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Foreign Investment

This chapter begins in section 18.1 with a discussion of the role of foreign investment as perceived by the Chinese government. Section 8.2 reviews the government's program to promote foreign investment, while the state of foreign investment as of 1999 is reviewed in section 18.3. Policies for regulating foreign investment are summarized in section 18.4. Opportunities for foreign investors and how best to take advantage of them are the subject of section 18.5. Section 18.6 summarizes an econometric study to determine how attractive China's environment is to foreign investors. Although China attracted a large amount of foreign capital, the question is whether it could have attracted more given the economic factors determining foreign investment if not for institutional deficiencies such as corruption. (The answer is yes.) Section 18.7 discusses the possible impact of China joining the WTO on its foreign investment. Section 18.8 contains my proposal for increasing foreign investment from Taiwan.

18.1 The Role of Foreign Investment

To attract foreign investment is a main motivation of Deng's open-door policy. That policy was a 180-degree turn from the previous thinking prevalent in the Chinese Communist Party that foreign capitalists came to China to exploit the Chinese people. Exploitation takes the form of using cheap Chinese labor and extracting Chinese natural resources at low prices. Foreign investors take over Chinese land to set up their business. Foreign factories pollute the physical environment of China. Foreign businesses make money from the Chinese people. The sale of their goods drives out domestically produced goods in Chinese markets. All these accusations of exploitation have some partial truth. Even educated people living in developed market economies today believe in them. Human rights advocates complain that capitalist investors exploit cheap laborers in developing countries because they pay the laborers at much lower wages than in the developed countries, although the wages are quite a bit higher than most domestic wages in those countries. Buying the right to dispose of waste on the cheaper land of developing countries is considered immoral. Polluting the environment is equally bad.

American pride was hurt when Japanese investors bought the Rockefeller Center in New York City and some well-known golf courses in California in the 1980s. Only when the real estate prices slumped did American businessmen feel relieved for having disposed of some expensive properties at high prices to the Japanese. Thus taking over domestic assets and creating business opportunities for themselves are signs of exploitation by foreign investors. From the viewpoint of the investing country, importing inexpensive Chinese goods to the United States produced by American enterprises located in China is said to hurt American workers.

The negative sentiments of critics towards foreign investment aside, the Chinese government sees it as beneficial to China if it is properly channeled and regulated. The "if" in the last sentence will be elaborated in the last paragraph of this section. With qualifications, it sees foreign investment as an important engine for China's modernization and economic development. It has encouraged foreign investment by setting up special economic zones and opening up 14 cities, as we described in chapter 3. Foreign investment has provided to China capital, new technology, managerial skill, and training for labor. It has introduced modern managerial systems, business practices, and a legal framework for conducting business transactions. In addition it has provided competition in the domestic market, and competition has forced domestic enterprises to become more efficient. China's entry into the WTO makes China's door even more open. Both foreign investment and foreign trade are expected to increase because of it. Foreign firms will begin to penetrate China's financial and telecommunications sectors. Trade will increase in both directions. The Chinese government has committed to lowering the tariffs on both agricultural and industrial products, which will lead to an increase in imports. Chinese exports will also increase because Chinese goods will have better access to world markets open to members of the WTO.

The Chinese government is well aware of the economic and social-political costs and benefits of joining the WTO. While the government is pursuing institutional reforms in state-owned enterprises and the banking and financial sectors, it is aware that reforms and the accompanying globalization of the Chinese economy have to proceed at an appropriate speed. If foreign competition enters China too rapidly, Chinese producers and enterprises subject to the competition may have to make adjustments that are too severe to be socially desirable.

While we note the enthusiasm of the Chinese government to promote foreign investment, we have to understand the restrictions on foreign investment. As in other areas of economic reform, including reform of state-owned enterprises, of the banking and financial system, and of foreign trade, many Chinese government officials do not view the market economy in the same way as economists who believe in the economic benefits of free trade and free capital flows. They see certain elements of the market economy as useful in promoting China's economic development and modernization while believing that the government should exercise an important role in regulating the market forces. We have discussed some of the restrictions on foreign trade. In section 18.4 we will discuss government regulations on foreign investment. Bear in mind that the government has the conception that certain industries need to be developed and it needs foreign investors to do the job. Hence the promotion of foreign investment in those particular industries.

This reasoning is different from the justification in terms of the economic benefits resulting from free capital flows. The latter reasoning is based on the idea that economic goods and resources should go where they can command the highest prices or returns. First, from the viewpoint of the foreign investor, he decides to invest abroad because doing so will enable him to yield a higher return to his capital than otherwise. Thus it is economically beneficial for him to do so, and is also beneficial to the GNP of his country. Second, from the viewpoint of the host country, capital flows in only because it supplies the need that domestic capital fails to supply, as the foreign investor must be able to compete successfully with other, domestic and foreign, investors. This supply of foreign investment must be good for the host country, just like any other investment project that can compete in the domestic market in supplying capital and technology. If this viewpoint is accepted, there is no need for the government to promote investment in particular industries, as the market can decide by means of demand and supply of capital in different industries. This difference in viewpoint should be clearly understood without having to decide which is correct and under what circumstances. Some of the issues in the role of government intervention will be discussed in the second half of chapter 20.

