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"REFORM AND OPENNESS"
Why China's Economic Reforms Have Delayed Democracy

By MARY E. GALLAGHER*

INTRODUCTION

MOST theories that seek to explain democratization look to changes in the economy as the precursor to significant political liberalization. Some locate the main causal factor in economic crisis while others look to the rising expectations of the domestic population during periods of rapid economic growth. One of the key explanations for the transition to democracy and the collapse of socialism in the Soviet Union and Eastern Europe is that these states failed to keep up their end of the social contract. As scholars of the regions point out, the fusion of economics and politics under socialism turned the failure of the economy into a moment of political opportunity, leading to the end of socialism.[1] Alternatively, a key explanatory factor for the democratization trend in East Asia during the 1970s and 1980s was its rapid growth. This growth led to the expansion of the middle classes and the rise of social movements concerned with the externalities of rapid growth, including environmental degradation, labor exploitation, and government corruption.

In the Chinese context, however, the Communist Party has managed to extricate itself from the socialist social contract with the urban working class without losing its grip on political power. Moreover, China has maintained a rapid pace of economic growth for over twenty years without succumbing to political liberalization—indeed with only the slightest movement toward democratic government. Thus, it seems that

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[1] Valerie Bunce, *Subversive Institutions: The Design and Destruction of Socialism and the State* (Cambridge and New York: Cambridge University Press, 1999); Katherine Verdery, *What Was Socialism, and What Comes Next?* (Princeton: Princeton University Press, 1996).

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neither severe economic crisis nor rapid economic growth is leading to political democratization. This article offers an analysis of this significant Chinese exceptionalism.

Comparative analysis of China's reform policies yields insights both across types of socialist transition, comparing China with Eastern Europe and Russia, and across time, comparing China with other high-growth East Asian economies. I argue that a key factor in China's ability to reform the economy without sacrificing political control is the timing and sequencing of its foreign direct investment (FDI) liberalization. Two variables are at the heart of this comparative analysis. First, China's *pattern of ownership diversification* stands in contrast to that of other reforming socialist economies. FDI liberalization preceded both the privatization of state industry and the development of a domestic private sector. Second, China's *mode of integration into the global economy* differs dramatically from the experiences of other East Asian high-growth economies, in particular, Korea and Taiwan. FDI has been the dominant source of external capital for the PRC, far outweighing the more indirect, managed ties to foreign capital established by other East Asian states. I relate these two variables to China's success in effecting economic change without political liberalization, in particular, to how FDI liberalization has affected relations between workers and the ruling Chinese Communist Party. "Reform and openness" (*gaige kaifang*) in this context resulted in a strengthened Chinese state, a weakened civil society (especially labor), and a delay in political liberalization.

The literature on the relationship between economic development and democracy is varied and complex, much of it jumping off from the Lipset hypothesis first proposed in 1959, which posited a causal relationship between economic development and democracy.[2] The literature includes theories of modernization, dependency, and, most recently, globalization.[3] Modernization theories posit a causal link between economic growth (and its corollaries of increased education, communication, and mobilization) and democracy. Indeed, the belief that economic growth, development, and greater integration with the outside world will lead to a more liberal and democratic China has

[2] Seymour Martin Lipset, "Some Social Requisites of Democracy: Economic Development and Political Legitimacy," *American Political Science Review* 53 (March 1959).

[3] For a recent review and in-depth analysis of the relationship between democracy and development, see Adam Przeworski and Fernando Limongi, "Modernization: Theories and Facts," *World Politics* 49 (January 1997); and Adam Przeworski, Michael Alvarez, José Antonio Cheibub, and Fernando Limongi, *Democracy and Development: Political Institutions and Well-Being in the World, 1950–1990* (Cambridge and New York: Cambridge University Press, 2000). Przeworski et al. find that the causal link posited by modernization theories is not strongly supported by the empirical evidence.

been the foundation of U.S. foreign policy toward China for the last twenty-five years. More recently, theories of globalization have posited that due to increased transnational flows of goods, money, ideas, and people, national economic and political systems would increasingly converge toward the "ideal" combination of a market economy and a liberal democratic political system.[4] Other theories of globalization predict a decline in the sovereignty of nation-states and their capacity to govern resulting from the pressures and demands of an increasingly global economy.[5] The argument presented here challenges these ideas by showing how economic development amid increasing openness has contributed to the stability of authoritarian rule in China. In opening its borders to large flows of foreign capital, China's communist leaders have made growth and globalization work for them.

Since the early 1990s the People's Republic of China has attracted more FDI than any other developing country in the world. And for several years since 1993 China attracted more FDI than any other country in the world except the United States. The policy of "reform and openness" (of which FDI liberalization was a central part) first promoted by Deng Xiaoping in the late 1970s is, of course, widely seen as a great success. So successful, in fact, that in late 2001 China became the newest member of the World Trade Organization (WTO). Accession to the WTO marks China's full acceptance into the global economy and shows the leadership's determination to continue to pursue increased openness, increased foreign investment, and dramatically increased competition within the domestic economy.

There is great debate among economists and policy analysts on the economic effects of FDI.[6] An equally vigorous and perhaps more polarizing debate surrounds the political and social effects of China's FDI

[4] Held et al. divide this "hyperglobalist" thesis into neoliberal and radical/neo-Marxist camps. There is of course much disagreement on the normative implications of convergence, particularly the debates on the fate of the social welfare state and the environmental and labor implications of globalization. David Held, Anthony McGrew, David Goldblatt, and Jonathan Perraton, *Global Transformations: Politics, Economics, and Culture* (Stanford, Calif.: Stanford University Press, 1999), 3–5.

[5] Susan Strange, *The Retreat of the State: The Diffusion of Power in the World Economy* (Cambridge: Cambridge University Press, 1996).

[6] Nicholas Lardy, "Economic Engine? Foreign Trade and Investment in China," *Brookings Review* 14 (Winter 1996); Yanrui Wu, ed., *Foreign Direct Investment and Economic Growth in China* (Cheltenham, U.K.: Edward Elgar, 1999). Lardy found that while foreign-invested enterprises contributed greatly to China's export boom, they did not provide many backward linkages to the domestic economy; nor did the presence of foreign-invested enterprises contribute to the reform of SOEs given their still-continuing protection. His FDI data for the article end in 1994, so the analysis misses the later boom years in FDI and their effects. Yanrui Wu and others find links between FDI and economic growth but show that the linkage is not a one-way causal relationship between FDI and GDP. See especially Jordan Shan, Gary Tian, and Fiona Sun, "Causality between FDI and Economic Growth," in Yanrui Wu.

policy, in particular, and its rapid integration into the global economy in general. Advocates and supporters of reform and openness portray FDI as the bearer of all that is good, legal, and advanced.[7] Critics of the social consequences of FDI liberalization portray it as the Trojan horse of exploitative global capitalism.[8] This debate is unsatisfying because it often fails to acknowledge that both of these characteristics coexist in time and space. FDI's political and social effects are highly complex and differ widely across different regions, firms, and individual workers. One major reason for the polarization of this normative debate surrounding the benefits of FDI and economic integration is that these broad Manichaean conclusions are often drawn from research that is narrowly focused.[9] Due to these constraints, the broad political consequences of FDI liberalization either have been reduced to the good-bad dichotomy or have been overlooked.

This study looks back on more than two decades of reform and opening in order to show that the political effects of FDI have been greatly underestimated in our explanations for why China has achieved rapid economic growth with little political liberalization, particularly since 1989. The two primary alternative explanations for China's economic success amid political stability privilege other aspects of China's reform path. One explanation argues that the gradual nature of the reforms determined success, particularly in contrast to the shock therapy administered in other postsocialist countries in the 1990s.[10] Another

[7] This argument is promoted by policy analysts, business executives, and academics who argue that greater engagement with the outside world, mainly through trade and economic investment, has a liberalizing effect on Chinese domestic politics. While most treatments of this question readily admit the presence of negative effects, the overwhelming conclusion is that interaction with global capitalism has liberalizing effects on politics and society. See, for example, Douglas Guthrie, *Dragon in a Three-Piece Suit: The Emergence of Capitalism in China* (Princeton: Princeton University Press, 1998); and idem, "Transition to a Market Economy: The Transformation of Labor Relations in China's Global Economy" (Paper presented at the annual conference of the Association of Asian Studies, Chicago, March 2001). Michael Santoro addresses the positive and negative effects of MNC investment in China while trying to lay out a way for investment to have "moral integrity"; see Santoro, *Profits and Principles: Global Capitalism and Human Rights in China* (Ithaca, N.Y.: Cornell University Press, 2000).

[8] Anita Chan, *Chinese Workers under Assault: The Exploitation of Labor in a Globalizing Economy* (New York: M. E. Sharpe, 2001); Greg O'Leary, *Adjusting to Capitalism: Chinese Workers and the State* (New York: M. E. Sharpe, 1997).

[9] This is not the criticism that it may seem to be. China is a large and complicated country, so for research to be good and careful, it must be limited. The criticism leveled here is at broad generalizations based on narrow empirical foundations. Guthrie's positive conclusions on the effects of FDI and marketization in general are drawn from research in Shanghai. Chan's analysis of labor exploitation looks mainly at industries that are labor intensive, export oriented, very cost sensitive, and located in China's southeastern coastal regions, where overseas Chinese investors are dominant. Shanghai, by contrast, attracts FDI from a more diverse group of investors, including Japanese, Americans, and Europeans.

[10] Ronald McKinnon, "Gradual versus Rapid Liberalization in Socialist Economies: The Problems of Macroeconomic Control," in Michael Bruno and Boris Pleskovic, eds., *Proceedings of the World Bank Annual Conference on Development Economics, 1993* (Washington, D.C.: World Bank, 1994); John McMillan and Barry Naughton, "How to Reform a Planned Economy: Lessons from China," *Oxford*

explanation argues that the ability to implement "reforms without losers" created the social consensus to continue reform and reduced the threat of political instability.[11] The argument presented here considers the first explanation to be incomplete and the second to be wrong. The gradual nature of Chinese reform was a characteristic shared by the reforms of many other socialist states. Russia, Hungary, and Yugoslavia all have reform histories nearly as long as or in some cases longer than that of China. The experiments with shock therapy came only after the political revolutions of 1989, when gradual, piecemeal reform was rejected in favor of systemic reform, both political and economic. While Chinese reforms can correctly be described as gradual, other aspects of the reforms, the sequencing of reforms in particular, are more important for explaining China's achievement of economic reform without accompanying demands for political liberalization.

