Correctly Handled Contradictions: A Regional Analysis of Foreign Direct Investment and Democratization in China

Sarah Chin*

Abstract: *As an increasingly large link between China and the rest of the world, as well as a key component of economic policy, foreign direct investment (FDI) is an investment made by a party in one country in business interests in another country. It represents the influx of both capitalism and globalism in China. This paper investigates the link between FDI and regime stability by examining how FDI has affected formal and informal institutional change, especially at the local level. I come to the conclusion that FDI has indeed created institutional change in multiple arenas but that this change has reinforced the CCP's stability.*

Introduction

What is the relationship between democracy and foreign direct investment (FDI)? Given that scholars often link economic liberalization, globalization, and democracy, it may seem that FDI and democracy should go hand in hand. However, it is clear that this is not the case in modern China. Though China receives the most FDI in the world, it remains a one-party authoritarian state.[1]

In December 1978, the Third Plenum of the Eleventh Central Committee under Deng Xiaoping instituted *gaige kaifang*, or "reform and opening up", marking a turning point in Chinese economic development. The 1978 reforms had two key components: decentralizing the economy and opening China up to foreign direct investment (FDI).[2] With newfound agency and growing resources, local governments in areas with foreign investment were able to promote local economic growth with greater intensity than ever before.

Economic decentralization gave more decision-making power to local governments, reemphasizing the importance of local actors in both political and economic matters.[3] In 1980, the Chinese Communist Party (CCP) took the first steps towards integrating China into the global economy with the establishment of four Special Economic Zones (SEZs) in southern China: Shantou, Shenzhen, Zhuhai, and Xiamen. These SEZs were designed to attract FDI and were under a legal system that allowed for more capitalistic labor practices. In the same way that Yan'an and the Jiangxi Soviet experimented with collectivized agriculture before Land Reform officially began, the SEZs acted as "experiments" for the

---

* Sarah Chin is an undergraduate student studying political science at Tufts University. Her research interests include women's rights, labor, democratization, and political economy in East Asia.

[1] *Freedom in the World 2016: China*, Freedom House, 2016, accessed November 22, 2016, www.freedomhouse.org/report/freedom- world/2016/china.
[2] Zweig, David. "China's Political Economy." *Politics in China: An Introduction*, edited by William A. Joseph, 2nd ed., Oxford UP, 2014, 256.
[3] Ibid., 257.

CCP. The goal was to determine whether FDI was sustainable and under what conditions it would flourish.[4] The observations gathered from the SEZs helped the CCP develop and implement the "Coastal Development Strategy," opening fourteen coastal cities to foreign investment only a few years later. Over six thousand foreign-invested enterprises (FIEs) were established, marking the beginning of China's export-oriented growth strategy, which continues today.[5] Nationally, China's massive economic growth has often been attributed to this influx of FDI.[6]

It is also important to note that regional development in China has been incredibly varied. Outside of SEZs and coastal cities, FDI was limited. This resulted in large disparities in regional wealth and economic development that persist today. On a macro level, this is reflected in regional differences in the number and geographic concentration of businesses; in 2003, nearly 70 percent of registered private enterprises were located on China's eastern seaboard.[7] In the same year, Guangdong province and Jiangsu province, the two biggest destinations for FDI, had over 70,000 FIEs. China's three western-most provinces, Xinjiang, Tibet, and Qinghai, combined had less than 600 FIEs. In 2014, the number of FIEs in Guangdong and Jiangsu's grew to over 150,000. On the other hand, Xinjiang, Tibet, and Qinghai still had less than 2,000 FIE's, showing that region does matter when it comes to FDI.[8]

Since the 1980s, FDI has only grown in importance to the Chinese economy. In 1982 (the first year this type of data was collected), China's net inflow of FDI was 430 million USD. By 2015, this number grew to 250 billion USD.[9] China also topped the United Nations Conference on Trade and Development's 2015-2017 list of most attractive investment destinations for multinational companies.[10] Clearly, FDI is a major link between China and the rest of the world. It is a particularly interesting area of study because of the transformative role FDI has had in China. Not only does FDI represent economic liberalization, but it also represents increasing globalization. An investigation into how FDI affects regime stability is necessary to understand the CCP's current stability, as well as its future trajectory.

It must be noted that the Chinese model of export-oriented growth is different from that of the East Asian Newly Industrialized Countries (NIC) (Hong Kong, Singapore, Taiwan, and South Korea). The East Asian NICs relied on export-driven growth with little foreign participation in their economies while FDI was much more prevalent in China.[11]

---

[4]Richard Pomfret, *Investing in China: Ten Years of the Open Door Policy*, Iowa State UP 1991, 3.

[5] Zweig, "China's Political Economy," 258.

[6]Dipak Dasgupta, *China Engaged: Integration with the Global Economy*. World Bank, September 1997, China 2020, *World Bank Group eLibrary*, accessed December 7, 2016, www.elibrary.worldbank.org/doi/abs/10.1596/0-8213-4079-4.

[7] Kellee S Tsai, *Capitalism without Democracy*, Cornell UP, 2007, 150.

[8]National Bureau of Statistics of China, "Number of Foreign Funded Enterprises (By Province)," *National Data*, 2014, accessed December 8, 2016.www.data.stats.gov.cn/english/mapdata.htm?cn=E0103.

[9]The World Bank, "Foreign Direct Investment, Net Inflows (BoP, current US$)," *World Bank Open Data*, World Bank Group, 2016, accessed 23 March, 2017, http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?end=2015&locations=CN&start=1982&view=chart.

[10]*World Investment Report 2015: Reforming International Investment Governance*, Geneva, United Nations, *United Nations Conference on Trade and Development*, accessed November 10, 2016.

[11] Mary Elizabeth Gallagher, *Contagious Capitalism: Globalization and the Politics of Labor in China*, Princeton UP, 2005, 24.

China is also not comparable to former Soviet states because the former Soviet states had more internal economic reform before opening up to the global economy.[12] China presents a unique case and cannot be understood through the developmental models of other seemingly similar countries.

