

Dadush, Uri; Weil, Pauline

Research Report

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How difficult is China's business environment for European and American companies?

Uri Dadush and Pauline Weil

Executive summary

URI DADUSH (uri.dadush@bruegel.org) is a Senior Fellow at Bruegel

PAULINE WEIL (pauline.weil@bruegel.org) is a Research Assistant at Bruegel

The authors are grateful to Bruegel colleagues for helpful comments.

DESPITE TENSIONS OVER China's discriminatory business practices, China's trade continues to thrive, and the country has taken over from the United States as the first destination for foreign investment. American and European businesses continue to be engaged in China's large and growing market, even amid a trade war between China and the United States.

DRAWING ON SURVEYS of companies and international comparisons, we show that – contrary to the prevailing narrative – China's business practices have improved significantly in recent years. China's business environment is today generally more favourable than that in other large countries at similar levels of development and, in some though certainly not all aspects, is in line with the Organisation for Economic Co-operation and Development average.

DIFFERENCES OVER GEOPOLITICS AND human rights must be addressed, but it is clear that trade and investment agreements conditioned on accelerated reforms in China would yield substantial dividends. The benefits of such deals would accrue not only to foreign investors in China and exporters to China, but also to consumers and importers in the European Union and, especially, in the US, where punitive tariffs on China remain in effect. Critical aspects in the negotiations would include better access for American and European investors to China's market for services and improved enforcement of rules and regulations in China. As in many middle-income countries, uneven enforcement of the law (rather than the law itself) remains a critical problem in China.

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1 Doing business in and with China

Unfair business practices represent one of the most frequent and persistent charges against China made by the European Union and the United States. Those practices are the justification, under Section 301 of the US Trade Act of 1974, for tariffs (averaging 20 percent) covering two-thirds of China's exports to the United States, put in place under President Trump. China has refused the charges and initiated a World Trade Organisation case against the United States. It has also retaliated by raising tariffs on most US imports. Despite strong pressure from American consumer groups and business associations, including lawsuits by thousands of companies, there is no sign yet that the Biden administration intends to remove these tariffs. Meanwhile, accusations of discrimination against EU companies are, in addition to violations of human rights in China, among the issues that may prevent ratification of the December 2020 EU-China Comprehensive Agreement on Investment (CAI) – the European Parliament voted in May 2021 to freeze the ratification process.

But to what extent does China discriminate against foreign firms? Is Chinese discrimination worse than other countries? Drawing on surveys of companies carried out by American, European, and Japanese trade associations – which we refer to in shorthand as 'western' even though Japan is to the east of China – we highlight the aspects of Chinese policies that most worry foreign firms operating in China, especially discrimination and uneven enforcement of laws and regulations. However, we also document the overwhelming interest among foreign firms in remaining and increasing their footprints in China.

Drawing on widely-used indicators compiled by international organisations we then show that, while China's business environment is less favourable than those of advanced countries in most respects, it is not out of step with those of other large economies at similar levels of development and in fact typically ranks more favourably. In some important areas, including protection of intellectual property, enforcing contracts and the freedom to invest in the manufacturing sector, China's policies and institutions rate ahead of peers, and even ahead of some OECD members. However, China ranks less favourably, even relative to some countries at similar levels of development, in the freedom to invest in the services sector (despite a big improvement in recent years), and in enforcement of laws and regulations, as distinct from the laws themselves.

In contrast to the prevailing narrative that China's policies have become increasingly anti-market, we show that doing business in China has become easier. Many foreign firms feel more welcome in China, notwithstanding growing concerns about the effects of the China-US Trade War. Under its 2019 Foreign Investment Law and recent international agreements – including the Regional Comprehensive Economic Partnership (RCEP) with China's Asian neighbours, the CAI and the Phase 1 deal with the US – China is clearly moving to address the concerns expressed by foreign investors and is showing willingness to enshrine its market-opening reforms in international treaties, as it did at the time of its WTO accession (Dadush and Sapir, 2021).

Of course, the efficacy of laws and treaties depends on their enforcement, an issue to which we pay particular attention. Though inadequate and discriminatory enforcement of laws and regulations is a weakness not unique to China, it is an issue that continues to be of great concern to foreign companies in China, and – not surprisingly – to Chinese companies as well.

This Policy Contribution has a purposefully narrow focus, ie China's business practices and their effects on western firms. It does not cover other equally important aspects of the economic relationship with China, such as the effect of tariffs on American and Chinese consumers, which is clearly negative. We do not take a view on issues relating to geopolitics, security or human rights, even though we are fully aware that such considerations play an important role in determining China policy.

Accordingly, our policy recommendations pertain narrowly to the economic relationship

with China. Encouraged by the improvement in China's business practices, we call on the EU and US to reject calls for protection and decoupling from China, and instead to engage in trade and investment deals that open markets and are conditional on accelerated reforms in China. Improved enforcement of China's existing rules and regulations should be a critical part of such negotiations. China's constraints as a rapidly developing middle-income economy characterised by young market institutions and marked spatial and social inequality should be recognised in the negotiations. But so should the special responsibility that China – now the world's largest or second-largest economy depending on the measure – must bear in ensuring that its business practices rise to a higher standard.

2 The evolution of China's trade and investment links

Despite trade tensions, the levying of US tariffs, and the Trump administration's active discouragement of investment in, and sourcing from, China, global business interest in China has continued to grow. China's effective (if sometimes draconian) management of the pandemic has helped, since China is one of the few major economies that grew in 2020. China's goods exports have doubled in value (current \$) over the last ten years and increased by about 20 percent during the term of the Trump administration.

A few data points help illustrate China's integration into the global economy and its business importance. China is now the largest export market for goods for 32 countries¹. As its imports have grown, its current account surplus has shrunk dramatically since the financial crisis; expressed as a share of GDP it is now a third that of Germany's. Still, its imports of goods represent just 69 percent of the US's and 82 percent of the EU's (WITS, 2018).

Chinese manufacturers overwhelmingly employ global industrial standards across all technologies, helping to account for the fact that 39 percent of the world's robots are sold in China². China's growth is increasingly reliant on domestic demand, but China is also becoming more integrated into global value chains, as shown by its exports of intermediate products (Figure 1 on the next page), which in 2018 almost matched those of the United States.

Foreign direct investment in China has grown rapidly. It was about 40 percent smaller than inward FDI in the US in 2019 but overtook the US in 2020. Chinese inward FDI grew 2 percent in 2020 despite the pandemic, even as it fell dramatically in the rest of the world. According to China's Ministry of Commerce, inward FDI grew 40 percent in the first quarter of 2021 over the same quarter in 2020. After growing strongly in the decade to 2016, China's outward FDI has grown less rapidly because of measures discouraging it, mainly the capital controls imposed by the Chinese government in 2017.

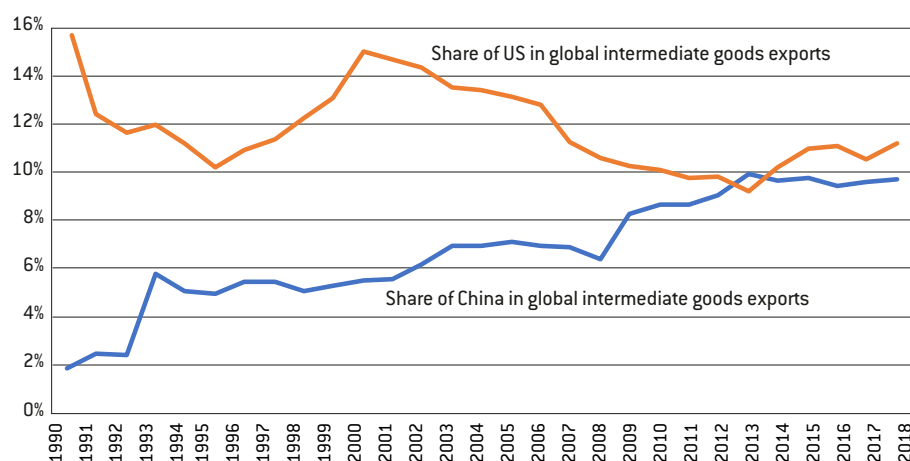
In recent years, there has been greater interest in portfolio investment in China as the onshore stock and bond market has grown rapidly and foreign investment restrictions have been eased³. Foreign ownership of onshore (excluding Hong Kong) stocks and bonds increased nearly eightfold from January 2014 to September 2020 (Lardy and Huang, 2020). Despite capital controls, China's holdings of foreign securities have also grown rapidly, attracting scrutiny in western capitals for fear of increased Chinese control over strategic industries.

