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Social Conflict in Rural China

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Social conflict is the taboo of Chinese political discourse. With "an overriding need for stability" and "a harmonious society" as the official policy lines, the potential negative social and political impacts of social conflict make it a highly sensitive topic in China. Thus, for academics, the subject is a veritable mine field that most stay away from – resulting in a lack of in-depth and systematic research on social conflict in China. This is evidenced by the mainstream characterization of normal social conflict as *pathological*, and thought better to be covered up out of a concern over negative political consequences. Because social conflict is seen as a kind of social disease, its legitimacy is often denied and the interests and needs of the relevant social groups dismissed – particularly those disadvantaged groups that lie at the core of conflict in society.

Rather than attempting to understand and address the roots of these conflicts, Chinese leaders are more inclined to suppress them in order to keep them out of the public eye. This mentality and practice not only works to aggravate conflict, but also diminishes the legitimacy of the rulers by contradicting their touting commitments to 'seek the truth from the facts'. When the leadership fails in its commitments, the likelihood of social

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turbulence breaking out in China increases. Conversely, while social action and mobilization increase the risk of social upheaval, they have important positive implications for social development. Understanding social conflict and its root causes creates an opportunity to both proactively confront social injustices and avert breakdowns in Chinese society.

In Chinese society today, large-scale conflicts are most likely to erupt in rural versus urban areas. This is primarily due to a combination of the central government's inability to control the vast and remote areas of China, and the lack of a clear set of common interests among the highly diverse populations of rural China. In the past ten years, China has experienced a rapid period of transition from a planned to a market economy. In the process, farmers' economic interests have grown far more slowly than the national average. This widening 'wealth gap' has made social justice a focal issue for disgruntled peasants. Peasant interests have also been gravely impacted by the huge tide of land appropriation in recent years.

Large-scale conflicts are most likely to erupt in rural versus urban areas.

In the next decade or two, China will likely enter a period of frequent social conflict. Peasants are likely to join hands with workers and members of the lower intellectual class and confront the elitist alliance that dominates society,[1] creating political, economic and social upheaval in China. To prevent social unrest from triggering a revolution, it is imperative to address issues of social injustice as well as create the effective channels for their expression. Such a mechanism must be built upon fair constitutionalism and reform of the core values in Chinese society.

Conflict in a Transitional Society

Social conflict theory holds that conflict arises when disparate social groups clash over antagonistic interests. In an unjust system, the governed group develops a sense of relative deprivation and unfairness, resulting in a loss of political authority of the governing group.[2] As the disadvantaged group grows aware of the unequal distribution of limited resources, it is more likely to rebel against the beneficiaries of the system.[3] It is during social and economic transition when these differences between social groups become most stark and when there is a raised awareness of citizenship and political participation. In addition, the government's inability to meet the changing expectations and demands can lead to the merging of interests among dissatisfied groups and mobilize large numbers of people. Increasing collective awareness and suspicion about the fairness of resource distribution amounts to a greater challenge to ruler's legitimacy and increases the likelihood of conflict. Under these unstable circumstances, a sudden deterioration in economic, social, political or environmental conditions can spark large-scale chaos. An example of how this can play out is the political and social turmoil in Southeast Asian countries triggered by the financial crisis in 1997.

For China, the Tiananmen Incident on June 4, 1989 highlights a significant shift in social conflict. Up to that time, social conflict in China appeared as a 'constructive struggle for political power', and was largely dominated by intellectual elites. Despite the continuing hostility to China's authoritarian regime by some radical intellectuals in the following years, the protests of 1989 marked the end of open confrontation between intellectual elites and the political elites (rulers). Most intellectual elites, under intense political pressure and by the persuasion of "enlightened" political elites, came to accept the reality that they could not change the regime at this time. Deng Xiaoping's tour of southern China in 1992 reinstated economic growth as the country's firm path ahead. Along with this event, the enthusiasm of intellectual elite opposition dissipated as they were themselves co-opted by increasing business opportunities. Those who maintained political aspirations found more inroads into China's power system as long as they recognized the current regime. However, by the end of the 20th century, a new exclusive form of rule had emerged in China and with it, a new phase of social conflict resulting from the neglect of the poor and disadvantaged – characterized by a reactive approach and organized around a defense of rights, primarily led by workers and peasants.

The elitist alliance enjoys the benefits of China's economic achievements.

An 'elitist alliance' has emerged during this new phase: a combination of political elites (government), economic elites (business professionals) and intellectual elites (academia and culture).[4] This group legitimately enjoys the benefits of China's economic achievements through a 'revolving door'. As the government emphasizes 'knowledge-based' (*zhishihua*) requirements or minimum educational level for its officials, many intellectual elites have entered positions of political power. Similarly, political elites have set up businesses (*xiahai*) or have become *guanshang* (establishing business while holding office). In 2002, the 16th Party Congress paved the way for economic elites to become political elites, giving the former greater identity with political power.[5] A common interest binds the three groups together to form a relatively stable Chinese ruling class with a broad base.

On the other side of the equation are the workers and peasants, who, because of their poverty, are suppressed by strong political forces and are on the whole, excluded from economic, political and intellectual life. They are increasingly marginalized and have become a socially disadvantaged group. Most intellectual elites have joined the elitist alliance and no longer speak on behalf of the lower classes. Peasants and workers have no true representation of their interests in the formal political process and have been unable to organize themselves to fight for a common interest.[6]

The juxtaposition of the elitist alliance vis-a-vis the disadvantaged group is characterized by 'rigid stability'. The former gains power through the accumulation of political, economic and social resources and then institute higher barriers for other groups wanting to share their power.[7] This exclusive arrangement becomes a one-way exchange as the elitist alliance gains from the success of China's development while the price for peasants and workers wanting to enter this group is too high. With the skewing of resource allocation, the disadvantaged group finds themselves increasingly reliant on the elitist alliance for their survival. The marginalization of workers and peasants is thus becoming irreversible in China's society.

Under the banner of development, China has witnessed an unprecedented growth of its economy at the cost of social justice.[8] This contradiction has ushered in a new stage of social resistance whereby the increasingly marginalized workers and peasants are standing up for their rights. The frequency of social conflicts is testimony to this growing trend, with the number of incidents of peasant/worker unrest rapidly increasing since 1999. China experienced 8,709 such incidents in 1993 but by 1999, they had exploded to over 32,000. The figure for 2005 was in excess of 87,000.[9]

Resistance by Legal Means

Forms of peasant unrest have been changing during the 1990s. Prior to 1992, peasants defended their rights mainly through sporadic resistance over trivial disputes.[10] After 1998, Chinese peasants' resistance became far more organized and over greater stakes. Their speakers or representatives are often demobilized soldiers, retired government officials who chose to spend their remaining years in the countryside and former village cadres. These individuals have clear political beliefs and understand how to motivate other peasants and directly challenge government agencies at the grassroots level through legal channels.

The representatives of the peasants form the core of an 'underground' organization to defend peasants' interests. They are loose in structure and bound mainly by commitments to morality and justice. Formerly, they concentrated on tasks such as reducing the tax burdens of peasants and protecting villagers' voting rights.[11] In recent years, however, these organizations have come to protect peasants' land rights as local governments and land developers increasingly appropriate the peasants' land without due compensation. Their fundamental belief is that peasants' interests and rights are violated because governments at the local level are not enforcing laws nor implementing policies devised by the central government.[12] This form of resistance uses the state's own laws to achieve its ends and thus reveals a more clear understanding of the abstract 'legitimate rights and interests' or 'citizens' rights' of peasants.[13]

China utilizes a socialist system of land ownership, where land is either owned by the state or collectively owned by the working masses. Peasant farmers do not own land and are entitled only the right to use land.[14] A constitutional amendment passed by the People's Congress in March 2004 stipulated that the state can legally appropriate land and take back the land-use rights from peasants, but must compensate for such appropriation. With the high economic growth and rapid urbanization, an enormous amount of farm land has been requisitioned, particularly in rural areas bordering big cities. As the government is technically both owner of the land and administer of its use (and often a developer itself), the appropriation of land is not supervised, resulting in frequent abuse.[15] Many local governments use any and all means to kick peasants off the land so that it can be converted it into industrial and business zones. Although there are clear details regarding the level and scope of compensation that should be given according to law, the majority of peasants are ignorant

Peasants are enlightening intellectual elites on civil rights, and shifting the political discourse in China.

of their rights and usually receive far lower compensation than a fair market value of the land. To add insult to injury, without a sufficient social safety net to fall back on once their land is taken, they are left in an extremely vulnerable position, often with their survival at stake. Local governments care about little outside their own interests; the lower the compensation to farmers for their land, the more profits they pocket.[16] Local governments often don't even have a sound plan for developing the land but just want to occupy as much as they can knowing its potential worth. The upshot has been a huge waste of fertile farm lands that are left abandoned after being appropriated from the peasants that till it. Therefore, land disputes – more than any crisis in the past – make conflict in the rural areas more explosive and violent than ever.

In addition to centering on land disputes, social conflict in China's countryside has also taken on new characteristics. First, participants in social conflict no longer only include peasants but also village-level government cadres, as they are both victims in land appropriation cases.[17] Their 'enemies' on the other hand, have upgraded to include municipal and county governments, real estate developers and administrators of economic development zones.

Second, previous rural conflicts that centered on tax burden disputes took place mainly in poorer, central China. Land-rights disputes are primarily in developed regions and the coastal provinces of Zhejiang, Jiangsu, Guangdong, Shandong and Hebei, where urbanization and industrialization has led to a bigger appetite for land.

Thirdly, in the past, peasants mainly resorted to *shangfang* (petitioning high-level government authorities to appeal against unfair local governments behavior), or propagandizing their cause and refusing to pay taxes. In land-rights disputes, however, they choose demonstrations, parades, or other forms of civil disruption including sit-ins (*jingzuo*) at the doorstep of government buildings or on highways and railways to obstruct the flow of key transportation.[18]

Confrontations between peasants and local governments have become explosive, especially with the growing involvement of police. In the past, the central government explicitly prohibited the use of force in constraining peasants' protesting tax burdens. Therefore, except in a few cases, large-scale incidents between the police and peasants were rare. Disputes over land have taken on far higher stakes for all sides, making the differences between parties far more polarized and intractable. As a result, the local government often resorts to the use of massive police force – in some incidents hundreds of police – to constrain those displaced peasants who are defending their rights. Results from 87 incident studies since 2004 have shown that several hundred peasants have been injured, three killed, over 160 detained and a number were tied up and paraded around in an attempt to publicly humiliate them.[19] Peasants were punished under the 'crime' of "disturbing public order", obstruction of public services and illegal gathering. Some local governments even resorted to falsely accusing peasants petitioning the provincial and central government as *Falungong* members.[20]

Finally, peasants have sought help outside their environments from intellectuals, legal professionals and non governmental organizations (NGO) that provide free legal support and other advice. Because of the intervention of these external actors, land-rights disputes have taken on political significance and in some cases were resolved in favor of the peasants.[21] A Beijing-based NGO aided peasants in preparing a massive petition by 20,000 displaced farmers to punish the Communist Party secretary of Tangshan city in Hebei Province. Similar initiatives have been taken with the NGO's help in several other cities and provinces.

Peasants' Contribution to Political Development

During the past decade, peasants have become China's disadvantaged group. They are both relentlessly exploited economically and deprived of political rights and they lack true representation in China's official political participation process.[22] Under China's current governance, the strength of the state takes precedence over the rights of citizens and a law-based system. Thus, while peasant resistance is *legally* acknowledged, it is *politically* prohibited.[23] Nevertheless, the resistance by peasants and defense of their rights have made an important contribution to the protection of citizen rights and the reshaping of governmental behaviors and attitudes in China.

Leaders are feeling the heat from these peasant activities and have begun to adjust policies to accommodate their demands. This change is not due to a sudden moral awareness or compassion for the miserable plight of peasants. Rather, it is because peasants' direct confrontation of local governments has shaken the foundations of governance of this nation.[24] In 1985, the central government still framed the tax burden dispute as an "exceptional factor that has harmed relations between the party and the people, workers and peasants…"[25] By 1993, the central government had issued executive orders explicitly stating that "reducing the peasants' tax burdens is no longer a purely economic issue, but a political problem" and urged local governments to treat it as such.[26] The volume was turned up again in 1996 when the central government announced "the reduction of tax burdens on peasants is an extremely urgent political task."[27] In short, pressure from the bottom has affected government priorities at the top, as those in power have realized the political consequences of not addressing these pressing needs.[28]

Peasants engaged in defending their interests have also successfully changed the conduct of local governments in many respects, making political consultation in rural areas possible. Because the political authority and legitimacy of local governments comes from their connection to the central government, this strategy has been very effective. The peasants use laws, regulations and orders by the central government as the standard by which to measure local governments' behavior. In this way, the peasants have actually played the role of oversight of local governments giving the former a substantial political power – a reality that local governments must factor in when making decisions.[29]

Local governments have traditionally used harsh measures (and even criminal elements) to persecute peasants or their representatives who dare to challenge their authority.[30] Instead of putting out the fire, however local governments have been burned themselves as such tactics increasingly instigate mass peasant resistance, forcing the central government to intervene. By supporting the peasants, the central government has gained their respect, but it has also given them a confidence and belief that their activities are justified and legitimate. It has created a reinforcing effect as the representatives of the peasants have become heroes, drawing even more peasants to their cause. In rural areas, where peasant representatives or elites are powerful, local governments have little choice but to hold consultations with these former enemies in hopes that the latter can help persuade the peasants to implement some policy favored by the local officials.

Perhaps most interestingly, these peasants activities are enlightening intellectual elites on the theme of citizens' rights, which has become the channel of shifting political discourse in China.[31] In the 21st century, as Chinese society enters a time of potential crisis caused by unemployment and peasant land disputes, these intellectual elites are gradually forming a consensus around the need for a "new enlightenment" movement. As it evolves, intellectual elites are attempting to rationalize and define the societal changes that are unfolding through their own lens – often by borrowing Western terms and ideas. However, grafting foreign concepts onto the historical and political context of China's reality often negatively effects society. China's modern history has experienced this before. Intellectual elites, who are co-opted by the elites in power, monopolize the discourse over society's rights and interests, often leading to the neglect of the majority of citizens – mainly workers and peasants – who then fall between the cracks and become disadvantaged.

Now, the peasants are rewriting history. For the past decade, it is they who have been educating China's intellectual elites and influencing the government. While some vanguard intellectuals are raising the rhetorical banner of constitutionalism – democracy and citizens' rights – the Chinese peasants have already been acting on their demand for legitimate rights for several years. Few have understood the extent and the gravity of the social problems in China. Fewer still have recognized the power of these bottom-up changes that are occurring and which offer the greatest hope for resolving the contradictions in the rural areas.

This movement by China's rural citizens has also worked to transform the peasants themselves. They have gained political experience and fostered a group of leaders and representatives through their long struggle to defend their legitimate rights. In their efforts to reduce their tax burden, farmers first tried to rebel against the unfair taxation without breaking the law. In their fight over land-use rights, however, they began to actively use the law itself to defend not only their own statutory rights but also those of others.[32] That transition has marked a significant political shift with high symbolic value. Currently, peasants' actions have taken on a more rational and less violent form because they are clearly more organized and have more confidence in their strength. This is an important indication of a raised awareness of the rights and status of Chinese peasants. They are increasingly aware of the influence of their struggle for not just their own individual rights, but the fate of the rural community as a whole. Such realizations have led peasant mobilization to pursue broader and higher goals.

This has significantly widened the scope of their actions. To a great extent, Chinese peasants' pursuit has become the defense of a more abstract notion of the dignity of law. It is foreseeable that political participation in making laws or through legislative action will become the next goal for Chinese peasants. If that succeeds, the nature of China's grassroots-level politics will be profoundly changed.

Averting Revolution

The existence of deep socioeconomic rifts in society (poverty, racism, exploitation) does not necessarily guarantee large-scale mass protests or revolution.[33] However, a collapse of China's social institutions will loom in the future if it fails to provide an effective channel of expression for the grievances of disadvantaged groups in society or fails to establish a mechanism to balance diverse social interests as the gap between the rich and poor continues to widen. If China's problems of socioeconomic equality in rural China are left to fester, revolution may indeed be unavoidable.

Whether confrontation between peasants (with workers) and the elitist group will lead to a social crisis or even a revolution will be determined by

> The foundations for mass social movement in China may already be laid as there are indications that workers, peasants and the lower class of intellectuals are forging a common identity. Up to this point, workers and peasants have not yet merged into one coherent social group, even though they share a common social status and interests. The formation of their common identity and goals may require an outside group that can act as the bond to bring workers and peasants together. This group could be the 20 million demobilized and retired soldiers living in rural China, which possesses the social capital, organizational, networking and mobilization capabilities to be the bridge between workers and peasants. They have already been prominently contributing to peasants' movement to reduce tax burdens and protect land rights. In some southern regions, demobilized and retired soldiers have launched movements to mobilize both workers and peasants. For example, in some regions in Hunan Province, demobilized and retired soldiers built a 100,000-person 'anti-corruption brigade' that was mainly comprised of laid-off workers, poor peasants and lower class intellectuals. In fact, corruption may be the one factor that could bring workers and peasants together since both see this as the root cause of their current predicament and misery. In all past and current social conflicts that involve a combination of workers and peasants, their demands have universally held up anti-corruption as the common enemy.

many unpredictable factors.[34] First and foremost is how China's leaders deal with the movement by these groups to defend their legitimate rights. Currently, this movement exists as political pressure on the government, but how much pressure can it tolerate? If pushed beyond its limits, the stress of such political pressure could tip the balance of stability in China. The moderates in the government who are sympathetic to the peasants' cause could either change their stand and side with hardliners, or completely split with them to support peasants and workers. Either result could lead to a revolution in national politics. The most effective release-valve for this pressure is governance by rule of law.

Looking to the past will shed light on how China's present leadership can use the current crisis to carry out appropriate reforms.[35] In the late 1970s, Chinese peasants instinctually rebelled against the socialist system that was plagued by incessant political upheaval. Deng Xiaoping and other open-minded leaders recognized the root of social conflict at that time and used it to drive the rural reform, which linked peasants' remuneration to productivity under the land contract system. A grave test for the current Chinese leadership headed by Hu Jintao and Wen Jiabao – and their successors – is not unlike that of Deng and his contemporaries. They must also recognize the unique root cause of the social conflict of the present time and adapt China's rural policy to accommodate peasants' political demands.

The most important political image the current Chinese leadership has built so far can be described as "reaching out to the common people" (*qinmin*) and respecting the common people's wishes. Some in academia have coined this new image as "new populism" and at its core is the protection of civil rights.[36] However, an image is not enough to sooth the peasants' grievances. The leadership needs to recognize the peasants' defense of their rights as legitimate, as a demand for political participation and consultation within the mainstream political institution.

Secondly, will the policies of a "benevolent government" (*renzheng*) carried out by the Hu-Wen administration be acceptable to the privileged ruling group? They tout being "close to the common people" and their policies have begun to cater to those poor and disadvantaged by acknowledging their legitimate rights and seeking to improve their wellbeing.[37] This has won them support from peasants and workers, however, such policies haven't really been acknowledged by the privileged group as it has not yet significantly impacted them. This group holds huge interests in the fortune it has amassed through the 'old power' or the privileged status in the old communist power structure. In a growing economy, and under the still fairly moderate policies of the Hu-Wen administration regarding solutions to the rural unrest, these privileged elites may yet bring enormous pressure to bear on the Hu-Wen administration as their interests become increasingly challenged.

Thirdly is the question of whether the central government can maintain stability between peasants and the local governments (and other interest groups). Undoubtedly, the Hu-Wen administration faces many complex dilemmas here as well. Primarily, the difficulty will come in balancing the contradictory interests of the elitist alliance with the poor and disadvantaged. As China continues to grow, a demand for land resources will only intensify and land can only come from the peasants' hands; the calculus is zero-sum. To protect the private property ownership, China recently passed the property law in 2007, which may intensify struggles between peasants and their "enemies" – local governments and land developers.

Other factors of instability also persist as the central government's authority is absorbed by the increasingly independent local governments who pursue their own agendas. The central government is stymied by local authorities who often pay lip service to the central government's policy but covertly sabotage it. The central government has fairly comprehensive directives for all levels of local governments, such as to strictly control the sale of land. Yet, many local governments feel uninhibited and appropriate peasants' land willfully without proper compensation.[38] The rise of harsher punishments doled out by the central government to curtail such behavior will invariably lead to conflict with local governments.

Finally, can the Chinese Communist Party (CCP) maintain its own identity and ideology while contradictions continue to rend the fabric of Chinese society? If not, what does that mean for China? The CCP's historical ideology and legitimacy declares that the "workers are the ruling class" and "peasants are allies"(of the ruling class). Yet, the capitalists' status has been raised far more in the past decades of reform. The nation is entering a stage of being a well-off society while hundreds of millions of peasants and workers cannot make ends meet. This gap between reality and professed ideology will inevitably shake the political root of the CCP's ideology and stability of its rule. Avoiding the escalation of social conflict will require, at a minimum, a better protection of the fundamental rights and interests of all citizens, particularly workers and peasants. This will entail, above all, a fairer and more equal sharing of the benefits of China's rise to prosperity.

