

The Dynamics and Progress of Competitive Liberalization in China*

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When post-Mao reforms began, few, if anyone, foresaw the rapidity and depth of China's economic liberalization. Using a model of competitive liberalization, this paper explicates the dynamics and consequences of induced policy disequilibrium, namely the introduction of preferential liberal policies in some regions of the country. The model accounts for the spatial extension of preferential policies, and its predications are empirically substantiated. Finally, the implications of competitive liberalization for macroeconomic control and interregional relations are discussed.

Keywords: China; competitive liberalization; central-local relations; decentralization; regional cleavages; political economy

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A number of developments during the post-Mao period have accentuated cleavages between the coastal and interior regions. Specifically, planners' introduction of a limited market sector alongside materials allocation has served as a poignant reminder to interior leaders that, under central planning, interior producers have not been adequately compensated for exporting resources at state-set prices. Adding insult to injury, the central government has switched from an interior-oriented development strategy to one that favors the economically more advanced coastal regions by adopting preferential policies for the latter while reducing the share of investment funds allocated to the interior. To cope with the changing policy environ-

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ment, leaders of interior provinces have engaged in a policy *panbi* in which they have lobbied central leaders to extend preferential policies to the interior. In the meantime, interior localities have taken matters into their own hands by processing the raw materials *in situ*.

In this paper, this author analyzes the dynamics and consequences of these two types of local behavior, and discusses the evolution of regional cooperation and cleavages under the reforms. This paper will discuss the spread of preferential policies under conditions of fiscal decentralization. After a brief review of decentralization trends, we will introduce a simple game-theoretic model to explicate the dynamics of competitive liberalization. The predications from the model will then be empirically substantiated through a discussion of the spread of preferential policies throughout the country. Finally, we will point out the implications of competitive liberalization for macroeconomic control and interregional relations.

Fiscal Decentralization

As numerous Chinese and Western commentators have pointed out, a key feature of China's post-Mao reforms has been the ongoing realignment of central-local relations, especially in terms of fiscal arrangements. Throughout the reform era (and even before it),¹ there has been a tendency to decentralize fiscal resources from the central government to local authorities. Government budgetary revenue as a share of gross national product (GNP) declined from 35 percent in 1978 to less than 20 percent in the early 1990s. Moreover, in tandem with the downward shift of fiscal resources, spending responsibilities for public works, education, and welfare subsidies have been transferred to local governments.

The transfer of both resources and obligations to lower levels of government has created powerful fiscal incentives for these governments to promote local economic growth in order to raise revenue

¹Since the Great Leap Forward, several waves of decentralization in the fiscal and administrative systems have stimulated local enthusiasm and initiative. For general discussions, see Audrey Donnithorne, "Center-Provincial Economic Relations in China," *Contemporary China Papers*, no. 16 (Canberra: Contemporary China Center, Australian National University, 1981); Michel Oksenberg and James Tong, "The Evolution of Central-Provincial Fiscal Relations in China, 1971-1984: The Formal System," *The China Quarterly*, no. 125 (March 1991): 1-32; *Dangdai Zhongguo caizheng* (Contemporary China's finance) (Beijing: Zhongguo shehui kexue chubanshe, 1988).

and create employment. David Granick has argued that regional governments in China acquired de facto property rights in economic agents (such as individual state-owned enterprises) by historical tradition, investment in the fixed capital of the agent, or both, and that this system of multiple principals, with property rights belonging to different levels of government, distinguishes China from the Soviet or East European centrally-planned economies.² The fiscal decentralization trend under the reforms has only served to accentuate the tendency of local principals in the hierarchy to pursue their own interests.³ The fact that as many as half of all county-level governments were suffering from budgetary deficits in the late 1980s and early 1990s served to accentuate the revenue imperative, whether through development or sometimes development-cum-predation.⁴

The Dynamics of Competitive Liberalization

The theory of agency predicts that once local governments are given de facto possession of property rights, including part of the fiscal revenue, they will pursue local interests. Nevertheless, the center may use other mechanisms, such as a tightly controlled nomenclature system, to moderate and curb localist behavior. Christine Wong has argued persuasively that fiscal direction from the center has been quite substantial during the reform era.⁵ Indeed, the severity of the economic austerity program of 1988-91 underscored the degree of central discretion. A recent study by Yasheng Huang has produced similar conclusions on the implementation of macroeconomic policies.⁶

²David Granick, *Chinese State Enterprises: A Regional Property Rights Analysis* (Chicago: University of Chicago Press, 1990).

³Thrainn Eggertsson, *Economic Behavior and Institutions* (Cambridge: Cambridge University Press, 1990), 40-45.

⁴It must be pointed out that local cadres may have mixed motives for pursuing certain policies, including economic growth. Local cadres may want to win promotions, but as local resources have expanded, officials in prosperous areas have few incentives to move to the center and become a functionary. See William Byrd and Alan Gelb, "Why industrialize? The Incentives for Rural Community Governments," in *China's Rural Industry: Structure, Development, and Reform*, ed. William Byrd and Lin Qingsong (New York: Oxford University Press, 1990), 358-87.

⁵Christine Wong, "Central-Local Relations in an Era of Fiscal Decline: The Paradox of Fiscal Decentralization in Post-Mao China," *The China Quarterly*, no. 128 (December 1991): 691-715.

⁶Yasheng Huang, *Inflation and Investment Controls in China: The Political Economy of Central-Local Relations During the Reform Era* (New York: Cambridge University Press, 1996).

Yet the theory of agency does *not* predict why local governments must pursue reform and/or development, even though a number of authors have provided strong empirical evidence that local government in China is developmentalist, particularly in prosperous localities situated in the coastal region.⁷ The interests of local governments (staffed by cadres who are of course not above pursuing personal interests) may be met in a variety of ways, with economic development only one of a choice set. In this subsection, I suggest that a simple model could account for why local governments have tended to compete and emulate each other in adopting certain policies of economic liberalization.

Theoretically, it is possible that all local units can get together to coordinate the country's economic activities and strive for macroeconomic stability. However, leaving aside the issue of inadequate information, each local government has strong incentives to be the first to pursue policies of liberalization once liberalization is deemed politically desirable. This can be illustrated by the following example.

Suppose there is a country comprised of two adjacent local governments A and B, with relatively porous borders between them. Both have to pay out considerable amounts of subsidies to urban consumers who purchase rationed grain from government stores at fixed (and lower than market) prices. The government in turn procures grain from farmers at a state-set price that is lower than the market price but higher than the price that it resells to urban consumers. In light of the fiscal pressure the subsidies exert, leaders in both administrations consider whether to liberalize grain prices (assuming that the central government encourages but does not dictate the decision in the intermediate term). There are four possible choice combinations in this case.

a> Both decide, whether independently or jointly, not to liberalize at the present time. The fiscal pressure remains but no major changes are made.

b> Both decide, whether independently or jointly, to liberalize grain prices at the same time. The price paid to farmers and by consumers soon reaches the market price. Both local governments get out of the business of procuring and selling grain and are no

⁷Jean C. Oi, "Fiscal Reform and the Economic Foundations of Local State Corporatism in China," *World Politics* 45, no. 1 (October 1992): 99-126.

longer burdened by grain subsidies.

c> In two other choices, however, either A or B liberalizes grain prices before the other does and, assuming that there is a considerable time lag before the other liberalizes, grain will move from the subsidized area to the liberalized area as farmers and grain traders seek to take advantage of A and B's price differentials. As a result, the late liberalizer faces procurement problems as well as the loss of subsidized grain to the other area. It adopts administrative measures such as border blockades to stop the grain from being taken out, but this is far from successful given the porous borders. In consequence, it is not only still burdened with the price subsidies that it pays urban consumers, but also confronted with a shortage in grain availability that threatens to become a source of social instability. In other words, the late liberalizer is the sucker in a competitive policy game.