18.2 Historical Developments

Foreign investors began to go to China soon after the British took over Hong Kong in 1842. A study of foreign investment in China by Remer (1938) provided statistics and analysis of the situation as of the 1930s. In the period from 1937 to 1949, China was engaged in a war with Japan, in the Second World War, and in a civil war. Soon after the establishment of the PRC in 1949 the Chinese government took over all foreign enterprises in China. Except for Soviet aid received until the beginning of the 1960s, China's door was closed to the outside world. Soviet aid ceased because Chairman Mao and Stalin disagreed on Sino-Soviet relations and Mao was unwilling to be number two among Communist countries. It was not until Deng Xiaoping came to power in 1978 that China's door was open again.

Early in 1979, the Law on Chinese–Foreign Equity Joint Ventures was announced. At that time, Chinese society was not conducive to foreign investment. Laws to regulate business conduct and to protect the investor's interest were very limited. The supporting facilities of power supplies, transportation, and communication were inadequate. The government was considered hostile by many potential investors who were unwilling to put their money in China. Furthermore, many Chinese Communist Party members and government officials mistrusted potential foreign investors and still considered such business to be exploitation by capitalist imperialists.

To solve these problems, four special economic zones were established. They are Shenzhen, Zhuhai, Shantao, and Xiamen, the first three in Guangdong province bordering Hong Kong and the fourth in Fujian province, which is also along the sea coast northeast of Guangdong and across the strait from Taiwan. The zones provide infrastructure, special business laws, and favorable tax conditions for foreign investors. They also served as experimental stations for skeptical Party members and gov-

Table 18.1 China's utilization of foreign capital (US$100 millions)

Year	*Total value of foreign capital actually used*	*Foreign loans*	*Foreign direct investment*	*Other foreign investment*
1979–1983	144.38	117.55	18.02	8.81
1984	27.05	12.86	12.58	1.61
1985	46.47	26.88	16.61	2.98
1986	72.58	50.14	18.74	3.70
1987	84.52	58.05	23.14	3.33
1988	102.26	64.87	31.94	5.45
1989	100.59	62.86	33.92	3.81
1990	102.89	65.34	34.87	2.68
1991	115.54	68.88	43.66	3.00
1992	192.02	79.11	110.07	2.84
1993	389.60	111.89	275.15	2.56
1994	432.13	92.67	337.67	1.79
1995	481.33	103.27	375.21	2.85
1996	548.04	126.69	417.25	4.10
1997	644.08	120.21	452.57	71.30
1998	585.57	110.00	454.63	20.94

ernment officials to observe. If the results turned out to be good, they would be convinced of the virtue of foreign investment. Better policies for foreign investment could also result from the experience observed in the special economic zones. Later, 14 coastal cities were opened, including Dalian, Shanghai, and Guangzhou. Hainan also became a special economic zone. One hundred forty counties were incorporated into open economic areas. In 1986, entirely foreign-owned enterprises were allowed, whereas previously only joint ventures with Chinese had been permitted. Both joint ventures and entirely foreign-owned enterprises took advantage of the cheap labor and engaged in activities including processing for exports, manufacturing, service and retail trades, finance, insurance, and foreign trade. As the Chinese economy expanded, investors saw the potential of a large Chinese domestic market. Foreign investment grew rapidly, as shown in the table 18.1.

18.3 The State of Foreign Direct Investment (FDI) as of 1999

In 1999 China ranked third in attracting FDI among all the countries and regions in the world. Chinese statistics measure FDI by both the contractual value and actually utilized value. This section follows official reports in classifying FDI by its legal form, its country of origin, its geographical location, its industrial distribution, and its value added and tax contribution. In 1999, FDI in operation employed over 20 million persons, accounting for nearly 10 percent of the employment in China's urban areas; 16,918 new enterprises with foreign investment were approved with a contractual value of US$41.223 billion. In 1999 the actually utilized FDI amounted to $40.319 billion, down by 11.31 percent from the 1998 level given in table 18.1.

18.3.1 Forms of foreign investment

There are three kinds of foreign investment: jointly funded enterprises, cooperative ventures, and entirely foreign-owned enterprises. Of the newly approved foreign invested enterprises (or FIEs) in 1999, jointly funded enterprises numbered 7,050 with a contractual value of US$13.515 billion, of which $15.827 billion has been brought in. Chinese–foreign cooperative ventures numbered 1,656 with a contractual value of $6.803 billion and actually utilized value of $8.234 billion. There were 8,201 entirely foreign-owned enterprises with a contractual FDI value of $20.706 billion and $15.545 billion actually utilized. In the order of the value of actually utilized foreign capital, joint investment ranks the first among the three. In the order of the number of newly approved enterprises, the wholly foreign-funded enterprises rank first.

