + (.17*(.0628y)) + (.17(.022*y)) + (.17(.0147y))]$$

$$2. \text{ VAT Paid} = (.13*1913.65) - [(.13(.8272*1910) + (.17(.0628*1910) + (.17(.022*1910) + (.17(.0147*1910))]$$

$$3. \text{ VAT Paid} = 248.7745 - [.13(1579.95) + .17(119.948) + .17(42.02) + (.17(28.077))]$$

$$4. \text{ VAT Paid} = 248.7745 - [205.3935 + (20.391 + + 7.1434 + 4.773)]$$

$$5. \text{ VAT Paid} = 248.774 - 237.7009$$

$$6. \text{ VAT Paid} = \text{RMB } 11.0731$$

The effective VAT is equal to the VAT paid by the flour miller, divided by the flour miller's sales price.

$$\text{Effective VAT} = \text{VAT Paid/Sales Price}$$

$$7. \text{ Effective VAT} = 11.0731/1913.65$$

$$8. \text{ Effective VAT} = .58$$

**The effective VAT paid by the wheat miller on wheat flour made from domestically produced wheat is therefore .58%.**

#### **D. Observations about the VAT Calculation**

The calculation of the effective VAT is dependent on component cost and profits estimates. To the extent that component costs or profits change, the effective VAT will also change.

Profits are directly related to the size of the effective VAT. The higher the profit as a percentage of total sales price, the higher the VAT. The lower the profit as a percentage of total sales price, the lower the VAT. In this sense, the VAT works in a way similar to a corporate income tax that is based on profit.

For purposes of the VAT calculation, component costs of production are obtained from the Special Invoice.

The deemed VAT deduction of 13 percent of the purchase price of the raw product accounts for a disproportionate amount of the total deductions afforded under China's VAT rules. For example, in the case above, the deemed 13 percent deduction accounts for 86 percent of the total deduction afforded. Based on the deemed 13 percent deduction alone, and ignoring the other deductions in the calculation, the effective VAT in the above example would be 4.7 percent.

#### **E. Effective VAT Calculations for Products in the Study**

The following table provides our estimates of the effective VAT for each of the commodities covered in this study. The detailed studies for each of the commodities listed below can be found in Annex III of this report.

**Table 4: Effective VAT Rates for Selected Products**

Commodities	Effective VAT rates		
	Producer	Primary processor	Valued Added Processor
Beef	0%	2.22%	6.26%
Pork	0%	1.27%	7.24%
Poultry	0%	2.86%	8.64%
Dairy	0%		
Homogenized milk		5.8%	
-- yogurt			9.8%
-- WMP			5.62%
-- NFDM			4.9%
Cheese			4.9%
Potatoes	0%	3.2%	
-- potato flour			7.64%
-- potato starch			7.56%
-- potato chips			10.86%
Almonds	0%	2.58%	4.78%
Apples	0%	3.50%	14.58%
Pears	0%	3.20%	6.34%
Cherries	0%	0.48%	10.60%
Wheat	0%	0.58%	8.72%
Corn	0%		5.15%
Barley	0%		9.00%
Sorghum	0%	.54%*	6.23%
Rice	0%	1.84%	5.21%
Soybeans	0%	0.00%	8.22%
Ginseng	0%	3.10%	8.75%

\* The .54% estimate is based on application of feed mill costs to nominal VAT deductions. However, feed mills are provided a full exemption from the VAT for mixed feeds, resulting in actual effective VAT of 0% at the feed mill level.

#### **IV. The VAT for Imported Product**

While domestic agricultural producers are completely exempt from application of the VAT, and merchandisers, wholesalers and primary processors receive major deductions from the nominally applied 13 percent VAT, the full 13 percent VAT must be paid on the vast majority of agricultural imports, including all of the products examined in this study. Decree 538, Article 2 establishes the 13 percent VAT on imported agricultural products and a 17 percent VAT on value added agricultural products. This is, incidentally, the same language that establishes the nominal 13 percent and 17 percent VAT on domestically produced agricultural products.

However, unlike domestically produced products, there are no deductions from the 13 or 17 percent VAT applied at the time of import.

The calculation of the 13 percent VAT on imports is based not just on the price of the imported product but also the assessed duty.<sup>11</sup> For example, if a product arrived at Chinese Customs with a price of \$100 and was subject to a 10 percent import duty, \$110 would be used as the basis for the assessment of the 13 percent VAT.

The effect of this policy is to immediately impose a full 13 percent tax burden on imported product that is not imposed on domestically produced product. This tax burden is reflected in the increased price of the imported product as it moves on to the Chinese market, putting the imported product at a permanent competitive disadvantage with domestically produced product.<sup>12</sup>

## **V. Comparison of China's VAT Charges for Imports and Domestic Product**

The tables in this section provide simple comparisons of VAT charges for agricultural products that are imported vs. those that are produced domestically. The differential between the VAT charged on imports and that applied to domestic product (i.e. the VAT differential) will vary depending on the processing stage at which the product is imported.

**Primary Products:** In the first example provided below for wheat, the VAT differential will be a full 13 percent, because the imported product is assessed a full 13 percent VAT charge at the time of import, after which it is assessed VAT charges identical to those that domestic wheat is charged as it moves through the flour mill and on to the retail level. This same principal would apply to all primary products, such as corn or soybeans. In this case, the VAT differential in terms of VAT applied to importers vs. the VAT applied to domestic products can be defined as follows:

$$\text{VAT Differential} = 13\%$$

**First Stage Processed Products:** In the second example provided below for pork, the VAT differential will be the 13 percent VAT charge on imports minus the VAT charged at the primary processing level, since imported pork cuts have already been processed and therefore do not need to go to a Chinese slaughter house or processing facility and are not subject to that VAT charge. In this case, the VAT differential in terms of the VAT applied to importers vs. the VAT applied to domestic product can be defined as follows:

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<sup>11</sup> Decree 538, Article 14.

<sup>12</sup> Primary processors, merchandisers, and wholesalers do receive a deduction in the VAT that they must pay at the time of sale for the VAT charged on imported wheat, which will significantly lower the 13 percent charge on their sale. However, sales of processed product from domestically produced products also receive this deduction, the deemed or imputed deduction, for a 13 percent VAT that was never imposed on the purchase of agricultural products from producers. Imported product thus remains at a permanent tax disadvantage relative to domestic product as the product moves through the marketing chain.

VAT Differential = 13% - Effective VAT at Primary Processing Level

**Value Added Processed Products:** An example is not provided below for product imported at the value added level, but the same methodology would apply. The VAT differential would be 17 percent minus the effective VAT at the primary processing level and the effective VAT at the value added level.

VAT Differential = 17% - (Effective VAT at Primary Processing Level + Effective VAT at Value Added Level)

#### A. Primary Product Example: Wheat

In the example below, VAT charges are displayed for wheat that is imported into China, vs. wheat that is produced domestically, using a hypothetical wheat price of \$230 MT for both imported wheat and domestically produced wheat at the producer level. The table clearly demonstrates the fact that imported wheat is put at an immediate competitive disadvantage by virtue of the full 13 percent VAT at the time of import, a charge not incurred by domestically produced wheat.

**Table 5**  
**Example 1**  
**Primary Product Trade**  
**Hypothetical VAT Charges on Domestic and Imported Wheat**

Marketing Stage	Imported Wheat CIF Price	Import Duty	VAT Charged	Accumulated VAT charges	Domestic Wheat	VAT Charged	Accumulated VAT charges
Import or Farm	\$230	1% or \$2.30	13%	\$30.20 1/	\$230	0	0
Price to Flour Mill 2/	\$262.50				\$230		0
Flour Mill Value Added \$48.52 3/	\$ 311.02		13% - deductions Assume .58% VAT charge 3/	\$30.20 + \$1.80 = \$32.00	\$278.52	13%- deductions . Assume .58% charge	0 + 1.61 = \$1.61
Post VAT flour mill price 4/	\$312.82			\$32.00	\$280.13		\$1.61

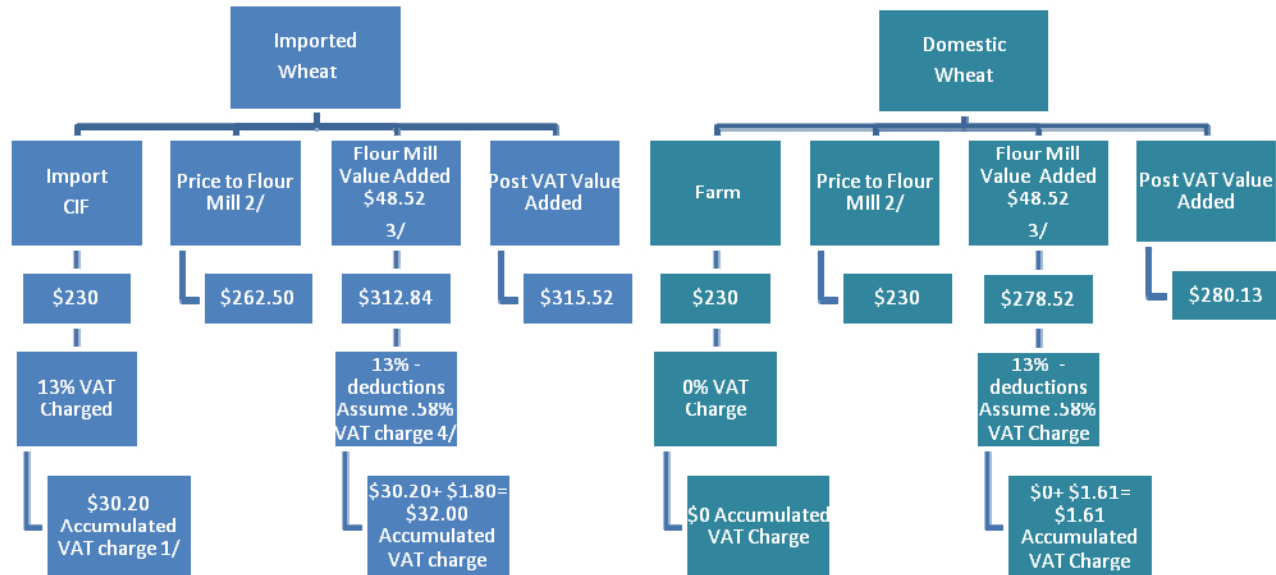
1/ Includes one percent import duty on wheat. CIF price plus import duty are included in calculation of 13% VAT (Decree 538, Article 14).

2/ Ignores transportation, handling and profit from importer to flour mill.

3/ Actual flour milling costs as estimated in wheat report.

4/ Assumes no profit in flour milling process.

**Flowchart 3**  
**Example 1**  
**Hypothetical VAT Charges on Imported and Domestic Wheat**



1/ Includes on percent import duty on wheat. CIF price plus import duty are included in calculation of 13% VAT.

2/ Ignores transportation, handling and profit to importers to flour mill.

3/ Actual flour milling costs as estimated in wheat report.

4/ Assumes no profit in flour milling process.

It can be seen from this simplified example that the 13 percent VAT on imports puts imported wheat at an immediate price disadvantage, and that the price disadvantage attributable to the tax accumulates in absolute value as the product moves through the marketing chain, since the VAT assessed is based in part on the delivered price of the raw product plus import duty.

