
Analysis of the Investment Activity Regulation in Priority Sectors of the Economy: A Case Study of China

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Abstract:

The attractiveness of the PRC as a recipient of foreign capital is determined by a high level of socio-economic and political stability, a capacious domestic market, cheap labor and an active national investment policy.

Thus, from the very outset of the "policy of openness to the outside world" (1979), a preferential investment regime for foreign investors was established in China maintained until now. Despite the sharp shrinking of cross-border investment at the turn of the 21st century and the economic stagnation in the majority of developed countries, China is actively attracting foreign direct investment heading the list of leading recipients of foreign capital.

The PRC's accession to the WTO (2001) had a great impact on the FDI growth. The principles of the "open unified foreign trade policy in compliance with the GATT requirements" largely contributed to attracting foreign investors to China. After the WTO accession, the volume of foreign investment in China rose 2.5 times of which the overwhelming majority belonged to FDI and China actually refused from such forms of foreign investment as foreign loans, credits, international leasing, etc.

Since 2005 until lately, the foreign investment inflows into the PRC came mainly from Hong Kong, Singapore and such offshore zones as the Virgin Islands and the Cayman Islands. In fact, after accession to the WTO, adjustments were made only in respect of certain previously adopted laws encouraging the attraction of foreign investment to the country.

Global trends in capital movements are getting increasingly apparent in China, a growth of interest in foreign portfolio investment is observed involving the acquisition by foreign investors of securities issued by Chinese companies.

Keywords: Direct Investment, Foreign Investment, Sector-Based Regulation, Tax Rate.

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1. Introduction

Nowadays, the inflow of foreign capital into the PRC is about 2% of gross investment. The sources of receipt fall into three groups: 1) external loans including those provided by foreign governments, international financial organizations and foreign commercial banks along with export loans and external bonds; 2) FDI raised for the establishment of enterprises with foreign participation; 3) other foreign investment including international leasing, compensation trade, product processing and assembly operations as well as equity issues on the external market (Bath, 2012; Fetscherin *et al.*, 2010; Kotlyarov and Ostrovskii, 2018). Whereas in the 80's the predominant source of inflows was foreign loans of all types, starting with the 90's the major inflows shifted towards foreign direct investment (FDI). In 2016 FDI rose to US\$2696 billion (Table 1).

Table 1. Foreign investment actually utilized in the PRC (1979-2016) (US\$ billion)

Year	Total	Foreign loans	FDI	Other foreign investment
1979-2005	1532.9	138.5	1355.14	39.19
1979-1982	13.060	10.690	1.769	0.601
1983	2.261	1.065	0.916	0.280
1984	2.866	1.286	1.419	0.161
1985	4.760	2.506	1.956	0.298
1986	7.628	5.014	2.244	0.370
1987	8.452	5.805	2.314	0.333
1988	10.226	6.487	3.194	0.545
1989	10.060	6.286	3.392	0.381
1990	10.289	6.534	3.487	0.268
1991	11.554	6.888	4.366	0.300
1992	19.203	7.911	11.008	0.284
1993	38.960	11.189	27.517	0.256
1994	43.213	9.267	33.767	0.179
1995	48.133	10.327	37.521	0.285
1996	54.805	12.669	41.726	0.410
1997	64.408	12.021	45.257	7.130
1998	58.557	11.000	45.463	2.094
1999	52.659	10.212	40.319	2.128
2000	59.356	10.000	40.715	8.641
2001	49.672		46.878	2.794
2002	55.011		52.743	2.268

Year	Total	Foreign loans	FDI	Other foreign investment
2003	56.140		53.505	2.635
2004	64.070		60.630	3.440
2005	63.81		60.330	3.480
2006	67.08		63.02	4.060
2007	78.34		74.77	3.570
2008	95.25		92.40	2.860
2009	91.80		90.03	1.770
2010	108.82		105.73	3.090
2011	117.70		116.0	1.690
2012	113.29		111.72	1.580
2013	118.72		117.59	1.130
2014	119.6		119.56	0.140
2015	126.3		126.3	...
2016	126.0		122.5	...

