THE CREATION AND EVOLUTION OF CHINA'S SPECIAL ECONOMIC ZONE POLICY

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Export Processing Zones (EPZs) have been used throughout the developing world as an export-oriented growth strategy since the 1960s. Following a similar path, China designated four Special Economic Zones (SEZs) – Shenzhen, Zhuhai, Shantou, and Xiamen, in the wake of the economic reform initiated in 1979 (Map). SEZs are geographically insulated but economically open areas, where special and flexible economic policies are carried out primarily to promote foreign investment, technology transfer, and exports. They were also designed, as secondary objectives, to experiment with new reform policies and a market system, and serve as buffer or intermediate zones for future reunification with Hong Kong and Taiwan.

At the time, the central government realized that China should take advantage of the global trend of industrial relocation to attract foreign investment to its capital-starving economy. Such investment would allow China to make full use of its large reserve of inexpensive rural surplus labor to produce labor-intensive goods for exports and ultimately foreign exchange earnings. The government also recognized the importance of foreign advanced technology in stimulating growth and the channel through which technology transfer often happen – foreign direct investment (FDI). So the promotion of foreign investment is not the end in itself, but a means to bring foreign technology to China. Since their creation, the central government has repeatedly stressed that the role of the SEZs is to experiment with and to digest western technology and management techniques so that inland enterprises can learn from their experience.

The locations of SEZs were carefully chosen in proximity to Hong Kong, Macao and Taiwan. It was hoped that integration with these external economies would eventually facilitate or lead to political reunification. Such proximity also proved to be a significant advantage for SEZs in their quest for foreign investment. Moreover, the experimental nature of SEZs determined that they would implement unprecedented economic policies and, undoubtedly, some policies would succeed and some would fail. The role of SEZs in the national economy would thus undergo changes and

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evolution over time as the country progressed towards further reform. The introduction of a market system into the zones would confront socialist planning with problems in both economic policy and ideological orthodoxy. For instance, one major feature of SEZs was that they fell outside the State Plan, which would affect sources of investment and supplies. They were to rely primarily on foreign and non-state sources for capital and technology to develop export production (Reardon, 1991, p. 14-20).

This paper serves as an introduction to China's SEZ policy. It will outline the shift in China's economic policies that led to the creation of SEZs, the political debate over SEZ policy, the experience of EPZs elsewhere that helped the formation of China's SEZ policy, and the legal and administrative framework established to promote foreign investment. A chronology of investment guidelines in SEZs aimed at attracting foreign investment to desirable sectors and activities will also be offered. The focus will be Shenzhen SEZ, the zone which is the largest, and has garnered the largest volume of foreign investment and received the most attention. Within fifteen years since 1979, it developed from a sleepy rural village of 3,000 residents to a booming city of over 1.2 million with the highest per capita gross domestic product in China at $2,000 (Litchfield, 1994, p. 13).

1 DOMESTIC POLICY SHIFT LEADING TO THE CREATION OF SEZS

The formation of a new open door policy around 1979 led to the creation of the SEZ policy. Such a domestic policy shift, however, was not accidental. In the mid-1970s there was already an economic policy debate in the central government. Deng Xiaoping took the lead in criticizing the old economic policies, pointing to widespread and fundamental problems such as stagnant grain production, declining industrial productivity, obsolete production technology and inadequate use of international resources. Even though at the time Deng had no real power, he still proposed to emphasize agricultural development, the acquisition of advanced technology, greater enterprise autonomy, and integration into the world economy. He also recognized that the successful exploitation of international opportunities could only be achieved if it was accompanied by domestic economic reform (Crane, 1990). By late 1978, he and the liberal reformist line finally took power and the Four-Modernization Program (industry, agriculture, defense, science & technology) was launched shortly after in an attempt to steer China toward a large-scale restructuring of its political and economic systems.

The open door policy has had strong spatial implications. From the onset of reform, it was recognized that development could not happen at all places at once, due to limited capital investment, and certain policies needed to be experimented in limited areas before they could be implemented nationwide. Coinciding with local enthusiasm, particularly that from Guangdong Province, radical reform policies were first used in the SEZs in 1979 and the early 1980s. In essence, these zones would serve as experiment stations as well as growth centers for China's new development era. Fourteen more cities were designated as coastal open cities in 1984, with special emphasis on promoting foreign investment[2]. The following year saw the declaration of the Yangtze River, Pearl River, and southern Fujian deltas as Open Economic Zones. In April 1988, the fifth SEZ Hainan was established following its newly-found status as a province. In the same year the coastal development strategy was launched, which was officially called the "outward-oriented development strategy" in the coastal areas, under the firm endorsement of the then premier Zhao Ziyang[3], (Yang, 1991, p. 42-64). This policy entailed a much larger scale and wider range, embracing twelve provinces and cities under direct control of the central government[4]. The coastal development strategy called for the more prosperous coastal provinces to be transformed into major centers of foreign economic activities and integrated with the international economy. The strong spatial orientation of the reform policy, however, was de-emphasized to some extent after the 1989 turmoil as inland areas intensified their dissatisfaction. In the Eighth Five-Year-Plan (1990-1994), the focus was placed more on the development of particular industries than regions.

