

**Foreign Capital Utilization in China:
Prospects and Future Strategy**

The World Bank Beijing Office

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Executive Summary

China has been very successful in attracting Foreign Direct Investment (FDI). Attracted by the country's relatively good investment climate and low wages, and more recently by its growing domestic market, China received about a quarter of all FDI to developing countries over the last 10 years, and a record \$60 billion in 2004, some 9.9 percent of the total FDI. In terms of share of GDP and investment, FDI made less of a contribution, with some 11 percent of total investment on average over the last five years, lower than countries such as Hungary, Czech Republic, Viet Nam and Singapore. Also as a share of GDP, China is not among the top receivers of FDI. Moreover, it is estimated that some 20 to 30 percent of FDI is not genuine FDI, but rather domestic investment rerouted through foreign countries to benefit from the special treatment foreign investment receives in terms of taxes and investment policies.

Clearly, FDI has had many benefits for China. FDI accelerated growth by providing more investment capital, contributed significantly to the country's export success with over 57 percent of exports from foreign invested firms, and generated over 120 million jobs. Foreign-invested firms generally have more value added per worker, higher labor productivity, and higher profits than domestic firms. Evidence on technology spillovers is more limited, but industries with higher FDI seem to have higher productivity increases than other industries, suggesting a positive spillover.

The benefits of FDI are unevenly spread across China's provinces. The coastal provinces have benefited in particular from the FDI flows, taking in almost 90 percent of total FDI, whereas the western provinces received less than 2 percent in 2004, despite the government's policies to encourage investments in these regions. FDI also remains heavily focused on industry, which took well over 60 percent of total in the 1990s, and some 75 percent in 2004, 71 of which in manufacturing. Services attracted a little over 20 percent of total FDI, but most of this was in real estate, whereas services such as banking and public utilities—key recipients of FDI in other countries—attracted only modest amounts. FDI in agriculture is negligible.

On current trends China is likely to continue to receive abundant FDI over the coming 11th Five Year Plan period. Developing countries are projected to receive some US\$250 billion in FDI on average over the coming 5 year plan, and China can expect to receive some 30 percent of this. This puts China in a relatively comfortable position, and it would allow the country to opt for policies that encourage FDI to align more with the country's objectives. These objectives themselves are changing, and over the next five-year plan, China is likely to focus on a more balanced development. The "Five balances" call for growth that is more focused on domestic development, that is more evenly spread across China's regions, and that is less resource intensive. For FDI policies, this would imply that greater attention should be given to investments in domestically focused industries, to investment in the interior, and to investments with a higher level of technology.

Some of the developments in FDI that the government desires will happen irrespective of policy. Accession to the WTO is opening up a whole host of activities previously closed for FDI, notably in services such as banking, distribution, and utilities. Further, rising wages and land prices in the East may well drive some FDI further inland when investment conditions are right. And China's increasingly skilled labor force is likely to attract gradually more industries with higher value added to the country. In addition, removing some of the existing policy biases, such as in taxation policies, special economic zones, and market accession will level the playing field between coastal and inland provinces and among sectors in the economy. However, China faces significant policy challenges in optimizing the use of FDI.

Maintaining an Attractive Investment Climate

China should continue to improve its investment climate. Increasing competition from other large emerging economies such as India, Brazil, Thailand and Mexico may limit China's share in world FDI, and if China desires to continue to attract large volumes of FDI, it must further improve its investment climate. While this climate is overall strong, it can be better, if China

- Reduces the complexity of investment approvals, increase government effectiveness by reducing overlap in authority and duplication in registration and approval requirements among agencies. Harmonizing registration requirements and registration forms across agencies, and promoting data exchange among the agencies so that firms could register with all authorities at any one of the agencies would greatly reduce the burden on investors. Monthly filing requirements at local and central tax bureau, labor bureau, and social security bureau could be streamlined as well.
- Improves access to equity finance of foreign invested firms through capital market reforms. Such access would also help reduce the current pressures on the balance of payments: because of limited access to domestic direct finance, foreign firms have to finance much of their investments from abroad, which causes upward pressures on the currency, and complicates monetary policy. Lowering equity requirements and allowing firms to pay up their full equity share on installment basis would help in this respect.
- Reforms its judicial system. China's weakest spot in its investment climate is its judicial system. As China's society is becoming more complex and market-based, and because the authorities hope to attract more investment in higher value added industries, the relative importance of an efficient judiciary will increase. Furthermore, as China hopes to gradually move up the technology ladder, stronger enforcement of intellectual property rights will gain in importance, as will public and private investments in research and development.

Leveling the Playing Field in Taxation

China has an array of tax incentives for foreign investment. The incentives promote foreign investment in general and regional and industry-specific investment. These incentives played a role in the early days of China's transition to a market economy, when domestic enterprises were seen to have an advantage over foreign ones. These advantages to domestic firms that in part motivated the FDI incentives are being eroded by China's WTO entry. Moreover, FDI is increasingly being directed at production for China's growing domestic market, not for export processing industries that are arguably more footloose, and more sensitive to tax advantages. The issue now is whether tax incentives for FDI should be continued.

Other countries have numerous incentives for investment. They range from (temporarily) lower income tax rates, tax holidays, tax credits for investment, accelerated depreciation for certain types of investment and exemption of VAT and import duties for exporters. However, it is rare for countries to have those incentives only for foreign-invested firms, and only a few countries (India, Viet Nam, Laos) have a separate tax code for foreign firms like China has. Incentives in other countries aim for a variety of objectives, including developing lagging regions, and promoting exports, technology transfer, employment, and local contents in production.

Economic analysis suggests that the impact of such incentives on investment is modest, especially compared to the often hidden costs to the government budget. Compliance monitoring is difficult as well, and regularly tax incentives end up sponsoring foreign governments rather than enterprises because of home country tax rules. Of course, some countries that are successful in attracting FDI have significant tax incentives for investment. At the same time, many countries *not* successful in attracting FDI have similar levels of incentives. In Indonesia, where abolishment of most incentives in the mid-1980s went along with a revision of the tax code, the move had no discernible impact on FDI flows.

Survey work suggests that tax incentives are a minor consideration for foreign investors. A fair, transparent tax code with competitive rates and indiscriminate implementation is more important, as are other factors in the investment climate, such as a reliable infrastructure, an independent judiciary, and a reliable policy process. The business advisory committee to the OECD advises that, if a country grants tax incentives, these should be available to all investors, be non-discriminatory, have a long term orientation, and be proportional to the goals. China's WTO entry sets limits to incentives that could distort trade, including tax reduction for exporters and firms in export processing zones.

For China, these observations would imply:

- Reducing incentives for foreign investors are unlikely to lower FDI by much, although "round-tripping" may disappear, causing a drop in *measured* but not actual FDI.

- Equalizing domestic and foreign income tax rates can best be done through merging the two existing tax codes. A lower tax rate than the current 33 percent rate on domestic enterprises would be in line with the international trend towards lower rates.
- In merging the tax codes, China should remove distortions from the current codes, including the limited tax deductibility of costs for R&D, some labor costs, marketing, and depreciation.
- If tax preferences are to be given, they should not discriminate to ownership, and be in line with China's industrial and regional development policies going forward.
- Presenting the costs of tax incentives together with the budget could reduce the lobbying for inappropriate incentives.

Whether to grandfather or not those foreign investors already in the country is to some extent a political issue. Such grandfathering would perpetuate distortions among existing investors and domestic firms, and would add a distortion between new and existing investors. Grandfathering would also perpetuate the revenue foregone due to the current policies at a time when profitability of foreign-invested firms is rising rapidly. On the other hand, grandfathering for a limited number of years would enhance China's reputation for consistency in policy, and general concern for the opinions of foreign invested firms.

Regional Policies

As observed before, the rising costs in the eastern provinces open up opportunities for the central and western provinces. At the same time, there is no guarantee that industries will move there over time. They may equally choose to relocate to other countries in Asia, to produce for the international market, or for the Chinese market that has opened up considerably with the WTO entry. Alternatively, industries confronted with rising costs in the east may respond by upgrading their technology and cost-effectiveness rather than relocating. Finally, agglomeration effects in the east may already be so large that productivity gains outrun the increase in costs, giving industries little incentives to move.

So how could inland provinces gain a competitive edge in attracting FDI?

- First, the inland provinces need to step up their efforts to **improve the investment climate**. World Bank research shows that inland cities do considerably less well than their coastal counterparts, particularly in protection of property rights and government effectiveness.
- Second, the inland regions need to **attract industries in line with their comparative advantage** and region-specific industrial policy and not necessarily copy the export-oriented manufacturing that led the way in the east. Land-intensive activities such as agriculture, or service activities that rely less on transport and distance (such as back-office work) could be promising areas for the west.
- Interior regions should learn from the mistakes in investment promotion in the east, and avoid unproductive activities such as setting up project lists, organizing investment fairs and the like. They could attract experienced investment promotion professionals from the eastern provinces to kick-start their own efforts.
- Finally, inland provinces could seek cooperation with coastal regions such as in “*Fei Di*”, in which they provide the land and the labor, and the eastern provinces the industry and the expertise, while the resulting tax benefits are shared.

Central government can play a role as well. International experience suggests that using FDI for regional development is hard in the best of circumstances of poor investment climate. But this leaves plenty other things to do for central government:

- It could **level the playing field** by phasing out advantages that largely benefit the east, such as special economic zones and tax preferences.
- It could also **review the restrictions on FDI** in sectors in which the interior has a particular advantage, including natural resources and public utilities such as water, electricity and gas.
- It should step up efforts against regional policies and practices that prevent **domestic market integration**, including the levying of illegal fees on imported” goods from other regions, biased government and state enterprise procurement practices, and court judgments skewed in favor of local enterprises.
- It must **improve the efficiency of the transport industry**. While central (and local) governments have invested heavily in transport infrastructure, the transport industry remains fragment and inefficient. More efficient pricing of railways, and enabling the integration of rail, water, and roads transportation could considerably reduce transport cost in China, and with it the competitiveness of the interior regions.

Sectoral Policies

Over the coming Five Year Plan, China intends to promote growth in the services sector as well as in higher value added industries. This is seen to be key for developing an economy that less dependent on exports, and less resource intensive than China's current one. Due to policies already in place, or planned, the prospects for this to happen in China are considerable.

First China's accession to the WTO means that many of the services previously closed or limited for FDI will be opened up over the coming FYP. Removing the barriers is likely to attract significant barriers to services such as banking, insurance, telecoms, distribution and transport. In addition, in the context of WTO accession, China has committed to significantly improved protection of intellectual property rights, and if implemented, the country stands a better chance to attract higher value industries for which infringement of these rights is a key issue.

Second, China's heavy investment in higher education in the past will reap benefits in the years to come. Education level is a key determinant foreign investors in deciding where to locate, the more so for the higher value added industries. Over the last FYP, enrollment in China's tertiary education rose from 1.6 million in 1999 to 4.5 million in 2004. Enrollment in secondary education is up as well, although but tertiary and secondary enrollment is still lagging behind competitors up the value chain such as Thailand, Korea, and Malaysia.

More can be done to promote China's sectoral goals in services and higher-tech. In particular, China should:

- **Continue to boost education levels in the labor force.** Expanding access to secondary education, especially in the interior province and for girls still has some way to go, and is likely to require significant government resources. For tertiary education—for which personal benefits are much clearer, government can increasingly be a facilitator, including a facilitator for private education. Access for the poor could be spurred by scholarships rather than free education, which often benefits the rich more than the poor.

- **Put more efforts into enforcing property rights.** Meeting the WTO commitments could be one reason for doing so, but perhaps more importantly the lack of property rights protection will increasingly hinder Chinese companies to move up the value chain, and even expand internationally.
- **Improve the environment for R&D**, in particular for R&D in firms, which is lagging far behind many of the OECD countries. China should review its corporate income tax code and accounting standards as to the treatment of R&D costs. It could also encourage joint laboratories between firms and universities. And finally, China could increasingly contract out government research to non-government suppliers of R&D as well as spin off some public sector service providers in this sector into the private sector.
- **Improve the general living environment of cities.**

Policies on Non-FDI Capital Flows

Liberalization of non-FDI capital flows should be a medium term objectives.

- Measurable efficiency benefits can be expected over time from capital account openness, as it increases the effectiveness of finance in contributing to growth by performing its key functions.
- Liberalization of bank lending and deposits, and other financial transactions has been associated in many countries with heightened volatility of capital movements, especially at times of exchange rate peg speculation and of crisis. Existing controls in China have been only partially effective in this regard and have not eliminated volatility of such flows. Under the present circumstances, further substantial liberalization of non-portfolio, non-FDI flows should not be a priority.
- It becomes ever more important to ensure that macroeconomic management and the risk management capacity of domestic firms, especially banks and other financial firms are highly effective.

- Liberalization of outflows is unlikely to make a sizable impact on China's accumulation of foreign exchange reserves in the short-run, pending on the RMB exchange rate movement. Other options exist. For instance, the floating of bonds by top-rated issuers on the Chinese market, as to be piloted by the International Finance Corporation, the Asian Development Bank, and others, can help develop market skills and absorb some of the excess liquidity in the market.

Chapter 1 Introduction

China has been among the world's largest recipients of FDI. Nonetheless, at the time China is moving into the 11th five year plan period, four issues with FDI into China are becoming increasingly recognized by policy makers: geographic concentration, excessive reliance on investment in export-oriented manufacturing, underinvestment in higher-technology industries, and heavy reliance on fiscal incentives to attract FDI. This report seeks to analyze these and provide benefit from international experience in suggesting policies.

Achievements during the 10th Five Year Plan

China has been very successful in attracting foreign capital for promotion of economic development. By the end of 2004, China has attracted a total of US\$562.1 billion in FDI since opening up in the early 1980s. Over the same period, China has mobilized an additional US\$256.8¹ billion by issuing equity in overseas stock market and a further US\$229 billion through foreign debt financing.

Clearly, foreign capital has contributed to China's economic development by financing investment and growth, smoothing consumption, expanding exports and generating jobs. Foreign direct investment also promoted economic growth by transferring technology, market access and marketing skills, and management know-how. And foreign investment has catalyzed China's economic reform. Together, these contributions have supported China in maintaining a record-high 9.5 percent during 1980-2004.

China's success in utilizing foreign capital, especially FDI, in expanding external trade is perhaps most striking. China's trade is now *thirty* times that of 1980,² and more than

¹ Data source: BOP statistics, SAFE.

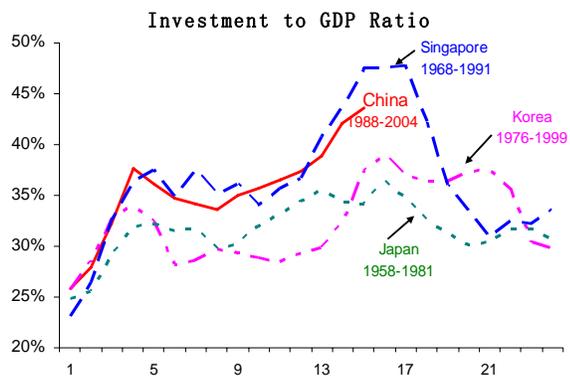
² Data source: CEIC

half of trade is due to foreign invested enterprises. In 2004, these enterprises accounted for 57 percent of exports, 58 percent of imports and 88 percent of processing trade. The trade surplus amounted to US\$59 billion in 2004 and is expected to further rise to US\$88 billion in 2005.³

Issues for the 11th plan

China's development objectives are changing, and with it the objectives for foreign capital utilization ought to change as well. Clearly, a country with a savings ratio as high as China does not need foreign capital to support the balance of payments. The domestic saving rate topped 47 percent of GDP 2004, whereas investment reached 44 percent of GDP—a level that was only exceeded by Singapore in its rapid growth phase in the 1970s and 1980s (Figure 1.1).⁴

Figure 1.1 China's high and rising investment



Source: World Development Indicators and Staff Estimates.

China has used its high savings to spur a rapid, investment and export driven growth, but this strategy has its price in terms of environmental sustainability as well as its limitations in terms on growth. In addition, the rising inequality that has accompanied China's rapid growth puts strains on social stability, and could lead to less efficient growth in the longer term. Over the coming 11th Five Year Plan (FYP) and beyond, China is therefore likely

³ Balance of Payments definition. Data source: IMF Article IV Consultation Report, 2005

⁴ Indeed, the large balance of payments surpluses resulting from high foreign capital utilization has become an emerging issue for macroeconomic management: capital inflows together with large trade surpluses have led to a rapid build-up of foreign exchange reserve, which has complicated monetary policy. By mid-2005, China's foreign exchange reserve stood at US\$ 700 billion, equivalent to 12 months imports of goods and services.

to focus on a more balanced development, as captured in the “*Five Balances*” emphasized since the 3rd CPC Plenary Session of the 16th Party Congress in October 2003. Among others, the five balances aim for more balance between external demand and domestic demand-driven growth, more balanced development between coastal and inland regions and between urban and rural areas, and between economic and social development. The challenge for policy makers is to align foreign capital utilization with these government-wide objectives.

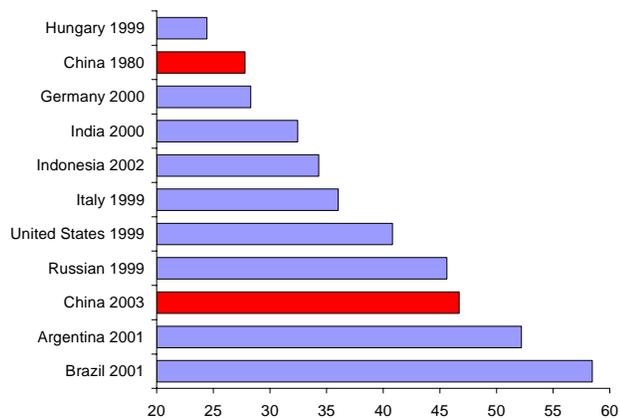
The first implication of China’s emerging development agenda is more emphasis on consumption rather than exports and investments as source of growth. This shift would require FDI to shift more towards domestically focused industries such as services rather than to export oriented industries as is currently the case. In principle, such a move makes sense, as exports will not be a sustainable source of growth for China. Apart from the increase in trade tensions that an export oriented growth strategy could create going forward, the fact is that with increased importance in export markets, China’s exports will over time only be able to grow with world trade. Moreover, China could face the unattractive prospects of permanently declining terms of trade, as it tries to sell more goods on the international market. The implication for FDI is that it should flow increasingly into activities more linked to domestic consumption.

If China is to succeed in shifting demand more towards consumption, it faces a dilemma: increased consumption requires a decline in savings, and other things being equal, such a strategy would either result in lower growth due to the decline in investments in line with lower savings, or would lead to the emergence of emerging and increasing current account deficits, which may not be acceptable. There are two solutions to this dilemma: one, services, which cater more for domestic demand and require less capital investment, so shifting growth to services may reduce the capital intensity of China’s economy, and with it the need for investment. Second, China’s growth could rely more on productivity increases rather than capital (and labor) inputs as it has done in the past. Although a respectable 20-25 percent of China’s past growth came from productivity increases, this share is higher in many other developing countries, and with declining investments,

China could aim for higher productivity increases. These will not come about by themselves: a stronger financial sector to finance more productive investments, further retrenchment of SOEs in competitive sectors, allowing more competition in sectors previously closed for competition, and more investment in R&D and technological capability of enterprises and government alike would support such a desirable trend. FDI can contribute to increases in productivity—directly, if and when more technologically developed enterprises chose China as a base, and indirectly by allowing FDI in sectors such as banking and in sectors previously closed for competition. The challenge for the authorities is to create the environment in which such desirable trends in FDI will take place.

A second implication of China’s emerging development goals for FDI relates to inequalities, particularly regional inequalities.⁵ China’s income inequality as measured by the Gini coefficient has been rising rapidly since the mid-1980s (Figure 1.2). From being one of the more equal countries in the world in the early 1980s, China has become one of the more unequal ones, and among to most unequal countries in Asia. Regional inequalities in China remain large: while inter-provincial inequalities in general are *not*

Figure 1.2: China’s income distribution compared (Gini Coefficient, Selected Countries)



Source: World Development Indicators and Staff Estimates.

⁵ Inequality can affect growth and development through various channels: (i) high inequality in income can lead to inequitable access to public services, and production inputs such as credits. In turn this may lead to inefficient growth—the smarter kids do not go to school, and the more capable entrepreneur does not get resources to grow. Second, those that have benefited from growth in the past may capture the political process to protect their privileges, which could also lead to lower growth. Third, large inequalities could lead to social unrest that may affect growth. At the same time, too much focus on growth could lead to inefficient policies that could undermine growth—for instance high redistributive taxes, or subsidies for agricultural production, which increase taxes on the rest of the economy, and could slow growth

increasing, disparities between eastern and western provinces have been rising, as are urban-rural income inequalities. It should be noted, however, that the largest rise in inequalities comes from increases in intra-urban and intra-rural inequalities. Nevertheless, regional development policies to reduce interregional inequalities could contribute to reducing inequalities overall.

As this report will show, there clearly is a potential for FDI to play a role: FDI remains heavily concentrated in the coastal regions, despite opening up of the whole country for FDI. The question the authorities need to answer is whether redirecting FDI more to inland provinces is feasible and desirable. The report will focus more on the feasibility and the concrete policy actions such redirection would require. However, the broader question whether such redirection would be efficient, or whether it would be better for China's overall development to further relax population movement, and have people from the West move to jobs in the east needs to be answered as well.

The "Five balances" call for growth that is more focused on domestic development, that is more evenly spread across China's regions, and that is less resource intensive. For China's foreign capital utilization policies, this would imply that greater attention should be given to investments in domestically focused industries, to investment in the interior, and to investments with a higher level of technology.

This report discusses China's foreign capital utilization strategy for the coming 5-year plan period, recognizing the changing external and internal contexts. The report comprises of 7 chapters. Following the introduction chapter, we discuss the external environment in Chapter 2. As the FDI is a major format of foreign capital that China utilized and of great significance in China's development strategy, we designate three chapters to FDI policies. After reviewing China's past and current FDI policies and developments in Chapter 3, we discuss the role of investment climate and fiscal tax incentive for mobilizing FDI in Chapter 4 and 5 respectively, whereas Chapter 6 focuses on how to improve FDI composition and efficiency. Policies related to non-FDI capital flows are discussed in Chapter 7.