China's reforms have also created losers, in terms of both economic status and political power. FDI liberalization made important contributions to the widening economic and social opportunities among Chinese regions, firms, and workers. This liberalization led to increased competitive pressure in three fundamental ways: regions compete for FDI inflows; individual state-owned firms compete for FDI inflows, as well competing against foreign-invested firms for market share, profits, and skilled labor; finally, workers compete for jobs. Such competitive pressure has led to increasing fragmentation; it has also reduced societal resistance to reforms, which in turn has delayed demands for political change.

The aggregate effect of China's policy of FDI liberalization has been negative for short-term political change and democratization. These aggregate effects can be explained by examining the effects that FDI liberalization has had on local governments, firms, and individual workers. By looking closely at these actors, we can begin to develop the foundation of a theory that seeks to explain the broad shape of Chinese economic reforms: rapid economic growth and dizzying social change, yet continued political authoritarianism. This argument is based on empirical research that examined the changing incentives and interests of

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Review of Economic Policy 8 (Spring 1992). Anders Aslund lists several reasons for the difference between Soviet and Chinese reforms. He includes the role of FDI, in particular, overseas Chinese capital, as crucial to China's economic success. He notes that "in a way, overseas Chinese represented an émigré civil society, making up for the lack of one within Chinese itself"; Aslund, *How Russia Became a Market Economy* (Washington, D.C.: Brookings Institution, 1995), 16. The analysis here presents a much different role for FDI and overseas Chinese capital.

[11] Lawrence Lau, Yingyi Qian, and Gerald Roland, "Reform without Losers: An Interpretation of China's Dual-Track Approach to Transition," *Journal of Political Economy* 108 (February 2000).

certain groups within the Chinese state and Chinese society. For example, how did the opportunity to attract FDI change the bargaining power and interests of local officials and state enterprise managers? How did the presence of a newly created foreign-invested sector alter the bargaining power and interests of urban workers? In addition to this microlevel approach, however, ideas and ideologies (and how they change) are also considered. In particular, I examine the changing parameters of the endemic ideological debate in all reforming socialist economies regarding the proper roles and legitimacy of public and private industry.

Throughout this article, I seek to account for why Chinese economic reforms, particularly reforms involving urban workers, have not led to widespread political instability and demands for political liberalization. Such demands, had they been made, may or may not have led to a process of democratization. Therefore, this argument does not explain the failure or success of democratization but rather focuses on an arguably prior social condition: demands from society for political change. This topic has not been the focus of most recent research on comparative democratization.[12] Instead, this literature has concentrated in the "moments" of transition, consolidation, and democratic survival. In such analyses, the role of broad social forces has already been accounted for with attention then shifted to the strategic behavior of elites, institutional design, and other issues of the posttransition period.[13] In order to better explain the Chinese case, which was, after all, the first socialist nation to undergo a democratic movement in 1989 but the only to remain state socialist after 1991, I shift our focus back to the role of social forces in fomenting pressure for political transition.

OUTLINE

The article continues with four main sections and a conclusion. The first section describes China's liberalization of its FDI policies over time, spanning the period from the beginning of the reforms in the late 1970s (with the establishment of Special Economic Zones in two

[12] Some notable exceptions include Eva Bellin, "Contingent Democrats: Industrialists, Labor, and Democratization in Late-Developing Countries," *World Politics* 52 (January 2000); Ruth Collier, *Paths toward Democracy: The Working Class and Elites in Western Europe and South America* (Cambridge: Cambridge University Press, 1999); Lisa Anderson, ed., *Transitions to Democracy* (New York: Columbia University Press, 1999).

[13] The generalizations derived from this research attest to the tendency to focus temporally on the transitional moment and after, with the exception of some of the research by Przeworksi et al. (fn. 3) on the link between economic growth and democracy. See Valerie Bunce, "Comparative Democratization: Big and Bounded Generalizations," *Comparative Political Studies* 33 (August–September 2000).

southeastern provinces) to the most recent stage of privatization of state-owned enterprises (SOEs) and WTO accession. China's liberalization of FDI was dynamic. Earlier policies tended to lead to greater internal and external demands for more openness. Moreover, China's regional decentralization created competition between regions and firms for FDI inflows. This had the effect of increasing the overall bargaining power of foreign investors. Finally this section notes that in comparison with the other two major reforms of socialist countries in transition (state enterprise reform and/or privatization and the development of domestic private industry), FDI liberalization was not only first in the sequence of reforms but was also the most successful of these policies.

The second section lays out a three-part general argument for why FDI liberalization has had the effect of limiting and delaying political liberalization. First, the foreign-invested sector of the Chinese economy has acted as a *laboratory* of capitalism. The success of China's FDI liberalization granted the Chinese state political space to enact difficult and destabilizing reforms. It fragmented key elements of society that stood to lose substantially from economic reform, most especially the urban working class, and it increased the numbers of urbanized workers through the hiring of rural migrants. Second, the foreign-invested sector created competitive pressure both between regions and firms and within firms. The growing opportunity to attract FDI inflows created interregional competition for those inflows. Moreover, within regions, FDI created greater competition between firms for those inflows, market share, and skilled labor. Such competition led to increased pressure to adopt capitalistic practices, learned from or mimicking the foreign firms themselves. It also spawned competition between different types of workers, in effect watering down the power of the previously powerful urban working class.

Finally, the infusion of foreign capital into China's economy changed the nature of the economic debate. A typical transitional economy debate over public versus private industry shifted to a debate that pits Chinese national industry over foreign competition in particular and globalization more generally. This shift in the debate is, of course, related to the competition mentioned above. Because the competition was increasingly identified as domestic versus foreign, the public/private ownership debate lost saliency over time. Privatization has become acceptable because it is justified in nationalistic terms—it will save Chinese industry from the threat of foreign competition. This reformulation of the key debate in socialist transition has insulated the Chinese Communist Party from charges that it has turned capitalist. Thus, although the Chinese Communist Party does increasingly embrace basic capitalist principles, this change is framed as being in the national interest and as essential for national economic survival in an increasing globalized economy.

The next two sections place this argument that FDI liberalization can delay political liberalization in comparative perspective. FDI liberalization is broken down into two separate variables. First, in transitions from socialism FDI liberalization is one method of shifting industrial ownership away from the state monopoly. The two most obvious alternatives are privatization of the state sector and the development of an indigenous private business class (most often accomplished in part by the legalization of the already existing second economy). Here we examine why FDI liberalization may be less politically destabilizing to a reforming socialist regime than these other reforms, which not only tend to threaten powerful interest groups directly but also to strengthen and legitimate the subversive forces of the heretofore underground economy. Comparisons are drawn with the economic reforms of Russia under Gorbachev and Hungary's early legalization of private industry.

Second, during the process of economic growth, developing countries have for decades given up on import substitution and turned toward greater integration with the world economy. Liberalization of the FDI regime is one method of such integration. Alternatives have included indirect capital flows, such as bank loans and more recently portfolio investment, as well as export-oriented industrialization without wider opening of the domestic economy to trade and investment. Comparisons are often made between China and its East Asian neighbors, whose economies are known for rapid economic growth through a heavy reliance on export-oriented industrialization promoted by an activist state. The PRC leadership has indeed at times quite openly adopted aspects of these "reference states" in order to direct economic growth in a particular way. The early special economic zones (SEZs) were based in part on the economic development zones that Taiwan established in the 1970s. More recently, the PRC central government encouraged state-owned enterprises (SOEs) to form large, diversified industrial groups modeled after the Korean chaebols.

China's early and continued opening to FDI, however, stands in stark contrast to the experiences of other East Asian states—in particular, Japan, Korea, and Taiwan. Although their industrial structures and development trajectories differ in important ways from each other, these East Asian economies were built on a strong domestic business class often closely allied with an interventionist state. Foreign participation in the domestic economy was extremely low despite the export orientation of their development paths. In particular, FDI, which entails active foreign presence in domestic enterprises, was strictly controlled at low levels. In the PRC, however, FDI has been continually liberalized over the past twenty years and has grown to become an integral part of the Chinese domestic economy. Moreover, the private sector economy has grown slowly under reform and has only recently after twenty years of reform been officially protected in the Chinese constitution. Unlike the strong domestic private sectors of Korea and Taiwan, PRC private industry is still small scale, often locally or regionally constrained, and starved of credit and bank loans, which continue to flow to the inefficient state sector.

While the business classes in Korea and Taiwan did not play the role of an enlightened, politically liberal bourgeoisie as occurred with their counterparts in the European model of democratization, their growing independence made the united front of authoritarian government and domestic capitalism increasingly untenable. In the PRC, however, there is little chance for the private economy to play a central role in political change. Of a small scale and dependent on local government support for its survival, private industry in China is still in its infancy. In fundamental ways FDI has become the substitute for domestic private industry in China. This substitution has important effects on the possibilities for democratization in China.

FDI LIBERALIZATION: DYNAMIC SEQUENCING

Since 1978 a key element of China's economic reform has been its opening to foreign investment and trade. As seen in Table 1, this has turned out to be one of the most successful reform policies. From 1979 to 1999 China pulled in over $306 billion in utilized FDI, second only to the United States worldwide (see Table 1). Compared with other socialist or postsocialist economies, China's ability to attract FDI has been unprecedented. Russia, a reforming economy that has also looked to foreign investment as an engine of growth and restructuring, attracted a mere $14.3 billion in FDI in the 1990s. Compared with other large developing countries, China is again in a league of its own, attracting over $234 billion in net FDI in the 1990s against Brazil's $66.3 billion and Mexico's $61 billion.[14]

China's ability to attract large inflows of FDI seems at odds both with

[14] *Global Development Finance: Analysis and Summary Tables, 1999* (Washington, D.C.: International Bank for Reconstruction and Development/World Bank, 2000), 51.

