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Government Policy and the Competitive Advantages of  
Foreign-financed Firms in Guangdong Province of southern  
China<sup>\*</sup>

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## Abstract:

This paper investigates the impact of various Chinese government policies on the competitive advantages of foreign-financed manufacturing firms in Guangdong province of southern China. The objectives of various government sector-specific policies are to lubricate the factor markets in labour, capital and products and to facilitate the operation of foreign-financed firms. However, the actual effects are often quite different: the ambiguity, complexity and inflexibility of policies impose higher transaction costs on foreign-financed firms. These disadvantages offset some economic benefits gained under the central government's preferential foreign direct investment policy and thus damages the competitive advantages of foreign-financed firms based in Guangdong. Worse still, the lack of co-ordination among various bureaux further hampers arbitration between government bureaux and foreign investors.

Keywords: government policy, competitive advantages, foreign-financed firms, Guangdong, China

JEL classifications: H2, H5, L6, O1, O2

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## **Introduction**

The effects of the Chinese government's preferential policy towards the inflow of FDI in China, which has been the most popular destination among the developing countries for foreign direct investment (FDI) for six consecutive years, have been well documented.<sup>1</sup> Ho and Huenemann (1984), Chu (1985), Thoburn *et al.* (1990), Huang (1995), Kueh and Ash (1996), Takahashi (1996), Zhang and Hung (1996), Cheung (1997) and Yeung (2001a, 2001b) all investigate the issue of FDI from the macro-geographical to the micro-geographical perspective. The performance of foreign-financed firms in China has also been widely researched. Several studies, such as Beamish (1993), EIU (1998), Shaw (1998), Yan (1998) and Jefferson *et al.* (2000), have revealed disappointing performance on the part of foreign-financed firms in China. Although high-profile administrative intervention in the operation of foreign-financed firms is not common, a number of studies have highlighted the bureaucratic red-tape and corruption among government officials faced by foreign investors (see, for example, ACC 1998, Melvin 1998, Transparency International 2001, Weldon and Vanhonacker 1999). Nonetheless, details of how Chinese government policies affect the daily operation of foreign-financed firms are surprisingly lacking.

To fill this literature gap, this paper investigates the impact of various Chinese government policies on the competitive advantages of foreign-financed manufacturing firms in Guangdong province of southern China. It must be emphasised that this paper focuses on the **impact of sector-specific policies** enforced by both central and local (from provincial to county) governments on the labour, capital and product markets of foreign-financed manufacturing firms.<sup>2</sup> The general effects of the Chinese government's policy incentives on the competitiveness of foreign-financed firms will *not* be investigated, as they are already well documented (see above). Furthermore, the effects of government policy on the competitiveness of foreign-financed firms in the service sector, although a very important topic, is outside the scope of this paper.

This paper draws heavily on materials obtained from fieldwork in China. In addition to informal interviews with government officials, owners and factory

managers of locally-funded and privately-funded firms, semi-structured interviews were conducted by the authors in 1996-97 and 2000 in 35 foreign-financed enterprises located in Guangdong. The sample firms ranged across various manufacturing sectors: plastics and metal products, textile and clothing, toys, leather products, jewellery, electrical appliances, electronic products, paper and foam packaging (including printing), and beverage and food ingredients. With the exception of one transnational corporation (TNC) and several subsidiaries of regional conglomerates, the majority of firms in the sample were owned by investors of Hong Kong origin engaged in processing and assembling (P&A) investments. In terms of industrial sectors, textile and clothing (11 cases) and manufacturing of electrical appliances (8 cases) account for more than half of the total firms interviewed. In terms of employment size, medium-sized firms (51-500 workers) represent more than two-thirds of the cases. Despite the use of non-random sampling and most (33 of 35) of the firms investigated were located in Dongguan municipality of Guangdong, there is no reason to suggest that the findings of this paper is favoured for or biased against certain industrial sectors or local governments.<sup>3</sup> It must be emphasised that the specific examples illustrated in this paper may not be generalised elsewhere as various local governments in different counties (even within Dongguan) may interpret and implement the central government's policy directives differently (so as the responses of individual firms). Nonetheless, it is argued that the general arguments about the impact of sector-specific policies on the factor markets of foreign-financed manufacturing firms presented in this paper are generally applicable elsewhere in China, especially in coastal provinces other than Guangdong.

In addition to the general policy on FDI laid down by the central Chinese government, the objectives of sector-specific government policies are to lubricate the factor markets in labour, capital and products and to facilitate the operations of foreign-financed firms in China. Yet in practice, government policies (from national to provincial to county) often receive negative comments for being ambiguous, authoritarian, inflexible and lacking in co-ordination among various government bureaux. How do government policies affect the daily operations of foreign-financed firms? To what extent are the costs of running these businesses raised, when compared with the locally-funded counterparts? This paper addresses

these questions in section 3, and goes on to provide policy implications for the further development of the investment environment in Guangdong in section 4. First, however, a brief introduction to the economy of Guangdong is in order.

## **Background on Guangdong**

With a total land area of 177,901 km<sup>2</sup>, Guangdong province is located in the Pearl River Delta of southern China, adjacent to Hong Kong and Macau. Guangdong was transformed into an export-oriented manufacturing-based economy through P&A-induced industrialisation and outward-oriented commercial agriculture during the early 1980s. After investing heavily in construction and infrastructure improvement, particularly in the areas of transportation, power supplies and telecommunications, Guangdong provincial authorities have focused on the development of higher value-added and higher technology *sanzi qiye* and supporting service sectors since the mid-1990s.