The discussion of SEZs in terms of official ideological orthodoxy relied primarily on Lenin's ideas on concessions and state capitalism, developed during the period of the New Economic Policy. The central theme of Lenin's idea was a policy of inviting foreign capitalists to obtain concessions, and the granting of concessions was not considered dangerous to socialism. Following the classical tradition of Marxism, Lenin believed (Chan *et al.* 1986, p. 94):

> *[S]ocialism is inconceivable without large-scale capitalist engineering based on the latest discoveries of modern science. ... By 'implanting' state capitalism in the form of concessions the Soviet government*

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2 These fourteen cities are Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhangjiang, and Beihai. Some argue that this move was a response to the disappointing performance of SEZs in the 1980s. I believe, however, it was rather a deepening of the open policy into the vast coastal region.

3 For detailed discussion on "coastal-oriented development strategy".

4 They are Liaoning, Beijing, Tianjin, Hebei, Shandong, Jiangsu, Shanghai, Zhejiang, Fujian, Guangdong, Guangxi, and Hainan.

strengthens large-scale production as against petty production, advanced production as against backward production. It also obtains a large quantity of the products of large-scale industry (its share of output) and strengthens state-regulated economic relations as against the anarchy of petty-bourgeois relations.

The peculiar conception of a "special economic zone" rose out of discussions among individuals in Hong Kong, Guangdong, and Beijing around 1979. It was the invention of local planners who played a key role in fleshing out the details of zone policy. The Guangdong provincial Party Committee proposed to the central government that the province be given special treatment in making economic policy. The committee argued that if it were allowed to make certain modifications to central policies on foreign trade and economic management, given the advantageous location of the province, the local economy would be boosted (Chan *et al.*, 1986). This local enthusiasm coincided with the government's reorientation toward the coastal region as the priority development area. Later a central work team was sent to investigate the possibility of setting up special zones in Guangdong and Fujian. Based on this, in mid-1979 it was announced that these two provinces were to be authorized to carry out a special policy and adopt flexible measures in external economic activities. "Special" implies that zone policy may not be extended to the rest of the country. "Economic" has two meanings. First, it distinguishes China's policy from EPZs in other Asian countries; China's SEZs would not be merely export zones but would encompass a broader array of economic activities such as agricultural production and commercial activities. Second, they were not "special administrative regions". The government at the time did not want to tie the success or failure of the zones too closely to other questions.

The location of China's SEZs was carefully chosen by the central government, who paid particular attention to the surrounding regional industrial and commercial cities and financial centers, in this case Hong Kong, Macao and Taiwan[5]. There were also some political considerations which overrode the economic ones, because of SEZs' strategic locations and uncertainties related to new reform policies. As a result, these zones were not cities or regions with a very strong industrial base, an adequate urban infrastructure, and most importantly a technologically innovative milieu.

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5 This consideration can be justified by the fact that Hong Kong and Macao together has been the second largest trading partner with the mainland China since the late 1960s (next only to Japan).

First, the zones needed to be easily separated from the vast inland areas as drastically different policies were to be experimented in the zones. All four SEZs are located along the coast, which makes physical separation from the inland areas easier. Fences were build around them and check points were stationed to inspect two-way traffic. Administrative procedures have also been used to control population inflows to the zones. Non-SEZ residents need to apply for an entry permit, which is usually valid for a month for a legitimate business visit, through local police departments. Second, SEZs should not be built into major industrial center so as to avoid significant losses if the experiment ever failed. Third, there were intentions to use these zones as intermediary or 'buffer' zones for future reunification, especially with the case of Taiwan.

Last, the central government recognized that the overseas Chinese community was a force to reckon with in raising productive capital. Towns along the southeast coast in Guangdong and Fujian have been homes to many overseas Chinese and historical links would lure them back. In particular, SEZs are close to the setting-off points for three of the most important dialect groups among overseas Chinese: the Cantonese(spoken in Shenzhen SEZ and Zhuhai SEZ), who predominate in Hong Kong; the Fujianese(spoken in Xiamen SEZ), who make up 85 percent of Taiwan's population and much of Singapore's; and the Teochews from around Shantou SEZ (Overseas Chinese, 1995).

