

# The Explosive Growth of China Outsourcing: Opportunities and Challenges

By Mark Williams and Peng Zhao

***Please note that an earlier version of this article was delivered by the authors at the annual TMA convention in Chicago, Illinois, in 2005.***

*This publication is intended to provide clients with information on recent legal developments. It should not be construed as legal advice or legal opinion on specific facts. Pursuant to applicable Rules of Professional Conduct, it may constitute advertising.*

# Table of Contents

|   | <i>Page</i> |
|---|-------------|
| <b>Preface</b> .....  | 1           |
| <b>Section I. An Introduction to China's Current Business Environment</b> .....                                     | 2           |
| A. Concerns of American Business People .....   | 3           |
| B. How WTO Membership Is Changing China .....   | 3           |
| C. Local Market Growth Promotes Multiple Forms of Outsourcing .....   | 5           |
| D. Inland Region Development Brings New Opportunities .....   | 7           |
| E. Financial Reform .....   | 8           |
| F. Rule of Law .....  | 9           |
| G. IPR Protections .....  | 10          |
| H. The Pending Anti-Trust Law and Bankruptcy Law .....  | 11          |
| I. The Human Resource Supply Is High in Quality .....   | 11          |
| J. Improving Infrastructure .....   | 12          |
| K. Economic Development Zones .....   | 12          |
| L. Hong Kong's Role .....   | 14          |
| M. Trends in Outsourcing Opportunities .....  | 14          |
| <b>Section II. Purchase-Only Businesses</b> .....   | 18          |
| A. What to Buy? .....   | 18          |
| B. Where to Buy? .....  | 19          |
| C. Export and Import Law .....  | 20          |
| D. Foreign Trade Rights .....   | 20          |
| E. Export Processing Trade .....  | 21          |
| F. IP Protection in Purchase Deals .....  | 21          |
| <b>Section III. JV v. WFOE (Wholly Foreign-Owned Enterprise)</b> .....  | 22          |
| A. Laws and Various Forms of Foreign Investment .....   | 22          |
| B. The Government's Financial and Policy Encouragement for Foreign Investments .....                                | 25          |
| C. Venue Shopping .....   | 25          |
| D. Allowed Business Scope .....   | 26          |
| E. Mergers and Acquisitions in China .....  | 27          |
| F. Foreign Currency Control: Investing and Repatriating .....   | 28          |
| G. Tax Issues .....   | 28          |
| H. Land Use .....   | 29          |
| <b>Section IV. Some Know-How</b> .....  | 31          |
| A. How to Handle Employment Issues .....  | 31          |
| B. How to Handle GuanXi .....   | 31          |
| C. How to Enter into a Contract in China .....  | 32          |
| D. How to Protect Your IPR with Legal Measures .....  | 33          |
| E. How to Arbitrate Disputes in China .....   | 34          |
| <b>Conclusion</b> .....   | 35          |
| Appendix 1: Catalogue of Advantageous Industries for Foreign Investment in the Central<br>and Western Regions ..... | Appendix 1  |
| Appendix 2: A Partial List of Economic Development Zones Open to Foreign Investment<br>(As of November 2003) .....  | Appendix 2  |

Appendix 3: Trade with China by Industry (in US\$ millions) ..... Appendix 3

Appendix 4: A Partial List of Laws and Regulations Governing Foreign Trade  
Management ..... Appendix 4

# Outsourcing to China

## *Preface*

Over the past three decades, the whole world has witnessed China's fast and stable economic developments. Today, we see China as the "World Factory," where foreign investors and purchasers find competitive low-cost labor and products. Indeed, the nickname World Factory accurately reflects China's current situation and strength. As the most populous developing country, China enjoys solid cost advantages in labor-intensive industries. To further promote its status as the world's manufacturing center, the Chinese government encourages foreign investors to participate in the Chinese economy with tax incentives, financial encouragement, and infrastructure facilitation.

Although large numbers of American companies have already stepped into China, there is always more opportunity for newcomers to benefit from outsourcing to this exceptional nation. China's domestic market is growing at a dazzling speed, creating tremendous demand for American commodities and products. Meanwhile, foreign investors know that the country will maintain its cost advantage over other developing countries for at least the next few decades because of its stable human resource supply. In addition, because China is upgrading its technology on a vast scale, the capacity of local Chinese suppliers to manufacture technically advanced products is improving. This development will provide American high-end product manufacturers and IT product and service providers with the opportunity to transfer their production to China.

However, establishing an outsourcing business in China is not simple. American businesses that want to set up shop in China encounter a completely different economic, legal, social, and cultural environment. This article tries to provide a general introduction of what American companies can expect when they outsource in China, as well as information about ways to approach outsourcing to China. Many of the issues discussed herein may equally fall under the broader topic of "how to do business in China."

This article also attempts to provide a step-by-step analysis based on a company's specific situation and business scope, of (i) whether an American company should seek outsourcing to China; and (ii) if it decides to do so, what the important issues are that it needs to know and the problems it may face in the establishment and operation of its outsourcing business in China.

Section I discusses China's macroeconomic situation in recent years and points out some important development trends that deserve foreign investors and purchasers' attention. Sections II and III are introductions to the forms of purchase-only outsourcing and investment-type outsourcing. The latter two chapters address the legal, economic, social, and cultural issues that are particularly important for the different types of business. Finally, Section IV covers some general topics that are important and practical knowledge for every business entering China.

## Section I: An Introduction to China's Current Business Environment

The integration of the global economy means that manufacturers from developed countries are constantly looking for places to move their production to achieve lower costs. The globalized economy and more open markets in certain developing countries make this effort both possible and financially rewarding for businesses. For the past two decades, China has been a favorite target for foreign direct investment (FDI). In 2004, China surpassed the US in terms of FDI and took the number one position in the world, with US\$153 billion of committed funds.

The increase in foreign investment in China reflects the growth of the foreign business presence in China, and the increase in China's foreign trade volume reflects the needs of the world for "Made in China" commodities. In 2005, China's total foreign trade volume hit US\$1.422 trillion, with approximately US\$762 billion of exports and US\$660 billion of imports. The United States has always been a large consumer of Chinese products. The following chart reflects US trade balance with China in 2004. In 2005, the total US trade deficit with China hit a US\$202 billion record high. "Made in China" commodities, in a wide range of categories, are more competitive than US commodities. China's edge in cost competition continuously attracts more US companies to outsource their manufacturing or service centers to China.

| Month                                     | Exports<br>(to China) | Imports<br>(from China) | Balance           |
|---|-----------------------|-------------------------|-------------------|
| January 2004                              | 2,629.0               | 14,089.0                | -11,460.0         |
| February 2004                             | 2,979.4               | 11,267.1                | -8,287.8          |
| March 2004                                | 3,374.6               | 13,800.1                | -10,425.5         |
| April 2004                                | 2,734.6               | 14,744.8                | -12,010.2         |
| May 2004                                  | 2,874.2               | 15,067.1                | -12,193.0         |
| June 2004                                 | 2,790.8               | 16,887.8                | -14,097.0         |
| July 2004                                 | 2,667.9               | 17,562.1                | -14,894.2         |
| August 2004                               | 2,674.9               | 18,067.9                | -15,393.0         |
| September 2004                            | 2,861.5               | 18,386.9                | -15,525.5         |
| October 2004                              | 2,946.7               | 19,718.2                | -16,771.4         |
| November 2004                             | 2,964.5               | 19,679.0                | -16,714.5         |
| December 2004                             | 3,246.0               | 17,412.0                | -14,166.0         |
| <b>TOTAL</b><br>*All numbers in thousands | <b>34,744.1</b>       | <b>196,682.0</b>        | <b>-161,938.0</b> |

Source: National Bureau of Statistics of China

## A. Concerns of American Business People

Despite the attractive opportunity to cut costs and move outsourcing to China, many American enterprises hesitate. Why? The below survey carried out in 2000 by the China American Merchants Association reflects challenges American businesses are facing, or believe they will face, when they do business in China. The business people surveyed all have experience, in one form or another, doing business with Chinese companies or in China. We can draw the conclusion from this chart that serious barriers remain that deter American businesses from doing business in China.

### ***Major Challenges Americans Face when Doing Business in China***

- Red tape and bureaucracy (67 percent)
- Human resources issues (56 percent)
- Lack of transparency (43 percent)
- Bankruptcy (42 percent)
- Difficulty obtaining permission to enter market (38 percent);

*Source: White Paper of 2000, issued by China American Merchants Association*

As the global economy evolves, the problems faced by foreign businesses also change. In 2004, the consulting firm McKinsey & Company issued a special report that outlines the major concerns of foreigners who do business in China. The top three issues listed in the report: (1) the status of China's financial system; (2) the country's progress in meeting its commitments to the World Trade Organization (WTO); and (3) the success of China's efforts to protect intellectual property rights. (The report can be found at [http://www.findarticles.com/p/articles/mi\\_hb3237/is\\_200411/ai\\_n13040336](http://www.findarticles.com/p/articles/mi_hb3237/is_200411/ai_n13040336)).

## B. How WTO Membership Is Changing China

China is changing, at an astonishing speed, to adjust itself to the international business environment. The old adage that states *you can't win if you don't play* applies here: if an American company never opens a business in China, it will never reap the benefits of doing business there. However, if an American company enters the Chinese market without obtaining a good understanding of China and solid knowledge of the changing environment, it will face problems in its formation, expend unnecessary resources, and at the very least, never enjoy some of the many benefits that doing business in China can bring.

On December 11, 2001, China became a member state of the World Trade Organization. That membership obligates it to implement a number of specific commitments. As China meets these commitments, foreign investors and trade partners will gradually reap a wide range of benefits, including greater market access, import/export benefits, and more protection for intellectual property rights (IPR). IPR protection is an area of great concern for foreign governments and companies. China has adopted increasingly severe measures to punish violators and is more closely cooperating with foreign companies to identify and redress IPR violations. Since the beginning of 2005, the average import tax in China has been reduced to 9.9 percent, which is consistent with China's WTO commitment. China also revised its *Catalogue Guiding Foreign Investment in Industry* (the Catalogue) in order to provide foreign investors with more open access to its various markets. The 2004 edition of the Catalogue

contains far fewer restrictions than existed in the previous edition. (This topic is discussed in greater detail in Section III). As China opens additional market sectors, it is predicted there will be a new round of foreign investment.

China's commitments to the WTO imposed many obligations on various industries of the country. Restrictions on foreign participation in many of these industries are to be lifted within five years of WTO entry—that is, by December 11, 2006. These industries include:

1. Telecommunications

*Value-added telecommunications and paging businesses:* Territorial restrictions were lifted after China's entry into the WTO, and the proportion of foreign investment in such business is allowed up to 49 percent.

*Infrastructural telecommunications:* Territorial restrictions are to be lifted in the area of mobile and statistical services within five years after China's WTO entry, and in other telecommunication services within six years, with the proportion of foreign investment limited to no more than 49 percent. However, all international telecommunication transactions must be conducted through the import-export bureaus authorized by the departments in charge of China's telecommunications.

2. Banking

China has permitted foreign-funded banks to provide foreign-exchange services to all their Chinese clients. Within five years of its WTO entry, China is obligated to permit foreign-funded banks to provide Chinese currency (RMB, or renminbi, the "people's currency") services to all their Chinese clients all over China. Banks will be allowed to introduce these services on a step-by-step basis. Foreign-funded monetary organizations other than banks will be permitted to provide consumers with credit for car purchases.

3. Insurance

In 2004, China authorized the establishment of life insurance joint ventures with foreign investment in such ventures limited to less than 50 percent. China's WTO commitment requires it to permit exclusively foreign-funded insurance broker companies to operate in China within five years of WTO entry.

4. Negotiable securities

Since WTO entry, China has authorized the establishment of securities investment management joint ventures, with foreign investment permitted to reach a proportion of 49 percent. China also has permitted jointly funded securities companies, with the proportion of foreign funding at no more than 33 percent.

5. Audio-visual products

Joint ventures are authorized to undertake the distribution of audio-visual products, except for movies and the leasing of videotapes, as long as these companies respect Chinese censorship of the contents of audio-visual products.

## 6. Distribution

Its WTO commitments obligate China to cancel restrictions in terms of territory, stock rights, and shares of foreign investments in commission agencies, wholesale businesses (except for salt and tobacco), and retail businesses (except for tobacco); the same commitments cancel all restrictions on foreign investment in franchised and distribution businesses. China is accelerating its legislation process to honor that commitment.

*Source:* China Council for the Promotion of International Trade (CCPIT)

China's obligations as a WTO member not only provide the country with additional momentum to open up and reform its economy, but also strengthen foreign investors' long-term confidence in the country.

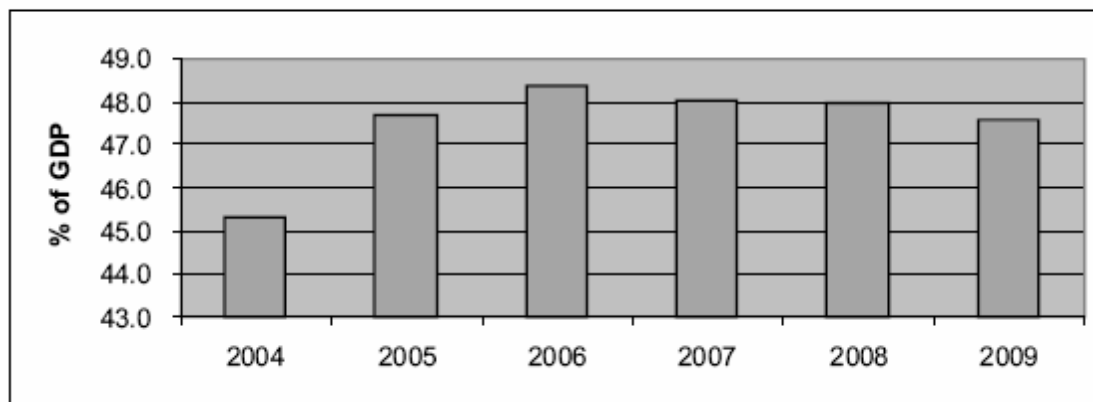
### C. Local Market Growth Promotes Multiple Forms of Outsourcing

China is not only a manufacturing factory, but also the world's largest consumer market. The expansion of the domestic market in China provides a huge potential profit motive for foreign manufacturers. Over the past several years, the purchasing power of the Chinese people has steadily grown, and it is natural that this trend will continue for years to come as the Chinese economy grows and matures.

