POLITICS OF THE STATE AND FOREIGN CAPITAL:
THE CASE OF CHINA 1979-1993

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Thesis submitted to the Faculty of the
Virginia Polytechnic Institute and State University
in partial fulfillment of the requirements for the
degree of Master of Arts
in
Political Science

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August 29, 1994
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Acknowledgements

First, I wish to thank the members of my committee, Professor Charles L. Taylor, Professor Deborah J. Milly, and Professor George Norton. To Professor Taylor, my committee chair, for his edification extended to me in classrooms and offices as well as on the Appalachian Trail, for his unfailing help and guidance, and for his willingness to read drafts of this thesis during his trip to Europe through email. To Professor Milly, for her valuable advice, generous support and inestimable understanding. The time and wisdom that she extended to this thesis paved the seemingly hopeless road for completing this study. To Professor Norton, an esteemed economist, for his valuable advice, insightful comments and kind support.

I would also like to express much appreciation to the other faculty and staff members of the Department of Political Science. To Professor White, the Director of Graduate Studies, for his kind help and valuable advice in addition to academical instruction. To Professor Luciak, for whom I worked as a teaching assistant for a better part of the two years, for his conducive support, advice and understanding. To Professor Edward Weisband, Professor Karen M. Hult, and Professor Richard Shingles, for their instruction, help and encouragement. Thanks also to
Professor Richard Rich, Professor Charles Walcott, Professor Lehlohonolo Tlou, Professor Timothy Luke and Mrs. Maxine Riley.

Finally, I would like to acknowledge the help and friendship of my fellow graduate students, especially Rafal Paczkowski, Bob Leweke, Todd Penland, Tim Meredith, Ajay Tandon, Janice McLaughlin, Marjukka Ollilainen, Satomi Niki, and Ka Zeng.
Introduction

Despite decades of intensive debate, how to deal with foreign capital is still a theoretical challenge as well as a practical problem for developing countries. When foreign capital penetrates or is lured into a Third World country, it interacts with the host state and local capital. Like a double-edged dagger, it may produce economic benefits or hinder the economic development in the host society, depending on how it is managed. Moreover, it also acts as a political and social force in host countries, changing the power structures and social formation there. To a large degree, interactions among the state, foreign capital and local capital determine the process and outcome of development in developing countries.

Policies and attitudes toward foreign capital vary among developing countries and areas, and so do the roles of foreign capital in these countries. Since the late 1950s, when some Latin American countries such as Brazil and Mexico began to undertake the second phase of import-substituting industrialization (ISI), they relaxed their restrictions on foreign investment, and their reliance on foreign borrowing and investment to finance industrialization increased (Haggard 1990:212-22). This practice eventually contributed to a debt crisis in the 1980s and hindered further economic
development. In Korea and Taiwan, however, the governments' policies regarding foreign investment were more restrictive, and foreign capital only played a moderate role (Barrett and Chin 1986:23-43). But their achievements in economic development have been regarded as examples of success.

When the Communists took power in China in 1949, they followed the Soviet model and built up a command economy. From the early 1960s, when it broke with the Soviet Union, until 1978, China almost entirely cut its links with the world economy, and foreign capital was negligible. In 1978, China started to carry out economic reforms and initiated an "open-door" policy in order to upgrade its economy to the world standard through utilizing foreign capital, technology, management and market expertise. Since then, foreign capital has increased enormously, from almost zero in 1977 to more than US$ 27.5 billion annually by 1993 ("Bright future and much to achieve" 1994). There were 1,675,000 foreign-funded enterprises in China by the end of 1993; and the total foreign investment amounted to US$ 382.4 billion ("The order of ..." 1994).

In the meantime, the past decade witnessed a great change in almost every aspect of Chinese life. The change has been so great that Paul Theroux, a Chinese specialist of the United States who visited China in 1980, could hardly recognize the China he knew when he re-visited it in 1987
and 1993 (Theroux, 1993). What he saw in 1980 was

people in blue suits and cloth slippers riding bicycles down muddy streets, workers going blind in poorly lighted factories, waiters refusing tips and chanting, 'serve the people!' The only bright colors were the ribbons the more daring women and girls wore in their hair. Near Guangzhou (Canton) I visited a Maoist model commune called Da Li. It was like a good-natured prison of reluctant sloganeers and suppressed ambitions—71,000 people working 6,000 acres of rice fields and making Whistling Cicada brand firecrackers. It seemed at once appalling and wonderful for its unity and its innocence. Every job was carried out with crude tools and great spirit. It was a society of intimidating and ingenious frugality in which everything was mended—shoes, clothes, vehicles. The Chinese were poor, but their ingenuity made them seem indestructible (ibid).

In 1987 Theroux was "astonished by the changes and new attitudes, the communes either closed or changed—the charade over, the rice fields buried, the people turned loose to find employment at large" (ibid). In 1993 he found "the dynamo of capitalism has been loosed, and the 'creative destruction' that economist Joseph Schumpeter called the defining feature of nineteenth century American capitalism is on display in the China of 1993" (ibid). Mr. Theroux's description provides a silhouette of China's transformation during the past decade.

Undoubtedly, foreign capital is linked to this great change. What role, then, has it played behind this change? As a student of political science, I am more interested in
the possible influence of foreign capital on the political structure than the economic impacts.

To be more specific, what is the relationship among foreign capital, the central government of a socialist state and the state's officials at the local levels? In Chinese history, alternation of power between the central government and local authorities has been an eternal theme, and the decline of power on the part of the central state in the past always led to social turmoil, rebellions and change of dynasties. Communist China is different from the past dynasties in fundamental ways, but it has kept the centralist tradition and there has always been bargaining between the central government and its subordinates at the local levels. Has the presence of foreign capital led to any change in the balance between the central and the local authorities, or any increase or erosion of the authority of the central government?

These questions, crucial but hardly discussed, are the focus of this thesis. It attempts to illuminate the Chinese model of coalition politics among the central government, local authorities and foreign capital during the 1979-93 period. First, the thesis explores relative goals and interests of the three regarding foreign investment. These goals and interests constitute the basis of the cooperation and/or conflicts among the central state, local authorities
and foreign capital. Second, the thesis illuminates how the cooperation between local authorities and foreign capital has contributed to the failure of the central government’s policy of controlling foreign capital. Third, the thesis tries to assess how coalition politics among them has affected relative economic power of the central state, local authorities and foreign capital, and how this in turn has affected the central government’s policy towards foreign capital and other policies.

The thesis is organized into six chapters. Chapter One briefly introduces the academic literature on foreign investment in China, discusses theories regarding the role of foreign capital in development of the Third World countries, and illustrates the analytical framework of this thesis. Chapter 2 examines the context of the coalition politics among the central government, local authorities and foreign capital—basically the central government’s policy of opening to the outside world and economic reform. Chapter 3 identifies the central government’s aims in introducing foreign investment and its policy of controlling foreign capital. Chapter 4 investigates the goals of local governments and foreign capital and the cooperation between them in evading the central government’s policy of controlling foreign capital. It also uses Shenzhen as a case to illustrate the argument of the chapter. Chapter 5
discusses the economic and political consequences of the coalition politics among the central state, local authorities and foreign capital—how economic strength has shifted among them and how this has shift in turn affected the central government’s policy towards foreign capital and its other policies. Chapter 6, the concluding chapter, summarizes the characteristics of the Chinese model of coalition politics among central state, local authorities and foreign capital as discussed in previous chapters. The chapter also discusses the implications of the Chinese model for other socialist countries.
Chapter 1 Literature, Theory and Methodology

This chapter first provides a brief introduction to the academic works on foreign investment in China. Then theories concerning the role of foreign capital in developing countries are discussed. The emphasis is on theories about coalition politics among the state and foreign and local capital as developed by Peter Evans and Stephan Haggard. Finally, a hypothesis about the coalition politics concerning foreign capital in China and the methodology to explore this hypothesis are discussed. The hypothesis is that local authorities and foreign capital were engaged in a cooperation, which greatly contributed to a shift of economic and political dynamics disadvantageous to the central state.

1.1 Review of Literature

Foreign investment has major implications for development in Chinese politics. However, these implications have not been sufficiently explored, though there are considerable descriptions of China’s policy of openness and foreign investment in China in both China and the Western societies.

Publications in English on foreign investment in China
largely fall into four types. The first kind are introductions to the Western World of China’s open-door policies. These books or articles, such as *China’s Open Door Policy: The Request for Foreign Technology and Capital* by S. P. S. Ho and R. W. Huenemann and *China’s Modernization and Transnational Corporations* by N. T. Wang, were written in the early 1980s and provided analyses of the background of China’s decision to invite foreign capital and its initial policies. The second kind are written to serve as business guides. Some examples are *Investing in China Where, How and Why?* by Lynette Kemp, *Foreign Investment in China Under the Open Policy: the Experience of Hong Kong Companies* by J. T. Thoburn’s, and *Foreign Direct Investment in China* by P. D. Grub and Lin Jian Hai. These books and articles focus on the Chinese government’s published policies and regulations, institutions and procedures for investment, possible benefits and obstacles to foreign business. The third kind focus on foreign investment in certain areas, a province (mostly Guangdong) or a Special Economic Zone (SEZ, mostly Shenzhen), or on one particular form of foreign investment such as equity joint venture (Chai 1986; Chan, Chen and Chin 1986; Fewsmith 1986; Jao and Leung 1986; Sit 1985; Sklair 1987; Wong and Chu 1985). The contents of these books are similar to those of the second kind but are more focused.

The other sort of these studies does not address
foreign capital directly, but they bear some relevance to this topic. One such example is the work by Ezra F. Vogel, who did field research in Guangdong province for seven months in 1987 at the province leaders’ invitation; his research resulted in a book *One Step Ahead in China* (1989). In this book Vogel describes how Guangdong has been pushing forward reform and leading the nation in opening to the outside world. Among other things, what is especially valuable about this book is that he was granted the privilege to interview many key local officials, which is rare in China, and was able to describe how some local officials took initiatives to attract and cooperate with foreign capital. Another example is Y.F. Woon’s study (1990) of the impact of international linkages on socioeconomic development in Chikan Zhen, a town in Guangdong province. By presenting an analysis of how overseas Chinese links helped the town socially and economically, the author challenges the world system approach’s thesis that international linkages with developed countries hinder the development of developing countries (Ibid). Although the theme of the paper is not foreign capital, it provides some examples of how external capital influences local politics in China.

Studies and reports on foreign investment in China by Chinese scholars and journalists have appeared in a wide
spectrum of national and local journals and magazines. It is estimated that People's Daily, the official party daily newspaper, has carried articles and reports on the Special Economic Zones about twice a week for years (Chen 1988:5), and this is only a small portion of the coverage related to foreign capital. However, most of these publications are laudatory accounts of the party's open-door policy - such as how much foreign investment has been attracted in a certain area and how successful a joint venture is and so on. As is usual with the Chinese publications, the really sensitive topics are rarely allowed to be discussed.

The accumulated materials provide a rich body of empirical descriptions of foreign investment in China. However, most of them are business- or economy-oriented, primarily concerned with investment environment, location, laws and regulations. There is little work written on the socio-political aspects. Moreover, most of the materials published are descriptive. Systematic empirical research and theoretical insight are lacking.

Margaret M. Pearson's works (1986; 1991) are an exception. Intended to investigate whether a centralized socialist state can control foreign capital, her research analyzes the bargaining power of the Chinese state and foreign capital, identifies the government's measures of controlling foreign capital, and assesses the success or
failure of these measures. Pearson’s findings constitute a significant academic contribution, and in my thesis the account of the mechanism of the central government’s control over foreign capital is basically borrowed from her writing. However, in Pearson’s publications, local authority is not considered a major actor with its own distinguished interests; thus her work is about the interactions between two actors—the state and foreign capital instead of the three including local governments. Moreover, Pearson’s research was mainly undertaken before 1987, when the model of foreign investment had not fully developed.

My thesis gives full appreciation to the role of local authorities, and sees local authorities engaged in coalition politics together with the central government and foreign capital. My thesis also attempts to establish the proposition that local authorities and foreign capital engage in a cooperation at the expense of the central state, and to link this cooperation to the failure of the central government’s policy of controlling foreign capital and the weakened position of the central state. In short, this thesis tries to develop a theoretical model of the coalition politics among the central government, local authorities and foreign capital in China, an effort that has not been made so far.
1.2 Theory and Methodology

The role of international links and foreign capital in the development of the Third World countries has long been part of the debate concerning development theories. The early debates were represented by different views on development between the neo-classical theorists and Paul Prebisch’s Economic Commission for Latin America (ECLA), and between modernization theory and dependency.

In the 1940s and 1950s the neoclassical approach dominated development theories. The pith of this approach is the classical and neo-classical theory of international trade and the notion of comparative advantage. The concept of comparative advantage dates back to David Ricardo. Ricardo argued that because countries varied in relative labor productivity for different goods, they tended to specialize in producing and exporting commodities in which they enjoyed comparatively higher labor productivity. The modern version of this theory, however, was developed in the early decades of this century by Eli Heckscher and Bertil Ohlin. The model they advanced consists of two factors of production—labor and capital. According to their theory, countries differ in their supplies of these production factors, and this in turn determines their relative comparative cost advantages. What a country exports are those commodities whose production uses relatively
intensively the factor in which the country is abundant. Heckscher and Ohlin concluded that all countries would benefit from free trade and world output would increase, and that relative factor prices would equalize between countries.

This model, often referred to as the two gap model, was further developed by Hollis B. Chenery and Alan M. Strout. They (1966:670) suggest that foreign assistance, "the flow of external resources", can lead to "rapid growth of GNP followed by a steady decline in the dependence on external financing. Foreign assistance is used to fill the two gaps, namely, the savings-investment gap and the trade gap, which affect the rate of growth of GNP and the inflow of capital in developing countries. By effectively using foreign resources, the developing countries would be able to increase saving and reduce the trade gap. The effectiveness of external resources, in the short run, depends on their use to relieve shortages of skills, saving, and imported commodities, and in the long run, largely on a high growth rate. To achieve this effectiveness, a good development policy should ensure that foreign resources are used to change the productive structure to improve balance of payments and to increase domestic saving. With this, developing countries can move more rapidly to self-sufficiency.
Raul Prebisch and his ECLA, however, did not agree with this conclusion. Prebisch argued that the cause of underdevelopment of Latin America lay in the international free trade system, which kept the developing countries under unfavorable terms of trade. The international division of labor resulted in a situation in which the periphery served as the supplier of raw materials while the center produced the manufactured goods. But the terms of trade had long been in favor of the manufactured products. So the solution for the developing countries is industrialization. The strategy for development they proposed is import substitution. Prebisch and the ECLA’s analysis greatly influenced the later dependency approach.

In the 1960s and 1970s, the debate was mainly continued between the modernization theory and dependency approach.

Modernization theory generally holds that there are "stages of growth", including the traditional stage and the modern stage, and that all societies were once at the traditional stage and will eventually evolve into the modern stage. One representation of this view can be seen in Walt W. Rostow’s book The Stages of Economic Growth: A Non-communist Manifesto published in 1960. Rostow assumes that societies follow five sequences of growth, traditional, "take-off," the drive to maturity, the age of high mass consumption, and post-consumption. The key to the crucial
"take-off" stage, he argues, is "a rise in the rate of productive investment from, say, 5% or less to over 10% of national income (or net national product)" (Rostow 1960:39). Although Rostow has been criticized for portraying development as a linear historical process and overstating his case, his view of the relationship between investment and growth and between growth and overall societal development has considerable influence on ensuing development policies (Oman 1992). Foreign aid and capital were regarded in the 1950s and 1960s as essential to "take-off" in developing countries as domestic capital formation was not sufficient there.

The dependency approach developed out of dissatisfaction with modernization theory. Dependency writers reject the idea that there is a linear model of development and developing countries are in a lower development stage as the modernization suggests. Rather, they argue, the underdevelopment of the Third World countries is just the result of the capitalist expansion and the international structure, which is characterized by a center-periphery relationship, with the periphery deprived of the surplus needed for development. The results of the integration of the developing countries into the international economy, according to the dependency approach, are disintegration, unevenness of development and
heterogeneity in economic structure within these countries (Taylor 1983:97-118).

One of the most influential dependency writers is A. G. Frank. According to him, "economic development and underdevelopment are the opposite faces of the same coin" (Frank, 1967:9). In analyzing the case of Latin American countries, Frank argues that the dominant outside forces not only expropriate economic surplus from these countries, but also align with internal dominant social forces and thus determine economy and politics as well as ideology and culture in the underdeveloped countries. Therefore the only solution is to cut ties with the advanced capitalist countries through socialist revolution.

In recent years, the debates have been revived, inspired by the experience of newly industrializing countries, by the neo-classical theory, the dependent development approach, and the statist approach.

Neo-classical theorists see the economic achievements as a proof of their theory of comparative advantages (Westphal 1978; Little 1982; Balassa 1982). They classify developing countries largely into two groups according to their development strategies, inward-looking or outward-looking. The inward-looking strategy associated with ISI, this approach argues, was adopted by many developing countries during 1950s and 1960s in order to develop a
modern industrial sector. With protectionism and government planning, this strategy resulted in an anti-export bias and eventually foreign-exchange shortage and inefficient industries. In the meantime, however, the few East Asian newly industrializing economies (NIEs), have switched to outward-looking strategies— to liberalize their economies to trade, and have "shown themselves to be markedly more successful in terms of growth, employment, income distribution, balance of payments and structural change" (Oman 1992:78). This view, however, has been criticized for overlooking the international environment, the impact of aid, the role of the state associated with economic success in these East Asian NIEs.

