Foreign direct investment

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Contents

Investment promotion and protection agreements and regulatory takings: understanding the debate
Emma Aisbett 1

Foreign direct investment and pollution in China
Ligang Song 4

China’s new corporate income tax law and its implications for foreign direct investment
Chunlai Chen 7

About this Policy Brief

This policy brief explores some fundamental underpinnings of foreign direct investment (FDI), with a particular focus on developments in China.

Emma Aisbett considers the proliferation of Investment Promotion and Protection Agreements and the implications for international investment flows. She examines the role of strict expropriation clauses and discusses the trade-off between policy flexibility and investment promotion in the design of investment treaties. Ligang Song examines the links between FDI and pollution in China and suggests that foreign capital may have played a role in mitigating pollution emissions. Finally, Chunlai Chen assesses the implications of the new tax law on the quantity and quality of FDI flows into China.

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Foreign direct investment

Investment promotion and protection agreements and regulatory takings: understanding the debate

Emma Aisbett

Issue overview

As their name suggests, Investment Promotion and Protection Agreements (IPPAs) are agreements between two or more states whose aim is to protect and promote reciprocal direct investment. There are more than 2,500 signed IPPAs world-wide and Australia is a party to 22 such agreements, with partner countries including China, Indonesia, Romania and Vietnam. Increasingly, investment agreements are incorporated into free-trade agreements. Australia has included an investment chapter in all its recent free-trade agreements including those with the United States and Singapore. Investment agreements are not, however, universally popular and they have been criticised by environmental groups, state and local governments and even leading academic proponents of globalisation.

Investment agreements are controversial principally because they tend to place a variety of obligations on the host government, and no obligations on the foreign investors. This asymmetry means that the costs and benefits of IPPAs fall very differently on different groups within a country (for example, owners of capital versus environmentalists). It also means that when partner countries have vastly differing reciprocal investment flows, the costs and benefits fall differently on each partner. While the partner governments make equal de jure commitments, de facto the smaller or poorer partner government tends to bear a disproportionate share of the obligations entailed in the agreement. The most controversial of these obligations is the compensation that parties commit to pay firms for government actions ‘tantamount to expropriation’, including regulatory actions that are non-discriminatory and are for the public benefit. This requirement that governments compensate firms for the full market value of losses resulting from government actions—even those actions that fall within the legitimate ‘police powers’ of the State—amounts to the adoption of what is known as the ‘regulatory-takings doctrine’.

The case for strong investor protection

According to proponents of IPPAs, strict expropriation provisions benefit participating countries because investors feel safer and are therefore willing to invest more there. Furthermore, the inflexible terms of an international treaty provide a commitment device that cannot be achieved by unilateral policy statements promising compensation for government actions.

Proponents of IPPAs suggest that governments need a commitment device because of what is referred to commonly as the ‘hold-up problem’ or the ‘dynamic inconsistency of optimal policy’. A simple economic model shows that in the pre-investment stage, the optimal policy for the government is to offer good conditions to the investor in order to encourage them to invest. Once the investor has sunk costs and cannot leave without suffering losses, however, the optimal policy for the government is to extract rents from the investment. Rent extraction can be achieved via outright expropriation or nationalisation of the investment, or via ‘indirect’ or ‘creeping’ expropriation such as increased taxes or stricter regulations. It is the potential for such indirect forms of expropriation that motivates many of the calls for the adoption of the regulatory-takings doctrine in international investment agreements.

A commitment to compensate for losses due to government action can also come about when the investment does not involve substantial sunk costs. Since foreign firms might be less politically embedded than local firms, host governments could suffer more severe ‘fiscal illusion’ in regard to them—meaning that the government does not consider the investor’s welfare when setting policy. Since the government does not fully internalise the welfare of the investor, it will tend to set taxes too high or regulate the firm too strictly in the face of new information (Aisbett et al. 2007). Once again, therefore, the firm faces indirect or creeping expropriation. This is the basic argument underlying the regulatory-takings doctrine whereby losses due to environmental and other public good
Foreign direct investment

regulations can be considered as measures tantamount to expropriation and therefore compensatable under the terms of most IPPAs.