The following two tables project the total estimated disposable income in China and the private consumption rates from 2004 to 2009 (as predicted in 2004).

| <b>Summary China: Snapshot Forecast Economic Indicators 2004-2009</b> |             |             |             |             |             |             |
|---|-------------|-------------|-------------|-------------|-------------|-------------|
| <i>(at constant prices for 2004)</i>                                  |             |             |             |             |             |             |
| <b>Indicator</b>  | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> | <b>2008</b> | <b>2009</b> |
| Population (in thousands)   | 1,304,130   | 1,313,015   | 1,321,915   | 1,330,812   | 1,339,724   | 1,348,655   |
| Real GDP growth (%)   | 8.5         | 8.0         | 7.2         | 6.4         | 6.2         | 5.8         |
| Inflation (%)   | 3.5         | 3.0         | 2.5         | 2.8         | 2.9         | 3.1         |
| Unemployment (%)  | 1.6         | 2.0         | 2.0         | 2.1         | 2.4         | 2.6         |
| Consumer expenditure growth (%)                                       | 10.8        | 11.2        | 8.8         | 3.5         | 2.5         | 5.9         |
| Disposable income (in millions of local currency)                     | 6,807,721   | 7,481,199   | 7,884,033   | 8,183,926   | 8,610,264   | 9,268,360   |
| Monthly earnings (in local currency)                                  | 660         | 730         | 777         | 823         | 843         | 921         |

## Share of private consumption in GDP 2004-2009



Source: National Bureau of Statistics of China and [www.euromonitor.com](http://www.euromonitor.com)

Outsourcing, in its broadest sense, includes not only purchasing labor-intensive products abroad or contracting foreign companies to design software, but also the establishment of entire manufacturing facilities in foreign countries using the mother companies' brand and/or technology. For example, an American cell phone manufacturer may outsource to China to set up its plant or enter into a joint venture agreement with local companies to manufacture cell phones. It then has the option to ship 100 percent of its products back to the US to satisfy the American market, or sell some of the cell phones in China to Chinese customers, or export the cell phones to a third country. Each of these scenarios involves outsourcing manufacturing to China, but with different tax, financial distribution, and export treatment. (This topic is discussed in greater detail in Section III). The fast-growing local consumption market continues to attract more foreign investors whose goal is to share in China's domestic market.

In China, not only is the total volume of consumption huge, but the consumer market also is changing its spending habits quite rapidly—a sign of the dramatic general uplifting of living conditions. Members of the new generation of Chinese don't spend a large portion of their income on basic household appliances, such as refrigerators and TVs—but they are willing to spend lavishly on sophisticated electronics, such as cell phones and MP3 players. Moreover, between 2004 and 2008, approximately 80 million of the single-child-policy generation will enter the work force, get married, and start their own families. Although the number of newlyweds will be smaller than in previous decades, the sheer number of these young families will still be enormous, and this new generation will have greater disposable income and will be more open to new technology and high-value products. For instance, it has already become more and more common for Chinese to listen to iPods and take pictures with their cell camera. The market for such items, which only a short time ago would have been regarded as out-of-reach luxuries, is growing and will attract ever more American businesses.

Investment-related outsourcing in China can take various legal forms, including:

**Wholly Foreign-Owned Enterprise (WFOE):** As its name indicates, WFOE means enterprises established in China by foreign companies, enterprises, other economic organizations, or individuals, according to China's laws, in which all the funds are provided by foreign investors and the foreign investors own all the equity in the enterprise.

**Equity Joint Venture (EJV):** EJVs are also known as Sino-Foreign Joint Ventures. An EJV established by foreign companies, enterprises, and other economic organizations or individuals and their Chinese counterparts to invest together in China. The foreign and Chinese parties share equity in the JV according to their contractual agreements.

**Cooperative Joint Venture (CJV):** CJVs are also called Contractual Joint Ventures. In establishing this kind of enterprise, usually foreigners provide all or most of the funding, and the Chinese enterprises or individuals provide land, factory buildings, available devices, and facilities. Some Chinese partners also provide funds. They negotiate their shares of equity in the JV based on each party's contribution.

**Acquired Enterprise (AE):** Any foreign company's acquisition of a Chinese company is subject to both the Merger and Acquisition Law and to the approval of government authorities, especially when state-owned assets are the acquisition targets.

**Branch:** Branches are not commonly used business entities in China. A branch is legally permitted and feasible; but, because of certain practical concerns, such as vague legal rights and the difficulty of obtaining government approval, China has not seen many such entities.

**Representative Office (RO):** Even though many foreign companies use representative offices as they first enter the Chinese market, because of the limitations imposed on their business scope (e.g., ROs may not engage in "direct business" or profit-making operations), ROs are treated more as an interim measure, a way for foreign companies to establish their presence in China.

## **D. Inland Region Development Brings New Opportunities**

Economically, China is divided into three major geographical regions: (i) Eastern coastal region; (ii) Central region; and (iii) Western inland region. Today, in most instances the Central and Western Regions are treated as one single region because of their similar economic situations.

**The Eastern Coastal Region:** China's Eastern region covers twelve provinces (municipalities and autonomous regions): Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Shandong, Zhejiang, Fujian, Guangdong, Guangxi, and Hainan. The region accounts for approximately 14 percent of China's land mass and 40 percent of its population. It has easy access to transportation, a dense population, and an early start in economic development. It is also rich in high-quality labor resources.

Ever since China initiated its opening up and economic reform after the Great Cultural Revolution (1966-1976), the focus of state investment has been on the Eastern coastal areas. Most of the reform measures formulated since the end of 1970s were implemented first in the Eastern region. The measures helped spur economic growth in the region. Since the opening up and reform, more than 85 percent of FDI has been made in the Eastern coastal region, which contributed 66.16 percent of China's GDP in 2001.

**The Central and Western Inland Regions:** China's Central and Western regions together cover 19 provinces (municipalities and autonomous regions): Heilongjiang, Shanxi, Inner Mongolia, Jilin, Anhui, Jiangxi, Henan, Hubei, Hunan, Yunnan (the central parts of the above), Tibet, Sichuan, Chongqing, Guizhou, Shaanxi, Gansu, Qinghai, Ningxia, and Xinjiang. These regions together account for 86 percent of China's land mass and 60 percent of its population.

In contrast to the Eastern coastal region, the Central and Western regions are relatively backward in infrastructure, such as transportation and telecommunications. Moreover, because of a relatively weak economic foundation and the slow process of industrialization and urbanization, by the end of 2000, the Central region and the Western region accounted for only 8.78 percent and 5.42 percent, respectively, of the total amount of foreign funds utilized by China.

Since 1996, the Chinese government has worked hard to attract investment in the Central and Western regions. Most foreign government loans and multilateral and bilateral assistance projects, except for those with special requirements, are used or implemented in the Central and Western regions (*Source*: [http://www.ccpit.org/static\\_ccpit/en/guide\\_enc6.jsp](http://www.ccpit.org/static_ccpit/en/guide_enc6.jsp)). The government has also carried out bold, long-range telecom, transport, and energy development projects, the most famous being the Three Gorges Dam project, and its bold, purposeful development plans also include upgrading a number of already relatively strong industrial areas. These efforts have helped the region improve its investment environment, and it has been gradually turning its resource advantage into an economic advantage. Appendix 1 contains a list of industries in the Western and Central regions where investment is particularly encouraged and supported.

The most recent government-promoted development has been in Northeast China. Heilongjiang, Jilin, and Liaoning, the northeast provinces that once were home to China's heavy manufacturing base, were largely left behind as other parts of the country moved toward a market economy. But now favorable government policies have targeted these provinces and they are starting to benefit from an increase in FDI. These policies offer such incentives as preferential tax and value-added tax to FDI in the Northeast. For example, manufacturing enterprises in the Northeast may shorten depreciation periods for their fixed assets (excluding houses and buildings) when calculating corporate income tax and cut the amortization period for transferred or invested intangible assets by up to 40 percent. At a time when China's more traditional coastal investment destinations are experiencing rising land costs, labor shortages, and the heavy impact of power shortages, investors may also be drawn by the Northeast's ample natural resources, under-utilized labor pool, and well-established infrastructure, a positive legacy of the centrally planned economy.

## **E. Financial Reform**

When China joined the WTO, it made a commitment to reform its financial sector. However, this reform was already a top government priority because such reform works to ensure that the country's current high growth will continue in an orderly fashion. A more robust financial infrastructure will help to ensure both sustainable economic growth and social progress.

Financial sector reform is having a twofold impact on foreign investments and outsourcing businesses. First, this reform will facilitate the ability of foreign investors and traders to carry out their daily business. In order to become integrated into the world financial system, China still needs to complete its adoption of financial products and systems that are broadly accepted in developed countries (*e.g.*, the credit system, international liquidation system, and foreign exchange system). As financial reform proceeds, foreign businesses in China will rely more and more on these efficient financial tools to accomplish their payments, collections, and capital repatriation.

Second, the opening up of as Chinese financial markets will enable a greater number of foreign banks to operate their businesses in China. These commercial banks will help foreign investors with their financing needs. Chinese local banks still lack the capacity and flexibility to serve all foreign businesses, and foreign banks operating outside of China are not sufficiently familiar with the situation inside China. Hence, local offices of international banks possess unique advantages. By April 2004, 64 foreign banks from 19 nations (in addition to banks from Hong Kong, Macau, and Taiwan) had established 192 operations inside China; 88 of these operations have been approved for RMB business. The total assets of these foreign-funded banks in China have reached US\$49.5 billion. Already in 2004, the *People's Daily* was reporting that foreign-funded banks had opened 209 representative offices in China (*People's Daily*, June 25, 2004). Foreign lenders in China can make secured or unsecured loans to foreign invested companies without seeking the approval of the Chinese authorities.. All that foreign invested companies need to do is to register their foreign party loans with the State Administration of Foreign Exchange (SAFE). In contrast, if domestic companies wish to accept a foreign-party loan, they need the approval of SAFE or its local delegate.

## **F. Rule of Law**

The Chinese central government has made it a priority to develop a state ruled by the operation of laws and not by the arbitrary decisions of government bureaucrats or government officials. China has attempted to strike a balance between learning from successful foreign legislative experience and adhering to its own unique dynamics.

In this time of transition, the legislature has enacted many interim laws, which are subject to frequent changes and modifications. The transitional problem is complicated by the important role that administrative branches play in making and enforcing laws and regulations. Chinese tradition still holds true today: administrative branches have broad discretion in the ways they regulate business operations in their "domains." Performing the administrative roles designated by relevant laws, the branches of the Chinese government issue rules and regulations that govern the day-to-day operations of relevant businesses. For instance, the Ministry of Commerce governs which kinds of companies may engage in export and which may not. The Central Bank governs how and when foreign companies may repatriate their profits. Also complicating the overall situation is the fact that, because of changes in the economic environment, commercial laws frequently change. Thus, it is very important for foreign businesses to keep up to the minute about the evolving legal landscape as well as the powers of China's multi-level legislative and administrative branches.

## **G. IPR Protections**

China has passed several laws to protect IPR. These laws include the Copyright Law (1990), the Trademark Law (1982), and the Patent Law (1992). These laws are generally consistent with the requirements of internationally accepted conventions, such as the Trade-Related Intellectual Property Rights Agreement (TRIPS). That is, these laws were designed so that, at least theoretically, IPR in China receives protections similar to those in Western countries. According to legislation, individuals and enterprises who violate IPR laws will be held responsible for any infringing activities and may be subject to civil and/or criminal liabilities.

China has also adopted some international standards in IPR protection. For example, China was one of the first countries to sign the Treaty on Intellectual Property in Respect of Integrated Circuits in 1989. The Regulation on the Protection of Layout Designs of Integrated Circuits was issued in April 2001 by China. China has also agreed to provide IP protection to any foreign legal person, based on China's mutual agreement with foreign countries or in accordance with any international treaty to which both countries are party. In case either of the conditions above are lacking, China will treat the foreign legal person according to its national law or based on the principle of reciprocity.

While sound IPR legal protections are already in place, without effective enforcement these laws are merely words on paper. That is a very essential point. China simply lacks the effective IPR protection enforcement structure found in Western countries. However, foreign investors may avail themselves of forums that the government provides where a company can seek remedies. Since 1992, special IPR courts have been set up in major cities such as Beijing and Shanghai.

Most IPR enforcement in China is done through administrative action. Listed below are six different agencies which are currently responsible for IPR policy formulation and implementation.

1. The State Intellectual Property Office (SIPO) is responsible for patent approval;
2. The Trademark Office under the State Administration for Industry and Commerce (SAIC) is responsible for trademark registration and unfair competition, including the protection of trade secrets;
3. The Copyright Office is responsible for copyright protection policy making;
4. The State General Administration of the People's Republic of China for Quality Supervision and Inspection and Quarantine and SAIC are jointly responsible for combating counterfeiting activities;
5. The State Drug Administration (SDA) is responsible for administrative protection of pharmaceuticals; and
6. The Ministry of Information Industry is responsible for the protection of layout designs of integrated circuits.

*Source: CCPIT*

Section IV includes a discussion of the ways a foreign business operating in China may carry out an investigation of IPR violations and file a lawsuit.

## **H. The Pending Anti-Trust Law and Bankruptcy Law**

Two pieces of pending legislation will interest every foreign business in China. First, China is passing a new bankruptcy law which may have a significant impact on its economy. Before now, two factors have made it very difficult and time consuming for China to adopt a new bankruptcy law: the country's complicated property ownership structure and the legal difficulties adhering to employee terminations. However, China recognizes that it needs new bankruptcy legislation to address the huge non-performing loan issue in its state-owned banks. A new bankruptcy law would also benefit foreign investors doing business in China because it will strengthen their confidence in taking over non-performing factories. The new law may provide foreign companies the opportunity to quickly expand their businesses because it will provide legal protections for their acquisition of distressed state-owned businesses in China. However,

foreign investors should be aware of the law's stringent requirements relating to laid-off employees. Labor matters are very sensitive in China due to the political system and culture of the country. Prior to entering into a takeover or turnaround, the foreign investor should have a very clear understanding of its responsibilities and rights towards the employees who are part of any such acquisition.

