

***Why More is Actually Less: New Interpretations of
China's Labor-Intensive FDI***

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Working Paper Number 375
May 2001

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Abstract

The fact that China is the second largest recipient of FDI in the world has been heralded by economists and government officials alike as one of the crowning achievements of Chinese economy. This paper questions this perspective. The paper focuses on FDI from ethnically Chinese economies (ECEs), which has financed China's labor-intensive industries and its export growth. First, the paper shows that the conventional wisdom about why China attracts so much labor-intensive FDI is flawed. Second, the paper offers what might be called an institutional foundation argument to explain the phenomenon of China's labor-intensive FDI. Labor-intensive FDI, according to this argument, is fundamentally driven by a political pecking order of firms in China that systematically disadvantages indigenous private firms both financially and legally. Labor-intensive FDI rises to alleviate the liquidity constraints afflicting Chinese private firms as efficient private entrepreneurs have no choice but to cede their claims on future cashflows to raise financing for their businesses.

Summary

This paper draws from a larger book-length research project—tentatively entitled, Selling China: The Institutional Foundation of Foreign Direct Investment During the Reform Era—which examines the important roles and functions of FDI in the Chinese economy. China is one of the most popular investment destinations in the world. Throughout much of the 1990s, China accounted for 50 percent of foreign direct investment (FDI) going into developing countries and in recent years, China has been the second largest recipient of FDI in the world, after the United States. The recent agreements between China on the one hand and the United States and the European Union on the other hand over China's accession into the World Trade Organization (WTO) may increase China's already impressive FDI inflows significantly. According to a forecast by Goldman Sachs, in three to four years, China's WTO membership could boost FDI to 100 billion dollars a year, from the current 40.4 billion dollars.

Chinese officials and foreign business practitioners hail China's large FDI inflows as one of the most celebrated achievements of the reform era. Institutions such as the World Bank have credited FDI as a main driving force behind China's economic success. International rating agencies routinely use FDI flows as an important macroeconomic indicator to assess China's creditworthiness. Standard & Poor's, for example, in its most recent report on China's credit rating, cited "strong inflows of foreign direct investments" as one of the factors to justify an upgrade of China's credit ratings. Academic researchers are equally enthusiastic about FDI flows into China. They tout the enormous benefits of FDI for China, such as technology transfer, the introduction of marketing know-how, capital infusion, etc.

The book project and this paper question this conventional wisdom on China's huge FDI inflows. My central claim is that the large absorption of FDI by China is not a sign of the strengths of its economy but of its fundamental weaknesses. In this paper, I focus on of the inefficiencies in the Chinese economy. Much of the export-oriented FDI—mainly originating from ethnic Chinese firms in Hong Kong, Macao, and Taiwan—materializes because of the severe liquidity constraints on the part of export-oriented indigenous Chinese firms. These liquidity constraints arise not because export-oriented Chinese firms are inefficient but because they are private and for years Chinese banks were explicitly prohibited from lending to private firms. Private firms have no choice but to raise financing in the only way they can—selling their claims on future cash flows to foreign firms. FDI rises as a result. This paper uses data from Chinese garment industry to test that the hypothesis that private firms low on the political pecking order of firms have to cede more equity controls to foreigners.

Why More Is Actually Less: New Interpretations of China's Labor-Intensive FDI

According to a study by the Organisation of Economic Cooperation and Development (OECD), during the twenty years from 1979 to 1999, China absorbed a total of \$306 billion in foreign direct investment (FDI). This is second only to the United States. During this period, FDI flows into China accounted for 10 percent of worldwide FDI and 30 percent of FDI going to developing countries. Firms based in three ethnically Chinese economies (ECEs)—Hong Kong, Macao and Taiwan—has contributed substantially to China's enormous FDI stock. In 1992, Hong Kong investments alone accounted for 68 percent of China's total FDI inflows. Although this share has declined since, Hong Kong is still the single most important investor in China. In 1998, Hong Kong's investment was about 40 percent of China's total FDI flows and the three ECEs together supplied just under 50 percent of Chinese FDI. Much of the FDI from ECEs has financed China's production of labor-intensive and export-oriented goods. As of 1995, foreign-invested enterprises (FIEs) co-funded by firms from the ECEs, accounted for 25 percent of China's industrial exports.

The preponderance of FDI supply from ECEs is illustrated by the example of Macao, a tiny island known more for its casinos and gangs than for its computer and garment industries. Since the early 1990s, Macao has established an improbably large investment position in China. In 1993, firms based in Macao invested 586.5 million dollars in China.¹ To put this number in perspective, Guangdong province, the prosperous economic giant located right across Macao, invested only 383 million dollars in the rest of China in the same year. Macao's investment position is also substantial as compared to investments in China from other countries. The 586.5 million dollars was about 70 percent of the Korean investments, 197 percent of German investment, 74 percent of British investments, and 236 percent of Canadian investments.² Unlike Cayman Islands and Bermuda, small islands that also have an outsized capital position abroad, Macao is not known as a tax haven. As evidence, Macao has virtually no investment position anywhere else in the world outside China.

Chinese government, international organizations, credit risk agencies and academic analysts take this huge FDI absorption as a badge of honor. The same OECD report cited above attributes the strong FDI flows into China to the fact that China "has had exceptional market potential and its economy has been growing rapidly." World Bank credited labor-intensive FDI as a main driver of China's economic success and export growth. Credit rating agencies routinely use FDI flows as an important indicator to assess China's macroeconomic health. Standard & Poor's, for example, in its most recent report on

China's credit rating, cited "strong inflows of foreign direct investments" as one of the factors to justify a triple-B long-term and A-3 short-term foreign currency sovereign and senior unsecured credit ratings on the PRC.

This paper challenges this perspective on China's FDI. The central claim of this paper is that the large absorption of FDI by China is not a sign of the strengths of its economy but of its fundamental weaknesses. The empirical focus of the paper is on the labor-intensive, export-oriented FDI originating from ECEs.³ The argument is developed in two steps. First, I show that the conventional wisdom on what is driving this type of FDI flows into China is flawed. The conventional wisdom is that this type of FDI is driven by China's low factor costs and by a complementarity between marketing and product design know-how controlled by firms in ECEs and low production costs in China. I will show that while China's low factor costs logically lead to the prediction that labor-intensive products will be produced in China the cost differentials *per se* do not necessarily imply that these production facilities in China have to be foreign-owned. Cross-border contract production, in labor-intensive industries devoid of proprietary technology, scale economies, and tacit organizational and production know-how, is theoretically viable and indeed is widely adopted in actual business practices. Furthermore, contract production, at least in other parts of the world, have provided host firms with access to overseas markets, marketing channels and design information at a level that has seemingly surpassed what Chinese firms have been able to obtain through equity arrangements with foreign firms. The prevalence of equity arrangements, in lieu of contractual arrangements, requires an explanation.

The second step is to construct what I call an institutional foundation argument to explain why contract production is often unviable in China. The argument is that there is a political pecking order of firms that severely biases against indigenous private firms in favor of inefficient state-owned enterprises (SOEs). Under this political pecking order, private firms are systematically disadvantaged financially and legally and are afflicted with severe liquidity constraints despite their efficiency and profitable business opportunities. Private firms have no choice but to raise financing in the only way they can—selling their claims on the future cashflows to foreign firms. Labor-intensive FDI rises as a result.

The paper starts with a detailed discussion on the conventional wisdom on labor-intensive FDI and on its flawed reasoning. The second section presents the details of the institutional foundation argument. The third section presents evidence drawn from one labor-intensive industry, garment making. The paper concludes with offering a number of policy implications.

Why conventional wisdom is wrong

Economists have stressed a number of causes as to why China is an attractive country for labor-intensive FDI. Two explanations are prominent in the economic accounts of Chinese FDI. One stresses the vast factor cost differentials between ECEs and China. Labor and land are much cheaper in China than in ECEs and thus labor-intensive FDI is viewed as a simple process of re-locating facilities producing labor or land-intensive goods from high-cost areas to a low-cost area. This is greatly facilitated by the geographic contiguity of the two areas. Naughton (Naughton 1996) has the most straightforward version of this explanation. Hong Kong investment in China, in his words, “represents the ordinary process of growth of a metropolitan economic region, expanding outward in roughly concentric circles” as the costs of central business districts rise. FDI by Hong Kong firms in China is, again in his words, “an accident of history.” It so happens that a metropolitan border coincides with an international border and direct investment becomes foreign as a result.

The other explanation assumes this cost advantage of locating production facilities in China but adds other complementary causes. One is a “synergy” benefit associated with such investments. According to this explanation, while Chinese firms hold an advantage in labor costs, they lack marketing channels, knowledge about overseas customers, and organizational know-how to compete effectively abroad. Firms based in ECEs supply this type of know-how and other “software” skills, even though they do not bring in advanced technology and R&D-intensive production processes. Richard Pomfret, when arguing for the benefits of low-tech FDI from Hong Kong and Taiwan, comments (Pomfret 1991, p. 135): “What was missing in PRC, rather than capital, was the knowledge of how to make bags or teddy bears or wind-up pandas or cigarette lighters in attractive designs to reasonable quality standards and of how to market them overseas.”

The problem with these two explanations is two-fold. First, none of the factors identified in these two explanations logically leads to the conclusion that labor-intensive FDI has to occur. Second, some of the empirical patterns of FDI into China directly contradict the predictions of the conventional explanations. Let me spell out these two points in greater detail below.

