Internal and external reforms in China

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Abstract

This paper argues that the characteristics of foreign direct investment (FDI) in the 1990s were shaped by the distorted institutional and business environment during that period. As these distortions began to dissipate since the late 1990s, China's FDI patterns began to undergo a substantial transformation. In the long run, the most dynamic part of the Chinese economy will come from domestic private sector, not FDI.

Internal and external reforms in China

The standard perspective on Chinese reforms is that the Chinese reforms have been a continuous and an ever deepening process. According to this perspective, the reforms started in small and incremental steps in the late 1970s and gradually expanded and deepened over time in the 1980s and 1990s.

Scholars point to China’s external reforms as the best illustration of this perspective. China began to open itself to foreign trade and foreign direct investment (FDI) in the early 1980s by setting up four special economic zones in Guangdong and Fujian. The more liberal policies on foreign trade and FDI then were copied by other coastal provinces in the 1980s and then by interior provinces in the 1990s. Not only did China’s external reforms expand geographically in a stepwise fashion, they also expanded to encompass more economic sectors. In the 1980s, the export-oriented labor-intensive sectors were open to FDI; in the 1990s, substantial liberalization occurred in the more capital-intensive and technologically-oriented industries. Beginning in 1999, after China acceded to the sweeping terms to join the World Trade Organization (WTO), the policy emphasis began to shift to service sectors, notably banking, insurance and retail.

This perspective on Chinese reforms—known as gradualism among studies of Chinese economy—can be usefully extended to account for other areas of economic reforms, such as reforms of state-owned enterprises (SOEs) and legal and financial policies on the domestic private firms. With some variations, in general Chinese economic reforms started out in a limited fashion and gradually progressed and deepened over time. There have been setbacks in the reform process—notably around the 1989-1991 period when the more conservative leadership attempted to assert more controls—but by and large the reforms have trended in a more liberal direction and at an accelerating pace.

This standard perspective is powerful, useful and quite accurate, up to a point. The gradualist perspective is most useful when explaining reforms *in a single area of economic activities*, for example when it explains the pace of FDI liberalization. It is less useful when accounting for reforms across different areas of economic activities. One of the noticeable aspects of Chinese reforms is that reforms in certain areas of economic activities have progressed much faster and more deeply than reforms in other areas of economic activities.

In this paper, I contrast the reforms in two areas—FDI policies and policies toward domestic private sector. In these two areas, there have been substantial gaps in reforms, i.e., FDI reforms have progressed quite deeply and expanded in an almost linear fashion in the 1980s and 1990s while liberalization toward the domestic private sector did not really begin until the late 1990s.

This paper will first provide an account of this lag between internal and external reforms in the corporate sector in the 1980s and in the 1990s. The second section of the paper shows how this lag between external and internal reforms accounts could have contributed to some important features of FDI inflows in the 1990s. The same section will describe the improvement in the business environment for domestic private firms since the late 1990s and the changes in the FDI patterns associated with this improvement. The concluding section argues that the accelerated pace of internal reforms, while neglected by many foreign observers of China, will be a far more important determinant of China's growth process in the next five to ten years than China's WTO accession.

Lags between internal and external reforms in the 1980s and 1990s

China began to permit FDI in 1979. The signature event of FDI liberalization is the passage of the Sino-Foreign Equity Joint Venture Law in 1979. As far as one can ascertain, the first joint venture (JV) with foreign firms was set up in 1980 after three decades of complete economic autarky. The legal regime for FDI and for firms funded by FDI—known as foreign-invested enterprises—became progressively and continuously more liberal and codified. In sharp contrast, the policies on domestic private sector remained highly restrictive and only began to substantially move in a liberal direction since the late 1990s.

In this paper, I will highlight the following constraints imposed on the domestic private firms: The insecurity of private property rights, financing constraints, and business environment biases. In all these areas, foreign firms were privileged above the domestic private firms in the 1980s and 1990s.

Legal biases

On balance, the legal treatment of foreign-invested enterprises (FIEs) has been far superior than that accorded to domestic private firms (although inferior to that of state owned enterprises or SOEs). The most remarkable example concerns the constitutional treatment of FIEs and domestic private firms. China's Constitution, adopted in 1982, only six years after the Cultural Revolution, clarified and offered protection to the legal status of foreign enterprises operating in China (Article 18). Foreign enterprises were permitted "to invest in China and to enter into various forms of economic cooperation with Chinese enterprises and other Chinese economic organizations…."[1] Article 18 also swore to protect their "lawful rights and interests."

While Article 12 of the Constitution prohibited "appropriation or damaging of state or collective property," no such a commitment was made about the property rights of private enterprises. Remarkably, until 2004, the Constitutional treatment of domestic private firms remained inferior to that of foreign firms investing in China. (In 2004, the Constitution was amended to include a clause not to nationalize or expropriate the assets of domestic private investors without "due cause and compensation," which foreign investors got in 1982.)

