

Developing Countries, China and Economic Institutions

Introduction

There has been a plethora of literature on the sudden growth of China as an international economic power but the reasons behind such growth have rarely been analyzed.. The growth has been attributed mainly to a remarkable level of Foreign Direct Investment (FDI), the effect of which is not only on China directly but indirectly on other developing countries as FDI investments have been diverted from Thailand, Malaysia, Philippines, India and other developing countries to China. North (1996) observed that formal economic theory and its dependence on mathematics has not been able to explain the economic problems of society. Using a deductive–axiomatic model, neoclassical economists have suggested optimally efficient outcomes through free trade between two liberal economies. Strategic Trade Theory has also suggested that economic outcome of a trade between a country having a high level of state intervention and a laissez faire economy is unsatisfactory.

A large number of studies have shown that it is the institutions that are responsible for various developmental progress (Scharpf, 2000) either through internal investment or through external investment (La Porta et al. 1998 and 1997, Levine et al, 1999, Keefer and Knack 1997, Mansfield, 1994). Keefer and Knack (1997) specifically mentioned that “...machinery and foreign investments are likely to be lower in countries where property and contractual rights are at risk” (p-601). Similarly, Maskus (1998, 2000) insisted that stronger systems for intellectual property rights would increase foreign direct investment and promote economic growth. Using the principles discussed in Douglas North’s book entitled “Institutions, Institutional Change and Economic Performance”, Marsh (1996, 1997) in a series of Working Papers has discussed the role institutions have played in the development and growth of countries of South East Asia.

Some of the important institutions identified by researchers are

- a. Financial institutions such as banks, stock exchanges, shares, the financial system such as currencies exchange system, openness and others (Bekaert et al 2000, Levine et al 1999, Beck and Levine, 2000, Easterly and Levine, 2000, Barth et al 2000, Levine, 2000, Filer et al, 2000)
- b. A proper legal system with an effective and impartial judicial system. The impartial and reliable contract enforcement system is a sine qua non of equitable and impartial enforcement relationships. The legal system is also responsible for certainty in property rights whether economic property or intellectual property (Pistor and Wellons, 1998, Lombardo and Pagano, 1999, Bortolotti et al, 2000, Mansfield, 1994).
- c. Political and governmental institutions and other administrative organizations like MITI in Japan, Economic Planning Board in Korea, and the taxation system (Olson, Jr. et al, 1998, Henisz, 2000, Mansfield and Milner 2000)

IFC (2000) in its report mentioned that “clearly defined property rights and the establishment of key supporting institutions” are a prerequisite for development and growth of any country.

In this article, I would discuss the important institutions identified by various research scholars such as rule of law, banking, privatization, equity capitalization, property rights

whether intellectual or economic, role of human resources or labor market institutions as described by Nelson and Sampat (2000), taxation policies, openness and other government related institutions leading to economic development in different countries including developed ones and their presence in China and whether these recognizable institutions were responsible for increase in external investment, export and phenomenal economic development in China in the last decade or so.

Institutions, Growth and Investment

North (1990) has defined institutions as the “rules of the game in a society, or, more formally, ...the humanly devised constraints that shape human interaction’ (p-3) . According to North (1996) ,’They are composed of formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behavior, and self imposed codes of conduct), and the enforcement characteristics of both.’ (p-8). Institutions affect economic performance by determining (together with the technology employed) the cost of transaction and production (North, 1997). Institutional environments operate at two levels

- a. the norms, customs, mores and religion and
- b. the polity, judiciary, laws of contract and property (Henisz, 2000).

These institutions have been studied in detail by La Ports et al (1997, 1998), Levine(1997, 1998a, 1998b, 1999).

Banks through informational asymmetries and economizing the costs apparently play a crucial role in technological upgradation, innovation, mobilizing resources, investments, and hedging of risks. A large number of empirical analyses ranging from firm level to country level suggests that there is a very close and positive link between the functioning of the financial system and long run growth (Levine, 1997). Sultan and Mishev (2000) concluded that the ‘the development of the financial system is a precursor and a necessary condition for sustained growth and economic transformation, especially in transition economies’. Levine (1997) went to the extent of arguing that the current level of financial development can predict the future rates of economic growth, capital accumulation and technological change. Chase Securities Inc. (1998) has also been quoted by Sultan and Michev, (2000) to argue that growth has positive relationships with lending to the private sector. By using credit to the private sector as the independent variable and the average increase in and the average of GDP growth between 1995 and 1997 as the dependent variable, Sultan and Meshev (2000) have shown that countries with a higher growth in private lending have higher levels of growth. They have also found that lending to the public sector reduces growth. Levine et al (1999) analyzed the causality between economic growth and the legal, regulatory, and policy determinants of financial development and found those countries with

- (1) “laws that give a high priority to secured creditors getting the full present value of their claims against firms
- (2) legal systems that rigorously enforce contracts, including government contracts and
- (3) accounting standards that produce high quality, comprehensive and comparable corporate financial statements

tend to accelerate economic growth through boosting financial intermediary development.”

China's progress in the last decade or so has been phenomenal and one of the important reasons for growth in China is because of foreign direct investment (FDI) which was only second to the USA in recent years (Coughlin and Segev 2000). What are the reasons for the sudden growth in foreign direct investment in China as compared to other developing countries?

If the USA is attracting foreign direct investment then one can understand that the institutions do exist in USA which are capable of absorbing the foreign direct investment and to make the appropriate return available. However, when FDI is directed towards China, then the analysis of institutions suggests something entirely different and quite difficult to understand. The FDI in China grew from 200 million dollars in 1980 to US\$ 44.9 billion in 1997. According to Coughlin and Segev (2000) the FDI in China would play 'a key role in the integration of China into the world economy' possibly suggesting that China was never a part of world economy and it is only FDI that can bring China into world economy. Branstetter and Feenstra (1999) suggest that SOE would oppose FDI but local governments are competing with each other to attract more and more FDI (Henley et al 1999).

FDI in China

Law of the Peoples Republic of China on Joint Ventures Using Chinese and Foreign Investment, 1979 followed by 'The Law of the Peoples' Republic of China on Enterprises Operated Exclusively with Foreign Capital, 1986 were two important steps in attracting FDI to China. The Law of 1979 was not very successful in attracting foreign capital. Apart from non-convertibility of Chinese currency, uncertain property rights were one of the important factors in realized FDI inflow. The majority of FDI started coming from overseas Chinese mainly from Hong Kong and Taiwan although the Taiwanese figure is very difficult to identify as Taiwan had officially not permitted Taiwanese firms to invest in China. The majority of Taiwanese firms used Singapore and Hong Kong as the indirect route for investment. FDI began to flow to China in large quantities only after 1992. Although there has been some slow down in FDI in China in 1999 (since 1998 the amount of FDI in China appears to be decreasing and it dropped by 7% in 1999 (China Ministry of foreign Trade and Economic Cooperation Statistical Data (http://www.moftec.gov.cn/moftec/official/html/statistics_data/e98-01-12d.htm) the estimated investment of US\$268 billion till end of 1998 is most impressive. China has become the largest recipient of FDI among developing countries and received 30% of the total amount of direct investment flowing to developing countries and 50% of total FDI going to Asia (Lemoine, 2000) although in 1998, the number of registered enterprises came down to 228, 000 from 240,000.

In the early nineties equity joint ventures were responsible for the largest amount of FDI but from 1993 to 1999, the share of EJV dropped from 50% to 32 %. From 1994 to 1999 the share of wholly owned foreign enterprises has gone up from 24% to 50% of the contract value essentially for management autonomy. FDI in shareholding increased rapidly in 1997 and 1998 but in 1999, it has come down. However, FDI stock per capita is much less than that in Malaysia and Thailand. FIEs constitute 45% of exports and 55% of imports in 1999. From 1992 to 1998, FDI provided China with 70% of total external resources although portfolio financing accounted for only 12% of external financing till the end of 1997. Almost all portfolio financing consisted of foreign bonds and only in 1997, investment in equity capital came up to 7% of external financing (Lemoine 2000).