To further understand the relationship between FDI and regime stability, I will investigate two questions: first, how does FDI change formal and informal institutions in China, especially entrepreneur and government behavior? Second, how does this institutional change or lack thereof affect regime stability?

This paper is separated into three parts: first, an explanation of the hypothesis and description of the methodology; second, a review of the relevant literature; third, an explanation and test of the hypothesis; and fourth, a critical analysis of what the findings mean for the CCP's future stability. I argue that that FDI causes domestic entrepreneurs to modify their own business practices. In order to help domestic firms better compete with FIEs, governments (both local and national) responded by changing formal institutions to reflect entrepreneurs' actual practices. It is this institutional change that reinforced the Chinese Communist Party's (CCP) stability. If the first component of this hypothesis is true, then we should also observe that entrepreneurs in regions with large amounts of FDI generally did not and do not act assertively towards the government, thus enhancing the region's political stability.

Methodology and Key Concepts

To evaluate my hypothesis, I will use mostly qualitative data, much of it from Kellee Tsai's study of entrepreneurial behavior in *Capitalism Without Democracy*, to evaluate a set of hypothesis-confirming criteria. In this paper, institutions are understood as the formal and informal norms regulating society and human behavior. I will focus specifically on the role of formal institutions because changes in formal institutions can indicate societal shifts, especially in the goals and priorities of a regime.[13] Scrutinizing the processes of transition and change is helpful in understanding how society-at-large currently functions as well as what it may look like in the future. This paper centers its analysis on entrepreneurs, the key actors whose arrival on the post-reform scene marked massive societal changes in China. Here, an entrepreneur is defined as an owner of a private business, both those involved in FIEs and those who are not.

This paper will also make use of several different models of Chinese political economy commonly used in the relevant literature. These models are demarcated by different developmental legacies, which in turn, are influenced by differences in natural resources, geography, and how local governments have implemented (or not implemented) national policies in the face of economic decentralization.[14]

---

[12] Ibid., 23.

[13] Hilary K. Josephs, "Labor Law in a 'Socialist Market Economy': The Case of China." *Columbia Journal of Transnational Law*, vol. 33, 1995, pp. 561-79, *Hein Online*, accessed December 2, 2016, 562.

[14] Tsai, *Capitalism without Democracy*, 151; Zhang, Xiaobo. "Fiscal Decentralization and Political Centralization in China: Implications for Growth and Inequality." *Journal of Comparative Economics*, vol. 34, no. 4, Dec. 2006, pp. 713-26. *Science Direct*, doi:10.1016/j.jce.2006.08.006, accessed November 22, 2016, 427.

The two most common models of Chinese political economy referenced in the literature are the Wenzhou and Sunan models. In the Wenzhou model (named after the municipality in Zhejiang province), economic development was led by private sector entrepreneurs beginning in the late 1970s and was supported by the state. Private businesses, most often producing low-end consumer goods, were prevalent and state ownership was not common.[15] Reliance on informal sources of finance is also a key factor in the Wenzhou model. Following the implementation of the Wenzhou model, extremely poor areas experienced rapid economic growth in the 1980s.[16] In contrast, the Sunan model is marked by government-led economic growth. Under the Sunan model, public ownership dominated the early years of reform while private ownership was stifled by government restrictions. It was not until the 1990s that areas began to experience a gradual transition to private ownership.[17][18]

In *Capitalism Without Democracy*, Kellee Tsai introduces two other models, the state-dominated model and the limited-development model. The state-dominated model, exemplified by the major industrial cities of the Mao era (Shanghai, Tianjin, Wuhan, etc.), is characterized by the legacy of collective ownership. Up until the 1990s, restrictions on private businesses remained heavily enforced and as a result, business made up a very small portion of the local economy.[19] Areas following the limited-development model are marked by their extreme underdevelopment during both the Mao and reform eras. This includes most of western China, including Xinjiang, Tibet, and Sichuan. The government does not restrict private enterprises in these areas but they still remain scarce.[20] This paper will make some mention of the Wenzhou and Sunan models but will not focus on them. These descriptions are provided here to demonstrate the complex diversity of Chinese political economy.

This paper will focus on the South China model, also known as the Zhujiang or Pearl River Delta model. It combines elements of the Wenzhou and Sunan models but with earlier and greater importance of foreign capital and trade.[21] In the Sunan model, rural industries grew out of collectively-owned (but usually local government-controlled) Town and Village Enterprises (TVEs) in the late 1970s, before the central government officially sanctioned TVE's as part of their development strategy. As in the Wenzhou model, small private entrepreneurs were able to pool their capital to establish light industrial factories; however, the powerful presence of FDI differentiates the South China model from any other model. A common saying in Xiamen, a SEZ in Fujian, sums up FDI's role in the local economy: "3, 4, 5, 6, 7, 8". This refers to the fact that FDI comprised 30 percent of Xiamen's fixed investment, 40 percent of its tax revenues, 50 percent of its labor force, 60-70 percent of its exports, and 80 percent of its industrial output.[22]

The South China model is considered a regional model because its dynamics were initially concentrated in south China. According to the China Urban Statistical Yearbook, in 1993, 86.8 percent of urban FDI was located on the eastern seaboard. Guangdong province

---

[15] Jianjun Zhang, "Marketization, Class Structure, and Democracy in China: Contrasting Regional Experiences," *Democratization*, vol. 14, no. 3, June 2007, pp. 425-45. *Taylor and Francis Online*, DOI:10.1080/13510340701303279, accessed December 5, 2016, 426.
[16] Tsai, *Capitalism without Democracy*, 154.
[17] J. Zhang, "Marketization, Class Structure, and Democracy in China", 426.
[18] Tsai, *Capitalism without Democracy*, 158.
[19] Ibid., 161-163.
[20] Ibid.,165-166.
[21] Ibid., 159.
[22] Ibid., 182.

alone accounted for 32 percent of FDI in the country. Much of South China's attractiveness came from its physical proximity as well as linguistic and cultural similarities to lenders. That same year, half of China's FDI came from Hong Kong and Macau, and another eight percent came from Taiwan.[23] FDI-rich regions experienced rapid development. Other cited benefits of FDI include the diffusion of new technology and managerial practices and the creation of foreign- exchange reserves through urbanization and export-led growth.[24]

Literature Review

Soon after Deng's economic reforms, most of the international business community as well as many academics began to predict that FDI (and private sector development more generally) would democratize China.[25] Many argued that the influx of foreign capital and business through FDI would destabilize the authoritarian regime and accelerate the democratization process by both creating western links and a politically active middle class.[26] In 2002, the American Society for Competitiveness stated that "global entrepreneurs must continue to invest in corporate infrastructure to help insure stability, success and the inevitable attainment of full democracy there."[27] The logic behind this can be described by a combination of modernization theory and Levitsky and Way's theory of western linkage.

