FOREIGN DIRECT INVESTMENT IN CHINA'S REGIONAL DEVELOPMENT

PROSPECTS AND POLICY CHALLENGES

Synthesis of Discussions and Conclusions

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CONCLUSIONS AND POLICY MESSAGES,

Rainer Geiger,
Deputy Director, Directorate for Financial, Fiscal and Enterprises Affairs, OECD

The OECD-China conference on Foreign Direct Investment in China's Regional Development: Prospects and Challenges was held on 11-12 October 2001 in Xian. The conference was opened by Vice-Governor Zhang Wei of Shaanxi Province, Vice-Minister Long Yongtu of the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and Ambassador Marino Baldi of Switzerland representing the OECD Committee on International Investment and Multinational Enterprises.

Overview

Globalization demands more rapid adjustment and strategic positioning of not only countries but also regions, so that they are not left to lag behind or decline in the process. In the new economic environment, policy-makers are helping build dynamic and flexible regions and cities. They also assist the transition from individual closed local economic systems to a new, open global system. To do this properly, it is important to "think globally and act locally".

FDI has a role to play, particularly in terms of local economies' establishing and enhancing links with the world economy. Not only can FDI bring capital, technology, know-how, jobs and exports, but it also induces further domestic investments. Today, countries and regions within countries face strong competition for attracting FDI. Foreign investment often targets the most dynamic regions in the world, notably highly urbanized areas so that only part of this flow is directed towards peripheral areas. Investments in outlying regions generally aim at establishing production subsidiaries mainly to take advantage of low labour costs, while investments with higher potential for research and innovation have primarily been located in urbanized regions.

China's impressive growth over the past two decades has been greatly assisted by FDI inflows. Although the volume of FDI is already high (at US$ 41 billion in 2000), there are a number of measures that can be taken to attract additional flows and extend the impact of foreign investment in China. The composition of FDI is shifting from investments undertaken by overseas Chinese companies (mainly Hong Kong-, Macao- and Chinese Taipei-based) to investments by large and medium sized OECD-based corporations.

China's economic development is characterized by wide geographic disparities between the coastal regions and the central/western regions. Two thirds of China's population, or around 900 million people, live in rural regions that are largely under-developed and have received very little in the way of FDI inflows. As a result of the substantial changes in the national investment environment and in light of China's World Trade Organisation (WTO) accession, regions are expected to face new challenges and opportunities.

With a view to redressing the growing regional imbalance and attracting greater investment flows, the Chinese government has taken a series of measures to help improve the investment environment and prospects in the country's less favoured regions. Regions should be able to benefit from larger FDI participation in infrastructure development and a number of pilot projects of this kind have already been undertaken in several provinces and autonomous Regions. China is also encouraging and facilitating the participation of multinational enterprises in domestic state-owned enterprise reform through mergers and acquisitions.

Key Policy Messages

Participants at the Xian conference considered a number of follow-up actions by the Chinese Government, the OECD, other local and international partners on the following ppolicy messages that have emerged from conference deliberations and that are relevant in reaping the full benefits of FDI in China's regional development:

- Enhance the attractiveness of China's central and western regions, in particular by investing selectively in infrastructure where competitive advantage can be realistically established as has been done in the coastal provinces. Identify sectors and industries with comparative advantages and analyse the regions' strengths and weaknesses. Base FDI policies to attract investors on the factors that firms consider in making investment location decisions.

- Develop an integrated approach that addresses broader policy areas affecting regional development: competition, taxation, financial markets, environment, technology, labour market, trade, capacity building. Combine actions in economic, social and environmental sectors and between different bodies at local, regional, national and international level. Develop effective mechanisms for consultation among key stakeholders in the strategic phases of design, implementation and evaluation of these policies.

- Develop a set of policy criteria by which to judge the investment environment and FDI attraction performances in each region.

- Remove administrative barriers, improve transparency, and promote coherence between central and provincial policies. Reduced transparency provides opportunities for corruption, creates an investment risk and has the effect of a tax on foreign companies' operations.

- Carefully consider the costs and benefits of incentives in light of the available evidence whether they are financial, fiscal or in kind. Such incentives can be costly in terms of government revenues without having much of an impact on investors' decisions.