Empirical evidence, caveats and counter-arguments

The arguments above—which have been promoted by institutions such as the World Bank, the UN Commission for Trade and Development (UNCTAD) and the World Trade Organization (WTO)—make it easy to understand the popularity of IPPAs. These arguments have, however, been challenged on theoretical and empirical bases. The fundamental empirical problem is that there is no good evidence that participation in IPPAs leads to improved investment climate ratings or higher inward investment flows. Though some studies claim to find strong positive effects of IPPAs on investment flows, they all suffer serious econometric problems that make a false positive finding highly likely (Aisbett 2007). The reason why it has been difficult to establish empirically the impact of IPPAs could be that the data used by existing studies are inadequate for the task, or it could be that IPPAs do not have a significant direct impact on the investment appeal of participating countries. To understand how this could be, we consider some qualifications and counter-arguments to the theoretical arguments made in the previous section.

The argument that IPPAs lead to higher investment flows by providing better protection for investors from government action relies on two things: that they offer substantially better protection than existing alternatives; and that protection is really needed. Legal and economic scholars have questioned the superiority of the protection offered by IPPAs. Legal scholars note that there are many alternatives to IPPAs in international law—including specification in pre-investment contracts that disputes between the investor and the host state will be heard by a court in the investor’s home country. Economists, on the other hand, question the effectiveness of IPPAs as a commitment device on the grounds that there is no way of enforcing the decisions of the arbitration tribunals: host countries might choose simply not to pay awards made against them. In effect, IPPAs can work only by raising the profile of disputes and therefore raising the reputation costs to countries of not adequately compensating investors.

The fact that IPPAs rely on government concerns about reputation raises the question of whether governments that are concerned about their country’s reputation really need a commitment device in the first place. The hold-up problem for governments and firms described in the previous section arises in a model with a one-off investment. In reality, however, there are a large number of potential investors who are able to observe the way in which current investors are treated. When the government considers the negative impacts on future investment flows, expropriation of existing investments is no longer likely to be the optimal policy. Indeed, outright expropriation almost never occurs in countries that seek to attract foreign direct investment (FDI). Industry groups have sometimes argued that the fall in outright expropriation has been accompanied by a rise in indirect or creeping expropriation as governments seek the same rent capture without suffering the reputation costs. The ready accessibility of country investment-climate surveys, which include measures of regulatory impediments, means that governments are well aware of the reputation costs of such actions.

So what of the ‘fiscal illusion’ argument for including regulatory and other actions within the definition of compensatable government takings? Several things can be said on this point. First, unlike the hold-up problem that leads to under-investment and sub-optimal host-country welfare, fiscal illusion is a problem only for the investor. The fact that the host government does not fully internalise the investor’s welfare is inefficient from a global perspective, but not from a national perspective for the host. Indeed, unless firms compensate governments for the change, making regulatory action compensatable will raise firm welfare but lower government welfare (Aisbett et al. 2007). When two countries with asymmetrical investment flows ratify an IPPA, it is therefore possible that the predominantly investment-recipient partner is made worse off.

The second problem with the fiscal illusion argument in favour of full market value compensation is that it leads to an inefficient outcome. The promise of compensation for regulatory losses means that firms do not internalise the social costs of their investment decisions. Full compensation therefore means that firms are effectively insured against the possibility that their investment is found to be socially or environmentally damaging, which results in over-investment (Blume et al. 1984). Seen in this light, full compensation merely transfers welfare from governments to firms while trading one form of inefficiency for another.

