

**Foreign Capital Utilization in China:
Prospects and Future Strategy**

The World Bank Beijing Office

Table of Contents

Table of Contents	2
Executive Summary	4
Chapter 1 Introduction	13
Chapter 2 External Environment	18
2.1 Medium-term global economic prospects.....	18
2.2 Robust recovery of private capital flows	20
Chapter 3 Foreign Direct Investment in China	30
3.1 FDI in China	30
3.2 FDI policies.....	35
3.3 Emerging problems of FDI policies.....	43
3.4 Summing up	47
Chapter 4 Maintaining an attractive investment climate	48
Chapter 5 Leveling the playing field in taxation	55
Chapter 6 Improving the Composition of FDI.....	61
6.1 Directing more FDI in service sector.....	61
6.1.1 Why directing more FDI in services.....	61
6.1.2 Scheduled service liberalization: China’s commitment to WTO accession ...	64
6.1.3 Policy recommendations on attracting and reaping benefits from service FDI	66
6.2 Maximizing technology transfer & directing more FDI in High-tech industry ..	70
6.3 Directing more FDI in Inland regions.....	74
Chapter 7 Non-FDI Capital Flows: Liberalization and Risk Management	85
7.1 Why liberalize?	85
7.2 Proposed China strategy: avoiding the hazards	94
Reference List	100
Annex I. Approval Procedures for Setting Up a Foreign Funded Enterprise	114
Annex 2. Comparison of Investment Climate in 23 Cities	117
Annex 3: Benefit-cost ratio for various tax incentive instruments	119

ACKNOWLEDGEMENTS

The report has been prepared by a core team led by Ms. Min Zhao (World Bank) and comprising of Messrs. Sudarshan Gooptu, Patrick Hanohan, Colin Xu and Dailami Mansoor. Overall guidance for the report was provided by Mr. Bert Hofman (Lead Economist for China, World Bank). The counterpart team of the Government of China was headed by Mr. Kong Linglong (Foreign Capital Utilization Department of the National Development and Reform Commission). The cooperation received from staff from the NDRC, especially Messrs. Fu Shan and Wu Chongguang, and officials from local Development and Reform Commission is greatly appreciated. Excellent research assistance was extended by Fei Wang and Henrik Larkander. Mss. Chen Jianqing and Niu Zijing provided able assistance with the administrative and logistical arrangements for the task team. Peer Reviews are Messrs. Richard Newfarmer (PRMTR-World Bank) and Yoichiro Ishihara (EASPR-World Bank).

Executive Summary

China has been very successful in attracting Foreign Direct Investment (FDI). Attracted by the country's relatively good investment climate and low wages, and more recently by its growing domestic market, China received about a quarter of all FDI to developing countries over the last 10 years, and a record \$60 billion in 2004, some 9.9 percent of the total FDI. In terms of share of GDP and investment, FDI made less of a contribution, with some 11 percent of total investment on average over the last five years, lower than countries such as Hungary, Czech Republic, Viet Nam and Singapore. Also as a share of GDP, China is not among the top receivers of FDI. Moreover, it is estimated that some 20 to 30 percent of FDI is not genuine FDI, but rather domestic investment rerouted through foreign countries to benefit from the special treatment foreign investment receives in terms of taxes and investment policies.

Clearly, FDI has had many benefits for China. FDI accelerated growth by providing more investment capital, contributed significantly to the country's export success with over 57 percent of exports from foreign invested firms, and generated over 120 million jobs. Foreign-invested firms generally have more value added per worker, higher labor productivity, and higher profits than domestic firms. Evidence on technology spillovers is more limited, but industries with higher FDI seem to have higher productivity increases than other industries, suggesting a positive spillover.

