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FOREIGN DIRECT INVESTMENT AND REGIONAL DEVELOPMENT: ASSESSMENT AND PROSPECTS FOR CHINA

Bernard Hugonnier, Director,
Territorial Development Service, OECD

Introduction

Foreign direct investment (FDI) is a strategic element of the development of all regions in the world. Not only can FDI bring capital, technology, know-how, jobs and exports, but it may also induce further investments. Thus regions face quite fierce competition, including between those of the same country, and a majority of regions provide potential investors with some incentives.

FDI often targets the most dynamic regions in the world, notably highly urbanised areas, and only part of this flow is directed towards peripheral areas. However, in some OECD countries, aggressive marketing by the central government and by regional agencies, competitive tax regimes and flexible labour markets have in recent years enabled less advanced areas to attract a greater level of FDI than their contribution to national GDP.

The most difficult objective is that incoming production facilities adhere to a vertical integration pattern and contribute to the establishment of a competitive regional environment. It is therefore important that policies for attracting FDI be selective in order to reduce the volatility of outside investment and increase its multiplying effect on regional economic activity.

This paper is organised in two parts : the first deals with the experience of OECD countries as far as regional development and FDI are concerned. In the second, the situation in China is discussed and some potential alternative measures regarding FDI are proposed.

FDI and regional development: the experience of OECD regions

To be effective, policies aimed at attracting direct investment from abroad should be based only on the factors that firms take into account in making investment location decisions. According to all studies made on this subject, the main factors that firms take into account when making location decisions are as follows, ranked by order of importance: market proximity, quality and availability of labour, sound infrastructure, quality of life, cultural affinities, information campaigns and the presence of other firms operating in similar sectors of activity.

More specifically concerning availibility of labor and infrastructure, the following points were made (Christodoulou, 1996):

- Labour: the conditions required are the availability of labour in general, and of university graduates in particular; low costs and high productivity; flexible labour legislation; good labour relations; knowledge of other languages; and good education and vocational training systems.
- Infrastructures: a good transport infrastructure system; inexpensive and accessible public services; available production sites and buildings; and high-quality telecommunications infrastructure.

These conclusions are shared by the European Commission (1994), as well as by UNCTAD, although the latter argues that an inexpensive labour force, which remains a major factor of attraction, is becoming less important since incomes ultimately rise and erode the initial advantage (UNCTAD, 1999).

Market proximity is a parameter that national and regional governments can do little to affect. However, regions can reduce the natural handicap of distance from the market by ensuring that high-quality, low-cost transport and communications infrastructures are available to businesses. To traditional infrastructure must now be added the infrastructure that makes it possible effectively to use new information and communication technologies (ICT), which are generally lacking in rural regions (OECD, 2001). As regards the quality and availability of labour, government initiatives can also be useful in this regard by improving education and training systems. It has recently been shown that "learning" cities and regions (those making the greatest effort to improve education and training) are particularly attractive to FDI (OECD, 2000a).

Backward regions have succeeded in attracting FDI by adopting such policies. This has been case, for example, in areas of Scotland and Ireland, the Porto region in Portugal, Valencia and Malaga in Spain, the Puglia region in Italy and Thessalonika in Greece (European Commission, 1993).

However, the bulk of FDI has been concentrated in the most urbanised central regions of OECD countries, especially in the service sector, and the analysis carried out by the OECD shows that this has widened the disparities between these regions and other regions (OECD, 1994). This has been the case in particular in the United States, France, Spain, the Netherlands and Germany.

It has also been observed that on the whole investments in outlying regions have been aimed at establishing production subsidiaries with limited decision-making power, mainly to take advantage of low labour costs, while investments with high potential for innovation and initiative have primarily been located in central regions (Amin, 1994).

Of the 17 transition countries in Central and Eastern Europe, four are Members of the OECD: Hungary, Poland and the Czech and Slovak Republics. The first three countries are the main beneficiaries of FDI in the region (Collis et al., 1999). The most interesting features observed in this regard are as follows:

- over three-quarters of FDI comes from the EU, which shows that the existence of significant and solid commercial ties is a major explanatory factor;
- the other explanatory factors are a relatively large domestic market for goods and services, a well-trained and relatively low-cost labour force, infrastructure that is being upgraded, sound economic performance, growing purchasing power and political and economic stability, with Poland being the leading country in all these areas.

The incentives, whether they are financial, fiscal or in kind, that countries may provide to attract FDI are not among the main explanatory factors behind the location decision (see above). The most recent summary of empirical work on the impact of incentive measures on FDI location decisions shows that these measures in fact play only a minor role (UNCTAD, 1996).

