

# THE FDI PARADOX: CHINA'S SOCIALIST MARKET ECONOMY AND THE "DEVELOP THE WEST" CAMPAIGN\*

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## Introduction: The Grand Campaign for FDI

In early January 2004, the task force of China's Western Regional Development Office of the State Council made recommendations regarding China's 11<sup>th</sup> Five-Year Plan. Their proposals included two primary target areas: first, a marked shift from production to social infrastructure in an effort to increase the share of national Gross Domestic Product (GDP) of the eleven western provinces<sup>1</sup> to 30-35 percent and second, a reduction of GDP disparity between eastern and western provinces to 55-60 percent.<sup>2</sup> This pronouncement was not new. In late 1999, China embarked upon an ambitious campaign of *Xibu da kaifa* (Develop the West), a region that constitutes 5.4 million square kilometers or 57 percent of the country's land mass and an estimated 285 million or 23 percent of its population.<sup>3</sup> In his speech announcing the project in 1999, China's former Premier Zhu Rongji focused on infrastructure, environment, forestation, industrialization, technology, education, and internationalization.

At its root, western growth is predicated upon the concept of attracting Foreign Direct Investment (FDI). This essay will examine the fundamental criteria for attracting and sustaining FDI and discuss whether or not China's western regions and policies meet these criteria.

While the Chinese government has been able to deliver on unprecedented growth in national GDP, with an annual average of 9.6 percent from 1978-1999, equitable economic development has been severely lacking.<sup>4</sup> As often pointed out by the Chinese government, this effect is part and parcel of economic transition. Yet, as economic growth and development continue at a breakneck speed on the coast, the inland areas are slipping further and further behind their neighbors. China's "Develop the West" Campaign in many ways is even more ambitious than its predecessor, the coastal Special Economic Zones (SEZs). While coastal provinces possessed a number of inherent advantages to attract FDI long after the relaxation of government subsidies and intervention, the

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west threatens to become one of China's greatest challenges. As a reflection of the magnitude of this project, in 1999 the industrial output of the western and coastal regions measured 403 billion RMB and 2,174 billion RMB respectively.<sup>5</sup> Road density in western China averaged 7 km of road per square kilometer compared with the coastal average of 29 km per square kilometer.<sup>6</sup> The number of long-distance lines in the west was 75 percent less than on the coast and the urban gas supply penetration rate was 65 percent compared with the coastal 95 percent.<sup>7</sup> The following chart dates to 1999, the starting point of the "Develop the West" Campaign and offers a breakdown of these differences. It further demonstrates the vast difference of 80:1 between the eastern and western provinces for the exports and imports of foreign invested enterprises (FIEs).

Table 1. Major Economic Indicators of the Chinese Mainland Economy -- Comparison of the Coastal, Central and Western Regions (1999)

Major Economic Indicators	National Total	Coastal Region	Central Region	Western Region <sup>a</sup>
Area ('000 sq km)	9600.0	1070.0	1750.0	6780.0
Population (mn)	1,259.1	463.9	419.8	358.5
- natural growth rate (%)	0.88	0.48	0.70	1.02
Employees (mn)	117.7	52.3	37.7	27.7
Gross Domestic Products (Rmb bn)	8,073.0	4,832.4	2,293.7	1,527.5
- primary industry (Rmb bn)	1,421.2	563.7	475.9	363.9
- secondary industry (Rmb bn)	4,080.7	2,421.0	1,195.6	628.1
- tertiary industry (Rmb bn)	2,703.6	1,914.3	762.7	535.8
Grain Output (mn tons)	508.9	173.7	201.6	133.8
Fixed-asset Investment (Rmb bn)	2,241.9	1,256.6	449.9	408.4
- capital investment (Rmb bn)	1,261.9	631.1	267.0	363.7
Consumer Goods Retail Sales (Rmb bn)	3,111.5	1,855.6	842.8	4,13.1
GDP Per Capita (Rmb)	6,546.0	13,061.3	6,290.8	4,483.5
Urban Per Capita Disposable Income (Rmb)	5,854.0	7,284.0	4,845.0	5,283.0
Rural Per Capita Income (Rmb)	2,210.0	3,344.0	2,331.0	1,604.0
Average Annual Wages (Rmb)	8,346.0	10,300.0	6,755.0	7,819.0
Fiscal Revenue (Rmb bn)	559.5	332.2	124.4	102.9
Fiscal Expenses (Rmb bn)	899.1	453.7	228.9	216.5
Exports (US\$ bn)	194.9	176.1	11.0	7.8
- exports by FIEs <sup>b</sup>	88.6	86.1	1.7	0.8
Imports (US\$ bn)	165.7	149.7	8.9	7.2
- imports by FIEs <sup>b</sup>	85.9	81.8	2.9	1.2
Utilized Overseas Investment (US\$ bn)	40.3	33.4	3.7	1.8
International Tourists Revenue (US\$ bn)	14.1	9.9	0.8	1.4

Note: <sup>a</sup> Western Region includes Guangxi, Inner Mongolia, Sichuan, Chongqing, Guizhou, Yunnan,

Tibet, Shaanxi, Qinghai, Gansu, Ningxia, Xinjiang.