The success of economic reform in Guangdong manifests itself in an array of extraordinary economic statistics. The average annual growth rate between 1978 and 1999 of real Gross Domestic Product (GDP) reached 12 percent (compared to a China-wide average of 9 percent), and real GDP per capita growth averaged 11 percent (compared to the Chinese average of 8 percent).<sup>4</sup> During these two decades of reform in Guangdong, real GDP jumped by eleven times, to 203 billion *yuan*, while real GDP per capita increased by eight times to an all-time high of 2,779 *yuan* (53 percent higher than that of China) in 1999.<sup>5</sup> In real value of industrial and agricultural output, the average annual growth rate in Guangdong was 22 percent between 1978 and 1998. The gross value of industrial and agricultural output in Guangdong as a percentage of China's output increased from 4.86 percent in 1978 to 9.14 percent in 1998, further illustrating the province's economic strength. Guangdong's increasing share of the gross value of industrial output in China, from 4.71 percent in 1978 to 10.24 percent in 1998, and the corresponding decrease in share of the gross value of agricultural output, from 5.32 percent in 1978 to 3.78 percent in 1998, illustrate its rapid industrialisation (GBS, 2000; SSB, 2001).

Guangdong has been the Chinese province the most popular with foreign investors. The contracted value of FDI in Guangdong increased enormously from 1983 to 1993, from US\$703 million to an all-time high of US\$33 billion, before dropping to US\$7.7 billion in 1999. The utilised value of FDI rose impressively during the same period, from US\$327 million in 1983 to US\$13.37 billion in 1999. In 1999, the cumulative contracted FDI in Guangdong reached US\$165 billion, and the corresponding utilised value of FDI reached US\$90 billion. These figures are equivalent to 26-28 percent of the cumulative contracted and utilised value of FDI in China between 1979 and 1999. In per capita terms, the average growth of utilised FDI in Guangdong reached the impressive rate of 28 percent per annum between 1983 and 1999. In 1983, the utilised FDI per capita in Guangdong was only US\$6, but this increased drastically over the next sixteen years, to US\$183 in 1999 (GBS, 2000; SSB, 2001).

As a result of export-orientation, Guangdong's export figures increased tremendously, from US\$1.4 billion in 1978 to US\$78 billion in 1999, an average annual growth rate of 23 percent. Export value per capita increased from a mere US\$27 in 1978 to US\$136 in 1989, before increasing by another eight times to US\$1,065 in 1999 (GBS, 2000; SSB, 2001).

## **Government Policies & Competitiveness of Foreign-financed Firms**

Before discussing sector-specific government policies, it may be useful to summarise the general preferential policy on FDI in China.

After the promulgation of economic reform in 1978, the central government in Beijing introduced a number of measures to encourage foreign entrepreneurs to invest in China. For instance, the State Council issued 22 Articles (*Provisions of the State Council of the People's Republic of China for the Encouragement of Foreign Investment*) in October 1986 to encourage FDI in forms of *sanzi qiye*, especially in the high-technology-intensive and export-oriented sectors. The measures to encourage FDI fall into two general categories: policies on *sanzi qiye* and policies on P&A.

The following preferential policies apply to foreign investment on *sanzi qiye* (EJVs, CJVs and WFVs):

- Two tax-free years after the first profit-making year and a 50 percent reduction during the following three years for *sanzi qiye* with a contract life of ten years or longer.
- For ventures engaged in agricultural sectors or established in remote or mountainous regions, an additional 15 to 30 percent concession on profit tax may be granted by the Finance Bureau for another ten years. Moreover, 40 percent of tax payable is reimbursed if investors re-invest their profits in China on a project with a period of five years or longer.
- Operational losses incurred by *sanzi qiye* can be recovered from the profit tax payable in the subsequent five financial years.
- *Sanzi qiye* engaged in infrastructure construction with investments of 15 years or longer are eligible for five tax-free years and another five years at a 50 percent reduction on the 15 percent profit tax rate. For ventures in financial difficulties after the expiry of the tax-free period, the tax-concession period may be extended with the approval of Finance Bureau.
- Exemption from tariffs (import duties) and Consolidated Industrial and Commercial Tax, from December 1984 onwards:<sup>6</sup>
  - ✓ Machinery and components purchased by foreign investors or venture capital as specified in venture contracts.
  - ✓ Machinery and components unavailable locally.
  - ✓ Raw materials, components and packing materials specified in venture contracts to produce final products for export (Yeung 2001b:69-70).

For foreign investment in P&A, the following privileges apply:

- Tax exemption on profits for first three profit-making years for P&A (the SOEs involved in P&A contracts are free from profit submission).
- Exemption from tariffs and Consolidated Industrial and Commercial Tax for the importation of raw materials, components, tools and machinery specified by P&A contracts, as well as the export of finished products.
- Import permits are waived for the importation of machinery and tools specified by P&A contracts.



- Exemption from property tax for three to five years on foreign investor-owned factory premises (Yeung 2001b:69-70).

In spite of the above policy incentives implemented by the Chinese government, foreign investors have found that their firms' operation in China is not without its constraints. There is a *network of bureaucratic restrictions* affecting the competitiveness of foreign-financed firms in Guangdong. This section investigates the complex web of sector-specific policies enforced by the central and local governments in three areas: the labour, capital and product markets. An understanding of these policies is crucial for an understanding of the changing competitive arena encountered by foreign-financed firms in Guangdong.<sup>7</sup>

### **Labour Market**

The effects of Chinese government policies in the labour market of foreign-financed firms manifest themselves in three areas: employment permits, the levying of miscellaneous fees, and the recruitment of factory managers.