Nevertheless, regions that cannot naturally attract FDI on their own, such as lagging behind regions, tend to offer foreign firms subsidies to encourage them to move there. These subsidies can be considered as a way of offsetting these regions' lack of attractiveness (or low competitiveness) and the extra costs that locating there will generate for the firm in comparison with a central region. If the social benefits that can be expected from a foreign investment and the multiplier effect that it may have on development are taken into account, this policy may be advantageous on the whole and may lead to a lasting investment that will attract further foreign investment.

If this proves not to be the case, there is a high risk of disinvestment, since the handicap to the firm's development is too great, and it may be attracted by the windfall of subsidies offered by other regions. According to the OECD, great care should be taken before resorting to this type of policy, which may ultimately turn out to be a zero-sum game (the FDI created in one region means that much less in another), with a high social cost for regions. What is more, the development derived from this kind of policy can only be superficial, since the companies would not have invested in these regions without the subsidies. As a result, volatility of investments and superficiality of development at a high social cost are the main risks of this policy that must be borne in mind (OECD, 1998).

Nevertheless, multinational firms are not indifferent to the incentives that they may be offered when they must choose between two countries where conditions are similar. In such cases, these incentives may make the difference. Uncommon though they are, situations of competitive bidding must be avoided, however; they are indeed beneficial to the investor, but at taxpayers' expense, since the firm would have made its investment even without the incentive.c) New incentive policies

New approaches have been devised to enhance the natural attractiveness of regions for FDI. The first consists of promoting the development of industrial districts, and the second of taking measures to facilitate the rapid integration of foreign firms once they have moved into the region. The privatisation of state-controlled enterprises and public services is another way of attracting FDI that has also become widespread in recent years. Lastly, local development agencies that seek to attract FDI appear to be playing a growing role.

i) Industrial districts

Industrial districts, which concentrate firms in the same sector or industry in a single area, help to increase the competitiveness of participant firms through the positive externalities that they generate (OECD, 2000b). Furthermore, small and medium-sized enterprises that belong to industrial districts can develop partnerships to undertake activities for which they would not have the necessary critical size or adequate financial resources (training, R&D, large-scale investments financed by pooling loans, exports, FDI, etc.).

These industrial districts are of special interest for FDI and the possibility of it being located in outlying regions. It has been observed that many of these districts have developed in remote rural regions without the advantages of central regions. This is the case of the Italian industrial districts located in the regions of Emilia-Romagna, Tuscany and the Veneto, but there are also similar districts in the outlying regions of countries such as Mexico and Spain.

This means that multinational firms can be encouraged to locate their subsidiaries in regions that already have industrial districts so that they can benefit from the advantages that this kind of investment provides, such as a labour market that is more specialised and highly developed than in isolated areas.

It has been shown that the subsidiaries of multinational firms located in industrial districts tend to have higher value added, to be more oriented towards international activities and to be better integrated into their local environment than firms that are not located in such districts (Birkinshaw and Hood). It has also been shown that a subsidiary of a multinational firm located in an industrial district can play an important role for its parent company, such as keeping it informed of practices specific to the industrial district that may be of interest to it (Enright, 1998).

ii) FDI retention policies

Solid and long-lasting integration into the local environment is also an important asset for the host region's development. This ensures not only that greenfield investments will endure, but also that repeat investment may ultimately be carried out. In a world in which secondary investment now exceeds initial investment, this aspect is essential [in the United Kingdom, according to Phelps and Fuller (2001), such investment accounts for more than 50% of all FDI].

This approach is increasingly being acknowledged as an essential win/win strategy, as it is beneficial not only to the host region, but also to the multinational enterprise, which enjoys a higher return on investment. The approach can be broken down into three parts: after-sales service; actions to integrate into the local economic, social and political fabric; and actions to foresee and limit possible closures by a variety of different means:

- Investor monitoring for problem resolution;
- Assistance with finding suppliers and employee recruitment;
- Aid for business expansion;
- Aid for training;
- Assistance in obtaining public services and forging ties with universities and research and technology institutes.