As of the end of December 1999, the cumulative number of enterprises with foreign capital reached 341,538 with a contractual FDI value of $613.717 billion, of which $307.631 billion had been paid off. In the total, jointly invested enterprises and cooperative ventures numbered 246,211, with a contractual FDI value of $411.135 billion and a utilized value of $210.348 billion. The wholly foreign-funded enterprises numbered 95,153 and had a contractual value of $197.975 billion and an actually utilized value of $90.754 billion. Jointly invested enterprises and cooperative ventures remain the major forms for China's absorption of FDI.

18.3.2 Countries/regions of origin

In 1999, the capital actually brought in from 10 Asian countries/regions was lower than in 1998, but the area still remained the major source of FDI. The 15 EU nations' direct investment in China stopped declining and began to grow. Investment from the US increased by a large margin, exceeding the total of the 15 EU nations, and its share in China's total absorption of FDI continued to grow.

Ten Asian countries/regions (including Hong Kong, Macao, Taiwan Province, Japan, the Philippines, Thailand, Malaysia, Singapore, Indonesia, the Republic of Korea) have invested and set up 12,344 enterprises with a contractual value of US$23.887 billion and an actually utilized value of $26.559 billion. The 15 EU nations established 877 enterprises with their investment in China, the contractual value of which was $4.233 billion and the actually utilized value was $4.472 billion. Among the 15 EU nations, investment from Belgium, Finland, Denmark, Germany, and France achieved a fairly big increase, their realized investment in China grew in 1999 by 184.44, 70.71, 42.95, 36.48, and 26.92 percent respectively. The US set up 2,047 enterprises in China with a contractual value of $6.16 billion, of which $4.387 billion has actually been utilized. In 1999 the top 10 countries/regions that invested in China (according to the value of utilized foreign investment) were Hong Kong, the US, Japan, Virgin Islands, Singapore, Taiwan, Germany, ROK, the UK, and

France. As of the end of 1999, the top 10 countries/regions that had the largest cumulative investments in China (according to actually utilized foreign investment) were Hong Kong, the US, Japan, Taiwan, Singapore, Virgin Islands, ROK, the UK, Germany, and Macao.

18.3.3 Regional distribution of foreign investment

In terms of the geographical distribution, the eastern areas accounted for about 85 percent of foreign direct investment in 1999, but the central and western regions were catching up gradually.

The eastern area approved 13,953 foreign investment enterprises in the whole year, with a contractual value of $35.065 billion and an actually utilized value of $3.434 billion. These figures account for 82.47, 85.06, and 87.88 percent respectively of the nation's total. The central area approved 2,100 foreign investment enterprises with a contractual value of $4.118 billion, accounting for 12.41 and 9.99 percent of the national total, and growing by 0.11 and 1.54 percent respectively. The western area approved 865 new enterprises using foreign investment, with a contractual value of $2.04 billion and an actually utilized value of $1.138 billion. Compared with the previous year, the contractual value grew by 0.34 of a percentage point.

As of the end of 1999, of the cumulative number of approved enterprises, cumulative contractual FDI value, and actually utilized value, the eastern area accounted for 82.13, 88.13, and 87.84 percent respectively; the central area had 12.86, 8.00, and 8.94 percent, and the shares for the western area were only 5.01, 3.87, and 3.22 percent respectively. The shares of the central and western area in the country's cumulative contractual FDI value and actually utilized FDI value went up by 0.36 and 0.11 percentage points over those at the end of 1997.

18.3.4 The industrial structure of foreign investment

The actually utilized foreign investment of primary and secondary industry accounted for 1.76 percent and 66.63 percent respectively in the country's total in 1999, up 0.39 and 2.26 percentage points over the previous year. Tertiary industry had a share of 31.61 percent, down 2.65 percentage point from the previous year.

While the national level of FDI declined in 1999, there was a considerable increase in primary industry. Both its contractual FDI value ($1.472 billion) and actually utilized FDI value ($710 million) experienced considerable growth, increasing by 22.2 percent and 13.85 percent and both achieving higher shares of the national total than the previous year. The average FDI value per investment project for primary industry was $1.93 million, implying a net growth of $560,000. For secondary industry the contractual value was $27.289 billion and the actually utilized FDI value was $26.862 billion, up 1.62 and 2.26 percentage points over the previous year. Tertiary industry experienced a large decline in FDI attraction. The contractual value ($12.46 billion) and actually utilized value ($12.745 billion) decreased by 27.8 percent and 18.17 percent from the previous year, taking up 30.23 percent and 31.61 percent in the country's total FDI utilization, down by 2.88 and 2.65 percentage points from the previous year.

For the three years 1997–9, the proportion of agriculture, forestry, husbandry, fishery, and manufacturing industry in the total FDI absorption was on the rise year after year, while the share of real estate industry declined. The share of manufacturing industry was increased from 49 percent in 1997 to 61.5 percent in 1999. The proportion of real estate industry decreased from 19.7 percent in 1997 to 10.1 percent in 1999. In manufacturing industry, high and new technology, especially the manufacturing of electronic and communications equipment, enjoyed the biggest growth margin, its share in the total in 1999 being 9.6 percent, 3.8 percentage points higher than that of 1997 and accounting for 15.56 percent of the manufacturing industry. Besides, the share of synthetic material and new-type building material with high-tech content in manufacturing industry was on the rise. In manufacturing, oil processing, coke making, nonmetal mineral-ware, and general machinery building declined by a big margin, the actually utilized FDI value in 1999 going down by more than 50 percent from the level of 1997 for all these industries.

