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Introduction

China's opening to the international economy has brought about a great transformation in its economy, society, and political system. Allowing trade, investment, international finance, and other vehicles of the international economy into China's domestic economy has changed the distribution of assets in society and, in turn, has changed the distribution of political power among important domestic constituents. I argue in this brief survey that the pattern and timing of China's opening was driven by the anticipated distributional effects on important domestic constituents of specific opening policies. Similarly, the areas that remain closed can be explained with the same distributional logic.

This survey of the patterns of China's opening is based on a simple, and highly stylized, three-actor model in which top leaders vie for support from subordinate constituents in either central government or local government positions.¹ The main thrust of the argument is that top leaders design and promote policies and regulatory structures in order to deliver support from one or the other set of constituents to individual top leaders. The simple point made is that, rather than being driven by an enlightened bureaucracy, or driven by multilateral economic negotiations, a sector will be opened only when the *political payoffs* to top leaders from opening outweigh the payoffs from intervention and protection in a sector.² These payoffs are related to the distribution of political power within society and the industrial organization of the sector in question. Top leaders used the distributional effects of opening to the international economy to

¹ Adherence to length requirements requires an overly stylized model in which policies that centralize control over assets and increase central authority are assumed to be in the interests of central government actors, and policies that decentralize authority and assets are assumed to be in the interests of local government actors.

their own benefit, and allowed for opening in areas where opening would either help current constituents, or attract new constituents to their supporting coalitions.

Direct Allocation of Resources Replaced by Allocation of Authority

Before dealing directly with the politics of authority allocation, it is essential to point out that the payoffs from central allocation of resources were rapidly dwindling. Central government's ability to influence the direction and shape of economic development has been limited in the reform period by its ever-decreasing share of distributable financial assets. Central government share of total fixed asset investment fell from over 65 percent in the first few years of reforms, to less than 10 percent by the mid-1980s, and by 1993 fell to a six-percent share.³ More than a diminution of central budget funds, this diminishing share reflects a reflection of the huge growth of other sources of finance. Equivalently, the potential to gain political support from the allocation of central government capital fell rapidly.

This loss in relative influence made allocation of authority an increasingly important tool for distributing economic benefits to constituents. The reasoning is straightforward, if local governments are able to deal directly with international economic actors, they are able to gain access to the financial resources, technology, and other economic benefits brought by foreign firms. With limited funds in the central budget for direct allocation, delegation of authority over economic activity was an acceptable substitute in the eyes of subordinates. As China has changed from a virtually autarkic country in 1978 a host of several billions of dollars in annual foreign direct investment (FDI), allocating authority over this investment has become an important source of political support. Allocation of authority over FDI requires no spending from the central budget, yet it has the potential to return great political support to those who make allocation decisions.

² Conversely, if a sector remains closed, it is closed primarily for political reasons rather than pursuit of industrial development policies or broad economic programs.

³ Jiang Xiaojuan. *Jingji Zhuangui Shiqi de Chanye Zhengce: Dui Zhongguo Jingyan de Shizheng Fenxi yu Qianjing Zhanwang* (Industrial Policy in the Period of Economic Transition: Analysis of China's Experience and Future Prospects. *Shanghai Renmin Chubanshe* (Shanghai People's Publishing House) 1996 p. 89.

The Joint Venture Law Generates Provincial Support

The joint venture (JV) law of 1979 marked the opening of China to foreign direct investment (FDI) and was the first important instance of trading authority over international economic transactions for political support. The fact that the JV law was vague in its applicability set a tone that anything not explicitly prohibited was implicitly acceptable. This allowed provincial and local governments political cover as they pushed for autonomy over FDI (as well as other assets). The JV law shifted the landscape of authority battles by placing central actors on the defensive. In the face of broadly implied decentralization, central actors were forced to expend effort and resources to win incremental steps back towards central control over relevant economic assets.

The JV law allowed local actors a wider range of financial options than had been previously available. In this sense, the JV law represented a reallocation of authority to local governments. With their newfound authority local leaders pursued foreign investment with a frenzy driven by their short time horizons and uncertainty over the longevity of the opening policies. It is reasonable to assume that local leaders directed a similar degree of enthusiasm toward supporting the top leaders who pushed the JV law and other reforms granting authority to local governments. The political support returned from this policy certainly outweighed that from a hypothetical alternative of opening to the outside world by allowing a small number of central ministries to pursue investments. The shape of the JV law was a conscious choice made to attract the support of a broad group of supporters over another version of a JV law that would return less political support.