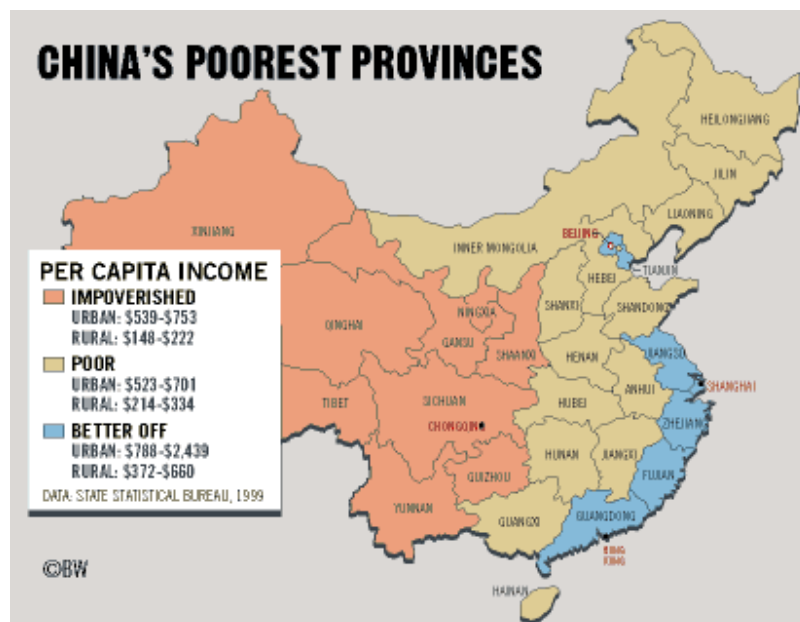
<sup>b</sup> Foreign-invested enterprises

Source: State Statistical Bureau (2000), China Statistical Abstract, "Opportunities for Hong Kong in Western China," *Hong Kong Trade Development Council*, 2000, <<http://www.tdctrade.com/gowest/opportunity.htm>>.

During China's industrialization of the 1950s, Mao Zedong's dictum of "man over nature" had a dramatic impact on all regions of China.<sup>8</sup> The disastrous Great Leap Forward during the late 1950s contributed to a massive famine that left an estimated 30 million dead and a number of failed industrial projects that accelerated deforestation, desertification, salinization, and a host of other ecological problems.<sup>9</sup> It was not until 1978 that Deng Xiaoping initiated a program that many suggest had already been growing at the grassroots level. The "Open Door Policy" spurred investment opportunities in China through gradual economic liberalization.<sup>10</sup> This experiment excelled to such an extent that only twenty years later, by 2002, the Foreign Direct Investment Confidence Index showed that China had for the first time surpassed the United States in FDI.<sup>11</sup> China's analysts point to six key factors allowing for the nation's overall profound economic growth that hovers between seven and nine percent per annum. These include the role of the state, reduction of income poverty, private sector development, trade as an engine of growth, and human capital.<sup>12</sup>

The policy engine driving this growth has been referred to as Special Economic Zones (SEZs) and National Economic and Technological Development Zones (ETDZs).<sup>13</sup> These zones have developed in stages and at the state level consist of a "relatively small piece of land carved up in the coastal cities and other open cities."<sup>14</sup> The main focus of this regional development has been to improve hard and soft investment and develop the high tech industry, focusing on industrial projects, absorbing foreign funds, and building up an export-oriented economy. The breakdown of these development targets is measured in three phases with the first set of fourteen cities in 1984-1988 that included Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Minhang, Hongqiao, Caohejing, Ningbo, Fuzhou, Guangzhou and Zhanjiang. The second set of eighteen cities, entered this development program from 1992-1993, included Yingkou, Changchun, Shenyang, Harbin, Weihai, Kunshan, Hangzhou, Xiaoshan, Wenzhou, Rongqiao, Dongshan, Guangzhou, Nansha, Huizhou Dayawan, Wuhu, Chongqing, Beijing, and Urumqi. The third set were introduced from 2000-2002 and featured Hefei, Zhengzhou, Xi'an, Changsha, Chengdu,

Kunming, Guiyang, Nanchang, Shihezi, Xining, Hohhot, Taiyuan, Nanning, Yinchuan, Lanzhou, and Lhasa. These locations, which are meant to serve as “windows and bases,” currently total 54 cities at the national level with 34 cities in the coastal regions and 21 cities in middle and western China.<sup>15</sup> The relatively similar number of bases in east and west can be misleading, suggesting a greater parity than exists. In fact, from looking at the distribution of cities in the list above and the map below, as one directs their gaze from east to west the disparity in wealth becomes increasingly pronounced. Part of the rationale for this disparity has to do with timing of development, yet another factor has to deal with what each region has to offer through comparative advantage. While the economic concept of “comparative advantage” has increasingly come under assault for its inapplicability to modern conditions and economic growth, it still retains strong resonance in the case of attracting FDI to China’s west.<sup>16</sup>



Source: “China’s Poorest Provinces,” *Business Week Online*, <[http://www.businessweek.com/2000/00\\_19/b3680013.htm](http://www.businessweek.com/2000/00_19/b3680013.htm)>, 2000.

### Overall Factors Attracting FDI

In order to better understand the basic foundation for regional economic growth, it is illustrative to view the factors that attract FDI. The degree to which a region fulfills these demands may influence the level of FDI. While by no means exhaustive, the following represents an

overview of these factors, including private sector development, human capital, macroeconomic stability, political stability, infrastructure, access, tax incentives, and exchange rate stability.

### *Private Sector Development*

Private sector development lays the groundwork for growth through investment by liberating companies and projects from the direct control of the government. This is a crucial first step that is dependent upon a government's willingness to liberalize and allow market forces and foreign conglomerates or individuals to exert a greater influence. While tending to attract foreign companies into the domestic market, this can be a destabilizing process since it may impinge upon sense of national sovereignty or create domestic resentment or corruption among companies that do not receive the same investment incentives.

