TIDAL CHANGES IN CHINESE FOREIGN INVESTMENT LAWS AND POLICIES

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I. INTRODUCTION: FOREIGN DIRECT INVESTMENT, THE PAST FIFTEEN YEARS (1979-93) . . . 24

II. REGIONAL POLICIES: FROM COASTLINING TO INLAND OPENING . . . 26
- A. *Special Economic Zones: The First Spatial Expression* . . . 29
- B. *Fourteen Coastal Cities: Development Catalysts* . . . 33
- C. *The "Uneven Development" Strategy Reconsidered* . . . 37

III. FOREIGN DIRECT INVESTMENT LAWS: FROM RUDIMENTARY CONTROL TO RATIONAL LIBERALIZATION . . . 41
- A. *Participants* . . . 45
- B. *Sectors* . . . 48
- C. *Labor* . . . 52
- D. *Tax* . . . 56
- E. *Foreign Exchange* . . . 62
- F. *Foreign Bank Operations* . . . 71
  1. Entry Requirements Under the 1990 Regulations . . . 76
  2. The People's Bank of China Supervision . . . 77
  3. Preventive Constraints . . . 78

IV. IMPLICATIONS, LIMITS, AND OPTIONS . . . 80

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I. INTRODUCTION: FOREIGN DIRECT INVESTMENT, THE PAST FIFTEEN YEARS (1979-93)

Direct investment abroad is an important vehicle for transnational corporations to make their presence felt in the world economy. From the perspective of the host countries, especially those in the developing world, foreign direct investment (FDI) is seen as an essential package of capital, technology, management skills and "know-how." In addition, FDI strengthens a country's balance of payments through both the injection of capital initially, and foreign exchange earnings in the long run. For the past decade, China, like other developing countries, has attempted to increase the inflow of FDI by relaxing restrictions and offering greater inducements. China's efforts have paid off. Between 1978 and 1993, China approved over 172,000 FDI contracts with total utilized capital exceeding fifty-nine billion dollars, propelling it into the ranks of major users of FDI in the developing world.[1]

The Law of the People's Republic of China on Sino-Foreign Joint Ventures Using Chinese and Foreign Investment, the first foreign investment law in the People's Republic since its founding, was promulgated in 1979.[2] Despite its vagueness and other shortcomings, the law was seen as a departure from China's practice of relying entirely on its own efforts for economic development.[3] China recognized that the worldwide integration of financial and technological resources had brought about a general breakdown of national and regional economic activities.[4] Consequently, no country could afford to avoid international cooperation and competition any longer. This altered mentality led to the use of FDI during the 1980s. To appreciate the significance of FDI in China's overall economic development, a brief probe into the role of FDI in China is necessary.

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1. PEOPLE'S DAILY (Overseas Ed.), Jan. 9, 1994, at 2. According to the World Investment Report published by the United Nations Transnational Corporation Center on July 19, 1991, the average annual value of utilized FDI in China during the 1980s was approximately $ 1.6 billion, making China the fourth largest FDI host country among developing countries after Singapore, Brazil, and Mexico. *World Investment Report*, U.N. TRANSNAT'L CORP. CENT., July 19, 1991.

2. The Law of the People's Republic of China on Sino-Foreign Joint Ventures Using Chinese Foreign Investment, promulgated July 1, 1971, *available in* LEXIS, Nexis Library, CHINA File [hereinafter Equity Joint Venture Law].

3. *The SEZs: Problems, Successes, Outlook*, 7 E. ASIAN EXEC. REP. 11 (1985).

4. *Id.*

First, FDI has provided sources of additional capital to alleviate China's capital shortage.[5] The annual average utilized FDI was 3.99 billion dollars between 1979 and 1993.[6] FDI accounted for an average of 29.3 percent of the total value of newly utilized foreign investment, reaching seventy percent at its peak in 1993. The overall ratio of utilized FDI to the nation's total investment in fixed assets ranged from insignificant to moderate -- from less than one percent during the first five-year period (1979-1983) to 7.7 percent and 11.6 percent respectively in 1992 and 1993.[7] Throughout the past decade the general trend has been upward.[8]

Two important points should be considered when evaluating the significance of FDI contribution to China's capital formation. First, the total investment in fixed assets is measured at the official prevailing exchange rate, and does not reflect the real value in United States dollars. If measured at the prevailing exchange rate at foreign exchange swap markets, FDI would impact capital formation in the Chinese economy to an even greater extent.

The second point relates to the geo-economic impact of China's development strategy. The FDI share of total investment in China's fourteen coastal cities,[9] and four Special Economic Zones (SEZ) plus Hainan Island in 1988 was thirteen percent and over sixty percent respectively, and would be seventeen percent and eighty-two percent respectively if measured at the more realistic exchange rate at swap markets.[10] As these figures demonstrate, FDI has not made a significant contribution to China's capital formation as a whole. The figures do indicate, however, that FDI has contributed substantially to capital formation in the coastal cities. This has had a tremendous bearing upon the initial success of the uneven development strategy[11] and, thereby, upon China's successful economic reform, begun in the early 1980s.

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5. *See infra* Table One.

6. *Id.*

7. *Id.*

8. *See infra* Table Two.

9. The 14 cities, from north to south are, Dalian, Qinghuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ninbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai.

10. Shen Xiaofang, *A Decade of Direct Foreign Investment in China*, 39 PROBS. OF COMMUNISM 65, Mar.-Apr. 1990.

11. *See infra* notes 34-40 and accompanying text.

Direct exports of FDI firms are a significant indicator of the overall impact of FDI on the Chinese economy. Direct export by FDI firms accounted for 25.7 percent of the total national exports in 1993.[12] This represents an 2500 percent increase over 1985, when most of the FDI firms established in the early 1980s began exporting their products.[13] Since 1985, China has recorded an average annual increase of three hundred percent of total national export of FDI firms.[14]

When evaluating China's achievements, questions arise as to whether more FDI liberalization will take place. In the 1990s, Chinese leaders balance encouragement of FDI in a highly competitive world with control of foreign investment. Continued investment is crucial to the nation's capital infusion and the build-up of technological capability. On the other hand, controlling foreign investment is vital to the maintenance of a healthy national economy and the enhancement of the government's political ideology. Ultimately, making foreign investment serve China becomes a process of weighing these two objectives.

For fifteen years, the Chinese leadership has given credit to FDI as an impetus to the country's economic growth and infrastructural development.[15] Accordingly, a progressive liberalization in the legal treatment of FDI has occurred in additional sectors of the country's economic life.[16] This generally explains foreign companies' growing interest in doing business in China. Part II of this article discusses the recent shift of China's regional development strategy with respect to FDI priority policies. Part III describes the changes in China's current statutory framework, which reflects the liberalization of FDI's participation in the Chinese economy. Part IV concludes by identifying the implications of FDI expansion upon the economy as well as limits and options that the Chinese government faces in light of the changing world economic order.

II. REGIONAL POLICIES: FROM COASTLINING TO INLAND OPENING

China's great size and natural resources are two outstanding features of the country. Equally significant are China's eastern and

12. *See infra* Table 3.

13. *Id.*

14. *Id.*

15. *China: Enter the Dragon*, PREDICASTS, Sept. 1993, at 28, *available in* LEXIS, Nexis Library, ASIAPC File.

16. *Id.*

southern peripheries which open onto the Pacific Ocean and adjacent seas. Thus, the southeastern region of the country has a high degree of accessibility to ocean and international air transportation, facilitating economic development. China's western region and the rest of the hinterland are closed off by extremely high, dry and cold plateaus of mountains, deserts and basins; however, they hold enormous natural resources. The economy of the western region is poorly developed, largely because of the difficult access to the coast.[17] Formulating a sound regional policy to take advantage of the eastern region's accessibility to world commerce, thereby allowing the landlocked regions to boost their economies is essentially a social, economic, and political process of structural engineering. Placing the issue in perspective, it is necessary to examine the magnitude of China's pre-1978 inter-regional and inter-provincial differentials in external trade and manufacturing power, as well as the government's previous efforts to reduce these differentials.

Prior to World War II, China's external trade was confined mainly to the ports on the coast of the Yangtze Valley.[18] Consequently, five coastal provinces, Guangdong, Jiangsu (including Shanghai), Shangdong, Hebei (including Beijing and Tianjin), and Liaoning, controlled more than half of the mineral industry and virtually all of the "modern" cotton-spinning, silk-reeling, and oil-pressing enterprises.[19] During World War II, the need to spread industry into the interior led to the evacuation of several hundred coastal factories to the southwest and northwest, resulting in the growth of some smaller industrial centers in these regions sponsored by so-called new provincial development corporations.[20] When the war ended, however, this trend reversed, and by the end of 1948, East China still accounted for more than two-thirds of total modern manufacturing industry.[21] Naturally, the uneven distribution of industry led to other dimensions of inequality, reflecting the overwhelming economic dominance of the coastal provinces.

When the Communist Party of China (CPC) finally attained nationwide power, Mao Zedong viewed this economic situation as

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17. Yang Dali, *Pattern of China's Regional Development Strategy*, CHINA Q., June 1990, at 231.

18. Suzanne Paine, *Spatial Aspect of Chinese Development*, 17 J. DEV. STUD. 133, 150-51 (1981).

19. *Id.*

20. *Id.*

21. *Id.*

"irrational," a "product of history," and one that must be rectified by striving to "promote industry in the interior."[22] The new policy was implemented by China's First Five-Year Plan (Plan) which primarily aimed to distribute the industrial forces across the country in proximity to sources of raw materials, fuel, and areas of consumption, while also strengthening national defense.[23] According to the Plan, 472 of the 694 new backbone industrial projects were to be built in the interior, and transportable industrial enterprises were to be moved from the coastal cities to the interior.[24] In addition, both light and heavy industries were redistributed geographically, necessitating the building of new steel works and other heavy industry projects in China's interior.[25] The general inward-shift of industries was sustained throughout the subsequent two decades, as evidenced by the Second, Third, Fourth and Fifth Five-Year Plans (1958-80).[26] The shift was accelerated in the late 1960s, when the ever-worsening Sino-Soviet relations culminated in a border fight in 1969.[27]

China's pre-1978 regional policy achieved some marginal improvements in the reduction of inequalities between the coastal and interior provinces.[28] The effects of the events dating back to the beginning of the twentieth century when treaty ports were established near the coast and along the banks of the Lower Yangtze could not be overcome, however, in two short decades. Prior to China's adoption of the Open Door policy in 1978, a significant gap in terms of per capita industrial output had existed between the coastal and interior regions.[29]

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22. MAO ZEDONG, 5 SELECTED WORKS OF MAO ZEDONG 287 (1977).

23. *Id.*

24. LI FUCHUN, REPORT ON THE FIRST FIVE-YEAR PLAN FOR THE NATIONAL DEVELOPMENT OF THE PEOPLE'S REPUBLIC OF CHINA (1953-1957) 51 (1955).

25. *Id.*

26. *See* Dali, *supra* note 17.

27. The Chinese government emphasized the so-called "third line" policy, which divided the Chinese territory into three regions with border areas being the most vulnerable first line, the intermediate or buffer belt the second, and the inaccessible redoubts of several interior provinces the third line. Mandated by this policy, large number of military production units, research institutes as well as other related industries were removed to the third line. For an extensive discussion, see CHINA'S REGIONAL DEVELOPMENT 7-10 (David S. Goodman ed., 1989).

28. *Id.* at 8.

29. In 1979, the per capita industrial output in coastal provinces was 200% of the national average, while that of the inland provinces was only 47%. *Id.* at 53.

The architects of the Open Door policy were faced with closing the gap between the coastal and interior provinces. In order to accomplish this, they sought to fully utilize the coastal region's geographic accessibility and its sophisticated technical and infrastructural receptiveness to foreign markets, capital and technology. The prescription given at the inauguration of the Open Door policy was a ladder-step theory, which allowed some people and regions to get rich first and left the other regions to follow.[30] This theory, which presumed that coastal development would eventually bring additional growth to the interior, was not consistent with socialist ideology. The pace and structure of economic reform and the emphasis on regional economic and political interests regarding foreign trade became disputed issues.[31] The key factors, however, were the extent to which the theory was applied when formulating the country's foreign investment policies and laws, and the change in these laws over time. The wisdom of hindsight makes apparent the dramatic shift from a pure geographic uneven development strategy[32] to a program that recognized the slow and prolonged process of growth transmission from the coast to the interior. The post-1978 strategy had accepted regional disparities as inevitable and encouraged foreign investment and international interaction in the coastal region, rather than launch a general operation. The most recently adopted policy viewed the coastal regions as growth poles in terms of FDI utilization and sought to alleviate regional disparities, essentially opening the central and western regions, particularly the Mid-and-Lower Yangtze Valley and border areas.[33]

A. *Special Economic Zones: The First Spatial Expression*

The uneven development strategy, endorsed by the post-Mao leadership, was inaugurated with the adoption of the Open Door policy in 1978.[34] Opening China's borders to the outside world was meant to be applied throughout the country, but primarily found its expression in

30. *See* Dali, *supra* note 17.

31. *Id.* at 244-45.

32. *See infra* notes 34-40 and accompanying text.

33. *See infra* notes 34-40 and accompanying text.

34. Dali, *supra* note 17, at 264.

the coastal region and the Special Economic Zones (SEZs).[35] The creation of SEZs constituted an integral part of the Open Door policy. The question remains: What comparative advantage was the government trying to achieve by establishing SEZs?

Apart from the political motive acknowledged by the government,[36] several reasons justified the government's strategy. First, China's geographic proximity to Hong Kong, Macao, Singapore, and other similarly located countries made it possible for the state to work a limited and controlled local opening to its advantage.[37] Furthermore, the linkage of these areas with millions of overseas Chinese most likely encouraged the creation of such zones on the southern coast. Second, by the time SEZs became operative, economic reform was well under way.[38] Not surprisingly, the SEZs were intended to serve as a testing ground for China's economic reforms.[39] Third, the SEZs were envisioned as a pioneering effort for a more extensive operation of the uneven development strategy, to be implemented later.[40] Implementation of the Open Door policy required an environment structured to permit foreign investment to serve as a window to obtain advanced technology and management methods, and to test preferential foreign investment policies and laws to be implemented later in the rest of the country during the initial stage of the policy.

Although the SEZs were to play an expansive role – political, cultural, educational, technological, and economic – their development however would rely on foreign financial resources in the form of FDI. The government believed that only FDI could produce the benefits it was seeking.

The creation of the first four SEZs is considered to be the beginning of the proliferation of new regional arrangements that

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35. The Special Economic Zones are Shenzhen, Zhuhai, Shantou and Xiamen along the southern coast. In 1988, Hainan Island, immediately off the southern coast, was added to the list.

36. The Chinese government's political purpose in promoting the SEZs lay in its strategic plans to resume sovereignty over Hong Kong by 1997, adjacent to Shenzhen. PEOPLE'S DAILY (Overseas Ed.), Aug. 12, 1985, at 1. In addition, as recent developments have shown, the SEZs positively contributed to a peaceful future process of reunification of Taiwan with mainland China.

37. Henry Zheng, *Law and Policy of China's Special Economic Zones and Coastal Cities*, 8 N.Y.L. SCH. J. INT'L & COMP. L. 193 (1987).

38. *Id.* at 207.

39. *See* Dali, *supra* note 17.

40. *Id.*

implemented the uneven development strategy.[41] It would be overreaching, however, to say that the leadership had formulated significant regional planning behind their creations. In the early stage, the SEZs acted only as direct stimulants to local FDI participation.[42] Accordingly, the SEZ Regulations and other subsequent legislative and regulatory developments sanctioned an array of preferential treatments for FDI firms.[43] Notably, the enterprise income tax rate stands at fifteen percent, far below other regions of the country and Hong Kong.[44] Also, foreign-funded enterprises engaged in production and scheduled to operate for a period of ten years or more are exempt from income tax in the first and second profit-making years and are allowed a fifty percent reduction of income tax in the ensuing three years.[45] In addition, income tax exemptions are provided on the remitted share of profit from export duties and from import duties for equipment used in the production of export products.[46] Finally, the easing of entry and exit formalities provides a significant initial advantage. The establishment of a statutory framework composed of national and local legislation and regulations, especially those concerning FDI firms, accorded the SEZs the highest priority for development.[47]

From 1980 to 1985, SEZs went through a construction phase. During this period, resources were concentrated on land development and infrastructure. By 1985, the total negotiated FDI reached 4.52 billion United States dollars with 1.17 billion actually having been made in United States dollars.[48] Of these construction projects, non-production projects accounted for forty-five percent and production projects accounted for fifty-five percent.[49] The majority were small, low-tech,

41. *Id.*

42. The Regulations on Special Economic Zones in Guangdong Province, promulgated by the State Council on Aug. 26, 1980, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter SEZ Regulations].