Notes

[1] The elitist alliance in China is made up of 1) political elites: the main power body (Party leaders and government officials at every level); 2) economic elites: the main capital body (capitalists and senior managers); and 3) intellectuals elites: the main cultural body (academics).
See, Xiaoguang, Kang. "An analysis of political stability in mainland China in the next 3-5 years," *Strategy & Management,* Issue 3, 2002.
[2] Turner argues that this is the view of Marx. See, Turner, Jonathan H. *The Structure of Sociological Theory*, Vol.1, translated by Qiu Zeqi et al, Huaxia Publishing House, 2001. p.164
[3] Huntington, Samual P. *Political Order in Changing Societies*, translated by Li Shengping, Yang Yusheng and others, Huaxia Publishing House, 1988, p.43.
[4] Kang Xiaoguang once did a very brilliant analysis of the "elitist alliance" which emerged in Chinese society in the 1990s. But, he particularly stressed: "Unlike economic elitists, the reason why the intellectual elitists want to form an alliance with the political elitists is to pursue the interests of the nation rather than their own. It is precisely for China's democracy tomorrow that they accept today's autocracy". See Xiaoguang, Kang. "An analysis of political stability in mainland China in the next 3-5 years", *Strategy & Management,* Issue 3, 2002. Scholars who observed the "elitist alliance" included He Qinglian.
[5] In 2002, the 16th National Congress of the Communist Party of China drafted an amendment to the Chinese Constitution that paved the way for private entrepreneurs to join CPC. Only members of CPC can take the important political positions in all level governments. The new amendment provides the way that private entrepreneurs, members of economic elites, become political elites through joining in CPC. See, "Private entrepreneurs gain political status," China Daily, Dec. 13, 2003. http://www.chinalaw.gov.cn/jsp/contentpub/browser/contentpro.jsp?contentid=co1053783647; and "October party meeting focuses on amending constitution," China Daily, Aug. 12, 2003. http://www.chinalaw.gov.cn/jsp/contentpub/browser/contentpro.jsp?contentid=co200975680-
[6] Sijian, Xu. "'Orderly participation' and the safeguarding of Chinese farmers' rights and interests," China (Hainan) Institute of Reform and Development (ed): *Safeguarding of Farmers' Rights and Interests in China*, China Economic Publishing House, 2004, p.315.
[7] Xiaoguang, Kang. "Elite Alliance: Making the rules of the game," see: http://www.xschina.org/show.php?id=539
[8] Dang Guoying noted that, "Economic growth is a two-edged sword for social conflict. On one hand, it improves infrastructure and helps lower the cost of social transactions, thus is good for

reducing the overall size of social conflict organizations. On the other hand, it expands the content of social transactions and thus requires new trading conditions. If new trading conditions (such as a new constitutional order) do not emerge, it will actually increase the cost of social transactions and thus generate social conflict." Guoying, Dang. "Development and Conflict, a Theoretical Hypothesis and Positivistic Analysis of Experiences," *Sociological Research*, Issue 4, 1998.

[9] Social conflicts are defined in the statistics as "mass contingency events." From 1993 to 2003, the numbers of "mass contingency events" increased from 10 thousand to 60 thousand in China. The numbers of participants increased from 0.73 million to 3.07 million. See: Blue Book of China's Society: Analysis and Forecast on China's Social Development, Social Sciences Academic Press, China, 2005.

[10] Scott, James C. *The Moral Economy of the Peasant: Rebellion and Subsistence in Southeast Asia*, translated by Cheng Lixian, Liu Jian et al. Yilin Press, 2001.

[11] Manion, Melanie, "Chinese Democratization in Perspective: Electorates and Selectorates at the Township Level," *The China Quarterly*, No. 163 (Sep., 2000), pp. 764-782

[12] Jianrong, Yu. "*Organized peasant resistance and its political risks," Strategy & Management*,,Issue 3, 2003.

13 Ibid.

14 Xianping, Wang. "Changes in the rural land system in China," *Economic Forum*, Issue 19, 2006.

[15] The added value of land refers to the great rise of land price due to the change of land use (such as fields are changed into commodity residence and fields become a source for industrial production) caused by land requisition for state. According to the research of Development Research Center of the State Council, as to the distribution of the added value of land, only 20-30 percent is given to the village (five-10 percent of which is used as peasant compensation fee), 20-30 percent is given to the local municipal and provincial government and 40-50 percent is taken away by the real estate developer.. For additional iformation see: http://www.chinareform.net/Article_Show.asp?ArticleID=623.

[16] Xiaoguang, Kang. "Elite Alliance: Making the rules of the game," see: http://www.xschina.org/show.php?id=539

[17] The statistics come from the Chinese rural situation joint-investigation, made by national soft-science projects and national social science foundation projects in China Academy of Social Science from August 2003 to June 2004. See, Jianrong, Yu. "Land becomes the focus of peasants' struggle," http://www.tecn.cn/data/detail.php?id=4128.

[18] Statistics show that among 87 incidents in which peasants clashed with police over land right disputes since January 2004, 55.2 percent (or 48) of such incidents were caused by peasants' attempts to stop construction on requisitioned land, while the incidents caused by repelling of *Shangfang* or petition peasants by police force totaled 31 or accounted for 35.6 percent; clashes caused by peasant "sit-ins" accounted for 9.2 percent or numbered 8.

See the Chinese rural situation joint- investigation which was made by national soft-science projects and national social science foundation projects in China Academy of Social Science from August 2003 to June 2004.

[19] In 12 of such incidents, SWAPs (anti-riot police) or special police were called in; armed police intervened in seven of such incidents. See, the Chinese rural situation joint-investigation which was made by national soft-science projects and national social science foundation projects in the China Academy of Social Science from August 2003 to June 2004.

[20] The Chinese rural situation joint-investigation was made by national soft-science projects and

national social science foundation projects in the China Academy of Social Science from August 2003 to June 2004.

[21] Baiguang, Li. "The Constitution takes root and flowers in the heart of the people: materials from the Workshop on Farmers' Dismissal Activities in Tangshan, Qinhuangdao, Ningde and Fuzhou," Beijing Qimin Research Center, 2004.

[22] Sijian, Xu. "'Orderly participation' and the safeguarding of Chinese farmers' rights and interests," China (Hainan) Institute of Reform and Development (ed): *Safeguarding of Farmers' Rights and Interests in China*, China Economic Publishing House, 2004, p.315.

[23] In China, law and politics are separate entities. Some behaviors accord with the law, but are not politically allowed. For example, appeal is a democratic right of citizens according to the constitution, but people are often stopped by local government through various means when they are actually doing so. See, Yongkun, Zhou. "Political civilization and constitutional development in China, " *Law Science*, Issue 1, 2003.

[24] Social conflicts are defined in the statistics as "mass contingency events." From 1993 to 2003, the numbers of "mass contingency events" increased from 10 thousand to 60 thousand in China. The numbers of participants increased from 0.73 million to 3.07 million. See: Blue Book of China's Society: Analysis and Forecast on China's Social Development, Social Sciences Academic Press, China, 2005.

[25] See, the text of "*Circular Concerning the Prohibition of Charging of Irregular Fees to Farmers,"* http://www.people.com.cn/GB/historic/1031/3644.html

[26] Li, Wu and Zheng Yougui. *The Road Towards a Solution to Agricultural, Rural and Farmers' Problems: A history of thoughts and policies of the Chinese Communist Party on agriculture, countryside and farmer*s, China Economic Publishing House, 2004, p.692.

[27] "The Decision on truly Doing Good Work on Reducing Framers' Burdens" was issued by the Central Committee of the Communist Party of China and the State Council in 1996.
See: http://web.peopledaily.com.cn/04/01/yaowen/yaowen1.htm.

[28] In the "Circular Concerning the Prohibition of Charging of Irregular Fees to Farmers," issued by the Central Committee of the Communist Party of China and the State Council in 1985, the issue of farmers' burdens was seen as "an outstanding genitive factor which damages the relationship between the Party and the masses and the relationship between workers and farmers, and affects the further implementation of the rural economic policies of the Party." In the "Circular Concerning Truly Reducing Farmers' Burdens" issued by the State Council in 1990, the issue of farmers' burdens was considered "to have seriously harmed farmers' enthusiasm for developing production and damaged the relationship between the Party and the masses and the relationship between cadres and the masses. If the situation continues, it is bound to affect rural economic development and social stability.".In the "Circular Concerning Opinions on the Examination, Verification and Handling of Items Relating to Farmers' Burdens," issued by the General Office of the Central Committee of the Communist Party of China and the General Office of the State Council in 1993, it was specifically pointed out that, "Reducing farmers' burdens is not just an economic issue. It is also a political issue. It relates to the development of the national economy and the political stability of rural areas and even the whole country." In "The Decision on truly Doing Good Work on Reducing Framers' Burdens," issued by the Central Committee of the Communist Party of China and the State Council in 1996, it was further pointed out that "Farmers' heavy burden has become an outstanding issue which affects rural reforms, development and stability" and that "reducing farmers' burdens is a very urgent political task."

[29] Zhenqian, Zuo. "Let landless peasants become illegal land requisition supervisors," *China*

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Southeast Asia and Energy: Gateway to Stability

Zhang Xuegang

Southeast Asia lies at the foot of China's most strategically important region. It envelops China's border from the most economically successful eastern coastal areas, to its poorer and vulnerable southwestern provinces. The region holds all the vital and viable passageways of energy transport to China from the Middle East, Africa and around the world, making it both a region of great significance for China's security and a source of vulnerability. The region contains not only the traditional bottlenecked sea lines of communication, but also, new opportunities for alternative land and water routes for importing energy. Southeast Asia directly helps slake China's growing thirst for energy, mainly in the form of natural gas – the cleaner alternative to its current dependence on oil and coal.

Energy interdependence between China and Southeast Asia has greater significance than trade and transport security. It is fundamental to the larger and long-term structure of regional security. China's evolution as a growing stakeholder in the Association of Southeast Asian Nations (ASEAN), and the latter's increasing importance in China, helps ensure prosperity for both sides

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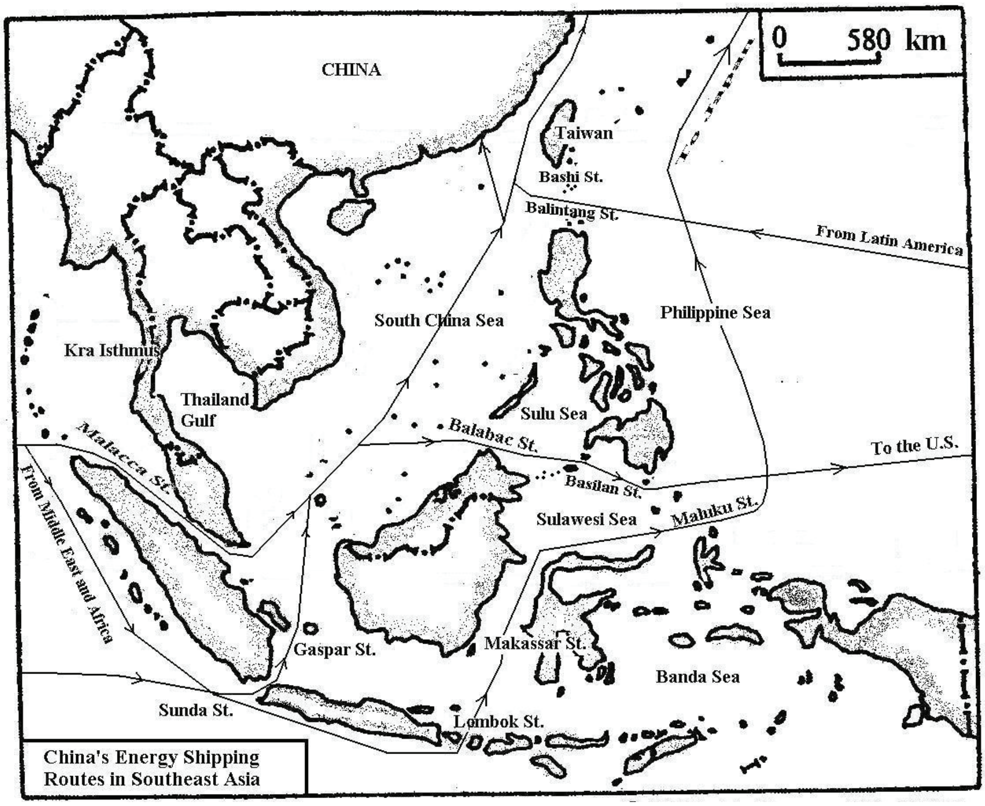
and helps channel China's development in a positive direction. China's willing and active participation in this process also engenders confidence in its neighbors, the United States, and the rest of the world, as it reveals China's mutually beneficial relationship among neighbors. But more than that, it demonstrates China's understanding that other countries demand more than words and actions. The constraints of interdependence place confidence in limiting China's ambitions, regardless of rhetoric or action.[1] As such, Southeast Asia is a 'gateway' for China to securing a position of regional and global influence while helping to maintain strategic stability.

Endowment of Vulnerability

Bounded by Northeast Asia, South Asia and West Pacific, the Southeast Asian region contains all the shipping routes for China's energy importation and transportation from the Middle East, Africa and Latin America. There are at least a dozen strategic straits and water bodies in the region including the Sunda Strait, Gaspar Strait, Lombok Strait, Makassar Strait, Maluku Strait and the South China Sea.[2] The most important channel, however, is the Malacca Strait, primarily because it is the shortest route to China (and the rest of East Asia) from the Middle East and Africa, approximately 2,000 km less than the next fastest route, the Sunda Strait.[3] China is dependent on the Strait for 80 percent of its oil importation and estimates predict that China's oil imports will grow to 200 million tons (per annum) by 2010, meaning that China will only increase its reliance on this sea line in the future. Over half of all vessels passing through the Strait now head for China, although Japan and South Korea also desperately rely on this waterway for 90 percent and 100 percent respectively of their oil imports. The United States mainland is less reliant on the Malacca Strait, though its military bases in Guam, Japan and South Korea are dependent on it.

A high dependence on the Malacca Strait leaves China vulnerable not only to threats of piracy and terrorism, but also to other powerful competitor nations, including the United States, Japan and India, who seek control of these sea lines and who are taking action accordingly.[4] The United States has taken the lead with a proposal in 2004, the *Regional Maritime Security Initiative* (RMSI), which called for the littoral countries – Singapore, Malaysia and Indonesia – to permit U.S. Marines to patrol against piracy and terrorism.[5] In addition, the *Cargo Security Initiative* (CSI), established in 2001, and the *Proliferation Security Initiative* (PSI), established in 2003, both involve the



Malacca Strait region in guarding against transportation of weapons of mass destruction and serve to secure international waters. However, RMSI – the one most directly relevant to the narrow shipping lanes – has never been presented as a mechanism open to Chinese or Japanese participation. Coupled with past experiences, particularly the Yinhe incident of 1993, which is etched deeply in the Chinese psyche, these initiatives arouse suspicion of U.S. intentions.[6] America's dominant control of this critical channel would provide it with a strategic grip on the whole of East Asia, an alarmingly vulnerable situation for China.

Japan and India have also taken similar actions to increase their control of the Malacca Strait. In 2005, Japan put forward a security mechanism to promote anti-piracy and anti-maritime robbery (ReCAAP) by 'unofficially' requesting littoral countries to allow the presence of the Japanese Self-Defense Force. This proposal was refused by Southeast Asian countries, mainly because

Japan's neighbors remain uneasy of its increasing reach into the western Pacific with their naval power. This resistance will remain as long as Japan's domestic politics, influenced by the right, continue to deny Japan's spotted history, particularly in China and the Korean Peninsula. The Indian Navy is also revealing its growing desire to be 'keeper' of the Strait. Their establishment of military bases at Andaman Archipelago and Nicoba Archipelago at the west end of the channel – beginning in the 1990s – and growing blue water patrolling capability from the Indian Ocean to the South China Sea, demonstrates the Indian Navy's ambition. While the implications of these actions by other states are not entirely clear, China has reason to suspect the motives of other nations, and must consider the long-term effects they will have on China's energy security.

More Diversity

In recent years, China has taken a number of important steps to address the inherent risks of the Malacca Strait. To begin with, China has actively developed closer cooperative relationships with Singapore, Malaysia and Indonesia, to secure China's interest in the Strait and to alleviate the growing rivalries among the world's major powers. Since 2005, China has played an active role in maintaining and strengthening security in the strait as well as the prevention of oil leaks in the region.[7] This approach stresses the fact that since trade and energy transport to China make up a majority of the strait's traffic, sea-lane security is becoming a core interest to China and as such, China is pursuing a leading role in its security. China's active engagement in this regard remains via international cooperation and diplomatic efforts. At the same time, this approach is not unconditional, and as the Malacca Strait is of great importance to China's energy security, China is certainly considering the use of force as a last option of defense against direct threats – such as a blockade during a Taiwan crisis.

To minimize its risk, China is planning on a diversified energy transportation strategy.

The potential bottleneck of the Malacca Strait, on which China is overly dependent for energy and trade transport, lends itself easily to worst case scenarios. Therefore, to minimize these risks, China is also rigorously planning for the long term with a diversified transportation strategy that utilizes

alternative channels, routes and countries to import energy to China.[8] While such alternatives create new opportunities for a sound energy strategy, there are important limitations that affect their development and functional capacity in the short term.

The development of a canal or pipeline across the Isthmus of Kra in southern Thailand would significantly shift the regional strategic energy landscape. The flat terrain, with a minimum width of 50 km and lying mainly within Thailand's territory and partially in Burma's, is ideal for a world-class canal. It would effectively redirect an estimated 90 percent of the vessels from the Malacca Strait since it would save approximately half the fuel.[9] Unfortunately, despite enthusiasm within the Thai government, it is unlikely that progress will be made on the canal in the near future due to economic and technical constraints as well as the more recent domestic political upheaval among Thailand's southern Muslim populations. A more simplified plan developed in 2004, consisting of roads, rail and underground pipelines, would greatly reduce transport capacity and would likely play a significant role in reducing the current overdependence on the Malacca Strait.[10] Even these less ambitious plans have been put on hold since the 2006 military coup.

In recent years, China and Burma have also proposed a plan for building an oil pipeline. According to the scenario, China can build a pipeline from Sittwe – a city on the southwest coast of Burma near the Indian Ocean – to the Chinese city of Kunming in Yunnan Province. This shortcut would reduce the Malacca voyage by 1200 km[11] and could help relieve China's dependence on the Malacca Strait by one-third or more.[12] However, this plan has also stagnated recently because the Burmese junta worries about being excessively dependent on exporting oil to China and is inclined to build an alternative gas pipeline toward China rather than the oil pipeline (the former is a less sensitive issue). This suggests a current strategy of hedging against China's excessive influence as well as Burma's growing tendency in recent years to seek closer energy cooperation with India. The junta's decision on this remains in flux, and prospects for a denouement are uncertain.

A third alternative energy transportation route that has been given more attention is the development of a comprehensive 5,500 km trans-Asian railway network that would link China to many ASEAN nations, creating an efficient means to transport energy and other goods. Talk of the rail system began in 1995 at the 5th ASEAN Summit and the idea has evolved into an elaborate three-line system that would reduce transportation time and costs significantly.[13] The plan is listed in *China's National Plan for Railway Network Constructions 2003-2020*, and construction is set to commence as early as 2008. This network will largely be constructed during the next five to 10 years. The trans-Asian railway network will also build up the infrastructure necessary to link Southeast Asia and China with Northeast Asia, Central Asia, South Asia, and eventually create a trans-Eurasian railway system that would connect Asia and Europe.[14] However, a number of problems plague this endeavor. For example, Laos lacks the railway infrastructure to effectively participate in the plan and the different rail diameters used in various ASEAN countries will prove an additional technical hurdle.[15] With a price tag of $11 billion USD, however, a shortage of committed investment remains the primary obstacle.

Clean Energy Prospects

While oil resources in Southeast Asia are minimal compared to those in the Middle East, Africa and Latin America,[16] the region has collectively become the fourth largest liquid natural gas (LNG) producer, which offers China an important opportunity to increase natural gas in its energy mix. China's declaration to shift from heavily polluting, oil-based energy consumption to cleaner gas-based alternatives is expressed in their 2004 Energy and Economic Transformation Strategy. This long-term goal places energy cooperation between Southeast Asia and China at the heart of the relationship, which was born from the strategic energy partnership that China and ASEAN initiated in 2002.[17] This mechanism was upgraded to include cooperation on energy security in the Joint Declaration, released in January 2007.[18]

These trends have been underscored by joint surveys, exploration and purchases of gas throughout Southeast Asia. China Offshore Oil Corporation, a Chinese state-owned energy corporation, bought a 17 percent stake in the Tangguh natural gas field, becoming the largest outside investor in the industry. In 2006, both Indonesia and Malaysia won bids for Zhujiang Delta and Shanghai Delta LNG projects, respectively.[19] China, the Philippines, and Vietnam also signed a working agreement for joint surveys in the South China Sea in 2005, which led to cooperation on a previously hotly disputed region.[20]

Thailand and Burma are also important players in the natural gas industry in the region.[21] Currently, Thailand's gas exports to China account for half (350,000 tons) of Thailand's total LNG exportation, making up about 5 percent of China's imports. According to Burma's energy companies, their resources exceed 1.4 trillion m^3 of natural gas and they currently extract 5 billion m^3 of that per year. If the gas pipeline comes into service by 2010, it will provide much larger proportion of China's imports than Thailand. China began to make joint explorations with Burma in 2001, and in 2005, Burma allowed China to explore deep-water areas off its coast in the Indian Ocean.

