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Country Business Guide:
China

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Snapshot

Basic facts

Population:	1.28bn
Fiscal year:	Starts January 1st
Main languages:	Standard Chinese or Mandarin
Currency:	Renminbi (Rmb) or Yuan
Inflation:	-0.8%
GDP per head:	US$1,024
GDP growth:	8%
GDP sources:	15% agriculture, 53% industry, 33% services

Political environment

The Chinese Communist Party (CCP) dominates the government. The transition from a "third generation" to a "fourth generation" party leadership took place in November 2002, when Hu Jintao succeeded Jiang Zemin as general-secretary of the CCP. Mr Jiang's continuing informal power limits Mr Hu's room for manoeuvre in pursuing further reform yet ensures broad policy continuity. Economic growth rates are robust, but structural weaknesses, particularly in the banking system, pose challenges.

Foreign trade & investment

In 2002 exports were US$322bn, imports US$278bn. The biggest export markets are the US, with 20%, followed by Hong Kong (18%), Japan (17%) and the EU (15%). China ranks 37th of 60 countries in the Economist Intelligence Unit's business environment rankings. China increasingly welcomes foreign investment, which reached US$53bn in 2002. WTO rules bind the country to open its industries further, but the government is keen to keep key sectors in domestic hands. Regulations for Guiding the Direction of Foreign Investment set out four investment categories--encouraged, restricted, prohibited and permitted--that determine the level of government approval required and the tax exemptions available.

Business & financing

Entering the Chinese market as a foreign company can be a challenging undertaking. Joint ventures are still the most common option, but foreign investors are increasingly turning to wholly owned foreign ventures. Securing official approval tends to be a complicated process, but China's membership of the WTO is expected gradually to lead to simpler, less cumbersome procedures. Exchange controls remain relatively strict; current account convertibility was introduced in 1996, but there is no timetable for capital account convertibility. Again, WTO membership is expected lead to liberalisation.

Labour environment

Education levels vary by region. English-speaking college graduates and engineers are common in Beijing or Shanghai, but personnel with specialised technical skills or training in accounting, finance, marketing and

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personnel management are scarce. Only state-sanctioned unions are permitted. Unemployment officially stands at less than 4%, but the Economist Intelligence Unit estimated the actual rate at 9.3% in 2002. Each province or municipality sets a minimum wage; this may not be less than half the local average wage. New labour rules stipulate that foreigners may be hired only where there is a demonstrated need to do so; approval is required from local labour authorities.

Taxation

Taxation occurs at the national, provincial and municipal levels. Resident companies and individuals are taxed on worldwide profits/income (with a credit for foreign tax). Most Chinese-source income of nonresidents is taxed. VAT applies to most transactions in goods and the business tax to most services.

Corporate tax rates:	The highest corporate tax rate is 33%.
Individual tax rates:	Progressive rates up to 45%.
VAT rates:	17% standard rate, and 13% and 0% lower rates.
Withholding taxes:	Dividends 0%; interest and royalties 10%. Rates may be reduced by tax treaty.
Tax treaties:	China has more than 75 tax treaties.
Capital gains:	Gains of companies are taxed as income. Individuals are taxed at 20% on gains.
Dividends:	Dividends are generally taxable, with some exemptions.
Revenue protection:	There is transfer pricing legislation.
Groups:	There is no provision for group taxation.
Incentives:	Special economic zones; export, high-tech and infrastructure projects
Other key taxes:	Business tax; construction tax; consumption tax; import duties; land appreciation tax; local land use tax; stamp tax; vehicle and vessel license tax; urban real estate tax.

The tax year is the calendar year for individuals and the corporate year for companies. All enterprises and corporations must pay tax in monthly or quarterly instalments. Individuals must pay tax monthly. VAT registration is compulsory.

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1.0 The Investment Climate

1.1 General

Land area	9,561,000 sq km
Population	1,284,303,705 (July 2002 est.)
Main towns	Population (m)
Shanghai	9.86
Beijing (Peking, capital)	7.61
Chongqing	6.61
Tianjin	5.33
Wuhan	4.41
Harbin	4.35
Shenyang	4.33
Chengdu	3.46
Nanjing	3.10
Changchun	2.88
Xi'an	2.86
Dalian	2.75
Climate	Continental, with extremes of temperature; subtropical in the south-east
Weather in Shanghai (altitude 4 metres)	Hottest months, July and August, 23-33°C (average daily minimum and maximum); coldest month, January, -1 to 9°C; driest month, September, less than 5 mm average rainfall; wettest month, June, 160-165 mm average rainfall
Languages	Mainly putonghua, or Standard Chinese, based on northern Chinese (the Beijing dialect known as Mandarin); local dialects and languages are also used
Weights and measures	The metric system is used alongside certain standard Chinese weights and measures.

1.2 Political background

The People's Republic of China (PRC) was founded in 1949 and the Chinese Communist Party (CCP) has been in power ever since. Politically, China remains a Marxist-style party-state, but free-market economic reforms since 1978 have transformed the structure of the economy and raised living standards.

Although changes revealed at the March meeting of the National People's Congress (NPC, the legislature) marked the end of the formal transition from the third- to the fourth-generation leadership, they did not signal an end to the informal handover of power. The two most senior officials in the new leadership line-up, the general secretary of the Chinese Communist Party (CCP) and state president, Hu Jintao, and the recently appointed premier, Wen Jiabao, do not control the bureaucratic power bases that are necessary in China for formal titles to translate into real political power. Better placed are six of the other seven members of the politburo standing committee (PSC, the CCP's nine-man elite), who are linked to the "core" official of the outgoing leadership, Jiang Zemin.

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1.3 Economic structure

Even before the programme of economic reform and opening began in the late 1970s, the Chinese economy was characterised by the unusually large share of industrial production in gross output value--in 1979 industry accounted for almost 50% of officially measured GDP. This was particularly striking because so much of the workforce remained on the land. Reforms in the early 1980s initially increased the relative share of the agricultural sector. Driven by a sharp rise in the procurement price paid for crops and what amounted to the semi-privatisation of agriculture, the share of agricultural output in total GDP rose from 30% in 1980 to 33% three years later. Since then, however, the share of agriculture has fallen fairly steadily and by 2001 it accounted for only 15% of GDP. During the 1980s agriculture was substituted for largely by a growing services sector: the share of tertiary industry in total output rose from around 21% of GDP in 1979 to over 30% ten years later. The relative share of the services sector has since remained steady, and the continued shrinkage in the relative contribution of agriculture has been reflected in a larger industrial sector, which in 2001 accounted for around 44% of GDP.

The structure of China's secondary industry changed fundamentally during the 1980s. Until 1978 output was dominated by large state-owned enterprises (SOEs). Since then, much of the boom in manufacturing output has been produced by "collective" enterprises under the aegis of local governments--particularly the township and village enterprises (TVEs)--or, increasingly, by private entrepreneurs or foreign investors either in wholly owned enterprises or in joint ventures with Chinese interests. By 2001 the share of state-owned and state-holding enterprises in gross industrial output value had shrunk to 44%. However, state-owned companies, controlled by economic ministries in Beijing, taken in isolation represented only 18% of industrial output. State-holding enterprises may control large numbers of state firms, and are not 100% state owned.

Comparative economic indicators, 2002

	China	India	Japan	Germany	US
GDP (US$ bn)	1,305.8	507.6	4,136.7	1,994.7	10.442.1
GDP per head (US$)	1,017	485.0	31,370	24,330	36,392.0
Consumer price inflation (av; %)	-0.8	4.2	-0.9	1.3	1.6
Current-account balance (US$ bn)	33.1	5.5	114.1	48.6	-494.3
Exports of goods fob (US$ bn)	325.4	47.9	387.6	603.4	686.1
Imports of goods fob (US$ bn)	281.2	55.0	293.4	485.4	-1,165.8

Source: Economist Intelligence Unit.

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1.4 Currency

The official currency of China is the renminbi, which is denominated in units of renminbi, jiao and fen (one renminbi equals ten jiao, or 100 fen). Since January 1994 the People's Bank of China (PBC--the central bank) has controlled the value of the currency in a "managed float", which allows the currency to fluctuate in a narrow range of Rmb8.277:$1 to Rmb8.278:$1. The currency closed a number of times outside this band in 2000, but that trend did not continue in 2001, and the authorities have ruled out any weakening of the currency regime.

It was not until Beijing's formal adoption of IMF Article VIII in December 1996 that the renminbi was officially convertible on the current account, though it had been in effect convertible since July 1996. The current account includes daily recurring business transactions. Examples are trading receipts and payments, service receipts and payments, and unilateral transfers, such as payment of royalties, repatriation of after-tax profits and dividends, remittance of after-tax wages and other legal income of foreign employees of foreign investment enterprises, and payment of interest on foreign debts.

The renminbi remains non-convertible in the capital account. This account deals with import and export capital, direct investment, and loans and securities investment, such as repayment of principals of foreign debts, overseas investment, investment in foreign investment enterprises (FIEs) and remittance of capital by FIEs following liquidation. Since 1993 the government has promised to obtain convertibility of the renminbi under the capital account on a gradual basis. However, the authorities lost their ardour for rapid liberalisation after the Asian financial crisis of 1997-98 and the subsequent depreciation of a number of Asian currencies.

The circulation of foreign currencies within China has been banned since January 1st 1994, the date on which China unified its currency. The interbank market and banks authorised to deal in foreign exchange (where individuals and enterprises may set up foreign-exchange accounts) are the only legal avenues for retaining and transferring foreign currency. To keep foreign exchange out of the market, the government has banned the setting of prices or settling of accounts in hard currency, including the Hong Kong dollar. However, the authorities have been unable to prevent the use of the Hong Kong dollar in cash transactions, and it remains a widely used currency in southern China.

1.5 Attitude towards foreign investment

Foreign direct investment (FDI), which contributes to the economy through the establishment of export enterprises and the absorption of redundant labour, rose further in 2002, boosted by China’s entry into the World Trade Organisation (WTO) in December 2001. Utilised FDI increased 12.51% from 2001 to US$52.74bn. This did not quite match the 14.9% growth recorded the year before, but marked a continued clear improvement from 2000, when utilised FDI was virtually flat, rising a mere 0.93%. In 2002 contractual FDI, indicating future investment flows, grew by 19.62% to US$82.77bn, compared with a rise of 10.4% in 2001.

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Statistics from 2002 confirm the recent trend of wholly foreign-owned ventures (WFOs) being the most popular investment vehicle, at the expense of equity joint ventures (EJVs) and contractual joint ventures (CJVs). Between January and November, WFOs accounted for US$28.7bn of utilised FDI, or 59.7% of the total. EJVs accounted for US$13.7bn, or 28.4%, and CJVs, US$4.5bn, or 9.3%. The increase in WFOs (including wholly foreign-owned holding companies) is an encouraging trend, bringing China more in line with international norms.

Unlike JVs (many of which continue to operate with life spans of 10-30 years or sometimes even 50 or more years), WFOs operate without time limits, making them potentially more integral to the economy. Together, China's foreign investment enterprises (FIEs) employed more than 23m persons as of late 2002.

Although China welcomes foreign investment, and is bound under WTO rules to open its industries further to foreign businesses, it does not wish to see control over important or "strategic" sectors of its economy slip into foreign hands. In an effort to clarify the country's national economic and social development priorities, the central government promulgated Regulations for Guiding the Direction of Foreign Investment, which took effect on April 1st 2002. The regulations replaced the Provisional Regulations for Guiding the Direction of Foreign Investment, which had been in force since June 1995. The regulations give the State Development Planning Commission (SDPC), the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) and the State Economic and Trade Commission (SETC) responsibility for regularly publishing a Foreign Investment Catalogue, which is to be used by MOFTEC and other foreign investment authorities to guide the examination and approval of foreign investment projects. A revised edition of the catalogue took effect on April 1st 2002, replacing two previous versions introduced in 1995 and 1998. The regulations also charge the SDPC, MOFTEC and the SETC with publishing a separate list covering China's less-developed inland regions for sectors in which foreign investment is encouraged.

Under the regulations, foreign investment projects fall into four categories: encouraged, restricted, prohibited and permitted. Foreign investment projects in the first three categories are listed in detail in the Foreign Investment Catalogue; permitted projects are deemed to be all projects not listed in the catalogue. The catalogue allows for some flexibility, as companies in the "permitted" category will be considered "encouraged" if they export 100% of their output. Similarly, enterprises in the "restricted" category may be upgraded to "permitted" status if their exports account for at least 70% of their output. The 2002 Catalogue marks an easing compared with the 1998 version, as the number of sectors in the "encouraged" category was expanded from 186 to 262 while the number in the "restricted" category fell from 112 to 75. The liberalisation evident in the new catalogue has been necessitated partly by concessions made by China to gain entry into the WTO; on the other hand, the schedule for implementation of WTO concessions means that certain industries, especially in the service sector, will only be opened after a certain number of years. The main implications of the classification are in terms of the level of government responsible for investment approval (and the extent of tax

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exemption available. The catalogue also lists various projects for which wholly foreign-owned enterprises are prohibited or for which the state must have a controlling interest.

Encouraged foreign investments, according to the provisions, include the following:

- Projects related to new agricultural technology, construction of energy sources, transport and raw materials for industry;
- Projects utilising new or advanced technology, including projects that can increase product quality, save energy and raw materials, raise economic efficiency and alleviate shortages in the domestic market;
- Projects that meet international market demand, enhance product quality, open up new markets and increase exports;
- Projects that involve integrated use of China's resources or use of renewable resources, involving new technology or equipment for preventing and controlling environmental pollution; and
- Projects that can develop the manpower and resources of central and western China. Some projects in the encouraged category may be eligible for preferential treatment. Both permitted and encouraged foreign investment projects are subject to existing examination and approval procedures for foreign investment.

Restricted categories of foreign investment include the following:

- Projects already developed in China, where the technology has already been imported and where capacity can meet market demand;
- Projects with an adverse effect on the environment and energy conservation;
- Projects involving exploring for and/or extracting rare or precious mineral resources; and
- Projects in industries requiring central planning by the state.

The 2002 regulations introduced a simplification of the "restricted" category, abolishing a previous distinction between "restricted (A)" and "restricted (B)". Projects previously categorised as "restricted category (B)" needed approval from the central authorities in charge of the industry, even if the project proposals were below the limit for which central approval was required. Since "restricted" projects are no longer subdivided into (A) and (B) classes, approval authority now lies with either local or central authorities, depending on investment size.

Prohibited foreign investments, under the provisional regulations, include the following:

- Projects that endanger state security or harm the public interest;
- Projects that pollute the environment or endanger human health;
- Projects that occupy large tracts of farmland or endanger the security or efficient use of military resources;

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- Projects that utilise manufacturing techniques or technologies unique to China; and
- Other projects prohibited under state laws and administrative regulations.

To date, the scope of operations allowed for foreign investment, or holding, companies, includes manufacturing, investment in subsidiaries, purchase of inputs and raw materials for subsidiaries, co-ordination and consolidation of project management, personnel recruitment and training for subsidiaries, market development and consulting to group companies, provision of product maintenance and technical support. Many foreign investors had assumed that they could convert their representative office to a holding company, which would then perform the activities of the old representative office as well as those of the holding company. But foreign investors are finding that they must keep their representative offices to perform their current export-import-related functions, since holding companies are banned from domestic or foreign trade.

Investment companies are banned from lending to subsidiaries. (In China only licensed financial institutions may lend money.) Some holding firms circumvent this rule, however, by placing funds with a group company and charging that company a “user fee” for the funds. By law, umbrella firms are allowed only to negotiate loans on behalf of their subsidiaries and to provide collateral and loan guarantees.

Existing foreign-exchange regulations open the door to investment companies balancing foreign-exchange shortfalls and surpluses among its subsidiaries; in practice, however, the State Administration for Foreign Exchange (SAFE) has refused to give its permission for these kinds of activities. Although some investment companies flout the rules and engage in direct foreign-exchange balancing, transfer pricing and intra-group lending, there have so far been no high-profile cases of enforcement of the banks on these practices. A holding company’s business licence must state the industries, projects or products in which it will invest. Thus it cannot obtain an open licence to engage in whatever business it wants.

China’s complex system of restrictions on foreign investment will probably change fundamentally now that the country is a WTO member. Among the industry-specific concessions made in order to gain access to the trade body were the following:

Telecommunications. Foreign companies, which were previously barred from investing in telecoms services, will be allowed a gradual entry into the industry. Immediately upon China’s accession to the WTO, they were allowed 30% ownership in joint ventures in value-added services, including paging, Internet service providers and Internet content providers in the cities of Beijing, Shanghai and Guangzhou; at the end of 2002, this was scheduled to rise to a maximum 49% ownership and the geographical area was to be expanded to 14 other cities (Chengdu, Chongqing, Dalian, Fuzhou, Hangzhou, Nanjing, Ningbo, Qingdao, Shenyang, Shenzhen, Taiyuan, Wuhan, Xiamen and Xian--though as of February 2003 there had been no formal announcement indicating that this had in fact occurred); in late 2003 the cap on ownership will be raised to 50% and all geographic limitations will be scrapped. For mobile voice and data services, ownership

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of 25% was allowed upon accession in Beijing, Shanghai and Guangzhou; by late 2002, this was scheduled to rise to 35% ownership in the 14 cities mentioned above (though as of February 2003 there had been no formal announcement indicating that this had in fact occurred); by late 2004, a maximum 49% ownership will be permitted; and by end-2006, all geographical limits will be abandoned. For fixed-line services, 25% ownership will be allowed by late 2004 in Beijing, Shanghai and Guangzhou; by late 2006, the cap will be raised to 35% and the geographical area will be expanded with the 14 cities; and by late 2007, maximum foreign ownership will rise to 49% with no geographic restrictions.

On December 11th 2001 the Ministry of Information Industry (MII) abolished two regulations, dating from 1993 and 1995, to align its own legal framework with these concessions. The removal of the ban may have gone some way towards alleviating jitters over an MII notice of March 27th 2001, which reiterated that foreign investors were not allowed to invest in telecoms networks prior to China’s entry into the WTO. The notice highlighted sensitivity of the Chinese government—and, in particular, of the MII--to foreign investment in Internet-related industries. It also served as a warning that investments in businesses in legal grey areas can be extremely risky and subject to sudden changes in the attitudes of regulators--even if such investments are not explicitly prohibited by the Chinese authorities. Some observers do believe, though, that China will promulgate new rules accepting foreign in vestment in telecoms networks now that the country has entered the WTO.

Insurance. Administrative Regulations for Foreign-Invested Insurance Companies took effect on February 1st 2002. The regulations require foreign-invested insurance companies to have Rmb200m in registered capital, and each branch to have Rmb200m in operating funds. The regulations also set requirements for foreign insurance companies seeking to enter China, demanding that they have US$5bn in assets, 30 years of experience and have operated a representative office in China for at least two years.

In accordance with China’s WTO accession protocol, foreign companies were allowed up to 50% ownership in life joint ventures immediately upon accession to the WTO; a special provision also allowed the foreign joint-venture partner to negotiate management control. The maximum foreign shareholding limit is similar to the present level, and below some 51% stakes in existing ventures, which will, however, be grandfathered. The EU has said that its agreement with China will provide “effective management control” for foreign investors in lifetime joint ventures, since they can choose their partners freely and will be guaranteed non-interference from regulators. For non-life businesses, China allowed 51% ownership or branching immediately upon WTO accession, and wholly owned subsidiaries will be allowed in late 2003.

Brokers for insurance of large-scale commercial risks, brokers for reinsurance and brokers for international marine, aviation and transport insurance and reinsurance were allowed up to 50% ownership immediately upon accession; in late 2004 this will be increased to 51%; and in late 2006 100% ownership will be allowed. Foreign insurers, previously limited

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to doing business in either Shanghai or Guangzhou, were allowed to expand their business to Dalian, Shenzhen and Foshan directly after China entered the WTO; in late 2003 the geographic scope will be expanded to Beijing, Chengdu, Chongqing, Fuzhou, Ningbo, Shenyang, Suzhou, Tianjin, Wuhan and Xiamen; in late 2004 all geographic limits will disappear. Foreign property and casualty firms were allowed to insure “large-scale risks” throughout China immediately after accession.

Wholesale and retail. The WTO agreement also sets out details about foreign investment in the wholesale and retail sectors. By the end of 2002, foreigners were scheduled to be allowed to set up wholesaling joint ventures dealing in all locally produced and imported products, with a few exceptions (though as of February 2003 there had been no formal announcement indicating that this had in fact occurred). The exceptions include books, newspapers and magazines, which were scheduled to be opened by late 2002; pharmaceutical products, pesticides, processed oil and mulching films, which will be opened by late 2004; and chemical fertilisers, which will be opened by late 2006. By late 2003, foreign majority ownership in wholesale joint ventures will be allowed, and by late 2004, wholly foreign-owned wholesaling subsidiaries will be permitted.