One example is the low political and legal status of private businesses. Article 11 of the 1982 Constitution acknowledged the property rights of self-employed private businesses—termed the individual economy—but it did not acknowledge the property rights of other types of private firms. In 1988, Article 11 was amended to add a clause that the state permitted private firms and that the state was to protect their "lawful rights and interests, " but the amendment also subordinated the private sector to "a complement to the socialist public economy."[2] This meant that private firms were allowed entry only in industries where they did not pose a competitive threat to the SOEs, but the strength of property rights protection provided to private businesses lagged far behind that for SOEs and even for FIEs.

There is substantial evidence that the lack of legal protection has reduced the security on the part of the private entrepreneurs. Our evidence comes from the perception data in the World Business Environment Survey (WBES). The survey was implemented in 2000 and it focused on perceptions of factors external to the firm. Many dimensions of business environment were surveyed, ranging from perceptions of the national business environment as shaped by local economic policy; governance to the perceptions of regulatory, infrastructural and financial

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[1] For an extensive analysis, see (Gelatt 1983).

[2] The text of the 1982 Constitution and the 1988 amendment is found in(1994).

impediments and public service quality. The survey was done on roughly 100 firms in each of some 80 countries. For the first time, China agreed to be a part of this type of surveys.[3]

One telling piece of data concerns the answer to the question, “Please estimate the number of firms in your industry who report 100 percent of their income for tax purposes.” The average response from the Chinese firms is 11.9 percent, which is identical to the ratio among firms in Haiti. In contrast, the average ratio among the surveyed Indian firms is 53.8 percent.

Previous research reveals two plausible reasons why firms under-report their income. One is to evade taxes. High tax rates, according to this logic, drive firms’ activities underground. It is noteworthy that the perceived tax burdens are not high in China. The average score for “high taxes” for Chinese firms is 2.42 (1=minimum tax burden; 4=maximum tax burden). This compares with 2.9 for the rest of East Asia and India, 3.47 for transition economies, 3.15 for Africa and 3.05 for OECD countries. Thus the cause for the high incidence of fraudulent tax reporting must lie elsewhere. Tax considerations do not appear to be an overriding factor.

A plausible explanation is that firms in China lack property rights security and thus they hesitate report their true taxable incomes because high tax payments act as an information-reporting device. Entrepreneurs who feel insecure about their property rights under-report their income because tax payments can reveal their financial situation to rapacious officials.

Financial biases

As China’s pace of integration into the world economy accelerated, some influential economists in China argued that domestic private firms were often regarded as inferior compared to other firms in the Chinese economy. A 2000 report by the Chinese Academy of Social Sciences concluded the following:[4]

> Because of long-standing prejudices and mistaken beliefs, private and individual enterprises have a lower political status and there are numerous policy and regulatory

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[3] A caveat in this type of survey research is that the responses given by foreign and domestic firms are not strictly comparable. Foreign firms may rate China’s business environment, implicitly or explicitly, against the their own home economies. For domestic firms, the implicit benchmark could be China’s business environment in the past. If this is the case, it is entirely possible to have a rather low rating by foreign firms and a high rating by domestic firms because China’s business environment has improved over time but has not obtained the level prevailing elsewhere.

[4] See Institute of Industrial Economics of Chinese Academy of Social Sciences (2000).

discrimination and limitations. The legal, policy, and market environment is unfair and inconsistent.

For a long time, there was a severe lending bias against private firms in favor of the SOEs.[5] Until 1998, the four big state-owned commercial banks, which controlled most of the banking assets, were specifically instructed to lend to SOEs only. (The Bank of China could lend to FIEs.) Lending to nonstate firms by the four commercial banks remained a miniscule portion of their loan portfolios. Among the nonstate firms, FIEs were able to access the Chinese banking system more readily than the domestic private firms. It should be pointed out, however, that the primary function of China's banking system is to serve the financial needs of the SOEs.

The WBES survey suggests that Chinese private firms are among the most financially constrained firms in the world. Table 1 presents data on the various measures of financial constraints faced by firms across a number of countries/regions. Chinese firms score very high on financing constraints, rely heavily on retained earnings for investment, and rely far less on credits supplied by commercial banks. It should be stressed here that this financial bias is not caused by the inefficiencies of the banking institutions or practices per se. Table 2 shows that Chinese firms in fact are not constrained by the high collateral requirements, paperwork, high interest rates, and lack of financial information. These technical constraints play a more important role in India and the rest of East Asia. Table 5 and Table 6 suggest that the binding financial constraint on the private firms in China is the fundamental lending orientation of the Chinese banks, which are statist and often refuse to lend to private firms.

Tables 1 and 2 here.

Regulatory biases

China's licensing policy also discriminated against private firms. In 2002, a top legislator, Tian Jiyun wrote in People's Daily that over 60 industrial sectors were open to FDI but only 40 industrial sectors were open to investments by domestic private firms. Foreign trade licensing was also biased against domestic private firms. While the FIEs could directly export and import products within their business lines and many SOEs could export directly, until 1999, most private firms were required to export through the official state-owned trading corporations.

