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Free Trade Zones in China

Review and Prospect

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Introduction

The first free port was established in Italy in 1547. Since then, many free ports, free trade zones (FTZs) and export processing zones (EPZs) of various sizes have been established throughout the world. At present, there are about 1,000 FTZs operating in over 90 countries and regions (Hsu 1991; Liu 1995; Kundra 2000). China was closed to the outside world during the period 1949-1978. The country's development since 1978 has been driven by two major policy changes conducive to the market economy and globalization. The first relates to the economic reforms and subsequent institutional re-engineering that have been partly successful in achieving decentralization, enterprise autonomy and overall administrative and economic efficiency (Lau and Shen 2000; Gu et al. 2001). The second is the policy of opening up to the outside world in an attempt to attract foreign investment, boost exports, acquire advanced technology and learn good management practices (Yeung and Hu 1992; Yeung et al. 1999; Yeung 2000).

These two major changes have fundamentally altered the environment for foreign investment and international trade. Before the economic reforms and opening that began in 1978, China's was a planned economy with strong centralized control of investment, production, consumption and trade. Imports and exports were monopolized by a few large but inefficient state-owned enterprises administrated directly by various central government ministries. In the early years of economic reforms,

import tariffs and the profit tax rate were very high. For example, import tariffs in 1992 were as high as 36.2% for primary products and 44.9% for secondary products (Xiao and Fang 2000). In 1996, even state-owned enterprises had to pay a profit tax as high as 28%. Inadequate infrastructure, complicated bureaucracy and widespread red-tape made things even worse. All these factors would deter any foreign investor from investing in China. Over time and expanding gradually from area to area, the Chinese government under Deng Xiaoping's leadership introduced step-by-step reforms and open policies. Starting with special economic zones (SEZs), China has steadily opened its territory to foreign investment and trade. In the run-up to China's entry to the World Trade Organization (WTO), policies favouring particular regions have been restructured since 1992 to create a level playing field for competition, necessitating the transformation and re-positioning of those privileged SEZs and FTZs that have benefited significantly from favourable provisions for foreign investment and trade.

This paper provides a detailed account of the process of China's opening and key policy measures implemented in various special areas, including SEZs and FTZs. Hong Kong, a former British colony and currently a Special Administrative Region of China, has been instrumental in the process of opening China up to the outside world. Hong Kong has been the main source of foreign investment in China. It has also acted as a model of free trade for China's SEZs and FTZs. The cases of Hong Kong, Shenzhen SEZ and Shanghai Waigaoqiao FTZ are examined in detail to shed light on the development and challenges of free trade areas.

A short note on terminology is in order here. The term "free trade zone" is used in both a generic and a specific sense. In a general sense, the term refers to a family of spatial creations designed to accelerate trade and economic development in China. In a specific sense, FTZs refer to actually restricted areas that are compatible with similar zones in other countries of the world. In an effort to be comprehensive, this paper attempts to cover both types of spatial designs, born essentially since 1978.

China's open policy and free trade zones: an overview

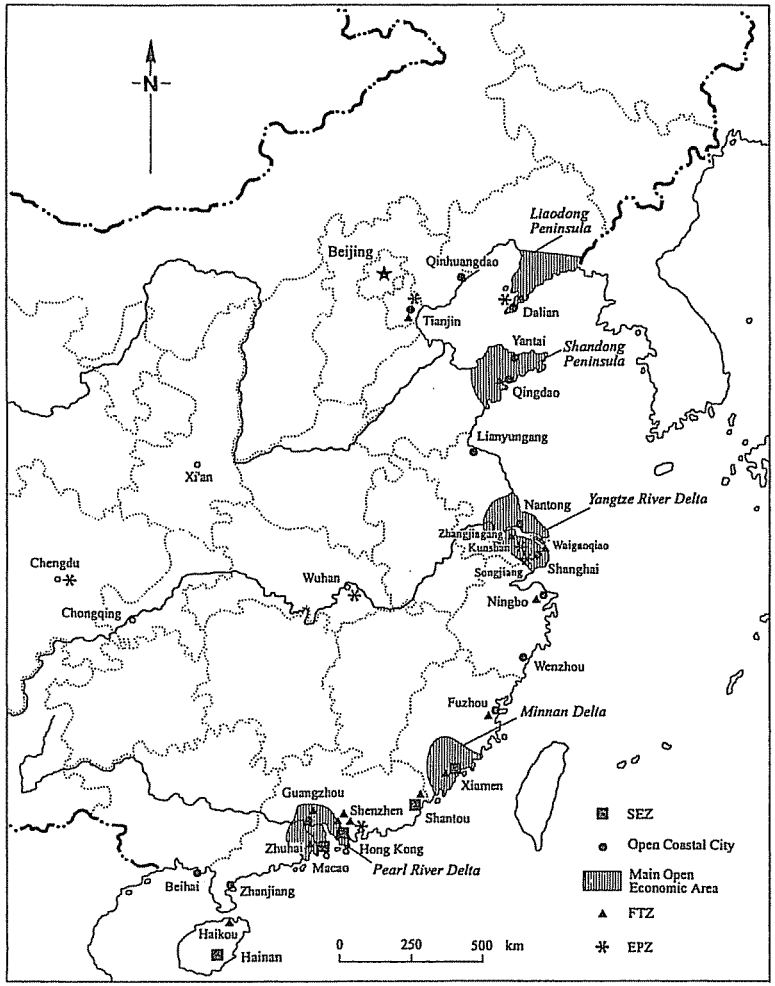
Spatially, the open policy is implemented through the introduction of a series of incentives to foreign investment in various kinds of SEZs, open coastal cities, open economic areas, economic and technology development zones and FTZs (Figure 1). This section provides an overview of these developments and the key incentive policies.

Special economic zones

In January 1979, the idea of Shekou industrial zone was proposed by the Chinese Merchants Group, an agency of the Ministry of Transport of China stationed in Hong Kong. Shekou industrial zone is located near the border of Hong Kong and has an area of 2.14 km^2. The idea was to make use of the advantages of capital, information and technology in Hong Kong and the abundant cheap labour and land in Shenzhen. The proposal was quickly approved by the central government, which was seeking ways of developing China's economy. The zone currently hosts 400 enterprises employing about 50,000 people. Encouraged by the initial success of the Shekou industrial zone, which was allowed relative autonomy and special policies in its management, the central government proceeded to establish Shenzhen and Zhuhai special export zones on a trial basis in July 1979. The title "special export zone" is roughly equivalent to the term EPZ used elsewhere. In August 1980, the 15th meeting of the standing committee of the Fifth National People's Congress approved the establishment of Shenzhen, Zhuhai and Shantao SEZs in Guangdong. The fourth SEZ, Xiamen, was established in Fujian in 1981. In August 1987, the largest SEZ, Hainan province, was established. Hainan was originally part of Guangdong province.

