

# China's Policies on Foreign Investment Liberalization after Its Entry into WTO: Fact or Disguise?

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## China's Policies on Foreign Investment Liberalization after Its Entry into WTO: Fact or Disguise?

### นโยบายการเปิดรับการลงทุนจากต่างชาติ ของประเทศจีนภายหลังการเป็นสมาชิก องค์การการค้าโลก: เปิดเสรีจริงหรือ?

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#### บทคัดย่อ

ภายใต้นโยบายการค้าเสรีขององค์การการค้าโลก ประเทศสมาชิกต่างเข้าทำความตกลงเขตการค้าเสรี (Free Trade Area) ทั้งที่เป็นความตกลงแบบทวิภาคีและพหุภาคีเพื่อลดอุปสรรคทางการค้าระหว่างกัน ในเวลาต่อมาความตกลงเขตเสรีทางการค้ามักครอบคลุมไปถึงข้อตกลงในการเปิดเสรีทางการลงทุนด้วย อย่างไรก็ตาม การเปิดเสรีทางการลงทุนยังคงถูกจำกัดด้วยกฎหมายภายในของประเทศต่างๆ ด้วยเหตุผลของความไม่พร้อมทางด้านการแข่งขันไม่ว่าจะเป็นด้านเงินทุน แรงงาน เทคโนโลยี กำลังการผลิต การหวงกันทรัพยากร เป็นต้น โดยกลุ่มประเทศที่มีกวางข้อจำกัดในการเปิดเสรีการลงทุน ได้แก่ ประเทศกำลังพัฒนา หรือ ประเทศที่พัฒนาน้อยที่สุด การที่ประเทศจีนซึ่งเป็นประเทศหนึ่งที่มีอิทธิพลต่อการค้า การลงทุนของประเทศคู่ค้าอื่นทั้งในภูมิภาคเดียวกันและต่างภูมิภาคกัน เข้าเป็นสมาชิกองค์การการค้าโลกอย่างเป็นทางการในปี ค.ศ. 2001 ทำให้จีนต้องเปลี่ยนนโยบายทางการค้าและการลงทุนจากเดิมที่เป็นนโยบายแบบปิดมาเป็นแบบเปิดเสรีภายใต้พันธกรณีที่มีต่อองค์การการค้าโลก อย่างไรก็ตาม แม้จีนจะอยู่ภายใต้นโยบายการเปิดเสรีทางการลงทุนก็ตาม แต่กฎหมาย กฎ

ระเบียบภายในที่ควบคุมการลงทุนของต่างชาติของจีนจะเป็นกฎเกณฑ์ที่สะท้อนว่านโยบายของจีนนั้นเปิดเสรีทางการค้ามากเพียงไร ซึ่งเมื่อพิจารณาจากกฎ ระเบียบที่เกี่ยวข้องกับการลงทุนโดยต่างชาติของจีนแล้ว จีนได้ดำเนินการแก้ไขกฎหมายเพื่อผ่อนปรนเงื่อนไขในการลงทุน อีกทั้งยังกำหนดสิทธิประโยชน์เพื่อส่งเสริมการลงทุนบางประเภทโดยต่างชาติอีกด้วย ถึงแม้ว่ากฎ ระเบียบดังกล่าวจะยังมีข้อจำกัดอยู่หลายประการแต่เป็นที่คาดหมายได้ว่าเงื่อนไขเป็นตัวแปรสำคัญของจีนในการปรับเปลี่ยนกฎ ระเบียบเพื่อลดข้อจำกัดทางการลงทุนจากผู้ลงทุนต่างชาติให้น้อยที่สุด