1 Out of 162 in the Coface *Country & Sector Risks Handbook, 2021*. Available at: <https://cofaceitfirst.co.uk/2021-country-and-sector-risk-handbook/>.

2 R. Fannin, 'The rush to deploy robots in China amid the coronavirus outbreak', *CNBC*, 2 March 2020, available at: <https://www.cnn.com/2020/03/02/the-rush-to-deploy-robots-in-china-amid-the-coronavirus-outbreak.html>.

3 *Bloomberg*, 'Foreign Investment Pours Into China Despite Trade War, Pandemic', 18 December 2020, available at: <https://www.bloomberg.com/news/articles/2020-12-18/foreign-investment-pours-into-china-despite-trade-war-pandemic>.

Figure 1: Intermediate goods



Source: Bruegel based on WITS.

The data on international flows of trade and investment provide only a partial picture of China's increasingly central role in world business, in part because the data does not measure the value added and sales of overseas subsidiaries of western companies in China. For example, China's manufacturing value added – of which foreign companies have a significant share – is now 167 percent of that in the US and 160 percent of that in the EU. In addition, Chinese consumer spending increased by over 170 percent in the decade to 2020 (compared to 35 percent for the US)⁴. In 2017, China accounted for over 40 percent of global electric vehicles sales, 30 percent of car sales and 40 percent of sales of mobile phones (McKinsey, 2019). The leading car brands in China were Volkswagen, Honda and Toyota, which operate in China as joint ventures with Chinese firms. Through its joint venture, General Motors sells more cars in China than in the United States. According to McKinsey (2019), the 30 top global brands have higher consumer market penetration in China than in the United States.

3 Views of western firms operating in China

Given the importance of the Chinese economy as a market and as a production base, the views of European, US and Japanese firms operating in China as surveyed by their respective business federations generate much interest. These views mainly relate to investors in China but have relevance for global competition with Chinese firms generally.

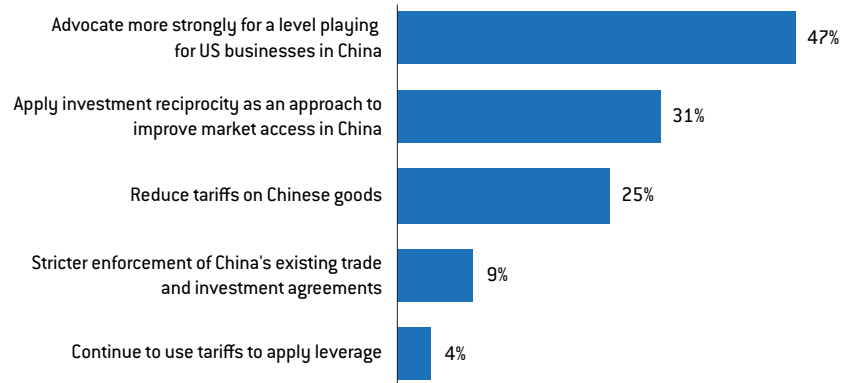
The main concerns flagged by foreign firms in China are quite consistent across surveys, though they sometimes differ from those usually put forward by western policymakers⁵. The most frequent worries of foreign operators in China relate to rising labour costs, slowing growth, and intensifying competition, especially from increasingly capable Chinese private firms. In terms of policy, the uncertainty caused by the tensions between the US and China and the tariffs imposed by both sides looms largest. According to the 2019 American Chamber

4 S. Yifan Xie, E-Y. Jeong and M. Cherney, 'China's Economy Powers Ahead While the Rest of the World Reels', *Wall Street Journal*, 13 January 2021, available at: <https://www.wsj.com/articles/chinas-economy-powers-ahead-while-the-rest-of-the-world-reels-11610552422>.

5 This section draws on the results of the most recent surveys of firms operating in China carried out by the AmCham China (2019), the European Chamber (2020) and the Japan External Trade Organisation (JETRO, 2019). Information from surveys by European national chambers of commerce is also included.

of Commerce (Amcham) business survey only 4 percent of American companies operating in China believe tariffs are an effective strategy in dealing with China (Figure 2), while many companies would like to see the US reduce its barriers to Chinese investment and imports of goods.

Figure 2: Actions the US should take to help foreign companies in China



Source: Bruegel based on AmCham China (2019). Note: % of companies responding to a survey question: *What top actions can the US government take to help foreign businesses in China (choose up to three)*. Selected answers; other responses were possible.

In the February 2020 European Chamber of Commerce report, carried out when the full effects of the pandemic were not yet evident, 40 percent of the 626 respondents ranked economic slowdown in China as among their top three concerns, followed by the US-China trade war (27 percent), the global economic slowdown (26 percent), and rising labour costs (22 percent). In the 2019 AmCham survey, rising labour costs were the second most frequently mentioned challenge, followed by US-China tensions, increased Chinese competition, and shortages of qualified employees.

Still, in line with the issues flagged by western policymakers, challenges relating to Chinese regulations and law enforcement also feature prominently. In the Amcham survey, *"Inconsistent regulatory interpretation and unclear laws and enforcement"* were considered the top business challenge consistently from 2016 to 2019. In the European Chamber survey, ambiguous rules and regulations and having to compete against non-compliant competitors were listed among the top three concerns by 17 percent and 16 percent of respondents, respectively. An unpredictable legislative environment and discretionary law enforcement were also mentioned among the top regulatory concerns.

Western firms are not leaving China

Western firms might have a range of concerns about operating in China, but this does not mean they are leaving. This remains the case though the pandemic has underscored the risk of over-reliance on global supply chains, especially over-reliance on China at a time of geopolitical tensions. The US, Japan and Taiwan, among others, have introduced schemes to encourage firms to relocate from China to their country of origin. Supply-chain disruptions during the pandemic have raised the question of whether risks could be mitigated by a separation of supply chains: one to serve the Chinese market and one for all other countries. At the same time, the rapid recovery of the Chinese economy during the pandemic has confirmed the importance of China as a market and as a source of supply⁶.

In an HSBC survey of 1100 companies carried out in November 2020 at the height of the pandemic, 75 percent of respondents expected to increase their supply-chain footprint in

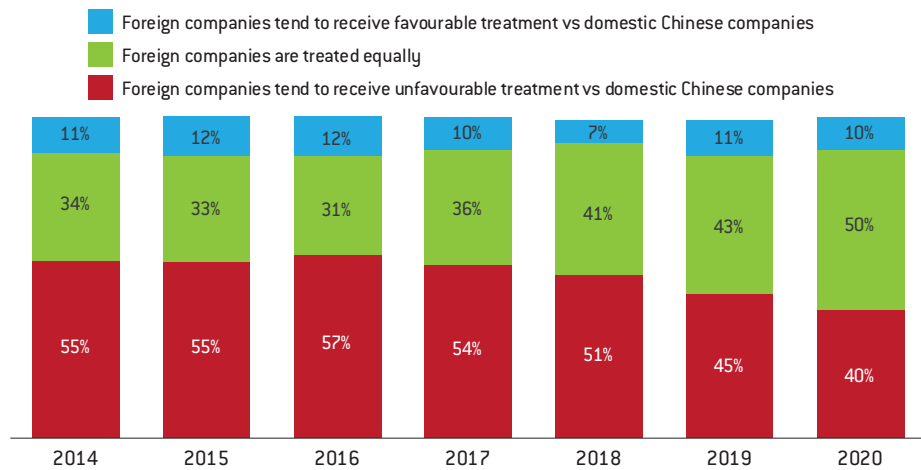
6 S. Yifan Xie, E-Y. Jeong and M. Cherney, 'China's Economy Powers Ahead While the Rest of the World Reels', *Wall Street Journal*, 13 January 2021, available at: <https://www.wsj.com/articles/chinas-economy-powers-ahead-while-the-rest-of-the-world-reels-11610552422>.

