Foreign Direct Investment in China: Some Lessons for Other Countries

WANDA TSENG AND HARM ZEBREGS

A driving force behind China’s exceptional growth performance has been the increasing openness of its economy, especially to trade and foreign direct investment (FDI). Indeed, attracting FDI has been a pillar of China’s policies to increase its openness to the world economy, and it has resulted in China becoming the largest recipient of FDI among developing countries.

This chapter looks into several questions posed by China’s success in attracting FDI. What explains that success? Can other countries replicate it, or is it unique to China? Has China benefited from the large inflow of FDI? And what lessons can China’s experience with FDI offer for other countries?

Key Trends and Characteristics

FDI inflows to China have surged from almost nil at the start of reform in the late 1970s to between $40 billion and $45 billion a year (nearly 5 percent of GDP) in the second half of the 1990s (Table 5.1; Figure 5.1). 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 to opening the economy to the outside world. His 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 antic-
ipation of China’s accession to the World Trade Organization (WTO). By the 1990s China had become the second-largest FDI recipient in the world, after the United States, and by far the largest recipient among developing countries, accounting for about 25–30 percent of FDI flows to all developing countries.

However, part of China’s success in attracting FDI may be exaggerated because of misreporting and round-tripping. The latter refers to capital originating in China that is sent to other economies and then returns disguised as FDI to take advantage of tax, tariff, and other benefits accorded to foreign but not domestic investment. The extent of this round-tripping is difficult to assess; estimates range from 7 percent

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Billions of dollars</td>
<td>2.3</td>
<td>28.3</td>
<td>16.1</td>
<td>40.6</td>
</tr>
<tr>
<td>Percent of GDP</td>
<td>0.7</td>
<td>4.4</td>
<td>3.7</td>
<td>4.7</td>
</tr>
<tr>
<td>Percent of total FDI flows to developing countries</td>
<td>12.7</td>
<td>24.3</td>
<td>27.1</td>
<td>25.3</td>
</tr>
<tr>
<td>Memorandum:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Growth in GDP (percent a year)</td>
<td>9.7</td>
<td>10.1</td>
<td>12.2</td>
<td>8.3</td>
</tr>
</tbody>
</table>

1Period averages.

Figure 5.1. FDI Inflows  
*(In billions of dollars)*

![Figure 5.1. FDI Inflows](image)

Source: *China Statistical Yearbook*, various issues.
of inflows in 1996 to almost 25 percent in 1992.¹ Some FDI is actually better characterized as foreign borrowing, because the inflows in question (mainly for infrastructure) were guaranteed a specified rate of return. Misreporting may also be a problem, because local officials have an incentive to exaggerate their ability to attract FDI, and foreign investors have an incentive to overstate their actual investment in order to report lower taxable income.

Hong Kong SAR and Taiwan Province of China have traditionally been important sources of FDI in China (Table 5.2). Their importance diminished somewhat in the 1990s as multinationals from Europe, Japan, and the United States entered China, but these two economies still account for almost half of FDI inflows.

The largest share of FDI is destined for manufacturing, which took up almost 60 percent of total contracted FDI in 1998 (Figure 5.2). Next is real estate at 24 percent, followed by distribution (transport, wholesale, and retailing) at 6 percent. Among manufacturing industries, about half of FDI has been directed toward labor-intensive products such as textiles and clothing, food processing, and furniture. Technology-intensive manufacturing (for example, medical goods and pharmaceuticals, electrical machinery and equipment, and electronics) and physical capital–intensive manufacturing (for example, petroleum refining and chemical materials) share almost equally in the remainder. This suggests that an important motivation for foreign companies has been to take advantage of China’s low labor costs.

The geographic pattern of FDI in China shows a huge disparity among regions. The eastern region accounts for 64 percent of GDP but took up nearly 88 percent of FDI entering China from 1983 to 1998.