The benefits of FDI are unevenly spread across China's provinces. The coastal provinces have benefited in particular from the FDI flows, taking in almost 90 percent of total FDI, whereas the western provinces received less than 2 percent in 2004, despite the government's policies to encourage investments in these regions. FDI also remains heavily focused on industry, which took well over 60 percent of total in the 1990s, and some 75 percent in 2004, 71 of which in manufacturing. Services attracted a little over 20 percent of total FDI, but most of this was in real estate, whereas services such as banking and public utilities—key recipients of FDI in other countries—attracted only modest amounts. FDI in agriculture is negligible.

On current trends China is likely to continue to receive abundant FDI over the coming 11th Five Year Plan period. Developing countries are projected to receive some US\$250 billion in FDI on average over the coming 5 year plan, and China can expect to receive some 30 percent of this. This puts China in a relatively comfortable position, and it would allow the country to opt for policies that encourage FDI to align more with the country's objectives. These objectives themselves are changing, and over the next five-year plan, China is likely to focus on a more balanced development. The "Five balances" call for growth that is more focused on domestic development, that is more evenly spread across China's regions, and that is less resource intensive. For FDI policies, this would imply that greater attention should be given to investments in domestically focused industries, to investment in the interior, and to investments with a higher level of technology.

Some of the developments in FDI that the government desires will happen irrespective of policy. Accession to the WTO is opening up a whole host of activities previously closed for FDI, notably in services such as banking, distribution, and utilities. Further, rising wages and land prices in the East may well drive some FDI further inland when investment conditions are right. And China's increasingly skilled labor force is likely to attract gradually more industries with higher value added to the country. In addition, removing some of the existing policy biases, such as in taxation policies, special economic zones, and market accession will level the playing field between coastal and inland provinces and among sectors in the economy. However, China faces significant policy challenges in optimizing the use of FDI.

Maintaining an Attractive Investment Climate

China should continue to improve its investment climate. Increasing competition from other large emerging economies such as India, Brazil, Thailand and Mexico may limit China's share in world FDI, and if China desires to continue to attract large volumes of FDI, it must further improve its investment climate. While this climate is overall strong, it can be better, if China

- Reduces the complexity of investment approvals, increase government effectiveness by reducing overlap in authority and duplication in registration and approval requirements among agencies. Harmonizing registration requirements and registration forms across agencies, and promoting data exchange among the agencies so that firms could register with all authorities at any one of the agencies would greatly reduce the burden on investors. Monthly filing requirements at local and central tax bureau, labor bureau, and social security bureau could be streamlined as well.
- Improves access to equity finance of foreign invested firms through capital market reforms. Such access would also help reduce the current pressures on the balance of payments: because of limited access to domestic direct finance, foreign firms have to finance much of their investments from abroad, which causes upward pressures on the currency, and complicates monetary policy. Lowering equity requirements and allowing firms to pay up their full equity share on installment basis would help in this respect.
- Reforms its judicial system. China's weakest spot in its investment climate is its judicial system. As China's society is becoming more complex and market-based, and because the authorities hope to attract more investment in higher value added industries, the relative importance of an efficient judiciary will increase. Furthermore, as China hopes to gradually move up the technology ladder, stronger enforcement of intellectual property rights will gain in importance, as will public and private investments in research and development.

Leveling the Playing Field in Taxation

China has an array of tax incentives for foreign investment. The incentives promote foreign investment in general and regional and industry-specific investment. These incentives played a role in the early days of China's transition to a market economy, when domestic enterprises were seen to have an advantage over foreign ones. These advantages to domestic firms that in part motivated the FDI incentives are being eroded by China's WTO entry. Moreover, FDI is increasingly being directed at production for China's growing domestic market, not for export processing industries that are arguably more footloose, and more sensitive to tax advantages. The issue now is whether tax incentives for FDI should be continued.

Other countries have numerous incentives for investment. They range from (temporarily) lower income tax rates, tax holidays, tax credits for investment, accelerated depreciation for certain types of investment and exemption of VAT and import duties for exporters. However, it is rare for countries to have those incentives only for foreign-invested firms, and only a few countries (India, Viet Nam, Laos) have a separate tax code for foreign firms like China has. Incentives in other countries aim for a variety of objectives, including developing lagging regions, and promoting exports, technology transfer, employment, and local contents in production.