When discussing FDI, it is worth emphasizing that FDI is an *ownership* arrangement. Foreign investment is most commonly defined as “direct” when the investment gives rise to “foreign control” of domestic assets. According to IMF, FDI “is made to acquire a lasting interest in an enterprise operating in an economy, other than that of the investor, the investor’s purpose being to have an effective voice in the management of the enterprise.” In the United States, the Department of Commerce defines inward FDI when a foreign investor’s stake exceeds 10 percent. In China, the legal and definitional hurdle is set

at a higher level—25 percent. As such, FDI is simply one of many forms of cross-border relationships between a foreign firm and a domestic firm. Other relationships—or commonly called alliances in business studies—include subcontracting (such as export processing), licensing, and asset leasing, etc., which are fundamentally contractual in nature.

Once the distinction between FDI and contractual alliances is made, it is easy to see why China's cheap labor supply does not logically lead to a prediction that labor-intensive FDI should be large. A firm based in an ECE can contract out its production to a Chinese firm and reap exactly the same labor cost savings as investing in a Chinese facility. Cheap labor *per se* explains why shoes, shirts and hats are made in China; *it does not explain why the facilities making these products are owned by foreigners*. To explain FDI is equivalent to explaining foreign ownership. To explain foreign ownership is equivalent to explaining the viability of an equity arrangement in carrying out labor-intensive production in China and, conversely, the inviability of contractual production. None of the conventional explanations of Chinese FDI poses, let alone answering, these questions.

Institutional economists explain the superiority of an ownership arrangement in terms of its ability to solve some of the well-known problems besetting contractual arrangements and indeed FDI theorists rely on a version of the institutional economics to explain incidence of FDI.⁴ The rationale is a familiar one and the most famous example in the institutional economics literature is the takeover by General Motors of Fisher Body in the 1920s to solve a potential “hold-up” problem.⁵ The Fisher Body example is relevant here for two reasons. One is that it serves to draw an important distinction between FDI and contract production such as export processing. The claim that Hong Kong investors invest in China because of lower labor costs amounts to saying that GM took over Fisher Body because Fisher Body's production costs were lower. This claim does not make any sense. The low production cost at Fisher Body explains why GM wanted to do business with Fisher Body, rather than with another firm; it does not explain why GM wanted to acquire Fisher Body. To explain FDI in China, one must first ask why foreign firms cannot reap the same cost savings benefits via contract production.

The second issue illuminated by the Fisher Body example is that those factors that normally beset contractual arrangements do not arise in labor-intensive industries, either at all or with the same force. Many of the labor-intensive industries, such as garment making, are perfectly competitive. In a perfectly competitive industry, switching costs are low or non-existent; production assets—such as sewing machines or needles—are of an overwhelmingly general-purpose kind, and the industry know-how is non-proprietary. In labor-intensive industries, the normally postulated attributes as important for FDI are absent, such as technological intensity, scale economies, entry barriers and tacit organizational

knowhow. Indeed, for this reason, general FDI theorists would not normally predict a high incidence of FDI in labor-intensive industries. In a widely-used textbook on FDI, Richard Caves writes (Caves 1996, p. 25), “MNEs [multinational enterprises] are logically incompatible with purely competitive organization of an industry.”

The prevalence of so many equity arrangements in Chinese labor-intensive industries, thus, is puzzling. It is puzzling not just for a seemingly weak theoretical rationale for such an arrangement (as laid out above) but also for a number of empirical anomalies. For one thing, cross-border contract production in a labor-intensive industry is extremely common in other parts of the world and there are well-honed business practices to minimize the incidence or the effect of hold-up problems. Equity arrangement is not the only mechanism to transmit knowledge about overseas markets and export product designs; contract production often accomplishes the same tasks. For example, in export-processing arrangement, a foreign buyer closely coordinates with a supplier by providing designs, specifications and components to the domestic firm. The domestic supplier then produces the goods in accordance and receives a payment for the goods delivered to the satisfaction of the foreign firm. Probably, the best-documented success story with export contracting is South Korea. South Korea in the 1960s and 1970s developed into an export powerhouse mainly on the basis of export subcontracting and product licensing, not through FDI. According to a survey by the World Bank, the most important source of product innovation rated by Korean exporting firms was “foreign buyers of output.” Buyers of exports had a strong incentive to work intensively with manufacturers to improve quality and to lower costs. In fact, Korean experience suggests that the knowledge-transfer benefits from export-oriented FDI were quite limited. According to one observer, “neither the direct nor the indirect economic benefits of this [export-motivated] type of foreign investments are very great.”

Under both equity and contract arrangements, the domestic firms export the product and rely on a foreign firm for the latter’s overseas marketing capabilities. Indeed many of the current garment Hong Kong and Taiwanese investors in China started out as contractees for Western firms in the 1960s and 1970s and numerous Indian and Turkish garment makers produce for Western markets via subcontracting arrangements. (More information on the viability of contract production in garment industry is presented in the next section of the paper.)

While in other parts of the world labor-intensive production might have begun as equity arrangements with foreign firms but over time contract production began to rise in proportion to equity arrangements, as domestic residents gained skills and know-how. China, on the other hand, has the opposite sequence, i.e., contract production for foreign businesses was quite common in the 1980s but it

was substantially eclipsed by equity arrangements in the 1990s. The history of export-oriented FDI in China is one of replacing market transaction mechanisms such as export processing with non-market transactions through intra-affiliate cross-border sales. National figures on FIE exports and contractual exports are only available since 1996 but more systematic data are available for Fujian and Guangdong provinces—two provinces that have received the lion’s share of export-oriented FDI. In Fujian province, in 1988, FIE exports to export processing ratio was 3.64; it rose sharply to 22.45 in 1990 and then to 45.47 in 1992. In Guangdong province, the FIE exports rose less dramatically but still far faster than export processing. In the early 1990s, FIE exports were about seven times the value of export processing.⁶ Given a choice, there seems to be a preference for FDI to contract production.

The third anomaly is that there is very little empirical evidence that equity arrangements in labor-intensive industries have *transferred* overseas marketing know-how from foreign home firms to domestic host firms. As pointed out before, both equity and contractual arrangements enable the domestic firms to utilize the overseas marketing channels controlled by the foreign firm but the rationale for an equity arrangement goes beyond utilization of overseas marketing channels. In his classic formulation, Stephen Hymer—widely regarded as the foremost theorist on FDI—argues that FDI is “an *instrument* which allows business firms to *transfer* capital, technology, and organizational skills from one country to another.”⁷ (“Instrument” and “transfer” are italicized here for emphasis.) “Instrument” and “transfer” underline the key premises in the conceptualization of FDI as an economic phenomenon. FDI is an instrument used to facilitate a transfer of know-how from home to a host location by extending corporate control and common ownership. Mere utilization of foreign marketing know-how and channels is not sufficient.

The empirical evidence for know-how transfer in labor-intensive FDI projects is thin at best. In the absence of such transfer, it is not clear what benefits an equity arrangement brings to the table other than a mere utilization of foreign marketing know-how and channels. Systematic data on transfer of marketing know-how are difficult to obtain but a good test is to see how much the Chinese managers of joint ventures know about the destinations, buyer characteristics, and pricing decisions of their export products. Based on interviews—conducted by this author and other researchers, this type of knowledge is either scant or non-existent. In fact, a persistent complaint among the Chinese managers is that foreign firms take advantage of their ignorance and many Chinese managers suspect that transfer pricing is used pervasively to benefit foreign shareholders. Two researchers, on the basis of their field research in the Pearl River Delta, corroborated this finding. They found that mostly non-state Chinese JV partners sometimes deliberately refrained from probing about overseas marketing channels lest it provoke the

Hong Kong investors.⁸ This observation directly contradicts the notion that Chinese seek out export-oriented FDI in order to source knowledge about overseas market.

The Chinese “veil of ignorance”—whether voluntary or involuntary—does call into question about the net benefits of an equity arrangement *in excess of* what can be obtained via a contractual arrangement. The following is how (Leung, Thoburn et al. 1991) describe the export processing: “the Hong Kong ‘partner’ receives the export order, the details of which are typically not revealed to the Chinese side, then simply places an order with the processing plant in China and pays a processing fee upon delivery of the product.” There may be other differences between a subcontracting arrangement and an ownership arrangement but informational transfer is apparently not one of them.

One way to demonstrate the lack of know-how transfer by is to look at the scale of transfer pricing. Transfer pricing can only occur if there is an asymmetrical distribution of knowledge about overseas markets in favor of investing foreign firms. The more asymmetrical that informational distribution is, the greater is the extent of transfer pricing. (Sun 1999) has provided some quantitative estimates of the magnitude of the transfer pricing. A firm can transfer profits abroad through under-invoicing exports or over-invoicing imports (or some combination of the two). By comparing Chinese customs data with Hong Kong customs data, what Sun found is that Hong Kong firms under-invoiced the Chinese exports by about 24.56 percent in the 1990s and over-invoiced the Chinese imports by about 26.5 percent. Subtracting insurance and transport costs from these price differentials, Sun shows that Hong Kong firms under-paid the Chinese exporters by about 15 percent whereas the imports were over-charged by about 17 percent. The sum of these two figures represents roughly what the Chinese lose due to their lack of market information. Sun argues that the extent of transfer pricing is due to foreign controls of market channels of FIEs and Chinese “lack of professional knowledge about the channels of international trade” and exclusion from “FIEs’ pricing decisions for exports and imports.”