In summary, both A and B will have strong incentives to avoid being the sucker. As the formal discussion in the appendix shows, if the provinces fear punishment by the central government for liberalizing, then their choices will depend on their sensitivity to the punishment relative to the cost of maintaining subsidies. Once the provinces know that they will not be punished by the central government for pursuing liberalization, they will rush to liberalize. As a consequence, outcome b> will become the outcome of this two-player game, leading to a rush to liberalize. The moral of this simple model can be extended to a country comprised of a multitude of local governments endowed with a certain degree of autonomy: It does not pay to liberalize later than one's neighbor. In the real world, however, the rush to liberalize will likely be initially less strong than indicated by the model because local leaders may be held back by ideology as well as lack of information. Once the benefits enjoyed by the early liberalizers are demonstrated, others will want to climb on the bandwagon, eventually producing a rush to liberalization.

The above discussion does not just apply to price liberalization but can, with some adjustment, also be applied to other policy arenas such as investment. In the case of investment, the long-term differential impact on early and later liberalizers can be particularly significant given the path-dependent nature of investment decisions. Theorists of regional change from Albert Hirschman to Paul Krugman have emphasized that regions which come to dominance in earlier periods tend to retain their preeminent positions for long periods, despite the existence of countervailing trickle-down

effects.⁸ If one area (such as a special economic zone, SEZ) in a country adopts preferential policies toward investors ahead of other areas of the country, then this one area will likely get a disproportionately large share of the total investment and remain ahead for a long period to come. Investors are unlikely to simply pack up their factories and move when another area catches up in liberalization. Because of the dynamics described here, localities are expected to emulate and compete against each other to liberalize and to offer more preferential policies as long as they are politically and ideologically permitted to do so. The competition to offer ever more attractive terms will tend to make the entire country a giant SEZ, with no area more attractive than the others in policy terms (investors will also consider other factors such as the quality of local labor force and access to transport facilities), though this will make China a more attractive investment target compared to other countries. This may result in more concessions being made than if the process is centrally coordinated. Furthermore, the dynamics of competitive liberalization lead to bandwagoning that exacerbates the difficulties of transitional macroeconomic management and thus invites administrative intervention, leading to cycles of decentralization-centralization.⁹

Overall, the above model of competitive liberalization describes China's opening-up trends quite well. In the early 1980s, political and ideological concerns about the spread of liberal policies were strong among some members of the top elite, constraining the liberalization progress. As these concerns were gradually eased, the dynamics of competitive liberalization came to predominate, producing a rush to establish special investment zones and programs throughout the country in the 1990s.

⁸See Albert Hirschman, *The Strategy of Economic Development* (New Haven: Yale University Press, 1958); Gunnar Myrdal, *Economic Theory and Under-developed Regions* (London: Gerald Duckworth, 1957); Harry Richardson and Peter Tonwroe, "Regional Policies in Developing Countries," in *Handbook of Regional and Urban Economics*, ed. P. Nijkamp (Amsterdam: Elsevier Science Publishers, 1986), 647-78; Paul Krugman, "Increasing Returns and Economic Geography," *Journal of Political Economy* 99 (1991): 183-99; Paul Krugman, "On the Number and Location of Cities," *European Economic Review* 37 (1993): 293-98.

⁹I elaborate on this theme in Dali Yang, "Policy Credibility and Macroeconomic Control in China" (Paper delivered at the American Political Science Association Annual Meeting, The Washington Hilton, September 2-5, 1993); Jude Howell points to the spiral nature of China's open policy. See Jude Howell, *China Opens Its Doors: The Politics of Economic Transition* (Boulder, Colo.: Lynne Rienner, 1993).

Interior Interests and Territorial Preferential Treatment

During the early 1980s, interior interests that relied on the planned economy and central budgetary transfers were more likely to seek limitations on preferential policies extended to selected areas in the coastal regions. In this endeavor, these interests had their advocate in patriarch Chen Yun, whose emphasis on economic adjustment gave the SEZs a slow start.¹⁰ Smuggling incidents in Shenzhen also invited criticisms from Communist Party stalwarts. At the Conference of First Provincial Party Secretaries held in December 1981, inland leaders supported Chen Yun in emphasizing that the number of SEZs would be limited to the four then in existence, although other parts of Guangdong and Fujian also sought to become such zones.¹¹ Chen Yun believed that the experiences of the existing SEZs had not been adequately reviewed, and was also afraid that SEZ export processing might wipe out domestic products, mentioning that provinces such as Jiangsu should not establish SEZs.¹² By limiting the scope of zonal development, planners stood to benefit from foreign investment but had no fear of losing control of the developmental process.

By 1981, various central leaders had expressed their strong support for SEZs. On each of their visits to Shenzhen, vice premiers Bo Yibo and Gu Mu took pains to stress that central policies toward the SEZs would not be reversed.¹³ In spite of central officials' support, however, SEZ leaders were not certain that the zones would be allowed to continue as long as Chen Yun was not yet on board. Indeed, Bo and Gu's remarks highlighted the pervasive skepticism and uncertainty then surrounding the future of the SEZs, which were criticized for spreading bourgeois influence and breeding economic crime.¹⁴

¹⁰Ruan Ming, *Lishi zhuanzhedian shang de Hu Yaobang* (Hu Yaobang at a historical turning point) (River Ridge, N.J.: Global Publishing, 1991), 58.

¹¹*Zhonghua renmin gongheguo guomin jingji he shehui fazhan jihua dashiji jiyao (1949-1985)* (A summary chronology of major events in PRC national economic and social development planning, 1949-85) (Beijing: Hongqi chubanshe, 1987), 449.

¹²Chen Yun, "Several Important Principles in Economic Construction," in *Chen Yun wenxuan (1956-1985)* (Selected works of Chen Yun, 1956-1985) (Beijing: Renmin chubanshe, 1985), 275-77.

¹³Shenzhen shi dang'anguan, *Shenzhen shi shinian dashiji* (A chronology of major events in Shenzhen, 1979-89) (Shenzhen: Haitian chubanshe, 1991).