Shenzhen was in a special position to take advantage of the opening up of China to attract investment from Hong Kong. The economic complementarity between Hong Kong and Shenzhen has been very strong. Hong Kong has served as a trading partner, financier, and middleman for China, with contacts taking place in Shenzhen in particular[6], (Sung, Yung-Wing, 1991; Ash, Kueh, 1993, p. 711-745). On the other hand, Hong Kong's rapid process of industrialization could not be sustained without supplies of food, water, energy, and raw materials from Shenzhen and China, generally at prices much lower than world levels. The most important element of the economic integration was essentially in the complementarity of factor endowments. To crowded Hong Kong, Shenzhen offered space, labor and energy for expansion of its industry, services and tourism.

2 POLITICAL DEBATE OVER SEZ POLICY

Although Shenzhen is geographically far away from the center of China, it is not politically peripheral. The central government in Beijing,

6 Guangdong and Shenzhen received about 43 and 11 percent of all Hong Kong direct investment in China respectively during the period of 1985 to 1991.

the reformists in particular, has made tremendous political investment to ensure its success. First of all, it has become one of the political battlefields between the reform and conservative factions in the central government. Its success or failure was, at least in the early 1980s, determining the fate of the reform. The SEZ promoters hoped to use it not only to promote foreign investment and technology transfer, but also to learn how to adopt selected features of capitalism into the socialist reform. Shenzhen as well as other SEZs represented in miniature the very essence of the new reforms (Pepper, 1988). Second, it attracted the attention of many top leaders, who took turns to tour the zone, using it as a tool to push for further reforms at various junctures. Shenzhen has also benefited enormously from the attention of China's top leadership. Each one of the major reformist leaders, including Hu Yaobang (1983 and 1984), Deng Xiaoping (1984 and 1992) and Zhao Ziyang (1988), visited Shenzhen. In particular Deng Xiaoping, the paramount leader of post-Mao China, used his two visits to advocate new measures of economic reform and endorsed the development of SEZs several times along the way. His first trip preluded the designation of fourteen coastal open cities 1984, and second in 1992 the deepening of market reform and opening of Shanghai[7].

Third, three major work conferences were organized to formulate and adjust development strategies for the zone (1981, 1985 and 1990). The 1985 work conference made some drastic adjustments in SEZ policy and consolidated the external orientation of the zone (Guoguang, 1992), see Liu, (1992). The 1990 work conference further stressed the role of SEZs in the coastal development strategy – as the foundation, and reinforced their importance in generating foreign exchange through export promotion. Last, the central government took direct supervision of policy making and personnel appointments for Shenzhen. An office of Special Economic Zones was established within the State Council at the central level, in charge of major economic policies. Unlike other cities in China whose top officials were named by provincial governments, the center appointed for Shenzhen and other SEZs. This also gives SEZs direct access to the center, often transcending the provincial governments.

Shenzhen SEZ, on the other hand, also had been under constant attack from oppositional conservatives although it was the brain child of reformist leadership. When the national political and economic policy context was favorable, Shenzhen would enjoy enormous support from the center; when national circumstances were working against reform, it often experi-

7 It was only after the apparent success of the zones after ten years that the government was willing to push the reform into other major urban areas, such as Shanghai. See *New York Times*, 22 December 1993.

enced policy fluctuation. But because of the increasing dominance of reformists and subsequent dwindling of conservatism, only at a few times the opposition conservatives were able to collect enough clout to threaten the SEZ policy seriously. These occasions include mid-1985, when SEZ performance was linked with the Hainan auto scandal; early 1987, when the anti-bourgeois liberalization campaign roiled Shenzhen; and mid-1989, when student demonstrations for democracy shook the entire leadership circle in China (Crane, 1992). After the 1989 leadership change in Beijing, Shenzhen went through a major round of reshuffling with top officials replaced and a new team in office.

The debate over SEZ policy has also been fueled by fluctuations in the overall performance of Shenzhen, particularly in the early 1980s. In addition to the economic shortcomings such as high development costs and foreign exchange deficits, there were some serious social and political problems. These included the proliferation of smuggling, corruption and the deterioration of the socialist morale (Harding, 1987). The debate was very heated between 1984 and 1986, when the economic and social costs of SEZs, Shenzhen in particular, became apparent. The large corruption and smuggling scandal of Hainan only exacerbated the doubt of some government leaders. They began to reconsider the level of openness of SEZs toward foreign investment and the effectiveness of the special policies. The debate was resolved in late 1985 and early 1986 when central leaders agreed to cut back on state investment in SEZs. Shenzhen SEZ was also ordered to undergo a period of adjustment in an attempt to improve its overall performance.