The fourth empirical anomaly has to do with the directionality of know-how transfer. Normally, production, organizational or marketing know-how is typically transferred from FDI suppliers to the FDI recipients and by definition, FDI suppliers would typically possess more advanced technology than FDI recipients. However, some of the FDI cases in China show a know-how transfer in the other direction, i.e., FDI recipients in fact hold more advanced technology than FDI suppliers. Two examples are presented here. In a most systematic study of technology transfers to date, two researchers, Stephen Young and Ping Lan, conducted a postal survey of 361 joint ventures in Dalian city and thirty-six follow-up interviews with managers. Among many of their interesting findings is the fact that in quite a few cases Chinese firms were more technologically advanced than their foreign investors.⁹

The second example comes from the degree of foreign controls in those industries at which Chinese firms, *ex ante*, are expected to excel. Two industries come to mind. One is Chinese handicraft industry—wood and silk engraving, jade and ivory carving and sculpturing, etc. As of 1995, there were 432 FIEs in this industry and remarkably, in an industry which the Chinese have practiced and perfected for thousands of years, the average foreign equity stake amounted to 88 percent. In herbal medicine, another industry at which one expects the Chinese to possess unrivaled operating knowledge (indeed herbal medicine is known as Chinese medicine in many quarters of the world), in 1995, there were some 325 FIEs in herbal medicine business, generating sales of 3.8 billion yuan. In comparison, in the same year, there were more than twice as many TVEs and private firms (784) in this business and together they generated a sale of 4.5 billion yuan.¹⁰

An institutional foundation argument

The starting point of our institutional foundation argument is that FDI, fundamentally, is a microeconomic, rather than a macroeconomic, phenomenon. In writing about FDI in the third world countries, Caves puts forward the following hypothesis: “[I]f entrepreneurial capability is a resource in inelastic supply (as in LDCs), foreign investment can occur simply because a nonnative entrepreneur can excel marginal native entrepreneurs” (Caves 1996, 239). The fundamental insight of this statement is that FDI activities occur because of *relative* not because of absolute advantages on the part of “nonnative entrepreneurs” over native entrepreneurs. The relative competitiveness between nonnative and native entrepreneurs can be stylized into the following simple expression:

$$\text{Relative foreign competitiveness} = \frac{\text{Competitiveness of foreign firms}}{\text{Competitiveness of domestic firms}}$$

This shorthand expression is enormously useful in illustrating the circumstances in which FDI occurs. High relative foreign competitiveness leads to a greater incidence of FDI and high relative foreign competitiveness can be due to one or a combination of the following two circumstances. First, a nonnative entrepreneur can be very good. She may possess patents that give her an unrivaled advantage in a product area; she may possess deep organizational and managerial capabilities that cannot be codified and transferred efficiently via a contractual arrangement or she may have developed sophisticated R&D capabilities.¹¹ An equivalent way that a foreign entrepreneur can have an edge is that the native entrepreneur is, in the words of Caves, “marginal.” He is not innovative or market savvy and he fails to respond to changing market conditions or to new market opportunities. Or he is efficient but he is short of funds to expand his business even in the presence of profitable business opportunities. A

logical inference from this way of conceptualizing FDI is two-fold. First, FDI can increase either because foreign entrepreneurship is strong or because domestic entrepreneurship is weak (or some combination thereof).¹² Second, FDI incidence can be high *even if foreign entrepreneurship is “weak” provided that domestic entrepreneurship is even weaker*

The argument

The second statement above is the basis for the institutional foundation argument for labor-intensive FDI. “Weak” foreign entrepreneurship here does not mean that foreign firms are inefficient but simply that they are devoid of those attributes normally considered as *sine quo none* for FDI to occur (as labor-intensive foreign investors are). That labor-intensive FDI has taken place in China on such a large scale and the theoretical and empirical anomalies found in labor-intensive FDI—some documented previously—suggest two inferences. First, the foreign dominance of labor-intensive FIEs cannot be all attributed to superior foreign know-how since this type of know-how can be utilized just as efficiently with contract production and since in certain industries Chinese ought to possess superior know-how in the first place. Second, a compelling reason for the marginality of domestic entrepreneurship is not because of the poor human capital in China. After all, Chinese should excel at handicrafts and herbal medicines and should be at least as capable of supplying quality garments to foreign firms on a contractual basis as Taiwanese, Koreans, Indians and Turks have done, as will be shown later.

The gist of our institutional foundation argument is that the paucity of domestic entrepreneurship in labor-intensive industries is fundamentally a result of a political pecking order of firms that systematically discriminates against private but efficient firms in favor of inefficient state-owned enterprises (SOEs). This bias reduces the supply of domestic entrepreneurship in two ways. First, because SOEs are inefficient, they cannot compete with foreign firms despite the fact that they have accumulated a vast and potentially valuable asset base. Nor can private firms do so effectively, despite their efficiency because they lack funding to expand. In this situation, domestic firms will tend to do poorly in response to some positive market shocks—say an expansion of domestic or export market—as compared with foreign firms because domestic firms are uncompetitive across-the-board. Either FDI or imports will rise depending on the presence or absence of particular regulatory restrictions. This observation is consistent with Chinese data showing that FDI is evenly distributed across all industries, rather than, as typically the pattern, being concentrated in certain industries. I deal with this dynamic in greater detail elsewhere.¹³

The second dynamic is more relevant for understanding the labor-intensive FDI. Private firms primarily operate in labor-intensive industries because government does not consider these industries as “strategic.” Due to the political pecking order, they are faced with severe liquidity constraints. This has two effects. First, private firms have no choice but to raise financing in the only way they can—selling their claims on the future cashflows (mainly to foreign firms). Second and more subtly, the liquidity constraints also create difficulties for private firms to enter into contractual arrangements with foreign firms. Suppose a private entrepreneur lands a contract from a foreign buyer to produce an export product. A contract brings forth a business opportunity to a contractee but it requires complementary resources to realize the benefit of the business opportunity. Machine has to be bought and raw materials have to be procured, all before the revenue from carrying out the contract can be booked. Liquidity constraints essentially deprive the private firms of the resources necessary to realize the benefit of the business opportunity that comes with a contract. Under this circumstance, an export-oriented FDI arrangement with a foreign buyer is superior because an FDI arrangement not only brings forth a business opportunity but also complementary resources necessary to convert this business opportunity into profits.

Political pecking order of firms in China

The insight of the institutional foundation argument is that labor-intensive FDI occurs fundamentally because Chinese private firms are rendered uncompetitive. The claim that a political pecking order of firms exists in China against private firms may be at odds with the conventional wisdom on Chinese reforms. The conventional wisdom is that Chinese have pursued a gradualist reform strategy that has permitted a rapid growth of a non-state sector while preserving the SOEs. “Growing out of the plan” is an apt description of this strategy.¹⁴ Such a conception of the Chinese reform strategy is debatable on two counts. First, the regime has never been satisfied with only preserving or maintaining the SOEs; in fact during the entire reform era, the regime has committed an enormous amount of precious financial and other resources toward *expanding* SOEs. Second, the regime has never permitted an unfettered growth of *truly* private firms. In fact, a host of severe legal, financial and policy constraints have been imposed on Chinese private firms.

Many economists use the output shares of officially-classified “non-state firms” as a measure of the de-statization of the Chinese economy. This is extremely problematic both as a conceptual and as a measurement issue.¹⁵ Many of the “non-state” firms, such as urban collective firms, are wholly-owned subsidiaries of the SOEs and the fact that they are counted as non-state firms is purely due to the arbitrary accounting convention of reporting output and financial data of subsidiaries and parent firms

separately. Under a consolidated accounting reporting rule, many collective firms would drop out of the non-state category all together.¹⁶ The other problem has to do with the fact that while a portion of revenue rights of some of the non-state firms—such as listed shareholding enterprises—is private the control rights exclusively belong to the state. This is demonstrated by an examination of the composition of the boards of directors of the listed companies. According to (Xu and Wang 1997), although individual shareholding constituted 30 percent of the outstanding shares of listed firms on Shanghai and Shenzhen stock exchanges, of the 154 companies they examined, on average, individual shareholders only occupied 0.3 percent of the board seats. In contrast, while the state equity amounted to 30 percent, the state retained 50 percent of the board seats.¹⁷

Table 1 about here.

A truly private firm is one whose control rights are private. In the Chinese official classification such a firm is referred to as an “individually-owned” or a “privately-operated” firm.¹⁸ Table 1 breaks down Chinese industrial enterprises by major ownership types and it shows the shares of total gross industrial output value (GIVO) by various types of firms in 1994 and 1998. Although the size of indigenous private sector—defined as the sum of individually-owned, private and jointly-owned, and privately-controlled shareholding enterprises—has grown rapidly between 1994 (15.5 percent) and 1998 (25.1 percent), the most ideologically suspect private firms are extremely small. In 1998, they only accounted for 0.22 percent of total GIVO, compared to 14.9 percent by the FIEs.¹⁹

The reason for this under-development of China’s private firms is due to the multitude of the biases against them in the Chinese system. The foremost bias against non-state firms—private firms in particular—is a legal one. Until 1988, there was no Constitutional recognition of the property rights of private firms. The Article 11 of the 1982 Constitution only acknowledged the property rights of individual enterprises—defined as self-employed family businesses. The conspicuous silence on the property rights of private firms stemmed from an ideological consideration. Since private firms were defined as those with more than eight hired employees, their operations raised the specter of exploitation by private capital owners. In 1988, Article 11 was amended to include a clause that the state permitted private firms and that the state was to protect their “lawful rights and interests.” However, the amended article reserved the right of the state to exercise “guidance, supervision and control over the private sector of the economy.” As if the vested power of the state to supervise the private sector was not sufficient, the amendment also carefully subordinated the private sector to “a supplement to the socialist public economy.”²⁰ This phrase justified the political pecking order firmly on constitutional grounds. Only in March 1999, did the Chinese Constitution acknowledge the private sector to be an integral part

of the Chinese economy and confer an equal status on private firms as on other firms. Private economy is now a “component” of rather than a supplement to Chinese economy.²¹

To put this shoddy legal treatment in perspective, one can compare the legal treatment of private firms with that of FIEs. China’s current Constitution, adopted in 1982, only six years after the Cultural Revolution, clarified and offered protection to the legal status of foreign enterprises operating in China (Article 18). Foreign enterprises were permitted “to invest in China and to enter into various forms of economic cooperation with Chinese enterprises and other Chinese economic organizations....” Article 18 also swore to protect their “lawful rights and interests.” Thus from the very beginning of economic reforms, FIEs were accorded a superior legal status as compared with the private firms despite the fact that FIEs, theoretically at least, could be 99 percent owned by foreign—and private—investors.