According to Lemoine (2000) an underdeveloped and closed financial system and the lack of any transparency is responsible for such development.

Structure of External Financing in Selected Developing Countries

Country	Loans	Bonds	Equity	FDI
China	23	4	9	65
India	24	2	51	24
Brazil	20	49	9	22
Mexico	19	28	18	35
Indonesia	30	8	17	45
South Korea	68	28	10	-6
Thailand	84	4	5	7

Source: Lemoine (2000)

Portfolio investment in China were negative in 1998(-3%).

FDI in China (1992-1998) main countries of origin

Country	% of FDI
Hong Kong	52.3%
Taiwan	8.5%
Japan	7.8%
U.S.	7.8%
Europe	7.5%
Other \Asian countries	10.5%
Other countries	6.0%

Source: Various issues of Chinese Statistical Yearbook

Foreign Investors in China in 1998

Country	Amount in US\$ (in Million)
Hong Kong	18508
United States	3898
Singapore	3404
Japan	3400
Taiwan	2915
Korea	1803
UK	1175
Germany	737
Netherlands	719
France	715
Macao	422
Malaysia	340
Cayman Island	324
Canada	317

Italy	275
Australia	272
Switzerland	229
Philippines	179

Source: China Statistical Yearbook 1999

FDI in China: A Comparison of China's and Partner's Statistics (cumulated FDI over 1992-1997) \$ million

	China's statistics	Partner's Statistics	Difference
USA	14965	4281	10684
Japan	15385	14266	1119
Unite Kingdom	5021	488	4533
Germany	2346	2424	-78
France	1568	878	690
Republic of Korea	5996	3332	2664
Total	45281	25669	19612

Source: OECD, International Investment Statistics and China Statistical Yearbook

The above picture does not show true nature of investment at all as Hong Kong is used as a route by a number of countries and in particular by Taiwanese firms and because of direct relationships between foreign investors and mainland partners. The comparison of statistics from partner's countries would show the discrepancy.

FIEs were found to be much more export oriented than domestic firms. The export output ratio of FIE's was 40% as compared to 9% of domestic firms. FIEs play a major role in the most export-oriented sectors, except in garments. Processing operations account for 85% of total exports of FIEs.

Export Orientation of Domestic Firms and FIEs, 1997

	Export Orientation			FIE share in Export In % of Chinese Exports		Sectors share in Exports %
	Export in % of Output			All exports	Processin g	
	All firms	FIEs	Domestic firms			
Total industry	12.9	39.7	8.6	41.9	36.5	100
Instrument s	72	92.3	65.5	30.8	26.9	18.4
Leather and Shoes	53.1	99.9	34.8	53.0	49.0	8.6
Electric and Electr5ico nic goods	28.1	51.5	13.6	70.3	67.4	19.1
Wood, Furniture	23.6	70.9	15.5	43.8	30.7	3.2

Paper, cultural and sports goods	17.6	50.0	11.7	44.1	41.1	5.1
Basic metals	9.4	47.2	7.8	20.1	15.0	6.2
Chemicals	9.1	47.2	7.8	20.1	15.0	6.2
Industrial raw materials	8.0	31.7	7.4	9.8	1.3	4.1
Transport Equipment	7.0	17.3	4.9	42.2	38.2	3
Building materials	5.1	32.8	3.4	37.5	23.7	2.9
Machinery	5.1	24.6	3.4	37.4	29.9	3.2
Food industry	4.8	11.4	3.7	34.7	21.8	4.3
Other manufactured products	3	14.8	2.0	39.0	30.5	0.8

Source: Lemoine (2000), p-44

Chinese Financial Market Structure and Foreign Investment

China has ‘monobank’ system of banking where the functions of the central bank and commercial bank (and capital markets, too) are concentrated in one organization and is not a banking institution normally recognized as part of banking in other countries. The extensive bad loan problems leaves a lot of banks exposed in China. Apart from very tightly controlled banking system, ‘the four major state-owned commercial banks, but also a large number of regional banks established by provincial governments are directed in their lending by political considerations and not by economic viability.’ (Schlotthauer, 2000). China’s banks do not have any foreign competitors and the lending is essentially controlled by lending plans, which have to take into consideration loans to the SOEs.

Rate of Growth of Lending by Chinese Banks (in %)

	1983-89	1990	1991	1992	1993	1994	1995	1996
Nominal growth	17,0	23,6	20,0	22,3	42,1	23,8	22,9	25,3
Real growth	8,0	21,5	17,3	16,9	29,1	2,1	8,1	19,2

Real growth = nominal growth – inflation rate; Source IMF (1997) p-49

Banking Reform

Change in the banking system started in 1984 when the People's Bank of China was designated as Central Bank and four specialist banks for different sectors of the economy were established. The Bank of China kept the foreign exchange business whereas The Construction Bank of China, Industrial and Commercial Bank and the Agricultural bank of China were responsible for different sectors as the names suggest. Only in 1985, China switched from a grant-based system to loan based investment system.

Breslin (2000) characterized 1994 as the significant period as it 'represents the (as yet) incomplete attempt to build a new financial system. In 1999, Gao Zhanjun and Liu Fei (1999), p-55) tried to explain the lack of fully developed financial system by stating that 'China is now in an important historical period during which an old financial system is shifting to a new one and two are hitting each other ... New Financial institutions and business lines are constantly emerging, whereas the old financial system has not been broken up completely, nor has a brand new financial system has taken place.'

About 12 years before, Zhao Shaohua (1987) has made a similar remark when he stated 'The central Governments' comprehensible management system has been dismantled while new economic pillars have not yet been erected'.

The overall picture that emerges that there has not been much of progress in the last 12 years. The four major banks account for 70 % of household deposits and 70 percent of domestic credit. (Lardy 1998, Huang et al 1999). Government of China has subsidized loss making SOEs using commercial banks in the form of policy loans. These policy loans accounted for 35 to 40 % of total bank loans in the 1990s (Institute of Economics, 1998)

Official and Implied fiscal deficits, 1990-98

	Fiscal Revenue	Revenue GDP	Fiscal Expenditure	Official deficit /GDP	Policy Loans	Implied deficit /GDP
	RMB b	(%)	RMB b	%	RMB b)	% GDP
1985	200.5	22.4	200.4	0.0	185.8	-20.7
1990	293.7	15.8	308.4	-0.8	545.9	-29.5
1991	314.9	14.6	338.7	-1.1	678.2	-31.4
1992	348.3	13.1	374.2	-1.0	741.1	-27.9
1993	434.9	12.6	464.2	-0.8	932.3	-26.9
1994	521.8	11.2	579.3	-1.2	1148.5	-24.6
1995	624.2	10.7	682.4	-1.0	1416.0	-24.2
1996	740.8	10.8	793.8	-0.8	1986.2	-26.6
1997	865.1	11.6	923.4	-0.8	1986.2	-26.6
1998	985.3	12.4	1077.1	-1.2	N/A.	N/A.

Source: State Statistical Bureau of China, various years, China Statistical Yearbook, Beijing, China Statistics Publishing House (in Bonin, J. and Huang, Yiping, 2000).

The above table shows that if the policy loans were included, the deficit would go to on an average of 25%. Bonin and Huang (2000) also concluded that the projects financed by policy loans usually have high default rates. 83% of the all loans by the big four were to SOEs and 90 % of all lending for fixed investment by ICBC was to SOEs (Lardy, 1998, p-83). Banks also appear to have little autonomy in determining interest rates as well as

risk assessment as revealed by data from a survey by Hongling Wang of The Chinese Academy of Social Sciences

Investment applied for and approved by SOEs, 1994

	No. of sample SOEs	Investment applied for	Proportion of approved investment	Amount of approved investment	Proportion of firms denied	Net value of fixed assets in 1994
		RMB 000	%	RMB 000	%	RMB 000
Loss making firms	200	14941	47.9	6061	22.1	25146
Profitable firms	221	11997	52.4	7918	19.0	30346
Total	421	13393	50.2	7037	20.5	27880

The average capital adequacy ratio in 1996 was only 4.4 % which was lower than in 1994 and apparently lower than that prescribed by China's Commercial Bank Law (Lardy 1998). However, in 1998, the government recapitalized the capital adequacy ratio to 8 per cent.

