

**CHINA TO END PREFERENTIAL TAX
TREATMENTS TO FOREIGN INVESTORS:
IMPLICATIONS FOR FDI**

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Executive Summary

1. On 16 March 2007, China's parliament adopted the Corporate Income Tax (CIT) Law, which provides that a unified corporate tax rate of 25 percent will apply to all firms in China, foreign and domestic alike, starting from 1 January 2008. This move indicates that China will formally end the preferential tax treatments that foreign invested enterprises (FIEs) have been enjoying for the past three decades.
2. These preferential tax treatments had played a key role in attracting foreign direct investment (FDI) to China, which contributed significantly to China's export-oriented development, technology upgrading and rapid economic growth in the past decades. Why has China chosen to end these preferential tax treatments at this time, and how does this move affect foreign investors and thus the inflow of FDI into China in the years to come?
3. The preferential tax treatments to FIEs placed Chinese domestic firms in a disadvantageous position in competition with their foreign counterparts in China. They are also in violation of the principle of fair competition and the WTO's rule of equal national treatment. China's move to end preferential tax treatments is part of China's commitment to WTO agreements.
4. The preferential tax treatments to FIEs provided Chinese domestic firms with the opportunities to evade tax. They registered in foreign countries or regions where tax is low or zero, and then return to China as foreign enterprises to enjoy preferential tax treatment. It was estimated about one third of China's inward FDI are made by these "fake foreign enterprises". The ending of the preferential tax treatments to FIEs will certainly help address the tax evasion problem.
5. The inward FDI has now generated negative productivity spillovers to Chinese domestic firms. It has "stolen" both the market and the talent from Chinese

firms and negatively affected the productivity of Chinese firms. It is thus the time for China to adjust its FDI policy.

6. With the ending of the preferential tax treatments, FIEs will see an increase in tax cost and a decrease in profit margin, while Chinese domestic firms will enjoy a reverse. It is expected that FIEs will face stronger rival Chinese firms and a much tougher competition environment in the China market in the years to come, and negatively affecting the inflow of FDI.
7. However, the negative impact on the inflow of FDI to China shall be rather limited for three reasons. First, the newly adopted corporate income tax rate of 25 percent is not high as compared to the average corporate income tax in other countries, especially China's major competitor India.
8. Secondly, after the new CIT Law takes effect in January 2008, FIEs can still enjoy, though together with Chinese domestic firms, preferential tax treatments in government-supported industries, projects and activities. They can also enjoy some grandfather reliefs such as a transition period of five years. FIEs can make use of the transition period to restructure their investment and adjust their business model to cope with changes in the tax regime.
9. Finally and most importantly, China's attractiveness as the host of FDI does not lie in low tax cost alone, but in other factors such as economic growth potential, large domestic market, low labor cost, economic and political stability, sound infrastructure, plus a pro-business and pro-growth government. Foreign investors will continue to move to China despite the ending of the preferential tax treatments.