¹⁴For contemporary criticisms of the SEZs, see Thomas Chan, E. K. Y. Chen, and Steve Chin, "China's Special Economic Zones: Ideology, Policy, and Practice," in

Relief came on October 30, 1982, when Chen Yun read a preliminary review on the zones submitted by the Guangdong leadership to the center. Chen commented, "The special zones should be built. [We must] continually sum up experiences and strive to run the special zones well."¹⁵ As soon as He Chunlin, head of the State Council Office of Special Zones, saw Chen's comments, he called Guangdong leaders to inform them of the good news. By this time, the zones were also test sites for domestic reforms in housing, labor management, and other practices. Shortly after Chen Yun's comments were made, general secretary Hu Yaobang made well-publicized visits to the Xiamen and Shenzhen SEZs in December 1982 and February 1983. Hu reiterated Chen Yun's message and reaffirmed the central leadership's determination to develop the SEZs using special, flexible policy measures.¹⁶ In early 1984, amid a conservative campaign against spiritual pollution, Deng Xiaoping made an inspection trip to Shenzhen. Deng praised Shenzhen's achievements and concluded that the decision to establish SEZs had been correct.

Internal Linkages

Since most provinces were prohibited from establishing their own SEZs at this time, it was natural for enterprises from these provinces to seek profit from the preferential policies that the four SEZs in Guangdong and Fujian enjoyed; for instance, the tax rate for Shenzhen companies was set at only 15 percent and zone companies retained most of their foreign exchange earnings.¹⁷ There was soon a

China's Special Economic Zones: Policies, Problems and Prospects, ed. Y. C. Jao and C. K. Leung (New York: Oxford University Press, 1986), 95-98; George T. Crane, *The Political Economy of China's Special Economic Zones* (Armonk, N.Y.: M. E. Sharpe, 1990), 35-40.

¹⁵*Shenzhenshi shinian dashiji*, 36.

¹⁶Shortly after Hu's visit, joint ventures that were previously required to export all output were given permission to sell some products within China. Other changes followed.

¹⁷It should be pointed out here that the opening of special zones in other parts of the country did not lead to terminations of the earlier cooperative arrangements for two reasons. First, the four SEZs still had more liberal business environments. Second, most cooperative ventures had likely become accustomed to doing business in the zones and it was costly to relocate. For a useful discussion of the many advantages Shenzhen possessed as an extension of Hong Kong, see Ezra Vogel, *One Step Ahead in China: Guangdong Under Reform* (Cambridge, Mass.: Harvard University Press, 1989), 148-49.

proliferation of what has been called “internal linkages” (*neilian*), that is, cooperative relationships within China. Provincial and local governments established links with Shenzhen and other special zones by opening representative offices, branch companies, and joint ventures in the zones, which served as China’s windows and bridges to international markets. For example, Hualian Textile Corporation was founded in Shenzhen in December 1983 with the participation of textile bureaus from eighteen provincial units.¹⁸

On their part, the SEZs faced many obstacles in their early years and eagerly sought cooperative relationships with non-zone areas for both economic and political reasons. Economically, the cooperative projects brought in human talent, investment funds, and technology, often leading to sales for products produced in or going through the zones. Bao’an county, which became Shenzhen, had only six engineers on its payroll in the beginning.¹⁹ Once it became an SEZ, it was able to attract thousands of technical personnel from around the country. Indeed, much of the investment funds for the special zones in their early years came from within China rather than abroad.

Politically, leaders of the SEZs sought to enhance linkages with interior provinces in order to garner political support, particularly because the zones were not very successful in attracting foreign high technology in the early 1980s.²⁰ Being officially “special,” leaders of the zones could not be sure whether the zones were experiments to be terminated or popularized. Because the zones were the closest approximations of capitalistic practices within China, they became easy targets for politically motivated attacks whenever the political environment became ideologically charged. Ever since their establishment, the SEZs have periodically faced criticism, including charges of selling out to foreign interests, internal exploitation, rising corruption, smuggling, and trade deficits.²¹ By building cooperative ties with interior interests that were likely to feel disadvantaged and resentful toward the SEZs, the special zones sought to improve their image, deflect domestic criticisms, and broaden their political support base.

¹⁸*Shenzhen shi shinian dashiji*, 59.

¹⁹Liu Zhigeng, *Fazhan, kaifang, gaige: Shenzhen jingji fazhan huigu yu qianzhan* (Development, opening up, and reform: A review of Shenzhen’s economic development and its prospects) (Shenzhen: Haitian chubanshe, 1991), 199.

²⁰Robert Kleinberg, *China’s “Opening” to the Outside World: The Experiment with Foreign Capitalism* (Boulder, Colo.: Westview Press, 1990), 74-75.

²¹*Ibid.*, 71-96; Crane, *The Political Economy of China’s Special Economic Zones*.

While cooperative ventures appeared in the SEZs from early on, the number of such ventures rose sharply beginning in 1983. There were a total of 29 cooperative projects over 1979-82, in contrast to the 969 such projects that were reportedly planned in 1984. Of the 969 projects, 395 came from 27 provinces and 236 were sponsored by lower-level domestic authorities.²² This increase was partly due to the zones' more certain status following Chen Yun's 1982 comments and Hu Yaobang's visits. Moreover, the Shenzhen government had convened its first meeting on enterprises built on internal linkages and approved a set of highly attractive policy measures for such enterprises. Besides tax and import duty privileges, enterprises based on domestic linkages could lease land in Shenzhen for 30 percent less than the going rate for foreign investors and retain 20 percent more in foreign exchange earnings.²³ These preferential policies for domestic investors signaled to interior interests that the SEZs would treat them more favorably than overseas investors. In short, as far as laterally-linked enterprises were concerned, the interests of coastal SEZs and interior governments seemed to converge, leading to a honeymoon period for interregional cooperation.

Since the mid-1980s, Shenzhen has redoubled its efforts to stabilize and consolidate its domestic linkages during gloomy political periods such as 1985-86 and 1989-90. During the storm of criticism that raged over SEZ performance in 1985, Shenzhen was attacked for relying on "state blood transfusions" and "only making money out of the interior." To burnish Shenzhen's image, Shenzhen leaders launched a publicity campaign. In November 1985, deputy mayor Zhou Xiwu discussed strengthening Shenzhen's linkages with the rest of China in order to make its industry more outward-oriented. The next month Mayor Li Hao stated that "Shenzhen needs the continual support from the rest of the country and Shenzhen must serve the rest of the country better."²⁴ Soon after, the Shenzhen leadership decided to adopt the slogan of "The whole country supports Shenzhen; Shenzhen serves the whole country" as the centerpiece of its publicity campaign.²⁵

²²Crane, *The Political Economy of China's Special Economic Zones*, 88.

²³*Shenzhenshi shinian dashiji*, 50.

²⁴*Ibid.*, 169, 174; Li Hao, "Expand Internal and External Cooperation and Raise the Level of Special Zone Construction," *People's Daily*, April 30, 1986.

²⁵Liu, *Fazhan, kaifang, gaige*, 200.

To fulfill the pledge of mutual support, the Shenzhen municipal authorities sought to soothe the grievances of enterprises based on internal linkages. During 1986-87, they cracked down on excessive levies and fees and strove to treat these enterprises on the same footing as local ones.²⁶ In May 1987, the municipal government established an office of economic cooperation and also issued a set of interim regulations for further promoting internal linkages. By mid-1986, 27 central ministries and 27 provinces had established 2,300 cooperative enterprises and institutions in Shenzhen, with a total pledged investment of 5.6 billion *yuan*. More than 500 cooperative industrial enterprises were producing 170-plus kinds of export products.²⁷ Many "Third Front" enterprises in the interior had set up branches in Shenzhen in order to gather market and technical information and exploit market opportunities.²⁸ Moreover, a growing number of Shenzhen-based enterprises were setting up plants in the rest of China.