Chapter 2 External Environment

This chapter outlines the World Bank's medium-term projection for the world economy and capital flows to developing countries. The world is passing through a cycle of strong economic rebound and is showing diverging growth across major countries accompanied by growing global macroeconomic imbalances. In international financial markets, yield curves have been unusually flat, spreads on emerging market debt unusually low, and financial linkages between developed and developing countries have seen significant changes in the past decades. Within this context, this chapter assesses the medium-term prospects for capital flows to developing countries, recognizing the different dynamics governing FDI and non-FDI flows, and the strenuous external adjustment made by developing countries in recent years.

2.1 Medium-term global economic prospects

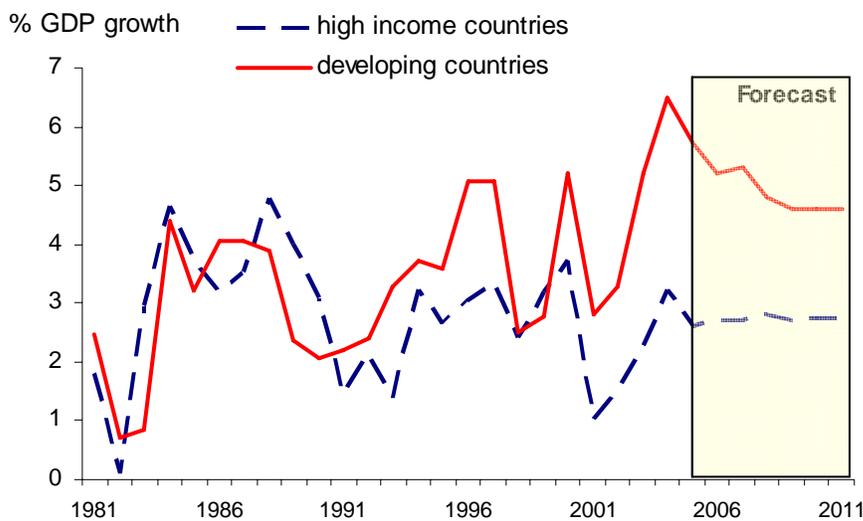
Following very strong growth of 3.8 percent in 2004, the global economy is slowing to a more sustainable rate. Output increased very quickly in the latter part of 2003 and the first half of 2004, driven by strong growth in the United States and developing countries, which posted their fastest GDP growth in thirty years – 6.6 percent. Having reached a cyclical peak, however, the World Bank projects a fairly sharp slowdown of global economic activity in 2005 and a reversion to trend growth rates over the forecast period.

High-income countries will be reverting to the mean growth rates of the previous decade, but developing countries have undergone a structural increase in their average rates of growth – from the 3.6 percent average annual growth in the 1990s to over 4.5 percent growth in the current decade. This structural shift is not limited to China, India, and Russia, to cite the most popular examples: over three quarters of developing countries are forecast to grow faster this decade compared to the last. This structural shift is due to two factors: (i) better, although still far from perfect, investment climates and

improved credit ratings at the country level, and (ii) trade liberalization at the international level, including a reduction in developing countries' average tariffs from 30 to less than 10 percent.

This benign outlook, however, should be interpreted with care. Indeed, as depicted in Figure 2.1, the reversion to trend growth rates from the cyclical peak in 2004 is portrayed as very smooth, but in part the “smoothness” is a technical outcome of our forecasting model.

Figure 2.1 Developing country and high-income growth, 1980–2011



Source: staff estimates

As is often the case with cyclical peaks, the year 2004 and the beginning of 2005 have been marked by growing signs of macroeconomic imbalances. These include: (1) an uneven pattern of global growth, with the US and developing countries having high growth, and much of Europe and Japan having relatively low growth; (2) an uneven pattern of global savings and investment, as manifested in high US current account deficits, signifying savings much lower than investment, and high rates of saving relative to rising investment rates elsewhere; (3) rapid increases in commodity prices, including a 31 percent rise in the price of oil over the last year, and rises in consumer prices more generally, particularly in developing economies; and (4) very high valuations in the housing and junk bond markets. How the global economy adjusts to these imbalances

will determine the actual path around our central forecast. Indeed, lower growth as a result of disorderly adjustment cannot be ruled out.

In our central scenario, imbalances are expected to stop increasing and may even diminish somewhat. In particular, the US current account deficit is expected to gradually decline reaching 5.3 percent of GDP in 2007 as a result of rising domestic interest rates and a modest tightening of fiscal policy, continued strong growth in developing economies, and a modest depreciation in the trade-weighted US dollar by some 10 percent to 2007. Rising interest rates are expected to dampen housing and credit markets, and moderate the rate of price inflation. Even so, the structural increase in the developing country growth rate is likely to have a lasting impact on the level of commodity prices, as much of additional demand for commodities is coming from developing countries—for instance 74 percent of the total increase in crude oil demand came from developing economies in 2004, and over 1/3 from China alone.

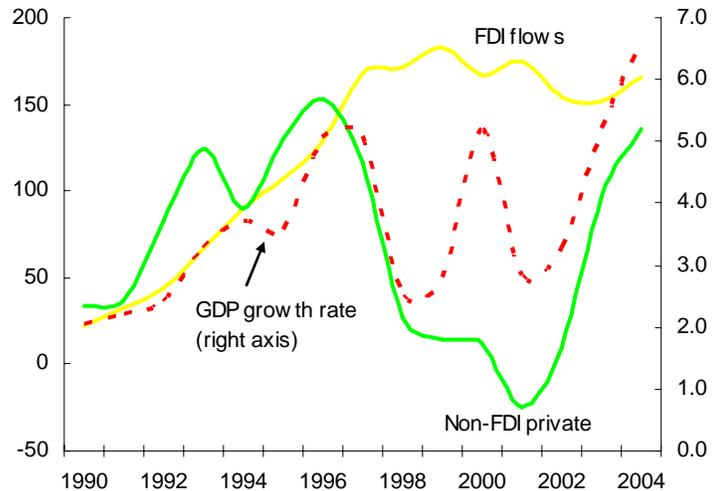
Policymakers ought to be aware of the potential for greater turbulence and structural shifts. Unexpectedly higher interest rates, rapid deflation in asset markets, and increased risk aversion among investors would add significant turbulence to our forecast, as would an abrupt and disorderly depreciation of the dollar. On the other hand, a prolonged increase in commodity prices and associated endogenous reactions to high prices, particularly in the form of a wage-price spiral, or the emergence of protectionist sentiment could lead to a structural shift in the forecast, resulting in lower growth.

2.2 Robust recovery of private capital flows

Private capital inflows to developing countries have grown strongly in the past two decades, with much of the expansion taking place in the 1990s. Total private flows, consisting of debt and equity (both FDI and portfolio equity) surged to \$301 billion in 2004 or 4.3 percent of total developing countries' GDP. Should capital flows return to reach 5 percent of GDP by 2006—a level that was reached in 1997--private capital flows could amount to about \$466 billion. Over the past decade, FDI flows have tended to

exhibit more stability and resilience than non-FDI flows, which have been more in line with growth of developing countries. The fact that flows continued to decline over the 1997-2002 period despite the sharp increase in the developing-country growth rate in 2000 suggests that other structural factors also determine behavior of private flows during the 1997-2002 period.

Figure 2.2 Developing countries' private capital flows and GDP growth

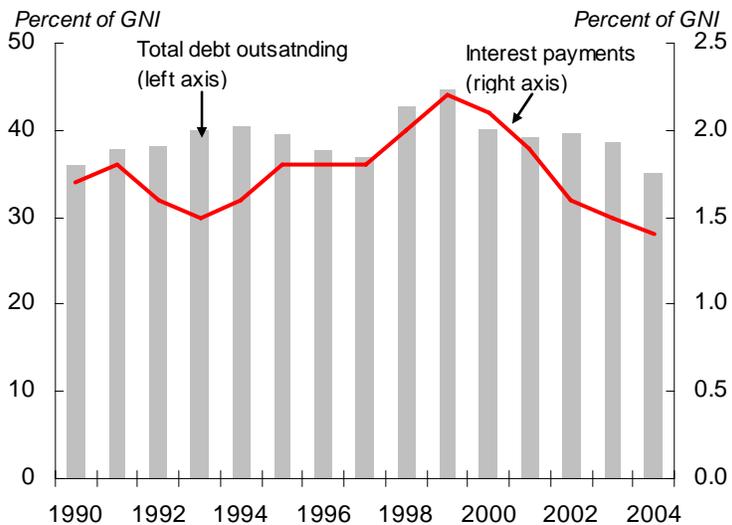


Source: staff estimates

The medium-term outlook for capital flows to developing countries remains cautiously positive. Grounded in better economic fundamentals in host countries and favorable financial conditions in developed countries, the current recovery in capital flows is more likely to

result in a durable and steady expansion than has been the case in the past. Years of structural reforms, improved macroeconomic stability, and more exchange rate flexibility in a growing number of developing countries have produced the current favorable cycle of healthy trade surpluses,

Figure 2.3 Developing countries' total debt outstanding and interest payments



Source: staff estimates

growing capital flows, surging foreign exchange reserves, low inflation, and stronger

growth. Most countries have succeeded in improving their financial positions (Figure 2.3) so that, even in the case of higher oil prices or a more moderate pace of world growth, their current account positions should not deteriorate to the point where financing becomes problematic. The current account position of the major groups of developing countries is in surplus (Table 2.1). There is ample global liquidity, low long-term interest rates prevail, and there is a search for yield, intensified by the phenomenon growth of hedge fund industry. As a result, the spreads on emerging market debt have narrowed to unprecedented low levels (Figure 2.4).

Table 2.1 Current account balances in 2004

	\$ billions	% of GDP
High Income countries	-319.9	-1.0
Developing countries	152.7	2.0
East Asia and the Pacific	71.3	3.1
Europe and Central Asia	9.6	0.6
Latin America and the Caribbean	28.2	1.5
Middle East and North Africa	41.7	9.3
South Asia	-0.7	-0.1
Sub-Saharan Africa	2.6	0.6

Source: staff estimates

This positive assessment, however, has several downward risks. One important source of uncertainty relates to the future course of long-term interest rates in major markets in light of the ongoing monetary policy tightening in the US and the ambiguity regarding the course of monetary policy in the EU. Higher global interest rates could moderate the supply of foreign capital to developing countries as they enhance the return on alternative investment opportunities in

Figure 2.4 Secondary market spreads for developing countries



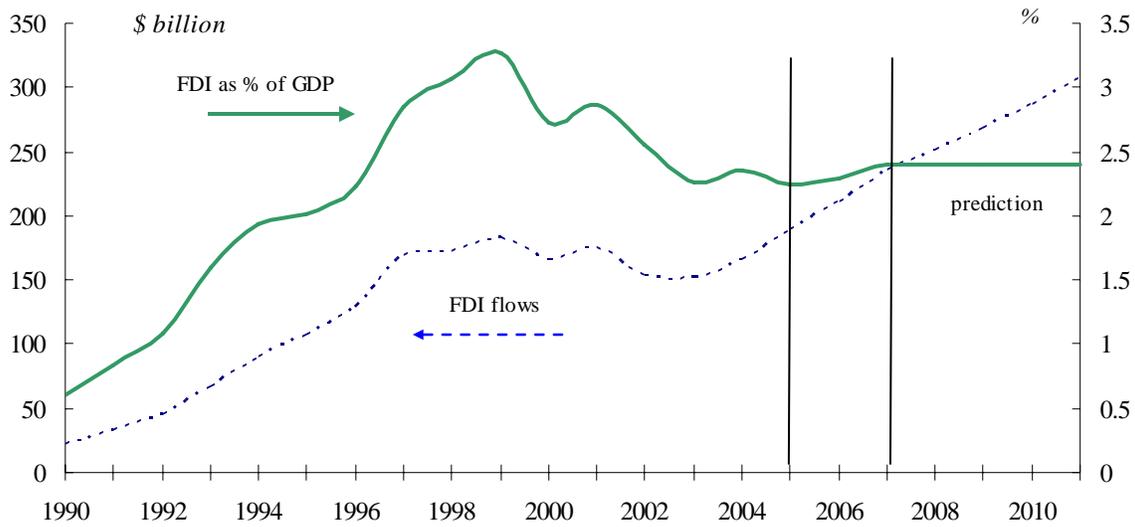
Source: Staff estimates

developed countries. And they could lead to higher spreads on emerging market debt: recent empirical findings show that a 200 basis points (bps) increase in the US 10-year Treasury yield would lead to an increase of between 6 bps to 65 bps in the credit spreads of emerging market economies, the exact increase depending on a country's debt over GDP (Dailami, Masson, and Padou, 2005).

2.2.1 FDI flows to developing countries: trends and prospects

Foreign direct investment has become the largest and most stable source of capital flows to developing countries. FDI flows are driven by long term economic factors, structural issues, and natural resources in host countries, as well as the long-term business strategy of multinational corporations. These flows therefore tend to be more stable than debt flows that are more determined by short-term market developments and shifting investors' risk aversion. Stimulated by large scale privatization and merger and acquisition (M&A) deals of early 1990s in LAC and later on in Eastern European countries FDI flows to developing countries surged from \$22.1 billion in 1990 to a peak of \$182.4 billion in 1999 (Figure 2.5). When the wave of privatization programs of the early 1990s cooled down and as the string of financial and currency crises of emerging market economies weighed on foreign investors' interest, FDI flows declined during 2000-2003. They recovered in 2004 to reach an estimated level of \$165.5 billion, or 2.4 percent of developing countries combined GDP. Much of FDI has continued to go to a few countries, and the share of the top 5 countries (Argentina, Brazil, China, the Czech Republic, and Mexico) has never fallen below 55 percent.

Figure 2.5 FDI flows to developing countries

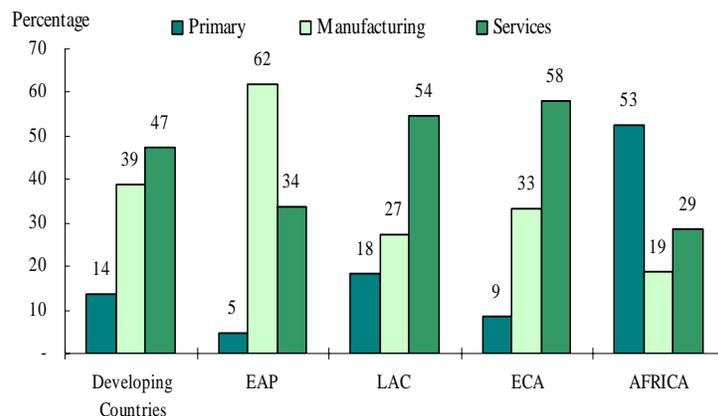


Note: The forecast for 2005 and 2006 are based on an econometric model (GDF 2004). Estimates for the period 2007 till 2011 are predictions assuming both nominal GDP growth and FDI to GDP ratio in developing countries remain constant at their 2000-2006 averages, 7 percent and 2.4 percent respectively. Source: World Bank staff estimates.

The surge in FDI flows to developing countries in the 1990s was mainly the result of the considerable progress in these countries’ investment and trade policies. In

addition, progress in transportation and communication technology have enabled companies to manage and control geographically dispersed production networks and supply chains, which triggered FDI in those countries that tied into those networks. Equally important in the FDI surge

Figure 2.6 Sectoral Composition of FDI Stock in Developing Countries in 2002



Note: Based on the definitions of the country sources that may vary according to the country’s classification system. Source: Global Development Finance 2004.

has been that many developing countries opened up their services sectors to foreign

investment, including the core infrastructure sectors of electricity power, telecommunications and transport, as well as banking, insurance. Reflecting the impact of such measures, FDI composition has shifted towards services and by 2002 services accounted for more than half of the total FDI stock in developing countries (Figure 2.6).⁶ The shift has been particularly pronounced in Latin America and Eastern Europe, whereas in East Asia and Pacific countries manufacturing has continued to be the primary destination for FDI flows.

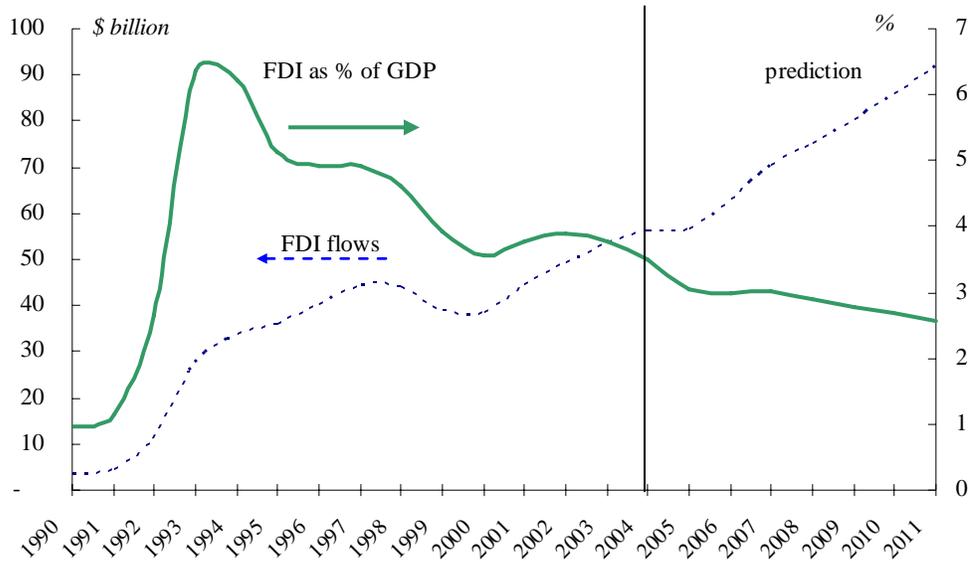
Looking forward, FDI flows to developing countries are expected to continue the recent recovery, assuming that the world economy will continue its projected growth trajectory. Thus, it is quite feasible that total FDI flows to developing countries could reach \$300 billion by 2011, if FDI grows at the same rate as nominal GDP of developing countries (Figure 2.5). Other factors also support the upward trend in the FDI flows: First, cross-border investments among developing countries themselves, so-called South-South FDI flows, are expected to increase as several large countries including China look for natural resources—stimulated particularly by recent oil price increases—and investment opportunities in other developing countries. Second, further progress in liberalization of trade and investment policies in both developed and developing countries is expected to generate more opportunities in developing countries for foreign investors.

FDI flows to China are expected to further increase. In our central scenario, China is expected to maintain its lead among developing countries in attracting FDI flows in coming years. Since the late 1990s, almost one-third of FDI to developing countries has gone to China and this is expected to remain intact by 2011 (Figure 2.7). Relative to

⁶ As conventionally defined, the service sector includes electricity, gas, water, transport, communication, construction, wholesale and retail trade and repairs, hotels and restaurants, transport, storage and communications, finance and insurance, real estate, renting, and business services, public administration, defense, education, health, social services, social and personal service activities, and recreational, cultural, and sporting activities.

China's GDP, however, FDI flows are not expected to reach the 1993 peak of 6.37 percent for the foreseeable future.

Figure 2.7 FDI flows to China are expected to surge



Note: The forecast for 2005 through 2011 are predictions assuming China's share in total FDI in developing countries remains constant at its 2000-2004 average, 29.9 percent.
Source: World Bank staff estimates.

The main driving forces behind China's future FDI trends are, perforce, the country's robust economic growth, successful bid for the 2008 Olympics, and the opening up the services sector to meet WTO requirements. Unlike other emerging economies, FDI flows to China have been so far highly concentrated in the manufacturing sector, in part because of the link between exports and FDI in manufacturing, and in part because of past restrictions on foreign investment in the services sector. China is also destined to become an important source of FDI outflows, Chinese firms have been investing abroad mainly in other developing countries, partly as a result of recent relaxation of capital controls by the government.

However, one should note that the forecast of FDI in China are predictions assuming China will continue excelling other big developing countries in improving its investment climate, so that China's share in total FDI in developing countries remains constant at its 2000-2004. If countries like Brazil and Russia make greater progress than China, China

may lose share in FDI to these countries. Other major risks to the projection include whether China can engineer a soft-landing down the road, the stable supply of public utilities, especially water, electricity and fuel and the developments of land and labor prices.

2.2.2 Non-FDI Flows

In contrast to FDI, net private debt flows to developing countries, in the form of bank loan, bond and portfolio equity have all been subject to considerable volatility and cyclical patterns of boom and bust. Such characteristics make it difficult to project their medium-term prospects. The following analysis provides some discussion of the key forces that are likely to shape the pattern of such flows.

International bank lending continues to decline, and to change in nature. Bank lending, the largest source of financing for developing countries during the 1980s, experienced the sharpest decline of any flows in the 1990s. This phenomenon, which has its roots in several domestic and international factors, has changed significantly the pattern of supply of foreign capital, and is expected to continue in the next several years. The string of currency and financial crises hitting developing countries in the 1990s has contributed to depress demand for external borrowing, replacing it with domestic sources of finance. These crises have also increased risk aversion of international banks, prompting a more cautious approach to lending to developing countries in general and to riskier countries in particular. There have also been significant structural changes in the operations of international banks, including more emphasis on lending through local subsidiaries and fee-based activities. Many international banks have increased their local presence in developing countries in recent years, often through the acquisition of local banks. According to BIS figures, local currency claims of foreign affiliates accounted for about 40 percent of total foreign claims of international banks in 2003, compared with only 14 percent in 1995, suggesting that banks have substituted in-country lending for traditional cross-border lending. Banks have also moved away from traditional lending towards fee-based activities such as managing bonds issues. Banks are increasingly

seeking more diversified sources of income as the competition are intensified. Some international banks are seeking to combine the provisions of traditional banking services with other financial services, hoping to benefit from the cross-selling of services (GDF 2004). The aversion of banks to developing country risk has also greatly increased the use of the risk-management techniques and instruments such as structured products and credit default swaps (CDS).

Growth in bond issuance is considerable. Access to the international bond market by developing countries was initially in response to their debt restructuring problems with international banks. This led over time to a growing volume of bond issuance by middle income developing countries, and net bond flows increased from about \$8 billion in 1991 to \$63 billion in 2004, although it declined in the aftermath of the Asian crisis before a recent recovery. This expansion reflected several factors, including better economic prospects and more stability in many debtor countries, liberalization of external and domestic financial transactions, market innovations such as derivatives and securitization that facilitated greater risk sharing; and lower inflation world wide. The strength in bond flows is likely to continue as investor appetite for emerging market bonds continues to stay intact. However, the risk of a sudden rise in U.S. interest rate remains a serious concern, whereas as noted before, rising long-term rates could increase spreads on emerging market bonds in 2005, especially because they are very low at present.