**คำสำคัญ:** การเปิดเสรีทางการลงทุน การลงทุนทางตรง กิจการที่ต่างชาติเป็นเจ้าของทั้งหมด กิจการร่วมค้า

## Abstract

By implementing the umbrella policy of the World Trade Organization (WTO) supporting trade liberalization, signatories have entered into both bilateral and multi-lateral Free Trade Agreements (FTAs) to eliminate barriers to trade as much as possible over time. The FTAs were later revised to include a clause of investment liberalization to mitigate limitations towards foreign direct investment as well. However, the trend of investment liberalization has been applied by nations with certain reservations through national laws due to a limited ability to compete in terms of capital, labor, technology, and resource preservation, for instance. The majority of those nations fall within the group of developing and least developed countries. China, one of the most influential trade and investment partners at the global level, became a WTO signatory in 2001. As a result, it was mandated to amend certain obsolete trade and investment policies to meet the liberalized investment policy of the WTO. Nonetheless, national laws significantly reflect to what extent the investment liberalization policy is recognized by China. Considering applicable Chinese laws governing foreign direct investment, China has aborted most obsolete laws, and has been amending them to lessen restrictions on foreign investment and to establish certain incentives for some businesses as well. Even though the amended laws retain certain limitations, especially on ownership of the foreign investors, it can be anticipated that time is important for China to get ready for another step of liberalization.

**Keywords:** Investment Liberalization, Foreign Direct Investment, Wholly Foreign-Owned Enterprise, Joint Venture

## Introduction

Previously, in the era of pre-entry into the World Trade Organization (WTO) by the People's Republic of China (herein after referred to as China), China's policies regulating foreign direct investment (FDI) were highly restricted and closely controlled by the government. However, over the preceding 20 years before entry into the WTO, such highly controlled policies became gradually and slightly more lenient as a consequence of China's attempt to reform those obsolete policies to serve the world's trend of international investment promotion. Besides, China subsequently entered into the WTO agreement as one of the signatories in 2001, which obliged China to comply with numerous rules of the WTO in a series of matters mainly including trade and investment liberalization. As a result, China has become one of the most important destinations for cross-border investment. The entry not only greatly affects changes and reforms of China's policies and structure of investment, but also brings about a greater contribution to the growth of investment cooperation with its partners, including Thailand and other developing countries in our region. Thus, this article discusses both the previous regulations and the newly amended ones regulating FDI with regard to the type of

businesses allowed for foreign enterprises to operate, foreign ownership, and barriers to open investment. It also projects further development in the future.

## Policies on Foreign Investment in Pre- WTO Entry China

The Chinese legal regime for foreign investment has evolved significantly since its inception following the Third Plenum of the 11<sup>th</sup> Central Committee of the Chinese Communist Party in 1978. The first foreign investment laws governed equity joint ventures only, and were a slightly broader statement of principle. Government policies are characterized by setting new regulations to permit joint ventures using foreign capital and setting up Special Economic Zones (SEZs) and "Open Cities." Regulations were gradually added and implemented that provided additional detail. In July 1979, the Law of the People's Republic of China on Joint-Ventures using Chinese and Foreign Investment was adopted, which grants foreign investment a legal status in China. In December 1982, the decision to open up China to the world economy was formally included in the 1982 State Constitution adopted by the Sixth National People's Congress. Late in 1983, Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures using

Chinese and Foreign Investment was formulated to further liberalize the domestic market and to clarify the business environment for foreign joint ventures. During this time the regulations allowed no more than 49% of registered capital of each project to be held by foreign investors. Basically, in this pilot period, foreign enterprises were commonly not recognized as wholly owning an investment project, since the joint venture concept prevailed strongly.

Gradually more liberalized regulations were adopted, and China began to increasingly recognize Foreign Direct Investment (FDI). As a result, a series of regulations opening the door of investment more widely were adopted. In 1986, more favorable regulations and provisions were used to encourage FDI inflow, especially export-oriented joint ventures and joint ventures using advanced technologies. Subsequently, wholly foreign-owned enterprises were minimally allowed.

On October 11, 1986, the State Council promulgated the Provisions of the State Council of the People's Republic of China for the Encouragement of Foreign Investment, or the so-called Provision of the Encouragement of Foreign Investment, also known as "Provision 22," which was

deemed as newly embracing investment liberalization for foreign enterprises. However, a number of restrictions applied, and joint venture promotions were preferred by the government. Specifically, foreign joint ventures were provided with attractive tax treatment, freedom to import materials and equipment, the right to retain and swap foreign exchange with each other, as well as simpler licensing procedures. However, in terms of rights to hold shares in a project, foreign enterprises were still restricted to 49% of the total shares. They were also not allowed to serve as a chairman of the board of directors of the joint venture. Besides, certain joint venture contracts were limited by time, which carried risks for the project investors in the case of low performance, inadequate capital, delay of construction, etc.