Every foreign-financed firm in Guangdong has to apply for eight licenses: (1) Business registration permit, (2) National tax certificate, (3) Guangdong provincial tax certificate, (4) Certificate of Quality License for Export Commodities, (5) Certificate of Quarantine License for Export Commodities (zoological and plant quarantine permits), (6) Hygiene certificate, (7) Labour insurance certificate and (8) Health insurance certificate. Moreover, firms have to acquire the following **permits** on behalf of their employees (Table 1).<sup>8</sup>

- Temporary residence permits issued by the local Public Security Bureau, renewable every three or six months to one year (this applies to migrant workers only).
- Employment permit issued by the Labour Bureau (this applies to migrant workers only).<sup>9</sup>
- Single card or planned maternity card for married employees, issued by the Labour and Planned Maternity Bureaux.
- Unemployment insurance, labour insurance, medical insurance and old age pension permits from the Social Insurance and Labour Bureaux.

[INSERT TABLE 1 ABOUT HERE]

The local government imposes a fine or administrative sanction (such as withholding of operational licenses) on 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 migrant workers prefer to work on a temporary basis, as it allows them to job-hop.<sup>10</sup>

By law, the local government levies a **miscellaneous charge** according to the number of workers in the firm, a certain amount of *yuan* per worker (Table 1). In 1997, the total miscellaneous fee for a foreign-financed firm could add up to over 100 *yuan*/worker/month. With the introduction of compulsory subscription to unemployment insurance, labour insurance, medical insurance and a pension fund, the total miscellaneous fee payable by foreign-financed firms in Guangdong has increased dramatically, to at least 150 *yuan*/worker/month in 2000, a figure that accounts for up to 50 percent of the monthly wage bill of an unskilled worker.<sup>11</sup> Obviously, this imposes tremendous pressure upon the profit margins of foreign-financed firms, as many had not factored these newly introduced charges into their original labour cost estimates. The competitiveness of foreign-financed firms in Guangdong is further undermined by the fact that a number of locally-funded firms are able to avoid paying some of these miscellaneous fees as the Labour Bureau focuses their resource on the inspection of foreign-financed firms (field survey, 1996-97, 2000).

In reality, the level of miscellaneous fees payable by foreign-financed firms is negotiable and varies geographically, partly because local governments in Guangdong realises the negative impact of high fees on the attractiveness of a locality for foreign investment if laws are fully enforced (Table 1). Ultimately, the level of fees paid depends on *guanxi* (personal connections), as those firms with better connections can get a more favourable “discount” on the fees payable. This fact helps to explain why foreign firms always employ local people as factory managers: in addition to being “up-to-date” with ever-changing government

policies, they have the right connections to the local government.<sup>12</sup> In fact, some foreign investors claim that the main role of their Chinese JV partners is “to do the public relations work with the bureaucracy” (field survey, 1996-97). The issue of miscellaneous fees also explains why many foreign-financed firms deliberately under-report their worker numbers to the local government. All the firms interviewed indicated that they have at various points under-reported by 30-80 percent their number of employees for the purpose of tax and miscellaneous fee evasion (field survey, 1996-97, 2000).

Fortunately, the degree of transparency of the various charges levied on foreign-financed firms is improving. All miscellaneous charges levied on foreign-financed and locally-funded enterprises must be approved either by the local municipal or provincial government. In an effort to stamp out illegal charges, the corresponding authorities now issue receipts for every miscellaneous charge. In Dongguan, all miscellaneous fees are payable into designated bank accounts instead of directly to officials (field survey, 1996-97, 2000).

Despite improvements in the transparency of the system, however, the general situation of miscellaneous charges has deteriorated in some regions within Guangdong province. In an extreme case, a foreign-financed firm in the Yantian administrative region of Fenggang town had to pay 46 types of miscellaneous fees.<sup>13</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, i.e., six to eight *yuan* per worker per annum. It is not difficult to understand why the firm only reported 20 percent of its 200-strong workforce to the government. Though the absolute amount of some charges is small and the total amount of miscellaneous charges is similar to those of the past, the increase in the number of charges imposes additional administrative costs on firms (field survey, 1996-97, 2000).

Furthermore, some local governments backdated the newly introduced charge for several months, even before the formal approval of the municipal government had been given. In other words, a firm could suddenly receive bills for some unknown charge for the last six months, as well as a fine for being overdue in paying it. This is another reason why foreign-financed firms employ

local people as factory managers, as they have the connections and knowledge to deal with the ever-changing regulations.

It is neither the miscellaneous charges *per se* nor the total amount of such charges that most annoy foreign investors in Guangdong; the most frustrating factors are the ambiguity and variety of regulations, and associated high transaction costs. The ambiguity of miscellaneous charges and the tie-in of such charges with the number of employees certainly increases the real labour costs of foreign-financed firms in China.

### **Capital Market**

The impact of Chinese government policies on the capital market of foreign-financed firms is felt through the uniform rate of value-added, the “estimated profits” approach of taxation, the export value-added tax (VAT) and the import-deposit.

