

WTO Accession, the Changing Competitiveness of Foreign-financed Firms and Regional Development in Guangdong of Southern China

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YEUNG G. (2002) WTO accession, the changing competitiveness of foreign-financed firms and regional development in Guangdong of Southern China, *Reg. Studies* **36**, 627–642. This paper investigates the changing competitiveness of foreign-financed manufacturing firms and its implications for regional development in Guangdong province of southern China in the run-up to World Trade Organization (WTO) accession. It is argued that transnational corporations (TNCs) and some competitive, large-scale, locally-funded firms in Guangdong will triumph after WTO accession. The crowding-out process of small and medium sized enterprises (SMEs) in Guangdong will be accelerated in the near future, as they are competing directly with TNCs, and as their competitive advantages are diminishing, due to bureaucratic red tape and the rigorous enforcement of new government policies. Due to close business linkages with local privately-funded firms, the competitiveness and vitality of foreign-financed enterprises will have profound long term effects on the economic development of Guangdong, before and after WTO accession.

WTO accession Competitiveness Foreign-financed firms Regional development Guangdong, China

YEUNG G. (2002) L'adhésion à l'OMC: l'évolution de la compétitivité des entreprises à capital étranger et le développement régional en Guangdong dans le sud de la Chine, *Reg. Studies* **36**, 627–642. Cet article cherche à étudier l'évolution de la compétitivité des entreprises industrielles à capital étranger et les conséquences pour le développement régional en Guangdong dans le sud de la Chine, à la dernière ligne droite avant l'adhésion à l'OMC. On affirme que des sociétés transnationales et certaines grandes entreprises à fonds de proximité compétitives en Guangdong réussiront au lendemain de l'adhésion à l'OMC. En Guangdong, le risque d'éviction des PME va s'accélérer dans un proche avenir, parce qu'elles sont en compétition directe avec les sociétés transnationales et car leurs avantages compétitifs diminuent à cause de la bureaucratie et de l'application rigoureuse des nouvelles politiques gouvernementales. En raison des liens étroits commerciaux avec des entreprises à fonds de proximité, la compétitivité et la vitalité des entreprises à capital étranger auront des conséquences profondes à long terme sur le développement économique de Guangdong, avant et après l'adhésion à l'OMC.

Adhésion à l'OMC Compétitivité
Entreprises à capital étranger Développement régional
Guangdong, Chine

YEUNG G. (2002) Beitritt zur Welthandelsorganisation (World Trade Organisation = WTO), die sich wandelnde Wettbewerbsfähigkeit vom Ausland finanzierter Firmen und regionale Entwicklung in Guangdong, Südchina, *Reg. Studies* **36**, 627–642. Dieser Aufsatz untersucht die sich wandelnde Wettbewerbsfähigkeit vom Ausland finanzierter, herstellender Firmen und ihre Implikationen für die regionale Entwicklung in der südchinesischen Provinz Guangdong angesichts des vereinbarten Beitritts Chinas zur WTO. Es wird der Standpunkt vertreten, daß sich TNC und einige wettbewerbsfähige, örtlich finanzierte Großfirmen der herstellenden Industrie in Guangdong nach dem Beitritt zur WTO durchsetzen, doch der Verdrängungsprozess der kleinen und mittleren Betriebe in Guangdong bald beschleunigt werden wird, da sie in direktem Wettbewerb mit TNCs stehen, und ihre Wettbewerbsvorteile sich infolge von Behördenvorschriften und rigoroser Einhaltung neuer Regierungspolitik verringern. Dank enger Geschäftsverbindungen mit ortsansässigen, privat finanzierten Firmen wird die Wettbewerbsfähigkeit und Beständigkeit vom Ausland finanzierter Unternehmen auf lange Sicht tiefgehende Auswirkungen auf die wirtschaftliche Entwicklung Guangdongs vor und nach dem Beitritt zur WTO haben.

Beitritt zur WTO Wettbewerbsfähigkeit
Vom Ausland finanzierte Firmen
Regionale Entwicklung Guangdong, China

INTRODUCTION

During the last few years, when the representatives of China and the US negotiated the accord to pave the way for the impending entry of China into the World Trade Organization (WTO), there were numerous discussions and debates undertaken by all parties.¹ Setting aside general discussions, such as ANDERSON, 1997; SHINDO, 1997; DONG *et al.*, 1998; WEI, 1998; HISHIDA, 1999; YANG, 1999; MCKIBBIN and HUANG, 2000; and PRYBYLA, 2000, the overwhelming majority, if not all, of the literature has focused on two themes. The first is the impact of WTO accession on the vitality of state-owned enterprises (SOEs) in China, e.g. BLUMENTAL, 1999; CHEN, 2000; and YU *et al.*, 2000. The second is the implications of WTO accession for foreign direct investment (FDI) and international trade between China and other major industrialized countries.² For instance, WANG, 1997, 1999; YANG, 1998; VANDERGEEST, 1998; and GARNAUT and HUANG, 2000, analyse the impacts of the labour-intensive export market after WTO accession, whilst SMITH, 1999, investigates the strength of patent rights requested by the WTO and the implications for Chinese exports. All these are very important issues for the future development of the Chinese and global economies. Nonetheless, it seems that Sinologists have overlooked an equally significant issue: the competitiveness of foreign-financed firms and its implications for regional development in southern China due to the WTO accession.

To fill this literature gap, this paper investigates the changing competitive landscape of foreign-financed manufacturing firms and its implications for regional development in Guangdong province of southern China *ahead* of WTO accession. The discussion focuses on the (combined) effects of the WTO accession treaties and the (new) Chinese government policies enforced ahead of accession on the competitiveness of foreign-financed manufacturing firms. Economic relationships, such as sub-contracting, between foreign-financed firms and privately-funded firms, and the policy implications of the development of private entrepreneurship and the SOE reform on the economic development of southern China will be highlighted.³ Although it is a very significant issue, the competitiveness of foreign-financed firms in service sectors is not the focus, and will not be discussed in this paper.

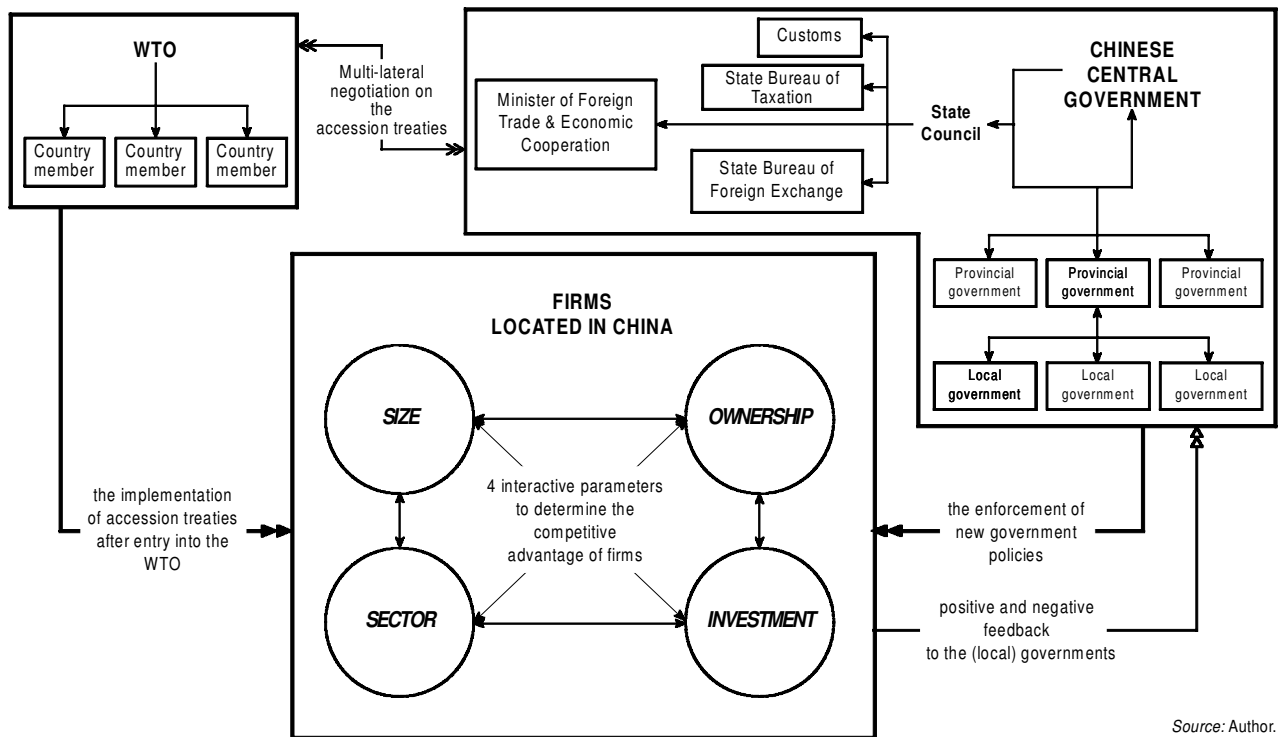
In PORTER's, 1998, seminal book, *The Competitive Advantage of Nations* (p. 127), he argues that the competitive advantage of a nation is determined by four interactive factors: (1) firm strategy, structure and rivalry; (2) factor conditions; (3) demand conditions; and (4) related and supporting industries. He applies this paradigm to explain the development of four national industries, e.g. the German printing press industry, the American patent monitoring equipment

