

Foreign Investment and Cultural Context: Law, Administration and Social relations in China

This paper will explore the relationship between foreign investment in China and the laws of that country, more specifically the often unique application of Chinese laws to foreign investment. In that exploration it is posited that some understanding of the nature, background and influences upon Chinese law is necessary.

The Chinese legal system, particularly as it relates to foreign investment, is still in a developmental stage but there are aspects of Chinese law that appear to be difficult to reconcile with Western laws. The most significant factors appear to be the variable administration of laws across geo-political boundaries and the legal and political difficulties that exist between central government and provincial and local governments and regulators.

China's 'Open Door' Policy –The Implications for Chinese Law

Law's relationship with social conditions is significant in any study of perceived problems in the application of laws. In the case of China, its social and economic conditions have been rapidly changing in the last twenty-five years as a result of the commencement of economic reform and in particular the internationalisation of its trading and extensive acceptance of foreign investment. China has been radically changed

into a capitalized and market economy. The nature and processes of legal development in China in the circumstances of such a dramatic economic transition have become particularly significant.

This paper briefly examines foreign investment issues in China's legal cultural context. It explores some effects of embedded tradition and practice contained in China's institutions and the systems of examination and implementation concerning foreign investment practice in China today.

Accordingly, questions of whether traditional social and historical conditions have functioned and are still functioning in the legal system and social environment in the context of China's economic transformation and what this means for foreign investors are examined. In this respect it will demonstrate the value of the general proposition that an understanding of the nature of law requires systematic empirical analysis of legal doctrine and institutions as well as the social environment in which legal institutions exist.¹

China's policy of concentration upon economic development has resulted in great success in both national economic growth and international economic and political influence. Foreign Direct Investment (FDI) has become an increasingly important factor.

“...China and India are the hot spots for FDI, followed by the United States, Thailand, Poland, the Czech Republic, Mexico, Malaysia, the United Kingdom, Singapore and the Republic of Korea. All countries are expected to intensify their

¹ Roger Cotterrell, *The Sociology of Law: An introduction*, 1984, p3.

efforts to attract FDI, reflecting increased competition worldwide for FDI projects.”²

China has, by virtue of its size and dynamism, become a powerful presence in Asia and globally in the new millennium.³

Foreign Investment in China – some Pitfalls

Foreign investors in China encounter a somewhat unpredictable investment environment and are witnesses to an unprecedented commitment to the modernization of laws and the Chinese legal system. Observers have expressed concerns about problems in the investment environment such as lack of predictability and unclear dispute processing, and these are continuing and possibly inevitable hurdles arising from China’s economic evolution. Richard Appelbaum, William Felstiner and Volmar Gessner commented;

“Business transactions are embedded in an environment of culture, practice and rule. The construction and fate of business relationships within a nation-state may encounter differences, for example, in modes of negotiation, enforcement of contract, and in dispute processing where nation-state control and support are weak or absent, and where the legal system and legal-cultural backgrounds of participants may diverge considerably.”⁴

² United Nations Conference on Trade and Development, *Location Experts bullish on FDI prospects*, GIPA Research Note 1: Findings of a survey of international location experts, 2004, http://www.UNCTAD_ORG Global Investment Prospects Assessment Research Note 1.htm

³ Calla Wiemer, *Introduction: China’s Economic Presence*, Asian Economic Cooperation in the New Millennium: China’s Economic Presence, Advanced Research in Asian Economic Studies Vol.1, 2004, p1.

⁴ Richard P. Appelbaum, William L.F. Felstiner and Volmar Gessner (edited), *Rules and Networks: the Legal Culture of Global Business Transactions*, 2001, p1.

Foreign companies find that the law in China is different in both appearance and practice. Xin Ren suggests;

“Understanding the penetration of law and social control in Chinese society has been as difficult for scholars in the fields of legal and social studies as actually establishing social control has been for China’s leaders. However, the distribution and penetration of the state’s power into the social fabric are far more subtle and complicated than understanding institutional reorganization and legislative stipulation.⁵

For foreign investors China’s huge market presents an opportunity for their business to expand enormously. However, China’s legal system is difficult to become accustomed to because it is not only operating within a complicated Communist social system but also has a long history of traditions.