Economists have made several attempts at designing mechanisms that are able to achieve the global welfare maximising investment and regulatory decisions in the presence of fiscal illusion. One such suggestion is a formalisation of what is known as a ‘police-powers carve-out’ whereby governments do not have to pay compensation for regulations that are globally welfare improving (Aisbett et al. 2007). All of the solutions proposed in the academic literature, however, suffer from a lack of ease of practical implementation.
Foreign direct investment

Current developments and future directions

The controversy about the potential for governments to be required to compensate firms for losses due to regulatory action taken for the public good has been most intense in the area of environmental regulation. Using the investment chapter of the North American Free Trade Agreement (NAFTA), several cases have been brought against environmental regulations and bans introduced by signatory governments (Canada, the United States and Mexico). The public objections to these cases have been so strong that the United States and Canada have now amended their model investment agreements to include a clause that expressly exempts environmental regulations from being considered as expropriation. While many people consider this to be a step in the right direction, it leaves an odd imbalance between environmental regulations that are exempt from compensation claims and other socially beneficial regulations that are not.

Further inconsistency in the current legal and policy environment is introduced by the ever-changing composition of the arbitration tribunals for disputes brought under IPPAs. Some tribunals have leaned towards a literal interpretation of the treaty texts and have tended to award compensation for regulatory takings. Other tribunals have been reluctant to deviate from existing international legal precedents and have therefore tended not to award compensation for regulatory takings.

A further source of uncertainty for regulators is that different investment agreements have different conditions. For example, the Australia–China IPPA does not exclude environmental regulations from potential compensation claims, while the investment chapter in the Australia–United States free-trade agreement does. Furthermore, the Australia–China IPPA allows investors to bring compensation claims to an international tribunal for arbitration, while the Australia–United States free-trade agreement does not. Regulators therefore face a different set of trade-offs when dealing with Chinese or US firms. The stronger protections for Chinese investors could, ironically, lead Australian authorities to be less willing to admit Chinese investments than American ones, particularly in sensitive sectors such as mining.

Some commentators have suggested that a multilateral investment agreement—for example, under the WTO—would be a solution to the inconsistency and uncertainty produced by the myriad bilateral investment agreements. Others have, however, noted that the existence of a multilateral agreement will not negate the existing agreements, and will only add another layer of complexity. One longer-term solution would be the inclusion of a clause in a multilateral agreement specifying that IPPAs and investment agreements in free-trade agreements not be renewed more than once after the multilateral agreement comes into force. Since investment agreements come up for renewal every 10–15 years, this would provide ample time for firms to adjust to the change in the legal regime.

References


Foreign direct investment and pollution in China

Ligang Song

China has been the largest destination for foreign direct investment (FDI) among all developing countries, and the second largest in the world, after the United States, for a number of years. While it is generally acknowledged that the entry of foreign investment to China has significantly boosted its economic growth, the environmental consequences of FDI have increasingly attracted attention, with concerns about the deterioration of China’s environment and pressure for increasing environmental protection growing.

As the majority of FDI is invested in industries that generate most of China’s pollution, one might ask whether FDI causes increased pollution in China and, if it does, through what channels will it affect China’s environmental quality?

A popular view about the FDI–pollution nexus is the so-called ‘pollution haven hypothesis’, in which developing countries with low abatement costs and less stringent environmental regulations usually have a comparative advantage in attracting pollution-intensive foreign capital. Another relevant argument is the ‘race to the bottom’ phenomenon, in which in order to attract foreign investment, developing countries purposely undervalue their environmental damage and lower their environmental standards (Copeland and Taylor 2004).

The impact of FDI on the environment in developing countries might, however, not be a linear one, as predicted by the well-known environmental Kuznets curve (EKC) hypothesis, which states that the relationship between economic growth and pollution emissions might follow an inverted-U curve—that is, environmental degradation increases in the early stages of growth, but eventually reaches a peak and starts to decline as incomes exceed a certain threshold level. Such an inverted-U curve relationship can be extended to the FDI–pollution nexus: in the initial stage of FDI utilisation, the entry of multinational firms leads to a higher scale of production activities in host countries. In the meantime, people in the poor host country have less demand for a cleaner environment as the pollution damage is trivial, and fewer resources will then be allocated to abate environmental pollution. As a result, foreign investment causes pollution emissions in host countries to rise.