While the regulatory hurdles facing private firms in China are onerous and high, in general, however, Chinese private entrepreneurs do not rank regulatory burdens as very severe

[5] The phenomenon of a lending bias on the part of the Chinese banking system in favor of SOEs was widely documented. See (McKinnon 1994)

constraints on their business operation. This is shown in Table 3, which shows that across a number of regulatory dimensions Chinese private firms are less constrained compared with firms in India, rest of East Asia and those in transitional economies.

Table 3 about here.

What is interesting and unique about China, however, is the fact that at a given level of regulatory constraints domestic firms are more burdened by regulations than foreign firms. This is shown in Table 4 and it is based on the WBES data again, which fortunately breaks down firms by their foreign and domestic ownership. Table 4 presents the average response scores given by foreign and domestic firms to a number of questions measuring regulatory burdens, rule of law, helpfulness of the government, and general business constraints. The minimum score is 1, indicating a good business environment perception; the maximum score ranges from 4 to 6, indicating a bad business environment perception. (The survey includes firms with ownership ties to the government. I have excluded them from Table 6 in order to demonstrate the contrast between FIEs and domestic private firms.)

Table 4 inserted here.

In some areas, domestic private firms feel more constrained than foreign firms; in other areas they feel less constrained. In general, domestic firms are constrained in the area of regulations. They gave a higher score for business and labor regulations and on general constraint on taxes and regulations. In general, foreign firms are less satisfied with China's legal system than domestic firms, although domestic firms appear to have less confidence than foreign firms in China's judicial system. Foreign and domestic private firms rate government similarly in terms of helpfulness of the government, although domestic private firms view local governments as more helpful. On the two critical measures of a business environment, financing and corruption, domestic private firms indicate more constraints than foreign firms and on the issue of financing constraint, substantially so.

It is important to note here that the above results are not uniform in pointing to the existence of advantages of FIE bias in China's business environment. This is evidence that China's economic legislations have mainly offset some of the inherent biases in China's economic system rather than giving foreign firms an overwhelming advantage. We should be cautious in drawing a conclusion that FIEs have an advantage across-the-board.

FDI and internal reforms

As I laid out in my book, Selling China: Foreign Direct Investment during the Reform Era (2003), the aforementioned lag between internal and external reforms contributed significantly to the volume and characteristics of FDI activities in China in the 1990s. Empirical details need not detain us here but let me mention, in relatively broad terms, the three prominent characteristics of FDI in China in the 1990s: 1) the large size of FDI compared with domestic investments, 2) the geographic spread of FDI, and 3) the substantial foreign controls of China’s export marketing channels.

Although data are limited, there are indications that since the late 1990s FDI patterns began to change quite substantially. Despite the widespread perception that China has become a more attractive place for FDI as a result of its WTO accession, in fact since the late 1990s the aggregate role of FDI in the Chinese economy has continuously and sharply declined. The most important reason is that the Chinese government began to accelerate internal reforms, especially in two arenas. One is that the government began to adopt or at least permit explicit privatization programs; the other is that the government has begun to encourage and support the growth of the domestic private sector with financial and legal policies. The greater pace of internal reforms has begun to affect both the volume and the characteristics of FDI inflows.

Characteristics of FDI in the 1990s

By a number of conventional measures, China’s economy in fact was quite open even without the benefit of the World Trade Organization (WTO) membership in 2001. On the trade side, a large portion of China’s GDP is accounted for by foreign trade. Using official exchange rate conversion would yield a trade/GDP ratio of 40 percent, an extremely large share for a continental economy of China’s size.[6] (Using PPP-based GDP will not significantly alter this conclusion.) For the US, the foreign trade/GDP was around 20 percent in the 1990s. Japan had a similar ratio.

China is also quite open to FDI—the principal focus of this paper. Since the early 1990s China has been one of the largest FDI recipients in the world. In 1994, for example, China alone

[6] Using the purchasing power parity conversion would yield a lower ratio, but the purchasing power parity measures are plagued by the uncertainty of exactly what constitutes the right purchasing power parity rate. If the “true” trade/GDP ratio is half of the ratio based on the official exchange rate, 20 percent of the GDP in foreign trade is still quite large. In comparison, the same ratio for Japan in 1998 was about 20 percent and for the United States, it was 23 percent for 1994.

accounted for 49 percent of the total FDI flows to developing countries and 15 percent of the worldwide FDI flows. This ratio has declined in more recent years but China no doubt is the largest recipient of FDI among developing countries. For 2003, according to a number of estimates, China will surpass the United States in terms of the absolute level of FDI.

Not only is the absolute size of FDI large, its relative size—measured by FDI/capital formation ratio—surpassed that of many countries in the world (discussed below). I will also provide evidence to show that foreign-invested enterprises (FIEs)—i.e., joint ventures between Chinese and foreign firms or wholly owned foreign subsidiaries—have established a sizeable presence in the Chinese economy and, in a number of industries, have come to command a dominant position.