Stability in China's Backyard

China's evolving relationship with Southeast Asia goes beyond a simple interest in energy cooperation. Southeast Asia geographically bounds China to the south and west, all of which are extremely important for China's continued economic stability and growth, from the booming coastal regions to the poorer and more vulnerable southwestern provinces of Yunnan, Hainan and Guangxi. Burma is a particularly vivid case in point. Minority groups lie on both sides of the long border shared by Burma and China, and some groups on Burma's side have their own armed militias (Shan State). Maintaining a working relationship with the junta and the country's neighboring regions is essential to maintaining stability. A volatile situation in Burma could overflow into China's own delicate ethnic balance and would surely entail a large flood of refugees into bordering Chinese territories, an area that is already economically lagging. Engagement with the junta is not to ignore or accept its repressive ways but, considering China's own social, economic and political balance, it is the path of least risk, and China should not be blamed for pursuing it. This path also stands the best chance for compelling Burma's junta to spend energy dividends in a way that improves the lives of its disaffected citizens and continue toward a democratic process.

China's evolving relationship with Southeast Asia goes beyond energy cooperation.

China's energy relations with Indonesia and Malaysia, which helps spur other areas of trade, also provide an important platform for changing historically hostile attitudes toward China – most recently expressed through the anti-Chinese riots of 1998. Energy deals have percolated down to greater maritime security cooperation. Such measures can only build trust and confidence and improve the safety of the Chinese Diaspora in these countries.

Territorial disputes between China, the Philippines and Vietnam in the South China Sea have even led to armed conflict in the past. However, a new direction for laying aside these differences and joining hands in exploration of the South China Sea began in 1986 and culminated in a code of conduct in 2002. Since then, China has vastly improved its relations and image with ASEAN, particularly with regard to the Philippines and Vietnam, who historically have had an uneasy relationship with China. Joint energy exploration projects have resulted from the recovering cooperation and have served to strengthen ties. These include the first agreement between China and the Philippines on energy exploration signed in 2004 and a second joint survey agreement in 2005. First-time negotiations have also begun with the Vietnamese for joint exploration over disputed areas in the South China Sea at the 11th intergovernmental meeting in late 2004. China and Vietnam also began their first joint patrol over the Gulf of Tonkin in 2006 and later in the year, the Chinese Coast Guard rescued 100 Vietnamese fisherman caught in a typhoon. The three countries are now discussing further security cooperation in the South China Sea against piracy, smuggling and transnational crime.

The Isthmus of Kra is also more than a mere alternative passage-way to the Malacca Strait for energy imports to China. It can also provide a useful strategic seaway for international navies in the Asian-Pacific region.[22] In this function, it could also provide a strategic seaway to the Chinese navy. As a result of improving relations between the two countries, the Thai navy has already begun to purchase hardware upgrades including Chinese-made warships. Through the Isthmus, Chinese fleets could also more easily protect the nearby sea-lanes and gain access to the Indian Ocean.

Progress in various areas with many of the ASEAN countries is not to deny that significant challenges still lie ahead. The littoral countries of the South China Sea continue to make efforts to secure their occupied islands and reefs as well as build new airports with military uses. Fishing conflicts in exclusive economic zones continue to flare up from time to time. However, in light of the vastly improved energy, economic, political and even security cooperation, the trend of Sino-Southeast Asian relations is distinctly moving upward.

The Ties That Bind

A Chinese proverb states that "two grasshoppers bound by one rope" share a destiny, because any action of the one affects the other. In that sense, China and Southeast Asia are two 'grasshoppers' bound together by their growing interdependence; the ties are political, economic, cultural and strategic, and are manifested in a number of ways. In political terms – despite a lack of efficiency that sometimes plagues regional discussions – multilateralism and non-interference are emphasized, which require compromise, accommodation and consensus between all countries. Economically, these countries prefer unconditional cooperation that emphasizes a practical, mutually-beneficial approach, as opposed to the values and principles that condition Western countries' international relations. This is not to suggest the 'Asian way' lacks principle, but rather, for historical and other reasons, it holds to different values. Cultural ties have their limitations, but the region shares more similarities within itself and China than it does with any other region, including the Middle East, Africa or the Americas. Most ASEAN countries not only share Chinese culture, but many have very large, resident ethnic Chinese groups that date far back in history. With respect to shared security goals, the ASEAN countries do not want to confront or align themselves with big powers (China included) partly because they don't have the power to do so and partly because their lowest risk strategy is to maintain a balance among the giant powers. Even non-traditional security plays a crucial role in binding the two regions together, including the management of avian flu, environmental disasters, combating drug trafficking, etc. More than any other factor, however, it is energy – including China's dependency on the Strait of Malacca and other alternative routes – and cooperation in exploration and imports that is the driving force behind China's growing interconnectedness with Southeast Asia. This is so because energy is the most prominent element that links economic, political and security considerations between the two sides.

More important than these natural affinities and cooperative links is the fact that China binds itself willingly, even actively, to Southeast Asia. This is best illustrated by China's preference to maintain a prominent and active role in the region through comprehensive means, rather than particularly political or military measures that could cause more friction. The *Peace, Wealth and Stability Pact* with ASEAN countries, initiated by China in 2003, created a strategic partnership within the region and built respect for China among the ASEAN countries, illustrated by Philippine President Gloria Macapagal-Arroyo's praise – without irony – that "China is the big brother to ASEAN."[23] Economically, China has pushed along the free trade mechanisms with ASEAN, leading eventually to the *China-ASEAN Free Trade Agreement (FTA),* which will become the third largest FTA after the North American Free Trade Agreement and that between EU countries. This augurs well for Asian economic security and growth. In addition, China's ongoing investments in many local energy projects within the more underdeveloped countries of Southeast Asia may help to ensure citizens of ASEAN countries a more prosperous future. In short, China has gradually grown into a willing stakeholder, transforming from an outsider to an insider.

China binds itself willingly, even actively, to Southeast Asia.

At the same time, Southeast Asian countries have recognized China's stabilizing role in the region and have also consciously bound themselves tighter with China. The most powerful proof for this is the fact that China has experienced a substantial trade increase with ASEAN beginning in 1997, which has greatly favored the latter in terms of a trade balance. China's trade deficit toward ASEAN jumped from $4.8 billion USD in 2000 to $19.6 billion USD in 2005.[24] In essence, ASEAN has hugely benefited from China over the last 10 years. China's steadying hand and contribution to economic growth in the region is in sharp contrast to the harsh criticism coming from the United States over China's economic policies.

These trends have done much to ameliorate the concerns about the 'China threat' that is emanating from other parts of the world. China's decision to bind itself to Southeast Asia goes beyond rhetoric and action. The interdependencies within political, economic, security and energy frameworks are creating structural connections that promote trust, confidence and mutual reliance that inherently relieve Southeast Asian fears of the 500-pound gorilla in their midst. Furthermore, these ties are in effect creating strategic constraints. Continued talk of China's rise as being 'peaceful', will only convince others to a limited degree. Rather, perceptions rooted in structural and irreversible economic and security mechanisms will carry far more weight than words, and both ASEAN and China have a mutual understanding of this concept. This intertwining of fates, as it were, is a new security concept and is effectively transforming China's soft power and influence in the region and beyond.

Southeast Asia can be described as a 'gateway' for China.

Put in the context of China's changing long-term strategic needs, China's full and active engagement in the region is part of a larger consideration that goes to the heart of its national strategy – China's 'peaceful rise' or 'peaceful development'. This slogan is often understood more as an active goal, but it is also a description of an inevitable trend, an economic and strategic reality. While China's continued rise will eventually extend beyond the region, the most viable method to ensuring that it occurs in a peaceful way is for China to prove its benign intentions to the region first.[25] This will lead to a critical mass of 'structural' soft power and influence as described above, which will hopefully spill over beyond the region and to other parts of the world.[26] Southeast Asia is currently described as a 'gateway' for China. This is true in a literal sense, as Southeast Asia is a necessary passageway for China's commercial trade and energy imports, but it is also true in a figurative sense, as Southeast Asia is the 'gateway' to shaping the belief in China's peaceful rise both in and beyond the region.

Unlikely Exceptions

China's conscious strategy of a peaceful and mutually constraining rise is not unconditional. The use of non-peaceful means cannot be ruled out and would be conceivable under only one or two remotely possible scenarios, one being the public and formal declaration of Taiwan's independence to the international community. In this case, China would have to resort to force under the anti-secession law. The difficult question is whether Southeast Asia would factor in to any conflict that involved Taiwan. This is particularly pertinent because such a scenario would almost invariably entail an embargo on China's energy and trade routes; that is, the Malacca Strait and other sea lanes of communication.

Drawing out the framework for such an event and what China's specific response would be is beyond the scope of this paper; however, there are important notes to stress. On the one hand, China can and will act to defend its interests in this regard, including the appropriate use of force in Southeast Asia, though that would be circumscribed by the extent to which the region was embroiled in such a conflict. China possesses the capability, through surface and subsurface naval capabilities as well as its short- and medium-ranged conventional missiles, to achieve such goals from the Taiwan Strait to the Malacca Strait. On the other hand, and importantly so, China will only do so in response to the region's entanglement in such a conflict and will not preemptively use force in the strait or the region to secure a military advantage. The distinction is important and points to the fact that China views Taiwan's status as its core national interest and will protect that interest at all cost, and secondly, any military conflict over a declaration of Taiwanese independence will be defensive in nature and will be pursued with purely defensive objectives. These strategic scenarios readily lend themselves to escalatory updrafts, where Taiwan, the United States and China would all lose in many ways, making the likelihood of such a conflict nearly inconceivable.

The second possible scenario is a limited conflict involving the Malacca Strait (though not Taiwan); however, primarily two deterrents work against any such scenario. The first is China's deep interests in the sea-lanes to secure safe passage of its energy and commerce cargo. As such, China would employ force against any military threats to those interests. However, China would not consider control over the strait in such a scenario as a core national interest and as such, the guiding principle in such an event would be limited to a regional conflict, not 'total war.' The second deterrent is the mindset of nearly every Southeast Asian nation that has maintained a 'balancing policy' or hedging strategy against China, the United States, and other major powers seeking strategic advantage in the region. The United States has historically held prominent influence and power in the region, both through bilateral alliances as well as raw naval power. However, Southeast Asia is also increasingly reluctant to offend China. The joint statement by ASEAN opposing Taiwanese independence supports this conclusion. In addition, two key countries in the region, Indonesia and Malaysia, are also Islamic states and with recent conflict in the Middle East, the countries have raised their vigilance against the meddling of outside powers. The formation of MALSINDO in 2004, a security cooperative mechanism between Malaysia, Singapore and Indonesia to patrol the Malacca and other straits, excludes others countries such as the United States.

Partners or Adversaries

The low probability for conflict in the region notwithstanding, the future prospects for a regional economic and security architecture with Southeast Asia and China is naturally the object of intense concern to the other principal interested party in the western Pacific: the United States. Those concerns can be boiled down to two main questions: first, are the mutual ties and constraints through economic, political and security mechanisms able to maintain a stable strategic environment in the region, and, if so, is that kind of close interdependent relationship beneficial or harmful to U.S. interests?

Naturally, a constructive outcome of the interaction between China and Southeast Asia cannot be predicted with any certainty. However, powerful forces of energy security, economic growth, globalization, and a natural resistance to China's rise by its neighbors are powerful elements that should point to such a conclusion. But rationales have limited value, and perceptions of China's rise as harmful or threatening cannot be discounted. However, China understands both regional and global anxieties and is working to close the loop of rhetoric, action and structural realities that will make a benign strategic environment a reality.

The United States has little objective cause for worry about China's unique relationship with Southeast Asia. China has officially and unofficially expressed its desire for inclusiveness, not exclusiveness, with regard to multilateral cooperation in the region, specifically with the United States as China is not looking to challenge U.S. presence or influence in the region.[27] Of course, there is significant anxiety over what China will do once it becomes more powerful. However, China is currently quite inferior to the United States in terms of hard power and will always have a strong Japanese regional soft power to contend with (because of Japan's formidable economic strength). In addition, China's neighboring countries are highly allergic to superpower resurgence in the region since the end of the Cold War and will always look to balance their interests between China and other global powers. Most importantly, it should not be overlooked that China's official commitment to develop peacefully is not a casual claim. China understands its strategic environment and has taken the lessons of history to heart. In short, China has elected to pursue its interests and goals through the comprehensive means of politics, economics, diplomacy and culture, rather than primarily political pressure and military coercion. China's military and hard power is not insignificant and it will grow, but China has demonstrated its intent to use its position to join in the international regime to defend against non-traditional crises such as curbing bird flu, transnational crimes, piracy and drug trafficking, and to protect the international market system – with universal access to energy as an important component.

China is not looking to challenge U.S. presence or influence in the region.

Distrust and differences in interest will continue to plague the relationship of all the major players in Southeast Asia. China's unpleasant memories of the Yinhe incident will continue to dictate its resistance to the *Proliferation Security Initiative, Cargo Security Initiative* and *Asian Security Conference (Shangri-La Dialogue* [SLD]), particularly if left unchanged. However, an expanded RMSI that would include China certainly seems to be favorable to China. This may be politically difficult in the United States, and so a multinational coast guard to patrol these waters, most likely under the auspice of a UN peacekeeping mission, should be operationally and even politically feasible. Such a mechanism should be acceptable to China and the United States as well as for Japan and India. However, the littoral states are key to any solution and China and the United States must think creatively to form a mechanism for maritime cooperation in the Malacca Strait based on mutual benefits and interests. This could either be established under a Malacca Strait Committee, which would be charged with funding, equipping and aiding littoral states to patrol the strait, and could include stakeholder participation in the duties of sea-lane security, in accordance with each country's proportion of ownership and use of the strait.

In addition, energy cooperation can have indirect effects on the 'war on terror'. Together, China and the United States could provide support in the Asia-Pacific region and ASEAN countries to assist with energy transport and infrastructure, such as oil and gas pipelines as well as roads and railways. This could be accomplished through using the model of the U.S. Peace Corps, which strives to assist underdeveloped nations and continues to inspire the international community today. A Peace Corps-like group could assist with energy (and other) infrastructure development and could help to eliminate poverty (one of the primary roots of disaffection among Muslims who resort to terrorism) in the Southeast Asian Islamic world, which is home to the world's most populous Islamic country with rising insurgencies.

Finally, China and the United States have taken important steps forward to improving bilateral relations with the *Strategic Dialogue Partnership* in 2005 and *Strategic Economic Dialogue* in 2006. High-level dialogues between the two countries have also been initiated to improve collaboration on crucial issues of global energy supply and coordination of energy policies.[28] But, they are merely policies, which a new administration in 2008 can change or even abandon. Thus, they need to be elevated in status and at least include a formal memorandum of understanding. An 'Energy Partnership' with legal force is required. From an immediate political perspective, it would benefit the United States because it would be able to negotiate and influence the direction of Chinese energy policies. At a more strategic level, China and the United States are the world's largest CO_2 emitters and their cooperation on this issue is extremely important to their respective economies and global security. This agreement should include the sharing of more clean energy technologies with China that will both reduce pollution and improve energy efficiency with attendant effects on total energy demand.

Notes

[1] Southeast Asia is the top energy transportation gateway for China as well as the vital area for Chinese clean energy exploration. Further, it has a strategic function beyond energy as the ultimate testing ground for Chinese national strategy of 'peaceful rising' – achieving massive influence in the region and the rest of the world. Zhai Kun, "China-ASEAN Enter Best Time," *People's Daily* (overseas edition), Dec. 25, 2006; and Wu Xinbo, "China's Future Power Increase and Strategic Footing," *Liberation Daily,* Feb. 9, 2006.

[2] China has at least four sea-lanes in the region: (1) Middle East/Africa-Malacca Strait-South China Sea-China: for ships under 100,000 tons; (2) Middle East/Africa-Sunda Strait-Gaspar Strait-South China Sea-China: for ships over 100,000 tons; (3) Latin America-South/North Pacific-Philippine Sea-Balintang/Bashi Strait-South China Sea-China; and (4) an alternative route Middle East/Africa- Lombok Strait-Makassar Strait-Maluku Strait-Philippine Sea-West Pacific-China, which is a Japanese transportation route.

[3] The Strait of Malacca is a narrow, 805 km long and 25-151 m deep-water area linking the Indian Ocean and the South China Sea, which is owned and managed by Malaysia, Singapore and Indonesia. It is the shortest route to China from the Middle East and Africa, 2,000 km shorter than sailing by the Sunda Strait. In terms of climate and geology, the equatorial calm zone and sandy flat sea floor guarantees a smooth voyage for tankers lighter than 100,000 tons (heavier tankers still need to sail through the Sunda Strait, or they will be subject to touching the sea floor). China is tremendously dependent on the Malacca Strait. Currently, China imports oil through four shipping lines: the Persian Gulf-Malacca Strait-Taiwan Strait line to transport oil from the Middle East; the North Africa-Gibraltar Strait-Good Hope line to transport oil from Africa; the Malacca Strait line to transport oil from Southeast Asia; and the Pacific line to transport oil from South America – three of which go through the Malacca Strait.

[4] According to statistics from the International Maritime Bureau Piracy Reporting Center, in 2003, 25 percent of vicious global sea cases occurred in the Malacca Strait and more than 20 crews were killed.

[5] Testimony of Adm. Thomas B. Fargo, U.S. Navy Commander of Pacific Command before the House Armed Services Committee and House of Representatives regarding U.S. Pacific Command Posture, Mar. 31, 2004.

[6] In July 1993, the U.S. government accused a Chinese ship (*Yinhehao*) of carrying lethal materials for producing chemical weapons. An investigation initiated by the Chinese government found the accusation to be false, but the United States continued to pressure China, leading to a 33-day impasse between the two nations where the ship remained blocked. In the end, China allowed U.S. personnel to board the ship, where the accusation was proved to be false.

[7] On Sept. 7, 2005, Ju Chengzhi, the head of China Maritime Administration, officially expressed Beijing's willingness to take active part in relevant cooperation for maintaining and strengthening sea-lane security and prevention of oil leaks in the Malacca Strait. From a Chinese perspective: (1) China will improve international cooperation with all players in the strait to effectively improve security; (2) China should and will go all out for playing a major role in the Malacca Strait due to China being one of the major-user states; and (3) the Malacca Strait is becoming a core interest for Chinese security, therefore, if any other large power is a threat to China's interest in the area, China is likely to act in self-defense. As an extreme case, there is possibility for China to use her military force as the last choice for counterattacking the possible blockages, which could be possibly caused by a Taiwan crisis. See: "Speeches of Mr. Ju Chengzhi, the Head of

China Maritime Administration on the Jakartar Conference on Malacca and Singaporean Straits Security," September 2005, http://www.zgsyb.com/Article/ArticleShow.asp?ArticleID=9900.

[8] "China Will Speed up Multiple Energy Supply Strategy," *National Development and Reform Commission.* http://www.hztz.com.cn/ReadNews.asp?NewsID=663.

[9] Lin Xixing, "Rivalries in Kra? Building Southwestern Passageway?" *World Knowledge* (Chinese version), no. 13, 2004.

[10] Even this 'scaled-down' project faces big troubles. Lacking the capability for solely constructing the pipelines, the Thai government began to seek cooperation from countries with strong economies, including China and Japan as of 2004, but the investment and sponsorship is still in vain due to Thailand's domestic situations. Since January 2004, the Islamic separatists in south Thailand revived and provoked even severe insurgencies and chaos causing at least 1,300 causalities until 2006. Then came the even more politically troublesome period for Thaksin's administration – the sweeping crisis in which the government was ultimately overthrown by a military coup on Sept. 19, casting doubts on the future of the project. So far, the Kra Canal or its variant, the complex project for pipelines and roads, is still in doubt and remains as a mission impossible in the near future.

[11] Besides the energy transporter, Burma is also an important energy supplier to China. According to the statistics of Burmese energy companies, Burma has 3.1 billion barrels of oil and 1.442 trillion m^3 of natural gas in resources. Currently, it produces 40 million barrels of crude oil and 5 billion m^3 of gas annually.

[12] Ying Zhenmao, "China-Burma Pipeline on the Way," *China Petroleum,* no. 4, 2007, 28-29.

[13] The Trans-Asian Railway Network currently has three scheduled lines in the Southeast Asian region: (1) the East Line extends as Singapore-Kuala Lumpur (Malaysia)-Bangkok (Thailand)-Phnom Penh (Cambodia)-Ho Chi Minh City (Vietnam)-Hanoi (Vietnam)-Kunming (China); (2) the Central Line extends as Singapore-Kuala Lumpur (Malaysia)-Bangkok (Thailand)-Vientiane (Lao PDR)-Shangyong (China)-Xiangyun/Yuxi (China)-Kunming (China); and (3) the West Line extends as Singapore-Kuala Lumpur (Malaysia)-Bangkok (Thailand)-Rangoon (Burma)- Ruili (China)-Kunming (China). This concept has come into being as a project listed in China's National Plan for Railway Network Constructions 2003-2020.

[14] It includes four stretching lines: (1) Linking up with Europe, from ASEAN: China-Tajikistan-Uzbekistan-Russia-EU; (2) Linking up with India, namely ASEAN: Kunming (China)-Ruili (China)-Mandalay (Burma)-Imbhal (India)-Dacca (Bangladesh)-Calcutta (India), making a shortcut of 2,675 km and saving at least 5,000 km or 15-30 days drifting on the sea via the Malacca Strait and South China Sea; (3) linking up with new Chinese-built Qinghai-Tibet Railway, namely ASEAN: Tibet (China)-Pakistan\Nepal-India; (4) linking up with Mongolia, Russia, North Korea and South Korea in Northeast Asia. See, "Negotiation Between 41 Countries on Pan-Asian Railway and there are Still Problems on Connecting the Line," *China.com*, [translated from Chinese] Nov. 9, 2006. To view a map illustrating the above routes, see http://www.china.com.cn/international/txt/2006-11/09/content_7336240.htm.