### *Human Capital*

Low wages combined with a relatively educated and stable supply of labor are key elements. While a basic level of development is optimal since it provides a steady stream of healthy and engaged laborers, for the investor low wages afford a region a cost advantage. If workers become more educated and demand salaries commensurate with their technical training, this may put out of some companies, especially in labor-intensive manufacturing industries. Conversely, technically adept and educated workers provide a ready-made and trained work force that offers high-tech and other industries access to specialized and efficient labor, which at the global market level is still relatively "cheap". Facilitated entry and exit visas for technical advisors to bring in training are central in developing an educated labor force. However, education can be a double-edged sword, while literacy and technical training are crucial to expanding growth potential in the workforce, some analysts have pointed out that contrary to popular belief, instability and resistance are primarily driven and populated by the educated unemployed middle class.<sup>17</sup> If education develops and jobs do not follow, the result may be mass migration in search of employment or destabilizing protests and riots.

### *Macroeconomic Stability*

Macroeconomic stability as the next factor in this list suggests that for investment to occur inflation and exchange rates must remain stable. Fiscal policies must drive toward keeping inflation at a low and manageable level, while the domestic currency may be valued at a low enough level

that it encourages exports or at a high enough level to facilitate purchasing power, depending upon the government's goals.

### *Political Stability*

Political stability represents another incentive for foreign investment. In this regard, democracies are not necessarily an essential component. In large part this is because a democracy by its very nature may facilitate dissent, union formation, work stoppages, protests, and even riots. Authoritarian societies are often viewed from a lens of ability to accomplish directives with little resistance. For example, when China's leadership decided to ban inexpensive cabs (*miandi*) with a high pollutant ratio in the capital, within months the directive had cleared the offending drivers from the streets. However, it may also be argued that authoritarian systems lead to uprisings among oppressed populations, as in the case of the Baren uprising or Yining riots in Xinjiang in 1997. The occurrence of ethnic conflicts and uprisings of any form are major disincentives to investment since they drain away participation of the labor force and often lead to infrastructure destruction. Corruption and graft are additional hindrances to effective investment incentives since they often diminish capital resources through embezzlement. An enforceable legal code, reciprocity and accountability are crucial in mitigating the impact of these various investment deterrents.

### *Infrastructure*

Infrastructure that includes transportation through viable road systems and waterways combined with well-constructed factories and other facilities creates the links necessary to provide for the smooth transfer of products between regions. Without basic domestic infrastructure, imports from other countries may often supplant the cheapness and accessibility of products that are technically geographically closer but harder to access. Ready availability of factories may be of assistance, yet if they are poorly located or equipped refurbishing such establishments may be more costly than starting anew. In addition to factories and transportation, sanitation facilities, adequate water supplies, and access to consistent and dependable electricity are also crucial to sustaining industry in any region.

### *Tax Incentives*

Tax incentives through reductions or exemptions on land and labor taxes also contribute the necessary conditions for a company to set up its business. Reductions in barriers to joint ventures,

purchasing rights, currency exchange, etc. help to create an environment conducive to entering domestic the market.

### *General Terms of Access*

Finally, geography, labor distribution, proximity to markets, lowered restrictions on investment and involvement of foreign subsidiaries are also major considerations as to where to direct FDI. Access can take a variety of forms, such as joint ownership, turn-key operations or branch plants and offices. These types of projects allow larger foreign companies to provide the funds and gain profits in a relatively hands-off approach that provides for distant ownership and local management.

### **Goals of the “Develop the West” Campaign**

A number of elements in China’s western region investment climate may be compared and contrasted with this general model for attracting FDI. It is instructive to analyze the extent to which the “Develop the West” Campaign coincides with and diverges from the aforementioned factors. In large part, the campaign was linked to China’s efforts to join the World Trade Organization (WTO).<sup>18</sup> China’s political and economic leadership was searching for ways to further liberalize its overall economic system and attract investment to meet WTO requirements. It is, therefore, ironic that while WTO membership and western development are both intended to bring economic growth and development, their means of achieving this common goal are diametrically opposed. In large part, this is because China’s liberalization, opening up to foreign investment and competition, and potentially allowing its currency to appreciate against the dollar from its current artificially low rate are linked to WTO membership and yet at the same time threaten to stifle western development through import pressures and competition. As a result, the Chinese government has taken a highly targeted approach towards development and protection of these infant industries in western provinces.

The “Develop the West” Campaign also factors in attempts by the Chinese government to diversify its economy and create a new domestic market to preclude an overdependence on exports and to spur the growth of China as a “consumer society.”<sup>19</sup> Consumer spending in China reportedly has been weak since the late 1990s. Chen Dongsheng of the Western Research Institute at the Chinese Academy of Social Sciences (CASS) comments, “If China does not develop the west, our country’s products will not have a market.”<sup>20</sup> While this statement exaggerates the inherent

purchasing power of the impoverished west, it still illustrates the growing desire for domestic diversification and concerns over the long-term sustainability and compromised strategic position of overdependence on exports. In fact, China's heavy dependence on exports conflates its traditional notion of self-sufficiency that reached its height under Mao Zedong's disastrous Great Leap Forward. Concerns that export and technical barriers in the EU, Japan, and the United States on Chinese exports will have a drastic impact on its earning potential have gone beyond traditional concerns to foment a resurgence of the demand for self-sufficiency.<sup>21</sup> The U.S. SA8000 export standard that links labor rights with order forms has become a particularly sensitive subject. This is in large part since it threatens China's low wage labor system that dominates the western provinces.<sup>22</sup>

Not all interest in the west is based on the push of external disincentives. Rather Chinese analysts suggest that strengthening ties with western provinces will enhance access to its stores of oil, natural gas, and minerals, create stronger ties with Central Asia, and establish employment opportunities for the tens of millions of unemployed Chinese. These economic incentives are heavily targeted towards increasing opportunities for western economic development to increase regional stability and diminish the chances for uprisings and separatism. Staggering poverty in many parts of western China compared with the rapid growth of the eastern coastal provinces has contributed to a great deal of inquietude on the part of China's leaders that with the decline of Communism regime survival and stability depend on economic growth and development. China has increasingly targeted the west in part due to its history riddled with separatist movements and revolt.

