

# Understanding Hainan Free Trade Port: China's Efforts to Explore High-level Opening-up

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## I. Introduction

On 13 April 2018, upon the 30<sup>th</sup> anniversary of Hainan province, Chinese President Xi Jinping announced to build Hainan into a free trade port.

According to the *Master Plan for the Construction of the Hainan Free Trade Port* released by the State Council on 1 June 2020, China aims to build this southern island province into a high-level free trade port with global influence by the middle of the century. As China's largest special economic zone, Hainan is expected to become the frontline of China's integration into the global economic system. Noting that the world is facing a new round of major development, changes and adjustment, with protectionism and unilateralism on the rise and economic globalization facing greater headwinds, it was also a strategic decision of Chinese authorities based on the domestic and international landscapes.

As such, Hainan Free Trade Port (HNFTP) is more than a regional development initiative, and it has a much bigger role to play in China's reform and opening endeavors.

## II. What Makes HNFTP Different from Other FTZs?

China had no experience of building a free trade port starting from scratch. What Hainan could do is to take opening policies in China's FTZs as a point of departure and benchmark successful global free trade ports such as Singapore, Hong Kong and Dubai. Therefore, HNFTP shares many of the FTZs' features, such as use of a foreign investment negative list, streamlined port and customs operations, simplified company registration, etc. Nevertheless, there are also significant differences.

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***HNFTP aims at establishing a new regime for open economy.***

Before Hainan was announced to be a free trade port, China's State Council had approved pilot FTZs in 11 provinces since 2013 (21 provinces by September 2020). The general goal of China's FTZs is to be in line with general rules and practices of international trade and investment by transforming government functions and innovating policies through reform and opening measures. It is to bolster and promote foreign direct investment in various industries varying by region. However, the HNFTP aims to go one step further and is more ambitious than FTZs. It is to benchmark the highest level of opening-up and is supposed to take initiatives to adapt to the changing international economic relations and trading rules, including the new trade norms that are being negotiated by developed economies. This means that HNFTP shall be one of the most open regions in the world when its reform and opening measures are well in place.

***HNFTP aims at more comprehensive deepening reform and opening, while FTZs have a narrower scope and mainly focus on trade of goods.***

First of all, FTZs cover only selected areas of cities with focused industries for each province, and the total area of the FTZ in each province is around 200 square kilometers. However, HNFTP covers all the administrative regions of the whole province, namely, about 35,000 square kilometers of its entire

land territory.

Second, FTZs focus on facilitating the flow of goods by introducing incentives and testing new regulations. These include, for instance, reduced corporate income tax (varies by FTZ), duty-free imports and exports, bonded warehouse capacity, etc. In the Shanghai Pilot FTZ, foreigners working in the zone can apply for a private affairs residence permit of up to 5 years, and those who have worked for three consecutive years can apply for a 2-year work residence permit.

However, HNFTP aims to facilitate free flows of goods, capitals and people. By 2025, the Hainan Free Trade Port (HNFTP) is set to introduce island-wide customs clearance operations, which means there will be free entry and exit of goods between the boundaries of the HNFTP and other regions and countries outside China's customs territory (the "first line"), while efficient controls will be adopted for the flow of goods between the island and China's mainland (the "second line").

For free cross-border capital flow facilitation, free trade (FT) accounts have been introduced in Hainan, enabling companies to handle local and foreign currency settlement of cross-border transactions and overseas financing business. The funds in FT accounts can be exchanged in the offshore market. Policies also include facilitation measures addressing the RMB settlement for cross-border investments, cross-border investment and financing exchange management, etc.

From May 1<sup>st</sup>, 2018, individuals with ordinary passports from 59 countries (including Korea) are eligible for visa-free entry to Hainan and can stay in the province for up to 30 days.

Thirdly, taxation. In the Shanghai Pilot FTZ, there are no preferential taxes, although there are tax incentives allowing enterprise/individual shareholders to pay income taxes by installments over a period of up to five years under certain conditions. As for HNFTP, there are favorable tax rates reduced to 15% for corporate income tax and favorable tax rates for individual income tax capped at 15%. What's more, HNFTP is to streamline VAT, consumption tax, vehicle purchase tax and some others into one single sales tax around 2025, and the taxation system is to be further simplified after the island-wide customs clearance operations are in place.

If we look into specific policies and opening measures, there are many more that are exclusively available in HNFTP. Foreign doctors are recognized and allowed to practice in Hainan's *Boao Lecheng International Medical Tourism Pilot Zone* (expected to be in the whole island soon). German University Bielefeld became the first overseas university to set up a wholly foreign-owned college in Hainan, and HNFTP will relax restrictions on overseas individuals taking professional qualification examinations and implement a one-way accreditation list system for overseas professional credentials, just to name a few more.

***HNFTP construction is assured and guaranteed by legislation.***

On 10 June 2021, the *Hainan Free Trade Port Law of the People's Republic of China* took effect. It is the first and so far the only national law that was formulated and passed to support the construction of a free trade port. What's more, it empowers Hainan's provincial legislative body to pave a way for HNFTP by eliminating legal barriers, as stated in its Article 10, "The Hainan Provincial People's Congress and its Standing Committee may, in accordance with this Law, formulate regulations on trade, investment, and related administrative activities ... in light of the actual conditions and needs of the Hainan Free Trade Port and under the provisions of the Constitution and the basic principles of laws and administrative regulations ...".

