

What has foreign investment done for China?

How to attract high-quality FDI?

Will a rules-based investment environment help domestic enterprises?

How can FDI policy serve China's regional development aims?

How to make things simpler for investors?

Is the financial sector open enough?

How to make the system more transparent?

How to improve the legal system?

For more information

For further reading

Where to contact us?

Attracting Investment to China

Introduction

Foreign investment has played an important role in China's economic development for almost a quarter of a century and is vital for that development to continue. But while China has been highly successful in attracting foreign direct investment (FDI) so far, and has made significant progress in improving its FDI policy framework, it has not fully exploited its potential to attract investment from OECD countries.

To make the most of the potential benefits of joining the World Trade Organization (WTO) and to increase FDI inflows while enhancing their contribution to domestic development China will need to persevere with efforts to bring its laws and regulations into harmony with internationally recognised standards and to ensure they are fully and consistently implemented at local level.

A new *OECD Investment Policy Review, China: Progress and Reform Challenges*, looks at progress to date in China in attracting foreign investment and in moving towards a more rules-based business environment. It suggests policy choices designed to increase the amount of foreign investment from advanced countries. ■

What has foreign investment done for China?

China has made significant progress in providing a business environment conducive to FDI since the major shift to economic reform in 1978. 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 and the financial system, are undergoing lengthy reform that will bear fruit in the future.

FDI has played an important role in this transformation. 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 have provided employment, directly or indirectly, to millions of people, as well as training and experience in both technological and managerial skills which can be transferred to domestic enterprises. FDI has played a major role in expanding China's international trade, which is now equivalent to half of the country's gross domestic product (GDP), with foreign-invested enterprises accounting for half of all two-way merchandise trade.

Even so, China receives far less FDI per head than many other developing as well as developed countries. For example, in 2000 China received USD 30 per capita while Brazil received USD 195 and OECD member countries an average of USD 1,321 (see table below). Much FDI in China still goes to 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. ■

How to attract high-quality FDI?

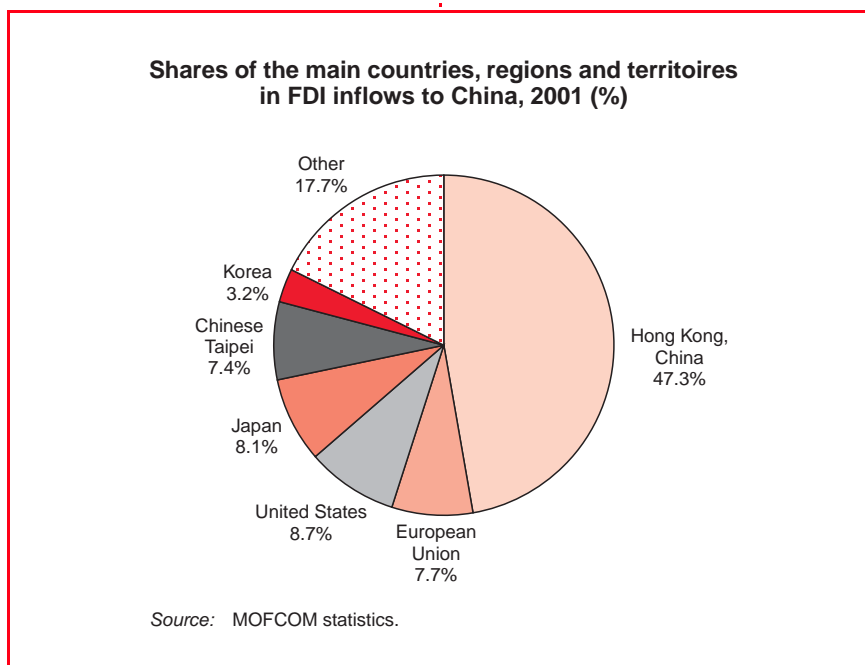
The challenge for China now is to improve further its policy framework in order to attract more long-term, capital-intensive, high-tech projects in more sectors of the economy and hence to reap the maximum benefit from spillovers of skills and expertise from the foreign corporate presence.

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, China is also opening up its services sectors, including the financial sector. Existing foreign-invested enterprises are now able to distribute their products in China and engage more widely in for-

FDI inflows per capita to China and selected countries and territories, 2000 (US\$)

Country or territory	FDI per capita
China	30.1
OECD average	1,320.9
India	2.2
Indonesia	-21.6
Malaysia	162.8
Myanmar	5.3
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.



eign trade. These changes will provide opportunities for enterprises based in OECD member countries to play a bigger role in making direct investments in China.

