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FOREIGN DIRECT INVESTMENT IN THE PEOPLE'S REPUBLIC OF CHINA

XIAMING LIU

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ABSTRACT

China's rapidly growing inward FDI has been initiated in five main ways. These are: moves stemming from family relations; Chinese government initiatives; action by China-based establishments registered abroad; action by local Chinese firms in search of a partner; and action by the foreign investor. Most of China's inward FDI has been made by ethnic Chinese businessmen who are motivated by family and local connections. Joint ventures are the basic organisational form of FDI, and conglomerate integration is an important phenomenon in China.

These peculiar features of China's inward investment not only pose a challenge to the currently dominant theories of FDI, but also have important implications for China's FDI policy. As for the theoretical challenge, the data obtained from our fieldwork and library research go beyond the range of possibilities explained by these theories, and therefore, a general analysis is developed, which is believed to extend the range of possibilities to be considered, and is used to incorporate the FDI determinants that appear to be important in China. The need to explain the motives of the local partner as initiator requires some of the questions answered by existing theories to be turned on their heads, and the importance of family and local connections in reducing transaction costs in FDI is probably unique to China.

Conclusions reached on policy are that an attempt should be made to achieve greater stability in policy; that discrimination between areas for foreign investment purposes should be removed; that closer approaches to convertibility will enhance the case for removing the residual bias in policy toward exporting and requirements for foreign-exchange "balance"; that, though the very large tax discrimination in favour of foreign firms and joint ventures as against local firms will undoubtedly be reduced, it has probably played a valuable role in leading local firms to find foreign partners and should not be removed entirely without careful consideration; and that correspondingly important questions are raised about whether investment from Hong Kong should be treated as domestic or foreign after 1997.

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INTRODUCTION

From almost a zero base, the People's Republic of China has experienced a rapid increase of FDI inflows since it opened the door to the outside world. At present, China accounts for about 20 per cent of all investment flows to the developing world, and has become a major host. As a result, it will be interesting to know the reasons why foreign businesses have invested in the People's Republic of China, the investment climate there and the impact of FDI on the Chinese economy.

The present project aims to investigate these issues. Methodologically it follows the "theory, then research" strategy. In the first four chapters of this thesis, a critical survey of the relevant literature is provided. The existing theories or knowledge that are needed for this project concern the determinants of FDI, the impact of FDI, the general trends of FDI in today's developing world, and the effects of government policies on FDI.

With command of these theories and knowledge, we then start our empirical investigation. There are immediate difficulties. Firstly, time and funds are very limited while the population is very large (by the end of 1992 there were more than 84,000 FDI projects approved by the Chinese government); secondly, the official statistics are incomplete, and it is even difficult to gain access to some existing information; finally, China's reform process is on-going, so that some of the policies outlined here may be dated by the time the thesis is written.

Facing the first two difficulties, I first did a pilot questionnaire survey of parent companies in Britain and Hong Kong which provided some empirical data, but the overall response rate was low. Following this I did an interview survey of seventeen ventures with foreign investment in several coastal areas of China. These ventures were selected because not only were they accessible, but they also followed the general pattern of FDI source countries in China. It is admitted that these were not chosen as a sample in the strict sense, but they were able to shed some light on general issues. However, these primary data are not enough for my analysis, especially for a macroeconomic analysis. I needed secondary data as well. These include existing government statistics and published research reports.

Chapters 5 presents a general picture of FDI in China and some of its peculiar

features, and Chapter 7 a survey of Chinese ventures with foreign investment. From the secondary and primary sources, we find that much of China's inward FDI is peculiar, and that currently dominant theories can not satisfactorily explain some forms of FDI in China, so that we try to extend the possibilities to be considered when particular cases of foreign investment are to be explained. This work is done in Chapter 8 where a general analysis is developed to cover the Chinese case.

Chapters 6 focuses on the government's fiscal arrangements which are an important element in China's investment climate. The information provided in this chapter will be heavily used in chapter 10.

Chapter 9 discusses the impact of FDI on the Chinese economy. The existing literature usually covers resource-transfer effect, income effects, employment effects and trade and balance-of-payments effects. In the case of China, it is appropriate to consider structural and regional effects as well.

Since we know from chapter 9 that FDI has a net positive impact on the Chinese economy, we need to encourage its further inflows and make best use of them by improving the government's policies described in chapter 6. Thus chapter 10 discusses some important policy issues

The final part of this thesis is chapter 11, which provides overall conclusions.

The course of our argument reflects the stages of the "theory, then research" strategy. The most relevant and important literature is reviewed in the first four chapters. The theories identified from the literature survey become propositions for empirical investigation. These propositions are tested by the empirical data and extended in some cases. The modified analysis is then used for the explanation of the FDI determinants in China. Finally some policy issues are discussed. In short, our analysis follows the route of "theory, then empirical study, then revised theory, and finally policy".

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CHAPTER 1 DETERMINANTS OF FDI

Section 1 Introduction

As is well known, FDI has become an important economic phenomenon in the second half of the twentieth century. Correspondingly, economic theory in this field has undergone arapid development. The development of theories of FDI can be divided into two stages. First is classical analysis, which includes traditional international-trade theories such as Smith's absolute-advantage approach, Ricardo's comparative-advantage approach and the Hecksher-Ohlin model; and traditional international capital movement theories, for instance, Nurkse's interest-rate-differential approach and the McDougall-Kemp equal-rate-of-return approach (see Black & Dunning, 1982). Second is modern analysis, which, in my opinion, can be subdivided into three phases: (a) early developments, including the structural-market- imperfections approach of Hymer, Kindleberger, Aliber, Vernon and others; the initiating forces approach of Aharoni; and the long-term-strategy approach of Reuber et al.; (b) the internalisation (or transactions-cost) approach of Buckley and Casson, Rugman, Hennart, and Kay; and (c) the integrated approaches of Dunning, Kojima and others.

Though there are some links between classical theories and modern ones, this chapter focuses on appraisal of various major modern theories about the determinants of foreign direct investment (FDI). Section 2 discusses early developments of the modern FDI theories and Sections 3 and 4 review the internalisation approach, and the eclectic and trade-oriented FDI approaches respectively. Conclusions and further research topics will be presented in Section 5.

This chapter provides a brief review of the currently dominant theories which will serve as our theoretical basis for this research. As will be seen in the second part of the thesis, these theories do not very satisfactorily fit China's inward FDI. Thus we need to extend these theories in order to explain some peculiar features of China's inward investment. This work will be presented in Chapter 8.

Section 2 Early Developments of Modern Analysis

Compared with classical approaches, the basic feature of the modern analysis is that economists break out of the arid mould of traditional international-trade and investment theory and focus attention upon the multinational enterprises (MNE) per se. They explore various kinds of new theories from different aspects, among which the structural-market-imperfections approach has made a very important contribution, and the initiating-forces approach and long-term-strategy approach have also had a certain influence.

2.1 The structural-market-imperfections approach

The structural-market-imperfections approach is sometimes referred to as the industrial-organisation approach, because it is a component part of industrial-organisation theory. The approach was advanced originally by Stephen H. Hymer (1960, published in 1976). Kindleberger (1969) also did his bit for the approach when he put forward monopolistic advantages to explain FDI. Instead of the general discussion of market imperfections, some other authors in this line of thought focused on particular kinds of ownership advantages of MNEs. For instance, Aliber (1970) refers to different currency areas as the causes of FDI, and Vernon (1966, 1974) explains the determinants of FDI by product cycles.

The following is our discussion of these approaches.

2.1.1 Hymer's Bainian-advantages approach

According to Hymer (1976), a MNE is a creature of market imperfections which lead a firm to possess advantages, and, because of this, it is possible for the firm to overcome economic and/or cultural/social distance and to earn a higher rate of return than local competitors in the host country. The advantages Hymer describes are

actually Bainian advantages (1) which are associated with structural market imperfections. They are grouped into three heads. (1) Control of production and techniques via either patents or secrecy, and imperfection of factor market and money market, may give an established firm absolute advantages. (2) Brand names and company reputation and control of superior product designs may create a product-differentiation advantage. (3) There may be significant economies for the large-scale firm. Possession by a firm based in one country of advantages over firms of all other countries in a certain line of activity makes possible international operation. But it is not a sufficient condition, because that firm could export commodities embodying the advantages or could collect the rent of its advantages by licence instead of directly investing.

We refer to Hymer's theory as one of structural-market-imperfections simply because his focus is on these aspects. This is not meant to imply that he has totally ignored the Coasian or Williamson type of imperfections (Coase, 1937; Williamson, 1975), i.e., natural or transactional market imperfections. For instance, Hymer discusses why the firm prefers direct investment to licensing, arguing that this is because in the latter case the firm finds it difficult to control price and output, and to achieve a satisfactory agreement with buyers.

It is Bain-type market imperfections which lead the possessor of the advantages to capture the foreign market for itself. Difficulties in controlling price and output, which lead it to invest (internalise these advantages) (2) rather than exporting or licensing, are caused by imperfect information and buyers' uncertainty, which are actually associated with natural market imperfections.

2.1.2 Kindleberger's monopolistic-advantages approach

Building on Hymer's use of Bainian advantages, Kindleberger attributes the determinants of FDI to four categories of monopolistic advantage(3):

(a) Departures from perfect competition in goods markets, including product differentiation, special market skills, retail-price maintenance, and administered pricing; (b) departures from perfect competition in factor markets, including the existence of patented or unavailable technology, of discrimination in access to capital, of differences in skills of managers organised into firms rather than hired in competitive markets; (c) internal and external economies of scale, advantage being

taken of the latter by vertical integration; (d) government limitations on output or entry.

Most of the above advantages are later referred to mainly as firm-specific or ownership-specific advantages which can be transferred within a MNE across distance. They include technology advantages, market advantages, capital advantages, management advantages and size advantages(4).

Technology advantage consists mainly of product secrets. It is also called "information", "knowledge", "intangible assets or capital" and "know-how" by different authors. This advantage is a special kind of "public good" for the firm which can be used within it without any additional cost. Market advantage rests on marketing research, selling experience, advertising and promotion. Capital advantage means the access of MNEs to large amounts of relatively cheap capital. Management advantage means management skills; and size advantage is economies of scale.

A common comment on Hymer's and Kindleberger's studies is that they explain necessary but not sufficient conditions for FDI(5). Here the necessary conditions mean advantages possessed by a firm because of market imperfection, but sufficient conditions must also include considerations favouring direct investment and a particular location of production. In my opinion, however, there are at least two problems with this comment. Firstly, though the firm-specific advantages are often important in inducing a firm to invest overseas, they are not always necessary conditions for the firm to do so. This point will not be discussed here but later in my own framework. Secondly, even if we accept that the critics' concepts of "necessary and sufficient conditions" are tenable, it is not fair to say that Hymer and Kindleberger did not explain the sufficient condition within their framework. Reasons for the second point are as follows.

Under perfect competition, there is perfect information on know-how, firms have no advantages, and products are homogeneous, so that there is no motive for direct foreign investment. The emphasis of the structural-market-imperfections approach is on the firm-specific advantages caused by market imperfections; so it does explain why a firm might have a reason for extending its activities abroad. Now the question is why the firm chooses FDI rather than exporting or licensing and why it chooses one location for investment rather than another, namely, the circumstances that complete

the sufficient conditions.

Before Kindleberger, there were some authors who attributed FDI to certain location-specific factors (such as favourable wage rates or raw-material prices or interest rates, or lower transportation, distribution, inventory or servicing costs)(6). In Kindleberger, however, lower product costs abroad than at home are not enough to explain "why the production abroad is not undertaken by local entrepreneurs, who have an inherent advantage over outside investors". The other factors, that is firm-specific advantages, should be considered also. He says "Australian tariffs stimulate investment behind the tariff walls. The advantages of American manufacturing concerns over Australian firms result in the entry into Australian manufacturing of American rather than Australian firms"(7). And he also argues that the Rome Treaty will lift the attention of United States business to a wider horizon and will focus interest on the fast-growing European market with its unfolding investment opportunities(8). Trade barriers and other market characteristics are of course the location-specific factors. Trade barriers restrict imports so that the firms with monopolistic advantages have to choose licensing or FDI rather than exporting. And the fast-growing markets with many investment opportunities make FDI profitable.

If we add Hymer's analysis of the choice between licensing and FDI mentioned before, we can conclude that Hymer and Kindleberger do show some conditions under which the firms prefer FDI to exporting and licensing. And it is not the case that Hymer and Kindleberger "stop short of explaining why foreign production is the preferred means of exploiting the advantage (i.e., `the sufficient condition')"(9). On the other hand, we should also realise that Hymer and Kingdleberger, though they have made some references to transaction costs, have not discussed them in any systematic way.

2.1.3 Aliber's Currency Area Approach

This approach is put forward by Robert Z. Aliber, who tries to explain the patterns of FDI by the existence of different currency areas. The world is divided into currency areas. Some currencies are strong and others weak. It is assumed that portfolio-investors pay no attention to the currency area in which a firm is operating. When firms in a strong-currency country launch direct investment in weak-currency countries, because of lower interest rates in the home country they capitalise the same stream of expected earnings at a higher rate than the host-country firms and they can also borrow at lower cost. Because of this, there exists a currency premium.

Aliber's approach is based on the imperfections of foreign-exchange and capital markets. The core of this approach is that "overvaluation of a currency is associated with outflow of FDI and undervaluation with inflow of FDI in the currency areas concerned"(10). This may be coherent theoretically and is consistent with the rapid growth of US direct investment during the 1950s and 1960s when the dollar was strong. But it fails to explain why opposite movements are also common. It can not therefore be the only factor determining FDI. Furthermore, Aliber's assumption about portfolio-investors' ignorance of the areas in which a MNE operates in different areas is also arbitrary, and not supported by the observed facts.

2.1.4 Vernon's Product-Cycle Approach

In Vernon's model, the life of a product is divided into three stages. In the new-product stage, the product is produced by the innovating firm and sold in the American local market. In the mature-product stage, the product is exported mainly to the next-highest-income countries (e.g. Europe). Because the demand for the product is by then expanded and the product is partly standardised, there is the possibility of price competition in the markets. This induces the innovating firm to produce directly abroad, and the site of production is moved to the next-highest-income countries. The characteristic of the final stage, i.e., the standardised stage, is that the product is completely standardised and that the production techniques belong no longer to the innovating firm exclusively. Facing severe price competition, the firm may invest mainly in the developing countries where there are labour-cost advantages. The approach has been extended and refined several times by the author himself.

The product-cycle approach is essentially a model considering both firm-specific and location-specific factors. The former is the product differentiation possessed by the innovating firm while the latter is the factor cost in host countries. As widely accepted, the approach offers a good explanation of the early post-war expansion of US investment into Europe, and it still has "some applicability for firms expanding abroad for the first time and for MNE activity associated with final product type" (11). But the model is originally based on the US experience and restricted to highly innovative industries; it can not explain all kinds of FDI. In addition, it is an over-simplified model, lacking systematic analysis of other important firm-specific and location-specific factors.

2.2 Initiating-Forces Approach

This approach is advanced by Aharoni, who argues that there are two categories of initiating forces leading an organisation to consider investment abroad. The one arises from a strong interest of high-ranking executives while the other is exogenous to the organisation, and may consist of an outside proposal; fear of losing a market; the "band-wagon" effect; or strong competition from abroad in the host market.

In addition to the two kinds of strong forces there are auxiliary ones that may work as catalysts toward the decision to invest abroad. They include need of factor and product markets, and a desire to use old machinery or to capitalise on know-how.

The approach pays special attention to executives' interests to "look abroad" and firms' environment, which, of course, are some of the factors determining FDI. But the theory is incomplete, and it is inappropriate to classify such important factors as a desire for creation of a market and to capitalise on know-how as supplementary forces. Robock and Simmonds call Aharoni's theory "the global horizons approach". They merge Aharoni's auxiliary forces into internal initiating ones, which perhaps is not Aharoni's original view(12).

2.3 Long-term Strategy Approach

Basing their work on a survey of 80 multinational firms operating in developing countries, Reuber at al analysed in detail the three categories of FDI they classify, finding that the most important determinant of FDI is a firm's long-term strategy.

The first category of FDI is export-oriented investment (over 10% of output is exported), where the focus is on new sources of inputs, mainly raw materials and component parts, and not only markets for finished products. The second category is market-development investment, the products of which are mainly sold in the host countries so that economic focus of the investment is put on the size of the local market and its long-run potential. The last category is government-initiated investment, which happens primarily in response to host-government subsidies of one kind or another.

It is suggested that the different categories of FDI are associated with the different kinds of determinants. For example, export-oriented investment normally requires a much faster payback or a higher rate of return than investment focusing on long-term

local markets abroad. But, if we put all kinds of FDI together, the conclusions of the Reuber study are as follows: liquidity considerations influence investment level (investors increase their new investment outlays with increase of internal cash flow)(13); prospective profit over the life of the investment rather than current rate of profit has a basic influence on the level of investment; short-run variation of the output-capacity ratio (also called the accelerator relationship, i.e., the relationship between output or sales and industrial capacity) could hardly affect the level of investment; the most important determinants are long-term strategy considerations relating to long-term profitability, especially market size and potential, and sometimes product cost; investment incentives have some effects on the location of export-oriented investment and increase the flow of market-development and government-initiated FDI to developing countries.

Reuber's study is based on empirical information and relates different sorts of FDI to the corresponding determinants, which promotes our understanding of the issues. But holes can be found in his classification of the determinants: he regards the prospective profit over the life of the investment as the basic factor for FDI and also says, as if it is a separate point, that the long-term strategic considerations are the most important factor. As Reuber himself explains, however, long-term strategic considerations are those affecting long-term profitability so that the relationship between the prospective profit and the strategic considerations is that between the purpose and the measures needed to pursue it. Therefore, it seems inappropriate to juxtapose these as two factors.

Section 3 Internalisation Approach

The second stage of modern analysis is the internalisation approach. As we know now, it is Hymer who, after the Coase theorem, advanced the relevance of internalisation. But Hymer and Kindleberger paid more attention to firm-specific advantages than to internalisation of market transactions.

The work of extending the application of the concept of internalisation has been done by McManus (1972), Buckley and Casson (1976 and 1990), Rugman (1981, 1982, 1985), Hennart (1982, 1991 and 1992) and Kay (1983, 1991). Because of their efforts, internalisation or transaction-cost economics of the multinational enterprise

emerges. The historical antecedents of this economics are Coase (1937) and Williamson (1975).

This approach is subject to many interpretations. The above authors have no consensus on perspectives from which the analysis can be carried out or even on fundamental concepts such as internalisation, opportunism, and specificity (see Kay, 1991, 1992; Williamson, 1992; and Casson, 1987). However, this should not prevent us from reviewing the basic views which they share.

The internalisation or transaction-cost approach focuses on the efficiency with which transactions between units of productive activity are organised. Because of structural and natural imperfections, markets are not very efficient. The structural market imperfections are of the Bainian type. They include possession of proprietary technology, managerial expertise and economies of scale, which have been discussed fully by Hymer and Kindleberger. The natural market imperfections arise as knowledge and enforcement are not perfect; therefore market transaction costs are positive. Hymer and Kindleberger have been criticised, by Dunning and Rugman (1985) amongst others, for neglecting natural market imperfections, but the present author and others (see previous sections of this chapter, and Horaguchi and Toyne, 1990) do not totally agree with this criticism.

Authors in the tradition of the internalisation or transaction-cost approach usually apply a set of concepts used by Williamson to their analysis of the existence of MNEs. These are bounded rationality, opportunism, uncertainty, frequency and asset-specificity.

Bounded rationality means that agents, though rational, have limited information available to them. They are "intendedly rational, but only limitedly so". With this the value of the goods and services exchanged will never be perfectly measured at market prices and it is simply impossible to write completely satisfactory contracts for the co-ordination of a transaction between agents. Opportunism refers to self-interested behaviour on the part of agents designed to give them an advantage in situations where they have information not available to the other party to a transaction. The combination of bounded rationality and opportunism causes many difficulties and problems for the organisation of transactions between agents and through markets. A unified governance structure (i.e. a firm) can then be set up as the direct organiser of

non-market transactions to improve efficiency. It is perceived that the greater the degree of uncertainty, the higher the frequency of transactions and the more specific the investment (Assets can not be used for other purposes at a low cost), the more appropriate it will be to organise a transaction within the firm.

Applying this line of thought to analysis of MNEs, they argue that there are imperfections in the markets for intermediate goods such as human capital, knowledge, and marketing and managerial expertise. This gives rise to time lags and transaction costs in the process of linking these intermediate products with many activities of a firm's outside production. The activities include research and development, marketing, the training of labour, and the building of a management team.

Internalising the intermediate-product market within a firm will give it benefits such as avoidance of time lags and of bargaining and buyer uncertainty, and minimisation of the impact of government intervention. On the other hand, there are costs of internalisation which include administrative and communication cost. The profit-maximising firm is willing to internalise the market until the marginal costs and benefits are equal.

Buckley and Casson think that there are four groups of factors influencing the incentives to internalise. They are industry-specific factors (nature of the product, external market structure and economies of scale); regional factors (geographical distance and cultural differences); nation-specific factors (political and fiscal factors); and firm-specific factors (management ability).

They have also discussed horizontal and vertical integration. Since knowledge has the characteristic of a "public good", the firm with this good tends to become multinational. If patent protection is fairly secure and segmentation is easy, the firm may license its knowledge. If not, an MNE becomes an effective vehicle for the commercial exploitation of knowledge. Joint ventures are alternative contractual arrangements to rationalise production in an oligopoly, or to share risks under bilateral monopoly, when there are significant economies of scale, and when there is political opposition to foreign control of production (Casson, 1987).

In the case of vertical integration, the intermediate products do not necessarily have

any characteristics of a public good. There are four main groups of factors that influence the decision to integrate: technical, market power, dynamic and fiscal factors. Consideration of these factors gives a firm incentives to integrate vertically in order to reduce transaction costs (Casson, 1987).

In short, Buckley and Casson argue that a necessary and sufficient condition for a MNE is a net benefit arising from internalising an intermediate-product market linking activities located in different countries. The internalisation approach improves FDI theories to a great extent, because the approach emphasises that it is a firm's internalisation of markets for important intermediate goods rather than a firm's mere possession of such goods that determines FDI.

One fundamental problem with the internalisation or transaction-cost approach is that the approach totally ignores the possibility that FDI may happen when little or no internalisation for the key intermediate goods is involved on the part of the foreign investor of markets. Further discussion of this issue will be provided in section 5 of this chapter.

Section 4 Eclectic & Trade-oriented FDI Approaches

4.1 Eclectic approach

The theories of FDI have been developing towards integration, and during this process Dunning's eclectic approach has also given a great impetus. His eclectic paradigm tries to combine the structural-market-imperfections approach, the internalisation or transaction cost approach and the location approach, in order to explain international production.

According to Dunning(1981, 1988, 1991), FDI is determined by three sets of factors, namely ownership advantages, internalisation advantages and location (country-specific) advantages. The ownership advantages mean that some firms possess, or can gain access to, assets or rights which foreign firms do not possess or to which they cannot gain access. These assets or rights are product or process, technological intensity, product differentiation, and scale economies. Internalisation advantages mean that some firms possessing the above assets perceive it to be in their best interests to internalise their use rather than to sell the rights to their use, because the markets are costly and inefficient for undertaking certain types of transactions.

Location advantages imply that some firms find it profitable to locate some part of their production facilities outside their home countries because of factors such as trade barriers, government policies, relative resource costs (especially labour costs), or market size and growth. Rugman et al offer a summary of it as follows(15):

Dunning's Eclectic Theory of International Production

Ownership-specific Advantages
- Firm-specific knowledge advantages,
- Management, marketing, financial skills,
- Vertical integration
  - Control of resources
  - Control of markets
- Risk diversification

Internalisation (by MNEs)
- To enforce property rights and overcome other transaction costs
- To reduce buyer uncertainty
- To overcome government regulations

Location-specific (country-specific) advantages
- National production functions
- Government controls and regulations
- Political risk; cultural values

Dunning argues that while three sets are required to launch FDI, firms need only ownership and internalisation advantages to export. As for contractual resource transfer (licensing), firms only need possession of ownership advantages, which is regarded as a necessary prerequisite for the three kinds of foreign involvement. This suggests that different kinds of international involvement are related with different kinds of advantage.

Dunning's main contribution to the theories of FDI is that he draws on several important approaches to set up his own "general" paradigm. This is the major reason why his theory is called eclectic. The theory has been criticised by several authors. For example, according to Casson(17), Dunning's ownership-advantage concept includes actually any advantages that a MNE possesses over rival indigenous firms, even including the advantage of transfer pricing. Thus the ownership advantages include some of the advantages of internalisation. Therefore, on his own use of the terms, Dunning's statement that internalisation, as well as ownership, advantages are

necessary appears to be redundant in some cases.

In my opinion, according to the normal meaning of the terms, while such factors as know-how, management and marketing skills and national product functions are advantages owned by a firm or a country (ownership and location advantages), the advantage of internalisation in itself is not. This is because internalisation of a market refers to the replacement of an arm's-length contractual relationship (i.e. the external market) with unified ownership (i.e. the internal market)(18); it is a firm's strategic choice: whether to export its goods which embody the ownership-specific advantages, to set up foreign subsidiaries, or to license the use of such intangible assets. Though internalisation can bring advantages, it is hard to say that these are advantages intrinsic to the nature of the firm.

Another problem with the eclectic paradigm is its interpretation of internalisation. A careful reader will find that Dunning uses the term internalisation in a different sense from authors of the transaction-costs approach. In the former case, it means internalisation of the USE of a firm's special assets. In the latter, it refers to internalisation of the MARKET for important intermediate goods. Because of this difference, the former approach's coverage may logically be narrower than that of the latter. Consider a backward investment into production of the key raw materials needed by the investing firm. In this case we can say that the firm internalises the market for the materials in order to reduce possible transaction costs. But it will not be relevant to say that the firm internalises the use of its specific assets.

Like the internalisation approach, the eclectic approach treats as critical the use of some key intermediate products such as know-how. By doing so, it actually precludes the possibility that a firm invests abroad without some gain from use of these intermediate products. Because I believe and hope to show that in fact such a possibility exists (I shall discuss this in section 5 of this chapter), I submit that neither the eclectic paradigmn or the internalisation approach is a sufficiently generalised framework to account for FDI activities.

4.2 Trade-oriented FDI approach

Kojima and other Japanese authors put forward this approach. They try to build up an integrated theory of international trade and direct investment on the basis of considering comparative costs in investing and host countries.

In Kojima (1978), there are two types of FDI. One is the trade-oriented or Japanese type of FDI; the other is the anti-trade-oriented or American type of FDI. Under the former head, Japan is inclined to launch FDI in an industry which is comparatively disadvantageous in Japan while comparatively advantageous in the host country. Thus the industry of the host country is able to obtain technology, capital and management skill as a result of Japanese investment. This industry relies on its comparative advantage in relation to Japan and exports its products. At the same time, Japan extends another promising industry, transferring the capital and labour force from the comparatively disadvantageous industry to the promising one. Consequently, this kind of FDI improves industrial structures of both investing and host countries and establishes harmonious trade between the countries.

While praising the above Japanese-type or trade-oriented FDI, Kojima criticises the American-type or anti-trade-oriented FDI: in some investing countries such as the U.S., FDI is launched from industries with the largest comparative advantage in the home country (often new industries such as computers), under which exports of the final products should be strengthened. Thus it ignores home-country comparative advantage and induces increased imports of those products from the host countries. This leads to loss of jobs, balance-of-payments difficulties and unemployment and the need for protection of the remaining traditional industries such as textiles, steel, and agriculture. This is why this type of FDI is anti-trade-oriented.

Unlike many American and European authors who develop their analysis on the basis of theories of the firm, industrial organisation and location, Kojima pays special attention to the international division of labour, discussing FDI with a two-commodity, general-equilibrium model.

However, the trade-oriented-FDI approach is exposed to criticism. For example, it uncritically accepts by implication the neo-classical view that efficient trade depends on differences in resource endowments and it contains various unclear and contradictory aspects.

What I am interested to discover, however, is whether there is a real difference between American-type and Japanese-type FDI. In Kojima's view, American-type FDI is what Vernon's product-cycle theory describes, while Japanese-type FDI is lower-

labour-cost-oriented. So, according to Kojima, there are two differences between Vernon and him(19): firstly Vernon's product is a new one rather than one suitable for developing countries; secondly, Vernon himself does not think the United States should undertake low-labour-cost-oriented direct investment. Unfortunately, Kojima's statement is not correct. Firstly and obviously, Vernon does not say that the U.S. should produce "new products" abroad. Rather a mature, especially a standardised, product could be produced abroad. It takes time for a product to finish a cycle, and, when it becomes mature or completely standardised, it is no longer new. Secondly, Vernon thinks that, when a product becomes mature, the U.S. producers should start FDI, often in low-labour-cost countries, on the basis of comparative-cost advantage, but "as long as the marginal production cost plus the transport cost of the goods exported from the United States is lower than the average cost of prospective production in the market of import, United States producers will presumably prefer to avoid an investment" (20).

When coming from theoretical discussion back to economic reality, we also find that there is little evidence to support the existence of the "Japanese-type pattern" of FDI. For example, some authors argue that the pattern Kojima envisages "may be due to a series of fortuitous circumstances which took place in Japan in the late 1960s (namely a strong domestic demand, with less scope for FDI in some sectors and strengthening of the trade company system; concentration in South East Asia of labour- intensive production activities)"(21).

As a matter of fact, "top" (or monopolistic) advantage is also a kind of comparative advantage. A U.S. firm sets up a computer subsidiary because the firm has its ownership advantage while the host country owns cheap labour, for example. Japan builds up a textile factory in a developing country for the same reason. It is hard to say that there is a real difference between "American-type" and "Japanese-type" FDI.

Section 5 Conclusions and Further Research Questions

This chapter has reviewed some important theories of FDI. It stated that modern theories started from Hymer, who pointed out that an MNE exists mainly because a firm finds it beneficial to internalise its own advantages arising from structural market failure. He and Kindleberger regard Bainian advantages and monopolistic advantages

in general as reasons for a firm to invest abroad, but they have not paid enough attention to natural or transactional market imperfections. In Dunning's eclectic paradigm, firm-specific (or ownership) advantages are necessary, together with internalisation and locational advantages, for a firm to invest abroad.

Thus these approaches predict that the investing firm will certainly have, and have reason to internalise, the use of ownership advantages such as know-how, managerial expertise and economies of scale.

These approaches may offer good explanations of horizontal integration where the investing firm internalises the use of its specific assets in order to exploit advantages. But it will be difficult for them to explain some forms of vertical integration, because in this case the investing firm's specific assets may not be applicable since the integration involves different stages of one productive sequence.

For the internalisation or transaction-cost approach, FDI does not require that the investing firm possess monopolistic advantages. Plants in different countries are brought under common ownership simply because the transaction costs incurred in intermediate products can be reduced by internalising these markets within the firm. Because of this, the approach can explain vertical integration as well as horizontal integration in general terms. Vertical integration will be carried out if market transaction costs for raw materials and components, or for distribution and marketing services, are high because of the problems with small-number conditions, information asymmetry and quality control.(See Hennart, 1991; Casson, 1987.).

It is fair to say that the transaction-cost approach can cover vertical integration to a great extent, and that it is more general than the structural-market-imperfections approach and the eclectic paradigm, because the transaction-cost approach regards FDI not only as the way firms exploit their specific assets abroad, but also as the means by which firms reduce or eliminate transaction costs. To put it in another way, ownership advantages are not necessary for the existence of MNEs (Buckley and Casson, 1976; Casson, 1987). But one problem arises: though emphasis on transaction costs explains the existence of firms as a whole, it can not explain why a particular firm or a group of firms grows while others do not. For example, why have Japanese MNCs grown at the expense of US firms? The answer should be that the former have stronger ownership advantages (see, Cantwell, 1991, pp.47-48.)

Now let's see how the above approaches deal with conglomerate integration. Conglomerate integration involves more than one productive sequence, and one single firm's specific assets are seldom applicable to activities in other productive sequences. Since the structural-market-imperfections approach and the eclectic paradigm emphasize the internalisation of use of the firm's specific assets, they can not be used to explain this form of FDI. To defend his paradigm, Dunning simply says that conglomerate investment of many types is not really a direct investment (Dunning, 1991, p.132). But conglomerate integration usually involves control following an investment, and this increasingly important form should not be excluded from FDI.

On the other hand, many authors taking an internalisation or transaction-cost approach seem to avoid its use in discussing conglomerate integration, though they explain horizontal and vertical integration in great detail (See, for example, Buckley and Casson, 1976 and 1991; Casson, 1987.). An important reason for this asymmetrical analysis may be that, in the case of conglomerate integration, little internalisation is involved of intermediate-product transactions. As a part-exception, Hennart's explanation of the existence of free-standing firms (Hennart, 1991) is worth mentioning because these firms have basic characteristics of conglomerates.

By definition, free-standing firms set up a head office in major capital exporting countries, but all their productive assets are located abroad. According to Hennart, these firms "arose to bypass international capital markets when loan transactions would have been subject to high transaction costs" (Hennart, 1991, p.94). However, capital is a very common and homogeneous intermediate good. Information on its value is readily available, and transaction costs of capital are not high, compared with substitution of internal organisation for the capital market which may be subject to distortions in capital allocation and diminishing returns in conglomerate firms (see, Clark & McGuinness, 1987, p.111; Williamson, 1981, p.1559.) It seems that internalisation of the market for capital is not necessarily a better choice than borrowing from the market. In Hennart, internalisation of the market for loanable funds is one solution to financial problems faced by those entrepreneurs who cannot show a good track record, have no contracts, or cannot provide collateral and therefore cannot obtain finance from the market (Hennart, 1991, p.95.). If Hennart is correct and if his analysis of free-standing firms is applicable to conglomerate integration, then conglomerate integration will be carried out basically by those firms

with no good reputation or track record. This conclusion contradicts the fact.

Another problem with all the above approaches arises from their implicit view that firms which launch FDI take the initiative in the whole process. In the case of the structural-market-imperfections analysis and the eclectic paradigm, firms with specific advantages perceive it profitable to internalise their use of these advantages. The transaction-cost or internalisation approach assumes that firms with the sole purpose of profit maximisation have an incentive to bypass the imperfect market for intermediate products. But in some cases, for instance in the People's Republic of China, the initiative is taken by host governments and local firms for various reasons (see chapters 7 & 8 for details). Foreign investors are passive while receivers are active. This also needs explanation.

Since the Second World War, the rise of MNEs has been one of the most remarkable economic phenomena because of their rapid growth and large size. The very largest MNEs, Exxon, Ford and General Motors, each have a turnover which is larger than the GNPs of all but fourteen countries individually. Thus the nature of decision making within such an MNE is important for the global allocation of resources (see, Griffiths and Wall, 1991; Casson, 1987). On the other hand, there has so far been no single approach that can sufficiently cover all forms of FDI. This suggests that there is a knowledge gap in this area and it is of academic significance to develop a more general analysis to explain this important economic phenomenon.

Chapter 8 tries to advance a general analysis by extending (rather than replacing) currently prevailing approaches. This analysis can then be applied to the discussion of the determinants of China's inward FDI and of policy issues.

NOTES: Chapter 1

1. See Bain, 1956.

2. Hymer, 1976, pp. 48-49.

3. Kindleberger 1969, p. 14.

4. Rugman et al, 1987, chapter 5.

5. See Hood and Young, 1979, Robock and Simmonds, 1983.

6. Krause and Dam, *Federal Tax Treatment of For Income*, Washington, D. C, The Bookings Institute, 1964, p. 64.

7. Kindleberger, 1969 p. 13.

8. Ibid, p. 27.

9. Robock and Simmonds, 1983 p. 44.

10. Agarwal, 1980, p. 49 .

11. Hood and Young 1979, p. 61.

12. See Robock and Simmonds, 1983, Chapter 3.

13. See Duesenberry J. S. Duesenberry, *Business Cycles and Economic Growth*, New York, Mcgraw Hill, 1958.

14. Rugman A.M., "Internalisation as a General Theory of Foreign Direct Investment: A Re-Appraisal of the Literature", *WeltwirtschaftlichesArchiv*, June, 1980, p.370.

15. Rugman et. al, 1987, p. 118.

16. See Mainardi, 1987.

17. See Casson 1982, 1986.

18. Casson, 1986 pp. 45-46.

19. Kojima, 1978, p. 64.

20. Vernon, 1966 p. 197.

21. Mainardi, 1987, p. 439.

CHAPTER 2 IMPACT OF FDI ON HOST COUNTRIES

Section 1 Introduction

The previous chapter critically surveyed the literature on determinants of FDI. This chapter deals with the impact of FDI on a host country's economy. If chapter one serves as a theoretical basis for studying why foreign businesses have invested in China, this chapter will help us understand what effects FDI has on the Chinese economy.

There is abundant literature on the impacts of FDI on both home and host countries. For the purpose of the present research, this chapter is confined to the effects of FDI on host countries, especially on host developing countries.

Ideologically there is such major disagreement on the effects of FDI that four different schools on the subject are identified: Proponents of FDI, the Dependencia School, the Bargaining Approach and the Structuralist Approach(2).

These approaches represent different forms of evaluative structuring of the complicated activities and impacts of FDI. It is not surprising that there are widely divergent views on the same issues, given the difficulties of the theoretical analysis, limited information, different methods and especially the variety of situations (sectors and markets concerned) and contexts (various types of home and host countries). It is obvious that what is true for FDI in this sector/county/time is not necessarily true in that sector/country/time. But by reviewing the literature we can at least know various possible effects.

Section 2 Criteria of Measurement

In order to evaluate the impacts of FDI on developing countries we should first fix the criteria: what kinds of impact should be taken into account or what kind of methods should be adopted. Bos et. al. (1974) use four criteria for classifying effects of FDI: (a) a distinction can be made between effects which can be verified and those which are non-verifiable; (b) a distinction can be made between effects of a socio-economic character and effects which are of a different nature; (c) a distinction can be made between effects which are measurable and effects which are not measurable; (d) a distinction can be made between direct and indirect effects.

There is, however, another very important distinction that should be listed: the distinction between the project and the aggregate approach. Bos et. al. have discussed the nature of both approaches, but they do not think it necessary to make such a distinction because the approaches "are complementary to each other rather than being alternatives, let alone substitutes"(3). In my opinion, there are reasons to make such a distinction, which will be discussed later in this section. So now we have (e) a distinction between project and aggregate approach.

As for the first distinction, most economists are concerned with verifiable effects rather than nonverifiable ones, for where there is no test of effects, there can be no validated judgement of FDI.

As regards the second distinction, economists pay more attention to socio-economic effects than to others. The socio-economic effects involve many aspects, but

economists often focus on several important ones, namely, productivity, employment, economic growth, balance of payments and income distribution. Other effects are political or cultural. Though the list of the other effects is endless, political ones such as sovereignty and autonomy impacts may be of importance in some cases and should be taken into account. It is not appropriate that economists should exclude all non-socio-economic effects from their analysis just because some of these effects are non-verifiable, nor is it necessarily right that political, cultural and other non-economic effects "have to be evaluated by the host country, and not by outside economists"(4). This is because some important non-economic effects can be identified by theoretical analysis and supported by empirical evidence. FDI is not a purely economic phenomenon. Rather, it has manifold influences. There is a close relationship between political, cultural and economic impacts. Pure economic analysis may not be very suitable analysis.

The third distinction is between measurable and non-measurable effects. The former are those which could be tested quantitatively in a conventional way while the latter are not. Verifiability is a necessary condition for measurability, and measurability is a sufficient condition for verifiability. Almost all the non-economic impacts are non-measurable, but many of them are verifiable.

The existence of direct and indirect effects is well known. Many direct effects are measurable while it is less easy to test indirect effects quantitatively. For example, a MNE may introduce the competitive mechanism and generate demonstration effects in a host country which may prompt local firms to adopt advanced technology and managerial skills to raise productivity. The effects are obviously verifiable but hardly measurable quantitatively.

The project approach uses social cost-benefit techniques at a project level, assessing the contribution of individual investment proposals to the aims of economic policy, while the aggregate approach aims at a more general appraisal of the impact of FDI on the economies of the host countries. Since the two approaches serve different purposes and they are not alternatives or substitutes, we should investigate at both project and aggregate level in order to arrive at a complete account of the impacts of FDI.

Section 3 Cost-Benefit Analysis

There are two broad kinds of cost-benefit analysis. One is from the view of a firm (a MNE in the case of FDI), i.e. private cost-benefit analysis; the other is from the view of a society, namely, social cost-benefit analysis. There is a lot of literature available under these two headings (5), among which the OECD *Manual of Industrial Project Analysis in Developing Countries* (1968) is very popular.

3.1 Private Cost-Benefit Analysis

Private cost-benefit analysis is undertaken to assess the profitability of a proposed new industrial project or a major extension of an existing one. It has the following requirements(6):

(a) the prediction of the values of the variables entering into the measure of profitability. The values of the variables include all receipts from the sale of outputs of the project for each year of the life of the project; and all expenditures on goods and services according to the year in which they are made, from the date of the first expenditure until the end of the life of the project.

(b) the definition of the best measure of profitability. There are several measures one of which is "discounted cash flow (DCF)": for every year all expenditures on goods and services for the project (including capital expenditures) and all expected receipts from the project are recorded. For each year, the subtraction of the former from the latter shows how much cash the firm gains or loses as a result of the project. Then the firm discounts future cash flows back to the present, arriving at the present value of the project. If the firm does not have unlimited access to borrowing at the market rate of interest (its investment fund is limited), then a "profitability ratio" (Discounted Current Cash Flow/Discounted Capital Expenditure) could be used as the measure of profitability. There is a third measure of profitability: the internal rate of return of the project. It is defined as the rate of discount which makes the present value of the project zero.

(c) the selection of the best set of projects, given that all projects calculated to be profitable could not be simultaneously pursued.

Private cost-benefit analysis is conducted from the view of a firm. There are many

reasons for divergence between private and social costs and benefits. The basic one is that market prices when used to evaluate projects in private cost-benefit analysis might fail to reveal social costs and benefits because of distortions in the price mechanism. Therefore, considering the impact of FDI on host countries, one should assess projects from the viewpoint of a society. The Little-Mirrlees method meets the needs to some extent.

3.2 Social Cost-Benefit Analysis

According to Little and Mirrlees (1968), social costs and benefits of a specific project should be analysed by the following steps.

(a) Estimate quantities of inputs and outputs (including skilled labour) for each year. (b) Estimate the number of unskilled man-days for each year. (c) Estimate any external effects. (d) If the project is very large, possibly subtract something for risk.(e) Find the net value of outputs less inputs, as estimated and valued under (a) and (b) above, which, subject to possible adjustments under C and D above, is the social profit for each year. (f) Discount each year's social profit at the accounting rate of interest, and add up to give the present social value (PSV). If the PSV is positive, undertake the project; if not, reject it.

The above social cost-benefit analysis is very useful for host countries, especially for host developing countries where there are pervasive divergence between market prices and social values. It is also useful because the measures of it are quantitative and relatively simple in concept, and it provides a consistent basis for comparing a number of projects (8).

It has its limitations, however. Firstly, it is not easy to quantify value of inputs and outputs (especially those of non-traded goods) because of data inadequacies, whereas projects are very sensitive to these values. Secondly, it is difficult to predict external economies though some of them are in fact of great importance in practice; these, in Lall and Streeten's view, include the effects of MNE entry on tastes, technology, industrial structure and society generally (9). It is difficult not only because some external effects are not easily measurable, but also because the same project under different political, economic and social conditions will have different externalities. Because of the limitations, modifications of the above social cost-benefit analysis become necessary when specific projects are assessed.

Section 4 Macro-economic Impact

Economic effects of FDI should be considered at both micro- and macro-economic levels. For the former, we pay more attention to the FDI projects themselves by use of traditional cost-benefit analysis; for the latter, we consider the effects on growth, employment, productivity and balance of payments of host countries.

There are different, and even opposite, views on the impact of FDI on host countries. In the view of supporters, FDI benefits host countries greatly. MacDougall and Kemp argue that under competitive conditions and with no domestic distortions, the influx of foreign capital will generate direct and indirect gains to host countries. The most important direct gains to a host country from more rather than less private investment from abroad are higher tax revenue from foreign projects, and advances in productivity through economies of scale and through external economies generally, especially where local firms acquire "know-how" or are forced by foreign competition to adopt more efficient methods. These gains will in turn promote immigration and increase the host country's income, leading to higher domestically financed investment and a further increase of the host country's income (10).

Other authors support and develop the above view. Firstly, Harry Johnson, for example, argues that FDI brings to a host country "a package of cheap capital, advanced technology, superior management ability, and superior knowledge of foreign markets for both final products, and capital goods, intermediate inputs, and raw materials" (11). Secondly, FDI creates the source of foreign exchange. Capital, technology, management and market skills are certainly important elements not only for internal economic development of developing countries, improving their standard of living, but also for export-oriented development of those countries, meeting their foreign-exchange and employment-creation requirements(12). Thirdly, FDI offers external benefits. It trains managers and workers who may be available for local firms, and its competition with local firms induces them to aspire to greater efficiency (13).

According to the pro-FDI view, since FDI is favourable to economic growth, host countries should promote FDI rather than impede or deter it by restrictive policies.