A good relevant measure of China's openness to FDI is not the absolute size of FDI but FDI normalized by the size of the host economy. Countries vary in their economic and market size and the size of FDI flows ought to be gauged relative to the size of the host economy. The absolute size of FDI flows for the United States in 1990 was much larger than the Chinese FDI but the US economy is roughly seven times as large (on the basis of official foreign exchange conversion). In that sense, the United States is less "dependent" on FDI than China is even though the absolute size of FDI flows into the United States is much greater.

A common measure of the relative size of FDI is the "FDI/capital formation ratio," given by the amount of FDI inflows in one year divided by the total fixed asset investments made by foreign and domestic firms in the same year. (In the paragraphs below, I use the term, FDI dependency, to refer to this ratio.)

Between 1992 and 1998, on average, FDI flows into China accounted for about 13 percent of the gross capital formation of all firms annually. This ratio is one of the highest among the countries in the table, even compared with countries traditionally considered to be very FDI-dependent, such as countries in Southeast Asia. As pointed out earlier, even though the United States attracted a greater amount of FDI, the relative importance of FDI in the United States, at 6.9 percent during the 1992-98 period, was far smaller than it was in China. Compared with other Asian economies, China was less dependent on FDI in the 1980s, but its FDI dependency was among the highest in the region in the 1990s. China's FDI/capital formation ratio during the 1992-98 period was lower than that in Singapore and Malaysia, but much higher than that in Indonesia, Thailand, and the Philippines. The standard wisdom is that China is more similar to the Southeast Asian countries than it is to Korea, Taiwan, and Japan in terms of FDI dependency. That is true, but in fact China was among the most highly FDI-dependent economies in Asia during much of the 1990s.

There are a number of other important characteristics of FDI in China that are rather unusual if one were to compare them with other countries. For example, in China FDI is dispersed across many industries rather than concentrated in a few industries as observed in other countries or as predicted by economic theory. [7] The best way to illustrate this point is to compare FDI's industry distribution on the part of firms based in Hong Kong across a number of countries. In this type of exercise, it is important to control for the characteristics of investing firms in order to isolate the country-specific factors.

Data are available for FDI from Hong Kong broken down by industries for the 1990s for a number of countries on a consistent basis. These data show substantially less concentration patterns in China. For example, in Malaysia, the top three industries with the most Hong Kong FDI accounted for 58.9 percent of the total materialized Hong Kong FDI in 1994. In the same year, on an approval basis, the top three industries in Indonesia with the most Hong Kong FDI accounted for 77.6 percent of the total Hong Kong FDI.[8] But in China, the top three industries, electronics, plastic products, and textiles, only accounted for 46.7 percent of total Hong Kong FDI as of 1993. The lower concentration ratio means that FDI is also present in many other industries in China. In fact among the twenty-eight manufacturing industries, none received more than 10 percent of total FDI as of the mid-1990s. The highest share was 9.6 percent in the electronics and telecommunications industry. The textile industry followed, at 8.9 percent.

Another demonstration of the substantial economic role of FDI in China is that foreign firms have established substantial controls of China's export marketing. This is demonstrated in Table 5. As of 1995, foreign-invested enterprises (FIEs) controlled over half of China's manufactured exports, or 51.2 percent. Because FIEs are restricted in the primary industries and FIEs are not allowed to be pure trading corporations, their export share of total exports is smaller;

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[7] For example, in a survey article Newfarmer and March find that over 80 percent of foreign subsidiaries in Mexico and Brazil were in industries with four-firm concentration ratios exceeding 50 percent. Similar concentration patterns of foreign firms were found in Peru, Chile, Colombia, and Malaysia. This research is summarized in (Moran 1998, p. 23).

[8] These data are calculated on the basis of Table 4.2 and Table 4.3 in (Yeung 1998).) In the text, I use data from the 1970s because the industrial groupings are most similar to those in China, thus facilitating a direct comparison. The materialized amount may differ from the approval amount if an investor fails to invest the pledged amount of capital.

in 1995, it was 31.5 percent.[9] By 2002, FIEs accounted for over 50 percent of Chinese exports. Again, it is easier to illustrate the substantial role of FIEs in the Chinese economy by benchmarking China against other economies. FIEs in China have established a far more dominant position in export production than their counterparts in Taiwan, when Taiwan was in a comparable stage of development as China in the 1970s. As of the mid-1970s, FIEs in Taiwan accounted for only 20 percent of Taiwan's manufactured exports.[10] The share of FIEs in China's exports not only exceeds that of Taiwan but of other Asian countries as well during comparable stages of development. Two authors, Seiji Naya and Eric Ramstetter, provide some of the most complete statistics. Their paper shows that, except for Singapore, where multinational corporations (MNCs) have traditionally dominated domestic firms, no other Southeast Asian country came close to the 51 percent share of manufactured exports claimed by Chinese FIEs.[11] In Korea, between 1974 and 1978, foreign firms accounted for 24.9 percent of manufactured exports. In Thailand, in the 1970s, the share ranged from 11 to 18 percent, and in 1984 it was 5.8 percent.