- Put emphasis on the presence of a reliable and transparent legal and regulatory environment. What is important in the long run is that firms with different ownership can compete on a level playing field under fair competition rules. Ensure greater coherence between national/provincial tax rules and policies.

- Promote domestic market-oriented FDI. Foreign direct investors could find it worthwhile to locate in provinces other than the coastal areas on which they have until now been concentrating as an easier and less costly base for exports to the rest of the country.

- Promote stronger linkages of FDI with the local economy. Encourage investments that build on local resources and initiative, while taking account of the opportunities afforded by globalisation in trade, technologies and finance. Foster public-private partnerships and small-firm networks as the most expeditious path to a dynamic small and medium size enterprise (SME) sector. Improve financial support services to SMEs and township and village enterprises (TVEs) including access to equity funding.

- Encourage industrial districts. Mobilise domestic capital and overseas Chinese business communities, as they will have less concern about the risk of investing in the interior.

- Create effective investment promotion agencies (IPAs). Focus on effective strategic planning and targeted policy actions supplemented by an appropriate organisational structure. Reconsider the relationship between IPAs and other institutions undertaking FDI related functions at the national and local levels.

Follow-up Actions

- Dissemination by MOFTEC of the foregoing key messages widely to regional and local governments across China;

- Publication of the selected papers from the conference in English by OECD and in Chinese by MOFTEC by mid 2002;

- Further work on investment promotion in regions, on the basis of OECD's best practices manual;

- Further work on tax treatment of foreign investment and on fiscal federalism;

- Organisation of an expert workshop on "Re-industrialisation of the Western and Central Regions of China", Chongqing, Spring 2002;

- Possible OECD evaluation of regional development in a particular province, similar to the OECD territorial development policy reviews;

- Review of progress at the planned Xiamen Investment Fair, September 2002.

SUMMARY REPORT:
FOREIGN DIRECT INVESTMENT IN CHINA'S REGIONAL DEVELOPMENT,
PROSPECTS AND POLICY CHALLENGES

Introduction

The conference's primary objective was to exchange views and experiences with China's senior central and provincial government officials on the changing patterns of regional development in China, and the role of best FDI policy and promotion practices in this process. Participants also shared varied relevant international experiences and highlighted the significance of policy tools and good governance structures in maximising benefits of FDI for regional development.

This conference brought together more than 120 representatives of OECD and non-OECD countries, central and provincial government officials and experts from China. Also attending were representatives of other multilateral organisations that provide technical assistance and loans for regional development projects in China, among which the World Bank and the Asian Development Bank, as well as the European Commission and the United Nations Industrial Development Organisation. Private sector representatives, including interested members of the Business and Industry Advisory Committee to the OECD, also took active part in this conference.

The two-day discussions focused, on the first day, on the issue of regional development and the role of FDI, examining the challenges laying ahead in China, and sharing international experiences in this field, and, on the second day, on the means to attract FDI into China's regions, concentrating on effective promotion of FDI, and building links with local enterprises.

The main points which emerged from the presentations and discussions are summarised as follows.

Regional Development and Foreign Direct Investment

As FDI flows worldwide increase, performance gaps are widening between regions, and rapid technological change, extended markets and a greater demand for knowledge are offering new opportunities for regional development.

China is a country, where regional development is of a foremost priority. The launch of the economic reforms in 1978 and the shift in China's dominant development policies from ones based on self-reliance to ones favoring comparative advantage and open door policy have attracted large inflows of FDI, placing China among the top ten non-OECD recipients of FDI. However, these flows have not been equally shared: a large amount of existing foreign direct investment has been located in China's relatively prosperous coastal regions (88% of the country's total FDI from 1978 to 1999), without any significant catching up by the interior central and western regions (approximately 10% of total FDI flows to China in that period).

In an effort to narrow this economic gap, the Chinese government launched the "Great Western Development Strategy" (or "Go West" policy) in January 2000, aimed at redressing the growing regional imbalance and attracting greater investment flows to China's hinterland.

Challenges for China's Regional Development

Participants stressed that any analysis of the development of FDI flows over time, as well as their regional distribution, had to take into account what factors attract enterprises to invest in host countries.

