CHAPTER THREE

Taiyang Company, 1979–94

The life history of Taiyang Company,[1] including its move from Taiwan to China, provides this book with a microscopic foundation for its macroscopic argument. Taiyang experienced three stages of development: as a trading company in Taiwan (1979–88), when it leased a building and established a factory in China (1989–94), and when it built its own factory and improved its product quality and production capacity (1995–2010). In this chapter and the next, I use Taiyang Company to illustrate how the migration of global value or commodity chains led Taishang to move their manufacturing bases, capital, technology, and markets into China; how the interaction of Taishang (as foreign-invested companies) with local structures, institutions, and actors generated special embedded relationships; how Taishang adapted to the environment of this corruption- and chaos-filled period of China's transforming economy to surmount the problem of rent seeking and achieve relatively stable ownership arrangements; and how institutional and policy changes and their costs caused manufacturers to adjust their collaborative partnerships and influenced their decisions about whether to continue investing or withdraw their investments.

The year 1994 marks the dividing line between this chapter and the next. As described in chapter 2, it was in this year that China's central

1. In Wu 1997, I discuss the first stage of Taiyang's development in China. This chapter contains some updated information based on data I collected since that publication appeared.

government carried out a reform of the country's foreign exchange system, a major devaluation of the renminbi, and a reform of the tax system. This changed the relative cost of manufacturers' factors of production and institutional conditions, and therefore also altered the relative negotiating power of local governments and manufacturers. The central government's policy changes, along with the implementation of those policies by local governments, affected the behavioral patterns of manufacturers, as reflected in Taiyang's business activities. The crucial year of 1994 therefore demarcates two distinct developmental stages in Taiyang's history in Guangdong.

1. A Brief History of Taiyang Company

The parent company of Taiyang's Dongguan factory was established in Taipei in 1979 as an import-export trading company. This was the period in which Taiwan's economy took off, and EOI advanced at a rapid pace. Taiyang's main business was the sale of leather goods overseas. Acting as a trading company, Taiyang took orders from international buyers and then outsourced the orders to Taiwanese manufacturers, most of which were located in central and southern Taiwan. Taiyang's first generation of top-level managers regularly rushed between factories along the Vertical Line, inspecting goods and carrying out other tasks.[2] As a result, by the time Taiyang established a factory in China, its proprietors and managers were old hands at manufacturing, quality control, and estimating costs for their products.

By the mid-1980s, Taiwan's first stage of EOI was approaching saturation and exhaustion. Pressure was building to reshape the international division of labor, while domestic labor costs were increasing, environmental protection requirements were being enhanced, and factory space was becoming more expensive and harder to obtain. In addition, the 1985 Plaza

2. The Vertical Line is a popular term for Taiwan's Provincial Highway 1. Before the construction of the national superhighway networks, the Vertical Line was the main road running from northern to southern Taiwan on the west side of the island, and many export processing factories were clustered along it.

Accord caused a major appreciation of the Japanese yen and the New Taiwan dollar, weakening the competitiveness of local products abroad. These factors led small and medium-size Taiwanese export manufacturers to look for new manufacturing bases overseas. At that time, the first choices for these small and medium-size Taishang were China (specifically, Guangdong and Fujian) and Southeast Asia. Taiyang was part of that wave of industrial redeployment, and in 1988 it decided to invest in Guangdong. As a result, Taiyang changed its role from trading company and became both a trader and a manufacturer.

Taiyang headed west to the mainland via Hong Kong. It was first registered in Hong Kong as a trading company, and a Hong Kong company (or Gangshang) then helped Taiyang identify several original equipment manufacturers near Dongguan. Taiyang tried giving small orders of goods to the contracting factories for the processing of shipped materials. Eventually, because of quality control problems, Taiyang decided to set up its own factory. It first rented an existing factory and staff quarters in Xishui Town, in Dongguan City, and it found a Chinese partner (*guakao danwei*).[3] This Chinese partner was an SOE called Guanqiang Import-Export Company, located in Dongguan City. Taiyang established a joint-venture enterprise with its new partner called Taiyang Dongguan Company (hereafter Taiyang).[4] Taiyang quickly set up its factory and began production in 1989 under half a dozen Taiwanese managers who had transferred from its Taipei headquarters. These managers included financial affairs and sampling staff members, a mold master, a workshop supervisor, and other such personnel, and the CEO (Mr. Lee) made regular trips between Taipei and Dongguan. At this stage, like many other westward-shifting Taishang, Taiyang kept part of its operations (in this case, its sample department) in Taiwan. As Taiyang's mainland management became increasingly localized, the number of Taigan residing in China was reduced to three or four in the early 2000s. And in 2001, Tai-

3. *Guakao danwei* is a sponsoring unit, usually a government branch or state-owned enterprise that offers affiliation to a private enterprise, NGO, or quasi-governmental entity.

4. Xishui Town and Guanqiang Import-Export Company (hereafter Guanqiang) are pseudonyms.

yang eliminated the sample department at its Taipei headquarters and ran that department's operations directly from its Dongguan factory.

Due to a series of macroscopic reforms implemented by the Chinese government in 1994, Taiyang decided to terminate its partnership arrangement with Guanqiang and reached an agreement with Nafu Village,[5] in Xishui Town, to buy land and build its own factory. The reason for this relocation was mainly because Nafu Village was willing to charge a lower sponsorship fee than Guanqiang. Taiyang began using its new factory in 1995.

As the twenty-first century began, Taiyang experienced a major change in its internal management. Because its first generation of proprietors and senior managers had gradually reached retirement age, the company needed to identify their successors. The son of the chairman of the board came back from abroad to take over managing the factory in the early 2000s, and Taiyang modernized its business management after that. From the mid-1990s until around 2006–7, Taiyang constantly enhanced its product quality, and it began receiving orders from a number of European and American brand-name manufacturers, while also promoting domestic sales. This stage marked the high point of Taiyang's revenue. In 2008–9, Taishang in Guangdong encountered multiple business problems. For example, the Chinese government's new Labor Contract Law improved protections for migrant workers, which greatly increased labor costs for Taishang. At the same time, the Guangdong provincial government began implementing its new industrial upgrading policy. Furthermore, export manufacturers experienced a major decline in orders following the global financial crisis, and Taiyang's 2009 orders were 70 percent lower than those in the previous year. In 2008, Taiyang experienced labor strikes and demands by workers for the payment of docked wages. Under enormous pressure, Taiyang accepted most of the demands of its employees. At this stage, many foreign investors (mainly Taishang and Gangshang) opted for a midnight run, closing their factories without making good on their outstanding obligations.

The business slump and labor strikes led Taiyang to decide to close its Dongguan factory. The factory ended its business operations at the end

5. Nafu Village is a pseudonym.

of 2010, but the practical procedures for closing the factory took another few years as the company faced the issues of paying severance to its staff members and transferring its lease of the factory's land to another company.

2. The Business Model at the Taiwan Stage

Before analyzing Taiyang's history of operating a factory in China, I expand the timeframe to first describe Taiyang's business as a trading company in Taiwan. This will help explain the company's subsequent development. Like most of Taiwan's small and medium-size companies, Taiyang was a family-owned business, and its top managers were all members of the same family. After Taiyang was established, it mainly exported synthetic leather goods. From 1979 to 1988, 90 percent of the buyers of its exported products were in the United States, with the remainder in Japan, Europe, and elsewhere. According to Lee's recollections, at their peak (in terms of sales volume), exports reached an average of New Taiwan (NT)$1 billion per year. Since the exports were considered low-grade mass consumer products at a low unit price, the average free on board was only US$3.0–4.0, or only US$1.5 for lower-grade shopping bags, and profit margins were slim. At that time, Taiwan had two or three leather goods trading companies similar in scale to Taiyang, and twenty to thirty such companies of various sizes.[6]

1) Operational Model

Taiyang mainly used two models for accepting orders from international buyers. In the first model (known as the OEM model), the international buyer would give Taiyang a sample drawing, sometimes enclosing a sample as a reference. Taiyang would make a prototype, and after gaining the buyer's approval, Taiyang would accept the order. Under the other model (the ODM model), Taiyang would develop its own new sample

6. Interview: Leegm201510.

and offer it to clients as a reference for sending orders. For this reason, although Taiyang was a trading company, it had quite a large sample department. During the late 1980s, Taiyang's Taipei office had around a hundred employees, half of whom were in the sample department.

After Taiyang received an international order, it followed one of two kinds of manufacturing models:

(1) It transferred the order to a manufacturer. At that time around seven or eight manufacturers (typically employing 300–500 people) took orders from Taiyang. Most of these manufacturers took orders exclusively from Taiyang, but a small number also took orders from other trading companies. These manufacturers procured the raw materials and outsourced some processes to lower-level contracting factories. This business model earned Taiyang a gross profit of around 4 percent.

(2) Taiyang procured the main materials (including leather, linings, hardware, etc.) and commissioned a contracting factory to produce the goods. The contractor had to procure the secondary materials (e.g., wire) and provide its own sewing machines and other equipment. At that time, around three or four factories (each with around one hundred workers) took contracting work from Taiyang. These factories accepted orders exclusively from Taiyang. Under this model, Taiyang earned a gross profit of 8 percent.

In the first model, the manufacturer that accepted an order from Taiyang made a profit on the raw materials but had to provide more working capital than manufacturers in the second model. The main raw material was synthetic leather, and at that time almost all of it was purchased in Taiwan, with a small amount coming from Germany or Japan. Taiwan's leather goods production had a complete supply chain and outsourcing system. In Taiyang's transfer order or OEM process, the most important link was quality control, so the company had a quality control department. Its personnel had to make regular trips to the various factories in central and southern Taiwan to inspect the production conditions and monitor the quality of the goods.

2) Relations with International Buyers

Taiyang's buyers could be divided into two types. The first type was what Lee called "stores" (retail chains), including Kmart, Sears, JCPenney, and other chain stores, which were retailers that dealt directly with customers in the US market. The second type was what Lee called "importers," which were on a smaller scale than stores. After these importers purchased merchandise from Taiyang, they would sell it to stores. Most of these small-scale importers had offices in Taipei, which facilitated their contacting Taiwanese trading companies and factories.