### **B. First Stage Processed Product Example: Pork**

In the simplified example below, VAT charges are displayed for hams that are imported into China vs. ham that is produced domestically, using a hypothetical price of \$1800 MT for both imported ham and domestically produced ham. Since the imported ham can be marketed directly at the retail level, the point of comparison is at the supermarket level, under the assumption that the ham is sold directly to the supermarket with no intermediary. The table demonstrates that imported pork is put at a competitive disadvantage equal to the difference between the 13 percent VAT charged on imported product, minus the effective VAT paid at the slaughter

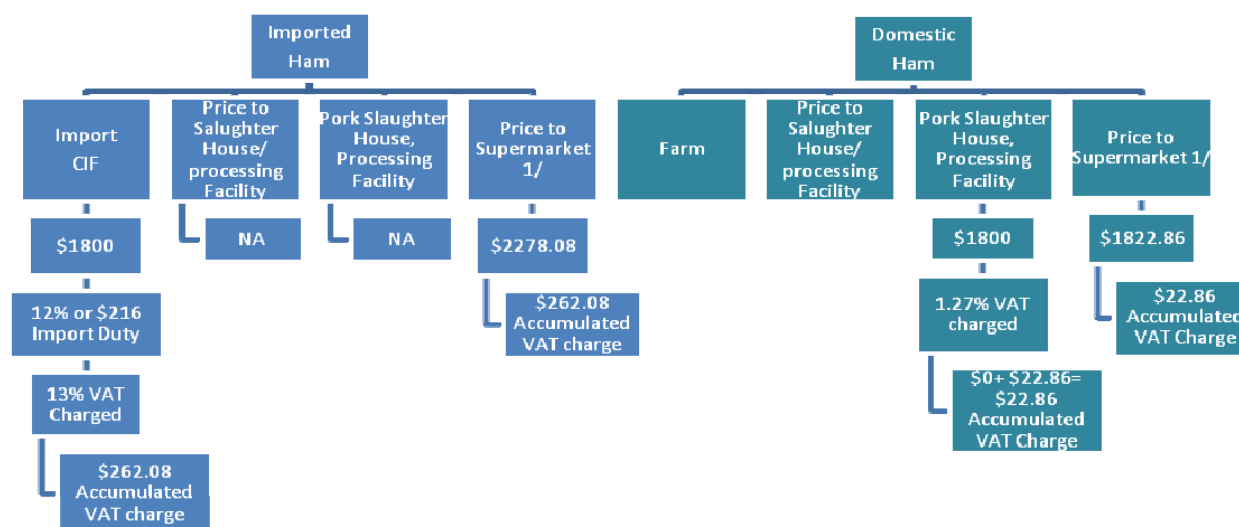
house/processing level for domestically produced pork of 1.27 percent. Therefore the effective VAT discrimination at the supermarket level is 11.73 percent.

**Table 6**  
**Example 2**  
**Processed Product Trade**  
**Hypothetical VAT Charges on Domestic and Imported Frozen Pork**

Marketing Stage	Imported Ham CIF Price	Import Duty	VAT Charged	Accumulated Total VAT charges	Domestic Ham	VAT Charged	Accumulated Total VAT Charges
Import or Farm	\$1800	12% or \$216	13%	\$262.08		0	0
Price to slaughter house/processing facility	NA		NA				
Pork slaughter house, processing facility	NA		NA		\$1800	1.27%	0 + \$22.86 = \$22.86
Price to supermarket 1/	\$ 2278.08			\$262.08	\$1822.86		\$22.86

1/ In the case of imported ham, includes both VAT and 13% import duty. VAT is based on import price plus 13% duty. Ignores transportation, handling and freezing charges.

**Flowchart 4**  
**Example 2**  
**Processed Product Trade**  
**Hypothetical VAT Charges on Domestic and Imported Frozen Pork**



.1/ In the case of imported ham, includes both VAT and 13% import duty. VAT is based on import price plus 13% duty. Ignores transportation, handling and freezing charges.

## VI. Special VAT Rules for STEs

Chinese state trading entities (STEs), led by the state owned COFCO, play a significant role in the import, export, domestic trade and processing of agricultural products, particularly grain and oilseed products.<sup>13</sup>

A Ministry of Finance and State Administration of Taxes Circular, Caishu Notice No. 198, implemented on June 1, 1999 (see Table 1, Item 5), establishes that authorized state owned grain companies will be exempt from VAT charges.<sup>14</sup> While the circular does not explicitly state it, Larkin Trade International (LTI) confirmed through discussion with government officials that this policy applies to both domestically traded and imported grains.

“Notice of the State Administration of Taxation on Some Issues Concerning the VAT Management of the State Owned Grain Companies,” implemented on July 19, 1999 (see Item 6 in Table 1) establishes that state owned grain companies should make use of special invoices, and that “when purchasing grains from state owned grain purchasing enterprises, other enterprises as ordinary taxpayers can deduct 13 percent of the sales

<sup>13</sup> Information on COFCO, a state owned grain and oilseeds trader and merchandiser, can be found at <http://www.cofco.com/en/index.asp>.

<sup>14</sup> Chinese regulations and notices provide that the term “staple food” includes not just wheat and feed grains, but also rice.



amount on the special VAT invoices obtained from the state owned grain purchasing enterprises as an input tax.”

In other words, purchases by processors and merchandisers of grain from state owned enterprises are treated the same way as direct purchases from producers; even though the state owned enterprise has paid no VAT, the purchaser is allowed to take a deemed 13 percent deduction on the purchase, significantly reducing the VAT liability.

The economic and WTO legal implications of China’s VAT policies for state owned enterprises are considered later in this report.

### **VII. Informal Off the Book Transactions**

As noted in each of the commodity reports in Annex III containing VAT estimates, it is a relatively common practice in China for sellers and buyers to agree upon a lower price if they agree not to use a Special Invoice, thus avoiding the need to make VAT payments on the transaction. In discussions with processors and merchandisers, we found that this practice is relatively common place in transactions involving small companies and exists to a lesser degree among medium to large scale primary and value added processors. To the extent that this practice takes place, the effective VAT estimates in this report can be viewed as a high end estimate of the average effective VAT assessed in the Chinese market place.

“Circular of Income Tax Exemption for Leading Agricultural Enterprises by State Administration of Taxes”, Circular No. 124 implemented on January 1, 2009 (see Item 11 in Table 1), provides for an income tax exemption for certain “leading enterprises” that are designated by the Chinese government. While this regulation applies strictly to income tax exemptions, it was our finding that many leading enterprises that received income tax exemptions were also granted VAT exemptions by the Chinese government.

### **VIII. Calculation of VAT Discrimination**

The three tables contained in Annex IV provide a breakdown of VAT discrimination charges for key products in this study. The tables are broken down by primary, first stage processed, and value added products, reflecting the fact that each of these product groups is subject to a different level of VAT discrimination. Information contained in Columns 5 and 6 of these tables, on the effective discrimination imposed on imports by VAT policies, serve as the basis for the econometric work on trade impact found later in this report.

As a rule, bulk commodity shipments (e.g. wheat, corn, soybeans, almonds, fruit) are subject to the highest level of discrimination, a full 13 percent, because they are subject to full VAT charges while like domestic products do not pay any VAT. “First stage” processed products (e.g. pork, beef and poultry) are subject to a slightly lower level of discrimination, because they are subject to full VAT charges while domestic

product only pays a small portion of this due to the allowable input tax deductions, such as the deemed deduction. Value added products (e.g. dairy, processed potato products) are subject to the lowest level of VAT discrimination, because they are subject to the full VAT charges and many of these charges are also applied to domestic products at both the primary and value added processing levels.

## **IX. Results of Econometric Analysis**

The information in the tables in Annex IV were used as a basis for econometric analysis of the trade and price impact of a removal of China's VAT charges on imports that are determined in this study to be discriminatory. Econometric analysis of all products except ginseng was conducted by Ag Risk Management LLO of Ames, Iowa. Econometric analysis for ginseng was conducted by Dr. Daniel Sumner and Hyunok Lee of the University of California at Davis.

Ag Risk Management made use of the Food and Agricultural Policy Research Institute (FAPRI) and Center for Agricultural Development (CARD) econometric model to determine the impact of removal of VAT import charges on China's imports, U.S. exports, and U.S. commodity prices for the products covered under the model.

The CARD/FAPRI system is ideal for purposes of differential VAT removal scenarios because the results are current and specific to China, and because the model calculates both the first year impact and multi-year impact of trade liberalization. The model also allows for interaction among commodities. For example, liberalization in the feed grain market can influence results in the livestock sector.

Products covered in this study that are included in the CARD/FAPRI system are: wheat, corn, barley, sorghum, soybeans and soybean products, beef, pork, poultry and dairy products. Because they are included in the CARD/FAPRI system, analysis is also provided on sugar, ethanol and processed corn products.

The full results of the trade impact analysis are included in Annex V of this study. A summary of trade impact results for individual commodities is covered in Section X below.

The CARD/FAPRI system does not cover specialty crops included in this study, including potatoes and potato products, almonds, apples, pears, cherries and ginseng. For this reason, independent analysis of these commodities was conducted not making use of the CARD/FAPRI system. Most of this analysis was conducted by drawing on previous academic research as a source for trade elasticities. Ag Risk Management conducted analysis for potatoes and potato products, almonds, apples, pears and cherries. Economists at the University of California Davis conducted analysis for ginseng.

The full results of this analysis are included in Annex V of this study. Individual commodity results are covered in Section X below.

## **X. Summary of Product Specific Results**

As noted above, detailed results of commodity specific analysis are presented in Annex V. Summary results of the analysis, and preliminary conclusions related to those results, are presented below, with order based on Harmonized Trade System (HTS) nomenclature.<sup>15</sup>

### **A. Beef HTS 0201, 0202, 0206, 0210, 1601, 1602**

The effective VAT for beef producers and small scale feed lots is zero. This compares to the 13 percent applied to imported beef. The effective VAT on beef slaughter houses and processing facilities is estimated at 2.22 percent. The effective VAT on value added products, in this case, vacuum packed cooked beef, is estimated at 6.26 percent. This compares to the 17 percent VAT rate that would be applied to value added beef products.

Integrated production facilities that provide feed inputs, cattle raising and slaughter and processing facilities within a single corporate structure are subject to a full 13 percent charge on the finished beef product. Since the animal was not purchased from a small producer, the deemed VAT deduction of 13 percent would not be available to these integrated operations. However, in discussions with integrated facilities it became clear that these facilities would not integrate if they were to lose major VAT deductions. Most of these production facilities are either declared key enterprises, and therefore informally provided VAT exemptions, or declare themselves as non integrated facilities (i.e. separate cattle raising, slaughter and processing facilities) for tax purposes, and therefore are able to take the same VAT deductions as other non integrated operations.

Chinese fresh/chilled and frozen beef imports are miniscule relative to the size of the total Chinese market, although there is significant cross border trade through Hong Kong. USDA's Foreign Agricultural Service (FAS) estimates the total size of the Chinese market at 6 million MT in 2008, compared to total imports of beef of 10,000 MT.<sup>16</sup> Moreover, China restricts the import of U.S. beef due to bovine spongiform encephalopathy (BSE). Over the last ten years, China has been a small net exporter of beef.

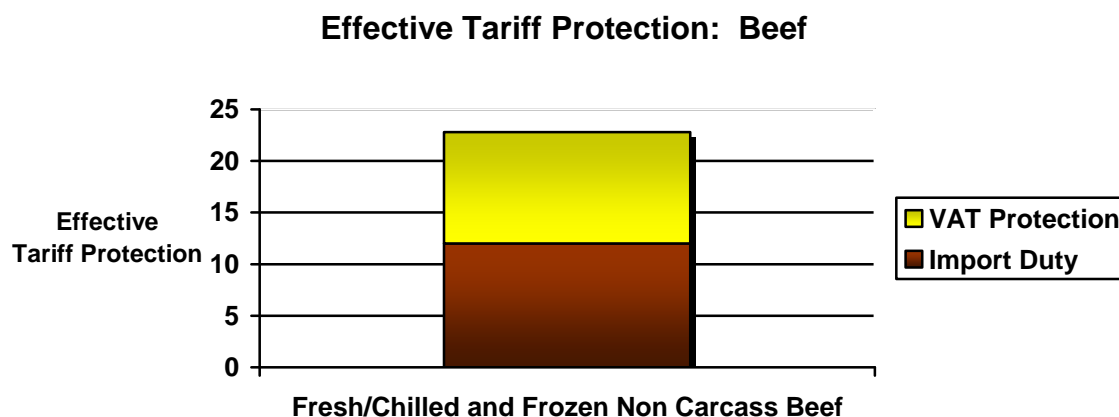
However, on the assumption that China's BSE related restrictions will be eventually removed, China's discriminatory VAT policies would have a negative impact on U.S. beef export prospects to China, and are already having a negative impact on China's overall imports of beef from the world.

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<sup>15</sup> Note that all results presented in this section with respect to effective border protection are simply the sum of the import duty and effective VAT protection. These estimates slightly underestimate actual VAT protection, because the VAT is applied based on import prices plus duty. Actual border protection including import duties plus VAT charges after application of import duties can be found in Annex IV of this study.

