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Pioneering Economic Reform in China's Special Economic Zones

The Promotion of Foreign Investment and Technology Transfer in Shenzhen

Weiping Wu

PIONEERING ECONOMIC REFORM IN CHINA'S SPECIAL ECONOMIC ZONES

For my parents

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The promotion of foreign investment and technology transfer in Shenzhen

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List of Abbreviations

ACFTU	All China Federation of Trade Unions
CCP	Chinese Communist Party
CND	*China News Digest*
EPZ	export processing zone
FBIS	Foreign Broadcast Information Services
FDI	foreign direct investment
FEER	*Far Eastern Economic Review*
FIE	foreign-invested enterprise
GNP	gross national product
GVIO	gross value of industrial output
NICs	newly industrializing countries
NYT	*New York Times*
R&D	research and development
RCA	revealed comparative advantage
SCN	*Shenzhen Commercial News* (Shenzhen Shang Bao)
SEZ	special economic zone
SSZD	*Shenzhen Special Zone Daily* (Shenzhen Tequ Bao)
TNC	transnational corporation
WSJ	*Wall Street Journal*
WTO	World Trade Organization

Glossary

Assembly/processing—The foreign partner supplies raw materials or intermediate goods to the Chinese partner for assembly or manufacture. The Chinese are paid for their services and the foreign partner markets the product abroad.

Compensation trade—The foreign partner provides technology and equipment. The Chinese partner repays with goods produced using the technology and equipment. The foreign partner markets the goods internationally.

Contracted foreign investment—The amount of investment from the foreign partner(s) as specified in a contract.

Contractual joint venture—Also called a co-production or co-operative project. It can involve the foreign partner providing the technology, and a capital share. The foreign investor is paid on a schedule of return negotiated beforehand. The Chinese partner usually provides land, materials, workers, buildings, services, etc.

Equity joint venture—A limited liability corporation in which Chinese and foreign partners invest jointly in and operate a corporation, and share the profits, losses and risks.

Foreign direct investment—Includes equity joint ventures, contractual joint ventures, and wholly foreign-owned enterprises.

Foreign investment—Includes foreign loans, foreign direct investment, and other foreign investments.

Foreign-invested enterprises—Enterprises receiving any form of foreign investment.

Gross output value—Monetary measure of the total output.

Net output value—An approximate indicator of value added. Major components include profits and taxes, wages, employee welfare payments, interests, and other payments.

Other foreign investment—Includes international leasing, compensation trade, and assembly/processing.

Registered investment—The amount of investment registered with the Shenzhen Administration for Industry and Commerce, including contributions from all partners of an enterprise.

Utilized foreign investment—The amount of investment actually provided by the foreign partner(s).

Wholly foreign-owned enterprise—The foreign partner covers all production, labor, and utility costs.

Introduction

China first designated four Special Economic Zones (SEZs)—Shenzhen, Zhuhai, Shantou, and Xiamen—as part of the domestic economic reform initiated in 1979. The SEZs are geographically insulated but economically open areas, where special and flexible economic policies are carried out primarily to promote foreign investment, technology transfer, and exports. At the outset of the economic reform and open door policy, the central government realized that China should take advantage of the global trend of industrial relocation to attract foreign investment to its capital-starving economy. Such investment would allow China to make full use of its large reserve of inexpensive rural surplus labor to produce labor-intensive goods for export and, ultimately, foreign exchange earnings. The government also recognized the importance of advanced foreign technology for stimulating growth and the channel through which technology transfer often happens—foreign direct investment (FDI). Thus the government promoted foreign investment, not merely as an end in itself, but as a means of bringing foreign technology to China. The role of the SEZs was to experiment with and to digest western technology and management techniques so that inland enterprises could learn from their experience.

Moreover, the SEZs had secondary objectives: to function as a buffer between China and certain external territories, and to experiment with new reform policies and a market system. The locations of the SEZs were carefully chosen in proximity to Hong Kong, Macao and Taiwan. It was hoped that the integration with these external economies would eventually facilitate or lead to political reunification. Moreover, the experimental nature of the SEZs implied that they would implement unprecedented economic policies and that, undoubtedly, some policies would succeed and some would fail. The role of the SEZs in the national economy would thus evolve as the country progressed towards further reform. The introduction of a market system into the zones would confront socialist planning with problems in both economic policy and ideological orthodoxy. For instance, one major feature of the SEZs was that they fell outside the State Plan, which affected their sources of investment and supplies. They were to rely primarily on foreign and non-state sources for capital and technology to develop export production (Reardon, 1991).

There were also certain political considerations, and these overrode the economic ones because of strategic locations of the SEZs and uncertainties related to new reform policies. As a result, the zones were not selected on the basis of whether there was a strong industrial base, an adequate urban infrastructure, or a technologically innovative capacity. First, the zones needed to be easily separated from the vast inland areas, since drastically different policies were to be experimented in the zones. All four SEZs were located along the coast, which made physical separation from the inland areas easier. Fences were built around them and check points were stationed to inspect traffic. Administrative procedures also were used to control population inflows to the zones. Non-SEZ residents have to apply through local police departments for entry permits, usually valid for a month for a legitimate visit. Second, the SEZs were not to be built into major industrial centers at first, so as to avoid significant losses if the experiment should fail. Third, the central government intended to use these zones as intermediary or 'buffer' zones for future reunification, especially in the case of Taiwan. Last, the central government's recognition that the overseas Chinese community was a potential source for productive capital promoted attention to towns along the southeast coast in Guangdong and Fujian, which have been homes to many overseas Chinese. It was thought that historical links would lure them back. The SEZs are close to the setting-off points for three of the most important dialect groups among overseas Chinese: the Cantonese (spoken in Shenzhen and Zhuhai), which predominates in Hong Kong; the Fujianese (spoken in Xiamen), which is used by 85 percent of Taiwan's population and much of Singapore's; and the Teochews from around Shantou.[1]

