
RESEARCH NOTES

Rhetoric and reality in international business: a note on the effectiveness of incentives

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Government incentives abound. It is hard to find a Government that does not offer tax incentives or subsidies for either savers or investors. A survey by Price Waterhouse found that one half of 54 countries surveyed offered a tax holiday for investors. Brazil has more than 117 fiscal incentives. And incentives have important budget implications: according to André Blais, the foregone revenue from the 51 tax advantages provided Canadian firms amounts to almost 2 percent of GNP (Blais, 1986, p. 52).

Many researchers have concluded that Government incentives do not work. For example, Helen Hughes and Graham Dorrance argue that: "it has . . . been known for some time that give-away incentives such as tax holidays are not effective in attracting [foreign direct investment] and yet are costly, particularly when developing countries compete against each other." (Hughes and Dorrance, 1987, p. 52).

Other researchers have reached the opposite conclusion. And the proliferation of incentives in so many different countries suggests that somebody believes they work.

The present note argues that language is a major stumbling block in resolving those controversies, not lack of analytical cleverness, econometric finesse or adequate data. Economists do not interpret "incentives" and "effectiveness" the same way and they are not communicating clearly enough to reach consensus on their findings. Readers cannot compare the findings of empirical studies on incentive effectiveness because researchers employ different standards in defining incentives and measuring effectiveness. Readers are trapped in a *dialogue de sourds*. The fault lies neither in the models nor the data, but in rhetoric. The present note argues that the conclusions of many empirical studies about the effectiveness of incentives

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owe more to persuasive rhetorical devices than to hard evidence or economic theory.

Rhetoric matters

George Orwell once noted:

“Now, it is clear that the decline of a language must ultimately have political and economic causes: it is not due simply to the bad influence of this or that individual writer. But an effect can become a cause, reinforcing the original cause and producing the same effect in an intensified form, and so on indefinitely. A man may take to drink because he feels himself to be a failure, and then fail all the more completely because he drinks. It is rather the same thing that is happening to the English language. It becomes ugly and inaccurate because our thoughts are foolish, but the slovenliness of our language makes it easier for us to have foolish thoughts. The point is that the process is reversible.” (Orwell, 1954, p. 163).

This unvirtuous circle of rhetorical degradation has invaded business research like a computer virus. Ambiguous definitions and unexamined assumptions circulate unchallenged through the network of scholarly publications and attach themselves to each new piece of research. Confusion and misunderstanding grow at exponential rates.

Orwell is right. The process is reversible with recourse to proper filters to identify and trap the virus before it spreads. To do that, rhetoric must be given more attention. Not that rhetoric can replace method or data in international business research. But much greater attention to the devices of literary persuasion can actually improve analysis and expose bad arguments. As Don McCloskey has noted in his *Rhetoric of Economics*:

“Rhetoric, then, might be a way to look at economic talk, and a way to make it better. . . . Were economists to give up their quaint modernism and open themselves officially to a wider range of discourse, they would not need to abandon data or mathematics or precision. They would merely agree to examine their language in action, and converse more politely with others in the conversations of mankind.” (McCloskey, 1985, p. 35).

Bad rhetoric mars studies of incentive effectiveness

Studies of incentive effectiveness are a good place to examine the uses of rhetoric in international business research. Research on this topic has a

clear target. Incentives either do or do not work. Data are not hard to find. All Governments use incentives, which directly influence investors, and most have varied their incentives over time. Persuading the reader that incentives do or do not work ought to be easy.

None the less, there are bumps in the road. Many factors influence investors' decisions; incentives are only one of several cost factors involved. Moreover, Governments often grant several incentives simultaneously to the same project. And no single measure condenses their effects into a simple index the same way, say, that the effective rate of protection registers the effects of trade barriers.

Some researchers have deployed rhetorical devices in an attempt to skirt the plurality problem. They have concentrated on just one incentive instrument to the exclusion of others, using a rhetorical device known as synecdoche—taking a part for the whole. But what is valid rhetorically is not necessarily valid economically. Synecdoche in economic terms amounts to model misspecification. Economic theory teaches that the value of an entire incentive package, not just one instrument, governs investment profitability. In countries like Brazil with 117 different fiscal incentives, the variety of instruments understandably puzzles researchers. Lacking time, patience or resources, researchers too frequently resort to oversimplification of a complex research problem by limiting inquiry to just one instrument. Yet they become trapped by their own tropes, convincing themselves that the part really is the whole. They confuse the tree with the forest.