Much of the literature on Chinese FDI employs modernization theory or at least relies on its main premise that democracy is the natural result of capitalism. There is little evidence outside Western Europe that supports modernization theory; in fact, Przeworski and Limongi find that the probability of democratization decreases as new states develop under authoritarian regimes.[28] Nonetheless, the basic logic of modernization theory underlies many of the beliefs about China's democratization prospects post-FDI. According to this logic, capitalism creates a new private sector middle class who will advocate for an increased role in politics.[29] In the case of FDI, multinational corporations (MNCs) and foreign-invested enterprises (FIEs) promote democratization by creating jobs that give rise to a middle class.[30] The middle class would see a democracy with a strong rule of law and limits on the government's power as beneficial to their business interests and would thus advocate for democratization. Applying this logic specifically to China, Shaohua Hu wrote in 2000 that "[China's] growing economy will bring higher living standards, a higher level of education, and a more complicated socioeconomic structure in its wake. Under these circumstances, more people will demand more freedom and democracy."[31]

Levitsky and Way's theory of linkage and leverage can also explain how FDI might be a democratizing force. They primarily apply this theory to "competitive authoritarian" regimes, or regimes in which formal, nominally democratic institutions exist but are widely

[23]Ibid., 161.
[24]Dasgupta, *China Engaged: Integration with the Global Economy*.
[25] Tsai, *Capitalism without Democracy*, 2.
[26]William H. Meyer, *Human Rights and International Political Economy in Third World Nations: Multinational Corporations, Foreign Aid, and Repression*. Praeger Publishers, 1998, 91.
[27] Tsai, *Capitalism without Democracy*, 2.
[28]Adam Przeworski, and Fernando Limongi, "Modernization: Theories and Facts," *World Politics*, vol. 49, no. 2, Jan. 1997, pp. 155-83, accessed March 24, 2017, 176, *JSTOR* www.jstor.org.ezproxy.library.tufts.edu/stable/25053996.
[29]Meyer, *Human Rights and International Political Economy in Third World Nations*, 90.
[30]Seymour Martin Lipset, "Economic Development and Democracy," *Political Man*, Doubleday, 1960, pp. 31-51, *Trunk*. Accessed November 11, 2016, 274.
[31]Shaohua Hu, *Explaining Chinese Democratization*, Praeger Publishers, 2000, 155.

viewed as favorable to the incumbents and hostile to the opposition. China is not one of these regimes and is indeed classified as a "closed regime where no viable channels exist for opposition to contest legally for executive power."[32] However, Levitsky and Way's basic logic can yield some insights into why some believe China might democratize.

Broadly defined, linkage is a regime's connections to "the West," defined here as Western states and Western-dominated multilateral institutions, like the United Nations (UN), and the European Union (EU). Linkage is most effective when working in tandem with leverage, which is defined as an authoritarian regime's "vulnerability to external democratizing pressure."[33] Leverage can take the force of diplomatic pressure, military threats, and economic sanctions. Levitsky and Way note that China has low leverage because of its considerable size, military strength, and economic power.[34] While leverage comes specifically from other states, linkage can come from either states or private actors.

Levitsky and Way argue that the more links a country has to the West, the more likely it is to democratize.[35] They posit five distinct categories of linkage: economic, geopolitical, social, communication, and transnational civil society.[36] In the case of FDI and China, economic, social, and communication linkages are the most salient. FDI establishes direct monetary connections between the West and China, and drives interstate travel and communication. Linkage raises the cost of authoritarianism in several ways. First, by heightening Western awareness of government abuse; second, by increasing the probability of international response to this abuse; third, by creating domestic constituencies with a stake in democratization and democratic norms; and fourth, by strengthening democratic forces, especially opposition parties.[37]

In states with high linkage and low leverage, Levitsky and Way predict that external democratizing pressure will be "diffuse and indirect but nevertheless considerable."[38] Even though there is an absence of direct external pressure, intense scrutiny of government actions from transnational civil society organizations, diasporic groups, international media, etc. will raise the cost of authoritarianism significantly. Thus, "linkage blurs international and domestic politics, transforming international norms into domestic demands."[39] Levitsky and Way cite Mexico under the Institutional Revolutionary Party and Taiwan under the Kuomintang as prime examples of this blurring.[40] In both of these cases, high linkage raised the cost of authoritarianism by increasing the flow of information across borders and strengthening the indigenous pro-democratization oppositions. China's similarly low leverage and high linkage, created by FDI, would seemingly put China on a similar trajectory to democratization.

The aggregate of modernization theory and Levitsky and Way's linkage and leverage theory sums up the dominant beliefs concerning China's prospects for democratization immediately following economic reforms. That is, the introduction of capitalism and global

[32]Steven Levitsky, and Lucan A. Way, *Competitive Authoritarianism*, Cambridge UP, 2010, 7.
[33]Steven Levitsky, and Lucan A. Way, "International Linkage and Democratization," *Journal of Democracy*, vol. 16, no. 3, July 2005, pp. 20-34, *Project MUSE*, accessed November 11, 2016, 21. www.muse.jhu.edu.ezproxy.library.tufts.edu/article/185273/pdf.
[34] Ibid.
[35] Ibid., 24.
[36] Ibid., 22-23.
[37] Ibid., 23.
[38] Levitsky and Way, *Competitive Authoritarianism*, 53.
[39]Ibid., 48.
[40]Ibid., 53.

business would strengthen democratizing forces within China. The diffuse flow of information from the west would heighten "citizen awareness of their country's international standing – and its consequences."[41] This new awareness, along with the wealth brought by FDI, would fuel the rise of an indigenous middle class with a stake in creating Western-style democratic institutions.