industry, the Italian ceramic tile industry and the Japanese robotics industry. Despite the usefulness of Porter's competitive advantage paradigm, it is not fully applicable in this paper due to the unique nature and the implications of WTO accession for the transitional economy in China. For instance, the ownership of a manufacturing firm is not considered explicitly in Porter's paradigm, yet it has profound implications for its taxation status in China (see below). Obviously, a new analytical framework is required to analyse the changing competitiveness of foreign-financed manufacturing firms and its implications for the development of Guangdong.

In contrast to the conventional dichotomized approach that classifies firms in China as foreign-financed and state-owned, this paper uses a multi-faceted and dynamic approach to analyse the impacts of WTO accession and government policies on the changing competitiveness of different categories of foreign-financed firms in Guangdong (Fig. 1). Apart from government policies, it is argued that a firm's competitive advantage is determined by four interactive parameters in China:

- *Size*: The size of a firm (e.g. large, small, etc.) which determines its production capacities (economies of scale) and capabilities (economies of scope)
- *Sector*: The industrial sector of a firm (e.g. textile and clothing, automobile, etc.) which determines the extent to which it is affected by the WTO accession treaties
- *Ownership*: The origin of the firm's capital (e.g. US-financed, overseas Chinese-financed, state-owned, locally-funded, etc.) which determines its taxation status in China
- *Investment*: Firm with investment/manufacturing bases in China versus those without, which in turn determines the extent to which it is affected by WTO accession treaties.

The four parameters – size, sector, ownership and investment – are interacting and react to the dynamic economic and political environment inside and outside China (Fig. 1). For instance, the Chinese government implements a number of policies to encourage foreign entrepreneurs to abide by the international rules on intellectual property rights (IPRs), partly in preparation for WTO accession. Firms affected by the new policy, especially those in printing, publishing, and in musical, movie and computer software production, will channel their positive and negative reactions (those firms with IPRs are going to support the new policy whilst those engaged in IPRs violation activities are going to be against it) to the corresponding local governments and then eventually reach the specialized bureau(x) in the State Council. If there is no other administrative intervention by the local authorities, the firms which can adapt to the new policy will enhance their competitive



Source: Author.

Fig. 1. The basic analytical framework

advantages, whilst those which fail to adapt are going to be crowded out of the market.

To examine these issues, informal interviews with government officials, owners and factory managers of locally-funded and privately-funded firms, and semi-structured interviews in 35 foreign-financed enterprises located in Guangdong were conducted by the author in 1996–97 and 2000. The interviews were focused on factors that may affect the competitiveness of manufacturing firms in Guangdong and the implications for regional development in southern China of WTO accession. The sample firms ranged across various manufacturing sectors: plastics and metal products; textiles and clothing; toys; leather products; jewellery; electrical appliances; electronic products; paper and foam packaging (including printing); beverages and food ingredients sectors. With the exception of one transnational corporation (TNC), and several large regional firms with overseas subsidiaries, the majority of the sample comprised investors of Hong Kong origin engaged in processing and assembling (P&A) investment. Most of the firms investigated (33 cases) are located in the Dongguan municipality of Guangdong.⁴ In terms of industrial sectors, textiles and clothing (11 cases) and manufacturing of electrical appliances (8 cases) accounted for more than half of the total firms interviewed. In terms of employment size, medium sized firms (51–500 workers) represent more than two-thirds of the cases.

The analysis of empirical evidence via the multi-

faceted and dynamic approach suggests that the playing field for manufacturing firms in southern China is far from equal under the new competitive landscape. It is argued that TNCs and some competitive, large-scale locally-funded firms in Guangdong will triumph after WTO accession. With abundant capital and their own globalized sourcing and marketing channels, TNCs can penetrate the market, either through direct import or setting up their manufacturing firms in southern China. It is also argued that the crowding-out of small and medium-scale enterprises (SMEs) in Guangdong will be accelerated in the near future, as they are competing with TNCs directly and their competitive advantages (such as 'first-mover' effect and economies of scale through sub-contracting to a network of firms) are diminishing due to the bureaucratic red-tape and the rigorous enforcement of new policies by the Customs, the State Bureau of Taxation and the State Bureau of Foreign Exchange. Because of the close business linkages (in the forms of sub-contracting and supplier and customer relations) with local privately-funded firms, the competitiveness and vitality of foreign-financed SMEs in southern China not only have profound implications for the development of private entrepreneurship locally, but may also have further implications for reform of the SOE in southern China, as the successful *de facto* privatization of SOEs is partially determined by the vitality of the private sector. Obviously, the vitality of foreign-financed and privately-funded enterprises has profound long term

implications for the economic development of Guangdong, before and after WTO accession. To prepare for WTO accession, therefore, policy makers in China should be more open-minded and allow more room for non-state enterprises to manoeuvre in the transitional economy.

Before analysing the effects of the WTO accession treaties and the (new) Chinese government policies enforced ahead of accession on the competitiveness of foreign-financed firms in the fourth section (below), a brief introduction to the economy of Guangdong and a brief summary of the WTO accession agreement are presented in the second and third sections respectively. The conclusions and the policy implications of the development of private entrepreneurship and the SOEs reform for the regional development of southern China will be discussed briefly in the final section.

BACKGROUND OF GUANGDONG

With a total land area of 177,901 km², Guangdong is located in the Pearl River Delta of southern China, adjacent to Hong Kong and Macau. Guangdong was transformed into an export-oriented manufacturing-based economy through processing and assembling (P&A) induced industrialization and outward-oriented commercial agriculture during the early 1980s. After investing heavily in the construction and improvement of its infrastructure, in particular transport, power supplies and telecommunications, Guangdong has focused on the development of higher value-added and higher technology *sanzi qiye* and its supporting service sectors since the mid-1990s.

The result of economic reform in Guangdong is shown by an array of extraordinary economic statistics. The average annual growth rate of real gross domestic product (GDP) and real GDP per capita reached 12% (higher than the 9% in China) and 11% (higher than the 8% in China) between 1978 and 1999, respectively.⁵ During the two decades of reform in Guangdong, real GDP jumped eleven-fold to 203 billion *yuan*, while real GDP per capita increased eight-fold to the all time high of 2,779 *yuan* (more than 50% higher than that of China) in 1999.⁶ In the case of the real value of industrial and agricultural output, the average annual growth rate in Guangdong was 22% between 1978 and 1998. The gross value of industrial and agricultural output in Guangdong as a percentage of China's increased from 4.86% in 1978 to 9.14% in 1998, providing further evidence of its economic strength. Guangdong's increasing share of the gross value of industrial output in China, from 4.71% in 1978 to 10.24% in 1998, and the corresponding decrease in its share of gross value of agricultural output, from 5.32% in 1978 to 3.78% in 1998, illustrates its rapid industrialization (GUANGDONG BUREAU OF STATISTICS (GBS), 2000; STATE STATISTICAL BUREAU, 2001).

