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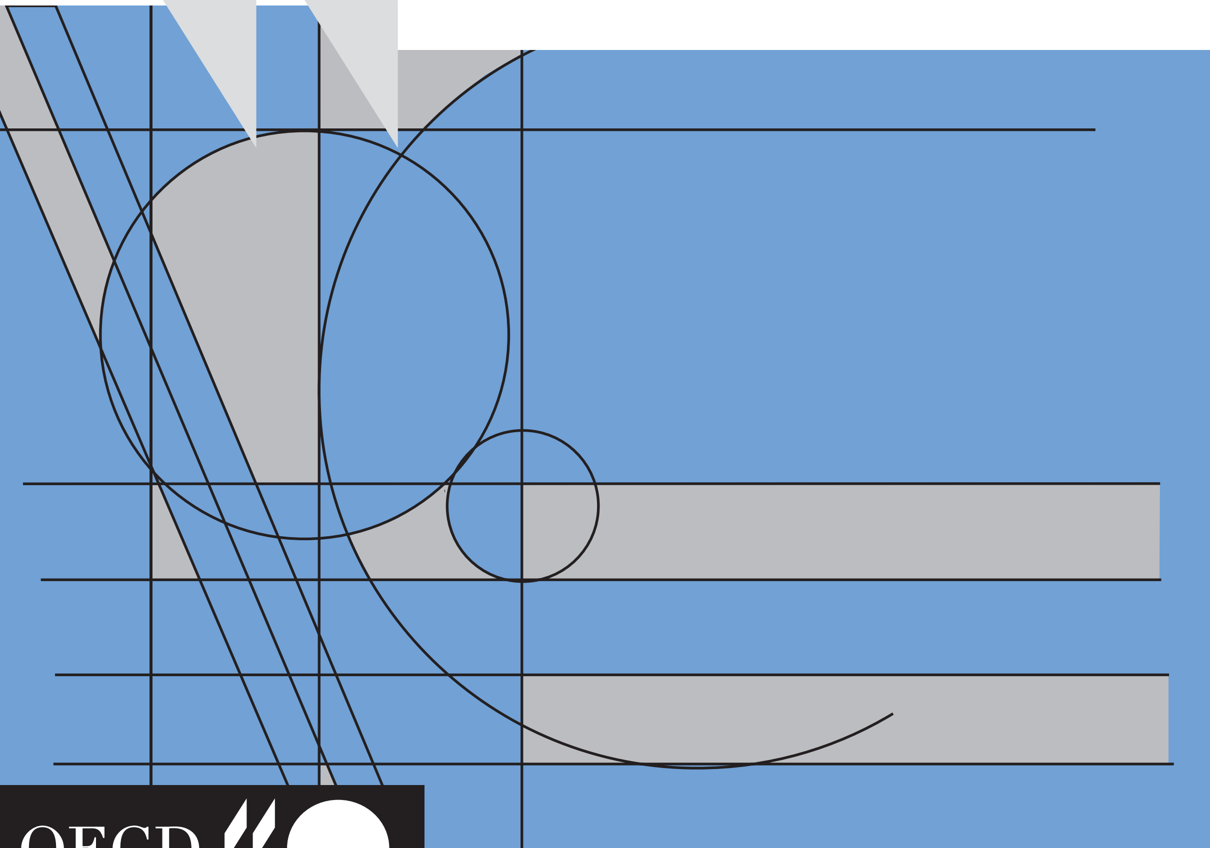

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OECD Investment Policy Review

China

Progress and Reform Challenges

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Foreword

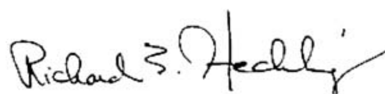
This OECD report examines China's progress to date in developing a policy framework to attract and make good use of foreign direct investment (FDI) since China's economy began to open to international trade and investment in the late 1970s. It outlines the challenges that still face the Chinese government in its efforts to attract more high-quality FDI and draws on the experience of OECD member countries to offer a range of policy options to address these challenges.

Although China became the world's largest recipient of FDI in 2002, the country continues to rank below OECD economies and several major developing countries in terms of FDI inflows per capita. Also, while OECD countries provide over 90% of FDI globally, their share of FDI in China is much smaller. Accordingly, China has now a goal of attracting long-term, relatively capital-intensive and high-tech projects from multinational enterprises in OECD countries. Improvements in the business environment that will help achieve this goal will also have the broader effect of increasing domestic investment.

Many of the changes needed have already been set in motion. For instance, a number of services industries are gradually being opened up to foreign investment following China's accession to the WTO at the end of 2001. Removal of performance requirements for foreign-invested projects, stronger enforcement of intellectual property rights and greater transparency are also encouraging greater foreign investment in China.

Yet much remains to be done in areas such as ensuring local compliance with national policies, streamlining the foreign investment project approval process, further removal of sectoral FDI restrictions and prohibitions, and opening capital markets to foreign participation. Also, further progress needs to be made in the areas of increasing the transparency of the FDI regulatory framework, strengthening intellectual property protection, and improving the functioning and independence of the legal system

These and other issues are outlined in this report, the aim of which is to provide a positive input to China's decision-making on FDI policies based on the experience of OECD member countries. The report, which has benefited from comments from Chinese government agencies and the OECD committee in charge of investment, is an important element of the growing programme of co-operation between China and the OECD.



Richard Hecklinger
Deputy Secretary-General

Note by the editor

This report has been developed as part of the work programme of the OECD's Committee on International Investment and Multinational Enterprises and under the auspices of the OECD's Centre for Co-operation with Non-Members. It has been prepared in the context of continuing co-operation between the Ministry of Commerce (MOFCOM, formerly the Ministry of Trade and Economic Co-operation, MOFTEC) of the People's Republic of China and the OECD.

The report has benefited from the views of the Chinese authorities, members of the Committee on International Investment and Multinational Enterprises and consultations with the private sector and other partners. It is based on a study prepared by Ken Davies, principal administrator in the Capital Movements, International Investment and Services Division of the OECD Secretariat. The study has benefited from contributions on tax matters by Dagmar Balve-Hauff and on China's FDI statistical methodology by Ayse Bertrand and from comments from Rainer Geiger, Pierre Poret and other colleagues in the Directorate for Financial, Fiscal and Enterprise Affairs.

The report is published under the responsibility of the OECD Secretary General as a tool for fostering further dialogue and co-operation between the OECD and the Chinese authorities in support of China's reform efforts in the field of international investment.

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Preface

Foreign investment absorption is a key component of China's basic state policy of opening to the outside world. During its nearly twenty-five-year-long reform and opening up, China has steadfastly adhered to its opening-up policy, vigorously developed foreign trade and actively absorbed foreign investment, having made world-renowned achievements. After being the largest FDI (foreign direct investment) recipient among all the developing countries for nine consecutive years since 1993, China ranked the first in the world in terms of FDI inflow in 2002. By the end of April 2003, 436 394 foreign-invested enterprises had been established in China, with actually utilized foreign investment of over US$460 billion. Investors come from over 180 countries and regions. Over 400 multinational companies out of the world's top 500 have made investment to establish their operations in China.

Twenty five years' practice has proven that the active and rational foreign investment utilization has promoted the sustained, rapid and sound development of China's national economy, and has played an active role in advancing the reform of China's economic system, introducing advanced technology and management expertise, facilitating economic restructuring and industrial upgrading, creating more job opportunities and increasing the state revenue. Meanwhile, with the rapid growth of its FDI inflow, China has furthered and improved its involvement in the economic globalization, and contributed actively to the world's economic development and common prosperity.

China has outstanding comparative advantages in foreign investment absorption for enjoying political and social stability, abundant natural resources, high-quality and low-cost human resources and one domestic market with great potential.

The long-term devotion of the Chinese government to improving its soft environment for foreign investment and strengthening its comprehensive national competitiveness is a decisive factor contributing to the sustained and rapid growth in its foreign investment absorption. In particular, since China's accession to the WTO, the Chinese government has been faithfully honoring its commitments and attaching greater importance to building the legal

framework for foreign investment. Along with an overall adjustment, the existing laws, regulations and rules governing foreign investment have been improved and a legal and regulatory framework for foreign investment is in initial shape, which both fits the current national situation and conforms to the WTO principles of uniformity and transparency. In addition, the Chinese government has implemented a series of foreign investment incentives, further expanded the areas open to foreign investment and stepped up the protection of intellectual property. China's WTO membership uplifted its investment environment to be notably and increasingly attractive to overseas investors.

The Chinese government will unswervingly pursue its basic state policy of opening up and continue to implement various policies to encourage foreign investment. To raise the level of foreign investment absorption, the Chinese government will further improve its foreign related economic as well as legal and regulatory framework and maintain the stability and consistency of its foreign investment policies to create a sound legal environment. Also it will further transform the government functions, improve work efficiency, promote service consciousness and create a sound administrative environment. At the same time, it will continue to rectify and regularize the market economic order, fight counterfeit and piracy, protect intellectual property and create a market environment of uniformity, openness, fair competition, standardization and good order. The Chinese government will press forward all-roundly with its opening up in the service trade sector and in such infrastructure building areas as energy, transportation and telecommunications. It will participate in the process of economic globalization with a more active stance, further promote opening-up in multiple directions, levels and areas, and to facilitate its modernization drive.

OECD members are active investors in China. By April 2003, a total number of 117 180 enterprises had been established by OECD members through investment in China, and the actual input of capital in China amounted to USD14.04 billion, accounting for 26.85% and 30.14% respectively of China's accumulative foreign investment absorption. Enterprises receiving investment from OECD members are concentrated in the eastern seaboard of China, all boasting a high capital intensity and technical content. Most enterprises are in sound operation and generate relatively high returns on investment for investors.

The Ministry of Commerce of the People's Republic of China attaches great importance to the long-term cooperative relationship with OECD in terms of foreign investment promotion. In recent years, both sides have made great progress in collaboration in such areas as training for investment promotion staff, optimization of the foreign investment statistical system, and research on foreign investment policies. On the basis of in-depth research of China's foreign investment absorption, the OECD compiled "Investment

Policy Review of China: Progress and Reform Challenges". This research report gives credit to China's accomplishments in FDI absorption, favorably evaluates the role of foreign investment in China's national economic development and elaborates on the prospects of China's economic development and its policy and legal framework on foreign investment absorption. The report also sheds illuminating light through proposals on how to further expand China's foreign investment absorption scale and improve the quality and level of efforts in this regard.

"Investment Policy Review of China: Progress and Reform Challenges" will surely furnish OECD members investing or intending to invest in China with more information and render more assistance in China's endeavor to improve its investment climate. China welcomes more investors from OECD countries to come and cooperate with Chinese enterprises so as to jointly shape a bright future.

Madame Ma Xiuhong

Vice Minister

Ministry of Commerce of the People's Republic of China

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Chapter 1

Overview of progress and policy challenges

Abstract. *China has made progress in providing a business environment conducive to foreign direct investment (FDI). The challenge now is to move towards a more rules-based policy framework that will attract high-quality FDI from OECD countries. The OECD proposes a number of policy options for the Chinese government to consider in further developing such a framework. These include additional streamlining of the investment project approval process, reconsideration of unnecessary sectoral restrictions on foreign investment, and measures to increase transparency and strengthen the rule of law.*

A. OVERVIEW

China has been highly successful in attracting foreign direct investment (FDI) and significant progress has been made in improving the FDI policy framework. However, there remains an unexploited potential to attract FDI from OECD countries. Continuing efforts need to be made both in bringing laws and regulations into conformity with internationally recognised standards and in ensuring their implementation at local level. Policy options are available to enable China to develop a more rules-based system.

1. China has made significant progress in providing a business environment conducive to FDI

China has made significant progress in providing a business environment conducive to FDI since the major shift to economic reform in 1978, as evidenced in this study. A closed economic system has been rapidly opened to trade and investment. Major economic institutions have been replaced or transformed. Others, like the state-owned enterprises (SOEs) and the financial system, are undergoing lengthy reform that will bear fruit in the future.

FDI has played an important role in China's economic development for nearly a quarter of a century. It has enabled China to establish new branches of industry and Chinese consumers to experience a far wider range of goods and services. It has brought in new technology in many fields. Foreign-invested enterprises (FIEs) have provided employment, much of it embodying training and experience in both technological and managerial skills which are transferable to domestic enterprises. FDI has played a major role in expanding China's international trade, which has developed to half of GDP. FIEs now account for half of China's two-way merchandise trade. They provide employment directly and indirectly to many millions of employees.

At the same time, it is worth bearing in mind that China receives far less FDI per head than many developing as well as developed countries and that much FDI in China still takes the form of short-term, labour-intensive manufacturing, while investment in high-tech activities, particularly in services sectors, lags behind. There is therefore still much scope for raising the quality of FDI as well as continuing to increase its quantity.

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2. Following WTO accession, the challenge is to attract high-quality FDI

The challenge now is to attract more long-term, capital-intensive, high-tech, high-value-added projects in more sectors of the economy. China also needs to adopt policy frameworks designed to ensure that spillovers from the foreign corporate presence to the domestic economy are optimised.

China's accession to the WTO has already brought about major advances in FDI policy. In addition to the removal of trade-related investment measures (TRIMs), China is also opening its services sectors, including the financial sector. Existing FIEs may now distribute their products in China and engage in foreign trade. These changes will provide opportunities for OECD members to play a bigger role in making direct investments in China.

Multinational enterprises in OECD countries have the capital and the technology to be able to provide longer-term projects embodying advanced production methods. However, OECD members have between them provided a disproportionately small amount of FDI to China, especially by comparison with their relatively large share of China's merchandise trade.

3. Towards a rules-based FDI attraction strategy

FDI has in the past been attracted to China partly by incentives such as lowered taxes. Such incentives were effective in the early period of reform and opening up in the early 1980s to the extent that they were perceived as compensating in part for the lack of a pre-existing business and infrastructure capable of accommodating foreign investment. They also drew attention to the attraction of China as an investment destination at a time when it was not yet widely perceived as such. It is not clear that such a rich set of incentives is necessary for attracting FDI now that China is now well on the global investment map. As pointed out later in this study, recent surveys show that foreign investors are much more concerned about the overall regulatory regime than about incentives.

Financial incentives for foreign investors can best be reconsidered when this process is part of a broader effort to make the overall national tax system fairer, simpler, more transparent and more conducive to private investment, whether foreign or domestic. Such enhancement may reasonably be rated a greater priority than abolishing fiscal incentives before the deficiencies for which they are perceived as providing some compensation have been rectified.

A recent OECD report on FDI for Development confirms that foreign investors prefer to locate investments – especially large, long-term investments – in countries and territories that have predictable policy regimes. Major changes in policy and legislation require sufficient preparation

and consultation time, and it is highly advisable that foreign investors be given an opportunity to express their views before changes are implemented.

In addition to fiscal incentives, the Chinese government has worked hard to attract FDI by making investment in China more convenient. Measures to accomplish this aim include the reduction of delays in approving FDI projects and the expansion and improvement of the physical infrastructure. These measures enhance the investment environment for FDI and may also benefit domestic enterprises. Such convenience-based attraction measures can be used by local authorities to compete with each other to attract FDI. Such competition is healthy because it improves the overall national business environment without the risk of exhausting fiscal resources.

A sound legal system is a major pillar of the rules-based investment environment that is beginning to take shape in China, where the government has, in a remarkably short period of time, established a wide-ranging body of FDI-related legislation. It is also striving to develop an impartial and effective court system, but, for institutional and manpower reasons, this work will take years, rather than months, to achieve its objective.

Effective implementation of law matters because investors, whether foreign or domestic, need to have guaranteed property rights, including intellectual property rights (IPR). Many countries, including some of China's neighbours, have gone through a stage of copying the products of their competitors. But, as the history of world technology shows, Chinese people are themselves highly inventive when the institutional framework allows them to be so. The sharply rising number of domestic patents is testimony that this is still true. Much stronger implementation of China's IPR protection legislation and its international commitments in this regard is needed, not just to attract FDI but also to stimulate domestic creativity.

Transparency requires the establishment of a legislative and regulatory regime that is stable, internally consistent and publicly available in an understandable form. Coherence between national and local legislation and regulation is required by WTO, OECD and other internationally recognised standards. The existence of internal, undisclosed rules governing investment project approval, for instance, is not compatible with the principle of transparency.

Consultation with the foreign investor community on new FDI-related legislation and regulations does now take place, but it still tends to be selective, so that some major foreign investors who consider themselves to be the key players in a specific sector complain about being left out. In OECD countries, the free climate of discussion and debate facilitates the formulation of new laws by allowing the public, including all interested parties, to raise objections and make suggestions before laws are passed. Waiting until after the laws are

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promulgated to find out what are the problems in implementing them complicates the situation by obliging the government to issue, in addition to the original law, sets of implementing regulations and revised laws.

In moving towards a rules-based FDI attraction strategy, there is a concomitant move to competition based on raising standards in areas such as environmental protection and labour management. An important aspect of this change of strategy is a move from lax to strong implementation of environmental standards. A country or locality that does this could deter investment by polluting industries, but will more certainly attract FDI from companies in services sectors and in high-technology manufacturing, because these will be seeking locations capable of attracting and retaining staff who are highly mobile and who do not wish to live in unpleasant environments.

Even where a dominant state-owned enterprise has been partly privatised, there is no guarantee that it will cease to exercise monopoly power not justified by the nature of the market concerned. Competition policy needs to be strengthened to make it easier for new companies, whether domestic or foreign-invested, to enter the market. Competition policy is particularly important as state-owned enterprise reform reaches a new stage in which foreign corporations play an increasing role in privatisations, allowing them to contribute positively to industrial restructuring that will greatly increase industrial productivity.

The increasing part played by mergers and acquisitions in FDI will necessitate more effective prudential regulation of China's capital markets and a visible improvement in the general standard of corporate governance. Bank reform will also have to be completed if the financial system is to be strong enough to fulfil its function in this process.

4. Improving the operating environment for FDI will benefit domestic enterprises

The experience of OECD countries is that a regulatory environment that is conducive to competition and in which foreign-owned enterprises are generally treated no differently from domestically-owned enterprises provides the best basis for the development of home-grown enterprises. China's own experience is also instructive in this regard. The enabling environment established for foreign business in the Special Economic Zones (SEZs) and other open areas has proved fruitful for the emergence of thriving domestic private enterprises, which represent a larger share of output there than in hinterland provinces. Most of the cases heard by the IPR courts, which were established partly in order to respond to problems faced by foreign investors, have been brought by domestic plaintiffs. Those industrial sectors that have been opened wide to FDI are already characterised by more

successful domestic firms, while protected sectors have generally remained dominated by state monopolies that are often inefficient and provide customer service that is not always satisfactory. Fears that liberalisation of these sectors would lead to domination by FIEs are largely unfounded, provided such liberalisation is accompanied by the development of vigorous anti-monopoly and competition legislation applied in non-discriminatory fashion to both domestic and foreign firms. Improving consistency will require improved co-ordination and strengthening of administrative structures which will benefit public governance. Steps in this direction could include:

- The appointment of a single agency, for example MOFCOM, to play a co-ordinating role in developing China's FDI policy, including co-operation with the OECD.
- The establishment of an inter-ministerial group to examine, develop and implement FDI policies.

B. POLICY OPTIONS

1. Consolidating gains from WTO accession

The commitments that China entered into when it acceded to the WTO represent a major step forward in the liberalisation of its investment regime, in particular in relation to trade-related investment measures (TRIMs) and intellectual property rights (IPRs) covered by WTO requirements. A major effort is being made to fulfil these commitments, supported by other WTO members.

Local protectionism

While there is no doubt that the central government is determined to live up to these expectations arising from WTO accession, it appears that protectionist opposition survives at local, enterprise and, in some instances, ministerial level. Local authorities are prohibited from engaging in local protectionism, according to a government regulation adopted in April 2001, but it is not yet clear to what extent this prohibition has been effective. To ensure that foreign investors and other observers understand that all possible efforts are being made to ensure compliance with WTO obligations relating to FDI at local level, steps to be taken by the Chinese authorities could include:

- Preparing an annual report on local compliance with regard to investment-related commitments, listing the problems that have been encountered and the measures taken to deal with them.
- Ensuring that the Provisions on Guiding Foreign Investment Direction remain in conformity with agreed practices relating to performance requirements, including Article 10 on export sales requirements.

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Transparency and regulations governing the approval process

The existence of internal (*neibu*) regulations governing the process by which FDI projects are approved alongside public (*gongkai*) regulations is not transparent. It is reported that some local *neibu* regulations persist, and that they are generally more restrictive than national legislation and regulations. The existence of unpublished regulations permits the existence of rules that would not be acceptable if they were published. However, unless such unpublished regulations are made public, it is not possible to judge whether or not they are acceptable.

The Chinese government is already familiar with this problem and is committed to solving it following WTO accession. The rational solution involves a two-step procedure:

- It may be considered advisable that all local-level *neibu* rules and regulations should be disclosed, that is, converted to *gongkai* rules and regulations, initially by the local authorities that administer them to MOFCOM at national level, then by MOFCOM to the public, including foreign investors, along with any *neibu* rules still operating at national level.
- After full disclosure, it may be considered advisable that such rules, where they are inconsistent with national law or with other regulations or are in breach of China's international obligations, be abolished. Otherwise, if they are considered worthy of retention and are both compliant with China's international obligations and consistent with domestic legislation, they may be incorporated into existing *gongkai* regulations or promulgated separately.

2. Other measures for attracting and maximising the benefits of FDI

China's existing international commitments are a milestone on the road to liberalisation, not full liberalisation itself. In moving towards a fully rules-based FDI attraction regime further investment liberalisation measures could enhance the operating environment for FDI.

Further liberalisation of the approval process

Streamlining the approval process

The approval process could be amended to obviate unnecessary delays and obstacles in the approval process. Possible solutions may include:

- Raising the FDI project value limit above which approval has to be submitted to central government departments at national level and increasing the approval powers of local governments accordingly.
- Reclassifying projects from restricted to permitted or from permitted to encouraged, as appropriate, in accordance with a set timetable, to ensure

that they are submitted for approval at local, not national, level. (Unless and until the catalogues for guidance of foreign investment industries are replaced by an alternative guidance framework, as recommended below.)

- Reducing the number of steps in the approval process by merging and elimination to produce a genuine "one-stop shop" procedure.
- Fast-tracking the national-level approval process by allocating more resources, including staff, to it and reorganising the process to make it more efficient.
- Providing an acceptable time limit for approval or non-approval of a project by the examining and approving authority or authorities.
- Eventually introducing automatic approval within a reasonable time limit for all projects meeting the published approval criteria in full.

Separating FDI approval from other operations

It is inappropriate to maintain the FDI project approval process as part of administrative procedures that are the legacy of a central Reform system that has long ago fallen into disuse.

The separation could be made clearer by:

- Separating FDI approval by the State Development and Reform Commission (SDRC) from the SDRC's function of approving investment plans by domestic state-owned enterprises (SOEs).

It is confusing and inappropriate for authorities concerned with FDI approval to be also engaged in local FDI promotion/attraction activities. Although specialised bodies have been set up for FDI promotion in many localities, in others the activities are still located in the same body.

Remaining confusion could be obviated by:

- Establishing separate bodies for FDI approval and FDI promotion at all levels where this has not already been done.

Regional incentives

To the extent that the investment incentives available to FIEs are the same as those on offer to domestic enterprises, the policy of attracting capital investment to the Western and Central regions is consistent with the principle of national treatment. However, such incentives do not constitute a sufficient condition for increased investment in those regions. If the Chinese government wishes to redirect investment westward, it may prefer to put the main emphasis on improvements in the business environment there.

The current policy of allocating state funds to infrastructure construction in the Western and Central regions is already an important part of this effort.

Institutional development is also necessary. Steps to ensure such development could include:

- Raising the standard of investment promotion and investment approval in these regions to that prevailing in the open coastal zones, where the authorities are generally much more flexible in their interpretation of FDI laws and regulations.
- Organising visits by officials in the Western and Central regions to their counterparts in SEZs and other open zones in the Eastern Region to share experience and gain a deeper understanding of procedures that have been successful in attracting investment.

Such measures would be relatively cost-effective and would retain their relevance even if the "invest in the West" policy were to be modified.

Reconsidering remaining ownership restrictions

As detailed in Chapter 3 of this study, market-access commitments in both industrial and services sectors already allow full foreign ownership of individual enterprises in a range of sectors within a reasonable time frame varying in most cases from 3 to 5 years (in reinsurance, wholly foreign-owned enterprises were allowed on accession, management consultancies will only be permitted wholly foreign ownership after 6 years). But not all sectors will be so fully opened up. There will still be restrictions within sectors that are scheduled for greater market access.

In view of the positive experience to date of sectors that have been opened to 100 per cent foreign ownership, the next steps in opening up could include:

- Publishing a consolidated list of all foreign ownership restrictions in all sectors.
- Explaining the reasons for each of these ownership restrictions.
- Progressively removing remaining foreign ownership restrictions.
- Phasing in full foreign ownership in the remaining sectors over a period similar to that prevailing in other sectors under existing commitments where no such case can plausibly be made.

The catalogues for guiding foreign investment

Following China's accession to the WTO, three revised catalogues for guiding foreign investment (respectively: encouraged, restricted and prohibited) took effect in April 2002. These catalogues represent a major step forward in FDI regime liberalisation. The Chinese authorities are to be commended for this step and encouraged in their efforts to achieve further liberalisation by removing more categories of project from the catalogue of

prohibited foreign investment industries. The inclusion of sectors where national control is considered desirable, such as projects that endanger the safety and performance of military facilities, is understandable; where not self-evident, an explanation of the reasoning involved would be helpful.

It is not clear that there is any benefit in maintaining an extensive catalogue of restricted industries that effectively raises the approval hurdle higher for a wide range of industries and services, including, it is important to note, most of the services sectors that are being opened as a result of WTO accession. The existence of the restricted catalogue necessitates the reference of a project approval decision to a national authority (usually the State Development and Reform Commission, SDRC). The national authority then decides on approval on the basis of criteria regarding national economic policy or other considerations which are opaque because they are not precisely specified in such a way that a foreign investor can make a reasonable effort to comply with them.

- Abolition of the restricted catalogue in its entirety could be considered, at a time when the Chinese authorities judge further opening to foreign investment to be appropriate to the stage of development of the Chinese economy, as part of the next phase of liberalising the FDI catalogue regime.

Unlike the other two published catalogues, the encouraged catalogue does not restrict FDI in any way. The future of this catalogue will be largely determined by the Chinese government's policy regarding FDI-attracting incentives.

One reason for questioning the need for the continued existence of the encouraged catalogue is the increasing length and complexity that has resulted from successive liberalisations and that will undoubtedly be exacerbated by further liberalisation. The list is now so detailed that many of the items are likely to become rapidly obsolete as a result of technological progress.

The so-called "catalogue" of permitted investment projects – far larger in practice than the other three – is not published, but consists of all projects not listed in the three published FDI guidance catalogues.

A clearer presentation of the permitted range of foreign investment activities could be achieved by:

- Replacing the catalogue regime with a single short list of sectors that are barred to foreign participation, supplemented by a clear explanation of the grounds for selection. All projects not on the list would then be permitted.

As a transitional step towards wholesale reform of the catalogues, it would be good practice to reconsider the prohibition of foreign investment where the intention of controlling specific activities may be more effectively achieved in

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other ways, such as prudential regulation. The result would be the publication of a smaller prohibited catalogue containing only items which it is international practice to restrict or which China has a special and understandable reason for restricting.

China currently prohibits FDI in a few traditional crafts such as the production of green tea, traditional Chinese medicines, bodiless lacquer ware, rice paper and ink tablets. The intention of this prohibition is presumably to ensure the continued existence of these activities because they are considered to be part of the national heritage. If this is the case, then the prohibition of inward financial flows supporting such activities would appear to be an inappropriate means of achieving such an aim, which might more effectively be pursued by other measures, for example by increasing the resources available for education and training in these fields.

Another category of prohibited FDI is in the establishment of futures companies. There appears to be no advantage to be gained from banning FDI from entering this financial sector that could not be more effectively obtained by imposing appropriate prudential regulation covering both domestic and foreign-owned enterprises.

PBC licensing criteria for foreign banks

China has committed itself to a major opening of the banking sector to foreign participation (see Chapter 1 of this study). However, the resulting regulations promulgated by the People's Bank of China (PBC) in February 2002 require such high capital requirements for setting up branches in China that only the largest foreign banks will be able to take advantage of the new market access opportunities. While the requirements for opening a representative office are relatively modest, those for establishment are much more strict: the parent bank must have US$20 billion in total assets to open a branch and US$10 billion to open a subsidiary. There are six levels of bank offices, with corresponding minima for operating funds in the case of branches and capital in the case of subsidiaries, in each case varying from Rmb 100 million to Rmb 600 million, or foreign currency equivalent. Considering that the regulations also include reasonable stipulations requiring foreign banks to be governed by adequate supervisory systems in their home countries and to possess adequate internal control systems, such high capital requirements appear disproportionate to guarantee stability and are interpreted by some representatives of foreign banking institutions as protectionism.

According to the Code of Liberalisation of Current Invisible Operations agreed by OECD countries, the total amount of any financial requirements imposed for the establishment of a branch or agency of a non-resident enterprise engaged in banking or financial services shall be no more than that

required of a domestic enterprise to engage in similar activities. Furthermore, the total of the financial requirements to be furnished by all the branches and agencies of the same non-resident enterprise shall be no more than that required of a domestic enterprise to engage in similar activities. The minimum capital requirements in the foregoing paragraph apply only to foreign, not domestic, banks. Assessing the extent to which this might be considered as discriminating against the establishment of foreign banks in China is complicated by the lack of a firm basis for comparison, since there are no private banks in China and state-owned domestic banks are the subject of a different set of regulations.

Greater opening of the banking sector to foreign participation could be achieved by:

- Lowering the capital requirements for branches and subsidiaries of overseas banks to less discouraging levels, in accordance with OECD and other internationally recognised standards.

Capital market opening

Portfolio FDI inflows are restricted by the largely closed nature of China's capital markets. At the same time, the expansion of FIEs is limited by restrictions on capital-raising measures such as corporate bond issuance. Steps towards allowing portfolio inflows to play a more effective role in enhancing inward FDI would include:

- Allowing more FIEs to list on domestic stock markets.
- Allowing FIEs to issue corporate bonds on the Chinese market.

3. Transparency-enhancing measures

Web sites dealing with FDI issues in China

Governments are increasingly using the World Wide Web to communicate information to their citizens and those of other countries, and also as a transparent, cost-effective, efficient and speedy method of supplying government services. All OECD member countries are taking steps to implement e-government initiatives at national, regional and local levels. China has itself made great progress in establishing web sites for government departments which in many cases are readable in English as well as Chinese (see list at the end of the Bibliography section). The quality of official web sites varies widely. Some are user-friendly, easily navigable, rich in content and frequently updated; others bear the hallmarks of neglect, with obsolete and irrelevant content, dead links, navigation problems and no pages in non-Chinese languages.

Those sites that deal with issues of interest to foreign investors have until recently displayed a similar quality variability (although the best of them are

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actually much better than those of most other developing – and some developed – countries) and in addition have often suffered from excessive dispersion. Many localities have web sites that have selective content. There were until 2003 several national-level sites, with no clear indication for the uninitiated as to which was predominant. One of the best sites is actually a local one (Shanghai Foreign Investment Service Centre), which presents the most important information in English and is easy to navigate. However, this site may not be easy to find if the user is seeking a national information source. There has therefore not hitherto been a single easy or reliable method of finding an authoritative source of information on China's FDI policies, laws and application procedures on the World Wide Web.

This problem is one that is relatively easy to remedy. Doing so will constitute a step towards greater transparency of the FDI policy and legislative framework and will also provide a model for any other government departments that may eventually be required to comply with e-government standards.

- The OECD welcomes the inauguration of MOFCOM's FDI-related web site, Invest in China, *www.fdi.gov.cn*, on 1 January 2003 and offers its assistance in helping to ensure that the site is up to date, contains appropriate content in both Chinese and English, and is easily navigable.

Transparency of taxation legislation and regulations

It would be good practice to ensure that

- Authoritative versions of all tax regulations promulgated by the Ministry of Finance (MoF) and the State Administration of Taxation (SAT) relating to a foreign investment project, including all implementing rules, local rules and regionally-specific incentives, be made available on a regularly updated basis in English to foreign investors and members of the public requesting them. This may be done in print (for example, by upgrading the existing the SAT's journal of taxation) or on a web site, or (preferably) both.

Competition policy

Competition policy could be further enhanced by combining and developing the various fragmentary and dispersed policy initiatives of different ministries and departments into a coherent policy that provides a sound, transparent and non-discriminatory framework for competition.

This policy may well be made concrete in specific laws, formulated in a transparent manner to ensure consultation of all stakeholders, including foreign investors.

Transparency of labour compensation rules

The obligations of FIEs towards their employees in regard to the payment of social benefits remains inconsistent and unclear. This situation could be remedied by:

- Developing and implementing a consistent national body of regulations governing the entitlement of employees to social and pension benefits and clearly specifying the contributions to be made by employers to such benefits.
- Establishing mechanisms whereby both employers and employees can ascertain their individual pension and other entitlements in a fully transparent manner.

Accuracy and international comparability of China's FDI statistics

Accurate and internationally comparable FDI statistics constitute an important component of the transparency of a country's FDI policy framework, providing a realistic basis on which to judge the requirements for, and the success of, such a framework.

As explained in Annex I, current methods of compiling China's FDI statistics are inconsistent with international practice and in particular with those in use in OECD countries. The result is that there is a lack of clarity and occasional confusion regarding such statistics as the geographical distribution of investment sources and the existing stock of FDI. The continuation of co-operation between the Chinese government and the OECD to standardise and improve FDI statistics will contribute to greater transparency and a better understanding of actual trends in China's FDI inflows and outflows. This work is consistent with the statistical transparency commitments inherent in China's April 2002 participation in the IMF's General Data Dissemination System (GDDS).

Steps to improve transparency with regard to FDI statistics could include:

- Aligning the Chinese government's concepts, definitions and data collection with OECD and IMF recommended standards.
- Announcing the dates for regular public release of a set of FDI statistics revised in line with standards agreed with the OECD.
- Where the relevant data are available, revising back series of FDI statistics and publishing these in the same tables as statistics for the most recent year to allow comparisons over time using the latest available data.

4. Rule of law

Judicial independence and competence

Current efforts to improve the functioning and independence of the legal system could be intensified by:

- Training and appointing legally-qualified judges to all courts.
- Raising the pay of judges and other key legal personnel to reduce their vulnerability to offers of bribery.
- Enhancing the status of judges *vis-à-vis* local government and party officials.
- Establishing at national and regional level mechanisms to guarantee the execution of court judgments.

An accountable and transparent legislative process

Current efforts to establish a more transparent and accountable process of formulating legislation and regulations could be expanded to include:

- Publishing all legislation and regulations on a single, comprehensive, up-to-date and easily-navigable web site in both Chinese and English.
- Exploring the possibility of establishing a mechanism similar to that of the US Federal Register or equivalent systems in other OECD countries to publish draft laws and regulations and obtain public feedback on them as early as possible before promulgation.
- Increasing the scope of stakeholder consultation with regard to FDI-related legislation.
  - ❖ As a first step in this direction, a study might well be undertaken of existing forms of consultation with the intention of designing a more consistent and comprehensive method of organising such consultation involving all major players in an industry in both public and closed fora.
  - ❖ A full consultative process would in addition include an open public debate on proposed legislation, using all print and electronic media. Such a process has already been adopted in non-economic legislation (*e.g.* the new marriage law). This would be particularly helpful in the case of complex legislation on which maximum public discussion would help elucidate the main issues and facilitate the examination and evaluation of a wide variety of options. Such a procedure might be adopted on a trial basis in the case of proposed business legislation, such as that on mergers and acquisitions.

IPR protection

China has made progress in protecting intellectual property rights (IPR), but this remains an area in which multinational enterprises from OECD

countries still have serious concerns. Addressing IPR issues more effectively will enable China to attract more long-term investment, especially in high-tech areas where technology transfer is more likely to occur in an environment in which IPRs are well protected. It will also encourage domestic creativity.

Further measures to improve IPR protection could include:

- Continuing to educate citizens in the principles of IPR protection and its value for the promotion of discovery and invention in the modern world.
- Allowing all holders of copyright, patent rights and trademark rights, both foreign and domestic, to seek enforcement of those rights.
- Establishing minimum penalties for all categories of IPR violation.
- Providing means of sharing experience of best practice in IPR courts nationwide to enable upgrading of courts in hinterland areas to the advanced standards that have already been set in major cities such as Beijing.
- Establishing an effective mechanism to implement existing copyright law, in particular to detect, punish and deter software piracy on the part of manufacturers, wholesalers, retailers, the general public and other end-users, including both businesses and government departments.
- Closing down wholesale markets in which counterfeit goods are predominant.

Corruption

China has made some progress in tackling corruption and has also made a positive contribution to the ADB-OECD Anti-Corruption Initiative for Asia-Pacific. Further progress will be greatly enhanced by implementing the recommendations of this report regarding increased transparency and rule of law, in particular reducing regulatory ambiguity and the scope of official discretion, and raising the pay of state officials.

Further progress will also be supported by deepening the co-operation between China and the OECD in dealing with corruption issues.

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Chapter 2

The role of FDI in china's economic development

Abstract. *Attracting foreign direct investment (FDI) is a major component of the policy of opening up China's economy to trade and investment that was initiated in the late 1970s. FDI inflows have increased rapidly over the past quarter of a century. These inflows are largely concentrated in Eastern China, particularly in Guangdong province. FDI has played an important role in China's economy, for example by stimulating trade growth and promoting productivity improvements in the domestic economy. Hong Kong remains the largest source of FDI. Measured by the size of its population and other objective factors, China's potential for attracting more FDI from OECD countries remains underexploited.*

1. The genesis of FDI policy

The Chinese government's decision to solicit foreign investment in the late 1970s represented an about-turn from the closed economic policy of the preceding three decades. The new policy has since been so successful that it has radically altered the background against which China's neighbours now formulate their own economic policies; self-sufficiency, central planning and import substitution strategies have been jettisoned in almost all other Asian countries in an attempt to emulate China's rapid economic growth, and in particular its success in attracting FDI. This success should not, however, obscure the fact that a policy change of such magnitude requires decades of institutional change to complete. To understand the difficulty of this process it is necessary to consider some essential elements of the historical background.

The problem: failure of autarky and central planning

Soviet-type central planning, adopted in 1953 at the height of China's alliance with the USSR, failed to achieve the economic development desired by the Communist Party leadership. Following the onset of the so-called "great leap forward" in 1958, mismanagement of the system culminated a devastating famine, which produced a trauma that has motivated economic policymakers ever since. In the early 1960s, a partial loosening of the system of collective agriculture ended the famine and assisted the economy to recover from deep recession, but this tentative move away from orthodoxy ended abruptly with the so-called "great proletarian cultural revolution" of 1966-69.[1] In the first half of the 1970s economic policy was aimed at sustaining food security and restoring economic growth while maintaining the framework of guaranteed full employment (the so-called "iron rice bowl"), albeit at internationally low productivity levels in both industry and agriculture. However, because of its inability to generate rapid productivity growth, this framework was insufficient to achieve the government's other goals of catching up with advanced economies and raising living standards above developing-country levels.

Central planning was accompanied by autarky (self-sufficiency). Following the United Nations boycott of China announced in 1950 at the start of the Korean war, and the break with the USSR in the 1960s, trade was reduced to a minimum, with total merchandise export and import value representing generally no more than 10 per cent of GDP.[2] A few basic

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commodities and relatively simple manufactures were sold abroad to pay for essential items that China could not itself produce. During the intensification of the Sino-Soviet dispute in 1959 the element of self-reliance gained in importance with the departure of Soviet specialists and the ending of Soviet economic assistance in 1960. By the mid-1960s, the country had already paid off all its foreign debt. As a proportion of GDP, two-way trade fell to a low of 5 per cent of GDP in 1970. In practice, autarky had to be applied flexibly, for example to allow for grain imports when domestic food supplies were scarce. In the early 1970s a small increase in trade accompanied the political initiative that resulted in China's readmission to the United Nations and the restoration of diplomatic relations with the United States and some other countries, but there was no fundamental change in economic policy.

A major result of autarky was that a wide range of consumer goods common in the rest of the world was not available in China. While the mass media remained closed to outside influences, this disparity was only evident to the few officials who travelled abroad and those in contact with foreign residents in China. Once the media started to open to the outside world in the late 1970s it became apparent to the majority of the population and in the following decade a widespread "demonstration effect" was detectable in consumption patterns. Chinese consumers have since become amongst the most discerning in the world.

China was even more closed to foreign investment than it was to trade. As a result of the embargo on China enforced by Western countries after the outbreak of the Korean War in 1950, FDI from those sources virtually ceased. The nationalisation of Chinese domestic companies in the early 1950s also deterred most foreign companies from seeking to establish a presence in China at this time, as the risk of confiscation was high. A number of joint ventures were set up with Soviet bloc countries in the 1950s, but these were wound up in the early 1960s as a result of the Sino-Soviet dispute. Only two joint ventures, one with Albania, the other with Tanzania, operated in the 1960s and 1970s before the opening-up policy was inaugurated.

It is against this background that the scale of the strategic reversal in policy that began at the end of 1978 should be understood. One element of the reversal was a turning away from the centrally-planned economy towards a market economy that would bring about the dismantling of major economic institutions which had taken a great effort to build in preceding decades, beginning with the rural people's communes, and would result in the restoration of other economic institutions which had long since been abolished, such as stock exchanges. Policy reversals of such magnitude can not be accomplished instantly and require a long period of institutional development and culture change lasting several decades. The other element of policy reversal was the opening up of the Chinese economy to foreign trade

and investment, which meant the increasing insertion of China into the world economy. As with the movement from plan to market, this major strategic shift involved considerable risk, since it involved a partial devolution of control from the central authorities to global market forces.

The solution: FDI as part of the process of opening up and economic reform

The decisive turn from autarky to opening was, like other areas of policy, strongly pragmatic. The country's leaders lacked experience in dealing with foreign business and had to move cautiously in developing a policy that was still little understood and much opposed at many levels in the Communist Party. The initial enunciation of FDI policy, in a discussion between Deng Xiaoping and several rehabilitated businesspeople in early 1979, was limited to a readiness to welcome Sino-foreign joint ventures, beginning with those with a rapid turnover of capital. It was still too early to mention the possibility of allowing foreign multinational corporations to establish wholly-owned subsidiaries in China, but, suggested Deng, overseas Chinese and foreign citizens of Chinese origin should be allowed to establish factories in China (Deng, 1984).

In comments made later in 1979, Deng Xiaoping welcomed foreign capital, both as FDI and loans, while stressing the need to ensure its efficient use. He listed three benefits of the foreign-funded factories he had visited in Singapore: the government received 35 per cent of their profits in taxation; employees received wages for their labour; domestic service industries were encouraged. Another key aim was technology transfer. It was already recognised in principle that China would have to compete for FDI with other potential recipients by providing the requisite infrastructure to enable foreign companies to make profits, though experience was still inadequate to determine what this would entail (Deng, 1984).

The decision to solicit foreign capital was not motivated by a need to compensate for a shortage of investible savings. Throughout the reform period, China has experienced a savings: GDP ratio of between 30 and 40 per cent, the highest rate in Asia apart from Singapore, which has for several decades operated a compulsory retirement savings scheme. Moreover, this high savings rate has been sustained by household savings, which rose from a third of total savings in 1980 to over two-thirds by 1990. The result has been a savings:investment ratio that has hovered around 100 per cent.[3]

However, although savings were high at the beginning of the reform period, the means of mobilising them for productive investment were absent. The banking system was merely a conduit for allocating funds in accordance with the national economic plan and lacked the infrastructure and experience to make loans on a commercial basis. Stock markets were nonexistent, hitherto politically taboo.

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The role of foreign capital was therefore to provide a substitute mechanism for China's nonexistent commercial financial system in allocating investment funds.[4] Foreign lenders would make loans on a commercial basis. Foreign companies, themselves funded via their own domestic capital markets, could build productive capacity in China on a profit-making basis denied to state-owned enterprises, which operated, and largely continue to operate, under a "soft budget constraint".

FDI, in particular, was sought as a means of upgrading China's outdated manufacturing technology, in terms of both products and processes. In the late 1960s and early 1970s, China's leaders boasted that China had "attained the heights of world science and technology". The reform era began with a more realistic assessment of the country's development needs. Deng Xiaoping himself noted that productivity in the iron and steel industry was only a small percentage of that in the advanced countries and even lower in newer industries (Deng, 1984). The new recognition that labour productivity was low by global standards, and that this was a situation that needed to be rectified, represented a major shift in Chinese government policy from maintaining full employment at all costs to seeking output maximisation to raise overall living standards.

Initial success: progress of trade and FDI in 1980s

The "open door" policy was highly successful. Two-way merchandise trade, which had already begun to grow faster than the domestic economy as China's external diplomacy began to recover from 1971 onward, more than doubled from 11.3 per cent of current-price GDP in 1979 to 26.8 per cent in 1990. The changing composition of exports and imports demonstrated an expansion both of the capacity to manufacture a greater quantity and variety of items and also an expansion of consumer choice in the domestic market. In 1979, trade consisted largely of bulk commodities and relatively simple products such as textiles and bicycles. By 1991, an increasingly sophisticated array of manufactured goods comprised 77.5 per cent of exports and 83.1 per cent of imports.[5]

FDI inflows, negligible before the 1980s, rose from US$916 million per year in terms of actually realised investment in 1983 to US$3 487 million in 1990 (Annex II, Table 1), by when the stock of realised FDI (in gross, cumulative terms) had reached US$20.7 billion (Annex II, Table 2). The bulk of these flows came from Hong Kong (China), sourced either in the territory itself or in the global Chinese diaspora – and some had also started to come from China itself (so-called "round-tripping"). In 1986-1990, for example, Hong Kong (China) and Macao (China) were cited as the combined source of 62 per cent of realised annual FDI (almost all of this was from or via Hong Kong (China), with Macao (China) providing a relatively tiny additional amount), while Japan provided

12.4 per cent, the US 11 per cent and the EU only 5 per cent (MOFCOM FDI statistics). Much of this FDI was resource-seeking in that firms were seeking to escape rising land and labour costs in their home territories. The average wage in China during the 1980s was far lower than in Hong Kong (China), where industrialisation had led to steadily rising labour costs starting in the early 1960s. In Hong Kong (China), the cost of land and property was rising to levels comparable with those in Tokyo and New York, while on the Chinese mainland large tracts of land could be made available in Special Economic Zones and other open areas at comparatively low rates. Similar labour and land cost pressures drove manufacturers in Chinese Taipei to migrate their plants to the Chinese mainland from the late 1980s onward.

Debate won by early 1990s: subsequent policy stability

During the 1980s Deng Xiaoping's economic reforms were challenged by other veteran communist leaders, who feared a loss of central control over the economy and hence over society. A major concern of foreign investors at this time was that the communist leadership would reverse the policy of economic reform and opening up if its members felt that the influx of ideas from outside China threatened their grip on society. In particular, there were serious worries about possible changes in economic policy after the departure of Deng Xiaoping from the political scene in view of the persistent difficulties that had been experienced by Chinese leaders in the post-1949 period in appointing stable successors. These worries were largely laid to rest as a result of the establishment of a ruling group centred on Jiang Zemin. From 1989, Jiang took on all the top national leadership posts and gathered round him a group of leaders who shared the same outlook: a firm commitment to persevere with economic reform coupled with a determination to retain power by deferring political reform. The stability of the country's leadership ensured that policy debates were conducted within the confines of the policy consensus established by Deng, with differences of emphasis or over the pace of reform replacing differences of principle over the very existence of an economic reform programme. The 16th congress of the Chinese Communist Party, which took place in November 2002, anointed a new "fourth generation" of leaders who have clearly been selected on criteria which include their commitment to maintaining the policies of economic opening up and reform. Variations in policy emphasis will doubtless emerge in coming years, but it is highly unlikely that there will be any major change in policies affecting FDI.

Entrenchment of FDI in the 1990s

The solid consensus in favour of economic reform in the "third generation" of leaders grouped around Jiang Zemin allowed the process of FDI absorption to become further routinised and entrenched as part of China's

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economic system. In the 1990s the patchy legal framework governing FDI in China was refined and expanded so that by the end of the decade a body of law and regulations was in place. Experience gained in the 1980s enabled the authorities to expedite the process of examination and approval of foreign investment projects so that as the decade progressed it became less arduous and time-consuming. In the early 1980s FDI was largely concentrated in the five Special Economic Zones (SEZs) in South-East China and most of the rest of the country was officially closed even to visitors. By the mid-1990s most of the coastal region consisted of various types of open zones operating preferential policies to attract FDI and China had for all practical purposes become a completely open country.

In the 1980s FDI projects had initially been largely limited to the hotel sector and had then broadened to include joint venture labour-intensive export manufacturing. As a result of the more favourable climate for FDI, in the 1990s a growing proportion of FIEs were wholly-foreign-owned enterprises, oriented to the expanding domestic market as well as to overseas markets, and a number of large, relatively high-technology projects initiated by multinational enterprises from OECD countries began to appear.

Had the settled, but impressive, growth path of the 1980s (averaging 15 per cent a year in nominal terms) remained unchanged, FDI inflows would have grown to well over US$7 billion by 2000, making China the largest recipient of FDI in the developing world. In fact, they grew far faster. Deng Xiaoping's early 1992 policy change brought about an immediate acceleration in FDI growth that brought annual FDI inflows to over US$40 billion in the second half of the decade. Realised FDI shot up by 152.1 per cent per year to US$11 billion in 1992, then by 150 per cent to US$27.5 billion in 1993. From 1993, measures to bring the overheating economy under control also had the effect of slowing the growth of FDI inflows to 22.7 per cent in 1994 and further to just over 11 per cent in 1995 and 1996, then to 8.5 per cent in 1997. At the height of the 1997-99 Asian economic crisis, when many of its neighbours were experiencing reduced capital inflows, and in some cases (such as Indonesia) large capital outflows, China's realised FDI inflows held steady at over US$45 billion in 1998, before falling to US$40 billion in 1999 and 2000 (Annex II, Table 1).

By 2001, the proportion of current-price GDP represented by merchandise exports and imports had reached 44.7 per cent,[6] while two-way trade in goods and services accounted for only 20.5 per cent of GDP in Japan in 2000 and 23.4 per cent of GDP in the US in 2001. FDI inflows rose sharply in 2001 to US$46.9 billion, equivalent to 10.7 per cent of gross domestic fixed capital formation and 4.1 per cent of GDP.[7] This recovery was almost certainly due not so much to the return of investors who took fright during the Asian economic crisis of 1997-99, which had only a limited impact on China compared to the

rest of Asia, as to the diversion of FDI from South-East Asia and other investment targets in anticipation of China's imminent accession to the WTO.