Arthur Schopenhauer once said that “it would be a very good thing if every trick could receive some short and obviously appropriate name, so that when a man used this or that particular trick, he could at once be reproved for it”. (Fernside and Holther, 1959, frontispiece). That stage has not yet been reached, but rhetorical sleight of hand is frequently encountered in research.

Consider, for example, the statement of Hughes and Dorrance quoted earlier. They employed several rhetorical devices to persuade the reader. The principal device was “appeal to authority”, by quoting authorities so numerous and exalted that they communicate with the reader anonymously and behind the veil of the passive voice. Another device is “question-begging”. “Give-away” prejudges the issue. It glosses over the key question that Hughes and Dorrance sidestep: do the gains from incentives exceed the costs? The final device is “faulty generalization”. Do the authors mean to

say that an incentive, or indeed any expenditure, is ineffective if it is costly? The essence of any incentive—indeed any public expenditure—is that a Government gives up something valuable. Hughes and Dorrance deflect the reader's attention from the cost-benefit question towards the intellectual cul-de-sac of costless incentives.

B. A. Mukherjee's study of foreign direct investment in India provides another example of rhetoric gone astray. "Even if . . . incentives are not a major factor influencing an investor's decision, once tax incentives have been freely given by neighbouring countries, it may be difficult to withhold them." (Mukherjee, 1987, p. 174).

The logic is hard to follow. Like Hughes and Dorrance, Mukherjee sees Governments compelled by competitive pressures to offer incentives, even though incentives are, allegedly, not effective. Mukherjee is not alone in depicting Governments throwing money after foreign investments, even though researchers claim that incentives make no difference to investors' decisions.

This is a modern variant of the irrational expectations imputed some years ago to farmers by economists expounding cobweb theorems. Now economists realize that consistency in economic theory requires farmers, on average, to be as rational about their investments as they are about their own consumption. Unless Mukherjee, Hughes and Dorrance and others develop a theory of selective irrationality for policy makers, their conclusions are themselves inconsistent. If tax holidays do not matter, then Governments surely have no rational reason to copy other Governments. If they do copy, then tax holidays must make a difference.

What is the meaning of effectiveness?

Part of the rhetorical problem in interpreting incentive studies lies in the vagueness of the term "effective" and its synonyms. Some economists, such as Dan Usher, have correctly dodged the ambiguities of "effectiveness" by spelling out exactly what variables change in response to incentives. But Usher's precision leads him to exasperation.

"There is reason for supposing that a programme of incentives might encourage investment to some extent, and that the amount of net investment actually recruited by an incentive programme is substantially less than the amount of investment in receipt of incentives. We are completely at a loss when it comes to estimating what precisely the impact of incentives on investment might be." (Usher, 1977, p. 144).

Usher concludes that, since Governments know so little about the immediate effects of incentives or their future economic and political ramifications, they would be wise to avoid their use. The reader does not come away from his study with the view that incentives are a good thing.

“The more one considers the multiplicity of the effects of tax incentives upon the host country and the uncertainty surrounding all of the alleged costs and benefits—the problem of redundancy, the room for error in the choice of investments to subsidize, our inability to determine whether the demand for labour is increased or even to say whether tax collections increase or decline, the risk of an eventual revulsion against privileged foreign and local investors—the more difficult it is to balance off costs and benefits of an incentive program to the host country as a whole, and the more important does it become to consider the advantages and disadvantages to the different social classes or interest groups within the country.” (Usher, 1977, p. 146).

Grant Reuber’s study provides one of the most thorough, thoughtful and lucid accounts of the foreign investor’s decision-making process. Reuber based his conclusions on two types of empirical information: a survey he and his associates conducted of 80 investment projects, and a review of published research on incentive effectiveness. Incentives were prevalent among the surveyed firms: one half enjoyed tax relief and one quarter received accelerated depreciation.

Did incentives make a difference? Reuber notes that, “. . . while some respondents felt that incentives made little or no difference to whether the project was undertaken or not, this was true of *only 10 out of a sample of 69 responses*” [emphasis added]. (Reuber, 1973, p. 128). Reuber leaves the clear impression that 59 respondents believed incentives made a difference. Reuber also stated that:

“The survey evidence . . . indicates that incentives have had some effect on decisions about where to locate projects among the LDCs. The most important of these seem to be tariffs and quotas on competing imports, concessions on imports of inputs, and tax concessions [emphasis added].” (Reuber, 1973, p. 128).