Guangdong is the most popular province for foreign

investors in China. The contracted value of FDI in Guangdong increased enormously from US\$703 million in 1983 to the all time high of \$33 billion in 1993, before dropping to \$7.7 billion in 1999. The utilized value of FDI rose impressively from \$327 million in 1983 to the all time high of \$13.37 billion in 1999. In 1999, the cumulative value of contracted FDI in Guangdong reached \$165 billion, and the corresponding utilized value reached US\$90 billion. This is equivalent to 26–28% of the cumulative value of contracted and utilized FDI in China between 1979 and 1999. In per capita terms, the average growth rate of utilized value of FDI in Guangdong is at an impressive 28% per annum between 1983 and 1999. In 1983, the utilized value of FDI per capita in Guangdong was only \$6, but it increased dramatically to \$183 in 1999 (*ibid.*).

As a result of export-orientation, the export value of Guangdong increased from \$1.4 billion in 1978 to \$78 billion in 1999 – an average annual growth rate of 23%.⁷ The export value per capita increased from a mere \$27 in 1978 to \$136 in 1989, before increasing eight-fold to \$1,065 in 1999 (*ibid.*).

THE TREATIES OF WTO ACCESSION

According to the Sino-US bilateral trade agreement, signed on 15 November 1999, WTO accession for China required liberalization in a number of areas ranging from tariff reduction to distribution rights. In return, the US government will grant Permanent Normal Trade Relations (PNTR) status to China, which entails levying the same tariffs on Chinese imports as on other major US trading partner imports.⁸ The major areas of liberalization related to the manufacturing sectors are as follows (*South China Morning Post*, 1999f, 2000a):⁹

- *Import tariffs*
 1. Tariffs will be reduced from an average of 24.6% at present to an average of 9.4% (7.1% on US priority products) by 2005.
 2. China will participate in the Information Technology Agreement (ITA) and eliminate all tariffs on computers and computer equipment, telecommunications equipment, semi-conductors and other high-technology products by 2005.
 3. China will reduce the tariffs on automobile and automobile parts from the current 80–100% to 25% and 10% respectively, by 2006.
- *Elimination of import quotas and licences*
 1. China will eliminate existing quotas upon accession for the US priority products, e.g. fibre optic cable.
 2. Quotas and other quantitative restrictions will increase from the current trade level at 15% per annum and be phased-out no later than 2005.

- *Import and distribution rights*
 1. Foreign-financed firms (including WFVs) will have comprehensive trading (import and export) and distribution rights (wholesaling, retailing, transportation, etc., including the provision of services and goods made in China) in China for the first time.
 2. Trading and distribution rights will be phased in progressively over three years.
- *SOEs*
 1. China will ensure that the sales and purchases of SOEs and state-invested enterprises (SIEs) are based solely on commercial considerations, such as price, quality and marketability, rather than 'government procurement'.
 2. The SOEs and SIEs are regulated under the *WTO Agreement on Subsidies and Countervailing Measures*, e.g. no export subsidies.
- *Textiles*
 1. The deal incorporates an existing Agreement on Textiles and Clothing (ATC) signed in 1995, under which the Multilateral Fibre Agreement restrictions (export quotas to the US) will be phased out in 2005.
 2. The US special safeguard mechanism to prevent a surge of imports of textile and clothing products will be phased out in 2008.
 3. The US maintains its current anti-dumping methodology (treating China as a non-market economy) in future anti-dumping cases for 15 years after Chinese accession.

WTO ACCESSION: LEVELLING THE PLAYING FIELD?

Apart from the direct effects of the accession treaties, the newly enforced Chinese policies also have important implications for the competitiveness of foreign-financed firms. As mentioned previously, the analysis of the competitive advantages of foreign-financed firms in southern China is based on four interactive parameters: size, sector, ownership and investment (Fig. 1).

The effects of WTO accession on foreign-financed firms

Contrary to the general perception, foreign firms that invested in southern China before WTO accession do not necessarily enjoy 'first mover' advantages, mainly due to the reduction of tariffs, elimination of export quotas and the opening up of distribution channels.

In the textile and clothing industry, the ability to use *Hong Kong export quotas* is one of the greatest competitive advantages of foreign-financed firms located in Guangdong. The majority of foreign-financed textile and clothing firms (including the large-scale ones) in Guangdong are operating under *outward-processing* arrangements. The labour-intensive manu-

facturing processes are normally conducted in Guangdong, while the semi-finished products are then exported to Hong Kong for final value-added work. For instance, the garment firm in Guangdong manufactures different parts of a shirt (sleeve, collar) and does all the cutting and initial treatment of cloth, and then another firm in Hong Kong sews them together into a shirt. By doing so, the firm can sew the 'Made in Hong Kong' labels on the final products and then export them to overseas markets legitimately (Field survey, 1996–97, 2000). At the same time, the foreign investors can enjoy the lower production costs in Guangdong and the less restrictive Hong Kong export quotas assigned by the US. Although the wage in Guangdong is one of the highest in China, the abundant supply of skilled labour and the ability to use Hong Kong export quotas explain why a large proportion of foreign-financed textile and clothing firms are located in southern China.¹⁰

According to the ATC, signed under the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) (the predecessor of the WTO) and treaties of WTO accession, however, the US is scheduled to eliminate the export quotas on textiles and clothing from China by 2005. Without the restriction of export quotas, it is expected that the competitive advantages that foreign-financed firms derive from dividing the manufacturing processes between Guangdong and Hong Kong would diminish rapidly, if not be eliminated. Foreign investors can look further inland in China or elsewhere, such as to Bangladesh, where real labour costs are lower than Guangdong, for their new investment. Moving up the value-added chain is probably the only viable way for the textile and clothing industry in Guangdong to remain competitive. This up-grading path has in fact been pursued by the large-scale foreign-financed textile and clothing firms in Guangdong during the last few years in the expectation of Chinese accession to the WTO. With limited design capability, and limited capital to invest in advanced equipment, however, SMEs in Guangdong are less likely to be able to up-grade to higher value-added manufacturing processes which demand stringent quality control. For example, ISO-9000 certification is essential to secure the sub-contracting orders from the design studios of brand name clothing companies, such as Next and Gap (*ibid.*). This 'win-lose' scenario is not revealed by conventional econometric studies, such as YANG *et al.*, 1997, and ZHONG and YANG, 2000, pp. 188–90, which reported large gains to China from the WTO membership and the trade liberalization on textiles and clothing.

In the case of daily household goods, foreign-financed firms are protected by the high import tariffs and restricted distribution channels in China. For instance, the Chinese market is shared by only 15 foreign-financed and locally-funded disposable nappies' manufacturers as they have long been shielded from

competition from imported nappies. The partial opening up of the distributional channels in China ahead of WTO accession has already set off a ferocious price war since October 1999 when the international giant, Procter & Gamble, began selling Pampers in China. After joining the WTO, China will further open up the once-tightly controlled domestic distribution channels, and will reduce the import tariffs on raw materials, such as plastic and fabric, by 40% (LANDLER, 2000, p. 15). The restructuring of the daily household goods sector in China is likely to be unavoidable in the near future. Similar phenomena are expected in the beverages and food processing industry. For instance, Nestlé has 14 manufacturing firms in China (four of them in Guangdong) to supply the local market. As Nestlé is using mainly local ingredients, the WTO accession of China will bring few financial benefits for their manufacturing firms in China. On the contrary, the lower tariffs on imported goods and the opening up of import and distribution rights in China will induce more competition for Nestlé, both from parallel imported Nestlé products and other newly imported brand name products (Field survey, 2000).

Rather than enjoying 'first mover' advantages, the reduction of import tariffs on raw materials, the elimination of export quotas and the opening up of distribution channels may actually deprive foreign-financed firms with investment in southern China of some of the competitive advantages many used to enjoy.¹¹ This is especially the case for the textiles and clothing industry where the ability to use Hong Kong quotas is one of the greatest competitive advantages of foreign-financed firms in Guangdong. It must however be emphasized that this argument is sector-specific and circumstance specific or individual case-specific.¹²

Government policy and the competitiveness of foreign-financed firms

Apart from the direct effects of the accession treaties, there is a network of bureaucratic restrictions affecting the competitive advantage of different categories of foreign-financed firms in southern China. This section is going to examine the complex effects of four Chinese government policies enforced ahead of WTO accession, namely: (1) production contract; (2) verification rules on imports and exports; (3) uniform rate of value-added and the 'estimated profits' approach to taxation; and (4) import-deposit. They are crucial for the understanding of the changing competitive arena encountered by foreign-financed firms in Guangdong.