The number of projects for which contracts were signed rose to a peak of 83 437 in 1993 before settling at around 20 000 per year in the late 1990s (Annex II, Table 1). The amount of contracted investment similarly peaked at US$111.4 billion in 1993 and then subsided to US$41.2 billion in 1999 before recovering in 2000. The apparent fall in the second half of the decade is more a result of stricter recording procedures than of a real fall in investment; actually realised (or "utilised") FDI continued to show a steadily rising trend after 1993 until the temporary fall-off in 1999-2000. The amount of contracted investment exceeded that of realised investment by 305 per cent in 1993; in 1997-2000 it was only 20.4 per cent higher. One reason that contracted FDI tends to exceed utilised FDI is that a contract includes investment for more than one year. This reason is insufficient, however, to explain the discrepancy, since if this were the only factor then the difference between contracted and realised FDI would have increased, not decreased, in recent years as contract terms have reportedly increased. It is clear that contracted investment includes projects which are not completed.

WTO entry: new phase in opening up

On 11 December 2001 China acceded to the WTO. Bilateral agreements signed with other WTO members as part of the accession process were heavily weighted in favour of market-opening concessions by China.[8] Although the main focus of the agreements was on opening Chinese markets to imports by eroding trade barriers, increased market access is also being greatly accelerated by opening a number of sectors, service sectors in particular, far wider to foreign investment within periods generally varying up to five years from accession.

China's WTO commitments will also widen the scope of operation of FIEs in the non-services sectors, especially manufacturing. The liberalisation of trading and distribution rights will enable FIEs to import and export on their own behalf and to distribute and service their products throughout China. All FIEs will enjoy national treatment in such matters as the pricing and availability of production inputs and discrimination against them in the business activities of the government and state-owned enterprises will not be permitted. Trade performance, trade balancing, foreign exchange balancing and local content requirements have now been abolished.

As well as providing wider choice to domestic consumers, WTO membership is also expected to produce efficiency gains by provoking accelerated restructuring of state-owned enterprises in response to increased competition from both imports and FIEs. Entities such as foreign banks and insurance companies will soon be able to do business with customers

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throughout China in ren min bi or foreign currencies. Foreign-invested manufacturing enterprises will be able to distribute their goods nationwide and provide after-sales service. As a result, FDI inflows are widely forecast to accelerate strongly over the next ten years.

A fuller treatment of China's WTO commitments relevant to foreign investment is in the next chapter.

New investment catalogues and bank licensing regulations

Another FDI investment liberalisation initiative was the revision of the catalogues for guiding foreign investment industries that was previously promulgated at the end of 1997. The number of encouraged industries has been increased from 186 in the 1997 catalogue to 262 in the 2002 catalogue, while the number of restricted industries has been cut from 112 to 75. Similarly as a result of WTO accession, new foreign bank licensing regulations were promulgated by the People's Bank of China (PBC) in February 2002 covering market access rights of foreign banks (details are in Chapter 3). These changes represent a modest continuation of the process of opening the Chinese economy to foreign investment.

WTO accession caused a surge in FDI inflows

The prospect of China's imminent accession to the WTO prompted foreign companies to step up their investment in China. Realised FDI inflows rose 14.9 per cent per year to US$46.8 billion in 2001 and in 2002, following formal WTO accession in December 2001, they rose by 12.6 per cent to US$52.7 billion.[9] By 2002, China had reportedly become the world's most popular FDI location, according to one study (A.T. Kearney, 2002), which found in September that year that senior executives of multinational enterprises in Asia, the United States and Japan preferred it to any other destination. The writers of the study attribute China's increased attractiveness for global investors to the country's WTO accession and also to market opportunities perceived as arising from its growing economy, changing lifestyles and increasing incomes.

2. China's FDI performance in international perspective

Both in China and in the rest of the world there has been a tendency to exaggerate China's success in attracting FDI and overlook important aspects of the growth in FDI inflows that need to be taken into account when considering policy development. First of all, China is the world's most populous country. If it were to receive global average FDI per head, it would receive far more total FDI than, for example, the United States, which it does not-it receives far less (Annex II, Table 4). Secondly, the quantitative leap has not yet been fully matched by a qualitative leap: much FDI in China still takes the form of short-

term, labour-intensive manufacturing, while foreign investment in high-tech activities, particularly in services sectors, lags far behind (not surprisingly, since these were largely closed to foreign investors before 2002). There is therefore still much scope for raising the quality of FDI while at the same time further increasing its scale and penetration.

It should be borne in mind that FDI reporting in China does not yet meet internationally recognised standards (see Box 2.1 and Annex I). MOFTEC has accordingly been working with the OECD to improve FDI statistical reporting and it is hoped that reporting standards will be improved in subsequent years. An important point to note is that the cumulative figures reported by MOFTEC as "FDI stock" are merely gross cumulative totals, and should therefore be taken to be indicative rather than substantive.

How China compares with other FDI destinations

FDI to China and OECD countries

Since the mid-1990s China has attracted more total FDI than most OECD member countries. For example, in 1998-2001 it absorbed US$167.9 billion, exceeded only by the United States (US$907 billion), Belgium and Luxembourg (US$355.7 billion), the UK (US$327 billion), Germany (US$306.4 billion), the Netherlands (US$179.7 billion) and France (US$173.6 billion). Other OECD countries received amounts ranging from US$600 million (Iceland) to US$38.7 billion (Canada) (Annex II, Table 3).

However, the above figures do not take into account the fact that China's population is far larger than those of any OECD member country. If FDI totals are divided by population, it is clear that China's FDI per capita was smaller than that received by any OECD member country in 2000 except Turkey. Even Japan, where FDI accounts for a tiny fraction of GDP, received 7.6 times China's GDP per capita, while Ireland absorbed over 200 times as much as China by this measure (Annex II, Table 4). The comparison may be more favourable to China if economic and geographic conditions are taken into account.

FDI to China and other developing countries

During the 1990s China became by far the largest recipient of FDI among developing economies. The second largest was Brazil, with US$195.3 billion in 1995-2001, US$95 billion less than China. The third largest, Hong Kong (China), was also one of the largest sources of FDI, and has acted largely as an entry point for FDI to the Chinese mainland. The nearest country in population size, India, attracted well below US$20 billion during this period, while Indonesia, which experienced sizable disinvestments in 1998-2000, recorded FDI inflows totalling less than US$7.6 billion in 1995-2000 (Annex II, Table 5).

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Box 2.1. **Foreign direct investment statistics of China**

Official foreign direct investment statistics for China are regularly disseminated by MOFCOM in an annual publication, *Statistics on FDI in China*. The same data are integrated into the statistical systems of other national agencies such as the National Bureau of Statistics (NBS) and the State Administration of Foreign Exchange (SAFE).

MOFCOM FDI statistics focus on FDI inflows, as China is a major recipient of foreign investment. Limited information is also available on investments by Chinese entities abroad. MOFCOM does not compile FDI position (stock) data; cumulative flows are used as a proxy.

While the statistics on FDI flows provide indicators relating to the present economic climate, stock figures can be used as structural indicators designating the interdependence of national economies. Flows describe the *current* attractiveness of countries and sectors for new investment as well as withdrawal of investments. Stocks, on the other hand, measure the *share of foreign ownership* in the national enterprises and *of national ownership* in foreign enterprises. The image obtained by these two sets of statistics – flows and stocks – relating to FDI activity may be quite different.

The statistics include various breakdowns: by geographical allocation of FDI; by industrial classification; by form of FDI; by number of projects; and by status of investments ("contracted" and "realised", also translated as "actual", "utilised" or "actually utilised"). Most tables of statistics relate to a single year and do not provide time series reflecting historical trends, although these can be found in previous yearbooks or by requesting these back figures directly from MOFCOM.

A sound analysis of FDI activity requires the existence of comprehensive statistics collected from reliable sources and compiled according to internationally recognised standards. International organisations provide a set of guidelines for the correct measurement of FDI activity. These guidelines are included in the *OECD Benchmark Definition of Foreign Direct Investment (3rd edition)* and the *IMF Balance of Payments Manual (5th edition)*, both of which are available in Chinese.

MOFCOM FDI statistics are not based on the internationally recognised standards that are generally applied by OECD countries. Consequently, the differences in the statistics compiled by OECD countries on their investment in China and the statistics published by MOFCOM on OECD members' investment in China exhibit serious inconsistencies between these sources.

Box 2.1. **Foreign direct investment statistics of China** *(cont.)*

Comparison of FDI flows into China from OECD countries (US$ billion)

	1995	1996	1997	1998	1999	2000	1995-2000
Reported by OECD countries	6.9	10.4	6.2	3.5	5.2	7.1	39.3
Reported by MOFTEC	9.7	11.8	14.5	13.7	13.5	13.8	77.0

The Chinese authorities are of the view that the OECD Benchmark Definition of Foreign Direct Investment (3rd edition) and the IMF Balance of Payments Manual (5th edition) provide a reference framework that permits each country to set up its own statistical system on the basis of its own practical situation, and that when documents such as UNCTAD's World Investment Report are compiled countries are not compelled to use a single statistical method. The Chinese government has offered to discuss discrepancies between MOFCOM and OECD data with a view to establishing comparability on a case-by-case basis.

In terms of FDI inflows per capita, China ranks relatively low even among developing countries, receiving far less than the main South American FDI destinations, Argentina, Chile and Brazil, or its competitors for FDI in South-East Asia, Singapore and Malaysia, though still somewhat ahead of Vietnam and the Philippines, which each have just under US$17 per head, and far ahead of Myanmar and India (Annex II, Table 6). These figures suggest that China has received far less than its maximum absorptive capacity for FDI inflows, although the latter is a difficult concept to define.

Even if economic and geographical characteristics are taken into account, China's performance still compares quite modestly with that of other developing countries. In a recent econometric study of FDI inflows into 32 developing countries in the period 1987-1998,[10] Chen Chunlai showed that, controlling for a number of economic development variables,[11] China ranked fifteenth out of all 32 countries and fifth out of eight East and South-East Asian countries, better than the Philippines, Thailand, Chinese Taipei and Korea, and similar to Hong Kong (China) but lower than Singapore, Malaysia and Indonesia.

Changing forms of FIE

The forms of FIE have gradually altered as China has gained experience in handling FDI, as the body of law governing FDI has expanded and as economic conditions have evolved. In the initial period, 1979-1985, the most common form of FDI was the contractual joint venture (a relatively loose form of joint

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venture, which comprised nearly 30 per cent of all FDI, largely because of the flexible nature of this form of Sino-foreign organisation (Annex II, Table 7). Contractual joint ventures still occupy an important place but have since declined to less than 20 per cent of total FDI.

Joint exploitation of natural resources also started as a major form of FDI distinct from joint ventures, actually exceeding contractual joint ventures in total realised value in 1983-84, but other forms increased far faster because of the increasing importance of investment in manufacturing and services, and by the 1990s joint exploitation had fallen to a negligible proportion of total FDI.

Compensation trade is a form of using foreign capital in which a foreign enterprise provides production equipment to a Chinese enterprise, which pays for the equipment with the goods produced from it. The Chinese government had hoped that compensation trade would develop into a major form of co-operation with foreign business, experienced a similar pattern of decline up to 1996, after which it was no longer counted as FDI.

To begin with, equity joint ventures (a relatively well-defined form of limited liability company in which at least 25 per cent of the investment was contributed by the foreign partner (before December 2002), comprised one of the least popular forms of FIE, accounting for only 5.8 per cent of realised FDI value in 1979-82. They then rapidly displaced other forms, reaching 56.1 per cent in 1987 and retaining dominance until the late 1990s, when wholly-foreign-owned enterprises, which were almost non-existent in the 1980s and had then grown rapidly, especially in the second half of the 1990s, became the favoured form of ownership (Annex II, Table 7).

Foreign-invested shareholding enterprises are still in their infancy, still accounting for only 1.1 per cent of realised FDI value in 2001, but have started to increase gradually. Other forms of FDI that China is trying to attract include foreign-invested venture capital companies, build-operate-transfer (BOT) and transfer-operate-transfer (TOT).

Cross-border mergers and acquisitions started to emerge in the 1990s

Cross-border mergers and acquisitions (M&A) became an increasingly important component of global FDI in the 1990s (see Chapter 5, Section 4). Estimates for M&A activity in China – rough estimates at best – indicate a fluctuating rise from 1990 onward. In the period 1998-2001 cross-border M&A inflows to China totalled an estimated US$65.3 billion, midway between the highest and lowest OECD member country recipients and already ahead of other Asian industrialising countries such as Korea (US$48 billion) and Singapore (US$15.2 billion) (Annex II, Table 8). Wide variations between countries are a result of institutional differences rather than of receptivity to FDI or economic growth. The "lumpiness" of M&A activities also causes a wide

variation from year to year, sometimes by a factor of ten – see for example the rise and fall to and from US$45.2 billion in China in 2000 and a similar peak in Germany and Canada in the same year. In the case of China, however, these large amounts do not indicate strong cross-border M&A activity between China and other countries, as they are largely the result of mergers and divestments taking place between Chinese companies in Hong Kong and in mainland China and are effectively part of domestic M&A activity. For example, two-thirds of the very high 2000 cross-border M&A figure is accounted for by a single deal between China Mobile (Hong Kong), a wholly-owned subsidiary of China Mobile Telecommunications Group based in Beijing, and China Telecom, based in Beijing, as part of the restructuring of China's telecommunications sector.

3. Sources of FDI inflows into China

Motivations of FDI in China

Understanding the motivations of companies seeking to make direct investments is essential not only for an appreciation of the factors that have influenced the composition of FDI in China so far, but also in deciding the most appropriate way to attract the desired types of FDI in future.

Using the typology described in a recent OECD study of the benefits and costs of FDI for development (OECD, 2002b), a high proportion of FDI inflows into China, especially in the first decade and a half of the opening-up policy, consisted of resource-seeking FDI. Industrial economies in which labour and land costs had risen to uncompetitive levels experienced a massive shift of manufacturing capacity to China to take advantage of low land lease charges and far lower wages. Chief among these was Hong Kong (China), which accounted for the largest single share of FDI inflows, probably even after stripping out overcounting resulting from the funnelling of investment from overseas, or from China itself, through Hong Kong (China), although once can not be certain, as these factors are impossible to estimate accurately from available data. From 1989, a similar deindustrialisation began to occur in Chinese Taipei, from where whole industries were transferred to the Chinese mainland.

Despite the traditional lure of the vast Chinese market, market-seeking FDI was not common in the early stages of the opening-up process. Although China has a large population, the market for consumer goods has until recently been smaller than that of several South-East Asian countries because of low per capita disposable incomes. In the 1980s manufacturing FIEs were encouraged to export and not attempt to serve the domestic market, not merely by export performance requirements but also by restrictive government policies such as restrictions on distribution of products and the provision of after-sales service within China.

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The situation changed in the 1990s as disposable incomes rose high enough to provide sufficient disposable income to allow substantial discretionary spending. Urban households, in particular, now possess a wide range of consumer durables, and this range is constantly widening. As purchasing power has increased, legal restrictions on consumption have been relaxed, allowing the development of entirely new markets, including family cars and tourism. Market-seeking investment is thus increasing in response to the burgeoning Chinese domestic market. The lifting of the restrictions noted above can be expected to increase the attractiveness of this kind of FDI.

Other motivations are less in evidence. There is some natural-resource-seeking FDI, but this is very much subject to fairly strict government controls. Unlike some countries at an earlier stage of economic development, China has more to offer foreign investors than cheap energy or raw material sources. Efficiency-seeking FDI, which involves outsourcing of whole products to the host country, does occur, but its potential will not be realised until China has reached a higher stage of technological development. Investors seeking strategic assets to acquire market power have, with a few notable exceptions, steered clear of China; those that have gained such power are likely to face strong challenges to it.

The gradual shift from resource-seeking FDI to market-seeking FDI is associated with an alteration in geographical sourcing. FDI from Hong Kong (China), initially predominant, is gradually subsiding as a proportion of total FDI, its place being taken by FDI from OECD countries, although these, particularly the United States and Japan, still tend to be under-represented.

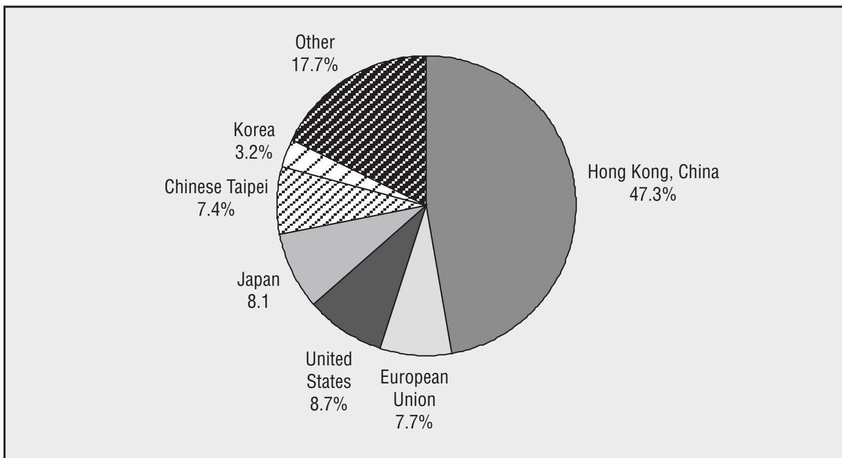
It is also important to note that many multinational corporations have invested in China for what may be judged less than rational motives, in particular the "herd" instinct, often expressed as a fear of being overtaken by rivals in the same industry who got there first. One argument often heard in support of such a stance is that of the necessity of entering the China market early to establish a presence and steal a march over latecomers. This has increasingly proved false, especially as the Chinese business environment has in recent years become more "normal", with customers and suppliers more concerned about quality and price than about establishing "*guanxi*" (connections), although *guanxi* still matters to some extent. The assumption underlying these attitudes is the old one of the potentially limitless China market, a concept which has paid its believers far less than they would have gained from solid market research in localities such as Shanghai where consumers possess the purchasing power to form a real, albeit not unlimited, market.

Hong Kong (China) has declined in importance but remains the largest source

During the first half of the reform period, the majority of FDI came from Hong Kong (China). The proportion of FDI listed as being sourced in Hong Kong (China) and Macao (China), almost all of it from Hong Kong (China), fluctuated around 60 per cent, peaking at 70 per cent in 1992 before declining steadily to 38.9 per cent in 2000 (Annex II, Table 10). In absolute terms, realised FDI from Hong Kong (China) and Macao (China) rose to a maximum of US$21.3 billion in 1996 and then subsided year by year to US$15.8 billion in 2000. Although Hong Kong (China) has declined in importance as an FDI source, it remains the largest single provider of realised FDI to China, far outweighing the contributions of much larger economic units like the United States, the European Union and Japan (Annex II, Table 9).

By end-2000 Hong Kong (China) was the source of 48.9 per cent of the stock of realised FDI accumulated since 1979, with the combined contribution of the next three providers, the United States, Japan and Chinese Taipei, summing to less than half that proportion (Annex II, Table 9).

Figure 2.1. **Shares of the main countries, regions and territorie in FDI inflows to China, 2001 (%)**



Source: MOFCOM FDI statistics.

Another indication of the disproportionate importance of Hong Kong (China) as an FDI provider to China is that its share of realised FDI in 2000, at 38.1 per cent, was more than double its share of import-trade with China, even

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though Hong Kong (China) remains the main entrepot for China's trade with the outside world. Other locations for which this is true include the British Virgin Islands and the Cayman Islands, which have practically no trade with China but together accounted in 2000 for 10.9 per cent of realised FDI (Annex II, Table 11).

Major OECD economies have contributed relatively little FDI to China

By contrast, several major OECD economies, notably the United States, Japan, Germany and the Republic of Korea, have contributed a relatively small share of realised FDI to China by comparison with their proportion of export-import trade with China (Annex II, Table 12), though these shares may understate the actual proportions as they exclude FDI routed through tax havens such as the British Virgin Islands.

4. Regional and sectoral distribution of FDI

More than a quarter of FDI has gone to Guangdong

The spatial distribution of realised FDI has been skewed towards the eastern coastal areas throughout the period of economic reform. The South-Eastern province of Guangdong has received the lion's share of FDI, largely because it is adjacent to Hong Kong (China), the main provider of FDI and China's largest port, and also because it houses three of the Special Economic Zones (SEZ) of Shenzhen, Zhuhai and Shantou, together with the prosperous Pearl River Delta open zone. By end-2000 Guangdong, whose population was only 6.8 per cent of the national total and which contributed only 11 per cent of GDP in that year, had absorbed 28.2 per cent of China's cumulative realised FDI (Annex II, Table 13). Within Guangdong, Shenzhen SEZ accounted for 4.5 per cent of cumulative national FDI, more than most provinces.[12] The second largest recipient of cumulative FDI in 2000 was Zhejiang, where the share of national FDI stock was 12.6 per cent, more than double its 5.9 per cent share of population and rather higher than its 9.7 per cent share of GDP.

Proximity to major investors was the main determinant of high levels of FDI inflows in other coastal provinces (Annex II, Table 13). Fujian, which is located opposite Chinese Taipei across the Taiwan Strait, received 9.1 per cent of cumulative investment, of which just over one-third went to the Xiamen SEZ. Liaoning, which otherwise had limited attractiveness because of its concentration of state-owned heavy industry, benefited from Japanese investment in Dalian, a coastal city which had played a key role in trade with Japan during the Japanese occupation of North-East China. Cumulative FDI inflows into Dalian up to 2000 represented 2.5 per cent of the national total and over half of inflows to the whole of Liaoning. Shandong, near to Japan and South Korea, absorbed 6.1 per cent of investment stock. The whole coastal region was also more attractive to foreign investors than were hinterland

provinces because of the government's encouragement of export-oriented FDI, which favoured locations possessing easy access to ports and shipping routes.

Another important determinant of high levels of FDI has been state expenditure on infrastructure, notably in the major province-level cities of Beijing, which received 4.1 per cent of cumulative FDI, Tianjin, which received 3.8 per cent, and Shanghai, which, although major construction work and FDI attraction only really took off in the 1990s, received 8.1 per cent of total national realised FDI stock in the two decades up to 2000 (Annex II, Table 13).

Guangdong and Fujian also benefited from revenue-sharing agreements with the central government which allowed them to keep a relatively large share of their tax revenue, which they were able to use to upgrade the inadequate or nonexistent (in places such as Shenzhen, which had been a mere border village) physical infrastructure. By contrast, Shanghai, which had been the centre of political upheavals in the 1960s, especially the "cultural revolution", and was therefore not favoured in the early part of the reform period, was compelled to turn in a high proportion of its tax revenues to the central government. As a result, it lacked resources to restore its infrastructure, once the envy of Asia, which had become dilapidated over the previous four decades.

Inland provinces suffered a relative dearth of FDI because of the difficulty and high cost of transporting products to ports for export. As labour has become gradually more mobile, skilled labour has shifted from these areas to the more prosperous coastal zones, raising labour costs, especially in high-technology projects. Whereas FIEs have increasingly been servicing the domestic market in the Eastern region, consumer markets in the Central and Eastern regions remain relatively weak. Consequently, there has been a tendency for foreign investors to adopt a "wait and see" posture towards the hinterland, purchasing land leases for possible future use there while maintaining an eastward bias in the distribution of productive investments.

This pattern has not changed greatly over the past two decades and is evident in the figures for FDI inflows in 2000 (Annex II, Table 14). Guangdong has remained the largest recipient, while other coastal provinces, notably Jiangsu, Fujian, Shandong, Liaoning and Zhejiang also continued to absorb disproportionately large shares of national realised FDI inflows. Conversely, western and central provinces again received relatively small amounts of FDI.

Eastern China has received over 80 per cent of FDI

This regional imbalance is clear from a comparison of the three regional groupings currently used in the government's economic development strategy. The Eastern region, comprising Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong and Hainan, accounted for 85.96 per cent of the national stock of realised FDI at the end

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of 2001 (Annex II, Table 15). At the same time, the Central region, consisting of Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei and Hunan, received 8.78 per cent and the Western region, encompassing Inner Mongolia, Guangxi, Sichuan, Chongqing, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia, Xinjiang and Tibet, the remaining 5.26 per cent. The figures for 2001 show that this pattern persists, with the Eastern region actually increasing its share slightly at the expense of the Central region (Annex II, Table 16).

The initial strategy towards FDI in the 1980s was to maximise FDI inflows to the whole country, initially to experimental zones remote from the capital but then to any areas favoured by foreign investors, without attempting to ensure even geographical distribution. This policy was encapsulated in the slogan "let some areas get rich first", a counterpart to the policy of letting some individuals and households get rich first, *i.e.* initially disregarding the regressive effects of economic growth on wealth and income distribution in society. It was therefore acceptable to the central government that the coastal region, starting with the SEZs, would benefit from FDI inflows while other regions received relatively little.

By the mid-1980s, representatives of hinterland provinces were complaining in the National People's Congress (the NPC, China's parliament) that they were not benefiting from rapid economic growth and that, they were falling further behind the coastal provinces. From 1993 onward the government responded increasingly to such calls by switching to a policy of actively attempting to divert resources towards the Central and Western regions. As well as commencing major infrastructure initiatives, for example a programme to connect all villages to the road system, the government also invited foreign investors to participate in this policy by investing more in the Western and Central regions.

The bulk of FDI is in secondary industry

By end-2000 the majority, 60.9 per cent, of contracted FDI stock was in the secondary sector (Annex II, Table 17). Foreign involvement in the agricultural and extractive sectors has been limited, which is why only 1.8 per cent of cumulative FDI went into the primary sector. Prior to the post-WTO accession opening of services sectors FDI in the tertiary sector, although high in absolute terms, has been low by comparison with investment in the secondary sector, which has been dominated by manufacturing. Statistics for 2000 demonstrate that secondary-sector dominance persists (Annex II, Table 18).

In 1978-2000 60.9 per cent of cumulative realised FDI value went into industry, mainly manufacturing, as investment in utilities and construction is not included in this sector (Annex II, Table 19), a proportion that has remained

roughly stable, with the manufacturing sector reaching 63.5 per cent in 2000 (Annex II, Table 20). The more detailed breakdown makes clear that investment in services has been very small as a share of total FDI, with real estate, 11.4 per cent of FDI in 1978-2000 and 11.4 per cent in 2000, accounting for the largest element of tertiary-sector FDI. By contrast, FDI in banking and insurance was too small to be separately enumerated in earlier years and in 2000 still only contributed 0.2 per cent of total FDI inflows.

The largest projects are power stations and banks

Average project size of all foreign-invested projects in terms of current value of utilised investment[13] in 2000 was US$1.8 million. The largest projects were in the utilities sector, where the average size was US$21 million, as is to be expected, since most of these are power stations, followed by the banking and insurance sector, where average size was US$15.2 million. Manufacturing projects averaged US$3.6 million.

5. The impact of FDI on the Chinese economy

There are several ways of measuring the impact of FDI on an economy. In crude terms, it is possible to compare FDI inflows in one year with the value of GDP for the same year to obtain a snapshot of its importance. Using MOFTEC figures for cumulative FDI inflows as an indication of FDI stock and comparing this to GDP in a single year it is possible to extend this picture over time to gain an impression of the amount of absorbed foreign capital stock embodied in the country's productive capacity. Although FDI inflows include elements other than fixed capital investment, the latter comprises the bulk of FDI, so it is possible to obtain an approximation of the contribution of FDI to total fixed investment by comparing the former to the latter in any particular year and to use the result for both spatial and inter-temporal comparisons.

The Chinese customs service publishes separate figures for exports and imports by FIEs which can be used to estimate the proportion of foreign trade accounted for by such enterprises and therefore, by implication, the extent of the stimulus given by FIEs to China's merchandise trade.

Lastly, the National Bureau of Statistics[14] also publishes separate figures for the industrial output of FIEs which are used by MOFTEC to calculate the proportion of national industrial output they produce.

All these measures are inexact but provide indicators which are credible in that they accord with anecdotal and other non-statistical information.

FDI has played an increasingly important role in the economy

Foreign direct investment (FDI) played an increasingly important role in China's economy in the last two decades of the twentieth century. Realised FDI

accounted for less than 0.1 per cent of GDP in the initial, experimental phase of the reform period in 1979-82. By 1994, it had reached 6.2 per cent, and even after it remained level and then fell in subsequent years, it was still 4 per cent of GDP in 2001. By 1999 China's stock of FDI had reached 30.9 per cent of GDP, well above the global average of 17.3 per cent and the developed country average of 14.5 per cent, but not significantly above the 28 per cent norm for developing countries.

The role of FDI in China's economic growth

This period also coincided with the most rapid economic growth rates recorded by the National Bureau of Statistics since the People's Republic of China was founded in 1949.[15] Real GDP growth averaged 9.7 per cent in the 1980s and 1990s, compared to 7.4 per cent in the 1970s and 3 per cent in the 1960s[16] (which included years when GDP shrank, during the post-Great Leap Forward depression of 1960-62 and in 1967-68, the central years of the so-called Great Proletarian Cultural Revolution of 1966-69).

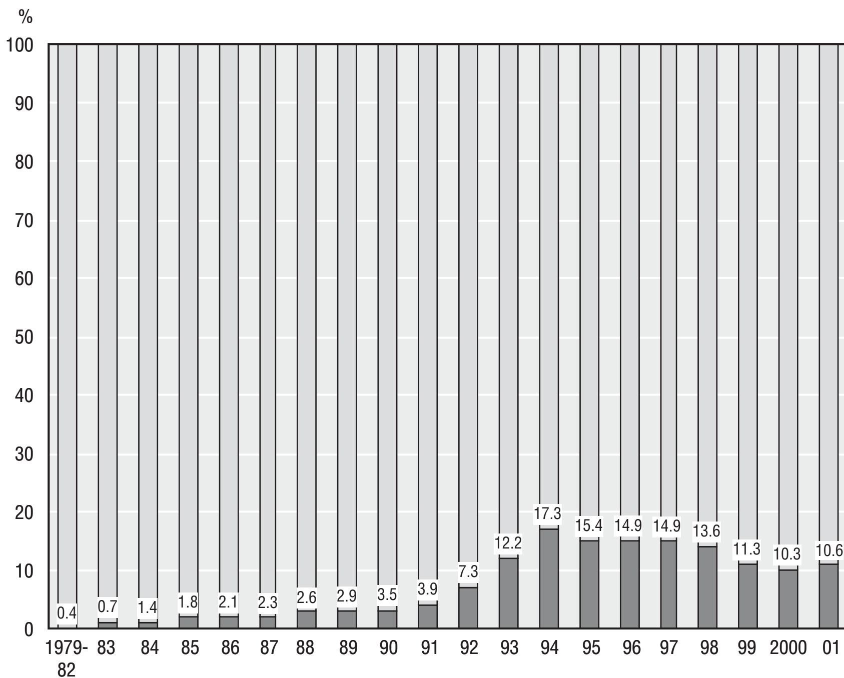
However, it would be an exaggeration to attribute the high economic growth rates recorded in the 1980s and 1990s (leaving aside the question of the accuracy of official national income statistics) largely to FDI, since to do so would be to neglect other important changes in government economic policy. For example, at the same time as the economy was being opened to foreign investment in the late 1970s and early 1980s, the rural people's communes were being dismantled into family farms, a measure that raised labour productivity in agriculture and crop yields, thereby boosting rural incomes and creating an enlarged market for consumer goods among the rural population, then about 80 per cent of the total. The shift of labour from agriculture, where the marginal product of labour was generally zero, to industry also contributed to the overall raising of productivity in the economy. The removal of the stigma formerly attached to private enterprise, at least in the form of small individual or family businesses, allowed the rapid development of small producers and traders who contributed to the provision of basic services. The establishment of Special Economic Zones contributed to a volatile building boom.

While FDI doubtless contributed to China's economic growth after 1978, the direction of causality is also likely to have been in the opposite direction: high published rates of economic growth greatly added to the attraction of China as an investment destination.

The main engine of GDP growth in the past two decades has been fixed investment (gross fixed capital formation), to which FDI made an increasing contribution, rising to a peak of 17.3 per cent in 1994 and subsiding to 10.6 per cent by 2001 as other sources, notably government infrastructure investment, continued to grow while FDI inflows remained relatively flat.

Inward FDI inflows consist of other components as well as fixed investment, so the correct measure to use is the proportion of fixed investment component of FDI to total fixed investment, but this figure is not readily available.

Figure 2.2. **FDI inflows as a proportion of fixed investment**



Note: Calculated using current-price expenditure on gross fixed domestic capital formation, converted at the official exchange rate for the year.

Source: National Bureau of Statistics, China Statistical Abstract [Zhongguo tongji zhaiyao] 2002.

The figure of 10.6 per cent in 2001 was a far higher share of fixed investment than was recorded by other Asian countries which are at a comparable stage of development, such as India, Indonesia and Thailand.

It is likely that fixed investment would have been smaller without the contribution of FDI. As mentioned earlier in this chapter, although China maintained a high saving ratio throughout the reform period, the lack of effective mechanisms of financial intermediation, restrictions on private enterprise and provincial trade barriers prevented the full realisation of the potential of market-based domestic investment. Given that it was not possible to remove these institutional obstacles in a short time, FDI made a valuable contribution to China's economic development by substituting for such

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investment. However, it should also be borne in mind that the establishment of FIEs, which often produced more marketable products and frequently used more advanced production methods, may well have discouraged the expansion – or led to the closing down – of some domestic competitors, thus reducing domestic fixed investment. The entry of major global brands into the China market also raised entry barriers to some industries by introducing strong product differentiation. Nevertheless, it is generally perceived that the net effect of FDI on fixed investment in China was positive.

FIEs have stimulated trade growth

FIEs now account for half of China's combined exports and imports. The proportion rose from 4 per cent in 1986 to 47.3 per cent in 1996, since when it has remained roughly stable. While it is possible that some of the development of FIE export capacity occurred at the expense of domestic producers, the accelerated growth of total exports after the arrival of large quantities of FDI indicates that the net effect was positive and large, although it should be borne in mind that the opening of China to foreign investment occurred simultaneously with an opening up to foreign trade after three decades of almost complete autarky, so expansion of export capacity (albeit a less rapid expansion) might have occurred even without FDI.

The proportion is now approximately the same for exports and imports, with FIEs supplying 50.1 per cent of China's exports and 51.7 per cent of its imports in 2001, reflecting the high import content of FIE exports. However, for most of this period FIEs represented a higher share of imports than of exports. The average FIE import share in 1986-2000 was 34.8 per cent, that of exports 25.1 per cent. In 1986 the FIE import share was nearly three times that of exports; this difference was gradually whittled away over a decade and a half to the narrow margin evident in 2001 as FIE exports grew at an annual average rate of 47 per cent compared to 32 per cent for FIE imports. This is consistent with the usual pattern of foreign investment in a developing country, in which the early stage is characterised by large-scale imports of capital goods which are not locally available and by the gradual establishment and commissioning of export manufacturing facilities.

The excess of FIE imports over FIE exports in 1986-2001 produced a total trade deficit of US$80.9 billion for the period, during which the annual FIE trade deficit rose to a high of US$18.2 billion in 1994 before shrinking rapidly in the three subsequent years and turning into a surplus after 1997 which reached US$7.4 billion in 2001. FIEs therefore contributed to the external element of GDP growth only in five years out of sixteen: in 1995-97, when their balance of trade deficit shrank by comparison with the previous year, and in 1998 and 2001, when they produced a larger trade surplus than the year

before. Only in one year, 1997, was the deficit reduction large enough (US$11.3 billion) to make a significantly positive difference to GDP growth.

Provincial share of national FDI inflows is highly correlated with provincial share of national FIE exports, and with its share of national FIE imports. Guangdong, which absorbed 28.2 per cent of realised FDI by 2000, was responsible for 40.8 per cent of FIE exports and 35.2 per cent of FIE imports in 2001. However, FIE export and import intensities vary widely between provinces and there is a much weaker association between these and provincial FDI shares.

The role of FDI in Chinese industry

FIE industrial output rose to a peak of 27.8 per cent of total industrial output in 1999 before falling back to 22.5 per cent in 2000. This is less than half the proportion of China's merchandise trade accounted for by FIEs, reinforcing the conclusion already inferred from FIE export figures that FIEs are far more export-oriented than domestic producers. It is also more than five times the 5.2 per cent proportion of foreign investment funds to total investment in fixed assets in 2000. Productivity of capital is clearly higher in FIEs than in domestic industry. Labour productivity is difficult to measure, but there is no doubt that FIEs were also punching above their weight in this respect also.

FDI has also modified China's industrial structure in that it has played a major part in boosting the share of output of the non-state sector and has also shifted the balance of investment towards industries such as electronics, telecommunications equipment and textiles (OECD, 2000a).

Job creation and higher wages

At the end of 2000 FIEs employed over 6.1 million people according to the NBS (though this may have been an underestimate – one MOFTEC estimate ranged as high as 20 million for end-1999), a high proportion of them in manufacturing, equivalent of 0.9 per cent of the total national registered workforce and 1.7 per cent of those employed in secondary industry. Considering the much higher share of output registered by FIEs, these figures indicate far higher productivity in such enterprises than in domestically-owned enterprises. This difference is particularly noticeable in high-tech industries. It is therefore not surprising that FIEs pay higher wages than domestically-owned firms. In addition to employment provided directly in FIEs, a far larger number of jobs have been created in the firms that supply local production inputs and sell the output of these FIEs.

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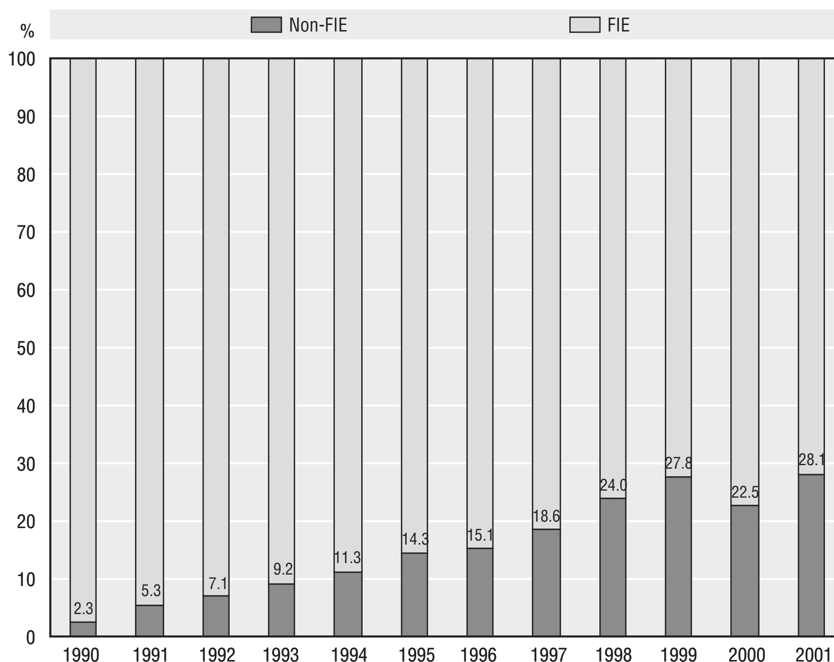
Figure 2.3. **FIE industrial output**



Source: National Bureau of Statistics, China Statistical Abstract [Zhongguo tongji zhaiyao] 2002.

Spillover to the domestic economy

FIEs raise the overall productivity of China's economy because they are more productive than other sectors. Labour productivity in industrial FIEs is 88 per cent higher than in domestic industrial enterprises.[17]

FDI can also affect productivity in other sectors of the economy in various ways. Employees hired and trained by FIEs may move to domestically-owned enterprises, thus transferring the latter's investment in human capital at no or low cost. Productivity improvements may also be brought about as FIEs introduce new technologies or new product requirements in local firms that supply them with inputs. Competition from an FIE can also stimulate product and process improvements that would otherwise not be forthcoming in the domestic industry. The positive effects of such competition on local firms is clearly visible in China, where it is precisely those industrial sectors that were first opened to foreign investment that have provided fertile ground for the emergence of domestic companies that are now competing on the world market and even starting to invest in productive capacity in other countries. The new knowledge

diffused from FIEs into the local economy constitutes a cluster of external benefits that may prove more effective in promoting productivity growth in the economy as a whole than the direct technology transfer embodied in an FDI project. Too few studies have so far been conducted to determine the extent of spillovers from FDI in the Chinese context to draw firm conclusions; one such study indicates that modest productivity spillover is detectable in the electronics industry (Wei and Liu, 2001).

As demonstrated in the OECD study on maximising benefits and minimising costs of FDI for development (OECD, 2002b), the experience of OECD member countries is that productivity spillovers are not automatic and that governments may effect policy measures to maximise opportunities for such spillovers to occur. It would seem reasonable to suppose that China will maximise returns from attracting FDI if it builds its capacity to absorb external economies emanating from them. One aspect of this is the need to invest in human capital. The extensive system of vocational training that has been constructed in recent years enables employees hired by FIEs to benefit from the training they receive in them. The same is true at a higher level of knowledge of the world-class graduates produced by China's top universities. But the supply of educated labour is still insufficient for China's needs, let alone those of FIEs. Expenditure on education needs to be increased well beyond the current low share of GDP, teaching and learning methods need to be reformed and diversified. Chinese enterprises also need to invest in physical capital to take advantage of new products and new methods of production from abroad.

Notes

1. The term "Cultural Revolution" is now used by the Chinese government to refer to the period 1966-76, which form a policy (or lack of policy) continuum, although strictly speaking the cultural revolution ended with the Ninth Congress of the Chinese Communist Party in 1969. The economic policies advocated by the country's leaders during this ten-year period were characterised by an insistence on central planning without the use of material incentives.
2. All the figures in this paragraph are from the China Statistical Yearbook, 2001.
3. All the figures in this paragraph are calculated from statistics in the China Statistical Yearbook, 2001 and earlier editions.
4. This point is well made in several talks and writings by Professor Huang Yasheng, for example in Huang 2002.
5. All the figures in this paragraph are calculated from statistics in the China Statistical Yearbook, 2001 and earlier editions.
6. National Bureau of Statistics, China Statistical Abstract *[zhongguo tongji zhaiyao]* 2002.
7. National Bureau of Statistics, China Statistical Abstract *[zhongguo tongji zhaiyao]* 2002.

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8. The accession documents are available on the WTO web site *www.wto.org*

9. www.fdi.gov.cn.

10. Chen Chunlai, *Provincial Distribution of Foreign Direct Investment in China*, Research Paper to the MOFCOM/OECD co-operation programme on FDI, cited in *Foreign Direct Investment: Prospects and Policies* in (OECD, 2002a) page 339.

11. Market size (GDP), per capita GDP, GDP growth rate, efficiency wage defined as the real wage rate adjusted by labour productivity, labour quality approximated by the illiteracy rate, accumulated FDI stock, economic distance defined as the average distance of a country to the rest of the world weighted by share of global GDP, and a dummy variable for the countries that adopted the Export Promotion Development Strategy to capture the effects of trade and investment regime on FDI inflows.

12. "Province" is used in this study to denote all provincial-level administrative units, including the 23 provinces, the five autonomous regions (Guangxi, Inner Mongolia, Ningxia, Tibet and Xinjiang) and the four cities directly responsible to the State Council (Beijing, Chongqing, Shanghai and Tianjin). The two special administrative regions of Hong Kong (China) and Macao (China) which became part of China in 1997 and 1999 respectively, have their own separate statistical systems and are not included in China's national statistics. Chinese Taipei, which is considered a province of China (Taiwan) by the Chinese government, has a separate administration and is also not usually included in China's national statistics.

13. Total realised FDI in US$ for the year divided by number of projects.

14. *Guojia tongji ju*, formerly translated as the State Statistical Bureau.

15. GDP figures are available from 1953, the first year of the First Five-Year Plan for Development of the National Economy and the first year after the 1949-52 period of economic recovery after the 1937-45 Anti-Japanese War and the 1946-49 civil war.

16. It should be borne in mind that serious questions have arisen over the accuracy of China's national income statistics in recent years, particularly in regard to industrial and GDP growth. Discrepancies between the national GDP growth rate and the average of provincial growth rates have been accompanied by discrepancies between the growth rates of real industrial output and of such indicators as freight tonne-kilometres and electricity consumption. Combined with anecdotal evidence suggesting slow or no growth in 1998, these discrepancies have thrown doubt on the accuracy of the high growth rates reported in the late 1990s. Nevertheless, the weight of other evidence does support *prima facie* the assertion that the Chinese economy achieved relatively high real growth rates in the 1980s, a decade which coincided with the initial inrush of FDI.

17. *Foreign Direct Investment: Prospects and Policies*, in (OECD, 2002a), page 328.

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Chapter 3

The regulatory framework for FDI in China

Abstract. *A body of legislation relating to foreign direct investment (FDI) and foreign-invested enterprises (FIEs) has been passed since 1978. Separate laws govern FIEs of different forms. These laws specify the procedures for examining and approving FDI projects as well as some incentive measures. Major changes resulted from China's accession to the World Trade Organisation (WTO) in 2001, including the opening up to foreign investment of several services sectors. FDI is guided into or away from specific sectors of the economy by four Catalogues for Guidance of Foreign Investment Industries: prohibited, restricted, permitted and encouraged. Incentives are provided to encourage investment in the Central and Western regions. One result of WTO entry was the removal of trade-related investment measures (TRIMs) such as local-content requirements and export performance requirements, and the requirement that FIEs balance their foreign exchange receipts and expenditures. China's currency is convertible on current account, so profits and other income may be freely remitted abroad, but capital-account controls persist. China's capital markets are at an early stage of development and not fully open to foreign participation. Land is not available for purchase and foreigners may only purchase a limited range of buildings and associated land-use rights. The freeing of the formerly state-controlled labour market has improved the supply of labour to FIEs. A sounder environmental regulatory framework has been established and the government appears to be moving away from the use of lax application of environmental protection standards to attract FDI.*

1. FDI laws and regulations

Before the onset of economic reform in 1978, Chinese law governing foreign economic relations consisted almost entirely of a handful of customs regulations adopted between 1950 and 1976. Since there was practically no foreign investment, there was no need for foreign investment law. When the decision was taken to attract foreign capital, there was therefore a legal vacuum that had to be filled in a hurry.

At the end of 1978 the Chinese government began to consult foreign experts on the establishment of a legal framework to govern the new economic institutions emerging as a result of the reform policy. This was considered necessary because there was at the time no company law governing the operation of both domestic and foreign enterprises. Shortly thereafter the first legislation relating to foreign investment started to emerge. Not surprisingly, the economic and business legislation of the late 1970s and early 1980s, despite having benefited from outside advice, bore all the hallmarks of having been hastily drafted. It also embodied the traditional vagueness of many Chinese laws, leaving maximum room for government officials' interpretation.

Subsequent refinements, especially since the early 1990s, have added clarity and precision to existing law, as well as many new subjects that were not previously covered by legislation. Laws and regulations governing FDI will continue to evolve. In particular, major changes to FDI and trade laws have been made as a result of China's accession to the WTO at the end of 2001, and more such changes are in the pipeline. The general trend of FDI legislation is now in the direction of further liberalisation combined with national treatment, *i.e.* treating FIEs no less favourably than domestic enterprises. Some recently issued documents, including the revised catalogues for guidance of foreign investment industries, largely accord with this trend, but may still contain elements which are inconsistent with investment liberalisation and national treatment. It would be good practice for these documents to be examined and, where necessary, amended to ensure such consistency.

Apart from laws directly addressing FDI issues, several important laws have been passed which are of direct interest to foreign investors, including the company law and laws on intellectual property rights (IPR) protection. A number of laws are reportedly on the drawing board and need to be prepared and promulgated soon to ensure the development of a genuinely competitive business environment within which domestically-owned, as well as foreign-

invested, businesses can operate effectively. These are likely to include a competition law and/or an anti-monopoly law and a law governing mergers and acquisitions (M&A).

The general form of FDI law: a law for each form of enterprise

China's laws relating directly to FDI take the form of separate legislative enactments for each form of FIE, together with some laws which apply to all FIEs. The advantage of such multiform legislation is that foreign investors can be certain of the rules governing the particular form of investment in China that they have chosen. The disadvantage is that this legislative division produces a compartmentalisation that makes it difficult to co-ordinate the activities of enterprises governed by different laws. For instance, merging enterprises of different forms is made excessively complex. Nor is it clear that there is any long-term benefit in having so many, and such detailed, laws on FIEs. As a result of China's accession to the WTO, it has already been necessary to remove a number of requirements from these laws and it is likely that future relaxation of restrictions on foreign investment will necessitate further changes. The Chinese government may wish to consider a possible evolution towards the integration of FDI law into domestic company law so that FIEs are eventually treated on a par with domestic enterprises.

In the initial phase, FDI inflows were limited to joint ventures between foreign companies and Chinese entities, usually state-owned enterprises (SOEs). This form suited both China and foreign investors. Starting from an economy in which all major enterprises were state-owned and there was no foreign participation, it would have been difficult politically for the government to accept entirely foreign-owned private enterprises at the outset. For their part, foreign investors needed Chinese partners to help them understand and deal with an unfamiliar, uncertain and still largely closed operating environment, especially in regard to finding and servicing local markets. Joint ventures took two general forms: equity joint ventures and contractual (also translated as co-operative) joint ventures. In July 1979 the NPC adopted a law on Sino-foreign equity joint ventures. This was followed in 1988 by a law on Sino-foreign contractual joint ventures. This sequence may have reflected the government's preference for equity joint ventures. It was, however, the reverse of the actual sequence of development of joint ventures, in which contractual joint ventures predominated in the first half of the 1980s before equity joint ventures gained dominance (see Chapter 2).

Equity joint ventures

Equity joint ventures are limited liability companies in which, in general not less than 25 per cent of the investment (denominated in ren min bi, unless the partners agree to use another currency) is contributed by the foreign partner.

According to a MOFTEC document issued on 30 December 2002 entitled "Circular on Certain Questions Concerning Strengthening the Management of Approval, Registration, Foreign Exchange and Taxation of Foreign-Invested Enterprises", the proportion of total enterprise capital subscribed by the foreign investor in an equity joint venture may be less than 25 per cent, though in such cases the venture is not entitled to tax rebates on imports of producer goods for its own use or for other tax exemptions and reductions normally granted to foreign-invested enterprises (see Chapter 6). Either side may contribute investment in the form of cash, capital goods or property rights; the Chinese partner's contribution may include land use rights for the site. The registered capital of the joint venture could not originally be reduced during the term of the venture, which is ordinarily from 10 to 30 years, but may be extended to 50 years in certain circumstances or beyond 50 years with approval by the State Council. This is no longer the case: according to a MOFTEC regulation of 1995 and newly amended implementing rules appended to the equity joint venture law, registered capital may now be reduced after approval; approval is required because such reduction involves a change in the contract that was originally approved. The foreign investor could (and still may) withdraw his or her investment by transferring his or her share to the Chinese partner or to a third party or by closing the joint venture altogether. Closure is only possible after a resolution to this effect has been passed by the board of directors and approval granted by the approving authority.

The net profit of a joint venture is distributed between the parties to the venture in proportion to their respective shares in the registered capital. The governing body of an equity joint venture is a board of directors consisting of at least three members. The chairman of the board originally had to be from the Chinese side, and the vice-chairman a representative of the foreign partner. This requirement has been deleted from the newly amended implementing rules.