TABLE 1
FOREIGN DIRECT INVESTMENT IN CHINA
(1990–2000)

Year	*Contracted FDI (U.S. $Billion)*	*Change from Previous Year (%)*	*Utilized FDI (U.S. $Billion)*	*Change from Previous Year (%)*
1990	6.6	18	3.5	3
1991	12.0	82	4.4	26
1992	58.1	384	11.0	150
1993	111.4	92	27.5	150
1994	82.7	−26	33.8	23
1995	91.3	10	37.5	11
1996	73.3	−20	41.4	9
1997	51.7	−29	45.2	8
1998	52.1	2	45.5	1
1999	41.54	−20.2	40.39	−12.7
2000	62.66	50.8	40.77	.94

SOURCES: Data compiled from China Ministry of Foreign Trade and Economic Cooperation (www.moftec.gov.cn); and "Foreign Investment in Brief," U.S.-China Business Council (www.uschina.org/public/briefinvest/html).

the traditional assumptions about the nature of foreign investor preferences and with the normally assumed preferences of the Chinese Communist Party. Foreign investors care about reduced risk, clear property rights, a stable institutional setting, and a clear chance for profits. Ruling communist parties, one might assume, cherish stability, control, the preservation of economic sovereignty, and the protection of state-owned industry and state-sector workers. Yet since 1979 FDI has become an increasingly significant part of the Chinese economy. In 1995 foreign-invested enterprises contributed 19.5 percent to China's gross industrial output and by 1996 exports from foreign-invested enterprises (FIEs) made up 40.7 percent of China's total exports. From 1993 to 1997 FDI as a proportion of gross fixed-capital formation was 14.56 percent, much higher than in the more closed economies of Korea and Taiwan (1.06 percent and 2.78 percent, respectively) and even higher than in Malaysia (14.12 percent) and Thailand (3.76 percent), countries that are considered relatively open to FDI.[15]

The initial decision to liberalize the economy and allow FDI was made in the late 1970s in the aftermath of the Cultural Revolution. It was a calculated decision to allow limited FDI in order to overcome a dire capital shortage and a dearth of technology, modern industrial

[15] Yasheng Huang, "Internal and External Reforms: Experiences and Lessons from China, Part I," *Chinaonline* (www.chinaonline.com, accessed September 22, 2000).

equipment, and managerial know-how. FDI was to supplement China's primary socialist, state-owned economy. The original vision of state leaders was to see FDI as a passive tool to be controlled and manipulated in keeping with the goals of China's leadership. Keeping FDI under control was important for political reasons because the last time that foreign capital had thrived on Chinese soil, China ended up a humiliated, nearly colonized, wrecked empire. Nor did the large-scale presence of Western and Asian capital fit with China's economic goals of nationalistic economic development and rapid growth, such as that enjoyed earlier by Japan, Korea, and Taiwan.

In general when studying China's experience with FDI, too much emphasis is placed on the "choice" factor. Liberalization was dynamic and gradual. State policy often changed to reflect practices already occurring on the ground. The process of FDI liberalization was dynamic and unintended, much in the way that other sectors of the economy liberalized. Despite the veneer of government-initiated liberalizing policies, FDI liberalization has been the result of two interacting mechanisms: the liberalization of state policies and regulations regarding foreign investment (especially the lifting of regional and sectoral restrictions on FDI) and the spontaneous policy innovations of local officials, state-owned enterprise managers, and foreign investors.[16]

This interaction effect was compounded by external changes that also increased the importance of FDI elsewhere, both worldwide and within East Asia. These factors include rising wages in Japan, Korea, and Taiwan, the lifting of direct investment restrictions by Taiwan, and the increased use of FDI by multinationals throughout the late 1980s and 1990s. Moreover, the sequencing of China's reforms (fast liberalization of FDI, slow reform of the state sector, and delayed liberalization of the urban private sector) also enhanced the importance of FDI as a source of capital and employment opportunity.

The decision to allow FDI was made in 1979, with the promulgation of the first Sino-foreign joint venture law.[17] In 1980 four SEZs were es-

[16] This dynamic perspective on reform is seen in many important works on China's political economy, yet most of these works were either written too early to incorporate the boom in FDI in the mid- to late 1990s or focused on domestic examples of dynamism. Naughton's work is the best example of this line of argument, covering both urban and rural phenomena. Because it was published in 1995, Naughton just misses the FDI boom and subsequent domestic reforms, although he does briefly note the increasing importance of the foreign sector. See Barry Naughton, *Growing Out of the Plan: Chinese Economic Reform, 1978–1993* (New York: Cambridge University Press, 1995), 302–4; and Kate Xiao Zhou, *How the Farmers Changed China: Power of the People* (Boulder, Colo.: Westview Press, 1996).

[17] Sino-Foreign Equity Joint Venture Law, adopted at the Second Session of the Fifth National People's Congress, July 1, 1979, and revised April 4, 1990. Herald Translation Services, *Chinalaw Web* (www.qisnet/chinalaw/prclaw, accessed April 18, 1997).

tablished in China's southeast. Zhuhai, Shenzhen, Shantou, all in Guangdong Province, and Xiamen in Fujian Province were situated close to the capitalist economies of Macao, Hong Kong, and Taiwan, but in areas that were still largely rural and agricultural. One of the most important characteristics of this early FDI policy was the way in which FIEs were separated from the domestic economy—geographically, organizationally, and legally. Barry Naughton argues that the SEZ policy was one of many policies of "disarticulation, in which successive sections of the economy are separated from the planned core, which persists."[18] The SEZs, in particular, "initially had almost no links to the remainder of the economy."[19]

By 1984 the central leadership came to the conclusion that the SEZ policy was a mixed success at best. As the core of China's attempt to build up export-led industrial capacity, the SEZs had failed to perform as hoped. High-tech industry was not thriving and the SEZs still required large infusions of state money for development of the infrastructure. Coupled with several high-profile cases of corruption, crime, and "unsocialist" behavior, like prostitution, in the SEZs, the conservatives in the central leadership were ready to declare the Open Policy a failure.[20] Reformers, Zhao Ziyang in particular, were forced to find a new direction for the Open Policy.

The Coastal Development Strategy (CDS) was a radically expanded version of the Open Policy and served as the glue holding together several reform coalitions: groups that benefited from increased openness and that would lobby the central government for such policies. "The CDS could potentially purchase political support from representatives of the coastal provinces, while also delivering a considerable economic benefit to the country as a whole."[21]

The CDS was successful in generating the support that the then premier and reformist leader Zhao Ziyang anticipated. Coastal provincial and local leaders leapt at the chance to exploit opportunities using FDI and new liberalized regulations guiding foreign trade. The increases in growth and industrial capacity and the transfer of high-tech equipment and management skills benefited the entire economy. Moreover, Zhao was successful in creating an external reform coalition: a multinational group of foreign investors, from overseas Chinese investors to Western

[18] Naughton (fn. 16), 11.

[19] Ibid.

[20] Barry Naughton, "Economic Policy Reform in the PRC and Taiwan," in Naughton, ed., *The China Circle: Economics and Technology in the PRC, Taiwan, and Hong Kong* (Washington, D.C.: Brookings Institution Press, 1997), 93.

[21] Ibid., 97.

multinationals, who began to have entrenched, long-term interests in the liberalization of the Chinese economy.[22]

The CDS decentralized decision making over foreign investment and liberalized FDI policy in several ways. It granted local officials much greater autonomy in authorizing projects with foreign investment. The CDS also clarified and liberalized preferential policies for foreign investors. The CDS was extremely successful in opening up the Chinese economy to foreign trade and foreign investment, spurring growth on the coast, and gaining new supporters of the reform program. It also spiked the interest and envy of inland leaders. The CDS exacerbated economic inequality between the inland and coastal regions. Regions not authorized to set up development zones with preferential policies for foreign investors found it extremely difficult to compete with the coast. The inland provinces also lacked the human capital and infrastructural advantages of the coast, so that the CDS added insult to injury by widening the historical gap between the advanced coast and the backward inland areas. Thus the proreform coalition added a new, albeit disgruntled group: inland leaders excluded from the boom who wanted to see the coastal policies extended nationwide.[23]

As the income gap widened, pressure on the central government to extend the CDS grew. Inland provinces watched with envy as the coast boomed and FDI poured in. The central government, eager to make these poor areas more self-sufficient (and to build a larger revenue base), finally relented in 1994 and extended the preferential polices of the CDS to all provinces. Coupled with a more general proreform atmosphere associated with Deng Xiaoping's Southern Tour to the booming provinces bordering Hong Kong, this decision heralded a new period of rapid growth and foreign investment. It also extended nationwide the competitive drive for FDI that had already been occurring in the coastal provinces. Thousands of local governments set up development zones in a mad dash to court foreign investors, announced breaks in taxes and land-use fees, and offered foreign investors access to low-cost labor.[24] This "competitive liberalization"[25] between regions

[22] Susan Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993), 50.

[23] Ibid., 48.

[24] Yang notes that by the end of 1991 China had only 111 development zones, including 27 approved by the central government. But by the end of September 1992 there were 1,951 such zones. A later report estimated that by 1993 there were 8,700 zones nationwide, including development zones set up at the township level. Dali Yang, *Beyond Beijing: Liberalization and the Regions in China* (New York: Routledge Press, 1997), 56.

[25] This phrase and analysis of reform dynamics was developed by Yang (fn. 24).

accelerated the trends of expanded foreign investment autonomy and control.

Foreign investor autonomy and control expanded once again when the Chinese leadership decided to push the languishing state-owned enterprise reforms forward by allowing FDI participation. In the late 1980s the trends of increased autonomy and control mostly reflected the interests of foreign capital and were realized in part by the enhanced bargaining position of foreign investors. The government reactively liberalized FDI policies at the behest of foreign investors unhappy with the business environment.[26] In the 1990s, however, these trends accelerated due to a domestic crisis: the fact that over half of all SOEs were losing money and that most were deeply in debt. Reformist leaders now saw FDI as a means to save the state-owned sector from bankruptcy, financial crisis, and rampant unemployment.

