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Rule of Law in China: Chinese Law and Business

The Role of Foreign Investment in China's Transition

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Executive Summary

- The rate of increase of foreign direct investment (FDI) has slowed and its proportion of total investment in China has declined.

- Although there is a reaction on the part of some in the government against foreign investment, such reaction has been largely sector-specific rather than systemic. Foreign investment in most sectors is now permitted in the form of wholly foreign-owned enterprises (WFOEs) rather than joint ventures, allowing foreign investors greater control.

- Rather than being trapped in a transition, China's foreign investment has generally continued to expand. Foreign investment through such newer forms as mergers and acquisitions, private equity, venture capital, and open market share purchases has substantially increased. The resultant economic growth has enhanced state capacity whether measured in terms of fiscal revenues, military strength, international prestige, or communications.

- Unified enterprise and income taxes are levelling the playing field for domestic and foreign investors. The unification of income tax rates is intended to combat partly the round-tripping of investment funds from domestic sources to offshore tax-favoured jurisdictions.

- The lower unified tax rate will encourage restructuring of the economy away from production to service enterprises, which will encourage foreign investment in that sector. It will additionally encourage environmental and energy conservation, of benefit to society at large.

- Additional to economic growth, foreign investment is furthering the development of society as well as the economy. Foreign investment has exerted a positive influence, not only through its immediate economic impacts, but also by serving as a model for domestic economic reform, and for domestic businesses to become more socially conscious.

The Role of Foreign Investment in China's Transition

Implications of Mixin Pei's argument for foreign investment

The argument set forth by Mixin Pei, in so far as it affects the relationship between foreign investment and China's suspension in a state of trapped transition, is complex and multi-layered.

In brief, several members of the Party state leadership, led by Deng Xiaoping, opened the country to foreign investment and technology, beginning in the late 1970s, to help the country recover from the chaos of the Cultural Revolution and narrow the widening gap between China, the advanced industrialized countries, and the newly industrializing countries of East and South East Asia.

The path was not straightforward, however. It was not until the early mid-1990s, after Tiananmen, Deng Xiaoping's inspection tour of the south, and the inflation surge of 1992–1994, that the acceptance of a role for foreign investment was assured. While foreign investment's welcome was far from smooth, unlimited, and unconditional, more product markets were opened to foreign investors than to private domestic investors.

Pei attributes this to the weaker political position of foreign investors who were less threatening to the entrenched Party elite. Foreign investment enhanced the Party state by enabling the economy to expand faster than would otherwise have been possible, perpetuating the political power of the Party state by supplying it with resources to co-opt the populace, and, perversely, enabling its local agents to become predators on the state's material resources. As a consequence, China finds itself trapped in a decentralized predatory state. It is incapable of transition from a closed to an open economy, and from a controlled to a more democratic society.[1]

1. Pei, M. (2006) *China's Trapped Transition: The Limits of Developmental Autocracy*. Cambridge MA: Harvard University Press.

Trapped between a closed an open economy

Has foreign investment stagnated or been controlled to such an extent that China is trapped in a transition between a closed economy and an open economy? If so, is this because of predation by the Party state's agents? The rate of increase of foreign direct investment (FDI) has slowed substantially in recent years. Its proportionate share of total investment has correspondingly declined. For details, see Figure 1.