Source: Statistical Yearbook of the People's Republic of China 1979-2016, 2017. China's National Bureau of Statistics (NBS), Beijing: Xinhua; Report on the country's economic and social development in 2016, 2017.

Since the late 70's, a legislative framework facilitated the FDI attraction to the country. In April 1979, the CPC Central Committee adopted a resolution "On Some Issues of the All-Round Development of Foreign Trade to Increase Foreign Exchange Receipts." Two provinces were chosen - Guangdong and Fujian - for which a resolution on special economic zones was adopted ("SEZs") (Gao and Zhang, 2013; Modern Law of Chinese Public Republic, 2012).

In the early 80's of the 20th century, two laws were adopted - "The Income Tax Law Concerning Chinese-Foreign Equity Joint Ventures" and "The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises". Under these laws, the effective average corporate tax rate for joint ventures and foreign enterprises was 17%, compared to 33% for national companies. Foreigners were granted two-to-three year tax holidays followed by long-term half-rate taxation along with customs privileges, bank-lending preferences, etc. However, later these laws were amended. The new legislation details the procedure for setting tax rates (Fung, 2011; Modern Law of Chinese Public Republic, 2012).

In 2007, "The Enterprise Income Tax Law of the People's Republic of China" was passed. In accordance with the new law, since 2007, the earlier privileges for companies with foreign investment were gradually revoked as required by WTO. According to this law, all enterprises in China were divided into two groups: resident enterprises and non-resident enterprises. The resident enterprises pay taxes in full. The

non-resident enterprises are subject to tax only on their income from China sources. For enterprises of all forms of ownership, a single income tax rate of 25% was established (Modern Law of Chinese Public Republic, 2012).

The "Law of the People's Republic of China on Chinese-Foreign Joint Ventures" stipulates control over the financial activities, the insurance, the right to import needed materials and to export manufactured goods, the remittance abroad of legally received income of foreign partners, wages and salaries of the foreign staff, the dispute settlement procedure (Lo and Li, 2011; Modern Law of Chinese Public Republic, 2012). In 1995, the Foreign Trade Law came into effect. In April 2004, this law was substantially amended to strengthen the intellectual property protection and foreign trade investigations (Modern Law of Chinese Public Republic, 2012).

2. Foreign Direct Investment Activity in China

At present, China has made a decision to enlarge the openness of the Chinese market to foreign investment (Bhatt, 2013; Xi Jinping's report at 19th CPC National Congress, 2017).

In November 2017, during the visit of the US President D. Trump to China, the Ministry of Commerce of China made a statement on expanding the access of foreign investors to financial markets (China widens access to financial markets for foreign investors, 2017; Ostrovskii, 2016; Ostrovskii, 2017). By 2015, the size of FDI received by the Chinese economy from nearly 200 countries and territories reached \$3,798 billion. According to statistics, over 460,000 JVs and wholly foreign-owned enterprises operated in the PRC in 2014 (Table 4). Totally, from 1995 to 2015, the annual FDI inwards in China rose to \$126.3 billion (Table 2).

Table 2. *The structure of the FDI distribution in the PRC by countries of the world (1995-2015) (US\$ million /%)*

Country (Territory)	1995	2005	2013	2014	2015
<i>Total (\$ million)</i>	<i>48133/ 100</i>	<i>60324/ 100</i>	<i>117600/ 100</i>	<i>119600/ 100</i>	<i>126300/ 100</i>
<i>Asia</i>					
Hong Kong	20402/ 42.4	17949/ 29.8	73400/ 62.4	81300/ 68.0	86400/ 68.4
Japan	5113/ 10.6	6530/ 10.8	7060/ 6.0	4300/ 3.6	3200/ 2.5
Indonesia	111/ 0.23	87/0.14	126		
Macao	440/0.9	600/1.0	460		
Malaysia	259/ 0.54	361/0.6	280		
Singapore	1861/ 3.87	2204/ 3.65	7230/ 6.1	5800/ 4.8	6900/ 5.5
The Republic of Korea	1191/ 2.47	5168/ 8.6	3050/ 2.6	4000/ 3.3	4000/ 3.2
Thailand	288/0.6	96/0.16	483		
Taiwan	3165/ 6.6	2152/ 3.6	2090/ 1.8	2000/ 1.7	1500/ 1.2

