Sustainability Impact Assessment (SIA) in support of an Investment Agreement between the European Union and the People's Republic of China

Executive summary English

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Executive summary

Context and objective

Over the past decades, 27 out of 28 European Union (EU) Member States (MS) have signed Bilateral Investment Treaties (BITs) with China, providing for investment protection, but not for investment market access. Restrictions caused by investment barriers mean there is still significant untapped potential in investment flows between China and the EU.

Following an impact assessment carried out by the European Commission (EC) in October 2013, the EC received an authorisation from the European Council to enter into negotiations aimed at concluding an investment agreement between the EU and China. This Investment Agreement would replace the existing BITs. Negotiations were officially launched during the 16th EU-China Summit held on 21 November 2013 and the first round of negotiations took place in Beijing in January 2014.[1] By November 2017, fifteen rounds of negotiations have taken place.

This document is the Final Report for the Sustainability Impact Assessment (SIA) in support of an Investment Agreement between the EU and the People's Republic of China. This study explores the potential sustainability impacts of such an investment agreement to inform the negotiators from both the EU and China.

The objective of the study is thus *"to assess how the investment provisions under negotiation could affect economic, social, human right and environmental issues in the EU and China and to make recommendations to maximise the benefits of the agreement and prevent or minimise potential negative impacts."*

In this Final Report, we summarise our approach and conceptual framework as established during the inception phase, provide information on the baseline and change scenario (i.e. the situation without and with an investment agreement), and present the overall economic, social, human rights, and environmental assessments. Furthermore, the impact on six sectors is studied in more depth, being Transport Equipment, Mining and Energy Extraction, Chemicals, Manufacture of Food and Beverages, Finance and Insurance, and Communication and Electronic Equipment. The last chapters concern a description of the stakeholder consultations conducted, followed by the conclusions and policy recommendations of the SIA.

Approach and conceptual framework

The overall approach to the entire SIA can be divided in three linked phases:

- Overall analysis of the sustainability impacts arising from a potential Investment Agreement between the EU and China;
- Analysis at sectoral level of the sustainability impacts arising from a potential Investment Agreement between the EU and China;
- Proposals for policy recommendations and accompanying measures.

Our approach is based on the two methodological elements of a SIA as described in the Terms of Reference (ToR) and the SIA Handbook[2]: 1) analysis of economic, social, human rights and environmental impacts; and 2) stakeholder consultations. These two elements are complementary and of equal importance. Hence, the sustainability assessments are characterised by both quantitative and qualitative elements and throughout the SIA, we have engaged in continuous feedback and consultation with key stakeholders to collect their input and to verify the results. Main consultation activities consist of electronic consultation and dissemination (dedicated SIA website, electronic newsletters, social media, etc.), three Civil Society Dialogues for EU civil society, a SIA stakeholder workshop in Brussels that took place on the 5th of July 2016, personal interviews, and online surveys. Consultation and dissemination has taken place both in the EU and in China, and directly fed into the various SIA analyses.

As indicated above, the EC carried out its own impact assessment of the EU-China Investment Agreement in 2013, which was partially based on a quantitative study prepared by Copenhagen

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1 European Commission (2013, 19 November). *16th EU-China Summit Beijing.* Press Release, Brussels.
2 This SIA Handbook is available at: http://trade.ec.europa.eu/doclib/docs/2016/april/tradoc_154464.PDF.

Economics in 2012. This impact assessment is taken as a starting point for the analysis in this SIA. We focus on those issues that have either not been studied yet, need to be updated, or that come out as particularly important and warrant further analysis, thereby providing value added to the negotiators.

Background to the EU-China Investment Agreement

Before diving into the sustainability impacts of the future EU-China Investment Agreement, it is important to understand the context in which the negotiations take place and what the agreement will entail. The comprehensive Investment Agreement between the EU and China that is currently being negotiated would be the EU's first ever stand-alone investment agreement covering both market access and investment protection. Once concluded it will replace the 26 bilateral investment protection agreements currently in place between China and 27 EU Member States (all but Ireland).

Areas covered by the Investment Agreement that is currently under negotiation include investment market access and protection, a regulatory framework for investment, including transparency, licencing and authorisation procedures, sustainable development and dispute settlement. Regarding sustainable development, the future agreement will include rules on environmental and labour-related dimensions of foreign investment.

Under the EU's reformed approach on investment protection, the EU also proposes a distinct provision on the right to regulate, which reaffirms the capacity of states to adopt measures in pursuit of public policy objectives; these provisions might provide a safeguard for states against claims from investors whenever public policy initiatives protecting its citizens or the environment clash with the interests of the investors.