In effect for several years now, such policies for the retention and integration of FDI seem to have been particularly effective in a number of countries, including the United Kingdom (for Wales) and France, where it is acknowledged that "firms are sensitive to the attention that is paid to them, and, when economic conditions remain favourable, prefer relationships with territories that treat them with consideration and keep their promises, as opposed to other regions that are more sensitive to public relations initiatives" (translated from Rocchi, 2001). In London, there are plans to follow this course (Clark, 2001). The OECD advocates such a policy, which fosters sustainable development insofar as it is based on a region's own advantages, and not on contrivances to attract FDI temporarily.

iii) Privatisation

In addition to the countries of Central and Eastern Europe, for which privatisation was an inevitable stepping-stone to a market economy, a large number of countries, in Europe, Asia and Latin

America alike, undertook sometimes massive programmes in the 1990s to privatise government-owned enterprises and public services, most notably in telecommunications.

Of course, this privatisation attracted FDI and enabled certain countries to benefit from substantial inflows of foreign capital. This was naturally the case for the Central and Eastern European economies in transition (Collis et al., 1999), but also for Latin America, where privatisation led to a more than 50% rise in FDI flows in 1999 (from an average of $60 billion in previous years to $93 billion, according to ECLAC, 2001). In these countries, certain outlying areas in particular were able to benefit, as was the case in the mining sector in Chile and Peru, and in the energy sector in Chile and Argentina.

But this policy for attracting FDI entails substantial risks, and above all that a similar pace of FDI flows cannot be sustained without further privatisation. Such inflows of capital, which facilitate government budgeting, only defer major structural reforms. Moreover, they place large segments of a country's industry and its mining, energy and service sectors into the hands of foreign interests, which in many cases would rather maximise immediate returns than invest for the long term. This policy, which the United Nations has rightly called into question (ECLAC, 2001), does not seem *per se* to be an appropriate instrument for attracting FDI.

iv) Regional development agencies

In many countries, the component regions have their own agencies or other organisations dedicated to promoting and facilitating local development. In some cases, there are even agencies of this sort for cities or clusters of cities.

These agencies, which promote and market their respective regions, can play a significant role with regard to FDI, as the experience of many OECD countries has shown. The same agencies can play an important role in the essential aim of retaining and integrating existing FDI (see above).

In addition, they can be supplemented by other agencies, which on a nation-wide level play a similar role in attracting FDI. It can be noted, for example, that in each of the three Central and Eastern European transitional economies that attracted the greatest amount of FDI over the past decade (Hungary, Poland and the Czech Republic), such agencies had been created at a relatively early stage (respectively 1993, 1992 and 1990, Collis et al., 1999).

FDI and regional development in China

In order to make the best of foreign direct investment, the present policy in China needs to be reconsidered along the five following lines:

Re-orient FDI towards the Centre and the West

The FDI situation in China is especially polarised. The ten coastal provinces, which account for 36% of the population, actually absorb over 85% of foreign direct investment, whereas a decade ago the proportion was roughly 70% (Table 1). Three maritime provinces alone account for nearly 50% of these investment flows.

As one heads westward, FDI flows become increasingly rare: while central provinces may still receive 14% of the annual flows, the proportion falls to less than 1% for all of the western provinces combined. In the 21 central and western provinces, the highest figure is 2% (in Guangxi and Hubei), and the lowest is 0.2% (in Ningxia).

Table 1. Geographic polarisation of FDI
(% of total flows)

Provinces	Year 1998
Coastal	85.5
Central	14.0
Western	0.5

Source: China Statistical Yearbook, 1998

The heavy geographic concentration of FDI in the coastal provinces can only lead to an aggravation of economic and social disparities with the other provinces, and especially those in the Centre and the West in view of the lack of sufficient industrial linkages between the provinces, the low level of inter-regional co-operation and the relatively undeveloped level of domestic economic integration have impeded the dissemination of the benefits of FDI in coastal areas to other parts of the country (Sun and Chai, 1998). Moreover, the coastal provinces have been able to take advantage of the benefits accorded to inward foreign investment to build their stock of FDI. This incentive policy could only widen the gap with the western and central provinces, which naturally have fewer assets with which to lure foreign investment.

Alternative measures must therefore be taken to enhance the attractiveness of the other provinces, in particular by investing in infrastructure, as has been done in the coastal provinces, by developing forms of inter-regional co-operation and by fostering domestic economic integration.

Diversify the origin of FDI

Taking in more than 26% of the flows, the coastal province of Guangdong remains the most attractive region. Thanks to its geographical location, the province has benefited more than any other from the liberalisation of foreign investment that has taken place since the early 1980s. In fact, Hong Kong is the leading economy of origin for foreign direct investment in China as a large number of businesses left the territory over the past twenty years in order to relocate in Guangdong (Dunning, 1997).