Prospects for portfolio equity are promising. Portfolio equity inflows were the second largest financing source for developing countries in 1993 and 1994, accounting for about 21 percent of private capital flows to developing countries, but they started to decline in 1995, and then they recovered strongly in recent years, rising from \$7 billion in 1998 to \$27 billion in 2004. The significant expansion in 2003-04 was largely accounted for by a substantial increase in international equity investment. The prospects for portfolio equity flows to developing countries are promising, but important challenges lie ahead. Portfolio equity flows are estimated to show steady gains, given the continued upward trend in international equity issuance in initial public offerings (IPOs) and American or global depository recipients (ADRs or GDRs). A major part of such transactions are

expected to come from China, reflecting ongoing overseas stock listing and IPOs of state-owned companies. Challenges lie in corporate governance in developing countries, and the need to meet the more stringent requirements of overseas' markets in the case of listing abroad, or that of institutional investors in the case of domestic listing.

The appetite of international investors for China's equity, bond and other liabilities is also expected to be large. China's low external debt, good macroeconomic conditions, rapid GDP growth, large foreign exchange reserves, and China's strict control over bond issuing and debt financing makes the country highly creditworthy. Indeed, currently China stays far below its borrowing capacity. Therefore, of the inflows of non-FDI flows into China are not a question how much international investors want to invest, but how much China wants to finance from the international capital market.

From a macroeconomic point of view, non-FDI flows are less desirable at this point in time. China should consider lowering the overall size of these capital inflows by carefully scrutinizing any proposal of Chinese enterprises to seek listing abroad or issue overseas' bonds. Only when clear benefits of such a move arise, for instance improvements in management and governance, should non-FDI inflows be considered. The dominant channel for utilizing foreign capital to support China's economic development for the next five year plan is likely to continue to be FDI.

Chapter 3 Foreign Direct Investment in China

This chapter reviews role of FDI in China's economic development.⁷ It reviews trends and composition of these flows, and their effects on economic development, growth, employment and exports. Attracting FDI has been a national goal since the early 1980s, and this chapter reviews China's evolving policies and procedures towards FDI.

3.1 FDI in China

Since China opened up to the world, it has been very successful in attracting FDI. By the end of 2004, China has been the largest recipient developing country of FDI for twelve consecutive years, and cumulative inward FDI stood at US\$562.1 billion, equivalent to 34.1 percent of 2004 GDP.⁸ FDI flows to China have been pro-cyclical: China's share in world FDI peaked at 12.4 percent in 1993, a year of over-heating, then sharply fell through the "soft-landing period" to 3.2 percent in 2000. With the economic boom in the wake of China's accession to the WTO in 2001, FDI in China picked up momentum, growing from 40.7 billion in 2001 to 60.6 billion in 2004 (Figure 3.1), and its share of the world FDI recovering to 9.6 percent in 2003⁹.

In relative terms China's performance has been more modest. The ratio of FDI to capital formation in China is roughly the same as the average of all developing countries,

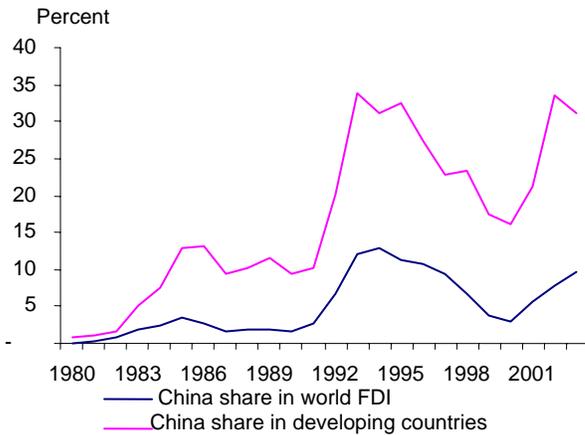
⁷Foreign Direct Investment (FDI) refers to foreign investment being made in a host country to acquire a lasting interest in an enterprise operation. There is no clear distinction of FDI from portfolio investment. The IMF suggests recording foreign equity investment as direct investment when the foreign investors hold more than 10percent of total equity (BOP Manual, 5th edition). In China, only when the share of foreign investors exceeds 25percent, the investment made by foreign investors will be recorded as foreign direct investment, and the firm is eligible for the treatment of foreign funded enterprises.

⁸ If it is deducted by depreciation, the stock of FDI in China is estimated US\$250 billion according to a Ministry of Commerce study.

⁹ Source: UNCTAD database and staff calculation.

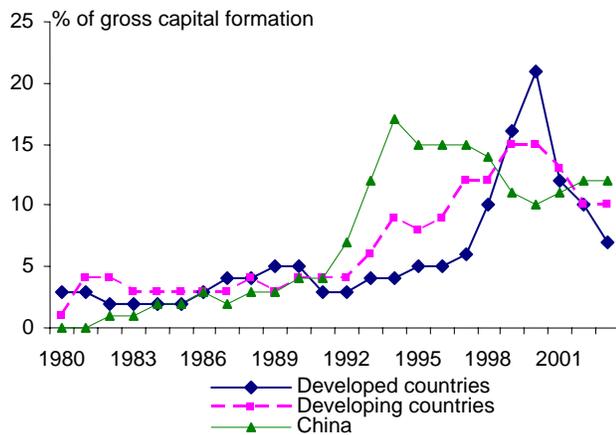
lower than that of most East Asian economies, and lower than Eastern European economies such as Hungary, the Czech Republic, and Poland during the 1990s. Furthermore, “round-tripping,” the investment of Chinese firms disguised as FDI, is estimated to be about one-fourth of total inflows, and deducting this from the FDI numbers would further reduce the importance of FDI into China is even lower. (We will elaborate the round-tripping later in this chapter).

Figure 3.1 China gradually resumed its share since 2001



Source: UNCTAD and staff estimates

Figure 3.2 FDI as a percentage of gross capital formation

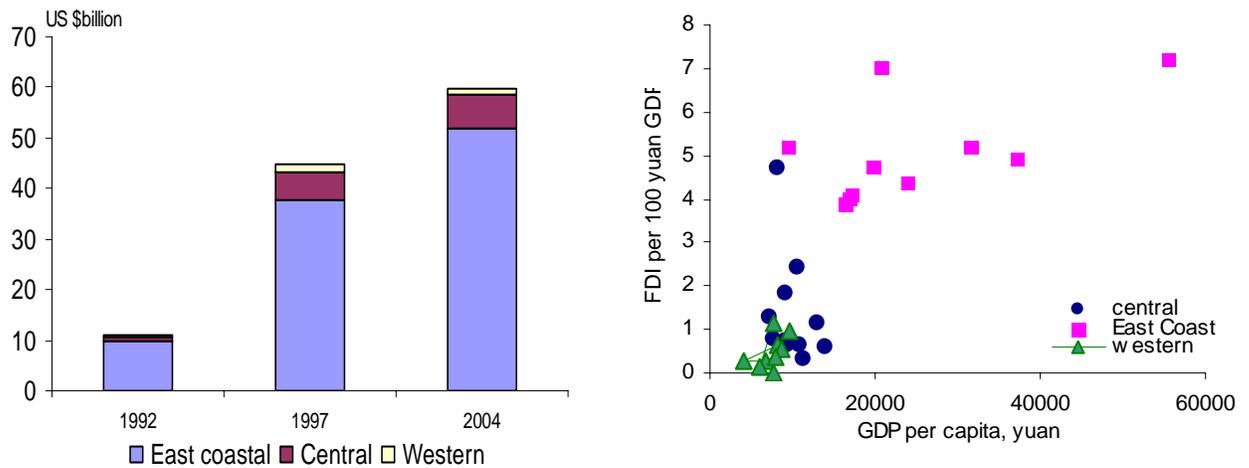


Source: UNCTAD

FDI into China has been highly concentrated in coastal areas¹⁰. The coastal region attracted over 92 percent of FDI in 1990 at the time when only coastal regions were open to foreign investors. The share of the coastal region declined to 84 percent when foreign investment was allowed in inland area, but subsequently recovered through the 1990s, and in the year 2000, about 87 percent of FDI went to the coastal region, while only 10 percent went to the central region and 3 percent to the western region. This heavy bias towards coastal areas came about despite policies to promote more FDI in the inland provinces. In the mid-1990s, developing the western region was made a national development priority and preferential policies were granted to investment located in the western and central region. Despite this, the western region failed to attract more of FDI. This was partly due to the fact that incentive mechanism have limited effect on FDI, but also because the small effects preferential policies did have were largely offset by the improving competitiveness of coastal region in attracting FDI. Coastal regions have a competitive advantage in term of market size, high growth potential, dense population, better labor, geographic proximity to major markets, and linkages with production networks, all found important in directing firms' investment (Coughlin & Segev, 2000, Ng & Tuan, 2002). Overcoming these advantages with preferential policies is hard. More recently, with wages of non-skill labor and property prices on the rise in the coastal region, some foreign investment has been redirected toward the inland region. The central region has increased its share in FDI, rising to 12 percent in 2004 while the western region continued to decrease its share, declining to 1.8 percent in the same year. (Figure 3.3)

¹⁰ Coastal region includes Beijing, Tianjin, Shanghai, Jiangsu, Zhejiang, Guangdong, Shandong, Fujian and Liaoning.

Figure 3.3 FDI in China—regional distribution



Source: China Statistics Yearbook, various issues.

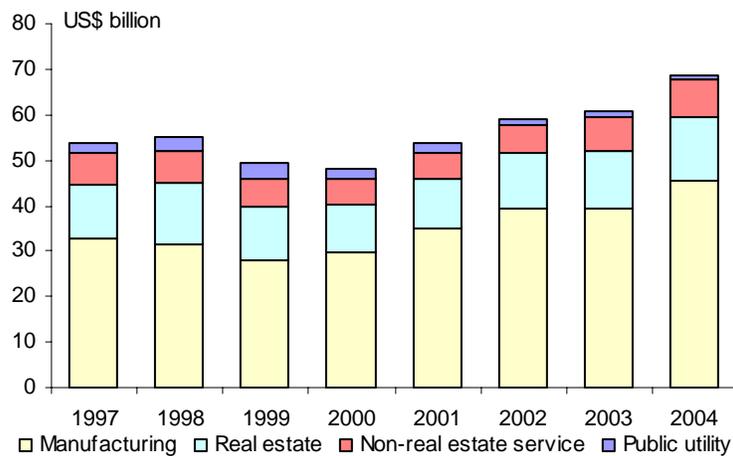
FDI sector distribution

FDI in China has been mainly concentrated in manufacturing while services, especially financial services, have attracted far less investment than in other developing countries. In 2004, almost three quarters of total FDI in China went to the industrial sector, only 1.8 percent to agriculture, 1.8 percent to public utilities and 23 percent to the service sector (Figure 3.4). The share of the public utility sector in total FDI topped at 9 percent in 1999, the sharp decline due to a shift of policy that prohibited local governments to grant a fixed rate return to foreign investors. Globally, services account for about half of all FDI, more than double the share in China. Moreover, of the FDI going into in China’s service sector, the majority went into real estate. This low share of FDI in services is largely due to the restricted access to services such as finance and insurance, in which developed countries globally invest 20-40 percent of their outward FDI. This indicates an opportunity for China to attract more of FDI in services, as most restrictions on access to that sector are being lifted as a result of China’s accession to the WTO.

The share of FDI in manufacturing has increased since the accession to the WTO. The share rose from 56 percent in 1999 to 71 percent in 2004. China’s trade liberalization has more strongly integrated China international production networks, which increased the

country's attractiveness for FDI, and enhanced the already existing advantages of abundant and cheap labor, an relatively strong investment climate, good infrastructure and export orientation. China has become a major recipient of multi-national companies' (MNC's) investment in sectors ranging form electronic components (especially semiconductors), computers, to telecommunications. So far, though investments in China have been at the lower-end of the value chain—in low value added activities such as assembly and processing, Production in these activities are highly mobile across countries, and can be dropped at short notice. (Ernst, 2004)

Figure 3.4 FDI by sectors



Source: China Statistic Yearbook, 2004 and staff calculation

FDI has made a positive contribution to China's economic growth. This has been widely confirmed in the literature. Hsiao & Shen (2003) report that a 1 percent increase in FDI leads to a 0.049 percent rise in GDP in the short run, and a rise of 7.5 percent in the long run. FDI in China promoted the economic development through employment generation, trade expansion, and technology upgrading. In 2003, FFEs in the industrial sector employed 126 million workers, accounting for 21.9 percent total employment in the industrial sector. By absorbing the lay-offs of non-performing SOEs and redundant agriculture workers, FDI also cushioned the ramifications of China's transition toward a market economy. China's growth in trade during the reform years has on average been 2.3 that of world trade growth, and FFEs' share in trade rose from a low point of 1

percent of trade in 1985, to a remarkable 57.4 percent in 2004. The most important factor in this development was processing trade, which in 2004 made up almost 82 percent of FFE trade. FDI has contributed to China's TFP growth by introducing technology embedded in machinery into China through investment and by reallocating labor from the agriculture sector to the more productive industrial sector. By year 2003, FFEs had contributed about 38 percent of assets in technology-intensive industries. The empirical evidence on technology transfer from FDI however is mixed. Kunrong Shen (1999) reports an elasticity of TFP to FDI/GDP ratio of 0.37. Jinping Zhao (2001) confirmed the significant impact of FDI on technical upgrading in China. But Jin He (2000) and Xiaoqi Xiong (2002) conclude that FDI has had little effect on China's overall efficiency.

3.2 FDI policies

Chinese authorities have attached great importance to attracting FDI, because they considered it not only as a source of investment capital, but also as a channel of technology transfer and industrial upgrading. This importance is reflected in the fact that the volume of FDI utilization is among the few indicator by which the center evaluates local officials' performance. Since opening up in 1980, policies regarding have evolved over time, and they can be characterized by five features: industrial promotion, spatial gradualism, strong fiscal incentives, complicated investment regime, and fierce competition among sub-national governments.

Box 3.1 Measures on Foreign Investment in China

- A. Measures relating to admission and establishment
 - 1. Specifying the scope of admission. Sectors and industries for FDI are divided into four categories: encouragement, permission, restriction and prohibition.
 - 2. Minimum foreign capital requirements (25percent).
 - 3. Conditional entry upon FDI meeting certain criteria (positive and negative criteria).
 - 4. Screening, authorization and registration of investment.
- B. Measures relating to ownership and control
 - 1. Restrictions on foreign ownership in certain sectors or industries.

2. Compulsory joint ventures in certain sectors or industries.
 3. Nationality restriction on the Chairman of the board of directors (repealed in 1990).
- C. Measures relating to operations
1. Performance requirements.
 - a. Local content requirements (repealed in 2000).
 - b. Export performance requirements (repealed in 2000).
 - c. Trade – balance requirements (repealed in 2000).
 - d. Foreign exchange balance requirements (repealed in 2000).
 - e. Replacement of import with certain goods produced within China (repealed in 2001).
 - f. Local equity requirements in certain industries.
 - g. Manufacturing requirements in certain industries.
 - h. Technology transfer requirements in certain industries.
 2. Requirements for the filing of the production plan of enterprises (repealed in 2000).
 3. Requirements for priority in employing local workers or personnel (repealed in 2001).
 4. Restrictions on the diversification of operation.
 5. Restrictions on access to local credit facilities (relaxed in 1999).
 6. Restrictions on repatriation of profit (repealed in 1996).
 7. Restrictions on repatriation of capital.
 8. Requirements for appraisal of imported equipments.
- D. Incentive measures provided to foreign invested enterprises
1. Fiscal incentives, including:
 - a. Tax holidays.
 - b. Income – tax reduction.
 - c. Tax refund for reinvestment of profit.
 - d. Allowing losses to be written off against next year’s profit.
 - e. Exemption from or reduction of import duties on capital goods, equipment or raw materials related to the production process.
 - f. Exemptions from export duties.
 - g. Tax refund for the products exported.
 2. Other incentives
 - a. Financial incentives, including: allowing “product-for export enterprises” and technologically advanced enterprises to exempt from payment of state allowances to employees; exemption from or reduction of the fees for the use of land.

- b. Giving the above two types of enterprise the priorities in supply of water, power, transportation and communication facilities required for production and operations and in offering credit loans
 - c. Preferential treatment for import and export of goods.
-

Source: Yu, 2002, a background paper for the World Bank

Industrial promotion strategy

FDI policies have been a part of China's industrial promotion strategy. The strategy has two pillars, "market for technology" and "export promotion".

The "market-for-technology" pillar was initially aimed at import substitution. The approach was largely reactive, exchanging access to domestic market for a commitment on the part of foreign firms to meet substantial performance requirements including local content requirement, foreign exchange balance, and ownership restriction. As China moved towards a market-based economy, an increasing number of these measures have been repealed or relaxed. In 1992, the Chinese authorities relaxed the limit on the foreign participation in FFEs, and relaxed access to the domestic market, even opening up some service industries on an experimental basis. A particularly important development started in April 1996 was experiment with the national treatment of FDI-enterprises, allowing them access to the domestic market. As of 2001, as required by China's accession protocol with the WTO, most import substitution measures have been repealed, including local content requirement, export performance requirement, foreign exchange balance requirement and ownership restriction in most industries.

The export promotion strategy has been more proactive, and was aimed at international companies that wanted to use China as an export platform. Under this strategy, export-oriented FFEs are granted preferential treatment in several areas: the corporate income tax rate is further lowered from an already concessional 15 percent to 10 percent for

export-oriented firms in special economic zones¹¹ (SEZs), and export oriented FFEs are exempt from industrial and commercial tax, value-added tax and export tariffs.¹² Export processing zones and customs warehouses are established, in which firms enjoy trade facilitation and exchange facilitation¹³

More recently, the industrial promotion strategy has shifted toward “upgrading industrial structure,” especially in some coastal cities. Measures include setting up High-Technology Park, providing grants to expatriates to start up new businesses, promoting agglomeration and cluster buildup, and encouraging MNCs’ to set up research and development centers and regional headquarters in China.

Spatial gradualism of FDI liberalization

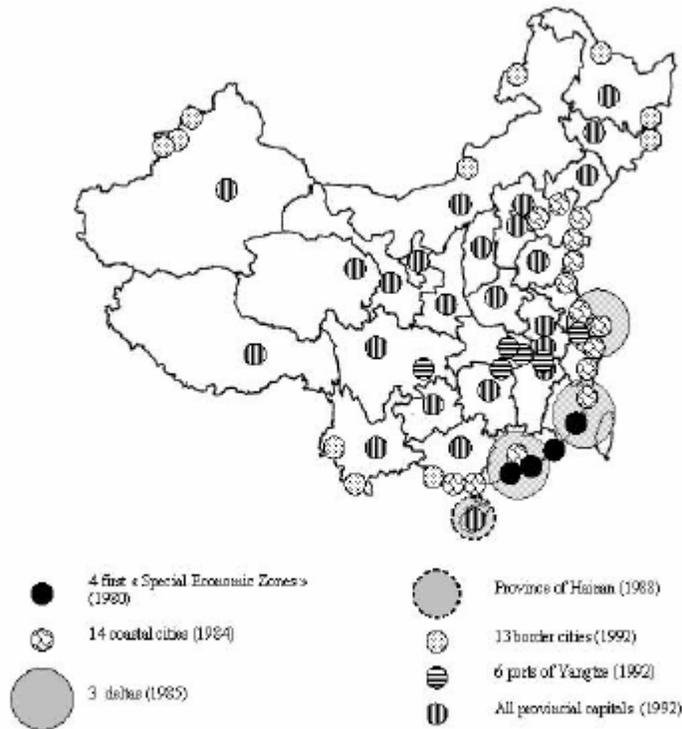
Since the early 1980s the government of China gradually extended the open-door policies from the coastal region to the inland regions (see Figure 3.5). In 1980, the first Special Economic Zones were established in four coastal cities (Shenzhen, Zhuhai, Shantou in Guangdong and Xiamen in Fujian) in the provinces Guangdong and Fujian, hometowns of many oversea Chinese investors. To scale up the success of these zones to the entire coastal region, the open-door policy extended to 14 coastal cities in 1984, and to the deltas of the Yangtze, Pearl and Minnan Rivers in 1985. In 1988, the policies were expanded to Hainan Island and another 140 coastal cities and counties including Nanjin, Hangzhou and Shenyang in 1988. After the coastal region took-off in the 1980s, the open-door policy was gradually extended to the inland region in the 1990s. A big leap was made in 1999 when the whole western region was opened for FDI (Catin, Luo and Huffel, 2005).

Figure 3.5 Spatial Gradualism of the open-door policies in China

¹¹ The SEZs have a status close to that of the duty-free zones in which experimentation with industrial countries’ management techniques are piloted.

¹² Notification on Tax Issues related to Foreign Funded Enterprises’ exports, 1996

¹³ Notification on Exchange Management Issues in Export Processing Zones, 2000.



Source : Luo (2003).

FDI administration: decentralized and complicated investment regime

In the incremental process of opening up to FDI, the control over FDI authorizations has been gradually decentralized from central to local governments. In 1983, the central government allowed provincial governments, autonomous regions, and directly-administered cities to approve FDI projects. In 1985 the authority to approve FDI projects up to \$10 million per project was extended to municipal and county-level governments. Following the Communist Party's 1992 decision to develop a "socialist market economy," the central government progressively lifted state control over investment planning and committed itself to the development of a more transparent legal and regulatory system. This regulatory system comprises national laws on FDI and regulations to guide their implementation as well as a growing body of international investment-protection agreements. Since 1995 China has only a negative list of industries where FDI is restricted or prohibited. In 2004, in the process of China's

investment regime reform, investment projects in encouraged and permitted categories are required only “verification” instead of “approval”. Provincial governments can verify FDI projects in encouraged and permitted categories up to US\$100 million, or projects in restricted categories up to US\$50 million. Many provincial governments authorize the city or county governments to verify FDI projects except those in restricted category.

Despite the streamlining efforts, China’s approval procedures for FDI are still among the most extensive in the world. Annex I lists the more than 17 procedures required to set up a FFE. Some procedures are conflicting with each other, or ambiguous. For instance, the approvals for land use, investment, and environment are conditional upon each other, so investors have to go back and forth between these departments. Fragmented authority further complicates establishing a firm. For instance, the authority to approve an enterprise establishment lies with MOFCOM, whereas the authority to approve investment lies with NDRC.