Second, in 2005, the Ministry of Commerce cooperated with the State Council and the National People's Congress to formulate the Antitrust Law of China. Monopoly was still a new topic to Chinese society when in March 2004 SAIC released a controversial report entitled *Competition-Restricting Behavior of Multinational Companies in China and Possible Countermeasures*. The report alleged that many leading multinationals exploit financial and technological advantages to dominate markets, suppress competition, and thus injure competitors and consumers. Several multinational companies (among them Kodak and Microsoft) were attacked in this report. The report initiated China's effort, including new legislation, to fight monopolies, especially those introduced by multinational companies. Investors should carefully note China's laws and regulations in this area.

## **I. The Human Resource Supply Is High in Quality**

The leading reason so many foreign businesses are now exploring China is undoubtedly its low-cost but high-quality labor pool. Foreign businesses interested in entering China should first acquire a strong knowledge of the labor supply in different areas of China, since the quality of the available labor force will substantially contribute to the cost of company operations. In the past, the huge labor force that supported the concentrated manufacturing bases along the country's eastern coast consisted mostly of workers who had migrated to the region from the inland provinces, with very little education and only the most basic skills. In 2003, 113.9 million workers moved to the cities from rural areas. That is, 23.2 percent of the total number of laborers in all rural areas migrated to China's manufacturing regions, according to the National Bureau of Statistics.

However, China also boasts a huge number of highly educated workers, among them technical engineers, software engineers, and biotechnology technicians. Interestingly, in the past two or three years the number of college graduates who have had difficulty securing a job upon graduation has skyrocketed. This unemployment problem is partially a result of the rapid expansion of the Chinese higher education system. In 2005, the Chinese Ministry of Education "required" that all universities try their best to promote graduates' placement and keep the unemployment rate of this group below 27 percent. The existence of this large force of unemployed but well educated workers is a boon to foreign companies, enabling them to outsource their sophisticated business operations to China at low labor costs.

## **J. Improving Infrastructure**

The local infrastructure is always one major consideration for any business considering moving to a new place. China has a significant advantage over India and the countries of Southeast Asia in its infrastructure and convenient transportation system. China's railway system is very reliable, and the country is building more railroads in its inland provinces. Shanghai is building the world's biggest port at Yangshan with a designed handling capacity of more than 20 million TEUs (20-foot equivalent units) and 52 berths. Modern airports, seaports, and transportation transit centers are being built all over the country.

The country is also investing heavily to minimize the negative effects of power shortages. These energy problems are more frequent in some of the heavily industrialized provinces. China is building a “West-East Natural Gas Pipeline” of approximately 4,000 kilometers from its Western inland Uygur Autonomous Region to the Eastern coastal city Shanghai. Not only Shanghai but all the cities and provinces along the pipeline will benefit from this colossal project. China has now completed the Three Gorges Dam spanning the Yangtze River, the world’s largest hydropower project and one of the most spectacular feats of engineering in history. The dam is expected to generate 18 gigawatts of hydropower and will certainly help resolve critical energy shortages.

## **K. Economic Development Zones**

Whether foreign businesses are looking for manufacturing opportunities or simply purchasing in China, they should consider the various kinds of economic development zones spread throughout the country.<sup>1</sup> When the Chinese government decided to open the country’s economy to the outside world in 1978, it chose a step-by-step approach to reforming its economic structure. A key aspect of these reforms was the establishment of special economic zones. Since 1980, China has established special economic zones in Shenzhen, Zhuhai, and Shantou in Guangdong Province and in Xiamen in Fujian Province, and has designated the entire province of Hainan a special economic zone. In 1984, China opened 14 additional cities along the coasts—Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai—to overseas investment. These special economic zones are still leading China’s economic development process.

In 1985, the state decided to extend the open economic zones to the Yangtze River Delta, Pearl River Delta, Xiamen-Zhangzhou-Quanzhou Triangle in south Fujian, Shandong Peninsula, Liaodong Peninsula, Hebei, and Guangxi.

In 1990 the Chinese government decided to open the Pudong New Zone in Shanghai to overseas investment, and also opened more cities in the Yangtze River valley. Since 1992 the State Council has also opened a number of cities along China’s borders, as well as all the capital cities of inland provinces and autonomous regions. In addition, 15 free trade zones, 32 state-level economic and technological development zones, and 53 new and high-tech industrial development zones have been established in large and medium-sized cities.

The most significant benefit these zones bring to foreign investors is significant tax concessions during the early life of a business. These rates can vary by site and are subject to change from time to time. This is a typical example of tax concessions offered to a manufacturing startup:

---

<sup>1</sup> Economic development zones are those areas designated by China’s relevant authorities to encourage foreign investment. For foreign investments in the zones, not only can the foreign businesses enjoy tax benefits, but they also can enter into some forms of businesses not allowed in other parts of the country, such as manufacturing imported raw material for purposes of export, without paying import tax.

- No tax during start-up years until the business is making a profit;
- The “tax clock” only starts in the first year that the company makes a profit;
- There is no tax the first and second year following the commencement of the “tax clock”; and
- For years three through five, the company is taxed at half the normal tax rate.

There are several types of economic development zones--for example, Economic and Technological Development Zones, Duty Free Zones, Country Border Economic Cooperation Zones, Processing for Export Zones, and New and High Technology Industries Zones. Different levels of government (central, provincial, or municipal) may have control over these zones, affecting the treatment of businesses within them (for instance, regarding tax holidays, financing support, or land use cost subsidies).

The names of many of the special economic zones tell us a great deal about the businesses they encourage. For example, “Processing for Export Zones” is a unique practice that may benefit only certain qualified groups of businesses. In such zones, foreign manufactures use locally purchased materials and imported materials to manufacture good for sale outside China. Investments in such zones are subject to the examination and approval of the foreign trade department responsible at the provincial level or below the provincial level. In contrast, however, the processing trade is managed separately according to the category of commodity. Different categories are subject to supervision of different levels of the government. For instance, to process sugar, vegetable oil, wool, natural rubber, and crude oil, manufacturers must get approval from the responsible provincial level foreign trade department.

The differences among these zones make certain locations more or less attractive to various foreign investors. High-tech businesses will find a better environment and facilities in New and High Technology Industries Zones, while outsourcing companies that are repatriating all their products may want to choose Processing for Export Zones for the tax benefits. Furthermore, in China different geographic areas often attract different types of foreign businesses. Guangdong province (formerly known in the West as Canton), for example, hosts many manufacturers that target the Hong Kong market because of its geographic proximity. Zhejiang province, in contrast, is famous for the concentration of home appliance manufacturers that sell mostly within China. Shanghai, Beijing, and certain big inland cities are the best choices for high-tech industries, such as software and biotechnology, because of the concentration of colleges and universities in those locations, and thus, the highly educated workforce.

In 2005, the Chinese government began to reevaluate all the economic development zones established by different levels of government. This initiative was motivated by the fact that many such zones possess vast areas of land not utilized for business development and do not attract sufficient investment to justify building extensive new infrastructure. As a consequence of this reevaluation, some existing special economic zones will be closed down. It is essential that foreign investors seeking to enter China conduct a careful case-by-case analysis to determine not only the optimal location for investment, but also the potential negative impact caused by possible future policy adjustments.

Appendix 2 is a list of many types of Chinese special economic regions and development areas open to foreign investment.

## L. Hong Kong's Role

Hong Kong is considered the best place through which foreign companies may gain access to China, due to its physical proximity to and cultural association with mainland China. Hong Kong has a financial and legal system that is much more similar to that of developed countries than to that of mainland China. Hong Kong provides foreign businesses with an English-language environment, sufficient market intelligence, flexible business strategies, channels for financing, and favorable tax treatments.

In June 2003, China and Hong Kong entered into the Closer Economic Partnership Arrangement, which gives Hong Kong products access to the Chinese market without tariffs, while simultaneously allowing Chinese products to enjoy free trade treatment in Hong Kong. This change is particularly beneficial for those foreign companies that are looking not only at the huge Chinese market, but also at the Southeastern Asian region, since Hong Kong offers convenient access to the surrounding Southeastern Asian market.

## M. Trends in Outsourcing Opportunities

The most common form of outsourcing to China is when a foreign business contracts with Chinese companies to manufacture products according to the foreign company's specifications and requirements. Over the past 15 years, China's exports to the United States have grown by 1,600 percent. The respected Public Broadcasting System news program *Frontline* estimates that 80 percent of Wal-Mart's 6,000 suppliers manufacture their products in China (<http://www.pbs.org/wgbh/pages/frontline/shows/walmart/view/>).

The structure of Chinese exports has changed tremendously over the last 20 years. Chinese exports were previously dominated by low-end labor-intensive products (such as textile, toys, and furniture). Today, while China still maintains a high surplus in production of such items, its largest sales to the US are in computers, electrical machinery, and equipment. According to Ronil Hira, Assistant Professor of Public Policy at Rochester Institute of Technology, China runs a \$50 billion annual surplus in these products. This change in the type of exports also is a sign of industrial upgrading in the US and other developed countries.

China's huge domestic market also contributes to changes in the outsourcing industry. Not only is the absolute number of potential customers in China extremely large, but the purchasing power of the average Chinese person is also increasing at a very high rate. In addition to purchasing from China for their home market, more and more foreign companies are looking to establish a presence in Chinese local markets. Foreign companies seeking to establish a presence in China may use one of two legal structures. The first structure establishes a joint venture with a local Chinese company. The second establishes a wholly foreign-owned enterprise (WFOE). Each of the two forms has its benefits and detriments, which will be discussed in greater detail in Section III. The following chart reflects the numbers of different forms of foreign-invested companies in major Chinese cities as of October 2004. The characteristics and difference of various forms of corporations also will be discussed in more detail in Section III.

| Location  | Joint Stock | WFOE   | EJV   | CJV   |
|-----------|-------------|--------|-------|-------|
| Shanghai  | 100         | 18,793 | 5,921 | 2,097 |
| Zhejiang  | 76          | 4,164  | 5,124 | 265   |
| Jiangsu   | 563         | 5,862  | 5,133 | 428   |
| Beijing   | 160         | 5,035  | 2,641 | 443   |
| Tianjin   | 136         | 3,299  | 1,571 | 171   |
| Guangdong | 284         | 7,561  | 3,319 | 1,329 |
| Sichuan   | 24          | 735    | 411   | 67    |

Source: <http://www.chinamarketresearch.com.cn>

WFOE= Wholly Owned Foreign Enterprise (a.k.a. WFOE)

EJV= Equity Joint Venture

CJV= Cooperative Joint Venture

The latest development in the world's outsourcing industry is to outsource information technology businesses to developing countries. In 2000, Forrester Research Company estimated that the number of United States IT jobs moving overseas would rise from 27,000 in 2000 to a cumulative total of 72,000 in 2015. At the end of 2002, Forrester issued another report which predicted that 472,632 IT and mathematics positions would be moved offshore by 2015. India is often viewed as the number-one choice when considering software outsourcing, but China's potential in this area has been somewhat neglected. China, even though it is a latecomer in the industry, possesses one of the largest talent pools in the world. Although language is a barrier for foreign businesses, more and more Chinese are studying English, not least the country's many IT majors, giving them significant competence in this type of work. Statistics indicate that the sales revenue of the Chinese software industry increased from RMB 59.3 billion in 2000 to RMB 160 billion in 2003, and software exports increased from US\$25 million in 2000 to US\$2 billion in 2003 (Forester Research Co., <http://www.forrester.com>; China Software Industry Association, <http://www.csia.org.cn>).

There are generally three types of work that foreign IT companies outsource to China. The first is outsourcing of short-term on-site work. This means working at the clients' premises, or body-shopping. The risk for this kind of operation is low and the value-added component is also low. Foreign IT companies serving their clients in China have every reason to outsource this work to Chinese companies or hire local staff to handle it because of cost and efficiency considerations. The second type of IT work typically being outsourced to China is outsourcing of software development services. This generally takes three forms: (i) development of custom-made software in accordance with clients' specifications; (ii) development of software in the framework of subcontracting; or (iii) establishment of software development centers as joint ventures. This type of outsourcing requires higher investments and the risk is also higher. These risks are justified by the higher return.

The last type is outsourcing of product manufacturing. This approach requires capital management skills and marketing and product support services. It also requires long-term commitment and strong local connections. The following chart provides information about the Chinese provinces with the most highly developed software industries.

| <b>Provinces' total 2003 revenue and export revenue from software industry (in US\$ millions)</b> |               |        |          |               |        |
|---|---------------|--------|----------|---------------|--------|
| Province  | Total Revenue | Export | Province | Total Revenue | Export |
| Anhui   | 190           | 1.8    | Jiangxi  | 88            | 1.4    |
| Beijing   | 4333          | 5.1    | Jilin    | 288           | 0.4    |
| Chongqing   | 76            | 1.2    | Liaoning | 912           | 8.8    |
| Fujian  | 97            | 6.7    | Ningxia  | 15            | 0      |
| Gansu   | 98            | 0.1    | Qinghai  | 0             | 0      |
| Guangdong   | 4100          | 16.3   | Shaanxi  | 840           | 1.8    |
| Guangxi   | 28            | 0      | Shandong | 867           | 0.8    |
| Guizhou   | 116           | 0.1    | Shanghai | 1404          | 12.5   |
| Hainan  | 26            | 0      | Shanxi   | 0             | 0      |
| Hebei   | 92            | 10.8   | Sichuan  | 816           | 1.2    |
| Heilongjiang  | 481           | 0.1    | Tianjin  | 445           | 13.5   |
| Henan   | 154           | 0      | Tibet    | 0             | 0      |
| Hubei   | 216           | 1.3    | Xinjiang | 6             | 0      |
| Hunan   | 600           | 0      | Yunan    | 139           | 0.2    |
| Inner Mongolia  | 48            | 0      | Zhejiang | 1320          | 0      |
| Jiangsu   | 900           | 0      |          |               |        |

Source: Stefan Klotz, *The Future of China's Software Outsourcing Industry* (2004).

