

## Foreign direct investment and investment environment in Dongguan Municipality of southern China

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## Foreign Direct Investment and Investment Environment in Dongguan Municipality of Southern China\*

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## **Abstract:**

Based on 26 case studies, this paper investigates the socio-economic causes of the inflow of FDI and its policy implications in Dongguan. The favourable factors for foreign investors in Dongguan can be categorised under the Dunning's OLI (ownership, locational and internalisation advantages) framework. This paper argues that factors other than policy incentive, such as sub-contractual and pseudo integration, are playing more important roles to attract the inflow of FDI and maintain the high level of economic growth in Dongguan. This finding questions the effectiveness of policy incentives, such as tax-break, implemented by the government as a mean to attract the inflow of FDI in Dongguan. The existence of "Chinese crony capitalism" calls for further improvement in the implementation of laws and regulations in Dongguan and the reduction of bureaucratic red-tape by the central and local governments.

# **1 Introduction**

At US\$45.3 billion in 1997, China was the world's second-largest recipient of foreign direct investment (FDI) after the United States (US) for the fourth consecutive year.<sup>1</sup> Labour-intensive, low technology and low value-added manufacturing relocated from Hong Kong are the generally perceived characteristics of foreign-financed firms in the Pearl River Delta. But how can we reconcile the fact that a number of Transnational Corporations (TNCs) in different industrial sectors selected Dongguan as (one of) their manufacturing bases in China?<sup>2</sup> What are the favourable investment factors in Dongguan? What are the policy implications of this phenomenon?

Being one of the "Four Little Tigers" (*sixiaohu*) in Guangdong province, Dongguan municipality (*dejishi* or prefectural city, hereinafter called Dongguan for simplicity) has been one of the fastest growing cities in the Pearl River Delta since the implementation of open policy in 1979.<sup>3</sup> As the national symbol of processing and assembling (P&A), Taiping administrative region (*guanliqu*) of Humen town in Dongguan was the site for the first P&A (handbag manufacturing) firm established in September of 1978 in China.<sup>4</sup> With its excellent location and strong ethnic linkage with the overseas Chinese, Dongguan is popular for foreign investors.

Despite the significance for FDI policy, only a small amount of research has been conducted in Dongguan. Most, if not all, of the literature in Dongguan consists of Chinese official internal reports, which are not accessible to the general public in China, e.g. Gao, Liu and Ye, etc.<sup>5</sup> In the literature published in English, with the exception of Yeung<sup>6</sup>, no systematic and in-depth research has been published on the relationship between FDI and the socio-economic development of Dongguan. Thoburn *et al.*, Thoburn, Chau and Tang, Chui, Fitzgerald, and Zhang and Hung covered Dongguan in the study of FDI in southern China briefly.<sup>7</sup> However, none of these studies is comprehensive. With the exception of Shenzhen, there is hardly any comprehensive study on the causes of FDI conducted at a micro-geographical scale (e.g. municipal level) in China, even taking account of the Chinese official internal reports. This bizarre

phenomenon is partly due to the scarcity of information and the difficulties of data accessibility, e.g. the official statistics on Dongguan were scarcely comprehensive and most of them were not disclosed until 1998. This explains why the bulk of literature is either confined to macro or meso-geographical scale studies (e.g. Lau *et al.*, Chu, Huang, Cheung, Kueh and Ash, and Takahashi, etc.)<sup>8</sup> or else focus on the characteristics of certain industries or investment categories (e.g. Ho, Child and Yan, etc.).<sup>9</sup>

Rather than focusing on the economic growth *per se*, this paper investigates the **socio-economic causes** of the inflow of FDI and its **policy implications** in Dongguan. Unlike the conventional definition of FDI, which is defined as “the act of acquiring assets outside one’s home country”<sup>10</sup> or the “cross-border expenditures to acquire or expand corporate control of productive assets”<sup>11</sup>, 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 (WFV) – and joint exploration of resources. The conventional definition of FDI embraces WFV and EJV, but excludes CJV and *sanlai yibu*. *Sanlai yibu* (three forms of P&A 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 those from Hong Kong and Macau) in forms of *sanzi qiye* and *sanlai yibu*. It must be emphasised that this paper does not attempt to modify the existing FDI model or propose a new FDI paradigm.<sup>12</sup>

Dunning’s eclectic paradigm of international production, which postulates that ownership-specific, locational and internalisation advantages (the OLI paradigm) are dominant factors affecting the pattern of FDI, is used to explain the favourable investment environment in Dongguan.<sup>13</sup> The ownership-specific advantages (O) are the prerequisite for contractual resource transfers, exportation or FDI by TNCs in the home country, i.e. the exclusive production and technical know-how, and managerial and marketing skills possessed by TNCs in the home country superior to those of its rival firms in the host country. Through exporting to or investing directly in the host country, TNCs in the home country can reduce their transaction costs and internalise the externalities in factor or product markets.

These internalisation advantages (I) are larger than the benefit from licensing production know-how to foreign firms. Moreover, the theory postulates that TNCs moved out of their country of origin because the pull factors of locational endowments (L), such as low labour costs and preferential investment incentives available from the host country, are stronger than those in the home country. In other words, TNCs select FDI because it can reap the locational advantages enjoyed by the local industry in the host country, in which direct exportation and licensing cannot be obtained.

Between 1996 and 1997, semi-structural interviews on 26 foreign-financed enterprises located in seven towns of Dongguan were conducted by the author.<sup>14</sup> The sample firms ranged across various manufacturing sectors: plastics and metal products, textile and clothing, toys, leather products, jewellery, electrical appliance, electronic products, and printing and paper products sectors. The overwhelming majority of the sample are investors of Hong Kong origin engaged in the P&A investment. Most of the firms investigated (15 cases) are located in Humen town. In terms of industrial sectors, textile and clothing (eight cases) and manufacturing of electrical appliances (six cases) accounts for more than half of the total firms interviewed. In terms of employment size, the medium-sized firms (51-500 workers) represent more than two-thirds of the cases. However, it is arbitrary and even misleading to use the number of workers to determine the size of firm, as a large-scale, highly automated firm might employ only 200 workers but a medium-size labour-intensive clothing firm may be employing 500 or more workers. The majority of the firms investigated belong to the class of small and medium-scale enterprises (SMEs), if capital value and size of factory premises are used to determine the size of firm.

The unprecedented development of the physical and social infrastructure has literally shaped Dongguan's landscape. The nine major favourable factors for foreign investors in Dongguan can be categorised under the Dunning's OLI framework. This paper argues that factors other than policy incentive, such as sub-contractual and pseudo integration, are playing more important roles to attract the inflow of FDI and maintain the high level of economic growth in Dongguan. This finding questions the effectiveness of policy incentives, such as tax-break,

implemented by the government as a mean to attract the inflow of FDI in Dongguan. Furthermore, the existence of “Chinese crony capitalism” calls for further improvement in the implementation of laws and regulations in Dongguan and the reduction of bureaucratic red-tape by the central and local governments.

The background of Dongguan is described in section 2 briefly. The investment environment in Dongguan is illustrated in terms of infrastructure, production factors (section 3) and bureaucracy (section 4). The nine major favourable factors for foreign investors in Dongguan and the applicability of the OLI paradigm are summarised in section 5, before the conclusions and implications of this paper are presented in section 6.

## **2 Background to Dongguan**

Dongguan is located in the middle of the Shenzhen-Guangzhou economic corridor in the Pearl River Delta of southern China. To be more specific, Dongguan is 60 km south of Guangzhou municipality (the capital of Guangdong) and 97 km north of Shenzhen municipality (located just adjacent to Hong Kong). At present, Dongguan is divided into 33 administrative towns/districts within its 2,465 km<sup>2</sup> of land. In the 1990s, about 900,000 of the overseas Chinese population (700,000 in Hong Kong and Macau, and another 200,000 in 65 different countries) originated in Dongguan.<sup>15</sup>

Dongguan was transformed into an export-oriented manufacturing-based economy through P&A induced industrialisation and outward-oriented commercial agriculture during the first stage of economic reform up to the late-1980s (the “first industrial revolution”). After being upgraded to municipal status in 1988, Dongguan invested heavily in the construction and improvement of its infrastructure, in particular transportation, power supplies and telecommunications. The “second industrial revolution” aims at transforming the *sanzi qiye* and its supporting service sectors into higher value-added, skill-intensive and higher technology sectors is implementing since the mid-1990s.<sup>16</sup> The privately-funded enterprises in Dongguan were selected by the government to crowd-in other complementary foreign-financed high value-added and high technology industries.<sup>17</sup> The Dongguan government also implemented a

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Singaporean-style “pioneer industrial policy” and set up a “high technology industrial zone”. The government gives exemption from taxation, assistance in finance and human capital for privately-funded enterprises that invest in the selected high technology industries, e.g. biotechnology, vehicle component manufacturing, etc.<sup>18</sup>

The result of economic reform in Dongguan is shown by an array of extraordinary economic statistics. The real GDP and real GDP per capita growth rate reached double-digits each year, with the exception of five years: 1978-80, 1987-89 and 1992.<sup>19</sup> Between 1978 and 1997, the average annual growth rate of 14% of real GDP (higher than the 12% in Guangdong and 9% in China) and 13% of real GDP per capita (higher than the 11% in Guangdong and 8% in China) made Dongguan one of the fastest growing regions in the world. During the two decades of reform in Dongguan, real GDP jumped by eleven times to 6.98 billion *yuan*, while real GDP per capita increased by nine times to the all time high of 4,742 *yuan* in 1997. The real GDP per capita in Dongguan was double that of Guangdong and triple that of China.<sup>20</sup>

Even including migrants in Dongguan when data are available, the average annual growth rate in real GDP per capita between 1986 and 1997 was still respectable at 5%. Despite the austerity policy implemented nation wide and that the number of migrants in Dongguan doubled during the 1990s, the real GDP per capita doubled, from a relatively high figure of 1,371 *yuan* in 1990, to 2,391 *yuan* in 1997. That is to say, the high growth rate in Dongguan was able to offset the tremendous increased of migrants population in Dongguan from 15,622 in 1986 to about 1.45 million in 1997, which is as large as the local population.<sup>21</sup>

In real industrial and agricultural output value, the average annual growth rate in Dongguan was 20% between 1978 and 1997. The gross value of industrial and agricultural output in Dongguan as a percentage of Guangdong’s increased from 2.8% in 1978 to 4.6% in 1997 is another evidence of the economic strength of Dongguan. Dongguan’s increasing share of gross value of industrial output in Guangdong, from 2.1% in 1978 to 4.7% in 1997, and the corresponding decrease in share of gross value of agricultural output, from 4.5% in 1978 to 2.9% in 1997, illustrates its rapid industrialisation.<sup>22</sup>

Dongguan is popular for foreign investors. In terms of absolute value, the contracted value of FDI in Dongguan increased enormously from US\$4.76 million in 1979 to the all time high of US\$3.55 billion in 1993 before dropping to US\$1.21 billion in 1997. The utilised value of FDI also rose impressively from US\$1.73 million in 1979 to the all time high of US\$1.21 billion in 1997. In 1997, the cumulative contracted FDI in Dongguan reached US\$17.92 billion and the corresponding utilised value of FDI reached US\$7.02 billion. This is equivalent to 12% of the cumulative contracted and utilised value of FDI in Guangdong between 1980 and 1997 and 3.5% of the cumulative contracted value of FDI and 3.4% of the cumulative utilised value of FDI in China between 1979 and 1997. In per capita term, the growth of utilised FDI in Dongguan is as impressive as in Singapore.<sup>23</sup> In 1979, the utilised FDI per capita in Dongguan was only US\$1.54, which was much lower than the US\$8.51 recorded in Singapore in 1965 (when Singapore became an independent country). In 1997, the per capita value in Dongguan increased dramatically to US\$825, which was even higher than the US\$661 recorded by Singapore in 1986 (but lower than the US\$1,084 in 1987). Even when the migrant population in Dongguan is taken into consideration, the per capita value of US\$416 recorded in 1997 attained the 1985 level of Singapore of US\$409.<sup>24</sup>

As a result of export-orientation, the export value of Dongguan increased tremendously from US\$39 million in 1978 (for Customs figure, US\$56.83 million in 1990) to almost US\$5 billion in 1997 (for Customs figure, US\$11.37 billion in 1997): an average annual growth rate of 30%.<sup>25</sup> Apart from 1984 and 1989, when economic retrenchment occurred due to the over-heated Chinese economy, Dongguan recorded a double-digit annual growth rate of export value. The export value per capita increased from a mere US\$35 in 1978 to US\$295 in 1989, before increasing by another eleven times to US\$3,397 in 1997.<sup>26</sup>

### **3 Physical Infrastructure & Factors of Production**

In this section, the physical infrastructure and production factors in Dongguan are discussed.