Incentive Policies for FDI

Central government authorizes two major incentives to promote FDI. One is various *corporate income tax incentives*. The most common incentive is a five-year tax reduction available to *all* foreign enterprises engaged in production that operate for 10 years or more. This comprises a 2-year tax holiday and a subsequent 3-year 50 percent tax reduction. The tax holiday starts with the first profitable year after the enterprise has commenced operations and earlier losses have been carried forward and set off against profits.¹⁴ Furthermore, reduced tax rates are provided to those foreign manufacturing firms located in the designated areas of China including special economic zones (15 percent), open coastal economic zones (24 percent), and the central and western regions (15 percent.)¹⁵ A further reduced income tax rate of 10 percent is available to the foreign

¹⁴ This feature of tax holidays provided in China is unseen in any other tax regimes we have observed.

¹⁵ The standard corporate income tax (CIT) rate for domestic investors is 30 percent. Localities can impose a surcharge of 3 percent on top of that, but usually do not do so for FFEs.

manufacturing firms in the specified zones if the firms are either deemed to be technologically advanced or export-oriented. The combination of incentives could give a manufacturing firm located in a special economic zone that uses advanced technology a two-year tax holiday, three-year reduced income tax rate of 7.5 percent, and a 10 percent income tax rate for the rest of its business life.

The second incentive is *exemption of import duties*. The FFEs in an encouraged industry or in processing trade are exempt from import duties and value added tax, consumption tax and customs duties on imported capital goods. High-tech equipment of FFEs is also exempt from import duties. And export-oriented FFEs can also enjoy duty exemption for their imports of inputs for export processing.

Local Competition and FDI Promotion

The decentralization of FDI approval and vague definitions in regulations and laws grant considerable discretion to local authorities in competing for FDI. For instance, the definition of industries in encouraged, permitted, prohibited or restricted is to a considerable degree subject to the interpretation of local governments, which gives them flexibility in their choice of projects for approval and in granting tax concessions. This creates opportunities for some healthy competition among governments, but can also become cause of excessive red tape and corruption.

The major instruments that local governments use to compete for FDI are a variety of incentives to compete for FDI. There are at least three kinds of incentives. The first incentive is *local surcharge of the corporate income tax* (3 percent). This is levied at the discretion of local governments, and is often reduced or eliminated as a means to attract FDI.

The second incentive is *free or subsidized use of land and exemption of other administrative fees and charges*. Land appears to be the most important means of competition for FDI in terms of costs. Often, land has been made available free of charge

to foreign investors, or at costs far below market price. Recently, with rising cost of converting land from agriculture to commercial and industrial use and abundant supply of FDI, some coastal cities have begun to repeal their free land use policy. Others have started to impose conditions on the provision of land for greenfield investment, for instance “investment density” requirements. In Shanghai, projects with investment intensity less than US\$10 million per acre will not be provided with new land, and when the land is provided, the government charges about RMB 100 per square meter for 50 to 70 year leases. In Guangzhou Industrial Park, the minimum investment is \$2 million per acre, and charges for leases are RMB 25 in Guangzhou.¹⁶ However, the land lease is often negotiable case by case. Concessional rates on utilities charges are also used by local governments to compete for FDI.

Thirdly, many local governments are improving their *physical infrastructure* to attract FDI. A growing number of them seek to attract FDI in infrastructure, including via “BOT” (Build, Operate and Transfer) agreements with foreign companies.

Data from three examples — the Shenzhen and Xiamen Special Economic Zones and Dalian City — suggest that tax holidays account for about half of the total amount of incentives given to foreign investors, with land concessions accounting for another 30 percent, infrastructure 10 percent, and “others” 10 percent. (Omen, 2002)

In addition, the local governments spend heavily on investment fairs and missions (*zhao shang ying zi*). Many of which turn out to be showy events, very costly but inefficient, as criticized by local technocrats and the public. Empirical study confirmed that these activities, that are often referred to as *investment generation* in literature, are the least cost effective—it is expensive and it is often not adapted to the reality of countries that have relatively poor investment climates and low levels of economic development. Investment generation is not associated with higher FDI flows, even though it absorbs the greatest share of most IPA budgets. (Wells & Wint, 2001)

¹⁶ The price is still much lower than the market reference according to local officials.

Many sub-national governments also compete through seeking to ensure the administrative and operational efficiency of the approval process. Indeed, because the approval procedures are so complex, some local government such as Ningbo have added one more procedure, “project consultation,” to advise investors on how to establish an enterprise. The most common practice to streamline the approval process is setting up “one-stop” facilities, which aim at allowing investors to absolve all procedures in one place¹⁷. However, the results of these streamlining efforts vary considerably across regions. The limited success can in part be explained by the lack of coordination across the public sector and by the resistance from mid-level bureaucrats, who may prefer to maintain the status quo, as holding on to approvals assures their position and associated benefits. Last but not least, simplifying approval procedures requires changing mentality and behavior, which takes time and prolonged actions as well as strong political commitment. (Omen, 2002)

3.3 Emerging problems of FDI policies

Despite their great success, the side-effects of FDI policies have begun to emerge. Firstly, China’s export-promoting strategy is approaching its limit; FDI driven trade has generated a large trade surplus of China with most developed countries, and this surplus has generated trade conflicts with trading partners. Because of the conditions of China’s WTO entry, which classifies the country as a non-market economy, the country is vulnerable to anti-dumping actions. And because China’s trade is expanding so rapidly, safeguards, which under WTO rules exist to fend off import surges, are easily invoked. Recently, the United States and the Europe Union applied the Special Safeguard Clause of WTO and re-imposed quota on China’s textile exports. The Europe Union has also been negotiating with Chinese authorities about the smooth growth of China’s textile exports to Europe Union. Furthermore, there is an increasing call for an appreciation of

¹⁷ Many cities build up an administration hall, where all relevant departments set up a stall and designate staff to answer inquiries, collect application forms and stamp on qualified documents.

the RMB to correct the trade imbalance. Irrespective of trade conflicts, China's rise in world trade makes continued reliance on trade for growth difficult, as over time its exports will only be able to grow with the world market. Already in products such as air conditioners, China has more than 80 percent of world production,

The large trade surpluses and FDI inflows that are associated with them have domestic consequences as well. They complicate monetary policy as China's previously fixed exchange rate required the central bank to buy the foreign exchange inflows to keep the currency stable. This, in turn caused domestic liquidity to expand, which fed inflation. While the central bank managed to absorb much of this expansion through open market operations with central bank bills ("sterilization") the surpluses did restrict the use of monetary policy for domestic purposes. Now, with more flexibility in the exchange rate, this issue may become less, but it will only disappear with a fully flexible exchange rate, a policy China is not ready and willing to adopt.

Second, FDI promoting policies have also caused market distortions. The most obvious distortions result from tariff and income tax policy. As more and more foreign firms enter the Chinese market and produce for the export and domestic market, the tax and quasi-fiscal incentives exclusively for foreign investors tend to make it more difficult for domestic firms to compete with foreign firms. Many local firms have therefore moved capital out of the country and re-invested this in China as foreign investors in order to enjoy these preferential treatments. This phenomenon has been dubbed "*round-tripping*". A comparison of Chinese and foreign statistics on FDI into China shed light on the scale of the round-tripping FDI (Table 3.3). While for the world as a whole inward and outward FDI are roughly balanced, FDI recorded by China is universally higher than that recorded by source countries. UNCTAD estimated that round tripping FDI from China through Hong Kong (China) and back to China was about 25 percent of Hong Kong's outward FDI flows (WIR, 2003, P45). Table 3.3 suggests the share of roundtripping may be considerably more than that.

Table 3.3 FDI in China—data comparison from various sources, US\$ million

	1998	1999	2000	2001	2002	2003	Data source
FDI from HK (1)	18,508	16,363	15,500	16,717	17,861	17,700	China Statistics Yearbook
FDI from HK (2)	6,987	10,129	46,309 ¹⁸	8,500	15,951	7,720	Hong Kong
(2)/(1)	38%	62%	299%	51%	89%	44%	
FDI from EU (3)	4004	4495	4467	4175	3704	3929	China Statistics Yearbook
FDI from EU (4)	1041	2424	1725	2690	2117	2331	OECD
(4)/(3)	26%	54%	39%	64%	57%	59%	
FDI from US (5)	3898	4216	4384	4433	5424	4199	China Statistics Yearbook
FDI from US (6)	1497	1947	1817	1912	924	1540	BEA,USA
(6)/(5)	38%	46%	41%	43%	17%	37%	
FDI from Japan (7)	3400	2973	2916	4348	4190	5054	China Statistics Yearbook
FDI from Japan (8)	1053	755	1034	1496	1718	3065	Japanese MOF
(8)/(7)	31%	25%	35%	34%	41%	61%	
FDI from Taiwan, China (9)	2915	2599	2297	2980	3971	3377	China Statistics Yearbook
FDI from Taiwan, China (10)	2035	1253	2607	2784	6723	7699	CEIC
(10)/(9)	70%	48%	114%	93%	169%	228%	
Total FDI recorded by China (11)	32727	30645	29563	32654	35149	34259	
Total FDI reported by source economies (12)	12612	16508	53493	17383	27433	22355	
(12)/(11)	39%	54%	181%	53%	78%	65%	

Source: China statistics yearbook; Bureau of Economic Analysis, USA; MOF, Japan; European Statistics Bureau, OECD; CEIC;

A further distortion results from local private firms' lack of protection from property disposal and difficulties in access to credit. Huang (1999) found that FDI inflows into China are driven by fundamental inefficiency in the Chinese economy, such as difficulties in access to formal finance. Huang's 2001 study on FDI in labor intensive industry found that efficient private entrepreneurs cannot attract sufficient domestic

¹⁸ The abnormal increase of FDI from Hong Kong to mainland China in 2000 is mainly invested in real estate outside of Guangdong area. This is a likely reason that the Chinese authorities failed to capture these FDI.

finance, and by attracting foreign investors, they cede their claims on future cash-flows. In such a case, using FDI will generate a pure welfare loss to domestic investors.

A third side-effect of China's FDI promotion policies maybe rising regional income disparity. The development of the export sectors and the inflows of FDI encourage a rapid growth of the coastal provinces and manufacturing has become more and more geographically concentrated. So far, the rapid growth in the coastal regions has not had the expected positive spillover effects on the inland regions, and regional income disparity increases (Catin, Luo and Huffel, 2005). This could be for three reasons. The first is agglomeration effect: FDI is most productive there where already much of it is in place. The second is market size effect. FDI tends to generate new jobs and pay higher wages than domestic firms. And its geographical concentration causes an increase of population in coastal region and a loss of population in other regions due to a reallocation of the labor force. The rising purchase power makes coastal region even more attractive for FDI that seeks local markets. The third one relates to China's fiscal system. Under current fiscal regime, a major share of the tax revenue generated from FDI is retained in the host city, which allows the city to invest more in infrastructure and to provide better public services. The improved investment climate further increases the city's attractiveness to FDI. The result of these effects is is that regional disparities may be perpetuated. This situation may well persist in the future: Shan (2002) finds that GDP growth and FDI "Granger-cause" each other, but that GDP growth's effect on FDI is stronger than the reverse, and that current GDP growth and FDI are most influential to future values. Therefore, it also suggests that the first-mover advantage triggered by the coastal development strategy may be hard to reverse in the future without policy interventions. The actual decline in the share of FDI going to the western regions is an indication of that happening, despite the favorable policies granted to these regions and the more recent establishment of SEZs in those regions. Reforming the fiscal regime and allowing it to better perform the re-distribution function would help mitigate the effect of FDI on regional disparity. Improvement with the investment climate in inland regions may reduce some of the agglomeration effect.

3.4 Summing up

The synthesis of the international literature on FDI as presented in this chapter suggests six key messages:

- First, FDI played an important role in promoting China's economic development, and attracting FDI remains important for growth and employment creation.
- Second, incentives granted to FDI should be reconsidered. The incentives cause domestic distortions, are increasingly seen to be unfair to domestic firms now that their advantages are eroded in the course of WTO entry, and their effectiveness in achieving goals such as regional balance is in doubt.
- Third, the strategy of attracting export-oriented FDI should be reconsidered.
- Fourthly, administrative procedures are overly complex and should be rationalized.
- Fifth the competition for FDI across sub-national governments should be redirected from incentive based to rules-based policies. One way to accomplish this would be to strengthen the IPA of local governments by improving their capacity and governance.
- Sixth, to reap the full benefits from FDI, the composition and efficiency of FDI should be improved. More of FDI needs to be directed to inland regions and to the service sector. China should upgrade their position in the supply chain of international production, and aim to maximize the effect of FDI from technology transfer and spill-over.

Chapter 4 Maintaining an attractive investment climate

In this chapter, we first review policies that affect the FDI's operation environment (investment climate) that is outside the control of investors, and then discuss areas for China to make improvement by looking into investor's view and comparing China's investment climate with other countries.

Whether investors, foreign and domestic alike, invest in a country depends in part on the country's investment climate. The investment climate consists of factors that are beyond the control of existing and potential investors, but that affects the expected returns of investment and the uncertainties around those returns (Dollar et al., 2004). The investment climate can be usefully categorized into the following broad yet interrelated components:

- First, macro or country-level factors comprising economic and political stability and national policy towards foreign trade and investment.
- Second, efficacy of a country's regulatory framework. As far as firms are concerned, these relate to the ease of entry and exit, quality of labor relations and flexibility in the labor market, efficiency and transparency of finance and taxation, and efficiency of regulations on the environment, safety, health, and other public interests. The question is not whether to regulate or not, but whether such regulations are designed in incentive-compatible ways, and implemented expeditiously without discrimination among categories of firms, bureaucratic harassment or corruption. While such variables are hard to measure, World Bank surveys suggest that regulatory efficacy varies widely across countries and, as far as China is concerned, across provinces.
- Third, the quality and quantity of available physical and financial infrastructure. This includes power, transport, telecommunications, and banking and finance. Given the imperfect mobility of skilled workers and the increasing importance of clustering of technology, the endowment of skills and technology is of importance as well. In surveys of entrepreneurs about their problems and bottlenecks, they will often cite infrastructure issues such as power reliability, transport time and cost, and access and efficiency of finance, along with the lack of skilled workers and the difficulty of access to advanced technologies as key determinants of competitiveness and profitability.

Why it matters?

Empirical evidence suggests that regions with a favorable investment climate tend to attract more investment. Most studies find that market size, as measured by GDP or population, wage level, the quality of labor as measured by level of schooling and infrastructure are strong determinants of FDI. Nonnemberg et al (2004) provide a thorough review of determinants of FDI distribution across countries. The study uses a panel of 33 countries, including China, over the period 1975-2000. They find that GDP growth, level of schooling, and openness are all strong determinants of FDI. Inflation as a proxy for macroeconomic stability is found to have no significant effect. The econometric exercise using the micro data from the survey of investment climate of 23 cities in China confirmed that the city with better investment climate attracted more FDI.¹⁹

In addition, regions with better investment climate tend to attract more FDI in the services sectors. Most services sector, such as banking, insurance, infrastructure, and retail trade, are characteristically location-bound, generate local currency revenues, and unlike primary and manufacturing products, their market size depends importantly on local economic conditions and prospects. FDI flows in the service sector are thus more sensitive to the host country investment climate, than other forms of FDI (Table 4.1) (GDF 2004).

Table 4.1 Services FDI by investment climate in selected economies (percent)

Investment climate	Services FDI as share of total FDI	Services FDI as share of GDP	Total FDI as share of GDP
High	61	3.9	6.4
Average	42	1.5	3.6
Low	34	0.6	1.6

Note: All averages are weighted averages for 1999–2002. CPIA in 2000 is used for investment climate index for 30 developing countries in Asia, Eastern Europe, and Latin America where available.

Source: Global Development Finance 2004.

¹⁹ Clarke and Xu, (2005)

Moreover, regions with better investment climate tend to achieve a higher effectiveness in investment promotion. Investment promotion effectiveness is positively correlated with the quality of the investment climate and the level of development. Countries with relatively few assets, as reflected by poor investment climates or low levels of development, get better results from improving these conditions than from spending limited resources on investment promotion.

Furthermore, investment climate plays even bigger role in attracting FDI in current globalization time. More recent research on determinants of FDI shows that a dynamic change factors such as evolving production sharing and global production networks of MNCs are driving FDI. With improvement in management and technology, lower trade barriers and lower transport costs, these dynamic factors are likely to become more important. According to the cluster theory, FDI tends to be more concentrated geographically responding to agglomeration economy that affects the firms. Agglomeration and clustering are also found to be prime factors in FDI location decisions in China (Ng & Tuan, 2003). With this change, the impact of the traditional determinants of FDI, such as market size, market potential, labor cost, on FDI distribution is likely to decline, though still significant. Countries and regions with better investment climate including good infrastructure, innovatory capabilities, suppliers and institutions will have more chance to be networked and attract more FDI (UNCTAD, 2001).

China's investment climate: views from investors

Potential investors hold a strongly positive view on China. According to an entrepreneur survey by A. T. Kearney²⁰, in 2004, four in ten executives had a more positive view than in the year before on FDI investment in China, whereas one in ten had the opposite view. The factors that attract investors are “market size, access to export markets, government incentives, favorable cost structure, infrastructure and macroeconomic climate”.

²⁰ <http://www.atkearney.com/main.taf?p=1,5,1,151>

Meanwhile, concerns are raised about the legal aspects of investments – rule of law, IPRs, terrorism and such. Also, the ability for the Chinese government to engineer a soft landing for the economy is closely monitored, along with the performance of the dollar. Among the Japanese investors, according to a JBIC survey²¹, the most reported current problems in China in terms of risks are “Insufficient electrical power supply” (56.5%), “Rising prices for energy and raw materials” (36.5%) and “Infringement of intellectual property rights” (29.3%).” Among future risks “Revaluation of the Yuan” (67.7%) is the most common, not only due to direct costs, but also due to concerns over a slowing down of the Chinese economy and currency fluctuations as a result of such a revaluation. There are some concerns about rising labor costs in China, concerns not present in the evaluation of India and Vietnam.

How China compares with other countries: good, but with room for improvement

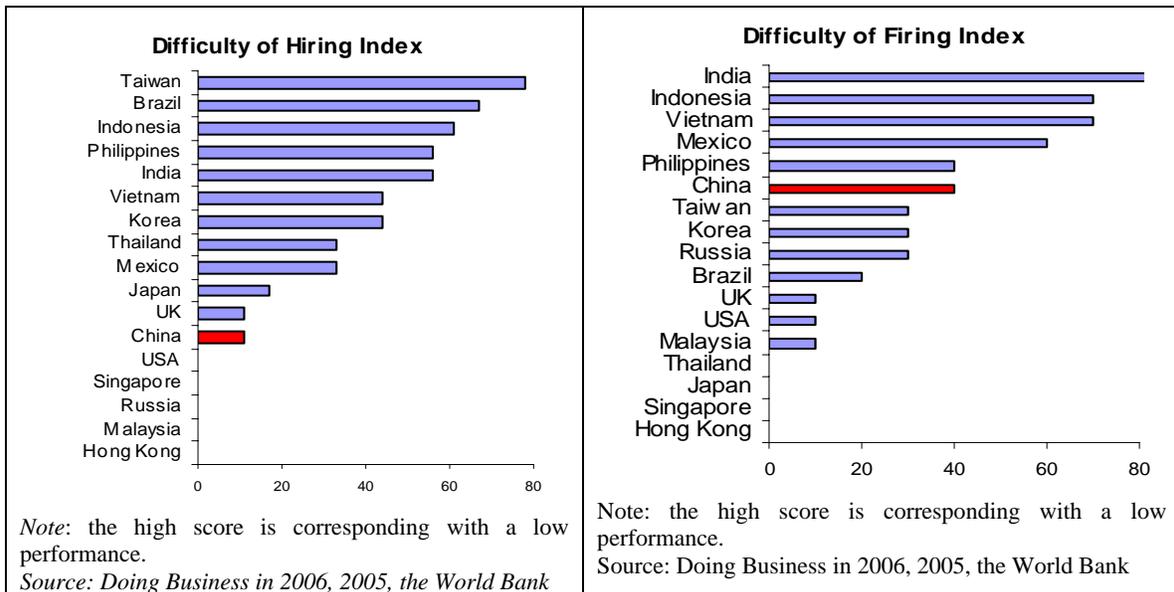
Recent World Bank research has compared China to other countries in terms of the investment climate.²² In general, the studies suggest that China has been doing quite well among low-middle income countries in terms of investment climate. Compared to high-middle income countries in the East Asian region, China is doing well in a number of important dimensions, but also lags behind in other dimensions.

1. China scores high on macroeconomic stability and political stability among 140 countries surveyed (ICRG, June 2005)
2. China scores high on the hiring index, thanks to the abundant labor supply and the high labor mobility. China gets a much lower score in the firing index, especially when acquisition of an SOE is involved (Figure 4.1).

²¹ Survey Report on Overseas Business Operations, 2004, JBIC

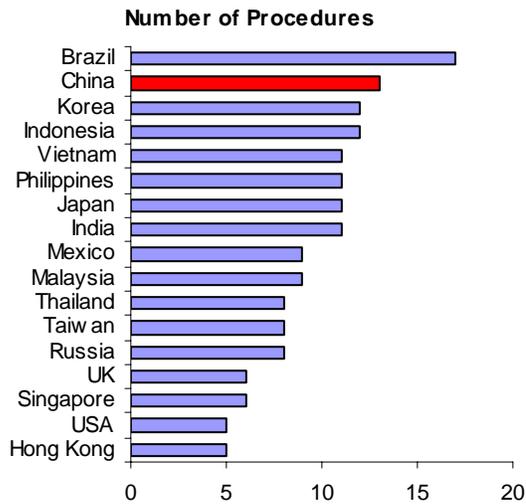
²² The World Bank’s *Investment Climate Surveys* now comprise 140 countries. The Annual *Doing Business* surveys look at the regulatory regimes on over 100 countries; and the World Bank China Investment Climate Survey covers 23 cities.