The changes in the leadership's SOE reform policy were announced during the Fifteenth Congress of the CCP in late 1997 but had been in the works for months.[27] The new policy was heralded with the slogan, "Hold the Big, Release the Small" (*zhuada, fangxiao*), signaling the government's willingness to allow many small and medium-size SOEs to change ownership; this effectively allowed large-scale privatization, although the government resisted using those words (*siying hua*).[28] Thus, foreign acquisition of SOEs became a major facet of the as yet undeclared privatization process.[29] More strikingly, this announcement at the Fifteenth Congress did not signal anything new or novel from the center; rather, it bestowed official approval on phenomena that had been occurring in many localities since 1992: "The 15th Congress merely set the ideological tone by officially acknowledging the need to clear out the redundant workforce and to allow the state to abandon its medium and small enterprises step by step."[30]

Foreign investment has figured significantly in the state's letting go of its small and medium-size enterprises through a rapid increase in the

[26] Dong Dong Zhang, "Negotiating for a Liberal Economic Regime: The Case of Japanese FDI in China," *Pacific Review* 11, no. 1 (1998).

[27] Zhu Rongji gave a speech at the Congress later excerpted in the domestic media. Zhu Rongji, "Cut Staff, Increase Profits, Distribute the Laid-Off Workers, Standardize Bankruptcy, Encourage Mergers" (*jianyuan zengxiao, xiagangfenliu, guifanpochan, gulijianbing*), reprinted in *Jingji Guanli Wenzhai* (March 1997); Kathy Chen, "Chinese President Ratchets Up Reforms," *Wall Street Journal*, April 7, 1997, A11.

[28] If fully implemented this would affect over one hundred thousand small and medium-size state enterprises. Jean-Francois Huchet, "The Fifteenth Congress and the Reform of Ownership: A Decisive Stage for Chinese State Enterprises," *China Perspectives* 14 (November–December 1997), 17.

[29] Edward Gu, "Foreign Direct Investment and the Restructuring of Chinese State-Owned Enterprises, 1992–1995: A New Institutionalist Perspective," *China Information* 12, no. 3 (1996), 47.

[30] Ibid., 18.

number of "grafted" joint ventures, the foreign acquistion of firms, and the renting of factories to foreigners on long-term leases. Accurate information on such activity is mostly anecdotal or region specific. Official statistics regularly underreport such activity because local officials fear punishment for selling off state-owned assets too cheaply.[31] Chinese journalists and academics have, however, exposed these phenomena through a vigorous debate on the future of Chinese "national industry" (*minzu hangye*).[32] Due, however, to the undercapitalization of private firms in China, their second-class citizenship status, and local protectionism toward Chinese firms from other regions, foreign firms stood out as the primary beneficiaries of the deeper structural reform of SOEs.

From the early "disarticulation" policy of the SEZs to the Fifteenth Party Congress's policy of "letting go," FDI liberalization has been a dynamic, continuous process. Reform of the SOE sector and the development of domestic private industry, however, stand in stark contrast to FDI liberalization. Reform of the state sector, begun in earnest in 1984, has continually failed to yield results that corrected the failings of socialism. In a four-city study of SOE reform, Huang and Duncan concluded: "After 16 years of reform, however, the financial performance of the state sector is still far from satisfactory. Old problems like soft budgets and economic inefficiencies remain. Some new problems, such as the hemorrhaging of state assets, have arisen."[33]

Most research on SOE reform and the related problems in China's banking and financial sectors accord with this general conclusion that SOE reform has not gone far enough in allowing the market to choose winners and losers. Large swaths of China's state sector remain financially dependent on bank loans, which tend to prop up failing, inefficient firms with large numbers of workers on their payrolls.[34] Thus, despite the various efforts at tinkering with SOE reform since 1984, China's state sector lags far behind the nonstate sector in productivity

[31] Kathy Chen, "Orient Express: China's Businesses Push for Faster Economic Reform," *Wall Street Journal*, October, 16, 1997.

[32] A few examples include Dongshui Su et al., eds., *Zhongguo Sanzi Qiye Yanjiu* (Research on China's foreign-invested enterprises) (Shanghai: Fudan University Press, 1997); Haitao Zhang et al., eds., *Waizi Nengfou Tunbing Zhongguo: Minzuqiye ying xiang hechuqu?* (Will foreign capital swallow up China? Where should national industry go?) (Beijing: Qiye Guanli Chuban She, 1997); and Liu Lisheng et al., eds., *Waizi Binggou Guoyou Qiye: Shizheng fenxi yu duice yanjiu* (Foreign capital's acquistion of state-owned enterprises: Analysis and countermeasures) (Beijing: Zhongguo Jingji Chubanshe, 1997).

[33] Yiping Huang and Ron Duncan, "How Successful Were China's State Sector Reforms?" *Journal of Comparative Economics* 24 (February 1997).

[34] Edward Steinfeld, "Free Lunch or Last Supper? China's Debt-Equity Swaps in Context," *China Business Review* (July–August 2000) (www.chinabusinessreview.com/0007/steinfeld.html, accessed July 7, 2001).

and employment creation. Over time the state sector's contribution to GNP has fallen dramatically. In 1998 the state sector's share of industrial output stood at only 28 percent, falling from nearly 80 percent at the beginning of the reform era. In comparison, the private sector (including foreign-invested enterprises) has increased its contribution to 33 percent.[35] Ironically, perhaps, some research finds that the state-owned enterprises made positive contributions to reform outcomes initially by facilitating growth outside of the plan.[36] Unfortunately, the nonstate sector of the Chinese economy has left its helpmate behind. Failure of SOE reform has led to increased demands for significant reform and privatization of property rights.

The domestic private sector is currently experiencing a relative boom in growth—both economically and in its legitimacy and prestige. By 1997 there were 960,000 registered private firms in China, employing 13.5 million people.[37] This boom is a result of the 1999 decision to grant the private sector greater constitutional protection and legitimacy.[38] More recently President Jiang Zemin made a controversial and still contested decision to allow private entrepreneurs to join the Chinese Communist Party. This change of heart toward China's "red capitalists" is considered a signal of the party's increasing desire to strengthen both the private sector and the party links to a burgeoning private business elite.[39] Despite this recent attention to the well-being of the private sector, for the previous twenty years of reform China's private sector was severely constrained, both in terms of its economic rights and in terms of its political legitimacy.

The foremost barrier to private business development has been the lack of adequate channels for capital formation. Private business in China is mostly excluded from China's capital markets, which are reserved for raising money for publicly listed state enterprises. Moreover, China's state-owned banks continue to lend overwhelmingly to state enterprises. "State-owned enterprises, which account for only 30% of the country's industrial growth, receive over 70% of its loans, whereas

[35] *Reforming China's Enterprises* (Paris: OECD, 2000), 19. The foreign-invested sector contributes 15 percent to gross industrial output. The remaining 18 percent comes from private enterprises, individually owned enterprises (*geti*), and share-holding enterprises in which the state does not hold a controlling share.

[36] "State Enterprise Reform," China Economy and Business: Issues, and Briefings, *Chinaonline*; (www.chinaonline.com/features/chinaonline2/research/entref.htm, accessed August 6, 2001).

[37] "Development of Private Enterprise," China Economy and Business: Issues and Briefings, *Chinaonline* (www.chinaonline.com/features/chinaonline2/research/entref.htm, accessed August 6, 2001).

[38] Gene Linn, "China's Sanction of Private Sector Opens Doors for Investment, Trade," *Journal of Commerce*, May 12, 1999; idem, "China's Private Surprise," *Economist*, June 19, 1999.

[39] Mary Kwang, "CCP Welcomes Private-Sector Members," *Straits Times*, July 2, 2001; Ching Cheong, "Opening the Doors to the Capitalists," *Straits Times*, July 15, 2001.

private enterprises, which produce the lion's share of China's industrial growth, cannot obtain sufficient capital."[40] Private entrepreneurs also regularly complain of informal bureaucratic discrimination (reflected in difficulty obtaining licenses and approvals), as well as of legal barriers to full participation in the global economy.[41] These legal barriers included a ban on foreign trade rights for private enterprises, which was only lifted in December 2000 in anticipation of increased foreign competition after China was admitted to WTO membership.[42]

Examining these three facets of economic reform—FDI liberalization, SOE reform, and the development of private enterprise—the relative success and speed of China's FDI liberalization stands in stark contrast to the failure of SOE reform and the delayed development of private enterprise. The recent attention to the development of private industry amid renewed calls for SOE privatization by leaders in the CCP is understandable in light of this lopsided performance. As an analyst in Hong Kong warned: "If state-owned enterprises can't perform and there isn't a viable domestic private sector, the economy will by default become mostly foreign-owned."[43] The success of FDI liberalization in comparison with these other reforms does pose significant economic challenges to the Chinese leadership, particularly as foreign competition is expected to intensify with WTO membership. Yet this cloud has a silver lining, at least for the Chinese Communist Party. The initial success and dynamic expansion of FDI liberalization has delayed demands for political change and decreased societal resistance to difficult, destabilizing reforms.

WHY HAS FDI LIBERALIZATION DELAYED POLITICAL CHANGE?

FDI liberalization delayed political liberalization in China (or made political liberalization less necessary from the regime's standpoint) because it preceded the other key reforms of a socialist transition: reform and/or privatization of the state sector and the development of an indigenous capitalist class. The sequencing of reforms is very important for their overall effects on the political and social landscape of the

[40] "More Private Banks Could Stimulate Chinese Economy," *Chinaonline* (www.chinaonline.com, accessed December 30, 1998).

[41] "China Economist to Government: Give Private Investment a Chance—and Soon," *Chinaonline* (www.chinaonline.com, accessed July 12, 2000); Craig Smith, "Private Business in China: A Tough, Tortuous Road," *New York Times*, July 12, 2000, A1.

[42] "MOFTEC Grants Foreign Trade Rights to Private Enterprises," *Chinaonline* (www.chinaonline.com, accessed December 19, 2000).

