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COVER NOTE

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COMMISSION STAFF WORKING DOCUMENT

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT REPORT ON THE EU-CHINA INVESTMENT RELATIONS

Accompanying the document

Recommendation for a Council Decision

authorising the opening of negotiations on an investment agreement between the European Union and the People's Republic of China

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1. BACKGROUND

The Commission Communication[1] of 7 July 2010 "Towards a comprehensive European international investment policy" identifies China as a potential partner for an investment agreement, given the shortcomings of the current legal framework and climate for investment between the EU and China. In April 2010 the European Commission President José Manuel Barroso and Chinese Premier Wen Jiabao discussed ways of deepening the EU-China bilateral investment relationship. In consequence, the European Commissioner for Trade, Karel De Gucht and the Chinese Minister for Trade, Chen Deming agreed in May 2010 to launch a Joint EU-China Investment Taskforce to evaluate potential negotiations of an EU-China investment agreement. As a consequence of this mutual political intent and in order to guide next steps, this impact assessment analyses the underlying problems in the current EU-China investment relationship and possible solutions.

2. STAKEHOLDER CONSULTATIONS

This impact assessment report has been prepared taking into consideration the views expressed by a wide range of stakeholders, including Member States, civil society, industry and NGOs. In order to gather those views, the Commission organised civil society dialogues, public consultations and commissioned an extensive business survey among firms in the EU and European firms in China. The respondents generally agreed that China is an increasingly strategic market for European investors. Most respondents reported that investment barriers hindered or complicated investment in China. They reported problems stemming from i.a. licensing and joint venture requirements, subsidies, the conduct of state-owned enterprises, unfair and discriminatory treatment and the lack of legal certainty in China. Overall, the consultations confirmed strong support for an EU level initiative to facilitate investing in China and improving legal certainty for European investors.

[1] Commission (2010c).

3. PROBLEM DEFINITION

3.1. The EU-China investment climate

China is regarded as one of the most strategic destinations for FDI by European companies. Yet while FDI between the EU and China has become a more visible factor of the bilateral relationship, there remains a discrepancy between the EU-China trade relationship and the investment relationship. Compared with other key trading partners such as the United States and the other key emerging economies such as Brazil and India, EU-China FDI flows and stocks are lagging behind.

EU FDI accounted for 5% of all FDI flows into China in 2010 and this represents only 4-5% of the EU's total outflows. While indeed Chinese FDI flows into the EU grew by over 100% in 2010 compared to 2009 according to the Chinese Ministry of Commerce (MOFCOM) data, these only represent 1% of total inflows into the EU. Chinese FDI stocks in the EU amount to something between €6.7bn (Eurostat) and € 9bn (Mofcom), representing only 0.2% of total FDI stocks in the EU.

3.2. Lack of level playing field for prospective and existing European investors in China

Despite the growing attraction and strategic importance of China as an FDI destination, the lack of a predictable and secure environment negatively affects EU outward FDI flows to China. The result is not only an untapped potential, but also a growing imbalance, given the relative absence of barriers in the EU towards increasing Chinese inward investment. Market access limitations for EU investors in China are a major concern and exist at various administrative levels (national, regional, municipal) and in manifold forms (foreign ownership prohibitions and equity limitations, joint venture requirements, screening mechanisms, capital and licensing requirements to name but a few). These market access barriers increase the costs and/or prevent investing in China. Particularly SMEs which dispose of fewer resources are thereby prevented from entering China.

EU investors already established in China complain about discriminatory treatment in form of more burdensome administrative rules and requirements for foreign investors, insufficient protection of intellectual property rights and key technologies, subsidies to Chinese competitors and the conduct of state-owned enterprises (SOEs).

As regards protection of investors and their investments, a patchwork of agreements exists. China has concluded 25 Bilateral Investment Treaties (BITs) with 26 EU Member States. However, these BITs provide for different levels of investment protection and post-establishment treatment. They do not address market access issues and are not concluded for an undetermined period of time.

3.3. Lack of comprehensive framework to remedy shortcomings of the EU-China investment relationship

There is currently no framework/negotiation in place under which all issues pertaining to investment could be addressed in a comprehensive manner. At EU level the ongoing renegotiations of an EU-China Partnership and Cooperation Agreement only cover certain aspects of investment (establishment for non-services) but not investment protection and are blocked due to discrepancies in expectations, interests and mandates.