China. The 2020 AT Kearney FDI Confidence Index (Kearney, 2020), based on a survey of 500 international executives, measured investment intentions over the next three years. China is eighth on the list, ahead of most advanced countries, and is the only developing country among the top-25 ranked destinations, except for Brazil which is ranked twenty-second.

Surveys of foreign firms in China carried out by trade associations confirm this trend. Most firms – 83 percent of US firms and 89 percent of EU firms – are not considering relocating their manufacturing capacities. Over 93 percent of Japanese firms plan to stay in China, of which 43 percent plan to expand. China was listed as a first or top-three priority in near-term global investment planning by 62 percent of US firms – most notably in the consumer goods sector and in technology and R&D.

Both American and European firms report an improvement in the business climate for foreign investors in China, and say that they are more welcome than in years past. For example, in the EU Chamber survey, 60 percent of respondents view their treatment by the Chinese government as equal to or better than that Chinese firms receive (the 10 percent who report better presumably do so because they benefit from investment incentives). This compares with 43 percent of firms in 2016. In the Amcham survey, 56 percent of firms say they are treated as well as, or better than, Chinese companies.

Figure 3: Companies' perceptions of treatment in China



Source: Bruegel based on European Chamber. Note: % of survey respondents.

Of course, far too many EU and US firms still complain of discrimination in China. However, it would be wrong to assume that there is a systematic effort by the government in China to disadvantage foreign firms. Instead, it appears that discrimination is contextual, depending on sector, size of company, and – one may only assume because of lack of data – locality.

Slower growth, increased competition, and rising labour costs are the most frequently cited worries of western companies in China

The recent slowdown of Chinese economic growth and increased competition by Chinese firms has weighed on foreign firms' perspectives in China. Because of these factors, even though China has managed to navigate the pandemic better than most other countries, only 48 percent of EU firms and 22 percent of US firms are optimistic about the business outlook in China. Labour costs are also a recurring concern, with 55 percent of EU firms expressing pessimism about their rise. Higher labour costs are also ranked as a top challenge by US (48 percent) and Japanese firms (38 percent). Reflecting dim expectations, 17 percent of EU firms planned to cut costs, including 33 percent via headcount reductions. Nearly a quarter of respondents to surveys by the French Chamber and Austrian Chamber stated that they already have or plan to cut their workforces.

US-China tensions create uncertainty and weigh on the business outlook

Since 2019, the American Chamber of Commerce has included the option of highlighting “rising tensions in US-China relations” in their survey. This was found to be the third main challenge to US firms operating in China. US-China tariff measures were listed as the first issue of concern by Japanese firms. Only 33 percent of EU and US firms indicated that they were not concerned by the tensions. Because of the tensions, US and EU firms have postponed or reversed investment decisions (28 percent and 15 percent respectively) or adjusted supply chains by sourcing outside the US (23 percent and 3 percent) or outside China (19 percent and 8 percent).

It is notable that, in response to tariffs, more US companies signalled an intention to source outside the US instead of outside China. In other words, faced with increased tariffs in China, US companies exporting to China that source partly in the US have a choice to leave things as they are and take lower profits, or to move production to China or to third countries to avoid Chinese tariffs. The many US companies that source in China for exports to the US face a different choice: to avoid US tariffs, they can keep things as they are and accept lower profits, re-shore to the US or source in third countries to sell in the US. It turns out that few US companies are re-shoring to the US, and few US companies are leaving China. But where they are changing, they are more likely to source less in the US than source less in China.

Mirroring western policymaker’s discourses, Chinese regulations and their enforcement are high on the list of business preoccupations

A big grievance flagged by US and EU firms operating in China is uncertainty and inconsistency surrounding laws, their interpretation and enforcement. US firms rank this as their top concern. EU firms also complain about red tape and market access restrictions. In the European Chamber survey results, a recurring theme is the discrepancy between *de-facto* and *de-jure* restrictions. Only about 15 percent of EU firms report overt impediments to their operations, but twice as many report less-transparent barriers including lengthy, complicated and opaque licensing and administrative approval processes. About 41 percent of respondents recognise that reforms that improve market access have progressed, but stress that most were limited to minor fixes. In 2019, a new Foreign Investment Law (FIL) addressed some of the restrictions, and China’s FDI Negative List was shortened, but how effective implementation will be remains uncertain (Box 1)⁷.

Box 1: China’s 2019 Foreign Investment Law aims to encourage foreign investors

China’s Foreign Investment Law (FIL), drafted in 2015, was passed in March 2019 and took effect in January 2020. The FIL aims to provide more clarity, transparency and protection for foreign entities operating in China. It repeals three laws, dating from China’s opening-up period (1980s), that previously regulated FDI. It bridges differences in treatment of local and foreign entities and thus responds to requests for a level playing field between foreign and domestic firms. Foreign invested enterprises (joint ventures or not) and foreign investors are now governed, like Chinese firms, by the Company Law.

Overall, the FIL’s intent is to liberalise and encourage foreign investment. Sector and region-specific regulations remain under the pre-existing Catalogue, which lists restricted and encouraged sectors (World Bank, 2019). Investment in sectors listed in the Negative List is prohibited or restricted (such as through equity caps or nationality requirements for senior management). This list has been gradually reduced. It now provides for some restrictions in 33 sectors (compared to 63 in 2017), including agriculture and fisheries, mining, automotive,

7 S. Baruzzi, ‘What EU Investors Seek from China: Fair Market Access, Transparency’, *China Briefing*, 6 October 2020, available at: <https://www.china-briefing.com/news/what-eu-investors-seek-from-china-market-access-transparency-level-playing-field/>.

nuclear plants, air transport, internet and telecommunications, legal services, research and development, education and media (European Chamber, 2020a). The rationale for restrictions includes the political sensitivity of the sector (media and education sectors), outdated technologies (internal combustion engine vehicles), protection of some promising sectors, and concerns about overcapacity, such as in steel, cement and shipbuilding. Changes to the Negative List demonstrate China's intent to open up the services sector, including the financial and transportation sectors. Authorities have discretion to override the Negative List when circumstances warrant. In some cities, dubbed free-trade zones, a less-restrictive Negative List is applied to experiment in attracting FDI in specific sectors (Henderson, 2020). In the 12 sectors in which FDI is expressly encouraged, FDI is eligible for incentives and preferential treatment. The eligible sectors are predominantly manufacturing industries, but also include some retail, R&D and health industries. All sectors not mentioned in the Catalogue are considered open to FDI.

In addition to enshrining in national law equal treatment of Chinese and foreign investment, the FIL accounts for China's international commitments. The FIL acknowledges that if provisions included in international treaties or agreements are more preferential, they should take precedent over the FIL. These include commitments made under WTO agreements or bilateral trade and investment treaties.

In practice, under the FIL, limitations on the legal organisation of wholly foreign-owned enterprises are lifted. These companies are no longer forced into limited liability company structures. Like Chinese firms, they can be joint-stock companies or sole proprietorship companies. Firms are given more leeway in decision-making: under the Company Law, shareholders have more decision-making power and do not have to operate through the board of directors (Li, 2019).

The FIL ensures equal participation and treatment of foreign-invested firms in government procurement (Baker McKenzie, 2020). It also ensures equal participation and treatment of foreign-owned enterprises in terms of subsidies, land supply, tax regimes, industry standards-setting and rulemaking. Investment protection is increased through improved ease of remittance transfers (although controls remain), and recourse opportunities. The FIL forbids forced technology transfer.

The FIL also increases capacity and flexibility for mergers and acquisitions in China, notably by relaxing rules on the origin of funds or the companies allowed to invest (Baker McKenzie FenXun, 2020). However, cross-border mergers, including between foreign entities and China-based foreign-owned enterprises, remain prohibited. And FDI continues to be subject to antitrust and national security review.