The dependent development approach is a modification of the dependency approach. While following its predecessor's (dependency theory) tradition to stress the constraints of the international system on the development of Third World countries, these writers reject the conclusion of earlier dependency theory that dependency excluded development in developing countries (Cardoso 1979, Evans 1979). According to Peter Evans, an arch theorist of dependent development who made an analysis of the Brazilian experience, the shift from dependency to dependent development occurred because of (1) transformations in the international system, including the changes in competition among the center countries,
increasing the relative bargaining power of the third world countries; (2) changes in multinational corporations due to serious challenges to the center states' monopolistic division of the periphery and intensified economic competition among center states themselves (Evans 1979:23); (3) "decentralization of the means of violence" that resulted from the failure of the United States in Vietnam (Evans 1979:24), causing international capital to rely more on the elite in the periphery countries for protection, and the center countries to allow certain development in the developing countries; (4) the need of many developing countries that sought industrialization through attracting international capital because of stagnant economic development.

According to Evans, the state, foreign capital and local capital each has its own interest in the dependent development.

**The Multinationals (MNCs)** Their goal is maximization of global profit. MNCs tend to maintain an international division of labor that keeps the LDCs (less developed countries) technologically lagging behind and reinforces the "disarticulation of technology and social structure" (Evans 1979: 37). Long-term strategic decisions are made in the center. It helps the MNCs to gain profits to spread the idea and style of consumption of the center to the LDCs, so that
they could increase their profit without putting more money in developing new technology. Their activities cause internationalization of the internal market of developing countries.

**Local Capital** The "national industrial bourgeoisie," according to Evans, is "the stepchild of imperialism, never completely abandoned but never given a full opportunity to develop" (Evans 1979:39). "Its position and privileges were always contingent on its ability to make alliances with other elite groups," because "dependent industrialization left political domination or economic hegemon" (Ibid).

Though the internationalized bourgeoisie allied with foreign capital, they still have their own interest in local accumulation. They might put restrictions on those activities which only helps the MNCs. They have to retain some nationalism. so they are playing a dual role (Evans 1979:40).

**The State** plays an important role in accumulation. Because of the weak economic position of local capital, the state has to assume the position of sponsor to effectively push forward local accumulation and industrialization. One of the roles of the state is to "redirect the global rationality of the multinational when it conflicts with the necessities of local accumulation" (Evans 1979:44). On the one hand, the state must undertake measures to attract the
international capital, and let them gain profit at the cost of the state and the local capital. The problem is always how large a portion of the surplus should be shifted to the MNCs.

Based on a common interest in the accumulation of capital and some degree of industrialization on the periphery, international and local capital and the state form a triple alliance, with the mass of the population economically, politically and socially excluded (Evans 1979:52). In Brazil, the alliance normally tilted toward the state and the multinationals, which "were (are) gradually expanding their control over the Brazilian industrial establishment at the expense of local capital" (Evans 1979:281).

However, Evans argues, even favored Third World countries are still fundamentally dependent, because "the international economy is dominated more thoroughly than ever by capitalist relations of production and exchange. Control of capital internationally is still concentrated in a few industrialized countries of the west (and Japan). Production in both center and periphery is still directed toward the accumulation of capital, particularly capital controlled by center country corporations. The political and military resources of center states are still used to preserve and maintain capital invested in the periphery" (Evans 1979:50).
While criticizing both neo-classical and dependency perspectives for ignoring "how domestic political forces constrain economic policy and shape state responses to the external environment" (Haggard 1990:21), the statist approach emphasizes the importance of developmental states in guiding export-oriented industrialization through strategic intervention in the economy (Amsden 1979; Hofheinz and Calder 1982; Haggard and Moon 1983 and 1987; Haggard 1990; Wade and White 1984). According to Stephan Haggard, this approach "explains policy in terms of the preferences and organizational power of state elites" (Haggard 1990:43). Through policies favoring certain social groups, state elites create coalitions and build new bases of support. The capability of the state to build and sustain coalitions, however, depends on the degree of isolation or autonomy from social pressure, the cohesion of the policy-making apparatus, and the available policy instruments (Ibid.).

Although factors determining foreign direct investment are complex, Haggard believes, phases of development and national policy are among the most important. First of all, choices of development strategy, Haggard argues, greatly affect the role of foreign capital (Haggard 1987:86). Specifically, developing countries are more dependent on foreign capital during the ISI than the export-led growth, because an ISI strategy underplays exports and thus causes
an unfavorable balance of payments and in its turn a reliance on foreign capital. For example, when Korea was implementing ISI, its dependence on foreign capital was much greater than later on. In the same way, when Brazil and Mexico were in the secondary phase of ISI beginning in the mid-1950s, they let foreign companies dominate leading industries in return for capital and technology (Haggard 1990).

Meanwhile, the state can also employ policy instruments to influence foreign capital. Among these tools are tax incentives, trade policies, pricing policies, and other regulatory controls (Ibid).

Moreover, development strategies and policies also influence the alliance-making and the bargaining power between state and foreign capital and the behavior of multinational corporations. For example, when Brazil turned to the secondary phase of ISI, the balance in the triple alliance between local, foreign, and state capital "tilted against the domestic private sector (Haggard 1990:194)."

Haggard does not deny, however, that other domestic political and economic factors, such as fear of foreign threat, developmental level of domestic firms and the government-private capital link, play a role there. For example, Haggard argues, the East Asian states are characteristic of a relatively insulated and strong nature
(Haggard 1987:101). Thus, facing crisis of the development strategy of import-substituting industrialization (ISI), these states were able to shift to a strategy of export-led growth. In Korea, the nationalist fear of Japan that resulted from the Japanese invasion led the state to support and protect state-owned enterprises and domestic firms from foreign competition, and thus avoided a domination by foreign capital. Consequently, the state and local capital formed a closer coalition with each other rather than with foreign capital (Haggard 1990:194).

In summary, all the theories discovered above have their merits. As a theoretical model, each of them considers some variables they deem to be important and overlooks some others. This in turn constitutes their relative contributions and deficiencies. While neo-classical theory and modernization approach stress the importance of internal factors in development, the ECLA view and dependency approach emphasize the external influence in determining the economic path of the developing countries. Actually, both the external factors and the internal factors are essential in understanding development in LDCs. Despite the differences among them, these earlier development theories largely understate or neglect the impacts of politics on development and on the role of foreign capital in developing countries. The dependent development approach and the
statist approach intend to make up this deficiency. Yet even Evans himself admits that his previous view on the relation between foreign capital, the bureaucratic authoritarian state should be modified when considering the East Asian NIEs (Evans 1987). One may agree with Haggard that the state played a crucial role in implementing export-led development strategy and regulating foreign capital, but one cannot ignore the impact of geopolitics. As G.K. Helleiner (1989:1454) summarizes, "the role of such institutions as the transnational corporation and the state, and the interplay between political, economic, and social forces" are crucial to understand the situation in developing countries; but "facile generalization" should be avoided.

This said, however, it is not the purpose of this thesis to evaluate these theories. What is important is the insight that these theories may provide in investigating the situation of China, although the theories discussed above do not apply to China directly. Two propositions can be drawn from these theories, which should be manifest in China as well as in other developing countries.

First, the relationship between a developing state and foreign capital is determined by both international and domestic political and economic conditions. Second, where foreign capital exists, there is usually some cooperation as well as competition between foreign capital and the host
state and local capital. Once again, the relative bargaining power of and concrete forms of cooperation and competition among three parties may shift and are shaped by the economic, social and political conditions in the host societies as well as the international economic and political context. The most important factors include development strategies, government-private capital link, domestic level of development, the position of the state in geopolitics and the international economic structure and environment.

1.3 Hypothesis

Thanks to the work by theorists of the dependent development approach and the statist approach, two typical models of interactions among the state, foreign capital and local capital have been sorted out and depicted in newly industrializing economies (NIEs) from the 1950s to the beginning of the 1980s. One is the Latin American NIE model, the other is the East Asian NIE model.

The Latin American model is represented by Brazil. It was characteristic of ISI strategy, the state’s favorable policies toward foreign capital, and an alliance tilted toward state and foreign capital rather than local private capital.

In contrast, the East Asian NIE model is represented by
Korea. It is characterized by an emphasis on exports, state regulatory policies toward foreign capital, and a balance of cooperation tilted toward the state and local capital rather than foreign capital.

China decided to utilize foreign capital in 1978. Has China repeated some experiences of other developing countries such as Brazil and Korea? The process is still evolving. However, China is different from these countries in fundamental ways. China is a socialist country, and there was almost no private local capital existing before 1978. That makes China different from the case of Latin American countries. It is also different from Korea in that it is a party state and its affiliated interest is great. Thus, neither of the two models can explain what happened in China.

When considering the case of China, two characteristics that distinguish it from most other developing countries are worth attention. First, before 1978 the Chinese economy was a centrally planned public one. Foreign capital, however, represents the private capitalist economy. In order to attract foreign capital, the Chinese state has to allow room for other forms of economy to exist as well as to loosen its ideological orientation that threatens foreign capital. Second, before reforming and re-opening to the outside
world, political power was concentrated in the hands of the central government, substantiated by its control of economy and the dominance of state enterprises. Since 1978 the local officials and enterprises have been given more autonomy in economic decision-making and the right to retain the profits they make above the quota. Moreover, the fiscal reform in the early 1980s made local governments responsible for their own revenues and expenditures, differentiating economic interest between the central government and local authorities. Local officials have also been responsible for directly dealing with foreign capital. Desperate to develop the economy within their own regions, local authorities had to compete with state-owned enterprises under the central government for raw materials, capital and market, whereas foreign capital was primarily interested in having a share of the market dominated by products from state-owned enterprises. This common interest made cooperation between foreign and local capital benefit each other (I will discuss the reasons in the next part). This development, however, would overshadow the power of the central state and make some of its policies difficult to execute.

From the above analysis the hypothesis of this thesis is derived. That is, the state, local officials and foreign capital have engaged in a pattern of cooperative coalition politics that eventually contributed to a shift of economic
and political dynamics disadvantageous to the central state.

My thesis synthesizes elements of the statist approach and the dependent development approach. Basically agreeing with the statist approach, the thesis takes for granted the autonomy of the Chinese institutions. In China, especially, social groups generally are allowed no interest expression except through official institutions. Institutions, or the leaders of these institutions, enjoy more autonomy than in many other countries. Thus, the thesis considers governments, not social groups or classes, as the chief actors. However, the thesis also considers that different levels of institutions, especially the central level and various local level, have different interests, and therefore may vary in their attitude towards foreign capital.

In this thesis, the central government, or the central state, refers to what Lucian Pye described as the "Center," "the State Council, the Standing Committee of the Politburo, the Politburo itself, and the Military Affairs Commission of the Central Committee" (Pye 1981:14-5), and the ministries under the State Council. These institutions and their leaders are supposed to take care of the interests of the whole party and the country. Local governments, or local authorities, refer to governments below the central levels, including province (autonomous region, municipalities),

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prefecture, county, township, village. Foreign capital includes foreign loans and foreign direct investment; but in this thesis it basically refers to foreign direct investment because it was more actively and directly involved in the coalition politics.

1.4 Research Design

When the authorities in Beijing decided to attract foreign capital, they aimed at obtaining the benefits of foreign investment while constraining its negative effects. Through utilizing foreign investment, the central state intended to gain advanced technology, management skill, and links to international markets. In the meantime, the state wanted to prevent control of management and domination of the market by foreign capital, and to resist threats to its sovereignty, foreign "bourgeois" values, life-styles and "spiritual pollution." The chief instruments that the central government designed to achieve this goal consist of controls of management, ideology, technology transfer, and access to domestic market. However, over time the state has lost or has been compelled under pressure from foreign capital and local officials to relax many of its controls. Moreover, once the central state lost or relaxed these controls, it could hardly regain them.

This thesis contends that local governments and foreign
capital have jointly played a part in bringing about the declining position of the central authority. As direct partners, they share some interests (I will discuss this in the Chapter 4). Thus, the two would cooperate in such activities as tax evasion and avoidance of controls from the central authority.

To explore the hypotheses, this thesis attempts to explain 1) why there was cooperation between local authorities and foreign capital; 2) how they cooperated; 3) what the impact of this cooperation was on the central government.

1) Why was there cooperation between local authorities and foreign capital. To answer this question, the thesis first delineates the background, or the domestic and international context, that conditions the initial positions and bargaining powers of the three parties. Basically this is about why the state decided to re-open itself to the outside world and undertake economic reform. The reason was mainly that the central state faced pressure from the international system and problems of the command economic system. The solutions that the leaders perceived were the policy of openness and of economic reform. The essence of the policy of openness was to import foreign investment so as to acquire foreign capital, technology and managerial skills. With economic reform, local governments were allowed
more autonomy to manage business. One of the most important parts of economic reform was the fiscal reform of the early 1980s. Initially intended to reduce the central state’s fiscal burden and stimulate local authorities for economic development, this reform introduced a tax responsibility system, according to which the central government set a quota of revenue to local governments and allowed them to retain the remaining tax revenue. This has provided great incentive for the local governments to promote local industrialization and lure foreign capital with more favorable conditions.

Second, the thesis examines the interests and goals of each of the central government, local governments and foreign capital in China. Although the policies discussed above were initiated by the central government to solve its own problems and to strengthen itself, local governments and foreign capital have used these policies to advance their own interests often at the cost of the central state. An analysis of the respective interests of the three will disclose the motivations of local authorities and foreign capital to engage in cooperation. While the central state wants to utilize foreign capital, it also needs to restrict the negative effects of foreign capital. The local officials, however, primarily interested in attracting foreign investment so as to increase their own revenues, are
far less concerned or even ignore those state-defined interests. For foreign capitalists, their interests are in the Chinese market, or cheap labor, or direct economic benefits such as tax holidays and low cost of land use. As local authorities and foreign capital share more common interests with each other rather than the central state, it is not hard to understand the cooperation between them.

2) How did the local authorities and foreign capital cooperate? In order to take advantage of foreign capital and to constrain negative effects due to foreign investment, the central government designed a mechanism to control foreign capital, including sectoral control of foreign investment, limitation of access to the domestic market, requirement of technology transfer, prevention of excessive economic concession to foreign capital, territorial containment, and prevention of spiritual contamination. And the central government expected local authorities to effectuate the policy of controlling foreign capital.

The cooperation between local officials and foreign capital was reflected by their defiant attitude and actions towards the central government’s policy of controlling foreign capital. For instance, while the central government expected to import foreign investment with advanced technology, most of the foreign investment approved by local authorities failed to meet this requirement. Local
authorities often provided foreign investors with favorable investment incentives that went beyond what were allowed by the central state. To identify the cooperation between local officials and foreign capital, the thesis first tries to draw a general picture of foreign investment in the country, and then focus on the case of Shenzhen. Shenzhen was the first place and also the model that the central government intended to utilize foreign investment. The failure of the mechanism for controlling foreign capital there is a good indicator of the situation in the whole country.

3) What was the impact of the cooperation on the central government? The impact has two aspects. First, the cooperation contributed to a shift of economic distribution disadvantageous to the central state. Second, the cooperation fostered stronger resistance against or defiance toward the central government’s policies.

The hypothesis of this thesis implies a comparison between the period before the reform or at the beginning of the reform in the late 1970s and early 1980s and the period during which the reform has been carried out through 1980s to the present time. The former period was characterized by a strong position of the central government versus local governments, and of the central government’s stringent control of foreign capital. The state controlled almost the whole economy, with state enterprises dominating both
industrial production and market. There was almost no private capital, and private business was also negligible. However, important changes occurred in the process of interactions among the three parties during the past decade. There have occurred a shift of economic distribution towards the local governments, an erosion or relaxation of controls over foreign capital, and an erosion of central authority at local levels. This thesis argues that the cooperation between local officials and foreign capital has played an important role in bringing about these results.

Indicators of the economic distribution shift include revenue share between the central and the local levels, portion of investment from each of the three parties, and the ratio of industrial output from state-owned enterprises and from foreign-funded enterprises. Revenue share has long been one of the most important means of leverage of the central government over local authorities. Investment and state-owned enterprises have traditionally been the monopoly and the economic basis of the power of the central government. Changes in these three indicators reflect the shift of economic distribution between the central and local authorities. With increased economic power and autonomy, local authorities can resist the central government's control because now the former "have the financial where-withal (sic) to ignore the center altogether" (Shambaugh
1993:254). Since the reform, where foreign investment has been concentrated and economic growth rapid, the local officials have been more defiant to and gained more autonomy from the central authority.

The cooperation between local officials and foreign capital and the erosion of central authority may also be reflected in the policy orientation at the local level, in which local officials depart from the stand of the central state. It is beyond the scope of the thesis to make a comprehensive assessment of this point; but it gives some examples, for instance, how some local governments defied the central government’s policy of controlling economic growth rate, to show the degree that central government was weakened.