Both types of buyers had staff members to control quality, and with Taiyang's cooperation these people would enter the factories where Taiyang had placed orders to carry out quality inspections. Was it necessary to wine and dine the American clients?[7] Lee said: "It wasn't necessary. Many of these buyers and clients were importers themselves, so they didn't need you to look after them. In any case, Americans didn't enjoy that kind of thing. The Japanese liked it more."[8]

Taiyang usually developed its own samples for chain retailers like Kmart, but importers tended to bring their own new product designs to Taiyang to create a prototype. The time from placing an order to delivering the goods was typically two months for importers and three to four months for chain retailers. Why was there a difference? The lead time was shortened for importers since they were more sensitive to fashion trends and still had to sell the items to stores after receiving the goods.

Both stores and importers had to pay for transportation costs (because the goods were priced free on board), the packing tissue inside the leather goods, and the delivery costs. Compared with the Taiwanese exporter's slim profit margin, how much profit did the international buyer make? Lee estimated that it was 35 percent, but duty had to be subtracted from that.

At this stage, Taiyang already had the capacity to design its own new products, so it could be said that Taiyang grew from a trading company engaged in OEM production to one also engaged in ODM production. Using GVC analysis, figure 3.1 shows Taiyang's production network with its buyers and contracting manufacturers and its relationship with raw material suppliers at this stage.

7. To wine and dine (*he huajiu*) meant treating clients to lavish banquets as well as sexual entertainment.

8. Interview: Leegm201510.

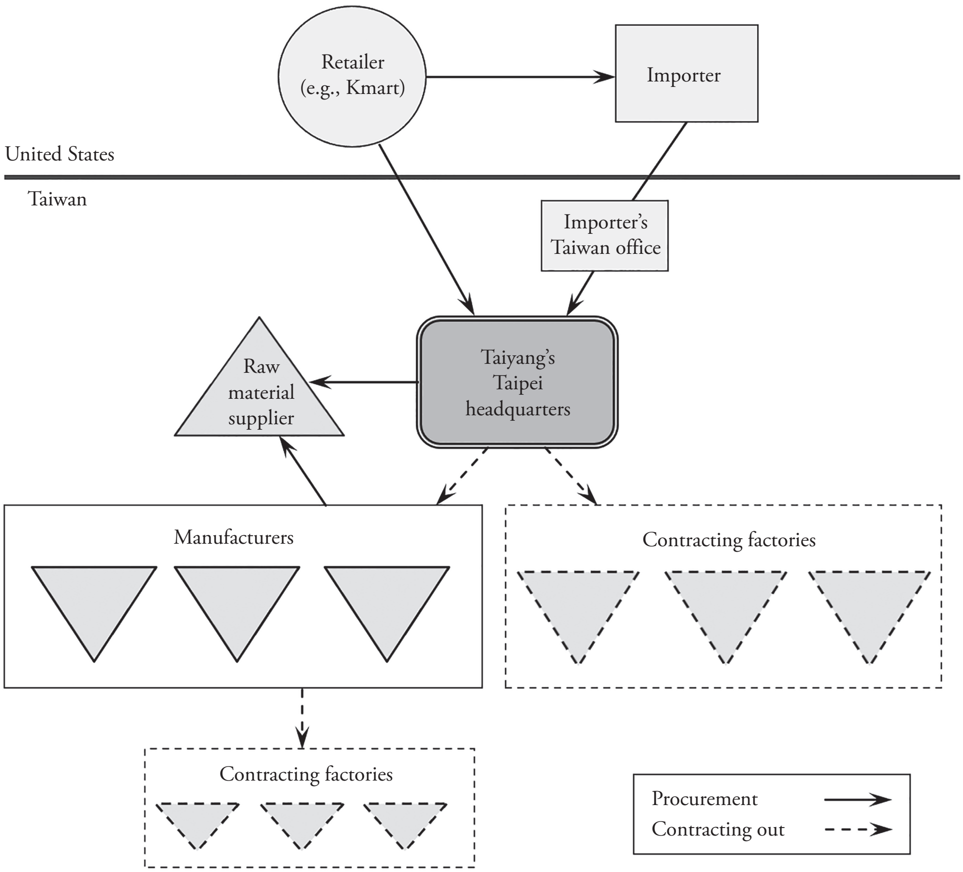

FIGURE 3.1. Taiyang Company's supply chain structure, 1979–88.

3. Proceeding to Guangdong: The Shifting of GVCs

When Taiyang decided to establish a factory in China in 1988, other Taiwanese leather goods manufacturers were also moving west, extending GVCs to Guangdong.

At the outset, Taiyang transferred its orders to a Hong Kong manufacturer. By then, some Hong Kong companies had been moving their manufacturing to Guangdong, so Taiyang's orders were in fact being fulfilled in Guangdong. Because of this relationship, Taiyang's Lee had to go to the factory in Guangdong to inspect the manufacturing conditions, and thus he became familiar with the mainland environment. Taiyang then sent orders directly to three factories (one in Huizhou and two in Dongguan, all operated by mainlanders). These factories had been recommended by a "Hong Kong friend," the term Lee used for the Hong Kong company to which Taiyang initially transferred its orders. The mainland factories that took Taiyang's orders employed around 500–800 people and specialized in accepting OEM orders from overseas. How did these mainland factories acquire the technology needed for leather goods production? According to Lee, "it was initially brought in by Hongkongers." When Guangdong began processing shipped materials in the late 1970s, Hong Kong businesses began contracting OEM production to Chinese factories and in that way trained the first batch of local export-oriented factories. Leather goods are not high-tech products, but there were still quality control problems at these factories.

The orders that Taiyang sent to mainland factories differed in one key aspect from its operational model in Taiwan: the mainland OEM factories were required to buy raw materials from Taiyang. Taiyang bought the raw materials in Taiwan and sold them to the mainland factory through its Hong Kong branch specifically to produce Taiyang's order. This operational method allowed Taiyang to gain more profit at the stage of reselling the raw materials, which increased its gross profit to 15–20 percent.

Its operations required Taiyang to establish a Hong Kong branch office, although this kind of OEM model violated the Taiwan government's prohibitions against "three exchanges" (air traffic, postal communications, and trade) at that time. This was the first-generation triangular trade model that Taishang used in China. Taiyang continued this transfer production model until 1990 and then ended it for two reasons: First, Taiyang was already running its own factory in Dongguan in 1989. Second, there were constant problems with production quality in Chinese factories, and Taiyang was afraid this would cause compensation disputes and discourage international buyers from placing orders.

1) Establishing a Factory in Dongguan

In 1988, while Taiyang was sending orders to Guangdong, it also began preparing its own factory. Taiyang settled on Dongguan for the location.

Through its Hong Kong friend, Taiyang found a state-owned factory that could be managed through the rental model, as well as a joint-venture partner: Guanqiang Company. Lee said, "Initially, the main reason for running our own factory was for the sake of quality control." In 1989, Taiyang's Dongguan factory began production, and from then on Taiyang was a manufacturer as well as a trading company. At that time, Taiyang employed more than a thousand people and provided them with room and board. The investor had to cover half the cost of the meals, while the housing was free. Lee said: "It was impossible not to provide housing, because all of the workers were migrants from other provinces, and the rent outside was too expensive. . . . At that time it was really easy to hire people; you could get as many as you wanted. Back then, the mainland salaries of 150 yuan per month were about NT$5,000 less than [salaries] in Taiwan, so the wage difference alone was enormous. At Dongguan, a certain large factory hired fifty thousand people and saved NT$3 billion per year on wages."[9]

Taiyang's output value (sales volume) from 1989 to 1994 was 70–80 percent of the value when it was a trading company in Taiwan, but its gross profit was 20 percent, much higher than in Taiwan. The main profit came from low labor costs.

Among Taiyang's first batch of Taigan (six people) at the Dongguan factory, several (including the assistant general manager, manager, mold master, etc.) came from its Taiwan OEM factories, and the others were transferred from the Taipei headquarters. Their salaries were doubled, with the assistant general manager's pay increasing from NT$60,000 to NT$120,000, and the mold master's from NT$40,000 to NT$80,000. Taiyang had never carried out its own factory production in Taiwan, but its Dongguan factory was fully integrated, with only a tiny number of procedures outsourced. Direct production on the mainland inevitably encountered problems, mainly in terms of production flow, technology, and quality control. However, because the technology involved in producing leather goods was not very advanced and Taiyang's top management was already quite familiar with the production process and quality control, the problems were surmounted within one or two years.

Did American buyers ever directly place orders with mainland factories at that time? As far as Lee knows, that didn't happen with any of

9. Interview: Leegm201510.

Taiyang's American clients. The situation was different from the time when Nike tried to find an OEM factory in China but gave up because of poor quality and then asked its Taiwan manufacturer to relocate to China (see Cheng Lu-lin 1999). But generally speaking, the GVCs for leather goods, sports shoes, ready-to-wear fashions, and bicycles shifted at similar times through similar methods and used similar operational models.

In 1995, after Taiyang bought its own land, built a factory, and expanded its production capacity, the quality of its products also improved, and its unit prices and gross profits increased. All the Taishang in Guangdong knew how to avoid and reduce taxes. At that time, although Taiyang had established a joint venture with Guanqiang, it was basically exempt from income tax (or paid very little, as I discuss below). Thus, it largely followed the operational model of processing shipped materials that was prevalent at that time. The earnings were deposited in Hong Kong, and China's local governments gave preferential tax rates to FIEs. Even more important was the triangular trade accounting method. Taiwan would accept an order and export raw materials to its Hong Kong branch under an inflated price that gave the Taiwanese company a higher profit. The Hong Kong branch didn't show profits in its accounting because it reported higher than actual wages at the mainland factory. This narrative is consistent with the intra-firm trading method of multinational corporations commonly seen in international political economics.

2) Changes in the Procurement of Raw Materials

In the early 1990s, the main materials and components needed by Taiyang's Dongguan factory were almost all imported from Taiwan, with only a small portion (such as packaging material, including cardboard boxes, polyethylene bags, etc.) purchased in Guangdong. But sometime around 1995, Taiwan's raw material factories began establishing factories on the mainland, including factories that produced synthetic leather materials (polyurethane, polyvinyl chloride), hardware, and zippers. Taiyang, like many Taiwan-invested factories, then turned toward local purchasing. Leather manufacturers—including the main ones, Nan Ya Plastics and San Fang Chemical Industrial Co. Ltd.—established factories on the mainland. Nan Ya established one in Nantong, in Jiangsu

Province, in 1995–96 and others in Guangzhou and Huizhou in 2000. These leather factories were suppliers to the manufacturers of leather goods, sport shoes, furniture, and automobiles. Guangdong's local supply chains gradually formed beginning in the mid-1990s, but at this stage, most of the raw material suppliers were still Taiwanese-invested factories. Manufacturers referred to synthetic leather production as secondary processing and to the manufacturing of leather goods, sports shoes, and furniture as tertiary processing. The westward movement of tertiary processing drove the arrival of the secondary processing industries only a few years later.