[43] Smith (fn. 41).

country. To have the effects described here, FDI liberalization must occur prior to large-scale, deep reform of the SOE sector and prior to the development of a large private business class. If FDI is prior in the reform sequence, then its role can be summarized as follows: The formation of a foreign-invested sector of the economy creates a *laboratory* for reform, new *competitive pressure* across different types of ownership for deeper reform, and *ideological reformulation* of the public versus private industry debate. This reform process tends to increase dynamically the chances for further reform, thus avoiding the traps of "partial reform," which tends to create winners who then block further reform in order to preserve their special position.[44] At the same time, however, it reduces societal opposition to reform, first through fragmentation and then through increased competition, which reduces the political power of groups that benefited from socialism and were protected under that system.

Laboratory for Change

The creation of a foreign-invested sector alongside the state and collective sectors in 1978 is but one example of China's dual-track system of economic reforms. In this system two economic "mechanisms" exist side by side. One is controlled by the state plan and the other by the market, with little overlap or direct competition between the two. This was particularly true at the beginning of the reform period, when SEZs were geographically separated from the rest of China's industry and "disarticulated" from the domestic economy. Barriers and restrictions to selling on the Chinese domestic market further limited contacts between these firms and the domestic economy. Over time, as the FDI sector grew in size and was allowed to expand first to other coastal cities and then across most of the rest of China, it became more integrated into the domestic economy. Foreign brands manufactured in China began to have a real presence in the Chinese domestic marketplace.

This early stage of dual-track reform and "disarticulation" between the foreign-invested sector and the rest of the economy is important, however, for expanding the political space for experimentation and radical reform. The foreign-invested SEZs and development zones that sprang up all over China's coast by the early 1990s became laboratories of capitalism, introducing new and destabilizing reforms of employment, social welfare, and enterprise management. Many of these new practices were encoded in laws and regulations expressly designed for

[44] Joel S. Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," *World Politics* 50 (January 1998).

the foreign sector, allowing short-term labor contracts, wage and bonus-setting autonomy for enterprise managers, and a sharp reduction in the social welfare burdens of the enterprise. Implementation of these new laws and practices avoided, however, overt conflict with the norms of socialism and the "iron rice bowl"—China's system of lifetime employment and extensive social benefits for urban workers. Workers drawn into the foreign-invested sectors and the development zones of coastal China are overwhelmingly young, inexperienced, and unfamiliar with the labor practices of socialist firms. Often migrant female workers from China's poorer inland regions make up the bulk of the production workforce of the foreign-invested enterprises.[45]

At the same time, of course, these development zones attract older and more skilled workers, managers, and technicians away from the state and collective sectors. These workers, while socialized into the socialist enterprise system, are drawn into these capitalist laboratories because they tend to benefit from a much less egalitarian system. The widening of wage and bonus differentials, special perquisites like manager housing and training abroad, and the perception of more opportunity for advancement all draw China's special "human talent" (*rencai*) into the foreign-invested sectors.[46] Thus this laboratory of capitalism includes workers who are least invested in or who benefit least from the socialist system of employment. It is only as competitive pressure builds on other sectors of the economy that the effects of this laboratory are more widely felt.

COMPETITIVE PRESSURE

The decentralizing aspects of Chinese economic reforms are often credited with creating the correct incentives for local officials and unleashing their developmentalist tendencies. A key element of this decentralization process has been the increasing authority of local officials to attract FDI. In addition to this interregional competition for FDI in-

[45] These statements are based on the author's observations during field research in foreign-funded and rural collective firms in 1997, 1999, and 2001. Management positions were often filled by former SOE employees (often the partner of the foreign firm), but production positions were filled almost exclusively by young urban residents or young rural migrants. Women make up the vast majority of the workforce in the electronics industry and other relatively labor-intensive industries. See Ching Kwan Lee, *Gender and the South China Miracle: Two Worlds of Factory Women* (Berkeley: University of California Press, 1998), 68–70.

[46] In a speech at the National Conference of Labor Dispute Resolution, an SOE manager complained of the inability of SOEs to retain workers, who were leaving in droves for the private and foreign sectors. Chen Quansheng stated: "Presently SOE workers fire the enterprise more than SOEs fire workers." Speech of Chen Quansheng at the National Conference of Labor Dispute Resolution, "Laodong zhengyi chuli yu yanjiu" (Handling and research of labor disputes) (January 1996); Carrie Lee, "Industry Frustrated by Job-Hopping," *South China Morning Post*, August 9, 1997.

flows, what Dali Yang has called "competitive liberalization," there are two other modes of competition sparked by the presence of foreign investment in China's domestic economy.[47] This competition has reshaped relationships within firms and firm behavior in the economy more generally. First is the competition between domestic firms for FDI infusions. Second is the competition between foreign-invested firms and other firms in China's domestic economy for market share and skilled labor. Competition between firms for FDI inflows is an extension of the logic of competitive liberalization, which demonstrated the way in which regional and local governments in China competed against each other for FDI. Similarly, within one region, firms court foreign partners or, as has been happening even more recently, foreign buyers. The allure of foreign investment is multifaceted, having to do with the perception that it brings more sophisticated managerial and technical skills, greater access to foreign export markets, capital infusions to replace government support, and more broadly the cachet of internationalization through association with a globally recognized brand name.

Such competition, on the regional level and between firms, is a powerful force for convergence with capitalist practices of foreign firms.[48] It reduces resistance from those in state enterprise because to cling instead to "socialist enterprise" would mean losing out on the chance to gain not only capital and technology but also the prestige that comes with ties to the international economy. Economic reform is pushed ahead dynamically by such competition. At the same time, resistance is reduced.

The second mode of competition, that between firms for market share and skilled labor, is also important as an impetus for further reform amid reduced societal resistance. As foreign-invested enterprises began to become more integrated into the domestic economy, competition increased, particularly for SOEs, which had long monopolized positions in the domestic market. Competition between SOEs and FIEs in the domestic economy led to calls from within the SOE sector for a "level playing field." That is, the state sector began to perceive the preferential policies accorded to joint ventures and wholly foreign-owned enterprises to be a barrier to their own development and a hindrance to fair competition.[49]

[47] Yang (fn. 24).

[48] Shaomin Li, Shuhe Li, and Weiying Zhang, "The Road to Capitalism: Competition and Institutional Change in China," *Journal of Comparative Economics* 28 (June 2000). This article includes a large quantitative study of firms using China's industrial census. Although it does not focus on the particular effects of foreign-invested firms, it generally finds that cross-regional competition leads to market-conforming behavior by managers of SOEs and collectives.

[49] Articles in the national media as well as more scholarly articles on the problems of reform hammered away at this point of the absence of a level playing field between SOEs and FIEs. These articles

One way to demonstrate how this competitive pressure affected other types of ownership is to examine the development of Chinese labor and employment law. FIEs were the first to introduce and strictly implement employment contracts. In tandem with the rising labor mobility associated with short-term employment came a revolution in firm-level employment relations. Many of these firm-level changes were encoded into Chinese labor law, the development of which had been nearly moribund since the 1950s. At first, these laws were written expressly for the foreign-invested sector and were considered outside of the realm of normal socialist production. Legal analysts argued that labor laws should be tailored to workers in FIEs because workers in that particular sector were at greater risk of exploitation. A related but opposing reason for the development of specific foreign-invested laws was the need to satisfy demands of foreign investors for a more flexible labor force and increased managerial autonomy over human resource issues. Labor laws for FIEs reflect both concerns, although in implementation they tend to favor management.[50]

One important characteristic of these laws is that they came to be considered part of a system of preferential treatment accorded to foreign firms alone. These laws and regulations increased enterprise and managerial autonomy and flexibility in almost all areas of personnel management. Regulations on hiring, firing, term of employment, nonwage benefits, and the designated role of institutions representing workers granted FIEs significantly more flexibility and reduced burdens related to the employment of Chinese workers. The leadership justified these changes by pointing to the mandated higher wages in the foreign-invested sector. However, these differences in treatment led to the demands for a level playing field among state managers and their supporters in the leadership.

Accordingly, over time laws began to be developed that were not "ownership specific"; that is, they did not dictate enterprise behavior

focused on the heavy employment burden, the gap in managers' salaries, and the inability of SOEs to retain skilled workers. "Shubaiwanyuan nianxin gaibugai na?" (Should one take a yearly salary of hundreds of thousand RMB?"), *Nanfang Zhoumo*, December 20, 1996, 2; "Guoqi zenyang liuzhuren?" (How can SOEs retain people?"), *Renmin Ribao*, November 19, 1996, 10; "Shulirencaiyishi jianquan liangge jizhi" (Establish a consciousness of talent, perfect the two mechanisms), *Workers Daily*, April 8, 1997, 7. The two mechanisms include the collective contract system (to make it more difficult for workers to leave) and the incentive wage system (to improve skilled workers' wages). "Jishugongren huhuan zhengce fuzhu" (Skilled workers call for policy help), *Workers Daily*, December 13, 1996, 3; "Wanshanqiyegerenshouru fenpei tiaokongjizhi" (Perfect the adjustment mechanism for the distribution of individual salaries), *Zhongguo Gongshang Shibao*, May 5, 1997, 3; "Qiyequanyi yebixu weihu" (The rights and interests of enterprises must also be protected), *Jingji Ribao*, October 9, 1996.

[50] Mary Gallagher, "Why Labor Laws Fail to Protect Workers," *China Rights Forum* (Summer 1997).

based on type of ownership. *Yet laws that were adopted for the whole economy were largely based on the laws already written for foreign-invested firms.* The market logic of FIE employment law, with its notions of contract and autonomy, trumped socialist notions of guaranteed employment and the "working class as the master class." SOE managers were granted the right to act like capitalist firms in order to be able to compete against them. This greater managerial autonomy entailed larger wage differentials between workers and managers in order to stop the drain of top-level managers to the FIE sector, a lighter social welfare burden, and the right to lay off redundant staff. More generally, SOE managers won the right to pursue profits and efficiency at the expense of socialist goals like full employment and egalitarianism. A schematic explanation is illustrated in Figure 1.[51]

The competitive pressure unleashed by FDI liberalization operated at both a regional and a firm level. Regions competing for FDI inflows exploited this competition in order to pursue reform faster and more deeply. At the firm level, preferential treatment for FIEs gradually led to demands on the part of state firms for equal treatment and for the extension of practices and regulations to the economy as a whole.

