

Historical Attitudes and Implications for path dependence:
FDI development and Institutional changes in China

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Historical Attitudes and Implications for path dependence: FDI development and Institutional changes in China¹

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Abstract:

This paper attempts to explain how institutions in the reform era of China have evolved by looking into the FDI policies and regulations. As history matters, we don't look solely into the previous direct stage to the reform era, and rather look into a longer history starting from prior to the 14th century. The study shows that a dimension of time is crucial to understand institutional change in China. Though the initiation of the open-door policy in the reform era is commonly regarded as path-break event, we claim that this institutional change is a path dependent event from a longer historical view. The path takes a zigzag that is shaped by interaction among interested parties: the central government, local governments and economic agents (foreign investors in terms of the open-door policies). The historical study shows that mutual needs and their behaviours influence their attitudes which further influence institutional building. This also further implies how Chinese institutions may evolve in the future and what we should concern more about institutional changes in transitional economies.

¹ This paper is part of the research project "MNCs' strategies: authority sharing by co-evolution" in the research program "Shifts in governance: local states and private networks in China" sponsored by the Netherlands Organization for Scientific Research (NWO).

1. Introduction

China is a success story of economic reform². From 1978 to 2003, the average annual growth rate of China's real GDP reached 9.4%, outperforming away other socialist countries in transition. This development was accompanied by China's integrating into the global market. Its overall share in world trade has increased from less than 1 percent in 1979 to about 6 percent in 2003³, which demonstrates that China has become an important actor in the international economy. This achievement can be ascribed to two hands: the liberalization of the economic systems and FDI. It is claimed that foreign direct investment (FDI) has played an important part in driving China's economic transformation over the last 20 years⁴, by adding to capital formation, stimulating upgrading of total factor productivity, creating positive spillover effects to domestic enterprises, as well as creating employment opportunities⁵. The precondition of these contributions is the inflow of FDI to China. China is now the largest recipient of FDI in the world. It is interesting enough to investigate how China, previously rejecting FDI due to ideological collision, has opened its door to FDI which consequently contributes to China's economic development and transformation.

Some studies show that the Chinese leadership learned to enforce the open-door policies, breaking from the direct past. They mainly drew clues from evidence in the period of 1949 to 1978. Though China was to a large degree isolated itself from outside of the world, some foreign investment (e.g. from overseas Chinese or in a way of import substitution) did exist on a experimental base. The leadership learnt from these experiments that foreign investment could be harmless under the proper control. Ideologically, China made a path break in 1978 when the economic reform and open-door policy was initiated. This change is historically of significance,

² Typically, the success of China's economic reform is compared with the relatively unsuccessful reform of Russia, as manifested by Peter Nolan in his 1995 book title "China Rise, Russia Fall". This comparison is often made by outcomes in terms of annual growth rate of GDP. This comparison is extremely revealing before the mid 1990s. In the period of 1990 and 1996, China was growing at an average rate of 10% annually, while Russia was decreasing at an average rate of 7% annually (WDI 2004).

³ Prasad (2004), "China's Growth and Integration into the World Economy: Prospects and Challenges", p.1.

⁴ EIU (2003), Country Profile: China; World Bank (1997b) also claims that FDI has been a main driving force behind in China's economic success

⁵ Tseng and Zebregs (2002) have addressed this issue. They further draw on it the implications for other countries.

not only to China and all Chinese people, but also to the world and foreign investors. To understand this striking initiation and the following changes and achievement, it is not enough to trace back to the previous socialist past in China. Instead, given China's history, a long historical perspective is needed, looking into China's historical attitudes towards foreign participation, which will help us to understand this change much better and richer. Historically, China has experienced different phases in which they treated foreign investment differently, from indifferent to reluctant to hostile and to positive. The historical attitudes show that the institutional change since 1978 is a path break from the previous stage, but not necessarily a break from a long historical perspective. We argue that path dependence or path break has a time dimension in which institutional path shapes a zigzag, which is highly influenced by attitudes of interested parties involved.

The paper is organized as follows: Section 2 gives an overview of FDI development in China and conventional explanations; Section 3 looks into historical attitudes of China towards foreign investment and their influence on policies; Section 4 searches for sources of institutional path in the reform era in terms of FDI-related institutional changes; Section 5 concludes the paper with implication of understanding path dependence in China's economic reform and suggestions for further study.

2. Explanations for FDI development

World Bank claims that FDI is a major driving force behind the economic success in China. In 1990s, China has absorbed about half of the FDI inflows into all developing countries. This is a remarkable achievement, considering that (1) China is a socialist country with institutions that differ from those in developed countries; and (2) there are still many complains about the investment climates.

Due to historical and ideological reasons, explained below, FDI was very limited in China before the economic reform. However, the reform policy, together with the open-door orientation, has changed this significantly. This change takes a gradual process. At the beginning, FDI was attracted as "experimental" reform and confined to certain regions. Gradually, the regulation on FDI has been liberalized, and consequently FDI has been rapidly increased and spread over all

regions. By the end of 2003, 465,277 foreign invested enterprises have been approved to establish, and cumulative contracted FDI value has reached to US \$943.13 billion, of which US \$501.47 billion has been realized⁶. Figure 1 shows the development trend of FDI in China. In the year of 2003, the total realized FDI inflow reached US \$53.5 billion, which is about 30 times the amount in the years of 1979-1982, and 12 times that in the year of 1991. Comparatively, the FDI inflow has been faster in 1990s than in 1980s.

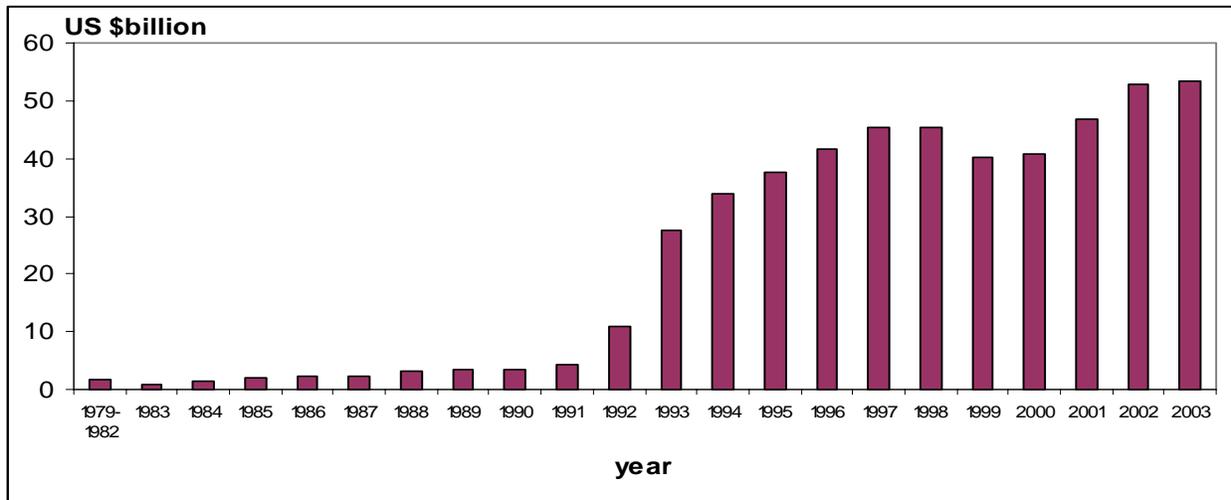


Figure 1 Trend of Realized FDI in China

There are different interpretations for China's success, especially in attracting FDI inflows. One typical interpretation is that China is a large domestic marketplace with a large pool of cheap labour and a rapid growing market. Second, complementary to the above, studies show that increased inflow of FDI is a response to the improving investment climates, especially the improving FDI regimes and legal framework⁷. Third, yet, there is also a contrasting interpretation that increased inflow of FDI may be results of institutional deficits of the Chinese economy⁸. These institutional deficits, nevertheless they may also have negative effects on FDI's

⁶ Data source is China MOC.

⁷ Lardy (1994) and Fu (2000).

⁸ This is argued by Huang (2001). Put it particular, the economic fragmentation in China's economy weakens the bargaining power of China as a whole, and further leads to more than enough favourable conditions for FDI due to locational competition.

contribution to the economy especially when these effects are studied at sub-national level⁹ and industry level¹⁰, led to increasing of FDI inflows due to locational competition. These explanations need to be further clarified.

2.1. Global Trend

The FDI growth in China is not a single case. It is accompanied with or highly influenced by the global trend of FDI development. Figure 2 demonstrates the development of world trade. In the years before 1997, the FDI development in China followed a same trend as that of the world mode and that of other economies. In the years between 1997 and 1999, the FDI development in China followed a same declining trend as that of developing economies, while the global FDI inflows and those into developed economies were increasing. Since the year of 2000, the FDI development follows a complete different pattern. While the world FDI flows and inflows to other economies have been experiencing a decrease, FDI inflows to China have been growing at a rapid rate.