### III. HNFTP: China's Efforts to Explore High-level Opening-up

China follows its own pace in its advancement for reform and opening-up. Nevertheless, concerning its domestic and external factors, it seems that HNFTP is not only a logical follow-up of China's reform and opening efforts, but also could be understood as a pilot experiment to cope with potential risks and challenges ahead. It is to test, first, how China can interact with regional and global players to develop sound institutions for the purpose of surviving external challenges and shocks; and second, to what extent can China manage to open up at the

highest level possible with necessary reforms to develop a market economy with socialist characteristics.

*China's efforts for reform and opening have been consistent and it is exploring an alternative way to crack hard nuts to move further.*

China is a firm believer of development through opening. Experience shows that China's significant economic progress is largely attributed to its reform and opening-up efforts. Starting from the Special Economic Zones (SEZs), China had successfully introduced various reforms from utilizing international capitals to reforming its administrative bodies to be in line with common practices of industrialization and modernization, in a step-by-step approach. Successful experiences and feasible practices were soon introduced in other non-SEZs throughout the country, which had driven China's phenomenal growth for more than four decades. Particularly, joining the WTO marked a key milestone of its opening and brought China a "golden decade" of development, just as Chinese Ambassador Yi Xiaozhun to the WTO had put it.

However, as reform and opening reached the deep water, it has been rather hard to crack vested interest to further advance reforms. Particularly, when some of the former reformers became vested interests, also called crony capitalists, it seems that maintaining the status quo is of their best interests. Although they do not want to go back to the old days of the planned economy, neither do they want to move ahead

in further reforms, which are very likely to deprive them of privileges and threaten their interests. This is why China's leadership vowed to break the impediments of vested interests with tenacious determination.

Yet, this is never easy. In parallel to the pilot projects in those FTZs, having another bold and affordable experiment in a more manageable region like Hainan, a geographically isolated island, could be an alternative way out. Chinese leadership may hope to press forward domestic reforms with external forces through further opening-up, like what China did and achieved by joining the WTO in 2001.

*With changing international climate of economic relations, HNFTP has a bigger role to play in response to potential risks of "General retreat" from globalization among Western economies.*

Shen Xiaoming, former head administrator of the Shanghai Pilot FTZ (2015-2016) and the then governor of Hainan Province (2017-2020), once said that the international background of HNFTP is different from that of the FTZs. The early FTZs were created in the tide of economic globalization, while the idea of HNFTP was developed in the context that globalization has been experiencing strong headwinds.

Besides BREXIT, "America First" and stalled WTO reform, China has been frequently targeted because of its increasing size and competitiveness that has been developed through its integration into the global economy.

Among China's major trading partners, the United States is fundamentally changing its approach to China from "engagement" to "decoupling," waging trade and technology wars against China, out of concern of the Thucydides Trap. Meanwhile on the European Union side, its approach to China is becoming more value-based, and it labelled China as a "systemic rival" in its strategic outlook paper in 2019, practically putting a halt to its "strategic partnership" with China started in 2003. In May 2020, the European Parliament voted to freeze the ratification of the China-EU Comprehensive Agreement on Investment (CAI) due to China's counter sanctions over the West-narrated "Uyghur genocide" in China's Xinjian autonomous region, although it has been quite clear that many of those unfriendly policies were not well supported by sufficient evidence and proofs.

Such significant changes give HNFTP a unique role to play in China's opening endeavors. Chinese leadership and elites understand very well that China has strong interests to remain economically integrated into the international community. This is why China's official discourse has been that China needs to uphold globalization and multilateralism. Although it seems that emphasis has been put on the "domestic circulation" of China's new "dual circulation" development paradigm, we need to understand that it was just a logical result of the aggressive "decoupling" and "containing" measures from the United States and some of its allies, in addition to the covid-19 pandemic challenge.

Interestingly, if we perceive it positively, it turned out to be an effective external force for China's domestic market-oriented reforms. In May 2022, China's National Development and Reform Commission announced to accelerate plans for building a unified national market through eliminating domestic market barriers across provinces and municipalities, which is encouraging news for global investors that have presence in China's market. More measures and progress can be expected in the coming years.

Another wing of the "dual circulation" is international circulation. With such changes of international economic climate, HNFTP has a critical role to play as an intersection of China's domestic circulation and international circulation. With free flows of goods, capitals and people, as well as the ambition of introducing the highest level of opening practices, HNFTP would become an attractive destination for those who would like to take HNFTP as a gateway to China's lucrative market with increasing demand of the middle-incomers, if they have various concerns and difficulties to have physical establishments in China's mainland.

In this manner, China would be able to maintain an open and effective international circulation even in a very critical situation. Nevertheless, this is not enough. As Asia is gaining its weight in the global economy, HNFTP could be an instrument to facilitate closer economic relations between China and other regional economies. ASEAN, which became China's biggest trade partner in 2020, has been taken by

Hainan as a priority for China's international circulation.

