

# **The Role of the State in Foreign Direct Investment Regulation in China**

## **O Papel do Estado na Regulação do Investimento Direto no País na China**

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### **Resumo**

Este artigo pretende corroborar o argumento defendido por economistas heterodoxos como Akyüz, Chang e Furtado de que a regulação estatal é fundamental para extrair eventuais benefícios dos investimentos diretos no país (IDP). Fazemos isso analisando as políticas usadas pela China desde sua abertura para este tipo de investimento em 1979. O artigo inova ao examinar as principais leis, regulamentos e catálogos de orientação do IDP na China que forneceram a estrutura formal sob a qual empresas estrangeiras operaram no país por quase 40 anos. Em seguida, confrontamos a visão tradicional de que a China se desenvolveu simplesmente porque abriu cada vez mais seu mercado e adotou um modelo de crescimento puxado pelo investimento estrangeiro. E argumentamos que foi por causa da forte regulação que o IDP teve de fato um efeito positivo, contribuindo para a transferência de tecnologia e a expansão do comércio – sem, no entanto, definir a taxa de acumulação de capital.

Palavras-chave: investimento direto no país, regulação, China

### **Abstract**

This article intends to corroborate the argument advocated by heterodox economists such as Akyüz, Chang and Furtado that state regulation is crucial to extracting the possible benefits of foreign direct investment (FDI). We do so by analyzing the policies used by China since its opening to this type of investment in 1979. The article innovates by scrutinizing China's major FDI laws, regulations and guidelines that compose the formal framework under which foreign-owned enterprises have operated in the country for almost 40 years. We then address the traditional view that China developed simply because it increasingly opened its market to foreign investment and adopted a foreign investment-led growth model. We argue that it was because of this strong regulation that FDI had such a positive effect, contributing to technological transfer and trade expansion, although not defining the ratio of capital accumulation.

Keywords: foreign direct investment, regulation, China

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## Introduction

Foreign direct investment (FDI) is generally perceived as intrinsically beneficial to the host country according to mainstream economics. Much is said about increased domestic investment, technology transfer and access to global markets. However, not only are these benefits not automatic, FDI is also accompanied by potential problems, which gives host country policies a crucial role in extracting their positive impacts.

Examining the history of the main developed countries shows that when they were in their initial stage of development, control policies on foreign investments were systematically adopted in order to promote domestic industry. Chang (2004) analyzed the cases of United States, United Kingdom, France, Germany, Finland, Ireland, Japan, Korea and Taiwan, and showed that the varied set of instruments used to regulate foreign investment included limits on ownership; requirements on exports, transfer of technology and/or local content; insistence on the formation of joint ventures with local firms; and barriers to mergers and acquisitions. All these countries followed a strategic approach to the regulation of foreign investment in order to align investors' interests with their national interests.

In this same line, Akyüz (2015a) sought to demystify several commonly associated qualities as intrinsic to FDI. He argued that the emerging countries that were most successful in their relationship with FDI were not those that attracted the greatest volume, but those that knew how to use it in the context of a national industrial policy. As Furtado (1962) put it, there is a need for a disciplinary entry policy for foreign capital, subordinating it to the national objectives of economic development and political independence.

In this context, in this article we intend to corroborate the argument put forward by heterodox economists such as Chang, Akyüz and Furtado that state regulation is crucial to extracting the possible benefits of FDI. We do so by analyzing the policies used by China since its opening to this type of investment in 1979. We scrutinize China's major FDI laws, regulations and guidelines (set out in a "guiding catalogue") that have established the formal framework under which foreign-owned enterprises have operated in China for almost 40 years (our last document analyzed is from 2017). We then confront the traditional view that China developed simply because it increasingly opened its market to foreign investment (Tseng and Zegrebs, 2002), and argue that it was because of such regulation that FDI had positive effects, contributing to technological progress and trade expansion.

Before entering the core of this article, it is essential to make two observations. First of all, Chinese FDI rules were not adopted in isolation, instead having been inserted in a larger context of macroeconomic and industrial policies subordinated to the economic development strategy, such as fixed or highly controlled exchange rates (always favorable to exports), control over the capital account, low interest rates, subsidized public credit for national companies and tax incentives, among many others. Therefore, the impressive results achieved by China in terms of economic and industrial development are the result of a whole set of policies, instruments and regulations, including the regulation of FDI that we analyze here.

Second, China has never adopted a "foreign investment-led growth" strategy. FDI to finance external constraints was only used in the beginning of the reform period, notably in the 1980s since current account deficits only occurred in China's post-reform history in five years (1985, 1986, 1988, 1989 and 1993). And even then, maintaining a

fixed exchange rate in order to prevent the negative effects of overvaluation of the local currency. After that, China adopted a policy aiming at strong current account surpluses, thus avoiding the dependence on foreign capital to finance itself.

This is to say that FDI has never defined the rate of capital accumulation in China. With an amazingly high investment rate over 40% of GDP for three decades, it has sustained the highest investment rate of any other major economy in history, with a marginal role given to FDI. Indeed, China has financed its development with current account surpluses, state-owned banks and local government financing vehicles. The sources of such economic development can be found at a complex set of national developmental policies (see Medeiros, forthcoming, and Nogueira, 2021, for reviews), with FDI playing a specific (and highly regulated) role.