But Reuber then goes on to say that:

“It is evident that incentives are of some importance, particularly those provided via trade policy and tax measures. On the other hand, most firms are acutely aware of the difficulties posed by such incentives and frequently assert that they are reluctant to undertake projects that are heavily dependent for their success upon the incentives provided by the

host country. How important this is depends on whether the incentives provided are general in nature or specific to particular industries or projects. In the latter situation, the bargaining power of the investor inevitably is weak relative to that of the host country and the long-term future of the project from the investor's viewpoint is subject to considerable risk. This in turn provides an additional reason for inefficiency in the incentive system and relatively small responses in capital flows to the incentives provided." (Reuber, 1973, p. 129).

After fairly encouraging statements about incentives based on his own survey as well as previous research, Reuber concluded that:

"The evidence assembled in several studies on the effectiveness of incentives in attracting foreign investment to the LDCs is somewhat inconclusive, in large measure because of the many elements affecting the investors' decisions and the difficulty of separating out the partial effect of the incentives provided. Nevertheless, these studies generally suggest that the incentives provided, while of some consequence in stimulating the inflow of foreign investment, were relatively ineffective." (Reuber, 1973, p. 131).

Reuber's choice of "ineffective" in this last sentence deals a fatal blow to the idea that incentives work. And its modifier, "relatively", raises more questions than it answers. Relative to what? The term "relatively" occurs frequently in Reuber's prose — "relatively small responses in capital flows", for example. What is "relatively small"? Reuber admitted that incentives are of "some consequence", but, where are the standards to mark the distance from the benchmark? What separates effective from ineffective? Why was little weight given to the 59 of the 69 survey respondents, who said that incentives were *more* than of little or no consequence? When does 59 of 69 become a large and significant response? How large is large? Donald McCloskey noted that: "What is remarkable about this obvious question is how often it is not asked. The question of how large is large causes great embarrassment, for example, when economists and other social scientists pretend to advise." (McCloskey, 1985, p. 141).

Those rhetorical issues are not inconsequential. Many economists have advised Governments that incentives are not "effective" by citing Reuber's landmark study. For example, Udom Kerdpibule and Eric Ramstetter cited Reuber's study to support their assertion that "incentives are generally not significant determinants of [foreign direct investment] flows into LDCs". (Kerdpibule and Ramstetter, 1988, p. 11). Reuber's findings were carefully hedged and at best ambiguous. How many economists could read Reuber's

study, especially the passages cited above, and agree with Kerdpibule and Ramstetter's statement? Would each have the same standard of significance in mind? How many would find it curious that 59 (out of 69) instances where incentives made a difference do not even qualify as a factor in Reuber's scale of effectiveness? What if Reuber had written that incentives were "only somewhat effective" instead of "relatively ineffective"? Would more economists disagree with Kerdpibule and Ramstetter's statement? Would Kerdpibule and Ramstetter have changed their conclusion?

Note how Kerdpibule and Ramstetter also deploy a hidden yardstick. "Generally", the reader assumes, means often but not always. What level of frequency would make incentives significant? Incentives, they concluded, are determinants, but not "significant" ones. Where does insignificance end and significance begin? Does their "not significant determinants" mean the same as Reuber's "relatively ineffective"? Here again McCloskey's insights are telling.

"For reasons that are not clear . . . scholars are notably reluctant to exhibit their scales for public test and adjustment. . . . The last step of most calculations in economics or history is sleight of hand, the more convincing because the magician performs it so absentmindedly." (McCloskey, 1985, p. 143).

The meaning of effectiveness needs clarification

"Effective", has become a weasel word. If "effective" ever had widely-shared agreement on what it means, it does not have it now. The word "effective" is no longer effective—it is not even relatively effective. Writers have pushed around its meaning to suit their persuasive purpose. The perplexed reader can find at least five distinctly different meanings of "effective" in the literature on incentives.

1. Absolute effectiveness—this is perhaps the traditional meaning. Absolute effectiveness means that incentives cause something to happen. It means only that a change in incentives leads to a change in investment levels.
 2. Relative effectiveness *vis-à-vis* goals—this meaning adds to absolute effectiveness the notion that the benefits from whatever happens exceed the costs of incentives. "Ineffective" means that costs exceed benefits.
 3. Relative effectiveness *vis-à-vis* other instruments —this meaning adds to absolute effectiveness the notion that incentives are more efficient in achieving the goal than other policy instruments.
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4. Effectiveness over time—in this usage, incentives can be relatively effective (either version) at first, but lose relative effectiveness over time.
 5. Periodic effectiveness—this version acknowledges that incentives are not necessarily effective (versions 1 to 4) every time they are applied, but often enough to be regarded as worthwhile.¹ Implicit in this version is the assumption that incentives are effective only under certain conditions.