[15] China and ASEAN countries now use three types of rails that vary from 1,000 mm to 1,067 mm and 1,435 mm.

[16] According to the World Energy Report 2005 released by the British Petroleum corporation in the United Kingdom, the oil reserves in Southeast Asia account for about 1 percent of the world total, less than China's 1.4 percent; the oil production is also smaller than China, as China has been the 6th largest oil producer in the world since the end of 2004.

[17] Zhang Ying NS Chen Fu, "Natural Gas: A Model for ASEAN+3 Cooperation," *International*

Finance (Chinese version), Apr. 5, 2004.
[18] "The Cebu Declaration for East Asian Energy Security," released by ASEAN secretariat, Jan.16, 2007.
[19] "ASEAN Summit: Energy Battle behind Gas," *Nanyang Sangpo* (Chinese version), Malaysia, November 2006, http://www.singtaonet.com.
[20] The near 100 islands and reefs in south China are claimed partially or entirely by five parties – China (including Taiwan Province), Brunei, Vietnam, Malaysia and Philippines, while Indonesia has wrapped exclusive economic zones but no territorial disputes with China.
[21] On Mar. 31, 2005, Sinopec (China) and PTT (Thailand) signed an agreement for LNG importation from Thailand with a total of 2,400 tons. In October, China and Thailand signed a memorandum of understanding for joint exploration in the Gulf of Thailand. On the Burmese coasts, China has been participating in the entire project in Water Areas D, M, A4, M10, C1, C2 and M2. These areas are even larger than China's domestic oil and gas fields on the Bohai Sea.
[22] Kavi Chongkittavorn, "Thai Sea Powers and Kra Isthmus Canal Project," *The Nation*, Aug. 14, 2006.
[23] Yang Baoyun, "Peace, Wealth, Safety: New Development of Relationship Between China and Neighboring Country," *New Vision* (Chinese version), no. 3, 2004.
[24] China's trade deficits with ASEAN from 2000 to 2005 are respectively $4.84 billion USD, $4.844 billion, $7.629 billion, $16.4 billion and $20.08 billion, http://www.lzet.com.cn/news/news-2.php?id=78892
[25] Zhai Kun, "China-ASEAN Enter Best Time," *People's Daily* (overseas edition), Dec. 25, 2006; and Wu Xinbo, "China's Future Power Increase and Strategic Footing," *Liberation Daily,* Feb. 9, 2006.
[26] Ibid.
[27] See Chinese President Hu Jintao's speech at the commemorating conference of the victory over Japanese militarism (China Version), *Xinhua New Agency*, Sept. 3, 2005; See Chinese Premier Wen Jiabao's interview with the Indian media reiterating that China no longer seeks hegemony, Southeast China Express (Chinese version Dongnan Kuaibao), June 25, 2003.
[28] Both China and the United States are active in Asia-Pacific Economic Cooperation (APEC) organization's Energy Working Group, which focuses on developing and implementing an Energy Security Initiative and includes enhanced data transparency, sharing best practices for trading LNG, strategic oil stocks, and a Real-time Emergency Information System. China and the United States also participate in several multilateral agreements to promote the development of transformational technologies needed to address climate change. The United States also works to support American firms from all industrial sectors to invest in China. The U.S. State Department initiated the U.S.-China Economic Development and Reform Dialogue in 2003 with the Chinese National Development and Reform Commission (NDRC). The dialogue on energy, known as the new Energy Policy Dialogue, began in May 2004. Through the "Dialogue on Climate Change, Clean Energy, Sustainable Development," newly established at the G8 Summit in 2005, developing countries can receive lessons and guidance for their transitioning economies from more developed nations.

Coal Mining Safety: China's Achilles' Heel

*Tu Jianjun**

Tragedy of Necessity?

Coal is a dilemma for China's energy security. On the one hand, coal will be irreplaceable as the primary form of energy driving China's economic juggernaut for the foreseeable future.[1] Despite major growth in the oil industry after the discovery of the Daqing oilfield in 1959, coal has never accounted for less than 70 percent of China's energy resource supply over the past 50 years. Since 2000, coal consumption has increased at an astonishing rate of more than 10 percent annually. It is unlikely that China's coal utilization will drop below 50 percent of China's energy mix before 2050. Furthermore, with limited petroleum resources, China's energy planners have relied heavily on domestically abundant coal to fuel modernization ambitions. Even after decades of intensive development, alternative energy sources (mainly hydro electricity) have never constituted even close to 10 percent of China's primary energy demand.

On the other hand, coal is also fueling a safety (and environmental) crisis in China. Extracting coal from the earth has never been a safe activity, but China's numerous, tragic mining accidents make for a particularly stained history of coal mining. A methane gas explosion in 1942 killed 1,549 miners at the Benxihu mine in Liaoning province; 682 miners died from the 1960

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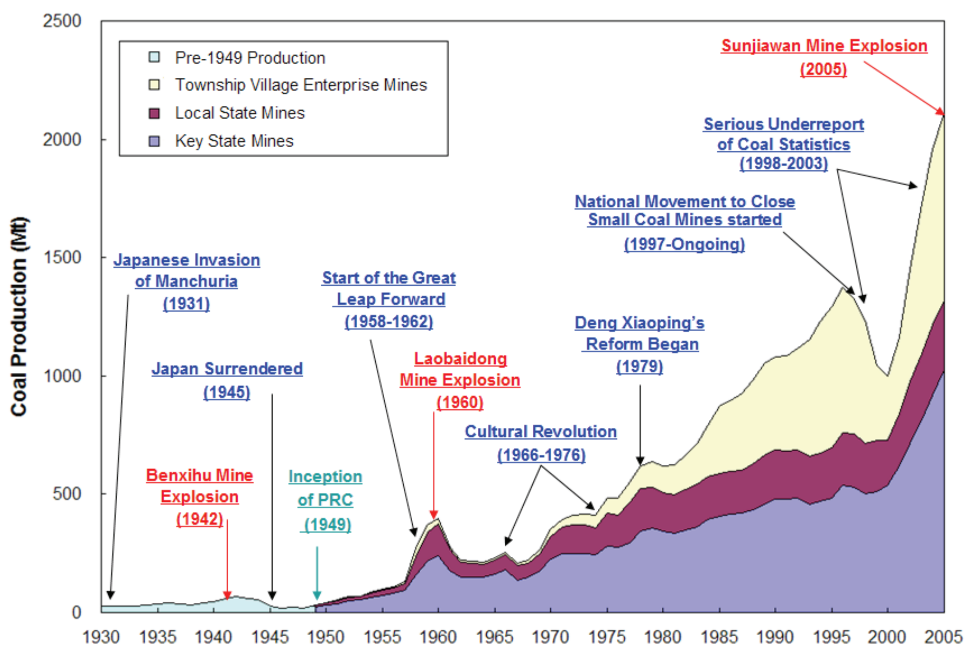
explosion at the Laobaidong mine in Shanxi province; and in 2005, at the Sunjiawan mine in Liaoning province, 214 more perished.[2] The list goes on. Official statistics put the number of coal miners killed by mining accidents since 1949 at more than 250,000.[3] Unofficial numbers are sure to be higher.

More importantly, however, is whether the danger of working in China's coal mines has improved over the years. According to an independent assessment in 2006, China's annual coal mine fatalities during the early 1950s, 1980s and 1990s were estimated to be approximately 70,000, 40,000 and 10,000 deaths respectively.[4] At face value, this would indicate an improving fatality rate, however these figures obscure the fact that it began from a very low point in safety. Secondly, despite a reduction of fatality rates from 22.5 deaths per million metric tons (Mmt) of coal in 1949 to 2.04 in 2006, official annual fatality statistics continue to range from 4,746 to 6,995 deaths per year over the past decade.[5] In other words, China's coal mines remain highly risky working environments.

Moreover, China's mining accident rates sharply contrast with those of other countries around the world – industrialized and developing nations alike – where mining risks have dropped dramatically. For instance, in the

Coal Production in China, 1930-2005**



United States, the fatality rate per Mmt of coal was a mere .04 in 2006. Even India, a sizable developing country with a notorious coal mining safety record of its own, was able to reduce its rate to just 4 percent of China's in 2006.[6] Viewed against the context of the global death rates from mining accidents, China's mining accidents and deaths remain high. In fact, China still currently accounts for approximately 80 percent of the total deaths in coal mine accidents worldwide.[7]

Given China's reliance on coal *and* the continually growing economy, these alarming statistics do not bode well for the future of coal mining safety in China. Exploring the unique complexities of China's coal mining industry reveals its intractable features as well as plausible measures to ameliorate its worst impact. The issue of safety in Chinese coal mines reflects other socio-economic ills in Chinese society and therefore, a solution must go beyond merely stricter regulations. It will require a fundamentally different way of coal mining in China as well as an improvement in the status of those who work in the mines.

The Stagnant Flow of Information

Despite the bleak picture painted by the statistics above, the reality may be even worse. A chronic lack of accurate information, at many levels, combined with poor statistical measures probably underestimates the severity of coal mining safety challenges in China. Independent experts state that China's actual death tolls are much higher than reported.[8] The discrepancy between reported coal mine deaths and true fatality levels is due in part to the government practice of concealing information about major accidents, a problem that was particularly acute during the first three decades after 1949 (founding of the People's Republic of China [PRC]). For instance, the Chinese government classified the deadly coal mine methane explosion at Laobaidong mine in Shanxi province in 1960, which killed 682 miners, as a 'state secret'. It suppressed the event for more than three decades until it was finally revealed in 1992.[9]

Although the discrepancy between reported coal mine deaths and true fatality levels has been narrowed down in recent years, it has not been eliminated, mainly due to a lack of transparency. This is evidenced by the fact that independent reports continue to be significantly different from official figures.[10] Unofficial data provided by a senior work-safety bureaucrat suggests that as many as 20,000 miners actually die each year. That count does not include the tens of thousands more miners who die of lung afflictions and other mining-related diseases every year.[11]

A further obstacle to accurate information comes from the mine operators and owners, who routinely falsify death counts in order to avoid mine closures or fines. While Beijing imposes increasingly stringent regulations to counter the widespread corruption in recent years, colliery owners – often in collusion with local officials – withhold fatality figures in mining accidents. For instance, when 81 miners died in Nandang County on July 17, 2001, local officials quickly teamed up with the coal mine owner to cover-up the accident.[12] After the catastrophe was disclosed, it was revealed that the head of Nandang County had received 3.21 million RMB ($412,000 USD) in bribes during the prior two years.

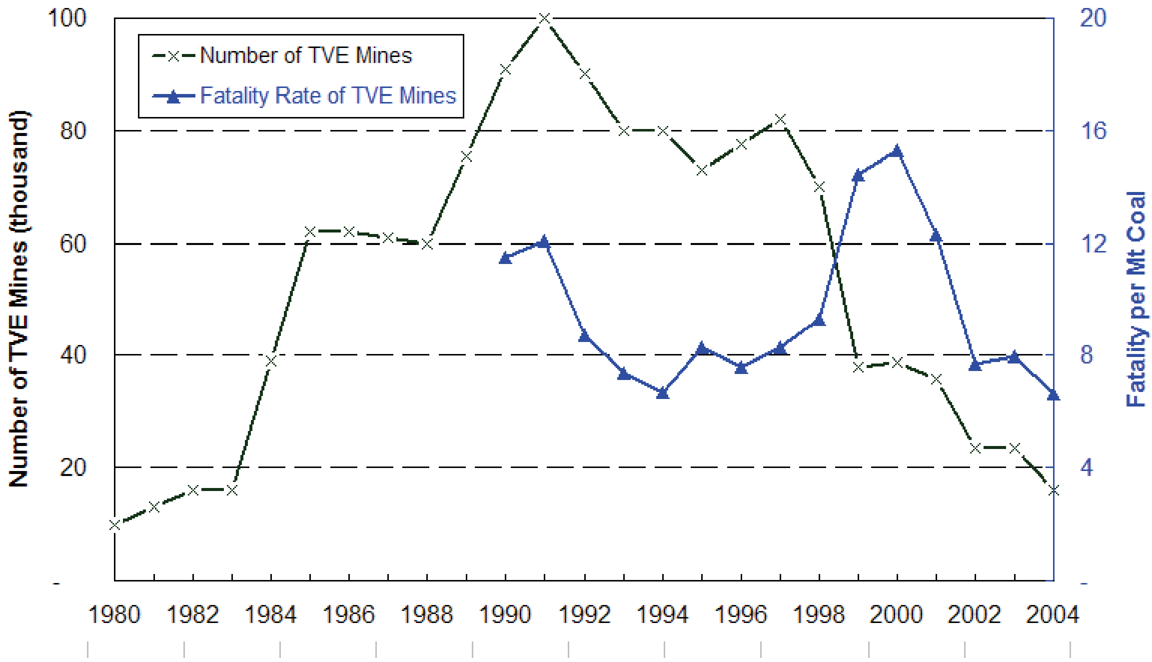
The issue of safety in Chinese coal mines reflects other socioeconomic ills.

Even the media, which is officially tasked with disseminating information to the public, does not always function the way it is supposed to. Since the inception of the PRC, media in China has long been regarded as the propaganda machine of the state and ruling party.[13] Unsurprisingly, the reporting of major catastrophes was controlled by the government.[14] However, journalists and reporters have become more critical, particularly regarding coal mines, but the focus remains on rescue operations and seldom provides in-depth coverage of collusion between officials and colliery owners. There is even less follow-up on the impact on victims' families.[15] In May 2005, a legislative bill intended to hinder media exposure of such accidents was initiated at the Standing Committee of the National People's Congress. If passed, any reporting on a major emergency event without permission could incur a fine between 50,000 and 100,000 RMB ($6,400 and $12,800 USD).[16] To make matters worse, even the media itself is not immune from the widespread corruption in the coal-mining industry. Some journalists have found the extortion of private mine owners a lucrative business.[17] There is still a long road ahead before the Chinese media can fulfill its role as an independent watchdog for coal mine accidents.

Coal Mining with Chinese Characteristics

Regardless of how much coal mining statistics are underreported or misreported, there is no denying the extreme dangers associated with coal mining in China. Such risks are not new to the industry, but there is a need to understand

Number vs. Fatality Rate of TVE Mines, 1980-2004



why these conditions persist today in China when there are tenable solutions that many other countries have pursued successfully.

Importantly, China remains highly reliant on underground operations as the primary method of coal extraction. In most countries, this form of mining has increasingly given way to surface mining, due to the great advantage the latter has in terms of productivity and safety. The mechanization of underground mining has increased productivity from less than one ton per man-shift in 1900 to six tons per work hour today, however, surface mines can easily have a productivity of three to four times that amount.[18] As a result, the share of coal derived from surface mines in the United States has increased steadily from 25 percent in 1949 to 67 percent in 2005.[19] By contrast, China is the only coal superpower with a minority share of its mining in the form of surface mines (approximately 10 percent).[20] Its productivity reflects this as well. In 2005, China mined 400 tons of coal per employee per year compared with 13,000 tons per employee in Australia.[21]

One reason for why China relies heavily on underground mining is because China's reserves of the lower quality sub-bituminous coal and lignite (more likely to be located in shallow coal seams), remain low. Moreover, as burning lower-quality coal actually requires more advanced technology and investment, higher quality coals (bituminous and anthracite) continue to be the industry preferences. The private sector in China is resistant to the capital-intensive surface mines, leaving 95 percent of Chinese coal mines to keep their underground operations.[22]

The different mining techniques have had a dramatic impact on mine safety as well. Slope failure, the principle hazard of surface mines, is much easier to control than underground mining dangers, which include gas explosions, flooding and roof collapse. In addition, due to the low productivity of China's coal industry, about 5 million workers are necessary for China's coal-mining industry to meet the growing demand for the resource.[23] The high number of workers often leads to crowded underground mines and explains why accidents in China often have very high fatality rates.

The dominance of township and village enterprise (TVE) collieries has also influenced the nature of China's coal mining industry.[24] TVE coal mines began forming in large numbers with the opening of the economy in 1979. Prior to that time, state coal mines accounted for an overwhelming share of national output. However, a rapid rise in demand for coal dramatically raised their numbers (peaking at 100,000 in 1991) and by 1995, their market share had reached 46 percent. The large amount of TVE mines soon led to problems of regulation, tax evasion, environmental degradation and mounting mining accidents. Despite a decade-long effort by the central government to close them down, thousands continue to operate. [25]

The extreme dangers associated with coal extraction persist in China.

The problem with most TVE mines is their unwillingness (or lack of capital) to invest in proper safety mechanisms. Coupled with poor regulation enforcement, TVEs have created a coal mining industry that constantly operates at a capacity far beyond its safe threshold. In 2004, 19 of the 27 coal producing provinces/regions in China supplied coal at 10 percent over capacity while some of them were working at more than 50 percent over capacity.[26] Even state mines could not observe the safety regulations. Moreover, the misperception of a long-term coal surplus in late 1990s convinced Beijing to compete aggressively with other major coal exporting countries in the international market. As a result, China's coal exports grew from 17 Mmt in 1990 to 94 Mmt in 2003.[27] This not only aggravated the supply and demand balance, but pushed coal output beyond the capacity of China's mines, increasing worker fatigue, safety violations and equipment failures that have increasingly become a catalyst for deadly accidents. Although TVEs currently produce about one-third of the national coal output, they account for 70 percent of the industry's fatalities.[28]

China's highly undesirable coal mining conditions have also made it nearly impossible for the coal mining industry to attract and retain qualified employees. With the hardships that come with the job and constant negative media exposure, many engineers and technicians in the industry have extremely low morale. This creates a widespread brain drain that results in a shortage of expertise required to raise mine safety standards. To compensate, in as early as 1964, state coal mines in China began short-term contracting with peasants to fill the void of workers for these unwanted jobs by permanent staff.[29] Since then, migrant peasants have gradually become the back bone of the industry. According to an official survey, even China's large state-owned mines have to rely on peasant workers to fill 80 percent of their underground mining positions.[30] This phenomenon has significant consequences for this coal mining working class.

The coal mining industry places little value on the life of a miner.

Voice of the Powerless

The majority of peasants laboring in the coal mines come from poverty-stricken rural regions with large numbers of desperate job seekers. Many coal mining companies take advantage of this vulnerability and push peasant workers to fill the most dangerous underground mining positions without adequate training or equipment. Insufficient safety measures coupled with work fatigue from long shifts increasingly explains many coal mine accidents in China.[31]

It is not surprising then that compensation in the coal mining industry is the second lowest of 49 industries in China.[32] In 2000, the annual average income for employees was 12,000 RMB ($1,500 USD) and 7,200 RMB ($925 USD) in key and local state mines respectively. The annual pay in TVE mines is significantly lower.[33] In some collieries in northwest China, miners were allegedly paid only 1,200 RMB ($155 USD) per year in 2005[34] (compared to the salary of experienced coal miners in the United States who can make more than $100,000 USD per year[35]).

The coal mining industry in China places little value on the life of a miner

– an unfortunate reality with direct consequences for the safety record of many coal mines. Prior to 2004, compensation for the death of a miner ranged from 10,000 to 50,000 RMB ($1,300 - $6,500 USD). This low price tag on human life makes it much easier for coal mine owners to settle privately with the families of victims' in exchange for their silence. Such behavior also reduces the incentive for colliers to improve safety practices and equipment and has also led to an underreporting of deaths in the coal mines.

In 2005, the Shanxi provincial government took the significant step of increasing the amount of compensation to 200,000 RMB ($25,000 USD) per coal mine fatality to redress this problem.[36] An upsurge of positive reaction to the Shanxi government's action from the media soon led to an initiative for other major coal-producing provinces to follow suit.[37] In fact, even this higher level of compensation remains only a small percentage of the industry's gross annual profits, which are at least 50 million RMB ($6.4 million USD) per Mmt of coal produced. Given that the 2005 fatality rate in China was 2.73 miners per Mmt of coal, the penalty imposed by the new regulation represented only 1 percent of the gross profits collected by mine owners. While the benefits of raising the compensation for miner fatalities seems positive on the surface, it has the effect of a 'divide and control' strategy; that is, individual families are bought off and silenced, reducing the impetus for group dissatisfaction and social mobilization. The Shanxi provincial government quickly realized the new regulation was insufficient. Rather than increase the level of compensation to families, officials imposed an additional fine of one million RMB ($128,000 USD) per coal mine fatality, payable to the local government itself.[38] This had the unintended consequence of not only turning coal mine accidents into a lucrative source of revenue for the authorities who collected the fines, but also increased the incentive for mine owners to buy the silence of victims' families.

Under these conditions, the plight of mine workers in China seems bleak. They are the most vulnerable group in society and lack the means to advocate for safe work conditions, income levels, adequate training, or other job-related issues.[39] Unionizing and public expression of discontent is met by fierce repression by mine operators, local governments or both.[40] As a result, there is a grave imbalance in the power between those who own or operate China's coal mines and those who work in them. Therefore, it is the responsibility of the government to enact fundamental reform of the coal mining industry to redress these contradictions.

Failure to Reform

Many government attempts to bring China's vast and atomized coal industry to heel have proved unsuccessful. Indeed, it may be an impossible task as the country's demand for coal grows ever higher along with the industry's power and vested interests.