### 3.1 Physical Infrastructure

Accessibility is a significant locational factor considered by foreign investors. With its particular geographical features and strategic location, **roads** play a more significant role than other means of transportation in Dongguan.<sup>27</sup>

Within one decade of tremendous investment by the Dongguan government, the roads in Dongguan were transformed from narrow, uneven, sandy or even muddy lanes into cement or asphalt-covered motorways connecting all villages to the 33 towns and districts of Dongguan. Subsequently, the time spent travelling from Hong Kong to Humen town was reduced from six hours in 1990 to less than two hours in 1997. In terms of accessibility, the total length of road doubled from 1,225 km in 1980 to 2,330 km in 1997 (Table 1). As a result, the road-area density increased dramatically from 49.7 km/100km<sup>2</sup> in 1980 to 94.5 km/100km<sup>2</sup> in 1997. Apart from building new roads and bridges, the quality of the roads improved tremendously as the total length of all-weather roads covered with cement or asphalt increased from 719 km in 1980 to 1,949 km in 1995. Moreover, the proportion of graded to non-graded motor roads increased from 29% in 1980 to 90% in 1997. The first-grade motorways were built from scratch in 1987, 690 km by 1997, which accounted for 30% of total road length in Dongguan. In 1993, the 315 km of first-grade motorway was equivalent to about half of the total length of all first-grade motorways in Guangdong.<sup>28</sup>

[PLACED TABLE 1 ABOUT HERE]

The tremendous improvement in accessibility was achieved by a number of strategic major programmes carried out by the Dongguan government during the 1990s. In inter-regional accessibility, the most significant development is the Guangzhou-Shenzhen Superhighway and the Tiger Gate Bridge. With 50 km of motorway passing through ten different towns in Dongguan, the four-lane two-way Guangzhou-Shenzhen-Zhuhai Superhighway has significantly improved the routes between Hong Kong, Dongguan and Guangzhou. The Tiger Gate Bridge in Humen was opened in 1997. With a capacity of 10,000 cars per day, the Bridge has not only improved the accessibility of Dongguan and the Pearl River Delta tremendously as it reduces the travelling distance between Shenzhen and Zhuhai

by 100 km, but also helps to alleviate traffic congestion in Guangzhou. In intra-regional accessibility, the most significant development includes the upgrading of four major motorways, the construction of four first-grade ring-roads and 13 motorway networks.<sup>29</sup>

There is a consensus among foreign investors that transportation in Dongguan has been improving dramatically over the years. The costs of transportation is rising but it was still acceptable for the majority of interviewees. Severe traffic congestion after traffic accidents in motorway was common in the early 1990s as it was very difficult to locate a telephone along the road to call for help. This demonstrates the significance of telecommunications and its inter-dependence with roads for infrastructure development.

The **electricity supply** plays a vital role in the location of foreign investment in Dongguan. During the early 1980s, where power shortages and electricity blackouts were common, Dongguan's electricity supply relied mainly on the province-owned thermal power plant in Shajiao of Humen town.

Apart from a number of small capacity power plants operated by township governments, the Dongguan government has invested heavily in locally and provincially funded power plants to improve the power supply. Between 1987 and 1990, the Dongguan government invested US\$247 million and 82 million *yuan* in building the Humen power plant, expanded the capacities of Dongguan Sugar power plant and City power plant in Guancheng district. The result was an increase of 386,340 kilowatt (KW) of generated capacity and 560,000 KW of power supply by various electricity stations. This translates into more than three billion kilowatt/hour (KWH) of annual capacity with all three power plants operating at peak capacity. Between 1991 and 1993, the Dongguan government injected another one billion *yuan* into the Humen power plant and 340 million *yuan* into the provincially-owned Shajiao power plant. This resulted in an additional 245,000 KW of power supply. Furthermore, the Dongguan government has improved the access of power supply in remote areas through the construction of 20 electric sub-stations. In 1991, all 509 administrative regions in Dongguan had installed their own electricity stations.<sup>30</sup>

Despite the tremendous regional differentiation in electricity charges and its rising price, it is not a major factor in the locational choice for foreign investment in Dongguan as the stability and abundance of the power supply is the prime concern of foreign investors.<sup>31</sup> The regional difference in electricity charges is a result of different surcharge levied by different local power plants. A typical example is Humen town. Electricity costs 0.89 *yuan*/KWH in Botou of the Daning administrative region, while it cost 1.3 *yuan*/KWH in the Beishan administrative region, which is an adjacent village a stone's throw away. In Taiping administrative region, about ten minutes drive, it costs 0.66 *yuan*/KWH. It seems that the local authorities have no formal guidelines for settling prices.<sup>32</sup> Except in the energy-consuming sectors, all the interviewees agreed the economic loss from failure to deliver goods on time (and the subsequent loss of customers) due to unannounced power blackouts is much higher than the differences in electricity prices.

The development of **telecommunications** is unprecedented in Dongguan's history. An automated switchboard for programmed telephone and optical-fibre cable communication systems was installed during the early 1980s. Through five different stages, the capacity of the automated switchboard increased from 11,400 sets in 1985 to 577,600 sets in 1997 (Table 2). The number of household telephone subscribers increased from 3,000 in 1980 to 426,500 in 1997. In 1990, Dongguan was already the city with the highest teledensity (the number of telephones per 100 people) in China.

[PLACED TABLE 2 ABOUT HERE]

To improve the efficiency of the telecommunications system, city, village and long-distance telephone lines were combined into the first integrated automate digital telephone network in China through fibre-optic, digital microwave or ordinary cables in 1989. Subsequently, the city-village direct telephone and fax services went into operation. As alternative or supplementary communication devices, fax machines, pagers and mobile phones are rapidly gaining market share (Table 2). Given the high cost of mobile phones for ordinary people, this device is not only an effective communication tool for those desperate users who need to

keep in touch with others all the time, but also acts as a symbol of wealth in the booming economy.<sup>33</sup>

Apart from local connections, Dongguan started an IDD telephone service for direct dialling to 100 domestic cities and 17 foreign countries in 1986. Within four years, the IDD service was directly connected to 250 cities in China and 150 foreign countries. To cater for the booming demand, the number of telecommunications service centres in Dongguan was increased from 50 in 1980 to 339 in 1997 (Table 2).

### **3.2 Factors of Production**

The **labour** market can be divided into two broad categories: local and migrants. Most of the local workers in Dongguan are former farmers. At present, they either work in foreign-financed firms or are engaged in private businesses. Most manual workers, especially the unskilled, are migrants from other counties of Guangdong or Sichuan, Hunan, Guangxi, Hubei and Heilongjiang. Most are farmers aged under 20 for females and under 30 for males. The average age of the newly arrived migrant workers tends to get younger: 17-18 years old.<sup>34</sup>

In terms of absolute numbers, migrants are the backbone of the labour force in Dongguan. In 1997, there were 1.31 million migrant workers (accounting for 91% of its 1.44 million local population), which was 49% higher than the 876,053 local workers.<sup>35</sup> However, the generally perceived abundant supply of cheap labour is misleading since there is a mismatch in the labour market: an excess demand for skilled female workers in the labour-intensive industries and an excess supply of unskilled male and female workers.<sup>36</sup> The low level of versatility to adapt and low productivity of migrants is understandable, as most of them are farmers who have little or no working experience in the manufacturing sector. The mismatch in the labour market leading to voluntary unemployment – the skilled (female) workers resign and search for jobs with better monetary and non-monetary remuneration – increases production cost in terms of labour recruitment and training, and product quality control. Furthermore, migrant workers tend to change jobs before settling down with a firm since “most of the newly arrived migrant workers work for a few days to a few months and then exaggerate their

work experience to get a higher paid job in another firm.”<sup>37</sup> Ten to twenty *yuan* makes a difference as the majority of them earn less than 200 *yuan* in their hometowns. This explains the 10-50% (or higher after the Chinese New Year) of worker turnover rate in foreign-financed firms.

In 1997, an unskilled migrant worker earned about 300 *yuan* a month while a skilled technical worker could earn up to 1,000 *yuan* per month. The increase in wage is about 2% higher than the inflation rate over time. Given the rapid depreciation of *Renminbi* to USD from 1.51:1 in 1980 to 8.28:1 in 1997, the wage increase was in fact much lower in real terms for foreign investors.<sup>38</sup> The geographical variation in wages can be significant. For unskilled workers, the monthly wage ranged from 300-350 *yuan* in Tangxia town to 310-470 *yuan* in Humen town. For skilled workers or technicians, the monthly wage is 800-900 *yuan* in Xiegang town and 700 *yuan* in Humen town. In general, the wages of workers in Dongguan is 5-10% that of Hong Kong. Even when the low productivity of migrants is taken into consideration, the wage of workers in Dongguan is still about 70% lower than their counterparts in Hong Kong.

However, the “real” competitive advantage of labour market in Dongguan is the overwhelming majority of migrant workers are willing to work over-time with little additional payment. A Hong Kong entrepreneur claimed that “I just have to pay two to three *yuan* an hour more than the normal wage and 95% of them are willing to work over-time. In Hong Kong, most workers are reluctant to work over-time even with double pay!”<sup>39</sup> This provides a much greater degree of flexibility for the firm to accept large orders during the hectic peak season.<sup>40</sup>

The typical **industrial site** in Dongguan has two blocks – one in the workplace and the other is for accommodation. The quality of factory premises varies from good to very poor, due to the quality of original building and its routine maintenance. The accessibility and geographical location of factory premises determines its rent. For example, it costs 4,200 *yuan* per month in Qingxi town, 12,000 *yuan* per month in Fenggang town and 13,000 *yuan* per month in Xiegang town for an ordinary sized factory premise (about 16,000 m<sup>3</sup>). In Humen town, it cost 10,000 *yuan* a month of rent for small factory premises. Although the

rising rate of rent for factory premises is almost twice that of inflation, it is still much cheaper (70-90%) than in Hong Kong.<sup>41</sup>

Due to the higher minimum amount of investment in *sanzi qiye*, most SMEs from Hong Kong were registered as “collective ownership and P&A”, even if they were operated as WFVs (with the exception that factory managers were appointed by the local government). Since a number of Hong Kong investors only moved their machinery into Dongguan, it was not uncommon to set up a P&A firm with a registered **capital** of 100,000 *yuan* during the early 1980s. This explains a large number of SMEs located in Dongguan that are not operating in the “original” form of P&A, with foreign investors holding all the financial and managerial power while Chinese partners only lease the land and factory premises to their foreign partners.<sup>42</sup> The “alternative” form of P&A common in Dongguan is a way of overcoming the managerial and financial constraints associated with central government regulations for foreign investment. This demonstrates the flexibility of the Dongguan government regarding foreign investment.

With the growth of the economy over time, the local governments in Dongguan are being more selective about the type of foreign investment.<sup>43</sup> A number of *sanzi qiye* investment projects in various sectors funded by Japanese, Taiwanese and European have been established in Dongguan. The P&A investment format is still welcomed by the government as it is regarded as more flexible. Coupled with inflation and economic growth, the unofficial minimum amount of registered capital for P&A was increased to 500,000-600,000 *yuan*. It is indeed the practical minimum amount of investment as the electricity installation costs for a typical factory alone can be more than 100,000 *yuan*. As with other production factors, the actual value of the minimum amount of investment for P&A varies geographically, e.g. it was one million *yuan* in Qingxi town and 500,000 *yuan* in Changan town in 1997.