The year 1986, therefore, witnessed large-scale policy adjustments in Shenzhen SEZ. First, measures were introduced to reduce the economic costs of the zone. There was a one-third reduction in Shenzhen's budget for infrastructure development. The central government also ordered banks to enforce strict controls on credit and loans to the zone. Shenzhen was being held to its servicing obligations and required to repay within three years of 1986 the 700 million RMB loan used for infrastructure construction (Pepper, 1988). Second, new regulations were set to limit the power of municipal officials and trading companies. One objective was to stop trade in parallel goods, whereby Shenzhen was undercutting established inland suppliers. Another was to ensure that goods imported duty-free into the zone were used there and not trans-shipped inland. A new "second line" administrative border along Shenzhen's northern boundary was also built and staffed with custom officials to prevent unauthorized shipments and smuggling. Third, efforts were made to curtail corruption and black market trading of foreign currencies. The first audit of all SEZ's enterprises was conducted to detect the allegedly pervasive practice of fraud and tax evasion.

Despite these political maneuvers and debates, the 1990 SEZ Work Conference announced that SEZs would remain the foundation of the coastal development strategy. The SEZ policy also would stay unchanged: to establish an export-oriented economy based on foreign investment, industry, and imported advanced technology to develop their function as windows between China and the outside world. Deng Xiaoping's 1992 tour of Shenzhen and Zhuhai gave the status of Shenzhen another major boost. On July 1, 1992, Shenzhen became the first city in China to be granted autonomous legislative power by the Standing Committee of the National People's Congress[8]. This move enabled the free-wheeling zone to make its own rules and regulations to cope with the needs of its fast growing economy. So in the end, it seems certain that Shenzhen will keep its external orientation so long as the Chinese government is committed to the open door policy.

3 LEARNING FROM THE EXPERIENCE OF EXPORT PROCESSING ZONES

The planning of China's SEZs has relied on, to a large extent, the experience of EPZs in other Asian countries, particularly those in Taiwan and South Korea (Pepper, 1988; Falkenhein, 1986; Wall, 1993). Since the 1960s, many developing countries have implemented an export-oriented growth strategy, custom-free manufacturing, to promote industrialization. EPZ is perhaps the most common form in which this strategy has been used. Somewhat similar to SEZs, an EPZ can be defined as an industrial enclave that engages in export manufacturing with the assistance of foreign investment and enjoys preferential treatment that is not generally available to the rest of the country. EPZs are also a direct response to the growing tide of offshore assembly by firms from industrialized countries. Using their comparative advantage of low-cost labor, most EPZs are designed to increase foreign exchange earnings through manufacturing exports, provide employment opportunities, and promote foreign investment.

Such a zone policy became attractive to the Chinese government for two principal economic reasons. First, it was the second best method, in a purely economic sense, to a free trade regime. Although there is no such thing as completely free trade, a liberal trade regime can provide an environment that facilitates flows of capital and goods, encourages competition both domestically and internationally, and allocates resources efficiently. Since

8 The norm till then was that People's Congresses at provincial levels had the local law-making power. *Far Eastern Economic Review*, 16 July 1992, p.49.

China was unable to adopt a liberal trade regime nationwide, zone policy offers the second-best and the quickest solution for export promotion through the creation of an enclave to attract FDI into labor-intensive manufacturing industries. SEZs could be used as a transitional strategy at an early stage of development to experiment with new economic policies and facilitate the opening up of the economy, a path which China has apparently followed. Second, export processing could provide a gateway to the international community for China. Indeed, SEZs were the key instrument for China to attract FDI from countries where globalization of production and industrial relocation have led to increased capital for overseas investment. With the introduction of FDI also came the opportunity for China to enter global export markets. However, some argue that as soon as China has acquired adequate know-how and exposure to export markets, the focus should be shifted from SEZs to the whole country (Klan, 1991).

A SEZ policy was also expected to offer some advantages over a large-scale nation-wide development strategy. First, they could be operated at much lower costs than some other alternative ways of attracting foreign investment including infrastructure upgrading, given that China lacks adequate infrastructures and the resources for large-scale development. The administrative costs of operating a few zones are also lower than streamlining the entire bureaucracy, since China also suffers from antiquated bureaucracy. Second, SEZs presented a smaller domestic political risk, compared to opening up the entire country to foreign participation. Here the issue of national sovereignty becomes relevant. Allowing foreign investment into the entire territory of China not only may present a threat to the domestic economy but also could stir up widespread resentment and political resistance. By physically separating SEZs from the vast inland areas, the Chinese government hoped to have a greater control over the extent foreign investment can penetrate its economy. Furthermore, the separation helps slow down the spread of capitalist ideology into the vast socialist territory.