Sectors in which equity joint ventures could be formed according to the original law were: energy, building materials, chemical and metallurgical industries; machine building, instrumentation, meter and offshore oil exploitation equipment manufacturing; electronics, computer and communications equipment manufacturing; light industries, particularly textiles, foodstuffs, medicines, medical apparatus and packaging; agriculture, animal husbandry and fish breeding; tourism and service trades. Equity joint ventures were not, however, limited to these sectors, which were merely stated as examples. Limits to setting up equity joint ventures were subsequently imposed in the catalogues for the guidance of foreign investment industries, the most recent editions of which became effective in April 2002.

The original version of the law contained a requirement to submit production and operation plans to the competent authorities for filing. In 1979, when the joint venture law was formulated, the Chinese economy was still functioning according to five-year and annual production plans, so this

requirement merely placed the same obligation on equity joint ventures as on other business units. By the mid-1990s mandatory central planning had in practice been largely replaced by indicative planning so that production plans no longer fulfilled any practical role, so this requirement has fallen into disuse in recent years. Its deletion in 2001 because of inconsistency with the market economy and consequent contravention of WTO rules represented formal recognition of disuse rather than a change in policy.

Technology and export requirements for equity joint ventures were broader and weaker than for wholly-foreign-owned enterprises (see below). In addition to adopting advanced technology and management methods to widen the variety of products, raise both the quantity and quality of output, and save energy and materials, the joint venture must provide technical and managerial training. No fixed export minimum is specified in the law; joint ventures are merely enjoined to enable expanded production for export and increased foreign currency income. Since, following China's accession to the WTO, enterprises can not be required to fulfil export performance requirements, balance their exports and imports or balance their foreign exchange income and expenditure, these exhortations have no force and are mere expressions of preference. In the original version, equity joint ventures were told to give priority to domestic sources in purchasing production inputs; this article was deleted in 2001 as a trade-related investment measure violating the WTO TRIMs agreement. In responding to market forces, both international and domestic, equity joint ventures, like all other enterprises, will sell in whichever market is most profitable; it therefore appears unnecessary to retain a clause encouraging any particular form of enterprise to export its output.

Contractual joint ventures

A contractual joint venture is a much looser arrangement than an equity joint venture; it may or may not have legal person status. The law does not state that such a venture shall be a limited liability company and does not specify the share of either partner, except in the case of a contractual joint venture which has legal person status, in which case the foreign partner must provide in general not less than 25 per cent of the registered capital. According to a MOFTEC document issued on 30 December 2002 entitled "Circular on Certain Questions Concerning Strengthening the Management of Approval, Registration, Foreign Exchange and Taxation of Foreign-Invested Enterprises", the proportion of total enterprise capital subscribed by the foreign investor in an equity joint venture may be less than 25 per cent, though in such cases the venture is not entitled to tax rebates on imports of producer goods for its own use or for other tax exemptions and reductions normally granted to foreign-invested enterprises (see Chapter 6). Unlike in an equity joint venture, where profits are shared in proportion to shares

in the registered capital, in a contractual joint venture profit may be distributed in other ways, which must be stipulated in the contract. For example, the law states that the contract may prescribe that the foreign partner recovers its share of the investment during the term of co-operation if ownership of all the fixed assets reverts to the Chinese partner at the end of that term. As with an equity joint venture, the registered capital could not originally be reduced during the term of the venture, but may now be reduced if approval is granted; unlike equity joint ventures, contractual joint ventures have no maximum specified legal term. A contractual joint venture is managed by a board of directors or "a joint management body" consisting of at least three members; the two parties must share the two top positions.

The contractual joint venture law was amended in advance of China's accession to the WTO to comply with WTO commitments. In particular, Sino-foreign contractual joint ventures no longer have to balance their foreign exchange receipts and expenditures.

Wholly-foreign-owned enterprises

The law governing wholly-foreign-owned enterprises was passed in April 1986. A wholly-foreign-owned enterprise is a limited liability company or other form of organisation, if approved, established in China by foreign investors exclusively with their own capital. The term "wholly-foreign-owned enterprise" explicitly excludes branches of foreign companies in China.

In the original law, such enterprises were required either to use advanced technology to develop new products, save energy and raw materials, upgrade existing products and/or to substitute for imports, or to export at least 50 per cent of their output value. These requirements have been since removed in compliance with WTO rules and replaced with a general exhortation to adopt advanced technology and equipment, engage in the development of new products, realise the upgrading of products, conserve energy and raw materials and be export-oriented. The original law states only that wholly-foreign-owned enterprises may engage a Chinese foreign trade company to sell its products on a commission basis. In 2001 this was revised to allow such enterprises to sell their own products in China or to appoint other business organisations to sell their products

Implementing regulations specifically excluded wholly-foreign-owned enterprises from being formed in the prohibited areas of news, publishing, broadcasting, television and film production; domestic commerce, foreign trade and insurance; posts and telecommunications. Additional approval by MOFTEC was required to form wholly-foreign-owned enterprises in the restricted areas of public utilities; communications and transport; real estate; trust investment; leasing. The two articles embodying these restrictions have been deleted and

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replaced by advice to consult the relevant sections of the catalogues for guidance of foreign-investment industries. (Many of these sectors are in the prohibited or restricted catalogues.)

The law protects wholly-foreign-owned enterprises from confiscation by the state, except under special circumstances, in which case legal procedures will be followed and compensation made. The bilateral investment treaties (BITs) that China has signed with many countries (see Chapter 7) routinely include a clause guaranteeing this protection.

Registered capital may not be reduced during the term of the contract. However, this prohibition has been relaxed following WTO entry to take account of the fact that actually utilised investment may be less than the contracted amount. The investment contributed by a foreign investor may be provided in convertible foreign currency or in the form of equipment, industrial property rights, know-how or, with approval, profits in ren min bi from other enterprises in China. Capital may be subscribed in instalments over a period of not more than three years, the first instalment of not less than 15 per cent to be paid within 90 days after the enterprise's business licence is issued.

Wholly-foreign-owned enterprises have become increasingly popular as foreign investors have gained experience in operating within China's business environment, which itself is becoming more user-friendly to outsiders, and as more distribution channels have opened up. Many foreign partners in joint ventures have discovered problems arising from differences in culture and expectations ("same bed, different dreams" in Chinese parlance) between themselves and their Chinese partners and now prefer to operate independently.

Foreign-invested company limited by shares

A foreign-invested company limited by shares is an enterprise with legal person status in which the foreign shareholder holds a minimum of 25 per cent of the company's total registered capital, which must be the same as the total registered (and actually paid in) share capital. The company's registered share capital must be at least Rmb 30 million. Such a company may reorganise itself to seek a stock exchange listing and offer shares to the public [B shares in China, or shares on stock exchanges outside mainland China such as Hong Kong (China) and New York].

Foreign-invested holding companies

An investment company (also called a holding company) is a limited liability company, either wholly-foreign-owned or an equity joint venture, established by foreign investors for the purpose of engaging in direct investment. The foreign investor must contribute at least US$10 million in actually paid in capital, if the investor's total assets exceed US$400 million and has actually paid-in investment

in China of at least US$10 million; otherwise, the investor should have already set up 10 enterprises in China and the actually paid-in capital must be no less than US$30 million before applying to set up a holding company. It is not clear what public interest is served by restricting the option of establishing holding companies only to firms that meet these conditions.

Joint exploitation

Joint exploitation contracts are signed between a foreign company and a Chinese entity for projects involving joint exploration for both inland and offshore oil and gas, or other mineral resources.

Build-operate-transfer (BOT)

Build-operate-transfer (BOT) projects are allowed in a limited range of infrastructure areas (coal-fired power stations, hydroelectric power stations under 250 MW, high grade roads, local railways, bridges, tunnels, city water supply sources, water purification plants and sewage treatment plants). Such projects are included in national and local five-year plans and are carried out by limited liability companies in which the registered capital is at least 25 per cent of total investment. The project company owns and manages the franchise of the project for up to 30 years before transferring ownership to the Chinese government without further claim. The foreign investor in a BOT company is selected by international competitive bidding. Transfer-operate-transfer (TOT) pilot projects are also being encouraged in hinterland areas as a method of improving the operation of existing infrastructure facilities.

Examination and approval procedures

The application to establish an FIE in one of the categories described above must be submitted for examination and approval by the department under the State Council which is in charge of foreign economic relations and trade (now the Ministry of Commerce, MOFCOM) or by other authorities entrusted with such powers by the State Council. The examining and approving authority must make a decision on whether or not to grant approval within 90 days of receipt of the application in the case of a wholly-foreign-owned enterprise, three months in the case of an equity joint venture and only 45 days in the case of a contractual joint venture. In all three categories of FIE, the foreign investor must then apply to the authorities in charge of industry and commerce for registration and a business licence within one month (30 days) after receiving a certificate of approval.

Approval powers of different levels of government

The cut-off point between approval by central and local authorities is a project size of US$30 million. Projects valued at more than US$30 million must be submitted for approval to MOFCOM at national level and they will then be considered by the State Development and Reform Commission (SDRC). Projects with a value exceeding US$100 million must also be submitted to the State Council (China's cabinet) for approval.

Projects below US$30 million may be approved by government departments at provincial level, including the governments of municipalities like Beijing and Shanghai directly under the State Council and autonomous regions such as Tibet. However, if a project is in an industry classified as restricted it must be submitted to higher authorities even if it is below the US$30 million threshold. Conversely, it is in the encouraged catalogue and is regarded as not having future side effects it may be approved by the local authority and merely filed in the State Council offices even if it is larger than US$30 million.

This division of authority is open to abuse in that it encourages local authorities to split projects valued at over US$30 million into smaller segments to avoid having to submit them to national level authorities, a practice which is in clear breach of the rule. A project which is submitted only to local, not national, approval is more likely to be approved, as local authorities seek to maximise revenue and employment creation of FDI projects, while the national authorities have to take into account other factors (such as the perceived need to avoid localised overcapacity and overall macroeconomic considerations) which may cause approval not to be granted.

However, insofar as this stratagem of local authorities is efficiency-seeking rather than revenue-seeking, it does indicate the existence of real bottlenecks in the approval process. Local authorities complain that if a project is submitted to a central government department such as the SDPC the approval process will be delayed. While this delay generally averages about six months, which is already long by modern standards, in some cases it may be as long as three years, in which case the market for the product to be produced by the FIE may have changed and the project may be no longer viable.

Another violation of the rules that may occasionally occur is that an FIE may go into operation before it has obtained approval to do so, evidently with the tacit, if not explicit, connivance of the local authority. This practice is another indication that project approval times tend to be too long.

The Chinese government may wish to consider amending the approval process to obviate unnecessary delays in the approval process caused by

submission of a foreign investment project to higher authorities. Possible solutions may include:

- Raising the limit above which approval has to be submitted to central government departments at national level and increasing the approval powers of local governments accordingly.
- Fast-tracking the national-level approval process by allocating more resources, including staff, to it, reorganising the process to make it more efficient, or both.
- Shortening the time limits for decisions on approval or non-approval by the examining and approving authority or authorities.
- Reclassifying projects from restricted to permitted or from permitted to encouraged, as appropriate, to ensure that they are submitted for approval at local, not national, level. (Unless the catalogues for guidance of foreign investment industries are further liberalised, as suggested in this report.)
- Standardising and simplifying the whole approval procedure.
- Making all changes transparent, for example by putting them all on the MOFTEC web site in both Chinese and English as early as possible.
- MOFTEC is encouraged to consider establishing a web site to advanced internationally recognised standards, that could include as many as possible of the following:
  - ❖ Navigation and content to be fully and equally available in both Chinese and English.
  - ❖ All legislation directly or closely related to FDI to be posted on the site in Chinese in a specified number of days after it has been promulgated.
  - ❖ All legislation directly or closely related to FDI to be posted on the site in English within a specified number of weeks after it has been posted on the site in Chinese.
  - ❖ The above standards to apply to all local regulations, incentives, procedures and other FDI-related information.
  - ❖ Draft legislation directly or closely related to FDI to be posted on the site at the earliest possible stage and a regular system of online feedback provided, equivalent to the US Federal Register and other similar systems in OECD countries.
  - ❖ A relational database management system used to maintain queriable databases of information relevant to foreign investors; such content development to be on the basis of need, based on feedback from users.
  - ❖ Navigability to be completely transparent so that there is never any need to contact the webmaster to locate information on the site.

Problems encountered by applicants

The procedures for examining and approving FDI projects involve a large number of administrative steps. These typically involve lodging documents with local branches of a number of different authorities, such as the State Administration of Industry and Commerce (SAIC), the State Administration of Foreign Exchange (SAFE), the customs authority and the National Bureau of Statistics (NBS).

A serious problem is the co-existence of two sets of rules governing the approval process. National laws and implementing regulations are available to foreign investors, though not always in an instantly accessible form. These are described by Chinese officials as "*gongkai*" (public) rules. Accompanying these, there are other rules, characterised by Chinese officials as "*neibu*" (internal) rules, that are not published. This latter category includes rules used by local authorities to decide whether or not a project will be approved. Because of their secretive nature, it is not known if there are also unpublished rules operating at national level. The Chinese national authorities are of the view that internal rules at local level no longer exist.

Where internal rules grant benefits in addition to those to which an enterprise is entitled according to the published rules, the problem is less serious, provided such benefits are available to all qualifying FIEs (if they are only available selectively, or on a discretionary basis, then this amounts to privilege and it should cease). It is, however, likely that some of the internal rules are more restrictive than the published rules, to the obvious detriment of potential investors that have done their best to meet approval requirements on the basis of publicly available information.

Incentive measures

Investment-attraction measures have taken a number of forms, including tax incentives, low land lease charges in comparison with other FDI target locations, provision of low-cost labour and the development of physical infrastructure. A consideration of tax incentives offered to foreign investors can be found in Chapter 6 and a discussion of the general trend of investment-attraction measures from incentives-based to rules-based measures in Chapter 1. Here it is sufficient to point out that the initial aim of policy-makers in China was to convince foreign investors that it could be worthwhile investing in China despite the history of discouraging foreign investment before the reform period and the subsequent lack of a totally suitable operating environment. Though it has, for example, offered labour at wages lower than those in FDI source economies, as one would expect from the wide difference in productive resource endowment between China and its more sparsely populated neighbours, China

does not appear to have concentrated on engaging in bidding wars to divert investment away from competing FDI recipients.

Investment zoning policies

China's investment zoning policies are a reflection of the process of opening up an economy that was initially closed not only to foreign investment but also to travel. Although from 1978 onward FDI was welcome in any part of China that foreigners were allowed to access, the first areas to be provide special attractions to foreign investors, the Special Economic Zones (SEZs), were on the coast, partly because these were easier for foreign investors to access and partly also because of the export orientation that the Chinese government expected FIEs to adopt. Channelling FDI to areas that had lacked investment appears not to have been a major objective in the initial stages, though it may have played a part in policy discussions regarding Guangdong and Shanghai. More recently, the opening up of the Central and Western regions has been accompanied by policies designed to attract both domestic and foreign investment to these less-developed areas.

Special Economic Zones

The Special Economic Zones (SEZ) were the first areas to provide special attractions to foreign investment at the beginning of the reform programme. The first SEZs, established in August 1980, included three in Guangdong province, Shenzhen SEZ, Zhuhai SEZ and Shantou SEZ, plus Xiamen SEZ in Fujian province. The island of Hainan, formerly a part of Guangdong province, became a separate province and also China's largest SEZ in 1988 and in 1990 the Pudong New Zone in the eastern half of Shanghai became an SEZ.

The first four SEZs were set up near Hong Kong (China) and Chinese Taipei to attract capital from those locations. In the 1980s Hong Kong (China) industry decamped wholesale to China in search of cheaper land and labour, and the process continued in the 1990s. Investment from Chinese Taipei only started to arrive in the late 1980s after travel restrictions to mainland China began to be gradually relaxed in 1987 by the government of Chinese Taipei and it was not until the early 1990s that FDI from this source became noticeably large. The other locational factor was remoteness from Beijing. Establishing the SEZs was a bold initiative not accepted by the entire Communist Party leadership. Stationing them far away from the capital reduced the danger of capitalist cultural and economic contamination while also ensuring that the main body of the Chinese economy would not be endangered if the experiment failed and the SEZ economies collapsed.

Shenzhen rapidly grew from a small border village to a thriving metropolis adjoining Hong Kong (China), attracting immigrants from other parts of China. Zhuhai, situated next to Macao (China), benefited less from capital inflows from

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its tiny neighbour but embarked nevertheless on ambitious urban construction projects. Shantou, already an established city near the Fujian border, used its SEZ status to attract labour-intensive industries to soak up its pool of surplus labour. Xiamen remains a model new town but has not managed to attract the large projects from Chinese Taipei that it wanted because of the restrictive policies of the government of Chinese Taipei towards investment in China. The Chinese government bestowed SEZ status on Hainan with the intention of making it a "second Chinese Taipei" attracting high-tech investment from Japan, but this dream has not materialised. Despite having a head-start because of its comparatively long commercial and industrial history, Shanghai lagged behind the SEZs during the 1980s. Shanghai had been a major contributor of tax revenue in the 1980s and in the 1990s became a major recipient of state funding to develop its infrastructure. Shanghai benefited from greater public investment and FDI encouragement after the accession to power of Jiang Zemin and Zhu Rongji, both of whom had been successful mayors of Shanghai and are commonly referred to as leaders of the "Shanghai clique". Renewed interest in Shanghai was also encouraged by Deng Xiaoping, who regretted publicly in 1991 that Shanghai had not been one of the original SEZs.

The SEZs have, to varying extents, been successful in attracting FDI and building their local economies. Shenzhen, in particular, has grown more rapidly than the national economy and is a major exporter. SEZs have also been successful as hothouses and showcases for new forms of enterprise. However, it is arguable that they have not been so successful in spreading the benefits of their development to hinterland areas and may even have detracted from their growth insofar as they have attracted talent and manpower eastward from inland areas with fewer employment opportunities (the so-called "backwash" effect noted in earlier decades in the enclave economies of port cities in developing countries).

Other open areas

In 1984 another 14 coastal cities were opened to foreign investment: Shanghai, Tianjin, Dalian, Qinhuangdao, Yantai (including Weihai), Qingdao, Lianyungang, Nantong, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai. A year later, virtually all the major urban and semi-urban coastal areas on China's coastline were thrown open to foreign investment: the Pearl River Delta in Guangdong province; the Yangtze River Delta centred on Shanghai; the Xiamen-Zhangzhou-Quanzhou Triangle centred on Xiamen in Fujian province; the Liaodong Peninsula including Dalian; Hebei in North China next to Beijing and Tianjin; and Guangxi in South China.

Though the Yangtze River Delta zone was subsequently extended westward along the Yangtze River valley, these open areas have remained largely concentrated in China's eastern coastal plain. While they do constitute to some extent an enclave economy, it should be remembered that because of China's

physical geography it is an enclave that contains a disproportionately high share of the country's population, so that the benefits of economic growth resulting from FDI have not been confined to as small a group as has been the case in some other developing countries where coastal development areas have emerged.

Major changes in FDI policy resulting from China's WTO accession

By far the most important development of FDI policy in recent years has been the accession of China to the WTO on 11 December 2001. To secure accession, China signed treaties with a number of countries guaranteeing not only further lowering of trade barriers but also increased market access for foreign investors. WTO accession necessitated progressively opening up a range of services sectors (GATs), the removal of trade-related investment measures (TRIMs) and the implementation of trade-related intellectual property rights (TRIPs) in compliance with WTO rules.

Opening up of services sectors

A wide range of services sectors is being progressively opened to foreign investors, with geographic, business scope and ownership restrictions generally being phased out over a period of not more than five years. The level of market access to foreign investors already available at the date of WTO accession is guaranteed by grandfathering clauses in the accession agreements.

Financial services

- **Banking:** Foreign financial institutions were previously limited to a few geographical areas and were restricted to conducting foreign-currency business with FIEs. From the date of accession, they may now conduct foreign-currency business without restriction anywhere in China and local-currency business in Shanghai, Shenzhen, Tianjin and Dalian. Within one year after accession the area where they may conduct local-currency business will be expanded to include Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan; within two years this area will also include Jinan, Fuzhou, Chengdu and Chongqing; within three years after accession, Kunming, Beijing and Xiamen; within four years after accession, Shantou, Ningbo, Shenyang and Xi'an. Within five years after accession banks will be able to conduct business in local or foreign currency anywhere in China. Foreign financial institutions will be able to service domestic enterprises within two years after accession and after five years also to local individual customers. Foreign financial institutions licensed for local-currency business in one part of China may service clients in any other region that has been opened for such business.
- **Securities:** Foreign securities houses may engage directly in B-share business (B shares are denominated in foreign currency, Hong Kong dollars in Shenzhen

and US dollars in Shanghai, and are available to foreign holders; A shares are denominated in ren min bi and are for domestic purchasers). From accession, foreign investors may establish joint ventures to conduct domestic securities investment fund management business with the maximum foreign equity participation limited to 33 per cent, rising to 49 per cent three years after accession. Three years after accession, foreign securities institutions will be permitted to establish joint ventures with a maximum equity participation of one-third to engage directly in underwriting all types of shares, including A shares, as well as government and corporate bonds, to engage in trading in B shares and H shares [issued on the Hong Kong (China) stock exchange] and participate in the launching of investment funds. Although the government has for some years been considering the possibility of eventually opening the A share market to foreign participation, probably by merging the A and B share categories, such a measure has not been agreed to as part of China's accession to the WTO.

- **Insurance:** Foreign non-life insurers are permitted to become established in the form of branches or as joint ventures with 51 per cent foreign ownership; within two years after accession they may establish wholly-owned subsidiaries. Foreign life insurers are permitted, since accession, to take up a 50 per cent share of a joint venture with a local partner. Upon accession, foreign life and non-life insurers were permitted to provide services in Shanghai, Guangzhou, Dalian, Shenzhen and Foshan; two years after accession they will be permitted to provide services also in Beijing, Chengdu, Chongqing, Fuzhou, Suzhou, Xiamen, Ningbo, Shenyang, Wuhan and Tianjin; three years after accession they will be able to provide services anywhere in China. From accession, foreign non-life insurers have been allowed to provide master policy insurance of large-scale commercial risks without geographic restriction. Two years after accession foreign non-life insurers may provide the full range of non-life insurance services to both foreign and domestic clients. Upon accession foreign insurers were permitted to provide individual insurance to both foreign and domestic clients; three years after accession they will be allowed to provide health insurance, group insurance and pension/ annuities insurance to both foreign and domestic clients.

Distribution

- **Wholesalers, retailers and franchising:** One year after accession foreign wholesalers may establish joint ventures to engage in the commission agents; business and wholesale business of all imported and domestically produced products, except for: salt and tobacco (indefinitely); books, newspapers, magazines, pharmaceutical products, pesticides, and mulching films (until three years after accession); chemical fertilisers, processed oil, and crude oil (until five years after accession). Foreign

majority ownership in distribution services will be allowed after two years and no geographic or quantitative restrictions will apply to the enterprises concerned. Upon accession Zhengzhou and Wuhan were opened to joint venture retailing enterprises. Two years after accession foreign majority control will be permitted in joint venture retailing enterprises, which will be allowed to operate in all other provincial capitals, as well as in Chongqing and Ningbo. The same phasing out of restrictions on products that applies to foreign wholesalers applies to foreign retailers. Market access and national treatment restrictions on franchising and wholesale or retail trade services away from a fixed location will be lifted after three years.

Business services

- **Legal services:** Before accession, a foreign law firm could only establish itself in China in the form of a single representative office. This restriction was lifted on accession, but foreign law firms were initially restricted to Beijing, Shanghai, Guangzhou, Shenzhen, Haikou, Dalian, Qingdao, Ningbo, Yantai, Tianjin, Suzhou, Xiamen, Zhuhai, Hangzhou, Fuzhou, Wuhan, Chengdu, Shenyang, and Kunming. Geographic and quantitative restrictions will be lifted one year after accession. The chief representative of a foreign law firm must be a partner or equivalent of a law firm of a WTO member and have practised law at least three years. Other representatives must be practitioner lawyers who are members of the bar or law society in a WTO member and must have practised for at least two years outside of China. All representatives shall be resident in China no less than six months each year; the representative office shall not employ Chinese lawyers registered outside of China. Representative offices may engage in for-profit activity. However, the work of such offices does not include Chinese domestic law practice, for which foreign law offices may entrust Chinese law firms to act on behalf of foreign clients.
- **Accounting, auditing and bookkeeping:** Foreign accounting firms may establish wholly foreign-owned subsidiaries. They may also affiliate with Chinese firms and enter into contracts with their affiliated firms in other WTO countries. Partners or professional accountants employed by incorporated accounting firms are limited to Certified Public Accountants (CPAs) licensed by the Chinese authorities. Foreign accounting firms may affiliate with Chinese firms. From accession licenses are issued to foreigners who have passed the Chinese CPA examination in accordance with the principle of national treatment.
- **Management consultancy and tax services:** Foreign firms providing tax services will be permitted to establish wholly-owned subsidiaries six years after accession.

- **Architectural, engineering and business planning services:** Foreign service suppliers may provide architectural, engineering (including integrated engineering), and urban planning services through joint ventures, with foreign majority ownership permitted. Wholly foreign-owned enterprises will be permitted five years after accession. Foreign service suppliers must be registered architects/engineers or enterprises offering architectural/ engineering/urban planning services in their home country.
- **Oilfield services:** Offshore oil-field services, including geological, geophysical and other scientific prospecting services, and sub-surface surveying services are permitted in the form of petroleum exploitation in co-operation with Chinese partners. The foreign service supplier must establish a branch, subsidiary or representative office within China and register in accordance with applicable laws. The locations of these offices will be determined through consultation with CNPC.
- **Computer services:** Certified engineers, or personnel with bachelor's or higher degrees and three years experience in this field may provide services. Only joint ventures are allowed in software and data-processing services; foreign majority ownership is permitted.
- **Advertising:** Foreign service suppliers may provide advertising services through joint ventures, with a maximum foreign investment of 49 per cent. Foreign majority ownership will be permitted two years after accession and four years after accession wholly foreign-owned subsidiaries will be allowed.
- **Translation and interpreting:** Foreign service suppliers may provide translation and interpretation services through joint ventures, with foreign majority ownership permitted. Translators must have at least three years of experience in translation or interpretation and a good command of the working language(s).

Communications

- **Courier services:** Foreign service suppliers will be permitted to establish wholly-owned subsidiaries four years after accession.
- **Telecommunications:** From accession, foreign service suppliers may establish joint-venture value-added telecommunications enterprises and provide services in Shanghai, Guangzhou and Beijing; foreign ownership is limited to 30 per cent. Geographical restrictions will be abolished two years after accession and the maximum foreign equity stake raised to 50 per cent.
- **Audiovisual:** Foreign suppliers are permitted to establish contractual joint ventures with Chinese partners to engage in the distribution of audiovisual products, excluding motion pictures. Motion pictures for cinema release may be imported on a revenue-sharing basis, subject to an annual ceiling of 20.

Foreign service providers are permitted to construct and/or renovate cinemas in conjunction with domestic providers, with foreign ownership limited to 49 per cent.

Travel and tourism

- **Travel agencies and tour operators:** Wholly foreign-owned subsidiaries will be permitted in this sector four years after accession. From accession foreign services suppliers who meet certain conditions are permitted to provide services in the form of joint-venture travel agents and tour operators in tour resorts designated by the Chinese government in Beijing, Shanghai, Guangzhou and Xi'an. In practice, geographical restrictions have already been removed.
- **Hotels and restaurants:** Foreign service suppliers may construct, renovate and operate hotel and restaurant establishments in China through joint ventures, with foreign majority ownership permitted. Four years after accession, wholly foreign-owned subsidiaries may be established, and hotel and restaurant services will not be subject to any further market access or national treatment restrictions.

Healthcare

- **Medical and dental:** Foreign service suppliers are permitted to establish joint venture hospitals or clinics with Chinese partners, subject to quantitative limitations in line with China's needs as evaluated by the authorities. Foreign majority ownership is permitted. The majority of doctors and medical personnel of joint venture hospitals shall be of Chinese nationality.

Environmental services

- **Environmental services:** Foreign service suppliers may provide environmental services in the form of joint ventures, with foreign majority ownership permitted. Joint venture enterprises may provide sewage services, solid waste disposal, sanitation, cleaning of exhaust gases, noise abatement, nature and landscape protection, and other environmental protection services, but environmental quality monitoring and pollution source inspection services are prohibited, as these are forms of environmental policing which are a normal function of government. China reserves the right to place market access restrictions on the cross-border supply of environmental services, except for environmental consultation services.

Education

- **Schools and educational services:** Joint venture schools may be established, with foreign majority ownership permitted. Foreign educational service

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providers may provide primary education services, secondary education services, higher education services, adult education, and other education services, including English language training. Foreign educational service providers may not provide primary and secondary national compulsory education. China reserves the right to place national treatment restrictions on educational services. Qualified education professionals must have a bachelor's degree or above and an appropriate professional title or certificate, with two years of professional experience. China reserves the right to place market access and national treatment restrictions on the cross-border supply of educational services. The provision of educational services outside of China is not subject to market access restrictions and is accorded national treatment.

In the past year and a half since China gained accession to the WTO, many of these commitments have been realised following a flurry of new regulations passed – in some cases in advance of WTO accession – in accordance with the various accession agreements and membership requirements.

Distribution and trading rights of FIEs

In addition to opening up specialised distribution services to foreign investors, China is also committed under its WTO accession agreements to phase out all restrictions on distribution of most products by FIEs within three years after accession. This means that foreign-invested manufacturers will be able to distribute their own products throughout China and will not have to depend on local intermediaries. They will also be able to provide a full range of after-sales services.

FIEs were previously denied full rights to import and export goods of all kinds (although they could always import machinery and production inputs for their own use and export their own products) by the imposition of such requirements as export performance, trade or foreign exchange balancing and prior experience as criteria for obtaining or maintaining the right to import and export. Since accession to the WTO, they are no longer subject to such import and export restrictions. Joint ventures with minority foreign ownership were granted full trading rights one year after accession, and joint ventures with majority foreign ownership will be granted full trading rights two years after accession. All enterprises, including those in the civil aircraft industry, will be granted full trading rights three years after accession, except for a few products, including such items as agricultural commodities and steel products, reserved for state trading enterprises.

National treatment

Foreign enterprises are accorded treatment no less favourable than that accorded to domestic individual and enterprises with respect to: the procurement

of production inputs and the conditions under which goods are produced, marketed or sold in the domestic market and for export; the prices and availability of goods and services supplied by national and sub-national authorities and public or state enterprises, in areas including transport, energy, basic telecommunications, other utilities and factors of production.

Discrimination against FIEs or against imports in the making of purchases and sales by state-owned and state-invested enterprises is not permitted, nor may the Chinese government influence, either directly or indirectly, commercial decisions of such enterprises, including decisions on quantity, value or country of origin of any goods purchased or sold, in a manner inconsistent with WTO rules. Government procurement is treated separately (see Section 7).

TRIMs

As part of its WTO accession agreements, China is committed to implementing the WTO Agreement on Trade-Related Investment Measures (TRIMs) in full from the date of accession. As a result, all trade performance, trade balancing, trade performance and local content requirements imposed on FIEs must be removed from laws and regulations pertaining to FDI.

TRIPs

As part of its WTO accession agreements, China is committed to implementing the WTO Agreement on Trade-Related Intellectual Property Rights (TRIPs) in full from the date of accession. China already has legislation in place governing copyrights, patents and trademarks; modifications were made to these laws in line with TRIPs. This legislation has a major bearing on FDI because China is more likely to attract FDI embodying technology transfer if intellectual property rights are effectively protected.

The Catalogue for Guidance of Foreign Investment Industries

The Catalogue for Guidance of Foreign Investment Industries forms part of an industrial policy designed to promote specific industrial sectors. This kind of industrial policy has been extensively tried in OECD countries and has not been found to be particularly successful. As a result, governments in OECD countries have in recent years become disenchanted with such policies.

All comparisons made below in analysing the most recent changes are between the revised end-1997 edition of the Catalogue, which was the version in force before China acceded to the WTO, and the post-WTO accession revised edition of 2002, which was promulgated on 11 February 2002 and came into force on 1 April 2002.

The classification remains fourfold: encouraged, permitted, restricted and prohibited foreign investment projects. As before, only three catalogues are

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published, those for encouraged, restricted and prohibited projects. Projects that do not fall into the classifications listed in these catalogues can be presumed to be permitted.

The main benefit of investing in a project that is listed in the Catalogue of Encouraged Foreign Investment Industries is that, apart from any preferential terms accorded it in other laws and regulations, it may enlarge its scope of business with approval, if it is engaged in the construction and operation of infrastructure facilities, such as fuel and power, transport networks or waste disposal, that require a large amount of investment and a long payback period. Projects in encouraged sectors may also benefit from lower income tax and value-added tax (in the form of rebates), may import capital equipment duty free, and may be allowed to borrow more than restricted-category investments. Other forms of encouragement are reportedly being considered.

The main disadvantage of investing in a project that is listed in the Catalogue of Restricted Foreign Investment Industries is that approval authorisation may not be delegated to lower-level authorities and may therefore take longer and run a greater risk that the project will not be approved. The Chinese authorities have expressed the view that the submission of restricted-catalogue projects to higher level organs for approval can not lengthen the approval process and does not involve an increased risk of non-approval. The Chinese authorities are also of the opinion that the approval process for restricted-catalogue projects is identical to that used for other project categories and is conducted according to identical principles.

Encouraged industries

The number of types of projects included in the 2002 Catalogue of Encouraged Foreign Investment Industries has been increased to 262 from 186 in the 1997 Catalogue.

The general types of encouraged industries are sixfold:

1. Projects for new agricultural technology and for comprehensive agricultural development, and for energy, transport and key raw materials industries.
2. Projects for new and high technology, advanced applicable technology which can improve the performance of products and increase the technical efficiency of enterprises or produce new equipment and new materials for which domestic capacity is deficient.
3. Projects that meet market demand and can promote the quality of products, enter new markets or strengthen the competitiveness of products in international markets.

4. Products adopting new technology and new equipment for saving energy and raw materials, for comprehensive utilisation of resources and renewable resources, and for preventing environmental pollution.
5. Projects that can make full use of manpower and natural resource advantages in the central and Western regions and are in accordance with the state's industrial policies.
6. Other cases that are regulated by state laws and regulations.

In the first group, that covering farming, forestry, animal husbandry and fishing, the number of items has been reduced, but this is largely because several items have been reclassified as manufactures. Serial production of soil-less cultivation of vegetables, flowers and plants has been dropped from the 2002 Catalogue, while some items have been added: the production of flowers and plants; comprehensive utilisation of straws and stalks and the production of organic fertilisers; planting of rubber, sisal and coffee; and the construction and operation of ecological environmental protection projects preventing and treating desertification and soil erosion, such as planting trees and grass. Foreign investment is also now encouraged in the cultivation of traditional Chinese medicines, but only in the form of equity joint ventures or contractual joint ventures.

These changes are minor compared with those in the second section, mining and quarrying, where foreign investment is now encouraged in prospecting for and exploiting oil, natural gas and coal. In the 1997 Catalogue, foreign investment was only encouraged for prospecting and exploitation of coal bed gas. In the case of oil and natural gas, prospecting and exploitation is at present only allowed in co-operation with a Chinese partner, as is the development and application of new technologies that can increase the recovery factor of crude oil and the development and application of new technologies for prospecting for and exploiting petroleum, such as geophysical prospecting, well-drilling, well-logging and down-hole operation. Foreign investment in gold mining is also now permitted, though only in the case of mines where the gold is of low quality or difficult to beneficiate, and only in the form of equity joint ventures or contractual joint ventures, except in western areas, where wholly-foreign-owned enterprises may mine gold.

Restricted industries

The number of types of projects included in the 2002 Catalogue of Restricted Foreign Investment Industries has been reduced to 75 from 112 in the 1997 Catalogue.

The general types of restricted industries are fivefold:

1. Projects adopting out-of-date technologies.

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2. Projects unfavourable to resource-saving and ecological environmental improvement.
3. Projects for prospecting and/or mining specified mineral resources protected by state laws and regulations.
4. Projects in those industries that shall be opened gradually.
5. Other cases that are regulated by state laws and regulations (in the absence of precise specification, it is not clear to which projects this prohibition refers).

Prohibited industries: items remaining and new items

The number of types of projects included in the 2002 Catalogue of Prohibited Foreign Investment Industries is similar to that of the 1997 Catalogue, but some items have been reduced in scope and one noteworthy addition has been made.

The general types of prohibition are sixfold:

1. Projects that endanger the safety of the state or damage social and public interests.
2. Projects that pollute the environment, destroy natural resources or impair the health of human beings.
3. Projects that occupy large amounts of arable land and are unfavourable to the protection and development of land resources.
4. Projects that endanger the safety and performance of military facilities.
5. Projects that adopt the unique craftsmanship or technology of China to make products.
6. Other cases that are regulated by state laws and administrative regulations.

The Catalogue of Prohibited Foreign Investment Industries contains a number of prohibitions which are necessary for China to meet its international treaty obligations. These are largely unchanged from the original catalogue, except to the extent that new treaty commitments have arisen which necessitate the addition of new prohibitions. Foreign investment is thus, as before, prohibited in ivory carving and tiger-bone processing, and also in the development of wild animal and plant resources protected by the state, while a new prohibition has been added to prevent foreign investment in the production of carcinogenic, teratogenic, mutagenesis and persistent organic pollutant products. Since these sectors are also closed to domestic investment, their listing in the prohibited catalogue is not discriminatory.

The last item in the prohibited list is "X. Other industries restricted by the State or international treaties that China has concluded or taken part in". Although it is understandable that the Chinese government wishes to ensure that foreign investment prohibitions match its international treaty obligations, including those not yet entered into, the use of such catch-all phrasing is less

than transparent. A potential foreign investor would not know from this clause that a specific sector was covered by it without reading a large number of legal documents, not all of which may be available in English. Transparency would be better served by a precise listing of all such sectors and subsequent regular updating and publicising of such a list. The Chinese authorities are of the view that the existing wording of this item is clearly stipulated and can not be said not to be transparent.

Another type of prohibition relates to defence and national security. Foreign investment in projects that endanger the safety and performance of military facilities are disallowed. This stipulation is in accordance with international practice, provided it is interpreted literally. Foreign investment in the manufacture of weapons or ammunition is prohibited, presumably also on national security grounds.

There are also prohibitions which, although not internationally standard practice, arise from China's internal criminal law regime. Foreign investment is not allowed in gambling, explicitly including racecourse gambling, or in pornographic services. As gambling and pornographic services are illegal in China, these prohibitions do not constitute discrimination against foreign investors. There may be other areas in which it would be helpful to potential foreign investors to provide an inventory of activities which are illegal in China but which are not illegal in other countries.

A number of prohibitions have been maintained on foreign investment in traditional Chinese industries. These include the processing of green tea and specialised Chinese teas; the processing of traditional Chinese medicines that have been listed as state-protected resources, such as musk, liquorice and jute; the application of preparatory techniques of traditional Chinese medicines in small pieces ready for decoction; the production of secret recipes of traditional Chinese patent medicines; the production of bodiless lacquer ware; the production of enamel products; and the production of rice paper and ingot-shaped Chinese ink tablets. The need for such prohibitions is not entirely clear. There has already been substantial foreign direct investment in Chinese medicine companies, usually from overseas Chinese investors.

In the financial sector, foreign investment in futures trading companies remains prohibited.

Research into genetically modified plant seeds

One new item in the Catalogue of Prohibited Foreign Investment Industries in Section I, Farming, Forestry, Animal Husbandry and Fishery Industries, is the production and development of genetically modified seeds. It has been suggested that prohibition is designed to protect domestic

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researchers while Chinese companies catch up with internationally advanced GM research and that such insertion therefore constitutes discrimination against foreign investors, as there is no concurrent prohibition of the production and development of GM seeds by domestic manufacturers.

Export performance criteria in the guidance catalogues

The 2002 Catalogue of Encouraged Foreign Investment Industries retains from the 1997 Catalogue a final clause which includes permitted foreign invested projects whose products are to be wholly exported directly. This clause is amplified in Article 10 of the implementing guidelines:

> *Those permitted projects that export all their products directly shall be deemed as encouraged projects. Restricted foreign investments may be deemed as permitted foreign investment projects with approval from the government of provinces, autonomous regions, municipalities directly under the central government or cities of direct planning by the state, if the export sales of products amount to over 70 per cent of total sales of the product.*

Since the inclusion of a proposed foreign investment project in either the permitted or the restricted foreign investment list can determine whether or not it is approved, this stipulation may be regarded as effectively imposing an export-performance requirement on such projects.

Further liberalisation of the catalogues for guidance of foreign investment industries

The Chinese government would be well advised to pursue further liberalisation of the catalogues for guidance of foreign investment industries. In particular, it may wish to consider abolishing the catalogue of restricted industries, which, to the extent that it allows the placing of extra obstacles to project approval, does not accord with moves towards applying the principle of national treatment. There is no objection in principle to the encouraged catalogue, since the granting of extra privileges to a foreign investment project does not violate the principle of national treatment. However, if the project approval process were wholly transparent and efficient there would be no need for such a catalogue. Where items are included in the catalogue of prohibited foreign investments because they are already prohibited by other national legislation, such as sea fishing within territorial limits, gambling or endangering the safety and performance of military facilities, this could be stated explicitly in each case. It is not clear why items such as book publishing are off-limits for foreign investors. The Chinese government may wish to consider replacing the existing restricted and prohibited catalogues with a single catalogue listing industries which are restricted to domestic enterprises. There should be a clear explanation of the reasoning for the inclusion of all items in such a catalogue.

Perhaps the simplest solution would be to publish such a catalogue and no other. All projects not covered by the terms of the restricted catalogue would then be permitted. Such a system would obviate the necessity to describe industrial sectors in precise detail – an impossible task in any event, since the accelerating pace of industrial change renders such classifications perpetually obsolete.

2. Sub-national measures

China is a unitary, not a federal, state. Its policies towards FDI are therefore determined by the central government. However, administration has been greatly decentralised during the reform period. As a result, implementation varies widely between the various provincial-level units and also within provinces between smaller localities such as municipalities and special economic zones (SEZs). Insofar as there are major differences in policy between regions, these are a result of national policy to shift FDI, along with domestic investment, towards the less-developed hinterland.

Incentives to invest in Central and Western regions

From the mid-1990s, the government has encouraged FDI flows into the Central and Western regions as part of its policy of attempting to spread the benefits of economic development to China's vast interior. In 1996 the government raised the project approval limit of provincial authorities in the Western region to US$30 billion to bring it in line with that of the open coastal areas. Additional incentives to direct FDI more positively to the Western region began in 1999.

The Central region comprises the eight provinces of Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei and Hunan. The Western region consists of twelve provinces and provincial-level administrative units: Chongqing (formerly a municipality in Sichuan province, now a municipality directly under the central government); Sichuan province; Guizhou province; Yunnan province; Tibet autonomous region; Shanxi province; Gansu province; Ningxia autonomous region; Qinghai province; Xinjiang autonomous region; Inner Mongolia autonomous region; Guangxi autonomous region. The remaining eleven provincial-level units make up the Eastern region: Beijing, Shanghai and Tianjin municipalities; Hebei province; Liaoning province; Jiangsu province; Zhejiang province; Fujian province; Shandong province; Guangdong province and Hainan (formerly a part of Guangdong, now a separate province).

As shown earlier (Chapter 2, Section 4), the bulk of realised FDI – 85.8 per cent by end-2000 – has gone into the Eastern region, with only 8.78 per cent received by the Central region and 5.42 per cent by the Western region. Figures for contractual FDI are similar. In terms of projects, the Eastern region accounted for 80.4 per cent by end-2000, compared to 12.25 per cent for the

Central region and 7.35 per cent for the Western region, indicating that average project size was smaller in the Central and Western regions.

Incentives are provided to attract FDI to both the Central and Western regions, but more incentives are available for the west than for the centre. While specific incentive provision is made for the Western region as a whole, the Central region is understood to be covered mainly by provincial-level measures. The tax incentives for investment in these regions are covered in the tax chapter in this report (Chapter 6).

In addition to the national catalogues for guiding foreign investment industries (above), the government has published a Catalogue of Advantageous Sectors for Foreign Investment in the Central and Western Regions. Projects included in this catalogue enjoy the same treatment as those in the catalogue of encouraged projects.

A major emphasis of policies designed to attract FDI to the Western region is on the construction of basic infrastructure facilities. Foreign investors are encouraged to invest in infrastructure projects in agriculture, water conservancy, ecology, transport, energy, municipal administration, environmental protection, minerals, tourism and resource development.

FDI is also encouraged to contribute to the development of services sectors in the Western region. The regulation adopted in 2000 outlining the opening of sectors such as banking, retail and foreign trade, initially only to pilot projects, has, however, been largely overtaken by the WTO commitments entered into by late 2001, which specify a more comprehensive opening of these sectors nationwide (Section 1 of this chapter).

Restrictions on the operation and financing of FIEs are less strict in the Western region, but the terms of relaxation have been left vague in the relevant regulation. The forms of foreign investment in the Western region may now include BOT (build-operate-transfer) and TOT (transfer-operate-transfer), though initially only on an experimental basis. Foreign-invested projects may be partly financed in ren min bi and financing by IPO is encouraged if the projects concerned are qualified to do so. Equity holding restrictions on foreign-invested projects in infrastructure construction and priority industries in the west "will be relaxed", though the precise form of this relaxation is not specified in the regulation.

Expected results of regional FDI policy

Current research supports the proposition that localised incentives have been positively associated with FDI inflows, but only as one among several independent variables. One econometric study using a panel framework (Wei and Liu, 2001) shows that contracted FDI in a survey of 28 of China's 31 provincial-level administrative units is positively influenced by the level of international trade, R&D manpower, GDP growth, infrastructure, and the availability of

information and of incentives. However, this study explicitly omits (for reasons of data scarcity) an econometric investigation of the regional distribution of FDI in China in relation to its geographical sources. There is no doubt that this factor has played a major role in the location of FDI, as is evident from the pattern of investment from Hong Kong (China) (largely in neighbouring Guangdong), Chinese Taipei (disproportionately high in Fujian, which faces Chinese Taipei across the Taiwan Strait), South Korea (mainly in nearby Shandong) and Japan (mostly in areas of China that received investment from Japan before the second world war, such as Dalian, Shanghai, Jiangsu and Zhejiang).

The conclusion of Wei and Liu (Wei and Liu, 2001) that FDI in "the inner areas" (*i.e.* the Central and Western regions) can be expected to "increase quickly" is based on the twin assumptions that government infrastructure construction will improve the investment environment sufficiently to provide a workable environment for investment projects and that the incentives now in place will be more effective than in the coastal areas, since the hinterland lacks several of the variables (for example, high level of international trade, R&D manpower) present there.

A recent study by Deloitte, Touche, Tohmatsu (Deloitte, Touche, Tohmatsu, 2002) showed that the Eastern region remained the most popular FDI destination for the 680 foreign companies surveyed. Of those respondents already operating in China, 56 per cent were located in Shanghai, 46 per cent in Beijing, 18 per cent in Shenzhen and 17 per cent in Guangzhou (some companies operate in more than one location). A small shift in location is discernible from the plans of those not yet operating in China, 54 per cent of whom intended to put their investment in Shanghai, 30 per cent in Beijing, 9 per cent in Shenzhen and 6 per cent in Guangzhou. However, the latter figures still demonstrate an overwhelming preference for the Eastern region.

It is unrealistic to expect a major diversion of FDI from the Eastern region to the Western and Central regions until the difference in infrastructure endowment has been greatly evened out, a process that will take decades, not least because the coastal provinces are continually upgrading their own facilities. The cities of the Eastern region have large populations that will continue to grow, especially after the eventual abolition of the *hukou* (household registration) system, which restricts population movement. They are therefore in a better position than the hinterland to pay for infrastructure improvement and to call upon central funds for the same purpose. Foreign investors remain sceptical about the attractions of hinterland provinces, where the market for their products and services is much thinner than in coastal cities because populations are smaller and incomes far lower. They are also wary of entering regions where skilled labour is scarce – and therefore relatively expensive – as young and well-qualified workers migrate eastwards in search of higher-paid employment and a greater variety of occupational opportunities.

Future regional FDI policy

To the extent that the investment incentives available to FIEs are the same as those on offer to domestic enterprises, the policy of attracting capital investment to the Western and Central regions is consistent with the principle of national treatment. However, such incentives do not constitute a sufficient condition for increased investment in those regions. If the Chinese government wishes to redirect investment westward, it may prefer to put the main emphasis on improvements in the business environment. The current policy of allocating state funds to infrastructure construction in the Western and Central regions can be considered part of this effort. Institutional development is also necessary, in particular an initiative to raise the standard of investment promotion and investment approval in these regions to that prevailing in the open coastal zones, which are generally much more flexible in their interpretation of FDI laws and regulations. More officials in the Western and Eastern regions may, for example, be encouraged to visit their counterparts in SEZs and other open zones to experience and understand the procedures that have been so successful in attracting investment there. Such measures would be relatively cost-effective and would retain their relevance even if the "invest in the West" policy were modified.

3. Abolition of trade-related investment measures (TRIMs)

As noted above, before acceding to the WTO in December 2001, China notified the WTO of its intention to comply fully with the 1994 Agreement on Trade-Related Investment Measures of the General Agreement on Tariffs and Trade (GATT, the predecessor to the WTO) and that it would eliminate foreign-exchange balancing and trade balancing requirements, local content requirements and export performance requirements. Nor would the Chinese government henceforth enforce the terms of contracts containing such requirements. The allocation, permission or rights for importing and investment would not be conditional upon performance requirements set by national or sub-national authorities, or subject to secondary conditions covering, for example, the conduct of research, the provision of offsets or other forms of industrial compensation including specified types or volumes of business opportunities, the use of local inputs or the transfer of technology. Permission to invest, import licences, quotas and tariff rate quotas would be granted without regard to the existence of competing Chinese domestic suppliers.

Local content requirements

The original Joint Venture Law of 1979, revised in 1990, required in Article 9 that joint ventures give first priority to Chinese sources when purchasing raw and semi-processed materials, fuels, auxiliary equipment and

other items. Alternatively, a joint venture could acquire these from the world market, but only with foreign exchange funds already acquired by the enterprise. The implementing regulations make the terms of reference of this clause slightly more precise by adding components, means of transport and things for office use, and allows joint ventures to choose whether to buy these items in China or from abroad. However, where conditions are the same, the enterprise should give first priority to purchase in China. The Wholly Foreign Owned Enterprise Law adopted in 1986 contains a similar stipulation in Article 15, which allows a wholly-foreign-owned enterprise to purchase raw and semi-finished materials, fuels and other materials it needs in China or from the world market, but requires that when these are available from both sources preference should be given to Chinese sources.