#### **4 Bureaucratic Red-tape & the Abuse of Power**

Despite the openness of the Dongguan government, bureaucratic red-tape and power abuse associated with the local government and the Customs still exists.

#### 4.1 Miscellaneous Fees

To employ workers, foreign-financed firms have to apply for the following permits on their behalf:<sup>44</sup>

- Temporary residence permit (this applies to migrants only).
- Employment permit (this applies to migrants only).
- Single card or planned maternity card for married employees.
- Unemployment insurance and old age pension.<sup>45</sup>

By law, the amount of the miscellaneous charge is determined by the number of workers in the firm, e.g. it can easily over 100 *yuan* per worker per month.<sup>46</sup> In reality, the amount payable by foreign-financed firms is negotiable and various geographically. After all, it depends on *guanxi* as those firms with better connections can get a more favourable “discount” on the payable fee. This explains why the local people with the right connections are employed as factory managers and accountants in foreign-financed firms. This also explains why all the firms interviewed have under-report the number of workers, by 30-80%, to the local government for purposes of tax and miscellaneous fee evasion.

Despite improvements in the transparency of the system, the situation of miscellaneous charges has deteriorated in some regions.<sup>47</sup> In an extreme case, a foreign-financed firm in Yantian administrative region of Fenggang town had to pay 46 types of miscellaneous fees.<sup>48</sup> One was a “postal delivery fee” charged by the Telecommunications Bureau. In addition to paying the postal fee, the firm had to pay a “postal delivery fee” based on the number of workers, e.g. 6-8 *yuan* per worker per annum. This is why the firm only reports 20% of its 200 strong workforce to the government. Several entrepreneurs even suggested that they had been “cheated by the local government!”<sup>49</sup> Moreover, some local governments backdated the newly introduced charge several months, even before the formal approval of the municipal government had been given.<sup>50</sup> This is another reason why foreign-financed firms employ local people as factory managers and accountants as they have the connections and knowledge to deal with the ever-changing regulations.

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It is neither the miscellaneous charges *per se* nor the total amount of such charges that annoys the foreign investors in Dongguan. It is the ambiguity, variety and the associated high transaction costs which frustrate foreign entrepreneurs.

## **4.2 Connections Cultivation**

It is a public knowledge that entrepreneurs used various methods of monetary and non-monetary tactics (including corruption) to cultivate connections with government officials, who hold the power in various bureaux but receive artificially low salaries. As legal representatives of Chinese partners under the (P&A) investment contracts and usually knowing government officials well, factory managers are naturally prime candidates to act as the middle-persons to assist foreign investors in cultivating a relationship with local government officials. In fact, the majority of factory managers in foreign-financed firms are local people with (very) close links to influential officials in local government.

The perception of a partisan and corrupt government is fuelled by its business role and the uneven implementation of laws. For instance, an application for a foreign investment project is more likely to be approved on time if the feasibility study is conducted by a specified consultant company, which is an affiliated company of the Dongguan government. The original rationale for setting up a consultant company is to standardise the criteria of feasibility study and speed up the approval time-lag for venture projects. Nonetheless, the dual role – both as the governing body and a profit-making consultant company – of the Dongguan government naturally provides ammunition for conspiracy theorists to suggest that the standardisation of procedures is *de facto* a golden excuse to raise revenue. As the frequency of factory inspections is determined by the connections between owners and factory managers, the implementation of labour and fire safety laws is likely to encourage rent-seeking or even on-the-spot bribery to avoid hefty fines for violations of fire or labour regulations.

Even though some well-connected foreign investors are frustrated by the “black-box operation” adopted by some local governments in Dongguan: “rule-of-the-people instead of rule-of-law”.<sup>51</sup> Obviously, the power abuse by some officials tarnishes the reputation of Dongguan.

### 4.3 Customs

To facilitate the operation of foreign-financed enterprises and relieve the pressure on transportation, the “transferred goods arrangement” allows a foreign-financed firm to sell and transport their finished goods to another foreign or locally-funded firm located in China directly.<sup>52</sup>

However, the convenience of the transferred goods arrangement for foreign-financed firms is offset by the bureaucratic regulations in import or export declaration permits.<sup>53</sup> The foreign-financed firms have to submit monthly records of the importation of raw materials, the exportation of finished goods and the amount of raw materials in stock. The customs declaration procedure (*hexiao*) is used to prevent any illegal re-selling of tariff-free raw materials or machinery imported by foreign-financed firms for profit-making purpose. Whenever there is any discrepancy between the import and export declaration forms, the Customs inspectors would regard undeclared goods as illegal sales for the local market. In addition to imposing a fine, the Customs inspectors would impose a surcharge of 40% of the value of undeclared raw materials on the foreign-financed firm. In reality, this documentation imposes extra transaction costs on foreign-financed firms and provides golden rent-seeking opportunities for Customs inspectors.

To offset the relatively low salaries (less than 1,000 *yuan* a month), Customs officials explore the legal loopholes and illegal means to boost their incomes. The three most common methods employed by Customs officials to generate revenue are as follows:

- Data entry fee: a Customs affiliated company charges 70 *yuan* to enter the information on the import or export declaration form into a computer.
- Truck inspection fee: 500 *yuan* or more.<sup>54</sup>
- Fines for false or incorrect declarations: the cargo is impounded and fines imposed for any intentional or unintentional discrepancies between import or export declaration documents and the cargo in terms of weight and content.

From the above, it can easily be estimated that the minimum Customs charge is 570 *yuan* if a truck is selected by the officials for inspection. Fines for false or incorrect declarations are legitimate since it is a way of discouraging

foreign-financed firms from engaging in illegal re-selling of tariff-free raw materials to local firms.<sup>55</sup> No matter what the rationales behind the truck and cargo impoundment enforced by the Customs inspectors, the documentation *per se* is an improvement. Since the procedure is official, it at least provides a way for foreign investors to trace and negotiate the release of the detained cargo.<sup>56</sup>

There is a “delicate balance” between foreign investors and Customs officials. On the one hand, most Customs officials know the rules of the game and usually charge a “standard price” to release a cargo.<sup>57</sup> On the other hand, no foreign investors dare complain as most of them are either afraid of being subject to revenge from the Customs officials or fear the exposure of their own illegal activities. As there are tens of thousands of container trucks passing through the Hong Kong-Shenzhen border every day, the stakes are simply too high and peer pressure is too strong not to play the game by its rules – accept bribes. In circumstance, both foreign investors and Customs inspectors are engaged in “win-win” illegal activities: foreign investors are willing to pay to cover up their under-reporting of tariff-free raw materials in import permits whilst Customs officials are content to ask for unauthorised payments.

Obviously, efforts to maintain Customs as an efficient institution is partially tarnished by the intrinsic deficiency of the reform (the artificially low salaries of civil servants) and the bad reputation associated with a group of corrupt Customs officials. This definitely mitigates against the investment environment in Dongguan. Unlike the “early birds” of the early 1980s, the majority of foreign investors are now well informed and realise the “hidden” transaction costs of doing business in China before establishing their firms. The bottom line is that the relocation of manufacturing to southern China, and in Dongguan particularly, is one feasible way for them to maintain their competitiveness.

## **5 Favourable Investment Factors in Dongguan**

Before discussing the nine major favourable investment factors (ranked according to its significance) in Dongguan for foreign investors, four points have to be clarified. First, the arguments presented below explain why foreign entrepreneurs invest in Dongguan instead of elsewhere within or outside China.

Second, the favourable factors are inter-dependent. Third, the following factors are summarised from the interviewees' scripts and so do not include all the favourable investment factors that may be considered by other foreign investors. Fourth, the following characteristics are not unique and some of them may appear in other regions which are popular with Hong Kong investors, e.g. Shenzhen and Guangzhou. However, the competitive advantages of foreign-financed firms in Dongguan may be **higher** than in other regions due to the high concentration of Hong Kong-funded firms in Dongguan and the relatively "flexible" policy on foreign investment implemented by the Dongguan government.<sup>58</sup> In fact, the demonstration effects of competitive advantage for foreign-financed firms in Dongguan are likely to crowd-in more foreign investment in Dongguan, *ceteris paribus*.

### **5.1 Sub-contractual & Pseudo Integration**

Rather than operating independently, a number of foreign-financed SMEs in complementary and substitute (industrial) sectors located in close proximity collaborate informally to achieve economies of scale and dynamic flexibility through the following means:

- By sub-contracting one firm's order to a network of complementary and substitute firms. This practice allows a firm to accept bulk orders beyond its production capabilities and capacity.<sup>59</sup>
- By ordering in bulk and combining goods from different firms into a single shipment, the unit cost of raw material sourcing and transportation is lower due to the discounts offered.
- By sharing of raw materials, tools, machinery and spare parts in case of emergency, this allows the network members to enjoy a greater degree of flexibility. Moreover, this arrangement reduces the costs of an excessive inventory of raw materials.
- The sharing of P&A production contracts with member firms in the same sector to allow the prompt import of raw materials, resources, semi-finished goods and the export of finished goods. Since every production contract has its own pre-determined import-export quota and lasts for six months, it is common for export-oriented foreign-financed firms to over-use or under-use

their quotas during the peak and non-peak seasons respectively.<sup>60</sup> This form of informal contractual transaction (usually an under-the-table transaction between friendly firms) is able to circumvent the bureaucracy associated with the Customs and the intrinsic constraints of P&A production contracts.<sup>61</sup>

Through the informal collaboration and sub-contracting network, the agglomerated network of firms is not only has the critical mass to enjoy certain aspects of economies of scale belonging to large-scale firms, but can also maintain flexibility within each individual firm. This form of networking is *de facto* the dynamic characteristic of Hong Kong-style SMEs, which allows a network of SMEs to engage in “David versus Goliath” warfare through competing with the large-scale firms. The successes of network firms has naturally crowded-in substitute and complementary industries, which is likely to enhance the remodelling process of Hong Kong-style SMEs practice in Dongguan as foreign investors try to exploit the ownership-specific advantages of economies of scale and the internalisation advantages of lower transaction costs in searching and bargaining for components supplies and the prompt delivery of cargos. The agglomeration of complementary and substitute SMEs based on commercial pragmatism can be called “sub-contractual and pseudo integration”.

## **5.2 Local Sourcing & Targeting of the Chinese Market**

The agglomeration of complementary industries implies the proximity of suppliers of raw materials, packaging components or semi-finished goods. This allows foreign-financed firms to source inputs locally and target the Chinese market.

On the one hand, local sourcing reduces transport costs and the time-lag for the shipment of raw materials or semi-finished products from foreign-financed firms. The ordering and billing paperwork between suppliers and customers is usually carried out in the Hong Kong offices and the goods are delivered by the appropriate firms located in Dongguan. This division of labour reflects the comparative advantages of Hong Kong and Dongguan and this explains why foreign-financed firms maintain offices in Hong Kong.

On the other hand, foreign-financed firms can cater for existing customers by locating their manufacturing bases in Dongguan. This is especially the case with complementary industries as most of their customers' manufacturing bases have already relocated to southern China. For instance, three-quarters of the total output of a Hong Kong-funded cardboard box manufacturing firm in Xiegang town supplies foreign-financed firms located in Dongguan or elsewhere in southern China. The transport and time costs are prohibitively high for the cardboard boxes to be transported from Hong Kong to China. To serve their existing customers, the pulling force is becoming irresistible for entrepreneurs who hesitate about relocating their manufacturing bases in Dongguan from Hong Kong. Moreover, the potential market is much bigger in China.

The demonstration effects of existing firms is likely to further encourage the agglomeration of industry (through cumulative causation of investment) as foreign investors explore the locational advantages of establishing their manufacturing bases in Dongguan.

### **5.3 Ethnic Networks & Personal Connections**

Ethnic networks and connections cultivated with local officials are usually inter-related. With the right connections, a foreign-financed firm can not only secure "favourable" terms for miscellaneous charges and the foreign exchange retention rate, but can also resolve the problems with the Customs. In fact, a number of Hong Kong entrepreneurs established firms in their native home villages in Dongguan after suggestions from their relatives. Other interviewees were persuaded by their colleagues or friends from the Dongguan government.