Any business outsourcing to China should pay attention to the issue of IPR protection, but this need for vigilance is especially true for outsourcers in the IT industry. Such companies may find their intellectual property rights being violated in a variety of ways. When a foreign IT outsourcer contracts with a Chinese company to serve its customers in China, its IPR may be violated when the foreign company releases technology features or software codes to its Chinese partner. The foreign company must exercise the utmost control over such information releases, and make sure that confidential information is shared among the fewest possible people. A foreign company may at times find it advisable to take technical steps ensuring that only the most necessary parts of its technology will be released and that the foreign company retains absolute control even over that release.

Second, a foreign company must make sure the software or product designed by a Chinese company will be used only on the foreign company's products (assuming that is the business deal), and that the Chinese company will not leak relevant information to other companies.

These preventative measures are critical to eliminating potential competitors and protecting the safety of the company's products. One important factor is how to manage the relationship with Chinese employees. Foreign companies may want to use very restrictive and binding employment contracts, which include clearly enumerated non-competition terms, to prevent "employee backlash." However, at the same time the foreign companies should be careful to comply with Chinese local laws, because some provinces and municipalities in China have regulations about the kinds of employee "lock-up" agreement that are allowed or prohibited. Any foreign company entering China must obtain a clear understanding of employment matters before it contracts with and seeks to retain key technical staff and before it shares its intellectual property with such employees.

## Section II: Purchase-Only Businesses

It is imperative for any business interested in continuous large-scale purchasing to understand the market dynamics and understand the suppliers. Before making the decision to purchase from China, a foreign business should analyze many economic factors.

### A. What to Buy?

First of all, what to buy from China? Regardless of the industry, not every American purchaser should buy from China. Over time, the products manufactured in China and purchased by American buyers have evolved. We can also observe some trends by looking at the relevant statistics.

In 1989, the United States' largest trade deficit with China was in apparel (US\$2.9 billion deficit), leather and leather products (US\$977 million deficit), household audio-video equipment (US\$697 million deficit), communications equipment (US\$284 million deficit), and rubber and plastic products (US\$542 million deficit).

The situation changed dramatically between 1989 and 1997. By 1997, the United States' net export deficit with China in manufactured goods had swelled to US\$51 billion. Apparel still had the largest deficit (US\$7.9 billion deficit), but other product sectors were catching up, including leather and leather products (US\$6.6 billion deficit), household audio-video equipment (US\$3.5 billion deficit) communications equipment (US\$1.2 billion deficit), and rubber and plastic products (US\$4.3 billion deficit). Between 1989 and 1997, the US surplus with China in chemicals remained essentially flat (US\$1 billion deficit) and what had previously been a surplus in non-electrical machinery turned into a sizeable deficit (US\$3.8 billion deficit). The change in the non-electrical machinery category was driven by a surge in computer exports to the United States, resulting in a net export deficit of US\$4.2 billion in this sector.

The largest change since 1997 has been in the increasing share of advanced technology products imported into the US from China. In 2003, the situation changed again. The combined share of electronics, machinery, and transport equipment now occupies 42.9 percent of total Chinese exports to the US. This change reflects China's rapid growth in industrial base construction and research capacity. It also reflects China's rapid climb up the product ladder from low-wage, low-capital-intensive industries to sectors requiring higher degrees of capital, skills, and technology. By 2004, China's total foreign trade volume of high-tech products exceeded US\$326.97 billion, according to the Chinese Ministry of Commerce. China's import of high-tech products reached US\$161.43 billion and exports stood at US\$165.54 billion, up 35.3 percent and 50.2 percent respectively (*Source*: Ministry of Commerce of China; the US-China Business Council; <http://www.uschina.org/statistics/tradetable.html>; also see Appendix 3).

These figures reflect the road map of China's very rapid development. The country's sophisticated facilities, convenient transportation, modern infrastructure, and sufficient number of highly educated workers all come together to make the upgrade of its economy possible.

One factor that Americans interested in importing from China must consider is the increasing number of anti-dumping cases that the US has raised against China. Up through the end of 2001, approximately 30 countries had initiated anti-dumping investigations aggregating approximately 500 cases against Chinese products, covering an export value of over US\$10 billion US. After China's WTO entry in 2001, the number of anti-dumping investigations raised

by countries like the US increased noticeably. The categories of Chinese products being targeted by these anti-dumping actions include wooden furniture, crepe paper, hand trucks, shrimp, ironing tables, plastic shopping bags, color televisions, steel fence posts, iron pipe fittings, and saccharin. During the period when an antidumping investigation is going forward, the product being investigated may be subject to heavy taxes—and it is important to note that the investigation period may be quite prolonged. This could endanger the smooth operation of a foreign purchaser's operations as well as its obligations to third parties. Therefore, it is very important for American purchasers to have a clear understanding of economic developments in their particular industries and to take preventative measures to avoid potential losses or risks that would result from an anti-dumping investigation (*Sources*: The World Trade Organization, [www.wto.org](http://www.wto.org); the Ministry of Commerce of China, [www.mofcom.gov.cn](http://www.mofcom.gov.cn)).

## **B. Where to Buy?**

Although foreign purchasers may find suppliers throughout China, two regions are active leaders in manufacturing and foreign trade. The first is Guangdong province (formerly known in the West as Canton). Because it is adjacent to Hong Kong and Macau, at the beginning of the opening-up period Guangdong was mainland China's window to the outside world. Together with Hong Kong, Macau, and its neighboring provinces in China, the Guangdong region is known as the Pearl River Delta. The province was also in the vanguard of privately owned business developments. By the end of 2004, the province had at least 390,000 private enterprises (not including proprietary individual businesses) with total registered capital of ¥559 billion (US\$70 billion). These private enterprises supply the majority of foreign purchases. Guangdong is traditionally famous for its garment, toy, and household appliance industries. In recent years, science and technology have played a leading role in upgrading the small, unprofessional workshops that sprang up in the early 1980s to larger, technology-intensive enterprises, and have given birth to renowned enterprise groups. By the end of 2004, more than 6,500 privately run technology firms were operating in Guangdong. Nearly half the province's total number of high-tech firms are privately owned. Many private businesses in Guangdong have started to tap the international market in their expansion in a globalized environment. Private firms in Guangdong reported total exports of US\$12.59 billion in 2004 (*Sources*: Guangdong Province official website, [www.gd.gov.cn](http://www.gd.gov.cn); Invest in China, [www.fdi.gov.cn](http://www.fdi.gov.cn)).

The second region that deserves particular attention is the Zhejiang and Jiangsu region, also known as the Yangtze River Delta area. Shanghai, China's economic heart, is considered a part of this region. Although the Pearl River Delta in Guangdong province just north of Hong Kong remains an important manufacturing hub, the Yangtze River Delta area around Shanghai has become the new locus of Chinese industrial development.

The Yangtze River Delta boasts convenient transportation, sound infrastructure, and rich human resources. It has developed very rapidly in a number of manufacturing sectors, among them electromechanical household appliances, office supplies, furniture, and garments. There are also several very promising economic development areas (such as Suzhou, Ningbo, and Wuxi) in the Yangtze River Delta, and many foreign companies have established a presence in the Yangtze River Delta. In Jiangsu Province, for example, foreign invested companies dominate foreign trade, which amounted to US\$170.86 billion in 2004, a lion's share of 79.3 percent of the province's total trade (*Source*: *People's Daily*, January 17, 2005).

## C. Export and Import Law

With 1994's Foreign Trade Law, China has instituted a foreign trade system that covers management of foreign trade dealers and import and export commodities and technology, foreign exchange, customs control, import and export commodity inspection, animal and plant quarantine, protection of intellectual property rights, and economic and trade arbitration related to foreign interests and proceedings.

The Foreign Trade Law, which came into force on July 1, 1994, serves as the basic law on standardizing foreign trade activities in China. Its basic principles are:

- Practicing a unified foreign trade system throughout the country;
- Safeguarding a fair and free foreign trade regime;
- Ensuring the independent operational authority of foreign trade dealers;
- Encouraging the development of foreign trade; and
- Promoting trade relations with other countries and regions on the basis of equality and mutual benefit.

Appendix 4 provides a partial list of laws and regulations relating to foreign trade management.

## D. Foreign Trade Rights

"Trade rights" refer to the right to import and export products, excluding the right to distribute such products in domestic markets. Prior to China's WTO entry, those enterprises and organizations that were not included on the list of state-run trade enterprises or on the list of designated business management were forbidden to undertake the import and export of goods on which state-run trade control or designated business management was enforced. Today, four years after WTO entrance, China has lowered the requirement of minimal registered capital for Chinese enterprises to obtain trade rights, permitted foreign-funded enterprises to obtain complete trade rights, and canceled the system of trade-rights examination and approval.

Some limitations on import and export still exist in China. Eight types of goods deemed essential to the national economy and people's livelihoods can be imported into China only by the state. These are grain, cotton, vegetable oil, sugar, crude oil, finished oil, chemical fertilizer, and tobacco. State-run trade control is also enforced in the export of such commodities as tea, rice, maize, soybean, tungsten sand, tungsten ware, coal, crude oil, finished oil, silk, unbleached silk, cotton, cotton yarn, cotton textile, antimony sand, oxidized antimony, antimony ware, and silver (*Source*: CCPIT).

The government permits non-state-run trade enterprises to undertake the import and export of a restricted amount of the goods on which state-run trade control is enforced. The department of the State Council in charge of foreign trade and economy may designate certain companies to act as agencies of the import and export of certain products over a period of time. The department also has the power to decide the amount of such products that such companies may handle.

## **E. Export Processing Trade**

In 2000, China established a series of Export Processing Zones within which foreign investors could establish factories with their own or local technology, and use foreign or local resources to manufacture. The key is that the foreign materials are not considered imported and the finished products are stored within the zones and are not taxed as imported commodities. The products from these Export Processing Zones cannot be sold domestically; they must only be shipped out of the country. In this way, China works as a labor and resource provider and the investors save the inefficiencies of handling complicated import and export procedures.

The following 15 such zones had been approved by the State Council through the end of 2000: Dalian of Liaoning province, Tianjin, Beijing's Tianzhu, Yantai and Weihai of Shandong province, Kunshan and Suzhou Industrial Garden of Jiangsu province, Shanghai's Songjiang, Hangzhou of Zhejiang province, Xiamen's Xingling of Fujian province, Shenzhen and Guangzhou of Guangdong province, Wuhan of Hubei province, Chengdu of Sichuan province, and Hunchun of Jilin province. Since 2000, several new Export Processing Zones have also been established around the country.

Export Processing Zones should be attractive to those manufacturers targeting the international market and the market in their home countries. These zones provide manufacturers with China's advantageous labor and resource costs, while at the same time allowing them to protect their intellectual property.

## **F. IP Protection in Purchase Deals**

If a foreign company wants a Chinese supplier to manufacture a product based on foreign patents or other forms of intellectual property owned by the foreign company, then it should take steps to achieve full protection of its IPR. The foreign company should pay special attention to the IPR protection coverage in its contracts. Any contract between foreign and Chinese companies should include detailed provisions aiming to prevent the Chinese supplier from sharing intellectual properties with any related or unrelated party for a period of time long enough to offer the foreign company sufficient protection. These provisions may well need to cover a far longer time than that of the manufacturing contract. It is important for owners of intellectual properties to understand that, despite taking these contractual precautions, ineffective IPR protection enforcement has often enabled a foreign company's Chinese supplier to become its competitor in local or even international markets—immediately after and, at times, even before the conclusion of the contract.

## Section III: JV v. WFOE (Wholly Foreign-Owned Enterprise)

### A. Laws and Various Forms of Foreign Investment

Three important basic laws governing foreign investment in China are (i) the Chinese-Foreign Joint Ventures Law (amended in 2001); (ii) Chinese-Foreign Cooperative Enterprise Law (1988); and (iii) Foreign-Funded Enterprise Law (1989). In addition, foreign investment companies are governed by the Company Law (1999), and foreign companies acquiring Chinese companies will also need to abide by regulations and rules regarding merger and acquisitions.

The following chart describes the characteristics of several types of Chinese business entities and their respective advantages and disadvantages.

| Type of Corporate Form            | Characteristics   | Advantages   | Disadvantages  |
|-----------------------------------|---|--|--|
| Equity Joint Venture <sup>2</sup> | <ul style="list-style-type: none"> <li>Each partner contributes cash, facilities, equipment, materials, IPR, labor, or land-use rights</li> <li>Foreign majority share needs approval</li> <li>Encouraged to be used in software industry</li> <li>Maximum term of operation is 50 years</li> </ul> | <ul style="list-style-type: none"> <li>Strong link to local market</li> <li>Convenient access to local resources</li> </ul>                              | <ul style="list-style-type: none"> <li>Difficult to protect IPR because of the need to transfer technology</li> <li>Subject to regulations from various levels of government</li> <li>Difficult negotiation of contract</li> <li>Strong local relationship maintenance required</li> </ul> |
| Wholly Foreign-Owned Enterprise   | <ul style="list-style-type: none"> <li>Operates independently and is responsible for its own gains and losses</li> </ul>  | <ul style="list-style-type: none"> <li>Sole discretion in business decision making</li> <li>Good IPR protection</li> <li>Quicker to establish</li> </ul> | <ul style="list-style-type: none"> <li>No initial access to Chinese market</li> <li>No local government protection</li> <li>Investment threshold is higher</li> <li>Higher public relationship skills needed</li> </ul>  |

<sup>2</sup> Equity Joint Ventures are enterprises co-established, and co-invested, cooperatively by foreign enterprises, companies, and other economic entities or individuals (foreign participants), within the territory of the PRC, with Chinese companies, enterprises, or other economic entities (Chinese participants), in accordance with the principles of equality and mutual benefit and subject to approval by the Chinese government. Wang Xuanjun, *The Types of Foreign Investment Enterprises in the People's Republic of China* (1999), based on definitions in Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures, Law of the People's Republic of China on Chinese-Foreign Cooperative Joint Ventures, and Law of the People's Republic of China on Wholly Foreign-Owned Enterprises.