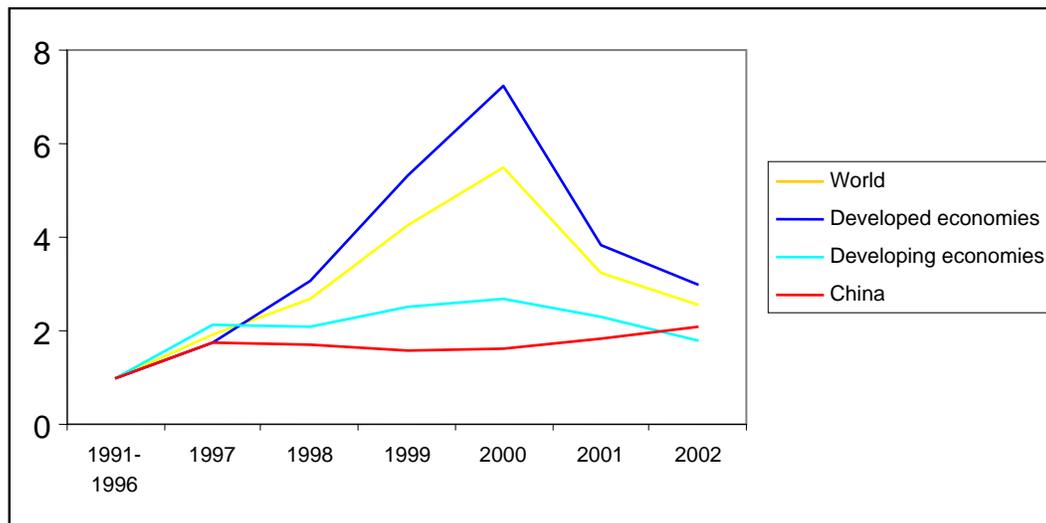


Figure 2 Index of FDI inflows by host region 1991-2002¹¹ (Data source: UNCTAD 2003)

⁹ Braunstein and Epstein (2002) demonstrate that “inward FDI has a relatively *small positive* impact on wages and employment, while having a *negative* impact on domestic investment and tax revenue” at the *provincial level*. (emphasis added).

¹⁰ In auto industry, it has been widely criticized that FDI didn’t lead to more innovation as expected. By recognizing the weakness of the Industry Policy in Auto Sector promulgated in 1994, it was revised in 2004 in order to better capture the spillover effects.

Though the FDI inflows to China are to a certain degree a reflection of the world trend of FDI, the trend in China, especially the high steady growth, can't be explained simply by the world trend. More explanations are needed to answer why FDI or high proportion of world FDI flow into China.

2.2. Economic determinants

Many empirical studies have been oriented to features of China that attract to foreign investors. These studies are categorized into two groups: studies at the national level and those at the regional level¹². Most of these studies are focused on economic determinants, mainly including market size, foreign trade, endowments of labour and infrastructure.

Market size is often measured by GDP or GDP per capita. Rapid economic growth may create large local markets and business opportunities for foreign investors and hence foster their confidence in investing in China or in a region in China. This positive relationship between market size and FDI inflows has been confirmed by empirical studies¹³. These studies also investigate the mutual causality between market size and FDI inflows¹⁴. The GDP development in China is demonstrated in Figure 3. By comparing Figure 1 and Figure 3, it can be seen that FDI inflows to China do follow the similar macroeconomic cycles¹⁵, which proves the causal relationship between these two factors.

¹¹ The calculation of index is on the base of the average annual volume in 1991-1996 at which point the index is equal to 1.

¹² Wei (2003). Studies at the national level answer to the question why foreign investors come to China, and differently, those at the regional level answer to the question why a foreign investor chooses a specific region in China. They tackle some same determinants, i.e. market size, human capital and labour costs, while with some additional factors respectively. Studies at the national level also investigate factors like exchange rate, geographic proximity, cultural and linguistic ties, and regulatory burden. Differently, studies at the regional level have also considered factors such as agglomeration effects, infrastructure and investment incentives.

¹³ Zhang (2000) confirms this by studying US and Hongkong investment in China. Wei, et al (1999) and Wei & Liu (2001) confirm this relationship at the regional level.

¹⁴ E.g. Zhang (1999).

¹⁵ Oppers (1997) analyzes the macroeconomic cycles of China in the period of 1979-1997. In this paper, we further extend the analysis to 2003, while adjusting a little the connection point between cycles.

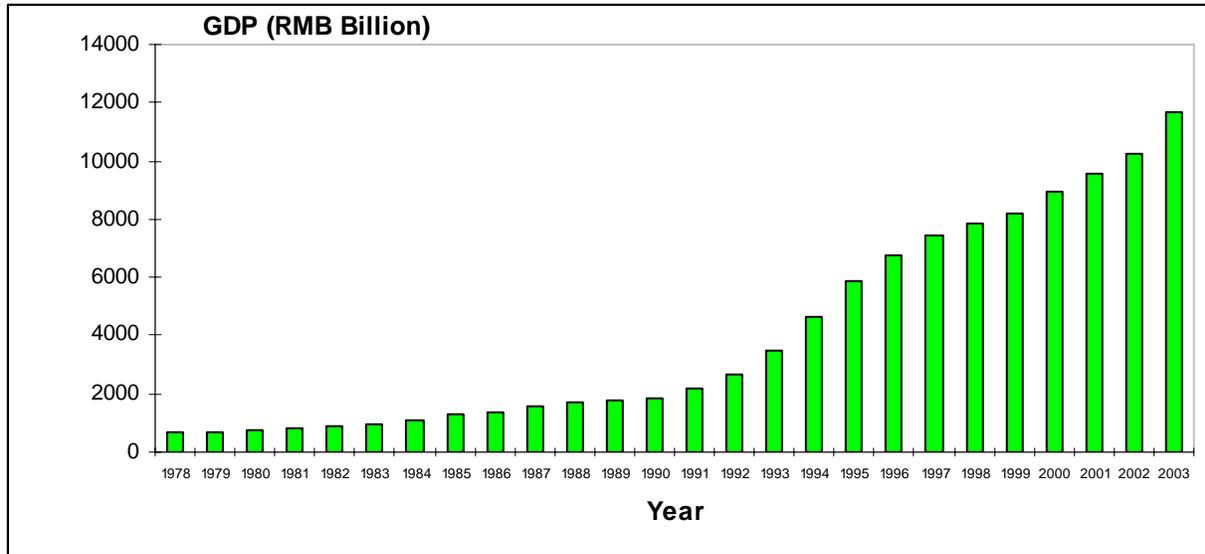


Figure 3 GDP Curve in China 1978-2003

In addition, low labour costs and relatively large export volume also have significant effects on FDI inflows to China¹⁶. Not only labour cost, but also labour quality (or human capital) plays an important role in attracting FDI. High quality of labour (or skilled labour) is a significant determinant of FDI irrespective of its country of origin¹⁷. This implies that China's advantage over other developing economies in attracting FDI is not cheap labour alone, but the combination of cheap labour and skilled labour. Finally, sound infrastructure and agglomeration have also a positive relationship with FDI inflows¹⁸. This suggests that once a region has attracted a critical mass of FDI, it will be easier for it to attract more as foreign investors perceive the presence of other foreign investors as a positive signal¹⁹. China's infrastructure has been rapidly improved. For example, the telephone density at the dawn of the reform was only 0.2 per 100 people in 1979, which has been significantly improved (see in Figure 4). By the end of 2003, the fixed telephone density was 21.2 per 100 people; and the mobile telephone density was 20.9 per 100 people²⁰.

¹⁶ Liu, et al (1997) and Wei and Liu (2001).

¹⁷ Wei (2003) and Zhao & Zhu (2000).

¹⁸ Zhao & Zhu (2000).

¹⁹ Tseng and Zebregs (2002), and Cheng and Kwan (2000).