To simplify administrative duties and regulate transfer pricing by the TNCs, the State Bureau of Foreign Exchange uses a **uniform rate of value-added** and the State Bureau of Taxation uses the **“estimated profits” (“deemed profits”) approach** to assess the profitability of every foreign-financed firm conducting the “value-added verification” in the same industrial sector (Table 1).<sup>14</sup> The State Bureau of Foreign Exchange determining the rate of value-added according to the industrial sector that the firm belongs to (e.g. *x* percent of value-added for the textile industry, *y* percent of value-added for the garment industry, etc.). The State Bureau of Taxation uses a pre-determined and progressive percentage rate to determine the value of the firm’s output and its profitability.<sup>15</sup> However, these two general rules of thumb take neither the productivity nor the special circumstances of the individual firm into consideration. For instance, the value-added of polo shirts manufactured by a US-based garment firm is very high, due to its successful marketing strategy and its allocated US quotas. However, the value-added of its two wholly foreign-owned ventures (WFOVs) in Shenzhen is well below the industrial norm, since these only produce part of the polo shirt (e.g. a sleeve or collar) and use costly imported raw materials. Since the State Bureau of Foreign Exchange has granted no exemption for the firm, the firm’s Asian headquarters

has to remit more than 14 million *yuan*/month from Hong Kong to Shenzhen, even though the actual value-added of these two firms is about 10 million *yuan*/month. Consequently, the two WFVs have accumulated about 40 million *yuan* of idle cash within a year since the new policy was implemented.<sup>16</sup> The State Bureau of Taxation generally assumes that profitable firms will produce more, but there is no standardised procedure for the Bureau to determine the rate of “estimated profits”. The rate of “estimated profits” may be negotiable when the foreign-financed firm is able to provide adequate evidence from independent auditor reports (e.g. PriceWaterhouseCoopers) to support their claims (field survey, 2000). This arrangement unavoidably leads to discontent among foreign-financed firms.

In July 1998, the State Administration of Taxation announced that a 8 percent VAT would be implemented from 1 January 1999 (Table 1) on the export value of import-processing P&A firms (*laiyang jiagong*, where P&A firms import raw materials and export finished products on their own accounts). As the new VAT law was backdated for two years, this had a tremendous impact on the import-processing P&A firms: the VAT was not budgeted in their export prices, since their imports and exports were VAT-free before the implementation of the new law. To circumvent the VAT, P&A firms changed from import-processing to contract-processing (*lailiao jiagong*, where P&A firms manufacture finished goods for clients who import their own raw materials). If the new VAT law is fully implemented, the Guangdong Provincial Foreign Economic and Trade Commission estimates that its back-dating will wipe out the combined 1997 profits of import-processing P&A firms.<sup>17</sup> Due to the slowing of the influx of FDI and the lobbying efforts of the Guangdong government, the State Council decided to grant a two-year extension of the so-called “grandfather rule” (tax relief on the VAT), which was introduced on 1 January 1994 and stated that import-processing P&A firms established before 1994 could have tax refunds for five years if they paid more taxes due to taxation reform at the beginning of 1994. The two-year extension allowed import-processing P&A firms to refund any extra VAT that they may have to pay until 31 December 2000. However, the tax relief is not applicable to import-processing P&A firms established after 1994, as their export

VAT is calculated according to the same criteria as locally-funded exporters (SCMP, 1998a, 1998b, 1998c).

With the exception of firms classified as class AA, A or B, Customs regulations stipulate that, from 1 October 1999 (Table 1), foreign-financed firms have to put down about 30 percent of the value of imported raw materials as a **deposit**, to guarantee that all of their finished products are for export.<sup>18</sup> Customs inspectors have the authority to confiscate the deposit if the firm does not verify its production contract with export documents within three months of the import of raw materials. Moreover, foreign-financed firms also have to appoint designated auditors to prepare daily records of imports/exports for Customs.<sup>19</sup> Following the announcement of the agreement on World Trade Organization (WTO) accession with the US in late 1999, customs verification rules have been enforced strictly, a situation that has profound implications for the cash flow of foreign-financed firms. For instance, a Hong Kong-based textile fabric enterprise has to set aside up to HK\$100 million per month as import-deposit for its three cotton yarn spinning firms in Guangdong. For a large-scale firm with abundant capital, the strict enforcement of the customs verification policy resulted in an immediate quadrupling of its cash flow. This obviously causes considerable disruption to the short-term operation of the firm. For a small and medium-size enterprise (SME) with limited capital, the likely result is a severe drain of working capital, which in the worst scenario may push the firm to the edge of closing down (field survey, 1996-97, 2000).

The authoritarian nature of these policies (especially the uniform rate of the value-added and the “estimated profits” approach to taxation) obviously counters some of the policy incentives, such as the tax-free holiday, designed to attract foreign investors. This is because the “saving” on profit tax granted to foreign-financed firms at the time of their establishment is partially offset by the (possible) increase in the payment of the profit tax (due to the “estimated profits” approach of taxation) after the expiration of their tax-free holiday in Guangdong.

## **Product Market**

The impact of Chinese government policies in the product market of foreign-financed firms manifested itself in forms of production contracts and verification rules on imports and exports.<sup>20</sup>

To facilitate the operation of foreign-financed enterprises and relieve pressures on transportation networks, the Guangdong government has collaborated with Chinese Customs to introduce a “transferred goods arrangement” for foreign-financed firms. This arrangement, which requires the prior approval of Customs, allows a foreign-financed firm to sell and transport directly its finished goods to another foreign or locally-funded firm located in China, provided that the following three conditions are fulfilled: (1) all final products of the transferred goods are for export; (2) both companies have import licenses for the transferred goods; and (3) the quantity of transferred goods is less than the quantity of goods imported by the firm.