Economic impacts

After having a look at the economic baseline, i.e. the inward and outward foreign direct investments (FDI) flows and stocks of both China and the EU without the future Investment Agreement, we have assessed the expected economic impact. Copenhagen Economics (2012) has modelled the agreement with a scenario of moderate and ambitious market opening. It should be noted that given the early stage of the negotiations, it is not clear what the actual level of market opening will be, and to what extent this will differ by sector. The model estimates a modest effect on FDI stocks. The EU FDI stock in China is expected to expand by 0.6 percent in the moderate liberalisation scenario and by 1.9 percent in the ambitious liberalisation scenario, while Chinese FDI stock in the EU is expected to increase by 0.3 and 0.9 percent respectively. This model only estimates the effects on existing investments. Based on additional analysis, we find that there will potentially also be an interest from new EU and Chinese investors, including SMEs, to start investing in the partner country as a result of the Investment Agreement, given that certain barriers will be taken away and hence investment costs will be reduced. Therefore, the findings from the model are likely to underestimate the increase in bilateral investments.

Based on literature review, increased EU investments in China are not expected to be at the expense of EU employment, and are more likely to contribute to the good performance of EU companies. Furthermore, some positive productivity and market access spill-overs can be expected for SMEs, both in the EU and in China. Also, Chinese investments in the EU can contribute to economic growth and employment. Literature suggests that the impact of Chinese FDI on income generation in the EU host countries does not differ significantly from investments of other countries like the US or Japan.[3]

Next to the positive expected impacts, there are also some concerns in the EU about FDI from China. These concerns mainly relate to the fact that Chinese companies, either SOEs or private companies receiving preferential treatment from the Chinese government, seem to use acquisitions for obtaining expertise and advanced technologies from the EU.

3 J. Clegg. H. Voss (2012) *Chinese Overseas Direct Investments in the European Union,* Europe China Research and Advice Network, 2012.

Social impacts

The social impact of the Investment Agreement between the EU and China will predictably stem from the impact of labour related provisions of the agreement, changes in the government's approach to social rights as a result of increasing international exposure, transparency and openness, and as a result of the expected increase in FDI that is expected from the agreement.

The agreement is likely to provide an additional framework to discuss matters covered by the Sustainable Development chapter of the agreement and promote transparency, and non-state actors' involvement. Such mechanism, overseeing the whole agreement or SD specific, might increase transparency on labour and sustainable issues in the host countries and improve governance and social dialogue. However, the social impact and effectiveness of the mechanism will largely depend on their scope, including involvement of non-state actors, considering the specific contexts of the host countries. Finally, transparency provisions on new regulation affecting economic operators could provide reasonable opportunities to comment on proposed measures, and endeavour to take into account the comments received from interested persons. Transparency procedures may have an effect on the quality of governance, increase national and international exposure and, as a result, promote changes in the social field. Some stakeholders consulted were sceptical though on international exposure as a driver for social change in China. National security was mentioned as the major driving force for policy initiatives in the labour field in recent years.

A second source of impact could result from differentiated employment and labour practices of foreign employers compared to national employers in China and the EU. Working conditions in EU firms operating in China are said to be better than their Chinese counterparts as a result of policies brought by the top management from the country of origin. It is also more likely that EU firms in China might properly compensate workers for overtime. All these seem to result in lower employee turnover in EU firms. These human resource practices – and the resulting decrease in turnover - might have a spill-over effect on Chinese HR management. In terms of industrial relations, well-run European companies seem to have fewer strikes than their Chinese counterparts and often have a workers' committee for consultative purposes. While no genuine collective bargaining exists, some forms of bargaining are emerging in foreign firms when striking workers elect their own representatives outside the influence of the All-China Federation of Trade Unions (ACFTU) and engage in negotiations with the management. This results in ad-hoc agreements, after which the workers' structure is dissolved.

In the EU, trade unions have expressed concern on the potential impact of Chinese investment on working conditions in Europe. So far, there seems to be no evidence of changing working conditions of workers affected by Chinese investment made through mergers and acquisitions, neither on existing collective agreements of large firms. The EU system of labour market governance and public scrutiny could play a role in maintaining existing working conditions and labour relations practices.

Human rights impacts

Potential drivers for change in the human rights impact scenario as a result of the agreement include increased transparency and participation in the process of law-making, increased exposure of countries to international scrutiny, and Corporate Social Responsibility (CSR) practices of foreign investors in host countries. Human rights impacts – either positive or negative- will largely depend on the existing level of protection through laws and policies in host countries. Countries with legal frameworks compliant with international human rights standards and good governance institutions are more likely to benefit from positive human rights impacts of FDI.