Like other Taiwanese-invested companies, Taiyang's main method for procuring materials in Guangdong was the interplant transfer method. The payment didn't need to be made on the ground in China but could be paid in Hong Kong so it wouldn't affect profit. The internal leather materials, hardware, and zippers that Taiyang used were bought on the mainland, but exterior leather materials (considered relatively high-level materials in the technical sense) were still procured in Taiwan. Taiyang eventually produced genuine leather goods, and the genuine leather was procured from South Korea, Taiwan, or mainland Taishang.

Brand-name firms and raw material suppliers would develop a cooperative relationship of mutual development and establishing standards. The development departments of raw material suppliers geared themselves toward brand firms' department of new products and designers, developed forward-looking products jointly with the brands, and became involved in research and development for manufacturers (such as Pou Chen). This production model generally emerged in Taiwan's OEM industry, including both traditional industries and the ICT industry. For example, Nan Ya's development and promotion staff members would develop shoe materials jointly with Nike and Adidas. It often took a year to develop new materials, and in the last stage of this process Nan Ya would share information with Pou Chen, Feng Tay, and other leading shoe manufacturers. After new footwear material was successfully developed, the brand-name firm would require these shoe manufacturers to buy their raw materials from Nan Ya.[10] Taiyang's Lee said that this kind of cooperation

10. Interview: LTM201510.

also appeared in leather goods, luggage, and other manufacturing industries.[11]

3) Developing High-Unit-Price Products

As Taiyang diversified its products and improved its product quality from 1995 onward, it was able to gain OEM orders from European and American name brands. Taiyang's buyers had previously been concentrated in the United States, but now the European and Japanese markets made up nearly half of its business. Buyers included the European brands Le Coq Sportif and Victorinox Swiss Army and the American brands Samsonite and Ghurka. These brand name products had a high unit price of up to US$40–50, and gross profit was as high as 35 percent. But the size of each order was small, so arranging production for these orders required even greater precision and flexibility. In the late 1990s, factories in Dongguan and the surrounding region that could match Taiyang's production quality were OEM factories from Taiwan (there were around ten of these), Hong Kong, or South Korea. A local South Korean factory could produce on an even larger scale than Taiyang. At this stage, Taiyang added buyers from European, American, and Japanese brands, but the chain retailers and importers that originally placed orders with Taiyang in Taiwan were still important customers.

4) The Extension of the Global Leather Goods Value Chains

The lead firms that bought leather goods produced by Taiyang were American chain retailers and name brands. As with goods such as ready-to-wear garments and sports shoes, the products these firms bought had initially been mainly produced in the United States. Around 1965, leather goods supply chains shifted to Japan, but they quickly became a sunset industry there. In the 1970s, supply chains shifted from Japan to Taiwan, South Korea, and Hong Kong. Beginning in the late 1980s, these supply chains extended and shifted to China's coastal regions. In this process we can clearly observe the stratified power relations of GVCs dominated

11. Interview: Leegm201511.

mainly by core countries, all pursuing lower labor costs. Fluctuations in the relative price of other essential factors (exchange rates, environmental protection, social insurance costs, etc.) served as an additional impetus to shift value chains.

The period from the mid-1970s until the late 1980s was a time when Taiwanese synthetic leather goods manufacturers flourished, and Taiyang sprang up at this time. At this stage the production chain shifted from Japan to Taiwan, and Taiyang took orders and contracted out production as a trading company. Leather goods producers in Taiwan formed production networks as well as complete production chains (see figure 3.1). Taiyang moved to the mainland through Hong Kong in 1988 and changed its corporate business model after establishing its own factory for direct production in 1989. Taiyang's cross-strait business operations concretely illustrate the shift and extension of the GVC, which drew capital, manufacturing and management techniques, and markets into the Pearl River Delta region. Taiyang experienced industrial upgrading and witnessed the gradual establishment in Guangdong of the supply chain system brought over by Taiwanese investment. In the westward movement, Taiyang also set up a holding (shell) company in a Caribbean tax haven for financial manipulation—which was almost standard operating procedure for emerging Taishang multinational corporations, regardless of their size. From an organizational standpoint, this change was enormous and comprehensive, and Taiyang was a classic case rather than an exception in this historical trend (see figure 3.2).

5) The Results of the Extension of Value Chains and the Transnationalization of Taiwanese Small and Medium-Size Companies

The shift of leather goods value chains described above was not an exception. During the same period (late 1980s to 1990s), the shifting of value chains from the newly industrialized countries of East Asia (Taiwan, South Korea, Hong Kong, and Singapore) to China was a synchronized trend, with traditional industries moving first, followed by the ICT industry. Taiwanese companies rapidly completed their redeployment along the China coast, consolidating mass production in spatially concentrated manufacturing bases. One key driver was the American retail revolution

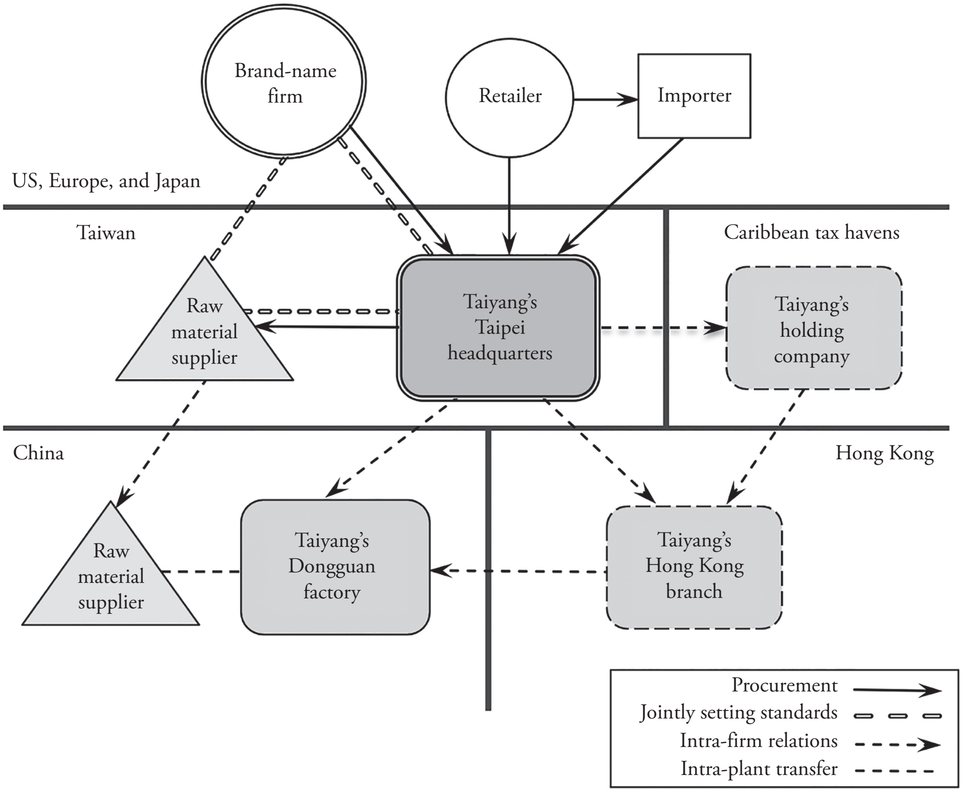

FIGURE 3.2. Taiyang Company's supply chain structure, 1998–2010.

(Hamilton, Petrovic, and Senauer 2011). Gary Hamilton and Kao Cheng-shu believe that the retail revolution spurred a concentration of global production and that the entire process was a "rationalization of demand-led capitalism" (2018, 184). Beginning in the 1990s, the retailers and brand-name manufacturers that served as lead firms in the GCC began using the lean inventory technique to systematize the GSC and became titans of globalization. One such example is the American retailing giant Walmart, which moved its global purchasing hub to Shenzhen in 2001. By 2004, Walmart was buying US$18 billion worth of goods from China annually, which accounted for 10 percent of the total imports to the United States (Hamilton and Kao 2018, 42–52 and 184–85). This shows the power of the lead firm. By emulating the redeployment of global production space, Taishang gained the opportunity for mass production.

In terms of Taiwan, we can see the significant effects that shifting GVCs had on exporters:

First is the transformation from trading companies to manufacturers, or from small or medium-size manufactures to large manufacturers. The former change was one of business content, as happened with Taiyang. The latter change was the expansion of organizational scale and the emulation and updating of organizational techniques, as happened in the cases of Pou Chen Corporation (and its subsidiary Yue Yuen Industrial Limited, listed in Hong Kong, the largest footwear maker in the world) and the Hon Hai Precision Industry Co., Ltd. (trading as Foxconn Technology Group).

Second are the changes in the organization of production. Many Taishang that established factories in China or moved their factories to China early on had mainly applied the networking model to their production in Taiwan. But when they first established factories in China, especially in the Pearl River Delta region, they lacked a set of subcontracting firms, so many manufacturers internalized the outsourcing procedure, integrating production and expanding their production capacity. For example, the production capacity of Taiyang's single Dongguan factory was nearly as great as that of all of the factories to which it subcontracted production in Taiwan. From the perspective of new institutional economics, this internalization could reduce transaction costs in a new manufacturing environment and with new production conditions, and it could facilitate quality control. But this kind of integrated production is also flexible: as Taishang networks emerged locally, hub factories also began outsourcing certain working procedures. Furthermore, organizational change was related to the nature of the product. For example, when Taiwan's computer assembly industry began establishing factories in Suzhou and Kunshan in the mid-1990s, Taiwanese firms also required their subcontracting factories to establish factories there at the same time. As a result, the westward movement of the entire computer industry duplicated and shifted Taiwan's production chains and collaborative networks.