Broad Attempts at Recentralization

The response from centralizers to the JV law came in a 1982 State Council proclamation with broad applicability, clear restrictions, and specific mention of a number of sectors.⁴ This was an example of a significant attempt to move regulatory authority back towards the center as the State Council called for the return of categorical power over allocation of fixed asset investment funds. This attempt to rein in non-state sources of financial assets specifically included use of foreign capital, along with bank loans, and retained funds. All investment in productive capacity was declared to be strictly under the control of the State Council, prohibiting any investment

⁴ The mention of several sectors was redundant given the complete applicability of the restrictions. The function of this mention was to send a clear signal that evasion would not be tolerated.

exceeding the amounts set in the state plan and stating that, “All sources together must not exceed the plan.”⁵ Large and Medium sized enterprises were required to submit requests to the State for approval and small enterprise requests were subject to approval of the local authorities and local ministry offices.

Though the State Council wrote this policy into law, it was ineffective in implementation because of the high political costs of monitoring and sanctioning those in violation of the restrictions. The struggles over distribution of authority and assets continued through several rounds of generally applicable laws and regulations, none of which were decisive. The inability of either side to gain a clear victory through broad policies shifted the political fights towards more narrow, sector-specific regulations over trade and investment with the international economy. In these cases the degree of decentralization and openness to the international economy was driven by two important characteristics in each sector: 1) the anticipated distribution of political power among potential constituents affected by authority allocation; and 2) the costs of controlling valuable assets in the sector through centralization. The remainder of this paper will survey a number of different sectors to demonstrate that the nature of authority allocation and regulation varies according to a political logic.

Foreign Trade Reform

Decentralization of control over foreign trade represents a common, and over-generalized, characterization of China’s reforms. This decentralization is often cited to demonstrate that the central government has either lost control over the economy, or given up control.⁶ At the start of reforms, trade was controlled by a ministry with fewer than ten authorized trading agents.⁷ Every transaction involving trade in goods between a domestic firm and a foreign firm was carried out

⁵ *Guowuyuan Guanyu Yangye Kongzhi Guding Zichan Touzi Guimo de Buchong Guiding*. (Additional State Council Regulations Concerning the Strict Control of Fixed Investment Capital) Issued by the State Council March 26, 1982. Published in *Zhonghua Renmin Gongheguo Fagui Huibian* (Laws and Regulations of the People's Republic of China) 1982 pp.192-195.

⁶ Margaret M Pearson. Joint Ventures in the People’s Republic of China: The Control of Foreign Direct Investment Under Socialism. Princeton: Princeton University Press, 1991; Pitman Potter “Foreign Business Law in china: Past Progress and Future Challenges” San Francisco: The 1990 Institute, 1995.

⁷ The relevant ministry was the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), later renamed the Ministry of Foreign Economic Relations and Trade (MOFERT). For a comprehensive survey of trade reforms see Lardy (1992).

by one of these central ministry agents. Within a few years of opening, authority over trading had been decentralized to literally thousands of licensed traders, many at the level of the individual firm. This trade reform generated great wealth throughout the economy, reducing the power of the central ministry in charge, and in turn, reducing the control of the central government over the nature of trade. This decentralization returned a great deal of political support from local leaders, who took a share in the growth through taxes and graft. From the perspective of a top leader, the payoffs from this decentralization outweighed any benefits from maintaining strict authority over trade while attempting to open.

Decentralization of Electronics

Authority over foreign direct investment in the electronics sector followed a roughly similar pattern. The reform period electronics industry was most centralized at the start of reforms.⁸ The Ministry of Electronics (MEI) was responsible for coordination of the sector, and the pursuit of industrial policy goals. However, after a few short years of reform, in 1986, the vast majority of MEI's authority and assets, including approval authority over FDI was decentralized to local governments, while direct control over many of the electronics ministry's most important material assets was transferred to provinces and municipalities.⁹ After this initial period of decentralization, the approval authority of local leaders has steadily increased in both the scope of their authority and in the size of the projects they were permitted to approve.

Decentralization in the electronics sector does in fact fit well with interpretations that the central government is losing control over, or giving up control over FDI, and the economy as a whole, as China moves steadily towards decentralization and marketization. Restricting FDI access of locals and forcing them through a central approval process limited the ability of the provinces to grow economically, provinces promised support for top leaders who promoted decentralization. From the perspective of a top leader, this support outweighed any potential

⁸ While not as centralized as other sectors, electronics in the early period experienced the height of centralization.