Directly upon WTO accession in late 2001, China allowed foreign retail participation in joint ventures in the five special economic zones of Hainan, Shantou, Shenzhen, Xiamen and Zhuhai, as well as the cities of Beijing, Dalian, Guangzhou, Qingdao, Shanghai and Tianjin. In Beijing and Shanghai, China allowed a maximum of four foreign-invested retailing joint ventures, whereas in the other locations, the maximum was just two. After China’s entry into the WTO, the cities of Wuhan and Zhengzhou were immediately opened to foreign-invested retail JVs, and by late 2003, the geographic scope will be expanded to all provincial capitals and to the cities of Chongqing and Ningbo, while foreign majority control will be permitted. By end-2004, all geographical restrictions and limits on ownership will disappear.

In a “consensus” agreement signed with the US in June 2001, China also allowed greater foreign access in the area of distribution by narrowing the definition of chain stores (where foreign participation in joint ventures is limited to a minority equity share). Prior to this consensus, China had maintained that any retail operation with more than two outlets was considered a chain store and therefore could have only minority foreign equity share. After the consensus, the minority-share limitations were restricted to stores that sell different types of goods and brands from multiple suppliers and that have more than 30 outlets, as well as department stores of more than 20,000 sq metres.

Banking. Foreign banks are gradually being allowed greater scope both in permissible areas of business and geographical scope for their investments. Foreign banks, so far limited to doing business in local currency with foreign companies, will be allowed to conduct business in the local currency with Chinese enterprises in late 2003 and with local individuals in late 2006. For renminbi business, the geographic scope was widened as of December 1st 2002, from the cities of Shanghai, Shenzhen, Dalian and Tianjin to include Guangzhou, Nanjing, Qingdao, Wuhan and Zhuhai. In late 2003 Chengdu, Chongqing, Fuzhou and Jinan will be

added to the list; in late 2004, Beijing, Kunming and Xiamen; in late 2005, Ningbo, Shantou, Shenyang and Xian; and in late 2006, all geographic limitations will be scrapped. As of late September 2002, 45 of 181 foreign bank branches in China had obtained permission to conduct renminbi business.

It will be cumbersome, however, for foreign banks to utilise the full opening in the banking sector mandated by the WTO. While the working-capital requirement for doing business under the current level of opening is US$12m, this will rise to US$72m once the last curbs disappear in late 2006. The WTO agreement also specifies that foreign financial institutions, in order to be allowed to do renminbi business, must have a track record of three years of operations in China, and must have been profitable for two consecutive years prior to application. For foreign banks' business in foreign currencies, all geographical limits disappeared immediately upon accession and there were no limits as to local customers. However, some barriers hampering the utilisation of this opening, including a rule that the SAFE must approve foreign-currency loans by foreign banks branches to Chinese companies, have emerged.

Non-bank financial institutions should have been able to offer car financing immediately upon accession, but the relevant rules were slow in coming. Only on October 8th 2002 did the PBoC issue draft regulations for foreign companies seeking to engage in this business. The rules imposed requirements considered extremely strict by international standards, including minimum equity capital for foreign auto financing companies of Rmb500m and minimum assets of the parent company of Rmb8bn. As of late 2002, this business was still conducted by Chinese banks only.

Securities. In the securities industry, joint ventures with minority foreign shareholdings have been allowed to engage in fund management on the same terms as Chinese businesses. Minority joint ventures are allowed to underwrite domestic securities issues and underwrite and trade in securities denominated in foreign securities. China has pledged that as the scope expands for local securities firms in the coming years, foreign joint ventures will automatically enjoy access to the same new areas opened for business. Upon accession to the WTO, foreign securities companies were allowed to establish fund-management joint ventures and hold ownership in them of up to 33%. By end-2004, that ownership cap will be raised to 49%. Also by late 2004, foreign securities companies will be allowed to establish joint ventures, with their ownership not exceeding one-third, to engage in underwriting A shares and in underwriting and trading B and H shares as well as government and corporate bonds.

Legal services. Regulations for Administration of Representative Office of Foreign Law Firms in China took effect on January 1st 2002. They affect all foreign firms except those from Taiwan, Hong Kong and Macau. To some extent, they relax requirements--reducing from three to two the number of years that a foreign lawyer must have practised abroad to secure permission to work in China, for example. However, in a number of areas, the regulations place significant burdens on foreign law firms hoping to enter the Chinese market. They require a lengthy approval process for setting up offices, as applications must first be processed by the local

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justice bureau, which has 90 days to reply, and then to the Ministry of Justice, where processing the application can take up to six months.

Foreign law firms are also not allowed to practise Chinese law, but can merely offer advice to their clients about the impact of China's legal environment on their businesses. Implementing Regulations on law offices, which took effect on September 1st 2002, tightened the rules further; they require a comprehensive study of the need to set up a representative office, including the general social and legal needs of the locality where establishment is proposed, and whether the foreign law firm can help meet those needs. In addition, the Implementing Regulations demand that a foreign law firm cannot set up a new representative office within three years of the establishment of its most recent representative office.

Other professional services. Professionally licensed accountants, who had been subject to mandatory localisation requirements, now have unrestricted access to the Chinese market. According to the US Trade Representative's office, China has also offered a "broad range of commitments" in areas such as taxation, management consulting, architecture, engineering, urban planning, medical and dental services, and computer-related services.

Hotels. China offered immediate unrestricted access to the Chinese market for hotel operators, permitting majority ownership upon accession, and wholly foreign-owned hotels four years after.

Automobiles. In the automobile industry, China abolished requirements that previously forced engine producers to enter into joint ventures with Chinese partners.

Alongside the implementation of its WTO concessions, China is undertaking parallel incremental moves at opening certain markets.

On August 1st 2002 new regulations promulgated by MOFTEC and other agencies on foreign investment in the **aviation** sector took effect. The rules allow foreign investment in aviation joint ventures, requiring that the Chinese partner control the venture and that no single foreign investor hold more than 25%. The rules also permit joint ventures operating civil airports, again requiring Chinese control.

Logistics, one area not specifically addressed in China's WTO accession protocol, was covered by MOFTEC regulations that took effect on July 26th 2002. The regulations permit the establishment of joint ventures in a number of pilot areas, including the cities of Beijing, Chongqing, Shanghai, Shenzhen and Tianjin as well as the provinces of Guangdong, Jiangsu and Zhejiang. The minimum registered capital is US$5m and investment must be in the form of joint ventures, in which foreign majority ownership is not allowed. The logistics area has been a source of considerable bitterness among foreign express-delivery companies because of the insistence of China's own postal service, China Post, on protecting and expanding its market share. In a notice published in February 2002, China Post ordered that private delivery companies were allowed to handle only packages weighing more than 500 grams and must charge prices higher than those charged by China Post itself.

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Detailed rules on foreign investment **printing** enterprises took effect on January 29th 2002, elaborating on broader regulations promulgated the previous August. The rules allow the establishment of foreign investment enterprises engaged in the printing of publications and printed matter for packaging decoration, requiring registered capital of at least Rmb10m. Wholly foreign ownership is allowed for enterprises engaged exclusively in printing printed matter for packaging decoration, while joint ventures, controlled by the Chinese partner, are required for enterprises printing publications.

These liberalisations taken independently of the WTO concessions are partly used by the Chinese authorities as a way to absorb advanced foreign technology, financial expertise and management practices. On September 1st 2001, for instance, new MOFTEC regulations took effect allowing foreign investment venture-capital companies, providing new access to capital for China's cash-starved **high-technology** companies. Among the requirements for such foreign investment enterprises are a minimum 25% foreign ownership and (in a bid to ensure that only well-established foreign enterprises enter the new industry) the condition that the foreign joint-venture partner has managed at least US$100m in the three years prior to application. A potential problem in attracting foreign investors to the new field is the absence of a domestic stockmarket focused on high technology that would provide foreign venture capitalists with a clear exit opportunity (though the regulations do allow venture capitalists to use either local or overseas stockmarkets for exit strategies). Another problem is that the venture capitalists have to use their own capital in their investments and are not allowed to borrow the funds.

Also since September 1st 2001 new MOFTEC regulations have allowed the establishment of **leasing companies** with foreign investment, explicitly to take advantage of the experience and management expertise of leading international leasing companies. Towards this end, the regulations require the foreign joint-venture partner to have at least five years' experience in financial leasing and at least US$400m in assets. The foreign partner can contribute up to 80% of the registered capital, and the leasing joint venture must operate for at least 30 years.

Other new regulations published during 2001 included rules on establishing foreign investment **employment agencies**, which took effect in December 2001. The main objective of the rules appeared to be the legalisation of a long-standing foreign presence in the industry, thus strengthening the hands of the regulators. In a clear sign that foreign investment employment agencies have long been active in China, the government accompanied its announcement of the new rules with a warning that already existing foreign investment businesses had to register by year-end or face closure. The rules outlawed wholly foreign-owned enterprises in the sector, required that the foreign joint-venture partner have previous overseas experience and barred representative offices of foreign enterprises from engaging in the business.

On March 29th 2001 the Ministry of Communications said it would encourage foreign investment in its **harbours,** to help the government in its 10th Five-Year Plan (2001-06), which calls for the development of 135

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new deep-water berths. However, the ministry did not indicate that any specific regulations would be issued to clarify its accommodating policies.

The Provisional Measures for Administration of Chinese-Foreign Joint Equity and Joint Co-operative Medical Institutions, in force from July 1st 2000, allow foreigners to hold up to 70% of shares in **medical institutions** using either Western or traditional Chinese medicine. The measures state that the total investment in the institutions must be at least Rmb20m and that the joint-venture contract must have a maximum term of 20 years. Approval of joint ventures must be obtained from MOFTEC, the Ministry of Health and, for institutions that use traditional Chinese medicine, the State Administration of Traditional Chinese Medicine. The rule legalised many existing joint ventures in the field, since statistics indicate that as many as 200 joint-venture hospitals and clinics already exist in China.

MOFTEC and the Ministry of Railways jointly issued a set of regulations on August 29th 2000 allowing foreigners to invest in **rail-freight** transport. Foreign companies with at least ten years' experience in the industry may now participate in joint ventures and are allowed a maximum 49% share. The freight joint ventures must have at least US$25m of registered capital and may operate for up to 20 years.

Information on the overall profitability of investment in China is sketchy at best. An indirect measure is in the form of the taxes paid by FIEs. According to data from the State Administration of Taxation, FIEs paid Rmb231bn in taxes in 2000, an increase of 40.5% from 1999. Taxes from FIEs accounted for 18.3% of total tax revenues in 2000, up from 16% the year before. The trend appeared to continue in 2002; in the first two months of the year tax payments by FIEs rose 45.9%, while tax payments by local companies dropped 7.7%, according to the China Daily. The absolute amount of funds paid was not disclosed. These figures should probably be viewed with caution, however, since some FIEs probably underreport profits to evade taxes.

According to data from the US Department of Commerce, US investments in China enjoyed returns of 12.44% in 2001. This reflected a slight decrease from the 14.25% profitability rate achieved in 1999.

1.6 Banking and financing

There are more than 40,000 financial institutions operating in China, a number that continues to increase. Nevertheless, the dominant players in the market remain the four state commercial banks: Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), the China Construction Bank (CCB) and the Agricultural Bank of China (ABC). They accounted for 86% of total banking assets in the country at end-2000; other banks (including foreign banks) shared the remaining 14%.

Besides this dominant foursome, there are national and regional commercial banks, rural and urban credit co-operatives (many of which are being transformed into banks), and foreign and joint-venture financial institutions. Three policy banks were set up in 1994 with instructions to take over government-mandated lending from the four state commercial banks.

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China's banking sector remains almost entirely state owned, either directly or through state-owned companies. In November 2000 the state media reported that the People's Bank of China (PBC--the central bank) had sanctioned the creation of ten privately owned banks. However, this proved to be a false lead: in April 2001 the central bank denied having any such intention. As of February 2002 China Minsheng Banking Corp, established in 1996, remained China's only privately owned bank.

The Chinese financial system will be forced to evolve more quickly to a market-oriented system following China's accession to the World Trade Organisation (WTO) in December 2001. Agreements that the Chinese authorities negotiated with foreign countries in advance of entry to the trade body will require the gradual opening of the banking, insurance and fund-management sectors. Other sources of change to the financial system arise from the re-incorporation of Hong Kong and Macau to Chinese sovereignty, the rise of domestic investment banks and securities brokers, and official efforts to manage bad bank debts through the use of specialised asset managers.

The country's banking system is regulated by the Commercial Bank Law, which was passed by the National People's Congress in March 1995 and became effective in July of that year. The law formalises a 1994 policy to make the banking system adhere to market principles. The more detailed General Rules on Lending, issued in August 1996, largely reiterate the main principles of the Commercial Bank Law, stressing that banks should rate borrowers' creditworthiness according to objective rather than political criteria.

The law's most important feature is that it liberates the state commercial banks from political pressure and requires them to "go fully commercial". Under the law, the banks are to conduct their lending operations on the basis of profitability, liquidity and risk minimisation. However, this new freedom can be limited or suspended where it runs counter to the interests of the state in the sense that the State Council "may direct the banks to conduct their loan business in accordance with the need for development of the national economy.” Losses arising from such operations are to be compensated by the State Council, although these measures have yet to be clearly defined.

Foreign investors in China fill their renminbi financing needs mainly through specialised banks and other members of the commercial-banking system. Offshore sources of finance continue to play an important role in meeting foreign companies' financing needs. The World Bank is a big lender to China, and the International Finance Corp (IFC--the World Bank's private-sector financing arm) has an office and a growing presence in Beijing.

Despite its vast size, China has a highly centralised political system with nearly all government authorities located in the capital, Beijing. By contrast, the main economic centres are Shanghai in the east and Shenzhen in the south. The country's stockmarkets and many of its most dynamic companies are located in those two cities. Within China's borders but outside its jurisdiction, Hong Kong is one of the world's key financial centres

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1.7 Foreign trade

Exports increased by 22.3% in 2002 from the previous year, a significant improvement on the 6.3% growth recorded in 2000 and 2001. Consequently, the trade surplus rose to US$28bn, up about 20% from a year earlier. China continues to grant export-tax rebates for specific sectors. This was originally a means to ward off the worst effects of the 1997-98 Asian financial crisis, but it has been instituted as a more or less permanent export-boosting measure. Some have characterised this practice as “hidden devaluation”, but the advantage over a regular devaluation is that it can be made industry specific. The average export-tax rebate rate now stands as 15%. China’s top trading partners in 2002 were (in descending order) Japan, the US, the EU, Hong Kong, the Association of Southeast Asian Nations (ASEAN), Taiwan, Korea, Russia, Australia and Canada.

China’s overriding trade goal, to gain admittance to the World Trade Organisation (WTO), was achieved after 15 years on December 11th 2001. China withdrew from the WTO’s predecessor, the General Agreement of Tariffs and Trade (GATT), in 1950, following the establishment of separate governments on the mainland and in Taiwan. As the sixth-largest trading nation in the world, China had long argued the WTO could not be complete without its membership, but China, of course, was seeking the benefits associated with membership. In finance, telecommunications and distribution, the main sectors in which foreign countries were looking for substantial concessions, China offered considerable compromises in agreements with the US and the EU.

China’s Ministry of Foreign Trade and Economic Co-operation (MOFTEC) received high marks from its foreign counterparts for its co-operative approach to WTO negotiations, but MOFTEC found it extremely difficult to win co-operation from the country’s key industry ministries; many of these saw WTO accession more as a threat to their protected fiefdoms than an opportunity. The deal with the US, for example, was clearly formulated to ward off resistance from the powerful Ministry of Information Industry, which watches over China’s telecoms and Internet sectors, where foreigners would not be allowed more than a 50% stake in joint ventures.

China’s trade regime was subjected to an immediate, comprehensive overhaul, since the country is now committed to revising many regulations to conform to WTO standards. MOFTEC said on March 28th 2002 that a total of 381 regulations and 178 trade-related internal documents had been abolished. Overall, 1,150 different laws and regulations will be examined and, if necessary, revised in order to conform to WTO standards, an effort requiring the involvement of 25 different ministries and ministry-level departments.

Nevertheless, some WTO members believe that China’s past actions raise questions about its commitment to abide by WTO rules. In April 2002, for example, China banned the import of 177 cosmetics items imported from the EU, saying that they could cause mad-cow disease. The month before, a simmering Sino-US trade dispute seemed to have found at least a temporary solution. The dispute was caused by rules published by China

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in January 2002 demanding “safety certificates” for all genetically modified agricultural products imported from abroad, and stated that the certificates might take up to nine months to obtain. US agricultural producers were worried about the trade-disruptive effects, and meetings between US and Chinese officials included intensive lobbying on their behalf. As a preliminary solution, China published new measures on March 12th 2002 allowing for the issuance of “interim certificates” to exporters within 30 days of application.

Meanwhile, China has also shown its determination to avail itself of the rights that WTO membership brings. On November 19th 2002 it extended to three years the duration of safeguard measures for three kinds of steel products that had been in place since May. The measures were introduced in response to higher tariffs on steel products introduced by the US government in March.

China’s entry into the global trade body also means that foreign investment enterprises (FIEs), previously forced to rely largely on Chinese state-owned enterprises to handle their imports and exports, will be allowed to engage in foreign trade by the end of 2004. China had taken only incremental steps in the past to allow FIEs greater access to foreign trade. MOFTEC issued a notice on July 2nd 2001 stating that foreign investment manufacturing enterprises were allowed to export products purchased inside China under certain conditions, including a requirement that the companies engaging in business export had not violated any Chinese tax or trade laws within the prior two years. The Provisional Measures on the Establishment of Sino-Foreign Joint-Venture Trading Companies on a Pilot Basis were made effective in September 1996; they allow for the creation of joint-venture trading companies in the Pudong New Area (east Shanghai) and the Shenzhen Special Economic Zone. The law requires a Chinese party to hold at least 51% in any joint-venture trading company with a foreign entity. The criteria for foreign partners to qualify are extraordinarily tough: gross annual revenues exceeding US$5bn, an average annual trade volume with China exceeding US$30m over a three-year span and an existing investment in China of at least US$30m. Chinese partners must possess trading rights and have an average annual trade volume of US$200m over a three-year period, of which at least US$100m must be exports.

2.0 Labour relations and work force

2.1 General

China’s massive workforce, both urban and rural, stood at about 700m at end-2002, with registered urban unemployed projected to have reached 8m by the end of the year, up from 6.81m in late 2001. Not included in the statistics are about 6m laid-off workers from state-owned enterprises who still receive benefits from their former employers. The government has stated that its official unemployment rate--measured as registered urban unemployed as a percentage of the total urban workforce--is expected to have reached 3.9% by late 2002; however, in a startling revelation, Zhang Zuoji, the minister of labour and social security, said on November 11th

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2002 that if laid-off workers are included, the real unemployment rate is approximately 7%.

Restructuring of state enterprises is already leading to massive lay-offs and is perceived to be creating a major threat to social stability, as evidenced in the government's assertion that 7% economic growth is the general minimum that will be required to absorb excess labour. Employment centres have been created throughout China, with some success, according to official sources. The Ministry of Labour and Social Security claims that 95% of laid-off workers from state companies have now registered with the centres, and 90% of them receive financial aid there.

The level of education of workers varies by region. In Beijing or Shanghai, it is easy to find college graduates who speak English and persons with engineering or technical degrees. However, it is difficult to find people with specialised technical skills or with training in accounting, finance, marketing, quality control, retailing and personnel management. Most engineers are either unspecialised or bound for employment in state enterprises. Chinese universities offer Western-style business classes on a limited, though expanding, basis. There is a shortage of educated and skilled labour in the south and in Shanghai, Beijing and other up and coming cities such as Tianjin, Hangzhou, Chengdu and Suzhou.

Although demand for experienced local managers continues to outstrip supply, foreign managers see the gap narrowing. Moderating economic growth since 1997 (particularly in the state-owned and collective sector), coupled with a rise in the supply of capable young graduates from universities, has relieved some of the pressure on foreign investment enterprises (FIEs) searching for the best and brightest workers.

According to Watson Wyatt, a benefits consultancy, staff turnover varies widely by region, industry and type of enterprises. A 2002 survey conducted by the company found that the average turnover rate at all types of FIEs in China was 13.3%, nearly unchanged from 13.4% the year before. Some companies combat this problem with comprehensive retention schemes--providing valued staff with a career-development plan, a balanced and generous compensation-and-benefits package, and retention bonuses for key employees with high market value.

Because of the high costs and bureaucratic hurdles in sending local employees overseas, more companies with multiple investments in China (among them Siemens, Motorola, Asea Brown Boveri and LM Ericsson) are establishing state-of-the-art employee training centres in the country, which can offer technical and managerial development to staff.

Traditional attitudes that stress the importance of equality in pay and assume pay differentiation is based on seniority are still well entrenched. FIEs' efforts to implement systematic compensation-and-benefits packages are helping to close the huge gaps previously seen in pay between workers doing the same job. The emergence in the past year of human-resources networks in major cities, like Beijing and Shanghai, has made a significant contribution towards developing a more uniform market for skilled staff.