Third is mass production. With the redeployment of global production space, output was closely related to two factors: the abovementioned organizational changes and expanded production capacity and the massive increase in the employed labor force. The latter was determined by China's abundant and low-cost labor supply. In the early 1990s, a single Taishang shoe manufacturer employed up to 30,000 employees in Dongguan. From 2000 onward, some manufacturers (such as Yue Yuen) employed upward of 100,000 people, and Foxconn, which subsequently moved into Shenzhen, employed 100,000 people in a single plant. This scale of production was unimaginable in Taiwan. Taiyang's Dongguan factory employed 2,400 people at its height, making Taiyang what would have been considered a large-scale business at that time in Taiwan, but a business of that size in the Pearl River Delta would be considered only a medium-size enterprise.

Fourth are changes in profit margins. Expanded production and low labor costs generally increased Taishang profits to a considerable degree. For example, although Taiyang's products were in a relatively low-tech traditional industry, its profits increased markedly after it established its factory in Dongguan. This was mainly because of low wages, but it was also because Taiyang put effort into industrial upgrading. As a result, Taiyang began receiving orders from brand-name firms soon after it entered China, which elevated its unit prices and gross profits. But changes in profit margins depended on the industrial category and the nature of individual products. Companies in the ICT industry's computer and cellphone assembly sectors (such as Foxconn) relied on output to increase business volume, but their profit margins were much lower than those in many traditional industries.

Fifth is the triangular trade and transnationalization of small and medium-size companies. Taishang that moved west to the mainland launched an export manufacturing model of taking orders in Taiwan and producing in China. At the same time, due to geopolitical factors and political considerations at the early stage, Taishang usually went in and out of China via Hong Kong, and gradually they developed a model of overseas capital management and shell companies in tax havens. Previous literature on international political economics has focused on large-scale transnational companies, but while this round of migration of GVCs hastened the birth of corporate giants such as Foxconn and Pou Chen, it also created countless small and medium-size Taiwanese transnationals. Compared with the classic transnational corporation, these smaller companies had a different transnationalization experience: one that mainly involved restructuring the division of labor in East Asia. And this regionalization, or perhaps a transnationalization within the so-called Greater China region, is even considered Sinicization. If we focus our observations on Taiwan's major corporate groups, their transnationalization was highly concentrated in the dependency structure of the triangular manufacturing trade formed by their relations with China's processing trade. In 2012, for example, about 30 percent of the total revenues of Taiwan's top three hundred businesses came from China.[12] Among the top thirty-two corporate groups (ranked by global total revenue, and excluding financial holding groups and banks), eighteen received more than 30 percent of their global net revenues from China. Nine of the eighteen earned higher revenue from China than from Taiwan. Six of these (Foxconn, Quanta, Kinpo, Inventec, Lite-On, and Delta Electronics) were in the ICT industry; one was the footwear manufacturer Pou Chen; and one was the diversified manufacturer Walsin Lihwa (Wu Jieh-min 2016).[13] Given the transnationalization of large export manufacturers, the degree of reliance on China (especially its labor supply) of small and medium-size manufacturing Taishang goes without saying.

6) The Position of Hong Kong in the Extension of GVCs

Taiyang and many other Taiwanese companies that entered China used Hong Kong as a bridgehead. We can observe that Hong Kong played a key intermediary role for certain types of products in the shift of value chains.

Information and social trust played important roles. Until the 1980s, Chinese society had been closed to the outside world for a long time but had maintained ties with Hong Kong. Consequently, Hongkongers were more familiar with China (especially Guangdong) than people in other

12. Calculated from "Ranking of mainland investment's contribution to the enterprise (top 300) using the total sum method" (data for 2013–2014), China Credit Information Service, 2014, Taipei.

13. The ninth was Ruentex, which was engaged in the distribution industry and drew 51.5 percent of its business revenue from China. It is heavily reliant on China's domestic market, but its industrial type is not a focus of this book's analysis.

countries were, and their human ties and social relations with Chinese were also plentiful. Furthermore, once China embarked on opening reforms, Hongkongers were the first to enter China, especially Guangdong. Using Gangshang connections therefore saved Taiwanese companies substantial transaction costs when they began migrating to China in the late 1980s.

Moreover, at that time cross-strait relations were just beginning to thaw, and the Taiwanese government still did not allow Taishang to invest in China. This meant that they had to take a circuitous route by establishing branch offices in Hong Kong and engaging in triangular trade outside of China's borders. In the early 1990s, the Taiwanese government allowed Taishang investing in China to register retroactively, and it gradually became more open about investment in China. However, a *jieji yongren* (go-slow policy) in the mid- and late 1990s attempted to limit this investment. From 2000 onward, the administration of President Chen Shui-bian, a member of the ruling Democratic Progressive Party, adopted a policy of proactive liberalization, and Taiwanese investment in China increased dramatically, as did the use of the model of taking orders in Taiwan and manufacturing in China. Even so, Hong Kong retained a valuable intermediary role for Taishang investing in Guangdong, because the processing trade model that prevailed in Guangdong still required Hong Kong to handle imports and exports and documentary bills offshore. Handling financial affairs (such as documentary bills) in Hong Kong also allowed Taishang to retain a large amount of their profits overseas. Even when Taiwanese companies were eventually allowed to invest in China, it remained common for them to use Hong Kong as an intermediary for offshore operations.[14]

Hong Kong's status as an intermediate stop in the westward movement of Taiwanese investment shows that Hong Kong was a node in the reorganization of the regional division of labor, and it also highlights Hong Kong's importance to China's linking up with the global capitalist

14. The example of Taiyang shows that when Taishang selected Hong Kong as a middle ground when they first invested in China, it was due to political considerations, geographical factors (Hong Kong was contiguous to Guangdong, and at that time many Gangshang had already established OEM networks in the Pearl River Delta), and so on. These factors facilitated the capital remittance operations of Taishang and helped them avoid legal problems. See also Hamilton and Kao, 2018, 144.

system (Chiu and Lui 2009). Until recently, Hong Kong continued to have the largest proportion of FIEs in China, and China's offshore investment is also concentrated in Hong Kong. Hong Kong plays an irreplaceable role in China as it deepens its links to the global marketplace.

4. Faux Joint Ventures and the Head Tax

From the stages of Taiyang's development, we can observe the capital migration and diffusion of technology resulting from the shift and extension of GVCs. When value chains extended to China's coastal regions, how did global-local linkages occur? How did FIEs create interactive relationships with local institutions and structural endowments? Specifically, how did Taiyang interact with the local government? How did it arrange the ownership of its factory? How did it surmount problems such as rent seeking, corruption, and the solicitation of bribes? With what government units did Taiyang seek to cooperate? What were the organizational characteristics of this cooperation? What was its institutional foundation? What institutional results did it produce?

Taiyang's Dongguan factory was a classic labor-intensive export processing factory. The registration certificate hung on the wall of the factory office stated that it was a Chinese-foreign joint-venture enterprise, and its partner was the plastic products department of Guanqiang Import and Export Company. It was therefore a joint-venture company in the nominal legal sense.

In fact, the factory was a wholly foreign owned enterprise. Several key pieces of evidence show that Taiyang was a single-venture foreign company: First, according to the cooperation agreement between the two parties, Taiyang had invested 70 percent of the total capital, and Guanqiang had invested 30 percent. But in fact, Guanqiang did not invest any capital. Second, the chair of Taiyang's board of directors and the factory's deputy general manager were appointed by the Chinese side, while the vice-chair and the general manager were appointed by the Taiwanese side. But Guanqiang did not send anyone to Taiyang to take charge of production management. Third, Guanqiang did not take on any business risk, nor did it share in the company's profits. Taiyang's success or failure was the complete responsibility of the Taiwanese side: the amount of Taiyang's profits or losses would not affect the profit that Guanqiang gained from the cooperative relationship (as I will explain in detail below). Put plainly, Taiyang was a faux joint-venture enterprise. In this kind of relationship, the cooperating partners had a tacit agreement under which each took what it needed and neither exposed the other, and the relationship was therefore able to operate smoothly.

At that time, Taiyang and Guanqiang's faux joint-venture relationship was the norm rather than the exception in China. Because of the laws and implementation methods left over from China's state-socialist system—especially the extensive economic controls, the approval authority enjoyed by executive units, and the lack of safeguards for private property rights—all kinds of fictive ownership arrangements were extremely popular, including private enterprises wearing a red cap and fake collective enterprises (Wu Jieh-min 1998). These kinds of flexible ownership rights became a key feature of government-business relations in China from the 1980s to the 1990s, benefiting private enterprises and FIEs but also planting the seeds of commercial disputes. They were the concrete manifestation of the dependence on institutional evolution, a residue that affected subsequent government-business relations.

In 1986–87, when the NT dollar appreciated sharply (with the exchange rate for the US dollar falling from NT$38 to NT$26), Taiwan's labor costs and other expenses also increased, and labor-intensive export processing factories began moving out in large numbers. At that time, geographical proximity and shared language made China the best choice for Taishang. Adding in the cheap labor force led many Taishang to believe that investing in China would be more productive than investing elsewhere in Southeast Asia. Additionally, in the mid-1980s, the Chinese government began implementing a series of preferential measures to encourage investment by so-called compatriots in Hong Kong, Taiwan, and Macau and by overseas Chinese.