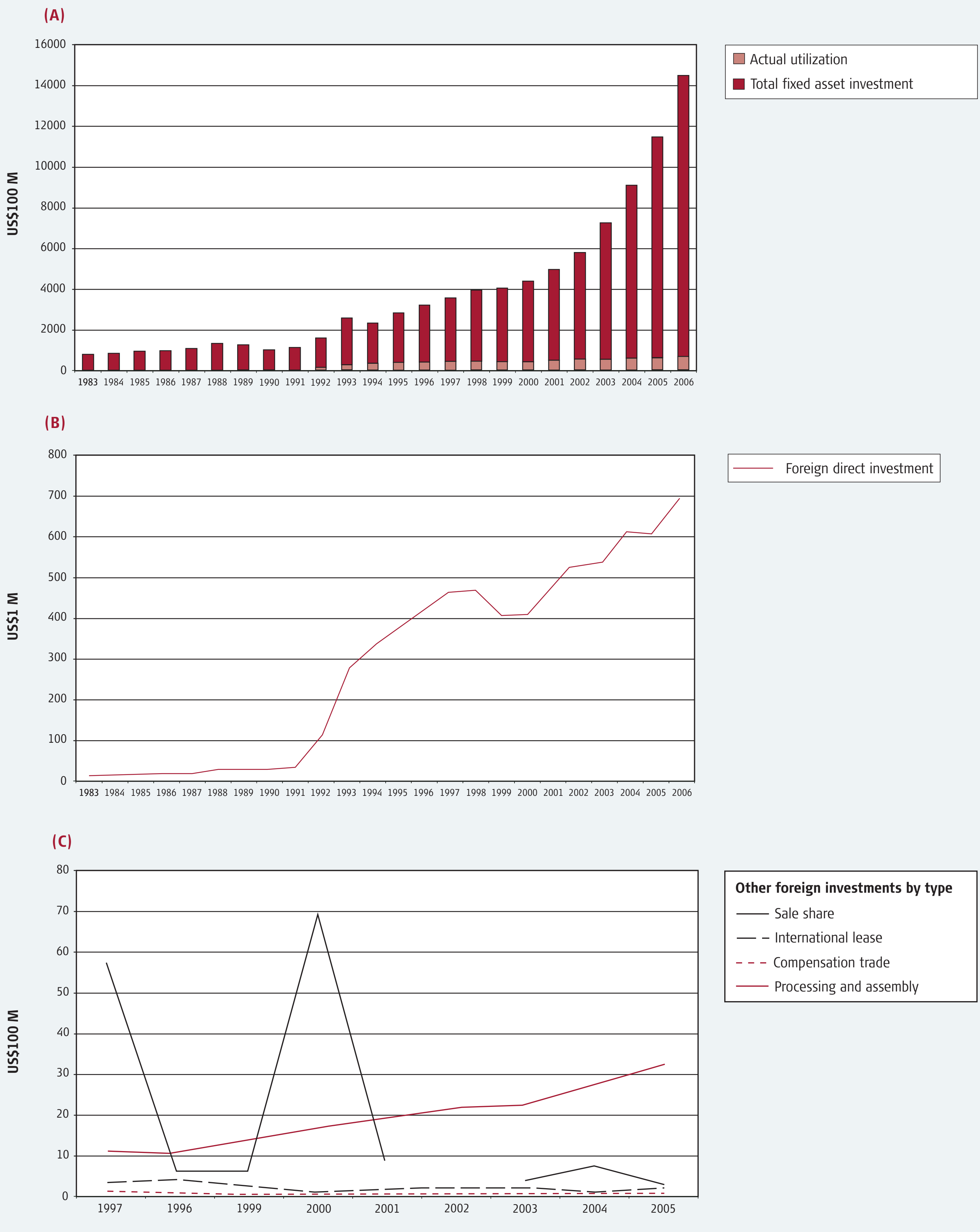
WTO compliance

An argument can be made that foreign investment has slowed because of government action. There has been some resistance towards and reaction against foreign investment. Although China has arguably met all of its specific commitments under the terms of its accession to the World Trade Organisation (WTO) (a few items do not have to be met until 11 December 2007), it is less clear that China has honoured the spirit of its WTO membership. Foreign governments have brought complaints against China in the WTO with respect to tax regimes, local content requirements and subsidies, and intellectual property rights protection.

While China has repealed, revised, or enacted more than 1000 laws, regulations, and other measures to conform to WTO requirements, actual implementation is still lacking in certain instances. For example, China has formally removed the barriers on foreign-invested insurance companies to geographical expansion in China. Nevertheless, implementation remains problematic. Foreign-invested insurance companies are effectively restricted to consecutive branch application review, while domestic insurance companies, even newly established companies, have regularly received concurrent approvals to open multiple branches, enabling them to expand much faster.