<sup>16</sup> FAS GAIN Report CH9017, March 9, 2009. People's Republic of China, Semi-Annual Livestock Report.

As indicated in the graph below, the effective tariff protection on non carcass beef is 22.78 percent, comprised of a 12 percent import duty and estimated effective VAT protection of 10.78 percent.



### *Economic Analysis*

China is a potentially major market for U.S. beef, and the elimination of China's discriminatory VAT policies would have a significant impact on China's demand for imported beef, including beef from the United States.

As noted, the border protection provided on beef due to discriminatory VAT charges is 10.78 percent. Econometric analysis conducted by Ag Risk Management using the CARD/FAPRI modeling system indicates that if these discriminatory charges were removed in marketing year 2010/11, total Chinese imports of beef would increase by 203,000 MT annually in the first year of removal, and by 596,000 MT annually in 2015/16. U.S. beef exports to China would increase by 125,226 MT in the first year of VAT removal, and by 112,522 MT annually in 2015/16. U.S. beef prices would increase by 2.96 percent relative to current prices in the first year of removal, and by 2.78 percent by the 2015/16 marketing year.

### **B. Pork HTS 0203, 0206, 0210, 1601, 1602**

The effective VAT for pork producers is zero. The effective VAT for pork slaughter houses and processing facilities is estimated at 1.27 percent. This compares to a VAT on imported pork of 13 percent. The effective VAT on value added products, in this case, vacuum packed cooked pork, is estimated at 7.24 percent. This compares to the VAT on imported valued added pork products of 17 percent.

Integrated production facilities that provide feed inputs, pig raising and slaughter and processing facilities within a single corporate structure are subject to a full 13 percent charge on the finished pork product. Since the animal was not purchased from a small producer, the deemed VAT deduction of 13 percent would not be available to these

integrated operations. However, in discussions with integrated facilities it became clear that these facilities would not integrate if they were to lose major VAT deductions. Most of these production facilities are either declared key enterprises, and therefore are informally provided VAT exemptions, or declare themselves as non integrated facilities (i.e. separate pig raising, slaughter and processing facilities) for tax purposes, and therefore are able to take the same VAT deductions as other non integrated operations.

China currently bans imports of U.S. pork due to the H1N1 virus, even though it has been scientifically demonstrated that the virus cannot be contracted by eating pork.<sup>17</sup> Prior to the Chinese ban, in 2008, China was one of the largest markets in the world for U.S. pork, with China's pork imports from the United States totaling 176,000 MT. However, even before the imposition of a ban on U.S. pork, Chinese pork imports were very small relative to the total size of the Chinese market. In 2008, China's consumption of pork was estimated at 46.4 million MT, compared to total pork imports of 522,000 MT.<sup>18</sup> China has a declared policy of self sufficiency in pork, and has in recent years directed major subsidies toward the pork sector. Until 2007/08 and the "blue ear" disease epidemic that reduced China's swine herd, China was a small net exporter of pork.

However, on the assumption that China's H1N1 related import restrictions on U.S. pork will be eventually removed, China represents a potentially huge market for U.S. pork exports. China's discriminatory VAT policies have a negative impact on U.S. pork export prospects to China, as they do on total Chinese pork imports from the world. Major U.S. competitors in the Chinese market are currently the European Union and Canada.

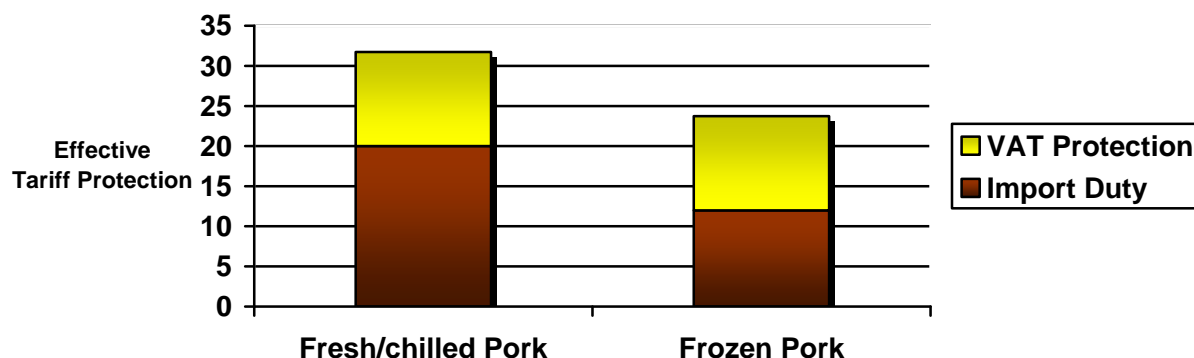
As indicated in the graph below, the effective tariff protection on fresh/chilled pork is 31.73 percent, comprised of an import duty of 20 percent and estimated effective VAT protection of 11.73 percent. The effective tariff protection on frozen pork is 23.73 percent, comprised of an import duty of 12 percent and estimated effective VAT protection of 11.73 percent.

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<sup>17</sup> There is however a significant cross border trade through Hong Kong. In the Jan –May 2009 period, U.S. pork exports to Hong Kong totaled 32,739 MT, a significant portion of which was cross border trade.

<sup>18</sup> Supra.

### Effective Tariff Protection: Pork



#### *Economic Analysis*

As noted, the border protection provided on pork due to discriminatory VAT charges is 11.73 percent. Econometric analysis conducted by Ag Risk Management using the CARD/FAPRI modeling system indicates that if these discriminatory charges were removed in marketing year 2010/11, Chinese imports of pork would increase by 66,000 MT in the first year of removal, and by 342,000 MT annually in 2015/16. U.S. pork exports to China would increase by 2,722 MT in the first year of VAT removal, and by 113,883 MT annually in 2015/16. U.S. pork prices would increase by 1.69 percent relative to current prices in the first year of removal, and by 3.69 percent by the 2015/16 marketing year.

#### **C. Poultry, HTS 0207**

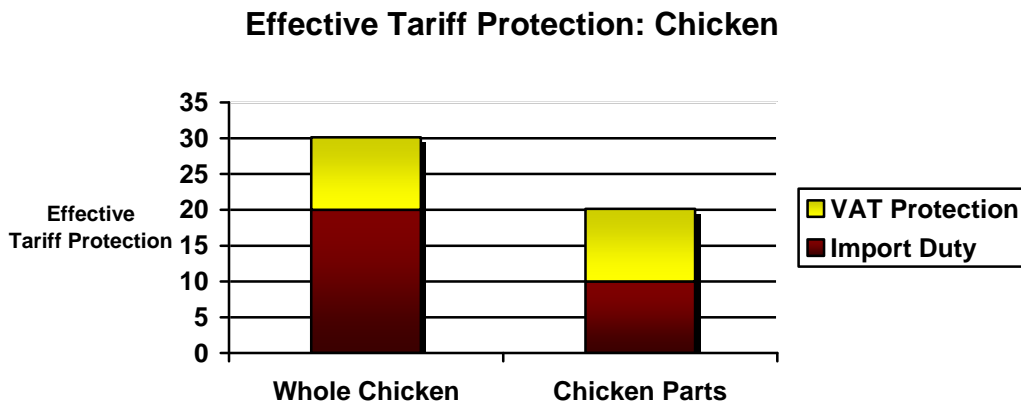
The effective VAT for poultry producers is .323 percent. The effective VAT out of the slaughter house/processing facility is 2.86 percent. This compares to an import VAT of 13 percent. The effective VAT for a value added poultry product, in this case baked poultry, is 8.64 percent, compared to an import VAT of 17 percent.

As in the pork sector, integrated production facilities that provide feed inputs, poultry raising and slaughter and processing facilities within a single corporate structure are subject to a full 13 percent charge on the finished product. Since the animal was not purchased from a small producer, the deemed VAT deduction of 13 percent would not be available to these integrated operations. However, in discussions with integrated facilities it became clear that these facilities would not integrate if they were to lose major VAT deductions. Most of these production facilities are either declared key enterprises, and are therefore informally provided VAT exemptions, or declare themselves as non integrated facilities (i.e. separate poultry raising, slaughter and processing facilities) for tax purposes, and therefore are able to take the same VAT deductions as other non integrated operations.

In recent years China has turned into a major market for U.S. poultry exports, with sales totaling 796,000 MT valued at \$720 million in 2008. From January to July 2009, the total exports from the U.S. to China were approximately 361,350 MT valued at \$453 million. Although U.S. exports to China have recently been restricted by licensing problems, at present there are no major constraints on U.S. exports. In addition, there is significant cross border trade in U.S. poultry products via Hong Kong. U.S. export prospects to China are clouded however by a Chinese government countervailing duty anti-dumping investigation on U.S. poultry imports.

Assuming that there are no major trade barriers imposed, China represents a major long term market for U.S. poultry exports. However, even in the absence of other restrictions, China's VAT policy remains a significant obstruction to increased U.S. poultry sales.

As indicated in the graph below, the effective tariff protection on whole chickens is 30.14 percent, comprised of an import duty of 20 percent and estimated effective VAT protection of 10.14 percent. The effective tariff protection on chicken parts is 20.14 percent, comprised of an import duty of 10 percent and estimated effective VAT protection of 10.14 percent.



### *Economic Analysis*

As noted, the border protection provided on chicken due to discriminatory VAT charges is 11.73 percent. Econometric analysis conducted by Ag Risk Management using the CARD/FAPRI modeling system indicates that if these discriminatory charges were removed in marketing year 2010/11, Chinese imports of chicken would increase by 163,000 MT annually in the first year of removal, and by 288,000 MT annually in 2015/16. U.S. chicken exports to China would increase by 72,595 MT in the first year of VAT removal, and by 98,911 MT annually in 2015/16. U.S. chicken prices would increase by 1.39 percent relative to current prices in the first year of removal, and by 2.41 percent by the 2015/16 marketing year.

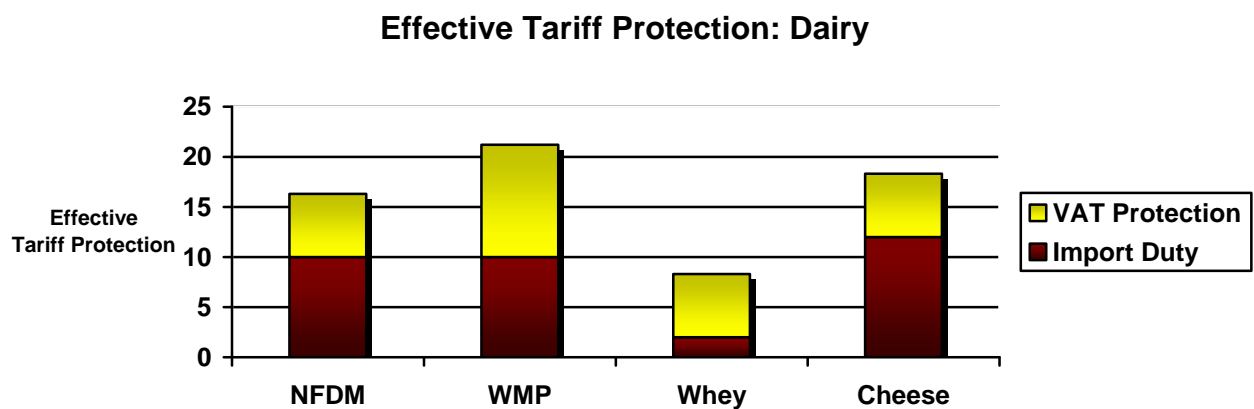
#### D. Dairy HTS 0401, 0402, 0403, 0404, 0405, 0406

The effective VAT on milk producers in China is zero. The effective VAT for homogenized milk is estimated at 5.8 percent, compared to a VAT on imports of 13 percent. The effective VAT on yogurt is estimated at 10.77 percent, compared to a 17 percent VAT on imports. The effective VAT on whole milk powder is estimated at 5.62 percent, compared to an import VAT of 17 percent.