The second kind of bias is a severe lending bias against private firms and in favor of the SOEs, as a number of researchers have pointed out.²² The lending bias in favor of SOEs is in part a policy choice the authorities have made to commit massive financial resources to the state sector and in part it is rooted in the way the Chinese financial institutions operate. Until 1998, the four big state-owned commercial banks, which control most of the banking assets, were specifically instructed to lend to SOEs only (as well as to FIEs). As an indication, the lending to the non-state firms by the four commercial banks remained a miniscule portion of their loan portfolio. In 1996, of the new loans extended, 3 percent went to urban collective firms and only 0.1 percent went to the purely private enterprises. As a comparison, FIEs accounted for about 3 percent of the new lending from the commercial banks in the same year.

Like bank credits, foreign exchange is a financial resource a firm needs in its production. The special nature of foreign exchange, however, warrants some emphasis here because labor-intensive FDI plays a major role of alleviating the foreign exchange constraints of the private firms. Even more than bank credits, the allocation of foreign exchange has been historically implemented on the basis of the political pecking order in favor of SOEs. Survey data suggest that SOEs have been the overwhelming beneficiaries of an administrative allocation of foreign exchange. According to a study based on 1,966 firms in Jiangsu province, between 1984 and 1988 of 1,890 turnkey projects, SOEs accounted for 934 of them; collective enterprises, 735, and rest by FIEs and private firms. This comparison of absolute numbers of the turnkey projects between SOEs and non-state firms is a bit misleading because SOEs were fewer in number than non-state firms. When measured against the ratio of the SOEs with turnkey importation programs to the entire SOE population, SOEs stood out even more as the beneficiaries. The ratio of firms with turnkey projects to their entire population was 19 percent for the SOEs and only 1.73 percent for the collective firms (He Baoshan, Gu Jirui et al. 1995, pp. 225-227). This policy bias in favor

of SOEs persisted well into the 1990s. According to a 1995 survey, 25 percent of sampled SOEs imported technology from abroad; as did 18.4 percent of collective firms. However, only 12.5 percent of private firms reported having imported technology from abroad.

Statistical evidence: Garment industry

A good place to empirically demonstrate the argument that liquidity and other constraints have motivated Chinese private firms to seek out FDI is garment industry. A number of attributes of garment industry make the industry an appropriate test of our institutional foundation argument. First, the garment firms employ simple technology and production processes. Typically a couple of sewing and knitting machines would be sufficient to start a business. Proprietary assets such as patents and sophisticated organizational and managerial know-how are not defining characteristics of this industry and the rationale for FDI associated with transferring proprietary or firm-specific know-how does not readily apply here. To be sure, there are situations in which brand names are involved but it is important to point out that even in those facilities which involve premium brand names cross-border contract production is both theoretically feasible and is observed empirically.

Second, there is no *a priori* reason why firms would naturally prefer an ownership arrangement to a contractual arrangement. Garment industry is perfectly competitive and those factors that theoretically give rise to hold-up problems and opportunism are absent here. Cross-border contractual arrangements—such as export processing—are widely adopted and have proven successful in raising the export capabilities of host nations. Third, in this industry, as in every other industry in the Chinese economy, the political pecking order in favor of SOEs is present. In particular, firms high on the political pecking order have an advantageous access to a critical resource for successfully engaging in export production—foreign exchange, compared to the lower-tiered firms. If the institutional foundation argument is correct, then one should see a greater appetite for FDI among those lowered-tiered firms on the political pecking order, all else being equal.

FDI in China's garment industry

By 1995, FIEs had already established a formidable position in this industry. FIEs producing garments and fiber products accounted for 61 percent of China's exports and 51 percent of the sales. Foreign firms were the majority shareholders of these FIEs. In 1995, foreign equity share of these FIEs was 63.3 percent on average. FIEs in an affiliated industry, leather and related products, were similarly dominant. In 1995, they accounted for 73.2 percent of the exports and 54.1 percent of the sales. Foreign

equity share of these firms was 63.9 percent.²³ To put these numbers in perspective, in 1995, FIEs exported 49.1 billion yuan of garment products, compared to 28.5 billion yuan by collective firms and 28.6 billion yuan by village enterprises in the same year. (SOEs, in contrast, exported 3.2 billion yuan.)²⁴ Not only do FIEs export more than indigenously-owned firms, they have a far more significant control over exporting channels than did FIEs in the Taiwanese economy in the 1970s, when Taiwan also heavily courted labor-intensive FDI. In 1976, FIEs accounted for 22.1 percent of Taiwanese garment exports, about one-third of export share by the Chinese FIEs (1985).²⁵

Viability of contract production

In garment industry, contract production is eminently viable on theoretical grounds and is widely adopted in actual business practices. Many developing countries relied on contract production to successfully develop their production capabilities and to acquire access to international markets. Referring to cross-border contract production as outward processing (OP), two German economists, Petra Naujoks and Klaus-Dieter Schmidt, studied OP practices in the garment industry and drew the following conclusion: “a subcontractor firm gets the opportunity to climb on a running tandem. The success story of labour-intensive industries in many developing countries cannot be written without OP.”²⁶

In a labor-intensive and technologically-simple industry, subcontracting yields many of the same benefits as equity investments and it is not afflicted with those problems that give rise to hold-up problems and opportunistic behavior, scenarios economists theorize to warrant ownership arrangements. Access to overseas markets and access to technical and managerial know-how accompany this form of cross-border alliances. In some situations, from the point of view of a foreign firm, the benefits of subcontracting can exceed those associated with an equity investment. In an equity investment arrangement, the investor is stuck with one group of managers and workers and this might be undesirable given the fast-changing nature of the garment business. In a contractual arrangement, a contractor often plays off one sub-contractor against another to extract the most favorable conditions.²⁷ The built-in flexibility associated with a contractual arrangement holds a special appeal, especially considering the fact that many of the foreign investing firms in the garment line of business are fairly small. According to Kitty G. Dickson, an expert on garment industry, although contracting entails some loss of control as compared with direct manufacturing, in recent decades, contracting has become more popular and has grown relative to the use of direct manufacturing.²⁸

Several factors mitigate against hold-up problems and opportunistic behavior in this industry. One is when a supplier does breach a contract, the contractor can turn to another supplier relatively

quickly. One prominent characteristic of garment industry is clustering. Small producers tend to congregate. This is true everywhere. In the United States, for example, in the 1970s, 46.7 percent of textile and garment plants were located in Southeast and another 32.4 percent were located in the Mid-Atlantic states.²⁹ Most of the Indian garment makers producing for export are located in a region called Tirupur.³⁰ In China, three southern provinces, Guangdong, Jiangsu and Zhejiang accounted for about half of garment output as of the early 1990s. In Guangdong province alone, there were over 4,000 garment township and village enterprises (TVEs) located only miles away from Hong Kong.

Everywhere outside China, the industry consists of numerous indigenous mom-and-pop operations. In India, most of the garment makers ranged from 5 to 500 workers, competing fiercely with each other. It is a situation as close as one can get to the textbook version of perfect competition. Whereas garment design, especially involving high-fashion garment goods, requires sophisticated know-how and utilizes computer-aided devices, the manufacturing end is low-tech. It uses mature, standard and general-purpose manufacturing technology and capital equipment. Skill requirements are quite low and of a general type. Barring government-imposed restrictions, labor substitution is easy and swift. These characteristics--geographic clustering, the numeracy of firms, and general nature of requisite physical and human capital--have important implications for the nature of firm alliances in this industry. Switching suppliers is costless and no individual reneging garment maker can present much of a "hold-up problem." There is no economically compelling reason why a garment retailer, or a retailer's agent or a designer or a downstream manufacturer has to vertically integrate backward. According to Pankaj Ghemawat and Murali Patibandla, the geographic cluster "improved the flow of information about export markets and how to serve them, reduced fears about buyer/supplier holdup that might prevail in smaller number situations, and facilitated organized cooperative efforts in areas such as lobbying the government for infrastructure." (Ghemawat and Patibandla 1999)