|  |   |  |  |
|--|---|--|--|
| Cooperative Joint Venture <sup>3</sup> | <ul style="list-style-type: none"> <li>• Profits and responsibilities are determined in the JV contract, not according to invested capital</li> <li>• Each partner is a separate legal entity</li> <li>• May be unlimited liability entity</li> </ul>   | <ul style="list-style-type: none"> <li>• No minimum investment requirement</li> <li>• Flexible cooperation forms</li> <li>• Easy to form, easy to dissolve</li> <li>• Links to local market, resources and networks</li> </ul> | <ul style="list-style-type: none"> <li>• Difficult to protect IPR because of possible transfer of technology</li> <li>• Subject to regulations from various levels of government</li> <li>• Difficult negotiation of contract</li> <li>• Strong local relationship maintenance required</li> </ul> |
| Acquired Enterprise                    | <ul style="list-style-type: none"> <li>• The acquired asset may be all or part of a Chinese company</li> <li>• The acquired asset can be converted into a foreign-invested enterprise (whole company acquisition), or change shares on the stock exchange (minority stake acquisition)</li> </ul> | <ul style="list-style-type: none"> <li>• Cheap turnaround opportunities</li> <li>• Not necessary to participate in management</li> <li>• Quickest way to access China</li> </ul>   | <ul style="list-style-type: none"> <li>• Slow and difficult government approval</li> <li>• Lack of transparency of company information</li> </ul>  |
| Branch                                 | <ul style="list-style-type: none"> <li>• Liability is with the foreign parent entity</li> <li>• Parent company is usually offshore</li> </ul>   | <ul style="list-style-type: none"> <li>• Flexibility in investment, management and exit</li> <li>• Less liability and risk</li> </ul>  | <ul style="list-style-type: none"> <li>• Difficult to get approval</li> <li>• Lack credibility</li> </ul>  |
| Representative Office                  | <ul style="list-style-type: none"> <li>• Representing foreign companies with limited business scope and representation</li> </ul>   | <ul style="list-style-type: none"> <li>• Very easy to set up</li> <li>• Easy exit strategy</li> </ul>  | <ul style="list-style-type: none"> <li>• Limited business scope – as defined by law<sup>4</sup></li> </ul>   |

<sup>3</sup> Cooperative Enterprises are also named contractual operative enterprises. When Chinese and foreign partners establish a cooperative enterprise, provisions on such items as investment or terms for cooperation, distribution of earnings or products, sharing of risks and losses, method of business management and the ownership of property on the expiration of the contract term shall be prescribed in the cooperative enterprises contract in accordance with the provisions of Chinese law. *Id.*

<sup>4</sup> The resident representative office of the foreign enterprise may engage in non-direct business activities and may, on behalf of their enterprise, conduct business liaison activities, product introductions, market studies, and technical exchanges, which are within their business scope. Detailed rules of the Ministry of Foreign Trade and Economic Cooperation on the Approval and Control of Resident Representative Offices of Foreign Enterprises Article 4 (1995).

The total amount of FDI into China is enormous, with most of the investment flowing in through WFOEs. The following chart reflects foreign investment in China in 2004.

### Foreign Investment in China, January - December 2004 (in '000 US\$)

*Note:* Percentages may not add up because some minor categories were omitted from this table.

*Sources:* Ministry of Commerce and the US-China Business Council

| Investment Vehicle                              | Number of Contracts |                 |            | Amount Contracted |                 |            | Amount Utilized |                 |            |
|---|---------------------|-----------------|------------|-------------------|-----------------|------------|-----------------|-----------------|------------|
|   | Total               | Annual % Change | % of Total | \$ Billion        | Annual % Change | % of Total | \$ Billion      | Annual % Change | % of Total |
| Foreign Direct Investment (FDI)                 | 43,664              | 6.29            | 100.0      | 153.47            | 33.38           | 100.00     | 60.63           | 13.32           | 100.00     |
| Equity Joint Ventures                           | 11,570              | -7.60           | 26.50      | 27.64             | 8.37            | 18.01      | 16.39           | 6.46            | 27.03      |
| Contractual Joint Ventures                      | 1,343               | -13.19          | 3.08       | 7.79              | 4.13            | 5.08       | 3.11            | -18.88          | 5.12       |
| Wholly Foreign Owned Enterprises                | 30,708              | 13.97           | 70.33      | 117.28            | 43.70           | 76.42      | 40.22           | 20.49           | 66.34      |
| Share-based Enterprises with Foreign Investment | 43                  | 16.22           | 0.10       | 0.77              | 99.09           | 0.50       | 0.77            | 136.68          | 1.27       |

Establishing a foreign invested enterprise (FIE), which includes each type of investment entity mentioned above, requires compliance with a set of government approvals and registration procedures. The life of an FIE, usually 10 to 30 years, may be stipulated by investors through negotiation and is subject to national regulations based on the nature and situation of different industries. If investors want to extend the time of operation of an FIE beyond its initially established duration, they must apply to the approval authorities at least 180 days before its initial term expires. Also, if an FIE dissolves or ceases to operate prior to the end of the term specified when it was incorporated, then it may be liable to pay additional tax that had previously been exempt based on the originally specified duration of the FIE.

In some special situations, the government may appropriate property of an FIE based on the need of social public interests. Any such appropriation must be based on legal procedures, and the foreign enterprise must be fairly compensated.

It has long been a practice for foreign investors to form new subsidiaries in China if they decide to increase the direct investments they are making in China. The compelling tax reason for doing this is that additional investments into an existing subsidiary will not provide any new income tax breaks, whereas the formation of a new subsidiary will provide such tax breaks.

## **B. The Government's Financial and Policy Encouragement for Foreign Investments**

China's economic opening began first in the Eastern region, and then gradually, in phases, moved to interior regions. The Eastern coastal region enjoys a fairly favorable investment environment and many preferential policies. The overwhelming majority of overseas-funded enterprises have been established in this region. Foreign companies have launched relatively fewer investment projects in China's Central and Western region.

In recent years, with the strategic focus of China's economic development shifting gradually westward, the Chinese government has formulated policies to assist the Central and Western region, vigorously increased investment in the region, and increased construction of infrastructure, such as water conservancy, transport, and telecommunications. It has also been encouraging foreign companies to invest in the region. (See Section I, D.)

To direct foreign investment to the Central and Western region, in 2000 the State Development and Planning Commission and the Ministry of Foreign Trade and Economic Cooperation jointly formulated a "List of Advantageous Industries for Foreign Investment in Provinces, Autonomous Regions and Municipalities Directly under the Central Government in the Central and Western Parts" (the Advantageous Industries List). This list cites industries the government wishes to encourage to enter the provinces of the Central and Western regions. The sectors emphasized in the Advantageous Industries List include tourism, processing of agricultural products, forestry, mineral resources exploitation, construction of communications facilities, and development of novel electronic components. Projects on the Advantageous Industries List that utilize foreign investment enjoy preferential policies, such as exemption of duties for imported self-use equipment and import-linked value-added tax.

Some of the current incentives encouraging foreign investors to invest in the Central and Western regions include:

- Between 2001 and 2010, foreign-funded enterprises in the West which fall into encouraged categories enjoy a 15 percent reduction in income tax;
- Newly established enterprises with over 70 percent of total income from the industries of transportation, electric power, water conservancy, postal service, or radio or TV broadcasting enjoy a two-year income tax exemption, plus a further three-year 50 percent reduction on income tax that is payable starting the first profit-making year;
- Exemption from the tariff on imported non-commercial equipment;
- Eligibility to borrow money from China's state-owned banks; and
- Eligibility to issue A shares (ordinary domestic shares) or B shares (shares traded in foreign currencies) for certain investments.

### C. Venue Shopping

The coastal region may have certain advantages in its mature business culture, more advanced technology, and convenient transportation, but the inland regions boast lower labor costs, rich supplies of raw materials, and ample supplies of the utilities (water and electricity) necessary for manufacturing. Another important factor for investors as they consider possible locations is the region's educational facilities. This is an important consideration because of the impact that educational systems have on the price and quality of a work force. Furthermore, as previously discussed, investors also should analyze the presence of economic development zones. In addition, businesses looking at selling to the local Chinese market should consider the purchasing power of the region's consumers, to be sure they are offering their products to appropriate markets.

Foreign investors also need to be aware that certain parts of China still suffer from power shortages. These shortages have plagued China during peak load times since 2004 and are likely to continue into the near future. In Shanghai, for example, power shortages are expected to continue through the next two summers. The government has taken steps to address this problem, such as increasing the price of energy and working to boost production. but, despite this, energy demand during peak times remains heavy and continues to exceed the modest increases in supply. Although current power shortages do not appear to have significantly dampened FDI flows in 2004, the shortages may influence future investment choices. As mentioned earlier, locations such as China's northeastern provinces, or the inland areas of Sichuan, Hubei, or Chongqing, are all better able to cope with rising energy demands because of their relatively high capacity and relatively low industrialization. Foreign investors may consider placing or even moving their manufacturing facilities from the hard-hit East Coast in order to benefit from this regional disparity (*Source: the US-China Business Council*).

### D. Allowed Business Scope

There are limitations on the kinds of business FIEs may operate. The *Catalogue Guiding Foreign Investment in Industry*, compiled by the Ministry of Commerce and the National Development and Reform Commission, provides a clear roadmap of the business sectors in which the government is currently encouraging foreign investment and also provides insight into further areas of encouraged foreign direct investment growth.

Foreign investments in China are classified into four categories: (i) industry encouraged investment, (ii) permitted investment, (iii) restricted investment; and, (iv) prohibited investment. The differences among the first three categories mostly lie in the level of authorization required for government approval of the business. "Permitted" requires approval from a higher level of authority than does the "encouraged" category, and "restricted" requires a higher level than "permitted." For example, when a proposed project falls into the category of restricted foreign investment, it must be authorized by the State Council - the highest governing body of China. Examples of the restricted category include construction of airports, hotels, and commercial retail outlets; leasing businesses; cargo transportation agencies; banking; and insurance. "Prohibited" means that the industry is not open to foreign investment.

It is important to note that an FIE will receive a certificate recording the business scope under which it is allowed to operate. If the company later wishes to expand its business beyond the initially authorized scope, then the FIE must apply to the proper Chinese authorities to request approval for such expansion. It is illegal to operate without first receiving permission and registering.

The government issued a revised version of the Catalogue in November 2004 that took effect on January 1, 2005. The new Catalogue provides that foreign investment in encouraged industries enjoy preferential treatment, including the right to establish wholly foreign owned subsidiaries, while investment in restricted categories is often limited to JVs. All project areas not expressly listed in the Catalogue and not restricted by other Chinese regulations are permitted.

A full translation of the Catalogue is available on the website of the US-China Business Council ([www.uschina.org](http://www.uschina.org)). Interestingly, the government recently relaxed restrictions on investment in the previously tightly controlled areas of film production and TV and radio program production and distribution. Television program production and distribution, as well as film production, have been moved from the prohibited to the restricted category, though a Chinese investor must still retain a controlling share. Additionally, as part of China's WTO accession agreements, foreign companies may now invest in the construction, renovation, and operation of cinemas and may increase their stake to more than 50 percent after an initial grace period.

## **E. Mergers and Acquisitions in China**

In the last few years, mergers and acquisitions in China have become increasingly complex. The predominant merger and acquisition regulations in China deal with acquisition of shares of FIEs. Other types of acquisitions have been governed more by practice than by specific regulations.

**Purchasing Shares:** If a foreign company is acquiring the shares of a domestic Chinese company, then the foreign company should consider the following issues:

***Is the ownership interest state owned?*** If so, then state-approved valuation requirements, as well as a requirement to list these shares on state asset exchanges, will be applicable. If not, then less formal valuation requirement will be applicable.

***Will foreign interest in the company after the acquisition be 25 percent or higher?*** If so, the targeted company will be granted FIE status (WFOE if 100 percent foreign owned; JV otherwise) and will enjoy FIE benefits (e.g., if the targeted company is a manufacturing company, then FIE status would allow it to be entitled to a five-year tax holiday).

***Does the investment category require approval and classification as an Encouraged, Permitted, Restricted, or Prohibited Industry?*** This is discussed above in Section III.D., "Allowed Business Scope."

***What other issues should be considered?*** Such issues may include employee resettlement (for former employees) or foreign exchange remittance.

**Purchasing Assets:** In China, the purchase of assets is more complicated than a share purchase, but offers the purchaser the peace of mind of not acquiring liabilities not specifically assumed. Sales of assets both by FIEs and by domestically owned Chinese companies are covered by the new set of regulations promulgated in 2003/2004. There are quite a number of issues to be considered:

- A foreign investor who wishes to conduct business activities in China from a fixed location is always required to first establish a registered presence in that location (e.g., a representative office, a WFOE, or a Chinese-foreign JV). Each registered entity is required to set out an approved business scope which is stated on its business license, and the entity is only approved to conduct activities within those stated in its specific business scope. An entity which acts outside its business scope lacks the legal capacity to conduct such acts. Accordingly, before a foreign company may take over and operate the assets of a Chinese-based company (FIE or domestically owned), a JV or WFOE must first be formed with the approved business scope.
- If the seller is considered a state-owned enterprise, or a company with a state interest, then the state-approved valuation requirements will be applicable to the transaction.
- Creditors' notice must be given to the seller's creditors if substantial assets are being sold.
- The acquisition of assets may also take a form whereby the Chinese party contributes its assets as equity to a JV formed jointly by the foreign company and the Chinese party. This is the traditional JV model, which has been in existence for more than 20 years.

## **F. Foreign Currency Control: Investing and Repatriating**

After strictly controlling foreign currency inflow and outflow for many years, China recently introduced a series of new measures for enterprises and individuals which allow them to better obtain and transfer foreign currencies. China wants to monitor every dollar that flows into the country, but foreign businesses are allowed to repatriate registered dividends and profits if they follow certain procedures.

In recent years, the Chinese government has adopted more stringent control over foreign money being used for speculative investment in China. Officially, only a limited number of government approved financial institutions may invest freely in mainland China. These institutions are called Qualified Foreign Institutional Investors (QFII). They are permitted to invest in RMB denominated shares listed on China's stock exchanges, A shares, treasuries listed on stock exchanges, convertible bonds and enterprise bonds, and other financial instruments as approved by the Chinese Securities Regulatory Committee (CSRC).