The operation of SEZs is governed by specific laws, the first of them being "The regulation on the special economic zones in Guangdong," passed by the Fifth National People's Congress in 26 August 1980. Special economic policies introduced in the SEZs are summarized in the following (Wang 1998; Su 2001):

Figure 1 Special economic zones, open coastal cities, main open economic areas, free trade zones and export processing zones in China



(1) SEZs are given greater power in the administration of international economic activities. Previously, many projects had to be approved by the central government according to the old model of the planned economy, which would cause unnecessary

delays and difficulties for foreign investors. It was stipulated in November 1982 that an SEZ project involving an investment under 100 million yuan (US$1 converted to 8.3 yuan in 2001), a light industry project involving an investment under 30 million yuan and a heavy industry project under 50 million yuan could be approved by an SEZ authority. This was further relaxed in March 1988 so that any project under US$30 million could be approved by an SEZ authority. In many areas, such as project approval, transfer of land use right and foreign economic activities, an SEZ authority has equivalent power to the government of a province.

(2) Tax incentives are given to foreign-invested enterprises. The profit tax rate is only 15% in SEZs, which is as low as in Hong Kong. Manufacturing firms whose operation lasts over ten years are exempted from profit tax in the first and second year with net profit and tax rate halved in the third to fifth years. A tax rate of 10%, significantly lower than the prevailing rate in Hong Kong, applies to enterprises that export over 70% of their output.

(3) No import tax is imposed on machinery, raw materials and office equipment imported for use by enterprises themselves. Except for oil and a few other products, no export tax and industry-trade tax is collected from enterprises' exports. An SEZ authority can also import necessary capital and consumer goods. Special concessions are given to SEZs with regard to the import of goods regulated by quotas and licences.

(4) Immigration control for entering and leaving SEZs is simplified greatly. Hong Kong and Macao residents of Chinese origin are issued with home visiting permits allowing them to travel to SEZs and other parts of China freely.

The fifth SEZ, Hainan province is given even more flexibility for foreign investors. For example, foreign investors can develop land and mines on a large scale, and invest in infrastructure such as ports, airports, highways, railways and power stations. It is clear that the SEZs are operating like large EPZs found in other countries. There is almost no tariff on the import and export of goods for export-oriented activities. Profit

tax rate is also very low. An SEZ authority is given great power in economic administration. These measures facilitate the free flow of capital, goods and personnel between the SEZs and the outside world.

Open coastal cities

The initial success of SEZs in stimulating economic development was instrumental to the introduction of special open policies in more cities and areas in China. In April 1984, 14 cities — Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai — were designated open coastal cities. Economic and technology development zones were also established in these cities.

Key policy incentives for open coastal cities may be summarized as follows:

(1) The open coastal cities are given greater power to approve projects involving foreign investment, subject to the following conditions: the state is not responsible for the sale of products; no export quota is needed; and the enterprises can repay the foreign loans themselves. These cities can approve any non-manufacturing project meeting the above conditions. Shanghai and Tianjin can approve any manufacturing project involving foreign investment under US$30 million, Dalian under US$10 million and other cities under US$5 million. These limits were further relaxed in March 1988. Guangdong, Fujian, Hainan and Beijing can approve any project under US$30 million. Liaoning, Hebei, Shandong, Jiangsu, Zhejiang and Guangxi can approve any project under US$20 million. The limits applied to counties and cities within these provinces are to be decided by the provincial governments.

(2) A low profit tax rate of 15% applies to projects involving foreign investment in the old urban areas of open coastal cities where the projects meet one of the following conditions: they are technology- or knowledge-intensive projects; they are long-term projects involving foreign investment over US$30 million; or they are energy, transport and port construction projects. Other manufacturing enterprises in the old urban areas that do not meet any of the above conditions are taxed at 80% of the prevailing profit tax rate.

(3) City government can give concessions on collection of local profit tax to some enterprises in the old urban areas. A flat 10% tax rate applies to the income from stock dividends, interest and rentals by investors who have no formal establishment in China.

Unlike SEZs, the incentive policies for open coastal cities make no special arrangement for import and export tax. Thus SEZs are more attractive to foreign investors. Shanghai's economy grew slowly in the 1980s, a factor that led in April 1990 to the central government choosing and opening Pudong as a new area in Shanghai, using special policies similar to those in SEZs. But the exemption from import and export tariffs is confined to Waigaoqiao FTZ established in Pudong. The real surge in foreign investment in the area came in 1992 when Deng Xiaoping called for further reforms during his trip to South China. In Pudong New Area, foreign investment soared from US$0.1 billion in 1991 to US$1.4 billion in 1992.

Open economic areas

In February 1985, the favourable policies for foreign investment in the open coastal cities were extended to three designated open coastal economic areas, including Pearl River Delta, Yangtze River Delta and Minnan Delta open economic areas, covering 13 cities and 46 counties. In March 1988, these three open economic areas were further extended, with cities and counties in the Liaodong Peninsula, Shandong Peninsula, Bohai ring and part of Jiangsu, Zhejiang, Fujian, Guangdong and Guangxi also designated part of an extended open coastal area, covering 260 cities and counties in total.

The policies introduced in open economic areas are similar to those applied to open coastal cities. Generally, provincial and city/county governments are empowered to approve foreign investment projects that do not involve quotas and licences. The policies for open coastal cities can be extended to urban districts, seats of county governments, key satellite towns, and to the

import of key equipment for upgrading the technology of enterprises and export-oriented agricultural projects with direct foreign investment. To break the import-export monopoly of state-owned enterprises, provincial governments are empowered to issue import and export licences to newly established import and export enterprises, and to allow medium and large manufacturing enterprises to export and import their own goods.

Economic and technology development zones

Compared with open coastal cities and open economic areas, economic and technology development zones are small in scale and are established within cities. Such zones are designed to introduce advanced technology, and to attract foreign capital for establishing joint research institutions, joint ventures, or wholly foreign-owned enterprises to develop new technology, and design and produce new and high-quality products. The emphasis is on the introduction and development of new technology and new products. Currently, there are 32 state-level economic and technology development zones and over 300 provincial-level development zones (Gu and Zhao 1998). If one includes the development zones designated by counties, towns and townships, the total number in 1992 was over 6,000, occupying 1.47 million hectares of arable land (Liu 1995:44-45).