The thesis uses both primary and secondary sources. Primary sources used include Chinese leaders’ speeches, the central government’s laws and regulations regarding foreign investment, and newspaper editorials and articles that reflect the official views. As to the secondary sources, there are statistic yearbooks, and books, papers and dissertations by authors who have conducted extensive interviews with both Chinese officials and managers and foreign capitalists.
Chapter 2 Background

This chapter examines the formative background that significantly affected the relationship among the central state, local authorities and foreign capital. First, it will analyze why the central government decided to open the country to foreign capital. The reason rests mainly in two aspects: challenge from the international system and economic problems within the country. Then the chapter will briefly examine solutions to its problems as perceived by the central state: the policy of openness and economic decentralization. The main points of this chapter are that the central state, confronting both internal and external pressures, decided to utilize foreign capital; in the meantime, it learned from historical lessons that foreign capital should be controlled; however, the central government’s policy towards foreign capital was also linked to economic decentralization, which changed the central-local relationship and would affect the effectuation of the central government’s policy.

2.1 The Central State’s Dilemma

The close of the third plenum of the eleventh Central Committee in December, 1978 marked the beginning of a new wave of open-door policy of the Chinese government, as well
as inauguration of economic reform. This top meeting of the Chinese Communists declared that the country would "actively expand economic cooperation in terms of equality and mutual benefit with other countries on the basis of self-reliance, striving to adopt the world's advanced technologies and equipment...to meet the needs of modernization" ("Communique of ..." 1978). It was also at this conference that the Party decided economic development should replace class struggle as the top priority for both the party and the state.

These decisions of the central government were conspicuously different from its policies of the past thirty years. From the break-up with the Soviet Union in the early 1960s till the late 1970s, China was almost an isolated country. During that period, China's development strategy was to emphasize self-reliance, sometimes even to the extreme. There were few external economic activities with foreign countries and, needless to say, little foreign investment in China.

Why did the central state choose a remarkable break with its past? The cause was that the central state faced both external pressure, which threatened its security, and internal pressure, which jeopardized its legitimacy. The external pressure came first from the tremendous threat to China's security posed by the Soviet Union. Beginning in the late 1960s, the Soviet Union was perceived by China as the
arch enemy that endangered China's existence. The Chinese Communist leaders believed that the Soviets planned to invade China and a war between the two countries was inevitable. To prepare against the anticipated invasion, China moved its key factories and production lines into the deep interior mountain areas during the late 1960s and early 1970s, at huge costs. As the Soviet Union was much stronger than China in terms of economy, technology and military power, the Chinese leaders felt the pressing need to develop their country's technology and economy.

Apart from the Soviet threat, the pressure at the international level upon the Communists to reform and open to the world also came from its neighbors and rivals in East and southeast Asia. "Chinese leaders were increasingly aware that China was being outperformed" by these countries, "most irksomely by its political alter ego, the Guomindang (Kuomintang) regime in Taiwan" (White 1991:4). The pressure from these countries was mainly of a political nature. The Communists believed and told the people that the Socialist system was superior to the capitalist; but they had to do well economically to prove this. The gap of economic development, technology and living standard between the mainland China and its neighboring countries and areas was really embarrassing to the Communist leaders. As Gordon White sees it, the central government faced also "these
fundamental political problems: of restoring China’s rightful status as a world power and reconstructing the battered legitimacy of the regime by providing the dramatic improvements in popular welfare which Chinese socialism had promised but, as of the late 1970s, had not delivered" (Ibid). Meanwhile, the gap between the prosperous Taiwan, Hong Kong, and Macau and the mainland also posed a problem to the reunification to the country, a task that the Communist leaders were determined to complete.

Confronting these external challenges, China, however, was not in a position to meet them effectively. After almost two decades of isolation and self-reliance, China realized that it lagged behind the Western countries about twenty years in technology and industry, and about forty or fifty years in agriculture (Xu, Dixin 1984:29; cited in D.K.Y. Chu 1986:36). There was a tremendous need to modernize the economy and technology in the country.

This backwardness was caused by both external and internal factors. Externally, because of the embargo of the Western countries and the break with the Soviet Union, China had few chances to learn the scientific and technological advancement of other countries. Until the early 1970s, American governments imposed strict restrictions on trade with China, and they urged their allies to follow suit, cutting China’s access to Western technology, capital and
market. External hostility pushed the central state to enforce a self-reliance policy, which was reinforced by the extreme leftist ideology during the Cultural Revolution to the degree of a self-imposing isolation. Isolation rid China of the benefits of economic and technological exchanges with other countries.

Internally, the command economy system had serious problems because of its inefficiency, lack of incentive and failure to raise living standard of the population. The command economy was a part of a centralist system of "total control and total mobilization" (Tsou 1968:277) built by the Chinese Communist party after 1949. Susan Shirk (1985:197-198) gives a good generalization of the characteristics of China’s political economy from 1949 to 1978. These characteristics include "the Soviet-style command economy," "the centralized bureaucratic state," "a collectivized agricultural sector," "the extensive growth strategy," "regional redistribution," and "the policy of economic self-reliance." Under this system the power was concentrated in the hands of the central government. It "set prices, wages, and output quotas, and allocated supplies and products according to national plan," aggregated and decided the use of taxes and industrial profits, controlled investment, and monopolized the foreign trade (Ibid). The central dominance was so great that for the first time in Chinese history, the
central government’s control reached the lowest level of community, the village.

The Soviet-style command economy was highly inefficient and provided few incentives (Shirk 1993:23–37). The inefficiency was inherent because of "irrational prices, isolation from foreign competition, lack of contact between supplier and consumer, and a pervasive emphasis on quantity rather than quality of output (Harding 1987:31). Within this economic system, the central planners emphasized high growth rates and heavy industries such as steel. The resources were channelled into industry, especially heavy industry, at a cost to agriculture and light industry. The country achieved a high rate of industrial growth of about 10% per year during 1949–80 period (Shirk 1993:27). However, because of the inefficiency, the growth was very costly and in order to sustain the high growth, more and more production factors (including capital and labor) had to be pumped into industry (Ibid). The result was that from the mid-1950s to the early 1970s, the growth rate declined while the investment rate steadily rose, and "the Chinese economy was requiring more and more investment to obtain smaller and smaller increases in output" (Harding 1987:31). Consequently, there were few resources left for improvement of the people’s living standard and, during the first thirty years of the Communist control, the living standard barely rose (Ibid). This
greatly impaired the legitimacy of the Communists, for they failed to realize their promise to improve people's life.

Moreover, the situation was worsened by the disaster caused by the Cultural Revolution, which not only disrupted the economy and hindered any possible improvement of living standard, but also tarnished the credibility of the Communist regime. During the Cultural Revolution, the legal system and the bureaucracy were almost paralyzed, scientists and experts were despised and a large part of them were sent to work in the countryside, education was disregarded, production was often interrupted by political movements, the national economy was disrupted and economic development neglected. In short, the Cultural Revolution was a disaster for economic and technological development in China as well as for the legitimacy of the regime.

To sum up, the central government faced fundamental challenges to develop effectively the economy and technology so as to safeguard the country’s security, and to restore the regime’s legitimacy through enhancing the living-standard of the population.

Confronting these challenges, the leaders strongly felt the urgency to modernize the country. They were aware that the country could no longer afford the old development strategy, as Zhao said in 1981 in his government report: "In the past, we carried on expanded reproduction chiefly by

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building new factories.... Now we will have to rely chiefly on the technical transformation of existing enterprises and on their initiative for expanded reproduction in the future" (Zhao 1981:6-36). They realized that more capital investment was not enough to solve the problem, but technological innovation, better management, and so on were also needed. They needed to increase incentives and improve on efficiency.

The leaders also realized that continued isolation and over emphasis of self-reliance could not help to solve their problems. To compensate for the technology and managerial gap with advanced countries, China had to learn from others. In former Communist Party General Secretary Hu Yaobang's words, only with foreign capital and technology could China develop its national industries faster, solve its problems quicker, and realize the socialist modernization more rapidly (Hu, Yaobang 1984:118).

In seeking options, they counted on two policies: open up to the outside world, and reform within the country. Two factors contributed to this decision. First, there was a reconciliation with the United States and other Western countries. Second, the death of Mao enabled more pragmatic leaders to undertakes policy changes.

During 1970s, the common threat from the Soviet Union pushed China and the United States and the allies of the
United States into a closer relationship. China felt that the Soviets were trying to surround China with their allies and regarded building an anti-hegemonic coalition against the Soviet as the utmost priority. The United States also wanted to use China as a "card" against the Soviets. This common interest made possible China's opening to the Western world and utilizing foreign capital. The fact is that the declaration of China's open door policy and the declaration of China and the United States to establish formal diplomatic relationship with each other occurred at the same time, both in December, 1978. The Communist leaders were, it is well documented, convinced of the favorable international conditions for them to concentrate on modernization and to develop economic relations with capitalist countries (Hu, Yaobang 1984:116).

The death of Mao Zedong in 1976 had provided an opportunity for the more pragmatic leaders to come to power and for them to redirect policy orientation. This eventually led to the opening of the conference of the Party's Central Committee discussed earlier, which settled the basis of the policy of openness and economic decentralization.

2.2 The Policy of Openness

The policy of openness was one of the key measures with which the central government intended to modernize the
country. The main elements of this policy consisted of utilization of foreign capital, technology transfer, and liberalization of the foreign trade system with an emphasis on exports (Grub 1991:17; Ho 1984:26; Kleinberg 1990:12).

Attracting and utilizing foreign capital, especially foreign direct investment, was the most important element of the policy of openness because foreign investment would not only supplement the shortage of internal capital, but would also help to import technology and expand export. As Hu Yaobang explained, there were two advantages in attracting foreign direct investment: one was to share risk as it is directly connected with investors’ interests; the other was to learn foreign technology and management skill (Hu, Yaobang 1984:121). In order to attract foreign investment, the central government provided a series of incentives to foreign investors, including tax holidays, preferential foreign exchange treatment, long-term and favorable land lease privileges, and special labor policies (Grub and Lin 1991:6). The forms of investment allowed included joint ventures and wholly foreign-owned enterprises, although the first was favored by the central government (Pearson 1991b:33). In July, 1979, the central state passed its first law regarding foreign investment, "Law of the People’s Republic of China on Joint Ventures Using Chinese and Foreign Investment." This law defined the rights and
obligations of each partner of a joint venture.

As to the goal of the policy of openness, nearly all top Communist leaders addressed this problem. Deng Xiaoping said that foreign economic relation was a strategic issue crucial to China's four modernizations—modernization of industry, agriculture, science and technology, and national defense (Hu, Yaobang 1984:116). In former Communist Party General Secretary Hu Yaobang's words, only with foreign capital and technology could China develop its national industries faster, solve its problems quicker, and realize the socialist modernization more rapidly (Hu, Yaobang 1984:118). Zhao Ziyang (1984:24; quoted in Nan Zhou 1987:22), the then Chinese Premier, also specifically addressed this issue in an article. According to Zhao, the open door policy means that "China is ready to develop trade with all countries on a basis of equality and mutual benefit, to import advanced technology and key equipment from abroad, to draw on foreign management experience, and to make use of foreign funds—all for the purpose of speeding up China's modernization" (Ibid). In the eyes of the Communist's chief decision makers, foreign capital and technology is nothing but a means to strengthen the party state.

The Communist government also hoped that this policy could contribute to the return of Hong Kong, Macau, and
Taiwan to China (Vogel 1989:126). The areas, under capitalism, had achieved far more prosperity than the socialist mainland. The differences between the two in political and economic system and in developmental level was an obstacle to the reunification of the country. By establishing special economic zones close to Hong Kong, Macau and Taiwan, the central government expected that the incorporation of capitalist practice would not only provide them with experience in dealing with the different system in Hong Kong, Macau and Taiwan, but also win over the minds of the people in these areas.

However, though it had so much expectation of foreign investment, the central government was nonetheless concerned with possible negative influences of foreign capital. It worried that foreign capital might violate China's sovereignty, undermine its economic interests, and bring in "decadent capitalist values." These concerns were well grounded on China's past experience with foreign capital.

Historically, China's involvement with foreign capital was a bitter experience, because it was forced upon China with violation of China's sovereignty and with unequal treatment, though objectively this contact enabled China to get in touch with modern technology and mode of production. China used to be a self-reliant country. The ruling group had little interest in foreign trade and no more in foreign
investment. Thus only with military forces did foreign capital enter China. In 1842, the Qing (Ch'in) dynasty which was ruling China was defeated by Britain in the Opium War and forced to sign the first unequal treaty. This treaty stipulated that five cities were opened as trade ports to Western countries, marking the beginning of a series of unequal treaties that the Chinese government was forced to sign under the political and military pressure of the European powers. By the late 19th century, approximately 120 town and cities, located mainly along the coasts and major rivers of China, had been assigned as treaty ports (Pannell 1984:201), where foreigners enjoyed free duties and extraterritorial status. Among these treaty ports all but 22 were compelled to open by treaty with one power (for instance, Britain, France, Russia, and Japan), and then became accessible to others through the "most favored nation clause" (Rozman 1981:34).

Treaty ports represented financial domination by foreign capital so that overwhelming advantages were enjoyed by foreign firms (Woetzel 1989:26); they also reflected the Western countries' use of military power and encroachment of China's sovereignty for economic benefits. It was in these treaty ports that foreign merchants began to build factories to exploit the advantage of Chinese labor and raw materials. At first factories were set up illegally, such as several
tea-processing factories by some Russians in mid-south China in the 1860s (Hou 1965:7). It was not until 1895 when the Qing (Ch’in) government was defeated by Japan, that foreigners were allowed to build factories legally in China as stipulated in the Sino-Japanese treaty (Hou 1965:8). The principal sources of foreign capital came from Britain, Russia, Germany, France, Japan and the United States (Hou 1965:18). Because these countries were the major powers in the world, they often backed their economic interests with political and military power, and even sought economic privileges through force. From the late nineteenth century to 1936, foreign investment, which was put primarily into sectors such as transportation, shipping, insurance, and banking (Ibid), gained a dominant position in China’s economy. By 1937, foreign powers controlled 91% of China’s railroads, 66% of its coal output, 97% of its iron output, 64% of its cotton cloth and 55% of its electricity (Ch’ en 1979:359-361; quoted in Woetzel, 27). Moreover, the custom revenues were controlled by British officials and the control was not returned to China until 1930 (Osterhammel 1984:260-287).

More importantly, foreign capital was used by the Qing and other regimes in China for support, while foreign capital was involved in the politics in China. The Qing government obtained foreign loans to suppress peasant
rebellions. During the 1910s and 1920s, foreign powers supported the warlords in fighting with each other for control of the central government. In the 1920s, during their competition for influence in China, the Japanese patronized the Wan Clique warlords, while the Americans and the British supported the Zhi Clique warlords (Wang Shenzu 1982:344). Another example of the involvement of foreign capital in Chinese politics was the role played in pushing Chiang Kai-shek, the late President of the Nationalist government who needed loans from foreign bankers, into combatting the Communists (Ch’en 1979: 268-270, 277-282; quoted in Woetzel 1989:26).

The role of foreign capital in the development and underdevelopment in China is still a matter of debate. On the positive side, foreign investment "played an important role in bringing about economic modernization or ‘preconditions’ for development China experienced before 1937 (Hou 1965:216), as modernization theory and classic economic theory expected. Foreign factories were the precursors of many Chinese industries. Foreign investment had positive effects in fostering China’s export capacity, personnel training, technology transfer, and promotion of entrepreneurship. On the other side, there were also negative effects as predicted by dependency theorists. Foreign capital retarded development of Chinese-owned modern
enterprises, drained profits and wealth out of the country, and caused a lopsided export development and excessive internal instability (Hou 1965).

Within China, however, foreign capital was more often regarded rather negatively. "The Chinese people by and large considered foreign capital in China as dominating and oppressive" (Cheng, Yu-Kwei:1956:41). Both the Nationalist and the Communist officials were critical of what foreign capital had done in China. Chiang Kai-Shek, the Nationalist leader, blamed foreign capital for "crippling" the national economy, destroying traditional industry, undermining agriculture and degenerating Chinese values and morality (Chiang 1976:63-75). Mao, the Communist, admitted its having accelerated the "commodity economy" in China, but charged foreign capitalism with destroying the foundation of the traditional economy, conspiring with feudal forces in retarding the development of Chinese capitalism and productive forces, and attempting to transform China into a semi-colony and colony (Mao 1961:309-314).

Because of these memories and the Communist ideology, the communist regime took steps to eliminate the "imperialist" political and economic privileges once they came to power in 1949 (Wang, Shenzu 1983:134). By the end of 1953, most of the business owned by Western countries had withdrawn from China or were managed by the government.

Now that it had to court foreign capital by itself, ironically, the Communist government faced a dilemma: on the one hand, it wanted and had to open itself to foreign investors; on the other hand, it could not but be worried about the possible accompanying negative effects. To deal with this dilemma, the central government came up with a strategy towards foreign investment: use it, but also control it. This point will be examined in more detail in the next chapter.

2.3 Economic Decentralization and the Central-Local Relation

The open policy of the central state was also linked with economic decentralization and other economic reform policies. Economic decentralization changed the central-local relationship within China. This in turn had an important impact on the central state's plan to use and control foreign investment, and on the relations among the central government, local authorities, and foreign capital.

The initial purpose of economic decentralization was to solve the problems of central planning and to provide incentive to local governments to develop the economy. Among policies of economic reform, the most important was fiscal reform. As the cornerstone of all reform measures (Wu,
Jianqi 1991:9), fiscal reform stimulated local interests and reshaped China's economic structure.

