

IMF Policy Discussion Paper

Foreign Direct Investment in China: Some Lessons for Other Countries

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Asia and Pacific Department

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February 2002

Abstract

<p>The views expressed in this Policy Discussion Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Policy Discussion Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.</p>
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China's increasing openness to foreign direct investment (FDI) has contributed importantly to its exceptional growth performance. This paper examines China's experience with FDI and identifies some lessons for other countries. Most of the factors explaining China's success have also been important in attracting FDI to other countries: market size, labor costs, quality of infrastructure, and government policies. FDI has contributed to higher investment and productivity growth, and has created jobs and a dynamic export sector. China's success, however, did not come without some pitfalls: an increasingly complex tax incentive system and growing regional income disparities. Accession to the WTO should broaden China's "opening up" policies and continue FDI's contributions to China's economy in the future.

JEL Classification Numbers: F21

Keywords: China, Foreign Direct Investment

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¹ A version of this paper was presented at a seminar held at the Department of Industrial Policy and Promotion in Delhi, India on November 12, 2001. The authors are grateful to a number of colleagues for useful comments and inputs: Christopher Towe, James Gordon, Markus Rodlauer, Ray Brooks, Paul Heytens, Jahangir Aziz, Patricia Reynolds, Jingqing Chai, Christina Daseking, Alex Lehman, and Yongzheng Yang, and Anna Maripuu for research assistance.

I. INTRODUCTION

1. **The market-oriented reforms and “opening up” policy pursued by China have produced high economic growth and a dramatic economic transformation.** Since the start of reforms in 1978, real GDP growth has averaged 9½ percent, raising per capita income five fold and enabling China to make unprecedented strides in reducing poverty. The nonstate sector is now estimated to account for about 60 percent of GDP. A driving force for this exceptional growth performance has been the increasing openness of the economy, especially to trade and foreign direct investment (FDI). Indeed, attracting FDI has been a key pillar of China’s “opening up” policies.

2. **This paper looks into the questions:** What explains China’s success in attracting FDI? Can it be replicated by other countries, or is it unique to China? Has China benefited from the large inflow of FDI? What lessons can China’s experience with FDI offer for other countries?

3. **The paper is organized as follows:** It begins with an overview of the key trends and characteristics of FDI to China and touches on the question whether, at the start of reforms in the late 1970s, China was in an economically better position to develop a potential for attracting large amounts of FDI than other countries, such as India. It then discusses the determinants of FDI in China, the impact of FDI on China’s economy, and identifies some tentative lessons from China’s experience with FDI.

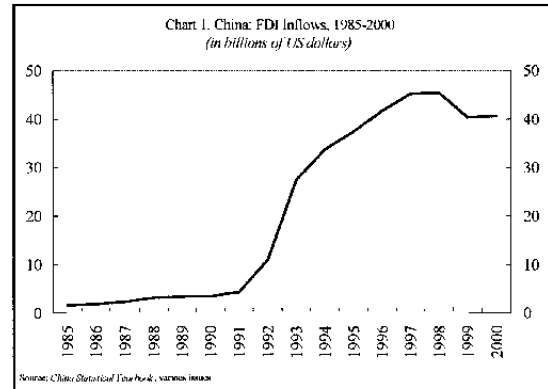
II. KEY TRENDS AND CHARACTERISTICS OF FDI IN CHINA

4. **FDI inflows to China have surged from almost nil at the start of the reform in the late 1970s to US\$40–45 billion per year in the second half of the 1990s** (Table 1 and

Chart 1). The surge occurred in the early 1990s, following Deng Xiaoping’s tour of the southern coastal areas where he reaffirmed China’s continued commitment to reforms and policies to open up the economy to the outside world. The tour ushered in an era of renewed confidence and entrepreneurship. Although FDI inflows declined slightly during the Asian financial crisis, they picked up again in 2000 partly in anticipation of China’s WTO

Table 1. China: FDI inflows and GDP growth, 1984-99				
	1984-89	1990s	1990-94	1995-99
	(period averages)			
FDI				
In billions of US dollars	2.3	28.3	16.1	40.6
In percent of GDP	0.7	4.4	3.7	4.7
In percent of total FDI flows to developing countries	12.7	24.3	27.1	23.3
Annual GDP growth	9.7	10.1	12.2	8.3

Sources: *Balance of Payments Statistics Yearbook*; *China Statistical Yearbook*; and *International Financial Statistics*.



accession. In percent of GDP, FDI inflows rose from almost nil to about 5 percent during the reform period. By the 1990s, China became the second largest FDI recipient in the world, after the United States, and by far the largest recipient of FDI among developing countries, accounting for about 25–30 percent of FDI flows to all developing countries.

5. **However, part of China’s success in attracting FDI may be exaggerated because of misreporting and round-tripping.** The latter refers to capital originating from China that returns disguised as FDI to take advantage of tax, tariff, and other benefits. The extent of this round-tripping is difficult to assess; estimates range from 7 percent of inflows in 1996 to almost 25 percent of inflows in 1992.² Some FDI is actually better characterized as foreign borrowing as these inflows (mainly for infrastructure) were promised a guaranteed rate of

² Harrold and Lall (1993), Lardy (1995), and Wei (1998).

return. The data may also be affected by misreporting, as local officials have an incentive to exaggerate their ability to attract FDI and foreign investors have an incentive to overstate the actual investment to report lower taxable income.