The Bandwagon of Special Zone Creation

Once central leaders unanimously supported the SEZs in Guangdong and Fujian, leaders in other parts of China abandoned their wait-and-see attitude and lobbied central leaders to request that similar zones be established in their provincial units as well. In the words of Chen Yun, "Every province wanted and sought special treatment."²⁹ In the meantime, provincial officials from across the country began making visits to Shenzhen to take a firsthand look at China's leading SEZ and discuss the establishment of cooperative ties. The Shenzhen official chronology lists only provincial delegations led by first Party secretaries. Between December 1983 and January 1985, eight such top-level provincial delegations toured Shenzhen, including Henan, Tibet, Sichuan, Hunan, Guizhou, Jilin, Shanxi, and Shanghai.³⁰

While Chen Yun approved the decision to establish SEZs in 1982, Chinese authorities deferred to his earlier injunction on limiting the number of SEZs; they did not designate new SEZs until 1988,

²⁶Ibid., 200-201.

²⁷*Shenzhen shi shinian dashiji*, 217-18.

²⁸Vogel, *One Step Ahead in China*, 142.

²⁹Chen Yun, "Strengthen and Improve Economic Planning Work," in *Chen Yun wen-xuan (1956-1985)*, 280.

³⁰*Shenzhen shi shinian dashiji*.

when Hainan, which had been a leading candidate since the early 1980s, was finally made the fifth SEZ as well as a separate province. Instead, reformers seeking to expand the reformist coalition and garner political support for economic liberalization devised new appellations to differentiate the newly designated areas from the four SEZs.

Most of the newly designated zones were granted preferential treatment for foreign investors, but on terms that were less generous than those in SEZs. For example, shortly after Deng Xiaoping's 1984 visit to Shenzhen, the State Council approved the extension of this open policy to fourteen coastal cities and Hainan Island; others were added to the list in later years. The open coastal cities also set up Economic and Technological Development Zones. The following year, the open policy was extended to the Yangtze, Pearl River, and South Fujian deltas. By now, the coastal regions had become dotted with various development zones, laying the ground for the coastal development strategy that was formally promulgated in 1988.³¹

Our discussion of liberalization dynamics has suggested that as the benefits of being an SEZ become clear, there is a growing demand for territorially-based preferential policies. Shanghai, for example, felt threatened by the rise of Shenzhen and asked for preferential policies. It received some in the form of the Shanghai Economic Zone in 1983, which accorded the city greater leeway in managing international economic interactions.³² This fell far short of SEZ status, however, and Shanghai officials complained bitterly.³³ Deng Xiaoping himself stated during his 1992 tour of the south that Shanghai should have been made an SEZ from very early on, and the delay had caused the city to lag in reforms. Yet the case for making Shanghai an SEZ was extremely difficult to make in light of the elite cleavages and China's fiscal situation in the early 1980s.³⁴ Because of its disproportionate contribution to state revenue, it would have been difficult for planners to relax their grip on Shanghai at the time. On the other

³¹Dali Yang, "China Adjusts to the World Economy: The Political Economy of China's Coastal Development Strategy," *Pacific Affairs* 64, no. 1 (March 1991): 42-64.

³²Crane, *The Political Economy of China's Special Economic Zones*, 39.

³³Susan Shirk, *How China Opened Its Door: The Political Success of the PRC's Foreign Trade and Investment Reforms* (Washington, D.C.: The Brookings Institution, 1994), 39.

³⁴Lynn T. White, *Shanghai Shanghai? Uneven Taxes in Reform China* (Hong Kong: University of Hong Kong Center for Asian Studies, 1989).

hand, by giving it a degree of preferential policy treatment, Beijing reformists at least tempered Shanghai's resentment.

As the streams of visitors to Shenzhen increased, leaders of inland areas also began to turn from complaining about the preferential coastal area policies to actively seeking those policies for their own turf in the mid-1980s, having seen a growing amount of foreign investment being attracted to the SEZs and open cities in the coastal regions.³⁵ After Deng affirmed the success of the SEZs and suggested that fourteen coastal cities be given preferential treatment, twenty-four inland cities reportedly asked for the same privileges.³⁶ In Yunnan's case, Yan Liankun and Chen Zhi not only advocated improvement of its infrastructure and adopting preferential policies to attract foreign investment, but also asked the central government to make Yunnan an interior trading port and offer it more favorable policies than those enjoyed by the coastal open cities.³⁷

Broadly speaking, two types of argument were used to justify the adoption of preferential policies in interior regions. The first type of argument claimed that the establishment of special zones in the interior was a natural extension of China's opening-up process. Indeed, an article in a Yunnan economic journal contended that the existing special zones were too isolated (*gulinglingde*) and not well integrated with the Chinese economy.³⁸ The authors of the article proposed that SEZs be established in interior provinces to form a cluster of special zones across China that would link the Chinese economy with the world economy. The second type of argument pointed out the special conditions in parts of the interior regions, particularly the backwardness and political importance of ethnic minority areas. It was argued that areas inhabited by ethnic minorities were special and should not be governed with universal policies. Instead, they needed special preferential policies to attract technology, capital, and

³⁵ *Jingji ribao* (Economic Daily), June 3, 1985, in Foreign Broadcast Information Service (FBIS), *Daily Report: China* [hereafter cited as *FBIS-CHI*]-85-113 (June 12, 1985): K5-6.

³⁶ Howell, *China Opens Its Doors*, 23.

³⁷ Yan Liankun and Chen Zhi, "Adopt Preferential Policies and Speed Up the Pace of Foreign Investment in Yunnan," *Jingji wenti tansuo* (Inquiry into Economic Problems), 1985, no. 6:8.

³⁸ Wu Jixue and Yang Linjun, "The Strategic Implications of Establishing a Cluster of Special Economic Zones, Including Zones in the Interior," *Jingji wenti tansuo*, 1985, no. 4:1-6.

human resources.³⁹

While it is difficult to quantify the impact of local demands on national policy, it is certain that the provinces' many demands for preferential treatment reinforced the trend toward decentralization and liberalization. By mid-1986, many provinces had been allowed to offer tax exemptions, reductions, or holidays to targeted foreign ventures.⁴⁰

This interior effort at joining the "opening-up" bandwagon reached a climax following the promulgation of the coastal development strategy by Zhao Ziyang in early 1988 and the decision to make Hainan a separate province and China's largest SEZ.⁴¹ For example, the special open zones authorized by the State Council after the promulgation of the coastal development strategy included Sanwan, Ya'an, and Suining in Sichuan, whose leaders had complained about the preferential policies for Guangdong in 1987.⁴² These open zones typically offered various enticements to foreign investors, including tax breaks and other kinds of sweet deals. In the meantime, the central government sought to be more regionally balanced by initiating a program of high and new technology industrial development zones. Many of the zones so designated were located in interior cities such as Wuhan, Xi'an, Chengdu, Changchun, Changsha, and Chongqing. From 1988, these zones were part of the State Torch Plan for technology development under the auspices of the State Science and Technology Commission.