This paper is divided into three sections besides this introduction. In the first section, the problems and potential risks associated with FDI are discussed according to the heterodox approaches. In the second, the Chinese rules on FDI, specifically its laws, regulations and guidelines, are detailed. Finally, the third section brings an analysis of the policies' impact and concludes.

## **1. The Potential FDI Problems**

FDI flows can be divided into two types: those that aim at the domestic market and are mostly motivated by the size and growth of the host country; and those that are export oriented and look for cost competitiveness, especially wage costs. Although much is said about the potential benefits of FDI on capital accumulation, technological progress and growth, there is little discussion about its problems and potential risks, which tend to be very large if not neutralized through state regulation. Indeed, Akyüz (2015a) pointed out that a very liberal policy on FDI can have more negative than positive effects.

The first problem of FDI is the generally negative contribution to the balance of payments in the long run. Many developing countries with chronic current account deficits resort to FDI as a source of external financing that is preferable to borrowing. The rationale is that direct investments will not generate fixed payment obligations. However, FDI can result in remittances abroad - which include profits, royalties, license fees, wages and interest paid on loans from parent companies - that can put pressure on the balance of payments in the same way as the payment of debts (Akyüz, 2015a).

Foreign companies focused on the domestic market, which export little or nothing, have a negative impact due to profit remittances. Foreign-oriented firms can also have a negative impact because they are often more import-intensive than local firms. Thus, the revenue generated by their exports may not be sufficient to cover the imports plus the FDI-related income remittances abroad (Akyüz, 2015a).

Even in countries with a strong presence of export-oriented FDI, such as China, the contribution of foreign firms to the balance of payments has been negative. Akyüz (2015a) presented data on the foreign companies in that country from 2000 to 2013 and showed that, given the increasing income remittances on FDI stock, from 2010 to 2013 the contribution of these companies was negative, despite the improvement in their trade balance. It was the local firms with their strong export performance that covered the increasing remittances on the FDI stock, guaranteeing the surplus in the Chinese current account.

Against this backdrop, many countries have resorted to export requirements and the balance between revenues and expenses in foreign currency. Another way to increase the contribution of foreign firms to the balance of payments is to reduce the import content of their production, i.e., to replace imports, which would mean going up in the value chains and starting to produce domestically high-value parts and components that were previously imported (Akyüz, 2015a). In addition, the externalities and positive spillovers of FDI to the rest of the economy should be stimulated in order to offset the costs generated by its negative impact on the balance of payments. Otherwise, it may be more advantageous to borrow abroad and carry out the same investment domestically (Akyüz, 2015a).

Second, many investments by foreign companies may not contribute to the domestic investment expansion by adding to the productive capacity of the host country and ultimately causing growth. Mergers and acquisitions of domestic firms by foreign companies, also called brownfield investments, consist of the transfer of ownership of existing firms. Only greenfield investments, i.e., when the investor builds its facilities from the ground up, and those that promote expansion of the capacity of existing firms make this type of contribution (Akyüz, 2015a).

Even so, these investments that add to the productive capacity can crowd out domestic investors, thus not contributing to increase the aggregate investment. The competitive advantage of transnational corporations with their financial and technological strength can damage local firms and suppress domestic investment. For this reason, deliberate and careful policy design is needed to prevent the adverse effects of transnational corporations and to promote positive spillovers for local firms (Akyüz, 2015a).

Additionally, the inflow of FDI, like any other inflow of foreign capital, may have a negative impact on domestic investment through the appreciation of the real exchange rate (Bresser-Pereira & Gala, 2007). To avoid this problem, many countries resort to a policy of exchange rate management, aiming to achieve current account surpluses. Thus, the widely proposed association of foreign investments, domestic investment and growth is not at all straightforward and will likely not materialize without strong government regulation.

Third, foreign firms may resist transferring their technological and managerial knowledge, since this is part of their competitive advantage. These companies invest in emerging countries to exploit their competitive advantages such as abundance of natural resources, cheap labor and infrastructure services, not to make them advance technologically (Akyüz, 2015b).

In this context, technological and management skill spillovers to local firms are not automatic, instead needing to be extracted via interventions. Learning by local firms is facilitated when foreign firms establish upstream and downstream relationships with them, rather than establishing relationships with firms abroad. Foreign firms can also have a major impact on the industrial structure when they invest in high-technology industries or bring some of their R & D activities to recipient countries (Akyüz, 2015a). Thereby, requirements for local content and for technology transfer, and encouragement of joint ventures, are ways of ensuring the direct transfer or indirect spillovers of advanced technologies and management skills to local firms (Chang, 2004).

In the absence of these regulations, the integration of developing countries in global value chains may be restricted to low value-added activities. Two successful examples are the cases of South Korea and Taiwan, which during their catching up process adopt-

ed fairly restrictive stances on FDI, having used local content requirements extensively not only for balance of payments issues but also to promote relationships with domestic suppliers. On the other hand, Malaysia and Thailand followed a liberal approach to FDI, and despite their initial success in attracting assembly industries, failed to develop a diversified industrial base and reduce their dependence on imported capital and intermediate goods (Akyüz, 2015a).