Foreign-financed firms in Guangdong have to apply every six months for a production contract from the Chinese Customs to import raw materials free of tariffs into China (Table 1). To counter bureaucratic red tape, a number of foreign-financed firms in Guangdong are either sharing their production contracts to have the right to import tariff-free raw materials, or are

smuggling some of their raw materials into China without the proper documentation. To ensure that a cargo is not impounded in the Shenzhen-Hong Kong border zone, foreign-financed firms in Guangdong normally pay-off Chinese Customs inspectors to cover up their illegitimate activities. In some cases, the under-reporting of the amount and/or value of imported raw materials can be purely unintentional, i.e. a careless mistake by the people who fill in the customs documentation. As the timely delivery of the cargo is essential, and as it is too time-consuming to negotiate with the Chinese Customs, foreign owners normally instruct their truck drivers to bribe the Customs inspectors (Field survey, 1996-97, 2000). This phenomenon is also documented by YEUNG, 2001a, 2001b.

Due to the corruption eradication policy implemented by central government, most Chinese Customs inspectors in the Shenzhen-Hong Kong border zone will not accept bribes nowadays (Field survey, 2000). The strict enforcement of regulations on production contracts is equivalent to removing the 'first-mover' competitive advantage of foreign-financed firms in Guangdong. This is because the production contract strictly defines the quantity and variety of raw materials that the firm is allowed to import tariff-free in every six-month period.¹³ Obviously, this inflexibility does not facilitate rapid adaptations to market demand, as the firm is unable to increase production to meet an unexpectedly large order at short notice from its customers or to introduce new products which demand raw materials not specified in the production contract. The rigidity of the production contract has far-reaching consequences for the competitive advantages of SMEs in Guangdong, especially those engaging in sub-contracting businesses where the flexibility to change the production lines to adapt to the seasonality of markets and to sell new products are vital for their success.

To prevent tax evasion, and the illegal reselling of tariff-free raw materials imported by foreign-financed firms in southern China, the State Bureau of Foreign Exchange co-operates with Customs to implement strictly the verification rules on imports and exports (*hexiao*) (Table 1). Foreign-financed firms in Guangdong have to submit their production contracts with export documents to the Chinese Customs to verify that its imported tariff-free raw materials are processed and exported to overseas markets. There are two types of regulation on verification of imports and exports of foreign-financed firms: 'gross-value verification' (*cune hexiao*) and 'value-added verification' (*chae hexiao*). Under the 'gross-value verification', the foreign owner/buyer must remit the total amount of foreign exchange to China to import/export their raw materials/finished products. Under the 'value-added verification', the foreign investor only remits the amount of value-added, that is the difference between the value of imported raw materials and the value of the exported semi-finished or finished goods. This method of verification

Table 1. A typology of effects of Chinese government policies on the competitive advantage of foreign-financed firms in Southern China

Policies	Aims	Policy details	Effects on foreign-financed firms
Production contract	<ul style="list-style-type: none"> To prevent the illegal reselling of tariff-free raw materials imported by FDI firms in the local market 	<ul style="list-style-type: none"> The production contract outlines the strict definitions of the quantity and variety of raw materials that the FDI firm can import free of tariffs in a six-month period The FDI firm has to apply to the Customs for the renewal of a production contract every six months 	<ul style="list-style-type: none"> High transaction costs to justify the need to import more raw materials than allowed under the contract Rigidity of the production contract prevents the firm from meeting market demand and removes the 'first-mover' competitive advantage of sub-contracting SMEs
Verification rules on imports and exports (<i>hexiao</i>)	<ul style="list-style-type: none"> To prevent the illegal reselling of tariff-free raw materials imported by FDI firms in the local market To prevent tax evasion by FDI firms 	<ul style="list-style-type: none"> Under the 'gross-value verification' scheme (<i>cune hexiao</i>), the foreign owner/buyer remits the total amount of foreign exchange to China to import/export their raw materials/finished products Under the 'value-added verification' scheme (<i>chae hexiao</i>), the foreign investor remits the value-added (difference between the imported value of raw materials and the exported value of finished products to China) provided that the transaction is conducted within the enterprise FDI firms have to submit production contracts with export documents to the Customs periodically to verify that their imported tariff-free raw materials are processed and exported overseas 	<ul style="list-style-type: none"> The 'full-value verification' arrangement demands much more working capital (foreign exchange) from SMEs while the 'value-added verification' arrangement favours TNCs with vertical integration from manufacturing to wholesaling Strict enforcement of the regulation, lack of transparent legal channels for arbitration and Customs inspectors' lack of intimate knowledge of the industry lead to the unnecessary impounding of cargo
Uniform rate of value-added and the 'estimated profits' approach of taxation	<ul style="list-style-type: none"> To simplify the administrative duties of the State Bureau of Foreign Exchange and the State Bureau of Taxation To regulate the transfer pricing of TNCs 	<ul style="list-style-type: none"> For the FDI firms who conduct the 'value-added verification', a single rate of value-added is applied to each industrial sector The firm's profitability is equal to its output value multiplied by a pre-determined and progressive percentage rate, as the State Bureau of Taxation assumes that the profitable firm will produce more 	<ul style="list-style-type: none"> It takes neither the productivity nor special circumstances (e.g. US quotas in the textiles and clothing industry) of an individual firm into consideration TNCs can bargain the rate of 'estimated profits' using professional audit reports whilst SMEs may not have the resources to do so Discontent among FDI firms as there is no standardized procedure for the determination of the estimated rate of profits
Import deposit	<ul style="list-style-type: none"> To prevent the illegal reselling of tariff-free raw materials imported by FDI firms in the local market To prevent tax evasion of FDI firms 	<ul style="list-style-type: none"> Since 1 October 1999, FDI firms are classified into 5 classes (AA, A, B, C and D). Firms classified into classes A and B have to pay the import deposit only for the import of restricted goods, whilst those classified into classes C and D have to advance about 30% of the value of imported raw materials as a deposit to guarantee that all of its finished products are for export Class AA: FDI firm with annual export value of US\$10 million and without a record of illegal smuggling or in high-tech sector Class C: FDI firm with low export value and with poor records of compliance with Customs laws Class D: FDI firm involved in smuggling of over 500,000 <i>yuan</i> since 1 August 1998 Customs can confiscate the import deposit if the firm does not verify that the finished products have been exported within 3 months of the import of raw materials 	<ul style="list-style-type: none"> Favours firms in high-tech sectors (priority industry) and export-oriented large-scale firms as they are automatically classified into class AA, where the import deposit is waived A severe drain on operating capital for SMEs with low export value due to the large amount of payable import deposit The possible confiscation of import deposits further strains the cash flow of SMEs Additional administrative duties to prepare the daily import-export records submitted to the Customs

Source: Field survey, 1996-97, and 2000.

is only applicable if the transactions (imports and exports) are conducted within the same enterprise. Obviously, the 'value-added verification' arrangement demands much less operating capital for the foreign-financed firms, and this regulation favours the TNCs in Guangdong with vertical integration from manufacturing to wholesaling. For the SMEs in Guangdong, the 'gross-value verification' arrangement imposes more financial pressure upon them.¹⁴

Paradoxically, the stringent enforcement of the Customs inspection rule in China affects not only the foreign-financed firms which are conducting illegal trade, but also creates obstacles for the law-abiding foreign-financed firms in southern China. As there are numerous products and different categories of tariff systems, it is unlikely that every Chinese Customs inspector would have intimate knowledge of all of them (Table 1).¹⁵ It is also not easy for Customs inspectors to decide which cargo is deliberately under- or over-reported in import or export documents. As a transparent legal channel for arbitration on the legality of import and export activities does not exist, the general practice for Customs inspectors is to refer suspected cases to the Inspection Department if they find minor irregularities between the cargo and the documents. By so doing, the Chinese Customs inspectors avoid the pitfall of being accused of being lenient towards a particular firm and of raising suspicions of corruption. To 'scare off the monkey by killing the chicken' (*shaji xiahou*), they can also send an unambiguous signal to other foreign investors in Guangdong that they can no longer bribe their way out. Once the cargo is impounded, however, it takes at least two to three days for the investigation, and the company involved may miss the shipment date (Field survey, 1996–97, 2000).¹⁶