The spread of various types of zones and local discretion in setting investment policies intensified competition among local governments to attract foreign capital. In order to compete with southern cities, the city of Dalian in Liaoning offered free land for a Canon factory in 1989. Other companies such as Toshiba basically determined their own land prices when they chose to invest in Dalian in 1991.⁴³

³⁹Xu Jingjun, "Use Lateral Economic Linkages to Promote Economic Development in Ethnic Areas," *Jingji wenti tansuo*, 1987, no. 2:19.

⁴⁰Harry Harding, *China's Second Revolution: Reform After Mao* (Washington, D.C.: The Brookings Institution, 1987); "Overview of Investment Incentives," *China Business Review* 13 (May-June 1986): 20-23.

⁴¹See note 31 above.

⁴²"Zhao Ziyang Discusses the Outward-Oriented Strategy for Economic Development," *Inside China Mainland* 10, no. 5 (1988): 29.

⁴³Emily Thornton, "Opportunity Knocks," *Far Eastern Economic Review*, December 8, 1994, 56.

Competition with the southeastern coastal provinces and especially Guangdong was the most important reason behind the drive for open-zone status in a number of adjacent interior provinces. Amid the fanfare for the coastal development strategy, land-locked Henan announced the establishment of two open zones for foreign investment in June 1988 despite higher-level disapproval.⁴⁴ The policies of Hunan and Jiangxi, both of which border on free-wheeling Guangdong, have been to deal with the coastal challenge by “countering openness with openness, dynamism with dynamism” (*yi fang dui fang, yi huo dui huo*); as the game-theoretic model predicts, if you can’t beat them, join them. Such a strategy led Wu Guanzheng, the then-governor of Jiangxi, to announce new preferential measures to attract outside investment, make southern Jiangxi an experimental zone for reforms, and abrogate all barriers to commerce between Jiangxi and the coastal regions (i.e., Guangdong and Fujian) in the late 1980s.⁴⁵ The competitive dynamics also affected Jiangxi’s price policies, as Jiangxi’s richer neighbors Guangdong and Fujian tended to purchase agricultural and raw materials from Jiangxi at higher prices than the Jiangxi government offered. In order to compete, Jiangxi had to repeatedly raise its procurement prices for agricultural and raw materials before eventually freeing up prices.⁴⁶

In Hunan, the provincial government maintained cooperative ties with its Shenzhen counterparts. In July 1987, for example, then-Hunan governor Xiong Qingquan led an economic cooperation delegation to Shenzhen and signed documents on the production and supply of agricultural and sideline products; the development of export products in textiles and food production, machinery, chemicals, and electronics; and the promotion of trade and tourism.⁴⁷ Meanwhile, faced with the repercussions of Guangdong’s reforms, which had led to rising prices and labor costs, and under pressure from residents to be given more autonomy to compete with Guangdong, Hunan petitioned the State Council and received permission to transform

⁴⁴Willy Wo-Lap Lam, *The Era of Zhao Ziyang: Power Struggle in China, 1986-1988* (Hong Kong: A. B. Books & Stationery, 1989), 249.

⁴⁵*Ibid.*, 248; Wang Guoxing, “Initial Thoughts on Establishing a Special Green Industry Zone in Southern Jiangxi,” *Jiangxi shehui kexue* (Jiangxi Social Sciences), 1991, no. 2:31.

⁴⁶Li Xianghua and Wu Shaohua, “Jiangxi’s Economic Strategy Within an Environment of [Macroeconomic] Control and Adjustment,” *Jiangxi shehui kexue*, 1990, no. 4:44.

⁴⁷*Sherzhenshi shinian dashiji*, 268.

the municipality of Hengyang and two adjacent counties in southern Hunan into an open economic zone.⁴⁸ In effect, the southern Hunan zone was designed to act as a buffer between rapidly liberalizing Guangdong and the rest of Hunan. Gradually, however, the Hunan leadership (and new leaders) have called on Hunan to actively develop in concert with Guangdong. In the 1990s, Hunan has worked under the motto "Hunan will do whatever Guangdong does" and used the southern Hunan zone to integrate the Hunan and Guangdong economies in order to gain better access to the Guangdong market and attract capital and technology from Guangdong.⁴⁹

From Tiananmen to Zone Rush

Political crises within China and other socialist countries stimulated a drive by Chinese leaders to become more balanced in treating different regions and thus broaden their territorial base of support. While it did not scrap the SEZs, as some had feared, the central government nevertheless increased demands for financial contributions from Guangdong and Fujian.⁵⁰ Moreover, the introduction of a unified foreign exchange retention system in preparation for China's entry into the General Agreement on Tariffs and Trade (GATT) curbed the SEZs' foreign exchange privileges.

Yet even while the central leadership emphasized that no new SEZs were to be created, all attention was on Shanghai's new Pudong (eastern Shanghai) area, which in 1990 came to enjoy practically the same preferential policy treatment as the SEZs and was slated to become China's financial center. Beijing's support for Pudong generated fears in the existing five SEZs that Shanghai, with its entrepreneurial tradition and strong pool of human resources, would

⁴⁸The zone was formally called *gaige kaifang guodu shiyan qu* (a transitional and experimental zone for reform and opening up). The two counties were Binzhou and Lingling. Both have since upgraded to city status. See Zhang Ping, "On the Regional Realization of Reformist Goals and the Reform of Transitional Areas," *Jingji yanjiu* (Economic Research), 1988, no. 9:46-50; Elizabeth Cheng, "Beggars Thy Neighbor," *Far Eastern Economic Review*, January 12, 1989, 46.

⁴⁹Zhang Annan, "The Openness of Southern Hunan," *People's Daily* (Overseas edition), February 24, 1996, 1.

⁵⁰Chang Mu, "A New Economic Operational System Will Be Established in 10 Years with the Aim of Seeking the Unity of the Nucleus and Ensuring the Stability of the General Situation," *Ching Pao* (The Mirror Monthly) (Hong Kong), no. 163 (February 10, 1991): 22-25; *FBIS-CHI-91-040* (February 28, 1991): 38-39.

steal the show. That Shanghai's leaders took every opportunity to trumpet Shanghai's technical depth and financial ambitions did little to allay southeastern provinces' anxiety.⁵¹ Competition within the coastal regions thus served to enhance the center's political leverage.

Interior lobbying for preferential policies continued after the Tiananmen crisis of 1989 and was especially visible during discussion of the Eighth Five-Year Plan at the Seventh Plenum of the Chinese Communist Party's (CCP's) Thirteenth Central Committee held at the end of 1990. Even though interior provinces were not permitted to establish Shenzhen-style SEZs, these provinces exploited the generally relaxed policy environment to their advantage. Anhui, for example, designated five cities as open cities for foreign investment in April 1991.⁵² On its part, the central leadership also sought to garner the support of interior leaders in the Tiananmen aftermath and moderate the impact of sanctions imposed on China by Organization for Economic Cooperation and Development (OECD) member states. Interior regions such as Xinjiang demanded that they not only be allowed to open up their border areas but be permitted to establish free trade zones and economic development zones in order to promote industrial development, enhance China's opening up, and alleviate the rising disparities between east and west.⁵³ In early 1990, China's leadership advocated an all-round opening up that would span the coastal rim as well as the western region. Thus, China's frontiers along the western borders were opened. Within this context, Deng Xiaoping's much publicized 1992 tour of southern China provided the stimulus for the climax of the movement.