The FIL represents a fundamental alteration of the Chinese legal environment and Chinese regulators are expected to take some time to adapt. Foreign entities were granted five years (to 2025) to comply with the FIL. Sceptical observers have argued that vague language remains and have underlined that more provisions are needed to ensure equal treatment with local firms⁸. In December 2020, more detailed provisions were provided on how China intends to screen FDI on national security grounds⁹.

These major reforms to the FDI regime are part of the Chinese response to US and western allegations of unfair business practices. The Comprehensive Agreement on Investment between China and the EU, concluded at the end of 2020, the ratification of which has been, at time of writing, frozen by the European Parliament, included many commitments by China which are based on the 2109 FIL, proposing to enshrine them in an international treaty.

8 H. Broadman, 'China's new foreign investment law is a missed opportunity', *Financial Times*, 23 December 2019, available at: <https://www.ft.com/content/2fb69129-2938-4ca0-a523-426c8bc259ad>.

9 *Reuters*, 'China issues national security rules on foreign investment', 19 December 2020, available at: <https://www.reuters.com/article/china-investment-idUSKBN28T0FS>.

On the thorny issue of intellectual property (IP) protection, most European respondents assess positively the “*effectiveness of China’s written IP protections laws and regulations*” (67 percent). However, fully 42 percent of respondents assess their enforcement as inadequate. About one fifth of US respondents felt that their IP is not well protected, a concern also frequently expressed by Japanese firms¹⁰.

Operating in the IT sector presents specific challenges

China’s attraction is greatest for firms in the high-tech sector, despite the many difficulties of operating in China. Not only is China seen as the biggest market presently or in the future but China is also seen as a rapidly improving production hub. China’s ambition of becoming a global leader in innovation, entailing large investments and tax incentives in clusters that include universities, reinforces this trend. Chinese regulatory reforms are intended to allow firms to bring new products to markets faster. To benefit from these policies and to be closer to the expanding Chinese market, increasing numbers of multinationals are establishing R&D centres in China. These companies range from food processors to healthcare to aircraft and car manufacturing. For example, French companies including Danone, PSA, Sanofi and Airbus appear on this list.

However, the perception of double standards in treatment by regulators varies across sectors, and the IT sector is among those where discrimination is perceived most keenly. European Chamber (2020) notes China is moving towards a “*one economy two systems*” model in which market forces can play a bigger role in some sectors but in others, deemed strategic, Beijing is reasserting its grip. Protected sectors include the ten priority industries covered by the Made in China 2025 policy; in these areas, the European Chamber refers to a ringfencing of the Chinese market for Chinese companies¹¹. US companies in high-tech also report more market access restrictions (73 percent of companies) than those operating in services (61 percent of companies) and consumer products (55 percent of companies).

All firms nowadays rely on the internet, but firms in the high-tech and digital sector are crucially dependent on a reliable and rapid internet service. A feature specific to China that hinders the expansion of firms is internet access. In the Amcham survey, most firms said that they were somewhat or extremely impacted by slow cross-border internet speeds (88 percent), inability to access or use certain online tools (83 percent), cross-border internet access via virtual private networks (83 percent) and data security/IP leakage (79 percent). An increasing share of EU firms (50 percent in 2020) consider the level of internet access unfavourable to R&D activities, and internet restriction was ranked as the fourth biggest challenge by German firms in 2019 (AHK Greater China, 2021).

Our summary of foreign firm surveys shows that the most frequently cited concerns relate to normal business operations (market growth, labour costs, competition) and to the China-US trade war, not to regulations. Despite the political uncertainties, few foreign firms intend to leave China, and many intend to scale up operations. EU and US firms feel increasingly welcome in China. Nevertheless, the surveys demonstrate that the business environment in China leaves much to be desired, especially in law enforcement (as distinct from the letter of the law), and that executives in some sectors, notably IT, are especially worried about discrimination. The next section explores how China compares with other countries in these areas.

10 An example of inadequate IP protection, according to the European Commission, is the shortfall in payment of adequate royalties relating to the use of standard essential patents for the functioning of 4G technologies widely used by Chinese companies (2020).

11 Made in China 2025, issued in 2015, is a national strategic plan to increase Chinese technological independence in several sectors by 2025. The programme aims to spur production and innovation in 10 priority industries: information technologies, robotics, green energy and vehicles, aerospace equipment, ocean engineering, railway equipment, electrical power equipment, new materials, medical devices and agriculture machinery.

4 International comparisons

Surveys of companies operating in China, while important for understanding the business environment, are necessarily limited. Any serious assessment of business conditions in China must include comparisons with other countries since foreign investors rank China against alternatives, and – at least implicitly – policymakers compare China with conditions at home.

In this section we widen our focus to compare China not only with advanced countries, but also with large economies (population above 70 million) at a similar level of development as measured by PPP GDP per capita, selecting those which tend to attract foreign investment, namely Brazil, Indonesia, Mexico, Russia, Thailand and Turkey. Incomes in this sample range from \$12,000 to \$29,000, with China at \$17,000 (GDP *per capita* in PPP, World Bank data). Insofar as the data allows, we focus the comparison on the concerns raised by companies operating in China as reflected in complaints against China by western policymakers.

We draw mainly on the World Bank's Doing Business 2020 (DB) study¹², the OECD's FDI Restrictiveness Index 2019 (FDIRI)¹³ and the World Economic Forum's (WEF) *Global Competitiveness Report 2019* (GCR)¹⁴. Each of these annually updated compilations provides extensive benchmarks for the comparison, even though they do not always precisely match the phenomenon we want to measure. No index is perfect, but the studies we use are carefully prepared, draw on international experts and are subject to peer review inside the issuing institution. Moreover, these indices are widely used both in business and policy circles.

The studies are complementary in the range of criteria assessed and in methodology. In DB, the World Bank team examines business regulations in detail – for example, how many documents are required to start a business and how many layers of approval are needed. It also includes actual measures of how long it takes to complete important tasks, for example connecting to the electric grid or clearing goods through customs. The OECD FDIRI evaluates the number and nature of regulations that govern approval of FDI in various sectors. The WEF's GCR aims to provide a more comprehensive assessment of competitiveness. For our purpose, the GCR is especially useful because it helps reveal discrepancies between *de-jure* and *de-facto* business practices based on standardised surveys of some 11,000 executives covering 139 countries. In China, the survey is based on a sample of some 400 firms from all sectors and including small, medium, and large enterprises. The WEF's methodological note on the survey does not break down answers by nationality of firms surveyed or by state ownership, but there is a strong likelihood that the sample consists mainly of Chinese firms operating in the private sector, with several international firms included.

This is not ideal. Ideally, we would want to ask international executives questions such as, “On a scale of 1 to 7, rank the rule of law in China against that of all other countries,” but few executives could answer this question reliably and the data is not available to us anyway. The GCR executive survey does the next best thing: it asks executives operating in China, “from a score of 1 to 7, how would you rank rule of law in China?” using identical methodology across

12 DB measures 12 aspects of business regulations affecting small domestic firms in 190 economies; we focus on the criteria relevant to foreign firms. The scores are established by mixing surveys of relevant trades and relevant data for each indicator. See <https://www.doingbusiness.org/en/data/exploretopics/trading-across-borders>.

13 The FDIRI focuses on 87 economies and four types of FDI restrictions across 42 industries. We have focused on the overarching score rather than industry specific scores. The scores stem from analysis of national measures on FDIs, weighted according to their scope of application across economic sector. However, they are not weighted according to the weight of sectors or by the extent to which measures are implemented. See <https://data.oecd.org/fdi/fdi-restrictiveness.htm>.