While the agreement might not include specific human rights provisions, it might contain pre-ambles reaffirming the attachment of the parties to democracy and fundamental rights and recognising the importance of international security, democracy, human rights and the rule of law for the development of international cooperation. These preambles will provide interpretative guidance for the implementation of the agreement.

The increased engagement of the Parties on labour- and environment-related aspects of investment following from the sustainable development provisions could have a spill-over effect also to address human rights issues; the institutional mechanisms might provide an opportunity for participation of the non-state stakeholders established in the territory. But as indicated under social impact, their impacts and thus the spill-over effect will largely depend on the effectiveness and involvement of non-state stakeholders, considering the specific contexts of the host countries, particularly with regards to the right to freedom of expression in China.

The inclusion of sustainability clauses might include the recognition and obligation to respect the rights contained in multilateral standards and agreements. The obligation to ensure transparency and to promote public participation and public information might positively impact the right to freedom of expression in China.

General liberalisation investment provisions and the resulting increased presence of foreign investors and their contribution to economic growth and economic and social development may positively impact access to an adequate standard of living of the local population, particularly if wages are positively affected by foreign investment.

With regards to CSR practices, stakeholders were mostly of the view that European MNEs particularly large ones - operating in China establish global CSR practices of higher standards than those implemented by Chinese firms in the country, although with some flaws in their application, particularly in the supply chain. CSR practice of EU firms in China, including information disclosure, might have a positive spill-over effect on Chinese firms operating in China and abroad. Some stakeholders raised concerns about the practice of undertaking human rights risk assessment by EU companies and their perceived incompleteness.

Environmental impacts

The overall conclusion on the likely impact of the agreement on environment is that the agreement is unlikely to cause the degradation of environmental quality. The overall effects of the agreement are small to negligible with respect to the following indicators: energy use, carbon dioxide, water use, land use, material use, biomass forestry, methane, nitrous oxides, sulphur oxides and industrial solid waste. We foresee a very small decrease of environmental intensities with relation to the value added for all above environmental indicators.

In case of carbon emissions, this will help to reach one of the targets of China’s Intended Nationally Determined Contribution (INDC) to the 2015 Paris Agreement under the United Nations Framework Convention on Climate Change. The INDC stipulates lowering of carbon dioxide emissions per unit of GDP by 60% to 65% until 2030 from the 2005 level.

The higher influx of foreign investment is unlikely to lead to the relaxation of environmental requirements in China. In fact, available evidence suggests that increased foreign investment might lead to an improvement of environmental quality in China.

The inclusion of the environmental provisions in this agreement is an important means to preclude the appearance of pollution havens and to strengthen environmental regulations.

In-depth sector studies

The six sectors that are studied in-depth are Transport Equipment, Mining and Energy Extraction, Chemicals, Manufacture of Food and Beverages, Finance and Insurance, and Communication and Electronic Equipment. For these sectors, we have described the current situation and market access issues currently being encountered by both EU and Chinese MNEs (baseline), and the expected sustainability impacts of the Investment Agreement for these sectors.

Transport Equipment

EU transport equipment firms face some substantial barriers when investing in China. Several significant barriers are local content requirements, joint venture requirements, lack of transparency, and intellectual property right violations. According to stakeholders there is a lack of written regulations in China. Foreign investors are often only informed about these regulations by Chinese investors when they have already entered the country. Regulations that are written down are often subject to change based on the government’s needs and wishes. The lack of transparency further increases uncertainty. Due to inter alia local protection or close ties between Chinese companies and local governments, there is currently a lack of a level playing field between Chinese and foreign companies. Stakeholders have indicated that creating a level playing field is one of the ‘musts’ of the future Investment Agreement.

According to the modelling of Copenhagen Economics (2012), the EU motor vehicle sector is likely to see its output in the EU grow, ranging from 0.0 percent to 0.7 percent depending on the scenario modelled. For other transport equipment these figures range from 0.0 percent to 0.5 percent. Because of the increase in EU output, employment in the EU is also likely to expand. For both low skilled and high skilled employment the expected change equals 0.6 percent for motor vehicles, and 0.4 percent for other transport equipment. EU firms in the other transport equipment sector that are already present in China, on the other hand are, according to the modelling, expected to be negatively impacted both in terms of turnover and employment. The impact on EU firms in the motor vehicles sector already present in China is expected to be positive when low spill-overs are considered, but negative when high spill-overs are considered. This suggests that if current barriers to investment in China are removed this could also benefit countries other than the EU.