A troublesome aspect of researchers' rhetoric is the desire for the sweeping generalization. Researchers seem to want only definitive judgments. They dodge discussions of critical conditions, preferring clear-cut, but ultimately misleading, conclusions. Why are researchers uncomfortable with the phrase "it depends"?

Of the writers cited, Hughes, Dorrance and Mukherjee employ version 4 (or perhaps 5); Reuber, version 2; and Usher, version 1. With multiple meanings clouded further by qualifiers such as "relatively" and "generally", it is impossible to know if these authors agree on anything. Would they agree, for example, that incentives are absolutely effective (version 1) but disagree (or agree?) about other versions? Downstream scholars who synthesize the works of these and other researchers on incentives, such as Kerdpibule and Ramstetter, perpetuate and even multiply the confusion by adding their own qualifiers. Why has this come about?

Why has the meaning of "effectiveness" become obscured?

Can Orwell be right that political motives lie behind the lack of clarity in writing on incentive issues? Can it be that economists prejudge incentives based on their view of the proper role of Government, not on empirical evidence? Can it be that a few economists writing some years ago about effectiveness strayed from the path of scientific method and the scholarly literature on incentives now amounts to accretions of compounded error and sloppy thought?

For some time, this author has believed that some researchers have developed a bias against investment incentives for reasons more related to the emotive power of language than to economic theory or the conclusions of empiri-

¹ The author is indebted to Louis T. Wells, Jr. for emphasizing, in correspondence with me, that incentives may be effective only under certain conditions. He argues that if researchers avoid discussion of these conditions, their conclusions will be far less useful than they should be.

cal research. To those researchers, the notion of a tax concession implies a yielding by Governments to powerful business interests. The noun "holiday" used to describe one form of these concessions conjures up images of insouciant investors enjoying unfair advantages at taxpayers' expense. The same researchers, who do not approve a Government "marking down" its tax rate to attract investors, would almost certainly applaud a department store that marked down its prices to reduce inventory. In fact, the effective taxes paid in a country with a tax holiday may approximate those of another country without any holiday. Whether higher statutory tax rates accompanied by tax holidays are preferable to uniformly lower tax rates is an open question. Economists seem to prefer "every-day-low-price" strategies for Governments, while marketing scientists would probably recommend "mark-down, sales-price" strategies if the net revenue implications for government were the same. Because of their narrow disciplinary focus, economists overlook the value of marketing strategies when making tax policy recommendations.

Other economists worry that discretionary incentives in the hands of vulnerable bureaucrats lead inevitably to corruption. It is easy for those economists to deny the efficacy of incentives if that will lead to the elimination of rent-seeking opportunities for corrupt parties. Finally, some economists take as an article of faith that most, if not all, incentives are redundant, that is, firms would invest either without incentives altogether or incentives less valuable than those provided. Part of this faith rests on the largely unexamined assumption that taxes form a small part of costs and changes in tax rates have little effect on financial rates of return. That assumption is incorrect for the labour-intensive investments that developing countries attract. Tax elasticities of two are not uncommon: a decline in the effective corporate tax rate by 20 percent leads to a 40 percent increase in the after-tax rate of return to equity investors.

Economists who believe that tax incentives are redundant would do well to recall Reuber's 59 investors (out of 69) who said they made a difference. Too many judgements about tax incentives come from a priori reasoning and not enough from careful analysis of what investors actually do.

Rhetoric can deflect attention from important issues

What about surveys that show incentives ranked far down the list of factors investors consider when making an investment? Many such surveys exist, but a particularly good example was the one conducted by the Group of Thirty in 1983. Rhetorical devices are at work here to direct the reader's

attention in a predetermined way. The Group of Thirty surveyed 52 companies that controlled and managed, according to them, almost one half the world's stock of foreign direct investment (Group of Thirty, 1984, p. 2). They concluded that:

“Tax ‘advantages’ and ‘inducements offered by the host country’ were regarded [by the respondents] as unimportant influences on investment decisions, though some companies stressed that specific inducements could, on occasion, tip the balance of a decision in favour of investment in a particular country if all other conditions were satisfactory — which was, however, rare.” (Group of Thirty, 1984, p. 32).