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To assist FIEs in their recruiting drive for both local and expatriate labour, a number of foreign recruitment companies are now teaming up with organisations in China to establish executive search firms. US-based executive search firm Heidrick & Struggles International announced in early December 2002 that it had formed China's first head-hunting joint-venture company with Beijing Leading Human Resources Consulting. Korn/Ferry International, another US-based executive search company, has also been given the green light to establish a joint venture with China International Economic Consultants, state-run Business Weekly reported on December 10th 2002. Hiring a foreign search firm that has a local partner can offer an FIE the influence and negotiating skills needed to release local job candidates from state-owned employers.

There are essentially two labour markets operating within China: one for domestic enterprises and the other for FIEs. To leave their jobs, workers in the domestic sector must obtain permission from their work unit (danwei). In practice, though, many local employees manage to leave their domestic employers for work in the foreign investment sector with impunity. Eventually, it is likely that the two labour markets will merge into one, given the greater freedom Chinese workers are enjoying to seek employment according to their preferences. Several factors are contributing to this, including housing reform. In the past, state-owned enterprises (SOEs) provided free lifetime housing for their employees, giving them an extra incentive to stay on throughout their careers. As Chinese employees are increasingly forced to buy or rent their own housing, the SOEs have lost this crucial leverage over their workforce. Contributing to the same development, the increasing sophistication, management skill and language ability of Chinese recruits has resulted in a tendency for multinationals to localise their staff and hire locals for positions that in the past would automatically have been filled with expatriates.

To avoid negotiations, which are mediated by the local labour service bureau (LSB) and frequently prove difficult, many joint ventures go directly to Chinese universities and technical institutes to recruit higher-level technical personnel. University recruitment is expected to become more popular as more graduates pay tuition fees in exchange for the right to select their own employment upon graduation. In most surveys of FIE human-resources managers, individual referrals by existing employees, job fairs (usually sponsored by an official labour service company), newspaper advertising and personal relationships are cited as the most popular way to recruit local staff. Once workers enter the FIE labour market, they are not required to stay in their jobs.

2.2 Employee benefits

Foreign investment enterprises (FIEs) remit wage and benefit payments to the local labour service bureau (LSB) or trade union, or they entrust the matter to the Chinese partner. Under the Provisional Regulations on the Payment of Wages (effective January 1st 1995) and the Supplementary Regulations of the Ministry of Labour on Relevant Issues Concerning the Provisional Regulations for the Payment of Wages (effective May 1995), FIEs are also permitted to appoint a bank to issue wages. A joint venture may determine its wage scales independent of the rates of the Chinese

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partner and other Chinese enterprises. Most JVs take advantage of this right, believing Chinese wage scales to be cumbersome and inappropriate. The foreign partner in a JV often negotiates a wage scale with the Chinese partner or local LSB and includes this in the labour contract, spelling out carefully what benefits and subsidies are included and which party pays for them.

The labour law stipulates that wages be paid according to the principle of equal pay for work of equal value, a notion often invoked by Chinese JV partners, who insist on comparable pay for Chinese and expatriate managers. Apart from meeting minimum-wage requirements, the labour law reaffirms the right of FIEs and state-owned enterprises (SOEs) to set their own wages. The Provisional Regulations on the Payment of Wages clarify that wages must be paid in currency--not in goods or vouchers--directly to employees. Under the provisional regulations, daily wages are calculated on the basis of 21.5 working days per month under the new working-hour system of eight hours a day and 40 hours a week. However, enterprises that are still operating under the old system of 44 hours a week may calculate daily wages on the basis of 23.5 working days per month. The regulations permit payment on an hourly, daily, weekly or monthly basis. China's labour law empowers the central government to implement "macro-control" over the "total amount" of wages and salaries, leaving open the possibility of the government implementing wage freezes as an inflation-fighting measure in future.

Starting annual salaries for foreign managers in China are US$60,000-200,000 or more, depending on the type of operation and the location. Housing and schooling allowances, perks and hardship pay are added to this salary. Wages and salaries for Chinese staff vary widely by region, and total labour costs can be as much as five times higher than basic wages, with a range of benefits and subsidies making up the balance.

Managerial salaries for Chinese staff vary widely by skills but generally start at around Rmb3,000 per month for junior managers. Skilled financial officers working in JVs can earn as much as US$15,000–40,000 per annum, but salaries may be substantially higher for local executives working in representative offices. (Compensation packages tend to be more generous at representative offices because local staff members are recruited via government-approved labour service agencies, which take a share of the employee's income as a commission.) JVs in the southern special economic zones frequently pay managers according to Hong Kong salary scales. Despite enjoying higher salaries than their state-sector counterparts, however, most FIE employees continue to feel underpaid.

Under a rule in effect since July 1994, a minimum wage must be set by each province or municipality and must not be less than half the local average wage. According to Watson Wyatt, a benefits consultancy, the minimum monthly wage in Beijing as of late 2002 was Rmb465. The minimum pay in the Chinese capital is clearly in the upper tier of Chinese localities but still below Shanghai, where minimum pay in late 2002 was Rmb535.

With the sharp fall in inflation over the past several years, there has also been a gradual tapering off in wage hikes. Nevertheless, a survey by

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Watson Wyatt found that salary increases among multinational companies in all industries averaged 8% in 2002, down slightly from 9.5% in 2001. Although slackening inflation and economic growth are easing wage pressures, FIE managers still complain that employees' expectations for salary increases far exceed any reasonable adjustment based on inflation and merit.

Many JVs pay a single sum to a comprehensive insurance scheme administered by the labour service bureau, which then divides up the premiums. This costs about 35% of total wages in the south, more in the north. If paid separately, insurance premium rates are as follows: unemployment, 1.5% of basic wages; pensions, 20-30% (though this will be limited to 20% under the 1997 regulations); and health and other insurance, 10-30%.

The 1997 decision on the old-age insurance system was previously expected to be up and running by the turn of the century; it is now expected to be instituted by 2008 at the earliest. The most important reason for the slow implementation is that cash-starved state-owned enterprises do not have the funds to make the contributions they are supposed to. By the end of 2001, 108.0m workers were insured, up from 103.7m the year before; by late 2002 the number had exceeded 110m, according to preliminary statistics from the Ministry of Labour and Social Security. As of late 2001, 33.8m retired workers received pensions under the scheme, compared with 31.4m one year earlier. The Ministry of Labour and Social Security has said it will actively seek to include all foreign investment enterprises (FIEs) under the system to ensure universal coverage.

The regulations set up a three-tiered structure: basic pension, personal account and supplementary schemes. The new system requires employers (including state-owned, collective, foreign-invested, private and joint-stock enterprises) to contribute about 20% of basic payroll for the basic pension portion. Most of this will go into a municipal-run pension fund; however, this fund will eventually transfer into a provincial pension pool to fund the basic pension. The actual percentage of contribution varies across China, as it is determined by local government authorities; in Beijing employers contribute 19%, while in Shanghai they contribute 22.5%, and in Guangzhou, 20%.

Employee contributions to the personal account are now 5% of a worker's salary and will increase by 1 percentage point every two years thereafter until it reaches 8%, with all employee contributions going into employees' personal accounts. Employer and employee contributions together will contribute a total of 11% of each employee's salary into the personal account. The personal account will be portable when an employee moves to a new location. The third tier consists of voluntary supplementary schemes that the individual employee can choose to join.

Under the new system, benefits upon retirement will be as follows:

- If contributions have been paid for at least 15 years, a monthly payment equal to 20% of the previous year's provincial or municipal

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average monthly salary payable from the basic pension fund plus 1/120 of the personal account balance.

- If the contributions have been for fewer than 15 years, a lump sum equal to the personal account balance is payable.
- A benefit payable on death, equal the balance in the personal account.

Like all other social security reforms promulgated over the past years, the new unified pension regulations cover only urban workers and not the 80% of the population living in the countryside. But the longer-term objective is to extend coverage to China's rural population, who currently rely entirely on their families for support in old age.

Employers' contributions to housing vary by city, according to a 2001 Watson Wyatt survey. In Beijing the government requires FIEs to contribute 10% of an employee's monthly salary to the Housing Provident Fund for employees' housing. In Shanghai the government requires FIEs to accrue 15-20% of each employee's monthly salary for a housing fund, of which 7% of the employees' monthly salary--up to three times of city average earnings for the prior year--should be contributed to the fund. The company should use the difference to set up a supplementary housing scheme for the employees in Shanghai.

The government also allows companies to set up a welfare fund equalling 14% of the employees' total pay. Companies may use this fund to purchase supplementary insurance through commercial insurers.

Following a revision of the relevant legislation in September 1999, there are nine state holidays (up from six under the previous regulations, which had been in force since 1949). Most JV employees are entitled to 6-12 additional days of annual leave. Employees separated from their families may be entitled to additional leave. The 1994 labour law notes that the State Council will formulate specific regulations on annual paid leave.

After involuntary dismissal, a worker is entitled to unemployment insurance benefits for up to two years while actively seeking renewed employment. If the person has not found employment at the end of this period, he or she will be entitled to regular social security benefits, as stipulated in the Circular on the Establishment of a Minimum Livelihood Assurance System for Urban Residents, effective September 2nd 1997. As of late 2001, 103.6m employees were covered by unemployment insurance. Although the unemployment insurance rules look workable on paper, even Chinese government think-tanks admit that funds may be insufficient to implement them in practice.

In one of its largest social projects ever, China has set itself the task of completely revising its social security system to complement the ongoing efforts to restructure the economy and streamline the state-owned sector. Based on the 1994 Labour Law, several pieces of legislation have been promulgated over the past few years, covering all social security functions previously provided by the individuals' workplace, although actual nationwide implementation will likely take several years.

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All new social insurance laws follow the principle of setting up specific forms of insurance for specific needs, rather than overall insurance covering all the needs of a worker. This applies to the Pilot Procedures Regarding Maternity Insurance for Enterprise Staff and Workers, effective January 1st 1995, the Pilot Procedures Regarding Industrial Injury Insurance for Enterprise Staff and Workers, effective October 1st 1996, and the Decision on the Establishment of a Unified Basic Old Age Insurance System for Enterprise Staff and Workers, effective July 16th 1997. They also mark abrupt departures from past practices in being financed mainly by mandatory employer and employee contributions, complemented by contributions from the state. Finally, they provide the basic framework of social security, enabling employees to seek supplementary coverage through individual insurance policies.

The Decision on the Establishment of a Basic Medical Insurance System for Urban Staff and Workers, effective December 14th 1998, foresees a healthcare system to which employers contribute 6% of a worker's salary, and employees, 2%. Like the revised regulation on old-age pension, the medical insurance decision foresees a three-tiered structure: personal account (into which all the employee contributions and 30% of the employers' contribution are deposited); a basic pension pool; and supplementary schemes. Medical expenses below 10% of the employee's annual salary will be paid entirely out of the personal account; expenses above that will be paid out of the personal account, the pooled pension fund and, possibly, supplementary schemes. According to optimistic projections in the local media, the new healthcare system was to have nationwide coverage before the turn of the century; by late December 2002, however, preliminary statistics from the Ministry of Labour and Social Security showed that only about 90m employees participated in basic medical insurance programmes, compared with 76.3m the year before; the programme had been initiated, but obviously not completed, in 97% of all prefectures and cities nationwide.

The final piece of legislation completing China's social security reform, the Unemployment Insurance Regulations, was adopted December 26th 1998, with effect from January 1999. According to the regulations, employers, including foreign investment enterprises (FIEs), must pay the equivalent of 2% of the total payroll for unemployment insurance funds. Previously, FIEs were not subject to any national legislation in the area, but they typically complied with local rules requiring them to pay 1% of wages for unemployment insurance. The new regulations also require employees to pay 1% of their wages to unemployment insurance funds (up from zero), whereas government agencies are to supply an unspecified amount.

2.3 Termination of employment

The labour law allows foreign investment enterprises (FIEs) to dismiss workers (without advance notice) if they do not fulfil requirements during the probation period, if they "seriously" violate labour discipline or company regulations, are "seriously" derelict in their duties, or engage in graft, favouritism or other activities that cause "serious" damage to the employer. Workers may be dismissed for other reasons if circumstances are serious enough. Despite these provisions, which on paper are stricter than earlier

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practices, most foreign partners find that firing employees is almost impossible without the support of the union and the local labour service bureau (LSB).

Employers may dismiss an employee with one-month notice if the employee remains incompetent after training or rearrangement of duties or where there are “major” operational or production difficulties. The trade union must then be advised 30 days in advance, and permission from the local LSB is required. Employees dismissed because of major difficulties must be given priority if the same enterprise recruits employees within the subsequent six months. Trade unions are entitled to “raise objections” to dismissals they deem inappropriate. If disputes arising about such dismissals cannot be resolved, the courts or labour arbitration boards should handle the matter, with union representatives retaining the right to assist with such actions.

Under the labour law, employers must make severance payments; local regulations generally govern the amount. Measures for Economic Compensation for Violations and Cancellations of Labour Contracts, issued by the Ministry of Labour in December 1994, with effect from January 1st 1995, calculate severance payment on the basis of one-month salary for every full year worked by an employee. A worker whose contract is terminated because of incompetence is limited to a total possible payment of 12 months’ salary.

2.4 Rules for foreign nationals

The Chinese generally do not object to employing foreign managers. But under the new foreign investment enterprises (FIE) labour regulations and the Regulations for Administration of the Employment of Foreigners in China (effective May 1996), the ability to hire expatriates appears to be circumscribed by the stipulation that foreigners may be hired only where there is demonstrated need to do so and where approval is obtained from local labour authorities. Although the requirement that local labour bureaux approve expatriate hires has been in effect since March 1993, it has not been enforced. The purpose of the new regulations appears to be to stem the flood in recent years of young foreigners who have found work in China, mostly in Beijing and Shanghai, after arriving on spec. The rules subject foreigners to a new licensing system before they can start working; the system requires employment certificates, professional visas and residence permits. However, foreigners in the following categories need not obtain the new employment certificates:

- Foreign diplomats;
- Foreign firms’ China–based representatives;
- Chief representative and other foreigners with advanced and special skills or managerial titles;
- Professionals and executives with senior titles and special skills employed and financed by government departments and institutions; and

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- Foreigners engaged in Sino-foreign-exchange programmes sponsored by Chinese and foreign governments or international organisations.

The Ministry of Foreign Affairs and other government agencies issued new regulations in April 2002 allowing certain groups of foreigners to obtain multiple-entry visas of up to five years. People eligible for the visas include consultants and advisers to the Chinese government; personnel above the level of assistant general manager; and people who have invested at least US$3m in China.

Some foreign companies are voluntarily reducing the number of expatriate staff, allegedly to strengthen their local identity. LG Group of South Korea, for example, said in December 2002 that it would raise the number of Chinese employees engaged in research and development at its Chinese operations from 700 to 1,000 by late 2003, and to 2,000 by 2005.

Residents of Taiwan, Hong Kong and Macau are governed by earlier (1994) regulations and are not required to go through employment procedures before entering China. However, such persons must proceed to the labour bureau after entering China and follow procedures to obtain an employment certificate for persons from Taiwan, Hong Kong or Macao.

3.0 Business Regulations

3.1 Registration and licensing

Under China's regulations on technology imports, foreign companies with patents, trademarks or other intellectual property are free to enter into licensing agreements with Chinese companies. Licensing, used mainly for technology- or trademark-related products, has the advantage of limiting a foreign company's exposure, since it need not set up an office or a joint venture. However, a licenser has less control over how its product is priced, marketed and distributed. Furthermore, in practice, greater reliance on centralised decision-making, uncertainty over China's intellectual-property protection, and shifting Chinese priorities and policies can undermine deals with Chinese enterprises.

Problems also arise because of fundamental differences between foreign licensers and potential Chinese licensees concerning the boundaries of technology transfer. While Western firms tend to view a licensing agreement as an ongoing relationship between licenser and licensee, the Chinese often see technology as a commodity to be purchased and then used freely.

This view influences basic technology-transfer legislation, that is, the Regulations for the Administration of Technology Import Contracts, which took effect on May 24th 1985.

The Regulations for the Administration of Import and Export of Technology, issued by the State Council, or Cabinet, took effect on January 1st 2002, covering a broad range of technology and patent transfers. According to the regulations, imported and exported technologies are classified into three categories: freely imported and exported technology, restricted

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technology and prohibited technology. As of early 2003, 11 categories of technology were included on the list of items whose import is prohibited, including certain technologies related to petrochemical production and chemical engineering.

The regulations clarify procedures for approval and registration of imported technology, replacing previous contradictory regulations in the field. For restricted technology, an application for import licence must be filed with the Ministry of Foreign Trade and Economic Co-operation (MOFTEC), which must process the application within 30 days. Upon approval of the licence, and after the technology import contract has been signed, it must be submitted to MOFTEC again, which must reply within ten days. The importer must also file a registration with MOFTEC after the licence is approved.

For freely tradable technology, no prior application is needed, but registration must take place after the technology has been imported. Registration takes place online via the China International E-Commerce Network. MOFTEC is responsible for registration of technology imports for “large projects”, including projects that have required approval by the State Council and those funded partly by the national budget or by foreign government loans. Provincial-level foreign trade bureaux are in charge of registration of other contracts involving the import of freely tradable technology.

The licenser is advised to keep the registration certificate provided by MOFTEC, as the regulations still require the certificate to be produced when applying for foreign-exchange settlements, including overseas remittances of royalties. Technology or equipment import contracts considered part of the capital contribution to the establishment of a Chinese-foreign joint venture or a wholly foreign-owned enterprise continue to be governed by China’s joint-venture law and its related implementing regulations.

The 2002 regulations remove previous rules that generally restricted technology contracts to ten-year terms and required the licensee to maintain confidentiality only for this period. No time limit is set in the new regulations, and it is now up to the contracted parties to determine whether the licensee can use the technology beyond the end of the contract. However, the regulations could make life harder for the licenser by imposing a series of new warranties. This has also been a problem in the past, when Chinese licensees and approval authorities have often pushed for a broad range of warranties that could leave the foreign vendor exposed to a long list of liabilities. They require the licenser to guarantee that he is the owner of the technology, that the technology is without glitches and that it will achieve the technological objectives described in the import contract. Foreign licensers must carefully limit the warranties to which they agree. The licenser might also require the licensee to meet certain competence standards before offering a warranty in order to avoid becoming liable when a technology fails to perform because of incorrect use or inadequate provision of power or utilities on the part of the licensee.

Foreign companies interested in licensing the same technology to different end-users might have difficulties negotiating compensation. For example,

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authorities challenged one US company's technology-transfer agreements with Chinese recipients on the grounds that the country should pay for the same know-how only once. But the contract with the original Chinese licensee included a non-disclosure clause that prevented sharing know-how. The US licenser eventually got around the objections by charging a "documentation" fee when it passed on technology.

The State Administration of Industry and Commerce provides some protection for foreign licensers of technology in Several Provisions Concerning Prohibition of Acts of Infringement of Commercial Secrets, effective November 1995. Under these regulations "business or commercial secrets", which are protected under the regulations, include information relating to the design, procedures, product formulas, manufacturing process, manufacturing know-how, client lists, information on sources of goods, production and sales tactics, and the details of bids submitted in contract tenders. The commercial secrets provisions also vest local authorities with the power to seize any secret materials that were unlawfully obtained and either to destroy them or to return them to their rightful owners. Violators are subject to fines of Rmb10,000-200,000.

3.2 Price controls

Although double-digit retail and consumer price inflation was China's problem ten years ago, the country has now entered into a period of protracted deflation and is only gradually showing signs of recovering. The benchmark consumer price index fell 0.8% in the first 11 months of 2002 from the year before, compared with a rise of 0.8% in the same period of 2001. The reason was sluggish consumer demand and a build-up in inventories; cheaper imports brought about by WTO membership also played a role. This has led several industries, such as producers of flat glass, to form cartels to set price floors and stop steep declines in corporate earnings. In what appeared to be a bid to curb such tendencies, the State Development Planning Commission (SDPC) said in June 2001 that it would target price irregularities and regional price protectionism in areas such as electricity, medical care and telecommunications.

The Price Law, passed in January 1998 by the Standing Committee of the National People's Congress (parliament), took effect on May 1st 1998. That law aims to "promote the development of the socialist market economy" by creating a sound market environment for rational pricing and equal competition and protection of consumers' and business' interests and rights. The law reinforces a system in force since 1987, under which prices are classified as stipulated by the state, guided by the state or governed by the market. Although specifically stating companies' freedom to set their prices, it outlaws both price collusion and price slashing by individual companies to eliminate competition. The Price Law, which applies to the pricing of all goods and services in China, allows for fines of 500% of the income derived from illegal price slashing and gives authorities the right, in serious cases, to close operations of businesses that have violated the law.

An amended Pharmaceutical Law, which took effect on December 1st 2001, lets authorities introduce price controls on pharmaceutical products,

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if deemed necessary. Even for pharmaceutical products where market-determined pricing is allowed, the amended law stipulates that pricing must be fair and not too far out of line with production costs. To ensure implementation of the rules, the law provides that pharmaceutical companies should offer precise and unbiased information about production costs to the authorities.

