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PART I

INTRODUCTION

ONE

Local Governments, Foreign Direct Investment, and Industrial Development

The challenge for Chinese leaders during the first two decades of reform and development – much like in Japan in the 1960s or Korea in the 1970s – was to choose a development path that would lead to the creation of competitive industries. Like its neighbors in previous decades, China faced the classic problems of late development. Rather than accept the division of labor dictated by comparative advantage, China sought to develop industrial sectors that would create a "multidimensional conspiracy"[1] in favor of development: sectors and firms that would foster entrepreneurial activity and create positive spillovers in the economy as a whole. For reasons that had as much to do with national security and pride as economics, China's leaders were not content to build yet another workshop for the developed world, manufacturing whatever products required cheap labor and low skill levels. They wanted to fly airplanes made in Shanghai, use computers built in Beijing, and drive automobiles manufactured in Guangzhou. China was a poor country at the beginning of the reform era, but it was not lacking in ambition.

Although the ability of China to realize these ambitions rested on many factors, none was more important than its capacity to effectively utilize foreign direct investment (FDI) as a means of developing its own industrial base. By definition, a "late" developing nation confronts the challenge of creating strong and independent firms in a context of intense competition from the industrialized world. However, as Alexander Gerschenkron pointed out in the 1960s, there are also distinct economic advantages to being a late developing country. Industrialization has the potential to be

[1] The term is Albert Hirschman's, cited in Evans (1995: 7).

more rapid when a society, rather than moving forward through a tedious process of trial and error, can borrow the most recent technology and techniques from more advanced nations.[2] In some cases, it may even be possible to jump past established firms that are burdened with outdated technology and ideas. The challenge is to maximize the advantages of "backwardness" by drawing on the knowledge, technology, and capital that is available in advanced industrial economies, while taking care to prevent firms in nascent industries from being either inundated or co-opted by the more established foreign competitors.

China's neighbors excelled at this process of leapfrogging forward in the development process. Indeed, the success of Japan, Korea, and Taiwan in managing the industrialization process led to the rise of a new development paradigm. Rather than being condemned to positions of dependency in the global economic system due to structural factors beyond their control, some observers of rapid growth in East Asia concluded, states could control their own destiny.[3] Autonomous and well-trained state officials could facilitate the accumulation of capital, carefully control interaction with the global economy, and through a process of selective intervention, promote the development of sectors that were deemed to be of strategic importance. Although this account of rapid economic growth was certainly not without its critics,[4] the "developmental" state model was extremely influential, particularly among states that hoped to emulate the rapid success of the East Asian miracle. China was no exception, and there were many early indications that Chinese policymakers sought to emulate the example of its neighbors: from plans for "pillar industries" beginning in the mid-1980s to formal industrial policies in the mid-1990s.

The international context within which China was confronting the challenges of economic development, however, was very different from that faced by its neighbors in the 1950s and 1960s. The Cold War provided an unusually benign context within which American allies could focus on economic development. As part of its effort to contain the Soviet Union, the United States donated extensive foreign aid to its allies in East Asia, unilaterally opened its markets to their goods, and embraced

[2] Gerschenkron (1966).
[3] On the "developmental state" in East Asia, see Johnson (1982), Amsden (1989), Wade (1990), Woo-Cumings (1999). These views were subject to considerable revision in the aftermath of the Asian financial crisis. See Pempel (1999), Haggard (2000), Prakash and Hart (2000). The problem of institutional change in East Asia is explored at greater length in Chapter 9.
[4] See, for instance, Saxonhouse (1983), World Bank (1993), Krugman (1994).

them under its security umbrella. The rapid rise of Japan, Korea, and Taiwan, far from being perceived by the United States as a threat to its economic supremacy, was the explicit objective of U.S. strategy in the decades following World War II. In the current era of the World Trade Organization (WTO), developing countries are granted concessions, but they are carefully limited. In the case of China, the United States was not willing to grant even the normal concessions, due to the demographic and economic size of the country, and in some areas, Chinese obligations actually exceeded WTO standards.[5]