However, the convenience of the transferred goods arrangement for foreign-financed firms is offset by other Customs regulations, e.g. production contracts (field survey, 1996-97). Foreign-financed firms have to apply every six months for a **production contract** from Customs to import raw materials into China free of tariffs (Table 1). For every shipment of raw materials or finished products, foreign-financed firms have to apply to Customs for import or export declaration permits. To counter bureaucratic red tape, some foreign-financed firms are either sharing their production contract to have the right to import tariff-free raw materials, or are smuggling part of their raw materials into China without proper documentation. In cases when cargo impounded at the Shenzhen-Hong Kong border, foreign-financed firms normally pay off Customs inspectors to cover up their illegitimate activities. As the timely delivery of cargo is essential, and as it is too time-consuming to negotiate with Customs inspectors, foreign owners normally instruct their truck drivers to bribe the inspectors (field survey, 1996-97, 2000). This phenomenon is also documented in Yeung (2001a, 2001b).

Due to the corruption eradication policy implemented by the central government, most Customs inspectors will no longer accept bribes (field survey,

2000). The strict enforcement of regulations on production contracts is equivalent to removing the “first-mover” competitive advantage of foreign-financed firms. This is because production contracts contain strict definitions of the quantity and variety of raw materials that the firm is allowed to import tariff-free every six months. Obviously, this inflexibility does not facilitate meeting dynamic market demand, as the firm is unable to increase production at short notice for an unexpectedly large order, or to introduce new products which demand raw materials not specified in the production contract. The rigidity of the production contract system has far-reaching consequences for the competitive advantages of foreign-financed firms, especially those engaging in sub-contracting businesses where flexibility to change production lines to adapt to the seasonality of markets and to sell new products is vital to success.

To prevent tax evasion and the illegal re-selling of tariff-free raw materials imported by foreign-financed firms, the State Bureau of Foreign Exchange cooperates with Customs to strictly implement **verification rules on imports and exports** (*hexiao*) (Table 1). Foreign-financed firms have to submit their production contracts to Chinese Customs, with daily records and documentation pertaining to the importation of raw materials, the export of finished goods, and the amount of raw materials in stock, in order to verify that their imported tariff-free raw materials are processed and exported to overseas markets. There are two types of regulation on verification: “gross-value verification” (*cune hexiao*) and “value-added verification” (*chae hexiao*). Under “gross-value verification”, the foreign owner/buyer must remit the total amount of foreign exchange to China to import/export the exact value of their raw materials/finished products. Under “value-added verification”, the foreign investor only remits the amount of value added, that is the difference between the value of the imported raw materials and the value of the exported semi-finished or finished goods. This method of verification is only applicable if the transactions (import and export) are conducted within the same enterprise. Obviously, the “value-added verification” arrangement demands much less operational capital from foreign-financed firms, and this regulation favours those TNCs that are vertically integrated, from manufacturing to wholesaling.<sup>21</sup> For SMEs, the “gross-value verification” arrangement imposes great financial pressure (field survey, 2000).<sup>22</sup>



Paradoxically, the stringent enforcement of customs inspection rules in China not only punishes foreign-financed firms who are conducting illegal trade, but also creates obstacles for law-abiding foreign-financed firms. All the documentation imposes extra transaction costs on foreign-financed firms and provides golden rent-seeking opportunities for Customs inspectors. Whenever there is any discrepancy between the import and export declaration forms, Customs inspectors regard undeclared goods (the raw materials not declared for sale to other foreign-financed firms as finished products) as sales for the local market. In addition to imposing a fine, Customs inspectors impose a surcharge of 40 percent of the value of undeclared raw materials. As there are numerous products and different categories of tariff systems, it is unlikely that every Customs inspector has intimate knowledge of all of them (Table 1).<sup>23</sup> It is also not easy for Customs inspectors to decide which cargo is deliberately under- or over-reported in the import or export documents. As a transparent legal channel for arbitration on the legality of import and export activities does not exist, the general practice for Customs inspectors is to refer the suspected cases to the Inspection Department pending further action when they find minor irregularities between the cargo and the documents. By doing so, Customs inspectors avoid the dangers of being accused of being lenient towards a particular firm. By “scaring off the monkey by killing the chicken” (*shaji xiahou*), they also send an unambiguous signal to other foreign investors that they can no longer bribe their way out. Once the cargo is impounded, however, it takes at least 2-3 days for the investigation, and the company involved may miss its shipment date. Worse still, Customs can downgrade the foreign-financed firm’s rating, thus further diminishing its competitiveness, since after downgrading, a firm is obliged to pay 30 percent of its imported value as import-deposit (field survey, 1996-97, 2000).<sup>24</sup>

Undeniably, the stringent nature of the policy (especially the verification rules on imports and exports) and the resultant possibility of impoundment of cargo at the border partially counters some of the competitive advantages of foreign-financed firms over locally-funded firms, who are allowed to import raw materials tariff-free.

## **Conclusions & Policy Implications**

The stated objectives of government sector-specific policies in the labour, capital and product markets are to lubricate the factor markets and to facilitate the operation of foreign-financed in China. For example, the policy on employment permits aims to provide a social safety net for workers, to implement birth control policies, and to regulate the control of migrant workers, whilst the “estimated profits” approach to taxation and the import-deposit are aimed to prevent the transfer pricing by TNCs, tax evasion, and the illegal re-selling of tariff-free imported raw materials by foreign-financed firms. Nevertheless, in reality the implementation of such policies directly and indirectly imposes higher transaction costs on foreign-financed firms’ daily operation, which offsets some of the economic benefits gained under the central government’s preferential FDI policy and thus diminishes their competitive advantages over locally-funded firms in Guangdong.