To simplify the administrative duties and regulate transfer pricing by TNCs, the State Bureau of Foreign Exchange uses a *uniform rate of value-added* in each industrial sector, and the State Bureau of Taxation uses the '*estimated profits*' ('*deemed profits*') approach to assess the profitability of every foreign-financed firm in southern China that opts for the 'value-added verification' (Table 1). The State Bureau of Foreign Exchange determines the rate of value-added according to the industrial sector that the firm belongs to, e.g. $x\%$ of value-added for the textiles industry, $y\%$ of value-added for the garment industry, etc. The State Bureau of Taxation uses a predetermined percentage rate and the value of the firm's output to determine its profitability.¹⁷ However, these two general rules of thumb take neither the productivity nor the special circumstances of individual firms into consideration. For instance, the value-added of the polo shirt of a US-based garment firm is very high, due to its successful marketing strategy and its allocated US quotas. However, the value-added of its two wholly foreign-owned ventures in Shenzhen is well below the industrial norm since it only produces

part of the polo shirt (e.g. a sleeve or collar) and uses costly imported raw materials. In the absence of an exemption granted by the State Bureau of Foreign Exchange, the Asian headquarters have to remit more than 14 million *yuan* per month from Hong Kong to Shenzhen, even though the actual value-added of these two firms is about 10 million *yuan* per month. Consequently, the two wholly foreign-owned ventures have accumulated about 40 million *yuan* of idle cash within a year since the new policy was implemented. The State Bureau of Taxation generally assumes the profitable firm will produce more, but the Bureau does not have a standardized procedure for determining the rate of 'estimated profits'. The rate of 'estimated profits' may be negotiable when the foreign-financed firm in Guangdong is able to provide adequate evidence from the reports of independent auditors (e.g. Price-WaterhouseCoopers) to support their claims (Field survey, 2000). With far fewer resources, SMEs in Guangdong may not be able to present professional audit reports to the Bureau and thus have to accept the 'estimated profits' approach to taxation. This arrangement will unavoidably lead to discontent among foreign-financed firms in southern China.

Since 1 October 1999, with the exception of firms classified as class AA, A or B, the Chinese Customs regulations stipulate that foreign-financed firms in Guangdong have to pay a *deposit* equal to about 30% of the value of imported raw materials to guarantee that all of its finished products are for export (Table 1).¹⁸ The Chinese Customs inspectors have the authority to confiscate the deposit if the firm does not verify its production contract with export documents within three months of the import of raw materials. Moreover, foreign-financed firms in Guangdong also have to appoint designated auditors to prepare daily records of import/export for the Customs.¹⁹ Since the announcement of the agreement on WTO accession with the US in late 1999, the Customs verification rule has been enforced strictly. This has profound implications for the cash flow of foreign-financed firms in southern China. For instance, a Hong Kong-based textile fabric enterprise has to set aside up to HK\$100 million per month as an import deposit for its three cotton yarn spinning firms in Guangdong. For a large-scale firm with abundant capital, the strict enforcement of the Customs verification policy resulted in an immediate quadrupling of its cash flow. This obviously causes considerable disruption to the short term operations of the firm. For an SME with limited capital in Guangdong, the likely result is a severe drain on working capital which may even contribute to its closure (Field survey, 1996–97, 2000).

The intention of the new policies enforced by the State Bureau of Foreign Exchange, the State Bureau of Taxation and the Customs is to prevent transfer pricing by TNCs, tax evasion and the illegal reselling of tariff-free imported raw materials by foreign-financed firms

in southern China. Without making provisions for special circumstances, in reality this 'punish someone as a warning to others' strategy of policy implementation imposes unnecessary and even damaging cash flow constraints upon foreign-financed firms in Guangdong, especially upon SMEs with limited capital, in the shape of import deposits, uniform rates of value-added and 'estimated profits' taxation.²⁰ For law enforcement officers in southern China, the stringent implementation of the new policy is a signal of the rule of law and a necessary part of preparation for WTO accession. For the law-abiding foreign investors in Guangdong, the inflexibility and rigidity of the government officials, who do not take into account firms' circumstances, is equivalent to imposing extra obstacles on the development of foreign-financed firms in southern China.

'FDI of Chinese origin' vs. 'real FDI'

The WTO accession of China may level the playing field between large-scale foreign-financed firms in southern China and TNCs which would like to penetrate the Chinese market through direct import. The WTO accession of China is however not going to level the playing field between the 'FDI of Chinese origin', where the capital is originally from China, and 'real FDI', where the capital originates from a foreign country.

Due to the loopholes and the difficulties of enforcing existing Chinese laws which regulate FDI, it is not uncommon for a locally-funded enterprise or a SOE in southern China to channel capital through its overseas subsidiaries to invest in the 'FDI of Chinese origin' firm.²¹ The overseas subsidiary can either be a second-tier ('spin-off') company or a 'shell' company taken over by the core enterprise based in southern China. The overseas 'shell' company can be a so-called 'briefcase company' where the 'nominal owner' is the emigrant relative or friend of the 'real owner' of the core enterprise, who contributes most of the investment. As the source of the investment capital can be questionable, deriving, for example, from illegal gains from corruption and/or asset stripping of SOEs, the operation of such a company is secret.²² The overseas 'shell' company can also be an overseas listed company taken over by the core enterprise in southern China. Apart from being used as a vehicle to raise capital overseas, the 'shell' company can be operated with an unprecedented level of managerial and financial autonomy, e.g. free of the welfare legacy normally associated with SOEs. Some analysts estimate that such 'FDI of Chinese origin', valued at HK\$30 billion (GOODMAN and FENG, 1994, p. 191), ranged from 25–40% of the foreign-financed firms in China (LEVY, 1994, p. xv; LU and TANG, 1997, p. 2; *South China Morning Post*, 1998).²³ However, the actual amount of such investment is unknown. It is very difficult to make an accurate estimate as the capital usually comes from

subsidiaries based in Hong Kong, which are likely to be partially owned by Hong Kong based conglomerates in the form of inter-locking share-holding.

As the registered 'owner' of the firm is based outside China, the firm can be legally classified as a foreign-financed firm, although the investment can originate from southern China. In addition to the exclusive policy incentives for foreign investors, such as tax holidays, 'FDI of Chinese origin' enjoys other types of preferential treatment from local governments in Guangdong (Fig. 2). This is well illustrated by the history of the inter-locking ownership of a large-scale fabric firm in Guangzhou.

The fabric firm was established in Guangzhou with capital injected from a well-known SOE subsidiary in Hong Kong in 1988. In 1991, the SOE subsidiary in Hong Kong – an investment vehicle (company A) owned by Guangdong provincial government – injected another US\$500,000 into the firm and transformed it from a processing and assembling operation into an equity joint venture with the local government in Guangzhou. In 1997, the equity joint venture conducted the first round of a 10 million *yuan* fund-raising exercise after being selected by the government as one of the experimental enterprises to implement the 'employees stock-option reform'. In 1999, the equity joint venture conducted the second round of a fund-raising exercise where company A sold all of its equity (34%) to another investment company (company B) registered in Hong Kong at a fire-sale price of 1.65 million *yuan*.²⁴ It is suspected that company B is owned by senior managers of the fabric company, who in turn are senior officials of an investment company owned by the local government in Guangzhou. Despite being classified as an equity joint venture, it can be argued that the fabric firm is 100% funded locally: 60% of the equity is owned by the local people in Guangzhou (the firm's employees own 35% of the equity share, and company B owns another 25%) while the local government's investment company owns the remaining 40% (Field survey, 2000).