Economic analysis suggests that the impact of such incentives on investment is modest, especially compared to the often hidden costs to the government budget. Compliance monitoring is difficult as well, and regularly tax incentives end up sponsoring foreign governments rather than enterprises because of home country tax rules. Of course, some countries that are successful in attracting FDI have significant tax incentives for investment. At the same time, many countries *not* successful in attracting FDI have similar levels of incentives. In Indonesia, where abolishment of most incentives in the mid-1980s went along with a revision of the tax code, the move had no discernible impact on FDI flows.

Survey work suggests that tax incentives are a minor consideration for foreign investors. A fair, transparent tax code with competitive rates and indiscriminate implementation is more important, as are other factors in the investment climate, such as a reliable infrastructure, an independent judiciary, and a reliable policy process. The business advisory committee to the OECD advises that, if a country grants tax incentives, these should be available to all investors, be non-discriminatory, have a long term orientation, and be proportional to the goals. China's WTO entry sets limits to incentives that could distort trade, including tax reduction for exporters and firms in export processing zones.

For China, these observations would imply:

- Reducing incentives for foreign investors are unlikely to lower FDI by much, although "round-tripping" may disappear, causing a drop in *measured* but not actual FDI.

- Equalizing domestic and foreign income tax rates can best be done through merging the two existing tax codes. A lower tax rate than the current 33 percent rate on domestic enterprises would be in line with the international trend towards lower rates.
- In merging the tax codes, China should remove distortions from the current codes, including the limited tax deductibility of costs for R&D, some labor costs, marketing, and depreciation.
- If tax preferences are to be given, they should not discriminate to ownership, and be in line with China's industrial and regional development policies going forward.
- Presenting the costs of tax incentives together with the budget could reduce the lobbying for inappropriate incentives.

Whether to grandfather or not those foreign investors already in the country is to some extent a political issue. Such grandfathering would perpetuate distortions among existing investors and domestic firms, and would add a distortion between new and existing investors. Grandfathering would also perpetuate the revenue foregone due to the current policies at a time when profitability of foreign-invested firms is rising rapidly. On the other hand, grandfathering for a limited number of years would enhance China's reputation for consistency in policy, and general concern for the opinions of foreign invested firms.

Regional Policies

As observed before, the rising costs in the eastern provinces open up opportunities for the central and western provinces. At the same time, there is no guarantee that industries will move there over time. They may equally choose to relocate to other countries in Asia, to produce for the international market, or for the Chinese market that has opened up considerably with the WTO entry. Alternatively, industries confronted with rising costs in the east may respond by upgrading their technology and cost-effectiveness rather than relocating. Finally, agglomeration effects in the east may already be so large that productivity gains outrun the increase in costs, giving industries little incentives to move.

So how could inland provinces gain a competitive edge in attracting FDI?

- First, the inland provinces need to step up their efforts to **improve the investment climate**. World Bank research shows that inland cities do considerably less well than their coastal counterparts, particularly in protection of property rights and government effectiveness.
- Second, the inland regions need to **attract industries in line with their comparative advantage** and region-specific industrial policy and not necessarily copy the export-oriented manufacturing that led the way in the east. Land-intensive activities such as agriculture, or service activities that rely less on transport and distance (such as back-office work) could be promising areas for the west.
- Interior regions should learn from the mistakes in investment promotion in the east, and avoid unproductive activities such as setting up project lists, organizing investment fairs and the like. They could attract experienced investment promotion professionals from the eastern provinces to kick-start their own efforts.
- Finally, inland provinces could seek cooperation with coastal regions such as in “*Fei Di*”, in which they provide the land and the labor, and the eastern provinces the industry and the expertise, while the resulting tax benefits are shared.