The experience of EPZs, particularly those in Asia, can serve as a useful reference for evaluating China's zones (Anirahmadi, Wu, 1995). EPZs in South Korea and Taiwan, as well as Malaysia to some extent, are widely considered to be performing quite satisfactorily. The major gains have been in areas of employment and foreign exchange earnings. The zones in South Korea and Taiwan realized their full planned capacity shortly after they were established. The share of foreign investment remained high and most products were exported. Some domestic linkages also have been established and domestic value-added in exports has been increasing over the years. In Taiwan, local supplies of materials and equipment meet almost half of the needs of industries in the three EPZs. Technology transfer occurred largely through training of workers. In addition, Kaohsiung EPZ in Taiwan has aided in the modernization and development of its surrounding region.

There are various factors behind the relatively satisfactory performance of these zones. Two of them are critical, which often do not exist in most other zones in Asia. First is a successful overall national industrialization strategy in the host countries, on which the success of zones depends. For instance, in South Korea, EPZs were established at the time when the country had just formulated its national industrialization strategy and made considerable headway in its export-oriented policy: a realistic exchange rate, a partially liberalized trade regime and a low inflation rate. These conditions paved the path for the success of EPZs, not the other way around. The second factor relates to the nature of governments in South Korea and Taiwan: they have successfully played the role of a developmentalist state through strong interventions. They have had the legitimacy and ability to discipline the private sector and labor force by setting performance standards, providing subsidies, and controlling trade union activities, particularly in the early stage of development. But they also allowed the growth of the private sector, which was the engine of the rapid economic growth.

Despite some similar characteristics between EPZs and SEZs, such as custom-free manufacturing, export orientation, spatial enclaves, and preferential treatment, China's SEZs have some very distinctive features. They differ from other Asian EPZs in four major ways. First, most Asian EPZs have been developed in free market economies. China, by contrast, has its own form of socialism and central control was very evident when SEZs were first designated and throughout the 1980s (Phillips, Yeh, 1989; Wong 1985). Second, the objectives of the zones differ. The most important primary goals of the Chinese SEZs have been to attract foreign investment, earn foreign exchange via exports, and encourage technology transfer. They were to play the role of "four windows" of technology, know-how, management skills, and open policy for the rest of the country. Employment generation is only a remote secondary objective. In fact, the then premier Zhao Ziyang noted during his tour to Xiamen that SEZs were not being developed for the purpose of providing jobs[9]. Other EPZs, while also aiming at attracting foreign investment and earning foreign exchange, have given priority to employment generation. Technology transfer is only a subordinate purpose. Third, the development of the Chinese SEZs has proceeded with emphasis not only on industrialization but also on agriculture, tourism, commerce and services, real estate, and science and education – a comprehensive nature.

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9 Zhao also noted that SEZs also should not go solely after increases in their output value (Falkenheim, 1986).

Fourth, the Chinese SEZs are usually much larger in scale than other Asian EPZs. Therefore, SEZs surpass being simply EPZs and can be considered as growth centers, particularly when three SEZs were later integrated into a larger regional framework – the Pearl River Delta region.

The rationale behind the concept of growth center, which channels development resources and efforts to a few favored places, is that it is impossible to develop everywhere at once. This is especially true in developing countries, where such resources and efforts are scarce. A growth center strategy may then be pursued with the aim of maximizing national as well as regional growth (Dewar *et al.*, 1986; Glasson, 1978). A process of spread or trickle-down effects is often implicitly associated with the growth center concept, which should in time radiate the dynamic growth of these centers into the surrounding regions. Such spread effects seem very appealing to policy makers and regional planners and, as a result, growth center strategy has been used in many developing countries. For China in the open-door era, since an overall development of export industries was not feasible, a pragmatic alternative would be the creation of special policy areas to allow the growth of competitive export industries through joint ventures. But there would be a potential danger in viewing SEZs as growth centers. While the zones could be expected to produce a trickle-down effect in the future, this may never happen. On the contrary, SEZs may have the tendency to become isolated enclaves whose development can be disjointed from the domestic economy and does not benefit the surrounding regions.

4 ESTABLISHING ADEQUATE LEGAL AND ADMINISTRATIVE FRAMEWORKS

In order to attract foreign investment to SEZs, China needed to establish an accommodating legal system and to streamline administrative procedures to cut down redtape. In particular, an adequate legal system that conforms to international standards would be essential for foreign investors, which was virtually absent in the country before it opened up. Since 1979 the central government has made great efforts to protect the legitimate rights and interests of foreign investors in China. An entire article addressing this was added to the new Constitution passed in 1982, as the legal system for foreign investment is governed by the Chinese Constitution. The central government has signed treaties on the mutual promotion and protection of investment and agreements to avoid double taxation and prevent tax evasion (Shenzhen Municipal Government, 1991). In addition, it has signed various foreign trade agreements, such as accords on industrial and technological cooperation.