Deeply Rooted Influences upon Chinese Law

China’s economic openness and privatization have not changed its authoritarian tradition and lack of democratic processes in State-commanded social control mechanisms. What is puzzling to Western observers is that though China might have created what can be called laws; they are often sidestepped by governmental officials.⁶

During the process of the ‘Open Door’ policy reform, many problems became apparent. A number were related to policy formulation and implementation procedures

⁵ Xin Ren, *Tradition of the Law and Law of the Tradition: Law, State, and Social Control in China*, 1997, p1.

⁶ Ibid, p2.

but a significant proportion of problems were (and are) institutional, caused by inherent contradictions within the Chinese political and economic systems.⁷ Not surprisingly, China's legal system today is a result of the effects of historical and cultural factors.

Jianfu Chen states;

“The features of law in a given society and at a particular historical stage are shaped not only by the prevailing environment of that time, but also by the cultural heritage of that society, though the role of culture and tradition in shaping the law may be muted, implicit and even unconscious. Thus a study of current Chinese law requires some basic understanding of legal traditions in China.”⁸

China's legal reform has attracted attention from scholars, politicians and international lawyers who are interested in Chinese economic development and its significant role on the international stage. Issues relating to the Chinese legal system and political reform as well as application of the rule of law in China have attracted the attention of numerous researchers. Those studies have contributed significant and helpful findings or suggestions in regard to China's legal evolution in the long-term.

It is this researcher's view that a complete understanding of China's current legal reform requires analysis of the effects of traditional embedded customs that are still operating within the legal system in subtle but persuasive ways. Careful consideration of the social conditions within which the legal system is operating is, this researcher suggests, worthy of significant attention in order to move towards efficient and successful

⁷ David C. B. Teather and Herbert S. Yee (editors), *China in Transition: Issues and Policies*, 1999, pxvi.

⁸ Jianfu Chen, *Chinese Law – Towards an Understanding of Chinese Law, Its Nature and Development*, 1999, p3.

outcomes in legal reform in China today. It is suggested here that some understanding of such factors is an important prerequisite for foreign investors in equipping them to operate in China.

Chinese law was indigenously developed from the secular philosophies of social morality, namely legalism and Confucianism.⁹ The patriarchal relationships and behavioural norms within the extended family or clan were not only reflected in the power structure of officialdom but also formed the basic foundation and standards for social conformity. But law everywhere is evolutionary and this quality seems to be even more evident in China in terms of its relationships with the international community.

Some Practical Issues

Foreign investors' activities in China must meet the challenge of differences of legal culture and tradition because those differences will, according to the findings of this research, continue to provide significant influence in the future shaping of the legal system of the PRC and in particular, how that affects foreign investors' activities and success.

Among the many issues that are important and indispensable for a potential foreign investor wishing to do business in and with China, are an understanding of Chinese political and legal systems and sensitivity to Chinese social and cultural issues. No doubt, once the complete setup of a foreign business is achieved many aspects of

⁹ Xiangming Xu, Ducai Liu and Jianhong Ma (edited), *History of Chinese Legal Thoughts*, 2004, Beijing University Press, Beijing, p61.

domestic law will be applicable to its operation. However, there are major issues of practical concern regarding ambiguities and imperfections of the laws and their administration as well as the impact of governmental policy on foreign investors' operations.

The unsettled legal environment resulting from an instrumental approach to law is another factor of concern for foreign investors. This is so because the central government makes policy decisions tied to the development of the economy.¹⁰ According to K H Wang, referring to the policy emphasis on economic development, "...the Party's tolerance towards economic freedom decides the scope or usefulness of law in the PRC."¹¹ These issues illustrate the fact that the function and standing of law are uncertain as a result of differing needs of development.

Instead of a uniform legal framework for business entities, different enterprises have been subject to various individual laws and regulations for specific forms of enterprises operating in the PRC. These legal frameworks include the Chinese Constitution of 1999, the General Principle of Civil Law (GPCL) of 1987 and Company Law of 2006. These laws have effectively established a system of legal persons in which economic entities are differentiated and accorded different legal status and legal capacities. These occur because of such variable factors as forms of ownership and departmental and regional subordination relations. The establishment of the civil law institution of legal personality was meant to provide formal legal status to economic entities and to establish a uniform legal framework for all economic entities.