Ideological Reformulation

The final effect of FDI liberalization occurs at a more abstract level than are its consequences for relations within firms, between firms, and between regions. FDI liberalization and the competition that it has spawned have led to a radical reformulation of one of the key debates of socialist transition: the proper role of public ownership in a marketizing economy. In other reforming socialist economies, the debate over privatization leads to mortal divisions both within the party-state and between the state and society. A decision to abandon public ownership and privatize signals the death of socialism—for what is socialism if not a commitment to public industry for the improvement of the entire economy and the protection of the working class? Socialist transitions generally begin with a struggle to allow a limited role for the private economy in the hope that it will contribute to a general improvement in economic conditions and lessen some of the negative attributes of the plan—shortages, lack of consumer goods, and poor-quality goods. In the

[51] This schematic depiction of legal convergence is borrowed from an article explaining how to reduce staff in Japanese-invested enterprises in China. In a 1999 interview one of the authors described the importance of the convergence of labor laws for determining changes in enterprise behavior. Hiroaki Tsukamoto et al., "Chugoku niokeru gaisho taishi kigyo no resutora oyobi" (Restructuring FIEs in China and procedures to cut staff), *Kokusai Shoji Ho* 27, no. 5 (1999); author's interviews with one of the authors, Tatsuo Murao, Shanghai, July 1999.

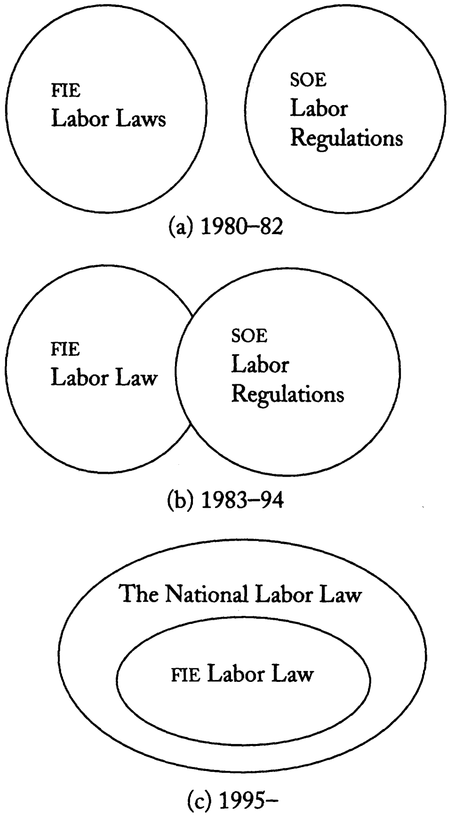

FIGURE 1
THE EVOLUTION OF LABOR LAWS IN THE PRC
(1980–95)

1980s, however, the plan continued to falter, while the private economy spawned greater subversion, increased corruption, and ever shrinking legitimacy for the regime. Thus in the debate over public versus private, the standing of public ownership continuously fell and further contributed to the dissolution of socialism in the USSR and Eastern Europe.

What we see in China is, empirically speaking, not entirely different. The SOE sector of the economy has lost out repeatedly under reform. SOEs have shown themselves to be immune to reform as they continue to operate under incentives not entirely different from those of the socialist era: the soft budget constraint, continuing state support for failing firms, irrational investment, and politically determined personnel appointments. By contrast, the nonstate economy, including the foreign-invested sector, has time and time again shown itself to be more efficient, more dynamic, and more capable of bringing widespread benefits like increased employment, better goods and services, and higher levels of technological accomplishment. In the earlier stages of reform, a debate between public and private ownership was largely unnecessary because the dual-track system allowed both to continue side by side, even as the nonstate sector succeeded and the state sector failed. By the Fifteenth Party Congress in 1997, when the regime finally signaled its willingness to privatize large swaths of Chinese state industry, this debate was reformulated as a debate over Chinese national industry versus foreign industry. The Chinese regime has retained its legitimacy by simply refashioning the debate into one of Chinese industrial survival amid ever increasing foreign competition. Privatization ("letting go") is necessary so that Chinese "national industry" (*minzu hangye*) can be revitalized and strengthened to meet its global competition. A nationalist perspective has replaced a socialist perspective and so far has shielded the Chinese leadership from accusations that it has sold out socialism.

FDI AND OWNERSHIP DIVERSIFICATION: CHINA IN COMPARISON WITH EASTERN EUROPE AND RUSSIA

Janos Kornai argues that the deepest kind of reform for a socialist system is one that alters property relations.[52] Public ownership of the means of production is the defining characteristic of the political economy of classic socialist systems, with unchallenged rule of the Communist Party its political counterpart. As the economies of socialist countries worldwide began to falter by the late 1970s, attempts were made to modify the classical pattern. Reforms generally included both attempts to recalibrate the incentives and constraints within public ownership and increased toleration for diverse forms of ownership.

In the transition from socialism, FDI liberalization is only one method for shifting industrial ownership away from the state monopoly. The two most obvious alternatives are internal reform and/or privatization of the state sector and the development of an indigenous private business class (most often accomplished in part by the legalization of the already existing second economy). Here we examine why FDI liberalization may be less politically destabilizing to a communist regime than these other reforms, which tend not only to threaten

[52] Janos Kornai, *The Socialist System: The Political Economy of Communism* (Princeton: Princeton University Press, 1992), 433.

powerful interest groups directly but also to strengthen and legitimate the subversive forces of the heretofore underground economy. Comparisons with the economic reforms of Russia under Gorbachev and Hungary's early legalization of private industry are brought to illustrate the point.

Reform of State Industry

China's reforms in agriculture and foreign investment and trade had gone far beyond those of the Soviet Union by the end of the 1980s. In their urban and industrial reforms up to the same point, however, the Chinese and the Soviets were not very different. Both countries attempted to improve the external and internal environments of state industry, to reduce the number of planning indicators, to put greater emphasis on profits, and to introduce management contracts to improve managerial performance. From the 1984 Large-Scale Economic Experiment in Industry to the 1987 Law on State Enterprises, Soviet reformers tinkered with the public ownership system in a way almost identical to the Chinese experiments that began in 1984.[53]

Chinese and Soviet reformers also encountered similar problems and difficulties. Reforms in enterprises in both countries led to indiscriminate wage increases, large-scale corruption related to the ability of state managers and bureaucrats to profit from the gap between plan and market prices, and conservative and bureaucratic resistance to reforms that reduced the power of ministerial bureaucrats. Many of these issues surfaced in the popular uprising associated with the student demonstrations in Tiananmen Square in 1989. In Russia as well, failure to reform the socialist system and the concomitant problems of corruption and bureaucratic interference "led to increasing liberal radicalization of state bureaucrats and economists because the reforms demonstrated the inability of piecemeal reforms to get the USSR out its economic crisis."[54]

Why, despite these similarities in both the nature and the problems of state enterprise reform, did Soviet and Chinese reforms go in nearly opposite directions by 1989? Soviet leaders were increasingly radicalized in favor of totalistic system reform, including political liberalization, while Chinese leaders gravitated to gradual, piecemeal reform of the economy alone. One major difference in the nature of Chinese and

[53] Aslund argues that Russia's mistake was not in diverging from the Chinese path but from following it too closely when their objective differences (in the labor supply, level of industrialization, length of time under communism, and so on) were so stark; Anders Aslund, *How Russia Became a Market Economy* (Washington, D.C.: Brookings Institution, 1995), 13–17.

[54] Anders Aslund, *Gorbachev's Struggle for Economic Reform* (London: Pinter Publishers, 1991).

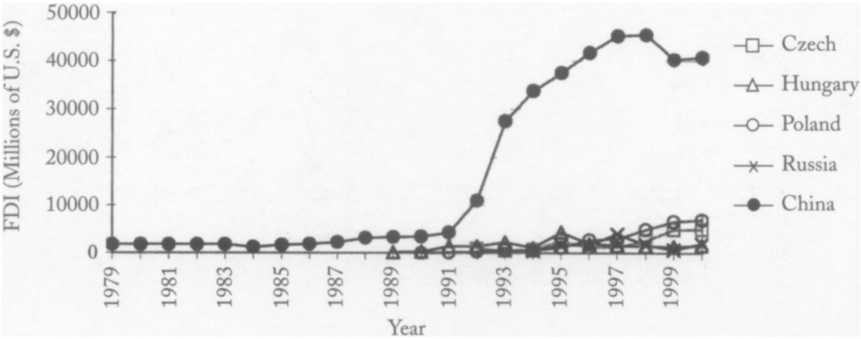

FIGURE 2
FDI IN TRANSITIONAL ECONOMIES
(1979–99)

SOURCES: Data compiled from the *European Bank for Reconstruction and Development Annual Yearbook* (various years); and the *China Statistical Yearbook* (various years).

Soviet industrial reforms is that the Chinese reforms in state industry were only a part of the much wider scope of industrial change. At the same time that China's SOE reforms were failing, Chinese reforms in foreign investment were starting to yield fruit and rural township-village enterprises were taking off. By 1992, with Deng Xiaoping's Southern Tour to the Shenzhen Development Zone, FDI liberalization accelerated and picked up the slack of a failing, inefficient state sector.

The Soviet Union's exclusive reliance on SOE reform as the linchpin of its industrial reforms doomed it to failure. Such failure led directly to subsequent radicalization and the growing appeal of shock therapy. The Soviet reform led to failure because it directly challenged with some of the most entrenched, recalcitrant, and powerful groups under socialism: bureaucrats, state managers, and state enterprise workers. Whereas SOE reform treats the dying patient directly with the hard-to-swallow medicine of competitive capitalism, the creation of a foreign-invested sector as a laboratory gives the medicine in small doses and corrodes resistance gradually. For a comparison of FDI inflows among the transitional economies, see Figures 2 and 3.