Local content requirements are a trade-related investment measure (TRIM) designed to make the approval of a foreign investment project conditional on compliance with a policy that favours domestic products and is therefore inconsistent with the obligation of national treatment provided for in paragraph 4 of Article 3 of the 1994 GATT agreement. WTO members are prohibited from enforcing such conditions, so China was obliged to remove such requirements from its foreign investment legislation as a logical consequence of accession to the WTO.

In the 22 July 2001 revised version of the implementing regulations for the Joint Venture Law, Article 51 states that equity joint ventures have the right to decide on their own whether to purchase machinery, equipment, raw materials, components, means of transport and articles for office use in China or abroad. Article 52 further specifies that articles of office and personal use purchased by joint ventures in China are to be purchased in accordance with the amounts needed and are not subject to restriction. With regard to items not mentioned in Article 52, including machinery, equipment, components, raw materials and fuel, these may be imported, where necessary, after obtaining import licences, which must be applied for every six months. (Such licences are similarly required for imports made by domestic enterprises.) The revised Wholly Foreign Owned Enterprise Law of 31 October 2000 goes further by stating simply, in Article 15, that a wholly-foreign-owned enterprise may purchase the required raw and semi-processed materials, fuels and other materials on the domestic or international market. The only restriction on such purchases is a requirement that they be "fair and rational" – a clause intended to provide the authorities with a means of dealing with transfer-pricing tax avoidance practices such as purchasing items from abroad within a multinational enterprise at excessively high prices.

Export performance requirements

According to Article 3 paragraph 2 of the implementing regulations of the 1990 Wholly Foreign Owned Enterprise Law, before a wholly-foreign-owned enterprise could be established it was required to show either that it was using advanced technology and equipment or else that was exporting at least 50 per cent of annual output value. Articles 10 and 15 of the implementing regulations included a similar requirement in the form of the inclusion of "the anticipated ratio of product sales in domestic and international markets" as one of a number of items to be included in a report to be submitted by a foreign investor to the local government before applying for the establishment of a wholly-foreign-owned enterprise.

These requirements separately and in combination constitute a TRIM that was inconsistent with the obligation of general elimination of quantitative restrictions provided for in paragraph 1 of Article XI of the 1994 GATT agreement, since it restricted the export or sale for export by an enterprise of products in terms of volume or value of products.

The Chinese government removed all these export performance requirements in the 12 April 2001 revised version of the implementing regulations of the Wholly Foreign Owned Enterprise Law. Article 3 is now limited to the inclusion of a general encouragement to establish export-oriented foreign-owned-enterprises and the requirements in Articles 10 and 15 to submit a plan including the proportion of exports to domestic sales were both deleted. The general statement in the original Equity Joint Venture Law that an equity joint venture be encouraged to market its products outside China does not constitute a TRIM and has been retained in the revised law of 15 March 2001.

Abolition of performance requirements is expected to be effective

The implementation of performance requirements before they were abolished was not always effective. Local authorities, in particular, had a strong motive to disregard them so as to maximise FDI inflows to their localities. Insofar as FIEs bring in tax revenue and boost employment, they have a beneficial effect on the local economy. Officials in charge of FDI promotion have more incentives to gain promotion if they can demonstrate a record of attracting large quantities of FDI, whether or not such FDI meets restrictive performance criteria. Interpretation of these criteria thus tended to be generous. Since the nationally-imposed performance requirements have been abolished and the local incentive to grant approval to as many projects as possible remains intact, it is unlikely that any attempts to retain informal performance requirements would succeed.

4. Foreign exchange arrangements

China's currency régime

The ren min bi

The ren min bi (people's currency) has been the official currency of the People's Republic of China since the state was founded in 1949. It replaced not only similar national currencies that were also denominated in yuan, but also the many foreign currencies that were circulating during the hyperinflation of the late 1940s. The ren min bi was devalued several times after the economy began to be opened to foreign trade and investment in 1978. Since early 1994 it has been pegged to the US dollar by means of a managed float at a rate of approximately Rmb8.3 to the dollar.

Ending of the dual currency system

From 1985 to the end of 1993, visitors to China were issued with Foreign Exchange Certificates (FECs) in exchange for foreign currency when they entered the country. These could be used in designated retail outlets, such as Friendship Stores, and some items could only be purchased with FECs, rendering them desirable by the domestic population. FECs could only be officially bought and sold at the official exchange rate. The intention was to prevent Chinese people purchasing imports or domestic manufactures produced for export. The existence of FECs also made it possible to charge foreigners higher prices than domestic customers. During this period there was therefore a dual currency system. In practice, FECs frequently found their way on to the black market, where they were traded at exchange rates which valued the ren min bi lower than the official rate. At the beginning of 1994 FECs were abolished and the separate exchange rates merged into a single exchange rate. Foreigners were henceforth able to change their foreign currency directly into ren min bi when entering China. The unification of the two exchange rates, accompanied by devaluation to a more realistic exchange rate, largely removed the incentive for illegal currency trading, and the foreign currency black market gradually dried up.

Current-account convertibility

On 1 December 1996 China accepted the obligations of Article VIII of the Articles of Agreement of the IMF, by which it committed itself not to impose restrictions on the making of payments and transfers for current international transactions without IMF approval.

As a result of Article VIII adherence, all enterprises, whether foreign-owned or domestic, may purchase foreign exchange to make payments abroad for trade settlement, commissions, fees, royalties and dividends without the need for approval by the State Administration for Foreign Exchange (SAFE).

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The legitimate profits, other legitimate income and funds gained through settlement by foreign investors in their operation of the enterprises can be freely remitted outside China after income tax has been levied. The profits gained by foreign investors from their enterprises are exempt from income tax on remitted profits when remitted directly outside China. After providing the remittance bank with the relevant certificates confirming the amount of after-tax profit and also that the enterprise capital has been fully paid, profit can be speedily remitted.

Explicit provision is made in the Equity Joint Venture Law, the Contractual Joint Venture Law and the Wholly-Foreign-Owned Enterprise Law and in the relevant implementing rules permitting the profits earned by the foreign party to be fully remitted abroad after performing lawful obligations such as tax payment and the fulfilment of contracts. The foreign party may also remit abroad the funds it receives upon the expiration of the venture's term of operation or on early termination. The wages, salaries and other legitimate income earned by foreign employees of all three types of FIE may also be remitted abroad, after payment of individual income tax, in accordance with foreign exchange control regulations.

Trade credits are not subject to major restriction. The rates and terms of export credits used to finance imports into China are governed by OECD terms on export credits, which allocate China a maximum repayment term of 10 years and give it eligibility under the Arrangement on Guidelines for Officially Supported Export Credits for tied aid or partially untied aid. By December 2001 the stock of non-bank trade credits was approximately US$11 billion.

Abolition of the foreign exchange balancing requirement

FIEs were initially required to balance their foreign exchange receipts and expenditures. However, it was not possible for all such enterprises to do so within a short space of time. Some FIEs, for example export manufacturers using domestic inputs, were likely to be earning a surplus of foreign-exchange earnings in excess of their import purchasing needs while suffering from a shortage of local currency. On the other hand, those serving domestic customers might have large earnings in ren min bi but little foreign currency with which to purchase imported inputs.

Before 1994, FIEs could obtain foreign exchange at a more market-determined exchange rate than the official exchange rate at swap centres where FIEs with surplus ren min bi could trade this surplus for the surplus foreign currencies of other FIEs. In April 1994 the China Foreign Exchange Trading Centre (CFETC) was established, with headquarters in Shanghai and branches in major cities, as China's sole interbank foreign exchange market, eventually completely replacing the swap markets when the latter were closed at the end of 1998 because they had become defunct.

The CFETC is a physical market which predominates over the corresponding non-physical market that has developed between CFETC members, who must be financial institution headquarters, and their customers. The currencies traded on the CFETC are limited to the US dollar, the Hong Kong dollar and the yen, and there is no trading in futures or options based on these currencies.

As a member of the WTO, China is bound to abide by the WTO Agreement on Trade-Related Investment Measures (TRIMs), which requires it to notify the WTO of all TRIMs it is applying that are not in conformity with the provisions of the Agreement. TRIMs that are inconsistent with the obligation of general elimination of quantitative restrictions provided for in paragraph 1 of Article 11 of the 1994 GATT agreement include those that restrict access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise. As the foreign-exchange balancing requirement was therefore in conflict with the TRIMs agreement, China had to remove it to comply with the terms of WTO membership. The offending clauses were removed from the various laws governing the different categories of FIE in 2000 and 2001, well before accession was accomplished in December 2001.

Capital controls

In 1993 the Chinese government stated that it was moving gradually towards capital account liberalisation. However, when the Asian economic crisis of 1997-99 began with the devaluation of South-East Asian currencies China decided to refrain from letting the ren min bi depreciate and also announced that it would maintain capital controls for the duration of the crisis. However, there is now no indication of a desire to relax capital controls in the near future. The main features of China's capital controls are:

- Capital brought in from abroad must be deposited in special accounts. Repayments or remittances from these accounts are subject to approval by SAFE.
- Foreign investment in the Shanghai or Shenzhen stock markets is limited to B shares. Foreigners may not lawfully buy A shares.
- All foreign borrowing for a term of over one year, including project loans, must be mentioned in the comprehensive state commercial loan plan. Loan contracts must be approved by SAFE, which can suggest a distribution plan among various financial institutions and set individual foreign exchange loan ceilings for each financial institution.
- SAFE assigns foreign debt balance quotas to designated financial institutions for foreign borrowing of one year or less. Each financial institution can borrow from abroad without having to obtain local SAFE approval of each loan. No SAFE approval is required for loans of less than three months under current accounts. Loans of between three months and

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one year must be registered with SAFE and SAFE must approve the conditions for principal repayment and interest rates.

- Only state organisations approved by the People's Bank of China (PBC) may issue bonds abroad. Such issues are determined in accordance with the state foreign capital utilisation plan.
- Leasing and trust loans from abroad are subject to local and national plans for technological upgrading and foreign capital utilisation. Such loans may not exceed the foreign exchange quotas set for the enterprises involved and must be registered with SAFE.
- All foreign loan guarantees require SAFE approval. Only authorised financial institutions and enterprises are allowed to provide foreign exchange loan guarantees, under strict conditions.
- Outbound FDI by domestic enterprises must receive SAFE approval and, under the provisions of the Securities Law, is also subject to approval by the China Securities Regulatory Commission (CSRC).

Some smaller relaxations of capital account controls have occurred recently, indicating that the possible direction of future changes. For example, on 1 July 2002 SAFE promulgated a notice on reforming the method of administration for foreign exchange settlement for foreign investment capital funds. This notice implements on a nationwide basis trial reforms that were introduced in selected areas in August 2001 permitting FIEs to convert foreign currency funds in their foreign exchange capital accounts into ren min bi without obtaining approval from the foreign exchange authorities. Ren min bi obtained in this way must be used for normal production and operation spending only.

5. Access to capital markets

Capital markets are at an early stage of development and not fully open to foreign participation

Chinese shares are traded domestically on two stock exchanges, located in Shanghai and in the southern city of Shenzhen, the Special Economic Zone nearest to Hong Kong. The majority of shares are denominated in ren min bi and are known as A shares; these are available only for purchase by domestic Chinese investors. Shares designed for purchase by foreign investors are called B shares. On the Shanghai exchange, B shares are denominated in US dollars; on the Shenzhen exchange, B shares are denominated in Hong Kong dollars. Since February 2001 domestic Chinese purchasers have also been allowed to purchase B shares.

The total capitalisation of China's stock markets is high in international terms, reaching Rmb4,424.3 billion (US$534.3 billion) in 1,212 listed companies in September 2002, by when the total number of investors had risen to 68.5 million.

(Total market capitalisation of the Hong Kong Stock Exchange, by comparison, was US$453.5 billion in 803 listed companies at the end of October 2002.)

Chinese shares are also issued on stock exchanges outside mainland China. The most important location for such issues is Hong Kong, where the shares of Chinese companies are known as H shares; there were 50 such listings on the Hong Kong exchange in May 2002. Mainland Chinese companies also allow their subsidiaries in Hong Kong to issue shares known as "red chips", which have attracted investor attention principally because of the standard practice of transferring assets from the parent company to the Hong Kong company after IPO. Chinese shares may also be purchased in the United States the form of American Depositary Receipts (ADRs, negotiable certificates held in banks in the United States representing a specific number of shares of a Chinese stock), which are tradable on the New York Stock Exchange.

Only 32.9 per cent of shares issued by listed companies on China's stock markets are officially classified as negotiable (Rmb1,455.8 billion in September 2002). The remaining 67.1 per cent are non-tradable and are largely held by SOEs. SOEs also hold a high proportion of marketable shares. Institutional shareholding is too small to be able to exert much influence.

Table 3.1. **Total market capitalisation of the Shanghai and Shenzhen stock markets, 1994-2000**

(Rmb billion)

	1994	1995	1996	1997	1998	1999	2000
A shares	351.6	331.1	944.9	1 715.4	1 929.9	2 616.8	4 745.6
B shares	17.5	16.4	39.4	37.5	20.6	30.4	63.5
TOTAL	**369.1**	**347.4**	**984.2**	**1 752.9**	**1 950.6**	**2 647.1**	**4 809.1**

Source: Shanghai Stock Exchange web site.

Table 3.2. **Number of securities quoted on the Shanghai stock market, 1990-2001**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Shares	8	8	38	123	203	220	329	422	477	525	614	690
Funds	0	0	0	1	12	12	15	15	19	26	18	23
Bonds	22	32	37	44	24	20	24	22	20	23	25	31
TOTAL	**30**	**40**	**75**	**168**	**239**	**252**	**368**	**459**	**516**	**574**	**657**	**744**

Source: Shanghai Stock Exchange web site.

Although China has a high savings rate, surveys consistently show that households prefer to put their money in bank deposits, despite unattractive interest rates and the unstable financial structure of the main state-owned banks, because they lack confidence in companies whose adherence to

corporate governance standards is described as inadequate by government officials. (The banks are widely understood to be insolvent, but it is generally assumed that the government will ensure their survival.) Consequently, the market remains relatively shallow and illiquid and both the Shanghai and Shenzhen indices are characterised by persistent volatility.

The A share market, which is closed to foreigners, is the predominant element on the two stock exchanges: for example, in 2001 the market value of A shares on the Shanghai stock market was Rmb 2 693.5 billion, while that of B shares was only Rmb 65.6 billion. The B share market, originally open only to foreign purchasers, was opened to domestic investors in February 2001, but has remained relatively small and illiquid.

Table 3.3. **Initial public offerings (IPOs) on the Shanghai stock market, 1993-2001**

(Rmb billion)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
A shares	18.9	38.8	46.4	62.6	90.8	120.6	149.9	194.7	307.4
B shares	1.8	3.1	3.5	4.5	6.8	7.4	8.1	8.5	9.1

Source: Shanghai Stock Exchange web site.

Table 3.4. **Market capitalisation of the Shanghai stock market, 1993-2001 (Rmb billion, end-year)**

	1993	1994	1995	1996	1997	1998	1999	2000	2001
A shares	206.8	248.4	243.4	531.6	903.2	1 052.5	1 444.1	2 659.6	2 693.5
B shares	12.8	11.7	9.2	16.2	18.6	10.1	14.0	33.5	65.6

Source: Shanghai Stock Exchange web site.

The corporate bond market, which started operating in the 1980s, is strictly regulated in accordance with national financial planning. The government sets annual quotas for total corporate bond issuance and authorises individual bond issues. The 2002 target is Rmb 27 billion to be raised by ten enterprises, all of them domestic.

FIE access to China's capital markets is limited. The stock exchanges have hitherto been almost the exclusive preserve of domestic enterprises and it is difficult for FIEs to obtain listings. A small number of multinational enterprises started to restructure themselves in preparation for listing after it was announced in November 2001 that FIE listings would be permitted following China's accession to the WTO. Current plans indicate that a dozen or so FIEs will become listed in the next few years, compared to nearly 1 200 domestic enterprises listed at present. FIEs are not yet able to raise

money via corporate bond issues. Access to venture capital is limited, and investment by venture capital funds is discouraged by the lack of a liquid stock market in which to effect an exit strategy.

A major form of FDI in OECD countries is the acquisition of a lasting interest in an overseas company by means of equity participation. The OECD benchmark definition of FDI includes the acquisition of 10 per cent or more of the ordinary shares or voting stock of an incorporated enterprise, as well as the acquisition of a similar interest in an unincorporated enterprise (OECD, 1999b). Such portfolio FDI inflows are relatively scarce in China because of obstacles to foreign participation in the stock markets.

6. Real estate rights for business purposes

China's system of public ownership of land does not allow the purchase of land. The Land Administration Law (amended and adopted on 1 January 1999) stipulates that all land in the urban areas of cities is subject to government ownership whilst land in rural and suburban areas shall be owned by peasant collectives. In principle, foreign units and individuals that need land for construction purposes can only apply for the use of state-owned land. Land owned by peasant collectives can be used to build houses for villagers, township and village enterprises (TVEs) or public welfare undertakings as well as utilities of a township or village.

Authorities can allocate or sell land-use rights in conformity with this law. In 1993 foreigners were given their first opportunity to buy or lease in China when the Chinese government began to license real estate for sales to the foreign market. Thereafter real estate service agencies have mushroomed. The real estate market was one of the last markets introduced in China allowing land use to be determined in part by market forces instead of by state allocation. As a rather new, more transparent method of land transfer, some municipalities like Beijing and Guangzhou have started to offer city land-use rights via auction to interested land-users, both domestic and foreign. Whilst allocated land use rights are usually given free and without allocation of time, granted land use rights are limited in time against payment. Foreigners are only entitled to the latter type of land use right.

Allocated land can be used only for a specific purpose. The State applies a system of control over the purposes of land use. Any change in land use that involves the shift of agricultural land to non-agricultural use raises serious concerns in China, where the entire population relies for its food supply on the cultivation of only 10 per cent of the land. Although China expects new construction to surge now that China is a member of the WTO, the Ministry of Land and Resources has disclosed that the further expansion of development

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zones and science parks is unlikely, all new construction projects should take place within already designated areas (China Daily, 6 August 2002).

Foreigners can purchase real estate in China, but they can only buy those buildings or flats that are for sale to foreigners. In principle, rights to buildings and land must be acquired together. This is important for the foreign investor to know, since when setting up a foreign-invested enterprise, it is usually the Chinese partner that contributes land use rights. In such a situation it is important that FIEs ensure that the Chinese partner disposes of a granted land-use right, because the Chinese partner cannot dispose of allocated land.

Joint ventures and wholly-foreign-owned enterprises can lease land from the local authority (county or municipality). If a Chinese joint-venture partner already has site use rights it may contribute these as part of its investment in the joint venture, its value being the site use fee paid to acquire the site. The standard for the site use fee in the case of a joint venture is set by the province-level administrative unit (province, autonomous region or municipality directly under the central government) in which the joint venture is located. The standard for land use and land development fees paid by wholly-foreign-owned enterprises shall be fixed "in accordance with the relevant provisions of China", a phrase capable of varying interpretations. In practice land-use fees for FIEs are set by the local authority, not the central government. They therefore constitute one of the few means available to a local government to compete with other localities for FDI and can occasionally provide grounds for bidding wars.

Because land use rights are limited in time, it raises the interesting issue of what happens to the right to a building after the land use right has expired. In accordance with Article 12 of the *Provisional Regulations on granting and transferring the State-owned Land Use Rights in Urban Areas*, (issued by State Council May 19, 1990), the maximum term for which the state grants land use rights can range from 40 to 70 years, depending on the usage of the land: 70 years for residential use of the land, 50 years for both industrial use and the usage of the land for educational, scientific and technological, cultural and sportive purpose, 40 years if the land is used for commercial, tourist and entertainment purposes. The rights to buildings are subject to the same terms: upon the expiry of the land use rights, the land together with the buildings on the land shall be returned to the state. Taking into account depreciation, the state will in general not compensate for this transfer. The owner of the land use rights may try to renegotiate a contract for the same piece of land, but there is no guarantee that the contract will be renewed. Alternatively, the owner of the land use rights may under certain conditions, well before the expiry of his current land use contract, transfer the land, together with the building, to a third party. In cases in which the land use contract is suddenly abrogated by the state before the statutory end of the term, the foreign contractor is (at least in theory) entitled to compensation by the state.

Amongst other conspicuous problems in the real estate sector is corruption in the building and construction industries: the vice-minister of construction, Liu Zhifeng, said in an interview published in China Daily on 16 February 2001 that all construction-sector intermediary-service organisations should be disconnected from building administrative authorities as soon as possible and all of the sector's administrative units should begin cultivating complete conformity with laws and industry regulations. At the same time, he said, administrative units in charge of construction should not suggest specific intermediate-service agencies to customers and should not be allowed to force customers to accept any kind of intermediary services that are not absolutely necessary. According to Liu, agencies in charge of construction information dissemination, project cost consultation, engineering monitoring and real estate evaluation, among others, must cut ties with the government at both the central and regional levels. The Chinese government has already made some progress in this field, but the real estate sector still needs to become more transparent in order to introduce more clarity and certainty into the market.

Since foreigners can may only buy buildings or flats specifically allotted for sale to foreigners, they enjoy a more limited choice and almost always pay a far higher price for property than domestic customers. A study recently conducted by the Ministry of Construction recommended that the difference in treatment between foreign and domestic purchasers of real estate be abolished in respect to real estate for FDI purposes, as it breaches the national treatment principle.

In principle, rights to buildings and land must be acquired together. Land use rights are limited in time, and it is not clear what happens to the right to a building after the land use right has expired. This issue requires clarification by the Chinese authorities.

Conspicuous problems in the housing and real estate sector include: illegal housing and building development projects; disorder among real estate agencies; unfair contracts; and lack of warranties. The Chinese government has already made some progress in dealing with these problems and is encouraged to introduce more clarity and certainty into the market.

7. Government procurement

China's government procurement market has grown enormously in recent years, reaching Rmb 32.8 billion, equivalent to 2.1 per cent of government expenditure, in 2000. Although a government procurement system has been implemented since 1998, a new Government Procurement Law was promulgated in July 2002, although implementing regulations have not yet been issued. Until the new law goes into effect, government procurement is governed by interim measures adopted by the Ministry of

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Finance covering such matters as tendering and bidding, and surveillance of government procurement contracts.

The building of institutions capable of handling government procurement is still at an early stage. Governments at all levels have set up administrative agencies responsible for establishing policies and supervising and managing government procurement activities, but there is a severe shortage of qualified professional staff in this area. This deficiency has been alleviated to some extent by internal training courses arranged by the Ministry of Finance and exchanges of information with other countries on government procurement procedures. Limited resources are first being concentrated on a few pilot projects. As part of an effort to make the process more transparent, the government has set up a web site in English to advertise tenders and collect bids for all projects.

In 1998 the Chinese government commenced a domestic preference policy under which an import licence may not be granted for items purchased by the government that may be sourced in China. While this policy is clearly a restraint on trade, it does not in principle constitute discrimination against foreign investors, since it explicitly (as elaborated by the State Economic and Trade Commission in its 1999 regulations on purchases of capital equipment) directs that such items be purchased either from domestic enterprises or from FIEs in China.

Foreign companies complain that the system is still not transparent and that the FIEs in which they have an interest do not have access to all the information about forthcoming government purchases on the same basis as domestic enterprises (American Chamber of Commerce, 2001). It is incumbent upon the Chinese government to demonstrate that the system is transparent and, to the extent that transparency can be improved, to publish details of any further measures it is taking or intends to take to ensure such improvement.

8. Entry arrangements for key personnel

The entry of foreigners into China is governed by the Law Of The People's Republic Of China On the Entry And Exit Of Aliens, which came into effect on 1 February 1986, and the accompanying implementing regulations promulgated the following year and subsequently revised in 1994.

Article 6 of the law states that aliens shall apply for visas to Chinese diplomatic missions or consular posts abroad and also allows for visas to be issued on a discretionary basis at ports of entry. Visas are issued either for single entry or for multiple entry over a period of six or twelve months. The normal procedure for business visitors is that the applicant first obtains an invitation letter from the Chinese business partner and then submits that together with the visa application form, photographs and appropriate fee. Tourists do not need an invitation but must still apply for a visa before

entering China. Although some ports of entry (for example, the new Beijing International Airport) do possess permanent facilities for issuing visas to entrants, these can not be relied upon, as their discretion is limited by law (and airlines may refuse to allow embarkation on flights to China to travellers without valid Chinese visas). The implementing rules list 10 criteria as being the only allowable reasons for granting such visas at ports of entry:

1. Invitation at short notice by the Chinese side to attend a trade fair in China.
2. Invitation to China to enter a bid or to sign formally an economic or trade contract.
3. Coming to China under contract for supervision over export shipment, import commodity inspection or check on the completion of a contract.
4. Invitation to install equipment or make rush repairs.
5. Coming to China at the request of the Chinese side to settle a claim.
6. Invitation to China for scientific or technological consulting services.
7. Arrival in China as a last-minute replacement or addition, approved by the Chinese side, to a delegation or group that has been invited and has already obtained visas for travelling to China.
8. Visiting a patient in a critical condition or making funeral arrangements.
9. Arrival in China as persons in immediate transit who, because of *force majeure*, are unable to leave China by the original aircraft within 24 hours or have to leave China by other means of transport.
10. Arrival in China as other kinds of invitees who genuinely do not have enough time to apply for visas to the above-mentioned Chinese agencies abroad but hold letters or telegrams from designated competent authorities approving the application for visas at port visa agencies.
11. In addition, passengers in transit may obtain visas to leave an airport if their connecting flight leaves within 24 hours of arrival.

The only entry ports which have the authority to grant visas are: Beijing, Shanghai, Tianjin, Dalian, Fuzhou, Xiamen, Xi'an, Guilin, Hangzhou, Kunming, Guangzhou (Baiyun Airport), Shenzhen (Luohu, Shekou) and Zhuhai (Gongbei).

Aliens are divided into two groups. The first consists of aliens who are to reside permanently in China; aliens who come to China to take up employment and their accompanying family members; aliens who come to China for study, advanced studies or job-training for a period of six months or more; and resident foreign correspondents. Those in this group staying in China for more than one year must obtain aliens' residence cards within 30 days of entry, and those staying for less than one year must obtain temporary residence cards within 30 days of entry. The duration of their permitted stay in China is determined by the validity of the certificate supporting the original visa issue.

The second group consists of aliens who are invited to China on a visit or on a study, lecture or business tour, for scientific-technological or cultural exchanges, for short-term refresher course or for job-training, for a period not more than six months; aliens who come to China for sight-seeing, visiting relatives or other private purposes; aliens passing through China; train attendants, air crew members and seamen operating international services, and to their accompanying family members; and foreign correspondents making short trips to China on reporting tasks. The duration of the permitted stay in China of any member of this group is limited only by the validity of the visa.

Articles 21 and 22 of the Law on the Entry and Exit of Aliens states that aliens who hold valid visas or residence certificates may travel to places declared open to aliens by the Chinese government and that aliens wishing to travel to places not open to aliens shall apply to the local public security organs for travel permits. When the law was first passed in November 1985, internal travel had already become easier than before the start of economic reform in 1978, but many areas of the country were still officially closed to foreigners. Since then the list of open areas has expanded to 1 330, and the remaining closed areas are off limits largely for the same safety or military reasons as in other countries.

While journalists are restricted in their movements, since they need permission to report even from open areas, business visitors are generally free to go where they wish, provided their presence is reported to the Public Security Bureau within 24 hours of arrival (this is done automatically if checking in at a hotel).

China has endeavoured to provide improved access to foreign investors and specialist personnel in the wake of WTO accession. In April 2002 ten ministries and government departments[1] issued Regulations on Facilitating Entry into the Country and Residence for Foreign Senior-Level Skilled Personnel and Investors. These regulations provided for the issue of 2 to 5 year multiple-entry F visas (visiting visas) and 2 to 5 year multiple-return Z visas (work visas) to managers of assistant general manager level or above, or equivalent, and to persons investing a minimum of US$3 million in China (or US$1 million in poor counties in the Western and Central regions) or equivalent management or professional status.

The experience of visitors representing multinational companies investing in China varies. While many report no difficulties, others complain that the procedures have become more cumbersome in recent years. Such differences may result from the way that visa applications are administered in different places outside the Chinese mainland. Some visa offices in foreign capitals are open for limited hours and, like the visa offices of many other countries, are not equipped to supply additional facilities to speed

applications. Others, notably the Chinese ministry of foreign affairs office in Hong Kong (China) (which has to accommodate a far larger number of applicants) are spacious, open during normal business hours, provide a photographic service, and process applications speedily. It may be helpful to emulate best practice by providing a similar service in those capital cities where demand for visas is high to that provided in Hong Kong (China).

9. Labour market development

Box 3.1. **Freeing the labour market**

Under the system of central planning that prevailed before economic reforms began in 1978, there was effectively no mobility of labour. Geographical mobility was prevented by a system of fixed household residency permits (*hukou*) and occupational mobility was prevented by the effective guarantee of lifetime employment provided by the rural people's communes in rural areas and by state-owned enterprises in urban areas. School and college graduates were allocated to work units in accordance with economic planning criteria. Compensation was determined mainly on egalitarian principles and "material incentives" such as bonuses and salary increases in reward for harder or better work were disallowed. Labour was therefore not free to move to areas, occupations and work units in response to market signals. The consequence was chronic misallocation of labour resources, together with large-scale concealed unemployment and underemployment.

In the past quarter of a century the Chinese labour market has developed rapidly. In the early 1980s, the replacement of the rural people's communes by the system of household responsibility in agriculture raised farming productivity massively, creating a large pool of surplus labour, currently approximately estimated at between 100 million and 200 million people. This "floating population" became a flexible – though largely unskilled – workforce available for construction and infrastructure projects in large cities.

One of the main aims of SOE reform since the 1980s has been the breaking of the "iron rice bowl" system of lifetime employment in SOEs. Although these reforms are not yet completed, they have already contributed to a relaxation of the system of guaranteed employment sufficient to allow far greater mobility in the urban workforce. Material incentives were restored in the late 1970s, though the development of an effective individualised bonus system took some years to complete. From 1980 onward, the government officially encouraged workers to seek employment on their own behalf or

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Box 3.1. **Freeing the labour market** *(cont.)*

provide their own employment. Beginning in 1985, SOEs were given the right to hire and fire workers. At the same time, the system of school and college graduate allocation was gradually replaced by a genuine labour market in which employers bid against each other for graduates, who are free to choose jobs for themselves.

A major factor holding back both SOE reform and labour mobility has been the comprehensive social provision provided by enterprises to their employees, which is now being gradually phased out (see Chapter 5).

Improved labour supply for FDI

When FDI inflows began in the late 1970s, the system of planned labour allocation was still in place and there was no labour market. Consequently, foreign investors had to rely on the allocation of labour to their enterprises by a Chinese state body, the Foreign Enterprise Service Corporation (FESCO), established in November 1979. Its monopoly of labour supply allowed FESCO to allocate employees to FIEs who were often regarded by FIE managers as suboptimal, while retaining a high proportion of the wage paid by the FIE.

The quality of the workforce has improved as a result of the expansion of higher education on the foundation of the basic education system established in the half-century following the establishment of the People's Republic of China in 1949. Increased investment in specialised vocational education in the past two decades has produced a new generation of skilled workers. Alongside a similar expansion in higher education, there has also been a large contingent of higher-education graduates who have studied at overseas universities and who may therefore often be more familiar with the ethos of FIEs, as well as with the academic disciplines in which foreign managers of FIEs have been trained. There is also now a large number of employees and ex-employees of FIEs whose on-the-job training has enabled them to acquire transferable skills. One expression of the improvement in the quality of FIE employees is that an increasing number and proportion of higher positions in FIEs are being filled by locally-hired Chinese in place of expatriates.

In line with the development of the overall labour market, the market for FIE employees has now become relatively free and competitive. FESCO no longer retains its monopoly of labour supply, but has had to restructure itself to compete as one among many labour supply agencies. Such agencies are becoming increasingly professional and efficient. FIEs are now free to choose their employees on the open labour market as in OECD countries. Most

recently, widespread use of the Internet has enhanced the flow of information and speeded up the recruitment process. In addition to paying bonuses, FIEs are now allowed to offer stock options to attract high-quality staff.

Legislation relating to employment in FIEs

The law stipulates that FIEs must obey general labour laws on such matters as recruitment, employment, dismissal, wages, welfare benefits, labour insurance, labour protection and labour discipline. Employees in an FIE have the right to establish official trade unions, that is, unions affiliated to the All-China Federation of Trade Unions (ACFTU). Union representatives have the right to attend meetings of the board of directors as non-voting delegates when the board is discussing enterprise development plans and operational activities or labour-related issues such as wages, welfare benefits, labour protection and labour insurance. Equity joint ventures and wholly-foreign-owned enterprises must allot 2 per cent of total real wages for the enterprise for payment into the trade union fund. They must also provide accommodation for the union to carry out its activities, including office space and cultural and sports facilities. The law on contractual joint ventures is less precise, specifying only that such a venture shall provide the necessary conditions for the trade union to carry out its activities.

Remaining labour problems for FIEs

FIEs continue to report that benefits in addition to basic wages add substantially to labour costs. Such extra costs occur elsewhere, including in OECD countries, but their application is usually predictable. In China, such costs are not always predictable, since there is a lack of national consistency in their application. For example, some local authorities allegedly exact large one-off payments towards the cost of such items as housing that are not required in other locations. Statutory allowances and subsidies payable by employers appear not to take into account the differential between pay at FIEs and at SOEs.

A further problem is that although the central planning system has been abandoned, elements of it survive in the form of local controls over employment and pay. Wages in FIEs are often set by local authorities rather than the market and FIEs are often contracted to retain surplus labour unnecessarily.

Although training and education have expanded, there remain shortages of skilled labour, especially in high-tech sectors. Many graduates who went overseas for higher education have decided not to return to China, creating a "brain drain" which affects FIEs as well as domestic enterprises.

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10. Environmental and social policies

The role of environmental and social policies in attracting FDI

Well-implemented environmental social and environmental policies and legislation can benefit China not only because they directly improve the life of the Chinese people but also because they may attract more, and higher-quality, FDI. Enterprises operating in accordance with relatively high social and environmental standards favour host locations with regulatory frameworks that are consistent with internationally-agreed norms. The authorities of OECD countries and other adherents to the OECD Guidelines on Multinational Enterprises (Box 3.2) recommend that multinational enterprises encourage their business partners, including suppliers and sub-contractors, to apply principles of corporate conduct compatible with the Guidelines. Enterprises operating on relatively high standards may also feel inhibited from investing in China if their local competitors are not observing similar standards. If the consequential differences are large, investors will have concerns about the evenness of the playing field.

Box 3.2. **The OECD Guidelines for Multinational Enterprises**

The OECD Guidelines for Multinational Enterprises are recommendations addressed by 37 (OECD and non-OECD) governments to multinational enterprises operating in and from their countries. They provide voluntary principles and standards for responsible business conduct in areas such as product safety, environment, labour management, supply chain responsibilities, disclosure of major risks and competition. The recommendations express the shared values of the nations that are the source of most of the world's direct investment flows and home to most multinational enterprises.

A key value added of the Guidelines resides in the unique follow-up procedures created by governments and business. Governments of the 37 adhering countries have established a system of National Contact Points to promote the observance of the Guidelines by multinational enterprises operating "in or from" their territories.

Evidence so far suggests that the Guidelines are making a difference. Many companies have publicly acknowledged that they use the Guidelines as a benchmark for good behaviour. The Guidelines are being used to help prevent misunderstandings and promote mutual confidence and predictability between the business community and home and host societies. About twenty-five specific instances where there are questions about whether or not a company has observed the Guidelines in a particular business situation have been considered so far.

Box 3.2. **The OECD Guidelines for Multinational Enterprises** *(cont.)*

The Guidelines are part of a broader instrument – the OECD Declaration on International Investment and Multinational Enterprises. The Declaration promotes a comprehensive and balanced approach for governments' fair treatment of foreign direct investment and for corporate responsibility.

Environmental protection is now a key national policy in China

The Chinese government has repeatedly stressed its commitment to a long-term policy of protecting the environment. All development planning, both urban and rural, is supposed to combine "economic returns" with social and environmental benefits. The three main policy principles to be applied are:

- Prevention first; combining prevention with control.
- Making the causer of pollution responsible for treating it.
- Intensifying environmental management.

The resulting network of policy measures includes: the incorporation of environmental protection into the overall planning process; the enactment of environmental legislation; the creation of an environmental control system comprising environmental control organisations under each level of government to supervise and administer this legislation; allocating resources to environmental R&D and to education on environmental issues at both popular and specialist levels; and increasing co-operation with other countries on environmental protection.

A sound environmental regulatory framework has been established

A firm foundation of environmental laws, regulations and national standards has been established over the past three decades. These laws govern all enterprises, including both domestic enterprises and FIEs.

China's environmental protection legislation predates the start of economic reform: it was in 1973 that the government issued provisional Draft Rules on the Protection and Improvement of the Environment as a result of the holding of the first National Conference on Environmental Protection, which also led to the formation of the Steering Group on Environmental Protection of the State Council.

However, it was only in 1979 that the Steering Group produced a major report on environmental protection in which it stated that China could not adopt the approach of "polluting first and controlling later". It took another ten years before the Environmental Protection Law of the People's Republic of

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China came into effect in September 1989. During that time, laws were passed on a range of pollution issues, mainly related to sea pollution and water pollution. Measures most directly related to FDI were the Regulations on the Administration of Environmental Protection in the Exploration and Development of Offshore Petroleum, effective from December 1983, and the Interim Provisions for the Administration of the Environment in the Economic Zones open to the Outside World, effective from March 1986.

Despite the serious problem of air pollution, about which local governments were seriously concerned, it was not until 1991 that the Rules for Implementation of the Law on the Prevention and Control of Atmospheric Pollution was passed, coming into effect in July 1991. Laws on other pollution-related issues, such as the law controlling the transference of foreign wastes to China, laws on protection of scenic areas, and laws on noise pollution control, were also passed in the 1990s. There are now over thirty national laws and regulations related to environmental protection, together with 364 national environmental standards (including compulsory environmental quality standards and pollutant discharge or emission standards, basic environmental criteria, criteria for samples, and criteria for methodology) and over 600 rules and regulations issued by local authorities.

Environmental impact assessment of proposed investment projects

Under the Environmental Protection Law, the State Environmental Protection Administration (SEPA) of the State Council and local Environmental Protection Bureaux (EPBs, established at provincial, city and county level as well as in harbour and transport administrations) are responsible for environmental standard-setting at national and local levels respectively. They also engage in environmental management, including the screening of proposed investment projects. Each project has to undergo an environmental impact review process if it is perceived as potentially environmentally harmful. Project proposals must contain an analysis of environmental impact and corresponding preventive measures. After the proposal has been screened by the environmental administrative authorities the applicant has to engage a qualified firm to prepare an environmental impact report which must be approved before the project may go ahead.

When a new project is commissioned, the Environment Protection Law stipulates that a pollution-prevention facility must be built with it and operated simultaneously with the design, construction and operation of the main production line (this is known as the "three simultaneous steps"). In 1976 only 18 per cent of projects applied this principle; by 1995 the proportion had risen to 87 per cent.

Although there are a number of provisions related to environmental protection in several laws and regulations governing FIEs (FIEs), their general effect is not discriminatory; their intention is clearly to ensure that such enterprises comply with the relevant provisions of environmental protection legislation, for example by forbidding the import of environmentally harmful technology. In some cases, there are additional incentives to encourage FIEs to recycle waste or introduce environmentally sound technologies.

Penalties for excess effluent discharges

Enterprises that emit pollutants must register and report pollution, and are charged excess effluent fees for above-limit discharges, plus the costs of controlling and eliminating the pollution and various fines and compensation charges. If excess discharges continue for more than two years, the effluent fee increases by 5 per cent each year. Receipts from such charges rose from Rmb 70 million in 1978 to Rmb 2.7 billion by 1995.

"Race to the bottom" *versus* ***"beauty contest"***

The prevailing views on regulatory investment incentives have undergone considerable changes in recent years. At one time it was assumed that investors sought to minimise the costs of regulatory compliance (for example with social, labour and environmental standards) and that lowering such standards could therefore be used as a tool for attracting investment. Where host countries were in competition for foreign investment, a competitive lowering of standards would, according to this argument, lead to a regulatory "race to the bottom". However, numerous studies of FDI attraction have failed to produce much evidence of such worst-case scenarios, and whilst there are documented cases of investors being attracted by low standards (including China, see below), most of the evidence pertains to particular national and sectoral contexts. Firstly, only the enterprises in certain economic sectors place great emphasis on the cost of regulatory compliance (*e.g.* mining and mineral extraction, certain labour-intensive manufacturing sectors). Secondly, the level of economic development and the strength of social and environmental public concern in investors' home countries influence investors' preferences in many instances.

As an economy develops, the emphasis tends to shift away from sectors in which FDI is more likely to be attracted by low compliance costs. As sectors employing more-highly-skilled (and in many cases internationally mobile) staff grow in importance, governments may actually prefer to raise environmental protection standards and strengthen their enforcement in an effort to win the "beauty contest" with FDI destinations that have also decided to compete on quality rather than cost. In the longer term, the "beauty contest" strategy will, if successful, pay off by attracting more highly-qualified

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managers and technologists working on more long-term, high-technology projects. This strategy is best practice among OECD members.

China is increasingly adopting the "beauty contest" approach, with large eastern conurbations moving faster than the hinterland.

The initial approach: lax environmental standards attracted low-technology investment

In the 1980s, FDI inflows into China were dominated by the transfer of manufacturing from Hong Kong (China) to Guangdong. During the 1950s industries such as textiles and plastics developed rapidly in Hong Kong (China) as a large body of immigrants from China was absorbed into the labour force, with wages remaining flat throughout the decade. Immigration clampdowns in subsequent years limited the labour supply, pushing up wages, while property prices rocketed, so that by the late 1970s Hong Kong (China) manufacturers sought to reduce land and labour costs by moving to cheaper locations. China's open-door policy provided an opportunity to shift industries over the border and immediately lower both fixed and variable costs of production. Lax environmental controls were a welcome incidental benefit, not the main reason for moving. After investment from Chinese Taipei began to arrive in 1987, and particularly after June 1989, when the Western countries and Japan imposed an FDI pause, investors from Chinese Taipei were warmly welcomed. The strong green movement in Chinese Taipei prompted many companies with polluting manufacturing processes to move their operations to China to take advantage of less stringently applied environmental protection standards.

While the implicit acceptance of lower standards of environmental protection may remain an FDI attractant in poorer inland areas where there is a large quantity of surplus labour for which employment is sought, there are signs of an attempt to move to a "beauty contest" strategy in major eastern cities, including Beijing and Shanghai. Beijing is attempting to clean up its pollution as part of its preparations for the 2008 Olympic Games. For example, the Capital Iron and Steel Works, a major contributor to air pollution in the capital since it was established in the 1950s, is to be split up into a number of high-technology companies and moved further away from the centre of the city. For its part, Shanghai is being cleaned up ready for Expo 2010.

In its attempt to attract multinational corporations looking for sites to build national or regional headquarters, Shanghai is competing not only with Beijing but also with Hong Kong (China) and Chinese Taipei. It therefore has to provide housing, education and other elements contributing to the general quality of life of the international executives that it hopes to persuade to settle there. For this reason, and also to benefit the local population, the Shanghai municipal government has embarked on measures to improve air quality.

Another major factor in the government's decision to adopt policies leading to sustainable development is that China faces serious problems of environmental degradation stemming from both its large and locally dense population and its recent rapid economic development. Industrialisation and urbanisation have caused cities to encroach on cropland and have increased air and water pollution to unacceptable levels that in many areas are a serious threat to health. Intensive agriculture has lowered the water table so far that an increasing area of north China is too dry to cultivate and major cities, including Beijing, are facing acute water shortages. Urban population agglomerations like that of Shanghai are producing more waste than can be adequately stored or recycled. The combination of these various forms of environmental deterioration threatens, if unchecked, to stop economic growth altogether.

The Chinese government is well advised to continue with its programme of tackling all forms of environmental pollution, both as a benefit to the people of China and of the world and also as a means of attracting high-quality FDI. Implementation has inevitably been uneven, so an important strategy will be to spread the best-practice experience of pilot areas such as Xiamen to the rest of the country. Local authorities are also well-advised to bear in mind that in competing with each other to attract FDI they should not neglect mutual co-operation and experience-sharing.

Note

1. The Ministry of Trade and Foreign Economic Co-operation (MOFTEC, since reorganised into the Ministry of Commerce, MOFCOM), the Ministry of Public Security, the Ministry of Foreign Affairs, the Ministry of Personnel, the Ministry of Education, the Ministry of Science and Technology, the Ministry of Labour and Social Security, the State Council Office of Overseas Chinese Affairs and the State Bureau of Foreign Experts.

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Chapter 4

The legal system and FDI

Abstract. *Laws relating to FDI have become increasingly precise. Moves towards strengthening judicial independence and training more judges are to be welcomed. Improvements could be made in consulting stakeholders, including foreign investors, during the process of drafting legislation. Available legal recourses include conciliation and arbitration both within and outside China. Intellectual property rights (IPR) protection was introduced into Chinese law after economic reform began in 1978. IPR laws, which give equal rights to domestic and foreign-invested enterprises, protect patents, trademarks and copyrights. Progress has been made in providing such protection, though enforcement remains incomplete. Corruption persists, despite legislation against it, and the Chinese government is working with the OECD on improving enforcement.China has made progress in providing a business environment conducive to foreign direct investment (FDI). The challenge now is to move towards a more rules-based policy framework that will attract high-quality FDI from OECD countries. The OECD proposes a number of policy options for the Chinese government to consider in further developing such a framework. These include additional streamlining of the investment project approval process, reconsideration of unnecessary sectoral restrictions on foreign investment, and measures to increase transparency and strengthen the rule of law.*

1. Developing the rule of law

The role of law

Laws relating to FDI have, especially since the early 1990s, become increasingly precise and focused. Codes of law tended in the past to be brief and vague, allowing maximum room for interpretation by officials. The rationale for this practice was that officials should not be restricted by inflexible rules when dealing with concrete local situations, but should be able to judge according to specific circumstances. The system has therefore generally been weighted in favour of maximum flexibility. During the reform period, however, national leaders have postulated an overall goal of moving from the "rule of man" to the "rule of law" which, if it is to be achieved, will necessitate more precise framing of legislation and more consistent and transparent implementation and enforcement.

A major feature of the reform process since 1978 has been the devolution of policy application and legal enforcement to local level. This has enabled enforcement to become more thorough than if it had remained dependent on central initiatives, and it has also allowed more adaptation to local conditions – a consideration that has traditionally been considered important in China. On the other hand, localised enforcement can be less consistent than national, and it is also more likely to be subject to pressure from local officials to conform to local vested interests. Since 1985, the central government has attempted to ensure more regular application of national policies and regulations at local level by introducing an element of accountability to the local population in the form of a system of local elections.

Judicial independence

A larger body of qualified legal personnel should, in principle, be better able to resist pressures from outside the legal system, but they will only be able to do so if the political system embodies respect for the principle of judicial independence. A crucial test of judicial independence is the existence or non-existence of judicial review of government action. If a court may rule a government action illegal, overturn it, and enforce that action, such a judgment demonstrates strong judicial independence. China's legal system was not until recently characterised by such independence, but regulations are now in place which do provide the possibility of judicial review of official decisions. It is of particular importance following WTO accession that judicial

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independence by strengthened and that administrative review become entrenched, because the protocol of accession explicitly stipulates that China must establish independent, disinterested tribunals and procedures for prompt review of all administrative actions relating to implementation.

Box 4.1. **Restoration of the legal system in the reform era: the quantitative record**

Law was regarded as subordinate to political ideology during Mao Zedong's ascendancy (1949-1976), especially during the last ten years of that period, when the courts largely ceased to function, even in terms of the limited – and frequently ignored – "socialist legality" established in the 1950s. The lack of an effective and independent judicial system left a vacuum that was partly filled at national level by Communist Party organs and, at local level, by the police and by such bodies as street committees in the cities and the rural peoples' communes in the countryside. A system of mediation by 800 000 local mediation committees which is apparently unique in global terms was established in the pre-reform era. These continue to play an important, though diminishing, role: over 5 million civil disputes were mediated by them in 2000, compared with 3.4 million civil law cases and 1.3 million economic disputes handled by the courts (National Bureau of Statistics, 2001).

The new policy of economic reform and opening announced at the end of 1978 was accompanied by moves to reinstate and improve the legal system that had been set up in the early years of the communist regime. Criminal and civil law codes were drawn up, lawyers trained and judges appointed. In 1985, there were only 13 403 qualified lawyers in the whole of China, and nearly half of these (6 573) were part-time. There were 3 131 law offices, which therefore had an average of only 4.3 lawyers each. By 2000, the number of lawyers had risen to 117 260, the majority of them (69 117) full-time, working in 9 541 law offices with an average of 12.3 lawyers. In 1985, only 39 453 units (*e.g.* factories) had permanent legal advisers; by 2000 this number had risen to 247 160. The number of cases reaching first trial in court has increased more than tenfold from 447 755 (146 968 of them criminal, 300 787 civil) in 1978 to 5 356 294 (560 432 criminal, 3 412 259 civil) in 2000. The preponderance of civil cases, which account for approximately two-thirds of the total, has remained stable. (National Bureau of Statistics, 2001.)

Economic disputes were not recorded separately from other civil cases before 1983, when 43 553 were listed as such. By 2000 this figure had increased nearly 30 times to 1 290 867. The overwhelming majority of these (91.3 per cent) involved economic contracts, with only a negligible proportion (0.3 per cent) accounted for by claims for damage compensation. Likewise, bankruptcy cases constituted only 0.6 per cent. Of the economic cases settled

Box 4.1. **Restoration of the legal system in the reform era: the quantitative record** *(cont.)*

in 2000, 39.9 per cent were settled by adjudication and 34.2 per cent by mediation, while 20.8 per cent were withdrawn and 1.3 per cent rejected by the courts (the other 3.8 per cent are unexplained).

Such quantitative data indicate the importance attached to the construction of a legal foundation for business by the government and the successes achieved to date in policy implementation, but on their own they provide an incomplete picture of the role of law in China. It would be incorrect to extrapolate from existing figures and derive the conclusion that the rule of law will be entrenched once sufficient lawyers have been trained and judges appointed after a specific number of years.

In China, judges are not only responsible for overseeing the work of the courts, they also decide cases. It is therefore crucially important that they be both highly qualified and completely independent. At present, they are often neither, as pointed out by the President of the Supreme People's Court, Xiao Yang, in July 2002, who stated that many judges were incompetent, that "incompetent judges" were "one of the most vital factors in judicial inequity", and that judges are frequently "viewed as civil servants who have to follow orders from superiors, which prevents them from exercising mandated legal duties" (reported by the official Xinhua News Agency).

Most of the 200 000 judges in China, except in the major coastal cities where the courts are better established, are drawn from the ranks of retired officers from the People's Liberation Army (PLA) and more than two-thirds have no higher educational qualifications whatsoever, let alone law degrees. The legal system is so new that there is not yet a cadre of experienced lawyers to provide the feedstock for the judiciary; those judges that are legally qualified therefore tend to be recent law graduates.