Multinational enterprises in OECD countries have the capital and the technology to provide longer-term projects embodying advanced production methods. However, OECD members have so far provided a disproportionately small amount of FDI to China, at least partly because of perceived weaknesses in the legal and regulatory framework for investment.

In the early period of reform and opening up of the economy, China's offer of incentives such as lower taxes was effective in attracting foreign investors. But now China is well on the global investment map, it is not clear that such a rich set of incentives is necessary for attracting FDI. Indeed, recent surveys show that foreign investors are much more concerned about the overall regulatory regime than about incentives, and that they prefer to locate investments, especially large, long-term ones, in countries with predictable policy regimes.

Beyond offering fiscal incentives, the Chinese government has in fact worked hard to make investment easier by measures such as reducing delays

in approving FDI projects and improving the physical infrastructure. A rules-based investment environment is also now gradually beginning to take shape, though there is still much to be done.

China is striving to develop an impartial and effective court system, but, for institutional and manpower reasons, this work will take years, rather than months. Effective implementation of law matters because investors, whether foreign or domestic, need to have guaranteed property rights, including intellectual property rights (IPR). 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. 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.

Investor confidence also relies on 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 encouraged by WTO, OECD and other internationally recognised standards. The existence of undisclosed internal rules for approval

of investment projects, 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 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.

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. ■

Will a rules-based investment environment help domestic enterprises?

The experience of OECD countries is that a regulatory environment that is conducive to competition and in which foreign-owned enterprises are gener-

ally treated no differently from domestically-owned ones provides the best basis for developing 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 also encouraged 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 foreign-invested enterprises 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. ■

How can FDI policy serve China's regional development aims?

Foreign-invested enterprises are offered the same incentives as domestic enterprises to invest in the Western and Central regions, which are poorer and less developed than the Eastern coastal region, but this is not enough to entice them away from the more established areas. If the Chinese government wishes to redirect investment westward, it may prefer to put the main emphasis on improvements in the business environment in the hinterland provinces. The current policy of allocating state funds to infrastructure construction in the Western and Central regions is an important part of this effort.

But institutional development is also necessary. Steps to ensure this 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. The government could

also organise visits by officials from 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 remain useful even if the “invest in the West” policy were to be modified. ■

How to make things simpler for investors?

Proposed foreign investment projects are divided into a fourfold classification categories: encouraged, restricted, permitted and prohibited categories. The so-called “catalogue” of ‘permitted’ investment projects – far longer in practice than the other three – is not in fact a published list, but consists of all projects not listed in the other three categories, which are published as separate catalogues.

Following WTO accession, China reduced the number of prohibited and restricted project types and increased the number that are permitted and encouraged. The Chinese authorities are to be commended for this step and encouraged in their efforts to achieve further liberalisation of the catalogue regime.

More categories of project could be removed from the list 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. For instance, 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, 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 increas-

ing the resources available for education and training in these fields. Another category of prohibited FDI is 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.

It is therefore not immediately clear that there is any benefit in maintaining an extensive “restricted” list, effectively raising the approval hurdle higher for a wide range of industries and services, including, it is important to note, most of the services sectors being opened as a result of WTO accession. The Chinese government could consider abolishing this category entirely when it considers further opening to foreign investment to be appropriate.

Unlike the other two published categories, the “encouraged” category does not restrict FDI in any way. The future of this category will largely be determined by the Chinese government’s policy regarding FDI-attracting incentives. One reason for questioning the need for its continued existence is the increasing length and complexity that have resulted from successive liberalisations. The list is now so detailed that many of the items are likely to become rapidly obsolete as a result of technological progress.

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.

One problem that appears to persist is that internal regulations (*neibu*) governing the process by which FDI projects are approved still exist alongside public regulations (*gongkai*). The internal local regulations, which are not published, are said to be generally more restrictive than national legislation and regulations but unless they are made public it is not possible to judge whether or not they are acceptable. The Chinese government is committed to solving this problem. A rational solution would involve a two-step procedure. First, local

neibu rules could be made available to the public, including foreign investors, as well as any internal regulations still operating at national level. The government could then abolish any that are inconsistent with national law, other regulations, or international obligations. If they were worth keeping, they could be re-issued as public regulations.