The first 11 economic and technology development zones were designated in 1984 among the 11 open coastal cities. Three economic and technology development zones, Hongqiao, Minhang and Caohejing, were established in Shanghai in 1986. A further six, seven and five economic and technology development zones were established in 1992, 1993 and 1994 respectively. Since 1992, six economic and technology development zones have been established in the central and western part of China, such as Urumqi in Xinjiang and Harbin in Heilongjiang province. The size of an economic and technology development zone ranges from those like Hongqiao of just a few km^2 to those over 30 km^2, such as Tianjin and Ningbo economic and technology development zones. Generally, the larger zones

are considered too big in the initial stage of development so the central government now requests them to control their planning area to 10 km^2 and the initial area for development to 1-3 km^2.

The policies applied to the economic and technology development zones lie somewhere between those for SEZs and open coastal cities. The power to approve foreign investment projects and the profit tax rate are the same as those for SEZs. A low profit tax rate, the same as in SEZs, applies to all enterprises with foreign investment in development zones, rather than to selected enterprises as in open coastal cities. On the other hand, in common with open coastal cities, no provision is made for import and export tariffs in the development zones.

Like SEZs, economic and technology development zones have become hot spots of foreign investment and industrial growth. By 1994, 16 economic and technology development zones in the coastal areas had attracted foreign investment of US$4.9 billion in their 6,651 projects, with the total accumulated export value reaching US$3 billion. In 1994, the total industrial output in these zones was 75 billion yuan and the tax contribution was over 4 billion yuan. In some large cities, such as Tianjin and Dalian, economic and technology development zones contributed more than half the increase in their industrial output.

Free trade zones

FTZs are designated and fenced areas with the most favourable policies for foreign investment and international trade. These zones are fenced areas that impose no import or export taxes. No residents live in these zones, which are engaged mainly in processing, warehousing and packaging goods for export. Compared to SEZs, FTZs are small but formally designated special customs areas. They are referred to as "bonded areas" in Chinese to distinguish them from fully-fledged FTZs elsewhere in the world.

The first and largest FTZ in China was Waigaoqiao FTZ in Shanghai, which was designated in May 1990 with an area of 10 km^2. Currently, there are 15 FTZs in China located in coastal

cities or SEZs (Zhong 1999). Three are located in Shenzhen SEZ — Futian, Shatoujiao and Yantian. The remaining 11 are Tianjing port, Dalian, Qingdao, Zhangjiagang, Ningbo, Fuzhou, Xiangyu in Xiamen, Shantou, Guangzhou, Zhuhai and Haikou. The smallest is the Shatoujiao FTZ, located right on the Shenzhen-Hong Kong border with an area of 0.3 km^2. There are three types of FTZs. Waigaoqiao and Futian FTZs are engaged in international trade and export processing. Tianjing port, Dalian and Shenzhen's Yantian FTZs are engaged in international trade and re-export. Shatoujiao FTZ is engaged in export processing, which is very successful. In 1999, the value of industrial output and exports from Shatoujiao FTZ reached 12.5 billion yuan and US$1.4 billion respectively.

Key incentive policies for FTZs can be summarized as follows:

(1) No import and export licences, import and export tariffs, or industry-trade tax are collected for importing various kinds of materials or for the export of the finished products.

(2) A low profit tax rate is applied to export processing enterprises owned by foreign or domestic investors in FTZs. The profit tax rate is 15% for manufacturing enterprises. No profit tax will be collected until the third year in which an enterprise has made a net profit. The profit tax is collected at half the normal level in the third to fifth year of net profit, and that arrangement is extended for a further three years for hi-tech firms. Enterprises that export over 70% of their products are only levied a profit tax rate of 10%.

(3) Enterprises are allowed to import and export their own materials and finished products.

(4) Enterprises can import raw materials and parts from non-FTZ areas to use in the manufacturing of goods for export. Such imports from non-FTZ areas are regarded as exports and subject to normal customs procedures.

(5) Trade enterprises, warehouses, and financial and insurance institutions can be established in FTZs.

(6) There is easy entry to and exit from FTZs for foreign investors in FTZs.

The development and challenges of Waigaoqiao FTZ will be examined in detail in section 5. The following passage reviews land development and land use policies, which have not been touched upon so far in the discussion of the various special areas.

Land policy has been an important part of the economic reforms and open policy in China. Foreign and domestic developers can acquire land use rights on various terms (Liu 1995:33-52). Typically, a developer would pay a lump sum for the land use rights plus an annual usage fee. The lump sum for the land use right is determined by agreement and, increasingly, by auction and tender. The annual land use fee varies from 5 to 14 yuan per m^2. In Guangzhou economic and technology development zone, the annual land use fee is 5 yuan per m^2. The terms vary between the different development zones, SEZs and other areas. In Pudong New Area, the period of land-lease is 40 years for commercial, tourist and recreational use, 50 years for industry, education, science and sports, and 70 years for residential use. In the city of Shenzhen, the lease period is shorter than in Pudong New Area: 30 years for land used for industry, commerce, services and tourism, and 50 years for residential use and land used for offices, education, science and health services. The re-lease of developed land is charged at a higher rate. In Guangzhou and Shenzhen, the base line prices of developed commercial, residential and industrial land were 5,500 yuan, 1,300 yuan and 600 yuan per m^2 respectively in 1998.

Local governments are keen to sell the land use rights to raise revenue. Many ignore the regulation that a large land development project involving 67 hectares of arable land or 133 hectares of other land requires approval from the state council. In 1993, the total land revenue was estimated to be 123.1 billion yuan for the country as a whole. It is clear that local governments have used land lease, land development and the collection of land use fees as an important channel of revenue to finance infrastructural development and other public spending while the profit tax rate and industry-trade tax are kept at an extremely low level. Nevertheless, a surplus of land for lease and complicated land speculation meant that land prices in 1988

and 1989 fell to only 48% and 32% of their 1987 levels. Many development zones simply remain empty for many years, resulting in a waste of land resources.