Deng Xiaoping went on his highly symbolic southern tour and supported faster economic growth because he had become impatient with the limited reform measures that had been adopted after the Tiananmen crisis and sought to set the agenda for the upcoming Fourteenth Party Congress in fall 1992.⁵⁴ In his remarks on the tour, Deng

⁵¹Central leaders including Li Peng, Zhu Rongji, Qiao Shi, and Tian Jiyun visited the SEZs in 1991 to soothe their fears.

⁵²Radio Beijing, Service to North America (in English), April 7, 1991.

⁵³Tang Lijiu and Hu Ye, "Border Opening: The New Angle of China's Strategy for Opening Up to the Outside World," *Jingji wenti tansuo*, 1991, no. 2:51-52.

⁵⁴For discussion of other probable reasons behind Deng's move, see Tony Saich, "Peaceful Evolution with Chinese Characteristics," in *China Briefing 1992*, ed. William A. Joseph (Boulder: Westview Press, 1993), 9-34. For background analysis as well as the chronology surrounding Deng's southern tour, see Directorate of Intelligence, the Central Intelligence Agency, "The Chinese Economy in 1991 and 1992: Pressure to

emphasized that economic development was vital to the legitimacy of the CCP and called for bolder reform experimentation. For Deng, the economic austerity program of 1988-91 was necessary but insufficient. It only served the goal of stability and did not adequately promote growth.

Deng especially sanctioned more locally-based growth patterns:

Areas with adequate conditions should try to grow faster; as long as they emphasize efficiency, quality, and outward-oriented economy, [we] should not worry about them [growing too fast]; slow growth [in the context of faster growth rates by China's neighbors] is tantamount to stagnation, even retrogression. [We] must seize the opportunity and the present is a good opportunity.⁵⁵

In particular, Deng pointed out that Guangdong, Shanghai, and Jiangsu should grow faster than the national average. Indeed, it was hoped that Guangdong would "strive to catch up with the Asian 'four little dragons' in twenty years."⁵⁶ In contrast to the 6 percent growth rate premier Li Peng called for in his government report to the National People's Congress (NPC), Deng reportedly called for 10 percent annual GNP growth in China.⁵⁷

The Deng line soon dominated the political agenda, and his southern tour prompted a new wave of reform euphoria in China that encouraged local initiatives. In effect, Deng, like Mao had done on numerous occasions, allied himself with the provinces while the central government had been trying hard to rein in the provinces to prevent a repeat of high inflation. Deng's clamoring for growth upset a precarious balance that had coalesced in the aftermath of the Tiananmen crisis. On the one hand, provincial authorities could now invoke Deng and justify highly expansionary policies,⁵⁸ thereby precipitating an intense round of emulation and competition among

Revisit Reform Mounts" (Paper submitted to the Subcommittee on Technology and National Security of the Joint Economic Committee, Congress of the United States, August 1992). A number of Chinese books include detailed reports on Deng's southern tour and its ramifications; see, for example, Yuan Shang and Han Zhu, *Deng Xiaoping nanxun hou de Zhongguo* (China after Deng Xiaoping's southern tour) (Beijing: Gaige chubanshe, 1992).

⁵⁵Deng Xiaoping, "Major Points of Comrade Deng Xiaoping's Talks in Wuchang, Shenzhen, Zhuhai, and Shanghai" (1992), in Lu Keng, *Deng Xiaoping zuihou de jihui* (Deng Xiaoping's last chance) (Hong Kong: Pai Shing Cultural Enterprise, 1992), 207.

⁵⁶Ibid.

⁵⁷Saich, "Peaceful Evolution with Chinese Characteristics," 22-23.

⁵⁸Yuan and Han, *Deng Xiaoping nanxun hou de Zhongguo*, 102-41.

the provinces in adopting “innovative” policies such as development zones. Hainan’s Party secretary, for example, called for making the island a “socialist Hong Kong.” More generally, provincial leaders from across the country advocated more reform and opening up. On the other hand, as central leaders jumped on the bandwagon of bolder reforms, there were no longer any serious efforts by central leaders to exercise macroeconomic control and prevent economic overheating unless things threatened to get out of hand. Words of caution could easily be interpreted as political disloyalty; indeed, Deng had reportedly stated that whoever obstructed the reform campaign ought to be removed.

The balance thus tipped toward the localities, particularly after the issuance of Central Document No. 4 in June 1992, which extended opening-up policies from the coastal regions to the rest of China. During that year, five cities along the Yangtze River and eighteen provincial capitals in the interior were granted the same treatment as the coastal open cities.⁵⁹ Finally, interior provincial units bordering on foreign countries, including Heilongjiang, Liaoning, Jilin, Inner Mongolia, Xinjiang, Yunnan, and Guangxi, were given permission to designate open border cities, and each also set up a border economic cooperation zone. The thirteen border zones so designated by the State Council enjoyed lower tax rates and special import privileges to attract investment from the rest of China and encourage export processing and trade with all of China’s neighbors, including bustling border trade with erstwhile enemy Vietnam and the republics of the former Soviet Union.⁶⁰

Each of the border provinces adopted various flexible strategies to take advantage of the new opening. Heilongjiang advocated “opening up to the north and linking up with the south”; Xinjiang emphasized “linking up with the east and going out to the west”; and Yunnan proposed “linking up with the coast and turning to South Asia in the west.” One study even suggested that Yunnan should make use of its extensive border openings to create a “little Hong

⁵⁹Zhongguo gaige yu fazhan baogao zhuanjiazhu, *Zhongguo gaige yu fazhan baogao (1992-1993): Xinde tupo yu xinde tiaozhan* (China reform and development report 1992-93: New breakthroughs and new challenges) (Beijing: Zhongguo caizheng jingji chubanshe, 1994), 3.

⁶⁰Wang Sanmin, Xu Fan, and Huang Deli, eds., *Da kaifang* (The great opening) (Dalian, Liaoning: Dongbei caijing daxue chubanshe, 1993), 517-699.

Kong in the interior.”⁶¹ The border provinces accordingly received a boost from the changes. Xinjiang, which also benefitted from the opening of the Second Eurasian Continental Bridge (railways), saw its trade volume jump from US\$459 million to US\$750 million in 1992; the number of foreign-invested enterprises rose from 46 to 164 in the same year.⁶² Between 1993 and 1995, the average annual economic growth rate of these border open cities was 17 percent, several percentage points higher than the national average. There was a rapid rise in both domestic and foreign investment as well as foreign trade.⁶³

The opening up of border areas in the interior provinces signalled the completion of China's opening-up process. While open policies initially had been confined to a few SEZs, by the early 1990s, they had become multidimensional in both geographic and economic terms. Yet the political momentum for reform in 1992 involved far more than the opening up of border regions. Fundamentally it empowered localities to pursue local interests through offering various preferential policies and designating special zones.⁶⁴ As our model for the dynamics of competitive liberalization would anticipate, once the center gave the signal that all localities could set up development zones, a race to establish such zones ensued across China. It was common for localities to disregard central government edicts in their scramble for outside investment. Localities set up such zones by offering preferential policies to attract outside investment. Since the amount of such investment was not infinite, localities inevitably competed against each other to offer more favorable terms such as low tax rates.⁶⁵ Moreover, the rush to develop real estate and processing industries also diverted much-needed funds from infrastructure and

⁶¹Xiong Siyuan, “Conceptualization of Yunnan's Opening Up to the Outside World,” *Jingji wenti tansuo*, 1993, no. 1:59.

