# REFORM OF STATE-OWNED ENTERPRISES AND FOREIGN DIRECT INVESTMENT IN THE PRC

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## 1. Introduction

The People's Republic of China (PRC) is second only to the United States as a recipient of foreign capital. In 1996 total foreign direct investment (FDI) established in the PRC was US$42.3 billion — see Table One. This is the largest amount of FDI received by any of the developing countries.[1] However, China has not always been open to foreign investment. Six factors have led to increases in foreign investment in the PRC since economic reforms began in 1978. These are: (1) political stability and an open door policy; (2) offering preferential treatments to foreign investors; (3) improved legislation and regulatory frameworks; (4) improvements in infrastructure facilities; (5) low labour and land costs, and, (6) a large and growing market. Together, these factors have prompted foreign multinational corporations (FMNCs) to move into the PRC to build dominant market shares and preempt the entry of rivals.[2]

While the PRC has had great success in attracting foreign capital, efforts to enhance the performance of State-owned enterprises (SOEs) have been unsuccessful. In late 1997, however, the PRC realised that drastic action to reform SOEs was required. Two significant aspects of the reform process are the adoption of the joint stock company system and outright sale of smaller SOEs. The latter provides a significant business opportunity for foreign businesses wishing to establish a presence in the PRC. This article considers operating problems of SOEs, FDI, and the reform of SOEs.

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1 In descending order, the FDI amounts received by other major developing countries in 1996 were Mexico (US$6.4 billion), Malaysia (US$6.2 billion), Indonesia (US$5.8 billion), Brazil (US$5.5 billion), Poland (US$4.2 billion), Thailand (US$ 2.9 billion), Chile (US$2.2 billion), Argentina (US$2 billion) and Hungary (US$1.7 billion).

2 D. Li, G. Walker, M. Fox, S. Lau and T. Leung, "Foreign Direct Investment in the PRC: Foreign Exchange Reform and Business Risk" (1996) 7 (7) International Company and Commercial Law Review 254.

**TABLE 1**
**Foreign Direct Investment in the PRC, 1979 to 1995**

| Year | Actually Utilised FDI in US$ millions | Annual % Growth |
|---|---|---|
| 1978 to 1983 | 1,802 | n.a. |
| 1984 | 1,258 | n.a. |
| 1985 | 1,661 | 32.03 |
| 1986 | 1,874 | 12.83 |
| 1987 | 2,314 | 23.48 |
| 1988 | 3,194 | 38.03 |
| 1989 | 3,392 | 6.20 |
| 1990 | 3,487 | 2.80 |
| 1991 | 4,365 | 25.18 |
| 1992 | 11,007 | 152.16 |
| 1993 | 27,515 | 149.98 |
| 1994 | 33,767 | 22.72 |
| 1995 | 37,521 | 11.12 |
| 1996 | 41,726 | 11.21 |

Source : China Statistical Yearbook, 1997 and various issues

## 2. Operating Problems of SOEs and Impact on the PRC's Economy

The 7.6 million industrial enterprises in the PRC can be classified into three groups:

- 5.76 million private enterprises. Of these, 5.7 million are small-sized with, on average, seven employees, and 60,000 are medium to large-sized. Most of the medium to large-sized enterprises are wholly foreign-owned enterprises, Chinese-foreign equity joint ventures or cooperative joint ventures;
- 1.5 million town and village owned enterprises, and,
- 350 thousand SOEs.

Ever since the economic reforms began in late 1978, SOEs have been a major impediment to the reform process. Official data shows that the overall net profit after tax of SOEs for the financial year ended 31 December 1996 deteriorated by 37.1 per cent (the decline in the previous year was 19.7 per cent). Among all SOEs, 37.7 per cent showed a net loss in 1996.

The reform measures set out in the Eighth Five-Year Plan (1990-1995) have failed to deal with the problems faced by SOEs. The main problems derive from the preferential treatment given to FMNCs in areas such as taxation and trade and investment policy. Other problems flow from poorly defined property rights; powers and responsibilities of SOEs; ambiguous separation of government administration from SOEs' management; unrealistic transfer pricing practices, reciprocal business contracts, backlog of long overdue accounts receivable and payable among SOEs; management ethical problems; excessive reliance on national industrial protections through preferential policy, industrial subsidy and commodity price subsidies, and excessive tax imposition by provincial/local government on SOEs. The SOEs' poor performance has impacted on the PRC economy in the following ways:

*1. Heavy Burden on the Banking System*

Historically, the debt ratio of SOEs has been high resulting in banks carrying a huge amount of bad and doubtful debts. Overdue loan interest as at 31 July 1997 amounted to RMB 140 billion, of which the average time overdue was two years. To improve SOEs' solvency and reduce their liabilities, RMB 30 billion will be especially allocated in 1997 along with actions to assist SOEs with persistent losses to become profitable within three years.

*2. State Financial Disequilibrium*

One-third of SOEs currently run at an operating loss and require substantial subsidies from the Chinese government to continue trading. With the exceptions of 1978 and 1985, the PRC has been operating with deficits since the commencement of economic reforms in 1978. These deficits have increased rapidly since 1985 — see Table 2.