Table 5 inserted here.

Table 5 presents FIE shares of total exports in three economies, China (1995), Taiwan (1980), and Indonesia (1995). The table breaks down export data by labor-intensive and capital- (or technology-) intensive industries. Two patterns emerge. One is that the FIE shares of exports in labor-intensive industries are much higher in China than in Taiwan or Indonesia. For example, garment and footwear FIEs accounted for 60.5 percent of exports in China, but only 5.7 percent in Taiwan and 33 percent in Indonesia. FIEs similarly dominated exports in leather and furniture in China to a far greater extent than they did in Taiwan and Indonesia. The second pattern is that in capital- or technology-intensive industries, FIEs in China and Indonesia dominated exports to a far greater extent than they did in Taiwan. This is a more common pattern in developing countries, not only because the local capabilities in modern industries are low, but because the goods being produced are intermediate inputs, such as electronic components. Japanese firms, for example,

[9] Export data for 1995 are from (State Statistical Bureau 1996). For some unknown reason, the Chinese government no longer released disaggregated FIE export data, broken down by economic sector or industry, after 1995.

[10] The export share data for Taiwan come from (Ranis and Schive 1985).

[11] All the data on Korea and the Southeast Asian countries are from (Naya and Ramstetter 1988). Data for later years are more difficult to find, except for the export production data by FIEs in Indonesia cited in the text.

have invested heavily in Southeast Asia to produce electronic components, which are re-exported to the parent firms.[12] Ownership arrangements are more common for this type of goods because often the only way for local producers to gain access to the supply chain of the MNCs is to be part of the MNC system. (In contrast, garments, footwear, and furniture are final goods or near final goods).

Acceleration of internal reforms since the late 1990s

Much of the attention, among scholars and China observers, has focused on WTO, but arguably there have been far more fundamental changes in the Chinese economy than WTO since the late 1990s. These changes result from an acceleration of internal reforms that the government began to put in place in 1997. Typical of the Chinese approach, they began as ginger baby steps but rapidly built upon each other to reinforce the momentum.

Several important internal reforms are particularly noteworthy. In 1997, the authorities adopted an explicit privatization program that for the first time openly sanctioned the sale of SOEs. However, the sales were limited to the small and loss-making SOEs. In terms of value of the assets, these firms accounted only a small fraction of the state sector but in terms of political symbolism this was a very significant policy development.

In 1998, the government shifted from a quota-based lending practice to one based on profitability and allowed, at least as a matter of formal policy, the biggest four state-owned banks to lend to private firms. (In reality, the access to bank credit continued to be difficult for private firms.) The government also began to grant export licenses to the largest private firms and allowed them to export directly. In the same year, the government announced a plan to privatize the vast housing stock. This entailed substantial implications for the orientation of banks, because banks then began to shift from an exclusively business focus to consumer finance.

In 1999, the Constitution was amended to include a wording that gave a greater recognition to the private sector. Under the previous Constitutional formulations, the private sector was a supplement to the socialist economy, which means that the private sector was not allowed to compete directly with the state sector. The 1999 Constitutional amendment elevated the private sector as "an integral part of the socialist economy."

A number of policy measures followed from the 1999 Constitutional amendment. In 2000, the government abolished many formal restrictions on private firms' access to equity financing

[12] A good discussion on this topic is found in (United Nations Conference on Trade and Development 1998), especially pp. 209-221.

and abolished stock market listings based on quotas in favor of a system that gave more discretion to underwriters. The government further expanded private firms' access to overseas product and capital markets.

In 2001, former President Jiang Zemin welcomed private entrepreneurs into the ranks of the Party and formulated the famous "Three Represent" doctrine. This is an explicit recognition that the political status, not just economic policies, have hindered private sector development. In 2002, more restrictions on investment activities by private firms were eased and private firms were allowed to acquire controlling stakes of fairly large SOEs. These reforms continued under the new leadership of Hu Jintao and Wen Jiabao. Probably, the most significant step the new leadership has taken is the 2004 Constitutional amendment that pledged that the state would not expropriate the lawfully-acquired private assets.

The cumulative effect of these policies is a substantial improvement of the business environment for domestic private firms. Although we lack hard data to document this improvement, there is some anecdotal evidence. For example, we now have examples of private firms entering into the previously most protected industries and economic sectors. Xinhua News Agency reported recently that Okay Airways, a private firm, was cleared to begin operations in November in airline business. The Beijing-based firm has six leased planes and will operate domestic cargo and passenger charter flights. According to the same report, two other private airlines, United Eagle Airlines and Air Spring, are now waiting for the final clearance from the Civil Aviation Administration of China to begin operations next year.