The basis of fiscal reform was set in 1980, when the State Council decided to implement a fiscal system based on "dividing revenues and expenditures" among different levels in which each level "assumes financial responsibility for its own level" or "eating in different kitchens" ("fenzao chifan"). The purpose of this reform was to appease and gain support from local officials by granting them more fiscal power and in the meantime to guarantee the revenue of the central government. According to Xiang Huaicheng (1990:15-25), China's vice Minister of Finance, the essence of the 1980 reform was that revenue and expenditure were "clearly defined and divided between the central and local governments according to the relationship of subordination prescribed in the economic system." In other words, the profit of centrally owned enterprises would go to the central government and that of locally owned enterprises would go to the local governments. The central and local governments were engaged in contracts of revenue sharing based on the 1979 figures and the rate would remain unchanged for five years; and each level of government was responsible for its own revenue and expenditure (See also Oksenberg & Tong 1991; Wong 1991a; Shirk 1990 & 1993). In 1985, the central government made some changes, namely
substituting tax payment for profit delivery, but it was soon abandoned because of opposition from local officials and the core of the 1980 reform, the fiscal contracting, remained intact there.

The fiscal reform not only provided incentives to local authorities to seek economic development within their relative regions, but also changed the central-local relationship. Before the reform, the central-local relationship was confined within a hierarchical political and economic system, one over which the central government had total control and total mobilization (Tsou 1968:277). Susan Shirk (1985:197-198) gives a good generalization of the characteristics of China's political economy from 1949 to 1978. These characteristics include "the Soviet-style command economy," "the centralized bureaucratic state," "a collectivized agricultural sector," "the extensive growth strategy," "regional redistribution," and "the policy of economic self-reliance." Under this system the power was concentrated in the hands of the central government. It "set prices, wages, and output quotas, and allocated supplies and products according to national plan," aggregated and decided the use of taxes and industrial profits, controlled investment, and monopolized foreign trade (Ibid). For the first time in Chinese history, the central government's control reached the lowest level of community, the village.
What shaped the central-local relationship were mainly the party-state political system and the central-planning economic system. The former was a closed, hierarchical system which tolerated no political and ideological deviation, with the central government issuing orders from the top the Communist party monopolized the interest aggregation function and achieved a political hegemony through the party-state apparatus (Townsend & Womack 1986:260). The later was one under which the central government monopolized entry into industries and controlled the revenue and budget (C.P.W. Wong 1992; Naughton 1992). "The Ministry of Finance approved not only the consolidated budget but annual revenue and expenditure plans at the provincial level and set the amount of revenue transfers" (C.P.W. Wong 1992:205).

The local governments, including the provincial authorities and those below, were the agents of the central government to implement and execute the plans and directives from the center (J.C.F. Wang 1989:163). They had to look to the central government for budgetary grants, and consequently their power and autonomy were limited. Although there were instances in which local officials resisted policies of the central government to protect local interests (Nee 1983:23), and there were short periods of administrative decentralization of economy, started even in
Mao's era (C.P.W. Wong 1991b:23-49), local officials were basically submissive and dependent on the central government.

With the fiscal reform, decentralized management replaced centralized management, and "distributing fiscal resources shifted from distribution among various ministries to distribution among various regions" (Xiang 1990:20-21). Before reform, because the economic system was based on unified revenues and expenditures (which means that revenue from a locality is not linked to its expenditure), local officials were not so motivated to develop their economical interests. The new fiscal system provided unprecedented incentive for local governments, as they could now legally retain and autonomously use the above-target revenue and savings. Their fiscal power expanded (Oksenberg & Tong 1991:18). They were now in the position to determine their fiscal arrangement and to arrange the structure of their budgets, whereas central ministries would no longer "issue mandatory fiscal targets" (Ibid). Moreover, local governments were allowed the entry into industry, the major source of revenue surpluses monopolized by the central government (C.P.W. Wong 1991:693).

On the other hand, the central government shifted increasing budgetary obligations to local governments (Shirk 1990:244; C.P.W. Wong 1991:704). "The center handed over to
provinces virtually all responsibility for price subsidies, housing and urban infrastructure construction, education, health, and many other budget items that were calculated according to uniform formulas" (Shirk 1990:244).

With both opportunities and pressures, local officials plunged into local enterprises, the income of which was now linked up with local revenues (C.P.W. Wong 1991 and 1992; Wu, Jianqi 1991:15). As agriculture generated little profits and industry has been the overwhelmingly chief source of revenue (C.P.W. Wong 1991 and 1992; Naughton 1992), local governments had no other options to meet their central government's quota and their own needs. As Jean C. Oi (1992:114) describes:

To ensure that all local officials do their utmost to develop rural enterprises, officials at each higher level of government set quotas for the subordinate level. The bonus pay of officials becomes linked to the performance of township enterprises in meeting profit and production quotas. The prefecture docks the county, and the county docks the bonus of township-level officials if the enterprises for which they are responsible fail to meet the quotas set by the county... The village-level officials have their own incentive to promote village industries actively since their salaries are directly tied to the total income of the village. The system is structured so that local officials have a double incentive to promote rural industry: growth allows them to benefit economically as individuals, without resort to corruption, and it allows them to alleviate the budget constraints that make their jobs difficult.
The fiscal reform also intensified the sense of ownership or quasi-ownership of enterprises on the part of the local governments. Although separation of ownership started before the reform, it did not mean as much to local officials because "budgetary revenues were only weakly linked to expenditures" (C.P.W. Wong 1992:211). Now they could really claim the profits from enterprises they "owned".

Consequently, the fiscal reform started the process of the declining of the central state, a process that had periodically occurred in China's history. Though the communist regime was different from past dynasties and even from the nationalist regime in many respects, it did inherit the centralist structure and developed central control to an unprecedented level with a Communist ideology. During the past two thousand years, power was normally concentrated at the top government level and partly delegated to various local levels. There were periods when regional or sectional forces pulled away from or even challenged the center, especially when the ruling dynasty or other type of central government was in decline. Then the "mandate of Heaven" was ignored and even challenged. The same would happen in the 1980s, when the local authorities increased economic power relative to the central government. But the latter did not seem to foresee or be concerned about this trend.
The differentiation of interests between the center and localities had important implications for the central government's policy towards foreign investment. While the central government initiated economic reform, it wanted to keep the political system intact. It still relied on its traditional channels and ways to have its policies executed by local officials. But now, as the local authorities had more interests different from those of the center than in the past, they would not carry out some of the center's policies if these were against their own interests, as they did to the central government's policy of controlling foreign capital. This point will be examined in more detail in Chapter 4.

In summary, this chapter examines the historical and present background underlying the relations among the central state, local authorities, and foreign capital. The background includes the rationale that the central state decided to utilize foreign investment, the historical memories that reminded the central government of the need to control foreign capital, and the fiscal reform that changed the central-local relationship and would affect the effectiveness of central government's measures to control foreign capital. Based on the discussion of the above background, the next chapter will elaborate the central
government's goals of utilizing foreign investment and measures it designed to control foreign capital.
Chapter 3 The Central Government's Policy
Toward Foreign Capital

This chapter explains the central government's goals in introducing foreign investment and its policy of controlling foreign capital. The last chapter has touched upon this topic, but this chapter will examine it in detail. In the first part of this chapter, discussion focuses on the central state's political, economic and cultural/ideological concerns in introducing foreign investment. The second part examines institutional arrangements created by the central government to control foreign capital, and it details the major forms of control. The following chapter will analyze how this control did not work out because of the cooperation between local officials and foreign capital.

The concepts of the central government and local government are relative to each other. The central government, or the central state, refers to the highest level institutions of the party and the government, including the Standing Committee of the Politburo, the Politburo, and the Military Affairs Commission of the Central Committee, the State Council, and the ministries under the State Council. In Chinese politics, the key leaders of these institutions, especially members of the Standing Committee of the Politburo, hold overwhelming power.
in decision-making and what they say is normally equal to the policy of the central government. The most important members of the Standing Committee of the Politburo included Deng Xiaoping and Chen Yun in the late 1970s and the early 1980s, Hu Yaobang in the early and mid-1980s, Zhao Ziyang from the early 1980s till June 1989, Li Peng since 1987 and Jiang Zemin since June 1989. Local government refers to the bureaucratic organizations at the provincial level and those below provincial level.

3.1 Aims of the Central State in Introducing Foreign Investment

In order to ensure that foreign investment would be conducive to its socialist modernization, the central state's aims extended to three domains: economically, to import foreign capital, advanced technology and managerial skill while protecting its own market and socialist economic system; politically, to protect China's sovereignty and equality with other countries; culturally/ideologically, to protect its original culture, ideology and value systems from those associated with foreign capital.

As has been discussed in Chapter 2, the main goal of the central government in seeking foreign capital, an essential part of the policy of openness, was to utilize foreign investment, technology and managerial skills of
capitalist countries to realize socialist modernization. However, it by no means wanted the political and economic system, ideology or lifestyle in those countries. Former Premier Zhao Ziyang, named by Deng as the "engineer of the reform", addressed the difference between China's socialist economy and the capitalist economy, saying in the government report in 1983: "For a considerably long time to come, we will strive to expand socialist commodity production and exchange, which nevertheless are essentially different from the profit-grabbing and anarchic commodity production characteristic of the capitalist system of private ownership" (Zhao 1983). Most of the top decision-makers, including Deng Xiaoping, Chen Yun, Hu Yaobang and Zhao Ziyang, risked their lives in fighting for Communism. Deng and Hu even went through the Long March. They would not want to see socialism replaced by capitalism in China.

Politically, the central state's concern was mainly with possible negative affects--violating China's sovereignty and equality between China and other countries, especially the Western countries. Most of the top Communist leaders experienced the days when China was weak and bullied, and they had fought to make the country stronger. Now, believing 30 years of socialist construction had made the socialist country strong enough not to "fear capitalism" (Li, Honglin 1985:34), the top officials considered that
foreign investment did not necessarily lead to China’s loss of sovereignty and equality with other countries. Nevertheless, the Communist leaders, even the most liberal ones, did not give up their cautiousness about capitalism. Hu Yaobang warned that "in no circumstances must we forget that capitalist countries and enterprises will never change their capitalist nature simply because they have economic and technical exchanges with us" (Hu, Yaobang 1983:31). Even Sun Ru, a theorist in Guangdong who was the first in developing a theory to defend the SEZs "emphasized that the SEZs constitute a sacrifice on the part of communists and that this sacrifice should be limited and temporary" (Chan & et al, 1986:94).

Out of this concern, Regulations on Joint Ventures stipulated that foreign investment should not cause "detriment to China’s sovereignty," or "inequity". This concern resulted from China’s modern history, as discussed in last chapter. As perceived by the central state, only with the safeguard of sovereignty could China’s modernization be realized, and the purpose of modernization was to defend China’s sovereignty. Sovereign independence means that China and other countries should be equal, and so should Chinese enterprises and foreign investors. Therefore the central government emphasized the "principle of equality and mutual benefit" concerning joint ventures, as it did
with all other economical cooperations with the foreign outside world. For the same reason, the central government demanded that these enterprises be subject to "authorization by the Chinese Government" ("The Law of the People’s Republic of China on Joint Ventures Using Chinese and Foreign Investment," hereafter "the Joint Venture Law").

Another concern of the central government was "socialist spiritual civilization." The leaders in Beijing have repeatedly declared that material progress and socialist spiritual civilization are of equal importance to SEZs and "failure to achieve either one is tantamount to complete failure" (Chang 1986:113). Actually, the central authorities seemed to be more concerned with socialist spiritual civilization, for it distinguishes them from capitalists (Ibid). In the early years of the open policy, the leadership frequently expressed the concern that "bourgeois values" would compromise or even endanger socialist values and the socialist system (Pearson 1991b:51). This concern later developed into the Campaign Against Spiritual Pollution (CASP) in 1983. "Spiritual pollution", as Deng Xiaoping defined it, was "the spreading of decadent and declining ideologies of the bourgeoisie and other exploiting classes, and the spreading of sentiments of distrust regarding the cause of socialism and communism and the leadership of the Communist Party" (Deng 1983:2). Deng
Liqun, then head of the Central Committee's Propaganda Department, named some of the phenomena such as "things which are obscene, barbarous or reactionary," "vulgar taste," "efforts to seek personal gain, indulgence in individualism, anarchism, liberalism," etc, as "spiritual pollution" ("Clearing Cultural Contamination" 1983:13). The leaders worried that foreign investors would bring their values and ideologies with them, affecting Chinese values that the leaders wanted to keep such as discipline, self-sacrifice for the good of others and the state, collectivism, moral and professional integrity, patriotism, "socialist humanitarianism," hard work, and good manners, and so on (Pearson 1991:49).

While desiring economic benefits of foreign investment, the government was nonetheless conscious of possible economic disadvantages accompanying foreign capital. Among them the Regulations on Joint Ventures mentioned "nonconformity with the requirements of the development of China's national economy" and "environmental pollution." Pearson has offered a list of the government's concerns with potential negative effects of foreign investment:

Loss of control over the general direction of development (particularly the industries and sectors to be emphasized), and over the uses for and scope of foreign capital
Loss of control over the domestic market, with
joint ventures monopolizing market share, or providing undue competition for developed Chinese enterprises.

Extraction by foreigners of "excessive" profits through unsavory accounting practices, low wages, and transfer pricing.

Net drain of foreign exchange.

Transfer to China of outdated, excessively expensive, insufficient, and/or inappropriate technology.

Absence of backward linkages to the domestic economy, particularly the use of domestic supplies. (Pearson 1991b:59)

Despite all those worries and concerns, however, the leaders decided to introduce foreign investment, because they needed foreign advanced technology and managerial skills. While most of its technology and industrial facilities were out of date, the central state lacked foreign exchange to import advanced technologies from the West. And there were the Soviet threat to the security, the pressure from the neighboring countries and areas, the problems with the command economic system, and the urgency to improve people's living condition. The leaders were aware that they had to make an economic "sacrifice" to foreign capital in order to attract it. They were also aware of the political and cultural/ideological risks. But there seemed to be no other options. They needed the benefits accompanying foreign investment.

The government specified the benefits that it intended
to gain from foreign investment in its regulations regarding joint ventures and wholly foreign-owned enterprises. The government required joint ventures "to promote development of China's economy and the raising the scientific and technological levels for the benefit of socialist modernization" ("Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment" 1983, hereafter "Regulations on Joint Ventures"). They had to meet at least one of the following requirements:

1. They shall adopt advanced technical equipment and scientific management which help increase the variety, improve the quality and raise the output of products and save energy and materials;
2. They shall provide benefits in terms of technical renovation of enterprises and result in less investment, quicker returns and bigger profits;
3. They shall help expand exports and thereby increase income in foreign currency;
4. They shall help the training (sic) of technical and managerial personnel (Ibid).

For wholly foreign-owned enterprises, they must be beneficial to the development of the Chinese national economy, be able to gain remarkable economic results and meet at least one of the following requirements:
1. Adopt (Adopting) advanced technology and equipment which can help develop new products, save energy and raw materials, upgrade existing
products, and substitute importation;
2. The annual output value of the export products accounts (sic) for 50 percent or more of the total output value of all products of that year with a balance or surplus in the foreign exchange revenues and expenditures ("Detailed Rules for the Implementation of the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises in China," hereafter referred as "Detailed Rules on Wholly Foreign-Owned Enterprises").

Consequently, the ambivalent feeling toward foreign capital—the aspiration for the benefits versus the concerns about the negative effects—resulted in a policy of controlling foreign capital. This policy is discussed in the following section.

3.2 The Policy of the Central Government's Control Over Foreign Capital

In order to utilize successfully foreign capital, the central government designed various ways of controlling foreign capital to promote only the positive effects while restricting the negative ones. It "asserted a number of overarching, higher level controls defining and limiting the status of joint ventures" (Pearson 1991b:102), sought to subordinate the foreign investment to Chinese law and the government's plan for the national economy, and tried to defend its own ideological stand. Major forms of control include: control of foreign capital in investment sectors,
restriction of sales to the domestic market, technology transfer and prevention of excessive economic benefits to foreign investor, which were designed to guarantee China’s economic interest, insistence that Chinese share in the management of joint ventures, a means to serve its political concern, and territorial containment and prevention of spiritual contamination, which especially reflected its cultural/ideological aims.

To protect China’s economic interests

Sectoral control of foreign investment. The central government adopted policies to guide foreign investment into designated sectors and restrict or even prohibit them from protected sectors. Listed as encouraged sectors for foreign investment in joint ventures in 1983 were energy development, the building material, chemical and metallurgical industries, machine manufacturing, electronics and computer industries, light, textile, foodstuffs, medicine, agriculture, and tourism and service trades, etc ("Regulations on Joint Ventures" 1983). Foreign investment in the defense industry and in industries causing environmental pollution were forbidden. After 1985, aviation and transportation were added to the encouraged list, but new investment in tourism and real estate were rigidly restricted (Pearson 1991b:117). The government also initially planned to "limit the number of joint ventures in
any given industry to one or two" (Ibid). Wholly foreign-owned enterprises were prohibited in news, publication, foreign trade, posts and telecommunications and restricted in public utilities, communications and transportation, real estate, trust investment and lease ("Detailed Rules on Wholly Foreign-Owned Enterprises").

**Restrict access to the domestic market.** Although many foreign investors wanted to take advantage of the Chinese domestic market, the central government expected them to export. Article 9 of "Joint Venture Law" states that "a joint venture is encouraged to market its products outside China." Access to the domestic market was restricted. Article 61 of "Regulations on Joint Ventures" maintains that only "products of joint ventures that China urgently needs or imports can be mainly sold on the Chinese market." For wholly foreign-owned enterprises, their products must be either of high technology or reach an exported-rate of at least of 50% ("Detailed Rules on Wholly Foreign-Owned Enterprises").