Promoting foreign investment has always been the center of attention in SEZs' development, whose objectives can be summarized symbolically as "*waiyin, neilian*"—attracting from the outside and linking with the inside. Although the scholarly and policy circles worldwide have been attentive to the evolution of China's SEZs, little attention has been paid to analyzing the composition of foreign investment inflows by sector and industry, particularly those from the dominant source—Hong Kong. Neither the effects of foreign investment on the local industrial structure nor, more importantly, the extent of technology transfer has received significant attention.

The purpose of this book is to examine SEZs' promotion of foreign investment during the recent fifteen-year period—1979 to 1994—and, in particular, the magnitude and composition of foreign investment inflows, their technological content, and export performance and the creation of domestic linkages by foreign-invested enterprises (FIEs). The focus of the inquiry is Shenzhen SEZ, the largest zone and the one that has garnered the largest volume of foreign investment and the most attention.

The book pursues four goals. The first goal is primarily descriptive: to measure Shenzhen's performance in promoting foreign investment against the explicit targets of the central government. This account of both the magnitude and the composition of foreign investment inflows examines its major sources, and assesses Shenzhen's importance to China in attracting foreign investment. Given the fact that investment from Hong Kong has accounted for between one-half and two-thirds of all foreign investment, for China as a whole, it is plausible that Hong Kong also has been a principle source of investment for Shenzhen.

The second goal is to understand why Shenzhen has been able to attract large foreign investment inflows, and particularly those from Hong Kong. Traditional investment theory identifies labor costs, investment incentives, and domestic market potential as the main factors in investment decisions. A chief argument of this book, however, is that the growth of foreign investment in Shenzhen has been a positive function of its proximity to a major source—Hong Kong. It will be shown that, in addition to geographical proximity, a powerful impetus is provided by the strong economic complementarity across the border, manifested in factor endowment, production, trade and services. Cultural and historical affiliations, too, have significantly facilitated economic integration and contributed to mutual development. These economic and cultural ties have been reinforced by a historic political change: the return of Hong Kong to Chinese sovereignty in July 1997.

In demonstrating this proximity and complementarity, this book also answers these relevant questions: (1) Has the proximity to a neighboring source with an advanced economy and higher factor costs favored Shenzhen's development above that of cities less well situated? and (2) Has Shenzhen's success in attracting foreign investment, particularly that from Hong Kong, been a zero-sum game for China (i.e. occurred at the expense of other cities)? Or has it captured investment inflows that otherwise might have bypassed China altogether?

The third goal of the book is to show why more investment from other sources has gone to Shenzhen rather than to non-SEZ areas in China. An underlying, broad question here is whether favorable treatment with special investment policies and government infrastructure investment, has led Shenzhen to fare better than other cities have as recipients of foreign investment. To answer this, I use a comparison with Guangzhou—the more industrialized city that is the capital of Guangdong Province and has similar proximity to Hong Kong and distance from other sources. I have found the difference to have been the local policy environment, specifically reflected in policy autonomy and openness, liberal investment policies, and large government investment in infrastructure. The analysis also shows labor costs to have been only a residual factor, despite the fact that most foreign investment related to industrial relocation has been labor intensive. In fact, labor costs in the SEZs have been higher than those in other cities in China and may not be as competitive as those in some Southeast Asian countries. Nonetheless, in Shenzhen the pull of a large, relatively inexpensive, disciplined labor reserve has been stronger than that of the domestic market potential. The fact is that market access has been extremely limited for FIEs; they have had to export between 70 and 80 percent of their output value. Moreover, the actual size and purchasing power of the Chinese market have been overestimated.

The last goal of the book is to examine whether the proximity to a major source of investment has biased the composition of these inflows to Shenzhen and limited meaningful technology transfer. The book's analysis of the sectoral distribution and technological content shows that foreign investment has, indeed, been low-tech in nature, and that technology transfer has been limited. Such a result can be accounted for largely by the dominance of Hong Kong investment. Another factor constraining technology transfer has been Shenzhen's lack of a strong industrial base and modernized infrastructure. The only intrinsic advantages Shenzhen could offer investors have been cheap land and unskilled labor. Even when some foreign investors have considered transferring advanced technology, serious roadblocks to doing so have been the lack of a proper framework for intellectual property rights and Shenzhen's underdeveloped industrial capabilities. Designed to function as pivots between the Chinese and international economies, the SEZs also have been expected to lead the country in exports and create domestic linkages. The analysis here of gross exports and net exports finds that Shenzhen has performed poorly in increasing net exports and, ultimately, foreign exchange earnings. The explanation lies in the high import propensity of FIEs. Their import activities and the limited domestic supply capabilities, together, have seriously undermined the possibility of FIEs establishing production and supply linkages with inland Chinese enterprises.

The scope of the book is confined to Shenzhen's foreign-invested sector and leaves aside the domestic sector, comprising mostly of state and collective enterprises. The evaluation focuses on economic performance; such areas as income distribution and social consequences of foreign investment are not addressed but may be appropriate topics for further research. The analysis concludes with suggestions of methods to attract