In 2000 a system of appointing judges through public competition was introduced and in 2001 the president of the Supreme People's Court, China's highest judicial organ, proposed the adoption of a collegiate court system that, he suggested, would ensure more independent, impartial and clean judicial activities. In July 2002 he announced a programme under which all judges will be subject to professional examinations over the next five years. All who fail these examinations will be dismissed. Such initiatives designed to reform the court system and render it less subject to external official interference and corruption are to be welcomed.

The gradual development of public respect for the law

All China's economic legislation has been created since 1978 on the basis of foreign models. It has not been developed incrementally to meet specific needs but has been imported wholesale and imposed on a society to which the concepts on which it is based are alien to their historical traditions and their individual socialisation. In many respects it is like a transplant or graft that is in danger of being rejected by the many natural antibodies it encounters.

Since economic and business laws have only been formulated very recently, and are based on foreign models, they have not had time to become established in the minds of the population. The government has therefore spent substantial resources on education designed to familiarise the public with these new laws. Official press reports make it clear that such efforts have not yet prevented large numbers of people from engaging in frequent and flagrant abuses of the law. However, there are signs of increasing use by ordinary citizens to obtain redress. As more and more people experience the courts first hand as an effective means of securing justice, the laws involved, and law in general, will begin to take root and become more accepted by the public.

The genesis of laws and regulations

Although laws are passed by the NPC, the country's legislature, the similarity to legislative processes in other countries is merely formal, as it is not usual for the NPC to reject any legislation placed before it. Laws originate from numerous specialised government bodies charged with formulating them and are then delivered for passage to the NPC, or its Standing Committee if it is not in session, and subsequent promulgation. Legislation is a secretive process, with discussion and debate typically taking place within ministries without public participation, although there have been some notable exceptions to this closed procedure. Where consultation does take place, it is at the behest of the officials in charge of drawing up the law; those consulted have no automatic right to make representations on their behalf, even if they belong to a constituency directly affected by a new law.

FIEs are occasionally invited to participate in consultations when a law is being drafted, but they are sometimes consulted without seeing or without being able to review at leisure a written draft of the law or regulation. Government officials say that a major criterion used to decide which companies to invite is whether or not the company has a dominant position in a particular market or industry. However, some FIEs complain of having been left out off the list while, they allege, other companies with a lesser claim have been asked to attend and proffer advice. The consultation process is inevitably incomplete, falling far short of the free discussion in the electronic and print media normal in many OECD countries. Consequently, a company taking part

in a closed consultation session is likely to feel that it has been granted a special privilege denied to those not invited; if the session is open, it may decide not to make too many of its comments public and its advice is therefore likely to be of less practical use. The Chinese authorities state that they do not consider that only a few foreign-invested enterprises are invited to participate in the process of formulating laws.

Because laws are not freely discussed by a wide range of stakeholders before promulgation, they frequently contain elements that are incomplete, inappropriate or inaccurate. After these imperfections have been drawn to the government's attention, a set of implementing regulations is drafted to fill the gaps, elaborate the details and rectify blatant errors. Until the implementing regulations are published it is often difficult to apply the original law because its detailed terms remain uncertain. Publication is not automatic; implementing rules are often circulated internally for some time, so that they are not available to the public. Advance publication would increase transparency regarding legislation and would also have the effect of forcing officials to explain the specific public purposes intended to be served by laws and regulations.

The role of international law firms in China

A large number of foreign law firms set up representative offices in China in anticipation of the opening up of the legal sector to foreign participation following WTO accession. Between 1992 and August 2002, the Ministry of Justice approved the establishment of 109 foreign law offices and offices of 28 Hong Kong law firms in 11 Chinese cities, largely in Shanghai and Beijing. The "one firm, one office" rule that limited foreign law firms to a single office in China was lifted in 2000, permitting foreign law firms to service clients who have business operations in several cities. By end-2001, 20 foreign law firms had submitted applications to open second branches in China.

However, foreign law firms still report a number of difficulties in both establishment and operation. Some foreign law firms, including law firms based in Hong Kong (China), that they have had to wait up to five years before being granted a licence to operate on the Chinese mainland. The lifting of restrictions on the location and number of foreign law firms which China has agreed to implement, and which was implemented in regulations promulgated in January 2002,[1] appears to be heavily qualified by regulations that took effect in September 2002[2] that give the Ministry of Justice the right to decide whether to allow the opening of new offices on grounds of local social, economic and legal-services development. Foreign law firms may not hire locally qualified lawyers and may not invest in local law firms. Since lawyers qualified in other legal jurisdictions may not practice Chinese law, this limits the services foreign law firms may offer their clients. The September 2002 regulations further restrict the activities of foreign law firms by prohibiting them from dealing directly with

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any Chinese government department and from acting on behalf of foreign companies in arbitration cases. Multinational enterprises often prefer to use a single law firm in order to co-ordinate their operations effectively round the world. At the same time, Chinese firms investing or trading abroad have a harder time obtaining foreign legal expertise.

2. Legal recourses[3]

Conciliation

The Chinese legal system contains an element of conciliation that is not present in many other jurisdictions. Although litigation is becoming more common in Chinese society, usage of such conciliation procedures remains popular, since it offers a quicker, cheaper and less vituperative method of dispute resolution. Local mediation committees handled over 5 million civil disputes in 2000.

A more specific conciliation procedure is available for disputes relating to the economy, trade, finance, security, investment, intellectual property, technology transfer, real estate, construction contracts, transport, insurance and other commercial and maritime business. In 1987 the China Council for the Promotion of International Trade (CCPIT) and the China Chamber of International Commerce (CCOIC) set up the CCPIT Conciliation Centre in Beijing for this purpose and in the 1990s this was expanded to form a national network of over 30 conciliation centres. Such centres are not restricted to cases involving foreign investors or enterprises.

Cases are accepted by the centres in accordance with a conciliation agreement between the parties, or, in the absence of such an agreement, on application by one party with the consent of the other party. Cases taken to the conciliation centres are expected to reach "an amicable settlement agreement" by the free will of both parties.[4] The number of cases referred to the centres has not been great (some 2 000 by the end of 1999), presumably because disputes that are capable of easy resolution can be handled without recourse to outside conciliation, but the CCPIT states that the success rate is about 80 per cent.

The CCPIT Conciliation Centre has signed co-operation agreements with similar centres outside China, including the Hamburg and New York centres. In 1995 it joined the International Federation of Commercial Arbitration Institutions (IFCAL) and in 1997 it joined the London Court of International Arbitration (LCIA).

Arbitration

When foreign partners in Sino-foreign joint ventures find themselves in disagreement with their Chinese partners over such matters as the interpretation of the provisions of a joint venture agreement, contract or

articles of association, they are first expected to resolve the dispute through consultation or mediation, for example via a conciliation centre. If this fails, there are several avenues for dispute resolution, including arbitration within China, arbitration abroad and litigation within China. Litigation is increasingly being used, but arbitration remains the preferred option, especially as enforcement of court judgments is largely left to the public security bureaux, who do not regard it as their top priority. The Chinese authorities do not share the view that public security organs are the executors of court judgments.

Domestic arbitration

A dispute may be taken to the China International Economic and Trade Arbitration Commission (CIETAC) or, if appropriate, to the Chinese Maritime Arbitration Commission (CMAC). The CIETAC has its headquarters in Beijing and also has branches in Shanghai and Shenzhen and is reportedly the busiest such centre in the world. Other large cities also have their own arbitration centres which can handle disputes involving foreign partners as well as purely domestic disputes. CIETAC handles:

- International or "foreign-related" disputes.
- Disputes relating to Hong Kong (China), Macao (China) and Chinese Taipei.
- Disputes between FIEs or between an FDI and a Chinese legal person.
- Disputes arising from project financing, invitations to tender and bidding submissions, project construction and other activities conducted by a Chinese legal person and other persons or economic organisations that use capital, technology or services from foreign countries, international organisations, or from Hong Kong (China), Macao (China) or Chinese Taipei.
- Any other disputes that the parties have agreed to arbitrate by CIETAC.[5]

Disputes are accepted on the written application of one of the parties to the dispute in accordance with the arbitration clause in the contract or other written agreement signed between the parties and are handled by arbitration panels selected by CIETAC from among Chinese and foreign persons with professional knowledge and experience in various fields. The tribunal must render an arbitral award within nine months from the date of formation of the tribunal.

Arbitration tribunals are empowered to combine conciliation with arbitration. This means that an arbitration tribunal may, with the consent of both parties, help the parties to reach a voluntary amicable agreement and make a consent arbitral award, saving time and expense that would otherwise usually be necessary for an ordinary arbitral award.

As would be expected from the more complex procedures involved in arbitration as compared with those of conciliation, CIETAC fees are slightly

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higher than those charged by the CCPIT Conciliation Centre. For example, for disputes relating to claims of between Rmb 10 million and Rmb 50 million, CIETAC charges Rmb 210 000 plus one per cent of the amount above Rmb 10 million while the Conciliation Centre charges between 0.5 per cent and 0.75 per cent of the claimed amount.[6]

Arbitration outside China

With the mutual consent of the parties concerned, arbitration can also be carried out through an arbitration agency in the country where the sued party is located or through one in a third country. The availability of an enforceable arbitration procedure outside China allows foreign investors to avoid the current shortcomings of the legal system in China in many cases. China has been a member of the International Centre for the Settlement of Investment Disputes (ICSID), so that arbitral awards by the ICSID in disputes involving China and the 135 other contracting states can be enforced under the terms of the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, which China joined in 1987 (for commercial disputes only).

The option of taking arbitration to centres outside China has been taken by many foreign joint-venture partners in recent years. The main centres involved are the Stockholm Chamber of Commerce (SCC), the London Court of International Arbitration (LCIA), the International Court of Arbitration of the International Chamber of Commerce (ICC) and the Hong Kong International Arbitration Centre (HKIAC).

Bilateral treaties signed by China with many countries (see Chapter 7) include detailed provisions for the formation of arbitration tribunals chaired by a third-country national to make binding judgments regarding unresolved disputes between nationals of the two countries concerned. Such mechanisms are an important addition to domestic dispute resolution procedures because they remove any element of bias perceived to exist in the domestic court system of either country.

It should be borne in mind that enforcement of an international arbitral award in China is still the function of Chinese courts and is not automatic, as it is possible for a Chinese court to challenge the status of such an award and cases in which awards have been overturned on such grounds have occurred.

Handling complaints against government departments

In addition, local centres established under such bodies as municipal service centres for foreign investment and municipal foreign economic and trade committees deal with complaints against government departments and suggestions for improving the FDI environment. These appear to be becoming more systematic. For example, in March 2001 a set of measures for handling

FIE complaints was promulgated in Beijing designating the Beijing Centre for Handling Complaints Lodged by Foreign-Funded Enterprises within the Beijing foreign investment service centre. Under this system, local governments down to county level are charged with setting up centres to handle complaints from FIEs and report them to the municipal centre within three days of receiving them. The municipal centre must then reply to all questions that it can answer within three days and transfer those that it cannot answer to the handling department within three days and inform the complainant of the transfer. The handling department must then contact the department being complained about to verify the related information and inform the complainant of the result within 15 days.[7]

3. Intellectual property protection

The development of intellectual property rights legislation: starting from scratch

Before the economic reforms began in 1978, the concept of intellectual property rights was not fully enshrined in Chinese law. Nor was it widely accepted. Copying of foreign products was widespread, partly encouraged by the policies of autarky and import substitution that reigned for the first three decades after the foundation of the People's Republic of China in 1949. For example, pirated books were sold on a regular basis in special *neibu* (internal) sections of the larger bookshops which were inaccessible to foreigners.

The need for legislation to protect intellectual property rights was recognised in the late 1970s, when the government realised that without such protection it would be difficult to attract foreign investment embodying new technology. It was also realised that legal recognition of patent rights was necessary to stimulate and nurture indigenous inventiveness; this perception was supported by the return to the use of material incentives in the economy after a long period during which these had been disallowed.

The Chinese government initiated co-operative links with other countries in step with its promulgation of specific intellectual property rights protection legislation. On 3 June 1980 China became a member of the World Intellectual Property Organisation (WIPO). Just over two years later, on 23 August 1982, the Standing Committee of the NPC passed the Trademark Law of the People's Republic of China, which came into effect on 1 March 1983. This was followed by a Patent Law, effective from 1 April 1985. On 19 March 1985 China became a member of the Paris Convention for the Protection of Industrial Property.

However, these measures were initially incomplete because they lacked an effective foundation in civil law. This problem was rectified in April 1986, when the NPC passed the General Principles of the Civil Law of the People's Republic of China, which came into effect on 1 January 1987. This new civil law

code contained the first explicit definition of intellectual property rights as the civil rights of citizens and of legal persons, and the first affirmation of the rights of authorship/copyright as rights of citizens and legal persons.

During the following six years, China entered into a number of international agreements to strengthen the protection of intellectual property rights. In 1989 China was one of the first countries to sign the Treaty on Intellectual Property in Respect of Integrated Circuits adopted by WIPO. In October of the same year China also became a member state of the Madrid Agreement for the International Registration of Trademarks under WIPO auspices. On 15 October 1992 China was accepted by WIPO as a member of the Berne Convention for the Protection of Literary and Artistic Works and on 30 October 1992 China became a member of the UNESCO Universal Copyright Convention. On 30 April 1993 China became a member of the WIPO Convention for the Protection of Producers of Phonograms Against Unauthorised Duplication of Their Phonograms. China also became a member of the WIPO Patent Co-operation Treaty on 1 January 1994.

In the early 1990s China continued to fill gaps in its domestic IPR legislation. A Copyright Law, passed by the NPC Standing Committee in September 1990 went into effect on 1 June 1991. This was supplemented soon after by Regulations on the Protection of Computer Software, effective from October 1991, and by Regulations on the Implementation of the International Copyright Treaty, effective from 25 September 1992, which specifically protects the rights of foreign authors. On 1 December 1993 the Law of the People's Republic of China on Combating Unfair Competition went into effect. Basic IPR laws passed in the 1980s, notably those on trademarks and patents, were also refined and expanded.

The Trademark Law and its implementing rules were revised in 1993 to expand the range of trademarks protected to include services trademarks as well as commodity trademarks in line with the requirements of the GATT Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS). In February 1993, the NPC Standing Committee adopted the Supplementary Regulations on Punishing Criminal Counterfeiting of Registered Trademarks. A second revision took place in September 2001.

In September 1992 the Patent Law was revised. The new law expanded the scope of patent protection to all types of technological inventions, whether new products or new techniques, including pharmaceutical products and substances obtained by means of a chemical process, foods, beverages and flavourings. The duration of an invention patent was lengthened from 15 to 20 years from the date of application. In addition to extending the protection of a patented process to include products directly produced by that process, the new law stipulated that the importation of patented products

requires the explicit permission of the patent holder. The Patent Law was revised again in August 2000.

In addition, the Supreme People's Court has made a number of important interpretations which have further refined and strengthened IPR legislation, especially in areas where existing law does not cover new technology. For example, in December 2000 the Court ruled that works protected by the Copyright Law included digital forms of protected works and in July 2001 the Court set out rules governing the elements that must be proved to show that the registration and use of a computer network domain name constitutes infringement or unfair competition.

IPR education and training

Recognising that many people in China do not understand the concept of intellectual property rights, the government has endeavoured to educate the population by a variety of means. The promulgation of each of the laws mentioned above was followed by widespread publicity in the mass media and by the distribution of texts of the law and of explanatory videotapes. The government has run numerous training classes to explain new IPR laws to the general population, sometimes, as in the case of the revision of the Patent Law, involving millions of people.

The government has also devoted resources to training a large number of officials responsible for implementing IPR laws. This has been done in co-operation with WIPO and other international organisations, and has included classes mounted in China and overseas. IPR education and research is conducted at over 70 higher education institutions; some major universities, including the People's University of China (in Beijing) and Beijing University, offer higher degrees in IPR subjects.

The scope and nature of IPR protection

China's IPR legislation gives equal rights to domestic and FIEs

According to Article 1 paragraph 3 of the TRIPS Agreement, WTO members must accord the treatment provided for in the TRIPS Agreement to the nationals of other WTO members; Article 3 paragraph 1 further states that each member shall accord to the nationals of other members treatment no less favourable that that it accords to its own members with regard to the protection of intellectual property. There is no requirement to extend this treatment to non-WTO-member nationals. However, since the majority of economies are already WTO members and some of the remainder may accede to the WTO during the period of operation of current legislation, compliance with this requirement can be ensured by providing a wholly non-discriminatory framework of IPR protection legislation, which China has done.

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In addition to providing protection guaranteed by bilateral treaties, Chinese laws explicitly stipulate that all FIEs enjoy the same rights as domestic companies and individuals with regard to trademarks and patents.

Patents

Patent law is administered by the Patent Administration Department (PAD) under the State Council. The PAD receives patent applications and grants patent rights to designs, inventions or utility models if they are deemed to meet the three criteria of novelty, inventiveness and practical app1icability. Foreigners as well as Chinese citizens may apply for patent rights. Once the patent right for a design, invention or utility model is granted, no entity or individual may, without the authorisation of the patentee, exploit the patent by making, using, offering to sell, selling, or importing a patented product, or using a patented process to sell, offer to sell, or import a product directly obtained by the patented process. A patent can be exploited by another entity or individual after concluding a written licence contract and paying an appropriate fee; the licensee has no right to authorise any other entity or individual not referred to in the contract to exploit the patent. The patentee has the right to affix a patent marking and to indicate the number of the patent on the patented product or on its packaging. The inventor has the right to be named in the patent, and is entitled to receive reasonable remuneration from its exploitation.

A patent application filed by a foreigner or foreign entity not based in China is treated in accordance with any agreement concluded between China and the country to which the applicant belongs. FIEs, which must all, according to Chinese law, be registered in China, enjoy the same rights as domestic companies and individuals in submitting patent applications.

The duration of the patent right for 20 years for an invention and 10 years for a utility model or a design, counted from the date the patent application is filed. If the application meets the above requirements, the PAD will publish the application promptly after the expiration of 18 months from the date of filing; earlier publication is possible if the applicant requests it. The latter stipulation is of benefit to patent holders and accords with good practice in other countries. (Article 33 of the TRIPs Agreement requires that the term of protection available shall not end before the expiration of a period of 20 years counted from the filing date, except in the case of layout designs of integrated circuits, where Article 38 contains a minimum protection term of 10 years from the date of filing or, when registration is not required, from the date of first commercial exploitation.)

Infringement of patent rights that can not be settled by mutual consultation is taken either to a court or to the administrative authority for patent affairs, which can issue a notice to stop infringement. If the infringer

fails to comply, the administrative authority may take the matter to a court for compulsory execution. A similar procedure applies for the granting of compensation to the patentee.

In addition to such civil law proceedings, the administrative authority may confiscate illegal earnings from the passing off of a patent, or of a patented production process, by an infringer, or, if there are no such earnings, fine the infringer up to Rmb 50 000.

Trademarks

Two bodies oversee trademarks in China: the Trademark Office of the administrative authority for industry and commerce under the State Council, which is responsible for registering and administering trademarks, and the Trademark Review and Adjudication Board under the administrative authority for industry and commerce under the State Council, which handles trademark disputes.

Entities and individuals that have submitted successful trademark registration applications to the Trademark Office enjoy the exclusive right to use their registered trademarks for goods that they produce, manufacture, process, select or market. The same rights apply to service marks. The usual exclusions apply (for instance, marks that could be confused with state names or organisations, marks representing generic goods, marks that lack distinctive features, marks that discriminate against nationalities).

A trademark registration application filed by a foreigner or foreign entity not based in China is treated in accordance with any agreement concluded between China and the country to which the applicant belongs. FIEs, which must all, according to Chinese law, be registered in China, enjoy the same rights as domestic companies and individuals in submitting trademark registration applications.

The duration of the trademark registration is 10 years from the date of filing the application; the holder may apply for renewal for subsequent periods of 10 years. A trademark will be registered after three months if it meets the above criteria and no objection has been filed against it during that time. These stipulations comply with the TRIPs agreement, Article 18 of which requires that initial registration , and each renewal of registration, of a trademark shall be for a term of no less than 7 years and that trademark registration shall be renewable indefinitely.

A registered trademark is protected against infringement by various means, such as counterfeiting representations of the registered trademark of another entity or person, or using a trademark that is identical with or similar to a registered trademark in respect of identical or similar goods without authorisation from the trademark registrant.

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Infringement of a registered trademark that can not be settled by mutual consultation is taken either to a court or to the administrative authority for industry and commerce, which can issue a notice to stop infringement, confiscate the infringing goods and tools used to make fake trademarks, and levy a fine on the infringer. If the infringer fails to comply, the administrative authority may take the matter to a court for compulsory execution.

In addition to such civil law proceedings, the administrative authority may confiscate illegal earnings from the passing off of a patent, or of a patented production process, by an infringer, or, if there are no such earnings, fine the infringer up to Rmb 500 000.

Copyright

China's Copyright Law is administered by the Copyright Administration Department (CAD) under the State Council at national level, and at local level by CADs responsible to provincial-level governments. Copyright owners may authorise a collective non-profit-making organisation to exercise their copyright or any copyright-related right.

The Copyright Law protects the copyright of Chinese citizens and legal entities within China. Works of foreigners eligible to enjoy copyright under an agreement between China and their countries of origin are also protected, as are works of foreigners first published in China.

The scope of the law embraces literature, art, natural science, social science, engineering technology "and the like", and includes: written works, oral works (even traditional storytelling), music, drama, choreography, art, architecture, photographs, films, engineering designs, product designs, maps, drawings and computer software.

Protection is not granted to any works whose production or distribution is prohibited in China. Official documents such as laws and regulations are also not protected by the law, nor is news of current affairs or generic material such as calendars.

Copyright as defined in the Copyright Law includes: the right of publication, *i.e.* the right to decide to make a work available to the public; the right to claim authorship; the right of alteration; the right of integrity, *i.e.* to defend a work against distortion and mutilation; the right of adaptation; the right of distribution; the right of rental; and rights of exhibition, showing, broadcast, distribution on networks, compilation and translation.

Exploitation of a work without permission from or compensation to the author is allowed in the usual instances, for example for private study, research or entertainment. Works may also be compiled into official school textbooks without the author's permission, provided there is correct citation and compensation is paid.

There is no time limit on the rights of authorship, alteration and integrity of an author. The right of publication and most other rights expire 50 years after the death of the author.

Civil liabilities can be incurred by anyone infringing copyright by such acts as publishing a work without the permission of the copyright owner, publishing a work of joint authorship as one of sole authorship, plagiarism, or mutilation and distortion. If mediation fails, the copyright owner may apply to a court to hear the case and also to take immediate action, for example to preserve evidence. Remedies may include cessation of the infringement, making an apology or paying compensation for damages. Where the copyright holder's injury or the infringer's unlawful earnings are difficult to assess, the court may judge damages for itself up to Rmb 500 000.

Computer software is covered by the Copyright Law and also by a separate set of detailed regulations formulated in accordance with it.

Indices of success of IPR protection in China

Patent applications as an indicator of confidence in patent protection

One indicator that should be considered is the number of patent applications filed. Inventors and innovators who consider that patent protection is not effective are less likely to file such applications, so if the number of applications is increasing, it is reasonable to suppose that the public places some trust in patent protection.

In 1985, 14 372 patent applications were examined. By 1990 the number examined had risen to 41 469, an increase of 189 per cent in five years. In the subsequent five-year period the number of applications more than doubled, reaching 83 045, and a similar rate of growth persisted up to 2000, when 170 682 applications were recorded. The continuation of a rapid rate of increase in applications well beyond the initial stage, when one would expect temporary exponential growth as slack was taken up, indicates that applicants thought it worthwhile to spend their time on application procedures.

It also indicates why there has been no discernible movement against IPR protection legislation in China as there has been in other developing countries where a substantial section of the population, for example the farming community, fears the effect of foreign patents on existing indigenous technology. Many Chinese are just as interested in protecting their inventions as are foreign companies, judging from the fact that a majority of patent applications have been domestic. The proportion of domestic patent applicants rose from 65.5 per cent in 1985 to 88.2 per cent in 1990, then eased slightly and stabilised at 82.9 per cent in 1995 and 82.2 per cent in 2000. The figures also support the argument that more needs to be done to stimulate domestic creativity: while nearly all the patents filed for utility models and

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designs are domestic, domestic patent filings for creations and inventions have consistently accounted for just under half the total.

Confidence by foreign patent applicants in the system is also indicated by the large number of applications (30 043) examined in 2000, the majority of them from OECD countries (see Table 4.1). It is not possible to compare these with applications from Hong Kong (China) and Chinese Taipei, which are major investors in China, because such applications are not considered to be foreign.

Table 4.1. **Number of patent applications examined, 2000**

Country of origin	Patent applications
Japan	9 888
United States	8 418
Germany	2 787
Republic of Korea	1 861
France	1 387
Netherlands	993
Switzerland	867
UK	802
Sweden	768
Italy	382
Finland	378
Canada	235
Australia	232
Denmark	229

Source: National Bureau of Statistics, China Statistical Yearbook 2001.

IPR courts are starting to deal with IPR violations

An increasing number of cases involving intellectual property have come before the courts in China in recent years. From 1990 to 2000, 36 504 intellectual property disputes were heard and 99 per cent of these cases were concluded. Of these, the largest categories were disputes related to technology contracts (38 per cent of the total) and patent disputes (26 per cent). Three other categories figured significantly: unfair competition (16 per cent), copyright disputes (12 per cent) and trademark disputes (8 per cent). The vast majority of these disputes did not involve foreign litigants.

To solve the problem of lack of specialised knowledge in the ordinary courts, China has established a number of courts that deal exclusively with IPR dispute resolution. The first IPR court was established in Beijing in 1993, when the city established a special IPR division in its higher people's court, two intermediate people's courts and two local courts in the Haidian and Chaoyang districts. By late 2001 these courts had heard 59 overseas-related IPR cases. Approximately one-third of these were trademark disputes and a

quarter involved patent issues. More than 30 higher and intermediate courts have been set up throughout China to deal with IPR cases. By 2001, almost half the judges in these courts were reported to have been sent abroad to receive training and meet their foreign counterparts.

Where IPR infringement has been confirmed, the sums awarded to foreign companies have tended to be smaller than those demanded. For example, one widely quoted case is that of a judgment in favour of Mitsubishi in which the latter was paid Rmb 500 000 after being found guilty of infringing its trademark; Mitsubishi had wanted Rmb 36.5 million. However, it is not unusual for such settlements to vary widely in magnitude between countries, especially developed countries like Japan and the US and developing countries. In another landmark judgment in 2002, Yamaha was awarded an even larger sum, Rmb 900 000, against a Chinese company, Tianjin Gangtian, which had been producing and selling copies of Yamaha motorcycles. Tianjin Gangtian was also ordered to stop using the Yamaha trademark and to apologise in the newspapers to Yamaha. In general foreign investors and their representatives express approval of the procedures adopted and the results obtained.

Prominent media coverage has been given to campaigns to stamp out practices such as copyright pirating and producing counterfeit goods. Television news coverage has frequently been given to the confiscation and destruction of items such as fake CDs.

1999 Sino-US IPR enforcement roundtable

In 1999 China held a roundtable with the US to discuss the issue of counterfeit goods. The US complained that it had lost US$200 billion in 1996 compared with US$5 billion for the preceding fifteen years; although some of this loss was accounted for by counterfeiting in third countries, it is likely that China was the main source. At the conference, the officials of the State Administration for Entry-Exit Inspection and Quarantine (SAIQ) said that they had implemented a crackdown on counterfeit products with American UL (Underwriters' Laboratories) marks from 1995 to the end of October 1999, during which time they investigated about 350 such cases and sent 100 factory owners whose infringements were judged to be "serious" for prosecution in criminal courts. The value of confiscated and destroyed fake products and marks was more than Rmb10 million. The SAIQ worked together with General Customs Administration, State Administration for Industry and Commerce and State Intellectual Property Office in the crackdown on counterfeit products.

The scale of the problem

China has made great progress in developing legislative protection of intellectual property rights. Implementation has improved, but foreign

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investors continue to raise concerns about instances of intellectual property rights violations which are not always dealt with effectively by the courts. The main task ahead is to improve enforcement of existing laws on a regular rather than a sporadic basis and at the same time develop a public culture which respects intellectual property rights at all levels of society and the economy. Doing so will benefit domestic companies and individuals by protecting their trademarks, copyright and patents, and will also help attract more high-quality FDI to China. As one author puts it: "China cannot realistically hope to attract foreign direct investment, secure transfers of cutting-edge foreign technology, or foster world-class research and development if foreign firms are not convinced their IPR will be adequately protected" (Maruyama, 1999).

IPR violations were not widespread in the 1980s, when the Chinese economy was first opened up to foreign trade and investment, mainly because Chinese manufacturers lacked the skill and the equipment to be able to copy foreign brands. In the 1990s copying developed as an offshoot of technology transfer and the upgrading of skills and manufacturing capacity resulting from both FDI and rapid economic growth. As Chinese consumers became more sophisticated in their ability to discriminate between different brands, so did local manufacturers become more adept at producing them. At the same time, strong action by OECD countries such as the United States in demanding an end to counterfeiting in Hong Kong (China) and Chinese Taipei, combined with the simultaneous shift of productive capacity in general (most of it not of course involving IPR violations) from both those territories to mainland China as a result of cost differentials, resulted in the wholesale transfer of counterfeiting in that direction. It is important to bear this historical process of the development of counterfeiting in mind when considering the prospects for dealing with the problem, since it reinforces the understanding that IPR violation is a response to an economic stimulus and hence can be reduced by altering economic stimuli. It also shows that, as in the cases of Hong Kong (China) and Chinese Taipei, external pressure can help to support domestic authorities in suppressing IPR violations. Lastly, the inventiveness shown by counterfeiters is an asset that will, when counterfeiting has been stopped, be put to better use in the development of new products, provided training is provided for the very different skills that will then be needed.

Remaining concerns

A number of concerns voiced by foreign investors and their representatives need to be addressed. In the Deloitte survey alluded to in the previous chapter, 39 per cent of respondents listed fraud and piracy as the greatest area of risk to their post-WTO operations.

Lack of legal precision and incomplete enforcement

While maximum penalties and damages are specified in the patent, trademark and copyright laws, there are no minima. The deterrent effect of the law is therefore not inherent in the law itself, but in the stringency with which it is applied, which may vary with time and place. It is also unclear how serious a violation of IPR must be before it can be brought to court. The laws do not explain clearly the procedure for taking IPR cases to the courts. Although a framework of IPR legislation in accordance with WIPO standards has been constructed, examples of IPR violations are still clearly visible in cities all over China. The existence of at least one large wholesale market which engages mainly in the distribution of copies of products of well-known global brands indicates that some local governments have not yet managed to deal with the problem. The government is itself unable to prevent counterfeiting of products produced by government monopolies, such as the tobacco industry, which lose large sums of money each year from lost sales. The Chinese government's inability to protect itself against counterfeit manufacturers raises doubts about its ability to protect the intellectual property rights of foreign investors.

Product liability: a potentially great danger

A further problem is that the sale of copies is not restricted to China. Counterfeit products are being exported from China to both developed OECD countries and to emerging markets, in large quantities. The consumer of such products suffers both from a lack of quality control and of after-sales service. A serious danger is that these insufficiencies will lead to product liability disputes when they cause actual physical harm to purchasers or to third parties. Examples have already occurred of Chinese producers of food products suffering lost sales because of reports of health risks from copies of their products made in China and sold abroad.

Lack of public acceptance of IPR legislation

Despite education campaigns, there is insufficient public respect for IPR. As Zhou Lin, deputy director of the Centre for Intellectual Property under the Chinese Academy of Social Sciences, put it: "Many people have little idea that intellectual property rights are just like a TV, a VCD and a house, that they are owned by somebody, and, if you want to use them, you should ask the owner first".[8] Although no sales figures are available, there is no doubt that many businesses and individuals regularly purchase counterfeit software, undermining sales of the genuine article. One indication of this is the very low ratio of sales of computer software to sales of computer hardware, which in other countries is usually near 1:1. The widespread purchase and open use of

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unlawful products at all levels of society bespeaks a public tolerance of IPR violation that makes successful prosecution of infringement difficult. The practice of forging qualifications is widespread: the 2000 population census recorded over 600,000 more higher education certificates than had actually been awarded. These cases are of crucial importance to foreign investors who wish to hire skilled personnel and need to be able to trust documentary evidence of educational qualifications.

Patent application procedures

While confidence in the patent application process appears to be strong, judging by the number of applications, concerns are frequently heard about the length of time taken before an application is examined and granted (or refused). This complaint is partly borne out by the magnitude of the discrepancy between the number of applications filed and the number granted. For example, in 2000, 170 682 applications were filed, while only 105 345 were granted. To some extent this discrepancy is explained by the 18-month time lag and by the rapid increase in applications, but this is not a complete explanation, as there were already 134 239 applications in 1999.[9]

4. Anti-corruption measures and FDI

Anti-corruption legislation

China now has legislation in place to fight both active and passive bribery of public officials. Three different government bodies and one Communist Party organ are responsible for combating corruption in China: the Supreme People's Procuratorate, the Ministry of Supervision, the Ministry of Public Security, and the Communist Party Committee for Discipline Inspection. The Procuratorate and the Ministry of Public Security are responsible for investigating criminal violations of China's anti-corruption laws, while the Ministry of Supervision and the Party Discipline Inspection Committee enforce government ethics and party discipline. Anti-corruption efforts seem to be hampered by the lack of truly independent investigative bodies. Numerous senior provincial and municipal officials have come under scrutiny, but there are widespread reports that more senior officials and their family members have used their connections to avoid prosecution.

Offering and receiving bribes are both crimes under Chinese law. China's Criminal Law has two specific chapters on "suppression of the crime of corruption": crimes of graft and bribery, and crimes of dereliction of duty. The former includes embezzlement, accepting and offering bribes, while the latter includes abuse of power by state personnel. There is a clear distinction in the legislation between active bribery (giving a bribe to a public official) and

passive bribery (which occurs when an official successfully solicits or extorts a bribe). Different sanctions should in principle be applied to these two crimes.

Chapter VIII of the criminal law code adopted in 1979 and amended in 1997 covers graft and bribery. Graft is defined as the action of state personnel, including anyone put in charge of state assets, such as the directors of state-owned enterprises, in taking advantage of their office to misappropriate, steal, swindle or use other illegal means to acquire state properties. Embezzlement by such officials is defined as the misappropriation of public funds for personal use or illegal activities or the misappropriation of large amounts of public funds without returning the money within three months. Bribery is defined as taking advantage of one's official position to demand money and things from other people or illegally accepting money and things from other people in exchange for favours, including "kickbacks and handling fees" in economic operations. It is a crime to offer bribes by giving state functionaries articles of property in order to seek illegitimate gain.

Punishments for corrupt actions vary widely. For example, for graft involving a sum of less than Rmb 5 000 the maximum sentence is two years imprisonment or administrative detention. Graft involving a sum of Rmb 5 000-50 000, the maximum sentence is ten years imprisonment. If the sum involved is between Rmb 50 000 and Rmb 100 000, the offender may be sentenced to life imprisonment, above Rmb 100 000 the maximum sentence is death and confiscation of property. As with other offences covered by the criminal law, stipulations concerning "especially serious cases" are left undefined and punishment "in a severe manner" (undefined, but including the death penalty) is prescribed for some offences, such as misappropriating disaster-relief or flood-prevention funds. One example is Article 386, in which the punishments for those who take bribes are specified as the same as for graft, but the only indication of punishment for those who demand bribes is that they shall be given "a heavier punishment".

Were more FIEs to be found guilty of such crimes and publicly punished, the deterrent effect may conceivably be greater than if it is always the Chinese officials who are punished. Under the terms of the OECD's 1997 Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, all member countries now have legislation prohibiting and sanctioning the bribery of foreign public officials in international business transactions. The OECD Guidelines for Multinational Enterprises stipulate that enterprises should not offer, promise, give, or demand a bribe or other undue advantage to obtain or retain business or other improper advantage. Companies from OECD countries have no legal justification for accepting or offering a bribe to a Chinese public official in order to obtain any advantage in a business transaction.

The "cancer of corruption"?

As in other transition and developing economies, corruption has been described by various commentators, including the country's leaders, as constituting a serious problem in China. Former President Jiang Zemin frequently described it as a "cancer" in China's body politic. It is intrinsically unmeasurable because corrupt activities are illegal and therefore hidden. The only statistics available are those on investigation and punishment, which, as with all crime figures, omit by definition all undetected offences. In 2000, procurators' offices in China investigated 104 427 cases of alleged offences by public officials.[10] Of these, 20 966 involved abuse of power, dereliction of duty and fraudulent practices, while the majority, 83 461 cases, were listed as "corruption and bribery". The latter category was further broken down into 44 874 cases of corruption, 20 771 cases of bribery, 14 958 cases of misappropriation of public funds, 901 cases of illegal possession of public funds, 281 cases of unstated source of large properties and 1 676 other cases. Published figures indicate that the size of bribes and amounts of state property embezzled have increased. For example, a fraud involving hundreds of officials in Guangdong province who had used fake export certificates to claim tax rebates that was unearthed in 2001 was reported to have run into billions of dollars. Similar sums, amounting to a significant proportion of government revenue, have been reported missing from state funds in recent years. However, it is widely believed that even these figures greatly understate the true extent of corruption. Corruption reported by foreign investors also understates the problem because the multinationals may be subject to prosecution in the countries in which they are based for corrupt payments made in China, according to the 1997 OECD Convention Against Bribery in International Commercial Transactions.

Reasons for the persistence of corruption

The institutional setting of official corruption

The movement from a centrally-planned to a market economy has generated many rent-seeking opportunities for officials. For example, the dual-track pricing system that was introduced in 1985 generated rents estimated by one group of Chinese experts as being equivalent in 1988 to between 10 and 20 per cent of GDP (quoted in Li, 2001). This is not a new phenomenon: another writer, using firm-level data, estimates that corruption proceeds were already 8 per cent of GDP in 1980 (Li, 1999). This particular form of corruption must have decreased as the dual-track pricing system was phased out in the 1990s. It cannot survive, as dual pricing is not allowed under WTO rules.

However, there are still situations in which uncertainty and ambiguity generate opportunities for corruption. As pointed out in Chapter 3, despite much tightening up in recent years, laws and regulations still tend to lack specificity and are therefore subject to interpretation by those responsible for implementing them. They may also on occasion be inconsistent with each other, forcing the authorities to choose which to enforce.

Another area of uncertainty relates to registration, licensing procedures and technical controls such as auditing or inspection. Registration procedures remain complex and sometimes lengthy. One way to speed up the process is to give bribes (sometimes known as "facilitation payments"). Although technical controls are officially motivated by the interest of verifying that an investment project complies with all business-related laws, they may often lack transparency and leave considerable room for administrative discretion in inspecting or auditing an investment. Foreign investors have complained of deliberate disruption of production schedules by spurious inspections forced on them by agencies of whose existence they have not previously heard; such agencies allegedly request payment in exchange for their departure.

The monopoly power of officials renders them vulnerable to offers of monetary or other rewards for "special treatment" and also provides them with opportunities to make such offers of special treatment. A major reason for the existence of corruption is the disparity between low salaries and strong powers. This combination of a high level of discretion, monopoly of administrative power and low pay is typical of the settings in which corruption flourishes worldwide. It can be dealt with by tackling each element in the situation, that is, by raising salaries, eliminating ambiguity from the regulations and reducing the decision-making powers of officials.

Corruption is also involved in the problems that beset the legal system. Government and communist party officials have been known to interfere in the making and enforcing of court decisions, and the financial and social status of judges can conceivably render it difficult for them to maintain total independence. Nor are local public security bureaux always assiduous in enforcing court decisions in favour of foreign investors when these conflict with local vested interests. The Chinese authorities have stated that public security organs do not enforce court judgments.

Corruption has altered in form as economic institutions have evolved. In the early part of the reform period, when there was a chronic shortage of consumer goods, officials could use their privileged access to goods, employment and promotion opportunities and other in-kind benefits to obtain other scarce items. The dual-track pricing system encouraged the monetisation of corruption, especially since bank accounts containing corrupt payments could be held anonymously. This loophole was closed when,

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in 2000, the government required depositors to use their real names when making deposits and prepared to link computer systems of all banks to enable the authorities to identify all deposits made by a single individual. Another form of corruption is the use of loans to state-owned enterprises (SOEs) for investment in stocks or real estate, with officials keeping any profits and leaving the banks to bear losses.

The form taken by corruption involving foreign investors and government officials may vary. Direct cash payments occur, but other, more subtle, methods are reportedly also used. A local official who has been co-operative in achieving some desired goal of the FIE may be rewarded with a consultancy contract. The child of another high-level local official who has helped ensure project approval may be awarded a scholarship to attend an educational institution in the foreign investor's home country.

Corruption is harmful for FIEs

The cost of corruption outweighs any benefit

Corruption can be a deterrent to FDI because it imposes a cost on the FIE for which there is no corresponding benefit. It is sometimes argued that corrupt practices such as bribing officials to circumvent unnecessarily lengthy bureaucratic procedures can produce an efficiency gain and therefore increase the overall volume of goods and services available. Two commentators on corruption in China even suggest (not very persuasively, since they adduce no evidence) that it also provides an effective inducement to local officials to promote economic reform (Fan and Grossman, 2001). However, the damage done to trust in official institutions by the existence of systematic corruption and the higher cost suffered by honest companies that refuse to pay such bribes should also be taken into account.

There is an extensive and growing exposure of OECD-based enterprises and their foreign subsidiaries to the sensitive Chinese business environment. It is clear that the volume of FDI, which includes a large number of government contracts (government procurement and construction projects are among the sectors most afflicted by corruption), entails the exposure of OECD companies and their subsidiaries to corrupt practices and the solicitation of bribes.

It should be borne in mind that trials of public officials on serious bribery charges are not always conducted in public and that therefore the identity of bribers is not always clear; in a few cases, it is conceivable that the bribes received by such officials emanated from external sources. It is therefore not possible to provide a categorical affirmation that no project approval has ever been granted as a result of corrupt payment.

Corruption affects FIEs even if others bear the direct cost

The existence of systematic corruption in the Chinese economy affects FIEs even when they do not appear to be directly involved. For example, even if an FIE is not approached for bribes, it may encounter problems that result from the payment of bribes by domestically-owned competitor companies if those companies benefit from favours from bribed officials. In the next few years, FIEs are likely to be increasingly involved with domestic companies as M&A starts to play a larger role in FDI in China. They will therefore have to cope with any corruption that may occur such companies as well as any corrupt practices indulged in by competing FIEs.

Companies from uncorrupt economies may have difficulties operating in a corrupt environment

OECD-based enterprises are accustomed to operating in a legal and administrative framework that eschews corruption. Adapting to a business environment characterised by systematic corruption involves a cost to multinationals, whether this is in the form of corrupt payments actually made or in the form of revenue lost by refusing to make such payments.

It is sometimes suggested that it is difficult for an executive to separate corrupt from non-corrupt patterns of behaviour when attempting to adapt to a genuinely different cultural environment, entailing confusion about the correct behaviour to engage in. For example, gift-giving is a deeply embedded part of Chinese culture, so it is difficult to refuse all gifts from actual or potential business partners or, on the other hand, to refrain from giving gifts to them.

However, it is quite possible to work within the confines of a gift-giving culture without indulging in corrupt behaviour, as there is nothing inherently corrupt in the practice of making gifts. Such gifts are only corrupt if they lead to the granting of an advantage which would otherwise have been withheld.

The Chinese government has recognised that eliminating corruption is a long-term task. Specific anti-corruption measures are being discussed with the OECD in the context of the ADB-OECD Anti-Corruption Initiative for Asia-Pacific, to which China has already made a positive contribution.

Notes

1. Regulations on Representative Offices of Foreign Law Firms in China, promulgated by the State Council as its Order No. 338 on 22 December 2001 and put into force on 1 January 2002.
2. Stipulations of the Ministry of Justice Concerning the Enforcement of the "Regulations on the Management of Representative Offices set up by Foreign Law Firms in China", Order No. 73 By the Ministry of Justice of the People's Republic of China.

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3. China has a four-level court system. The Supreme People's Court, which is the highest judicial organ, responsible to the NPC, or, when the NPC is not in session, to the NPC Standing Committee, sits in Beijing. Higher People's Courts sit in the provinces, autonomous regions and municipalities directly under the State Council, such as Shanghai. Intermediate People's Courts sit at the prefecture level and also in parts of provinces, autonomous regions, and municipalities directly under the State Council. There are also basic People's Courts in counties, towns, and municipal districts. Special courts handle matters affecting military, railroad transportation, water transportation, and forestry. The court system is paralleled by a hierarchy of prosecuting organs called People's Procuratorates; at the apex of this structure stands the Supreme People's Procuratorate.
4. China Council for the Promotion of International Trade (CCPIT) and China Chamber of International Commerce (CCOIC) Conciliation Rules (2000).
5. China International Economic and Trade Arbitration Commission (CIETAC) Arbitration Rules, revised and adopted by the China Council for the Promotion of International Trade and the China Chamber of International Commerce on 5 September 2000, effective from 1 October 2000.
6. CIETAC Arbitration Fee Schedule and CCPIT/CCOIC Conciliation Fee Schedule.
7. Measures Governing the Handling of Complaints Lodged by Foreign-funded Enterprises in Beijing, promulgated by the Beijing Foreign Economic and Trade Commission on 16 March 2001.
8. People's Daily, Internet edition, 2 May 2001.
9. All the figures in this paragraph are from the China Statistical Yearbook, 2001.
10. All the figures in this paragraph are from the China Statistical Yearbook, 2001.

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Chapter 5

The evolving competitive environment for FDI

Abstract. *State-owned enterprises (SOEs) are playing an increasingly smaller role in the Chinese economy. They no longer employ most of the workforce; their share of output has fallen to less than half the total; they appear on average to be less profitable than all other enterprises. The reform of SOEs has been slow to start but is now accelerating. Domestically-owned private enterprises, once banned, are now being encouraged. SOE reform offers opportunities to foreign investors, including the possibility of acquiring SOEs or their assets, improved corporate governance and accounting in domestic partners of FIEs, a reduction of unfair competition, stronger competition and a growing market for consultancy and other business services. Although cross-border mergers and acquisitions (M&A) have become the main form of FDI flow between developed countries, cross-border M&A still plays a negligible role in China's FDI inflows, largely because the legal status of M&A there remains uncertain and several regulatory obstacles continue to impede M&A involving FIEs. Recent measures to improve corporate governance are welcome, but problems such as high state ownership of shares, related party transactions and inadequate transparency and disclosure have yet to be fully addressed.*

The competitive environment in which both FIEs and domestic enterprises operate in China is still evolving. China's accession to the WTO and its international commitments to open and transparent FDI policies more generally will provide a major impetus to remove barriers to competition, which have hitherto been acute as local authorities, industry ministries and large state-owned enterprises (SOEs) have been able to use administrative monopolies and regional protectionism to exclude foreign investors. In particular, China can achieve sustained economic growth from foreign participation in the process of restructuring its inefficient SOEs. For this to happen, the regulatory and informational environment will have to be further improved so that foreign investors are able to gauge accurately the profitability of domestic enterprises and, if appropriate, participate in some form of M&A activity with them. The Chinese government is currently preparing the relevant legislation.

1. The relative importance of China's private sector and state-owned enterprise sectors

SOEs no longer employ most of the workforce

SOEs, though no longer dominant, retain a major role in the Chinese economy, while the private sector, virtually nonexistent at the beginning of the reform era, is increasingly firmly established as an important provider of goods, services and employment.

At the beginning of the reform period, SOEs employed 78.3 per cent of the urban workforce (then a minority of the total workforce, since over 80 per cent of the population lived in rural areas and was engaged mainly in agriculture), while almost all the remainder, 21.5 per cent, worked in collective enterprises. Total SOE employment increased in absolute terms from 74.5 million in 1978 to a peak of 112.6 million in 1995 before falling back steadily thereafter to 81 million by 2000, but as a proportion of total employment it fell steadily throughout the period. By 2000 SOEs employed only 38.1 per cent of all urban employees. Collectively-owned enterprises followed a similar path, though initially rising as a proportion of total employment to 26.3 per cent in 1984 before declining to 7 per cent by 2000.

More now work in the non-state sector

The private sector in China is difficult to define, since some of the categories employed by statisticians are ambiguous, ownership rights are

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often unclear, and categories such as Sino-foreign joint ventures may include both public and private ownership. It is nevertheless possible to trace the development of the private sector in broad terms by aggregating the non-state, non-collective sectors, including not only officially-designated private enterprises but also limited liability companies, shareholding companies, self-employed individuals and foreign-funded enterprises, including enterprises funded by investors from Hong Kong (China), Macao (China) and Chinese Taipei. So-called "individual" or household enterprises may have started as one-person businesses, but have often grown into larger units that would be classified in other economies as private enterprises.

This loosely-termed aggregate "private sector" accounted for only 0.2 per cent of total urban employment in 1978, in the form of 150 000 self-employed individuals. By 2000 it had expanded to nearly a quarter. Moreover, it is likely that these figures understate private-sector employment, since they are increasingly incomplete; non-state employment is more likely to be difficult to capture in official statistics, so the missing employees are more likely to be in private-sector than SOE employment. Since a rising proportion of foreign-funded enterprises are wholly-foreign-owned enterprises, with the foreign ownership usually private-sector, the figures are likely to understate rather than overstate the participation of private enterprise in the Chinese economy, since they do not distinguish between different forms of foreign-funded enterprises.

The most striking increase in private-sector employment has been in the "self-employed" sector, which now employs 10 per cent of urban employees. Because of time lags in reclassification, this category in practice is likely to include at any time a number of enterprises which have grown rapidly beyond the original scale of operation. Limited liability and shareholding companies, which did not exist before the 1990s, now already employ over 5 per cent of urban employees. Foreign-funded enterprises of all kinds employ over 3 per cent, but are doubtless responsible for a far larger segment of employment if associated enterprises involved in such tasks as distributing the products of foreign-funded enterprises are included.

The distribution of domestically-owned private enterprises (including self-employed individuals) is heavily skewed towards service sectors and less heavily towards manufacturing. In 2000, the number of private-sector employees in wholesale and retail trade and catering services reached 36.2 million, nearly half the total workforce and representing a ratio of 1.9:1 with private-sector employment in manufacturing, contrasting with a ratio of 1:1.7 of these sectors to manufacturing in the total workforce. These figures are consistent with the mushrooming of shops and restaurants serving a rapidly growing consumer market over the past two decades.

Table 5.1. **Number of employees in private enterprises and self-employed individuals by sector, 2000**

	Number of employees (million)	Proportion of total (%)
Farming, forestry, animal husbandry and fishery	3.4	4.5
Mining and quarrying	0.7	0.9
Manufacturing	19.3	25.9
Construction	1.4	1.9
Transport, storage, post and telecom services	4.5	6.0
Wholesale, retail and catering services	36.2	48.4
Social services	7.8	10.4
Others	1.5	2.0
Total	**74.8**	**100.0**

Source: National Bureau of Statistics, *China Statistical Yearbook 2001*.

