CHINA STIMULUS PACKAGE

By Geoff Revelle and Jerry Chiang
Stoel Rives LLP

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I. INTRODUCTION

After enjoying five years of annual GDP growth in excess of 10 percent, China's economy began to weaken last year. In response to its weakening economy, China announced a $4 trillion RMB ($586 billion USD) stimulus package in November 2008 (the remaining figures in this memorandum will be in US dollars). As part of the stimulus package, China also announced a "proactive fiscal policy." A "proactive fiscal policy," according to some commentators, means that China will encourage state-owned banks to loosen credit and lend more freely, thereby avoiding the credit freeze experienced in western countries. Beijing announced that the stimulus package would focus on 10 sectors of the Chinese economy, including rural infrastructure and health care, with the goals of creating jobs and increasing China's GDP.

While the main beneficiaries of the stimulus funding are government-owned or privately-owned Chinese companies, opportunities for foreign companies will still emerge in areas such as high-tech products and value-added services that Chinese firms cannot provide. This memorandum will provide a brief overview of investing in China, discuss the major sectors of the Chinese economy that will benefit from the stimulus package, how the stimulus funding will be distributed, and analyze how foreign investors and companies can take advantage of the stimulus funding.

II. BACKGROUND DISCUSSION

In order to fully appreciate the opportunities that China's stimulus package will generate, particularly those for foreign companies, it is necessary to develop a general understanding of three aspects of the Chinese economy: 1) the industries that foreign companies can invest in; 2) the types of business organization that foreign companies can form in China; and 3) the approval process for an investment project by a foreign company. These three categories are important to understand because they determine what stimulus-funded opportunities will be available to foreign companies.

A. Investment Laws and Restrictions

The National Development and Reform Commission ("*NDRC*") and Ministry of Commerce ("*MOFCOM*") publish and revise the **Foreign Investment Industrial Guidance Catalogue** ("*Foreign Investment Catalogue*") every few years. The most recent version became effective on December 1, 2007 and has not been updated since. This document regulates what sectors of the Chinese economy foreign companies can and cannot invest in and delineates the Chinese economy into four broad investment categories: "Prohibited," "Restricted," "Encouraged," and "Permitted."

Prohibited: foreign companies cannot invest in the prohibited areas, which are areas that implicate national security, public interest, traditional media, harmful pollution, natural resources, and defense/military. Some prohibited areas include:

- Production and development of transgenic plant seeds;
- Arms and munitions manufacturing;
- Construction and operation of power grids; and
- Distribution of motion pictures.

Restricted: Activities and sectors restricted to foreign investment are largely those that use outdated technology, are harmful to the environment or are in protected sectors of the economy. Investment in the restricted sectors requires partnership with a Chinese company. Examples include:

- Exploration and mining of gold, silver, platinum;
- Mobile and data telecommunication services (foreign investor limited to 49% of equity ownership in a joint venture with a Chinese company); and
- Development and production of grains.

Encouraged: foreign companies can invest in encouraged sectors on their own and are not required to partner up with Chinese companies. There are more than 250 encouraged activities and sectors, including:

- Development of various agricultural technologies;
- Production of engineering plastics and plastic alloys;
- Development and manufacture of software products; and
- Construction of thermal power stations with power production capacity of 300,000 KW or more.

Permitted: permitted sectors include all activities and sectors not found in the Foreign Investment Catalogue.

In March 2007, the National People's Congress, China's highest legislative body, passed a new Corporate Income Tax Law, which eliminated many tax advantages that had been enjoyed by foreign investors. The law, which went into effect January 1, 2008, fixed corporate income tax rates for both foreign and domestic firms at 25 percent. The law maintained two exceptions to the flat rate: one for qualified small-scale and thin profit companies, which will pay 20%, and another to encourage high-tech investments by companies, which will pay 15%. The new law also permits financial services, securities, consulting, and other professional services firms to deduct all wage outlays from their taxable income, which had previously been limited to $234 per month, per employee.