The organization of the industry is one mitigating factor against the theoretically derived "contract problems"; another factor is that contracting parties in this business have developed a set of long-standing practices to carefully manage relationships with suppliers and to minimize the effects of voluntary or involuntary contractual breach. A buyer typically does not book 100 percent capacity of a supplier; instead he distributes the order among a number of suppliers. In that case, if one supplier does not deliver, the supply disruption will be minimized. Furthermore, a buyer goes to a stable network of suppliers on a long-term basis. Reputational effects and repeated interactions would deter attempts to seek gains from engaging in short-term opportunism. The buyer/supplier practices in this business offer comfort not only to buyers but also to suppliers. Because fashions change quickly and often

unpredictably, to minimize risks to suppliers, a buyer offers a mixture of fashion goods—say 30 percent—and staple goods (70 percent). That way, if fashion style changes suddenly, the financial costs to each supplier would be less as the costs would be shared among a group of suppliers.³¹

For all these reasons, garment buyers have no compelling reasons to shun contract production systematically in favor of ownership production. The choice between direct manufacturing and contractual sourcing will depend on conditions specific to a firm making such a decision. One indication of the prevalence of contract production is that it is even widespread in structuring buyer/supplier relations involving highly branded products as well. Levi is one of the best known brands in the garment industry in the world.³² Even for a firm with such a premium brand, in 1993 contractor sourcing accounted for more than 50 percent of its global output that bears its name (Katz 1997).³³

Cross-border subcontracting in the garment industry not only serves the interests of contracting foreign firms but also producers in the host countries. A number of countries have gained capabilities and market access on the basis of subcontracting with foreign buyers, proving that equity arrangement is not the only viable method to develop export capabilities. Two countries, Turkey and India, have successfully developed competitive garment exports mainly on the basis of subcontracting with foreign buyers. In 1995, Turkey dislodged China as the number one garment exporter to European Union. As typical in other developing countries, several thousands of small firms dot the Turkish garment industry. Most of them are family-owned and are small. They do not perform design work but they bid on designs on an extremely competitive basis. These designs are usually accompanied by detailed specifications and standards provided by the large retailers in Europe and the United States.³⁴ Between the late 1980s and the mid-1990s, in rupee terms, Indian garment exports grew at an annual average rate of 26 percent. Seventy percent of India's exports of cotton knitwear are accounted for by hundreds of indigenous firms, which range considerably in size, from five workers to 500. A typical exporter operates through a network of 10 to 20 subcontractors, each with an average size varying from 20 to 50 machines. The advantages of this arrangement are the built-in flexibility in handling large and small orders, low overhead costs and sharing of capital costs among numerous producers.³⁵

Political pecking order in garment industry

In China, garment industry is one of the few industries private entrepreneurs can enter into relatively freely. The important success factors in this industry are attentions to details, flexibility in production organization and operation, on-time delivery so as to suit different fashion trends or to seasonal needs. These are the kind of attributes best suited to small private firms but even in this industry

in which private firms possess a clear competitive edge over SOEs, the political pecking order works against them. The most systematic form of discrimination has to do with allocation of foreign exchange. Research on Taiwanese garment exports shows that imported inputs constituted 70 percent of the production costs (Scott 1979, p. 358). For a firm to successfully engage in export production, it needs to have access to foreign exchange to purchase the exact types of fibers and cloth to meet the design and textural specifications of the foreign buyer at a low cost. The firm may also need to import machinery and equipment from abroad to fulfill an export contract.

Until recently, most of the non-state firms were not allowed to export directly and they had to go through the state-owned trading corporations. (FIEs, on the other hand, are granted automatic trading licenses within their own lines of business.) This is one of the most persistent complaints voiced by Chinese garment producers, as a report by the Office of International Trade Administration of the US Department of Commerce noted.³⁶ The requirement to export through state-owned foreign trade intermediaries is highly unfavorable to the small garment producers. First, the indirect trading system deprives them of access to market, fashion and production process information that is critical to a garment producer. Fashions and market conditions change quickly in this business and just-in-time access to information is vital. Second, the garment producers were paid in RMB, not in foreign exchange. Since during much of the reform era, foreign exchange was rationed by government bureaucracy to support import-substituting SOEs, private garment producers could not access foreign exchange even though they generated much of the foreign exchange earnings. Third, under the Chinese foreign exchange regulations, only those firms authorized to engage in foreign trade can open foreign exchange accounts at banks. This means that even if non-state garment producers can get hold of foreign exchange somehow, it would be very difficult for them to keep it. This was costly. During much of the 1980s and 1990s, the Chinese currency was over-valued. Thus non-state firms took a loss each time when they converted foreign exchange into RMB, rather than retaining it in a bank account.

The extent of distortions in China's foreign exchange allocation in the garment industry can be demonstrated by comparing the share of non-state firms in export production with the number of non-state firms formally authorized to market their products directly to foreign buyers. In 1991, TVEs accounted for 77.45 percent of garment exports. But in 1992, out of tens of thousands of TVE garment makers, only 20 of them were allowed to trade directly with foreign firms. In 1993, the number was increased to 156. But in Guangdong province alone, there were 4,214 TVEs producing garments engaged in export production to varying degrees. In comparison, over 300 SOEs were permitted to trade directly with foreign firms despite the fact that they accounted for a tiny share of garment exports. In 1995, SOEs

exported 3 billion yuan of their output whereas TVEs exported ten times as much, 26.27 billion yuan.³⁷ Note that TVEs occupied a higher position on China's political pecking order than private enterprises and in all likelihood, purely private firms fared even worse than TVEs. Until 1999, private firms were categorically banned from exporting directly.³⁸

Statistical evidence

In this section, we attempt to demonstrate the effect of political pecking order on Chinese preferences for FDI. According to the institutional foundation argument, lowered-tiered Chinese firms on the political pecking order ought to exhibit a greater preference for FDI than higher-tiered firms, all else being equal. This section tests this hypothesis directly. In this paper, FDI preference is operationalized as the foreign equity share of a joint venture. The idea is that a Chinese shareholding firm has a higher demand for FDI if it is more willing to accept more foreign controls. For example, a liquidity-constrained private firm may be more willing to accept a large foreign equity stake because it has no other financing recourse. A more privileged firm may need foreign equity financing less because it can borrow from a bank.³⁹ In international business studies, equity ownership splits are often used to study the bargaining dynamics between foreign and domestic firms and it is possible to formulate our institutional foundation argument in bargaining power terms. Essentially, a private firm is less powerful vis-à-vis a foreign firm as compared to a more statist firm and can be more inclined to accept more foreign controls when it co-finances a joint venture with a foreign firm, all else being equal.⁴⁰

The database is supplied by the Chinese State Statistical Bureau (China Statistics Consultants 1998). The government compiled the database—henceforth FIE database—as a part of its 1995 industry census. The FIE database contains data on *all the industrial* FIEs established in China as of December 31, 1995.⁴¹ Although it does not have a large number of variables, the FIE database contains a few key performance and balance sheet variables such as sales revenue, export sales, pre-tax profits, employment, fixed assets, foreign-domestic equity breakdowns, paid-in capital, and, very importantly for this paper, the administrative classifications of the Chinese shareholding firms.

Our research strategy entails two steps. First, it is necessary to control those business or economic factors that international business scholars have hypothesized to influence foreign ownership controls. Second, once these business influences are identified and appropriate controls are imposed, we can test the institutional foundation argument by correlating the standings of Chinese shareholding firms on the political pecking order with their FDI preferences.

The standard perspective among scholars of international business studies is that technological and organizational know-how, proprietary assets, controls of market channels lead to greater foreign ownership controls. Here the selection of the garment industry helps control for a number of these factors by research design. Because garment industry does not involve sophisticated technology and proprietary assets, any variance in the foreign ownership controls would be independent of these factors. Probably, the most important factor that increases foreign bargaining power in the case of garment FDI would be foreign controls of marketing. Fortunately, our database contains how much each firm exports and we use the ratio of export to sales revenue as a measure of foreign marketing power. One can also argue that organizational know-how may also bear on the extent of foreign ownership controls. We use two variables as proxies of foreign organizational know-how. One is the capital intensity of FIEs and the other is the size of the FIE employment. The underlying idea here is that when an FIE is larger and thus, presumably, more complex to manage, foreign investing firm has a bargaining advantage.

The other factor that needs to be controlled has to do with any differences that may arise from different technological endowments of firms and product variations. Fortunately our research design helps impose controls on these differences. I deliberately choose a very narrow scope of the industry to ensure that both human and physical capital deployed is as homogenous as possible. This is to control for the possible influences of different types of capital equipment and production processes on equity structures of our firms. The data are disaggregated at a four digit Chinese Standard Industry Classification (CSIC) level (1810) and are confined to garment makers using fiber and cotton-based materials. Leather, fur and feather-based clothings are excluded. So are footwear and headgear products. The making of fiber and yarn is excluded. This is a far more disaggregated treatment than many of the studies that use industry characteristics to estimate foreign bargaining power.

The empirical analysis also imposes an additional set of controls. All the FIEs included in the analysis are joint ventures. This is to ensure that the equity structure of these firms is a function of joint negotiations and decisions between foreign and domestic firms. In the business studies literature, there has been a speculation that equity preferences of MNCs vary cross-nationally. American MNCs often demand more equity controls than, say, Japanese MNCs. To control for the country variations in equity preferences, I have limited the FIEs to those with investors from ECEs, i.e., Hong Kong, Taiwan and Macao. The idea is that ethnically Chinese investors may have similar equity preferences.⁴² Another factor that has been hypothesized to influence foreign ownership controls has been the policy environment of the host country. More liberal policy environment is associated with greater foreign ownership controls while a more controlling one is associated with the opposite. To control for any

effects arising from changes of China's FDI regulatory and policy environment, I have limited the FIEs only to those established between 1992 and 1995. During this period, the policy environment was more liberal than in the 1980s and this has an additional benefit of ensuring the outcome we observe was driven by firm-level dynamics, rather than by policy and regulatory constraints. (For garment industry, FDI controls are not a binding constraint as compared with those in, say, automobile industry because garment industry has never been a priority sector for the central government.) Because of these additional controls, the number of firms is reduced to 1,226 as compared to 5,373 firms contained in the FIE database. For this group of firms, the average employment size is 152 persons and the export/sale ratio is 0.486. foreign equity share is just above 50 percent, at 52.2 percent.