Being an 'FDI of Chinese origin', the fabric equity joint venture enjoys various indirect subsidies in the form of capital injection and soft loans as well as other preferential policies exclusively provided to a selected category of foreign-financed firms in southern China. To name a few examples, the local government's investment company in Guangzhou injected capital in the form of low-interest to interest-free short term loans into the equity joint venture during the early period of its establishment (the 'infant industry argument'), e.g. a one million *yuan* interest-free loan to build the accommodation block for staff. The local government's investment company continues to inject capital into the equity joint venture to allow it to import more than 60 million *yuan* of state-of-the-art computerized multi-bar raschel machines and other equipment to expand production capacity. After the initial two-year tax

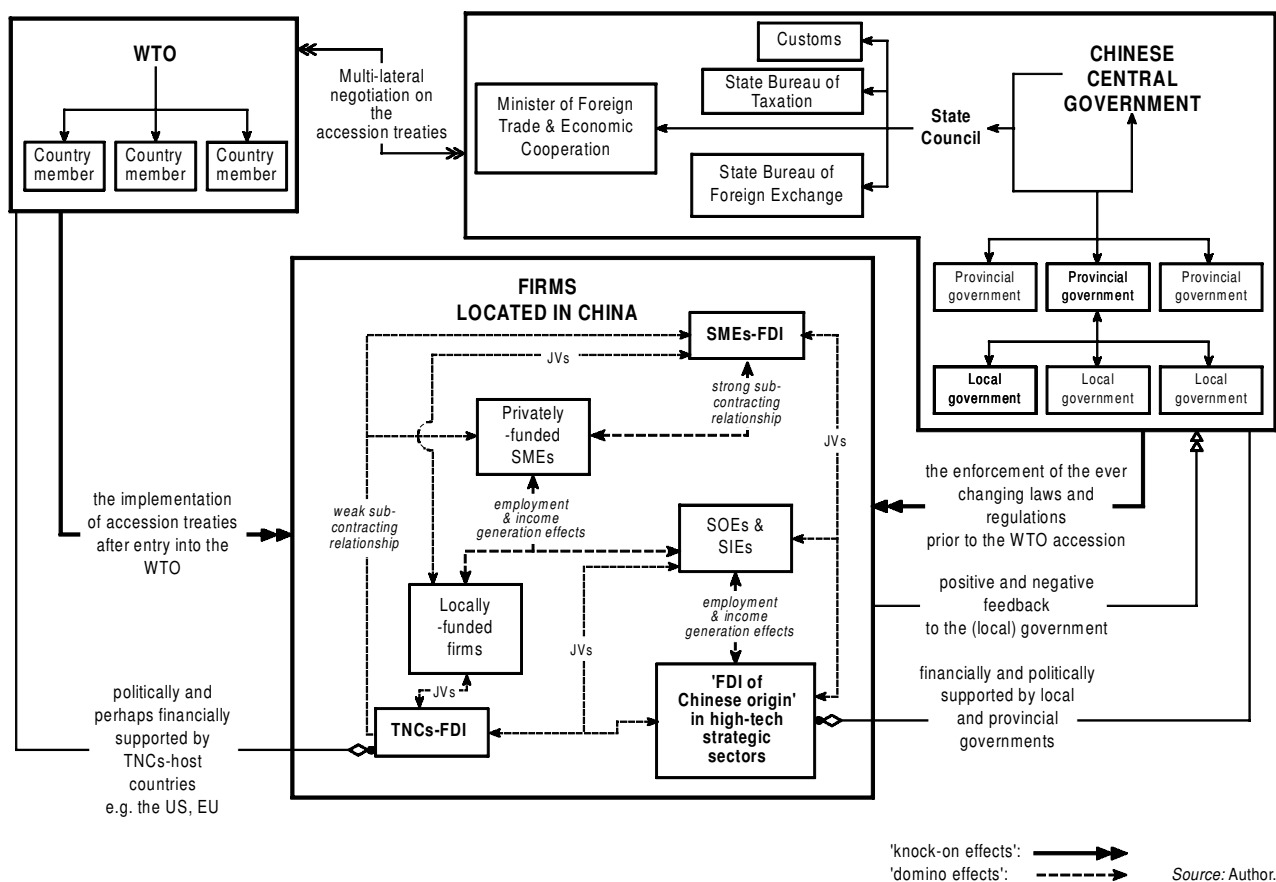


Fig. 2. A multi-faceted and dynamic analysis on competitiveness of foreign-financed firms in Southern China

holiday expired, the local government in Guangzhou granted the equity joint venture an extra year of tax holiday and waived 50% of the profit tax for another three years.²⁵ The local government also helped the equity joint venture to secure 'High Technology Enterprise' and then 'New and High Technology Enterprise' status in Guangzhou as well as the associated preferential policies applied by the Guangdong provincial government (Field survey, 2000).²⁶

The WTO accession of China may level the playing field between large-scale foreign-financed firms in southern China and TNCs seeking to enter the Chinese market through direct import. However, the evidence presented above does not suggest that WTO accession will bring about parity between foreign-financed and foreign-financed firms of 'Chinese origin' in southern China. This is partly because central government implements some policies to tilt the playing field against foreign-financed SMEs in southern China, and partly because a number of local governments in Guangdong have implemented various policies to favour locally-funded firms and 'FDI of Chinese origin' firms.

CONCLUSIONS AND POLICY IMPLICATIONS

The analysis of empirical evidence using the multi-faceted and dynamic approach adopted in this paper

suggests that the playing field for manufacturing firms in southern China is far from level under the new competitive landscape created as China prepares for WTO accession. The process of industrial consolidation in manufacturing sectors will be accelerated in Guangdong. On the one hand, it is argued that TNCs and some competitive large-scale locally-funded (including 'FDI of Chinese origin') firms in Guangdong will 'win' after WTO accession (Table 2). With abundant capital and their own globalized sourcing and marketing channels, TNCs can penetrate the Chinese market either through direct import or set up their manufacturing operations in southern China. Despite the regulations established in the WTO accession treaties, large-scale locally-funded firms and foreign-financed firms of 'Chinese origin' (especially in high-technology sectors) can still be competitive, as local governments in Guangdong have hundreds of ways of enhancing their competitive advantage, either through direct and indirect subsidies (e.g. capital injection, interest-free loans or tax rebates for exports) or less visible administrative measures (e.g. by classifying them as 'High and New Technology Sector' firms thereby making them eligible for a number of exclusive privileges). This is illustrated by the case of the 'FDI of Chinese origin' fabric firm in Guangzhou. As local governments in southern China grant taxation

Table 2. A taxonomy of the effects of WTO accession on the competitive advantage of foreign-financed firms in Southern China with respect to their sizes and ownership

Ownership	SMEs	Large-scale
'Real FDI'	↓↓	$\bar{\Delta}/\uparrow\uparrow^1$
'FDI of Chinese origin'	↓	$\bar{\Delta}/\uparrow$

Note: 1. The competitive advantages of TNCs without manufacturing bases in southern China also increased due to the WTO accession treaties, i.e. they can penetrate the Chinese market via direct importation.

Source: The author.

privileges to foreign-financed firms of 'China-origin' according to the FDI laws, other 'real' foreign-financed firms may not be able to use the WTO provisions on SOEs and SIEs to challenge the alleged favouritism of the government of Guangdong. Central government is also likely to support the SOEs in the near future as the socio-economic consequences of massive unemployment are simply too high to be acceptable politically. In other words, trade disputes over the legitimacy of 'special provisions' granted by local governments in Guangdong may be one of the battlegrounds between the Chinese and foreign governments in the WTO.

On the other hand, the crowding-out process of foreign-financed SMEs in Guangdong will be accelerated in the near future for three main reasons (Table 2). First, they are competing with TNCs directly as TNCs will be able to distribute their lower-tariff imported products in southern China through their own marketing channels. SMEs will no longer enjoy competitive advantages (such as 'first-mover' advantages and economies of scale through sub-contracting to a network of firms) over the locally-funded firms, as the Guangdong government refocuses its FDI policy towards large-scale, high technology inward investment projects. Second, the bureaucratic red-tape and the rigorous enforcement of new policies by the Customs, the State Bureau of Taxation and the State Bureau of Foreign Exchange further diminish the competitive advantage of foreign-financed SMEs in southern China. This is especially the case for those SMEs with limited capital. Third, the competitive SMEs in Guangdong are likely to be the targets of mergers and acquisitions sought by large-scale locally-funded enterprises (or even TNCs). It is expected that the capital rich locally-funded enterprises in southern China will resort to mergers and acquisitions to consolidate their competitive advantage and market share before China joins the WTO.²⁷ Despite all the contributions made to local economic development ranging from generating employment to promoting economic growth, especially during the early period of economic reform, the SMEs with limited capital in southern China are likely to be the big losers when the Chinese

economy becomes more integrated with the global economy.

The above 'win-lose' scenario is different from the 'win-win' scenario implied in most of the econometric studies in China, e.g. YANG *et al.*, 1997; BACH *et al.*, 2000; ZHANG, 2000; ZHONG and YANG, 2000, etc.