At the same time, there is no multilateral investment framework under the World Trade Organisation covering market access and post-establishment treatment for all sectors (only for services) and no rules regarding investment protection with no prospects for any change in the near future. As China is not a member of the OECD, the OECD investment codes the EU adheres to do not apply either. A standalone EU-China investment agreement allows creating a comprehensive and uniform legal framework for investment liberalisation, treatment and protection.

3.4. China's and the EU's bilateral agreements and negotiations with third countries and implications for investment

China and the EU negotiate or have concluded trade and investment agreements with third countries, which contain important bilateral commitments. These commitments could potentially create competitive disadvantages for EU and Chinese investors in the EU and China. Notably, the US-China investment agreement could deliver significant commitments on market access, post-establishment treatment and protection, which would give US investors a competitive edge in China while constituting a competitive disadvantage for EU investors.

3.5. Concerns linked to Chinese investments in the EU

While the first wave of Chinese investments abroad targeted natural resources, current Chinese investment activities target firms and sectors with specific technologies and knowhow. Many Chinese investments come from state-owned enterprises (SOEs), which stand presumably under the control of the Chinese government. Current bilateral investment agreements do not provide for rules on conduct of SOEs.

3.6. The EU investment environment for Chinese investors

China considers the current situation of having 25 Member State BITs as sub-optimal. It is strongly interested in negotiating a uniform EU level agreement on investment protection. China has also complained about varying national screening mechanisms for foreign investment, burdensome national licensing and authorisation mechanisms as well other restrictions. China is worried about the increase of what it considers protectionist sentiments in the EU and possible future limitations of market access. Furthermore it raises regularly the question of work permits and visa regimes.

4. ANALYSIS OF SUBSIDIARITY

The question of subsidiarity does not arise in the context of this initiative, as it falls within the scope of the common commercial policy. The Lisbon Treaty provides for the European Union to contribute to the progressive abolition of restrictions on foreign direct investment. Articles 3(1)(e), 206 and 207 of the Treaty on the Functioning of the European Union confer exclusive competence to the European Union in the field of foreign direct investment.

5. OBJECTIVES

The EU's general objectives derive from Articles 3(1)(e), 206, 207 TFEU and Article 21 TEU. They stipulate that the EU shall contribute to the progressive abolition of restrictions on trade and foreign direct investment as well as promote the Union's general external action principles and objectives. Above identified problems of EU-China investment relations and the EU's general objectives translate into the following specific objectives:

- Improving legal certainty regarding treatment of EU investors in China,
- Improving the protection of EU investments in China,
- Reducing barriers to investing in China,
- Increasing bilateral investment flows.

China's key specific objectives could be summarised to be similar overall:

- Creating uniform EU wide protection for Chinese investments in the EU
- Improving legal certainty regarding treatment of Chinese investors in the EU,
- Safeguard existing openness in the EU for Chinese investors.
- Increasing Chinese investment flows to EU
- Push more favourable consideration of visa, work permit and intra-corporate transferees in the EU for Chinese investors

6. POLICY OPTIONS

6.1 Option 1: no policy change: The baseline scenario stipulates no change in policy. Member State BITs would remain in force protecting investment. No changes regarding market access to China would accrue. It must be pointed out that BITs can be terminated and/or may require renegotiation.

6.2 Option 2: a standalone investment protection agreement: The second policy option would be for the Commission to propose negotiating guidelines for a standalone investment protection agreement between the EU and China to replace the 25 existing BITs with one single agreement for the EU. This agreement would cover protection and post-establishment treatment of investments, but not market access. The agreement would be based on Member State best practice, contain all standard BIT provisions, investor-to-state dispute settlement (ISDS), but would also seek to contain additional clauses on state's right to pursue legitimate policy objectives, the non-lowering of labor and environmental standards, reference to corporate social responsibility, provisions on performance requirements and the conduct of state-owned enterprises.

6.3 Option 3: a separate agreement combining investment protection with market access; A third policy option for the Commission would be to propose negotiating guidelines for a standalone investment agreement which would cover - like option 2 – investment protection and post-establishment treatment standards as well as commitments on market access liberalisation. The actual degree of market access liberalisation would obviously depend on negotiations with China.