Compared to other Chinese legal branches, the area of foreign investment is in fact better developed (Pearson, 1991). There are now three major laws governing foreign investment at the national level. The 1979 Joint Venture Law marked the beginning of legislation on foreign investment. This law applied to all forms of foreign investment, although joint venture was viewed then as the basic form. The law legitimated the right of foreigners to invest and profit. It contained fifteen articles addressing such fundamental areas as legal status of joint ventures, foreign capital contribution, labor management, foreign exchange, taxation, and dispute resolution. Since it was the first such law in China, the 1979 Law was ambiguous in many aspects and vague in operational details. In September 1983, the second major law was released – the Joint Venture Implementation Regulations. The main purpose of these regulations, which were much more complicated and specialized than the 1979 law, was to improve the investment environment primarily by clarifying the rules. These regulations, in particular, provided greater detail about the government's policy on such important issues as profit repatriation, technology transfer, and foreign exchange. The third major law came out in 1986 – the Provisions for the Encouragement of Foreign Investment. The 1986 Provisions went beyond the 1983 Regulations by liberalizing many aspects of the investment environment. The most significant aspect was that special incentives were designed to encourage investment in advanced technology and export sectors. The 1986 Provisions also offered further guarantee for the autonomy of joint ventures and relaxed requirement on borrowing short-term loans from the Bank of China. But the 1986 Provisions on wholly foreign-owned enterprises did not exclude the possibility of nationalizing or expropriating these enterprises when special circumstances arise.

SEZs were certainly under the guidance of these national laws, but the zones also had the privilege to go further to induce investment. The Fifteenth Session of the Standing Committee of the Fifth National People's Congress in 1980 ratified the Regulations on Special Economic Zones in Guangdong Province, providing SEZs with legal guarantee for development. These regulations clarified the nature, role, and goals of SEZs. They also allowed SEZs to offer preferential treatment to foreign investors in order to promote foreign investment and technology transfer. They defined the legal status and incentives available to foreign investors, as well as obligations and responsibilities. In addition, more regulations were issued concerning general policies on SEZs. One critical development happened in 1981 when the central government decided to give Guangdong and Fujian provinces the power to make laws or regulations on SEZs, in an attempt to accelerate the development of SEZs. The Shenzhen Municipal Government has since formulated more than thirty regulations on foreign investment, most of which were approved by Guangdong Provincial People's Congress. These include regulations on land control, business registration, personnel entry and exit, labor and wages, foreign real estate, technology transfer, and foreign contracts (Wong, Chu, 1985; Herbst, 1985). Shenzhen SEZ has been the forerunner of much important economic legislation in China.

Compared to the rest of the country, administrative procedures for contract approval were reduced substantially in Shenzhen SEZ. The lines of authorities and their responsibilities also were relatively well defined. The municipal government had direct access to provincial and central government officials for approval of special contracts without having to go through ministries. It could approve contracts up to $30 million in light industry, $50 million in heavy industry and $100 million in other sectors, a power not enjoyed by most other cities[10]. Only projects over this amount or those with special purposes, such as transferring high technology or producing import substitutes, needed to be approved by the central government. However, the contract approval process was still complicated and slow compared to western standards, involving several authorities and taking anywhere between four months to two years. It was not until early 1993 that Shenzhen SEZ finally implemented an one-stop approval procedure for foreign investors, which was practiced by many EPZs in other Asian countries from the onset.

A package of preferential incentives was also offered to foreign investors. They enjoyed one of the lowest corporate income tax rates in the world, at 15 percent, and most generous tax holidays, up to five years. Enterprises excelling at export production and using advanced technologies could claim even longer periods of tax exemptions or reductions. To boost export performance and ultimately foreign exchange earnings, SEZs exempted value-added tax and duties on exports by foreign invested enterprises, and duties on imports of capital goods and materials to be used for export production. Unlike elsewhere in China, wholly foreign-owned enterprises were allowed and a new labor contract system was initiated in the zones. To partially overcome the inconvertibility of the Chinese currency, the first currency swap market in the country was set up in Shenzhen in 1986, which allowed the widest access by both foreign and Chinese enterprises. Compared to elsewhere in China, foreign invested enterprises in SEZs also enjoyed the most favorable retention rates of their foreign exchange earnings. There were additional preferential treatments in the areas of land use fees and profit repatriation.

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10 Only the city of Shanghai and Tianjin had the same power as SEZs and other cities could only approve contracts under $10 million.