China's milk production has surged over the last ten years, from 7.4 million MT equivalent in 1998 to 37.7 million MT equivalent in 2008. Nevertheless, China is a significant dairy import market, with total dairy imports in 2008 valued at over \$850 million. In addition, there is significant cross border trade with Hong Kong. Principal U.S. exports have been whey (HTS 0404), non fat dried milk (HTS 0402.1) and cheese (HTS 0406). U.S. dairy exports to China were valued at \$136.9 million in 2008.

China is a potentially major market for U.S. dairy exports, and the elimination of China's discriminatory VAT policies would have a significant impact on China's demand for imported dairy products, including those from the United States. Major U.S. competitors in the EU market are New Zealand, Australia and the EU.

As indicated in the graph below, the effective tariff protection on nonfat dry milk is 16.3 percent, consisting of a 10 percent import duty and estimated effective VAT protection of 6.3 percent. The effective tariff protection on whole milk powder is 21.2 percent, consisting of a 10 percent duty and estimated effective VAT protection of 11.2 percent. The effective tariff protection on whey is 8.3 percent, with a 2 percent duty and estimated effective VAT protection of 6.3 percent. The effective tariff protection for most types of cheese is 18.3 percent, with a 12 percent import duty and estimated effective VAT protection of 6.3 percent.



#### *Economic Analysis*

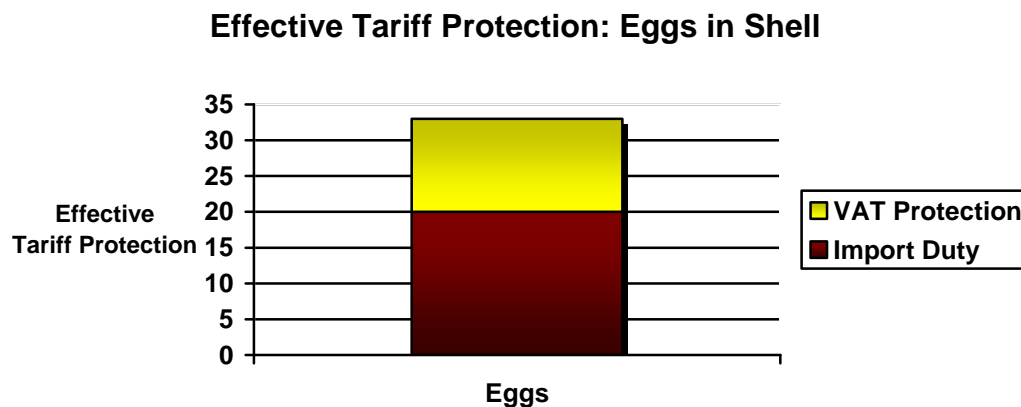


Econometric analysis conducted by Ag Risk Management using the CARD/FAPRI modeling system indicates that if discriminatory VAT charges were removed in marketing year 2010/11, overall U.S. exports of non fat dry milk would increase substantially, from 1.05 percent to 2.24 percent on an annual basis, from 2010/11 to 2015/16. After an initial slight decline in 2010/11, U.S. milk prices would also increase, in a range from .23 percent to .55 percent annually, during the period 2011/12 to 2015/16.

### **E. Eggs, HTS 0407.00**

The effective VAT for egg producers is .17 percent. This compares to an import VAT for unshelled eggs of 13 percent. The effective VAT for a value added egg product, in this case salted eggs, is 9.82 percent, compared to an import VAT of 17 percent.

As indicated in the graph below, the effective tariff protection on eggs in shell is 33 percent comprised of an import duty of 20 percent and estimated effective VAT protection of 13 percent.



#### *Economic Analysis*

As noted, the border protection provided on eggs in shell due to discriminatory VAT charges is 13 percent. Econometric analysis conducted by Ag Risk Management indicates that the removal of this VAT protection, as well as VAT protection on egg products, would result in an annual increase of \$7.1 million annually in U.S. exports in the first year of removal, \$11.3 million after five years, and \$13.8 million in ten years.

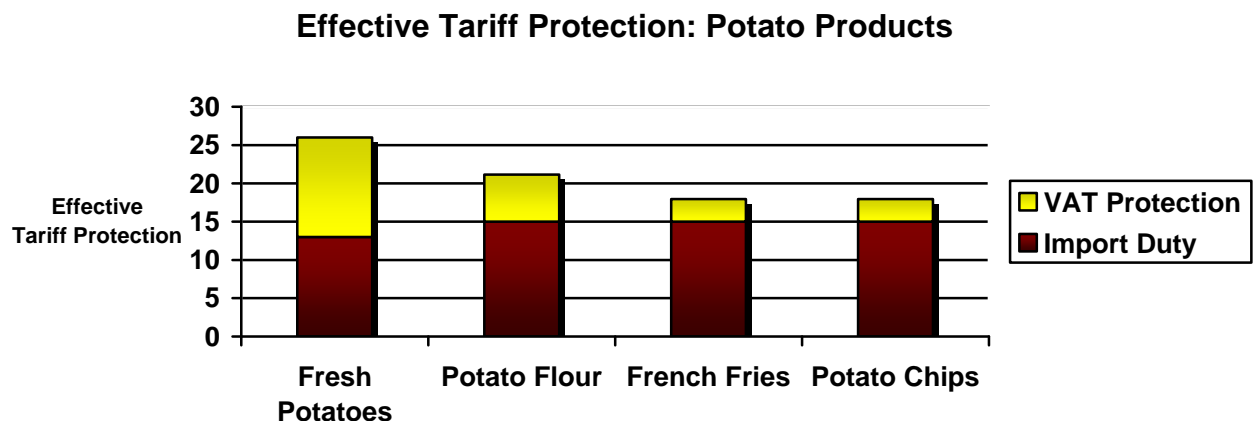
### **F. Potatoes HTS 0701, 071010, 1105, 2004.10, 2005.2**

The effective VAT for potato producers is zero. This compares to an import VAT of 13 percent. The effective VAT for fresh potatoes marketed at the wholesale level is 3.2 percent. The effective VAT for frozen potato pieces is 2.98 percent, compared to an

import VAT of 17 percent. The effective VAT for potato flour is 7.64 percent, compared to an import VAT of 17 percent. The effective VAT for potato chips is 10.86 percent, compared to an import VAT of 17 percent.

While Chinese potato production has remained relatively steady, China is a major importer of frozen and processed potato products, and the expansion of Western fast food chains and the growth in snack food consumption is expected to continue this trend into the foreseeable future. While U.S. exports of fresh potatoes are blocked by SPS related measures, the market for processed potato products is open except for import tariffs and VAT charges. Until a downturn in 2009, China was one of the fastest growing markets in the world for U.S. french fry exports and remains a major market for that product.

As indicated in the graph below, the effective tariff protection for fresh potatoes is 26 percent, consisting of an import duty of 13 percent and estimated effective VAT protection of 13 percent. The effective tariff protection on potato flour is 21.16 percent, consisting of an import duty of 15 percent and estimated effective VAT protection of 6.16 percent. The effective tariff protection on french fries is 17.94 percent, consisting of an import duty of 15 percent and estimated effective VAT protection of 2.94 percent. The effective tariff protection for potato chips is 17.94 percent, consisting of a 15 percent import duty and estimated effective VAT protection of 2.94 percent.



### *Economic Analysis*

As noted above, the effective VAT protection for fresh/chilled potatoes is 13 percent. U.S. export growth for fresh/chilled potatoes to China based on removal of VAT discrimination is \$8237 in the first year of VAT removal, \$13,127 in the fifth year of VAT removal, and \$15,988 in the tenth year of VAT removal.

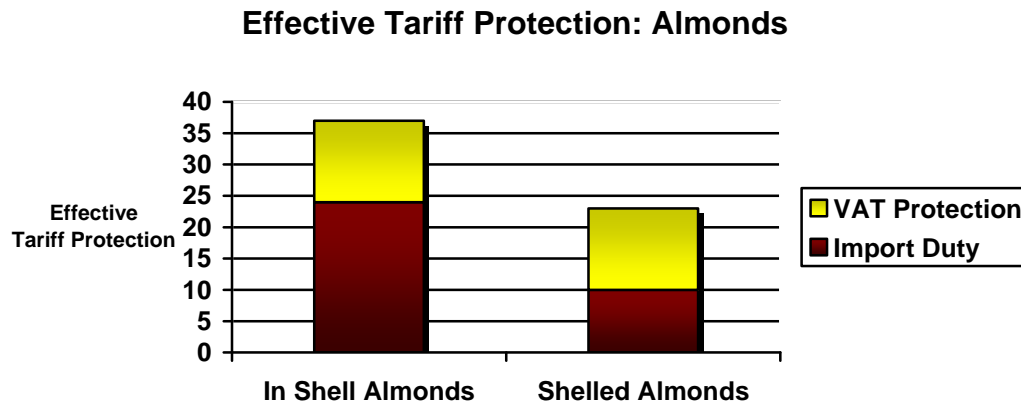
The effective VAT protection on french fries is 2.94 percent, and that level of discrimination is assumed for all potato products in the econometric analysis. U.S. annual export growth for potato products to China is estimated at \$520,000 in the first year of VAT discrimination removal, \$828,000 in the fifth year, and \$1 million in the tenth year.

### **G. Almonds HTS 0802.1, 2008.1990**

The effective VAT for almond producers is zero. This compares to an import VAT for almonds shipped in bulk of 13 percent. The effective VAT for packaged dried almonds is 2.3 percent. The effective VAT on salted almonds is 4.78 percent, compared to an import VAT of 17 percent.

Chinese almond production is very small, totaling an estimated 400 MT in MY 2008. U.S. exports of almonds and almond products have grown significantly since the time of China's WTO accession, and there appears to be significant potential for further growth, both for almonds as a snack food and for use in confectionaries. There is significant cross border trade with Hong Kong, particularly of shelled almonds. Total U.S. exports of shelled almonds to Hong Kong in the January – May 2009 period was 18,508 MT.

As indicated in the graph below, the effective tariff protection for in shell almonds is 37 percent, consisting of a 24 percent import duty and effective VAT protection of 13 percent. The effective tariff protection for shelled almonds is 23 percent, with a 10 percent import duty and effective VAT protection of 13 percent.



### *Economic Analysis*

China is a potentially major market for U.S. almonds and almond products, and the elimination of China's discriminatory VAT policies would have a significant impact on China's demand for imported almonds from the United States.

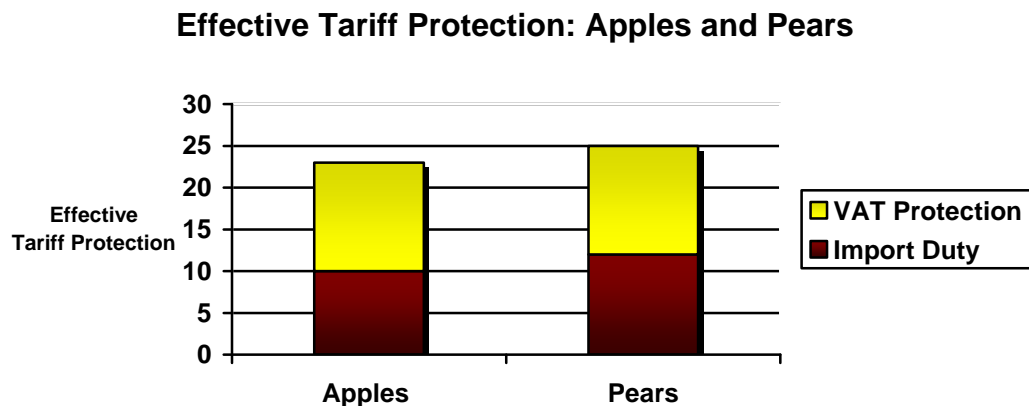
As noted above, the effective VAT protection for shelled and unshelled almonds shipped in bulk is 13%. U.S. annual export growth is estimated at \$1.0 million for in shell almonds and \$4.3 million for shelled almonds in the first year of VAT discrimination removal, \$1.6 million for in shell and \$6.9 million for shelled in the fifth year, and \$1.9 million for in shell and \$8.4 million for shelled in the tenth year.

#### **H. Apples and pears HTS 0808.1, 0808.2, 2008.4, 2009.7**

The effective VAT for apple producers is .71 percent, and the effective VAT for pear producers is 1.19 percent, compared to an import VAT of 13 percent. The effective VAT for apple merchandisers is 3.5 percent and for pears 3.2 percent. The effective VAT on apple cider is 14.58 percent and for pear juice 6.34 percent. This compares to an import VAT on both products of 17 percent.