14 In the GCR, the World Economic Forum ranks 141 economies by their competitiveness based on criteria affecting productivity, with emphasis on human capital, markets, innovation ecosystem and enabling environments. The criteria are divided into 12 pillars ordering a total of 103 indicators. Scores stem from statistics from international organisations and from a survey of executives. See <https://www.weforum.org/reports/the-global-competitiveness-report-2020>.

countries, and then compares the response with those of executives based in other countries. Because the GCR executive survey is mainly composed of Chinese companies it provides us only limited insight on the extent to which foreign companies are discriminated against, but it does help make judgments about rule of law and institutional quality, which are concerns expressed not only by international firms but by Chinese firms as well. Further, surveying Chinese firms on their perception of market contestability, rule of law and other issues is of interest to gauge differences in the treatment of Chinese privately owned firms and state-owned enterprises (SOEs).

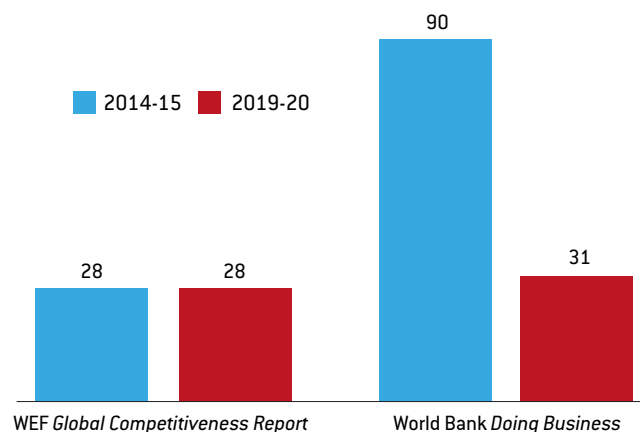
In the comparison that follows, we refer to the group consisting of Brazil, China, Indonesia, Mexico, Russia, Thailand and Turkey as ‘the sample’.

Both the World Economic Forum and the World Bank rank China highly for overall competitiveness and ease of doing business

Helping us understand the attraction that China holds for international business, the WEF ranks China 28 out of 141 countries, the same as the OECD average and ahead of many advanced countries. It ranks China first in the sample of middle-income countries, with Thailand second best, ranked 40. China also ranks high in the world in DB, 31 out of 190 countries, again in line with the OECD average and ahead of some advanced countries. However, in DB, China ranks only second in our sample of middle-income countries, well below Thailand which is ranked 21. According to the DB, then, Thailand’s business regulations make it easier for business than do regulations in China. The GCR ranks China higher than Thailand because its competitiveness assessment allocates greater weight to factors such as size (economies of scale), human capital and the innovation ecosystem, which are not included in DB.

Over the last five years, China’s GCR rank has been stable but in DB has improved greatly, from 90 to 31, illustrating the government’s effort to simplify and accelerate business procedures (Figure 4). For example, in 2020, according to the World Bank, such efforts included: “Simplifying exporting and importing by implementing advance cargo declaration, upgrading port infrastructure, optimizing customs administration and publishing fee schedules” and “Making contract enforcement easier by regulating the maximum number of adjournments that can be granted and limiting adjournments to unforeseen and exceptional circumstances.”

Figure 4: China’s business practices ranking



Source: Bruegel based on DB, GCR.

Businesses appear to be especially attracted by China’s readiness to innovate and adapt. A 2020 GCR special report included composite indicators designed to measure countries’ “transformation readiness” (WEF, 2020). One of these indicators is based on a survey question relating to the ability to “Rethink competition and anti-trust frameworks needed in the Fourth Industrial Revolution, ensuring market access, both locally and internationally”. Based on

answers to this question, China's scores turned out to be in line with those of advanced countries, higher than Germany, for example, though lower than the United States.

China's overall scores in DB and GCR, informative as they are, do not relate directly to the concerns we are trying to address: whether foreign firms have adequate market access and whether within China, the playing field is level. For that reason, we need to probe more deeply into component indicators of GCR and DB and of the FDIRI, which does measure discrimination against foreign companies directly.

Table 1 lists the main concerns about business discrimination in China, as typically expressed by western policymakers, and the proximate indicators (few are perfectly suited) we use.

Table 1: Western firms' and policymakers' concerns about China's business practices, comparative indicators

Overall assessment of the business climate	
Competitiveness	GCR overall score
Ease of doing business	DB overall score
Market access	
Trade in goods, tariff barriers	GCR 'Trade openness', MFN applied tariffs (WTO)
Trade in goods, non-tariff barriers	DB 'Trading across borders'
<i>De jure</i> restrictions on FDI	FDIRI overall score
<i>De jure</i> openness to foreign competitors in the services sector	FDIRI 'Tertiary'
<i>De jure</i> openness to foreign competitors in manufacturing	FDIRI 'Manufacturing'
Predictability and enforcement of regulations	
Consistency of policymaking and law enforcement	GCR 'Government ensuring policy stability'
Burden of regulations	DB overall score; DB 'Paying taxes', GCR 'Burden of regulation'
Fair treatment	GCR 'Judicial independence', GCR 'Incidence of corruption'
Efficiency of the legal system	DB 'Contract enforcement', DB 'Resolving insolvencies', GCR 'Efficiency of legal framework in settling disputes'
Level playing field	
Forced joint ventures and technology transfer	DB 'Protecting of minority investors'
Contestability of markets/SOEs	GCR 'Extent of market dominance'
Effects of subsidies and taxes on competition	GCR 'Distortive effects of taxes and subsidies'
Intellectual property protection	GCR 'Intellectual property protection'
Business climate in high-tech sectors	
<i>De jure</i> openness to foreign competitors	FDIRI 'Electric, electronics and other'
<i>De facto</i> openness to foreign competitors	GCR 'Diversity of the workforce'; 'International co-inventions'
Adapting the business environment to digital industries	GCR 'Rethink competition and anti-trust frameworks needed in the Fourth Industrial Revolution, ensuring market access, both locally and internationally'

Source: Bruegel.

China has higher tariffs than advanced countries, but in line with middle-income countries and 100 percent bound; Chinese low trade costs are relatively low

In surveys of western firms operating in China, tariffs are often mentioned as a hindrance to business, especially in the context of complex supply chains that rely on many imported components or sell imported products directly to Chinese firms. China's most-favoured nation (MFN) applied import tariffs have been reduced a bit over the last two years and they are on average 7.6 percent, much higher than those of advanced countries, which are typically in the 2-4 percent range. However, China's tariffs are now in line with those of our sample of middle-income countries, except for Brazil's which are considerably higher. Importantly, China (like Russia) agreed an upper bound on 100 percent of its tariff lines upon accession to the WTO. This feature means that trade in goods with China is predictable.

China ranks highly in the middle-income sample in "trading across borders", the DB assessment of the time and cost of exporting and importing (excluding tariffs), including processing merchandise through customs. China ranks 56 in the world, again well behind most advanced countries, but better than Brazil, Russia and Indonesia, which rank near 100 or worse, and second only to Turkey in our sample. China ranks less well on the GCR "trade openness" indicator, which is more comprehensive and includes non-tariff barriers as assessed by replies to the executive survey (Table 2), as well as tariffs. China is a far less open economy than Mexico, according to the GCR, partly reflecting Mexico's membership of the US-Mexico-Canada Agreement (USMCA) and of many other trade agreements. But China compensates a bit by its more efficient customs and logistics.