	Capital Adequacy Ratio	Reported profit-/net asset ratio	Loan circulation rate
State owned commercial Banks	4.37	5.55	1.07
Industrial and Commercial Banks	4.35	6.17	1.3
Agricultural Bank	3.49	1.44	1.3
Bank of China	4.84	10.29	1.01
Construction Bank	4.81	5.7	0.68

Source: Peoples Bank of China (Li, 1998) and RGCFSR (Research Group for China's Financial System Reform, 1997)

Non-Performing Loans are very difficult to quantify in the Chinese system of accounting and confidentiality. The NPLs, which were still paying the interest, were not counted in the Chinese reporting. External auditing has only recently been introduced (Lardy 1998). The central bank once dictated that not more than 5, 8, and 2 percent should be classified as overdue, doubtful and bad loans respectively (Lardy, 1998). Bonin and Huang (2000) estimated that NPLs were in the range of nearly 29%.

Estimated proportion of NPLs and estimated costs of clean up

Study	Period	Estimate
Problem Loans(as % of outstanding loans)		
Li(1998)	End of 1996	24.4%

	Mid-1997	29.2%
CCER(1998)(China Center for Economic Research)	1997	24.0%
Fan(1999)	1997	26.1%
	1998	28.3%
Clean up costs (as percentage of GDP)		
Moody	1999	18.8%
Breslin, Shaun (2000)	2000	20%
Dornbusch and Givazzi (1999)	1999	25%

Compiled by Bonin and Huang (2000)

CCER¹, Dornbusch, R. and Givazzi, F. 1999, Bonin and Huang (2000) inferred the figure from Fan's (1999) reporting of share of NPLs in GDP. Moody's estimate was quoted from Australian Financial Review, August 1999).

Since the majority of the Bank's loans are made to the SOEs, non-performing debts of SOEs reported by Yuan (1999) should reflect the % of NPLs.

Data on NPLs exclude inter-bank and trust lending. If the trust bankruptcies are any indication of NPLs, then NPLs would cover more than 30 per cent of total credit.

Two observations quoted by Breslin (2000) from Xie Ping (1999, p-13) are quite disturbing.

“a considerable number of financial institutions to be restructured are jointly invested by local Governments and controlled by them. It is local government's intervention of senior management and business that cause the loss and difficulties of these financial institutions. Consequently, upon merger, restructuring and closure or even bankruptcy of these financial institutions, on the one hand local governments are only responsible for liabilities up to the amount of their investment, but on the other hand for the local interest their intervention in the described processes are severe. Even judicial justice can not be guaranteed since local judicial departments have to obey the orders of local governments.”

Xie Peng (1999) further stated

‘Since courts and judiciary department are subject to local Government, justice cannot be brought along in many fields’.

Gao Zhanjun and Liu Fei (1999) noted that despite the closure of GITIC and subsequent policy of merging these Trusts, there were 222 locally controlled ITICs with total assets of over RMB 460 billion Yuan at the end of 1998. Only in August 1998, PBC decided to remove the influence of local governments and introduce nine multi-provincial regional offices after abolishing 49 provincial branches (Breslin, 2000). China's banks are essentially extension of treasury and their responsibility appears to be limited to channeling savings to state owned enterprises. The US-China Agreement on WTO emphasizes that foreign banks would be able to conduct local currency business with

¹ China Center for Economic Research, 1998, Seeking Effective Policy Combinations under Multi Economic Objectives: Analysis of China's macroeconomic situation in 1998 and some recommendations, Economic Research Journal (Jingji Yanjiu) 4 (April 1998) 1-10).

Chinese enterprises and local currency business with individuals five years after accession.

Only in 1998, the credit quota system (for both working capital and fixed assets) was replaced by indicative quota and a system of asset/liability management.

Foreign Banks are permitted to operate only in Shanghai, Shenzhen, Guangdong, Guangxi, Hunan, Zhejiang and Jiangsu. The ceiling on their domestic lending was raised from 35 to 50 % of foreign exchange liabilities.

Reform of Stock Market

Levine and Zervos (1998) and Bekaert et al (2000) found that the equity market liquidity is correlated with rates of economic growth. ‘Decision on Issues Concerning the Establishment of a Socialist Market Structure’ adopted by the Third Plenary Session of the 14th Party Central Committee in November 1993 (Liew, 1997:86) was the first attempt in China to establish a modern enterprise system through corporatisation and shareholding. This program was followed by new tax system, downfall of CMRS and promulgation of Corporate Law (Zhu, 1999).

Only legal organized exchanges recognized in China are Shanghai Securities Exchange (SHSE, 1990) and Shenzhen Securities Exchange (SZSE 1991)

However, the Chinese stock market is primarily serving the SOEs (State Owned Enterprises) to help them in diversifying their ownership. There is no specific ban in Securities Law or in administrative regulations preventing non-state firms from seeking public listing but the quota system and the size requirements do not permit private firms to make it to the Stock Exchange either through initial public offerings or through buying into listed companies. Of the 976 companies listed on the Shanghai and Shenzhen stock exchanges, the number of private firms has gone up to 11 in 1999 from 4 in 1998 (IFC 2000). The Chinese Securities Regulatory Commission has recently announced the scrapping of the quota system permitting the underwriters to determine the timing and pricing of new issues. The quota was in the form of quotas to each province.

World Bank (1997, p-34) has calculated that if the capital market grows at more than projected GDP growth, by 2020 the value of stocks and bonds in relation to China’s economy, it would only approach the level of India’s capital market in 1997.

Reform of the taxation system

The taxation system reform took place only after 1994 when three categories of taxation were created. These were central taxes, local taxes and shared taxes. The Central government established a national tax service to collect both central taxes and those taxes, which it had to share with the local governments (Zheng 1999). China’s tax revenue increased to RMB 1 trillion (US\$124.54 billion) in 1999, nearly 13 percent more than 1998. The share of total tax revenue between central –province had reached 58/42 (Xinhua, 11 January 2000). However, tax revenue comprises only 40 per cent of all government revenue in China. Rest of 60 per cent revenue comes from extra fees (Gao Peiyong 1999).

Before 1994, provinces used to transfer fixed amount of taxes to the central government and retained the rest. After 1994, provincial governments may collect up to 25% of value-added tax, (of non-SOEs), agricultural tax, property tax and other smaller taxes. However, local governments can collect new fees which has led to proliferation of fees and they can be imposed without any legislative approval. The taxes appear to be negotiated rather than levied.

Labor

The PRC had more than 709 million people in labor force in 1999 accounting for about a quarter of the world's total labor force. The workers can be laid off for at least three years before they can be counted as unemployed.

Bajpai et al (2000) stated that Chinese Labor laws permits both employee and employer to give 30-day notice to the other party in the event that their labor contract is to be discontinued. Considering the employment problem in China, it essentially boils down to the right of the employer to terminate the contract after giving 30-days notice. China enacted a Trade Union Law on 3 April 1992 which permitted workers to participate in and organize trade unions but the Trade Union Law requires that a higher level trade union organization be in charge of leading and directing the lower level trade union organization (Article 11) and establishment of unions at any level be submitted to a higher level trade union organization for approval (Article 13). The total trade union activities are controlled by ACFTU (The All – China Federation of Trade Unions which is a part of Communist Party of China. According to Li (1999) , “some unions have been headed by top managers, deputy managers, department managers, or managerial cadres. Due to the problem with divided loyalty, predominant managerial presence in the union structure seems unable to counteract the emerging offensive of organized employers” (p-46). Right to strike is not permitted in the 1982 Constitution and neither it is part of the Labor Law. In the light of socialist public ownership, ‘the legislator might consider it impossible and meaningless for the workers, namely, the owners or the masters for the enterprises, to go on strike which would finally hurt the interests of workers themselves as well as social productivity” (p-47) . The lack of right to strike, practically no trade union freedom and control of trade unions by managers along with freedom to remove the workers make sure that the labor market institutions existing in other countries do not exist in China.