Although China's production of apples and pears continues to climb, and the country is a major net exporter of both fresh apples and pears and concentrated apple juice, the country is also an important market for U.S. apple exports. There are also major transshipments of apples through Hong Kong. China currently imposes varietal restrictions on U.S. apples, with only red and golden delicious apples from the United States allowed entry. Major U.S. competitors are Chile and New Zealand, both of which have free trade agreements with China that allow preferential tariff access.

As indicated in the graph below, the effective tariff protection for apples is 23 percent, consisting of a 10 percent import duty and 13 percent effective VAT protection. The effective tariff on pears is 25 percent, consisting of a 12 percent import duty and 13 percent effective VAT protection.



#### *Economic Analysis*

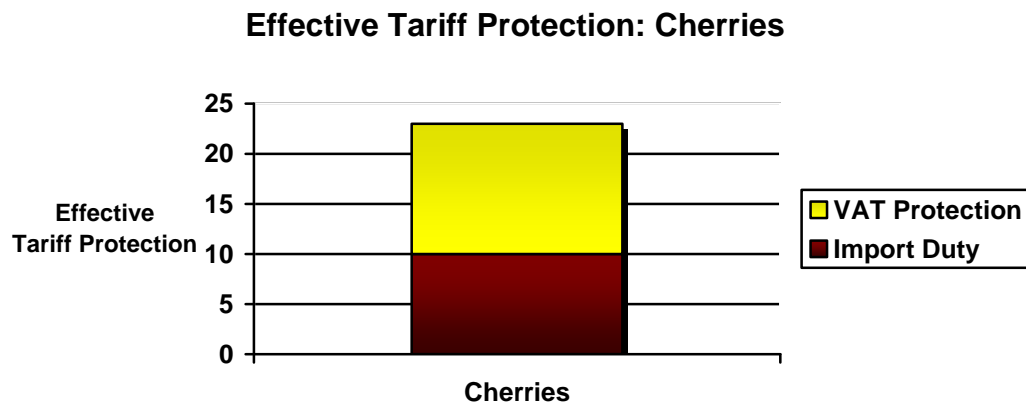
As indicated above, the effective VAT protection for U.S. apples and pears shipped in bulk to China is 13 percent. U.S. annual export growth for apples and pears is estimated at \$3.3 million in the first year of VAT protection removal, \$5.3 million in the fifth year, and \$6.5 million in the tenth year.

### I. Cherries HTS 0809.20

The effective VAT for cherry producers is .61 percent. The import VAT on cherries shipped in bulk is 13 percent. The effective VAT for cherry merchandisers is .48 percent. The effective VAT for cherry liquor processors is 10.6 percent, compared to an import VAT of 17 percent.

Following the resolution of SPS related issues, U.S. exports of cherries to China have grown in recent years. Chile is a major supplier of cherries to the Chinese market, and benefits from a reduced import duty of 4 percent under a China – Chile free trade agreement. However, as a southern hemisphere supplier, Chile normally does not compete directly with the United States for sales to China.

As indicated in the graph below, the effective tariff protection for cherries is 23 percent, consisting of a 10 percent import duty and 13 percent effective VAT protection.



### *Economic Analysis*

As indicated above, the effective VAT protection on cherries shipped in bulk to China is 13 percent. U.S. annual export growth for cherries to China is \$451,000 in the first year of VAT protection removal, \$720,000 in the fifth year, and \$877,000 in the tenth year.

### J. Wheat HTS 1001

The effective VAT for wheat producers is zero percent. The import VAT for wheat is 13 percent. The effective VAT for flour millers is .58 percent. The effective VAT for a value added product, cookies, is 8.72 percent, compared to an import VAT of 13 percent.

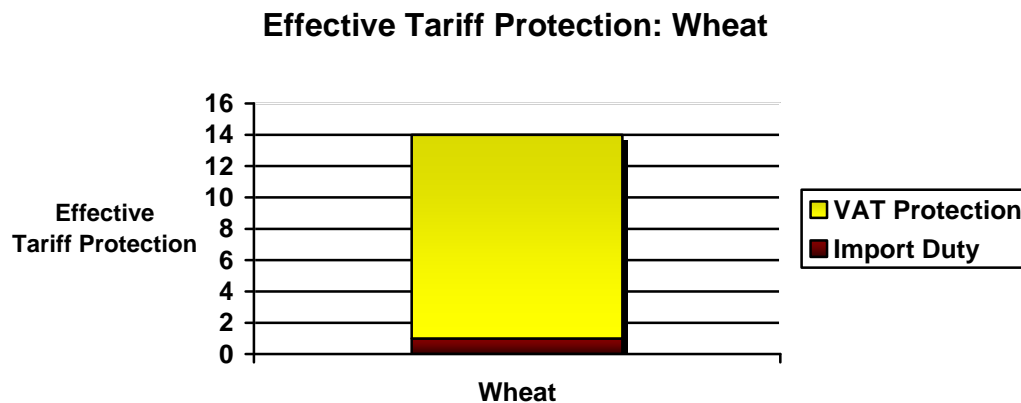
In addition, any purchases or trading of wheat by state trading entities such as COFCO or the Jilin Grain Group are conducted free of VAT charges.<sup>19</sup>

With the exception of a large year in CY 2004, China has been a modest market for U.S. wheat exports, and overall Chinese wheat imports have also been modest, with Australia and Canada the primary U.S. competitors. China's wheat imports have been relatively small in recent years in spite of the massive size of the Chinese market, with consumption estimated by USDA/FAS at 102.5 million MT in 2008.

China has been a significant net exporter of wheat in recent years, with exports in MY 2008 estimated at 400,000 MT, down from 2.3 million MT in MY 2007. China is also a significant exporter of wheat flour. Increasing Chinese wheat production is being encouraged by subsidies, including a price support scheme, direct subsidies and tax breaks.

Recent reports indicate that the landed price for U.S. wheat is relatively close to the domestic price of Chinese wheat.<sup>20</sup> With this relative proximity in prices, the 13 percent VAT charged on imports becomes critical.

As noted in the graph below, the effective tariff protection for wheat is 14 percent, consisting of a one percent in quota duty and 13 percent effective VAT protection.



### *Economic Analysis*

<sup>19</sup> Notice of the State Taxation on Some Issues Concerning the VAT Invoice Issue by the Grain Company. Guo Shui Ming Dian No.10, 1999.

<sup>20</sup> FAS GAIN Report CH 9013, March 3, 2009. "Grain and Feed Annual". p. 5.

As noted, the border protection provided on wheat due to discriminatory VAT charges is 13 percent. Econometric analysis conducted by Ag Risk Management using the CARD/FAPRI modeling system indicates that if these discriminatory charges were removed in marketing year 2010/11, Chinese imports of wheat would increase by 2.0 million MT annually in the first year of removal, and by 2.8 million MT annually in 2015/16. U.S. wheat exports to China would increase by 435,967 MT in the first year of VAT removal, and by 490,463 MT annually in 2015/16. U.S. wheat prices would increase by 2.30 percent relative to current prices in the first year of removal, and by 2.50 percent by the 2015/16 marketing year.

### **K. Feed Grains HTS 1003.0090, 1005.90, 1007.0090**

The effective VAT for corn, barley and sorghum producers is zero. The import VAT for these products is 13 percent. The effective VAT for feed grains coming out of feed mills is estimated at .54 percent. However, feed mills are provided a full exemption from the VAT if they mix feeds with three or more components, where grains constitute at least 95 percent of the total mix.<sup>21</sup> Our finding has been that virtually all feed mills take advantage of this exemption, so we view the real effective VAT at the feed mill level to be zero. The effective VAT for corn ethanol companies is estimated at 5.15 percent, compared to an import VAT of 17 percent. The effective VAT on beer brewing companies making use of barley is measured at 9 percent, compared to an import VAT of 17 percent. The effective VAT on sorghum ethanol producers is 6.23 percent, compared to an import VAT on that product of 17 percent.

In addition, any purchases or trading of corn, barley or sorghum by state trading entities such as COFCO or the Jilin Grain Group are conducted free of VAT.<sup>22</sup> This includes imports of feed grains.

Also, three government supported companies producing ethanol from corn are also exempt from VAT charges: Ji Lin Fuel Alcohol Co. Ltd., Heilongjiang Huarun Alcohol Co. Ltd., and Anhui Fengyuan Fuel Alcohol Company.<sup>23</sup>

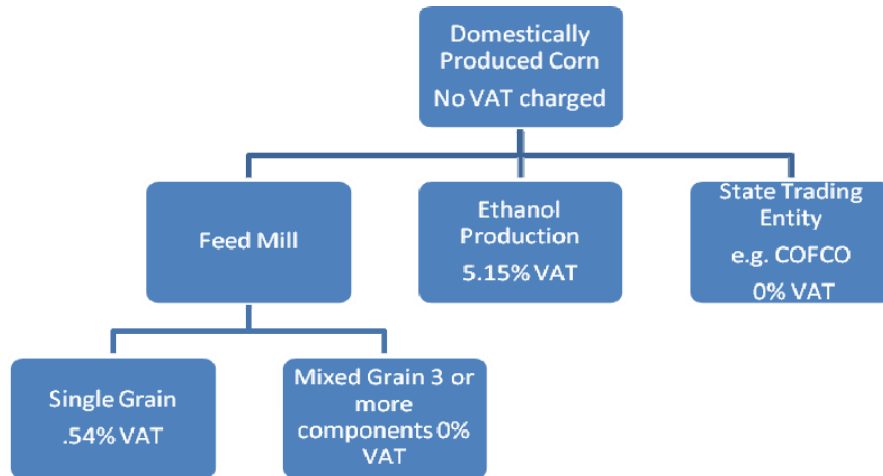
### **Flowchart 5 VAT on Domestic Feed Grain Transactions in China**

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<sup>21</sup> Circular of the Ministry of Finance and the State Administration of Taxation on Exemption of VAT for Feed Grains, Cai Shui No. 121, 2004.

<sup>22</sup> Notice of the State Taxation on Some Issues Concerning the VAT Invoice Issue by the Grain Company. Guo Shui Ming Dian No.10, 1999.

<sup>23</sup> Per Notice [2005] No. 174

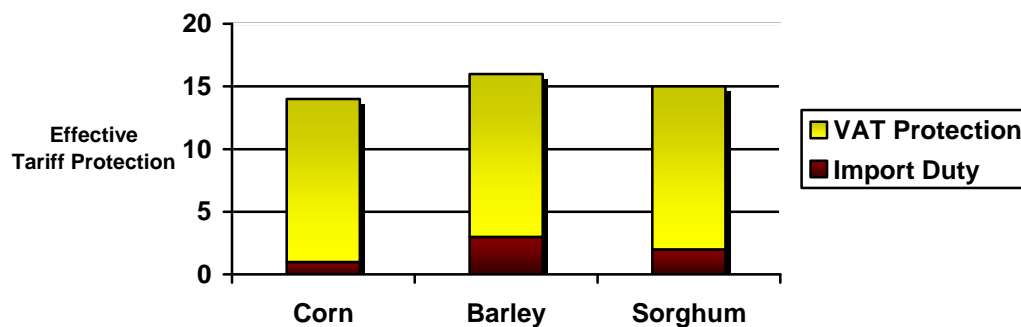


Overall Chinese domestic demand for feed grains, and corn in particular, has grown significantly over the last decade. Although there has been a slight downturn in corn for industrial use in recent years, long term prospects remain strong. While China was a major corn exporter in the first years of this decade, corn exports have gradually dwindled as domestic supply has struggled to keep up with demand.

Given the long term trend in Chinese demand, it is reasonable to assume that import demand will increase in coming years, and China's VAT policies for feed grains will have a significant impact on import demand.

As indicated in the graph below, the effective tariff protection on corn is 14 percent, consisting of a one percent in quota import duty, and 13 percent effective VAT protection. The effective tariff protection on barley is 16 percent, consisting of a 3 percent import duty and 13 percent effective VAT protection. The effective tariff protection on sorghum is 15 percent, consisting of a 2 percent import duty and 13 percent effective VAT protection.