In the labour market, the ambiguity and variety of miscellaneous fees and their associated high transaction costs frustrate foreign entrepreneurs. The ambiguity of miscellaneous fees and the backdating of such charges for several months after they are formally approved, in addition to the government’s linkage of miscellaneous charges to the number of a firm’s employees, certainly increase the real labour costs of foreign-financed firms. In other words, one of the seeming locational advantages of Guangdong for foreign-financed firms, the low nominal labour costs, is not as attractive as it may have first appeared.

In the capital market, the authoritarian nature of government policies (especially the uniform rates of the value-added and “estimated profits” approaches to taxation) obviously offset some of the policy incentives, such as the tax-free holiday, exclusive for foreign investors in China. This is because the “saving” on profit tax granted to foreign-financed firms at the time of their establishment is partially offset by the (possible) increase in the payment of profit tax (due to the “estimated profits” approach of taxation) after the expiration of their tax-free holiday in China. Other policies implemented by the government, such as the export VAT, will further fuel the conspiracy theory that the aim of such policies is to re-gain the “lost” profit-tax from foreign-financed firms.<sup>25</sup>

Moreover, the compulsory submission of daily import-export records to Customs imposes additional administrative duties and thus increases the transaction costs of operating manufacturing firms.

In the product market, the stringent nature of policies and the resultant possibility of the impoundment of cargo at the border partially cancels out some of the competitive advantages of foreign-financed firms over locally-funded firms, which are allowed to import tariff-free raw materials into China. In practice, the verification rules on imports and exports partially offset the saving on transport and transaction costs for foreign-financed firms under the “transferred goods arrangement”. Without making provisions for special circumstances in a specific industry, such as the sub-contracting firms in clothing industry, in reality, this “punish someone as a warning to others” strategy of policy implementation imposes unnecessary and even detrimental constraints on the cash flow and operations of foreign-financed firms, especially SMEs with limited capital.

For law enforcement officers, the stringent implementation of new policies is a signal of the rule of law and a necessary preparation for WTO accession. For law-abiding foreign investors, the inflexibility and rigidity of government officials who do not take into account firms’ circumstances imposes serious roadblocks. Worse still, the lack of co-ordination among different bureaux further restricts the arbitration between bureaux and foreign investors. Consequently, the plight of some foreign investors can easily be exaggerated and dramatised by the media, e.g. the 46 items of miscellaneous fees levied in Fenggang town. If this sentiment of discrimination among foreign investors is not openly and firmly addressed by government officials through appropriate reforms in policy implementation, SMEs with limited capital could be rapidly crowded out, increasing the numbers of unemployed, especially among migrant workers, in Guangdong. Furthermore, it is possible that some of the large-scale foreign-financed firms, annoyed with the “bureaucratic maze”, may consider pulling out of Guangdong as well.

To prevent the crowding-out of SMEs having a domino effect among all types of foreign-financed firms, the central and Guangdong governments should reduce the unnecessary uncertainty of the investment environment in Guangdong and increase the transparency on policy implementation. For instance, there

should be no backdating of miscellaneous charges; the policy should be uniform for every firm (i.e. no special “discounts” for firms with personal connections).<sup>26</sup> The government might consider holding consultations on FDI policy with foreign investors on the issue of implementation before its enforcement. Such a process would improve communication and reduce unnecessary misunderstanding between government officials and foreign investors. The Chinese government can also improve the training of Customs inspectors. More knowledgeable Customs inspectors would reduce the chance of unnecessary impounding of cargo at the China-Hong Kong Customs border. Transparent legal channels for arbitration would also reduce rent-seeking opportunities for the Customs officials and factory managers. Obviously, this would reduce the transaction costs of doing business and improve the investment environment in Guangdong.

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<sup>1</sup> Unlike the conventional definition of FDI as “the act of acquiring assets outside one’s home country” (Grubel, 1987:403) or “cross-border expenditures to acquire or expand corporate control of productive assets” (Froot, 1993:1), the official Chinese definition incorporates three forms of direct foreign-invested enterprises (*sanzi qiye*) – equity joint ventures (EJVs), contractual joint ventures (CJVs) and wholly foreign-owned ventures (WFVs) – as well as joint exploration of resources. The conventional definition of FDI embraces WFVs and EJVs, but excludes CJVs. For simplicity’s sake, this paper defines FDI as the inflow of foreign capital (including that from Hong Kong and Macau) in the forms of *sanzi qiye* and *sanlai yibu*. *Sanlai yibu* (three forms of processing and assembling, P&A, and compensation trade) are defined by the Chinese authority as an “other form of foreign investment” rather than FDI. Readers interested in the detailed classification of FDI in China can refer to Yeung (2001b:3-7).

<sup>2</sup> “Sector-specific policies” are those *Chinese (central and local) government policies specifically formulated to regulate the operation of labour, capital and product markets of foreign-financed manufacturing firms*. This term is used to distinguish these strategies from other general government policies, such as policy incentives to attract the inflow of FDI, implemented in China.

<sup>3</sup> Every Sinologist knows that securing the appropriate personal connections is a necessary and probably the most important precondition for conducting a field survey in China. This explains why the majority of interviewed firms are located in Dongguan. The use of non-random sampling is, in fact, commonly employed by Sinologists, e.g. Child (1994), Warner (1994, 1995), Lin (1996), MacBean (1996).

<sup>4</sup> As the consumer price index is only available from 1984 onward, the retail price index-based GDP deflator is used to estimate real GDP.

<sup>5</sup> It is estimated that migrants working and living in Guangdong account for one-third to one-half of its local population of 72.99 million. The official statistics only report the size of the local population. Therefore, it can be argued that the economic performance of Guangdong in terms of real GDP per capita is “inflated” by official data. This has tremendous implications on the regional inequality of growth at provincial level.