**TABLE 2**
**State Revenue, Expenditure and Deficits, 1978 to 1995**

| Year | Total Revenue (100 Million) | Total Expenditure (100 Million) | Net Surplus / (Deficit) (100 Million) | Indices (Preceding Year = 100) Total Revenue % | Total Expenditure % |
|---|---|---|---|---|---|
| 1978 | 1121.1 | 1111.0 | 10.1 | 128.2 | 131.7 |
| 1979 | 1103.3 | 1273.9 | (170.6) | 98.4 | 114.7 |
| 1980 | 1085.2 | 1212.7 | (127.5) | 98.4 | 95.2 |
| 1981 | 1089.5 | 1115.0 | (25.5) | 100.4 | 91.9 |
| 1982 | 1124.0 | 1153.3 | (29.3) | 103.2 | 103.4 |
| 1983 | 1249.0 | 1292.5 | (43.5) | 111.1 | 112.1 |
| 1984 | 1501.9 | 1546.4 | (44.5) | 120.2 | 119.6 |
| 1985 | 1866.4 | 1844.8 | 21.6 | 124.3 | 119.3 |
| 1986 | 2260.3 | 2330.8 | (70.5) | 121.1 | 126.3 |
| 1987 | 2368.9 | 2448.5 | (79.6) | 104.8 | 105.0 |
| 1988 | 2628.0 | 2706.6 | (78.6) | 110.9 | 110.5 |
| 1989 | 2947.9 | 3040.2 | (92.3) | 112.2 | 112.3 |
| 1990 | 3312.6 | 3452.2 | (139.6) | 112.4 | 113.6 |
| 1991 | 3610.9 | 3813.6 | (202.7) | 109.0 | 110.5 |
| 1992 | 4153.1 | 4389.7 | (236.6) | 115.0 | 115.1 |
| 1993 | 5088.2 | 5287.4 | (199.2) | 122.5 | 120.5 |
| 1994 | 5218.1 | 5792.6 | (574.5) | 120.0 | 124.8 |
| 1995 | 6242.2 | 6823.7 | (581.5) | 119.6 | 117.8 |
| 1996 | 7366.6 | 7914.4 | (547.8) | 118.0 | 116.0 |

*Source A Statistical Survey of China, 1997 and various issues.*

*3. Opening of the Domestic Market and Joining the World Trade Organization*

Most SOEs can only continue to operate because of subsidies and other forms of industrial protection. This hinders progress towards the complete opening of the domestic market, a necessary requirement for joining the

World Trade Organisation (WTO).[3] As part of its strategy to join the WTO the PRC has been gradually reducing import tariffs since 1991 and is working toward a target level of 15 per cent by the year 2000. Prior to a series of tax reductions, the average import tariff rate was as high as 35.9 per cent, more than double the 15 per cent generally adopted in developing countries around the world.[4]

*4. Distortions in market efficiency*

As part of the industrial protection strategy for SOEs, the Chinese government acquires most supplies from SOEs. To remedy cash-flow problems and implement the directives of local government, SOEs undertake intra-group acquisitions of materials and goods. The backlog of accounts receivable and accounts payable are offset by bilateral and multilateral netting. These practices distort market efficiency and hinder the opening of the domestic market.

## 3. Development of Foreign Direct Investment Policies

Since the PRC implemented an open-door economic policy in 1979, FDI has played an increasingly important role in promoting economic and trade development especially in providing technology transfer and capital. FDI's contribution to the total value of imports and exports of the whole country increased from 34.3 per cent in 1993 to 37.0 per cent in 1995. Over the same period the portion contributed by SOEs declined from 65.7 per cent in 1993 to 60.9 per cent in 1995. This development signalled an urgent need to reform SOEs so as to improve their operating efficiency and competitive strength — see Tables 3 and 4.

**TABLE 3**
**Import and Export Value of Foreign-invested Enterprises (FDIs) for the Period from 1993 to 1995 (US$ Billion)**

| | 1993 | | | 1994 | | | 1995 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Total | Exports | Imports | Total | Exports | Imports | Total | Exports | Imports |
| National | 195.70 | 91.74 | 103.96 | 280.85 | 121.01 | 115.61 | 236.62 | 148.77 | 132.08 |
| FDI | 67.07 | 25.24 | 41.83 | 109.82 | 34.71 | 52.93 | 87.64 | 46.88 | 62.94 |
| Portion of FDI | 34.27% | 27.51% | 40.24% | 39.10% | 28.69% | 45.79% | 37.04% | 31.51% | 47.66% |

*Source: China Statistical Yearbook, 1996 and Various Issues, A Statistical Survey of China, 1996 and Various Issues*

3 J. Rosen, "China, Emerging Economies and the World Trade Order" (1997) 46(6) Duke L.J. 1519.

4 In November 1995 it was announced that the PRC would reduce import tariff rates by no less than 30 per cent in 1996. Subsequently the State Council of the PRC promulgated new tax and trade reforms which took effect on 1st April 1996. Under these reforms, the average customs tariff rate will be reduced by 36 per cent (down from 35.9 per cent to 23 per cent) for 4,962 trade items. See further, D. Li, G. Walker, S. Lau and T. Leung, "Tax and Trade Reform in the PRC: Implications for FDI" [1996] 1 Asian Commercial LR 241.

**TABLE 4**
**Comparative Statistics of Foreign Direct Investment, Imports and Exports, Gross Domestic Product, and Population of Mainland China Provinces for the Year 1995**