**Effective Tariff Protection: Feed Grains**



### *Economic Analysis*



As noted, the border protection provided on corn due to discriminatory VAT charges is 13 percent. Econometric analysis conducted by Ag Risk Management using the CARD/FAPRI modeling system indicates that if these discriminatory charges were removed in marketing year 2010/11, Chinese imports of corn would increase by 3.2 million MT annually in the first year of removal, and by 5.0 million MT annually in 2015/16. U.S. corn exports to China would increase by 2.48 million MT in the first year of VAT removal, and by 3.57 million MT annually in 2015/16. U.S. corn prices would increase by 2.23 percent relative to current prices in the first year of removal, and by 2.25 percent by the 2015/16 marketing year.

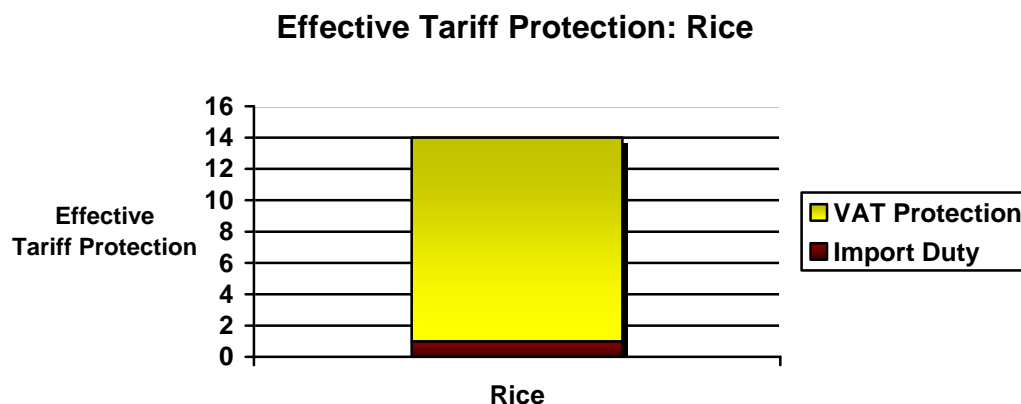
#### L. Rice HTS 1006

The effective VAT for rice producers is zero. The import VAT on bulk rice imports is 13 percent. The effective VAT on rice millers is 1.84 percent, compared to a 13 percent VAT on imported product. The effective VAT on a value added product, instant rice noodles, is estimated at 5.21 percent, compared to an import VAT of 17 percent.

In addition, any purchases or trading of rice by state trading entities such as COFCO or the Jilin Grain Group are conducted free of VAT.<sup>24</sup> This includes imports of rice.

China is a massive market for rice, with total rice consumption (milled basis) of 129 million MT estimated for MY 2008/09. China has historically been a net exporter of rice, mostly Indica rice to African nations. However, China has also imported from 300,000 MT to 650,000 MT of rice over the last five marketing years, primarily from Thailand.

As indicated in the graph below, the effective tariff protection is 14 percent, consisting of a 1 percent import duty and 13 percent effective VAT protection.



#### *Economic Analysis*

<sup>24</sup> Notice of the State Taxation on Some Issues Concerning the VAT Invoice Issue by the Grain Company. Guo Shui Ming Dian No.10, 1999.

Econometric analysis conducted by Ag Risk Management using the CARD/FAPRI modeling system indicates that if the 13 percent discriminatory VAT charge on rice was removed in marketing year 2010/11, Chinese farm prices for rice would decline over a five year period by 4 percent to 7 percent, as the removal of VAT import protection forced price competition in the domestic market. As noted, China is currently a net exporter of rice. China's rice exports would actually increase, as it draws from existing rice stocks and competes on the world market with lower domestic prices. However, there is an eventual decline in the export growth pattern, as rice stocks are depleted. Chinese imports of rice increase in all years. U.S. rice exports to China initially decline slightly, then increase from 2013/14 onward. There is an average annual increase in domestic U.S. rice prices of .66 percent over the 2010/11 to 2015/16 period due to removal of China's VAT discrimination.

### **M. Soybeans HTS 1201**

The effective VAT for soybean producers is zero. This compares to an import VAT of 13 percent. The effective VAT for soybean crushers is also zero, due to financial losses that crushers interviewed were incurring at the time the report was conducted. The effective VAT on a value added product, soybean isoflavone, is 8.22 percent, compared to an import VAT of 17 percent.

In addition, any purchases or trading of soybeans by state trading entities such as COFCO are conducted free of VAT.<sup>25</sup> This includes imports of soybeans.

China is an enormous market for U.S. soybeans, with sales totaling 16.5 million MT valued at \$7.2 billion in 2008. U.S. soybean exports to China currently account for about half of U.S. soybean sales worldwide. Primary U.S. competitors in the Chinese market are Brazil and Argentina.

Over the last ten years, China's soybean production has been relatively stagnant, in a range generally between 15 million MT to 16 million MT. Stagnant production has occurred at the same time that domestic demand has soared, both for animal protein and vegetable oils. It is generally believed that as long as the Chinese economy continues to grow at a 7 to 8 percent rate, demand for soybeans will remain strong.

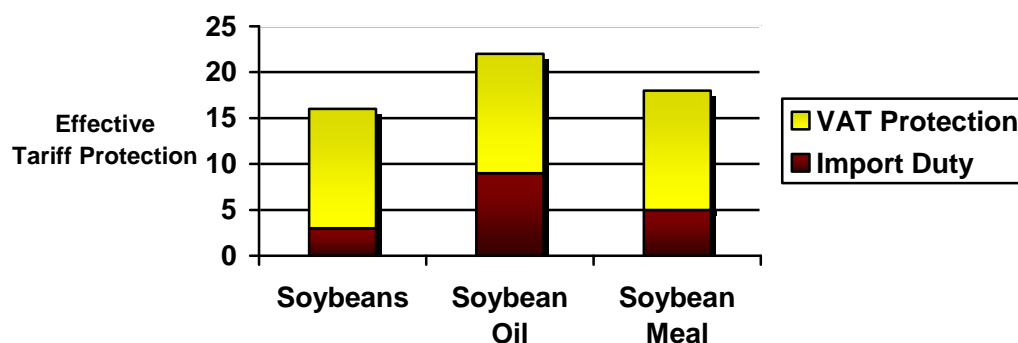
The 13 percent effective VAT discrimination does however act as a significant impediment to imports, significantly increasing the effective level of tariff protection to 16 percent. At the same time, because China's VAT policies are designed to lower VAT charges as profit falls, Chinese soybean crushers in 2009 were operating at very low or zero VAT charges. This provides tax relief to soybean crushers in times of financial duress, helping to maintain stable domestic demand for soybeans.

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<sup>25</sup> Notice of the State Taxation on Some Issues Concerning the VAT Invoice Issue by the Grain Company. Guo Shui Ming Dian No.10, 1999.

As indicated in the graph below, the effective tariff protection for soybeans is 16 percent, consisting of a 3 percent import duty and 13 percent effective VAT protection. Because the effective VAT on domestic soybean oil and soybean meal is zero, the effective tariff attributed to VAT discrimination for these products is 13 percent.

### Effective Tariff Protection: Soybeans and Products



### *Economic Analysis*

As noted, the border protection provided on soybeans and soybean products due to discriminatory VAT charges is 13 percent. Econometric analysis conducted by Ag Risk Management using the CARD/FAPRI modeling system indicates that if these discriminatory charges were removed in marketing year 2010/11, there would be a decrease in domestic Chinese prices of 9.9 percent, 8.9 percent, and 10.4 percent for soybeans, soybean meal and soybean oil respectively. This combined price reduction would result in an average decline in the real crushing margins of roughly 9 percent. Thus, while domestic demand for products would increase driven by lower prices, the crush demand for soybeans would decline. This decline would outweigh the reduction in soybeans production, leading to lower imports of soybeans. On the other hand, for soybean products, the increase in demand would reinforce the decline in domestic production, leading to higher imports.

Chinese imports of soybeans would decrease by 537,000 MT annually in the first year of removal, and by 465,000 MT annually in 2015/16. U.S. soybean exports to China would decrease 190,735 MT in the first year of VAT removal, and by 381,471 MT annually in 2015/16. However, U.S. soybean prices would increase by 1.48 percent relative to current prices in the first year of removal, and by 1.53 percent by the 2015/16 marketing year. This is attributable to the increase in demand for soybean products, described below.

If discriminatory VAT charges were removed in marketing year 2010/11, Chinese imports of soybean oil would increase by 446,000 MT annually in the first year of removal, and by 431,000 MT annually in 2015/16. U.S. soybean oil exports to China would increase by 177,858 MT in the first year of VAT removal, and by 199,183 MT annually in 2015/16.

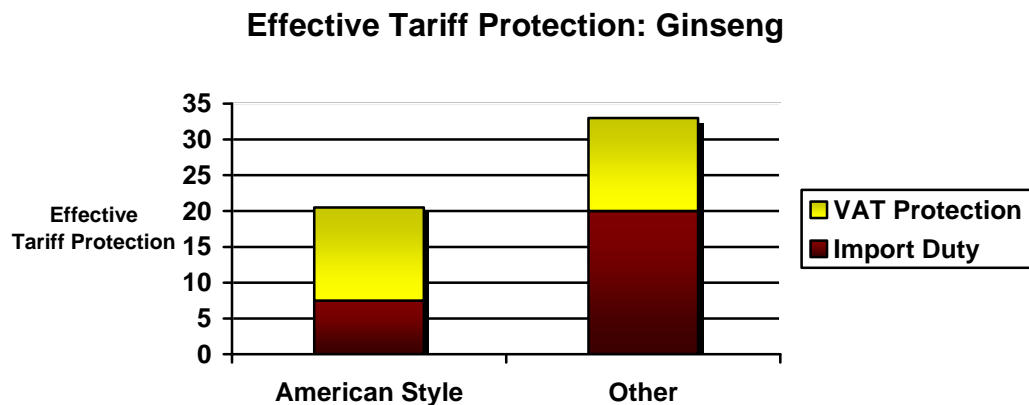
If discriminatory VAT charges were removed in marketing year 2010/11, Chinese imports of soybean meal would increase by 1.0 million MT annually in the first year of removal, and by 772,000 MT annually in 2015/16. U.S. soybean meal exports to China would increase by 113,000 MT in the first year of VAT removal, and by 41,000 MT annually in 2015/16.

## N. Ginseng HTS 1211.20

The effective VAT for ginseng producers is zero. This compares to an import VAT of 13 percent. The effective VAT for ginseng primary processors is 3.1 percent. The effective VAT on a value added product, ginseng pills, is 8.75 percent, compared to a 17 percent VAT on imports.

U.S. exports of ginseng to China totaled 87 MT, valued at \$5.6 million. Primary U.S. competitors in the Chinese market are Canada and South Korea.

As indicated in the graph below, the effective tariff protection for American style ginseng is 20.5 percent, consisting of a 7.5 percent import duty and 13 percent effective VAT protection. The effective tariff protection for other types of ginseng is 33 percent, consisting of a 20 percent import duty and 13 percent effective VAT protection.



### *Economic Analysis*

As noted, the border protection provided on ginseng due to discriminatory VAT charges is 13 percent. Econometric analysis conducted by economists at UC Davis indicates that if these discriminatory charges were removed, U.S. ginseng exports to China would increase in a range from 18.9 MT to 28.3 MT in marketing year 2010/11, with an increased export value ranging from \$1.63 million to \$2.59 million.<sup>26</sup>

## XI. WTO ANALYSIS

<sup>26</sup> Increases in ginseng exports were based on average U.S. exports in the 2006 to 2008 period of 145 MT.

As established in this study, China, as a matter of regulation and practice, maintains a system under which Chinese agricultural producers and processors are provided with either complete exemptions or significant deductions from VAT charges that are generally applied to other sectors of the Chinese economy. The effect of these exemptions and deductions is to either completely eliminate, or substantially reduce the effective VAT charges that accrue to Chinese agricultural enterprises, to rates that are consistently below the nominal domestic VAT rates of 13 and 17 percent. Chinese regulations provide for these exemptions and deductions at the same time China applies a full 13 or 17 percent VAT charge on almost all imported agricultural products.