¹⁰ K. H. Wang, *Chinese Commercial Law*, 2000, p44.

¹¹ *Ibid.* 14

However, within a particular type of ownership, economic and business entities are further differentiated. They are subject to different individual statutes and administrative regulations in accordance with administrative subordination relations, the regional locations of enterprises concerned, forms of foreign investment and even the size of the business. These statutes and administrative regulations prescribe not only governing organizational structures but provide, together with many other administrative measures and regulations, detailed rights and duties as well as advantageous or discriminatory treatments. This results in a number of difficulties including;

- ∞ ambiguous legal status of many economic entities,
- ∞ lack of an abstract and general approach towards the legal status of economic entities and,
- ∞ creation of an unequal and unfair environment for economic competition among different economic entities.

Discussing these problems, Peter Howard Corne has asked why law on its face does not or cannot connect with reality, why it is haphazard and inconsistent in its implementation and why there is an absence of legal autonomy.¹² He suggests that these problems result from what might be termed as the “administratisation” of law rather than the legalisation of administration.¹³ Mary Rose Liverani observed;

“Law is basically regulatory in its functions but lacking in a sufficient state or social structure on which to ground application. There has been, as a result of

¹² Peter Howard Corne, *Foreign Investment in China: the Administrative Legal System*, 1997, p256.

¹³ Ibid. 256

recent social and political changes and adaptations – both western and Marxist – a normative dislocation which creates an enormous and persistent gap between the law and the reality in which it operates or is intended to operate.”¹⁴

Initially there was no legal framework for direct foreign investment in China. As foreign investment proliferated the volume of Chinese laws and regulations grew *at both the central and local levels*. These laws and regulations have established a special legal regime for foreign investment enterprises. A unique feature of these laws and regulations is that they deal with specific types and specific aspects of foreign investment, there being no unified code for foreign investment.

In 2003, Foreign Direct Investment in China had increased substantially with the actual utilized foreign investment in China being the highest in the world. In that year 41,081 new foreign-invested enterprises were set up, with a contractual foreign investment of US\$115,070 billion and an actual utilized foreign investment of US\$53,505 billion, increases of 20.22 per cent and 39.03 per cent respectively over 2002.¹⁵ According to the UNCTAD Global Investment Prospects Assessment (GIPA) and based on a joint survey conducted by UNCTAD in Geneva and by Corporate Location Magazine in London, China ranks in the top three foreign investment hot spots for the next four years - in front of India and the United States.¹⁶

¹⁴ Mary Rose Liverani, *Our Man In Shanghai Where An Australian Explains China To The World*, The Law Society Journal, June 1998, p99.

¹⁵ *An Overview of Chinese Absorption of Foreign Direct Investment in 2003*, 27/09/2004, <http://www.fdi.gov.cn/common/info.jsp?id=ABC0000000000017187>, at 20/06/2005

¹⁶ *PROSPECTS FOR FDI FLOWS, TRANSNATIONAL CORPORATION STRATEGIES AND PROMOTION POLICIES: 2004–2007 (UNCTAD XI)*, *Global Investment Prospects Assessment (GIPA) Research Note 1: Results of a Survey of Location. (TD/(XI)/BP/5)*, 27/04/04, p6, <http://www.unctad.org/Templates/Page.asp?intItemID=3350&lang=1>, at 20/06/2005

China's continuous economic growth provides massive opportunities globally to business participants. Accordingly, the nature of the legal and business environments in China have been of great interest to those enterprises that have been operating in China as well as to potential foreign investors. It is not surprising that Australian enterprises also desire to join this enormous economic market.

Once a foreign firm sets up its operation, it must face the problems of actually functioning in China. A survey of Australian enterprises operating in China conducted for this research provided some practical insights into the issues facing multinational foreign investment in the business environment of China.