18.3.5 Industrial value added and tax contribution to the economy

In 1999, the industrial value added of foreign invested enterprises (FIEs) amounted to $420.1 billion, accounting for 20.69 percent of the national total and growing by 12.90 percent, up 0.74 of a percentage point over that of the previous year. During the same period, industrial output (constant price) of FIEs was valued at 1.769649 trillion RMB yuan, growing by 18.30 percent over the previous year and taking up 27.7 percent of the country's total. In 1999, the foreign-related tax takings of the country (tariff, land tax, and fees excluded) totaled 164.886 billion, growing by 33.78 percent over the previous year. Of this amount, tax from FIEs accounted for over 96 percent. The FIEs set up in 1999 had a growth rate for the industrial value added, for export volume, and for tax payment – all higher than the national average. The industrial added value of FIEs in 1999 grew by 12.9 percent over that of 1998, paid tax increased by 33.78 percent, export value went up by 9.47 percent, and a foreign-exchange surplus of $5.997 billion was realized through bank account settlement. The FIEs in operation had a total employment of over 20 million, accounting for nearly 10 percent of the employment in urban areas of the country.

18.4 Policies for the Regulation of Foreign Investment

As we pointed out in section 10.1, under China's open-door policy, foreign investment is welcome and even encouraged, provided that, in the view of the Chinese government, it is beneficial to China's economic development as the government sees it. Therefore, certain categories of investment are encouraged and other categories are discouraged and even prohibited. There are numerous regulations governing foreign investment.

1) Interim Regulations and the Industrial Catalogue

In order to direct foreign direct investments in compliance with the national industrial planning, the Interim Regulations on FDI Directions and the Industrial Catalogue Guiding Foreign Investment were formulated and promulgated in June 1995. For the first time, the industrial policies aiming at inviting foreign direct investment were publicized in the form of laws and regulations, which promote the transparency of policies. The Regulations and the Catalogue classify industrial projects into four categories – items to be encouraged, items to be permitted, items to be restricted, and items to be forbidden – which are absolutely clear for the investors.

In December 1997, the State Development Planning Commission and the State Economic and Trade Commission together with the Ministry of Foreign Trade and Economic Cooperation began to revise the Industrial Catalogue Guiding Foreign Investment and put it into enforcement. The revised text of the Industrial Catalogue Guiding Foreign Investment reflects an expansion in the investment scope encouraged by the state. According to the new version, 272 items, or 83 percent of the total, involving the importation of equipment may enjoy tariff exemption. The revision highlights priority industries for the purposes of structural adjustment, contribution to the introduction of advanced technology, and encouragement to invest in central and western areas. The revised Industrial Catalogue gives encouragement to foreign businessmen on establishing export-oriented enterprises. Items in the Category of Permission whose products are 100 percent exported are listed in the Category of Encouragement. The Catalogue is revised to suit the needs of economic development.

2) The items to be encouraged in foreign direct investments.

The items to be encouraged in foreign direct investments mainly include: agricultural new technology and agricultural comprehensive development as well as industrial projects pertaining to energy, transportation, and vital raw materials; high-tech projects; export-oriented projects; projects comprehensively utilizing resources, renewing resources, and prevention and cure of environmental pollution; projects which can give play to the advantages of the western and central regions. Direct foreign investments are encouraged for the technological upgrading of traditional industries and of labor-intensive industries.

3) Foreign direct investment in services

China has launched pilot projects utilizing foreign investment in services. In commercial retailing, ever since 1992 when the State Council decided to launch trial operations of foreign-invested commercial retail businesses in Beijing, Tianjin, Shanghai, Dalian, Qingdao, Guangzhou, and five Special Economic Zones, the utilization of foreign direct investment in the commercial retail sector has been expanding gradually. In foreign trade, in September 1996, with the approval of the State Council, the

Ministry of Foreign Trade and Economic Cooperation (MOFTEC) published the Interim Procedures on Establishing Pilot Sino-Foreign Joint Venture Wholesale Business, which is a major step toward opening up the service sector. In tourism, at the end of 1998, the Interim Procedures on the Joint Venture Travel Agent were promulgated, which enlarged the geographical areas for permitted joint-owned travel agents to the regions outside the tourism development zones. At the turn of the century, in addition to the fields of commerce and foreign trade, China expanded the opening of foreign investment in other areas such as finance, insurance, transportation, international freight forwarding, legal services, tourism, advertising, medical care and public health, accounting, assets appraisal, education, leasing, engineering design, consulting, and real estate. China's entry into the WTO should help promote further opening of the service sectors to foreign investment.