However, there are many faults with this type of thinking. First, it is overly linear and deterministic in its assumption that economic development and/or Western linkages always lead to democracy. Second, it assumes that an entrepreneurial middle class will want democracy, although there is no proof that this has been the case in China. Third, it underemphasizes the role of the state and does not address why a state would allow economic liberalization if it would undermine their rule. These weaknesses will become apparent as we explore the case of China and FDI.

The fact remains that China has not democratized, despite economic growth and Western linkages. Most of these writers' false predictions about FDI's democratizing effect were published immediately after China's FDI boom in the 1990s, before the real effects of FDI were detectable. The vast majority of domestic entrepreneurs has neither created a cohesive class identity nor has made any significant attempts to create democratic institutions.[42, 43] Entrepreneurs come from a wide array of regional and socioeconomic backgrounds, which influence their equally diverse array of opinions about the government. As a result, the diversity among Chinese entrepreneurs prevents the formation of a cohesive class identity.[44] As a whole, entrepreneurs are generally not assertive in the political sphere, rarely advocating for democratization. Despite increasing levels of Western linkage, entrepreneurs show no sign of wanting Western-style democracy, as they are satisfied with the current regime.[45] This is not to say that class is not important; indeed, we will return to it at the end of the paper. However, class has not functioned as the catalyst for democratization that many predicted it would.

Mary Gallagher's 2005 book *Contagious Capitalism* is one of the only major works on FDI and democratization since the 1990s. She argues that FDI does not provide any real democratizing force; rather, it enhances authoritarianism. Gallagher argues that this can be attributed to the sequencing of economic reforms, with FDI liberalization coming first, private sector development coming second, and state-owned enterprise (SOE) reform coming third.[46] Because FDI liberalization came first, foreign capital made up a large proportion of the overall domestic economy in the past and thus became a political priority for the CCP. These provinces became very wealthy, which helped the CCP gain local support for more controversial economic reforms.[47]

According to Gallagher, it is especially important that FDI liberalization preceded private sector development. If private sector development occurred first, it would create a domestic middle class who could pressure for political change.[48] In this way, Gallagher does not challenge modernization theory's "no bourgeoisie, no democracy" argument head on;

[41] Ibid., 49.
[42] Tsai, *Capitalism without Democracy*, 3.
[43] Jie Chen, *A Middle Class without Democracy: Economic Growth and the Prospects for Democratization in China*. Oxford UP, 2013, 5.
[44] Tsai, *Capitalism without Democracy*, 95.
[45] Ibid., 45.
[46] Gallagher, *Contagious Capitalism*, 9.
[47] Ibid., 32.
[48] Ibid., 10.

rather, she argues "no bourgeoisie at the right time, no democracy." She argues that if the middle class developed while the CCP was still in the early stages of economic reform and the regime was less stable, they would have been a democratizing force.[49] Unlike the rest of her argument, this logic seems simplistic and overly linear.

Another problem with Gallagher's argument is that it portrays the central government as a homogenous entity, rather than seeing it as multifaceted and diffuse. She does touch on the "piecemeal fashion" of economic reform, noting that the first regions that opened up to FDI enjoyed all the benefits and opportunities of the global economy, while regions who took longer to open up lagged behind in development.[50] However, her argument does not explain how local governments can implement formal institutional changes. This is one of the main sites of analysis in this paper.

Analysis

If the hypothesis is correct, we should find that: FDI caused entrepreneurs to modify their own business practices; local and national governments wanted to help domestic firms better compete with FIEs; local and national governments were responsive to entrepreneurs' modifications by creating institutional change; and institutional change enhanced regime stability. I will evaluate each of these criteria in turn.

Modifications in Business Practices

Did FDI cause entrepreneurs to modify their own business practices? Yes, FIEs utilized more Western managerial and labor practices, in line with their investors' wants. FIEs were largely concentrated in Special Economic Zones (SEZ), which were governed under an entirely different legal system than the rest of China that allowed (and encouraged) capitalist business practices. For example, FIEs used strongly enforced labor contracts, which outside of SEZs, were mere formalities. Enforcement of labor contracts outside of SEZs was almost non-existent. Most firms relied on at-will employment, resulting in high employment insecurity.[51]An example of this employment insecurity is the right to lay off unnecessary staff.[52] In addition to this, SEZs also gave special tax breaks to FIEs.[53]

Non-FIE firms also changed their practices in response to FDI. Tsai notes that the dominance of FDI had "mixed implications" for entrepreneurs in areas following the South China model; the clearly preferential treatment accorded to FIEs placed domestic entrepreneurs at a disadvantage. While local governments were eager to help certain entrepreneurs attract FDI and engage in export industries, private businesses that lacked overseas connections and FDI were at a disadvantage.[54] Because of this, private businesses wanted to adopt the Western managerial and labor practices of FIEs in order to better compete.[55]

[49]Ibid., 9.
[50]Ibid., 12.
[51]Ibid., 78.
[52] Zweig, "China's Political Economy", 257.
[53] Tsai, *Capitalism without Democracy*, 159.
[54] Tsai, *Capitalism without Democracy*, 182.
[55] Gallagher, *Contagious Capitalism*, 6.

As a result, domestic entrepreneurs in SEZs began to disguise their businesses as FIEs. The most common method was "round tripping," the process of sending money from China abroad in order to disguise it as FDI and later import it. Often, money was sent to an offshore entity in a tax haven, like Hong Kong. In 2004, the Asian Development Bank estimated that round tripping accounted for 40 percent of total FDI.[56] Falsely registering businesses as FIEs was also very common.[57] By round tripping and registering as FIEs, domestic entrepreneurs were able to access all of the benefits accorded to FIEs, enabling them to better compete with FIEs and giving them an advantage over domestic firms without foreign investment.