Country (Territory)	1995	2005	2013	2014	2015
United Arab Emirates	...	...	44		
<i>Europe</i>					
United Kingdom	1009/ 2.1	965/ 1.6	392/ 0.3	700/ 0.6	500/ 0.4
Germany	527/ 1.1	1530/ 2.5	2078/ 1.8	2100/ 1.8	1600/ 1.3
France	716/ 1.5	615/ 1.0	752/ 0.6	700/ 0.6	1200/ 0.95
Italy	548/ 1.13	322/ 0.5	317		
Netherlands	147/ 0.3	1043/ 1.73	1274		
Switzerland	120/ 0.25	206/ 0.34	314		
Russia	22.9/ 0.04	211/ 0.35	22/ 0.002		
<i>Other countries</i>					
Virgin Islands	304/ 0.63	9022/ 15.0	6159/ 5.2	6200/ 5.2	7400/ 5.9
Cayman islands	12/ 0.02	1948/ 3.2	1668/ 1.41	1300/ 1.1	1400/ 1.1
Canada	620/ 1.29	454/ 0.75	536/ 0.46	400/ 0.33	200/ 0.16
USA	3135/ 6.5	3061/ 5.1	2820/ 2.4	2400/ 2.0	2100/ 1.7
Australia	343/ 0.7	401/ 0.66	330/ 0.28	200/ 0.17	300/ 0.24
Samoa	63/ 0.13	1352/ 2.24	1858/ 1.57		

Source: Statistical Yearbook of the People's Republic of China 1979-2016, 2017. China's National Bureau of Statistics (NBS), Beijing: Xinhua; Report on the country's economic and social development in 2016 (Updated: 2017-02-28), 2017.

All major international investors are represented on the Chinese market; however, their contributions differ. In the recent years, the EU, US, Canadian and Australian companies, with the exception of Germany and the Netherlands, have not been increasing their FDI flows directed annually to the PRC. The share of these countries is small and does not exceed 2% of the FDI inflow from each country. The volume of investment from European countries plus the US, Canada and Australia in the recent years accounted for approximately 7-9% of the gross annual FDI.

Hong Kong traditionally holds the strongest position among the largest foreign investors in China. Along with that, such well-known offshore centers as the British Virgin Islands, the Cayman Islands, Samoa and others came to the foreground.

3. Industry-Sectoral Structure of Attracted Foreign Direct Investment

The Chinese legislation allows sector-based regulation of investment attracted to the national economy. In late 1997, China amended the "Catalog of Industries for Guiding Foreign Investment". In 2004, this document was updated to establish four categories of investment projects for which foreign investment was encouraged, permitted, restricted and prohibited.

The 2004 Catalog restricts or prohibits foreign investment in industries related to the state security, strategic and raw material resources as well as environmental pollution.

Following the accession of the PRC to the WTO (2001), a circular "On Further Standardizing the Administration of Development and Filing of Equity Investment Enterprises in Pilot Zones" was adopted which codified the requirements for transactions, information disclosure and registration of private equity enterprises investing in SEZ.

In 2011, a new Catalog of Industries for Guiding Foreign Investment was released (Catalogue of Industries for Guiding Foreign Investment, 2011). The Catalog is a list of activities structured into three categories: encouraged, restricted and prohibited. If foreign investment is made in projects not categorized by the Catalog, it is deemed "permitted". In case the activity of a newly created enterprise with foreign participation is classified as prohibited for foreign investment the departments are not entitled to grant a pre-approval for setting up such an enterprise. For industries that are listed as restricted the establishment of an enterprise is possible, provided additional restrictive conditions are observed.

Foreign investment is restricted in such industries as cultivation of cotton; planting rare tree species; deposits of precious metals; certain types of the tobacco and food industries; construction and operation of oil refineries with capacity of less than 8 million tons per year; the chemical and pharmaceutical industry, manufacturing of metal products, insurance; international transportation.