Taiyang was not exceptional in arriving in China in the first mainland rush. What is interesting is why it would choose to cooperate with Guanqiang. As mentioned above, this was mainly because of the relationship between Taiyang and a Hong Kong company (Hong Kong Star).[15]

15. Hong Kong Star is a pseudonym.

Hong Kong Star had transferred Taiyang's orders in 1988 for manufacturing products in the Pearl River Delta region. Hong Kong Star recommended that Taiyang go to Dongguan City, and it represented Taiyang in arranging the initial business negotiations. The key to this consultation process was Taiyang's trust in Hong Kong Star. Some people may wonder why Taiyang didn't go to Shenzhen, which had a better infrastructural standard at that time. "Of course, under normal conditions Shenzhen looked better," Taiyang's Lee said. "But right because it was an SEZ, there were more constraints. Its labor policies were stricter, its wages higher, and its land prices more expensive, while Dongguan was more flexible in all of these things." He added, "The Special Economic Zone was not special!"[16]

The bureaucratic protective umbrella that Guanqiang provided allowed Taiyang to quickly build its factory and put it into production. Guanqiang provided Taiyang with many services. For example, it helped Taiyang obtain liberal tax reductions, handled complicated bureaucratic paperwork on Taiyang's behalf, and coordinated with government departments. It also delivered certain special benefits, such as providing a portion of its export quotas at no cost (at that time some of the products that Taiyang exported to the United States were still subject to quotas). Most important, China was notorious for its three arbitraries (local governments arbitrarily collected fees, levied fines, and imposed the apportioning of extrabudgetary funds), and when other government units would come to Taiyang demanding various miscellaneous fees, Guanqiang would step in to smooth the way. Taiyang's assistant manager, Mr. Su, who was from Taiwan, says: "They had units as numerous as buffalo hair, and they wanted money for everything! The number of times they came extorting payments was unbearable. . . . They were always bringing along a photocopy of some decree or other that made no sense to me. It made it impossible for me to manage the factory. . . . What could I do? I telephoned Guanqiang and asked them to handle it. They were almost always able to take care of things very quickly. You know, we gave them a lot of money. If we didn't ask for their help, what were we paying them for?"[17]

16. Interview: Leegm199404.
17. Interview: Su199405.

Su said this complacently and laughed. What he said had rich implications and revealed a great deal of information: local officials frequently solicited fees and engaged in rent-seeking activities, and the greatest benefit to Taiyang of its partnership was to have Guanqiang help eliminate this annoyance. The relationship between Taiyang and Guanqiang seems to have been very friendly at this stage. Guanqiang's helping Taiyang address the three arbitraries, quarantining it from the harmful outside environment, and creating relatively stable production conditions could be considered an isolation effect. Doing business in an environment of socialism with Chinese characteristics seemed to make an official protector essential. There's an old Chinese saying that "he who lacks a mother-in-law wishes he had one." Guanqiang was Taiyang's mother-in-law in dealing with Chinese officialdom. The relationship between Guanqiang and Taiyang was a clientelist transactional relationship between government and business.

Some people may wonder if the large fee that Guanqiang collected from Taiyang wasn't a source of the three arbitraries. For Taiyang this was a relative question, and it was closely related to the course of China's opening reform. At this stage, at a reasonable price Guanqiang provided FIEs with convenience in entering the government-business network of the local market (the market for factors of production such as labor and factory space). Because of the functionality of this government-business network, paying a fee to solve problems had a degree of legitimacy in the perception of foreign investors. Below I analyze how the fee demanded by Guanqiang was not entirely like the standard three arbitraries or corrupt conduct, and I show that instead it was relatively stable rent-seeking behavior with a high degree of predictability. What did Guanqiang gain from this cooperative relationship? Taiyang's Lee says: "They gained a head tax (*rentou shui*) of more than one million yuan every year."[18]

What is a head tax? In the early 1990s, when Lee blurted out the term, it could not be found in the academic literature and had not even appeared in news reports. I investigated the term for a time, carrying out multiple interviews and consulting books and periodicals relating to China's foreign exchange management system until I was finally able to clarify its meaning. The trick lies in the institutional design of the double-

18. Interview: Leegm199401.

Taiyang remitted Hong Kong (HK) dollars from Hong Kong every month to Guanqiang's Bank of China account in Dongguan.

→ The bank converted HK$ into renminbi according to the official exchange rate.

→ Taiyang obtained that amount of renminbi.

→ Guanqiang obtained foreign exchange use rights for that foreign exchange retention quota (20 percent).

→ Pearl's Light in Guangdong Province obtained a portion of Guanqiang's foreign exchange use rights for a portion of Guanqiang's transferred quota.

→ Guanqiang and Pearl's Light were allowed to purchase their shares of foreign exchange at the official exchange rate, or sell their foreign exchange use rights at the foreign exchange swap center at an adjusted exchange rate.

FIGURE 3.3. The foreign exchange earning mechanism of local Chinese foreign trade companies, using Taiyang as an example.
Source: Collected and compiled by the author.

track exchange rate. The abridged version here of this complex research process describes the results of my investigation.

The head tax in the foreign trade and economic relations in Guangdong at that time referred to the processing fee remittance spread. Chapter 2 described in general the nature and payment method of the processing fee. The remittance spread refers to the price differential between the official exchange rate and the market exchange rate applied to the remittance of foreign currency to China. The head tax was therefore not really a tax: referring to it jokingly in this way had satirical implications. Digging deep into this satirical term can help us understand the institutional mechanism of the processing trade in Guangdong at that time.

In terms of its financial character, the processing fee remittance spread was something like a management fee. But it was not collected directly from the FIE by the partnering unit on the Chinese side. Instead, it was collected through a complicated foreign exchange earning process in which the FIE paid its sponsoring Chinese unit and the local government through an indirect and circuitous method. How was the remittance spread created and levied? The mechanism is summarized in figure 3.3.

According to this set of rules, Taiyang remitted HK$270,000 every month to the Bank of China in Dongguan. This amount was specified in the cooperation agreement that Taiyang and Guanqiang signed. According to Taiyang's calculations, it lost the exchange rate differential between the HK dollar black-market price and the official price.[19] This remittance spread was the "head tax" that Lee referred to. In the fourth quarter of 1993, the official exchange rate was 0.76 yuan to one HK dollar, while the black-market exchange rate was around 1.15 yuan to the HK dollar. The exchange rate differential was therefore 0.39 yuan.

How were the heads of the "head tax" calculated? Lee said, "It was calculated as the total number of 'heads' [workers] that Taiyang employed." This was the origin of the expression. According to the processing contract between the two sides, Taiyang anticipated hiring six hundred workers, with each paid an estimated monthly salary of 340 yuan, equivalent to HK$450 (according to the official exchange rate at that time). Because Taiyang was basically a processing and assembly enterprise and did not earn renminbi in China, it had to use renminbi to pay the processing fee. According to the agreement, each worker was paid a monthly processing fee of HK$450, and HK$270,000 was remitted every month to Guanqiang's Bank of China account. So according to the above formula and exchange rate, how much did Taiyang pay Guanqiang each year? The amount was around 1.26 million yuan:

0.39 (exchange rate differential) × 450 (HK$, for each month's wage)
× 600 (workers) × 12 (months) = 1,263,600 yuan

Why did FIEs regard this processing remittance spread as a loss or extra encumbrance? Lee explained: "When we needed renminbi, we could always buy it on the black market in Dongguan or Hong Kong. Why should we use the official exchange rate with them?"[20] To cooperate with Chinese work units, FIEs had to do as the Romans do—that is, abide by the local rules of the game and buy renminbi at the official exchange rate. Accordingly, Lee asserted, the loss on the remittance exchange rate was a tax or political insurance fee paid to the Chinese government. "Tax" in

19. The black-market price referred to here was close to the adjusted exchange rate at the foreign exchange swap center.

20. Interview: Leegm199401.

this context has a negative implication. In fact, the head tax was an operational cost, and Taiyang used it to pay for the services that Guanqiang provided. The head tax implied a specific exchange relationship, and essentially it was the price the manufacturer paid for official protection. In short, the price paid for dealing with the Chinese side was not cheap, but relative to the profits that the FIE earned, it was worth the price, because at that time the wages of migrant workers and other production costs were kept very low.

5. Guanqiang and the Head-Counting Game

Guanqiang Import and Export Company emerged in the early stage of opening reform in 1979. It was a Dongguan subordinate unit of Pearl's Light Import and Export Company in Guangdong Province.[21] Institutionally, provincial-level Pearl's Light led and supervised prefectural-level Guanqiang, which was accountable to Pearl's Light both administratively and financially. Guanqiang was divided into many specialized departments, of which plastic products was one. Guanqiang had around four hundred employees in 1994.

When Guanqiang was first established, apart from its ordinary foreign trading business, it also drew in FIEs to invest in the processing of shipped materials and in processing and assembly, and it sought opportunities to cooperate with FIEs. The plastics department launched its first joint-venture business with Hong Kong Star in 1985–86. Headquartered in Hong Kong, Hong Kong Star moved most of its labor-intensive assembly plants to Dongguan, where labor was cheap. Later, Hong Kong Star acted as a go-between in recommending that Taiyang establish a factory in Dongguan.

Guanqiang signed hundreds of processing contracts with FIEs that came to China to engage in the processing of shipped materials, and it opened joint-venture enterprises with around ten FIEs (all Gangshang or Taishang). Most of these were only faux joint ventures for which Guanqiang served as the sponsoring unit. The main operational model was as

21. Pearl's Light Import and Export Company is a pseudonym.

follows: The joint-venture company signed a processing contract with a certain Chinese processing plant for shipped materials (which did not qualify as a legal entity), and it was the contracting unit in name only. The Chinese side collected rent for the factory and appointed a factory head, accountant, and other staff members to be stationed at the factory, but in fact the FIE had all of the factory's administrative power. Like Taiyang, these companies remitted HK$300–500 every month for each worker, with the amount of head tax set according to specific investment agreements. As Ms. Zheng, the deputy director of Guanqiang's plastics department, said, "We were very flexible when discussing business with foreign companies."[22] The term "flexible" inevitably brings to mind the advantageous policies that the central government granted to Guangdong, which were also special and flexible and which the provincial government passed down to lower-level governments.

The processing fees remitted by FIEs helped Guanqiang accomplish two fiscal tasks. First, according to the remittance formula mentioned above, every year Guanqiang had around HK$3.36 million in foreign exchange remitted by Taiyang. According to Guanqiang's agreement with its provincial-level import-export company in Guangdong, it was to earn US$20 million in foreign exchange in the 1993 financial year. Guanqiang therefore needed to cooperate with only fifty FIEs of Taiyang's scale to achieve its yearly foreign exchange quota. In this way, remittances by FIEs helped Guanqiang accomplish its foreign exchange earning assignment. What if Guanqiang was unable to realize its contracted foreign exchange earnings in a certain year? Zheng said, "We could also buy it [the required currency] on the black market!" But that situation never arose.