As the income level of host countries’ residents steadily increases with the accumulation of foreign investment, people become less tolerant of worsening environmental quality, propelling governments to implement more stringent environmental regulations, and more pollution-abatement efforts will therefore be made. Meanwhile, as foreign firms adopt more environmentally friendly techniques, the entry of FDI can cause a spill-over effect of cleaner technology into local firms, which eventually affects the industrial structure in host countries. As a result, once it has passed a certain threshold point, foreign investment will be beneficial to local environmental quality.

Some studies have investigated the environmental consequences of foreign firms in China, but most of these used single-equation estimation techniques that were subject to two problems. One is that their estimation results could be biased because of the presence of simultaneity. Furthermore, it is difficult to understand the specific mechanisms through which foreign investment affects local environmental quality in China in their reduced-form estimation. Grossman and Krueger (1991) first decomposed the environmental outcome of the North American Free Trade Agreement (NAFTA) into three effects—the scale effect, the composition effect and the technique effect—and this kind of decomposition has been used widely in empirical studies on the trade–environment nexus (Copeland and Taylor 2003).

Following this approach, Bao et al. (2008a) divide the environmental consequences of FDI into three effects: the first is the scale effect, meaning that by enlarging local output, foreign investment causes increased usage of resources and hence increased emissions of pollutants in host countries. The second is the composition effect—that is, the entry of foreign firms can affect the industrial composition, depending on the pollution intensity of FDI. FDI can also affect the ratio of factor inputs in production activities such as the capital–labour ratio, which in turn determines
Foreign direct investment

the level of pollution. For example, it is assumed that capital-intensive industries usually cause more pollution emissions than labour-intensive ones. The third is the technique effect, in which foreign firms adopt more environmentally friendly techniques, thereby the entry of FDI can cause some positive spill-over effects resulting from the adoption of cleaner technology by local firms. Furthermore, if foreign firms help improve productivity in local firms, they also have a positive impact on local environmental quality since resources are utilised more efficiently and, accordingly, less pollution will be emitted.

To test the existence of these three effects through which FDI impacts on China’s level of pollution, our study applies a simultaneous equation estimation technique using China’s panel data of 29 provinces during 1992–2004. To ensure the robustness of our estimation results, five kinds of different pollutants are used: industrial polluted water emissions, chemical oxygen demand in industrial water pollution, sulphur dioxide emissions, industrial dust emissions and industrial solid wastes. The key findings of the study are as follows. First, the estimated results demonstrate that the entry of foreign firms helps reduce pollution emissions in China in general. Among the five pollutant indicators we have chosen for this study, the emission levels of four pollutants are estimated to fall with the entry of foreign investment; the exception was industrial solid wastes. This finding is consistent with those reported in Wang and Jin (2002) and Liang (2006), who used a single-equation estimation technique in their studies.

Second, the results further reveal the channels through which FDI affects China’s overall and regional environmental pollution, by decomposing the pollution effect of FDI into the scale, technique and composition effects. It is found that while there is a positive scale effect, the technique and composition effects of FDI are both negative. A further calculation demonstrates that the role of FDI in pollution reduction can be attributed mainly to its technique effect—that is, foreign investment helps reduce pollution emission intensity per unit of industrial output. After dividing the technique effect into the direct and indirect effects, we show that the indirect technique effect of FDI also plays an important role in pollution control. In other words, if we overlook the indirect technique effect of FDI by raising the capital–labour ratio and thereby speeding up economic growth, the role of foreign investment in environmental protection will be underestimated.

Third, it is found that the environmental effect of FDI varies significantly among different regions in China. Although the eastern coastal regions have attracted most FDI, the inflow of foreign investment hasn’t caused significant environmental improvement, especially for provinces such as Guangdong, which attracts a larger share of FDI than others. The regional disparity of the environmental consequences of FDI implies that the relationship between foreign investment and pollution emissions could be a non-linear rather than a linear one, as assumed in this study. The existence of the non-linear relationship between FDI and environmental quality could imply that for those more developed regions, more foreign investment inflows will begin to contribute to further reduction of the pollution levels there while further increases in foreign investment in inland provinces will continue to worsen their environmental quality (Bao et al. 2008b).