Governmental Support Towards Domestic Firms

Did local and national governments want to help domestic firms compete with FIEs? Yes. After the fall of communism in Eastern Europe, it was clear that the CCP's political survival was tied to its economic performance.[58] Helping domestic firms grow and compete with FIEs would increase economic prosperity. This was especially salient on the local level where cadres were often rewarded by the central government for positive economic performance.[59] Coupled with the central government's cuts in financial support to local governments, local economic growth was needed.[60]

Helping domestic firms compete with FIEs would also defuse rising tensions and increase social stability. As mentioned previously, Gallagher points out that the CCP had a stake in reframing the economic conflict as one of "Chinese firms versus foreign firms", rather than "public versus private firms."[61] The transition to a "socialist market economy" was ideologically controversial; only ten years after the class-focused Cultural Revolution, FIEs were thriving under the CCP's preferential policies while SOEs and private businesses were floundering. In order to defuse rising societal tensions, the CCP took deliberate steps to emphasize nationalism and unity. Placing ownership in a competitive, international context helped the CCP reduce the importance of public ownership and increase the importance of nationalistic consumerism.

In this way, economics became less about morality and more about pragmatism.[62] This was a central point of Deng's 1992 "Southern Journey" to the south China coast and is evident in the CCP's ninth Five-Year Plan, authored in 1996. In the plan, the CCP framed the disparate development of different regions as inherent to the process of modernization; "fundamentally speaking, to allow regions capable of development to progress faster is favorable for enhancing the economic strength of the country and for helping underdeveloped regions in developing their economies."[63] In 1997, "Deng Xiaoping Theory" was incorporated into the official 15th Party Congress platform. It stated that privatization was

[56]Geng Xiao, *Round Tripping Foreign Direct Investment and the People's Republic of China*, Asian Development Bank Institute, July 2004, ADB Institute Research Paper Series, 58, accessed December 1, 2016, 23. www.adb.org/sites/default/files/publication/157240/adbi-rp58.pdf.
[57] Tsai, *Capitalism without Democracy*, 185.
[58] Zweig, "China's Political Economy, 258.
[59] Gallagher, *Contagious Capitalism*, 32.
[60]Ibid., 12.
[61]Ibid., 6.
[62]Ibid., 19.
[63]Li Peng, translator, *Report on the Outline of the Ninth Five-Year Plan (1996-2000) for National Economic and Social Development and the Long-range Objectives to the Year 2010 (Excerpts)*, Delivered at the Fourth Session of the Eighth National People's Congress, March 5, 1996, accessed December 8, 2016, www.china.org.cn/95e/95-english1/2.htm.

necessary so that domestic industries could be strong enough to compete in the international economic arena.[64] In 2004, the CCP changed its constitution to guarantee property rights and emphasize the importance of the private sector in Chinese society. Tsai notes that "private entrepreneurs themselves were remarkably absent from the actual process, but the cumulative effect of... the changes that they engendered in formal institutions governing the private sector enabled reformers to justify further protection on their behalf. The causal mechanisms were indirect, informal, incremental, and fundamentally political."[65]

Institutional Changes in Government

Did local and national governments respond to entrepreneurs' modifications by creating institutional change? Yes. Both FIE entrepreneurs and local and national governments had an incentive to appease domestic entrepreneurs, namely because they wanted to maintain stability. Stability is important for obvious reasons to local and national government but FIE entrepreneurs also depended upon political and social stability. Without it, FIE entrepreneurs would not be able to conduct business, much less international business. For example, most business owners did not support the 1989 Tiananmen Square protests because they "disrupted the business environment."[66] On the other hand, local and national governments were eager to help FIEs, as they boosted the economy and increased wealth in the region and the country as a whole.[67] Local governments had an additional incentive to partner with entrepreneurs, as the central government and the general public looked favorably upon economically prosperous regions and their cadres. In order to achieve their overlapping goals, both groups must work together to maintain the status quo. An important part of this is appeasing domestic entrepreneurs.[68]

Economic decentralization, which was a key element of Deng's reforms, granted greater decision-making power to local governments.[69] In overseeing day-to-day business, local government acted as "part administrator and part chamber of commerce" with little supervision from the central government.[70] Local governments granted FIEs (and the entrepreneurs and foreign investors associated with them) more managerial control and autonomy over labor practices before the central government did.[71] Officials in local foreign investment bureaus were "well aware" of which FIEs were fake but tolerated all FIE's nonetheless, likely because of the wealth and prestige that increased economic growth brought.[72] David Zweig notes that entrepreneurs and local governments "did not collectively press Beijing to liberalize its foreign trade and foreign investment rules. Instead, as each county or township pursued its own global linkages, this unorganized collective action undermined the central state's regulatory regime".[73] Local government's tolerance of fake FIEs undermined the central government's capacity to collect taxes and create credit policy.

[64] Gallagher, *Contagious Capitalism*, 18-19.
[65] Tsai, *Capitalism without Democracy*, 70.
[66] Ibid., 3.
[67] Ibid., 182.
[68] J. Zhang, "Marketization, Class Structure, and Democracy in China", 436.
[69] Gallagher, *Contagious Capitalism*, 12.
[70] Ibid., 86.
[71] Tsai, *Capitalism without Democracy*, 196.
[72] Ibid., 184-185.
[73] David Zweig, *Internationalizing China: Domestic Interests and Global Linkages*. Cornell UP, 2002, 159-160.