Legal System

According to North (1997), ‘In the Western world the evolution of courts, legal system and a relatively impartial body of judicial enforcement has played a major role in permitting the development of a complex system of contracting that can extend over the time and space, an essential requirement for a world of specialization.’ (p-2). Qian (1999) has observed that two of the most important aspects of the economic role of the rule of law are that first, the law should be applied to the government which would provide a foundation for secured property rights and the second is that the government needs to protect private property rights, to enforce contracts and to create a level field for market competition. Qian (1999) suggested that there has been one incident where villagers sued the provincial government for excess charging but so far there is no such thing as rule of law in China.

IFC (2000) has observed that rule of law “presupposes a protected private sphere whose economic aspects are defined mainly in terms of property and contract rights.” (p-35). Only in 1999, the principle of governing the country according to law was incorporated in the Chinese constitution (Li, 1999).

Although foreign investment has penetrated every major manufacturing sectors through joint ventures, technology transfer, export manufacturing, public securities, construction, real estate, and heavy industry, according to Corne (1997) the legal system of China is still uncertain. The law appears to be vaguely drafted, misapplied and arbitrarily

enforced. The Western style laws were introduced to attract badly needed foreign investment but the extent to which these laws have been actually established in the socialist legal system is open to question. Corne (1997) has characterized this as 'normative dislocation' because of normative vacuum created by weakened local norms. Although the Western law has been attempted to be applied in China, but in practice officials are applying provincial norms leaving extra-legal norms like nepotism, corruption and guanxi to run a system.

Administrative law comprising organic law, civil servants law, the law of administrative acts, and sectorial law, in China regulates China's vast economy and the relationships between its various actors. The sectorial laws responsible for administration of the legal area concerned with foreign investment, include public security, industry, cities, customs, finance, advertising, prices, transport, health, insurance, environment and natural resources, culture, patents, labor, quality, quality and standards. Quite unlike Western democracies, administrative organs wield overwhelming power in the Chinese legal system acting as legislative, interpretative, and enforcing institutions. According to Corne (1997), in the attempt to introduce market socialism and also to maintain central control over China's vast economy, China has 'adopted a rationale that lends itself to the creation of laws that are inherently flexible so that they may be adjusted according to the vagaries of human behavior.'

The Company Law of People's Republic of China ("Company Law") of the National People's Congress of China ("NPC") was passed only in 1993 with the purpose of regulating and standardizing the organization and conduct of companies to protect the legitimate interests of the shareholders and creditors and to stimulate the development of a socialist market economy (Company Law, Article 1) (Yuan, 2000). This law came into effect only on July 1, 1994. For the first time, the legality of private Chinese citizen's ownership of such organization and limited liability was recognized. Three types of companies are provided as per this law:

- a. The State Owned Company
- b. The Limited Liability Company
- c. Joint Stock Company Limited.

Foreign Invested Enterprise covers three types of enterprises

- a. Equity joint Venture: Limited liability company in which foreign investment should not be less than 25% of the total registered capital. It is the principal form adopted in China but the position is now changing
- b. Contractual Joint Venture
- c. Wholly foreign-Owned Enterprise

Unlike in western countries, the incorporation of a company is created not by right but through approval by MOFTEC and State Administrative of Industry and Commerce (SAIC).

The problem appears when it is found that Chinese written law does not reflect Chinese Law in practice. According to Yuan (2000), 'Part of the explanation for this problem is the de facto supreme position of the Communist Party in China...the policies of the Communist Party of China are essentially superior to the constitution and to governmental legislation....Therefore...some provisions of the Company Law and the FIE laws are not strictly enforced and are sometimes even totally disregarded by relevant governmental agencies; and that some governmental agencies may, without any statutory authority, impose additional requirements to the written laws and regulations.' (p-483).

Similar views have been expressed by Friend (2000), Yuanyuan (2000) and Berrings (2000).

Friend (2000) observed, ‘To be sure, the volume of legislation passed in China in recent years does not in and of itself mean that courts and legal system are any stronger or that the rule of law has taken hold. ...Judges frequently use “ideological discretion” to achieve “correct” ideological result which is consistent with CCP policy. This is not only legal in China but is actually mandated by the 1982 PRC Constitution”’ (p-374-375). According to Woo (2000), uniformity of result is not the goal of Chinese judges.

The new Company Law is also quite vague about private property when it talks of special rights over assets belonging to privatized companies.

Only in 1999, China adopted the Administrative Review Law permitting citizens and the private entrepreneurs the right to appeal an administrative decision. The bankruptcy law is applicable differently to SOEs and to other types of enterprises. There is no notion of personal bankruptcy. Transformation of WIOE or partnership into another legal entity is not permitted unless they liquidate their business and establish a new entity.

Law on Economic Contracts (ECL) was adopted in 1981, the Law on Technology Contracts in 1987 and Law on Economic Contracts concerning Foreign Interests or Foreign Economic Contract Law (FECL) in 1985. The contract between Chinese and Foreign Parties covers all international loans, sales and purchases, technology transfers and economic cooperation. The freedom of contract is not reflected in any of the present Chinese contract laws and it is still in fragmentary stage. A unified Contract Law has just been adopted in January 1999 and is part of the future Civil code

Intellectual Property Rights in China

The development of intellectual property rights in China is best illustrated by the relationship between USA and China and the number of agreements signed between these two countries ranging from 1992 to 1996. In spite of Sino-US Agreements, Seth Faison (1998) concluded that US loses over US\$ 2 billion due to intellectual property piracy in China alone². The cycle of threats and counter threats between China and USA has made the implementation of Intellectual property Rights in China particularly in the field of piracy lose its credibility (Feder, 1996).

The 1979 Agreement between China and USA required that “each party shall seek, under its laws with due regard to international practice, to ensure to legal or natural persons of the other party protection of patents and trademark protection correspondingly accorded by the other Party” and “each party shall take appropriate measures, under its laws and regulations and with due regard to international practice, to ensure to legal or natural persons of the other party protection of copyrights equivalent to copyrights protection correspondingly accorded by the other party”³. Following this agreement, China introduced a new trademark law in 1982 and patent statute in 1984 and joined WIPO and the Paris Convention for the Protection of Industrial Property in 1982 and 1984 respectively. There was always a question of property rights where the property rights have always been a nebulous entity under the socialist regime in China. In fact, enactment of these statute were related “to rapidly develop social productive forces,

² . Seth, Faison, China turns blind eye to pirated disks, N.Y. Times, Mar. 28, 1998

³ Agreement on Trade Relations between the United States of America and People’s Republic of China, July 7, 1979 U.S.-P.R.C., 31, U.S.T. 4652

promote overall social progress, meet the needs of developing a socialist market economy and expedite China's entry into the world economy"⁴ (Maruyama, 1999).

The USA introduced Special 301 was introduced in 1988 along with Super 301. Special 301 deals only with unfair trade practices dealing with Intellectual Property Rights and permits upon identification and non-resolving of issues within six months extendable to 9 months, to suspend or withdraw trade benefits or enter into binding agreements requiring the offending country to eliminate the offending practice or compensate the USA. Following the placement of China on priority watch list, China passed a new copyright law in 1990 and a separate set of computer software regulations in 1991. After threatening each other with trade sanctions in 1991, China and USA signed a Memorandum of Understanding on the Protection of Intellectual Property (1992 MOU)⁵ which led to sharp restrictions in availability of compulsory licenses. The new patent law was amended in 1992 by China with the extension of patent period from 15 years to 20 years and extended protection to all chemical inventions including pharmaceuticals and agricultural products. China also acceded to Patent Cooperation Treaty and Berne convention for the Protection of Literary and Artistic Works and ratified the Geneva Convention or Protection of Producers of Phonograms Against Unauthorized Duplication of Their Phonograms. Through a fresh amendment of its Copyright Law, China extended protection to software programs as literary works for fifty years. The National Trade Estimate Report in 1995 said that US industries lost more than US\$850 million due to copyright theft, alone which is accentuated by the export of counterfeit products to other countries. (Hu, 1996). Feder (1996) quoted Kantor that intellectual property laws in China was "sporadic at best and virtually non-existent for copyrighted works."

