

# Entrepreneurship in China: A Review of the Role of Normative Documents in China's Legal Framework for Encouraging Entrepreneurship

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## ABSTRACT

**Objective:** The objective of the article is to provide an overview of the Chinese legal framework while examining the laws and legal provisions influencing entrepreneurship in China for both Chinese and foreigners, arguing that the current legal environment encourages domestic entrepreneurship and foreign investment.

**Research Design & Methods:** This article explores the legal environment for entrepreneurship in China by taking a comparative and normative approach to introducing several recent initiatives established through normative documents.

**Findings:** As China seeks to transform from an export economy towards a domestic consumption model, the government is increasing implementing initiatives to encourage domestic entrepreneurship. The majority of these initiatives are established through normative documents that, while not technically defined as law, nevertheless have legal effect.

**Implications & Recommendations:** It argues that the legal framework is principally targeted at domestic entrepreneurship but has also benefited foreign entrepreneurship.

**Contribution & Value Added:** This article is unique in that it explores the role of normative documents in Chinese initiatives to encourage entrepreneurship. In conclusion, China has invested heavily both economically and legally in the encouragement of entrepreneurship and in the cooperation between domestic and foreign entrepreneurs.

**Article type:** research paper

**Keywords:** China; business law; entrepreneurship; entrepreneurship policy

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## INTRODUCTION

The Chinese economic miracle experienced over the past four decades has resulted in the country's transformation from a centrally planned economy to a largely market based economy. This transformation, however, was fuelled largely by the development of a manufacturing sector coupled with international demand for Chinese goods powering an export economy. With China becoming a developed economy and bypassing the United States as the world's largest economy measured by purchasing power parity (IMF, 2017), the country is again seeking an economic transformation – one away from manufacturing and towards domestic consumption coupled with innovation and entrepreneurship.

This approach is not unique as the continued economic success of developed countries like China's main competitor, the United States, has depended on the 'inventive genius of the human experience, fostered by [a] legal system which has been designed to stimulate, promote and protect' property rights (Benson, 1994). An understanding of China's legal framework and provisions influencing entrepreneurship is essential in examining opportunities for innovation as '[l]aw is the last great untapped source of competitive advantage.' (Downes, 2004). However, business scholarship often ignores the central role of law, perhaps echoing the common sentiment in the business world that law constitutes an 'impediment to growth.' (Evans & Gabel, 2014).

Within the context of business academia, entrepreneurship has established itself as a distinct discipline with a number of theories relating to the promotion of entrepreneurship and its impact on stakeholders, including the local community. While there is no question that law impacts entrepreneurship, the theoretical relationship lacks consensus among scholars with some advocating unique theoretical frameworks and others arguing that entrepreneurship merely operates within the tools provided within existing legal frameworks (Means, 2011). Ultimately, law operates to facilitate or bar transactions. Within the context of entrepreneurship, it can be seen to facilitate or bar the implementation of business theories as the role of the lawyer is to 'facilitate another person's process.' (Hobbs, 1997).

In many economies there exists a clear distinction between law and policy. However, the role of normative documents in China's socialist market economy is to bridge the statutes and regulations with the policies underlying the provisions. This article, therefore, provides an overview of the Chinese legal framework encouraging entrepreneurship by introducing recent provisions introduced largely or entirely via normative documents.

Much of the existing legal literature examines domestic Chinese entrepreneurship through a law and economics perspective and foreign entrepreneurship by examining restrictions on foreign investment and requirements for establishing a WFOE or Joint Venture. There are few articles directly addressing the role of normative documents with only one addressing arguably the most significant of recent reforms established through normative documents, the foreign work permit system (Watters, Feng, & Tang, 2018). China has also experienced numerous reforms in recent years, including the transformation of the judiciary from former bureaucrats, often without legal training, to a sophisticated judiciary of trained lawyers. The transformation of the legal bar and of substantive legal provisions, including normative documents, has resulted in an environment where protection of legal rights is easier than in the previous decade (see e.g. Keupp, Beckenbauer, &

Gassmann, 2010). While numerous articles mention the role of local variation in legal interpretation (Xin, 2009; Snyder, 2018) or normative documents (Yan, 2011; Zhang, 2016), there are still many opportunities for case studies and empirical research addressing the content and impact of these variations and those that address local variation or normative documents in the context of entrepreneurship. The variations themselves, however, often exist due to the central role of normative documents in the Chinese legal system. In response, much of the literature focuses on policy and foreign law (Shen & Watters, 2016a; 2016b). This review, therefore, seeks to examine key normative documents and their corresponding statutes, regulations and rules influencing entrepreneurship in China.