In April 1990, the government promulgated the Amended Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures, which allowed foreigners to hold shares in a joint venture varying from 25-90%. It allowed extensions to the terms of operation of joint ventures and replaced the limit to the proportion of registered capital (25%) contributed by the foreign partner with a wider range of capital contributions (25-90%).

Not until the middle of 1995 did China pronounce the Ninth Economic and Social Development Plan (1995-2000). The plan included certain regulations determining types of businesses promoted by the government in some specific zones, which mainly covered agriculture, communication, transportation, mining, electricity, and fuel. The government aimed to promote fair and equal competition between national investment and foreign enterprises in the long run. Even after the reforms, FDI in China tentatively remained controlled by state policy. Specifically, both the central and provincial governments of China closely regulate entry of Foreign Direct Investment (FDI), and entry of foreign firms is subject to numerous conditions. This is because China seeks access to foreign capital and technology but still seeks to avoid competition between domestic enterprises and enterprises with foreign investment.

Therefore, in the period of post-WTO, even though China has attempted to incorporate a more open policy for foreign investment, requirements of national partners in the form of joint ventures and close control by the government greatly permeate the investment climate. Wholly foreign owned enterprises are extremely rare and restricted.

## **Newly Adopted Policy Subject to China's Obligations with WTO**

Foreign direct investment approvals by Chinese authorities rose in 2000 and 2001 over approvals previously granted. One interpretation of the rise of approvals is that foreign investors have been registering intent to invest in China in anticipation of reforms that are likely to accompany Chinese entry into the WTO.

“The People’s Republic of China may accede to the Marrakesh Agreement Establishing the World Trade Organization on the terms and conditions...” was the official obligation conceded to by China on November 10<sup>th</sup>, 2001, as a significant outcome resulting from the impact of the U.S.-China Agreement on the terms for China to join the World Trade Organization (WTO) entered into on November 15<sup>th</sup>, 1999. As a result, China actively started imposing laws regulating a more liberalized investment to comply with the Agreement and to comply with the free trade and liberalized investment of the WTO’s policy. Three main regulations on foreign investment have been revised: The Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures (2001 revision), The Law of the People’s Republic of China on Chinese-Foreign Contractual Joint Ventures (2000 revision), and The Law of the People’s

Republic of China on Wholly Foreign-Owned Enterprises (2000 revision).

According to the laws, common types of foreign enterprises that can be operated are as follows:

### **I. Wholly Foreign-Owned Enterprise**

The Wholly Owned Foreign Enterprise (also known as WOFEs) is a limited liability company wholly owned by the foreign investor(s). They are permitted to register in cases where at least half of their annual output is exported, or if the nature of their operations relies heavily on advanced technology and the application of this high technology is beneficial to China. Approval to establish a wholly foreign owned enterprise is granted much more sparingly when compared to joint ventures.

They are in most cases, like joint ventures, required to balance their foreign exchange and are allowed to occupy facilities other than those managed by the Foreign Management Bureau. As a Chinese legal entity they may sign separate contracts with the appropriate government authorities or Chinese business entities to acquire land use rights, rent buildings, and receive utility services. Besides, they must abide by all Chinese laws and employ Chinese labor in accordance with local and central government labor laws and are encouraged

to establish trade unions (but not required to do so).

One of the most important issues covered in the project documentation is the business scope of the WOFE. Business scope is narrowly defined for all businesses in China and the WOFE can only conduct business within its approved business scope, which ultimately appears on the business license. Any amendments to the business scope require further application and approval. Inevitably, there is negotiation with the approval authorities to approve as broad a business scope as is permitted. General business scope usually includes, investment consulting, international economic consulting, trade information consulting, marketing and promotion consulting, corporate management consulting, technology consulting, manufacturing, etc.

Recently some major international players in China's telecommunications industry, including AT&T and Ericsson, have set up wholly owned enterprises to handle much of the domestic management originally handled by their representative office. They have done so only after years of business experience in China and, despite their registration as a wholly foreign owned enterprise, maintain the registration of their representative office.