In addition to the altered international context, the Chinese were integrating into a global economy that had changed tremendously in the decades since Japan, Korea, and Taiwan had begun the development process. Accession to the WTO represented not only a dramatic change in the formal rules of the game, but also recognition on the part of (at least) some Chinese leaders that the very nature of the game itself was changing. Although the globalization of manufacturing in itself was nothing new – multinational firms have been relocating manufacturing facilities to the developing world for centuries – what was new was the degree to which production chains had become globalized. Rapid advances in transportation and telecommunications were making it possible to divide production chains, and firms were increasingly outsourcing components based on comparative advantage rather than geographic convenience.[6] The result was a bifurcation of the manufacturing process in some sectors. The research and design of technology-intensive products such as computers, cars, and planes continued to be performed in relatively few locations, as did the final assembly in some cases, but for components that did not require co-location with an assembler or other major suppliers, sourcing could be done from wherever costs were lowest. Improvements in transportation and communications technology, along with an improved ability to codify complex information through digitization, increased the ability of multinational companies to widely disperse the production of components even when design and development remained geographically concentrated. Boeing, for example, continued to design and manufacture planes in Seattle, but outsourced parts and components from more than 70 countries.[7] Not joining the WTO would both prevent China from fully participating in global production networks – and the country clearly had

5 Lardy (2002: 2 and 10).
6 For work on international production networks, see Borrus, Ernst, and Haggard (2000).
7 Lardy (2002: 21). Even design work is beginning to be more widely dispersed as firms seek to take advantage of inexpensive and high quality engineering talent in countries such as India and China.

a great deal to gain – and make it more difficult for Chinese firms to develop the competitive ability that would allow them to carve out high-value–added pieces of such networks. For reasons of prestige and power, Chinese leaders did not want domestic companies to be temporary cogs in production networks controlled by foreigners.

By the late 1990s, according to Joseph Fewsmith, "China's leadership had determined that globalization was unstoppable and that China could either join the trend or be left behind."[8] WTO accession, it was hoped, would provide the final pressure necessary to restructure the state-owned sector and create a new breed of internationally competitive Chinese firms. As Premier Zhu Rongji explained at a joint Washington press conference with President Clinton in April 1999, "The competition arising [from WTO membership] will also promote a more rapid and more healthy development of China's national economy."[9] And there was certainly reason for optimism. Since the start of the reform period in 1978, the gross domestic product of China had expanded at an average of 9% a year and foreign trade had grown at an average of 15% a year. After 25 years of reform, China's trade surplus with the United States was twice that of Japan's, it was attracting over $1 billion of FDI every week (on average), and depending on the measure, it was either the second largest economy in the world (using purchasing power parity) or the sixth (using market prices).[10] Integration with the global economy had transformed the Chinese economy, and it was a force to be reckoned with. The gradual decline of tariff barriers would create new challenges, but these challenges would, in the long run, only increase the global competitiveness of Chinese firms.

The less sanguine view, however, and one that was not uncommon in Beijing in the late 1990s, was that WTO accession represented the final capitulation. Zhu Rongji's compromises in Washington were seen as the "new 21 demands selling out the country" – a reference to Japan's infamous attempt to colonize China in 1915.[11] Chinese firms that had benefited from high tariff walls, despite two decades of reform and development, would not be able to meet the challenge of international

[8] Fewsmith (2001: 206).
[9] "Joint Press Conference of the President and Premier Zhu Rongji of the People's Republic of China," Office of the Press Secretary, The White House, April 8, 1999. Accessed from www.usconsulate.org.hk/uscn/wh/1999/0408b.htm
[10] Figures are from "Behind the mask: A survey of business in China," *The Economist*, March 20, 2004, p. 3.
[11] Fewsmith (2001: 211).

competition. Skeptics in China and abroad pointed not only to the profound weaknesses in the Chinese economy, such as the crippling burden of non-performing loans in the financial sector and the rapidly growing income inequalities between coastal regions and the interior, but the extent of Chinese dependence on foreign firms.[12] While it was true that the country's exports were rising rapidly, as much as 50% of these exports were from foreign-invested firms. As Yasheng Huang argued in his provocatively titled book, *Selling China*, even prior to China's accession to the WTO accession, an institutional bias against truly private firms (a result of favoritism toward state-owned enterprises and economic fragmentation) created an unnecessary dependence on foreign firms.[13] Further lowering the restrictions on foreign investment, one might reasonably expect, would only increase the dominance of foreign firms in the Chinese industrial landscape.