The Government Procurement Law establishes the baseline criteria to qualify domestic and foreign suppliers and various categories of procurement, as well as broad standards for publicity, notification, bid scheduling, sealed bidding and bid evaluation. The law clarifies that purchases by state owned enterprises do not constitute government procurement, which eliminates the bulk of commercial value from the procurement system. The legislation requires domestic procurement unless the goods or services are unavailable in China.

B. Chinese Business Entities

The focus of this section will be on the various types of business entities that foreign companies can form in China. However, it is helpful to know the following three indigenous business entities for the stimulus package discussion:

- **State Owned Enterprise** *("SOE")* - As the name indicates, this type of organization is run and owned by the government;

- **Provincial Investment Vehicle** *("PIV")* - a provincial government may form this entity in order to participate in stimulus-funded projects; and

- **Domestic Private Enterprise** *("DPE")* - this refers to corporations which are run and owned by Chinese nationals.

In order for a foreign company or investor to engage in business in China, it must form one of the following types of a **Foreign Invested Enterprise**, or FIE.

Wholly Foreign-Owned Enterprise ("*WFOE*"). This type of entity is 100% foreign-owned. It is able to conduct business activities in China on its own, within the categories where foreign investment is permitted or encouraged. WFOEs are most common in the encouraged sectors such as manufacturing, consulting, trading, wholesale and retail. Other characteristics include:

- Multiple foreign investors allowed;
- Liability limited to one's share of the entity's registered capital (equity);
- No shares are issued; rather, investors hold a proportion of the registered capital;
- Managed by a Board of Directors; and
- Qualifies for tax incentives generally available to FIEs.

Equity Joint Venture ("*EJV*"). This is a limited liability company with both Chinese and foreign investors. Commonly used to invest in restricted areas of the Chinese economy. Characteristics include:

- Foreign and Chinese joint ownership;
- Limited liability – an investor's liability limited to her share of registered capital (equity);
- No shares are issued (investors hold a proportion of the company's equity);

- Managed by a Board of Directors;
- Early withdrawal of equity is difficult;
- Certain decisions require unanimous consent;
- Equity transfers are subject to the consent and pre-emptive rights of EJV partners; and
- Qualifies for various industry-specific tax incentives.

Cooperative Joint Venture ("*CJV*"). This is a joint venture with both foreign and Chinese investors. A CJV may be incorporated as a limited liability company or may exist as an unincorporated entity. Commonly used to invest in restricted areas of the Chinese economy. Characteristics include:

- Foreign and Chinese joint ownership;
- No shares issued (investors hold a proportion of the company's equity);
- Early recovery of equity permitted on certain statutory and contractual conditions;
- Transfers of rights require consent of other CJV partners; and
- Qualifies for various industry-specific tax incentives.

Other Arrangements

- **Foreign-Invested Companies Limited by Shares** ("*FICLS*"). This is an entity that a foreign company forms if it wishes to issue shares on China's stock exchanges.

- **Holding** Company. A qualifying foreign company (as a WFOE, EJV, CJV) may create this entity in order to invest in and manage the activities of its Chinese subsidiaries.

- **Representative Office** ("*RO"*). This is the simplest and quickest type of business entity to form. However, it is also the most limited. An RO is not allowed to engage in profit-making activities. This form is typically used to set up a local office to conduct research and establish contacts.

C. Foreign Investment Process

In China, every business entity needs to be approved and licensed by the government. The principal law governing the establishment of an enterprise in China is the **Administrative Permissions Law,** which requires the government to review proposed investments for compliance with Chinese laws and regulations. This is also the authority for China's complex approval system for foreign investment.

The steps for securing approval for an investment project are as follows:

1. Submit an application to China's Environmental Protection Ministry and Land Resources Agency. The proposed project will be reviewed for compliance with environmental and land use regulations;

2. The province in which the proposed investment will take place will review the project (specifically by the provincial Development and Reform Commission);

3. The provincial DRC passes the investment project to the National Development and Reform Commission for "project verification," which includes assessing the investment project's compliance with Chinese laws and regulations, national security, and economic development needs;

4. Ministry of Commerce conducts an "enterprise establishment verification," which certifies that the documents establishing the Foreign Invested Enterprise ("*FIE*") conforms to China's laws and regulations;

5. The FIE applies for a business license from the State Administration of Industry and Commerce, which allows the entity to operate and conduct business.