Table 2: China's openness to trade, comparison with a peer group and the OECD

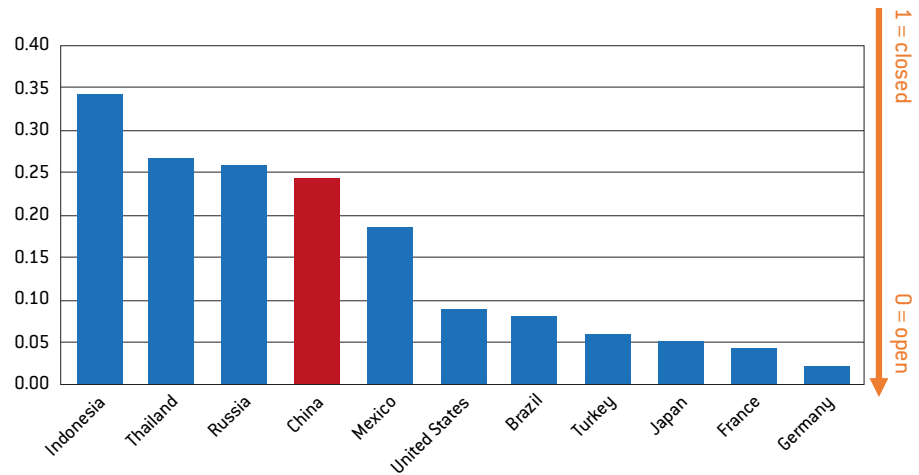
	WEF GCR, Trade openness, Rank (1-141)	WB DB, Trading across borders, Rank (1-190)
Brazil	125	108
China	71	56
Indonesia	62	116
Mexico	27	69
Russian Federation	116	99
Thailand	99	62
Turkey	88	44
OECD average	39	31

Source: Bruegel. Note: In the GRC, the 'trade openness' indicator is a composite indicator comprising the results of a survey on the prevalence of non-tariff barriers, the weight of trade tariffs, the complexity of the tariff regime and border clearance efficiency. The DB 'trading across borders' indicators measures the time and cost (excluding tariffs) associated with three sets of procedures: documentary compliance, border compliance and domestic transport, within the overall process of exporting or importing a shipment of goods.

FDI restrictions in China remain high, mainly in the service sector, though they have come down sharply in recent years

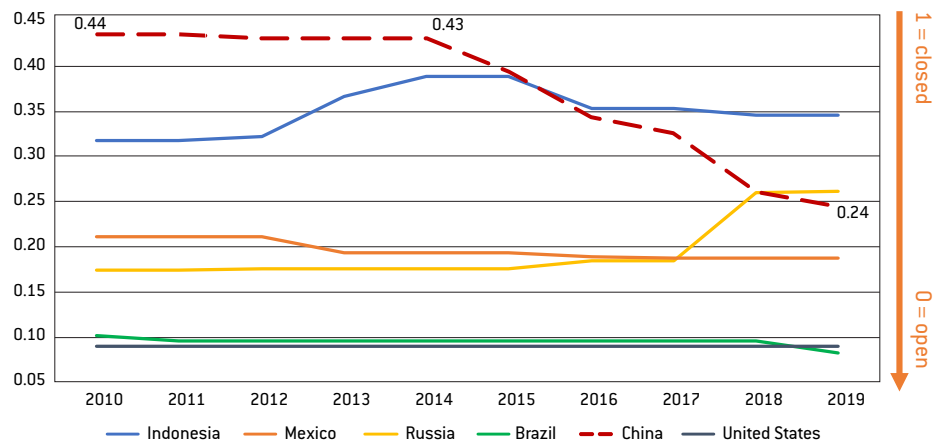
Viewed from the standpoint of foreign firms, market access depends crucially on restrictions in the FDI regime. In comparison to our sample, China ranks in the middle of the FDIRI. China's overall score is 0.24 (scoring ranges from 0 to 1, with 1 being the worst outcome), which is much higher than Turkey (0.06), Brazil (0.08) and advanced countries (Figure 5). However, China's FDI regime is much more liberal than it was ten years ago (Figure 6), and is far less restrictive in manufacturing, where most FDI in China is directed, than in services (Figure 7). China's manufacturing FDIRI score is 0.07, which compares well with that of some OECD members, including Australia, Canada and Mexico, which have more restrictive regimes.

Figure 5: OECD FDI Regulatory Restrictiveness Index, 2019 score



Source: Bruegel based on OECD.

Figure 6: China shows the biggest overall opening to FDI over the last decade

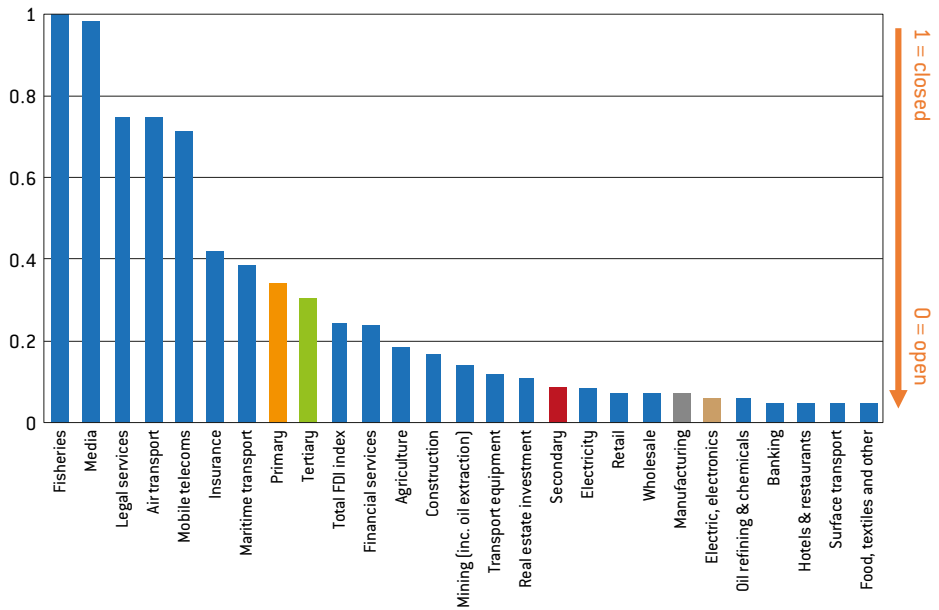


Source: Bruegel based on OECD.

China has shown the best overall improvement in the FDIRI since 2010, with a 19 percent decrease in score (Figure 6). Importantly, the financial sector was largely closed in China but has been recently liberalised. However, we should note that the OECD scores are based on *de-jure* restrictions, which – according to some reports – turn out to be more restrictive in practice.

Foreign investors most often complain that they are forced into joint ventures with Chinese partners (Grieger, 2020). The FIL should change this: it eliminates joint venture requirements in manufacturing and across many service sectors. Although in the FDIRI, ‘electric, electronics and other’ is reported as open to FDI, the GCR tends to confirm the findings of business surveys that, even as China aspires to be a global leader in high-tech and associated R&D, it is not sufficiently open to trade and investment in those sectors. Although the GCR ranks China high in innovation (10 in innovation capability, second in the prominence of its research institutions, and 18 in ICT adoption), China is ranked only 78 in diversity of the workforce in the innovation sector and is ranked 50 in international co-inventions.

Figure 7: China's secondary sectors and industries are more open



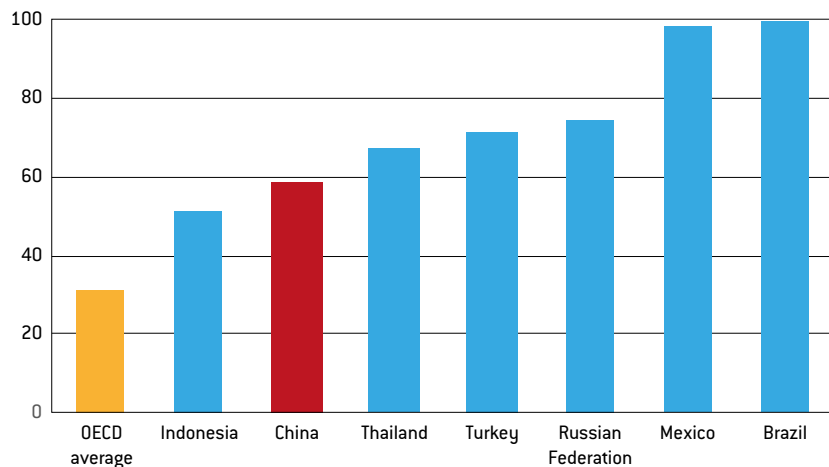
Source: Bruegel based on OECD.

A mixed picture on predictability and enforcement of regulations in China

EU firms operating in China report uncertainty and inconsistency in the application of regulations and uneven law enforcement as major concerns, while US companies report it as their topmost concern. Unfortunately, there is no direct measure of regulatory discrimination and uncertainty in the available international comparison studies, only proximate information. For example, the GCR ranks countries according to the answer to the following survey question: *“In your country, to what extent does the government ensure a stable policy environment for doing business?”* China ranks 45, behind most advanced countries, though second only to Indonesia in our sample of middle-income countries.