Table 2 here.

Table 2 presents data on the possible influences on foreign ownership arising from firm size, capital intensity, and export propensity (as a proxy of foreign marketing controls)—standard variables in business studies literature as influencing foreign ownership. Table 2 divides all the FIEs along three dimensions, their employment size, their asset size per employee, and their export propensity (given by export/sale ratio). The hypothesis is that larger employment size, greater capital intensity, and greater export propensity tend to be associated with greater foreign ownership controls. Large firms and more capital-intensive firms may require more sophisticated managerial and organizational know-how and foreign firms may be in a stronger bargaining position when this type of FIEs is involved. There is no empirical evidence for this hypothesis. Reading down the table, there is no positive correlation between the size of employment and capital intensity on the one hand and foreign equity shares on the other. If anything, the correlation is slightly negative. Foreign equity share is smaller if the average employment size of an FIE is between 108 and 197 persons than if the firm employs between 50 to 108 persons. Only when the firms get extremely large—those with more than 750 persons, does foreign ownership increase substantially, to 0.703, compared to 0.514 at the next lower level (between 197 and 750 employees). The lack of a clear correlation holds when export propensity of FIEs and when regional effects—of being in Guangdong—are controlled for, either in a descriptive or statistical analysis of the data.⁴³

Capital intensity is even a poorer predictor of foreign equity holdings. On average more capital-intensive FIEs seem to exhibit less foreign equity controls, as indicated by the nearly monotonic decrease in the foreign ownership shares as the fixed asset per employee increases in size. The highest foreign equity share is found among the least capital-intensive firms, whereas the smallest foreign equity share is found among FIEs with the highest fixed asset per employee ratio. On export propensity, there is strong support for the standard bargaining perspective that foreign marketing controls increase foreign

bargaining power. When all the FIEs are divided into four categories, those exporting less than 25 percent of their output, those exporting between 25 to 50 percent, those exporting between 50 to 75 percent and those exporting above 75 percent, foreign equity holdings increase monotonically. When an FIE exports less than 25 percent of its output, the average foreign ownership is about 0.447 compared to 0.486 and 0.537 at the next two export levels, respectively. The high exporters, those exporting more than 75 percent, have an average foreign equity holding of 0.605. Clearly, foreign marketing controls have a substantial and positive effect on foreign ownership controls, just as scholars of international business have shown for other countries as well.⁴⁴

Political pecking order is operationalized in two ways. First, the FIE database provides clear information about two ownership types of Chinese shareholders of the FIEs: TVEs and private firms.⁴⁵ This classification is not ideal as village enterprises and private firms are fairly bunched together politically and one would want to see a greater variance in the measure of the political pecking order, for example, by comparing SOE shareholders with private shareholders. But it is also true that TVEs are sufficiently higher-tiered than private firms that it is still possible to test the effect of the political pecking order with the available data.⁴⁶ The second measure is the political hierarchy of the Chinese shareholding firms. In the Chinese system, regardless of ownership types, almost all the firms—including FIEs—are designated to a particular level of government for supervisory purposes. The broadest breakdown is between central and local governments but locally-controlled firms are further broken down into provincial, municipal or county levels, etc. For garment industry, the FIE database classifies all the firms as belonging to six categories of government agencies—provincial level, prefectures, counties, townships and villages, neighborhood committees, and a category called, “other types.” Other-type firms refer to those firms that are not formally affiliated with a government agency. They comprise of two kinds of firms. One consists of privately-controlled shareholding enterprises (such as a proprietorship or a partnership); the other consists of those privately-operated enterprises with more than eight hired employees.

The Chinese political system consists of five hierarchical levels: Central government, provincial government, prefecture, county, and township. Below township, there is another layer of administration that performs some quasi-governmental functions but it is not itself a part of the governmental apparatus. It is called a neighborhood committee in urban areas and village committee in the countryside. They operate more or less as self-appointed community councils rather than being a formal part of bureaucracy. The functionaries of these committees are not paid out of the government budget and therefore are not classified as government officials formally. Because the Chinese political system is

strictly unitary, it is a plausible conjecture that firms run by provincial and county governments are higher-tiered than firms at the neighborhood level and firms with no governmental affiliation. This ranking has practical economic implications. Chinese banks often demand credit guarantees or sizable collateral assets, the kind of things a government agency sometimes provides. In China's highly politicized environment, an affiliation with a higher level government opens business doors and contacts more effectively than an affiliation with a lower level. Firms without any bureaucratic affiliation are probably the most disadvantaged as their legitimacy is often questioned; their access to formal capital market is denied, and, most importantly, they are more easily predated by bureaucrats. The value of the bureaucratic affiliation is demonstrated by the fact that private entrepreneurs are often willing to pay a substantial amount of money to stave off bureaucratic predation—strangely termed as “management fees”—to acquire just such an affiliation.

Table 3 about here.

Table 4 about here.

Table 3 and Table 4 present foreign equity shares of firms broken down in several ways. Several controls are imposed. First, as export/sale ratios have shown to exert strong influences on foreign equity shares, it is necessary to compare FDI preferences among FIEs with a similar level of export orientation. Table 3 breaks down all the FIEs in four ways, high exporters with an export/sale ratio in excess of 75 percent and low exporters with an export/sale ratio less than 25 percent and two categories in between. Second, because the large investment projects are reviewed by government more closely than smaller projects, it is possible that the large investment projects are subject to greater bureaucratic control, which may influence foreign equity shares. In order to minimize this bureaucratic attention effect, all the FIEs in Table 3 and Table 4 are classified as “small firms” in the Chinese statistical reporting.⁴⁷ Again all the FIEs are joint ventures and all the foreign shareholders are based in ECEs.

Table 3 provides strong evidence in support of our institutional foundation argument. At a given level of export orientation and firm size, a private firm makes a far greater equity concession to a foreign firm in creating a joint venture as compared with a TVE. For example, if a FIE affiliated with a TVE is a high exporter, i.e., with an export/sale ratio in excess of 75 percent, the average foreign equity stake of this FIE amounts to 65.3 percent. But for a similarly situated FIE in export orientation, but with an affiliation with a private firm, the foreign equity stake was 92.1 percent. This differential persists throughout all the values of export/sale ratios.

Table 4 is also broadly consistent out our institutional foundation argument but the statistical pattern is less clear cut. The political pecking order runs from top to bottom in Table 4, with firms at the

top of the table being the more politically privileged than the firms at the bottom of the table. In general, firms at the bottom tiers of the table, neighborhood level and private firms, exhibit larger foreign equity stakes than firms at the top of the table. However, this negative correlation between political pecking order and foreign equity stakes seems to hold true only for high exporters, with export/sale ratio in excess of 75 percent, but not for low exporters (i.e., those firms that export less than 25 percent of their output). But this finding is consistent with our hypothesis that foreign exchange constraints, which afflict export-oriented private firms most severely, are an important driver of FDI preferences.

Conclusion

In many ways, the Chinese economic miracle in the last twenty years happened in a most paradoxical fashion: Its economy took off but none of the indigenous Chinese firms did. The political pecking order of firms has been the main contributor to this outcome. It systematically rewards innately inefficient SOEs while constraining the growth prospects of efficient private firms. The result is across-the-board uncompetitiveness at the firm level. That Chinese economy was able to grow despite its massive institutional imperfections is a function of three things. First, the political pecking order is gradually being eased because of the reforms. Second, China still is a large agrarian economy, which means that the agricultural sector is able to supply surplus labor to fuel the growth of the non-state sector as an input.⁴⁸ Third, it is simply lucky in that it is situated close to Hong Kong, Macao and Taiwan, sources of footloose capital that has funded the much-maligned private firms in China. (The labor-intensive FDI story here complements the explanation provided by (Sachs 1994), which does not address how the capital demands of non-state firms have been met.)

Although the effect is efficient, at its core, what labor-intensive FDI has done is to offset some of the massive inefficiencies in the Chinese system. By this logic, we must assess the contribution of labor-intensive FDI in more realistic terms. Its contribution to the Chinese economy is fundamentally ameliorative, not additive. The econometric findings that FDI has promoted Chinese exports must be interpreted appropriately by recognizing that FDI's contributions to export growth are predicated on a systematic suppression of the potentials of the indigenous private firms to make the same contribution.⁴⁹ FIEs have created exports but they have also diverted exports from indigenous Chinese firms, which have succumbed to controls of ECE firms because of an ideologically-induced liquidity constraint. In the 1990s, export growth has not risen nearly as fast as rising control by FIEs of Chinese export production. Between 1990 and 1997, export/GDP ratio rose from from 15 to 20 percent, a rise of 5 percent. During the same period of time, FIEs' shares of Chinese exports rose from 15 percent to 40 percent, an increase

of 25 percent. That FIEs' share of China's exports has risen much faster than China's overall export levels is *prima facie* evidence that FIEs have both created exports and diverted exports from Chinese-owned firms at the same time.