Surveys are convincing to the extent that they reflect the respondent's authority. If 52 of the world's largest investors say that tax advantages and other inducements are unimportant, then that should be considered definitive.

In order to appreciate the rhetorical deflection implicit in that approach, however, the reader should understand how the survey responses were compiled. The survey instrument asked respondents to choose the six most important influences on foreign direct investment from a list of 20 and then rank them. The Group then computed the percentages of respondents that listed each of the 20 items in the top three. Eighty-seven percent of the respondents listed “access to host country's domestic market” in their top three. The Group asked respondents to provide separate rankings for industrial and less developed countries. For industrial countries, only 13 per cent listed “inducements offered by host country” and 4 per cent “tax advantages” (Group of Thirty, 1984, p. 30).

The sleight of hand performed involves the lack of a relationship between the question asked of firms and the conclusion drawn about the effectiveness of government policies. Firms were asked to choose from a list that included many factors over which governments have little or no control. Access to host country's domestic market is an amalgam of market size (both population and per capita GNP) and the size of the protective barriers around that market. Governments have little ability, under GATT, to alter protective barriers, nor can Governments modify the size of their populations or their per capita incomes in the short run. Market access is not within a Government's power to change quickly, while inducements and tax advantages are.

To draw a conclusion about the ineffectiveness of tax incentives, the Group of Thirty should have asked a different question: “What policies can Governments of host countries change in the short term that would affect

your investment decision?" If firms had indicated that inducements offered by the Government of host countries and tax advantages would not have changed their investment plans, then the ineffectiveness of government policies could have been established. As it was, the Group of Thirty merely confirmed the obvious: factors largely outside the control of Governments are the principal determinants of investment decisions and thus government policies are marginal at best.

Marginality itself, however, does not imply ineffectiveness. That is where rhetorical sleight of hand comes in handy. Ineffectiveness can only be established on grounds of a benefit-cost test or some other measure of the efficiency. Asking investors to compare the importance of access to markets with tax incentives is the reverse of a false dichotomy. Inclusion of those two factors in the same survey creates a false impression that Governments have influence over all the factors. Since tax incentives come out low on this inclusive list, the Group of Thirty and other researchers have concluded (incorrectly) that they are relatively ineffective.

A final weakness of the respondent survey in incentive analysis is hidden circularity in most researchers' reasoning. Most investigators start with the assumption that incentives are bad because they breed cut-throat competition that results in no net gain for any participant—the classic prisoner's dilemma. If competition does occur, then incentives offered by competing jurisdictions are often similar, though this is not always the case. If they are similar, however, respondents would naturally report that incentives were not a deciding factor in choosing among competing locations. Armed with this "finding", researchers have sometimes reached the astounding conclusion that incentives are not "effective" and Governments should *unilaterally* withdraw them. It is one thing to recommend that all Governments should collectively agree to limit incentives, but quite another that one Government should eliminate incentives regardless of what other Governments do.

Conclusion

Rhetoric, once an essential element in school curricula, has fallen on hard times. Too little attention is paid to rhetoric and the use of the rhetorical devices of persuasion. One often hears "that's just rhetoric" when the speaker means nonsense. Economic research, and especially the critique of this research, would benefit from more attention to rhetoric.

The purpose of the present note is not to suggest that tax incentives are either effective or ineffective, but that there has been a rush to judgement, pushed along by persuasive yet, in the end, unsatisfactory analytical reasoning. A careful review of the existing research on the effectiveness of tax incentives leaves the reader with an uneasy feeling that rhetorical sleights of hand are used when researchers wish to push their own ideas beyond the limits of available data.

Attention to rhetoric is no substitute for theory and empirical research. It is needed as part of a system of checks and balances, however, to keep the scholarly research system on track. Research on the effectiveness of incentives is one area where the system seems to have veered off the rails. ■

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Chinese transnational corporations*

Ye Gang**

China's outward investment

Chinese enterprises began to establish affiliates abroad as late as 1979. It has only been since the end of 1985, however, that Chinese foreign direct investment (FDI) abroad began to grow notably. At the end of 1985, the number of non-trade overseas affiliates of Chinese enterprises was 187, while the total value of the investment was equal to \$290 million, of which \$170 million represented the Chinese equity share. By the end of 1988, the number of overseas affiliates had increased to 526; the value of total investment, to \$1.9 billion; and the amount invested by China, to \$715 million. The number of foreign affiliates and China's investment abroad increased 1.8 and 3 times, respectively, between 1985 and 1988, while the aggregate value of investment rose 5.5 times. The situation of Shanghai, Beijing and Fujian Provinces largely coincides with the above picture. The number of foreign affiliates of Shanghai-based transnational corporations (TNCs) rose from 16 to 51 between the end of 1985 and June 1989; the Chinese equity contribution rose from \$11 million to \$27 million during the same period. Similarly, the number of foreign affiliates of Fujian-based TNCs rose from 78 to 190 between the end of 1986 and March 1989.