6. The FIE registers with China's tax and foreign exchange agencies.

Since 2004, provincial governments have enjoyed expanded authority to directly approve many foreign investment projects. Currently, in "encouraged" and "permitted" sectors, only proposed investments valued above $500 million require approval by the national government. Projects in "restricted" sectors valued above $50 million require Beijing's review and approval.

III. STIMULUS PACKAGE DISCUSSION

A. Stimulus Package's Focus Areas

The main goal of the stimulus package is to maintain a pace of growth of China's GDP at, or near, 8 percent (also referred to as "bao ba" or "preserve eight"), by focusing on ten sectors of the Chinese economy: transportation, rural infrastructure, environment, finance, earthquake reconstruction, taxes, housing, health and education, incomes and industry. Some of these sectors are in line with the priorities already established in China's 11th Five Year Plan[1]. Each of these 10 sectors will be discussed briefly.

Rural Infrastructure

The central government's focus in this area is to hasten rural infrastructure construction. Improvement efforts will focus on the roads and power grids in the countryside and drinking

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[1] China's economic development initiatives are promulgated in a Five-Year Plan. While a Five-Year Plan is national in scope, in contains detailed economic development guidelines for all of the regions.

water safety. The South to North Water Transfer Project (the construction of water diversion routes to alleviate water shortages in the northern regions of China) will receive extra attention under the stimulus plan, as well as reservoirs that need to be reinforced or renovated. Efforts will also be directed at water conservation in large-scale irrigation areas. The central government has committed to spend some $54 billion on projects aimed at improving the infrastructure of rural China.

<u>Transportation</u>

The goal for the transportation sector is to accelerate the improvement and expansion of the transportation network. This includes extending trunk railways, developing more passenger rail links and coal routes, and building airports in central and western parts of China. Stimulus funding will also focus on increasing subway lines and improving the national highway system.

70 new rail projects are planned with a total investment value of $147 billion for 2009. The funding will result in the construction of approximately 6,213 miles of new rail lines. A further $147 billion is scheduled for investment in 2010 for an additional 6,213 miles of rail lines.

The central government has allocated $30 billion for airport construction in 2009, and another $37 billion for 2010. The funding will be used to build 50 new regional airports (five in tier one cities – e.g., Beijing, Shanghai), relocate 12 airports and renovate 78 airports across China.

<u>Environment</u>

The plan for the environmental sector is to fund projects in improving tainted water sources, expanding garbage recycling, water anti-pollution, energy-saving and clean energy technologies. Ecological and environmental protection projects will receive around $31 billion of the planned stimulus funding in 2009/2010.

Of the earmarked amount, $19 - $20 billion will be targeted at waste-water management and water supply projects with a particular emphasis on alleviating the continuing water shortage in the northern provinces. China's 300 cities that presently lack waste-water treatment facilities will also receive particular attention under the stimulus package.

The State Grid and National Energy Administration have announced plans to increase investment to $175 billion on grid construction in the next two years in order to address many of the grid bottlenecks that are limiting renewable energy development and grid connectivity.

As of this writing, the central government has drafted an energy stimulus plan, but the contents and the timing of the bill's launch have not been revealed. The general plan is to encourage investments in the production of alternative energy from sources such as wind and solar. China also plans to invest about $290 billion in the alternative energy industry through 2020 as it looks to replace usage of coal and oil with clean energy.

Finance

The central government plans to enhance financial support to maintain economic growth. Prior to the stimulus package, the central government placed loan quotas on banks, in an effort to limit credit growth. This in turn placed a ceiling on the amount in loans that banks could make. In order to spur the sagging economy, the loan quotas are likely to be removed to free up credit and to conform to the "proactive monetary policy." The stimulus package also calls for increasing bank credit for key stimulus projects, such as infrastructure improvement, rural reconstruction and technical innovations. For instance, lending to the farming sector and areas hit by the Sichuan earthquake has been excluded from lending quotas. Because many of the banks in China are state-owned, the central government is ready and able to flood the market with more credit if necessary.