In many parts of the world and in China nowadays, extravagant claims are made about the benefits of globalization and cross-border capital flows. In the 1990s, relative to the scope and pace of internal reforms, Chinese government has pushed ahead external reforms aggressively. China's decision to accept far-reaching, across-the-board accession terms of the World Trade Organization (WTO) is a telling indication of government's reform agenda. According to press reports, one of the important considerations behind the WTO decision was to stem the contractionary trend of FDI inflows in the last two years.

Our analysis shows that China's reform priorities are fundamentally wrong. By a number of conventional measures, China's economy in fact is quite open. The extent of China's dependency on FDI is in fact extraordinarily high already. Not only is the absolute size of FDI large, its relative size—measured by FDI/capital formation ratio—surpassed that of many countries in the world. Between 1994 and 1997, on average, China's FDI/capital formation ratio was 14.6 percent, compared to Mexico's 15.3 percent, Hong Kong's 10.2 percent, Brazil's 5.3 percent, and Malaysia's 14.1 percent.⁵⁰ The FDI dependency occurred despite the fact that China has one of the world's highest savings rate and is one of the world's largest net capital exporters.⁵¹ As officials at all levels of the government eagerly court foreign investors, domestic investors face a multitude of barriers. Ideological barriers against private entrepreneurs are one example; the other is local protectionism. In all likelihood, it is easier for a foreign investor to invest in China than for a Chinese firm to invest in another province within China. As evidence, according to a 1994 World Bank study, foreign investment, as measured by ratios to capital formation, was several multiples of similarly-measured inward investments from other provinces for Guangdong, Liaoning and Beijing or was equal in size as other-provincial investments for Shaanxi and Sichuan.⁵² China's problem is not that it does not have enough FDI but that its massive internal inefficiencies are not being addressed.

Our analysis illuminates why the leadership believes that China's economic growth is highly sensitive to FDI flows. In a nutshell, the government systematically suppresses domestic entrepreneurship with its left hand (or with its "left wing," as a more ideologically appropriate metaphor), which increases pressures on its right hand to import foreign entrepreneurship *en mass* in order to maintain a given economic growth rate. As our stylized equation shows, at any given level of

foreign entrepreneurship, suppressing Chinese entrepreneurship would increase relative competitiveness of foreign firms and hence would increase volume of FDI inflows.

Finally, it is high time to assess the benefits and costs of China's reform strategy. The political pecking order has been eased but the pace has been tepid and it is questionable whether the government can give up this pecking order completely without giving up its ideological commitment to socialism. Some researchers have offered a political rationale for China's reform strategy. According to a noted formulation, Chinese reform has been "Pareto-optimal" in that it has created winners without creating losers (Lau, Qian et al. 2000). It is worth noting that this way of conceptualizing Chinese reforms in part depends on limiting the analysis to "overt" losers. The fact is that there are many "implicit" losers. These losers are private entrepreneurs, who have foregone profitable growth opportunities and forsaken controls over their own businesses, most likely at disadvantageous terms. Purely in financial terms there is no reason why these foregone benefits should be less worthy than the actual losses incurred.

Table 1 Ownership taxonomy of Chinese industrial enterprises, 1994 and 1998

	Percentage shares of total industrial output value by enterprise ownership (%)		Number of enterprises (10,000 units)	
	1994	1998	1994	1998
State-controlled firms	37.3	28.2	10.22	6.47
Collective firms	37.7	38.4	186.3	179.8
Individually-owned firms	10.1	17.1	800.7	603.38
Private firms	1.15	0.22	0.99	1.18
Privately-controlled shareholding enterprises	4.23	7.78	0.46	1.14
FIEs	9.47	14.9	3.00	6.25

Notes: State-controlled firms refer to traditional SOEs and state-controlled shareholding corporations. The Chinese Statistical Yearbook 1999 does not provide data on private firms directly; it provides, instead, data on “enterprises of other types.” Under “enterprises of other types,” data are given for shareholding cooperatives and FIEs. In the explanatory notes, the statistical yearbook defines “enterprises of other types” as encompassing private and jointly-owned enterprises as well as shareholding cooperatives and FIEs. Thus data on private and jointly-owned enterprises are derived as a residual of enterprises of other types minus shareholding cooperatives and FIEs. In the table, private and jointly-owned enterprises are grouped together under private firms.

Source: (State Statistical Bureau 1999).

Table 2 Foreign Equity Shares, Employment Size, Capital Intensity, and Export Propensity in the Chinese Garment Industry, 1992-1995

Employment size (employees)	Foreign equity shares	Number of firms	Fixed asset per employee (10,000 yuan)	Foreign equity shares	Number of firms	Export/sale ratio	Foreign equity shares	Number of firms
Less than or equal to 50	0.528	256	Less than 1.034	0.535	306	Less than 0.25.	0.447	561
Between 50 and up to 108	0.525	338	Between 1.034 and 1.809	0.526	302	Between 0.25 and 0.5.	0.486	56
Between 108 and up to 197	0.516	318	Between 1.809 and 3.328	0.506	306	Between 0.5 and 0.75.	0.537	72
Between 197 and up to 750	0.514	304	Between 3.328 and 20.14	0.526	295	More than 0.75.	0.605	535
More than 750	0.703	10	More than 20.14	0.392	16			

Note: All the FIEs are joint ventures and are limited to those investors from Hong Kong, Macao and Taiwan. All these joint ventures were established between 1992 and 1995.

Table 3 Ownership Hierarchy and Foreign Equity Shares, 1992-1995

Export/sale ratios	Chinese shareholder = Township and village enterprises	Number of firms	Chinese shareholder = Private firms, etc.	Number of firms
Export/sale ratio<0.25	0.495	179	0.787	179
0.25<export/sale ratio<=0.5	0.491	20	0.818	11
0.5<export/sale ratio<=0.75	0.553	33	0.796	18
0.75<export/sale ratio<=1.00	0.653	291	0.921	295

Note: All the FIEs are joint ventures and are limited to investors from Hong Kong, Taiwan and Macao. These are small firms as classified in the Chinese industry classification. The FIE database does not explicitly categorize firms as “private firms.” Instead, it labels certain firms as “other types.” Per explanations provided by the SSB officials, “other types” refer to those private firms or privately-controlled firms without a significant governmental affiliation.

Table 4 Political Hierarchy of Firms and Equity Structures of FIEs

	High exporters: Export/sale ratio > 0.75	Low exporters: Export/sale ratios <=0.25
Political hierarchy	Foreign equity shares	Foreign equity shares
Provincial level	0.408	0.418
Prefectural level	0.586	0.426
County level	0.623	0.439
Township and village level	0.559	0.451
Neighborhood level	0.731	0.607
Private firms, etc.	0.686	0.417

Note: FIEs are limited to JVs only, to those established since 1991 and to those with foreign investors from Hong Kong, Macau, and Taiwan. All the FIEs are classified as small firms in the Chinese statistical classification. The FIE database does not explicitly categorize firms as “private firms.” Instead, it labels certain firms as “other types.” Per explanations provided by the SSB officials, “other types” refer to those private firms or privately-controlled firms without a significant governmental affiliation.

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Notes

¹ Just to make sure, China bans investments in casinos and therefore Macao's large investment position cannot be attributed to this source of its competitive advantage.

² Calculated from data provided in (Ministry of Foreign Trade and Economic Cooperation 1995, pp. 647-648).

³ The argument of this paper is based on an ongoing book project I am engaged in. In this book project, I examine the institutional origins of both labor-intensive, export-oriented FDI as well as capital-intensive FDI destined to domestic markets. The book is tentatively entitled, (Huang 2000).

⁴ The so-called industrial organization theory of FDI is commonly attributed to (Hymer 1976). See (Caves 1996) for a recent summary of the developments in this field.

⁵ See (Klein 1978).

⁶ Statistical Yearbooks for Fujian and Guangdong, various issues.

⁷ (Hymer 1970, p. 443).

⁸ (Leung, Thoburn et al. 1991, pp. 285-286) explains this phenomenon this way: "Many Chinese partners whom we have interviewed pledged never to probe the source of export custom of their Hong Kong counterpart. This is sometimes done with such conviction that, knowing the crucial role of export orders if they ever wanted to by-pass the Hong Kong side and export goods themselves, they seemingly wanted to assure their Hong Kong partner of a long-term, or even permanent, role in this cooperative relation. "

⁹ Their findings suggest that on average the level of technology as embodied in the FDI was two years ahead of China's existing level even though the "technology gap" between investing countries and China was commonly perceived to be 20 years. The "technology package" was in most cases incomplete, meaning that the package includes only one or two of the three components of what constitutes a complete technology transfer -- product, process and organizational technology. Less than 25 percent of the technology transfer projects incorporated all three components. See (Young and Lan 1997).

¹⁰ Data on handicraft and herbal medicine are from (Office of Third Industrial Census 1997).

¹¹ Notice that this is the standard perspective on FDI and is an approach commonly known as industrial organization theory of FDI in economics.

¹² Standard accounts of FDI, however have been entirely devoted to studying how strong foreign entrepreneurship leads to high FDI. Since the FDI incidence depends on the relative competitiveness of a foreign entrepreneur vis-à-vis a domestic entrepreneur, the standard analysis of FDI does not go into an in-depth analysis of why native entrepreneurs are lacking. As long as foreign entrepreneurs hold an advantage relative to domestic entrepreneurs FDI is likely to occur. Whether the competitive differentials are a result of a high numerator (foreign competitiveness) or a result of a low denominator (domestic competitiveness) is irrelevant to the substantive claim of

the IO argument. Furthermore, it is generally assumed that supply of entrepreneurship is low in developing countries any way. After all, isn't this the reason why they are—and remain—developing countries in the first place?