If the biased business environment in favor of foreign firms at the expense of domestic privates shaped many of the characteristics of FDI inflows in the 1990s, then the recent improvement in the business environment for domestic private firms suggests that there should be some changes in these FDI characteristics. The lack of data prevents a full evaluation but available data are suggestive. Since 2000, despite the fact that China has become more open to FDI as a result of the WTO membership, FDI/capital formation ratio has sharply declined. FDI/capital formation ratio was 10.5 percent in 2001, 10.1 percent in 2002 and then about 8 percent in 2003. There are some modest changes in the industry composition of FDI. In the garment industry, in 1998, after the government removed some export restrictions on private firms, direct exporting by private producers increased by 140 percent.[13] As a sign that private firms are able to carry out contract production, indirect exporting by private firms has also sharply increased. In the mid-1990s, the Import & Export Garment Corporation of Jiangsu

[13] From (Development Center of the State Council 1999).

province purchased about 20 percent of its garment supplies from private firms; in the late 1990s, this share increased to 65 percent. [14] Even the industry distribution of FDI has become more concentrated. In 1995, on an approval basis, the top four industries with most of the FDI inflows accounted for 25.2 percent of the total manufacturing FDI; in 2001, for the months from January to June, the share went up to 41 percent.[15] The share of FDI in textiles declined from 7.8 percent to 4.5 percent.[16] This is entirely to be expected. Domestic firms have become more competitive in some industries; foreign firms either decide not to invest or to contract with domestic firms in industries where domestic firms are perceived to be strong. In the late 1990s, China's FDI dependency ratio declined, especially as measured against domestic private investments, as shown in Chapter 1—another development that is entirely consistent with our argument. This is a sign that the economy is getting healthier and the deep-seated institutional distortions are being eased.

Another substantial change has occurred within China's capital account. Throughout the 1990s, China's capital account recorded large FDI inflows but also at the same time large unauthorized capital outflows—in the form of the large and negative net errors and omissions. As I argued in Selling China, one of the principal reasons for the large unauthorized capital outflows was the lack of property rights security on the part of domestic private investors. Therefore an improvement in the property rights security should reverse this flow. This indeed happened. After peaking at $22 billion in 1997, China's net errors and omissions declined to $18.9 billion in 1998, to $17.7 billion in 1999, and sharply to $11.8 billion in 2000 (International Monetary Fund 2001, p. 234).

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[14] Interview with Jimmy Chen, vice president of Import & Export Garment Corporation of Jiangsu province, recorded in (Huang 2003).

[15] These are based on data on an approval basis and therefore may differ from data based on a paid-up basis. Data based on a paid-up basis, broken down by industries, are not available for 2001.

[16] Unfortunately, textile data are not further broken down between garments and textiles. The 1995 figure is calculated from data in (State Statistical Bureau 1999, p. 293). FDI sectoral data for between January and June 2001 are available at http://www.moftec.gov.cn/moftec_cn/tjsj, accessed in January 2002.

Conclusion

How does one explain the declining role of FDI while China became more open to FDI and Chinese economy grew so quickly? An important reason is that the pace of internal reforms has picked up substantially since the late 1990s. These internal reforms have improved allocative efficiencies and have provided greater property rights security to private businesses. An improved business environment has enabled domestic private firms to increase their investment levels, which has reduced China's dependency on FDI.

My own view is that the most dynamic part of the Chinese economy in the next five to ten years will be the domestic private sector, not foreign firms. Some of the reasons why foreign firms played such an outsized role in the Chinese economy in the 1990s were due to the substantial institutional and policy distortions. As these distortions dissipate, one would find a realignment of FDI and foreign firms in China. Foreign firms would tend to gravitate toward the high-tech and the most sophisticated industries while the domestic firms—mainly domestic private firms—would excel in those areas of the economy where they have a competitive edge, such as many of the consumer products, labor-intensive exportables and some of the less sophisticated capital-intensive industries. In the long run, FDI, as a proportion of China's GDP, may very well decline but this is a sign that the Chinese economy is getting healthier, not sicker.

Table 1 Various measures of financing constraints

	Financing constraints: 1=no obstacles, 4=Major obstacles.		Sources of financing of fixed asset investment over the last year (%).		
	Financing as a general constraint	Lack of access to long-term loans	Retained earnings	Equity	Local commercial banks
China	3.35	2.28	57.8	2.62	9.3
East Asia	2.45	2.32	35.5	3.6	15.2
India	2.55	N/A	27.1	5.2	22.0
Transition economies	3.04	2.82	62.2	5.1	8.1
Africa	2.86	N/A	2.47	N/A	N/A
OECD	2.19	1.72	39.1	8.5	14.6

Source: WBES.

Table 2 Sources of financing constraints: Functions of the financial system (1=No obstacles, 4=Major obstacles)

	Collateral requirements	Paperwork or bureaucracy	High interest rates	Inadequate credit and financial information
China	1.8	2.01	2.06	2.29
East Asia	2.3	2.09	2.90	2.21
India	2.53	2.57	3.25	2.04
Transition economies	2.47	2.50	3.31	2.21
Africa	2.55	2.45	3.37	2.52
OECD	2.1	2.2	2.44	1.82

Source: WBES.