Earthquake Reconstruction

Approximately $146 billion of the stimulus package will fund the reconstruction of the areas hit by the May 12, 2008 earthquake (Sichuan region).

Taxes

Under the existing tax incentives, foreign companies enjoy a 15% tax rate if they are engaged in high-tech investments. The central government may announce more tax incentives to spur technological investments.

The State Council announced late last year that beginning in January, it would reform Value-Added Tax ("*VAT*") for all industries to encourage transition from a production-based VAT regime to a consumption-based one. Under a production-based VAT regime, enterprises are only allowed to use direct costs such as production materials, wage payment and factory expenses to offset sales, but they are not allowed to use the purchase of fixed assets (including annual depreciation) to offset sales. Under a consumption-based VAT regime, the input VAT on fixed assets newly acquired by enterprises can be deducted in full amount.

Starting this year, the transition to a consumption-based VAT regime will be implemented nationwide, except for industries restricted for development by the state (such as the military). Companies from industries covered by the VAT reform will be able to offset the full amount of input VAT paid on newly purchased machinery and equipment against VAT collected when they sell their goods. Some commentators have estimated that the VAT reform will lower the purchasing cost of fixed assets by an average of 7% and reduce the expected VAT burden by about $17.6 billion.

The central government will continue to monitor the export markets and may cut export-related taxes and raise financial support for exporters in order to avoid a sharp drop in external demand. The Commerce Minister Chen Deming has stated that the government would "steadily restore zero tax rates for export products," as well as ensuring that high-energy and resource-consuming exports are curtailed.

Housing

Around $58 billion of the stimulus funding will be used to build more affordable and low-rent housing and accelerate the clearing of slums.

Income

The central government will raise average incomes in rural and urban areas. The central government will also raise next year's minimum grain purchase and farm subsidies, and increase subsidies for low-income urban residents. The stimulus funding will also be used to increase pension funds for employees of certain state-owned enterprises.

Healthcare and Education

The stimulus package allocated about $27 billion for healthcare and education projects. Some of the planned healthcare projects include upgrading medical equipment used in rural areas and health information technologies. The central government plans to allocate an additional $125 billion over the next few years to focus on expanding basic coverage to at least 90% of the population by 2012. The education projects include constructing more schools in central and western areas and more special education and cultural facilities.

Industry

$53 billion of the stimulus funding will focus on innovating and upgrading China's aging industries and building up China's high-tech services industries.

B. Recent Developments in Stimulus Funding

The National People's Congress ("*NPC*") met in March for a two-week session. Many commentators expected that the NPC would announce a second stimulus package. However, the NPC did not announce round two of stimulus funding and instead emphasized the government's commitment to delivering 8 percent GDP growth in 2009. The NPC indicated that it would "wait and see" further economic data before announcing another round of stimulus funding.

The NPC also announced a shift in spending priorities of the stimulus package:

Prioritized Sectors	Original Total (billion)	Revised Total (billion)	Change (billion)
Infrastructure: railway, highway, airport, grid construction	263	219	-44
Sichuan Earthquake Reconstruction	146	146	0
Housing	41	58	+17

Rural Livelihood and Infrastructure	54	54	0
Industry Innovation	23	53	+30
Environmental Projects	51	31	-20
Healthcare and Education	8	27	+19

Despite this shift in funding priorities, the spending will still focus on infrastructure development projects because they are the most effective in fulfilling Beijing's two overarching goals: 8 percent GDP growth in 2009 and creating jobs.

The NPC announced that $15 billion will be provided by the central government to fund a rural home-electronics-appliances subsidies program. Farmers will be granted a 13% subsidy when they buy color TVs, refrigerators, washing machines, mobile phones, air conditioners, computers, motorcycles, water heaters, and agricultural equipment. International vendors BenQ, Sharp, LG Electronics, and Sanyo have been selected as TV vendors under the program. Dell and Hewlett-Packard have been selected as PC brands eligible for subsidies

C. Stimulus Funding

<u>Approval Process for Applications for Stimulus Funding</u>

Although all projects need to be approved by the central government, the stimulus funding and the projects themselves will be distributed and implemented at the provincial level. The National Development and Reform Commission ("NDRC"), China's key economic planning agency, and other relevant ministries solicit proposals and applications for stimulus funding. Typically, a province or municipality will submit an application for stimulus funding.