¹³ See (Huang 2000). In addition, there is another dynamic that will cause FDI to rise. SOEs are nearly insolvent despite their favorable treatments. The insolvency of the SOEs is a familiar story. What is not familiar is the fact that SOEs have built up a potentially valuable asset base during the reform era. On top of a good asset base, SOEs have generated a thin or close to negative cashflow, rendering them potential acquisition targets. The poor performance of SOEs and mounting financial burdens on the state budget increased demand for privatization measures—those measures that transferred corporate controls from government to private entities. Here is the relevant function of FDI. Because FDI is an ownership arrangement, each FDI project results in a change in the ownership of invested SOEs. Much of the domestically-oriented FDI—mainly in capital-intensive industries—has not gone toward financing creation of new capacity but toward financing acquisition of existing assets, mainly from state-owned enterprises (SOEs). Thus each FDI transaction, in essence, is a *de facto* privatization story. But this is not the end of the story. A legitimate question arises as to why *foreign* firms should have played a disproportionate role in China's *de facto* privatization drive. The political pecking order of firms plays a role here. Because the government explicitly shuns a privatization stance and has historically restrained private sector from growing big, private firms are not viable competitors to buy the assets in the hands of SOEs. The only viable acquirers end up being foreign firms. FDI rises on this account.

¹⁴ See, for example, (Naughton 1996) for a standard account of Chinese reforms.

¹⁵ (Qian 1996) deals with some of the complications in enterprise classifications in China.

¹⁶ In 1998, industrial collective firms accounted for about 53.5 percent of the gross industrial output value of the non-state sector.

¹⁷ There are no proxy voting procedures, which puts individual shareholders in a disadvantageous position vis-à-vis the institutional investors such as a government agency. This usurpation of the rightful shareholder power is direct evidence that the state harbors no intention of relinquishing its control rights even over those firms that have been partially privatized.

¹⁸ The distinction between an individually-owned enterprise and a privately-owned enterprise is that the former does have hired labor while the latter does. Technically speaking, an individually-owned enterprise is defined as self-employed business with no more than eight hired employees. A privately-operated firm has more than eight employees and as such is considered more ideologically suspect. That the Chinese state chose the number eight to distinguish between an ideologically acceptable private firm and an ideologically suspect private firm is a testimony of the degree to which the Chinese regime is still committed to communism as an ideology. The number came from a hypothetical example which Karl Marx used in Das Kapital to illustrate how capital owners could extract surplus value from hired labor. For a detailed illustration of ideological commitment by the Chinese state, see (Huang 2000).

¹⁹ In 1994, private firms accounted for 1.15 percent but the decline is most likely due to legal re-registration by private firms into shareholding enterprises.

²⁰ The text of 1982 Constitution and the 1988 amendment is found in (1994).

²¹ See (Anonymous 1999).

²² The phenomenon of a lending bias on the part of the Chinese banking system in favor of SOEs has been widely documented. See (McKinnon 1994) and (Lardy 1998).

²³ (State Statistical Bureau 1996).

²⁴ The 1995 data come from (Office of Third Industrial Census 1997).

²⁵ It should be noted that the fact that Chinese FIEs account for a greater share of garment exports than Taiwanese FIEs is not because of their greater export orientation. In fact, Taiwanese garment FIEs were more export-oriented than Chinese FIEs. On average, export/sale ratio for the Taiwanese garment FIEs was 83.7 percent, compared to 71.7 percent for the Chinese FIEs.

²⁶ [Naujoks, 1994 #2166].

²⁷ [Naujoks, 1994 #2166].

²⁸ [Dickerson, 1999 #2167].

²⁹ Exhibit 10 from [Yoffie, 1990 #2168].

³⁰ See (Ghemawat and Patibandla 1999).

³¹ For a fascinating insight into how sourcing operations in garment business work in practice, see a HBS case study and an interview with Victor Fung in Harvard Business Review. Fung is the CEO of Li & Fung, Hong Kong's largest export trading company. In this interview, Fung describes the operation of a "virtual supply chain" across the globe and some of the specific practices the firm uses to ensure on-time delivery of quality products. For details, see [Magretta, 1998 #2169].

³² Levi, according to the vice president for corporate marketing, epitomized "freedom, originality, youthfulness and the spirit of America." Levi jeans are included in the permanent collection of the Smithsonian Institute. One study valued Levi brand at \$4.8 billion, the top apparel brand in the world. Levi jeans are market leaders everywhere they are sold.

³³ Other brand-name firms also rely heavily on outsourcing. OshKosh, a specialist in children clothes, sourced from between 30 and 50 "captive contractors" worldwide. Hagggar Clothing Co, another high-brand producer, also sources heavily from facilities worldwide in addition to its directly-owned facilities in Dominican Republic and Mexico. See [Mona, 1998 #2170] and [Winger, 1998 #2171].

³⁴ Amidst this group of firms, a few have become very large and they are now able to do their own design work. They have invested heavily in automation and they reduce the average age of their capital stock from twelve years in the early 1990s to five years in 1995. They are active participants in the major European trade shows. One firm, IPAS, directly contracts with Marks and Spencer and Tom Hilfiger. These large firms have begun to outsource

labor-intensive components of their production in East Europe by entering subcontracting arrangements with producers there. For information on Turkish garment industry, see [Ghemawat, 1998 #2172].

³⁵ A study of Indian garment industry can be found in (Ghemawat and Patibandla 1999).

³⁶ As the report says, “Garment producers frequently complained that China’s indirect trading system, which forces garment sales to pass through authorized trading companies, distanced producers from their buyers and their markets. While a number of structural reforms have expanded the number of trading corporations authorized to conduct the garment trade, this limitation continues to inhibit the rapid transmission of market information to China’s producers. See (International Trade Administration 1993).

³⁷ Data are reported in (Office of Third Industrial Census 1997).

³⁸ Jean Oi, a political scientist at Stanford, documented instances in which township and village officials derisively referred to private firms as “underground snakes.” See (Oi 1999).

³⁹ Ideally, a direct demonstration of our institutional foundation hypothesis would be to illustrate liquidity and regulatory constraints as parameters influencing Chinese firms’ decisions between going into an equity arrangement and a subcontracting arrangement, both with a foreign firm. However, subcontracting data are simply not available.

⁴⁰ The measure is not perfect as foreign and domestic firms can bargain about other things, but the advantage is also obvious. For one thing, data are more available and research does show that firms do bargain very hard about equity shares in an enterprise. The other advantage is unique to this paper: Because the product and investing firms are homogenous by research design, many of the extraneous influences on equity preferences are minimized. Ideally, one should collect information on all terms of arrangement, not just ownership splits. For a discussion of the problems of using this measure, see (Fagre and Wells 1982). For a number of applications of using foreign equity ownership, see (Krobin 1987) and (Gomes-Casseres 1990).

⁴¹ The FIE database here contains data at the firm level whereas the published versions are either at an industry or regional level (presumably aggregated over the firm-level data contained in this database). As such, this database presents the most detailed and most disaggregated depiction of FIEs to date.

⁴² It would be ideal to further divide this group of investors but data of further disaggregation are unavailable.

⁴³ Results from statistical analysis are presented in (Huang 2000).

⁴⁴ One can argue that this correlation is merely spurious. For example, it is possible that greater export propensity and high foreign ownership reflect the fact that these firms are merely more internationally oriented. I am unable to resolve the causal ambiguity and to illustrate the institutional foundation argument it is not necessary to resolve this issue definitively. All that is needed is to control for the export propensity of FIEs when one assesses the effect of the political pecking order so that one does not attribute an export effect to ownership treatments of firms.

⁴⁵ The database does not contain a category of firms called private firms; it labels a group of firms as “other types.” Several conversations with officials from the State Statistical Bureau clarified this labeling. According to SSB, in the 1995 industry census, “other firms” refer to two types of firms, privately-controlled shareholding firms and private firms that are not closely affiliated with a government agency. As such, other-type firms are at the lowest rung of the political pecking order.

⁴⁶ Jean Oi, for example, presents data showing that in 1995 joint and private firms received 14.6 percent of total loans for the non-state sector, compared to 60.6 percent for township firms and 24.9 percent for village firms, despite the fact that private firms are more profitable. See (Oi 1999).

⁴⁷ Firm size is determined on the basis of industry-specific criteria. The usual criteria include the size of fixed asset and physical output capacity.

⁴⁸ For more analysis along this line, see (Sachs 1994)

⁴⁹ (Wei 1996) has shown positive contributions of FDI to China’s export growth.

⁵⁰ The data are reported in (United Nations Centre on Transnational Corporations 1998).

⁵¹ The institutional foundation argument explains why China generates a surplus both on its current and its capital accounts, a rather unusual pattern for a developing country. Basically, the large export surplus is denied to private firms, which need foreign exchange. Instead, private firms satisfy their foreign exchange demand by ceding their equity claims to foreigners, leading to an accumulation of foreign holding of Chinese assets—a credit item in the capital account. Both developments lead to an accumulation of foreign exchange reserves.

⁵² See (World Bank 1994). Other factoids are just as revealing. The largest and the most profitable automobile firm in China, Shanghai Automotive Industry Corporation, does not have single facility outside Shanghai. The immobility of domestic capital increases foreign relative competitiveness as foreign firms are not constrained by local protectionism and foreign firms can choose projects from the entire country while a domestic firm can only choose projects within a province. For more details of this argument, see (Huang 2000).



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