Private-enterprise employment is also geographically uneven. Guangdong province, whose population, according to the 2000 census, was 6.8 per cent of China's total population, was in the same year home to 26.8 per cent of domestic private-enterprise employees, Shanghai, with 1.3 per cent of population, had 9.4 per cent of private-sector employment, the province of Hebei, with 5.3 per cent of population, had 14.2 per cent of employment, and Shaanxi, with 2.8 per cent of population, had 8.7 per cent. Guangdong was home to all but one of the original Special Economic Zones (SEZs) and also to the Pearl River Delta open zone, where SOEs were relatively underrepresented and the regulatory regime more favourable both to foreign investment and to domestic private enterprise.

SOE output share has fallen to less than half the total

The relative contribution of SOEs to industrial production has declined in line with, and initially rather faster than, their proportion of urban employment. At the beginning of the reform period, virtually all industrial output was from SOEs or collectively-owned enterprises. By 2000 the share of SOEs had fallen to 47.1 per cent and that of collectively-owned enterprises to 13.8 per cent, while that of foreign-funded enterprises (including those funded by investors from Hong Kong (China), Macao (China) and Chinese Taipei) exceeded 27 per cent and production by shareholding companies approached 12 per cent. Comparing these figures with the relatively tiny proportion of employment directly employed by FIEs, it is clear that the latter are characterised by far higher productivity of labour than the other categories.

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Table 5.2. **Gross industrial output value by form of ownership of enterprise, 2000**

(Rmb billion at current prices)

Form of ownership	Output	Share of total
State-owned[a]	4 055.4	47.1
Collective-owned	1 190.8	13.8
Shareholding	1 009.0	11.7
Foreign-funded	1 289.0	15.0
Hong Kong (China), Macao (China) and Chinese Taipei funded	1 057.4	12.3
Total	**8 601.7**	**100.0**

a) Including enterprises with a controlling share held by the state.

Source: National Bureau of Statistics, *China Statistical Yearbook 2001*.

SOEs appear to be the least profitable enterprises

Official statistics suggest that shareholding enterprises were the most profitable. While such enterprises produced 11.7 per cent of output (and employed only 2.1 per cent of the urban workforce), they were responsible for 23.2 per cent of profits, indicating that they were roughly twice as profitable as SOEs. These figures are of course aggregates and do not show the wide variety in profitability in each category of ownership. The SOEs, in particular, range from firms that have already established themselves in world markets to loss-making enterprises that are destined to disappear in a more competitive environment.

Table 5.3. **Profit by form of ownership of enterprise, 2000**

(Rmb billion at current prices)

Form of ownership	Profit	Share of total
State-owned	240.8	44.7
Collective-owned	45.1	8.4
Shareholding	125.0	23.2
Foreign-funded	74.8	13.9
Hong Kong (China), Macao (China) and Chinese Taipei funded	53.4	9.9
Total	**539.2**	**100.0**

Source: National Bureau of Statistics, *China Statistical Yearbook 2001*.

SOEs no longer dominate fixed investment

At the beginning of the reform period, SOEs accounted for over 80 per cent of total fixed asset investment; by the end of the century this share had fallen to 50 per cent. Enterprises with individual ownership increased from 13.1 per cent of fixed investment in 1980 to a peak of 23.4 per cent in 1989

before falling back to 14.3 per cent by 2000. Enterprises in the "other category", including FIEs and private enterprises of various kinds, doubled in the period 1993-2000.

Table 5.4. **Share of units of different kinds of ownership in total fixed asset investment, 1980-2000**

(%)

	State-owned	Collective	Individual	Other
1980	81.9	5.0	13.1	
1981	69.5	12.0	18.6	
1982	68.7	14.2	17.1	
1983	66.6	10.9	22.5	
1984	64.7	13.0	22.3	
1985	66.1	12.9	21.0	
1986	66.6	12.6	20.8	
1987	64.6	14.4	21.0	
1988	63.5	15.0	21.5	
1989	63.7	12.9	23.4	
1990	66.1	11.7	22.2	
1991	66.4	12.5	21.1	
1992	68.1	16.8	15.1	
1993	60.6	17.7	11.3	10.3
1994	56.4	16.2	11.6	15.8
1995	54.4	16.4	12.8	16.3
1996	52.4	15.9	14.0	17.7
1997	52.5	15.4	13.7	18.3
1998	54.1	14.8	13.2	18.0
1999	53.4	14.5	14.1	18.0
2000	50.1	14.6	14.3	21.0

Source: Calculated from statistics in National Bureau of Statistics, *China Statistical Yearbook 2001*.

Measured in terms of financial appropriation, SOEs accounted for a smaller proportion, 41.7 per cent, of total fixed asset investment in 2000, while FIEs (including those with investment from Hong Kong (China), Macao (China) and Chinese Taipei accounted for 6.6 per cent and shareholding economic units 10.3 per cent. The low proportion of FIEs in fixed asset investment compared to their share in total output suggests that these enterprises are more efficient in terms of capital:output ratio than domestically-owned enterprises of all kinds.

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Table 5.5. **Total investment in fixed assets in 2000**

	%
State-owned Units	41.7
Collective-owned Units	12.1
Individual Economy	11.9
Joint Ownership Economic Units	0.2
Shareholding Economic Units	10.3
Foreign Funded Economic Units	3.3
Economic Units with Funds from Hong Kong (China), Macao (China) and Chinese Taipei	3.3
Others	0.4

Source: Calculated from statistics in National Bureau of Statistics, *China Statistical Yearbook 2001*.

2. Main motivations and characteristics of state-owned enterprise reform

After its highly successful reform of the agricultural production system in the early 1980s, the Chinese government turned its attention in late 1984 to reforming the state-owned industrial system. Whereas the establishment of the rural responsibility system had entailed effective privatisation of agriculture (though not of land, which remains state-owned in urban areas and largely collectively-owned in the countryside) by breaking up the collective structures imposed after the completion of land reform in the early 1950s, the government maintained the view that state ownership of industry was an essential component of the existing political system which could not be jettisoned, so privatisation was ruled out. The initial approach was therefore to alter management structures and incentives to render the SOEs more efficient.

SOE problems are the legacy of a centrally-planned command economy

Industries were vertically organised into monopolistic groups headed by government ministries, largely ruling out domestic competition. Competition from imports was not yet significant, since import penetration was still relatively limited (merchandise imports were only 6.6 per cent of GDP in 1980, compared to 20.8 per cent in 2000). Since prices were controlled by the state, they were unable to act as market signals. The quantity and composition of output were not decided by managers but by the central planners in the State Planning Commission (SPC, renamed the State Development Planning Commission, SDPC, in 1998 and then the State Development and Reform Commission, SDRC, in March 2003), which had formulated five-year and annual top-down production plans based on the Soviet model since 1953.

Lacking control over output and pricing decisions, and with accounting systems intended merely to encourage input minimisation, managers had

neither the information systems nor the stimuli to enable them to maximise profits. As a result, many SOEs made losses and depended for their survival on subsidies from the central budget. After such subsidies were phased out, they were replaced by loans from the state-owned banking system which were in many cases not repaid or even serviced. SOEs have throughout the reform period thus enjoyed a "soft budget constraint" in the form of permissive financing which enabled them to survive chronic loss-making.

Since the mid-1980s, a number of SOE bankruptcies have occurred, but these have been far fewer than would have been the case if the authorities allowed all insolvent SOEs to do so. A major reason for keeping inefficient enterprises alive by subsidies or by restructuring is that they provide employment to large numbers of workers and so help to bolster social and political stability.

The government has tolerated such inefficiency largely because SOEs acted as major providers to their employees of basic services such as housing, healthcare, education and social welfare. Closure of an SOE can therefore only be contemplated if alternative provision is available. Such alternatives are gradually being established, but this is a slow process. Housing reform is now well under way; factories may no longer allocate housing units to their employees and a small but increasing number of urban families are buying their own apartments. Social welfare schemes have been set up in most localities, though some are experiencing funding difficulties, since provinces where the need is greatest tend to be those where fiscal resources are most limited.

The other major unfunded SOE liability is pension rights, which are more generous than in many other countries, in some cases reaching as high as 100 per cent of salary replacement. Pension payments in 2000 exceeded Rmb 230 billion after having grown at an average annual rate of 26.4 per cent during the 1990s. Many SOEs have not had sufficient income to maintain pension payments, and, in some cases, wage payments to underemployed employees.

Although SOE employment has fallen from its peak, it remains large in absolute terms. A further shake-out of surplus labour would add to unemployment at a time when it is already a large and chronic problem in the overall economy. In rural areas efficiency gains from the implementation of the rural responsibility system in the 1980s have produced a "floating population" of unemployed estimated to number between 100 million and 200 million. Urban unemployment, officially enumerated at 3.1 per cent in 1997-2000, is in reality far higher, largely because of the restricted definition of unemployment used in China.

After a slow start, SOE reform has accelerated

Gradual progress has been made in 16 years of SOE reform. First of all, the business environment in which SOEs operate has been transformed. The

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central planning system has been relaxed to the extent that although five-year plans are still published by the government they have, since the mid-1990s, become indicative rather than mandatory. Output decisions are now in the hands of the SOEs, which also now have autonomy in purchasing inputs and selling products. Prices are no longer set by the state, but are determined by the market. The enterprise can, in most cases, use its retained earnings as it sees fit. A labour market has developed (see Chapter 3, Box 3.1).

State-owned enterprises have lost their monopoly power over many consumer markets, especially those that have long been open to FDI. Competition with world-class producers has stimulated a diversification of product range, an improvement in product quality, and greater efficiency in production processes. As a result, a number of SOEs have become major exporters, especially in consumer durables sectors.

At the 1993 Communist Party National Congress it was decided to transform the SOEs into limited liability and joint stock companies by means of "corporatisation" (*gongsihua*) as part of a programme to establish a "modern enterprise system". The intention was clearly to promote the autonomy of SOEs to enable them to orient their decision-making towards the market rather than to continue to take direction from government authorities. However, since such authorities retained controlling shareholdings, there was in practice no major alteration in the actual running of SOEs.

Especially in the past six years, the pace of SOE reform has been considered too slow by the government, which is concerned at the persistence of the chronic problem of nonperforming loans to SOEs by the state-owned banking system. An equally important problem was the drain on government finances that SOEs entailed by their low profitability. Direct subsidies to loss-making SOEs have fallen since their 1989 peak of Rmb 60 billion, but remain high, for example Rmb 28 billion in 2000 (though this was greatly exceeded by tax revenue from profitable SOEs). As subsidies have been replaced by loans, the main fiscal problem is inadequate tax revenue resulting from the poor performance of many SOEs. The potential danger of a banking collapse began to appear more acute after the onset of the Asian economic crisis in July 1997. At the Communist Party National Congress held later that year it was decided to implement a shareholding system for SOEs and to sell off small and medium-sized SOEs to the private sector.

Reform has included restructuring

Since the mid-1990s, SOEs have been transformed into corporations of various kinds. Large-scale SOEs generally acquired autonomy from the state by transmuting themselves into listed companies, while small and medium sized enterprises were disposed of in various ways that removed them,

together with their financial obligations, from local government account books. (The majority, 72 per cent, of firms owned by local governments were in the red in 1995.)

Transformation of small and medium-sized enterprises (SMEs)

While wholesale privatisation of SOEs has been ruled out by the government, privatisation of small and medium sized SOEs in accordance with the principle of "grasping the big and releasing the small" started in the mid-1990s and has gathered pace in recent years. According to the former State Economic and Trade Commission (SETC), quoted in a recent World Bank study of corporate governance (Tenev and Zhang, 2002), over 80 per cent of small and medium sized SOEs had by 2000 been "transformed" in that they had been restructured, merged, leased, contracted, turned into joint stock companies, sold or been declared bankrupt. Most of these were in fact bought by managers and/or employees, a solution that was more ideologically acceptable than outright privatisation or sale to foreign investors. While the dispersion of ownership may initially have provided an incentive for the workforce to improve the performance of the firms in which they worked and in which they had acquired a direct interest, in the longer term there appears to have been excessive dividend distribution resulting in inadequate capital investment and a failure to strengthen performance monitoring and participation in decision making. The diffused ownership structure gave inadequate control rights to employees who had power over key resources such as technology. Many such employees left to form their own enterprises, sometimes taking the technology with them.

The perceived failure of employee buy-outs has led local governments and enterprise managements to attempt a second wave of restructuring aimed at concentrating shareholding in the hands of managers and key employees. To the extent that this has succeeded, it has replaced the problem of excessive diversification with that of insider control, which may threaten the rights of minority shareholders.

National champions policy

An important feature of SOE reform in China is that the government intends to create 156 internationally competitive industry groups ("national champions") by merging existing enterprises into large diversified groups capable of cross-subsidising their operations to support large-scale investment in export manufacturing capacity and high technology. This strategy is largely modelled on the Korean government's nurturing of the *chaebol*. To the extent that less profitable or unprofitable SOEs are merged with highly profitable SOEs, this policy is likely to give new life to soft budget constraints. It also threatens to stifle competition in markets dominated by

the new groups. Taking into consideration the difficulties facing merger and acquisition attempts by FIEs and also the lack of "trust busting" or other competition laws, this process of domestic industrial agglomeration may appear to constitute a form of effective protectionism.

The emergence of private enterprises

Private enterprise was not initially encouraged or even officially recognised. In 1988 it edged its way into the state constitution, but only in the form of individual, or household, enterprises, regarded as very much subsidiary to SOEs. It was only in 1999 that a further constitutional amendment recognised that private enterprise played an "important part of the economy" and that private property rights should be protected.

3. Implications of SOE reform for FDI

SOE reform offers interesting opportunities to foreign investors.

Opportunities to acquire SOEs or their assets

Foreign investors will play an increasingly important role in restructuring of SOEs, increasingly by acquiring such companies, in whole or in part, or their assets. Doing so promises benefits such as increased access by foreign investors to market sectors hitherto dominated by SOEs.

Improved corporate governance and accounting in domestic partners

The reform of state-owned industry and the development of private-sector forms of enterprise necessitate improvements in corporate governance and accounting standards which are also supported by the correction of defects in the banking system and the development and opening up to foreign investors of capital markets. As these improvements take shape, foreign investors will benefit increasingly from greater transparency in their dealings with joint-venture partners and other entities with whom they do business.

Reduction of unfair competition

The business environment has already benefited greatly from the removal of the main mechanisms of central planning such as price and output controls. SOE monopoly power persists in some sectors, but in others it has been eroded by the entry of FIEs and private enterprises. Provided the government fulfils its WTO accession obligations in this respect, foreign investment will suffer less from uncompetitive practices such as subsidies to domestic producers.

Stronger competition from stronger domestic companies

Improvements in the regulatory environment and the development of a sounder financial system will also benefit domestic companies, including both the better-organised of the SOEs and the private-sector companies. The government may will succeed in its aim of build some domestic corporations into global brand names, and these will provide stiff competition that will compel FIEs to continue with product and process improvements.

Opportunities for consultancy and other services

Since China is a both a developing country and a transition economy, the process of economic reform has so far been pragmatic. However, Chinese corporations are now facing problems that are increasingly complex but for which there is often an available solution in more developed countries. The corporate consultancy market will therefore continue to grow in China, providing opportunities for multinationals based elsewhere to sell their expertise and experience there.

4. Mergers and acquisitions

The increasing role of mergers and acquisitions (M&A) in global FDI flows

Cross-border M&A flows have been increasing rapidly since the 1980s, growing at annual average rate of 26.4 per cent in 1986-90 and 23.3 per cent in 1991-95 before accelerating to 49.8 per cent a year in 1996-2000. They then fell back sharply – by 47.5 per cent – in 2001 as world economic growth slowed. Nevertheless, M&A flows remain a major form of FDI flow. In 1982 they accounted for a negligible share of total FDI outflows. By 1990 they already amounted to US$151 billion, 64.8 per cent of total global FDI outflows, and in 2001, despite the plunge from 2000, they stood at US$601 billion, 81.8 per cent of FDI outflows. M&A flows have since the mid-1990s become the main form of FDI flow between developed countries. They have generally played a less important role in developing countries, but nevertheless in 2001 – a year when "megadeals" slowed abruptly in the developed world – the ratio of M&A inflows to GDP was actually higher in developing than in developed countries.

The increasing role of M&A in FDI flows to China

In the existing regulatory environment M&A activity is inherently difficult to measure and no precise figures for it are as yet collected and published by China's statistical system. Nevertheless, it is clear that M&A is increasing rapidly; over the past five years, it has grown by about 70 per cent per year, according to one estimate. Most of this activity has involved domestic, not foreign-owned, enterprises. In the period 1998-2001 there were

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reported to be over 1 700 mergers and acquisitions by domestic enterprises, totalling Rmb 125 billion, but only 66 cases, worth a mere Rmb 6.6 billion, of a foreign-owned enterprise acquiring a domestic firm. These figures do show the average size of such transactions to be rather larger in the case of cross-border mergers and acquisitions, at Rmb 100 million compared with Rmb 73.5 million for domestic mergers and acquisitions. Such figures need to be read with caution. Many mergers and acquisitions may be difficult to identify, as they often involve the foreign partner in an equity joint venture or a contractual joint venture buying out the Chinese partner and forming a wholly-foreign-owned enterprise.

The legal status of M&A in China remains uncertain

There is at present no uniform legal structure within which M&A activity, especially M&A activity involving FIEs, can take place and there is no single piece of legislation covering M&A. As a result, the M&A activity that does take place is constrained by piecemeal regulation, administrative rulings and advisory documents. This is hardly surprising, since such activity is a relatively new phenomenon in China; such laws have taken some time to evolve even in countries where cross-border M&A is commonplace. But the lack of a relatively complete legal framework has hitherto been a serious impediment to M&A and the Chinese government is now starting to put such a framework in place.

Acquisition is limited by the catalogues for guiding foreign investment

No FIE may acquire a domestically-owned enterprise if the latter is not in an industry designated as "encouraged" or "permitted" in the MOFCOM catalogues for guiding foreign investment. The government organs that judge such eligibility include MOFCOM, at both national and local level, and the State Development and Reform Commission (SDRC). Even if the target firm is in the "encouraged" or "permitted" categories, a merger or acquisition by a foreign-owned enterprise may not be approved if it fails to meet the (often unpublished) criteria of local government departments in charge of specific industrial sectors. If it is in the "restricted" category, approval must be granted before acquisition is possible.

Takeover rules

Takeovers of listed companies are covered by chapter IV of the 1998 Securities Law and by the Measures Concerning the Administration of Listed Company Takeovers issued by the China Securities Regulatory Commission (CSRC) which came into effect on 1 December 2002. The 1998 law stipulate that an investor must notify the regulator, the target company and the public within three days of having acquired 5 per cent of a company's shares on the market, and that when an investor's holding reaches 30 per cent of a

company's shares the investor must issue a takeover offer to all the shareholders. Listing and trading of the shares stops after the investor has acquired 75 per cent of the listed shares. Where the company no longer meets the conditions prescribed in company law, the enterprise form may be changed, which theoretically means that the diverse legislation on forms of business enterprise ownership should not prevent a FIE acquiring a domestically-owned enterprise. Interpretation of this law is in the hands of the CSRC. The 2002 Measures cover the acquisition of shares of listed companies by agreement and by public offer as well as by stock exchange trading. They allow a takeover by public offer when the acquirer holds at least 30 per cent of the shares of the target company; the validity period of such an offer is 30-60 days.

Global M&A agreements

In many countries, M&A activity occurs because of a global merger agreement involving multinational enterprises that have subsidiaries or other forms of local sub-enterprises there. In China this would take the form of the merger of two FIEs as a result of a global merger agreement between their parent companies outside China, or a FIE splitting into more than one enterprise as the result of a similar split in the parent company outside China. However, such operations are rare in China, where regulatory complexity reportedly results in China being "cut out" of such global agreements.

Acquisition of listed companies

As is common practice elsewhere in the world, M&A may occur via the stock market. Foreign companies or FIEs may buy shares denominated in foreign currencies, such as B shares in Shanghai (denominated in US dollars) or Hong Kong (denominated in Hong Kong dollars), or in external markets such as Hong Kong or New York. Currently, foreigners may not buy A shares, which were originally intended for domestic buyers only, but in 2002 the CSRC indicated that foreign investment would eventually be allowed in Chinese securities fund management firms, which can hold A shares, and that some qualifying foreign institutions would be allowed to buy A shares. It is not yet clear when the A-share market will be opened to foreign buyers. When it does, it will obviously be easier for a foreign company or a FIE to purchase a controlling stake in a listed company.

Acquisition of legal-person shares

On 1 November 2002 the CSRC, the Ministry of Finance and the State Economic and Trade Commission (SETC) jointly issued a Notice on Relevant Issues Concerning the Transfer to Foreign Investors of State-owned shares and Legal-person Shares of Listed Companies. The effect of this Notice is to allow

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foreign investors, as well as investors from Hong Kong (China), Macao (China) and Chinese Taipei, to buy unlisted shares of listed companies, which have hitherto been largely held by state-owned enterprises. (Such purchases had been explicitly prohibited in 1995.) Foreign investors wishing to buy unlisted shares must be of good standing and must acquire such shares by open bidding. Insofar as transactions involve industrial policy and industrial restructuring they are subject to examination and approval by MOFCOM; where they involve state-owned shareholdings they are subject to examination and approval by the Ministry of Finance; very large transactions (size unspecified) must be approved by the State Council. Foreign investors may not acquire shares in any industry in which foreign investment is prohibited and may not acquire control of any enterprise in any industry where enterprises must be under Chinese control.

Article 9 of the Notice stipulates that enterprises in which foreign investors acquire an interest by purchasing unlisted shares do not thereby qualify for any incentives offered to foreign-invested enterprises (FIEs). This stipulation appears to be designed merely to make explicit the effect of existing incentives rules. Tax exemptions and reductions are available only newly-established FIEs (see Chapter 6). CSRC rules do not allow newly-established enterprises to obtain listings, so even if a foreign investor were to acquire 100 per cent ownership of a Chinese listed company it would not qualify for all available FIE concessions.

Approval procedures

All M&A activity, whether or not it involves a foreign investor, is regulated by a number of government organisations, each of which must be consulted before a particular merger or acquisition can be completed. Mergers and acquisitions involving state-owned enterprises or collective enterprises must be approved by the State Bureau of State-owned Property. Local industry and commerce bureaux are responsible for registering the business scope and registered capital of the new legal person entity and for deregistering the old legal person entity. Local tax bureaux have to decide on the continuation or otherwise of entitlement to favourable tax treatment and other taxation matters. It is up to the customs administrations to decide on the continuation or otherwise of entitlement to duty-free status on imported machinery and equipment of the old legal person entity by the new legal person entity. Local labour bureaux need to be consulted and informed about what happens to the workforce after a merger or acquisition takes place.

After obtaining approval from relevant government departments, the entity acquiring a company must then obtain the consent of the target company itself, as well as its main stakeholders, including the workforce,

creditors and bondholders, and major suppliers and customers, with whom formal agreements must be signed.

Participation of foreign investors in SOE restructuring

The role of cross-border M&A in assisting the process of SOE reform is explicitly recognised and welcomed in the Temporary Rules on Utilising Foreign Investment for the Restructuring of State-owned Enterprises, jointly issued by the former SETC, the Ministry of Finance, the State Administration of Industry and Commerce (SAIC) and the State Administration for Foreign Exchange (SAFE) on 8 November 2002. These rules expressly allow SOEs to be transformed in whole or in part into foreign-invested enterprises in various ways, including the acquisition of the SOE's assets, shares or bondholder rights by foreign investors. The selection criteria for foreign investors include management qualifications, level of technology, reputation, managerial ability, financial situation and economic power. As with other forms of cross-border M&A, project approval is limited by the catalogues for guiding foreign investment. Acquisition by a foreign investor can only take place after the workforce of the enterprise to be acquired have been consulted and only after agreement by those holding ownership rights – state representatives in the case of an SOE, shareholders and bondholders in the case of a listed company – have consented. Approval for foreign participation in SOEs may be granted by the economic and trade departments at the same level as the enterprise, unless the post-restructuring capital of the enterprise is $30 million or above, in which case the request must be submitted to the State Council, which is responsible for rejecting submissions considered likely to result in monopoly.

Current difficulties of M&A involving FIEs

A major problem with current M&A procedures involving foreign investors is that they are unclear. At the national policy level, there is uncertainty over the precise nature of policy in this field, although quite clearly aimed at gradually facilitating more cross-border M&A activity as a stimulus to improvement in company performance. At local level, this uncertainty is manifested by a lack of clarity with regard to M&A procedures. In particular, it is not clear in all cases how many agencies must agree before approval is obtained. The addition of yet more powers of examination and approval has in this regard not been consistent with the government's programme of administrative reform.

Although M&As involving foreigners and FIEs are possible in principle, in practice they have so far been rare. A major factor in this regard is protectionism. Some government bodies and representatives of domestic industry maintain that foreign investors use M&A to establish foreign investor control of a sector,

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causing Chinese firms to lose control of it, so they oppose cross-border M&A activity and refuse assent if it is in their power to do so. Protectionism is also common at local level. This is largely because of taxation arrangements. When two or more enterprises situated in different local government jurisdictions merge, tax liability is no longer shared and must be concentrated in the headquarters of the merged enterprise. Local governments are therefore likely to withhold approval for any merger or acquisition which would result in such a loss of tax revenue.

Current practice is in several respects out of line with international norms. For example, the entire management of a company that is being acquired must agree before a company can be acquired. In other countries, many acquisitions take the form of hostile takeovers, in which the managers of the target company are generally against any change in control. It could be argued that the requirement to ensure prior management approval of a target company renders it impossible for efficient companies to acquire underperforming companies and turn them round.

5. Corporate governance

If foreign investors are to play a full part in the restructuring of Chinese industry by developing relationships with existing domestic corporations, whether privately-owned or state-owned, improvements in corporate governance practices are necessary. Although the Chinese government has established a framework of laws and regulations designed to ensure sound corporate governance, a substantial effort at better implementation of existing rules is perceived as a key issue in strengthening corporate governance in China. Improvements are needed on many fronts, but of particular interest to foreign investors is to progress with reforms in the areas of transparency and disclosure and in reducing state interference in corporate affairs.

Corporate governance: legislation and guidance

The corporate governance system in force at present is based on the Company Law of the People's Republic of China that was promulgated on 29 December 1993 and amended on 25 December 1999, on the Code of Corporate Governance for Listed Companies in China adopted on 7 January 2001 and on regulations and guidance documents issued by government bodies including the China Securities Regulatory Commission (CSRC) and the Ministry of Finance (MOF). The other major piece of legislation whose provisions have some bearing on corporate governance is the Securities Law of the People's Republic of China promulgated on 29 December 1998.

The Company Law

The Company Law sets out the legal basis for the organisation and establishment of limited liability and joint stock companies.

The shareholders' committee, or the general shareholder meeting

The "organ of authority" in a limited liability company or a joint stock company (but not a wholly state-owned company) is the so-called shareholders'committee, comprising all the shareholders.

This committee has the following powers:

- To determine the company's operational guidelines and investment plans.
- To elect and replace directors and decide their remuneration.
- To elect and replace supervisors who represent the shareholders and decide their remuneration.
- To consider and approve reports by the board of directors.
- To consider and approve reports by the supervisor or board of supervisors.
- To consider and approve annual financial budget plans and final accounting plans.
- To consider and approve company profit distribution plans and plans to cover losses.
- To adopt resolutions relating to any increase or decrease in the company's registered capital.
- To adopt resolutions relating to bond issuance by the company.
- To adopt resolutions relating to the assignment of share of capital contribution by a shareholder to anyone other than a shareholder of the company.
- To adopt resolutions relating to merger, division, change of corporate form, dissolution and liquidation of the company.
- To amend the articles of association.

Resolutions relating to the increase or decrease of registered capital, division, merger, dissolution or change of corporate form, or amendment of articles of association, require affirmative votes by shareholders representing two-thirds of the votes. Votes are allocated in proportion to shareholdings.

The board of directors

The board of directors is the decision-making body of China's companies. The size of the board ranges from 5 to 20 members, elected at shareholders'meetings. The board of directors convenes the shareholders' committee, to which it is accountable. The representation of employees in the

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supervisory board is mandatory. The board has one chairman, who is the legal representative of the company, and one or two vice-chairmen.

The board of directors has the following powers:

- To call shareholders' committee meetings and present reports to it.
- To implement resolutions adopted by the shareholders' committee.
- To determine operating plans and investment programmes.
- To prepare annual financial budget and final accounting plans.
- To prepare profit distribution plans and plans to cover losses.
- To prepare plans for increasing or reducing registered capital.
- To draft plans for merger, division, change of corporate form or dissolution of the company.
- To determine the structure of the company's internal management.
- To appoint or remove the general manager, deputy managers and the financial officer, and determine their remuneration.
- To formulate the basic management scheme of the company.

The maximum term of office of the directors is set in the articles of association for not more than three years. Directors may be re-elected to further terms.

The board of directors meeting is convened and presided over by the chairman, or, if the chairman is unable to do so, by a vice-chairman or other director. Meetings may also be convened at the request of at least one-third of the directors.

The general manager

A limited liability company has a general manager who is accountable to the board of directors and is appointed and removed by it. The general manager attends meetings of the board of directors.

The general manager has the following powers:

- To be in charge of management of production and operation, and to organises the implementation of resolutions of the board of directors.
- To organise the implementation of annual operating plans and investment programmes.
- To prepare the internal management structure plan and the basic management scheme, and to formulate detailed company rules.
- To recommend the appointment or removal of a deputy general manager and a financial officer.

- To appoint and remove officers of the company other than those who are appointed and removed by the board of directors.

Executive director in small-scale companies

A small-scale limited liability company may have an executive director instead of a board of directors. The executive director is then the legal representative of the company and may also be the general manager.

The board of supervisors

Large-scale limited liability companies have a board of supervisors consisting of at least 3 members. The board of supervisors elects one of its members convenor. The board of supervisors is made up of shareholders' representatives and employee representatives; the ratio is prescribed in the articles of association. A small-scale limited liability company with only a few shareholders may have one or two supervisors. The term of office of supervisors is 3 years; supervisors may be re-elected to further terms. Supervisors attend board of directors' meetings.

The supervisor or board of supervisors has the following powers:

- To review the financial affairs of the company.
- To monitor the acts of the directors or the general manager to guard against violation of national statues, administrative regulations or the articles of association.
- To require the directors or the general manager to make rectification when any action causes harm to company interests.
- To propose interim meetings of the shareholders' committee.

The Code of Corporate Governance

The Code of Corporate Governance for Listed Companies in China was issued jointly by the China Securities Regulatory Commission (CSRC) and the former State Economic and Trade Commission (SETC) on 7 January 2001. The Code applies to all listed companies within China and is used as a standard to measure corporate governance performance by the CSRC, making it a major determinant of whether or not a company fulfils listing requirements on China's stock exchanges. A special inspection was introduced in 2002 to check companies' compliance with the Code.

The Code lays down a number of basic principles, some of them to be fleshed out by subsequent regulations and guidelines, on such matters as:

- Shareholder rights and rules for shareholders' meetings.
- Rules for written agreements on related party transactions.

- Rules for the behaviour of controlling shareholders.
- Independence of listed companies from controlling shareholders.
- Election procedures for directors and duties and responsibilities of directors.
- Duties, composition and rules of procedure of boards of directors.
- Independent directors.
- Specialised committees of boards of directors.
- Appointment and performance assessment of directors, supervisors and managers.
- Stakeholders, including creditors, employees, consumers, suppliers and the wider community.
- Information disclosure and transparency.

Guideline on the Management of Listed Companies

The China Securities Regulatory Commission (CSRC) issued a Guideline on the Management of Listed Companies on 7 January 2002. The aim of the Guideline is to encourage domestically listed companies to establish and develop a modern enterprise system; regulate the operations of domestically listed companies; and promote the healthy development of the securities market in China. The Guideline lists the basic principles on the governance of domestically listed companies, the measures needed to protect the interests of investors and the behaviour and professional ethics of the directors, members of the supervisory committee, and managerial staff of listed companies.

Existing measures to tackle problems regarding corporate governance

A number of serious problems with corporate governance of limited liability and joint stock companies have been identified by regulators and by outside commentators.

Limiting insider control: CSRC Guidelines on Independent Directors

Boards of directors usually consist largely of executive directors, with very few independent directors. The board of directors is thus subject to "insider control" (*neibu kongzhi*) and is unable to monitor the company's executives effectively. Boards of supervisors may report to shareholders' meetings, but their role is effectively nullified if the shareholders' meetings are dominated by the controlling shareholder (usually the state), who may also control the board of directors. It is, therefore, vital to enhance the role and independence of boards and ensure that minority shareholders are represented on boards of directors.

Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies were issued by the China Securities Regulatory Commission (CSRC) on 16 August 2001. These Guidelines require at least one-third of board of directors to be independent directors by June 2003. Independence in this context is defined as being independent of management and of relatives of the management, of the controlling shareholder (which is usually the state) and of persons providing financial, legal or consulting services to the company. Candidates must be verified by the CSRC in each case before a director can be considered for appointment as an independent director. Candidates must declare their independence publicly and the declaration must be published in the newspapers. By the end of June 2002, 2 327 independent directors had been appointed by shareholders' meetings; 80 per cent of the 1 084 companies had at least two independent directors on their boards (not too far short of the interim target of 100 per cent set for that date in the Guidelines), and 70 per cent had at least one accounting professional as an independent director. The Guidelines also stipulate that listed companies must provide adequate working facilities for independent directors and that they can not dismiss independent directors without good cause (such as failure to attend three consecutive board meetings).

Inadequate knowledge: training programmes now under way

In 2001 classes to train independent directors began in Beijing and Shanghai; in the ten months to the end of June 2002, 5 000 candidates for independent director positions had been trained in these. The Shanghai and Shenzhen stock exchanges are also mounting courses for existing directors. By 2005 all directors will have attended training classes. Training programmes for investors are also being organised in major cities and on the Internet.

State control and concentrated share structures

The state still holds at least half the shares of all listed companies (some estimates range much higher) and the largest shareholder, usually the state, tends to hold about 45 per cent of the shares of each listed company. It is often not clear who represents the state and who has control over state-owned assets, since state control of the original pre-corporatisation SOEs was vested in various levels of government. State control is also linked to the influence of the communist party. Communist party committees in listed companies are also reported to retain influence that is not always wholly transparent, for example in regard to controlling membership of boards of directors. Large state shareholdings also require a clear distinction between the state's two roles as shareholder and regulator.

One study of the performance of publicly-listed companies in China in 1995 (Xu and Wang, 1997) suggests that ownership concentration was positively correlated with performance, but that this effect was stronger for companies dominated by legal person shareholders than in companies dominated by the state. This is largely because the goal of managers and boards of directors appointed by the state is the preservation and increase in value of state assets as opposed to value maximisation for all shareholders.

The role of institutional investors

It would be reasonable to conclude from such research findings that company performance would be likely to improve if state shareholdings were to be gradually replaced, including by large institutional shareholdings. Reducing the role of the state in corporate affairs in this way is difficult at present, as only about one-third of shares are traded on the stock exchanges, the rest consisting of non-tradable shares. The development of institutional shareholder involvement has been a slow process in OECD countries and may take some years in China. Institutions have to be careful with their choice of good quality financial products and therefore demand high standards of corporate disclosure and transparency. It is thus not surprising that institutional investors, most of them held wholly or in part by the state, currently hold a mere 2.3 per cent of market capitalisation. Institutional investors can play a vital and independent role in stimulating improvements in corporate governance, but only if they are fully empowered to do so in a system that provides full rights to shareholders. The entry of foreign institutional investors can be a major catalyst for change in this regard.

Related party transactions

Related party transactions between the controlling shareholder, or the holding group to which the company belongs, and the company are common, often against the interests of the company and minority shareholders in particular. One OECD study of corporate governance in China[1] identifies related party transactions as the "key threat to shareholder value". They are aggravated by the need to maintain a vast array of social assets and services at the parent level and by politicised resource allocation decisions. Such practices may be concealed and exacerbated by the lack of transparency alluded to below.

Overcoming the lack of incentives for managers

Since the state controls many companies, it also appoints and controls their executive managers, a practice which is not necessarily a great improvement on that which prevailed under the former system of central planning. Since managers are routinely regarded as civil servants, managerial

salaries tend to be low and unrelated to performance. There is therefore little incentive for managers to improve. This problem is particularly acute in poorer hinterland areas where it may be difficult to consider the possibility of paying a manager more than the local officials who may be involved in appointing him or her. Stock options can not be substituted for incentivised salaries as they have as yet no legal basis. This situation, though, will change as provision for stock options is expected to be included in future legislation.

Inadequate transparency and disclosure

Information is not generally disclosed accurately, on time or in a form understandable by shareholders. The statistical system of SOEs was designed to produce information on the fulfilment of output plans. During the reform period it has metamorphosed into a system that is intended to supply data for the calculation of enterprise income tax. Managers of both listed and unlisted companies therefore have little or no practical experience of the type of financial information that should be provided to shareholders and the public (*i.e.* potential investors). There are also strong incentives to distort and manufacture information, often stemming from the loyalty of management to parent companies who may be benefiting from related party transactions which entail a diversion of funds that may in some cases be detrimental to the profitability of the company concerned.

The problem is equally severe on the demand side. Shareholders tend on the whole to be unfamiliar with such techniques as ratio analysis of listed companies. One reason for this is inexperience: Chinese stock markets are still in their infancy, there are few experienced professional analysts and institutional investor involvement remains minimal. Another reason is that investors tend to expect, not entirely without foundation, that share values will be supported by the state. The stock market at present tends to fall somewhat short of the task of providing a wholly objective standard by which to value companies. This lack of transparency may tend to weaken the use of stock market valuation as an incentive to optimise company performance. One study (Chen and Shih, 2001) has even shown that initial public offerings (IPOs) by SOEs are more likely to worsen than improve the performance of the enterprises concerned . This is because companies tend to submit inflated figures in the financial statements they are required to provide, concealing their real situation until well after they have secured a financial listing.

6. Accounting standards and regulations

China has made enormous progress in developing accounting systems and standards that conform increasingly to internationally recognised

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standards. The opening of the accounting sector to foreign participation (Chapter 3 of this report) is likely to stimulate further improvements.

The institutional framework

In creating an institutional framework for business accounting the government had to start from scratch in the late 1970s. The Soviet-type accounting system developed in China in the 1950s was designed to meet the needs of a centrally-planned economy with enterprises operating the "cost accounting" (*khozrashchet*) system. The accounting function was essentially reduced to bookkeeping for statistical reporting and cost reduction purposes, using standardised procedures that required no judgment. As a result, there were no certified public accountants (CPAs) and no professional body representing accountants at the beginning of the reform period. Financial information relevant to business planning was not collected, since no consideration of profit and loss was made in the command economy, nor could the data that was available be used for such a purpose. Independent auditors and regulators did not exist.

The Accounting Law

The Accounting Law of the People's Republic of China, adopted in January 1985 and amended in December 1993, provides the main legal basis for accounting, but not in excessive detail (it consists of 30 articles). The law specifies:

- The range of transactions that must go through an accounting procedure.
- That the financial year runs from 1 January to 31 December.
- That the ren min bi is the unit of account (except for units whose primary income and outlays are in foreign currency).
- Which documents have to conform to uniform state accounting systems.
- Which original documents must be kept.
- The setting up of a property-checking system.
- Arrangements for accounting supervision and accounts-checking systems.
- Accounting bodies and accounting personnel.
- Legal responsibilities of accountants.

The law lacks precision on some counts, for example in stipulating that accounting personnel must have "necessary professional knowledge", without mentioning any specific vocational qualifications. Imprecise specification may to some extent be deliberate in that the law allows enterprises a degree of flexibility in designing accounting systems that is an express element of government policy.

The Division of Administration of Accounting Affairs of the Ministry of Finance

Under the law, the Division of Administration of Accounting Affairs (DAAA) of the Ministry of Finance is responsible for setting accounting standards that all companies must follow. The first such standard, the Basic Accounting Standard (BAS), based on the International Accounting Standards issued by the International Accounting Standards Board, was promulgated in 1992 and implemented formally in 1993. In the same year, the Ministry of Finance set our a new uniform accounting system in line with the BAS to replace the existing Soviet-type accounting system. In 1993, the DAAA published the Accounting Standards for Business Enterprises (ASBE) and the DAAA has since been developing specific accounting standards and regulations under the ASBE. In 1998 an Accounting Standards Department responsible for developing accounting standards, subject to approval by the Ministry of Finance, was established in the DAAA.

The Chinese Institute of Certified Public Accountants

The Chinese Institute of Certified Public Accountants (CICPA) was established in 1988 under the Ministry of Finance and now has 135 000 members. Since 1997 CICPA has been a full member of both the International Federation of Accountants (IFAC) and its regional offshoot, the Confederation of Asian and Pacific Accountants. Through membership of these bodies, CICPA works to harmonise China's accounting practice with internationally recognised standards. CICPA works under the joint guidance of the Ministry of Finance and the National Audit Office. Like similar bodies in other countries, it sets standards, organises training and the national CPA examinations and registers CPAs. The CICPA promulgated its first set of Independent Auditing Standards in 1995. It also decides on the admission of foreign accounting firms into China and supervises and regulates them after admission. CICPA members must state in their audit reports whether or not the company being audited has complied with the ASBE.

The Chinese Accounting Standards Committee

The seven-member Chinese Accounting Standards Committee, which advised the Ministry of Finance on issues related to the promulgation of accounting standards, was inaugurated in 1998.

Establishment of independent accountancy firms

Initially the government allowed ministries and enterprises to set up their own accounting firms to fill the vacuum. Then from 1992 onward it

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forced accounting firms to separate from their parent organisations and merge into larger groupings.

Remaining tasks

The Ministry of Finance is continually upgrading China's accounting systems and standards in line with international practice, which is itself also being continually improved. Future tasks in this regard will include the elimination of existing inconsistencies between different standards and regulations.

7. Implications for the competitive environment

One of the main aims of China's WTO accession is to allow competition from increased imports and FDI to stimulate the competitiveness of domestic industry and thereby encourage the emergence of world-beating Chinese brands. There is no doubt that competition will intensify. In China there is a debate between those who espouse traditional infant-industry protectionist arguments and their opponents, who argue that in the long term domestic industry will benefit from competition with FIEs, the so-called strategy of "dancing with wolves".[2] Evidence from industries that have already been opened wide to foreign involvement, such as the white goods sector, strongly supports the latter.

A study conducted by the OECD in 2000 (OECD, 2000a) concluded that FDI had increased domestic competition in several industrial sectors where it had established a strong presence. In these sectors, state-owned enterprises (SOEs) had been largely driven out but domestic collective and privately-owned enterprises were responsible for more than half of industrial production. The study found a positive correlation between SOE dominance in an industry and SOE pre-tax profit rates, suggesting that SOEs were largely reliant on a monopolistic situation for their profitability and tended to lose profitability when faced with competition. In those sectors where SOEs accounted for less than half of output, their profit margin was lower than that of FIEs and non-state Chinese firms.

The OECD study also showed that FIEs played a much more important part than imports in opening up the Chinese economy to "foreign" competition, since FIEs supplied a much higher proportion of the demand for industrial goods than imports for domestic use (as opposed to imports destined as production inputs or capital goods for export industries). The study found that in several sectors the relatively strong presence of FDI in the domestic market was associated with relatively high tariff protection. As such protection is removed as a result of China's 2001 accession to the WTO, competition from FIEs in such sectors will be supplemented or replaced by competition from imports.

It is not only Chinese firms that are concerned about the prospect of increased competition. In recent survey of foreign companies, including both actual and potential investors in China respondents (Deloitte, Touche, Tohmatsu, 2002), fears of increased competition from both other foreign investors, from private domestic companies, from imports and, to a lesser extent, from SOEs in China were voiced by a significant proportion of respondents. A full 80 per cent of respondents from the Asia-Pacific region expressed concern over increased competition from foreign investors, suggesting that the traditional sources of foreign investment suspect that they may be partly displaced by more competitive FDI. These fears are actually a healthy phenomenon. They clearly demonstrate confidence in China's ability to fulfil its WTO commitments towards market opening. They also point to the likelihood that such opening will increase competitive pressures, allowing market forces to weed out inefficient foreign investors as well as inefficient domestic companies.

For this process to operate effectively, market opening needs to be accompanied by a business environment that facilitates competition. Such an environment is gradually emerging from the major institutional changes of the past two decades, which are not yet complete. In particular, SOE reform, which is an essential precondition for ensuring both banking system stability and healthy government finances, will, when completed, remove major obstacles to competition. The process of SOE reform itself offers opportunities for foreign investors to participate in industrial restructuring, helping to create more efficient enterprises, strengthen financial markets and offer employment opportunities to mitigate the negative employment effects of SOE reform.

For foreign investors to play a full part in SOE reform, the regulatory regime needs to be enhanced. The Chinese government is currently preparing legislation which will do this, reportedly including:

- A competition law.
- An anti-monopoly law.
- A law on mergers and acquisitions (M&A).

Once these laws have been promulgated, the role of foreign investors in the restructuring of SOEs will be clearer. Improvements in the regulation of capital markets, corporate governance, accounting standards, bankruptcy procedures and transparency throughout the corporate sector will help provide a stable foundation for such restructuring.

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Provided these institutional improvements are effective in rendering the business environment more competitive, the Chinese economy will benefit in several ways:

- Inefficient domestic firms will be allowed to exit via bankruptcy or M&As.
- A core of strong domestic companies will emerge.
- Inefficient FIEs will similarly be weeded out.
- Higher-quality FDI will be attracted.

Notes

1. *Establishing Effective Governance for China's Enterprises*, in (OECD, 2002a), page 443.
2. This phrase is the title of a study of the role of FDI in China's electronics industry (Yan and Kan, 2000).

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Chapter 6

The Tax treatment of FDI in China

Abstract. *Tax legislation regarding foreign-invested enterprises (FIEs) consists of a complex system of tax incentives to attract foreign direct investment (FDI). It is not easy to obtain complete information on the tax liability of an FIE, partly because of regional differences in incentives. FIEs contribute about 10 per cent of all tax revenue. Separate laws govern income taxation of domestic enterprises (which are subject to a 33 per cent corporate income tax rate) and FIEs (which are subject to a 15 or 24 per cent rate, depending on factors including location). There are plans to merge the two tax régimes. The effect of such a merger would depend on the level of the single rate of tax that would then apply to both domestic enterprises and FIEs. Domestic enterprises would no longer be able to benefit from "round-tripping", i.e. the practice of investing in China via shell companies in Hong Kong or other foreign locations*

1. Overview of the Tax System

Since 1994, the Chinese authorities have made some progress in making the tax system more transparent. The value-added tax (VAT) system has been simplified and a unified tax system produced for all domestic companies; they had previously been subject to separate tax regimes according to their forms of ownership. However, separate tax regimes for corporate income still exist for domestic and foreign enterprises.

Tax legislation regarding FIEs consists of a complex tax incentive system as a tool of the government to attract FDI in pursuit of national development priorities. Most of these incentives are not available to Chinese enterprises. Currently, 14 taxes relate to foreign investment, including corporate income tax, personal income tax, VAT, business and consumption taxes. Fees are also imposed by local governments. Other compulsory payments include social security contributions, mainly to pension funds and health insurance schemes. VAT is the largest single source of revenue. The Chinese tax system therefore differs from tax structures in OECD countries, where personal income tax is the largest single revenue source, followed by social security contributions (OECD Revenue Statistics, 2001).

Although the national budget is generally adopted in March at the annual session of the NPC, the Chinese tax year corresponds to the calendar year. This means that the budget and related tax rules become effective retroactively on 1 January of each year.

2. Forces shaping tax policy

Reflecting a system lacking universal public provision of health care and welfare and in which public provision of goods and services is decreasing, government spending as a share of GDP, and hence the tax burden, are very low compared to OECD countries, accounting for 17.8 per cent and 15 per cent of GDP respectively in 2000 (Chinese Fiscal Yearbook, 2001). For all OECD countries, the share of total tax revenue in GDP, including social security contributions, was 37.3 per cent in 1999.

The Chinese government strives to maintain rapid economic growth as a crucial determinant of social stability. Foreign investment and technology transfers from overseas are perceived as key sources of such growth. Tax policies benefiting specific sectors and regions are used to encourage FDI

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inflows, resulting in a tax system that is blurred by a plethora of special exemptions and allowances. The government therefore deliberately avoids extracting a high proportion of foreign corporate income for its own coffers. Sales taxes are designed to be the main source of tax revenue for the state budget. There are efficiency problems in the tax collection process, resulting in tax coverage being insufficient to meet fiscal needs.

The Chinese tax system will be vulnerable to erosion of the revenue base resulting from increasing financial pressures on domestic enterprises which will be exacerbated by tariff cuts resulting from the implementation of WTO agreements. Foreign enterprises, even if taxed more heavily, are not likely to fill the gap. At the same time, the government needs to be able to finance rising expenditure to deal with challenges such as rising unemployment. This need may force it to adjust both the level and the distribution of taxation, and possibly also to remove some tax privileges. The tax system is currently not balancing the trade-off between a fair income distribution and ensuring fair pecuniary rewards for investment in human capital.

Box 6.1. **Taxing powers**

The current tax system consists of state and local taxes. Only the central authorities have the right to introduce or suspend taxes by means of laws and regulations, but both central and local governments have a legal responsibility in the tax collection process. Laws are promulgated by the NPC or its Standing Committee, but many tax regulations are issued as administrative decrees and notices by the Ministry of Finance (MOF) and the State Administration of Taxation (SAT). Fees can be introduced and suspended by local authorities, but must comply with central provisions.

In 1994, tax collection was divided between the State Administration of Taxation (SAT, *guoshuiju*) and the local tax administration entities (*dishuiju*). Depending on the type of undertaking, foreign investors may have dealings with four tax collection entities: state and local tax offices, the customs office (*guanshuiju*) and the fiscal bureau (*caizheng ju*), and hence have to file separate tax returns. As a rule of thumb, all centrally owned taxes and the shared taxes are collected by the SAT, while the local tax authorities are entitled to levy locally owned taxes. There are few exceptions to this procedure.

Table 6.1 shows the distribution of tax collection responsibilities by type of tax. Sales taxes (VAT and consumption tax) and corporate income tax are managed by the state tax offices; local tax offices collect personal income tax, business tax and other smaller taxes. The agricultural tax is payable to the local fiscal bureau. Local authorities are not allowed to grant tax exemptions. However, it does happen that local governments, in pursuit of their local development goals, reimburse selected companies for the tax they have already paid.