At the other extreme, however, some economists are opposed to FDI. Theotonio Dos Santos, for example, argues that, for developing countries, "the most powerful obstacles to their full employment come from the way in which they are joined to this international system" (14). Contrary to the pro-FDI views, they think that FDI impedes economic development of developing countries in several respects: (1) technology transfer is a basic cause of further unemployment and further concentration of already extremely unequal income distribution, because of the excessive prices charged by MNEs in transferring; (2) MNEs' financial contribution is in fact a financial drain, reducing both current consumption and available local savings and, thus, further consumption for the vast majority of developing country inhabitants; (3) MNEs' impacts on foreign exchange and balance of payments of developing countries are also negative (15). Though other authors of this group admit that FDI may make a positive contribution in the sense of dependent economic growth, they think the cost of this pattern of FDI is very high, which includes income concentration, too great an emphasis on luxury consumer durables, foreign indebtedness, and unemployment (16).

The above two opposite views of MNEs' impact are both based on piecemeal empirical studies. They should be treated as extreme possibilities rather than general conclusions for the reasons mentioned in Section 1. For example, MacDougall and Kemp's approach is a neo-classical one. The approach assumes a perfect-competition and no-externalities condition which is far from economic reality. If that assumption is false, foreign investment will not always turn out beneficial to host countries. The scientific attitude toward the impact of FDI should be a concrete analysis of concrete conditions. Let's discuss several possible effects of FDI on host countries.

4.1 Resource-Transfer Effect

Capital transfer may be helpful for economic growth, because it may fill the resource gap between desired investment and domestic savings. But, if MNEs raise most of their capital within the host country, the effect will depend on whether these local savings would have been idle, less productive or more productive (17). In the first two cases, FDI certainly is likely to make a positive contribution to growth. Technology is a very important element for development. Technology transfer may give rise to new production activities, products or process, or reduce costs. But, as Hood and Young argue, the benefits to be gained by host states depend upon the terms under which the technology is transferred; including the price and the methods

of supply and the suitability of the technology and associated products (18). MNEs also provide managerial skills, which are useful if they are appropriate to the developing country's conditions.

4.2 Balance-of-Payments Effect

As for balance of payments, the effects of FDI on host countries also depend on circumstances. We know FDI means capital inflow into host countries; then there is reverse movement, remittance of dividends, royalties, interest and administrative charges, to home countries. Some authors simply compare the initial capital inflow with the continuing outflow of the above earnings, arguing that in most cases the former is less than the latter, so that the effects of FDI on the balance of payments of host countries are negative.

This argument, however, is based on the surface of things, and it neglects other important aspects of the effects. Firstly, the effects of FDI on foreign trade may overshadow the effects on capital inflows and repatriation outflows because MNEs may offer foreign-exchange benefits for host countries though expanding exports or substituting for goods and services previously imported, therefore improving the balance of payments(19). Secondly, FDI may lead to a rise of real income in host countries. If expenditure remained unchanged at the pre-FDI level, the whole of the real-income rise associated with the foreign investment would appear as a balance-of-payments surplus(20). On the other hand, transfer pricing also has an important relationship with the balance of payments. As is well known, a transfer price can be defined here as the price used for internal sales of goods and services between the divisions of a MNE. If a parent company overcharges its foreign subsidiaries for supply and underpays them for purchases of their output, the MNE may reduce or even avoid payment of taxes to host countries (21). Thus there are negative effects on host countries' balance of payments.

Section 5 Other Effects

Other effects of FDI are mainly political and cultural. Here we mention very briefly only political and sovereignty and autonomy effects.

Political effects, in Robock and Simmonds, are described as the political challenge

which means that MNEs may be exercising their power to influence political events in host countries (22). Sovereignty means internal supremacy and external independence. Autonomy effects may be defined as the effects of MNEs on host government decision-making. This includes formulation of various kinds of policies, especially trade, taxation, and subsidy policies.

Generally speaking, most political, sovereign and autonomy effects of MNEs seem negative in the sense that they may influence host countries' independence. These effects may be large, but may be minor, depending on MNEs' strength and interests, both host and home governments' attitudes and their strength.

Section 6 Conclusions

It can not be easy to evaluate the impact of FDI on host countries. Firstly, effects of FDI are various. They can be social, political or cultural; they can also be direct or indirect, and individual or aggregate. Consequently, the criteria should be fixed in the first place: what kind of effects should be taken into account, and what kind of methods should be adopted.

Secondly, the evaluation involves a comparison of costs and gains. Social cost-benefit analysis is of course appropriate rather than private, and there are often divergence between social and private costs and benefits. However, it is more difficult to apply the former approach because of the difficulties in assessing externalities.

Though it is difficult, the study of the impact of FDI is very important, and certain macro-economic impacts, such as resource-transfer and balance-of-payments effects, have often been discussed in the literature.

Notes: chapter 2

(1) See Dunning, 1981, Chapter 3.

(2) Moran, 1986, Chapter 1.

(3) Bos et al, 1974, P.16.

(4) Bos et al, op. cit. P.11.

(5) See, for example, Louis T. Wells, Jr., "Social Cost-Benefit Analysis for MNCs", *Harvard Business Review*, March-April, 1975.

(6) Little and Mirrlees, 1968.

(7) See Viyay Joshi, "The Rational and Relevance of the Little-Mirrlees Criterion", *Bulletin of the Oxford University Institute of Economics and Statistics*, Vol. 34, 1972.

(8) See Robock and Simmonds, 1983, P. 251.

(9) See Sanjaya Lall and Paul Streeten, 1977, P.85.

(10) G. D. A. MacDougall, "The Benefits and Costs of Private Investment from Abroad: A Theoretical Approach", in John H. Dunning eds. *International Investment*, Penguin Books, 1972, P.156.

(11) Harry Johnson, "Economic Benefits" in H. R. Hahlo, J. Graham Smith and Richard W.Wright, eds., *Nationalism and the Multinational Enterprise: Legal, Economic, and Managerial Aspects*, Leiden, The Netherlands: A. W. Sijhoff, 1977, P.168.

(12) Peter F. Drucker, "Multinationals and Developing Countries: Myths and Realities", *Foreign Affairs*, No. 53, October 1974.

(13) Harry Johnson, "Economic Benefits", op. cit. P.169.

(14) Theotonio Dos Santos, "The Structure of Dependence", in Charles K. Wilber, ed., *The Political Economy of Development and Undevelopment*, Random House, New York, 1973, P.116.

(15) Ronald Muller, "The Multinational Corporation and Underdevelopment of the Third World" in Wilber eds., op. cit. P.173.

(16) Fernando Henrique Cardoso, "Associated Dependent Development: Theoretical and Practical Considerations", in Alfred Stepan ed., *Authoritaian Brazil: Origins, Policies, and Future*, New Haven, Conn: Yale University Press, 1973, P.149.

(17) Hood and Young, 1979, P.184.

(18) Hood and Young, op. cit. P.185.

(19) Robock and Simmonds, 1983, P.240.

(20) Deepak Lal: *Appraising Foreign Investment in Developing Countries*, Heinemann, London, 1975, P.31.
(21) To know more details, see Rugman and Eden, eds., *Multinationals and Transfer Pricing*, Croom Helm,
London and Sydeny, 1985.

(22) Robock and Simmonds, op. cit. P.233.

CHAPTER 3 RECENT TRENDS OF FDI IN DEVELOPING COUNTRIES

Section 1 General Trends

The previous two chapters discussed the theories on determinants and impact of FDI. This chapter deals with the general pattern of FDI in developing countries, and serves as a reference to show the position and importance within the Third World of FDI in China .

1.1 Flows of FDI to Developing Countries

In the past 25 years, the absolute rate of inward foreign direct investment increased in both developed and developing countries. The annual average gross inflow of FDI to developing countries in the period 1985-89 in current prices was US $ 19.5 billion, while that between 1980 and 1984 was US $ 16.4 billion. In 1990, this figure jumped to US $ 30.9 billion.

Though there was an absolute increase in inward direct investment to developing countries, the share of developing countries in total inflows decreased from an average share of 31% during the period 1980-1984 to 17.2% in 1990.

There are several reasons for the fall of the share of developing countries. Firstly, the outward investment from the United States, the most important source of FDI in

developing countries, dropped while inward investment to the US increased (1). In addition, technologically intensive investment was becoming increasingly important in the 1980s. This kind of investment favours locations in developed countries (Tolentino, 1990). This diversion decreased the level of FDI inflow to developing countries. Secondly, the generally weak market situation for mining and minerals, in which FDI has been concentrated in the developing countries, represents a sectoral effect which has also been against the developing countries in particular (2). Thirdly, the worsening growth performance and the "debt crisis" in some developing countries which are major recipients of FDI had negative effects on the level.

Table 3.1 Foreign Direct Investment Gross Inflows, 1975-91, (US $ Billion at current prices, annual average)

Countries	1975-79	1980-84	1985-89	1990	1991*
Industrial	19.9	36.2	98.1	148.7	115.2
Developing	7.0	16.4	19.5	30.9	42.7
TOTAL	26.9	52.6	117.6	179.6	157.

* Partly estimated.
Source: *Financial Times*, 16 June 1992.

Outward flows from developing countries as a whole increased quickly from an average of US $ 1.4 billion between 1980 and 1984, to US $ 12.9 billion in 1990 (see Table 3.2), but their share in the total outflows remains small. In 1990, it was only 6%, though that was higher than the share of 3% between 1980 and 1984. Outward investment is closely associated with national stage of development. This explains why outflows of FDI from developing countries are so small.

Table 3.2 Foreign Direct Investment Gross Outflows, 1975-91, (US $ Bn at current prices, annual average)

Countries	1975-79	1980-84	1985-89	1990	1991*
Industrial	34.7	41.0	128.4	209.5	165.5
Developing	0.6	1.4	6.5	12.9	11.8
TOTAL	35.3	42.2	134.9	222.4	177.3

* Partly estimated.
Source: *Financial Times*, 16 June 1992.

It should be noted that the totals table 3.1 and 3.2 are different presumably because of differences in sources for inflows from outflows.

1.2 Stocks of FDI in Developing Countries

Table 3.3 World Foreign Direct Investment Stock,
(% of Total, 1988)

	Developing countries	Developed countries
Outward	4	96
Inward	25	75

Source: *The Economist*, August 24th 1991.

By the end of 1989, the world's total stock of FDI reached US $ 1.5 trillion (the Economist, 1991). Though the absolute amount of inward investment stock in developing countries increased, the share of developing countries in the total stock of inward investment had declined since 1960. From Table 3.3 we can see that the share of developing countries in the total stock was only 25%. This was the result of a continuous decline of the share in developing countries in past the 30 years: in 1960, the share was 32.3%; in 1971, 30.9%; in 1980, 26.6% (see Stopford & Dunning, 1983).

The small share of the FDI stock in developing countries is consistent with their small share of inflows of FDI. On the other hand, the mining and petroleum assets of MNEs were nationalised in some Middle Eastern and African countries in the 1960s and 1970s, which also decreased the stock of FDI in developing countries.

In sum, the general trends are as follows: flows of FDI to developing countries did not grow as fast as those to developed countries; consequently the share of the stock of FDI in developing countries declined. As we will see from chapter 4, the level of foreign direct investment is generally associated with the nature of a country's investment climate in which political and economic stability, market size, and production costs are thought to be important. The unfavourable investment climate was the main reason for the small share of inward investment in developing countries.

Section 2 Geographical Trends

2.1 Distribution by Regions

In terms of regions, some Latin-American countries have been traditional recipients of FDI. But some Asian countries have become more and more important absorbers of FDI, and their share in its inflows, and therefore in stocks of FDI in developing countries has been growing significantly; the flow of FDI to Africa has increased slightly; Eastern Europe also saw a large increase in foreign investment, although from a small base. This is the picture of regional trends in past eleven years.

Table 3.4 Regional Distribution of FDI Gross inflows
(US $bn at current price, annual average)

Developing Countries	1975-79	1980-84	1985-89	1990	1991*
Asia	1.9	4.7	10.8	19.9	25.7
Eastern Europe	0.0	0.1	0.1	0.5	2.3
Latin America	3.6	5.4	5.7	7.8	12.0

* Partly estimated.
Source: *Financial Times*, 16th June 1992.

From the table we see that, since 1985, the annual inflow of FDI into Asia has been larger than that into Latin America. The former outstripped the latter as the largest host region among developing countries. The reason for this change is that domestic growth prospects in Latin America were not encouraging enough to inspire a flow of FDI on the scale seen in this region in the 1960s. In Asia, however, changes in the investment climate, exchange-rate changes and the growing complexity of economic specialisation attracted increasing inflows of FDI. In 1990 and 1991, however, FDI also rose quickly in several Latin American countries, following the liberalisation of trade policies, greater openness to foreign investment and more stable macroeconomic policies.

2.2 Distribution by Countries

The main features of the distribution by countries are that the newly industrialising countries (NICs), have accounted for a large part of the stock of FDI in developing

countries, while low-income countries, particularly the People's Republic of China, have begun to absorb more and more of the flow of FDI in recent years. Currently, just five countries/territories account for more than half of all investment flows into developing countries. These are Singapore, Brazil, Mexico, People's Republic of China and Hong Kong (*The Economist*, 1991).

Since 1979, China has made active and effective efforts to attract FDI by improving its investment climate. In 1988, FDI inflows into China reached US $ 3.2 billion, representing a share of 12% of all inflows to developing countries during the period 1984-1988, compared to 4% during the period 1981-1983 (Tolentino, 1990). This sharp rise resulted from China's policy of opening the country to the outside world and utilising foreign capital with a view to accelerating the realisation of its four modernisations.

FDI tends to concentrate in NICs. This distribution pattern confirms the view of an IMF Occasional Research Paper that "countries with small internal markets, few natural resources, a relatively underdeveloped infrastructure and limited possibilities for manufactured exports may not be able to attract substantial direct investment" (3).

Section 3. Sectoral Trends

In the last two decades, the sectoral trends of FDI in developing countries comprise a relative decline in the primary sector on the one hand and an increase in the manufacturing and service sectors on the other hand.

Between 1971 and 1978, the share of the extractive sector in the FDI stock of developing countries dropped from 22.9 per cent to 12.8 per cent, while the corresponding figures increased from 59.0 to 64.5 per cent in the manufacturing sector and from 18.1 to 22.7 in the service sector (see Stopford & Dunning, 1983).

In the 1980s, a greater proportion of the world's investment was directed to services than to manufacturing. By the end of the last decade, FDI in services by OECD countries represented more than 40% of the total FDI outflows compared with 25% in the early 1970s (OECD, 1991).

3.1 Primary Sector

The primary sector in developing countries has attracted FDI for a long time, during which petroleum and major metal-mineral industries have been prominent. The long-term decline in the relative importance of the primary sector within FDI in developing countries since the early 1970s may be due to several factors. Firstly, an inevitable result of the development process is that the share of the sector's output in national income has declined while that of the manufacturing and service sectors continues to increase. Secondly, the change may reflect developing countries' desire for increasing domestic control of natural resources: during the 1970s they nationalised some existing enterprises from MNEs. Finally, the decline may also have resulted from increased uncertainty. The mining industries are characterised by large individual investments and long duration. Recognition of increased difficulties in forecasting the world economic prospects and enhanced fear of nationalisation may have hindered the growth of FDI in the primary sector in developing countries.

3.2 Manufacturing Sector

Since the early 1970s, there has been an upward trend in the share of the manufacturing sector in the stocks and flows of FDI in developing countries. There are two features in the trends. Firstly, during the 1970s, import-substitute-oriented FDI was the main form in Latin America. The evidence is that between 1966 and 1976, the majority-owned manufacturing affiliates of United States companies in Latin America exported only 6 per cent of their total sales.

Secondly, the Asian region, especially NICs, in contrast, paid more attention to export-oriented FDI. During the same period, the majority-owned manufacturing affiliates of United States companies in Asia exported 24 per cent of total sales(5). The export-oriented industries with FDI are mainly electronics and semiconductors, textiles and clothing, iron and steel.

3.3 Service Sector

In recent decades, developing countries have been moving toward the position of "service economies", though the trend is much more pronounced in developed countries. Relatively, shares of the service sector in FDI in developing countries have increased.

The most rapid growth of FDI in the sector has been experienced in Latin American countries and some East Asian countries. The largest service industries with FDI are trading and banking. Others are accounting, advertising, data services and hotels.

There are several factors promoting FDI in the service sector in developing countries. Basically it is the natural result of the development of FDI in the primary and manufacturing sectors. The growing network of foreign industrial subsidiaries creates a demand for a wide range of services such as trading, insurance, advertising. Then service companies set up the relevant subsidiaries to serve their clients. On the one hand, further development of primary and manufacturing sectors would be impossible without a corresponding growth of the service sector. Introduction of FDI in this sector may improve trading, communication, transportation and financing, and as a result the primary and manufacturing sectors as well. On the other hand, service industries interact with one another. Development of tourism, for example, needs transportation and hotels, which require capital, technology and managerial skills. FDI is one of the important ways to meet the needs.

Section 4 Conclusions

Flows of FDI to developing countries have increased in the past years, but they have not grown as fast as those to developed countries. As a result, developing countries' share of the total stocks of FDI has declined. This pattern results from the generally weak market situation for mining and minerals, in which FDI has been concentrated in developing countries, and the worsening economic performance in some traditional host developing countries.

Geographically, there is an uneven development of FDI among developing countries. While Latin-America has still remained as a traditional host of FDI, Asia has now outstripped it as the largest receiver in terms of absolute FDI inflows, because of its size and good growth performance. FDI has also increased quickly from a small base in Eastern Europe.

Generally speaking, FDI tends to concentrate on the newly industrialised and middle-income countries. But China, which is ostensibly a low-income country, has become an increasingly important host no doubt because of its cheap labour and huge

potential market.

As for sectoral distribution, the share of FDI in the primary sector has declined, but that in the manufacturing and service sectors has increased. This shift probably reflects a general trend associated with economic growth.

NOTES: Chapter 3

(1): See United Nations Centre on Transnational Corporations (UNCTC), 1985, P.28.

(2): See OECD, 1987.

(3): See IMF, 1985.

(4): See UNCTC, 1988.

(5): See OECD, 1987, P.32.

CHAPTER 4 POLICIES OF HOST DEVELOPING COUNTRIES TOWARDS FOREIGN DIRECT INVESTMENT

Section 1 Introduction

Policies of host developing countries towards FDI consist of all means used by host governments to affect the scale, location, level and composition of input and output of FDI. These policies encourage and regulate FDI to varying degrees in different countries. The most common classification of the policies is into investment incentives and investment regulations, though the two elements often appear together in a specific project.

The purpose of this chapter is to evaluate the impact of FDI policies. After a discussion of definitions and categories of investment incentives and regulations in Section 2, Sections 3-4 focus on the impact of incentives on foreign investors, and the choice of these incentives. Section 5 concentrates upon the effects of regulations. Section 6 provides summaries and conclusions.

This is the final chapter of part one, the literature survey, and it aims to provide a theoretical basis for our study of China's FDI policy.

Section 2 Types of Policies

2.1 Investment Incentives

2.1.1. Definitions

Investment incentives are governments' measures designed to encourage investment. This is, of course, a very simple definition. Bracewell-Milnes and Huiskamp have offered us a precise definition: an investment incentive is "any measure conditional on new investment taking place which is designed to increase the prospective net-of-tax return from the investment relatively to its cost at the time of the investment decision". (1). According to the authors, this definition has three points as background. First, when considering policy effects, we should compare what happens and what would have happened if policy had been different. Second, an investment incentive is an incentive, not a command, which makes investment more attractive to the investor absolutely as well as relatively. Third, an investment incentive is an incentive, not a windfall. It must improve the prospect of profit before the investment decision is taken, not afterwards (2). This definition emphasises the pre-encouragement effects on decision making, revealing the basic character of the incentives.

Different authors set different ranges of policy instruments under the heading investment incentives. Some have used a narrow range which includes only investment tax credits or cash grants applying solely to the acquisition of capital goods. Others have fixed too broad a range to be appropriate, even comprising deep harbours and cheap labour, which obviously do not form part of government policy but are natural advantages. The proper definition should include all policy instruments used specifically and exclusively to encourage the increase of investment. If we used the narrow definition, we would improperly neglect many other important policy instruments; if we were to take such a broad definition that non-policy factors were covered, our research would be thrown into confusion.

2.1.2. Types

There are several ways to classify investment incentives that bear on FDI, each of which serves a particular purpose of research. We know, for instance, that some incentives influence FDI directly while others do not. Consequently, we could divide incentives into direct ones and indirect ones. The former are designed with specific purposes; the latter include all incentives without such purposes, which nevertheless

affect FDI. One example of the latter is a cut in the rate of corporation tax, which could improve the general investment climate.

Considering the relationship between incentives and taxes, we could classify incentives into tax-related ones and non-tax-related ones. The former are tax allowances while the latter are cash payments without tax consequences, such as subsidies and grants.

Another common distinction among investment incentives is that between commodity-based (commodity-protection) incentives and factor-based (factor-protection) incentives (4). Commodity-based incentives alter the prices of goods and services bought or sold by a firm (such as tariffs and quotas on imported competing products and exemptions from import duty on inputs), and they therefore influence the revenues and intermediate input costs of an investment; factor-based incentives alter the prices of the inputs of production employed by a firm (for example, tax holidays, investment allowances, and subsidies for the training of local labour), and hence affect the costs of factors of production. These two kinds of incentive could be divided further (see Table 4.1).

Table 4.1 Classification of Incentives and Disincentives

Incentives/disincentives (effect on after-tax return on owner's equity)
Affecting revenues
Tariffs
Differential sales/excise taxes
Export taxes/subsidies (including income tax credit) + or
Quotas
Export minimum
Price controls (or relief from)
Multiple exchange rates
General over-valuation of currency
Government procurement preference
Production capacity controls
Guarantees against government competition
Prior import deposits
Transfer price administration

Affecting inputs
Tariffs
Differential sales taxes (and exemptions therefrom)
Export taxes/subsidies (including utilities)

- Quotas
- Price control
- Multiple exchange rates
- Subsidy or tax for public-sector supplier
- Domestic-content requirements (including research and development)
- Prior import deposits
- Transfer price administration
- Limits on royalties, fees
- Multiple deductions for tax purposes
- Cash or in-kind grants for research and development

Affecting components of value-added

- Capital
  - Direct subsidy
    - Cash grant
    - Tax credit/investment allowance
    - Subsidised leasing
  - Cost of capital goods
    - Tariff/sales tax exemption on imported domestic equipment
    - Prior import deposits
    - Local-content requirement for capital equipment

  - Limits on use of used equipment
    - subsidised buildings
    - subsidised cost of transport
  - Cost of debt
    - Subsidised loans
    - Loan guarantees
    - Covering of foreign-exchange risks on foreign loans
    - Priority of access(including limitations on foreign firms
  - Cost of equity
    - Subsidised equity through public investment agencies
    - Exemption from capital gains taxes/regulation tax
    - Dividend tax/waiver
    - Guarantee against expropriation or differential treatment
    - Limitations on debt-equity ratio
    - Controls/taxes on remitted dividends
    - Minimum financial/in-kind ratio
  - Corporate tax
    - Tax holiday/reduction
    - Accelerated depreciation

Special deductions and valuation practices
(inflation adjustment multiple plant
consolidation)
Tax sparing and double-taxation agreements
Loss-carry-forward provision
Contractual stabilisation of rates
Labour
Wage subsidies (including direct, i.e., multiple
deductions for wages, tax computations/reduction
of taxes on labour)
Training grants
Minimum wage
Relaxation of industrial-relation laws
Local labour requirements
Land
Cash subsidy for purchase/rental
Exemption/rebate of taxes on land

Not classified
Limitations on foreign ownership
Free-trade zones
General pre-investment assistance
Countertrade requirements
Foreign-exchange balancing requirements

Source: Guisinger, S. and Associates, *Incentives and Performance Requirements*, Praeger, New York, 1985, Pp.2-3.

The table lists more than forty policy instruments. For simplicity, Guisinger uses the term "incentives" to include both positive and negative (disincentive) measures. The table is comprehensive indeed. But not all the investment incentives/disincentives can be divided under the headings of commodity and factor protection. Limitations on foreign ownership and free-trade zones, for example, could not be simply classified under the two headings.

Many writers have analysed features and impacts of some incentives that they thought important, but they have not classified them carefully. Rather, they have discussed them one by one (5). It is important, though not easy, to find criteria under which all incentives could be classified properly, in order to make a systematic analysis of investment incentives.

2.2 Investment Regulations

2.2.1. Definition

Investment regulations are measures taken by host governments to restrict or to direct FDI. Investment regulations or restrictions are disincentives for FDI. Many developing countries restrict or direct FDI for any of a variety of reasons, among which are the political sensitivity of certain industries (e.g., defence, public utilities, broadcasting, publishing, banking, and the petroleum industry), and the desire to reserve for local enterprises those industries with relatively simple technical and financial requirements (such as the retail and wholesale trade) (7).

2.2.2. Types

Writers such as Guisinger have classified investment regulations in the same way that they have classified investment incentives. Consequently we have direct and indirect investment regulations, and commodity-based and factor-based regulations, while others have developed other criteria, one of which is that used by Lall and Streeten. This criterion was set up by Lall and Streeten in 1977. In their view, regulation issues should be discussed at both macro-economic and firm levels. Firstly, a general regulation of FDI at economy level is to be considered with a view to a certain composition of output, technology, marketing and consumption pattern, and local distribution of enterprise. Secondly, once the desirable amount and pattern of FDI has been decided, there should be regulations at industry level focused on technological and marketing practices, industrial concentration, access to capital and infrastructure, labour relations and relationships with suppliers. Finally, there should be regulations at firm level, mainly related to case-by-case control of restrictive business practices, payments for technology and transfer pricing, as well as such issues as labour relations, technology, product range, promotion (9).

The Lall-Streeten method is very useful for exploring the nature and impact of investment regulations because it has classified the regulations according to possible impacts of FDI on the host economy at various levels. This method has also been used by Rugman et. al. (1986). According to them, regulations affecting macro-economic environment include taxes, tariffs, capital costs, wages, exchange rates, and prices; regulations affecting a firm's micro-economic environment comprise local-ownership requirements, local-value-added regulations, capital rationing, hiring quotas, export requirements, import licensing, and controls on technology, foreign exchange, prices, or transfer pricing.

The most popular classification, however, is that according to the objects or contents of regulations. Under this criterion, there are five categories of regulations or restrictions.

(1) Regulations on entry of FDI: some developing countries have listed sectors and industries in which foreign firms are allowed to operate to permitted degrees varying from country to country, or even are not allowed to operate at all. On the other side, however, once foreign investment in certain industries would be welcome, it is often eligible for special incentives.

(2) Regulations on degree of foreign ownership: a limited extent of foreign ownership is imposed in many developing countries. India, Mexico, Philippines, Yugoslavia and most centrally planned economies, for example, generally require minority equity participation of foreign investment. In some cases, existing foreign firms are asked to dilute their equity in favour of nationals.

(3) Regulations on repatriation of profits and capital: the extent to which dividends from FDI and fees for technology transfers are permitted is limited in many developing countries. Some limit repatriation to a certain percentage of invested capital.

(4) Performance requirements: performance requirements or specific performance obligations are measures used by host governments to direct foreign investors to do what the governments wish them to do. The concepts vary according to the context in which they are used. The most common forms of requirement are trade-related ones, namely, stipulated shares of production that must be exported and stipulated shares of inputs to be procured domestically. Other forms of requirement are classified differently among different writers. Balasubramanyan has added employment generation and the setting up of domestic R and D facilities to performance requirements. The OECD's (1983, 1987) definition includes the use of appropriate technologies, health and safety, or the protection of the environment; Guisinger has used the term in such a broad sense that it includes restrictions on foreign ownership of equity.

(5) Restriction on access of foreign-owned firms to local capital markets: Argentina,

Kenya, Nigeria, Peru, the Philippines, Turkey and other developing countries impose such restriction to insulate the domestic financial system in order to maintain non-competitive interest rates.

This classification is very useful in practice because it is straightforward and easy to understand.

Section 3 Impact of Incentives

3.1 Costs & Benefits of Incentives

Provision of investment incentives imposes costs on a host country's economy and at the same time potentially brings in returns. There are two kinds of costs. First is the cost on the host government in expenditure or tax forgone. Second is the loss of efficiency in the economy from incentive-induced distortions in resource allocation (12). It is difficult to measure these costs, especially the second.

Several definitions of the benefits of investment incentives are available. According to Bracewell-Milnes and Huiskamp, there are two kinds of benefits. The one is to the fisc, i.e., the increase in tax revenue caused by the incentives: incentives cause a rise in industrial investment which implies a rise in future activity; and the fisc has a stake in this rise through its stake in the economy in general. The other benefit is to the economy in general, i.e., the removal of a fiscal impediment to investment. This tends to increase prosperity as long as the taxation of investment remains positive. Correspondingly, the efficiency of investment incentives is the ratio of additional investment to cost (in government expenditure or tax revenue forgone). The efficiency of incentives for the fisc is the ratio of additional tax revenue to fiscal cost. The efficiency of incentives for the economy is the ratio of incremental national income to fiscal cost (13).

In Galenson's view, the evidence of effectiveness of benefits can be found either (ex post) in the impact of the incentives, in the form of induced investment and the consequent economic growth, and change in the structure, characteristics and size-distribution of industry, or (ex ante) in surveys of firms to determine which factors are the most influential in foreign investment decisions (14). As a matter of fact, these two aspects belong to statistical or economic research and behavioural research

respectively, for the former is the interpretation of movements in aggregates such as national income, profit, investment, and tax revenues, as indicators of the benefits, while the latter is concerned with the process of investment decisions and the means of affecting it through investment incentives.

3.2 Impact of Incentives on Foreign Investors

Now we consider whether investment incentives are crucial for FDI. The issue has two aspects. The one is the attraction of FDI to developing countries; the other is the role of investment incentives in it. There are plentiful survey data in the literature by which we can see that the attraction of FDI is affected by a number of factors, and investment incentives play a limited role in it.

A survey in 1961 asked 205 companies covering 365 investment projects made in 67 countries around the world, and also 20 governments, to judge the incentives offered to foreign investors (Robinson, 1961). The governments ranked the five most important incentives as follows: tax relief, equality of treatment with domestic enterprises, progressive domestic climate, favourable terms for transfer of profits and repatriation of capital, and government-sponsored credit institutions. In contrast, three important incentives rated by the foreign investors are establishment of and firm adherence to a national development plan (as a measure of the government's dedication to economic development), non-discrimination against foreign ownership and control, and freedom from detailed or burdensome regulations on organisation, ownership, and management. The most important non-policy factor mentioned by the foreign investors was the opportunity to earn a profit and, given this, the opportunity to expand or maintain sales by entering a new market or preserving an established one in the face of tariff or exchange barriers.

In 1983, David Lim found that a fiscal incentive is not necessary to attract FDI, and that what matters is the presence of resources and a proven record of economic performance (Lim, 1983).

A report published in 1983 (OECD, 1983b) concluded that, on the basis of empirical and theoretical considerations, three types of variable, related to medium-term expected profit, are the main determinants of medium-term investment at a macro-economic level. They concern, respectively, demand (levels of output or changes in output), relative prices (cost of capital relative to other factors such as labour or

energy), and spending capacity of firms (level or changes in cash flow) in the country concerned. Investment incentives, and in particular tax incentives, offered by the country concerned are seen to influence investment decisions through their effect on relative-price variables or cash-flow variables. Their effect through demand variables, being a "second-round" effect, has to be considered as significantly smaller. What the report surveyed are the results of investment incentive policies of OECD member countries, but they are valid for developing countries. The 1987 OECD report expressed a similar view on the role of investment incentives.

In 1984, the Consultative Group on International Economic and Monetary Affairs (Group of Thirty), asked 52 major multinational enterprises the following question: "You will find possible influences on foreign direct investment. Please rank the six most important to your company's new foreign direct investment in industrial countries and in less developed countries, in both 1970 and 1983 by writing the number '1' for the most important factor, '2' for the second most important factor, and so on". The results are presented in Table 4.2.

Table 4.2 Main Influences on Foreign Direct Investment Decisions: Per cent of respondents mentioning a factor in their "top three."

Group	ICs*	LDC*	ICs	LDCs
Year	70	83	70	83
Access to host country's domestic market	89	67	82	87
access to markets in host country's region	41	37	29	34
Avoidance of tariff barriers	24	16	51	43
Avoidance of non-tariff barriers	13	8	29	28
Integration with your existing investment	26	37	4	17
Changes in your (home) country's structure	20	22	11	9
Slower growth of home market	17	18	11	11
Access to raw materials	13	10	13	11
Inducements offered by host country	11	12	16	13
Integration with other companies' investment	4	8	4	4
Comparative labour cost advantages	4	6	11	13
Comparative material cost advantages	4	6	2	4
Shifts of political and social stability	2	8	9	8
Tax advantages	6	4	7	0
Market presence	6	5	3	0
Distribution of risk	0	5	0	3
Return on investment in R & D	3	3	3	3

Development of local market	3	3	3	0
Acquisition opportunities	3	3	0	0
Exchange rate movements on investment	0	2	0	0

Source: Group of Thirty, *Foreign Direct Investment, 1973-87.*

* ICs and LDCs are industrial countries and less developed countries respectively.

A World Bank survey of 30 multinational enterprises covering 74 projects in four industries (automobiles, computers, food processing and petrochemicals) found that, in roughly one third of the investment projects, attributes of the host country other than investment policies were responsible for the location decision. But in the rest of the cases the location decision was made because of government investment policies, and in nine of the investments the threat of changes in incentive policies, rather than existing levels, motivated the investment decision (Guisinger, 1985, 1986). The results are shown in Table 4.3.

Table 4.3 Dominant Influence on Location Decisions: numbers of projects out of 74

Investment to	Nature of the incentive			
	Non-policy	Policy stability	Commodity-based policy	Factor-based policy
Host market	8	3	23	2
Regional market	9	6	0	11
World-wide market	7	0	1	4
Total	24	9	24	17

Source: Guisinger and Associates, *Investment Incentives and Performance Requirements* (New York: Praeger, 1985) P. 49.

According to the cross-Commonwealth-country surveys (Cable and Persuad, 1987), FDI decisions depend largely on the assessment of a country's overall attractiveness, which includes access to a large host-country domestic market (or a regional market); by contrast, low labour costs and tax/financial-incentive advantages are relatively unimportant; much more important are long-term social and economic stability and a climate conducive to business in general. In terms of economic policy, governments' principal economic policies are more important than specific incentives, and financial, fiscal and trade policies are by far the most important. Together they set the price levels in relation to the rest of the world. In a poor and small country with none of the

above advantages, incentive schemes and free-trade zones may, at the margin at least, have some effect in stimulating foreign investment flows, for what encourages FDI is highly project-specific.

So far we have listed several research results from which we could find that there are many factors contributing to the determination of level and location of FDI in host developing countries. All of the factors constitute an investment climate in which market size and production costs are very important and specific investment incentives offered by host developing countries do affect foreign-investment decisions to a certain extent.

It is worthwhile discussing some implications of the above findings here. We can see that almost all the literature on the issue suggests that the fundamentals attracting inflows of FDI are largely beyond government control, or only indirectly controlled. They include resource endowment, size of market, political and social stability. On the other hand, what host governments can directly control are basic economic policy as well as investment incentives, which are, unfortunately, not the "fundamentals". Consequently, the role of host governments in attracting FDI seems limited.

In my opinion, however, we should be careful when evaluating the role of host governments in altering the general investment climate. Firstly, we should note that different categories of the fundamentals have different influences on foreign investors. Political and social stability is very important only in its relevance to investment security. In itself it would not bring in any profit. Resource endowment and size of markets (local and regional) are very important because the former is the main determinant of the host country's production cost advantages and the latter guarantees a potential outlet for products. If there is political and social stability but no other advantages, it is difficult to attract FDI. If there is political and social stability plus large markets and/or a favourable resource endowment, the investment climate is attractive.

Secondly, we can find enough evidence that a host government may both indirectly and directly influence the above fundamentals by various measures. It may formulate proper policies and/or rules to secure political and social stability, to promote the size and the rate of growth of the economy (and the size of markets), or to alter the relative prices of production factors. Of course, the roles of host governments vary

from country to country, and the more the economy is centrally-planned, the more direct controls the government has. If a developing country with one of the three fundamentals wishes to attract FDI, it is possible for the government to do so: it can offer favourable general industrial policies and specific investment incentives if the country has no advantages other than political and social stability (it is difficult in this case); it can take all means to guarantee the political and social stability if the country has favourable size of markets and/or production costs.

Section 4 Choices of Incentives

The purposes of investment incentives for FDI may be divided into two main categories: growth policy and structural policy (regional and sectoral), though the two purposes are generally combined. Growth policy may be defined as policy to increase national income more rapidly by bringing more resources into use or using them more productively. Structural policy is discriminatory growth policy: certain industrial sectors or regions of the country are favoured relatively to others. The favoured sectors or regions may be the strong or the weak (15).

Correspondingly, there are several possible criteria that might be applied for the receipt of investment incentives. Usher (1977) has summarised four categories of criteria for awarding investment incentives to FDI in developing countries. The first one is to grant concessions to all new investment. This method has been expected to increase total inflow of FDI. The drawback to the method is its high costs to the government, unless taxes raised from the induced investment make up the difference.

The second is to restrict the concessions to a limited number of industries believed to be important to the country. This criterion serves structural policy. In this case, a government should identify the areas of a country's comparative advantage. For example, in countries endowed with abundant unskilled labour and scare capital resources, policy measures should not be used to raise labour cost (through minimum wages) or to reduce capital costs (by exemptions from import duties on capital inputs, accelerated depreciation); otherwise the policies will encourage capital-intensive rather than labour-intensive industry.

The identification of a country's comparative advantage is not easy, especially in an

economy where previous interventions have so distorted prices that they can not be used as indicators of value, and there is a risk that areas with significant potential may be omitted from the list to be promoted.

The third category of criteria is to apply a vague guideline offered by a host government such as "good of the country", or consistency with the national development plan. This criterion can serve growth or/and structural policy. It may be the least costly in terms of forgone revenue, for it could restrict concessions to those investments that would not be made otherwise, but the criterion might be abused in some cases.

The last category of criteria is to use certain characteristics, such as size, job creation, economic rate of return, increased domestic value added, or improvement in the balance of payments.

Section 5 Impact of Regulations

Many foreign-investment projects are subject to various regulations. It is difficult to assess the impact of these regulations. But, as a general rule, they have a negative impact on an investment climate and may not always work to the advantage of developing countries, though host governments may have reasons for applying them.

Firstly, regulations on entry of FDI may be considered as a measure to protect infant industries from foreign competition, but the measures may cause lower quality and higher prices of the products in these industries.

Secondly, regulations on degree of foreign ownership may only serve to divert domestic savings, with a high social opportunity cost, to foreign firms, and on the other hand such regulation may create substantial disincentives to foreign investment in high-technology industries, In cases where firms are especially concerned to protect proprietary information, a number of foreign firms have withdrawn when faced with such regulation (16).

Thirdly, regulation on repatriation of capital and profits may impede the inflow of superior-quality technology and know-how, and it may be one of the proximate

reasons for the frequently noted transfer-pricing practices on the part of foreign firms. The comment by an official of a large MNE has been cited very often to describe such a practice: "if I cannot get dividends out and my royalty rate is fixed, and I want to remit more money, then I do this on an uplift on my transfer prices" (17).

Fourthly, the effectiveness of performance requirements is also hard to measure. In some cases, the requirements are not operative; for instance, requirements for certain export levels may not significantly affect investments which in any event are aimed at export markets. In other cases, they end up being totally prohibitive, leading MNEs to disinvest in the country and sectors concerned. Requiring MNEs to purchase their requirements of components and materials locally may lower their productive efficiency to the extent that locally produced components are relatively expensive or low quality.

Restriction on access of foreign-owned firms to local capital markets and other fiscal or financial disincentives may impede inflow of FDI too.

There are great differences in points of view about FDI policies of host governments on the one hand, and of MNEs on the other, due to some inevitable conflicts of interest between them. It is understandable for host governments to direct FDI by various regulations on their own behalf. But the issue is how to improve their effectiveness, providing less disincentives for FDI. Suggestions found in the literature include the following measures: regulations should not be too burdensome; negotiated regulations are more acceptable to investors than imposed measures of the same nature; regulations should be transparent and predictable.

Section 6 Conclusions

Though investment incentives encourage FDI, their effects are limited. Market size and production costs in general are the key factors for an investment environment. Investment incentives merely make attractive locations more attractive.

Investment incentives impose costs on a host country's economy and may or may not at the same time bring in returns. To achieve a specific purpose (growth or structural adjustment) we should make an appropriate choice of incentives.

As a general rule, regulations discourage FDI. Though host countries have various reasons to regulate FDI, it is wise to improve the effectiveness of regulations so that they offer as little disincentive as possible to FDI.

Notes: Chapter 4

(1) Bracewell-Milnes and Huiskamp, 1977, P. 20.

(2) ibid..

(3) OECD, 1983a, P. 10.

(4) ibid., P. 17.

(5) Guisinger, 1986.

(6) Guisinger, 1985, 1986; IMF, 1985.

(7) See Lall and Streeten, 1977, Chapter 11; OECD, 1983a, Part I; Cable and Persaud, 1987; Chapter I and II.

(8) IMF, 1985, P. 14.

(9) Lall and Streeten, 1977, Chapter 11.

(10) OECD, 1983b, P. 17.

(11) See IMF, The Annual Report on Exchange Arrangements and Exchange Regulations, 1983; IMF,1985, Chapter IV; Balasubramanyam, 1984; OECD, 1983a; and 1987, P. 41.

(12) See Bracewell-milnes/Huiskamp, 1977; Galenson, 1984. The former only mentioned the first cost, while the latter listed both.

(13) See Bracewell-milnes/Huiskamp, 1977, Chapter X.

(14) Galenson, 1984, Pp. 28-29.

(15) See Bracewell-Milnes/Huiskamp, 1977, P. 23. The authors' third category of the purpose of investment incentives is conjunctional policy (economic management), defined as aims at reducing the cyclical variations in the whole or in parts of a country's economy. The category is not cited here because it is not often seen in

stimulating FDI but in encouraging domestic investment.

(16) See IMF, 1985.

(17) See Robbins and Stobangh, *Money in the Multinational Enterprise, A study in Financial Policy*, London, 1974; Contractor, *International Technology Licensing*, Lexington, 1981; Balasubramanyam, *International Transfer of Technology to India*, New York, 1973; and Balasubramanyam, 1984.

CHAPTER 5 DEVELOPMENT & PRESENT SITUATION OF FDI IN CHINA

Section 1 Introduction

Part two of this thesis deals with various issues of FDI in the People's Republic of China. It contains 6 chapters, discussing the investment climate, the determinants and the impact of FDI in that country. It also discusses several selected questions about China's FDI policies.

This chapter aims to present a general picture of FDI in China, providing some empirical data for our further studies in chapter 8.

The People's Republic of China can trace back its history of opening the economy to FDI to the 1950s. Because of historical, ideological and practical reasons, however, the amount of FDI during the period between 1949-1978 was extremely small.

The new era of absorbing FDI began in 1979 when the Chinese-Foreign Joint Venture Law was promulgated. Between 1979 and 1992, China had approved about 84,000 ventures with foreign investment, and the cumulative amount of FDI utilised was US $34 billion (*The Economist*, 20 June 1992; *The People's Daily*, 21 April 1992 and 19 February 1993; *The China Business Review*, May-June 1992). This era can be subdivided into four phases. A first is the experimental period (1979-1983). During

this period, a limited amount of FDI was introduced into 4 small special economic zones (SEZ) for the purpose of experiment. A second is the quick-development period (1984-1985) in which 14 open coastal cities (OCC) and 3 open coastal economic areas (OCEA) were established in the light of China's coast-oriented regional strategy. Then followed the adjusted-development period (1986-1991). In these years the Chinese government adjusted the sectoral distribution of FDI. Investment in technologically-advanced and export-oriented enterprises were particularly encouraged. In this period, the Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises (the Unified Income Tax Law) was passed; Hainan Special Economic Zone and Shanghai's Pudong New Area were set up. Finally there is a leap forward period (1992-) China's inward FDI has surged since Chinese leader Deng Xiaoping launched a new wave of economic reforms in yearly 1992.

If we observe inflows of FDI to China through time, we will find that the development followed a "determined but erratic course" (Shen, 1990). In addition, if we look at the locations of FDI in China, we will find that it was concentrated in the coastal area. This pattern reflected the Chinese leadership's ideology and its corresponding policy. The next section describes the development of FDI in China in the past 40 years, and its focus is on the new era. Section 3 presents the present position of FDI: its sources, types, and sectoral and regional distribution. Section 4 provides conclusions.

Section 2 Development

2.1 1949-1978

Long ago the Chinese Communist Party set up its well known approach to foreign policy, "relying mainly on our own efforts while making external assistance subsidiary". For about thirty years that was regarded as the fundamental principle in foreign economic relations. The practice did not always follow the policy in the sense that external assistance was sometimes totally ignored. Though there were inflows of FDI during the first three decades of the PR China, the amount of it was almost negligible.

Shortly after the founding of the People's Republic in 1949, the Korean War broke

out. The United States and other major western countries embargoed transactions with China. In order to recover and develop the national economy, the Chinese government turned to the Soviet Union, obtaining rouble loans equal to US$ 1.427 billion for importing 156 complete plants. Meanwhile China set up a few joint ventures with Soviet and other East European countries: the Sino-Soviet Zhongchang Railway, the Sino-Soviet Xinjiang Nonferrous Metal Company, Dalian Sino-Soviet Shipbuilding & Repairing Company Ltd, the Sino-Polish Joint Stock Shipping Company and the Sino-Czechoslovakian International Marine Transportation Stock Company. The establishment of these joint ventures marked the starting point of the PR China's absorbing FDI. During that period, however, all the investment came from the "socialist camp" in which China was a member.