The applications are reviewed by the NDRC and other ministries (e.g., Ministry of Railways, Ministry of Transportation, Ministry of Commerce, etc.). The reviewing body will focus on the application's potential to meet the twin goals of the stimulus: create jobs and bolster GDP. In addition to receiving approval from the relevant ministry, the applicant province will also need to demonstrate its ability to raise a significant portion of the funds necessary to carry out the proposed project.

Once an application has been approved and funding secured, the entity whose application has been approved will solicit bids for the main contract. The main contracts will normally be awarded to a Chinese entity because of China's policy of economic nationalism and restrictions on direct involvement by foreign companies. After the main contract has been awarded, for instance, to a domestic private enterprise, the main contractor will solicit bids for subcontracts. This is where many of the opportunities for foreign companies will emerge. In bidding on a stimulus-funded project, the foreign company must comply with the province's procurement guidelines and the investment restrictions and guidelines discussed earlier. In reviewing the provincial procurement guidelines, foreign companies need to keep in mind that each province will have a different set of guidelines.

Project Financing

Financing for projects such as rural reconstruction or infrastructure improvement will come from a mixture of sources, with the central government providing around 25 to 30% of the total project cost and the remainder coming from provincial governments, banks, state owned enterprises and private companies. The NDRC has committed $1.73 billion to fund key stimulus projects before the end of 2010 (the phrase "key stimulus projects" refers to projects that fall within one of the ten sectors of the economy that the stimulus package has chosen to revitalize).

D. Opportunities for Foreign Investors and Companies

General Overview

Given the existing restrictions on foreign investments and China's policy of economic nationalism, the main beneficiaries of the stimulus package will be state owned enterprises ("*SOE*"), provincial investment vehicles ("*PIV*") and domestic private enterprises ("*DPE*"). Nonetheless, many opportunities for foreign invested enterprises ("*FIE*") will emerge. FIEs can tender bids as subcontractors to the larger contracts awarded to Chinese entities. Opportunities will center around providing advanced intellectual properties and value-added services that domestic Chinese firms cannot provide.

Examples of such opportunities include providing clean energy technologies for Chinese companies that have been awarded contracts in the environmental arena, or providing technical systems such as control and automation processes for machinery used in railway infrastructure projects, or construction, logistics and project management services in the rural infrastructure development or earthquake reconstruction efforts.

FIE Friendly Stimulus Sectors

Below are some stimulus-focus sectors that may provide good opportunities for foreign companies:

Environment

The environmental sector is one of the most promising sectors for FIEs in China. The central government is committed to its clean energy technology/alternative energy development and environmental protection policy. More importantly, there is a significant gap between the clean energy technologies of Chinese companies and foreign companies. This gap undercuts the policy of economic nationalism and allows FIEs to exploit the stimulus-funded projects. Clean energy technology development is also an encouraged area of foreign investment.

As an example, the Ministry of Finance announced the Solar Roofs Program on March 26, 2009, which will offer incentives of approximately $2.90 per watt for systems of more than

50 kilowatts. The program is designed to increase demand for solar energy and incentivize building Integrated PV, roof-mounted solar projects and rural electrification. The central government will distribute 70% of the program funds to provincial governments, which will then be charged with payment of the subsidies.

Transportation

The transportation development efforts, including construction and renovation of roads, railways, airports, will require high tech equipment and value-added services such as logistics solutions. This will be an area rife with opportunities for foreign companies with the capabilities of providing high tech equipment or value-added services.

Healthcare

As the central government plans a rapid expansion of China's rural healthcare system in the next couple of years, this will develop a market for foreign companies dealing in medium to low-end medical equipment.

<u>Best Practices</u>

In order to take advantage of China's stimulus package, a foreign company must understand the stimulus goals and priorities of Beijing, the needs and agenda of each province, and the market realities (i.e., where the technology gaps lay, which sectors could use value-added services). This information will enable a foreign company to anticipate which sector will receive special funding mandate from Beijing, which province will receive that funding, and where competition from native companies will be weakest. In terms of approaching stimulus funding, one size does not fit all as each province's needs will vary significantly from another.