43. *Id.*

44. *Id.*

45. For an extensive analysis of the statutory framework of the SEZs, see Zheng, *supra* note 37.

46. *Id.*

47. *Id.*

48. Dahe Huang, *Development of China's SEZs*, BEIJING REV., Apr. 8-14, 1991, at 23.

49. This gave rise to several major criticisms, including the cost of establishing the SEZs vis-à-vis their seemingly unpromising returns; the nature of activities attracted to the zones, which showed less involvement of high-tech, productive, modern projects and more

labor-intensive processing projects.[50] During the second phase, however, a strong indication of improvement emerged with regard to the anticipated returns of their initial investment. By 1990, the SEZs had approved 6,489 FDI projects, which accounted for twenty-six percent of the country's total in the same period.[51] The foreign funds actually used rose to 4.5 billion United States dollars, comprising twenty-seven percent of the country's total FDI intake.[52] More significantly, FDI productive projects increased steadily to comprise ninety percent of the total number of FDI firms in these SEZs.[53] Many of these projects are technology-intensive rather than labor-intensive operations, as was the case during the first phase.

Given these commendable local achievements, the impact on overall development in China is difficult to discern. Two types of analysis are useful to determine the benefits that accrued by to the rest of the country. The first is an analysis of the tangible, measurable gains made by the SEZs for China. Dramatic growth contributed significantly to the country's present trade surplus and foreign exchange earnings.[54] In addition, the growth indicated a successful reorientation of the SEZs' industries with respect to their export capability. Another measurable gain is the SEZs' actual utilized value of FDI. Although its percentage of the national total dropped substantially in 1990, due to the proliferation of nationwide FDI promotion, it still accounted for a twenty-three percent of total FDI.[55] Given the ratio of SEZs to the national total, China's gains have been tremendous.

The second analysis of the SEZ gains involves China's benefits accruing from the diffusing effect of FDI. Included in this analysis are the transfer of technology, management, quality control skills, and the

participation by retail, recreation-related industries, and the alleged lack of export orientation. For a detailed discussion of these criticisms, see CHINA'S REGIONAL DEVELOPMENT, *supra* note 27, at 121-27.

50. *Id.*

51. *Id.*

52. *See* Huang, *supra* note 48, at 23.

53. *Id.*

54. PEOPLE'S DAILY (Overseas Ed.), Feb. 17, 1992, at 3; Israel Epstein, *Friendship Studies: Goals and Prospects*, BEIJING REV., Apr. 8-14, 1991, at 26.

55. Calculated from data in UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION, CHINA: TOWARDS SUSTAINABLE INDUSTRIAL GROWTH, 73 (1992). If the actually utilized FDI in Hainan SEZ ($75 million) is taken into account, the percentage would be 24.9% of the national total in 1990.

determination to foster new outlooks toward development goals in conjunction with international competition. To effectuate this objective, new types of economic-technological cooperations have been established, both vertically and horizontally, between the SEZs and the various State Council ministries, and between the SEZs and their immediate neighboring regions as well as hinterland provinces.[56]

B. Fourteen Coastal Cities: Development Catalysts

Although blessed with sound industrial, cultural and educational structures, a labor force of skilled workers and well-trained technical and managerial personnel, and some of the finest seaports in the world, China's coastal cities had never developed to their full potential. Despite the coastal region's dominance in industrial production, it suffered a stunted pattern of growth for decades, due to China's policy since the First Five-Year Plan of striving for spatial balance in economic development.[57] This pattern waned after the Open Door policy required the establishment of the SEZs in 1979.[58] Due to the small size and the location of the initial SEZs, however, the diffusing effect of economic growth was geographically limited. China declared the opening of fourteen coastal cities in 1984 to further prove the government's commitment to the stability, continuity and long-term nature of the Open Door policy. The government sought to fully tap the advantages that would ensue from encouraging the influx of FDI to facilitate the process of sub-regional and regional diffusion for inland development.[59]

These fourteen coastal cities together with the SEZs form a coastal belt which, geographically, is important for linkage with foreign markets, and for wider connection with the massive domestic hinterland. First, this coastlining belt constitutes a significant portion of the Pacific Rim, which positions it well to attract investment from Japan, South Korea, Taiwan, Southeastern Asian countries, European countries, and the United States. It was hoped that the relatively sophisticated labor force, technical capabilities and infrastructures in the region, would facilitate better and more sustainable returns of capital formation, technological progress, structural transformation and overall economic development. Second, most of the coastal cities have established Economic and Technological

56. *See* Huang, *supra* note 48, at 23.

57. *See* Li, *supra* note 24.

58. *See supra* notes 34-36 and accompanying text.

59. *See* Shen, *supra* note 10.

Development Zones (ETDZ), which were conceived by the central government to emphasize productive enterprises or scientific and technological research institutions for the purpose of exploring new technologies to make new products and to develop new sectors of industry.[60]

At least three reasons for the development of the fourteen coastal cities exist. First, during the construction stage prior to 1984, a need emerged to designate a coastal city in which to build infrastructures and to provide energy, communication, and other basic public facilities both necessary and suitable for production and technology development enterprises.[61] Second, investors with potential markets and suppliers in areas other than those near the SEZs could offer parallel investment incentives in the coastal cities along the coastline from north to south.[62] Finally, by designating the goals of the coastal cities, the government clarified its primary objective: concentration on establishing more technology-intensive and knowledge-based projects.[63] A secondary goal was the utilization of FDI and foreign technologies in the coastal cities to upgrade the industrial and technical capabilities of existing factories and gradually spread the newly attained strength to more remote areas. All of these reasons can be appreciated considering China's urgent need to acquire capital and technology in order to compete with other countries.

The coastlining belt can diffuse its influence to regions immediately bordering the SEZs and to more remote regions. From a geo-economic point of view, the belt links remote regions of China with Europe and Northeast and Southeast Asia. The recent opening of the trans-Europe and Asia railway from Rotterdam to Lianyungang, a coastal city on the Pacific, provides further impetus to FDI entry as well as domestic resource movement. In addition, the major inland water transportation routes, including the Yangtze, the Grand Canal, Minjiang and Pearl Rivers are embraced by the belt. These links to the coastal cities from north to south give greater hope of economic growth to former "landlocked losers."[64] Indeed, for the interior provinces, the

60. Zheng, *supra* note 37, at 263-64.

61. *Id.*

62. *Id.*

63. *Id.*

64. For example, Sichuan, a province with a population of 107 million and situated in a mountain-ringed area in the southwest of China, was considered a landlocked loser for its below-national-average per capita industrial value and per capita consumption value

coastal belt provides easier and broader access to a window through which the coastal economic vitality can be transmitted to provinces in the form of investment, technology transfer, information service, and training of personnel.[65]

The elevated status of the fourteen coastal cities is manifested by the special privileges that foreign investors enjoy when they utilize their investment and technologies. Additionally, the fourteen city governments have greater authority to approve FDI projects than other cities.[66] The tax regime applicable in the fourteen coastal cities is similar to the existing SEZ regime. Some of the modifications implemented by the coastal cities include: (1) A fifteen percent income tax reduction applied only to FDI firms that are technology- or knowledge-intensive for the purpose of developing energy, transportation, or parts, or to those that have an investment exceeding thirty million dollars with a low profit margin, or to those productive projects set up within the ETDZs; (2) a twenty percent income tax reduction applied to FDI firms that do not meet the foregoing requirements, yet are involved in one of the categorized sectors; (3) an exemption for foreign investors from paying the usual income tax equivalent to ten percent of their remittance; and (4) an exemption for all FDI firms, whether within the ETDZ or not, from customs duties, import taxes and VAT with respect to production and management equipments, raw and semi-finished materials, components, spare parts, and packaging materials for producing export products, and communication and office equipment.[67]

These and other intangible benefits, in addition to the government's infrastructural investments in the areas of transport, water and electricity, telecommunications, and land use special privileges, were a great inducement to foreign investors.[68] In the first nine months alone, 420 foreign investment contracts were signed for projects in the fourteen coastal cities.[69] The total investment amounted to 880 million dollars, or 1.5 times of the total investment in the previous five years. By the

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The opening of Beihai, one of the 14 coastal port cities, provides the province with a relatively direct, cheaper access to the ocean, which make it possible for Sichuan to boost its foreign export as well as external relations with coastal regions. Robert Delfs, *Landlocked Loser*, FAR EAST. ECON. REV., Apr. 4, 1991, at 28.

65. *Id.*

66. Zheng, *supra* note 37, at 270-86.

67. *Id.*

68. *Id.*

69. *Id.*

end of 1991, the fourteen ETDZs in twelve cities approved the establishment and operation of approximately 1,200 FDI firms.[70]

Concomitantly, these coastal cities have extended their administrative jurisdiction to include rural counties, thereby developing satellite towns. This is consistent with the theory that a city seen as a growth pole will generate the kind of national wealth which will eventually be distributed to the peripheral region through a diffusing process.[71] In China, the catalyst function of the coastal cities is seen in both their direct economic influence and in the establishment of more extensive FDI priority regions.[72]

In order to attract additional FDI and expedite the diffusion process in several key coastal cities, three open areas were designated in 1985: the Yangtze Delta Region (surrounding Shanghai), the Pearl River Delta Region (surrounding Guangzhou), and the Minnan Delta Region (surrounding Xiamen).[73] All FDI preferential policies applicable in the fourteen coastal cities were extended to these areas. This expansion continued from 1986 to 1988 to include the Liaodong and Shandong peninsulas respectively.[74] The primary goal of these operations was to apportion benefits from the SEZs and coastal cities to surrounding regions. The operations were also an effort to accommodate foreign investors' growing interest in expanding their operations in China.[75]

The expansion of FDI priority regions has enhanced the development of an externally oriented economy in the coastal areas.[76] In 1988, to fully tap the potential of these areas[77] and to improve the price competitiveness on the international market, the government

70. PEOPLE'S DAILY (Overseas Ed.), Oct. 24, 1991, at 3.

71. For a discussion of this theory, see JOHN FREEDMAN, REGIONAL DEVELOPMENT POLICY: A CASE STUDY OF VENEZUELA 12 (1966).

72. *See* Dali, *supra* note 17.

73. MARGARET M. PEARSON, JOINT VENTURE IN THE PEOPLES' REPUBLIC OF CHINA: CONTROL OF FOREIGN DIRECT INVESTMENT UNDER SOCIALISM (1991).

74. *Id.*

75. *See* Zheng, *supra* note 37.

76. *Zhao on Development of Coastal Areas' Development Strategies*, BEIJING REV., Feb. 8-14, 1988, at 18.

77. It is believed, due to rises in labor costs, that the industrialized countries have been readjusting their industrial policies and moving labor-intensive industries to areas where labor costs are low. China's coastal areas, with low-paid but fairly-skilled labor, good transport facilities and infrastructures, and importantly, a good scientific and technological development potential, should not miss this opportunity. *Id.*

declared the implementation of the "coastal area development" strategy.[78] This strategy emphasized two priorities: first, the government emphasized the strategic importance of developing labor-intensive industries in the coastal area; and second, it emphasized the growth of processing industries basing exports on imported raw materials.[79] These priorities were necessary to further develop the export-oriented economy without relying solely on the inland areas for raw materials. This strategy effectively brought the eleven coastal provinces as well as centrally administered municipalities, including rural areas, into a state of "commercial internationalization" through the acquisition of foreign capital, technology, raw materials, and market opportunities through FDI.[80] The process has enabled China to take advantage of its vast supply of inexpensive labor and increase its manufacturing sectors' ability to compete in world markets. Therefore, although the strategy is export oriented, it is fundamentally aimed at raising the technological level of the existing manufacturing operations.[81]

The fourteen coastal cities have also functioned as growth poles, stimulating the economy, at least within the boundary of the coastal provinces where they are located, in both the hi-tech industries, as reflected in the fourteen ETDZs, and the low-tech, export-oriented industries in counties and rural areas.[82] Gradually, the "trickle-down" effect is flowing from the coastal to the interior provinces.[83]

C. *The "Uneven Development" Strategy Reconsidered*

The coastal region has reaped many benefits from having implemented the uneven development strategy from the SEZs to the coastlining belt to the coastal areas.[84] These benefits have taken the form of foreign exchange earnings through processing industries,

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78. *Id.*

79. *Id.*

80. *Id.*

81. In the first half of 1993, the total value of import and export in the 14 cities reached to $20.3 billion, which amounted for 25.7% of the national total. PEOPLE'S DAILY, (Overseas Ed.), Aug. 10, 1993, at 1.

82. Geoff Crothall, *China: Provinces Will Benefit from Pudong Zone*, S. CHINA MORNING POST, REUTERS, July 5, 1990, *available in* LEXIS, Nexis Library, CHINA File.

83. *Id.*

84. *Deputies from Remote Regions Support Coastal Development*, XINHUA NEWS AGENCY, Mar. 29, 1988, *available in* LEXIS, Nexis Library, ASIAPC File.

acquisition of capital and technology, and the opportunity to obtain market shares and locational "good will." Some benefits have been bestowed upon the inland economies; however, the process has been slow and may be unsustainable in the long run because the coastal provinces are being given more freedom to make economic decisions.[85] The inland provinces are in a worsening and tenuous position because skilled workers, technical personnel, and technology are flowing to the coastal provinces in search of more lucrative opportunities.[86] Consequently, the gap in industry performance between the coast and the interior remains wide, and the harmony of interests among the regions is being challenged.[87]

The interior provinces are becoming increasingly concerned about regional disparities resulting from the FDI preferential policies permitted in the coastal region.[88] The tunnel effect that had kept the interior quiescent for almost a decade is disappearing.[89] Concerns were expressed at the National People's Congress (NPC) in the spring of 1988 when the coastal development strategy was submitted for approval.[90]

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85. *Id.*

86. *See* Dali, *supra* note 17.

87. *Id. See also Deputies from Remote Regions Support Coastal Development*, *supra* note 84.

88. *See* Dali, *supra* note 17.

89. The "tunnel effect" is analogized to a driver in a jammed tunnel. If the driver sees the other line moving, he will feel his situation has improved as well. However, this period is not indefinite. At a certain point in time, the driver will decide to take action and end the effect. Dali, *supra* note 17, at 231 n. 58, *citing* Albert O. Hirschman, *The Changing Tolerance for Income Inequality in the Course of Economic Development*, *in* UNDERDEVELOPMENT IN DEVELOPING ECONOMIES 519-43 (S.P. Singh ed., 1973).

90. Wan Deyong, NPC deputy from Gansu province, stated that while coastal areas are being developed, inland areas should not be neglected. He further stated that areas in West China felt left out of the development strategy, and that the state should formulate a corresponding development strategy for central and western areas. The same concerns were expressed by Song Ruixiang, NPC deputy and Governor of Qinghai province. Although Qinghai has latent potential in terms of natural resources, it is economically weak and can hardly advance on its own; the State Council should formulate a policy encouraging economic cooperation between eastern and western China so that additional funds, technology and trained people would be transferred from the coast to China's western areas. *Coastal Development Strategies Discussed*, BEIJING REV., Apr. 25-May 1, 1988, at 20. Pointed remarks also came from Bube, Chairman of the Inner Mongolia Autonomous Regional Government: "I hope the central government will also step up the development of the central and western regions, particularly the border areas, to narrow the economic gap between these areas and the coastal areas." *Deputies from Remote Regions Support Coastal Development*, *supra* note 84, *adapted from* Dali, *supra* note 17.

According to a report prepared by the China Regional Economic Society in 1990, transregional economic vitality strengthened in the 1980s, but the overemphasis on some regions has caused unequal competition and increased the disparity of economic development among regions.[91] The report recommended that industrial and regional policies be implemented to prevent natural resources, labor, and funds from flowing exclusively to more developed areas.[92]

In addition, the coastal region's three-tier FDI priority policy must be revitalized. First, the capital construction investment to open the SEZs, the ETDZs, and the coastal areas has been a heavy financial burden for both the central and local governments.[93] Since the early 1980s, the most frequently adopted model has been to map out, fund, and construct the basic infrastructural facilities for FDI projects.[94] This process is funded by the local host government, frequently before negotiations concerning the projects are concluded. When a development zone is involved, not only are production facilities necessary, but also residential, recreational, and social service facilities are required and most of these projects incur significant cost overruns.[95] Second, notwithstanding the exemptions from taxation, repatriation of profits, exemptions from import restrictions, and priority access to labor that are competitive with the terms offered by other developing countries, the opening of the Eastern European countries and the improved economic climate in Latin America have created increased competition for all forms of investment inflow. The competition intensified because of the capital shortage caused by the shrinkage of Japanese and German current account deficits, the financial problems of United States banks and corporations, and the constraints being imposed by other countries.