This review provides an overview of the Chinese legal framework while examining the laws and legal provisions influencing entrepreneurship in China for both Chinese and foreigners, arguing that the current legal environment encourages domestic entrepreneurship and foreign investment. The article takes the comparative and normative approach to analyse the recently adopted normative documents and corresponding literature in western legal databases (Heinonline, LexisNexis and Westlaw). The first section provides the background to entrepreneurship in China and provides an overview of the Chinese legal system explaining the relationship between laws, rules and normative documents with legal effect. The second section introduces the legal provisions encouraging entrepreneurship and limitations with respect to foreign entrepreneurs, followed by the third section, which provides an analysis of the implication of recent initiatives. The article concludes with a summary viewing the legal environment from the perspective of China's objective of encouraging innovation.

## **LEGAL ANALYSIS, RESULTS AND DISCUSSION**

### **Chinese Law and Entrepreneurship**

#### **Emphasis on Creating a Legal Framework**

The relationship between law and entrepreneurship is complex; harmonious in that law provides protections and a common framework of acceptable behaviour, and discordant in that law creates barriers and increases transaction costs. Following instituted major economic reforms liberalising the domestic economy and encouraging foreign investment, the need for law to regulate transactions and private corporate governance has in the last several decades become essential in the context of China. Even within the first couple of decades after Deng Xiaoping, China's then paramount leader, instituted major economic reforms liberalising the domestic economy and encouraging foreign investment, recognized business entities remained largely state-owned enterprises.

Throughout history, sole traders have operated largely without need to resort to the courts. However, as these businesses grow, the owners must rely upon others and the importance of contracts and other legal protections become increasingly apparent. This is particularly true when investors are involved. As China's wealth increases, an increasing number of entrepreneurs will seek to grow their businesses.

Clear legal rules are also increasingly important to protect foreign entrepreneurs and investors. Unlike Chinese citizens who may form a number of business entities, foreign investors are limited to establishing a corporation as a Wholly-Foreign Owned En-

tity ('WFOE')<sup>1</sup> or a joint venture, and are restricted from many industries. Historically, the procedures for forming a WFOE have been quite onerous and required significant registered capital.<sup>2</sup> Additionally, until established, the WFOE cannot employ locally and it is illegal to employ someone in China without a valid business entity. This has forced many start-ups to hire local consultants to established companies at significant expense. These requirements have the effect of ensuring that foreigner entrepreneurs establish businesses with sufficient size and assets to require reliance on an established legal framework. This reality makes a thorough understanding of the laws encouraging entrepreneurship and those establishing barriers necessary for both foreign entrepreneurs and medium to large domestic entrepreneurs.

### **The Role of Normative Documents in the Chinese Legal Framework**

At the national level, the National People's Congress ('NPC') and its standing committee hold sole authority to promulgate statutory law, with the State Council authorised to issue regulations. Legislation passed by local People's Congresses at the provincial level and for designated major cities is also deemed law (Watters *et al.*, 2018). Although law is officially defined at the national level as statutes, regulations and departmental rules, other documents such as Guides, Notices and other normative documents are commonly issued by government organs and may have binding legal force. Therefore, in a general sense, normative documents can be deemed law.

A lack of understanding regarding the importance and role of normative documents in the Chinese legal system compounded by the difficulty in determining which provisions will be strictly implemented has resulted in such documents being under analysed in much of the academic literature. Therefore, the next section will introduce a number of normative documents with legal force issued by Chinese government entities along with corresponding regulations and statutory law.