On the broad issue of quality of institutions, which includes eight sub-indicators in the GCR (security, social capital, checks and balances, public sector performance, transparency, property rights, corporate governance, and future orientation of government), China is ranked higher than all others except Indonesia in the sample of middle-income countries, but lower than the OECD average (Figure 8).

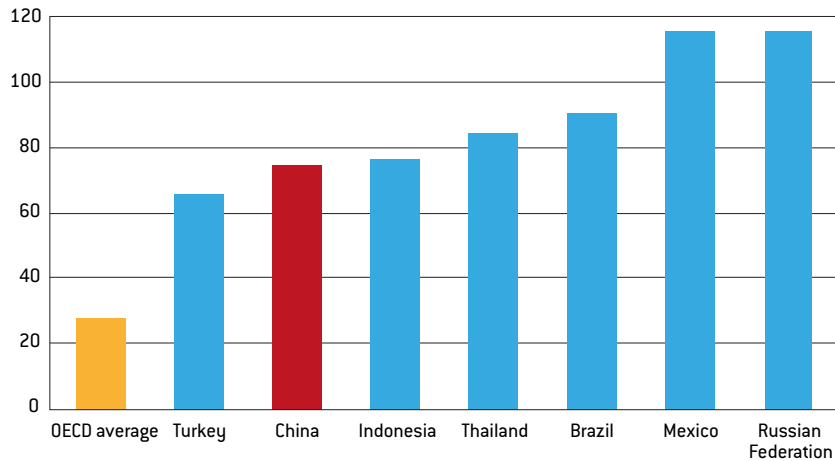
Figure 8: Institutional ranking, GCR (1-141)



Source: Bruegel based on GCR.

In line with observations on the importance of networks and relationships with government officials (the ‘guanxi’) for effective operations (Meltzer and Shenai, 2019), China’s GCR ranking is least favourable on the incidence of corruption indicator (75), far worse than advanced countries and behind Turkey in our sample but ahead of the other five countries (Figure 9). The GCR takes this measure from Transparency International and reports it as transparency.

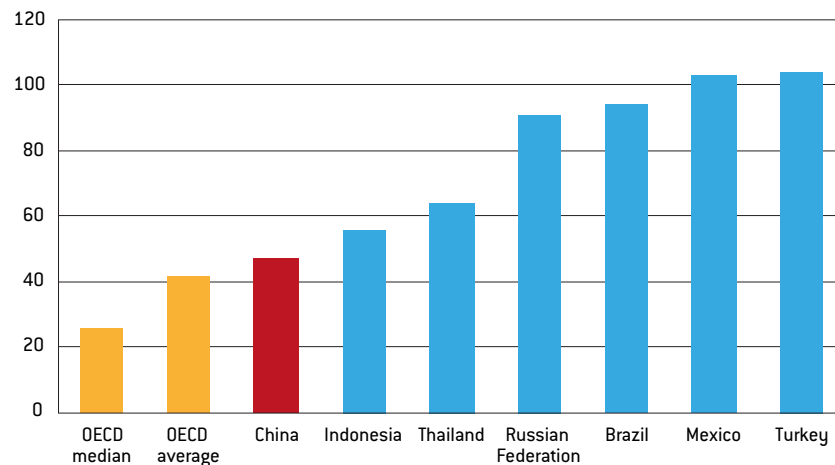
Figure 9: Transparency ranking, GCR (1-141)



Source: Bruegel based on GCR.

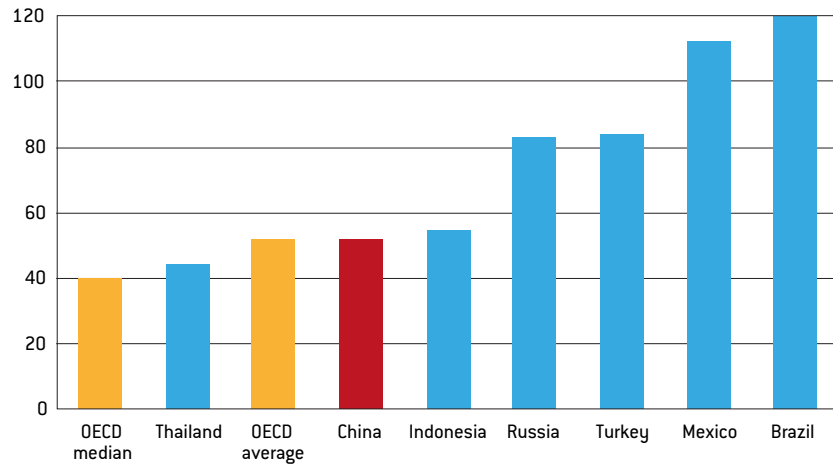
However, the GCR ranks China surprisingly well on burden of regulation (19). China is ranked highest in our sample on the efficiency of the legal framework in challenging regulations, and 36 globally. On judicial independence, which is addressed by the WEF with the question “*In your country, how independent is the judicial system from influences of the government, individuals, or companies?*”, China ranks 47, well ahead of Brazil, Mexico, Russia and Turkey, all of which are ranked near 100. But on this measure, China is well below advanced countries (Figure 10). China fares similarly in efficiency of the legal framework in settling disputes (52), although not as well as other countries in our sample, of which Thailand is highest ranked at 44 (Figure 11).

Figure 10: Judicial independence ranking, GCR (1-141)



Source: Bruegel based on GCR.

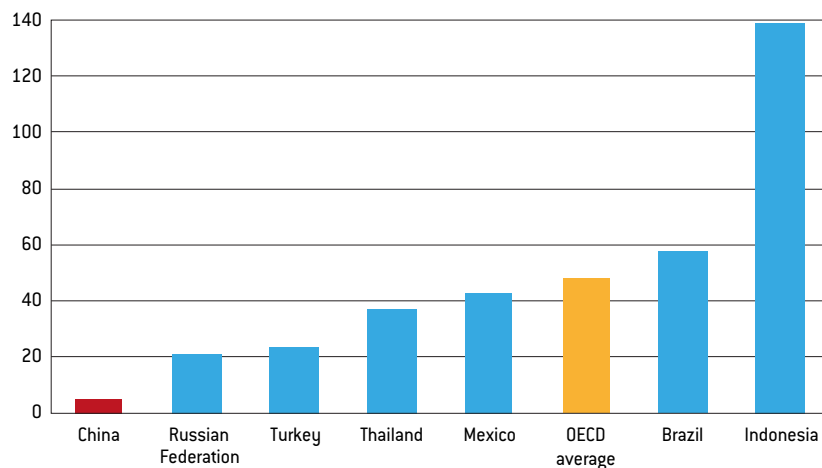
Figure 11: Efficiency of legal framework in settling disputes, GCR ranking (1-141)



Source: Bruegel based on GCR.

The DB report monitors contract enforcement by evaluating the time, cost and quality of judicial processes, based on a review of codes and procedures and a survey of lawyers and judges. According to this, China ranks highly, fifth out of the 190 economies covered (Figure 12).

Figure 12: Contract enforcement ranking, DB (1-190)



Source: Bruegel based on DB.