Table 5.2. Sources of FDI
(In percent of total)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong SAR</td>
<td>55.3</td>
<td>53.4</td>
<td>41.0</td>
</tr>
<tr>
<td>Japan</td>
<td>13.1</td>
<td>8.5</td>
<td>7.2</td>
</tr>
<tr>
<td>Taiwan Province of China</td>
<td>10.1</td>
<td>8.4</td>
<td>6.5</td>
</tr>
<tr>
<td>United States</td>
<td>7.1</td>
<td>8.2</td>
<td>9.9</td>
</tr>
<tr>
<td>European Union</td>
<td>5.7</td>
<td>5.7</td>
<td>11.0</td>
</tr>
<tr>
<td>Singapore</td>
<td>1.2</td>
<td>4.9</td>
<td>6.2</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>0.0</td>
<td>2.8</td>
<td>3.0</td>
</tr>
<tr>
<td>Other</td>
<td>7.5</td>
<td>8.2</td>
<td>15.1</td>
</tr>
</tbody>
</table>

Source: China Statistical Yearbook, various years.

¹Harrold and Lall (1993); Lardy (1995); Wei (1998).
while the central region (with 29 percent of GDP) took up 9 percent and the western region (with 23 percent of GDP) attracted only 3 percent (Figure 5.3). 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 reforms consisted of experi-

Figure 5.2. FDI Inflows by Sector, 1998
(In percent of contracted value)

- Real estate (24.4)
- Manufacturing (59.6)
- Distribution (6.0)
- Construction (3.1)
- Primary (1.8)
- Other (5.1)


Figure 5.3. FDI Inflows by Region, 1983–98
(In percent of total)

- East (87.8)
- Central (8.9)
- West (3.3)

ments 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; see below) in the southern provinces of Guangdong and Fujian at the outset of the reforms in the late 1970s, followed by the opening of another SEZ in Hainan and the designation of 14 cities in China’s coastal regions as “open coastal cities” 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.

Equity joint venture companies, cooperative joint venture companies, and wholly foreign-owned enterprises have been the main forms of FDI entering China. Early in the reform period, China allowed FDI only in the form of joint ventures (except in the SEZs), for ideological reasons and because the authorities thought this form was better suited to tapping advanced foreign technology. It was not until 1986 that wholly foreign-owned enterprises were permitted outside the SEZs. Accordingly, equity and cooperative joint ventures accounted for the lion’s share of FDI in 1990 (Figure 5.4). 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.

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 at the time shared a number of characteristics with China. Both countries had relatively closed economies, with low average incomes and a large share of the population dependent on agriculture. Neither China nor India was then receiving significant amounts of FDI. This picture has since changed dramatically. India remains a fairly closed economy while China has become more integrated into the global economy. And as India’s GDP per capita more than doubled between 1978 and 2000, China’s GDP per capita quadrupled (in constant dollar terms).

China’s increasing openness to the outside world can be seen in the rapid growth of its foreign trade. Exports and imports as a share of GDP rose from negligible amounts to about 25 percent in 2000. The average

---

2Under an equity joint venture, Chinese and foreign investors operate the venture and share the risks, profits, and losses jointly. All the parties agree on the equity share of each party, and profits are distributed in proportion to these shares. In a cooperative joint venture, the Chinese partner provides land, natural resources, labor, and equipment or facilities, while the foreign partner provides capital or technology, key equipment, and materials. Both parties decide on the proportions in which products, revenue, and profits will be distributed.
The tariff rate in China fell from well over 50 percent in the early 1980s to about 15 percent now, less than half 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 percentage of total import value has been much lower. The effective tariff rate—that is, tariff revenue as a percentage of total imports—is only 3 percent in China, compared with 23 percent in India (Table 5.3). As a percent of GDP, net FDI inflows into China in 2000 were more than seven times those in India.

**Main Determinants**

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 market economies.\(^3\) Two types of FDI flows can be considered: domestic market-oriented flows and export-oriented flows. Domestic market-oriented FDI is motivated mostly by the size and growth rate of the host country. Export-oriented FDI mainly looks for cost competitiveness. The factors that have been most important in influencing FDI in China can be grouped into three categories: eco-

---

\(^3\)Cheng and Kwan (2000); Liu and others (1997).

©International Monetary Fund. Not for Redistribution
Economic Structure, liberalization and preferential policies, and cultural and legal environment.