3. Availability and accessibility of tax information

A foreign investor will find it difficult to get a full, updated picture of China's tax framework for FDI. Firstly, all the tax laws are in principle printed in the official bulletin of the State Council, but not all the relevant tax regulations issued by the MOF or the SAT are easily available. Tax regulations are in principle only available in Chinese. It is difficult to identify the latest version of relevant laws with all the amended, changed and cancelled stipulations included. The official web sites of relevant government agencies are rather inefficient in providing the necessary information, as they are incomplete and outdated, especially where the English online versions are concerned.

Secondly, the tax incentive system is complicated and varies according to location. Many laws are complemented by by-laws which differ according to location.

According to a notice issued on 13th May 2002, SAT is now issuing an official journal of taxation, in order to comply with the WTO request for more transparency. However, it remains to be seen whether it will be available in English as well as in Chinese and how far it will also include rules on tax implementation. It should also be noted that upon its accession to the WTO, China has established a contact point within its Ministry of Commerce (MOFCOM), the *China WTO Notification and Enquiry Centre*.[1] This office is intended to become a useful source of information for any legislation implementing China's WTO obligations. More importantly, companies that experience conduct by a government department, provincial or local government agencies or any other entity, which they consider to be in violation of WTO rules, may inquire whether such conduct corresponds to China's WTO obligations and domestic law.[2] This office is supposed to respond to all questions within 30 days of receipt of the written enquiry, which may be extended to 45 days under unspecified "special circumstances".

4. Contribution of foreign investors to Chinese overall tax revenue

Currently tax revenue accounts for more than 93 per cent of total government revenue (China Statistical Yearbook, 2001). In 1999, FIEs (including enterprises with investment from Hong Kong (China) and Macao (China) and Chinese Taipei) contributed 15.7 per cent of overall tax revenue. By contrast, almost half of the tax take came from domestic state-owned enterprises (SOEs). Foreign enterprises [excluding Hong Kong (China), Macao (China) and Chinese Taipei] were responsible for 17.7 per cent of overall corporate income taxes, which equals 2.2 per cent of overall tax revenue (see Table 6.1). According to official statistics, FIEs [including Hong Kong (China), Macao (China) and Chinese Taipei] contribute approximately 19 per cent to the national tax revenues from industry and commerce (MOFTEC, 2002).

Overall, in 2000, sales taxes and corporate income taxes were the largest revenue sources, accounting for 66.8 and 15.5 per cent of total tax revenue respectively. The most important single tax was VAT with a 44.1 per cent share (see Table 6.1). However, from 1999 to 2000, the share of sales taxes shrank by over three percentage points, reflecting an increase in corporate and individual income tax revenue, partly as a result of successful efforts by the SAT to improve collection of tax from private enterprises and households.

China's tax structure differs largely from the average tax structures in OECD countries in that the share of sales taxes is far higher, while personal income tax plays a minor role. Taxes on personal and corporate incomes combined are the main source of revenue in most OECD countries, exceeding 45 per cent of total revenue in 1999 in five member countries[3] (OECD Revenue Statistics, 2001).

Table 6.1. **Composition of national tax revenues, 1999 and 2000**

Tax categories	In Rmb (1999)	In %	In Rmb (2000)	In %
Sales taxes, hereof	69 561 876	70.1	81 022 844	66.8
VAT	44 114 098	44.5	53 468 950	44.1
Consumption tax	8 482 490	8.5	8 696 900	7.2
Business tax	16 965 288	17.1	18 856 994	15.5
Corporate income tax, hereof	12 271 873	12.4	17 707 963	14.6
Domestic companies	10 093 752	10.2	14 446 479	11.9
FIEs or foreign companies	2 178 121	2.2	3 261 484	2.7
Individual income tax	4 143 118	4.2	6 303 715	5.2
Other taxes, hereof	13 227 960	13.3	16 224 257	13.4
Resource tax	628 647	0.6	636 456	0.4
Stamp tax	2 823 340	2.8	5 218 507	4.3
Vehicle tax	208 639	0.2	234 419	0.2
Overall tax revenue	99 204 827	100	121 258 779	100

Source: Tax Yearbook of China, 1999 and 2000.

Table 6.2. **Taxes paid by type of enterprise, 1999**

	In Rmb	In % of total
Domestic enterprises, hereof	75 891 605	78.3
State-owned enterprises	47 962 527	49.5
Collectively-owned enterprises	11 467 181	11.8
Co-operative stock enterprise (*gufen hezuo qiye*)	1 476 693	1.5
Affiliated company (*lianying qiye*)	1 121 679	1.2
Stock companies (gufen gongsi)	10 442 211	10.8
Private enterprises	2 549 617	2.6
Other	871 697	0.9
Individual households	5 758 083	5.9
Hong Kong (China), Macao (China) and Chinese Taipei invested enterprises	5 449 524	5.6
Foreign invested companies	9 779 447	10.1

Source: Tax Yearbook of China, 1999.

5. Direct taxes

5.1. *Personal income tax*

Since managers of FIEs coming from outside China are subject to Chinese income tax, the terms of such taxation constitute an important factor in the facilitation of movement of key personnel. The income tax on individuals is regulated for both foreigners and Chinese citizens in the personal income tax law which became effective in 1980 and was amended in 1993.

Taxable persons

Under this law, a person who is resident in China for more than 1 year is liable to pay tax on income from sources on his/her worldwide income. Anyone staying in China for more than 183 days shall pay individual income tax on his/her income from sources within China.

Tax base and tax rate

Wages and salaries, income from individual household production or business operations and income from contract or lease operations are subject to tax. However, these different types of income are taxed differently. Wages and salaries are taxed at progressive rates ranging from 5 to 45 per cent. While Chinese citizens have a lump sum deduction of Rmb800, foreigners may deduct a monthly lump-sum of Rmb 4 000. Business income is subject to tax at progressive rates ranging from 5 to 35 per cent. Other income is generally taxed at a flat rate of 20 per cent. In general, the personal income tax is assessed on a monthly basis, thus necessitating the filing of monthly returns through the employer to the tax office.

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5.2. Corporate income tax for FIEs and foreign enterprises

General remarks

China has two separate laws for the corporate income taxation of domestic and foreign enterprises, although discussions are under way to merge the two regimes. The main law regulating corporate income taxation of foreign companies in China is the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, promulgated on April 9, 1991. This tax law also provides legal grounds for preferential policies.

Taxable entities

Taxable entities are enterprises with foreign investment, including Sino-foreign equity joint ventures, Sino-foreign contractual joint ventures and wholly-foreign-owned enterprises established in China. Income tax is paid in the same way by all foreign enterprises which derive income from within China.

The tax base and tax rate

The tax base of taxable income includes profits, interest, rental, royalty and other income from sources within China. The taxable income rate on enterprises which are subject to the corporate income tax is set at 33 per cent, which includes a 30 per cent national tax and 3 per cent local tax. This standard tax rate is identical with the tax applicable to domestic companies. However, unlike many other countries where tax incentives are available to both domestic and foreign taxpayers, many tax incentives in China are applicable to foreign investment only. A large array of tax incentives is available which includes tax holidays, reduced tax rates and refunds for reinvestment (for more details, see Section 7 below).[4]

Key differences in taxation of foreign and domestic enterprises

Overall, domestic Chinese enterprises are usually subject to higher tax burdens than foreign companies. Domestic companies pay not only higher nominal tax rates, but are also limited in their ability to deduct expenses. They are also subject to less favorable depreciation rules.

For a comparison of the major differences between the foreign and domestic tax regimes, see Table 6.3:

Table 6.3. **Key differences in taxing of domestic and foreign companies**

	Domestic	Foreign
Taxation	Worldwide	Territorial
Tax rates	18-33%	33%
Intercompany dividends	Tax credits	Exempt
Deduction for wages	Limited	Actual
Depreciation rates[a]		
Houses and buildings	1.8%-12%	5%
Machinery and equipment	2.9%-20%	10%
Cars, computers and tools	2.9%-20%	20%
Salvage value	5%	10%

a) Depreciation for foreign enterprises is on a straight-line basis. For domestic enterprises, rates are industry specific.

Source: Tax Notes International, 4 March 2002.

6. Indirect taxes: VAT, business and consumption tax

The system of indirect taxation is an important component of the overall business environment for FDI. Since January 1994 China has implemented a unified value added tax, consumption tax and business tax on FIEs while abolishing the previous industrial and commercial consolidated tax.

6.1. Value Added Tax (VAT)

In 2000 FIEs contributed a 13.1 per cent share of total VAT revenue (China's Tax Yearbook, 2000). Any citizen, legal person or entity engaged in the sale or import of goods within Chinese territory is liable to pay VAT. VAT only covers services related to industrial activities; all other services are subject to Business Tax. VAT is levied on rather strict terms, as the annual budget includes, on all levels of government, a detailed plan of how much VAT each tax office should collect from taxpayers. Such a plan does not exist for corporate and individual income tax. VAT is collected on a monthly basis. The standard VAT rate is 17 per cent. A reduced rate of 13 per cent applies on some basic foodstuffs, books, magazines and other items. A 6 per cent VAT rate is applied to small businesses dealing with the production of taxable goods and/or services with annual sales of less than Rmb1 million. Export of goods may be taxed at zero per cent. It is to be noted, however, that the effective tax rebate is always less than 17 per cent. Unlike their domestic counterparts, foreign-invested companies can get this rebate only on export goods which they themselves manufacture in China.

6.2. Business tax

Business activities that are not subject to VAT are subject to the business tax. This tax, which applies to most taxable services, is levied on turnover as

well as on transfers of real estate and intangible assets at rates ranging from 3 to 20 per cent. The business tax is a local tax, but in some cases tax revenue up to three percentage points belongs to the centre.

6.3. Consumption tax

Consumption tax is an excise tax imposed on selected categories of luxury products in addition to VAT. These categories include: cigarettes, alcoholic beverages, jewellery, petrol, diesel, cars and motorcycles.

7. Tax incentives for foreign investment

General features

The People's Republic of China has decided to keep – at least for the time being – most of the features of its current tax regime that provide preferential treatment for FIEs. The incentive system is extremely complex and difficult to specify, as no comprehensive document on the rules seems to be available. The availability of incentives to FIEs depends on a number of factors, including geographic location, type of entity, type of industry and period of operation. In general, the government encourages investment in: designated geographical areas, manufacturing, export-oriented and technologically advanced (high-tech) projects and infrastructure development.

In terms of geographic location, most of the incentives tend to target the coastal area and the Western and Central regions. The tax incentive regime consists mainly of reduced corporate income tax rates, tax holidays and refunds of tax on reinvestment.

Reduced tax rates

The 33 per cent corporate income tax rate may be reduced to 15 or 24 per cent, depending on the geographic location and the type of foreign investment. Generally the 15 per cent rate is applicable to FIEs located in Special Economic Zones (SEZs), high-tech companies located in special technology zones and companies engaging in specifically designated industries in the Western and Central regions. The 15 per cent rate can also be applied to production-oriented FIEs located in open provincial or port cities, provided the enterprises are engaged in high-tech industries. The 24 per cent rate applies to production-oriented FIEs located in open coastal economic zones or in port cities. When an FIE has affiliates in different locations, it may be the case that each branch is taxed differently, at the rate applicable in that particular location.

Tax concessions

China offers FIEs a five-year preferential tax regime that consists of two years of tax exemptions followed by a 50 per cent reduction of the general corporate income tax rate for three years (know in Chinese as *jian er mian san*). However, this holiday is applicable only to FIEs engaged in production-oriented activities for at least ten years. The five-year concessional period starts to run from the first profitable year and continues for five consecutive years, regardless of subsequent profitability.

On top of that, a preferential tax holiday may be available for particular types of investments, such as export-oriented enterprises or technologically advanced enterprises, or investments in port and wharf development. This preferential holiday entitles the FIE to a further tax reduction after expiry of the initial five-year concessional period. For example, an export-oriented enterprise may qualify to be taxed at 50 per cent of the usual rate after the five years have expired.

The standard concessions for a company thus include a top income tax rate of 15 per cent which only comes into effect in a company's sixth full year of profit-making after a two-year tax holiday and three years at 7.5 per cent income tax.

Tax refunds for reinvestment

Under certain conditions, a foreign investor is entitled to a refund of the corporate income tax already paid on the underlying profits out of which the dividends used for reinvestment in China are calculated. The rebate may vary between 40 and 100 per cent. To qualify for the refund, the FIE must, *inter alia*, meet the following conditions: the funds must be reinvested for a minimum of five years and the funds used for reinvestment must be from dividends to a non-Chinese parent.

Loss of "foreign status"

Foreign ventures can lose their "foreign" status if they fail to fulfil their pledges to bring foreign capital into the country. Joint ventures and wholly-foreign-owned enterprises that achieve less than 25 per cent of the total promised capital will be denied the preferential 15 per cent income tax rate, and may be taxed at the standard 33 per cent corporate tax rate.

Preferential policies to engage in Western and Central China

In 2000 and 2001 there was a major shift of the preferential tax policies towards an emphasis on investment in the less developed hinterland in the Western and Central regions. Different sets of regulations are in place for these two locations. On the whole, the central government's steps to give these provinces preferential tax policies for investments is in line with the

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idea of promoting economic development in these areas, which have fallen behind the more dynamic Eastern region. It is not yet clear how the preferential policies will work in practice, as the content of the circulars remains vague. The Chinese government seems to place high hopes on FDI to help the Western and Central regions to develop, but infrastructural problems in these regions cannot be solved by FDI alone.

The Circular concerning preferential tax policies for developing the Western region, issued jointly in December 2001 by the Ministry of Finance and the SAT, provides foreign and domestic enterprises with incentives for specific investment projects in the 12 province-level administrations of the Western region: Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shaanxi, Gansu, Ningxia, Qinghai, Xinjiang, Inner Mongolia and Guangxi.[5] It is unclear what preferential tax policies apply to the Central Region, since the relevant regulations are not easy to locate.

In the Western and Central regions, tax privileges are only available for specific industries. In general, investments have to go towards important infrastructure industries which are listed in the relevant catalogues on national development objectives. But different catalogues apply for domestic and foreign investment. Investments in high-tech industries, agricultural innovation and technology and investment which can help promote the human and natural resources of Central and Western China rank amongst those foreign business activities which the state generally strongly encourages (see Chapter 3). But FIEs are not allowed to engage in all industries. Foreign investment can be encouraged, allowed, restricted or forbidden.

Specifically, investments which according to the above-mentioned circular are encouraged in Western China are basic infrastructure projects such as railways, ports and roads, and in the telecommunications, electricity and hydraulic power industries. While the circular stipulates that the revenue in the above-mentioned business areas must account for more than 70 per cent of the overall income in order to be entitled to tax privileges, this rule remains unspecified.

Although both domestic and foreign businesses who establish new branches or establishments in Western China can be granted tax privileges, the implementing details differ. Enterprises are subject to a standard corporate income tax of 15 per cent. Domestic enterprises are exempted from this tax during the first two years of their business activities, then in the following three years they are subject to the reduced corporate tax rate of 15 per cent, while the same tax concessions are available for FIEs on condition that they pursue investment projects with a term exceeding ten years. Companies which engage in environmental projects may be exempted from agricultural tax for ten years.

Again, getting the full picture of all the preferential tax policies which may apply is a rather difficult task for any potential investor, as no comprehensive document seems to exist for reference. Instead each province has developed its own interpretative guidelines.

8. The fate of tax incentives

The principle of neutrality stipulates that tax policies should not vary between different types of enterprises. The working assumption of many experts was that when China acceded to the WTO it would merge the rules to provide similar treatment for foreign and domestic enterprises.

The Chinese government has since 1994 been carefully studying the question of whether the two separate tax regimes for domestic and foreign enterprises should be merged. Discussions have intensified in the light of WTO accession. The then Finance Minister, Xiang Huaicheng, announced in June 2002 that income tax for foreign-funded and domestic firms would be unified in 2003; however, the standard rate of tax that will then apply has not yet been made public. The long-expected policy change is a response to the increased financial strains experienced by domestic Chinese companies in recent years. Competitive pressures have led to corporate restructuring and layoffs. Now that it has acceded to the WTO, China is less able to protect its inefficient state-owned enterprises. In addition, the decrease in import tariffs agreed to in the WTO accession agreements will reduce government revenue. Once it has been decided, implementation of the unification of the two income tax regimes will take time to accomplish.

Effects of a unified tax regime

A unified tax system for all enterprises irrespective of national origin would comply with the principle of tax neutrality, thus reducing incentives to take advantage of the current dual-track system. It could well produce unintended effects, especially regarding Chinese enterprises.

Chinese companies appear to welcome the establishment of a "level playing field" which would improve their competitive position, especially in the case of financial institutions. The main concern of FIEs is to ensure that concessions already extended will not be revoked retroactively, but protected by grandfather clauses.

Some foreign enterprises claim that the difference between the current effective tax rates for Chinese and foreign-owned enterprises are not as far apart as the income tax rates indicate, since their domestic competitors, whose financial procedures are less standardised, may enjoy other privileges, such as budget subventions or cheap loans, some of which may not comply with existing legislation. On the other hand, some Chinese entrepreneurs

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claim that this practice is a natural by-product of the current unequal tax regimes. Other Chinese companies who pay their corporate income taxes as a contracted lump sum argue that the change in the tax rates would not greatly influence their financial situation (*Guoji Jinrong bao,* 12 June 2002). Foreign investors may therefore worry that domestic companies might end up being privileged after the tax merger if the above practices persist.

Any attempt to close the gap in income tax rates between foreign and domestic enterprises might have far larger consequences than would ordinarily be the case, because the "foreigners" involved are not all foreign. There is evidence that large amounts of China's outbound FDI is channelled back into the country to take advantage of FDI incentives – a practice commonly referred to as "round-tripping". There is no firm data available to describe the magnitude of the phenomenon, but back in 1992, according to one estimate, 13 per cent of China's total FDI intake stemmed from round-tripping (Jun Fu, 2000, p. 187); a contemporary World Bank estimate put the 1992 figure at 25 per cent.

Since Chinese companies also benefit from tax reductions to the extent of their involvement in joint ventures, any change in FDI incentives will concern some local companies. Local governments reportedly offer fiscal concessions to FIEs beyond the limits allowed by the central government, partly in order to attract FDI and perhaps also with the intention of conferring fiscal advantages on local enterprises which are joint venture partners.

Foreign companies have also tried to seek loopholes in the system: to ensure that they will continue to benefit from tax concessions, some FIEs have closed down their facilities in one location and opened up others elsewhere.

The effect of the disappearance of tax incentives on companies based in the United States may be less than on companies based elsewhere. The United States' tax treaty with China does not include a "tax-sparing" provision to allow a credit against the home country's taxation on the income of its businesses in China, so that such businesses can not offset the tax paid in China against their tax liability in the United States and are therefore effectively taxed at the same rate whether or not they are subject to incentive tax reductions in China. Such companies can, however, benefit from tax incentives if they do not repatriate their profits but instead reinvest them in China or send them to a subsidiary based in a third country, because in either case such profits are not taxable in the United States. It is not clear whether the lack of a "tax-sparing" provision has had any major impact on the decisions of companies in the United States to invest in China. A recent OECD study found that a precise estimate of the FDI sensitivity of United States companies to a given amount of tax relief was difficult to make because a number of theoretical and empirical issues remained unresolved (OECD, 2001c, Chapter 3).

What would be the fiscal effects of a merger of the two tax regimes? From the viewpoint of foreign investors, it would be disadvantageous if the standard rate were not lowered, but set at 33 per cent (or raised above that), while rendering FIEs liable to that rate. From the viewpoint of the Chinese government, the consequent increase in tax revenue would depend on the inelasticity of response by foreign investors, which may be quite large. Tax considerations can break, but do not usually make, a decision as to whether a foreign company should invest. Even if investment decisions already taken remained unchanged, the increase in tax revenue would not be very large as a proportion of the government budget, considering that the contribution of the corporate income tax paid by companies with foreign status to the budget was only 2.2 per cent in 1999. If a single tax rate were extended without concession to all enterprises, foreign companies might increase their contribution to the Chinese state budget by a maximum of 2 percentage points. However, since some investors might be put off, and considering that grandfathering clauses will probably protect concessions already extended, while some incentives, such as those in the Western and Central regions, will still remain in place, such an increase would probably not exceed 1 percentage point.

Lack of transparency

The rules governing tax incentives are complex and confusing. Although most tax incentives are specified in taxation laws and regulations, their application is not automatic. Submissions must be filed and the relevant Chinese agencies must approve them. The implementation of the regulations may further vary according to location. There appear to be numerous grey areas in the application of tax incentives, so that eligibility is not clearly defined in all cases. Foreign investors may, in the course of their negotiations regarding their investment projects with local governments, on occasion acquire unrealistically optimistic expectations regarding their future tax treatment. Such expectations may prove unfounded, since only the State Administration of Taxation (SAT), not the local authority, is entitled to provide special tax arrangements. Some development zones and high-tech zones have allegedly been established without prior approval of the central government, rendering any incentives they may offer less than totally reliable.

The area of taxation related to FIEs remains less than wholly transparent, both in regard to the complex tax incentive system, which, is not directly affected by WTO entry, and in regard to the two-tier corporate income tax system. Although the latter is likely to be replaced by a single tax rate, the tax incentive system may continue to provide room for manoeuvre. The ultimate effectiveness of tax incentives depends largely on how successful companies are in responding to them.

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Table 6.4. **Tax Administration related to FIEs and foreign enterprises**

Tax category	Tax collection agency				Revenue assignment	
	SAT	Local tax office	Customs duty	Fiscal bureau	Centre	Regional/local
1. VAT	x				75%	25%
2. Consumption tax	x				100%	
3. Business tax	x[a]	x			x (3%)[f]	x (everything else)
4. Custom duty			x		X	
5. Corporate income tax	x[b]	x			x[b]	x
6. Personal income tax	x[c]	x			x[c]	x
7. Resource tax	x[d]	x			x[d]	x
8. Land appreciation tax		x				x
9. Urban real estate tax		x				x
10. Vehicle tax		x				x
11. Stamp tax	x[e]	x			x (Stock transactions: 88%)	x (Stock transactions 12%), all the rest
12. Contract tax		x		X		x
13. Slaughter tax		x				x
14. Agricultural tax				X		x

a) Large State-Owned Enterprises, headquarters of corporation.
b) State-owned Enterprises, financial institutions, off shore oil companies, foreign enterprises and FIEs. The tax revenue belongs to the centre.
c) Bank deposits.
d) Off shore oil.
e) Stock exchange transaction (*zhengjuan jiaoyi*).
f) Big companies, headquarters: tax rate percentage points beyond up to 3% belong to the centre.
Source: OECD.

Double taxation treaties

The Chinese tax system is both a source-based and a residency-based system. The source of income or capital gain, together with the nature of the recipient's connection with China, determine whether such income or capital gain falls within the Chinese tax net. The income concerned need not have a Chinese source as long as the recipient has a relevant connection with China. All China-sourced income is automatically subject to taxation in China, regardless of the recipient's connection with China. It follows that attention has to be given to both factors when deciding whether income or gain has a tax nexus with China. Once that nexus is established in relation to an item of income, it remains to be determined how that income is to be taxed.

The primary factor in determining whether a potential taxpayer has a relevant connection with the People's Republic of China is that of residency. In the case of individuals, it is also necessary to consider the individual's ordinary residence and domicile. For example, personal income is only subject

to Chinese taxes if the beneficiary has resided in China for more than 183 days during the relevant tax year.

Double taxation treaties regulate the taxation of both income and capital if the source of the income is different from the residency status of the taxpayer. In the light of its increasing economic interdependence and co-operation with other countries, China has recognised the need to establish a comprehensive network of bilateral taxation agreements in order to avoid double taxation. Since 1978, it has concluded double taxation treaties with 76 countries; 63 of these treaties were effective as of May 2002. Double taxation treaties are in place with all the OECD member countries except for Mexico (see Annex II, Table 31).

Annex II, Table 32 shows the withholding tax rates (in per cent) on Chinese source dividends, interest and royalties paid to a resident of other contracting states. The provisions follow in most cases by and large the OECD Model Convention (MC) for the taxation of dividends, interests and royalties.

The tax charged for dividends in the Contracting State of which the company paying the dividends is resident does except for Thailand not exceed 15 per cent of the gross amount of the dividends. For most OECD countries the general rates are set at 10 per cent. Likewise, the provisions regarding the taxation of interests arising in a Contracting State and paid to a resident of the other Contracting State charge except for Brazil not more than 10 per cent.

Notes

1. China WTO Notification and Enquiry Center, Ministry of Commerce, 2, Dong Chang An Street, Beijing 100731, PR China, Tel: 0086-10-65197341, Fax: 0086-10-65197340.
2. China's 900 page WTO obligations were drafted in English, while, in order to be implemented, the WTO obligations must be converted into domestic law, which of course is only in Chinese. Thus, it remains to be seen, whether these "translations" comply with the original WTO commitments.
3. Australia, Canada, Denmark, New Zealand and the United States.
4. Prior to 1994, the gap between foreign and domestic income tax was even larger. State-owned enterprises used to be taxed at a 55 per cent rate.
5. Some specifically designed areas in the Western parts of Hunan, Hubei and Jilin provinces are equally entitled to grant these preferential policies.

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Chapter 7

Bilateral investment treaties

Abstract. *China has signed bilateral investment treaties (BITs) with more than 100 countries. These mostly adopt the so-called European BIT model based on the 1967 OECD Draft Convention on the Protection of Foreign Property whose provisions apply only to investment and investors after establishment.*

China has an established bilateral investment treaty (BIT) programme and continues to pursue opportunities to enter into new treaties. Currently, China disposes of a BIT network which comprises more than 100 countries (102 by the end of 2001). Of these, 27 treaties were concluded with OECD members (not including the United States, Canada and Mexico). The speed of signing agreements accelerated after the adoption of the first treaty with Sweden in 1982. In the 1990s China was party to 66 bilateral investment treaties. Overall, China ranks third (after Germany and Switzerland) among the top countries in terms of the number of BITs concluded and first among developing countries and transition economies.

China initially concluded its BITs in the 1980s with developed capital-exporting countries (25 in total). The pattern changed in the early 1990s, when China started signing BITs with the governments of other developing countries and transition economies. 57 BITs were signed with developing countries by the end of 1999, 20 with developed countries and 17 with the Central and Eastern European countries of transition. Among the developing countries, the countries of the Asia and Pacific region have concluded the largest number of BITs with China with more than 50 per cent of the total (33 BITs). The Central and Eastern European transition economies were also actively involved in BIT agreements during the 1990s, signing 17 contracts with China during that time. China has also signed 15 BITs with countries in Africa and 9 with countries in Latin America and the Caribbean.

China became an adherent to the *United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards* on 22 January 1987. This so-called New York Convention of 1958 is considered the most important multilateral treaty on international arbitration. China is equally a member of the *Washington Convention on the Settlement of Investment Disputes between States and Nationals of other States* of 18 March 1965 which China signed on 9 February 1990. China's membership of the Washington Convention came into full effect on 6 February 1993.

These trends demonstrate the importance China attaches to promoting inbound FDI. They will also be of increasing use in protecting China's own outward-bound FDI, which is starting to assume significant proportions.

China's BITs appear to be based on the European BIT model rather than on that of the United States Bilateral Investment Treaty Programme in that they do not include a clause allowing national treatment in the pre-entry

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phase. China has not yet concluded a BIT with the United States. MFN is accorded to China's investment partners on a post-entry basis.

In other respects, China's BITs follows both models in, for example, guaranteeing that expropriation will not occur unless it is in the public interest, in accordance with domestic law, conducted without discrimination and subject to compensation. They also guarantee investors the right to transfer funds, including profits, dividends, interest, money from the liquidation of investments, royalties, service fees and other legitimate earnings immediately at the prevailing market exchange rate.

Dispute resolution mechanisms generally provided in China's BITs include both resort to domestic judicial bodies for unresolved disputes between investors and host countries or nationals of host countries, accompanied by provision for the establishment of arbitration tribunals comprising nationals from both contracting parties and from a third country, though resort to external arbitration is not automatic.

Investment from Chinese Taipei is protected by a law passed in March 1994 on the Protection of Investment of Taiwan Compatriots. This law protects investments by "Taiwan compatriots" in a similar fashion to the protection provided under BITs with foreign countries. Nationalisation or requisition is only allowed in accordance with law and subject to compensation. Lawful returns on investment and other earnings may be remitted to Chinese Taipei or outside China. Arbitration of disputes is to be conducted in accordance with the arbitration clause in the establishment contract of the enterprise concerned, or, if there is none, by suit in a people's court.

A list of BITs to which China is signatory appears in Annex II, Table 33.

ANNEX I

The international comparability of China's FDI statistics1

	International Standard and recommendation for FDI statistics (IMF/OECD guidelines[1])	FDI statistics of MOFCOM[2]
Main breakdowns of FDI	FDI flows, positions (stocks) and income for inward and outward investment	The transactions data relates mostly to FDI inflows while outflows are based on the UN statistics. MOFCOM does not compile FDI stocks but used cumulated flows as a proxy. There are no statistics on FDI income. *The limited coverage does not provide a complete analysis of FDI in China while stock and flow analysis provide different indicators and FDI income allows for the analysis of the earnings of foreign enterprises.*
Foreign direct investment (definition)	A category of international investment made by a resident entity in one economy (direct investor) with the objective of establishing a lasting interest in an enterprise resident in an economy other than that of the investor (direct investment enterprise). "Lasting interest" implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor (evidenced by the 10 per cent rule explained below) on the management of the direct investment enterprise. Direct investment involves both the initial transactions between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated.	All foreign investments are included in MOFCOM statistics disregarding the percentages of equity ownership. *Non-compliance with the standard definition of FDI is the initial obstacle to the international comparability of the statistics. There may be greater discrepancies in the future as the nature of foreign investment in China is diversified.* MOFCOM statistics are understood to relate only to initial transactions, *which is likely to result in an underestimation of the amount of transactions over a given period of time.*

1 For the purpose of the present appendix, the analysis is limited only to broad issues. However, there are other aspect of FDI statistics which are equally important and which should be reviewed for a more complete assessment of the international comparability of FDI statistics of China.

	International Standard and recommendation for FDI statistics (IMF/OECD guidelines[1])	FDI statistics of MOFCOM[2]
Foreign direct investment enterprise (definition)	An incorporated enterprise in which a foreign investor owns 10 per cent or more of the ordinary shares or voting power for an incorporated enterprise or an unincorporated enterprise in which a foreign investor has equivalent ownership. Ownership of 10 per cent of the ordinary shares or voting stock is the guideline for determining the existence of a direct investment relationship. An "effective voice in the management", as evidenced by an ownership of at least 10 per cent. Absolute control by the foreign investor is not required. Direct investment enterprises are defined as those entities that are either directly or indirectly owned by the direct investor and comprise: subsidiaries, associates and branches.	MOFCOM statistics include the following (according to their definitions): • Equity joint-ventures. • Contractual joint-ventures. • Wholly foreign-owned enterprises. • FDI share-holding system. • Joint exploration. *The definition of MOFCOM does not necessarily follow the international guidelines and may therefore include cases which are not considered as FDI enterprises by internationally recognised standards.*
Standard components included in FDI statistics	*Equity capital:* equity in branches, all shares in subsidiaries and associates and other capital contributions. *Reinvested earnings:* direct investors' shares in proportion to equity held of earnings that foreign subsidiaries and associated enterprises do not distribute as dividends and earnings that branches and other unincorporated enterprises do not remit to direct investors. *Other capital:* borrowing or lending of funds between direct investors and subsidiaries, branches, and associates – including debt securities, suppliers' credit, and non-participating, preferred shares.	MOFCOM observes only the equity capital transactions but not the reinvested earnings or other capital transactions. *Excluding such reinvested earnings may result in the underestimation or overestimation of FDI in China*.
Contractual value *versus* realised value	These FDI classifications are not recommended by internationally recognised standards.	MOFCOM provides different classifications of FDI data: "contractual" and "realised" FDI. *The interpretation of these series is difficult for analytical purposes as the underlying concepts and definitions and the methods of calculation are not clearly explained.*

	International Standard and recommendation for FDI statistics (IMF/OECD guidelines[1])	FDI statistics of MOFCOM[2]
Geographical allocation	*Debtor/creditor principal:* transactions resulting from changes in financial claims of the compiling economy are allocated to the country or residence of the non-resident debtor, and transactions resulting in changes in financial liabilities are allocated to the country of residence of the non-resident creditor, even if the amounts are paid to or received from a different country.	It appears that the method used by MOFCOM for the geographical allocation of FDI is more in line with the *transactor principal* whereby transactions are allocated to the transactor, even if this is not the country of residence of the direct investment enterprise or direct investor (a method not recommended by internationally recognised standards). *The use of such a method explains, to a large extent, the classification of off-shore centres amongst the largest investors in China (even if in many cases transactions are made on behalf of investors from other countries or relate to round-tripping of domestic)*
Industrial classification and allocation of sectors	Industry classification should be based on the *United Nations International Standard Industrial Classification for all Economic Activities* (ISIC) which enables a comprehensive cross-country comparison. OECD recommends that direct investment enterprise be analysed both by its industrial activity in the host country and by the industrial activity of its direct investment.	MOFCOM statistics are based on a national classification of economic activities. *Consequently, international comparison is difficult.* The method used by MOFCOM for the allocation of industry classification is not indicated.
Data sources and collection methods	There are three major sources: enterprise surveys, international transactions reporting systems, and administrative sources. A large number of OECD countries use enterprise surveys or ITRS as their primary data source for FDI flows and stocks. Administrative sources are used in only a few countries as a secondary source for verification.	MOFCOM statistics rely on administrative sources. *Keeping in mind that the data sources have a direct impact on the ability to implement internationally recognised standards, it is strongly recommended to use enterprise surveys and ITRS for compiling FDI statistics of China.*

1. Reference: OECD *Benchmark Definition of Foreign Direct Investment, 3rd edition* and IMF *Balance of Payments Manual, 5th edition.*
2. Reference: *Statistics on FDI in China*, MOFTEC.

ANNEX II

Statistical tables

Table 1. **Growth of FDI inflows, 1979-2001**

	Projects (Number)	Contracted (US$ million)	Realised (US$ million)
Total stock as of 2000	363 885	676 098	348 349
1979-82	920	4 958	1 769
1983	638	1 917	916
1984	2 166	2 875	1 419
1985	3 073	6 333	1 956
1986	1 498	3 330	2 244
1987	2 233	3 709	2 314
1988	5 945	5 297	3 194
1989	5 779	5 600	3 393
1990	7 273	6 596	3 487
1991	12 978	11 977	4 366
1992	48 764	58 124	11 008
1993	83 437	111 436	27 515
1994	47 549	82 680	33 767
1995	37 011	91 282	37 521
1996	24 556	73 276	41 726
1997	21 001	51 003	45 257
1998	19 799	52 102	45 463
1999	16 918	41 223	40 319
2000	22 347	62 380	40 715
2001	26 140	69 195	46 878

Source: MOFCOM FDI Statistics.

Table 2. **Growth of cumulative FDI, 1979-2001**

	Projects (Number)	Contracted (US$ million)	Realised (US$ million)
1979-82	920	4 958	1 769
1983	1 558	6 875	2 685
1984	3 724	9 750	4 104
1985	6 797	16 083	6 060
1986	8 295	19 413	8 304
1987	10 528	23 122	10 618
1988	16 473	28 419	13 812
1989	22 252	34 019	17 205
1990	29 525	40 615	20 692
1991	42 503	52 592	25 058
1992	91 267	110 716	36 066
1993	174 704	222 152	63 581
1994	222 253	304 832	97 348
1995	259 264	396 114	134 869
1996	283 820	469 390	176 595
1997	304 821	520 393	221 852
1998	324 620	572 495	267 315
1999	341 538	613 718	307 634
2000	363 885	676 098	348 349
2001	390 025	745 291	395 223

Source: MOFCOM FDI Statistics.

Table 3. **FDI inflows to China and all OECD member countries, 1998-2001**
(US$ billion)

Country or territory	1998	1999	2000	2001
China	43.8	38.8	38.4	46.9
Austria	4.5	3.0	8.8	5.9
Belgium and Luxembourg	22.7	38.7	243.3	51.0
Canada	22.6	25.2	63.3	27.6
Denmark	7.7	6.8	14.5	4.1
France	31.0	47.1	42.9	52.6
Germany	24.6	54.8	195.2	31.8
Greece	-	0.6	1.1	1.6
Iceland	0.1	0.1	0.2	0.2
Ireland	8.9	19.0	24.1	9.8
Italy	4.3	6.9	13.4	14.9
Netherlands	37.9	31.9	54.3	55.6
Norway	4.0	7.5	6.0	2.2
Portugal	3.1	1.2	6.4	3.3
Spain	11.8	15.8	37.5	21.8
Sweden	19.6	60.9	23.4	12.9
Switzerland	8.9	11.7	16.3	10.0
Turkey	1.0	0.8	1.7	3.3
United Kingdom	70.6	82.9	119.7	53.8
United States	179.0	289.5	307.7	130.8
Japan	10.2	21.1	29.0	17.9
Finland	2.1	4.6	8.8	3.6
Australia	6.1	5.7	11.9	5.1
New Zealand	1.8	0.9	1.3	3.2
Mexico	11.9	12.5	14.7	24.7
Czech Republic	3.7	6.3	5.0	4.9
Hungary	2.0	2.0	1.6	2.4
Poland	6.4	7.3	9.3	6.8
Korea	5.2	10.7	10.1	3.2
Slovak Republic	0.5	0.4	2.1	0.6

Source: IMF, International Financial Statistics (for China, except for 2001, where the figure is from the National Bureau of Statistics); OECD, *International Investment Perspectives*, No. 1, 2002 (OECD countries).

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Table 4. **FDI per capita in China and all OECD member countries, 2000 (US$)**

Country or territory	FDI per capita
China	30.1
Austria	1 089.1
Belgium and Luxembourg	4 770.8
Canada	897.0
Denmark	2 720.5
France	728.5
Germany	2 370.1
Greece	109.9
Iceland	714.3
Ireland	6 276.0
Italy	232.0
Netherlands	3 412.9
Norway	1 336.3
Portugal	329.7
Spain	950.1
Sweden	2 415.6
Switzerland	2 273.4
Turkey	25.2
United Kingdom	2 011.8
United States	1 117.8
Japan	228.6
Finland	1 698.8
Australia	621.1
New Zealand	339.4
Mexico	146.6
Czech Republic	486.9
Hungary	159.7
Poland	240.6
The Republic of Korea	213.6
Slovakia	388.9

Source: Calculated from IMF, International Financial Statistics, October 2002.

Table 5. **FDI inflows to China and selected developing countries, 1995-2001**
(US$ million)

Country or territory	1995	1996	1997	1998	1999	2000	2001
China	35 849	40 180	44 237	43 751	38 753	40 710	46 880
Hong Kong (China)	–	–	–	14 776	24 587	61 883	22 834
Myanmar	277	310	387	314	253	255	n.a.
India	2 144	2 426	3 577	2 635	2 169	2 315	n.a.
Indonesia	4 346	6 194	4 677	–356	–2 745	–4 550	n.a.
Malaysia	4 178	5 078	5 137	2 163	3 895	3 788	n.a.
Philippines	1 478	1 517	1 222	2 287	573	1 241	1 792
Singapore	8 788	10 372	12 967	6 316	7 197	6 390	n.a.
Thailand	2 068	2 336	3 895	7 315	6 213	3 366	3 820
Vietnam	–	2 395	2 220	1 671	1 412	1 298	n.a.
South Africa	1 248	816	3 811	550	1 503	969	7 162
Argentina	5 609	6 948	9 160	7 291	23 988	11 657	3 214
Brazil	48 590	11 200	19 650	31 913	28 576	32 779	22 636
Chile	2 957	4 633	5 219	4 638	9 221	3 675	n.a.

Source: IMF, International Financial Statistics, October 2002; National Bureau of Statistics, *China Statistical Abstract [zhongguo tongji zhaiyao], 2002* (China figures for 2000 and 2001).

Table 6. **FDI inflows per capita to China and selected countries and territories, 2000 (US$)**

Country or territory	FDI per capita
China	30.1
Hong Kong (China)	9 277.8
Myanmar	5.3
India	2.2
Indonesia	–21.6
Malaysia	162.8
Philippines	16.3
Singapore	1 547.2
Thailand	54.0
Vietnam	16.7
South Africa	22.2
Argentina	314.8
Brazil	195.4
Chile	241.6

Source: Calculated from IMF, International Financial Statistics, October 2002.

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Table 7. **FDI by type, 1979-2000 (US$ million realised FDI)**

	Equity joint ventures	Share of total %	Contractual joint ventures	Share of total %	Wholly-foreign-owned	Share of total %	Joint exploitation	Share of total %	Compensation trade	Share of total %	Foreign-invested shareholding enterprises	Share %	Other	Share of total %	Total
1979-82	103.0	5.8	530.0	29.9	0.0	0.0	487.0	27.5	413.0	23.3	0.0	0.0	237.0	13.4	1 770.0
1983	73.6	8.0	227.4	24.8	42.8	4.7	291.5	31.8	197.3	21.5	0.0	0.0	83.5	9.1	916.0
1984	254.7	18.0	465.0	32.8	14.9	1.1	522.9	36.9	98.5	6.9	0.0	0.0	62.8	4.4	1 418.9
1985	579.9	29.6	585.0	29.9	13.0	0.7	480.6	24.6	168.6	8.6	0.0	0.0	129.1	6.6	1 956.2
1986	804.5	35.9	793.8	35.4	16.3	0.7	260.3	11.6	181.1	8.1	0.0	0.0	187.7	8.4	2 243.7
1987	1 485.8	56.1	620.0	23.4	24.6	0.9	183.2	6.9	222.3	8.4	0.0	0.0	110.8	4.2	2 646.6
1988	1 975.4	52.9	779.5	20.9	226.2	6.1	212.6	5.7	316.6	8.5	0.0	0.0	221.4	5.9	3 731.7
1989	2 037.2	54.0	751.8	19.9	371.4	9.8	232.2	6.2	261.3	6.9	0.0	0.0	119.6	3.2	3 773.5
1990	1 886.1	50.2	673.6	17.9	683.2	18.2	244.3	6.5	158.7	4.2	0.0	0.0	109.0	2.9	3 754.9
1991	2 299.0	49.3	763.6	16.4	1 134.7	24.3	169.0	3.6	208.3	4.5	0.0	0.0	92.0	2.0	4 666.6
1992	6 114.6	54.2	2 122.5	18.8	2 520.3	22.3	250.1	2.2	172.3	1.5	0.0	0.0	111.8	1.0	11 291.6
1993	15 347.8	55.3	5 237.6	18.9	6 505.6	23.4	424.0	1.5	89.7	0.3	0.0	0.0	166.2	0.6	27 770.9
1994	17,932.5	52.8	7 120.2	21.0	8 035.6	23.7	678.2	2.0	88.9	0.3	0.0	0.0	90.4	0.3	33 945.8
1995	19 077.9	50.5	7 535.6	19.9	10 3168	27.3	590.2	1.6	211.5	0.6	0.0	0.0	73.7	0.2	37 805.7
1996	20 754.5	49.3	8 109.4	19.2	12 6061	29.9	255.5	0.6	158.3	0.4	0.0	0.0	251.3	0.6	42 135.2
1997	19 495.4	41.7	8 930.0	19.1	16 1875	34.6	356.0	0.8	90.0	0.2	288.2	0.6	1 383.3	3.0	46 730.3
1998	18 388.0	40.4	9 719.0	21.4	16 470.0	36.2	179.0	0.4	0.0	0.0	707.0	1.6	0.0	0.0	45 463.0
1999	15 827.0	39.3	8 234.0	20.4	15 545.0	38.6	384.0	1.0	0.0	0.0	292.0	0.7	0.0	0.0	40 319.0
2000	14 343.0	35.2	6 596.0	16.2	19 264.0	47.3	382.0	0.9	0.0	0.0	130.0	0.3	0.0	0.0	40 715.0
2001	15 754.0	33.6	6 212.0	13.3	23 873.0	50.9	511.0	1.1	0.0	0.0	528.0	1.1	0.0	0.0	46 878.0

1. From 1997, compensation trade is not included in the official figures for realised FDI inflows. It is included in the total here to show how the proportion of compensation trade has changed over the whole period. Total realised FDI calculated from this table is therefore higher than the official total, from which compensation trade has since been excluded, and all percentages therefore differ from those calculated with compensation trade omitted.

Source: MOFCOM FDI Statistics.

Table 8. . **Cross-border mergers and acquisitions, inflows by country, 1998-2001, China, OECD countries and selected other countries**

(US$ billion)

	1998	1999	2000	2001
China	4.5	10.2	45.2	5.4
Hong Kong (China)	3.7	9.5	15.1	13.8
Singapore	0.8	5.9	2.2	6.3
Argentina	12.7	25.1	11.5	5.5
Brazil	31.1	11.1	34.4	9.6
Chile	2.7	8.3	4.6	5.1
Australia	12.8	29.2	19.2	17.6
Austria	4.4	0.2	2.7	10.3
Belgium-Luxembourg	65.4	37.9	12.5	18.9
Canada	18.3	31.2	139.3	50.9
Czech Republic	2.9	3.4	2.9	2.0
Denmark	9.6	6.5	14.1	1.5
Finland	22.7	4.9	5.0	4.3
France	38.5	29.3	50.8	27.5
Germany	20.1	63.8	293.2	60.8
Greece	3.8	7.1	1.4	1.3
Hungary	1.2	1.1	3.9	0.6
Iceland	0.0	0.1	0.0	0.0
Ireland	0.7	6.9	5.5	6.5
Italy	27.9	42.7	20.1	17.0
Japan	19.3	22.9	19.9	17.8
Korea	7.3	19.6	9.7	11.4
Mexico	3.5	1.2	25.4	16.3
Netherlands	28.4	45.8	40.0	16.1
New Zealand	2.6	4.8	4.4	3.3
Norway	1.5	6.2	10.2	5.3
Poland	2.8	7.3	10.4	3.5
Portugal	5.4	2.9	9.8	0.8
Slovakia	0.0	0.1	1.8	1.3
Spain	17.0	13.0	24.9	9.7
Sweden	14.0	58.7	29.0	12.8
Switzerland	16.4	19.0	28.4	17.4
Turkey	0.3	0.1	3.6	0.7
United Kingdom	80.5	147.6	214.8	112.7
United States	189.8	265.9	269.5	188.0

Source: Dealogic, cited in OECD, *International Investment Perspectives*, No. 1, 2002.

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Table 9. Cumulative FDI inflows by source as of 2000

	Contracted (US$ million)	Share (%)	Realised (US$ million)	Share (%)
Hong Kong (China)	327 918	48.5	170 297	48.9
United States	60 611	9.0	30 032	8.6
Japan	38 814	5.7	27 801	8.0
Chinese Taipei	47 816	7.1	26 160	7.5
Singapore	35 380	5.2	16 992	4.9
British Virgin Islands	27 926	4.1	13 228	3.8
The Republic of Korea	18 706	2.8	10 326	3.0
United Kingdom	16 975	2.5	8 748	2.5
Germany	12 235	1.8	5 853	1.7
Macao (China)	9 482	1.4	4 871	1.4
France	5 748	0.8	4 435	1.3
Netherlands	9 657	1.4	3 984	1.1
Canada	7 484	1.1	2 990	0.9
Malaysia	7 934	1.2	2 329	0.7
Australia	4 935	0.7	2 205	0.6
Total	**676 097**	**100.0**	**348 346**	**100.0**

Source: MOFCOM FDI Statistics.

Table 10. Changing sources of FDI, 1986-2000

(% of total realised FDI inflow for year)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Hong Kong (China) and Macao (China)	59.2	69.1	65.6	61.2	54.9	57.0	70.0	64.9	59.8	54.6	51.0	46.5	41.6	41.4	38.9
European Union	8.0	2.3	4.9	5.5	4.2	5.6	2.2	2.4	4.6	5.7	6.6	9.2	8.8	11.1	11.0
United States	14.5	11.4	7.4	8.4	13.1	7.4	4.6	7.5	7.4	8.2	8.3	7.2	8.6	10.5	10.8
Japan	11.7	9.5	16.1	10.5	14.4	12.2	6.5	4.8	6.2	8.3	8.8	9.6	7.5	7.4	7.2
Chinese Taipei	–	–	–	4.6	6.4	10.7	9.5	11.4	10.0	8.4	8.3	7.3	6.4	6.5	5.6

Source: MOFCOM FDI Statistics.

Table 11. Proportion of China's trade and investment of selected non-OECD countries and territories in 2000

Country or territory	Proportion of China's two-way trade	Proportion of contracted FDI	Proportion of realised FDI
Hong Kong (China)	17.9	27.2	38.1
British Virgin Islands	0.0	12.1	9.4
Chinese Taipei	12.3	6.5	5.6
Singapore	4.3	3.3	5.3
Cayman Islands	0.0	5.0	1.5
Macao (China)	0.3	0.6	0.9

Source: China Statistical Yearbook, 2001; MOFCOM FDI Statistics.

Table 12. **Proportion of China's trade and investment of selected OECD countries in 2000**

	Proportion of China's two-way trade	Proportion of contracted FDI	Proportion of realised FDI
United States	15.7	12.8	10.8
Japan	17.5	5.9	7.2
The Republic of Korea	7.3	3.8	3.7
United Kingdom	2.1	1.3	2.9
Germany	4.2	4.7	2.6
France	1.6	1.0	2.1
Netherlands	1.7	5.5	1.9
Australia	0.7	1.1	0.8
Canada	0.7	1.4	0.7

Source: China Statistical Yearbook, 2001; MOFCOM FDI Statistics.