For the liberal scholars in the West to the reformists and policy makers in Guangdong, the squeezing out of SMEs is indeed no more than the result of southern China joining the globalized market economy: the playing field is levelled and the less competitive SMEs are crowded out under the rules of free market competition.

This argument is misleading, at best, and even faulty. First, there is unlikely to be a conclusive 'real' level playing field in southern China after WTO accession. This is at odds with the convenient assumption of a 'level playing field' claimed in the literature, e.g. GARNAUT and HUANG, 2000; and ZHONG and YANG, 2000; etc. The WTO accession levels the playing field between the TNCs with and without investment in southern China, but certainly does not level it between TNCs and other foreign-financed SMEs in Guangdong, nor between foreign-financed and locally-funded or foreign-financed firms of 'Chinese origin' in southern China (Fig. 2). In reality, WTO accession tilts the playing field against the SMEs in southern China, as newly enforced government policies absorb a larger proportion of their capital and thus diminish their competitive advantage.

Second, the crowding-out of foreign-financed SMEs may also hinder the development of private entrepreneurship in southern China due to 'domino effects'. This is mainly because the competitiveness of foreign-financed SMEs is closely correlated with the survival of the large proportion of privately-funded SMEs in southern China that are either their sub-contractors or their suppliers of raw materials, packing materials and semi-finished goods.²⁸ Their complex contractual relationship is illustrated in Fig. 2. Yet this vital 'domino effect' is not discussed in most, if not all, of the literature, e.g. GARNAUT and HUANG, 2000; SONG, 2000; and DRYSDALE, 2000; etc. Once Chinese membership of the WTO causes one of the main pillars – the foreign-financed SMEs – of this closely interlinked business relationship to collapse, it is very likely that a large number of privately-funded SMEs in southern China will lose their competitive advantage. The impacts of the Asian financial crisis upon SMEs in southern China – when a number of foreign-financed and privately-funded firms, especially SMEs, collapsed partly due to the closely interlinked sub-contracting relationships between themselves – can be in fact regarded as a 'rehearsal' of WTO accession.²⁹ The entry of TNCs into China is not expected to provide for the sub-contracting roles played by foreign-financed SMEs for the privately-funded SMEs in southern China simply because TNCs tend to use their own globalized

sourcing, sub-contracting, original equipment manufacturing (OEM) and marketing channels, rather than rely on the tens of thousands of small and medium-scale sub-contractors in Guangdong. Although some TNCs may eventually use small and medium-scale sub-contractors locally, it may be too late and too little to resuscitate the once viable privately-funded SMEs in southern China. The successful large-scale locally-funded firms, SOEs and SIEs may not be able to fill the void created by the contraction of private entrepreneurship in China. Paradoxically, the major reason (the closely interlinked sub-contracting relationship) which may bring about the downfall of privately-funded SMEs in southern China, was regarded as one of the greatest competitive advantages of SMEs in Dongguan municipality of Guangdong (YEUNG, 2001a, 2001b).

The decline of privately-funded SMEs in Guangdong may have further negative impacts on local governments in southern China, such as the reduction of taxation income and employment generation (Fig. 2). It may also undermine SOE reform in southern China as the *de facto* privatization of SOEs is partly dependent on employment and capital generation in a dynamic private sector. Undeniably, the competitiveness and vitality of foreign-financed and privately-funded enterprises have had and will have profound long term effects on the economic development of Guangdong, before and after the WTO accession. Therefore, policy makers in Guangdong and Beijing should not only pay attention to the direct 'knock-on effect' of WTO accession on China, but also to the 'domino effect' of WTO accession on the competitiveness of foreign-financed firms as well as the positive impacts of SMEs, both foreign-financed and privately-funded, on the Guangdong economy.³⁰ By the same token, Chinese policy makers should allow more room for non-state enterprises to manoeuvre in the transitional economy. By doing so, they may actually facilitate Chinese accession to the WTO.

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NOTES

1. Created in 1995, the World Trade Organization (WTO) is an inter-governmental body comprising the majority

of the world's countries. Based on the spirit of classical liberalism and the rule of law, the purpose of the WTO is to promote multi-lateral trade through the reduction in obstacles erected by individual countries to global trade in goods and services, settle trade disputes and lay down rules governing international trade. Although decisions are normally arrived at through consensus of all members, WTO actions are based on non-discrimination and equal treatment of member countries.

2. Unlike the conventional definition of FDI, which is defined as 'the act of acquiring assets outside one's home country' (GRUBEL, 1987, p. 403) or 'cross-border expenditures to acquire or expand corporate control of productive assets' (FROOT, 1993, p. 1), the official Chinese counterpart incorporates three forms of direct foreign-invested enterprises – *sanzi qiye*, that is, equity joint venture (EJV); contractual joint venture (CJV); and wholly foreign-owned venture (WFOV) – and joint exploration of resources. The conventional definition of FDI embraces WFOV and EJV, but excludes CJV and *sanlai yibu*. *Sanlai yibu* (three forms of processing and assembling and compensation trade) are defined by the Chinese authority as 'other forms of foreign investment' rather than FDI. For simplicity, this paper defines FDI as the inflow of foreign capital (including that from Hong Kong and Macau) in forms of *sanzi qiye* and *sanlai yibu*. Readers interested in the detail of the classification of FDI in China can refer to YEUNG, 2001b, pp. 3–7.
3. *Privately-funded* firms are funded by private individuals, in contrast to the *locally-funded* firms which include the firms funded by collectives and local governments.
4. Every Sinologist knows that securing appropriate personal connections is the necessary and probably the most important precondition for conducting a field survey in China. This explains why the majority of interviewed firms are located in Dongguan. The use of non-random sampling is, in fact, commonly employed by Sinologists, e.g. CHILD, 1994; WARNER, 1994, 1995; LIN, 1996; MACBEAN, 1996.
5. As the consumer price index is only available from 1984 onwards, the retail price index-based GDP deflator is used to estimate the real GDP in Guangdong.
6. It is estimated that the number of migrants working and living in Guangdong accounts for one-third to one-half of its local population of 72.99 million. The official statistics only report the local population.
7. As the economy developed, the share of export value channelled through Guangdong's Commission of Foreign Economic Relation and Trade in the total export value in Guangdong (the Customs' figures) diminished from 75% in 1990 to 45% in 1998 (GBS, 1999, p. 501).
8. As the US's Jackson-Vanik amendment requires an annual review of the Most Favoured Nation (later renamed as Normal Trade Relations) trade status with China, full WTO membership for China is feasible only when the US (with the approval of the Senate and the Congress) grants her the PNTR.
9. The following summaries are based on the news released by the office of the US Trade Representative. The bilateral deals between China and the US will be 'multi-lateralized' to all WTO members.
10. There are more than 10,000 *sanzi qiye* (more than 25% are in Guangdong) in the textile and clothing sector,