In the early 1980s, the key organizational unit for foreign investment was Shenzhen SEZ Development Corporation, which was established in 1981 and sponsored by Guangdong Provincial SEZ Development Corporation. It acted on behalf of the Shenzhen Municipal Government as a medium for foreign and Chinese investors coming to Shenzhen SEZ, particularly in such sectors as infrastructure, transportation and communication. It was also responsible for seeking appropriate Chinese partners for joint ventures. Since 1984, Shenzhen Bureau of Economic Development became the unit most responsible for foreign investment, especially two departments in the Bureau – Sectoral Planning Department and Investment Clearance Department. Shenzhen Bureau of Economic Development also oversaw the economic planning of the zone, including both foreign and domestic investment projects. The Sectoral Planning Department controlled the amount of investment distributed to the various sectors of the zone. It also coordinated investment projects to avoid wasted efforts in any one specific sector[11]. For instance, each year it planned the number of foreign invested enterprises that were allowed to be established in any sector or branch, and it had the power to approve or disapprove an investment proposal. The Investment Clearance Department would then examine the contract and other required documents, and make a decision on the approval or disapproval of the contract.

With the newly implemented "one-stop" contract approval process, Shenzhen SEZ Administration for Industry and Commerce has become the most powerful organization in handling foreign investment in the zone. In accordance with China's regulations, contracts could only be altered or dissolved with the consent of the approval unit. This power was also given to the Administration, and it had the authority to supervise the realization of a contract, mediate disputes arising from a breach of contract, rectify illegal conduct by both parties, and if necessary impose fines. Another organization, Shenzhen Municipal Investment Promoting Center, also had an important role in promoting foreign investment. It is an investment service organization established by the municipal government to facilitate the investment process. It provides foreign investors with a variety of services, such as finding a Chinese partner, preparing contract documents, facilitating communications among enterprises, and providing legal consultation.

5 SEARCHING FOR EFFECTIVE INVESTMENT GUIDELINES

While the adequate legal and administrative framework was gradually in place, the implementation of effective investment guidelines, to

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11 This function was actually lost after the establishment of the "one-stop" investment approval procedure in 1993.

attract foreign investment into desirable sectors and activities, proved to be difficult. It was proposed from the onset that manufacturing industry should be the key production activity and basis of the zone's economy. The following industries or products were to be restricted for investment: products with high output, but limited markets; low-end products made of raw materials in short supply in China; non-export products processed with imported raw materials; products using obsolete technologies, consuming large amount of water or energy, or causing serious environmental problems; labor-intensive, low-end products processed with imported raw materials; and products proclaimed to be obsolete (Shenzhen Municipal Government, 1991). Those investment projects that had detrimental social or economic impacts, were heavy environmental polluters, or were hazardous to public health were forbidden. But to attract overseas capital and to launch the zone, the interests of investors were often given higher priority and greater consideration than the needs of the zone. This was particularly true in the beginning when many compatriots from Hong Kong aimed to take advantage of the real estate market in Shenzhen. As of mid-1981, the zone was experiencing a real estate boom as a result of the concentration on property development. But the 1982/83 Hong Kong property market slump forced a hard fact upon zone officials. Restrictions were imposed on direct investment in residential buildings, and it became quite evident that the zone had to shift its development priority back to industry (Chan, Kwok, 1991). Early in 1982 the zone amended its incentive package in order to appeal to foreign investment in manufacturing.

The 1982 Shenzhen Social and Economic Development Plan was the first major effort to specify the directions of industrial development. The plan conceded that although a large portion of investment would be used to finance infrastructure, public utilities and housing, industrial development would account for the lion's share of all economic activities. It was also expected that manufacturing industries would generate a significant amount of employment and absorb about 40 percent of the total labor force (Wong, 1985). Several industrial groups were selected as the priorities, including light consumer goods, textile and garment, electrical goods and electronics, food and beverages, metal and machinery, furniture, and crafts (Sit, 1988)[12]. But the magnitude of industrial growth since then was still small, partly because of the low level of industrial capability of the zone and the surge of retail and service activities. Retail, in fact, became a very profitable pursuit as the result of price differentials between the

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12 As a legacy of the old socialist planning system, this plan also reflected a emphasis on such heavy industries as metal and machinery in order to be self-reliant. (Sit, V. F. S., 1988).

zone and inland areas. In addition, the rising number of organized tours from inland areas to the zone in 1983/84 caused a temporary shortage of hotel accommodation, which brought about a big wave of hotel development in the following year (Huozhao, 1990).