### **Normative Provisions Encouraging Entrepreneurship and Foreign Investment**

#### **Encouraging Domestic Entrepreneurship**

At the national level, China has adopted several provisions together with policy initiatives aimed at increasing entrepreneurship. The announcement of 'population entrepreneurship and innovation' on September 10, 2014 by Keqiang LI, Premier of the State Council, provided the foundation for several future initiatives, each building upon each other. In March 2015, the State Council issued the 'Guideline for the General Office of the State Council on Developing Public Space to Promote Popular Innovation and Entrepreneurship.' The guideline emphasised building a group of 'low-cost, convenient, full-factor, open-minded and creative spaces,' and reducing barriers to innovation and entrepreneurship by deepening the reform of the commercial system and giving appropriate financial subsidies to encourage science and technology personnel. The guidelines also sought to address support for innovation and entrepreneurship in public services, strengthening the guidance of financial funds, improving the investment and financing mechanism for entrepreneurship, enriching innovation and entrepreneurial activities, and the creation of an atmosphere ripe for innovation and entrepreneurship culture.

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<sup>1</sup> Also, commonly referred to as a WOFE.

<sup>2</sup> The amount of the required registered capital varied by industry and local government standards.

Since the 2015 Guidelines, the State Council has released several 'Opinions' including in June 2015 ('State Council's Opinions on Vigorously Promoting People's Innovation in Public Entrepreneurialism'), in September 2015 ('State Council's Guidance Opinions on Accelerating the Construction of Public Innovation Platform for Massive Innovation'), in February 2016 (Guiding Opinions of the General Office of the State Council on Accelerating the Economic Transformation and Upgrade of the Public Space Development Service Entity'), in June 2017 ('Opinions on the Implementation of the Second Batch of Public Innovative Demo Demonstration Bases') and July 2017 ('Opinions of the State Council on Strengthening the Implementation of Innovation-Driven Development Strategies to Further Advance the Popular Innovation of the People's Business Community').

This section examines recent initiatives based on normative documents that encourage entrepreneurship in the areas of banking and tax regulations, encouraging the development of technology for industrial growth and access to labour.

### **Banking and Tax Initiatives**

Whilst China is encouraging entrepreneurship more broadly, policies relating to finance and tax, research and development and employment have been emphasised at both the national and local levels. Supportive financial policies are crucial for the nurturing of entrepreneurial activities. To remove any financial obstacles for entrepreneurship, ensuring development of innovative financial products, expansion of credit support and the development of venture capital investment is crucial. Under the premise of effective prevention and control of risks, local corporate banks can establish small and micro sub-branches and community sub-branches at the grass-roots level to provide inclusive financial services for social welfare (Reply of the China Banking Regulatory Commission to Proposal No. 3736). The credit process and credit evaluation model can be simplified to improve efficiency. Further, innovative taxing methods such as bank card acceptance terminals, online banking and mobile banking are promoted at both the national and regional level.

Small and micro enterprises ('SMEs') can benefit from favourable tax policies where the entrepreneurship entity provides employment activities. (Notice on Further Expanding the Scope of the Preferential Policy on Income Tax on Small Profitable Enterprises). For instance, from October 1, 2015 to December 31, 2017, for small profit-making enterprises with annual taxable income between 200,000 yuan and 300,000 yuan inclusive, their income was reduced by 50%, paying corporate income tax at a rate of 20%. Laid-off workers, retired soldiers, college graduates and others are regarded as key groups. To encourage their employment, create jobs from entrepreneurship activities, policies of reducing the tax on corporate income and value-added tax are implemented to engage them in entrepreneurial activities. Business enterprises, including service-oriented enterprises, labour-based processing enterprises, and processing enterprises in the labour service enterprises, which recruit key groups can obtain tax relief in relation to business tax, city maintenance and construction tax, education surtax and corporate income tax.