To cite three examples, each with a different level of connections or ethnic network in affecting the locational decisions of foreign investors. The owner of a Hong Kong publicly-listed company, who has two clothing manufacturing EJVs in Dongguan, is a friend of Mrs Wu Yi, the former Minister of Foreign Trade and Economic Co-operation in China. The head of a Hong Kong-funded P&A cardboard box manufacturer selected his brother-in-law's native village in Xiegang town to locate the firm as he can feel assured that "the channel to local government is always available" for him.<sup>62</sup> Humen town is the native village of

the owner of a Hong Kong-funded P&A electric wire manufacturing firm. He knows every officer in the local authority and the factory premises are rented from his relatives. In fact, Dongguan officials estimate that about half of the Hong Kong-based P&A contracts come from former Dongguan residents who emigrated decades earlier. The significance of *guanxi* for the selection of investment location is compatible with the survey results reported by Lever-Tracy, Ip and Tracy, and Huang.<sup>63</sup>

This locational advantage of Dongguan based on kinship and connection is unlikely to be disclosed in the questionnaire survey as most foreign investors are reluctant to reveal their personal ties with government officials to outsiders.

#### **5.4 Strategic Location with Low Land & Labour Costs**

As with foreign investment in other LDCs, the strategic location with low land and labour costs are significant locational advantages for foreign investors in Dongguan.

The low cost of production factors was especially noticeable during the early and late 1980s, e.g. 60 *yuan* a month for an unskilled worker in 1986. At present, the monthly wage is about 300 *yuan* for an unskilled worker and about 10 *yuan/m*<sup>3</sup> per month for the rent of factory premises, which is still less than 10% of that in Hong Kong. In contrast to the workers in Hong Kong, there are plenty of migrant workers in Dongguan who are more than happy to work over-time. This explains why the attractiveness of the labour market for foreign investors does not fade even with low productivity, rising wages and higher worker turnover, which are all well publicised. After all, the total cost of employing four workers (e.g. two for sewing and another two for quality checking in a clothing manufacturing firm) is still 80-90% less than employing one skilled sewing worker in Hong Kong, with the same level of productivity. More importantly, employers have a greater level of flexibility of production, which is one of the greatest assets of the SMEs. The prompt delivery of quality goods at bargain prices is definitely one of the most important competitive factors in the commercial world.

In addition to Shenzhen, Dongguan is an ideal place for foreign investors due to its accessible and efficient transport networks. Since the majority of foreign-financed firms have their offices in Hong Kong for marketing, finance, administration and liaison purposes, the location of Dongguan is within “striking distance” of their managerial staff based in Hong Kong, e.g. a half or one day return trip to the firm in Dongguan is possible. In case of emergency, Hong Kong staff can “present themselves personally at the firm within two to three hours.”<sup>64</sup> Those towns nearest to Hong Kong and with direct access by railway or motorways are generally more popular for foreign investors, e.g. Humen, Changan, Fenggang, Tangxia, Zhangmutou. This locational advantage explains why the majority of Hong Kong-funded firms are located in southern China instead of western or northern China, where the labour costs are even lower.

### **5.5 Effective Channels of Communication**

To facilitate the articulation and mutual understanding of policies implemented by central and local governments, the Foreign Entrepreneurs and Investment Association has been established by the open-minded officials in Changan township government. There are three regular meetings a year, with representatives of the foreign investors, Customs and local government officials. Apart from being a discussion forum, the meetings provide a feedback mechanism for foreign investors and allows them to air their opinions and complaints about the existing investment environment. Subsequently, a number of guidelines to minimise the chance of illegal levies were issued by the local government.

A number of Hong Kong entrepreneurs have established non-profit commercial organisations in Hong Kong to strengthen their collective bargaining and marketing positions.<sup>65</sup> They publish their own marketing brochure to attract others to invest in the area and have formed an alliance of collaborating firms, e.g. Yantian Industrial City in Fenggang town. For collective bargaining, The Hong Kong Small and Medium Business Association organises a number of trips to Shenzhen and Dongguan to promote dialogue with Customs and local governments officials.

The availability of a formal channel of communication with the local government officials reduces the information costs for clarifying and understanding new policies. Moreover, the collective marketing and lobbying activities organised by autonomous commercial organisations in Hong Kong is able to reduce the transaction costs and improve the lobbying effectiveness that would otherwise have to be undertaken by individual firms. This is a form of internalisation advantage for foreign investors.

## **5.6 Systematic Urban Planning with supporting Social Infrastructure**

With the negative press reports (on crime, prostitution, etc.) in the late 1980s, most Hong Kong people were reluctant to work in southern China initially. In addition to the monetary reward, they would like to live comfortably in China. The availability of Hong Kong-style social and entertainment facilities, such as restaurants, night clubs, Karaoke bars and discos, make Hongkongers feel at home. The hotels located in every town centre also provide an ideal place for business meetings with potential customers. Apart from the wide, grid system motorways that are normal in other towns of Dongguan, the Changan township government invested heavily in the improvement of the environment. For example, the green belt along every major road and good public hygiene (not the lidless rubbish bins that are commonly found elsewhere) made it one of the cleanest towns in southern China. This is one of the reasons why it has been able to attract 1,300 foreign-financed enterprises, a number of which are JVs with TNCs or the subsidiaries of regional conglomerates. It is estimated that about 100,000 expatriates (mostly Hongkongers) work in foreign-financed firms in Dongguan. The interaction of the demand-pull (expatriates demand it) and supply-push (the provision of facilities) of social infrastructure in terms of a comfortable living environment and the proximity of ample entertainment facilities attracts even more expatriates to work in Dongguan.

The comfortable living environment and its associated ample social and entertainment facilities can be interpreted as an unorthodox locational factor for foreign investment in Dongguan.

## **5.7 Competitive Retention Rate of Foreign Exchange**

The P&A fee is the value-added of the finished products, usually the difference between the import value of raw materials and the export value of the finished products. Foreign-financed firms have to pay a P&A fee in foreign currency (usually in Hong Kong dollars) through Chinese banks in Hong Kong to the local External P&A Office in China. A portion of the foreign exchange remittance is retained by the local (village) authority as foreign exchange retention (there is a discrepancy between the official and local authority exchange rates) before converting it into *renminbi* and depositing it in the accounts of the foreign-financed firms.

It appears that there are no concrete guidelines on the percentage of foreign exchange retention by different township governments.<sup>66</sup> For example, the foreign exchange retention rate in Tangxia town was 22% in 1997. That is, 22% of the foreign exchange remitted from foreign-financed firms was levied by the Tangxia township government as foreign exchange retention, of which 19% was the village authority's charge and the other 3% Tangxia government's charge. The "real" RMB-HKD exchange rate offered by Tangxia town (0.78:1) is in fact 29% lower than the open market exchange rate of 1.07:1. In Changan town, the foreign exchange retention rate was 25% in 1997, which is 3% higher than that in Tangxia town.

The RMB-HKD foreign exchange retention rate offered by local governments in Dongguan is usually between 0.7-0.8:1, which is generally 10-20% lower than other areas in the Pearl River Delta with the rate of 0.6-0.7:1. The lower the foreign exchange retention rate (if one HKD can exchange for more RMB), the less the transferred amount of precious foreign exchange required of the foreign investors, the stronger the locational advantage.

## **5.8 Flexibility & Openness of the Dongguan Government**

To improve the locational advantage and compete for foreign investors with other regions, the Dongguan government maintains a high level of administrative flexibility under the foreign investment laws. To centralise and

simplify administrative procedures for foreign investment, the Dongguan government established the Dongguan External P&A Office in 1978. Most of the administration, taxation and Customs procedures can be processed through administrative region authorities, with the exception of contractual documents, which have to be processed by Guancheng district government. Moreover, some township governments implement policies of special privilege to attract foreign investors, e.g. foreign investors were granted three years instead of the usual two years of tax-free “holiday” and exemption from miscellaneous fees were offered by Liaobu, Changan, Xiegang governments up to the early 1990s. Wang also observed similar phenomena elsewhere in the Pearl River Delta where local regulations were implemented long before they were approved by the central government to maintain the inflow of foreign investment.<sup>67</sup>

In general, foreign investors have full control of the production and the day-to-day management – foreign investors are treated as entrepreneurs and allowed to make profits. This is in contrast to the “iron-fist” approach adopted by “some towns in southern China, where a cargo will be held up by Customs if the firm has any overdue payments to the local government.”<sup>68</sup>

## **5.9 Social Stability**

Social stability, and especially the low crime rate, is another locational advantage of Dongguan for foreign investors. The crime rate in Dongguan was so low during the 1980s that local people went to bed without locking their doors. With the inflow of migrants and the development of the local economy, the crime rate in Dongguan increased rapidly during the 1990s.<sup>69</sup> There has been some improvement during the recent years as the government is aware that the safety of foreign investors is vital for capital to continue to flow into the area.

At present, the crime rate fluctuates between bad and good in Dongguan. In Humen town, crime has increased rapidly during recent years. There have been regular break-ins and most foreigners do not dare go to remote areas after 10 p.m. Foreigners take extra care in the capital of Dongguan, Guancheng district, as it has the highest crime rate. Changan town now has one of the lowest crime rates in Dongguan, after the establishment of the “Safe Civilised District” (*anquan*

*wenming xiaoou*). The “Safe Civilised District” is a comprehensive neighbourhood watch area with patrols of hired security guards. In Fenggang town, the Hong Kong owner of a P&A metal mould manufacturer can walk along the streets at mid-night without worrying about his safety.

### **5.10 Applicability of the OLI Paradigm**

In general, all the favourable investment factors can be categorised according to OLI framework. This is especially the case for conventionally favourable factors for foreign investment, e.g. low labour and land costs, economies of scale, etc. This is not unexpected as most, if not all, of the push-pull factors for investment can be classified under the broadly defined OLI framework.

Nonetheless, the classification of investment factors into O, L or I is more controversial. To name a few examples, the practice of P&A production contract sharing and the subsequent reduction of transaction costs can be classified as locational rather than an internalisation advantage. This is because a firm with an over-used production quota may not be able to find another firm in the same sector with an under-used production quota in an area other than Dongguan. This is why pseudo integration is one of the competitive advantages of foreign-financed firms in Dongguan and not in other areas of southern China. The ethnic networks and personal connections of foreign investors can be classified as an internalisation rather than locational advantage as the personal ties of foreign investors are able to dramatically reduce the information and transaction costs originating from the bureaucratic red-tape.

The OLI framework is able to explain the general picture of the FDI pattern in the country. It is also useful to formulate the research questions in a structured interview. However, it may be less useful for a semi-structured interview, except for producing a checklist of a number of relevant parameters for FDI. From the discussion in this paper, the theory is unable to explain the following factors satisfactorily:

- The ethnic networks and personal connections, which itself cannot be quantified meaningfully without losing its unique role and nature in foreign investment.

- Business styles or culture: flexible pragmatism allows the establishment of sub-contractual and pseudo integration, etc.
- Regional differences within Dongguan in the implementation of foreign investment policies by local authorities, as illustrated by the retention rate of foreign exchange and the levy of miscellaneous fees, etc.

No matter how powerful the OLI paradigm is, it is clear that it cannot explain the dynamic interaction between foreign investment and the investment environment at a micro-geographical level satisfactorily. It is, in fact, not surprising to discover that the grand theory does not fit into a local geographical scale comfortably as it was originally formulated to analyse macro phenomena. Furthermore, the semi-structured interviews conducted in an informal and friendly environment were able to collect much more detailed information from the interviewees than the formal and rather rigid framework implied by the theory. In fact, the flexibility of the semi-structured interview allows interviewees to point out factors that neither the theory nor the investigator realised its significance of, e.g. business culture. Therefore, the international production paradigm of FDI is less useful in the case study research approach, in particular, for semi-structured interviews.

## **6 Conclusions & Implications**

Apart from the geographical endowment (such as its strategic locations), the effective implementation of foreign investment policy and the openness of local government officials to FDI are two of the reasons why Dongguan has been able to industrialise its economy rapidly.