**Technology transfer.** Technology transfer was a main reason to seek foreign investment. Article 5 of the "Joint Venture Law" sets the standard that "the technology or equipment contributed by any foreign participant as investment shall be truly advanced and appropriate to China’s needs." "Regulations on Joint Ventures" (Article 44)
further requires that the technology "enable the venture's products to display conspicuous social economic results domestically or to be competitive on the international market," and "expenses for the use of technology shall be fair and reasonable" (Article 46). Technology transfer is a chief criterion to approve a foreign investment project.

**Prevention of excessive economic concession to foreign capital.** Although the central government provided incentives such as tax exemptions for foreign investment, it did not want to see too much concession given to foreign capital. Through various laws and regulations regarding foreign investment, the central government established guidelines for what incentives were allowed. It also tried to restrict foreign capital from repatriating profits, and to prevent overvaluing the investment from the foreign side while undervaluing the investment from the Chinese side such as the use of land.

**To ensure sovereignty and equality with foreign capital**

**Share in Management.** This control mainly applies to joint ventures, which have been the major form for foreign direct investment. By insisting that the Chinese side directly participate in the management of a joint venture, the government not only wanted to absorb foreign capital, technology and managerial skills, but also to protect Chinese control and sovereignty. Thus "the Joint Venture
Law" (Article 6) stipulates that the chairman of the board of directors, the highest authority of a joint venture, shall be appointed by the Chinese side. A "shadow" (or deputy) management system was also set up in joint ventures (Pearson 1991b:169) so as to prevent foreign capital from dominating the decision-making.

To prevent spiritual contamination and other possible negative effects

Territorial containment. The regime made clear that foreign direct investment "was to have only a limited and clearly defined-albeit crucial-place in China’s economy" (Ibid). For this purpose the central government designed the four special economic zones (SEZs), Shenzhen, Zhuhai, Shantou, and Xiamen. The first three are in Guangdong province, and the last in Fujian province. All these areas are hometown to many overseas Chinese and close to Hong Kong or Taiwan. SEZs were set up in remote frontier townships in the south-eastern provinces, and the sizes of the four SEZs initially designed were fairly small. In locating SEZs in relatively uninhabited areas away from existing urban settlements, the central government planned a territorial containment that would restrict "capitalist influence" (Zhu 1986:36). Even if the policy of using foreign investment failed in these test grounds, the influence would not spread to the major body of the country.
Prevention of spiritual contamination Deng himself claimed that "the opening up of external relations will [would] mean the infiltration of the corrupt things of capitalism" (Deng 1985, cited in Pearson 1991b:121). Illegal drugs, pornography, inappropriate consumption patterns, and individualism and distrust in socialism and the Party were linked to negative effects of capitalism. In an effort to counter these influences, the government initiated the 1983 Campaign Against Spiritual Pollution and the 1989 Campaign against "bourgeois liberalization", so as to keep "communist values" such as the spirit of collectivism, thrift, and self-sacrifice, and traditional Chinese values, including modesty, respect for authority, and conservative sexual mores. Other efforts in the early years of the "open policy" included regulating contacts between Chinese and foreigners and limiting advertising by foreign firms and restricting sales for luxury products—foreign cigarettes, soft drinks, and liquor (Pearson 1991b:120-125).

The institutions available for carrying out these forms of control were the party-state institutions, consolidated in a hierarchical bureaucratic system. This system, dating back to the time when the Communists were fighting the nationalists, had proved rather effective for carrying out the central government's policies in the past. Since the
late 1970s, the Communists had made important changes in
economic policy, but no significant attempt had been made to
reform the political institutions. Although local
authorities had been granted more autonomy in managing their
local economies, they were still supposed to follow the
policy and guidelines of the central government and never go
beyond. The same was true for the policy towards foreign
investment.

The control over foreign capital was executed both at
the central level and at the local levels. At the central
level, the state established the principles, laws and
regulations regarding utilization of foreign capital. The
guiding principles were "equality" and "mutual benefit." The
laws and regulations defined the requirements, rights,
duties and restrictions of foreign investment. Authorities
at every level were supposed to follow these principles,
laws and regulations. Moreover, the central government
retained the power to supervise and even to revoke decisions
made by the local authorities in dealing with foreign
investment. The central government also solely held certain
means of control, including foreign exchange control, and
control of the planning system that would guarantee supply
of some raw materials and sale of some products. But with
the economic reform, the functions of central planning had
been greatly reduced; that means the central government’s
economic lever over foreign capital was limited and it had to rely more on local authorities for controlling foreign capital. At the local level, local officials were agents of the central state. They had power to approve foreign investment up to a certain amount, and to supervise these investments. They were supposed to execute the central state's policy toward foreign investment, following the same principles, laws and regulations set by the central government. But basically it was the local governments that were to approve and supervise foreign investment within their own regions. Although the central government held the final authority over foreign investment, normally it did not meddle in the local governments' decisions until serious problems were found.

One crucial lever of the control over foreign capital was the approval of foreign-funded projects. The government expected to prevent undesirable projects of foreign investment by just not approving them. The power to do this was held by both the central and local authorities. At the central level, the authority lay with the Ministry of Foreign Economic Relations and Trade (MOFERT). Article 8 of "Regulation for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment" (1983), and Article 5 of "Detailed Rules for the Implementation of the Law of the People's
Republic of China on Wholly Foreign-Owned Enterprises in China" (1990) states that both joint ventures and wholly foreign-owned enterprises are subject to the examination and approval of the MOFERT. At the local levels, the authority was in the hands of government branches with functions similar to the MOFERT. Before setting up a joint venture, the venture should supply a joint application, feasibility study report, agreement, contract and other documents to the MOFERT or local authorities, depending on the amount of the projected investment. The SEZs authorities had power to approve a project of up to US$ 50 million, the Shanghai and Tianjin governments up to US$ 30 million, and other governments of the provincial level up to US$ 10 million. Local governments of provincial level in turn granted local officials below them the authority to approve foreign investment. As the majority of foreign-funded projects were less than US$ 10 million, actually it was the local authorities that approved most of foreign investment.

Thus, the execution of control over foreign capital was heavily dependent on local officials. Here lies the problem: as the center-local relationship underwent important change under the fiscal reform, local governments might not follow the central government's directives. This will be discussed in Chapter 4.
In summary, this chapter has examined the central government’s aims and methods in controlling foreign investment. When the central government decided to import foreign investment, it did not mean to import capitalism or the capitalist mode of production. Rather, it wanted to use some capitalist means to serve the socialist goal. To ensure its goals, the central government designed various forms of control over foreign capital. Yet, because of the way that the party-state was structured and the central government’s policies were carried out, the effectuation of these controls heavily depended on the cooperation of local officials. The next chapter will examine how the intended means of control failed because of the cooperation between local authorities and foreign capital.
Chapter 4 Local Authorities and Foreign Capital

Whereas the previous chapter addressed the goals of the central state in introducing foreign investment, this chapter examines the aims of foreign capital in investing in China, and the local governments' goals in attracting foreign investment. It is argued that local authorities and foreign capital share more interests with each other than with the central state, especially on the matter of controlling foreign capital. Then, the chapter traces how, during the past decade and a half, the central government's control of foreign capital failed at the local level, and how local governments, in their competition for foreign investment, took an active part in evading the controls over foreign capital designed by the central government. The discussion first depicts the general condition throughout the country, and then focuses on the case of Shenzhen.

4.1 The Aims of Foreign Capital

Phillip Donald Grub and Jian Hai Lin (1991:63) list foreign investors' motivations in China as the following:

1. Receive assurance of a share of China's potential market and the rapid growth of its economy;
2. Reduce production, labor, and other costs, including benefits from China's investment
programs;
3. Obtain raw materials available in the Chinese market that can be either used to meet production needs or be sold in third markets;
4. Meet their competitors' move to China and/or forestall or reduce competition from other firms' earning markets in the same geographical area;
5. Test the Chinese market as a potential for large scale investments at a later stage; and
6. Full sentimental and other reasons, such as returning to their homeland.

The market potential is the leading motivation for foreign capital to invest in China (Grub 1991:64; Pearson 1991b:31; Kemp 1987:75). The potential of a market with a population of over one billion has always been very attractive. The Chinese government's import substitution policy also predicted that a strong market would appear for industrial goods and infrastructural development (Grub 1991:64). Despite the central government's intention to control stringently access to the domestic market, most foreign investors set up operations in China in the hope of getting into the domestic market eventually (Kemp 1987:66). This was especially true for investors from West European countries and the United States as well as for many firms from Hong Kong (Pearson 1986:31 & 1991b:31-32). Because China was short of foreign exchange reserves for imports, foreign investment was "considered by many investors as the only possible way to penetrate the Chinese market" (Grub 1991:64).
Another major aim of many foreign investors, especially those from Hong Kong and Japan, was to gain immediate profits by reducing product cost (Grub 1991:64; Pearson 1991b:32). The costs of labor, land and raw materials were relatively much lower not only than those in the major industrial countries, but also than in most neighbor Asian countries (Grub 1991:64). For some other companies, particularly some textile companies, the purpose of building factories in China was to make use of the Chinese quota under international trade agreements for exports to Western countries (Kemp 1987:67). For those firms seeking low production costs, China's tax incentives were also important (Kemp 1987:75).

The interests of foreign capital and China were compatible in that both sides hoped to see their joint ventures or other projects to be economically successful (Pearson 1991:33). The two also shared interests in China's political stability, which is indispensable to realize profits. According to Michael Oborne, political stability is, as demonstrated by some recent studies, the most important factor in determining foreign investment in developing countries (Oborne 1986:139-140). This was proved after the 1989 Tiananmen tragedy when foreign investment increased in spite of punitive measures against the Communist government by governments of Western countries.
Another domain in which the central government and foreign investors shared interests was protection from maltreatment of foreign investors by some local officials. If such occasions arose, foreign investors needed to go to the central government for justice, while the central government would respond in order to protect the country's image of having a good investment environment. For example, one businessman from Taiwan formed a joint venture with a local government in Guangdong. He was told first that the business could be engaged in gambling, which was supposed to be very profitable but illegal in China. But after he put in his share of capital, he found out that he had been cheated by the local officials. So he had to resort to the central government and drew back his capital ("Luring investment may be illegal" 1994).

Nevertheless, there were major differences between the goals of the Chinese central government and foreign capital. First, conflict arose around the market problem. While the major interest of foreign capital was in the Chinese market, the central government wanted to protect its own market. While the Chinese expected joint ventures and wholly foreign-owned enterprises to export, many foreign investors were reluctant to do so, because they did not want to compete with themselves in the market outside China that they already occupied.
Another area of conflict lay in technology transfer. The Chinese demand for technology transfer contradicted the interest of most foreign investors, who wanted to restrict the distribution of their proprietary technology (Pearson 1991b:34). Some foreign investors, such as Swarovski Crystal, were unwilling to transfer technology to China so as to avoid new international competitors (Woetzel 1989:121). Among Japanese firms, many were afraid that by transferring valuable technology and management skills to China, they would strengthen its economic and political power and foster a rival (Pearson 1991b:32).

Still another source of discord between the central state and foreign capital concerned management, especially in joint ventures. The central government emphasized Chinese's equal share of management and opportunities to learn foreign management skills, whereas foreign investors preferred to manage their overseas operations by themselves (Pearson 1991b:34).

It is also in the interest of foreign capital to see the influence of their life style and ideology increasing, contrary to the central state's desire. Many foreign investors or employees sent by foreign investors to work in China, especially during the early 1980s, often found themselves bored or stressed because of lack of recreational facilities and cultural activities, Western goods and food,
and they had "difficulty coming to terms with a culture that is completely alien to their own" (Kemp 1986:86).

On these discrepancies of interests, foreign investors often put pressure on the central government to relax or change controls to meet their goals (Pearson 1991b:34). Another method that foreign investors frequently used was to seek cooperation of local officials to evade the central governmental's control. This will be discussed in section 4.3.

4.2 The Interest of Local Authorities

As has been discussed in Chapter 2, local governments became actual economic entities under the fiscal reform. Acting as "representatives" of the interests of their localities, local officials fought for investment.

Jean C. Oi has suggested that local government in rural areas (villages) became "socialist landlords" "in essence."

They sell the right to operate collective property or business. The village retains ownership; it has the right both to conduct periodic inspections and to terminate contracts if the original terms of the agreement are not met or the quality of the franchiser's performance does not meet village standards. Village cadres dictate the terms of land contracts and select the tenants who can have the privilege of running village enterprises (Oi 1989:193).
I would argue that local governments have become "socialist capitalists" or "quasi-capitalists." Because of a lack of separation between government administration and enterprise management, local governments were granted the property rights and power of management of most state enterprises; and they could directly interfere in the economic activity of those enterprises directly under their control (Li, Shihua 1993:67). As collective enterprises were concerned, they were mostly set up and owned by local governments at different levels. Therefore, local governments became the actual owners of state enterprises under their control and local collective enterprises. They were investors. "At present, although Chinese enterprises are nominally the investing entities, local governments are the de facto ones" (Wu, Jianqi 1993:13). Having acquired power over the banks and financial matters, they often intervened and instructed banks to issue loans to projects in which they want to invest (Ibid). The weakened central government’s macro-economic regulatory power after the fiscal reform could not do much to curb this tendency. Local authorities were also managers. Needless to say, they have been beneficiary and allocator of the profits of the enterprises under their control.

Like capitalists in the Western societies, local officials had a desire to expand industrial production, and
in doing so they repeatedly denied the central government's appeal to curb excessive growth. In order to increase local revenues, different localities hurried to set up their own system of industries, concentrating on forward processing of primary products as these required little investment, showed quick returns, and yielded high profits (Wu, Jianqi 1991:10). They also wanted to monopolize the market within their administrative control, yet at the same time expand their share in other markets. More than capitalists in the Western countries, they could use administrative power to achieve the monopoly within their region. "To protect their fledgling processing industries, many local governments began to interfere administratively against products from outside and blockade their markets, resorting to such measures as prohibiting out-of-town procurement, limiting sales of out-of-town enterprises not based locally, and forbidding goods in short supply from being exported" (Wu, Jianqi 1991:10).

Capital was what every local government wanted but lacked. In order to gather funds, local officials welcomed funds in but forbade funds to leave. Some local governments even "issued clear instructions to banks to 'temporarily withhold' and 'legally default' on repayment of outside debts" (Wu, Jianqi 1991:12). Many localities used funds the central government gave them to relieve capital shortages
for commercial investment (Ibid).

By attracting foreign capital, local officials could be benefitted in the following four aspects:

First, they could obtain "political capital" for promotion or award. Foreign capital itself is sanctioned by the central government. The result of attracting foreign investment has been one of the measurements of the merits of local officials. For example, Yu Fei, the former mayor of Foshan Municipal who was well known for his success in attracting investment from Hong Kong (Vogel 1989:181-189), was later promoted to the position of vice governor of Guangdong Province. Similarly, "local governments made the quantity of foreign investment the main criterion of their work. So they vied with each on providing preferential incentives to foreign capital and engaging in "abnormal" competition" (Zhu, Yanting 1993:74-75).

Second, foreign investment could help the economic growth of their region and increase their revenue. Economic growth rate within an area was regarded as one of the criteria for evaluating local government officials utili recently. The technology from the foreign investment might also help them compete with other areas within the country.

Third, foreign investment could bring employment to their region and give them a sense of achievement as a "patron" of people within their region. This in turn would
help them in their administration. Moreover, local officials could gain personal benefits. The exports from joint ventures could generate foreign exchange, which local officials could use for travelling abroad and purchasing foreign cars and consumer goods. They could let their relatives and friends work in joint ventures. They could even gain commissions or bribery.

Local governments and the central state shared some fundamental interests in utilizing foreign investment. The job of introducing foreign capital largely lay with local officials, and the success of local officials theoretically should contribute to the success of the whole country. The central government's control of foreign capital would also protect the interest of local governments as a whole. Some individual local governments needed help and protection from the central state when facing competition of or dispute with foreign investors.

However, individual local governments differed with the central government in their priorities for foreign capital. The basic conflict was that the central government was concerned with the effect of foreign investment on the whole country, while individual local governments cared only about the effect on their respective regions. For instance, while the central government wanted to restrict foreign-funded enterprises from selling to the domestic market, local
governments which administrated these enterprises preferred to sell more domestically so long as this was profitable. Some individual governments also ignored the central government's sectoral control of foreign investment, because the sectors that the central state wanted to protect were in other areas of the country. Local governments, especially those of interior areas, did not share an interest in containing foreign investment in certain areas, because they also wanted to enjoy the benefits of foreign investment. Since the reform, the coastal areas had been accorded preferential treatment in dealing with foreign capital and gained enormous benefits, leaving the other areas crying for the same treatment and causing an impression that the more privileges in attracting foreign investment, the better. Moreover, local government did not need to care so much about the ideology as the central government did. Unlike the central government, local governments competed mainly with one another or with state enterprises subordinated to the central government, which used about the same technology and competed in the same market, rather than with foreign capital. Local governments found that foreign capital could help them increase capacity in competition while the central government's control restricted them.

Under these circumstances, it is not hard to see why local officials wanted to cooperate with foreign capital. In
the remaining part of this chapter discussion will focus on how this cooperation led to evasion of the central government’s control of foreign capital.