The whole cycle of threat and counterthreat of sanctions again started in 1994 and in 1995, both countries reached Agreement Regarding Intellectual Property Rights (1995 Agreement) following closure of 26 compact disc factories including The Shefei factory in Shenzhen. On February 26, 1995, Chinese Minister Wu Yi confirmed a series of actions taken and going to be taken and also enclosed an action plan to deal with infringement of intellectual property rights. (<http://www.cptech.org/ip/health/c/agreements/china-1995-ip.html>).

However, the 1996 National Trade Estimate Report on Foreign Trade Barriers: People's Republic of China stated that pirated and counterfeit goods exported from China to third markets continued at the same or higher level than before conclusion of the 1995 IPR enforcement agreement. In 1996, USA designated China as Priority Foreign Country for not protecting intellectual property rights. This led to another threat of sanction and countersanction game. The new Accord did stipulate that China would close down its piracy factory but it forbade American officials from monitoring and conducting on-site verification. Chow (2000) concluded that counterfeiting of trade marks, brands and other forms of intellectual property appears to be still on the rise in China. US Customs seized counterfeiting and infringing goods worth US\$29 million from China making China the leading country of origin of counterfeit goods accounting for 38% of the total seizure in USA (Chow, 2000).

⁴ Information Office, State Council of the People's Republic of China, Intellectual Property Protection in China (1994) Lexiis, News Library, BBCSWB File

⁵ Memorandum of Understanding Between China and the United States on the Protection of Intellectual Property Rights, 34, I.L.M. 677 (1995). Art 1(1) 34 I.L.M. at 677

In 1997, China introduced Regulations for the Protection of New Plant Varieties and followed by joining the International Union for the Protection of New Varieties of Plants on April 2000. In August 2000, China issued its first law to protect the owners of recognized trademarks from Internet squatters. The State Patent Bureau was upgraded in 1998 to Ministry level branch of the State Council known as the State Intellectual Property Office. It also established China Intellectual Property Training Center in Beijing in 1997 to provide training to government officials, businessmen and lawyers. The year 2000 National Trade Estimate Report even suggested that China has become net importer of pirated music and video CDs. However, the Copyright Alliance gives different story. The loss calculated by US industry due to piracy can be questioned on the basis whether Chinese consumers would be able to afford the goods at normal prices set by the western manufacturers. The American trade deficit has also been attributed to the American policy of raising the exchange rate of dollar thereby raising the cost of the American goods in the international market (Maruyama, 1999).

According to Bloch (1997) a large portion of all Chinese exports earnings go to foreign firms who process nearly half of Chinese exports.

Patrick H. Hu (2000) also suggested that so called protection of intellectual property in USA itself is subjected to so many exceptions that the American debate overstates the intellectual property right situation. According to Hu (2000), "It protects the public domain against ill-advised improvisation by copyright holders, the statute includes safeguards such as the originality requirement, the fair use privilege, durational limits of copyright protection, and the idea-expression dichotomy" (P-29).

The 1976 Copyright Act of USA lists four criteria to determine fair use. These are

- a. the purpose and character of the use, including whether such use is of commercial nature or is for nonprofit educational purposes;
- b. the nature of the copyrighted work
- c. the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and
- d. the effect of use upon the potential market for or value of a copyrighted work.

17 U.S.C. §107. (Fisher, 1988, Pierre, N. Leval, (1990).⁶

(Landes and Posner, 1999).

Allford (1995) has mentioned that the software industry has lost more than US\$ 3.4 billion in revenues in 1990s in the USA itself because of software piracy. The International Planning and Research Corporation has, in 1996 Global Software Piracy Report estimated that the piracy rate in US itself is nearly 25 %. Assafa Endeshaw (1996) was quite categorical that all the present industrialized countries did not open up or had strong IP system before becoming industrialized. Although this does not justify the violation or abuse of intellectual property rights but it should keep the industrialized countries away from their moral pedestal. (RIAA v. Diamond Multimedia Sys., Inc., 180 F.3d 1072(9th Cir. 1999).

Only about 9.8% of the world's inventions are non-service inventions and these non-service inventions done by individual inventors are normally have a lower technological level. However, People's Daily (Overseas ed.) Aug. 5, 1989 at 1 reported that non-service inventions account for 54.5% of all patent applications.

⁶ Eldred v. Reno, No. 1, 99CV00065 JLG (D.D.C. 1999, Sonny Bono copyright Term Extension Act

Ansson (1999) has quoted from China: New Measures Will be taken to Protect IPR⁷ using the plea that Chinese products have been patented by foreigners as such these patent laws were supposed to protect Chinese businesses in patenting their goods. According to Endeshaw (1996) the USA signed 1883 Paris Convention but did not approve 1886 Berne Convention due to the presence of an international copyright clause. Only in 1952, did the USA become a member of Universal Copyright Convention (UCC).

China Daily, China: Laws Being Promulgated to Protect IPR,⁸ in Ansson (1999) estimated that from May 1991 to 1997, 20839 IPR cases were heard of which 3915 were related to copyright, 4557 to patents, 1362 to trademarks, 8569 to contracts and 3156 to infringement of scientific know-how and technical know-how and unfair competition. Five cases were made public involving pirating of films, copying of toy theft of geological praopector's results and the illegal printing of book. One involved trademark of a shoe.⁹

Wang (2000) and Hu (2000, 2001) have been emphasizing that the problem of Intellectual Property rights in China is that of an infant legal system which has just started to come to terms with the enactment and enforcement of Intellectual Property Law. According to them, China has not been a pluralistic society and did not need laws regulating business transactions because it was a small scale farming society. The rule of law was approved only in principle and that only in 1996 in Fourth Session of the Eighth National People's Congress of the PRC.¹⁰ Since the legal profession has been established in 1980, China has nearly 95000 lawyers out of which 49500 are full time lawyers. Among full time lawyers, 13, 800 have the law degree and about 25000 attended training schools. (Wang 1998, p-25, quoting peoples Daily Overseas eds, Nov. 16, 1996, at 3). 24% of 7500 China's law firms are not state funded (Forney, 1966). These figures are paraded as the legal progress of China, which to an outsider appears to be miniscule for an economy the size of China. Both Wang (1998) and Hu (2000) mentioned that judges are not qualified at all and the majority of the judges have political background and they come from army. Legal training seems unnecessary to become a judge. The law of judge was enacted only in 1995.

There are very few contract theories and rules in old traditional China and practically none in Socialist China. Quoting Song and Dai, (Yan Rong Song & Zi Geng Dai, Intellectual Property Lawsuits Increased Yearly and the Legal Experts Are Worried as Well as Pleased, Guangming Ribao [Enlightenment Daily], June 6, 1993, at 4), Wang (1998) said that 20% of the patent law suits resulted from ignorance and sometimes under misconception that imitation of patented products is in conformity with the free competition and anti-monopoly.

However, one theory has emerged from the recent studies of Chinese patent and IPR problem that the piracy problem or the infringement of IPR has resulted from crisis of morality or disillusionment with ideology.

⁷ China Bus. Info Network, Apr. 4, 1997 available in 1997 Westlaw 9842657

⁸ NO 10 1997, available in 1997 WestLaw 13647865

⁹ China: IPR Violators Penalized by Courts in China, China Business Info. Network July 17, 1997 available in 1997 Westlaw 10577882.

¹⁰ (Digest of the Speeches of the Forum on "Rule of Law", 3 FAXUE YANJIU, [Cas Journal of Law], 3,3 (1966).