But the good times did not last long. Because of the worsening of Sino-Soviet relations in 1960, the Soviet Union withdrew the economic assistance and asked China to pay back the debt. All the Sino-Soviet joint ventures were discontinued. The Chinese people had to stand for self-reliance and spent several hard years paying off all the debt by 1965. The Sino-Czech International Marine Transportation Stock Company was stopped also because of the bad relations between China and the Soviet Union. But the Sino-Polish Joint Stock Shipping Company has survived.

In the 1960s, there were only two joint ventures formed, i.e., the Sino-Albanian Joint Stock Shipping Company (1962) and the Sino-Tanzanian Joint Stock Marine Transportation Company (1967), though the Chinese government continued importation of machinery, equipment and even complete plants (mainly for the oil industry, chemical fertilisers, chemical fibres, metallurgy and electronics) by means of delayed payments. Later the Cultural Revolution stopped this practice.

The formation of the two joint ventures in the 1960s reflected China's policy toward external relations. As a "bright socialist light in Europe", Albania had close relations with China. In addition, Mao put forward his third-world theory at that time, urging that all the third-world countries rallied to form a united front. Unfortunately, the Sino-Albanian Shipping Company disintegrated in 1978, as a result of the worsening relations between the two countries, but the Sino-Tanzanian company continued.

The Chinese people gained from the use of foreign funds in the 1950s and the 1960s (see, for example, Liu, 1983). Some of the technology, equipment and complete

plants imported have played and still play an important role in China's industrialisation; by creating joint ventures China has learnt technology and management skills; the Sino-Polish Joint Stock Marine Transportation Company helped to overcome difficulties in China's foreign trade at the time that western countries were embargoing transactions with China in the 1950s. Late in the 1960s when the Cultural Revolution was still on, using foreign capital was regarded as a "forbidden area"; people did not, or more exactly dared not, talk about it, and foreign direct investment in China did not advance at all until 1979.

It is obvious that inward direct investment in China was very small indeed in the first three decades of the P.R. of China. As a result many authors neglected it and set 1979 as the first year of China's accepting FDI (see, for example, Chu, 1987). We, however, are interested in the reasons behind the disappointing picture rather than simply ignoring it just because the amount of FDI was so insignificant during that period.

Historically, for more than two thousand years: the commodity economy in China was little developed and the idea of self-sufficiency was rooted deeply. As a matter of necessity, facing the embargo from the western countries, China relied mainly on its own painstaking efforts to realise certain achievements in economic construction, which led to the idea that the Chinese people could do anything without foreign capital. Ideologically, during the Cultural Revolution the use of foreign capital, especially foreign direct investment, was regarded as "contradictory to socialism", "begging from capitalist countries", and "losing face". This ideology dominated China for many years until 1976 when the Cultural Revolution came to an end.

2.2 1979-1992

"China's 1979 decision to accept foreign direct investment was the result of a fundamental shift in political leadership and economic policy that began after the end of the Cultural Revolution and that crystallised during the Third Plenary Session of the Eleventh Central Committee of the Chinese Communist Party in 1978 (UNCTC, 1988, P.54)". The Third Plenum is a very important conference in the history of the Chinese Communist Party, in that it shifted the main task of the party to the "four modernisations", i.e., the modernisation of agriculture, industry, science and technology, and national defence, in order to quadruple China's 1980 gross national product of 480 billion yuan to 1800 billion yuan by the year 2000, raising the living

standards of its people through economic development.

To realise this objective, China needed capital, technology and managerial expertise. As known to all, China had already developed from a backward agricultural country into an industrial and agricultural country with certain material and technological bases, but it was still very poor. In agriculture, China was still basically in the stage of manual labour and animal power. In industry, mechanical and manual production coexisted and automated production had barely begun. Equipment was generally poor. After analysing 26,000 kinds of products from mechanical industry in the 1980s, some authors found less than 5% of the products with technology of the 1970s level, 35% of the 1960s level and 60% of the 1950s level (Lin, 1988, P.28). China faced the problems of a huge population, and a low level of capital and technology.

In response to the problems, the new Chinese leadership formulated the pathbreaking policies of economic reform and opening the economy to the outside world, trying to use two sorts of resources, domestic and foreign; to explore two kinds of markets, internal and international; and to learn two sets of management skills, in domestic economic construction and in foreign economic relations. An important component of the latter policy was to attract FDI to China, an aspiration which was based on the following reasoning. Firstly, it could introduce foreign capital, compensating for a shortage of capital in economic construction without increasing China's external debt burdens; secondly, it could introduce advanced technology, equipment and management skills at the same time; thirdly, it could help existing enterprises to improve technology and to develop more technologically advanced and export-oriented practices, changing the economic structure and the quality of products and increasing exports; fourthly, it could help in training technical and management personnel and in promoting China's foreign economic co-operation; finally, it could offer extra jobs, increasing employment and income.

The development of FDI in China since 1979 can be divided into four phrases.

2.2.1 Experimental Period (1979-1983)

In this period, China combined the Committee for Import and Export, the Ministry of Foreign Trade, the Ministry of Foreign Economic Relations and the Administrative Committee of Foreign Investment into the Ministry of Foreign Economic Relations and Trade (MOFERT), the highest agency responsible for foreign investment as well

as trade and other foreign economic affairs. Secondly, China enacted and promulgated a series of laws and regulations governing FDI, among which were the Law of the People's Republic of China on Chinese-Foreign Joint Ventures (1979), the Income Tax Law of the People's Republic of China Concerning Chinese-Foreign Joint Ventures (1980), and the Individual Income Tax Law of the People's Republic of China, to improve the investment environment. Finally, the central government allowed Guangdong and Fujian Provinces to have special policies, and established Special Economic Zones (SEZs), which marked the beginning of the new era of China's opening to the outside world.

Guangdong and Fujian Provinces carried out special policies and flexible measures from 1979. According to this arrangement, both provinces were responsible for their own fiscal revenues and expenditures, sharing with the central government the foreign-exchange incomes augmented by increasing exports, instead of having revenues assigned and allocated by the state. They also gained more autonomy in foreign economic activities. The two provinces , the original homes of many overseas Chinese, were rich in certain resources, and adjacent to Hong Kong and Macao. They were expected to develop their economies rapidly by exploring the above advantages, and to move ahead of the rest in economic reforms, offering the whole country their experience.

The establishment of the SEZs was a very important experiment in opening the Chinese economy to the outside world. On 26th of August, 1980, the 15th Session of the Standing Committee of the 5th National People's Congress approved the Regulations on Special Economic Zones in Guangdong Province, followed by the construction of Shenzhen, Zhuhai, Shantou and Xiamen SEZs. The original areas of the four SEZs approved by the State Council were 372.5, 6.7, 1.67 and 2.5 square kilometres respectively. In order to attract more foreign capital and to facilitate the administration and development of the SEZs, the State Council adjusted the areas of the three SEZs other than Shenzhen in June 1983: Zhuhai SEZ was expanded from 6.7 square kilometres to 15.16 square kilometres, Xiamen from 2.5 to 131 square kilometres to include the whole of Xiamen Island, and Shantou from 1.67 to 52.6 square kilometres.

The four SEZs were not political zones, nor were they areas, like the Hong Kong Special Administrative District, under a "one-country two-system" arrangement. They

were special, according to China's definition, just because they could have special economic policies and special management systems (see, for example, Liu, 1986). The SEZs had three characteristics:

Firstly, the economic development in the SEZs depended mainly on foreign investment. The economy in the SEZs was a mixed one with Sino-foreign equity joint ventures (JVs), contractual JVs, and wholly-foreign-owned enterprises, dominant.

Secondly, the economic activity in the SEZs was mainly market-oriented rather than mainly controlled by the plan, as was the case in the non-SEZ areas.

Thirdly, SEZs were given more autonomy in economic activities. They could, for example, approve a project of up to 50 million yuan in heavy industry and up to 30 million yuan in light industry.

Because of these features, there was a heated discussion on the basic nature of SEZs. Many thought that the SEZ economy was one of capitalism. Since the Chinese leaders had no experience in accommodating capitalist elements into China's socialist economy, they needed experiment and therefore deliberately directed FDI into these small SEZs. If the experiment was successful, they would allow FDI in other areas. If not, the possible negative effect of the experiment would not be significant because of the small size of the SEZs.

During the experimental period from 1979 to 1983, the development of FDI was not fast. The cumulative number of agreements, the contracted and the utilised amounts of FDI, were US$ 2,452 million, US$ 7,452 million and US$ 2,685 million respectively (see Table 5.1). The most popular form of investment was contractual joint ventures though, paradoxically, there was no law governing such joint ventures in China during that period.

Here we should note that the Chinese definition of FDI used to be "broader than the ordinarily accepted usage of the term" (UNTCT, 1988). Firstly, foreign investors referred not only to foreign enterprises, individuals and other economic organisations, including overseas Chinese and compatriots from Hong Kong and Macao, but also to China's enterprises registered outside its borders, which signed the agreements (contracts) on using foreign capital with the companies and other economic

organisations within the borders of the P. R. C. (MOFERT, 1984). Secondly, FDI included the use of foreign funds for co-operative ventures, co-operative development of oil resources, compensation trade, and sometimes processing and assembly arrangements for foreign firms, as well as investment in equity and contractual JVs and wholly-foreign-owned enterprises. Since 1986, however, compensation trade, and processing and assembly arrangements for foreign firms, have no longer been included in the Chinese official statistics of foreign direct investment.

Table 5.1 Foreign Direct Investment in China, 1979-1983

Type	Number	Contracted amount US$bn	Utilised amount US$bn
TOTAL	2458	7.45	2.69
Equity JV	190	0.32	0.17
Contract JV	1123	3.23	0.76
Joint exploration	31	2.43	0.79
WFOE	48	0.37	0.08
Compensation trade	1060	0.83	0.60

Source: MOFERT, 1984

An equity JV, according to the Chinese definition, was a limited-liability company financed and run by participants who shared both risk and profits. It must be approved by the Chinese government and located on Chinese territory. A contractual JV referred to the co-operation between two separate economic entities or two separate persons who "reach agreement in a co-operative-venture contract on such matters as the investment or conditions for co-operation, the distribution of earnings or products, the sharing of risks and loss, the manner of operation and management and the ownership of the property upon termination of the co-operative venture" (the Law on Chinese-Foreign Co-operative Joint Ventures). Co-operative development of oil resources meant mainly the exploitation of China's offshore resources. Compensation trade meant that the Chinese party bought capital goods abroad and paid in goods produced rather than in cash.

The biggest source of investment was Hong Kong and Macao, and the amount they invested accounted for 58% of the total (see Table 5.2). They were followed by Japan, U.S.A., Britain and France. The leading investment site was Guangdong, which hosted 58% of all the equity JVs and 89% of the total contractual JVs with foreign

investment over US$ 1 million. The second most popular investment site was Fujian, and then Beijing, Shanghai and Tianjing. The leading investment sectors ranked as follows: tourist hotels, apartment buildings, electronics, machinery and off-shore oil development (MOFERT, 1984).

Table 5.2 Sources of Foreign Investment in China, 1979-1983 (Contracted Investment, US$ 1 Billion)

Country (Region)	Cumulative total	% share
TOTAL	7.45	100
Hong Kong, Macao	4.32	58.0
Japan	0.95	12.8
U.S.A.	0.86	11.5
Britain	0.32	4.3
France	0.21	2.8
Italy	0.10	1.4
Australia	0.087	1.2
Canada	0.066	0.88
Singapore	0.054	0.73

Source: MOFERT, 1984

2.2.2 Rapid Development Period (1984-1985)

In this period China continued to promulgate laws and regulations governing FDI, among which were the Regulations for the Implementation of the Law of the People's Republic of China on Chinese-Foreign Joint Ventures, to improve further the legal environment. In addition, China opened 14 coastal cities and three coastal economic zones. FDI in China underwent a very rapid development during the two years compared with the period 1979-1983.

In 1983, the Chinese leaders thought that conditions for further opening its economy were ripe: (1) the experiment in SEZs seemed successful in that ventures with foreign investment not only absorbed foreign capital, but adopted advanced technology and management; they could produce much more efficiently than the state-owned enterprises; (2) the overall economic situation then was also satisfactory: rural economic reform led to continuous increase in grain output, and macro-economic readjustment had realised some important achievements. As a result, the Central

Committee of the Communist Party and the State Council held a conference in April, 1984, and decided to open further 14 coastal port cities, i.e., Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai.

"Opening further" meant two things. On the one hand, the cities were given more autonomy for pursuing foreign economic activities. On the other hand, favourable treatment was given to foreign investors in order to attract more investment. If conditions permitted, these cities could establish economic and technical development districts to absorb more advanced technology. In November 1984, the State Council approved a provision that equity JVs, contractual JVs and wholly-foreign-owned enterprises in these cities should pay only 80% of the current enterprise-income tax applied to local firms, and, if the above ventures were located in the economic and technical development districts, they should pay the tax at only 15%.

The above 14 coastal cities were the most prosperous areas in China at the time that they were proclaimed. Though their population accounted for only 8% of the national total, their gross industrial product came to 23% and gross exports to 40%. Labour productivity was 66% higher than the national average. The purpose of opening these cities was explained as that of exploiting these advantages further by using foreign funds, technology and markets, updating the existing enterprises' technology and strengthening the competitive abilities of their products in world markets so that these enterprises could turn from a basically domestic orientation to both domestic and external orientation, accelerating economic growth. These central cities, which were regarded as the next layer of China's opening to the outside world after the SEZs, were intended to transfer information, personnel resources and funds to the interior area, promoting economic development there, and hence across the entire economy.

In January 1985, the State Council, according to the CCCP's suggestion, turned the Changjiang Delta, the Zhujiang (Pearl River) Delta and the South Fujian triangle area into "Open Coastal Economic Areas". It was another important measure in the policy of opening to the outside world. The three Deltas included both cities and vast rural areas. The development strategy for the OCEAs was from "small deltas" to "large deltas": the more favourably placed cities such as Shuzhou, Wuxi, Changzhou in Changjiang Delta, Fuzhou, Jiangmen and Quanzhou in the South Fujian triangle area, Dongguang and Xinhui in the Zhuhai Delta, would develop first in order to gain

experience, followed by other areas in the Deltas.

These Deltas had favourable natural conditions, known as "homes for fish and rice, for silk, and for flowers and fruits". They had relatively advanced industries and agriculture, with a long history of foreign economic relations. All of this would help the development of their foreign economic and technical exchange. The OCEAs were the next layer of China's opening to the outside world after the SEZs and the OCCs, and they were also expected to promote the economy of the interior.

Partly because of the Chinese government's initiative and the continuing improvement of the investment environment, FDI in China in 1984 and 1985 underwent a very rapid development contrasting with the slow investment between 1979 and 1983. While the number of approved agreements in 1984 was 2,166, with a contracted investment of US$ 2.88 billion, in 1985, 3,073 agreements were approved, with a value of US$ 6.33 billion. The sum of FDI in the two years was twice as high as that in the previous 5 years in terms of the number of projects and 23% higher in terms of the nominal amount. As for the sources of FDI, while Hong Kong was still the leading investor, the USA's cumulative investment surpassed Japan's, and the U.S.A. became the second largest investor in China. (See Table 5.3).

Table 5.3 Sources of Foreign Investment in China, 1979-1985.

Country (Region)	Cumulative total (US$ bn)	% share
TOTAL	46.3	100
Hong Kong	*37.0*	*80*
U.S.A.	3.7	8
Japan	3.2	7
Europe	1.86	4
Asia, other countries	0.46	1

Source: Chu, 1987.

Though the increase in the total amount of FDI in China seemed satisfactory, structural problems appeared. Table 5.4 shows that, in the first 8 years from 1979, investment in the construction of hotels and apartment buildings took the lead over that in all other sectors, accounting for about half of the total amount of FDI brought in. The reasons for this dominance were as follows: while the policy of China's opening to the outside world attracted in more and more foreigners for business and

sightseeing, there was a serious shortage of suitable hotels and apartments for them. Facing the problem the Chinese government encouraged such investment in this area. For foreign investors, great demand, hence promising prospects of good returns in terms of foreign exchange, lured them to invest. Consequently, too many high-level hotels and apartment buildings were built in Beijing and Shanghai, and even more so in Shenzhen and Guangzhou where the occupation rate declined sharply, especially in the low season of tourism.

Table 5.4 Cumulative Sector Distribution of FDI in China, by 1986.

Sector	% of total amount	% of total projects
Energy exploration, transport service, metallurgy, manufacture of machinery, electronics, chemicals, telecommunications equipment, construction materials	36	43
Light industries, textiles, foodstuffs, pharmaceutical	14	25
Tourism & service industry	48	26
Agriculture, animal husbandry, fishery, forestry	2	6
TOTAL	100	100

Source: Chu, 1987.

While the proportion of FDI in tourism was very large, that in energy resources, raw materials and infrastructure, which were the areas the Chinese government particularly encouraged, was regarded as too small. As a result, the government began to adjust the investment structure in 1986, imposing restrictions on FDI in tourist hotels in the above-mentioned cities.

2.2.3 Adjusted Development Period (1986-1991)

A first adjustment was made in 1986 when the "Provisions of the State Council of the People's Republic of China for the Encouragement of Foreign Investment" (also known as the 22 Articles) with other related legislation were formulated. The main purpose of the provisions and legislation was to readjust the structure of FDI in China by offering specially favourable treatment: encouraging foreign businessmen to invest in technically-advanced enterprises and export-oriented enterprises, as well as in the basic industries and infrastructure.

'artly because of this adjustment and partly because of the Chinese government's ıusterity programme which started in 1986, FDI, in terms of both number of projects approved and amount, declined sharply from 3,037 and US$ 6.3 billion in 1985 to 1,498 and US$ 3.3 billion in 1986. From 1987 to 1989, FDI, in terms of the contracted amount of additional FDI in China, increased continuously, but it did not exceed that of 1985.

The structure of FDI shifted during this period. In 1985, for example, the "productive projects" approved accounted for less than 50% of the total, but from 1986 to 1989, the proportion increased to 60%, 75%, 85% and 90% respectively (Wang Yongjun, 1990).

A second adjustment was to replace several individual income tax laws with the Unified Income Tax Law in 1991. This adjustment aimed to make Chinese foreign taxation clearer. Detailed discussions of these tax arrangements will be provided in Chapters 6 and 10 of this thesis.

During this period, China opened more areas to foreign investors: (1) Shandong Peninsula and East Liaoning Peninsula was added to the OCEAs; (2) Hainan Province was granted full special economic zone status in 1987; (3) Shanghai's Pudong New Area was set up in 1989; and (4) some cities and counties in the interior were more recently opened to the outside world as well.

The Pudong New Area comprises a triangular area of 350 sq. km of Shanghai municipality's Chuansha County. This bold programme is supported by the central government. One of the purposes is to transform this old city by using foreign resources. The physical infrastructure is now being improved and the area is to be divided into five zones: the Lujiazui Finance Zone, the Jinqiao/Qingningsi Export Processing District, the Waigaoqiao Free Trade Zone, the Zhoujiadu/Liulu industrial zone, and the Beicai/Zhangjiang science and education zone.

Though the incentives available to foreign partners are basically similar to those in the SEZs, the Pudong New Area is not just another SEZ because it allows foreign investors to do things not allowed in the SEZs (see Gold, 1992). The Pudong New Area is now the focus of China's propaganda on the economic reform. It is said that, if

the 1980s was the age of the SEZs, the 1990s is the age of the Pudong. However, there are difficulties with the development of the area, and the most important one may be with money: the area needs infrastructure to attract foreign investors, but the development of the infrastructure needs foreign investment as well.

2.2.4 Leap forward period (1992-)

In 1992, there was a surge of China's inward FDI: about 47,000 enterprises with foreign investment were approved by the Chinese government, and the amount of FDI actually utilised reached US$ 11.16 billion. In terms of the number of enterprises approved, 1992's figure exceeded the total of the previous 13 years.

The investment boom in 1992 was closely associated with the following two events: Deng Xiaoping's tour of the southern provinces, and the opening up of new sectors and areas for FDI.

During his tour in January 1992, Deng Xiaoping urged his audience to "emancipate the mind and pluck up the courage further and go at a faster pace". In response to this, local governments lost no time to compete to attract foreign investment by establishing thousands of special economic zones. (Unfortunately much of the confiscated land lies idle because the amount of foreign investment available falls short of the amounts that have been projected).

Since 1992 China has also allowed FDI to go to some previously forbidden sectors. These include domestic retail, finance, tourism, real estate, shipping, and resource development. Furthermore, in 1992, 28 cities and 8 regions in the Yangtze River Triangle Area and along the river were opened to the outside world. The opening up of these sectors and areas has attracted much FDI.

Section 3 Present Situation

Since 1979, more and more FDI has flowed into China. It will be interesting to examine the basic features of China's inward investment. Thus this section discusses three aspects of the general picture: breakdowns by source countries; by types of investment; and by sectors. Because of a lack of the most recent detailed data, the latest statistics were the year 1989's. Theoretical and policy implications of some

features will be discussed in detail in chapters 8 and 10.

3.1 Breakdown by Source Countries (Regions)

After China adopted the policy of opening to the outside world, enterprises from 47 different countries and regions invested in China between 1979 and 1989 inclusive. The main sources of the investment are shown in Table 5.5.

Table 5.5 Sources of Foreign Investment* in China, 1979-1989 (Contracted investment, US$ million)

Year	79-84	1985	1987	1989	79-89 TOTAL	%
National total	10327	6333	4319	6294	36795	100
HK. Macao	6494	4134	2364	3734	*22662*	*62*
US	1025	1152	361	645	4110	11
Japan	1158	470	386	515	3183	8.7
Singapore	117	76	80	147	698	1.9
W.Germany	142	20	140	160	586	1.6
UK	334	44	29	33	548	1.5
France	213	50	74	18	399	1.1
Italy	113	25	19	63	334	0.9
Canada	66	9	34	49	288	0.8
Australia	91	14	47	84	285	0.8
Netherlands	2	3	0.1	18	176	0.5
Thailand	26	15	5	57	157	0.4
Switzerland	22	0.7	57	12	156	0.4
Austria	-	-	0.9	9	104	0.3
Philippines	6	41	31	5	102	0.3
Belgium	50	3	2	21	77	0.2
Sweden	33	5	5	28	72	0.2
Denmark	3	4	0.6	0	50	0.1

* This includes all kinds of investment - EJVs & CJVs, WFOEs, joint offshore oil exploration, leasing, compensation deals, and processing and assembly. Sources: MOFERT; *Business China*.

Hong Kong and Macao have always been the leading source of investment since 1979, and this overwhelmingly dominant position is expected to remain for many years to come because of their geographical advantage and close economic relations with Mainland China, and, much more importantly, because of the same cultural

background and their family links with the mainland. A close relationship between clanship and China's inward investment was revealed in our fieldwork which will be presented in chapter 7.

Before 1984 Japan ranked second, but it has been replaced by the USA since that year. It will be difficult because of lack of information to explaint why the US could overtake Japan as the second largest investor in China.

The UK's proportion of the cumulative FDI in China declined from 4.3% in 1983 to 1.5% in 1989; accordingly, it fell from the position of 4th largest cumulative investor to that of 6th largest during the same period. With the rapid increase in FDI from Hong Kong, Taiwan, South Korea, Thailand, and other Asian countries, the UK's share in China's total inward FDI will decline further.

The most significant feature in the sources of FDI in recent years may be that Taiwan has become a more and more important investor in Mainland China. Before 1988 the cumulative FDI from Taiwan was US$ 0.1 billion only. It increased quickly to US$ 0.5 billion in 1988, US$ 1 billion in 1989 (Lin, 1990). The upsurge in Taiwanese business activity in Mainland China contributed much to the growth of FDI in recent years. The amounts of investment contracted from Taiwan in 1988 and 1989 accounted for 7.5% and 8.9% of the totals respectively The pace of FDI inflow from Taiwan has been quickened further in recent years. For instance, Taiwan companies invested about US$ 1.5 billion in 1992 alone. (Goldstein 1992). On this trend, Taiwan will be the second largest investor in mainland China in the near future.

Like FDI from Hong Kong, direct investment from Taiwan is motivated basically by the family and local connections. Taiwanese now make a million trips to the mainland a year and a Taiwanese who goes back to his hometown is received like a hero (Kraar 1992). An overseas Chinese usually has strong affection for his original home and strong feeling of commitment to his family. Just as Hong Kongers have international marketing skills, Taiwanese have technology and financial power. They have been committing themselves to the development of their hometowns by investing there since China adopted the policy of opening to the outside world.

Another reason for Taiwan's rapid investment in China is that the investment environment in Taiwan has been worsening. Firstly, accompanying economic growth,

there has been a shortage of labour and hence the labour cost is so high that the wage for hiring one worker in Taiwan can be used to hire 7 to 10 workers in Mainland China; secondly, land-use fees are very high compared with those in the Mainland; thirdly, high foreign exchange reserves have caused appreciation of the Taiwanese currency, which, in turn, has reduced export-competitiveness. At the same time, the Taiwanese authorities adjusted their policy towards the Mainland, and the relations between the two parts have improved. Through frequent contacts, more and more Taiwanese come to know more and more about the Mainland. Because the Taiwanese authorities have acquiesced in direct investment by medium-sized and small enterprises in the Mainland through third countries or regions, Taiwanese businessmen have changed their mode of activity from "coming secretly and investing silently" in the past to "coming group by group and investing boldly". Thus the expertise and capital among the ethnic Chinese is combined with China's vast supplies of land, workers and ambition. This combination helps form "Greater China", a potential economic superpower.

Hong Kong, Taiwan and Macao are not the only source of investment by ethnic Chinese. Some FDI from other Asian, European, Australasian and Northern American countries has actually been made by people of Chinese extraction as well. Thus we can find that the majority of China's inward investment is contributed by ethnic Chinese. This is the unique feature of FDI in China and has important theoretical and policy implications which will be discussed in chapters 8 and 10.

3.2 Breakdown by Types of FDI

As mentioned before, the main types of FDI in China have been equity JVs, co-operative JVs, wholly-foreign-owned enterprises and joint developments. In an equity JV, while the foreign side usually brings equipment, industrial property rights (including technology), and funds as its contribution, the Chinese side contributes land, plant, equipment and Renminbi. Because of joint investment, operation and risk-taking, foreign businessmen are, by Chinese government standards, interested in economic efficiency, so that they are likely to contribute advanced technology and equipment, which helps the existing enterprises in China to improve technology and the quality of products. Secondly, by the running of an equity JV, a foreign businessman's selling channels and experience can be exploited to expand exports. In an equity JV contract, an export ratio of products is usually set, and the foreign partner is responsible for the export, gaining enough foreign exchange to remit the

value of the investment at a profit. As a result, while foreign businessmen serve their own interests in doing so, they help China to export its products. Thirdly, the Chinese side in an equity JV can learn advanced management skills by joint operation. This form of investment has actually been encouraged by the Chinese government. So far the equity JV is the most popular type of FDI in China. Between 1979 and 1989, 12198 equity JVs were approved with a value of US$ 12.53 billion. They accounted for 59% of the total number of projects approved and 38.7% of the total amount(see Table 5.6).

The views listed above on the advantages of EJVs are mainly the Chinese government's. There are further reasons why foreign partners generally favour EJVs. As the main source of FDI in China, HongKongese, Taiwanese, overseas Chinese and people of Chinese origin are in a position to make a good use of specific advantages when they invest in China. These include shared culture and family relations. Because of this, there is less uncertainty but more mutual trust, and both parties can act more rationally. Thus, these investors find it not necessary to follow the form of wholly-foreign-owned enterprises (WFOEs) to protect their own interests. The Chinese partners also favour the JV status in order to gain preferential treatment from the government. The popularity of JVs in China provides a challenge to the traditional transactions-cost approach to determinants of FDI, which would be likely to consider a WFOE as a superior form to a JV. Chapter 8 will provide a more detailed analysis of this issue.

Table 5.6 A Breakdown of Foreign Investment in China, Contracted and Utilised (US$ billion; units)

Year	79-84	1985	1987	1989	79-89 TOTAL~
FI contracted					
Total value	8.99	5.93	3.71	5.60	32.36
Total number	3248	3073	2233	5779	21734
EJV value	1.38	2.03	1.95	2.66	12.53
EJV number	931	1412	1395	3659	12198
CJV value	4.71	3.50	1.28	1.08	13.56
CJV number	2212	1611	789	1179	7994
WFOE value	0.47	0.05	0.47	1.65	3.14
WFOE number	74	46	46	931	1525
JOE* value	2.42	0.36	0.01	0.20	3.13

JOE number	31	4	3	10	61
Other** value	1.34	0.40	0.61	0.69	4.62
FI utilised					
Total value	3.06	1.66	2.31	3.39	15.49
EJV value	0.43	0.58	1.49	2.04	7.31
CJV value	1.22	0.59	0.62	0.75	4.75
WFOE value	0.10	0.01	0.03	0.37	0.75
JOE value	1.31	0.48	0.18	0.23	2.68
Other value	1.27	0.30	0.33	0.38	3.20

* Joint oil exploration;
** Other foreign investment includes international leasing, compensation deals, and processing and assembly;
~ Cumulative total.
Sources: MOFERT, *Business China*

Profit distribution, together with other co-operative conditions in a contractual JV, is based not on the amounts invested by both sides, but rather on the terms of the contract. Because the kind of arrangement is flexible, this form of FDI has developed relatively fast. Though only 7,994 contractual JVs were approved, compared with 12,198 equity JVs, between 1979 and 1989, the contracted amount of cumulative investment reached US$ 13.56 billion, accounting for 42% of the total. These JVs include ventures in industry, agriculture, aquatic farming, schools and hospitals, transportation, and especially tourist hotels and apartment buildings.

The Chinese government also has reasons for allowing wholly-foreign-owned enterprises to operate in China (see, for example, Liu, 1983). Firstly, the WFOE brings in advanced technology and management experience. In order to strengthen its competitive ability, the WFOE is likely to use advanced technology and management skills. The efficiency of the WFOE will have a bandwagon effect, encouraging local enterprises to improve. Secondly, the WFOE helps China gain more foreign-exchange revenue: through income tax, land-use fees, salary, rent, payments for raw materials. Lastly, the WFOE increases employment and helps by training local employees.

The WFOEs in China grew slowly in the first 9 years from 1979. By the end of 1987 there were only 184 WFOEs in China. In recent years, however, the number of new contracts for wholly-owned projects has jumped. In 1988, for instance, 410 WFOEs were approved with a value of US$ 0.48 billion, and in 1989, 913 WFOEs with a

value of US$ 1.654 billion.

The quick development of WFOEs in recent years has been promoted by two factors. The austerity programme beginning in late 1988 caused a lack of RMB, which made the formation of JVs more difficult. For this reason the Chinese government encouraged WFOEs. For foreign businessmen, WFOEs guarantee greater management latitude. The proportion of WFOEs increased to 23% of the total number of projects approved in the first half of 1990, compared with 14% in the same period of the previous year.

Joint development means mainly joint exploration for oil in the Chinese offshore areas. This is regarded as an effective way of using foreign funds, technology and equipment to explore for oil, promoting China's economic growth. In today's world there are three ways of co-operation over resource-exploration: technical service; project contract; and risk contract: in increasing order of risk taken by the foreign partner. China mainly adopted the risk contract, i.e., foreign companies take all the risks of exploration; the two sides then invest jointly in the field. After oil is produced, China pays back principal and interest, and gives the foreign companies further compensation. Joint development helps China to improve its technology, and to know more about its resources. In 1989, the number of joint-exploration ventures doubled from that in 1988.

According to the nature of the organisational forms, FDI can be grouped into joint ventures and wholly-foreign-owned enterprises. In terms of the type of operational links, FDI can be classified into horizontal, vertical and conglomerate integration. Based on the Chinese government's published list of the approved enterprises with foreign investment, the most popular type by value of FDI integration in China is horizontal, then vertical, and finally conglomerate.

Pure conglomerate integration means that a firm is integrated into another unrelated industry. One example can be found in *Time* 10/5/93: the Lippo Group from Indonesia , itself already a conglomerate, will develop a major power plant, port and industrial park in Putain, Fujian province. Detailed discussion of conglomerates and their theoretical implication will be presented in chapter 8.

3.3 Breakdown by Sectors

Because of discouragement of investment in tourist hotels and some other service sectors, more and more FDI has been directed into manufacturing and some basic industrial sectors. As a result, the ratio of the cumulative FDI in tourist hotels apartment buildings and other service sectors fell down

Table 5.7 Sectoral Distribution of Cumulative FDI in China, by 1989 (US$ billion)

Sector	Amount	% share
Tourist hotel & apartment buildings	5.5	35.6
Energy	3.3	21.4
Light industry & textile	2.6	16.9
Machinery & electronics	2.4	15.6
Transportation	1.3	8.4
Building materials	0.2	1.3
Agriculture, husbandry & fishing	0.13	0.8
TOTAL	15.43	100

Source: Chu, 1990.

During this period, technologies brought in with FDI in manufacturing sectors were thought to be upgraded gradually. According to MOFERT, the cumulative number of the "two-kind enterprises" (technically advanced and export-oriented) approved by different levels of the Chinese government increased from 1,674 by the end of 1988 to more than 2,000 by the end of 1989.

It is very likely, however, that the share of FDI in China's services industry will increase in the near future. The Chinese government, after its several years' efforts in encouraging investment in manufacturing sectors, are now aware of the importance of FDI in tertiary sectors. It allows foreign investors to operate in banks, transport, domestic and international trade, and hopes that this will improve services in these sectors and therefore provide a good environment for the manufacturing sectors.

3.4 Breakdown by Regions

FDI in China is concentrated in 4 SEZs, 14 OCCs and 3 OCEAs. Between 1979 and 1989 these coastal areas absorbed more than 80 % of the total FDI in China (Zhang, 1990). The apparently uneven geographical distribution of FDI is, as a matter of fact, a part of China's regional development strategy.

China has a vast territory with a large population. For historical and geographical reasons, China's economy is relatively backward with uneven regional development; there are three economic belts: east, west and central. The east belt is the relatively well developed coastal area, including Liaoning, Hebei, Tianjin, Beijing, Shandong, Jiangshu, Shanghai, Zhejiang, Fujian, Guangdong, Guangxi, Hainan; the west belt, the least developed area, refers to very dry and cold western provinces: Xinjiang, Xizhang (Tibet), Qinghai, Ganshu, Ningxia, Neimonggu (Inter Mongolia), Shaanxi. The remaining provinces belong to the central belt, consisting of Heilongjiang, Jilin, Shanxi, Henan, Anhui, Jiangxi, Hubei, Hunan, Guizhou, Sichuan, Yunnan. A combination of both central and west belts is also known as the interior area. Compared with the interior area, the east has many advantages, such as better industrial and agricultural bases, with advanced science, technology and equipment, and relatively plentiful capital, and technical and managerial personnel, and convenient transportation. It also has a long history of a commodity economy and foreign economic relations. All of this is held to show that the east is qualified to go ahead of the rest in international economic exchange, by means of which it can improve its science, technology and management skills, catching up with advanced world levels. On the other hand, the eastern area is required to help the other two areas develop.

The western belt is rich in natural resources, with a large territory and small population. It is to be developed. The central belt has a large population and its gross industrial product accounts for about 30 % of the national total. The economic features of the belt are between those of the east and the west, like its geographical location: not too backward, with certain traditional industries and resources.

In recent Chinese history, there has been a particular regional tendency in economic growth: gradual development from the coast to the interior, or from the east to the west. An emphasis given to the east in the opening to the outside world is based on this tendency. The main purpose of the strategy is to promote the coastal economy, and then to transfer information, technology, funds and qualified personnel from this belt to the hinterland, helping along the development of the interior.

Following the strategy, China actually formed a `SEZ-Pudong-OCC-OCEA-Interior" opening structure with emphasis on the coast. The SEZ, OCC, and OCEA link all the coastal areas to form a long belt, covering one entire province, and 300 other cities

and counties. The vast interior is the hinterland of these coastal areas. By doing this China tried to combine coastal growth with interior development, gradually solving the imbalance between the east and the west, and advancing the entire economy.

The strategy, however, did not work well simply because it has not reduced the difference between the east and the west. Rather, the gap between the two areas has been widened since the adoption of the opening to the outside world. In the past decade the eastern coastal areas, with their higher level of economic activity and living standards, have attracted more funds, technology, and high-quality human resources from the interior. Some leaders in the interior are worried about the situation, warning that the deepening economic conflict might cause a worsening of political and national problems.

As a result, some economists suggested a policy of "caring for both the east and the west and opening to the outside world in all directions" (see Hu, 1989). From their point of the view, in addition to the resource advantages, the western area, especially the Southwest, also has many key enterprises and research institutes which were built during the so-called "third-front" construction period (1960s and 1970s) with an investment of about RMB 200 billion. While the east and the west cooperate and support each other, each with its own advantages, the west has a certain ability to take part in international exchange directly. It can open its economy to the neighbouring countries, absorbing foreign funds to explore natural resources and to develop raw-material and manufacturing industries. It can also expand border trade. By doing this, it can develop more rapidly with both internal and external assistance.

Maybe partly as a response to this, the Chinese government most recently opened some interior cities to the outside world: from 1992, ten central cities along the Yangtze River will carry out policies similar to those applied in the coastal cities. These ten cities are Nanjing and Zhenjiang in Jiangsu Province; Maanshan, Tonglin, Wuhu and Anqin in Anhui Province; Jiujiang in Jiangxi Province; Yueyiang in Hunan Province; Wuhan in Hubei Province; and Chongqing in Sichuan Province. Some border areas will also be opened soon. A detailed comment on the Chinese government's regional policy of FDI will be provided in Chapter 11.

So far Guangdong is still the most popular investment site with cumulative FDI of US$ 12.2 billion between 1983 and 1989 (see Table 5.8). The following advantages

explain Guangdong's leading position in attracting FDI: it is next to Hong Kong and was one of the first provinces allowed to implement special policies and to establish SEZs. Guangzhou is also a traditional commercial and industrial city with a long history of foreign economic activities and is the place of origin of many overseas Chinese.

The second favourite investment site used to be Fujian province, which has similar advantages to those of Guangdong. Many Taiwanese are of Fujianese origin and much of their investment has been located in Fujian in recent years. For instance, Xiamen SEZ has hosted 31 % of the total ventures that have Taiwanese investment.

Now, however, Shanghai has surpassed Fujian, becoming the second favourite site. In addition to the fact that FDI in Shanghai ranks second only behind Guangdong, six out of the "Ten Best Joint Ventures" chosen through public appraisal are located in Shanghai. It is not surprising because Shanghai has been and still is the largest industrial centre in China with advanced technology, high-quality human resources and much experience of foreign economic activities. In policy, it is one of the 14 coastal cities. It established three economic and technological development districts in 1984, and recently also New Pudong District with an area of 350 square kilometres to attract FDI, by offering many incentives, some of which have even never been used before even in SEZs.

Section 4 Conclusions

Though the People's Republic of China started its absorption of FDI in the 1950s, there were only a few projects set up during the first three decades, and the source of FDI was limited to a few socialist countries. The year 1979 marked a very important turning point of the P. R. China's history of economic development in that the policy of opening to the outside world was adopted. By the end of 1992, China had approved about 84,000 FDI projects and the cumulative amount of utilised FDI reached US $34 billion. As a result, China has become one of the major hosts of FDI in the developing world.

Though FDI increased quickly in China, its course of development was not smooth. This phenomenon was a comprehensive reflection of China's economic conditions, the

leadership's ideology and its policy.

Between 1979 and 1983, the amount of FDI was limited and mainly confined to the four experimental fields (SEZs) in Guangdong and Fujian provinces. The arrangement of this experiment was but a response to the compromise between the Chinese leaders' aspiration and their ideology. On the one hand, they longed for foreign resources for the modernisations drive. On the other hand, they had no experience in accommodating capitalist elements into China's socialist economic system.

In view of the general success of FDI in the SEZs and of the economic reforms in both rural areas and cities, however, the leadership decided to open its economy wider to the outside world. Following the announcement of opening 14 coastal cities and 3 coastal economic areas, there was an upsurge of FDI in China in 1984 and 1985. But there was a sudden fall in 1986, because China's two-year retrenchment and the corresponding readjustment of the sectoral structure of FDI reduced the credit supply and curtailed FDI in tourist-hotel construction and related service activities. Since 1986, FDI has increased steadily, and even the Tiananmen event did not change this trend. FDI jumped in 1992 as a result of Deng Xiaoping's launch of new waves of economic reforms early that year.

The most important sources of FDI in China are Hong Kong and Macao, and increasingly Taiwan. The fact that the overseas Chinese are the vital investors is a peculiar feature of China's inward FDI. They are followed by the US and Japan. The UK's share in China's total inward investment has been declining.

The sectoral structure of FDI has been switched toward the manufacturing sectors since 1986 with a gradual reduction in the proportion of cumulative FDI in hotel construction and the related services. But the share of FDI in the service sector may increase in the near future because the Chinese government now allows foreign investors to operate in banking, insurance, foreign and domestic trade, and transport.

In China JVs are much more popular than WFOEs. This fact contradicts the traditional transactions-cost approach to determinants of FDI. Also in China, conglomerate integration of FDI is an important phenomenon which can not be satisfactorily interpreted by the dominant FDI theories. These features not only constitute a challenge to the existing theories but also have important implications for

China's FDI policy. These will be discussed in chapters 8 and 10.

Following the overall regional development strategy in the early 1980s, FDI is concentrated in the coastal areas. This policy has not assisted in reducing the gap between the prosperous east and the backward interior. Rather, it has helped to increase the difference. Most recently, this policy has been changed and more and more interior areas have been granted to carry out similar FDI policies to that of the coastal cities. A discussion of this FDI policy will be given in chapter 10.

CHAPTER 6 CHINA'S FISCAL ARRANGEMENTS FOR FOREIGN INVESTORS

In chapter 5 we looked at the development and present situation of China's inward investment. In this chapter we focus our discussion on one important aspect of China's investment climate: fiscal arrangements for foreign investors. we find that some features of China's inward FDI are closely associated with these arrangements. Thus a change in government policy may lead to a corresponding change in the patterns of FDI in China. A detailed assessment of some policies described here will be presented in chapter 10.

Section 1 China's Fiscal Arrangements for Local Firms

1.1 Main Features of China's Tax System

Since the foundation of the People's Republic of China in 1949, the Chinese taxation system has undergone several major changes or reforms. In 1950, China replaced the old tax regime with a single national tax system, and it made some rearrangements of several taxes in 1953. Then it readjusted the industrial and commercial tax system and unified agricultural taxation in 1958. But five years later China reformed industrial and commercial taxation again. Finally, the extensive and systematic reform in taxation began in 1979 which led to the present system (For details, see Appendix 1).

The present system of taxation has several main features. Firstly, turnover taxes dominate the system. From the table in the Appendix we can see that turnover taxes accounted for about 60% of total tax revenue, and income taxes for about 35%. This balance between indirect and direct taxes is common in the low-income developing countries.

Secondly, in the new system taxes are imposed at various levels and in various sectors. Resource allocation between the state and the state-owned enterprises is, for instance, carried out at four levels: (1) the product tax, VAT, business tax and city maintenance-construction tax are imposed as a general levy on turnovers; (2) the resource tax, salt tax, land-use tax and property tax are levied; (3), the state-owned-enterprise income tax and regulating tax are collected as a direct level on profits; (4) the bonus tax, salary-regulating tax and construction tax are imposed as a levy on the profits left in the enterprises. Taxes are also collected in various sectors in order to strengthen the macroeconomic management of the entire economic process. In the production sector there are the agricultural tax, product tax, resource tax, land-use tax; in the exchange sector, there are the business tax, customs duty, transaction tax; in the distribution sector there are various enterprise-income taxes, the individual income tax and individual income-regulating tax; in the consumption sector there are the special consumption tax and banquet tax.

Thirdly, tax categories and collecting methods have been set up according to the status of different economic elements. Before 1978, a consolidated tax had been applied to various economic elements, with preferential treatment to state-owned enterprises and collective enterprises. Since 1979, a separate tax has been imposed on each economic element. Taxes on enterprise incomes, for instance, now have six categories: the state-owned-enterprise income tax, the collective-enterprise income tax, the individual industrial-commercial-enterprise income tax, private-enterprise income tax, enterprise-with-foreign-investment income tax and foreign-enterprise income tax. Collecting methods are different as well. Among the economic elements the middle-and large-sized state-owned enterprises are subject to a high proportional income tax, and small-sized enterprises, hotels and restaurants to a progressive tax.

Fourthly, a relatively independent system of foreign taxation has been established. In the first place, tax categories and collecting methods applied to ventures with foreign investment, foreign enterprises and foreigners are different from those applied to local

Chinese enterprises and Chinese individuals. In the second place, the extent of preferential treatment in foreign taxation varies across areas. The most preferential treatment can be found in the Special Economic Zones and Shanghai's Pudong New Area, followed by the Open Coastal Cities, then the Open Economic Development Areas, and finally, the interior areas.

1.2 Fiscal Arrangements for Local Enterprises

A typical local Chinese enterprise is in principle subject to the turnover tax, income tax, property tax and special behaviour tax.

In the first place, the enterprise may be subject to a proportional product tax if it produces or imports any of the 260 items of industrial products listed in the "Product Tax Regulations". The rates vary from 3% to 66%. But, if the enterprise is in the service industries, it pays a proportional business tax, which ranges from 3% to 10%. If it pays neither the product tax nor the business tax, it may be subject to a VAT which is imposed on 12 items of manufactured products such as machinery, automobiles, bikes.