SOE reform does little to spark competition between regions or firms. The soft budget constraint is still in effect because under partial reform no firm is expected to take ultimate responsibility for its losses: with so many other parts of the economy not working well, that is, enterprise failure can be anyone's responsibility or no one's. Unfortunately, with the continuation of soft budgets, an environment of experimentation

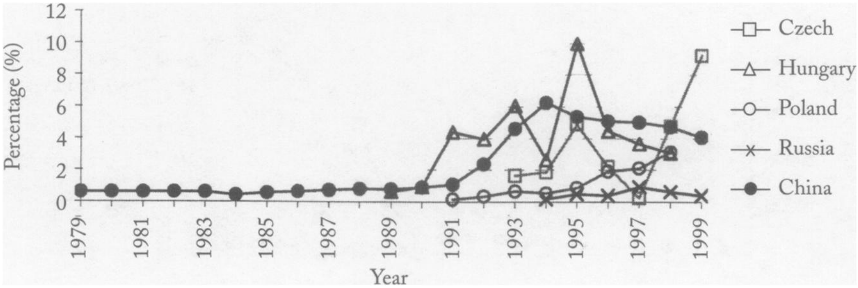

FIGURE 3
FDI AS A PERCENTAGE OF GDP IN TRANSITIONAL ECONOMIES
(1979–99)

SOURCES: Data compiled from the *European Bank for Reconstruction and Development Annual Yearbook* (various years); and the *China Statistical Yearbook* (various years).

fosters trends like irrational investment, speculation, indiscriminate wage hikes, and managerial corruption. Experimentation without fear of failure or bankruptcy makes for bad reform. The competition for FDI inflows between regions and firms that prevailed in China was absent in the Soviet Union. Funds for investment or experimentation were handed down from the state but, because of budget constraint, did not lead to marked increases in efficiency.

There is also little chance for SOE reform to lead to fragmentation and increased competition between workers. Amid tight labor markets and a history of labor hoarding, changes in enterprise behavior tends to strengthen worker resistance to reforms that threaten their privileged position.[55]

Finally, exclusive and primary reform of the state sector leads not to an ideological reformulation of the reform's significance but rather to a heightened focus on the proper role of public ownership. The departure from socialism is the center of the debate and the leadership becomes extremely sensitive to charges that it is abandoning its own historical platform. Unlike the Chinese case, which saw a reformulation of the debate away from public versus private to foreign versus Chinese, the Soviet debate in the late 1980s was inwardly focused. Every step away from socialism was one step closer to capitalism. And every step toward

[55] Xueguang Zhou, "Unorganized Interests and Collective Action in Communist China," *American Sociological Review* 58 (February 1993). Zhou argues that under state socialism "state monopoly of the public sphere fosters and reproduces large numbers of individual behaviors with similar claims, patterns, and targets." Extending this argument to all state socialist countries, it is plausible that exclusive and primary reform of the state sector would intensify the reactions of urban workers affected by such reforms, leading to greater likelihood of mobilization and resistance.

capitalism further reduced the legitimacy of the Soviet leadership and the rule of the Communist Party.

THE SUBVERSIVE PRIVATE ECONOMY

Other socialist countries had long diverged from the classical socialist system, by introducing reforms that encouraged the development of small-scale private economy, increasing ties with West, and generally trying to modify the rigidities of the socialist planned economy. The interesting case of Hungary has frequently been examined in comparative perspective with China. Hungary's market reforms began early and in their sequencing were the most radical of any reforming socialist economy. In 1980 Hungary legalized the second economy and began to create a burgeoning private sector. In 1987 the private economy was liberalized further in response to a faltering economy. Many of these private firms worked through partnerships with state firms. The close association between private firms and state firms led to the by now familiar problems of worker outflow to private firms, moonlighting, use of public assets for private gain, and corruption.

The growth and development of the private economy in Hungary led over time to the erosion of state authority. As one scholar has observed: "The role of the second economy in Hungary was clearly a subversive one. It accomplished very few of the objectives the leadership had set for it, it destroyed the leadership's control over labor, and it upset its ability to plan the macro-balance of income flows. Moreover, it deprived the party leadership of its social base."[56] The tight relationship between the private economy and the state sector led to a situation where the party's core at the enterprise level benefited and supported ongoing liberalization. Despite the fact that the private economy was doing little to improve the overall scope of reform (and in fact probably delayed it because private owners and state managers alike benefited from the partialness of the reforms), "[d]iscontinuing the reforms would have meant that the leadership would have had to turn against the party's own ranks."[57]

The Hungarian legalization of the second economy and the Chinese introduction of a foreign-invested sector created laboratories of capitalism within a socialist economy. The private economy in Hungary gradually infiltrated the state sector and led to the reduction of societal

[56] Akos Rona-Tas, "The Second Economy as a Subversive Force," in Andrew Walder, ed., *The Waning of the Communist State: Economic Origins of Political Decline in China and Hungary* (Berkeley: University of California Press, 1995), 79.

[57] Ibid., 78.

resistance to reforms. In fact, as Rona-Tas argues, the success of the private economy fostered growing support among managers and party activists for greater reform and reduced the state's ability to control the reform process. The laboratories in both countries had a subversive effect on state socialism by placing great economic pressure on the state sector. This economic pressure led to broad demands for deeper reform. It is on the political front that their effects have been quite different.

The development of a private economy and a private entrepreneurial class created an obvious alternative to socialist rule. As in the Soviet Union, the ideological debate centered around the issue of public versus private enterprise. As public enterprise faltered during the 1980s, the second economy hummed along and satisfied the domestic population in a way unheard of under socialist planning. The wisdom of state ownership was cast increasingly in doubt and the supporters of the second economy (who are now in both the second economy and the state economy) grew in numbers while resistance declined.[58] Unlike China, where the ideological debate was reformulated along foreign and nationalist lines, the Hungarian debate came to focus more sharply on the private/public dichotomy. It is the subversive success of the second economy that sealed the fate of socialism, as the rise of an alternative ruling elite (private entrepreneurs and their collaborators within the state) and the development of the "new interest politics" generated demands for political liberalization and the end to the monopoly on political power.[59]

FDI AND INTEGRATION IN THE GLOBAL ECONOMY: CHINA IN COMPARISON WITH KOREA AND TAIWAN

The second variable of FDI liberalization, as the mode of integration into the global economy, yields insights across time rather than space. Comparisons are often made between China and its East Asian neighbors, economies known for rapid economic growth through a heavy reliance on export-oriented industrialization promoted by an activist state.[60] China's early and continued opening to FDI, however, stands in stark contrast to the experiences of other East Asian states, in particu-

[58] Hungary's reforms in the early 1980s led to the gradual loss of control over enterprises as managers grew more powerful and, with the help of the growing private economy, spun off state assets into privately controlled commercial entities. Roman Frydman, Andrzej Rapaczynski, and Joel Turkewitz, "Transition to a Private Property Regime in the Czech Republic and Hungary," in Wing Thye Woo, Stephen Parker, and Jeffrey Sachs, eds., *Economies in Transition: Comparing Asia and Eastern Europe* (Cambridge: MIT Press, 1997), 53.

[59] Ibid., 51.

[60] For example, Barrett McCormick and Jonathan Unger, eds., *China after Socialism: In the Footsteps of Eastern Europe or East Asia* (New York: M. E. Sharpe, 1996).

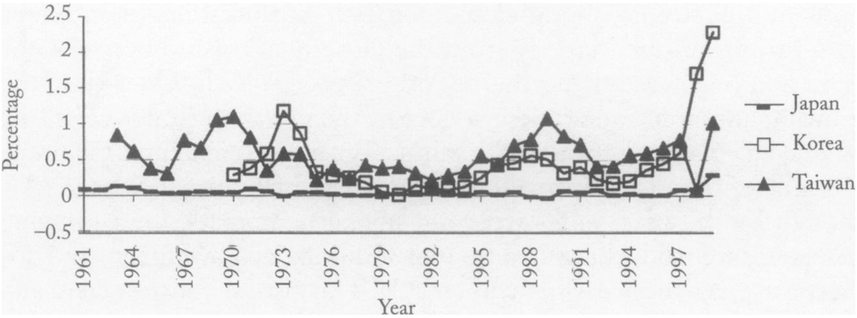

FIGURE 4
FDI AS A PERCENTAGE OF GDP IN EAST ASIAN ECONOMIES
(1961–97)

SOURCES: Data compiled from *International Financial Statistical Yearbook* (Washington, D.C.: International Monetary Fund, various years); *The Statistical Yearbook of the Republic of China* (Taipei: Executive Yuan, various years).

lar, Japan, Korea, and Taiwan. Although their industrial structures and development trajectories differ in important ways from each other, these East Asian economies were built on strong domestic business classes often closely allied with interventionist states. Foreign participation in the domestic economy was extremely small despite the export orientation of their development paths. Due to the limited space, we focus on the experiences of Korea and Taiwan. (See Figure 4.)

China's path toward greater integration into the global economy began with foreign direct investment, which remains the most significant form of foreign capital. Korea and Taiwan, however, chose quite different paths, limiting severely the amount and nature of FDI while pursuing export-led industrialization through the promotion of domestic firms.[61] The Korean and Taiwanese governments chose to keep their domestic economies closed and protected while taking an outward orientation that spurred efficiency and technological development up the production ladder over time. China's leadership opted instead for much greater integration with the global economy, with foreign capital flowing in as exports flow out.

How does this difference between China and other East Asian states advance our understanding of the democratization process? The devel-

[61] The top ten firms in Korea account for 63.5 percent of the country's GDP in 1987, showing the very large dominance of the chaebols within the Korean economy. In Taiwan, however, the ten largest firms, four of which were state owned, made up only 14.3 percent of GDP. Most of Taiwan's growth came from the small-medium size, ethnically Taiwanese private firms. Gary Gereffi, "Big Business and the State," in Gary Gereffi and Donald Wyman, eds., *Manufacturing Miracles: Paths of Industrialization in Latin America and East Asia* (Princeton: Princeton University Press, 1990), 92–96.

opment and strengthening of the domestic business classes in Korea and Taiwan resulted largely from the close relationship between the state and business during the period of high growth. Over time the growing autonomy and independence of the private business class (the large chaebols in Korea and the ethnic Taiwanese small and medium-size enterprises in Taiwan) led to pressure for political change. Although the business elites were not liberal democrats, their growing independence made the united front of authoritarian government and domestic capitalism increasingly untenable. This fissure between state and business in the late 1970s and early 1980s led to increased support and political space for the democratization movements in both countries.[62]

In the PRC, however, there is little chance for the private economy to play a central role in China's political change in the near future. Small in scale and dependent on local government support for its survival, private industry in China is still in its infancy. Rather, FDI has become in fundamental ways the substitute for domestic private industry in China, with important implications for the possibility of democratization there. While foreign investment may indirectly improve the environment for future democratization, through the promotion of the rule of law, transparency, and the freer flow of information, in the short term its presence has afforded the regime more time and more political space to pursue economic reform without political liberalization.