- which accounts for 25% of the gross production and export value in the Chinese textile and clothing industry (SHI, 2000, p. 208).
11. In the automobile industry, foreign-financed firms have long been shielded from international competition through high tariffs under the pretext of 'infant industry protection'. With inadequate designing and manufacturing capabilities and capacities, locally-funded automobile firms are unable to compete with their foreign-financed counterparts. This explains why the major Sino-foreign JV automobile assemblers can still dominate the Chinese market with outdated models. For instance, Santana is still the major player in the medium-size automobile market in China although it is extremely outdated after it was launched a decade ago. After the WTO accession, the significant reduction of tariffs will definitely impose tremendous pressure on the less productive and extremely fragmented 170 vehicle assemblers and another 600 *sanzi qiye* of automobile firms in China (MORGAN STANLEY DEAN WITTER, 2000, p. 16; SUN, 2000, p. 393). This is the case even for the large-scale Sino-foreign JVs, such as Guangzhou Honda, as the imported cars cost a similar amount to the locally manufactured ones. As the 600 *sanzi qiye* account for about 50% (US\$20 billion) of the total asset value of Chinese automobile firms, it is expected that the decline in competitive advantages will have far reaching implications for the local economy, e.g. it is expected that 500,000 jobs (14.5%) in the Chinese automobile industry will be lost within seven years of WTO accession (*Far Eastern Economic Review*, 1999, pp. 81–82; SUN, 2000, p. 393).
 12. Based on a computable general equilibrium model, ZHANG, 2000, pp. 134–37, estimates that the large-scale tariff cut and domestic market liberalization implemented by China after WTO accession will result in an increase in employment and an increased trade surplus. This is due to the expansion of the export-oriented manufacturing sector outweighing the contraction of the import-substitution sector. ZHANG's, 2000, finding is reconfirmed by BACH *et al.*, 2000.
 13. To determine the validity of the production contract, the Chinese Customs inspectors come to the firm to evaluate the production processes, e.g. does the firm really need x amount of raw materials to produce y amount of good or are they trying to import more tariff-free raw materials than required and then re-sell them for profits?
 14. Recent legislation approved by the National People's Congress in China stipulated that CJVs and WFVs are no longer required to remit foreign exchange from abroad to meet their foreign exchange requirements (*South China Morning Post*, 2000e). However, this may have little impact on the foreign-financed SMEs since most of them are neither WFVs nor CJVs.
 15. The lack of (qualified) manpower in the Customs service accentuates the difficulties of law enforcement. Educated and well-qualified young people in China tend to join foreign-owned JVs or private companies rather than work in the public sector.
 16. This partially explains why there were numerous complaints against the Chinese Customs during the last several years. A number of Hong Kong-based investors assume that *guanxi* (personal connections) plus money pay-offs can solve most, if not all, problems that their ventures may encounter. When the central government cracked down hard on corruption, their previous 'magic formula' no longer worked and they are therefore complaining (Field survey, 2000).
 17. The State Bureau of Taxation uses the information provided by the Customs rather than the accounts of foreign-financed firm to determine the value of output.
 18. The import-deposit consists of about 10% of Customs duty and about 17% of import value-added tax levied on the import of raw materials classified as protected or sensitive in China. According to the Customs Administration of Enterprises by Categories, foreign-financed firms with an annual export value of US\$10 million or above and without records of illegal smuggling are given priority to be granted the import-tariff-free class AA status. Firms in aircraft and ship manufacturing industries for export will be granted class AA automatically. Companies ranked as class A or B have to pay the import-deposit only for the import of restricted goods (*South China Morning Post*, 1999a, 1999b, 1999c, 1999d, 1999e, 2000b). After a year of negotiation with the Guangdong government officials, Hong Kong investors are now allowed to provide bank guarantees in lieu of a cash deposit (*South China Morning Post*, 2001).
 19. Previously, foreign-financed firms in Guangdong only had to submit a monthly import/export report to the Customs to verify its production contract. The submission of daily import/export records obviously imposes additional costs on the firm.
 20. The compulsory subscription to the Labour Insurance and Pension Fund for any employee (including migrants) working in the firm for three years or longer imposes additional financial pressure upon the foreign-financed SMEs in southern China, e.g. the Pension Fund ranged from 30–117 *yuan*/month/worker in Guangdong (Field survey, 2000).
 21. In some cases, investment by the recipients of foreign exchange loans from the Bank of China are classified as 'foreign investment' (THOBURN *et al.*, 1990, p. 5). This is possible because Chinese laws governing foreign investment, such as the *Chinese-Foreign Equity Joint Venture Law*, the *Chinese-Foreign Contractual Joint Venture Law* and the *Foreign Capital Enterprise Law*, do not define clearly what sort of company is considered as 'foreign' (WANG, 1995, p. 247). This reinvestment phenomenon may be more prominent in Guangdong due to the liberal interpretation of rules by its local authorities. Thus, the investment figures by country of origin should be treated as general benchmarks rather than precise.
 22. A research report published by Beijing University estimates that illegal capital flight from China might be double the amount estimated by the government (generally classified as 'errors and omissions' by the State Statistical Bureau): US\$36.4 billion in 1997, \$38.6 billion in 1998 and \$23.8 billion in 1999. SOEs or SIEs can easily transfer hard currency abroad via under-reporting of exports or over-reporting of imports. By under-reporting of export earnings, SOEs can keep the foreign exchange revenues that they would otherwise have had to hand over to the State Administration of Foreign Exchange (SAFE). By over-reporting imports, SOEs are able to secure the documents to exchange

- more *renminbi* into US dollars. The affiliates or 'shell' companies of SOEs abroad can also over-report or over-pay for raw materials and other inputs or exaggerate their foreign exchange currency expenses, etc. This partly explains why only 36.6% of the 2,202 SOEs subsidiaries abroad surveyed by the State Administration of Foreign Exchange were breaking even or earning profits (KYNIGE, 2000, p. 11).
23. Four China-origin subsidiaries in Hong Kong invested approximately US\$1.5 billion in China, which accounted for approximately 14% of all FDI inflow during the first three quarters of 1993 (LIN, 1996).
 24. The fabric company was very profitable – gross sales of 100 million *yuan* and net profits of 20 million *yuan* in 1999 – at the time of the equity transfer (Field survey, 2000).
 25. Despite the plan to unify tax regulations covering domestic and foreign-financed firms before WTO accession, the Chinese government is going to maintain the preferential 15% profit tax rate (in contrast to the 33% levied upon local firms) granted to foreign-financed firms located in selected economic zones. In fact, the government may extend the preferential tax rate to all foreign-financed firms in China (*South China Morning Post*, 2000d).
 26. Being an 'FDI of Chinese origin' firm, the biggest winner of the complex interlocking share-ownership game is/are the 'real owner(s)' of company B. Apart from various forms of preferential taxation privilege granted to FDI, the 'real' owners of company B also enjoy a much lower income tax rate in Hong Kong, e.g. a maximum of 16% in Hong Kong versus the 40% or higher in China. Moreover, the dividend payable to shareholders of company B can be easily converted into foreign currencies through a trading company, i.e. to use the dividend to purchase a shipment of other goods and then export it overseas. As the annual rate of return of equity joint venture shareholders ranged from 10–30% per annum, the 'routing' of capital via Hong Kong and the converting of it into foreign currencies not only saves the 'real' owner(s) of company B up to 1 million *yuan* per annum in profit and income tax, but also acts as a safeguard for the dividend as many can, for example, deposit them in a Swiss bank account, etc.
 27. In 1999, China accounted for only 0.5% of the global merger and acquisition activities in value term. But the average annual growth rate of mergers and acquisitions in China was a staggering 89% between 1990–99, so there is plenty of 'virgin land' to be explored (MORGAN STANLEY DEAN WITTER, 2000, p. 10).
 28. In fact, the development of privately-funded firms is partly due to the demonstration effects of foreign-financed firms in southern China.
 29. For instance, a small-scale Hong Kong-funded jeans laundry processing and assembling firm in Guangdong was almost bankrupted during the Asia financial crisis when a number of its customers became insolvent and failed to pay up more than 2 million *yuan* of processing and assembling fees (Field survey, 2000). It is very difficult to estimate accurately the impact of the Asian financial crisis on foreign-financed and privately-funded SMEs in southern China as local governments regarded this information as 'sensitive and confidential'. However, the number of firms registered in Guangdong can be used as an indirect benchmark. In 1997, there were 59,040 foreign-financed firms – of which 374 were registered as (large-scale) 'major foreign-financed firms' – registered in Guangdong (GBS, 1998, pp. 507–09). In 1998, the total number of foreign-financed firms registered in Guangdong decreased to 57,665 while the number of 'major foreign-financed firms' almost doubled to 676 (GBS, 1999, 526–28). The total number of industrial enterprises (including locally- and privately-funded firms) registered in Guangdong decreased even more dramatically. For instance, the total number of industrial enterprises in Guangzhou decreased from 7,528 to 2,830 while the real gross value of industrial output increased from 138 billion *yuan* in 1997 to 184 billion in 1998, respectively (*ibid.*, p. 331). The above evidence suggests that a large number of foreign-financed and privately-funded SMEs have either closed or moved elsewhere during the Asian financial crisis.
 30. Apart from the recent 50% reduction in the import deposit imposed on foreign-financed SMEs by the Guangdong government, the establishment of 15 special Economic and Technological Development Zones (one of them is in Guangzhou) reserved for export-processing industries, and in which businesses are exempted from import deposits may be a first-step in the right direction in addressing the capital constraints experienced by SMEs (*South China Morning Post*, 1999d, 2000b, 2000c).

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