Secondly, if an enterprise involves exploitation of oil, gas, coal, metal or non-metal minerals, it pays resource tax as well. The tax aims to adjust the differential incomes caused by different natural conditions.

Thirdly, the enterprise is subject to the income tax. There are several different situations here. If the enterprise is a large-or middle-sized state-owned enterprise, it faces a proportional rate of 55%. If the enterprise is a small-sized state-owned enterprise or any service enterprise, it is levied at progressive rates on amounts in excess of specified amounts of taxable income. If the income is not in excess of Renminbi 1,000, the rate is 10%; if is above Renminbi 20,000, the rate on the part above Rmb 20,000 is 55%. The criterion for a small-sized enterprise is that the enterprise's original value of assets is less than Renminbi 4 million and its profit less than 0.4 million if it is located in Bejing, Tianjin or Shanghai, or that its asset value and profit are less than 3 million and 0.3 million respectively if it is located elsewhere. A collective enterprise is subject to a progressive tax similar to that applied to small state-owned enterprise.

Fourthly, the enterprise may be subject to the bonus and salary-regulating taxes. If the

enterprise is a state-owned one and if the annual bonus given to the employees exceeds their 4 months' standard salaries, it pays the progressive bonus tax. In addition, it has to pay the progressive salary-regulating tax if the employees' salaries are 7% or more higher than last year's. For example, if they are 12-20% higher, the tax rate for the increase in excess of 12% is 100%. A collective enterprise faces a similar progressive bonus tax. The bonus and salary-regulating taxes are used by the government to control the growth of consumption funds.

Finally, the enterprise has to pay a special tax if it uses crude or heavy oil as fuel. This is a specific duty: i.e., Renminbi 40-70 is imposed per ton of such oil to be used. The main purpose of this tax is to switch the enterprise from using oil to using coal which is relatively abundant in China. The low price of oil relative to coal explains why enterprises tend to use oil as fuel.

Section 2 Fiscal Arrangements for Foreign Investors

2.1 Main Features of the Foreign Taxation

Since 1979, China has formulated a series of laws and rules concerning taxes on ventures with foreign investment, important among which are the "Income Tax Law of the People's Republic of China Concerning Chinese-foreign Joint Ventures" (1980), the "Individual Income Tax Law of the People's Republic of China" (1980), and the "Income Tax Law of the People's Republic of China Concerning Foreign Enterprises" (1981); and their rules of implementation, namely the "Regulations for the Implementation of the Law of the People's Republic of China on Chinese-foreign Joint Ventures" (1983), the "Provisions of the General Administration of Customs, the Ministry of Finance and the Ministry of Foreign Economic Relations and Trade Concerning the Supervision of, and the Imposition of or Exemption from Tax on Imports and Exports by Chinese-foreign Co-operative Enterprises" (1984), the "Provisions of the General Administration of Customs, the Ministry of Finance and the Ministry of Foreign Economic Relations and Trade on the Supervision of and Levy of or Exemption from Tax on Goods Imported and Exported by Chinese-foreign Joint Ventures" (1984), the "Interim Provisions of the People's Republic of China Concerning the Reduction of and Exemption from Enterprise Income Tax and Consolidated Industrial and Commercial Tax in the Special Economic Zones and 14 Coastal Port Cities" (1984), and the "Provisions of the State Council of the People's

Republic of China for the Encouragement of Foreign Investment" (1986).

The most recent development in the fiscal arrangements for foreign investors was the formulation of the "Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises" (1991) and its "Detailed Rules and Regulations for the Implementation of the Income Tax Law" (1991). The new arrangement replaces joint-venture income-tax law and foreign-enterprise income-tax law, which had governed foreign income taxation since 1980.

In addition to these newly-formulated foreign economic laws, there are Chinese laws applied to ventures with foreign investment as well as those without, among which there are the "Regulations of the People's Republic of China Concerning the Consolidated Industrial and Commercial Tax (Draft)" (1958), and its rules of the implementation (Draft); the "Interim Provisions for the City Estate Tax"(1951) and the "Interim Provisions for the Tax of Vehicle and Vessel Licence Plates"(1951).

China's foreign taxation has three main features. Firstly, the principle of "light burden, generous benefit and simple procedure" is followed. (For details, see Appendix 2). The light burden means few separate taxes and lower than standard domestic rates. There are only two main taxes imposed on ventures with foreign investment: the income tax and the consolidated industrial and commercial tax. If other secondary taxes are added, the total categories are about six or seven. Tax rates for ventures with foreign investment are low. For instance, the income tax rate applied to a venture with foreign investment and a foreign enterprise is only 33%, much lower than the rate of 55% which is applied to the large or middle-sized state-owned enterprise. Generous benefit implies the wide-range, large-extent and long-run preferential treatments of foreign investors. Simple procedures mean easy calculations of taxable income, and convenient methods of collection.

Secondly, the legislative power over foreign taxation belongs to the state. China's foreign taxation is formulated by the state. Local authorities can neither formulate their own foreign taxation nor change the state's, though they have power to reduce, or exempt from, local taxes. There are indeed certain special tax arrangements for the Special Economic Zones, Pudong New Area, the Economic and Technological Development Districts, and the Coastal Port Cities, but they are usually formulated directly by the state.

Finally, separate income taxes used to be set up according to the different categories of foreign investment. For example, while an equity joint venture paid a proportional tax in accordance with the law on equity-joint-venture income tax, a wholly-foreign-owned enterprise paid a progressive tax according to the law on foreign enterprises, and the Chinese and foreign partners in a contractual joint venture paid their respective income taxes: the Chinese partner paid it under the local enterprise-tax law but the foreign partner did so under the law on foreign-enterprise-income tax. One of the main reasons for such separate income taxes was that the use of foreign direct investment on a large scale was new to the Chinese government. It would take time to acquire the experience needed for setting up a consolidated income tax applied to all kinds of foreign investment. These separate income taxes were unified in 1991 when the "Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises" was formulated. Bo doing so China tries to show foreign businesses that any form of investment is welcome in that country and the difference in categories of investment should not be a reason for separate income taxes.

As will be seen in the next chapter, the big difference in the enterprise-income-tax arrangements between foreign-invested and local Chinese firms induces the latter to call in FDI, and by doing so they can be qualified as foreign-invested enterprises and enjoy the preferential treatment.

2.2 Tax Incentives for Foreign Investors

Since 1979, China has issued a series of tax incentives for ventures with foreign investment in the form of tax exemption and reduction in accordance with the principle of minimum tax burden and maximum preferential tax treatment and in the spirit of the policy of opening wider to the outside world.

However, China's incentive system for foreign investors can be very complicated. Firstly, incentives are provided at both national and local levels, and there is a policy distinction among different areas (See Appendix 3).

Nation-wide tax incentives are applicable to all ventures with foreign investment in China. These incentives are presented in China's various tax laws and regulations. According to these arrangements, "productive" ventures with foreign investment

scheduled to operate for a period of ten years or more can be exempted from income tax in the first and second profit-making years and allowed a 50% reduction between the third and the fifth years. As a result, the difference in tax treatments between local firms and ventures with foreign investment is widened. Interestingly, what the Chinese government might not have expected is that the discrimination against local firms actually acts as an important incentive for local firms to initiate FDI projects.

Furthermore, there are regional incentives, and ventures with foreign investment located in different areas receive different treatments. Those operating in Shenzhen, Zhuhai, Shantou, Xiamen and Hainan Special Economic Zones (SEZs) and Shanghai's Pudong New Area obtain maximum preferences. For example, income tax there is levied at the rate of only 15%, or even 10% if the ventures are regarded as export or technologically-advanced enterprises. They are followed by ventures in the Economic and Technological Development Districts (ETDZs), which receive slightly less tax preferences than those in the SEZs, and then in the old city districts of the 14 Coastal Port Cities. And the three delta regions enjoy the lowest preferences. There had been almost no incentives offered in the vast interior until 1992 when some cities in the interior were allowed to carry out FDI policies similar to those of the coastal area.

The policy distinction between areas reflects China's regional development strategy which paid much attention to the development of the coast. From chapter 5 we can also see that the regional distribution of China's inward FDI actually follows this strategy. We shall discuss the implications of this policy further in Chapter 10.

Secondly, China's incentives are also enterprise-oriented. Export enterprises and technologically advanced enterprises are especially welcomed by the government. Export enterprises are those production enterprises with foreign investment whose products are mainly for export, and which have a foreign-exchange surplus after deducting from their total the annual foreign exchange needed for the annual foreign-exchange expenditures incurred in production and operation and the foreign exchange needed for the remittance abroad of the profits earned by the foreign investors. Technologically advanced enterprises are those production enterprises with foreign investment possessing advanced technology supplied by foreign investors which are engaged in developing new products, or upgrading and replacing products, in order to increase foreign exchange generated by exports or for import substitution.

In 1986, the State Council formulated the "Provisions of the State Council of the People's Republic of China for the Encouragement of Foreign Investment" (also known as the "Twenty Two Articles") in order better to introduce advanced technology, improve product quality, and expand exports. Under its provisions, four special preferences are granted to export enterprises and technologically advanced enterprises, which mainly involve further reduction of, or exemption from the enterprise-income tax (See Appendix 3).

Thirdly, China's investment incentives are also sector-oriented. For example, ports and harbours are regarded by the Chinese government as main elements of infrastructure for both internal transportation and foreign trade. In order to accelerate their construction, the State Council formulated the "Interim Provisions of Preferential Treatment for Chinese-foreign Joint Ventures Engaged in Port and Harbour Construction". The provisions grant four special tax incentives for these ventures. Since transportation is one of the bottlenecks for China's economic growth, the government tries to use foreign as well as domestic capital to accelerate its construction.

Very recently the Chinese government has encouraged foreign investors to engage in other infrastructure projects which include power stations, railways, highways, and telecommunications. All these once were considered vital to national security and therefore off-limits to foreigners (AP-DJ, 24/5/93).

Joint ventures engaged in low-profit operations such as agriculture and forestry, or located in economically underdeveloped and remote areas, can also be allowed a further reduction in income tax (See Appendix 3).

While continuing to encourage enterprises with foreign investment, and especially those technologically-advanced or export-oriented enterprises operating in "productive" sectors, the Chinese government now allows foreign investors to operate in tertiary sectors such as banking, insurance, foreign and domestic trade. But ventures with foreign investment in these tertiary sectors usually are not qualified for the special tax treatments unless they are located in particular areas.

2.3 International Agreements on Avoiding Double Taxation

Double taxation is a negative factor influencing international investment. It increases

overseas investors' tax burdens and hence hinders businesses from developing overseas investment sites; it also offsets the positive impact of tax incentives granted by host countries.

There are two possible ways to avoid double taxation. The one is unilaterally through a domestic law; the other is bilaterally or multilaterally through international agreements.

In the first case, the United States, United Kingdom, Canada, Japan, and other countries practise a tax-credit system. In the second case, China has since 1981 concluded several international agreements on avoiding double taxation and tax avoidance or evasion with Japan, the United States, the United Kingdom, France, Germany, Belgium, Canada, Singapore, Malaysia, Finland, Denmark, Norway, Sweden, New Zealand, Thailand, and Italy. Through these agreements, the developed nations mentioned (except the U.S.) have implemented tax credits towards China: for the taxable income derived by their overseas investors in China, the tax reduced or remitted under China's preferential policies is reduced or remitted from their liabilities in these countries. In other words, these home countries agreed that China has the right of reduction or remission of taxes and that the benefits from such reduction or exemption shall go to the investors rather than to the exchequers of their home countries. These agreements help China to attract foreign investment efficiently with its investment incentives.

Section 3 Foreign Exchange Policies

3.1 Foreign Exchange Administration

China pursues a policy of centralised control and unified management of foreign exchange by the state. The agency that implements foreign-exchange control in China is the State General Administration of Exchange Control (SGAEC) and its branch offices. The specialised bank that engages in foreign exchange business is the Bank of China.

Relevant provisions on foreign-exchange administration for ventures with foreign investment can be found in such documents as the "Interim Regulations on Foreign Exchange Control of the People's Republic of China"(1980), "Rules for the

Implementation of Foreign Exchange Controls Relating to Overseas Chinese Enterprises, Foreign Enterprises and Chinese-foreign Joint Ventures" and the "Regulations for the Implementation of the Law of the People's Republic of China on Chinese-foreign Joint Ventures", which involve management of foreign-exchange accounts, foreign income and expenditures, renminbi loans against foreign exchange, and remittance of investment principal and profits.

China is a developing country. Its currency is not convertible and in the past foreign exchange has been undervalued. One of the main purposes of attracting FDI is to increase foreign-exchange earnings by improving the quality of its products and expanding exports. Consequently, a ratio of products for export is usually prescribed in a contract for setting up a venture with foreign investment, in order that the venture should maintain a balance between its foreign-exchange receipts and expenditures or have a surplus. This means that the foreign-exchange receipts should cover at least the three basic costs: expenditures on imported raw materials, spare parts, components; salaries for foreign staff and workers; and dividends for foreign investors.

3.2 Foreign Exchange Adjustment

Though the Chinese government requires in general that a venture with foreign investment should keep a foreign-exchange balance by exporting its own products, it has promulgated regulations to help these ventures which cannot fulfil the requirement. The flexible measures are as follows.

3.2.1 Included in the plan

(1) When a foreign-exchange imbalance is experienced by a joint venture that, on the basis of its approved feasibility-study report and joint-venture contract, sells its products primarily on the domestic market, the people's government of the relevant province, autonomous region or municipality directly under the central authority, or the department in charge under the State Council, is to resolve the problem by making up the deficit from its own foreign-exchange reserves. If the problem cannot be resolved in this manner, it should be resolved after examination and approval by the Ministry of Foreign Economic Relations and Trade acting together with the State Planning Commission, through inclusion in the (state) plan.

(2) If a venture with foreign investment produces sophisticated products with advanced technology or key technology, or high-quality products with an ability to

compete in the international market which are badly needed in China, concessional treatment can be given in the domestic-selling ratio and time limit, on the basis of examination and approval by the department in charge, "in effect allowing domestic sales at the cost of a direct foreign-exchange deficit". The proposal for foreign-exchange balance is sent to the Ministry of Foreign Economic Relations and Trade or its local counterparts for examination, and to the State Planning Commission or its local counterparts for approval, and is then included in the long-run or annual plan for foreign-exchange use.

(3) If a venture with foreign investment is capable of providing advanced technology needed by China, or involved in developing new products or upgrading existing products, it can apply for import-substitution status if the following conditions are met: (a) temporary difficulties in balancing foreign exchange in the initial period of operation are encountered in respect of a product made by the venture which has advanced technology needed by the country and which is the process of localising sourcing of components; (b) the products produced by such enterprises are of types presently being imported and expected to need to be imported in the next few years by central and local authorities and departments; (c) the specifications, performance, delivery time and the technical service and training relating to those products meet the requirements of domestic users, reach the same quality standards as imported products of the same kind after being tested by a product-quality examination centre at the national level, and in principle, are sold at prices that are not higher than the prices current on the international market.

3.2.2 Mutual adjustment between enterprises

In practice, some ventures with foreign investment have a foreign-exchange surplus but a Renminbi deficit, while others have a renminbi surplus and a foreign-exchange deficit. Under the existing laws, these ventures may adjust their foreign-exchange surplus and deficit between themselves in four ways.

(1) Through relevant authorities responsible for the adjustment

(a) If a joint venture needs to buy foreign exchange, it applies to the authorities that approved the venture. Then the authorities are responsible for adjustment of its deficiency from other ventures approved by the authorities. Because joint ventures can be approved by either local or national authorities, the adjustment can be carried out at either local or national level.

(b) If a foreign investor has established more than one joint venture in China, he may, on the basis of approval by the foreign-exchange-control authorities and of agreement by other parties to the ventures, adjust the surplus and deficit between his own ventures.
(c) Under the supervision of the foreign-exchange-control departments, ventures with foreign investment may also mutually adjust their foreign-exchange surpluses and deficits among themselves. The usual way is to establish foreign-exchange-adjustment centres in which the ventures can buy and sell foreign exchange at agreed rates.

(2) Comprehensive compensation
Under the "Measures of the Ministry of Foreign Economic Relations and Trade Concerning the Purchase of Domestic Products for Export by Enterprises with Foreign Investment to Balance Foreign Exchange Receipts and Disbursements" (1987), production enterprises with foreign investment that are in temporary difficulties may, within a fixed period of time, apply to purchase domestic products (except commodities subject to unified operation according to state stipulations) for export so as to balance the foreign-exchange receipts and disbursements of such enterprises. The quantity of domestic products for export approved to be purchased by an enterprise with foreign investment is limited to the amount required in that year to make up for the foreign exchange for the production and operation of the enterprises and the remittance of products shared by the investors of the foreign party, or the foreign exchange required to be remitted upon the winding up and liquidation of the enterprise.

(3) Expanding ranges of settling accounts
Joint ventures may, on the basis of approval by the foreign-exchange-control departments, receive foreign exchange in settlement of accounts if they sell products to ventures which have foreign-exchange-payment ability and are located outside the Special Economic Zones or the Economic and Technological Development Districts in the Open Coastal Cities.

(4) Reinvestment with Renminbi
If a foreign partner in a joint venture who cannot balance his foreign-exchange receipts and expenditures reinvests his share of the renminbi profit in a local venture which can generate or increase foreign-exchange income, he may, on the basis of approval by the foreign-economic-relations-and-trade departments and the foreign-

exchange-control departments, not only apply for a refund of a part of the income tax already paid, but also obtain newly-increased foreign exchange from that venture, to remit his legitimate profit. Here the Renminbi reinvestment is treated as if it were foreign-exchange investment; the venture that accepts the investment is treated as a joint venture if the foreign investor's share exceeds 25 per cent.

These measures are useful alternatives for solving the foreign-exchange problem, but they themselves are not without difficulties. A detailed discussion will be presented in Chapter 10.

Section 4 Conclusions

The principle of China's foreign taxation is said to be "light burden, generous benefit and simple procedures". In order to develop such a system, China has made an impressive effort and has received positive comments. For instance, "China's tax officials deserve considerable credit for having developed as sophisticated a system and responded to as many concerns as they have in such a short time", and the continuing improvement in China's foreign tax system is welcomed by foreign companies because "the results have often, thought not always, benefited foreign investors" (Gelatt, 1987), and "All in all, Chinese tax authorities have made remarkable progress in the past 10 years" (Peck, 1991).

Under this arrangement, ventures with foreign investment enjoy very low income-tax rates and a number of other deductions and exemptions to which local Chinese enterprises cannot gain access. The tax system is favourable not only by China's standards, but also by international standards. Enterprise-income-tax rates for foreign investors in China are comparable with those in the Philippines, Thailand, Singapore and Taiwan (See Dean, 1988). The discrimination against local Chinese firms leads these firms to call in foreign capital in order to get preferential treatment from the government.

It is commonly accepted that, while tax incentives may not always be the main factor that determines where to locate a project, they are often a key part of the investment decision. (See, for example, *The Chinese Business Review*, May-June, 1986 and Tai, 1988). The continuous rapid increase of foreign direct investment in China in recent

years may to some extent be due to the competitive incentives granted by the Chinese government.

In China, export-oriented and technologically-advanced enterprises, ventures engaged in infrastructure, and ventures located in the SEZs, the Pudong New Area, and the 14 Coastal Port Cities receive the most preferential investment incentives. Since special economic zones provide most preferential treatment for foreign investors, local authorities in China since permission was given in 1992 have competed intensely to attract FDI by establishing thousands of such zones (UPI, 15/4/93). This cuts tax revenue and also contributes to China's severe economic overheating by boosting local investment in infrastructure for zones. At the same time, much of the confiscated land remains idle because of relatively limited inflow of foreign capital. This has forced the Chinese government in 1993 to control the blind development of zones.

China practises a restrictive policy of foreign-exchange control. But it makes exceptions for ventures with foreign investment in order to improve the business environment. In view of the non-convertibility of the renminbi, China has designed various measures to help ventures out of foreign-exchange problems. Detailed analysis of the above policy issues will be presented in Chapter 10.

Neither foreigners nor Chinese think that the tax system itself and its administration are adequate. Foreigners complain about unfairness and vagueness in some cases. One example is the individual income tax. China allows a monthly "standard deduction" of renminbi 800, which is regarded by foreigners as being too low. Apart from this there are no deductions of many standard expenses, such as interest and medical expenses, allowed under the US and other tax systems. Foreigners have hoped that the standard deduction could be increased.

The other example is the tax on technology transfer. According to the enterprise-income laws, income from the lease or transfer of proprietary technology is subject to a 20% withholding income tax. Considering that the tax would hinder technology transfer, the government reduced the rate to 10% for certain types of technology and granted a total exemption if the technology is "advanced" and offered on "preferential terms". But, as Gelatt points out, under this arrangement, foreign investors are usually not able to obtain an advance ruling from the local or central tax authorities as to whether, and if so at what rate, income from a technology transfer contract under

negotiation will be taxed.

CHAPTER 7 A SURVEY OF CHINESE VENTURES WITH FOREIGN INVESTMENT

Section 1 Introduction

In chapter 5, we presented a general picture of FDI in China, i.e., the level, the source-country breakdown, the sectoral breakdown, and the forms or types of FDI. In chapter 6, we looked at the fiscal arrangements for foreign investors and mentioned that the operational behaviour of both foreign investors and local partners is influenced by the policy. This chapter aims to present detailed results of the present author's survey in China. The purpose of the survey was to investigate such questions as foreign investors' motivation to invest in China, foreign investors' and local partners' response to fiscal arrangements for foreign-invested firms, and the impact of FDI on the Chinese economy.

In recent years the most significant event for inflows of foreign direct investment to the developing countries is that the People's Republic of China has become a major host. During the period 1984-1988, FDI inflows into China represented a share of 12% of all inflows to developing countries (*The CTC Reporter*, No.29, 1990). The share increased further to about 20% in 1992 because of the jump of FDI inflows in China recently. Consequently, a study of the reasons why foreign businessmen have gone there and the role of FDI in Chinese economic development is obviously very important.

The author of this thesis carried out an investigation of a sample of foreign-investment enterprises in China from July to September 1990. Because of the limited time and funds, only seventeen companies were surveyed among which there are fourteen equity joint ventures, one contractual joint venture and two wholly-foreign-owned

enterprises. While an equity joint venture involves the establishment of a limited liability company with equity investment by a foreign partner of at least 25%, a contractual joint venture is the more flexible type of joint venture which involves the co-operation between two separate economic entities or two separate legal persons and normally does not require the formation of one unified economic entity or one single legal person.

The foreign investors in these ventures were from nine different countries or regions: six from Hong Kong, four from the USA, and the other seven from Australia, Belgium, Japan, Taiwan, Thailand, United Arab Emirates and the United Kingdom respectively. Nine foreign investors or their representatives provided information, but foreign partners in the remaining ventures were either absent or unwilling to be interviewed when the field work was done. Information for these remaining ventures was provided by the Chinese managers.

The sectors in which the FDI of the sample had been launched included chemicals, electronics, food, garments, hotels, medicine, plastics and printing. A few surveyed companies were very small; most were middle or large sized. The amount which the foreign investors had committed varied from less than US$ 60,000 up to approximately US$ 40 million.

Geographically six of the seventeen companies were located in Ningbo, one of the Open Coastal Cites in Zhejiang Province; five in Shanghai, the largest Open Coastal City in China; two in Xiamen Special Economic Zone; one in the Open Coastal Economic Area in Fujian Province; and the remaining three in Guangzhou, the Open Coastal City in Guangdong Province. These particular companies were chosen not only because they were located in the most popular areas but also they were willing to co-operate.

In accordance with the questionnaire, managers were asked to answer 28 questions in three parts: investor's motivation for investing in China, investment climate in China and impact of the direct investment. Accordingly, the results of the survey are presented in this order, together with the conclusion as the last section.

Though the number of companies interviewed is of little significance compared with the population, and, though not all the foreign investors in these selected companies

were available to be interviewed, the survey does provide certain practical insights into the views coming from those multinational companies operating in China and the issues facing them.

The information provided in chapters 5-7 will be used in chapters 8-10 where theoretical and policy implications and effects of China's inward FDI are analysed.

Section 2 Investor's Motivation

A study of motivation can involve several aspects. When one FDI project is launched in China, we will naturally ask who has originated the project and why it is located in China, and at a particular site.

For the first question, existing FDI theories usually suppose that foreign investors take the initiative when FDI is considered (see Chapter one). However, our survey reveals that either the foreign or the Chinese party could be active in the following five interesting ways of initiating a project, all of which appeared within our sample.

In the first case (we can call it mode A), foreign investors are overseas Chinese or people of Chinese origin. After China's adoption of the policy of opening to the outside world, a number of overseas Chinese visited their relatives and friends there. Some of them went to China with the prior purpose of investigating the investment environment, and others not. Relatives and friends sometimes suggested that they should visit investment sites, and even proposed potential partners for joint ventures. If the foreign investors were happy with the business environment that they saw with their own eyes, they would apply to the Chinese government or ask their relatives or friends to do so. A typical example from our sample is as follows. When a Taiwanese businessman visited China, his relatives suggested that he should visit the Economic and Technological Development District in their city. After he got the information on labour costs, legal and financial arrangements and infrastructure in the district, he said that he had an interest in investing there. Later on, the mayor of that city visited the USA, meeting the businessman (who had a business in the USA as well) in passing and encouraging him to invest in his home town. Consequently, a wholly-foreign-owned enterprise was established.

Foreign investors of Chinese origin often appear to do business in China mainly for reasons of patriotism or to improve the living standards of their mainland relatives and friends by offering better jobs and good salaries. As a rule, because they trust their relatives and friends, such foreign investors rarely turn up at the sites of the ventures. They are mainly from Hong Kong, Taiwan and other Asian countries. Their ventures, usually small- and middle-sized with simple technology, are concentrated in Guangdong and Fujian Provinces. For example, in a well known garment-manufacturing centre in Fujian, almost all the manufacturing ventures fall into this category. In the sample, five ventures are of this type.

The second way (mode B) in which a venture with foreign investment is formed is through the Chinese government's initiative. Usually the Chinese government announces various industries or projects for which it is seeking potential investors. Each level of the government puts forward fields for investment based on its own interests, so that there are national, provincial, municipal and even county projects. The investment industries or projects are announced by many means such as newspapers, video programmes, investment guides, business visits and various trade and investment talks. For example, from the investment guide prepared by the Ningbo authorities we can discover that investment in laser-technology applications, new energy resources, electronics and optical communication is very welcome in the Ningbo Economic and Technological Development District.

In our sample three projects were originated by the Chinese government, among which two are large-sized and chosen through national appraisal as among the "Ten Best Joint Ventures" in 1990; the other project is middle-sized.

Thirdly (mode C), a project can be originated by Chinese establishments registered abroad. Such establishments are usually companies set up in Hong Kong by various levels of the Chinese government, or by individual ministries, or by large companies. Investment from companies registered abroad is actually arranged by the Chinese organisations that have generated them. Such investment is, according to the broader Chinese definition, regarded as foreign direct investment. Some Chinese economists call such investors "pseudo-foreigners", and the investment "pseudo-FDI".

As a matter of fact, these economists somewhat misunderstand the position. Our survey reveals several different stories here. The Chinese companies in Hong Kong

may use their own money to invest as in several cases in our sample. If the money is from the mainland, it is not really foreign investment. The usual way, however, is that these Chinese companies form groups with Hong Kong companies to invest jointly. Projects originated by such Chinese establishments vary from small to huge in size. From one interview the author found that a Chinese municipal government had established a company in Hong Kong which had raised its funds through various channels, even including loans from Hong Kong banks. Then the company had set up in the municipal city a subsidiary which had invested in many village-town enterprises under conditions laid down by the municipal government. Two such village-town enterprises from this venture are included in my sample.

The fourth way (mode D) of forming a venture with foreign investment is through the efforts of China's local companies. These companies look for foreign partners by many means such as past business relations and information provided by the Chinese Trust and Investment Companies or by government departments. By forming joint ventures they try to improve their performance. In the sample two equity joint ventures and one contractual joint venture were originated in this way. In forming the equity joint ventures the Chinese partners were seeking foreign funds and technology in order to improve the quality of their goods. In forming the contractual joint venture, the Chinese partner aimed to use the foreign partner's management skills, brand name and marketing network. But the most important incentive for a local Chinese firm to seek a foreign investor was that, by doing so, the firm obtained joint-venture status and therefore enjoyed preferential fiscal treatment from the government. A local firm may be subject to a 55% income tax, but a joint venture to only 33%, or even 15% if it is located in a SEZ. This explains why Chinese firms are usually eager to get in foreign investment. In our sample, three enterprises came into this category.

Finally (mode E), foreign parent companies and governments often originate projects as well. The foreign companies involved have usually had trade or other economic relations with China in the past. Foreign embassies in China and other foreign organisations often provide companies in their countries with information, promoting international economic co-operation.

In the sample there are four joint ventures formed in this way. One of the parent companies, for example, has had an agent in China since the Second World War. As soon as China announced the policy of opening to the outside world, the chairman of

that company went to the Chinese embassy to test the water. Later on, he met a high Chinese official who encouraged him. Then he found the Chinese partner through the partner's national management authorities. After several rounds of negotiation, an equity joint venture was formed. The five modes of establishment and the numbers of firms following the modes can be summarised in table 7.1.

Table 7.1 Establishment modes of Foreign-invested Firms

Establishment mode	A	B	C	D	E
Number of firms	5	3	2	3	4

From other interviews with Chinese government officials, I was informed that the above five ways of originating a venture with foreign investment are the most common in China.

A second aspect of the motivation study is to know the reasons why foreign investors have gone to China. We listed the factors which may influence foreign businesses' decisions to choose China as a place to invest. We asked the managers to rate the degrees of influence for each factor, and the result was summarised in the table 7.2.

Table 7.2 Influences on Investment in China

Factors	Major influence	Some influence	No influence	No answer
1. Access to China's domestic market	7	5	5	0
2. Access to other Asian markets	7	4	5	1
3. Access to raw materials	1	8	6	2
4. Access to cheap labour force	13	2	0	2
5. Need for a valuable source of supply	1	2	5	9
6. Past business relations	3	1	9	4
7. Family relations	3	2	9	3
8. Similar cultural tradition	0	6	6	5
9. Inducement by the Chinese govt.	10	4	1	2
10. Competition with other foreign investors	2	0	9	6
11. Others, please specify (Patriotic sentiment, suggestion from former classmates)	2	0	0	15

From Table 7.2 we can see that "access to cheap labour force" has the highest frequency in the column of "major influence", followed by "inducement offered by the Chinese government", "access to China's domestic market" and "access to markets

elsewhere in the Asian region". We also see that "access to raw materials", "similar cultural tradition", "access to China's domestic market", "access to markets elsewhere in the Asian region" and "inducement offered by the Chinese government" were mentioned more often than the other factors as having "some influence" on the investment decision. If we analyse the managers' ratings as a whole, we shall find that "access to cheap labour force" is the most important factor influencing foreign businessmen to invest in China. Other important factors are Chinese government inducement, access to China's domestic market and other Asian markets, and much less importantly access to raw materials.

It should be noted that almost all the ethnic-Chinese foreign investors in our sample agreed that family relations, patriotic sentiment, and/or similar cultural tradition had either major or some influence when they decided to invest in China. Thus we can say that, though the low labour cost and the government's inducements are the most important for all the foreign businesses, the family and cultural links are probably essential for the businessmen of Chinese extraction.

As for the labour costs, the Ministry of Labour and Personnel of China has set a minimum level of salaries or wages for employees in ventures with foreign investments, which is 120% of the average salary in state-owned enterprises with similar conditions in the same area. Because of the policy of "low salary with high subsidy", employees in state-owned enterprises are subsidised by state's provision of housing, education, and health services. The level of such welfare expenditure is about 130% of the average salary. Ventures with foreign investment are required to pay the state this amount of money in addition to the normal salaries paid to their employees.

As a result the minimum labour cost per worker in a venture with foreign investment is 250% of the average nominal salary in a state-owned enterprise. But even so, labour cost is still low in China, only about one-eighth of average labour cost in Hong Kong or Taiwan. It is therefore not surprising that access to cheap labour was regarded as the most important factor favouring investing in China.

Government inducement here is a broad term which includes all means used by the Chinese government to recruit foreign investors, such as establishing various investing sites with generous financial incentives and freedom from certain regulations.

China is a huge potential market with a 1.2 billion population. Why doesn't this factor rank first in attracting FDI? This is because the Chinese currency, the renminbi, is not convertible so that an export ratio of products is usually required, especially in a wholly-foreign-owned enterprise, in order for foreign investors to get enough foreign currency from their exports to repatriate their investment and profit. As a result a foreign investor is not able to consider the domestic market at its true potential from the very beginning. However, since the Chinese government has now a strong desire to join the General Agreement on Tariff and Trade, which requires further market openings to global competitors, and since China's economy has grown quickly and the government tries to make Rmb convertible as early as possible, China's domestic market will become a more important factor inducing foreigners to invest in China.

The influences listed above are for all the seventeen ventures. However, it may be more interesting to know the relationship between the particular mode of foreign investors' entry into China on the one hand, and the particular influences and the integration strategy on the other hand. For instance, for those projects which were initiated by overseas Chinese, people of Chinese origin, and their relatives or friends, which factors were regarded as particularly attractive? and, what kind of integration strategy was most likely to follow? Table 7.3 summarise these relations.

Table 7.3 provides interesting findings. From it we can see that different entry modes were associated largely with different sets of motives.

If a project was originated by overseas Chinese, people of Chinese origin and their mainland relatives or friends (mode A), then family and local connections, patriotic sentiment, cheap labour and the government's inducements were the important attractions.

However, if a project was initiated by the Chinese government (mode B), China's inducements, China's domestic and other Asian markets, cheap labour, and competition became major considerations.

If a project was originated by a Chinese establishment (mode D), the government's inducements, cheap labour, China's domestic and other Asian markets, cheap labour, past business relations, government inducements and competition were important influences.

If foreign governments or companies took the initiative (mode E), then cheap labour, China's domestic market, past business relations, the government's inducements, access to other Asian markets, and a valuable source of supply were regarded as the important influences.

Table 7.3 Influence, Entry mode & Integration Strategy

Company	Ostensible source of foreign partner	Mode of establishment (see table 7.1)	Sector	Entry mode EJV, CJV or WFOE	Major influence in choosing China (see table 7.2)	Integration strategy (horizontal, vertical or conglomerate)	Market orientation (domestic or foreign)	Commercially successful (+, -)
1	Australia	A	Electronics	EJV	4,7,9	H	F	+
2	Belgium	B	Electronics	EJV	1	H	D	+
3	HK	D	Engineering	EJV	1,2,4,9,10	C	D	+
4	HK	E	Electronics	EJV	2,4,9	H	F	+
5	HK	C	Frozen food	EJV	2,3,4,9	C	F	+
6	HK	C	Manufacture	EJV	4,9	V	F	-
7	HK	A	Garments	EJV	2,4,7,9	V	F	+
8	HK	B	Manufacture	EJV	9,10	H	D	+
9	Japan	D	Manufacture	EJV	2,4,6	H	F	Not sure
10	Taiwan	A	Plastic	WFOE	2,4,7,9	C	F	+
11	Thailand	A	Printing	EJV	11	H	D	+
12	UAE	B	Manufacture	WFOE	2,4,9	H	F	+
13	UK	A	Medicine	EJV	1,4,11	H	F,D	-
14	USA	E	Medicine	EJV	1,4,9	H	F,D	+
15	USA	E	Pharmaceut	EJV	1,4,5,6	H	D,F	+
16	USA	D	Hotel	CJV	1	H	D	+
17	USA	E	Manufacture	EJV	1,4,6	H	D,F	+

From table 7.3 we can also see that all the projects in the sample initiated by the Chinese government and by foreign governments and companies were horizontally-integrated. This suggests that these governments and companies paid more attention to exploitation of foreign companies' know-how. On the other hand, though a majority of the projects originated through family relations and by Chinese establishments abroad and local Chinese firms were also horizontally-integrated, some of them were vertically- or conglomerately-integrated. From the fieldwork we find that the major type of vertical integration was backward combination: local Chinese firms acted as processing factories and trading companies abroad sold the products. In this way, international marketing expertise could be exploited within the firms. We also find that one local Chinese firm owning intangible assets such as special technology called in FDI to form a conglomerately-integrated joint venture. By doing

so it could not only obtain capital to develop new products but also be qualified for preferential tax treatment.

A final aspect of our motivation study is to identify the factors which influence a foreign investor's decision to choose a specific location for the project. Managers' responses to this issue are shown in Table 7.4.

Table 7.4 Influences on Investment in Specific Location

Factors	Major influence	Some influence	No influence	No answer
Easy access to natural resources	1	3	9	4
Easy access to skilled workers	2	4	7	4
Easy access to local market	4	0	10	3
Existence of a qualified partner	4	3	4	6
Inducements by the local govt.	9	1	1	6
Traditional industrial centre	2	6	5	4
Relatively good infrastructure	3	9	2	3
Others	2	0	0	15

Many managers indicated "inducements by the local government" as the most important influence on their decision to invest in a particular site. These inducements include those of the national government applied to the local area. The companies in the sample are all located in the most prosperous east coastal areas which are industrial or commercial centres or both. Ten companies out of the total have settled down in the areas with special concessions, namely the Industrial District in Xiamen Special Economic Zone and the Economic and Technological Development Districts in the Open Coastal Cities. The above districts, which provide very good infrastructural facilities, were built by the corresponding local governments which, under the central government's arrangements, also offer additional special preferential treatment to the foreign businesses investing there.

Other important influences are existence of a qualified partner, and easy access to the local market. These two factors were regarded by some ventures as critical for their success.

Section 3 Investment Climate

Investment climate is a comprehensive concept, which comprises general political, social and economic situations, government policies, and input and output markets. To learn something of foreign investors' views on China's investment climate was another important purpose of this survey. Many issues investigated in the fieldwork were what had often been subjects of concern on the part of both foreign and Chinese parties, and had been raised in a report prepared by the United Nations Centre on Transnational Corporations (UNCTC, 1988).

A first issue is the foreign-exchange balance. The Chinese currency, the renminbi, is currently not convertible. Because of this, a venture with foreign investment in China is in principle required to balance its foreign-exchange revenue and expenditure. This means that the venture should earn enough foreign exchange to cover three basic costs: expenditures on imported raw materials and components; salaries for foreign employees; and dividends for the foreign investors.

Before 1987, not a few ventures with foreign investment had encountered difficulties with the balance, and this issue had been regarded as a serious obstacle in the Chinese investment climate. However, our fieldwork suggested that this situation had become a thing of the past.

Among the companies which we investigated eight had a foreign exchange surplus. These were all export-oriented, and the products of the two wholly-foreign-owned enterprises among them were all sold abroad. There were two companies just keeping in balance, and the other seven had foreign-exchange deficits.

Through the interviews these last seven companies were found to have different reasons for their deficits. Two of them were operating normally and expected to expand their exports, and therefore to balance their foreign-exchange revenue and expenditure within two years. A third had failed to fulfil the export-ratio requirement mainly because neither the foreign nor the Chinese partner was familiar with the world market. A fourth sold all its products in China instead of selling all abroad as originally required.

All these companies bought the foreign exchange they needed in China's foreign-exchange-adjustment markets. A fifth and a sixth company had losses in both renminbi and foreign-exchange terms. The main reasons for this failure will be discussed later in this section. The last company in the seven was domestic-market-oriented. It introduced and developed advanced foreign technology and then applied the technology in China. Its operations were healthy and it got the necessary foreign exchange from the foreign-exchange-adjustment market.

From this survey at the micro level (see Table 7.5), and other interviews with Chinese government officials at macro level, we found that the foreign-exchange problem is no longer the major obstacle in China's investment climate. Since 1987, enterprises with foreign investment have overall had a foreign-exchange surplus. In 1989, for example, they sold US$ 1.572 billion, and bought only US$ 0.49 billion, in the foreign-exchange-adjustment markets. An enterprise with renminbi profit does not find it difficult to get enough foreign exchange in the market.

A second issue was about labour cost. All the managers interviewed agreed that the labour cost per worker was lower in China than in the investor's country. But this was the cost per worker, and would be misleading if we did not compare it with labour productivity. Thus, we asked further questions and found that all but two managers agreed that labour productivity in China was lower, but of these all but one agreed that this difference did not remove the lower-wage advantage. The remaining two managers (who were both Chinese) each said that the labour productivity in his company was higher than that in foreign investor's own country. One of these two companies paid by piecework while the other paid by time. This point reinforced the finding presented in the previous section that cheap labour was one important factor when foreign investors consider investing in China.

A third issue was the land-use fees. Some managers thought that the fees were low by the investing country's standards; others thought they were reasonable. One manager said that his project did not involve a land-use fee, because he had bought a standard plant on an industrial estate. Only one manager complained that the land-use fee had originally been low, but had later increased.

A fourth issue was the availability of raw materials for inputs in Chinese local markets. During the survey we found that one company had never produced anything

since it had formed the productive capacity, so that it had had nothing to do with buying raw materials. Ten companies had no problem, among which one manager said that the chemical material which the company needed had at one time been in short supply because of "official speculation". After the Chinese government had brought the distribution system under control, the market situation had turned normal.

Three companies complained that, though the raw materials that they required were available in the Chinese market, their quality was not guaranteed. Another company criticised the Chinese dual-price system. Because the company could not buy the raw material at the price fixed by the Chinese authorities, it had to buy it at the adjustment price (or free-market price) which is 3.2 times as high as the planned price. This was one of the main reasons why the company made a loss.

The remaining two companies of those that had actually been in production could get materials of required quality, but they were afraid that the only qualified suppliers might raise the prices.

A fifth issue was the negotiation cost. The responses to this issue were mixed. Eight companies spent less than one year in negotiations on their projects, among which one wholly-foreign-owned company spent only seven days before it got approval. Six companies took more than one year but less than three, and the other three more than three years. No manager could tell the amount of money his firm spent on the negotiations.

A sixth issue involves Chinese bureaucracy. We found that most managers were satisfied with the processes of approval, administration and enforcement of contract by the Chinese party, but three companies complained that there were too many interventions from various authorities, which often lacked experience. The managers mentioned that operation of a company involved many Chinese authorities such as the foreign-investment administrative organisation, customs, taxation agents, transport companies, and public-utility authorities, some of which did not provide good service. For instance, if you submitted a report to certain authorities you might have no reply for a long time. When you went there to follow it up they simply said that they had had not received it at all. For the sake of good relations, you dared not argue: a good relationship often leads to success in China.

Another example was that, if you were authorised to do something by the head of a government unit, and the head had poor relations with his office workers, they might be unwilling to deal with the matter, and you had to wait for some time before you got the thing done.

A seventh issue concerns the laws and regulations applying to the project. While twelve managers regarded the relevant laws and regulations as reasonable, five had some complaints. Firstly, the legislation was not complete, especially in the case of wholly-foreign-owned enterprises. There was no specific tax law on these enterprises, and they were regulated under the law on foreign enterprises instead, and actually discriminated against. This view raises a policy issue: is it necessary or helpful to make a difference in treatment between different forms of FDI? We shall discuss this issue in Chapter 10. Secondly, they complained that some laws and regulations were ambiguous and Chinese and foreign partners might understand them differently. The Chinese side seemed to have no strong sense of legality, and administrative arrangements sometimes replaced the laws and regulations. Finally, regulations were relatively unstable. For instance, the foreign-exchange rate underwent a large change just before our interview was conducted: while there was a 27% depreciation of the renminbi at the official rate, there was a 20% appreciation of the renminbi at the adjustment rate. Some managers were confused. As far as the author knows, the Chinese government thought that the adjustment rate was too low and the official one was too high. That policy aimed at narrowing the difference between the two rates.

An eighth issue was the taxation applied to the project. Almost all the managers were satisfied with the taxation applied to their projects. All foreign and some Chinese managers said that the income-tax rate was reasonable. Other Chinese managers said the rate was low and preferential: because their ventures were located in special investment zones or areas, the income tax rate was not only much lower than the 55% rate which was applied to local Chinese enterprises, but also lower than the 33% standard rate applied to the foreign-invested ventures located in other areas. This response raises another policy issue, i.e., is it necessary to make such a distinction between local and foreign-invested firms, and between foreign-invested firms in different locations? Again we shall discuss this issue in Chapter 10.

The income tax constitutes only one aspect of the total cost. Three managers complained about various fees charged by different authorities instead of taxes. One

manager said that the telephone installation fee had been doubled though the authorities had originally agreed that his venture should pay the normal price. The other two managers said that they had had to pay so called transportation fees, illegal road tolls, and fines for "unclean lorry appearance".

After getting responses to the above individual issues, we asked the managers to rate a set of the factors which had negative effects on their consideration of investment and operation in China. The results were summarised in Table 7.5.

Table 7.5 Negative Influence on Investment and Operation in China

Factors	Major influence	Some influence	No influence	No answer
Uncertainty of political stability	2	4	7	4
Uncertainty of social stability	0	6	8	3
Uncertainty of general economic policy	7	2	3	5
Limited access to the domestic market	0	2	11	4
Non-convertibility of renminbi	0	2	12	3
Escalation of labour cost	0	2	12	3
Escalation of land-use fees	0	1	13	3
Escalation of prices of raw materials	3	6	5	3
Poor infrastructure	2	4	8	3
Time-consuming & expensive negotiation	0	1	13	3
Limited autonomy in labour management	0	4	11	2
Limited autonomy in operational matters	0	1	13	3
Bureaucratic style of the Chinese authorities	4	6	6	1
More generous terms in neighbouring countries	0	0	8	9
Others, please specify	0	0	0	17

From the interviews we found that what both foreign and Chinese managers most worried about was uncertainty of general economic policies, which included industrial policy, overall financial and fiscal arrangements, and even policy on foreign economic relations. They hoped that the Chinese government would keep its general policy stable. The second most important obstacle was the bureaucratic style of Chinese authorities' decision-making. Some managers complained about the Chinese government's dilatory style of work and practice of doing things for show.