Figure 4.1 Labor market

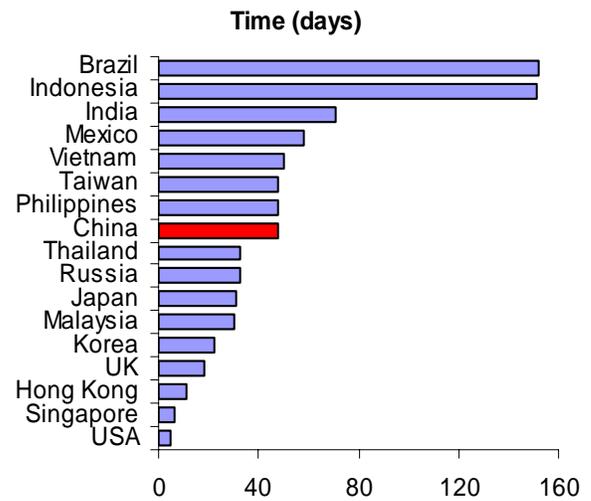


3. China is comparable in human resources and skills to other East Asian countries, although it has relative low tertiary enrollment.
4. China lags behind some East Asian neighbors in terms of R&D intensity. Firms in Thailand, for instance, spend over 5.6 percent of sales on R&D, while China's number is only 2 percent.
5. China has been doing well in infrastructure in general. However, the data also show that China lags behind Thailand in telephone density (294/1000 versus 371/1000), computer density (12/1000 versus 23/1000), and paved roads (88 percent versus 97 percent).
6. China has a mixed record in terms of entry and exit barriers. Starting a business requires 48 days in China, less than most neighboring countries, but as it has to go through 13 procedures, the largest number among East Asian countries (Figure 4.2). According to our survey on the currently effective procedures for setting up a foreign funded enterprise, the number of procedures is even higher, 17. (Annex 1 lists all procedures required to set up a foreign funded enterprise.)

Figure 4.2 Starting a new business



Source: *Doing Business in 2006, 2005, the World Bank*

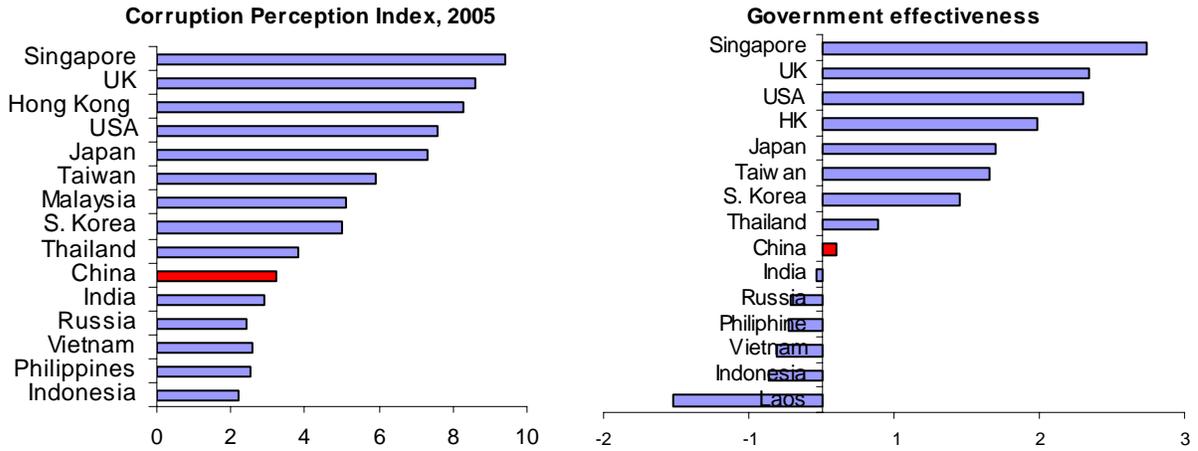


Source: *Doing Business in 2006, 2005, the World Bank*

- China scores near the median for government effectiveness, but below the median for corruption among the sample countries (Figure 4.3). China has a legal system with many conflicting rules and regulations created by many different authorities (Yusuf 2003). Also, the Chinese courts are expected to adjudicate, not interpret, the laws. While such a system works well in continental Europe, it is an issue in China where much of the legal infrastructure for a market economy is yet to be codified, and laws are in general rather vague. Enforcement of court decisions is also an issue: courts do not have primacy over ministries and other government organs, and decisions are often simply ignored by officials, who, if they are of high enough level, can informally overrule both courts and government organizations. Institutions and practices for creating a stable and predictable policy environment should be strengthened and contracting arrangements enforced by a higher quality, more independent judiciary²³. The complicated investment approval procedures create room for ad hoc interpretation, local protection and opportunity for corruption (Chapter 3).

²³ Beck et al. (2001) find strong evidence that a strong legal framework of financial systems and protection of outside investors strongly contributes to development. Yusuf (2003) stresses that the courts and regulators must be strengthened relative to the executive and legislative branches of government in order for a true market economy to prosper in a globalised world economy.

Figure 4.3 Corruption and Government effectiveness

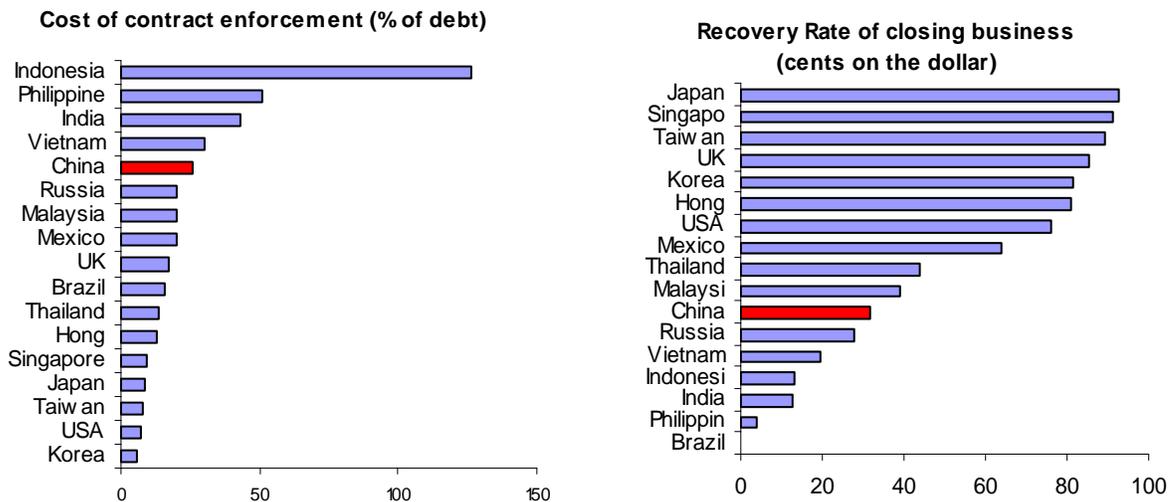


Note: the low score indicates high corruption.
 Source: International Center for Corruption Research
http://www.icgg.org/corruption.cpi_2005_data.htm

Note: This indicator ranges from about -2.5 to 2.5, with higher values corresponding to better governance outcomes.
 Source: 'Governance Matters IV: Governance Indicators for 1996-2004', D. Kaufmann, A. Kraay and M. Mastruzzi,
www.worldbank.org/wbi/governance

8. China is particularly weak in providing access to financing. The underdeveloped capital market and weak enforcement of contract significantly raises firms' operation costs (Figure 4.4). Creditors recover on average only 31.5 percent of their claim in the case a debtor firm closes, far less than in Taiwan, China (89.5 percent), Hong Kong, China (81.2 percent) and South Korea (81.7 percent). The cost of contract enforcement also reached 25.5 percent of the claim. In other words, in China, on average, it pays little to enforce a claim on a bankrupt enterprise. These costs sharply contrast with South Korea where they are only 5.4 percent of the claim, and Thailand, where they are 13.4 percent.

Figure 4.4 Operating Cost



Source: Doing Business in 2006, 2005, the World Bank

Source: Doing Business in 2006, 2005, the World Bank

Chapter 5 Leveling the playing field in taxation

China grants foreign investors with lower corporate income taxes relative to domestic investors. In the past such differential tax treatment may have been justified in light of the barriers and disadvantages that foreign firms faced in China compared to domestic ones, notably State Owned Enterprises. Now that WTO accession is leveling the playing field among foreign and domestic enterprises, the share of private domestic firms is on the rise, and as more and more foreign firms entering the Chinese market, such a differential tax should be reconsidered. This chapter examines international experiences on taxation policies for FDI to assess whether China should change its existing tax incentives for FDI.

Incentives for attracting investment exist in many countries, often with focus on specific sectors, regions, technology, employment creation, local contents, scale economies, or other policy related goals. Tax incentives have been rationalized on the grounds that they can induce investors to follow policy directions favored by the government in the interest of ensuring wider benefits (or “positive externalities” and “spillovers”) for the overall economy.

But separate tax codes for domestic and foreign enterprise income tax are rare. In Asia, for instance, only China, India and Vietnam have differential corporate income tax codes for domestic and foreign firms.

Some countries that have been particularly successful in attracting FDI have used tax incentives extensively. These countries include Ireland, Hong Kong (China), Singapore, and Malaysia. In the case of Malaysia, tax incentives granted during the 80’s and 90’s have affected the level of investment as well as its composition.

At the same time, many countries with equally extensive incentives have failed to attract significant FDI. Wells and Allen (FIAS Occasional Paper No. 15) note that when tax incentives were eliminated in Indonesia in the mid-1980s there was no decline

in the rate of foreign direct investment into the country, even though its neighboring countries continued to offer various tax incentives to foreign investors. It should be noted that Indonesia ended its tax incentives in the context of a general tax reform whereby corporate taxes were reduced across-the-board and brought in line with international practice. According to many surveys of managers of MNCs, fiscal incentives are typically given low weight in the investment decision compared to other factors such as wage costs, market potential, and investment risks (Wells and others 2001).²⁴

Empirical evidence suggests governments rarely have been able to foresee economic structural change accurately and typically had a poor record in “picking winners” compared to those that have been chosen by the market, existing industry-specific incentives have often become obstacle as instruments for fostering infant industries (e.g. Brazil, and Indonesia). The consensus seems to be that firms most likely to respond to fiscal incentives are banks, insurance companies, and internet-related companies and activities associated with export-oriented processing trades, which tend to be more footloose (Blomstrom and Kokko 2003; Morisset 2003).²⁵

The experience of other East Asian countries shows that there appears to be no strong correlation between the volume of tax incentives and either Research and Development (R&D) spending as a share of GDP, or private sector R&D expenditure. The countries that offer the highest tax incentives, Malaysia, are the ones doing the least amount of R&D. The economies that appear to do the most R&D, Taiwan, China and Korea, are least generous in tax terms, but offer non-tax incentives.

²⁴ However, fiscal incentives can be useful tools if two locations offer similar advantages to MNCs. For instance, two cities competing with each other for FDI within a country may find it necessary to offer fiscal incentives to affect the location decision. It is questionable whether such tax competition among localities within one country is beneficial for the country as a whole (Wells and others 2001).

²⁵ For instance, Motorola invested in Scotland, employing 3000 workers in 1991 receiving 51 million pounds as part of the incentives. It closed down the factory in 2001, repaying 17 million pounds. Similarly, Siemens opened a factory in Northern England in 1996, only to close it down 18 months later (Haskel, Pereira, and Slaughter 2002).

Similarly, as for promoting regional development, tax incentives have seldom attracted investors to areas where the fundamental conditions for profitability did not exist (such as availability of abundant natural resources, skilled workers, adequate infrastructure, or even the population density required to support growing markets).²⁶ As study by Morisset and Pernia (FIAS) support the results of other research that tax incentives neither significantly affect the amount or location of foreign investment in a country. A favorable general investment climate, economic and political stability, a transparent and non-corrupt public administration are more important instead.

Furthermore, regardless of how carefully these targeted tax incentives work, their immediate fiscal impact is to reduce tax revenues by narrowing the tax base. When this revenue loss cannot be offset by the expected trickle-down or spill-over effect of the induced capital investment, government is forced to raise revenue elsewhere or cut expenditures – both measures potentially harm the economy.

Moreover, **when the overall investment environment is less attractive to investors, tax incentives do not attract unwilling investors.** Tax incentives may also not be effective in attracting foreign investors from those countries whose parent country taxes worldwide income (including repatriated profits as in the U.S.A. and the U.K.) and provide credit for foreign taxes paid. Under these circumstances, tax incentives given to foreign investors results in a lower tax credit for the investors at home and a pure revenue transfer from the host government (China) to that of the investors' home country (e.g. U.S. or U.K.). This is particularly true if the main purpose of FDI is “market-seeking” and it is likely that the future flow of FDI will increasingly serve China’s vast domestic market.

²⁶ As pointed out by Shankar and Shah (2003), “regional development policies have failed in almost all countries—federal and unitary alike—to reduce regional inequalities.”

Cost-benefit analysis of investment incentives has been rarely done. Annex 3 compares alternative fiscal incentives for FDI in selected middle-income countries as computed by Anwar Shah, World Bank (1995). For example, the effects of tax holidays on the user cost of capital have three possible consequences – one positive and two negative. A zero tax rate during the holiday period has a positive effect on investment. The overall effect of tax holiday on investment depends on the extent to which capital consumption allowances and tax losses can be carried forward to the post-holiday period. Without loss carry-forward provisions, some firms only receive tax reductions or exemptions in the years that they in making losses, and therefore do not benefit. In contrast, with full loss carry-forward, effective subsidies in certain instances may be too generous. **In general, a tax holiday is generous to firms that use non-depreciable factors of production such as labor.**

Tax holidays open tax arbitrage opportunities for investors to shift taxable income into activities in which they can take advantage of the tax holiday. Tax holidays may thus encourage fly-by night or short-term operations at the expense of long term investments. Mintz (in Shah, 1995) shows, for example, that in Malaysia with tax holidays, investors enjoyed large negative effective tax rates during the holiday period—in other words a subsidy.

Effective incentives systems tend to rely less on tax holidays and more on instruments such as low and stable Corporate Income Tax rates, Investment Allowances, and/or Investment Tax Credits, which have proven to have more success in promoting investment. This basic approach meets the many, and sometimes contradictory, objectives of a business tax system including raising revenue for the government, avoiding disincentive to new private investment, and avoiding distortions in resource allocation. This basic approach to fiscal incentives has worked well for a number of successful countries, including Chile, Hong Kong, Hungary, and Mauritius, and more recently has been adopted by several Eastern European countries such as Estonia, Latvia, Ireland, Romania and Poland.

World Bank Investment Climate Surveys suggest that firms see tax incentives as much less important for investment than government officials do. In studies where taxation is identified as a significant factor influencing FDI, investors rank transparency, simplicity, stability and certainty in the application of the tax law and in tax administration ahead of special tax incentives.²⁷ A recent paper by the IMF on tax incentives in the Mekong region (Cambodia, Lao PDR and Vietnam) reiterates that (1) tax incentives can be costly, e.g. in excess of 0.7percent of GDP in Vietnam), (2) tax incentives are not a primary determinant of FDI inflows, (3) they do not perform better in attracting FDI than simple, uniform regimes with low moderate rates of taxation, and (4) if tax incentives are to be given, accelerated depreciation is more efficient and has fewer drawbacks in terms of the incentives they generate than tax holidays.

An efficient tax incentives system is one that is simple, transparent, automatic, and thus easier to enforce. The *Business and Industry Advisory Committee* (BIAC) to the OECD, which makes public views held by members of the business community, has recommends the following on incentives: “FDI incentives should be: generally available, non-discriminatory, transparent, in proportion to the expected benefits, closely linked with the actual investment, non-trade distorting, oriented toward long-term investment, temporary, and rooted in a coherent business model”.²⁸ Singapore has been moving towards a simpler and more efficient tax structure with fewer selective tax incentives. Empirical evidence suggests that the lower the development, the more incentives. As for the countries in transition to market economies, such as the former socialist economies such as Vietnam, and Laos, these FDI incentives have been extensive.

International experiences, investment climate surveys, and academic research taken together suggest that tax incentives for FDI play a limited role in investment, and are less important than a stable, favorable investment climate and a level playing field for domestic and foreign investors. The implications for China are:

²⁷ OECD, “Attracting FDI for Development”, paper presented at the *Global Forum on International Investment*, Shanghai, December 2002.

²⁸ OECD, “Investment: BIAC Position on incentives”, November 2002.

- *Unify foreign and domestic enterprise income tax so as to move towards a tax regime that is simpler, less discretionary, and with a lower Corporate Income Tax rate.* For now, a rate between the 15 and 33 percent rates would be the appropriate path. This is consistent with international empirical evidence (corporate income tax rates in other comparable countries trend between 20-25 percent). Most studies have identified a low tax rate accompanied by loss carry-forwards for tax purposes and accelerated depreciation as key components of an effective tax system and one that is highly attractive to foreign investors.
- *Remove existing distortions in the tax code such as limited deductibility of certain costs.* In moving in the direction of lower tax incentives and a general decline in Corporate Income Taxes, the Government should undertake a prior costing exercise for all existing corporate tax and non-tax schemes including those for Research and development spending by firms. The Government may want to reduce the overall corporate income tax further over time building on the savings realized from eliminating non-effective tax incentives.
- *Retain or create specific tax incentive that fit China's industrial and regional policies.* China could consider maintaining incentives that are directly linked to the amount of investment undertaken, such as *Investment Tax Allowances*, but simplify and enforce their application. However, these tax incentives should apply to all types of enterprises (domestic and foreign).
- *Ensure transparency in tax policy and administration and improve the investment climate, focusing on justice sector, intellectual property rights (IPRs).*

Chapter 6 Improving the Composition of FDI

This chapter discusses policy interventions that would improve the composition of FDI, so as to better align FDI with China's evolving development goals. Over the next Five Year Plan, creating a harmonious society, with more balanced development is likely to take center stage. FDI can support this goal by contributing more to service sector development to balance growth between the domestic and external economy; increasing technology transfer to increase the efficiency of China's economy and with it create more balance between economic and other development; and by contributing more to the development of inland regions. China has a good opportunity to archive these goals: China's accession to the WTO will open more service sectors to FDI while at the same time, as China grows richer, the demand for services will increase as well. And economics will dictate both more rapid technological upgrading as well as increased attractiveness of inland regions, as wages and land values in the coastal are likely to go up. Central and local governments should take those measures that reinforce those trends.

6.1 Directing more FDI in service sector

6.1.1 Why directing more FDI in services²⁹

China's government has set a service-driven growth strategy as a national priority in view of the potential contribution of services to employment, growth, and international competitiveness. Services are usually more labor and skills intensive than industry and developing a service sector can therefore create employment. The sector is already a big contributor to jobs growth: while agriculture shed over 30 million workers, services

²⁹ As conventionally defined, the service sector includes electricity, gas, water, transport, communication, construction, wholesale and retail trade and repairs, hotels and restaurants, transport, storage and communications, finance and insurance, real estate, renting, and business services, public administration, defense, education, health, social services, social and personal service activities, and recreational, cultural, and sporting activities.

created nearly 73 million jobs over the past decade, and have even greater potential. Services can also contribute to exports and foreign exchange: a more recent trend is to *outsource* serviced form developed economies to less developed ones, and China has an opportunity to tap into that market. Services have also increasingly become important for efficiency and competitiveness: efficient services can expand the domestic market, revive agricultural and industrial investment, facilitate industrial restructuring, accelerate human resource development, and improve competitiveness in the global economy. In recent decades, the services content of manufacturing has been rising steadily and the efficiency and productivity of service sector are therefore important for the overall competitiveness of economies. In particular, the availability, cost and quality of modern intermediate services – infrastructural, financial, professional, business–affect the competitiveness of products in domestic and foreign markets.

Directing more FDI into services could facilitate the development of China’s service sector and thus the implementation of the service-driven growth strategy. First, directing more FDI in services, like FDI in other sectors, could *increase total investment* in this sector. The financial strength of multi-national corporate (MNCs), together with their ability to implement and manage complex systems, enables them to expand supply capacities rapidly in complex, capital intensive services, such as telecommunications, power supply and transportation. Unlike FDI in manufacturing, FDI in services is likely to yield less pressure on the external balance and monetary operation because the bulk of FDI in services is market-seeking and in non-tradable activities. At the same time, they entail external payments in the form of repatriate profits.

Second, FDI in service can *increase households’ welfare*. FDI in the service sector can lead to productivity growth by improving the supply, cost, quality and variety of services. It can add significantly to the volume and quality of services available in China. Better consumer services, especially basic services such as health, education, water and sanitation can directly contribute to improving living standards as well as to building human resources. People can also benefit from better-paid jobs generated by service FDI. Compensation in services FFEs is found on average to be 63 percent of that what the

company pays in developed economies, whereas the comparable figure in manufacturing was 31 percent (UNCTAD, 2004). The reason is that foreign affiliates of service MNCs in developing countries are more skills-intensive than those of manufacturing MNCs.

Third, FDI in services can contribute to the *spillover* and *transfer of technology*. Services MNCs can bring both hard technology such as plant, equipment, production processes and soft technology such as knowledge, information, expertise, skills in organization, management, and marketing. Soft technologies are the main form of knowledge and skills transfer in services FDI. MNCs that have skill advantages can contribute to China's capabilities: they can transmit these skills to local employees, who can then disseminate them when they move to a local competitor. Or local competitors can imitate the foreign firm. Take for example, insurance, banking, and the hotel industry. Insurance requires specialized skills in risk management which is currently a scarce skill in China. In banking, where risk-management techniques and technology have been changing due to competition and the use of information and communication technology, foreign banks may transfer organizational managerial and marketing expertise to affiliates. They may also transfer know-how regarding new or standardized financial products. In the hotel industry, which has been open to foreign investment for some time now, specialized skills concern the pre-operational phase (engineering, architecture, mechanical, interior design, choice of location and market segments) as well as the operational phase (preparation of rooms and food, laundry, other personal services). Hotel services also involve direct interaction between personnel and customers and the processing of information (e.g. computerized reservation systems, credit facilities, centralized billing, check-in and check-out, other front- and back-office operations). (UNCTC 1989b, p. 22; *WIR95*, p. 185; *WIR94*, p. 229; Denizer 2000). In addition, transnational consultancy firms help upgrade indigenous management expertise in domestic firms in manufacturing as well as services sectors (*WIR95*, p. 185).

Finally, attracting FDI in service sector is an effective means to increase the volume of overall FDI: as noted in Chapter 3, the composition of outward FDI has shifted to services: FDI flows in services rose during the second half of the 1990s to overtake FDI

in manufacturing. By 2002 services accounted for nearly half of the FDI stock in developing countries.

6.1.2 Scheduled service liberalization: China's commitment to WTO accession

China's fulfillment of its WTO accession commitment has already improved the prospect for FDI in China's services.³⁰ The WTO's General Agreement on Trade in Services (GATS) distinguishes among four modes through which services are supplied internationally: cross-border supply (Mode 1); consumption abroad (Mode 2); commercial presence (Mode 3); and movement of individual service providers (Mode 4). China has made commitments to liberalize FDI in each of these modes (Figure 5.1). Trade in services through commercial presence typically involves foreign direct investment (FDI). Most international trade in services is conducted through commercial presence and the ambition of China's liberalization program in services manifests itself precisely in this mode. Most countries experienced a boom in FDI following service liberalization. For instance, the 1990s saw a sharp increase in FDI in Latin America and Eastern Europe in wake of removing barriers to entry and other impediments for foreign banks.