Article 62 of both 1984 and 1992 Patent Law provides that where ‘any person uses or sells a patented product not knowing it was made or sold without the authorization of the patentee’, it shall not be deemed an infringement of the patent right. Wang (1998) suggested that this part of the law should be changed. However, according to Wang (1998) major problem is not the legislation but in the law enforcement. Quoting case of Mengqiu Yan, Wang (1998) stated that ‘...the problem is the conflict between the authority of the CCP and the authority of law, a subject of political reform. Whether the legislation is defective or perfect means little’.

Both Wang (1998) and Hu (2000) have concluded that the non-implementation of the judgments passed and the local protectionism are so pervasive in China that legislation and the judges cannot make any impact. The independence delegated to the local administration has resulted in fuzzy division line between economic powers of state and local governments. Judges are elected by the local people’s congresses and judges are subject to removal. Judicial Departments have no real power and are controlled to a large extent by the officials of the CCP. Local courts are supposed to report to party committees, people’s congresses and upper level people’s courts but leadership in China is more personal than institutional and the lack of concrete institutional support in the form of financial and political help to judges makes it difficult for a judge to be impartial. or judicious.

Tackaberry (1998) has compiled a list of piracy and its violations in China quoting a number of sources which suggest that only 4% of the software was legitimate in China in 1996 and that 9 out of 10 compact discs manufactured in China are counterfeit (South China Morning Post 1999, IP Asia 1997, Business Software Alliance 1996). According to Korski (1996) more than 32 million pirated compact disks were produced in China in 1996 which is many times more than the demand in China and were used for flooding international market. However, CDs are not the only item to be copied. They include Kiwi shoe polish, Dupont chemicals, Chrysler Jeeps to Kellogg’s cereals (Blusstein and Mufson 1996). According to Tackaberry (1998), ‘the march towards effective, reliable IPRs in China will indeed be a long one’. (p-29).

Ansson (1999) has narrated the case of Prozac manufacturer in China quoting a number of publications.¹¹ Eli Lilly had the patent for manufacturing Prozac through 2003. It applied to State Pharmaceutical Administration with details of drug patents to ensure that local drug makers do not manufacture the said drug. The lower Chinese courts decided in favor of Chinese pharmaceutical manufacturer. In 1998, Eli Lilly appealed this judgement to Chinese Supreme Court.¹² Novartis has similar problem with fungicide Lamisil and the immunosuppressive agent Neoral, both patented by Novartis AG.

The Chinese piracy problem percolates to Hong Kong, which was put on priority watch list in a special Section 301 review in May 1997¹³. Hong Kong, Malaysia and Singapore reported 5% increase in software piracy whereas piracy level went down in all other

¹¹ The Independent: Prozac Makers Act Over Chinese Copy, Chemical Business NewsBase: The Independent, June 26 1998 available in 1998 WestLaw 10611957

¹² (Craig S. Smith and Jennifer F. Maurer, Eli Lilly Targets Chinese Law Allowing Copying of Patented Drugs, Dow Jones Online News, Mar 24, 1998 available in Westlaw DJONLINE 16:32:00

¹³ News Analysis: SPA Launches War on Illegal software Use, Asian Computer Weekly, Oct27 1997 available in 1997 WL 12606878)

Asia-Pacific countries by nine percent.¹⁴ Asia Computer Weekly again reported that in spite of large number of modern laws, Hong Kong was again placed on the USTR's copyright piracy watch list on May 1, 1998 because of extensive CD, software and films piracy. According to USTR, prevalence of pirated products is highest in Hong Kong.

Privatization

In 1999, Constitutional Amendment brought a formal recognition of private sector but only leading to the formation of a socialist economy. IFC (2000) has classified three phases in the development of private sector in China. These are

Phase 1: 1978-83

Here the private sector was limited to individual businesses and they were perceived as supplementing the state and collective sectors.

Phase 2: 1984-92

It is signified by the rise of privately run enterprises employing more than 8 people. The State Council issued the Tentative Stipulation on Private Enterprises (TSPE) to govern the registration and management of private firms. They were still recognized to be part of the socialist publicly owned economy.

Phase 3 : 1993-present

The 15th Party Congress held in September 1997 first time brought the private economy as an important component of the economy along with the rule of law which were incorporated into the Chinese Constitution in March 1999.

The sequence of development has followed the route where unpublicized experimentation is in general leads to 'in principle' approval and followed by regulations. Such development took place without clearly defined property rights which made McKinnon (1992) to conclude that property rights is not necessarily a precondition for development of private sector. However, IFC (2000) observed that unclear property rights slowed growth of many firms and the hybrid form of firms has led to massive corruption.

However, the performance of private sector is difficult to measure because the classification system for the components of economy mixes the concept of "ownership, sectors and corporate organizing methods". Less than 1% of working capital loans were disbursed to private sector. IFC (2000) study also emphasized that it can be roughly estimated that private sector's contribution has been significant if agricultural and cooperatives are added to it but its continued development needs rule of law and removal of informal system of transaction. The Government of China does not permit private firms from entering 15 types of industries. These are

- a. Production and sale of gold and silver products
- b. Taxis
- c. Private real estate market except in Beijing
- d. Radio and audio products
- e. Safety products and rubber products
- f. Pressure containers
- g. Inflammable products
- h. Radio Transmission Equipment
- i. Anesthetic, psychiatric and radiation medicines
- j. Recycling

¹⁴ Joy Tang, Hong Kong needs Tougher Anti-Piracy Laws, Asia Computer Weekly, Mar 31, 1997 available in 1997 West Law 8890172

- k. Air guns and hunting rifles
- l. Antiques designated by the government
- m. Important raw materials
- n. Copper, steel, iron and platinum
- o. Polyethylene products

Private capital is also not permitted in banking, railways, freeways, telecommunications, and wholesale networks for a large number of goods. According to IFC (2000), automobiles manufacturing and chemical fibers are restricted through an unpublished list. Before 1998, private firms were not allowed to export directly. After 1998 only, private companies were granted direct export license. Only 150 private firms were granted Self-Import/Export Rights. The minimum registered capital as well as net assets of more than US\$ 1 million and minimum annual sells of US\$ 6 million and the export value must exceed US\$120,000 continuously in the previous two years. Pure trading companies to export and import are still not statutorily permitted. Under, an agreement with US regarding entry of China to WTO, all Chinese enterprises would be granted free trade rights within three years after Chinese accession to the WTO.

Types of Entry Barriers by firm Size (percentage of firms with yes answer)

Number of Employees	Licenses	Policy Restrictions	Local Protection	Industry Monopoly	Market Size
< 51	22.6	29.0	6.5	29.0	12.9
51-100	50	12.5	12.5	25	0
101-500	37.5	37.5	18.8	0	6.3
> 500	80	0	20	0	0

Source: Survey of IFC (2000)

The main barriers are government licenses, general policy restrictions and local protection. Registered capital requirement for a private limited company in China is one of the highest in the world.” It should be US\$ 60,000 in case of wholesale trade or manufacturing and US\$ 36,000 for retail trade.

With few exceptions private firms were excluded from exporting directly .

Explanation for FDI in China

Zhang (2001) analyzed the inward foreign direct investment (FDI) by multinational corporations. He concluded that China’s huge market size, liberalized FDI regime, and improving infrastructure were found to be attractive to multinationals.

Although many multinationals have had a positive experience from investing in China, scores of others have little or no profit to show after years of effort (Johnson, 2000). In the first nine months of 2000, China raised more than 9 billion in international equity issues and had foreign investment to the tune of US\$40 billion a year for the past five years. The high flying 1996 and 1997 “red chip” H-share issues traded on Hong Kong market went down by 20 to 30% of their value. Lubman (2000) found that the substantive law is so unclear ‘that a fair and predictable interpretation of the law is nearly impossible ...enforceability of that judgment by a local Chinese Court is extremely difficult, unnecessarily time consuming, and often unsuccessful.’. Chuang (2000) described in detail withdrawal of certain multinationals altogether from Chinese market.

USA has granted Permanent Normal Trade Relations (PNTR) to PRC in 2000 to stop the annual debate on extension of MFN Clause.