Figure 1: Foreign direct investment (FDI) in China

Source: China Commerce Year Book 2000–2006. Chinainfobank, China Statistics Database Ministry of Commerce



Meanwhile, foreign-invested property and casualty insurance companies have been told that they will be accorded national treatment if they convert their structures from branches of the foreign parent to domestic subsidiaries. Such companies, which have applied to do so despite the additional capital investment this entails, have nevertheless found to their continuing dismay that their applications still remain under review more than a year after submission, a period far longer than the sixty-day review period provided for under regulations.

The treatment of foreign, national, and domestic enterprises

Regulations have been promulgated which restrict or hamper mergers and acquisitions of domestic companies, and, indeed, even of foreign companies with sales or operations in China. The provisional regulations on mergers and acquisition of domestic enterprises by foreign investors, for the first time, established review procedures for mergers and acquisitions of domestic companies by foreign companies. Clearances are required for transactions meeting one or more thresholds based not only on market share, but also on a party's total sales in China, total assets in China, and number of enterprises in the relevant industry in China, even though these latter three criteria have little, if any, direct relation to competition.

After the provisional regulations were promulgated, the then Director General of the Department of Treaty and Law in the Ministry of Commerce (MOFCOM) privately stated that they would not be enforced because they were patently discriminatory against foreign businesses.[2] But, in fact, the regulations have been enforced and MOFCOM has reviewed nearly 400 transactions since the regulations entered into force.

The provisional regulations have been superseded by the rules on mergers and acquisition of domestic enterprises by foreign investors, which took effect on 8 September 2006. While the rules included some improvements, such as, for the first time, recognition of the use of stock swaps as a medium for transactions, they also established new grounds for challenging mergers and acquisitions by foreign investors, relating to undefined and vague grounds of national economic security, famous trademarks, and historic brand names.

Moreover, third parties, competitors not excluded, have standing to challenge transactions. Most notably, the Carlyle Group has been compelled to reduce its planned interest in Xugong Group Construction Machinery Co. from 85 to 45 per cent as a condition of approval, which remains pending.[3] A few transactions have already undergone second phase reviews, apparently on such a basis, without the benefit of procedural guidelines and under conditions in which the capability of MOFCOM's Anti-Monopoly Investigation Office is suspect, as the entire Department of Treaty and Law has only forty-six personnel, of whom but a handful are assigned to the office.

MOFCOM, on 8 March 2007, and on its own authority, subsequently promulgated the *Guidelines on Anti-Monopoly Reports by Foreign Investors in Mergers and Acquisitions of Domestic Enterprises*, a document which clarified some issues, but added further complexity to the filing of mergers and acquisition notifications without addressing their discriminatory impact on foreign investors. This document appears to have been rushed into promulgation in response to Premier Wen Jiabao's statement in the *2007 Government Work Report* delivered to the National People's Congress (NPC) that '[t]he guidance and standardization of foreign mergers and acquisitions be strengthened'.[4]

Other actions have also been taken to remove particular sectors of the economy from foreign investment. The principal document governing the

2. MOFCOM is the renamed successor of the Ministry of Foreign Trade and Economic Cooperation.

3. Batson, A. 'Carlyle Settles for Lesser Stake', *Asian Wall Street Journal* (19 March 2007), p. 21.

4. ‹http://www.gov.cn/ztzl/2007zfgzbgjd/content_555764_5.htm›

opening of industrial sectors for foreign investment is the *Guide Catalogue of Industries for Foreign Investment*, currently in a 2004 version. Over the years, a wider range of industries have been opened to foreign investment in successive versions of the catalogue, either expressly as industries in which foreign investment is encouraged, or tacitly, by omission, as industries in which foreign investment is permitted, but not necessarily encouraged through investment preferences.

There have been reports that the next version of the catalogue, now in preparation and expected to be published late in 2007, will place more industries under the categories of restricted for foreign investment, or even prohibited for foreign investment.

Irrespective of what the next version of the catalogue may provide for, in June 2006 the State Council issued a set of opinions in which machinery companies in sixteen sets of industries were designated for special protection from foreign investment. In December 2006, there were unofficial reports that the state-owned Assets Supervision and Control Commission had determined that state-owned enterprises under the central government would remain in control of seven industrial sectors considered crucial to national security and national economic life. The defence industry is an obvious selection, but rather less so are the electric grid, power, oil, petrochemicals, telecommunications, coal, civil aviation, and shipping.