4.3 Cooperation between Local Authorities and Foreign Capital

The convergence of interests of local governments and foreign capital has led to cooperation between them. In this cooperation, foreign capital tried to evade the controls of the Central government and gain profits, while local governments wanted to gain the privileges associated with foreign investment, to develop their own economy, and even to turn state assets into their own.

The zeal of local governments in courting foreign capital was manifest in their fervor in setting up economic-technical development areas. In 1984, the central government decided to allow 14 coastal cities to set up economic-technical development areas within clearly-designated boundaries in these cities, for the purpose of importing advanced technologies. Foreign investment in these areas could enjoy preferential treatment similar to that of SEZs. However, local governments other than these cities wanted the same privileges. According to the statistics of the Ministry of Agriculture, by the end of 1992, there were 19,000 development areas, with a total space of 150,000
square kilometers (nearly 2% of the territory) designated for foreign investment. Only 95 of these development areas were approved by the central government, with all the others approved or set up by various local governments (Zhang, Kai 1993:15). In one province, there are 109 local governments at the county level, but there were 153 development areas at the county level and 88 development areas at the town level ("Where are development areas leading to" 1993). Even some village governments in rural areas set up development areas. In Jiangsu Province, for example, a village had four development areas; and in a town of Hunan Province, 40 square kilometers were designated for development area (Ibid), larger than those of many large cities. According to an official newspaper, most of the enterprises in these areas are not of advanced technology, but rather of high cost, high pollution and low profit (Ibid). Many development areas were residential areas, villa areas, and places for real estate speculation (Zhang, Kai 1993:15).

Local governments made efforts to meet needs of foreign investment. Foreign investors, most local governments promised, would be given priority in obtaining land, raw materials, and electricity, and loans, which were often in shortage, even before domestic enterprises. Foreign-funded enterprises could get employees, technicians and other personnel they wanted, even at the sacrifice of other state
enterprises. As Roehrig (1993:94) found in his research, "the battle for power can also involve foreigners working with local Chinese authorities to wrest power from other Chinese." If a foreign-funded enterprise needed some special personnel, the local authority would find ways to arrange such personnel transfer from local state enterprises, or other localities, or the countryside, even though this went beyond the regular procedure of hiring and transferring of employees stipulated by law (Ibid). Roehrig gave one example. In Wuhan city, management of a joint venture needed to hire engineers from a state enterprise. But the state enterprise wanted to keep these engineers for itself. So the joint venture management asked the help of the local labor authorities, who ordered the personnel transfer to be made (Roehrig 1993:91).

The competition among local governments for foreign investment made them more compliant with foreign capital. Many local officials appeared to feel as did the mayor of Wuhan, the largest city in Central China, in saying: "We have to be better than other areas of China with respect to our joint venture policies." He made this remark in support of a foreign manager's plea for tax exemption after being denied by the tax bureau of the city (Roehrig 1993:107).

In their efforts to attract foreign investment, they often went beyond the limits set by the central government.
According to the official *Beijing Review*, one of two problems confronting China's tax authorities was that "the local governments were providing, without approval from higher authorities, preferential tax reduction and exemption in order to attract more foreign investment, actions which threw China's taxation situation into confusion" ("Attuning taxation to Investment Climate" 1991:23). The magazine admitted that such steps were frequently taken and there was competition among local governments for providing even more preferential treatment to foreign investors (Ibid:24). Of the 30 local governments at the province level, 23 of them made unauthorized regulations for tax reduction and exemption (Ibid). The magazine reported, in examining local tax rules and regulations stipulated by 15 provinces and autonomous regions, the State Administration of Taxation had found a total of 77 articles that violated current state tax law. One case of such a violation was committed by extending "the period and the number of items for which foreign-funded enterprises could enjoy preferential treatment of reduction and exemption from enterprise income tax" (Ibid). For instance, the central government only allowed a five-year income tax reduction and exemption to export-oriented and technically advanced foreign-funded enterprises. But the government of Hunan Province stipulated that in addition to what was allowed by the state, such enterprises could enjoy
a reduced rate of 50% income tax beginning in the sixth year, and foreign investment in energy and raw materials resources or in undeveloped areas in the province could also enjoy the same preferential treatment. Some local governments, without authorization, extended deduction of and exemption from the industrial and commercial consolidated tax and individual income tax, or expanded the scope of preferential treatment, or enlarged the tax rebate rate on reinvestment. Some interior areas promised foreign investors preferential treatment only allowed in coastal open cities (Ibid).

In their cooperation with local governments, foreign capitalists just invested their money more with localities rather than the central ministries (Y.Y. Kueh 1992:646-7). From 1979 to 1991, provincial absorption of foreign direct investment increased at the expense of central ministries (Ibid). During the 1985-90 period, provincial share of absorption of foreign capital (including both FDI and foreign borrowing) increased from 36% to 53%, while the share of central ministries dropped from 64% to 47% (Ibid).

In the cooperation, local officials have often been the more active partner of the two. They have provided incentives and been responsive to demands of foreign capital, while foreign capital chooses where there are greater incentives and more profit potential. Studies show
that the attitudes of local officials were an important factor in Hong Kong businessmen's decisions on where to invest (Thoburn 1990:2).

The cooperation between local authorities and foreign capital was reflected by local authorities' approvals of foreign investment. After 1984, the local governments in a few large cities such as Guangzhou, Beijing, and Dalian and the provincial governments of Guangdong, Fujian, and Liaoning obtained the authority to approve foreign-funded projects up to $10 million in total investment, the Shanghai and Tianjin governments up to $30 million. In 1988 all the other provinces obtained the power to approve foreign-funded projects up to $10 million in total investment (Pearson 1991b:109). These provincial local governments in turn further delegated to local governments of subordinate levels the power to approve investment of smaller amounts.

With the authority to approve foreign investment, local governments were in a better position to cooperate with foreign capital. A foreign investor could go to some government at the local level to have a project approved when it might have been rejected by the central government. One such example is given by Pearson. She recounts that one foreign investment project was turned down by authorities from a central ministry because there had already been a similar joint venture elsewhere. But one local government
approved it. What the local officials and the foreign investor involved in this venture did was that they "made various accounting and financing schemes, [and] kept the amount of total investment low enough so that local authorities, who favored the project, would be authorized to approve it" (Pearson 1991b:110). When local officials were to approve a foreign-funded project, they considered their own interests before the interests of the whole country or of other areas if these interests conflicted. Some officials at the level of district and municipality thought that the simpler the approval procedure the more the efficiency, and the more the tax reduction and privileges, the better the investment environment (Gao, Guoquian 1994:13). "Localities did not pay much attention to whether the projects they were approving were similar to projects under way elsewhere. This led to redundancy of projects across regions " (Pearson 1991b:110). In the same way, local governments approved foreign investment in sectors that were discouraged by the central government, projects of low technology and even bogus joint ventures.

One form of the cooperation between local authorities and foreign capital was that they set up a joint project secretly, trying to avoid the central government’s attention and make the existence of the joint project de facto. When the central government discerned it and wanted to veto the
contract, the foreign partner would spread rumors abroad that the government did not honor contracts, in order to force the central agency to give up (Ye, Zuotan 1993:34).

Another extreme but common form of local-foreign cooperation was a "bogus joint venture" ("jia hezi"), which was a joint venture in form but with no actual foreign investment or insufficient foreign investment. Bogus joint ventures occurred when some local Chinese enterprises first remitted or transferred money to a foreign partner and then the foreign partner used this money to invest; or the foreign side first invested a certain amount of capital and as soon as the "joint venture" got approved, the foreign side withdrew the money to invest somewhere else or got the money back plus interest in the form of profit. It could be that the foreign side just wanted to sell their equipment, and once they got the profit, they extracted the invested capital. But these enterprises still enjoyed tax exemptions and reductions and other benefits. In one joint venture, for instance, the contract stipulated that the foreign partner would invest 60% of the total capital. After the joint venture got approved, the foreign investor actually put in only 15% of the total capital, below the 25% minimum rate required by the joint venture law (Zhu, Tingqun 1993:74).

Out of their own interest, local governments tolerated the existence of unqualified foreign-funded businesses that
the central state would not. According to the Party's official newspaper, the central state has, since 1979, revoked 7,500 unqualified foreign-funded projects, about 4.3% of the total ("China revoked more than 7,000 foreign-funded enterprises" 1994:1). This was a rather high ratio, considering the government's reluctance in discouraging foreign investment. These 7,500 projects were nullified because "some foreign investors actually did not invest; some just wanted to use the favorable policies to smuggle, speculate, or cheat; some just wanted to sell instruments of low quality for [a] high price; some operated unlawfully, even [engaged] in prostitution, pornography and gambling" (Ibid). Most of these businesses were approved and allowed to operated by local authorities. An official of the central government in charge said that in 40% of foreign-funded enterprises through the country the foreign investors failed to inject the contracted capital (Ibid), failing to meet the central government's requirement.

Because local authorities shared interests with foreign capital in evading or breaking the central government's controls over foreign capital, they did not abide by the policies of the central state, though they were supposed to. This led to the failure of the central government's major forms of control over foreign capital, as demonstrated below.
Sectoral control of foreign investment. The central government wanted to encourage foreign investment in those sectors in which China was weak, such as energy and computer industries, and those that would help China's exports, but to restrict foreign investment from protected sectors. However, local governments' interests were often different. For example, new investment in tourism and real estate was rigidly restricted after 1985. But foreign investment in these sectors was highly desirable from the viewpoint of local officials, because these sectors could usually bring in the largest amount of foreign funds to show local officials' achievement in executing the open policy (Pearson 1991b:118), and the locality could obtain direct economic benefits.

In Guangdong, foreign investment was concentrated in the processing industry, such as electronics, household electric, food, textile, clothing, chemicals, toys, and machinery (United Investigation Group of Guangdong Statistics Bureau 1990:56). In Quanzhou, Fujian province, 70% of foreign investments were in labor-intensive sectors, such as clothing (Wu, Xinwen 1994:25).

As Pearson notes, by late 1986, the central government's initial intention to limit each sector to one joint venture was not realized (Pearson 1991b:117). Many more foreign-funded enterprises were built in automobile,
pharmaceutical, and hotel industries (Ibid). The aim to attract foreign investment to technologically advanced or export-oriented industries rather than to tourism and real estate also failed (Ibid).

Restrict access to the domestic market. As discussed earlier, one of the major interests of foreign capital was in the Chinese market. Many joint ventures, too, preferred selling their products in the domestic market, because it was more profitable than selling to the international market (United Investigation Group of Guangdong Statistics Bureau 1990:59). In order to get approval, many joint ventures promised an export ratio of their products. But after starting the operation they tried to sell domestically. In Guangdong province, for example, the majority of the joint ventures did not reach the export ratios as promised in the contract (Ibid). In Quanzhou, Fujian province, the export rate for joint ventures was 46.5% (Wu, Xinwen 1994:25). While not a few foreign investors broke their promises of selling to foreign markets, the Chinese partners generally did not charge the foreign side for breaking contracts ((United Investigation Group of Guangdong Statistics Bureau 1990:58).

Under the pressure of local officials and foreign capital, the central government had to make concessions. According to Pearson, the 1980 draft of the Implementing
Regulations of [the] Joint Venture Law did not mention that joint ventures could sell their products in the domestic market (Pearson 1993:130). But in 1986, the central government officially allowed joint ventures to sell domestically products that used high technology or large amounts of domestic materials, and that were substituted for imports or of better quality than those produced by other local enterprises (Ibid).

**Technology transfer.** In seeking foreign investment, local governments compromised the requirement of technology transfer. In Shenzhen, where the central government intended to import high technology, only 10% of joint ventures used advanced technology (Pearson 1991b:158). In one city of a south-eastern province, 90% of the equipment imported by the foreign partners was old and had been used for many years. From 1990 to June, 1992, Beijing Bureau of Commodity Inspection found 25% of equipment imported by the foreign partners had serious problems in quality (Zhu, Tinggun 1993:74).

In joint ventures, the foreign partners very often invested in the form of equipment or raw material rather than capital in hard currency. But for some foreign investors, this was a way to sell their outdated equipment, or make money by selling equipment and technology to China. The equipment and technology were often overvalued (Song,
Xiangang 1993:64; Wu, Xinwen 1994:25, Zhu, Tingqun 1993:74), with an average of 20% above the real value (Zhu, Tingqun 1993:74). It was estimated that through selling equipment, the foreign side extracted wealth of several billion US dollars (Song, Xiangang 1993:64). For example, in one joint venture, the foreign side invested US$ 83,000 in the form of equipment. The Foreign partner asked for US$ 135,000 for the equipment, which was actually worth only US$ 37,000. Through this, the foreign partner not only gained a profit without investing anything, but also obtained 33% of the stock rights of the joint venture (Ibid). As many foreign investors did not want to transfer advanced technology, foreign capital came in but with little advanced technology.

**Prevention of excessive economic concessions to foreign capital.** As priority was given to attracting foreign capital, local authorities were willing to offer foreign investors concessions that the central government did not allow, more often than not at a cost to the central state.

One common form of these concessions was tax exemption and reduction. Although the central state has unified policies regarding tax holidays and other incentives for foreign investment, tax and other incentives varied among different areas (Thoburn 1990:2). While the central government ruled that foreign-funded enterprises could enjoy two years' tax holiday, one village development area
declared a tax-exemption for three years, and another
tourism development area in Sichuan proclaimed that foreign
investment would have an exemption of industrial and
commercial tax for two years and an exemption of income tax
for 5 to 10 years ("Where are development areas leading to"
1993). The central government allowed export-oriented and
technologically-advanced enterprises (TAEs) more tax breaks.
But local government decided which enterprises could enjoy
these breaks. As Michael F. Roehrig (1993:105) describes,

Negotiation for high-tech status is most
apparent in Kwangtung (Guangdong). Hong Kong
investors know best how to elicit favorable tax
treatment from local officials and all joint
ventures enjoy control over their capital
(especially their foreign exchange) which allows
them to entertain and reward local policy
implementors on a much wider scale than, for
instance, state enterprises. A frequent example of
a type of joint venture that will enjoy TAE status
without being technically advanced is a joint
venture that is involved with computer sales.
Although many of these enterprises do not produce
computer-related products, they are often able to
obtain the "necessary paperwork" to warrant the
special status.

Local tax authorities considered it "their primary
responsibility" to help local joint ventures. If these
enterprises needed more tax breaks, local tax authorities
were willing to give them (Roehrig 1993:107).

Another practice of local officials was to tolerate tax
evasions of foreign investors. "Some even cooperated in fabricating a deficit so as to evade tax" (Song, Xiangang 1993:64). A common way to evade tax was to report a loss while actually making money. Beijing Review ("Attuning taxation to Investment Climate" 1991:25) provided such an example. One foreign-funded enterprise, which was put into operation in 1983 in Shenzhen, produced tape recorders, color TV sets and other electronic goods. After enjoying tax breaks in 1984-84, it reported in 1986 a loss of HK$88,970. What it really did was to have sold most of its products to the mother company of the transnational corporation at a price 20% to 40% lower than the normal. "The manager of the Shenzhen enterprise frankly told investigators that the profit margin was decided by his overseas administrators. If they decided to show a profit in the Shenzhen company, it did. Otherwise, it suffered losses" (Ibid). In 1989, 34% of foreign-funded enterprises reported losses in the whole country. The figure reached 35.15% in Guangdong Province, 42.7% in Fujian Province, and 60% in Putian area in Fujian (Ibid).

There have been other forms of concessions on the part of local authorities. The contract of one joint venture in Hebei Province stipulated that the Chinese side guarantee that the foreign side get back its investment and interest within three years (Gao, Guoquan 1994:13), violating the
state's law that both partners should share the risk. Another joint venture in textiles in the same province acquired an operation space of 100,000 square meters almost free (Gao, Guoquan 1994:13). The mayor of Putian, Fujian, signed a contract with a foreign-funded enterprise to develop the Meizhou island, stipulating that no visa or custom services were needed for personnel and goods to or from this island (Ye, Zuotan 1993:34).

Some local governments went even further. In contrast to the policy of the central government, Shunde Municipality hurriedly sold the best state-owned enterprises under their control to foreign capital, including 65% of the stock of six enterprises under Huabao Corporation, whose value of production was over 1 billion Renminbi Yuan and annual profit more than 100 million, for 1.28 billion to a Hong Kong company (Zhang, Kai 1993:13). To sell the well-managed, profitable large state-owned enterprises to foreign capital is ostensibly against the policy of the central government. Much of the money from selling these enterprises might have found its way into pockets of the officials (Ibid).

Share in management. With management control the central government had two goals, one to learn advanced managerial skills, the other to prevent foreign capital from dominating the decision-making so as to protect Chinese control and sovereignty. Among foreign investors, there were
generally two attitudes toward this control. Those who had a long-term interest in producing and selling in China preferred to manage in their own way. Those who just wanted to sell equipment or to make a quick profit had little motivation to manage a joint venture. For local officials, the need to attract and retain foreign investment and to make profit was more important than the worry about sovereignty. Thus, when the foreign partner demanded more power in management, the Chinese counterpart rather readily surrendered (Pearson 1991b:171).

According to Pearson (1991b:171), in most joint ventures it was the foreign partner that took the top post of general manager. Furthermore, the final authority on many key decisions, "such as the setting of international prices," was also held by the foreign partners (Ibid).