18.5 Opportunities and Problems for Foreign Investors

The Chinese government is eager to build infrastructure, including highways, ports, telecommunications systems, etc., that require capital and modern technology which can be supplied by foreign investment. Chinese state enterprises are also looking for foreign partners to upgrade their technology, management, labor, and marketing abilities. These needs are well known. Many foreign investors have taken advantage of such investment opportunities, which can be seen from the data in table 18.1. The Chinese consumer markets are being opened wider as import quotas and tariffs are being reduced, partly as a result of the Chinese government's desire to join APEC and the WTO, and partly as a result of the rapid increase in China's reserves in hard currencies which can be spent to increase imports. Besides selling to the Chinese market, foreign companies also take advantage of the cheap and skilled labor in China to produce for exports. To take advantage of economic opportunities in China, investors have to deal with the Chinese bureaucracy in the bureaucratic market economy. Dealing with the Chinese bureaucracy requires special attention to the following areas.

1) Finding the right partners

Doing business in China is different from doing business in Western countries, mainly because in China economic power is to a large extent in the hands of bureaucracies at different levels of government, because China does not have a Western-style legal system, and because Chinese workers and managers have different habits, ethics, outlooks, and training from those found in the West. To succeed in China a foreign investor needs approval and help from the Chinese bureaucracies, in addition to assistance from Chinese labor and management.

To set up a foreign-owned enterprise or a joint venture a foreign investor needs the approval of many levels of the government, possibly including the central government in Beijing, a provincial and/or local government, ministry A and/or bureau (a) as well as ministry B and/or bureau (b), etc. It sounds like an impossible task. At each step, the approval of a business agreement may take a long time and require patient negotiations. Many foreign companies have had the sad experience of believing that the agreement of one or two Chinese bureaucrats is sufficient to conduct their business, only to find that the approval of many more bureaucrats is needed. Some less relevant bureaux or people can simply make trouble in order to reap some profit from the investor. The reason for the existence of so many bureaucrats surrounding an investment project is that many bureaucrats are looking constantly for opportunities to make money in the same way that all Western businessmen are looking for opportunities to make money. The bureaucrats are working under a system in which economic power is to a large extent in their hands. Many of them utilize their power to make money.

Is there any rule that can be followed to find the right local contact for a potential investor? The local contact or partner must have the authority, or must be able to acquire sufficient authority, to do the business desired. If the person or the agency is the right one, he/she can get the approval, or can help the investor get the approval from all others that may be trying to extract some benefit from the investor. If the investor cannot find such a person, his investment is unlikely to succeed. The way to find such a person depends partly on what the investor's business is and how much he has to offer. If he is investing in an area that China needs to encourage, as listed in the last section, the task is easier because many Chinese bureaucrats would be interested in cooperating and the investor only needs to select the right partner among them. Choosing the right person requires knowledge of the Chinese bureaucratic system and its personalities. If the investor is knowledgeable in this regard, and has the right contacts, he can find the right people to work with.

2) Dealing with an imperfect legal system

Many Western businessmen and scholars point out that a Western-style legal system does not exist in China and that makes it hard to do business. An economic historian might be interested to explain why such a legal system has flourished in China, and whether and how it compares with the Western legal system. Suffice it to state here that such a semi-legal system has functioned in China for a long time and it has served Chinese society. To deal with the semi-legal system in China, an investor can try to develop a network, getting to know the right people and making the right friends. This is called "developing *Guanxi*" in Chinese. Interpreted in modern economic terms, *Guanxi* is a kind of human capital both in the sense of your knowing and having access to influential people in China and their recognition that you are useful to them. Establishing personal connections in order to do business is common in Western societies as well, but the degree to which one needs to rely on it compared with the formal legal system is much higher in China. The subject of *Guanxi* is discussed further in chapter 20, dealing with the Chinese legal system.

If an investor cannot depend on legal contracts, how can he be sure that his Chinese partner will keep his part of the bargain? One way to ensure it is to remain an indispensable partner in the project or to maintain a position such that his services will be needed in the future. If he has a contract to share profits in the future, how does he guarantee that his Chinese partner will honor the contract? When Mr. Roebuck presumably lost his usefulness to Mr. Sears, the company's name was changed from

Sears-Roebuck to Sears. This can also happen in China. To maintain his usefulness, a foreign investor has to keep his other business connections and maintain his influence in the world business community so that his Chinese partner will continue to value a good relationship with him. The above remarks apply equally to a Chinese partner who wants to maintain a good relationship with his foreign investor – he must try to maintain a position in the business community so that his foreign partner will honor all agreements and the partnership. If one loses his usefulness as a partner almost no legal protection can keep the partnership for him. The same applies even to some marriage contracts. It is prudent for a potential investor in China to recognize the Chinese semi-legal system. However, from a historical perspective, China's legal system will gradually improve in the twenty-first century as the system has already improved to some extent in the last 15 years of the twentieth. The improvement is a part of the process of economic development, and not just because of the need to deal with foreign investors. China's legal system is the topic of chapter 20.