## G. Tax Issues

China maintains a policy of low taxes for FIEs and has also implemented preferential tax policies in those industries and regions where investment is encouraged by the state. At present, there are 13 types of taxes applicable to foreign-funded enterprises, foreign enterprises, and foreign individuals (apart from the agricultural tax, tariffs, and ship tonnage tax). These types of taxes are: (i) value-added tax; (ii) consumption tax; (iii) business tax; (iv) income tax on foreign-funded enterprises and foreign enterprises; (v) personal income tax; (vi) resource tax; (vii) land value-added tax; (viii) stamp tax; (ix) tax on urban real estate; (x) tax on the use of automobile and ship plates; (xi) slaughter tax; (xii) contract tax; and (xiii) construction fees for cultural undertakings.

The Law of the People's Republic of China on Managing the Levy and Collection of Taxes and other laws and regulations related to the different tax types described above constitute China's legal and tax system governing foreign interests (*Source: [www.china-asean.net](http://www.china-asean.net)*).

China's tax law provides many preferential terms that allow foreign investors to enjoy a vast range of advantages. FIEs are advised to employ a public accountant with a good knowledge of China's tax laws. In particular, to encourage long-term investment (longer than 10 years), China uses a tax holiday policy. The tax holiday begins on the first day of a foreign-financed enterprise's operation. When the operation becomes profitable, for the first two years in which profit is shown such enterprises do not pay any tax; after the two-year period, they then continue to benefit in the following three years, paying only 50 percent of taxes that would otherwise be due.

The sectors where this beneficial tax policy applies include:

- Machinery and electronics;
- Energy (excluding pumping petroleum and natural gas);
- Metallurgy, chemical, and building material industries;
- Lighting, textile, and packaging industries;
- Medical equipment and pharmaceutical industries;
- Agriculture, forestry, livestock breeding, fisheries, and water conservancy;
- Construction;
- Transport (excluding passenger transport);
- Scientific and technological development, geological prospecting, and industrial information consultancy, as well as the production equipment and precision meter maintenance and service industries that directly serve such types of production; and
- Other industries designated by the relevant taxation department of the State Council.

It is possible that foreign investors may in future also benefit from special reduced-tax-rate legislation that may be introduced to attract investment in regions such as the Central and Western Region and in Special Economic Zones like Shenzhen, Zhuhai, Shantou, Xiamen, and Hainan. These benefits are applicable in addition to the tax holiday policy mentioned above. Therefore, foreign investors should consider the venue of their proposed operations to take maximum advantage of the tax benefits China offers (*Source: CCPIT; State Bureau of Taxation of China*).

## H. Land Use

China's law on land use and possession is extremely important for foreign investors. China maintains a system of public ownership of land. The system manifests in two forms: (i) ownership of land by the state; and (ii) ownership of land by collectives. The land in urban areas is owned by the state, while the land in suburban and rural areas is owned by collectives, except for land otherwise defined by law as owned by the state.

However, it is possible for foreign enterprises, including JVs and FIEs, to obtain the use of land. There are generally five ways in which foreign-funded enterprises may obtain the right to use state-owned land:

**Compensated Transfer.** The state, in its capacity as the owner of land, transfers to a foreign enterprise the right to use the land for a number of years, and the FIE pays a land-use right transfer fee in one lump sum. Foreign-funded enterprises may obtain the right to use land transferred through the invitation of tenders and auctions, or in the form of signing contracts.

**Administrative allocation.** Foreign enterprises may sign contracts for land use with land administration authorities, and proceed through the formalities for registration and obtain the certificate of land use. Under such an arrangement, users of land pay the government a land development fee in one lump sum and also pay a land-use fee on an annual basis.

**Offer of land by Chinese partners as investment in equity joint ventures or contractual joint ventures.** The Chinese partner buys shares or proposes conditions for cooperation with the foreign investor by offering its workshops, buildings, equipment, or land as its investment to form equity joint ventures or contractual joint ventures with a foreign investor.

**Leasing of real estate and sites.** Foreign-funded enterprises directly lease real estate from, and pay rent to, state-run enterprises or collectively-owned enterprises in urban areas or township businesses.

**Retransfer.** Foreign-funded enterprises may obtain the right to use land for a number of years from other non-governmental users of land in the form of retransfer.

There are generally two ways in which foreign-funded enterprises can obtain the right to use collectively owned land:

Because no collectively owned land may be directly transferred or leased, **collectively owned land must first be converted into state-owned land** through expropriation by the state before it can be transferred to foreign-funded enterprises for use.

Collectively-run economic organizations in rural areas or township businesses may purchase shares or propose conditions for cooperation by **offering their collectively owned land as their investment contribution** to form with the foreign investor's equity joint venture or contractual joint ventures. However, joint venture projects of such a nature are subject to approval by the people's government at the county level or higher (Source: [www.China-Asean.net](http://www.China-Asean.net)).

## **Section IV. Some Know-How**

### **A. How to Handle Employment Issues**

Seeking to safeguard the legal rights and interests of workers, China has enacted various laws and regulations, among them the Labor Law of the People's Republic of China and the Decision of the State Council on Work Hours of Employees. Noteworthy points here include:

- Enterprises may independently employ personnel, but they may not use child labor, nor may they assign women to do work specified by the state as "unsuitable" for women.
- Foreign-funded enterprises are generally not allowed to employ overseas personnel, including those from Hong Kong, Macao, and Taiwan. If a company wishes to employ overseas personnel with special skills unavailable in China, including senior technicians and senior managers, then the company must apply to the labor management authorities for approval before proceeding to employ such personnel, and it must adhere to certain formalities and comply with relevant regulations if it brings in employees from overseas to reside and work in China.
- Terminating workers is a right of enterprises under Chinese law. However, in an effort to prevent enterprises from arbitrarily dismissing workers, the state has defined a category of conditions which prohibit the dismissal of workers. Workers cannot be dismissed while they are pregnant, while they are breastfeeding, while they are receiving medical treatment, or during times surrounding childbirth.
- The monthly remuneration paid by enterprises to their employees may not be lower than the minimum level of salaries defined by the local government.
- Employees shall work no more than 8 hours per day and 40 hours per week. Legal requirements also determine the compensation for extended working hours.

China is paying increasing attention to the matter of unionization. According to Chinese labor law, every business entity must have a union if the employees want one. Some Chinese government branches have recently started investigating issues regarding the establishment of unions in foreign-invested companies. Foreign investors should bear in mind that resistance to unionization could negatively impact their relationship with the local government and community, which could seriously hurt their business in China.

### **B. How to Handle GuanXi**

It is very difficult to do business in China without understanding "GuanXi." The literal translation of GuanXi is "connections." This translation has a tendency to create misconceptions, since the concept is much more complex than merely connections. GuanXi is based on reciprocity and mutual obligations, trust, and shared experiences. It creates profound links between business life and personal lives, financial concerns and social concerns. Generally, the deepest GuanXi is found between family members, but it also extends beyond the family unit. A common misperception is that one can purchase GuanXi with money. In reality, the personal component is much more important. The following table shows differences between Western networking and the Chinese concept of GuanXi.

| <b>Chinese</b>   | <b>Western</b>  |
|--|---|
| Personal relationship have organizational implications, and vice versa | Clear distinction between individual and organizational relationships |
| Personal and trust based   | Contract based  |
| Symbiotic relationships between networked organizations                | High independence of networked organizations                          |
| Motivated by economic and social concerns                              | Motivated mainly by economic concerns                                 |
| Flexibility and informality  | Formality and clearly defined roles                                   |

Adapted from M. J. Chen, *Inside Chinese Business: A Guide for Managers Worldwide* (2001)

In China, GuanXi is not always considered a bad thing. The understanding, development, and use of GuanXi can facilitate the day-to-day work of foreign investors.

### **C. How to Enter into a Contract in China**

China adopted its most recent Contract Law in 1999. In drafting the new Contract Law, the Chinese legislators referred extensively to the UNIDROIT (International Institute for the Unification of Private Law) principles of international commercial contracts. Many articles of the new Contract Law, in particular those in the chapter on general provisions, are similar in spirit to the principles of UNIDROIT. Specific provisions were included in the law to regulate particular kinds of contracts. Interpreting the Contract Law can be complicated, and hence, below we present some legal issues that foreign businesses should be cognizant of when they contract with Chinese suppliers:

**Jurisdiction:** Foreign investors and parties to a contract should carefully designate a dispute resolution forum in the contract. Quite often, the contracting parties designate non-Chinese jurisdictions (e.g., California, New York) as the chosen forum for disputes, filing suits, and arbitrations, even though most of the business activities occur within China. Most investors may favor the selection of a familiar jurisdiction. However, they should also consider the cost and difficulty of executing the foreign court's decision in China, where local protectionism and insufficient legal enforcement mechanisms may prevent a decision from ever being carried out.

**Law enforcement:** Foreign investors must understand that it is common in China to have problems with law enforcement due to local protectionism, bureaucracy, and an legal system that is insufficiently developed in its enforcement mechanisms. That is, investors should not depend solely on the judicial remedies set out in a contract. It is also wise to deploy other structural means (such as controlling the supply chain or customers) to enforce one's position.

**Forms of contract:** Although the new Contract Law provides that a contract may be concluded orally, Article 10.2 states that "where the law or administrative regulations so require, the contract shall be in writing." This restriction of the general principle allowing oral contracts is found in a number of other Chinese domestic laws and regulations which specifically require the contract to be concluded in writing (such as the Chinese Guarantee Law in respect of guarantee

contracts). Furthermore, as in other parts of the world, it is far easier for both the parties and the courts to enforce a contract that has been set down in writing.

**Negotiations in bad faith and duty of confidentiality:** The law provides that “a business secret of which a party becomes aware in the course of negotiating the contract shall not be disclosed or unfairly used, regardless of whether the contract is concluded or not. The party who causes the other party to suffer losses due to disclosure or unfair use of the business secret shall be liable for damages.” These terms provide protection to foreign businesses, especially those with essential intellectual property and proprietary know-how. However, even with the existence of such protective laws, foreign investors should still enter into confidentiality agreements prior to commencing serious negotiations or disclosing confidential information, and should also bear in mind the challenges of enforcement. As discussed earlier, it may also be necessary to protect one’s IP by restricting information flow.

**Performance concerns:** Many times when foreign companies purchase products from Chinese companies, they find the products they receive are somehow different, or inferior, to the sample they were previously provided or the product defined in the contract. Therefore, it is very important to insert an inspection provision and other appropriate provisions in the contract. Not only should the provisions of the contract provide very specific definitions and specifications for the expected product, but it also may be necessary to designate a third-party inspector. As a deterrent measure, the purchaser may also want to add a provision to the contract attempting to transfer the purchaser’s liability to third parties to the supplier in the event the purchaser is not able to abide by its obligations due to the supplier’s fault, and thereby hold the supplier liable for the loss.

In addition, in cases where there is no provision in the contract between the parties on terms such as quality, price, remuneration, or place of performance, or where such provisions are unclear, the Contract Law stipulates that the parties may agree on supplementary terms even after the initial contract was signed.

## **D. How to Protect Your IPR with Legal Measures**

In most IPR violation cases, an IPR holder starts exploring the potential enforcement of its rights by conducting an investigation. An investigation can determine the scope and level of the infringement and provide evidence for filing a complaint. Investigations help determine: (i) whether the infringer manufactures and/or sells goods that infringe IPR; (ii) the volume of infringing goods produced and/or sold; and (iii) the possible location of these goods. Any evidence revealed during these investigations can help the rights holder determine whether to proceed with raid actions, file a lawsuit, or issue cease-and-desist letters.

In China, the first step in a low-key, low-cost enforcement program is to issue a cease-and-desist letter (CD letter) to the infringer. A CD letter demands that the infringer immediately cease the production and sale of any and all infringing goods. It also typically demands:

- an agreement not to infringe in the future;
- an agreed amount of liquidated damages if that agreement is breached; and
- compensation for past infringement.

Depending on the response to the CD letters, the rights holder can either pursue a settlement arrangement--typically consisting of monetary compensation and the publication of a statement of apology in a major metropolitan newspaper--or begin amassing evidence, which could be used to file a criminal suit against the infringer.

China designates a law enforcement force consisting of the State Administration for Industry and Commerce (SAIC), the Public Security Bureau, the Copyright Office, and the Sino Intellectual Property Office to separately or jointly enforce intellectual property rights, depending on the complexity of the case. **The amount and quality of evidence the rights holder presents during litigation has a direct bearing on the success of the case.** There is no meaningful discovery procedure in China. The IPR holder can cooperate with local law enforcement to collect evidence, but there are no standard forms of action that these officials will take in such instances.

After evaluating the amount and value of goods seized during a raid, the rights holder will be in a position to determine whether to pursue administrative procedures, litigation, or settlement. If an IPR holder chooses to pursue a civil lawsuit, then a claim for damages or injunction should be sought from the civil courts. A trial is conducted at a series of hearings usually occurring over a period of three to six months.

If an IPR holder wishes to pursue criminal remedies against infringers, it can file a complaint directly with the public prosecutor's office. The prosecutor has the discretion to initiate a raid, and may sometimes do so upon a rights holder's request. After the raid, depending on its results, the prosecutor may next hold a set of hearings. The proceedings usually last two to three months before the prosecutor files an indictment.

An IPR holder is entitled to an injunction that is reasonable to deter infringement in China. Under certain circumstances, the rights holder may apply to the court for a preliminary injunction to prevent infringement before a lawsuit is filed. Once the preliminary injunction order is granted by the court, the rights holder then has 15 days to file a lawsuit with the court. If the IPR holder seeks an injunction, the court has the authority to order prompt preliminary execution of the injunction against the infringer in order to stop the infringement, remove the obstacle, and eliminate danger to the IPR holder's business (Source: Civil Procedure Law of China, 1982).

## **E. How to Arbitrate Disputes in China**

China advocates and encourages the use of arbitration to resolve international commercial disputes. Two commonly used arbitral organizations handling cases involving foreign investment in China are the China International Economic and Trade Arbitration Commission (CIETAC) and the China Maritime Arbitration Commission (CMAC). CIETAC handles disputes arising from international economic and trade activities, while CMAC handles maritime disputes.

Mediation, sometimes called conciliation in China, is also widely used. Mediation has several advantages: it saves time, it is less costly than litigation or arbitration, it is confidential, and it is flexible. The China Chamber of International Commerce Conciliation Center, affiliated with the China Council for the Promotion of International Trade, is a permanent conciliation institution in China, which independently resolves disputes arising from international commercial and maritime transactions by means of mediation.