6. As for the sources of FDI in China, Hong Kong SAR and Taiwan Province of China have traditionally been the most important ones

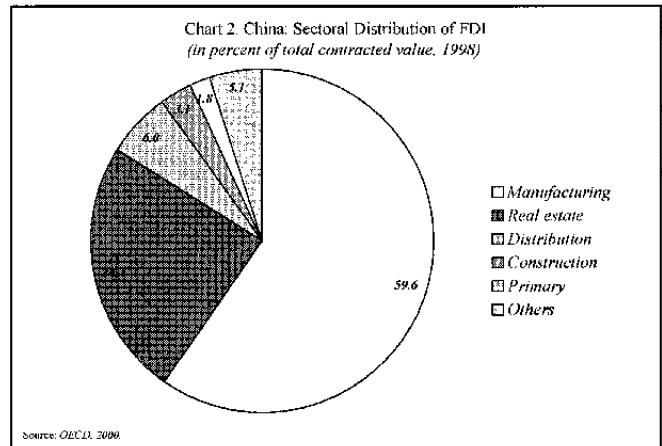
(Table 2). The importance of these two economies as sources of FDI diminished somewhat in the 1990s as multinationals from Europe, Japan, and the United States entered China, but Hong Kong SAR and Taiwan Province of China still account for almost half of FDI in China.

	1991	1995	1999
Total	100	100	100
Hong Kong SAR	55.3	53.4	41.0
Japan	13.1	8.5	7.2
Taiwan Province of China	10.1	8.4	6.5
United States	7.1	8.2	9.9
European Union	5.7	5.7	11.0
Singapore	1.2	4.9	6.2
Korea	0.0	2.8	3.0
Other	7.5	8.2	15.1

Source: *Statistical Yearbook of China*.

7. In terms of sectoral distribution of FDI, the largest portion of FDI is destined for manufacturing, which took up almost 60 percent of total contracted FDI (Chart 2).

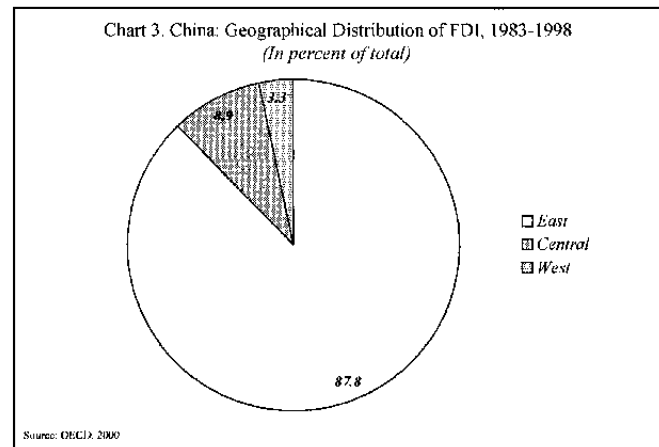
Next is real estate at 24 percent, followed by distribution (e.g., transport, wholesale, and retailing) at 6 percent. Among the manufacturing sectors, about half of FDI has been directed toward labor-intensive manufacturing (e.g., textiles and clothing, food processing, furniture). Technology-intensive manufacturing (e.g., medical and pharmaceuticals, electrical machinery and equipment, electronics) and capital-intensive manufacturing (e.g., petroleum refining, chemical materials) almost share



equally in the remainder. This suggests that an important motivation for foreign companies was to take advantage of China's low labor costs.

8. **In terms of geographical distribution**, the FDI pattern in China shows a great disparity among regions. The eastern region (accounting for 64 percent of GDP) took up

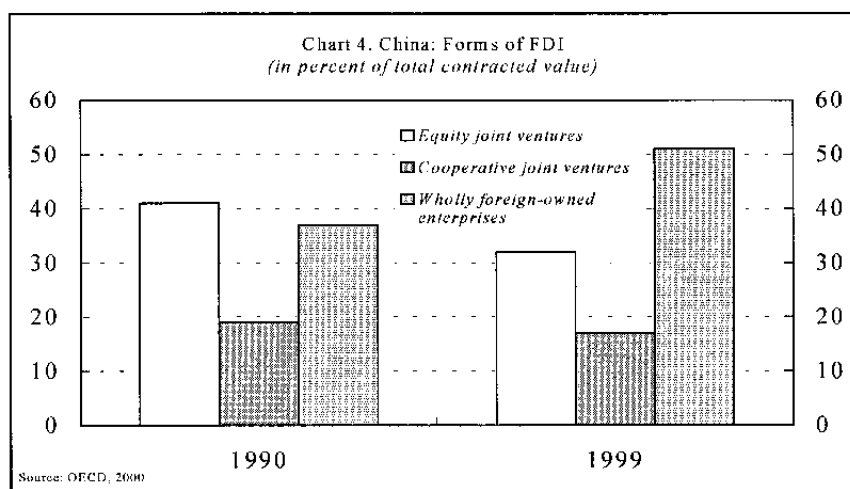
nearly 88 percent of FDI to China while the central region (29 percent of GDP) took up 9 percent and the western region (23 percent of GDP) attracted only 2 percent (Chart 3). This pattern stems from the FDI policies pursued by the Chinese authorities and reflects the



incremental nature of the reform process in China. Much of the early reform consisted of experiments in selected regions and sectors—this allowed the authorities to assess the results of these experiments before extending them to other parts of the country. The “open door” policy started with the creation of the Special Economic Zones (SEZs) (Section III below) in the southern provinces of Guangdong and Fujian at the outset of reforms in the late 1970s, followed by the opening of another SEZ in Hainan and 14 coastal cities in 10 provinces in the 1980s. This has resulted in an overwhelming concentration of FDI in the eastern part of the country. When the authorities adopted more broadly based economic reforms and open door policies for FDI in the 1990s, FDI started to spread to other provinces.