Domestic Business and the Developmental State

Korea and Taiwan experienced rapid economic growth in the postwar period despite near economic collapse after the end of their civil wars in the early 1950s. Growth was achieved through policies of state-led industrial development that continuously expanded export markets abroad while leaving their domestic economies quite closed. In the 1960s both countries relied on labor-intensive manufacturing and the open markets of the United States. By the 1970s, experiencing a slowdown in rapid growth and also new competition from other developing countries in low-level manufacturing, both countries sought to move up the production ladder. Following the Japanese model, they began to shape policies that would shift their industries, in Korea toward heavy industry, and in Taiwan toward the high-tech sector, petrochemicals, and plastics.[63]

[62] Yun Tae Kim, "Neoliberalism and the Decline of the Developmental State," *Journal of Contemporary Asia* 29, no. 4 (1999).

[63] Tun-Jen Cheng, "Political Regimes and Development Strategies: Korea and Taiwan," in Gereffi and Wyman (fn. 61), 142.

Although the state and business were acting in concert and business was obviously benefiting from the policies, these actions would change the balance of power between the developmental state and the domestic private business class, strengthening the business class against the state in both cases. Of course there are important and very large differences between the industrial structures of Taiwan and Korea. Taiwan's economy is largely populated by small and medium-size enterprises that are privately owned, often by ethnic Taiwanese. The Korean business elite was embodied in the chaebol, the large diversified industrial groups that were modeled after the Japanese system of keiretsu:

> The link between the government and business groups in South Korea is quite direct. These vertical pressures cannot be easily countered, because intermediate or independent local institutions are weak, repressed, or absent. A homogeneous and very nationalistic big business class thus is available in South Korea to carry out the government's objectives in terms of domestic and overseas investments and external trade.[64]

The drive for heavy industrialization in Korea in the 1970s further increased the importance of the Korean chaebols. In the early 1980s, during a time of economic crisis and political instability, the Chun regime encouraged policies of financial and economic liberalization that were intended to curb the importance of big business and end the practice of guaranteed policy loans to Korea's biggest firms. Nevertheless, the general trend toward increasing the power and influence of the chaebols at the expense of the Korean state did not end and, in fact, intensified. The chaebols' share of the economy continued to grow, with the contribution of the top ten chaebols to total manufacturing sales reaching 67 percent in 1984.[65] Moreover, the opening of the Korean economy in the early 1980s granted big business alternative paths for capital financing—on international capital markets, leading to less reliance on the state for credit.[66]

Taiwan's move to strengthen and diversify the economy in the 1970s and 1980s targeted many small to medium-size Taiwanese firms that were owned by ethnic Taiwanese. The growth of Taiwan's private industry over time intensified the ethnic cleavage between the mainlander-dominated political elite and the ethnically Taiwanese economic elite. In combination with changes with the leadership (the liberalizing

[64] Gereffi (fn. 61), 98.

[65] Yin-Wah Chu, "Labor and Democratization in South Korea and Taiwan," *Journal of Contemporary Asia* 28. no. 2 (1998).

[66] Sejin Pak, "Two Forces of Democratization in Korea," *Journal of Contemporary Asia* 28, no. 1 (1998).

rule of Chiang Ching-kuo and the increasing Taiwanization of the ruling party, the KMT), Taiwan's private business class grew increasingly powerful.[67]

Neither the Korean nor the Taiwanese business class became frontrunners in the push for democratization. However, the changing balance of power between the state and business did have ramifications for politics and did increase pressure from other social forces for democratization. Karl Fields writes of Korea:

> In Korea, the symbiotic collaboration between powerful bureaucrats and giant chaebol achieved the mutually beneficial objective of rapid, Fordist, economic growth. But the social and political consequences of this developmental strategy and the increasing strength and financial autonomy of the big business sector have significantly altered the nature of state–big business relations and the mutuality of benefits.[68]

In China, however, the development of private industry has lagged behind the liberalization of FDI. The development of private industry has been subjected to informal bureaucratic discrimination, barriers to capital and financing, and barriers to expansion both across different regions and into the global economy. Even with China's upcoming accession to WTO, the relationship between the ruling party-state and the private business elite remains contested. CCP support for domestic private enterprise, in the form of allowing entrepreneurs to join the CCP, has led to a divisive debate between conservatives and reformers on the proper nature of the CCP and its relationship to capitalists.[69]

China's developmental trajectory, while modeled in some ways after its East Asian neighbors, diverges in its widespread use of FDI rather than of a strong, domestic private enterprise. This may change in the future as China's leadership grows increasingly concerned with the ability of the remaining state sector firms to compete internationally and the growing dominance of foreign firms in China's domestic marketplace. At this point, however, this difference in development paths is likely to affect the direction of political change in China. It is unlikely

[67] Tun-jen Cheng, "Democratizing the Quasi-Leninist Regime in Taiwan," *World Politics* 41 (July 1989). Cheng writes on the social character of the political opposition in Taiwan: "This new political opposition is essentially a middle-class movement, the consequence of rapid economic development.... Many of its members are social-science trained intellectuals with professional skills and legal expertise. *Moreover, they are socially connected to small and medium businesses*" (p. 474, emphasis added).

[68] Fields, "Strong States and Business Organization in Korea and Taiwan," in Sylvia Maxfield and Ben Schneider, eds., *Business and the State in Developing Countries* (Ithaca, N. Y.: Cornell University Press, 1997), 146.

[69] Willy Wo-Lap Lam, "China's Struggle for 'Democracy'" (www.cnn.com/world, accessed August 7, 2001).

that domestic private enterprise in China will play a significant role in politics in the near future. The private business elite, only recently given constitutional protection in 1999 and now embroiled in a debate over the nature of its proper relationship to the CCP, will lie low, as the junior partner in the relationship with the party.

Conclusion: Delayed Democratization

The sequencing of reforms in China, in particular the early and dynamic liberalization of FDI vis-à-vis other reforms, has led to a delay in political change. The foreign-invested sector of the economy acted like a laboratory for the difficult and sensitive reforms of a marketizing socialist economy. Over time, however, the competitive pressures inherent in the liberalization of FDI across regions and firms has led to increased convergence with capitalism and reduced societal resistance to reforms. Finally, the presence of foreign competition and the looming specter of WTO has reformulated the transition debate over public and private industry into a debate over foreign versus Chinese competition. The Chinese Communist Party has survived intact despite a declining commitment to its core principles (state ownership, elevated role of the working class, notions of economic justice). These core principles have been rejected in favor of principles of nationalism, Chinese industry, and the ability of China to compete in the international economy.

In light of problems associated with transition in some Eastern European countries and Russia, there may be benefits to delayed political change in China. Integration into the global economy, the increased use of legal institutions to mediate conflict, and the influence of a small but growing middle class may together slowly build up a more stable societal foundation for democratization, something that was absent at the time of the 1989 student-led Tiananmen Pro-Democracy Movement. This is not an argument to say that the "Chinese are not ready for democracy"—many countries can go through democratization and be unprepared. In fact, historically this has probably been the case for most countries. This argument is merely to point out that there may be benefits to continued authoritarianism, in particular, to permit the development of broader social foundations for democratization, including a growing middle class and the institutions to mediate societal conflict.[70] For example,

[70] I am not weighing the relative benefits and disadvantages of continued authoritarianism. In fact, I am overlooking the costs of continued authoritarianism (political repression, human rights violations, arbitrary punishment, torture, and lack of freedom of speech and religion, and so on). The focus here is on what may in fact be happening below the surface of continued political authoritarianism.

legal institutions are developing to mediate mostly, but not only, economic conflicts. Many different social groups are increasingly resorting to the law to protect their rights or protest perceived injustice. The state itself promotes these institutions as a way of both staving off demands for further political liberalization and forcing societal demands into channels under its control. Social groups do not enjoy complete autonomy and these legal institutions still do not work well, but as in an iterated game, people become more adept at using them to their advantage. In particular, as incomes grow, citizens have expanded access to lawyers and there is growing consciousness about civil and political rights.

China's integration into the world economy has surely contributed to these trends, as its legal system has incorporated bodies of law necessary for increased contact with the outside world.[71] China also regularly uses international codes of conduct and covenants as models for its own domestic legal development.[72] Economic integration has helped this progress and given greater justification for convergence. A very important qualification of the general argument presented here is the conclusion that political change has been *delayed*, not stopped. The influence of FDI liberalization and integration with the global economy has differential effects over time. This article has made the point that "reform with openness" can produce economic change without political liberalization in the short term. Reform with openness reduces societal resistance to reform, buying the existing regime time to implement politically difficult reforms and to reformulate the ideological foundation of their legitimacy to rule. In comparison with East European and Soviet reforms, the Chinese reforms avoided a frontal attack on the existing institutions of state socialism. Instead, these institutions eroded slowly in a losing competition with the market. In comparison with Korea and Taiwan, China's much wider opening to FDI achieved rapid, export-led growth without the concomitant creation of a strong private business class. This reform path may come to hinder further economic progress, particularly as foreign competition is expected to increase dramatically with China's accession to the WTO. Up to this point, however, China's early embrace of foreign capital should be credited with saving the Chinese Communist Party.

[71] Many scholars of China's legal development have noted the reliance on foreign laws for the creation of China's domestic laws. Ann Seidman, Robert Seidman, and Janice Payne, *Legislative Drafting for Market Reform: Some Lessons from China* (New York: St. Martin's Press, 1997).

[72] Ann Kent, "China, International Organizations and Regimes: The ILO as a Case Study in Organizational Learning," *Pacific Affairs* 70 (Winter 1997–98); Margaret Pearson, "The Major Multilateral Economic Institutions Engage China," in Alastair Iain Johnston and Robert S. Ross, eds., *Engaging China: The Management of an Emerging Power* (London and New York: Routledge, 1999).