| Province /Regions | Population (Million) | Gross Domestic Product (RMB Billion) | National Exports (US$ Billion) | National Imports (US$ Billion) | Total National Imports & Exports (US$ Billion) | Contracted Foreign Direct Investment (FDI) (US$ Million) | FDI's Portion of National Imports & Exports (%) |
|---|---|---|---|---|---|---|---|
| Greater Pearl River Delta | | | | | | | |
| Fujian | 32.4 | 216.1 | 8.1 | 7.0 | 15.1 | 8,906.7 | 7.49 |
| Guangdong | 68.7 | 538.2 | 59.0 | 49.5 | 108.5 | 24,832.4 | 48.45 |
| Yangtze River Delta | | | | | | | |
| Shanghai | 14.2 | 246.3 | 13.1 | 12.8 | 25.9 | 10,296.6 | 10.22 |
| Jiangsu | 70.7 | 515.5 | 10.1 | 8.0 | 18.1 | 12,374.7 | 7.11 |
| Zhejiang | 43.2 | 352.5 | 8.3 | 4.5 | 12.8 | 3,248.9 | 2.78 |
| Bohai Bay | | | | | | | |
| Beijing | 12.5 | 139.5 | 6.0 | 10.8 | 16.8 | 2,735.1 | 2.35 |
| Tianjin | 9.4 | 92.0 | 4.4 | 4.5 | 8.9 | 3,850.1 | 4.54 |
| Hebei | 64.4 | 285.0 | 2.5 | 2.0 | 4.5 | 2,250.7 | 0.91 |
| Liaoning | 40.9 | 279.3 | 7.1 | 6.1 | 13.2 | 3,974.5 | 4.55 |
| Shandong | 87.1 | 500.2 | 9.0 | 7.6 | 16.6 | 4,625.2 | 5.61 |
| Shanxi | 30.8 | 109.2 | 1.8 | 0.5 | 2.3 | 228.4 | 0.15 |
| Others | | | | | | | |
| Anhui | 60.1 | 200.4 | 1.3 | 0.8 | 2.1 | 1,206.4 | 0.34 |
| Gansu | 24.4 | 55.3 | 0.3 | 0.4 | 0.7 | 109.8 | 0.05 |
| Guizhou | 35.1 | 63.0 | 0.4 | 0.3 | 0.7 | 86.3 | 0.08 |
| Hainan | 7.2 | 36.4 | 0.5 | 1.4 | 1.9 | 2,780.8 | 0.52 |
| Heilongjiang | 37.0 | 201.5 | 3.0 | 1.6 | 4.6 | 1,105.7 | 0.48 |
| Henan | 91.0 | 300.3 | 1.5 | 1.4 | 2.9 | 915.7 | 0.46 |
| Hubei | 57.7 | 239.1 | 1.8 | 1.9 | 3.7 | 1,088.5 | 0.83 |
| Hunan | 63.9 | 219.6 | 1.4 | 1.0 | 2.4 | 1,354.6 | 0.25 |
| Jiangxi | 40.6 | 120.5 | 0.8 | 0.6 | 1.4 | 539.7 | 0.18 |
| Jilin | 25.9 | 112.3 | 1.1 | 1.8 | 2.9 | 847.4 | 0.77 |
| Qinghai | 4.8 | 16.5 | 0.1 | 0.04 | 0.14 | 24.2 | 0.005 |
| Shaanxi | 35.1 | 100.0 | 1.0 | 0.9 | 1.9 | 403.3 | 0.18 |
| Sichuan | 113.3 | 353.4 | 2.0 | 1.9 | 3.9 | 1,206.9 | 0.47 |
| Yunnan | 39.9 | 120.7 | 1.2 | 1.1 | 2.3 | 374.0 | 0.18 |
| Guangxi | 45.4 | 160.6 | 1.6 | 1.7 | 3.3 | 1,041.8 | 0.75 |
| Inner Mongolia | 22.8 | 83.3 | 0.5 | 0.8 | 1.3 | 98.9 | 0.14 |
| Ningxia | 5.1 | 17.0 | 0.2 | 0.07 | 0.27 | 28.8 | 0.014 |
| Tibet | 2.4 | 5.6 | 0.01 | 0.2 | 0.21 | - | 0.023 |
| Xinjiang | 16.6 | 83.5 | 0.5 | 0.9 | 1.4 | 91.3 | 0.095 |
| Total | 1,211.2 | 5,862.1 | 148.6 | 132.1 | 280.72 | 91,281.5 | 100% |

*Source. China Statistical Yearbook, 1996 and Various Issues*
*A Statistical Survey of China, 1996 and Various Issues*

The deteriorating situation of SOEs is attributable the PRC's previous preferential investment policies to FDIs and problems within SOEs that arose with the transition from a planned economy to a socialist market economy. The PRC's preferential investment policies to FDI created a number of competitive advantages for FMNCs. The strategies for the utilisation of foreign capital and the reform of SOEs proposed in the PRC's Ninth Five-Year Plan (1996-2000) and Long-Term Targets for the Year 2010 will modify previous policies to provide FMNCs and SOEs with a business environment which facilitates competition. We now review the historical policies that made the PRC an attractive destination for FDI.

In the 1950s, the PRC began to use government loans from foreign countries. In the 1970s the PRC also utilised export credit facilities extended by foreign commercial banks for international trade transactions. Prior to 1 July 1979, foreign companies were not permitted to set up in the PRC. Compensation trade and the processing of materials supplied by foreign clients were the only economic cooperative activities undertaken by SOEs with foreign firms. After 1 July 1997, foreign investment legislation was promulgated to encourage FDI and to facilitate joining the WTO.[5] The most popular forms of FDI are wholly foreign-owned enterprises, cooperative joint ventures, joint-stock limited companies and Chinese-foreign equity joint ventures. In addition the PRC has utilised huge amounts of foreign loans for economic development — see Table 5.