The role of Dongguan government in economic development has been affected by the inflow of foreign capital over time. The Dongguan government learned from the development experience of the “Four Little Tigers” (especially Singapore and Hong Kong) and Shenzhen. They realised that the role and significance of overseas Chinese capital for the industrialisation of Dongguan. When the economy started to develop and the local government gained a higher level of autonomy in administration and financial matter since 1988, the Dongguan government invested billions of *yuan* to develop the physical

infrastructure, especially motorway networks, electricity supplies and telecommunications facilities.<sup>70</sup> To facilitate the growing demand for semi-skilled and skilled labour, the government also invested heavily in the enrichment of human capital endowment (entrepreneurial state). With tremendous investment in education, the proportion of lower secondary school graduates continuing to higher secondary school education increased more than three-fold, to 87% in 1997.<sup>71</sup> To further improve the investment environment, the Dongguan government tailors the social infrastructure for foreign (Hong Kong) investors' demand, establishes various channels of communication to foreign investors and improves the social stability, etc. Obviously, the foreign investment policy and the policy incentives, such as tax-holiday and low land cost, implemented by the local and central governments are playing their roles to improve the attractiveness of Dongguan for foreign investors.

Nonetheless, the evidence presented in paper suggests that **other factors than policy incentives** – such as sub-contractual and pseudo integration, local sourcing and targeting of the Chinese market, ethnic networks and personal connections – are weighted more heavily by foreign investors in their decision-making process whether to invest in Dongguan. This finding is compatible with the extensive survey of 3,000 TNCs conducted under the World Economic Forum: the *World Competitiveness Report* argues that the giant market size, the potential for sustainable growth in the next decade and the cheap labour force rather than taxation incentives are the main attractive aspects of China for FDI.<sup>72</sup> Moreover, this finding questions the **long-term effectiveness** of policy incentives implemented by the central and local governments as the means to maintain the attractiveness of Dongguan (China) for FDI. This is especially the case after the Asian economic crisis, when the real production costs (in terms of USD) in Thailand, Indonesia and other Asian countries decreased substantially through currency depreciation while the exchange rate of *renminbi* remain unchanged. Due to the intense lobbying from governments of inland provinces, the central government decided to extend the policy incentives for foreign investment to the poorer inland provinces recently.<sup>73</sup> Rather than improve the competitive advantages of inland provinces (who have under-developed physical infrastructure), this new policy may actually leading to a vicious circle of “policy

concessions” between different provinces where foreign investors maximise their competitive advantages by relocating their manufacturing sites from time-to-time.

Apart from the government policy, the significance of the so-called “Chinese crony capitalism” or “Chinese cronyism” (where business transactions are largely based on personal connections rather than on purely financial grounds) is demonstrated at almost every level, from the formation to the operation of foreign-financed firms in Dongguan.<sup>74</sup>

On the one hand, the so-called “Chinese cronyism” is able to **reduce the transaction costs** of “kinship-crony” foreign investors dramatically from the first phase of foreign investment on site selection, forms of investment and negotiation of contracts. Guidance through the bureaucratic minefields in China means the right connections can lower the transaction costs of daily administrative chores with the local government and secure better terms for investment contracts (including the retention rate of foreign exchange) and miscellaneous charges. The sharing of P&A production contracts, raw materials, machinery and spare parts among friendly firms is able to circumvent the bureaucratic red-tape governing the foreign-financed firms. It may also protect against illegitimate extortion from corrupt government officials. For the host country, “kinship-crony” foreign investment may be the source of capital inflow to assist the development of its economy, as clearly illustrated by the experience of Dongguan.

On the other hand, the so-called “Chinese cronyism” unavoidably leads to **favouritism, nepotism** and even **corruption**.<sup>75</sup> The special relationships between the government, government-funded firms and overseas Chinese-funded enterprises are hot-beds for generating rent-seeking activities. It also implies the implementation of policies which are biased against outsiders without the appropriate connections. This explains why the “strike hard” anti-corruption policy enforced by the central government has only had moderate success in southern China. As the “mountain is high and the king is far away” in Beijing, neither partners in the closely intertwined politician-entrepreneur partnership are willing to rock the boat and jeopardise their own safety.

With the 1997 contagious financial and banking crises unfolding in Southeast and East Asia, the negative impacts of the “Asian cronyism” have become exaggerated. In fact, some allegations of “Asian cronyism” are highly hypocritical. For instance, the capital flight out of Asia, Russia and Latin America during the financial crisis is the response from the market economy and the penalty for flawed policies and corrupt “crony capitalism”. “Crony capitalism” *de facto* exists in North America and Europe too, as demonstrated by the recent near-collapse and the rescue of John Meriwether’s Long-Team Capital Management (LTCM) hedge fund, orchestrated by the New York Federal Reserve Bank.<sup>76</sup> The major differences between “Asian cronyism” and “Western cronyism” (including “American cronyism” and European cronyism”) are the **forms** and **magnitude** of its occurrence.<sup>77</sup>

In Dongguan, it is obviously that the power of *guanxi* network is greater than the law in some circumstances. The existing *guanxi* network game tilts the balance toward local government-funded enterprises and overseas Chinese-funded enterprises with the right connections. The Dongguan government is both regulator and player simultaneously. By laying down and implementing the laws governing foreign-financed firms, the government is the regulator (referee) of the game. However, the government acts as a player by participating in the game for profit-making purposes in the form of government-funded enterprises and JVs with foreign investors.<sup>78</sup> From this perspective, the laws and regulations governing “Chinese crony capitalism” in Dongguan are less frequently implemented than the laws and regulations of “Western crony capitalism” in North America and Europe. Obviously, there is room for further improvement in the implementation of laws and regulations in Dongguan.<sup>79</sup> To promote “long-term cost-saving” measures for foreign investors in Dongguan by lower the (political) transaction costs and reduce the rent-seeking opportunities in the Customs, the reduction of bureaucratic red-tape should ranked high in the policy objectives of the local and central governments. Rather than focus on policy incentives for foreign investment with questionable long-term effectiveness, the experience of Dongguan suggest that the investment on physical (such as physical infrastructure) and human capital (such as education, including the concept of the

“rule-of-laws”) is the **cost-effective** policy to improve the competitive advantages of China for FDI.<sup>80</sup>

Table 1 The Development of Roads in Dongguan, 1980-97

	1980	1985	1990	1997
<b>Total road length (in km)</b>	1,225 (100%)	1,240 (100%)	1,325 (100%)	2,330 (100%)
<b>All weather roads (in km)</b>	719 (58.69%)	810 (65.32%)	1,032 (77.89%)	1,949* (83.65%)
<b>Graded motor roads (in km)</b>	355 (28.98%)	490 (39.52%)	1,102 (83.17%)	2,087 (89.57%)
<b>First grade</b>	---	---	6 (0.45%)	690 (29.61%)
<b>Second grade</b>	---	58 (4.68%)	65 (4.90%)	362 (15.54%)
<b>Third grade</b>	---	61 (4.92%)	61 (4.60%)	139 (5.97%)
<b>Fourth grade</b>	355 (28.98%)	371 (29.92%)	971 (73.28%)	896 (38.45%)
<b>Non-graded motor roads</b>	870 (71.02%)	750 (60.48%)	223 (16.83%)	243 (10.43%)
<b>Road density (in km/100km<sup>2</sup>)</b>	49.70	50.30	53.75	94.50

\*: 1995 data.

Source: Calculated and compiled from Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998*, p. 304.

Table 2 Telecommunications in Dongguan, 1980-97

	1980	1985	1990	1997
<b>Telephone capacity</b>				
<b>Switchboard (in unit)</b>	---	11,400	69,800	577,600
<b>Long distance (in line)</b>	---	---	2,100	15,000
<b>Subscriber households</b>				
<b>Telephone</b>	3,000	8,000	49,000	426,500
<b>Fax</b>	---	---	1,193	5,115
<b>Pager</b>	---	---	19,563	94,071
<b>Mobile phone</b>	---	---	546	152,933
<b>Teledensity</b>	---	1	4	32
<b>Number of telecommunications service centres</b>	50	52	53	339
<b>Gross value of telecommunications market (in 1990 price &amp; 10,000 yuan)</b>	927	1,560	17,555	284,278

Source: Compiled from Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998*, p. 307.

<sup>1</sup> According to the World Bank estimate, China accounted for 40% of the US\$110 billion FDI flow into the LDCs while Mexico, which ranked second, accounted for only US\$6.4 billion in 1996 (*South China Morning Post*, “World Bank says China’s Poor Interior being Ignored.” by Simon Beck. 12<sup>th</sup> March 1997. Business Post, p. 1. & “China Eclipses US as Favourite Overseas Investment Destination.” by Foo Choy Peng. 11<sup>th</sup> April 1997. Business Post, p. 4.). With more than US\$145 billion in its treasury in December 1998, China ranked second to Japan in the world in terms of foreign exchange reserves. If the US\$89.6 billion of foreign exchange reserves in Hong Kong is included, the US\$234.6 billion of reserves in China is marginally higher than the US\$215.9 billion in Japan. (*Hong Kong Standard*, “Mainland’s Reserves on the Rise.” 2<sup>nd</sup> September 1997; *South China Morning Post*, “Foreign Currency Assets dip to US\$96.2b in April.” by Enoch Yiu. 23<sup>rd</sup> May 1998. Business Post. & “Proposed Road Law runs into NPC Barrier.” by Daniel Kwan. 6<sup>th</sup> November 1998.).

<sup>2</sup> The examples of TNCs are Nestle Coffee, Nokia mobile phone, Duracell battery, AST Computer, Samsung and Hitachi, while the examples of regional conglomerates are the sub-contractors for Nike sneakers, original equipment manufacturers (OEMs) for Gucci watch and Hong Kong-funded VTech, etc.

<sup>3</sup> To parallel the “Four Little Dragons” (Hong Kong, Taiwan, Singapore and South Korea) in Southeast Asia, the “Four Little Tigers” are the four fastest growing municipalities or dependent cities (Zhongshan, Shunde, Nanhai and Dongguan) in the world at an average annual growth rate of 17% between 1981 and 1991 [John Fitzgerald, “Autonomy and Growth in China: County Experience in Guangdong Province.” *Journal of Contemporary China*, Vol. 5, No. 11. March 1996. (1996), pp. 7-22, especially page 8].

<sup>4</sup> Ezra Vogel, *One Step Ahead in China: Guangdong under Reform*. (Cambridge: Harvard University Press, 1989); Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998*. (*Statistical Yearbook of Dongguan 1998*) (Beijing: China Statistical Publishing House, 1998), p. 15. Thoburn et al. [*Foreign Investment in China under the Open Policy: The Experience of Hong Kong Companies*. (Hants: Avebury, 1990), p. 18.] report that *lailiao jiagong* contracts were recorded in Shunde county of Guangdong province in 1978, even before the establishment of Special Economic Zones (SEZs) in China.

<sup>5</sup> Jing-rong Gao, *Qianxi zhongwai heziquye zhi libi*. (“The Pros and Cons of EJV’s.”) in Dongguan Municipal Government Research Office (ed.), *Dongguan Economy, 1988-1993: Selected Research Reports*. (*Dongguan Jingji, 1988-1993*) (Official reference material for internal circulation, 1994), pp. 270-276; Zhen-bang Liu, *Sishijia yu waishang hezihouzou de qiye wenjuan diaocha fenxi*. (“A Questionnaire Survey on 40 EJV’s and CJV’s in Dongguan.”) in *Ibid.* pp. 228-231; Jing-tu Ye, *Lailiao iagong qiye ke yousuo zuowei*. (“The Feasibility of P&A: A Survey on Dongguan.”) in *Ibid.* pp. 232-237.

<sup>6</sup> Godfrey Yeung, *Foreign Investment and Socio-economic Development in China: The Case of Dongguan*. (London: Macmillan, forthcoming).