It is difficult to determine to what extent the central government was aware of fake FIEs but they were surely aware that it was a problem.[74]

In response, the national government began to extend the special privileges previously reserved for FIEs to domestic businesses, both in and outside of SEZs. National labor laws slowly adopted more characteristics of FIE labor laws: required social welfare contributions decreased, labor contracts were enforced, and formal labor dispute mechanisms were implemented.[75] By the mid-1990s, FIE labor law effectively became part of national labor law.[76] The CCP passed the Enterprise Income Tax Law in 2007, which made the income tax rate for domestic enterprises the same as FIEs. Finance Minister Jin Renqing specifically referred to fake FIEs and round-tripping as reasons why taxes between domestic firms and FIEs needed to be equal.[77]

Relationship between Domestic Institutions and Regime Stability

Did institutional change enhance regime stability? Yes. According to Samuel Huntington, rapid social and/or economic change "undermines traditional sources of political authority and traditional political institutions" and creates political instability.[78] Certainly, China underwent swift social and economic change as a result of Deng's economic reforms. Huntington argues that the more adaptable an institution is, the more institutionalized it is.[79] Applying Huntington's logic specifically to China, Heberer and Schubert argue that the CCP has been especially stable because it made a deliberate effort to reform and adapt institutions.[80] As previously described, the adaptations of the legal system and labor practices indicate that they are highly institutionalized.

Another key institutional change is the dramatic transformation in party ideology post-1978. The CCP was able to successfully transform party ideology in a way that maintained stability. As Gallagher notes, the incorporation of "Deng Xiaoping Theory" restructured the conflict as "China versus foreign firms", rather than "public versus private firms."[81] Addressing the tension between public and private firms was important in preserving social stability and increasing patriotic feelings toward Chinese private firms. In addition, "Deng Xiaoping Theory" undermined socialist labor institutions by framing them as "obsolete but also inimical to the continued [capitalist] development of the economy".[82] In this way, the malleability of party ideology encouraged stability, as well as cleared the way for reforms. As Huntington notes, "success in adapting to one environmental challenge paves the way for successful adaptation to subsequent environmental challenges".[83]

One can also make the argument that changing domestic institutions to resemble Western institutions could promote democratization. In the case of China, however, this has not happened. Rather, this incorporation has strengthened China's legal institutions, which, as

[74] Tsai, *Capitalism without Democracy*, 186.
[75] Josephs, "Labor Law in a 'Socialist Market Economy'", 562.
[76] Gallagher, *Contagious Capitalism*, 17.
[77] Tsai, *Capitalism without Democracy*, 186.
[78] Samuel Huntington, *Political Order in Changing Societies*, New Haven; London: Yale University Press, 1996. http://www.jstor.org/stable/j.ctt1cc2m34.,5.
[79] Ibid., 13.
[80] Thomas Heberer and Gunter Schubert, "Introduction," *Regime Legitimacy in Contemporary China*, edited by Heberer and Schubert, Routledge, 2009, pp. 1-9, Routledge Contemporary China Series, 2.
[81] Gallagher, *Contagious Capitalism*, 18.
[82] Ibid., 13.
[83] Huntington, *Political Order in Changing Societies*, 13.

Huntington points out, strengthens the CCP's legitimacy as a whole. First, it creates more political and social stability domestically, as laws are applied more evenly across society. In post-Cultural Revolution China, this stability grants legitimacy to the government in the public's eyes.[84] A strong legal system also grants legitimacy to the CCP in the international community.[85]

Second, it fosters sustained economic growth. In its ninth Five-Year Plan, the CCP emphasized the importance of legal reform, as it would help strengthen "economic order."[86] FDI, and participation in the general world economy through membership in the World Trade Organization, requires a transparent legal system. Indeed, implementing business-friendly legal reforms made China more attractive to FDI. From 1980 (when the first SEZs were established) to 1999 (a point by which most FIE labor law had become part of national law), China's GDP rose from 191 billion USD to 1 trillion USD. China's GDP growth shows little sign of slowing, reaching 11 trillion USD in 2015.[87] This sort of rapid and sustained economic growth proved to both Chinese citizens and other states that the CCP was fast becoming a key player in the global economy. In turn, it helped grant legitimacy to CCP rule.[88, 89]

One point of criticism is the problem of implementation; just because the law has been changed does not necessarily mean that it is implemented. No systematic or statistically meaningful research has been done on the actual implementation of written law and evidence of implementation remains anecdotal.[90] However, the law is important as a signal of party values and societal values, both to entrepreneurs and the international community.

The self-reinforcing nature of China's institutional adaptability indicates that the CCP will likely stay stable and in power for years to come. In its ninth Five-Year plan, the CCP itself said that the "maintenance of political and social stability is the basic prerequisite for the promotion of reform and development... stability in turn is realized through the deepening of reform and sustained development."[91]

Because all the criteria are confirmed, this hypothesis is confirmed. FDI has indeed caused domestic entrepreneurs to modify their own business practices and the government has made an effort to help domestic firms adopt business practices more like that of FIEs in order to be more competitive. Formal institutional changes reinforce the CCP's overall stability, as described by Huntington.

Implications for Regime Stability – Areas Lacking Collusion between Political Elites and Entrepreneurs

In areas with large amounts of FDI, democratization seems unlikely. The adaptability of formal institutions, both on the local and national levels, indicates a high degree of institutionalization and thus, a high degree of stability.

---

[84] Gallagher, *Contagious Capitalism*, 102.
[85] Zweig, "China's Political Economy," 255.
[86] Peng, *Report on the Outline of the Ninth Five-Year Plan (1996-2000).*
[87] The World Bank, "GDP (current US$)," *World Bank Open Data*, World Bank Group, 2016, accessed March 23, 2017, http://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=CN.
[88] Gallagher, *Contagious Capitalism*, 102.
[89] Zweig, "China's Political Economy", 254.
[90] Josephs, "Labor Law in a 'Socialist Market Economy'", 562.
[91] Peng, *Report on the Outline of the Ninth Five-Year Plan (1996-2000).*

Using a class-based explanation, Jianjun Zhang argues that some models of political economy encourage democratization while others are inherently antagonistic to democratization. In his analysis of the Sunan and Wenzhou models, J. Zhang finds that if market reform only enriches a few (as in the Sunan model), then the economic and political elite have common interests and will work together to maintain the status quo. This is because in the Sunan model, the government has a history of a "hands-on" approach to economics.[92]

Though the Sunan and South China models are different, they are similar in this regard. As discussed previously, both local and central governments were closely involved with fostering FDI growth. In addition, there is certainly a wide gap between the rich and the poor in areas following the South China model, mostly because of the massive population of migrant workers from Chinese provinces and other countries.[93] The rewards of FDI are usually concentrated in a small, overlapping group of economic and political elite. Thus, FIE entrepreneurs and local governments also have an incentive to work together to maintain the status quo. A large part of this is appeasing non-FIE entrepreneurs through reforming institutions.