Fourth, FDI contains speculative elements that can create financial instability, which requires control and management as does any form of international capital flow. In particular, FDI in the banking sector tends to contribute to the growth of financial fragility and the transmission of shocks originating in the home countries. In addition, real estate investments are usually motivated by speculative capital gains and are subject to bubble cycles (Akyüz, 2015a).

Finally, even when FDI generates growth, it may not promote the social development of a country. In these situations, the share of surplus retained domestically is extremely concentrated. One example is Mozambique, which despite having high growth rates and becoming one of the most attractive economies for FDI in sub-Saharan Africa, has been inefficient in reducing poverty and promoting economic and social development (Castel-Branco, 2014).

That country adopts a liberal stance on FDI, resulting in investment projects with low reinvestment rates, high profit remittances, low job creation, weak linkages with local industry, and low contribution to the public budget due to tax exemptions. Hence, there has been a trajectory of extractive growth led by the performance of foreign companies in the exploitation of natural resources (Nogueira et al, 2017). In such cases, the domestic content of production by foreign companies is mostly limited to labor and some intermediate inputs, so regulations on FDI are necessary to promote local processing in order to increase the domestic value added (Akyüz, 2015a).

Thus, the above observations strongly suggest that policy interventions are needed to restrain the adverse effects of FDI on balance of payments, domestic investment, industrial development, stability and social development, as well as to activate its positive effects. As Furtado has argued emphatically, developing countries “must have a legal status that disciplines the action of foreign capital, subordinating it to the goals of economic development and political independence” (Furtado, 1962, p. 32).

It is important to note that several studies have shown that FDI regulations have made a positive contribution to development goals without greatly harming the flow of investments (Akyüz, 2015a). Both the US at the beginning of the twentieth century and China in the twenty-first century were major recipients of foreign investment despite the severe regulations adopted, which shows that these are not the major determinants of the amount of foreign investment and contradicts the common argument that regulation reduces investment flows (Chang, 2004).

Another contested argument is that the regulation of foreign investment would harm the growth and development prospects of the economy. Given that many of today's developed countries have performed well despite adopting strict regulations on foreign investment, it can be concluded that a well-designed foreign investment regulation regime can help rather than hinder economic development (Chang, 2004). The case of China, considered at the next sections, corroborates this conclusion.

## 2. The Chinese Experience in FDI Regulation

The presence of foreign capital in China has always been a rather delicate subject due to the period of submission to world powers that lasted from the end of the Opium War in 1842, passing through Western and Japanese occupation, and ending with the victory of the Communist Revolution in 1949. After Mao Zedong's death, the Communist Party leadership adopted a pragmatic modernization project aimed at making China a leader among the industrialized countries. Based on this objective, the acquisition of foreign technology was crucial.

In this context, the Chinese opening to foreign investment began in 1979 with the approval of the *Law on Joint Ventures using Chinese and Foreign Investment*. Under this law, in order for foreign investment to take place, the investor must associate with a Chinese counterpart in the form of a joint venture. This type of arrangement implies joint assets, joint management and profits and losses proportionally to the share of capital of each party. From this law<sup>3</sup>, the most important sections are cited below (official translation, emphasis added).

**ARTICLE 1: With a view to expanding international economic cooperation and technological exchange**, the People's Republic of China permits foreign companies, enterprises, other economic entities or individuals (hereinafter referred to as foreign participants) to incorporate themselves, within the territory of the People's Republic of China, into joint ventures with Chinese companies, enterprises or other economic entities (hereinafter referred to as Chinese participants) on the principle of equality and mutual benefit and **subject to authorization by the Chinese government**.

ARTICLE 5: Each party to an equity joint venture may contribute cash, capital goods, industrial property rights, etc. as its investment in the venture.

**The technology or equipment contributed by any foreign participant as investment shall be truly advanced and appropriate to China's needs.** In cases of losses caused by deception through the intentional provision of outdated equipment or technology, compensation shall be paid for the losses. (...)

ARTICLE 6: A joint venture shall have a Board of Directors with a composition stipulated in the contracts and the articles of association after consultation between the parties to the venture, and each director shall be appointed or removed by his own side. **The Board of Directors shall have a Chairman appointed by the Chinese participant and one or two Vice Chairmen appointed by the foreign participant(s).** (...)

ARTICLE 7: (...) **A joint venture equipped with up-to-date technology by world standards may apply for a reduction of**

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<sup>3</sup> Adopted by the Second Session of the Fifth National People's Congress on July 1, 1979. Available at Salem (1981) and Shiao-Ming (1980).

**or exemption from income tax for the first two to three profit making years.**

**A foreign participant who re-invests any part of his share of the net profit within Chinese territory may apply for the restitution of a part of the income taxes paid.**

ARTICLE 9: **The production and business programs of a joint venture shall be filed with the authorities concerned and shall be implemented through business contracts.**

**In its purchase of required raw and semi-processed materials, fuels, auxiliary equipment, etc., a joint venture should give first priority to Chinese sources, but may also acquire them directly from the world market with its own foreign exchange funds.**

**A joint venture is encouraged to market its products outside China.** It may distribute its export products on foreign markets through direct channels or its associated agencies or China's foreign trade establishment. Its products may also be distributed on the Chinese market.