Investment flows come essentially from Asia (over 65%), with the leading investors, after Hong Kong, coming from Taiwan (China), Japan, Singapore, Korea and Macao. This situation results from the fact that special incentives have been offered to investors from Taiwan, Singapore, Hong Kong and Macao—a policy that has lead to a heavy concentration of FDI in southern coastal China, to the detriment of the other provinces.

Furthermore, the present origin of investment flows has introduced a certain fragility to the development of the coastal provinces. The recent financial crisis in fact led to a slowdown of FDI from these economies, and the neighbouring provinces, and Guangdong in particular, have suffered (see Table 2). In contrast, the northern coastal provinces, where there is more FDI from the industrialised countries, were less affected by the crisis and have seen their relative position improve (Fur et al., 1999, p. 135). A policy to diversify the origin of FDI would therefore be advisable in order to ensure a more harmonious development of the provinces. Flows should henceforth come to a greater extent from the OECD countries, thanks to a reformed incentive policy.

Table 2. Trends in FDI flows in the coastal provinces
(% of total flows)

Province	79-91	97-98
Beijing	8.5	4.1
Tianjin	1.7	5.1
Hebei	0.6	2.8
Liaoning	4.2	4.9
Shanghai	5.8	8.7
Jiangsu	2.7	13.4
Zhejiang	1.2	3.1
Fujian	6.5	9.3
Shandong	2.4	5.2
Guangdong	36.6	26.3
Coastal provinces	69.9	82.9

Source: Fur & al., 1999 and 1998 China Statistical Yearbook

Less export oriented FDI

Until now, the main purpose of FDI has been to bolster Chinese exports. FDI located in the ten coastal provinces accounts for nearly 97% of total exports by foreign enterprises in China (1998 data), and for over 30% of China's aggregate exports. Guangdong province alone accounts for nearly half of all exports by foreign enterprises, and for over 15% of the nation's total exports. At the same time, both of these export statistics are negligible for the central and western provinces (Table 3).

Table 3. Contribution to the exports of foreign-owned enterprises (FOEs)
1998

Province	% of total exports by FOEs	% of aggregate Chinese exports
Beijing	1.6	0.5
Tianjin	4.7	1.5
Hebei	0.8	0.2
Liaoning	4.7	1.5
Shanghai	10.1	3.2
Jiangsu	10.0	3.1
Zhejiang	3.3	1.0
Fujian	6.7	2.0
Shandong	6.4	1.9
Guangdong	48.4	15.4
Total coastal provinces	96.7	30.3
Other provinces	3.3	1.1

Source: China Statistical Yearbook 1998.

To enhance the development of China, and of the central and western provinces in particular, FDI should also aim to serve the Chinese market. Foreign direct investors could find it worthwhile to locate in provinces other than the coastal areas on which they had been concentrating as an easier and less costly base for exports to the rest of the country.

Better exploit FDI to import technology

As in most Asian countries, and in South-East Asia in particular, foreign investment is heavily concentrated in the manufacturing sector, with over 75%, which is higher than the average for developing countries (67%) and far higher than the world-wide average (44%, see Table 4). The investment has primarily been channelled into labour-intensive export industries, textiles in particular (Dunning, 1997) and as a result subsidiaries of foreign companies have played a growing role in Chinese exports.

Table 4. FDI by sector, 1998
(% of total flows)

	Sector		
Host countries	Primary	Secondary	Tertiary
Industrialised	9.2	37.5	42.9
Africa 10.1	28.7	39.7	
Asia 5.7	76.6	16.2	
Latin America	9.0	45.9	45.0
Total developing countries	6.7	66.8	25.0
World 8.6	44.0	38.9	

Source: UNCTAD, 1999, Tableau A.I.16

In the end, the concentration of FDI in the labour-intensive export sector has given rise to relatively limited technology transfers, with investment from Hong Kong, Taiwan, Singapore and Macao generally involving a low technology content (Young & Lan, 1997). In contrast, FDI from industrialised countries generates more substantial transfers of technology. As a result, northern coastal provinces, where such investment has been greater, exhibit more extensive development. Overall, however, it appears that China has not fully exploited FDI to import the technology which could be beneficial for its economy.

Introduce new incentive measures

Finally, as noted above, new policies have been formulated in the OECD countries to stimulate FDI. Whether they involve privatisation, the development of industrial districts, measures to retain FDI or the creation of local development agencies, these new policies, which seem to have proven their worth, could be developed in China as well.

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