### **Transfer of Technology**

Since October 1, 2015, the income from technology transfer acquired by non-exclusive license use rights for the transfer to resident enterprises nationwide for more than five years has been included in the scope of income derived from technology transfer that en-

joys preferential corporate income tax. The part of the annual resident enterprise's technology transfer income that does not exceed 5 million yuan is exempted from enterprise income tax. For those that exceed 5 million-yuan, half of the enterprise income tax will be levied (Notice on Promoting Taxation Pilot Policy of the National Independent Innovation Demonstration Zone to National Implementation).

Research and development are paramount to the success of products created by entrepreneurial businesses. To encourage innovation, the establishment of technology incubators and university innovation bases are encouraged through several tax policies that waive specific taxes (Notice of Ministry of Finance and the State Administration of Taxation on the Tax Policy of the National University Science Park 2016). For instance, the land used to establish incubators is provided free of charge or, when leasing the land, there is an exemption from land use tax and business tax.

### **Labour and Mobility of the Workforce**

Mobilising Chinese rural migrant workers and encouraging them to return to their hometown to start up a business also features high in the State Council's entrepreneurship policy. For example, in Guangxi Province, 'The Guiding Opinions on Further Strengthening the Compulsory Education of Migrant Workers Working in Cities' and 'the Circular on Further Improving the Guarantee Mechanism for Compulsory Education in Urban and Rural Areas' have been issued to guarantee the right of migrant workers' children to receive education. The compulsory education for children of migrant workers is included in the public education service system. The establishment of a school entrance policy based on residence permits where migrant workers are concentrated has been introduced. Local governments have solved the problem of insufficient public education resources through the purchase of places in private schools, effectively protecting migrant workers' children (Huang & Fan, 2017).

Under the adoption of these policies, entrepreneurship in China has been encouraged. The encouragement is a mixture of tax exemptions and the State Council policy. Whilst there is clear encouragement for Chinese companies to engage in entrepreneurship activities, that may also include the hiring of foreign experts, the core of the policies, understandably, is targeted at the domestic and predominantly local level.

### **Policies for the Encouragement of Foreign Entrepreneurs and Investment**

Predominantly, there are two ways for foreigners to make an investment in China. Wholly Foreign-Owned Enterprises 'WFOE' and Joint Ventures 'JVs'.<sup>3</sup> WFOEs give foreign companies greater control over their operations, allow the maintenance of full equity ownership and are considered as being quicker to establish than a JV. Nevertheless, WFOEs must contribute to the benefit of the Chinese economy and therefore are limited to particular industries and subject to currency controls. JVs, aside from contractual joint ventures, require the establishment of a Sino Foreign company in which equity and capital will be shared (Chen, 2010).

Since 2017, China has issued a series of policies to promote high-level trade and investment. The 'Circular on Several Measures for Expanding the Use of Foreign Capital for Opening to the Outside World' suggests measures on strengthening foreign investment through the easing of restrictions on foreign investment in the service, manufacturing, and mining sectors and through encouragement of foreign investment in high-end manufacturing, smart

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<sup>3</sup> JV's can take two forms. Equity Joint Ventures 'EJVs' and Cooperative Joint Ventures 'CJV'.

manufacturing and green manufacturing. A point of emphasis on the use of foreign capital to participate in infrastructure construction, setting up R&D centres, and supporting overseas high-level talents to start businesses in China, has also been made at the national level. This section first addresses the opening of additional industries to foreign investors before discussing tax initiatives and policies encouraging foreign talent acquisition based on normative documents.

### **Opening Industries to Foreign Investment**

The August 2017 'Circular on Measures to Promote Foreign Investment Growth' addressed improving the level of legalisation, internationalisation, and facilitation of the foreign investment environment in China. Further, the 2017 version of the 'Foreign Investment Industry Guidance Catalogue' reduces the restrictions on foreign investment access in the service, manufacturing, and mining industries.

The National Standards Commission, the National Development and Reform Commission, and the Ministry of Commerce jointly issued the 'Guiding Opinions on the Participation of Foreign-Invested Enterprises in China's Standardization Work' which aims to create a fair and standardised environment for foreign-invested enterprises. The introduction of the above 'Opinions' will allow foreign-funded enterprises to participate in the standardisation work in China with specific guidelines, which means products produced by foreign-invested enterprises in China will receive equal treatment.