Another factor increasing interest in western China relates to its largely uninhabited expanses that provide an outlet for the mass scale transfer of population from such projects as the Three Gorges Dam or as a zone to attract Han Chinese through government-led business opportunities and incentives. While these transfers are meant to siphon off tension from eastern provinces, it could be argued that they increase tensions in the west since the Han Chinese are often the recipients of the better jobs and access to the benefits of government subsidized economic initiatives.<sup>23</sup> Still, on the whole, the Chinese government has the larger goal of improving local living conditions to mitigate the effects of workers from western provinces moving east. This "floating population" of migrants has contributed to increasingly dire spread of infectious diseases such as AIDS.

While inherently contradicting government encouragement of Han migration to the west, the Chinese government has begun massive projects on reforestation and river diversion to support the

west's growing population and industry. Reforestation projects also mark an attempt by the Chinese government to mitigate the potential recurrence of massive floods that devastated the southwest in Sichuan Province in 1998 and to stem the expanding desertification of the northwest that stretches out toward and nearly touches Beijing.

### **China's Incentives to Attract FDI**

In creating a systematic method of addressing western development, China has broadly targeted water conservancy, communications, energy, telecommunications, urban development, economic development, environmental protection, agricultural services, and social development.<sup>24</sup> More specifically, China has developed an increasingly flexible and yet government-directed approach toward stimulating growth. The following represents an overview of the various stimulus packages that fall within and outside of the aforementioned factors that attract FDI. It further describes various aspects that are still lacking or may be problematic in sustaining long-term regional economic growth and development.

#### *Private Sector Development*

As its first step toward attracting FDI, China has engaged in an incremental process of liberalization and privatization of firms. This has resulted in a degree of success in attracting investment but it has also contributed to a degree of the instability and uncertainty associated with unemployment of large segments of its population, resulting from the closure or conversion of State Owned Enterprises (SOEs). Protests and even violence in such provinces as Liaoning and Shaanxi are increasingly common as many workers find themselves disenfranchised from the security of their traditional work units. In spite of these consequences, privatization continues to accelerate in a number of provinces. For example, Sichuan province on June 1, 2003 leveled the "playing field" between private and other enterprises by increasing market access for private enterprises, deregulation of patents and institution of intellectual policy regulations, increased availability of government funds, reduced requirements for import-export rights, enhanced credit transparency, and emphasis on treasury bonds.<sup>25</sup> Even the once impregnable SOE has been opened up to partial buyouts from foreign investors that will no longer be responsible for the outstanding debts of the enterprise.<sup>26</sup>

### *Human Capital*

China's west may actually out-leverage the east in its ability to offer lower wages for labor. However, a lack of economic development in the region has also severely curtailed human capital offerings in terms of the frequent migration of the most technically capable inhabitants to the coast. The Chinese government has a system of 'affirmative action' programs intended to increase minority access to higher education but this also often draws the best and brightest away from the region. In 2000, Wan Xueyuan, director of the State Administration of Foreign Experts Affairs, addressed this dilemma by suggesting that the presence of foreign experts and training in the west might stem the flow: "In allocating funds for employing foreign experts the state will take the west into primary consideration to increase the presence of foreign professionals in the areas of urban construction, commerce, finance insurance, risk prevention through active recruitment, and improvements in salaries and living conditions."<sup>27</sup> "Program of the Light" also has been attempting to reverse the migration of talent out of the region through approximately 117 research groups and a 15 million yuan investment in 1,000 young researchers to "attract and stabilize" young professionals in the region.<sup>28</sup> Still, the outward migration trends continue with not just the loss of higher-level skilled technicians but also unskilled labor. As stated by James Kynge, Bureau Chief of China's *Financial Times*, "All the peacocks have flown to the coast and now it's not only the peacocks but the sparrows are migrating, too."<sup>29</sup> The main benefits derived from this process are the "repatriated" funds from migrants on the coast and yet this money offers little consolation for the overall loss of manpower.<sup>30</sup>

### *Macroeconomic Stability*

The Chinese government has been assiduously protecting its currency exchange rates to keep the renminbi (RMB) from appreciating in value against the dollar, and thereby diminishing the competitiveness of its exports. China has been long assailed by the United States on this issue, especially since its entry into the WTO. China is reportedly considering pegging the RMB to 10 currencies, including the Yen, Euro, the Hong Kong and U.S. dollar allowing its exchange rate to float within fixed limits.<sup>31</sup> At the beginning of 2004, Central Bank Deputy Governor, Li Ruogu stated, "China will give up the US dollar pegged exchange rate regime at an appropriate time, and turn to peg the renminbi to a package of currencies."<sup>32</sup> Still, promises of this transition occurring at an "appropriate time" suggest that China will maintain its exchange rate at an artificial level as long as possible to protect its domestic industries.