With both problems and new opportunities at hand, the government was forced to reconsider the uneven development strategy and its implementation in the 1990s, and devise the Eighth Five-Year

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at 254.

91. *China Strengthens Research on Regional Economies*, XINHUA NEWS AGENCY, May 22, 1990, *available in* LEXIS, Nexis Library, CHINA File.

92. *Id.*

93. *Wang Gingquan's Budget Report*, XINHUA NEWS AGENCY, Apr. 19, 1990, *available in* LEXIS, Nexis Library, CHINA File.

94. *Id.*

95. *Id.*

Plan (1991-95).[96] This plan is clearly a continuation of its predecessor. The emphasis now, however, is on the promotion of knowledge-based and technology-intensive industries in large interior cities, and the implementation of a series of measures related to FDI that improve the existing unfair competition and make more concessions to foreign investors.[97] The new plan not only continues to endorse a geographic preference, but also formulates and implements industrial policies. Specifically, any FDI project in line with state industrial policy and involving hi-tech or new-tech industry, or engaging in a major manufacturing undertaking, is entitled to the same preferential treatments applied to the ETDZs, regardless of its location.[98]

In addition, more than fifteen border cities and counties in southwest, northwest, north, and northeast China are declared open border cities.[99] Some areas are authorized to offer coastal FDI preferential policies, while others are to reopen or expand their existing border trade ties with neighboring countries.[100]

China has recognized that the service sectors of the Chinese economy, which involve lower entry costs, are potentially attractive to foreign investors.[101] Accordingly, the government now allows FDI participation in the service sector areas of banking, finance, and tourism. The government also permits entry into other service industries in a limited and experimental fashion.[102]

Finally, the government now allows foreign businessmen to purchase land-use rights to build infrastructural facilities, including residential, commercial, industrial, and recreational real estate. The most highly publicized project is the Yanpu Economic Development Zone, which occupies a thirty square kilometer (11.56 square miles) area of

96. THE EIGHTH FIVE-YEAR PLAN OF THE PEOPLE'S REPUBLIC OF CHINA 1991-1995 (1991).

97. *Id.*

98. *Id.*

99. *Id.*

100. The neighboring countries are Manzhouli, Heihe, Suifenhe, Dandong and Hunchun in Northeast China; Erenhot in North China; Pinxiang, Hekou, Wanding, Ruili and Zhangmu in Southwest China, and Yining, Bole, Tacheng, Kuitun, Shihezi and Urumqi in Northwest China.

101. *China Hand*, THE ECONOMY, May 1, 1991, *available in* LEXIS, Nexis Library, ASIAPC File.

102. Some of designated coastal cities are permitted to host FDI banking, finance and retail entities. Shanghai, as a major commercial center, is also permitted to establish a FDI insurance company.

land, is a seventy-year leasehold to the Kumagaya-Gumi (Hong Kong) Co. Ltd.[103]

The government's new policies imply the emergence of a more dynamic and open interior region of China with the Mid- and Lower Yangtze Valley acting as an additional growth pole. This area, with the industrial strength accumulated throughout the years and its comparative advantage in natural resources, should be a new hot spot for FDI in the 1990s and beyond. It is hoped that the Yangtze Valley will aid the coastal region in expediting the trickle-down effect. More fundamentally, the area's openness may stimulate a change in the economic mentality of the interior. The policies also indicate the government's attempt to maximize the coast's comparative advantage in order to make the interior more competitive in the FDI market.

China's opening and its priority policies favoring the coastal area gave rise to regional inequalities. Foreign investment and its related activities are not the only reason for the increased disparities, however, they have been significant contributors. To minimize the uneven impact of regional development policies, including foreign investment, comparable FDI priorities must be offered in the interior. The recent development of a strategy to open the areas along the borders, along the river, and along the coast demonstrates this effort. The uneven development strategy, however, is not entirely discarded. With respect to FDI, the evolution of the strategy is in the expansion of the favored region from the coast to the interior, especially the Mid and Lower Yangtze Valley. The emerging pattern is one in which the coast, the Valley, and the inland provincial capitals act as channels for capital, technology, and information for their respective hinterland relying on the latter for labor, energy and materials. Thus, the stimulative effects of FDI are constantly diffusing.

III. Foreign Direct Investment Laws: From Rudimentary Control to Rational Liberalization

Six months after the conclusion of the Communist Party of China's (CPC) Third Plenary Session of the Eleventh Central Committee which formally adopted the Open Door policy, the Second Session of the Fifth National People's Congress produced several significant laws

103. *Japanese Leasing of Chinese Zone to Go Ahead*, CHINA NEWS SERV., Apr. 15, 1989, *available in* LEXIS, Nexis Library, CHINA File.

including the Equity Joint Venture Law.[104] This was China's first foreign investment law. Seven years later, the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises was promulgated.[105] Finally, the law that legalized existing contractual joint ventures was adopted in 1988.[106] These three laws, despite delays, imperfections, and ambiguities, manifested China's enthusiasm toward foreign investment as a catalyst for its modernization program. The laws also provided the basic statutory framework for the operation of FDI firms in China.

The governmental endorsement of joint ventures (JV) in the late 1970s was justified by the need to recover from the economic disruption caused by the "Cultural Revolution."[107] Specifically, the JV law was intended to partially capitalize the industrialization program adopted in early 1978, but was later revised due to its overambitious goals. As China's trade deficit increased, foreign exchange reserves were depleted.[108] Profits from state enterprises dropped dramatically and problems generated by the shortage of experienced engineers and the lack of infrastructure that limiting China's capacity to absorb new technologies began to surface.[109] Solicitation of foreign capital was inevitable. A package of capital providing technology, management skills and access to international markets as well as capital was necessary to resolve these immediate problems.

The shift of political dominance and the demand for economic growth facilitated the creation of FDI firms. These same motivating forces brought about significant changes in FDI laws. The process of

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104. Equity Joint Venture Law, *supra* note 2.

105. Law of the People's Republic of China on Wholly Foreign-Owned Enterprises, promulgated June 12, 1986, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter Foreign Enterprise Law].

106. The Law of the People's Republic of China on Contractual Joint Ventures, promulgated Apr. 13, 1988, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter Contractual Joint Venture Law].

107. The Great Cultural Revolution officially began in early 1966 and ended in October 1976. It was initiated by Mao Zedong, then Chairman of the Communist Party of China, to oust his rivals within the Party and the government. The drama was concluded with Mao's death in September of 1976 and the subsequent arrest of his wife and her political allies, known as the "Gang of Four." For a general discussion of the growth and fluctuation in China's national economy, see CHENG CHU-YUAN, CHINA'S ECONOMIC DEVELOPMENT, GROWTH AND STRUCTURAL CHANGE 293-334, 477 (1982).

108. *Id.*

109. *Id.*

shifting from rudimentary control to rational liberalization is roughly related to the three phases that form the statutory framework for FDI firms.[110]

The initial phase from 1979 to 1986 saw the adoption of the Equity Joint Venture Law.[111] Several key points aid in understanding this important piece of legislation. First, the general principle behind China's economic development was reliance on internal efforts.[112] Therefore, the relative magnitude of foreign capital entering China must be small and it must not affect the system of socialist public ownership of the means of production.[113] Second, the radical's influence lingered and the Chinese leadership acted under the constant constraint of economic nationalism. Third, some Chinese leaders were wary of the negative political and economic effects of FDI, even though they favored an open policy. Finally, the leadership was inexperienced in dealing with FDI in JVs and, accordingly, exercised caution in formulating JV laws and regulations. Given this background, it is not surprising to find that the Equity Joint Venture Law explicitly required adherence to the principle of "equality and mutual benefits."[114]

China was keenly aware of the importance of adopting foreign investment policies that both attract and control FDI.[115] The growing and sustainable competitiveness over FDI of the neighboring Asian countries with their liberalization measures posed a great threat to China's solicitation of FDI. This evoked a "prisoner's dilemma"[116] which required competitive bidding. To respond to the difficulties inherent in competitive bidding and to appease general complaints from foreign business interests over difficulties encountered in operating FDI firms, the State Council adopted the Encouragement Provisions in 1986 to enhance

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110. For a different analysis and categorization, see PEARSON, *supra* note 73, at 70.

111. *Id.*

112. MAO, *supra* note 22.

113. *Id.*

114. Equity Joint Venture law, *supra* note 2.

115. Zheng, *supra* note 37, at 280-89.

116. This refers to the dependence of outcomes upon the strategies of other participants in a particular process. For a general discussion, see Stephen Guisinger, *Host-Country Policies to Attract and Control Foreign Investment*, *in* INVESTING AND DEVELOPMENT: NEW ROLES FOR PRIVATE CAPITAL 165-66 (Theodore H. Moran ed., 1986).

the attractiveness of China in the eyes of FDI firms.[117] These provisions led to the adoption of similar encouragement regulations on municipal and provincial levels. This rapidly growing body of laws marked the second phase of efforts to regulate FDI firms.

The Encouragement Provisions and accompanying implementation regulations proved to be a major governmental effort in encouraging FDI by offering incentives. The provisions, while falling short of a clear delineation of a foreign investor's rights, appeared to demonstrate the government's willingness to accommodate FDI activities through regulatory means. Consequently, the paradigm established in the first phase gave way to tolerance, reflecting the interplay of the leadership's political profundity with the demand for economic expansion and, more specifically, a conscientiously guided evolution of the legal treatment of FDI firms.

Until late 1990, the second phase had greatly facilitated the growth of FDI inflows. The number of projects pledged in all forms from 1987-1989 was 13,962, as compared to 7,853 from 1979-86, and the value of the projects actually utilized from 1987-1989 averaged an annual 2.97 billion United States dollars which was a three hundred-plus percent increase of the annual average of 0.94 billion United States dollars for 1979-1986.[118] This paradigmatic shift toward a liberal investment climate, increased foreign investors' confidence in doing business in China and, simultaneously, committed the Chinese government to establish a more consistent and rational regulatory framework.

In the spring of 1990, the Third Session of the Second NPC adopted the Amendment to the Equity Joint Venture Law,[119] which marked the beginning of the third regulatory phase. One year later, the New Income Tax Law was adopted.[120] On June 1, 1991, the first Copyright Law of the People's Republic of China came into force.[121]

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117. The Provisions for the Encouragement of Foreign Investment, promulgated Oct. 11, 1986, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter Encouragement Provisions].

118. *See* PEARSON, *supra* note 73.

119. Amendment of the Equity Joint Venture Law, Apr. 4, 1990, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter Amendment].

120. The Income Tax Law of the People's Republic of China Concerning Enterprises with Foreign Investment and Foreign Enterprises, Apr. 1991, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter New Tax Law].

121. The Copyright Law of the People's Republic of China, Sept. 1990, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter Copyright Law]. The Copyright Law extends protection to works of Chinese citizens, legal persons and units without the status

Simultaneously, the State Council promulgated the Computer Software Protection Regulations.[122]

These legislative developments, responding directly to both foreign criticisms and a demand for FDI expansion, have distinguished themselves from those having arisen in the previous two phases. Attempts were made to expunge technical inconsistencies in the existing laws and regulations. In addition, emphasis was placed upon the creation of a more consistent and systematic regulatory framework. For example, the adoption of the New Tax Law consolidated an array of foreign tax legislation into a coherent whole, in turn, providing a more rational tax system to facilitate further FDI growth.[123] Finally, the government exhibited a willingness to respond to foreign discontent and to defer to accepted international practice by adopting the Copyright Law and the Software Protection Regulations.[124] Although the economic results of the third stage efforts remain to be seen, the general trend to use rational economic regulations, rather than politically implicated controls, to accommodate FDI is self-evident. The following sections examine this process more in greater detail.

A. *Participants*

In the early phase of its foreign investment drive, China adopted a discriminatory policy with respect to the qualifications of JV participants. The Equity Joint Venture Law allowed foreign companies, enterprises, and other economic entities or individuals to enter into JV contracts.[125] The only Chinese permitted to participate in JV contracts, however, were companies, enterprises, and other economic entities.[126] Despite the dearth of Chinese individuals financially and technologically capable of entering into a JV contract during the late 1970s and early 1980s, the leadership's unwillingness to allow capitalist participation to

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of legal persons of China.

122. Computer Software Protection Regulations, promulgated May 24, 1991, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter Software Protection Regulations]. The Software Protection Regulations are designed to treat computer software as specifically protected subject matter. *See* Copyright Law, *supra* note 121, art. 53.

123. New Tax Law, *supra* note 120.

124. *See supra* notes 121-22.

125. Equity Joint Venture Law, *supra* note 2.

126. *Id.*

join the domestic private sector was conspicuous.[127] Consequently, Chinese participation was limited to authorized state, and later, urban collective enterprises.[128]

The General Principles of the Civil Law (GPCL), adopted in 1986, provided the first formal legal protection to individual enterprises.[129] These individual or private enterprises, however, are not classified as economic entities. Rather, they are grouped under the title "Citizen (Natural Person)."[130] Consequently, this category was excluded from Article 1 of the Equity Joint Venture Law.

In 1988, the NPC amended Article 11 of the Constitution to recognize and grant protection to the private economy.[131] A few months later, the State Council issued the Provisional Regulations Concerning Private Enterprises (Private Enterprises Regulation).[132] These regulations were designed to respond to the private economy's rapid growth and to complement the State Council's 1987 Provisional Regulations on the Administration of Urban and Rural Individual Industrial and Commercial Households.[133] The Provisional Regulations permitted the hiring of no more than seven employees.[134] Together, these regulations sought to distinguish private from individual enterprises by defining the former as profit-seeking economic organizations that employ eight or more persons as either sole proprietorships, partnerships, or limited companies.[135] Article 22 of the Private Enterprise Regulation also permits private enterprises to form equity or contractual JVs with foreign companies, enterprises, and other economic entities or with individuals.[136]

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127. *Id.*

128. *Id.*

129. General Principles of the Civil Law of the People's Republic of China, art. 28 (1986) [hereinafter GPCL].

130. *Id.* ch. II.

131. *China Amends Constitution*, XINHUA NEWS AGENCY, Apr. 12, 1988, *available in* LEXIS, Nexis Library, ASIAPC File.

132. Provisional Regulations Concerning Private Enterprises, *reported in* E. ASIAN EXEC. REP., Oct. 15, 1988, at 24 [hereinafter Private Enterprise Regulations].

133. Provisional Regulations on the Administration of Urban and Rural Individual Industrial and Commercial Households, Aug. 5, 1987, *available in* LEXIS, Nexis Library, CHINAL File.

134. *Id.*

135. *Id.*

136. Private Enterprise Regulations, *supra* note 132.

The leadership's evolution from its banning of private sector participation to a more positive and tolerant attitude evidenced its change in perspective with respect to JV controls. Three factors made this change possible. First, the overall economic structural reforms which began in the early 1980s were based upon the premise that private initiatives must be liberated. The successful reformation in rural areas, resulting from having allowed individual households to lease public land, inspired a similar reform drive in urban areas. This attempted reformation proved that public ownership of the means of production should be supplemented by private ownership.

Second, the private sector had established itself as a dynamic growth sector when provided with stable policy objectives. By the end of 1991, 14.168 million individual enterprises employed more that 22,580 workers.[137] By the end of 1992, approximately 140,000 private enterprises employed more than 1.84 million workers.[138] The total registered capital of both types exceeded 20.21 billion United States dollars and the payment of income tax in 1991 alone was almost three billion United States dollars.[139] Some private enterprises now operate on a vast scale resulting in a total of 488 millionaire households reported in 1991.[140]

Third, the general trend during the second phase to liberalize FDI control and to improve FDI climate favored adopting regulatory measures rather than imposing rigid controls. Although the Private Enterprise Regulations do not expressly encourage the creation of JVs with private enterprise participation, any qualified enterprise may participate.[141] This policy was further liberalized more recently as the growth of the private sector gained momentum.[142] In May 1993, the State Administration of Industry and Commerce issued "Several Guidelines on the Promotion of Economic Development of Individual and Private Enterprises," which specifically stated that, with the structural transformation of state enterprises, the private sector would face a new

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137. PEOPLE'S DAILY (Overseas Ed.), May 18, 1992, at 1; PEOPLE'S DAILY (Overseas Ed.), Feb. 20, 1993, at 1.