<sup>6</sup> From 1 April 1996, the central government removed the tax-free status of imports of machinery and capital goods by foreign-financed enterprises. After protests from numerous foreign entrepreneurs, the government granted a period of grace to those foreign-financed projects launched before 1 April 1996. For projects valued below US\$30 million, the tariff exemption period was extended until the end of 1997, while the grace period was extended until the end of

1998 for those projects valued above US\$30 million. To encourage foreign investment in high-technology sectors, the Chinese government decided to give exceptional waivers of import duties to 18 industries from 1 January 1998 onwards (FT, 1998).

<sup>7</sup> Some of the arguments in this section are discussed in more detail in Yeung (2001b).

<sup>8</sup> As most migrant workers do not have enough cash to process the application themselves, firms employing them have to report to and pay the appropriate authorities before deducting the application fees from their wages in instalments.

<sup>9</sup> Local people can work for any firm by producing their identity cards before signing the employment contract.

<sup>10</sup> As the majority of (unskilled) workers are migrants, the local government does not pressure foreign investors to keep on poorly performing staff; the local government does not have to shoulder social security benefits for sacked migrants. After all, the local government benefits economically from the success of joint ventures (JVs) through tax income. Ironically, one manager of a JV suggests that “it is much more difficult to sack an employee in the Hong Kong branch than in China, due to the ‘unique’ corporate culture of our company” (field survey, 2000).

<sup>11</sup> The pension fund is for any employee, including migrants, who has worked in the firm for three years or longer. The cost of pension funds alone ranged from 30-117 *yuan*/worker/month (field survey, 2000).

<sup>12</sup> As might be expected, nepotism is not uncommon in recruitment for “non-critical” posts.

<sup>13</sup> In 1998, the central government disciplined 1,273 officials in local governments for levying 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 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 percent (HKS, 1999).

<sup>14</sup> Refer to the next section on product markets for an explanation of “value-added verification”.

<sup>15</sup> The State Bureau of Taxation uses the information provided by Customs rather than the account books of foreign-financed firms to determine the value of output.

<sup>16</sup> The firm cannot remit the cash overseas, due to strict Chinese foreign exchange controls.

<sup>17</sup> However, some analysts estimate that the real impact of this new VAT law will be limited, as most P&A firms in the Pearl River Delta are engaged in contract-processing. The “real” impact of the VAT law on import processing P&A firms also depends on the proportion of materials and finished products that are actually imported and exported respectively.

<sup>18</sup> The import-deposit consists of about 10 percent of customs duty and about 17 percent of import VAT levied on the import of raw materials classified in the protected or sensitive sectors in China. According to the new “Customs Administration of Enterprises by Categories”, foreign-financed firms with annual export values of US\$10 million or above and without records of illegal smuggling are given priority to be granted the import-tariff-free class AA status. Firms in aircraft and ship manufacturing industries for export (or other selected high-tech sectors) will be granted class AA automatically. Companies ranked as class A or B have to pay the import-deposit only for the import of restricted goods. Firms with low export value and poor records of compliance with customs laws are classified as class C, while firms involved in smuggling of over 500,000 *yuan* since 1 August 1998 are classified as class D (SCMP, 1999a, 1999b, 1999c, 1999d, 1999e, 2000a). After more than a year of negotiation, the Guangdong government has allowed Hong Kong-based foreign investors to provide bank guarantees in lieu of cash for the import-deposit (SCMP, 2001).

<sup>19</sup> Foreign-financed firms only have to submit a monthly imports/exports report to Customs to verify their production contracts in the past. The submission of daily imports/exports records obviously imposes additional costs.

<sup>20</sup> Some foreign investors also complain about the conflict of their business interests with those of their JV partners, e.g. their JV partners establish new firms which compete with the JV businesses directly (field survey, 2000).

<sup>21</sup> The restrictions upon the local distribution channels of foreign-financed firms also limit their ability to sell their products locally.

<sup>22</sup> Recent legislation approved by the National People’s Congress stipulates that CJVs and WFVs are no longer required to remit foreign exchange from abroad to meet their foreign exchange requirement (SCMP, 2000b).

<sup>23</sup> The lack of (qualified) manpower in Customs accentuates the difficulties of law enforcement. Educated and well-qualified young people in China tend to join foreign-owned JVs or private companies rather than work in the civil service sector.

<sup>24</sup> This partially explains why there have been numerous complaints against Chinese Customs during the last few years. A number of Hong Kong-based investors assume that *guanxi* (personal connections) plus money pay-offs can solve most, if not all, of the problems that their ventures may encounter. Since the central government cracked down hard on corruption, to investors' dismay, this previous "magic formula" is no longer working (field survey, 2000).

<sup>25</sup> It can be argued that "economic factors" may partially explain the ambivalent attitude of some local governments toward foreign-financed firms. After more than two decades of economic reform, some local governments in Guangdong may realise that there can be various reasons for them to collect revenues from foreign-financed firms, e.g. by charging them various miscellaneous fees (although some of the reasons may not be fully legitimate). This is an "unintended" consequence of decentralisation of authority by the central government since the economic reform.

<sup>26</sup> The recent abolishment of 27,770 items of miscellaneous fees by the central and local governments is the first step in the right direction (the arbitrary levies in Guangdong have been reduced by 30 percent) (HKS, 1999).