Economic growth

China's open policy has been associated with stable economic growth of 7-10% per year since 1978. Table 1 provides a summary of a few key indicators in selected regions and cities, and for China as a whole. In total, China attracted US$40.7 billion of foreign direct investment (FDI) in 2000. Its exports reached US$249.2 billion. Its GDP increased from 362 billion yuan in 1978 to 8,940 billion yuan in 2000. Economic growth in Shanghai lagged behind other coastal provinces like Guangdong in the 1980s but has greatly speeded up since 1992. In 2000, FDI to Shanghai reached US$3.2 billion and exports reached US$61.6 billion. Shanghai's GDP grew from 27 billion yuan in 1978 to 455 billion yuan in 2000.

Guangdong is the province that has experienced the most rapid growth since 1978 due to its close ties with Hong Kong (Yeung and Chu 1998). It hosts three of the five SEZs and one large open economic area, Pearl River Delta Open Economic Region. In 1978, Guangdong had a weak economy and its GDP was only 70% of Shanghai's. By 2000, Guangdong's GDP accounted for over 10% of China's total and twice as much as Shanghai's. Guangdong attracted 30% of China's FDI and contributed 37% of total exports from China. Shenzhen city is one of the two main economic centres in Guangdong. Its growth is more dramatic than any other city in China. Starting in a similarly under-developed state as Pudong New Area in Shanghai, but at a much earlier stage, Shenzhen has become one of the top cities in China. In economic terms, Shenzhen is currently much stronger than Pudong New Area. For comparative purposes, Table 2 presents the number of people employed, foreign investment (FI) and exports in special areas of various countries and regions in the world. In terms of its employment and exports, Shenzhen is outstanding. But in terms of export value per unit of area and employee, Waigaoqiao FTZ is still behind EPZs in Korea and Taiwan.

Table 1 GDP, FDI and export of China and its major regions/cities, 1978-2000

	GDP (Yuan billion)	FDI (US$ billion)	Export (US$ billion)	Cargo handled at seaports (Billion tonnes)
China				
1978	362	0.6[a]	9.8	0.2[b]
1990	1860	3.5	62.1	0.5
1995	5749	37.5	148.7	0.8
2000	8940	40.7	249.2	1.3
Shanghai				
1978	27	0.003[c]	4.9[d]	0.08
1990	76	0.2	8.7	0.14
1995	246	3.2	44.3	0.17
2000	455	3.2	61.6	0.20
Guangdong				
1978	19	0.1[c]	1.4	0.07[c]
1990	156	1.5	22.2	0.12
1995	573	10.2	56.6	0.19
2000	966	12.2	91.9	0.29
Shenzhen				
1979	0.2	0.005	0.009	—
1990	17	0.4	8.2	0.01
1995	80	1.3	20.5	0.03
2000	167	2.0	34.6	0.06

Notes: a. 1983; b. 1980; c. 1981; d. 1985.

Sources: State Statistical Bureau (2000); Shanghai Municipal Statistics Bureau (2001); Shenzhen Statistics and Information Bureau (2001); Statistical Bureau of Guangdong (2001).

Table 2 Comparison of key indicators among special areas in various countries/regions

Special areas	Year	Area (km^2)	Employment (Thousand)	FI (US$ million)	Export (US$ million)
224 FTZs in USA	1993	—	280	—	12240
6 EPZs in India	1997/98	—	81	—	1294
2 EPZs in Korea	1998/99	1.09	15	192[a]	2474
EPZs in Philippines	1998	—	609	—	13270
3 EPZs in Taiwan	1996	1.92	55	370[b]	6897
Mainland China					
Shenzhen	2000	1949	3085	2968	34560
Zhuhai	2000	705	243	739	3646
Shantou	2000	298	619[c]	171	2600
Xiamen	2000	1634	493[c]	1032	5880
Hainan	2000	34000	3262[d]	613	800
Pudong New Area	2000	523	1041	2884	9580
Waigaoqiao FTZ	1999	6.4	66[e]	2062[f]	1760

Notes: a. Accumulated FDI.
b. Including domestic and FDI.
c. 1998 figure.
d. 1999 figure.
e. 2001 figure.
f. Accumulated contact foreign investment by June 2000.

Sources: Research Centre of Shanghai Free Trade Zone Administration (1996: 398-99); Research Institute of Place Names of the Ministry of Civil Affairs and the Association of Administrative Divisions and Place Names (1999); Urban Socio-economic Survey Team (1999); Zhong (1999); Kundra (2000); State Statistical Bureau (2000); Zhong (2000); Shanghai Municipal Statistics Bureau (2001); Statistical Bureau of Guangdong (2001); Su (2001:655).

Hong Kong: economic transition in a free port

By the end of 2000, Hong Kong had an area of 1,097 km^2 and a population of 6.9 million. Its territory consists mainly of hilly areas with almost no natural resources. Its major assets are a deep-water harbour and its resourceful population (Rimmer 1992). When it was seized by the British as a colony in 1841, Hong Kong was only a tiny fishing village. Since then, it has acquired increasing significance as an entrepôt. And unlike Macao, which was under the exclusive rule of the Portuguese in its early years, Hong Kong was developed as a free port from the very beginning (Chiu 1973:17).

Currently, Hong Kong is a special administrative region of China. "One country, two systems" has been practised in Hong Kong since July 1997, according to the Basic Law of Hong Kong Special Administrative Region (HKSAR). Crucially, Hong Kong has maintained its status as a free port since 1997 — its success as a major global city in Asia has much to do with its free port status and its role in international trade and re-exporting. The current free port policy and the government's non-intervention policy on the economy can be summarized as follows.

Hong Kong follows the economic policy of free enterprise and free trade. There are no import tariffs and excise duties are levied only on four categories of materials, including locally manufactured or imported tobacco, alcoholic liquors, methyl alcohol and hydrocarbon oils. A tax is also payable on first registration of motor vehicles. The Customs and Excise Department is assigned the tasks of fighting smuggling, collecting government revenues on dutiable goods, detecting and deterring narcotics trafficking and abuses of controlled drugs, and protecting intellectual property rights. In the year 1999/2000, it collected HK$7,377 million excise duties, about 4.55% of the government's revenue.

For health and safety reasons, five kinds of commodities are subjected to the licensing control of the Director-General of Trade and Industry, as set out in the "Import and Export Ordinance," the "Reserved Commodities Ordinance," the "Ozone Layer Protection Ordinance" and their subsidiary legislation. An import licence is required for radioactive substances and irradiating apparatus. Import and export licences are required for the following commodities: (1) pharmaceutical products and medicines; (2) reserved

commodities; (3) strategic commodities; and (4) ozone-depleting substances.