Curbing inflation is another arena that Zhou Xiaochuan has made a priority for 2004.<sup>33</sup> China has been largely successful in its macroeconomic controls by avoiding the wild rates of inflation that plagued some of its neighbors during and after the Asian Financial Crisis, and in 2003 reportedly keeping its inflation rate roughly between 1.5 and 1.7 percent.<sup>34</sup> Combined with a growth rate estimated at 8 percent during 2003, China has been largely successful in this regard and yet at the microeconomic level the issue of economic stability is still lacking. A nascent or, as some might argue, nonexistent legal system in the west further complicates the standards and enforcement of regional economic policies. Most regional officials reportedly lack experience in implementing economic policies and these inconsistencies have augmented the risk associated with investment.<sup>35</sup> The geographical distance of these provinces from the center of state governance while allowing for greater policy flexibility also adds to the potential for corruption and a lack of policy coordination. Wang Songqi, deputy director of the Financial Research Center of the Chinese Academy of Social Sciences, emphasized that three “mysteries” still plague and are unexplained by China’s high economic growth rate including unemployment, resources pouring into “traditional” rather than high-tech enterprises and the loss of “secrecy” through the transfer of land utilization rights to foreign investors at low prices.<sup>36</sup>

### *Political Stability*

Political stability also has proven to be one of the most difficult aspects to control due to the reported rampant corruption, graft, bureaucratic harassment, and organized crime in a number of western provinces. While these conditions also exist in the east, the difficulty of coordinating a government response to deeply ingrained corrupt practices has been difficult. First beginning in 1983 and later in 1996, China instituted its “Strike Hard Campaign” that sporadically emerges to confront corruption at all levels of society. Much of this program relies on summary trials and executions to instill a sense of fear among the community that corruption will not be tolerated. In Mandarin this periodic cleansing is known as “killing the monkey to scare the chickens” or making examples of the few to affect the actions of the many. However, it could be argued that the “Strike Hard Campaign” goes beyond targeting the few and in many cases fuels resentment among local and particularly minority populations such as the Uighur. Minorities that primarily inhabit the western regions of China (Xinjiang alone accounts for thirteen ethnic groups) are often targeted in these corruption sweeps in thinly veiled attempts by the government to reign in ethnic and labor unrest.

### *Infrastructure*

Perhaps one of the most heavily targeted areas for attracting FDI to the west has been infrastructure. Much of this initiative derives from the severe disadvantage of many of these provinces in terms of access to markets and suitable transportation and communication networks. According to one account, while it takes less than a week to move grapes from California to Guangdong Province, it takes nearly fifteen days from Xinjiang.<sup>37</sup> Northwestern China is covered with deserts and few viable roads. While the south has ties to the Yangtze River, river transport is slow and the road system connecting neighboring provinces with this outlet are still largely inadequate. As a result, as of 2000, the Chinese government reportedly allocated 70 percent of its annual budget to infrastructure development in western China.<sup>38</sup> One of the primary targets of this funding in the northwest consists of an eight trunk highway that is meant to serve as a major artery with the east.<sup>39</sup> As of 2002, ten scheduled projects in western China included completing construction of a railway to link Xi'an with Nanjing, construction of the 640-km Chongqing-Huaihua Railway, establishment of 17,000 km highways, building of the Xi'an-Xianyang International Airport, a 5 billion yuan investment in building 20 airports, a 13.5 transportation rail project in Chongqing, creation of a 953-km 2 billion cubic meter capacity natural gas pipeline from Sebei in the Xinjiang Uygur Autonomous Region to Lanzhou in Gansu Province, water conservancy projects in Zipingpu, Sichuan Province, and Shapotou, in the Ningxia Hui Autonomous Region, a 343,300 hectare forestation project on the Yangtze River, development of a potash fertilizer project, and improvements in tertiary education.<sup>40</sup> Construction funds for these various projects are to come from government appropriation, treasury bonds, bank loans and investment by enterprises.<sup>41</sup> Still, the quality and even existence of these projects is often lacking and has been dubbed by Zhu Rongji as "tofu projects" or bridges, buildings, and roads of flimsy construction. It could be argued that some of these projects as in the case of the Three Gorges Dam could be termed "invisible projects" for a number of peasants were promised and resettled to nonexistent homes.<sup>42</sup> In fueling factories and urbanization in the west and east alike, the Chinese government has further issued a recent decision for 12 billion in treasury bonds to fund gas pipelines and power plants. Many of these projects are meant to redress the decision of Mao Zedong to locate a number of factories in remote areas of western China ostensibly to stave off attack from U.S. and Soviet missiles.<sup>43</sup> While this encouraged industrialization within a region that would otherwise have been severed from growth by its inaccessibility, these projects lack the surrounding

structures of electricity, water, transport, and sanitation to function as viable institutions. Infrastructure development is one of the few ways out of this conundrum of access.