These findings do not, however, imply that the only effective way to alleviate the pressure for environmental protection in the early stage of development—especially in those less developed inland regions in China—is to attract more foreign investment until they pass a certain threshold value along the inverted-U curve. In other words, it is misleading to conclude that the environmental damage caused by the entry of foreign firms in the initial stage can be remedied naturally by the continual accumulation of foreign investment. This is mainly because there is still a long way to go for most provinces in China in attracting foreign investment before they reach the turning point along the inverted-U curve, since the real value of foreign investment in these regions is much lower than the estimated threshold value—that is, their FDI–pollution relationship is still located on the left side of the inverted-U curve. In other words, they have to continue to pay a significantly high cost of environmental degradation as a result of attracting foreign investment and economic growth.

Given that China has set targets for reducing overall pollution emissions, whether these inland provinces can achieve their objectives in reducing emissions along the path of growth and development will be crucial. In the same way that developing countries are treated in fulfilling their obligations to reduce emissions, those inland provinces would need financial means and technological support to enable them to comply with the tougher government emissions regulations. Firms in China’s more developed regions and foreign investment could help the inland provinces fulfil their obligations.

It is also in the interest of the inland regions to reduce emissions by improving their environmental standards, even though pollution-abatement efforts will involve additional costs, which usually increase with pollution emissions. The costs associated with pollution damage could, however, be even higher, especially in certain areas where, once incurred, environmental damage cannot be remedied in the short term—for example, land erosion, deforestation, radiation pollution, the loss of species diversity and even the extinction of certain species. These
considerations require that governments regulate and monitor environmental pollution even in the early phase of industrialisation when environmental quality is most compromised. In order to avoid the trap of the race to the bottom, more attention should therefore be paid to the industrial structure of foreign investment rather than the scale of that investment.

Finally, our results suggest that a combination of complementary policies should also be considered in order for China to better deal with the trade-off between economic growth and environmental pollution, by implementing policies aimed at alleviating environmental pressures such as increases in environmentally related research and development and the provision of technical support. At the same time, there could be other channels through which foreign investment affects host countries’ environmental pollution. For example, foreign firms might affect local environmental standards and regulation stringency, which could be regarded as an indirect environmental policy effect of FDI.

References


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Notes

1 Xu and Song (2000) find that the bilateral net export content of environmental factor services imputed by using the trade-share weighted average for the majority of Asian Pacific countries does not experience systematic structural change in the period 1970–96 despite the diversity of environmental regulations across this region.

2 Grossman and Krueger (1991) first proposed the existence of such an inverted-U curve in their study on the environmental consequences of the North American Free Trade Agreement (NAFTA).

3 These studies include Wang and Jin (2002) and Liang (2006).

4 There are only a few studies that simultaneously estimated the environmental effect of FDI in China. For example, He (2002) decomposes the impact of FDI on sulphur dioxide emissions in China into the three effects using China’s city-level panel data during 1993–99, and the estimation results show that the entry of FDI helps reduce these emissions.
Foreign direct investment

China’s new corporate income tax law and its implications for foreign direct investment

Chunlai Chen

Trends for foreign direct investment inflows into China

Foreign direct investment (FDI) is the most significant feature of China’s opening up to the outside world. FDI inflows into China presented three distinct phases (Figure 1): the experimental phase from 1979 to 1991, the boom phase from 1992 to 2001 and the post-World Trade Organization (WTO) phase from 2002 to 2007.