Other problems were the escalation of prices of raw materials, poor infrastructure and uncertainty of political stability. The increases in prices of some raw materials actually arose in part from China's price reform and in part from the world market situation. In the case of infrastructure, the managers complained about unclean water, backward

road and communication systems, the lack of a guaranteed electric power supply and low-quality living conditions (especially entertainment). Uncertainty of political stability was regarded by the manager who was in the tourism industry as the biggest obstacle. The room occupancy of his high-quality hotel was 80% in May 1989. It dropped sharply to 22% in June when the Tiananmen Square Event happened, and went down further to 20% in July.

Though faced with the above problems, the majority of the managers thought that the operating environment in China had improved since 1987, but six managers thought that there was no change. No one thought that it had worsened.

As for the aspects of China's investment climate which were in most urgent need of improvement, there were six mentions of inefficiency on the part of the Chinese authorities in dealing with routine matters. Four managers asked for stable macroeconomic policies, and three of these had found difficulty in obtaining enough working funds for their ventures or in securing the payment of a debt owed by another firm because of China's austerity programme. Other managers listed the problems in the legal environment, the great difference between planned and market prices, infrastructure, living facilities and various fees charged by various authorities.

Among the seventeen projects fifteen were judged commercially successful (or normal) from the foreign investors' viewpoint. One had suffered a serious loss and would have shut down without Chinese government support. The remaining one had never started production since its capacity was formed. Reasons for the unsuccessful projects are as follows.

From the foreign investor's viewpoint, the project that had made a serious loss had done so simply because of poor management, which had caused poor quality of products and hence poor sales. The Chinese manager, who was also interviewed later, agreed that poor management was one of the factors responsible for the loss and that this resulted from too many participants and frequent changes in personnel on the Chinese side. But the Chinese manager added two other factors. One was that the technology brought in with the FDI was not mature, so that there was a waste of time in testing and adjusting. The other involved transfer-pricing: according to the contract the foreign partner was responsible for selling the products in the world market. The Chinese manager believed that the foreign partner had sold the products at a price

nine times as high as that at which he had bought them from the venture!

A Chinese manager in another venture in our sample had a similar complaint though the venture was operating without loss. The products of this venture were sold by a foreign agent arranged by the foreign partner. Sometimes the venture had been informed by the agent that because of deficient quality the products could not be sold. In such cases the Chinese manager had asked for the evidence and return of the products, but had got no reply. But sometimes the venture would receive two acknowledgements, one of which said that a part of the products were not accepted while the other said that all of them were rejected.

The venture which had never operated told another story. In 1988 it had expected that one commodity would be continuously in demand in the world market so that it formed a joint venture. Unfortunately, when the venture was ready to operate (though there was still some problem with the quality), the price for that commodity dropped sharply by 50%. As a result the venture ceased its preparation for production. During the interview the manager told the author that the venture would shift to producing other products.

From our survey we also knew that nine out of the seventeen ventures planned to expand their operations, and five of them intended to do so rapidly, while the other four aimed to do so slowly at a steady rate.

There were four companies that did not plan to expand their operations, among which two wanted to overcome the problems with their present activities in order to improve efficiency. The other two foreign investors had no interests in expansion, though the operations in either case were not unsuccessful. One Chinese manager told the author that his foreign partner had great enthusiasm for setting up new joint ventures but less for expanding production in the existing ones, which were sited in several Chinese cities. The manager believed that, through buying capital equipment at a lower price in the world market and contributing it to a new joint venture at a higher price, the foreign investor could achieve large earnings.

Three other companies were not sure at the time whether they would expand their operations in the near future. (The enterprise that had never produced is excluded from these figures on expansion intentions.)

Section 4 Impact of Foreign Direct Investment

The final part of our survey was on the impact of FDI on the Chinese economy. We tried to discover the effects of these ventures on intermediate-goods supply, corporate methods, local-personnel training, employment, technological improvement and export.

A first aspect is the source of raw materials for these ventures. From the demand-side data we may judge the ventures' second-round effects on Chinese economic development. The responses are shown in Table 7.6.

Table 7.6 Sources of the Raw Materials (%)

Company No.	Parent company	Investing country, other	Other overseas country	Locally-based foreign co.	Indigenous firm
1	100	0	0	0	0
2	0	0	0	0	100
3	100	0	0	0	0
4	0	0	100	0	0
5	0	0	85	0	15
6	60	0	0	0	40
7	0	0	20	0	80
8	0	0	60	0	40
9	50	0	0	0	50
10	80	0	0	0	20
11	0	100	0	0	0
12	0	10	0	0	90
13	50	0	0	15	35
14	40	40	0	20	0
15	30	0	0	0	70
16	0	85	0	10	5

From the table we can see that most of the sample ventures bought most of their raw materials and services from their parent companies, from other firms in the investing countries or from other overseas countries. The result suggests a different picture from an estimate by the China newspaper *China Imports* (21.9.1990) which indicates that ventures with foreign investment buy 70% of their total raw materials in China.

Two managers explained why they had imported raw materials. In the first case, it was because the quality of the local materials had not been high enough; in the second case, it was because, as the result of a shortage, the prices of the materials had been higher in China than in the world market.

Though the ventures' activities had created a certain demand for existing suppliers, only one of the sample ventures had seemed to have a strong stimulating effect on new suppliers. Its establishment had led to the appearance of hundreds of new private individual enterprises across vast rural areas, which provided the venture with domestic fowls for processing and exporting.

In the sample there were no such individual local distributors or sales organisations reported as having themselves come into being because of foreign ventures' activities.

A second aspect of the FDI impact is the expertise transfer. FDI is usually a package which contains capital, technological and managerial skills. As a result, FDI may help improve corporate methods in a host country. Our survey result basically supports this view (see Table 7.7).

Table 7.7 Changes in Corporate Methods in Local Component
(15 Joint Ventures)

Corporate methods	Great change	Some change	No change
Accounting & cost control system	2	10	3
Production or processing methods	10	4	1
Quality control system	7	5	2
Marketing methods	4	7	4

Most managers agreed that the production or processing methods had undergone a great change, though two Chinese managers mentioned that their foreign partners contributed only funds and that it was Chinese rather than foreign technology that was used in the ventures.

There had apparently been less change in marketing methods than in production and quality-control methods. This was not surprising because many foreign partners were required by their contracts to take full responsibility for sales abroad.

Generally, some change, rather than great change, had happened to the accounting and cost-control systems. In the sample two foreign partners were not involved in any management at all and some others played roles in only technical and marketing management, but not in financial and personnel affairs. That might be a reason why the foreign managers had apparently less influence on accounting and cost-control systems.

A third aspect is the training of local labour and supplier firms. Our survey indicated that eleven out of seventeen ventures trained some of their employees before they began to work. The cost was borne by the ventures themselves except in one case where the parent company paid all the training costs. Other ventures provided no prior training, and their employees had been trained on the job. Only one manager could estimate the amount of the cost (about US$ 60,000) borne by the venture.

As for the training of supplier-firms, ten ventures had not engaged in such activities. The basic reason was that the products of their supplier firms (the majority are foreign) satisfied their needs. Three ventures had sent engineers to help the local supplier firms solve technical problems. Two other ventures had given their supplier firms suggestions for improvement. The remaining company had not trained its suppliers directly; rather, it had lent money to them for their development.

A fourth aspect is the employment effects. Among the seventeen ventures sixteen were operating, and they had taken on in total 4,411 additional employees. Manual workers accounted for 67% of the total, management and engineers for 31%, and foreign staff for 2%. In other words, 4,333 local Chinese had been employed as a result of the ventures.

The manual workers and engineers were employed in several different ways. If a wholly-foreign-owned venture was set up, they had usually been recruited directly from the public or recommended by labour service companies. If equity joint venture not based on a pre-existing local enterprise (it is called a newly-built JV) was established, the Chinese investor had usually recruited some workers and engineers for the venture from his parent company, inviting public application for jobs as well. The potential employees recruited from the public might be school-leavers; workers or engineers employed in other firms; lecturers in universities; or government servants. If a foreign business invested in an existing Chinese firm (with the Chinese

partner contributing the existing equipment and plant) so that a joint venture was formed (it is called a marriage JV), employees were basically those already in the firm's employ. Employees in this last case are not included in the "additional workers" in this study.

In a joint venture, the senior local Chinese managers (general manager or deputy) had usually been appointed by the Chinese investor or its authorities, and approved by the board of directors. Many Chinese branch managers had been appointed by the Chinese investor as well, and some had been appointed by the general manager in the venture.

The Chinese government particularly welcomes ventures with foreign investment which are aimed for export or to lead to import substitution, or to introduce advanced technology. The government thinks these ventures can better help upgrade and replace China's existing products, expand exports and develop the national economy.

Ten manufacturing companies in the sample were regarded as export-oriented (some of them with the purposes of introducing technology and import substitution as well), though three of them had failed to meet the export-ratio requirements for the destination of output as expressed in their contracts. Another three companies were accepted as introducing advanced technology, and another one as designed for import substitution. There was one treated as for manufacturing not fitting any of the government's requirements, and the remaining one was classified as for another foreign-exchange earning purpose: tourism.

Though there were ten ventures which were regarded as export-oriented, not all the foreign investors in these ventures were willing to help their Chinese partners exploit world markets. Our survey indicates that, in three out of the ten ventures, the foreign and Chinese sales managers had enjoyed a happy co-operation in exploring world markets, but the Chinese managers in the remaining ventures held different views. The three cases in which the Chinese managers did not think that their foreign partners had helped them in developing sales networks abroad were usually those where the foreign partners took full responsibility for exporting, had no intention of co-operating with their Chinese partners, and in some instances kept secret their marketing networks and the prices they charged for the products offered for sale abroad. By doing so these foreign investors treated the ventures as their processing plants rather than joint ventures. These Chinese managers made complaints about this.

Section 5 Conclusions

Foreign direct investment flowed into China through five major channels. First, it could be launched by the overseas Chinese or people of Chinese origin, together with their mainland relatives or friends. In this case, family and local connections, patriotic sentiment, cheap labour, and the government's inducements were the important attractions. The projects formed in this way were usually small or middle-sized. Second, it could be made through the Chinese government's initiative. In this case, China's inducements, China's domestic and other Asian markets, cheap labour, and competition were regarded as crucial. These projects were often large-sized. Third, it could be originated by Chinese establishments registered abroad. Fourth, it could also be promoted by China's local companies' efforts. In these two cases, the government's inducements, cheap labour, China's domestic and other Asian markets, cheap labour, past business relations, government inducements and competition were important influences. Finally, it could be originated by foreign parent companies or governments. In this case, cheap labour, China's domestic market, past business relations, the government's inducements, access to other Asian markets, and a valuable source of supply were regarded as the important influences. The projects established in the last three ways could vary from small to large in size.

The fact that FDI can be initiated by either foreign investors or local partners poses a challenge to the dominant FDI theories which imply that investing firms are naturally the initiators of the investment. This point, together with other important theoretical issues, will be discussed in the next chapter.

The majority of the investors agreed that the investment climate in China had improved since 1987. Foreign-exchange shortage was no longer such a serious obstacle as it had been. Though labour productivity was generally rated lower in China than in the investors' countries, the difference did not remove the low-wage advantage. The financial arrangements such as land-use fees and taxation were reasonable. Generally speaking, the process of approval, administration and enforcement of contracts by the Chinese side was satisfactory. A large majority of the ventures were judged commercially successful (or normal) and two-thirds of them planned to expand their operations.

Instability of general economic policies had the largest negative effects on the foreign investors' consideration of investment and operation in China, followed by the bureaucratic style of Chinese authorities' decision-making, and then the escalation of prices of raw materials, poor infrastructure and uncertainty of political stability.

Contrary to a received prediction, inward FDI in China in 1989 was higher than in any of the previous three years, and it has continuously increased since. The negative impact of the Tiananmen Square event was transient, and it seemed that business confidence could be restored very soon. This confirms what a foreign investor said during the survey: "Business is non-political". According to the latest statistics, FDI inflows jumped in 1991 and 1992, and they are expected to increase further in 1993. This indicates that China is now an attractive host country.

Lack of experience on the part of the Chinese government may explain the businessmen's complaints of unstable economic policies. Absorbing FDI is a newly emerging task, so that the Chinese government has been feeling its way in setting up, co-ordinating and improving its general policies on the subject.

The survey shows that all investors but one found the cost of labour, after allowing for its productivity, was lower than in Hong Kong, Taiwan or wherever the foreign partners were from and that some found labour actually more productive, beside being cheaper. This fact suggests that China has a great potential competitive advantage in world trade in manufactures which can be realised if it can get the marketing and technical expertise presumably from foreign investors. But it requires that China overcome the uncertainties and other deficiencies in the investment climate, which, though the survey suggests they are not large, do persist. However, the uncertainties may only be reduced gradually with the increase of China's authorities' experience in regulating FDI and with further improvement of the legal system. The Chinese government's dilatory style of work may also be overcome gradually with progress in China's political reform.

The foreign direct investment investigated appears to have had a positive impact on the Chinese economy. It was a source of both direct and indirect employment opportunities; it brought into China funds and equipment, production and processing methods, internal management skills, and, to a less extent, international marketing methods. The Chinese government recognises the role of FDI and continues luring

foreign investors. The open-door policy is expected to remain unchanged.

The survey raises some policy issues such as discrimination among different forms of FDI, among different locations of FDI, and between a foreign-invested venture and a local Chinese venture. Do these distinctions help or deter FDI inflows in China? What are their implications for China's economic development? These issues will be discussed in Chapter 10.

CHAPTER 8 PECULIAR FEATURES OF CHINA'S INWARD FDI & THEIR EXPLANATIONS

Section 1 Introduction

This chapter is a further development from chapters 1, 5 and 7. If chapter 1 tells us various theories on determinants of FDI, and if chapter 5 and 7 outline the broad recent historical pattern of China's inward FDI and summarise conclusions from a sample survey of the Chinese ventures with foreign investment, this chapter aims to identify and explain some peculiar features of China's inward foreign direct investment. These peculiar, if not unique, features not only constitute a challenge to the atlantocentric theories of FDI described in chapter 1, but also have implications for China's FDI policy.

Section 2 of this chapter presents four specific characteristics of China's inward FDI, and then section 3 discusses the challenges posed by these features to the currently dominant FDI theories. Section 4 offers a theoretical explanation of China's inward FDI by using a triple-pole diagram. Section 5 provides summary and conclusions. Policy implications of these features will be considered in chapter 10.

Section 2 The Peculiar Features

If we compare carefully the information on China's inward FDI presented mainly in chapters 5 and 7 with what is known of some other host countries', we can identify the following four features peculiar to China. 1) The overseas Chinese are the dominant investors; 2) The local Chinese party often acts as an initiator for an FDI

project; 3) pure conglomerate integration is an important phenomenon; and 4) joint ventures are the normal type of FDI. We now look at these features in turn.

8.2.1 Overseas Chinese as the dominant investor

From chapter 5, we know that, since 1979, Hong Kong and Macao and very recently Taiwan have constituted between them the leading source of investment in Mainland China. Their investment accounted for two-thirds of the total. Furthermore, from our fieldwork and the Chinese government's detailed statistics, we find that some direct investments from the rest of the world, from the US, Japan, France, Australia and Thailand, let alone Malaysia and Singapore, are actually made by people of Chinese origin. For instance, the Chinese of South-East Asia add another 10-15% (See *The Economist*, July 18th 1992). Thus, the overwhelming preponderance of the total FDI in China comes from the overseas Chinese.

The phenomenon that FDI in China is mainly undertaken by the ethnic Chinese living outside China is unique. There are 55m overseas Chinese who have acted as a driving force since China adopted the policy of opening to the outside world in 1979. While the overseas Chinese push forward China's economic development, they strengthen themselves. Russia has no ethnic Russian businessmen overseas; India, with its 11m overseas Indians, can only partly copy. Thailand experienced a rapid increase in FDI in the 1970s and 1980s, and the average annual growth rate of the inward investment between 1982 and 1989 was 37% in current prices. But most of its inward investment has been made from Japanese and American sources and probably very little by ethnic Thais of whom there is not a large overseas population. (See Table 8.1).

Table 8.1 Net FDI Inflows into Thailand by Country, 1970-1988. (billion baht)

Country	Value	Share
Japan	35.75	38.8%
USA	22.33	24.2%
Hong Kong	7.39	8.0%
Taiwan	4.27	4.6%
Singapore	4.02	4.4%

Source: Thailand Office of the Board of Investment, 1990.

When making investments, these overseas Chinese businessmen are partly motivated by family and local connections. The basis for this motivation is the deeply rooted culture nourished by Confucianism, which calls for loyalty, discipline, hard work, thrift, respect for education and hierarchies, and commitment to the family. Grounded in this belief, the Chinese realise that dialect, kinship, or a common origin in a clan, a village or a county, can provide a sure footing of trust for business deals. This view is confirmed by our fieldwork. As mentioned in chapter 7, all the overseas Chinese investors in our sample regarded family relations and similar cultural traditions as a major, or at least some, influence on their investment decisions.

8.2.2 The Chinese party often as the initiator

A second peculiar feature of China's inward investment is that the Chinese party often behaves as the initiator.

In chapter 7, we saw that a particular FDI project could be originated by the Chinese government, Chinese establishments registered abroad, local Chinese firms, or individual Chinese. They have different reasons for initiating FDI projects. The central government calls in FDI in order to realise its four-modernisations drive. Some local governments may encourage inflows of FDI simply to show their political achievements because FDI activity is regarded as one important indicator of the performance of the "economic reform & opening to the outside world" strategy. Local companies may also try to obtain capital, new technology or marketing skills through introducing FDI. This not only may possibly make the companies more competitive, but will certainly make them qualified as ventures with foreign investment and cause them to be treated favourably by the government in terms firstly of exemption from, or reduction of, taxation and secondly of access to low-interest bank loans. Encouraged by Deng Xiaoping's famous slogan "To get rich is glorious", individual Chinese try to persuade their relatives and friends abroad to invest in their hometowns, so that they can have good jobs and remuneration, and therefore a higher standard of living.

This feature is noteworthy because the existing literature implies that the investing firms usually take the initiative in order either to internalise their use of special assets that they possess or else to internalise markets for intermediate goods. In the literature, the receivers of FDI are implicitly regarded as passive.

8.2.3 Pure conglomerate integration

FDI may involve any of three forms of expansion of the foreign parent: horizontal, vertical and conglomerate. In China the bulk of the ventures with foreign investment produce similar products to their parents. Drawing on the list of individual ventures with foreign investment approved by the Chinese government during 1979 and 1983 (the most complete list of all types of ventures), we estimate that about 69% of the total FDI projects in China follow horizontal expansion. Vertical combinations are not as common as the horizontal type. According to our estimate, about 18% of total ventures with foreign investment in China have expanded vertically. The rest of the FDI projects (13%) follow conglomerate expansion. Though the percentages of these three forms of FDI in China are similar to those in other host countries (see Buckley & Casson, 1991), it is very interesting and important to note that contrary to the expectations generated by some current theory, most of the conglomerate projects in China are pure conglomerates.

Pure conglomerate integration means that a firm invests in another unrelated industry, and no market and technological synergies can be exploited in the process. For instance, a car manufacturer invests in a brewery. However, a non-pure conglomerate expansion involves diversification around core skills. In Kay's example (Kay, 1991), the company named Manfac diversifies from aluminium skis into aluminium tennis rackets, cricket bats and baseball bats. In this case, both the key technology and the traditional market can be exploited by the firm when it produces new commodities. While pure or "sprawling" conglomerates are out of fashion in Europe and America, they are setting the pace in Southeast Asia (see *The Economist*, 17/7/93), and particularly in China.

Some foreign investors of the pure conglomerate type are themselves conglomerates. Charoen Pokphand (CP) of Thailand, which traces its roots to a family-run seed business opened in Bangkok in 1921 by immigrants from Guangdong province in China, has diversified into many other industries, and in China alone its activities run from brewing to petrochemicals to building motorbikes with Honda (ibid). Other foreign investors of the pure conglomerate type, are mainly Hong Kong trading firms, development companies, and enterprises of other kinds. They invest in manufacturing sectors in China. In this case, the principal resource transferred from the parent firm is capital, because the firm does not intend to export the products itself, or to be

involved in daily management. By investing in an unrelated productive sequence in China, the parent firm gains some controlling interest. Thus it is interesting to know why these foreign companies have made pure conglomerate investments in China.

8.2.4 Joint ventures as the basic type of FDI

FDI involves the ownership and therefore the control of domestic production facilities by foreigners. This poses a dilemma to host countries: economic growth needs FDI as an important source of capital and technology, but the control by foreigners lessens political and economic independence. To resolve this dilemma, different host countries have adopted different policies. Such countries as Burma and Albania have chosen autarky. Most countries have accepted FDI, but many have put various restrictions on foreign ownership.

Much of the literature on the traditional transaction-cost approach predicts that, if there is no foreign-ownership restriction, foreign businesses will generally prefer wholly-foreign-owned enterprises to joint ventures because the former entry mode involves lower transaction costs. There is no foreign ownership limitation in China, but joint ventures are overwhelmingly the major type of FDI there. As described in chapter 5, between 1979 and 1989, 21,734 ventures with foreign investment were set up in China, among which there were only 1,525 wholly-foreign owned enterprises, accounting for merely 7% of the total. Joint ventures, either equity or contractual, are so popular in China that they have become the basic entry mode. This is another peculiar feature of China's inward investment.

Section 3 Theoretical Challenges

Not all the peculiar features of China's inward investment can be explained by the existing atlantocentric theories of FDI. Though the transaction-cost considerations in both the internalisation and "eclectic" approaches are useful in helping us to assess the importance of the family and local connections in the investment decision-making, neither of the approaches can fully cover the Chinese case. The particular characteristics of China's inward FDI pose several challenges to the currently dominant FDI theories.

Firstly, the existing theories imply that the investing firm takes the initiative whenever an FDI project is launched. In Hymer's "structural-market-imperfections" approach, it is the firm which possesses advantages that wishes to internalise them and sets up a subsidiary abroad; According to the internalisation approach. a profit-maximising firm invests abroad in order to reduce transaction costs. Under the "eclectic" paradigm, a firm with ownership advantages invests abroad in order to exploit internalisation and location advantages. All three models explain the decision on the assumption that it is taken exclusively by the foreign party. However, this is not always the case in China. Our fieldwork indicates that the Chinese party, though it is a receiver of FDI, can in some cases also originate FDI projects.

Thus, a problem with the existing FDI theories is that they all regard the investing firm as being active in the origin of an FDI while the receiver is always in a passive position. As a matter of fact, a host government or a local firm often has good reasons, and is in a good position, to initiate an FDI project.

A second theoretical challenge is the interpretation of pure conglomerate integration. If a firm produces in two or more productive sequences which are not related at all, then the structural-market-imperfection approach and the eclectic paradigm can not explain this phenomenon because it would seem that no internalisation of the use of firm-ownership advantages is involved in this case. This type of investment is indeed very special, but it still belongs to direct investment because control usually follows the investment. We should try to explain the determinants of international conglomerate expansion of this type, rather than, as Dunning does, simply regarding it as portfolio investment (Dunning, 1991, p.132).

It is also difficult for the internalisation or transaction-cost approach to explain this form of FDI. Unrelated productive sequences normally require unrelated raw materials, components, technology, managerial and marketing skills. Consequently, no transactions in such intermediate goods and resources are involved. Facing this problem, some authors simply skip conglomerate integration when they discuss forms of FDI (see Chapter 1.)

One solution to the problem is a statement that a somewhat different perspective is required to explain this phenomenon: in the case of conglomerate integration, "transaction-cost economising arises, not in the internalisation of intermediate product transactions, but in the internalisation of production of separate goods" (Clarke &

McGuinness, 1987, P.110.). Many transaction-cost theorists of FDI may not accept this statement, because for them internalisation as the general explanation of FDI unambiguously means internalising MARKETS for intermediate goods rather than PRODUCTION of separate goods (see Buckley and Casson, 1976, 1991; Casson, 1987; Cantwell, 1991; Hennart, 1991.). Transaction-cost explanations do not really apply when there is no occasion for transaction between the parent and the subsidiary.

An alternative argument of transaction-cost economics is that a conglomerate firm can exploit specialised resources (e.g., know-how, specialised capital equipment) (Clarke & McGuinness, p.112). This is of its nature an argument of economies of scope: the firm will benefit more from exploiting a sharable or quasi-public input in production of two or more goods internally than if it does so via market transactions. However, if this is the case, it might be argued that this integration is not purely conglomerate.

Thirdly, the traditional transaction-cost approach naturally leads to the judgement that a wholly-foreign owned enterprise is preferred as an entry mode to a joint venture. But again, the Chinese evidence does not lend support to this view.

A joint venture is a dual- or multiple- ownership firm. Control is shared by the partners. As a result, transaction costs of transfer or organisation of resources are usually thought to be higher than in the case of a wholly-foreign-owned firm (see, for instance, Kay, 1991, p.140.). But why are joint ventures so popular in China?

It can be argued that the modern transaction-cost framework can be used to explain why wholly-foreign owned enterprises are in a definite minority in China. As mentioned before, the overwhelming majority of foreign investors in China are actually overseas Chinese. The family and local links and language familiarity provide a solid basis for mutual trust between the overseas and local Chinese. This mutual trust can substantially reduce transaction costs so that wholly-foreign ownership is not necessarily a very good choice for entering the Chinese market.

However, this explanation is not the whole of the story on why joint ownership is so popular there. There is also the fact of local Chinese partners' government and business connections and their intimate knowledge of local situations. By forming joint ventures, not only the overseas Chinese investors but other foreigners can better combine their strengths (say, availability of capital and technology) with the local

partners' (e.g. their knowledge of China's policy and market situation and their links with officials).

Section 4 Explanations of China's Inward FDI

From the previous sections of this chapter it seems that much of China's inward investment departs from the usual stereotypes and that this is a challenge to the atlantocentric theories of FDI.

The currently prevailing theories are very useful for interpreting "normal" forms of FDI. However, recent examination of types of direct investment in China leads us to be dissatisfied with the incompleteness of these theories. As a result, the challenge here is to extend the range of possibilities to be considered when particular cases of foreign investment are to be explained, rather than to replace these theories. The rest of this section tries to give general economic reasoning for motives and types of FDI in the first instance, and then to explain China's inward investment.

FDI is one kind of international business, which is but an extension of domestic business. Because of market imperfection, each firm has its own combination of factors of operation. Relevant here are three broad categories of market imperfection. One is structural imperfection, or Bain-type market imperfection (Bain, 1956 & Dunning, 1985). This includes control of production techniques, superior product design, market networks, credit advantages and scale economies. A second is natural or transaction-cost imperfection, or Williamson-type market imperfection (Williamson, 1975). This includes information, enforcement and bargaining costs. A third category is government regulations, including imposition of taxes, tariffs and price controls. Government interventions can cause economic distortions both domestically and internationally.

The term "factor of operation" is used here to refer to all those conditions that affect the relative performance between one firm and another. In universally perfect markets there could in principle be no such differences in performance. The factors can be divided into two broad types. The one is firm-based, and the other is environment-based. Examples of the elements are presented below.

Firm-based elements:

- technology or know-how
- production-management skills
- human-resource-management skills
- marketing skills
- capital
- labour
- economies of scale
- culture
- pre-existing relationships

Environment-based elements:

- input market (local or regional)
- output market (local or regional)
- infrastructure
- socio-political conditions
- government intervention

Structural market imperfection leads to differences in the factors of operation owned by firms in the same industry. We know that technology and various management skills come from experience and R & D. A firm with better technology or management skills has competitive advantages over other firms. In the theoretical world of perfect competition, such advantages would disappear: since perfect competition implies that perfect and free knowledge prevails in the market, each firm could get free access to this technology and managerial expertise. However, in the real world, this condition does not hold. Because of imperfect information on R & D and patent protection, the technology or know-how used by one firm will be different from that used by another firm. Even when the technology becomes standardised, the production and processing methods will be different. As a result, there are differences in product and brand name. Also as a result of imperfect information, human-resource-management skills in one firm will be different from those in another, and so will marketing skills, capital accumulation and availability, labour quantity and quality, and the exploitation of economies of scale.

The differences in access to the factors of operation mean differences in combinations of these elements in different firms. One firm may be superior in some aspects such as

technology or marketing, while another may have other strong points. The combination of firm-based elements forms a firm's specific competitive advantage.

The firm-based elements, however, are not the whole story. We have to consider environment-based elements as well. Any firm is performing business activities in certain socio-economic-political conditions, and subject to its government's regulations. A certain socio-political condition may favour one firm against another, and so does government intervention. And, to operate normally, a firm must get access to its input market, output market and infrastructure. But, because of market imperfection, such as imperfect control over production of materials, inadequate information on labour supply, interest- and exchange-rate uncertainties and buyer and seller uncertainty, firms with differing combinations of firm-based elements will derive different advantages from the same environment.

The combination of all the factors of operation determines a firm's overall competitive advantages. Any improvement in one factor, and therefore in the combination, will increase its competitive advantages and vice versa. A successful firm in competition in a final-goods market implies a better combination of the factors of operation.

It is generally assumed that a firm's ultimate purpose is profit-maximising. This means that the firm sets out not only to make a profit but to make that profit as large as is rendered possible by all the circumstances affecting the firm's costs of production and demand for its product. In addition, many other objectives have also been identified in the literature. These include sales-revenue maximisation, security, survival and growth and the maximisation of various possible multi-dimensional utility functions that include some or all of these goals, either in a maximising or in a satisficing sense, as arguments (see Barback, 1984, and Curwen, 1976).

Of course, we can add other objectives to this list. For example, one very important motive for some overseas Chinese or people of Chinese origin to invest in China is non-commercial. They do so mainly for sentimental or patriotic reasons. An assessment of a firm's objectives is beyond the scope of this chapter, but it may be true that one firm may have different objectives in different development periods, or have more than one objective in a particular development period.

It is obvious that a firm with competitive advantages realises its objectives relatively easily. But that does not always happen for long: both firm-based and

environment-based elements tend to be changing. With time, there may appear constraints and threats, either active or potential, to the firm's performance. It is clear that the firm must repeatedly adjust its combination of factors of operation in the process of realising its objectives, given changing economic conditions.

A firm's competitive advantages may be weakened and even lost because of an improvement of firm-based elements in another firm. For example, that firm may adopt new technology, producing superior products. That firm may also use more advanced production methods and human-resource and marketing-management skills to perform at a lower cost. The active or expected performance of that firm will pose a real or potential threat.

A firm's competitive advantages may also be weakened and even lost because of changes in environment-based elements. For example, a difficulty in obtaining inputs, such as raw materials, intermediate products, finance, or labour, will reduce the firm's ability to grow. An output market is also important. For instance, the domestic market for the firm's particular product may be saturated; consumers' tastes may shift; competition from domestic rivals and importers may increase.

Governments' regulations also affect a firm's competitive advantages. The home government's tax, for instance, will add burdens to the firm and raise its production cost.

Because the world is changing, the firm must adjust its combination of factors of operation with time. Geographically, there are two broad ways of adjusting the combination. Firstly, it can be done on the domestic base. There are two situations here. (1) The firm makes some changes in its possession and combination of factors of operation, but still remains a single-plant firm. For example, it may strengthen its R & D, or improve management skills to differentiate its product in order to meet consumers' new needs, or try to obtain cheap inputs to provide the product more efficiently, or improve its advertising to attract more demand and get more sales-revenue. It may, because of economies of scale, simply employ more factors of production to get even more profit. But even with these improvements it is still a one-plant firm located in a specific site. (2) The firm may improve its combination by becoming a multi-regional and a multi-plant firm within the country. For example, the domestic market for the firm's product may be large. But because of transportation costs, diseconomies of scale, and difficulties in pricing the know-how, it is more

favourable for this firm to set up new product lines or to expand in other regions. By this horizontal development or integration, the firm may minimise transaction costs and realise its objective of growth, sales-revenue maximisation or profit maximisation. In this case, the firm internalises the use of its invisible assets while investing. But this is domestic investment rather than FDI. The firm may also develop into a vertically-integrated firm: it may acquire the suppliers of material inputs such as raw materials and semimanufactures or develop a system for direct marketing of its output. By doing so it may increase its security and efficiency (see, Reekie & Allen, 1983) by reducing transaction costs.

But domestically based adjustment is not always feasible. If there is a difficulty in adjusting in the home country, or if the net benefit of the international recombination is greater, the firm will go global.

Though international business is the outgrowth of domestic business, there are significant differences of degree between them. These include the fact that international business must often deal across different currency areas, interest rates, inflation rates, tax systems, government restrictions, languages, and cultural and economic barriers. It is in this sense that a FDI theory goes beyond the pure theories of firm and industry and involves disciplines of international trade and international finance.

Foreign trade and leasing may help the firm to reach its objective more fully. For example, the firm may import inputs and export its products in order to bypass obstacles in the domestic market. Thereby it may reduce its production costs and increase its sales revenues. The firm may also lease advanced technology or managerial skills from abroad, combining it with its own firm-based elements and its home country's existing environment-based elements to improve its competitiveness.

Though international trade and leasing are possible means of adjustment, there are barriers. For example, governments' high tariffs on import and export, together with other forms of trade and non-trade barrier, will hinder the firm's global trading or even make it impossible. Because of the difficulties in pricing intangible assets in a situation of uncertainty and of market segmentation, leasing may be unfavourable to both parties in many cases.

If there are barriers to leasing, the firm may have incentives to invite in FDI. By doing so the firm may obtain the technology and managerial skills as well as capital, and therefore achieve a better combination of factors of operation. In this case, it is the host firm which initiates the FDI project, rather than the investing firm as implied by the dominant FDI theories. In this case, however, though the initiator is host, rather than foreign, firm, the basic point of the internalisation approach is still relevant: the market for the technology and managerial skills is internalised and the transaction costs of buying or leasing these intangible assets are minimised.

A host-country firm may have a better knowledge of its firm- and environment-based elements. It may have some idea of what it actually wants. It therefore will try to obtain the complementary firm-based elements from a relevant foreign firm by originating FDI.

This analysis also applies to a host-country government. To obtain complementary factors of operation, the government may encourage particular categories of inward investment in its own interests. For instance, foreign investors may be invited to develop certain intermediate and final products to meet the host country's particular needs. This strategy aims to improve the product structure of the economy.

A host country may also have an interest in increasing the general level of inward investment. In this case, FDI is used to fill a general resource gap and therefore to reach given macroeconomic objectives. Increases in employment, exports and economic growth are the most common macroeconomic purposes. Good economic performance can be promoted by FDI, and it implies general improvement of firm- and environment-based elements, which in turn attracts more FDI. There is a relationship between a host country's economic performance and the level of inward investment.

To achieve certain purposes such as growth, establishment of a presence, and profitability, a firm may also invest directly abroad. If the firm does so, it gets access to other sets of firm- and environment-based elements and therefore has far wider choice than it does merely in the home country. For example, the firm can combine its capital, know-how and production-management skills with the host country's input and output markets, and the host firm's local human-resource management and marketing knowledge, familiarity with business culture and pre-existing relationships, in order to improve its previous combination.

We put culture and pre-existing relationships into the list of characteristics of factors of operation because they, in perhaps more than one sense, are important in explaining why firms do as they do in some particular cases. The culture concerned can be in a foreign firm, a host environment, or a local firm. In China's FDI, for instance, culture can be important in the sense of a common language and a common set of expectations about business relations, and also in the sense of administrative behaviour. Pre-existing relationships may also exist between the owners of foreign and local firms, and also between local firms and government institutions. In some cases there is good reason for foreign firms to accept relationships with particular local firms.

If a foreign firm makes a direct investment, some firm-based elements in its home country are integrated with some other firm-based elements and environment-based elements in the host country. It is obvious that relevant combinations of such elements are numerous. By launching direct rather than portfolio investment, the firm can also gain control over decision-making, and hence minimise transaction costs during the process of the transfer of intangible resources such as know-how, and management and marketing skills.

From the literature, a list of the situations in which FDI is necessary or more favourable than domestic production with international trade, and also than leasing, must be very long, if it is to be exhaustive. Examples include Dunning's firm-specific and location advantages (Dunning, 1981, 1988) and Kolde's marketing, production, financial and general management advantages (Kolde, 1982).

FDI means that one firm domiciled in one country has a controlling interest in another firm within another country. A host country has certain firm-based and environment-based elements which comprise the overall investment climate. A careful reader will notice the difference between my definition of investment climate and the traditional one in that I integrate firm-based elements into the climate. My reasoning is that many individual FDI projects are based on participation with local firms, and the projects' advantages depend on both environment-based and firm-based elements in the host country, the firm-based elements relating to the potential local partners. This is always true if the entry mode is a joint venture, or if it is a takeover of a wholly-owned subsidiary. Even when a greenfield investment is made, a investor needs to check the whole investment climate before committing himself to that mode, in order to make

sure that there are no ready complementary firm-based elements available. Excluding consideration of the host-country firm-based elements from the assessment of an investment climate does not conform to reality.

Thus, a FDI project usually involves three poles, foreign firm, host environment, and local firms, and in some cases a local firm can be very enthusiastic about inviting in the FDI.

From the structural point of view, there are three main forms in which a firm may expand through FDI. These are horizontal, vertical and conglomerate integration. It should be noted here that these forms of FDI are similar to those by which a firm becomes a multi-regional and multi-plant firm within a country. The only difference is that the former combination is carried out internationally, and the latter domestically.

As mentioned in the previous paragraph, a first form of FDI is horizontal combination; namely, the firm produces the same product in more than one country. In this case, the firm which makes the investment usually internalises the use of some of its intangible assets, combining them with a host country's environment- and firm-based elements. For instance, it may combine know-how and certain managerial skills such as new technology, production methods and international marketing, with the input and output markets, infrastructure, and socio-political conditions, as well as local marketing and/or human-resource-management expertise, in the host country.

The investing firm has incentives to combine elements in this way. Knowledge has characteristics of a public good and is sometimes difficult to patent and price. Because of the existence of bounded rationality and opportunism, the transaction costs of licensing will be high. Exploitation of this knowledge within a firm will enable the firm to minimise transaction costs and realise given objectives such as growth and profit maximisation. This form of combination has attracted much attention in the literature. What the structural-market-imperfections approach and the eclectic paradigm interpret basically is this phenomenon.

Like other forms of combination, horizontal expansion can be realised through the establishment of green-field subsidiaries, the acquisition of overseas companies and the formation of joint ventures. These different "modes" are usually associated with different methods by which resources are transferred or organised, and different extents to which control is practised.

A wholly-foreign-owned enterprise established by either green-field investment or acquisition is a single-ownership firm. The investing firm gains as a rule total control of the enterprise. Resources transferred in this case include mainly capital, some forms of technology, managerial skills. However, a difference in the methods of combining resources exists between green-field investment and acquisition. In the former case, the investing firm needs to combine its transferred resources with all other factors of operation, and these have to be obtained without prior organisation from the host country's environment. It usually takes time for the investing firm to acquire information on quantity and quality of these factors and to organise them to start a business. In the latter case, the investing firm combines its transferred resources directly with all the other factors of operation that have already been organised by a local firm. This route may involve less uncertainty, but rationalisation usually follows the investment.

A joint venture is traditionally thought to be unable to constrain efficiently the behaviour of the parties, and to incur high transaction costs (see Casson, 1979, 1982, 1987; Hennart, 1977, 1982; Kay, 1991, p.140). But nowadays more and more FDI theorists have begun to realise that, while there are conditions under which a wholly-foreign-owned enterprise is more efficient than a joint venture, in other cases a joint venture incurs lower costs than a wholly-foreign owned enterprise. (Datta, 1988, Hennart, 1989; Shan, 1991; Agarwal & Ramaswami, 1992; Yu & Tang, 1992). Both parties in a joint venture may benefit from this integration. The investing firm can be in a good position to bring into play the enthusiasm of the local partner, and to use factors of operation otherwise not available to itself, for instance, the local partner's knowledge of environment-based elements in the host country. On the other hand, the receiver may also get complementary resources from the foreign investor. Thus we can compare the costs and benefits in the case of a wholly-foreign-owned enterprise with that in the case of a joint venture, and choose the entry mode with the bigger net benefit.

A choice of the modes of combination will be on a case-by-case basis. If (1) transaction costs of resource transfer (mainly know-how in the case of horizontal combination) are high, and if (2) there are no ready factors of operation (labour, capital, input and output markets) organised by a local firm, a green-field investment may be chosen. If (1) still holds, but there is a similar local firm and utilisation of local knowledge is deemed to be important, acquisition may be selected. Finally, if there is

political opposition to foreign control of production, and if certain forms of transaction costs are low (these cases will be discussed in the next section), a joint venture is preferable.

A second form of FDI is vertical combination, i.e., a firm is involved in activities for a whole productive sequence that occurs in several countries. There are two broad types of vertical combination: backward and forward. In vertical integration, it is not very common for a local firm to possess know-how and managerial skills for the whole range of the productive sequence. Let's take an example of an ore-steel-car-body sequence. A car-body-making firm may own expertise only in its own field, but other firms in other countries may produce ore or steel advantageously because they can get access to natural resources and possess the production expertise though specialisation.

If the car-body-making firm invests in ore and steel production, backward integration occurs. The firm has an incentive to do so if transaction costs of purchasing ore and steel are high. From the viewpoint of the ore and steel producing firms, this is forward integration. Though they are receivers of investment rather than investors, they may also favour the integration in order to reduce transaction costs caused by small-number conditions.

In this case, the resource transferred by an investing firm in vertical combination is mainly capital. By this means two or more firms are integrated to be an MNE which possesses the whole range of ownership advantages for a particular productive sequence. We should note that capital is not an intangible asset, not a special advantage possessed by the investing firm. The action of the car-body-producing firm's investing capital does not involve internalisation of the market for this firm's intangible assets (know-how on car-body production). This indicates that a firm with specific assets does not necessarily internalise the use of them when it makes a foreign direct investment. The structural-market-imperfection approach and the eclectic paradigm do not cover this vertical-integration case. However the internalisation analysis of Buckley, Casson and Hennart does appear to apply.

The previous "mode" analysis of horizontal combination applies also to vertical integration. If transaction costs of intra-firm purchasing raw material and intermediate goods are likely to be high, green-field investment or acquisition may be chosen. If wholly-foreign-owned enterprise is not feasible or transaction costs between the

partner companies in an enterprise are not high, an equity joint venture may be selected.

A last form of FDI is conglomerate combination. Purely conglomerate combination means that a firm invests in another unrelated industry. In this case, the firm gains some controlling interest by combining its capital with all other factors of operation needed in that industry. This type of combination helps the firm reduce uncertainty and risk, and the philosophy behind this activity is "not having all one's eggs in one basket".

If its industry is found to be in long-run decline, its future to be uncertain, and other industries to be more promising, the firm has incentives to move gradually to these other industries, which may be located in other countries. By combining resources and therefore pooling activities from different industries, the firm reduces risk and uncertainty.

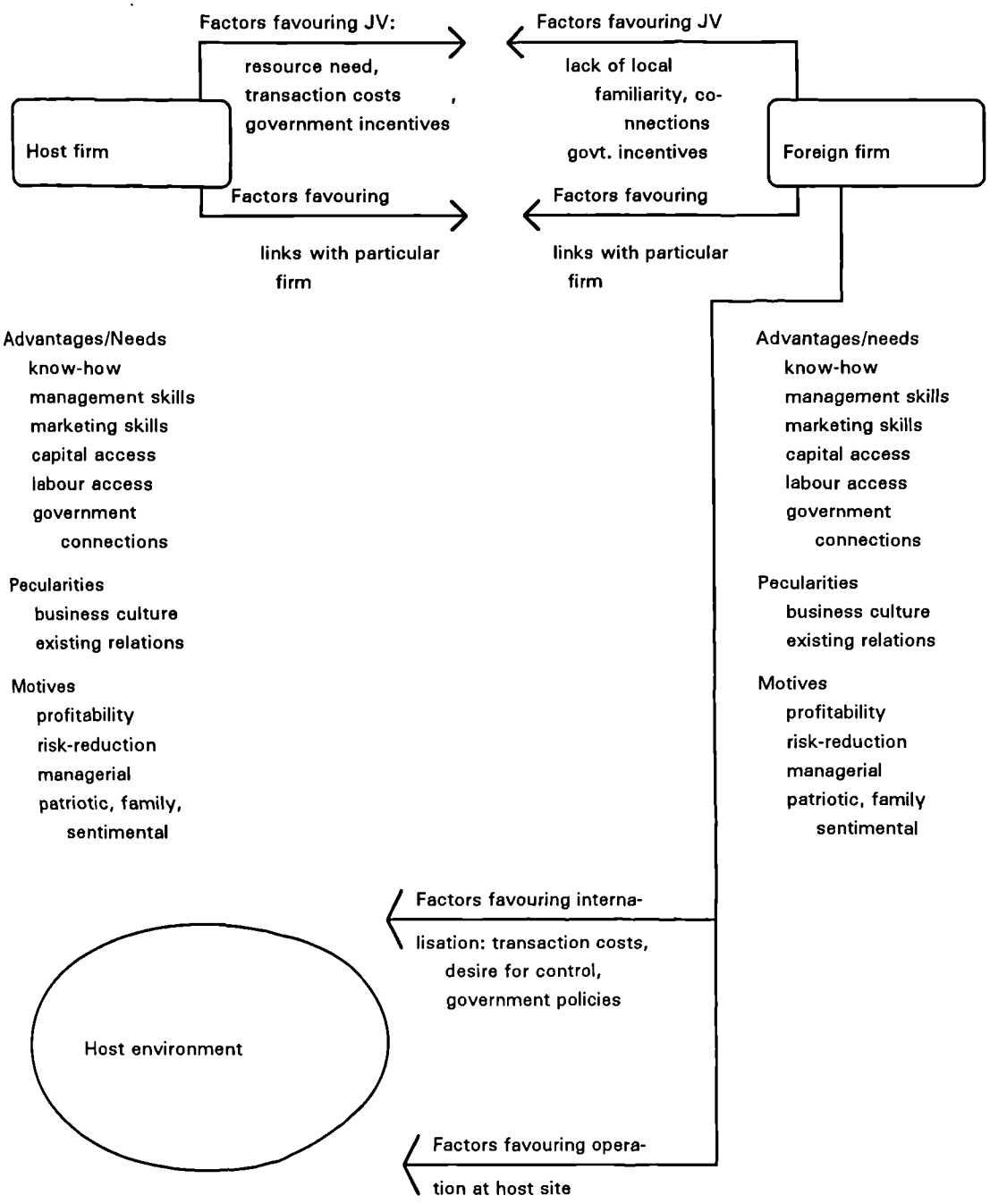
Though a firm may have these financial reasons to go conglomerate, there may be managerial motives as well. If the firm is management-controlled and the objectives of management are growth and good performance, the firm may invest in other industries located abroad where the factors of operation may be more favourable, reducing fluctuations in performance of the firm.