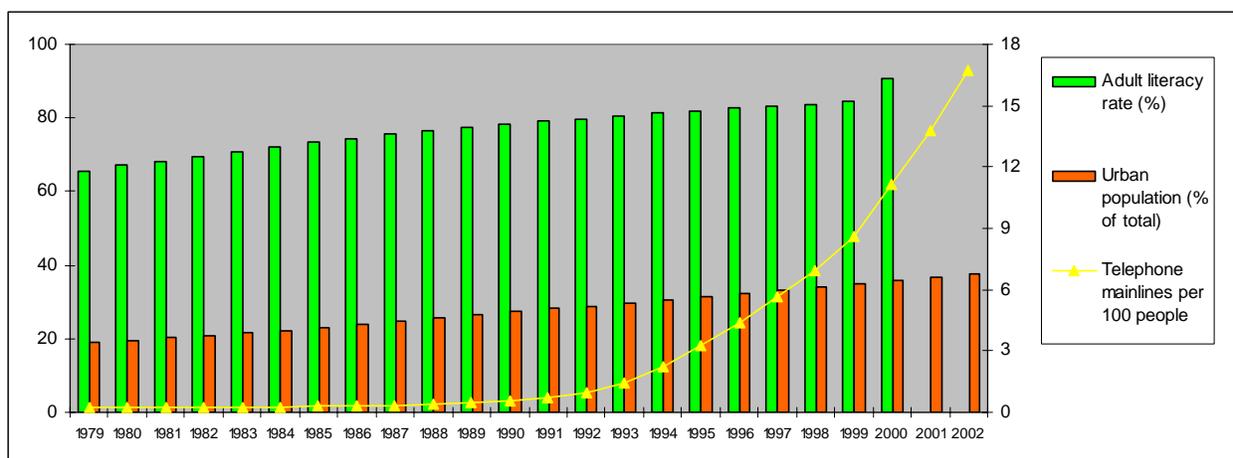
²⁰ China MII.

2.3. Societal determinants

Studies show that culture may also be a determinant of FDI inflows. Put it particular, FDI may prefer to enter into countries where foreign investors experience less cultural difference²¹. This explains why Asian investors, especially those from Hongkong, are dominant in China's marketplace²². In a location with cultural similarity, investors feel more familiar and comfortable with business routines and hence perceive low investment risk.

Besides, the societal development of China also has a positive impact on FDI inflows.

Particularly relevant is the educational level of the country, which has broad impact on many issues of economic development, such as better quality of labour, better understanding of new things and more open to new things. In a sense, this aspect is closely related to human capital issue that is an economic determinant²³. The educational level of a country can be measured directly by adult literacy rate. Urbanization can also be variable for the societal development of a country, which indicates the degree to which a country is industrialized. This indicator is also related to economic development. It can be argued that higher urbanization may indicate higher industrialization, which makes a location more attractive to foreign investors. Figure 4 demonstrate that adult literacy rate and urban population are steadily increasing, which, in a sense, reflects that these indicators may be societal determinants of FDI inflows though further investigation is needed.



²¹ Wei and Liu (2001).

²² Khan (2001), Kelley and Luo (1999)

²³ Wei (1995) uses adult literacy rates as a crude measure of average human capital.

Figure 4 Infrastructure and Societal Development (Data source: WDI 2004)

2.4. Institutional determinants

Besides, studies show that corruption and regulatory burden have a negative impact on FDI inflows²⁴. These two indicators have deterred foreign investment from North America and EU²⁵. Nevertheless, the rapid growth of FDI inflows to China needs other political explanation. More likely, the liberalization of FDI regimes and creation of new institutions are significant determinants of FDI in China²⁶. These institutional changes have significantly influenced MNCs' decisions and hence FDI inflows²⁷. At the turn points of the development curve of FDI, there are always institutional breaks or important events accompanying with (see in Figure 5 by comparing with Figure 1), which highly influenced the inflows of FDI, either increasing foreign investors' confidence or weakening their confidence in investing in China. Furthermore, the FDI regimes have been gradually more and more liberalized and reform scope has been extended.

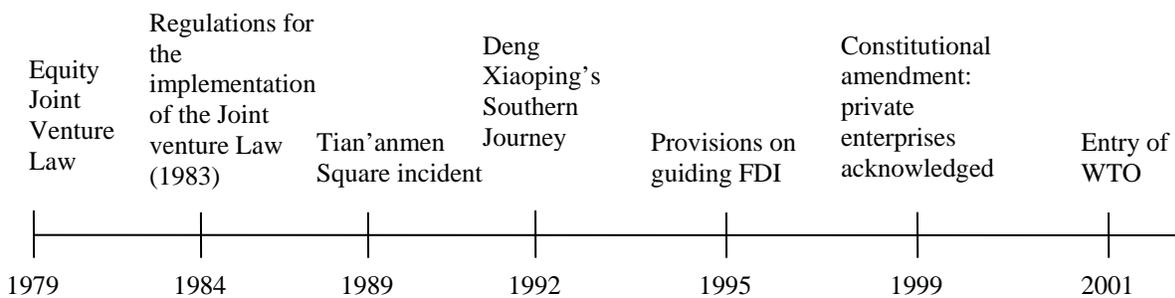


Figure 5 Development phases and institutions

At the beginning of the reform era, only joint ventures were officially accepted as means of investment, according to the Equity Joint Venture Law. In 1986, the Wholly Foreign-Owned Enterprises (WFOE) Law set up the legitimacy of WFOE, which extends options of foreign investors in terms of investment modes. In 2004, a revised Investment Regimes of China has been published, which offers more autonomy for foreign investors. In addition, China's FDI policy has also a geographic dimension. This scope has been enlarged over time. In 1980, four

²⁴ Wei (2000). Khan (2001) also states that bureaucratic red tape, which is often related to corruption and regulatory burden, is one of the chief problems in the operation of FDI.

²⁵ Zseng and Zebregs (2002). Betra, et al (2003) demonstrate that China is ranked low in terms of bureaucratic efficiency, regulatory burden, corruption, and so on, which form part of the investment climate.

²⁶ Khan (2001), Tseng and Zebregs (2002), Roehrig (1994), Shirk (1994), Fu (2000), and Brown (1986).

²⁷ Luo (2002)

Special Economic Zones (SEZs) were established in Guangdong and Fujian provinces. Due to both internal and external pressures, another 14 coastal cities and the Hainan Island were open to foreign investors in 1984. In the following year, another three regions, the Yangze River Delta, Pearl River Delta and the Min River Region, were open again. Foreign invested enterprises operating in these regions often obtain preferable treatment (such as tax holidays). These institutions, together with the market size of China, undoubtedly attract foreign investors to establish their businesses (in a specific region) in China. Following the promise of entering into WTO, China will open more fields for foreign investment on schedule, which can further foster the growth of FDI in China.

2.5. Summary

Empirical studies on China demonstrate that the above determinants all have impacts on FDI inflows into China. However, it should be noted that institutional determinants are more fundamental. It is the economic reform and opening-up policies that lift the ban on FDI and lead to rapid growth of FDI inflows by liberalizing investment regimes, accelerating economic development and foreign trade²⁸. First, political and legal determinants are subjective, while economic and societal determinants are all objective, which is then subjected to attitudes and implementation of the host country. Second, these policies create opportunities for foreign investors to enter. Third, these policies define the scope of foreign investment and shape their behaviours in China. Therefore, it is of significance to investigate how these policies are developed and implemented in order to understand the amazing growth of FDI in China. In section 4, we further discuss the institutional changes in more detail.

3. Historical attitudes of China

As it is described earlier, the development of FDI is accompanied by the creation and evolution of institutions, in terms of laws, rules and regulations, which form China's FDI regulatory framework. The FDI inflows into China and its China's acceptability need to be explained at the level of institutions. These institutional changes are results of changes of perception and attitudes from both sides. These institutions reflect changes of the Chinese attitudes towards FDI, while the FDI inflows reflect changes of the Western attitudes towards investing in China. Therefore, it

²⁸ Fu (2000).

is helpful to look into the development of the economic relationship of China with the West and their attitudes towards each other, in order to search for the source of the change. Broadly, the historical development of this relationship can be divided into six phases²⁹: the first phase (ancient China up to 1368 A.D.); the second phase (1368 – 1842); the third phase (1842 – 1911); the fourth phase (1912 – 1949); the fifth phase (1949 – 1978); and the sixth phase (1978 onwards).

3.1. The First Phase: Ancient China to 14th century

In this phase, China's economic trade with western countries was operated on a sporadic base³⁰ at very beginning and became much more extensive later on. During this historical period, China was predominant in the world economy³¹. The Chinese attitude at the central level was a feeling of superiority over minor or foreign "barbarians" due to its technological advance³². As a consequence, China was officially indifferent to the benefits derived from economic relations with those "barbarians". However, China was just like "a strong magnet for trade"³³. This implies that foreigners were enthusiastic about trading with China. "Silk road" was established in this period by which trade was vastly developed across Eurasian land³⁴, through which many goods were exchanged to and from China. In terms of technology transfer, China was innovator and technological innovations were "poured into Europe in a continuous stream in the first thirteen centuries of the Christian era"³⁵.

Culturally, the Confucian Chinese state had an anti-commercial attitude³⁶. Though the Chinese state aimed at self-sufficiency, they still could tolerate and absorb foreign ideology and ideas³⁷. In

²⁹ Brown (1986).

³⁰ Brown (1986: 8) states that the extent of the commercial contacts that developed between the Roman Empire and Han Dynasty China around two thousand years ago and the flourishing trade which existed *sporadically* thereafter are not widely appreciated.

³¹ Frank (1998: 5) states that "If any regions were predominant in the world economy before 1800, they were in Asia. If any economy had a 'central' position and role in the world economy and its possible hierarchy of 'centers,' it was China".