Economic Structure

Market Size

Empirical studies at both the national and the provincial level have found a strong correlation between GDP and FDI inflows in China. 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). It appears that market size has been a more important determinant of FDI from Europe and the United States than of FDI from Hong Kong SAR and Taiwan Province of China, as the latter tends be more export oriented. In contrast, many European and American multinationals have set up factories in China with the aim of producing for the domestic market.

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. Some analysts have

---

4Cheng and Kwan (2000); Liu and others (1997); Zhang (1999). See also Chapter 6 of this volume.
5Zhang (1999). See also Chapter 6 of this volume.
6Chen (1996); Cheng and Kwan (2000); Head and Ries (1996); Liu and others (1997).
suggested that low wage costs have been especially important in attracting export-oriented FDI from Hong Kong SAR and Taiwan Province of China, as a response to rising wage costs in those economies and others in the region. This has contributed to China’s rapid emergence as an important global competitor in labor-intensive manufacturing.

Although most empirical studies have not found the quality of labor to be a significant determinant of FDI in China—indeed, the shortage of highly qualified personnel is 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.

**Infrastructure**

Empirical studies confirm that those provinces with more developed infrastructure have tended to receive more FDI. 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 the open economic zones (OEZs), allowed them to upgrade their infrastructure in an effort to attract FDI (Table 5.4). Of the increase in fixed-asset investment from the late 1980s to the late 1990s, which amounted to

---

7Cheng and Kwan (2000); Head and Ries (1996).
8Open economic zones include SEZs, the open coastal cities, and various development zones. For a taxonomy of the different types of zones see Box 5.2 and Wall, Jiang, and Yin (1996).
6½ percent of GDP, local governments accounted for about 3 percentage points; these were mainly in infrastructure, particularly electricity, gas, water, transport, and posts and telecommunications.

Scale Effects

Several studies have found a strong persistency in FDI flows. 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 finds it easier to attract more, 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, allowing 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.

Reduced Barriers and Preferential Policies

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 an important goal, expecting that 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 certain ideological obstacles to FDI that were rooted in the historical legacy of the Western powers’ opening of Chinese port cities after the Opium War. This legacy had 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, however, the authorities responded to the complaints of foreign investors, by clarifying the legal environment for FDI, relaxing governmental controls, and providing practical assistance as well as political and

—

©International Monetary Fund. Not for Redistribution
legal assurances (Box 5.1). What had begun as an experiment limited to a few localities and sectors at the outset of the reforms became accepted practice as more and more regions and economic sectors were opened to FDI by the 1990s.

The preferential policies used to attract FDI have been tax concessions and special privileges for foreign investors and the establishment of OEZs (Box 5.2). Tax incentives for foreign-funded enterprises (FFEs) are mostly in the form of reduced enterprise income tax rates and tax holidays (Box 5.3). These are available to all FFEs as well as domestic firms in the OEZs and to export-oriented and advanced-technology FFEs outside the OEZs. In addition, firms in the OEZs enjoy great autonomy in managing operations: they face minimal controls on the movements of goods and are allowed to export and import almost freely (Grub and Lin, 1991). These firms also benefit from more flexible labor relations and more liberal land use rights. Additional benefits are available for export-oriented and advanced-technology FFEs, including tax exemptions on profit remittances, additional tax benefits for reinvested profits, and larger reductions in land use fees.

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 made 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 wholly or partly own, 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.

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

---

Box 5.1. China’s FDI Regime

FDI in China was heavily restricted before 1978. Since then the FDI regime has been liberalized gradually. A legal framework was progressively developed to facilitate and regulate FDI. China’s accession to the WTO promises further liberalization of FDI.

Key Laws and Regulations

The legal framework for FDI has been progressively codified and clarified. The 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. The 1983 Regulations for the Implementation of the Law on Joint Ventures Using Chinese and Foreign Investment provided greater detail on operations and preferential policies for joint ventures. The 1986 Law on Enterprises Operated Exclusively with Foreign Capital formally permitted the establishment of wholly foreign-owned enterprises outside the SEZs. The 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 or producing for export. These provisions were subsequently codified in the 1988 Cooperative Joint Ventures Law. The 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 rules abolished the stipulation that the chairman of the board of a joint venture be appointed by Chinese investors and provided for protection from nationalization.