As noted earlier in this study, the application of the full 13 or 17 percent VAT to imports, while allowing for significant exemptions or deductions for like domestically produced commodities, results in a VAT policy that discriminates against imported product. The level of discrimination, as estimated in this study, is a full 13 percent for imported bulk commodities like wheat, corn, rice and soybeans, 13 percent minus the effective VAT at the primary processing level for imported “first stage” processed products like beef, pork and poultry, and 13 percent minus the effective VAT at the primary processing and value added level for imported value added products like dairy products and processed potato products.

China’s policies with respect to the application of the VAT, including those applied to domestic agricultural enterprises, were originally consolidated under Interim Regulations of the Peoples Republic of China on the Value Added Tax (Decree [1993] No. 134 of the State Council, dated December 13, 1993). China’s updated VAT policies were again consolidated in 2008 under Interim Regulations of the Peoples Republic of China on the Value Added Tax, State Council Decree 538, dated November 10, 2008, and implemented on January 1, 2009.

## **I. GATT 1994**

As demonstrated in the market based analysis conducted in this study on the application of VAT exemptions and deductions to domestically produced and marketed products, the clear effect of China’s VAT policies is to impose higher VAT charges on imported products relative to like products produced in the domestic market. The relevance of China’s discriminatory VAT policies for agricultural products to WTO disciplines is examined below.

### **A. Article III.2 Discrimination**

WTO rules related concerns with respect to the discriminatory effect of China’s VAT policy on agricultural imports would be based primarily on Article III of the General Agreement on Tariffs and Trade (GATT) of 1994, which reads in relevant part as follows:

*1. The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.*

*2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.*

Annex I of the GATT contains “Notes and Supplementary Provisions” on the GATT. *Ad Article III* provides the following clarification with regard to the language in Article III.

*Any internal tax or other internal charge, or any law, regulation or requirement of the kind referred to in paragraph 1 which applies to an imported product and to the like domestic product and is collected or enforced in the case of the imported product at the time or point of importation, is nevertheless to be regarded as an internal tax or other internal charge, or a law, regulation or requirement of the kind referred to in paragraph 1, and is accordingly subject to the provisions of Article III.*

The first relevant question is whether a value added tax can be considered an “internal tax” for purposes of GATT Article III.2. A WTO panel examining a complaint brought by the European Union against Argentina related to Argentina’s export policies for hides and leather is instructive.<sup>27</sup> In *Argentina – Hides and Leather*, the Panel addressed the question of whether pre-payment of a VAT, applied to imported goods, was nevertheless to be considered an “internal measure” within the meaning of Article III.2. The Panel addressed in particular *Ad Article III*, and the language in it which states that a measure applied to a product at the time of importation is nevertheless an internal measure within the meaning of Article III if this measure is also imposed on the like domestic product. The panel thus found the VAT in Argentina to be an internal measure for purposes of Article III.

If the VAT is an internal tax for purposes of Article III, then the question is whether China’s VAT policies with respect to agricultural products are in conflict with the fundamental discipline contained in GATT Article III.2 cited above, that taxes on imported agricultural products not exceed those applied to like domestic products.

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<sup>27</sup> “Argentina- Measures Affecting the Export of Bovine Hides and the Import of Finished Products”. WTO Panel Report WT/DS155/R. December 19, 2000.

This study has demonstrated that Chinese regulations provide explicit exemptions and deductions on domestically produced and processed agricultural products that, when applied, lead to the VAT on domestically produced products being substantially lower than the 13 to 17 percent VAT China applies on like imported products. The study has further provided market based observations of the application of China's VAT policies on domestic agricultural products, with the empirical results demonstrating for those products examined that the VAT applied to domestic agricultural products is consistently well below the 13 to 17 percent VAT applied to like imported agricultural products.

These findings therefore demonstrate that China's VAT policies with respect to the agricultural products examined in this study are, from a *de jure* and *de facto* standpoint, in violation of GATT Article III.2.

#### *Previous Relevant WTO Dispute Settlement Cases*

##### *China Semi-conductors*

In March 2004 the U.S. requested WTO Consultations with China on what the U.S. alleged were discriminatory policies by China on the application of the Value Added Tax to imported vs. domestically produced semi-conductors.<sup>28</sup> The case is mentioned in part because the basic issues involved in the semi-conductor dispute, as they relate to the discriminatory effect of the VAT, are comparable to the issues related to China's VAT import policy on agricultural products.

In requesting WTO consultations with China, the U.S. pointed out that China applied the full 17 percent VAT to imports of semi-conductors, while refunding up to 14 percent of the VAT to domestically produced semi-conductors. China also provided a partial refund for semi-conductors designed in China but manufactured abroad. In requesting WTO consultations with China, the U.S. argued that China was in violation of Articles I and III of the GATT, China's WTO Protocol of Accession and the General Agreement on Trade in Services. At the heart of U.S. legal arguments was the requirement contained in GATT Article III.2 prohibiting discrimination against imports in the application of internal taxes.

Following several rounds of formal WTO consultations, in July 2004 the U.S. and China formally resolved the WTO dispute. In notifying the WTO that they had resolved the dispute, the two countries included a Memorandum of Understanding containing Chinese commitments on changes to its VAT policies.<sup>29</sup> In the MOU, China committed to end the VAT refund on domestically produced semi-conductors, and semi-conductors designed in China but produced in other countries. The actions were taken to eliminate the discriminatory effect of the full 17 percent VAT that would continue to be applied to Chinese semi-conductor imports.

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<sup>28</sup> "China- Value-Added Tax on Integrated Circuits", WT/DS 309/1.

<sup>29</sup> WT/DS309/7, G/L/675/Add. 1

### *Peru – Differential Application of General Sales Tax*

A recent formal WTO consultation between Chile and Peru is also relevant to China's VAT policies on agricultural products. In its notification to the WTO requesting consultations with Peru, Chile alleged that Peru was applying a general sales tax of 18 percent to imports of a wide variety of agricultural products, while that sales tax was not applied to domestically produced product in Peru. Chile complained that Peru's application of the general sales tax to imports but not to domestically produced goods was a violation of Article III. In October 2002, following several months of formal consultations, Peru issued regulations exempting imports from the 18 percent tax, thus resolving the dispute.<sup>30</sup>

### *Other Relevant Cases*

There have been a number of other previous WTO cases in which a WTO member has challenged another over application of internal taxes applied in a manner inconsistent with Article III.2 of the GATT. One such case was brought in 1997 by the U.S. and the EU against Japan for discriminatory application of liquor taxes on imports.<sup>31</sup> In finding that Japanese liquor taxes discriminated against imported products, the WTO panel made the following observation, of likely relevance to China's VAT import policies:

The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. More specifically, the purpose of Article III "is to ensure that internal taxes 'not be applied to imported or domestic product so as to afford protection to domestic production'. Toward this end, Article III obliges Members of the WTO to provide equality of competitive conditions for imported production in relation of domestic products. The intention of the drafters of the Agreement was clearly to treat the imported product in the same way as the like domestic product once they had been cleared through customs. Otherwise, indirect protection would be given".<sup>32</sup>

WTO panels made similar findings in a number of other cases. Of particular relevance is the "*Argentina – Measures Affecting the Export of Bovine Hides and Imports of Finished Leather*" mentioned earlier.<sup>33</sup> This case involved *inter alia*, Argentina's imposition of a 30 percent on imports of hides and leather, vs. a 21 percent VAT that was applied on domestically produced product. The WTO panel and Appellate Body in this case ruled *inter alia* that the additional 9 percent VAT applied on imports was in violation of GATT Article III.2, using a line of reasoning that would be directly relevant to China's VAT policies for agricultural products.

## **B. Article XVII and State Trading Issues for Grain and Oilseeds**

<sup>30</sup> (WT/DS255/5)

<sup>31</sup> "Japan Tax on Alcoholic Beverages." 1997. WT/DS 10.

<sup>32</sup> Appellate Body Report on Japan – Alcoholic Beverages, WT/DS11/8, p.16

<sup>33</sup> WT/DS155/R. December 19, 2000.



China's Notice No. 198 of the Ministry and Finance and State Administration of Taxation on Collection of the VAT for Grain Companies, dated June 29, 2009, provides that state owned grain companies are exempt from paying any VAT. This exemption also applies to rice and oilseed imports. State owned operations, principally COFCO (China National Cereals, Oils and Foodstuffs Corporation) and the Jilin Grain Group, are therefore provided a full exemption from the VAT when importing these products, while private sector importers are provided no such exemption, and must pay the full 13 percent VAT on imported grain.

From a commercial standpoint, the fact that private importers are subject to the 13 percent VAT while state trading entities are exempt from the tax puts private traders at a significant competitive disadvantage. With this policy in effect, COFCO and the Jilin Grain Group are always in a position to import grain rice and oilseeds at a price 13 percent cheaper than private traders.

In addition, as organizations that are ultimately controlled by the Chinese government, decisions by the two state trading entities on whether or not to import grain, rice and oilseeds may be driven by considerations other than price. As an example, even if grain from the United States or other international suppliers is competitively priced, COFCO or the Jilin Grain Group might make a decision not to import grain because of domestic grain stock considerations, or considerations related to the impact such imports might have on domestic grain, rice and oilseed prices.

It should be noted that in the case of China's wheat tariff-rate quota (TRQ), 90 percent is reserved for STEs, 60 percent is reserved for STEs in the case of the corn TRQ, and 50 percent in the case of the rice TRQ.

Article XVII of the GATT establishes WTO rules with respect to state trading. Paragraphs 1(a) and (b) of Article XVII read as follows:

*1.(a) Each contracting party undertakes that if it establishes or maintains a State enterprise, wherever located, or grants to any enterprise, formally or in effect, exclusive or special privileges, such enterprise shall, in its purchases or sales involving either imports or exports, act in a manner consistent with the general principles of non-discriminatory treatment prescribed in this Agreement for governmental measures affecting import or exports by private traders.*

*1.(b) The provisions of subparagraph (a) of this paragraph shall be understood to require that such enterprises shall, having due regard to the other provisions of this Agreement, make any such purchases solely in accordance with commercial considerations, including price, quality, availability, marketability, transportation and other conditions of purchase or sale, and shall afford the enterprises of the other contracting parties adequate opportunity, in accordance with customary business practice, to compete for participation in such purchases or sale.*

Article XVII.1(a) provides that if a WTO member uses a state trading entity for imports, that state trading entity should not act in a way that discriminates against private importers. Paragraph 1(b) further defines the obligations of the state trading entity to require that they make purchases solely on the basis of price, quality and other defined conditions in the paragraph.

China has clearly created a situation in which state trading entities, e.g. COFCO and the Jilin Grain Company, are afforded a distinct advantage in importing grain, because they do not have to pay the 13 percent VAT, while private sector importers do. This makes it virtually impossible for the state trading entities to act in a non discriminatory manner with respect to the private trade, because they are given *a priori* an inherent advantage in the import of grain relative to private traders. The operation of these state trading entities would therefore appear to be inconsistent with the general principle of non discrimination as it relates to private importers contained in Article XVII.1(a). As such, the benefit afforded COFCO and the Jilin Grain Group, as it relates to exemption from the 13 percent VAT for imported grain, appears to be in violation of GATT Article XVII.

Two WTO panels have given particular scrutiny to the language in Article XVII 1(a) and (b). The first was in *Canada – Measures Related to Export of Wheat and Treatment of Imported Grain*.<sup>34</sup> This WTO case related to export activities of the Canadian Wheat Board, and Canada's import policies with respect to grain. The Appellate Body in this case found that a panel must first identify discrimination as that term is defined in Article XVII.1(a) prior to determining the consistency of a state trading enterprise's activities with the specific language in Article XVII.1(b) related to price, quality, availability, etc.

*Korea – Measures Affecting Imports of Fresh/Chilled and Frozen Beef* was a case brought by the United States against South Korea for a variety of restrictions the United States claimed Korea imposed on imported beef.<sup>35</sup> The WTO Panel report in this case found that a violation of either Article XVII.1(a) or XVII.1(b) would be sufficient, by itself, to establish a violation of Article XVII.