Article 1 makes clear that one of the objectives of the law is exchange of technology and that joint venture proposals must be approved by the government. Article 5 states that the technology provided by the foreign party as investment must be advanced, requiring compensation if this does not happen. Article 6 requires the chairman of the board of directors to be chosen by the Chinese party, while one or two vice-chairs should be appointed by the foreign party. Article 7 grants tax benefits to foreign companies that use up-to-date technology and also to those that reinvest part of their profits in Chinese territory. Article 9 states that the joint venture must submit its business and production programs to the concerned authorities; give priority to Chinese sources in the purchase of inputs, and in case of acquisition in the international market, use its own foreign currency funds and encourages production for export. Although this article also says that the products can be sold in the Chinese market, the regulations of this law introduced in 1983<sup>4</sup> determine that only products urgently needed or that would otherwise be imported can be sold in the domestic market. These regulations also provide a list of industries in which joint ventures would be permitted.

Also in 1979, four *Special Economic Zones* were set up in Shenzhen, Zhuhai, Xiamen and Shantou to attract foreign investment in export activities. These areas followed the pattern of the Export Processing Zones that spread throughout Asia during the 1970s, which sought to attract FDI by offering lower taxes, simplified administrative and customs procedures, and above all, tariff exemption for imported components and inputs. They offered a way to move toward export promotion while keeping the protection of domestic manufacturers (Naughton, 2007).

Given the successful experience of the *Special Economic Zones*, in 1984 fourteen cities along the coast were opened to foreign investment, in which *Economic and Technological Development Zones* were established, offering many of the benefits of special eco-

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<sup>4</sup> Article 61 of the *Regulations for the Implementation of the Chinese Foreign Equity Joint Ventures*.

conomic zones. As Naughton (2007) pointed out, one of the peculiarities of the Chinese relationship with FDI is the proliferation of special investment zones of different types, a strategy that allows for incremental progress within a rigid system. It is also important to note that initially FDI was concentrated in the eastern part of the country.

In 1986, there was permission for companies with 100% foreign capital, with the approval of the *Law on Foreign Capital Enterprises*<sup>5</sup>. Below we cite the most relevant articles (emphasis added).

**ARTICLE 3: Enterprises with foreign capital shall be established in such a manner as to help the development of China's national economy; they shall use advanced technology and equipment or market all or most of their products outside China.**

**Provisions shall be made by the State Council regarding the lines of business which the State forbids enterprises with foreign capital to engage in or on which it places certain restrictions.**

ARTICLE 15: Within the scope of the operations approved, enterprises with foreign capital may purchase, either in China or from the world market, raw and semi-processed materials, fuels and other materials they need. **When these materials are available from both sources on similar terms, first priority should be given to purchases in China.**

ARTICLE 18: (...) **Enterprises with foreign capital shall manage to balance their own foreign exchange receipts and payments.** If, with the approval of the competent authorities, the enterprises market their products in China and consequently experience an imbalance in foreign exchange, the said authorities shall help them correct the imbalance.

These articles are in line with those in the Joint Ventures Law. Article 3 states clearly that foreign companies must contribute to the development of China, determining that they shall either use advanced technology or produce mostly for export. In addition, the state would determine in which sectors these firms could operate. Article 15 says that they must prioritize the purchase of inputs in the Chinese market while article 18 requires them to maintain the balance between revenues and expenses in foreign currency. This last point means that if a firm wants to make a capital remittance out of China, it must use its own foreign currency funds.

In 1988, the *Law on Chinese-Foreign Contractual Joint Ventures* was approved. This type of arrangement, which was already adopted in practice even without being formal-

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<sup>5</sup> Prior to the adoption of this law, Special Economic Zone (SEZ) regulations allowed the operation of 100% foreign-owned companies, so there were already businesses of this type in the SEZs and in the 14 cities opened to foreign investment in 1984. However, as Powell (1987) pointed out, in general they were small-scale projects of the Chinese community overseas, with short business cycles, rapid returns and high profits, which are not the kind of investment desired by long-term planners.

ized, differs from the initial joint venture, called equity joint venture, by being more flexible. In this case, there is no need to form a joint legal entity, and the profit sharing does not have to be proportional to the contribution of each party to the project's capital and can be mutually agreed (Gelatt, 1989).

With this law, the three main legal entities by which foreign investors could invest in China - equity joint ventures, contractual joint ventures and wholly foreign owned companies - were defined. New arrangements for foreign investment were gradually allowed throughout the 1990s, such as limited liability companies with foreign investors and foreign-invested holding companies (Chen, 2011).

In 1990, an *Amendment to the Joint Ventures Law* was published abolishing the requirement that the joint venture's chairman must be appointed by the Chinese investors (Chen, 2011). According to the new version, when one of the parties appointed the chairperson, whether Chinese or foreign, the other would appoint the vice-chairperson<sup>6</sup>.

Also in 1990, the *Detailed Rules for the Implementation of the Law on Wholly Foreign-Owned Enterprises* were published, stipulating in article 3 that foreign companies operating in China must either adopt advanced technology or meet an export quota of at least 50% of the production, always maintaining a balance or surplus in their foreign currency transactions.