9. **Turning now to forms of FDI**, equity joint venture companies, cooperative joint venture companies, and wholly foreign-owned enterprises have been the main forms of

absorbing of FDI into China.³ Early in the reform period, China allowed only joint ventures as the entry form for FDI (except in the SEZs) for ideological reasons and because the



authorities thought this form was better suited to tapping advanced technology. It was not until 1986 that wholly foreign-owned enterprises were permitted in areas outside the SEZs. Accordingly, equity and cooperative joint ventures had accounted for the lion's share of FDI (Chart 4). Recent trends, however, show that FDI is increasingly directed into wholly foreign-owned enterprises, which accounted for more than half of total commitments in 1999.

10. **It appears that at the start of the reform process in 1978, China was not evidently better placed to attract large amounts of FDI than, for example, India, which shared a number of characteristics with China** (Table 3). Both countries had relatively closed economies, with low income levels and a large share of the population dependent on agriculture. Neither China nor India was receiving significant amounts of FDI. This picture has changed dramatically since then, as a result of China's economic reforms and "open door" policy. While India's GDP per capita more than doubled between 1978 and 2000, China's

³ Under an equity joint venture, Chinese and foreign investors operate the venture and share the risks, profits, and losses jointly. All parties involved agree on the equity share of each party. Profits are distributed to the parties in proportion to their equity share. In a cooperative joint venture, the Chinese partner provides land, natural resources, labor, and equipment/facilities, while the foreign partner provides capital/technology, key equipment,
(continued)

GDP per capita quadrupled (in constant U.S. dollar terms).

India still remains a fairly closed economy while China has become more integrated into the global economy.

11. China's increasing openness to the outside world can be seen in the rapid growth of its foreign trade.

	1978		2000	
	China	India	China	India
GDP per capita (in constant US dollars)	225.1	196.8	855.0	467.4
	(In percent of GDP)			
<i>External Trade and Investment:</i>				
Current account balance	0.3	0.1	1.9	-0.7
Exports of goods	4.6	5.1	19.1	9.2
Imports of goods	5.2	6.8	23.1	12.4
Net inward FDI flows	0.0	0.0	3.6	0.4
Net inward FDI flows (in percent of total investment)	0.0	0.1	9.8	1.9
<i>Composition of output:</i>				
Primary sector value added	28.1	38.6	15.9	25.9
Secondary sector value added	48.2	25.6	50.9	26.1
Tertiary sector value added	23.7	35.7	33.2	48.0

Sources: *International Financial Statistics*; and *China Statistical Yearbook*.

Exports and imports as a share of GDP rose from negligible amounts to nearly 25 percent in 2000 (Table 4). The average tariff rate in China fell from well over 50 percent in the early 1980s to about 15 percent now, less than half of that in India. Equally important, because China exempts so many goods entirely from import duties and because a significant share of imports of goods subject to high tariffs are imported illegally, actual tariff collection as a percent of the total value of imports has been much lower. The collection rate, that is tariff revenue as a percent of

All figures are 2000, unless otherwise noted	China	India
Share in world trade flows	3.7	0.7
Exports of goods and services (in percent of GDP)	25.9	13.1
Imports of goods and services (in percent of GDP)	23.2	16.0
Average tariff rate (China 2001, India 1999)	15.3	32.9
Effective tariff rate (1998) 1/	2.8	23.0
Share of tariff revenue in total government revenue (1998)	6.3	20.1

1/ Tariff revenue/Import value.

Sources: *Government Finance Statistics*; *International Financial Statistics*; and Fund staff estimates.

and materials. Both parties decide on the proportions in which products, revenue, and profits are distributed. A wholly foreign-owned venture is wholly owned by foreign investors.

total imports, is only 3 percent in China, compared with 23 percent in India. Net FDI inflows into China in 2000 were more than 15 times that of India.

III. MAIN DETERMINANTS OF FDI IN CHINA

12. **Studies of FDI in China have shown that the determinants of FDI in China are not unique to China but have also been important in attracting FDI to other emerging economies.**⁴ Two types of FDI flows can be considered: domestic-market oriented flows and export-oriented flows. Domestic-market FDI is mostly motivated by the size and growth of the host country. Export-oriented FDI mainly looks for cost competitiveness.

13. **The factors that have been most important in influencing FDI in China can be grouped into three categories: economic structure, liberalization and preferential policies, and cultural and legal environment.**

Economic Structure

14. **Market size.** Both at the national and the provincial level, empirical studies have found a strong correlation between GDP and FDI inflows in China.⁵ The causality between the two variables runs in both directions: FDI has been attracted by the enormous market potential that China has to offer, and has at the same time contributed to GDP growth through various channels (discussed below).⁶ It appears that market size has been more important as a determinant of FDI from Europe and the United States than for FDI from Hong Kong SAR and Taiwan Province of China, as the latter tends to be more export-oriented. In contrast, many

⁴ Cheng and Kwan (2000) and Liu et al. (1997).