Prohibited industries are not so many. In particular, real estate transactions, setting up brokerage houses, construction of five-star hotels, villas, exhibition centers as well as laying out parks; construction and operation of coal-fired thermal power plants with power less than 300 megawatts in Tibet, Xinjiang and Hainan Island. There are also local regulations on foreign capital that are issued by the provincial authorities. In particular, the Xinjiang Uygur Autonomous Region encouraged foreign investment by providing tax benefits for nine sectors:

- (1) major urban manufacturing and infrastructure sectors such as irrigation, energy, utilities, communications, environmental protection;
- (2) bioengineering, new technologies, new materials and new products featuring high productivity, energy saving, advanced technology, high added value;
- (3) processing of petrochemical products;
- (4) agricultural machine-building industry;
- (5) cotton- and wool-spinning and clothes manufacturing;
- (6) manufacture of household chemicals and silicate products;
- (7) advanced finishing materials for walls and architectural appearance;
- (8) comprehensive development of agriculture and livestock, higher output processing of agricultural products;
- (9) integrated development of tourism resources (from personal talks notes made at the XUAR Commerce Department).

FDI in such areas as trade, food, logistics, public utilities and real estate has been growing at fast rates, as shown in Table 3 below.

Table 3. FDI breakdown by industries (1996-2016)

Industry	1996		2006		2014		2016	
	No. of projects	FDI (US\$ billion/%)	No. of projects	FDI (US\$ billion/%)	No. of projects	FDI (US\$ billion/%)	No. of projects	FDI (US\$ billion/%)
<i>Total</i>	24556	73.3/100	41485	69.5/100	23778	119.6/100	27900	122.5/100
Agriculture	812	1.14/1.6	951	0.6/0.86	719	1.52/1.27	558	1.85/1.51
Manufacturing sector	18280	50.5/68.9	25373	41.8/60.1	5421	42.7/35.7	4324	36.8/30.0
Construction	387	2.0/2.7	352	0.69/1.0	230	1.24/1.04	...	...
Transport and Communications	196	1.6/2.2	665	1.98/2.84	376	4.46/3.7	425	4.96/4.0
Information Technologies and SW products	...	...	1378	1.07/1.5	981	2.76/2.3	1463	8.13/6.6
Trade, Food, Logistics	1655	2.35/3.2	5724	2.62/3.8	8545	10.11/8.5	9399	15.2/12.4
Public Utilities, Real Estate	1961	12.85/17.5	5519	12.95/18.6	4409	47.1/39.4	5009	34.8/28.4
Finance	...	...	64	6.74/9.7	970	4.18/3.5	...	...
Health Care and Social Services	128	0.35/0.5	20	0.02/0.03	22	0.078/0.07	245	0.5/0.4
Education, Culture, Physical Culture, Art	63	0.17/0.23	268	0.27/0.38	214	0.84/0.7	...	...
Science and Science Services	124	0.175/0.24	1035	0.5/0.7	1611	3.25/2.7	...	...
Other sectors	950	2.15/2.9	136	...	181	0.72/0.6	...	...

Source: *Statistical Yearbook of the People's Republic of China 1979-2016, 2017*. China's National Bureau of Statistics (NBS), Beijing: Xinhua; *Report on the country's economic and social development in 2016 (Updated: 2017-02-28), 2017*.

In this context, one should consider the progressive lifting of restrictions on business activities of foreign investors observed in recent years. Consistent steps are being taken towards liberalization and simplification of the regime for the establishment and operation of foreign capital enterprises (Grima *et al.*, 2017; Grima and Caruana, 2017).

4. Regional Structure of Attracted Foreign Direct Investment

The regional distribution of foreign investment is characterized by the preferred orientation of foreign investors towards the coastal areas and the cities of central subordination to the PRC (Table 4).