Industrial Guidance

The Interim Provisions on Guiding Foreign Investment Direction (revised in 1997) classify four categories for FDI: encouraged, permitted, restricted, and prohibited. The regulations aim to encourage greater geographic dispersion of FDI inflows within China and to promote FDI inflows in targeted sectors and industries, such as export-oriented and high-technology industries, agriculture, and infrastructure.

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 have been substantially less, given the restrictive environment in
In broad terms, projects are encouraged or at least 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 or 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 sectors and industries is limited. Regulations specify those industries where Chinese partners must play a leading role or have a majority share, and those 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, and water projects, as well as projects in aerospace, automobiles, defense, high-technology vaccines, medical institutions, mining, petrochemicals, printing and publishing, shipping, satellite communications, and tourism (Foreign Investment Administration, 1998). About half of these industries are considered high-technology industries.

**WTO Agreement on FDI**

China has made substantial commitments to trade and investment liberalization as conditions for its 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 a significant expansion of market access, particularly in the services sector. These involve eliminating geographic and other restrictions in key sectors (such as motor vehicles) and increasing foreign ownership limits in telecommunications (to 50 percent by 2002), life insurance (to 50 percent on accession), distribution and retailing, and securities (to 49 percent by 2003), and giving full national treatment to foreign banks (by 2005).
Box 5.2. Open Economic Zones in China

Since the beginning of China’s 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. Although open to both domestic and foreign investors (indeed, most of the investment in the zones has come from domestic sources), these zones have played an important role in attracting FDI (IMF, 1997; Wall, Jiang, and Yin, 1996).

Special Economic Zones

SEZs were the first and, until 1984, only open economic zones in China. 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 worth up to $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 and for 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

In 1984, 14 cities in the coastal regions with already established industrial bases and infrastructure were designated open coastal cities.

Cultural and Legal Environment

Shared Cultural Background

It has often been argued that the unique phenomenon of a large Chinese diaspora has been key to China’s success in attracting FDI. The fact that Hong Kong SAR, Singapore, and Taiwan Province of China together account for more than half of FDI inflows into China is usually used to support this argument. Although indeed few countries have such a large overseas ethnic community, 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, that deter foreign investors from entering...
China could be a sign that the investment climate is difficult for outsiders, which implies a cost, not an advantage.

**Corruption and the Legal Environment**

Two factors that have been found to be significant in explaining FDI to many countries are the degree of official corruption and the presence or absence of a strong legal environment.\(^\text{11}\) In the case of China, many foreign investors perceive Chinese law as ambiguous, and legal disputes

---

\(^{11}\)Wei (2000).
Figure 5.5. Transparency International Corruption Perceptions Index for Selected Countries, 2001
(Index, 10=least corrupt)

Source: Transparency International.

often are settled through personal contacts rather than formal contracts enforceable in the courts. The ambiguity in the law has, in turn, contributed to corruption. China scores relatively poorly on corruption and governance indicators in international comparisons (Figure 5.5). This situation has deterred foreign investment from Europe and the United States more than it has investment from Hong Kong SAR and Taiwan Province of China. Familiarity with the local culture helps in passing bureaucratic hurdles, and that is one reason why European and American investors have often sought local partners. One study found that China could attract more FDI from Europe and the United States were it not for the implicit tax imposed by bureaucratic hurdles.¹²

Impact of FDI

FDI flows to China have contributed to GDP growth in at least two ways (see Chapter 6):

- *Increased capital formation.* This effect is estimated to have contributed about 0.4 percentage point to annual GDP growth in the 1990s. The direct contribution of FDI to GDP growth has been

highest in those provinces that have attracted the most foreign investment: it has ranged from almost 4 percentage points a year in Guangdong to negligible amounts in most inland provinces.

- **Higher total factor productivity (TFP).** Empirical research suggests that FDI raised TFP growth in China by 2.5 percentage points a year during the 1990s. Again, this effect was found to be strongest in the provinces that have received the most FDI. Thus, in sum, FDI has contributed nearly 3 percentage points to potential GDP growth for China.