Table 3 Measures of regulatory burdens on operation and growth of business: 1=No obstacles, 4=Major obstacles

	Business regulations	Labor regulations	Customs regulations	Environmental regulations	Fire regulations
China	1.84	1.7	1.82	1.70	1.64
East Asia	1.90	2.1	2.03	1.96	1.95
India	1.91	2.82	2.51	2.26	1.81
Transition economies	1.93	1.87	2.01	1.88	1.77
Africa	1.92	2.25	2.47	1.90	1.77
OECD	2.0	2.45	1.90	2.10	2.00

Source: WBES

Table 4 The average response scores given by foreign and domestic private firms on business environment in China, 2000

	Foreign firms	Domestic private firms
Business regulations: 1=no obstacle; 4=major obstacle	1.79	1.90
Labor regulations: 1=no obstacle; 4=major obstacle	1.62	1.70
General constraint-taxes and regulations: 1=no obstacle; 4=major obstacle	1.86	2.17
Confidence in judicial system today: 1=fully agree; 6=fully disagree	2.59	2.77
Quality of courts: 1=very good; 6=very bad	3.15	2.97
Changes in laws and regulations: 1=completely predictable; 6=completely unpredictable	3.37	3.15
Helpfulness of central government today: 1=Very helpful; 5=Very unhelpful	3.0	3.02
Helpfulness of local government today: 1=Very helpful; 5=Very unhelpful	2.76	2.62
General constraint—financing: 1=no obstacle; 4=major obstacle	2.93	3.48
General constraint—corruption: 1=no obstacle; 4=major obstacle	1.93	2.13

Source: World Bank Business Environment Survey.

Table 5 Export Shares of FIEs in Total Exports of Three Economies: China, Taiwan, and Indonesia (%)

	China (1995)	Taiwan (1980)	Indonesia (1995)
Labor-intensive industries	Garments and footwear: 60.5 Leather and fur products: 73.2 Furniture: 75.1	Garments and footwear: 5.7 Leather and fur products: 9.6 Lumber and bamboo products: 2.7	Garments and footwear: 33 Leather and related products: 19.7 Furniture: 14.0
Capital or technology-intensive industries	Electronics and electrical appliances: 83.4 Paper and paper products: 53.4 Chemical materials and products: 31.6	Electronics and electrical appliances: 50.5 Pulp paper and paper products: 4.5 Chemicals: 34.9	Electric, measuring, and photographic apparatus: 78.8 Computers and parts: 91.8 Machinery and vehicle parts: 86.1 Paper and paper products: 29.8 Chemical materials: 42.3
Manufacturing industries	51.2	20.6	29.0

Sources: Chinese data are from (Office of Third Industrial Census 1997) and Taiwanese data are from (Ranis and Schive 1985, Table 2.12, p. 109). Indonesian data are unpublished and were provided to the author by the Indonesian government through the kind assistance of Timothy S. Buehrer.

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Internal and External Reforms in China

Yasheng Huang

MIT Sloan School of Management

ICCS International Symposium 2004

Aichi University

Topics:
- Internal and external reforms
- A comparison with India
- Why internal reforms matter

1

INTERNAL AND EXTERNAL REFORMS

- **Internal reforms**
  - **Rule of law**
  - **Property rights security**
  - **Financial sector reforms**
  - **Privatization**
- **Collectively known as "soft infrastructures"**

- **External reforms**
  - **FDI liberalization**
  - **Trade reforms**
  - **WTO accession terms**

2

CHINA'S REFORM PATH

- **Aggressive external reforms**
  - **Very liberal WTO agreement**
  - **Substantial investments in hard infrastructures**
  - **Financed by and to attract FDI**
- **Lagging soft infrastructural development**
  - **Internal reforms have been gradual and slow**

- **A difference in time horizon:**
  - **Building hard infrastructures has immediate economic payoffs via investment booms**
  - **The economic payoffs of building and having good soft infrastructure are less immediate and less obvious.**
  - **But the long-term payoffs are enormous**

3

SOFT INFRASTRUCTURES AND FDI

- Basic idea:
  - FDI dependency = Foreign investment / Domestic investment
  - Two ways to increase this dependency: 1) ↑ Foreign investment and/or 2) ↓ Domestic investment
- FDI literature: Why foreign investment?
  - Technology, market controls, know-how, etc.
- Selling China: Why low domestic *private* investments?
  - Political pecking order: 1) Lack of financing and 2) Lack of legal protection

4

IMPROVING SOFT INFRASTRUCTURE IN CHINA

- **Selling China (Cambridge, 2003):**
  - **External reforms far ahead of internal reforms**
  - **A pecking order that favored the least efficient SOEs at the expense of most efficient domestic private firms**
  - **Foreign firms, although restricted, were treated better than domestic private firms but worse than SOEs**
- **FDI in China: 1) some property rights security, 2) alleviating credit constraints, and 3) overcoming market access restrictions**
- **Declining role of FDI as institutions improve**