Except for the above regulations, Hong Kong has no trade barriers. Any company operating in Hong Kong, regardless of its ownership, is regarded as a Hong Kong company. It is very easy to set up a new company in Hong Kong in six working days. Hong Kong has a simple tax system and the profit tax is only 15-17%, one of the lowest in the world. Hong Kong exercises no control over the movement of foreign currencies. The Hong Kong dollar is currently pegged against the US dollar so the exchange rate is extremely stable.

The HKSAR government does not practise any economic planning and there is no protection or subsidization of manufacturing in Hong Kong. This is a distinct departure from the FDI policies in mainland China with their provision of tax incentives and cheap land. Nevertheless, a sound and satisfactory infrastructure has been constructed in Hong Kong. With a clean and efficient government, Hong Kong is an ideal place for business. The only concerns for business have been the high property prices and labour costs, especially prior to the Asian financial crisis in 1997.

Hong Kong has enjoyed sustained economic growth over the past four decades. According to the latest GDP estimates (Census and Statistics Department 2001a:12-13), its real annual GDP growth rate was 5.8% in the period 1965-1975, 8.5% in the period 1975-1985 and 6.1% in the period 1985-1997. The GDP per capita tripled during the period 1975-1997. In 1998, due to the Asian financial crisis, Hong Kong had a negative GDP growth rate of -5.3% but its economy gradually recovered in 1999 and 2000, with a GDP growth rate of 3.1% in 1999 and 10.5% in 2000. In 1999, the GDP per capita, after purchasing power adjustment, was US$20,939, ranking it 26th in the world (World Bank 2000).

This sustained economic growth was based on Hong Kong's industrialization prior to the 1970s, when the China factor played almost no role. The proportion of the labour force employed in manufacturing was as high as 47% in 1971 and was still 41.3% in 1981. Since the introduction of China's open policy

in 1978, the economic complementarities and comparative advantages of Hong Kong and mainland China have led to a spatial division of labour, generally referred to as the "front shop, back factory model" (Sit 1989, 1998). Hong Kong has transferred the majority of its manufacturing to the Pearl River Delta and focused on its role as a prominent service centre, specializing in trade, transport and communication, and financial services. Hong Kong's economy has been significantly de-industrialized and its trade with mainland China and the United States has become very important. By 2000, the share of labour force in the tertiary sector was as high as 82.3%. The service sector accounted for 85.4% of the total GDP in 1999.

In 1997, Hong Kong ranked 9th, 6th and 8th worldwide in exports, imports and total merchandise trade respectively. It still stood at 11th, 9th and 10th in 1999, after the Asian financial crisis (Census and Statistics Department 2000). One important role played by Hong Kong, especially for mainland China, is that of middleman, importing from and exporting to the rest of the world. As shown in Table 3, re-exports accounted for over 64% of imports or exports in 1990, a share rising as high as 84% in 2000. The majority of such re-export activities relate to mainland China, which is Hong Kong's largest trading partner. Re-export trading activities with mainland China brought huge profits to the business community in Hong Kong. According to Hong Kong government statistics (Sung 1998), the gross profit rate from exporting mainland China's products via Hong Kong increased from 13% in 1989 to a magnificent 34.4% in 1996, while that from exporting other products via Hong Kong fell from 11.5% to 6.6% in the same period. The main reason for the high gross profit rate from trade with the mainland is that many of these cross-border manufacturing activities are operated by Hong Kong investors or by joint ventures with partners in mainland China, particularly in Guangdong. Table 4 shows that, in 2000, 52% of mainland imports from Hong Kong and 79.3% of mainland exports to Hong Kong resulted from these FDI activities by Hong Kong investors. It is notable that, in the same year, US$69.9 billion of the US$72.9 billion of exports to Hong

Table 3 GDP, import and export in Hong Kong, 1978-2000 (HK$ billion)

	1978	1980	1990	1995	1997	2000
GDP per capita (HK$ thousand)	18	28	102	175	202	187
GDP	85	142	583	1077	1324	1272
Domestic export of goods	41	68	226	232	211	181
Re-export of goods	13	30	414	1112	1245	1392
Import of goods	63	112	645	1496	1619	1661
Export less import of goods	-9	-14	-5	-152	-164	-89
Export of service	20	29	142	266	298	334
Import of service	10	17	88	161	180	185
Export less import of service	10	12	55	105	118	149
Export less import of goods and service	1	-1	49	-47	-46	60

Note: Some figures do not add up exactly due to rounding errors.
Source: Census and Statistics Department (2001a:12-13).

Table 4 Trade related to outward processing and its share in total trade between mainland China and Hong Kong, 1989-2000 (US$ billion)

	1989	1995	1997	2000
Mainland China direct import from Hong Kong	4.1	5.7	6.1	3.9
(Percentage share in total)	(76.0)	(71.4)	(76.1)	(72.7)
Mainland China import via Hong Kong	5.8	22.5	25.6	24.3
(Percentage share in total)	(43.6)	(45.4)	(44.7)	(49.7)
Subtotal	9.9	28.1	31.6	28.2
(Percentage share in total)	(53.0)	(49.0)	(48.6)	(52.0)
Mainland China export to Hong Kong	14.6	51.7	63.4	72.9
(Percentage share in total)	(58.1)	(74.4)	(81.2)	(79.3)
Guangdong export to Hong Kong	13.6	49.1	59.9	69.9

Note: Some figures do not add up exactly due to rounding errors.
Sources: Sung (1998); Census and Statistics Department (2001b:209, 2001c).

Kong from the mainland induced by outward processing actually originated in Guangdong.

As a highly open economy, Hong Kong's development path has been shaped by the changing political, social and economic situations across the region and worldwide. Hong Kong's economic position was adversely affected by the Asian financial crisis in 1997. It has been a painful process for Hong Kong to re-adjust its prevailing housing prices and labour costs. The conditions in mainland China and trade with the United States have a tremendous impact on its economic activities. Hence, the economic slowdown in the United States, exacerbated by the 9.11 tragedy in New York in 2001, has begun to affect Hong Kong's export/re-export trade dramatically and its economy is entering another period of stagnancy and recession. Hopefully this will be only a short-term phenomenon. In the meantime, with the entry of China into the WTO in December 2001, Hong Kong needs to redefine its role in the world economy. Upgrading the human resources in Hong Kong through education and training, and creating more service and manufacturing jobs for Hong Kong's residents are some of the strategies essential to the revival of Hong Kong's economy.