Amended rules on the operation of wholly foreign-owned enterprises (WFOs) announced on April 12th 2001 removed a stipulation that subjected WFOs to domestic price controls for the part of their production sold inside China. The same rule was abolished for equity joint ventures in regulations announced on July 22nd 2001.

The SDPC imposes price controls on only 13 categories of products, compared with 141 categories a decade ago; as a result, prices of more than 90% of products traded in China are now determined by market forces. In general, prices remain controlled only for goods and services deemed essential, such as foodstuffs and tobacco. Price maintenance is rarely an issue for commodities (except perhaps for silk) since most food, transport and energy prices are kept far below their free-market levels. Although the government promised to free coal prices fully in 1994, it has in fact continued to purchase a fixed supply from money-losing mines at prices higher than its own selling prices to the power, metallurgical and chemical-fertiliser sectors. The remainder may be traded in the free market. Coal, which accounts for three-fourths of China's energy consumption, has been one of the most important commodities under price controls. Over the longer term, however, the government remains determined to continue with price reform in both the energy and the commercial sector.

Price controls generally apply at the ex-factory level, in the form of subsidies to state-owned enterprises, to let them produce and sell goods to wholesalers and retailers at artificially low prices. The government has controlled the prices of imports through licensing and quota regimes, but these are now being revamped to fit China's new status as a member of the WTO.

3.3 Monopolies and restraint of trade

China has no specific antitrust legislation, but its Unfair Competition Law (effective September 1st 1993) comes close by defining specific business practices as constituting unfair competition. The law applies to legal persons, other economic organisations (including FIEs) and individuals engaged in business. Among those activities it defines as unfair are the use of bribes to sell or buy merchandise; restrictions by the government (including subordinate departments) on the entry or exit of merchandise from or to a local market; collusion in the submission or acceptance of tenders; restrictions imposed by businesses with legal monopolies (such as utilities) requiring the purchase of products from designated business operators; spreading of false information injuring the reputation of competitors; and selling merchandise below cost to force out competitors. The central government has acknowledged that the Unfair Competition Law has so far had only limited effect on monopolistic practices. As part of

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its anti-inflation campaign, the central government introduced Provisional Rules on Banning Exorbitant Profits in January 1995 to curb price-gouging by enterprises and retailers.

Increasing decentralisation of economic control and intensification of competition from a variety of sources are weakening some of the state-run monopolies that have dominated in industries such as banking, insurance, telecommunications, utilities and foreign trade. Competition is coming from rural township enterprises, joint ventures--particularly in consumer products, permitted to sell their output on the domestic market--and foreign imports. Li Rongrong, chairman of the State Economic and Trade Commission, said in March 2001 that aviation, railway, banking and power were the first sectors where monopolies would be dismantled. Although the central government has been curbing the power of some state-run monopolies (eg telecommunications and foreign trade companies), it has also had to reinstate previous monopolies. For example, a two-year drop in cotton production coupled with increasing demand from textile producers prompted the government in 1994 to reintroduce its monopoly over cotton pricing, marketing and sales to curb chaotic pricing; the measures were abandoned again only in September 1999. Similar chaotic pricing in the oil sector prompted the government to re-institute state monopoly control over prices, marketing, and the import and export of oil and oil products.

The telecommunications industry, once a huge, all-encompassing and inefficient state monopoly, has been split into several companies that--even though they are all still large by any standards--are meant to partly compete with each other. China now has two fixed-line operators, China Telecom Group and China Netcom Group, which were initially divided according to geographic lines but are being encouraged to compete; by early 2003 they had already started moving into each other's turf. There are also two cellular phone operators, China Mobile and China Unicom; China Telecom Satellite; and China Railcom, which provides fixed lines for leasing.

Foreign trade companies are one example of an industry where anti-monopoly measures may gradually benefit foreign investors. The business was originally the exclusive province of state-owned enterprises, but in a bid to increase competition in the field, the government began allowing foreign investment in foreign trade joint ventures on a trial basis in the Shenzhen Special Economic Zone and the Pudong New Area of Shanghai in September 1996. Onerous requirements, including the stipulation that the Chinese side hold at least a 51% stake, quickly killed the interest of many potential overseas investors. However, a big improvement is expected now that China is a WTO member; as part of its accession, it agreed to allow all companies to engage in foreign trade by the end of 2004.

3.4 Intellectual property

Major laws and regulations on protecting intellectual property rights (IPR) have been issued almost every year since 1982, and in the months before and after China's accession to the World Trade Organisation in December 2001, the National People's Congress--the national legislature--adopted a

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series of important amendments to existing legislation. The main motivation was to align Chinese laws with the minimum requirements of the WTO's Trade-Related Aspects of Intellectual Property (TRIPs) protocol, which contains general standards for IPR enforcement.

Amendments to the 1990 Copyright Law were adopted on October 27th 2001 and took effect December 1st the same year. Contrary to expectations, the amendments did not take into account new technological developments, saying instead that IPR regulations on the Internet would be included in separate rules to be published by the State Council. It did, however, conform with expectations in clarifying some issues left obscure by the first law of 1990--such as a much-abused Article 43, which had allowed radio and TV stations to broadcast published sound recording for "non-commercial purposes". In the amended article, broadcasters should pay remuneration, although they do not need to obtain permission from the copyright holder. The amendment ran counter to many state broadcasters' claims that most artistic work in China is sponsored by the state and therefore artistic products should be part of the public domain. The amended law allows statutory damages of up to Rmb500,000. Implementing Rules of the Copyright Law took effect on September 15th 2002. Among other provisions, the implementing rules protect the copyright of work by foreigners that is first published in China, or that is published in China within 30 days from the first publication abroad.

Amendments to the Trademark Law were also adopted on October 27th 2001 and took effect on December 1st. The original law dated back to 1982, when China had a mere 30,000 registered trademarks and a revision was deemed highly necessary, especially to achieve more efficient law enforcement. The amendments allow authorities and courts to confiscate and destroy pirated products and the equipment used to manufacture them. They also make it possible for brand owners to seek compensation for legal costs, and they provide for statutory damages up to Rmb500,000 if the damage incurred by the brand owner cannot be determined. In addition, the amended law deletes a previous regulation that said the infringing party could only be deemed responsible if it could be proved that he knew he was selling products carrying a protected trademark. An interpretation of the Supreme People's Court, enforced on January 22nd 2002, enables trademark holders to ask courts for preliminary injunctions aimed at preserving evidence and stopping production infringing on their trademark. Implementing Rules of the Trademark Law took effect as of September 15th 2002. The Implementing Rules clarify, among other things, the procedure for foreign companies seeking to register trademarks in China.

Prior to these steps, amendments to the 1994 Patent Law were promulgated on August 25th 2000, with effect from July 1st 2001. This version of the law enhanced judicial review of administrative decisions, broadening it to cover applications not only for inventions but also industrial designs and utility models. Following the amendment, any patent applicant could appeal to the Patent Re-examination Board and, failing that, take his case to court. The amendments also better aligned legislation with WTO principles by deleting special references to foreign investment enterprises (FIEs) in a part that previously stated the patent rights to

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inventions made by FIE staff while at work belonged to the FIEs. This right is now extended to all enterprises, foreign invested or Chinese. The amendments also detailed penalties for patent infringements, including fines of up to three times illegal proceeds or criminal liability.

Implementing Rules of the Patent Law also took effect on July 1st 2001, along with the amended Patent Law. These sought to bring China up to date on patent regulation by streamlining the allocation of patent rights and by allowing the regime to meet international standards in keeping with China's entry into the WTO in December 2001. As part of the streamlining measures, the Implementing Rules provided that allocation of patent rights to foreigners should be performed jointly by the relevant departments of foreign trade and of science and technology. The new rules also stated that foreign applicants should pay maintenance fees for patent application only upon completion of the formalities associated with the grant of the patent; previously, fees had to be paid on an annual basis, regardless of whether a patent had actually been granted. The new Implementing Rules also removed previous regulations that discriminated in favour of state-owned enterprises; they stipulate that state companies must follow the same application procedures as non-state enterprises.

New procedures accompanying the amended Patent Law will also allow companies to take decisions made by the State Intellectual Property Office (SIPO) on patent issues to the Beijing No. 1 Intermediate People's Court. The court is now preparing detailed procedural guidelines, but the state media have disclosed the rough outlines of how companies will be able to appeal. According to reports, companies dissatisfied with a SIPO decision must first appeal to a special committee; if that appeal is rejected, the company will have the option of appealing a second time to the Beijing court.

Other amendments, regulations and notices that have been added to China's growing legal framework include the following:

- Regulations on Protection of Computer Software took effect on January 1st 2002; additional measures took effect on February 20th 2002. The regulations, which are aimed at meeting WTO standards, designate the China Copyright Protection Centre as the agency in charge of copyright protection, and reduce the maximum time registration can take 60-90 days. The regulations encourage but do not force software owners to register their software. While owners of software do not need to register their product before they can take legal action against an infringing party, the regulations state that regulatory authorities will prioritise the legal protection of registered software. According to the latest figures provided by the SIPO, the number of registered software copyrights stood at 7,000 in 2001, about double the number of the year before.

- Amendments to the Pharmaceuticals Law that took effect on December 1st 2001 stated that generally recognisable names for pharmaceutical products would not be accepted as trademarks.

- In order to conform with the legal requirements of WTO membership, the government announced rules in late March 2001 to protect IPR as they pertain to the design of integrated circuits. The rules, which took effect on

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October 1st 2001, also cover foreigners' IPR over integrated circuit designs, if these designs have first been used commercially in China or if both China and the foreign country in question are parties to the same bilateral or multilateral agreement on the protection of designs. Companies have two years to apply for protection with the Chinese government, starting from when the design is first used commercially. Once protection has been granted, it remains in force for ten years.

- Policies on Encouraging Development of the Software and Integrated Circuit Industries, published by the State Council on June 24th 2000. The policies explicitly prohibit Chinese work units from using unlicensed software on their computers, and they call for periodic campaigns against unlicensed software. They also urge relevant government departments to strengthen systems for registration of software.

- Notice Concerning Several Issues on Applying for Recognition of Well-Known Trademarks, published by the State Administration of Industry and Commerce (SAIC) on April 28th 2000. The notice provides details on implementing rules originally stipulated in the Provisional Regulations on Confirmation and Administration of Well-Known Trademarks, effective since August 14th 1996, so it could ease complaints from foreign companies over lax enforcement of the rules. The 1996 provisional regulations define well-known trademarks (for both goods and services) as registered trademarks that enjoy a high reputation in the market and are known to the relevant public. The provisional regulations set out procedures for applying for protection of rights and interests of well-known trademarks in China. Under the regulations, the Trademark Office of the SAIC is responsible for confirming and administering well-known trademarks.

The April 28th 2000 notice states that application for registration of well-known trademarks can be made by a company if another entity has registered or used a trademark either identical with or closely similar to its own, either in China or abroad. Applications must be made to a provincial-level administration of industry and commerce that, after formulating an opinion, forwards the application to the national-level SAIC. The notice also details the material that must be submitted by the applicant, including evidence that it has suffered damage because of the improper use of its trademark. In an effort to curb excessive charging, the notice also emphasises that only trademark agencies approved by the SAIC are allowed to handle applications and that they may charge only standard fees for handling trademark registration applications.

The notice may help enforcement, as may amendments of January 1997 to the criminal procedure code that permit trademark holders to launch private criminal prosecutions of pirates without going through public prosecutors or the police. So far, however, few, if any, companies have availed themselves of this option.

- Regulations Concerning Copyright in the Production of Digital Products, published in December 1999 by the National Copyright Administration. The regulations state the range of digital products in which copyright law must be respected, such as CD-ROMs, VCDs, DVDs and laser discs. The government followed this up with royalty standards, in

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force since July 1st 2000, giving guidelines for the size of royalties--such as a royalty rate of 5-12% for the use of copyrighted material in digital products.

- Tentative Provisions Regarding the Administration of Software, published March 30th 1998. The provisions ban the development, production and trading of software products that infringe on IPR. Under the provisions, software producers must either hold the property rights of their products or have obtained specific permission by the holder of the property right.

With the legal framework now meeting international requirements in most respects, the issues of implementation and enforcement are gaining importance. Chinese authorities seek to project the image of having adopted a hard-line stance against infringements. In the first seven months of 2002, authorities seized a total of 43.4m CDs, VCDs and similar products, and on August 13th 2002, 27.5m confiscated audio-visual items were destroyed in a high-profile move aimed at showing to the outside world that China is dealing with the problem.

In general, however, the level of implementation of regulations is considered unsatisfactory by foreign businesses, even if a few landmark cases testify to some incremental change. In August 2002, for example, the Tianjin Higher People's Court ruled in favour of Japan's Yamaha Motor Co, which had accused China-based Tianjin Gangtian of producing motorcycles using the Yamaha name. The Chinese company was ordered to pay Rmb900,000 to Yamaha, stop producing the Yamaha motorcycles and publicly apologise to the Japanese company.

There are other signs that the Chinese authorities seek to strengthen their administrative hand in the area of IPR. A June 2001 decision by the Shanghai Intermediate People's Court at the end of a five-year lawsuit involving AST Research (a computer development company based in the US) was seen as giving a boost to foreign enterprises' confidence in China's willingness to abide by international standards for patent protection. According to the *China Daily,* the decision went against a claim by a local software inventor that AST's Pen X Computer, which allows character input both by keyboard and handwriting, infringed on a patent filed by the inventor with the China Patent Bureau in 1992. The Shanghai court ruled against this claim, finding that AST had previously registered its patent for the product in several foreign countries, including the US. It suggested that the China Patent Office made its decision based on incomplete information, which led it to believe that the local inventor was holding the original patent of the product.

Patent cases are usually settled through the courts; technology licensing disputes are normally settled by arbitration. By contrast, copyright infringements have received little court or administrative attention. According to foreign experts, however, this pattern is beginning to change. Local Patent Administration Offices are becoming more aggressive in raiding suspected patent violators, making administrative solutions a more attractive option. At the same time, more copyright cases have resulted in substantial penalties being handed down by the courts against Chinese IPR violators. The advantage of pursuing a court battle is that suing is the

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only way a company can obtain compensatory damages. Moreover, the publicity of a court case can be a strong deterrent to other potential infringers.

However, a continuing weakness in China's court system is the lack of expertise among the country's specialised IPR courts. The Supreme People's Court, the higher people's courts and intermediate people's courts in 22 provinces have set up special IPR sections. Although the three-judge panel in Beijing handles nothing but IPR cases and is very competent, judges in other jurisdictions do IPR work only part-time and are not necessarily well versed in the law.

Fees for filing cases with the courts can also be steep, since their calculation is based on a percentage of damages claimed. The intellectual property divisions of these courts are also short of manpower. Various initiatives, including a programme financed by the EU in 2001 to educate law professors in IPR issues, should help overcome some of the court system's shortcomings in the medium term.

SIPO, an independent agency under the State Council, or Cabinet, was formed in 1998 from the Patent Administration Office. The establishment of SIPO was originally seen as the first step towards consolidation of all regulators in the IPR field, and it was expected eventually to take charge of the National Copyright Administration and the Trademark Office as well. This had not happened as of early 2003, however. Under the current administrative arrangement, SIPO deals with patent cases, and the National Copyright Administration--part of the State Printing and Publishing Administration--is in charge of copyright and software cases. Both also do a good job investigating violators, but they have far less leeway to conduct raids and impose punishments than the State Administration for Industry and Commerce (SAIC). The SAIC and its local bureaux are the only government departments authorised within the context of their ordinary duties to investigate alleged infringers. The Trademark Office, an agency under SAIC, handles registrations of trademarks, while another institution, the Trademark Review and Adjudication Board, is in charge of disputes. Administrative decisions of both the SAIC and the National Copyright Administration can be appealed through the court system.

The China Copyright Protection Centre (CCPC) is a comprehensive state agency under the commission of the NCA; it executes some of that agency's functions, such as copyright trade negotiations and co-operation at home and abroad. The centre is responsible for the authentication of copyrights of works imported from or exported to other countries and for the registration of publishing contracts of audio-video and electronic publications involving a foreign party. The centre provides consultation services to authors and users of the works and legal services for publishing units, radio and television stations, and performing troupes. The centre can function as a mediator in copyright disputes and as an agent in copyright lawsuits. The CCPC is the agency in charge of software registration, according to rules published in early 2002.

Companies with a stake in the solution of IPR issues have also organised themselves. Chinese software producers set up the China Software Association in 1995 to raise IPR awareness and clamp down on pirating.

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The Quality Brands Protection Committee groups together 83 foreign companies and is engaged in active anti-counterfeiting efforts in co-operation with the Chinese government. IPR enforcement has also been bolstered by the recent emergence of several Chinese and foreign investigative agencies, which undertake assignments on behalf of foreign parties in China. Foreign investigation firms are technically not supposed to operate in China, but they have so far been able to submit information to officials on behalf of clients with impunity. Besides investigation agencies, some domestic company search agencies have also sprung up in China.

Despite the efforts to establish a detailed legal framework and set up an administrative apparatus to implement it, pirating of trademarks, copyrights, computer software, and foreign video and audio products continues to be rampant and has, in many cases, actually worsened over the past few years. China, previously on the “priority watch list” under the US Trade Representative’s Special 301 trade legislation that lets the US impose trade sanctions on countries not meeting its standards, remains under supervision. In April 2002 the US Trade Representative confirmed China’s position on a lower-level “section 306” watch list, which still requires it to show “continuous improvement” in IPR enforcement.

According to the Business Software Alliance (BSA), based in the US, 92% of software in China was pirated in 2001, down only slightly from 94% the year before; the China Software Association put the figure lower, at 80%. The Interactive Digital Software Association, also based in the US, said in 2000 that US makers of computer and video games alone lose US$1.38bn a year from Chinese piracy. Chinese software makers also suffer from piracy, losing at least Rmb10bn every year, according to the Xinhua News Agency. Nonetheless, the BSA’s campaign to improve China’s record in this area has notably fallen silent recently. Observers say both the US government and US business interests want to acknowledge China’s success in dealing with audio-video piracy. They hope China will now demonstrate equal determination in its efforts to eradicate software piracy.

Although software and audio-visual violations have been the major focus of US lobbying efforts, trademark infringement is perhaps even more widespread and growing fast. According to SIPO data released in June 2002, China's administrative cases involving trademark infringement totalled 41,163 in 2001, up from 22,001 the year before. Some foreign companies have seen their products counterfeited within days after their introduction into the Chinese market. Foreign businesses reported in 2001 that in anticipation of China’s entry into the WTO, local counterfeiters had begun manufacturing cheap copies of well-known brands, especially in the personal-care sector, that were not yet available in the Chinese market but were expected to enter it after China became a member of the trade body. Equally worrying, some Chinese counterfeiters are now exporting their products to markets in Europe and North America. The EU said on July 26th 2002 that 18% of all counterfeit goods seized within the EU’s borders were from China.

Until recently, only a trademark’s registered owner could initiate an action, but the US-China Agreement on IPR now gives all licensees in China, including WFOs and joint-venture companies, the right to act on behalf of a foreign trademark owner. Chinese courts, which had been almost useless

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in trademark cases, are becoming increasingly competent; in a few instances, they have levied heavy damages on infringers. But court cases are still rare--there were only 187 trademark-related convictions in the first five months of 2002—and most penalties remain light, and criminal cases against violators are rare. Moreover, foreign investors cannot themselves call for public prosecutors to raise a criminal case; they must induce the Chinese authorities to do so.

Under Chinese criminal law, counterfeiting cases that violate the public good have faced more drastic penalties, including long prison sentences and even capital punishment. If the bureau or court hearing the dispute decides that a violation has occurred, it can order the infringer to cease production and destroy related goods. It can also impose a fine and order the infringer to pay damages. Under the trademark law as amended in 2001, local administrations of industry and commerce investigating infringement must hand over cases for criminal investigation if they suspect that a crime has been committed. The amended law also allows authorities to destroy infringing products. (The unamended law did not require offenders to destroy their products; it merely said the trademark must be removed from the product.)

Intellectual property and the new economy

No specific rules exist yet on protecting intellectual property on the Internet, and amendments to the Copyright Law published on October 27th 2001 did not do much to clarify the issue. In an attempt to rectify this situation, the National Copyright Administration has said it is preparing temporary rules on online copyright protection, and the MII has said it would issue detailed rules on e-commerce, including copyright protection. By early 2003, however, neither of these sets of rules had been published. Local governments have in some instances taken the initiative to issue their own regulations. In the Interim Measures for E-Commerce Supervision and Control, for example, issued by the Beijing municipal government and effective since August 1st 2002, trademark infringements are explicitly prohibited.

Meanwhile, the Supreme People’s Court took a major step on December 21st 2000 towards better protection of online intellectual property rights (IPR) when it stated in a judicial interpretation that the Copyright Law also extends to the Internet. The interpretation said that “copyright owners have the right to use or permit others to use their works in digital format, and must be paid for it,” permitting courts to order offenders to remove unauthorised material from their websites and allowing owners of copyrighted material, whether originally published in print or on the Internet, to sue others over unauthorised use.