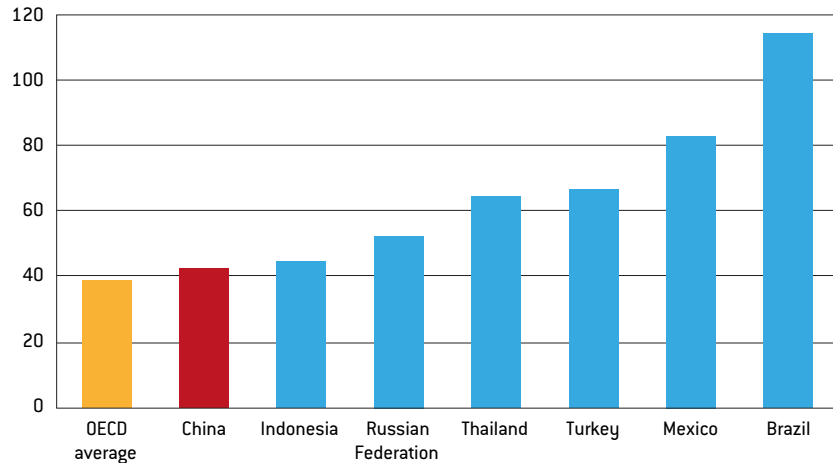
The large differences in ranking on judicial effectiveness between the DB and the GCR may be attributed to the fact that GCR scores are based on perceptions of the business sectors while DB scores are based on an examination of formal procedures and the perceptions of lawyers. Here again there appears to be a significant gap between *de-jure* procedures and their application, at least as viewed by business executives.

It should be noted that China's legal system has been evolving rapidly since the 1990s, a period that coincides with the run-up to its WTO accession. This evolution may continue in coming years as the Chinese Communist Party aims to improve business confidence in the legal system while retaining political control (Mankikar, 2020).

The playing field for foreign companies in China is not level in many respects but is not out of line with those of other middle-income countries

The GCR ranks China unfavourably low on the distortive effect of taxes and subsidies at 51 in the world, though this is ahead of the sample of other middle-income countries except for Indonesia. In contrast, the GCR ranks China quite highly, 27, on the extent of domestic competition in the economy, a measure of the contestability of markets, in line with the OECD average (Figure 13).

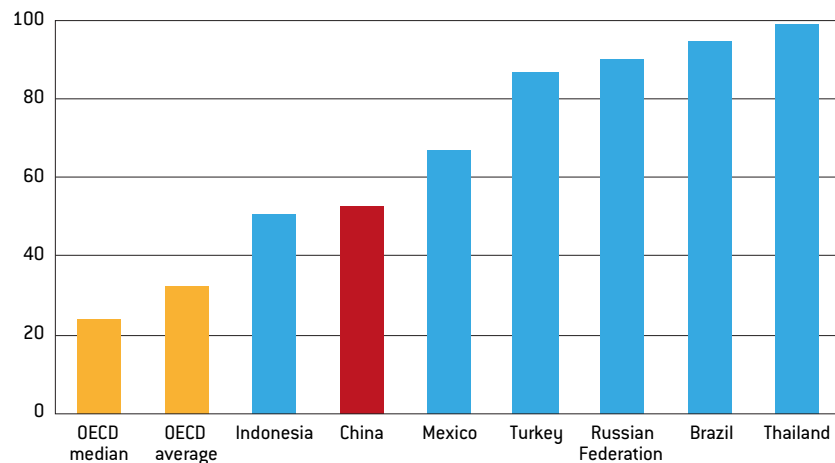
Figure 13: Domestic competition ranking, GCR (1-141)



Source: Bruegel based on GCR.

According to the GCR, China ranks an unimpressive 53 on IP protection, slightly behind Indonesia in our sample, but ahead of the others (Figure 14).

Figure 14: Intellectual property protection ranking, GCR (1-141)



Source: Bruegel based on GCR.

This finding reflects generally weak IP protection in developing countries. EU firms report numerous violations of IP rights in all the countries in our sample, as well as in other large developing economies including India, Argentina and Malaysia (European Commission, 2021). An important issue that is systematically associated only with China is forced technology transfers. However, the 2019 FIL has made forced technology transfer illegal and removed nearly all joint venture requirements in manufacturing and in many services sectors. Since

China is now a large investor in R&D, a user of patents and copyrights, and is rapidly moving up the value added/technology ladder in many sectors, it is also showing increased interest in tightening its IP regime to protect and incentivise Chinese innovation.

To summarise our international comparison, China is ranked overall highest on competitiveness in our sample of middle-income countries by the GCR and second after Thailand on ease of doing business by the DB. China is ahead of some advanced countries in both reports. Considering that China does better than nearly all others in the sample on indicators relating to quality of institutions, it would be a stretch to conclude that China's business practices stand out among middle-income countries as discriminating against foreign firms. In fact, on most indicators in DB and GCR, and on the FDI in manufacturing, China generally does better than countries at similar levels of development. Moreover, various indicators, including the FDI and the DB, show that China is improving rapidly. China is still a middle-income country (about a quarter of the Chinese population is below the \$5.50 per day that the World Bank defines as the poverty line in upper-middle-income countries), and it is not unusual for middle-income countries to have less protection of intellectual property, more corruption, more closed trade regimes, and more arbitrariness in implementing regulations, than advanced countries.

That said, two areas of special concern relating to China emerge from our comparisons. First is the restrictiveness of China's FDI regime in the services sector. The expectation is that the FIL and the CAI (if ratified) will mark a material improvement in opening China's services sector. Second is the gap between *de-jure* rules and their application *de facto*, which is especially evident in the gap between the DB, which measures procedures, and the GCR, which reports the perceptions of executives, on assessing judicial effectiveness in China. Laws and regulations in China are moving in the right direction, but their fair and effective enforcement remain major issues.

5 Conclusion

The treatment of western firms operating in China is a major cause of friction, though significant as this issue is, it is – of course – not the sole economic consideration in shaping EU and US policy on China. The interests of American and European workers, consumers and importers of parts and raw materials from China are equally important, for example. Concerns over human rights, security and geopolitics, which we do not discuss here, also loom large in China policy.

Within the narrow bounds of our review, we find that foreign firms in China worry mainly about markets, costs and competition, as in any normal business situation, and that despite the uncertainties created by the China-US trade war, they want to stay in China. They also worry about patchy enforcement of rules. Our international comparison of the business environment suggests that China does not stand out as a poor performer in a sample of middle-income countries. Indeed, China generally does better, and the overall assessment of the business environment in China by the World Bank in the DB and World Economic Forum in the GCR is in line with that of the average of OECD countries. However, as claimed by western policymakers, a major concern for foreign firms is the arbitrary implementation of regulations and laws and the *de-facto* discrimination against them, a concern that is especially acute in the IT sector. The fact remains that most EU and US firms do not feel discriminated against in China and that some believe they are treated better than Chinese firms, presumably owing to investment incentives.

If our broad assessment is correct, important policy observations flow from it for Chinese and western policymakers. First, China's trading partners tend to hold it to a higher standard compared to countries at similar levels of development. We believe this is justified by the size

and dynamism of China's economy. China is not only the world's largest trading nation by some measures and the largest destination for foreign investment, it is also moving rapidly up the value chain and increasingly competing with advanced countries in some high-technology sectors.

This means that discriminatory practices by Chinese authorities are far less likely to escape attention than those of, say Thailand or Mexico. Chinese policymakers should accept this fact and recognise that they bear special responsibility for accelerating reforms. Most important, though Chinese laws and regulations, such as the 2019 FIL, appear to be converging with those of advanced countries, their application is still too spotty and arbitrary. Chinese policymakers should also recognise the sensitivity of western firms and policymakers to their targeting of priority sectors, as in Made in China 2025. While it is understandable that China wants a big stake in the sectors of the future (as do many other countries), any impression that the massive Chinese state apparatus will adopt a coordinated approach that favours Chinese firms in these sectors will naturally be resisted by western firms and their governments.

Policymakers in the EU, Japan and the US, meanwhile, should moderate their expectations of China. It is after all an economy with big regional differences and where average incomes are a third those in Europe and a quarter of those in the United States. China's capacity to evolve and adapt is impressive, but it cannot be expected to quickly match the regulations and institutions of advanced countries built over decades and centuries.

Western policymakers – especially in the United States, which has increasingly seen China as a rival and security threat – need to sort out what they want from China. Insofar as their concern is China's discriminatory business practices, it should be dealt with in a manner that is consistent with business and consumer interests, ie by striking appropriately structured deals which promote or bind both market access and reforms that level the playing field in China. Erecting more trade barriers, or worse, decoupling is the last thing US and European businesses want, and would be a course guaranteed to hurt consumers in China and the West.

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