This is echoed in the results of Tsai's 2002 survey of entrepreneurs across China. Tsai typified 86 percent of South Chinese entrepreneurs' as "loyally acceptant," meaning that they have the ability to confront the state but no desire to.[94] Loyally acceptant entrepreneurs are generally satisfied with the government, though they still may be dissatisfied with certain aspects. In addressing these problems, loyally acceptant entrepreneurs do not act assertively; in fact, these entrepreneurs try to actively cultivate positive relationships with state agents in order to solve problems.[95] Entrepreneurs rarely expressed their opinions through participatory organizations such as entrepreneurs' associations (7.8 percent), mass organizations (6.4 percent), and National People's Congress delegates (2.9 percent). Entrepreneurs who did engage in assertive behavior made up less than five percent of all entrepreneurs in the South China model.[96]

J. Zhang also finds that if a majority of the population benefits from market reform and development (as in the Wenzhou model), citizens will be more politically assertive. His reasoning for this is because "self-reliant" development creates a class of citizens who are accustomed to being actively involved in politics, fundamentally changing the power dynamic between citizens and the government.[97] There is also less overlap between economic and political elites. Thus, they are more likely to compete with each other for power which promotes democratization.[98]

This is also echoed in Tsai's survey. Entrepreneurs in the Wenzhou model are also more politically active, with close to 30 percent saying that their primary means of solving disputes is through entrepreneurs' associations.[99] J. Zhang concludes that in areas where

[92] J. Zhang, "Marketization, Class Structure, and Democracy in China", 426.
[93] Wu, Xinming, and Jeffrey M. Perloff. "China's Income Distribution, 1985-2001." *The Review of Economics and Statistics*, vol. 87, no. 4, Nov. 2005, pp. 763-75. *JSTOR*, www.jstor.org/stable/40042892. Accessed 8 Dec. 2016, 763.
[94] Tsai, *Capitalism without Democracy*, 108.
[95] Ibid., 115.
[96] Ibid., 171.
[97] J. Zhang, "Marketization, Class Structure, and Democracy in China", 435.
[98] Ibid., 440.
[99] Tsai, *Capitalism without Democracy*, 171.

economic reform benefits the majority of people, conditions conducive to democratization are more likely to arise.[100]

Implications for Regime Stability – Areas with More Equal Wealth Distribution

Will there be a democratic transition in places where wealth is distributed more evenly? The short answer is no. China is massive and diverse, "more like a continent than a unified country both historically and contemporarily."[101] Should a local democracy arise, it would likely exert some pressure on local governments to become more democratic. However, the fragmented nature of national-level politics would make it extremely difficult for a pro-democracy movement to move beyond the local level. Most scholars agree that if democratization were to occur, it would be a top-down process. Zhang notes, "an alternative scenario-- a tumultuous process pushed from below, with the state unable to cope with demands of change-- is almost unthinkable."[102]

The rapid growth of the private sector also reduces resistance from those in the public sector because to "stand by and hold fast to 'socialist enterprise'" would mean losing out on the opportunities and benefits provided by foreign capital, as well as "prestige from association with the international economy."[103] This competitive dynamic further pushes forward the process of economic reform.

Implications for Regime Stability – Disadvantaged Workers

What about workers, both from the public sector and the private sector, who are disadvantaged by new labor laws and practices? Could they potentially act as a democratizing force? This is highly unlikely. Migrant workers make up about one-third of the working population; most come from extremely poor, rural areas.[104] Paired with this, their social, economic, and political statuses are extremely low in the cities to which they migrate. Thus, migrant workers are not in a position to present any real threat to the existing regime. In addition, the bloody end to the 1989 Tiananmen Square protests (which advocated for increased employment among youth and democracy) serves as a constant reminder of the danger involved in political action. On top of this, the large numbers of people previously employed by the public sector are likely to be loyal to the CCP; former state employees were less likely to endorse democracy than those who had not worked for the state.[105]

Gallagher notes that FDI could potentially "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, however, FDI "has afforded the regime more time and more political space to pursue economic reform without political liberalization."[106]

---

[100] J. Zhang, "Marketization, Class Structure, and Democracy in China", 440.
[101] Ibid., 441.
[102] Ibid., 441.
[103] Gallagher, *Contagious Capitalism*, 14.
[104] China Labour Bulletin, "Migrant Workers and Their Children," *China Labour Bulletin*, 2016, accessed December 8, 2016, www.clb.org.hk/content/migrant-workers-and-their-children.
[105] Tsai, *Capitalism without Democracy*, 94.
[106] Gallagher, *Contagious Capitalism*, 25.

Conclusion

In the ninth Five-Year plan, the CCP committed to "correctly [handling] contradictions among the people so as to eliminate factors that cause social instability."[107] This interesting and vague statement seems to sum up the dynamics of formal institutional change prompted by FDI. "Contradictions" in regional development have given way to societal tensions, specifically between domestic entrepreneurs and FIE entrepreneurs. Formal institutional change, designed to adapt to domestic entrepreneurs' actual practices, as well as to appease them, have "eliminated" tensions. Thus, formal institutional change "correctly handled" these problems and decreased overall social instability. Though we cannot determine whether the CCP reformed its formal institutions with this specific goal in mind, this has been the effect of institutional change.

This is not to say that FDI is the only source of political stability or instability in China. Indeed, factors such as economics, culture, ethnicity, international standing, and demographic changes all play a role in determining stability. However, FDI is a key piece of China's political economy as well as a potential catalyst for conflict. Not only has the CCP successfully navigated this rocky area, but it has also manipulated it to preserve its own stability.