However, with China's entry into the WTO, these conditions were gradually abolished and the WOFE is increasingly being used for service providers such as a variety of consulting and management services, software development and trading as well.

## II. Equity Joint Venture

This type of foreign investment is currently still the most widely used in China, even though Wholly Owned Foreign Enterprises are developing strongly. It is a limited liability company as a joint venture between a Chinese and a foreign company within the territory of China. This means that the investor or partner is not personally liable for the debts that the company might incur in the future and it has the status of a Chinese legal person. It is also known as the Sino-Foreign Equity Joint Venture (EJV). EJV is capable of buying land, hiring Chinese employees independently, constructing buildings, etc.

There are specific requirements for the management structure of a joint venture, but either party can hold the position as chairman of the board of directors. A minimum of 25% of the capital must be contributed by the foreign partner(s). There is no minimum investment for the Chinese partner(s). The investments made can consist of cash, intellectual property rights,

technology or buildings, as well as materials or equipment and are commonly referred to as registered capital. The lowest possible registered capital requirement is around US\$100,000. The management of the EJV is in the hands of a board of directors consisting of at least three members (but possibly more if the parties agree thereon), with each party either appointing the chairman or the vice-chairman. The standard length of time for an EJV is between thirty and fifty years. In certain situations it is, however, possible to get approval for an unlimited period of operation, especially when the transfer of advanced technology is involved.

Profit and risk sharing in a joint venture are proportionate to the equity of each partner in the joint venture, except in cases of a breach of the joint venture contract.

Share holdings in a joint venture are usually non-negotiable and cannot be transferred without approval from the Chinese government. Investors are restricted from withdrawing registered capital during the life of the joint venture contract. Regulations surrounding the transfer of shares with only the approval of the board of directors and without needing approval from government authorities will probably evolve over time as the size and number of international joint ventures grow.

It is preferable that foreign exchange accounts are balanced in order to remit profits abroad so that the repatriated foreign exchange is offset by exports from the joint venture. With the elimination of foreign exchange certificates and the further opening of the China market, this requirement is becoming more and more relaxed.

The permissible debt to equity ratio of a joint venture is regulated depending on the size of the joint venture. In situations where the sum of debt and equity is less than US\$3 million, equity must constitute 70% of the total investment. In joint ventures where the sum of the debt and equity is more than US\$3 million, but less than US\$10 million, equity must constitute at least half of the total investment. In cases where the sum of the debt and equity is more than US\$10 million, but less than US\$30 million, 40% of the total investment must be in the form of equity. When the total investment exceeds US\$30 million, at least a third of the sum of the debt and equity must be equity.

Like the WOFE, after a joint venture is registered, the entity is considered a Chinese legal entity and must abide by all Chinese laws. As a Chinese legal entity, a joint venture is free to hire Chinese nationals without interference from government employment industries as long as they abide

by the Chinese labor law. Joint ventures are also able to purchase land and build their own buildings, privileges not allowed to representative offices.

### **III. Contractual Joint Venture**

In a cooperative venture, the parties involved may operate as separate legal entities and bear liabilities independently rather than as a single entity. A cooperative venture may also be registered as a limited liability entity resembling an equity joint venture in operation, structure, and status as a Chinese legal entity.

There is no minimum foreign contribution required to initiate a cooperative venture, allowing a foreign company to take part in an enterprise where they prefer to remain a minor shareholder. The contributions made by the investors are not required to be expressed in a monetary value and can be contributed such as labor, resources, and services. Profits in a cooperative venture are divided according to the terms of the cooperative venture contract rather than by investment share, allowing a more flexible schedule for return on investment in cases where one investor provides cash while the other party's investment is primarily in kind.

Greater flexibility in the structuring of a cooperative venture is also permissible, including the structure of the organization,

management, and assets. There is no term for unlimited terms in cooperative ventures, but also no provisions for the term of the duration. The term of the cooperative venture contract may be renewed subject to the consent of the parties involved and approval from the examination and approval authorities. The foreign investor is permitted to withdraw registered capital or a portion thereof from the cooperative venture during the duration of the cooperative venture contract.

Because of the unique privileges and added features offered to the foreign party in a cooperative venture, trade unions must be allowed to represent the employees in employment matters to protect the interests of the employees.