Provisional Measures for Administration of Recording and Registration of Business Websites, in force since September 1st 2000, go some way in providing online protection of IPR. The measures require all profit-oriented websites to register with the Beijing Administration of Industry and Commerce (BAIC). The BAIC then gives the website a trial period of operations of up to one year. During this period, other companies, such as

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those that might consider that their IPRs have been infringed, have the opportunity to protest the registration.

The World Intellectual Property Organisation has drafted two treaties to protect the exclusive rights of copyright owners, performers and composers to control public access to their works on the Internet. They will become active when ratified by 30 countries. China had not yet ratified them by February 2003.

Encryption software. The State Encryption Management Commission issued a notice in March 2000 on Questions Concerning the Administration of Commercial Encryption to US businesses, clarifying rules that had previously sent jitters through the foreign business community. The rules mainly centred on the Administrative Regulations on Commercial Encryption, promulgated on October 7th 1999 and another Announcement No. 1, both published by the commission, which banned the use of foreign encryption software by companies inside China. The rules also stipulated that foreign companies must register their encryption software, which protects data transmission in mobile phones and on computer systems from eavesdropping. The registration was required even if the encryption software was not activated, and it was in general considered both extremely strict and practically unenforceable.

Most companies missed the deadline for registration--January 31st 2000--expecting that the Chinese authorities would listen to foreign lobbying efforts and not implement the new rules. A first sign that the Chinese authorities were backing down was a decision by the MII in early March to allow Microsoft, based in the US, to introduce its Windows 2000 in China without substituting its encryption components with software produced in China. The March notice further explained that the draconian encryption rules would be targeted only at software solely aimed at encoding and decoding data. The implication is that software for mobile phones as well as Microsoft Windows and browsers will be exempt from the regulations.

Domain registration. Domain names are a special area of intellectual property, and they have proven a particular headache to many foreign companies operating in China: so-called cyber-squatters acquire the right to domain names similar to the names of well-known foreign companies and then request a fee from the companies to relinquish that right. A first clarification of that issue came on June 20th 2000, when the Beijing Second Intermediary People's Court ordered a Chinese cyber-squatter to stop using the domain name www.ikea.com.cn, similar to that of IKEA, a furniture retailer based in Sweden. Similar decisions followed, such as one on November 14th 2001 in which the same court ruled that two Chinese companies, Beijing Guowang Information and Guangzhou Yuejing Information, had to stop using "maliciously registered" domain names containing the well-known brand names of 11 foreign companies, including Kentucky Fried Chicken, United Parcel Service, Subway, Boss, Elle and Olay. The two companies, which had been using the brands in their domain names since 1998, were also ordered to pay an unspecified amount in monetary compensation.

The China Internet Network Information Centre (CNNIC), an agency formally under the Chinese Academy of Sciences, has been charged by

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the MII with managing the administration of domain names in Chinese since 2000. In December 2002 the CNNIC said it would no longer handle the registration of domain names, handing that task instead to 23 qualified registering organisations. The CNNIC will now focus on its administrative functions. Once assigned a domain name by one of the 23 registrars, a company may not transfer it to a third party; thus for a transfer to take place in practice, the original owner of the domain name must first cancel it before the new owner applies for it. The main reason for giving CNNIC, and now the 23 registrars, this authority was to help Chinese companies that were not sufficiently aware of the English-language domain name registration procedures and therefore had fallen victim to cyber-squatters. To perform its responsibilities, the CNNIC has reserved many well-known Chinese trademarks in advance, expecting the owners of the trademarks eventually to apply for the domain names.

An announcement issued in late 2000 by the Beijing Higher People’s Court gives companies the possibility of taking to court other entities for using domain names that are identical or similar to the companies’ trademarks. This was followed by more elaborate rules on domain-dispute resolution issued by the CNNIC in November, which foresaw the establishment of a non-state agency to settle such disputes. According to the rules, trademark holders can complain about the use by other entities of domain names they believe infringe on their trademarks, provided that the complaint is made within two years of registration of the domain name.

New rules adopted by the Supreme People’s Court taking effect on July 24th 2001 clarify the circumstances under which disputes over domain names can be taken to court. According to the rules, the plaintiff has to demonstrate legal possession of a trademark, show a sufficient degree of abuse of his trademark and also prove bad faith on the part of the defendant. The rules state that bad faith is present if the defendant has adopted a domain name identical to the plaintiff’s trademark or sufficiently similar to it that the public will mistake the defendants’ products or services for those of the plaintiff.

However, Chinese courts do not always adopt an accommodating attitude to complaints. According to the Xinhua News Agency, Beijing’s No. 2 Intermediate People’s Court turned down a case on December 13th 2000 filed by Pfizer, the US pharmaceutical firm that markets Viagra, against a Chinese company that had registered a website called viagra.com.cn. The reason for turning down the case was that the website had already closed down, that it was registered at a time when Pfizer had not yet started selling Viagra in China and that Pfizer’s product is known in local markets under its Chinese rather than the English name.

3.5 Mergers and acquisitions

China continued to encourage mergers in 2002 in a bid to create large, competitive local conglomerates that can withstand the pressure of foreign competition expected based on the country’s entry into the World Trade Organisation. On May 16th 2002 China launched two new telecommunications conglomerates, ChinaTelecom Group and China Netcom Group. Although the restructuring involved the split along

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geographic lines of what was once a nation-wide fixed-line monopoly, it also caused a series of large mergers to take place. China Netcom Corp was formed by merging China Netcom, an existing provider of high-speed network services to corporate clients, with China Telecom's enterprises in ten northern and north-eastern provinces and with Jitong Communications; China Telecom Group became a conglomerate initially focusing on operations in 21 provinces in southern and western China. However, both groups are expected gradually to move into each other's areas and improve services through increased competition.

The automotive industry, which was considered to be under particular pressure after China's entry into the WTO, also saw several mergers in 2002. In the largest-ever domestic auto merger, China First Automotive Works (FAW) Group, the country's top carmaker, bought a 51% stake in Tianjin Automotive Xiali, a maker of compact cars, in an agreement signed on June 14th. The transaction was of particular interest to FAW, because Tianjin Automotive Xiali was engaged in a joint venture with Toyota Motor Corp of Japan. In a smaller deal announced in August, China's largest private carmaker, the Zhejiang Jeely Group, took over the sedan-manufacturing assets of Shanghai JMStar Group, another private company.

On October 11th 2002 China formally launched three aviation groups of roughly equal size that resulted from the absorption of smaller regional carriers into existing large aviation companies. Flag carrier Air China merged with China Southwest Airlines and China National Aviation Corp, the owner of Zhejiang Airlines and part owner of DragonAir of Hong Kong; the result was China National Aviation Holding Co, a conglomerate with US$6.9bn in assets. In the same revamp of the aviation sector, Hong Kong-listed China Southern Airlines merged with Xinjiang Airlines and China Northern Airlines to form a group with assets of US$6.1bn. China Eastern Airlines, also listed in Hong Kong, merged with China Northwest Airlines and Yunnan Airlines, forming a group with US$5.7bn in assets.

Regulations on Mergers and Divisions of Enterprises with Foreign Investment, which took effect on November 1st 1999, combines previous regulation and best practice on the rights and obligations of merging and dividing foreign investment enterprises (FIEs), approval authority, capital requirements and share distribution. Specifically, the regulations seek to ensure that foreign shareholding does not fall below 25% after merger or division in types of FIEs where this minimum percentage is required. They also state that an FIE cannot participate in a merger if the registered capital has not been paid in full, or if the FIE has not yet commenced operations.

For a merger between a joint venture and a state-owned enterprise (SOE), joint-venture regulations require prior approval from all joint-venture partners and from the original approval-granting authority. The resulting merged enterprise would presumably be some sort of joint venture, in which control would be based on the shares of registered capital held by each partner. In practice, however, such mergers do not really occur. Instead, the partners generally create a separate entity through contributions of assets and cash from existing enterprises, which are left effectively the same in terms of ownership structure.

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Mergers involving a wholly foreign-owned enterprise (WFO) and any other kind of enterprise (private or state owned) would be governed by the same procedures applicable to joint ventures. The main factor is the government's determination to keep tight control over the activities of all FIEs by making any corporate restructuring or change in business subject to approval by the Ministry of Foreign Trade and Economic Co-operation and other authorities. The procedure includes review of accounting statements verified by a Chinese registered accountant. On approval, changes must be registered with the local office of the State Administration for Industry and Commerce.

Under the Company Law, a joint-stock company seeking to undertake a merger must notify its creditors and give them 90 days to raise objections. All parties involved enter into a merger agreement, and they must also make three separate announcements of the merger in approved publications. Each party then submits the agreement along with an application for merger to the appropriate administrative department. On receiving the department's consent, the parties submit the same application to the examination authorities and for approval by the two companies. The newly merged entity must then apply to the authority in charge of registration of enterprises to amend its registration.

4.0 Foreign Investment

4.1 Foreign investment incentives

Chinese officials have stated repeatedly in recent years that the government's incentive policies are due for a major overhaul. The 1991 Unified Tax Law for foreign investment enterprises (FIEs) is expected to be replaced with a more universal income tax law, applicable to all enterprises in China, regardless of ownership. A timetable for the move to a single national corporate tax rate has not been given, but Chinese officials have said several times since China's entry into the World Trade Organisation in December 2001 that membership in the global trade body would accelerate its introduction. According to the State Administration of Taxation (SAT), contracts signed before the introduction of the new taxation regime will probably remain in force, with the original incentives, even afterwards. With the introduction of the new regime, however, the preferential 15% rate available to foreign investors in state-approved zones will probably disappear. In keeping with previous regulatory practice, companies set up now should be able to have their present tax rates "grandfathered".

Under provisional enterprise income tax regulations, which took effect in January 1994, state-owned enterprises (SOEs) had their tax rate reduced from 55% to 33%--the same rate now applicable to FIEs outside the special economic zones (SEZs--in Shenzhen, Shantou, Zhuhai, Xiamen and the entire Hainan Island) and other areas where special regulations apply. The SAT announced in 1994 that although foreign investors could keep their existing income tax privileges for now, they must pay the new indirect taxes on the same basis as domestic enterprises. But existing

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regional policies still offer favourable tax incentives to FIEs that are unavailable to domestic enterprises.

Zone policy now in place has encountered two main objections: (1) preferential policies foster robust growth in investment zones while letting other regions lag, resulting in a growing gap between SEZs and open cities on the coast and poorer inland regions; and (2) preferential policies slow the overall move to a national market economy, making it harder for China to fulfil WTO requirements.

Although the government is committed to unifying the tax code, exactly how this will be done is still a topic of debate. One option is to grant the same incentives now enjoyed by foreign enterprises to all companies operating in China. Some localities appear already to be going this way. Local authorities in Shanghai extended the 15% corporate tax rate to some 100 local companies in 1998 to put them on an equal footing with foreign firms operating in the city. A second option is to remove fully all incentives in all zones and raise foreign firms to the 33% level now levied on domestic Chinese firms. Setting a new scale of tax rates somewhere in the 15-33% range has been suggested as the third and most likely option. A level reportedly considered reasonable by the majority of Chinese officials is 25%.

For special zones and coastal cities, the strategy for maintaining competitiveness in the absence of preferential policies will be to deepen reform and rely on improved management and infrastructure gained during years at the forefront of China's economic development. Specifically, the SEZ Office has said that the five SEZs will experiment in key areas of reform over the next few years, with the following goals:

- Reduce government market intervention;
- Equalise treatment of foreign investors and domestic investors;
- Open the commerce, trade, finance and insurance sectors;
- Develop closer links to overseas markets;
- Make exports more competitive abroad;
- Standardise and improve laws and regulations; and
- Enhance integration with the less-developed regions.

Rules issued by the Ministry of Construction in 1995 governing the management of development zones have curbed the unrestrained development of China's various zones. The rules require any new zones to be included in the overall construction plans of cities. New zones must be approved by urban planning departments and must conform to the comprehensive city plan on site, land use, density and building height.

Tax officials have hinted that any future tax incentives will probably be for favoured industries rather than specific regions, as with existing special zones. China's implementation in January 1994 of a new range of indirect taxes, a value-added tax, a business tax (on some service industries) and a consumption tax has already changed tax incentives offered to foreign investors.

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4.1 Restrictions on foreign investment

Entering the Chinese market as a foreign company can be a challenging process. Establishing a joint venture--the most common but increasingly less preferred investment vehicle used by foreign investors--generally involves protracted negotiations. Approval procedures for most foreign activity remain complicated. Legislation governing foreign investment can be bewildering (and arbitrary, as authorities experiment with new regulations). Earlier efforts to lighten bureaucratic burdens on foreign investment enterprises (FIEs) have been reversed in the past few years. China has increased its scrutiny of proposed foreign investment to ensure that only those projects that support national development priorities and are capable of balancing their foreign-exchange flows are given the go-ahead. However, China's entry into the World Trade Organisation (WTO) could gradually lead to a more transparent, less cumbersome investment environment.

China's business environment remains demanding in both market entry and day-to-day management. Standard obstacles facing investors include maintaining management control, obtaining permission to sell on the domestic market, securing domestic financing and recruiting skilled managers and workers. All foreign entities seeking to invest in China must obtain pre-approval. The process for a direct investment depends on which form it takes. The three most commonly used forms are the wholly foreign-owned (WFO) venture; the equity joint venture (EJV), which is typically used for long-term projects and must register as a legal person; and the contractual, or co-operative, joint venture (CJV).

A WFO is funded entirely with foreign investment, and has sole responsibility for profits and losses. It must register as a legal person, giving it, among other things, the right to sue other entities or persons in a Chinese court. WFOs are expected to become the most popular investment vehicle following China's entry into the WTO, as the need to secure a Chinese partner's help in penetrating the market decreases. WFOs are governed by the Law on Wholly Foreign-Owned Enterprises, amended most recently in October 2000, as well as related implementing regulations, amended in April 2001.

An EJV is typically used for long-term projects and must register as a legal person. EJVs are limited-liability companies, with liabilities limited by the investments. Both the foreign and the Chinese investors contribute capital, obtaining equity and subsequently receiving redistributed profits accordingly. The minimum share that a foreign investor can hold is 25%; there is no maximum. EJVs are governed by the Law on Equity Joint Ventures, amended most recently in March 2001, as well as related implementing regulations amended in July 2001.

A CJV often is the model adopted for shorter-term projects or build-operate-transfer investments. It can register as a legal person with limited liability, but does not have to. In case the company does register as a legal person, the foreign investor must contribute at least 25% of the registered capital. Typically, the foreign investor provides funding and technology, while the Chinese partner provides land, labour, natural resources, and

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power and water facilities. Profits do not have to be redistributed according to the investors' respective contributions, giving both parties significant flexibility in negotiating contracts. CJVs are governed by the Law on Co-operative Joint Ventures, amended in October 2000, and related implementing regulations, amended in April 2001.

Apart from the three most widely used investment forms, a series of more recent models have been adopted by the Chinese authorities:

Foreign investment joint-stock companies (also known as foreign investment companies limited by shares--FICLS), require a minimum registered capital of Rmb30m, at least 25% of which must be contributed by foreign shareholders. FICLS are governed by a separate set of regulations under the Company Law, the Provisional Regulations on Several Issues Concerning the Establishment of Foreign Invested Companies Limited by Shares, which were promulgated and took effect in January 1995. FICLS form a subclass of joint-stock companies, a corporate form that, together with limited-liability companies, was introduced with China's Company Law, effective July 1st 1994. Joint-stock companies are similar to Western-style public shareholding companies. The limited-liability company described in the Company Law is essentially the same as the corporate form provided for under the existing laws governing joint ventures and wholly foreign-owned enterprises.

Limited-liability companies are another form permitted under the 1994 Company Law. It is essentially the same corporate form provided for under the existing laws governing joint ventures and wholly foreign-owned enterprises.

Investment, or holding, companies represent another investment organisation form that can be either in the form of a Sino-foreign joint venture or a WFO. These can be formed by a foreign company seeking to combine two or more of its joint ventures or other forms of investment in China into a fully integrated company that can combine sales, procurement, subsidiary investment, manufacturing and maintenance service for a broad range of product lines. The Ministry of Foreign Trade and Economic Co-operation (MOFTEC) published Provisional Regulations Concerning Investment in and Establishment of Investment Companies by Foreign Business Entities in April 1995, which took effect upon publication. They formalise, and sometimes change, existing requirements for establishing holding companies in China. According to the rules, an investment company may not hold shares in a company limited by shares or a joint-stock company. The regulations also require that in order to set up a holding company, whether as a JV or a WFO, a foreign investor must either (1) previously have invested in at least ten FIEs with a total investment of US$30m, or (2) have net assets totalling US$400m, existing investments totalling US$10m and permission for at least three future investment projects. In addition, if the proposed investment company is a JV, the Chinese partner must have assets of at least Rmb100m. According to supplements to the Provisional Regulations promulgated in the *International Business Daily* on September 5th 1999, holding companies are allowed to extend loans up to four times their paid-up registered capital. As further stipulated in Ministry of Commerce Decree [2003] No. 1, issued in June 2003, large holding companies with registered capital

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exceeding US$100m may take out loans up to six times their paid-up capital; they need permission from MOFTEC if loans exceed that amount. The supplementary regulations also state that holding companies may sell their products within China through agents and may offer transport and warehousing for constituent companies. In addition, the supplement encourages holding companies to engage in research and development within China.

Another investment vehicle developed in recent years is the **partnership enterprise**. The Law of the People's Republic of China on Partnership Enterprises (effective August 1st 1997) sets rules for establishing, operating, terminating and liquidating partnership enterprises. The law defines a partnership enterprise as a profit-making organisation established in China by legal entities that jointly contribute capital, share profits and risks, and undertake unlimited liability for the debts of the enterprise. The law requires a partnership enterprise to have at least two partners, a written partnership agreement, paid-up contributions from each of the partners and a place of business. Partners must be persons with full capacity for civil acts. Like other forms of investment organisation, partners in a partnership enterprise may make capital contributions in currency, in kind or in the form of land-use rights, intellectual property or other property rights. Profits and losses of the partnership enterprise are shared between the partners in proportion to the ratio stipulated in the partnership agreement or, where the partnership agreement fails to stipulate such a ratio, on an equal basis.

China has not published comprehensive guidelines on the authority of various government levels to approve foreign investment projects. The approval authority usually is MOFTEC at the national or local level, though the State Development Planning Commission (SDPC) gives ultimate approval. The total amount of the investment and the location of the proposed project largely determine what level of government is authorised to approve the project. But the rules are not always applied rigidly, and there are many exceptions.

Branches are yet another investment organisation form.

For projects valued at more than US$30m, the approval authority is MOFTEC. For projects below that limit, the agencies in charge of approval include state ministries, provinces, autonomous regions and municipalities with independent development plans, provided a project does not require overall balancing in terms of production, construction and operations; state assistance is not necessary for balancing foreign-exchange revenues and expenditures; and the proposed products are not subject to quotas or export licensing.

This general rule applies to investment projects in the "permitted" and "restricted" categories according to the Regulations for Guiding the Direction of Foreign Investment and the accompanying Foreign Investment Catalogue, both effective April 1st 2002. For investments in the "encouraged" category, the approval authority is the provincial level for projects of more than US$30m and for local authorities for projects below that.

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The SDPC issued a statement on March 21st 2000 saying that provincial-level authorities, including provinces, autonomous regions and municipalities, were allowed to approve investment projects regardless of their size. The practical significance of this announcement is debatable, however, since it lists a range of important industries where the new rules do not apply--such as power plants, chemicals, electronics, air transport and mining. The rules will be applied explicitly only in light industries and pharmaceuticals. The statements also described a range of specific cases where the rules will not be applied at all: projects where financing from the national budget or from state-owned banks is necessary; projects that form part of "national planning"; projects where land use must be approved by the State Council; forestry projects with a negative effect on the environment; projects that need export or import licences; and pilot projects. Moreover, MOFTEC will sometimes have the right to turn down a project exceeding US$30m within one month of application.

Nevertheless, the announcement can be viewed as the latest in a series of opening measures adopted by the authorities over recent years. To encourage more direct foreign investment in China's interior, the State Council, or Cabinet, granted permission to inland provinces in August 1996 to approve FIEs in manufacturing with investments of up to US$30m. Previously, China's interior provinces could approve investments of only less than US$10m. Non-manufacturing foreign investment projects in inland provinces are still subject to the US$10m limit, as are projects in nationally approved high-tech zones. Projects of more than US$100m must be approved directly by the State Council.

Local districts, counties and bureaux may approve investments of less than US$5m. The State Council has jurisdiction over approvals of projects that do not fall within these limits. MOFTEC reserves jurisdiction over WFOs that are to produce goods for domestic sale or that are subject to state restrictions on the use of foreign capital. Resource-based joint ventures may require approval from the relevant ministry or government body (for example, airline ventures involving foreign companies are approved by the Civil Aviation Administration of China, and an infrastructure-related joint venture involving China's roadways is approved by the Ministry of Communications).