ARTICLE 3: A wholly foreign-owned enterprise to be established must be beneficial to the development of the Chinese national economy, be able to gain remarkable economic results and meet at least one of the following requirements:

(1) Adopting advanced technology and equipment which can help develop new products, save energy and raw materials, upgrade existing products and substitute importation;

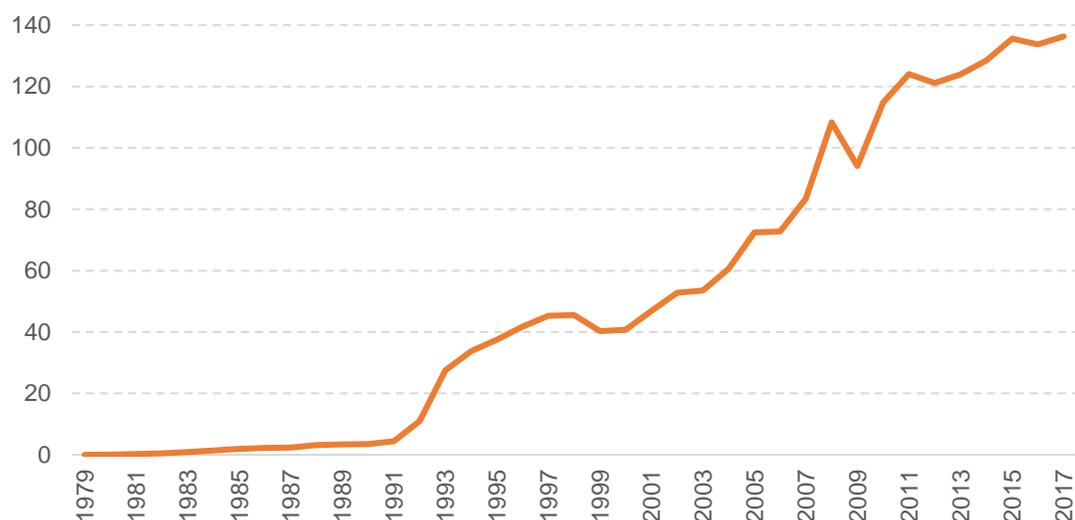
(2) The annual output value of the export products accounts for 50% or more of the total output value of all products of the year with a balance or surplus in the foreign exchange revenues and expenditures.

Starting in 1992, as shown in graph 1, there was a strong boom in the volume of FDI received by China that has continued in the ensuing years. In that year China began a process of selective opening of its domestic market to FDI, which until then was largely confined to the export industry. New sectors, especially real estate, were opened to foreign participation, and there was growing permission for industrial investors to sell their products in the domestic market. Thus, the great potential and rapid growth of the Chinese market started to have a direct role in attracting foreign investment. Additionally, Deng Xiaoping's statements in the famous "Southern tour" in 1992, during which he reaffirmed the agenda of reforms and opening of the Chinese economy, contributed to dispel the uncertainties caused by the Tiananmen Square episode (Naughton, 2018).

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<sup>6</sup> In this review, a provision was added protecting the investment from nationalization, which could only occur under special circumstances and with financial compensation.

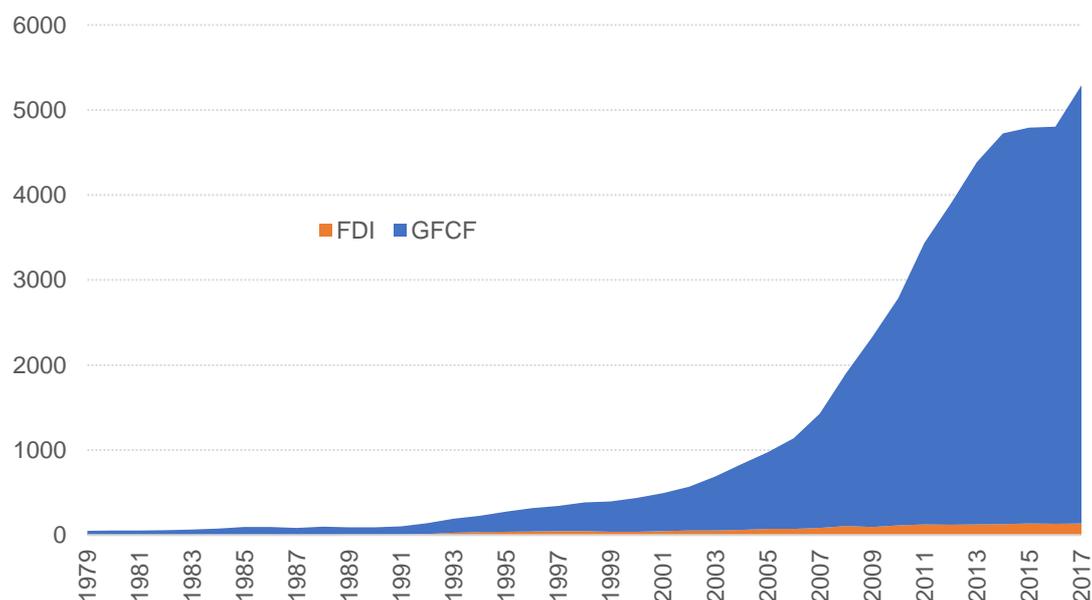
Graph 1: FDI Flows to China – 1979-2017 – US\$ billion