138. *Id.*

139. *Id.*

140. *Hong Kong China News Agency Reports China Has 488 Millionaire Households*, KYODO, June 26, 1991, *available in* DIALOG, News-asap File.

141. Private Enterprise Regulations, *supra* note 132.

142. PEOPLE'S DAILY (Overseas Ed.), May 12, 1993, at 1.

challenge, and the state would support any qualified private enterprise seeking to commence JVs with foreign investors.[143]

In recent years, foreign participation has initiated substantial growth in the Chinese private sector. Generally, private enterprises that have established foreign economic relations are limited to compensation trade, processing, or assembly. With the Private Enterprise Regulations in place, however, the stage is set for the entrance of qualified foreign players from the industrial sector, increasing the probability of considerable growth in the coming years.

B. *Sectors*

Article 3 of the Implementing Regulations broadly defines the industries open to JV undertakings: 1) energy development, building material, chemical and metallurgical industries; machine manufacturing, instrument and meter industries, and offshore oil exploration equipment manufacturing; 2) electronics and computer industries, and communication equipment manufacturing; 3) light, textile, foodstuffs, medicine, medical apparatus, and packing industries; 4) agriculture, animal husbandry, and fish breeding; and 5) tourism and service trade.[144] The regulations did not bar foreign investors from participating in any sector. Therefore, foreign investors could to enter into JV contracts in their particular line of business as long as the project did not threaten China's sovereignty, violate Chinese law, or cause environmental pollution.[145] In certain areas, however, foreign participation was virtually prohibited during the initial stage. These prohibitions promoted certain governmental goals. For example, the objective of promoting self-reliance required prohibitions on outside entry in onshore oil exploration.[146] Gradually, the informal restrictions on foreign participation in the form of JVs gave way to a greater flexibility when the foreign investment drive entered its second phase.

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143. *Id.*

144. The Regulations from the Implementation of the Law of People's Republic of China on Sino-Foreign Joint Ventures Using Chinese and Foreign Investment, promulgated Sept. 20, 1983, *available in* LEXIS, Nexis library, CHINAL File [hereinafter Implementing Regulations].

145. *Id.* art. 5.

146. Kim Woodard & Bruce Vernor, *Petroleum Exploration Update*, E. ASIAN EXEC. REP., Apr. 15, 1989, at 9, *available in* LEXIS, Nexis Library, ASIAPC File.

The banking industry was the first sector to undergo significant change.[147] In 1985, the State Council issued the Regulations of the People's Republic of China Relating to the Operations of Foreign Banks and Chinese-Foreign Joint Banks in Special Economic Zones (1985 SEZ Banking Regulations).[148] The Shanghai Regulatory Measures Relating to Foreign Financial Institutions and Joint Chinese-Foreign Financial Institutions followed in 1990 (1990 Shanghai Banking Regulations).[149] The formerly cautious attitude, which reflected a concern that foreign participation would disrupt the existing Chinese financial system or lead to the manipulation of Chinese financial market, was unnecessary, and perhaps even unjustified. A growing number of foreign banks set up joint operations with Chinese financial institutions or opened branch offices in the SEZs and Shanghai.[150] This process invigorated the financial markets and brought with it new capital in the form of loans.[151] By the end of 1992, 170 foreign banks, foreign-Chinese joint banks, and other financial institutions had opened their offices.[152] These operations are currently expanding to industrial and commercial centers such as Canton, Tianjin, Qindao, Nanjing, and Dalian.[153]

Another area of governmental interest is real estate development. Until the 1982 Constitution and the 1987 Land Management Law were amended in 1988, national law prohibited the lease or transfer of state- or collectively owned land.[154] The only exception was land used by JVs in accordance with special land use legislation.[155] The prohibition of foreign participation in real estate development was not surprising given

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147. Pauline Loong, *Japanese Joker in the Pack*, EUROMONEY, Oct. 1987, at 137.

148. Regulations of the People's Republic of China Relating to the Operations of Foreign Banks and Chinese-Foreign Joint Banks in Special Economic Zones, *available in* LEXIS, Nexis Library, CHINAL File.

149. Shanghai Regulatory Measures Relating to Foreign Financial Institutions and Joint Chinese-Foreign Financial Institutions, *available in* LEXIS, Nexis Library, CHINAL File.

150. *Id.*

151. *Id.*

152. PEOPLE'S DAILY (Overseas Ed.), June 25, 1992, at 1.

153. *Id.*

154. Article 10 of the 1982 Constitution formerly provided that "no organization or individual may appropriate, buy, sell, or lease land or otherwise engage in the transfer of land by unlawful means." The 1988 Amendment deleted "or lease land," and added that "[t]he right to the use of land may be transferred according to law." *See supra* notes 131-32.

155. *Id.*

its history of humiliations suffered by leasing land to foreigners under gun point.

The absolute ban on foreign participation in real estate development was lifted in 1988, with the adoption of an Amendment to the 1982 Constitution,[156] and the issuance of the Interim Administrative Measures for the Investment in and Development and Management of Parcels of Land by Foreign Businesses by the State Council in 1990.[157] The latter measures are applicable in the SEZs, the open coastal cities, and the open areas.[158] Until 1991, the number of provinces, autonomous regions, and centrally administered municipalities engaging in this "lease to foreigners" or "joint development" flurry had exceeded seventeen, and the total space committed to such lease or development was well over 2,500 hectares.[159] For the first half of 1993, an astonishing 9.54 billion United States dollars of FDI went into real estate, which accounted for 16.4 percent of the total committed foreign investment in that period.[160]

The government successfully eased restrictions on foreign participation in other sectors. Two onshore oil exploration contracts were signed in 1990 and 1991, respectively,[161] and a total of twenty-one provinces, autonomous regions, and centrally administered cities are now open to foreign petroleum companies.[162] A foreign firm that had applied to import and export in the Waigaoqiao Bonded Zone in Shanghai recently secured permission from the Ministry of Foreign Economic Relations and Trade (MOFERT).[163] This is the first such permission that MOFERT has granted, and more applications are expected to be filed

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156. *Id.*

157. Interim Administrative Measures for the Investment in and Development and Management of Parcels of Land by Foreign Businesses, promulgated May 19, 1990. For an English translation, see E. ASIAN EXEC. REP., Sept. 15, 1990, at 22, *available in* LEXIS, Nexis library, CHINAL file.

158. *Id.*

159. PEOPLE'S DAILY (Overseas Ed.), June 26, 1992, at 1. These leased lands will be used to develop residential, commercial as well as industrial and hi-tech facilities.

160. *See Foreign Investment in China Increases Greatly*, XINHUA NEWS AGENCY, Aug. 24, 1993, *available in* LEXIS, Nexis Library, CHINA File.

161. The onshore restriction was lifted in 1986, and foreign companies were given access to 11 southern provinces. ASIAN WALL ST. J. WKLY., June 3, 1991, at 15.

162. PEOPLE'S DAILY (Overseas Ed.), Feb. 26, 1992, at 1; PEOPLE'S DAILY (Overseas Ed.), Feb. 18, 1993, at 1.

163. PEOPLE'S DAILY (Overseas Ed.), Feb. 26, 1992, at 1.

with MOFERT.[164] Finally, an agreement was signed recently between China Fujian Local Railway Corporation and a Japanese investment group to jointly build and manage a high-speed railway from Fuzhou to Xiamen with a total investment of two billion United States dollars.[165]

What has caused these changes? How does the Chinese leadership shift from its former absolute banning of foreign participation in those areas, to the present, more lenient, and liberal stance? First, demand is outstripping production. Second, economic growth and expansion need continual infusions of new capital. In the case of foreign banking and joint banking operations, new capital must be brought in because the bank loans have so far surpassed deposits made to these institutions.[166] Real estate development must change to provide industry with more modern facilities.[167] In addition, leases bring in a considerable amount of revenue for the local and the national governments. This revenue, in turn, helps develop other priorities. In the case of onshore oil exploration, the development activities remain undercapitalized while consumption of refined petroleum products driven by China's rapidly expanding economy is rising at a rate of six to ten percent per year.[168]

In order for the Open Door policy to succeed, a comprehensive and systematic line of infrastructure must be established. For example, the creation of a sound financial environment from the perspective of national and international financial strategy would greatly benefit China's integration into the world economy. The leadership has come to understand that opening particularly important areas does not necessarily lead to international dominance or manipulation as it did in the pre-1949 period. With the gradual formulation of a regulatory framework that guarantees government supervision, foreign participation in these areas can be manipulated to yield benefits for both China's economy and foreign investors. Finally, in exchange for GATT membership, China must open a broad range of service sectors, such as banking, accounting, publishing, and legal services.[169]

The earlier investment policy with respect to permissible areas of foreign investment has changed significantly. As evidenced by the CPC

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164. *Id.*

165. PEOPLE'S DAILY (Overseas Ed.), June 16, 1992, at 1.

166. *See* Loong, *supra* note 147.

167. PEOPLE'S DAILY (Overseas Ed.), Feb. 18, 1993, at 1.

168. *See* Woodard & Vernot, *supra* note 146, at 9.

169. Xiao Wang, *China: Economic Reform Buoys China's Bid to Rejoin GATT*, BUS. WK., REUTERS, Sept. 19, 1993.

Central Committee and State Council's decision to make service industry development a priority in the 1990s, continued liberalization in this direction is inevitable. This emphasis promises a new receptacle for foreign participation.

C. *Labor*

Labor, more than any other FDI-related issue, is directly linked to every social consequence.[170] This is especially true in China where both the movement and management of labor are tightly controlled by the state. In order for FDI firms to fully understand hiring, managing, paying, and dismissing Chinese workers it is necessary to examine the evolution of labor management in China as a whole.[171]

In 1949, the CPC came into power and established a massive foundation of state enterprises. The government created a presumption in favor of indefinite, or permanent, employment in state enterprises, in part to prove the virtue of socialism.[172] A full range of fringe benefits and higher wages were directly budgeted by the state and guaranteed regardless of individual job performance.[173] State enterprise employees became a privileged group who enjoyed higher social status. Workers in other groups were much less privileged.[174] From the state's perspective, the privileged group of workers was permanent because they enjoyed virtual immunity from dismissal.[175] From the employees' perspective, they were permanent because they could not change their jobs even if they so desired.[176] Once employed, they remained with their employer unless they were approved to do otherwise.[177] Workers in urban collective industry were subject to similar labor management regulations.[178] In each case, whether the worker was permanent or

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170. CARL RISKIN, CHINA'S POLITICAL ECONOMY: THE QUEST FOR DEVELOPMENT SINCE 1949, 354-56 (1987).

171. *Id.*

172. *Id.*

173. *Id.*

174. Those less privileged are workers in urban collective industry, temporary workers in urban enterprises, both state and collective; and rural workers in collective town and village industries. *Id.*

175. RISKIN, *supra* note 170, at 355.

176. *Id.*

177. *Id.*

178. *Id.*

temporary, relocation to another city depended on whether registered permanent residency could be obtained. Such relocation had been strictly controlled, until recently.[179] This control was particularly stringent when applicants intended to migrate to cities from rural areas, to coastal regions from inland provinces, or to major metropolitan areas from smaller cities or towns.[180]

Against this backdrop, the State Council issued the Regulations of the People's Republic of China on Labor Management in Joint Ventures Using Chinese and Foreign Investment (Labor Regulations) in 1980.[181] The Labor Regulations provide that employee related affairs, including dismissal and resignation of workers for JVs, must be included in a labor contract approved by the requisite government labor management departments.[182] Specifically, the regulations provide that JVs may employ workers recommended by either the local government in charge of the venture or the local labor management department, or recruit on their own.[183] According to the Labor Regulations the government must approve any discharge of workers.[184] A wage ceiling was imposed at a level not exceeding 150 percent of the real wages of the staff and workers of state enterprises in a particular locality in the same line of business.[185] Although the government frequently endorsed permitting FDI firms to exercise control over hiring and firing of staff and workers, the Labor Regulations fulfilled their intended goal. First, most ventures were pressured to accept the recommendations of the Chinese partner to use personnel from its own unit without instituting formal selection procedures.[186] The Chinese rationalized this local government control by declaring that China should not allow state enterprise workers to lose

179. *Id.* at 356.

180. The control is justified by the attempt to achieve a rational distribution of population in alignment with economic developments in various regions. This mechanism is still in place despite the fact that additional exceptions have been created and de facto relaxation provided.

181. Regulations of the People's Republic of China on Labor Management in Joint Ventures Using Chinese and Foreign Investment, promulgated July 26, 1980, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter Labor Regulations].

182. *Id.* art. 2.

183. *Id.* art. 3.

184. *Id.* art. 5.

185. *Id.* art. 8.

186. Michael J. Moser, *Foreign Investment in China: The Legal Framework*, *in* FOREIGN TRADE, INVESTMENT, AND THE LAW IN THE PRC 126 (1984).

their permanent jobs.[187] Second, although provisions governing dismissal must be included in labor contracts to be approved by the labor management department, the Labor Regulations still subjected management decisions with regard to dismissal to further discretionary approval by the same labor department.[188] This is anomalous since dispute resolution provisions were included in the contract. Dispute resolution should have entitled the management to seek judicial or quasi-judicial recourse rather than arbitrary and discretionary administrative approval. Consequently, JVs' rights to independently control their own affairs were impaired. Third, the government was willing to exercise its control through the wage ceiling provision to avoid exacerbating domestic inequalities among different categories of workers.[189] Resentment may increase if the gap in incomes widens between venture employees who were former state enterprise workers and those who had remained.

Government controls were rooted in the country's labor management system causing a mismatch of skills to job requirements, and an imbalance of labor supply and demand. These deficiencies had to be corrected before offering FDI firms greater freedom in managing their labor.

The contract employment system was later introduced in 1983.[190] Although its ultimate goal was to replace the permanent employment system, the new strategy was accepted by Chinese society.[191] In the following year, the Ministry of Labor and Personnel changed the emphasis in the recruitment rules with the Provisions for the Implementation of the Regulations on Labor Management in Joint Ventures Using Chinese and Foreign Investment (Implementation

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187. Most Chinese partners to JVs established in the early 1980s were state enterprises. *Id.*

188. Labor Regulations, *supra* note 181, art. 14.

189. R. KLEINBERG, CHINA'S "OPENING" TO THE OUTSIDE WORLD 199 (1990).

190. In contrast to temporary workers as traditionally defined, a contract worker is placed on the enterprise's official roster and paid out of the same state wage fund used to pay permanent workers. They are treated on equal terms with permanent workers with respect to fringe benefits and other social, technical, political and ideological activities. One difference exists, however, that while permanent workers enjoy job security, the contract worker retains his position only if his contract is renewed. *Id.*

191. *Id.*

Provisions).[192] This regulation allowed managerial, engineering and technical personnel to be recruited from anywhere in the country.[193] Under this regulation, transfer disputes are resolved by the appropriate regional labor departments.[194]

The contract employment system improved labor mobility by freeing people with higher career goals from the "permanent employee" mentality.[195] The Implementation Provisions also removed the approval requirement for discharging JV employees by substituting a procedural report for record.[196] Therefore, the government cannot intervene when JVs' sanction their employees by discharging them.[197]

In July 1986, the State Council issued four sets of regulations concerning the hiring and dismissal of workers in state enterprises.[198] These regulations aligned the practice of state enterprises with the labor management systems of FDI firms in such key areas as the content of labor contracts and procedures for hiring and dismissing employees. Three months later, the State Council issued the Encouragement Provisions which further emphasized the autonomy of FDI firms to determine their organizational and personnel system, wage levels, forms of wages and bonuses, and allowance system, thereby lifting the government controls and restrictions imposed by the Labor Regulations in 1980.[199]

The changes imposed by the new regulations should be evaluated with an understanding that labor management in JVs is contingent upon improving labor qualification and increasing mobility within the country. A gradual increase in the number of contract employees in state

192. Provisions for the Implementation of the Regulations on Labor Management in Joint Ventures Using Chinese and Foreign Investment, Jan. 19, 1984, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter Labor Implementation Provisions].

193. *Id.* art. 3.