Unification of separate tax regimes

In addition, at its March 2007 annual meeting, the NPC enacted the unified Enterprise Income Tax Law. Although the law includes many tax preferences, its fundamental purpose is to eliminate the separate tax regimes that existed for domestic-invested enterprises under the Enterprise Income Tax Law on the one hand, and for foreign-invested production enterprises under the Foreign-Invested and Foreign Enterprise Income Tax Law on the other. It introduces a unified flat rate tax that falls midway between the two current rates.

Stagnation or increased foreign investment?

However, despite these various factors restricting or closing off foreign investment, it would be inaccurate to describe this process as a slide of foreign investment into stagnation or trapped transition. As shown in Table 1 and Figure 2, while FDI has slowed, other forms of foreign investment have increased: venture capital, private equity, and public market share purchase. The proportionate decline of foreign investment is due in any event to the rapid increase of domestic investment, spurred in part by the success of foreign investment.

Table 1: Venture capital investments

Year	US$1,000,000
2001	518
2002	418
2003	992
2004	1269
2005	1200
2006	1900

While FDI has slowed, foreign investment in other forms, especially through securities purchases, both offshore in H (Hong Kong), N (New York) and L (London) shares, and onshore through the Qualified Foreign Institutional Investor programme, are growing. Moreover, large pools of venture capital and private equity money are being mobilized to invest in Chinese equities. China-dedicated venture capital funds raised US$4 billion in committed capital in 2005 alone. Foreign venture capital investment in 2006 amounted to US$1.9 billion, an increase of 55 per cent from US$1.2 billion in 2005. The number of deals was up from 156 to 214, and the average size of investments up from US$7.8 million to US$8.8 million.

As illustrated in Table 2, in 2006, private equity acquisitions of Chinese companies increased substantially from five deals valued at US$117 million in 2002 to eighty-seven deals valued at US$7.742 billion dollars.

Figure 2
Trends in China venture capital investments

Sources: Zero Zipo-China Venture Capital Annual Report 2004, cited in Dixon Doll's presentation to CSPA Conference, September 24, 2005; Dow Jones VentureOne and Ernst & Young Quarterly China Venture Capital Reports.

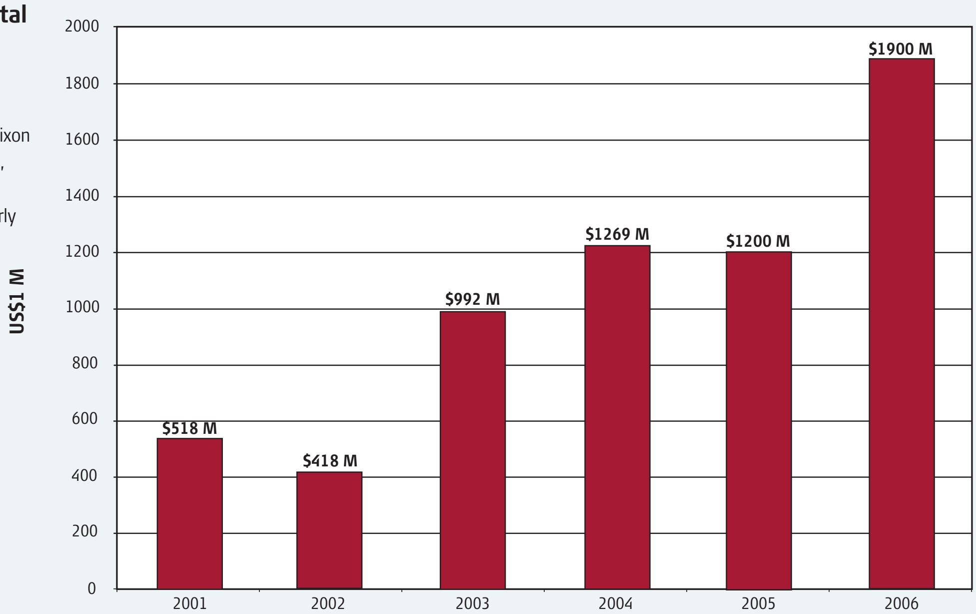


Table 2
Acquisitions by private-equity firms including add-on transactions

Source: dealogic as reported in Santini, L. 'Buyout Firms Stumble in Asia', *Asian Wall Street Journal* (14 March 2007), 17.