5 Prominent FDI legislation includes: (i) Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures (effective as of 8 July 1979); (ii) Law of the People's Republic of China on Wholly Foreign-Owned Enterprises - effective as of 12 April 1986, and the "Detailed Implementing Regulations for the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises" - effective as of 12 December 1990; (iii) Law of the People's Republic of China on Chinese-Foreign Cooperative Joint Ventures - effective as of 13 April 1988; (iv) Company Law of the People's Republic of China - effective as of 1 July 1994, and Guangdong Company Law - effective as of 1 August 1993; (v) Provisional Regulations of Shanghai Municipality Concerning Joint-Stock Limited Companies - effective as of 1 June 1992, and Regulations of the Shenzhen Special Economic Zone Concerning Joint-Stock Limited Companies - Effective as of 1 October 1993; (vi) Provisions of the State Council for the Encouragement of Foreign Investment - effective as of 11 October, 1986, and Regulations of the People's Republic of China Concerning Financial Administration of Foreign-Investment Enterprises - effective as of 24 June 1992. See further, L. Tokley and T. Ravn, *Company and Securities Law in China* (1998) and Symposium on China's Business Laws in (1997-98) 4(1) and (2) Canberra Law Revew

**TABLE 5**
**PRC's Utilisation of Foreign Loans, Foreign Direct Investment and Other Foreign Investment for the period 1979 — 1995 (US$100,000,000)**

| Year | Total | | Foreign Loan | | Foreign Direct Investment | | *Other Foreign Investment |
|---|---|---|---|---|---|---|---|
| | Number of Contracts | Value | Number of Contracts | Value | Number of Contracts | Value | Value |
| Total Value of Foreign Loans and FDI Through Signed Contracts Agreements | | | | | | | |
| 1979-1983 | 1471 | 239.78 | 79 | 150.62 | 1392 | 77.42 | 11.74 |
| 1984 | 1894 | 47.91 | 38 | 19.16 | 1856 | 26.51 | 2.24 |
| 1985 | 3145 | 98.67 | 72 | 35.34 | 3073 | 59.32 | 4.01 |
| 1986 | 1551 | 117.37 | 53 | 84.07 | 1498 | 28.34 | 4.96 |
| 1987 | 2289 | 121.36 | 56 | 78.17 | 2233 | 37.09 | 6.10 |
| 1988 | 6063 | 160.04 | 118 | 98.13 | 5945 | 52.97 | 8.94 |
| 1989 | 5909 | 114.79 | 130 | 51.85 | 5779 | 56.00 | 6.94 |
| 1990 | 7371 | 120.86 | 98 | 50.99 | 7273 | 65.96 | 3.91 |
| 1991 | 13086 | 195.83 | 108 | 71.61 | 12978 | 119.77 | 4.45 |
| 1992 | 48858 | 694.39 | 94 | 107.03 | 48764 | 581.24 | 6.12 |
| 1993 | 83595 | 1232.73 | 158 | 113.06 | 83437 | 1114.36 | 5.31 |
| 1994 | 47646 | 937.56 | 97 | 106.68 | 47549 | 826.80 | 4.08 |
| 1995 | 37184 | 1032.05 | 173 | 112.88 | 37011 | 912.82 | 6.35 |
| 1996 | 24673 | 816.09 | 117 | 79.62 | 24556 | 732.76 | 3.71 |
| Total Value of Foreign Loan and FDI Actually Used | | | | | | | |
| 1979-1983 | | 144.38 | | 117.55 | | 18.02 | 8.81 |
| 1984 | | 27.05 | | 12.86 | | 12.58 | 1.61 |
| 1985 | | 46.47 | | 26.88 | | 16.61 | 2.98 |
| 1986 | | 72.58 | | 50.14 | | 18.74 | 3.70 |
| 1987 | | 84.52 | | 58.05 | | 23.14 | 3.33 |
| 1988 | | 102.26 | | 64.87 | | 31.94 | 5.45 |
| 1989 | | 100.59 | | 62.86 | | 33.92 | 3.81 |
| 1990 | | 102.89 | | 65.34 | | 34.87 | 2.68 |
| 1991 | | 115.54 | | 68.88 | | 43.66 | 3.00 |
| 1992 | | 192.02 | | 79.11 | | 110.07 | 2.84 |
| 1993 | | 389.60 | | 111.89 | | 275.15 | 2.56 |
| 1994 | | 432.13 | | 92.67 | | 337.67 | 1.79 |
| 1995 | | 481.33 | | 103.27 | | 375.21 | 2.85 |
| 1996 | | 548.04 | | 126.69 | | 417.26 | 4.09 |

*Note: Other Foreign Investment consists of (i) Financial Leasing, (ii) Compensation Trade, and (iii) Processing and Assembly.

*Source: Statistical Yearbook of China, 1997and various issues*

The PRC has become one of the most competitive production bases for FMNCs in the world. This is because of low wages, low land costs, a large domestic market, and endeavours to modernise its industries and infrastructure. For example, by 1995 more than 16 million workers were employed by more than 150,000 foreign-invested enterprises (FIEs). The economic contribution of these enterprises accounted for 39.1 per cent of the PRC's total foreign trade and 13.8 per cent of total industrial output. As at 31 December 1995, the accumulated number of approved FDI contracts and the actual value of FDI were 258,788 and US$133.16 billion respectively. Since 1983, the share of FDI in total fixed assets investment in the PRC grew by 18.5 times from 0.87 per cent to 16.11 per cent in 1995. Since the commencement of economic reforms and the open door policy in late 1978, the PRC's GDP reached RMB5,773 billion or US$691 billion in 1995 with an average annual growth rate of 9.8 per cent. In 1995 the PRC was, globally, the eleventh largest trading nation (from the 28th place in 1978). These data are evidence of FDI's extensive contribution to economic reform and growth. The major policies are described below.

*1. Open Door Policy and Political Stability*

In 1978 the economic reform policy for opening the PRC to the outside world and measures for stimulating the domestic economy were decided. This policy has subsequently been reaffirmed. These re-affirmations of the policy can be viewed as signalling China's ongoing commitment to economic reform. With regards the economic reforms, an important development occurred on 15 May 1984, when the Premier of the State Council, Mr. Zhao Ziyang, outlined the following development plan for economic reform: (i) The "open door" policy will be unswervingly implemented; (ii) A number of coastal cities to be opened as the Special Economic Zones (SEZs) to foreign investment; (iii) All local authorities and departments to adopt a positive attitude to develop economic and trade relations with foreign countries and actively utilise the investment capital and advanced technology associated with foreign investment. Following these announcements, the PRC opened the Hainan Administrative Region and fourteen coastal cities as Special Economic Zones (SEZs) in 1984.[6] In these areas, economic-technological development zones (ETDZs) have been designated to encourage advanced technology transfer. Foreign Companies enjoy preferential tax treatment as well as other benefits.