Outward Chinese investment has become increasingly diversified in terms of destination. At the end of 1985, foreign affiliates were located in 45 countries and territories, but were mostly concentrated in Hong Kong and Macau (54), the United States (21), Thailand (11) and Japan (11). Those countries and territories accounted for 63 per cent of the total number of foreign affiliates. By 1988, foreign affiliates had spread to 79 countries and territories, of which more than 240 were in Asia, more than 80 in Africa, more than 50 in Europe, nearly 40 in Oceania and more than 20 in North America and Latin America. By the first quarter of 1989, foreign affiliates of Shanghai-based and Fujian-based TNCs, formerly concentrated in Hong Kong and Macau, had expanded their activities to a number of countries in Europe, Asia and Africa.

* Investigations were made by both interviews and questionnaires. The reasons for the choice of provinces are that Beijing is the capital of China and the location of most large centrally-owned enterprises; Shanghai is the most highly developed city in China; and Fujian is the province with the greatest number of foreign affiliates.

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Chinese foreign affiliates have invested in a multitude of industries and continue to diversify the sectoral distribution of their activities abroad. At the end of 1985, there were 45 manufacturing and agricultural projects, accounting for 24 per cent of all projects, 14 extraction projects (8 per cent of the total), 19 construction projects, 15 restaurant and transportation projects and projects combining industrial and trading activities. By the end of 1988, manufacture and agriculture accounted for about 40 per cent of all projects (50 per cent if extraction projects are included). By early 1989, most foreign affiliates from Shanghai and Fujian Provinces were engaged in industrial and services projects.

The number of Chinese TNCs with investments abroad has increased. At the initial stages of opening to the outside world, enterprises which were eligible to have foreign affiliates were limited to the international economic and technological co-operation companies of individual provinces and cities and to the import and export corporations, which were privileged to engage in foreign trade. In 1985, the Ministry of Foreign Economic Relations and Trade decided to allow an increase in the number of parent enterprises with investments abroad. Since then, parent enterprises have not only experienced a gradual increase in their number, but they have also become more diverse. Apart from former foreign trade companies and international economic and technological co-operative companies, enterprises currently engaging in overseas investment are professional enterprises, "group" enterprises and even scientific research units.

The Government at all levels has accumulated valuable experience in administering non-trade overseas investments. At present, the Foreign Economic Relations and Trade Commissions of different provinces and cities have assigned people and institutions to administer overseas investments and find ways of regulating, supporting and servicing foreign affiliates. This early stage of outward FDI from China requires attention and support from all areas in order to make it an integral part of the country's economic development. At present, however, the role of overseas investment in China's economy remains insignificant.

Motives for and benefits from investing abroad

Between the end of 1988 and May 1989, the Institute of World Economy, Fudan University, under the guidance of the International Economic Co-operation Bureau of the Ministry of Foreign Economic Relations and Trade and the International Economic Co-operation Association, carried out a survey

through questionnaires and interviews of Chinese enterprises with overseas investment, mostly in industries other than trading, in Shanghai, Beijing and Fujian Provinces. Those provinces were chosen on the basis of their importance as sources of Chinese outward FDI. The Institute interviewed managers of 37 Chinese enterprises—six of which were State-owned—with about 160 overseas affiliates, as well as leading officials of the Foreign Economic Relations and Trade Commissions in the relevant provinces and municipalities. Eighteen enterprises responded to the questionnaire.

The Institute circulated a questionnaire which gave 18 possible reasons behind the motives of Chinese TNCs for operating abroad. They were ranked by the parent enterprises according to their relative significance. The replies showed the degree of importance attached to each of these elements by the parent enterprises. The Institute grouped together some questions and discarded others in order to facilitate the analysis. The relative importance of each motive is shown in table 1.