### **Tax Initiatives**

There has also been a move to create simpler laws relating to foreign companies investing in China.

For example, previously China's tax policy stipulated that profits made from a foreign business operating in China are subject to a 10% withholding tax rate. However, China has recently implemented a deferred taxation policy which imposes no withholding income tax for those who meet the prescribed conditions. Further, a preferential tax rate of 15% will apply to technologically advanced businesses as is currently the case in 31 cities (Zeng, 2017).

Additionally, there have also been attempts to improve the business environment for foreign companies by relaxing the rules relating to repatriation of profits of foreign investors. Foreign investment returns, such as profits and dividends, that have been legally obtained in China may be freely remitted in RMB or foreign exchange.

### **Labour and Talent Acquisition**

To foster domestic entrepreneurial activities, China has also implemented rules for foreign talent visas, simplifying procedures for foreign high-level talents to apply for work permits and residence permits. For example, in Chongqing, high-level foreign talents, whose spouses and minor children work in the Chongqing Free Trade Zone and meet specified criteria are recommended by the Chongqing Free Trade Zone and can apply for permanent residence in China. This also applies to foreign students who are allowed to apply for a private residence permit with 'entrepreneurship' in accordance with the university graduation certificate and a business plan. (Promoting the Interpretation of 14 Entry-exit Supporting Policies and Measures in Chongqing's Open Upland Construction in Inland Areas). Taking Chongqing as a further example, foreign students who have the will to innovate and start a business can apply for a private residence permit upon graduation

from universities in China for two to five years. During the period, those who were employed by relevant units may apply for work permit residency in accordance with regulations. Foreign students who have been invited to practice by companies registered with the Chongqing Municipal Public Security Bureau's Exit and Entry Administration Bureau may apply for short-term private affairs visas ('internships') to enter the country for internship activities at the port of entry. Another example is in Suzhou, which has introduced several settlement policies such as the 'Suzhou Talent Plan', that provide financial assistance as well as a guide for entrepreneurship (SU, 2016).

Therefore, China has made real steps not only to encourage foreign investment but also to protect it and give foreign-owned companies an equal footing with domestic-owned companies. However, there are still some industry restrictions and foreign investment is usually dependent on collaboration with domestic companies.

### **Impact of Normative Provisions**

#### **Local Interpretation of Laws and Normative Documents**

The provisions enacted to encourage entrepreneurship and foreign investment provide a variety of incentives to encourage activities beneficial to the Chinese economy. These provisions however, are subject to local interpretation and variation (Xin, 2009; Snyder, 2018). Therefore, their effectiveness, as with many Chinese legal provisions, will depend largely on the local application. Different local policies may vary across key areas, such as incentive policies, foreign management service, and investment in environmental protection.

However, it should be noted that the State Council at the national level has taken meaningful steps to promote fair competition between domestic and foreign capital. To this end, the State Council has introduced several measures to emphasize the consistency of all regions and departments to ensure the implementation of policies and regulations and promote the fair participation of domestic and foreign enterprises in the standardisation of China (Circular on Several Measures for Expanding the Use of Foreign Capital for Opening to the Outside World). These policies are in line with broader reforms including adopting international standards on taxation and policies sought to eliminate the round-trip investment model (Shen & Watters 2015).

While China is making inroads on the path to harmonize the implementation of law and legally enforceable normative standards between regions, substantial local variation still exists. As such, it is essential for foreign companies seeking to establish a presence in China to ensure familiarity with local rules and interpretations. This often includes the hiring of local consultants, and therefore, incurring additional costs. Even with local experts, due diligence is necessary in making investments and hiring employees. The additional costs, which largely impact foreign or non-local enterprises, is another reason that implementation of policies on the local level favours domestic enterprises and local businesses in particular. The cost of assessing the legal environment and local interpretation increases start-up costs and may in some instances act as a barrier to setting up an enterprise. However, such costs can be alleviated by collaborating with a local enterprise through a joint venture. Nevertheless, joint ventures have their own set of challenges as costly disagreements regarding management and ownership of assets, including intellectual property,



may arise. Regardless of the approach, foreign enterprises must ensure a solid understanding of local interpretations of Chinese laws and normative documents to ensure proper compliance with the Chinese law.