Most important among the measures to reign in the power of the coal industry's leaders has been to eliminate the endemic corruption throughout the industry. As Beijing becomes less and less tolerant with coal mining related corruption, provincial governments are taking more action. A notable example of this occurred in 2006 when seven director-level officials at various coal mine safety administrations in Shanxi, China's largest coal producing province, were prosecuted for coal mine-related corruption.[41] However, there remains many places in China where "the mountains are high, and the emperor is far away." That is, China's historic and chronic difficulty of compelling local officials to obey central policies remains as real as ever. Even capital punishment is often an insufficient deterrent to greedy officials as the gains at stake are huge. On Aug. 26, 2005, Beijing launched a drive to cleanse the coal mining industry of shareholding by officials (widespread amongst TVEs), requiring all government employees and heads of state enterprises to withdraw their personal 'investment' in collieries.[42] However, the new anticorruption campaign immediately bogged down at the local level, when officials in some coal-producing regions refused to withdraw their investment and some even threatened (privately) to resign; others simply transferred their shares to relatives and friends.

The sharp contrast between Beijing's increasingly stringent punitive measures and the rampant corruption at local levels suggests that the perceived probability of being caught in a coal mining corruption related accident is still too low. Given the degree of collusion between local officials and colliery owners, bringing corruption to light is particularly challenging and would necessitate that the central government use its own State Administration for Worker Safety (SAWS) to directly investigate deadly coal mine accidents. The heavy work load for SAWS officials, however, inevitably limits their ability to operate at strategic and managerial levels.

Establishing a stable regulatory framework for safety standard setting and enforcement is also imperative, though the government has yet to be completely successful in this endeavor. From the inception of the PRC, coal mine safety regulations have been subject to turbulent government restructuring, leaving it largely ineffective.[43] A pre-1999 safety inspection system for coal mining was flawed due to a lack of proper national integration, partial coverage (only state mines) and a lack of independence from the coal production administration it was designed to oversee. The State Council fixed some of these deficiencies with the creation of two agencies, the State Administration of Coal Mine Safety (SACMS) in 1999 and SAWS in 2001.[44] However, the constant flux of bureaucratic reorganization continued to impair their inspection work. An acute shortage of inspectors has also left the agencies ineffective. The number of coal mine inspectors in China is wholly inadequate for the task thought the government is expanding the inspection force. Furthermore, the majority of inspectors are employees of state mines, creating a clear conflict of interest.[45]

Beyond administrative limitations, however, an over-simplification of the problem solving associated with the coal mining industry has led to counter-productive government responses. SAWS has recently banned all 'greenfield' coal mines with capacity of less than 300,000 tons per annum (for the *11th Five Year Plan, 2006-2010*), and a plan to shut down all small collieries with annual output less than 30,000 tons by the end of 2007.[46] However, not all small coal mines are operating dangerously. Closing coal mines solely based on capacity unfairly shuts down those small coal mines that strive to meet safety requirements. It is important for the government to maintain a healthy presence of licensed small TVE mines to induce competition in the coal mining industry and attract long-term investment from the private sector.

Closing mines without careful consideration has other negative consequences. Following the 2005 Daxing mine accident that killed 123 miners in Guangdong, the local government temporarily shut down all collieries within the mine's geographic vicinity.[47] Putting underground mines out of commission in this way, however, often leads to an accumulation of methane, increasing the chances of explosion once they are put back to operation.[48] Moreover, fearing negative impact on the performance review of provincial cadres, the Guangdong government eventually closed all collieries across the province permanently. This decision deeply impacted the interests of all stakeholders in Guangdong's coal mining industry, especially the colliery owners and thousands of migrant peasant workers.

Perhaps more destructive than a miscalculated government strategy is the failure of government regulations to be implemented in practice. After decade-long efforts by the central government to close many small and TVE collieries, thousands still continued to operate in China. Persistent government pressures have lowered the reported number of these mines, however, illegal mining operations have become rampant across the country.[49] In January 2006, SAWS reported that they had shut down 10,669 illegal coal mines.[50] Given the magnitude of illegal operations, the number of unlicensed mines left unscathed is certainly significant though largely unknown and thus beyond the purview of regulatory oversight.

To make matters worse, the lack of investment in safety measures has become a chronic issue for China's coal mining industry. According to SAWS, 45 key state mines alone had under-invested 16.4 billion RMB ($2.1 billion USD) on safety projects and equipment in 2003.[51] Even more problematic, about one-third of all coal produced in China for 2003 came from collieries lacking measures to ensure safe operations. Despite the central government's repeated pledges to solve the issue, safety measures for China's coal mines were still under-invested by at least 68.9 billion RMB ($8.8 billion USD) in 2006.[52]

A failure to sufficiently fund other aspects of the coal mining industry also contributes to unsafe mining conditions. While state coal mines accelerate mechanizing operations under the *11th FYP*,[53] TVE mines continue to rely on traditional underground mining techniques with low productivity and unsafe conditions.[54] In addition, a dearth of investment in the development of surface mining perpetuates the shortcomings of low productivity, over-crowded conditions, and the major safety risks associated with underground operations.

A Way Out?

The policy endeavors by Beijing reveal its firm commitment to improve coal mine safety, reduce the fatality rates of coal mining accidents, and end the collusion between TVE mines and government officials. However, unless the government undertakes more aggressive, effective and comprehensive measures, the contradictions and challenges inherent in China's complex coal mining industry will continue to haunt China for years to come.

Fundamentally, solving the coal industry's problems will require appropriate statistical measures and accurate information. To this end, the use of intensity-based measures standards for safety improvement must be adjusted to include quantity-based safety targets. The former, while important, is merely a measure of fatalities relative to coal production and thus an abstract statistic. A reduction in this rate may be offset by higher absolute numbers as a result of increased production levels. Thus, with a rising demand for coal, China could experience the paradoxical situation of lowering its intensity-based fatality rates while increasing actual deaths – a situation that could have significant social, economic and political impact. By using quantity-based standards, on the other hand, the industry is forced to reduce absolute numbers of coal mining injuries and deaths. This also places greater emphasis on the individuals and their tragedy and loss resulting from coal mining accidents. China's high fatality rate leaves plenty of room for safety improvements. Aggressive quantity-based targets are achievable if supplemented with effective enforcement. For example, the Shanxi province recently put limits on the number of miners allowed to work underground, based on the design capacities of each colliery.[55] Such initiatives can be executed at the local level, but should be encouraged by the central government and disseminated to other coal producing regions.

Gathering and publicizing accurate information is also basic to any solution for coal mining safety. Rather than restricting the media, as the government has been inclined to do in recent years, more freedom and flexibility should be allowed for in-depth media coverage not only on collusion between officials and colliery owners, but also on the impact on individual victims and their families. Moreover, the government needs to acknowledge the crucial role that non governmental organizations (NGOs) have played for similar problems in many other countries.[56] The scope of China's coal mining safety issue is probably too vast for the government to tackle alone. NGOs can fill in an important gap at the local level where specific knowledge of the stakeholders and their interests is crucial. However, given the current political context in China, such measures may not be achievable in the near future.

The question that remains is how to balance the powers and interests of the state versus society.

In addition, the government must focus on adequate mine capacity in order to meet both the national coal demand as well as ensure safe working conditions. For this to happen, investment in mining technology, safety equipment and adequate enforcement of safety measures are all imperative. Sufficient funding to ensure appropriate safety measures for Chinese coal enterprises has been chronically neglected. While SAWS needs to continuously improve the enforcement of safety measures, the central government should also provide more financial assistance to help the coal mining industry meet safety requirements.

Furthermore, the blanket national movement to close small coal mines based solely on production capacity must end. Such practice will only drive many to operate 'underground' and worsen their unsafe practices. Small coal mines account for about one-third of national coal output while their mining related fatalities make up 74 percent of the national total.[57] Thus, they are crucial both in terms of coal supply and coal mining safety. Illegal mines should be closed, but those working legitimately and struggling to meet better safety standards should be nurtured, invested in and regulated fairly. The government should also provide mechanisms for the private sector to legally enter the coal industry through long-term legal guarantees, ownership rights and access to government funds.

Finally, the industry's appalling track record on safety cannot be ameliorated without greater accountability of an endemically corrupt industry. Beijing has never lacked the political willingness to crack down on corruption in the coal industry. However, past initiatives based on punitive measures alone have clearly proved unsuccessful. Rather, tackling coal mining-related corruption needs to be considered as part of an integrated framework. This will necessarily entail an independent jury, media and public, particularly at the local level, if powerful government officials are to be held to account for their actions.

State-Society Shift

China's coal mining industry and its safety record also raises deeper issues about the nation's modern social, economic and political life. What is the balance between the country's needs for rapid economic growth versus the wellbeing of society? How should the overall progress of the nation be measured against the rights of the citizens that comprise it? Fundamentally, these are the thorny questions behind the relations between state and society and the widening gap between the rich and poor that China must address as it moves relentlessly forward.

In traditional Chinese culture, the value of human life was subsumed under the greater goals of the state (and emperor). The ancient chinese philosopher Mencius (372 – 289 BCE) famously said, "I love Life and I love Rightness. But forced to choose between them, I choose Rightness." During the PRC's early socialist era (1949-1979), individualism was deliberately suppressed by the state in favor of collectivity. The idea of the time was that the working class should be willing to give up their lives for the great revolution.[58] The bearing of these past attitudes on China's modern society are debatable. However, in the context of coal mining, the high fatality rates of coal miners are often regarded as a necessary sacrifice to achieve social and economic development targets. The value of individual human life for the underprivileged and most vulnerable citizens that labor in the coal mines has undeniably been very low.

However, the very progress that created economic losers has also unleashed social forces that are driving a fundamental transformation of Chinese politics. New powerful actors including poor farmers, the unemployed, dissatisfied consumers, industry associations, labor unions, religious organizations, special-interest groups and separatists have emerged to press for their own interests.[59] This is leading inexorably to a fundamental shift in the balance of power between the Chinese state and society. Power is moving both from the state and its representatives to the society and the individuals that comprise it. Power is also moving from a few ruling elites to diverse social groups including the millions of disadvantaged coal miners who have never had a voice. A 2005 visit by Premier Wen Jiabao to the families of victims from a coal mining accident in Shaanxi province brought him to tears. It was the first time in many years that a high-level communist party leader had expressed such deep sympathy toward a disadvantaged social group. The enacting of the property law in early 2007, despite fierce opposition, shows the Chinese Communist Party's commitment to protecting individual rights.

While sympathy of an official and individual legislation do not confirm a resolution that gives greater power to the individuals or resolve the plight of coal miners, they do indicate that change is in the air. However, the forces resisting that change are also formidable. The intractable problem of corruption within the coal mining industry is the most vivid example of this. The question that remains is how to balance the powers and interests of the state versus society, the few who benefit from economic growth against the many who do not, and, between those who benefit from coal mining and those that risk their lives working in mines. These will be the most pressing challenges for the Chinese government in the years ahead and it is in China's coal mines where the front line of this struggle, and the possible solution, can be found. Maintaining the status quo will not do as the disadvantaged social groups in China, including millions of coal miners, deserve to live with hope for a better tomorrow.

* The views expressed herein are author's own and do not necessarily represent the views of any organization with which author is affiliated.

** The coal statistics in this figure are the original data published by the National Bureau of Statistics. Liu Xueyi and Liu Anhua (2004) estimated that the unreported national coal production were 52, 225, 260, 175 and 173 million T for 1998, 1999, 2000, 20001 and 2002, respectively.

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China's Lopsided Population Pyramid

Li Jianmin

The 21st century will be the century of old age. From the vantage point of 2007, we are already beginning to witness major shifts in population structures all over the world that point in the same direction: an increase in the proportion of citizens over the age of 65. In China, the estimated number of seniors in 2035 will reach 391 million, or a ratio of more than one to four elderly to non-elderly persons.[1] While China's aging population trend is not unique, the rate at which this process is unfolding is. In France and the United States, for example, the amount of people over the age of 65 is predicted to double in 115 years and 69 years respectively.[2] The same phenomenon in China is expected to occur in just 27 years. Or viewed another way, while the number of people over the age of 65 grew by 28 million in the past 30 years in China, predictions for the next 30 years estimate that amount will swell to an elderly population increase of 247 million citizens.

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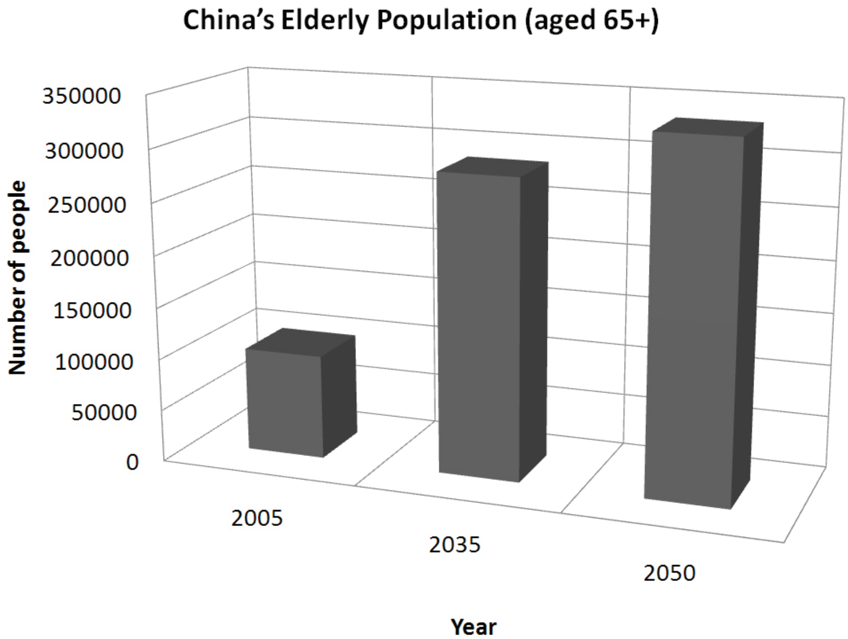
The sheer magnitude of this transformation and its implications for society are staggering. In fact, the public is not prepared for this rapid shift mentally or culturally, nor has the government made the institutional provisions or arrangements in public services necessary to manage it. An aging population poses great challenges to China. It has become an issue of national importance, drawing close attention from the world community.[3] The next few years will be a critical window of opportunity for China to take the necessary steps to avert a crisis brought on by a society dominated by an elderly population.

Enter the Population Skew

The main cause for the recent, sudden population shift in China is a rapid change in birth rates over past decades. Nearly 23 million babies were born per year during the 1950s and 1960s, leading to a total increase of 455 million people over two decades, creating a huge spike in the population.[4] When the generation born during the baby boom period of the 1950s-1960s began to reach the age of marriage and fertility, they had low childbearing rates due to the rigorous implementation of the family planning policy (instituted in the late 1970s).[5] The average number of births per woman fell from 5.5 in the 1950s to 2.2 in the early 1980s[6] and even below the replacement level in the 1990s.[7] The scale of this phenomenally high birthrate followed immediately by a low childbearing rate – which continues under current policies – dominates China's present and future demographic changes. Further exacerbated by the rise in life expectancy roughly during the same period (35 in 1949 to 68 in 1978), the result is a skewing of the 'population pyramid,' raising the proportion of senior citizens (top of the pyramid) to the rest of the population (base of the pyramid).

The implications of a Chinese population dominated by an old population will begin to appear as the baby boomer generation gradually enters old age – between the years 2010-2015. The real challenges will kick in when the entire cohort will be over the age of 65, which will occur by the second and third decade of this century. During this period, the working population will steadily dwindle and the demographic window of opportunity, measured by the dependency ratio (or the population's ability to support those not in the labor force), will close by 2030.[8] While the social and economic impact of these population aging trends have not yet been felt, the moment is drawing near and it is therefore imperative that China prepares for this change.



The Other Side of the Coin

The aging of a population makeup and the burden this reality will naturally bestow on a society is only one aspect of the problem that China will face as this phenomenon unfolds. There is another and perhaps more important side; that is, the particular social and economic environment in which the aging members of the baby boomer population will find themselves.

Since the initiation of reform and opening, China has witnessed profound political, economic and social transformations, both positive and negative. Although the reform of the economic system toward a market-based economy has promoted the rapid growth of the Chinese economy, these achievements have been eclipsed by lagging social development and inadequate social policies. In sharp contrast to China's economic expansion, institutional reform has been plodding along, especially in regard to important areas related to the well-being of individuals, such as income distribution, education, welfare, medical care, housing and social security. If the government efforts in the economy have been 'misplaced' or if they have over-stepped their boundaries, then their functions have been 'lacking' in terms of social development.

The problem is that the economic reform and social changes of the past 30 years have transpired simultaneously with – though separate from – the demographic shift under the family planning policy. Despite the great success in population control, these policies were largely implemented in exclusion of other social policies that should have been set up in coordination with them, such as a mature social security system. Having failed to establish a harmonized set of policies at the outset of these demographic transformations – or for a considerable period of time thereafter – the government has sown the seeds of social crisis that will develop in the future as a result of the aging population in the country.

Problems for Chinese senior citizens are occurring against a backdrop of social change characterized by the polarizing of the social strata, and the restructuring of social interests as China's traditional, moral principles are being abandoned. Furthermore, the aging crisis is taking place at a time when the distribution of public resources is both unreasonable and unfair, and when the social foundation, social policies and adequate public services have not yet been established. The rapid growth of an old population has served to heighten the social problems and contradictions that already exist. Therefore, the root cause of the aging crisis in China is not the changing structure of the population per se, nor is it the growth of the aged population. Rather, it is merely the 'fuse' to a series of explosive social and institutional ills.

Plight of the Elders

The bleak reality for the elderly in China today is not due to the size of their numbers or the extent to which Chinese society is aging, but the social and economic characteristics of this group. First, being born at a time of high birth rates, this generation caused a large surge in population growth. Second, their income was low and only increased very slowly throughout their productive lives. Many had several children (prior to family planning policies), which in addition to low income, leaves them with minimal savings as they enter retirement. Third, only 26% of people over the age of 65 enjoy social security benefits.

Under the changing conditions of a market economy, the cost to individuals to participate in a reformed welfare system has increased, the cost of living has risen and medical expenses have soared. Having retired from the labor market and with few savings, older people are more easily trapped into poverty and are often socially marginalized. Measures by the government to gradually increase pension rates have been canceled out by the inflation in cost of living in present day China, or, as is often the case, by the need to support their unemployed children. These factors have pushed a considerable number of retired people into poverty. Those who have no pension suffer even worse conditions. One study revealed that, in 2000, one-third of the urban and township elderly was living in relative poverty – the figure was as high as 40 percent in rural areas.[9] In rural areas, many people traditionally continue to live off their own land and look to their children for support in old age. However, using land as a means to provide for the older generation is gradually vanishing as both the size of land plots and the returns from them decrease. According to data from a sample survey in the *2005 Report on the Agricultural Development of China,* published by the Ministry of Agriculture, Chinese agricultural households had an average of only 0.13 hectares of cultivated land per person[10], which is not enough to live on.

The current predicament of the social safety net for the elderly has little to do with the increasing numbers of people over the age of 65, and far more to do with the issue of financial sustainability. The reasons behind this lie with the defects of the system's operation and the historical debt of the pension insurance fund. Although the institutional arrangement emphasizes 'overall planning', the system is essentially a 'pay-as-you-go' system, where current employees are paying (in addition to matching payments from the government and the work unit) into their 'personal accounts', which are then being used to pay pension for current retirees. These personal accounts are not only 'empty,' but as of 2005 had accumulated debts of up to 700 billion rmb ($88 billion USD).[11] Estimates show that by 2010, the cumulative pension fund debt will top $110 billion. As a result, the government is implementing measures to refund these accounts.

The reason for the pension fund's growing deficit is primarily an issue of burden sharing. A higher burden ratio within the social security system itself is not necessarily equated with a higher burden ratio for society as a whole. According to an annual report published by the Ministry of Labor and Social Security, the ratio of urban employees that participate in the pension insurance program to retirees was roughly three and a half to one. That is, there were 175 million insured employees to 51 million seniors. If all employed persons in urban (and town) areas were to participate in the pension insurance program, the same ratio would jump to roughly five to one. Thus, the best method for overcoming inherent problems in the program is to establish a comprehensive, national social security system that covers all the citizens.

In other words, the quandary facing those over 65 is fundamentally not one of insufficient social resources, but how those resources are distributed and what policies are required to transfer economic benefits more equitably among citizens. Under the present system, it is too hard for older people to receive their share of the benefits that have come with a strengthened and growing economy. This is evidenced most strikingly by the fact that as China's population over 65 has doubled in the last 25 years, the gross domestic product (GDP) and government revenues have also increased – at a faster pace and with greater magnitude. Therefore, as economic growth has far outpaced the aging of China's population, the conclusion can be made that it is not the size of the cake that is the problem, but how it is divided. If there is a crisis, it is only a crisis within the system itself.

Heading Off the Crisis

A number of trends have appeared in how the government is viewing the profound social issues of today's China. On the one hand, the current leadership is promoting a development policy of 'putting people first' that explicitly focuses on the individual and his/her livelihood and standard of living. In essence, this has created the political conditions necessary to meet the challenges of an aging population.

On the other hand, while the policies for the old age in the past were more 'technical', aimed mainly at solving specific problems in a particular context, recent initiatives show the Chinese government is committed to establishing a social security and welfare system at the national level and in a more holistic way. Examples include providing assistance to families that comply with family-planning regulations, participating in new rural medical insurance cooperatives and implementing policies of tuition fee exemptions for compulsory education. Effective solutions to challenges of an aging population will require a strategy that goes beyond technical fixes and is directed toward all Chinese citizens, not just those who are currently over the age of 65.