⁶²Chen Guojun, “Xinjiang Greets Important Turning Point in Economic Construction,” *Liaowang* (Outlook Weekly), October 2, 1995, no. 40:30-32; *FBIS-CHI-95-229* (November 29, 1995): 86-91.

⁶³Zhang Jinsheng, “Growth in Open Border Cities Reported,” Xinhua News Agency, February 12, 1996; *FBIS-CHI-96-037* (February 23, 1996): 25-26.

⁶⁴For a compilation of local preferential policies, see Renmin ribao guonei zhengzhibu, ed., *Dalu gedi youhui zhengce huibian* (Compendium of preferential policies of various Chinese localities), 2 vols. (Beijing: Renmin Zhongguo chubanshe, 1993).

⁶⁵Zhang Nianhai, “A Study of Experimental Zones' Policies for Local Reform and Opening Up in Ethnic Autonomous Areas,” *Guizhou minzu yanjiu* (Guizhou Nationalities Research), 1995, no. 1:31-33.

basic industries such as mining, raw materials, and energy.⁶⁶ Usually overseas investors setting up shop in the zones were free of income tax for the first two years and enjoyed tax reduction during the next three. Some areas, such as a Guangxi city, even eliminated the land-use funds charged investors, which violated China's Law on Land Management; in other words, investors obtained the use of the land in these areas for free. As a consequence, the number of development zones shot up in a matter of months. Whereas China had only 111 development zones (including 27 that were approved by the central government) at the end of 1991, by the end of September 1992, the number of development zones had jumped to 1,951. One report revealed that the total number of various development zones designated by township government authorities or above reached about 8,700.⁶⁷ The dynamics of competitive liberalization had reached its logical conclusion. Even the most geographically isolated areas in China such as Tibet were not left untouched by the march of global capitalism. In the words of a Tibet prefectural official, Tibet should not only make full use of the special policies authorized by the central government, but also adopt other flexible policies and measures, and encourage people to use them as long as they benefit Tibet's economic construction. In establishing cooperative ventures with other areas, the regional government should "offer low taxes and tax exemptions whenever they can."⁶⁸ In Qinghai, another landlocked province that also lacks international borders, the provincial leadership has called for establishing windows along the coast and border areas in order to "sail with borrowed boats, exit with others' borders, sing on rented stages, and make money on foreign land."⁶⁹

The scale of land enclosure into development zones was astounding. According to one estimate, by May 1993, the total size of development zones in China had reached about 15,000 square kilometers, or larger than the country's 517 cities combined (about 13,000 square kilometers). One official from the Ministry of Con-

⁶⁶Liu Li, "State Must Get Basic Right to Boost Economy," *China Daily*, July 23, 1993, 4.

⁶⁷"Rampant Founding of Economic Zones Wastes Good Land," *China Daily*, May 24, 1993, 4.

⁶⁸Zhu Yaoping, "Completely Open Tibet's Doors and Speed Up Opening to the Outside World," *Jingji wenti tansuo*, 1993, no. 9:56.

⁶⁹Yan Zhengde, "Several Issues Concerning the Qinghai Economy's Rise to a New Stage," *Qinghai shehui kexue* (Qinghai Social Sciences), 1993, no. 1:6.

struction admitted, however, that 98 percent of the zoned areas remained to be developed.⁷⁰ Much of the outside investment that did come went into real estate rather than industry, and rampant real estate speculation in the early 1990s was a major source of corruption. Most importantly, as each locality strived to grow faster than the national average, macroeconomic stability soon became the casualty of uncoordinated local actions.

Reining in the Localities

The zone fever thus became both cause and symptom of China's macroeconomic difficulties in 1993. It was high time for the central government to standardize rules and their implementation, and to do so, the center sorely needed the localities' cooperation. However, the task of gaining local compliance had been made difficult by Deng's encouragement of local initiatives in 1992. Whereas the center tightened control during 1988-89 and put a premium on provincial compliance with central policies, by 1992, it was provinces (such as Guangdong and Jiangsu) pursuing growth policies despite the austerity program that received praises from Deng and the center. This sent a powerful signal to local leaders that in spite of central policies, the most important criterion for evaluating performance was growth.

The center thus had a credibility problem with local leaders who sought to blunt the center's punches and protect local initiatives with greater verve than they did during the last austerity program. Indeed, the perception of economic overheating was largely confined to the center, and virtually no local leader admitted that his province or locality had the problem. Whereas leaders in more developed coastal provinces called for full-throttle growth to catch up with the "four little dragons" in Asia, their counterparts in interior regions were concerned about lagging behind the coastal regions. As a newspaper article noted, "Sichuan says it's backward, it needs to develop; Hainan says it's lagged behind; Jiangsu says it's not overheated. No one thinks the message applies to them."⁷¹ All (including central

⁷⁰Wang Yong, "A Freer Market for Real Estate," *China Daily Business Weekly*, May 10, 1993, 8.

⁷¹Kathy Chen, "In Some Provinces, Beijing's Go-Slow Directives Spawn Innovative Strategies for More Growth," *Asian Wall Street Journal Weekly*, July 19, 1992, 2.

leaders) justified their pro-growth attitudes by conveniently invoking Deng's authority.⁷²

The central leadership recognized the difficulties of eliciting local compliance with its policies. It had to adopt various administrative measures and replace the head of the central bank in order to impress its seriousness about inflation-fighting on local leaders.⁷³ After issuing documents in April that sought to restrain stock-issuance fervor, the State Council in mid-May issued a circular which reasserted its veto power over the establishment of local economic development zones. Noting that local governments had competed among themselves to set up such zones with preferential policies to attract outside investment, the circular concluded that the development had resulted in the loss of large tracts of farmland and aggravated the shortage of funds in energy, communications, transport, and raw materials. The circular decreed that only provincial-level administration and above had the authority to set up development zones. Moreover, if zones set up without proper approval were examined and found lacking in adequate infrastructure and funding, they had to be suspended.⁷⁴ By August 1993, it was reported that provincial authorities in the coastal regions had eliminated 1,000 of 1,200 unauthorized economic development zones set up by local officials, most of which had been established only in name.⁷⁵ However, in an apparent gesture to interior interests, the center indicated that it wanted to promote development zones in inland and riverside regions to bridge the growing gap between the wealthy coastal areas and the rest of the country, and make exceptions for impoverished provinces such as Guizhou.⁷⁶ Vice premier Zhu Rongji reportedly backed Guizhou's attempts to catch up with its prosperous neighbors by sparing it from the national austerity drive; Beijing would not apply across-the-board cuts to Guizhou and

⁷²Yi Shuihan, "Interior Provinces Promote Innovative Strategies to Attract Businesses," *Zhongguo shibao zhoukan* (The China Times Magazine), July 25-31, 1993, 50-51; Carl Goldstein, "Full Speed Ahead: Guangdong Party Congress Ignores Calls to Slow Growth," *Far Eastern Economic Review*, June 3, 1993, 21.