But China's existing international commitments are a milestone on the road to liberalisation, not full liberalisation itself. Further measures that could help include streamlining the approval process for FDI to avoid unnecessary delays and obstacles, for instance by raising the value of a project that local authorities can approve without having to refer it to central government departments. The government could also merge the various steps in the approval process to produce a genuine "one-stop shop" system. The national-level approval process could also be given more resources and reorganised to make it more efficient, and the government could consider introducing automatic approval within a reasonable time limit for all projects meeting the published approval criteria in full. ■

Is the financial sector open enough?

China has committed itself to a major opening of the banking sector to foreign participation. However, the regulations promulgated by the People's Bank of China (PBC) in February 2002 set 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 opportunities. While the requirements for opening a representative office are relatively modest, those for establishment are much more strict: the parent bank must have USD 20 billion in total assets to open a branch and USD 10 billion to open a subsidiary. The minimum capital requirements in the latest Chinese legislation apply only to foreign, not domestic, banks, but assessing the extent to which this should be considered as discriminating against the establishment of foreign banks is complicated by the fact that there are no private banks in China and state-owned domestic banks are the subject of a different set of regulations. Considering that the regulations also include reasonable stipulations requiring foreign banks to be governed by adequate supervisory systems in their home coun-

tries and to possess adequate internal control systems, such high capital requirements appear in any event disproportionate to guarantee stability and are interpreted by some representatives of foreign banking institutions as protectionist. Lowering the capital requirements for overseas banks to less discouraging levels would help open the banking sector to foreign participation.

Portfolio FDI inflows are also restricted by the largely closed nature of China's capital markets. At the same time, the expansion of foreign-invested enterprises is limited by restrictions on capital-raising measures such as corporate bond issues. Allowing more foreign-invested enterprises to list on domestic stock markets and to issue corporate bonds on the Chinese market would help enable portfolio inflows to play a more effective role in enhancing inward FDI and in fostering the development of Chinese securities markets. ■

How to make the system more transparent?

Both actual and potential foreign investors would find it easier to plan investment projects if they could obtain a clear and consistent picture of all relevant elements in their operating environment in China. There are a number of ways in which the Chinese government could enable them to do so.

Governments are increasingly using the Internet to communicate information to their citizens and those of other countries, and as a transparent, cost-effective and efficient way of supplying government services. China has made great progress in establishing websites for government departments which in many cases are readable in English as well as Chinese. The quality of these 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.

Sites dealing with issues of interest to foreign investors have until recently displayed a similar quality variability. And although the best of them are actually much better than those of most other developing – and some developed – countries, they

are not always easy to find. There were until 2003 several national-level sites, with no clear indication for the uninitiated as to which was predominant. But the problem of establishing a single easy and reliable method of finding an authoritative source of information on China's FDI policies, laws and application procedures on the Internet is relatively easy to resolve. The OECD welcomes the inauguration of MOFCOM's FDI-related web site, www.fdi.gov.cn, at the beginning of 2003 and offers its continued assistance in helping to ensure that the site is up to date, contains appropriate content in both Chinese and English, and is easily navigable.

It would also 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 related rules and 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, on a web site, or preferably both.

The obligations of foreign-invested enterprises 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 would also help. ■

How to improve the legal system?

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 and enhancing their status in relation to local government and party officials. Raising judges' pay, as well as that of other key legal personnel, could help reduce their vulnerability to

offers of bribery. Establishing national and regional mechanisms to ensure that court judgements were carried out would also be helpful.

The Chinese government may wish to explore the possibility of establishing a mechanism to publish draft laws and regulations and obtain public feedback on them as early as possible before promulgation, as happens in several OECD countries. In the case of FDI-related legislation, it could be helpful to design a more consistent and comprehensive method of organising such consultations, involving all major players. A full consultative process would also include an open public debate on proposed legislation, using print and electronic media. This would be particularly helpful in the case of complex legislation. Such a procedure might be adopted on a trial basis in the case of proposed business legislation, such as that on mergers and acquisitions. ■

For more information

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For further reading

- **OECD Investment Policy Review of China: Progress and Reform Challenges, 2003**
ISBN: 92-64-10195-0, €34.00, 240p
- **Foreign Direct Investment in China: Challenges and Prospects for Regional Development, 2002**
ISBN: 92-64-19780-X, €40.00, 238p
- **China in the World Economy: The Domestic Policy Challenges, 2002**
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