⁵ Cheng and Kwan (2000), Liu et al. (1997), Zebregs (2001), and Zhang (1999).

⁶ Zebregs (2001) and Zhang (1999).

European and American multinationals have set up factories in China with the aim to produce for the domestic market.

15. **Abundant supply of cheap labor.** Although the empirical evidence is somewhat mixed, low wage costs appear to have played a significant role in attracting FDI to China and in the distribution of FDI flows across provinces.⁷ Some analysts have suggested that low wage costs have especially been an important factor in attracting export-oriented FDI from Hong Kong SAR and Taiwan Province of China as a response to rising wage costs in their own and other economies in the region. This has contributed to China's rapid emergence as an important global competitor in labor-intensive manufacturing. While the quality of labor has not been found to be a significant determinant of FDI in China in most empirical studies—indeed the shortage of highly qualified personnel has been a problem often noted by foreign investors—this will likely change in the future as China's comparative advantage evolves toward higher value-added manufacturing.

16. **Infrastructure.** Empirical studies confirm that provinces in China with more developed infrastructure have tended to receive more FDI.⁸ This partly explains the concentration of FDI in the eastern coastal areas with their superior infrastructure and transport links to external markets. The devolution of investment decisions to local governments, particularly in Open Economic Zones⁹ (OEZs), allowed them to upgrade infrastructure in an effort to attract FDI (Table 5). Of the increase in fixed asset investment

⁷ Chen (1996), Cheng and Kwan (2000), Head and Ries (1996), and Liu et al. (1997).

⁸ Cheng and Kwan (2000), and Head and Ries (1996).

⁹ Open economic zones include SEZs, open coastal cities, and various development zones. For a taxonomy of the different types of zones see Box 1 and Wall, Jiang, and Jin (1996).

from the late 1980s to the late 1990s (by 6½ percentage points of GDP) about 3 percentage points were accounted for by local governments and were mainly in infrastructure, particularly electricity, gas, and water, transport, post, and telecommunications.

Table 5. China: Infrastructure Indicators		
	1990	1998
Power		
Electric power consumption (kwh per capita)	471.00	746.00
Electric power transmission and distribution losses (in percent of output)	7.50	7.10
Transportation		
Air transport, freight (million tons -km)	818.00	3,345.00
Roads, goods transported (billion tons -km)	336.00	548.00
Communications		
Telephone mainlines (per 1,000 people)	5.90	69.60
Mobile phones (per 1,000 people)	0.02	19.00
Telephone, average cost of call to US (US\$ per three minutes)	...	6.70
Telephone, average cost of local call (US\$ per three minutes)	...	0.01
Internet hosts (per 10,000 people)	0.00	0.20
Source: World Bank, <i>World Development Indicators</i> .		

17. **Scale effects.** Several studies have found a strong persistency in FDI flows.¹⁰ This is the case not only for total FDI flows to China, but also for FDI flows to China's provinces. This suggests that once a province has attracted a critical mass of FDI, it will find it easier to attract more FDI as foreign investors perceive the presence of other foreign investors as a positive signal. In addition, economies of scale make it more efficient for foreign multinationals to locate in the same area, which allows them to share information and facilities, such as schools and health facilities for expatriate workers. The coastal provinces, in particular the southern provinces of Guangdong and Fujian, which are close to Hong Kong SAR and Taiwan Province of China, have been the largest recipients of FDI and have acquired an important advantage over the inland provinces in attracting FDI over the past two decades.

¹⁰ Cheng and Kwan (2000) and Head and Ries (1996).

Reduced Barriers and Preferential Policies

18. **The reduction of barriers to FDI and policies to improve the investment environment have played a key role in attracting FDI to China.** From the beginning of the reform process, the Chinese authorities considered attracting FDI as an important goal as it would introduce new technologies, know-how and capital, and help to develop the export sector. However, they also recognized that it posed a risk to state control. In addition, the authorities had to overcome “ideological obstacles” to FDI that were rooted in the historical legacy of the opening of Chinese port cities by the Western powers after the Opium War: this legacy left a tendency to equate FDI with imperial colonialism and the exploitation of China by “Western capitalists”. These factors affected the evolution of FDI policies in China. Initially, laws and regulations tended to be too restrictive and many bureaucratic and legal problems were encountered. Over time, the authorities responded to addressing the complaints of foreign investors. This was done by clarifying the legal environment for FDI, relaxing governmental controls, and providing practical assistance, as well as political and legal assurances (Box 1). From an experiment limited to a few localities and sectors at the outset of reforms, more and more regions and economic sectors were opened to FDI by the 1990s.

19. **The preferential policies to attract FDI have been tax concessions and special privileges for foreign investors, and the establishment of OEZs** (Box 2). Tax incentives for foreign funded enterprises (FFE) are mostly in the form of reduced enterprise income tax rates and tax holidays (Box 3). They are available to all FFEs in OEZs and to export-oriented and advanced technology FFEs outside the OEZs, as well as to domestic firms in the OEZs. In addition, firms in OEZs enjoy a high level of autonomy in managing operations, as they face

Box 1. China's FDI Regime

FDI in China was highly restricted prior to 1978. Since then, the FDI regime has been liberalized gradually. A legal framework for FDI was progressively developed to facilitate and regulate FDI. China's accession to the WTO promises further FDI liberalization.