⁷³Yang, "Policy Credibility and Macroeconomic Control in China."

⁷⁴"State to Strictly Control New Zones," *China Daily*, May 17, 1993, 1.

⁷⁵"Local Governments Ordered to Close Unauthorized Development Zones," UPI, August 12, 1993. Note, however, that the *People's Daily* reported a different set of figures, saying that the number of development zones was reduced from 1,006 to 249 in four months (*People's Daily*, August 17, 1993, 1).

⁷⁶Zhu Ling and Wang Yong, "Bid to Plug Economic Chasm as Zones Close," *China Daily*, August 18, 1993, 1; *Dow Jones News*, August 17, 1993.

roll back reform. Guizhou would be treated as an exception and allowed to develop overheated sectors that other provinces are being advised to cool down. For instance, Guizhou would be allowed to expand its fledgling real estate market and build more development zones and tourist facilities.⁷⁷ Jiang Zemin and Zhu Rongji also gave Shanghai—where both had served before moving to the center—generous credit targets and other exceptions in order to maintain its high growth.⁷⁸

Conclusion

In this paper, I have argued that the spread of preferential policies across China can be understood in terms of the dynamics of competitive liberalization. As the constraints of ideology and lack of information are reduced over time, the local competition model accounts for the rush toward the adoption of reformist policies in localities and underscores the need for central coordination and guidance. This opening up began slowly, but culminated in the early 1990s zone rush. Leaders of interior provinces have recognized that they currently lag in liberalization. Yan Haiwang, Party secretary of Gansu province, summed up the race this way: “Practice has led us to an increasingly deeper understanding that early opening up results in early development, late opening up results in late development, large-scale opening up results in large-scale development, and small-scale opening up results in small-scale development.”⁷⁹

The preferential treatment given to the more prosperous coastal regions was fundamentally an unstable policy and unjustified over the long haul, as such policies initially benefitted the already more developed (southeastern) coastal regions almost exclusively and thus constituted a major source of interior dissatisfaction. Thus, while reformist leaders such as Zhao Ziyang used pro-coast policies to solidify the reform coalition, they also planted the seeds for interior discontent which Zhao’s political enemies would mobilize in the af-

⁷⁷Daniel Kwan, “Zhu: Guizhou to Be Spared Austerity Drive,” *South China Morning Post*, July 21, 1993, 11; *FBIS-CHI-93-138* (July 21, 1993): 15.

⁷⁸Zhong Xingzhi, “The Policy Compromise Between the Center and Shanghai,” *Zhong-guo shibao zhoukan*, August 29, 1993, 19.

⁷⁹Ma Zhiqiang, “Emancipate the Mind, Change Concepts, and Promote Development by Opening Up,” *Gansu ribao* (Gansu Daily), September 12, 1995, 1; *FBIS-CHI-95-202* (October 19, 1995): 41-43.

termath of the Tiananmen massacre. As Wu Ren points out, the preferential policies accentuated regional inequalities which in turn threatened to undermine the economic development of the whole country.⁸⁰ Wu argues that the preferential policies for the coastal regions must be moderated and rectified in order to promote the harmonious development of regional economies. This means increasing investment in the interior regions, more uniform macroeconomic control, uniform foreign exchange retention rules, and the abolition of special treatment for some areas. Instead, regional preferences should become industrial preferences.

The creation of a policy disequilibrium has had both a demonstration effect and a political effect. In the former, the success of the early liberalizers provided models for others to emulate. In the latter, efforts by the late liberalizers to jump on the bandwagon generated momentum for further liberalization. From this perspective, even though they did not begin with a theoretical model, Chinese reformers were logically and politically correct in emphasizing the implementation of reforms in specific regions, especially along the coast. By doing so, reformers reduced the political shocks simultaneous reforms throughout the country might have caused (had they been able to overcome the conservatives' objections) but nonetheless initiated the disequilibrium process that would lead the entire country down the path of liberalization reforms.⁸¹ Indeed, because of the spread of preferential policies across the country, the SEZs are currently far less special than they used to be. In spite of the central government's efforts to check their proliferation, China is still dotted with such zones as this article goes to press. Fujian province alone has three central government authorized economic and technological development zones as well as two free trade zones, two Taiwan investment zones, two state tourist zones, two high-tech industrial zones, and 101 other types of development zones.⁸² In a sense, China itself has become a giant SEZ in order to compete with other emerging economies for foreign investment.

⁸⁰Wu Ren, "Regional Economic Development," *Jiangxi shehui kexue*, 1990, no. 1:14-17.

⁸¹For a Chinese discussion of the political advantages of emphasizing reforms in the coastal regions, see Yang Zhongwei, Chen Kaiguo, and Pei Changhong, "Regional [Reform] Battles to Ensure National Stability," *Jingji yanjiu*, 1988, no. 1:43-50.

⁸²"Zhao Haoruo Believes Both Domestic and International Conditions Exist and the Time Is Ripe for Speeding Up Development of the Western Region," *Qiaobao* (China Press), May 9, 1996, 4.

So far we have assumed that both P1 and P2 possess perfect information; i.e., one player always knows the structure of the game and the repertoire of moves by the other. This assumption is actually not necessary. In the following strategic form, we assume that P1 and P2 always know the central government's moves; i.e., they know if they are in the left or right part of the game.¹

Let us first examine the right half of the game, i.e., when the CG plays NP. We know $X'j < Xj$ for $j = 1, 2$ (defined). Assuming that $Sj > Xj$ for $j = 1, 2$, we know that L becomes the dominant strategy for both P1 and P2. Thus we know that (L, L) is the Nash equilibrium.

As mentioned above, assuming that the game is a repeated game, with time represented by $t \geq 1$ for each stage and discount rate $\delta = 1$ for both P1 and P2, we can show that (L, L) with $t = 1$ is also subgame perfect as long as the CG plays NP (actually this is also true when $\delta_j \neq 0$ for $j = 1, 2$). This means the outcome predicted by the model is that both P1 and P2 will play L in the very first stage when the CG plays NP.

Things become a little bit more complicated in the left half of the game, i.e., when the CG plays P. However, the equilibrium can still be predicted once we know the relationship between Dj and Sj , which may be different for P1 or P2 given their different sensitivity to punishment by the central government.

Implication: Our game-theoretic model predicts that once the provinces know that the central government will not punish them for pursuing liberalization, they will rush to liberalize as soon as possible. However, if they know that liberalization will be met with punishment, their choice will depend on their sensitivity to the punishment relative to the cost of maintaining subsidies.

¹The present game can also be modeled as a game between the CG and a province with incomplete information where the province cannot be sure if liberalization will be met with punishment from the center. The introduction of uncertainty makes the game more complicated but the basic dynamic remains unchanged.