⁹ *Zhonghua Renmin Gongheguo Guowuyuan Gongbao* (People's Republic of China State Council Gazette) *Guowuyuan Pizhuan Dianzibu Guanyu Tuijin Dianzi Gonggye Guanli Tizhi Gaige Baogao de Tongzhi* (State Council Announces Support for Ministry of Electronics Plan to Reform the Management System of the Electronics Industry) April 20, 1986, pp. 246-250.

support returned from MEI and the few potential beneficiaries of centralized industrial development programs in the electronics sector.¹⁰

However, the conclusions drawn from the political logic of trade decentralization and decentralization of authority in the electronics sector cannot be readily extended to other sectors in the economy. The remainder of the paper points out cases that do not conform to the above pattern. In the following cases top leaders pursue support from central government actors through centralization policies rather than pursuing support from local leaders through decentralization. The political logic of regulatory policy remains the same, but the potential support returned to top leaders from centralization changes as the potential power of central actors increases, especially in sectors in which economic rents are easily created, captured, and distributed to important constituents. While the industrial organization of the sector determines which sectors are more attractive for centralizing, the timing of recentralization follows the growth of assets available through centralization policies.

Recentralization of Authority in the Automotive Sector

In the automotive sector the pattern of authority allocation over FDI follows the exact opposite direction as the decentralization in the electronics sector, presenting a difficult case for those who claim that the government capacity or will to control the economy is waning. The auto sector was most decentralized in the first seven years of reform. From 1979 to 1986, provincial level municipalities were relatively unconstrained in attracting FDI and signing deals with little more than perfunctory approval from the center. Central control over trade and FDI in the auto sector was initially and partially reasserted beginning in 1986, and consistently increased through a series of policies culminating in the strict 1994 automotive industrial policy. In 1994 the State Council effectively banned any foreign investment in the sector for three years, after which central bodies had all authority over FDI approval, and drove a hard bargain with foreign firms seeking market access.

The recentralization of authority over FDI in the auto industry follows the increase in the assets available in the sector. The value of FDI contracts grows enormously during the reform period, and the assets are concentrated in a small number of easily monitored assembly

¹⁰ The only exceptions to the decentralization of MEI's assets were its two large scale semiconductor fabrication plants, which are large in scale and relatively easy to monitor and control. Thus they are good sources of support from particularism and central control.

operations - therefore, they are easily controlled and allocated. Starting with an initial foreign investment of eight million US dollars in the Beijing Jeep joint venture in 1984 (representing half of the total registered capital of sixteen million dollars) growing to a foreign investment of more than one and a half billion dollars in the 1997 General Motors joint venture with Shanghai Automotive Industrial Corporation.¹¹ As the share of directly distributable central budgetary funds dwindled, allocating authority to central government actors returned strong political support to top leaders.

Some argue that this policy follows the industrial structure of the industries in question, that it is the rational pursuit of development policy that leads to recentralization and conditionality on FDI. However, if the industrial structure drove the choice of institutions, the institutions would not vary within a given sector over time. I argue here that from the moment of opening to the international economy, there were vocal interests in the center lobbying for control over the auto sector. They were ignored in favor of provincial interests until the value of FDI deals in the sector became sufficiently large to provide substantial allocatable assets. The presence of early period lobbying for centralization can be seen in a collection of proposals for recentralization published internally in 1985. Among the various self-interested proposals for recentralization was one that anticipated the 1994 policy almost perfectly

We have a big market which gives us the ability to attract foreign investment. However, if we do not protect our domestic market with tariffs, foreign companies can easily enter our market, draw out huge amounts of foreign exchange. At the same time they can vastly improve our unemployment problem and increase the competitiveness of domestic auto firms. Currently foreigners are not interested in domestic investment, but if we limit imports and implement protectionist tariff policies to restrict their access to the market, we might induce them to invest and to help construct auto factories...¹²

This early argument is consistent with the core of the 1994 auto policy. The 1994 policy was very successful at creating leverage over foreign firms. If the policy was proposed nine years

¹¹ *Zhongguo Qiche Jishu Yanjiu Zhongxin* (China Automotive Technology Research Center) *Qiche Gongye Guihua Cankao Ziliao* (Automotive Industry Plan Reference Information) 1997. Tianjin, China: China Automotive Technology Research Center Printing House, p. 120.