6.4 Option 4: integrating protection into the current negotiating guidelines for the PCA and thus covering both market access and protection in the PCA: As a fourth policy option, it could be conceivable for the Commission to make a proposal to amend the PCA negotiating guidelines to include investment protection. However, PCA negotiations are blocked on numerous issues that prevent progress. Adding investment to the agenda would not change these prospects. Therefore this Option has to be dismissed as it cannot be considered a realistic, feasible policy option to achieve the objectives.

6.5 Option 5: a comprehensive FTA with China including investment protection and ambitious market access for investment: This option is mentioned for completeness, but it is not explored further since there is no interest on the side of China to negotiate an FTA with the EU in the nearest future. Hence, this scenario cannot be considered as a realistic policy option and has to be dismissed.

7. ASSESSMENT OF IMPACTS

7.1 Economic impact: Copenhagen Economics (2012) was commissioned to provide a qualitative and quantitative analysis of the economic impacts in both the EU and China of an EU level protection agreement (Option 2) and an investment agreement including protection and market access (Option 3).

The analysis relies on econometric techniques (gravity model) to estimate the impact of improved investment access conditions using an adjusted computable general equilibrium model (CGE). The modelling of FDI flows and the impact of reduction of barriers to FDI involved an innovative extension of the CGE framework which has usually been used for trade policy but is currently the only option available to analyse changes in FDI rules in a general equilibrium setting. It is based on the assumption of the complementarity between trade and FDI, which means that the lowering of FDI restrictions leads to an increase in affiliates' sales.

Policy option 1 implies that no actions are taken. The quantitative modelling tools do not permit to model the dynamic evolution of a "non-shock" scenario and it is therefore impossible to quantify the economic impact of policy option 1.

Policy option 2 stipulates the conclusion of an EU-China investment protection agreement. No additional market access would accrue. Existing literature and research are inconclusive regarding the correlation between pure investment protection agreements and FDI flows between signatory parties. At the same time literature, surveys and the public consultation confirm that BITs main value lies in increasing legal certainty and providing insurance to investors. Policy option 2 is therefore not deemed to impact investment flows and therefore its economic impact cannot be quantified through economic modelling.

Policy option 3 stipulates the conclusion of an EU-China investment agreement covering market access liberalisation and investment protection. Copenhagen Economics modelled the economic impact of a moderate (3% reduction of costs stemming from investment barriers) and ambitious (10% reduction) liberalisation scenario. This reflects the asymmetry in relative openness of the EU and restrictiveness of China for FDI which needs to be featured into an attainable negotiating scenario. Overall, policy option 3 should have a positive, but marginal economic impact on the EU and China. The CGE model results suggest that any scenario should lead to increases in EU-China investment stocks. The ambitious scenario should yield an increase of up to 1.9% in EU investment stocks in China and up to 0.9% of Chinese stocks in the EU. A reduction of investment barriers in China should increase turnovers of EU firms in China due to reduced operation and investment costs. Reduced costs and better legal certainty should particularly promote investments of EU SMEs in China. All scenarios should have a very small, but positive impact on real income in the EU and in China. Furthermore, the model predicts a positive impact of an agreement on EU-China trade. It predicts an increase of EU investment in China in manufacturing and to lesser extent in services. Few sectors in China might see minor disinvestments by European firms, but this should be balanced out by additional investment in other sectors. Additionally, as policy option 2, option 3 will also increase legal certainty through uniform EU investment protection standards.

7.2 Environmental impact: It is recalled that the analysis has to assume no impact of policy option 1 due to the impossibility of modelling a non-shocks scenario. Policy option 2 should not have a direct environmental impact, as both policy options do not affect the volume or direction of EU-China investment flows.

Policy option 3 should have a marginal and probably positive direct impact on the environment in China and in the EU. First, policy option 3 should trigger only marginal increases in investment stocks. Hence, only marginal increases in economic and polluting activities might accrue. Second, any additionally flowing investments should be directed to mostly "clean" manufacturing or services sectors and potentially substitute outdated Chinese production facilities. Third, EU investment into China should promote the diffusion of resource- and energy-efficient technologies and knowhow, while Chinese investors in the EU are bound to high European environmental standards. Fourth, Copenhagen Economics modelled the impact of policy option 3 on CO2 emissions. The result suggests that – across all liberalisation scenarios – the impact should be marginal ranging from -0.01 to +0.03%. Due to the unquantifiable effect of technology spillovers, these results should overstate increase, while underestimating decreases.