3) Technology transfer to China

Somewhat related to the fact of an imperfect legal system in China is the lack of sufficient protection of patents and intellectual property rights in China. This issue has been discussed widely in the Western press. Within the informal framework of doing business, what prevents a Chinese partner who is producing some products in a joint venture from setting up a business of his own to produce the same products? Lacking sufficient legal protection, a foreign investor can hardly stop his Chinese partner from doing so. Western investors are aware of this and have tried to devise means to protect their interests, for example by keeping an essential part of the technology secret and known to only a limited number of people whom they can trust. If a certain technology or patent is difficult to protect from a technical point of view, the investor has to take this fact into account in investing in China, possibly by reaping enough profits in a short time before the technology can be copied, or by sacrificing a calculated part of the Chinese market while maintaining a large part of the international market which is protected legally. Even protection in international markets can be uncertain – newspapers are full of stories of Chinese manufacturers copying videotapes, compact discs, movies, and software packages for export into the international market. One story is that in October 2000 the Chinese national government itself had difficulty in preventing a popular film on corruption, which the government itself sponsored, from being illegally copied, sold, and shown in theaters all over China. The number of pirated products in China offered for sale in the world market is so large that it draws much attention in the world community.

There is no solution yet for the problem of pirating in China. This phenomenon is easy to understand from the historical and cultural background of the Chinese. Patents are a recent product of world history after the Industrial Revolution. There were not too many scientific inventions to protect in Chinese history. If a Chinese knew of certain ways to produce useful drugs, for example, he would try to keep it a family secret. Many products in China were protected in this way. If a product cannot be so protected it is publicly available. Such products include all the herbs that are sold in traditional Chinese drugstores and are therefore available to benefit the Chinese population. The lack of patent protection is said to be socially undesirable because it may discourage people from investing in new products. Such discouragement may have negative effects, but the negative effects have to be weighed against the benefits of having a perhaps smaller number of invented products available to consumers on the market at lower prices. Before legal protection can be effectively enforced in China, foreign businessmen have to recognize this fact, while trying to put pressure on the Chinese government to enforce the laws on intellectual property at the same time.

A related point is that some Western governments may also have to recognize this fact. In February 1996, the United States government registered a strong protest to the government in Beijing for the large number of Chinese pirated products being sold in the world market. This worsened the already tense diplomatic relations between the two countries at the time. This protest to the Chinese government had a small effect, similar to that of a protest to the government of Mexico for having illegal drugs produced in Mexico and sold in America. The difference is that some of the Chinese products were said to be produced by firms which are otherwise legal in China, in some cases allegedly firms affiliated with the Chinese military. The similarity in both cases is that there is simply so much money to be made that the central governments in both countries have found it difficult to stop the illegal operations. The protest to the central government in either country is unlikely to be very effective. The government itself wishes to stop the illegal activities.

4) Cooperation with Chinese state enterprises

There are a number of examples of successful joint ventures between a foreign investor and a Chinese state enterprise controlled by the central, provincial, or local governments. By successful, I mean both the Chinese and the foreign partners have made profits. Such joint ventures are still available and plentiful if the foreign investor is resourceful enough to find them. The advantage of cooperating with a state enterprise is that the Chinese partner is likely to have sufficient authority to produce and market the product and may even have sufficient power to protect the product from infringement by pirating. If the foreign investor can find ways to protect his share of the profits, as discussed above, there may be much profit to be made by both partners. A potential investor should study the successful cases to find out what makes such cooperation successful. In addition, he or she should look into successful cases of cooperation with township and village enterprises. These enterprises, in contrast with the slow-growing state enterprises, constitute a very important component of the rapid economic growth of China.

5) Corruption and related institutional problems

In addition to facing a different legal system, foreign investors also face the problem of corruption. The need to compensate government officials to get approval for an investment project is an example of corruption. The payment of bribes might be considered as just a cost of doing business that has to be included in the calculation of profit. However, the problem is not so simple. It may require the right method and the right channel to pay the bribes required. The investor may not know which bureaucrats have to be paid and how much to pay them. For US investors, though not Japanese investors, payment of bribes is illegal. How to handle such problems is an art. Chinese bureaucrats sometimes get free trips to the United States on business and sometimes get scholarships for their children to study in the United States at the recommendation of their US investors. Perhaps such favors are legal according to US law. A related set of institutional problems can be called regulatory burden. It includes foreign-exchange control, interest rate control, and domestic financial market imperfection, which make doing business difficult and costly for a foreign investor.

In spite of all the above-mentioned problems, there are profit-making opportunities. By producing what is needed by the governments at different levels or by the consumers in China, and by producing for exports, some foreign investors have made profits. It would be interesting to find out what fraction of foreign investors has made profits so far. Perhaps the number is small, but many investors are counting on making more profits in the future by exploiting the large domestic markets in China and by using China as a base for producing goods for export to other parts of the world.

18.6 How Attractive is China for Foreign Investment?

In the last section we pointed out some special conditions in China which make it difficult or unattractive for foreigners to invest in China. Have such conditions affected the amount of foreign investment in China? In 1999 China received the third largest amount of foreign direct investment. If such unfavorable conditions had not existed would China have received even more? To answer this question it is necessary to specify a relation between the amount of foreign investment and a set of important determining factors that is valid for many economies. Given the values of the determining factors prevailing in China, if the amount of investment in China is below the normal amount predicted by this relation, then China is said to have underperformed. Such an econometric analysis was performed by Wei (1999).