The real question regarding the challenges brought by an aging population is whether or not a fair, rational and effective state institutionary arrangement and social reaction mechanism can be established under the conditions of economic and social transformation and the rapid aging of the population. Specifically, a government focus on three key areas will prepare China for an older population and work to address many other social problems simultaneously.

Pillar 1: Nationalizing the Social Security System

A social safety net that is able to effectively support the retirees of the Chinese nation will require many innovative policy measures, but more importantly, it will entail a redevelopment of the system's goals and how the government should act accordingly. Why are people so skeptical of the current system's ability to cover those over the age of 65, even in urban areas? Why are most of the employed laborers excluded from the existing urban social security net? Why has its expansion to the rural areas been delayed for so long? These questions and many others go to the heart of the problems in supporting the country's older citizens. In China's social security system, efforts are certainly made in technical and operational aspects. More important for long-term stability of the system, however, is that it embodies principles of social justice and fair play, that is, the core problem lays in the system's underlying values.

The basic function of any security system for people over the age of 65 is to harmonize income and consumption over a person's life cycle (in productive years, income exceeds consumption and in old age, it's vice versa). Traditionally, this balance was met through traditional mechanisms – children cared for elders. Under the conditions of a rapidly changing Chinese economy, society and population, however, such familial support systems are losing their effectiveness, leaving many seniors unprotected or under-protected.

The system is failing in other important ways as well. For rural residents, who account for two-thirds of the national population, a nation-wide support system for older citizens has not yet been established. As detailed above, only a small number of old people are presently covered by the social security system. While 70 percent of old people residing in urban areas receive pension and medical insurance benefits, fewer than 5 percent of elderly people in rural areas are covered, where two-thirds of China's people over the age of 65 live. It is the fundamental right of every person to enjoy social security. Specifically, that means every member of society should have the means to guard against old-age income risks and health risks. Equality and universal coverage should be the basic principles of a social security system.

While access to social security is the right of every Chinese citizen, it is also the obligation of every laboring person in society to contribute to it. Real reform to the social safety net requires meeting the funds needed to support it, which will entail expanding participation in the system to the national level. As described above, drawing in the entire urban labor force, and even 'migrant workers' would almost halve the financial burden on the system. Even providing benefits for the entire elderly population of China, both in rural and urban regions (approximately 140 million) would be sustainable if the entire national working force (roughly 758 million) paid into the system. It is true that compared with developed countries, China has lower levels of economic development and personal income. However, the physical needs of old people in China are also more modest. In its present national economic position, obviously China cannot support its massive elderly population by standards of developed countries. Nevertheless, China can certainly make their standard of living better.

The next few years will be a critical window of opportunity for dealing with China's aging problem.

Propping up the lop-sided population pyramid of China, and ensuring that the social security system is provided for all of China's old aged is within China's means, but it will also necessitate long-term planning and key legislation. The previous practice of defining social identity and the provision of social support systems based on the household registration system must be discarded. This system has seriously disadvantaged peasants and migrant workers. The social security system is a basic system structure of a modern society, and should be expressly prescribed by laws for all Chinese nationals. As such, a national social security law or, perhaps more generally, a national social welfare law is urgently needed. If the property law that was adopted at the 5th Session of the 10th National People's Congress held in March this year is the so-called new 'economic constitution' of China, a law on the social security system should become the "welfare constitution" of China.

Pillar 2: Human Capital

If an economy's dynamism is based on labor and capital, China's abundant and low-cost supply of the former has been an important driver of the economy. Many in China's labor force have transferred to urban jobs from the large underemployed rural areas, providing China with a comparative advantage in the cost of labor. Studies have shown that the size of China's labor force accounted for 24 percent of economic growth during the period 1978-1998, equal to the contribution made by human capital itself.[12] And this edge will last for some time to come – as the labor market will continue to grow over the next 10 years and the remaining hundreds of millions of rural laborers create the potential for shifts to more productive work.

However, over the long term, the reduction of labor supply could eventually lead to shortage and could even eliminate the traditional comparative advantage of a low-cost labor pool. These circumstances dictate that China make the strategic decision to begin substituting cheap labor for human capital now. In other words, China must invest in its people and raise their productivity to support the pressures that an aging society will bring. Given the current trends of globalization and international competition, achieving these goals requires the upgrading of China's manufacturing sector in its current (mid- to late-) stage of industrialization.

The aging crisis in China is the 'fuse' to a series of explosive social and institutional ills.

Investing in China's education system is also key to building human capital. The results of China's fifth census reveal that in 2000, the employed population averaged only eight years of education. As much as 40 percent received no education or only primary school. A mere 31 million laborers had higher education, averaging less than 5 out of every 100 employed laborers. Under these circumstances, China will have difficulties sustaining the economic growth needed to cope with the changes in its labor force. Although problems remain, the government has begun a strategy to turn this situation around by increasing investment in education, popularizing higher education, exempting rural students from paying tuition fees and vigorously promoting vocational education for farmers. Education's close correlate in raising quality of life will be enhancing personal health, which the government should include in its strategic investment in human capital. In short, there is no escape for China in the path it must take to meet the challenges of an aging society. Only replacing low-efficiency and low-income labor with higher skills that command better wages will build up the necessary comparative advantage of human capital to achieve sustainable development and support an aging society.

Pillar 3: Public Service Infrastructure

The growing numbers of Chinese citizens over the age of 65 combined with a shortage of family resources for their care will quickly lead to pressure for the expansion of public services. Currently in China, the infrastructure available for the elderly is deficient, and cannot meet their needs. The government should establish public service systems for the elderly in medical care, rehabilitation, terminal care, senior community services, transportation and communication facilities.

In the development of such programs, the current divisions between urban and rural areas and between regional public services must be reformed. Under China's current administrative and fiscal systems, public resources are allocated according to a regional hierarchy, with urban citizens receiving the majority of the country's social resources and with bigger cities receiving far more than smaller ones.

Implementing programs will require a general policy principle that is oriented toward caring for seniors, for instance, employing existing resources and facilities with preferential policies geared at the citizens over 65. In addition, the government should support and expand the 'third sector' (non profit services) to encourage as many service providers for older citizens as possible. While such initiatives will require an extensive amount of government funds, their development and implementation now will be prudent compared to a reactive approach in a time of social crisis.

There is Still Time…

China is now in a 'golden age' in terms of its population structure. In comparison with Japan, Europe and the United States, China has a lower dependency ratio (society's dependents to working population). The economy continues to grow at a dizzying pace, and although it is presently in the later stages of industrialization, a significant amount of low-cost labor remains untapped in the country side. There is vast room for increasing labor productivity across the country. This 'golden age' will last for at least 20 years barring unforeseen events.

On the other hand, the demographics are changing rapidly and while the dependency ratio is still balanced, China's absolute numbers of citizens 65 or older is growing and underscores a formidable challenge in itself. China's economy remains at a low level of development, on average, and its future economic performance cannot be guaranteed. Many socially dislocating events are also underway, such as the turn-away from the traditional filial piety system that once secured older citizens care. All of these add up to an urgency to meet the challenge before China.

Therefore, the time to act is now. China may currently be experiencing its final opportunity to establish a national social security system. The burden of an increasingly aging society will not be unbearable for China if the above framework for action is implemented as quickly as possible.

Notes

[1] World Population Prospect: The 2004 Revision, Population Division of the Department of Economic and Social Affairs, United Nations, 2006.

[2] National Institute on Aging, U.S. Census Bureau, "An Aging world: 2001," Issued November 2001.

[3] Nicholas Eberstadt, "China's Aging Population Deteriorating (USA)," *Policy Review Quarterly,* May 2006; Center for Strategic and International Studies, Center for Strategic and International Studies, Prudential Financial, *The Graying of the Middle Kingdom: The Demographics and Economics of Retirement Policy in China*, 2006

[4] During this period, the death rate also began to nosedive from 20 percent in 1949 to 6 percent in 1979.

[5] China's family planning policy, launched in the late 1970s to check China's rapid population growth, has reduced the country's population by an estimated 300 million. The basic requirements of family planning are late marriages (age 25 for males, 23 for females), one child per couple, and late childbearing. A more flexible family planning policy is adopted in rural areas, where couples may have a second baby in some exceptional cases (however, they must wait several years after the birth of their first child). For more information see: http://www.npfpc.gov.cn/en/index.htm

[6] The replacement level is when the number of babies born is less than two per woman (when parents do not 'replace' themselves). Currently, the birth rate in almost all developed countries sits

below the replacement level. It is generally considered that the birth replacement level is reached when the sum birth rate is 2.1. For more information see: http://www.un.org/esa/population/publications/completingfertility/2RevisedRAHMANpaper.PDF

[7] Department of Development and Planning, State Commission of Population and Family Planning and China Population & Development Research Center, *2005 Statistical Manual of Population and Family Planning*, China Population Press, 2006

[8] Most commonly the window is opened when birth and fertility rates decrease, causing young populations to shrink, while the working-age population stays the same. As that small cohort of young people grow older however, the elderly population will increase rapidly causing the dependency ratio to rise and the demographic window of opportunity to close.
More information see, http://www.aacu.org/peerreview/pr-wi01/pr-wi01feature1.cfm

[9] Yu Xuejun, Study of the Poverty Problem of Aged Population, compiled by the Old Age Scientific Research Center of China, Data Analysis of One-off Sampling Survey of Conditions of Urban and Rural Aged Population of China, China Standard Press, Beijing, 2002, pp. 445-452

[10] "2005 Report on the Agricultural Development of China," Ministry of Agriculture of China, see: http://www.gov.cn/banshi/qy/rlzy/2005-09/01/content_29024.htm

[11] Wang Li, Wu Yong, Liu Wenguo, "empty personal accounts reached nearly 800 billion," *Economic Information Daily*, Nov. 21, 2006.

[12] Cai Fang, Wang Dewen, *Sustainability of China's Economic Growth and Labor Contribution*, Economic Research, Issue No. 10, 1999.

Economic Security: Redressing Imbalance

Jiang Yong

Competition *vs.* Security

Much ink has been spilt over how to measure a nation's economic security.[1] As each country is uniquely endowed with their own level of economic development, a capacity for risk management, a national culture and its position in the international environment, each will invariably perceive economic security differently. For developing countries, such as China, economic security is best defined as the ability to provide a steady increase in the standard of living for the whole population through national economic development while maintaining economic independence. In other words, there are two sides to the economic security 'coin': competitiveness and independent economic sovereignty.[2] Competition generates healthy development while a degree of autonomy guards against undue external influence on the economy.

Economic competitiveness is vital not only to stimulate national economic growth, but also to penetrate the international market. In an era of globalization, the two are inextricably linked as no country can close itself off to challenges from the outside. Furthermore, the two are mutually reinforcing as competition through comparable advantage in the world market is the basis

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for domestic sustained economic growth, and growth, in turn, gives a country an edge in a globalized economy. Without growth and competition there is no economic security.

The other side of the proverbial coin is economic sovereignty, which should be seen as a measure of the control a country has over its own economic development and their abilities to resist outside intervention. Economic sovereignty includes 1) what can be termed 'non-distributive' economic authority, which is inherent and cannot be shared with other nations, 2) 'distributive' economic power, which can be shared with others. Sovereignty itself, like a country's identity, is not transferable to others. In the economy, sovereignty is reflected in a country's control over its domestic market and the government's control over key industries and enterprises. The 'non-distributive' economic authority entails aspects such as a nation's stratgic decision-making power over its economic system and ownership over natural resources. The 'distributive' economic power roughly includes economic and industrial policies and the devising non-essential economic institutions.

Competitiveness and independent economic sovereignty are two sides to the economic security 'coin'.

The boundaries between non-distributive sovereignty and distributive powers under sovereignty differ in each country, depending on national economic strength and economic development. Under the current international order – shaped by the developed nations and designed to maintain their economic position – the powerful competitive forces of developed nations lead them to encroach on the sovereignty of other countries. Foreign multinational companies are acquiring Chinese enterprises one by one and even gaining control of industries. If industries are controlled, the notion of autonomous economic integrity is a moot point. Although the majority of developing countries are gaining substantial economic interests by opening up their economies to the international market, their economic sovereignty is being increasingly violated.[3]

Maintaining the delicate equilibrium between these often contradictory trends requires vigilant monitoring of the complex competitive relationships between domestic and foreign entities by regulatory mechanisms under a country's control. During the first 30 years of China's development (roughly

1949-late 1970s), preserving absolute sovereignty was the mantra for ensuring the country's national security.[4] In the economic sphere, this meant strictly following principles of self-reliance, self-sufficiency and the independent building of a full-fledged industrial system. Influenced by a perceived hostile international environment and ideological factors during the Cold War period, the Chinese market closed itself off to the world and international market competitiveness did not enter into the equation. At the close of the Cultural Revolution in the mid-1970s, China's economic security was very unbalanced and on the edge of collapse. However, since the 'reform and opening up' of the economy, China has steadily improved its global competitiveness by aggressively attracting large inflows of foreign capital and enhancing foreign trade.[5] This brought advanced technologies, management experience, the training of local talent and the rapid development of the Chinese market. Foreign capital has played an active role in helping China to improve its competitiveness. However, in the process, economic sovereignty has been neglected. Regulatory departments have been blinded by the current prosperity with too much emphasis on the positive influence of foreign capital.[6] In other words, the pendulum has swung too far in the other direction and China's economic security is now out of kilter.

This phenomenon is manifested in the economy in a number of ways. At present, 65 percent of foreign capital is invested in the manufacturing sector, an area crucial to any country's development.[7] With the expansion of the service industry, foreign capital has penetrated new fields such as the bond market and insurance sector. Foreign capital has also disproportionately gone to the eastern and coastal regions of China (87 percent), with a mere 13 percent invested in the central western provinces.[8] This dramatically skewed development has played a role in widening the economic gap between the two regions. In this way, foreign capital has not only impaired economic sovereignty but is also threatening China's economic security. Even the positive influence of foreign capital on China's competitiveness is shifting. All of these factors amount to the emergence of a 'critical threshold' for the role of foreign capital in China.

Breaking Point

Foreign capital continues to play a primarily beneficial function in China's current stage of economic growth. That role has mainly been in the area of improving technological innovation and application, marketing, management techniques, and overall increased competition. However, as the Chinese economy evolves, domestic private and state-owned enterprises are improving their economic strength and abilities, thereby narrowing the gap with their foreign invested counterparts on many levels. As the former have improved their position, foreign capital's contribution to boosting China's competitiveness is reaching the point of diminishing returns. In fact, a more negative role has begun to emerge, hampering market competition.

The combination of changes to the nature of foreign capital and China's demand for it significantly contributes to the advent of this breaking point. As China's economic strength increases, China has seen changes in its demand for foreign capital in the form of funds, management and the market. In the early days of reform, including the opening of China's market to foreign investments, there was a dire shortage of capital funds for economic development in China as the country had been closed to the world economy for such a long time. Large amounts of capital, especially foreign direct investment, were needed to jump-start the economy. Currently, however, China has ample – and perhaps excessive – funds to keep its economy humming. In addition to the $1 trillion USD of foreign reserves, Chinese banks now have large amounts of surplus funds that they are able to use toward investments. In terms of technology and management, state-owned and private enterprises have notably improved their expertise through learning from foreign invested enterprises (FIEs) (Appendix 1). Though much learning remains to be done, the skills are there that will allow the Chinese to adapt to the international, best market practices and help China attain an appropriate, high standard of management techniques.

The contribution of foreign capital to China's economy is reaching the point of diminishing returns.

As for the market, the role of foreign capital has changed significantly. Before China's accession to the World Trade Organization (WTO) in 2001, FIEs mainly sold their products to overseas markets, hence, they had little impact on the Chinese market itself. However, with the new conditions under the WTO, China has opened its domestic market to FIEs, which have since waged fierce competition with China's state-owned and private enterprises. Consequently, FIEs are beginning to obtain significant market shares. The circumstances that led the government to granting FIEs comprehensive, preferential terms (in taxation and certain corporate, social and environmental responsibilities) – in order to attract the needed foreign capital – have changed, and their continuance is leading to unfair competition in the Chinese market.

The nature of foreign capital and how FIEs behave in the Chinese market has also shifted. In the past, foreign investors adopted a strategy of sacrificing short-term economic gains for a secured position in the domestic economy, with an eye for long-term market share. Often operating at a loss, they would persist in China, committed to making a good impression on the government, consumers and other state-owned enterprises. But now they are familiar with the Chinese market and have recruited large numbers of local talent to operate their business activities. Consequently, FIEs have begun to modify their past strategy described above to one that stresses immediate profits and returns. In addition, foreign capital previously entered China mainly in the form of joint ventures. After entering the WTO, China relaxed its policies toward foreign capital, allowing foreign investors to shift their joint ventures into foreign wholly-owned enterprises (WFOEs), who have taken advantage of the relaxed policies by increasing their capital contributions and thereby expanding their shares, or by directly acquiring the shares held by their Chinese partners. This practice is accomplished in a planned manner whereby the joint venture artificially creates 'losses' on the books through 'transfer pricing' so that each party is forced to increase its investment to compensate. The Chinese side, usually with a shortage of capital, often cannot increase its investment and is forced to reduce its shares and can eventually (after it has no shares left) be squeezed out of the enterprise (Appendix 2). 'Backbone' enterprises (defined as critical to national economic security[9]) in various industries in China have seen WFOEs gaining advantageous positions and gradually taking over the controlling rights from their Chinese partners.[10] According to a report released by the Development Research Center of the State Council, the top five enterprises in 21 of China's 28 leading industries are already under the control of foreign wholly-owned enterprises.[11]

Foreign Capital

The question posed by many may be why the shifting nature of foreign capital in China is necessarily a negative development. After all, foreign capital has played an important role in promoting economic growth in China, and furthermore, the nature of capital is to pursue profits. Why is that bad? The short answer to this is that the new conditions are allowing foreign capital to seek profit at the expense of China's economic security.

Preferential Policies

Though these deteriorating conditions are multifarious, a large factor in the possible deterioration of China's economic security is that foreign capital has been entitled to excessive preferential policies in China. These policies, which began in the early days of reform and were mainly in the form of favorable taxation rates, increasingly hamper fair competition between domestic enterprises and FIEs within the Chinese market. Prior to 2007, the income tax rate for Chinese enterprises (including state-owned and private enterprises) stood at 33 percent, while only 15 percent was required for FIEs. Together with the "two exemptions, three reductions" policy, the actual average rate of income tax paid to the Chinese government by enterprises with foreign investment was a mere 11 percent.[12] Even under these advantageous terms, research studies indicate that many FIEs have evaded taxes by turning actual 'profits' into artificial 'losses,'[13] and then moving actual 'profits' overseas through 'transfer pricing' (Appendix 3).[14] Unpublished statistics show that tax evasion by foreign enterprises through 'transfer pricing' accounts for over 60 percent of the total amount of evaded taxes by FIEs.[15] Also, while the accounting books of certain FIEs show losses, they continue to increase investment resulting in a peculiar state of affairs where income taxes from FIEs are growing far more slowly than foreign capital inflow.[16] Using their high profits, FIEs also offer high salaries or rates of pay to local talent, competing with Chinese enterprises.

Preferential policies enjoyed by FIEs have essentially become a state subsidy.

With the development of private domestic enterprises in China, fair market competition is increasingly imperative. The preferential taxation terms which FIEs have enjoyed has essentially become a kind of state subsidy. Chinese government has also realized the unfairness of the existing environment and has finally passed the new tax law this year, leveling out the rates for all enterprises operating in China to 25 percent.[17] This legislation largely addresses the broader inequities in the system, yet there remains plenty of room for preferential treatment by local governments, who often use other means to attract foreign investment, such as a reduction or exemption of fees incurred for environmental protection and land resources, the provision of basic social welfare for workers, as well as corporate social responsibility.[18]

Threat of Monopoly

Currently, foreign capital has gained a foothold in some industries in China through mergers and acquisitions (M&As),[19] which has also hampered fair competition in the market. In recent years, FIEs have taken advantage of their powerful capital strength, a sluggish Chinese stock market and the undervalued listed Chinese companies to establish cheap M&As. They have targeted a number of bellwether enterprises in a wide range of industries and strive to gain absolute control over them. Some of the sectors in which FIEs have already gained a strong position include chemicals, alcohol and beverages, the food industry, pharmaceuticals and logistics (e.g. distribution, retail supply circulation).[20] Emerging targets for M&As by foreign capital consist of resource industries such as iron, steel, cement, asset sectors (e.g. real estate), machinery and financial services.[21] FIEs have seen an increase in their share of industrial production value as a percentage of the national total rose to over 35 percent today from only 2 percent in 1990.[22] In light industries, the chemical, machinery and electronics industries, FIE products occupy over one-third of the Chinese market.[23] Although these figures are not yet sufficient to conclude that FIEs have already formed monopolies in China, the threat is real, especially as the surge of M&As by foreign capital continues. It is reasonable to assume that FIEs, building upon their technological, brand name strength and economy-of-scale advantage in the Chinese market, will create high industry entry barriers and set monopolistic prices to gain large profits. Without a relevant legal system or regulatory infrastructure, it is not possible to properly protect against monopoly formation in China, and even makes it difficult to determine the degree of monopolization by foreign capital.[24]

The biggest negative effect of M&As by foreign capital is their ability to monopolize the market as it not only hampers fair competition, but also endangers China's national security. Though foreign capital has yet to form monopolies in financial services, information or other key industries, the danger has nevertheless emerged. FIEs have already established a monopoly in some service sectors, such as consulting service for overseas listings of Chinese enterprises and auditing.