194. *Id.*

195. *Id.*

196. *Id.* art. 10.

197. Labor Implementation Provisions, *supra* note 192, art. 10.

198. These regulations include: 1) Provisional Regulations on the Implementation of the Contract Employment System in State Enterprises, promulgated July 1986; 2) Provisional Regulations on the Hiring of Workers in State Enterprises, promulgated July 1986; 3) Provisional Regulations on the Dismissal of Workers and Staff for Work Violations in State Enterprises, promulgated July 1986; and 4) Provisional Regulations on Unemployment Insurance for Workers and Staff in State Enterprises, promulgated 1986.

199. Encouragement Provisions, *supra* note 117, art. 15.

enterprises and in other types of domestic enterprises will eventually resolve the problems of labor management in JVs.

D. Tax

China is a developing country. As such, its status as a host country makes the development of a rational tax system of paramount importance. A rational tax system would facilitate the generation of maximum revenues for the state from the income of FDI firms and other trading activities, without discouraging FDI entries and other business activities in China.

Although "taxation in China is almost as old as the country itself," taxing the income of foreign-related business and trading activities is relatively new.[200] Historically, China had never enacted income tax laws for such purposes. In the early 1980s, however, when China began its program of economic reform and opening to the outside world, the government passed a series of laws and regulations designed to tax certain aspects of FDI firms and other foreign-owned business activities.[201]

The past fifteen years have seen three stages of the tax regime, as applied to FDI firms and other types of China-related foreign business activities. The first stage began with the adoption of the Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment (Equity Joint Venture Income Tax Law) in September 1980.[202] The Individual Income Tax Law of the People's Republic of China,[203] the Foreign Enterprise Income Tax Law of the People's Republic of China[204] and their respective implementing rules established an initial scheme for taxing FDI firms, foreign companies, and individuals.

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200. Li Jinyan, *Taxation of Foreign Investment in the People's Republic of China*, 12 LOY. L.A. INT'L & COMP. L.J. 35 (1989).

201. *Id.*

202. Income Tax Law of the People's Republic of China Concerning Joint Ventures with Chinese and Foreign Investment, *adopted* Sept. 10, 1980, *repealed* in 1991 when the New Tax Law was adopted, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter Equity Joint Venture Income Tax Law].

203. Individual Income Tax Law of the People's Republic of China, *adopted* Sept. 10, 1980, *available in* LEXIS, Nexis Library, CHINAL File.

204. Foreign Enterprise Income Tax Law of the People's Republic of China, *adopted* Dec. 13, 1981, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter Foreign Enterprise Income Tax Law].

Initially, the goal of the drive to encourage FDI was to seek revenue from sources other than taxation,[205] especially in light of the limited performance of the FDI and foreign businesses during their start-up stages. Accordingly, initial tax favors were offered to attract a greater number of FDI commitments and to guide FDI flows into desired sectors of the economy.[206]

The second phase of the tax regime began in 1984 with the adoption of the Provisional Regulations on the Reduction and Exemption of Enterprises Income Tax and Consolidated Industrial and Commercial Tax in the Special Economic Zones and fourteen coastal port cities.[207] The regulations recognized existing tax incentives for FDI firms in the SEZs and extended those incentives to the fourteen coastal cities.[208] After this geographic proliferation of tax incentives, the State Council issued the Encouragement Provisions in 1986, which developed a set of performance-targeted preferential tax rules.[209] During this time, expansion of national income tax concessions beyond those initial favors allowed by the Equity Joint Venture Income Tax Law was limited to the SEZs and fourteen coastal cities.[210] Tax incentives, however, were being adopted on the local level to reduce local income tax.[211]

The Encouragement Provisions made some of the tax incentives formerly available only in the SEZs and fourteen coastal cities available nationally.[212] The Encouragement Provisions also introduced new tax concessions to promote technologically advanced export FDI firms without imposing geographic limitations. Consequently, these provisions precipitated the rapid adoption of local regulations offering similar tax concessions.[213] Some local concessions were even greater than those allowed by the national legislation.[214] This proliferation of tax favors

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205. Li, *supra* note 200.

206. *Id.*

207. Provisional Regulations on the Reduction and Exemption of Enterprises Income Tax and Consolidated Industrial and Commercial Tax in the Special Economic Zones, *adopted* Nov. 15, 1984, *available in* LEXIS, Nexis Library, CHINAL File.

208. *Id.* art. 1.

209. Li, *supra* note 200, at 43.

210. *Id.*

211. Han Guojian, *Attuning Taxation to Investment Climate*, 34 BEIJING REV., Mar. 11-17, 1991, at 23.

212. Encouragement Provisions, *supra* note 117.

213. Han, *supra* note 211, at 24.

214. *Id.*

for FDI firms continued until 1988, when the central government began to correct local tax rules and regulations that had been formulated without authorization.[215]

By 1988, China had an impressive body of legislation and administrative rulings relating to the taxation of FDI firms and other foreign business operations. This piecemeal legislation played a vital role in China's decade-long FDI promotion, particularly the Equity Joint Venture Income Tax Law and the Foreign Enterprise Income Tax Law. Imperfections and limits in their application, however, became apparent when China began moving to a new phase of FDI development.

The Chinese government recognized the importance of the tax environment when judging the quality of an investment environment.[216] Furthermore, the government knew that a good tax environment maintains a stable, reasonable and equitable tax rate, has easy filing procedures, and generally holds to international practices. Prior to 1991, the tax regime did not provide such a climate. Thus, the system had to be overhauled. Hence, the third phase of China's taxation scheme for FDI firms was begun in the late 1980s.

Perhaps the most important problem facing the Chinese legislature was the source rule adopted by the Foreign Enterprise Income Tax Law.[217] Pursuant to the jurisdictional provision, the law applied to foreign companies participating in cooperative or contract JVs, or setting up their own operations or other activities deemed to have taxable establishments in China, and to the passive income of foreign companies not having establishments in China.[218] The rule governing the taxation of passive income of foreign companies with establishments in China was clear: Only passive income derived from China was subject to taxation.[219] The rule was ambiguous, however, as it pertained to other

215. By the end of 1990, a total of 31 provinces, autonomous regions and municipalities, and cities, under a separate state plan, rectified and revised their unauthorized tax preferential rules and regulations. *Id.*

216. *Id.*

217. *See* The Explanation on the Draft Income Tax Law of the People's Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises, delivered by Mr. Wang Binquan at the Fourth Session of the 7th NPC, Apr. 2, 1991, PEOPLE'S DAILY (Overseas Ed.), Apr. 17, 1991, at 3.

218. Foreign Enterprise Income Tax Law, *supra* note 204, art. 1, ¶ 2.

219. *Id.* art. 11.

foreign business operations in China.[220] It could be interpreted to mean that, regardless of whether the foreign company had establishments in China, it was only taxed on its China source income.[221]

The Foreign Enterprise Law together with the Contractual Joint Venture Law legislatively pronounced FDI firms to be Chinese legal persons.[222] Consequently, in addition to potential jurisdictional problems, the Chinese tax authority was troubled by entities registered as Chinese legal persons and headquartered in China, but not paying tax on their worldwide income.[223] This was the case even though tax was to be paid by these entities under the residence principle incorporated into the Equity Joint Venture Income Tax Law.[224]

An additional flaw in the existing tax regime was the disparity between taxing equity JVs at a flat rate of thirty-three percent, including a local tax, and taxing contractual JVs and one hundred percent foreign-owned enterprises at a progressive rate ranging from twenty to forty

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220. *Id.* art. 1, ¶ 1. "In the People's Republic of China, the income of foreign enterprises from production, business operations and other sources will be taxed according to the provisions of this law." *Id.*

221. Timothy Gelatt & Richard Pomp, *Tax Aspects of Doing Business with the People's Republic of China*, 22 COLUM. J. TRANSNAT'L L. 465 (1984). Conversely, equity JVs, sanctioned as legal person by the Equity Joint Venture Law, were subject to tax on worldwide income. *Id.*

222. Foreign Enterprise Income Tax Law, *supra* note 204, art. 8.; Contractual Joint Venture Law, *supra* note 106, art. 2, ¶ 2. It is important to note that, although some contractual joint undertakings organized pursuant to the law did not create such a Chinese legal person for the reason that they did not intend to create an entity as required by the GPCL, *supra* note 129. Most contractual JVs did acquire the status of a Chinese legal person. Under the GPCL, a legal person must:

> (1) be created pursuant to the law; (2) possess necessary property or funds; (3) have its own name, organization and premises; and (4) be capable of bearing civil liabilities independently.

Id. art. 37.

223. The Foreign Enterprise Income Tax Law had its jurisdictional limits which, theoretically, should exclude 100% foreign owned enterprises from its application. In reality, however, because no appropriate law was applicable, these enterprises were still subject to the Foreign Enterprise Income Tax Law. For those contractual joint ventures established as Chinese legal persons, the Equity Joint Venture Income Tax Law applied.

224. Equity Joint Venture Income Tax Law, *supra* note 202, art. 1, ¶ 2. "Income tax on the income derived from production, business and other sources by branches within or outside the territory of China of such joint ventures shall be paid by their head offices." *Id.*

percent.[225] In other words, while the real tax rate did not show a great differential as compared to the thirty percent flat rate under the Equity Joint Venture Income Tax Law, the maximum rate for a company whose annual income was below RMB 750,000 could approach fifty percent once a ten percent local tax was added.[226] This differential in favor of equity JVs created an impression of unequal treatment of different FDI forms, and served as a disincentive to prospective investors that preferred joint undertakings or sole operations to equity JVs. An income tax rate of fifty percent was formidable to any investor, despite China's other advantages when compared to the trend in other countries of reducing income tax rates.

The legislature rectified the inconsistent tax concessions contained in the two laws. For example, the Equity Joint Venture Income Tax Law offered a two-year tax exemption followed by three years of fifty percent reduction to JVs scheduled to operate for ten years or more, regardless of whether they were productive or non-productive and whether they were engaged in a priority industry or project.[227] The tax concession offered by the Foreign Enterprise Income Tax Law, however, was limited to a one-year exemption followed by two years of fifty percent reduction for only a small category of low margin profit operations scheduled to operate for ten years or more, such as those in agriculture, forestry and animal husbandry.[228] While the government's favoritism toward equity JVs was probably a necessary and rational position in the early 1980s, before the two more creative FDI vehicles gained any legislative backing, the disparity negatively impacted the state's industrial policies and created inequity in its tax policies.[229]

After three years of extensive drafting and debate, the Implementing Rules of the Income Tax Law of the People's Republic of China Concerning Enterprises with Foreign Investment and Foreign Enterprises (New Tax Law)[230] took effect on July 1, 1991. The law repealed the Equity Joint Venture Income Tax Law and the Foreign

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225. Foreign Enterprise Income Tax Law, *supra* note 204, art. 3.

226. *See infra* Table 4.

227. *See* Equity Joint Venture Income Tax Law, *supra* note 202.

228. *See* Foreign Enterprise Income Tax Law, *supra* note 204.

229. Li, *supra* note 200, at 48-49.

230. The Implementing Rules of the Income Tax Law of the People's Republic of China Concerning Enterprises with Foreign Investment and Foreign Enterprises, June 30, 1991, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter New Tax Implementing Rules].

Enterprise Income Tax Law and merged many of their provisions, including the panoply of existing provisions on tax benefits for enterprises in different categories.[231]

Many features of this newly-emerged Chinese tax regime are noteworthy. First, it offers tax incentives to strengthen productive industrial sectors, such as energy, transportation, and ports.[232] These sectors are targeted for growth and development in the 1990s. The new regime also seeks to stimulate exports of manufactured goods and to ensure that manufacturing moves progressively up the ladder of value-added production. Second, the New Tax Law ensures that incentives apply to every FDI firm regardless its form, as long as it is among the designated industries or areas.[233] The new regime also introduces a new tax concept: arms-length transactions.[234] The adoption of the concept was designed to reduce transfer pricing practices at FDI firms.[235] "Fair market price" and "regular business practice" standards are used to curb tax evasions previously accomplished by manipulating transfer prices between related enterprises.[236] Thus, China has entered an era of adopting international practices.

Next, the tax regime exempts profits from FDI firms obtained by foreign investors from Chinese income tax.[237] This relieves foreign investors of a ten percent profit repatriation tax under the Equity Joint Venture Income Tax Law, and places them on equal footing with FDI firms in the SEZs and ETDZs.

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231. *See infra* Table 5.

232. *Id.*

233. *See* Equity Joint Venture Income Tax Law, *supra* note 202.

234. New Tax Law, *supra* note 120, art. 13. Strictly speaking, the concept is not new. In 1988, the Shenzhen SEZ adopted China's first local law against tax evasion through transfer pricing. Han, *supra* note 211, at 26.

235. Tax evasion through transfer pricing has not been infrequent in FDI firms in China, particularly those in south coastal areas. For example, a company located in Shenzhen manufacturing electronic products reported losses for two consecutive years, immediately after the expiration of granted tax holidays up to HK$88,970, while its annual sales volume reached to HK$400 million. An investigation conducted by the local tax authority revealed that the company sold its products to an affiliate based in Hong Kong at a price 20-40% lower than fair market price. In addition, a survey showed that many FDI firms in Guangdong and Fujian provinces that reported business losses were in fact profitable. Han, *supra* note 211, at 25.

236. New Tax Law, *supra* note 120, arts. 52-58.

237. *Id.* art. 19, ¶ 3.

The new regime surpasses its predecessors both in its treatment of categorized taxpayers, tax rates and tax concessions and in equity by placing FDI firms on a level playing field. The New Tax Law's most admirable achievement, however, is its attempt to align with international practices while accommodating China's established practices and its needs.[238] Overall, the new regime appears to provide a more inviting tax climate for FDI and other foreign business operations by placing key elements in perspective and eliminating confusion.

In 1979, the Chinese government invited several American tax professors to conduct a seminar under the auspices of the Harvard Law School International Tax Program to aid Chinese tax officials in understanding the generally accepted practices of the international tax community.[239] The journey from that seminar through the encouragement proliferation period to the adoption of the New Tax Law in 1990 is a process that necessitated many changes in the tax regime. While the income tax contributes to the state's revenue, the main thrust of China's tax regime is to attract FDI through tax concessions to bring in technology and increase manufacturing capabilities.[240] Given the solid foundation that the new regime provides and the accumulated experiences of China's tax officials in the tax process, China has come of age with a stable tax climate for FDI operations.

E. *Foreign Exchange*

As a socialist country with a planned economy, China determined that in order to build a healthy and strong foreign exchange reserve, foreign exchange earnings and their use should be coordinated under a unified national plan.[241] This reserve was needed to fund economic reconstruction and development. Establishment of an effective mechanism to centralize foreign exchange management was essential because central foreign exchange management could not be established while foreign powers continued to enjoy economic and financial

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238. *E.g.*, the source rule, the arms-length transaction rule, the foreign credit rule and both deductible and non-deductible items.

239. Richard Pomp & Stanley Surrey, *The Tax Structure of the People's Republic of China*, 20 VA. J. INT'L L. 1 (1979).

240. *Id.*

241. Claudia Gilman, *Provisional Regulations for Foreign Exchange Control Announced*, E. ASIAN EXEC. REP., Feb. 15, 1981.

operations in China, particularly when private sector continued to dominate the nation's foreign exchange transactions.[242]

Accordingly, the primary tasks of foreign exchange control from 1950 to 1956 were to terminate foreign privileges, to eliminate the foreign exchange black market, and to restrict foreign exchange transactions conducted by private industrial and commercial entities.[243] Toward the end of this phase, a centralized foreign exchange control system was established which required foreign exchange income, whether derived from export or from services rendered, or remitted from Chinese outside the country to help their families or relatives, to be deposited with, or sold to the state bank.[244] Foreign exchange expenditures also had to be approved by the Administrative Council of the Central Government. Greater priority was placed on centrally planned projects, industrial strengthening, and state enterprises, than on locally funded projects, commercial expansions, and private or collective enterprises.[245] These extraordinary measures were necessary to stabilize price and banking activities, to strengthen its industrial capabilities, and to transform privately owned financial, industrial and commercial entities into state-operated enterprises.[246]

A second phase of China's foreign exchange control mechanisms began in 1956 with the conclusion of the socialist transformation of private entities.[247] The government prohibited foreign exchange transactions among its citizens and enterprises; foreign trade was monopolized by state foreign trade corporations; and most foreign banks discontinued their operations in China.[248]

The Open Door policy introduced in 1978 brought China's foreign exchange control mechanism into its third phase of evolution. Soon after the State Administration of Exchange Control (SAEC) was established in 1979, the State Council promulgated the Provisional Regulations for Foreign Exchange Control of the People's Republic of China (Foreign

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242. *Id.*

243. *Id.*

244. *Id.*

245. *Id.*

246. JOHN K. FAIRBANK, CHINA: A NEW HISTORY 345-59 (1992).

247. *Id.*

248. For a background discussion, see *infra* notes 290-339 and accompanying text.

Exchange Regulations).[249] These regulations were followed by a host of detailed implementation rules. To facilitate FDI firms in their foreign exchange transactions and to implement Chapter Five of the Foreign Exchange Regulations, SAEC issued the Detailed Rules for the Implementation of Foreign Exchange Control Governing Enterprises with Overseas Chinese Investment, Foreign Enterprises and Sino-Foreign Equity Joint Ventures in 1983 (Foreign Exchange Implementation Rules).[250] Generally, FDI firms enjoy a more relaxed treatment under this regime than their Chinese counterparts. The fundamental principle of the Foreign Exchange Implementation Rules is to encourage FDI firms to achieve a foreign exchange balance in their operations.[251] This goal reflects the government's consistent effort to adopt various flexible measures that placate foreign investors experiencing foreign exchange shortfalls, particularly during their start-up stages.