³² Brown (1986: 8) and Frank (1998: 5).

³³ Colin Simkin (1968): *The Traditional Trade of Asia*, London: Oxford University Press. It is cited in Brown (1986).

³⁴ Brown (1986) and Frank (1998).

³⁵ Needham, J. (1971). *Science and civilization in China*. Cambridge: Cambridge University Press. It is cited in Brown (1986).

³⁶ Swanson (1982: 15). This attitude was related to the traditional suspicion of merchant, who held a very low position in the Chinese social scale.

³⁷ *Ibid*: "Its ability to do so can be likened to grafting". They attempted to graft things from others in need and those grafted cells later became indistinguishable from the organism.

a commercial sense, “the Chinese government played an active role in regulating trade”³⁸ with foreigners. As early as at least Han Dynasty, China had developed the “tribute system”³⁹. Following this system, “barbarian emissaries would bring gifts in tribute as testimony to the vassalage of their nations to China. In response, the Chinese would generously bestow presents upon them”⁴⁰. Though indifferent in feeling of trading with barbarian, China’s tolerance led to the growth of international trade.

Along with the development of trade, China had set up extensive regulations on it. With these regulations, the Chinese government attempted to retain control in hand while the foreign trade became extensive and significant to national revenue. Taxes on commerce had been widely used and were of great importance to the national treasury⁴¹. Besides, a more extensive regulation framework had been also developed. In the closing years of the 10th century (Tang dynasty), China declared the state monopoly of trade, induced foreign traders coming by granting special import licences, and established inspectorates for Maritime trade⁴². Outside merchants could make commercial exchange with the Chinese at tribute meetings, but it was monitored closely by the government by predesignating the time and place of the meetings. However, the Chinese provincial officials, as well as traders, “were well aware of diversity of people and cultures and recognized the potential for a flourishing trade”⁴³ at those borders. By these regulations, China sought to sanitize and milk her foreign trade⁴⁴. Though these regulations demonstrate attitude of superiority on one side, they also manifest some consideration of mutual benefits.

3.2. The Second Phase: 1368 - 1842

This is a period of China’s relative decline and that of Europe’s rise. The “Chinese superiority over time produced a dormancy that manifest itself in distain for the very things that led to the development of Western seapower prior to the twentieth century: commercial pursuits and the establishment of colonies”⁴⁵. Although China was the “center” of the world economy prior to the

³⁸ Brown (1986: 13).

³⁹ Swanson ((1982: 13). The tribute system was originally established as a defence system to protect the sovereignty. Later on it evolved into a diplomatic and political system and further into a trade system.

⁴⁰ Ibid.

⁴¹ Ibid: “Under the Tong and Song, customs revenue from trade assumed great importance to the treasury/”

⁴² Brown (1986: 13-14).

⁴³ Hutcheon (1996:11).

⁴⁴ Brown (1986: 14).

⁴⁵ Swanson (1982: 15).

10th century, this position had been threatened due to development of Western seapower since then on.

China had also recognized the significance of seapower, but it was struggling between continentalism and maritime ideology⁴⁶, while led to its short-lived maritime power. In the early 15th century, China had a progressive attitude toward exploitation of the sea, which led to a series of naval voyages into the South China Sea and the Indian Ocean. In the years between 1405 and 1433, Zheng He was commissioned to seven diplomatic expenditures to southern Asian countries to promote trade, the success of which proved that “China was the supreme world seapower”⁴⁷ that was unmatched by any other nation. However, Chinese seapower declined soon after those voyages due to a number of political, military, social, and economic factors from internal⁴⁸. Up to the Opium War, the Chinese had been deemphasizing the maritime power despite the ascendancy of the maritime spirit in the world. In this period, piracy and smuggling had become a widespread calling. As a consequence, China didn’t take a progressive attitude but turned more inward and receded from trading with foreigners⁴⁹. This led to a distain feeling of China side for foreign commerce. Meanwhile, foreigners were still attracted by the profit of trade with China. In this period, more and more foreign traders set up their businesses and increased their presence in China, such as Portuguese in 1531, Spanish in 1575, Dutch 1604, English in 1637 and Russian in 1618⁵⁰.

Meanwhile, the Chinese government reinforced the tributary system. The first Ming emperor, once taking position of emperor, immediately re-established this system. “He ordered missions to proceed to peripheral states such as Japan, Annam, Champa, and Korea, where it was proclaimed that all who wished to enter into relations with China must acknowledge the suzerainty of the new emperor. Very soon some of these states sent reciprocal missions to Peking”⁵¹. However, this tributary system was threatened in the Qing dynasty by the two first treaties with western countries, Nerchinsk (1689) and Kyakhta (1727) treaties with Russia. Under these treaties, there was to be “free travel between the two countries by their citizens having proper passports and

⁴⁶ Swanson (1982: 28).

⁴⁷ Ibid.

⁴⁸ See Swanson (1982: 40-43) for detailed discussion.

⁴⁹ Brown (1986: 15).

⁵⁰ Brown (1986: 16).

⁵¹ Swanson (1982: 29).

wishing to carry on commerce and other private business”, and “Russian trade caravans were to be permitted to arrive in Peking once every three years and to stay for 80 days, and Russia could trade without paying duties on the goods it exported and imported.”⁵² These demonstrated that Russia was active in promoting trade with China. However, the border trade proposed by these treaties didn’t develop very well, partly because these agreements didn’t fit well into the tributary system, and partly because Chinese side lacked of interests⁵³.

In this period, foreign trade was carried on under a system of tight control and supervision, representative by “Gong Hong” system⁵⁴. The “Gong Hong” system emerged in Guangzhou as an officially licensed guild of merchant houses, which was governed by a code of articles that defined how they should deal with foreign traders. Under this system, foreign trade was constrained to certain locations (often at borders, after which the trade system was named as border trade.) and to dealing with quasi-monopolistic partners. The regulations in the period were much more severe than previous phase, and thus also created opponent feeling of foreign traders. It is argued that China’s indifference to trade with foreigners was because the Chinese rulers considered the empire to be self-sufficient, containing all they would ever need. Thus, the close control can be understood as protection of their resources from being exploited. These institutions reflected attitude of the emperor or the government, however, they were inconsistent with interests of traders and local officials. They sought to bypass some controls.

3.3. The Third Phase: 1842 - 1911

In this period, China was opened up by foreign military power. Foreign attacks broke down China’s system. Thus, a hostile feeling was created on the Chinese side. Meanwhile, foreigners expanded their penetration quickly as a consequence of “opening up” of China’s ports.

This period started in the year 1842 at the end of the Opium War. This war was started by the British trading company who didn’t satisfy with the trade control of China and didn’t like to carry silver from the UK to exchange goods in China. They smuggled opium into China, which led to the opium war (1839-1842). The UK took military action to invade China and to force Qing Dynasty to accept this kind of trade. Due to the weakening of Qing dynasty in both technology

⁵² Brown (1986: 16).

⁵³ Brown (1986: 17).

⁵⁴ Ibid.

and military, the ruler was forced to sign an unequal Nanjing Treaty by which Hongkong was ceded in perpetuity to the UK. This represented the beginning of new trade system: “treaty port” system, which replaced the tribute system.

The Western powers successfully destroyed the official Chinese border trade system, and replaced it with treaties to colonize parts of China. They sought to secure exclusive rights in various regions of China. Following the Nanjing Treaty, other Western powers, such as France, Russian, Germany, Japan, and so on, took similar actions to gain their treaty ports. From 1842 to 1930, “no less than 105 open ports were established, of which 73 were opened by treaties and conventions, and [only] 32 were opened voluntarily by the Chinese government”⁵⁵. As a result, China was divided into “sphere of influence” with leased areas and special concessions. By treaty, these treaty ports became foreign colonies on China’s own land. At the treaty ports, foreign traders obtained much autonomy. They were allowed to reside, to pursue commercial trade without restraints, and to carry on trade with whatever persons they please⁵⁶. They were even granted to extraterritorial rights and to engage in manufacturing and thus the Chinese internal customs duties were limited.

By these treaties, foreign traders started to exploit China’s resource and market. Many joint ventures had been established, and they were primarily under foreign control. However, due to the cultural or institutional differences, foreigners found difficulties in operating in China, even in the westernized treaty ports. As a consequence, the comprador (Maiban in Chinese) system emerged⁵⁷. The comprador system became a bridge to link Chinese and western commerce, enabling “fusion of western technology, capital, and managerial skills with the native financial institutions and commercial ability of Chinese”⁵⁸. The compradors helped foreigners to face with difficulties in language, non-standard currency, nonstandardized system of weights and measures, complex credit, commercial relationship and guild system in China⁵⁹.

Though forced to cede ports to foreigners, the Chinese government didn’t let foreigners dominate all areas and all fields. The government struggled to remain some control. A typical case is

⁵⁵ Brown (1986: 23).