### *Environment*

Another area of infrastructure development focuses on the environment. The Chinese Academy of Sciences (CAS) reportedly has 23 institutes in western China including monitoring stations and botanic gardens founded in the 1950s and 1960s with the objective to “harness the local eco-environment, develop natural resources and promote regional economy.”<sup>44</sup> In 2001, CAS reportedly arranged 18 projects of capital construction in western China totaling 149 million RMB.<sup>45</sup> The severe shortage of water and desertification of the northwest combined with the frequent flooding of the southwest exhibit the worst of economic disaster potential in both regions. In 2002 Xiang Huicheng, Minister of the Ministry of Finance, disclosed that over the next five years China would devote 110 billion RMB to address the issue of environmental degradation in the west.<sup>46</sup> However, given the accelerated pace of population pressure associated with government-induced migration of Han Chinese and ambitious plans for urbanization creating massive pressures on water and land supply, this relatively small amount of investment in the environment suggests that it is still largely lacking as a priority in development. And in spite of these investments, inadequate “soft” infrastructure investment has been cited as one of western China’s greatest weaknesses as private firms, which are reportedly 30 percent more productive than SOEs, receive little financing from the formal financial system.<sup>47</sup> To mitigate the effects of lack of access to the coastal regions, provinces in the west in particular Xinjiang have been increasingly linked to Central Asian economies for trade. However, the struggling economies of a number of these landlocked neighbor states continue to limit these ties primarily to informal border trade. In this regard, initiatives through the Shanghai Cooperation Organization (SCO) may be one of the best ways to increase the establishment of joint ventures between Xinjiang and neighboring Kazakhstan, Kyrgyzstan, and Tajikistan.<sup>48</sup>

### *General Terms of Access*

In terms of other forms of access, since the mid-late 1990s, China has been assiduously pursuing investment from all avenues. Some of these initiatives have not been well-received due to questions over sovereignty and foreign ownership.<sup>49</sup> Still, the Chinese government has set out to liberalize entry and exit visa requirements for foreign personnel while encouraging investment and

in some cases ownership. One example is in the case of a west-to-east natural gas transmission project in which foreign companies will be allowed to have a controlling stake. This project represents a significant break with the past when regulations stipulated that China must retain the dominant share. As another development, BOT (build, operate, transfer) and TOT (transfer, operate, transfer) have become integral parts of Chinese government initiated projects to attract investment with oil and gas companies utilizing right transfer, equity sales, mergers, and reorganization.<sup>50</sup> The Chinese government has also opened the potential for foreign firms to gain access to RMB loans in contrast to the former practice of forcing foreign investors to raise the funds in foreign currencies.<sup>51</sup> In part due to these policies, some larger multinationals have demonstrated an interest in projects in western China. For example, Motorola, Microsoft, Compaq, Itochu, and Walmart have all initiated the investment process.<sup>52</sup> Siemens has invested in a fiber-optic cable venture in Chengdu, Sichuan province as well as railway and traffic control systems in Xi'an.<sup>53</sup> Pratt & Whitney has also reportedly set up factories for production of aircraft engine parts on Chengdu and Xi'an.<sup>54</sup> Xi'an has further attracted foreign companies to its high-tech industrial zones through low taxes, cheap land, adequate power and road systems, and its reputation as the third largest scientific research center in China.<sup>55</sup> During early 2000, IBM reportedly agreed to develop management software and Hewlett-Packard announced its plans to open a \$7 million e-commerce research and development center.<sup>56</sup> Xi'an's technical zone has also hosted foreign investment delegations and launched an \$18 million venture-capital fund for small companies.<sup>57</sup> Initiatives such as Chengdu's introduction of the China Compulsory Certification for 132 products under 19 categories including health, safety, hygiene, and environmental safety have also contributed to assuring greater quality control for would-be investors.<sup>58</sup>

Yet, not all investment in the region has been smooth. In fact, a number of multinationals have pulled out or threatened to do so as a result of protests, corruption, and local disregard for laws. For example, in 2000 Enron Corporation threatened to halt a \$50 million investment in a natural-gas drilling and sales venture near Chengdu after its local partner Sichuan Petroleum Authority neglected to honor agreements on production levels and payments.<sup>59</sup> Since investment from larger foreign subsidiaries in western China, in some cases, has proven less robust than anticipated, the government has placed significant pressure on domestic financial institutions and companies in the east to extend loans to and invest in the west. Some do so willingly, such as Shenzhen Zhongxing Telecom and its \$6 million investment in a Xi'an research and development institute.<sup>60</sup> The Chinese government has also impelled national banks such as its Agriculture Bank to extend micro-credit

programs in small towns such as Erguan in Guizhou.<sup>61</sup> Still, most of these loans tend to focus on salvaging larger institutions and companies of the SOE system. Estimates of over \$250 million USD in nonperforming loans suggest that the weight of the old system may be an unsupportable yet necessary evil to avoid mass scale unemployment protests.<sup>62</sup> Extending nonperforming loans, draining funds away from companies in the east to support the west and creating this artificial link through quotas have been criticized by numerous economists for their lack of sustainability and potential for introducing insolvency to eastern institutions. Furthermore, Xi'an and Chongqing are the most frequent targets of investment but their geographic location technically rests in central not western China. In the case of Xi'an, it has already established itself as a center of tourism and technology, while Chongqing is a river port and former capital under the Nationalists during the 1940s. As a result, these two cities are not highly representative of the investment conditions of most western cities. Each began with a much stronger comparative advantage. Their inclusion as 'western' cities, therefore, may be viewed to a greater extent as a method of raising the statistics on western investment rather than necessarily a geographical reality.