In recent years, many joint ventures in Guangdong province engaged in a "one-sided contract" ("Danfang Chengbao"), which means that one partner of a joint venture claimed full responsibility for managing the business and turned a certain amount of profit to the other partner (United Investigation Group of Guangdong Statistics Bureau 1990:59). Normally it is the foreign side that obtained the power of control. Statistics showed that of their respective joint ventures, two thirds in Shantou (one of the SEZs), and one half in Shenzhen (another SEZ), were contracted by one
partner (Ibid). This practice brought joint ventures profits (Ibid), but it breached the laws and regulations of the central state.

In some joint ventures, however, the foreign side rarely participated in management, or it even delegated the right of management to the Chinese side (Zhu, Tingqun 1993:75). The traditional style of management prevailed in these enterprises, leaving the goal of adopting advanced managerial skills hopeless.

Some local governments even officially declared policies to allow formally the foreign side’s control of a joint venture. In 1987, Guangdong Province put regulations into effect to allow the foreign partner to appoint the board chair, giving up "even symbolic control over joint ventures" (Pearson 1991b:171). That was three years before the central government permitted this practice in the 1990 amendments to the 1979 Joint Venture Law. The governments of Xiamen and Fuzhou went even further, deciding "to exclude Chinese managers from holding the positions of either general or deputy general manager" (the Joint Venture Law stipulates that if one partner holds the position of general manager, the other should take deputy general manager), "and to leave foreign general managers with full responsibility for joint ventures operations" (Pearson 1991b:172).

**Territorial containment.** Local officials, especially
those in interior areas, did not want foreign investment to be contained in certain areas, because they also wanted the economic benefits coming with foreign investment. The zeal of local governments in setting up economic-technical development areas was just a reflection of this local ambition.

**Prevention of spiritual contamination.** In order to attract foreign investment, local officials downplayed the ideological issue as much as possible. In Shenzhen, for instance, some officials disagreed with the central government’s emphasis on controlling "the flow of ideas and other superstructural elements from outside China to Shenzhen (such as the transmission of commercial television programs from Hong Kong)" (Pearson 1991b:155).

Hainan was originally a backward area in terms of both culture and economy. It is widely agreed that the remarkable economic expansion it achieved depended on the policy privileges of a big SEZ, the essence of which was to try "fearlessly" the market economy and to discard political and economic controls (Zou, Duo 1994:42-43). One successful businessman said, "You can spot no sign of the Communists except the red flag in front of the municipal hall" (Ibid). Many people in Hainan positively evaluated the role of prostitution and pornography, as an indispensable part of creating an investment environment. They even called the
situation a booming of both economy and prostitution (Zou, Duo 1994:43).

4.4 The Case of Shenzhen SEZ in Controlling Foreign Capital

This section uses the case of Shenzhen SEZ to illustrate how the central state's control of foreign capital was eroded at local levels. SEZs were what the central state designed for foreign investment. The creation of SEZs itself embodied both the desire to utilize and to control foreign capital. In 1984, Deng Xiaoping himself clarified the functions of the SEZs: to be "windows" in bringing in technology, scientific knowledge, management expertise, and articulating China's policy of openness (Chen, Xiangmin 1988:19). In order to obtain these benefits, experiments with capitalist economy were permitted.

On the other hand, the central state wanted to control the influence of foreign capital. The choosing of the name of the SEZs (Special Economic Zones) was to make clear that these zones were only special in terms of economy, but not in politics, culture or anything else (Vogel 1989:128). As perceived by the central government, the SEZs were an open "window" that should welcome only what was positive and keep out what was negative. The latter included unhealthy cultural influence, conspicuous consumption, and greedy profiteering. Thus, the number and size of SEZs were
restricted and controlled. Initially there were only four SEZs, and not until in 1988 was Hainan pronounced the fifth SEZ. SEZs consisted of controlled experiments, a meeting point of interacting socialist and non-socialist worlds under socialist control (Sit 1985:69-87). The SEZs also had distinct borders, so that if problems developed in the experiments, they could be shut out from the rest of the country. They could, as Premier Zhao Ziyang put it, "be a place for sifting out practices useful for all of China" (Vogel 1988:127).

Local authorities were expected to exercise vigilance to guard against the undesirable influences of foreign capital (Vogel 1989:129). However, once the SEZs were set up and the local governments were given authority to manage them, they soon found their own interests distinct from that of the central state. In Shenzhen, for instance, many enterprises made money by taking advantage of loopholes in controls and of the availability of imported consumer goods, which were scarce in the rest of the country. They imported these goods duty-free but re-sold them at much higher prices to other areas (Wu, Wai Man 1990:160). They also misused the preferential treatment granted by the central government to speculate on the black market for foreign exchange (Ibid). These behaviors were at a cost to the interest of the central state.

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As the local authorities put their interests before that of the central state and did not abide by the central government’s policy regarding foreign investment, the goal of the central government to control foreign capital was doomed to fail. The case of Shenzhen can be used to show how this failure occurred.

Shenzhen was the first and also the most important SEZ. In terms of space, Shenzhen was granted 327.5 square kilometers, compared with 15.6 square kilometers of Zhuhai, 52.6 square kilometers of Shantou, and 131 square kilometers of Xiamen (China International Economic Consultants 1985:69-77). For a long time it was regarded as a model of utilizing foreign capital. The authorities there were granted the power to approve light industry joint venture projects with investment of up to US$30 million and heavy industry joint venture projects with investment of up to US$50 million (D.K.Y. Chu 1986:35), much higher than for any other local authorities except those in other SEZs. Although the Shenzhen authorities were supposed to abide by the central government’s policy, they often did not in reality. One example concerns a fire in 1993 in the Zhini Crafts & Toy Factory funded and owned by Hong Kong capital. The fire devoured the lives of more the eighty Chinese workers. The reason that so many people died was that the factory seriously violated fire-prevention regulation, while some
officials had received bribes and granted the factory a fire-safety permit (Chen, Mingxin 1994:9). Discussion in the following part will focus on how several aspects of the central government’s intended control of foreign capital failed in Shenzhen.

**Sectoral control of foreign investment.** Shenzhen was supposed to develop high-tech sectors by importing foreign investment. As early as 1980, the central state began to downplay the desirability of "low wages" and simple assembly work (Chen, Xiangming 1988:278).

The reality was that, by 1983, industry consisted of only 10% of all foreign investment, which was predominantly geared toward property and tourism (Sit 1986:233). Up until 1987, foreign direct investment in Shenzhen was mainly concentrated in service sectors, such as hotel and restaurant businesses, and in processing, assembly work and countertrade, which did not involve large-scale production activities or large sums of capital (Wu, Wai Man 1990:65).

The reason was that the real estate and processing industries were in the interest of foreign investors and the locality in Shenzhen. Real estate firms proved to be the most profitable, and tourism the second; the profit rate for manufacturing sector was only 18% that of real estate (Chen, Xiangming 1988:284). For the majority of foreign investors, who came from Hong Kong, Shenzhen was attractive because the
average wage of Shenzhen workers was only one third that in Hong Kong, and land development fees were at least 30% lower. "Thus Shenzhen was a safer haven for Hong Kong small and medium-size processing plants that were struggling to survive the turbulent world economy" (Chen, Xiangming 1988:281).

Foreign investment in real estate also brought benefits to Shenzhen authorities, who were happy that the idle land there became money generating capital and housing conditions were improved for the local population (Chen, Xiangming 1988:284-285). The processing industry brought a labor processing fee in the form of foreign exchange for local authorities.

But the central government was disappointed that Shenzhen had a large deficit of foreign currency because it imported more than it exported, and that it invested much more on lavish hotels than on manufacturing technology (Vogel 1989:148). As early as 1984, the central government then commanded Shenzhen authorities to develop industry of higher technology instead of low-tech processing industry (Ibid).

**Restriction of access to the domestic market.** The central government demanded that Shenzhen concentrate on exports (Vogel 1989:148). But "if foreign companies were to establish plants in Shenzhen, they wanted them to be bases
to sell to inner China" (Vogel 1988:143). For the government and enterprises in Shenzhen, if selling to inner China could be more profitable, they would do it. The result was that much of Shenzhen's products were sold in the internal market (Wu Wai Man 1990:155). During the period 1979-1987, foreign invested enterprises produced 63% of the total industrial output in Shenzhen, but less than half was exported (Wu, Wai Man 1990:60).

When confronting obstacles, the officials in Shenzhen and foreign investors could find ways to overcome them to "meet the needs of both parties" (Vogel 1988:146). Although normally there was a limit on domestic sales for a joint venture (the percentage for domestic sales written in the contract), the Chinese partner of the joint venture "would find ways to allow the company to exceed the contracted percentage for domestic sales" (Ibid).

**Technology Transfer.** As the central government expected, one major goal of Shenzhen was to introduce advanced technology. But foreign investors were more often unwilling to commit advanced technology, while the Shenzhen authorities had to accept foreign investment with no high technology because such investment might help exports (Vogel 1989:134), or bring economic benefit in the short term. Consequently, the initial goal was compromised. Only 7% of technology imported in Shenzhen met the international
standard (do Rosario 1987: 102-103). Only 10% of joint ventures used advanced technology (Pearson 1991b:158). Over 75% of the equipment used in Shenzhen joint ventures were "geared to intensive labor" and were of low technology (Li, Li 1987; cited in Chen, Xiangming 1988:160).

Shenzhen was also supposed to transfer technology to inner areas. But some firms in Shenzhen were reluctant to do that, because they feared that firms receiving technology might compete with them (Vogel 1989:142). The Shenzhen authorities admitted that there had been few significant transfers of technology and skills from Shenzhen to the inner areas (China Newsletter No.48 p.22-23; cited in Wu, Wai man 1990:115).

**Territorial containment in Shenzhen.** At the beginning, the central government was very cautious in designing areas for foreign investment, granting about 1 square km in Shenzhen (Shekou) as a export-processing zone (D.K.Y. Chu 1986:22). The initial projected population of Shenzhen was 200,000-300,000 by the end of this century (the number was exceeded as early as 1985) (D.K.Y. Chu 1986:24). The existing town of Shenzhen was originally excluded from the Shenzhen SEZ, because "it is believed that the total absorption of the existing population would prevent the special zone authorities from selecting 'socialist' workers able to resist Western influences from outside the special
zone" (D.K.Y. Chu 1986:25). The leaders in Guangdong province, however, favored a larger Shenzhen, and they even considered turning the entire province into a special zone (D.K.Y. Chu 1986:22). Through the effort of the Guangdong officials, the existing town of Shenzhen was included into the Shenzhen SEZ and the area of the SEZ was extended to more than three hundred square kilometers (D.K.Y. Chu 1986:21-25).

In order to control strictly the flow of goods and people between Shenzhen and the rest of the country, a border fence began to be built and was completed in 1984. This border was officially named "the SEZ Management Line" (Tequ guanli xian). More often it is called "the second border," to distinguish it from the border between Shenzhen and Hong Kong. However, the local officials in charge of this border did not seriously carry out their duties, and regulations were often violated (Yu, Jiwen 1992:52). The border only existed in form (Ibid).

Prevention of spiritual contamination. In order to attract foreign investment, local officials in Shenzhen downplayed the ideological issue as much as possible. According to Pearson, the attitude of local officials, especially the younger officials, who did not take seriously the problem of unhealthy tendencies, was a factor that thwarted the central state's effort to control negative influences (Pearson
1991b:156). She further concluded that "The SEZ experiment thus failed to meet the concern for the spread of negative influences into China" (Pearson 1991b:156).

The erosion of the socialist ethics in Shenzhen was criticized by many people. The deviances included the rise in corruption, rising materialism, speculations on the black market for foreign exchange, fraud and other economic crimes (Pearson 1991b:157). Many people, including ordinary people and even young cadres, "considered the people of Shenzhen materialistic, arrogant, decadent, and sometimes corrupt" (Vogel 1989:150). "There were well-known stories of senior cadres who cried upon visiting Shenzhen, feeling that all they fought for during the socialist revolution was being lost" (Ibid).

Because even reformist officials in Beijing who supported Shenzhen were "disgusted with Shenzhen’s decadence and misuse of funds" (Vogel 1989:150), there was a crackdown in 1984 to cleanup "decadent capitalist" influences. But this crackdown caused problems for many businesses in Shenzhen, especially restaurants and hotels (Vogel 1989:148). Soon afterwards, controls were slackened. Nowadays, prostitution has become a part of life of Shenzhen despite the central government’s repeated calls to prohibit it, and even police officers have engaged in the business of prostitution (Yu, Jiwen 1992:54). At present, the life style
in Shenzhen is not much different from that of the capitalist Hong Kong.

In summary, this chapter analyzes the aims of foreign investors and of local governments regarding foreign investment in China. It also examines how, based on common interest, local authorities and foreign capital cooperated in evading or breaking the control over foreign capital designed by the central government, including sectoral control of foreign investment, restriction of access to the domestic market, technology transfer, prevention of excessive economic concession to foreign capital, share in management, territorial containment, and prevention of spiritual contamination. The case of Shenzhen illustrates how the central government’s measures to control foreign capital failed. Though the central government expected the local government in Shenzhen as well as in all the other localities to follow suit strictly, the latter often played around the former’s policies for its own interest in attracting and cooperating with foreign capital. This cooperation greatly contributed to the failure of control over foreign capital. The next chapter will examine the effect of this failure on local governments, foreign capital and especially the central state.
Chapter 5  Consequence: Weakened Central Government

This chapter examines the consequence of the cooperation between foreign capital and local governments and the failure of control over foreign capital. The local authorities-foreign capital cooperation greatly contributed to a weakened central government. The central government was weakened in the sense that its share of the economic distribution declined relative to local authorities and foreign capital, and this further affected the central government's capacity to implement its policies and fortified localities' resistance against the central's policies. Facing resistance from below, the central government could not reverse the unfavorable trend but had to turn away from its initial policy and follow the change toward capitalism, an economic mode of production represented by foreign capital.

The cooperation between foreign capital and local governments has brought about an increased importance of foreign capital in the economy both at the national level and the local levels. This is reflected in investment, industrial output, and foreign trade. First, contribution of foreign investment to the total fixed assets investment has greatly increased. In 1985, contribution of foreign direct
investment to total fixed assets investment was 2.26%, and it reached 3.09% in 1988, 4.03% in 1990 (Keuh 1992:656). While the ratio of actual foreign investment in the national fixed investment averaged 2.5% in the 1980s, the ratio soared to 8% in 1992, and to 13% in 1993 ("Bright future and much to achieve" 1994:1). In Guangdong province, this figure was even higher, with a ratio of foreign direct investment to total fixed investment of 9.99% in 1985, 13.57% in 1988, and 18.56% in 1990 (Keuh 1992:656). Wu Yi, the Minister of MOFET admitted that foreign investment had became one of most important financial sources to the country’s economy (Ibid). The dependence of the national economy on foreign investment has greatly increased.

Similarly, the output from foreign-funded enterprises has also greatly increased. The contribution of the industrial output from foreign-funded enterprises to the total national industrial output reached 7.5% in 1992 and 11% in 1993 ("Bright future and much to achieve" 1994), from almost zero in 1978. In the same time, the portion from state-owned enterprises has fallen remarkably. The portion of the output from state-owned enterprises, which has been the main source of economic support of the central state, in total industrial output decreased from 70% in 1985 to 48.4% in 1992, with 38.2% from collective enterprises (Zhang, Kai 1993:14), and 7.5% from foreign-funded enterprises in 1992.
and 11% in 1993 ("Bright future and much to achieve" 1994).

The importance of foreign investment in international trade has also increased. In 1993, imports and exports of foreign-funded enterprises amounted to US$67.1 billion, about 34.4% of the nation's total volume of foreign trade. In the same year, foreign-funded enterprises accounted for 27.5% of the total export, with a volume of US$25.2% ("Bright future and much to achieve" 1994).

In the meantime, the presence of foreign investment has contributed to a shift in economic distribution that favors local governments rather than the central government. Foreign investment was concentrated in 11 open coastal provinces, accounting for around 80% of total foreign investment inflow during 1979-90 (Keuh 1992:653). Guangdong alone took over 40%. Of all the 167,500 foreign-funded enterprises, 44,705 are in Guangdong ("The Rank of" 1994). These areas are also places where a disproportionate part of the national wealth was concentrated. In 1987, the opened municipalities and counties in the 11 opened coastal provinces, which have only 19.5% of the country's total population, produced almost 40% of the national gross value of industrial output and 33.45% of the gross domestic product (Kueh 1992:641).

In terms of the gross domestic product, Guangdong increased from 20.707 billion yuan in 1979 (in contrast to
the national total of 399.81 billion yuan) to 167,054 billion yuan in 1991 (in contrast to the national total 1,892.413 billion yuan) (Kueh 1992:688), from one twentieth to almost one tenth, doubling its contribution.

These coastal provinces also kept most of the economic resources they generated according to the contract of the financial reform. Guangdong keeps 8 billion of its 9.4 billion income (Wu, Jiangqi 1991:17). Guangdong's financial revenue in 1986 totaled 8.24 billion yuan, doubling that of Anhui. Yet both handed over the same absolute amount to the state (Xu, Changming 1993:80).