Table 13. **Regional distribution of cumulative FDI inflows as of 2000**

Locality	Projects (number)	Share (%)	Contractual Value (US$ million)	Share (%)	Realized Value (US$ million)	Share (%)
Total	**363 885**	**100.0**	**676 096.9**	**100.0**	**348 345.5**	**100**
Beijing	15 870	4.4	30 775.6	4.6	14 398.4	4.1
Tianjin	13 654	3.8	27 645.0	4.1	13 274.6	3.8
Hebei	9 619	2.6	14 128.0	2.1	6 797.5	2.0
Shanxi	2 106	0.6	3 597.6	0.5	1 525.9	0.4
Inner Mongolia	1 512	0.4	1 703.6	0.3	640.9	0.2
Liaoning	21 218	5.8	37 665.1	5.6	14 844.5	4.3
Dalian	9 035	2.5	20 749.8	3.1	8 579.2	2.5
Jilin	5 964	1.6	5 627.8	0.8	2 921.7	0.8
Heilongjiang	6 198	1.7	5 909.8	0.9	3 663.9	1.1
Shanghai	22 032	6.1	64 739.6	9.6	28 339.8	8.1
Jiangsu	40 569	11.2	85 287.4	12.6	43 730.5	12.6
Zhejiang	18 369	5.1	24 221.4	3.6	11 187.6	3.2
Ningbo	5 090	1.4	8 669.6	1.3	3 999.4	1.2
Anhui	4 677	1.3	5 513.8	0.8	3 034.3	0.9
Fujian	27 766	7.6	64 082.7	9.5	33 510.4	9.6
Xiamen	4 795	1.3	17 426.2	2.6	10 801.4	3.1
Jiangxi	5 236	1.4	4 677.7	0.7	2 712.9	0.8
Shandong	29 046	8.0	41 617.2	6.2	21 109.1	6.1
Qingdao	7 602	2.1	13 783.6	2.0	6 547.4	1.9
Henan	6 325	1.7	8 290.4	1.2	4 317.4	1.2
Hubei	8 157	2.2	9 799.1	1.5	6 429.6	1.9
Hunan	5 721	1.6	7 377.4	1.1	5 243.4	1.5
Guangdong	84 237	23.2	171 849.6	25.4	98 192.1	28.2
Shenzhen	17 612	4.8	27 672.0	4.1	15 759.8	4.5
Guangxi	7 003	1.9	13 387.5	2.0	6 943.1	2.0
Hainan	8 894	2.4	11 896.7	1.8	6 229.8	1.8
Sichuan	5 404	1.5	7 794.3	1.2	3 178.6	0.9
Chongqing	2 898	0.8	4 047.6	0.6	2 248.9	0.7
Guizhou	1 423	0.4	1 622.4	0.2	422.4	0.1
Yunnan	1 959	0.5	2 820.2	0.4	969.8	0.3
Tibet	20	0.0	12.6	0.0	0.0	0.0
Shaanxi	3 197	0.9	5 852.2	0.9	3 046.0	0.9
Gansu	1 379	0.4	1 059.1	0.2	456.2	0.1
Qinghai	242	0.1	368.8	0.1	19.7	0.0
Ningxia	587	0.2	472.2	0.1	128.6	0.0
Xinjiang	1 002	0.3	1 058.3	0.2	369.7	0.1
Central ministries and commissions	1 601	0.4	11 196.7	1.7	8 458.7	2.4

Source: MOFCOM FDI Statistics.

Table 14. **Regional distribution of FDI inflows in 2000**

Locality	Projects (number)	Share (%)	Contractual Value (US$ million)	Share (%)	Realized Value (US$ million)	Share (%)
Total	**22 347**	**100.0**	**62 379.5**	**100.0**	**40 714.8**	**100.0**
Beijing	1 145	5.1	3 549.3	5.7	1 683.7	4.1
Tianjin	625	2.8	3 539.2	5.7	1 166.0	2.9
Hebei	492	2.2	1 184.1	1.9	679.2	1.7
Shanxi	71	0.3	261.7	0.4	224.7	0.6
Inner Mongolia	95	0.4	258.0	0.4	105.7	0.3
Liaoning	1 851	8.3	4 991.4	8.0	2 044.5	5.0
Dalian	693	3.1	2 255.8	3.6	1 112.3	2.7
Jilin	363	1.6	596.5	1.0	337.0	0.8
Heilongjiang	260	1.2	282.8	0.5	300.9	0.7
Shanghai	1 814	8.1	6 364.4	10.2	3 160.1	7.8
Jiangsu	2 645	11.8	11 250.9	18.0	6 425.5	15.8
Zhejiang	1 642	7.4	2 509.5	4.0	1 612.7	4.0
Ningbo	550	2.5	951.5	1.5	621.9	1.5
Anhui	247	1.1	636.0	1.0	318.5	0.8
Fujian	1 463	6.6	4 469.5	7.2	3 431.9	8.4
Xiamen	259	1.2	1 159.7	1.9	659.6	1.6
Jiangxi	272	1.2	264.8	0.4	227.2	0.6
Shandong	2 728	12.2	5 074.4	8.1	2 971.2	7.3
Qingdao	1 128	5.1	2 662.2	4.3	1 308.0	3.2
Henan	237	1.1	699.2	1.1	564.0	1.4
Hubei	330	1.5	1 065.8	1.7	943.7	2.3
Hunan	320	1.4	665.1	1.1	678.3	1.7
Guangdong	4 243	19.0	11 519.6	18.5	11 280.9	27.7
Shenzhen	1 130	5.1	1 738.1	2.8	1 961.5	4.8
Guangxi	246	1.1	710.3	1.1	524.7	1.3
Hainan	184	0.8	137.1	0.2	430.8	1.1
Sichuan	293	1.3	604.8	1.0	436.9	1.1
Chongqing	190	0.9	357.2	0.6	244.4	0.6
Guizhou	55	0.3	67.4	0.1	25.0	0.1
Yunnan	106	0.5	297.5	0.5	128.1	0.3
Shaanxi	215	1.0	499.3	0.8	288.4	0.7
Gansu	76	0.3	123.4	0.2	62.4	0.2
Qinghai	42	0.2	122.3	0.2		
Ningxia	31	0.1	74.3	0.1	17.4	0.0
Xinjiang	58	0.3	92.3	0.2	19.1	0.1
Central ministries and commissions	8	0.0	111.8	0.2	381.9	0.9

Source: MOFCOM FDI Statistics.

Table 15. Cumulative FDI inflows to East, Central and West China as of 2001

Region	Projects (number)	Share (%)	Contractual value (US$ million)	Share (%)	Realised value (US$ million)	Share (%)
Total	**390 025**	**100.0**	**745 291**	**100.0**	**395 223**	**100.0**
East	315 053	80.8	643 923	86.4	339 726	86.0
Central	46 713	12.0	56 521	7.6	34 693	8.8
West	28 259	7.2	44 847	6.0	20 804	5.3

Source: MOFCOM FDI Statistics.

Table 16. FDI inflows to East, Central and West China in 2001

Region	Projects (number)	Share (%)	Contractual value (US$ million)	Share (%)	Realised value (US$ million)	Share (%)
Total	**26 140**	**100.0**	**69 195**	**100.0**	**46 878**	**100.0**
East	22 492	86.0	60 351	87.2	40 855	87.2
Central	2 133	8.2	4 873	7.0	4 101	8.8
West	1 515	5.8	3 971	5.7	1 922	4.1

Source: MOFCOM FDI Statistics.

Table 17. Sectoral distribution of FDI stock in 2000: primary, secondary and tertiary industries

Sector	Projects (number)	Share (%)	Contractual value (US$ million)	Share (%)
Total	**363 885**	**100.0**	**676 097**	**100.0**
Primary	10 355	2.9	12 310	1.8
Secondary	265 609	73.0	411 534	60.9
Tertiary	87 921	24.2	252 253	37.3

Source: MOFCOM FDI Statistics.

Table 18. Sectoral distribution of FDI inflows in 2000: primary, secondary and tertiary industries

Sector	Projects (number)	Share (%)	Contractual value (US$ million)	Share (%)	Realised value (US$ million)	Share (%)
Total	**22 347**	**100.0**	**62 380**	**100.0**	**40 715**	**100.0**
Primary	821	3.7	1 483	2.4	676	1.7
Secondary	16 257	72.80	45 988	73.7	28 670	70.4
Tertiary	5 269	23.6	14 909	23.9	11 369	27.9

Source: MOFCOM FDI Statistics.

Table 19. **Sectoral distribution of FDI stock in 2000: specific sectors**

Sector	Projects (number)	Share (%)	Contractual value (US$ million)	Share (%)
Total	**363 885**	**100.0**	**676 097**	**100.0**
Agriculture, forestry, animal husbandry and fishing	10 355	2.9	12 310	1.8
Industry	265 609	73.0	411 534	60.9
Construction	9 059	2.5	19 691	2.9
Transport, warehousing, post and telecommunications	4 027	1.1	16 386	2.4
Wholesale, retail and catering	18 410	5.1	23 396	3.5
Property and utilities	37 252	10.2	159 543	23.6
Healthcare, sports and social welfare	1 030	0.3	4 773	0.7
Education, culture, arts, broadcasting, film industry	1 336	0.4	2 123	0.3
Scientific research and technical services	2 510	0.7	2 124	0.3
Other sectors	14 297	3.9	24 217	3.6

Source: MOFCOM FDI Statistics.

Table 20. **Sectoral distribution of FDI inflows in 2000: specific sectors**

Sector	Projects (number)	Share (%)	Contractual value (US$ million)	Share %)	Realised value (US$ million)	Share (%)
Total	**22 347**	**100.0**	**62 380**	**100.0**	**40 715**	**100.0**
Agriculture, forestry, animal husbandry and fishing	821	3.7	1 483	2.4	676	1.7
Mining	162	0.7	506	0.8	583	1.4
Manufacturing	15 988	71.5	44 254	70.9	25 844	63.5
Utilities	107	0.5	1 227	2.0	2 242	5.5
Construction	233	1.0	831	1.3	905	2.2
Geological survey and water management	7	0.0	15	0.0	5	0.0
Transport, warehousing, post and telecommunications	306	1.4	1 417	2.3	1 012	2.5
Wholesale, retail and catering	852	3.8	1 435	2.3	858	2.1
Banking and insurance	5	0.0	79	0.1	76	0.2
Real estate	684	3.1	5 232	8.4	4 658	11.4
Social services	2 679	12.0	4 255	6.8	2 185	5.4
Healthcare, sports and social welfare	31	0.1	154	0.3	106	0.3
Education, culture, arts, broadcasting, film and television industries	19	0.1	83	0.1	54	0.1
Scientific research and comprehensive technical services	100	0.5	250	0.4	57	0.1
Other sectors	353	1.6	1 157.0	1.9	1 453	3.6

Source: MOFCOM FDI Statistics.

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Table 21. **Foreign direct investment in China by industry sector, 2001**

Industry	Number of projects	Contractual value	Actual input
Total	**261 400**	**69 194 550**	**46 877 590**
Agriculture, forestry, animal husbandry, and fishery	8 870	1 761 740	898 730
of which: Agriculture	5 360	961 940	513 190
Mining	1 490	644 480	811 020
of which: Petroleum and natural gas exploration	80	43 900	524 240
Manufacturing	191 060	48 846 860	30 907 470
of which:			
Textiles	8 810	2 396 690	1 917 480
Chemical raw material and products manufacturing	11 630	4 196 770	2 199 420
Pharmacy	–	–	–
General machine-building industry	3 370	1 306 560	621 750
Special equipment manufacturing	9 110	2 307 700	1 327 260
Electronics and telecommunications equipment manufacturing	7 940	1 578 010	774 350
	19 930	10 647 630	7 092 310
Production and supply of electricity, steam and hot water	1 360	2 134 220	2 272 760
Construction	2 560	1 822 810	806 700
Geological survey and water management	110	13 080	10 490
Transport, warehousing, post and telecommunications	2 970	883 540	908 900
Wholesale, retailing, and catering	12 320	1 398 060	1 168 770
Banking and insurance	80	86 120	35 270
Real estate	8 200	5 030 610	5 136 550
of which: Property development and operation	7 070	4 784 290	4 759 180
Social services	26 730	4 288 840	2 594 830
of which: Hotel industry	640	383 950	456 190
Health care, sports and social welfare	390	133 050	118 640
Education, culture, arts, broadcasting, film and television industries	280	71 740	35 960
Scientific research and comprehensive technical services	1 960	654 290	120 440
Other sectors	3 020	1 425 110	1 051 060

Source: MOFCOM Foreign Direct Investment Department.

Table 22. **Average project size in 2000 (US$1 000, realised investment basis)**

Sector	Realised
Total	**1 821.9**
Agriculture, forestry, animal husbandry and fishing	823.4
Mining	3 598.8
Manufacturing	1 616.5
Utilities	20 953.3
Construction	3 884.1
Geological survey and water management	714.3
Transport, warehousing, post and telecommunications	3 307.2
Wholesale, retail and catering	1 007.0
Banking and insurance	15 200.0
Real estate	6 809.9
Social services	815.6
Healthcare, sports and social welfare	3 419.4
Education, culture, arts, broadcasting, film and television industries	2 842.1
Scientific research and comprehensive technical services	570.0
Other sectors	4 116.1

Source: MOFCOM FDI Statistics [calculated from Table 20].

Table 23. **FDI inflows as a proportion of GDP**

	Realised FDI/GDP (%)
1979-82	0.1
1983	0.2
1984	0.4
1985	0.6
1986	0.6
1987	0.7
1988	0.8
1989	0.8
1990	0.9
1991	1.1
1992	2.3
1993	4.6
1994	6.2
1995	5.4
1996	5.1
1997	5.0
1998	4.8
1999	4.0
2000	3.8
2001	4.0

1. Calculated using current-price expenditure on gross domestic product, converted at the official exchange rate for the year.

Source: National Bureau of Statistics, China Statistical Abstract [Zhongguo tongji zhaiyao] 2002.

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Table 24. FDI as a proportion of GDP, China and OECD countries, 2001

(US$ billion)

	%		%
China	4.0	Greece	1.4
Canada	4.0	Hungary	4.6
Mexico	4.0	Iceland	2.6
United States	1.3	Ireland	9.5
Australia	1.4	Italy	1.4
Japan	0.4	Netherlands	14.6
Korea	0.8	Norway	1.3
New Zealand	6.4	Poland	3.9
Austria	3.1	Portugal	3.0
Belgium and Luxembourg	20.5	Slovak Republic	3.0
Czech Republic	8.7	Spain	3.7
Denmark	2.5	Sweden	6.1
Finland	3.0	Switzerland	4.0
France	4.0	Turkey	2.2
Germany	1.7	United Kingdom	3.8

Source: OECD, *Main Economic Indicators*, October 2002 (OECD countries); National Bureau of Statistics, China Statistical Abstract [zhongguo tongji zhaiyao], 2002 (China).

Table 25. FDI inflows as a proportion of fixed investment: China and OECD countries, 2001

	%		%
China	10.7	Japan	17.9
Australia[1]	8.4	Korea	3.2
Austria	5.9	Mexico[1]	14.7
Belgium-Luxembourg	98.1	Netherlands	55.6
Canada	3.0	New Zealand[1]	6.1
Czech Republic	4.9	Norway[1]	2.1
Denmark	4.1	Poland[1]	5.5
Finland	3.6	Portugal	3.3
France	52.6	Slovak Republic[1]	0.8
Germany	31.8	Spain	21.8
Greece[1]	4.0	Sweden	12.9
Hungary	2.4	Switzerland	10
Iceland	0.2	Turkey	3.3
Ireland[1]	9.8	United Kingdom	53.8
Italy	14.9	United States[1]	15.5

1. 2000 figures.

Source: Calculated from OECD Statistics (OECD countries) and National Bureau of Statistics, China Statistical Abstract [zhongguo tongji zhaiyao], 2002, for China.

Table 26. **Share of FIEs in total exports and imports, 1986-2001**

	FIE exports and imports as share of total (%)	FIE exports as share of total (%)	FIE imports as share of total (%)
1986	4.0	1.9	5.6
1987	5.6	3.1	7.8
1988	8.1	5.2	10.6
1989	12.3	9.4	14.9
1990	17.4	12.6	23.1
1991	21.3	16.8	26.5
1992	26.4	20.4	32.7
1993	34.3	27.5	40.2
1994	37.0	28.7	45.8
1995	39.1	31.5	47.7
1996	47.3	40.7	54.5
1997	47.0	41.0	54.6
1998	48.7	44.1	54.7
1999	50.8	45.5	51.8
2000	49.9	47.9	52.1
2001	50.8	50.1	51.7

Source: MOFCOM FDI Statistics.

Table 27. **FIE Exports and imports, 1986-2001**
(US$ million)

	Exports	Imports	Trade balance
1986	582	2 403	–1 821
1987	1 210	3 374	–2 164
1988	2 461	5 882	–3 421
1989	4 914	8 796	–3 882
1990	7 813	12 302	–4 489
1991	12 047	16 908	–4 861
1992	17 360	26 387	–9 027
1993	25 237	41 833	–16 596
1994	34 713	52 934	–18 221
1995	46 876	62 943	–16 067
1996	61 506	75 604	–14 098
1997	74 900	77 720	–2 820
1998	80 962	76 717	4 245
1999	88 628	85 884	2 744
2000	119 441	117 273	2 168
2001	133 235	125 862	7 372

Source: MOFCOM FDI Statistics.

Table 28. **. Contribution of FDI to trade by province, 2001**

Locality	FIE exports as a proportion of total exports (%)	FIE imports as a proportion of total imports (%)	Merchandise trade balance (US$ million)	FIE merchandis trade balance (US$ million)
Total	**50.1**	**51.7**	**22 550.0**	**7 372.2**
Beijing	27.5	13.6	–27 960.0	–2 167.3
Tianjin	74.8	83.4	810.0	–135.9
Hebei	28.8	37.1	2 180.0	481.1
Shanxi	10.5	22.9	1 000.0	46.8
Inner Mongolia	20.5	3.5	–780.0	79.4
Liaoning	57.2	67.1	2 210.0	393.6
Jilin	29.3	60.8	–290.0	–636.9
Heilongjiang	16.1	10.9	–160.0	66.4
Shanghai	57.8	62.6	–5 650.0	–4 879.9
Jiangsu	57.6	78.1	6 390.0	–907.0
Zhejiang	30.9	48.6	13 160.0	2 327.1
Anhui	18.9	41.8	940.0	–129.2
Fujian	59.5	77.5	5 230.0	1 541.4
Jiangxi	10.8	34.3	550.0	–55.9
Shandong	51.0	64.9	7 290.0	2 206.5
Henan	18.5	26.2	620.0	30.9
Hubei	27.8	45.9	20.0	–316.0
Hunan	12.1	34.7	750.0	–134.5
Guangdong	57.0	54.6	14 360.0	10 115.4
Guangxi	19.6	39.1	680.0	24.6
Hainan	37.5	53.6	–150.0	–208.8
Chongqing	8.4	30.3	370.0	–128.9
Sichuan	15.2	28.1	60.0	–187.4
Guizhou	10.5	8.3	190.0	25.2
Yunnan	8.8	13.7	490.0	7.1
Tibet	2.7	1.9	70.0	2.0
Shaanxi	9.7	27.1	160.0	–149.8
Gansu	11.0	12.1	180.0	16.8
Qinghai	1.0	43.5	100.0	–20.2
Ningxia	16.9	8.6	170.0	43.7
Xinjiang	8.8	3.4	–430.0	21.8

Source: China Statistical Abstract [Zhongguo Tongji Zhaiyao], 2002.

Table 29. **Employment in SOEs as a proportion of total urban employment, 1978-2000**

(%)

	SOEs	Collective enterprises	Private enterprises	Limited liability companies	Share holding companies	Foreign funded enterprises	Hong Kong, Macau and Taiwan funded enterprises	Self-employed individuals
1978	78.3	21.5						0.2
1979	76.9	22.7						0.3
1980	76.2	23.0						0.8
1981	75.7	23.2						1.0
1982	75.5	23.2						1.3
1983	74.7	23.4						2.0
1984	70.6	26.3						2.8
1985	70.2	26.0						3.5
1986	70.2	25.7				0.1		3.6
1987	70.0	25.3				0.1		4.1
1988	70.0	24.7				0.2		4.6
1989	70.2	24.3				0.3		4.5
1990	62.3	21.4	0.3			0.4		3.7
1991	62.8	21.4	0.4			0.6	0.4	4.1
1992	63.2	21.0	0.6			0.8	0.5	4.3
1993	62.1	19.3	1.1		0.9	0.8	0.9	5.3
1994	60.9	17.8	1.8		1.6	1.1	1.1	6.7
1995	59.0	16.5	2.5		1.7	1.3	1.4	8.2
1996	56.7	15.2	3.1		1.8	1.4	1.3	8.6
1997	54.7	14.3	3.7		2.3	1.5	1.4	9.5
1998	43.8	9.5	4.7	2.3	2.0	1.4	1.4	10.9
1999	40.8	8.1	5.0	2.9	2.0	1.5	1.5	11.5
2000	38.1	7.0	6.0	3.2	2.1	1.6	1.5	10.0

Source: OECD.

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Table 30. **. Number of employees in private enterprises and self-employed individuals by province, 2000**

		%
Beijing	436	0.6
Tianjin	590	0.8
Hebei	9 115	12.2
Shanxi	954	1.3
Inner Mongolia	2 011	2.7
Liaoning	4 043	5.4
Jilin	1 814	2.4
Heilongjiang	2 978	4.0
Shanghai	1 755	2.3
Jiangsu	5 161	6.9
Zhejiang	5 729	7.7
Anhui	4 016	5.4
Fujian	1 619	2.2
Jiangxi	1 871	2.5
Shandong	4 896	6.5
Henan	3 386	4.5
Hubei	3 235	4.3
Hunan	2 740	3.7
Guangdong	5 264	7.0
Guangxi	1 700	2.3
Hainan	396	0.5
Chongqing	1 366	1.8
Sichuan	2 498	3.3
Guizhou	790	1.1
Yunnan	1 283	1.7
Tibet	71	0.1
Shaanxi	2 982	4.0
Gansu	726	1.0
Qinghai	270	0.4
Ningxia	239	0.3
Xinjiang	831	1.1
Total	**74 765**	**100.0**

Source: National Bureau of Statistics, China Statistical Yearbook, 2001.

Table 31. **China's bilateral treaties for the avoidance of double taxation**

State	Date of signature	Date of entry into force
Armenia	5 May 1996	1 January 1997
Australia	17 November 1988	1 July 1991 (Australia)
		1 January 1991 (China)
Austria	10 April 1991	1 January 1993
Bangladesh	12 September 1996	1 January 1998 (China) 1 July 1998 (Bangladesh)
Barbados	15 May 2000	1 October 2000
Belarus	17 January 1995	1 January 1997
Belgium	18 April 1985	1 January 1988
Bosnia-Herzegovina	2 December 1988	1 January 1990
Brazil	5 August 1991	1 January 1994
Bulgaria	6 November 1989	1 January 1991
Canada	12 May 1986	1 January 1987
Croatia	2 December 1988	1 January 1990
Cuba	4 April 2001	Pending
Cyprus	25 October 1990	1 January 1992
Czech Republic	11 June 1987	1 January 1988
Denmark	26 March 1986	1 January 1987
Egypt	13 August 1997	1 January 2000
Estonia	12 May 1998	1 January 2000
Finland	12 May 1986	1 January 1988
France	30 May 1984	1 January 1986
Germany	12 June 1985	1 January 1985
Greece	3 June 2002	Pending
Hong Kong	11 February 1998	1 April 1998 (Hong Kong) 1 July 1998 (China)
Hungary	17 June 1992	1 January 1995
Iceland	3 June 1996	1 January 1998
India	18 July 1994	1 January 1995 (China) 1 April 1995 (India)
Iran	12 February 2002	Pending
Ireland	19 April 2000	1 January 2001 (China) 1 January/6 April (Ireland)
Israel	8 April 1995	1 January 1996
Italy	31 October 1986	1 January 1991
Jamaica	4 July 1996	1 January 1998
Japan	6 September 1983	1 January 1985
Kazakhstan	12 September 2001	Pending
Korea (South)	28 March 1994	1 January 1995
Kuwait	25 December 1989	1 January 1989
Latvia	7 June 1996	1 January 1998
Lithuania	3 June 1996	1 January 1997
Luxembourg	12 March 1994	1 January 1996
Macedonia	9 June 1997	1 January 1998
Malaysia	23 November 1985	1 January 1987

State	Date of signature	Date of entry into force
Malta	2 February 1993	1 January 1995
Mauritius	1 August 1994	1 July 1995 (Mauritius) 1 January 1996 (China)
Moldova	7 June 2000	1 January 2002
Mongolia	26 August 1991	1 January 1993
Nepal	14 May 2001	Pending
Netherlands	13 May 1987	1 January 1989
New Zealand	16 September 1986	1 January 1987 (China) 1 April 1987 (New Zealand)
Nigeria	16 April 2002	Pending
Norway	25 February 1986	1 January 1987
Oman	25 March 2002	Pending
Pakistan	15 November 1989	1 July 1990
Papua New Guinea	14 July 1994	Pending
Philippines	18 November 1999	1 January 2002
Poland	7 June 1988	1 January 1990
Portugal	21 April 1998	1 January 2001
Qatar	2 April 2001	Pending
Romania	16 January 1991	1 January 1993
Russia	27 May 1994	1 January 1988
Serbia	1 March 1997	1 January 1998
Seychelles	26 August 1999	Pending
Singapore	18 April 1986	1 January 1986
Slovak Republic	11 June 1987	1 January 1988
Slovenia	13 February 1995	1 January 1996
South Africa	25 April 2000	1 January 2002
Spain	22 November 1990	1 January 1993
Sweden	16 May 1986	1 January 1987
Switzerland	6 July 1990	1 January 1990
Thailand	27 October 1986	1 January 1987
Tunisia	16 April 2002	Pending
Turkey	23 May 1995	1 January 1997
United Arab Emirates	1 July 1993	Pending
Ukraine	4 December 1995	1 January 1997
United Kingdom	26 July 1984	April 1985 (United Kingdom) 1 January 1985 (China)
United States	30 April 1984	1 January 1987
Uzbekistan	3 July 1996	1 January 1997
Venezuela	17 April 2001	Pending
Vietnam	17 May 1995	1 January 1997
Yugoslavia[1]	1 March 1997	1 January 1998

1. The agreements of former Yugoslavia are still effective for some of its successor states.

Source: OECD.

Table 32. **Maximum withholding tax rates on Chinese source dividends, interest and royalties (%)**

	Dividends	Interest	Royalties
Domestic Taxation	20	20	20
Armenia	5-10	10	10
Austria	7-10	10	10
Germany	10	10	10
Japan	10	10	10
United States	10	10	10
France	10	10	10
United Kingdom	10	10	10
Belgium	10	10	10
Malaysia	10	10	10-15
Norway	15	10	10
Denmark	10	10	10
Singapore	7-12	7-10	10
Finland	10	10	10
Canada	10-15	10	10
Sweden	10	10	10
New Zealand	15	10	10
Thailand	15-20	10	15
Italy	10	10	10
Netherlands	10	10	10
Czech Republic	10	10	10
Poland	10	10	10
Australia	15	10	10
Hungary	10	10	10
Malta	10	10	10
Luxembourg	5-10	10	10
South Korea	5-10	10	10
Russian Federation	10	10	10
India	10	10	10
Mauritius	5	10	10
Belarus	10	10	10
Slovenia	5	10	10
Israel	10	7-10	10
Vietnam	10	10	10
Turkey	10	10	10
Ukraine	5-10	10	10
Armenia	5-10	10	10
Iceland	5-10	10	10
Lithuania	5-10	10	10
Latvia	5-10	10	10
Uzbekistan	10	10	10
Yugoslavia	5	10	10
Bulgaria	10	10	7-10
Pakistan	10	10	12.5

	Dividends	Interest	Royalties
Kuwait	5	5	10
Switzerland	10	10	10
Cyprus	10	10	5
Spain	10	10	10
Romania	10	10	7
Brazil	15	15	15-25
Mongolia	5	10	10

1. If the beneficial owner of the dividend is a company which holds a certain percentage of the capital of the company paying the dividends (in most cases 25 per cent), the lower percentage of the withholding tax for dividends becomes effective.

Source: The relevant bilateral tax treaties

Table 33. **Bilateral Investment Treaties to which China is signatory**

Parties	Signature			Entry into Force		
Albania	Feb.	13	1993	Sept.	1	1995
Algeria	Oct.	17	1996			
Argentina	Nov.	5	1992	June	17	1994
Armenia	July	4	1992	March	18	1995
Australia	July	11	1988	July	11	1988
Austria	Sept.	12	1985	Oct.	11	1986
Azerbaijan	March	8	1994	April	1	1995
Bahrain	June	17	1999	April	27	2000
Bangladesh	Sept.	12	1996			
Barbados	July	20	1998	Oct.	1	1999
Belarus	Jan.	11	1993	Jan.	14	1995
Belgium–Luxembourg	June	4	1984	Oct.	5	1986
Bolivia	May	8	1992	Sept.	1	1996
Botswana	June	12	2000			
Brunei	Nov.	17	2000			
Bulgaria	June	27	1989	Aug.	21	1994
Cambodia	July	19	1996			
Cape Verde	April	21	1998			
Cameroon						
Chile	March	23	1994			
Congo, Democratic Republic of	Dec.	18	1997			
Croatia	June	7	1993	July	1	1994
Cuba	April	24	1995			
Cyprus	Jan.	15	2001			
Czech Republic	Dec.	4	1991	Dec.	1	1992
Denmark	April	29	1985	April	29	1985
Ecuador	March	21	1994			
Egypt, Arab Republic of	April	21	1994			
Estonia	Sept.	2	1993	June	1	1994
Ethiopia	May	11	1998	May	1	2000
Finland	Sept.	4	1984	Jan.	26	1986
France	May	30	1984	March	19	1985
Georgia	June	3	1993	March	1	1995
Germany	Oct.	7	1983	March	18	1985
Ghana	Oct.	12	1989			
Greece	June	25	1992	Dec.	21	1993
Hungary	May	29	1991	April	1	1993
Iceland	March	31	1994			
Indonesia	Nov.	18	1994	April	1	1995
Iran	July	22	2000			
Israel	April	10	1995			
Italy	Jan.	28	1985	Aug.	28	1987
Jamaica	Oct.	26	1994			
Japan	Aug.	27	1988	May	14	1989
Jordan	Nov.	15	2001			

Parties	Signature			Entry into Force		
Kazakhstan	Aug.	10	1992	Aug.	13	1994
Kenya	July	16	2001			
Korea, Republic of	Sept.	30	1992	Dec.	4	1992
Kuwait	Nov.	23	1985	Dec.	24	1986
Kyrgyz Republic	May	14	1992			
Lao People's Democratic Republic	Jan.	31	1993	June	1	1993
Lebanon	June	13	1996	July	10	1997
Lithuania	Nov.	8	1993	June	1	1994
Macedonia	June	9	1997	Nov.	1	1997
Malaysia	Nov.	21	1988	March	31	1990
Mauritius	May	4	1996	June	8	1997
Moldova	Nov.	7	1992	March	1	1995
Mongolia	Aug.	26	1991	Nov.	1	1993
Morocco	March	27	1995			
Mozambique	July	10	2001			
Myanmar	Dec.	12	2001			
Netherlands	Nov.	26	2001			
New Zealand	Nov.	22	1988	March	25	1989
Nigeria	Aug.	27	2001			
Norway	Nov.	21	1984	July	10	1985
Oman	March	18	1995			
Pakistan	Feb.	12	1989	Sept.	30	1990
Papua New Guinea	April	12	1991	Feb.	12	1993
Peru	June	9	1994	Feb.	1	1995
Philippines	July	20	1992			
Poland	June	7	1988	Jan.	8	1989
Portugal	Feb.	3	1992			
Qatar	April	9	1999			
Romania	July	12	1994	Sept.	1	1995
Russian Federation	July	21	1990			
Saudi Arabia	Feb.	29	1996	May	1	1997
Sierra Leone	May	16	2001			
Singapore	Nov.	21	1985	Feb.	7	1986
Slovak Republic	Dec.	4	1991	Dec.	1	1992
Slovenia	Sept.	13	1993	Jan.	1	1995
South Africa	Dec.	30	1997	April	1	1998
Spain	Feb.	6	1992	May	1	1993
Sri Lanka	March	13	1986	March	25	1987
Sudan	May	30	1997	July	1	1998
Sweden	March	29	1982	March	29	1982
Switzerland	Nov.	12	1986	March	18	1987
Syria	Dec.	9	1996	Nov.	1	2001
Tajikistan	March	9	1993	Jan.	20	1994
Thailand	March	12	1985	Dec.	13	1985
Turkey	Nov.	13	1990	Aug.	19	1994

Parties	Signature			Entry into Force		
Turkmenistan	Nov.	21	1992	June	6	1995
Ukraine	Oct.	31	1992	May	29	1993
United Arab Emirates	July	1	1993	Sept.	28	1994
United Kingdom	May	15	1986	May	15	1986
Uruguay	Dec.	2	1993			
Uzbekistan	March	13	1992	April	14	1994
Vietnam	Dec.	2	1992	Sept.	1	1993
Yemen	Feb.	16	1998			
Yugoslavia, Federal Republic of	Dec.	18	1995			
Zambia	June	21	1996			
Zimbabwe	May	21	1996	March	1	1998

Source: UNCTAD, 2000.

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ANNEX III

Forty years of OECD co-operation with international investment instruments

Since its inception some 4 years ago, the OECD has long been at the forefront in efforts to develop international "rules of the game" relating to capital movements, international investment and trade in services. Member governments have established disciplines for themselves and for multinational enterprises by means of legal instruments to which member countries commit themselves. These instruments have been regularly reviewed and strengthened over the years to keep them up to date and effective.

OECD Codes of Liberalisation

Since its creation in 1961, the OECD has supported the liberalisation of trade in goods and services, and movements of capital between member countries. This support finds concrete expression in two legally binding agreements among member countries: the OECD Codes of Liberalisation of Capital Movements and of Current Invisible Operations, to which all member countries adhere.

The Codes' principal idea is simple: Capital and services should circulate freely across national frontiers. OECD considers that the progressive opening of markets to cross-border flows of capital and services is beneficial both to host and home countries and their citizens. The OECD Codes complement and reinforce other multilateral instruments promoting a more liberal international economic environment.

The ***Capital Movements Code*** is the only multilateral instrument promoting liberalisation of the full range of international capital movements, other than the rules of the European Union and of the European Economic Area. When it was created in 1961, its coverage was limited to foreign direct investment and some other long-term operations. However, since then,

national economies have become more integrated, financial market regulation has become more harmonised and financing techniques have become more sophisticated. As a consequence, member countries have gradually extended the list of transactions until it could be considered complete. Today, the Capital Movements Code applies to all long- and short-term capital movements between residents of OECD countries. Examples of such movements are the issuing, sale and purchase of shares, bonds and mutual funds, money market operations, and cross-border credits, loans and inheritances.

Coverage of cross-border trade in services by the ***Current Invisibles Code*** is large, but not quite as comprehensive. Cross-border trade in services means the supply of services to residents by non-resident service providers, and *vice versa*. The service providers can be companies or individuals. Major sectors covered are banking and financial services, insurance, professional services, maritime and road transport, travel and tourism, and films.

Although the two Codes differ from each other in certain respects, the general principles that govern these two instruments are broadly the same. In adhering to the Codes, the member countries undertake to remove restrictions on specified lists of current invisible operations and capital movements. The ultimate objective is that residents of different member countries should be as free to transact business with each other as are residents of a single country.

At the same time, OECD members believe that each country should be able to advance progressively towards this goal according to its own rhythm. The Codes provide the flexibility of lodging reservations to specific operations and a number of safeguards, to take account of the state of development of its economy and financial markets, as well as of public interest concerns.

Despite the progressive broadening of the Codes' obligations, the scope of member countries' reservations has dramatically declined. Apart from the remaining restrictions on inward direct investment in a few economic sectors and the non-resident acquisition of real estate, virtually all member countries have dismantled their controls on capital movements.

If the legal commitments under the Codes only apply to the OECD area, member governments shall endeavour to extend the benefits of liberalisation to all members of the International Monetary Fund. Thus, residents of developing countries and countries in transition have been able to reap the advantages of free market access in OECD countries to the same extent as OECD residents.

Technically, the OECD Codes of Liberalisation are legal Decisions of the OECD Council which are taken unanimously, on the basis of one country, one

vote. They are, however, not a treaty or international agreement in the sense of international law, such as for instance the WTO agreements.

The main provisions of the Codes can be summarised as follows:

- The obligation to subscribe to the general undertaking of liberalisation. This undertaking goes beyond the requirement that funds transfers to and from abroad should be free of exchange control restrictions. It also requires that the underlying transactions themselves should not be frustrated by laws, regulations or administrative approval processes.
- The right to proceed gradually towards liberalisation through a process of lodging and maintaining reservations where full liberalisation is not yet achieved.
- The obligation not to discriminate among OECD members. The only exception concerns provisions to ensure compatibility with special customs or monetary systems such as the European Union where faster internal liberalisation measures do not have to be extended to all OECD members automatically.
- Exceptions for reasons of public order and security.
- Temporary derogations for short-term capital operations and in case of serious balance of payments or financial system difficulties.
- A system of notification, examination and consultation administered by the Committee on Capital Movements and Invisible Transactions (CMIT). Specifically, members are required to notify all measures, which affect any of the transactions covered by the Codes and lodge reservations where restrictions are still imposed. To provide maximum transparency, reservations are drafted so as to reflect only restrictions that actually exist. Once a restriction has been abolished, it cannot be reintroduced. This is usually referred to as the "standstill" obligation. Together with the required precision in the wording of reservations, this obligation ensures that the regulatory status quo is locked in and can only evolve in the direction of further liberalisation, the so-called "ratchet-effect".

The Committee on Capital Movements and Invisible Transactions (CMIT) is the structure where member countries meet to discuss application and implementation of the Codes through the unique peer review process. All members are entitled to nominate an expert as a member of the Committee.

In recognition of the economy-wide nature of capital account control and liberalisation and of the fact that liberalisation is in the long-term best interest of the country concerned and its international reputation, there are no bilateral "retaliations", compensation or other direct sanctions involved in the CMIT compliance review process, which relies on consultation, discussion and examination of measures implemented by the members. Despite the absence

of direct sanctions and negotiations, the peer review process has proved quite a powerful tool for driving liberalisation forward. Peer pressure in a multilateral setting, according to the OECD approach, can at times provide strong incentives for authorities to undertake needed policy adjustments. By "benchmarking" regulations and administrative procedures against those adopted and enforced by peer members in the OECD, countries are encouraged to take further liberalisation measures.

How do the Codes process compare to the GATS? The GATS and the Codes both have the same objective: encouraging liberalisation. The GATS favours a "bottom-up" approach to defining countries' individual commitments, meaning that countries may select within the general coverage of the GATS those sectors where they wish to make commitments. Another distinction is that GATS seeks to achieve its goals through rounds of negotiation as opposed to unilateral liberalisation and peer persuasion as in the OECD.

The Codes process promotes regulatory transparency. In addition to exact pinpointing of the nature of remaining restrictions, transparency is also enhanced by publishing updated lists defining each country's current commitments on the OECD public website[1] (as well as in regular hard copy publications of the Codes, together with country positions). Any country's individual position at a given moment can thus be understood through reading of the lists of reservations annexed to each Code. Market participants can be confident that no restrictions exist except for those appearing in the reservation lists.

The Codes are being maintained as living instruments through continuous monitoring by the CMIT of developments in international financial markets as well as regulatory responses. Important examples of this work include:

- The 1984 amendment to the OECD Capital Movements Code established the obligation of "right of entry" and establishment by non-resident investors in all forms necessary to run a business.
- The 1989-1992 major revision of the Codes to cover short-term and non-insurance financial services.
- The 2002 abolishment of an earlier dispensation from the liberalisation obligations for portfolio investment abroad by private pension funds and insurance companies.
- The 2001-2002 agreed common understanding with respect to restrictions on cross-border trade and establishment in the professional services sector.
- The 2002 proposed addition of new insurance services provisions to the Current Invisible Code.

OECD Declaration on International Investment and Multinational Enterprises

The OECD Declaration on International Investment and Multinational Enterprises is a political agreement providing a balanced framework for co-operation on a wide range of investment issues. The Declaration contains four related elements: 1) the *National Treatment* instrument; 2) the *Guidelines for Multinational Enterprises*; 3) an instrument on *International Investment Incentives and Disincentives*; and 4) an instrument on *Conflicting Requirements*. It is supplemented by legally binding Council Decisions on implementation procedures, and by Recommendations to adhering countries to encourage pursuit of its objectives.

The Committee on International Investment and Multinational Enterprises (CIME), comprising all member countries and a number of non-member observers, is the OECD body responsible for promoting and overseeing the functioning of the Declaration. All OECD members are party to it. As of 30 June 2003, seven non-member countries (Argentina, Brazil, Chile, Estonia, Israel, Lithuania and Slovenia) have adhered to the Declaration and participate in related OECD work as a counterpart to the obligations undertaken under the instrument. As of this date, three other countries (Latvia, Singapore and Venezuela) have applied for adherence. Other non-members willing and able to adhere to the various instruments of the Declaration would be welcome.

National Treatment Instrument

The National Treatment Instrument stipulates that adhering countries shall accord to enterprises operating on their territories and owned or controlled by nationals of another adhering country, treatment no less favourable than that accorded in like situations to domestic enterprises. The instrument does not prevent adhering countries from taking measures necessary to maintain public order, to protect their essential security interests and to fulfil commitments relating to international peace and security.

Under the Third Revised Decision of the Council on National Treatment, countries adhering to the Declaration shall notify the Organisation of all measures constituting exceptions to the National Treatment principle within 60 days of their adoption and of any other measures which have a bearing on this principle (the so-called "transparency measures"). These measures are periodically reviewed by the CIME, the goal being the gradual removal of measures that do not conform to this principle. Exceptions to National Treatment fall into five categories: *i)* investments by established foreign-controlled companies, *ii)* official aids and subsidies, *iii)* tax obligations, *iv)* access to local bank credit and the capital market, and *v)* government

procurement. Transparency measures include *i)* measures based on public order and national security interests, *ii)* restrictions on activities in areas covered by monopolies, *iii)* public aids and subsidies granted to government-owned enterprises by the state as a shareholder.

Adhering to the OECD Declaration on International Investment and Multinational Enterprises

The OECD Council is the body in charge of inviting interested non-member economies to adhere to the OECD Declaration on International Investment and Multinational Enterprises and related OECD acts, and to become participants in that part of the CIME work which directly concerns them.

As a condition, applicants have to apply liberal policies towards foreign direct investment and be willing and able to meet the requirements of the Declaration's instruments and related OECD Acts. To ensure this, a full review of the applicant's foreign direct investment policies is carried out, after which the invitation may then officially be issued by the Council.

These reviews are conducted by the CIME with the representatives of the country concerned, and are published. They are divided into three parts. The first consists in a general assessment of the country's actual performance in attracting FDI and the contribution of FDI to the host economy. The second involves a thorough review of the country's regulatory framework for FDI and domestic business operations, including licensing, sectoral measures and administrative practices, investment incentives and government procurement, privatisation and monopolies, anti-corruption efforts, national security or public order measures. It also assesses the extent of the country's international commitments towards FDI (bilateral investment protection treaties, double taxation agreements, regional or multilateral commitments). The last part consists of an examination of whether the country's proposed exceptions to National treatment are not incompatible with the overall level of liberalisation expected from adherents to the National Treatment Instrument as well as of the steps envisaged to effectively promote the OECD Guidelines for Multinational Enterprises, notably the establishment of a National Contact Point and planned activities with interested partners and the general public. This process may also lead to the formulation of specific recommendations to the country's national authorities on how to further promote the objectives of the Declaration.

Non-members adhering to the Declaration are entitled to participate in the work of the CIME related to the Declaration and related acts, as a counterpart to the obligations undertaken under these instruments.

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The National Treatment Instrument is solely concerned with discriminatory measures that apply to foreign-controlled enterprises after they are established, *i.e.* not with their right of establishment. If restrictions prohibit or impede in any way the activities of foreign-controlled enterprises compared to domestic ones, these restrictions are to be reported as exceptions to National Treatment. If and when an official monopoly is abolished, the stipulations of the National Treatment Instruments will begin to apply to the sector formerly covered by the monopoly.

Adhering countries are expected to comply with the standstill principle, that is, to refrain from introducing new measures and practices that would constitute additional exceptions to National Treatment. The CIME conducts examinations to monitor and ensure compliance with the National Treatment Instrument, and to issue recommendations to this effect. Most of these recommendations have been made to individual countries, but a number of them were of a general character. Concerning investment by established foreign-controlled enterprises, adhering countries should give priority in removing exceptions where most adhering countries do not find it necessary to maintain restrictions.

In introducing new regulations in the services sectors, adhering countries should ensure that these measures do not result in the introduction of new exceptions to National Treatment. Adhering countries should also give particular attention to ensuring that moves towards privatisation result in increasing the investment opportunities of both domestic and foreign-controlled enterprises so as to extend the application of the National Treatment instrument.

In the area of official aids and subsidies, adhering countries should give priority attention to limiting the scope and application of measures which may have important distorting effects or which may significantly jeopardise the ability of foreign-controlled enterprises to compete on an equal footing with their domestic counterparts.

Finally, with regard to measures based on public order and essential security interests, adhering countries are encouraged to practice restraint and to limit such measures to the areas where public order and essential considerations are predominant. Where motivations are mixed (*e.g.* partly commercial, partly national security), the measures concerned should be covered by exceptions rather than merely recorded for transparency purposes.

The exceptions to National Treatment notified by all adherent parties to the Declaration can be found on the Internet, at *www.oecd.org/daf/investment*

OECD Guidelines for Multinational Enterprises

The Guidelines for Multinational Enterprises are recommendations jointly addressed by governments to multinational enterprises operating in or

from adhering countries. They provide voluntary principles and standards for responsible business conduct in a variety of areas, including employment and industrial relations, human rights, environment, information disclosure, combating bribery, consumer interests, science and technology, competition, and taxation.

The Guidelines express the shared values of governments of countries that are the source of most of the world's direct investment flows and home to most multinational enterprises. They aim to promote the positive contributions multinationals can make to economic, environmental and social progress.

Observance of the Guidelines is voluntary. Their non-binding nature, however, does not imply less commitment by adhering governments to encourage their observance. The active system under which the Guidelines are promoted and implemented attests to the importance adhering countries give the Guidelines. Adhering countries shall set up National Contact Points (NCPs) to deal with the implementation of the Guidelines at the national level. The purpose of NCPs is to undertake promotional activities, handle inquiries and to act as a forum for discussion with the parties concerned on all matters covered by the Guidelines so that they contribute to the solution of problems which may arise in this connection. NCPs also meet annually to share experiences and report to the CIME.

The CIME's responsibilities under the Guidelines include responding to requests from adhering countries on specific or general aspects of the Guidelines, organising exchanges of views on matters relating to the Guidelines with social partners and non-members, reviewing the Guidelines and/or the procedural Decisions so as to ensure their relevance and effectiveness, and reporting to the OECD Council on the Guidelines. The Committee is also responsible for issuing, as necessary, clarifications of the Guidelines. The purpose of these clarifications is to provide additional information on whether and how the Guidelines apply to a particular situation.

The Review concluded in 2000 enabled the OECD to respond to the need for a thorough consideration of the Guidelines and to ensure their continued relevance and effectiveness. Many features of the Guidelines have been maintained: observance by firms is still voluntary; the institutional structure of the follow-up procedures is broadly unchanged and the Guidelines remain an integral part of the OECD Declaration.

In comparison with earlier reviews, however, the changes to the text are far-reaching and reinforce the core elements – economic, social and environmental – of the sustainable development agenda. With respect to implementation, the Review has provided guidance for the functioning of National Contact Points, and has clarified the CIME's role. The Review benefited

from consultations with the business community, labour representatives, non-governmental organisations and non-member governments.

Incentives and disincentives

The instrument on International Investment Incentives and Disincentives recognises that adhering countries may be affected by this type of measure and stresses the need to strengthen international co-operation in this area. It first encourages them to make such measures as transparent as possible so that their scale and purpose can be easily determined. The instrument also provides for consultations and review procedures to make co-operation between adhering countries more effective. Adhering countries may be called upon to participate in studies on trends and effects of incentives and disincentives on FDI, and to provide information on their policies.

Conflicting requirements

The instrument on Conflicting Requirements encourages adhering countries to co-operate with a view to avoiding or minimising the imposition of conflicting requirements on multinational enterprises. In doing so, they shall take into account the general considerations and practical approaches recently annexed to the Declaration. This co-operative approach includes consultations on potential problems and giving due consideration to other countries' interests in regulating their own economic affairs.

Note

1. *www.oecd.org/daf/investment/*

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Chinese government

National

China Environmental Protection [Chinese/English] *www.zhb.gov.cn*

China National Chemical Information Center (CNCIC) [Chinese/English] *www.cncic.gov.cn*

China Securities Regulatory Commission (CSRC) [Chinese/English] *www.csrc.gov.cn*

Customs General Administration People's Republic of China [Chinese] *www.customs.gov.cn*

Development Research Commission (DRC) [Chinese/English] *www.drcnet.com.cn*

Invest in China, MOFCOM official FDI site [Chinese/English] *www.fdi.gov.cn*

Ministry of Communications [Chinese] *www.moc.gov.cn*

Ministry of Construction [Chinese] *www.cin.gov.cn*

Ministry of Foreign Affairs [Chinese] *www.mii.gov.cn*

Ministry of Commerce(MOFCOM) main web site [Chinese and English] *www.mofcom.gov.cn*

Ministry of Information Industry (MII) [Chinese] *www.mii.gov.cn*

Ministry of Labour [Chinese] *www.molss.gov.cn*

Ministry of Land and Resources [Chinese] *www.mlr.gov.cn*

Ministry of Railways [Chinese] *www.chinamor.cn.net*

Ministry of Science and Technology [Chinese/English] *www.most.gov.cn*

National Bureau of Statistics (NBS) [Chinese/English] *www.stats.gov.cn*

People's Bank of China [Chinese/English] *www.pbc.gov.cn*

State Administration of Foreign Exchange [Chinese/English] *www.safe.gov.cn*

State Development and Reform Commission [Chinese] *www.sdpc.gov.cn*

State Economic and Trade Commissioni [Chinese/English index] *www.setc.gov.cn*

Local

ipanet Investment Promotion Network [English] *www.ipanet.net*

Shanghai Foreign Investment Commission [Chinese/English] *www.investment.gov.cn*

Foreign investor community in China

American Chamber of Commerce in China [English] *www.amcham-china.org.cn*

US.-China Business Council [English] *www.uschina.org* and *www.chinabusinessreview.com*

OECD member country web sites

European Commission Conference on eGovernment: "From Policy to Practice" [English] *http://europa.eu.int/information_society/eeurope/egovconf/index_en.htm*

Abbreviations

ADR	American depositary receipt
BOT	Build-operate-transfer
CFETC	China Foreign Exchange Trading Centre
CIETAC	China International Economic and Trade Arbitration Commission
CMAC	Chinese maritime Arbitration Commission
CSRC	China Securities Regulatory Commission
FDI	Foreign direct investment
FEC	Foreign Exchange Certificate
FESCO	Foreign Enterprise Service Corporation
FIE	Foreign-invested enterprise
GATT	General Agreement on Tariffs and Trade
IPO	Initial public offering
IPR	Intellectual property rights
MOF	Ministry of Finance
MOFTEC	Ministry of Foreign Trade and Economic Co-operation
MOFCOM	Ministry of Commerce
NBS	National Bureau of Statistics (formerly translated as State Statistical Bureau, SSB)
NPC	National People's Congress (China's parliament)
PBC	People's Bank of China
Rmb	Ren min bi (national currency of the People's Republic of China)
SAC	State Administration of Taxation
SAFE	State Administration of Foreign Exchange
SAIC	State Administration of Industry and Commerce
SDPC	State Development Planning Commission
SDRC	State Development and Reform Commission
SETC	State Economic and Trade Commission (merged into MOFCOM in March 2003)
SEZ	Special Economic Zone
SOE	State-owned enterprise
TOT	Transfer-operate-transfer
TRIMs	Trade-related investment measures
TRIPs	Trade-related intellectual property
TVEs	Township and village enterprises
WFOE	Wholly-foreign-owned enterprise
WIPO	World Intellectual Property Organisation
WTO	World Trade Organisation

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