Shenzhen: experience of a special economic zone

The SEZs have been the test-bed of China's economic reform and open policies in the 1980s and 1990s, taking advantage of their close ties with Hong Kong and Macao. Shenzhen SEZ is located in the city of Shenzhen. Currently, there are five districts in the city, three belonging to the Shenzhen SEZ and the other two — formally Baoan county — not part of it. There is an internal border dividing the city between its SEZ and non-SEZ areas. The total area of Shenzhen city is 1,948.7 km^2, almost twice the size of Hong Kong, and the area of the Shenzhen SEZ is 391.7 km^2. Shenzhen is ideally positioned near Hong Kong, a world city and an economic and financial centre in the Asia-Pacific region, to act as China's window to the outside world.

There has been rapid economic, population and urban growth, both in Shenzhen city as a whole and Shenzhen SEZ in particular (Shen 1999; Su 2001). The pace of development is beyond the imagination of many people, including the planners making their projections in the Shenzhen Planning Bureau in 1981. The initial projected population in the Shenzhen SEZ was one million by the year 2000, a level already reached in 1989. The population in the Shenzhen SEZ increased from 0.09 million in 1979 to 2.05 million by 2000. The built-up area in the SEZ increased from less than 3 km^2 before the 1980s to 88 km^2 in 1995 and 136 km^2 by 2000. In the city of Shenzhen as a whole, the population increased from 0.31 million to 4.33 million over the same period.

Shenzhen SEZ has implemented a series of favourable and flexible policies to attract investment and stimulate economic growth. These include concessions on capital gains tax and income tax, low land use charges, relaxed foreign exchange management and banking regulations, easy border entry and exit, and low labour costs (Ma and Fang 1993; Ng 1994). Shenzhen was the first SEZ in China to allow the establishment of non-banking financial institutions and foreign banks in China. Hong Kong dollars were circulated widely and accounted for 45% of all currencies in the SEZ in 1984 (Sun and Xu 1988:173-81). Policy incentives have also been implemented in other parts of Shenzhen city, which is part of the Pearl River Delta Economic Region designated in 1994 by the government of Guangdong province (Lu 1995). For example, labour costs are only HK$500-600 per month in foreign-invested enterprises, only 10-40% of the cost of an average worker in Hong Kong. Generally, labour costs only account for 10% of the total operating costs of a manufacturing firm. These favourable conditions and the city's proximity to Hong Kong have attracted a great deal of investment from Hong Kong and abroad. China's domestic capital has also quickly moved into Shenzhen to take the advantage of its close economic and trading ties with Hong Kong and the overseas market. There has been dramatic growth, both in terms of GDP per capita and the total GDP (Table 5). The

Table 5 GDP and GDP per capita growth rate in Shenzhen city, 1979-2000

	GDP (Yuan million)	GDP growth rate (%)	GDP per capita (Yuan)	GDP per capita growth rate (%)
1979	196	—	606	—
1980	270	62.7	835	63.0
1985	3902	24.5	4809	2.6
1990	17167	32.5	8724	16.1
1995	79570	23.0	23381	13.9
2000	166547	14.2	39745	9.0

Source: Shenzhen Statistics and Information Bureau (1996, 2001).

GDP in the city of Shenzhen has rocketed from 196 million yuan in 1979 to 167 billion yuan in 2000. In most of those years, the GDP grew at a rate of more than 14% a year. The GDP per capita in the city also increased rapidly from only 606 yuan in 1979 to 39,745 yuan in 2000.

Rapid economic growth in Shenzhen is made possible by the heavy influx of capital, labour, and associated technology and information (Shen et al. 2000). All these are indicated by the influx of domestic and foreign capital into Shenzhen. Table 6 shows that total investment in Shenzhen in the period 1981-2000 was US$50.5 billion. Foreign investment contributed US$23 billion or 45.45% of total investment in the city. In the period 1981-1995, 78.76% foreign investment of the city took place in the Shenzhen SEZ. It is clear that investment from domestic enterprises also formed quite a large proportion of total investment in the development of Shenzhen (Shen et al. 2001).

An early study by Hu (1989) examined the reasons for investment in Shenzhen SEZ. "Tax incentives" and "low labour costs" were listed as top reasons by foreign investors. On the other hand, "rapid access to information on international markets" and "ease of importing and transferring advanced

Table 6 Total investment and foreign investment in Shenzhen city, 1981-2000

	Total investment (US$ million)	Foreign investment in the city (US$ million)	Foreign investment in SEZ (US$ million)	Share of foreign investment in total investment (%)	SEZ share of foreign investment (%)
1981	160.84	112.82	97.56	70.14	86.47
1982	389.68	73.49	66.90	18.86	91.03
1983	548.26	143.94	118.41	26.25	82.26
1984	836.15	230.13	226.24	27.52	98.31
1985	1134.73	329.25	324.27	29.02	98.49
1986	719.85	489.33	484.01	67.98	98.91
1987	766.22	404.99	393.80	52.86	97.24
1988	1171.90	444.29	414.39	37.91	93.27
1989	1327.49	458.09	434.11	34.51	94.77
1990	1210.80	518.57	476.54	42.83	91.90
1991	1491.01	579.88	512.52	38.89	88.38
1992	2556.94	715.39	585.82	27.98	81.89
1993	3385.18	1432.17	1114.44	42.31	77.81
1994	2679.72	1729.59	1107.83	64.54	64.05
1995	3303.01	1735.45	1044.56	52.54	60.19
1996	3939.37	2422.42	—	61.49	—
1997	4741.56	2871.68	—	60.56	—
1998	5802.44	2552.22	—	43.99	—
1999	6879.41	2754.22	—	40.04	—
2000	7485.10	2968.39	—	39.66	—
Total	50529.67	22966.31	7401.40[a]	45.45	78.76[a]

Note: a. 1981-1995 only.

Sources: Calculation by the author and also Shenzhen Statistics and Information Bureau (1996, 2001).

technology" were listed as top reasons by domestic investors. Clearly, Shenzhen is acting as a window through which international information, technology and markets reach the domestic economy. Both foreign and domestic investors considered "convenience in exports and imports" and "proximity to markets" as two important reasons for investment in Shenzhen SEZ.

Economic development in Shenzhen has benefited tremendously from the special policies applied to it and from its proximity to Hong Kong, especially during the period 1979-1994. Heralded by the announcement that a market economy was to be established in China, similar policy incentives have been adopted in many coastal cities and inland areas. Since then, in relative terms, Shenzhen's special policy advantage has been weakened. On the other hand, Shenzhen is running ahead of other cities in institutional reforms to increase the efficiency of government. The advantage of institutional innovations, and the proximity to and cooperation with Hong Kong will continue to drive further economic development in the city (Lo 1999; Shen et al. 1999).