Using a set of cross-country data on the stock of cumulated foreign direct investment (FDI) from 17 important source countries to 42 host countries, Wei estimated a relation of the amount of inward FDI for a host country like China to a set of determining factors. The source countries include the United States, Japan, Germany, the United Kingdom, France, Italy, and Norway. The dependent variable is $\log(FDI_{jk} + A)$, where the subscripts stand for source country j to host country k and A is a positive constant to prevent the value of log FDI from being too small. If FDI_{jk} is zero, which can happen, the log of zero is minus infinity, not suitable as the value of a dependent variable. Among the explanatory variables are an index to measure corruption, an index for regulatory burden, an index of degree of domestic financial repression, a measure of foreign-exchange control, the marginal corporate income tax rate (all above variables for the host country), a measure of the distance between the economic centers of the source–host pair, log GDP of host country, log GDP per capita of host country, linguistic tie between the source–host pair, the source countries' fixed effects (measuring the extent to which each source country wants to invest). Corruption is measured by a perception index based on a survey of 2,827 firms in 58 countries conducted by the World Economic Forum in 1996. Respondents were asked to rank each country on a scale of 1 to 7. Regulatory burden is measured by a ranking of 8 minus the original rating, where the original rating is from the same survey from 1 to 7 with a lower number meaning a more pervasive regulatory burden. Domestic financial repression is measured by an index on interest rate control obtained from the same survey.

Before introducing the last three explanatory variables Wei used the other variables and a dummy variable for China. The coefficient of this dummy variable is estimated to be approximately −1. This means that China is considered an unattractive country to invest in after we have allowed for the effects of all other factors. The coefficients of all other variables have the right signs. Then corruption, regulatory burden, and financial repression are introduced as additional variables to replace the dummy variable for China. The results show that all three have negative effects on foreign direct investment. This study has provided a quantitative measure of the total effect of the unfavorable institutional characteristics on foreign direct investment in China using a dummy variable, and three measures of the separate effects of corruption, regulatory burden, and financial repression, after the effects of other relevant factors on FDI have been taken into account. It is a supplement to the discussion of the institutional characteristics which affect foreign investment presented in the previous sections.

18.7 The Impact of WTO Membership on Foreign Investment

Membership in the WTO opens China's economy further for foreign investors. China has promised to open telecommunications, banking and finance, insurance, commercial, and other service industries to foreign investors. It has allowed foreign investors to acquire business enterprises in China, besides setting up joint or cooperative ventures and wholly owned enterprises. It has agreed to eliminate restrictions on foreign investors such as export quotas on products and limited sales in domestic markets, by allowing them to set up domestic sales outlets. It will lower tariffs and thus the costs of production, but the advantage of production for domestic sales will be decreased by competition from imports. The net effect of the further opening is to increase foreign investment. The composition will also change towards more of the service industries opened up under WTO membership.

The effects on China's economy are essentially positive. Domestic industries will be subject to more competition. State enterprises will be under more pressure to restructure. It may affect the unemployment situation adversely. On the other hand, the state enterprises will improve by absorbing foreign capital, technology, and management methods. Some may become joint ventures or be sold to foreign investors. Multinationals are helping China develop high-technology industries which the Chinese are not able to develop for lack of capital and management skills. Thus the industrial structure will be more rapidly modernized. The economic infrastructure of China will be improved by foreign investment in telecommunication and financial services. The business legal system will improve by the larger presence of foreign corporations. These corporations will help promote a modern legal system in China.

18.8 A Proposal to Increase Foreign Investment from Taiwan

In 1997, the largest sources of direct foreign investment were Hong Kong, Japan, Taiwan, and the United States, in that order. The United States overtook Taiwan as the third largest investor in 1998. Foreign capital from Taiwan amounted to over US$3.5 billion per year on average from 1996 to 1999. Since there is no direct transport from Taiwan to the mainland, Taiwan investors have to travel through Hong Kong or Tokyo and are greatly inconvenienced in the process. In a speech before the Foreign Investment Forum sponsored by the Ministry of Foreign Trade and International Cooperation held in Xiamen on September 8, 2000, I presented a proposal for the government of mainland China to allow Taiwanese ships and airlines to come to the mainland directly. The proposal was intended to increase investment from Taiwan and to improve economic ties between the two economies. The speech read in part:

> We are all aware that agreements to open direct postal and transport services between the two sides of the Taiwan Strait have not yet been reached, but the lack of agreement should not prevent the Chinese government from adopting this proposal. A major obstacle to the agreement appears to be that the Taiwan government is concerned about easy access to the island by travelers from the mainland. Whatever may be the reasons for the government of Taiwan to be concerned about the opening of the island to direct postal communication and travel from the mainland, it is in the interests of the Chinese people and the mainland government to allow Taiwan residents to come to the mainland directly without having to go through Hong Kong or Tokyo . . .
>
> I cannot think of any reasons why the Chinese government would decide not to allow residents of Taiwan to travel directly to the mainland. It has indeed been the government's policy to give special privileges to travelers from Taiwan, as we have witnessed the special passages and lines at airports and points of entry to China reserved for the convenience of Taiwanese residents. Allowing them to travel directly is simply to extend to them more convenience. The fact that the government of Taiwan might not reciprocate this convenience to residents of the mainland should not matter because the policy by itself is good for China. It is not a concession to the government in Taiwan because it is not directed to the government. It is a policy for the Chinese people . . .
>
> The proposal submitted here is good for China as a whole. The only part of China which may incur some economic loss from it is Hong Kong, but the benefits to the other parts of China and to promoting China's investment and trade surely outweigh the loss to Hong Kong. Historically the economy of Hong Kong has benefited from the port's being the only entry to China for many purposes. Under the open-door policy, Hong Kong's unique position cannot be maintained as direct access to other cities including Shanghai becomes easier. To pursue the open-door policy further, other parts of China should be open to direct travel by residents from elsewhere, especially of Taiwan. In a sense the proposal being discussed is not a new policy because, ever since Hong Kong was returned to China on July 1, 1997, Taiwanese airplanes and ships have been allowed to land or anchor in Chinese territory already. In fairness to other ports

and cities of China, they should be granted the same privilege that Hong Kong has, namely, the privilege of receiving airplanes and ships coming directly from Taiwan.

A major concern of the residents of China and of the entire world today is the relation between the governments on the two sides of the Taiwan Strait. The relation affects all aspects of life, including China's foreign trade and investment, the topic of this conference. If the relations can be improved, it will be of great interest to all of us. The proposal to allow Taiwan residents to travel directly to the mainland can only improve relations, in addition to promoting more investment from Taiwan. It is a win–win policy. Since this policy is one-sided, it could be terminated at any time if the Chinese government should find it desirable to do so. There is no risk in adopting this policy.

If the experiment with this policy is successful, the next step is to allow Taiwanese cargo ships to come to the mainland directly. An appropriate charge to the ship can be levied. This would improve trade across the Taiwan Strait. We all understand that direct shipping has been occurring through fishing boats. Why not make direct shipping by Taiwanese ships legal and collect the rightful dues? This would lower the cost of shipping and reduce the risk of shipping by fishing boats. Direct postal services are a byproduct of the policy. Once airplanes and passenger ships come directly from Taiwan they can carry mail, thus speeding up the postal service between the two sides.

Relations between the two sides of the Taiwan Strait are not making much progress at this time. The governments on both sides realize that it is a slow and gradual process to improve relations. One step forward is recognized to be the opening of direct postal services and transport. Even this step is being stalled indefinitely. Fortunately, the government in Beijing can take the initiative alone to accomplish this step as suggested in this proposal. I sincerely hope that it will take such a step without delay.

In January 2001, perhaps as a defensive move to prevent the rapid opening up of direct transport and trade nationwide, the Taiwan government took the initiative to open up direct trade and transport through the small island of Jinmen to Xiamen, a move considered by the mainland government as a delaying tactic. In 2001, we still await the mainland government making a bold move and the two governments coming to some additional agreements to promote trade and investment in China.

References

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1 List the most important laws and regulations on foreign investment in China and the years in which they were put into effect. (See Wei, 1999.)

2 Using data for 17 major source countries to 42 host countries in 1996 to explain the natural log of the dollar amount of cumulated foreign investment, plus a constant A, from source country j to host country k up to

1996, with some relevant variables and a dummy variable (= 1 if the host country is China, = 0 otherwise), Wei found a coefficient of about −1 for this dummy variable. What is the meaning of the value −1?

3 China had a cumulated foreign direct investment up to 1996 of about US$170 billion according to Chinese official statistics (lower according to foreign statistics). If the coefficient of the dummy variable representing China in a regression to explain the natural log of cumulated investment from other countries to China, plus a constant A, were zero instead of −1 as reported in question 2, i.e., if China had not suffered the bad effects of institutional factors like corruption, how would you calculate the country's cumulated investment from the regression?

4 List the most important variables which you would use to explain cumulated foreign investment in different provinces in China in the most current year for which you can obtain data. What is the appropriate dependent variable? Explain why each explanatory variable is important, and what the sign of its coefficient in the regression should be.

5 Why is foreign investment helpful for economic development in China? Name four of its contributions.

6 What are the special conditions in China that a foreign investor should consider in order to invest successfully?

7 How large was foreign investment in China in 1999 (or in a later year if you can find the data) as measured by the fraction of total gross industrial output value that it produced? What was the exponential rate of growth of actually utilized foreign direct investment from 1995 to 1998?

8 What are the three industries that account for the largest shares of foreign investment? Which five countries or regions account for the largest shares of foreign investment in 1999?

9 Explain the role of the special economic zones in attracting foreign investment. If such zones are good for attracting foreign investment, why not make the whole of China a large special economic zone?

10 What kinds of regulation does the Chinese government impose on foreign direct investment? Which of these regulations can be justified on economic grounds? Explain.