Coastal provinces may approve projects with total investment of US$30m or less, as can special economic zones (SEZs). No approval limits apply to most projects of a "non-productive" (that is, non-manufacturing) nature (for example, hotels and real estate), so the local governments generally retain approval authority for them. However, foreign investors pursuing deals involving non-productive forms of investment--such as motorway, rail, power generation and other infrastructure projects--must generally seek MOFTEC approval.

The 1988 Administrative Regulations on the Registration of Legal Corporations require all FIEs (both joint ventures and WFOs) to register as corporations with the State Administration for Industry and Commerce (SAIC). After obtaining a business licence, such enterprises must open a renminbi deposit account with the Bank of China or another designated bank, and a foreign-exchange account with a bank designated by the State Administration of Foreign Exchange.

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Expansions of an existing investment in a joint venture require unanimous agreement by the venture's board of directors and prior approval from the authority that approved the original investment. If expansion of an existing FIE puts the total investment of the project over the threshold for local approval, typically US$30m, the applications for increased investment must be submitted to MOFTEC. The approval procedures are essentially the same as for new investments. New rules promulgated in June 2002 institute tax incentives encouraging capital expansion.

One frequent problem is that the local partner in a joint venture cannot provide the capital it must contribute to a planned investment expansion to keep the venture in accordance with local regulations on distribution of shares, and it is often given a "free ride" by its foreign partner. In order to improve funding channels for Chinese joint-venture partners and help them maintain control over their businesses, the PBoC issued Measures for the Administration of Loans for Capital Addition Made by Chinese Joint-Venture Partners in March 2000. The measures provide a legal framework for lending by Chinese commercial banks to creditworthy Chinese JV partners planning to add to their registered capital. The loans have a limit of ten years and may not exceed 50% of the total amount of money that the Chinese JV partner pays in to add to the registered capital. According to the measures, the Chinese partner may start drawing down the loan only after he has paid the amount raised on his own and only after the foreign partner has also paid his part of the capital addition in full.

A joint-stock company (or company limited by shares) may raise capital to expand its investment by issuing shares of equal value, with each share within a class having an equal right to the payment of dividends and to the company's assets on liquidation. But the amount of money that can be raised is restricted. The Opinion on Standards for Companies Limited by Shares (the national legislation governing limited companies) imposes a limit of twice the value of existing assets; the Shanghai regulations governing joint-stock companies listed on the Shanghai Exchange restrict the increase to the current amount of registered capital; and the Shenzhen regulations governing Shenzhen–listed companies set a limit of twice the book value of existing shares. In contrast to EJVs and WFOs, an FICLS may also reduce its capital if the company has excess capital or suffers serious losses. The company may return subscription money or cancel shares if approval is received from the shareholders, the central bank and the responsible government departments.

4.3 Exchange controls

Following a string of government measures in the late 1990s to strengthen administrative controls on dealings in foreign exchange, forex outflow gradually subsided, and the Chinese currency, the renminbi, was kept from collapsing. The currency was stable during 2002 and was never allowed to veer far from the Rmb8.28:US$1 mark.

China's foreign-exchange reserves stood at US$286.4bn at the end of 2002, up US$74.2bn from US$212.2bn at end-2001. The reserves have risen not only from improving exports but also from recent policies such as bans on prepayment of foreign debt not explicitly stipulated in a debt

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agreement, demands on financial institutions to conduct more thorough checks on companies seeking to obtain foreign exchange and a ban on foreign-exchange trading by domestic bank branches.

Exchange controls remain relatively strict, but many foreign businesses believe that reforms aimed at simplifying procedures will need to be introduced, given the rapid increase in foreign trade and investment expected following China’s new status as a member of the World Trade Organisation. One step was taken on July 1st 2002, when new relaxed rules regarding foreign-exchange accounts held by foreign investment enterprises (FIEs) for receiving investment into the enterprise (on different types of accounts) took effect. According to these rules, FIEs no longer need to obtain prior approval from the State Administration of Foreign Exchange (SAFE) or its local bureaux before converting foreign exchange on these accounts into the local currency, the renminbi.

Despite a plethora of restrictions still in place, the general trend over the past decade has been towards a gradual liberalisation of China’s foreign-exchange market. The country reached its most significant milestone in December 1996 when it officially made the renminbi convertible on the current account. In doing so, China agreed to Article VIII of the IMF, which prohibits restrictions on payments and transfers for international transactions, multi-currency practices and other discriminatory measures. Extending this policy, China’s exchange authorities closed down the country’s foreign-exchange swap markets in December 1998. Rules on foreign investment equity joint ventures (EJVs) were amended in July 2001 to be consistent with the partial convertibility of the local currency, cancelling a previous requirement that EJVs maintain a balance of foreign-exchange revenues and expenditures. The rule had become obsolete after current-account convertibility allowed FIEs to sell and buy foreign exchange at local banks for trade purposes, and its enforcement had long ceased.

Current-account convertibility has required China to remove all restrictions on payments of enterprises--including FIEs--for imports, labour and services; repayment of interest on foreign debt; and repatriation of profits by foreign businesses in China. Although current-account convertibility is now a reality, convertibility on the capital account is not expected in the near future. Capital-account transactions include those related to direct investment, international loans and securities. Contributing to China’s intransigence in this area is its belief that non-convertibility on the capital account helped the country avoid the worst effects of the regional financial crisis of 1997–98. Even so, officials have repeatedly said that convertibility on the capital account remains a long-term goal. Vice-premier Wen Jiabao said on October 11th 2002 that opening of the capital account should proceed according to “orderly principles”. On November 25th Dai Xianglong, the governor of the People’s Bank of China (PBoC--the central bank), was quoted in the *People’s Daily* as saying that China would follow a gradual approach in opening up its capital account. No time frame for the implementation of such a reform has been given, however.

Under the 1996 rules, FIEs may make trade-related foreign-exchange transactions without prior approval from SAFE. FIEs need only take the related trade documentation to a designated foreign-exchange bank to

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obtain hard-currency funds. In exchange for this privilege, however, FIEs must sell all foreign exchange earned in excess of a limit set by SAFE in a “basic” foreign-exchange bank account aimed at covering trade-related needs.

The interbank market now consists of designated state foreign-exchange banks and approved foreign banks. These banks operate as members of the China Foreign Exchange Trading Centre (CFETC) in Shanghai, a national forex trading centre linked by computer to regional forex trading centres. The CFETC allows daily fluctuations in the renminbi’s foreign-exchange rate and oversees trading of US and Hong Kong dollars and Japanese yen.

Foreign and domestic banks and non-bank financial institutions participate in the centre’s transactions as member institutions. A unified rate for the US dollar and other major currencies is quoted daily by the PBoC, based on the previous day’s closing prices in the interbank market. Should the rate fluctuate during the day outside a narrow set band, the PBoC maintains a special hard-currency account for intervention.

Bucking the general trend towards more liberalised foreign-exchange regulations over the past decade, China issued a slew of measures to improve supervision in 1998-99, following the regional financial crisis. New restrictions have become scarcer since then, although occasional measures are announced to raise regulatory capabilities. On May 1st 2002 new regulations took effect, strengthening supervision of foreign currency used as capital contribution for foreign investments. According to the rules, accountants must check the foreign exchange registration certificates obtained by foreign investors to ensure that the funds have been paid into the investors’ special account for capital investments. Periodic crackdowns--including measures to curb black-market currency transactions and companies that overstate their imports to obtain hard currency--also take place.

However, given the continued growth in exports and the rise in foreign-exchange holdings, there appears to be no immediate major threat to the currency--giving regulators a rationale for not stepping up controls and, in some cases, for relaxing them. For instance, the SAFE published rules, effective from October 1st 2002, amending rules published during the height of the regional financial crisis in 1998, which had barred enterprises in bonded or free-trade zones from buying foreign currency. The new rules list the circumstances under which enterprises in free-trade zones are allowed to purchase foreign currency, including payments in foreign exchange to overseas businesses when the enterprises’ own foreign exchange is not sufficient.

New rules issued by SAFE took effect on October 15th 2002 abolishing a previous system that had allowed only FIEs to maintain limited levels of foreign exchange in special forex accounts while forcing domestic enterprises to sell all hard currency to designated banks. According to the new regulations, all domestic enterprises, including FIEs and wholly Chinese-owned companies, are allowed to hold a basic foreign-exchange account for current-account, or trade-related, purposes. The account is capped at 20% of the enterprise’s trade-related foreign-exchange receipts

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of the previous year. For companies that had no trade-related foreign-exchange receipts the previous year, the cap is set at US$100,000. Retained foreign exchange exceeding this limit must be sold into the local forex market; if the holder of the account does not do this of his own account, the bank is under obligation to perform the sale within ten working days. Accounts that have not been active for one year will be closed.

The 2002 regulations replace a previous graded system under which the cap was set using a formula determined by the FIE's paid-in capital or export volume. The maximum limit in the basic forex account for FIEs with paid-in capital of more than US$30m was US$7.5m; companies with lower paid-in capital faced lower limits. The new system allows a certain degree of flexibility, as companies allotted a higher cap or may be allowed to open more than one account--denominated either in US dollars or in another foreign currency--if the nature of their business requires it. In general, however, each locality within China is not allowed to let the total cap exceed 25% of trade-related foreign-exchange receipts of the previous year.

China requires FIEs to separate their foreign exchange into different forex accounts that can be used only for specified purposes. These are as follows:

- Accounts for receiving investment into the enterprise. Funds on this account are for purposes previously approved by SAFE.
- Accounts for receiving proceeds of foreign-exchange loans. Again, SAFE is involved in approving the project for which the loan is intended and the financial institutions must deny withdrawal if it is for purposes not covered by the loan agreement.
- Accounts to repay foreign-exchange loans. For debt repayment to take place via this channel, a request from the lender is to be submitted to SAFE for approval.
- Accounts for proceeds from disposal of assets.

Special regulations were issued in late 1997 concerning B shares, which were originally open only to foreign investors (they were not open to locals until 2001). The new measures issued by the PBoC allow domestic issuers of B shares to retain part of their hard-currency receipts (in special accounts), whereas foreign investors may open foreign-exchange accounts to trade in B shares.

The annual foreign-exchange inspections, launched by the SAFE in 1995, should provide the necessary supervision required to allow FIEs to buy foreign exchange from the designated banks making up the CFETC. Under these annual inspections, within the first three months of each year, FIEs must file a foreign-exchange examination report (FEER) to qualify for forex privileges. The report requires FIEs to provide a vast range of information on their foreign-exchange dealings, including compliance with capital-contribution requirements and agreed export undertakings as laid out in joint-venture and other contracts.

At the beginning of 1997 the documentation required by the SAFE was combined into a single consolidated annual report, dealing not only with

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foreign exchange but also with all aspects of an enterprise's business. Individual sections of the report must be approved by the relevant government departments and then submitted to the State Administration for Industry and Commerce (SAIC) for final approval. A joint circular issued in early 1997 by a number of government departments, including MOFTEC and SAIC, specified that foreign enterprises in China were to be categorised into "satisfactory" and "unsatisfactory" groups, based on the acceptability of their annual audits. There is no sign that unsatisfactory FIEs are being penalised, but it is possible that in the event of a currency crisis--where the central bank is forced to ration foreign exchange--companies with "satisfactory" ratings from the SAFE would receive preferential treatment.

Enterprises that meet the relevant foreign-exchange requirements will be provided with an approval stamped on its Foreign-Exchange Registration Certificate (FERC), which may then be presented to an approved foreign-exchange bank, so the enterprise can conduct foreign-exchange deals without obtaining SAFE approval each time. Businesses that fail to submit a report or to meet foreign-exchange criteria will have to seek approval from local SAFE offices for each transaction before obtaining money through designated foreign-exchange banks.

To obtain an FERC, an FIE must first apply to the SAFE. The FIE must give the SAFE evidence of its legal existence, its assets and the purpose of the desired foreign-exchange account. This requires submitting copies of the joint-venture contract, articles of association, the business licence issued by the SAIC and an investment verification report issued by a certified public accountant registered in China. Only after obtaining this certificate may the FIE apply with SAFE to open a foreign-exchange account. Based on the applicant's investment, the SAFE will determine the upper limit of deposits allowed on the account, but with the possibility of adjusting that upper limit for increased investment.

All foreign-exchange receipts and disbursements must flow through the "basic" and specialised foreign-exchange accounts. Companies from a country with an investment agreement with China are guaranteed convertibility of royalties arising from an investment or licensing agreement and convertibility of a foreign partner's investment (to the extent of contributed registered capital) on liquidation of a joint venture. Funds are convertible at the exchange rate at the time of repatriation or transfer. Foreigners are allowed to hold any amount of renminbi in a domestic savings or current account. Locals are free to open US dollar accounts at the Bank of China or other state-approved banks.

4.4 Imports and exports

See Section 1.7.

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5.0 Choice of Business Entity

5.1 Principal forms of doing business

Foreign investors may set up wholly foreign-owned ventures (WFOs), co-operative joint ventures (CJVs), equity joint ventures (EJVs), limited-liability companies, holding companies, joint-stock companies, representative offices and branches.

The following is a summary of the requirements of the main corporate forms for foreign investment enterprises (FIEs) in China--the EJV, CJV, WFO, joint-stock company (or company limited by shares) and limited-liability company. Umbrella or holding companies comprising several joint ventures follow the rules pertaining to joint ventures, whereas holding companies that are wholly foreign owned follow the rules for WFOs. The summary for CJVs is indicative, since regulations have yet to be issued. Another recently developed investment vehicle is the partnership enterprise via the Law of the People's Republic of China on Partnership Enterprises.

Capital

The concepts of authorised and issued capital are not used in China; instead, China considers registered capital in the capitalisation of joint ventures and joint-stock companies (also known as companies limited by shares). Joint-venture regulations define this as the total amount of capital contributed by the parties and registered with Chinese authorities at the time of the joint venture's formal establishment. For a joint-stock company, registered capital is its total paid-up subscription monies (defined as the total value of the company's shares).

Equity joint venture. The minimum level of foreign participation in an EJV is 25%. There is no upper limit on foreign participation. Capital can be contributed in the form of cash, with foreign currency converted into renminbi according to the exchange rate announced by the State Administration for Foreign Exchange (SAFE) on the day the funds are submitted. Under certain conditions, capital may also be contributed in the form of tangible assets--such as equipment, buildings and other material--or intangible assets--such as industrial property rights and know-how. When the participants in an EJV contribute either tangible or intangible assets, the assets' value is determined jointly by the participants or by a third party designated jointly by the participants, generally a Chinese-registered accountant. Officially, there is no upper percentage limit on the amount of intangible assets that can be provided by the foreign partner. According to internal government regulations, however, the value of industrial property and technology provided by a foreign investor may not exceed 50% of the foreign investor's total capital contribution or 20% of the total registered capital of the joint venture. However, Provisions on Several Questions Regarding the Use of High and New Technology Achievements as Capital Contributions to Subscribe for Shares, promulgated on July 4th 1997, qualifies this rule. According to the provisions, the total value of technology contributed as capital can exceed 20% of the joint venture's total registered capital, if it qualifies as new or high technology under

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definitions published by the Ministry of Science and Technology. Partners must pay their contribution within a time frame fixed in the joint-venture contract. Failure to make capital contributions in time may lead to cancellation and compulsory surrender or revocation of the business licence.

The ratio of registered capital to the total amount of the investment must comply with the following scheme: where total investment is US$3m or less, registered capital must account for 70% of the total; for US$3m-4.2m, registered capital must be at least US$2.1m; for US$4.2m-10m, at least 50%; 10m-12.5m, at least US$5m; US$12.5m-30m, at least 40%; US$30m-36m, at least US$12m; and more than US$36m, at least 33.3%.

Co-operative joint venture. Capital is contributed in a ratio agreed by the parties to the CJV contract. Contributed capital may take the form of cash, land-use rights, technology (patented or unpatented), materials and equipment, trademarks and other property rights--essentially the same forms as for an EJV. As with EJVs, foreign partners' contributions in the form of intangible assets may generally not exceed 50% of the total foreign capital contribution and 20% of the joint venture's total registered capital, but with the same qualifications introduced by the July 4th 1997 provisions. Both "hybrid" and "true" CJVs are governed by the Detailed Implementing Rules for the Law of the People's Republic of China on Chinese-Foreign Co-operative Joint Ventures (effective September 4th 1995). Under the new CJV regulations, CJVs that have obtained the status of a legal person (known as "hybrid" CJVs) are governed by essentially the same regulations on minimum equity requirements and the timing of capital contributions as EJVs.

Under "true" CJV arrangements, contributions by each partner are treated separately rather than as a single registered capital of the venture. In contrast to an EJV, parties to a CJV may share profit in a ratio that differs from the ratio of capital contributions.

Wholly foreign-owned venture. No legal minimum or maximum governs the amount of capital contributed by a foreign company to establish a WFO. As with joint ventures, capital may be contributed as cash or tangible assets or (with approval) in renminbi. Valuation must be consistent with international principles. Industrial property and technology may not exceed 20% of the registered capital of the enterprise. Registered capital of a WFO may not be reduced but may be increased upon approval of the proper authorities. When capital is contributed in instalments, WFO rules require that the final instalment be made within three years of the date of issuance of the business licence. The first instalment must be not less than 15% of the total contributed capital, contributed within 90 days from the date of issuance of the business licence.

Joint-stock companies. Under the Company Law, the minimum registered capital of a joint-stock limited company is Rmb10m. However, joint-stock companies seeking to list shares on a stock exchange must have total share capital of at least Rmb50m. A joint-stock company with foreign investment must have total registered capital of at least Rmb30m. In all cases, the foreign share capital of a Chinese-foreign joint-stock limited company should not be less than 25% of the registered capital. As

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with joint ventures and WFOs, capital may be contributed in the form of cash, tangible assets, proprietary technology or land-use rights needed by the company for production and business purposes. Industrial property and proprietary technology may not exceed 20% of the company's total registered capital.

Limited-liability companies as provided for under China's new Company Law allow contributed capital to be in currency, material goods, industrial property, non-patented technology or land-use rights. The value at which industrial property and non-patented technology are contributed may not exceed 20% of registered capital of a limited-liability company except where special state regulations for the use of high or new technology provide otherwise.

Partnerships. Under the Law of the People's Republic of China on Partnership Enterprises (effective August 1st 1997), there is no legal minimum or maximum that governs the amount of capital contributed by the partners to a partnership enterprise. As with JVs and WFOs, capital may be contributed in the form of currency, in kind or in the form of land-use rights, intellectual property rights or other property rights. Such contributions must be the lawful property of the partner. Contributions other than currency must be appraised at a specific value. Partners may increase their capital contributions to the partnership enterprise as stipulated in the partnership agreement or as decided by all the partners. Such additional contributions should be used to expand the scale of business or to make up losses.

Founders, shareholders

EJV and CJV. No specific limit has been fixed for the number of foreign or Chinese partners. For a CJV, the foreign and Chinese partners control the venture as outlined in the CJV contract.

WFO. If two or more investors jointly apply to establish a WFO, a copy of the contract among the joint investors must be filed with the examination and approval authorities.

Joint-stock company. The Company Law and the *Provisional Regulations on Several Issues Concerning the Establishment of Foreign Invested Companies Limited by Shares* (effective January 10th 1995) allow joint-stock companies to be established by means of sponsorship or a share offer. Shanghai regulations require companies with foreign investment to be established by means of sponsorship (that is, where all the shares to be issued by the company are subscribed for by the sponsors themselves).

Sponsors of a company limited by shares must be legal persons or departments that have been authorised by the state to make investments. Where the sponsor of a company limited by shares is a Chinese-foreign EJV or CJV, the parties to the venture should reach an agreement on their respective rights and obligations following establishment of the company. In Shanghai, before establishing a company limited by shares, the sponsors should reach an agreement and jointly select a sponsor

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registered in a Shanghai municipality to apply for the establishment of the company.

Limited-liability company. The Company Law states that the establishment of a limited-liability company requires no fewer than two and no more than 50 shareholders, more than half of whom must be domiciled in China.

Partnerships. No specific limit has been fixed for the number of partners to a partnership enterprise. Under the law, each partner has equal rights in the conduct of the routine affairs of the partnership enterprise. The admission of new partners is subject to the approval of the partners and the conclusion of a written partnership agreement according to law. New partners admitted have the same rights and responsibilities as the original partners.

Directors, management

EJV. The managerial structure of an EJV consists of the board of directors, management, staff and workers. The board of directors must have at least three members, including a chairman and a vice-chairman. New rules on EJVs in force since July 2001 remove a previous requirement under which the chairman had to be appointed by the Chinese partner, and the vice-chairman by the foreign side. The board, which must meet at least once a year, decides on all major issues (including the appointment of management) according to the articles of association.

The following decisions require the unanimous agreement of the directors: amendment of the articles of association, termination or dissolution of the venture, increase or assignment of the registered capital and merger of the venture with other economic organisations. There is no fixed number for managers of an EJV, but they must include a general manager (no particular nationality required) and a deputy general manager.

CJV. The CJV law requires the venture to have either a board of directors or a joint management committee. “Hybrid” CJVs tend to adopt management systems resembling those of the EJV, whereas “true” CJVs tend to take the more flexible form of a joint-management office. Under the latter structure, no general manager exists as such, though the parties usually appoint a legal representative. Under the new CJV regulations (effective September 4th 1995), the chairman of the board or the head of the management committee serves as the legal representative of the CJV.