Deng Xiaoping, former leader of the People's Republic of China, once said that finance is the core of the modern economy. In fact, the financial industry is also at the center of national competitiveness today. This is because financial capital commands commercial capital in global economic activities, and commercial capital in turn drives industrial capital. Put another way, the financial industry controls the distribution industry, which in turn controls the manufacturing industry. Consequently, financial security lies at the heart of national economic security. China's vulnerability to financial risk was high even before the country opened up to foreign capital. Risk mainly came from the large amounts of non-performing assets in the country's banking industry, which as early as 1999, amounted to 1.4 trillion RMB, or $175 billion USD (non-performing assets separated from the four largest state-owned banks).[25] Before listing the China Construction Bank and the Bank of China overseas, the Chinese government had also injected hundreds of billions of U.S. dollars to balance the percentage of non-performing assets and to increase capital fund. Even so, estimates show that there still remains roughly another 1 trillion RMB in non-performing assets in China's banking sector. This could induce a full-scale payment crisis in the entire banking sector, triggering a financial crisis if not handled with caution.

As the financial sector rapidly opens to the outside world, with foreign capital flowing in on a large scale, the country faces even greater financial peril. Admittedly, this trend may push forward the standardized development of China's financial institutions. However, compared with highly-experienced foreign financial institutions, Chinese financial institutions suffer from inadequate competitive abilities. At present, it is still difficult to predict to what degree China's financial market will be affected by foreign capital. Nevertheless, in an open financial market, fluctuations in overseas markets could negatively affect China, even setting off a national financial crisis. Consider that while the roots of the Asian financial crisis in the 1990s can be found within the problems of the affected financial systems themselves, it was actually triggered by foreign capital. Throughout the crisis, foreign financial institutions exacerbated an already deteriorating situation. Opening China's market too quickly and to many foreign financial institutions will bring more risks and more uncertainties to its financial security.

To make things worse, China's financial regulatory department is not adequate to manage the risks that will likely arise in any market opening. In addition to poor awareness of financial risks, they give greater consideration to traditional market risks (such as interest rate or exchange rate fluctuations), but have less understanding of new issues, such as the risks in financial derivatives.[26] They know even less about risks brought by international politics and national strategy. The personnel of the relevant agencies lack sufficient experience to cope with crises. Typically in developed countries, top regulatory personnel come directly from the private financial industry. For example, most regulators in the U.S. Federal Reserve have experience on Wall Street. By comparison, most of the regulatory personnel at China Banking Regulatory Commission, China Securities Regulatory Commission, China Insurance Regulatory Commission and the People's Bank of China, hail from universities – sometimes even from foreign ones – and often lack practical and contextual experience or adequate regulatory skills.

Securing the independence of sovereignty over the economy is the foundation of economic security.

A lack of skills and policies allow for consolidation of a stronger position by FIEs within the various financial services and information fields in China, including accounting, auditing, consulting and credit rating. Enterprises with foreign investment are now dominating the discourse in these industries, which is forming a trend toward monopoly, thus threatening China's financial and commercial information security.[27] For example, as Chinese financial institutions rushed to get listed overseas, the underwriters were foreign investment banks and the auditing was done by multinational accounting firms.

As a result, the 'business secrets' of financial institutions have fallen into the hands of foreign investors.[28] This poses a serious, hidden threat to China's financial and information security. In the credit rating field, foreign institutions also have access to Chinese enterprises' inside information and even China's national economic secrets through the collection and evaluation of their credit data. Foreign institutions may use such information to demand 'bundling', such as requiring consulting services along with financial evaluation services, in order to expand their advantageous position in the industry.[29] They could also provide this information to other enterprises – because of business interests – or even to the governments of other countries, which would threaten China's security.[30]

Interests Groups

Securing the independence of sovereignty over the economy is the foundation of economic security. But foreign institutions have weakened this by drawing upon their stakeholders to influence the Chinese government's decision-making and legislation. Some 20 years after entering China, foreign institutions have formed interest groups within China's borders along with a set of operational mechanisms. Members of these interest groups include enterprises with foreign investment, foreign industry associations, foreign business councils and the economic affairs offices set up by foreign governments in China.[31] These also work in conjunction with officials of some Chinese government departments, as well as Chinese experts and scholars. In the West, interest groups are a normal phenomenon and have a long history and 'relationship' with policy-makers. In this environment, when two or more actors take part in political game-playing, a balance of interests is usually achieved. However, China's domestic interest groups are not yet well developed, making the competition with well-established and skillful foreign interest groups imbalanced.

On the one hand, foreign interest groups use straightforward lobbying methods to affect Chinese government decision-making, including indirect pressure through their own government and the use of their politicians to sway Chinese officials. On the other hand, foreign interest groups also use covert means to influence government decisions. These mechanisms include 'buying over' the children and relatives of high-level Chinese officials or 'inviting' officials and employees of government departments to be consultants (with generous remuneration), or offering fringe benefits such as sightseeing, overseas travel, the granting of honorary titles, awarding of relevant projects to the research institutions and scholars of major ministries and commissions.[32] Through these measures, foreign interest groups are now exerting a growing influence on the decision-making and legislation of government departments in China. The upshot of this influence has been that certain key legislation relevant to safeguarding and boosting China's national interests have been hindered, such as the anti-monopoly law. In other ways, decisions that would otherwise curtail the interests of these foreign interest groups have been blocked, including the 'excessive national treatment' for foreign enterprises, which has only been adjusted in part and not abolished. Furthermore, these changes did not go through without strong opposition, and for which China has paid a dear political and economic price.[33] In the meantime, the interest groups that represent foreign investors have already had a significant impact on China's economic security.

The negative impact of foreign capital in China has reached a level which cannot be ignored. It is essential that China eliminate its blind worship of foreign capital and adjust existing policies.

A Level Playing Field

The overall implication is not that foreign capital will or should be driven out of China. On the contrary, China's economic security is rooted in a system of openness. The Chinese market should encourage competition, yet, it should be *fair* competition, which requires the government's independent and effective ability to ensure a level playing field in the market. Achieving these goals will require the adjustment of policies for foreign capital with guidelines of a balanced, selective and reciprocal open policy.

First, China should adopt a policy of a 'balanced opening'. The skillful guidance of any economy, particularly an emerging one such as China's, will require preferential policies to certain industries and regional economies to a certain extent. The problem is the unequal treatment between domestic enterprises and FIEs. This unequal treatment should end and Chinese private enterprises need to be given increased opportunities to take part in fair competition in all industries. This balance will primarily necessitate the harmonization of tax rates for Chinese enterprises and FIEs. Though China has made progress in this regard, the loopholes that allow local governments to continue offering these and other 'privileges' should be closed as soon as possible. Also, the practice of opening certain industries to foreign capital while closing them to Chinese private enterprises must be abolished. For example, the financial industry has consistently blocked Chinese private enterprises yet has gradually opened to foreign capital.[34] Ensuring sustainable economic growth requires redressing the imbalance between Chinese enterprises' ability to compete in all areas of the market with FIEs.

China must eliminate its blind worship of foreign capital and adjust the existing policies.

Second, China should adopt a policy of 'selective opening,' which means an end to welcoming all foreign capital without discernment. Instead, the government should be more selective toward foreign capital inflow in a way that carefully considers China's evolving economic arrangement, the imbalance in regional development, environmental and ecological protection, and other strategic needs of a comprehensive, national economic development. For instance, the examination and approval process for FIEs needs to be strengthened in order to weed out foreign capital that is destructive to the environment or consumes a lot of energy and other resources. At the same time, preferential treatment should be enhanced (under the conditions above) to attract more foreign capital that bolsters environmental protection, invests in China's underdeveloped western regions, or upgrades the country's capital and technology intensive industries. Naturally, national defense and other sensitive industries should also be off-limits to foreign capital.

The third factor in the process involves the necessary measures under the notion of 'reciprocal opening', that is, the degree to which China should liberalize its own economy should be a reflection of how open a said country is to Chinese investment and exports. The current free trade system is currently under threat from developed countries, who demand, for instance, that new markets be further opened to their financial and services industries, in which they hold the advantage. At the same time, those developed economies add layers of protection to their resource and manufacturing industries, in which they have no competitive advantage, and move to restrict the influx of foreign capital and foreign products in those areas.[35] This is a double standard that runs against the principle of free trade and is unfair to countries with emerging markets like China. As China's foreign exports grow, this double standard is increasingly detrimental to the entry of its labor-intensive products into the developed markets. China needs to adopt countermeasures to redress this unequal situation. Reciprocal opening means instituting a system of fair exchange: China's access to foreign markets should equal developed countries' access to Chinese markets. This will be an effective weapon against the current un-level economic playing field. It does not mean trade protectionism, nor does it imply simple trade retaliation, rather, it is a kind of deterrence policy. When developed countries build barriers for Chinese capital and products, they need to consider the losses which their capital and products will suffer from the Chinese market as a result of such a move.

Staying Ahead of the Pack

There is concern that the adjustments necessary to reduce the detrimental role of foreign capital in China may redirect it to other countries. However, large shifts in foreign investment are unlikely. The primary calculus for the cross-border flow of international capital is the pursuit of profits at minimal risk. An examination of foreign investment trends reveals that ultimately, preferential policies are not the decisive factor that attracts foreign investments. In *International Investment Perspectives*, released in 2005, the Organization for Economic Cooperation and Development (OECD) pointed out that for all countries, the primary condition that determines the flow of investment is the macroeconomic health of a country.[36] Research by the State Administration of Taxation of China confirms this conclusion and shows that when making investment decisions, foreign investors principally consider market potentials first and foremost, then descend to political stability, labor cost, land resources and supporting infrastructure. Preferential policies come in fifth and last place when considering whether to invest.[37] Foreign capital floods into China because it values the potential of the Chinese market. In terms of political stability and labor cost, China also has advantages. China's broad industrial foundation offers both *economy of scale* conditions,[38] as well as *economy of scope*, something that most of China's neighbors do not. For example, in developed industrial regions such as the Yangtze River Delta region and the Pearl River Delta region, there are an aggregate wide range of industries. Parts, components, as well as the intermediary products needed for producing other products, can all be fully procured within a range of 200 km.[39] This greatly reduces production costs and production time, improving overall efficiency and ensuring enterprise competitiveness. In many newly emerging markets, such economies of scope are not mature, at least for the short term.

Although China has reformed its tax system to a degree (harmonizing foreign and domestic enterprise taxes to 25 percent), lessening the absolute preference to foreign capital, China's market still offers an advantage. Currently, the average tax rate is 26.7 percent in China's 18 neighboring countries (regions), and 29.8 percent in OECD member states.[40]

China has greatly benefited from foreign capital in the past, but its evolving economic conditions demand comprehensive adjustments. Reforming the role of foreign capital in China is necessary for the nation to safeguard both national security and economic sovereignty. Within the parameters of maintaining China's competitiveness and sustainable economic growth, a more balanced role for foreign capital will be good for China and ultimately good for foreign capital as well.

Appendix 1: FIEs in China

In China, the foreign investments are basically divided into direct investment and other means of investment (compensation trade, processing and assembling). The main form of foreign investment into China includes Sino-foreign joint ventures (JVs) and exclusively foreign-owned enterprises (WFOEs). JVs are formed in China with joint capital by foreign and Chinese parties (enterprises and individuals). The main feature of this investment form is that the two parties invest together, operate together, as well as take risk and share responsibility for losses and profits according to the ratio of their invested capital. The Sino-foreign joint ventures were among the first forms of China's foreign direct investment and they accounted for its largest share between 1978 and 1997.

In 1998, the introduction of exclusively foreign-owned enterprises as a form of FDI began. These are invested wholly by a foreign party in China (enterprises and individuals) in accordance with the laws of China. In the first three months of 2007, the numbers of newly-founded exclusively foreign-owned enterprises was 3.3 times the number of joint ventures.

At present, while continuing to opening its domestic market, China is also actively exploring and expanding the utilization of new types of foreign investment (e.g. build—operate—transfer). Since multinational M&As have become a major type of international direct investment, the government is now researching and enacting relevant policies to facilitate them in China.

Appendix 2: A Case Study

In 2001, FAG Railway Bearing (Ningxia) Company Ltd. was founded as a Sino-foreign joint venture between the Ningxia Northwest Bearing Co. and the German Schaeffler Group. In three phases, the latter gradually gained full control of the techniques, the brand and the market of the joint enterprise. FAG Railway Bearing (Ningxia) Company Ltd. became an exclusively foreign-owned enterprise in 2003.

Before its joint venture with the German Schaeffler Group, the Ningxia Northwest Bearing Co. was a large SOE (state-owned enterprise) with a nationwide brand. The enterprise contributed the majority of the Ningxia provincial tax revenue. One of their products, railway bearings, comprised 40 percent of the national market share and accounted for 40 percent of the company's profits before the JV. The JV was a 49:51 split in equity between the Chinese and German parties. The Chinese party gained their shareholdings through provision of land, factory buildings, facilities, market and production license, while the German party invested 8,520,000 euros. However, technical innovation and efficient management was slow, and management staff were even fired. By the end of the first year, the JV had a deficit of 9.8 million RMB ($1.26 million USD), and 13 million RMB ($1.7 million USD) by the second year.

The Chinese party was unable to increase its investment, and the German side then immediately bought their 49 percent stock. Once the enterprise became wholly foreign-owned, its products quickly passed the market qualification in the United States and the United Kingdom and rapidly developed an international market. The company turned from deficits to profits and the original Chinese enterprise lost its brand, marketing, production license and years of experience running the company.

Foreign Investment	Ratified Projects of Foreign Investment 2007 (Jan-Mar)	Actual Utilization of Foreign Investment	
		2007 (Jan-Mar) billion USD	Compared to 2006 (percent)
Sino-Foreign Joint Ventures	2114	3.141	-8.79
Joint Exploitation	168	0.354	-16.91
Exclusively Foreign-Owned Enterprises	7004	12.348	19.82
Foreign-Funded Share-Holding Companies	11	0.05	-28.64

Appendix 3: Transfer Pricing

'Transfer pricing' refers to the internal price which is adopted when commodities, labor or technologies are traded between the parent company and subsidiaries as well as between subsidiaries of multinational companies. It is not subject to the influence of supply and demand relationships in the international market, but works only to meet multinational companies' global strategic goals and global interest maximization goals. Suppose that one U.S. enterprise, which has invested and set up a factory in China, imports raw materials from its parent company at a price of $10. The cost, after it has increased its investment by $2 in China, should be $12. But, its subsidiary in China sells the product back to the parent company at a price of $11. In the accounting books, the China-based enterprise, which this U.S. firm has invested in, is at a loss. However, the parent company will, in all likelihood, sell the product to consumers at a price of, say, $14. This way, its profits are retained overseas and China income tax cannot be levied. The report from National Bureau of Statistics of China, *Study of Foreign Investment Usage and FIEs* shows that 55 percent of FIEs reported a deficit each year prior to 2005, two-thirds of them being 'abnormal'. They transferred profit to low-tax countries and regions by transfer pricing and avoided taxes in China by having deficit. According to statistics, China lost 30 billion RMB (($3.8 billion USD) as a result of FIEs' transfer pricing.

Notes

[1] Generally speaking, economic security means a state when a nation and its social and economic development are free from foreign threats and disturbance. It involves economic sovereignty, important economic interests, development and ability to hedge against major economic risks. "Russian Economy: the Present Situation, Threats and Challenges," East European, Russian & Central Asian Market Studies, 2004. See also: Dezhao Chen, et al., "Thinking on Economic Globalization and China's Economic Security Strategy," *Studies in International Technology and Economy*, 2000; Zhu Liqun and He Hongjing, "On Post-Cold-War Economic Security," World Economy and Politics, 1999.
[2] Joseph J. Romm, "Defining National Security: The Nonmilitary Aspects," New York: Council on Foreign Relations Press, 1993, 76-79.
[3] Liu Li, "Economic Globalization's Impact on National Sovereignty and New Concept of Sovereignty," *World Economics and Politics*, Issue 4, 2006.
[4] *Collected Works of Mao Zedong*, Vol. 7, People's Publishing House, p.380.
[5] According to the *World Competitiveness Yearbook* (released annually since 1986 by the International Institute for Management Development in Lausanne, Switzerland), in 2006 China's competitiveness ranking was 19th.
[6] Enterprises with foreign investment already possess the strength to affect the 'rises and falls' of the Chinese economy. Between January and September 2006, taxes paid by enterprises with foreign investment grew by 27.5 percent year-on-year, accounting for 21.4 percent of China's total tax revenues. Their increased taxes accounted for 25.59 percent of the national total. Currently, 25 million people are directly employed in enterprises with foreign investment, accounting for over 10 percent of China's non-agricultural labor population. See, "The 2007's Guide to attract Foreign Investment in China," Ministry of Commerce of People's Republic of China. http://news.xinhuanet.com/fortune/2007-03/23/content_5885928.htm
[7] "Invest in China," Ministry of Commerce of the People's Republic of China, Department of Foreign Investment Administration, See: http://www.fdi.gov.cn/pub/FDI/wztj/lntjsj/wstzsj/2005nzgwztj/t20060906_61374.htm.
[8] Ibid.
[9] According to a report from the Institute of Macroeconomics of National Development and Reform Commission, China's backbone industries include military engineering and defense technology, power grid, oil chemistry, wire, coal, civil aviation, shipping, finance and culture. See, Wang Zhe, the Review Mechanism of Foreign Merger floating surface, *China Trade News*, Feb. 15th, 2007.
[10] Zhao Jinping, Fang Jin, "Outlook for foreign capital utilization in 2006," *China Economic Times*, Dec. 2, 2005.
[11] The Industrial Map of China (2004-2005), Global M&A Center. See: http://image.welan.com/index/?id=1322189&name=中国产业地图(2004%20-%20-%202005)
[12] "Two Exemptions and Three Reductions" refers to the policy where foreign-invested enterprises are entitled to the treatment of exemption of enterprise income tax for two years and a 50 pecent reduction of enterprise income tax for three years from the year in which it started making profits. For more information see: http://www.mofcom.gov.cn/aarticle/b/f/200207/20020700031410.html
[13] Xin Hua, "Tax evasion ￥30 billion by FIEs," *Economic Information Daily,* Mar. 26, 2007.

[14] See appendix 3. Also see: http://www.jonesday.com/transfer_pricing/

[15] Xin Hua, "Tax evasion ￥30 billion by FIEs," *Economic Information Daily*, Mar. 26, 2007, http://jjckb.xinhuanet.com/gnyw/2007-03/26/content_42137.htm.

[16] Ibid.

[17] For the text of "Enterprise Income Tax Law of the People's Republic of China," see: http://www.lawinfochina.com/DisplayPart.asp?Type=2.

[18] Shi Yonghong, "Foreign capital flux into China with New Tax Law," *China Industry Economy News,* Jan. 1, 2007.

[19] By 2001, the amount of FDI Sino-foreign M&As that China absorbed accounted for just 4.96 percent. Taking the securities market as an example, there have been some 50 cases of M&As involving foreign capital in China in the past decade or so. Compared with the more than 5,000 cases of acquisition of stock rights of domestic listed companies by domestic capital, M&As by foreign capital are sporadic, dispersed and indirect. See, Sang Baicuan, Tai Ping, "Opportunities and challenges: foreign mergers and acquisitions' impact on China," *World Affairs,* Issue 12, 2005.

[20] Xia Bin, "Establish Merger Rules to Protect the Economic Security," *China Newsweek,* Issue 29, 2005.

[21] "The Great Wave of FIE Acquisition and China should be Alert of Monopolistic Acquisition," *Xinhua News Agency*, Mar. 14, 2006.

[22] Yang Xiaoli, "The Evolution of Chinese Foreign Capital Policy," *Pioneering With Science & Technology Monthly,* Issue 1, 2005.

[23] Xia Bin, "Establish merger rules to protect the economic security," *China Newsweek,* issue 29, 2005.

[24] "Prospects of merger and acquisition in China," 2007 Merger and Acquisition Summit Forum in Shanghai, China.

[25] China founded four financial assets management companies in 1999 and separated from Industrial and Commercial Bank of China, China Construction Bank, Bank of China and Agricultural Bank of China ¥1.4 trillion of non-performing loans, which were sold by these four financial assets management companies. The large amount of money used to separate the bad assets comes from state coffers, central bank refinancing and the issuance of financial bonds.
See, "Who Pays the Bill for ¥1.4 trillion of Bad Loans," *Xinmin Weekly,* Mar. 23, 2005,
http://stock.hexun.com/detail.aspx?id=1080795.

[26] Chen Wei, "The Crossroads of Financial Supervision," *China Business News*, Jan. 1, 2007, http://www.zgjrj.com/jrjg/20070202-21.htm.

[27] Jiang Yong, "Perspectives on Three International Credit Rating Companies," *Qiushi Journal*, Issue 19, 2006. See: http://www.ccn86.com/news/world/20070125/21409.shtml;
Jiang Yong. "Eight External Factors to Challenge Chinese Economic Security in the Period of 11th Five-Year Plan," *China Comment,* Issue 8, 2006.

[28] Ibid.

[29] Jiang Yong. "Perspectives on Three International Credit Rating Companies," *Qiushi Journal,* Issue 19, 2006. See: http://www.ccn86.com/news/world/20070125/21409.shtml.

[30] Ibid.

[31] Jiang Yong. "Alert to Departments' Interests Expansion," *Outlook Weekly*, Issue 41, 2006.

[32] Ibid.