⁵⁶ Ibid.

⁵⁷ Brown (1986: 24) describes it as a new variant of the Gong Hong system.

⁵⁸ Ibid.

⁵⁹ Ibid.

mining sector. This sector was dominated by Sino-foreign enterprises, not by foreigners or Chinese. It was because (1) mining was carried out outside of the treaty ports, which required the cooperation of the Chinese; (2) it needed modern technology and capital which China was lack of; and (3) China was especially sensitive to foreign control over her mineral resources⁶⁰. For this last reason, the government had promulgated a series of mining regulations in 1898, 1899, 1902, 1904, 1908, 1914 and 1930⁶¹. Through these regulations, China imposed the Chinese majority ownership to mining enterprises, and stipulated that they could employ only Chinese except foreign engineers. China was successful in preventing at least formal foreign control over mining enterprises⁶². By recognizing the technological advance of foreigners, some leaders accepted that “China must accept a measure of western technology and build up her own industries in order to be strong enough to avoid foreign domination”⁶³. As the Chinese refused to accept foreign dominance, many Sino-foreign economic interactions took place through which Chinese made use of foreigners and of foreign techniques to begin Chinese ventures⁶⁴.

However, the progress towards modernization was very slow due to the conservative attitudes of the Chinese bureaucracy⁶⁵. On the other hand, the government concerned more about political and military power instead of economic gains. This made Chinese merchants unenthusiastic about participation in government-sponsored ventures. Instead, these merchants actively participated in their own ventures or in collaboration with foreign enterprises. In addition, many overseas Chinese returned to China, as a response to the hospitable attitudes of the Chinese government, and invested in many industries such as banks, infrastructures and other enterprises.

It can be argued that the partitioning of China in this period gave birth to the first open door policy. However, this open door policy was *towards* China, but not initiated *by* China, because China was out of the decision making⁶⁶. The invasion and exploitation of western powers gave Chinese a feeling of national humiliation. Hence, it is no surprise that Chinese grew a hostile

⁶⁰ Brown (1986: 43).

⁶¹ Hou, Chiming (1965). “Foreign Investment and Economic Development in China: 1840-1937. Harvard University Press. P.109.

⁶² Brown (1986: 34).

⁶³ Brown (1986: 30)

⁶⁴ Brown (1986: 32).

⁶⁵ Ibid.

⁶⁶ Brown (1986: 34) states that “China herself was not consulted as to her wished concerning an open door.”

attitude towards foreigners, and later initiated national boycotts against foreign powers and the rights recovery movement.

3.4. The Fourth Phase: 1912 - 1949

This period started in the year when the Republic state replaced the emperor. However, in this period China was in a chaotic situation which was characteristic with civil war and the anti-Japanese war which was associated with the WWII in the Pacific. In this period, the attitude of China towards foreign investors was mixed. The republic government aimed to strengthen its national economy by adopting foreign technologies.

The treaty port system continued in the early years of this period, but it withered later due to (1) Chinese nationalism, (2) Japanese aggression, and (3) the preoccupation of the Western powers with war in Europe⁶⁷. The First World War, Second World War and Russian revolution drew much of the energies of western powers.

In the early stage of this period, Chinese and foreign businessmen jointly developed a thriving economy in treaty ports, which “is indicated explicitly by such statistics as the presence of 20 Sino-foreign banks alongside the 43 foreign and 141 Chinese banks in the modern banking sector in 1925”⁶⁸. The Chinese and foreign concerns became more common and thus they cooperated more at industry level. With the growth of the power of the Republic, the extraterritorial status of treaty port system in the treaty ports was diminished. Their operations were first obstructed and then terminated by the Japanese during the war⁶⁹. Though the treaty ports resumed after the war, but were discriminated by the government. This system came to an end in 1943 by the Sino-American and Sino-British treaties, except the colony of Hongkong⁷⁰.

At the same time, the Chinese government sought to take back the rights previously granted foreigners. They imposed restrict control over certain areas of the economy. For example, in mining sector, the regulations stipulated the Chinese majority in shareholders, Chinese majority in the board of a mining enterprise, Chinese holding of chairman of the board of directors and

⁶⁷ Brown (1986: 49).

⁶⁸ Brown (1986: 49).

⁶⁹ Brown (1986: 51).

⁷⁰ Ibid.

that of the managing director. While China still absorbed foreign technical assistance, the western expertise was gradually supplanted by Chinese technical ability in many areas of modern industry because Chinese people had obtained experiences from training both abroad in universities and at home under tutelage of foreign experts⁷¹. Due to the bitter experience with Westerners, the Chinese government had a more positive attitude toward overseas Chinese. They were playing a significant role in this period in the struggling for modernization.

This was a period of political chaos and warfare. The Chinese government sought to achieve the control over the economy. However, “the Sino-Japanese and civil wars resulted in complete demoralization of both the domestic and foreign sectors of the economy, the latter having lost its preferred standing and having encountered official hostility”⁷².

3.5. The Fifth Phase: 1949 - 1977

This period started with the establishment of a unified China in 1949. Due to the previous bitter experience with foreigners and ideological distance with capitalism, the new China sought to reconstruct the national economy by nationalizing the industry.

Hence, foreign interests were expelled by China establishing a socialist planned economy, which generated fear among western investors. Meanwhile, the Chinese assisted the Koreans to fight against the aggression of the US. The political climate towards China was then worsened by the Korean War⁷³. As a response, the US froze Chinese assets in December 1950. This US-led boycott triggered China to take similar action towards FDI as well. This action was not only towards US investment, and was extended to British investment in April 1951 as well⁷⁴. At the end, the British merchants chose to leave the mainland in 1952.

In 1950s, while Western and Japanese enterprises were confiscated, Mao Zedong’s “lean-to-one-side” policy referred to maintain substantial economic relations with Soviet Union. In order to implement the reconstruction and modernization of the national economy, China’s lack of capital

⁷¹ Ibid.

⁷² Brown (1986: 55).

⁷³ Brown (1986: 56).

⁷⁴ Ibid.

and technology asked for loans and technical assistance from Soviet Union⁷⁵. As a consequence, a total of 10800 Soviet experts involved in the Soviet aid program between 1950 and 1959⁷⁶. Yet, due to increasing ideological conflicts, China ended this policy at the end of 1950s. All Soviet experts withdrew suddenly, which left China to a difficulty time.

After the withdrawing of western merchants, China was left in an economic autarky⁷⁷. However, this does not mean China was completely isolated from the outside of the world. First, there were investments from overseas Chinese because, traditionally, they were not regarded as foreigners. Secondly, in face of capital deficit, the Chinese leadership accepted the sellers' credit which was ideologically acceptable because it was not regarded as a form of foreign debts⁷⁸. Thirdly, the Chinese leadership had taken import substitution approach to achieve the goal of self-reliance. After the economic collapse from the Great Leap Forward, they experimented with export promotion measures, importing technologies that were needed and exporting products from these technologies. However these experiments were constrained within certain areas.

The self-reliance had been a highly stressed theme and goal in the economic relations with foreigners in this period. Yet, there is a disagreement within the Chinese leadership on which path of development China would achieve it. This led to the economic reform in 1978.

3.6. The Sixth Phase: 1978 onwards

In order to catch up with the developed countries, the Chinese leadership urged to modernize the economy, which quested for capital and expertise to assist the modernization process. Though China had accepted sellers' credit from the outside of world, the amount was limited and couldn't meet the requirement of modernization. Therefore, opening the door to absorb more capital became necessary. Following the policy endorsement in 1978, compensation trade agreements became accepted. In the following year, the Equity Joint Venture Law was promulgated, which authorizes the acceptance of foreign equity capital. Though there was doubt on how far the policy could be carried on, the progress of the past 25 years proves the insisting attitude of the Chinese

⁷⁵ Brown (1986: 57).

⁷⁶ Mah, F.H.(1971). *The Foreign Trade of Mainland China*. Chicago: Aldine-Atherton. It is cited in Brown (1986).

⁷⁷ Throughout the period, the only Sino-joint ventures remained active were China-polish Ship Brokers, Co. and China-Tanzanian Firm (Brown 1986: 61).

⁷⁸ Reardon (1998).

leadership towards the opening. In 1984, both Deng Xiaoping and Zhao Ziyang stated that “the policy of opening to the outside world is a basic policy of China. Whatever it changes, it can only change toward taking a more relaxed attitude”⁷⁹, which stressed the China’s firm commitment to the open-door policy. Nevertheless, the government still imposed control over foreign investment to (1) guaranteeing mutual benefits, and (2) avoiding “unhealthy tendency” coming with foreign investment.