Chinese law provides that only Chinese legal persons may contract with other Chinese entities to lease land, purchase supplies, etc. Therefore “true” CJVs, which do not have independent legal status in China, usually use the Chinese partner to enter into such contracts, under a grant of power of attorney by the foreign party.

WFO. There is no mandatory management structure for a WFO, but the articles of association must spell out a structure in considerable detail (including the duties and limits of authority of such personnel as the legal representative, chief accountant, general manager and chief engineer). The articles of association must also specify procedures for termination and liquidation, as well as for the amendment of the articles.

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Joint-stock company. A company limited by shares is governed by its articles of association, which must be approved by the local examination and approval authorities. The articles of association outline the system of management and control that is to govern the company. They detail the rights and obligations of the shareholders and the official powers and rules of procedure of the shareholders' general meeting; the establishment, official powers and rules of procedure of the board of directors, the supervisory board and the manager; and the procedure for amending the articles of association. The board of directors, which should have 5-19 members, is the permanent executive organ of the shareholders' general meeting. Shareholders and non-shareholders may serve as directors. The board of directors generally has one chairman (who is the legal representative of the company) and, when necessary, one or two vice-chairmen. The manager of the company is appointed and dismissed by the board of directors and is the person in charge of the company under the board. Generally, the chairman of the board of directors may not concurrently hold the position of manager. A supervisory board composed of no fewer than three members (one-third of whom must be staff and workers of the company) supervises the activities of the board of directors and such management personnel as the manager.

Limited-liability company. The Company Law says limited-liability companies must have a board of directors consisting of 3-13 members, whose term of office may not exceed three years. If re-elected upon expiration of his term of office, a director may serve consecutive terms. The board must have one chairman and one or two vice-chairmen. A limited-liability company must also have a manager who is accountable to the board of directors and is in charge of the production, operation and management of the company. If a limited-liability company's shareholders are few in number and it is small in scale, then the company may have an executive director rather than a board of directors. The executive director may concurrently serve as manager. If the scope of a limited-liability company is large, it must establish a supervisory board of at least three members, which examines the company's financial affairs, supervises the directors and the manager, and may undertake other functions and powers provided for in the company's articles of association. Supervisors shall attend meetings of the board of directors as non-voting attendees.

Partnerships. The routine affairs of the partnership enterprise may be run jointly by the partners, as stipulated in the partnership agreement or as otherwise decided by the partners. One or more partners may be entrusted with running the routine affairs of the partnership enterprise. The non-managing partners, however, have the right to supervise managing partners and to inspect the running of the routine affairs of the partnership enterprise. The partnership agreement must outline the methods for distributing profits and sharing losses; the conduct of the routine affairs of the partnership enterprise; admission to and retirement from the partnership; dissolution and liquidation of the partnership; and legal liability.

Disclosure

EJV and CJV. Following receipt of a formal certificate of approval, joint ventures must register with the State Administration for Industry and

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Commerce (SAIC) or its local delegate. Documentation consists of an application for registration; the joint-venture contract and articles of association; approval certificate; project proposal and feasibility study, with relevant approval documents; certificates attesting to lawful commencement of business by the investors; certificates indicating the credit standing of the investors; a list of the board of directors and management; and other relevant documents and certificates. Joint ventures must submit unaudited quarterly and audited annual accounts to the relevant government authorities, with auditing done by Chinese certified public accountants.

WFO. Upon completion of initial contacts, the following formal application documents are required: standard application for establishing the WFO, the feasibility study and proposed articles of association, articles of association and business registration certificate of the foreign parent, certificate of incorporation, balance sheet for the previous three years, a plan for the balance of foreign-exchange receipts and expenditures, a list of equipment to be imported and letter of creditworthiness issued by the bank with which the foreign investor has opened an account. An accounting system must be established in accordance with Chinese law, with reports subject to approval by the local financial and taxation authorities.

Joint-stock company. The Company Law requires that a joint-stock company's board of directors apply for registration within 30 days after the completed inauguration of the board of directors. Documents that must be submitted by a joint-stock company in its registration application include an application form signed by the chairman of the board; approval document from the relevant government department; for a company established by means of a share offer, the approval document from the State Council's securities administration department; minutes of the founding meeting; articles of association; auditing report of the company's establishment; certificate of verification of investment from an official investment verification organisation; notice of pre-approval of company name; certification that the company has the right to use its place of business; and other documentation relating to the legal status of promoters; names and residences of directors and managers, and their election or appointment certificates.

Limited-liability company. Under the Company Law, a representative or agent designated by the shareholders must file the registration application. Foreign-investment limited-liability companies, which are subject to examination and approval procedures, must file an application within 90 days. The documents that must be included in a limited-liability company's registration application are an application form signed by the chairman of the board; certification of the designated representative or agent; articles of association; certificate of verification of investment issued by official investment verification organisation; certificate of appointment by the company's legal representative; notice of pre-approval of company name; certification that the company has the right to use its place of business and other documentation relating to the legal status of the shareholders; and names and residences of directors and managers.

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Partnerships. An application to register the establishment of a partnership enterprise must be submitted to the enterprise registration authority (the law does not specify which body this would be.) This must include a written application, the written partnership agreement and documents such as proof of identity of the partners, along with other documents. After receiving approval (issued within 30 days of application) from the relevant authority for the establishment of a partnership enterprise, successful applicants will be issued a business licence. If the registered particulars of a partnership enterprise change for any reason or re-registration is required, the relevant registration procedures must be carried out with the enterprise registration authority within 15 days of the date on which such decision was made or such change occurred.

Taxes and fees on incorporation

All forms. Fees for registration are set forth in a 1988 document issued by the State Administration for Industry and Commerce, the Ministry of Finance and the State Bureau of Commodity Prices. Fees payable by ventures are calculated on the following basis: Rmb10m or less, 0.1% of registered capital (subject to a minimum of Rmb50); portion in excess of Rmb10m, 0.05%; portion in excess of Rmb100m, no fee. With any increase in registered capital, the same fees are payable again on the entire new amount. Fees of Rmb100 each apply to advance registration of a venture's name and to recording ordinary changes in registered items. Companies must also pay an annual registration inspection fee of Rmb50.

Partnerships. No taxes or fees on incorporation are outlined in the Law on Partnership Enterprises.

Types of shares

EJV and limited-liability company. No shares *per se* are issued in exchange for capital.

CJVs and WFOs do not issues shares.

Joint-stock company. All the capital must be divided into equal shares represented by share certificates. These firms may issue ordinary or preferred shares (of which the latter generally have no voting rights). Companies must receive approval from the local branch of the People's Bank of China (PBoC--the central bank) and other authorities to issue both A-shares (denominated in renminbi and available only to Chinese citizens) and B-shares (denominated in US dollars and available to foreign and local nationals, including citizens of Hong Kong and Macao). A-shares are further divided into shares owned by individuals, by legal persons and by the state. A-shares owned by individuals may be traded freely through a securities trading house under relevant laws and regulations of the state. Legal persons' shares are traded on a separate electronic network, whereas A-shares owned by the state are not traded at all.

Partnerships. Partnership enterprises do not issue shares.

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Control

EJV. Besides government intervention through administrative decrees or regulatory changes, only joint ventures' partners control management. Voting power is directly proportional to a partner's share of registered capital.

CJV. Control in a CJV is in effect held by the partners to the venture, though CJV law permits management of a venture to be delegated to a third party with government approval. This is the standard mode of operation for hotels, which usually appoint an outside hotel-management company.

WFO. Control is solely in the hands of the foreign investor contributing capital. Nonetheless, Article 25 of the WFO rules states that the legal representative of a WFO has the power to represent the enterprise. To avoid granting the representative powers that it seeks to reserve to itself, the foreign investor must spell out in detail the scope of the representative's authority in the articles of association.

Joint-stock company and company limited by shares. Control is exercised by shareholders of the company or their proxies through decisions made at the company's general meetings. When the shareholders' general meeting is in recess, the board of directors is responsible for the company's major policy decisions and is accountable to the shareholders' general meeting. The management of a company limited by shares is responsible for implementing resolutions of the shareholders' general meetings and the board of directors; it is also responsible for the routine administrative, business and financial affairs of the company.

Limited-liability company. Under the Company Law, shareholders' meetings are the organ of authority of the limited-liability company. Shareholders exercise voting rights at shareholders' meetings in proportion to their capital contributions. The board of directors is accountable to the shareholders' meeting and must implement the resolutions of the shareholders' meetings and also decide on business and investment plans of the company. The manager of the limited-liability company is accountable to the board of directors, which is in charge of production, operation and management of the company.

Partnerships. Control is exercised by the partners to the partnership enterprise through procedures set out in the partnership agreement. The agreement may set out the term of operation of the partnership enterprise and the method for settling disputes between partners. Certain actions of the partnership enterprise require the consent of all of an enterprise's partners; these include disposal of immovable property of the partnership; change to the name of the partnership; assignment or disposal of the intellectual property rights or other property rights of the partnership; application to register changes with the enterprise registration authority; provision of guarantees for outside parties in the name of the partnership; engagement of persons outside the partnership to serve as business or management personnel to the partnership; and other relevant matters.

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5.2 Branches

Articles 199-205 of the Company Law offer the possibility of creating a new kind of investment vehicle in China: a "branch of a foreign company". Certain foreign branches are already permitted in China (for example, foreign bank and insurance branches), but they operate under strict central-level restrictions. The Company Law, however, appears to permit any company to set up a branch.

The State Council has not yet released regulations governing examination and approval procedures and the scope of allowable activities for branches of foreign companies. Under the Company Law, however, branches of a foreign company in China remain part of the parent company and are thus not entitled to the rights and protections of Chinese legal persons. Branches must appoint a Chinese legal representative and will be held liable under civil law for business activities conducted in China.

It is expected that branches will be able to conduct direct business activities in China instead of being just a liaison, as with representative offices. Foreign lawyers also speculate that foreign companies setting up branches in China will be able to deduct the expenses of setting up this kind of venture from the profits of the company's head office. The branch will be a welcome option for foreign service companies and other firms not permitted by Chinese law to establish wholly foreign-owned ventures (WFOs).

Despite the advantages of branch offices, few companies have set up this form of investment vehicle to date, in part because the regulations governing branch office approvals and scope of business have not been published. Foreign companies, particularly those in the service industries, continue to rely on their representative offices to conduct business (though this is technically illegal). Representative offices offer the advantage that the rules governing their operation are clear-cut and of long standing.

In fact, representative offices remain the most common vehicle for foreign service companies establishing a presence in China, particularly in banking, accounting, consultancy and import-export trading. Moves by both central and provincial authorities to liberalise China's banking and insurance sector have led many foreign banks to set up representative offices in China's major coastal cities and some inland urban centres.

Although representative offices allow foreign investors to enter the Chinese market with little initial investment, such entities are prohibited from direct profit-making under revised regulations published by the MOFTEC, effective February 13th 1995. (In practice, however, foreign companies frequently conduct business through their representative offices.)

The Detailed Implementing Rules of the Ministry of Foreign Trade and Economic Co-operation Concerning Examination, Approval and Administration of Resident Representative Offices in China of Foreign Enterprises clarify that representative offices may engage in "indirect operational activities", set forth as:

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- Liaison for business purposes within the enterprise's scope of business;
- Product introduction;
- Market research; and
- Technology exchange.

Companies extending their activities beyond the allowable scope of business will be warned or have their approval certificates revoked under the revised regulations.

The revised regulations require foreign companies seeking to establish a representative office to apply to MOFTEC at the local or national level, depending on the business in question. Applications are to be approved or refused within 30 working days of receipt. The longest possible term of approval for a representative office is three years. Applications for extension must be made 60 days before a term expires. Separate rules exist for establishing representative offices by foreign financial institutions. Special rules also exist for representative offices established in the Shenzhen special economic zone in Guangdong province and Shanghai municipality. Despite differences in the details of these provisions and those of the national registration regulations, the basic registration procedure remains the same: (1) obtain formal approval to establish the office, and (2) complete formalities with the State Administration for Industry and Commerce to obtain a registration certificate.

The People's Bank of China is responsible for granting registration certificates to representative offices established by both foreign banks and insurance companies. It will be costly, however, for foreign banks to fully utilise the openings permitted by China's December 2001 entry into the World Trade Organisation. Foreign banks seeking to adopt the full scope of business permitted once the last curbs are abolished in late 2006 will face working capital requirements of US$72m.

In reviewing an application, an approval authority assesses whether a "genuine need" exists for maintaining a foreign office in China. To make this assessment, the authority considers the applicant's current and expected volumes of business in China and the extent to which the applicant's presence would facilitate the authority's own business activities.

5.3 Setting up a company

In the past year, wholly foreign-owned ventures (WFOs) continued to outpace equity joint ventures as the favoured investment vehicle, reinforcing a trend that emerged in 1997. In the first 11 months of 2002, WFOs accounted for 59.7% of all utilised investment, equity joint ventures (EJVs) accounted for 28.4% and co-operative joint ventures (CJVs), 9.3%. The number of WFOs has risen significantly because of China's efforts to attract foreign technology, coupled with a shortage of potential joint-venture partners with the necessary capital.

The trend is still for WFOs to spread from small-scale, export-oriented manufacturing projects to domestic transport, high-tech and integrated manufacturing/investment conglomerates. WFOs should continue their

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sharp rise as local officials become more familiar with this investment vehicle. Some municipalities, such as Qingdao in north-eastern Shandong province, are actually encouraging WFOs as a way to reduce potential disputes and buttress foreign investment interest.

Most new WFOs are inside the special economic zones, economic and technological development zones, free-trade zones or export-processing zones. WFOs have traditionally been established by Taiwanese or overseas Chinese investors who have extensive connections and the confidence to manoeuvre through the local web of bureaucracy. But more US and European companies are also successfully establishing and operating WFOs.

WFOs are also increasing as more multinationals create wholly foreign-owned holding companies. In the past few years, Mitsui (Japan), Siemens (Germany), LM Ericsson (Sweden), and AT&T and General Electric (both US) have established wholly foreign-owned holding companies. For foreigners, WFOs offer a simpler approval procedure (no protracted negotiations with a Chinese partner) and complete management control. Foreign companies often use the WFO form to protect technology.

For example, US-based food-processing company Heinz, which has an 18-year presence in China based mainly on joint ventures, broke with past practice in July 2002 and adopted the WFO format for a series of new investments. The company bought all shares in three state-owned sauce-making enterprises located in southern Guangzhou: Guangzhou Meiweiyuan Foodstuffs, Guangzhou Meiweiyuan Foodstuffs Factory and Panyu Jinmai Foodstuffs Factory, incorporating them into a new WFO named Heinz-Meiweiyuan (Guangzhou) Food Company. In May 2002 US chemical company DuPont, which operates several JVs in China, announced the establishment of a wholly owned soy protein plant in the central Chinese city of Zhengzhou. Earlier, in the late 1990s, 3M and WR Grace (both US) chose to form WFOs in Shanghai to control production technology. Motorola and Bio-Rad Laboratories (also US) note that a desire to control staff quality and training and to protect technology is a major reason for choosing the WFO form. Authorities accepted both these pioneer ventures because domestic factories needed their products and China lacked the necessary technology. WFO status also permits greater use of the renminbi in payments for business expenses and in receipts for local sales.

Selecting an appropriate Chinese partner is generally the most demanding aspect of establishing a joint venture. Factors to consider include a potential partner's political clout, with both local and central authorities; its access to domestic financing; its ability to provide a domestic market for its products; the skill level of its labour force; and its integrity and strength of management. The wrong partner can lead to innumerable difficulties and possible losses; an effective one can be a guide through China's bureaucracy and a "friend in court" for dealing with official intransigence. Companies in the food and beverage business are also known to have sought local joint-venture partners for the connection they provide to the Public Security Bureau, or police.

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Investment, or holding, companies offer many of the advantages and drawbacks of the EJV or the WFO (for those holding enterprises formed from WFOs). The holding company format may also, through its collection of investments under one corporate identity, offer certain economies of scale in operations and management. These might include centralised purchase of production materials, collective training of subsidiary project personnel and co-ordination of project management.

By contrast, joint-stock companies--or companies limited by shares--offer different advantages. An FIE opting for this format can invite participation of several shareholders in the company--both to expand capital and to secure links with other legal entities in China.

A joint-stock company also offers greater liquidity in transferring interests, compared with EJVs and CJVs. Both normally require the prior consent of the other joint-venture partners and also the original examination and approval authority to transfer interests. No prior consent of other shareholders is needed for companies limited by shares to dispose of interests, although promoters of a company must wait three years from the company’s first registration before assigning their shares.

In contrast to earlier legislation, the Provisional Regulations on Several Issues Concerning the Establishment of Foreign Investment Companies Limited by Shares, which took effect in January 1995, leave open the possibility that WFOs will be allowed to convert into foreign investment companies limited by shares (FICLS). Since WFOs are now the form of organisation most favoured by investors establishing holding companies in China, this potential may eventually allow for the financing of large groups of Chinese investments through access to the domestic or international capital markets by one holding company upon its conversion into a foreign investment joint-stock company.

The major drawback of the shareholding format is that the approval process is complex, and legislation governing companies limited by shares tends to impose more restrictions on an FIE in terms of capital increases allowed, statutory reserves and the level of public disclosure required.

The pros and cons of creating a limited-liability company under the 1995 Company Law are similar to those of joint ventures and WFOs. Among the disadvantages are the following:

- Stricter definitions on the internal workings of the company, including the functions and powers of shareholders’ meetings and the composition and duties of boards of directors;

- Stricter definitions of who may serve as a company officer. Article 57 of the Company Law lists many categories of individuals barred from acting as director, supervisor or manager of a company--including those with recent criminal records, managers of a bankrupt company who bore “personal responsibility” for the bankruptcy and individuals with large “unsettled” personal debts;

- Greater worker participation in management. Compared with JV and WFO enterprises, limited-liability companies must under the Company Law

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obtain the opinion and suggestions of its trade union and workers before deciding on major production and operational issues.

The procedures for investment and incorporation of limited-liability companies with foreign investment under the Company Law are essentially the same as those outlined for joint ventures and WFOs. Similarly, the Provisional Regulations on Several Issues Concerning the Establishment of Foreign Investment Companies Limited by Shares note that government approval of foreign investment joint-stock companies will accord with policies applicable to FIEs.

6.0 Corporate Taxation

6.1 Current taxation

Foreign investment enterprises (FIEs) have enjoyed a wide range of preferential tax treatment for several years. With China's entry into the World Trade Organisation in December 2001, however, these will probably be phased out and replaced with a tax regime favouring particular industries, regardless of the companies' ownership. Officials of the Ministry of Finance are now preparing draft amendments to the Income Tax Law that will eventually unify tax rates paid by FIEs and local companies. No decision has been made on the level of the unified tax, though officials are said to be favouring a general rate of 24% or 25%. Finance Minister Xiang Huaicheng said on June 2nd 2002 that the amendments would probably be passed and implemented in 2003. The state-controlled Securities Times reported on July 31st 2002 that under the new taxation regime value-added tax (VAT) would be levied primarily on the consumption side rather than the production side. The report also suggested that VAT would be expanded to a number of service-sector industries currently paying business tax instead.

While Chinese officials have long promised sweeping tax reforms, even relatively minor adjustments to the tax regime are currently being implemented at a painfully slow pace. A long-awaited reform to introduce a fuel tax to replace a plethora of fees--often arbitrarily levied by local provincial authorities--had still not been fully implemented in early 2003, partly because of concerns that the fuel tax might not be enough to pay fiscal needs in sectors such as education.

Until the unified tax regime is implemented, enterprises in China will still be subject to a regime that was introduced in January 1994 and includes implementation of indirect taxes applicable to both local enterprises and FIEs, a value-added tax, a business tax and a consumption tax.

The State Administration of Taxation (SAT) and its provincial and municipal offices administer China's taxation policies. The SAT and the Ministry of Finance work together to develop tax legislation and policy. Each locality in China boasts a state tax bureau under the SAT and a local tax bureau under the local government. This arrangement is an effort to improve control over tax administration, and it represents a compromise between the central and local governments on sharing tax revenue. The SAT and other government agencies have been involved in a prolonged effort to

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strengthen regulations and combat tax evasion. This focus continued in 2002, as the government estimated in March 2002 when the budget was released that the overall budget deficit would reach a near-record Rmb309.8bn for 2002--partly caused by the government's heavy reliance on aggressive fiscal policies to boost economic growth.

Although FIEs paid an increasing amount of taxes in 2002, they are nevertheless suspected of widespread tax fraud, such as transferring profits overseas or over-reporting losses. In July 2002 the People's Daily reported estimates by SAT officials that state coffers lose Rmb30bn every year because of tax evasion by multinational companies. In what could be just a first step in a prolonged campaign to curb tax evasion among FIEs, authorities in Beijing in 2002 launched a campaign urging representative offices to perform "self-examination" of their employees' income tax payments. In another measure designed to ensure that foreign companies do not escape the taxation dragnet, new rules that took effect on October 15th 2002 require that newly established FIEs register with the local SAT office within 30 days after receiving their business licence. SAT Director Jin Renqing said on August 13th 2002 that China would invest Rmb9bn over the next five years in a computerised system that will allow tax authorities throughout the country to share information on taxpayers and fight tax evasion.