By the end of 1995, 84 per cent of accumulated FDI was in coastal regions. The coastal regions that were the largest recipients of FDI were Guangdong (21.7 per cent) and Jiangsu (13.7 per cent) — see Table 6.

6 These other SEZs were: Zhanjiang, Guangzhou, Shanghai, Fuzhou, Wenzhou, Ningbo, Nantong, Lianyungang, Qingdao, Yantai, Tianjin, Qinhuangdao, Dalian, Beihai.

**TABLE 6**
**Comparative Statistics of Urban Per Capita Income, Retail Market Size, Added Value Output of Secondary Industry For the Year 1994-1995**

| Province/Regions | Urban Per Capita Income (RMB) | Retail Market Size Retail Sales Amount (RMB Billion) | %tage | Added Value Output of Secondary Industry (RMB Billion) |
|---|---|---|---|---|
| Greater Pearl River Delta | | | % | |
| Fujian | 4,326 | 58.7 | 2.85 | 98.0 |
| Guangdong | 6,849 | 230.4 | 11.18 | 276.0 |
| Yangtze River Delta | | | | |
| Shanghai | 6,822 | 97.0 | 4.71 | 141.6 |
| Jiangsu | 4,209 | 165.0 | 8.01 | 250.0 |
| Zhejiang | 5,718 | 139.6 | 6.78 | 183.2 |
| Bohai Bay | | | | |
| Beijing | 5,868 | 82.7 | 4.02 | 64.4 |
| Tianjin | 4,626 | 37.6 | 1.83 | n.a. |
| Hebei | 3,960 | 84.9 | 4.12 | 132.5 |
| Liaoning | 3,307 | 112.6 | 5.47 | 157.7 |
| Shandong | 3,953 | 144.3 | 7.00 | 238.4 |
| Shanxi | 2,927 | 37.6 | 1.83 | 56.4 |
| Others | | | | |
| Anhui | 3,406 | 60.0 | 2.91 | 94.9 |
| Gansu | 2,855 | 23.0 | 1.11 | 25.7 |
| Guizhou | 3,427 | 19.8 | 0.96 | 24.3 |
| Hainan | 4,344 | 10.9 | 0.53 | 14.0 |
| Heilongjiang | 2,968 | 68.3 | 3.32 | 96.1 |
| Henan | 3,029 | 90.7 | 4.40 | 142.5 |
| Hubei | 3,606 | 93.2 | 4.52 | 103.0 |
| Hunan | 4,069 | 83.7 | 4.06 | 81.8 |
| Jiangxi | 3,046 | 41.1 | 1.99 | 60.3 |
| Jilin | 2,914 | 48.2 | 2.34 | 51.5 |
| Qinghai | 3,051 | 5.8 | 0.28 | 6.5 |
| Shaanxi | 3,046 | 37.0 | 1.80 | 42.8 |
| Sichuan | 3,586 | 130.1 | 6.32 | 148.6 |
| Yunnan | 3,684 | 37.0 | 1.80 | 47.5 |
| Guangxi | 4,289 | 53.3 | 2.59 | 65.7 |
| Inner Mongolia | 2,600 | 29.5 | 1.43 | 32.0 |
| Ningxia | 3,026 | 5.7 | 0.28 | 7.5 |
| Tibet | 4,000 | 2.5 | 0.12 | 1.0 |
| Xinjiang | 3,800 | 25.4 | 1.24 | 34.6 |
| Total | - | 2,060.0 | 100% | 2,827.0 |

*Source: China Statistical Yearbook, 1996 and various issues*
*A Statistical Survey of China, 1996 and various issues*

**TABLE 7**
**The Distribution of Applied Foreign Direct Investment and Foreign Loan For the Period from 1994 to 1995 (US$ 10,000)**

| | 1994 | | | | 1995 | | | |
|---|---|---|---|---|---|---|---|---|
| Provinces/ Regions & Ministry | %tage | Total | Foreign Loans | FDI & Other Foreign Investment | %tage | Total | Foreign Loans | FDI & Other Foreign Investment |
| Guangdong | 25.29% | 1092758 | 146415 | 946343 | 22.17% | 1066967 | 40956 | 1026011 |
| Jiangsu | 8.76 | 378568 | 2253 | 376315 | 11.06 | 532577 | 13495 | 519082 |
| Fujian | 8.62 | 372328 | 1010 | 371318 | 8.62 | 414908 | 10518 | 404390 |
| Shanghai | 5.96 | 258217 | 10908 | 247309 | 6.24 | 300543 | 11282 | 289261 |
| Shandong | 6.02 | 260143 | 4901 | 255242 | 5.74 | 276497 | 7599 | 268898 |
| Tianjin | 2.69 | 116176 | 14677 | 101499 | 3.30 | 158686 | 6593 | 152093 |
| Liaoning | 3.51 | 151471 | 7457 | 144014 | 3.26 | 156838 | 14377 | 142461 |
| Zhejiang | 2.68 | 115650 | 624 | 115026 | 2.68 | 128968 | 3162 | 125806 |
| Beijing | 3.19 | 137911 | 754 | 137157 | 2.30 | 110648 | 2649 | 107999 |
| Other Provinces/ Regions & Ministries | 33.28 | 1438062 | 737701 | 700361 | 34.63 | 1666637 | 922069 | 744568 |
| Total | 100% | 4321284 | 926700 | 3394584 | 100% | 4813269 | 1032700 | 3780569 |

*Source · China Statistical Yearbook, 1996*

## *2. Preferential Treatments*

(i) Opening of the Domestic Market

Foreign investors intending to introduce advanced or new technology to the PRC and manufacture products that are superior to those produced by domestic industries are permitted to sell a larger portion of their products in the Chinese market. Furthermore, FDIs can set payment terms in foreign currencies to domestic buyers for their products which could be classified as import substitutes by the Chinese Government.