Date announced	Deal value, US$1 M	Number of deals	% of China's mergers and acquisitions
2002	117	5	0.4
2003	860	10	2.9
2004	741	28	1.3
2005	2257	41	3.6
2006	7742	87	7.2
2007 YTD	597	16	3.5

Insurance and banking sectors

Although there are sectors in which the relevant government departments and at least some of their constituent domestic companies continue to strongly resist foreign investment, for example, the China Insurance Regulatory Commission (CIRC) in insurance, and the Ministry of Information Industry in telecommunications, these are, to a considerable extent, exceptions to broader trends.

For example, although the CIRC appears to be deliberately dragging its feet on the approval of the conversion of foreign-invested property and casualty insurance companies to local subsidiaries, its counterpart regulator for the banking industry, the China Banking Regulatory Commission (CBRC), has committed to and implemented prompt review and approval of applications from the first group of foreign applicants. Moreover, the CBRC's rules allow foreign banks, which elect to convert to local subsidiaries, the right to retain one foreign branch to handle business for which that structure is best suited.

This indicates that reluctance or even opposition to foreign business is sector-specific rather than systemic. Perhaps the most fundamental point, demonstrated in Table 3, is that foreign investment in most sectors is now permitted in the form of wholly foreign-owned enterprises (WFOEs) rather than joint ventures, allowing foreign investors greater control.

Table 3: Trends in foreign direct investment

Year	Equity joint venture			Cooperative joint venture			Wholly foreign-owned enterprises		
	Number	Contracted value	Utilized value	Number	Contracted value	Utilized value	Number	Contracted value	Utilized value
2002	10,380	185.02	149.92	1595	62.17	50.58	22,173	572.55	317.25
2003	12,521	255.06	153.92	1547	74.79	38.36	26,943	816.09	333.84
2004	11,570	276.41	163.86	1343	77.88	31.12	30,708	1172.75	402.22
2005	10,480	324.42	146.14	1166	86.91	18.31	32,308	1459.09	429.61

Source: China Statistical Yearbook (annual). *Amount of Foreign Investment by Type*. All values in US$100 M.

The regulated industries and anti-monopoly law

Contrary to Pei's argument that China (admittedly as of 2003) welcomed foreign investment in many industries deemed critical to the government, including insurance and telecommunications services, the sectors in which opposition to foreign investment have been strongest are certain (though by no means all) of the regulated industries like insurance, telecommunications, civil aviation, and package delivery services, which have historically been resistant to deregulation, even in more market-oriented jurisdictions.

The regulations governing mergers and acquisitions are plainly discriminatory against foreign businesses. Such provisions did not survive enactment of the Anti-Monopoly Law in August 2007. In March 2007, a MOFCOM official privately stated that such provisions will be superseded, although this statement would not be dispositive even if publicly stated; as MOFCOM is engaged in a bureaucratic struggle with the National Development and Reform Commission and the State Administration for Industry and Commerce over control of competition regulation.

While that statute has the potential to be invoked in a discriminatory manner against foreign businesses, for example, to the extent that size alone is deemed to constitute market dominance, or that intellectual property rights are deemed to constitute a basis for the exercise of monopoly power, the law is facially neutral. Moreover, the law adopted restrictions on administrative monopolies which, in sectors like telecommunications, have been among the strongest barriers to market entry for both domestic and foreign businesses.

Unified enterprise and income taxes: national treatment or discriminatory burden

While the unified Enterprise Income Tax Law will eliminate the reduced tax rate enjoyed by foreign-invested production enterprises, and thus constitutes a disincentive to that type of foreign investment, it is hard to argue that national treatment constitutes an unfair imposition. Moreover, the unification of income tax rates is intended to combat partly the round-tripping of investment funds from domestic sources to offshore tax-favoured jurisdictions for reinvestment in China, which has been targeted since 2005.