During the experimental phase, FDI inflows into China were at a very low level, but grew steadily. The period was characterised by small investment projects, high investment costs, poor infrastructure and a lack of legal frameworks. FDI inflows were concentrated in the southeastern coastal areas, particularly in the four special economic zones (SEZs)

In the second phase, FDI inflows into China increased rapidly from 1992 to 1996; however, inflows slowed after 1997 and declined in 1999 and 2000, followed by a moderate recovery in 2001. The slowdown of FDI inflows into China during 1997–2000 could be explained by several factors. First, there was a slow-down in the surge in transfers of labour-intensive activities from neighbouring Asian economies. In addition, the East Asian financial crisis substantially weakened the ability of outward investment from the East and Southeast Asian economies. As a result, FDI flows into China from East and Southeast Asia

Figure 1 FDI inflows into China (current price)

declined substantially after 1997. Second, market rates of return to investment in China have not been as high as foreign investors expected. Informal relationships and corruption still hinder many business transactions by foreigners. In addition, inefficient state-owned enterprises still dominate many key sectors of the economy, especially in the services sector. Third, there were restrictions on FDI, such as on the ownership of shares, modes of FDI entry, business scope and operation, and regional and sectoral restrictions.

China’s accession to the WTO on 11 December 2001 came at a critical time, when the country was facing difficulties in sustaining a high level of FDI inflows. Could China’s WTO accession revive the trend of a high level of FDI inflows and bring increased FDI inflows?

After its entry into the WTO—with the implementation of the WTO commitments and broader and deeper liberalisation in trade and investment—China’s economy has been growing very rapidly. The average annual growth rate of China’s gross domestic product (GDP) was more than 10 per cent during 2002–07.2 China’s foreign trade has been expanding even more rapidly than its overall economic growth. The total value of China’s foreign trade increased from US$509.65 billion in 2001 to US$2,173.83 billion in 2007. Undoubtedly, China’s economy has benefited from entry into the WTO, especially from a more open and liberalised international trade and FDI regime.

After China’s accession to the WTO, FDI inflows presented an increasing trend. As shown in Figure 1, FDI inflows into China increased from US$46.88 billion in 2001 to US$74.77 billion in 2007. This demonstrates that with trade and investment liberalisation and reduction in foreign investment barriers, China’s WTO accession accelerated FDI inflows.

**Tax incentives and ‘round-tripping’**

There has, however, long been an issue of ‘round-tripping’ of investment in China. Round-tripping is driven by differences in the treatment of foreign and domestic investors, which can motivate investors to channel funds out of, and subsequently into, an economy in the form of FDI. Because the funds originate in the host economy itself, ‘round-tripping’ inflates real FDI inflows. From the time it began allowing FDI inflows, the Chinese government has used tax incentives intensively and selectively to guide FDI flowing into designated areas and industries. Because of the preferential treatment offered to foreign investors (mainly through tax incentives), a significant share of FDI inflows into China occur through round-tripping—mainly via Hong Kong (UNCTAD 2007) and, more recently and increasingly, via some tax-haven islands, such as the Virgin, Cayman and Samoan Islands (He 2006). Official estimates by the Chinese government are not available, but an estimate by Harrold and Lall (1993) suggested that round-tripping inward FDI accounted for 25 per cent of China’s FDI inflows in 1992. Some experts estimated that round-tripping FDI accounted for 33 per cent of China’s total FDI inflows (He 2006).

**Implications of the new tax law on FDI inflows into China**

On 16 March 2007, Chinese lawmakers passed a new corporate income tax law, unifying the tax rates for foreign and domestic enterprises. The new tax rate for domestic and foreign enterprises is 25 per cent. The law took effect on 1 January 2008 (Xinhua News Agency 2007). The new law has unified the two existing tax codes—one for domestic enterprises, the other for foreign-invested enterprises (FIEs)—into one and represents a fundamental change in China’s taxation policy. Many of the tax incentives and tax holidays that existed in the old code for foreign investors have been changed or eliminated.

The new corporate income tax law and the unification of the tax rate will substantially reduce the incentive for round-tripping. What are the impacts, however, of the new tax law on domestic and foreign-invested companies and on FDI inflows into China?