A factor identified by investors as fundamental concerns the *regulatory framework* covering all FDI-related activities in China. Establishing a competitive business environment through removal of unnecessary regulations was considered essential by many companies, according to a survey in Japan. An efficient administrative apparatus, devoid of excessive red tape, corruption, and striving to improve transparency and coherence, was also identified by participants as a factor likely to increase attractiveness of Chinese regions wishing to attract FDI.

Speakers also underlined the importance of developing an adequate protection regime of intellectual property rights, which would contribute greatly to enhancing China's attraction. In this respect, several participants suggested that transferring authority on investment policies from the central to the local governments would be a major step in the development of rural areas.

Access to *fundamental infrastructures* was also stressed as a factor highly taken into consideration by enterprises considering investment abroad. This includes supplying stable resources of gas, electricity, and water, good transport systems, telecommunications, as well as the provision of efficient financial services.

Attraction of FDI can also be increased through *availability of natural resources*. Resource seeking FDI, in particular, will be motivated by the wish to exploit interregional factor price differentials for the multinational enterprises' production process, a factor which could be exploited in the Western and Central regions of China. Authorities from Western China stressed the abundance of mineral resources, energy, agricultural products, and land development available in their region.

Speakers underlined the *human capital* aspect in promoting FDI flows to a region. Low-labour cost can be determinant in attracting FDI to a particular region. Regarding China, however, this factor may be considered less important, since the wage difference between regions is minor, as migrants continue to arrive in the Chinese coastal areas, thus preventing the wages in those industrial centres from rising excessively. In addition, China's Western and Central regions may be at a disadvantage as skilled labour is scarce and the non-availability of managers, technicians or engineers may be highly detrimental to the attraction of FDI. Hence, it was suggested to improve and encourage labour mobility to those regions, and speakers stressed the importance of improving education and professional training.

The importance of the presence of other foreign invested enterprises and *existing accumulated FDI stock* was also broached during the discussions. The presence of other firms and supporting industries operating in similar sectors of activity, for the potential development of partnerships, was quoted as an essential factor that companies take into account in making decisions on where to invest. This subject of industrial districts was further evoked during the following day's discussions (see part II B below).

Finally, investors stressed the importance of an *attractive environment* for skilled labour (Chinese and expatriates). Local governments able to create such an environment, including schools, hospitals, parks, etc… will increase the chances of their region to attract FDI.

The "Go West" strategy was identified by participants as a positive step towards improving the attractiveness of China's hinterland for FDI. Special emphasis was put on improving market access in the Central and Western regions, relaxing equity and investment control for FDI, improving infrastructures, protecting the ecological environment, improving and upgrading the services sector, and developing in particular the high-tech industry.

The question of the effectiveness of *investment incentives* as a means of attracting FDI was also discussed. Both investors and academics underlined that incentives were not critical in choosing a location for investment abroad. Rather, enterprises tend to look at business opportunity and competitiveness, or study the risk profile (legal and political risk, environmental risks) of the region. This point was further discussed during the afternoon's session (see below).

Finally, many participants underlined that the *accession of China to the WTO* could also improve the situation for China's Central and Western regions, offering lucrative trade opportunities, and the application of market-based rules, thus offering a safer investment environment for businesses (notably through application of international standard accounting practices, and stronger legal protection of intellectual property rights). Furthermore, the promotion of mergers and acquisitions involving FDI would provide a chance to substantially increase the inflow of foreign investment in the region, providing, simultaneously, a solution for the restructuring of ailing state-owned enterprises.

These points were further underlined during the second session, during which different countries exposed their own experience regarding the role of FDI in regional development, and how it could be transposed to China.

Sharing Country Experiences

Speakers outlined the necessary policies aimed at attracting foreign direct investment from abroad, which, they stressed, should essentially be based on factors taken into account by firms in making investment location decisions. Since major business-investment decisions are made by businesses themselves, the role of governments lies mainly in fostering a competitive business environment. Several lessons were drawn from OECD and non-OECD countries' experiences presented to the conference.

It was argued by business representatives that *Investment incentives*, be they financial, fiscal or in kind, were not among the main factors of location decisions for their enterprises. Moreover, they may be detrimental in terms of employment and local supply. Nonetheless, where incentives or subsidies can be seen as counter-balancing a region's lack of attractiveness, and where social benefits are expected from foreign direct investment, such policies may be justified and advantageous, leading to lasting investment, attracting, in turn, further investment.