Research survey – some conclusions

A survey conducted for this research was undertaken between June 2004 and March 2005 and was based on written questionnaires sent to 200 Australian enterprises operating in China and 7 follow-up interviews. Participants in the survey were asked to respond to questions concerning aspects of general company information, market entry issues, operating issues in China including the legal environment and administrative environment, and cultural issues and cross-cultural management issues based on their experience of doing business in or with China.

It was found that generally, China's large market is the primary motivation for the enterprises' entry to China and it was evident that partner selection and geographical location are the major concerns regarding the entry strategy. Most of the businesses surveyed rated negotiation as the preferential form of dispute resolution as far as the

industrial relations aspect of the legal environment was concerned. Respondents generally agreed that the relationship with the relevant government authority was very important and that networking played a significant role in the successful operation of their business.

The different understanding of law and attitudes towards disputes were rated as the main issues. Also, differences linked to cultural backgrounds were evident in management issues within joint ventures.

In follow-up interviews answering expanded questions based on the questionnaire, interviewees generally agreed that their business must function within a relatively new and incomplete legal system. The research showed that bureaucratic factors in the administrative system are still a major concern for foreigners doing business in China.

As the handling of legal issues and related disagreements in China can be sensitive, interviews were conducted face-to-face on the condition of anonymity. The interviews were conducted in Sydney, Australia, all at the interviewee's offices. One of the interviewees was the founder of a China-based legal consulting firm that also deals regularly with legal problems of foreign firms in China. The other six interviewees were senior managers of large foreign enterprises with extensive operations in China. The interviews elicited useful information and substantive observations that provided some insight to aspects of foreign investment in a rapidly changing China.

It would be an over-simplification to suggest that the survey and interview procedure would enable a grasp of all problems which foreign investors are facing in

their operations in China. However, it can safely be regarded as a window upon the reality of foreign investment and some of the special features of current legal practice in China today with regard to foreign investment. The survey was confined to a small sample of business operators thus the value of its findings will be somewhat limited.

Some socio/legal phenomena such as the administrative discretionary power and networks have caused the formal laws to be ignored or out of control. In response to the question ‘What are the major difficulties for a successful business in terms of cultural factors?’ an interview participant who is currently co-operating business with an influential Chinese state owned enterprise said,

“One of the big difficulties is finding the right person, the right decision-maker with the right amount of power who can implement things so you can do business. There is no doubt that relationship is very important depending on what type of business you’re dealing with. The business I deal with is a state owned enterprise, so obviously business, government connections and relationship and friendships come with that ...”¹⁷

There is little doubt that connections with people who have power may be crucial for business operations and that awareness of this aspect is important for foreign investors. The role of the government or the state owned enterprises associated with governmental power in the economy was always protected and important economic decision-makers at all levels, from the members of the State Council down to the managers of factories, comprise a powerful supplementary network for transmitting and

¹⁷ Interviewee ‘C’.

implementing the economic goals and policies of the government. Connections can be valuable in any country but in most western countries the primary focus of a business is its product or service because buyers and sellers deal at arm's length. In China, the quality of the product is important, but 'Guanxi'¹⁸ is even more so. It can take a long time to develop 'Guanxi' independently, but it can be accomplished vicariously. The most effective vehicle is the joint venture with a (local) participant that has 'Guanxi' at levels appropriate to the transaction.

Today, law in China serves as a means both to consolidate the achievements of economic reform and to promote further development of economic reform by way of standardising and institutionalising changes in the economic system.¹⁹ Deng Xiaoping said in the Communique of the Third Plenary Session of the Eleventh Central Committee of the CPC that law must be used to establish stability and order for economic development.²⁰

Party policy decides the direction of economic reform and development. China's prominent scholar Chen Shouyi suggests, "Law is the fixing and codification of policy. It is necessary to stabilize, in legal form, Party policies that in practice have repeatedly proven their effectiveness and whose implementation should be continued."²¹ Therefore, law is a better tool than policy, capable of securing and institutionalising

¹⁸ 'Guanxi' essentially in this context means connections or networking.

¹⁹ Liu Rongheng, (ed), *Economic Structural Reform and the Construction of an Economic Legal System*, Press of Current Affairs, Beijing, 1985, pp 3-4.