China's WTO commitments represent one of the most radical services reform program negotiated in the WTO. China has promised to eliminate over the next few years most restrictions on foreign entry and ownership, as well as most forms of discrimination against foreign firms. Over the space of some six years, China, one of the most closed services markets, has promised to become one of the most open. By 2008 a large number of key services will be fully or almost fully open to foreign entry—including important business services, courier services, wholesale trade, franchising, tourism services, rail and road transport, and freight forwarding services. In many other services, substantial foreign entry will be allowed—including in telecommunications,

³⁰ Note that the inclusion of FDI as a form of trade departs from the traditional economic view of trade as cross-border flows of goods.

audiovisual services, construction, retail trade, insurance, banking, securities, and maritime transport. . (Mansoor, 2002)

However, transitional arrangement and restrictions remain. The transitional arrangements and remaining restrictions under GATS include geographical limitations on where foreign service providers are allowed to establish a commercial presence, restrictions on foreign equity ownership, and limitations on the scope of business they are allowed to conduct. Key restrictions include:

- *Professional services.* Some restrictions will remain, especially in legal and medical services. Foreign firms are not allowed directly to participate in domestic legal activity and are only entitled to work on legal affairs related to their home country or to entrust work to Chinese firms on behalf of their clients. In medical services, hospitals cannot be fully foreign owned and are still subject to quantitative limitations.
- *Telecommunication services.* Majority foreign ownership will not be allowed in any area. Furthermore, there is no commitment to allow cross-border delivery of any of these services.
- *Insurance services.* On accession, non-life insurers are permitted to open a branch or JV with 51 percent foreign ownership, whereas life insurers are permitted 50 percent ownership of a JV in a partner of their choice. Non-life insurers can provide “master policy” insurance and insurance of large scale commercial risks without geographic restrictions. But when non-life insurers provide insurance of enterprises abroad, property insurance, related liability insurance and credit insurance of foreign-invested enterprises, they will be allowed only in five cities: Shanghai, Guangzhou, Dalian, Shenzhen and Foshan. Life insurers are permitted to provide individual (not group) insurance to foreigners and Chinese citizens only in the same five cities.
- *Banking services.* On accession, geographic and client limitations will be eliminated for foreign currency business. Even though the schedule states that on accession, local currency business will be allowed in 4 cities (Shanghai,

Shenzhen, Tianjin and Dalian), there seems to be a binding restriction on individual clients which will only be relaxed in two years after accession.

- *Securities service.* On accession, JVs with up to 33 percent foreign ownership will be allowed to conduct domestic securities investment fund management business. By 2004, foreign ownership of securities joint ventures will be allowed to increase to 49 percent. Joint ventures with up to 33 percent foreign ownership will be allowed to underwrite domestic equity issues and underwrite and trade in international equity and all corporate and government debt issues.

Two issues have emerged from transitional arrangements. One is that initial *restrictions on the geographical scope* of services liberalization could encourage the further agglomeration of economic activity in certain regions - to an extent that is unlikely to be reversed completely by subsequent country-wide liberalization, much like what happened with manufacturing. It may, therefore, be worth examining whether these restrictions could be phased out more quickly than currently planned. Second, *restrictions on foreign ownership* (temporary in most sectors but more durable in telecommunications and life insurance) may dampen the incentives for foreign investors to improve firm performance. The rationale for these restrictions also merits greater scrutiny.

6.1.3 Policy recommendations on attracting and reaping benefits from service FDI

Despite the good prospect and opportunities for China in attracting more FDI in service, China could do more to reap full benefits from service FDI. In chapter 4, we discussed that investment climate is of particular importance to service FDI. In addition to this, three sets of policy initiatives should be considered.

First is *increasing the supply of skilled labor and in particular increasing its quality.* Services use relatively more human resources than manufacturing, and given the relative scarcity of those resources noted in Chapter 4, skills development and education policies will be key in attracting and leveraging inward FDI in this sector. China lacks local experienced management talent in the shared service industry, and that all personnel must

be trained. Furthermore, unlike the competitive wages in manufacturing, China salaries in shared services are found to be the highest among East Asian neighboring countries, and second only to Malaysia in terms of the costs of unskilled and skilled labor (MIGA, 2003). Some of this may be due to the quasi monopoly and limited competition in this sector, but limited supply of skilled labor plays a role as well. The availability of skilled labor availability and incentives for training may determine whether the skills needed by foreign affiliates are acquired by training host country employees, competing for skilled labor in host-country markets or hiring expatriates. The first involves the transfer of technology, while the latter, depending upon the labor market, may represent an internal brain drain that could crowd out local firms. Therefore, in addition to increasing the quality of education, China may consider providing incentives, such as tax deduction for training expenditures, to investors in services (both domestic funded and foreign funded). To facilitate domestic firms to acquire soft technologies from foreign affiliates through contacts with experts, information flows and observation, government needs to nurture the linkages between foreign affiliates and domestic service suppliers and buyers in host countries.

Second is *national market integration policy*. Informal barriers exist in provision of service across the border of provinces, cities and even counties. While it is generally clear that regulation of China's international trade is a responsibility of the national government, responsibility for inter-provincial trade is still unclear (World Bank 2005c). Some Chinese provinces still attempt to impose their own regulations on inter-provincial trade and occasionally even on international trade. Further progress on deregulating inter-provincial trade will depend on a clearer understanding of the roles of the respective levels of government with respect to trade, so that reduced regulation at one level is not cancelled out by increased regulation at another. One measure to eliminate the local barriers is to make the firm registration as simple and flexible as possible. Registration of companies involved in inter-provincial as well as in international trade should follow a similar principle - registration in one province or with a national agency would be sufficient to allow participation in all inter-provincial trade. Logistics in the EU was

given a boost when registration of companies at one member country was sufficient for them to operate legally in all other member countries as well.

In some cases Government should also address narrow sectoral interests that may block services development. A lesson from the attempt to develop a multi-modal transport system on the Yangtze River was that of the ability of sectoral and local interests to block developments that would have benefited all of them. In that case, three line ministries and various provinces played a role: MOFCOM responsible for development of container transport and stimulating foreign trade; MOC responsible for regulating transport on the Yangtze, including continued responsibility for the present state-owned shipping line that transports containers on the river; and MOR responsible for the transport of containers by rail and a competitor to the proposed joint-venture and Anhui, Hubei and Sichuan provinces. The different interests among provinces, regulators, and owners of state assets proved hard to reconcile (Carruthers, 2001). The lesson is that to attract entry into services in some cases comprehensive reform is needed to re-align the regulatory responsibility, and to separate the function of SOE operation from the regulatory function of Ministries.

Thirdly, realizing the gains from services liberalization will require complementary regulatory reform and the appropriate sequencing of reforms. Many of these policies are not specific to FDI, but apply generally to all forms of investment.

- Services with built-in monopoly elements (power, water, telecoms) need a strong legal and regulatory framework to ensure efficient pricing, investment and delivery. For instance, according to studies on the impact of utilities services liberalization on poor people, private sector provision has had mixed effects on tariffs and hence mixed effects on the poor. Tariffs have usually fallen in cases where competition and effective regulation have cut costs. But there are also examples where tariffs have risen because of the need to ensure the financial viability of service providers in order to attract entry.

- Services that are widely used or raise particular governance or stability concerns such as finance and banking need appropriate regulation and strong supervision to ensure that private enterprises act in the social interest. China's banking system is a case in point: entry of foreign competition may, in the absence of strong supervision and mechanisms for weak banks to exit smoothly, lead to destabilize the banking sector. Indeed, there is a concern that foreign banks may attract the good clients, and the large depositors at the expense of domestic banks. The result could be that china's state and locally owned banks are left with a weaker loan portfolio and less liquidity. The proposed deposit insurance and better measures to deal with the large amount of non-performing loans in state banks are therefore needed to ensure that liberalization in financial services progresses without disrupting the sector.

- There is also a crucial role for *competition policies* to ensure the benefits of FDI in services (WIR97). In basic telecommunications and other network-based services, meaningful liberalization will be difficult to achieve without better regulation and supervision of competition. The government may wish to consider regulation and competition before others. Although some services remain natural monopolies, the technical progress has significantly reduced the extent of natural monopoly in sectors traditionally perceived as national monopoly. For example, technological advances have significantly lowered network costs in sectors like fixed line telecommunications, and vertical separation (e.g. through network unbundling) has widened the scope for competitive entry (Smith, 1995). Inefficiencies introduced by duplication of networks may be small compared to operational inefficiencies that can result from a lack of competitive pressure. Fink et al (2001), in a study of telecommunications reform in Asia, Africa and Latin America, find that privatizing the incumbent after introducing competition is likely to lead to a higher level of mainline penetration than the opposite sequence. When the institutions and instruments needed to manage privatization of utilities are weak, there is the risk of turning State-owned monopolies into private (and possibly foreign) ones. The risks are exceptionally high in countries

such as China where the service sector has been lingered by protection of monopolies, price and other forms of intrusive regulation, and an inadequate framework for promoting the smaller and more-agile non-state enterprises that normally form the backbone of the services sector.

6.2 Maximizing technology transfer & directing more FDI in high-tech industries

FDI may provide host countries with better foreign technologies and result in technological spillovers and greater competition. Case studies suggest that substantial technology diffusion occurs due to FDI (Blomström and Kokko 1997). Vertical technology transfer from MNCs to local suppliers has been documented to occur through firms from industrialized countries buying the output of Asian firms to sell under their own brand names. Such relations may result in transfers of technical information from foreign buyers. Econometric studies are more diverse, some finding that firms in sectors with a relatively high MNC presence tend to be more productive (Kokko et al 1997), while others find that domestically-held firms may actually do worse as the foreign presence in their industry increases (e.g., Aitken and Harrison 1994). Of course, in the short run, foreign entry may have negative effects on the domestic firms, if MNCs siphon off domestic demand or bid away high-quality labour. However, this is not a loss for the economy as a whole as long as the foreign entrant is the more efficient producer.

There appears to be great differences between the actual use that host countries are able to make of the technologies thus transferred. Studies find that, the magnitude of the technology transfer is conditioned on the host country's capacity to absorb technology, the linkage between MNEs and local firms, the protection of intellectual property rights (IPR) and the living environment in host country, in addition to a benign investment climate mentioned earlier.

The *capacity of host countries to absorb technology* is crucial to any benefits from FDI. Successful technology transfer typically requires capacity to learn and investments to apply technologies in production processes. If without proper human capital,

spillovers may be unattainable (Saggi, 2002). From this perspective, efforts to reap the benefits of technology and human capital spillovers could gain effectiveness when policies of technological and educational improvement are undertaken conjointly.

The supply of skilled workers affects not only the volume of FDI, but also the sectors to which it flows and how technology is assimilated by domestic industry. Investment in, and continuous upgrading of basic skills is quintessential in achieving domestic assimilation of FDI technology. Moreover, human capital development is a key source of spillovers generated by FDI. The direct impact on human capital from FDI derives mainly from the fact that MNEs tend to upgrade employee skills in host countries by providing training. (UNCTAD, 2000) Although the magnitude of MNE-sponsored training is necessarily smaller than that of general education, the presence of MNEs may provide a useful demonstration effect, as the demand for skilled labor by these enterprises provides host-country authorities with an early indication of what skills are in demand.

Government may consider creating policies/programs aimed at helping firms train their workforce. (Saggi, 2002 and te Velde, 2001) Tax subsidy for financing such training of low-skilled employees³¹ is one possibility. Training schemes would enable firms to upgrade labor skills in situations of skill-shortages. As labor turnover magnifies the effect of human capital spillover. Policies that facilitate labor mobility, such as removal of household registration (*hukou*) and build-up of a nationally integrated pension fund, would increase the technology transfer. However, the fact that workers and employees are highly mobile makes firms unwilling to take the whole cost of training, as they do not reap all the fruit from such investments. A scheme can be built in a way that employee contributes to training costs for those employees who can afford it, and government funding for those who cannot. (Te Velde, 2001)

Evidence suggests that for FDI to have a more positive impact on productivity than domestic investment, the "technology gap" between domestic enterprises and foreign

³¹ E.g. Skill Development Fund in Singapore and the Penang Skills Development Centre in Malaysia

investors must be relatively small. Chuang & Hsu (2004)³² find that FDI has positive spillover effects on productivity, and that this effect is larger for industries with high FDI involvement and in industries with an already high technology level. The scale of domestic R&D, and how well it acts to move domestic technology closer to the technology frontier are very important factors in the absorption of technology and the development of new technologies in collaboration with foreign firms.³³

Government may consider raising the caliber of key universities and strengthening their research orientation so as to attract more FDI in research and to motivate collaborative alliances with MNCs and foreign research centers. There are different ways to organize University-Industry linkage³⁴: licensing by universities, research collaboration between universities and industries, consulting by faculty members, and participation in business ventures. Over the medium term, universities should focus on diffusing known technology to domestic companies. The best way to do this is through consulting or co-authorship between university faculties and industry researchers. Companies might also benefit from funding university-based labs. (Yusuf, 2003)

“Vertical linkages” between MNEs and local suppliers is the most important source of technology spillovers. Foreign-owned enterprises usually provide their suppliers with technical assistance, training and other information to raise the quality of their products. Also, many MNEs assist local suppliers in purchasing raw materials and intermediate goods and in modernizing or upgrading production facilities. However, policies that force linkage, such as domestic content requirements, mandatory joint partnerships and technology licensing, contrary to the policy intention, are found detrimental to the efficiency of FDI. All of these restrictions are seen to make FDI less efficient through

³² using implicit industry sector analysis on data from the 1995 Third Industrial Census.

³³ Countries with substantial engineering skills and R&D programs for adaptation and learning are greater recipients of licensing flows than others (Yang and Maskus 2001).

³⁴E.g. In the National Technological Park in Limerick, Ireland, linkages between the university and multinationals and local firms are encouraged. MNCs are taking on graduates from the university, and the university offer courses aimed at the specific needs of MNCs (te Velde, 2001).

being of lower technical sophistication, slower in technology transfers, and less likely to implement the latest and most advanced management practices - constrained companies are found to have less dynamic backward linkages into the local economy (Moran 1998). Instead, a cluster strategy, under which the government provides information and facilities to help MNCs outsource their components and parts locally, is found to have a better chance to succeed. The Singapore experience is evidence of such a strategy (see box 6.3).

In addition, intellectual property rights (IPR) protection also plays positive role in stimulating formal technology transfer, through FDI in production and R&D facilities. Evidence from Eastern Europe points to the importance of protection of intellectual property rights for attracting technology intensive FDI (Smarzynska Javorcik 2004). IPR reform is associated with an increase in technology transfer from parent to affiliates in the IPR-reforming countries. Furthermore, R&D spending by affiliates increases after such reforms – which further strengthens the argument that stronger IPR protection is inductive to technology transfer. The quantitative analysis is backed up by interviews with “practitioners”, who claim that IPR regime is an important factor in the decision of scope and level of local affiliate operations (Branstetter et al 2003). The impact of strengthening IPR on technology transfer has been found most significant in recipient countries with strong imitative abilities. (Smith 2001). Similar findings emerge from the case study of IPRs and economic development in China by Maskus, Dougherty and Mertha. Weak IPR enforcement is found to make foreign companies reluctant to transfer R&D facilities to China. As China is increasing sophistication in technology use and technology development, stronger protection of IPR will gain more importance.

Despite China has made significant progress on the IPR legislation, entrepreneurs think the overall environment is still weak. Three general problems are identified including inadequate enforcement, low monetary penalties and limited compensation to victims of infringement and arbitrary and nontransparent enforcement actions (especially at local level). To effectively strengthen the enforcement, the government needs to raise the

public awareness of the need to respect intellectual property, address the regional protectionism, and enhance the training to local officials so as to raise their effectiveness.

Finally, the government should notice the role of the quality of the urban environment in increasing technology transfer. FDI in high tech and knowledge intensive activities is bundled together with skilled workers who attach importance to living conditions and lifestyle choices. Thus, attracting FDI into advanced electronics or biotech industries, for example, is synonymous with attracting knowledge workers and their families to urban locations. Municipalities in the U.S. and Europe have discovered talented and highly paid knowledge workers are drawn to cities readily supplied with social, housing, cultural, and recreational amenities combined with environmental quality and the low incidence of crime. In the U.S. cities such as Austin, San Diego, San Francisco, Minneapolis, and others have made determined efforts to create the physical and social ambience conducive to the growth of high tech industries with considerable success. In East Asia, Singapore is consciously pursuing such a strategy and hoping to attract the “star researchers” that can generate the technological “buzz” and catalyze the emergence of a high tech cluster. And the importance of the urban amenities for the next stage of industrial development is galvanizing other Asian cities such as Seoul and Bangalore to focus on lifestyle choices (Florida 2000).

6.3 Motivating more FDI to go to inland regions

Why it matters?

The need to attract more FDI in inland regions comes from a shift of China’s development strategy toward “building a harmonious society”. Regional inequality constitutes a major component of China’s overall income inequality. Variation of FDI across regions in China is quite considerable, with eastern and coastal areas generally having developed more quickly and attracted more investors than the central- and western areas, due to the differences in initial endowments, regional discretion in policy making, tax arrangements and first-mover advantage. As the land rent and wage went up in

coastal region, the FDI shows preliminary signs of reallocating toward central and western regions. The government can strengthen this trend with policy intervention, so as to narrow the inequality of FDI distribution across regions.

Directing more FDI into inland regions is also required to maintain China's overall competitiveness for attracting FDI. The coastal provinces faced constraints of land availability, environment carrying capacity, and resource scarcity. Some coastal cities, such as Shanghai, Guangzhou, Dongguan, Suzhou, reported that they have little land left to accommodate greenfield FDI (see Box 6.1 for the current restrict on farmland conversion). The high office rental costs in China's major metro areas are also found to be one of major barriers for coastal region to further attract FDI in shared service industry (MIGA, 2003). Shortage of electricity has been widely reported in coastal cities – firms in Guangzhou are suffering electricity shutdown 2-3 days per week. Meanwhile, the labor costs in the coastal regions are rising. (Anderosso-O'Callahan & Wei, 2003). Many coastal cities have started to impose the land-investment intensity as one criterion for newly established FFEs, \$10 million per mu³⁵ in Shanghai, \$5 million in Suzhou and \$2 million in Guangzhou and repeal the policy of exemption of land use fee.³⁶ Because of these cost pressures, it will be a challenge to further attract land and labor-intensive processing investment in coastal region, because most processing investments are footloose and sensitive to operation costs.

As a result of these cost pressures, cities in inland region may emerge as a choice destination for FDI. However, these cost pressures may equally result in FDI not locating in China, but elsewhere in Asia, especially now that the WTO entry has made it easier for companies to supply the Chinese market from abroad. Thus, improving the competitiveness of the inland provinces in attracting FDI may well become important to maintaining the volume of FDI to China as a whole.

³⁵ One hectare equal to 15 mu.

³⁶ Presentations made by local officials, 2005.

Box 6.1 Planning quota for farmland conversion

The rapid outward spread of cities led to increasing concern about the loss of China's farmland. In response to these trends, the central government has put in place a number of important restraints on the conversion of agricultural land. One of the measures is "planning quotas for farmland conversion" (hereinafter referred as "quota"). The quotas were set in 1997 covering a 13 year period up to 2010. Quotas are established at the provincial level, and within provinces at various sub-provincial levels. Areas exceeding their quotas must either purchase quotas from other areas (allowed within a province but not between provinces), or intensify land reclamation.

Driven by industrialization and infrastructure investment, the pace of conversion in some provinces has been so high that some provinces and sub-provincial units have already used up their quotas. In Zhejiang, conversion has in fact taken place at rates far faster than anticipated even a few years ago. By 2003, the 1997-2010 provincial quotas for the conversion of agricultural land to construction land set by central government had almost been reached. Between 1997 and 2003, Zhejiang converted 974.9 thousand mu out of total thirteen-year quota of one million mu.

The rate of conversion has been slower in Shaanxi – as of 2003, a total of 412.3 thousand mu had been converted out of a total quota of 800,000 mu, leaving about half of the quota left. However, the locus of conversion has been highly centralized geographically, in line with the disproportionate concentration of urban growth around Xi-an (the capital city of Shanxi province). By 2003, conversion of land to construction use in Xi-an had already reached 171.3 thousand, exceeding by 30 thousand mu its total quota up to the year 2010 of 135 thousand.

*Source: China Land Policy Reform for Sustainable Economic and Social Development-
An Integrated Framework for Action, the World Bank, Upcoming*

Is it feasible?

Some are sceptical about the feasibility that directing more FDI in inland region. They believe FDI simply chases the market size that the inland regions lack. Contrary to this belief, empirical analysis suggests that inland regions have a strong potential to attract

more FDI. Clarke and Xu (2005) use the micro data from 23 cities' investment climate survey to study on the FDI spatial decision across China. They found that cities in inland region fall far behind the coastal cities in terms of investment climate (see Annex 2), and investment climate is the most important factor for FDI's special decision. Market size, is an important factor, but ranks only the second. The most important factors for FDI location decision across China, by descending order, are government and court protection for property rights, market size, infrastructure, and lack of corruption. The policy implication from Clarke and Xu's study is clear—the inland region can attract more FDI just by improving their investment climate.

Moreover, the effect of market size is likely to be exaggerated. To minimize the socio-economic impact of the opening up of the economy and to reap tax revenues, many sub-national governments conduct some degree of local protectionism, inducing barriers, formal as well as informal, on intra-provisional trade³⁷. Underdeveloped infrastructure, poor logistic service and other informal barriers have equivalent effects to tariffs in raising internal trade costs. The high internal trade costs, in whatever form, often make foreign investors no choice but to stay close to the target markets. (Amiti & Javorik 2005, World Bank 2005) Therefore, even for the market size constraint, although it is hard to directly raise the income of inland regions, its effect can be significantly lowered by cutting logistic cost and removing informal inter-provincial/cities trade barriers and thus allowing firms in inland region to access to the whole Chinese market.

Of course, indiscriminately promoting FDI to inland regions is too simplistic a policy. Location of FDI in the inland regions could benefit these regions, but may lower the benefits of FDI for China as a whole. This is because it prevents the down- and upstream firms locating nearby the big firms, thus lowering the agglomeration, cluster effects and technology transfer. A better option would be to upgrade the industrial structure of FDI

³⁷ World Bank (2005) finds that this market fragmentation is still important, even though intra-provincial barriers to trade have declined over the 1990s.

in the coastal region, and at the same time facilitate the more of land and labor intensive FDI to inland regions.