Key laws and regulations on FDI

The legal framework for FDI has been progressively codified and clarified:

1979 Law on Joint Ventures Using Chinese and Foreign Investment provided a basic framework for the establishment and operation of foreign economic entities. It specified a variety of incentives and terms for joint ventures.

1983 Regulations for the Implementation of the Law on Joint Ventures Using Chinese and Foreign Investment provided greater details on the operations and preferential policies for joint ventures.

1986 Law on Enterprises Operated Exclusively with Foreign Capital formally permitted the establishment of wholly foreign-owned enterprises outside SEZs.

1986 Notices for Further Improvements in the Conditions for the Operation of Foreign Invested Enterprises and Provisions of the State Council for Encouraging Foreign Investment provided further incentives, particularly for FDI using advanced technologies and/or producing for exports. These provisions were subsequently codified in the *1988 Cooperative Joint Ventures Law*.

1990 Amendments to the Equity Joint Venture Law and Wholly Foreign-Owned Enterprise Implementing Rules provided a more complete legal structure to facilitate the operations of these enterprises. Notably, these laws/rules abolished the stipulation that the chairman of the board of a joint venture should be appointed by Chinese investors and provided for protection from nationalization.

1995 Interim Provisions on Guiding Foreign Direct Investment Direction (revised in 1997) classified FDI into four categories (see below).

Industrial Guidance for FDI

The *Interim Provisions on Guiding Foreign Investment Direction (revised edition 1997)* classify four categories for FDI: encouraged, permitted, restricted, and prohibited. The

Box 1. China's FDI Regime (concluded)

regulations aim to encourage greater geographic dispersion of FDI inflows within China, and promote FDI inflows into targeted sectors and industries, such as export-oriented and high technology industries, agriculture, and infrastructure.

In broad terms, projects are encouraged and permitted in designated industries that introduce new and advanced technologies, expand export capacity, raise product quality, and use local resources in the central and western regions. Restricted and prohibited are projects in designated sectors that make use of existing technologies, compete with domestic production or state monopolies, make extensive use of scarce resources, or are deemed to be a danger to national safety and the environment.

Sectoral Limits on FDI

Foreign participation in certain economic sectors/industries is limited; in particular, regulations specify (i) industries where Chinese partners must play a leading role or have a majority share; and (ii) industries where wholly foreign-owned enterprises are not permitted. These restricted industries include "strategically" important infrastructure projects, such as airports, nuclear power plants, oil and gas pipelines, subways and railways, water projects; as well as projects in aerospace, automobiles, defense, high-tech vaccines, medical institutions, mining, petrochemicals, printing and publication, shipping, satellite communications, and tourism.¹ About half of these industries are considered high-technology industries.

WTO Agreement on FDI

China has made substantial commitments in trade and investment liberalization upon accession to the WTO. General commitments include nondiscriminatory treatment of foreign and domestic enterprises, adherence to WTO rules on intellectual property rights, and elimination of various requirements on FDI, including foreign exchange and trade balancing, technology transfer, local content, and export performance.

Sectoral commitments involve significant expansion of market access, particularly in the services sector. These involve eliminating geographic and other restrictions in key sectors (e.g., motor vehicles) and increasing foreign ownership limits in telecommunications (50 percent by 2002), life insurance (50 percent on accession), distribution and retailing, securities (49 percent by 2003), and giving full national treatment to foreign banks (by 2005).

¹ See *Foreign Investment Administration (1998)*; MOFTEC; and *Tax Exemption Policies on Importation of Equipment by Enterprises with Foreign Investment*, MOFTEC.

Box 2. Open Economic Zones in China¹

Since the beginning of economic reforms, a variety of open economic zones have emerged, which have offered a more liberal investment and trade regime than other areas, as well as special tax incentives. While open to both domestic and foreign investors, these zones have played an important role in attracting FDI, although most of the investment in the zones has come from domestic sources.

Special Economic Zones (SEZs)

SEZs were the first, and until 1984 only, open economic zones. Four SEZs were established in 1980, three (Shenzhen, Shantou, and Zhuhai) in Guangdong Province near Hong Kong SAR, and one (Xiamen) in Fujian Province, close to Taiwan Province of China. In 1988, Hainan Province became the fifth SEZ.

SEZs have enjoyed considerable autonomy in their investment policies regarding both infrastructure projects (provided they can be financed locally) and investment approvals (for projects upto \$30 million). They have offered preferential income tax treatment, and exemptions from import licenses (for FFEs automatically, for domestic enterprises subject to approval) as well as tax and tariff concessions for raw materials, intermediate and capital goods (concessions for the latter were rescinded in 1996). Within SEZs, sales of locally produced goods have been free from duties and taxes, and sales of imported goods have been subject to a reduced tariff, with full tariffs and duties applying to sales outside SEZs (except exports).

Open Coastal Cities (OCCs)

In 1984, 14 cities in the coastal regions with already established industrial bases and infrastructure became OCCs and were opened to foreign investment. Although not separate customs areas and less independent than SEZs, OCCs have enjoyed greater flexibility in investment and tax policies than other regions in China. Several OCCs and the surrounding counties have created larger "development areas," such as the Pearl River delta and the Yangtze delta (including Shanghai).