Meanwhile, foreign investors also changed their negative attitudes towards investing in China. Due to the ideological constraints, foreign investors were afraid of investing in China at the beginning. They were sceptical about the continuation of the policy. Many foreign investors didn’t want to be part of an experiment despite Chinese assurances that their interests will be protected⁸⁰. Thus, their response was fairly reluctant. The foreign investment grew very slow due to their unwillingness to commit themselves to businesses in China, which partly is also due to the lack of a sound legal framework and sufficient infrastructure in China. However, this didn’t decrease the China’s attractiveness, with a biggest potential domestic market in the world and a rapid economic growth potential, to foreign investors. By 1984, China had learned to improve the legal framework, and the economic reform and growth also helped foreign investors to build up more confidence. In this process, many regulations and policies had been established to solidify conditions of investment in China which led to a rapid growth period of FDI. With these improvements, China’s attractiveness takes on its function. As a consequence, more and more foreign investors actively take steps to (re-)enter into China.

This period witnesses for the first time that China took her initiative to open the door to the outside world under her own willingness, not by external military force. Due to the lack of experiences in dealing with foreign investment, China has been in a learning process. Gradually, the Chinese leadership has gained confidence and therefore liberalized more the regulatory framework over foreign investment. This period also witnesses the growth of foreign investors’ confidence and attitude changes towards investing in China. Though foreign investors complained, and still complain, the imperfection of legal framework and the administrative

⁷⁹ Brown (1986: 79).

⁸⁰ Brown (1986: 106). It is cited from a 1980 article on Wall Street Journal.

bureaucracy⁸¹, they perceive China as a must destination. Learning from history, China doesn't give out the control rights when opening the door. The major principle China insists on in this process is interdependence and "equality and mutual benefit"⁸². On the one side, China proposes incentives to induce FDI, and on the other hand, China also imposes (strict) control over FDI such as industry constraints, local contents and export requirements.

In the implementation of these policies, however, local governments have their own pursuits that are not always consistent with those of the central government. As a consequence of decentralization, local governments have increasingly become entrepreneurs and major stakeholders in local enterprises, regardless of the policy instructions of the central government⁸³. All regions, recognizing the significance of FDI to the local economy, aim at attracting FDIs, which leads to locational competition, in terms of offering better preferential treatments, for FDI. Their competition leads to high inflow of FDI on the one side and may also lose the overall rents that the central government aims to gain. In a word, this period is characterized by more positive attitudes from both sides. The tension between the Chinese and foreign investors exists all the time, which has led to the evolution of institutions.

3.7. Summary

The brief overview of the history of the economic relationship with foreign investors demonstrates several themes: (1) China is always attractive to foreign investors in one way or another; (2) Chinese historical attitudes towards FDI shifts over time; (3) tension between them exists all the time; (4) this tension and their attitudes have shaped the institutional building of China concerning foreign investment; and (5) technological advance determines the dominant side.

Figure 6 outlines these changes throughout the historical phases. China's attitude towards foreign trade and investment has changed from indifference in the pre-Ming dynasty era to demanding in the reform era, which was accompanied with the exchange of the position of technological advance. Even in the period of foreign dominance, China was also aware of the applying foreign technology to strengthen her own muscle, though there was a hostile attitude towards foreign

⁸¹ E.g. Stuttard (2000).

⁸² Pearson (1991: 48)

⁸³ EIU(2003).

presence. In parallel, the foreign attitude toward trade with or investing in China has changed from enthusiastic in the pre-Ming dynasty to aggressive and exploitative in the late Ming and Qing dynasty, to hostile in the Mao era, and to positive again in the reform era.

In all phases of the history except in the Mao era (1949-1978), China has always been an attractive destination of foreign trade or investment. Originally, it was mainly due to the advance of China's technology and riches in goods, and later on resources and the big domestic market became attraction. Their attitude deviation and technological gap created tension in economic transactions, which further determined institutional building concerning these transactions. In the early phases when China was dominant, China developed tribute system for mutual benefits, while imposing control to maintain the dominance. In the middle phases when foreign powers obtained dominance by military force, China was forced to grant extraterritorial rights to foreigners at treaty ports, and yet struggled to remain control beyond ports. In the Mao era, hostility from both side led to an isolation situation of China. Perceiving the need of foreign capital and technology, in the reform era, China voluntarily opened its door to foreign investors. However, learning from the bitter experience in history, China developed the institutional framework on a base of equality and mutual benefit. The strong tension between Chinese and foreigners led to the evolution of institutions gradually in this phase.

Phases	Central Government Attitude	Local Government Attitude	Foreign Attitude	Tension	Features of Institutions
Pre-1368 Era	Indifferent	Indifferent	Enthusiastic	Weak despite China's dominance	1. Tribute system 2. Strong regulations over trade
1368-1842	Reluctant	Positive	Aggressive	Strong due to China's dominance	1. Tribute system 2. Strong regulations
1842-1911	Reluctant/ Hostile	Positive	Aggressive, Exploitation	Strong due to foreign dominance	1. Opening by unequal treaties 2. Remain weak control beyond ports.
1911-1949	Hate-love mixture	Positive	Aggressive, Exploitation	Strong due to foreign dominance	1. Continue treaty port system 2. Remain weak control beyond ports.
1949-1978	Hostile	Hostile	Hostile	Strong due to hostility	1. Isolation 2. Self-reliance
1978 onwards	1. Friendly and in demand 2. Cautious about negative effects	Active	1. From hesitating to positive 2. Positive but criticizing	Strong due to Chinese high attractiveness and foreign tech. advance	1. Voluntary opening 2. Seek mutual benefit 3. Self-reliance

Figure 6 Attitude Changes of Both Sides: historical review

In addition, it should be noted that there is an internal tension between the central government and local governments or business societies. This is due to their interests inconsistency. The central government concerns more about the political power of the country and its sovereign security, while local officials or business societies concern more about economic gains from foreign investment or trade. This tension determines what institutions will be built at the local level. In this process, two layers can be distinguished. On the first layer, the attitude tension between Chinese and foreign side determines what institutions (with particular respect to FDI policies) will be developed at the central level. On the second layer, the attitude tension between the central government and local governments or business societies determines what institutions will be built at the local level, by interacting with foreign investors. Nevertheless, the most crucial part is located at the central government's attitude that dominates over-time changes of the FDI policy.

4. Evolution of Institutions in the reform era: on path or off path?

Since the opening policy was first endorsed in 1978, China has been in a gradual process of improving the institutional framework that evolves towards more liberalized and more foreign concerned. Though the open-door policy is generally claimed to be a path-broken institution, it nevertheless didn't deviates completely from the previous path. As discussed before, self-reliance is still one of the major concerns of institution building in this stage.

4.1. Overview of Institutional evolution

Since 1970s, the Chinese leadership has learnt that the open-door policy can be a means to foster China's ability to achieve modernization and self-reliance. Deng Xiaoping, as designer of the economic reform, stated that "The most important thing we have learned is to rely mainly on our own efforts. That does not mean we should not seek outside help, but the main thing is to rely on our own efforts. Through self-reliance we can unite the people, inspire the whole country to work hard for prosperity, and thus make it easier to overcome the many difficulties in the way"⁸⁴. Since 1978, the Chinese leadership has sought better institutional framework to attract and control FDI, which leads to the evolution of institutions that are influenced by attitudes of all interested parties. We discuss three aspects: ideological breakthroughs, governing laws, and Special Economic Zones (SEZs). These changes are summarized in Table 1.

Table 1 FDI-related institutional changes (Partly adapted from Van den Bulcke, et al 2003: 22)

Phases	Accessible locations	Industry orientation	Entry modes
1979 - 1983	4 SEZs		EJVs
1984 – 1988	14 open coastal cities, Yangtze River Delta, Pearl River Delta, Golden Triangle Areas Hainan island Liaodong and Shandong peninsulas	Provisions for the encouragement of foreign investment with additional incentives for export, import substitution and high-tech project	WFOEs, CJVs
1989 – 1991	Pudong New Area in Shanghai		

⁸⁴ Deng Xiaoping (1984: 384), which is cited in Tang (1996: 14).