Motives that were not listed in the questionnaire will be examined next. Centrally-owned, ministry-owned and “comprehensive” enterprises, in particular, have placed great emphasis on the motive of adapting to Chinese economic reforms and on fulfilling the economic needs of local regions and sectors. Several enterprises considered undertaking investment abroad from the viewpoint of their long-term development into “modern international enterprises”. Others regarded foreign investment as a method of substituting for domestic investment. Some companies felt that their potential for domestic expansion was limited and that the possibility of investing abroad might solve that problem and enable them to engage in profitable activities. In view of the disadvantages facing foreign enterprises in relation to domestic firms, such as lack of familiarity with the local environment and additional communication costs, the question raised was what the benefits are that Chinese enterprises derive from their overseas investments. Nine items were listed in the questionnaire, and the enterprises were asked to rank their answers according to their relative importance (the degree of importance is classified the same as for motives). The answers from 18 enterprises are presented in table 2.

According to replies to the questionnaire, the advantages advocated by Chinese enterprises fall into the following categories: excellent customer relations and credit, indicating confidence in and recognition of the performance of foreign affiliates; technology of production, indicating that several Chinese products possess a certain comparative advantage, especially in

Table 1. Motives to invest abroad^a
(Number of enterprises)

Motives	Important (11)	Less important (10)	Not important (9)	Number of firms
Open up new markets	16	-	1	94
Circumvent trade barriers and maintain export markets	10	1	6	59
Promote exports of capital goods, materials and labour	13	-	4	77
Acquire foreign capital technology and managing skills	13	1	3	77
Acquire raw materials	10	3	4	59
Give full play to own advantages abroad	9	1	7	53
Enjoy preferential terms offered by local governments	13	2	2	77
Earn high interest	12	5	-	71
Acquire first-hand information on foreign production and market	16	-	1	94
Create conditions for other business activities of the enterprise	17	-	-	100

^a Managers of all 37 firms were interviewed, but only 17 questionnaires were received from these firms. The conclusions of most interviews conformed with the results of questionnaires returned.

relation to those goods produced in developing countries; quantity and quality of technical and management personnel; small-scale production, considered to be suitable to the needs of developing countries; cultural links with

Table 2. Main advantages of investing abroad^a
(Number of enterprises)

Advantages	Very important (1)	Important (2)	Not important (3)	Not considered	Share in total (%)
Technology of production	11	3	0	4	78
Reputable brand names and trade marks	9	0	2	7	50
Excellent customer relations	11	4	2	1	83
Small-size production	9	1	1	7	56
Use of local resources and ability to adapt to local markets	7	2	0	9	50
Quantity and quality of management and technical personnel	12	2	1	3	78
Low costs	5	4	3	6	50
Cultural and ethnic relations with local people (overseas Chinese)	6	4	0	8	56
Excellent credit	15	0	0	3	83

overseas Chinese; use of local resources; and ability to adapt to local markets, low costs and reputable brand names and trade marks.

The advantages of centrally-owned enterprises with investments abroad are more apparent. Those enterprises are large, with an abundance of funds and resources and a long history of operating in an international environment through trade. Management personnel are well-trained and experienced in the conduct of business abroad and knowledgeable about local conditions. In comparison, TNCs from the provinces are small or of medium size, but their advantage is that they are specialized in particular segments of the production process. Their level of technology is lower than that of the centrally-owned enterprises and their operations are more labour-intensive. However, small and medium-size enterprises also possess technical and managerial personnel of quality, which they regard as their most important advantage for investing abroad.

The importance of foreign affiliates for the economy of China

Foreign affiliates of Chinese TNCs have limited experience in the conduct of business abroad, although a number of them have gained a firm foothold. It has been found that, among a diverse range of foreign affiliates, there are some that are well-operated and profitable. By the end of 1989, of 376 TNCs, 208 possessed obvious economic advantages for investing abroad. These efficiently-run affiliates, despite their newness, are increasingly acquiring an important role in the development of China's economy.

Approximately 20 quantitative and qualitative indices regarding the possible economic benefits of overseas affiliates were listed in the questionnaire and parent enterprises were asked to answer them. The response rate was low; enterprises were unwilling to answer such questions in order to protect a sense of secrecy. More significantly, parent enterprises lack the system and habit of regularly issuing balance sheets and annual reports so as to monitor effectively and systematically the activities of their affiliates. Taking into consideration the above, the following conclusions can be reached on the contribution of outward FDI to the Chinese economy.