The forms of foreign investment business organizations are also subject to the preference of fields of business operation determined by laws.

### **Types of businesses that are encouraged**

Those foreign investment projects under one of the following circumstances shall be listed as encouraged foreign investment projects:

1. Projects for new agricultural technology, comprehensive agricultural development and for energy, transportation and key raw materials industries;

2. Projects for new and high technology, advanced applicable technology which can improve performance of products and increase techno-economic efficiency of enterprises or produce new equipment and new material in which domestic capacity is deficient.

3. Projects that meet market demands, and can promote the quality of products, enter into new markets or strengthen the competing capability of products in international markets;

4. Projects adopting new technology and new equipment for saving energy and raw materials, for comprehensive utilization of resources and renewable resources, and for prevention of environmental pollution;

5. Projects that can make full use of manpower and resource advantages in the mid-west region and are in accordance with the State's industrial policies;

6. Other cases that are regulated by laws and administrative regulations of the State.

### **Types of businesses that are restricted**

Those foreign investment projects under one of the following circumstances shall be listed as restricted foreign investment projects:

1. Projects adopting out-of-date technologies;

2. Projects unfavorable to resource-saving and ecological environment improvement;

3. Projects for prospecting and/or mining specified mineral resources protected by laws and regulations of the State;

4. Projects in those industries that shall be opened gradually;

5. Other cases that are regulated by laws and administrative regulations of the State.

#### **Types of business that are prohibited**

Those foreign investment projects under one of the following circumstances shall be listed as prohibited foreign investment projects:

1. Projects that endanger the safety of the State or damage social and public interests;

2. Projects that pollute the environment, destroy natural resources or impair the health of human beings;

3. Projects that occupy large amounts of arable land, unfavorable to protection and development of land resources;

4. Projects that endanger the safety of a military facility and its performance;

5. Projects that adopt the unique craftsmanship or technology of our country to make products;

6. Other cases that are regulated by laws and administrative regulations of the State.

According to the regulations determining the forms of foreign business aforementioned, even though wholly foreign owned enterprises emerged and were more widely suggested by the law, certain restrictions still remain. In other words, since the WOFEs have no Chinese partner to guide the project through the approval process and through the other regulatory issues associated with construction and operation of the enterprise, the logistics of establishing a wholly foreign owned enterprise can be difficult and costly. Traditionally the wholly foreign owned enterprise has rarely been the chosen method for investment in China. The independence offered to the foreign investor is often outweighed by the lack of direct links to the domestic economy. As a result, most international corporations choose to establish joint ventures for the relationships and connections provided by the Chinese partners although certain limitations to the joint ventures may be barriers to the operation such as a time limit for the project, prohibition of shares withdrawal, and so on. The top 50 foreign enterprises

making the biggest profits are mostly categorized as joint ventures. For example, Tianjin Motorola Electronics Co. Ltd., Beijing Capital-Nokia Mobile Telecommunications Co. Ltd., and Shanghai Volkswagen Car Co. Ltd.

## Conclusion

During the post-WTO period, the three main revised laws have been slightly and gradually implemented in a more liberalized manner in spite of the apparent preference for the structure of joint ventures. Therefore, the laws themselves currently remain barriers to investment liberalization, which tends to be gradually mitigated over time. This is because China has been pursuing entry into both bilateral and multi-lateral investment agreements to open the gates of investment between the members of the agreement. A significant investment agreement is ASEAN-China Investment. An agreement entered into in the late 2007, which is expected to be a key to stimulate fully liberalized foreign investment, is to be implemented by China in the near future. Consequently, considering attempts at continuous law reforms overtime, we may not categorize China's regulation reorganization as disguised liberalized policy, despite the remaining limitations and government controls over foreign enterprises. Positively, sustainable liberalized investment in China may only be

a matter of time.

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**Ms. Anocha Hongburin** earned her Master's Degree in Law (LL.M.) from the University of Southern California (USC), specializing in International Trade Law. She currently serves as a lecturer for Business Law, International Trade Law, and International Economic Law courses at the University of the Thai Chamber of Commerce. She has experienced in a variety of business law practices such as corporate, commercial, and investment. She has conducted and been pursuing legal research in the area of international trade and investment laws.