Waigaoqiao: the largest free trade zone at the crossroads

Waigaoqiao FTZ is the earliest and the largest FTZ in China. The decision to establish this FTZ came with the decision to develop Pudong New Area in Shanghai in April 1990. The FTZ was designated as a first step in a bid proposed by Deng Xiaoping to build several small "Hong Kongs" in mainland China. On 10 September 1990, two regulations regarding the operation of this FTZ were announced: "Procedures to regulate the movement of goods, vehicles and personal belongings to and from Waigaoqiao FTZ by the custom of P. R. China" and "Regulation of Waigaoqiao FTZ." The Waigaoqiao Joint Development Cooperation was established on 12 September 1990. The total planned area of the FTZ was 10 km^2. In March 1992, the development of 0.453 km^2 was completed and ready for

operation. Waigaoqiao FTZ administration was founded in April 1992. In April 1993, a further 2 km^2 was put into operation. By 2000, a total area of 6.4 km^2 had been developed. By June 2000, 4,150 projects had been approved, over 800 of them processing and warehousing firms. Some 62 of the top 500 transnational corporations (TNCs) in the world have invested in the FTZ. These projects involved a total investment of US$5.11 billion, including contracted foreign investment of US$2.06 billion. Four trading markets for productive materials and machinery have been opened, with about 480 companies operating in the first trading market, which has a floor space of 100,000 m^2 (Gu et al. 1994:177). Over 60,000 employees were working in the FTZ in June 2000 (Zhong 2000).

The FTZ consists of a port area, a warehouse area, a processing area and a trade area. The port now has 14 international routes and 15 domestic routes in operation. In 1999, it handled 7.71 million tonnes of cargo and 0.927 million TEUs (20-foot equivalent units) of containers. Two development stages of Waigaoqiao port have been completed and stages three and four of port development will follow. The warehouse area has a warehouse space of 0.74 million m^2 and hosts 376 warehousing and distribution enterprises. In 1999, these firms handled goods worth 7.45 billion yuan. The processing area hosts 152 processing enterprises. The industrial output of export processing reached US$12.98 billion in 1999. In the first seven months of 2000, the industrial output was US$8.32 billion, of which 43.2% were hi-tech products. Two hi-tech clusters of electronics and electronic equipment are taking shape in the processing area. In the trade area, the total value of imports and exports was US$13.4 billion in the period 1993-1999. Total export value was US$4.3 billion in the same period. Approximately 38% of imports and exports were conducted through the four tariff-free trading markets in the FTZ.

Despite significant developments in the Waigaoqiao FTZ, however, it faces severe challenges in the years ahead due to the changing domestic and international situations, as follows:

(1) The FTZ is not a perfect free trade zone and is much like

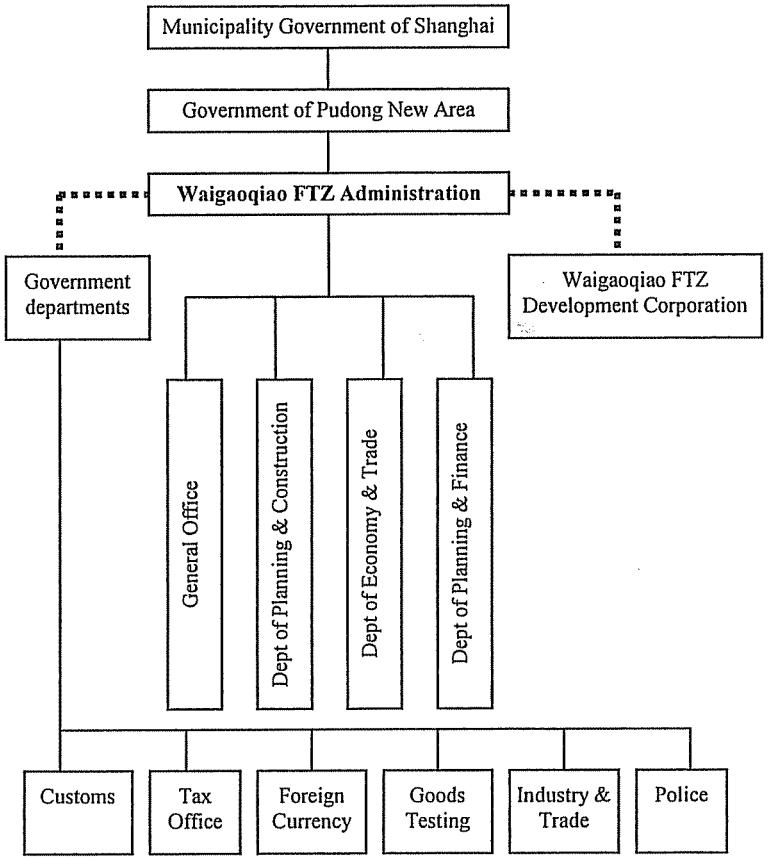
an EPZ. The activities inside the zone are closely monitored by the Chinese customs. The various government departments such as customs, taxation, foreign currency administration, goods quality testing, and industry and trade administration, as well as the police stationed in the zone, are poorly coordinated, being responsible directly to the municipal government of Shanghai and the ministries in the central government, instead of the FTZ administration. Thus, the FTZ administration does not have absolute authority in the management of the FTZ (Figure 2).

(2) China has designated 15 formal EPZs, including Dalian, Tianjin, Songjiang, Kunshan, Shenzhen, Wuhan and Chengdu EPZ since April 2000. The State Council approved "the temporary procedures for the regulation of export processing zones by the customs of China" on 27 April 2000. According to this regulation, there is no import and export tax generally but vehicles and consumer products have to pay normal import tax in the EPZs. No value added tax is collected from products produced in EPZs for export. By September 2001, 14 EPZs had been certified for operation and a total of 16 km^2 developed. Over 100 projects with foreign investment of US$1.65 billion have been started. In terms of tariff exemption, export processing and customs monitoring, the FTZ is similar to these newly designated EPZs. So will FTZs be converted to EPZs or will they still have their own special role to play, remaining to be decided in the near future.