Although the current nominal income tax rate is set at 33 per cent, the real average income tax burden on China’s domestic companies is 25 per cent (Xinhua News Agency 2007). The new tax law will not therefore reduce the average real tax burden of domestic companies.

The current real income tax burden on FIEs is 15 per cent (Xinhua News Agency 2007). On average, the new income tax law will increase the tax burden of FIEs by 10 percentage points. It seems that the new tax law will have a negative impact on FIEs, especially on the short-term, small-scale, labour-intensive, quick profit-earning enterprises from developing countries.

We would argue, however, that China’s proposed unified corporate income tax rate of 25 per cent for domestic and foreign-invested companies will have little effect on foreign investment in China, especially on large multinational enterprises.

First, the average corporate income tax rate for the 159 countries and regions of the world that levy corporate income tax is 28.6 per cent, and the average corporate income tax rate for China’s 18 neighbouring countries and regions is 26.7 per cent (Xinwen Shishi 2007). China’s proposed unified tax rate of 25 per cent is below the average rate of corporate income tax around the world. So, China’s corporate income tax rate is quite competitive for attracting foreign and domestic investment, and there is little reason therefore to believe that the new law will have a significant effect on foreign investment.

Second, in the past few decades, time-series econometric analyses and numerous surveys of
International investors have shown that tax incentives are not the most influential factor for multinationals when selecting investment locations (Morisset 2003). Foreign investors are of course interested in tax rates, but more important are factors such as a broad investment climate, the domestic market, the cost and availability of labour, basic infrastructure, economic and political stability and so on.

Third, China’s overall investment environment is quite competitive, with relatively efficient public services, good infrastructure, a large and fast-growing domestic market, abundant and well-educated human resources, low labour costs and macroeconomic and political stability, making China one of the most attractive locations for FDI. According to the 2005 Foreign Direct Investment Confidence Index (ATKEARNEY 2007), in 2005, China was the world’s most attractive FDI location.

According to the index, China has maintained its lead in the index for the fourth consecutive year and remains the top FDI location for first-time investors, with more than half (55 per cent) of investors expected to make first-time investments there in the next three years. One in five FDI dollars for first-time investments will be committed to the Chinese market.

China’s successful economic development has seen it overcome the perceived risk associated with first-time market entry, which is typically the biggest barrier to generating new FDI.

Fourth, the new tax law still has preferential stipulations: China will continue to offer tax incentives for investment in projects related to environmental protection, agricultural development, water conservation, energy saving, production safety, high-technology development and public welfare. High-technology enterprises can still enjoy a 15 per cent income tax rate, and small and medium-sized enterprises with slim profits are required to pay income tax at only 20 per cent. Certain tax breaks will also be granted to enterprises in SEZs and the less-developed western areas of the country (Xinhua News Agency 2007).

Fifth, the new tax law also provides a five-year transitional period to offset the impact on foreign companies. The income tax rate will be increased gradually to 25 per cent during this period, and existing foreign enterprises will still enjoy tax breaks within a regulated time limit, as before (Xinhua News Agency 2007).

The new law will therefore bring China’s tax laws more in line with international standards. It is a fulfillment of China’s commitment to the WTO for equal treatment for domestic and overseas investors. The change in the law not only proves that the Chinese government is determined to continue its reform and opening-up policies and to work hard to improve investment conditions, it will help to create a sound investment environment and promote China’s industrial restructuring and upgrading. In addition, the new tax law will substantially reduce the incentives for round-tripping, improving the quantity and quality of FDI inflows into China.

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Notes

1 The four special economic zones are Shenzhen, Zhuhai, Shantou in Guangdong Province and Xiamen in Fujian Province.

2 China revised its GDP growth rates for the period 1979–2004 in January 2006. The revised GDP growth rates were 9.1 per cent for 2002, 10 per cent for 2003, 10.1 per cent for 2004, 9.9 per cent for 2005, 10.7 per cent for 2006 and 11.4 per cent for 2007.
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