Additionally, a foreign company must also understand each province's procurement guidelines and the related rules and regulations. Since announcing the stimulus package, the central government has not shed much light on the procurement guidelines, and the overall process remains opaque. Information tends to emerge intermittently, and each province views the stimulus policies differently and writes procurement guidelines tailored to its own needs.[2] In addition to the provincial, stimulus-specific procurement guidelines, there are investment guidelines that foreign companies must review and understand.

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[2] This is especially true where a province has local companies with capacity in a given sector. For instance, if a province has local energy companies, the provincial government will write procurement guidelines that favor local over foreign energy companies, either explicitly through limits on contributions, or implicitly by writing specifications that only the provincial companies can meet. Understanding these often "under the radar" variations will be essential in accessing the stimulus funding.

Success in exploiting China's stimulus package, therefore, will require a good understanding of the following elements:

- Chinese bureaucracy – in order to gauge where the stimulus funding will go, it is necessary to understand all the moving pieces in the Chinese government that shape and influence spending agenda; this, in turn, requires an understanding of:
    - China's legislative arm – National People's Congress;
    - China's 11th Five-Year Plan;
    - Key ministries such as Ministry of Finance and Ministry of Commerce;
    - Important committees and commissions such as National Development and Reform Committee;
    - National leaders such as Premier Wen Jiabao and President Hu Jintao; and
    - The relationship between provincial governments and the national government (Beijing often sets the policies and provincial governments have authority to implement those policies, often with the province's needs and goals in mind – the divergent implementation of the stimulus package is a good example).
- Stimulus procurement guidelines
    - These will vary from province to province; the best practice is to determine which province is most promising and research the stimulus procurement guidelines implemented by that particular province
- The Foreign Investment Industrial Guidance Catalogue
    - Companies need to review this carefully to determine whether their potential investment projects are prohibited, restricted, encouraged or permitted
- Stimulus policies of Beijing
    - Because the central government's stimulus priorities change, foreign companies need to stay informed of the attitudes and sentiments of policymakers in Beijing in order to anticipate where the stimulus money will be spent
- The needs and agenda of each province
    - If a foreign company has a province in mind, it needs to carefully monitor the province's needs (be it infrastructure, healthcare or industry innovation) as this will determine what types of stimulus funding it is likely to apply for
- Economic conditions – as these change, so will the stimulus spending policies
    - For example, if the GDP growth is not near 8%, the central government is likely to unleash more spending in the area of infrastructure (the sector most likely to create jobs and to boost the GDP immediately)
- What technologies and value-added services domestic companies lack
    - Once a foreign company selects a province as its investment target, it should research comparable Chinese companies in that province and determine what kind of technologies and value-added services they provide; and
    - If indigenous companies lack the technologies and value-added services necessary to carry out certain projects, those will become prime opportunities for foreign companies.

Given the lack of a centralized source of information (such as recovery.gov for the American stimulus package), the divergent implementation practices of the provinces, the language barrier (many of the Chinese government websites are not available in English) and the lack of uniformity in procurement guidelines, achieving a good understanding of the foregoing elements is a difficult, expensive and time-consuming process. Achieving a good understanding of the foregoing, at a minimum, requires a foreign company to have personnel dedicated to researching stimulus-related developments of Beijing and various provinces. The alternative is to have local representatives who can perform the research in the targeted provinces.

IV. CONCLUSION

In response to China's weakening economy, Beijing announced a $586 billion stimulus package designed to create jobs and maintain an 8% GDP. While the main beneficiaries of the stimulus package will be state owned enterprises, domestic private enterprises and provincial investment vehicles, there will still be ample opportunities for foreign companies. Foreign companies can take advantage of stimulus-funded sectors where indigenous companies lack the capabilities to provide the necessary technology or value-added services. The environmental sector, in particular clean technology, is proving a fertile ground for foreign investment opportunities. Lastly, in order to exploit the stimulus funding and opportunities, a foreign company needs to expend considerable resources to stay informed of the stimulus funding policies, priorities and laws and regulations on procurement and investment.