Table 4. Distribution of Accumulated Foreign Investment Stock by Regions of China (US\$ /%)

Province	1995		2005		2014	
	No. of enterprises	US\$ billion/%	No. of enterprises	US\$ billion/%	No. of enterprises	US\$ billion/%
<i>The PRC Total</i>	240447/100	639/100	260000/100	1464/100	460469/100	3798/100
<i>Cities of the central subordination</i>	33137/13.8		52206/20.0	326.2/22.3		943.1/24.9

Province	1995		2005		2014	
	No. of enterprises	US\$ billion/%	No. of enterprises	US\$ billion/%	No. of enterprises	US\$ billion/%
		113.4/ 17.7			113647/ 24.7	
Beijing	9691/ 4.0	28.8/ 4.5	10980/ 4.2	60.7/ 4.1	28041/ 6.1	201/ 5.3
Shanghai	14487/ 6.0	67.7/ 10.6	28978/ 11.1	200.7/ 13.7	68952/ 15.0	530.5/ 14.0
Tianjin	8959/ 3.7	16.9/ 2.6	10933/ 4.2	56.8/ 3.9	11507/ 2.5	144.1/ 3.8
Chongqing ²	...		1315/ 0.5	8.0/ 0.5	5147/ 1.1	67.5/ 1.8
Coastal regions	147134 / 61.2	403.2 / 63.0	157633 / 60.6	856.2/ 58.4	251337/ 55.0	2042.9/ 53.7
including:						
Hebei	5368/ 2.23	12.3/ 1.9	3637/ 1.4	21.9/ 1.5	6811/ 1.5	62.1/ 1.6
Jiangsu	22950/ 9.5	53.2/ 8.3	33321/ 12.8	265.7/ 18.1	51634/ 11.2	718.1/ 18.9
Zhejiang	11237/ 4.7	24.4/ 3.8	19009/ 7.3	101.9/ 7.0	31005/ 6.7	262.9/ 6.9
Fujian	16527/ 6.9	36.7/ 5.7	17854/ 6.9	75.3/ 5.1	24322/ 5.3	173.2/ 4.6
Shandong	17988/ 7.5	37.4/ 5.9	20153/ 7.8	78.6/ 5.4	26023/ 5.6	199.2/ 5.2
Guangdong	59582/ 24.8	204.6/ 32.0	58762/ 22.6	288.9/ 19.7	104555/ 23.2	562.1/ 14.8
Hainan	8606/ 3.6	21.1/ 3.3	2456/ 0.9	9.2/ 0.6	3038/ 0.65	27.9/ 0.73
Guangxi	4876/ 2.0	13.5/ 2.1	2441/ 0.9	14.7/ 1.0	3949/ 0.85	37.4/ 1.0
North-East	18662/ 7.7	41.5/ 6.45	21318/ 8.25	113.2/ 7.75	26477/ 5.7	255.9/ 6.7
Liaoning	11284/ 4.7	28.1/ 4.4	16542/ 6.4	81.5/ 5.6	17091/ 3.7	198.6/ 5.2
Jilin	2990/ 1.2	4.8/ 0.75	2488/ 0.95	20.7/ 1.4	4370/ 0.9	33.3/ 0.9
Heilongjiang	4388/ 1.8	8.6/ 1.3	2288/ 0.9	11.0/ 0.75	5016/ 1.1	24.0/ 0.6
Hinterland	40965/ 17.0	184.5/ 11.3	28843/ 11.2	168.4/ 11.55	69008/ 14.6	555.8/ 14.7
including:						
Henan	4382/ 1.8	8.9/ 1.4	2877/ 1.1	20.6/ 1.4	10056/ 2.2	58.9/ 1.6
Hubei	5758/ 2.4	13.6/ 2.1	4284/ 1.6	25.8/ 1.76	8160/ 1.8	77.7/ 2.0
Hunan	3263/ 1.3	7.0/ 1.1	2712/ 1.04	15.8/ 1.1	5353/ 1.2	46.3/ 1.2
Shanxi	1364/ 0.6	2.4/ 0.4	776/ 0.3	7.7/ 0.5	3531/ 0.8	39.1/ 1.0
Sichuan	5897/ 2.5	12.7/ 2.0	4075/ 1.56	16.6/ 1.13	10253/ 2.2	82.8/ 2.2
Shaanxi	1894/ 0.8	4.6/ 0.7	2890/ 1.1	13.7/ 0.9	6782/ 1.5	44.7/ 1.2
Inner Mongolia	1074/ 0.4	2.0/ 0.3	914/ 0.35	12.6/ 0.86	3036/ 0.7	26.4/ 0.7
Xinjiang	656/ 0.3	1.4/ 0.2	345/ 0.13	1.9/ 0.12	1325/ 0.3	7.6/ 0.2

Source: Statistical Yearbook of the People's Republic of China 1979-2016, 2017. China's National Bureau of Statistics (NBS), Beijing: Xinhua; Report on the country's economic and social development in 2016 (Updated: 2017-02-28), 2017.