Percentage Composition of China's merchandise imports classified by Customs Regime

Regime	1992	1993	1994	1995	1996
Ordinary trade	44.5	39.6	33.2	32.8	28.4
Processing with Customer's materials	15.7	12.5	13.1	12.3	12.8
Equipment imported for PCM	1.5	1.3	1.1	0.9	0.8
Processing with Purchased materials	23.4	22.5	28.1	31.9	32.0
Customs Warehouse Imports	-	-	-	4.5	5.2
FIE Investment Goods Imports	10.0	16.0	17.5	14.2	17.9
Barter Trade	-	3.8	2.1	1.1	0.6
Residual	-	4.3	4.9	2.3	2.3

Sources: Dickson, Ian (1997)

Dickson (1997) concluded that processing constitutes a large part of imports to China. Import penetration ratio calculated by Lemoine (2000) where she has taken out imports for processing, shows that it represents on average only 5% of domestic demand in 1997 and a large part of it is directly connected with FIEs needs. Domestic firms constituted less than 3.2% of imports. FIEs constituted a relatively strong position in the domestic market as compared to imports.

Lemoine (2000) tried to identify the Chinese trade pattern. Breslin (2000, 1998) observed that growth in Chinese trade was to a large part because of the foreign affiliate activity where China serves as an assembly base for a number of Asian manufacturing firms and Chinese processed export account for half of exports have mostly imported content. Total Chinese exports rose from 2.3% to 3.4% of world exports from 1992 to 1998 and FIES were found to be responsible for almost all the increase as their exports rose from 0.5% to 1.5% of world exports. The share of processing exports almost doubled from 1.1 % to 1.9% accounting for almost 80% of China's gain in world exports. Hong Kong and Taiwan are two of the largest sources of FDI, Japan and USA are also actively pursuing the entry.

Market size and labor costs have been considered as significant factors. Other factors are local taxes and infrastructure. Fung et al (2000) found that FDI from Japan and USA is different from FDI from Hong Kong as the former FDI is concentrated in the regions having better labor quality whereas FDI from Hong Kong appears to be essentially in labor intensive industries requiring low skill of labor. Wage variables were found to be insignificant. IFC (2000) has observed that since foreign private enterprises operated as joint ventures with local collectives or SOEs and obtained significant tax advantages, many domestic entrepreneurs invested through offshore companies to qualify as foreign investors. A significant proportion of investment from Hong Kong is believed to be part of this "roundtripping" by domestic entrepreneurs.

Ethnic Chinese networks has also been said to be responsible for majority of Foreign direct investment (Rauch and Trindade, 1999). These explanations have ignored that it is not the foreign investment brought in China but the opening of the main reason is opening of the market for goods produced in China by Western countries. China was

never as isolated as has been projected as Hong Kong has always been used as the route for international trade with China (Fung 1996).

Comparison of FDI in China and India

The study of FDI in China and India would help us in coming to proper understanding and bring about proper perspective and would help in identifying the reasons for the extraordinary level of FDI in China.

Bajpai and Sachs (2000) observed that actual FDI as a proportion of approval in India was only 21.9 percent between 1991-1998 as compared to China and other similarly placed countries.

Foreign Direct Investment: Actual Inflows vs. Approvals

	1991	1992	1993	1994	1995	1996	1997	1998	1991-98 Total
Approvals in \$US Million	325	1,781	3,559	4,332	11,245	11,142	15,752	6,132	54,268
Actual Inflows in US\$ in Million	155	233	574	958	2,100	2,383	3,330	2,073	11,806
Actual as % of Approval	47.7	13.1	16.1	22.1	18.7	21.4	21.1	33.8	21.7

Source: Bajpai and Sachs (2000) based on Economic Survey, 1998-99, Government of India

FDI by Host Region (US\$ Million)

Country	1993	1994	1995	1996	1997	1998
India	233	574	973	1964	2382	3264
China	11,156	27,515	33,787	35,849	40,800	45,300
Indonesia	1,777	2,004	2,107	4,348	6,194	5,350
Korea, Rep. Of	727	588	809	1,776	2,325	2,341
Malaysia	5,183	5,006	4,342	4,132	4,672	3,754
Philippines	228	1,238	1,591	1,459	1,520	1,253
Thailand	2,114	1,804	1,322	2,002	2,268	3,600
Developing Countries Total	51,108	72,528	95,582	105,511	129,813	148,944
India's share in developing Countries	0.5	0.8	1.0	1.9	1.8	2.2

Economic Survey: Government of India, 1999

Bajpai and Sachs (2000) in fact did observe, “When it comes to comparing China and India, why can India not match or even outpace China in attracting FDI given India’s superior conditions regarding the rule of law, democracy, and the widely spoken English language?” (p-3)

WEF’s 1997 global executive survey identified six important factors that determine FDI location according to which the market size is supposed to be the most important factor, followed by expected growth in market size, Competitiveness, tax rates, exit barriers, wages, project approval procedures and decentralized decision making. The ability to repatriate capital, productivity and work habits and quality of infrastructure are also important factors influencing FDI.

Bajpai et al (2000) have compared the performance of Export Processing Zones in India and those of China. Starting as late as 1979, exports increased from US\$ 9.8 billion in 1978 to US\$38.1 billion in 1995 with more than 120000 enterprises with foreign investment employing more than 16 million workers. Corporate tax rate was only 15% when tax rate at other places was 55 percent for domestic firms and 40 per cent for foreign firms. Two years exemption for foreign firms from the date such firms start making profit and 50 % tax reduction for another three years. For promotion of exports, an additional 10 percent tax reduction has been implemented for firms that export more than 70 percent of their products and export duties are also not levied on goods produced in SEZs. The incentive in Indian Exporting processing zones are practically same and in certain cases more where twenty five percent of goods can be sold in domestic area with 50% customs duty. The incentives do not necessarily explain the reason for extraordinary growth in SEZs in China compared to those in India.

The Global Competitiveness Report, 1999 suggest some of the facts and give the respective position of different countries in 1999 although we have to examine old report to suggest the reason for competitiveness and attraction for FDI.

Factor rankings for India and Selected Countries

Country	India	China	Singapore	Malaysia	Korea	Thailand	Mexico	Philippines	Indonesia	Brazil
Overall Rank	52	32	1	16	22	30	31	33	37	51
Openness	59	52	2	23	35	33	28	42	21	53
Government	27	13	1	4	17	9	24	12	5	50
Finance	46	19	2	10	18	25	44	38	51	53
Infrastructure	51	49	7	25	27	36	40	46	41	44

Technology	38	43	2	24	19	44	31	41	51	37
Management	41	53	12	26	32	40	28	24	46	29
Labor	56	15	1	19	26	48	34	28	42	53
Institutions	35	36	2	30	32	34	45	49	55	41

Source: Global Competitiveness Report, 1999

There appears to be practically no difference between China and India as per the Global Competitiveness Report although some of the rankings need explanation particularly those pertaining to finance where China has been ranked at 19 compared to India without any worthwhile financial institutions. India allows repatriation of capital along with capital appreciation. Remittance of dividends is freely permitted and remittance of principal and interest on foreign loans is freely allowed if it has been previously approved by RBI. In terms of collaboration agreements, remittance of royalties, technical fees, and salaries to foreign employees are freely allowed. The most important difference is in the area of labor where India has been ranked at 56 compared to China's 15. In terms of current market size and the expected growth in market size, India is just after China.

Two of the important differences are that stringent condition of exit barriers and stringent labor conditions. With regard to labor regulations and hiring and removal practices, India has been ranked 55th and 56th respectively in the Global Competitiveness Report.

Competitiveness report appears to be quite flawed particularly regarding Finance and technology. The banking loans are normally directed towards SOEs, TVEs and collectives. Private enterprises would have to wear red hat to get banking loan. Similarly, the equity market has been diverted towards SOEs. There is a lack of clear asset title and a clear corporate governance. IFC (2000) has noted that, "without a transparent financial track record, clear asset ownership and clear corporate governance" (p-32), private firms do not have much hope ever getting the permission to list on the stock exchange. IFC (2000) found that among the private firms it had surveyed, 90 percent relied on self-financing for their initial capital.