Actually, FDI is not necessarily a relocation of capital from one on expense of another, but more likely to be a process of rationalization of labor division. When assembly operations were migrating to the relatively low wage Asian countries in 1960s-80s, economies like Japan, South Korea, Singapore and Taiwan increased their specialization in the manufacture of components. In the early 1990s, when the NIEs lost comparative advantage to ASEAN and China in term of labor cost, many MNEs upgraded their facilities in NIEs to a technology platform, while some did relocated their production to ASEAN countries. Nevertheless, the net effect on NIEs is positive, as a result, NIEs not only benefited from higher FDI volumes, but also from industrial restructuring and technology upgrading.

How to make it happen?

To attract more FDI in inland regions, inland regional governments must improve their investment climate. Critical for the investment climate in inland regions is improving the efficiency of the court system. The broad direction of reforms is to centralize the court system, at least in areas of commercial and criminal law (World Bank 2005). The specific actions required at this stage are the strengthening of the legal system (Judiciary court, probation, public security, enforcement services), which in turn requires increasing staff for the legal system, better training for cases involved commercial disputes, and settling economic cases based on commercial laws rather than government discretion. When government discretion is involved for FDI inflow, government officials should aim at the protection of contracting and property rights of the investors, and use uniform criteria in dealing with individual cases. As corruption, amongst other things, deters FDI, local governments should do whatever they can do to reduce corruption and informal payments, and make the processes of foreign entry transparent. Central government could focus its anti-corruption efforts more in the inland regions as well. (Clarke & Xu, 2005).

Further efforts should be made to cut the logistic cost and to remove market fragmentation. In section 6.1 on directing more FDI into the services sector, we have discussed how to reinforce market integration. Reinforcing market integration would help cut the implicit costs of inter-provincial trade, thus making the inland regions more attractive to foreign investors who chase the coastal market. In addition to promote early introducing national policies conducive for national market integration, inland regional governments can cooperate to lower the inter-province/city barrier. Regional cooperation, such as Yangtze River City Union, has been found to be an effective mechanism. Promoting such cooperation in inland provinces could improve their competitiveness in attracting investment—foreign and domestic alike.

Reducing logistics costs through improved transport services, especially intermodal services, and better information technology services should be of greatest benefit to locations with long average lengths of haul. The benefits would come in the form of lower costs, shorter transportation times, and more reliability. Specific policies on how to develop China's logistic industries are elaborated in the box 6.2. FFEs in export processing manufacturing are sensitive to logistic costs and time efficiency. Improving logistic service will make inland regions more attractive for FFEs that chase domestic market (mainly the China coastal region), and for those that produce for the export market as well.

China has done already much to alleviate bottlenecks in physical infrastructure.³⁸ However, there is an important qualifier to this: economies of scale. The volume of traffic significantly affects the frequency and costs of service. The same issue affects the strategic benefits associated with critical mass to get economies of scale in production and logistics. Within Central China, large cities provide a scale that allow for new international businesses to be developed. Improved logistics would likely trigger growth

³⁸ Indeed, some would argue too much: the policies to promote Western Region development has resulted in the creation of massive, often underutilized, infrastructure such as roads and airports.

in transportation volume, and the potential to reduce the time to move goods by rail from a city such as Wuhan is substantial: currently the transit time for general intermodal service from Wuhan to Shanghai is “within 14 days.” Further west, however, where economic activities are fewer and communities smaller, the potential for reducing the costs of distance is less clear. Improving processes at intermediate hubs are particularly important to the traffic of these communities. Any transition will be gradual. Particular attention should be given to the drive of first movers to meet the varied needs of customers so that interest in sourcing in the west is gained, not lost. (*World Bank, 2004b*)

Box 6.2 Developing the logistic industry in China

The challenges facing China in logistics development are great by virtue of the country’s size and restrictions on doing business. The size of the country and the economy affects the scale and allocation of investment in infrastructure. In particular, China needs greater intermodal rail capability. Improvement of this capability demands continued investment and dealing with important policy matters – such as the level of priority given to international container traffic; the use of international containers in domestic trade; the management structure of the railway to achieve better integration among the operating units; an incentive structure to encourage greater productivity and better customer service; and a market-sensitive pricing system for all modes of transport. There is also a need to emphasize information technologies (IT) as a means to change the design of systems and to speed up processes, and to support this with programs to accelerate its use. Like intermodal rail, the benefits of IT in overcoming distance can be greatest in central and western regions.

China’s Accession to the WTO requires, or is consistent with, a number of policies to facilitate trade through improved logistics. First, extending the freedoms of air cargo and courier services would be very beneficial. Second, relaxing the entry conditions for foreign-owned freight forwarders and other logistics service companies would increase the capacity and improve the quality of logistics services. Third, fewer restrictions on the lines of business of carriers and logistics service providers, regardless of the owner, are desirable to enable greater integration across logistics services. Finally, improvements in government services that are a part of logistics (for example, customs) are needed.

If the full benefits of better logistics services and freer trade are to be realized, internal trade barriers should be lowered. Education requirements exist so that there is full and common understanding about business concepts, including supply chain management and logistics.

Source: Global Production Networking in East Asia, 2004, the World Bank

Moreover, inland region can exploit a late-mover advantage in investment promotion. Inland region's government can learn a lot from experiences of coastal region. One experience is the strong support from the local highest political level that contributes to reinforcing effectiveness of investment promotion efforts. In Jiangsu province, one of the most successful provinces in attracting FDI, the province governor personally takes responsibility for investment promotion. Zhejiang province also witnessed a rapid growth of FDI when its governor took over this responsibility³⁹. Inland region may consider hiring investment promotion specialists from the developed cities, who have accumulated experience and client network. They can also set up investment promotion offices in coastal cities to target the firms about to move or unable to acquire land there and building up linkage with coastal cities. Some cities like Fujian and Hubei have been innovative in solving this problem: a tax sharing mechanism “*Fei Di*” was set up. Under this arrangement, a less-developed city (A) contributes a plot of land where a developed city (B) builds an industrial park. City B takes responsibility of infrastructure investment in the park, investment promotion and park management. City A helps to provide electricity, water and other facilitation. A and B share the tax revenue generated from the firms in the park according to a negotiated agreement. The inland government may focus on attracting FDI to the major cities. The idea is that this will lead to trickle-down effects in the economy.

Finally, inland governments should attract investment in industries in line with their comparative advantages, and at the same time the coastal region should upgrade the industrial structure of FDI. Inland regions are quite different from the

³⁹ Presentations by officials from Jiangsu and Zhejiang province in NDRC 11th foreign capital utilization plan meeting.

coastal region in terms of natural conditions that are beyond policy control. Its FDI strategy should be different as well—instead of copying the export-led FDI strategy applied in Coastal China, the inland governments should apply their efforts to attract domestic market-oriented and resource seeking FDI as well as attracting services that do not need to be located near consumers and costumers (Taube & Ögütçü 2003). In principle, inland regions should focus their efforts in attracting more FDI in labor-intensive industries in which most inland regions have comparative advantage. However, the natural endowment also differs significantly among provinces in inland regions. Some cities, like Chengdu, Chongqing and Wuhan, enjoy a big pool of research institutes and engineering, sizeable market, and strong industrial sourcing capacity. There is no reason cities like these can not attract more FDI in high-tech industry. Therefore, each province and city should make FDI strategy compatible with local industrial strategy, and when designing their FDI policy, the governments should desist from using approaches that have been proven inefficient such as creating lists of project profiles, pillar industries and investment fairs and missions.

In this context, it is worth repeating the observation made earlier that China's WTO accession geographically limits FDI in services mainly to eastern regions. This could mean a lost opportunity for inland regions—who might develop a comparative advantage in at least some services, for instance back-office services for coastal manufacturers or service providers. Although further research on this issue is warranted, central government should review whether the geographic limitations on FDI in services are truly desirable, or whether they would conflict with the goal of developing the inland regions, and repeat the experience with manufacturing, in which the agglomeration advantages of the eastern provinces are now hard to overcome with preferential policy for the inland provinces.

Upgrading the coastal region as a technology platform is an important complement to policies directing FDI into inland region. International experience suggests that the local availability of engineering, sourcing capacities as well as government incentives for technology upgrading are important location selection criteria for regional-technology

platform. See section 6.2 for more policy options on attracting FDI in high-tech industries. (Song, 2001)

Box 6.3 Singaporean Experience: coping with national industrial strategy

Singapore has one of the most successful investment promotion strategy. Its history of investment promotion can be traced back to 1960s⁴⁰. Its investment promotion strategy has been evolving with its national development objectives.

Phase I (from 1960s to early 1970s): directing FDI in labor-intensive sector. The main objective is to reduce the unemployment rate. By 1971, 26 percent of all firms were foreign, and they accounted for 63 percent of all employment, 75 percent of value-added and almost 75 percent of manufacturing exports, excluding re-exports.⁴¹ The successes of the EDB's reform strategy led to low unemployment rate—only 4.55 in 1973.

Phase II (from mid-1970s to early 1980s): directing FDI in capital intensive sector. During this time tax exemptions were the major incentives for FDI⁴², tax rebates on up to 90 for non-pioneer firms for five years were granted, and pioneer firms were exempt 10 to 15 years, depending on the size of the individual firm.

Phase III (since mid 1980s): directing FDI in knowledge intensive sector. In 1984-85 the Singapore economy hit its first post-war recession; this alongside the gradually rising wages, made the policy makers aware that upgrading the work force and FDI was not enough, and a new shift in policy was made; this time towards knowledge intensive sectors. Three approaches have been explored.

- Training. To jump start the process the EDB encouraged companies to employ foreign experts, and a Technical Education Centre was set up. The EDB initiated industrial

⁴⁰ The Economic Development Board (EDB)⁴⁰, set up in 1961 with an initial aim of leading the industrialisation of Singapore, is . The EDB has been involved in investment promotion as well as hands-on development of sites, but over time the EDB got more focused on promotion only, leaving other activities to different organisations.

⁴¹ Tan & Ow, in Balessa, 1984

⁴² te Velde, 2001

training schemes overseas, government-industry training centers and set up local training grants.⁴³

- Cluster strategy. The Local Industry Upgrading Programme was set up in 1986 – its purpose was get multinationals to enter into long term supply contracts with local firms, leading to technological transfers. The latest strategy has been to focus on a cluster approach, targeting firms around the electronics/semi-conductor, petrochemicals and engineering industries. The idea is to attract FDI, but also to create enhanced linkages and spill-over effects with the investing companies. When firms in the same sector compete, the idea is that this will stimulate productivity grow. Firms co-operate along the value-added chain, which links downstream to upstream industrial activities. The cluster-oriented approach looks for value chains that are dominant and for gaps can be identified and potentially filled - government policy can avoid what is essentially a market failure, and can support services or prepare infrastructure that is for joint use. The cluster strategy forms part of a greater plan of the creation of a knowledge-based economy (KBE).

- Regionalization program. The EDB now applied a regionalization program, dubbed as *The Growth Triangle*, aimed at attracting MNCs to locate their regional headquarters, R & D facilities, and purchasing, marketing and high-value-added service-oriented activities in Singapore, while letting the lower-value added processes go to other countries.

⁴³ Tan, 1999

Chapter 7 Non-FDI Capital Flows: Liberalization and Risk Management

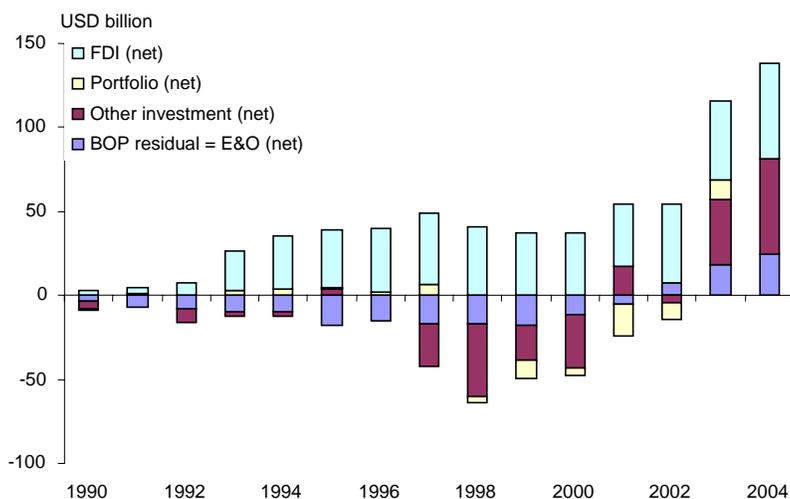
This chapter reviews recent trends and policy issues regarding China’s non-FDI flows. ⁴⁴ China has focused on opening up for FDI, and has maintained fairly strict controls on other capital flows. The question is whether such controls are still appropriate going forward. This question comes up at a time when *de facto* opening of the capital account is happening along with the increasing share of trade in the economy. The chapter reviews the pros and cons of opening up the capital account, and the conditions under which such opening up would be beneficial for China. There is a growing body of empirical literature investigating and quantifying these results. It concludes that liberalization of non-FDI capital flows should be a medium term objectives, and it requires for intermediaries to improve their risk management capacity, for exchange rate system to be more flexible, and for the authorities to revamp macroeconomic policies.

7.1 Why liberalize?

Attention of analysts and policy makers has focused mainly on the relatively stable and large FDI flows into China, which have averaged a net USD 32 billion (3.7 per cent of GDP) over the past 15 years. However, non-FDI flows have also been large, and rising in recent years. While reported non-FDI flows have averaged only USD 3 billion (outflow), they are likely to have netted more than USD 50 billion in some years, mainly outflows until the year 200, but increasingly inflows since the year 2000 (Figure 7.1). These flows went in and out largely unnoticed by the official statistical system, and ended up as “other items, net” in the balance of payment statistics.

⁴⁴ Non-FDI capital flows include portfolio investment in equities and bonds – i.e. investments that do not entail significant ownership control – as well as trade credit and banking flows. For most developing countries, the bulk of capital flows are non-FDI. In China, unusually, the opposite has been true for the average of flows, but non-FDI flows have experienced very wide swings, outward in 1997-2000, inward since then.

Figure 7.1 China: Capital flows and BOP residual



Note: This figure ignores the transfer of \$45 billion from the official external reserves to two commercial banks.

Source: BOP statistic yearbook, SAFE

With the recent large capital inflows and concurrent trade surplus, China has built up large international foreign exchange reserves. The official external reserves stand at \$711 billion at end-June 2005. In addition, Chinese banks are holding substantial and growing net foreign assets estimated at about USD 110 billion at end 2004,⁴⁵ which represents the counterpart of foreign currency-denominated deposits that are placed in the banks. Foreign currency deposits at the banks have been static at about USD 150 billion since 2002 and their share in total deposits has fallen to about 5 percent – low by international standards. In both cases, the foreign assets held are thought to be fairly short-term debt instruments of minimal default risk. In addition to these, there are working capital denominated in foreign exchange of corporate and other entities and legal holdings of foreign financial assets by non-bank Chinese residents, but both of these are probably small

⁴⁵ This figure, based on the banking survey does not include the USD 45 billion transferred to two commercial banks in 2003, which are separately accounted.

The recent inflows have become an issue for macroeconomic management. Because of China's *de fact* fixed exchange rate policy until July 21, 2005, the central bank had to intervene in the foreign exchange markets, and as a result built up international reserves, the resulting rise in domestic liquidity was in part offset by central bank measures, including issuance of central bank bills, several increases in the banks' reserve requirements, increase in the wholesale market interest rates, and liberalization of the lending rates. Despite these attempts by the authorities to limit the impact of inflows on domestic liquidity, the inflows partially fueled the surge in domestic credit extended by the banks.⁴⁶

In response to the large capital inflows, Chinese authorities are contemplating relaxing controls on capital flows. While domestic credit and movements in international reserves can be addressed through monetary and exchange rate policy, currently a reduction in net capital inflows may be desirable for reasons of macroeconomic management. For this reason, China has been encouraging capital outflows as of late. For instance, it has encouraged Chinese firms to acquire assets overseas, notably in the field of natural resources, information technology, and others. Nevertheless, for other flows, the elaborate administrative capital controls in China seemed to have favored inflows over outflows.⁴⁷ The authorities have recently taken some steps to relax exchange controls on non-FDI capital outflows.⁴⁸

No doubt many Chinese individuals and businesses may have specific reasons for making investments or capital transfers abroad, which they are not permitted to do under present

⁴⁶ It is generally accepted that a slowing of domestic credit growth is appropriate at present. This is not so much because of any strong immediate upward pressure on prices, but because of a perception that too much credit is going to finance ventures which will prove unprofitable because they assume unrealistic market growth, or because they will face supply constraints in terms of infrastructure or raw materials.

⁴⁷ Because of the discretionary nature of the controls, it is not easy to prove that inflows have been overall less controlled than outflows. (see Appendix section 2).

⁴⁸ Most importantly permission granted to qualified domestic investment intermediaries for foreign portfolio investment.

regulations. But it is not clear that liberalization of outward capital flows will result in any sizable reduction in the *net* inflows in the short-run. The liberalization of capital outflows makes it easier for investor to move capital out of the country when needed. The result could be that capital *inflows* increase first because these become less risky now that it is easier to take the money out again. In addition, liberalization of capital outflows is often interpreted by the market as a signal of strengthening of a country's economic performance by market—which in turn may also trigger more inflows. Finally, in the future, the balance of China's capital flows may yet again shift towards outflows rather than inflows, and turning back liberalization measures at that point may not be opportune. Thus, rather than determining capital flow policies based on short-term pressures, it is preferable to plan policy on the basis of the long run implications for efficiency, growth, volatility, and risk.

In the longer term, non-FDI flows can play a key role in developing China's economy. Even though their typical role of augmenting limited domestic savings for the purpose of capital formation is not immediately relevant to China, there are important benefits in terms of improving access to financial services, better risk diversification, and reduced scope for discretionary policy moves detrimental to an economy's health.

Capital account openness increases the effectiveness of finance in contributing to growth by performing its key functions.

- In particular, a market open to international debt and equity flows offers users of capital an expanded and diversified source of funding.
- By altering the terms on which firms can access finance, it can enhance the corporate governance environment: not only ensuring that creditworthy firms and those with potentially profitable investment opportunities get the needed funding at a reasonable cost, but also that they continue to be subject to market monitoring that helps ensure that they spend the money effectively.⁴⁹

⁴⁹ This is not just theoretical, Forbes (2005) provides a review of individual country studies and cross-country firm-level studies and concludes that they “present compelling empirical evidence that capital controls can affect the supply and cost of capital, market discipline, the allocation of resources, and the

- It allows a greater international pooling of risks as local investors and financial intermediaries construct a hedged portfolio of claims on foreign income from the vast array of financial instruments available in the global financial markets and as they shed local risk by selling instruments abroad.
- The open capital market also allows the economy as a whole to become a net creditor or debtor and to adjust this net asset position in response to shocks that may occur. It thus contributes to consumption smoothing.

In effect, over 95 percent of China's financial assets are intermediated through the banking system, the government and the monetary authorities. By channeling its holdings of such a high fraction of foreign assets through such a narrow channel, China has not benefited from the risk reduction and governance improvements that could be offered by global finance.⁵⁰ *However, the benefits of increased access to international finance should be carefully weighed against the risks.*

Non-FDI flows have been much more volatile than FDI. Figure 6.2 plots the net capital flow in the main categories against their. The flows have been pro-cyclical: substantial net outflows were recorded in the years following the East Asia crisis, but since then, capital flows turned around dramatically and they have been large and growing in the most recent boom period since 2002. In addition to measured capital inflows, the large residual item in the balance of payments reflects unmeasured and unapproved non-FDI capital flows.⁵¹ If one adds measured non-FDI flows with the BOP residual, the turnaround in this combined flow was over 7 percent of GDP between 1997-

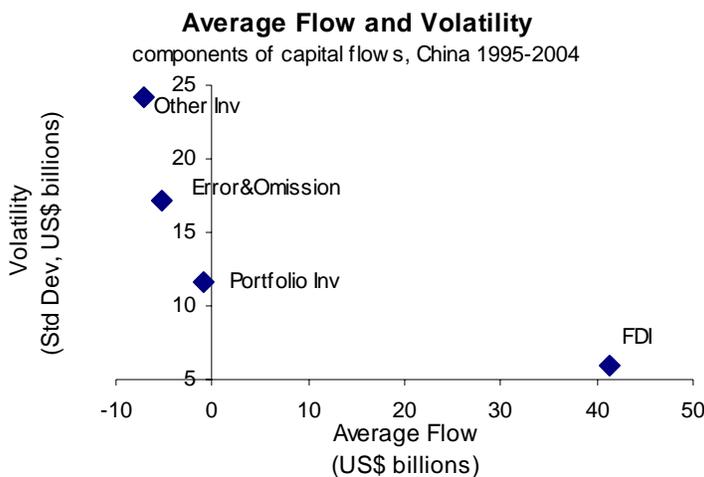
behavior of firms and individuals. Several studies also find that the effects of capital account liberalization vary across types of firms, reflecting different pre-existing distortions under capital controls. For example, although lifting capital controls tends to reduce financial constraints for most firms, it can have no effect (or even increase financial constraints) for firms that received preferential treatment under the controls or had already found ways to evade them.

⁵⁰ Many observers have pointed out that, to the extent that these assets are held in US\$ Treasury Bills, they are exposed to considerable exchange rate risk, but that is not the focus of the present paper (cf. World Bank, 2005).

⁵¹ Since 2004, "other items net" may also contain some unrecorded FDI flows.

2000 and 2000-2004, from an outflow of 5 percent of GDP to an inflow of 2.2 percent on average. The size of this swing indicates that, despite the relatively tight controls on the capital account,⁵² there is considerable scope for sharp fluctuations in these accounts, partly through unidentified and uncontrolled channels. This is in part the result of China's considerable opening on the current account, and the country's large share of trade in GDP of more than 70 percent. This provides considerable scope for effectuating changes in trade finance and the timing of trade transactions, which *de facto* result in short-term capital movements.

Figure 7.2 Flow and Volatility: Components of Capital Flows



Source: Based on China's Balance of Payments Data.