From a medium- and long-term perspective, HNFTP would also play an important role in connecting China and other advanced economies that have strong interests, especially in trade of services, if Hainan proceeds satisfactorily as expected in the opening of services sector.

*An experiment of moving from policy-driven to rule-based opening and following the principle of rule of law through integrated system innovation?*

During the annual Central Economic Work Conference in December 2018, for the first time, it was proposed that efforts should be made to promote rule-based institutional opening based on previous practices of facilitating free flow of commodities and production factors. Thus, institutional opening is interpreted as developing a set of fundamental institutions and regulation patterns that are transparent and in line with general rules and practices accepted internationally for trade and investment, by streamlining incompatible domestic laws and regulations.<sup>1</sup>

In July 2021, President Xi Jinping further advocated that China needs to promote high-level institutional opening, grant more reform autonomy to pilot FTZs, enhance integrated system innovations on reforms, and coordinate opening and security issues; and experiences are to

be summarized, copied and implemented in other regions in a timely manner.

It shows that China's leadership is fully aware what had been done in reform and opening were probably not enough and further efforts need to be made, not just to avoid potential risk of passive dis-integration from the global economy, but also to find another way out for continuous and sustainable development. It also illustrates that China acknowledged the complaints on market barriers from international and domestic investors and started exploring how to eliminate these problems at its own pace, as it needs to assure stability and security when making bold moves in opening. As it has been regularly emphasized that HNFTP is benchmarking the world's highest level of opening, HNFTP is undoubtedly expected to press ahead before other pilot FTZs.

HNFTP is expected to be prepared for the introduction of new trade norms at a higher level. There have been ongoing academic and policy discussions on carrying out pressure tests for *Comprehensive and Progressive Agreement for Trans-Pacific Partnership* (CPTPP) and other high-level trade agreements in Hainan, and it is foreseeable that it may not take long before Hainan government to act accordingly, especially after China has filed a formal application to join the CPTPP.

It is no surprise that the West remains skeptical of China's move for a CPTPP membership con-

<sup>1</sup> Liu, Hongzhong, *How to understand institutional opening*, 2019, <http://www.news.cn/sikepro/2021>

0310/C9335F4B6AD00001A5D4EF404B603D30/c.html (accessed on July 29, 2022)

sidering their dissatisfaction with China's slow progress in many domestic reform issues covering state-owned enterprises, intellectual property protection, etc., some of which Chinese reformers might have similar perspective. In fact, there were already voices in China proposing China to be prepared to join TPP, long before it changed to CPTPP after the exit of the United States.

Despite the western skepticism, it is worth noting that there are voices proposing for China to implement unilateral opening measures. "... China needs to open unilaterally. Even if the United States or the West opts to contain China, China should remain open to them and shall not choose to be self-closed," according to Zheng Yongnian,<sup>2</sup> a well-known scholar and a professor at the Chinese University of Hong Kong, Shenzhen, in a forum in 2020; and he is not the only one proposing as such.

Although unilateral opening was only proposed by scholars for the time being, it shall not be excluded as an option for China in the future.

Introducing the highest level of opening practices and preparing for pressure tests of various high-level trade pacts mean that HNFTP needs to innovate and establish institutions that are rule-based through rule of law rather than policy-based, as the former offers more stable expectation for market players.

So far, it seems that HNFTP is proceeding in

the right direction, and we need to be positive about its future.

## IV. Conclusion

From a medium- and long-term perspective, we should always be optimistic that China will not stop its efforts to press forward reform and opening, although we also need to be aware that there could be setbacks in case of domestic and external challenges, of which the West should be partly held accountable for the latter.

China has its development goals to achieve and its dream to realize. Without further reform and opening, it would be very possible to get stuck in the middle-income trap, which is definitely not desired by its leadership and its people.

It takes time for HNFTP to develop, take shape and become successful, and it also needs constructive engagement and interaction of the international community to assist and jointly steer its development conducive to realize our common interests.

As important neighbors and economic partners with each other, Korea and China can explore further developing their bilateral economic relations by jointly tapping the potential of HNFTP. Firstly, Hainan aims to become an international consumption center and its duty-free shopping has been hiking in recent years; from 2013, Hainan started to organize the China International Consumer Products Expo,

<sup>2</sup> Zheng, Yongnian, *China needs to be more open unilateral opening is also feasible*, 2020, <http://www.ne>

[www.cn/sikepro/20210310/C9335F4B6AD00001A5D4EF404B603D30/c.html](http://www.cn/sikepro/20210310/C9335F4B6AD00001A5D4EF404B603D30/c.html) (accessed on July 29, 2022)

one of China's national flagship events. Korean enterprises can consider entering this market with their competitive cutting-edge electronic appliances, cultural products, etc. Secondly, as Hainan is focusing on opening its services sector, Korea can cooperate with HNFTP in modern services, including but not limited to tourism, medical and health care, education, science and technology. Thirdly, with their presence and suppliers in China's mainland, Korean companies can work with their counterparts to further develop regional supply chains through HNFTP that has many advantages in connecting the markets between China and ASEAN. **KIEP**