# Outsourcing to China

## *Conclusion*

China, the “World Factory,” affords investors and purchasers numerous competitive advantages. Not least, the country has a vast supply of low-cost labor and is aggressively expanding its infrastructure to attract foreign investment, as well as striving to modernize its financial system. It is putting considerable economic incentives in place to attract even more foreign investment. At the same time, it is a country with legal and cultural codes that are very different from those we are acquainted with in the West. To operate in that world is not simple. Every business entering China, for any reason, needs to remain informed about an array of evolving practicalities. Before you leap into this potentially lucrative market, learn about the important issues you will encounter and the problems you may face. Forearmed, you will be able to enjoy the many benefits that doing business in China can bring.

**Appendix 1:  
Catalogue of Advantageous Industries  
for Foreign Investment in the Central and Western Regions**

**Shanxi Province**

1. Storage, preservation, and processing of grain, vegetables, fruits, and poultry products
2. Forestry, including planting trees and introducing improved tree varieties
3. Production of non-phosphate washing powder
4. Technical upgrading of cotton manufacturing, printing, and dyeing enterprises
5. Manufacturing of new-type textile machinery
6. Construction and operation of highways, independent bridges, and tunnels
7. Development of coal processing and application technologies and manufacture of coal products
8. Deep processing of coal tar
9. Exploration, exploitation, and utilization of coal-bed gas resources
10. Construction and operation of thermal power stations with a unit capacity above 300,000 KW
11. Exploration and exploitation of copper resources (no solely foreign investment permitted)
12. Development and manufacturing of high-performance neodymium-iron-boron material and rare-earth electric motors

**The Inner Mongolia Autonomous Region**

1. Storage, preservation, and processing of grain, vegetables, fruits, and poultry products
2. Forestry, including planting forests and introducing improved varieties of trees
3. Production of health care beverage
4. Post-trimming of leather and production of high-grade leather products
5. Processing of dairy products
6. Technical upgrading of wool manufacturing and wool knit goods manufacturing enterprises

7. Construction and operation of highways, independent bridges, and tunnels
8. Development of coal processing and application technologies and manufacture of coal products
9. Exploration, exploitation, and utilization of coal-bed gas resources
10. Construction and operation of thermal power stations with a unit capacity above 300,000 KW
11. Construction and operation of wind power stations
12. Processing of rare-earth ore and production of rare-earth products
13. Exploration and exploitation of copper resources (no solely foreign investment permitted)
14. Processing of Chinese and Mongolian medicinal crops

### Heilongjiang Province

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting trees and introducing improved tree varieties
3. Deep processing of soybean and corn and development and production of their products
4. Technical upgrading of wood pulp and papermaking enterprises
5. Flax processing and production of lingerie
6. Construction and operation of highways, bridges, and tunnels
7. Development of coal processing and application technologies and manufacture of coal products
8. Exploration, exploitation, and utilization of coal-bed gas resources
9. Exploration and exploitation of copper resources (no solely foreign investment permitted)
10. Technical upgrading of highly refined aluminum processing enterprises
11. Manufacturing of electro-technical instrument and electrical network intelligent administration systems and control systems and devices
12. Development of computer software
13. Development and production of new-type electronic components

14. Exploitation and processing of graphite and production of graphite products
15. Production of raw material for antibiotic medicine
16. Production of frozen, dry, powder, and injection agents used in traditional Chinese medicine

### **Jiling Province**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Construction and operation of good-quality crops and livestock and fowl breeding bases
3. Forestry, including planting trees and introducing improved tree varieties
4. Comprehensive utilization of byproducts of crops such as corn straw
5. Technical upgrading and comprehensive development of chemical fiber wood pulp production enterprises
6. Construction and operation of highways, independent bridges, and tunnels
7. Construction and operation of wind power stations
8. Production of down-stream deep processing products of ethylene and fine chemical products
9. Manufacturing of automobile components and parts
10. Manufacturing of automobile electronic components
11. Development and manufacturing of high-performance neodymium-iron-boron material and rare-earth electric motors
12. Development and manufacturing of liquid crystal displays (LCDs)
13. Development of computer software
14. Cultivation and processing of medicinal plants and development of new pharmaceutical technologies
15. Pharmaceuticals with biological engineering technologies

### **Anhui Province**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic

products

2. Forestry, including planting trees and introducing improved tree varieties
3. Comprehensive utilization of bamboo resources
4. Technical upgrading of cotton manufacturing enterprises
5. Development and production of carbon fiber
6. Construction and operation of highways, independent bridges, and tunnels
7. Development of coal processing and application technologies and manufacture of coal products
8. Exploration, exploitation, and utilization of coal-bed gas resources
9. Exploration and exploitation of non-metal mines and deep processing of nonmetal products
10. Manufacturing of agricultural machinery
11. Manufacturing of copper-related electronic products
12. Development, construction, and operation of tourist attractions and their supporting facilities

### **Jiangxi Province**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting trees and introducing improved tree varieties
3. Comprehensive utilization of bamboo resources
4. Production of high-grade domestic ceramics, except blue-and-white porcelain.
5. Ramie spinning and production of ramie products
6. Construction and operation of highways, independent bridges, and tunnels
7. Development of coal processing and application technologies and manufacture of coal products
8. Exploration, exploitation, and utilization of coal-bed gas resources
9. Refining and processing of rare metals such as rubidium, cesium, cobalt, tantalum, and

niobium

10. Production of wet phosphoric acid and high concentration NPK composite fertilizer
11. Development and manufacturing of new-type electronic components and electronic luminescent materials
12. Processing of Chinese medicinal crop and Chinese patent drugs
13. Development and production of pharmaceuticals with fermentation technologies
14. Development, construction, and operation of tourist attractions and their supporting facilities

### **Henan Province**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting trees and introducing improved tree varieties
3. Technical upgrading of cotton manufacturing, printing, and dyeing enterprises
4. Construction and operation of highways, independent bridges, and tunnels
5. Development of coal processing and application technologies and manufacture of coal products
6. Construction and operation of thermal power stations with a unit capacity above 300,000 KW
7. Technical upgrading of copper processing enterprises
8. Exploitation and processing of native soda ore
9. Development and manufacturing of new-type electronic components
10. Manufacturing of new-type digital products and accessories
11. Manufacturing of electric energy comprehensive management automation and electro-technical instruments
12. Processing of fine-quality float glass
13. Cultivation and processing of Chinese medicinal crops

### **Hubei Province**

1. Storage, preservation and processing of grain, vegetables, fruits, poultry and aquatic products
2. Forestry, including planting trees and introducing improved tree varieties
3. Comprehensive utilization of bamboo resources
4. Rational exploitation and utilization of water resources and protective works
5. Cultivation and deep processing of aquatic products
6. Technical upgrading of cotton manufacturing, printing, and dyeing enterprises
7. Processing of high-grade clothing, linings, and garments
8. Construction and operation of highways, independent bridges, and tunnels
9. Construction and operation of wind power stations
10. Exploitation of phosphorus deposits and production of high-concentration phosphate fertilizer, phosphorus products, and salt chemical industry products
11. Manufacturing of automobile components and parts
12. Manufacturing of large-size environmental protection equipment
13. Development and manufacturing of new-type electronic components
14. Exploitation and deep processing of graphite

### **Hunan Province**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting trees and introducing improved tree varieties
3. Comprehensive utilization of bamboo resources
4. Red earth reclamation projects
5. Rational exploitation and utilization of water resources and protective works
6. Production of high-grade domestic ceramics
7. Ramie spinning and manufacture of ramie products
8. Construction and operation of highways, independent bridges, and tunnels

9. Development of coal processing and application technologies and manufacture of coal products
10. Mining and dressing of iron and manganese ore and deep processing of manganese serial products
11. Design and packaging of large-scale integrated circuitry
12. Production of semi-finished and finished products of Chinese medicinal crops and Chinese patent drugs

### **The Guangxi Zhuang Autonomous Region**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting forests and introducing improved varieties of trees
3. Comprehensive utilization of bamboo resources
4. Deep processing of rosin
5. Cultivation and processing of aquatic products
6. Comprehensive utilization of cane sugar production
7. Construction and operation of highways, independent bridges, and tunnels
8. Exploitation, construction, and operation of hydroelectric resources
9. Exploitation of indium and zinc non-ferrous metal deposit (no solely foreign investment permitted)
10. Technical upgrading of salt fluoride, salt chloride, and phosphate polymerize production enterprises
11. Development and manufacturing of new-type electronic components
12. Processing of semi-finished and finished products of Chinese medicinal crops and Chinese patent drugs
13. Development, construction, and operation of tourist attractions and supporting facilities

### **Sichuan Province**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products

2. Forestry, including planting trees and introducing improved tree varieties
3. Construction and operation of fine-quality agricultural products
4. Comprehensive utilization of bamboo resources
5. Upgrading of cotton, baste fiber, and silk manufacturing production
6. Construction and operation of highways, independent bridges, and tunnels
7. Development of coal processing and application technologies and manufacture of coal products
8. Development, construction, and operation of hydroelectric resources
9. Exploitation and processing of ore (no solely foreign investment permitted)
10. Exploitation of natural gas resources and production of products of gas chemical industry
11. Development of computer software and manufacturing of network products
12. Manufacturing of new-type digital products and accessories
13. Manufacturing of new-type electronic components
14. Development and production of Chinese medicinal crops, Chinese patent drugs, and photochemical materials
15. Development, construction, and operation of tourist attractions and their supporting facilities

### **Chongqing Municipality**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting forests and introducing improved varieties of trees
3. Comprehensive utilization of bamboo resources
4. Rational exploitation and utilization of water resources and protective works
5. Protection and renovation projects for the ecological environment in the reservoir region
6. Technical upgrading of ramie spinning and ramie production enterprises
7. Construction and operation of highways, independent bridges, and tunnels

8. Construction and operation of city metro or light rail networks (the Chinese side holds the controlling share or takes the dominant position)
9. Exploration and exploitation of natural gas and production of industrial gas chemicals
10. Manufacturing of components and parts for automobiles and other vehicles and electronic components
11. Manufacturing of large-size environmental protection equipment
12. Manufacturing of large-size complete automatic control systems
13. Production of semi-finished and finished products of Chinese medicinal crops and Chinese patent drugs

### **Yunnan Province**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting forests and introducing improved varieties of trees
3. Introduction, development, and operation of floristry industry; construction and operation of modern flower and plant gardens
4. Comprehensive utilization of bamboo resources
5. Cultivation and processing of natural perfume materials and edible mushrooms
6. Rational exploitation and utilization of water resources and protective works
7. Pollution administration and environmental protection projects for batteries
8. Development and production of produce and health care food
9. Comprehensive utilization of sugar cane production
10. Construction and operation of highways, independent bridges, and tunnels
11. Development of coal processing and application technologies and manufacture of coal products
12. Exploitation of phosphorus deposits and production of high-concentration phosphate fertilizer and industrial phosphorus chemicals
13. Development and production of traditional Chinese medicines and biological medicines
14. Development, construction, and operation of tourist attractions and their supporting facilities

## Guizhou Province

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting forests and introducing improved varieties of trees
3. Comprehensive utilization of bamboo resources
4. Rational exploitation and utilization of water resources and protective works
5. Construction and operation of highways, independent bridges, and tunnels
6. Development of coal processing and application technologies and manufacture of coal products
7. Technical upgrading of titanium refining and processing enterprises
8. Exploitation of low-grade and hard-to-dress metallurgical mines
9. Technical upgrading of barium salt production enterprises
10. Exploitation of phosphorus deposit and production of high-concentration phosphate fertilizer and phosphorus industrial chemicals
11. Development and manufacturing of new-type electronic components
12. Manufacture of semi-finished and finished products of Chinese medicinal crops and Chinese patent drugs
13. Development, construction, and operation of tourist attractions and their supporting facilities

### **The Tibet Autonomous Region**

1. Storage, preservation, and processing of grain, vegetables, fruits, and poultry products
2. Forestry, including planting forests and introducing improved varieties of trees
3. Production of goods with national characteristics, arts and crafts, packing and container materials
4. Construction and operation of highways, independent bridges, and tunnels
5. Construction and operation of electrical infrastructure and new-energy power stations
6. Exploitation and processing of chrome minerals (no solely foreign investment permitted)
7. Exploitation and utilization of salt lake resources
8. New-type dry cement production lines
9. Development and manufacture of Tibetan medicinal products
10. Development, construction, and operation of tourist attractions and their supporting facilities

### **Shaanxi Province**

1. Storage, preservation and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting forests and introducing improved varieties of trees
3. Technical upgrading of cotton manufacturing, printing, and dyeing enterprises
4. Construction and operation of highways, independent bridges, and tunnels
5. Development of coal processing and application technologies and manufacture of coal products
6. Exploration, exploitation, and utilization of coal-bed gas resources
7. Exploration and exploitation of copper resources (no solely foreign investment permitted)
8. Exploitation of natural gas resources and production of industrial chemical gasses
9. Manufacturing of on-bus electronic management system
10. Development and manufacturing of new-type electronic components

11. Production of natural drugs, medicines, and health products
12. Design and manufacturing of civil aircraft (the Chinese side holds the controlling share or takes the dominant position)
13. Development, construction, and operation of tourist attractions and their supporting facilities

### **Gansu Province**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting forests and introducing improved varieties of trees
3. Cultivation of fine-quality vineyards and vinification of fine wines
4. Deep processing of potato flour and cornstarch
5. Rational exploitation and development of water resources and protective works
6. Technical upgrading of wool manufacturing enterprises, development and production of industrial textiles
7. Construction and operation of highways, independent bridges, and tunnels
8. Production of ultra-high-grade graphite electrode and carbon products
9. Production of industrial chemical gasses
10. Manufacturing of drilling machines and oil-field equipment
11. Packaging of IC-component integrated circuitry and manufacturing of dedicated electronic equipment and instrument
12. Development, construction, and operation of tourist attractions and their supporting facilities

### **Qinghai Province**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting forests and introducing improved varieties of trees
3. Rational exploitation and utilization of water resources and protective works