<sup>7</sup> Thoburn et al. *Foreign Investment in China under the Open Policy*; John T. Thoburn, Esther Chau, & S. H Tang, “Industrial Cooperation between Hong Kong and China: The Experience of Hong Kong Firms in the Pearl River Delta.” in Edward K. Y. Chen, Mee-Kau Nyaw, & Teresa Y. C. Wong, (eds.) *Industrial and Trade Development in Hong Kong*. (Hong Kong: Centre of Asian Studies, University of Hong Kong, 1991), pp. 530-558; Catherine C. H. Chiu, “The Reform Strategies of the Four Little Tigers of Guangdong: Dooguan, Nanhai, Shunde and Zhongshan.” in Joseph Y. S. Cheng & Stewart MacPherson, (eds.) *Development in Southern China: A Report on the Pearl River Delta Region including the Special Economic Zones*. (Hong Kong: Longman, 1995), pp. 22-37; Fitzgerald, “Autonomy and Growth in China”, pp. 7-22; Xiaohe Zhang, & Wansing Hung, “Foreign Investments as an Engine of Economic Growth: The Case of Guangdong.” in Stewart MacPherson, & Joseph Y. S. Cheng (eds.) *Economic and Social Development in South China*. (Cheltenham: Edward Elgar, 1996), pp. 162-182.

<sup>8</sup> Pui-King Lau, et al., “Foreign Investment.” in Pui-King Lau, (ed.) *Overview of Economic Investment in Guangdong*. (Hong Kong: The Commercial Press, 1996), Chapter 11. (in Chinese); David K. Y. Chu, *The Trends and Patterns of Direct Foreign Investment in China*. Centre for Contemporary Asian Studies, The Chinese University of Hong Kong, Working Paper No. 2, (October 1985); S. Y. Cheung, “The Means and Effectiveness of FDI.” in Pui-King Lau, (ed.) *The Trend of China’s Economy*. (Hong Kong: The Commercial Press, 1997), pp. 198-203. (in Chinese); Fanzhang Huang, “China’s Utilization of Foreign Capital and the Related Policies.” *Journal of Asian Economics*, Vol. 6, No. 2, Summer. (1995), pp. 217-232; Y. Y. Kueh & Robert F.

Ash, "The Fifth Dragon: Economic Development." in Brian Hook, (ed.) *Guangdong: China's Promised Land*. (Oxford: Oxford University Press, 1996), pp. 149-192; Yoshinobu Takahashi, "Economic Development of Coastal Region in China." in Basant K. Kapur, Euston T. E. Quah & Hoon Hian Teck, (eds.) *Development, Trade and the Asia-Pacific: Essays on Honour of Professor Lim Chong Yah*. (Singapore: Prentice Hall, 1996), pp. 358-368.

<sup>9</sup> Wai-nang Ho, "Individual Economy in the Pearl River Delta Region: A Study on Dongguan, Guangzhou, Zhongshan and Nanhai." in Stewart MacPherson & Joseph Y. S. Cheng (eds.) *Economic and Social Development in South China*. (Cheltenham: Edward Elgar, 1996), pp. 183-207; John Child & Yanni Yan, *Predicting the Performance of Sino-Foreign Joint Ventures*. WP 28/97. Research Papers in Management Studies, Judge Institute of Management Studies, University of Cambridge. (1997).

<sup>10</sup> Herbert G. Grubel, "Foreign Investment." in John Eatwell, Murray Milgate, & Peter Newman, (eds.) *The New Palgrave: A Dictionary of Economics*. Vol. 2: E to J. (London: Macmillan, 1987), pp. 403-406, quoted from page 403.

<sup>11</sup> Kenneth A. Froot, "Introduction." in *Ibid.* (ed.) *Foreign Direct Investment*. (Chicago: The University of Chicago Press, 1993), pp. 1-11, quoted from page 1.

<sup>12</sup> Interested readers on the proposed "dynamic symbiosis" paradigm of FDI can refer to chapter 6 in Godfrey Yeung, *Foreign Investment and Socio-economic Development in China*.

<sup>13</sup> The international production paradigm of FDI is developed by Dunning and modified by his associates, including Narula and Ozawa. John H. Dunning, "Trade, Location of Economic Activity and the Multinational Enterprise: A Search for an Eclectic Approach." in Bertil Ohlin, Per-Ove Hesselborn, & Per Magnus Wijkman. (eds.) *The International Allocation of Economic Activity: Proceedings of a Noble Symposium held at Stockholm*. (London: Macmillan, 1977), pp. 395-418. Reprinted in Benjamin Gomes-Casseres, & David B. Yoffie. (eds.) *The International Political Economy of Direct Foreign Investment: Volume I*. (Hants: Edward Elgar Publishing Ltd., 1993), pp. 97-120; John H. Dunning, "Explaining Changing Patterns of International Production: In Defence of the Eclectic Theory." *Oxford Bulletin of Economics and Statistics*. Vol. 41, No. 4, November 1979, pp. 269-95; John H. Dunning, "Toward an Eclectic Theory of International Production: Some Empirical tests." *Journal of International Business Studies*. Vol. 11, No. 1, Spring / Summer 1980, pp. 9-31; John H. Dunning, "Explaining the International Direct Investment Position of Countries: Towards a Dynamic or Developmental Approach." *Weltwirtschaftliches Archiv*. Vol. 119, 1981, pp. 30-64, Reprinted in John Black, & John H. Dunning, (eds.) *International Capital Movements: Papers of the Fifth Annual Conference of the International Economics Study Group*. (London: Macmillan, 1982), pp. 84-121, especially 85-86; John H. Dunning, *Globalization of Business*. (London: Routledge, 1993); John H. Dunning, *Alliance Capitalism and Global Business*. (London: Routledge, 1997); Rajneesh Narula, *Multinational Investment and Economic Structure: Globalisation and Competitiveness*. (London: Routledge, 1996); Terutomo Ozawa, "Foreign Direct Investment and Economic Development." *Tansnational Corporations*. Vol. 1, No. 1, February 1992, pp. 27-54.

<sup>14</sup> All the interviews were conducted unaccompanied by any government officials. To understand better the operation of foreign-financed firms in Dongguan, I worked part-time in a Hong Kong-funded P&A metal products manufacturing firm for six weeks (without pay) from April to May of 1997. The work experience enabled me to observe the firm in operation for an extended period, which is more informative than the rather limited observation allowed during a conventional "guided tour". Every Sinologist knows that securing the 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 Humen town. The use of non-random sampling is, in fact, commonly employed by Sinologists, e.g. John Child, *Management in China during the Age of Reform*. (Cambridge: Cambridge University Press, 1994); Malcolm Warner, *Beyond the Iron Rice-bowl: Comprehensive Labour Reform in State-owned Enterprises in North-East China*. 1994-1995, No. 1. October 1994. Research Papers in Management Studies, Judge Institute of Management Studies, University of Cambridge (1994); Malcolm Warner, *The Management of Human Resources in Chinese Industry*. (London: Macmillan, 1995); Danming Lin, "Hong Kong's China-invested Companies and their Reverse Investment in China." in John Child, & Yuan Lu, (eds.) *Management Issues in China: Volume II International Enterprises*. (London: Routledge, 1996), pp. 165-182; and Alasdair MacBean, "China's Foreign Trade Corporations: Their Role in Economic Reform and Export Success." in *Ibid.*, pp. 183-200, etc.

<sup>15</sup> Zhen-bang Liu & Xi-wen Zhen, *Dongguan touzi shiwu. (Investment Handbook in Dongguan.)* (Dongguan: Guangdong Higher Education Publisher, 1992), pp. 1, 15; Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998*, p. 3.

<sup>16</sup> Dongguan Municipal Government, *Zhengfu gongzuo baogao 1995. (Government Working Report 1995)* (Official document presented in the fifth session of the Eleventh Dongguan People's Congress held on 6<sup>th</sup> of July 1995), p. 43.

<sup>17</sup> Since the privately-funded enterprises do not have the welfare and debt burdens of their state-owned enterprise (SOE) counterparts, the government uses their entrepreneurship to assist the development of high technology industry. In contrast to TNCs which are looking for alternative low-cost investment opportunities, the sense of belonging and local knowledge of this group of entrepreneurs suggests that they will engage in long-term investment in Dongguan. Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1996. (Statistical Yearbook of Dongguan 1996)* (Official document for internal circulation), p. 25.

<sup>18</sup> *Ibid.*, pp. 17, 25; Dongguan Municipal Government, *Zhengfu gongzuo baogao 1994, (Government Working Report 1994)* (Official document presented in the first session of the Eleventh Dongguan People's Congress held on 18<sup>th</sup> of January 1994.), p. 220.

<sup>19</sup> As the consumer price index is only available from 1984 onward, therefore, the retail price index-based GDP deflator is used to estimate the real GDP in Dongguan.

<sup>20</sup> In 1997, Dongguan's 1.47 million local population and 2,465 km<sup>2</sup> of land accounted for 2.1% of the total population and 1.39% of total land area in Guangdong province and 0.12% of total population and 0.02% of total land area in China as a whole. Dongguan accounted for an average 3.7% of real GDP in Guangdong and an average 0.24% of real GDP in China. The real GDP per capita in Dongguan was on average 1.75 times higher than that of Guangdong and on average 2.1 times higher than that of China. Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998*; Guangdong Bureau of Statistics, *Guangdong tongji nianjian 1998. (Statistical Yearbook of Guangdong 1998)* (Beijing: China Statistical Publishing House, 1998); State Statistical Bureau, *Zhongguo tongji nianjian 1998. (China Statistical Yearbook 1998)* (Beijing: China Statistical Publishing House, 1998).

<sup>21</sup> The overwhelming majority of the migrant population are part of the labour force: 100% of migrants were part of the labour force in 1986 and the rate remained very high, at 90%, in 1997. During the 1990s, the number of migrant workers was larger than the local population workforce. In 1997, the 1.31 million migrant workers was about 150% higher than the 876,000 local workforce. Obviously, the inflow of migrants was able to keep labour costs down and this contributed to the high growth rate of Dongguan. Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1996*, pp. 98-100; Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998*, pp. 182-184.

<sup>22</sup> Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998.*; Guangdong Bureau of Statistics, *Guangdong tongji nianjian 1998.*

<sup>23</sup> The 647 km<sup>2</sup> of land area in Singapore is about 26% the area that of Dongguan. In 1997, Singapore's population was 3 million, which was slightly larger than the 2.92 million (including migrants) in Dongguan.

<sup>24</sup> The International Bank for Reconstruction and Development, *World Data 1995.* (Washington, D. C.: The World Bank, 1996); Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998.*

<sup>25</sup> The decentralisation of government-owned trading firms and the subsequent improvement in efficiency may have contributed to the growth in export value. Before the manager responsibility system was enforced in 1987, the Dongguan branches of government-owned trading firms were allowed to regulate their own export quotas. As the economy developed, the share of export value channelled through the Dongguan's Commission of Foreign Economic Relation and Trade in the total export value in Dongguan (the Customs' figures) diminished from 80% in 1990 to 44% in 1997 (Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998.* p. 345). As the Customs figures are only available from 1990 onward, this is why they are not used.

<sup>26</sup> *Ibid.*

<sup>27</sup> Roads are used more frequently than the railways or waterways to transport cargo. The Customs procedures allow container trucks to pass through one of the three Customs checkpoints in Lok Ma Chau, Sha Tau Kok or Man Kam To. Although the border gates are not opened 24 hours a day, cargo trucks are able to provide a door-to-door delivery service, which is more efficient than the water and rail routes as no transshipment is required. Commuters in Dongguan travelling abroad can use the *Baiyun* international airport in Guangzhou or the *Huangtian* airport in Shenzhen. It takes about 30-45 minutes by car from *Huangtian* airport in Shenzhen to Humen town and from

*Baiyun* airport in Guangzhou to Shilong town. In railway, the development is rather piece-meal. Between 1987 and 1990, the Dongguan government improved the passenger and cargo terminals in seven out of the eight towns on the Guangzhou-Kowloon double-track railway route – Shilong, Chashan, Hengli, Changping, Tangxia, Zhangmutou and Genggang. A new rail station in Changping – the intersection points of the 174 km Guangzhou-Shenzhen high speed route, Guangzhou-Meizhou-Shantou route and Beijing-Kowloon route – was opened (Dongguan Municipal Government, *Zhengfu gongzuo baogao 1988-1994*). The five major ports in Guancheng, Shilong, Mayong, Shatian and Humen play a supportive role in cargo and passenger transportation. The annual cargo handling capacities of the eleven berths in Humen port is about six million metric tons. At 47 nautical km to Hong Kong and 48 nautical km to Macau, the daily hovercraft service from Humen harbour to Hong Kong is a two-hour voyage popular with Hongkongers working in Humen (*Ibid.*; Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998*, p.7).