Conglomerate combination can also be realised through any of the three modes of green-field investment, acquisition and joint venture. When purely conglomerate integration is considered, control over resource transfer or intermediate-goods sales through non-market arrangements may not be so important as in the case of horizontal or vertical integration. This is because few, if any, transactions of important intermediate goods (such as know-how) are involved. As a result, green-field investment may not be the first choice unless there are other strong reasons; for instance, if the industry in which investment will be made is quite new and promising. Acquisition and equity joint venture may be more popular, since in those cases there are already organised resources to exploit.

A firm can improve its combination of factors of operation by either inviting or launching FDI. By doing so it may obtain complementary resources and therefore competitive advantages. This implies that the firm which becomes a MNE is not necessarily the leader in its domestic market. (This view is contradictory to Porter's;

see Porter, 1986); for example, given a certain combination, a firm may be in an unfavourable position in the home market. This might be caused by one or several unfavourable firm-based or environment-based elements possessed or faced by that firm. However, it may be possible to improve this position by obtaining a better combination on an international base. The firm can foster strengths and circumvent weaknesses by recombining its own favourable elements with other favourable firm- and environment-based elements. For example, it may introduce advanced technology by inviting FDI, or relocate its production in a country with cheaper inputs in order to overcome its own shortcomings. In this way the firm may regain competitive advantages.

The peculiar features of China's inward investment as well as normal forms of FDI are thought to be covered by the above general analysis. This can be illustrated by the following triple-pole diagram.


Factors favouring JV:
resource need,
transaction costs
government incentives
Factors favouring JV
lack of local
familiarity, co-
nnections
govt. incentives
Host firm
Foreign firm
Factors favouring
links with particular
firm
Factors favouring
links with particular
firm
Advantages/Needs
know-how
management skills
marketing skills
capital access
labour access
government
connections
Pecularities
business culture
existing relations
Motives
profitability
risk-reduction
managerial
patriotic, family,
sentimental
Advantages/needs
know-how
management skills
marketing skills
capital access
labour access
government
connections
Pecularities
business culture
existing relations
Motives
profitability
risk-reduction
managerial
patriotic, family
sentimental
Factors favouring interna-
lisation: transaction costs,
desire for control,
government policies
Host environment
Factors favouring opera-
tion at host site
Advantages
input market
output market
infrastructure
socio-political conditions
government policies
Pecularities
business culture
administrative culture
existing relations
Note: Arrows indicate possible
source of initiative

As indicated by the arrows in the diagram, either the foreign investing firm or the host-country receiver will originate an FDI project because either of them may have an incentive to realise a better combination of factors of operation. FDI may follow either of the two entry modes: wholly-foreign ownership and joint ownership. A joint venture is not necessarily inferior to a wholly-foreign enterprise in terms of efficiency from the viewpoint of the foreign party. Rather, a joint venture may be superior to a wholly-foreign-owned enterprise in many cases. FDI combination can also take any of the three forms of expansion: horizontal, vertical and conglomerate. While influences such as better exploitation of the public-good nature of knowledge, and reduction of uncertainties and hence of transaction costs, may be the reasons for horizontal and vertical integration, financial and managerial motives may account for conglomerate combination.

Generally speaking, China's cheap labour, government inducements and the world's largest potential market are the main attractions to foreign investors. This is confirmed by our fieldwork. China's labour cost is among the world's lowest, and is only one-thirtieth of the UK's when converted at official exchange rates (see O'Rourke, 1992). The government inducements can reduce production costs, and presence in China's domestic market can ensure one important outlet for foreign businesses' products. Foreign investors have reasons to combine their capital and technology with China's cheap labour to produce goods (say, labour-intensive goods) for both the foreign and China's domestic market. On the other hand, the Chinese side also has incentives to call in FDI. By doing so, a local Chinese firm, for instance, may obtain capital, technology and management skills, and qualification as a venture with foreign investment and therefore preferential fiscal and financial treatment from the Chinese government. This will reduce the firm's production costs, improve the combination of factors of operation and increase its competitiveness.

Foreign investors in China consist mainly of Overseas Chinese. Though the influences mentioned in the above paragraph will be taken into consideration, the overseas Chinese businessmen are also motivated by family and local links when they make direct investments in China. Affection for the motherland and especially for the home of origin and the commitment to the family have driven them to visit and invest in China since the Chinese government adopted the policy of opening to the outside world. If this sentiment motivates the FDI from the overseas Chinese, then the mutual trust originating from the family and local connections and language similarity provides a solid ground for business deals between them and local Chinese. This can

substantially reduce transaction costs. On this basis, the expertise and capital among the overseas Chinese are integrated with the local firm- and environment-based elements such as cheap labour and the domestic market in China. Thus, both the overseas Chinese and local Chinese firms complement each other to obtain better combinations of factors of operation simultaneously. China needs the help of the overseas Chinese for its economic development, and the overseas Chinese strengthen themselves when they help China.

On the one hand, China's cheap labour, government inducements and potential huge domestic market in general, and the obligation of commitment to the family in particular, motivate businessmen in the rest of the world to invest in China. On the other, foreign capital, superior technology and management skills, as well as the Chinese government's preferential policy toward foreign-invested enterprises, lure local Chinese firms and individual Chinese to call in FDI. Since foreign businesses would like to invest, and local Chinese firms to receive investment, either of the parties can be active in originating FDI projects.

A majority of the ventures with foreign investment in China take the form of horizontal integration. These involve such sectors as tourist hotels and the service industry, energy exploration, transport, electronics, machinery, textiles, foodstuffs, and pharmaceuticals. In this case, foreign investors usually provide technical, managerial, or marketing know-how, combining them with other factors of operation in China. The most important factors which foreign investors aim to exploit are cheap labour, favourable investment incentives and access to the world's largest potential market.

In China, the major type of vertical combination is backward integration: foreign, especially Hong Kong, trading companies have invested in manufacturing sectors in China. The ventures with foreign investment are treated as their processing factories. By virtue of their familiarity with international market networks, they export some or all of the ventures' products. These firms produce a wide range of goods, from artificial flowers, toys and paper mosquito-repellent incense, made with simple technology, to electronics and other high-technological goods. In this case, investors' marketing skills are combined with firm- and environment-based elements (such as cheap labour) in China and world output markets. By doing so, the foreign party gains from cheap supplies and the Chinese party and population from increased capital, employment and foreign-exchange revenue.

There are also reasons for both foreign and Chinese parties to follow pure conglomerate integration in order to realise certain objectives. There can be several situations here.

Firstly, some Chinese firms own intangible assets such as special technology and marketing expertise. For the firms with technological know-how, when they calls in foreign investment, they obtain capital, which is relatively scarce in China, and they can develop new products under favourable conditions because an enterprise with foreign investment enjoys tax privileges. One typical example identified in our fieldwork in Ningbo city is as follows. The Chinese Academy of Sciences and a local firm jointly developed a new material. To produce this new product they needed capital. They found that it was beneficial to combine foreign direct investment with the existing firm- and environment-based elements. They did so by calling in a foreign investor whose business was not related with the local firm's at all. In this case, it is the domestic firm that exploited its technical know-how under favourable taxation treatment by the government; the foreign investing firm was happy to obtain some controlling interest in the venture because it thought the new product was promising and profitable. This purely conglomerate combination may enable the foreign investor to pursue his long-run profit-maximisation objective.

Firms with traditional export channels for their products, when they invite in foreign investment, aim at exploiting economies of scale through extra capital and favourable fiscal and financial treatment. In this case, it does not matter if the foreign investors are not in the same industries as local firms. In this circumstance, there is again no internalisation involved on the part of foreign investors, but both parties have improved their combinations of factors of operation. They are both in a better position to realise their objectives. This is also confirmed by our fieldwork: a local poultry processing firm received investment from an unrelated firm from Hong Kong.

Secondly, foreign investors may invest in unrelated industries in China to exploit price distortions. Because of the long-standing practice of central planning and the closed-door policy of the past years, many prices in China do not reflect the real value of commodities and services and differ greatly from international prices. The open-door policy provides a good chance for foreign investors to make use of these advantages. In this case, the most important thing for an investor to do is to find out the commodities whose prices are significantly different from international ones, then to

exploit these differences by investing and producing these commodities in China and selling them in either the Chinese or the international market. This was particularly true in the early stage of China's adoption of the policy of economic reform and opening to the outside world. This is also an alternative way to adjust combination of factors of operation.

Finally, some foreign conglomerate firms themselves make conglomerate investment in China. They are motivated partly by the world's fastest-growing markets in China and South-East Asia, and partly by family and government connections. According to *Japan Economic Newswire* (6/4/93), Indonesian conglomerates owned by ethnic Chinese have invested heavily in southern China, and the value of investment by such conglomerates in Fujian Province reached 6.6 billion Hong Kong dollars for the year 1992. Much of the investment has gone to the development of infrastructure facilities. For instance, Lippo of Indonesia is the Riady-family-controlled conglomerate, and many of Lippo's projects in China are in Riady's old home town, Putian in Fujian Province (see *The Economist*, 17/7/93). In this case, affection for the home of origin and the obligation to the family appear to have played an important role in the decision. Through these conglomerate investments, capital among the overseas Chinese has been combined with all other firm- and environment-based elements in China.

Charoen Pokphand (CP) of Thailand, another ethnic-Chinese-family-controlled conglomerate, is very close to the Chinese leadership since the group's chairman, Dhanin Chearavanont, is one of three non-Chinese-nationals serving on China's advisory group on Hong Kong. It is explained that the attractiveness of CP to outsiders such as Honda is connections, with the result that its activities in China run from brewing and petrochemicals to building motorbikes (*ibid.*). In this case, CP's capital, Honda's technology and other firm- and environment-based elements in China are well combined. From the viewpoint of CP, it is a conglomerate investment through which CP can get access to Honda's technology, and to China's cheap labour and local knowledge and the market. On the part of Honda, it is a horizontal investment through which Honda can exploit the advantage of government connections owned by CP as well as China's cheap labour and local knowledge and market. The Chinese party in each investment, on the other hand, can obtain both capital and technology from CP and Honda. The three parties complement one another.

The above discussion indicates that our general analysis can well be applied to discussion of forms of FDI integration (horizontal, vertical and conglomerate) in China. However, this framework can also be used to discuss the choice of ownership structure (wholly-foreign-owned or joint venture) followed by foreign investors in China.

As described before, horizontal integration is a dominant form of FDI in China. This kind of combination usually, if not always, involves transfers of technological and managerial know-how from the investing firm to the host country. Facing market failure, the investor may have incentives to follow a wholly-foreign-owned structure (single ownership) to internalise the transfers in order that uncertainty and transaction costs can be kept at a minimum.

However, chapter 5 tells us that the most popular ownership form of FDI in China is the equity joint venture: from 1979 to 1989, there were 12,198 equity joint ventures set up, accounting for 56.1% of the total ventures with foreign investment. The next most popular structure is the contractual joint venture which is a more flexible, and therefore less formal, type of joint venture and accounted for 36.8% of the total during the same period. There is evidence that both ethnic-Chinese and non-ethnic-Chinese investors favour the mode of joint venture. One reason for this phenomenon may be that Chinese government policy used to discriminate against the wholly-foreign-owned enterprise (see chapter 6). But this entry pattern has continued after the discrimination was removed several years ago. It appears that the two types of investors have other reasons for preferring joint ventures to wholly-foreign-owned enterprises.

From our field work we found that investors of Chinese origin favour joint ventures in order to make good use of specific advantages. These are family relations, personal acquaintance and the same cultural background. As the most important peculiar feature of China's inward investment, a overwhelming majority of foreign investors are Hongkongese, Taiwanese, overseas Chinese or people of Chinese origin. It is surely no accident that their investment accounts for the preponderance of the total in terms of both value and the number of projects. The peculiar needs, advantages and motives that prompt their choice of joint ventures include ready access to potential local partner's knowledge and connections because of family connections or common dialect and cultural background. In terms of the analysis above of how the parties make better combination, these peculiar advantages help relax the information limits

to rationality, decrease opportunism, and therefore substantially reduce, or even eliminate, the possible uncertainty caused by shared control in a joint venture in a normal sense. Thus the investor's capital, together with some forms of know-how, is well combined with precious local knowledge and other firm- and environment-based elements in China. This ownership structure may thus be regarded by both parties as more favourable than the wholly-foreign-owned enterprise.

The importance given to personal acquaintance and family connections between business partners, not only in China but also in Korea and very markedly in Japan, may be due to the fact that there was much less legal protection of contracts in those countries when present commercial traditions were developing, probably in large part in the seventeenth and eighteenth centuries, than in Britain or Western Europe or the American colonies about the same time. Thus, what might have been a weakness has given East Asian business today a potential strength, and in particular it gives China an opportunity because of all the expertise and capital among the compatriot and Nanyang Chinese.

The other foreign investors (mainly from western countries), with no such peculiar advantages, favour joint ventures (usually equity joint ventures since they are more formal by western standards) because they need to overcome barriers. Because of cultural and physical distance, these investors generally have very limited knowledge of firm- and environment-based elements in China. For instance, they may not know much about China's economic operating mechanism, financial and fiscal arrangements, government regulations, and perhaps more important, business conventions and practice. They may have insufficient of the information which they need on the input and output markets. Because of the long-standing practice of central-planning in past years, local firms still have close relations with the government. Whenever they have problems, they may seek the government's help. The government's intervention often proves effective. It will not be easy for the foreign investors to identify the right authorities when they need them. Though the alternative of straight one-hundred-per-cent acquisition may allow the foreign investors to obtain certain local knowledge indirectly, there may be problems with the local firm's enthusiasm.

A foreign investor will certainly weigh advantages and disadvantages for each particular entry mode. In most cases, the disadvantages are apparently thought even by these genuinely foreign investors to outweigh the advantages of the wholly-foreign-owned enterprise in China. By investing in a wholly-foreign-owned enterprise,

the investor gains more control and internalises transfers of resources more easily, but may encounter more operating and managerial problems. A joint venture gives the foreign investor less control but often other advantages.

An important inference from this analysis of the variety of reasons why particular combinations through FDI may be advantages is that a foreign investor is not necessarily the leader in the industry in his home market. Rather, he happens to be able to gain competitive advantages by obtaining a better combination by moving internationally. In the case of China, most foreign investors are middle- and small-sized enterprises in their own countries and many are not leaders. Some transfer little more than capital. For example, many investors from Asia are businesses encouraged or forced to go abroad because of rising costs and competition in their home markets. They go to China to combine standard technology with cheaper labour in order to increase their strength.

Section 6 Conclusions

China's inward FDI has four peculiar features: (1) an overwhelming majority of foreign investors are overseas Chinese; (2) the local Chinese party is often active in originating FDI projects; (3) a certain amount of FDI takes the form of pure conglomerate integration; and (4) joint ventures are the prevailing entry mode. These particular characteristics constitute a challenge to the currently dominant FDI approaches because none of the theories can readily and satisfactorily cover the second, third and fourth of these features.

Dissatisfaction with the prevailing FDI theories induces us to extend the range of possibilities when particular cases of FDI, such as China's inward investment, are to be considered.

Under our general analysis, market imperfection causes differences in combinations of factors of operation across different firms, which in turn lead to differences in the degree of competitive advantage across the firms in any one industry. To realise its objective, a firm has to adjust its combination as the occasion demands. If it does so domestically, it remains a local firm. However, if it does so on an international base, and if the means of international trade and leasing are not feasible or are unfavourable, the firm may consider calling in FDI or making an outward investment.

Factors of operation may be divided into firm- and environment-based elements. A decision to originate a FDI project is a decision to obtain complementary elements or resources abroad. Since either a local firm (and sometimes a host government), or an investing firm, can have strong incentives to seek complementarity and therefore enhance its competitiveness by initiating a direct investment, FDI occurs not only because a foreign firm with certain advantages that it wants to exploit looks around the world to find a good site for investment (low labour cost, large domestic market, stable politics, and the rest). It is due more broadly to the interaction between the foreign firm's characteristics and the site's (including often a local firm's) characteristics; and the interaction between the foreign firm's culture and the culture of the local firm and government and of local business practice. FDI has to do with the complementarity among the characteristics of foreign firms, local firms, and local environments. Thus a picture of the generation of FDI involves these three poles, as presented in this chapter.

The differences between the prevailing theories (the "eclectic" paradigm and the transaction-cost approach) and our analysis are that, though many points of the former are relevant, there is a wider range of considerations. In our analysis, firstly, the motives for FDI are not simply financial (*profitability and risk-reduction*) or managerial; secondly, the advantages and needs are sometimes to do with personal relationships and culture; thirdly, the *complementarities* between the foreign-firm, host-firm, and host-environment factors are to be emphasised; and finally, the analysis covers the case of a host-firm as a possible initiator.

Our analysis implies that a particular FDI pattern will be determined by the characteristics of the investing firm, the local firm and the local environment. If a host country is the main supplier of the key raw material *for the investing firm,* the FDI will be resource-based. If a host country is the main market for the investing firm's product, the FDI will be market-oriented. If a host country has cheap labour but a very limited market and the product is labour-intensive, the FDI will be export-directed. Similarly, if a local firm possesses advanced technology to which a foreign firm wants to get access, the FDI may be technology-seeking on the part of the foreign investor; and, if a foreign firm has management (marketing) expertise, the FDI may be skill-seeking on the part of the local firm.

It should be emphasised that what I have tried to do is to stretch the boundaries wider rather than providing an alternative to the prevailing theories. Extending the analysis enable it to cover not only horizontal, vertical and conglomerate FDI expansion in general, but also such particular cases as characterise China's inward investment.

Both foreign and local-Chinese parties have incentives to initiate FDI projects in order to improve their combinations of factors of operation. While foreign investors in general are motivated by cheap labour, government inducements and the world's largest potential market in China, the overseas Chinese businessmen in particular are driven by personal acquaintance, local patriotism and family links. Since an overwhelming majority of foreign investors are actually ethnic Chinese, the mutual personal trust from the family and local connections forms a unique basis for the performance of China's inward FDI.

Confucianism gives importance to personal rather than legal relations. "Father-knows-best" is the management philosophy of a family, a firm and even a whole country. "Commitment to the family" indicates the obligations of members of the family. Prevalence of Confucianism coexisted with much less legal protection of contracts in China than in the western developed countries. By today's standard this is a shortcoming. However, it is the business habits that accompanied this shortcoming that provide China with special opportunities to combine overseas capital, technology and management skills with the firm- and environment-based elements in China to realise its four-modernisations drive.

A majority of the FDI projects in China take the form of horizontal integration. Foreign investors' capital and some forms of know-how are complemented with firm- and environment-based elements some of which are deemed to be favourable (cheap labour, generous incentives and the potential market size). By this combination, the public-good nature of some knowledge, economies of scale, and other favourable conditions, are exploited internally.

Backward integration is dominant in vertical combination in China. Foreign investors' marketing skills are integrated with other factors of operation in China and with world output markets.

In the case of conglomerate combination, foreign investors' capital is combined with Chinese technical, managerial and marketing know-how, and other factors of operation, even including a distorted price system.

Joint ventures rather than wholly-foreign-owned enterprises are the normal entry mode in China. Different types of investors have various reasons for favouring joint ventures. Hong Kongese, overseas Chinese and people of Chinese origin favour the mode because this is generally the best way of exploiting their peculiar advantages, while other foreign investors often prefer this way because they need to overcome critical barriers arising from their lack of cultural and local knowledge.

FDI from the overseas Chinese will still be dominant in the coming years because of the special relationship between the ethnic and local Chinese. The inward investment pattern can be versatile. Since China is endowed with rich natural resources, cheap labour, a huge potential market, and some advanced technologies and managerial skills, FDI motivated from abroad may be resource-oriented, export-based, host-market-directed, or know-how-seeking.

CHAPTER 9 IMPACT OF FDI ON THE CHINESE ECONOMY

Section 1 Introduction

This chapter is closely associated with chapter 5 and section 4 of chapter 7. The purpose of this chapter is to investigate the impact of FDI on the Chinese economy. In the literature, the economic impact of FDI has usually been classified into three categories: resource-transfer effects, employment effects and balance-of-payment effects (see, e.g. Young & Hood (1979 & 1988), Lall & Streeten (1977), Hufbauer & Adler (1968), Grosse (1988) and Pass & Neale (1990)). However, this list of the economic impacts is far from exhaustive. While these effects are generally accepted as being significant, others may be important as well in certain host countries. Structural and regional effects, for instance, may well be added to the list in the case of China.

There have always been difficulties in assessing the impact of FDI on developing countries, and the most important reason for that is of course the inadequacy of detailed economic data. This general conclusion applies to China. In some cases, the Chinese government does not compile, or else does not release, necessary information on the performance of the ventures with foreign investment, such as imports, repatriation, reinvestment. In other cases, it "lumps together all inflow of foreign capital including loans, foreign aid, portfolio investment and direct investment, making it difficult or impossible to identify which portion is direct investment" (Stoerer, 1989). It is also not uncommon that certain important numerical information appears in various newspaper or magazine articles rather than in China's statistical yearbooks.

In face of the difficulties, the first step of this study is to get as much direct or indirect information as possible; then, from the categories of the data, to decide the corresponding approaches which include both macro and microeconomic analysis.

The next five sections present findings concerning the impact of FDI on resource transfer, income, trade and balance-of-payments, employment, economic structure and regional development. The last section summarises the results and offers some conclusions.

Section 2 Resource-Transfer Effects

When multinational enterprises provide a host country with capital, technology and management, they exert resource-transfer effects on it. It is generally accepted that the effects will be positive if the following requirements are met: the MNEs raise their capital outside the host country, or, though they raise a certain amount of the capital in the host country, they do not divert domestic savings from other productive uses; the technology is suitable and the terms under which it is supplied are reasonable; the management skill is applicable in the host country and not mostly reserved for foreign staff. The resource-transfer effects of FDI on the Chinese economy can be measured in these three aspects.

2.1 Capital

China is a developing country pursuing the four-modernisations program. This program needs a large amount of capital. There is no doubt that FDI has made a contribution to increasing supplies of capital in China. From 1979 to 1992, a total $34 billion was utilised. The absolute amount of the FDI in China was not small, but what was its relative importance in China's total capital formation? To answer this question, we should measure the ratio of FDI in China's total social investment in fixed assets (TSIFA). The term TSIFA is the basic indicator for domestic capital formation, which includes both productive construction and so-called non-productive construction.

Table 9.1 Sources of Total Social Investment in Fixed Assets (RMB Billion)

	1983	%	1987	%	1989	%
Total	143.0	100	364.1	100	413.8	100
Budget investment	34.0	24	47.6	13	34.2	8.3
Domestic loans	17.6	12	83.6	23	76.1	18
Foreign Capital	6.7	5	17.5	5	27.4	7
Self financing	84.8	59	174.5	48	235.6	56
Other investment	0	0	40.9	11	45.0	11

Source: *Statistical Yearbook of China*, 1990.

Table 9.1 shows the various sources of the TSIFA. When considering foreign capital here, we must use caution: it is a lump-sum figure which includes foreign loans, portfolio investment and direct investment. From the table we can see that the percentage of the investment financed by foreign capital was small, ranging from 5 to 7, so that the proportion of FDI alone in China's capital formation must be smaller. Consequently it is safe to say that in relative terms FDI played only a small role in China's capital formation.

2.2. Technology

Application of science and technology constitutes a powerful element in increasing productivity. It is the key to economic growth. China's domestic ability to innovate is limited by a lack of capital, scientists and technicians. In order to realise the four-modernisations program quickly, China adopts established foreign technologies by various means among which FDI is important. By adopting foreign technology China aims to by-pass the risky, expensive invention and innovation stages, thereby making a significant leap forward.

In the light of this thinking, China encourages foreign investors to provide advanced technology. In 1979 when the policy of opening to the outside world was adopted, the Chinese government asserted in the Law on Chinese-foreign Joint Ventures that "a joint venture that possesses advanced technology by world standards may apply for a reduction of or exemption from income tax for the first two to three profit-making years". Then, the Regulations for the Implementation of the Law of the People's Republic of China on Chinese-foreign Joint Ventures stipulated that the technology imported by a joint venture must be appropriate and advanced, and enable the joint

venture's products to have marked social-economic benefits domestically or to be competitive in the international market. And in 1986, China began to grant special preferences to "technologically-advanced enterprises", which met at least one of the following conditions: the technology, process and major equipment fall within the category of projects to be encouraged for investment as announced by the state and are of an advanced nature that can be applied; the products are in shortage in China, or are newly developed and can renew and replace similar production in China; or the project can increase exportation or facilitate import substitution. These conditions are far from precise and seem designed to give maximum discretion to the bureaucracy.

There are no published official statistics on the number of technologically-advanced enterprises with foreign investment, but during an interview the present author was informed by the Ministry of Foreign Economic Relations and Trade that there were 1,647 technologically-advanced or export enterprises in 1988 and more than 2,000 in 1989. To be an "export enterprise" with foreign investment means that the products are mainly for export (50% or more of the total output value), and that a balance of or surpluses in foreign-exchange receipts and disbursements is realised. There were no separate records for the two kinds of enterprises because, as one official explained, the two kinds of enterprises were not exclusive to each other, and many export enterprises also qualified as technologically-advanced ones, but they had to opt for one or other category and then were entitled to the relevant preferential treatment. By 1988, a total of 15,997 projects with foreign investment had been approved by the Chinese government and about half of them had been in operation. If the MOFERT's figures were correct (they should be the most reliable), 20 per cent of the ventures in operation were technologically-advanced or export enterprises.

The other reliable information comes from a survey of the performance of the ventures with foreign investment by Zhang and Hu (1990). They investigated 8,038 ventures which accounted for 50.4% of the national total approved by the end of 1988. Among them there were 4,127 in operation, 3,469 in construction and 442 approved to disband (or for abandonment of their contracts). In the ventures in operation, there were 231 technologically-advanced enterprises and 780 export enterprises. They accounted for 5.6% and 17.6% of the total respectively. In other words there were 939 technologically-advanced or export enterprises, accounting for 22.75% of the total ventures in operation. This figure is very close to 20%, the proportion in the national statistics mentioned in the preceding paragraph.

In China, there are two levels of authority responsible for deciding whether an enterprise is due for special treatment. One of these is the foreign economic relations and trade department of the province, the autonomous region, the municipality directly under the central government, the municipality specially listed for its own planning, or the people's government of the special economic zone. However, authorisation of an enterprise for special treatment by the State Council is supposed to be uniformly verified and confirmed by the MOFERT. This system implies that there are various verification authorities at local level who make judgements based on their own knowledge and experience. As a result, a technologically-advanced enterprise in Ningbo, for example, might not be qualified by Shanghai authorities if it were located in Shanghai.

China has obviously benefited a lot from the technologies brought in by foreign investors. These technologies were regarded as being not only highly-advanced, but also well-applied and likely to carry forward the technical progress of many sectors such as automobiles, electronics, energy, communications, glass, machinery and medicine. There were lots of examples.

* Within its first-operating year, the joint venture formed by the Beijing Boiler Factory and Canadian company produced 200-Megawatt power station boilers which had never been produced in China before; in its second year, the venture supplied 300-Megawatt power-station boilers which met the technical requirements of internationally-acknowledged ASME norms; in the third year, the venture won a tender for providing 600-Megawatt power station boilers for Beilun Port in Ningbo city. This venture ran up three steps within three years, enabling China's design and manufacture of power station boilers to come to advanced world standards, and entering the highly-competitive international market.

* Shanghai Volkswagen Automobile Co. Ltd. produced 60,000 Volkswagen cars per year, making China's car-producing technology leap over 30 years, and bringing along technical progress in related industries such as rubber, steel, electronics.

* China Otsuka Pharmaceutical Co. Ltd introduced the advanced technology on which 40 years had been spent in R & D in Japan. The quality of its products reached the internationally-accepted GMP standards.

Some other ventures with foreign investment, such as Schindler Elevator, Beijing Jeep, Shenzhen Magnetic Head, Shanghai Sensor, Ningbo Permanent Magnetic, Shanghai Dajiang Chicken, Guangzhou Conductive Rubber, Fujian Feed Additive, were also accepted as being highly-technologically-advanced and well-applied.

We could add more examples to the list, but, as the statistics show, the majority of foreign investors supplied their ventures with ordinary technologies. A survey conducted by Chen et al. (1990), investigated 30 Chinese-foreign joint ventures. They found that there were only five foreign partners who transferred technologies. The technology provided by one partner was unfortunately not appropriate. That by a second foreign partner was similar to the technology which had already been developed in China. A third was only a recipe for a kind of input, and if the venture had used this input all the raw materials for the input must be imported. This recipe therefore was regarded by the Chinese party as being of little significance and as increasing the burdens of the venture. However, the remaining two ventures obtained appropriate technologies and the foreign investors promised to transfer technologies dynamically, i.e., continuously supplying the new technologies developed by their parent companies.

While the majority of foreign investors transferred general technology, some foreign businesses used obsolete machinery and equipment as their investment. A foreign partner in a joint venture contributed as investment a set of second-hand equipment. One year later this venture paid the maintenance and repair fees of RMB 800,000, accounting for 51.6% of the original price for that used equipment (from personal communications). Another foreign investor contributed as his investment machinery and equipment equal to RMB 6.85 million. Two years later, RMB 1.3 million was lost as the fixed assets were scrapped and another 0.9 million was paid as the maintenance and repair fees (from personal communications).

Technology transfer is a very sensitive area of multinational ventures' operation. Responsibility for the low proportion of ventures which acquired appropriate and advanced technology might lie on both sides. As for foreign investors, "technological invention is such a prized asset that it is usually patented and jealously `guarded' by its investigators" (Neale & Pass, 1990). As a result, technologies, skills and analytical methods transferred in many cases were related only to production of established

items. Key technologies which involve new product development may not be easily transferred.

Chinese institutional arrangements had an impact on technology transfer. Article 46 of the Regulations for the Implementation of the Law on Joint Ventures may reduce the willingness to transfer technology. The article asserts that "the time of a technology transfer agreement shall not, in general, exceed 10 years". Obviously, it did not take into consideration the suppliers' interests after 10 years. Another problem found by the present author during his survey was that the Chinese partner in a joint venture spread the technology to local enterprises without obtaining permission from the foreign partner. As a result the foreign investor was not willing to transfer further technology (personal information from a leading foreign firm).

The Chinese government requires that fees paid for the use of the technology shall be fair and reasonable. Payments shall generally be made in the form of royalties, the rate of which shall not exceed the standard international rate. According to the existing information, a majority of the Chinese partners found that prices for technology transfer were reasonable.

2.3. Management skills

Management is another kind of resource transferred to host countries when foreign investors set up multinational ventures there. It can have a positive impact. Directly, it may improve entrepreneurial ability and hence the efficiency of these ventures. Indirectly, local personnel who are trained in these ventures may later transfer to indigenous ventures, helping improve management skills there. Indirectly again, the multinational ventures may have positive demonstration effects on the local economy. But the multinational ventures may exert fewer beneficial effects if the management is mostly reserved for foreign staff, or even have a negative impact if the management skill does not apply to normal operating realities in host countries.

There were three categories of management in the Chinese-foreign joint ventures, and the extent to which management skills were transferred varied among them.

The first kind was direct management by a parent company, usually by a Chinese one. In this case, what a foreign partner did was the investment. He or she was involved in little business administration. The methods of management in the main followed the

Chinese parent company's and little change happened. Though this Chinese-side management made internal co-ordination of business matters easy because there was no cultural conflict, it could not give free rein to the foreign partner's advantages in operational management.

There were no national statistics on the percentage of the ventures with foreign investment that practised this kind of management. However, two separate sample surveys may provide some information. One was conducted by the present author. His study indicated that about one-third of the seventeen sampled ventures with foreign investment were directly run by local Chinese. Chen et al.'s survey found an even higher percentage: among the thirty sampled ventures there were sixteen in which the foreign partners did not participate in direct management.

Such a venture was characterised by joint capital, but little joint operation. It did not conform to one of the main purposes for China's absorbing FDI: to introduce modern management skills.

The second category was Chinese-foreign joint management. Under this arrangement, administrative duties were shared by Chinese and foreign managerial personnel recommended by the parent companies. This had been thought to be an ideal model: while the foreign party could get to know the Chinese cultures, obtaining experience of doing business in China, the Chinese party could learn, absorb and digest advanced management expertise, though the parties had to compromise between the different cultures. But it should be noted that the methods of sharing responsibility were important. In some cases, the Chinese and foreign partners divided all important duties, instead of being jointly responsible for each of them. For instance, the Chinese partner would deal with personnel matters and internal marketing, and the foreign partner with international marketing. The original purpose of this arrangement was to use each partner's strengths better, but not a few foreign investors tended to keep their international marketing skills and networks firmly in their own hands. Instead of transferring their marketing expertise, some foreign partners concealed the marketing information, obtaining large profits by supplying the ventures with machinery, equipment, and raw materials, at higher than world-equivalent prices and purchasing the ventures' products at lower than world-equivalent prices. This kind of "transfer pricing" was not rare in the ventures with foreign investment in China. Some examples are given below.

The last category was contracted management. In this case, a board of directors and a contractor signed an operational contract, under which the contractor took full responsibility for the venture's operational management. The contractor could be the foreign party, the Chinese party, or a Chinese-foreign joint-management team, or even a third party. This arrangement allowed the contractor to make full use of his initiative and expertise. However, under either form of one-party management, the venture could be expected to exhibit short-term behaviour because of absence of, or low level of, equity in the venture on the part of the contractor, and a transfer of the management skills from foreigners to local personnel would be very limited.

Section 3 Income Effects

Income effects may include changes in national income and income distribution caused by FDI. Because of data limitation, this study measures only the effects on national income.

There are three ways to estimate income effects of FDI in China. Firstly, Chinese authors tend to evaluate total gains from the ventures with foreign investment rather than separating out the part contributed by the foreign investment. For example, according to MOFERT, by July 1990, more than 25,000 ventures with foreign investment had been approved by the Chinese government. Among them, there were about 14,000 EJVs, 8,600 CJVs and 2,300 WFOEs. About 11,000 ventures were in operation, engaged in energy, communication and transport, metallurgy, electronics, chemical engineering, machinery, building materials, light industries, textiles, medicine, agriculture, forestry, animal husbandry, fishing and tourism. In 1989, the total gross value of the products of the ventures in operation reached RMB 43.6 billion, accounting for 1.5% of China's total gross value of industrial and agricultural products. Tax revenues from these ventures were RMB 3.6 billion, equal to 1.3% of China's total tax income.

As you may see from the preceding paragraph, the total product of 43.6 billion and the tax of 3.6 billion were the joint contributions of foreign and Chinese parties. It is extremely hard to distinguish the portion of these contributions made by FDI only and that by the local Chinese.

Zhang and Hu's study also falls into this category, evaluating total gains, but it offers more information. In 1988, the total value of products of the sampled 4,127 ventures with foreign investment in operation was RMB 22.74 billion, equal to 1.36% of China's total value of industrial and agricultural products; about 70% of these ventures made profit which was RMB 2.615 billion, accounting for 2.25% of the total profits made by China's enterprises. In 1988 the 4,127 ventures paid taxes of RMB 3.283 billion, being 3.13% of the total tax revenues from China's enterprises. The Chinese parties obtained profits of RMB 0.485 billion, contributions to employee benefits of RMB 0.247 billion, land-use fees of RMB 0.053 billion, plus wages and salaries of RMB 1.397 billion. China had total gains of RMB 5.465 billion, equal to 2.11% of China's fiscal income in the same year.

Though the above studies do not give us a satisfactory estimate of the foreign investors' contributions, they both seem to imply that FDI made a positive contribution to China's national income. However, we should have some reservations to this judgement if we followed the methods of social cost-benefit analysis described in Chapter 2: to make this judgement we should really need to know how far China's pricing system reflected true social costs and values. Unfortunately, it is difficult to know this matter in a centrally-managed economy.

A second way to evaluate the income effect is to compare tax-payment per person by the ventures with foreign investment with that by indigenous firms. Table 9.2 shows the relevant data in the two kinds of firms in Beijing in 1988.

Table 9.2. Output & (Tax + Profit) Created by MNEs & All Local Firms

Type	Labour productivity (yuan)	Tax+profit per person (yuan)
MNEs	83,000	11,400
Local	43,684	7,600

Source: *Zhuhai Special Zone Daily*, 19.9.1990.

We can see from the table that the ventures with foreign investment were more productive per worker than the local firms, and that they could therefore create more profit and tax per person. But there are two reasons for doubting that this gives a comparison of efficiencies: (1) Patterns of industries and typical production functions

may have been different. (2) Price distortions may have affected the two groups differently.

While FDI may have certain positive effects on China's national economy, it exerted a negative impact through some MNEs' transfer-pricing and tax-avoidance or evasion practices. The transfer price in general means the price at which a transfer or sale of goods takes place within a firm, regardless of whether or not the firm spans different countries. Such prices can be quite different from the prices that would obtain in arm's length transactions, and therefore can be used to shift profits between affiliates and the parent company or between affiliates themselves. The main factors that motivate shifting of profits by transfer pricing include inter-country differences in tariffs, taxes and subsidies. In China, some MNEs practised various ways of transfer pricing or tax avoidance or evasion, and therefore profit shifting.

The first one was "higher entry and lower exit" (See Luo, 1990). Higher entry means that foreign businesses contributed as their investment machinery, equipment, components, raw materials and industrial property at higher prices than average ones in the international markets. For instance, one joint-venture contract stipulated that the foreign party should use cash as investment. But later he was allowed to contribute jade materials instead and he offered the materials for US$ 400,000. The Chinese party then offered $200,000 and the foreign investor accepted. But later the experts found that the jade was worth only $30,000 - $50,000.

Lower exit means that foreign partners were responsible for selling products at lower than world prices. Through this practice, they transferred the industrial profits which should belong to the ventures to their foreign parent companies or subsidiaries. One of many examples was a joint equipment venture in which the foreign partner had the exclusive selling rights. He gave the venture US $5,600 per set which he sold abroad at $8,000.

The second way was to report to tax authorities their sales revenues omitting major parts of what was in fact sold; taxes thus were greatly reduced. A WFOE, for instance, produced TV sets which were bought and resold by another enterprise to the domestic market; the consolidated industrial and commercial tax was paid by this WFOE. But, after reaching an agreement between the two ventures, the WFOE sold TV sets at a price which did not include that of the tricolour tubes and reported the

taxable income in this way. When 20,000 sets were sold, the WFOE avoided tax of RMB 5,000,000 (ibid.).

The third method was by false invoicing. A typical example was as follows. When a venture with foreign investment was selling its products, customs duties on the imported materials were paid by the potential buyers. Then, the products were invoiced at a lower price, for example, excluding the customs and other taxes on imports though actually sold for the full price. The seller thus avoided some of the CICT (`turnover tax') that would otherwise be payable on the output (ibid.).

Other methods such as false declaration of taxable income, costs, or investment amounts, were often found among the ventures with foreign investment.

By these ways, especially the first, some foreign partners controlled their ventures' reported profits. They made the ventures register a loss or a small profit, while transferring part of the ventures' earnings abroad without paying any taxes. This explains a very strange phenomenon in the field of FDI in China: though some ventures with foreign investment made losses, the foreign partners were still eager to expand production.

Section 4 Employment Effects

Employment effects of FDI on a host country can be both direct and indirect. Direct effects mean jobs provided by the ventures with foreign investment; indirect ones mean jobs generated in local suppliers and customer industries, jobs created through multiplier effects of the ventures with foreign investment, and jobs lost as a result of the new competition.

Studies indicate the overall impact of FDI to be strongly employment-creating in most host countries. This was also true in China. But it is difficult to estimate this impact quantitatively because of dearth of data.

According to *Zhuhai Special Zone Daily* 10.9.1990, 1.5 million Chinese were employed by more than 10,000 ventures with foreign investment which were in operation. However, not all of these jobs were newly created because of FDI because

different categories of the ventures with foreign investment played different roles.

There were three main forms of FDI in China, i.e., equity joint ventures (EJVs), contractual joint ventures (CJVs) and wholly-foreign-owned enterprises (WFOEs). WFOEs were often newly established enterprises and jobs supplied were newly created.

With the remaining forms of FDI, things were different. There could be several ways to form an EJV or a CJV. In the first case, both Chinese and foreign parent companies agreed to set up a new plant, and to recruit employees mainly from the public, and perhaps partly from the Chinese parent company. The venture established was called a "newly-built" EJV or CJV. To a large extent, this venture played the same role in job-creation as a WFOE did. In the second case, a foreign company invested in a Chinese company which contributed its plant, equipment and site as its investment. The joint venture formed in this way was referred as to a "married" JV. Under this arrangement, the Chinese company might contribute all its assets to establish the JV, but it might also set aside part of its assets to do so. The married JV usually recruited employees from the Chinese company. As a result, not many new jobs were generated.

Of course, the above analysis is based on the assumption that a WFOE or a newly built JV constitute an enterprise that would not otherwise have come into being.

There were no national statistics available on the percentage of the ventures which created new jobs and those which did not. However, the two separate sample surveys by Chen and the present author both indicated that about half of their sampled ventures were of the married nature. If this figure was close to the population proportion and average employment per enterprise was roughly the same between the married and the rest, then about 0.7 million Chinese people might have got new jobs in newly created enterprises because of the FDI. Clearly this figure can be no more than the roughest indicator.

It is likely that the higher the unemployment in a host country, the stronger the job-creating effects of FDI. In China's official statistics, there was no unemployment rate, because it was believed that there should be no unemployment in a socialist country; there was simply a percentage of people in cities and towns who were "waiting for employment". These people waiting for jobs were generally school-leavers. People

who were willing to work but had no jobs were of course equal to the involuntarily unemployed. In recent years, the percentage of the people waiting for employment has been used as the unemployment rate in China's economic studies. The unemployment rate in recent years was only around 2%. This figure might to be taken to suggest that the employment effects of FDI in China were not significant.

However, the 2% was only the open urban unemployment. There were other categories of unemployment. One was countryside unemployment. The other was disguised enterprise unemployment.

With the adoption of the contracted-responsibility system which linked remuneration to output and to improvement in rural labour productivity, labour's supply in the countryside exceeded its demand. It was estimated that there was a superfluous labour force of 120 million (See Tu, 1989). If they were to be regarded as semi-employed, the unemployment in the countryside would be the equivalent of 60 million, and the rate of disguised rural unemployment would be 15% in a total rural workforce of 400 million. It was merely because the rural labour force attached themselves to land that their unemployment took the hidden form and did not present a serious social problem.

By definition, disguised enterprise unemployment means the superfluous labour force in enterprises. Chinese enterprises in general absorbed more labour than they really needed. It therefore led to "one person's work done by three, three persons' rice eaten by five". It in fact transferred part of the unemployed people in society into enterprises, reducing the rate of open unemployment at the cost of raising the disguised rate in the enterprises and reducing the apparent efficiency of the employment. Again from Tu, there were more than 20 million superfluous workers in state-owned enterprises. If they are treated as semi-employed, the rate of hidden enterprise unemployment was 10% in an enterprise workforce of 100 million.

Combining both open and hidden rates of both enterprise and countryside unemployment, the real rate of unemployment in China would be about 16% in a total workforce of 500 million. If this was the case, the inflows of FDI could make large contributions to increasing employment. Even if foreign businesses invested in existing Chinese firms rather than building new ones, their action might lead to an increase in output and an improvement in efficiency, and so reduce the rate of hidden enterprise

unemployment.