1992 – 1994	21 cities along the Yangtze River and in the Northeast	Open retailing sector	Umbrella companies
1995 – 1998		Orientation directory of industries Open banking sector	B share trading BOT
1999 – 2000	Inland provinces by “Go-west” strategy		M&As
2001 onwards		Other service sectors	

Ideological breakthrough: This is referred to those statements made by the CCPCC (Chinese Communist Party Central Congress) and the central leadership, which significantly deviate from the past in ideology and are supposed to provide guidance to the economic reform. Four ideological breakthroughs have occurred. The first was the *first wave* of “emancipation of mind” driven by the debate on “judge of truth”⁸⁵ in 1978. This debate was ended with the speech of Deng Xiaoping at the Central Work Conference before the 3rd Plenum of 11th CCPCC, affirming that “practice is the sole criterion of truth”⁸⁶. Following this ideology, the Chinese leadership endorsed the economic reform and open-door policy at the 3rd Plenum of 11th CCPCC, which deviated from the development path in the Mao’s time. The second was the endorsement of a socialist planned commodity economy at the 3rd Plenum of 12th CCPCC in 1984, by which the leadership has accepted elements of market in the economy, which deviated from a pure planned economy in the past. The third was the second wave of “emancipation of mind” after an ideological retreat as a consequence of the Tian’anmen Square Incident. Deng Xiaoping’s 1992 “Southern Journey” re-affirmed the economic reform and open policies. In 1993, the 3rd Plenum of the 14th CCPCC endorsed the shift of economic system to a socialist market economy. This shift, though insisting on socialist, has highly appreciated the role of market in the economy, and further loosened the previous ideological constraints. The fourth was the third wave of “emancipation of mind” in 1997. The 15th CCPCC in 1997 affirmed that the private ownership is an important component of the economy. This ideological breakthrough has led to many other institutional changes that are highly related to foreign interests. These breakthroughs loosens the

⁸⁵ This was initiated after Mao’s death by debating on which path the Chinese development should follow. The conservatives proposed to follow Mao’s path, taking “two whatevers” as principle. On the contrary, the reformists or pragmatists recognized the major problem of the past development and proposed to rethink about the past. “Two whatevers” are: whatever Chairman Mao’s policies are, we protect them; whatever Chairman Mao’s instructions are, we follow them loyally from start to finish.

⁸⁶ Howe, et al (2003: 39).

control of planning instrument and strengthens the role of market instrument, while appreciating, besides state-owned ones, other economic components.

Governing laws: Governing laws related to foreign investment are referred to those laws, regulations and policies that foreign investors should comply with. Soon after the decision on the open policy, the Equity Joint Venture (EJV) Law was promulgated in 1979. This law for the first time since 1949 welcomes foreign investment. This law legitimizes the status of equity joint ventures with foreign investors, while imposing certain control over them on a base of mutual benefits. In 1986, a national WFOE law was promulgated. This law permits foreign investors to set up exclusively wholly foreign-owned enterprises in China under certain conditions. This was considered as an important institutional breakthrough as China allowed foreign capitalist firms to establish on its soil territory of socialist. In 1988, the National People's Congress passed the Contracted Joint Venture (CJV) Law. This law is less significant than the EJV Law and WFOE Law. However, it provided the official status of legitimacy to contracted joint ventures. In many aspects of the law, it is similar to the EJV Law.

SEZs and Spatial Expansion: China's open-door policy has a very important dimension of geography. In 1980, six months after the EJV Law, China established four SEZs, Shenzhen, Shantou, and Zhuhai in Guangdong province, and Xiamen in Fujian province. The motives to establish these SEZs were (1) to attract foreign capital and technology, (2) to promote exports and generate foreign exchange, and (3) to experiment with the open policy⁸⁷. The striking feature of SEZs in China is that they are operating "under different institutional framework from the rest of China"⁸⁸. These localities were delegated to prepare their own regulations⁸⁹. Hence, the local authorities obtained a considerable degree of autonomy in organizing economic activities in SEZs without interference from the central government. To do the "experiment", these localities received generous financial subsidies. Their success further reinforced the SEZ policies. In 1984,

⁸⁷ Fu (2000: 32-33).

⁸⁸ Fu (2000: 33).

⁸⁹ For example, the National People's Congress (NPC) Standing Committee launched the "Resolution on the Authorization of the Guangdong and Fujian Provincial People's Congresses and their Standing Committees to Enact Specific Economic Regulations for their Special Economic Zones". The condition is that these regulations do not contradict central laws and must be reported to the NPC Standing Committee and the State Council.

the State Council granted another 14 coastal cities⁹⁰ the similar status to the SEZs, by which they were authorized to provide foreign investors the same preferential treatment as hitherto available only in the four SEZs. This expansion was extended again in 1985, to three “delta regions”, Yangtze River Delta, Pearl River Delta, and Golden Triangle Delta⁹¹, which was to satisfy those localities that are in coastal areas but were not selected in 1984⁹². Since then, the expansion becomes a routine through which the government gradually permits wider regions to provide preferential treatment to receive foreign investment. In 1988, Hainan Island was separated from Guangdong province and elected to be a new province, meanwhile granted as the fifth SEZ in China. In the same year, Liaodong and Shandong peninsulas were granted as “coastal economic open areas”. In 1990, Pudong New Area was established in Shanghai and afterwards Shanghai was granted greater autonomy over foreign trade and investment. In 1992, the state authorized another 21 cities along the Yangtze River and in the Northeast to offer special incentives to foreign investors. Since then on, more river and border cities, and inland provincial cities have been open. A significant progress of the opening is the “go-west” strategy which was announced by the central government in September 1999, aiming at encouraging foreign investors to engage in the restructuring of the state-owned industrial enterprises in the western regions. All in all, the strategy demonstrates a full opening of China geographically.

4.2. Path dependence

We can't interpret institutional changes in an isolated manner. We have to look for their historical sources along the past path. From the historical perspective, we can sort out three paths in the period before 1978 in terms of Chinese-foreign economic relations: Strong control over FDI with indifferent attitude, Weak control over FDI with reluctant attitude, Isolation from the West with hostile attitude. Currently, China opens the door to FDI. In this sense, it is a path break from the previous stage when China was closed to the West. Meanwhile, Chinese attitude towards FDI has changed from hostile to friendly with caution. This attitude is not completely new, which had already hints in the past. In addition, the current policy demonstrates strong control over FDI in

⁹⁰ They include, from north to south, Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai.

⁹¹ Yangtze River Delta includes part of Jiangsu and Zhejiang provinces and part of Shanghai. The Pearl River Delta lies in Guangdong, linking Shenzhen and Zhuhai SEZs with Guangzhou. The Golden Triangle Delta encompasses the cities of Quanzhou, Xiamen and Zhangzhou in Fujian.

⁹² Shirk (1994: 39).

terms of locations and industries to invest, which were clearly reflected in previous stages. Though the open door policy is generally claimed as a path break event, it is also claimed that the leadership learnt to initiate this policy⁹³. By learning, it is referred that the open-door policy followed the previous path in a certain way. Before the reform in 1978, the leadership has had experiences with small-scale experiments or overseas Chinese investment. These experiences reinforce the leadership's confidence in opening the door to FDI. To understand the institutional changes better, below, we trace the path of open-door policy back from a long-shot view.

Off Path: It is to a large degree true that the current FDI policy breaks the previous path in the Mao's time. The distinction is that China invites FDI now, while refused FDI in the previous stage. Ideologically, this is a path break in terms of attitudes towards FDI. In Mao's time, though China did accept some types of foreign investment such as the seller's credit, overseas Chinese investment and import substitution, China refused FDI since it was regarded as a foreign debt which was ideologically not acceptable. The open door policy broke these restrictions, inviting FDI into China. The most striking movement is to allow FDI to be hosted in a WFOE. Sure, these show that new institutions create a path deviating from the previous one.

On Path: In many respects, however, the current institutional changes are on path from a longer historical view. First, the current policy also imposes strong control over FDI. In the earlier stages prior to the Opium War, China exerted strong control over foreign economic relations. Even the in the stage of foreign fragmentation, the government was intended to exert strong control, at least in regions beyond treaty ports, as well. In the Mao' time, the control was exerted to extreme. Similar to the past, the initial FDI regulations were very cautious about foreign ownership, as demonstrated in the governing laws. Although this control has been gradually loosened to accept WFOEs, they should be established on conditions of (1) employing advanced technology, (2) developing new products or producing import substitutes, or (3) having an export ratio of over 50%. In addition, China has developed the industry policies to exert control over industries to invest. The "Orientation Directory of Industries for FDI" categorizes into FDI-encouraging industries, FDI-restricted industries and FDI-prohibited industries to guide the operation of promoting FDI. Second, the SEZs are very similar to tribute system or port system in their operation. Under the tribute system, all foreign trades were constrained in certain locations

⁹³ See Shirk (1994) and Reardson (1998).

and were banned beyond those locations. Port systems, due to the unequal treaty, offered foreign investors more autonomy in those ports. Beyond the ports, the Chinese government intended to exert strong control, though weak in effect. Even in the Mao's time, those import substitution projects were confined to certain bases. The SEZs are operated in a similar way. The first four SEZs were initiated as experiments, hosting FDI in those regions to learn how to manage them. In SEZs, looser control is imposed on FDI than beyond these SEZs. Third, the central government, though imposing control by law, can only exert a weak control over FDI in effect. This is once again mirrored in the history. There is always a tension between the central and local governments, or between the government and business societies. Local governments and business societies concerned more about their economic gains that triggered them to make use of the flexibility or ambiguity in policy to collaborate with foreign investors, which in turn weakens the central control. Fourth, the attitudes also have their historical path. The current policy demonstrates an attitude of mixture of friendliness with caution. The component of caution is more in a political sense. Due to the past experience, China is afraid of losing her sovereign control to foreigners who can exert their control by using economic power, which has led to the strict control over FDI at the central level. The component of friendliness is more in an economic sense. Economically, China needs to absorb capital and technology from the West in order to improve her economic capability, which has led to the cooperation. Especially at the local level, local governments and business societies wish to obtain more economic rents by cooperating with FDI. Last, but not least, China has always insisted on self-reliance although the open door policy has been issued, and insisted on some central control (planning) while a market economic system has been implemented.