(ii) Relaxation of Immigration Control of Foreign Businessmen

Efforts have been made to make it easier for foreign businessmen to run the operations of foreign-owned enterprises, Chinese foreign joint ventures, contractual joint ventures, joint exploration and exploitation of offshore petroleum and compensation trade. Effective 1983, such businessmen, their families and dependents were granted visas or resident permits issued by the Public Security Bureau of the province, autonomous region, or the municipality directly under the central government.

(iii) Income Tax Reduction and Exemption Periods for Chinese Foreign Joint Ventures

Under Article 5 of the *Income Tax Law of the People's Republic of China Concerning Joint Ventures Using Chinese and Foreign Investment (1980)* a newly established joint venture scheduled to operate for ten years or more can apply for an exemption from income tax in the first profit-making year and for a fifty per cent reduction in the second and third years. The Ministry of Finance extended this regulation in 1983 with more preferential treatments.[7]

(iv) Preferential Tax Rates for FDIs in ETDZs

Since May 1985, ETDZs have gradually been established to facilitate technology transfer from FDIs. In December 1984, the Standing Committee of the National People's Congress decided a series of income tax regulations with preferential tax rates for FDIs in ETDZs.

(v) Preferential Treatment to Foreign Investment in the Old Areas of the Coastal Cities

In order to promote foreign investment in under-developed areas of the coastal cities, the State Council promulgated the following two preferential treatments in December 1984: (a) FDIs paid only 80 per cent of the income tax levied by the "Income Tax Law Concerning Foreign Enterprises" and the "Income Tax Law Concerning Joint Ventures Using Chinese and Foreign Investment"; (b) FDIs' investment projects in excess of US$30 million with a long payback period engaged in producing import substitutes, applying advanced technologies, communications, harbour construction and energy infrastructures were subjected to a preferential income tax rate of 15 per cent.

(vi) The Removal of Remittance Restrictions on Personal Income of Foreign Employee

In 1983 Article 25 of the Provisional Regulations on Foreign Exchange Control of the PRC was amended by removing restrictions on outward remittance which only allowed 50 per cent of after-tax total of wages and other legitimate net earnings of foreign employee to be remitted or taken out of the PRC. With this amendment, foreign employees were allowed to remit abroad or withdraw the entire amount of their after tax wages and legitimate earnings.

(vii) Open More Industrial Sectors to Foreign Investment

As of 1985, FDIs were allowed to invest in the industrial sectors of finance and commerce in the Special Economic Zones. FDIs were encouraged to invest in the mining, melting and processing of ferrous metals, coal mining, quarrying and processing of marble and granite, the mining and processing of phosphate and potassium etc.

(viii) Allow More Forms of Foreign Investment

At the outset of the open door policy, foreign investment brought into the PRC was confined to contractual joint ventures, Chinese-foreign equity joint ventures and compensation trading. Later on, other forms of FDIs have been permitted to established, including wholly foreign-owned enterprises, branches, representative offices, processing and assembly contracts, management contracts, service centres, and variety of other forms of operations.

7 These allowed newly established joint ventures to be exempted from income tax in the first two profit-making years and be allowed a 50 per cent tax reduction in the third, fourth and fifth year. This preferential treatment could also be granted to those joint ventures approved before 1 April 1983 which have not yet made any profits. For those joint ventures which are presently in their first profit-making year, their periods of tax exemption and reduction will be extended by one year respectively. Where they are presently in their second or third year of profit-making year, their tax reduction period will be extended by one year.

*3. Improvements in Legislation and Legal Framework*

In order to protect and attract foreign investment, the PRC moved swiftly to improve aspects of the legal system governing foreign investments and international trade, the basic principles of commercial law and the court system. To keep up with changes in the business environment, new business laws were promulgated every few months. During 1993 and 1994 a variety of new business laws with international standards were introduced including national company law, competition law, national securities regulations, national foreign trade law, law on foreign financial institutions, a new foreign exchange regime, national labour law, urban real estate law, rules for international arbitrations conducted in China, a new arbitration law, company registration law, new laws on foreign investment in the mining sector and similar.

*4. Enactment of the "Economic Contract Law" of the People's Republic of China Concerning Overseas Interests*

The "Economic Law" consists of seven chapters with 43 articles which came into effect on 1st July, 1985. The provisions of the Law fall into the following categories: (i) definition of the application scope of the law and the indications of appropriate laws for settlement of contractual disputes; (ii) conclusion and validity of a contract; (iii) obligation of contract execution; (iv) termination, assignment and alternation of a contract, and, (v) method of arbitration.

## 4. Reform of State-owned Enterprises

Most of the SOEs are in a difficult situation as a result of their inefficiency and uncompetiveness. Currently their employees account for 67 per cent of the total urban workforce. SOEs absorb 54.4 per cent of the total investment of the State and 33 per cent currently run at an operating loss. Total operating losses of SOEs for the period from January to July 1997 was RMB 39 billion. 4,900 enterprises went bankrupt in 1996 of which 2,348 (47.9 per cent) were SOE's. Also, 1,190 SOEs were merged or acquired in 1996. The reform process as outlined below will intensify the bankruptcy, acquisition and merger of inefficient SOEs.

*1. The New Policy and Strategy of State-owned Enterprises Reform*

In September 1997 Mr. Jiang Zemin, Chairman of the State, delivered a report on the economic reforms to the Chinese Communist Party congress.[8] The report stated that the PRC would intensify the reform of SOEs. The proposed strategies include: (1) turning State-owned enterprises into joint-stock companies; (2) strengthening the competitiveness of State-owned enterprises through merger, reorganisation and leasing; (3) allowing State-owned enterprises more autonomy.