Some authors list wage and salary impact as a component of the employment effect of FDI. Studies by Mason & Stewart (1976), and Ingles & Fairchild (1978) showed that foreign multinationals in some developing countries paid higher wages and salaries than did local firms in the same industries. Grosse's survey (1988) in Venezuela did not confirm the previous studies. The Chinese evidence would surely indicate that employees in the ventures with foreign investment could get higher incomes than those in state-owned enterprises. There were three reasons. Firstly, the Ministry of Labour and Personnel of China had set up a minimum level of salaries or wages for employees in the ventures with foreign investment, which was 120% of the average salary in state-owned enterprises with similar conditions in the same areas. Secondly, by contrast with state-owned enterprises, ventures with foreign investment in China could practise a flexible management system, offering higher salaries and other benefits to attract qualified people away from their existing jobs. In China, when ventures with foreign investment recruited from the public, the numbers of applicants were usually dozens, and sometimes even hundreds, of times higher than the actual numbers needed by the ventures. Finally, as has been mentioned, the ventures in general had higher labour productivity. As a result, it is not surprising that their employees received higher incomes.

There are no data available on the national average salary for ventures with foreign investment. But, according to the present author's survey of seventeen ventures, the average salaries in these firms were 2.17 to 5 times as high as those in state-owned enterprises.

Section 5. Trade and Balance-of-Payments Effects

Measures of trade and balance-of-payments effects usually include four parts, namely, the export effect; the import-substitution effect; the import effect; and the repatriation effect. By taking all the parts into account, we can examine the net impact.

When FDI enters a host country, the capital account of the country's balance-of-payments benefits from the initial foreign-exchange inflow. But it may be a once-for-all effect. Later or contemporaneous operations of ventures with foreign investment

may involve imports of raw materials and components from abroad. And they will repatriate dividends, profits, interest, royalties and administration fees to their parent companies. The import and repatriation effects are adverse on the host country's balance-of-payments. But on the other hand, MNEs may lead to exports or import substitutions and therefore exert a positive impact on the host country's balance-of-payments.

The Chinese government has been particularly concerned about the trade and balance-of-payments effects of FDI. This concern is based on two facts. As a developing country China needs foreign exchange to import advanced technology, equipment and products for its four-modernisations program. On the other hand, its currency the renminbi is not convertible because foreign exchange is under-valued in Rmb. The lack of foreign exchange will remain a major problem in the long run. Facing this problem, the Chinese government decided to use FDI as one of the basic sources for introducing foreign capital and technology and increasing the country's foreign exchange income and reserves.

To fulfil this purpose, the Chinese government generally requires that a venture with foreign investment shall be responsible for the balance of receipts and expenditures in foreign currencies, except for a venture that introduces new technology which China does not have, or can produce products that fill a gap in China's own production and that are in urgent demand in China, or for a venture which produces import substitutes.

To fulfil this purpose, the Chinese government has since 1986 also granted special preferences to export ventures with foreign investment. An export venture is one in which the products of the venture are mainly for export, and which has a foreign-exchange surplus after deducting from its total annual foreign-exchange revenues the annual foreign-exchange expenditures incurred in production and operation and the foreign exchange needed for the remittance abroad of the profits earned by the foreign investors.

Though there are no data available on the ventures' imports, repatriation and import substitutions in the official publications such as China's Customs Statistics, or the Almanac of China's Foreign Economic Relations and Trade, we can find other relevant information provided in newspapers and journals, which can help to estimate

the net trade and balance-of-payments effects.

Table 9.3 Export & Foreign Exchange Positions Of MNEs (US$ Billion)

	1985	1986	1987	1988	1989
Exports of MNEs (gross)	0.32	0.48	1.00	1.75	3.59
% of above in total exports	1.2%	1.8%	2.9%	4.3%	8.3%
Foreign-exchange position	n.a.	+	+	+	+
Sale of Foreign exchange*	n.a.	n.a.	n.a.	0.62	1.57
Purchase of foreign exchange*	n.a.	n.a.	n.a	0.22	0.49

Source: *People's Daily*, 2.8.90; *International Business*, 10.7.90; Wu, 1989; Wang, 1990.
* in foreign exchange adjustment markets

From the table we can see first that exports by the ventures with foreign investment increased quickly in both absolute and relative terms. In 1989, the value of their exports was eleven times as high as in 1985, and their share in China's total gross exports also increased from 1.2% to 8.3% during the same period. The ventures with foreign investment in China were regarded as rapidly increasing source of exports.

The figures of exports by the ventures with foreign investment in the table are underestimated, because some of the ventures with foreign investment did not export their products directly by themselves; rather they sold them to China's foreign-trade companies that resold abroad. These quantities of exports are not included in the statistics though the ventures were regarded officially as the origin of the exported goods.

FDI could often involve import-substitution with inputs or with final products. As a result, imports of such goods would be reduced as they were replaced by home products. This import-substitution effect was similar to the export one, and was also encouraged by the Chinese government. Though we could give a long list of examples of import-substitutions generated by FDI in China, no aggregate data were available for a detailed assessment.

However, FDI would lead to imports of raw materials and components from parent companies or other subsidiaries for local assembly. The more import-intensive was a FDI project, the more unfavourable the trade effect it would have. Furthermore,

various payments of dividends, profits, interest, royalties and administration fees to the parent companies could have an adverse impact on China's current account.

Though we lack the data on imports and repatriation by the ventures with foreign investment, we can note from Table 9.3 that from 1986 these ventures as a whole maintained a positive balance of direct receipts and expenditures in foreign exchange. This means that the ventures could earn enough foreign-exchange income to cover expenditures on imported raw materials and components; salaries for foreign employees; and dividends for foreign investors.

Table 9.3 also shows the transactions of the FDI ventures in China's foreign-exchange-adjustment market. In 1988, they bought US $ 0.22 billion but sold $ 0.62 billion, so that their net supply of US dollars was 0.4 billion. In 1989, that figure increased to 1.082 billion. A net supply of foreign exchange implies an apparent foreign-exchange surplus, hence a positive contribution to China's foreign-exchange reserves.

Section 6 Structural & Regional effects

6.1. Structural effects

For a long time China put undue stress on heavy industry. As a result, agriculture and light industry became relatively weak and the economy was developed unevenly. From 1979 to 1983, China carried out a policy of "adjustment, reform, rectifying and improvement"; the economic structure was gradually improved; agriculture grew steadily; light industry developed quickly; and the internal structure of heavy industry was adjusted. As for national income distribution, the over-high accumulation rate was reduced gradually and people's living standards were raised to a certain extent.

However, from the last quarter of 1984, the economy was overheating again and the slightly improved economic structure again worsened. First, agriculture could not meet the needs of the national economy. From 1985 to 1988, the yield of major agricultural products fluctuated. The grain and cotton outputs did not exceed those of 1984. In the corresponding period, industry increased at a high rate of 17.8% per year. Consequently, agricultural products as raw materials for industry became further insufficient; the grain yield per capita of population reduced between 5% and 8% because of the net increase in population of 15 million each year.

Secondly, the basic sectors such as energy and raw materials were relatively weak while processing sectors developed too fast. Between 1982 and 1988, output of the basic sectors increased by 9.3% per year, but that of the processing sectors increased by 14.2%. This led to an expansion of the gap between primary and intermediate goods on the one hand, and final goods on the other. It was estimated that 20-30% of China's productive capacity was not utilised normally because of the electricity shortage.

Finally, growth of transport capacity did not match the quick development of the national economy. From 1979 to 1988, the rotation volume of goods transport increased by 9.3% per year while GNP and total industrial output increased by 9.6% and 12.8% per year respectively.

What kind of role did the FDI play in the structural changes of China's economy? The answer lies in an analysis of its sectoral distribution. From Table 9.4 we can see that, in the period from 1983 to 1989, the FDI flow into the agricultural, forestry, husbandry and fishing sectors accounted for only 2 to 4 per cent of the total FDI, while the proportion in the industrial sectors increased very quickly . This shows that FDI did not help to mitigate the imbalance between agriculture and industry. Rather, it helped widen that gap. Secondly, the percentage of the FDI flow into the transport and communication sectors declined from 3% to 1%. This fact indicates that the FDI failed to increase the relative capacities of these two sectors since the overwhelming proportion of it flowed into other industrial sectors.

This judgement is, however, based on China's industry policy. There is an implied assumption here that different sectors of the economy should grow at the same rate and that the country should be self-sufficient in food. Development has usually meant that a much more rapid increase in manufacturing, value added (and in that of certain services) than in that of agriculture. As a matter of fact, most industrialised countries are not self-sufficient in all raw materials.

Even if we use China's industrial policy criterion, FDI itself should not be blamed for worsening the economic structure. To know the reasons, we should consider the problems left by China's old economic system and those that arose from the current economic reform.

Table 9.4 Structural Distribution of FDI Inflow in China (percentage)

Year	83	84	85	86	87	88	89
Agriculture	1	3	2	2	3	4	2
Industries	14	21	38	28	48	76	83
Offshore oil	53	-	6	-	-	-	-
Building	3	3	2	1	-	2	1
Transport & communication	3	3	2	1	-	2	1
Commerce & tourism	7	36	8	4	1	1	1
Real estate & public utilities	-	-	36	57	40	10	9
Hygiene & welfare	-	-	1	1	-	-	1
Culture & education	-	-	-	1	-	1	-
Scientific research	-	-	-	-	-	-	-
Finance	-	-	1	-	-	2	-
Others	19	33	5	4	6	4	1
TOTAL	100	100	100	100	100	100	100

Source: *Almanac of China's Foreign Economy & Trade*, 1984-1990.

One of the major problems in China's price system had been the relatively high prices for finished manufactures and the relatively low prices for goods and services of the basic industrial sectors (raw and semi-processed materials and fuels). This problem was not practically corrected in the reform. The funds-profit rate for many manufacturing sectors was 14%, whereas that for the energy and raw-materials sectors was 6-11%. The income gap between the agriculture and the non-agriculture sector was large. The return from the former was only 1/3 of that from the industrial and commercial sectors. On the other hand, the economic reform so far had concentrated on giving more autonomy to enterprises and local authorities. This led to the emergence of decentralisation of investment decisions and the multiplication of the market of individual investors. As a result, in total social investment in fixed assets, investment from the state budget has accounted for only 13% in the past several years. Though most of the state investment entered the energy, transportation and raw-material sectors, the preponderance of the total social investment and bank loans flowed into manufacturing sectors in which the prices were high and the recovery period was short.

FDI in China followed this pattern, and was integrated into such a sectoral distribution. Though the central government encouraged FDI in basic industries, as it

encouraged export-oriented and technologically-advanced enterprises with foreign investment, and, though it did attract some huge FDI projects in the basic industries such as Pingdingshan Coal Mine, Dayawan Nuclear Power Station, Pingshu Open Coal Mine, and some other power stations, ports and motor ways, the bulk of the FDI approved by local authorities flowed into high-profit manufacturing sectors.

FDI also affects the particular industry where it is situated. The impact can be either positive or negative, depending on whether the investment meets that industry's particular needs. As has been mentioned in the second section of this chapter, the evidence shows that the automobile, super-volt power-station-boiler, lift, sensor, poultry and some other industries did benefit from FDI in that it upgraded the technologies and improved the product structures of these industries. A typical example was the automobile industry.

It is widely believed that an automobile industry is a mark of an industrial society, for automobiles are highly comprehensive final products which involve many other industries such as electrical, iron and steel, and rubber, and are of large-scale production. Consequently, developed countries often regard it as a crucial industry which brings along the development of other industries and regions.

China's automobile industry was backward. First, the internal structure was lopsided in terms of car output in relation to use. In the mid 1980s, the main product of the industry was medium-sized lorries, and car-production was almost nil. In 1986, the ratio of domestic supply of cars to demand for them in China was 0.05, while in USA, Japan, West Germany, South Korea and Brazil it was 0.68, 2.41, 1.34, 1.27 and 1.37 respectively (See Li, 1990). Secondly, the industrial organisation was loose. Though there were three large automobile groups (Jiafang, Dongfeng and Heavy), the factories were located separately with no advantage taken of scale-economy efficiency. Thirdly, the management and technology of the industry was also backward, and the products lacked competitive power in the world market.

With a shift of the development strategy of China's automobile industry from the medium-sized lorries as key products to cars, three "bases" and three "production points" (smaller complexes) began to emerge in which FDI played a very important role: China's No.1 Automobile Factory and Volkswagen Group jointly produce high-grade Audi and ordinary Golf cars in Changchun; No. 2 Automobile Factory and one

French automobile company co-operate in manufacturing cars in Hubei; Shanghai Group and Volkswagen Group have worked together to make middle-grade Volkswagen cars in Shanghai. In addition to these three bases, there were the smaller establishments: Guangzhou Peuguot, Tianjin Xiali and Beijing Cherokee Jeep manufacturing companies. And the American Panda Group would also set up a wholly-foreign owned company in Huizhou, Guangdong Province. Because of the FDI in the industry, China's car-manufacturing technology made a great leap, spurring on other related industries.

However, in certain areas for certain periods, excess of certain types of FDI also caused lower return rates and inefficiency. For example, before 1986, too many luxury hotels had been built in Guangdong, Beijing and Shanghai. For example, in one SEZ, 38 large and medium-sized high-grade hotels appeared during 1979-1985, among which 12 were with foreign investment. In order to attract the limited Hongkong and Macao tourists, they reduced their accommodation fees during the 5 years between 1982 and 1987. Even so, the average rate of room occupancy was still less than 40% and all the hotels made a loss (from personal communications). In another SEZ, there were too many enterprises with foreign investment engaged in fitting up buildings, so that losses were incurred in almost all of them.

The over-provision of such enterprises was mainly due to the local authorities. Some of them approved FDI projects only for the sake of approvals. The more FDI came to their jurisdictions, the more highly their achievements were regarded. Technical and allocative efficiency was another thing. The outcome shows that the performance of FDI partly depends on a host country's bureaucratic mechanism.

6.2. Regional Effects

According to the growth-poles theory, growth does not appear everywhere at the same time. The higher rate of growth is often found in certain propellant industries. Because these industries are usually located in big city centres, these centres become the growth poles. The most positive effect of the growth poles on a national economy is their "spread" effects on the peripheral areas but these have to be set against the "backwash" effects. On the one hand ("backwash"), the centripetal force makes relevant industries and supplementary firms gather around the propellant industries and more factors of production flow into the poles. On the other hand ("spread"), the centrifugal force lets the poles diffuse technology, organisation, factors and

information into linked/stimulated industries in the peripheral areas. According to the optimistic view of them, it is the poles at various levels that bring along the development of the national economy at various growth points.

The positive regional impact of FDI in China was to help set up new growth poles, or revitalise existing ones, which in turn spurred on regional and national economic development. The four SEZs were examples of newly-born growth poles.

Ten years ago, Shenzhen, Zhuhai, Shantou were backward border towns and Xiamen was also a small city. After they became SEZs, they turned quickly into new modern cities. Because of their relatively good investment environment, 1/4 of the FDI in China was located there. In 1989, the total industrial output in these areas was over Renminbi 21.4 billion, 17 times as high as 10 years before. In these areas electronics, textiles, light industry, building materials, foodstuffs, plastics and machinery, together with agricultural-product processing industries, developed very quickly. The export-oriented economic structure with foreign capital as the main financial source was formed. And the industrial output of the ventures with foreign investment accounted for 51% of the total (*People's Daily*, 27.8.90).

During the period of "self development", the first years of the SEZs, they radiated arrows of exchange and promoted the growth of the national economy. Because of the differences in geographical location, resources, and economic and technological conditions, this radiant effect acted from the near to the distant through several gradations.

The first gradation was the adjacent areas around the SEZs in which the radiant effect was direct and strong. Shenzhen City was divided into two parts: Shezhen SEZ and Bao-an County. There has been close co-operation *between industry and agriculture*, and between the city and the countryside. The SEZ absorbed labour, agricultural products and raw materials. But on the other hand, it supported the countryside with advanced technology, equipment, information and industrial products, bringing along the county's take-off. According to the *Almanac of China's Statistics*, the total industrial product in Bao-an County in 1988 was Renminbi 1.34 billion, more than 3 times as high as that in 1985.

The second gradation was the large area near the SEZs. In the absence of the SEZs,

Guangzhou had been the growth pole in the Zhujian (Pearl) River delta area. The growth was radiating from Guangzhou to the south, and the radiant effect reduced gradually with distance. After the establishment of Shenzhen and Shantou SEZs, two more growth poles were added in the south and the radiant effect acted from both north and south, accelerating the development in the delta area.

The last gradation was other areas in China. At this level the SEZs regarded other areas as auxiliaries while the other areas treated the SEZs as a "window". They complemented each other. The SEZs diffused advanced technology, management skills, and market information into the other areas by setting up integrated complexes linking local enterprises to ventures with foreign investment for reciprocal help, by co-operative production, and by offering various training courses, to help them develop. Shenzhen Aviation Standard Component Co. Ltd. transferred key technology to Tianjin, Yantai, Dalian and Hangzhou. Shechou China Silk Co. was integrated with Zhejiang Silk Co. to process deeply and pack delicately the grey silk provided by Zhejiang Province so that there was a 40% increase in price in the international market. Shantou SEZ processed white pottery provided by the interior area equal in value to HK$ 100 million each year, bringing along the development of the interior ceramic industry. By the end of 1988, the ventures with foreign investment in Xiamen SEZ alone had invested Renminbi 900 million to set up 935 integrated complexes with local enterprises located in more than 20 provinces, and the production co-operation among the integrated complexes gradually developed into science and technology co-operation (see Zhang & Hu, 1990).

In the same way FDI in non-SEZ areas also exerted a radiant effect to spur on development of related sectors. The American partner in Beijing Jeep Co. Ltd. invested dynamically with high technology. By the end of 1989, the company transferred 2,123 items of technologies and integrated 150 enterprises or institutes in 21 provinces to form a "National Content Complex", promoting technical progress in the relevant sectors. Shanghai Dajiang Chicken Co. spread technology and management skills to several provinces, helping create thousands of private individual enterprises engaged in chicken raising, and a similar number of chicken-farming "Wan-yuan-hu" (rich families with money deposits over Renminbi 10,000) (Zhang & Hu, 1990).

While SEZs as the new growth poles helped economic development in the vast non-

SEZ areas, they, together with some foreign-trade companies, managed to exploit the country's foreign-exchange control to achieve a redistribution of income favourable to themselves. The first negative impact was generated by the so-called "SEZ mechanism" (see Yang, 1990). It resulted inevitably from the contacts and integration of the two different systems, China's domestic economy and the external market, when the policy of opening to the outside world was pursued.

The preconditions for the SEZ mechanism were the very existence of the differences between domestic and external prices and between domestic and external currencies. The first difference means lower prices for agricultural and mineral products and higher prices for industrial products in China than in the world market, and the second refers to the artificially high official exchange rate of the renminbi, which was non-convertible. Because of the special policy for the SEZs, enterprises in SEZs could retain all their foreign-exchange revenues. In contrast, enterprises in non-SEZ areas are usually required to export their products though state-owned trade companies and to hand in 70% of the foreign-exchange revenues to the state.

These economic and policy factors made the SEZ mechanism work: enterprises in the non-SEZ areas set up companies (either joint or local ventures) in the SEZs engaged in exporting agricultural and mineral products and importing high-grade consumer goods, to make money by taking advantage of the price differences. Because their imports usually exceeded their exports in cash-value terms, this practice led to a large surplus in the Renminbi and a deficit in foreign exchange. These companies then carried out arbitrage transactions to exchange Renminbi for foreign currencies. The SEZs were close to Hongkong where there were lots of businessmen going to the mainland everyday. According to China's foreign-exchange control regulations, they should exchange HK$ for Renminbi at the official rate of 1:0.47 at the China Bank. But the companies in the SEZs did the transactions in private with these businessmen at a higher rate for the HK $, and, so long as the price difference was greater than the exchange-rate difference, these companies could still make profits. Thus the SEZ mechanism reduced China's foreign-exchange revenues by taking advantage of the distortion in domestic prices and the fact that they could retain all their foreign-exchange receipts.

The new growth poles formed mainly by FDI and supported by China's special policy also tended to transfer wealth from the other areas to the poles and, as explained in

the next paragraph, to shift inflation in the opposite direction.

China's economic reform was market-oriented and the open areas were encouraged to develop a market economy ahead of the rest. According to the central government's arrangement, Guangdong became the first province that was allowed to carry out a free-price policy. This policy led to the practice of relatively high prices, high salaries and high consumption in that province, especially in the SEZs and Guangzhou city. The high prices attracted, from the neighbouring provinces, agricultural products which were subsidised by the government. The continuous inflows of low-price goods made it possible to keep prices in the poles from rising higher than intended, while prices in the neighbouring provinces went up quickly as a result, and the effect spread to other provinces as well, though salaries in both neighbouring provinces and other areas were still low. As a result, the gap in real personal income of salary-earners between the growth poles in the open areas and other regions was widened.

This negative regional effect of FDI was again caused by a lack of policy co-ordination. After the Chinese government depreciated its currency and made the preferential treatment more industry-oriented than region-oriented, the unfavourable effect was reduced to a certain extent.

Section 7 Conclusions

From 1979 to 1992, there were about 84,000 ventures with foreign investment approved by the Chinese government, and about half of the ventures were in operation. The total FDI utilised had reached US$ 34 billion by the end of 1992. Though the absolute amount of the investment was not insignificant, it played relatively little role in China's capital formation because of its very small proportion in China's total social investment in fixed assets.

There were 10 per cent of the ventures in operation which were accepted by the Chinese government as technologically-advanced enterprises. They provided technology, processes and major equipment that brought them within the categories of projects encouraged by the government as being of an advanced nature with methods that could be applied in China. They produced newly developed products or renewed and replaced similar production in China so that they could increase exports

or substitute for imports. The majority of the foreign investors transferred ordinary technology, and some foreign businesses used obsolete machinery and equipment as their investment.

The low proportion of the ventures which provided advanced technology was caused by the sensitive nature of technology transfer itself and the Chinese government's policy. If the Chinese parties modify their policy and enterprises pay more respect to industrial property, that proportion may rise.

Because of the fact that about a third to a half of the ventures with foreign investment were directly managed by local Chinese, the transfer of management skills was also limited. This practice may spring mainly from the view shared by both parties that one-sided (usually Chinese) management could avoid conflicts between different cultures.

FDI probably made a positive contribution to the growth of China's national income. However, the transfer-pricing practices of some of the ventures had in themselves a negative impact on China's national income. This could be reduced by more positive co-operation between investing countries and China, and by progress on the part of the Chinese party in international business (especially marketing) expertise.

Taking into consideration both open and disguised unemployment, China's unemployment rate was very high. FDI helped to increase employment in China.

FDI also apparently made a positive contribution to China's foreign trade and balance-of-payments. From 1986, the ventures with foreign investment as a whole could not only earn enough foreign exchange to cover their corresponding expenditures, they also provided indigenous enterprises with foreign exchange in the adjustment market.

Though FDI had a favourable impact on the internal structure of the industries by producing new products and renewing or replacing old ones, it worsened the overall sectoral structure of China's national economy by Chinese standards. Though FDI helped set up new growth poles or revitalise existing ones and therefore had some positive effect on China's economic development by diffusing technology and information, these new poles, under China's special economic system and policies, led to exploitation of China's foreign-exchange control and an income redistribution

favourable to the poles.

The study of this chapter implies that whether or not the economic impact of FDI is positive depends partly on a host country's government policy and its economic system. An improvement in the government policy or economic system could make FDI more favourable to the national economy.

CHAPTER 10 POLICY IMPLICATIONS

Section 1 Introduction

In chapter 9 we looked at the impact of FDI on the Chinese economy. Since the advantages of introducing the investment overweigh the disadvantages, China has reasons to call in more of it in order to promote the four-modernisation drive.

To attract more FDI, China needs more favourable factors of operation. Though some factors of operation such as natural-resource endowment are beyond government control, policy elements can be largely adjusted by the government. Thus it will be important to analyse policies which affect the level and composition of FDI, and to identify the possible directions for improvement.

As discussed in chapter 8, China is faced with a special pattern of FDI: ethnic Chinese are the major investors; both foreign and resident parties are active in initiating FDI projects; joint ventures are the prevailing form of FDI; and purely conglomerate integration is an important phenomenon. These peculiar features not only put the currently prevailing FDI theories under challenge, but also have important implications for China's policy. For instance, the following questions may be worth discussing: does China's policy reflect these peculiar facts? Can any further suggestions be made? Sections 2 and 3 discuss these interesting issues.

However, our fieldwork also revealed other policy issues. They include general policy stability, location of FDI and foreign-exchange balance. These issues will be examined in sections 4 to 6. Section 7 will provide conclusions.

Section 2 Investment from the Overseas Chinese

As indicated in chapter 8, the overseas Chinese play a vital role in sourcing China's inward FDI. Driven by family and local connections and the Chinese government's incentives, they and their local Chinese partners are both active in originating FDI projects. There are about 55m ethnic Chinese outside the P.R.C.. Though they concentrate in south-east Asia, e.g.: 21m in Taiwan; 6m in Hong Kong; 7.2m in Indonesia; and 5.8m in Thailand, they may be found in almost every corner of the world. The 55m overseas Chinese command resources far beyond their numbers and are often regarded as one of the world's great economic engines (see *The Economist*, July the 18th 1992).

The position of the overseas Chinese as a driving force for China's inward FDI is determined by Confucian values. They are hardworking; they have a strong belief in the value of education and a penchant to save for the future. Because of these characteristics, they have not only developed expertise in doing business but also created one of the world's deepest pools of liquid capital. Examples include Hong Kong's international marketing skills and Taiwan's possession of the world's largest foreign-exchange reserves ($83 billion) and huge bank deposits ($300 billion) (ibid.).

But Confucianism comprises more than just these features. It also advocates an affection for the country and especially for the home and a commitment to the family. Motivated by these factors as well as the Chinese government's preferential policy, the overseas Chinese from Hong Kong, Taiwan and elsewhere have invested in China. Thus expertise and capital among these ethnic Chinese are combined with other necessary firm- and environment- based elements in their home country to improve their combination of their factors of operation.

However, the fact that Hong Kong will be handed over to China poses China's government with a very important policy issue. From 1997 Hong Kong will be treated politically as one special administrative district of China. Thus the two-thirds of today's inward investment that comes from Hong Kong may suddenly disappear from the government's FDI statistics. We know from chapter 6 that the tax burden for foreign investors in China is very light compared with that applied to local Chinese firms, and other forms of preferential treatment are also available to foreign investors.

Because of the difference in fiscal arrangements between foreign and domestic firms, the government has to decide whether investment from Hong Kong should continue to be treated as "foreign".

Politically Hong Kong will be a special administrative district of China from 1997, but we may still have economic-policy reasons to classify the investment from Hong Kong with foreign investment. An incentive consideration is essential here. Because the tax burdens on local Chinese firms are much higher than those that are normal in the world it is neither fair nor wise to subject foreign investors to the fiscal arrangements applied to locals. Thus, unless domestic tax rates change, incentives are needed to help create normal fiscal circumstances for Hong Kong businessmen operating in China. More importantly, incentives induce local Chinese firms to call in FDI. This is because by doing so these local firms can be qualified as enterprises with foreign investment and therefore enjoy preferential treatment. Thus, if local Chinese firms are still to be encouraged to initiate substantial FDI, investment from Hong Kong needs to be treated as foreign.

We believe that some differential treatment between enterprises with foreign investment and local Chinese firms is necessary for China to attract more FDI. To ensure fair competition, the government in 1993 is considering imposing the income-tax rate of 33 percent on all domestic state-owned, collective and private firms (Knight-Ridder, 26/3/93). However we would suggest that the difference between domestic and foreign rates be reduced gradually by lowering the income taxes applied to local firms, and that other forms of preferential treatment for foreign-invested firms be kept. The first suggestion is basically consistent with the Chinese government's proposed policy. Our reason for it is as follows. Though it is true that, the bigger the difference in fiscal treatment, the more incentives the local Chinese firms will have to call in FDI in general, it is also the case that, the smaller the difference, the more careful the local Chinese firms will be to select foreign partners, so that the pre-tax rate of return to enterprises with foreign investment may rise. More importantly, especially since overseas Chinese businessmen are motivated partly by family and local connections, the reduction in the difference (which will lead to a more standard environment for both foreign and local firms but will not worsen the position of foreign-invested firms) is not likely to reduce the enthusiasm of the overseas Chinese. But we suggest a gradual reduction over two or three years in the difference between the income-tax arrangements. Thus the incentive to the Chinese party to call in a

foreign partner can be reduced gradually rather than suddenly.

Though the difference in income taxes between foreign-invested and local Chinese firms needs to be removed gradually, other preferential treatment for foreign-invested firms such as tax holidays would be better continued. Local Chinese firms still need certain incentives to initiate FDI from Hong Kong which is, and failing drastic changes in conditions will still be, the leading investor in the near future.

As described in chapter 5, mainland China has already emerged as the main location for Taiwan's overseas investment. In April 1993, senior officials of quasi-official bodies from mainland China and Taiwan had a summit in Singapore, the first such meeting since the Chinese civil war ended in 1949. They agreed to strengthen economic and civilian ties. Though reunifying and resuming direct trade and investment links may remain distant dreams, this meeting helps the further massive transfer of Taiwan capital. As in the case of Hongkong, investment from Taiwan needs to be treated economically as foreign, even if someday the dream of political reunification becomes true. Thus all parties in the greater China will keep active in economic integration and development.

Section 3 JVs, WFOEs & Conglomerates

Joint ventures are the prevailing form of China's inward FDI. Most overseas Chinese and other foreign investors have their reasons for favouring this organisational form to combine their factors of operation. This choice happens to be consistent with the Chinese government's former policy which discriminated against wholly-foreign-owned enterprises (see chapter 6 for details). There might be two reasons for the discrimination, though they did not exclude each other. The one was related to social ideology: the distinction might arise from a view that WFOEs contained more capitalist elements and foreign control and should be restrained more than EJVs. The other was a desire to test the water before plunging in. We consider them in turn.

First, China's economic reform and the open-door policy have been carried out under the dominance of Marxism-Leninism so that it is no surprise for a non-traditional idea or policy to be assessed on Marxist grounds. As for the forms of FDI, it was widely accepted that a WFOE belonged to private capitalism in that the private foreign

capitalist hired labour with his capital to obtain surplus value. On the other hand, an EJV belonged to state capitalism, for the socialist state's funds and managerial methods were put into the venture. Since the four cardinal principles (including adhering to the socialist road) have been required to be followed, further development of WFOEs should be more strictly controlled because they contained more capitalist features.

The other reason for the discrimination might be that the use of FDI on a large scale was quite new to the Chinese government. The government might not be sure that all forms of FDI were equally appropriate to China's modernisation drive. Since it would take time to establish this point, the government, simply as a matter of expediency, made WFOEs and CJVs subject to less favourable terms than EJVs.

In 1991, Chinese officials realised the importance of a unified income-tax law on ventures with foreign investment and foreign enterprises. For instance, the finance minister admitted that it did not conform to the standard for WFOEs and CJVs to have been subject to the foreign-enterprise income-tax law while EJV were treated more leniently. In addition, the income tax for WFOEs and CJVs was not only higher than that for EJVs, but also higher than that in many other countries such as USA, UK, Singapore and Malaysia, after they had reduced their tax rates in the 1980s. As a result, the foreign-income-tax system should be revised in order to attract more FDI (*The People's Daily*, 17/4/91). Thus the Income Tax Law of the PRC Concerning Ventures with Foreign Investment and Foreign Enterprises, promulgated in September 1991, replaced the distinction with a unified income tax.

Though the discrimination has already been removed by the Chinese government, the tendency on the part of investors to prefer JVs to WFOEs seems to continue. Facing this situation, we would think that it will be in China's interest to facilitate development of WFOEs while not impeding that of JVs.

Because of family and local connections and therefore mutual trust, joint ventures between overseas and local Chinese will certainly continue to increase quickly. Because of unfamiliarity with the Chinese culture and firm- and environment- based elements there, some other foreign investors will also prefer JVs. Hence it is clear that JVs as the basic form of China's inward FDI will continue to increase in number.

On the other hand, the government also needs to make every effort to facilitate the growth of WFOEs. This is because some foreign (especially non-overseas-Chinese) investors still have reasons to favour WFOEs. There may be two reasons for this.

Firstly, as pointed out in Chapter 8, a wholly-foreign-owned enterprise is a single-ownership firm through which the parent company gains total control of the transfer and use of resources. Because of this, transaction costs of exploiting such key intermediate goods as technology can be internalised within the firm. Other things being equal, a WFOE may be an ideal organisation for the parent company to transfer its know-how to a host country while at the same time protecting it. Some foreign investors may be the possessors of intangible assets such as advanced technology or international marketing skills. Though they realise that JVs can help overcome barriers, these investors may not think that the benefits from forming JVs exceed limitations caused by this type of enterprises. One of the limitations is that a JV may involve more risk of technology disclosure than a WFOE.

Secondly, though JVs can help reduce unfamiliarity, joint management may involve conflicts between the parties. If reduction in technology disclosure and managerial conflicts is regarded as most important, foreign investors will naturally choose WFOEs.

Thus the Chinese government needs to encourage WFOEs in order to attract more investors. The investment from these businesses may promote China's technological progress as well as raise the general level of FDI. The investors in WFOEs will largely be non-Chinese. Hence the basic way to facilitate WFOEs is to reduce unfamiliarity. The Chinese government should help potential foreign investors learn more about China's firm- and environment- based elements. The less the unfamiliarity, the more WFOEs there will be, and probably the more advanced technology China will obtain.

Pure conglomerate integration is an important phenomenon in China's inward FDI. It seems that the Chinese government has never cared about the forms of extension adopted (horizontal, vertical or conglomerate). Though we can foresee a structural change in conglomerate FDI in China, this type of integration as a whole also needs promoting.

In section 5 of chapter 8, we explained why both foreign and Chinese parties had

reasons to follow pure conglomerate integration. We discussed three cases. Firstly, some Chinese firms possessing intangible assets call in FDI to develop their products under favourable conditions. Secondly, foreign investors may invest in unrelated industries in China to exploit price distortions. Finally, foreign conglomerate firms may make conglomerate investment in China. With the deepening of China's economic reform, this pattern may experience certain changes.

Two closely related elements of the present economic reform will alter the structure of conglomerate integration of FDI in China. Firstly, as one main element in its bid to join the world trade body, the GATT, China is allowing foreign businesses to gain more access to its huge potential market. As for FDI, foreign-invested-consumer product factories that were formerly required to export the bulk of their output are now allowed to target China's 1.16 billion consumers; foreign investors are permitted now to engage in banking, legal services, real estate development, retailing, and some public utilities. Secondly, China has been deregulating its price system, with the hope that the system can reflect the real values and demand and supply conditions of commodities. The opening of more domestic markets may in the first instance encourage conglomerate investment aiming to exploit price distortions. But the price reform will gradually reduce these distortions and hence this type of conglomerate investment will eventually fall. Actually, greater access of foreign businesses to China's domestic market itself helps the price reform by equating domestic and international prices.

The opening of more markets provides more opportunities for foreign businesses. Thus, foreign firms may increase their conglomerate investment as well as their horizontal and vertical extension. As a result, we can expect that "normal", productive, foreign-investor-motivated conglomerate FDI (such as Indonesian conglomerates' investment in China's infrastructure facilities) will rise.

The remaining case of conglomerate FDI is closely associated with the Chinese government's different policies between foreign-invested and local Chinese firms. The bigger the difference in the treatment, the more incentives local Chinese firms will have to call in conglomerate FDI. Since we expect that such difference will be reduced, this type of conglomerate FDI may fall.

Gradual reduction in conglomerate investment aiming to exploit the price distortions

will accompanying gradual progress in price reform. This may indicate an improvement in the efficiency of resource allocation and should be welcomed by the Chinese government. An increase in "normal" conglomerate FDI will be induced by the opening of more of China's domestic markets. This will bring about more inflows of foreign capital at least, and should be encouraged. As for the remaining case of conglomerate investment, since the difference in the treatment between local and foreign-invested firms is expected to fall, the incentive on the Chinese party may be reduced. Though this may lower conglomerate investment aiming mainly to exploit favourable treatment from the government, local firms may pay more attention to the efficiency of the usage of foreign capital. Thus the Chinese government may go with the tide of the development.

Section 4 Policy Stability

As identified in Chapter 7, what both foreign and Chinese managers most worried about was uncertainty over the Chinese government's general economic policies, which include industrial policy, overall financial and fiscal measures, and policy on foreign economic relations.

This obstacle may be caused by two factors. Firstly, as we were told during the interviews, one source of the worries was the fear of future changes in China's internal leadership. If there is an important change in the top leadership, a change in the country's general economic policies may follow. This is a quite reasonable speculation. A change in the top leadership in China is sometimes equivalent to a change in the government in a western country. Businesses will experience some uncertainty when a change is expected.

Though no one can really forecast detailed changes in China's general economic policy following a real transfer of power from senior men to a younger generation, few people in the world probably believe that China will deviate from its basic guideline: adhering to the economic reform and the open-door policy. This is because the adoption of this basic policy has brought about great increase in China's economic growth and a much higher standard of living over the past 13 years. The guideline has actually become a historical trend. Anyone who wants to be in power can only follow and advance rather than reverse the trend.

A major source of the worries about the instability of China's general economic policies was the lack of experience on the part of the Chinese government. To convert China from a closed and centrally-planned socialist economy to an open socialist market economy, the Chinese have had to alter their old ideology and economic mechanism while they have been learning from abroad. The Chinese government has made great progress in improving its business climate in accordance with international practice, but it still needs to do more to reduce uncertainty over its general economic policy.

Section 5 Location of FDI

Under the Chinese government's arrangements, different locations of FDI bring different fiscal and financial treatment. This location distinction can be discussed from two aspects: the different treatments between the coast and the interior, and that between subareas in the coastal region. Both aspects are closely related to China's regional-development policy, although the second may involve social ideology as well.

5.1 Policy Distinction between the Coast & the Interior

The FDI location policy reflects China's overall regional strategy. It is interesting to note that China's regional policy has formed a sharp contrast with that in many other countries. In the UK, for instance, the main objects of regional policy have been to reduce chronic unemployment in certain heavily depressed areas and to achieve a better balance in the geographical distribution of industry. In order to realise these objectives, private investment has been directed by the government to the "Development Areas" through provision of various financial inducements, infrastructure, and services, and by using the negative control of the Industrial Development Certificate (IDC) (See Armstrong, 1985; Estall, 1980 and Keeble, 1976). In Thailand, both domestic and foreign private investments are encouraged to locate in less prosperous areas in order to promote decentralisation. But in China the government seems to favour the prosperous coastal area and encourage foreign businesses to invest there. What is the rationale, if any, for this policy? What are the results of this policy? Are there any alternatives?

As we mentioned in Chapter 5, for historical and geographical reasons, there have

been great regional disparities in China. Therefore there has been a division between the coastal region and the interior region, which in turn can be subdivided into central and western regions. In 1949 when the Communist Party took over, 70% of the industrial assets were located in the coastal area and the same percentage of output was supplied from it, while the interior area accounted for the rest.

Under the first 14 years of Mao's leadership (1949-1963), even regional economic development was an important part of government policy. As a centrally-planned economy, China could use direct and uncompromising methods to correct regional disparities. The best indicator of this policy is the geographical distribution of state investment in fixed assets.

Table 10.1 State Investment in Fixed Assets (Rmb 100 Million)

Region	Coastal	% of total	Interior	% of total
1st 5-year plan	217.3	44.1	275.6	55.9
2nd (58-62)	462.6	40.6	675.6	59.4
1963-65	147.4	37.5	245.8	62.5
3rd (66-70)	262.9	29.4	631.2	70.6
4th (71-75)	625.4	39.5	959.3	60.5
5th (76-80)	988.2	45.8	1171.6	54.2
6th (81-85)				
1981	212.2	50.3	209.5	49.7
1982	266.5	50.8	258.0	49.2
1983	278.0	49.6	282.8	50.4
7th (86-90)				
1986	971.1	54.2	822.2	45.8
1988	148.2	56.6	113.4	43.4
1989	132.3	55.6	105.5	44.4

Source: Yang, 1990; *China's Statistical Yearbook*, 1987, 1989, 1990.

From Table 10.1 we can see that from 1953 to 1965, a preponderance of the investment went to the interior area. During the Cultural Revolution (1966-1976), an even higher proportion of it was located there. This is because, with the worsening relations between China and Soviet Union, China's interior-oriented investment policy was strengthened further from military considerations. In accordance with Mao's and the defence minister Lin Biao's ideas, the country was divided into three fronts with

the coast as the first and the west as the third. Under the so-called strategy of location "in mountains, in dispersion, and in caves", state investment was concentrated in the third front. Form 1966 to the late 1970s, about 29,000 new major enterprises and research institutes were built in Sichuan, Guizhou, Gansu and Shaanxi provinces (see Yang, 1990).

Before long, under the new leadership of Deng Xiaoping, however, Mao's equal-regional-development strategy was replaced by a coast-oriented one. This shift was mainly based on efficiency considerations. We can find at least two inefficient elements in Mao's strategy.

Firstly, it was not based on each region's factor-endowments. The western region is rich in natural resources. But it was an underdeveloped region with poor productive forces, lacking basic infrastructure, technology, managerial expertise and skilled labour. It was not a depressed region like a British Development Area "that has already achieved a high level of economic development but that now has an unsatisfactory performance when compared with other regions or with some national norm" (Smith, 1981, P.387). If state investment in the west was sophisticated-manufacturing-oriented rather than natural-resource-exploration-oriented or processing-oriented, there may be doubt whether in general the location was efficient.

Secondly, in the second half of the 1960s and the whole of the 1970s, many industrial projects were dispersed in the remote western mountain areas. Consequently, a large amount of the investment was spent on extremely costly infrastructure construction, while many such firms could not obtain advantages of economies of scale, and especially external economies of agglomeration and interindustry linkages. Thus it is no surprise that labour productivity in the interior area was generally lower than that in the coast.

The coast-oriented policy may also reflect the government's desire to obtain more fiscal revenue. Though we can not calculate the revenue elasticities in the coast and interior because of lack of data, we can compare the profits and taxes provided per Rmb 100 original value of fixed assets between the regions. From Table 10.2 we can see that the figure in the coast was consistently 20% higher than the national average, while that in the interior was 20% lower than the average.

Table 10.2 Profits & Taxes Per Rmb 100 Original Value of Fixed Assets

Year	1986	% of NA*	1988	% of NA	1989	% of NA
Coast	26.1	120	24.3	120	20.4	117
Interior	13.4	67	16.4	78	13.8	78

* NA = National average
Source: *China's Statistical Yearbook*, 1987, 1989, 1990.

This coast-oriented strategy was actually based on the echelon-movement approach. According to this, the coast should be developed ahead, and then the economic growth of the central and western areas should follow through the "trickle-down" effect.

China's FDI policy reflects this strategy. Since the policy of opening to the outside world was adopted, FDI has been encouraged into the coastal area. So far most FDI is located there.

The echelon movement from a prosperous area to a backward area can be found in the early history of industrial development in both the USA and the Soviet Union. But the economic conditions in China are different from either of those countries. The adoption of this approach has expanded regional disparities instead of reducing them, and has therefore deepened the conflicts between the interior and coastal areas. (See Table 10.3.)

Table 10.3 National Income Per Capita (Rmb at current prices)

Year	1984	% of NA*	1987	% of NA*	1989	% of NA*
Coast	766	114	1140	131	1553	139
Interior	567	86.3	883	78	808	72

*NA = National average.
Source: *China's Statistical Yearbook*, 1987, 1989, 1990.

Maybe it is partly due to a compromise that a regional strategy based on each region's factor endowments or supposed factor endowments has been developed in recent

years. The Seventh Five-Year Plan indicated in 1986 that the coast should strengthen the technological transformation of traditional industries, develop technology-intensive and high-value-added consumer-products industries, and transfer high-energy-consuming industries into other areas. The central area should emphasise production of energy and raw materials, certain forms of machinery, and electronic goods as well as agricultural products. The west should concentrate on agriculture, forestry, animal husbandry and transport, and develop its energy and mineral resources and certain local processing industries.

Recently a rational distribution of national productivity has been stressed in the Outline of the Ten-Year Program (1991-2000) of National Economic and Social Development and the Eighth Five-Year Plan (1991-1995). While the regional strategy under the Seventh Five-Year Plan is reaffirmed, a principle of overall arrangement, rational division of labour, mutual supplement of advantages, co-ordinated development, giving consideration both to each area's interests and to the common good, is laid down. This principle is actually directed against the present irrational allocation of resources under which all provinces have been setting up similar construction projects and their industrial structures tend to be the same. As a matter of fact, China's regional strategy has already evolved from the purely coast-oriented one to one that is resource- or industry-oriented.

From an economic viewpoint, the resource- or industry- oriented regional strategy, which is based on the comparative advantage of each area, is more appropriate than Mao's equal-distribution regional policy or the echelon-movement approach. To follow the logic of this strategy, FDI should naturally be encouraged to enter any area so long as the investment is based on factor endowments.

It is noted that energy and raw-material sectors have been the bottlenecks which need immediate expansion in the Chinese national economy. It is also true that the interior possesses the factor-endowments for these industries. Consequently, FDI should be urged into these sectors and therefore into the interior. In other words, the interior should not be discriminated against. But, as a matter of fact, FDI is still generally encouraged by the Chinese government to go into the coast. The government's view still seems to be that, since the economic conditions in the advanced coast are relatively mature compared with those in the interior, FDI should be used to promote the growth of the coast which in turn serves as an engine of growth to promote the

development of the interior. It is obvious that the regional aspect of China's FDI policy does not conform to the logic of its present overall regional-development strategy. Rather, it is the product of the pure coast-oriented strategy. This policy is likely to mean that investment opportunities are unnecessarily forgone in the unfavoured interior which badly needs capital to exploit its energy and other resources in order to support the coastal development. The coast-oriented approach has widened the gap between the coast and the interior.