[107] Peng, *Report on the Outline of the Ninth Five-Year Plan (1996-2000).*

Bibliography

Chen, Jie. *A Middle Class without Democracy: Economic Growth and the Prospects for Democratizationin China*. Oxford UP, 2013.

China Labour Bulletin. "Migrant Workers and Their Children." *China Labour Bulletin*, 2016, www.clb.org.hk/content/migrant-workers-and-their-children. Accessed 8 Dec. 2016.

Dasgupta, Dipak. *China Engaged: Integration with the Global Economy*. World Bank, September 1997. China 2020. *World Bank Group eLibrary*,www.elibrary.worldbank.org/doi/abs/10.1596/0-8213-4079-4. Accessed 7 Dec. 2016.

Freedom in the World 2016: China. Freedom House, 2016, www.freedomhouse.org/report/freedom-world/2016/china. Accessed 22 Nov. 2016.

Gallagher, Mary Elizabeth. *Contagious Capitalism: Globalization and the Politics of Labor in China*. Princeton UP, 2005.

Heberer, Thomas, and Gunter Schubert. Introduction. *Regime Legitimacy in Contemporary China*, edited by Heberer and Schubert, Routledge, 2009, pp. 1-9. Routledge Contemporary China Series.

Hu, Shaohua. *Explaining Chinese Democratization*. Praeger Publishers, 2000.

Huntington, Samuel. *Political Order in Changing Societies*. New Haven; London: Yale University Press, 1996. http://www.jstor.org/stable/j.ctt1cc2m34.

Josephs, Hilary K. "Labor Law in a 'Socialist Market Economy': The Case of China." *Columbia Journal of Transnational Law*, vol. 33, 1995, pp. 561-79. *HeinOnline*. Accessed 2 Dec. 2016.

Levitsky, Steven, and Lucan Way. "International Linkage and Democratization." *Journal of Democracy*, vol. 16, no. 3, July 2005, pp. 20-34. *Project MUSE*, www.muse.jhu.edu.ezproxy.library.tufts.edu/article/185273/pdf. Accessed 11 Nov. 2016.

Levitsky, Steven, and Lucan A. Way. *Competitive Authoritarianism*. Cambridge UP, 2010.

Lipset, Seymour Martin. "Economic Development and Democracy." *Political Man*, Doubleday, 1960, pp. 31-51. *Trunk*. Accessed 11 Nov. 2016.

Meyer, William H. *Human Rights and International Political Economy in Third World Nations: Multinational Corporations, Foreign Aid, and Repression*. Praeger Publishers, 1998.

Moore, Barrington. "The Democratic Route to Modern Society." *Social Origins of Dictatorship andDemocracy*, Beacon Press, 1993, pp. 413-32. *Trunk*. Accessed 11 Nov. 2016.

National Bureau of Statistics of China. "Number of Foreign Funded Enterprises (By Province)." *National Data*, 2014, www.data.stats.gov.cn/english/mapdata.htm?cn=E0103. Accessed 8 Dec. 2016.

Peng, Li, translator. *Report on the Outline of the Ninth Five-Year Plan (1996-2000) for National Economic and Social Development and the Long-range Objectives to the Year 2010 (Excerpts)*. 5 Mar. 1996. *china.org.cn*, www.china.org.cn/95e/95-english1/2.htm. Accessed 8 Dec. 2016. Delivered at the Fourth Session of the Eighth National People's Congress

Pomfret, Richard. *Investing in China: Ten Years of the Open Door Policy*. Iowa State UP, 1991.

Przeworski, Adam, and Fernando Limongi. "Modernization: Theories and Facts." *World Politics*, vol. 49, no. 2, Jan. 1997, pp. 155-

83. *JSTOR*, www.jstor.org.ezproxy.library.tufts.edu/stable/25053996. Accessed 24 Mar. 2017.

Tsai, Kellee S. *Capitalism without Democracy*. Cornell UP, 2007.

The World Bank. 1997. *China Engaged: Integration with the Global Economy*. Washington, DC.: World Bank.

The World Bank. "GDP (current US$)." *World Bank Open Data*, World Bank Group, 2016, http://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=CN. Accessed 23

Mar. 2017.

The World Bank. "Foreign Direct Investment, Net Inflows (BoP, current US$)." *World Bank Open Data*, World Bank Group, 2016, http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?end=2015&locations=CN&start=1982&view=chart. Accessed 23 Mar. 2017.

World Investment Report 2015: Reforming International Investment Governance. Geneva, United Nations. *United Nations Conference on Trade and Development*. Accessed 10 Nov. 2016.

Wu, Xinming, and Jeffrey M. Perloff. "China's Income Distribution, 1985-2001." *The Review ofEconomics and Statistics*, vol. 87, no. 4, Nov. 2005, pp. 763-75.

JSTOR, www.jstor.org/stable/40042892. Accessed 8 Dec. 2016.

Xiao, Geng. *Round Tripping Foreign Direct Investment and the People's Republic of China*. Asian Development Bank Institute, July 2004. ADB Institute Research Paper Series

58. *Asian Development Bank*, www.adb.org/sites/default/files/publication/157240/adbi-rp58.pdf. Accessed 1 Dec. 2016

Zhang, Jianjun. "Marketization, Class Structure, and Democracy in China: Contrasting Regional Experiences." *Democratization*, vol. 14, no. 3, June 2007, pp. 425-45. *Taylor and Francis Online*, DOI:10.1080/13510340701303279. Accessed 5 Dec. 2016.

Zhang, Xiaobo. "Fiscal Decentralization and Political Centralization in China: Implications for Growth and Inequality." *Journal of Comparative Economics*, vol. 34, no. 4, Dec. 2006, pp. 713-26. *Science Direct*, doi:10.1016/j.jce.2006.08.006. Accessed 22 Nov. 2016.

Zweig, David. "China's Political Economy." *Politics in China: An Introduction*, edited by William A. Joseph, 2nd ed., Oxford UP, 2014, pp. 254-90.

Zweig, David. *Internationalizing China: Domestic Interests and Global Linkages*. Cornell UP, 2002, pp. 159-160.