4.3. Path of Institutional building

Though it is often claimed that the FDI-related institutional building in the reform era is a path-break event, it is more appropriate to claim that it is of path-dependence with some deviation, see Figure 7.

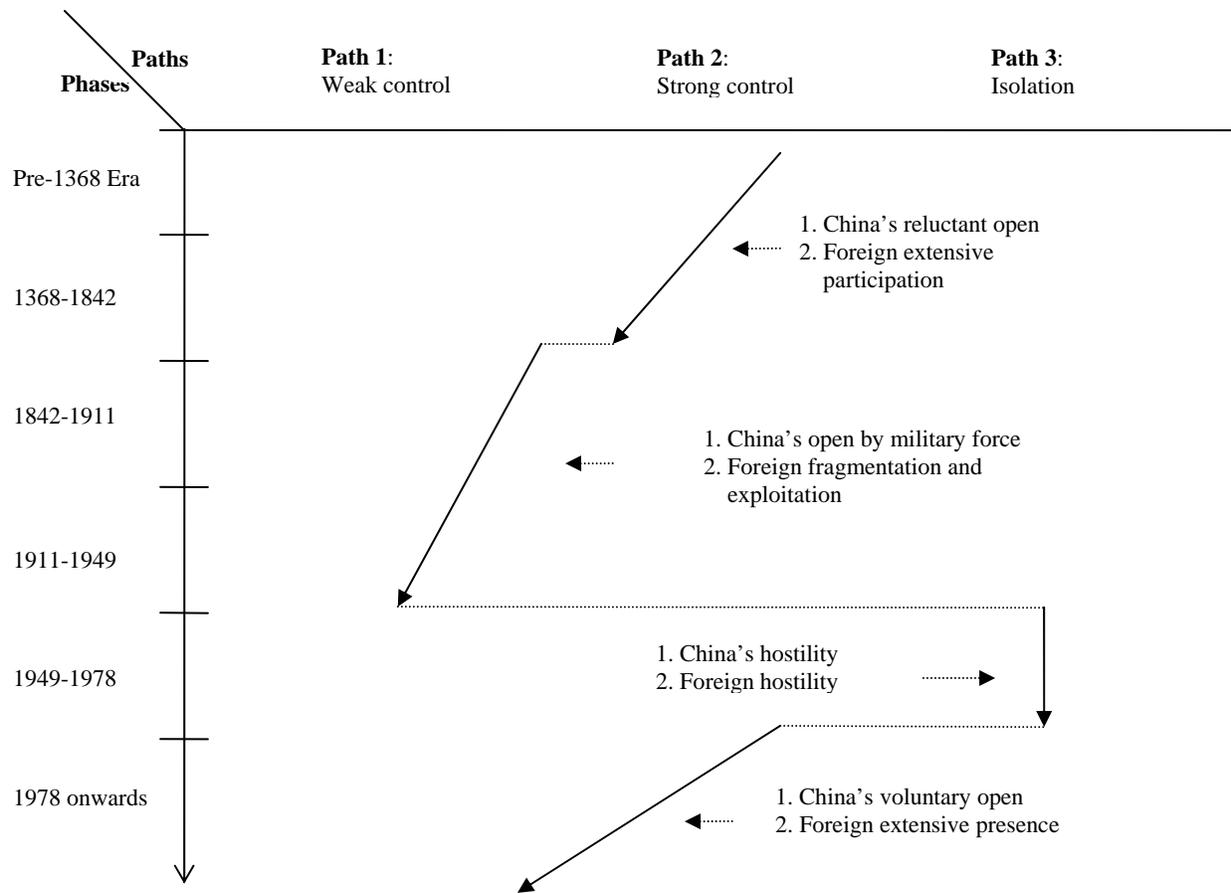


Figure 7 Path of FDI-related Institutional Building

Why is it a path-dependence? “Path dependence means that history matter”⁹⁴. Therefore, we can not simply trace back to the previous stage to claim the FDI institutions are off the path, though it does go off the path of the previous stage. Historically, the current institutional building takes many components from the past. Ideologically, although China accepts FDI especially those in a form of WFOE, China insists on self-reliance which has long been a feature of the Chinese institutions and attitudes when facing foreign participation. Local governments may weaken the central control due to locational competition and their eager needs for FDI, they do attempt or have intention to gain its own capability to develop local economy. Secondly, though China followed different patterns of path in the past, the history demonstrated that China’s control over FDI leans to weak once foreign investment gains high penetration in China in economic or political sense. In the first and second phases, though China could exert strong control over

⁹⁴ North (1990: 100).

foreign trade, this control did become weaker when these trades became more extensive. In the third and fourth phases, with the expanding of foreign fragmentation in China and the weakening of the Chinese government, the central control was also becoming weaker. The fifth phase could be seen as an adjustment in response to the past experience. Since the economic reform in 1978, we see a break from the fifth phase in term of opening door and accepting market components, however, we see more a reflection of the historical path in terms of FDI development in China. On the one hand, the central government follows the previous stages, exerting strong control over FDI by defining their organizational forms, restricting their investment locations and industries and so on. On the other hand, the central control has been weakened over time with the increasing of FDI. Regions that can offer incentive policies to FDI have been expanded from 4 SEZs to more open cities and then to all over the country. The selection of organizational mode, in most of cases, has been left to a choice of foreign investors themselves. Here, we clearly see a similar development pattern to those before 1949.

What are those deviations? It is mainly an ideological matter. Historically, China didn't show such a positive attitude towards FDI. In the earlier three phases, China was indifferent or reluctant to accept FDI. In the fourth phase, though China had recognized the significance of using FDI, China didn't accept it with a very open attitude. In the fifth phase, the FDI was even banned. It is in the current phase when China doesn't only recognize the significance of FDI, but also positively took steps to absorb them while imposing appropriate control. However, should we have to regard it as a deviation? Not necessary. It is clear that institutions in each phase are influenced by attitudes and behaviors in previous phases. In this sense, history matters, which then refers to path dependence.

5. Conclusion

It is interesting to looking back the historical development in terms of China's foreign relations. This historical exploration helps us to understand what attitudes China has had towards foreign investors, what foreign investors have had towards investing in China, and how they change over time. Historically, China's attitudes have been changed, although it doesn't change much at the local level for pursuing economic gains. This change is influenced by China' relative economic power and their attitudes towards China. The change in attitudes further influences institutional building.

In this process, historical attitudes matter. Attitudes are built on the relative (economic) capability and the behaviour of the other side. The initial attitude of indifference was generated on a ground of Chinese superiority. The following attitude of reluctance was due to the increasing foreign participation and their significance. The attitude of hostility was developed as a consequence of foreign exploitation and fragmentation. The current attitude of welcoming FDI is a result of need for foreign advanced technologies and capital supply and the perception of their performance. Meanwhile, the historical attitudes have formed some genes in society which explain the source of caution towards FDI.

The historical analysis shows that institutions are outcomes of interaction between the government and foreign participants. The government's institutional building is influenced by the previous behaviour of foreign participants. The foreign enthusiastic participation in the early days pushed the government to reluctantly accept foreign trade by establishing institutions to control them. Their exploitations in the 19th and the early 20th century created a hostile attitude towards FDI and, due part to this, led to the ban on FDI in the Mao's time. In the reform era, the Chinese leadership gradually changes the attitude as a response to the behaviour and performance of FDI, which led to a more open institutional framework and looser control over FDI.

The more interesting is that this interaction more directly takes place at the local level. Given the size of China in geography, the local governments are responsible for implementing the central policies. Those interactions between local governments and foreign investors determine how these institutions are enforced and how foreign investors respond to them.

To conclude, we can sort out, from the historical attitude changes, important actors that shape the path of institutional change. They are the central government, local governments/local business societies, and foreign investors/their home countries. Their attitude and behaviour together shape the development path of institutions. Therefore, to understand the institutional change in China in the reform era, a process approach is required. This also helps us understand how the institutions may evolve in the future. For example, the increasing influence of FDI on the local economy may push the government to strengthen the control again to protect its own benefits. Some studies have looked into the process of the institutional changes⁹⁵. However, it is at an overall level or

⁹⁵ E.g. Pearson (1991) and Shirk (1994).

national level. The local-level studies deserve more attention⁹⁶. The most interesting questions are how foreign investors and local governments collaborate to circumvent the central control policies, and how their relationship influences institutional building and shapes organizational choices of foreign investors. These questions will be further studied.

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