5

IMPROVING SOFT INFRASTRUCTURE IN CHINA

- **Abolition of bank credit quota in 1998/99**
- **Removing some licensing restrictions since 2000.**
  - **Direct export by private firms allowed**
  - **Privatizing housing stock and bank re-orientation**
  - **Investment restrictions enacted on a negative list principle**
  - **Greater market access**
  - **Conferring some investment incentives enjoyed by foreign firms on domestic private firms**

- **Improving the political and legal treatment of private entrepreneurs:**
  - **Communist Party represents ALL classes in the society.**
  - **1999 Constitutional amendment giving greater recognition to private sector**
  - **2004 Constitutional amendment**

6

IMPROVEMENT BUT FROM A LOW BASE

- Formal restrictions on domestic private sector have been extremely severe in the 1990s
  - – Survey after survey of domestic private businesses consistently indicate substantial credit constraints.
  - – Investment dominated by SOEs
  - – A huge perception bias (through survey of local officials): 1) Ranking of SOEs vastly exceeded SOEs' actual economic contribution and 2) Ranking of private firms vastly understated the economic contributions of private firms.
  - – The level of property rights security granted to private firms in 2004 was granted to foreign firms in the 1982 Constitution

7

AN ASSESSMENT BY TIAN JIYUN IN 2002


田纪云 (2002年3月19日)"放手发展民营经济 走富民强国之路" 《人民日报》 retrieved on June 21, 2003 from http://www.snweb.com/gb/people_daily/2002/03/19/e0319001.html

"放手发展民营经济 走富民强国之路"

田纪云 (Tian Jiyuan, former vice chairman of National People's Congress)

CROSS-COUNTRY EVIDENCE:WBES

- India is ahead of China in soft infrastructure, in property rights security and in the financial arena
  - – Honesty in tax reporting (proxy for property rights security): China at 11% (=Haiti); India at 41%.
  - – Major financial constraints on private firms: China at 80%; India at 50%
  - – China is one of the most dependent on retained earnings: 56.6% compared to India (27.1%) and Philippines (50.8%)
  - – NPLs: China at 25-40%; India at 10-15%
- India is not ahead of China in all areas
  - – Labor regulations are more rigid
  - – Tax regulations are more cumbersome
  - – Efficiency of legal system and bureaucracy are comparable

9

SUBTANTIAL MICROECONOMIC STRENGTHS OF INDIA

- CLSA's corporate governance measure
  - – India at 6th (5.4 out of 10); China at 19th (3.4)
  - – Singapore with 7.4; Hong Kong with 6.8.
  - – Taiwan with 5.3: Not due to linguistic and cultural bias
- Quality of firms
  - – Patent, quality certification measures: Indian strengths go beyond software
  - – Higher unit prices in garment exports to US
  - – Forbes List of "exciting new firms:" 1) 2002 list: 13 from India and 4 from China (all in Hong Kong); 2) 2003 list: 13 from India and 1 from China
  - – Far Eastern Economic Review ranking of leadership: Lowest Indian score is higher than the highest Chinese score (Haier)
  - – Stock market returns: Substantial portfolio investments

10

DOES IT MATTER MACROECONOMICALLY?

- Indian economy is gaining strength, despite bad fundamentals:
  - – Bad infrastructure
  - – Half of China's saving/investment rate
  - – Poorer average human capital
  - – Lack of single focus on economy
  - – Ethnic tensions and destructive social practices
  - – Cumbersome labor regulations and a 10-year reform lag
- India is NOT outperforming China overall
  - – Narrow base of excellence and low investment rate
  - – But higher quality of growth: 1) Lower NPL, 2) More energy/capital efficient, 3) Politically tested

Based on collaborative research with Tarun Khanna of HBS.

11

EVIDENCE FROM WITHIN CHINA

- Wenzhou city of Zhejiang
  - – Low score on hard infrastructure, technology, and international integration
  - – But high score on entry/exit, finance and private sector participation
- A World Bank study on firm performance in 23 Chinese cities
  - – Wenzhou is ranked number one on 1) Total factor productivity, 2) private investment growth, and 3) sales and profit growth
  - – Shanghai and Beijing with massive infrastructural investments are not ranked among top five cities in this study
  - – Similar contrast between Chengdu and Chongqing
- A tale of two provinces: Zhejiang and Jiangsu
  - – Broadly similar in the 1980s
  - – Zhejiang has substantially outperformed Jiangsu in the 1990s
  - – Zhejiang: 1) Better local firms and 2) Higher-quality and more technologically sophisticated foreign firms

12

PROJECTING FORWARD

- **Soft infrastructures and FDI**
  - **Improving micro foundation of growth is far more important than increasing FDI growth**
  - **Need to shift away from an FDI/investment mentality**
- **The costs of investment booms**
  - **Cheap capital benefits bad firms**
  - **Inflation and growing energy appetite**
  - **Worsening urban bias: 1) Investment booms and income gains of peasantry, 2) Economic payoffs of enriching peasants, 3) Dispossessed peasantry and political stability**
- **An optimistic note: Current leaders have the right visions and are taking the right steps**

13