²⁰ Deng Xiaoping, *Implement the Policy of Readjustment, Ensure Stability and Unity*, in Selected Works of Deng Xiaoping, Foreign Languages Press, Beijing, 1984, pp 335-355. See also Communique of the Third Plenary Session of the Eleventh Central Committee of the CPC, in *Selected Readings of Important Documents since the Third Plenary Session of the Eleventh Congress of the CPC*, People's Press, Beijing, 1987, pp 10-11.

²¹ Chen Shouyi, *A Review of Thirty Years of Legal Studies in New China*, 1988, 2 J. Chinese L. 181, p 196.

policies in a more universal manner and of providing stability and order through state coercive forces for economic development and defining rights and duties in relation to the state as represented by various administrative authorities.²² To date the ‘stability’ referred to has yet to be achieved in practical terms for many foreign investors whilst some very substantial, long term joint venture operations – notably some major motor vehicle manufacturers - seemed to have achieved such stability. In the mid-1990s, Shanghai Volkswagen was the largest Sino-foreign joint venture in China, and was listed as a “pillar firm” in Shanghai’s development plan.²³ At the venture’s full capacity of 300,000 vehicles in 1997, it contributed up to 17 percent of municipal output, and captured 52 percent of the sedan market in China.²⁴

The ‘Open Door’ policy recognises that China needs not only foreign technology and foreign capital, but also foreign management expertise, marketing experience and marketing networks. Competition among provincial and local authorities to attract foreign investment by offering preferential treatment and concessions (other than those granted or approved by the central government) has caused possibilities of conflict between central and local authorities. The Chinese Constitution does not expressly give any exclusive powers to the central government. It does allow local government at the provincial level to make local regulations and rules, provided that these regulations and rules do not contravene the Constitution, the law and administrative rules and regulations

²² Law Development of Beijing University, (ed), *Basic Theories of Legal Science*, Beijing University Press, Beijing, 1984, pp 212-221. and Wu Daying and Shen Zhongling, *A Basic Theory of Chinese Socialist Legal Science*, Publishing House of Law, Beijing, 1987, pp 165-177.

²³ Shanghai Economic commission 1995

²⁴ W. Xing, *Shifting Gears*, *China Business Review*, 1997, pp8-18.

issued by the central government.²⁵ Therefore, it remains unclear whether locally granted preferential treatments and concessions are legally valid, in particular when central government policies change. This clearly constitutes an important issue in the medium to long term for a potential foreign investor.

As in other areas of economic activities, various forms of foreign investment developed and were often permitted by *ad hoc* policies ahead of legislative sanctions. However, as foreign investment increased in China, so did the volume of Chinese laws and regulations both at the central and local levels. These laws and regulations have resulted in a special legal regime for foreign investment enterprises. A unique feature of these laws and regulations is that they deal with specific types and specific aspects of foreign investment, there being unified code for foreign investment.²⁶ The trend appears to be towards uniformity while allowing certain special concessions for foreign investment in order to attract foreign technologies and capital.

Even though substantial legal reform has been undertaken (involving global 'borrowing' of legal methods) in developing the legal system in China, it is clear that a primary driving force towards law reform has been for facilitation of a utilitarian reception of foreign legal institutions. But given the practical complications it is very important to have an understanding attitude to some of the apparent deficiencies of law in China. In part, this may involve an understanding of the effects of Confucian culture and legalism on the legal system in the course of its evolution.

²⁵ Article 100 of the *1982 Constitution of the PRC*.

²⁶ Alice E-S Tay and Conita S C Leung, (ed), *Great China: Law, Society and Trade*, 1995, The Law Book Company Limited, Sydney, pp 163-164.

Some of the vagaries of the day to day dealings in setting up and operating a new business in China will continue to cause frustration. Among the vital ingredients for an entry strategy for foreign investment and for sustained operations in China for the foreign investor are patience and a willingness to cope with the Chinese ways of conducting business.

There is a danger for foreign investors in relying upon the belief that the mere existence of a law guarantees that all parties will comply in the same way that western business operators expect the law to be complied with. Laws may often, in practical terms, be seen by Chinese partners as general guidelines. Understanding the variable nature of the administration of some laws relating to foreign investors and the building of strong administrative and personal relationships can be valuable strategies and may well result in desirable outcomes.