Finally, policy options 2 and 3 should have a positive indirect environmental impact, insofar as Commission will seek to integrate a non-lowering of standards clause for environmental legislation, which should promote environmental protection in China. (see section 4.5) Policy options 2 and 3 could theoretically have a positive impact on states' right to pursue legitimate public policy objectives, by including a specific clause to reaffirm this rights (see section 4.5).

7.3 Social impact: It is recalled that the analysis has to assume no impact of policy option 1 due to the impossibility of modelling a non-shocks scenario. Policy option 2 does not affect EU-china investment flows and it is thus impossible to predict their impact on employment on the basis of the CGE model.

Policy option 3 indicates the conclusion of an investment liberalisation and protection agreement. The CGE model suggests that the overall employment impact in an agreement should be marginal, but positive in the EU and clearly positive in China. In the EU some sectors should see very small decreases, others small increases in employment. Overall, the agreement should not destroy jobs for low or high skilled workers. The agreement should have no or a marginal positive effect on wages in the EU and China. It should also be neutral regarding social inclusion of vulnerable groups.

Finally, it should have no impact on labour standards in the EU, while it should indirectly enhance labour standards in China, since the Commission will seek to integrate a non-lowering of standards clause for labour legislation as well as provisions on corporate social responsibility. Policy options 2 and 3 could theoretically have a positive impact on states' right to pursue legitimate public policy objectives, by including a specific clause to reaffirm this rights (see section 4.5).

7.4 Human Rights impact: Policy option 1 should not affect the Human Rights situation in the EU or China. Policy options 2 and 3 should have no or a positive impact on the Human Rights situation in the EU or China. It would strengthen the investor's property rights directly, while not affecting the rights of other actors. Equally a clause reaffirming the right to pursue legitimate public policy objectives including Human Rights should provide reassurance to this end.

7.5 Impact of investment protection on states' right to pursue legitimate public policy objectives: Policy options 2 and 3 should have a positive impact on states' right to pursue legitimate public policy objectives. In principle, investment protection agreements recognise the right of states to adopt non-discriminatory legislation in the public interest. The EU intends to integrate appropriate language into an agreement, which reaffirms explicitly the right of states to pursue legitimate public policy objectives. As comparable language does not exist in Member State BITs, an EU-China investment agreement should enhance states' right to regulate in relationship to China.

7.6 Administrative and budgetary impact: Policy option 1 should not have an administrative or budgetary impact on public authorities or firms. Policy option 2 and 3 should have a positive administrative and budgetary impact on firms, as an EU-China investment agreement would replace the currently existing 25 Member State BITs. Under option 3, firms should experience a positive impact i.e. reduced costs for investing in China depending on the degree of achieved market access liberalisation. Policy options 2 and 3 might trigger marginal budgetary and administrative burdens for the EU due to managing ISDS, legal fees and award payments. These costs are, however, an inevitable and logical consequence of the EU's new competence to regulate FDI.

Policy option 1 stipulates that no actions are taken. It would not achieve any of the general, specific or operational objectives of the EU or China and is thus unacceptable.

8. COMPARISON OF OPTIONS

Policy option 2 envisages the conclusion of an investment protection agreement. The conclusion of such an agreement would address only two of the four specific objectives of the EU. The overall impact of such an agreement would be neutral to positive. It would be feasible albeit unsatisfactory for the EU. It would enhance legal certainty regarding the treatment and protection of EU investors in China. It might have a positive impact on labour and environmental standards in China due to non-lowering of standards and could reaffirm the right of a state to pursue legitimate public policy objectives. It would not create additional market access for EU investors to China or increase investment flows between the EU and China.

Policy option 3 provides for the conclusion of an investment protection and liberalisation agreement. The conclusion of such an agreement would address all four specific objectives of the EU and would have positive overall impact. It would enhance legal certainty for the treatment and protection of EU investors in China, create additional market access and increase investment flows between the EU and China. This policy option would deliver the highest welfare gains, address current imbalances in the EU-China investment relationship, and have a marginal positive environmental as well as employment impact.

In conclusion, policy option 3 is the preferred option of the EU. It is evident that negotiations with China in particular on market access for investors will be challenging. On the other hand, China has vested interests in achieving a uniform protection agreement as well as binding EU market access commitments to provide a safeguard against the rise of protectionist sentiments regarding Chinese investments.