(3) The absence of import and export tariffs and free movement of foreign capital are unique advantages of FTZs, while they share similar concessions on profit tax rate with SEZs and other open areas. China joined the WTO in late 2001 and overall import tariffs would be further reduced from 17.5% to 10% (Xiao and Fang 2000). The tariff advantage for the FTZs will be slashed from 42.9% (tariff rate) in 1992 to 10% in the near future.

Many scholars and officials have been exploring the future direction of Waigaoqiao FTZ. One direction is to convert the FTZ to an EPZ. Some scholars have suggested developing a fully-fledged FTZ in Waigaoqiao in order to play a leading role in

Figure 2 Waigaoqiao FTZ administration and its relations with other government departments



international trade, shipping and finance (Zhong 2000; Zhou 2000). The key directions for further development of Waigaoqiao FTZ are as follows:

(1) Create a fully-fledged FTZ according to international standards. The FTZ should be treated as a special area outside Chinese customs in the Chinese territory. Monitoring and surveillance by various authorities will be kept to a minimum

and carried out electronically with the highest efficiency. Tight customs controls will be focused on the crossings between the FTZ and the rest of the country.

(2) The economy of the FTZ will be based on the excellent port facility to serve international trade, re-export and goods distribution. The FTZ will further enhance its current warehousing, export processing and shipping functions.

(3) The FTZ will develop a viable trade in services. The exhibition industry will be further expanded to facilitate the exhibition of foreign products, especially advanced machinery and equipment. China imports large amounts of such foreign products. Exhibitions in the FTZ will bring the international market back home. Financial, banking and insurance services will also be developed to facilitate increasing international trade, re-export and shipping. The possibility of developing an offshore financial centre can also be explored so as to bring home international finance and capital.

(4) The FTZ will be developed as a free international marketplace and a logistics centre for the distribution of goods. Ideally, trading companies will use the FTZ as the goods distribution centre for two kinds of goods: foreign goods for distribution to the China market and goods made in China for distribution to destinations in the Asia-Pacific region and around the world. A distribution centre in Waigaoqiao FTZ will speed up the process of procurement and delivery, reducing response times and increasing flexibility. Arrangements may need to be made for the FTZ to use Pudong International Airport for speedy delivery of key products by air.

Overall, Hong Kong would be an excellent model for the further development of Waigaoqiao FTZ. Much effort is needed to improve the software and hardware to make the zone truly free in the movement of people, goods, capital and information.

Conclusion

China's open policy has been instrumental in the country's rapid development since 1978. Through the establishment of SEZs,

open coastal cities, open economic areas, economic and technology development zones, FTZs and more recently EPZs, China has gradually opened its territory to foreign investment and international trade. Initially, highly favourable incentive policies were introduced in selected areas, especially in SEZs and FTZs, to attract foreign investment and boost exports. In addition to tax holidays, an attractive low profit tax rate of 15% and favourable land lease conditions were introduced in selected areas. Since 1992, area-preferential policies have been replaced by industry-preferential policies and similar or even better incentive polices have been extended to the inland areas, border areas and western regions of China. In 1994, five industries — machinery, electronics, petrol-chemicals, motor vehicles and building — were chosen as pillar industries to be developed with the support of state policies. In the same year, China formally decided to develop a socialist market economy on the basis of fair competition. During the run-up to China's entry into the WTO, differential policies treating regions and corporations on an unequal basis have been gradually phased out so that market competition can proceed on a fair basis.

Nevertheless, SEZs and FTZs are special areas with privileged exemption from import and export tariffs. These zones have been designated, following the Hong Kong model, to facilitate hassle-free investment and trade. Specific regulations and laws have been introduced to govern the operation of SEZs and FTZs. The basic infrastructure for export processing, transportation and communication is provided and bureaucratic procedures are simplified for speedy processing. This paper has reviewed the major developments and key policies of various kinds of open areas. Development in Hong Kong, Shenzhen and Waigaoqiao FTZ have been examined in particular detail.

The Waigaoqiao FTZ in Shanghai is the first and the largest FTZ in China. However, the operation of Waigaoqiao FTZ is much like an EPZ, in that it is still under the tight surveillance of Chinese customs and the Waigaoqiao FTZ administration. It is still a long way from being a true FTZ or a free port of the sort that prevail in other countries. There are two possible directions

for Waigaoqiao FTZ in the future. It can either become an EPZ, 15 of which had been formally designated in China by 2000, or proceed to become a fully-fledged FTZ, given a free hand to deal with the enterprises operating in the zone. The latter appears to be the preferred option as it would represent another milestone in China's further opening up to the world. It would be also extremely beneficial to the Chinese economy and its enterprises if a special FTZ were operating under the rule of free trade within Chinese territory but outside the jurisdiction of Chinese customs. Chinese firms would have easy access to the international market via the FTZ, while foreign companies would have a convenient base from which to trade with China, or they could use the zone as a logistics centre for the distribution of goods in China and the Asia-Pacific region. If Waigaoqiao FTZ is run according to strict laws and regulations with the right institutions, it could develop a cluster of industries based around export processing, warehousing and distribution, exhibition, re-exporting and trading, shipping and off-shore financial service. A major overhaul of hardware and software in the FTZ is essential to achieve the objective of making a small Hong Kong in Shanghai's Pudong New Area.

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Free Trade Zones in China

Review and Prospect

Abstract

The open policy has been instrumental in the rapid economic development in China since 1978. Through the establishment of special economic zones (SEZs), open coastal cities, open economic areas, economic and technology development zones, free trade zones (FTZs) and more recently export processing zones (EPZs), China has gradually opened its territory for foreign investment and international trade. This paper provides a detailed account of the process of China's opening to the outside world, key policy measures implemented in various special areas, including SEZs and FTZs, and the progress to date. Cases of Hong Kong, Shenzhen SEZ and Shanghai Waigaoqiao FTZ are examined in detail to shed light on the development and challenges of free trade areas after the entry of China into the World Trade Organization (WTO) in December 2001.

中國自由貿易區的回顧與展望

沈建法
楊汝萬

摘要

開放政策在一九七八年以來中國經濟的迅速發展中發揮重要的作用。通過設立經濟特區、沿海開放城市、經濟開放區、經濟技術開發區、保稅區（自由貿易區）和出口加工區，中國逐步向外資開放並發展國際貿易。本文詳述中國對外開放的過程，在經濟特區、保稅區等特別地區實施的關鍵政策，以及最近的動態。對香港、深圳經濟特區和上海外高橋自由貿易區作了詳細分析，說明自由貿易區的發展和中國在二零零一年加入世界貿易組織之後自由貿易區面臨的挑戰。