Economic and Technology Development Zones (ETDZs)

Within the 14 OCCs, special areas were set aside for ETDZs, offering tax incentives similar to those in SEZs. Further ETDZs in the Yangtze valley, as well as border and inland cities, were subsequently approved by the State Council. The largest ETDZ, the Pudong New Area, opened in 1990.

High Technology Development Zones (HTDZs)

HTDZs emerged in the early 1990s. In most features similar to ETDZs, HTDZs have placed particular emphasis on attracting investment in high technology industries by providing additional tax concessions.

Free Trade Areas (FTAs)

The first two FTAs were established in the early 1990s in Pudong and Shenzhen, and a number of others have been opened since then. Exports and imports can be traded freely within FTAs and enterprises are free to engage in bonded entrepot trade as well as export-oriented production.

¹ Source: IMF (1997); Wall, Jiang, and Yin (1996).

Box 3. Tax Incentives for FDI

China has extensively but selectively used tax incentives to guide FDI into designated regions, economic sectors and industries. Foreign-funded enterprises (FFEs) enjoy exemptions and reductions in the national business income tax and other incentives including exemptions of custom duties and the value-added tax for imported equipment and technology, exemptions and reductions in local business income tax, full refunds for income tax paid on reinvested earnings, and no restrictions on profit remittances and capital repatriation. Generally speaking, the tax incentives offered in the SEZs and Economic and Technology Development Zones (ETDZs) in open cities are much more favorable than in other regions (see below). Also, the tax incentives are more favorable for technology and export-oriented FFEs.

In 1994, China adopted a new taxation system which unifies the taxation treatment of domestic enterprises and FFEs. At the same time, China decided to reduce gradually the preferential treatment for FFEs in order to establish a level playing field for both types of enterprises. With the implementation of this policy, the preferential policies, including tax incentives, will be gradually reduced and abolished.

Standard Income Tax Rates

Domestic enterprises: 33 percent

FFEs: 33 percent.¹ FFEs with contracts for operating periods of 10 years or more are exempt from income tax for 2 years after the first profit is realized, and eligible for a 50 percent reduction in their tax liability in the following 3 years. FFEs that export at least 70 percent of their annual output remain eligible for a 50 percent reduction after these five years. Advanced- technology FFEs receive a 50 percent reduction for 3 years after the initial 5 years.

Special Economic Zones

Domestic enterprises: 18 percent

FFEs: 18 percent¹ and the same 2-year exemption, 3-year reduction as under the standard income tax regime. Export-oriented and advanced technology FFEs pay 10 percent (instead of 15 percent) after the initial 5-year exemption and reduction period has expired. FFEs engaged in infrastructure projects in Hainan (airports, harbors, docks, railroads, highways, power plants, and water conservation) and with contracts for operating periods of 15 years or more are eligible for a 5-year exemption period followed by 5 years at a reduced rate (10 percent instead of 15 percent) after the first profitable year.

Open Coastal Cities and Areas, Open Boarder Cities, Inland Provincial Capitals, and Yangtze River Open Cities

Domestic enterprises: 33 percent

FFEs: 27 percent¹ and the same 2-year exemption, 3-year reduction as under the standard income tax regime. For projects with foreign investment of \$30 million or more (registered capital) and a long recovery period, knowledge- or technology-intensive projects, and energy, transportation or harbor construction projects, the 24 percent component may be reduced to 15 percent.

Economic and Technology Development Zones

Domestic enterprises: 18 percent

FFEs: 18 percent¹ for all production-related FFEs, with the same 2-year exemption, 3-year reduction as under the standard income tax regime. For export-oriented and advanced technology FFEs, the same extended reductions as in the SEZs apply.

High Technology Development Zones

Domestic enterprises: 18 percent

FFEs: 18 percent¹ and the same exemptions and reductions as under the standard income tax regime for high or new technology enterprises.

¹Includes a 3 percent local government component on which local governments may grant reductions.

minimal controls on goods movements, and are allowed to export and import almost freely. Firms in the OEZs also benefit from more flexible labor relations and more liberal land use. Additional benefits are available for export-oriented and advanced-technology FFEs, including tax exemption on profit remittances, additional tax benefits for reinvested profits, and larger reductions in land-use fees.

20. **OEZs have played a central role in the gradual opening of the economy to foreign investors.** In the early reform period, one important difference between the OEZs and other areas in China was the administrative decentralization that permitted investment decisions in the OEZs to be taken largely outside the state plan. Local authorities in the OEZs were allowed to attract foreign investors through preferential policies. They were also allowed to undertake their own infrastructure development and other investment as long as they could raise the funds from taxation, from profits of the enterprises they own wholly or partly, or from banks in the zones. Although the zones have provided favorable business conditions, a number of important constraints—such as restricted access to foreign exchange and domestic markets—remained in place in the early reform period. This largely limited the business scope of foreign enterprises to export-oriented activities. When these restrictions were eased in the second half of the 1980s, foreign investors gradually gained access to the domestic market and, as a result, links with the domestic economy increased.