<sup>28</sup> Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1996*, p. 335. Dongguan, in fact, had more miles of paved motor road than other counties in Guangdong during the late 1980s. Ezra Vogel, *One Step Ahead in China: Guangdong under Reform*, p.179.

<sup>29</sup> Dongguan Municipal Government, *Zhengfu gongzuo baogao 1988-1994*; Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1996*; Zhen-bang Liu & Xi-wen Zhen, *Dongguan touzi shiwu*.

<sup>30</sup> Dongguan Municipal Government, *Zhengfu gongzuo baogao 1988-1994*; Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1996*; Zhen-bang Liu & Xi-wen Zhen, *Dongguan touzi shiwu*.

<sup>31</sup> The rising cost of electricity can be interpreted as an inflation-indexed price adjustment in some towns. For instance, the inflation-tied average annual 13% price rise in Shilong town resulted in the price tripling from 0.4 *yuan*/KWH in 1988 to 1.2 *yuan*/KWH in 1997. The rapid industrialisation in Dongguan led to an increase in the total consumption of electricity of 58 times, from 149 million KWH in 1978 to 8.66 billion KWH in 1997. To match the increase in demand, the total electricity supply also increased 58 times from 163 million KWH in 1978 to 9.49 billion KWH in 1997. In spite of the enormous increase in supply, electricity consumption is about 90% of the total electricity supply (industrial consumption of electricity accounted for 65-75%) (Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998*, p. 146.) As there is little excess capacity, an unexpected surge of electricity demand will lead to blackout. This is why a number of foreign-financed firms installed in-house electricity generators as a backup power system.

<sup>32</sup> Due to the differences of surcharge levied by local authorities, the rural residents in Guangdong pay 1.3 *yuan*/KWH on average, compared with the 0.96 *yuan*/KWH in the province as a whole. However, Guangdong province aims to eliminate this price difference by upgrade the rural electric power network and overhaul of its system of power administration. The provincial government will invest nine billion *yuan* over the next three years for laying and improving 144,100 km of low-voltage transmission lines, 48,200 km of high-voltage wire and the installation of 56,000 transformers. According to the new governor, Mr Lu Ruihua, Guangdong will establish a unified electricity charge at 0.79 *yuan*/KWH when the upgrade is completed in 2002. *South China Morning Post*, “Plugs pulled on Old Power Networks.” by Matthew Miller, 15<sup>th</sup> December 1998, Business Post.

<sup>33</sup> Dongguan Municipal Government, *Zhengfu gongzuo baogao 1988-1994*; Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1996*; Zhen-bang Liu & Xi-wen Zhen, *Dongguan touzi shiwu*. A legal cellular-phone costs about 4,000 *yuan* or more and the monthly subscription fee is another 150-200 *yuan*. This is equivalent to two month’s salary for a factory manager in a foreign-financed firm or ten months wages for a migrant worker.

<sup>34</sup> Since the Labour Laws stipulates that the minimum age to work is 16 years old, some under-aged workers apply for jobs with false identity cards.

<sup>35</sup> Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998*, pp. 181-184.

<sup>36</sup> The majority of interviewees regard female workers to be more suitable in labour-intensive industries while male workers are trouble-makers, getting involved in strikes, fights and other undesirable behaviour. This is especially the case of male migrants of Sichuan and Hunan origins.

<sup>37</sup> Field survey in 1996-97. The worker turnover rate has been rising rapidly since 1992, partly due to better information available to migrant workers. Ironically, this is the result of a more developed labour market.

<sup>38</sup> Estimated from the quarterly value, the RMB to USD exchange rate was 1.5143:1 in 1980, 3.0691:1 in 1985, 5.0026:1 in 1990 and 8.2881:1 in 1997.

<sup>39</sup> Field survey in 1996-97.

<sup>40</sup> The apparent obedience of migrant workers is a result of “informal collaboration” between the local government and foreign investors. Foreign investors are able to contain and dismiss

disruptive workers (even illegally) with the blessing of the local government since large-scale labour unrest or strikes would damage the reputation of the “docile labour market” of Dongguan.

<sup>41</sup> For example, in Tangxia town, the rent increased five-fold from 25 *yuan*/m<sup>3</sup> in 1993 to 100 *yuan*/m<sup>3</sup> in 1997.

<sup>42</sup> The original form of P&A is SOEs or collective enterprises which use their surplus production and labour capacities to process or assemble products for foreign investors. The daily managerial and financial power of the firms are still in Chinese firms’ hands. Zhen-bang Liu & Xi-wen Zhen, *Dongguan touzi shiwu*, pp. 10-11.

<sup>43</sup> The change in the appearance of the Chinese Communist Party (CCP) secretary in Fenggang town reflects the new wealth of the township governments in Dongguan. The township government party secretary rode his bicycle and wore a pair of shorts to meet potential foreign investors 15 years ago. The foreign investors were treated to a VIP reception if they intended to invest three million *yuan* in the region and the corresponding memorandum of understanding was signed in the best hotel in Shenzhen. The party secretary later drove a motorcycle and then a Toyota Crown five years ago. Today, he sits in a chauffeur-driven Mercedes-Benz limousine.

<sup>44</sup> As most migrants do not have enough cash to process the application, the firm employing them has to report to and pay the appropriate authorities before deducting the application fees from their wages in instalments. Foreign-financed firms in Dongguan must possess the following licences or certificates: (1) business registration permit, (2) national tax certificate, (3) provincial (Guangdong) tax certificate, (4) certificate of Quality Licence for Export Commodities, (5) certificate of Quarantine Licence for Export Commodities, (6) hygiene certificate, (7) labour insurance certificate and (8) health insurance certificate.

<sup>45</sup> The *Regulations on the Unemployment Insurance in Dongguan* was implemented from 1 January 1997 onward. The monthly insurance premium is 1% of the average monthly remuneration of all employees in the firm during the last financial year. Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998*, p. 93-97.

<sup>46</sup> The local government imposes a fine of 200-1,000 *yuan* on those firms employing workers without all the required permits. In some cases, workers do not possess employment permits because their previous employers had not completed the appropriate application procedures before they resigned. They are usually employed as temporary workers and their employers do not sign formal employment contracts with them. In fact, some migrants prefer to work on a temporary basis as it allows them to job-hop.

<sup>47</sup> Any departments could charge “any amount of money” without legal grounds during the late 1980s. This is partly the result of the self-financing reforms as most government bureaux explored every means to raise revenue, both legitimate and illegitimate. In response to constant complaints by foreign investors, the Dongguan government conducted a survey of foreign-financed firms on the legitimacy of the miscellaneous charges after Mr Li Jin-wei was elected as the Dongguan CCP secretary. At present, all miscellaneous charges levied to foreign-financed and locally-funded enterprises must be approved by the Dongguan government (Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998*, p. 83.). In an effort to stamp out illegal charges, the corresponding authorities issue receipts for every item of miscellaneous charge.

<sup>48</sup> Each of the 38 McDonald’s restaurants in Beijing has to pay 31 fees, most of which are unauthorised. According to the investigation conducted by the Beijing mayor’s special tribunal, only two of the 31 fees are totally justified – such as the US\$600-1,200 per year trash collection fee –, while eight are questionable and 17 are illegitimate. For example, the US\$360-600 charge a year for “spiritual civilisation”, a campaign led by President Jiang Zemin that has covered Beijing in banners telling people to be more civilised (*International Herald Tribune*, “China’s Tax Collectors on a Roll at McDonald’s.” 11<sup>th</sup> September 1997, p. 17.). In 1998, the central government disciplined 1,273 local officials for levied illegitimate miscellaneous fees on enterprises. To improve the investment environment, the central government abolished 973 items of miscellaneous fees with a total value of 45 billion *yuan* per annum, while the local governments removed another staggering 26,710 items of miscellaneous fees with a total value of 98.5 billion *yuan* in 1998. In six provinces (Guangdong, Jiangsu, Hebei, Henan, Hunan and Sichuan), the items of arbitrary levies decreased by 30% (*Hong Kong Standard*, “Blitz on Random Fee Scams.” 23<sup>rd</sup> February 1999).

<sup>49</sup> Field survey in 1996-97.

<sup>50</sup> The central government also exercise backdated charges. In July 1998, the State Administration of Taxation announced that an 8% of value-added tax (VAT) on the export value of import processing P&A firms (*laiyang jiagong*, where P&A firms importing raw materials and exporting

finished products on their own accounts) would be implemented from 1<sup>st</sup> January 1999. As the new VAT law is backdated for two years, the Guangdong Provincial Foreign Economic and Trade Commission estimates that the new VAT law will wipe off the combined 1997 profits of the import processing P&A firms. Due to the slowing down of FDI and lobbying effort of Guangdong government, the State Council decided to grant a two-year tax relief on the new VAT law for the import processing P&A firms established before 1994. However, the tax relief is not applicable to the import processing P&A firms established after 1994 as their export VAT are calculated according to the same criteria as the locally-funded exporters. To circumvent the VAT, the P&A firms can be changed from import processing to contract processing (*lailiao jiagong*, where P&A firms manufacturing finished goods for clients who import their own raw materials). *South China Morning Post*, "VAT rise to Strike Exports." by Renee Lai, 27<sup>th</sup> November 1998, Business Post; *South China Morning Post*, "Ventures threatened by back-dated VAT." by Renee Lai, 3<sup>rd</sup> December 1998, Business Post; *South China Morning Post*, "Investors win Breathing Space as Mainland VAT Delayed Two Years." by Renee Lai & Matthew Miller, 17<sup>th</sup> December 1998, Business Post.

<sup>51</sup> A number of foreign investors air their grievances about the extent of involuntary donations and extortion. In 1995, the Public Security Bureau officials went to every foreign-financed firm in a town of Dongguan with 1,000 *yuan* receipts for donations for the completion of the Public Security Bureau headquarters. In 1996, five People's Armed Police officers armed with AK-47 rifles surrounded the factory premises and demanded to undertake an inspection at mid-night. The Hong Kong manager had to pay 30,000 *yuan* for them to resolve the "crisis".

<sup>52</sup> Since the cargo is delivered to customers in China directly instead of being exported to Hong Kong and imported into China again, the transferred goods arrangement lowers the transportation costs of foreign-financed enterprises. A foreign-financed firm is entitled to transferred good arrangement only if the following conditions are fulfilled: (1) a prior approval from the Customs; (2) all the final products of the transferred goods are for exports; (3) both companies have import licenses for the transferred goods; and (4) the quantity of the transferred goods is less than the quantity of imported by the firm.

<sup>53</sup> The transferred good management also hindered by the cargo declaration procedures. In general, there are two types of cargo declaration: "Centralised Customs Declarations" (*jizhong baoguan*) and "Sealed Customs Declarations" (*fengguan*). "Centralised Customs Declarations" are simpler in procedure and the cargo (usually destined to or originating from Shenzhen) can pass through any computerised checkpoints in the three Sino-Hong Kong border posts. The cargo for "Sealed Customs Declarations" procedure is usually destined to areas outside Shenzhen. The cargo is sealed after passing through the local Customs in Dongguan before passing through one of the Sino-Hong Kong Customs, therefore, the documents have to be inspected again. Moreover, the second-line Customs at Shenzhen SEZ has the authority to inspect the cargo even it has been inspected at the Sino-Hong Kong border or Dongguan Customs checkpoint.

<sup>54</sup> Rumours circulating among factory managers claim that the inspection company shares its profits with the Customs at a ratio of 40:60 (though it is not clear which gets the 60%) in exchange for the exclusive right to operate on the border.