### **Encouraging Domestic Entrepreneurship and Foreign Investment**

Like many jurisdictions, the primary goal of initiatives encouraging entrepreneurship is to encourage domestic entrepreneurship with separate initiatives aimed at encouraging foreign investment. This section will discuss the impacts of initiatives governing the development or acquisition of intellectual property.

One issue that has been traditionally topical amongst foreign companies operating in China is the protection of intellectual property rights of foreign-invested enterprises. At the national level, China has strengthened intellectual property rights by protecting against online infringement and piracy, patent infringement, and infringement of trademark monopoly rights, strengthened judicial protection and administrative enforcement, and increased the punishment for illegal infringement. This increase in the protection of intellectual property rights is important both for Chinese industries, which are increasingly taking a leading role in developing intellectual property, and foreign companies seeking to sell or manufacture products with an intellectual property element in China.

Specifically, the State Council has produced a Circular that emphasises the protection of intellectual property rights of foreign invested enterprises, the increasing protection of international intellectual property rights, the widening of investment and financing channels for foreign invested enterprises, and the implementation of the unified registered capital system of internal and external enterprises (Circular on Several Measures for Expanding the Use of Foreign Capital for Opening to the Outside World 2017).

The tax breaks discussed above for the transfer of intellectual property to domestic enterprises are predominantly intended to encourage domestic acquisition of technology and the resulting entrepreneurship. However, foreign owned enterprises are domestic entities and therefore will be likely to benefit from the initiative. This is an example of how the Chinese law is increasingly treating foreign and domestic owned enterprises equally. However, the complexities of establishing a WFOE as compared with a domestically owned enterprise have the effect of making the provisions predominately encourage domestic entrepreneurship. This should not, however, detract from the fact that many provisions are beneficial to foreign enterprises and reforms, such as opening increasing industries to foreign investment, solely benefit foreign enterprises.

## **CONCLUSIONS**

To create rules and policies that effectively achieve a harmonious result of protecting entrepreneurs whilst not discouraging entrepreneurship through barriers, is no simple feat. Through a combination of normative documents and regulations, China has taken a significant step in seeking to find that harmonious balance. Whilst the specific policies relating to both domestic and foreign entrepreneurs do exist, and the interpretation of rules can vary between regions, this is not out of the ordinary for any country. It can be said that China has invested heavily both economically and legally on the encouragement of entrepreneurship and on the cooperation between domestic and foreign entrepreneurs, while seeking to cultivate domestic entrepreneurship and development of technology. Foreign

entrepreneurs must, however, investigate local interpretations of laws and normative documents before engaging in business in China.

The main research limitation of this study lies in the fact that there is limited precedent resulting from the way in which the normative documents and regulations are fully applied in practice. Within the so called 'Common Law System' (adopted by Britain, The Commonwealth and the United States) the application of regulations is usually a judicial exercise resulting in a body of law that builds up over time (i.e. precedent) which explain and give application to the regulations. China, similar to some European countries, adopts more of a 'Civil Code' system that places more emphasis on the drafting of codes and regulations. Further, emphasis is placed upon regulations being applied by officials both nationally and locally.

We suggest that the further studies exploring the role of law in China for entrepreneurship should focus on two areas. Firstly, looking at the rules relating to transacting profit made outside China. This is an issue that is quite important for foreign entrepreneurs. Secondly, the rules regarding intellectual property. In recent years, China has made a concerted effort to address intellectual property protection and this is an issue that foreign entrepreneurs often inquire about before investing in China.

In conclusion, China has invested heavily both economically and legally in the encouragement of entrepreneurship and in the cooperation between domestic and foreign entrepreneurs.

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