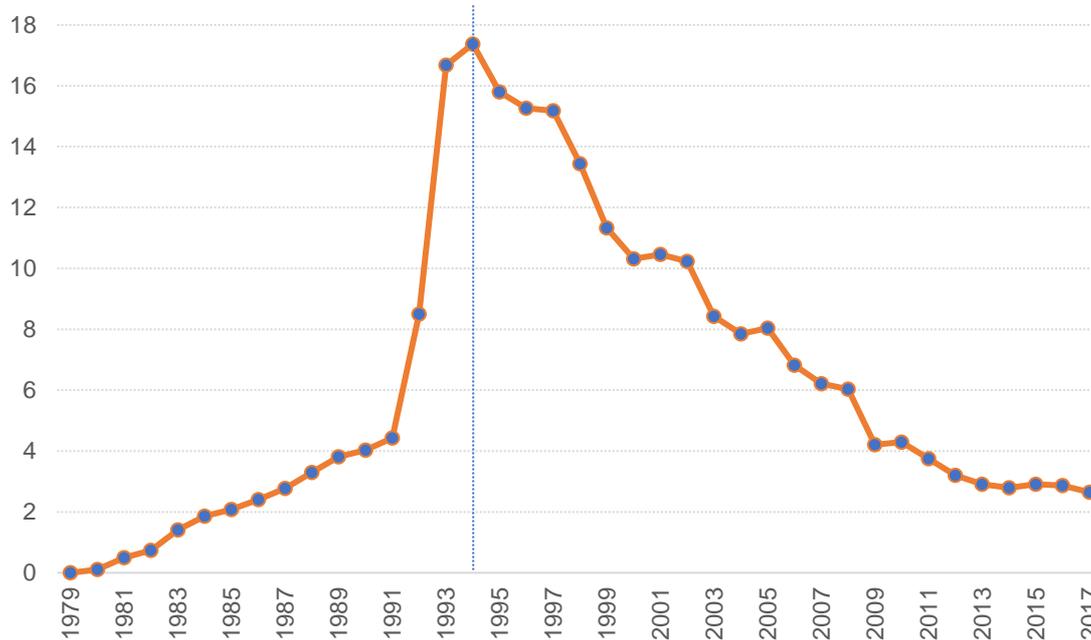
Source: UNCTAD

However, despite the sharp increase in FDI flows, in comparison with total gross fixed capital formation (GFCF) in China it corresponds only to a minor share, as shown in Graph 2. Indeed, when measured as a percentage of GFCF as in Graph 3, although increasing in absolute terms, FDI flows have been losing their relative importance in the last decades after reaching a peak of 17.4% in 1994. These data corroborate our argument that growth in China is not driven by foreign capital.

Graph 2: FDI and GFCF in China – 1979-2017 – US\$ billion



Graph 3: FDI Flow to China (%GFCF) – 1979-2017



Source: UNCTAD and World Bank

A distinguishing feature of the FDI entering China during the 1980s was the fact that most flows came not from developed countries but from other East Asian economies, especially Hong Kong and Taiwan, benefiting from the Chinese diaspora. If, on the one hand, these territories were often used as a gateway by Western investors, on the other hand there was also a significant proportion of Asian investors interested in entering China (Arrighi, 2007). Cultural and geographical proximity of these locations with China cause their investors to have lower transaction costs than investors from other countries, and low wage costs were an important factor of attraction. Hong Kong and Taiwan transferred labor-intensive export production to the mainland, creating production chains that allowed them to specialize, respectively, in high value services and technology-intensive production (Naughton, 2018).

In 1995, the State Council approved the *Provisional Regulations on Direction Guide to Foreign Investment* along with the *The Guiding Catalogue of Industries for Foreign Investment*. As stated in article 1 of the regulations below, the purpose was to channel FDI in accordance with China's national economic and development strategy. In the same direction, article 3 says that the catalogue will be regularly updated in accordance with the country's economic and technological development.

ARTICLE 1: The regulations have been formulated according to state laws and regulations on foreign investment and the country's industrial policy so as to give a guide to foreign investors in placing their investments in China to adapt to China's national economic and social development planning and to better protect the investors' legal rights.

ARTICLE 3: The State Planning Commission will regularly compile and update The Guiding Catalogue of Industries for Foreign Investment, which will be published after the approval of the State Council together with departments concerned of the State Council in accordance with this set of regulations and the situation of the country's economic and technological development.

Examination and approval of foreign-funded projects should be made in compliance with the Guiding Catalogue of Industries for Foreign Investment.

The investment catalogue classifies foreign funded projects as encouraged, restricted and prohibited, and determines not only the feasibility of the project, but also the level of foreign ownership allowed, the type of taxation and incentives available, and the complexity of the regulatory approval process. Most restricted projects require the formation of a joint venture, and in some cases foreign investors are only allowed to have a minority stake. The encouraged industries, in turn, have special incentives such as reduced tax rates but can also be subject to certain restrictions such as joint venture requirements.

In general, encouraged projects are those that introduce new and advanced technologies, expand export capacity, increase product quality, and use local resources in the central and western regions. Restricted and prohibited are those that, in certain sectors, use existing technology, compete with domestic firms or state monopolies, make intensive use of scarce resources or are considered dangerous to national security and the environment (Tseng & Zebregs, 2002).