The primary cause of foreign exchange imbalance for most FDI firms is the non-convertibility of the Chinese currency, the RMB.[252] Other complications exist, however. Maintaining a foreign exchange balance does not pose a problem for FDI firms whose objective is the utilization of China's low-wage labor or raw materials for the production of goods for export, if the business is successful. For firms whose goal is to sell their products domestically, however, locating enough foreign exchange to cover costs for imported equipment and materials, salaries for their expatriate staff, royalties for proprietary technologies transferred

249. Provisional Regulations for Foreign Exchange Control of the People's Republic of China, *adopted* Dec. 5, 1980, *available in* LEXIS, Nexis Library, CHINA File [hereinafter Foreign Exchange Regulations].

250. Detailed Rules for the Implementation of Foreign Exchange Control Governing Enterprises with Overseas Chinese Investment, Foreign Enterprises and Sino-Foreign Equity Joint Ventures, promulgated Aug. 1, 1983, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter Foreign Exchange Implementation Rules]. According to these rules, foreign enterprises include 2 types: wholly foreign owned enterprises and foreign companies that have formed contractual JVs with Chinese partners.

251. Allan Liu, *A Strategic Approach to Investment in China: Lessons to be Learned and Keys to Success*, 10 N.Y.L. SCH. J. INT'L & COMP. L. 51 (1989).

252. A survey conducted in 1988 revealed that, 52% of the respondents remained a deficit in foreign exchange; 18% reported a surplus, another 18% met their needs; and 12% had no foreign exchange at all. *Id.* at 54.

to the enterprise, and profits or dividends that are to be remitted outside China, is almost unmanageable without government assistance.[253]

Theoretically, the localization of component supplies keeps foreign exchange expenditures low while the export of products generates foreign exchange income. In practice, however, the continual technical upgrading required for international price competitiveness exceeded the capabilities of local suppliers in some industries.[254] Finally, swerving Chinese fiscal policy also hurt FDI firms in their foreign exchange planning.[255]

Despite China's recognition of the importance of foreign exchange balance to foreign investors, the government believed that FDI firms themselves should make efforts to increase foreign exchange earnings through export.[256] The foreign exchange balance directly affects FDI firms' ability to repatriate earned profits, which, in turn influences

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253. For example, when Volkswagen started its joint venture operation in Shanghai in the early 1980s, it imported all the kits needed to produce joint venture product "Santana" to sell 100% domestically, only with the promise of the government that money earned in RMB could be converted into hard currencies for the purchase of parts outside China and the repatriation of profits to West Germany. Amanda Bennett & Roger Thurow, *VW and China Complete Auto Production Pact*, WALL ST. J., Oct. 11, 1984, at 37.

254. For example, in Shanghai Volkswagen, the local content in 1990 was 28%; a target of 83.3% by the end of 1991 was put into doubt because the machine used in the venture could not stand up to the volume and produce component parts with consistent quality. *Joint Venture in China Inscrutable*, ECONOMIST, Mar. 17, 1990, at 67. The other related problem is contractual buy-back requirements. Chinese negotiators often insist on including a buy-back arrangement in the venture contract as a way of insuring joint venture foreign exchange income. Because local supplies are unable to cope with the international market's demand for top-quality goods in high-tech industry, however, products that should be bought back by foreign partners are internationally uncompetitive. As a result, these JVs had problems meeting their contractual obligations to both localize production and balance foreign exchange accounts. *Sino-American High Tech Joint Ventures in Shanghai*, E. ASIAN EXEC. REP., May 15, 1990, at 11.

255. For example, during the economic retrenchment in 1988-1989, the mounting receivable and tightening of bank credit added to the woes companies were already experiencing from the scarcity of foreign exchange. While FDI firms with surplus hard currencies could continue to swap with other firms for RMB, at the price of sustaining a loss due to lower swap rate, foreign exchange deficit firms were cornered to an even worse position: they just did not have enough RMB to swap in much-needed foreign exchange. Shanghai Johnson Ltd., 60% owned by U.S. consumer products giant S. C. Johnson & Son, Inc., was not getting paid by the state monopolies that distributed its products. As a result, the venture was not able to raise the needed foreign exchange to import approved duty-free equipment for a planned expansion. ASIAN WALL ST. J. WKLY., Dec. 18, 1989, at 20.

256. A. E. Yates, *The Role of the Black Market in China's International Financial System*, 7 NW. J. INT'L L. & BUS. 833 (1986).

prospective investors when making their initial investment decisions. Nonetheless, little government assistance, either direct or indirect, was available to FDI firms prior to 1986.

After 1986, Foreign Exchange Balance Provisions[257] and the Encouragement Provisions were promulgated. These provisions provided greater assistance to FDI firms by allowing: (1) domestic sales of sophisticated products;[258] (2) foreign exchange adjustment;[259] (3) reinvestment of RMB profits;[260] (4) domestic products export;[261] (5) government assistance;[262] (6) mortgage RMB on foreign exchange loans;[263] (7) import substitution;[264] and (8) foreign exchange swap.[265] These measures have improved foreign exchange management. Balancing foreign exchange will remain a problem, however, until the RMB becomes convertible.

Of the available alternatives, the establishment of foreign exchange swap centers was a significant move toward RMB convertibility.[266] China has been reforming its currency in order to achieve a unified,

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257. The Provisions on the Question of Balancing Foreign Exchange Receipts and Expenditures of *Sino-Foreign Joint Ventures*, *adopted* Jan. 15, 1986, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter Foreign Exchange Balance Provisions].

258. *Id.* This option permits foreign investment firms to domestically sell their technologically sophisticated products designed and manufactured with advanced or key technology for foreign exchange.

259. *Id.* This option permits foreign investment firms to mutually adjust foreign exchange among their related entities.

260. *Id.* This option is designed to provide foreign investment firms with an extra route for earning foreign exchange by allowing them to reinvest their non-convertible RMB profits.

261. *Id.* This option permits foreign investment firms to buy domestic products with their RMB profits and export these products for foreign exchange.

262. Foreign Exchange Balance Provisions, *supra* note 257. Government assistance by foreign exchange allocation has always been an option for foreign investment firms that encountered the shortfall of foreign exchange, although it is relatively difficult to meet the test.

263. *Id.* This option works well for those firms that need RMB for working capital or investment in fixed assets but are unwilling to use their limited foreign exchange resources to meet RMB obligations.

264. *Id.* This option applies only in cases in which import substitutes are those which China needs to import on a long term or urgent basis.

265. H. E. Chodosh, *Swap Centers in the People's Republic of China: A Step Toward Partial Convertibility of Local Currency*, 25 INT'L LAW. 415 (1991).

266. *Id.*

market-driven exchange rate. In addition, China is preparing for full RMB convertibility. Convertibility will facilitate FDI firms' balancing their foreign exchange accounts and, more significantly, promotion of external economic growth. Swap centers were initially designed to supplement the state foreign exchange allocations by allowing exchange rates higher than the official rates.[267] The centers have evolved into a vehicle that meets China's needs for foreign currency and provide market levels from which the government can create unified, market-driven rates.[268]

China had a three-tiered foreign currency market until recently, the government-pegged Foreign Exchange Certificate (FEC) rate; the swap rate; and the black market rate.[269] In an effort to stabilize the domestic market and promote external trade, the People's Bank of China established a series of FEC devaluation to narrow the gap between the swap rate and the official market rate in the hope that the black market would be eventually eliminated.[270] Obviously, the healthy development of swap operations is the key to success.

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267. Chinese domestic enterprises are required to sell all of their foreign exchange earnings to the state, but they may keep a portion in the form of vouchers that can be drawn on state banks (foreign exchange retention system). The percentage for allowable retention vary among provinces and also depend upon the nature of the commodities, the type of entities involved, and the method through which foreign exchange is generated. The purpose of the system is primarily to encourage export operations. By January 1991, the retention rate was anywhere from 40% to 70% of foreign exchange earned from exports at the local level. *Swap Centers: Past, Present, and Future*, CHINESE BUS. REV., Mar.-Apr. 1992, at 16.

268. *Id.*

269. In 1980, the government introduced the FEC in an attempt to curb foreign currency speculation and black market trading, while facilitating the growth of the tourist industry. Foreigners traveling or working in China are required to pay FECs in designated stores, hotels and other services. Since FECs could be used to purchase imported goods not readily available in regular stores, and a two-tiered exchange rate system was created to enable domestic exports to become more competitive on international market, a black market thrived. Although the two-tiered rate system was abandoned in 1985 when the strength of dollar caused the cost of exports to rise above the internal rate which was RMB 2.8 as opposed to FEC rate of RMB 1.7, the black market survived because an actual gap between the 2 rates had already been created. Chodosh, *supra* note 265, at 417.

270. RMB has been further devalued since 1991. This has made China's trade partners, particularly the U.S., uneasy even though they have been generally patient, reflecting their appreciation of China's long-term goal of RMB convertibility. In May 1992, China was cited by the U.S. treasury for the first time since the U.S. Congress in 1988 mandated a semiannual reporting of trade-partners' exchange-rate policies. S. Awanohara, *Caught in Crossfire*, FAR E. ECON. REV., June 4, 1992, at 68.

Since the first swap center appeared in Shenzhen in 1985, more than one hundred foreign exchange swap markets have been established.[271] These swap markets, while operating in dissimilar patterns in their initial stage,[272] generally have undergone two distinctive phases. In the first phase, swap transactions were government approved and mediated, enabling the monitoring of exchange arrangements.[273] The Chinese government became involved when either potential buyers or sellers made an application to identify their respective interest and continued its involvement through bidding, negotiating and finalizing the swap transaction. A ceiling rate was usually set to avoid possible usurious transactions.[274] FDI firms were first allowed to participate in such swap transactions in late 1986, following the adoption of the Encouragement Provisions, and were subject to lessened control with regard to market participation. Local SAEC have performed a close monitoring function in other respects.[275] For instance, only foreign exchange legitimately earned (proven by documentary and other evidence) may be sold, and foreign exchange bought is used exclusively for China-related business purposes, including the payment of royalties, raw materials, and other manufacturing resources imported, or profits repatriation. In 1990, approximately 13.16 billion United States dollars changed hands via these swap centers.[276]

Although foreign exchange balancing became less of an enigma to FDI firms once swap centers began functioning, some problems remained. The centers were not always dependable due to the government-sanctioned ceiling rate, the lack of liquidity, and more formidably, the unpredictable, expensive swap rates.[277] This situation improved during the second phase when more provincial and coastal

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271. *See* Chodosh, *supra* note 265.

272. Some swap centers permitted direct transactions between FDI firms and domestic enterprises, while others established separate centers for them, and still others lacked a physical center for swap transactions. *Id.*

273. Direct purchase, sale, or negotiation between seller and buyer was strictly prohibited with swap centers acting as the exclusive trader. Buyer and seller never spoke to or met each other. *Id.*

274. *Id.*

275. *Id.*

276. *Foreign Exchange Adjustment Network Expanded*, PEOPLE'S DAILY (Overseas Ed.), May 1, 1991, at 3.

277. In 1988, for example, the swap market rate was nearly double the official rate. Virginia Davis & Carlos Yi, *Balancing Foreign Exchange*, CHINESE BUS. REV., Mar.-Apr. 1992, at 14, 16.

municipalities introduced an open market operation with a freely floating system.[278] This system allowed for a more market-driven rate in a given province or municipality.[279]

The open market system consists of brokers, dealers, and jobbers.[280] Dealers represent the local swap centers in a given province. Consolidation of the swap centers resolved the liquidity problem to a considerable extent, and substantially narrowed the gap between the demand for foreign currencies and RMB.[281] Accordingly, the swap exchange rate averaged RMB ¥ 5.9/US $1 in January 1992, slightly higher than the official rate of RMB ¥ 5.46.[282] As a result, a fifty-seven percent increase was registered in the transacted volume in the nation's swap markets in 1991, reaching 20.4 billion United States dollars.[283]

FDI firms and other swap market participants were placed in an improved financial situation by markets where swap operations existed, as compared to previous arrangements. They were, however, still victims of illiquidity and a wide rate gap.[284] Independent operation, remained an impediment to the establishment of a unified rate and free convertibility of the RMB.[285]

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278. Fujian Province on the southeast coast created the first of such open markets in the spring of 1990, which was followed by Shanghai, Zhejiang, and other provinces. By August 1992, there was a total of 13. Such open markets were operating in local provinces and municipalities. PEOPLE'S DAILY (Overseas Ed.), Aug. 9, 1991, at 3. *See China's National Foreign Exchange Swap Market Opens*, XINHUA NEWS AGENCY, Aug. 8, 1992.

279. PEOPLE'S DAILY (Overseas Ed.), Aug. 9, 1991, at 3.

280. Brokers are financial institutions operating in the province or municipality; dealers represent local swap centers in different cities of the province; and jobbers are credible clients with large volume of transactions. All of these categories are members of the market. Non-members must entrust brokers or dealers to act on their behalf.

281. Virginia Davis, *Balancing Foreign Exchange*, 19 CHINA BUS. REV., Mar.-Apr. 1992, at 14.

282. *Business Trends: Beijing's Swap Market: Can it Unify Rates?*, BUS. CHINA, Oct. 5, 1992, *available in* LEXIS, Nexis Library, CHINA File.

283. *Id.* In 1992, a total value of $25.1 billion changed hands through these swap centers, which accounted for 49.8% of the nation's foreign exchange expenditures in that year. PEOPLE'S DAILY (Overseas Ed.), Feb. 16, 1993, at 1.

284. For example, in the first week of August, 1992, the U.S. dollar closed in Shanghai at RMB 7.4935, compared with an official rate of RMB 5.4335. In Beijing, it closed at RMB 6.88. J. Kohut, *China: Currencies Swap Centers for Beijing*, S. CHINA MORNING POST, Aug. 10, 1992, at 1.

285. *Id.*

A national foreign exchange swap market would have to be established to remove the obstacles to the establishment of a unified rate and free monetary convertibility. An initial step was taken to create such a market in August 1992 when the first state-level market for the exchange of hard currencies opened in Beijing.[286] The membership system allows major financial institutions, swap centers from different regions, FDI firms, and Chinese domestic enterprises that regularly swap a large volume of foreign exchange to participate in the market.[287] The membership is expected to grow once China abolishes the existing foreign exchange quota system and allows domestic enterprises to retain foreign exchange.[288] Since the beginning of 1993, the expansion of trading volume and the growing needs of clients have caused transactions of other currencies and forward transactions to be added to the market. Exchange system reform is merely a temporary phenomenon allowing FDI firms using swap markets to balance their foreign exchange accounts until the RMB becomes fully convertible.

China's cautious attitude toward possible inflation, and the sophistication of its developing economy seems to be impeding the process of full RMB convertibility.[289] Nevertheless, the strategic evolution of the swap markets to the intra-bank foreign exchange market,

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286. *Id.*

287. *Id.*

288. When the market was opened in August 1992, it claimed a membership of 79, with 8 brokers, 25 jobbers and 46 dealers. PEOPLE'S DAILY (Overseas Ed.), Aug. 11, 1992, at 1.