¹² Chen Xijin, (Beijing City auto industry technology open center technology qingbaosuo) *Qiche Gongye Touzi Wenti de Chubu Shenlun* (Preliminary Discussions on Auto Industry Investment Problems) In *Zhongguo Qiche Gongye Fazhan Daolu zhi Shenlun* (Discussions on the Development Path of China's Automotive Industry), Published by *Qiche Gongye Fazhan Zhanbei Wenti Yantaohui Lunwen Xuanbian Weiyuanhui* (Discussion Paper

earlier, why was it not implemented? It was not implemented because the administrative control necessary to carry out the policy demands strict centralization, which was simply would not have provided great political benefits in 1985, especially when compared with the great overall support of provincial leaders for continued decentralization across the entire economy.

The auto case demonstrates that top leaders have the capacity to reallocate control over a sector away from the provinces to the central bureaucracies if they so choose. The government is not losing control over international economic interactions, nor is it ceding all control. Instead, it is selectively intervening in the economy in some circumstances, and selectively decentralizing in others. The question this recentralization of authority over autos begs is why top leaders choose recentralization and a stronger government role in this sector, directly opposite the pattern in the computer sector.

Continual Centralization in the Telecommunications Sector

As the computer and auto sectors have undergone dramatic changes in authority allocations from one extreme to another, and in opposite directions from each other, authority in the telecommunications industry remained centralized throughout the reform period. Approval authority over FDI in the telecommunications sector in both equipment and services has been strictly centralized with practically no meaningful liberalization or decentralization of power at any time in the twenty years of reform to date.¹³ There have been repeated appeals from provincial level officials for increased access to key property rights in both investment approval and joint service-provision proposals.¹⁴ This sector has undergone extraordinary growth and change even by China's reform period standards. Because the most valuable assets in this sector are so easy to control (relative to other sectors studied) top leaders have continually reasserted the rights of the dominant ministry to almost complete control over the key assets and property

Selection Committee of the Research Conference on Automotive Industry Development Strategy Questions) May 1985. pp 70-76 (*Neibu ziliao* – Internal document) pp.170-178 quote from p. 176.

¹³ Provincial authorities have access to a vast supply of resources through their operations of local networks, especially from initial connection fees. However, the Ministry of Posts and Telecommunications (later the Ministry of Information Industry after March 1998 National People's Congress) had a number of levers through which it compelled provincial operators to reinvest profits in construction of a network over which the ministry had control of rates of interconnection - a lever the ministry used to draw the lion's share of profits from service provision.

¹⁴ Continual battles over authority were especially heightened around the creation in 1994, and subsequent marginalization, of a second cellular service provider Unicom (*Liantong*).

rights in the sector. This includes FDI approval, regulation of interconnection rates, procurement decisions, oversight of industrial policy, etc.

If China's policy were driven by economic efficiency, we would see liberalization in this sector similar to that in developed and developing countries around the world. The reason for maintaining central control over investment in telecom equipment production, and maintaining a complete prohibition of foreign entry into the telecommunications service sector is that both provide valuable assets to top leaders, which they in turn allocate to subordinate constituents. If control over this sector were decentralized there would be great efficiency gains across the economy as a whole, but a significant loss of rents available to top leaders for allocation..

Conclusion

The main point of this brief survey is that the logic that explains decentralization of authority over interactions with the international economy in sectors such as trade and electronics is limited in its applicability to the rest of the reform economy. The growth generating decentralization in some sectors goes hand in hand with particularistic intervention and protection in other sectors. In order to understand how China's foreign economic policy is made, we must follow the distributional effects of opening certain sectors of the economy.

Extending this logic beyond FDI to other sectors of the economy helps explain China's current position in WTO talks. Restrictions on China's capital account, on open competition for domestic financial services, provision of insurance, etc. are all means through which political leaders protect their most lucrative sources of allocative power. Even if there are efficiency gains to be had from liberalization, the political costs to top leaders far outweigh any political benefits they would gain through liberalization. Soft bank loans directed by central authorities allow the government to determine which state owned enterprises survive and which fail. Domestic insurance licenses are extraordinarily valuable and return important political support from their distribution. Other sectors follow this same logic.

The evolution of the domestic regulatory institutions governing economic transactions between domestic and international firms is a function of the distributional politics that result from institutional choice. The conclusion of this brief survey is that the timing and shape of reforms in China have been driven not by a desire for the step-by-step introduction of market reforms. Instead they follow the logic of political coalition building driven by the nature of the

sector in question, the nature of the asset to be controlled and the political costs of centralization versus decentralization.