The creation of *local development agencies* was also mentioned by several speakers as a useful tool in promoting FDI in regions. The aim of these agencies is not only to promote and market their respective regions, but also to retain and integrate existing FDI. Their role can even be further extended to ensure sustainable development in the region they represent. Such is the case of the South-Eastern Anatolia Project (GAP), created in Turkey, and which was presented by one speaker as an administration whose aim is to co-ordinate the implementation, management, and evaluation of all development-related activities in the region, in an effort to respond to the problems that typically face such underdeveloped regions (low access to education, health care, high unemployment, etc.). This issue of investment promotion agencies was also evoked during the discussions of the second day, when considering effective ways to promote FDI in China's regions (see II A below).

The importance of *FDI retention policies* was also underlined as an important aspect contributing to the sustainable development of regions. This ensures not only that greenfield investment will endure, but also that repeated investment may ultimately be carried out. Representatives of the business community pointed out that they felt this played for a mutually beneficial situation, not only for the host region, but also for the enterprise, which is likely to enjoy higher returns on its investments. Countries such as the United-Kingdom and France acknowledged that such policies had indeed been effective, and the OECD advocates such policies.

Most participants were of the view that retaining FDI could not be accomplished by the sole efforts of government agencies, but through the *involvement of all stakeholders*. They felt that FDI should be approached in a globalised context, and, in that respect, recommended that linkages be established between government authorities, businesses, educational institutions, financial institutions, professional institutions, as well as the local community.

In order to make the best of FDI in China, several suggestions were put forward by conference participants:

The first suggestion was to *re-orient FDI* towards China's Central and Western regions. This was felt as essential to avoid an aggravation of economic and social disparities among the different provinces. Enhancing the attractiveness of China's hinterland by investing in infrastructures, developing forms of inter-regional co-operation, and fostering domestic economic integration was suggested.

Diversifying the sources for FDI was also felt important. Current investment flows come essentially from Asia, which made for a fragile situation in view of the recent financial crisis in the region. Diversifying the sources for FDI (including from OECD countries) would help ensure a more harmonious development and a more stable situation. Moreover, FDI from industrialised countries have been shown to generate more substantial transfers of technology.

Some speakers also suggested that China should turn to a *less export-oriented FDI*. Currently, export statistics are negligible for the Central and Western provinces of China, and their development could be enhanced through FDI aiming to serve the Chinese market.

Bringing Foreign Direct Investment to China's Regions

The second day's discussions further explored effective ways of promoting FDI in China's regions, and focused on the importance of local capacity building.

Promoting FDI in China's Regions: Issues and Challenges

The main reasons for the *lagging behind in China's Central and Western regions* with regard to FDI flows include several factors. One speaker identified them as follows: government policies, which favoured the opening up of coastal areas throughout the 1980s and the first half of the 1990s; the more favourable geographical location of the coastal areas for export-oriented industries; the harsher natural conditions in China's hinterland; the greater central government's investments in the coastal regions in the period from 1980 to 1985 (Sixth Five-Year Plan); the resource-intensive and large size of the industries located in the Central and Western provinces, traditionally plagued by slow growth and outdated processing techniques; and the overweighed state sector, which holds a higher portion in those provinces.

The *"Go West" campaign* formulates a series of preferential policies to promote development in those regions. These include increasing government investment in the Central and Western regions of China. It also prioritises the construction of infrastructure facilities in energy, transportation, resources, high and new technologies, etc. Fiscal measures are also part of this plan, enlarging central fiscal transfer disbursement, and giving priority to China's Central and Western regions for the allocation of special funds. Another essential policy consists in encouraging rational movement of personnel towards those regions, notably for skilled labour.

Other preferential policies have also been put into practice. Preferential fiscal treatment is being granted to enterprises locating in the poorer regions. Similarly, foreign equity investment percentage will be broadened for foreign invested firms in the Central and Western provinces. Other advantages are also applicable to foreign enterprises investing in those regions, in order to expand the areas and channels for foreign investment.

Shanghai was discussed as an example of a Chinese region attracting large FDI inflows. Based on this and other examples, further suggestions for promoting FDI in those regions of China that most need it were put forward by participants.