289. The Regulations on Managing the Swap Market were publicly disclosed for the first time by the SAEC on April 15, 1993. Two provisions are worth mentioning. One, the regulations confirm that the trade will be conducted at a floating rate, decided by supply and demand. Two, if the market rate fluctuates too sharply, the central bank will adopt economic, administrative and legal measures to stabilize the price. *Regulations on Foreign Exchange Market Made Public*, XINHUA NEWS AGENCY, Apr. 15, 1993, *available in* LEXIS, Nexis Library, CHINA File. The most recent development in China's foreign exchange reform demonstrated the government's commitment to transform the RMB into a convertible currency. On January 1, 1994, the foreign exchange quota system was formally abolished. A national foreign exchange market, designed to replace the swap market with designated banks as the only players began to function April 1, 1994. The official exchange rate was also abolished. Economic entities, including FDI firms and individuals, may buy foreign exchange from the newly established foreign exchange market at the rate determined by the market and released daily by the central bank, the People's Bank of China, taking into consideration the changes in the international currency market. PEOPLE'S DAILY (Overseas Ed.), Mar. 8, 1994, at 2; PEOPLE'S DAILY (Overseas Ed.), Mar. 30, 1994, at 1; PEOPLE'S DAILY (Overseas Ed.), Apr. 1, 1994, at 1; PEOPLE'S DAILY (Overseas Ed.), Apr. 20, 1994, at 2.

along with the Foreign Exchange Balancing Regulations and the Encouragement Provisions, should help FDI firms, particularly those new to China or those with exceptionally large foreign exchange requirements, to gain more confidence in Chinese projects.

F. *Foreign Bank Operations*

International banking has a long history of involvement with foreign trade, shipping, and investment.[290] Foreign banking activities in China are no exception. From 1851, when the first foreign bank came to China, to 1949 when the People's Republic was founded, foreign banks played an active role in supporting foreign trade with short-term loans for both foreign and Chinese merchants.[291] Foreign banks accepted local deposits, issued currency in their own bank notes, and provided long-term credit for government agencies.[292] These foreign banking operations, however, were viewed unfavorably by the new government in 1949.[293] They were believed to be the outgrowth of imperialism in the late nineteenth century, facilitating foreign dominance in Chinese political and economic spheres. Therefore, it is no surprise that the CPC adopted a restrictive policy toward foreign banks when it took power in 1949.[294] This restrictive policy caused many banks to depart because it was no longer profitable to remain. From 1949 to 1982,

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290. WILLIAM A. LOVETT, BANKING AND FINANCIAL INSTITUTIONAL LAW 217 (3d ed. 1992).

291. The first foreign bank operating in China in 1851 was the Bank of East Asia of Hong Kong (British), which was followed by many others. Most of the foreign banks were European with the British having more than any other nation. American banks that followed included: the American Express International Banking Corporations, Chase, and First City National Bank. L.C. Wolken, *The Restructuring of China's Banking System Under the Economic Reforms, 1979-1989*, 25 COL. J. WORLD BUS. 53 (1990). By 1911, when the revolution overthrowing the Qing Dynasty proclaimed victory, 14 foreign banks having had operation bases in China. During World War II, Japanese banks Chinese operations grew substantially, and their American and British counterparts waited until after to further their banking expansions in China. Z. T. LIN ET AL., THE PRACTICAL GUIDE TO CHINA'S FOREIGN EXCHANGE CONTROL LAW 55 (1988).

292. Wolken, *supra* note 291, at 54.

293. *Id.*

294. Lisong, *supra* note 147, at 137.

only four foreign and overseas Chinese banks maintained their operations in China through their branches in Shanghai.[295]

The Open Door policy and subsequent financial demands made China an active player in foreign capital markets.[296] This generated increased foreign bank interest to enter China. Some of these banks sought to make loans, while others followed their clients who had started business operations in China.[297] The introduction of foreign banks improved the financial environment for FDI.[298] A foreign bank could provide short- or long-term loans to domestic enterprises in addition to the registered capital needed to satisfy the minimum capital requirement.[299] Furthermore, an international bank could bring in more investors once it had a worldwide client base and business network. The entry of foreign banks into China meant the importation of managerial skills and techniques to keep abreast of trends in the international financial market.[300] This, in turn, facilitated the ongoing reform of China's financial system.[301] Furthermore, a gradual expansion of foreign banking activities in China eventually forced domestic banks and financial institutions to improve their services and competitiveness. Finally, in light of China's desire to resume its GATT membership[302]

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295. Those Chinese banks are the Hong Kong Shanghai Banking Corporation, the Standard Chartered Bank, the Overseas Chinese Banking Corporation, and the Bank of East Asia. Business was minimal during that period. Banks handled petty remittances and a small amount of export bills. Starting from December 1, 1984, they have been given permission to handle foreign currency deposits, make foreign currency loans, issue guarantees, and provide consultancy and safe-deposit box services. The 2 banks with overseas Chinese capital, the Bank of East Asia and the Overseas Chinese Banking Corporation, are also allowed to handle RMB deposits on behalf of the Industrial and Commercial Bank of China, acting as its agent and being paid a handling fee. *Id.*

296. In the 2 year period of 1979-80, the Chinese government borrowed more than $20 billion from the foreign capital market. Wolken, *supra* note 291, at 53.

297. *Id.*

298. M.B. Baker et al., *Foreign Banks in China, the Legal Framework*, 6 CHINA L. REP. 87 (1990).

299. *Id.*

300. *Id.*

301. *See* Liu, *supra* note 251, at 57.

302. China was one of the 23 original signatories when GATT was established in 1947. Mainland China, however, had no relationship with the organization for more than 20 years since Taiwan's withdrawal in 1950. In 1971, China developed indirect relationship with GATT. On November 9, 1984, China was granted observer status, and 21 months later officially applied to resume its GATT membership.

and to expand its service exports to other countries,[303] easier access to the domestic market for trade in such services as foreign banking and insurance would be a convincing demonstration of China's willingness to integrate itself with the world economy.

Despite the Chinese government's recognition of the potential benefits to industrial modernization and liberal economic policy to be reaped from the establishment of branches or other forms of participation of foreign banks, it has been mindful that foreign banks could make control over domestic monetary variables difficult.[304] Foreign banks, with tremendous worldwide financial resources, could create a volatile movement of highly liquid funds across exchanges and increase balance-of-payments pressures. These competing factors caused China to proceed cautiously when expanding foreign bank participation. Maintaining a cautious approach would enable the government to map out a schedule for a gradual opening to foreign banks and to ensure that each step keep in pace with the country's overall liberalization of economic policies.[305]

The first legislative effort to provide a national statutory framework for the integration of foreign banks was the Interim Regulations of the People's Republic of China Concerning the Control of Resident Offices of Foreign Enterprises (1980 Regulations) adopted in 1980.[306] According to these regulations, foreign companies, including financial institutions, were permitted to maintain a presence in China in the form of resident representative offices.[307] The regulations, however, did not specifically address the establishment of offices for foreign banks. This omission led to the Procedures of the People's Republic of China for Controls Relating to Establishing Resident Representative Offices in China by Overseas Chinese and Foreign Financial Institutions in 1983

303. China's activities in the world service market, though insignificant in its share of the world total, have been growing and diversified, ranging from labor services to satellite launching. The Bank of China, and more recently, the Communications Bank of China, and the Industrial and Commercial Bank of China, have established a worldwide network of branches and representative offices.

304. *See* Baker, *supra* note 298.

305. *Id.*

306. Interim Regulations of the People's Republic of China Concerning Control of Resident Offices of Foreign Enterprises, *adopted* Oct. 30, 1980, *available in* LEXIS, Nexis library, CHINAL File [hereinafter 1980 Regulations].

307. *Id.*

(1983 Regulations).[308] Although the 1983 Regulations closely followed the general scheme established in the 1980 Regulations, additional obligations and various limitations were included. By the end of 1990, prior to the re-issue by the PBOC of the Procedures for Controls Relating to Establishing Resident Representative Offices in China by Foreign Financial Institutions, many foreign financial institutions had opened resident representative offices in China.[309]

These representative offices performed liaison functions for their head offices. This led to more and stronger branching and business expansion requests from foreign banks, particularly the four banks that had maintained their limited banking operations in Shanghai since 1949.[310] On December 1, 1984, the Shanghai Branch of the SAEC and the Shanghai Branch of the PBOC authorized the four foreign bank branches to expand their business to include the lending of foreign currency at unrestricted interest rates and the acceptance of deposits in foreign currency with interest payable at the rates of the Bank of China.[311] This authorization led to the State Council's adoption of the 1985 SEZ Banking Regulations, thereby, allowing foreign banks to open new branches and to conduct basic retail banking business in the SEZs.[312]

In 1990, the Chinese government made a strategic decision to develop the Pudong Zone after almost six years of hesitation and

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308. Procedures of the People's Republic of China for Controls Relating to Establishing Resident Representative Offices in China by Overseas Chinese and Foreign Financial Institutions, *issued* Feb. 1, 1983, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter 1983 Regulations].

309. According to the reissued rules, foreign banks are no longer required to establish their first representative office in Beijing, but may choose any open Chinese cities. This, in fact, has been in practice for several years, for instance, Kogyo Bank and NIKKO Securities, Co., each set up its only representative office in Qingdao. Regulations requiring foreign representative offices to re-register every 3 years are also eliminated. According to one foreign banker in Beijing, the new rules are "going to help enormously." *China Streamlines Rules for Foreign Banks*, REUTERS, June 13, 1991, *available in* LEXIS, Nexis Library, CHINA File.

310. *Id.*

311. *See Broaden Scope for Shanghai Branches of Foreign Banks*, BUS. ASIA, Feb. 15, 1985, at 51.

312. Certain Provisional Regulations Governing the Operations of Foreign Banks in the Special Economic Zones, June 17, 1987, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter 1987 Regulations]. These regulations elaborate the scope of business that foreign banks with offices in China may provide.

deliberation.[313] This decision made it clear that Shanghai's status as an international financial center must be re-established in order to facilitate the erection of a modern port-city in the zone designated as a catalyst and a growth pole for the opening of interior provinces along the Yangtze River. Foreign banks viewed this as a tremendous investment opportunity, particularly those banks that had already established their presence in China.[314] Thus, further liberalization of foreign banking restrictions was necessary.[315] On September 8, 1990, the PBOC issued the Shanghai Regulatory Measure Relating to Foreign Financial Institutions and Joint Chinese-Foreign Financial Institutions (1990 Shanghai Banking Regulations),[316] which allowed foreign banks to operate branches in non-SEZ coastal cities. This liberalization was the forerunner to the latest branch proliferation into additional coastal cities and the end of the ban on dealing in local currency. This accelerated

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313. Developing Pudong Zone is perhaps the most ambitious plan next to the "Three Gorges" Project that has been mapped out since 1949. Pudong, surrounded by the Huangpu and Yangtze rivers and Hangzhou Bay, covers 350 square kilometers (126 square miles) and has a population of 1.1 million. The zone is connected with Shanghai city proper by highways and 2 cross-river tunnels. Shanghai, with its sound industrial foundations, a great number of technicians and management personnel, millions of workers, a convenient transport network, and various channels linking it with the outside world, is expected to build Pudong into a modern, export-oriented industrial center. *Central Authorities Approve Shanghai's Pudong Development*, XINHUA NEWS AGENCY, Apr. 18, 1990, *available in* LEXIS, Nexis Library, CHINA File. According to Mr. Gong Haicheng, president of the Shanghai Branch of the PBOC, Shanghai realized that it is impossible to create an efficient banking system suitable to developing the Pudong Zone and revitalizing Shanghai as China's primary financial center without the participation of foreign banks. Experts believe that without the introduction of foreign banks it will be impossible for Shanghai to attract enough capital for the project. *Foreign Banks to Operate in Shanghai – Major Breakthrough*, XINHUA NEWS AGENCY, Mar. 25, 1991, *available in* LEXIS, Nexis Library, CHINA File.

314. PEOPLE'S DAILY (Overseas Ed.), Oct. 1, 1991, at 3.

315. Possibly the most decisive force for this liberalization, and perhaps the final decision made with regard to the Pudong Project, was China's eagerness to be recognized as not having diverted its course of opening and reforming by the world community, after the Tiananmen Incident. According to People's Daily, decision-makers of Shanghai city government and the CPC Shanghai Committee were enlightened and encouraged by the remarks made by Deng Xiaoping in the summer of 1989 to "be courageous, and accomplish a couple of tasks to show to the world that we are holding on to the open policy." *Id.*

316. Shanghai Regulatory Measure Relating to Foreign Financial Institutions and Joint Chinese-Foreign Financial Institutions, Sept. 1990, *available in* LEXIS, Nexis Library, CHINAL File [hereinafter 1990 Shanghai Banking Regulations].

development, particularly since 1990, stems from the PBOC's efforts to match the leadership's demand for faster economic reform.[317]

The 1990 Shanghai Banking Regulations appear to have been drafted with more sophisticated constraints than the 1985 SEZ Bank Regulations. In view of the recent regional expansion of foreign banks into the northern and inland provinces, the 1990 Regulations are likely to serve as the model for the national foreign banking legislation.

1. Entry Requirements Under the 1990 Regulations

Unlike the 1985 SEZ Bank Regulations, formal applications are not distributed to foreign banks or investors who intend to establish branches, head offices, or JV banks in Shanghai until statutory pre-requisites are met. Under the 1990 Shanghai Banking Regulations, only a foreign financial institution that has maintained a representative office in China for at least three years, and whose assets total at least ten billion United States dollars at the end of the year preceding that in which the application is to be made, is permitted to file an application to establish a foreign bank with a head office in Shanghai.[318] A foreign bank planning to branch in Shanghai must also satisfy the three-year representative office requirement, and year-end assets must be at least twenty billion United States dollars.[319] In addition, the country or region where the head office is registered must have maintained an established financial supervision and control system.[320]

Prerequisites for China-foreign JV banks and JV financial companies are less stringent. As long as both partners are financial institutions and the foreign partner has established its representative office in China, the statutory requirements are satisfied.[321] China seeks to permit only healthy foreign banking institutions holding strong financial positions.

One prominent difference between the 1985 and 1990 Banking Regulations is that the 1990 statute uses the United States dollar as the currency denominator rather than RMB to delineate the minimum capital requirement. This avoids the possible reduction in minimum capital that will result if further RMB devaluation takes place. Such devaluation is

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317. *See China Streamlines Rules for Foreign Banks*, *supra* note 309.

318. 1990 Shanghai Banking Regulations, *supra* note 316, art. 5.

319. *Id.*

320. *Id.* art. 6.

321. *Id.* art. 7.

likely in light of China's ongoing reform of its foreign exchange system. While the fifty percent paid-in capital requirement is consistent with the SEZ regulations, the minimum capital is set much higher: thirty million United States dollars for foreign banks with head offices in Shanghai and JV banks, and twenty million United States dollars for JV financial companies.[322] For foreign bank branches, a working fund of no less than ten million United States dollars is required to be allocated from their head offices.[323]

The 1990 Shanghai Banking Regulations also include rules for reserve funds. Under these rules, foreign banks are responsible for putting aside twenty-five percent of their after-tax profits annually until the total sum of reserve funds is twice as much as their registered capital, or, in the case of foreign bank branches, their allocated working funds.[324]

The 1985 SEZ Banking Regulations failed to address capital adequacy in relation to a banking institution's total assets. The 1990 Shanghai Banking Regulations stipulate that the ratio of paid-in capital plus reserve funds of foreign banks, other than branches, must be maintained at no less than five percent of total assets.[325] This minimum capital adequacy standard, a common practice in the Western countries, may help to prevent foreign banks from becoming under-capitalized as a result of over-expansion.

2. The People's Bank of China Supervision

The 1985 SEZ Banking Regulations fail to address the regulatory power of the PBOC when sanctioning foreign banks' violations of banking law. This is particularly true with respect to the exact circumstances in which administrative measures may be taken. The 1990 Shanghai Banking Regulations provide a remedy for this problem by adopting statutory sanctions for banking law violations such as unauthorized establishment of foreign banks, unauthorized banking activities, failure to maintain adequate capital base or required liquidity, excessive lending, failure to file required financial statements in a timely manner, and other violations of preventive constraints.[326] These

322. *Id.* ¶ 1.

323. 1990 Shanghai Banking Regulations, *supra* note 316, art. 17, ¶ 2.

324. *Id.* art. 19.

325. *Id.* art. 27.