21. **The international empirical evidence on the impact of preferential policies on FDI flows is mixed, and more work is needed to assess the impact in the case of China.**¹¹

What is clear is that in the political economy context of China's reform process, preferential

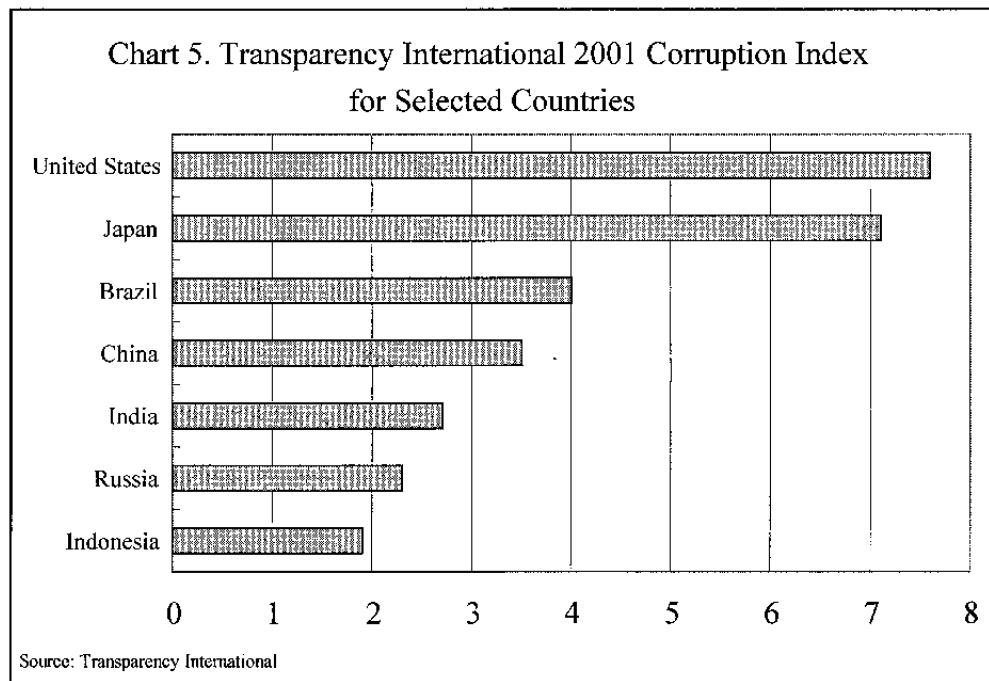
¹¹ See Chalk (2001).

policies provided a means for incremental experiments with economic reforms that was acceptable to the political leadership. Reforms were initially confined to certain localities and FFEs and gradually extended more broadly. In this environment, the success of OEZs in China suggests that preferential policies were useful in catalyzing economic development and attracting FDI. In the absence of preferential policies, FDI would likely to have been substantially less, given the restrictive environment in which Chinese enterprises outside the OEZs had to operate. Thus, it can be argued that preferential policies yielded a net gain to the economy—by allowing reforms to take hold and by attracting FDI which contributed to output growth. However, over time as the reform process advanced, preferential policies created distortions and inequities, particularly a complex and biased tax system and regional income disparities, that need to be addressed.

Cultural and Legal Environment

22. **Shared cultural background.** It has often been argued that China's success in attracting FDI is unique because of the large Chinese Diaspora. The fact that Hong Kong SAR, Singapore, and Taiwan Province of China account for more than half of FDI inflows into China is usually used to support this argument. While many other countries do not share this characteristic, it could be argued that the large share of nonresident Chinese in FDI flows into China is a reflection of distortions rather than a unique advantage. Cultural barriers, such as the language, which prevent foreign investors from entering China, could be a sign that the investment climate is too difficult for outsiders, which implies a cost.

23. **Corruption and legal environment.** These are two important factors that have been found significant in explaining FDI to many countries.¹² In the case of China, many foreign investors perceive the legal system as ambiguous, and legal disputes often are settled through personal contacts rather than formal contracts that are enforced by the court. The ambiguity in the law has, in turn, contributed to corruption. China scores relatively low on corruption and governance indicators in international comparisons (Chart 5). This situation has deterred foreign investment from Europe and the United States more than investment from Hong Kong SAR and Taiwan Province of China. Familiarity with the local culture helps in passing bureaucratic hurdles and that is one of the reasons why investors from Europe and the United States have often sought local counterparts. One study found that China could attract more



¹² Wei (2000).

FDI from Europe and the United States were it not for the implicit tax imposed by bureaucratic hurdles.¹³

IV. IMPACT OF FDI IN CHINA

24. **FDI flows to China have contributed to GDP growth in several ways:**¹⁴

- **FDI has raised GDP growth by adding to capital formation.** This effect is estimated to have contributed about 0.4 percentage points to annual GDP growth in the 1990s. The direct contribution of FDI to GDP growth has been highest in provinces that have attracted most foreign investment and ranged from almost 4 percentage points per year in Guangdong to negligible amounts in most inland provinces.
- **FDI has contributed to higher GDP growth through its positive effect on total factor productivity (TFP).** Empirical research suggests that FDI has raised TFP growth in China by 2.5 percentage points per year during the 1990s. Again, this effect was found to be strongest in provinces that have received most FDI. Thus, in sum, FDI has contributed nearly 3 percentage points to potential GDP growth for China.

25. **FDI has contributed to GDP growth directly through the establishment of FFEs and indirectly by creating positive spillover effects from FFEs to domestic enterprises.**

FFEs tend to be the most dynamic and productive firms in China's economy. Output of FFEs in the industrial sector has expanded at four times the rate of other industrial enterprises during 1994–97, while their labor productivity is almost two times that of public sector

¹³ Wei (1998).