*2. Joint-stock Companies*

Theoretically the joint-stock company system should solve the ownership, responsibility and authority problems presently associated with SOEs.[9] Some indication of the benefits of the joint-stock company system are suggested by the improved financial performance of those SOEs that have listed on Shenzhen Stock Exchange and Shanghai Stock Exchange- see Tables 8, 9 and 10.

8 On 13th September 1997 at the 15th Chinese Communist Party (CCP) congress, Mr. Jiang Zemin, the Chairman of the State, delivered a report on economic reform entitled "Hold High the Big Banner of Deng Xiaoping Theory for the All-Round Advancement of the Cause of Building Socialism with Chinese Characteristics to 21st Century".

9 See Tokley and Ravn, op. cit.

**TABLE 8**
**Total Number of Listed Companies and Transaction Volume of Shenzhen Stock Exchange and Shanghai Stock Exchange for the period from 1990 to 1995**

| Items /Years | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| Total Number of Listed Companies in Shenzhen S. E. & Shanghai S. E. | 8 | 13 | 58 | 182 | 289 | 311 | 530 |
| Total Transaction Volume of Shenzhen S. E. & Shanghai S. E. (RMB Billion) | 1.8 | 5.155 | 6.93 | 418.7 | 812.7 | 401.8 | 2,133.2 |

*Source Almanac of China's Stock Markets 1997 and various issues*
*Almanac of China's Finance and Banking, 1997*

**TABLE 9**
**The Size of Shenzhen Stock Exchange for the period from 1991 to 1995**
**(RMB Billion)**

| Year / Items | Par Value of Issued Share Capital | Market Value of Share Capital | Number of Listed "A" Shares | Number of Listed "B" Shares* | Total Amount of Transactions |
|---|---|---|---|---|---|
| 1991 | 0.56 | 8.078 | 6 | 0 | 3.557 |
| 1992 | 2.614 | 48.977 | 24 | 90 | 42.40 |
| 1993 | 12.206 | 132.677 | 76 | 16 | 128.667 |
| 1994 | 22.059 | 113.533 | 113 | 19 | 239.20 |
| 1995 | 26.739 | 105.935 | 127 | 34 | 91.50 |
| 1996 | 43.953 | 436.46 | 227 | 43 | 1221.74 |

*Note: "A" shares can only be traded by PRC nationals;
"B" shares are the only class of shares for foreign investors.

*Source Almanac of China's Stock Markets 1997 and various issues*
*Almanac of China's Finance and Banking, 1997*

**TABLE 10**
**The Size of Shanghai Stock Exchange, 1991 to 1995**
**(RMB Billion)**

| Year /Items | Par Value of Issued Share Capital | Market Value of Share Capital | Number of Listed 'A" Shares | Number of Listed "B" Shares | Total Amount of Transactions |
|---|---|---|---|---|---|
| 1990 | 0.26118 | 1.23433 | 8 | 0 | 0.00094 |
| 1991 | 0.27223 | 2.94271 | 8 | 0 | 0.80714 |
| 1992 | 4.96429 | 55.84036 | 30 | 90 | 24.71854 |
| 1993 | 23.55353 | 220.61962 | 101 | 22 | 246.76881 |
| 1994 | 41.88797 | 260.01298 | 169 | 34 | 573.50739 |
| 1995 | 49.825 | 252.566 | 184 | 36 | 310.30 |
| 1996 | 111.04 | 984.24 | 287 | 42 | 2,133.22 |

*Note: "A" shares can only be traded by PRC nationals;
"B" shares are the only class of shares for foreign investors.

*Source Almanac of China's Stock Markets 1996 and various issues*
*Almanac of China's Finance and Banking, 1997*

The positive results shown above served as the basis for the SOE reform policy on joint-stock system as promulgated at the 15th Chinese Communist Party congress in September 1997. By the end of October, 1997, nearly seven hundred listed SOEs (joint-stock SOEs) have shown gradual improvements in profitability as a consequence of the improved management system, higher level of technology, optimal assets re-structure, greater operating autonomy, better economy of scale through merger and acquisition etc.

*3. Strategies for SOEs Set in the Ninth Five-Year Plan (1996-2000) and Long-Term Targets for the Year 2010*

Despite resistance from the left-wing of the Chinese Communist Party, the joint-stock company system for SOE reform was approved at the 15th Chinese Communist Party congress in September, 1997. This ground-breaking reform is based on the rationale that there should be a wide variety of forms of public ownership and it is quite acceptable to adopt socialist as well as capitalist joint-stock company system. The following are the key points of the strategy of SOE reform set in the Ninth Five-Year Plans and Long-Term Targets for the year 2010 :

(i) The Goal of SOE Reform

The task here is to reform the SOEs with the modern enterprise system in order to optimise their industrial structure and then establish a micro-economic foundation for a highly-efficient economy. In pursuit of this goal, SOEs will be reorganised with the transformation of enterprises to reflect their western counterparts. The implementation time span is as follows:

***Phase One** : Pilot Run from 1995 to 1996*

The selected pilot projects will run with the defined features of the modern enterprises system with a view to achieving breakthroughs.

***Phase Two :** Full Implementation from 1997 to 2000*

To legislate complete set of laws, regulations and regulatory frames with reference to the experiences gained in phase one pilot run, and then implement the SOE reform in the whole country.

