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The effect of export tax rebates on export performance: Theory and evidence from China

Chien-Hsun CHEN [a], Chao-Cheng MAI [b,*], Hui-Chuan YU [c]

[a] *Chung-Hua Institution for Economic Research, 75 Chang-Hsing St., Taipei 10671, Taiwan*

[b] *Graduate Institute of Industrial Economics, Tamkang University and Research Center for Humanities and Social Sciences, Academia Sinica, 128 Sec. 2, Academia Rd., Nankang, Taipei 11529, Taiwan*

[c] *Graduate Institute of Industrial Economics, Tamkang University, Tamsui 25137, Taiwan*

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Abstract

This paper develops a Cournot quantity competition model to examine the effect of export tax rebate policy on export performance. The main conclusions drawn are as follows: (i) when a government raises the export rebate rate, the output of final goods for export by the domestic firm increases, while the output of the foreign competitor decreases; (ii) when a government raises the export rebate rate, the profit of the domestic firm increases, while that of the foreign competitor decreases; and (iii) the optimum export rebate rate is positive and greater than 1, indicating that the domestic government not only refunds fully the custom duties paid by the domestic firm on imported intermediate goods, but also offers export subsidies for its export of final goods.

To corroborate the conclusions drawn based on the theoretical model, empirical analysis was carried out using the statistical data of China from 1985 to 2002. The test results of Spearman rank correlation coefficient show that China's export tax rebate policy has significant positive correlation with its exports, final domestic consumption, and foreign exchange reserve.

JEL classification: F1; H2; P3

Keywords: Export tax rebate; Cournot quantity competition model; China's export

* Corresponding author. Tel.: +886 2 2782 1693x130; fax: +886 2 2785 4160.
E-mail address: ccmai@gate.sinica.edu.tw (C.-C. Mai).

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1. Introduction

Export tax rebates are an important trade policy tool for promoting exports. They entail the refund of value-added tax and consumption tax already paid on exported goods during production, circulation and sales. The aim is to let the exported goods enter the international markets at tax-excluded prices without being subject to double taxation, so as to promote export trade. Export tax rebates are allowed by the rules of the World Trade Organization and are commonly adopted by many countries.

China began implementing export tax rebate policy in 1985. In its 1994 tax system reform, the zero tax rate policy for exported goods has been declared. China's *Provisional Statute for Value-added Tax* also stipulates a zero tax rate for exported goods; its *Provisional Statute for Consumption Tax* stipulates a consumption tax exemption for taxable consumer goods designated for export. The Chinese government also drafted relevant provisions and measures, including the *Regulations Governing Export Tax Rebates (Exemption)*, which specifies the refund or exemption of value-added tax and consumption tax for exported goods. Presently the export tax rebate in China applies mainly to the refund of value-added tax (VAT) and consumption tax already levied during the domestic production or sales of exported goods. In light of the fact that the consumption tax applies to only a few consumer goods, the export tax rebate predominantly covers VAT paid. Value-added tax in China is levied by three categories: a 17% basic rate applied to general goods, processing and repair service; a lower 13% rate applied to farm produce, feeds, chemical fertilizers, medication, household water consumption, printed books, and newspapers; and a 0% rate applied to exported goods. Moreover, China adopts the production-type VAT, where VAT in relation to fixed assets purchased for the production of the exported goods is not deductible. Thus the prices of exported goods actually contain tax levied.

China's export tax rebate system is defective to some extent. Some unlawful enterprises bilk the government out of rebate money with fake VAT invoices, while law-abiding enterprises are faced with convoluted tax rebate procedures or have to wait for the refund for a considerable period of time due to the tax rebate quota. China's accumulated approved export tax rebate that has not been refunded to enterprises totaled 144 billion *renminbi* (RMB) in 2001, 200 billion RMB in 2002, and 277 billion RMB in 2003. The export tax rebate payable is owed predominately to enterprises along the southeast coast of China. In the case of Zhejiang province, it amounted to 4.725 billion RMB in 1999 and escalated to 40.8 billion RMB in 2002.

China's export tax rebate system has not stayed steady since 1994. The rebate amount has been rising continuously as exports grow. In the span from 1985 to 2002, the rebate amount rose 69 times from 1.795 billion RMB to 125.8 billion RMB. The central government slashed the rebate rates a couple of times, for example, in 1995, 1996 and 2004, to alleviate its fiscal burden.[1] In some other years, prompted by the macroeconomic situation, the government raised the rebate rates to encourage exports, as in the case of 1997, 1998, and 1999.

During 1997, when the Asian financial crisis broke out, China was faced with steep challenges in exports. The simplest and most direct measure to boost exports is to depreciate the country's currency. But *renminbi* depreciation at that juncture would have produced a serious impact on the world economy, and China reiterated on many occasions its resolve not to depreciate its currency. Faced with the dilemma of declining export competitiveness and the inability to depreciate the *renminbi*, raising the export tax rebate rate became the best alternative to China at

[1] China's central government budget deficit reached 309.687 billion RMB in 2002, while the export tax rebate amounted to 115 billion RMB, 15% over the allocated budget.