Central government can play a role as well. International experience suggests that using FDI for regional development is hard in the best of circumstances of poor investment climate. But this leaves plenty other things to do for central government:

- It could **level the playing field** by phasing out advantages that largely benefit the east, such as special economic zones and tax preferences.
- It could also **review the restrictions on FDI** in sectors in which the interior has a particular advantage, including natural resources and public utilities such as water, electricity and gas.
- It should step up efforts against regional policies and practices that prevent **domestic market integration**, including the levying of illegal fees on imported” goods from other regions, biased government and state enterprise procurement practices, and court judgments skewed in favor of local enterprises.
- It must **improve the efficiency of the transport industry**. While central (and local) governments have invested heavily in transport infrastructure, the transport industry remains fragment and inefficient. More efficient pricing of railways, and enabling the integration of rail, water, and roads transportation could considerably reduce transport cost in China, and with it the competitiveness of the interior regions.

Sectoral Policies

Over the coming Five Year Plan, China intends to promote growth in the services sector as well as in higher value added industries. This is seen to be key for developing an economy that less dependent on exports, and less resource intensive than China's current one. Due to policies already in place, or planned, the prospects for this to happen in China are considerable.

First China's accession to the WTO means that many of the services previously closed or limited for FDI will be opened up over the coming FYP. Removing the barriers is likely to attract significant barriers to services such as banking, insurance, telecoms, distribution and transport. In addition, in the context of WTO accession, China has committed to significantly improved protection of intellectual property rights, and if implemented, the country stands a better chance to attract higher value industries for which infringement of these rights is a key issue.

Second, China's heavy investment in higher education in the past will reap benefits in the years to come. Education level is a key determinant foreign investors in deciding where to locate, the more so for the higher value added industries. Over the last FYP, enrollment in China's tertiary education rose from 1.6 million in 1999 to 4.5 million in 2004. Enrollment in secondary education is up as well, although but tertiary and secondary enrollment is still lagging behind competitors up the value chain such as Thailand, Korea, and Malaysia.

More can be done to promote China's sectoral goals in services and higher-tech. In particular, China should:

- **Continue to boost education levels in the labor force.** Expanding access to secondary education, especially in the interior province and for girls still has some way to go, and is likely to require significant government resources. For tertiary education—for which personal benefits are much clearer, government can increasingly be a facilitator, including a facilitator for private education. Access for the poor could be spurred by scholarships rather than free education, which often benefits the rich more than the poor.

- **Put more efforts into enforcing property rights.** Meeting the WTO commitments could be one reason for doing so, but perhaps more importantly the lack of property rights protection will increasingly hinder Chinese companies to move up the value chain, and even expand internationally.
- **Improve the environment for R&D,** in particular for R&D in firms, which is lagging far behind many of the OECD countries. China should review its corporate income tax code and accounting standards as to the treatment of R&D costs. It could also encourage joint laboratories between firms and universities. And finally, China could increasingly contract out government research to non-government suppliers of R&D as well as spin off some public sector service providers in this sector into the private sector.
- **Improve the general living environment of cities.**

Policies on Non-FDI Capital Flows

Liberalization of non-FDI capital flows should be a medium term objectives.

- Measurable efficiency benefits can be expected over time from capital account openness, as it increases the effectiveness of finance in contributing to growth by performing its key functions.
- Liberalization of bank lending and deposits, and other financial transactions has been associated in many countries with heightened volatility of capital movements, especially at times of exchange rate peg speculation and of crisis. Existing controls in China have been only partially effective in this regard and have not eliminated volatility of such flows. Under the present circumstances, further substantial liberalization of non-portfolio, non-FDI flows should not be a priority.
- It becomes ever more important to ensure that macroeconomic management and the risk management capacity of domestic firms, especially banks and other financial firms are highly effective.

- Liberalization of outflows is unlikely to make a sizable impact on China's accumulation of foreign exchange reserves in the short-run, pending on the RMB exchange rate movement. Other options exist. For instance, the floating of bonds by top-rated issuers on the Chinese market, as to be piloted by the International Finance Corporation, the Asian Development Bank, and others, can help develop market skills and absorb some of the excess liquidity in the market.