<sup>55</sup> Recent Customs rules classify P&A firms into four categories according to their past compliance with the re-export laws and the value of re-export. The P&A firms classified as lower categories (categories C and D) are required to pay deposits on imported materials. Those P&A companies dump products earmarked for export on to the domestic market will have their deposits confiscated (*South China Morning Post*, "Honest Re-exporters to benefit from Crackdown on Dodgers." by Matthew Millers, Business Post, 30<sup>th</sup> August 1999.)

<sup>56</sup> As with the miscellaneous fees discussed above, the standardisation process itself has improved the Customs documentation but has little impact on the prevention of the abuse of power. In 1996, a soft-toys manufacturing firm in Laiobu town firm paid 20,000 *yuan* to Customs officials in Shenzhen after a container of Christmas toys exported to the US was detained for three days because the toys had no stuffing inside, and therefore did not exactly match the P&A production contract of stuffed-toy. In June and July of 1997, the same firm was forced to pay 25,000 and 20,000 *yuan* for two separate shipments as Customs inspectors found the eyes of the soft-toys were made of material other than plastic, again different from the product description defined in the production contract. The firm had to pay because "it is better to not make any profit or even lose some money on one deal rather than lose the customer by being unable to deliver the cargo on time." (field survey in 1996-97) Moreover, a number of entrepreneurs and factory managers revealed that Customs officials tend to target valuable cargo to inspect, especially electronic

components and toys. In one incident, the inspectors opened every box and counted the number of Integrated Circuit (IC) chips in a truck. Logically, smugglers have a greater incentive to transport valuable cargo through the border illegally and it is the duty of the Customs authorities to prevent such activities. From the conspiracy theory perspective, the Customs officials can extract their unauthorised payments more easily when the cargo involved is valuable as the owner has more to lose by risking the delay of shipment (when the cargo is detained).

<sup>57</sup> To avoiding traps set by investigators from the central government, there is usually no direct exchange of cash between foreign investors and Customs officials. Usually, the factory managers act as go-betweens and this may inflate the payment as they usually take a commission for their task, i.e. pocket a portion of the money by over-reporting the amount to be paid. Even though the connections of foreign investors and factory managers is important, it does not imply everything will be trouble-free as Customs officials “can turn the tables without apparent reason and it makes things very difficult to deal with. This is especially the case when someone deliberately violates the rules [by asking for too much money].” (Field survey in 1996-97) The Customs work on two shifts and most checkpoint inspectors will transfer from day to night shift, or *vice versa*, every six months before being transferred to another post the following year. Thus, some Customs inspectors may try to maximise their gains within that time and it is very difficult for foreign-financed firms to establish a “working relationship” with them.

<sup>58</sup> Readers interested in the issue of competitive advantage can refer to Michael E. Porter, *The Competitive Advantage of Nations*. (revised edition with a new Introduction) (London: Macmillan, 1998).

<sup>59</sup> For instance, the owner of a plastic toy firm can accept an order for electronic toys with the knowledge that he can secure the supply of tailor-made electronic components at short notice. The transaction cost is lower and the time-lag is shorter than searching for a component supplier and bargaining for a price. Moreover, the firm can sub-contract part of its order to other substitute firms located nearby to meet a tight deadline.

<sup>60</sup> The foreign-financed firm experiencing a situation of over-use of its quota can borrow a production contract from another firm which has under-used its quota to transport the raw materials and goods to and from Hong Kong. Financial incentives are usually involved in contract borrowing and the amount varies tremendously from case to case.

<sup>61</sup> Apart from contract borrowing based on friendship, some entrepreneurs explore the niche markets arising from the inherent constraints of P&A production contracts. Some transport companies (usually based in Hong Kong) offer a package of services, including P&A production contracts and transportation from Hong Kong to Dongguan, for some specific firms (e.g. textile firms) who are without or have over-used their own P&A production contract quotas. However, the premium for such a package is even higher than transport costs *per se*: HK\$3,200 versus HK\$1,300-1,500 for a 5-ton truck from Hong Kong to Dongguan.

<sup>62</sup> Field survey in 1996-97

<sup>63</sup> Ezra Vogel, *One Step Ahead in China: Guangdong under Reform*; Constance Lever-Tracy, David Ip, & Noel Tracy, *The Chinese Diaspora and Mainland China: An Emerging Economic Synergy*. (London: Macmillan, 1996); Cen Huang, “The Organization and Management of Chinese Transnational Enterprises in South China.” *Issues & Studies*. Vol. 34, No. 3, March 1998, pp. 51-70, especially p. 59. Also refer to Aihwa Ong, & Donald Nonini, (eds.) *Underground Empires: The Culture Politics of Modern Chinese Transnationalism*. (London: Routledge, 1997).

<sup>64</sup> Field survey in 1996-97.

<sup>65</sup> Despite the relative openness (in terms of flexibility on policy implementation) of the Dongguan government, the establishment of an autonomous formal organisation in China is still an issue too politically sensitive to be approved of. However, the township government does not object explicitly when an informal organisation is established in China without registration.

<sup>66</sup> The foreign exchange rate may also vary among different factories in the same area. As with the miscellaneous changes, it depends on the connections of factory owners and factory managers with the local government.

<sup>67</sup> Guiguo Wang, “Foreign Investment Law in the Pearl River Delta.” in Joseph Y. S Cheng, & Stewart MacPherson, (eds.) *Development in Southern China: A Report on the Pearl River Delta Region including the Special Economic Zones*. (Hong Kong: Longman, 1995), pp. 243-261, especially 244-245.

<sup>68</sup> Field survey in 1996-97.

<sup>69</sup> Migrants are usually treated as “scapegoats” for all sorts of crimes committed in southern China.

<sup>70</sup> The Dongguan government is able to collect large amounts of revenues to invest in the local economy. This contradicts the conventional belief about the inability of Chinese (central) government to collect taxes. Refer to Yasheng Huang, *Inflation and Investment Controls in China: The Political Economy of Central-Local Relations during the Reform Era*. (Cambridge: Cambridge University Press, 1996) for the discussion of the economic and political roles of local government officials in China.

<sup>71</sup> Dongguan Bureau of Statistics, *Dongguan tongji nianjian 1998*, p. 393. This is compatible with the six positive roles of government – promoting education, promoting technology, supporting the financial sector, investing in infrastructure, preventing environmental degradation, creating and maintaining a social safety net – that contributes to the economic development suggested by Joseph E. Stiglitz, “The Role of Government in Economic Development.” in Michael Bruno, & Boris Pleskovic, (eds.) *Annual World Bank Conference on Development Economics 1996*. (Washington, D.C.: The World Bank, 1997), pp. 11-23, especially pages 13-15.

<sup>72</sup> *South China Morning Post*, “China Eclipses US as Favourite Overseas Investment Destination.” by Choy Peng Foo, 11<sup>th</sup> April 1997, Business Post, p. 4.

<sup>73</sup> *South China Morning Post*, “New Tax Breaks for Foreign Firms.” by Choy Peng Foo, Business Post, 9<sup>th</sup> September 1999.

<sup>74</sup> “Crony capitalism” was first used in the 24<sup>th</sup> August 1981 issue of *Time* to refer to about the financial predictions of former President Ferdinand Marcos of the Philippines. It is a problematic term since it has negative connotations and is usually associated with the East, e.g. *guanxi* in China, *keiretsu* in Japan and *semibankirshchina* in Russia. *International Herald Tribune*, “Crony Capitalism Takes many Forms.” by William Safire, 2<sup>nd</sup> February 1998. p. 9.

<sup>75</sup> Constance Lever-Tracy, David Ip, & Noel Tracy (*The Chinese Diaspora and Mainland China: An Emerging Economic Synergy*, p. 56) argue that corruption is not part of *guanxi* since it involves extortion rather than mutual benefit, which is the purpose of *guanxi*.

<sup>76</sup> In his article published in *Financial Times*, John Plender writes: “The LTCM hedge fund fiasco has exposed not only inept banking practice from Wall Street via Switzerland to the Italian central bank, but a surprising degree of cronyism in the West; a cronyism less corrupt than in Indonesia, Malaysia or Russia, but **with more dangerous consequences**, given the scale of the financial risks involved.” (bold added) *Financial Times*, “Western Crony Capitalism.” by John Plender, 3<sup>rd</sup> October 1998, p. 10. This is indeed the case as the banks allowed the LTCM exposed up to US\$200 billion of derivatives trading, against an equity capital of only US\$4.8 billion. The allegation of “crony capitalism” also charge on the major US investment banks, such as Goldman Sachs and Lehman Brothers, who advising Thailand and Indonesia governments on the privatisation and selling off state assets simultaneously. The Financial Minister of Thailand, Mr Tarrin Nimmanahaeminda, comments: “These banks have an advisory side and a wheeler-dealer commercial side. They always say they maintain Chinese walls between them. I rather doubt it.” *Far Eastern Economic Review*, “Banking on Big Names.” by Michael Vatikiotis & Salil Tripathi, Vol. 161, No. 47, 19<sup>th</sup> November 1998, pp. 50-52, quoted in page 50. Refer to Mitchell Petersen, & Raghuram Rajan, “The Effect of Credit Market Competition on Lending Relationships.” *Quarterly Journal of Economics*. Vol. 110, 1995, pp. 407-443 for evidence of the existence of relationship lending practices in the US.

<sup>77</sup> In fact, there are differences within the so-called “Asian cronyism”, e.g. differences between the Chinese, Korean and Japanese versions. Gordon S. Redding, & Richard D. Whitley, “Beyond Bureaucracy: Towards a Comparative Analysis of Forms of Economic Resource Co-ordination and Control.” in Stewart R. Clegg, & Gordon S. Redding, (eds.) (assisted by Monica Cartner.) *Capitalism in Contrasting Cultures*. (Berlin: Walter de Gruyter, 1990, especially pp. 85-89. Chang asserts that “**capitalism developed on the basis of moral hazard**. The form taken was different (limited liability, lender of last resort facility, ...), but the principle was the same – **socialisation of risk**. It is therefore misleading to look at the cost side of those institutions that socialise risk while ignoring its benefits, and to condemn them.” (bold added). Ha-Joon Chang, *The Hazard of Moral Hazard: Untangling the Asian Crisis*. Paper presented at the American Economic Association Annual Meeting, New York, USA on 3<sup>rd</sup>-6<sup>th</sup> January 1999. (mimeo, quoted in pp. 6-7)

<sup>78</sup> This issue is further complicated by the existence of reverse investment from overseas-based companies of China origin. Moreover, the dual-role played by the state lead to comprising labour safety and the work environment due to a conflict of interests.

<sup>79</sup> It is suggested that a reflection on the role of connections and probably the establishment of a *guanxi* or crony model of development (or more specifically, a set of crony models for Asian and Western worlds) are required. The closest previous works are Redding and Hsiao, Leung, Redding

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and Chen, who investigated the role of connections in Chinese-style management. Rajan and Zingales also develop a framework to distinguish the differences between the relationship-based system and the arm's-length, market-based Anglo-Saxon system. Gordon S. Redding, & Michael Hsiao, "An Empirical Study of Overseas Chinese Managerial Ideology." *International Journal of Psychology*. Vol. 25, 1990, pp. 629-641, Reprinted in Gordon S. Redding, (ed.) *International Cultural Differences*. (Hants: Dartmouth, 1995), pp. 183-195; Chi Kin Leung, "Personal Contacts, Subcontracting Linkages, and Development in the Hong Kong-Zhujiang Delta Region." *Annals of the Association of American Geographers*. Vol. 83, No. 2, June 1993, pp. 272-302; S. Gordon Redding, *The Spirit of Chinese Capitalism*. (Berlin: Walter de Gruyter, 1993); Min Chen, *Asian Management Systems: Chinese, Japanese and Korean Styles of Business*. (London: Routledge, 1995); Raghuram G. Rajan, & Luigi Zingales, *Which Capitalism? Lessons from the East Asian Crisis*. (mimeo, 1998, download from the <http://gsblgz.uchicago.edu/Pspapers/whichcap.pdf>).

<sup>80</sup> As with other policies implemented in China, the effectiveness of such policy may be determined by the extent of its implementation by the local governments. Whether it eventually become a slogan-oriented policy objective ignored by the local governments (*shangyou zhengce, xiayou duice*) is however not in the agenda of this paper.