¹⁴ Zebregs (2001).

enterprises. In addition, empirical research has found that domestic enterprises appear to have benefited from the presence of FFEs, both through increased sales and positive spillovers.¹⁵ The latter come about when FFEs introduce new technologies and management skills. These externalities are thought to have become progressively more important as more links began to develop between FFEs and domestic enterprises in the 1990s.

26. **FDI has created employment opportunities.** The creation of employment opportunities—either directly or indirectly—has been one of the most prominent impacts of FDI in China. Looking only at the direct effects, employment in FFEs in urban areas quadrupled between 1991 and 1999, to a total of 6 million, accounting for 3 percent of China's urban employment.¹⁶ This has been particularly important in ameliorating unemployment pressures stemming from ongoing reforms of state-owned enterprises. FFEs are particularly important employers in the coastal provinces, accounting for over 10 percent of urban employment in Guangdong, Fujian, Shanghai, and Tianjin as of 1999.

27. **FDI has built a highly competitive and dynamic manufacturing sector for exports.** The growth of China's trade since 1978 has been four and a half times that of world trade, and China's share of world trade quadrupled from 0.9 percent in 1978 to 3.7 percent in 2000—an achievement that has not been matched by any other country.¹⁷ FFEs played a key role in this achievement. Between 1985 and 1999, the share of exports accounted for by

¹⁵ Zebregs (2001).

¹⁶ It is difficult to measure the indirect employment effects of FDI; these include the employment indirectly generated as a result of spending by FFEs, or as a result of linkages of FFEs with domestic enterprises, either as competitors or as suppliers and customers.

¹⁷ Lardy (2000).

FFEes grew from 1 percent to 45 percent; FFEes accounted for half of overall export growth and one-third of import growth during this period.

V. CONCLUSIONS

28. **While more work is needed to flesh out the lessons from China's experience with FDI, some tentative conclusion may be drawn.** Factors important in attracting FDI to other countries have also been key to China's success. China's large domestic market, low wage costs, and improved infrastructure, complemented with open FDI policies, especially the establishment of OEEZs, seem to have been major factors in attracting FDI. But China could probably attract even more FDI if governance improved and China's legal system became more effective in enforcing contracts.

29. **A unique factor in China's success is the large presence of investors from two of the most dynamic economies in the regions: Hong Kong SAR and Taiwan Province of China.** Although part of the FDI flows from these economies may be induced by distortions, the fact remains that, together with Singapore, they have accounted for more than half of the FDI flows to China.

30. **Apart from the economic environment, political commitment is an important ingredient in attracting FDI.** It was shown, for example, that India shares with China many of the structural factors that have been important determinants of FDI—market size, abundant labor, and a large Indian Diaspora. So, a priori, there seems to be no reason why India could not become an attractive destination for FDI if it so chooses. There is of course a big difference in how political choices are made among countries. In China, the political leadership imposed a vision for the path of growth and development of the country.

Nevertheless, China had to overcome the obstacles to FDI rooted in history and ideology. The

political leadership did so by limiting the opening to a few localities initially, but even then, a great deal of autonomy in economic decisions was given to the localities—allowing a market-based economy to develop alongside a centrally planned system. Although this decentralization created some problems, it also gave local authorities strong incentives to grow and develop their economies. The success of the initial experiments created strong demonstration effects, which induced broad support for further reforms and opening up. This created a virtuous cycle as reforms produced economic fruits, support for reforms became more widespread, allowing more reforms to be implemented.

31. **China's experience shows that FDI contributes to GDP growth.** The effect is likely to be strongest if foreign enterprises develop close links with domestic enterprises, so that the impact of FDI on productivity growth is extended beyond the firms receiving FDI.

32. **FDI will continue to contribute to China's economic development.** WTO accession is expected to lead to a continuation of these contributions as FDI can be expected to increase, particularly in the services sector, such as finance, telecommunications, and wholesale and resale commerce. FDI will continue to be an important source of growth and will help offset potential output losses and create employment opportunities for workers that have become redundant in state enterprise and banking reforms. It is significant that the Chinese authorities have invited foreign participation in the restructuring of state-owned enterprises and the resolution of the nonperforming loan problems in the banking sector. In sum, FDI can be expected to continue to play an important role in China's reform process for some time to come.

33. **There are also some pitfalls in China's FDI experience that provide lessons for other countries.** In particular:

- **An increasingly complex and biased tax incentive system.** The tax incentive system is heavily targeted at FFEs relative to domestic enterprises. Indeed, two different enterprise income tax laws apply to foreign funded and domestic enterprises. With the proliferation of OEZs and the widening of the range of eligible activities, China's system of enterprise income tax incentives has become increasingly complex and nontransparent, not to mention revenue losses for the government. This problem has become more prominent with China's accession to the WTO, as certain of the fiscal incentives do not conform with the WTO principles of national treatment and prohibition of export and import-replacement subsidies. China is in the process of amending various laws to meet its WTO commitments.
- **Growing regional inequalities.** By focusing on specific regions, China's FDI policy has contributed to the growing income disparity between the coastal and inland provinces. The Chinese authorities are giving priority to reducing regional income disparities by developing the western and central regions of the country, including by attracting FDI to these regions through increased investment in infrastructure.

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