On the other hand, the central state was in debt, with revenue shrinking. From 1988, the central government got less than 10% of the increase in local fiscal income. The fiscal income to GNP ratio fell from 31.2% in 1978 to 14.2% in 1992. The center's portion of the total fiscal income declined from 58% in 1981, 47% in 1988, 38% in 1992. In 1992, the internal and external debt of the central state amounted to 153.8 billion yuan, and the budget deficit was 23.7 billion yuan (Yuan, Chen 1993:51), posing serious fiscal problems to the central government. These figures indicate the degree that economic distribution shifted to local governments, especially to those local governments hosting foreign investment, and the weakened economic capacity of the central government.
This change in share of economic resources brought two consequences. First, it furthered the common interest shared by foreign capital and local governments hosting them, and strengthened their resistance against the central government's measures or intentions to control foreign capital and even the nation's macro-economy. The economies of localities, especially where foreign investment was concentrated, became dependent on foreign capital to a considerable degree. When the central government's policy went against their interest, local governments passively or actively resisted. Meanwhile, the economic growth in localities provided them with resources to resist the central government. As Goodsman noted (1989:20-24; cited in Ye, Zuotan 1993:32), with economic development, increase of wealth and more economic independence, local governments possessed the power to resist the central government's policy if they felt that this policy threatened the interest of their localities.

The resistance of local authorities weakened the central government's capacity to control the macro-economy of the country. For years the central government has been trying to cool down the over-heated economy, worrying about high inflation and social unrest. But local authorities were not cooperative with the central government. For instance, in early 1993 the central government initiated an austerity
program to curb the expansion of investment by the local governments (Lin, Fan 1994:20). But investment in fixed assets rose by 58% in 1993. In Zhejiang, Fujian, Guangdong and Hainan, provinces where foreign investment was concentrated, investment totals actually doubled (Goldstein 1994). While the national GNP growth was 13% in 1993, Guangdong, "fueled by external capital and trade, enjoyed over 22% growth" that year (Gong 1994:37). In Hainan, fixed investment increased by 55%, and GDP increased by 18.9% in 1993 (Zou, Duo 1994:42-44). The central government proclaimed a 9% target for national economic growth in 1994, and local authorities were supposed to abide by this target. However, officials in Guangdong and Hainan announced growth targets of 18% and 16%, respectively (Goldstein 1994), challenging the central government’s effort to discipline the national economy.

As Goldstein observes, because of divergent interests, conflicts between provincial and central governments were inevitable. The local officials’ attitudes toward the central government were reflected by the answer of a vice-governor of Guangdong province to a question of a senior US State Department official when dining together. The latter asked the former, just after the central state issued a directive regarding control of economic growth, how much control the center had over the province’s economic plans;
the former gave a very definite reply: "None whatsoever" (Goldstein 1994).

In addition, the local authorities-foreign capital cooperation affected the execution of other central government’s policies at local levels. For instance, as Woon (1990) shows, overseas Chinese, through investment and donations, exerted strong pressure on the local government and successfully resumed an old social institution the "Guan Lineage Library" in Chikan Zhen, a town in Guangdong province. Through this institution based on family lineage, foreign capital exerted influence on education policy of local schools. Under the pressure of foreign capital, the local authorities at Chikan Zhen allowed schools to teach students about notions of traditional lineage, which was against the state’s educational principle. The "Guan Lineage Library" was also allowed to mediate disputes among local residents and disputes between local people and foreign investors, supplanting the state’s legal authority. This is one example of how changes of policy orientation have been made by local officials under the pressure of foreign capital, and how erosion of central power has been occurred.

Consequently, the shift of economic distribution favoring local governments at the expense of the central government constrained the latter’s ability to control both local governments and foreign capital. As C.P.W. Wong
(1991a:711) notes, with fiscal decline of unexpected magnitude and persistent deficits, the central government's capacity to manage the economy was seriously restricted. A similar conclusion is drawn by David Shambaugh (1993:254). He observes that as a result of regional autonomy, passive resistance, and newly created wealth, the central government's budget deficit soared and levers over economy weakened, while local authorities acquired the "financial where-withal (sic) to ignore the center altogether," to make economic decisions irrespective of the central state's concern (Ibid). Moreover, the "de facto result of the emerging economic regionalism has been devolved (sic) political power to China's provinces and localities--the single greatest contribution to the erosion of state authority" (Ibid).

Under these circumstances, the central government often had to retreat from its initial stand and to recognize formally the practices of some local governments when it confronted passive resistance and challenges of local governments and pressure from foreign capital. As it could not change the course, the central government chose to adapt itself to the environment. It was unable to punish local authorities for violating laws and regulations; instead it changed the law or regulations.

One such example was adoption of the Amendment to the
Joint Venture Law in April, 1990 by the National People’s Congress. As has been discussed in Chapter 4, the government of Guangdong province promulgated a regulation in 1987 to allow the foreign partner of a joint venture to appoint the board chair, a practice against Section 1 of Article 6 of the original Joint Venture Law, which reads, "The board of directors shall have a chairman appointed by the Chinese participant and one or two vice-chairmen appointed by the foreign participant(s)." The Amendment on this point reads, "The chairman and the vice-chairman or vice-chairmen shall be chosen through consultation by the parties to the venture or through election by the board of directors." Thus foreign investors may lawfully hold the position of the highest authority of a joint venture, and Guangdong’s unlawful practice was officially recognized. In so doing, the central government gave up its insistence on equal share of management between Chinese and foreign managers, or in other words, the formal equality between Chinese and foreigners.

The Amendment also relinquished the state’s power to nationalize or requisition any foreign investment, and extended the term of the joint venture. According to an official publication, these changes of the Law were efforts to conform to international practice and to respond to requests of foreign investors and their Chinese partners ("A Major Step to Improve Investment Climate" 1990). All these
moved toward relaxation of control over foreign capital.

Another example is the fate of the central government's withholding of its earlier decision to levy tax on the increased value of real estate property from January 1994 on, so as to curb the disorder in real estate development and increase revenue. This policy would sharply reduce the profits of many foreign investors, who had acquired a large quantity of the land in high valued places (Zeng, Jianhua 1994:71). This policy would also hurt the interest of the provinces and municipalities, which had made much efforts to attract foreign investment into land development (Ibid). Immediately after the announcement of the policy, foreign investors expressed strong dissatisfaction (Lin, Fan 1994:62-63), and the municipal government of Guangzhou (the capital city of Guangdong province) publically announced it that would not execute this policy (Ibid). It was followed by most of the other provinces and municipalities (Zeng, Jianhua 1994:71). Under this pressure, the central government had to issue an order to delay the execution of the policy (Ibid).

Under pressure from local authorities and foreign capital, the central government "open(ed) the door wider" ("Planning to Open the Door Wider" 1991) for foreign investment, in terms of both territory and sectors.

In terms of sectors, the central government is now
gradually opening to foreign capital finance, insurance, real estate, commercial retail, consulting, accounting, and information services ("Bright future and much to achieve" 1994). These sectors were forbidden areas to foreign investment.

Foreign investment was initially designed to be confined to four tiny special export zones in 1979, which became the four SEZs in 1980. In April 1984, 14 port coastal port cities were opened to foreign capital; they were Tianjin, Shanghai, Dalian, Qinhuangdao, Yantai, Qingdao, Lianyungang, Nantong, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai. Unlike the four SEZs, these cities are economic and cultural and even political centers and stretch from the south to the north. In 1985, the Yangtze River Delta, the Zhujiang River Delta, and the Xiamen-Zhangzhou-Quanzhou triangular region were set up as the Coastal Open Economic Regions. In 1988, 140 other coastal cities and counties were opened, bringing the number of open cities and counties to 292, with an area of 320,000 square kilometers and a population of 200 million (about one fifth of the country's total) (Chen, Yue 1993:70). In 1992, there was another round of "opening of the hinterland areas along the rivers, the borders and the main lines of communication" (Ibid). By then the whole country was opened to foreign capital.
Moreover, the Party formally adopted the goal to build a market economy, withdrawing again from its former position. From a planned economy before the beginning of reform, it moved to a "planning economy with complementary market," and then to a "commodity economy under the guidance of planning." Now it officially abandoned the planning, which used to be considered an essential characteristic of the socialist economy. Although the central government still caps its market economy with the word "socialist," it is generally agreed that the economy is becoming essentially capitalist. Having almost given up central planning, the central government is now trying to use monetary policy to manage the macro-economy of the country, though without much success so far. Banks other than the central bank have been declared commercialized. Many state-owned enterprises, a large portion of which are in deficit, have been a burden of the central government and now are being "pushed to the market" to survive. Workers are not guaranteed a job and unemployment is officially recognized. Millionaires and even billionaires co-exist with beggars. From the statistics of the Bureau of Statistics, savings in banks of 3% of the population (36 million) is 293.2 billion yuan, while the total saving of the 73% of the population—800 million peasants was only 273.7 billion yuan; 80 million peasants receive average annual income of less than 300 yuan, below
the poverty line (Zhang, Kai 1993:14). More importantly, a privatization of public properties has been under way. Earlier the central state had already allowed foreign investors or other private owners to buy bankrupted state- enterprises. Ironically, the result of the central state's decision to utilize foreign investment has not strengthened socialism as it intended to, but instead the policy has gradually given rise to capitalism.
Conclusion: the Chinese Model

This thesis has described the Chinese model of coalition politics among the central state, local authorities and foreign capital during 1979-1993. The characteristics of this model were that the local authorities and foreign capital shared more common interest with each other than with the central state, and consequently a cooperation between two was formed at the expense of the central state.

Clearly, this model is different from that of Brazil, in which the coalition among the state, foreign capital and local capital "tilted against the domestic private sector" (Haggard 1990:194). The Chinese model was also different from the South Korea model, in which there was a close relationship between the government and private business to restrict foreign capital. In neither Brazil nor South Korea was local government mentioned as a force or an important factor in the industrialization or in politics concerning foreign capital. Instead, local private capital was one participant in the coalition politics concerning foreign capital in addition to the state and foreign capital.

In China, there were no social forces equivalent to local private capital in Brazil and South Korea; but local authorities largely assumed similar function to those of
local capital in Brazil and South Korea. Local governments in China have been owners, managers and investors of enterprises under their administration.

The politics among the central government, local governments and foreign capital in China was undertaken on the background of opening to the outside world and economic reform. Confronted with external pressure imposed by the former Soviet Union and problems resulting from a command economy and the cultural revolution, the central state initiated policies to open the country to foreign capital, and in the meantime to decentralize the economy. The central government expected to acquire advanced technology and management skills so as to modernize the country and strengthen its socialist economy. Nevertheless, it feared that foreign capital might bring some detrimental effects, including threat to sovereignty and "spiritual contamination." The solution designed by the central state was to control foreign capital while using it.

Measures of control of foreign capital included control of foreign capital in investment sectors, restriction of sales to the domestic market, technology transfer and prevention of excessive economic benefits to foreign investors, emphasis on a Chinese share in the management of joint ventures, territorial containment and prevention of spiritual contamination. With these measures, the central
state expected to promote the positive effects accompanying foreign capital.

The effectuation of these measures of control of foreign capital was heavily dependent on local officials, who were supposed to follow the central government’s suit. However, after the fiscal reform, a differentiation of economic interest developed between the central government and local governments. While local officials enjoyed the economic benefits accompanying foreign investment, they lacked an interest in controlling its negative effects as perceived by the central state. Local officials, whose main concern was how to compete with other localities in attracting foreign investors, found themselves restricted by the central government’s policy of control over foreign capital. Foreign capital, whose primary interest was in the market potential of China, certainly perceived the central government’s policy control not to be in its interest. On the basis of common interest, local authorities and foreign capital engaged in cooperative evasion of controls over foreign capital designed by the central state. The cooperation ranged from setting up foreign-funded enterprises that were not up to approval criteria of the central government, evading taxes, selling in the internal market rather than exporting as required, allowing foreign values and life-styles to spread, and so on. This
cooperation directly contributed to the failure of the central government's policy of controlling foreign capital.

As a consequence, the cooperation between local officials and foreign capital not only greatly contributed to the weakening or failure of the central government's policy of controlling foreign capital, but also greatly contributed to the weakened position of the central government relative to local authorities and foreign capital. It resulted in greatly enhancing the position of foreign capital in China's economy. It also significantly contributed to economic strength and independence of local authorities relative to the central state. In contrast, the central state was weakened economically. It had a large budget deficit and state-owned enterprises, the pillar of its financial resources, were greatly weakened in competition. This result further strengthened the tie between local authorities and foreign capital, fostered the local governments' resistance against unfavorable policies of the central state, and weakened the central government's capacity to control the macro-economy and affected the effectuation of its other policies such as education policy at local levels. The central state, however, could not but withdraw from its initial stand and modify its own policies to adapt itself to the situation caused by foreign capital.
and local governments.

In this thesis, the local authority-foreign capital cooperation is the focus. There were some other factors that affected negatively the policy of controlling capital. One factor rested with the central government itself. Deng Xiaoping and other reformist leaders took a strategy of "playing to the provinces" so as to gain support for the reform and the open policy (Shirk 1993). The open policy was associated with Deng and the reformist leaders and was criticized by the conservatives in the party. So when problems occurred, the reformist leaders in charge sometimes played them down to push forward the open policy and to provide the conservatives with no excuses, as in the case of the campaign against spiritual pollution (Pearson 1991b). This restricted the central government itself from taking actions against local governments' misconduct in executing the state's policy toward foreign investment.

Moreover, the central government's capacity to implement the policy of controlling foreign capital was also constrained by its status in the global system. Even though China was regarded somewhat as an ally by the Western countries after the Soviet invasion of Afghanistan, it "continues to be regarded as a potential adversary because it professes to be a communist nation" (N.T. Wang 1984:102). Technological transfer to China was restricted by the
Coordinating Committee on Communist Trade (COCOM) as well as by the governments of the Western countries (Ibid). As a socialist country, China’s economic relations "with the developed market economies are vulnerable to discriminatory treatment" (N.T. Wang 1984:106). Because of its large size, China could not enjoy specially favorable treatment for which other developing countries are eligible. Moreover, it was vulnerable to pressure to "make comparable concessions", for there was "increasing likelihood that attention will be focused on the socialist nature of the Chinese economy" (Ibid). Foreign investors might also be "worried that their investments in China be requisitioned or even confiscated in the future" (Ji 1983:43). After the Tiananmen Square tragedy in 1989, the communist regime was under great pressure from the international system. To break the isolation and to retain the dynamic of foreign investment, the government offered more incentives and concession. The pressure from the international system weakened the central government’s bargaining position with foreign capital. Similarly, the decrease of foreign investment in developing countries and the competition among these countries for foreign capital were also to the disadvantage of China.

Nevertheless, the cooperation between the local governments and foreign capital were by far the most important factor in causing failure of the central
government's policy of controlling foreign capital. The reluctance of local officials to execute this policy directly made ineffective the central government's initial goals of controlling foreign capital.

It should also be admitted that the cooperation between local government and foreign capital was not absolute. There were cases in which local governments and foreign capital disputed, and sometimes either side turned to the central government for help. But the cooperation between local authorities and foreign capital was the mainstay. The interaction among the central state, local governments and foreign capital is a process still evolving. The model that unfolded during the 1979-1993 period was associated with the center-local relationship based on the fiscal reform of the early 1980s. This fiscal reform allowed local authorities to retain what they gained in utilizing foreign capital, even at the expense of the central state. In 1994, the central state began to implement a new fiscal system, which was intended by the central state to ensure itself it would have a share in local economic growth. However, this new fiscal system has been strongly resisted by local authorities who want to protect their own interest. Even if this new policy succeeds, the basis of the cooperation between local authorities and foreign capital still remains and will not disappear for some considerable time. This
basis consists of factors such as the efforts of the central state to control foreign capital, the different interests between localities and the center, government (both central and local) ownership of the majority of the business, and competition of foreign capital and enterprises belonging to local authorities with state-owned enterprises of the central state. Unless this basis undergoes fundamental transformation, the basic structure of the Chinese model of coalition politics among the central state, local government and foreign capital shall continue.

The coalition politics among the central state, local authorities and foreign capital during the 1979-93 period has theoretical implications for both the dependent development approach and the statist approach. The coalition politics among the three may lead to different results from what occurred in Brazil, where the alliance tilted toward the state and foreign capital at the expense of the local capital as described by the dependent development model (Evans 1979:281), or in South Korea, where the state and local capital allied in restricting foreign capital as depicted by the statist approach. In other words, the result of the coalition politics could be a cost to the central state in a developing country, especially in a socialist country like China. The concrete form of the coalition politics among the three is linked to the internal political
and economic conditions as well as the international context. In China, the determining factor was that local authorities and foreign capital shared interests in seizing a share of the market which used to be dominated by the central state.

The Chinese model of coalition politics among the three may also have some implications for other socialist countries, such as Vietnam, Cuba and North Korea, which all have serious economic problems. Cuba and North Korea are still almost closed to foreign capital, although there has been some joint cooperation between Cuba and some foreign capital. In Vietnam, however, foreign investment has been gaining momentum. In fact, an economic reform similar to that of China has been underway there. Since the central state has a monopoly over the economy and market in these countries, it is possible that local authorities (capital) and foreign capital may engage in a cooperation to seize a share of the market, if given a chance.

More enlightening comparisons can be made between China’s experience in introducing foreign capital with that of other countries, which is beyond the scope of this thesis for Master’s degree. For instance, it may be illuminating to compare China’s policy of economic reform and openness with the reform of the former Soviet Union, to see whether the Soviet Union could have avoided its fate of collapse if it
had taken a policy similar to China's. Comparisons can also be made between China and Eastern European countries on how political power has been translated into economic capital. These will be subjects of future studies.
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