Moreover, Guanqiang relied on the remittance spread to pay a large portion of its expenses. Guanqiang was rewarded for earning foreign exchange by acquiring foreign exchange use rights (commonly referred to as foreign exchange retention) on 20 percent of that foreign exchange income, as well as a sum for special compensation, while 80 percent of the foreign exchange use rights were designated for the provincial-level Pearl's Light. Guanqiang and Pearl's Light, like other Chinese companies with foreign exchange use rights, could purchase the foreign exchange they required at the official price within that quota, or they could sell their

22. Interview: GQ_Cheng199405.

foreign exchange use rights at an adjusted exchange rate at the foreign exchange swap center.[23] Complicated formulas existed for the distribution of profit from foreign exchange among the various levels of work units. Assuming that the foreign exchange earnings created in Dongguan could be converted into renminbi, the formula would be something like this:

$$\text{HK\$1} = \{0.8 \times \text{official exchange rate} + 0.2 \times \text{adjusted exchange rate} + 0.8 \times 1/2\ [\text{adjusted exchange rate - official exchange rate}]\}\ \text{yuan}$$

Using the abovementioned fourth quarter of 1993 as an example, the official exchange rate for the HK dollar was 0.76 yuan, while the black-market rate was 1.15, and the adjusted exchange rate was close to the black-market rate, at around 1.05. Based on this conversion, each remittance of HK$1 produced by Guanqiang was worth around 0.934 yuan, or 0.174 above the official value, and this difference was the gross profit that Guanqiang gained for each HK dollar remitted by FIEs. However, from the perspective of the foreign company, for each HK dollar that Taiyang remitted, it lost 0.39 yuan, because it could obtain 0.76 yuan only under the official exchange rate. So where did the difference go? The answer could not be clearer: it went to Guanqiang, and into the coffers of the government units at the provincial and other levels. Driven by this incentive structure created by the double-track exchange rate, Guanqiang provided

23. In October 1980, the Bank of China opened foreign exchange swap branches in Beijing and eleven other cities. According to the market quote for renminbi, US$1 could be exchanged for 1.5 yuan. In 1981 China began implementing an internal trading settlement exchange rate of US$1 for 2.8 yuan. The basis for this calculation was the actual conversion cost plus a reasonable profit. This price was not changed until 1984. For this reason, three foreign exchange prices coexisted during this period (the official price, the internal settlement price, and the black-market price). In 1985, the internal settlement price was abolished, and a single exchange rate was restored. However, the official price and the adjusted exchange rate coexisted in a double-track pricing system. China referred to the difference between the official price and the adjusted price as the quota price (see Yin Yanlin 1993). When Li Hao was appointed vice-governor of Guangdong Province and mayor of Shenzhen in 1985 (he later also became party secretary of Shenzhen), part of his mission was to establish a foreign exchange swap center. His interviews also mention the coexistence at that time of an official price, internal settlement price, and black-market price for foreign exchange and the inevitable phenomenon of speculation in foreign exchange (Guangdong Party Committee 2008, 347–48).

Table 3.1. Various taxes and related fees paid by Taiyang in 1993

Item	*Department paid*	*Calculation method*
(1) Labor management fee	Labor Bureau	8 yuan per month ×1,000 people
(2) Application for temporary residence permit	Public Security Bureau	30 yuan ×1,000 people
(3) Extension of temporary residence permit	Public Security Bureau	4 yuan per month ×1,000 people
(4) Staff dormitory rent	Alfa Plastics Factory	30 yuan per month ×900 people
(5) Security guards	Coastguard local unit	700 yuan per month ×15 people
(6) Corporate income tax	Tax Bureau	200,000 yuan ×12%
(7) Head tax (processing fee remittance spread)	Guanqiang	0.39×450×600×12 (or 1,263,600 yuan)

Source: Author's analysis based on the information collected in the fieldwork.

sponsoring services (under the name of a joint venture) to FIEs. Apart from closely tracking whether or not Taiyang remitted funds on time every month, Guanqiang paid no attention whatsoever to Taiyang's business. In fact, this hands-off approach was exactly what FIEs hoped for.

The head tax was merely the most important fee that Taiyang paid to the Chinese side. It also had to pay a multitude of other fees. Table 3.1 lists some of the more notable items. This table reveals a great deal of important information that can explain the detailed mechanism of the head-counting game and the operational model of the informal institutions.

First, head counting was a method commonly used by the Chinese side for levying various fees. What is interesting is that the various work units Taiyang dealt with used different calculation methods. How many workers did this factory actually employ: 600 (according to the agreement between Taiyang and Guanqiang), 900 (according to the rent paid to Alfa Plastics Factory) or 1,000 (according to the fees paid to Labor Bureau and Public Security bureau)? Mr. Chang, the manager of the factory service department, revealed that it actually employed 1,500 people. This seems to indicate that Taiyang concealed 900 people from Guanqiang, 600 from the plastics factory that rented out its dormitory, and 500 from the Labor Bureau. At first glance, this is a story of an FIE cheating a local government, but the situation is not actually that simple. The crux of the problem is that "in calculating the head count, we had to see whom we were paying and the outcome of the negotiations and then finally decide. If we had somewhat better relations with them, we could report fewer [employees]," as Chang said. "They didn't actually come into the factory and count exactly how many people were there! Once we'd reached an agreement, they would come for a look around and then report the number."[24] In other words, head counting could be an empty gesture or could proceed strictly according to regulations.

The head count could be agreed upon and discounted, and individual agreements could be reached with different government departments, in the manner of separate fiefdoms and approaching what is called particularistic bargaining (Shirk 1993). Here, what local bureaucratic organs cared about was protecting their own interests, and they decided on reductions to the head count based on whether they had friendly or poor relationships with individual manufacturers. The shortfall in a head count was therefore not a deception but rather collusion between the government and business. In China, especially in Guangdong at this stage, all kinds of taxes and fees could be discounted: Taiyang's case was the rule rather than the exception. One study of Shenzhen at that time noted that according to government regulations, in Shenzhen City's Bao'an County, the processing fee remittance was 600 yuan per worker, while inside the Shenzhen SEZ it was 700–800 yuan. However, FIEs in these places generally enjoyed a 20 percent "discount" (Shao Mingjun 1992, 550).

Second, the discrepancy in the head counts that Taiyang reported shows a lack of communication and coordination between various departments regarding the business situations of FIEs, or perhaps that these departments simply did not care about the horizontal flow of information. If various government units could supervise the accounting of enterprises by way of interdepartment information networks, they would very easily have been able to grasp the true situation. Upper-level governments—especially the central government—should have an intense interest in clarifying the detailed situation of foreign companies.

24. Interview: Chang199405.

However, at this stage, because the monitoring tools of the Chinese government were still inadequate and the institutional structure was incomplete, the government lacked infrastructural power. Furthermore, at that time the government desperately needed to attract capital, technology, and export markets through foreign companies, so it turned a blind eye to the collusive activities at the local level and even tacitly consented to them.

Third, the formal tax that Taiyang paid to the Chinese government (table 3.1, item 6) was very small—only about 14 percent of the total that Taiyang paid in labor management and temporary residence fees (items 1–3) and only 1.9 percent of what Taiyang paid in head tax. Taiyang had US$20 million, or approximately 116.6 million yuan (according to the official exchange rate), in total sales in 1993. If profit is calculated at 10 percent, Taiyang's taxable profit would have been 11.7 million yuan. With the help of Guanqiang, Taiyang gained the preferential treatment of "three exempt and four reduced" on income tax.[25] Because Dongguan City was included among the coastal open economic regions, the income tax rate was 24 percent, so half of the rate was 12 percent. Nineteen ninety-three was the fifth year of Taiyang's official operations and the fifth year that it posted a profit. According to the official standards, Taiyang would need to pay 1.4 million yuan in income tax.

Because Taiyang was a standard "three ends outside" FIE (with its raw material supply, product export market, and letter of credit documentary drafts all outside of China), it was very easy to manipulate the accounts and very difficult for the Chinese side to vet the company's financial reports. In 1993 Taiyang reported a small portion of its profits to the Chinese side and paid a small amount of tax. Guanqiang accepted at face value the operating conditions that Taiyang reported because Guanqiang was the greatest beneficiary of this cooperative relationship. It is no accident that with Guanqiang's help, Taiyang never experienced any problems when it came to taxes.

Fourth, the head tax was the largest fee that Taiyang paid to the Chinese side (1.26 million yuan). Curiously, this fee was very close to the Chinese government's lost tax revenue (1.40 million yuan). In any case,

25. "Three exempt and four reduced" refers to the exemption from income tax for the first three years in which a company posted a profit and the taxation at only half of the usual rate for the next four years.

that money still went into the Chinese side's pockets, just to a different government unit—and the collection method was also different. The head tax was a fixed and unchangeable contracted amount and would fluctuate only according to differences in the exchange rate, rather than reflecting the enterprise's actual profits or losses. In terms of fiscal function, the head tax used the foreign exchange earning process to pay the local state-owned enterprise, and the enterprise's income tax was paid directly to the state tax organ: the former was informal, extrabudgetary income; and the latter was formal tax revenue.

The significance of this difference was that the taxes and levies that the Chinese side acquired from the FIE were diverted from government finances to the local government or local state-owned enterprise. This financial diversion is evidence of the operational model called delegating power and yielding profit to the local level in the market reforms of China's opening to the outside world. This method effectively drove local officials' economic incentives and led them to enthusiastically compete for outside investment. Ostensibly, Guanqiang took money by inserting itself between the FIE and the taxation unit. In fact, this was according to the government's plan, which allowed local officials and state-owned enterprises to join in the rent-sharing game.

Fifth, we see that the local coast guard unit in Dongguan also squeezed Taiyang. The unit's commanding officer sent fifteen soldiers to serve as security guards for Taiyang's factory. They wore military uniforms but were not armed, and they became associate staff members of Taiyang: they lived and ate at the factory, punched its time clock, and submitted to the factory management's work directives. Taiyang paid the soldiers a liberal salary (compared to what general staff members received). However, Taiyang paid these salaries to the commander of the coast guard unit, while the soldiers drew their ordinary military pay from the unit. For Taiyang's managers, this sum of money was a public relations fee that had to be paid and was worth paying. At that time, law and order was rather limited in the Pearl River Delta, and the managers acknowledged that "having troops stationed at the factory gave a sense of security." It was by no means an unusual scenario for "troops to run over to guard a factory."[26] In Guangdong, all kinds of local work units were seeking rent

26. Interview: Chang199405.

from foreign companies in the name of apportionments and donations, as I often observed in my field investigations.

Finally, we do not see an item in table 3.1 relating to social insurance. Taiyang was required to pay a social insurance fee to the Labor Bureau at one point in the mid-1990s, but the amount was very low, and the government did not go out of its way to collect it. Only in the late 1990s, when the relevant laws were gradually implemented and the government increased its collection enforcement, did the social insurance fee become an important topic. This issue is discussed in detail in chapter 4.