## **2. China's Protocol of Accession**

China made specific commitments in its WTO Protocol of Accession that its application of the value added tax would be in conformance with the GATT 1994.<sup>36</sup> Those commitments are contained in Paragraph 11 of the Protocol of Accession, and repeated below.

### ***11. Taxes and Charges Levied on Imports and Exports***

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<sup>34</sup> WTO Panel Report WT/DS276R, June 24, 2004. WTO Appellate Body Report WT/DS276/AB/R.

<sup>35</sup> WTO Panel Report WT DS161/R, July 31, 2000.

<sup>36</sup> WT/L/432. "Accession of the People's Republic of China." November 23, 2001.

1. *China shall ensure that customs fees or charges applied or administered by national or sub-national authorities, shall be in conformity with the GATT 1994.*
2. *China shall ensure that internal taxes and charges, including value-added taxes, applied or administered by national or sub-national authorities shall be in conformity with the GATT 1994.*
3. *China shall eliminate all taxes and charges applied to exports unless specifically provided for in Annex 6 of this Protocol or applied in conformity with the provisions of Article VIII of the GATT 1994.*
4. *Foreign individuals and enterprises and foreign-funded enterprises shall, upon accession, be accorded treatment no less favourable than that accorded to other individuals and enterprises in respect of the provision of border tax adjustments.*

As noted in the previous section, China's VAT policies for agricultural products are in clear conflict with Article III of the GATT 1994. They are also therefore in violation of the commitments it made in Paragraph 11.2 of its Protocol of Accession related to conformity of value added taxes with GATT 1994 rules.

As noted in the section above on state trading, China also appears to be in violation of GATT 1994 rules on state trading, as contained in Article XVII. In violating GATT Article XVII related to state trading, China is also violating its Protocol of Accession, in which it committed to abide by WTO rules as they relate to the operation of state trading enterprises.<sup>37</sup> China's Protocol of Accession commitments related to state trading, as contained in Article 6 of the Protocol of Accession document, are repeated below:

### ***State Trading***

1. *China shall ensure that import purchasing procedures of state trading enterprises are fully transparent, and in compliance with the WTO Agreement, and shall refrain from taking any measure to influence or direct state trading enterprises as to the quantity, value, or country of origin of goods purchased or sold, except in accordance with the WTO Agreement.*
2. *As part of China's notification under the GATT 1994 and the Understanding on the Interpretation of Article XVII of the GATT 1994, China shall also provide full information on the pricing mechanisms of its state trading enterprises for exported goods.*

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<sup>37</sup> China's Protocol of Accession, Paragraph 6.2, provides as follows: "China shall ensure that import purchasing procedures of state trading enterprises are fully transparent, and in compliance with the WTO Agreement, and shall refrain from taking any measure to influence or direct state trading enterprises as to the quantity, value, or country of origin of goods purchased or sold, except in accordance with the WTO Agreement."

### 3. VAT Exemption as a Possible Subsidy

In general, WTO law treats government “revenue foregone,” including tax credits and tax exemptions, as subsidies. Article 1.1 of the Subsidies Agreement describes certain condition under which subsidies are deemed to exist, including where “government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits).”<sup>38</sup> Annex 3 of the Agriculture Agreement, which provides instructions to WTO Members for making their AMS calculations, provides that “[S]ubsidies under Paragraph 1 shall include both budgetary outlays and revenue foregone.”<sup>39</sup>

WTO dispute settlement cases involving tax policy —most notably the *U.S. – Foreign Sales Corporation* and *Canada – Civil Aircraft* cases – also support the view that both full and partial tax exemptions can result in “revenue foregone” under the meaning of both the WTO Agriculture and Subsidies Agreements.<sup>40</sup>

#### *WTO Agriculture Agreement*

As noted, there is strong support in the text of WTO agreements and in WTO case law and in WTO practice for the view that a tax exemption is governmental revenue foregone and therefore a subsidy. It is also clear that, for the purposes of the WTO Agriculture Agreement, a tax exemption, as revenue foregone, is to be considered to be an “amber box” subsidy and is, generally, to be included in a Member’s calculation of its Aggregate Measure of Support (AMS). See Agreement on Agriculture, Annex 3.2.

Article 6.4 of the Agreement on Agriculture permits a Member to provide subsidies to agricultural producers and not have those subsidies count against its AMS commitment if the subsidies in question are considered *de minimis*. Article 6.4 defines two types of *de minimis*, one based on the value of the subsidy compared to the overall value of agricultural production, and another based on the value of individual product production. At the time of its WTO Accession, China was given a *de minimis* level of 8.5 percent.

When China acceded to the WTO, it notified the WTO of certain trade distorting agricultural subsidies that were in place during the applicable historic base period. However, since the value of those subsidies was below the *de minimis* threshold, China’s WTO AMS limit became, by application of the rules, effectively zero,<sup>41</sup> and China was not obliged to take on domestic support reduction commitments. This means that if China’s exceeds either its non product specific *de minimis* threshold, or

<sup>38</sup> See Subsidies Agreement, Article 1.1(a)(ii).

<sup>39</sup> See, Agreement on Agriculture, Annex 3.2

<sup>40</sup> “*United States – Treatment for “Foreign Sales Corporation”*”. Report of the Panel WT/DS 108/R8, October 1999. “*Canada- Measures Affecting the Export of Civilian Aircraft*”, Report of the Panel, WT/DS70/R, April 1999.

<sup>41</sup> See China’s WTO Schedule of Concessions for domestic agricultural support at [http://www.wto.org/english/thewto\\_e/countries\\_e/china\\_e.htm](http://www.wto.org/english/thewto_e/countries_e/china_e.htm). WTO Document G/AG/N/CHN/8 for China’s most recent WTO domestic support notification, reflecting its AMS ceiling of zero.

any product specific *de minimis* threshold, it is in violation of its WTO commitments with respect to agricultural subsidy spending, as contained in the WTO Agriculture Agreement.

Two key questions with respect to the WTO Agriculture Agreement and China's VAT exemption are (1) whether the VAT should be considered "product-specific" or "non-product-specific;" and (2) how to calculate the value of the subsidy being provided.

A careful reading of China's VAT related regulations appears to indicate that the VAT exemption is in fact accorded to all agricultural producers, and all agricultural products.<sup>42</sup> If this is the case, then relevant disciplines for purposes of Article 6.2 of the WTO Agricultural Agreement would be the non product specific *de minimis* limitation.

The total value of China's agricultural production is estimated at \$422 billion.<sup>43</sup> Using China's 8.5 percent *de minimis* allowance, this would result in a non product specific *de minimis* threshold of \$35.87 billion. If the VAT exemption is determined to be a non product specific subsidy, since it is available to the entire agricultural sector, a rough estimate of the subsidy value of the exemption can be obtained by multiplying 13 percent by \$422 billion, giving a subsidy value of \$54.86 billion.<sup>44</sup> This number is far in excess of the estimated non product specific *de minimis* of \$35.87 billion.

Any subsidies provided through the VAT exemption that count against China's AMS limit would be in addition to other product specific subsidies already being provided to Chinese producer groups. Based on our research, numerous commodity groups in China, including the wheat, feed grain, rice, oilseeds, pork, apple and almond industries, are receiving central government or provincial government subsidies that would likely be viewed as Amber Box subsidies under WTO rules.

In addition, although it is beyond the scope of this study, it is also likely that corporate tax exemptions China provides the agricultural sector would also be considered amber box subsidies for purposes of the Agriculture Agreement.

### *Subsidies Agreement Considerations*

It is worth noting that, irrespective of whether the VAT exemption is included in the calculation of China's AMS, if this exemption is determined to be a subsidy under the Subsidies Agreement, it might, depending on its effect on China's agricultural

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<sup>42</sup> Notice No. 52, 1995, Ministry of Finance and the State Administration of Taxation. See Item 3 in Table 1 of this report. The VAT is applied to most other sectors of the economy.

<sup>43</sup> CIA Factbook, China.

<sup>44</sup> This is a rough estimate based on the assumption that the VAT applied to all agricultural transactions in China is a nominal 13 percent. In fact, the VAT on value added transactions is 17 percent. However, it is also true that, as demonstrated in this report, processed products and value added products receive a VAT exemption that is in most cases less than the full 13 or 17 percent. To the extent that the \$422 billion estimate of the value of agriculture in China includes value added processing, the *de minimis* estimate we provide might be something of an overestimate.

economy and trade, result in “serious prejudice” to U.S. interests, as that term is defined in the Subsidies Agreement. We believe the subsidy is actionable because it is specific, as that term is defined in Article 2.1 of the Agreement.<sup>45</sup>

Article 5 and 6 contain the key disciplines of the Subsidies Agreement. Article 5 provides that no Member should cause adverse effects through the use of a subsidy, as that term is defined in Article 1. Among the adverse effects described in Article 5 is “serious prejudice”.<sup>46</sup>

Article 6.3 provides that “serious prejudice” may arise if:

*(a) the effect of the subsidy is to displace or impede the imports of a like product of another Member into the market of the subsidizing Member;*

*(b) the effect of the subsidy is to displace or impede the exports of a like product of another Member from a third country market;*

*(c) the effect of the subsidy is a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market;*

*(d) the effect of the subsidy is an increase in the world market share of the subsidizing Member in a particular subsidized primary product or commodity as compared to the average share it had during the previous period of three years and this increase follows a consistent trend over a period when subsidies have been granted.*

It is likely that China’s VAT exemption policy has a production augmenting effect, because it relieves China’s agricultural producers and processors of a tax burden imposed on other sectors of the economy, thus increasing profits and, as a consequence, the incentive to produce. Assuming that this is true, then it is likely that the VAT policy leads to one or more of the conditions described in Article 6.3 cited above, e.g., price suppression or depression, the displacement of imports, and/or the displacement of exports by other WTO members in third country markets.

### **3. Remedies**

#### **GATT Article III.2 and Discrimination**

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<sup>45</sup> As noted in the earlier quotation of Article 2.1 of the Subsidies Agreement, the Agreement considers a subsidy to specific when it is limited to “certain enterprises”. This is certainly the case with respect to the VAT exemption, which is provided only to certain agricultural enterprises and a limited group of other economic enterprises.

<sup>46</sup> Footnote No. 13 in Article 5 makes it clear that this includes also the “threat of serious prejudice.”

If China was found to be in violation of GATT Article III.2 rules related to discrimination, it would need to remedy the situation by ensuring that the value added tax applied to imports was not in excess of that applied to like domestically produced product. It could do so in one of two ways, either by lowering the VAT on imports to the level of the domestically applied VAT for the product in question, or by raising the VAT applied to domestically produced product to the full 13 to 17 percent applied to imported products.

It is worth noting, that in the case of the U.S. challenge of China's VAT policies for semi-conductors, China remedied the problem by increasing the domestically applied VAT on semi-conductors to the same 17 percent level applied to the imported product.<sup>47</sup> As a remedy, China could take the same approach in the case of the VAT on agricultural products, raising the VAT on domestically produced products to the same 13 to 17 percent level applied to imports. However, it is highly questionable whether China could afford to take this approach, given the effect that such a move would have on food prices and the significant economic implications for the very large rural population in China. Given an adverse WTO ruling, it is in our view far more likely that China would choose to reduce the VAT on imports to the levels applied domestically for various agricultural products. Regardless of whether China lowered the VAT on imports or increased the domestic VAT to the import VAT to the domestic VAT level, it would for purposes of WTO rules remove the discrimination created by the dual VAT policy, and thereby put U.S. agricultural products on a more competitive footing in the Chinese market.

#### *WTO Agriculture Agreement and WTO Subsidies Agreement*

Disregarding the remedies mentioned above with respect to the discriminatory effect of China's VAT exemption, if it was demonstrated that the VAT exemption was a subsidy as defined in the WTO Agriculture Agreement, and the value of that subsidy exceeded China's non product specific *de minimis* levels, then the VAT exemption would need to be reduced to a level where it did not generate a subsidy in excess of the relevant *de minimis* level.

If it was demonstrated that China's VAT exemptions resulted in "serious prejudice," as defined in the WTO Subsidies Agreement, then China would need to reduce the VAT exemption to a level that removed the serious prejudice.

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<sup>47</sup> WT/DS309/8/ G/L/675/Add.e. October 2, 2005. "China Value Added Circuits".