The speed with which wholesale cross-border portfolio holdings can be shifted from country to country, asset to asset, and currency to currency is what generates the risks associated with open capital markets. As has already been pointed out, Chinese capital controls are far from being completely watertight, and there is substantial correlation between surges in measured capital flows and the residual. However, the

⁵² In particular, it is striking how large the outflows in 1997-2000 were when, as noted by Ariyoshi et al. 2000, the Chinese authorities acted "to intensify the enforcement of the existing controls during the second half of 1998. Administrative screening of capital account transactions was enhanced and documentation and verification requirements for current international transactions were tightened."

potential scale and speed of capital flows in a completely liberalized environment is an order of magnitude higher, in particular, when international portfolio managers are able to sell – or to borrow and then sell – Chinese financial assets in unlimited quantities.

Opening up the capital account would also expose banks to the risk of a systemic outflow of funds. Allowing Chinese residents to hold investments abroad could undermine the banks' deposit base. This is likely to happen in any case already non-bank financial service providers begin to offer more attractive savings media and if the domestic savings ratio drifts down as it is likely to do in the years ahead. Moreover, the access that overseas' banks will have to the domestic market by the end of 2006 could further undermine the deposit base of Chinese Banks. This will place liquidity pressure on the banks, and force them to slow credit growth. In turn will reveal whether borrowers are really in a position to repay their existing loans.

With an open capital account, there could conceivably be a sudden outflow of deposits, if depositors get worried about the liquidity position of the banks, and consequently access to their funds. This is a remote possibility, but given the repeated statements of concern from official and informed circles during recent years on the financial soundness of the banks, it cannot be ruled out. Despite transfer of non-performing assets to AMC's and recapitalization of the banks, as well as efforts to improve the governance and the risk management of the major banks, concerns over the soundness of the banks remain. Were depositors to reappraise the financial soundness of the banks, and perceive a risk to immediate access to their funds, they might, if permitted, choose to switch their deposits offshore. While foreign exchange reserves are large, they still cover only a little over 10 percent of bank deposits an outflow of deposits could therefore erode the reserves sharply.⁵³ Such an outflow might be facilitated by liberalization of exchange controls, though it could also happen as an evasion of such controls. Serious as it would be, this has to be considered an unlikely scenario, considering the expectation that the Chinese government would stand behind these large

⁵³ Crisis-related outflows twice exceeded 20 percent of bank deposits in Argentina since 1994.

banks. This expectation will be strengthened once the announced deposit insurance scheme is put on a solid basis, and implemented.

The more immediate threat to the banks would come from their lack of experience in dealing with foreign exchange fluctuations and with the complex financial instruments that can be associated with international financial transactions. This was a problem in Mexico in 1994, when the banks bought complex derivative instruments from the New York market with a view to reducing their funding costs, but which left them extremely vulnerable to changes in the exchange rate peg (Garber, 1996). Chinese banks could make similar mistakes in the early years of liberalized capital movements. The prudential regulators would need to monitor the banks' risks management capacity in this regard, and impose rigorous controls on banks' behavior, even as the overall exchange controls were being relaxed. It will be impossible for official regulatory agencies to monitor such risks on a transaction-by-transaction basis.

The crisis in the 1990 in countries around the world shows there are indeed considerable risks to opening up financially. Countries as diverse as Mexico, Indonesia, Russia, Brazil, and Argentina suffered from large financial disturbances and sometimes financial crisis caused at least in part by capital flows. Other countries, including industrialized countries such as the USA, Sweden and Norway, suffered banking crisis as well because of domestic financial reforms.

The crises of the 1990s and the systemic issue of asymmetric information emphasize the importance of careful design and sequencing of reforms in opening up financially. At the same time, whether countries deliberately choose for opening up or not, it should be noted that opening up for trade opens up an economy financially to some extent as well. Trade financing and invoicing offers ample opportunity to move capital into and out of a country, even if the authorities formally control capital flows. The recent balance of payment numbers show some evidence of that happening in China as well. Moreover, countries such as Chile have experienced that the effectiveness of capital controls to limit the type of capital flows coming into the country is eroded over time. This de-facto

financial opening of countries that pursue trade integration reinforces the need for strong supporting policies.

How should the long-term benefits be assessed against the risks? Reflecting the importance of both the benefits and the risks, cross-country econometric evidence on the relationship between the removal of capital controls on portfolio flows and economic growth has been generally inconclusive. This does not mean that there is no positive effect, but more likely that the effects depend decisively on the accompanying policies and the environment within which capital account liberalization is conducted.⁵⁴

The alert manner in which international portfolio managers watch for any indication that their interests might be damaged by emerging developments including policy actions can be thought of as inducing a valuable discipline on fiscal and macroeconomic policy, preventing poor policies from becoming entrenched. For example, the balance of payments and exchange rate crisis suffered by France in 1983 is often pointed to as having resulted in a sweeping reform of macroeconomic policies which set the French economy on a growth path for the following decade.

However, portfolio managers are not omniscient; they can overreact to news and, follow fads with a herd-instinct.⁵⁵ This is a negative aspect of the open market which is a price that advanced economies are willing to pay because of the long-term benefits already discussed.

Nevertheless, the balance has tilted in recent years against the maintenance of tight controls on portfolio capital flows. This is because communications technology and the

⁵⁴ As shown on the basis of cross-country data by, for example, Eichengreen and Leblang (2003), while capital controls have inhibited growth-generating finance in stable times, they may also have protected against crises making the net effect hard to detect.

⁵⁵ This is reinforced by the manner in which fund managers are generally assessed on the basis of their deviation from average market performance. Following the herd may not generate a large profit for the fund, but it is usually helps to avoid large losses.

increasing sophistication of financial intermediaries have made it increasingly easy to evade such controls.⁵⁶ Increased globalization of non-financial economic activities – specifically the huge growth in trade (the sum of imports plus exports of China now exceeds US\$1.1 trillion, or about 70 percent of GDP) – has also brought with it enhanced opportunities for exploiting working balances and trade credit of non-financial corporations to effect what are capital flows in all but name. Thus the effectiveness of controls in insulating the economy from externally induced shocks is reduced.

A further and strong argument against maintaining tight discretionary controls relates to the rising administrative cost and lack of effectiveness. As is evidenced from the experience of many countries, the effectiveness of capital control tends to fall when a country is increasingly integrated with the world economy after trade and financial liberalization.

For these reasons, it is appropriate to gradually allow a further liberalization of non-FDI capital flows, both inward and outward, and applying both to residents and non-residents. As they cross the river from tight control to a more sustainable liberalized regime, though, the authorities will have to avoid the unstable stepping stones that could tilt over and cause an unfortunate wetting! Awareness of the risks will help determine the overall design, timing and sequencing of the liberalization process.

7.2 Proposed China strategy: avoiding the hazards

The planned shift to a more flexible exchange rate regime – not a focus of this chapter – will likely have a very large impact on the scale and even direction of non-FDI capital flows and policy planning needs to take this likely future environment into account.

⁵⁶ The way in which the net foreign currency liability of Chinese banks to residents has changed in response to interest differentials and to speculation over the RMB exchange rate peg is an illustration of one, perfectly legal, mechanism for nullifying the impact of the capital controls.

It becomes ever more important to ensure that macroeconomic management and the risk management capacity of domestic firms, especially banks and other financial firms are highly effective.

Box 7.1 Capital flows and the exchange rate peg

Maintaining a fixed exchange rate peg is made more difficult by the removal of capital controls, not least because the flood of speculative money against a peg that has lost its credibility can become irresistible. But even when the peg is fully credible, another problem often emerges, one that is important in the current Chinese context. This is when domestic demand management calls for monetary restraint: any attempt by the monetary authority to restrain demand through an increase in money market interest rates will, in the presence of a fixed exchange rate peg, encourage capital inflows to benefit from the higher yields, thereby thwarting the policy of restraint and tending to add to domestic overheating and excessive leverage. These are the most important reasons why most economists argue that full liberalization of the capital account should await the introduction of a flexible exchange rate regime (cf. Prasad, Rumbaugh and Wang, 2004).

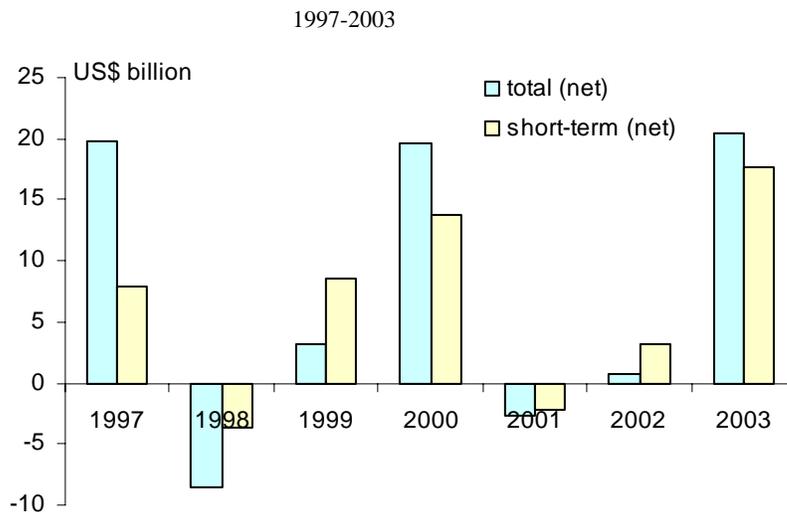
Partial liberalization brings its own risks. Adopting the wrong sequence of liberalization can result in a most unbalanced financial structure with considerable hidden risks.¹ And as the liberalization begins, market participants' behavior can be distorted by the anticipation of further liberalization. To illustrate, the sequencing of Korea's financial liberalization in the years before the crisis of 1997 is now recognized to have been flawed in three different ways: it encouraged too much reliance on short-term bill financing and short-term external borrowing, leading to highly fragile financial structures; it facilitated the emergence and rapid growth of lightly regulated trust subsidiaries of the banks, effectively shifting much of the growth in the system outside the purview of the main prudential regulators; and it failed to develop the institutions of the long-term capital market (cf. World Bank, 2001, p. 181-2; Cho, 2001).

In this respect the most obvious goal for the authorities is to help ensure that Chinese companies (and individuals) do not choose excessively leveraged positions in the newly

liberalized environment. This will be especially important in the early years, when risk management capacity and the understanding of financial instrument risks are insufficient.

So far, the policy statements on the course to be pursued have reflected a sound understanding of the risks. The emphasis on liberalizing long-term flows before short-term is appropriate, even if the data indicate that this has been of limited success so far (Figure 7.3). The decision to restrict elements of the opening at first to a limited group of pre-qualified institutional investors, both for inflows and outflows, building on the experience of some other East Asian economies, seems to offer a useful platform for experimentation, but one which will not prove desirable for the long-run.

Figure 7.3 China: Flow of Total and Short-term Liabilities, \$ billion



Source: the World Bank, DDP

Firms and financial intermediaries will not immediately have the necessary capabilities to appreciate and manage the risks that can be associated with greater openness to global finance, including unwise ventures into complex financial derivatives.⁵⁷ Finding the middle course between outright prohibition (which may be evaded) and a free-for-all (exposed to collapses) will not be easy. A style of “incentive

⁵⁷ The risks of which were evidenced in the example of China Aviation Oil, Singapore in 2004.

compatible” policy design, which exploits market participants’ own incentives⁵⁸ and nudges them in a socially desirable direction rather than trying to force them where they do not want to go, is the goal of the most sophisticated policy regimes in this field.

To ensure that a partially dismantled, but still opaque, structure of controls does not create perverse incentives for risky financial engineering as well as corruption in administration, there is much to be said for simplifying the controls, streamlining their administration and shifting from an elaborate and detailed pre-approval system to a mechanism of delegated authorities together with reporting, spot checks and penalties for violations.

Adding flexible tax-like administrative measures to discourage very short-term speculative flows, as was implemented for many years in Chile, is considered by some to be useful and not very costly, though the Chilean experience was not overwhelmingly successful, with researchers (including from the Central Bank of Chile) concluding that the effect was more on the composition of inflows than on their total volume (De Gregorio et al. 2000).

In the wake of recent international financial crises, attention has focused on this issue of information and transparency. The adoption and implementation of internationally-recognized standards and codes of good practice reflects this attention. The increased transparency in economic and financial affairs that these codes require is a tool to reduce the risk of future crises. These standards and codes can help countries to conduct their economic and financial affairs in prudent and transparent ways, so that the international financial system will be more stable and less prone to crises. Much of the work has been done at the International Monetary Fund and the World Bank. This has included a joint program of Reports on the Observance of Standards and Codes (ROSC) in individual countries. These cover a set of eleven standards in the areas of responsibility of the two institutions, including accounting and audit, financial sector,

⁵⁸ Including the incentive to monitor other market participants’ risk-taking.

debt management, and the like. ROSCs point to ways in which countries can strengthen their existing systems, which the Fund and the World Bank can help them do. Also, when ROSCs are published, they can help potential investors to better evaluate the investment climate. In both these ways, the standards and codes initiative can contribute to crisis prevention.

Opening up of the capital account requires the revamping of macroeconomic policies. With financial opening up, monetary and fiscal policies will have to shoulder more responsibility for maintaining macroeconomic stability. Moreover, exposure to international flows may increase to some extent macroeconomic fluctuations that needs to be managed by the macroeconomic policy makers. Countries have therefore pursued a wide variety of fiscal reforms to flank financial opening up, including improving the coverage of their fiscal accounts, improving their tax base, and strengthening their debt management. And countries have improved their tools for monetary policy by moving to objectives better suited for financially more open economies, by adopting instruments of monetary policy better suited to the new environment, and by reconsidering their exchange rate system to make these policies more effective.

Allowing foreigners access to China's financial intermediaries and markets

Two intermediate aspects in capital account opening relate to how much freedom should be granted to local financial intermediaries to lend to foreign entities seeking to operate in China, and how much freedom to foreign issuers of securities to list on China's securities markets. The issue is relevant because, as noted before, the considerable capital inflows that China currently enjoys are increasingly problematic for monetary policy. This section looks into options for liberalizing the domestic capital market for foreigners so as to reduce these inflows.

FDI into a countries need not be associated with very substantial net capital inflows.

If the investment can be funded from retained profits, or when the foreign investor can secure finance on the domestic capital market, associated capital inflows can be small.

Even without net inflow FDI can bring benefits to the host country in terms of product and process technology, management skills and market access. A country with a saving ratio as high as China is certainly not looking to FDI as a source of balance of payments support. From the point of view of macroeconomic balance, therefore, providing local financial facilities in support of inward FDI would be desirable. It would evidently be important to ensure that liberalization of this dimension was not abused as a loophole to get around the other controls.

The floating of bonds by top-rated issuers on the Chinese market, as to be piloted by the International Finance Corporation, the Asian Development Bank, and others, can help develop market skills and absorb some of the excess liquidity in the market. This is only the beginning of a process in which, as capital controls are progressively liberalized, it will become natural for banks and other financial intermediaries to undertake transactions which involve lending RMB to nonresidents who do not have an FDI presence in China. Here the most obvious risk is that of the accumulation of RMB in foreigners' hands that might at some future date prove to be hot money that could be used to speculate *against* the RMB.⁵⁹ Eventually, this is a risk that will have to be accepted as part of the liberalization process. Another risk is that the Chinese lender might not have sufficient information about the creditworthiness of the foreign counterpart. However, this latter risk is one which would be a matter for the capital markets regulators rather than for the foreign exchange control authorities. Indeed, the existence of prudential supervision is a reason why a somewhat more rapid liberalization of exchange controls in this dimension might be envisaged.

⁵⁹ This would not arise to the extent that bond issuers intend immediately to convert the proceeds of their bond issues into US dollars by selling the proceeds to Chinese banks.

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Annex I. Approval Procedures for Setting Up a Foreign Funded Enterprise

No.	Procedures	Qualification	Approval Department	Duration of Approval
1	Project Consultation (optional) /a		Project approval departments	
2	Location and Planning		Planning department	20 working days
3	Preliminary Approval of Land Use		Land resource administration	20 working days
4	Evaluation of Environmental Impact		Environmental protection departments	15-60 working days
5	Preliminary Check and Registration of Enterprise Name		Enterprise name registration departments (Industrial and Commercial Administration)	10 working days
6	Fixed investment project Approval and Filing	Projects in encouraged and allowed industries with more than USD500 million of investment. Projects in restricted industries with more than USD100 million of investment. /b	State Council	20-30 working days
		Projects in encouraged and allowed industries with more than USD100 million of investment. Projects in restricted industries with more than USD50 million of investment. /b	National Development and Reform Commission	
		Projects in restricted industries with less than USD50 million of investment./b	Provincial-level Development and Reform Commission	
		Projects in encouraged and allowed industries with less than USD100 million of investment./b	Local Development and Reform Commissions	

No.	Procedures	Qualification	Approval Department	Duration of Approval
7	Preliminary Approval from specialized departments		Planning, construction, land resource, public security, environmental protection, fire control, culture, real estate, and civil defense administrative departments as well as industry administrative departments.	
8	Enterprise Contract and Articles of Association, Approval from Board of Directors	Enterprises in encouraged and allowed industries with more than USD100 million of investment. Enterprises in restricted industries with more than USD50 million of investment./b	Ministry of Commerce	Three months
			Local commerce departments	Three months
9	Applying for Enterprise Legal Person Code		Enterprise code administration departments (Technical supervision departments)	
10	Applying for Enterprise Approval Certificate		Local commerce departments	
11	Industry and Commerce Registration		State Administration of Industry and Commerce	30 days
12	Official Seal to Be Made		Public security departments	
13	Filing of Business License		Local commerce departments	
14	Final Approval from designated departments		Industry administrative departments or other relevant designated departments	

15	Registration of Enterprise Legal Person Code		Enterprise code administration departments (Technical Supervision Administration)	
16	Foreign Currency Registration		State Administration of Foreign Exchange	
17	Verification of Registered Capital		Accounting firms	
18	Registrations for statistics, state taxation, local taxation, Customs, finance and social security. Collect formal business license.		All relevant departments	

a/ Because of the complication of the approval procedures, some cities like Ningbo add this procedure with an aim to provide investors with advice on the setup.

b/ NDRC distinguishes the project according to the Industrial Guidance for FDI, while MOFCOM applies the national industrial policy. The Industrial Guidance for FDI is generally consistent with the national industrial policy, but there are some exceptions. For instance, investment in steel plant is specified as being encouraged in the Industrial Guidance for FDI, but as being restricted according to national industrial policy.

Annex 2. Comparison of Investment Climate in 23 Cities

<i>City</i>	<i>Infra- structure</i>	<i>Entry-Exit</i>	<i>Labor market flexibility</i>	<i>Skill- technician</i>	<i>Inter- gration</i>	<i>Private sector</i>	<i>Informal Pay.</i>	<i>Court Time</i>	<i>Tax rate</i>	<i>Finance</i>
East coastal Region										
Guangzhou	B-	B+	B	A	A+	C	B+	A+	A+	B+
Hangzhou	A	A+	A	A+	B+	B	A+	B	A	A
Jiangmen	B	B	A	B-	B+	B	A	A	A	A
Shanghai	A	A+	B-	A+	A+	C	A	A+	A+	A
Shenzhen	B-	B+	A	B	B+	B-	B-	A+	A+	B-
Wenzhou	C	B	A	B	B-	A+	C	B	B	A
North coastal										
Beijing	B-	A	B-	B+	A	C	B+	A+	B	B
Dalian	A+	B	A	B	B+	B-	A	A+	B	B
Tianjin	B+	B+	B-	B	A	C	B	C	B+	B-
Western Region										
Chengdu	C	B+	B-	B+	B	B	B	A	B+	B
Chongqing	A	B+	B	A	B+	B	B	A	B+	B+
Guiyang	C	B-	B	B-	B-	B	B+	C	C	B-
Kunming	C	B-	B	C	B-	B	B+	B	B	B-
Lanzhou	A	C	B+	C	B-	B	B-	B	C	C
Nanning	B	C	B+	B-	B-	B+	A	B	C	C
Xi'an	B+	B	B	A	B	B	C	B	B-	B
Central Region										
Changsha	B-	B	B	B	B	B+	B-	B	B+	B-
Nanchang	B-	B	B+	B+	B	B+	B	A	B+	C

Wuhan	B	A	B	B+	B	B+	B+	C	B+	C
Zhengzhou	B	B	B+	B	B-	A	A	B	A	C
North-east Region										
Benxi	A	C	B	C	B-	B	B	A	C	C
Changchun	A	A	B	B+	B+	B	B+	B+	B	B
Ha'erbin	B+	B-	B	B	B	B	B-	C	B-	B-

Note: Court time and tax rate are not available for the five cities in the first IC survey. In general we give them the score with the city that has the closest income with two exceptions: Guangzhou is given the score of the average between Jiangmen and Shenzhen, the other two Guangdong provinces; Chengdu is given the score of the Chongqing, the other city that was originally part of Sichuan province. Beijing is given the score of Dalian, Tianjin is given the score of Wuhan, Shanghai is given the score of Guangzhou

Annex 3: Benefit-cost ratio for various tax incentive instruments

(Additional Investment per Unit of Foregone Revenues by the Treasury)

Tax incentive	Country	Short Run	Intermediate Run	Long Run
Corporate Tax Rate Reductions	Mexico: Detergents	0.03	0.04	0.05
	Other Chemicals	0.01	0.01	0.01
	Pakistan: Apparel	0.00	0.00	0.00
	Leather	0.00	0.00	0.00
	Cumulative			0.71
	Turkey: Electrical Machinery	0.20	0.21	0.28
Transport Equipment	0.03	0.06	0.10	
Accelerated Depreciation	Mexico: Detergents	0.32	0.38	0.40
	Other Chemicals	0.19	0.24	0.25
	Pakistan : Apparel	0.23	0.59	2.10
	Leather	0.09	0.23	2.13
	Turkey: Electrical Machinery	0.38	0.68	1.45
	Transport Equipment	0.94	1.44	2.25
Investment Tax Credit	Mexico: Detergents	0.44	0.51	0.54
	Other Chemicals	0.26	0.32	0.34
	Pakistan: Apparel	0.28	0.71	2.50
	Leather	0.11	0.28	2.54
	Cumulative			0.95
Investment Tax Allowance	Turkey : Electrical Machinery	0.40	0.72	1.54
	Transport Equipment	1.00	1.54	2.40
	Industrial chemicals			0.25
	Petroleum Derivatives			0.95
R&D Tax Credit	Canada			1.80
R&D Tax Allowance	Pakistan: Chemicals			1.38
	Pharmaceuticals			0.24
	Turkey⁴: Industrial chemicals			0.13
	Petroleum Derivatives			0.26
Expensing of Investment	Pakistan			1.49

Source: World Bank (1995). *Fiscal Incentives for Investment and Innovation*. Oxford University Press.

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