What is clear is that in this transactional game between government and business, migrant workers were subject to elimination and trading and became abstract numbers without individual faces. It wasn't until after the mid-2000s—a time of saturation in the labor-intensive industries, gradual increases in the minimum wage for migrant workers, stronger social insurance laws, and other factors—that the collective and individual faces of workers gradually came into focus, and workers began to challenge this highly exclusionary alliance through collective petitions, reports to the authorities, lawsuits, and strikes. This topic is explored in depth in chapter 6.

6. The 1994 Foreign Exchange Reform

In the final analysis, the abovementioned complex mechanism of rent creating and rent sharing was the outgrowth of the double-track exchange rate and foreign exchange retention systems, which were designed by the central government. In fact, this design was not original: many newly industrializing countries, including Taiwan, have adopted policies such as binary exchange rates in the past. Imitation may therefore be a more appropriate description of what happened in China. The head tax game was the local government's flexible application of central government policies, and driven by the central policies, it emerged under favorable local conditions. During my field investigations in Guangdong, I often found that local cadres mentioned that they flexibly applied policies or maximized their use. Although when the central government established the rules of the game, it could not have foreseen exactly how flexibly local governments would apply these policies, it certainly crafted the incentive structure in such a way as to spur local officials to attract investment. In the first stage of the reforms, the central government created institutional rent-seeking opportunities for local governments. So if the central government changed the rules of the game, how would the local governments react? And how would foreign investors react?

The rules were finally changed. Starting with Deng Xiaoping's southern tour in 1992, China's arrangements for its opening reforms underwent a structural transformation. The Pudong New District Development Plan in Shanghai was presented, the strategy of developing the Yangtze River Basin region to drive the economic development of eastern China gradually took shape, and many cities in the interior were added to the list of cities to be opened to foreign investment. In early 1994, the central government launched a new round of institutional reforms, which (especially the substantial depreciation of the renminbi and the unification of the exchange rate) had a serious effect on local governments, as well as administrative decoupling (reforms that broke administrative links between different administrative levels of foreign trade SOEs). All of these reforms sent the existing informal financial arrangements between local work units and FIEs into flux.

"Unification of the exchange rate" refers to the elimination of the double-track foreign exchange pricing system and allowing the price of the renminbi to fluctuate within a small range. In 1994, at the same time that unification of the exchange rate was carried out, the exchange rate for the renminbi was depreciated to near the market price, so that its value compared to the US dollar fell from 5.76 yuan to 8.62 yuan. Next came relaxation of foreign exchange controls within a small range and the cancellation of the foreign exchange retention system. "Administrative decoupling" meant that prefectural-level foreign trading companies were no longer administratively subordinate to the higher-level provincial foreign trading companies and now were local SOEs of the prefectural governments. Consequently, Guanqiang now reported to the Dongguan prefectural government. At the same time, this meant that the central government had extended the downward delegation of foreign trade rights and further relaxed the foreign trade management system.

For foreign businesses, once the exchange rate was unified, it was clearly no longer legitimate to pay processing fees through the remittance of foreign currency and have a high fee extracted in the process. FIEs could now easily obtain the yuan they needed at an official exchange rate close to the market rate, so why should they go to the expense and trouble of using the abovementioned complex remittance procedure?

The problem was the effect on the interests of local government units. According to the arrangements in the era of the double-track system, in 1993 Guanqiang made a gross profit of about 0.17 yuan for every HK dollar remitted for the processing fee. With the processing fee remittance spread eliminated, Guanqiang would suddenly lose a large amount of money. After the exchange rate was unified, there was no longer such a thing as a remittance spread, which is why the Chinese government declared that "unification of the exchange rate in itself is a new advantage for foreign businesses."[27]

Guanqiang announced that to compensate it for its losses under the unified exchange rate, all of the enterprises for which it was the sponsoring organ, including joint ventures, would still have to remit a monthly processing fee in renminbi, and Guanqiang would extract a 25 percent management fee from that. This move naturally drew opposition from FIEs, but Guanqiang's method was quite pervasive in the Pearl River Delta.[28]

What could be observed on the ground in the Pearl River Delta at that time was that many FIEs temporarily halted remittances and adopted

27. Interview: GQ_Cheng199405.

28. The following observation is consistent with the results of my field research: "Many Guangdong towns took at least 20 percent of the processing fees that were remitted to the banks as a municipal support fees or fees under different names. This was mainly before the end of 1993, when the official exchange rate and adjusted exchange rate hadn't yet been unified, and the wages for processing shipped materials had to be remitted to the local government in renminbi, and the local government would gain the differential. When the exchange rates were unified in 1994, the local government still didn't give up its vested interests and continued the same as before, merely extracting its fee under another name. Out of fear that foreign companies would underreport the processing fee, some local governments calculated the processing fee to be remitted based on the weight of exports. But it wasn't like that everywhere in Guangdong: for instance, Huizhou didn't 'levy a percentage of the processing fee' and didn't care if the processing fee was underreported. . . . In terms of foreign exchange, although some localities took a percentage of the processing fee for processing shipped materials, they were also often somewhat hostile to wholly foreign-owned companies and would charge them a higher management fee (head tax)" (Hsu He-jung 2005, 627).

a wait-and-see attitude. Taiyang held several talks with Guanqiang on this issue, which wasn't resolved until 1995.

Following the administrative decoupling of Guanqiang, the prefectural government now had a legitimate reason to share in the profits of subordinate state-owned trading companies. The new reforms also complicated the game of rent sharing. In March 1994, the Dongguan government issued a new formula for remittance allocation. The government wanted to take 5.5 percent of the remitted funds as a service charge, and it allowed the sponsoring work unit to take 24.5–29.5 percent, while the FIE could take the remaining 65–70 percent. This indicates that the fee that the FIE now had to pay was not lower than under the former dual exchange rate system. Needless to say, the Dongguan government's announcement immediately created an uproar among foreign companies. It also exacerbated the friction between Guanqiang and its clients. An increasing number of FIEs stopped remitting funds. Mr. Yen, the manager of a local shoe factory, said: "This hand had to be played. We temporarily held back to see their next move!"[29]

7. Building a New Factory in Nafu Village

In fact, Taiyang had quietly begun taking action to change its mother-in-law much earlier. In early 1994, Taiyang gave notice that it would be terminating its cooperative relationship with Guanqiang at the end of the year. At that time, a new Taiyang factory was being constructed with a sense of urgency in Nafu Village.

"Village" was not an administrative term in Guangdong, and the proper name was "Nafu Administrative District," but people still used the word "village." "Administrative district" was a term used only in Guangdong to refer to what other provinces called an "administrative village." It was the lowest level of administrative unit and usually encompassed multiple natural villages. But the extent of a Guangdong administrative district was typically much larger than that of an administrative village in other provinces, and the term was mainly an institutional

29. Interview: Yen199405.

remnant of the people's commune era. During that era, the commune in a typical province was around the scale of a township, but in Guangdong the scale of communes was very large (in some areas, a commune was the equivalent of a county), so production brigades in Guangdong were also very large. After the people's communes were dismantled, production brigades were changed into administrative districts. The Nafu Administrative District was subordinate to Xishui Town and was located a little over ten kilometers from the town center. Nafu included seven natural villages. In January 1994, it had around four thousand native village residents (registered permanent residents) and around three thousand migrant workers and their dependents (who made up the nonnative population), most of them from other provinces. The administrative district office owned five collective enterprises, and all of them contracted work out. The district had around fifteen FIEs (all small-scale factories) that paid head taxes to the district office. In the 1993 financial year, the district office's budgeted revenue was around three million yuan, which included 1.25 million yuan from subcontracting fees. The district office employed around fifteen people (including full-time cadres and temporary employees). According to the cadres, they shared a bonus totaling five thousand yuan that year.

Taiyang's Lee was quite well informed about changes in the Chinese central government's policies. It should not be surprising that Taiyang's decision to move to a new factory was timed to match the implementation of the new round of macroeconomic reforms launched by Zhu Rongji, vice-premier of the State Council. It is significant that FIEs started looking for new partners at the same time as the central government's new reform plan was implemented. As described above, the combination of the unification of the exchange rate and other decoupling measures changed the original interactive environment between local cadres and foreign businesses, and it also changed their respective incentive structures. Furthermore, Taiyang's "three exempt and four reduced" tax incentives were about to end. For Lee, what was most important at this time was to find a new partner that was cheaper and more reliable. Psychological factors also played a role. Lee had come to what he called a "chaotic society" and had done business there for seven years. Now he had the self-confidence to make sense of the rules of the game. He had his own information network as well as relationships with people outside of

Table 3.2. The annual fees Taiyang's new factory paid to Nafu Village

Item	*Cost*
(1) Head tax (management fee)	10 yuan × 1,700 people × 12 months (204,000 yuan)
(2) Special fee	200,000 yuan
Total	404,000 yuan

Source: Author's analysis.

Guanqiang. In this new situation, he "no longer wanted to mess around with mainlanders and engage in fake joint ventures."[30] Put simply, he hoped to have a more transparent and simpler cooperative relationship with local people. He was planning a new operational model for Taiyang: Taiyang wanted a new mah-jongg table, new mah-jongg partners, and a completely new relationship with them.

Taiyang was investing even more money in China. For example, the new factory in Nafu cost US$9 million. Plans for the company's move began to be carried out in 1993, including finding a new location for the factory and a new cooperation partner, as well as buying machinery and other equipment. Taiyang finally chose Nafu and signed a contract with the cadres there as a wholly foreign-owned company. The new factory would hire 1,700–2,500 workers, and its estimated maximum annual production capacity would reach US$40 million.

Taiyang leased a piece of land measuring 30,000 square meters at a cost of 140 yuan per square meter, paid to the Nafu Administrative District office. Taiyang began operating its new factory in Nafu in January 1995. It paid the administrative office a management fee of 204,000 yuan per year. Once again, the management fee was calculated on the basis of a head count: 10 yuan per worker per month, with the number of workers fixed at 1,700 (see table 3.2). This payment to the local partner was now called a management fee, but Lee was still accustomed to calling it a head tax. Apart from the head tax, Taiyang promised to pay another sum of 200,000 yuan as a special fee each year.