Measures Concerning the Use of Various Forms of Payment of the Security Deposit for Duties and Taxes by Processing Trade Enterprises, effective January 1st 2000, and their Detailed Implementing Rules, issued April 10th 2000, eased rules on security for the customs duties and import VAT that processing enterprises must pay on materials and parts. Processing enterprises have paid a security deposit since 1995 for duties and import VAT due if they do not export their finished products, or if they otherwise owe dues to the customs authorities. Under the new rules, processing enterprises can provide a letter of guarantee stating the customs authorities as beneficiary if the enterprises cannot pay their dues. The Bank of China (the nation's largest foreign-currency bank) issues the letter of guarantee based on security from the processing enterprise in the form of, for instance, mortgages and deposits.

In an effort to standardise the tax procedures for FIEs throughout China, the SAT issued the Audit Rules and Procedures for Foreign Tax Affairs in July 1999, based mainly on existing regulations made explicit for the first time. The SAT issued a notice August 21st 2000 clarifying specific points in the 1994 legislation, including rules on consolidated filing by FIEs operating various businesses inside China. Profitable branches and establishments can offset their profits against losses made by affiliated businesses, although they must, if possible, choose businesses that are subject to the same or similar tax rates. In a notice issued in April 2001, the SAT clarified the responsibilities of various local taxation authorities when dealing with consolidated filings, and in particular when detecting and rectifying irregularities. According to the notice, local tax offices must offer assistance to the taxation authority checking the consolidated filing, including the investigation of the tax matters of local branches of the FIE in question.

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A VAT rate of 17% (or 13% for some products) is levied on productive enterprises and companies engaged in import business. However, since 1998, in an effort to boost exports, the Chinese government has repeatedly introduced VAT rebates for export enterprises, allowing them to reclaim part of the VAT paid on input into the production process. As the VAT rebate rate has gradually risen--it now stands at an average 15%--and has been expanded to an ever-larger range of products, the cost to government finances has been considerable. In the first six months of 2002, the government paid back Rmb70.5bn in export tax rebates, a rise of 8% from the same period in 2001. VAT rebate increases have become less frequent recently, partly because the threat to exports has diminished and partly because the government has less leeway given previous increases.

A tax notice issued in 1997 clarifies that for export-VAT refund purposes, FIEs are divided into three categories: (1) those registered before January 1st 1994; (2) those registered on or after January 1st 1994; and (3) those that registered before January 1st 1994 but that have set up separate production lines approved by the examination authorities. These three categories apply only to production enterprises claiming VAT export refunds; they do not affect enterprises engaged in export processing supported entirely by imported materials.

Although the 1997 notice confirms that import of goods and services used for export will continue to be exempt from VAT, they make production FIEs liable for additional VAT costs equal to the lesser of the following: (1) VAT (that is, 17%) actually paid on the local materials used for export; or (2) 8% of the difference between the value of export sales and imported materials used for export. FIEs registered before 1994 are not eligible for any VAT export refund and must therefore bear the full VAT costs (17%) on local purchases used for export sales. Production costs for export will be increased by 17% of the attributable local purchases.

6.2 Capital gains taxation

The 1991 Unified Tax Law includes capital gains for income sourced in China subject to the basic withholding tax rate. The 20% capital gains tax (reduced to 10% in some areas) also applies to net gains from the transfer of shares or equity interests in enterprises in China held by foreign investment enterprises (FIEs) and from the transfer of shares in enterprises in China held by establishments or sites set up by FIEs in China. A provisional exemption from withholding tax applies to net gains from a transfer by an FIE or foreign national of B-shares or shares in a Chinese enterprise listed overseas (such as in Hong Kong or New York).

The Land Appreciation Tax (LAT) Provisional Regulation, effective January 1st 1994, introduced the following tax rates for gains on property net of development costs: zero for the portion of gains equalling up to 20% of the original purchase price; 30% for the portion of gains equalling up to 50%; 40% for gains equalling 51–100%; 50% for gains equalling 101–200%; and 60% for the portion of gains exceeding 200%. The LAT was introduced to discourage property speculation and is strongly opposed by Hong Kong and other overseas property developers.

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The Ministry of Finance released implementing regulations for the LAT in January 1995. The Detailed Implementing Rules for the Provisional Regulations of China Concerning Land Appreciation Tax outline certain permissible deductions to calculate value appreciated. The rules note that China will not levy taxes on real-estate projects where agreements were decided before January 1st 1994. Exemption from the LAT is also allowed where the property transfer is an owner-occupied residential unit and the resident has lived there more than five years. A half-exemption will be given to those who have occupied a site for more than three years; those occupying a site for less time would be subject to full tax.

The LAT applies to all types of land, structures and immovable property, including commercial, industrial and residential sites.

The new tax regime provides for some expense deductions and additional allowances, which help alleviate the effect of the LAT on projects begun after January 1994. The implementing regulations provide for the full deduction of financing expenses and limited deductions for administration and selling expenses. Nonetheless, the new tax regime applies a 5% business tax on the sale price of property and the standard 33% corporate profits tax. Thus the effective tax on property income, despite allowable deductions, is still close to 50%. Because the LAT is a source of revenue for local governments, there is the possibility a foreign investor can negotiate a refund with a local government before committing to new projects. Since this is a transactional tax, moreover, there may be some flexibility in administration and collection procedures. But developers should proceed carefully and plan their tax structures assiduously to avoid exposing their projects to added tax liabilities.

6.3 Profit repatriation

Dividends paid or profits distributed by a foreign investment enterprise (FIE) to foreign investors are exempt from withholding tax. Nevertheless, as required by the foreign-exchange control formalities in China, the relevant tax-exemption certificates must be obtained from competent tax authorities before such dividends/profits can be remitted overseas through designated banks.

6.4 Shareholder financing

The registered capital of foreign investment enterprises (FIEs) shall be subject to the following thresholds, depending on the magnitude of the FIEs' total investment:

Amount of total investment	Minimum registered capital
US$3m or less	70% of total investment
US$3m-10m	Greater of US$2.1m or 50% of total investment
US$10m-30m	Greater of US$5m or 40% of total investment
Exceeding US$30m	Greater of US$12m or 33.3% of total investment

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The amount by which total investment exceeds registered capital may be realised in the form of shareholder loans. Nevertheless, investment (holding) companies may borrow loans up to four times of their paid-up registered capital, and large holding companies with registered capital of more than US$100m may borrow loans up to six times of their paid-up capital.

A foreign-currency borrowing by an FIE is required to be registered with the State Administration of Foreign Exchange.

6.5 Depreciation

Depreciation is normally calculated on an annual basis, generally using the straight-line method and subject to certain minimum depreciation periods. But a foreign investment enterprise (FIE) may apply to the local tax authority for permission to use a scheme of accelerated depreciation or another method if it has specific justification for doing so. Minimum salvage value is usually estimated at 10% of the original value. Special depreciation rules apply for FIEs engaged in oil and gas exploration.

6.6 Loss relief

Net tax losses (tax losses may be different from accounting losses because of possible tax adjustments) incurred by enterprises engaged in production or business operations generally may be carried forward for a period up to five years. No carrybacks are allowed.

6.7 Consolidation

A foreign investment enterprise (FIE) having two or more business establishments in China must perform corporate tax filing on a consolidated basis. A foreign enterprise having two or more establishments in China may select one establishment for consolidated tax filing and payments as long as the following requirements are met:

- One establishment has supervisory and management responsibility over the business of the other establishment(s).
- One establishment keeps complete accounting records and vouchers that correctly reflect the income, cost, expenses, profits and losses of the other establishment(s).

The enterprise income tax paid with the consolidated tax filing shall take into account the respective enterprise income tax rates and tax holidays that apply to each business establishment.

Two or more FIEs may not file consolidated returns.

6.8 Reorganisations/Mergers & acquisitions

See Section 3.5.

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6.9 Foreign-earned income

By the end of 2002, China had signed 81 treaties with foreign governments to avoid double taxation, 66 of which had been ratified, in addition to one arrangement with the Hong Kong Special Administrative Region. For a list of withholding-tax rates under the various treaties, see below. The State Administration of Taxation issued a notice on April 13th 2001 to help foreign enterprises and individuals avoid the risk of double taxation. According to the notice, taxation bureaux at all levels are obliged to issue residence certificates if required by foreign enterprises and individuals. Although the notice does not change the criteria under which foreigners are classified as tax-paying residents of China, it does help provide documentation for enterprises and individuals seek to avoid double taxation both in China and in their home countries.

China and the Hong Kong Special Administrative Region signed a double-taxation arrangement in February 1998. Under it, the Chinese side will not tax a Hong Kong enterprise’s gains from transport business in China, and vice versa. The arrangement also affected personal income taxes.

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Withholding-tax rates under China's double-tax treaties

Country of recipient	Dividends (%)	Interest1 (%)	Royalties2 (%)	Country of recipient	Dividends (%)	Interest1 (%)	Royalties2 (%)
Armenia	10, 5[3a]	10	10	Malaysia	10	10	15, 10[6]
Australia	15	10	10	Malta	10	10	10
Austria	10, 7[3b]	10	10, 6	Mauritius	5	10	10
Bahrain	5	10	10	Moldova	10, 5[3c]	10	10
Bangladesh	10	10	10	Mongolia	5	10	10
Barbados	5	10	10	Netherlands	10	10	10, 6
Belarus	10	10	10	New Zealand	15	10	10
Belgium	10	10	10, 6	Norway	15	10	10
Brazil	15	15	25, 15[5]	Oman	5	10	10
Bulgaria	10	10	10, 7	Pakistan	10	10	12.5
Canada	15, 10[7]	10	10	Philippines	15, 10[7]	10	15, 10[6]
Croatia	5	10	10	Poland	10	10	10, 7
Cyprus	10	10	10	Portugal	10	10	10
Czech Republic	10	10	10	Romania	10	10	7
Denmark	10	10	10, 7	Russia	10	10	10
Egypt	8	10	8	Singapore	12, 7[3c]	10, 7[4]	10
Estonia	10, 5[3a]	10	10	Slovak Republic	10	10	10
Finland	10	10	10, 7	Slovenia	5	10	10
France	10	10	10, 6	South Africa	5	10	10, 7
Germany	10	10	10, 7	Spain	10	10	10, 6
Hungary	10	10	10	Sudan	5	10	10
Iceland	10, 5[3a]	10	10, 7	Sweden	10, 5[3a]	10	10, 7
India	10	10	10	Switzerland	10	10	10, 6
Ireland	10, 5[3b]	10	10, 6	Thailand	20, 15[3b]	10	15
Israel	10	10, 7[4]	10, 7	Turkey	10	10	10
Italy	10	10	10, 7	Ukraine	10, 5[3a]	10	10
Jamaica	5	7.5	10	UK	10	10	10, 7
Japan	10	10	10	US	10	10	10, 7
Korea, Rep. Of	10, 5[3a]	10	10	Uzbekistan	10	10	10
Kuwait	5	5	10	Vietnam	10	10	10
Laos	5	5 (in Laos)	5 (in Laos)	Former Yugoslavia	5	10	10
	10 (in China)	10 (in China)					
Latvia	10, 5[3a]	10	10				
Lithuania	10, 5[3a]	10	10				
Luxembourg	10, 5[3a]	10	10, 6				
Macedonia	5	10	10				

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This table is a summary only and does not reproduce all the provisions relevant in determining the application of withholding taxes in each tax treaty. Treaties with Cuba, Kazakhstan, Nepal, Papua New Guinea, the Seychelles, the United Arab Emirates, Greece, Indonesia, Iran, Kyrgyzstan, Morocco, Nigeria, Qatar, Tunisia and Venezuela have been signed but legal confirmation procedures have not been completed yet. In addition to the above tax treaties, a number of these countries have entered into investment protection treaties with China. There is also a tax arrangement with the Hong Kong Special Administrative Region.

(1) Nil on interest paid to government bodies. Reference should be made to the individual tax treaties. (2) The lower rate on royalties applies for the use of or right to use any industrial, commercial or scientific equipment. Reference should be made to the individual tax treaties. (3a) The lower rate applies to dividends paid by a company (not a partnership) and received by a company owning at least 25% of the capital voting right of the paying company. (3b) The lower rate applies to dividends paid by a company and received by a company owning at least 25% of the capital voting right of the paying company. (3c) The lower rate applies to dividends paid by a company and received by a company owning at least 25% of the shareholding of the paying company. (4) The lower rate applies to interest paid to banks or financial institutions. (5) The higher rate applies to trademarks. (6) The higher rate applies to artistic royalties/cinematographic films and tapes for television or broadcasting. (7) The lower rate applies where the beneficial owner of the dividend is a company that owns at least 10% of the voting stock of the paying company.

6.10 Transfer pricing

The 1991 Unified Tax Law plugged previous loopholes involving transfer pricing by requiring foreign investment enterprises (FIEs) to conduct business transactions with affiliated companies at arm's length (that is, as if with an unrelated company). To verify this, FIEs must regularly submit accounts to the local taxation bureau, as well as report the inter-company transactions in the final enterprise income tax settlement returns on an annual basis. Where inter-company charges or fees do not reflect an arm's-length arrangement, tax authorities may make compensatory adjustments by reference to normal market rates or prices for similar services or goods.

According to the 1991 law, an FIE's payments to its head office of administrative expenses for production and business operations of the FIE may be listed as deductible expenses, subject to examination and approval by the local tax authorities. FIEs may not list management fees paid to their affiliates as expenses. The head office of the FIE must supply documentary evidence on the scope of collection, total and basis, and method of allocation of administrative expenses; it must attach a verification report, signed and certified by a certified public accountant.

The SAT promulgated rules in April 1998 on taxing business dealings between affiliated enterprises, specifying what constitutes affiliated enterprises--such as when one company holds at least 25% of another's shares or when one company appoints more than half of another's board. The rules state that tax authorities should particularly target companies that have suffered losses for more than two years and companies that engage in business with each other inside duty-free ports.

The SAT has indicated that it may adopt measures in 2003 to curb transfer pricing. This comes more than four years after the SAT tried to address the same problem, issuing a circular on May 20th 1998 setting out rules on transfer pricing. The circular, Tax Administration Rules and Procedures for Transactions between Related Parties, brought together many existing regulations, added new provisions and superseded all conflicting rules. Overall, it aims to modernise Chinese policing of transactions by multinational companies while harmonising regulations with international

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standards. The document's 52 articles define what is meant by related enterprises, the factors that may lead a company to be audited and the methods the SAT will use to calculate the proper level of transfer payments. The circular directs provincial tax bureaux to establish specialist audit teams, and it requires Chinese tax authorities to share tax information with one another.

6.11 Other taxes

A licence tax is levied on all vehicles and vessels used in districts within the PRC. Being levied on either a yearly or quarterly basis, tax rates vary by tonnage for boats, Rmb0.60–5 per tonne, and by type and size for vehicles, of Rmb1.20–320 per unit.

A stamp tax, ranging from 0.005% (for loan agreements) to 0.2% (for listed shares transfer contracts and stock trading), applies to contracts, written certificates of property-rights transfer and other specific documentation. A flat amount of Rmb5 applies to certification evidencing business licences and patent, trademark or similar rights.

An urban real estate tax is imposed annually on the owner or user of a property at 1.2% of assessed value or 12% of rentals for leased property. The tax applies to Chinese legal entities, including foreign investment enterprises (FIEs) and individual citizens. A tax reduction in the range of 10% to 30% may be offered by local governments. A local land-use tax is also levied at varying rates, depending on the size of the city or locale in question. All local enterprises (FIEs and foreign enterprises are temporally exempted) incur a city and county maintenance and construction tax.

The national resource tax implementing regulation, in effect since January 1st 1994, outlines tax rates for enterprises and individuals engaged in exploiting mineral products or producing salt. Rates for crude oil are Rmb8-30 per tonne; natural gas, Rmb2-15/cu metre; coal, Rmb0.3-5/tonne; other non-metal minerals, Rmb0.5-20/tonne; ferrous-metal mineral mining, Rmb2-30/tonne; and non-ferrous-metal mineral mining, Rmb0.4-30/tonne. Tax liability arises on receipt of payment or proof of payment and is payable to local authorities at the place of production or exploitation. In lieu of a resource tax, mine area Usage Fees are levied on joint ventures exploiting crude oil or natural gas.

VAT

China implemented a value-added tax (VAT) on January 1st 1994 to replace the industrial consolidated and commercial tax (ICCT--a turnover tax levied on the transfer or sale of goods and services). The VAT applies at a 17% rate to the value of products at importation and wholesale and retail sale. A 13% rate applies to some goods, such as grains, vegetable oils, books and utilities. Small enterprises are liable for a 6% VAT. (Small enterprises are defined as entities engaged in manufacturing or providing labour services with sales not exceeding Rmb1m and as firms engaged in wholesale or retail trade with sales not exceeding Rmb1.8m.) The actual tax burden is intended to fall only on the final consumer, since producers pass it along in their prices.

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The business tax introduced in 1994 applies at rates of 3-20% in place of VAT to service-sector industries, including transport, insurance, posts and telecoms, real estate brokers, construction and entertainment (excluding commodity wholesale and retail sales). China raised the business tax on financial companies to 8% (from 5%) in February 1997. However, the State Administration of Taxation (SAT) announced in early March 2001 that business taxes paid by finance and insurance companies would be gradually reduced back to 5% over a three-year-long period ending January 1st 2004. The raise applied immediately to financial institutions established after January 1st 1997, whereas financial institutions established before that date did not face the new higher rate until January 1st 1999.

The SAT also began requesting in June 1997 that foreign banks pay a 10% withholding tax on interest paid by the banks on their borrowings from overseas affiliates, from which they had previously been exempt. The withholding tax did not apply to domestic banks. Foreign banks balked at the SAT's request and lobbied hard for a change in the new tax policy, eventually causing the SAT temporarily to suspend the tax pending a government decision on the issue. Firms operating in the nine service sectors liable for the business tax will have no mechanism to claim VAT credit for inputs of goods subject to VAT. Depending on the level of such recurring inputs, some service firms could face higher taxes.

A product (consumption) tax of 3-45% has applied since January 1994 to the following goods: tobacco, alcohol, cosmetics, skin and hair-care products, jewellery, motor vehicles, motorcycles, petrol, diesel fuel and fireworks. The tax, meant to discourage consumption of these goods, affects mainly those companies involved in producing or importing such goods. Exports are exempt from consumption tax. The State Council adjusted the consumption tax rate on cigarettes, raising it to 50% for deluxe categories, from mid-1998.

6.12 Tax compliance and administration

The taxable income of a foreign investment enterprise (FIE) is defined as the amount remaining from its gross income in a tax year after allowable expenses and losses have been deducted. All documented costs are allowable except those expressly identified as non-deductible. Non-deductible expenses include the following: costs to purchase or construct fixed assets; costs incurred on gains obtained through assignment or developing intangible assets; various income taxes paid; interest on capital; late-payment surcharges and fines incurred for various income tax payments; fines incurred for unlawful operations and losses sustained through the confiscation of property; losses from windstorms, fire and other natural disasters covered by insurance indemnity; donations and contributions other than those for public welfare and relief purposes; royalties paid by branch to the head office; and that portion of entertainment expenses either above established quotas or not relevant to production and operations, etc.

Foreign taxes levied on FIEs in China may be credited against Chinese corporate taxes. Interest on loans made to the Chinese government or

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Chinese state banks may be exempted from tax. Losses incurred by an FIE may be carried forward for five years; no carryback is permitted.

The tax year is the calendar year. FIEs must file provisional income tax returns with local tax authorities within 15 days of each quarter’s end.

These instalments are generally calculated on actual quarterly profits.

Enterprises that have difficulty prepaying tax based on actual quarterly profits may make prepayments based on one-fourth of the profit for the preceding year, or by another method approved by the authorities.

Final settlement of tax liability must be made within five months of the end of the fiscal year (January 1st–December 31st). Returns must be filed regardless of whether the enterprise’s operations result in a profit or a loss. FIEs that cannot file a tax return within the prescribed time because of special circumstances may apply to the local tax authority to extend the time limit before the normal filing deadline. A circular issued by the State Administration of Taxation on June 24th 1998 states that such special circumstances include, among others, natural disasters or shifts in national economic policy that make delays unavoidable. For both, up to three months delay is allowed. Tax returns are available from the local tax authority.

7.0 Deloitte & Touche Offices In…

7.1 China

Deloitte Touche Tohmatsu, a leading global professional services organisation, delivers world-class assurance and advisory, tax and consulting services through its national practices. In today's world of dynamic change, Deloitte's closely linked teams of industry and tax specialists monitor key tax and business issues around the globe, to provide knowledge to clients wherever they do business. This approach, enabled by innovative and award-winning technology, is essential to our "global, yet local" service.

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