4. Construction and operation of highways, independent bridges, and tunnels
5. Exploitation, refining, and processing of copper, aluminum, and zinc deposits (no solely foreign investment permitted)
6. Exploitation and processing of potassium resources
7. Comprehensive utilization of salt lake resources and manufacture of its products
8. Manufacturing of new-type building materials
9. Cultivation and processing of Chinese and Tibetan medicinal crops
10. Development, construction, and operation of tourist attractions and their supporting facilities

#### **The Ningxia Hui Autonomous Region**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting forests and introducing improved varieties of trees
3. Rational exploitation and utilization of water resources and protective works
4. Cultivation of grapevines and vinification
5. Cultivation and deep processing of corn and potatoes
6. Breeding of silkworms and processing of their cocoons
7. Construction and operation of highways, independent bridges, and tunnels
8. Refining and processing of tantalum and niobium ores
9. Manufacturing of tantalum capacitor and tantalum powder
10. Development, construction, and operation of tourist attractions and their supporting facilities

#### **The Xinjiang Uygure Autonomous Region**

1. Storage, preservation, and processing of grain, vegetables, fruits, poultry, and aquatic products
2. Forestry, including planting forests and introducing improved varieties of trees

3. Cultivation and deep processing of fine-quality tomatoes
4. Cultivation of fine-quality grapevines and vinification
5. Rational exploitation and utilization of water resources and protective works
6. Construction and operation of highways, independent bridges, and tunnels
7. Technical upgrading of cotton manufacturing enterprises and development of new products
8. Construction and operation of wind and solar power stations
9. Exploitation of lithium salts (no solely foreign investment permitted)
10. Development, construction, and operation of tourist attractions and their supporting facilities

*Source:* China Council for the Promotion of International Trade

**Appendix 2:  
A Partial List of Economic Development Zones Open to Foreign Investment  
(As of November 2003)**

| <b><u>Type</u></b>   | <b><u>Locations</u></b>  |
|--|--|
| Special Economic Zones (5 in Total)  | Shenzhen, Zhuhai, Shantou, Xiamen, and Hainan Province   |
| Coastal Open Cities (14 in Total)  | Tianjin, Shanghai, Qinhuangdao, Yantai, Qingdao, Lianyungang, Nantong, Ningbo, Wenzhou, Guangzhou, Zhanjiang, and Beihai   |
| Open Cities on Yangtze River (6 in Total)  | Wuhu, Jiujiang, Huangshi, Wuhan, Yueyang, and Chongqing  |
| Provincial Capital Cities in Inland Areas (including Capital Cities of Autonomous Regions) (19 in Total) | Harbin, Changchun, Huhhot, Taiyuan, Hefei, Nanchang, Zhengzhou, Wuhan, Changsha, Chengdu, Guiyang, Kunming, Lhasa, Chongqing, Xi'an, Lanzhou, Xining, Yinchuan, and Urumqi   |
| Open Cities (or Counties) on Border Land Areas (13 in Total)   | Suifenhe City and Heihe City of Heilongjiang Province, Tumenjiang City and Huichun City of Jilin Province, Eriianhaote and Manchuri of Inner Mongolia Autonomous Regions, Yining, Tacheng and Bole of Xinjiang Uygur Autonomous Region, Ruili, Hekou and Wanting of Yunnan Province, and Dongxing and Pingxiang of Guangxi Zhuang Autonomous Region            |
| Coastal Economic Open Regions  | A vast stretch of north-south panhandle on China's eastern coast including the Bohai Sea Rim, the Yangtze River Delta, and the Pearl River Delta   |
| Yangtze River Three Gorges Economic Open Zone  |  |
| Frontier Economic Cooperation Zones (14 in Total)  | Suifenhe City and Heihe City of Heilongjiang Province, Dandong City, Tumenjiang City, Huichun City of Jilin Province, Eriianhaote and Manchuri of Inner Mongolia Autonomous Regions, Yining, Tacheng and Bole of Xinjiang Uygur Autonomous Region, Ruili, Hekou and Wanting of Yunnan Province, and Dongxing and Pingxiang of Guangxi Zhuang Autonomous Region |
| Economic-Technological   | Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao  |
| Development Zones (32 in Total)  | Lianyungang, Nantong, Minhang, Hongqiao and Caohejing of Shanghai, Ningbo, Fuzhou, Guangzhou, Zhanjiang, Harbin, Changchun, Shenyang, Yingkou, Weihai, Kunshan, Hangzhou, Xiaoshan, Wenzhou, Rongqiao of Fuqing, Dongshan, Daya Bay of Huizhou, Nansha of Guangzhou, Wuhu, Wuhan, Chongqing, Beijing, and Urumqi   |

|  |   |
|--|---|
| High and New Technology Industries Development Zones (53 in Total) | Beijing, Wuhan, Nanjing, Shenyang, Tianjin, Xi'an, Chengdu, Weihai, Zhongshan, Changchun, Harbin, Changsha, Fuzhou, Guangzhou, Hefei, Chongqing, Hangzhou, Guilin, Zhengzhou, Lanzhou, Shijiazhuang, Jinan, Shanghai, Dalian, Shenzhen, Xiamen, Hainan, Suzhou, Wuxi (including Yixing Environment Protection Industrial Park), Changzhou, Foshan, Huizhou, Zhuhai, Qingdao, Weifang, Zibo, Kunming, Guiyang, Nanchang, Taiyuan, Nanning, Urumqi, Baotou, Xiangfan, Zhuzhou, Luoyang, Daqing, Baoji, Jilin, Mianyang, Baoding, and Anshan |
| Bonded Areas (15 in Total)   | Waigaoqiao of Shanghai, Tianjin, Futian and Shatoujiao of Shenzhen, Dalian, Guangzhou, Zhangjiagang, Haikou, Xiamen, Fuzhou, Ningbo, Qingdao, Shantou, Zhuhai, and Yantiangang of Shenzhen  |
| Tourist Resort Areas (11 in Total)                                 | Jinshitan of Dalian, Shilaoren of Qingdao, Taihu Lake of Jiangsu (including Taihu Lake of Suzhou and Wuxi), Hengsha Island of Shanghai, Zhijiang of Hangzhou, Mount Wuyishan of Fujian, Meizhou Island of Fujian, Nanhu Lake of Guangzhou, Dianchi Lake of Kunming, Silver Beach of Beihai, and Yalong Bay of Sanya in Hainan   |

Source: CCPIT; the US-China Business Council ([www.uschina.org](http://www.uschina.org))

**Appendix 3:  
Trade with China by Industry (in US\$ millions)**

| Industry                                 | 1997    |         |         | 2001    |          |         | 2003    |          |          |
|--|---------|---------|---------|---------|----------|---------|---------|----------|----------|
|  | Exports | Imports | Net Ex  | Exports | Imports  | Net Ex  | Exports | Imports  | Net Ex   |
| Agriculture, forestry, fisheries         | \$1,172 | -\$505  | \$666   | \$1,361 | -\$731   | \$630   | \$3,421 | -\$1,186 | \$2,235  |
| Mining                                   | 163     | -286    | -123    | 85      | -265     | -180    | 145     | -187     | -42      |
| Construction                             | 0       | 0       | 0       | 0       | 0        | 0       | 0       | 0        | 0        |
| Manufacturing                            | 10,976  | -60,885 | -49,909 | 15,372  | -100,478 | -85,107 | 20,556  | -150,106 | -129,551 |
| <b>Mfg. Industry</b>                     |         |         |         |         |          |         |         |          |          |
| Food & kindred products                  | 534     | -429    | 106     | 754     | -582     | 172     | 1,097   | -952     | 144      |
| Tobacco                                  | 3       | 0       | 2       | 0       | -8       | -8      | 1       | -5       | -4       |
| Textile mill products                    | 59      | -1,540  | -1,480  | 89      | -2,125   | -2,036  | 181     | -3,723   | -3,541   |
| Apparel & related products               | 9       | -7,248  | -7,239  | 28      | -8,394   | -8,366  | 11      | -10,613  | -10,603  |
| Lumber & wood products, except furniture | 35      | -440    | -405    | 102     | -836     | -734    | 176     | -1,115   | -938     |
| Furniture & fixtures                     | 15      | -1,570  | -1,555  | 18      | -4,580   | -4,562  | 22      | -7,649   | -7,627   |
| Paper & allied products                  | 397     | -340    | 57      | 489     | -652     | -163    | 594     | -1,048   | -454     |
| Printing, publishing & allied products   | 26      | -337    | -311    | 41      | -684     | -643    | 60      | -1,000   | -941     |
| Chemicals & allied products              | 1,989   | -1,159  | 829     | 2,105   | -1,696   | 410     | 3,190   | -2,263   | 928      |
| Petroleum refining & related             | 93      | -137    | -44     | 73      | -197     | -124    | 73      | -209     | -136     |

|  |       |         |         |       |         |         |       |         |         |
|--|-------|---------|---------|-------|---------|---------|-------|---------|---------|
| products   |       |         |         |       |         |         |       |         |         |
| Rubber & misc plastics products                        | 83    | -1,651  | -1,568  | 197   | -2,655  | -2,458  | 268   | -3,750  | -3,481  |
| Leather & leather products                             | 48    | -9,158  | -9,111  | 83    | -11,727 | -11,644 | 102   | -12,987 | -12,885 |
| Stone, clay, glass, & concrete products                | 1,645 | -1,388  | -1,224  | 191   | -2,286  | -2,096  | 154   | -2,747  | -2,593  |
| Primary metal products                                 | 277   | -648    | -372    | 253   | -879    | -626    | 839   | -1,000  | -161    |
| Fabricated metal prod., exc. mach & transp equipment   | 315   | -1,818  | -1,503  | 275   | -3,656  | -3,381  | 447   | -5,337  | -4,891  |
| Machinery, except electrical                           | 2,189 | -6,059  | -3,870  | 3,477 | -12,489 | -9,012  | 3,808 | -26,345 | -22,536 |
| Commercial & svc. industry                             | 47    | -1,634  | -1,587  | 145   | -1,860  | -1,715  | 189   | -3,283  | -3,094  |
| Computer equipment                                     | 308   | -3,332  | -3,024  | 1,182 | -8,174  | -6,992  | 1,011 | -18,642 | -17,630 |
| Engines & turbines                                     | 223   | -92     | 131     | 232   | -144    | 88      | 183   | -245    | -62     |
| Industrial machinery                                   | 265   | -46     | 219     | 377   | -101    | 276     | 515   | -229    | 286     |
| Electrical & electronic machines, equipment & supplies | 1,907 | -13,527 | -11,619 | 4,092 | -27,337 | -23,245 | 5,952 | -43,184 | -37,232 |
| Audio & video equipment                                | 16    | -3,515  | -3,500  | 93    | -6,921  | -6,829  | 128   | -12,305 | -12,177 |
| Communications equipment                               | 530   | -1,541  | -1,011  | 814   | -3,387  | -2,573  | 562   | -6,488  | -5,927  |
| Navigational instruments, optical, media               | 466   | -833    | -367    | 933   | -1,358  | -425    | 1,486 | -2,184  | -698    |

|                                |                    |                      |                      |                    |                       |                       |                    |                       |                       |
|--------------------------------|--------------------|----------------------|----------------------|--------------------|-----------------------|-----------------------|--------------------|-----------------------|-----------------------|
| Semi-conductors                | 562                | -2,736               | -2,175               | 1,799              | -6,514                | -4,714                | 3,239              | -9,609                | -6,369                |
| Transportation equipment       | 2,507              | -723                 | 1,784                | 2,669              | -1,782                | 887                   | 3,209              | -2,789                | 240                   |
| Motor vehicles & equipment     | 372                | -347                 | 26                   | 266                | -1,054                | -788                  | 586                | -1,791                | -1,205                |
| Aerospace                      | 2,125              | -44                  | 2,082                | 2,386              | -82                   | 2,304                 | 2,422              | -91                   | 2,331                 |
| Medical equipment              | 31                 | -504                 | -473                 | 96                 | -751                  | -655                  | 124                | -1,055                | -931                  |
| Misc. manufactured commodities | 295                | -12,210              | -11,915              | 339                | -17,161               | -16,822               | 427                | -22,336               | -21,908               |
| Transportation                 | 0                  | 0                    | 0                    | 0                  | 0                     | 0                     | 0                  | 0                     | 0                     |
| Communications                 | 0                  | -1                   | -1                   | 0                  | -6                    | -6                    | 1                  | -5                    | -4                    |
| Special industries             | 199                | -149                 | 50                   | 1,266              | -228                  | 1,038                 | 1,995              | -215                  | 1,781                 |
| <b>Total</b>                   | <b>\$17,570.00</b> | <b>(\$75,156.00)</b> | <b>(\$59,068.00)</b> | <b>\$24,864.00</b> | <b>(\$130,306.00)</b> | <b>(\$105,442.00)</b> | <b>\$33,052.00</b> | <b>(\$205,194.00)</b> | <b>(\$172,318.00)</b> |

Source: US-China Business Council

**Appendix 4:**  
**A Partial List of Laws and Regulations**  
**Governing Foreign Trade Management**

- Law of the People's Republic of China on Inspecting Import and Export Commodities
- Laws and Regulations Governing Management of Import and Export Commodities
- Regulations on the Management of Import and Export Business License
- Regulations on the Importing and Exporting of Cargoes
- Provisions of the People's Republic of China on Environmental Management of Chemicals imported for the First Time and the Import and Export of Poisonous Chemicals
- Provisional Regulations on Environmental Protection Regarding the Import of Wastes
- Procedures on the Implementation of the License System for Safety and Quality of Import Commodities
- Procedures on Exemption of Import and Export Commodities from Inspection
- Procedures on Re-Inspection of Import and Export Commodities
- Law of the People's Republic of China on Quarantine of Entrance and Exit Animals and Plants
- Law of the People's Republic of China on Border Hygienic Quarantine
- Regulations of the People's Republic of China on Foreign Exchange Control
- Provisions on Managing Settlement in, Sales of and Payment in Foreign Exchanges
- Procedures on Managing the Settlement in Foreign Exchanges Customs Law of the People's Republic of China under Current Account
- Customs Regulations of the People's Republic of China Concerning Protection of Intellectual Property Rights
- Import and Export Duty Regulations of the People's Republic of China
- Customs Inspection Regulations of the People's Republic of China
- Law of the People's Republic of China on Economic Contracts Involving Foreign Interests