The conditions that Taiyang gained from its move to Nafu were all much more liberal than those under Taiyang's relationship with

30. Interview: Leegm199508.

Guanqiang. The new company also gained the "three exempt and four reduced" tax incentive. Apart from the export quota, Nafu gave Taiyang almost the same services as Dongguan had provided, but the total fees were only one-third of what Taiyang had paid to Guanqiang. The new company also had a much higher production capacity than the old one. In calculating the actual head tax for each worker, Guanqiang had demanded sixty-four yuan, while Nafu required only sixteen yuan. Furthermore, the method for paying the management fee no longer required the tortuous foreign exchange-earning process: instead, the company paid renminbi directly to the Nafu Administrative District office. At first glance, the fee required by Nafu was much lower than Guanqiang's, but Taiyang had already spent more than four million yuan on the land lease.

The reason for choosing to become Nafu's son-in-law was very simple: Many nearby administrative districts were competing to provide the most advantageous conditions, and Taiyang found Nafu's conditions most advantageous. The main consideration was that this new partner's asking price was much lower. In fact, compared with neighboring villages, Nafu was rather remote and had developed later as an administrative district, so it was willing to offer better terms to attract investors. When Taiyang was preparing to build its new factory, Guanqiang's manager came to talk to Lee several times (although by then it would have been hard to change Taiyang's plans), demanding that Taiyang give Guanqiang a stake in the new company. Lee refused for this reason: "There was no benefit to having an extra mother-in-law!" Taiyang worried that continuing to cooperate with Guanqiang would only increase its outlay without bringing any actual benefit.

This policy change caused Guanqiang to lose some very profitable business, and the relationship between the two companies began to sour. Reportedly, when Guanqiang's manager saw that persuasion was ineffective, he threatened to create problems for Taiyang. What kind of problems? Lee wasn't willing to disclose the details, but he repeatedly complained that the manager used "despicable methods." According to regulations, one of the conditions for Taiyang to enjoy tax reductions was that the business had to continue operating for at least ten years. If Taiyang terminated its cooperative relationship with Guanqiang (i.e., closed down its business), it would have to pay back its previous tax breaks. This suggests that Guanqiang was not without bargaining chips. Furthermore, the dispute over the unpaid processing fee and service charge (the fee required by the prefectural government) had not yet been resolved. By taking on a new mother-in-law, Taiyang ended the increasingly acrimonious relationship of rival partners. In Lee's eyes, Guanqiang had changed from a protector into a plunderer. The long-drawn-out drama finally ended in 1995, as Taiyang ended its relationship with Guanqiang through the negotiation method. In the transitional period of this institutional environment, we can observe the state (the central government) carrying out a new policy that caused the relative price of the deal between a local government and a foreign company to change and then impelled changes to the interactive model between the two sides. Government-business relationship networks are embedded in a specific policy and structural environment, and as soon as the external institutional environment changes, the cooperation or collusion between government and business is bound to be affected and then adjusted.

8. The Institutional Emergence of the Head Tax

Taiyang's story shows that the function of head tax is an element in the Guangdong growth model. Starting with the head tax phenomenon, I have painstakingly examined and traced the institutional figuration of the Guangdong model. This includes formal and informal rules, as well as the rent-seeking behavior of the bureaucratic collective. Head tax as a medium of dealings between local government and business led Guangdong's labor-intensive industrialization to take off like wildfire under the dominance of foreign investment. Observed from the perspective of new institutional economics, the head tax can be said to reflect the institutional equilibrium of the Guangdong growth model.

Why did the head tax emerge in Guangdong? And how did it emerge? Figure 3.4 is a schematic diagram of the institutional origins of the head tax. First, the dual-track foreign exchange system in state policy encouraged exports to earn foreign exchange, and implementing a system of foreign exchange retention spurred local officials to attract outside investment. We cannot forget that in the early 1990s, China was still in desperate need of foreign exchange, and the lack of foreign exchange was

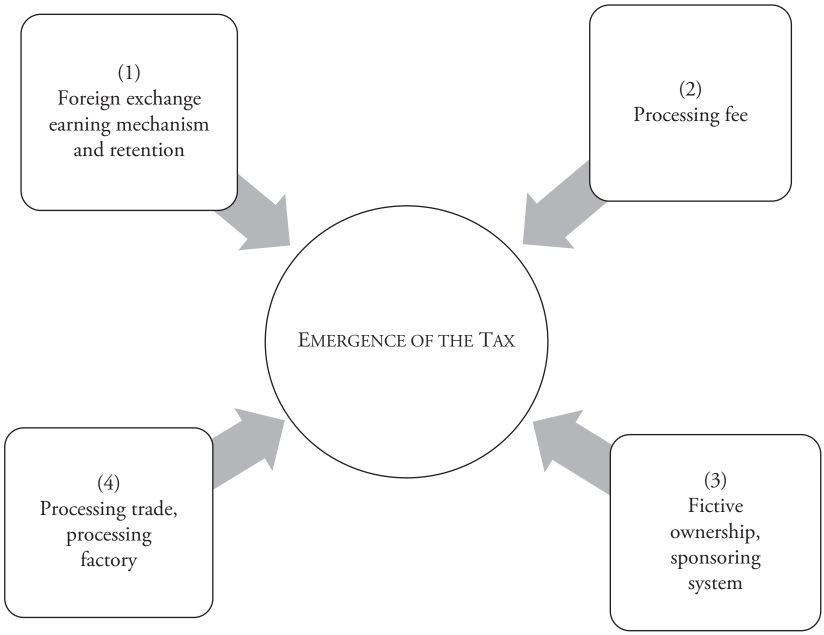

FIGURE 3.4. The institutional origins of the head tax.

the structural force that activated the mechanism to earn that exchange. At that time, engaging in foreign trade and using foreign exchange were both administrative privileges. In Guangdong, the right to engage in foreign trade was delegated down to grassroots government units, and each unit was tasked with earning a certain quota of foreign exchange. Each unit therefore explored all possible means of meeting its quota. But what actual benefit did local cadres gain from taking on these quotas? The answer is foreign exchange retention, which provided cadres with an incentive to put great amounts of effort into earning foreign exchange.

The second fountainhead for the head tax was the processing fee, which was closely linked to the mechanism of earning foreign exchange. The remittance procedure for processing fees was a mechanism for creating extrabudgetary fees. This procedure for earning foreign exchange was a bureaucratically collectivized institutional rent-seeking mechanism. The exchange relationship between Guanqiang and the FIEs it sponsored distinctly displays this quality. The processing fee then connected to the third fountainhead: The government work unit or state-owned enterprise could provide arrangements and protection for fictive ownership. The various elastic or flexible ownership relations pervasive in China at that time all point to the pervasiveness of the sponsorship system. A new form of local government–business relationship thereupon emerged, under which a work unit that accepted a company for sponsorship would collect a sponsorship or management fee from it.

These mutually linked institutional factors point to the fourth fountainhead: the processing trade. These ostensibly complicated and intertwined institutions allowed the smooth operation of factories for processing shipped materials, the main corporate organizational model at that time. Taiyang was ostensibly a joint-venture company, but its production

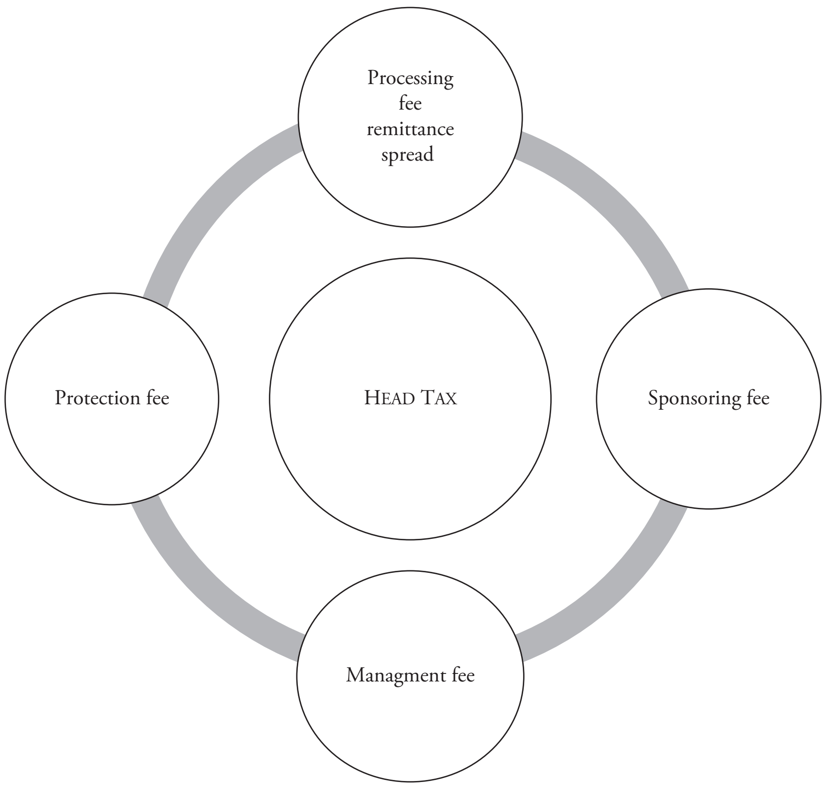

FIGURE 3.5. The floating significance of head tax.

methods, corporate operations, and sponsoring model were identical to those of the typical wholly foreign-owned factory processing shipped materials.

By granting sponsoring services for fictive ownership and gaining rent-seeking privileges from the companies they served, local cadres made these companies into their sphere of influence, with the companies both accepting the cadres' protection and having to pay a protection fee. At a certain stage in history, when the companies accepting sponsorship services felt that paying the management fee was reasonable, this fee was seen as legitimate by those companies. But after the policy environment had changed, companies felt that this fee was not justified, its legitimacy eroded, and the government units providing sponsorship became plunderers who forcibly extracted protection fees like gangsters. For this reason, the same fee charged to a different actor, at a different time, and in a different institutional relationship, acquired a different signifier and a completely different subjective affect (see figure 3.5). The variety of terms—"head tax," "processing fee remittance spread," "sponsorship fee," "management fee," and "protection fee"—all meant the transaction cost for government-business relations. In this study, I treat this transaction cost as institutional rent seeking. Like fluid semantic symbols accompanying changes in actors, the passage of time, and changes in the environment, different names call up diametrically opposite images and value judgments. The fluidity does not imply that there is no pattern to be grasped. Rather, the researcher must seize the historical moment within the flow and observe how an institution emerges in the structural interstices and then how it vanishes.