The *reform of the large state-owned enterprises* (SOEs) was pointed out as an important step towards increasing FDI inflows and maximising their benefits for the Central and Western regions. As pointed out earlier on in the discussions, the large presence of SOEs in those regions is a major factor withholding economic growth. Thus far, the reform of those SOEs has failed to take off quickly. One speaker even cautioned investors regarding investing in those enterprises.

Other participants, on the other hand, felt that SOEs could be made attractive to foreign investors, provided certain issues were taken seriously into consideration: encouraging foreign investment in those enterprises through mergers and acquisitions; creating favourable conditions to solve the overstaffing problems of many SOEs, notably by putting in place a sound social security system; and elaborating sensible plans to solve SOEs' debt problems. Some speakers warned that without such effective policies, uncompetitive enterprises like the SOEs were likely to go bankrupt, thus causing structural unemployment and financial problems, which would have an impact on the regions' social stability

Participants widely agreed that the Chinese hinterland could not be developed as a whole at one time. Rather, they suggested that *development policies focus on certain cities and areas* where conditions appear more favourable. The idea would be to put forward the existing advantages of certain cities, boasting, for instance, a large number of research institutes, or electronics industries, to attract foreign investors.

The further development of *investment promotion agencies* was also underlined as a major means of effectively promoting FDI in China's regions. Three main points were identified as essential for the effective functioning of investment promotion agencies: selecting and developing appropriate functions, creating and effective organisational structure, and establishing mutually beneficial relationships between national and local institutions.

Investment promotion agencies are also considered highly important in the context of the "*best practice guidelines for investment promotion*", developed by the OECD on the basis of the examples of smaller OECD countries. These Guidelines also define a role for government, as well as how to maximise the benefits to the local economy. Although initially intended for use in the transition economies of Southeast Europe, the Guidelines are largely relevant to the situation in China, in as far as there is a similar concern regarding how to attract investors to those regions.

Building Links with Local Enterprises

As discussed in previous sessions, attracting FDI can be a difficult endeavour. Yet, participants underlined that this was just a first step, and that once the capacity of a region to attract FDI had been increased, it was of prime importance to create an environment which would allow capturing the full benefits of FDI through linkages with local enterprise development.

It was stressed that FDI inflows were not automatically beneficial for the host regions, and could, in particular, lead to a *crowding-out of local investment* and already established local enterprises. This generally comes as a result of an uneven playing field, favouring foreign-invested enterprises with regard to global factor and goods market access. Where local and foreign enterprises are at different stages of development, this may also be detrimental to the local industries, forced to compete with the multinational enterprises at a point in time when they are not ready to do so.

Other participants dwelled on the *crowding-in effects* of FDI, inducing local investment and strengthening the local enterprise sector. This is most likely to be the case where foreign-invested enterprises do not compete directly with the local industry, but rather introduce new goods and services to the local community, thus creating new business opportunities both down and upstream, and creating large employment opportunities. One speaker quoted the case of a beverage company investing in China. The company and its bottlers directly employed 14.000 people in China, but 350.000 job were said to have been created in the supply chain, and a further 50.000 in the distribution sector.

In this regard, several speakers underlined that an important role could be played by the *township and village enterprises* (TVEs). Usually relatively independent from powerful local and administrative entities, they tend to be more responsive to market developments than the large, state-owned enterprises. In addition, a strong sector of highly entrepreneurial small and medium sized enterprises tends to attract foreign investors looking for a vivid local industry, ready to complement and reinforce their own business activities.

Further illustration of this attraction was provided by other speakers presenting the situation of *industrial districts* (or clusters). One participant describe industrial districts as local territorial areas with a high concentration of small and medium sized enterprises, a strong industrial specialisation, and special linkage between the industries and the local population. Indeed, such districts are usually characterised by a higher entrepreneurial density than the national average, a similarly high-level of specialised workforce, and a factor of industrial specialisation.

Participants underlined that the advantages brought about by these clusters included the development of innovation of products and working techniques, favoured workers mobility within the area, and, moreover, acted as a magnetic pole for investment from other enterprises, exterior to the district. The role of governments in creating favourable conditions for the establishment of such districts was also discussed.

As in previous discussions, the recommendations covered such areas as the provision of adequate infrastructures and services, favouring links between industries and educational institutions, adopting an efficient legislation on investment and intellectual property rights protection, facilitating access to third markets, providing insurance for commercial risks, and possibly implementing a system of financial facilities and incentives.