#### *Tax Incentives*

The Chinese government has sought to nationalize reductions in income tax rates from 33 percent to 15 percent with the potential for 5 percent in minority regions.<sup>63</sup> Reduction of land and labor taxes combined with exemptions on vehicle and vessel taxes for foreign and domestic investors have also been implemented in the west.<sup>64</sup> In particular, foreign companies investing in oil and gas projects in western China are eligible for corporate income tax at the reduced rate of 15 percent and those investing in minority areas may be eligible for exemption.<sup>65</sup> These incentives for foreign subsidiaries have in fact attracted foreign interest as exhibited by the presence of IBM, Siemens, Kodak, and Toshiba at the 2002 West China Fair for Attracting Overseas Investment.<sup>66</sup> However, it has also had unanticipated consequences with domestic investment being rerouted overseas back into China to benefit from the taxes meant to attract foreign investment. Concerns that a good deal of these funds may not return to domestic investments led to economists suggesting the potential for capital flight during the mid-1990s.<sup>67</sup> The Chinese government's attempts to extend these tax incentives to domestic investors to encourage involvement in the western provinces suggest attempts to reverse this trend. Yet, as pointed out by Matthew D. Moneyhan, the government may be taking a gamble. If government revenues are reduced beyond a certain level

and foreign direct investment does not make up the difference, the government may be draining away funds for building regional infrastructure thereby harming chances for FDI.<sup>68</sup>

### *Socialist Patterns*

While most of these incentives fall within the aforementioned conventional list of inducements to attract FDI, many of China's domestic policies correlate to its socialist traditions. Even as recently as 2003, China's Defense Minister Chi Haotian called upon the army to get actively involved in the "Develop the West" Campaign<sup>69</sup> harkening back to the initial role of the Xinjiang Production and Construction Corps (XPCC) in the region as a paramilitary organization intended to increase Han Chinese presence, reform methods of agriculture and animal husbandry, and finally to stifle dissent.<sup>70</sup> From this initiative, Xinjiang has developed a strong cotton industry contributing to the agricultural strengths of the western provinces that include Sichuan's production of rice.<sup>71</sup> However, agriculture has yet to drive the provinces toward greater profitability given the often cheaper prices of imports.<sup>72</sup> The government has also created quotas for each province stimulating competition for the best contracts and redirecting some foreign investment away from the coast to the interior.<sup>73</sup> Ironically, some foreign businessmen have resisted this quota system by redirecting their investments to other countries. Redirection of funds away from the coast has also taken the form of heavy government pressure and incentives to encourage domestic investment in the west. But this too may be increasing resentment, this time not among provinces in the west but rather among those in the east that are increasingly "compelled" to shoulder the economic burden of the west.

### **Conclusion: Whither the FDI?**

The above overview of the goals and policies of the Chinese government in western China raises the question of potential for further development. Is the west capable of attracting the FDI necessary to rival the east? An article issued in 2002 from the *People's Daily* declared triumphantly that, according to the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), FDI in western China not only continued to rise but for the three previous years had surpassed the national average.<sup>74</sup> While investment growth improved, the majority of sources suggest that much of this investment resulted from funds redirected from the coasts and domestic allocations rather than through foreign subsidiaries. Even the statistics quoted in the same article declaring that western China received \$4.4 billion of the \$69.2 billion in contractual foreign investment suggests the

inherent fallacy in these claims.<sup>75</sup> The following chart may in fact represent a more accurate picture of where China’s western provinces rank in comparison with the east.

<b>Where investors tread</b>			
Geographical distribution of FDI stock in China			
	1983-1998	1980s	1990s
Eastern region	87.8	90.0	87.6
Central region	8.9	5.3	9.2
Western region	3.3	4.7	3.2

Source: OECD

*Eleven provinces: Guangxi Zhuang, Xinjiang Uyghur, Ningxia Muslim, Tibet Autonomous Regions, and Yunnan, Sichuan, Shaanxi, Guizhou, Gansu, and Qinghai provinces, as well as Chongqing Municipality in the west.*

Source: Mehmet Ogutcu and Markus Taube, “Getting China’s regions moving,” No. 231/232, *Observer*, May 2002.

The western region as a whole faces a diverse set of challenges and each province has its own economic and geographic challenges. Extreme diversity within the region expands to an even greater scale when comparing western and eastern China. These dividing lines are by no means clear and the Chinese government further conflates the issue by including more centrally-located provinces in its western accounting to balance statistics on regional investment. Comparing a tourism center such as Xi’an, which contains the frequently visited Qin Emperor’s terracotta warriors, with a former Silk Road desert border outpost like Kashgar or Yangtze River port like Chongqing demonstrates the difficulty of pre-determining similarities in economic advantages, policies, and incentives for both domestic and foreign investment. Further complicating demands, even the basic level of Chinese government commitment to the “Develop the West” Campaign that originated under former President Jiang Zemin and Premier Zhu Rongji has come into question under the leadership of China’s President Hu Jintao. The direction of funding and attention suggests the government’s increasing interest in directing funds toward the development of the “rust belt” in northeastern China.<sup>76</sup>

Mao Yushi, director of a private economic consultancy firm in Beijing discusses this dilemma by arguing if economic growth is based on market incentives then it will survive, but if directed by solely by government initiatives then it will fail.<sup>77</sup> Yet, from viewing the conditions on the ground, the Chinese government must play a direct role in the development west to affect short-term gains due to regions’ size, lack of infrastructure, geographic isolation, as well as inadequate regional legal and economic policies. Long-term gains are less apparent given the comparative

advantages of the coast in terms of location and transport considerations. This inability of the western regions to compete even domestically makes successful competition in the global market even more difficult and demonstrates the Chinese government's attempts to shelter these regions from aftershocks of WTO accession. Ironically, while much of western development originated from WTO requirements,<sup>78</sup> as government priorities shift to the northeast of China, the west of China may find itself increasingly relegated to the bottom of the list. This has already been reflected in financial reports that often emphasize ameliorating unemployment and economic difficulties in the northeast of China with decreasing mention of the north and southwest.<sup>79</sup> In part this could relate to the highly visible and sometimes violent protests associated with the closing of SOE's in eastern China. In one such example in 2000 in Liaoning Province, thousands of workers, angry over the bankruptcy of their mine, burned police cars in a several-day standoff with the army. The closer proximity of these events to China's capital city and coastal engines of growth serve as major incentives to stem the trend from infecting China's main bases of political and economic power.<sup>80</sup>