In 2000, to meet WTO entry requirements, the Chinese government amended the *Foreign Capital Enterprise Law* and the *Contractual Joint Venture Law*, and in 2001 the *Equity Joint Venture Law*. Among the changes were the extinction of the requirements on foreign currency balance, local content, export quotas and business plan submission to government authorities (Chen, 2011).

Also to fulfill WTO requirements and as a step further in its opening strategy, a decree<sup>7</sup> in 2003 established the *Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* in order to regulate the purchase of Chinese companies by foreign investors, hitherto highly restricted. After a three-year trial period, six government agencies<sup>8</sup> promulgated in 2006 the *Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*<sup>9</sup>. According to article 4 of these regulations, the takeover of domestic enterprises must respect the restrictions imposed by the investment catalogue. Furthermore, article 12 adds a new screening requirement by saying that transactions that involve major industries, that have an impact on national economic

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<sup>7</sup> Jointly signed by the Ministry of Foreign Trade and Economic Cooperation, the State Administration of Taxation, the State Administration for Industry and Commerce, and the State Administration of Foreign Exchange.

<sup>8</sup> The Ministry of Commerce, State-owned Assets Supervision and Administration Commission of the State Council, State Administration of Taxation, State Administration for Industry and Commerce, China Securities Regulatory Commission and State Administration of Foreign Exchange.

<sup>9</sup> For the differences between the 2003 *Interim Provisions* and the 2006 *Regulations*, see OECD (2006).

security, or that result in the transfer of famous and traditional Chinese brands must be authorized by the government (Chen, 2011).

ARTICLE 4: To take over a domestic enterprise, a foreign investor shall satisfy the requirements of the laws, administrative regulations, and rules of China concerning the qualifications of investors, and shall comply with the policies on the industry, land, environmental protection, etc.

For the industries where solely foreign-owned operation is not permitted by the “Catalog of Industries for the Guidance of Foreign Investment”, the takeover shall not lead to the consequence of a foreign investor’s holding all the equity rights of the enterprise; for the industries where it is required for a Chinese party to control or relatively control the shares, the Chinese party shall, after an enterprise in such industries is taken over, still control or relatively control the shares of the enterprise; for the industries where foreign investors are prohibited from operation, no foreign investor shall take over any enterprise in such industries.

The business scope of any enterprise invested by the domestic enterprise prior to the takeover shall meet the requirements in the industrial policies on foreign investments. If it does not, adjustment shall be made.

ARTICLE 12: Where a foreign investor intends to obtain the actual controlling power of a domestic enterprise it plans to take over, and if any important industry is concerned, or if it has an impact on or may have an impact on the national economic security, or it will lead to the transfer of the actual controlling power of a domestic enterprise which holds a famous trademark or China Time-honored Brand, the parties concerned shall file an application with the MOFCOM.

Revisions to the investment catalogue were published in 1997, 2002, 2004, 2007, 2011, 2015, 2017, reflecting commitments related to China's accession to the WTO, and mainly the different stages of China’s economic development. Throughout the editions of the catalogue there is an increasing opening of sectors to foreign investment. However, the opening of the service sector has been particularly slow. In 2004, for example, sectors such as financial services, insurance, securitization, wholesale and retail sales, transportation, information and consulting services belonged to restricted or even prohibited categories.

The 2017 revision still classifies as highly restricted the investments in banking and securitization, healthcare and telecommunications. Restrictions in the rail transport equipment and motorcycle manufacturing sectors, which are already dominated by domestic Chinese companies, have been relaxed (Koty & Qian, 2017). In this sense, the requirement for the formation of a joint venture with a Chinese partner with at least 50% ownership, which still holds for automobile manufacturing, was abolished in the motorcycle sector, allowing production by wholly foreign-owned enterprises. On the

other hand, foreign investment in fields such as internet publishing and online media was moved to the prohibited category.

### 3. Analysis and Conclusion

In 1979, China began a process of opening to foreign investment in a controlled and gradual way, always seeking to conform FDI to its national development strategy. Openness to FDI was seen as a means to an end, which included the building of a strong Chinese economy with strong Chinese firms, rather than a local economy dominated by foreign firms (Enright, 2017). Toward this objective, a series of control measures on FDI were adopted, including the need for government approval; regional allocation in special economic zones; requirements on joint venture formation, technology transfer, local content, export performance, and equilibrium in the balance of foreign currency; and sectoral allocation with sectors where foreign participation was forbidden or limited, as we have just shown<sup>10</sup>. As Shutte and Reis put it, Chinese growth “was not the result of a simple opening up of its markets to capital influx, but of a careful state guidance of market mechanisms aiming at the objectives that were posed right in the beginning of the opening up process” (Schutte and Reis, 2020, p. 80).

The regulations analyzed in this article and implemented by the Chinese state to manage FDI in favor of national development goals are summarized in the table below.