This book seeks to understand how two decades of reform, development, and foreign investment have prepared state-owned Chinese auto firms for the challenge of global integration. Why the auto industry? First, the auto industry exemplifies the aspirations of Chinese leaders to cultivate powerful new business groups (*jituan gongsi* or *jituan qiye*) that can represent the country in the global economy. This effort began in the 1980s, long before similar efforts in other industries, when the automotive sector was chosen as a "pillar" industry and became a primary target of government industrial policy. The industry is not one in which government officials simply threw up their hands and hoped for the best. There has been a conscious effort to shape development in the sector, and the industry has emerged as one of the key drivers of growth in China. Sales of passenger vehicles increased nearly five-fold between 1998 and 2004, from 484,000 cars to 2.3 million. Foreign firms, lured by projections that the Chinese auto market would be the second largest in the world by 2015, invested approximately $12 billion in China between 1994 and 2003.[14] How has a country that is moving away from state planning – the core of the reform process – used the state to promote development in a critical industry?

Second, foreign investment has been central to auto sector development in China. It is the only industry in which each of the core projects is a

[12] Chang (2001); Wolf et al. (2003).
[13] Huang (2003).
[14] Automotive News (2004: 3). By the beginning of 2004, foreign firms had already committed to investing an additional $10 billion by 2007. Sales volume for 2004 is from "China's auto output and sales exceed 5 million in 2004," *Asia Pulse*, January 18, 2005.

joint venture (JV) with a foreign firm, and as such is emblematic of China's efforts to leverage foreign firm's access to the domestic marketplace for their technology and managerial skills. As explained later in this chapter, the prevalence of joint ventures, and the variation in both regional strategies and outcomes, makes it possible to choose multiple cases within a single industry. There are auto business groups in China that are healthy, if still dependent on foreign technology, but are indeed being spurred on by increased foreign competition. There are also business groups that have essentially collapsed in the face of increased competition, and have sold out to foreign firms. When the overall objectives have been the same – using foreign joint ventures as a catalyst for local development – why have results varied so widely?

Third, the development challenges within the auto sector are appropriate. At the local level, the supply network is critical to success. My interest is not in the success of individual firms, but in networks of firms, and the auto industry is unusual in the intensity of backward linkages – it is not uncommon for 60% of the value of a car to be purchased from outside suppliers. While success at a single assembly plant is heavily reliant on individual firms (both the Chinese and foreign partner), the successful development of a regional supply network requires the dissemination of technology, capital, and management skills to hundreds of firms. At the global level, the industry is an ideal example of the new development challenges that are posed by globalization. Multinational firms no longer relocate to a developing country and recreate a supply network with local firms, as was the norm when China began the process of reform and development in the 1980s. It has become a truly global industry characterized increasingly by common global platforms, rapidly changing technology, and consolidation in increasingly fewer firms. Will Chinese firms be able to carve out their own niche on this global stage?

The Argument in Brief

The core argument of the book revolves around local institutions in China, both political and economic, and how they shape industrial development and integration into the global economy. The starting premise is that firms are at the heart of the industrial development process. Many actors are involved in the process, but at some level, all of them – international institutions, governments, unions, or industry associations – revolve around individual firms, and their ability to compete in the global marketplace.[15] The development needs of firms vary systematically by sector, however. All firms must deal with the challenges of human capital (training workers, bargaining with labor), access to financial capital and governance of its utilization, and inter-firm relations (relationships with suppliers of both inputs and technology, customers, and other members of a supply network), but the specific nature of these challenges will vary by sector.[16] The ability of firms within a sector to meet these needs is central to the process of industrial development, and success is fundamentally shaped by the context of institutions and organizations in which the firms operate. There are three central points.

First, local governments are increasingly the agents of industrial transformation at the level of the firm. The extent to which this is true will vary by country, but in an era in which decentralization has been the dominant political and economic trend, it is often local political and economic institutions that must help firms meet their day-to-day development needs, and this is particularly true in the case of China. It is, of course, not unusual or new to focus on the developmental role of local governments. It is less common to focus on systematic patterns of institutional *differences* between localities.[17] There is no single dominant approach to development at the local level, whether it be market-led growth or local state corporatism, but rather multiple patterns. By focusing on the internal structure of local bureaucracies and economic organizations it is possible to characterize distinct institutional patterns – even in a country that was for decades centrally planned – and these differences have important economic consequences. Because different institutional arrangements vary in their ability to meet the development needs of different industrial sectors, it becomes possible to speak of a locality's comparative institutional advantage. There is no one-size-fits-all development approach, but a mosaic of local patterns within the national framework.