In fact, the priorities of government directed towards investment and FDI incentives appear to be shifting. For the western provinces, their best chance for attracting FDI in terms of comparative advantages remains tied to resource potential and cheap labor. Cross-border trade with Central Asia and tourism in the cases of some cities are additional incentives and yet these often informal modes of wealth accumulation are difficult to channel and often consist of barter rather than monetary gain for investors or the government. In the case of labor, the potential for regional instability serves as a major disincentive to investment in the west. Massive waves of outbound ethnic and inbound Han migration, combined with increasing instances of AIDS and environmental degradation all serve as significant obstacles to attracting external investment.

Ironically, natural resources may be one of the few viable avenues for man to triumph "over nature" in the west. According to a report extolling the virtues of western China designed to attract Hong Kong investors, Sichuan, Shaanxi, and Xinjiang reportedly have the three largest natural gas fields in the country with explored reserves amounting to 1,181 billion cu m or 61 percent of the country's total.<sup>81</sup> In Xinjiang Province, the Tarim Basin has an estimated 400 billion cu m of gas reserves with 16.4 billion cu m of gas reserves at Ordos Basin.<sup>82</sup> Responding to these statistics, Sinopec Star has established 2.15 million annual tons of crude oil production capacity at Tahe, which has an estimated 22.13 million tons.<sup>83</sup> However, Sinopec's reported goal was to find 88.5 million tons and these numbers fall far short. Natural gas reserves reportedly account for 84 percent of the country's total and hydropower stations in Liujiaxia of Gansu and Longyangxia of Qinghai

are among the largest in China. Yet, in 1999 natural gas represented only 3.1 percent and 2.8 percent, respectively, of China's total energy production and consumption.

While the west may possess rich potential according to government statistics, the current situation on the ground has led a number of analysts to question the extent of these reserves. Some suggest that even if the resources are as plentiful as claimed, at current prices, the costs of such endeavors would far outweigh the returns.<sup>84</sup> Lack of compatibility with most coal-based domestic energy infrastructure in the cities further constrains the consumer market for these natural gas reserves.<sup>85</sup> Moreover, the extent of these reserves have been called into question with reports of western firms “coming up dry” in their exploratory efforts.<sup>86</sup>

Since 1978, China has begun its long road toward a “socialist market economy,” which has tried to bridge economic philosophies by combining state controlled investment and quota systems with liberalized tax and ownership policies. This system has introduced an inevitable paradox in which the state may be supporting its western provinces indefinitely. While this state-directed investment is essential to building the infrastructure for growth and development, it retains few of the necessary components for long-term sustainability or self-sufficiency for attracting FDI. Labor while cheap remains unstable and continues to flow out of the region, projects while plentiful are tainted by a lack of quality and the potential for graft, resources while present are not easily accessed or transported, border trade while active remains informal and miniscule, foreign investment while available remains constrained and complicated by local officials, legal systems while advancing are unable to curtail corruption and regional interpretation, and bank loans while broad are often nonperforming and threaten the very foundation of China’s western and national economic growth. Until these various issues are mitigated or resolved, the development potential of western China remains constrained.

China’s central government remains the largest contributor to economic growth in the western provinces with FDI and local investment trailing far behind. Once again, Mao’s declaration regarding the triumph of “man over nature” and moreover the “government over markets” threatens to collapse under its own weight.

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## Notes

<sup>1</sup> China's western region includes between 10 and 11 provinces depending on the source: Shaanxi, Qinghai, Sichuan, Yunnan, Guizhou, Ningxia, Xinjiang, Inner Mongolia, Gansu, Tibet and Chongqing. Michael Glanz, Qian Ye, and Quansheng Ge, "China's Western Region Development Strategy and the Urgent Need to Address Creeping Environmental Problems," *Arid Lands Newsletter*, No. 49, <<http://ag.arizona.edu/OALS/ALN/aln49/glanz.html>>, 1 May 2001.

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<sup>15</sup> *Ibid.*

<sup>16</sup> In order to better understand the constraints and incentives on FDI, it is necessary to first address the regulations regarding foreign investment in China. The Regulation on Administration of Foreign Invested Construction Enterprises issued by the Ministry of Foreign Trade and Economic Cooperation and the Ministry of Construction came into effect on 1 December 2002, stipulating that only the following projects are permitted by their qualification and grade: 1) Projects wholly financed by foreign investment and/or grants. 2) Projects financed by loans from international financial institutes and awarded through international tendering according to the terms of the loan. 3) Chinese-foreign jointly constructed projects with foreign investment equal to or more than 50 percent; and projects with foreign investment less than 50 percent, but technically difficult for Chinese construction enterprises to implement alone can be jointly undertaken by Chinese-foreign construction enterprise with the approval of the construction administration departments of provinces, autonomous regions and municipalities. 4) Chinese-invested construction projects that are technically difficult for Chinese construction enterprises to implement alone can be jointly undertaken by Chinese-foreign construction enterprises with the approval of the construction administrations of provinces, autonomous regions and municipalities. "Four Types of Foreign-Invested Construction Projects Permitted," *Chinagate*, <<http://us.tom.com/english/3146.htm>>, 13 November 2002.

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