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*Table 1: A Typology of the Effects of Chinese Government Policies on the Competitive Advantage of Foreign-financed Firms in Southern China*

<b>Policies:</b>	<b>Aims:</b>	<b>Policy details:</b>	<b>Effects on foreign-financed firms:</b>
<b>Permits for employment</b>	<ul style="list-style-type: none"> <li>To provide a social safety net for workers</li> <li>To implement birth control policies</li> <li>To regulate migrant workers</li> </ul>	<ul style="list-style-type: none"> <li>Unemployment insurance, labour insurance, and old age pension for every worker</li> <li>Single card for unmarried employees &amp; planned maternity card for married employees</li> <li>Temporary residence &amp; employment permits for migrants</li> </ul>	<ul style="list-style-type: none"> <li>Compulsory subscription to pension fund increases the production costs, e.g. up to 30% of wage bills</li> <li>FDI firms are subjected to fines or administrative sanctions if any employee does not possess all permits</li> </ul>
<b>Miscellaneous fees</b>	<ul style="list-style-type: none"> <li>To recoup the costs of services provided by various bureaux</li> </ul>	<ul style="list-style-type: none"> <li>The amount of miscellaneous fees tied-in with the number of workers</li> <li>Some local governments backdated the newly-introduced charge by several months, even before the formal approval date of the municipal government</li> </ul>	<ul style="list-style-type: none"> <li>In reality, the amount of payable miscellaneous fee is negotiable and varies geographically</li> <li>Firms with better connections can get a “discount” on the payable fee</li> </ul>
<b>Uniform rate of value-added &amp; the “estimated profits” approach of taxation</b>	<ul style="list-style-type: none"> <li>To simplify the government’s administrative duties</li> <li>To regulate the transfer pricing of TNCs</li> </ul>	<ul style="list-style-type: none"> <li>For FDI firms who conduct the “value-added verification”, the same rate of value-added is applied in the same industrial sector</li> <li>The firm’s profitability is equal to its output value multiplied by a pre-determined &amp; progressive percentage rate</li> </ul>	<ul style="list-style-type: none"> <li>Takes neither the productivity nor the special circumstances (e.g. US textile quotas) of an individual firm into consideration</li> <li>Discontent among FDI firms, as there is no standardised procedure on the determination of estimated profits rate</li> </ul>
<b>Export VAT</b>	<ul style="list-style-type: none"> <li>To prevent tax evasion by FDI firms</li> </ul>	<ul style="list-style-type: none"> <li>From 1 January 1999 onwards, 8% VAT is levied on the export value of import-processing P&amp;A firms</li> </ul>	<ul style="list-style-type: none"> <li>The two-year backdated period of VAT law has tremendous impact on import-processing P&amp;A firms (imports and exports were VAT-free before the new law)</li> </ul>
<b>Import-deposit</b>	<ul style="list-style-type: none"> <li>To prevent the illegal reselling of tariff-free</li> </ul>	<ul style="list-style-type: none"> <li>FDI firms are classified into 5 classes (AA, A, B, C &amp; D) since 1 October 1999.</li> </ul>	<ul style="list-style-type: none"> <li>Favours firms in high-tech sectors &amp; export-oriented large-scale firms, as</li> </ul>

	<p>raw materials imported by FDI firms in the local market</p> <ul style="list-style-type: none"> <li>To prevent tax evasion by FDI firms</li> </ul>	<ul style="list-style-type: none"> <li>Firms classified as class A &amp; B have to pay the import deposit only for the import of restricted goods</li> <li>Firms classified as class C &amp; D have to put down about 30% of the value of imported raw materials as a deposit</li> <li>Customs can confiscate the import deposit if the firm does not verify that the finished products have been exported within 3 months of the import of raw materials</li> </ul>	<p>they are automatically classified as class AA (import deposit is waived)</p> <ul style="list-style-type: none"> <li>A severe drain of operational capital for the SMEs with low export value, due to the large amount of payable import deposit</li> <li>Additional administrative duties to prepare the daily import-export records submitted to Customs</li> </ul>
<b>Production contract</b>	<ul style="list-style-type: none"> <li>To prevent the illegal reselling of tariff-free raw materials on the local market</li> </ul>	<ul style="list-style-type: none"> <li>The production contract outlines the strict definitions of the quantity &amp; variety of raw materials that the FDI firm can import free of tariffs over a six-month period</li> <li>FDI firms have to renew their production contract every six months</li> </ul>	<ul style="list-style-type: none"> <li>High transaction costs to justify the need to import more raw materials than allowed under the contract</li> <li>Unable to facilitate market demand &amp; removes the “first-mover” competitive advantage of sub-contracting firms</li> </ul>
<b>Verification rules on imports &amp; exports</b>	<ul style="list-style-type: none"> <li>To prevent the illegal reselling of tariff-free raw materials in the local market</li> <li>To prevent tax evasion by FDI firms</li> </ul>	<ul style="list-style-type: none"> <li>Under the “gross-value verification”, the foreign owner/buyer remits the total amount of foreign exchange to China to import/export the exact value of their raw materials/finished products</li> <li>Under the “value-added verification”, the foreign investor remits the amount of value-added to China, if the transaction is conducted within the enterprise</li> <li>Imported tariff-free raw materials have to be verified as processed &amp; exported</li> </ul>	<ul style="list-style-type: none"> <li>The “gross-value verification” arrangement demands more working capital from the SMEs, while the “value-added verification” arrangement favours those TNCs that are vertically integrated, from manufacturing to wholesaling</li> <li>Unnecessary impounding of cargo</li> <li>Lack of a transparent legal channel for arbitration</li> </ul>

*Source:* Field survey, 1996-97 & 2000.