Table 1: Chinese Regulation of FDI

<b>Regulation</b>	<b>Year</b>
Law on Joint Ventures using Chinese and Foreign Investment	1979
Regulations for the Implementation of the Chinese Foreign Equity Joint Ventures	1983
Law on Foreign Capital Enterprises	1986
Law on Chinese-Foreign Contractual Joint Ventures	1988
Amendment to the Joint Ventures Law from 1979	1990
Detailed Rules for the Implementation of the Law on Wholly Foreign-Owned Enterprises	1990
Provisional Regulations on Direction Guide to Foreign Investment	1995
The Guiding Catalogue of Industries for Foreign Investment	1995, 1997, 2002, 2004, 2007, 2011, 2015, 2017
Interim Provisions on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors	2003
Regulations on Mergers and Acquisitions of Domestic En-	2006

<sup>10</sup> Tax incentives directed to foreign companies were in the same direction and could be divided into three groups: (i) operation in special zones, (ii) use of advanced technology and (iii) production for export. In general, the benefits were reduced enterprise income tax rates and tax holidays. Those that were export-oriented - i.e., that exported at least 70% of annual production - or used advanced technology still had additional benefits such as tax exemption on profit remittances, additional tax benefits for reinvested profits, and larger reductions in land-use fees (Tseng & Zebregs, 2002). Long (2005) classifies the tax incentives for export production as voluntary export promotion policies.

In particular, technology transfer, which is often difficult to materialize given the reluctance of the investing firms, has been very successful. According to Naughton (2007, 2018), despite having an active technology development program since the mid-1980s, technology transfer by multinational companies was China's largest source of new technology from 1993 until the turn of the century<sup>11</sup>. For this result, the requirements of technology transfer and formation of joint ventures with local companies were fundamental.

With regards to the industrial development, sectoral allocations imposed by the investment catalogue restricting the inflow of foreign capital to major service sectors meant that most of the FDI flow to China was concentrated in the manufacturing sector, proportionally much larger than seen in the rest of the world. Manufacturing accounted for more than half of FDI inflows leaving services with a small share, particularly when real estate is excluded (Naughton, 2018). Furthermore, the investment catalogue was a longstanding tool of general industrial policy that reflected the different stages of China's economic development (Chen, 2011).

In the same direction, in order to guarantee that foreign investments effectively expanded the country's productive capacity, the restrictions on acquisitions of Chinese companies channeled FDI to greenfield investments. This contrasts substantially with the rest of the world where FDI flows have been dominated by cross-border mergers and acquisitions, particularly in the services sector (Chen, 2011).

Also, to avoid the negative effects of overvaluation of the local currency on domestic investments caused by the foreign capital inflow, China pursued a policy of fixed or highly controlled exchange rate, always aiming at current account surpluses. The negative impact of FDI on the balance of payments was neutralized through requirements on export performance, foreign currency balance and local content. More recently, China has pursued an import substitution strategy, from the simple assembly of imported parts and components to operations with greater domestic content. As a result, the average import intensity of Chinese exports has been reduced since the early 2000s and there has been an improvement in the trade balance of foreign companies present in the country (Akyüz, 2015a). This strategy also promoted an industrial upgrade by preventing the country from being restricted to low value-added activities in global value chains.

While both the Chinese and the developed countries experience shows that the host country's FDI policies play a central role in ensuring their positive effects, the space for national FDI regulation policies has been sharply reduced in the last three decades due to multilateral WTO rules. In particular, the 1995 *Agreement on Trade Related Investment Measures* (TRIMS) prohibits local content and foreign currency balance requirements.

Despite these constraints, Akyüz (2015a) pointed out that the TRIMS provisions allow some flexibility that can be exploited by developing countries. Domestic content can be stimulated through the tariff regime. When export tariffs are low and import tariffs are high, a large import content is encouraged. Similarly, resource-rich countries may use export tariffs to discourage the export of agricultural commodities and unprocessed

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<sup>11</sup> Then the domestic R&D accelerated surpassing the contribution of foreign firms.

minerals. It is also possible to tie the entry of foreign investors to the production of certain goods. For example, an automobile plant may be authorized provided it is accompanied by a factory making engines or electronic components used in its production chain. In the case of the foreign currency balance, one can place export requirements as a condition of entry for foreign companies without relating them to imports. For the formation of joint ventures with local companies, there are no restrictions. Moreover, since TRIMS only applies to trade in goods, for foreign investments in services such as banking, insurance and transportation, local content clauses may be part of the entry conditions.

It is important to note that although many Chinese regulations have been affected by the WTO restrictions, others have been spontaneously withdrawn following the increasing liberalization of foreign investment in the country over the years. This trend of FDI regulation is in line with that adopted by the developed countries. It is further evidence that countries generally move towards a greater degree of liberalization as they develop. As argued by Chang (2004), only when the domestic industry reaches a certain level of sophistication and competitiveness do the benefits of a policy of liberalizing foreign investments appear to outweigh the costs. Thus, liberalization would be a result of development and not its cause.

This recent trajectory of China offers lessons for developing countries. We have shown that FDI regulation is essential to extract the possible benefits of foreign capital, notably technological transfer and the opening of new markets. Nevertheless, FDI regulation is not sufficient when a country aims at long-term development. As the Chinese economy has become more prominent, the share of FDI in its GDP has consistently declined. China has made many remarkable achievements because it disciplined FDI *and* because growth has been financed domestically. Long-term development never derives from a trajectory that is essentially dependent on foreign capital.

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