Furthermore, the lower unified tax rate will encourage restructuring of the economy away from production to service enterprises, which will encourage foreign investment in that sector. It will additionally encourage environmental and energy conservation, of benefit to society at large. Indeed, many incentives such as for high and new technology enterprises have been enshrined in the statute.

Similarly, the recent effort to extend government-controlled trade unions to foreign-invested enterprises constitutes national treatment rather than an imposition of a discriminatory burden.

The impact of foreign investment on the broader economy and society

Pei agrees that a gradual transition, as opposed to more rapid change, leads China, and arguably any other country emerging from authoritarianism, into a trapped transition, even if the central government desires progress, because local governments or agents grab control and rents. Foreign investment allegedly contributes to this obstacle along the path to development by providing the Party state with more resources to distribute and fend off the state's economic decline, and, arguably, by providing more sophisticated technology and instruments of control.

There is certainly some evidence that supports this argument. Foreign companies have provided technology, which has helped China erect sophisticated firewalls and monitoring mechanisms to track Internet and other telecommunications traffic. Some foreign companies have tailored their products to comply with Chinese laws and policies in ways that result in a reduced flow of information.

It would nevertheless be stretching the point to argue that the sustained high economic growth that China has enjoyed in recent years, due in part to foreign investment, constitutes an ultimately stabilizing force for the Party state, albeit for reasons different from those identified by Pei.

Pei argues that state capacity is declining, as is indeed the case in certain sectors such as health.[5] However, economic growth has, in fact, enhanced state capacity, whether measured in terms of fiscal revenues, military strength, international prestige, communications, or many other indicators.

Ideological decline and the free-flow of information

Conversely, foreign investment, trade, and more rapid economic growth have opened China's doors and the minds of its people to international influences, which has accelerated the decline of ideology as a force in Chinese society. This has weakened one vital support for Party rule. While it does not presage an end to Party rule, it does indicate that the nature of the Party is likely to continue to evolve in the direction of an institution whose legitimacy rests not on its claim to scientific truth, but rather on its ability to satisfy the wants and needs of society. The extent to which that trend and the maintenance of a one-party system are compatible remains at issue.

5. Pei (2006), op. cit. ch. 5.

To maintain otherwise would be to argue that foreign investment has been and will continue to be isolated from the rest of society. Despite limitations on the flow of information into China, it has been many years since Chinese citizens were restricted from having contact with foreigners and entering hotels where foreigners congregated, or for foreigners to be prevented from entering the homes of the Chinese.

Impact of foreign investment on the economic system

In fact, foreign investment has served as a model for policies diffusing into the wider society. This is apparent in the economic system in innumerable ways, including in the reform of the banking system; the break-up of the monopolies of state-owned import–export companies, with respect to cross-border trading rights; the opening and the reform of stock markets creating a culture of stock ownership; and the expansion of private housing. Domestic private equity and venture capital investments are also developing, especially following the amendment of the Partnership Enterprise Law in 2006 allowing the formation of limited partnerships.

Corporate social responsibility

With respect to social consciousness, foreign investment has inspired a rise in awareness of and commitment to corporate social responsibility.[6] Foreign investment has also inspired the formation of business interest groups, including those with a mission of social betterment, such as the China Business Council for Sustainable Development. Domestic business interests have been approaching foreign chambers of commerce to ask them to take a prominent role in proposing changes to legislative issues of common concern, for example, with respect to the pending Labour Contract Law.

In summary, in addition to continuing to grow, albeit in newer and often more sophisticated forms than FDI, foreign investment is responsible for fostering the development of society, rather than a trapped transition.

6. New Era, New Contributions: New Developments in China in Corporate Social Responsibility Trends Among Transnational Corporations', in the 2006 *Report of Transnational Corporations in China*, pp. 3-43. Beijing: Zhongguo Jingji Chubanshe.

The Foundation

The mission of the Foundation is to study, reflect on, and promote an understanding of the role that law plays in society. This is achieved by identifying and analysing issues of contemporary interest and importance. In doing so, it draws on the work of scholars and researchers, and aims to make its work easily accessible to practitioners and professionals, whether in government, business, or the law.

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