Second, the institutional differences that distinguish localities, while not unchanging, are durable over time. This is particularly important in

15 On theories of business in political economy, see Stephan Haggard, Sylvia Maxfield, and Ben Ross Schneider, "Theories of Business and Business-State Relations," in Maxfield and Schneider (1997).

16 This characterization of a firm-centered view of development follows Hall and Soskice, although they characterize firm needs somewhat differently. Hall and Soskice (2001: 6–7).

17 I will at times interchange the term "region" for "locality," and I use both terms to refer to a subnational jurisdiction of either the provincial or municipal (city) level.

the case of industrial development because the needs of industrial sectors tend to change quite rapidly. Not only do industries evolve as they grow and mature, but the external context of development can change rapidly (e.g., moving from a closed to open economy). An institutional pattern that is conducive to the development of a sector in one stage of growth might not be appropriate in the next stage, and it is difficult to transform institutions rapidly enough to meet evolving economic needs. This is especially true when economic and political institutions are closely intertwined because the latter will respond to a broad range of noneconomic incentives. As a result, it is both unrealistic to expect states to be able to easily imitate more successful development "models" and, in that success might be short-lived, probably unwise. It is more important to understand the historical roots of a particular set of local institutions, and the opportunities and constraints they create; analysis must be across time as well as space.

Third, while localities are the basic building block of industrial development, they must fit into the broader framework of national policies. Local states are not nation-states. The central government creates the framework of rules within which local governments operate (e.g., taxation policy, environmental policy, corporate law, etc.) and the form of interaction with the global economy (e.g., tariff policy, participation in international organizations, etc.). Throughout the reform period in China, local governments have exploited the inattention of the center to experiment with new policy approaches, but this does not negate the fact that the stamp of the central government is inevitably sought as these experiments develop and expand. The dynamics of local-center relations are important in the present and in the past. In the past, the relationship with the center is a key determinant of the structure of local institutions. In the present, the national economic framework – for instance, the degree of openness to international competition – creates the opportunities and constraints within which local states must operate, and a local policy that is highly effective in one national framework will not necessarily be as effective in another. As a result, analysis must be multi-tiered, and examine the interaction of the central and local state.

The remainder of this chapter develops each of these central points. The first section explains how decentralization has created new opportunities for local states. The second section argues that the political and economic structures of local states will vary, and this variation gives each an institutional comparative advantage with respect to different economic sectors. The third section explains how analysis of the local state fits into a broader national and international framework. The final section provides a roadmap for the book as a whole.

I. THE NATION-STATE: PRESSURED FROM ABOVE AND BELOW

The relationship between institutions and economic performance has always been central to the study of comparative political economy, of course, but traditionally the unit of analysis has been the nation-state.[18] Economic outcomes are explained by analyzing the relationship between domestic state institutions, patterns of industrial policy, and social actors.[19] Successive generations of this approach have analyzed how national institutional structures have responded to the challenges of economic adjustment in the advanced capitalist world. Early variants of this approach focused on the varied capacity of "strong" and "weak" states to carry out industrial intervention[20]; later approaches used the concept of neo-corporatism to explain the ability of governments to forge cooperative relationships with producer groups in an open economy.[21] Recently, the focus has been on the varieties of capitalism in the developed world, and whether the increasing integration of the global economy will ultimately lead to the convergence of different national models.[22] As Peter Hall and David Soskice write in the introduction to their work on varieties of capitalism, "comparative political economy revolves around the conceptual frameworks used to understand institutional variation across nations." In continuing in this tradition, they make the case that "the most important institutional structures – notably systems of labor market regulation, of education and training, and of corporate governance – depend on the preserve of regulatory regimes that are the preserve of the nation-state."[23]

Studies of late-development and transitional economies have generally followed from this traditional focus on the nation-state in that successful economic development is thought to be contingent upon getting national political and economic institutions right. Lessons are drawn from

18 On the problem of "whole nation bias" in political science, see Rokkan (1970: Chapter 2); Snyder (2001). This juxtaposition of a traditional national approach to political economy and a local approach builds on Segal and Thun (2001: 558–560).
19 The classic work in this tradition is Shonfield (1965).
20 See Katzenstein (1978); Zysman (1984).
21 See Schmitter and Lehbruch (1979); Berger (1981); Katzenstein (1985).
22 See Berger and Dore (1996); Hall and Soskice (2001).
23 Hall and Soskice (2001: 1 and 4).