(ii) Implementation of the Reform

There will be a series of reforms in structural re-organization, replacement of operational mechanism, technological transformation, internal management, enterprise leadership and the separation of government administration from enterprise management. The details are as follows:

*(a) The Launch of Four Pilot Run Projects*

For gaining experience, exploring potential problems and searching for a most suitable path for SOE reform, four pilot run projects have been launched since 1994:

· The "Modern Enterprise System" was run in 100 selected SOEs;
· The establishment of three "Joint-stock Companies";
· The formation of "Conglomerates" by 56 selected SOEs;
· Experiment optimisation of the capital structure of SOEs in 18 selected cities.

*(b) The Structural Re-Organization of SOEs*

The State-owned economy will be modified by structural re-organization. This contemplates the merger, leasing, outsourcing, bankruptcy of SOEs and other kinds of State-owned assets. Thereby benefit accrued from State-owned assets could be optimised and the quality and efficiency of SOEs could be improved.

*(c) Implementing the Policy of "Restructuring, Transformation and Reforming"*

SOEs will undertake structural reorganisation and intensify technological transformation in production systems. Reforming refers to the replacement of the inefficient operational system with the modern enterprise system.

*(d) Separation of Government Administration from Enterprise Management*

As a means to allow greater autonomy of SOEs' management and thereby improve their efficiency and competitiveness, government administration and directives will be separated from the management of the SOEs.

*(e) Formation of Conglomerates*

Some key and sizeable SOEs will be selected to implement the strategy of forming conglomerates as a means to improve their efficiency and competitiveness on the domestic market.

## 5. Conclusion

State-owned enterprises have been one of the main stumbling blocks in the PRC's economic reform process. The poor performance of SOEs continues to have a number of detrimental impacts on the PRC's economy. As of late 1997, the new policy is to focus reform efforts on medium to large-sized SOEs rather than the smaller entities. This will result in the restructuring of medium and large-sized SOEs into multi-industrial, multi-ownership, multi-regional and multi-national conglomerates. The objective here is to strengthen the competitiveness of SOEs by economies of scale through pooling of cash and other assets. The reform policy for the small-sized SOEs is to reorganise them through merger, sale, formation of joint-stock company, contracting out and leasing. The reform of SOEs has implications for FDI in the following areas:

*(i) The Joint-Stock Company System*

The systemic weaknesses of the PRC's stock markets (poor liquidity, overt inside trading, lack of standardisation in the presentation of financial information and the like), should be mitigated by the market maturity, standardisation and streamlining of the public company. Thus, the introduction of the joint-stock company system for SOEs will provide FMNCs with less expensive and more readily available capital via the option of going public on the Hong Kong Stock Exchange and China's two main stock markets.[10] Other advantages include reduced business risk through diversification of borrowing sources and operations.

10 D. Li, F. Tsang, S. Wong, G. Walker and M. Fox, "The Listing of China-based Enterprises on the Stock Exchange of Hong Kong" [1994] 9 Journal of International Banking Law 316.

*(ii) Opportunity for FMNCs to Establish an Operating Presence in the PRC Through Acquisitions of Small SOEs.*

The reform policy for small-sized SOEs offers a unique opportunity for FMNCs to establish an operating presence or geographic market in the PRC. FMNCs may also capture small SOEs' tangible and intangible assets such as imported world-class equipment, technical expertise and skilled workers.[11]

*(iii) Banking System Reform and the Injection of Government Subsidies to SOEs*

The State will subsidise SOEs by writing off their debts to banks in the future. The Bank of China is planning to set up a new banking procedure for dealing with bank loans to insolvent SOEs. These loans will be segregated from normal bank loans to solvent SOEs with good credit standing. In order to place SOEs in a satisfactory financial position for going public, Mr. Dai Xianglong, the China's Central Bank Governor, estimates that it will be necessary to inject RMB 1,000 billion into the SOEs over three years.[12]

*(iv) Industrial Protection for SOEs by the Tax Reform.*

In forthcoming years, the extension of national treatment will replace the previous strategy of mainly relying on preferential policies to attract FDI. This policy will provide SOEs and FIEs with a business environment where they can compete on an equal footing under a sound regulatory framework and legal system.[13]

To conclude, the reform of SOEs will relieve the PRC of a heavy financial burden and pave the way for rapid economic growth. FMNCs will be provided with a better business environment. There now exists a significant opportunity to establish an operating presence in the PRC by acquiring small-sized SOEs.

11 D. Li, M. Fox, G. Walker and S. Francis, "Acquisitions in the People's Republic of China: Opportunities, Constraints and Problems faced by Foreign Investors" [1995] 10 Journal of International Banking Law 361.

12 "China Steps Up Its Financial Reforms" The Economist, May 2 1998, 69; D. Li, G. Walker, M. Fox, S. Lau, and T. Leung, "Foreign Exchange Reform in the People's Republic of China: Impact on Foreign Direct Investment and State Owned Enterprises" [1996] 11 Journal of International Banking Law 228.

13 The PRC undertook intensive reforms to the tax system in 1995 and 1996. The positive effects of the reforms include: (a) aligning PRC tariff practices in with international norms; (b) establishing the preconditions for joining the WTO; (c) establishing a fairer domestic business environment and trading mechanisms which favour fair market competition, optimal allocation of resources and the healthy and rapid development of the economy; (d) placing domestic enterprises and foreign-invested enterprises on the same level playing field; (e) channeling foreign investments to priority industrial sectors such as energy, infrastructure facilities, transport, advanced technologies, raw materials etc.. There are a number of adverse implications for FDI: (a) the gradual cancellation of preferential import tariff exemptions and reductions for FDI enterprises' exports, lower profit margins and rise of product costs; (b) cash flow problems due to the delay in refund of VAT - Exports from the State Tax Bureau, and, (c) the potential detriment of bank credit stating as a result of the squeezed profitability and cash flow; (d) FDI enterprises' extra capital investments, added business risk and longer pay back periods for participation in domestic industrial sectors favoured by the PRC's industrial policy.