FDI has contributed to GDP growth both 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. Their output in the industrial sector expanded at four times the rate of other industrial enterprises during 1994–97, and labor productivity in FFEs is almost double that in public sector enterprises. In addition, empirical research has found that domestic enterprises appear to have benefited from the presence of FFEs, through both increased sales and positive spillovers. Such spillovers come about when FFEs introduce new technologies and management skills. They are thought to have become progressively more important as more links began to develop between FFEs and domestic enterprises in the 1990s.

The creation of employment opportunities—either directly or indirectly—has been one of the most prominent impacts of FDI in China. 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. 13 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.

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 not matched by any other country. 14 FFEs played a key role in this achievement. Between 1985 and 1999 the share of exports accounted for by FFEs grew from 1 percent to 45 percent; FFEs accounted for half of overall export growth and one-third of import growth during this period.

---

13It is difficult to measure the indirect employment effects of FDI, which 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.

14Lardy (2000).
Conclusions

Although more work is needed to flesh out the lessons from China’s experience with FDI, some tentative conclusions 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 by open FDI policies (especially

Box 5.3. Tax Incentives for FDI

China has extensively but selectively used tax incentives to guide FDI into designated regions, sectors, and industries. FFEs enjoy exemptions from and reductions in the national business income tax as well as other incentives including exemptions from custom duties and the value-added tax for imported equipment and technology, exemptions from and reductions in local business income tax, full refunds for income tax paid on reinvested earnings, and no restrictions on profit remittances or capital repatriation. Generally speaking, the tax incentives offered in the SEZs and economic and technology development zones 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 that unifies the tax treatment of domestic enterprises and FFEs. At the same time, China decided to reduce gradually the preferential treatment of 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 then abolished.

Standard Income Tax Rates

The standard income tax rate for domestic enterprises and FFEs is 33 percent. (This includes a 3 percent local government component on which local governments may grant reductions.) FFEs with contracts for operating periods of 10 years or more are exempt from income tax for two years after the first profit is realized, and eligible for a 50 percent reduction in their tax liability in the following three 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 three years after the initial five years.

Special Economic Zones

The income tax rate for domestic enterprises and FFEs in SEZs is 18 percent (again including the 3 percent local government component). FFEs receive the same two-year exemption and three-year reduction as under the
the establishment of OEZs), seem to have been major factors in attracting FDI. But China could probably attract even more FDI if governance improved and if China’s legal system became more effective in enforcing contracts.

A unique factor in China’s success is the large presence of investors from two of the most dynamic economies in the region: Hong Kong SAR and Taiwan Province of China. Although part of the FDI flows

standar...
from these economies may be induced by distortions, the fact remains that, together with Singapore, they have accounted for more than half of FDI flows to China.

Apart from the economic environment, political commitment is an important ingredient in attracting FDI. For example, India shares with China many of the structural factors that have been important determinants of FDI: a large market, abundant labor, and a large diaspora. So, a priori, there seems to be no reason why India could not become an attractive destination for FDI. There are, of course, important differences in how the two countries have made political choices. In China the political leadership imposed a vision of the country’s path of growth and development. Nevertheless, these leaders had to overcome obstacles to FDI rooted in history and ideology. They did so by limiting the opening to a few localities initially, but even then a great deal of autonomy in economic decision making 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 of the economy. This created a virtuous cycle: as the reforms produced economic fruits, support for reforms became more widespread, allowing more reforms to be implemented.

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 spreads beyond the firms receiving FDI.

FDI will continue to contribute to China’s economic development. WTO accession should lead to a continuation of these contributions, as FDI can be expected to increase, particularly in the services sector, in activities such as finance, telecommunications, and wholesale and retail commerce. FDI will remain an important source of growth and will help offset potential output losses and create employment opportunities for workers whom state enterprise and banking reforms have made redundant. It is noteworthy 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.

Some pitfalls in China’s FDI experience also provide lessons for other countries. In particular:

- China remains burdened by an increasingly complex and biased tax incentive system. The system is heavily targeted at FFEs,
favoring them over domestic enterprises. Indeed, two different enterprise income tax laws apply to FFEs 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, and it continues to impose revenue losses on the government. The problem has taken on greater salience with China’s accession to the WTO, because some of China’s 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 also remain a problem. By focusing on specific regions, China’s FDI policy has contributed to the growing income disparity between 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, among other things by attracting FDI to these regions through increased investment in infrastructure.

**References**