326. *Id.*

sanctions include fines ranging from RMBY 3,000 to 50,000, warnings, cease and desist orders, and revocation of license in extremely serious cases.[327]

3. Preventive Constraints

The 1990 Shanghai Banking Regulations also emphasize prudent diversification of risk. Both the 1990 Regulations and the 1985 Shanghai Regulations use the same thirty percent lending cap.[328] The problem, however, is one of definition. The language used in Article 25 of the 1990 Shanghai Banking Regulations refers to "an enterprise and its related enterprises,"[329] and appears only to apply to any wholly-owned subsidiaries of an enterprise. While this language is more precise than the 1985 SEZ Banking Regulations, which refer to a "single enterprise," the exact meaning of "its related enterprises" is not defined.[330]

Another significant difference between the two sets of regulations is the liquidity requirement. The 1990 Shanghai Banking Regulations take the non-ratio approach, merely requiring foreign banks, other than branches, to meet their cash needs.[331] In addition, a foreign bank's fixed assets may not exceed forty percent of the sum of its paid-in capital plus reserve funds.[332] Banks with a higher percentage of fixed assets are prone to both liquidity and solvency problems. This change enhances the solvency requirements essential to a stable banking industry.

Finally, to ensure that foreign banks with head offices in Shanghai and JV financial institutions are structurally and financially ready to absorb the impact of "bad loans," the 1990 Shanghai Banking Regulations require such banks to establish loan loss reserves.[333] This was not the case under the SEZ banking regulations. It appears that the Chinese government is more concerned with the safety and soundness of foreign banks than their competitive edge.

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327. *Id.*

328. 1990 Shanghai Banking Regulations, *supra* note 316, arts. 45-49.

329. *Id.* art. 22.

330. Regulations of the People's Republic of China Relating to the Operations of Foreign Banks and Chinese-Foreign Joint Banks in Special Economic Zones, Mar. 1985, art. 9, *available in* LEXIS, Nexis Library, CHINAL File.

331. 1990 Shanghai Banking Regulations, *supra* note 316, art. 30.

332. *Id.* art. 29.

333. *Id.* art. 32.

The 1990 Shanghai Banking Regulations are the most comprehensive foreign banking legislation in China. Yet, in light of the recent developments in both foreign banks' regional expansion and the government's expected lift of its ban on RMB transactions, the regulations may be replaced by a national foreign banking law. Nevertheless, the 1985 Regulations' fundamental principles and various operational constraints are likely to be adopted by the new law.

Permitting foreign banks to expand their Chinese operations beyond the SEZs and into the inland provinces is indicative of recent efforts to accelerate financial structural reform.[334] By the end of 1992, seventy foreign banks, branches, and JV financial institutions were operating in China.[335] Meanwhile, more foreign banks have applied for permission to establish branches in China.[336] Provincial governors and city mayors are clamoring for permission from Beijing to tap foreign capital to aid reform.[337]

These developments are rooted in China's current liberal economic policy which gained momentum after the Fourteenth CPC's National Congress recent recognition of the need for a market economy in China.[338] Hasty reforms will pose a challenge to China's banking regulators. Guidelines that will facilitate competition in the finance sector, benefit the overall economic development because of foreign participation, and maintain control of the money supply must be formulated. More sophisticated regulation of foreign banks is vital to their success.[339]

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334. Wang Deyan, the President of Bank of China, commented that, while competition between foreign banks and China's state-owned banks exists, the former has brought "fresh air" to the long-closed financial circle of the country by providing better consultation service to improve China's investment climate and economic situations. *Shares for Foreign Bankers as China Market Grows*, XINHUA NEWS AGENCY, Mar. 23, 1993, *available in* LEXIS, Nexis Library, CHINA File.

335. *Id. See also Citibank to Set Up China Headquarters in Shanghai*, XINHUA NEWS AGENCY, Aug. 19, 1993, *available in* LEXIS, Nexis Library, CHINA File.

336. J. Leung, *Beijing's Reserves Are Among Funds Frozen at BCCI*, WALL ST. J., Aug. 5, 1991, at A4.

337. *Id.*

338. *Shares for Foreign Bankers as China Market Grows*, *supra* note 334.

339. China's funds of more than $400 million were frozen after the collapse of the Bank of Credit and Commerce International (BCCI) in 1991. Some of the funds were placed with BCCI's branch in Shenzhen. According to a Chinese banker, there was initial resistance from banking authorities to giving BCCI a license, but political pressure prevailed. The same banker commented that "China was newly opened to the West and

IV. IMPLICATIONS, LIMITS, AND OPTIONS

Since the adoption of the Open Door policy in 1978, foreign capital has become an important dimension of China's contact with foreign countries in terms of funds, materials, technological exchanges, and economic cooperation. The overall assessment of FDI varies depending upon whether international economics, industrial organization theory, macroeconomic theory of the firm, economic development, or disciplinary perspectives are emphasized.[340] Nonetheless, the changes indicate that China has a desire to guide its socioeconomic development to more liberalized legal and policy schemes. This promotion includes encouraging FDI, and establishing a more market-oriented economy.

Recent developments create at least two implications for China's new political elite and for the country's industrialization. Politically, it raises the question whether the Open Door policy and the reform movement in China will survive Deng Xiaoping. The emergence of a more educated and technologically inclined elite, the liberal policy that brought about economic change, and the impressive progress made during the fourteen years of the reform movement domestically indicate that the movement will survive Deng. The formation of a new politburo at the Fourteenth CPC's National Congress in October 1992 and the new leadership's to establish a socialist market economy further support the survival of the movement. Thus, the new elite may promote the liberal policy in a pragmatic, problem-solving manner without shifting its attention to domestic ideological concerns.

China's industrialization, as compared to other Asian economies over the last decade, reveals that China's manufacturing strength and

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its officials weren't savvy enough to determine which bank was financially sound.' Leung, *supra* note 336. In the Spring of 1994, the national banking regulations, The Regulatory Rules of the People's Republic of China Concerning Foreign-Funded Financial Institutions were promulgated. The Rules basically follow the principles established by the 1990 Shanghai Banking Regulations. For the text of the Rules in Chinese, see PEOPLE'S DAILY (Overseas Ed.), Mar. 4, 1994, at 2.

340. *See* R.S. Eckaus, *A Survey of the Theory of Direct Investment in Developing Countries*, *in* DIRECT FOREIGN INVESTMENT: COSTS AND BENEFITS 111 (Richard Robinson ed., 1987); J.M. Grieco, *Foreign Investment and Development: Theories and Evidence*, *in* INVESTING IN DEVELOPMENT: NEW ROLES FOR PRIVATE CAPITAL 35 (T.H. Moran ed., 1986); Noel Kofele-Kale, *The Political Economy of Foreign Direct Investment: A Framework for Analyzing Investment Laws and Regulations in Developing Countries*, 23 INT'L BUS. 619 (1992); R.D. Singh, *The Multinationals' Economic Penetration, Growth, Industrial Outputs, and Domestic Savings in Developing Countries: Another Look*, 25 J. DEV. STUD. 55 (1988).

growing export capabilities have placed it in a relatively strong position.[341] The noteworthy exception to this positive performance is China's per-capita income, which is the lowest in Asia.[342]

China has positioned itself well for a journey toward sustainable industrial growth. This can be attributed to FDI contributions, export increase, government revenue growth, technological progress, and regional development over a period of fifteen years. Other factors contributing to China's success include a general trend of liberalization in FDI policies, a market structure transformation, and its resumption as a fully contracting party in GATT.[343] These factors indicate that China is likely to become a strong, industrialized economy by the middle of the next century.

Limits on China's anticipated growth exist. First, China's future export growth is likely to suffer from the world's apparent movement toward a more protectionist trading structure. China is facing a world without many of the advantages other Asian economies had. Other Asian countries' economies were nurtured by Western countries' exceptional prosperity during a period of free trade and free capital movement. This facilitated a successful export-oriented development strategy for the development of their manufacturing activities. Unfortunately for China, additional regional trading blocks are taking shape which will discriminate against non-block members' trading efforts. This, in turn, leads to the expectation of more protectionist pressure. Therefore, while FDI can generate more exports, it is not likely to perform the same role in China as it did in Japan, Korea or Taiwan. The situation could further deteriorate when China reduces and eliminates tariffs and import licensing requirements for a broad range of products as it meets readmission

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341. *See* Singh, *supra* note 340.

342. S. SCHLOSSSTEIN, ASIA'S NEW LITTLE DRAGONS, THE EMERGENCE OF INDONESIA, THAILAND, AND MALAYSIA 5 (1991). According to a recent study by Guonan Ma and Professor Ross Garnaut, of the Australian National University, China's per-capita income in 1990 could be $700-1,000, or more, rather than $370. The reason for this discrepancy, as suggested by the study, is that the World Bank officials were duped in 1979 in their then-current estimate of China's per capita GDP at $410, qualifying China for the bank's subsidized lending to the world's poorest countries. Guonan Ma & Ross Garnaut, *China: Getting the Sums Right on China*, AUSTL. ECON. REV., Oct. 9, 1992, at 59. The official statement made by the Statistics Bureau of the P.R.C., however, insisted that although the economy of the country has been greatly improved for the past 15 years, China still is a low-income developing country. Specifically, the statement indicated that the per-capita GDP remained under $400 in 1992. PEOPLE'S DAILY (Overseas Ed.), July 8, 1993, at 3.

343. *See* H.K. JACOBSON & M. OKSENBERG, CHINA'S PARTICIPATION IN THE IMF, THE WORLD BANK, AND GATT, TOWARD A GLOBAL ECONOMIC ORDER (1990).

obligations to GATT, which will certainly increase the level of imports.[344] This, in turn, will impact China's ability to maintain healthy foreign exchange reserves to fund technological modernization and its current growth rate.[345]

Excessive FDI entry in a short period of time could lead to an overheated economy and uncontrollable inflation. The recent improvement of China's investment climate, as a result of its unilateral economic reform efforts, has caused the country to be viewed as an investment bonanza.[346] In 1993 alone, foreign investment commitments shot up to more than fifty billion United States dollars.[347] While this growth in FDI should contribute to the economic expansion, some worrisome trends have emerged including a shortage of raw materials and energy, an underdeveloped transportation capacity, and a low level purchasing desire. These problems can be resolved only after an authentic market economy takes shape.

Finally, the leadership faces a challenge balancing liberalism in economic development and conservatism in political ideology. This is particularly true when forming legal and policy institutions and planning FDI participation in the domestic economy. While the leadership of the new political elite has been consolidated, the ideological concerns of the different factions of this elite must be considered when adopting a new policy. In this regard, patience and persistence must be emphasized. This will continue to be a problem until further political reform occurs.

China must construct action strategies to anticipate these and other limits to its economic growth. These strategies should focus on continued utilization of FDI, and the formulation of macroeconomic policies. Growing competition in the international market and pressure for trade

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344. In addition, given China's economic growth acceleration and its market expansion, the country's demand for the import of technology, equipment and materials needed for domestic growth will grow further. It is expected that China's total import over the Eighth Five-Year Plan (1991-95) is to reach $350 billion. The figure will exceed the original target of import by $500 million in the period. *China's Import Expected to Reach 350 Billion U.S. Dollars*, XINHUA NEWS AGENCY, Mar. 18, 1993 *available in* LEXIS, Nexis library, CHINA file. From January to July of 1993, China has suffered a trade deficit of $4.62 billion. PEOPLE'S DAILY (Overseas Ed.), Aug. 12, 1993, at 1.

345. At present, China is one of the world's fastest growing economies with an annual average growth rate of 9% for the last decade and an anticipated 10% annual growth rate for the rest of the century. *Deputy USTR Warns Against Revocation of MFN for China; Praises Bush Approaches*, Int'l Trade Daily (BNA) at 23 (Jan. 12, 1993).

346. *Id.*

347. PEOPLE'S DAILY (Overseas Ed.), Mar. 2, 1994, at 2.

protectionism necessitate a careful structuring of the country's FDI utilization model to account for China's specific conditions and needs.

What does China face now in terms of the environment for its future growth in the 1990s and beyond? Externally, four prominent trends in the world economy are currently impacting China's development. First, the growth rate of the world economy has remained lower than the growth rate over the last decade, at least for the first half of the 1990s.[348] This has lessened the demand for developing country exports. Second, trade protectionism is increasing. Third, the geographic distribution of FDI is expanding. FDI's primary direction may remain the Asia-Pacific area, however, some FDI will be diverted to East European countries and the former Soviet Republics, where market economies are being established. Finally, China's international obligations under GATT, which required reduction of tariff and non-tariff import barriers, may lead to increased imports. Since the external environment does not promise a relaxed atmosphere, China's economic development may be forced into more domestic channels.

Several aspects of China's internal workings should also be considered. First, although the new domestic economic policy is functional, China's vast size causes its cultural and technological qualities, natural agricultural and human resources, and sophistication of infrastructure to vary greatly from region to region. Second, a market economy, though rudimentary in every respect, is taking shape. This, in turn, creates a favorable environment for more effective FDI utilization, particularly in the introduction of technologies.[349] Third, a fairly sophisticated industrial structure has been established, which should allow more technology intensive and capital intensive operations to enter the country. Finally, the expansive domestic market should never be ignored by pursuing a pure export-promotion strategy.

To best utilize FDI to accommodate all possible changes in the external economic environment, China should promote three types of FDI usage, with import-substitution operating as the fundamental theme. Export-orientation and export-substitution should serve as supplements.

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348. The IMF compiled its world economic forecast in December for the third time in 1992, which noted prevalent recession in the world economy due to asset deflation, and revised downward its October forecast of 1993 GDP growth rates for industrialized countries. For instance, Germany's GDP growth rate forecast was lowered from 2.6% to 0.6%. *IMF Bumps Down Japan's GDP Forecast*, REPORT FROM JAPAN, Dec. 23, 1992.

349. *1993 National Trade Data Bank*, Nov. 16, 1993, *available in* LEXIS, Nexis Library, CHINA File.

Three observations support this view. First, the sheer size of China's domestic market and the potential role of FDI relating to the generation of exports imply that import-substitution should be the fundamental structure. Considering China's future growth, which is likely to continue at the present rate, coupled with the aforementioned trade pressures, it would be difficult for China to proceed on a pure export-promotion strategy. China's utilization of FDI must be geared toward its tremendous domestic market. It is important to note, however, that import-substitution in this stage of China's economic and technological development does not resemble the cruder versions that involved simple production processes as adopted by developing Asian countries in the 1950s. China should focus on the products of its backbone industries as well as consumer durable and intermediate products.

Second, China, with its enormous labor force and low wage level, still enjoys an international comparative advantage in developing and exporting labor-intensive products. Export-orientation[350] should be the focus in this area. In addition, the hundreds of thousands of processing and assembly factories in the coastal areas, which have been built over past decade with FDI participation, should garner more foreign exchange earnings. China is likely to maintain a competitive edge in certain sectors well beyond the end of this century. This edge is expected to be the primary source of China's foreign exchange earnings for funding its overall technological progress.

Finally, export-substitutions[351] are beginning to take shape. This is due to the entry of advanced technologies entering either with FDI, or through technology transfer arrangements. The establishment of ETDZs and hi-tech parks along the coastline and in other major cities, the various domestic research development programs, and the participation of China's defense industry will contribute greatly to the transition of the export of labor-intensive goods to that of technological- and capital-intensive products.[352] This technological transition has already begun in certain

350. Export orientation as a form of FDI has as its primary strategic object the use of foreign capital to develop export-oriented industries and increase labor-intensive production. *See* Anatole Kaletsky, *Financial Times Survey*, FIN. TIMES, May 15, 1985, at 2.

351. Export substitution is a transitional strategy for FDI that focuses on linking the export of labor-intensive goods to that of technology- and capital-intensive products. *Id.*

352. China's mechanical and electrical products, as well as electronics, have become the second largest category of export commodities in 1992, second only to textiles. The total export value reached in $19.5 billion which accounted for 23% of the nation's total export value. PEOPLE'S DAILY (Overseas Ed.), Feb. 16, 1993, at 1.

sectors, such as the provision of satellite-launching services. This is the future of China's progress. Therefore, its supplemental function within the framework of the strategic model should not be neglected over the long-term.

FDI participation in China's domestic economy over the past fourteen years has been critically important. It is clear that the future will generate a range of new challenges that may require more liberalization in legal, political, as well as economic structures. If the past can be a guide to the future, an evolutionary process that accommodates structural changes is the only viable alternative for China. FDI must play a significant role.