By 1985/86, the zone had come to a turning point and displayed a similar pattern of problems as in 1982: hyper-growth in capital construction, exceedingly large amounts of investment in hotel and tourism, rising trade deficits as a result of large domestic sales, and stagnation in manufacturing capacity at the level of rudimentary processing. The subsequent policy changes forced upon by the central government through the 1985 work conference reaffirmed the external orientation of the zone and the emphasis on industrial development[13]. Three goals were set for the zone: at least 50 percent of total industrial investment from external sources; at least 70 percent of total commodity output exported; and a favorable balance in foreign trade (Liu, 1992). These changes played a crucial role in promoting a significant growth in industrial investment after 1986, because again industrial development was weighted over trade and services[14]. As Liu asserted in the conference report:

> *Only [by] develop[ing] industry can [SEZs] integrate foreign funds, technology, knowledge, and management with Chinese realities and assimilate, change, and innovate them so they can be passed on to the interior; only so can [SEZs] bring primary products from the interior, and process and package them according to world market needs with the foreign technology and equipment* (Liu, 1992, p.12).

New standards were thus set for industrial development: output of industries using modern technology to manufacture new products should make up 20 percent of the zone's gross value of industrial output, that of traditional industries using updated technology 60 percent, and that of labor-intensive traditional industries limited to less than 20 percent. It was also recognized some processing/assembly activities, particularly in the electronics industry, had grown rapidly at the expense of other industries. As a result, investment in these activities was controlled since then. By early 1994,

13 However, some of local officials did not quite favor the idea of an exclusively outward orientation, while the central government seemed firmly committed. See Fewsmith (1986).

14 As a result, foreign investment in construction, hotels, real estate, and tourism went down drastically in 1986 and 1987.

no more incentive packages were offered to foreign investors involved in pure processing and assembly operations as well as compensation trade[15].

The zone government made a major change in its investment guidelines in the early 1990s, which proposed tertiary sectors as the pillar of the zone development with advanced industrial activities as the base. The rationale was that the first decade of Shenzhen's development had laid a solid foundation for the local economy and paved the way for a new phase. The zone needed to be further integrated with the international market and become a multi-functional trading center. Shenzhen also has some irreplaceable advantages in developing tertiary sectors: its proximity to Hong Kong – the regional center of trade and finance, good transportation and communication facilities, and the privileged status granted by the central government in making economic policy. The development of the financial sector in the zone clearly benefited from these advantages. The Shenzhen foreign exchange center (swap market) was among the first established in the country and was allowed the widest access for both foreign and domestic enterprises. In 1991, Shenzhen Stock Exchange was set up and, together with Shanghai Stock Exchange, was the only such stock market in China since Tianjin exchange was shut down in 1952. The zone also will concentrate on technology-intensive industries, such as electronics and micro-electronics, software, bio-engineering, new materials, and refined chemicals, and push out most of the heavy and labor-intensive industries[16]. Moreover, foreign investment in other service sectors including banking and insurance, retail and services, transportation and communication, and real estate grew substantially toward the end of the 1980s.

6 SUMMARY

The creation of the SEZ policy and the subsequent establishment of four zones in Guangdong and Fujian Provinces were a direct response to the changes in China's economic policies around 1979. After breaking up with the Soviet Union in the late 1950s and being closed economically and politically for over two decades, China for the first time opened its door to the outside world. This drastic reorientation, coinciding with local enthusiasm from Guangdong Province, paved the way for the

15 *Foreign Broadcast Information Services* (FBIS-CHI-94019), 28 January 1994, p. 43.

16 Shenzhen Commercial News, March 17, 1992.

development of the SEZ policy aimed at using special zones primarily to promote foreign investment, technology transfer, and exports. In the meantime, the amount of foreign investment associated with offshore assembly and processing was increasing globally as a result of the need of many manufacturing firms in both industrialized and some developing countries to relocate to lower-cost production sites. Learning from the successful experience of EPZs in some Asian neighbors, the Chinese government realized that it should take advantage of its vast reserve of low-cost rural surplus labor to engage in export manufacturing.

In order to attract foreign investment, China needed to create a legal framework that would be comparable to international norms and to cut down drastically official redtape often associated with a planned system. However, the central government was not ready to adopt new economic, legal and administrative rules nationwide. The inevitable comprise was the relative autonomy and flexibility granted to SEZs in policy – as well as law-making. A generous incentive package was designed to lure foreign investors. The government also devised investment guidelines, but their implementation proved to be difficult. The goal to attract foreign investment to desirable industrial sectors and activities was often compromised by the desire to please prospective investors, who were primarily interested in speculative real estate investment during the early 1980s. The situation improved significantly after 1985/86 when Shenzhen was forced by the central government to concentrate on industrial development. These policy maneuvers paved the way for a rather successful performance of SEZs in promoting foreign investment in the decade to come.

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