In legal terms, the incentives for attracting FDI into the regions designated by the Chinese government do not always work. In the early 80's, "Regulations on Special Economic Zones in Guangdong Province" did attract direct investment thereto (mainly from Hong Kong). However, similar regulations for Hainan Province (1988), Xiamen SEZ in Fujian Province (1994) did not produce a similar result (Table 2). Therefore, there are multiple challenges that urge China to constantly improve the national investment climate, maintain and develop the interest of foreign investors.

In general, the changes in the sphere of attracting foreign capital testify to the consistent orientation of the PRC towards full integration of the foreign

² In 1996 was a territory of Sichuan Province.

entrepreneurial sector into the national capital market with the establishment in the long-run of uniform rules for all participants regardless of ownership and country.

5. Summary of the PRC's Policy of Attracting Foreign Investment

Over the years of the economic reform, the PRC has formed the legislation for attracting FDI based on the main document, i.e. the Constitution of the PRC, laws as well as directions and circulars of relevant ministries and agencies.

An important regulator for foreign investors was the "Interim Provisions on Guidance for Foreign Investment" jointly developed by several agencies - the State Planning Commission, the State Economic and Trade Commission and the Ministry of Foreign Trade and Economic Cooperation. The annex in the form of a guiding catalog identified priority sectors for investing foreign capital. The Catalog was regularly amended and updated. Finally, four categories of investment projects were established: encouraged, permitted, restricted and prohibited.

To attract FDI to particular areas, starting with 1980, China created four special economic zones (further SEZs) - Shenzhen, Zhuhai, Shantou in Guangdong and Xiamen in Fujian Province - as the first "growth poles".

Three "poles of growth" evolved in the coastal regions: 1) the Pearl River Delta in Guangdong province with the Shenzhen and Zhuhai SEZs; 2) the Yangtze River Delta with the central subordination city of Shanghai, part of Jiangsu Province in the south and Zhejiang Province in the north; 3) the Bohai Bay Ring area with two big central subordination cities of Beijing and Tianjin and part of Hebei Province (Portyakov, 2017).

6. Conclusions

For Russia, the essential thing in the Chinese experience of FDI attraction is ensuring legal guarantees for foreign investors to safeguard capitals invested in Russia as well as the stability of the taxation treatment for at least ten years and the possibility to export profits of joint ventures or profits of wholly owned foreign enterprises derived in the Russian territory. Based on the Chinese experience, the following specific recommendations may be identified for development of the legal framework that could help attract FDI to the Russian economy:

1. Development in the Russian Federation of the necessary infrastructure which includes creation of favorable conditions for the commercial activities of foreign-participated enterprises or wholly owned foreign enterprises, covering banking, customs, information and transportation infrastructure. The Russian Federation government can attract FDI to infrastructure projects using the public-private partnership scenario.

2. Preparation and adoption at the Russian Government level of a catalog for guiding foreign investors that structures the national industries into four categories - encouraged, permitted, restricted, prohibited.
3. Establishment of the "Green Channel" customs regime for national enterprises categorized as "encouraged" with customs and tax benefits, including the zeroing of customs duties for equipment to be installed at these enterprises.
4. Establishment of regional investment funds for the implementation of priority projects designated by relevant economic commissions at various levels - the Russian Federation Government, federal districts, republics (regions, territories). The commissions should determine the total amount of funds, priority sectors as well as conditions for admittance of Russian and foreign investors.
5. Connecting the most important infrastructure projects implemented in the Russian territory to the Chinese One Belt One Road Initiative to expand opportunities of getting access to investment through the Asian Bank for Infrastructure Investment and the Silk Road Fund.

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