China faces a slow-down in export growth owing to trading barriers set by its trade partners. The main reason for establishing enterprises to produce abroad is to maintain or increase the existing export market share. Establishing factories abroad in countries where there is no export quota, or using the local quotas, may circumvent trade barriers and help maintain or increase export share. Formerly, most Chinese exports were channelled through Chinese agents and foreign offices abroad. Overseas affiliates can now establish marketing networks to penetrate export markets. Outward investment with advanced capital equipment and technology has promoted

Chinese exports. Raw materials or parts are usually supplied by China. Several TNCs first design and produce samples of goods in their foreign affiliates prior to producing them domestically, in order to be assured that the quality is suitable for sale in overseas markets. All of those factors facilitate the increase of exports and the opening-up of new products and markets.

Outward FDI may play a dual role in introducing or acquiring advanced technology. On the one hand, it can give full play to Chinese-owned technological advantages; on the other, it can help acquire advanced technology locally, that is, a “technology-recycling” type of investment. There have been several ways of acquiring advanced technology through investing abroad:

- By purchasing advanced equipment to start businesses when forming joint ventures from foreign enterprises possessing advanced technology;
- By purchasing shares of foreign enterprises with advanced technology;
- By using semi-advanced equipment in the operation of foreign affiliates;
- By connecting domestically-produced equipment with advanced-technology parts and components from abroad; and
- By acquiring technologically-advanced equipment through foreign affiliates at a lower price than otherwise for fulfilling the needs of China.

There is, however, potential for a more effective utilization of foreign capital. At present, the share of Chinese overseas investment normally accounts for less than 40 per cent of the total investment in joint ventures abroad. In general, when an enterprise sets up a new business abroad, it does not necessarily follow that all capital will come from its own resources. On the contrary, most of it is raised either locally or in the international market. Foreign affiliates are a new form of raising capital, with the difference being that this capital is utilized abroad. Moreover, only part of the investment stems from foreign exchange remitted abroad from China. Some capital stems from technology, equipment, labour and trade marks valued in monetary terms, and a large amount is raised abroad. It should also be noted that foreign investment induces an influx of capital should disinvestments occur. For example, out of \$60 million of total outward investment from Fujian Province, \$30 million have been repatriated; in that case, loans from abroad exceeded \$300 million.

Another possible benefit to the Chinese economy from the operation of foreign affiliates is the acquisition of raw materials. At present, more than 20 overseas investments are in operation in the fields of fisheries, forestry and mining, and they play a favourable role in compensating for the shortages of raw materials in China. The operation of foreign affiliates also encourages the training of managerial personnel. More than 3,000 management and technical personnel are working in Chinese foreign affiliates in an environment where business is conducted according to international standards, thus receiving first-hand training and acquiring invaluable experience. To a certain extent, international competition requires the collection of a diverse range of information, and overseas affiliates play a unique role in that respect. The information obtained is direct, accurate and prompt and its role is not to be ignored in understanding the operations of the international market, in taking advantage of marketing opportunities, in enlarging and opening up the export market and in introducing foreign capital and technology.

Although there is little systematic data concerning the profitability of the operations of affiliates abroad, according to recent reports, several large projects in the primary and manufacturing sectors have shown large profits. A number of small and medium-size enterprises have also shown sizeable profits. There have been, however, some unsuccessful cases. A small number of overseas affiliates registered losses, a few enterprises have wasted precious resources, and a minority have gone bankrupt or have withdrawn their investments. Those unsuccessful enterprises have the following common features:

- Feasibility studies have not been conducted prior to investing abroad;
- In most cases, sales of products have not been ascertained;
- The choice of partners in joint ventures is unsatisfactory;
- The control of the operation is not in Chinese hands, resulting in an unusual phenomenon, namely, that, although the project and operations are sound, the foreign side earns profits while the Chinese side incurs losses;
- Low quality of personnel sent to work in affiliates abroad.

In conclusion, China has achieved a remarkable growth in outward investment during the past few years. It must be affirmed that such investments have opened up new prospects for the Chinese economy. It should also be noted that these investments are only at an initial stage, lagging far

behind their full potential, as well as behind those from other countries in the world. There is still ample room for possible changes regarding the number and size of enterprises, industrial and geographical distribution, technical, managerial and organizational standards, structure of company operations, and social benefits. In addition, further changes in the regulatory framework and greater support by the Government are needed in order to strengthen and improve the conditions for outward investment. ■