9. MONITORING AND EVALUATION

The Commission will monitor and evaluate the impact and compliance with a potential future EU-China investment agreement. The actual monitoring and evaluation focus and criteria depend on the outcome of negotiations. DG Trade will draw on its established methodology and procedures to monitor and evaluate the impact of an agreement.

ANNEX 1

Table 1: Potential effects of Options

Objectives	Option 1	Option 2	Option 3
Progressive abolition of restrictions to FDI	0/-	0	++
Economic growth	0/-	0	++
Job creation and welfare	0	0	++
Competitiveness of the EU	0/-	+	++
Improving legal certainty regarding treatment of EU investors in China	0/-	+ (Partly positive but only regarding post-establishment)	++ (Positive potential for both pre- and post establishment)
Improving the protection of EU investments in China	0/-	++	++
Reducing barriers to investing in China	0/-	0	+
Increasing bilateral FDI flows	0	0	+ (positive potential)
Political feasibility	Feasible	High feasibility on both sides	Feasibility high on EU side with more reluctance on Chinese side
Overall expected impact (Effectiveness)	Neutral	Some positive impact could be expected for part of the objectives	Positive impact on investment protection and some positive impact achievable on market access related matters.
Efficiency	Neutral	+	++
Coherence with overarching EU policy objectives	0	+	++

Option 1 ("do nothing") included as baseline. Options 2 and 3 estimated against Option 1. Options 4 and 5 not included as not feasible

ANNEX 2

Table 8.1: Overview of objectives and monitoring indicators

	General Objectives	Indicators of progress towards meeting objectives
1	Progressive abolition of restrictions on FDI	Relative and absolute percentage change of bilateral investment flows and overall FDI trends (in particular in comparison with other strategic trade partners and the BRIC states) Changes in legislation Commitments taken in an agreement Ranking of China and EU in FDI restrictiveness indexes (e.g. OECD)
2	Economic growth	Relative and absolute percentage change of bilateral investment flows Percentage change in GDP & national income
3	Job creation and welfare	Percentage changes in employment & wages
4	Competitiveness of the EU	Placement of EU MS in global competitiveness rankings
	Specific Objectives	
1	Improving legal certainty regarding treatment of EU investors in China	Changes in legislation Commitments in agreement Increase of transparency/availability of information Business survey results
2	Improving the protection of EU investments in China	Changes in legislation Commitments in agreement Increase of transparency/availability of information Business survey results
3	Reducing barriers to investing in China	Changes in legislation Commitments in agreement Increase of transparency/availability of information Business survey results Ranking of China in restrictiveness surveys
4	Increasing bilateral FDI flows	Relative and absolute percentage change of bilateral investment flows
	Operational Objectives	
1	Provide EU investors with better market access and effective non-discrimination for FDI	Commitments taken (e.g. Number of sectors opened to foreign investors, number of barriers detected) Changes in legislation relating to foreign investors Increase of transparency/availability of information Business survey results Ranking of China in restrictiveness surveys
2	Increase transparency & predictability of controls/screening of EU FDI into China	Better availability of information Changes in legislation (e.g. time periods and procedures)
3	Seek highest level of uniform standards of protection for European investors in China	Changes in legislation relating to foreign investors Increase of transparency/availability of information
4	Ensure investment protection standards include strong protection of intellectual property rights.	Number of complaints by EU companies about IPR protection Business surveys
5	Seek to increase EU's attractiveness as Chinese FDI destination	Relative and absolute percentage change of bilateral investment flows Business surveys
6	Increase transparency of administrative procedures and implementation of rules for FDI	Increase of transparency/availability of information
7	Creation of enquiry points and one-stop shops for investors	Increase of transparency/availability of information Number of investors contacting enquiry points
8	Improve playing field vis-a-vis Chinese state owned enterprises/remedy effects of loans and subsidies.	Business surveys

9	Ensure right of the parties pursue legitimate public policy objectives	Commitments in agreement Monitoring of any disputes under the agreement
10	Provide for non-lowering of standards clause	Commitments in agreement Changes in legislation/practice Business survey results
11	Include a reference to Corporate Social Responsibility	Commitments in agreement Business and stakeholder surveys Corporate reporting
12	Ensure enforcement through adequate dispute settlement including out of Court arbitration.	Commitments in agreement Monitoring of any disputes under the agreement Business surveys/complaints by EU companies