IFC (2000) survey of Chinese private enterprises found that governments and administrative officials concentrate on rent seeking activities partly because their role is ill-defined and partly because their functions are obsolete and not in commensurate with the market system. With such type of situation, how China was ranked at 13 by WEF compared to India at 27 is quite surprising.

Discussion

The above analysis suggests that China does not have any of the properly developed institutions like banking, stock market, rule of law, contract and company law, intellectual property law, independent judiciary, property rights, or taxation system and neither an open economy facilitating both internal and external investment particularly foreign direct investment, even then it has shown phenomenal growth in and diversion of foreign direct investment from other developing countries. Lemoine (2000) identified reasons for FDI from Asian countries because of cheap labor whereas those of developed countries because of domestic market. Hatch (1999) concluded that out of US\$37 billion invested in China, US\$20.5 billion came from Hong Kong and about three billion each from Taiwan, Japan and USA.

Bergsten (1998) stated that China is emerging as the first economic superpower in modern times that is neither rich nor fully marketed nor democratic.

Chinese Networks have been suggested as responsible for FDI in China but the Chinese network had been given access to the Western market by specific intervention of the Western government particularly that of the USA. Although the majority of FDI has come from Hong Kong and Chinese network, but the fact that the market has been provided by Western countries supports the view that either through direct foreign direct investment or through buying the products manufactured by FDI from Hong Kong and Taiwan, the major role has been played by Western countries in pushing for FDI in China. The US and other governments ostensibly have the laudable aim of bringing human rights issues to the fore in China and possibly bring China in the market economy, the inroad of multinationals does not appear to support this laudable goal of their governments.

The most important aspect noticed in our research has been the role of foreign governments in FDI in China. It not only increased FDI to China but it diverted FDI from other countries to move to China. While Chinese networks have been reported to be largely responsible for FDI, other multinationals also did not lag behind and the Governments around the world opened and encouraged the market for goods from China through a number of incentives. The most remarkable incentive has been the non-application of trade barriers through imposition of countervailing duties. Anti-dumping duties are also not based on the actual value of cost of production but based on similar cost of production in other democratic countries from where the data are available.

Wang (1996) and Laroski (1999) have analyzed the approach of US Trade Laws concerning non-market economies. The US Department of Commerce determined that the concept of subsidization has no meaning in an economy in which costs and profits are determined by central planning rather than market forces. The Court of International Trade made following observations

“Government activity in a non-market economy cannot confer a subsidy because a subsidy, by definition, means an act which distorts the operation of a market. In other words, for a subsidy to exist there must be a free market to provide an independent, essential reference point or bench –mark for measuring whatever is allegedly a “subsidy” to a particular enterprise. Without the uncontrolled market, there can be no subsidization...”¹⁵

Wang (1996) concluded that

- a. subsidies used by non-market economies act as unfair trade barriers, as evidenced by the harm they can inflict on domestic producers of the importing country
- b. Specific countervailable subsidies can exist in non-market economies
- c. The determination of the amount of subsidy can be prohibitively difficult from a practical standpoint.

In case of the *Continental Steel Corporation v. United States*, the Court of International Trade Reversed earlier decisions of the Department of Commerce opposing the application of countervailing duties to non-market economies products. The Court stated that the US Department of Commerce was applying an incorrectly limited definition of what could constitute a subsidy and must identify as subsidies any beneficial deviations

¹⁵ Carbon Steel from Czechoslovakia, 49 Fed. Reg. (Dept of Commerce, 1984) Final Determination)

from those patterns.¹⁶ The Department of Commerce did not accept the decision of International Court and appealed to Court of Appeals who reinstated Department of Commerce's decision and obtained the judgement that US countervailing law in question was not intended to be applied to the "subsidizing" behavior of non-market economy countries. It was first time in the history of contingent protection that Department of Commerce wanted to remove imposition of countervailing duty imposition.

The implication is that US Countervailing Laws are applicable only against market economies, which tend to be democratic institutions. They have not spared even the privatized sectors like British Steel, which had got some benefit from the government when it was a public company.

As against the non-application of countervailing law against goods from China, other market economies have to suffer countervailing duties, which are imposed in most of the cases artificially. Similar situations prevail in European Union where again on the similar pretext of inability of calculating countervailing duty, no countervailing duties are imposed against goods coming from non-market economies. Countries like India, Brazil and other developing countries have countervailing duty imposed practically against all of the major export products like, steel, yarn, fabric, pharmaceutical medicines, and other capital goods. The Report of Global Competitiveness Report is quite appropriate that the major reason of FDI is the market size and anticipated growth in market size. What we have witnessed in the case of China, is not the size of the Chinese domestic market, but the western market of developed countries, which were opened for the goods from China without any hindrance. Antidumping duties are occasionally imposed but the fair value of antidumping goods is again compared to those of market economies giving an advantage to the goods of non-market economies. They do not have to suffer from arbitrary imposition of anti-dumping duties either in USA or in European Union for not furnishing the correct information and not- being cooperative.

Since the majority of Chinese export is controlled by Multinationals, the anti-dumping actions are taken only when interests of such manufacturers are affected. If the profit goes to the TNCs, there appears be no reasons for approaching the government to take action against such countries. Georgetown Steel case also came up with another observation from the Court of Appeal that that the Congress did not intend for countervailing duty laws to apply to non-market economies.¹⁷

The Georgetown Steel Decision was based on the reasoning that through subsidy, a non-market economy country does not intend to engage in "unfair competition", the ultimate target of the countervailing duty laws.

Although Russia and Ukraine tried to show themselves as market economies, China did not even try to so. Legally, non-use of countervailing duties has not discriminated between Russia, Ukraine and China, but in fact China is the greatest beneficiary of non-application of countervailing duties because of the structure of its trade.

Only disadvantage of being treated as non-market economy is that there is uncertainty regarding the country chosen as surrogate country in anti-dumping investigation but the use of factors-of-production method has been found to be favorable to the products from the non-market economy. (Laroski, 1999). According to Laroski (1999) it is theoretically possible to apply countervailing duty laws to a market oriented industry in a non-market country, but the strict market-oriented industry test used by the DOC ensures that a market oriented industry criteria would be impossible to apply. This protects such

¹⁶ *Continental Steel Corporation v. United States*, 614 F. Supp. 548 (Court of International Trade 1985)

¹⁷ *Georgetown Steel Corp. v. United States*, 801 F.2d 1317

industry from any countervailing duty application. The use of suspension agreements along with Section 406 of the Trade Act of 1974 codified at 19 U.S.C.: 2436 allowing imposition of additional duties on imported products if the goods have originated from non-market economies give USA sufficient flexibility to restrict import from any non-market country. In 1994, President Clinton rejected the ITC's recommendation to increase tariff levels on honey from China to 25%.

Factors-of-production method allows non-market economy countries to avoid certain indirect costs like social safety provided free of charge or below cost. Social burden of enterprises in China include housing, day care, sanatoria, sports facilities, social insurance, pension, medical service, and may extend to road building and school construction. Since, the market economy countries normally do not have such social costs system, non-market economy countries normally escape such cost addition in USA.

Another major difference between China and other developing countries has been the non-presence of trade union activities and no right to strike. This may explain the position of China at 15 as compared to that of India when labor factors have been compared in World Competitiveness Report 1999. Till these two advantages continue, foreign direct investment would continue to be diverted to China.

Conclusion

An analysis of institutions responsible for growth and investment suggest that China is in an early stage as far as commercial banking, rule of law including company law and contract law, institution of private property, stock exchange, intellectual property laws, privatization, taxation system and others are concerned. However, ethnic Chinese networks along with discriminatory preferential treatment of Chinese products compared to products from other developing countries by Western countries has helped China gain a disproportionate share of foreign direct investment. The lack of democratic labor rights has also made China an attractive investment and production center for a large number of multinationals.

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