It is important to note that, though productivity in the interior is generally lower than that in the coast, individual projects in the interior could still be profitable if they were based on the factor-endowments there. The ventures with foreign investment in Xinjiang had the highest return rate (52.54), followed by those in Gansu (see Zhang & Hu, 1990). These two provinces are both in the backward western area. Furthermore, after the Chinese government's huge investment in the interior over several decades, certain central cities were designated and developed as growth poles there. If these poles are promoted further, they will certainly exert powerful spread effects to bring along the backward areas around them. To follow the current industry-oriented regional strategy, it is rational to direct energy- and raw-material-oriented FDI into the interior and high-technology manufacturing-oriented FDI into the coast. As a result, the distinction made by the FDI policy between the coast and the interior neither makes sense nor benefits the economy.

4.2 Policy Distinction between Subareas on the Coast

A policy distinction is made not only between the coast and the interior, but also between subareas on the coast. From Chapter 6 and Appendixes 2-4, we have seen that while the SEZs, Shanghai's Pudong New Area and ETDDs enjoy the maximum tax benefits, the OCCs enjoy less and the COEAs least of all. Such a distinction may again involve social ideology and a process of gradually acquiring experience.

In 1979, the Chinese leadership decided to open its socialist economy to the outside world. This decision marked a very important turning point in China's history of economic development. As the most important element of this policy, the economy was opened to FDI. This meant that China's socialist economy had to accept capitalism, because foreign capitalists would come to set up factories and obtain profits on their capital.

To carry out this policy the government had to justify it in both theory and practice. Lacking experience, the Chinese leadership decided to establish several very small SEZs as experimental plots. Then there was a heated discussion on the nature of SEZs. Is a SEZ economy socialist or capitalist?

A few economists argued that the SEZ economy is socialist in that a SEZ is a small place that China delimits of her own accord, where a special economic policy rather than a different social and economic system is practised. But many argued that the SEZ economy is a state-capitalist one, because, though there are socialist state-owned and collective enterprises, as well as WFOEs and private individual enterprises which represent private capitalism, yet EJVs and CJVs account for the majority of all the economic formations and they are of a state-capitalist nature. Some other economists even said that the SEZ economy is a capitalist one because in the final analysis state capitalism is capitalism: there are both working class members and capitalists in these enterprises, and, though there are various types of formations in a SEZ, the economy there as a whole is adjusted mainly by market forces. Ventures with foreign investment in China's SEZs should be regarded as forming a capitalist economy confined by a socialist country to a small area. (For all these views, see Essays 1984).

Ideologically, though the prevailing view is that the SEZ economy is a capitalist one, almost all the economists in China agree that the social nature of SEZs is a socialist one because the direction, characteristics and scope of the economic development of the zones are determined by China's overall socialist economy. Practically, the rapid economic growth in the four SEZs made the Chinese leadership believe that the open-door policy was correct and successful. After gaining some experience, the leadership decided to open 14 coastal cities in 1984 where ETDDs could also be set up, 3 COEAs in 1985 and Hainan Island in 1988.

It appears that the policy distinction between the subareas on the coast follows an inverse-ratio rule. As the open area becomes wider, the tax privilege becomes less. This rule may reflect a compromise between practice and ideology. Since FDI plays an increasing role in China's economic growth, the government encourages it. But FDI contains capitalist elements, which should be restrained to some extent because the four cardinal principles require China to adhere to a socialist road. Since the larger the area and the scope of FDI, the larger the possible negative effect it will exert, it is natural to provide less generous tax treatment in a larger area.

The other possible explanation for the policy distinction between the subareas on the coast may be that the Chinese government aims to attract more FDI into the most prosperous cities where there are better industrial bases, infrastructure and skilled labour. FDI can be used more efficiently there and then can bring along the development of other areas. This reasoning can be easily inferred from China's coast-oriented regional strategy: the advanced area should be developed ahead.

However, one ground for doubt arises here. If it is true that the OCCs, because of the existence of industry linkages or external economies of agglomeration, are better locations than the COEAs, it is not necessary to provide extra concessions in the OCCs. In addition, though the OCCs have these advantages, they are not necessarily the best location for any individual project. The policy distinction may mean unnecessary tax forgone in the most favoured areas and a loss of efficiency in the economy from incentive- induced distortion in resource allocation. Thus, a wise policy is to unify the tax privileges between the ETDDs, the OCCs and the COEAs, letting investors optimise factors of operation without the government's possibly distorting interference.

Section 6 Foreign-Exchange Balance

As the largest potential market in the world, China is very attractive to foreign businesses. Based on the one-dollar-per-person hypothesis, not a few foreign investors have gone to that country with little understanding of China's real situation and policy. Some of them have suffered because not everything is welcomed in China and the general requirement of foreign-exchange balance makes it difficult to get access to that market. This conflict between foreign investors' motivation and China's policy has impaired the growth of FDI in China. It is reasonable to suggest that without such a requirement FDI would have developed even faster.

Questions will be raised here quite naturally: since the requirement is an impediment, why does the Chinese government impose it? If non-convertibility of the Rmb is the direct reason for that requirement, is it possible to make the currency convertible in the very near future? If not, what is the second-best arrangement? This section discusses these questions.

If the Rmb exchange rate approximated to a market clearing rate and there were no large distortions of domestic prices from relative social values, then there would be no need to take special measures to generate or to conserve foreign exchange. Enterprises following market signals would use or forgo foreign exchange only in substitution for other resources of equal social value. But it is obvious that the Rmb is not convertible and its rate can be presumed to under-value foreign exchange. Under such conditions, the Chinese government requires the ventures to earn enough foreign exchange by exporting. This policy discourages and even in principle precludes investment oriented to China's market. The best solution to this problem is to make the currency convertible. But there are two reasons, which explain why this solution is probably not feasible in the very near future.

One reason is that the Rmb has long been overvalued. This overvaluation may be a reflection of the Chinese government's desire to make favoured imports relatively cheaper so as import more technology, machinery and equipment to support its modernisation drive. The existence of overvaluation can be presumed from the fact that the official exchange rate of the Rmb against foreign currencies has long been below the market-equilibrium rate. In the early 1980s, the official rate was 3 Rmb per US $1 while the black-market rate was about 8 Rmb per US $1. In 1989, the official rate was 3.85 : 1, but the swap rate in China's Foreign-Exchange- Adjustment Centre was about 7 : 1 (See McKenzie, 1990, P.140). In December 1989 and November 1990, there were 21.2% and 8.96% devaluations of the Rmb against the US dollar. The 1990 devaluation was undertaken by the government to maintain the export drive, discourage a surge of imports that might follow the expected upturn in domestic demand, and cut export subsidies paid to manufactures via the losses of the state trading companies (See Bowring, 1990). Since these two devaluations, the gap between the official and swap rates has been narrowed, but it still exists. On the other hand, it should be noted that the reduction in the gap was partly due to the austerity programme adopted by the government between 1989 and 1991, which curbed the demand for imports. As soon as the programme is over, the gap may widen. .

The overvaluation of the Rmb precludes convertibility. It can be argued that if a future devaluation makes the official rate close to the market-equilibrium rate, then convertibility may be possible. However, a further reason for the unfeasibility of the Rmb's conversion results from China's price distortion. Because of a long-established

practice of central planing and of isolation from the outside world, Chinese prices reflect neither international values nor domestic demand-supply conditions. If the currency were fully convertible, the economy might suffer chaos at least in the short run. Many counter-productive foreign-exchange transactions might be undertaken. With further economic reform and opening to the outside world, efficiency in production may be gradually improved and domestic prices be adjusted gradually to reflect products' real values and demand-supply conditions. Only at that time does a full convertibility of Rmb become possible.

China has recently decided that it would phase out its import-permit system within six years, giving foreign companies greater access to its vast market (*Wall Street Journal*, 7/5/93). This decision reflects China's desire to join the General Agreement on Tariffs and Trade, which requires further market openings to global competitors. This decision will certainly help correct the price distortions in China, and promote early convertibility of the Rmb.

Since the Rmb will not be made convertible in the very near future, the Chinese government has made several alternative arrangements to reduce the negative effects caused by this problem. As we described in Chapter 6, though a firm with foreign investment is generally required to keep a foreign-exchange balance by exporting its own products, the Chinese government provides several flexible measures to help the firm which can not fulfil the requirement. However, these measures have never been without difficulties (See, McKenzie, 1990).

One of the solutions under "included in the Plan" is that the responsible government agency remedies from its own exchange revenues a firm's imbalance caused by unforeseeable reasons. But, given a general shortage of foreign exchange in China, it is not common for such an agency to have to make up the deficit from its own reserves.

The other solution under "included in the Plan" is to obtain the status of import-substitute. If a product is technologically advanced and expected to need to be imported in the next few years, it is qualified as an import-substitute, and therefore for being paid for in foreign exchange. But as time passes, the product may no longer be regarded as one that otherwise to be imported, and then the status will be lost. As a result, long-term reliance on import-substitute status is not reliable.

A further device consists of the various forms of "mutual adjustment between enterprises", but some of these also suffer difficulties. Firstly, though the responsible agency can adjust an exchange surplus and deficit between its client firms, a venture with a foreign-exchange surplus is obviously hesitant to sell its surplus at the official rate when foreign exchange is undervalued.

Secondly, though a foreign investor who has established more than one joint venture in China can adjust the surplus and deficit between his own ventures, a prior agreement by the Chinese partners in the ventures needs to be reached. For the same reason mentioned just now, it is not easy to obtain such an agreement with the Chinese partners.

Thirdly, "comprehensive compensation", which means purchases of China's domestic products for export so as to realise a foreign-exchange balance, does not always work. Since not a few domestic products that have viable foreign markets are either subject to state trade control or have been exported by state trading companies, it is not easy to obtain an export quota or licence, or to compete with the trading companies. Purchasing other domestic products for export often means developing new foreign markets for these products. It can be time-consuming and costly to do so.

Given the non-convertibility of the Rmb, the most reliable source of foreign exchange is no doubt exporting. However, the development of China's Foreign-Exchange-Adjustment Centres (FEACs) offers a second-best solution to the foreign-exchange problem. Though the FEAC system is in nature one form of mutual adjustment between enterprises, this arrangement is workable simply because the trading in the centres is based on the most reliable market rate rather than the official one. Since 1987, enterprises with foreign investment as a whole have had a foreign-exchange surplus. This factor supports the operation of the FEAC system. A survey by the present author indicates that all the companies in the sample with a foreign-exchange deficit bought the exchange they needed in FEACs (See Chapter 7).

As for other solutions discussed before, import-substitute status is still worth obtaining. This is because the Chinese government, in addition to urging expansion of exports, encourages ventures to produce new products or to upgrade and replace existing ones for import substitution. If import-substitute status is obtained from the

very beginning of the project, necessary foreign-exchange assistance can usually be secured.

Section 7 Conclusions

Much of China's inward FDI is peculiar. This not only leads us to develop an analytical framework which extends the range of possibilities to be considered when particular cases of foreign investment are to be explained, but also has important implications for China's FDI policy.

One of the main motives for the Chinese partners to be active in initiating inward FDI projects is to take advantage of the preferential treatment available for foreign-invested firms. To maintain this initiative certain benefits such as tax breaks should still be granted to foreign investment, though the difference in the income tax rates between local and foreign-invested firms need to be reduced gradually.

Hong Kong is the main investor in China. To maintain this position investment from Hong Kong should still to be treated as foreign, though the colony will politically become a special administration district of China from 1997. Inward investment from Taiwan has been increasing very quickly in recent years and will soon rank second only to Hong Kong's. The policy arrangement for Hong Kong after 1997 should also apply to Taiwan after the long-distant dream of political reunification of the two sides of the Straits comes to pass. Thus the incentive on the part of mainland Chinese will still be maintained, and reinforcing the strong motive of family and local connections on the part of overseas Chinese.

Though joint ventures are the basic form of China's inward FDI, some foreign investors have good reasons to favour wholly-foreign-owned enterprises. To attract more FDI, especially the investment coming with advanced technology, the Chinese government needs also to encourage the development of wholly-foreign-owned enterprises. This can be done principally by better informing potential investors, principally the non-Chinese, and providing better for the protection of property in technology.

With the deepening of the economic reform, and removal of the regular tax

disadvantage of local investors who lack a foreign partner, there will be a structural change in conglomerate FDI in China toward "normal" investment by foreign conglomerate, not necessarily or preponderantly ethnic Chinese. This should be welcomed and encouraged by the Chinese government.

Instability of China's general economic policies will be gradually reduced with the increase in experience of economic reform. Thus foreign businesses will have less uncertainty when they consider investing and operating in China.

The tax distinction between areas derives from the regional strategy based on the theory of echelon movement. This arrangement does not conform to the current and more appropriate industry-oriented regional strategy, and can only cause tax to be forgone unnecessarily in the favoured areas, and investment opportunities to be lost in the unfavoured areas. Therefore, it leads to a loss of efficiency in the economy in distorting resource allocation and unnecessarily deterring certain potential investments. The solution is to replace the existing distinction with impartial taxation.

The requirement of foreign-exchange balance probably impedes further development of FDI, especially of projects oriented to China's market. The requirement will not be removed in the very near future because of the Rmb's overvaluation; and the price distortions caused by the long-term practice of central planning and of isolation from the outside world. Though most alternatives to removing the requirement are not without difficulties, the foreign-exchange-adjustment-centre system has become a more and more important solution to the exchange problem. The status of import-substitute is also worthwhile obtaining, since it usually means secured assistance with necessary foreign exchange from the Chinese government.

Further economic reform can improve further the economic situation in China and therefore make the FDI policy more acceptable to foreign investors.

CHAPTER 11 OVERALL CONCLUSIONS

A strategy of the "theory, then empirical data, then revised theory, then policy" has been followed for this research.

The currently dominant FDI theories are the internalisation approach and the "eclectic" paradigm. These approaches tell us that, because of market imperfection, the transaction costs for trading some key intermediate goods such as know-how are high. As a result, a firm finds it profitable to internalise the market for these intermediate goods. Thus FDI happens. These approaches also imply that the investing firm usually takes the initiative when a decision to invest abroad is taken. And they would seem to imply that FDI is unlikely to use the joint-venture as a vehicle unless obliged to do so by a host government.

The empirical data obtained from our fieldwork and library searching seemed to go beyond the range of possibilities considered by the above approaches. We found that much of China's inward FDI is peculiar. This includes the following aspects: firstly, foreign investors consist overwhelmingly of ethnic Chinese businessmen; secondly, Chinese partners are often active in initiating FDI projects; thirdly, joint ventures are the basic form of the inward investment; and finally pure conglomerate integration is an important phenomenon.

These peculiar features pose a challenge to the atlantocentric theories of FDI: transaction-cost considerations need to be enriched by the fact that much of China's inward FDI is made by the overseas Chinese who are motivated by the family and local connections; the dominant theories' implication that the investing firm is the initiator of the FDI project does not fit the case where the local Chinese party is enthusiastic to call in investment in order to enjoy preferential treatment by obtaining the status of a foreign-invested enterprise; the dominance of joint ventures contradicts traditional transaction-cost considerations which would suggest wholly-foreign-owned enterprise would be preferred; finally, transaction-cost considerations can not satisfactorily explain why foreign investors undertake pure conglomerate expansion in China; the "eclectic" paradigm would reject it by definition as a form of FDI and the internalisation approach would not allow for it.

Because of dissatisfaction with the completeness of the currently prevailing

approaches to FDI, the author of this thesis tries to extend the range of possibilities to be considered when particular cases of foreign investment are to be explained. This involves emphasising that the motives for FDI are not simply commercial, financial or managerial; that the advantages and needs that prompt it have sometimes to do with personal relationships and culture; that the complementarities between the foreign-firm, host-firm, and host-environment factors are to be considered; and that a host-firm is a possible initiator. These points have been summarised by the triple-pole diagram.

By stretching the boundaries of the dominant theories our analysis is believed to cover China's inward FDI. Deeply rooted Confucianism, the family and local connections between ethnic and local Chinese, and low labour cost, a large potential market, and government inducements on the mainland, constitute the most favourable firm- and environment-based elements in China's investment climate. Between them these factors determine the overseas Chinese as the major investors, and the enthusiasm of the local Chinese for having foreign business partners. Mutual trust resulting from the same blood, culture and language between ethnic and local Chinese is the basic determinant of the popularity of JVs in China, and other foreign investors also often favour it, probably because of the local knowledge and the government and business connections that it may bring.

In China, a majority of the FDI projects take the form of horizontal combination. Foreign investors' capital and some types of know-how are combined with firm- and environment-based elements, of which cheap labour, government inducements, and the world's largest potential market are thought to be most favourable. This type of combination allows the public-good nature of knowledge to be exploited internally, and transaction costs to be reduced.

Backward combination is the main form of vertical integration in China. The marketing skills on the part of foreign investors are combined with world output markets and other firm- and environment- based elements in China.

Though it is out of fashion in the West, pure conglomerate combination is an important phenomenon in China. Local enterprises with intangible assets of their own call in unrelated overseas firms for their capital. Alternatively foreign investors may take the initiative in unrelated areas in order to take advantage of the distorted price

system, or foreign businesses that are already conglomerates may extend their spheres to China probably using cultural know-how from local partners.

The peculiar features of China's inward FDI have important implications for China's FDI policy. Since Hong Kong is an overwhelming source of FDI in China, it will be wise for the Chinese government to regard investment from post-1997 Hong Kong as FDI and to continue to allow it whatever preferential treatment is available to foreign investment. Thus local firms will still have incentives to initiate investment from Hong Kong, or at least Hong Kong investors will not be faced with tax rates well above prevailing world levels. So the total level of FDI inflows from Hong Kong may be maintained or enhanced.

It is probably appropriate that tax rates applying to purely domestic enterprises should be reduced towards those applying to foreign investment, but the change should take place gradually, and some incentive should remain for domestic firms to seek overseas partners.

Though JVs are, and probably will continue to be, the basic form of FDI, potential WFOEs need to be encouraged by information and assurances in order to promote the introduction of high technology from foreign, especially non-overseas-Chinese, investors.

Discrimination between the coastal area and the interior, and among subareas in the coast, should be removed. The distinction may lead to a loss of efficiency in the economy in its distortion of resource allocation and it generally increases inter-regional income differences. The solution is to replace the existing distinction with locationally impartial taxation and incentives.

The requirement of foreign-exchange balance probably impedes further development of FDI, especially of projects oriented to China's market. But it is not likely to be removed in the very near future because of the Rmb's overvaluation and the price distortions caused by the long-term practice of central planning and of isolation from the outside world. The Foreign-Exchange-Adjustment-Centre system is now the most important solution to the exchange problem.

China has abundant natural resources, relatively diversified industry and rapid

economic growth. It is the world's largest potential market. Labour costs in China are lower than in many other developing countries. Workers in China can be very productive under appropriate incentive programmes. The Chinese government recognises the importance of FDI and offers generous incentives for foreign investors. China has 55 million ethnic Chinese many of whom have strong feelings of commitment to their relatives. All these factors make China a favourable investment site. Quick growth of FDI in China in recent years confirms this view.

Though the absolute amounts of FDI inflows have been significant, they have played a relatively small role in China's domestic capital formation because of their small proportion in China's total social investment in fixed assets. However, the rate of new foreign investment has increased rapidly though not without interruption; foreign investment brings far more than just capital; and it is safe to say that the impact of FDI on China's economic growth is increasing.

To improve its investment environment according to international practice, China still has a lot to do. The improvement can only be made gradually with progress in overall economic and political reforms.

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Appendix 2 Foreign Tax Categories and Rates

There are six categories of taxation on ventures with foreign investment, i.e., enterprise income tax, consolidated industrial and commercial tax, customs duty, estate tax, tax on vehicle and vessel licence plate and individual income tax.

2.1 Enterprise income tax

Enterprise income tax is paid by ventures with foreign investment on all of their incomes from production and business operations and on other income. Income from production and business operations means income derived from production and business operations in industry, mining, communications and transportation, agriculture, forestry, animal husbandry, fishing, poultry-farming, commerce, tourism, catering, service trades and other lines of business. Other income means income from dividends, extra dividends, and interest, and income from the lease or transfer of tangible property, patent rights, proprietary technology, trademark rights, copyrights and other property.

Equity-joint-ventures used to pay income tax in accordance with the provisions of the "Income Tax Law of the People's Republic of China Concerning Chinese-foreign Joint Ventures", and wholly-foreign-owned enterprises with the provisions of the "Income Tax Law of the People's Republic of China Concerning Foreign Enterprises". However, in 1991, the "Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises" was formulated. The new legislation replaces both the foreign enterprise and joint venture income tax laws. The new law stimulates that all foreign investments be taxed under one system: 33%.

The taxable income of a venture with foreign investment or of a foreign enterprise is the excess of its gross income in a tax year over its deductible costs, expenses and losses. The income-tax rate 30%. In addition, a local income tax of 10% of the assessed income tax is levied, so that the total rate is 33%. When a foreign investor remits abroad its share of profit obtained from the venture, an income tax of 10% of the remitted amount is levied in addition.

Foreign enterprises are foreign companies, enterprises and other economic organisations that have establishments within the territory of China and are engaged in independent business operations or in co-operative production or co-operative

business operations with Chinese enterprises.

A flat income tax of 20% of taxable income is levied on other income mentioned before, which is also known as a withholding income tax.

2.2 Consolidated industrial and commercial tax

Consolidated industrial and commercial tax is imposed on business incomes or purchasing expenditures. All ventures engaged in production of manufactured goods, purchase of agricultural products, imports, retail, transportation and other service industries should pay the tax.

There are altogether 42 tax rates varying with different industries and products. Rates for capital goods are lower than for consumption goods and for necessities lower than for non-necessities. For example, the rate for cigarettes is 69%, for mechanical products is 5%, and for cloth is only 1.5%.

2.3 Customs duties

China's customs duty is imposed ad valorem. The rates vary from 5% to 200% across different goods. There are low rates for importing raw materials that are in short supply in China and for importing new technological products, but high rates for those goods which can be produced in China. In order to encourage exports, most products are exempted from export duties.

2.4 Estate tax

Estate tax is levied on owners of buildings and users of land in cities. It is a local tax. So far it is imposed only on ventures with foreign investment which have house properties. The annual rate is 1.2% of the value of buildings or 18% of the rents.

2.5 Tax on vehicle and vessel licence plates

This is also a local tax imposed on vehicle and vessel licence plates. The amount of the tax depends on categories and sizes. Among vessels at present, the tax is levied only on mechanised vessels owned by ventures with foreign investment and is rated according to their tonnages.

2.6 Individual income tax

If an individual resides for one year or more in China, he pays an individual income

tax on his income gained within or outside China; if he does not reside in China or resides in China for less than one year, he pays the individual income tax only on the income gained within China. An individual who has resided in China for one year but not more than five years pays individual income tax on income earned within China and income obtained outside China that is remitted to China; an individual whose period of residence in China exceeds five years pays tax on all his income obtained outside China beginning with the sixth year.

If an individual provides personal services performed in China, the remuneration obtained from employers outside China is exempted from taxation if his continuous residence does not exceed 90 days.

China practises a classified-individual-income-tax system. Income from wages and salaries in excess of specified amounts is taxed at progressive rates ranging from 5% to 45% (see Table 1).

Table 2. Tax Rates on individual Incomes

Level	Range of income	Tax rate
1	Total monthly income of 800 yuan or less	exempt
2	That part of monthly income from 801 to 1,500 yuan	5%
3	That part of monthly income from 1,501 to 3,000 yuan	10%
4	That part of monthly income from 3,001 to 6,000 yuan	20%
5	That part of monthly income from 6,001 to 9,000 yuan	30%
6	That part of monthly income from 9,001 to 12,000 yuan	40%
7	That part of monthly income from 12,000 yuan upwards	45%

Income from remuneration for personal services, royalties, interest, dividends, extra dividends and the lease of property and other kinds of income shall be taxed at a flat rate of 20%.

For income from wages and salaries, a monthly deduction of 800 yuan is deducted as a personal allowance; that part in excess of 800 yuan is allowed for expenses, if the amount received in a single payment is less than 4,000 yuan; for single payments of 4,000 yuan or more, a deduction of 20% is allowed for expenses. The remaining amount is taxed. Income from interest, dividends and extra dividends and other kinds of income shall be taxed on the amount received in each payment.

Appendix 3 Tax Incentives For Ventures With Foreign Investment

3.1 Nationwide tax incentives

3.1.1. Tax incentives available under the enterprise income tax law

Under the "Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprise"(1991), and its "Detailed Rules and Regulations for the Implementation of the Income Tax Law", ventures with foreign investment and foreign enterprises are subject to a unified 33% (including 3% of local tax) of income tax. However, it is the standard tax rate, and there are tax incentives available for these ventures.

(1) Incentives for newly-run ventures with foreign investment. A manufacturing venture with foreign investment scheduled to operate for a period of ten years or more may be exempted from income tax in the first and second profit-making years and allowed a 50 per cent reduction between the third and the fifth years. The first profit-making year means the year in which a venture has begun making profit after its losses, if any, in the initial stage of operation have been offset.

(2) Preferential treatment for ventures with low profits or in remote areas. Ventures with foreign investment engaged in low-profit operations such as agricultural and forestry or located in economically underdeveloped and remote areas may be allowed 15 to 30 per cent reduction in income tax for a period of ten years following the expiration of the term for exemption and reduction mentioned in the preceding paragragh.

(3) Incentives for reinvestment. A foreign investor in a venture which reinvests its share of profits in China for a period of not less than five years may obtain a refund of 40 per cent of the income tax paid on the amount of reinvestment.

(4) Accelerated depreciation. The depreciation periods for fixed assets of enterprises of enterprises with foreign investment shall be shall be classified into three categories and range from 5 to 20 years. In special circumstances, an enterprise with foreign investment may apply for an accelerated depreciation of various kinds of fixed assets.

(5) Local income tax reduction or exemption. Local income tax reduction or exemption for small-scale and low-profit foreign enterprises shall be decided by the people's governments of the province, municipality or autonomous region in which the enterprises are located.

3.1.2.Tax incentives for export enterprises and technologically-advanced enterprises
In 1986, the State Council formulated the "Provisions of the State Council of the People's Republic of China for the Encouragement of Foreign Investment" (also known as the "Twenty Two Articles") in order to better introduce advanced technology, improve product quality, expand exports to generate foreign exchange and develop the national economy. Under the provisions, four special preferences are granted to the export enterprises and the technologically advanced enterprises.

The export enterprises are those production enterprises with foreign investment whose products are mainly for export, which have a foreign exchange surplus after deducting from their total annual foreign exchange needed for the annual foreign exchange expenditures incurred in production and operation and the foreign exchange needed for the remittance abroad of the profits earned bt foreign investors. Technologically advanced enterprises are those production enterprises with foreign investment possessing advanced technology supplied by foreign investors which are engaged in developing new products, and upgrading and replacing products in order to increase foreign exchange generated by exports or for import substitution.

The special investment incentives are as follows.
(1) After the expiration of the period allowed for the reduction or exemption of the enterprise income tax in accordance with the provisions of the state, export enterprises exporting 70 per cent or more of their products, in value terms, in any particular years may pay their enterprise income tax at half the existing tax rate for that year. If the resultant tax rate after the 50 per cent reduction of enterprise income tax payable is below 10 per cent, income tax shall be levied at the rate of 10 per cent.

(2) After the expiration of the period allowed for reduction or exemption of enterprise income tax in accordance with the provision of the state, technologically advanced enterprises may enjoy a three-year tax reduction period during which enterprise income tax shall be paid at half the existing rate. The technologically advanced enterprises which do not qualify for such tax reduction orexemption may

pay enterprise income tax at half the existing rate in the first three profit-making years. If the resultant tax rate after the 50 per cent reduction of the enterprise income tax is below 10 per cent, the enterprise shall be levied at the rate of 10 percent.

(3) Profits remitted abroad by foreign investors of export enterprises and technologically advanced enterprises with Chinese and foreign investment shall be exempt from income tax.

(4) Foreign investors who reinvest the profits distributed by the enterprises to establish or expand an export enterprise or a technologically advanced enterprise for a period of not less than five years shall receive a full refund of enterprise income tax already paid on the amount of reinvestment.

3.1.3. Tax incentives for Chinese-foreign joint ventures engaged in port and harbour construction

Port and harbour are regarded by the Chinese government as main infrastructure for both internal transportation and foreign trade. In order to accelerate the construction, the State Council formulated the "Interim Provisions of preferential Treatment for Chinese-foreign Joint Ventures Engaged in Port and Harbour Construction". The provisions grant four special tax incentives.

(1) Income tax shall be levied on Chinese-foreign joint ventures engaged in port and harbour construction at a reduced rate of 15 per cent. Where the joint venture is for a period of 15 years or more, the enterprise shall be exempt from income tax for the first five profit-making years allowed a 50 per cent reduction during the sixth to tenth years.

(2) After the expiration of the tax reduction and exemption period which is provided for in the preceding paragragh: if the joint venture engaging in port and harbour construction still encounters difficulties in making the tax payments such tax exemption and reduction may be further extended subject to the approval of the Ministry of Finance.

(3) Reduction of or exemption from the local income tax of joint venture engaging in port and harbour construction is subject to the approval of the people's government of the province, autonomous region or municipality where the joint venture is located.

(4) When the foreign partner of the joint venture engaging in harbour construction remits abroad its share of profits obtained from the joint venture, such profits shall be exempt from income tax.

3.1.4. Reduction and exemption of customs duties and consolidated industrial and commercial tax (CICT).

According to the "regulations for the Implementation of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment", "the Twenty Two Articles" and the two separate provisions of the General Administration of Customs, the Ministry of Finance and the Ministry of Foreign Economic Relations and Trade on the supervision of and levy of or exemption from tax on imports and exports by Chinese-foreign co-operative enterprises and Chinese-foreign joint ventures, reduction and exemption of customs duties and CICT are granted.

(1) Ventures with foreign investment are exempt from customs duties and CICT with regard to the importation of the following goods: a. machinery, equipment, spare parts and other materials (other materials meaning the materials needed by the joint venture in the construction of factories, plants, and in the installation and upgrading of machinery) which the contract stipulates as being part of the foreign party's investment; b. machinery, equipment, spare parts and other materials imported with funds which are part of the joint venture's total investment; c. machinery, equipment, spare parts and other materials the production and supply of which cannot be guaranteed in China and which are imported by the joint venture with additional capital; d. raw materials, auxiliary materials, components, spare parts and packaging materials which are imported specially for the manufacturing of export products.

(2) Goods and materials imported by co-operative ventures according to the approved contract as the foreign party's investment or additional investment may be exempted from customs duty and CICT in accordance with the following provisions: a. advanced machinery and equipment which China cannot supply, and materials required for the construction of the factory (site) and for the installation or reinforcement of machinery and equipment imported according to the provision of the contract for Chinese-foreign co-operative ventures engaged in the areas of energy development, capital construction of railways, highways and harbours, and of industry, agriculture, forestry, animal husbandry, agriculture, deep-sea fishing,

scientific research, education, medical and health sectors;
b. raw materials, components, spare parts, auxiliary materials, packaging goods and materials specially imported for the processing of export products; c. machinery, equipment, spare parts and materials imported for exploration and development of offshore oil, and components and materials imported which are used to manufacturing machinery for extracting.

For building materials, auxiliary equipment, indoor electrical appliance as part of a construction project and other necessities imported for construction of tourist hotels by Chinese-foreign co-operative joint ventures, customs duty and CICT may be reduced or exempted in accordance with relevant provisions.

(3) During the initial stage of operation, if the enterprise with foreign investment manufacturing for domestic sales purposes encounters difficulties in making the tax payments, it may apply for reduction or exemption of CICT for a certain specified period.

(4) With the exception of crude oil, processed oil and other items for which the state has separate provisions, the export products manufactured by an enterprise with foreign investment shall be exempt form CICT.

From the above we can see that if a venture with foreign investment has its two ends abroad (importing materials and exporting products), it may not pay CICT by and large.

3.1.5. Reduction and exemption of individual income tax
(1) For wage and salary income derived by foreign personnel working in Chinese-foreign joint ventures, Chinese-foreign co-operative ventures and wholly-foreign-owned enterprises in China, and by foreign personnel working in the resident offices of foreign companies, enterprises and other economic organisations in China, the amount of individual income tax payable in accordance with the "Individual Income Tax Law of the People's Republic of China " shall be reduced by 50 per cent.

Non-China source investment income such as dividends, interests, etc., received from outside China by foreign employees working in Chinese-foreign joint ventures or cooperative ventures, and foreign employees of foreign companies, enterprises, and

other economic organisations working in China shall, regardless of whether the income is remitted into China, be exempted from individual income tax, provided that the employee has on intention of residing permanently in China and that the purpose of his or her being stationed in China for more than one year or over five years is merely to execute his or her duties and to fulfill his or her business assignments.

3.2 Regional Tax Incentives

Regional tax incentives are applicable to ventures with foreign investment which are located in special areas in China. Generally speaking, the higher the degree of openness of an area, the more preferential the incentives are. Under the "Interim Provisions of the State Council on Reduction and Exemption of Enterprises Income Tax and Consolidated Industrial and Commercial Tax in the Special Economic Zones and the Fourteen Coastal Port Cities"(1984), the "Provisions for Encouraging Investment and Development of Hainan Island"(1988), and the "Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises", the following tax incentives are available.

3.2.1. Tax incentives in the special economic zones

(1) Income tax shall be levied at the reduced rate of 15 per cent on the income derived from production, business and other sources by the ventures with foreign investment operating in Shenzhen, Zhuhai, Shantou, Xiamen and Hainan Special Economic Zones.

(2) For special zone enterprises engaged in industry, communication and transportation, agriculture, forestry and animal husbandry, which have a contract life of ten years or longer, a two-year tax holiday commencing from the first profit-making year shall be allowed followed by a 50 percent reduction in the third to fifth year.

(3) For special zone enterprises engaged in the service industry, with an foreign investment exceeding $ 5 million and a contract life of ten years or longer, income tax shall be exempt in the first-making year followed by a 50 per cent reduction in the second and third year.

(4) Foreign investors of joint ventures in the Special Economic Zones shall be exempt from enterprise income tax when repatriating profits distributed from the enterprises.

(5) After the expiration of the reduction or exemption period of enterprise income tax in accordance with the relevant provisions of the state, export enterprises within the SEZs exporting 70 per cent or more of their products in value terms in any one year, may pay enterprise income tax at the reduced rate of ten per cent for that year.

(6) After the expiration of the reduction or exemption period of enterprise income tax in accordance with the relevant provisions of the state, technologically advanced enterprises may pay enterprise income tax at a reduced rate of ten per cent for another three years.

(7) Dividends, interest, rentals, royalties and other kinds of income which are sourced in SEZs and derived by foreign investors which have no establishments in China shall be subject to income tax at the reduced rate of ten per cent, except in case where tax exemption is provided under the law. Where the terms and conditions for the provision of capital and equipment are preferential or the technology transferred is advanced such that it is necessary to grant additional reduction or exemption, the matter shall be decided by the people's government of the SEZs.

(8) Reduction or exemption of local income tax for special zone enterprises shall be decided by the people's government of the SEZs.

(9) Export products of special zone enterprises shall be exempt from CICT except for crude oil, processed oil or those for which the state has separate provisions.

(10) CICT shall be exempt for special zone enterprises importing machinery, equipment, raw materials, spare parts and accessories, means of transportation and other means of production that are required for their own production purposes. For imported oils, cigarettes, wines and other daily-use articles, CICT shall be levied at half of the tax rate prescribed in the tax law.

3.2.2. Tax Incentives in Shanghai Pudong New Area

The incentives offered in Pudong are basically identical to those available to foreign parties in the Special economic Zones.

3.2.3. Tax Incentives in the Economic and Technological Development Districts

(ETDZs) and Pudong New District

(1) A 15 per cent preferential enterprise income tax shall be allowed for income derived from production, business operation and other sources by joint ventures, co-operative enterprises or foreign enterprises of a production nature operating in the ETDZs of the 14 Coastal Port Cities of Dalian, Qinhuangdao, Tianjin, Yantai, Qingdo, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai, and Pudong New District in Shanghai. Those with a contract life of 10 years or longer shall enjoy a two-year tax holiday commencing from the first profit-making year followed by 50 per cent reduction in the third to fifth year.

(2) Foreign investors of a joint venture in the districts are exempted from enterprise income tax when repatriating their share of profits from the enterprise.

(3) After the expiration of the reduction or exemption period of enterprise income tax in accordance with the relevant provisions of the state, export enterprises in the districts exporting 70 per cent or more of their production in value terms in any one year, may pay enterprise income tax at the reduced rate of 10 per cent for that year.

(4) After the expiration of the reduction or exemption period of enterprise income tax in accordance with the relevant provisions of the state, technologically advanced enterprises in the districts may pay enterprise income tax at the reduced rate of 10 per cent for another three years.

(5) A 10 per cent preferential income tax shall be levied on dividends, interest, rentals, royalties and other income sources in the districts by overseas investors who do not have establishments in China, except in cases where tax exemption is provided under the law. Where the terms and conditions for the provision of funds or equipment are preferential or the technology transferred is advanced, such that it is necessary to grant additional tax reduction or exemption, the matter shall be decided by the people's government of the municipality where the district is located.

(6) The reduction and exemption of local income tax for the district enterprises shall be decided by the people's government of the municipality where the district is located.

(7) CICT shall be exempt on building materials, production equipment, raw materials,

spare parts and accessories, components, means of transport and office supplies imported by the district enterprises for their own use.

(8) CICT shall be exempt for products manufactured and exported by the district enterprises with the exemption of crude oil, processed oil and other goods for which the state has separate provisions.

3.2.4. Tax Incentives in the Old City Districts of the 14 Coastal Port Cities and the Delta regions

(1) In the case of manufacturing enterprises with foreign investment which are established in the old city districts of the 14 Coastal Port Cities, or in the municipalities or towns within the three delta regions, if the enterprise is engaged in technology-intensive or know-how-intensive projects, or in projects in which the foreign investors invest $ 30 million or more and have a long pay-back period, or in energy, transportation and harbour construction projects, the enterprise income tax shall be levied at the reduced rate of 15 per cent subject to approval by the Ministry of Finance.

(2) Subject to the approval of the Ministry of Finance, enterprises which are not entitled to tax reduction as prescribed in the preceding paragragh shall pay at the rate of 80 per cent of the rate prescribed in the enterprise income tax law if they are engaged in the following industries: a. machine building, electronics; b. metallurgy, chemicals, building materials; c. light industry, textiles and packaging; d. medical apparatus, pharmaceuticals; e. agriculture, forestry, animal husbandry, agriculture and their related processing industries; f. building and construction.

Appendix 4 Capital & Profit Distribution of Ventures with Foreign Investment

4.1 Capital

Under the law of the People's Republic of China on Chinese-foreign Joint Ventures and the Regulations for the Implementation of the Law of the People's Republic of China on Chinese-foreign Joint Ventures, the total amount of investment in a joint venture (including loans made to the venture) refers to the sum of the capital construction funds and the working capital necessary to allow for production on the scale stipulated in the joint venture contract and articles of the association. As a result, the capital of a joint venture includes two parts: registered capital and borrowed capital.

4.1.1 Registered capital

The registered capital refers to the total amount of capital registered with the agency for registration and administration in order to establish a joint venture or a contractual venture, and shall consist of the sum of the amounts of investment which the parties to the venture have undertaken to contribute to it. While the proportion of the investment contributed by the foreign party shall generally not be less than 25% of the registered capital of a joint venture, there is no upper limit for the foreign party's contribution. There is no such proportion requirement for foreign investors in a contractual venture.

The parties to a joint venture may contribute their respective investments in currency, or may use as their investments buildings, plant, machinery and equipment or other materials, industrial property rights, proprietary technology, the right to the use of a site, etc., each of which shall be assigned a fixed value. If a contribution is made in the form of buildings, plant, machinery and equipment or other materials, industrial property rights, proprietary technology, its fixed value shall be determined by the parties to the venture on the basis of negotiations conducted in accordance with the principles of fairness and reasonableness, or the valuation shall be made by a thied party agreed to by the parties to the venture.

The parties to a contractual venture may also contribute their respective investment in currency, or in kind, or may use as their investments the right to the use of a site,

industrial property rights, non-patent technology and other property rights.

4.1.2 Borrowed capital

In order to guarantee a normal operation, borrowed capital is usually needed for a venture in addition to the registered capital. Like many other countries, China has set up proportion requirements of registered capital for ventures with foreign investment so that the borrowed capital does not exceed the registered one too much.

Under the Provisional Regulations for the Proportion of Registered Capital to Total Amount of Investment of Joint Ventures promulgated by the State Administration of Industry and Commerce in 1987, the criteria of the proportion requirements are as follows.

(1) If the total amount of investment of a Chinese-foreign equity joint venture is less than US $ 3 million (including US $ 3 million), its registered capital shall be at least 7/10 of the total investment;

(2) If the total amount of investment of a Chinese-foreign equity joint venture is from US $ 3 million to US $ 10 million (including US $ 10 million), its registered capital shall be at least one-half of the total investment; within this, if the total amount of investment is less than US $ 4.2 million, the registered capital shall not be less than US $ 2.1 million.

(3) If the total amount of investment of a Chinese-foreign equity joint venture is from US $ 10 million to US $ 30 million (including US $ 30 million), its registered capital shall be at least 2/5 of the total investment; within this, if the total amount of investment is less than US $ 12.5 million, the registered capital shall not be less than US $ 5 million.

(4) If the total amount of investment of a Chinese-foreign equity joint venture is more than 30 US $ million , its registered capital shall be at least 1/3 of the total investment; within this, if the total amount of investment is less than US $ 36 million, the registered capital shall not be less than US $ 12 million.

The proportion of the registered capital to the total amount of investment in Chinese-foreign co-operative ventures or wholly-foreign-owned enterprises shall be carried

out with reference to these regulations.

According to Chinese laws, ventures with foreign investment shall open accounts with the Bank of China or other banks agreed by the Bank of China. The ventures may borrow money from financial institutions in China and abroad.

As for borrowing in China, the Bank of China promulgated the "Interim Procedures for the Handling of Loans by the Bank of China to Chinese-foreign Joint Ventures" in 1981. Six years later, the Bank of China replaced this interim procedures with the "Regulations on Providing Loans to Enterprises with Foreign Investment" in view of the development of other forms of investment.

In light with the regulations, the Bank of China grants the following kinds of loan to ventures with foreign investment.

(1) fixed assets loan, to finance the construction costs, purchase of technology and equipment, and installation costs in connection with capital construction and technological transformation projects. It takes the following forms: medium and short-term loan; buyer's credit; syndicated loan, and project financing.

(2) working capital loan, to meet the funds requirement of the enterprises in the process of their manufacturing and marketing of products and normal operation. It takes the following forms; production reserves and revolving funds; temporary credit and overdraft on current account.

(3) Renminbi loan against mortgage, ventures with foreign investment may mortgage their own foreign exchange (including the foreign exchange borrowed from outside) and apply for Renminbi loan. Prior to the maturity of the loan, the mortgagor cannot repay the loan; upon the maturity of the loan, the mortgagor shall repay the original amount of the Renminbi loan and the designated bank shall return the original amount of the foreign exchange mortgaged, without being subject to the impact of exchange rate fluctuations. Mortgage loans may be used as working capital and may also be used as investment in fixed assets.

(4) reserve loan, the loan applied by the ventures for special purpose, and agreed by the Bank of China for inactive use.

An enterprise is qualified to apply to the Bank of China for a loan, provided that it has obtained a business license and fully paid up its registered capital at the specifies time, and that its capital construction project has been approved by the planning authorities and it has the ability to repay the loan and can provide reliable securities for repayment.

4.2 Profit distribution

The methods of profit distribution vary with different categories of ventures with foreign investment. In the case of an equity joint venture, after payment out of the gross profit of the joint venture income tax, pursuant to the provisions of the tax laws, and after deduction from the gross profit of a reserve fund, a bonus and welfare fund for staff and workers, and a venture expansion fund with the ratio of such allocation to be determined by the board of directors, the net profit shall be distributed to the parties to the venture in proportion to their respective contributions to their registered capital. The reserve fund, in addition to being used to make up losses of the joint venture may, with the approval of the examing and approving agency, be used to increase the capital of the venture and expand its production.

A joint venture may not distribute profits until its losses from previous years have been made up. Losses incurred by a joint venture in a tax year may be carried over to the next tax year and offset against a corresponding amount from that year's income. Should the income in the subsequent tax year be insufficient to offset the said losses, the balance may be offset against income in successive years, but within a period not exceeding five years.

Reinvestment by foreign partners is encouraged. A joint venturer that invests in China its share of profit obtained from the venture for a period of not less than five years shall, upon approval by the tax authorities of an application filed by the joint venturer, be refunded 40% of the income tax already paid on the reinvested portion.

In the case of a contractual joint venture, Chinese and foreign partners shall prescribe in the contractual joint venture contract such matters as the investment or conditions for co-operation, the distribution of earnings or products, the sharing of risks and losses, the manners of operation and management and the ownership of the property at the time of the termination of the contractual joint venture.

If, upon the expiration of the period of a venture's operation, all the fixed assets of the contractual joint venture, as agreed upon by the Chinese and foreign parties in the contract, are to belong to the Chinese party, the Chinese and foreign parties may prescribe in the contract the way for the foreign party to enjoy a priority in recovering its investment during the period of the venture's operation. The usual ways for recovering foreign party's investment are through depreciation of fixed assets, or expanding proportion of profit distributed to the foreign party, or prescribing certain amount of profit as a recovering fund before the profit is distributed.