Mining and Energy Extraction

EU Mining and Energy Extraction firms face significant investment barriers in China. Some subsectors are open for foreign investments, whereas others are completely closed off. The former includes the development of new technologies to make mining more efficient, whereas the latter includes the category of rare earth minerals that are vital for many applications. Therefore, these restrictions were classified as ‘extremely important’. According to Copenhagen Economics (2012), the expected impact of the Investment Agreement on this sector is all 0.00 percent (with the exception of an increase of EU output in the ambitious scenario of 0.01 percent in case of high spill-overs. Should the market be opened, through one mechanism or another, the EU companies are in a good position to benefit. Their technologies are much more advanced and environmentally friendly, which prepares them for the mining and extraction (MEE) sector in the future.

Chemicals

The Chinese government is actively stimulating the domestic chemical sector by providing financial and regulatory support, which is not available to foreign companies. Therefore, the playing field for MNEs versus Chinese chemicals companies is unequal. MNEs already present in China currently face increasing competition from domestic Chinese players. The absence of a level playing field demotivates foreign companies to invest in China.

EU investors from the chemicals sectors currently face quite some investment market access barriers in China. For example, MNEs are subject to different rules than domestic companies. These barriers are expected to be partially taken away by the Investment Agreement, therefore bilateral FDI is likely to increase. While EU chemicals MNEs already present in China might experience some difficulties according to the computable general equilibrium (CGE) results from Copenhagen Economics (2012), overall the effects are expected to be small but positive. There is an interest by companies from both sides to increase foreign investment and investment opportunities do exist.

Employment effects from the Investment Agreement, both in the EU and China, are expected to be almost negligible. Health and safety standards in the Chinese chemicals companies are in most cases less strict than EU standards. The increased presence of EU chemical producers could potentially play a role there by transferring better health and safety standards.

China has environmental regulations in place, but the chemicals sector in China is currently one of the main contributors to soil and water pollution. Especially the riverside plants contribute to contamination of rivers and lakes, which have adverse health effects for the population. Based on the information found, it seems that the currently present MNEs often have higher technological standards and comply with international environmental standards. Increased FDI from the EU as a result of the Investment Agreement could enhance a spill-over effect of responsible practice and focus on sustainability. Stakeholders in China have confirmed positive expectations in this respect. Increased output in the EU might lead to some very small increase of pollution.

Manufacture of Food and Beverages

EU firms from the food and beverages manufacturing sector face several barriers when investing in China. According to the Investment Catalogue, investments are restricted in the processing of edible oil of soybean, rapeseed, peanut, cottonseed, tea seed, sunflower seed, and palm, processing of rice, flour, and raw sugar, and deep processing of corn. In these sub-sectors, a

Chinese partner has to hold the majority of shares. EU firms need to apply for several licences and certifications when investing in China. Other issues in the sector concern (registration of) intellectual property rights, lack of good infrastructure, and a lack of transparency.

According to Copenhagen Economics (2012), the EU food and beverages manufacturing industry is likely to see its output grow slightly, ranging from 0.0 percent to 0.1 percent depending on the scenario modelled. Given the small expected changes in output, employment in the EU is not expected to be impacted by the agreement. These figures also include the expected impact on the tobacco sector. Given the limited importance of this industry compared to food and beverages manufacturing we can assume these figures are representative for food and beverages manufacturing.

Finance and Insurance

Market access issues for EU financial sector firms are significant, and include, in particular, restrictions on ownership, equity caps and restriction on branch network expansion. This limits not only the expansion of EU financial sector firms, but also their effective control of their subsidiaries in China. Important business strategy decisions are therefore firmly held in Chinese hands. The absence of effective competition rules hinders a level playing field for foreign firms. In the Insurance sector, it is mostly the bureaucratic procedures that hamper foreign entry, while the foreign-owned equity is capped at 50 percent.

The economic impact of the Investment Agreement on the EU sector's output is very small (always less than 0.1 percent according to Copenhagen Economics (2012)), such that this will not lead to any major economic changes. EU MNEs may expect a small increase in their turnover of a maximum of €183 million in the most positive scenario.

Communication and Electronic Equipment

The industries considered in this in-depth sector study comprise electronic equipment manufacturing and communication services (telecommunication and postal services).

The Chinese government strongly promotes and supports its ICT sector. Also, while the Chinese central government encourages foreign enterprises in the communication and electronic equipment sector to invest in China, on the other hand there are severe restrictions on a wide range of foreign ICT products and services, with the goal to replace foreign products and services with domestic ones. This results in substantial market access barriers.

At this moment in the negotiations, it is not clear yet which Chinese sectors will open up. For some subsectors (postal), access of foreign companies is currently blocked. If this sector opens, then influx of foreign investment can be expected, with positive effects for China. Output and employment of the EU postal and telecommunication sector are expected to experience some very small negative effects according to Copenhagen Economics (2012), which could be caused by relocation of activities from the EU to China.

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