[33] Regarding the "Unified Tax System," there were over ten years' debate within the government on whether or not to cancel the FIEs' preferential taxation rate. The Ministry of Commerce was

against the unified tax system while State Administration of Taxation and the Ministry of Finance were for it – for the purpose of increasing the state's tax income, promoting the development of Chinese enterprises and enlarging domestic demands. See: http://www.chinaacc.com/zhuanti/lshb/.

[34] Before 2005, SOEs were allowed to enter about 80 industries and foreign investments were allowed to enter about 70, while individual and private enterprises only 40. Restrictions are placed on individual and private enterprises on monopolistic industries such as energy, telecommunication and finance. In February 2005, the State Council released "Several Opinions of the State Council on Encouraging, Supporting and Guiding the Development of Individual and Private Economy and Other Non-Public Sectors of the Economy," stating that individual and private capital can enter any industry and field the foreign capital can enter. However, in practice, local government still place restrictions through ratification on individual and private capital on industries such as oil processing and wire. See, Kong Fanhe and Ma Qian. "China private enterprise's market entrance difficulty -- Probing into "Wei Erjing" Phenomenon," *Special Zone Economy*, Issue 6, 2006.

[35] "The Two-edged Sword: Trade Protection of the United States," *People Daily* (overseas edition), Apr. 12, 2007. See: http://news.xinhuanet.com/world/2007-04/02/content_5921716.htm.

[36] See: www.oecd.org/dataoecd/13/62/35032229.pdf.

[37] "Two Taxations Merger for the Fair Competition between Domestic and Foreign Enterprises," *Market News,* Oct. 30, 2006. See: http://finance.people.com.cn/GB/4972421.html.

[38] Economies of scope are conceptually similar to economies of scale. Whereas economies of scale apply to efficiencies associated with increasing or decreasing the scale of production, economies of scope refer to efficiencies associated with increasing or decreasing the scope of marketing and distribution. Whereas economies of scale refer to changes in the output of a single product type, economies of scope refer to changes in the number of different types of products. Whereas economies of scale refer primarily to supply-side changes (such as level of production), economies of scope refer to demand-side changes (such as marketing and distribution).

[39] "China has become the World's Processing Workshop*," China Business News*, October 2005 See: http://news.xinhuanet.com/fortune/2005-10/08/content_3592992.htm.

[40] Currently, the world average enterprise income tax rate is 28.6 percent. The average tax rate stands at 29.8 percent for OECD member states (39.5 percent in Japan, 29.7 percent in South Korea, 30 percent in Britain and 28 percent in Australia). The average in neighboring countries and regions of China is 26.7 percent (30 percent in India, 28 percent in Malaysia, 35 percent in Pakistan, 32 percent in the Philippines, 35 percent in Sri Lanka, 30 percent in Thailand and 28 percent in Viet Nam). See: http://news.china.com/zh_cn/news100/11038989/20070308/13977780.html

Foreign Acquisition in China: Threat or Security?

Wang Zhile

Two months after the U.S. Congress smothered China National Offshore Oil Company's attempt to merge with Unocal in August 2005, China's Ministry of Commerce stopped the American Carlisle Group from purchasing 85 percent of the shares in China's biggest machinery engineering manufacturer, the Xuzhou Construction Machinery Corporation (XCM). These events have triggered a new round of debates in China about the impact of foreign mergers on China's economic security.

More alarming than the actual number of foreign mergers and acquisitions (M&As) in China, which are small compared to China's domestic acquisition and ownership transfer, is their sharply increasing scale and accelerated rate in recent years.[1] There were 16 foreign M&A deals in China in 2003, compared to only three deals the year before. In 2006, the capital involved in foreign acquisition totaled $14 billion USD – an increase of 75 percent from 2005.[2]

Some critics are warning that foreign companies are entering the Chinese market with an intention to behead China's largest companies, that is, to buy them out in order to permanently eliminate competition from China's home-

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grown brands or establish monopolies in large enterprises of key industries, looking for annual rates of return higher than 15 percent.[3] Some even warn that in terms of economic security, China has dipped to its most dangerous period since the establishment of the People's Republic of China in 1949.[4]

But this is not the case. Rather, an investigation of China's economic security reveals that China is actually enjoying its highest degree of security since the mid-1800s.[5] Further, the quick pace of foreign mergers has brought numerous benefits to domestic businesses, the broader economy and society.

Demonization of Foreign Acquisition

As foreign-invested enterprises (FIEs) move into the Chinese economy, and as Chinese enterprises integrate with the global market more than ever before, voices of suspicion have become louder in opposition to FIEs and the preferential policies they have enjoyed in the past. To attract foreign investment, the Chinese government has granted FIEs preferential tax status since the 1980s – a mere 15 percent compared with 35 percent for Chinese enterprise.[6] However, a newly-passed Enterprises Income Tax Law eliminated the tax difference between FIEs and Chinese enterprises by instituting a 25 percent tax rate across the board.

The rationale behind these preferential policies is the two-gap model theory, which examines how foreign capital has been employed to meet a shortage of domestic resources in an economy. As such, foreign capital should be utilized when a country lacks foreign exchange reserves and domestic capital. However, with the rise of China's economic power, it has accumulated massive amounts of capital. In 2006, China's foreign exchange reserves reached over $1 trillion USD and its gross domestic savings totaled $2 trillion.[7] Opponents conclude that China's own capital resources are sufficient to sustain economic growth and thus, foreign capital no longer has the importance it once did in China's development and should be treated accordingly.[8] Foreign M&As are the new form of foreign investment in China and are therefore bearing the brunt of this domestic resistance.

Foreign mergers have brought numerous benefits to China.

A second reason against foreign investment, critics argue, is the trend of economic nationalism Chinese companies have experienced as they step onto the global stage. During its first five years in the World Trade Organization (WTO), China has rapidly become dependent on international markets in its domestic economy while its enterprises have also vigorously engaged investment opportunities overseas. The further China moves into the global market, the more economic protectionism and political barriers it encounters in developed countries.[9] These circumstances are leading to increasing sanctions for Chinese enterprises investing abroad. CNOOC's failed merger attempt with Unocal is of course the quintessential example of this. It was the political intervention from the United States that buried CNOOC's efforts to acquire the company. Many in China (mainly in academia) complain that while some developed countries strive to pry open foreign markets, domestic constituencies are courting economic nationalism, resisting acquisitions of their own domestic companies by Chinese enterprises – in contradiction to principles of unrestricted free trade within their own borders.[10] These critics propose that China should do the same and put the brakes on FIE mergers and acquisitions in China.

Competitiveness is the most important index for economic security.

The third and most important argument against foreign mergers and acquisitions is the increased risk of a monopolization of the Chinese market by FIEs and the corresponding threats they pose to China's economic security. The trend in foreign M&A investments in China in recent years is the targeting of large and leading enterprises in China's manufacturing industry such as automobiles, electronics, petrochemicals and machinery, which are capital- and technology-intensive and have promising market prospects. Through the stock market, FIEs also try to acquire state-owned enterprises that already have monopolies in industries such as banks, stock exchanges, telecommunications, harbors, aviation and even running water services. This has grabbed the attention of Chinese scholars, who fear that once FIEs have established a monopoly in these key industries, they will essentially possess the capability to manipulate China's market.

FIEs Enhance Economic Security

In the post Cold-War era, economy and trade more than anything else have come to define relations among nations. Every country is concerned about the health and sustainability of their economies. But what determines a nation's 'economic security'? Though the term is hard to define comprehensively for any nation, let alone in a unified way across an international plane, the theory that perhaps best describes the core of economic security is a nation's competitiveness, which gives it status and influence in international politics.[11] Competitiveness is defined as the degree to which a nation produces the goods and services that meet the grade in international markets.[12] In the open global market, a nation that has no ability to compete has little hope of protecting or sustaining its economic security.

From a microeconomic perspective of the individual enterprise, the most important index for security is competitiveness. This is particularly true in today's globalized business environment. To take one example, among the list of Fortune 500 companies publicized in 1996, only three were from mainland China; while in 2005, the number climbed to 18.[13] Chinese enterprises have not only rapidly increased in quantity, but also in quality. The average return rate on sales for the average Fortune 500 companies in 2005 was 6.4 percent, while the 18 Chinese enterprises in the Fortune 500 reached 6.9 percent.[14] China's national competitiveness has risen from 35th to 19th place in the past decade.[15] China's exports to the rest of world have increased 700 percent in the last 15 years.[16] In fact, since the end of 1970s, China's economic competitiveness has reached its highest point and its economic influence has reached its strongest. Based on these conditions, it is fair to conclude that the degree of China's economic security is now greater than ever.

The rise of a nation is always accompanied by its companies becoming world-class and competing in international market. The most important single factor that has given Chinese enterprises this global competitive advantage is the role that foreign-invested enterprises have played in the Chinese market. For one thing, FIEs brought in the capital, technology and expertise that China urgently needed to develop its economy from its very backwards state. Furthermore, the mere existence of foreign capital and FIEs in China introduced real world competition into the Chinese economy. FIEs played an important exemplary role that taught Chinese enterprises about the complexities of a market economy and of the importance of integrating into global markets. If Chinese enterprises had not been exposed to foreign-invested enterprises, which caused a shift in Chinese business practices, the SOEs would never have survived in the market. The effect of enhanced competition brought by the presence of FIEs in China's economy 'weeded-out' the weak enterprises and strengthened others. Chinese enterprises operate most dynamically and productively in the face of challenges from FIEs. It is FIEs that have also forced Chinese enterprises to 'internationalize' themselves within the short time span of two decades. In an emerging economy like China, the transformation from a planned system to a market economy would be impossible without the catalyst of foreign competition. Chinese enterprises may have decreased in number but they have vastly increased their competitive vitality and as such security enhanced. FIEs have also been positive role models in terms of energy conservation and environmental protection, and they will continue to be a catalyst for Chinese-invested enterprises to move toward environmentally sustainable economic growth. In a word, the positive effects of FIEs have been critical in the past to enhancing China's economic security and will do so in the future. China should encourage foreign investment and expansion of FIEs even though it has ample foreign exchange reserves and domestic financial assets.

In today's globalized world, China must also keep the nature of FIEs in perspective. They have not harmed China's economic sovereignty in the past. That is because they themselves, being registered under China's Company Law, have not only played an indispensable part in the development of China's economy, but comprise the most dynamic and competitive part of it. The statistics tell a highly constructive story. FIEs presently contribute up to one-third of China's industrial output, one-fifth of China's tax revenues and employ 25 million workers, accounting for more than one-tenth of the nation's urban workforce.[17] Half of technology transfers to China entered via FIEs. Their exports currently account for approximately 60 percent of China's total export volume and by the end of 2006, 590,000 FIEs had been registered, channeling $685 billion USD of foreign capital into the Chinese economy. Moreover, FIEs have converted their huge investment into fixed assets in China, including factory buildings, workshops and equipment. With their fate closely intertwined with China's, FIEs have equal reason to fear a downturn in the Chinese economy.

> *With their fate closely tied to China's, FIEs have equal reason to fear a downturn in the Chinese economy.*

Also, the notion of what foreign-invested enterprises means in China requires proper perspective. It is increasingly difficult to label enterprises operating in China as absolutely 'Chinese' or 'foreign.' The nature of China's traditional state-owned enterprises are also undergoing ground-breaking changes, as they increasingly seek overseas listing to absorb as much foreign investment as possible. In essence, this is shifting their nature and identity toward being more 'foreign.' Thus, we can neither treat FIEs as 'outsiders', nor the foreign acquisition of Chinese companies as 'foreign control of Chinese state-owned enterprises,' because the products of these activities do not change their status as Chinese enterprises governed by Chinese laws. Even if the controlling shares of, for example, XCM are held by the Carlisle Group or another foreign entity, it remains an FIE of China and a Chinese enterprise. Under these legal and economic parameters, such FIEs cannot be a threat to China's economic security.

Counterarguments

Theory vs. reality

The debate in China over larger issues of economic security is complex, but it can be roughly divided into two major camps. In one camp are the analysts in research institutes under government agencies, who approach the relevant problems more through the practical experience of China's economic development. In the other camp are the academics studying these issues who are more systematic in their thinking. However, their inevitable weakness lies in a lack of knowledge about what is really happening on the ground and how FIEs are behaving in the real world. When judging whether foreign M&As make China's economy more or less secure, these academics often borrow outdated theories popular in other countries during the 1990s. They don't fully grasp that much in these theories cannot explain China's unique situation. For instance, the theories of 'market economy' and 'two-gap model' have limited application in describing and understanding China's economy, an economy that is still in transition. Again, some in this group view FIEs with a bias that has raised their role in China's economy beyond mere commercial activity. Their status and activities have been exaggerated to the point that opposition to them in the framework of national security has taken on an almost ideological tone.

An Eye for an Eye

It is true that China's CNOOC encountered unfair political intervention in the Unocal deal. Generally speaking, Chinese enterprises are indeed facing increasing obstructions in their own M&A deals in developed countries for reasons that transcend mere commercial considerations. This is not a good trend. However, that does not change the fact that enterprises that rely on protectionist measures and avoid (for whatever reason) the energizing stimulus of competition will ultimately be weakened in the market. Such economic nationalism is misplaced and creates the conditions for a threat to a nation's economic security. Even the critics of FIEs in China acknowledge that U.S. political intervention in the deal was detrimental to America's economy as the deal would have brought benefits not only to China but the United States itself. If they truly believe this, then why should China make the same mistake? Restricting M&As by foreign companies violates the guiding principles of a market economy and globalization from which China has benefited so much. The U.S. economy still has much to offer to China both in terms of the success of its system as well as its failures.

Who's the Real Culprit?

Many academics also worry about the monopoly FIEs might establish through M&As.[18] In fact, they argue this has already begun in some of China's industries and conclude these activities are essentially pernicious.[19]

It is important to understand that possessing a dominant market share doesn't necessarily mean a monopoly. The centralization of market shares is one condition for achieving a monopoly, but it is more specifically a situation where an entity uses its advantageous market position to restrict competition from others. With a lack of competition, prices for goods and services can be set a price above the equilibrium price allowing the monopoly to reap excessive profits. In this sense, China doesn't have any industry monopolized by an FIE or multiple FIEs. Moreover, it would be inaccurate to think that a group of FIEs, along with their market shares, could establish a monopoly in a single industry. FIEs in any particular industry not only compete with Chinese entities but with each other. For example, in 35 Chinese cities, FIEs occupy nearly 70 percent of the sales of soaps, with Safeguard at 31 percent, Luxor at 18 percent and Dazze at 17.5 percent. All three enterprises vigorously compete in the market with no sign of monopolistic behavior, singly or in aggregate.[20] If

Possessing a dominant market share doesn't mean a monopoly.

there is any danger of monopoly in China, it is by the state-owned enterprises that restrict access to others through administrative and political measures.

Although single FIEs do control the majority of market shares in a few industries, one FIE cannot establish an effective monopoly in the short term. Effective laws and regulations should suffice to constrain any tendencies by FIEs to establish a monopoly. Even if an FIE can establish a monopoly through a merger or acquisition, it would be a defect with China's market competition system rather than one of national economic security. China has been successful in channeling and managing foreign investment thus far, arguably under especially trying circumstances of China's reform and opening up, and the government should have the confidence in its ability to manage and constrain FIEs.

It's the Mutual Integration, Stupid!

Some critics have also argued that an influx of FIE brands causes the loss of China's homegrown brands and intellectual property rights, endangering China's 'identity' and economic security. One example cited is how *Coca Cola* has captured the market of soft drinks resulting in the virtual disappearance of China's own brands. There is no denying that Chinese enterprises sometimes are losers in this game of globalization and competition, yet Chinese enterprises have their own successes in creating brand names. For example, in 2005, Shanggong Shenbei Corporation, a Shanghai-based company, acquired a leading German industrial sewing machine manufacturer along with its advanced core technologies and world famous brands. As a result of this acquisition, this Chinese firm owns not only the brands, but the patents as well as the R&D center of this German firm. In this globalized market, stock equity, capital and ownership are highly fluid. FIEs in China have opportunities to acquire intellectual property and impact China's indigenous brand names, but Chinese enterprises have the same opportunities worldwide.

Toward Enlightened Economic Security

China needs to sustain an economic growth rate of at least two or three times higher than the world's average if it is to rise in the global economy. This feat will require China to move beyond its borders for more resources. Until the Second World War, all rising powers used war as the means to seize international resources for economic growth. Following this epoch, military force was no longer acceptable to accomplish these goals and in its place, the developed countries used unfair international trade and pricing mechanisms. For example, between 1917 and 1973, petroleum prices were maintained at $1.60 USD per barrel and developed countries relied on the cheap energy prices to sustain their growth. When it was China's turn to rise up, the use of force and skewed trade practices were no longer options. The only road for China to take is in accessing international resources through market exchange and competition. This means playing fairly and by a set of rules, but that does not diminish China's ability to obtain what it needs to sustain its economic growth. In fact, to achieve these goals, China must increasingly employ foreign investment, foreign trade and an expansion of Chinese enterprises overseas. In other words, China must commit itself even more fully to the trends of globalization.

China did not participate in the past two rounds of globalization, resulting in the nation's poverty and backwardness.[21] However, in this third, and current wave of globalization, China is perhaps the country that is riding this wave to the fullest. Commitment to globalization is perhaps most embodied by China's joining the WTO, into which it has fully locked itself. Both the world and China have benefited greatly from this commitment. Cheap goods from China have helped rein in international inflation and stabilized the world economy. China too has benefited enormously. The foreign investment that has flooded into China since 2001 accounts for 45 percent of all foreign investment China has received in the past 28 years. The volume of China's foreign trade reached $1.7 trillion USD in 2006, upgrading China's foreign trade dependency to 70 percent (greater than the United States). Chinese enterprises are also taking advantage of global economic practices by 'going out' - obtaining and investing in resources overseas. This hasn't made the Chinese economy insecure. On the contrary, fair international trade has allowed China to prosper. It is globalization that is playing to China's advantage with the country's great potential in human and capital resources. China itself has realized that the more integrated it is to the international community, the more influential China grows, and the more secure the nation becomes.

Only by embracing globalization can China move beyond its borders to access resources.

Therefore, the Chinese government must continue to follow the rules governing the market when managing foreign investment and FIEs. First and foremost, it is imperative to create a level playing field for Chinese state-owned enterprises (SOEs), privately-owned enterprises and FIEs to allow them all to both compete and cooperate fairly. This will entail the elimination of government protection and administrative intervention for any one type of enterprise, including SOEs. Naturally, in the short run, privately-owned enterprises and FIEs will grow faster than SOEs.[22] In the long run, the pressures and challenges the former can bring to bear on SOEs will surely play a critical role in driving them to greater efficiency. In this aspect of economic reform, China still has a long way to go.

Although the government previously imposed complicated approval procedures on foreign acquisition and merger deals, this is now changing. The process is gradually being simplified and more industries are opening for foreign acquisition. In December 2006, China publicized a new policy titled *Guidelines on Promoting Adjustment of State-owned Capital and Reorganization of State-owned Enterprises.* Under these guidelines, state-owned entities are to maintain "absolute control" in seven key industries and keep "relatively strong control" over several others.[23] Even in these sectors under absolute control however, foreign investment is not entirely shut out, as long as the SOEs are the controlling shareholders. In the petroleum industry, traditionally under absolute control of SOEs, 30 percent of CNOOC shares are held by foreign entities. Finance is an area requiring "relatively strong control," yet 25 percent of China's Construction Bank shares are in the hands of foreign investors. Four major telecommunication operators have also been listed overseas. 2006 saw the enacting of another policy, the *Interim Provisions on the Takeover of Domestic Enterprises by Foreign Investors*. It essentially provides guidance for all levels government and administrative agencies on foreign capital M&As.

The sum of these laws and regulations have both clarified and simplified approval procedures, which is a worthy aim. Yet, even in a market economy, foreign investors are not given absolute freedom to invest in a domestic market. The government is working to produce effective mechanisms for the examination and approval of foreign M&As that will include legally-established asset evaluation institutions to prevent any undervalued transfer of ownership, assets or shares of state-owned enterprises. Four categories of enterprises will draw particular scrutiny in such reviews and will have to be approved by Ministry of Commerce if they involve foreign acquisition: key industries, those that affect

China's national economic security, those with nationally-known brands or traditional brands with long histories.

The Chinese government should increase the transparency in economic information and government policies. In the planned economy, all the planning, decision-making, management practices, foreign trade policies and data were classified. The government has improved greatly in publicizing policies and data in the past several years. However, old habits die hard and confusion often still reigns with the boundaries blurred between commercial secrets, state secrets and open information. Information that should be publicized is still kept secret while certain commercial and state secrets are released. China should pass laws to regulate the flow of this information to raise the barriers on secret material while lowering the barriers to other information for foreign investors. Information transparency also means transparency and democracy in regards to the governmental economic decision-making process. The government should seek advice from the SOEs, privately-owned enterprises and FIEs when designing economic policies, as they all have their own legitimate interests.

Lastly, while this paper has argued for the creation of a level playing field for all enterprises operating in China, that primarily means an adjustment of past blanket preferential treatment for all foreign capital. That is not to say preferential treatment *per se* should no longer be employed. It should still be used for specific industries and regions that are particularly lacking in China such as the high-tech industry or in underdeveloped parts of western China or for investment that is particularly beneficial in energy conservation and environmental protection. However, preferential treatment serving these development goals should extend to all forms of capital, whether foreign or domestic.

Notes

[1] According to statistics from Credit Suisse First Boston, there were 1,700 domestic acquisitions that totaled 125 billion RMB in China from 1998 to 2001, among which 66 were foreign acquisitions that totaled 6.6 billion RMB. See, "The Sudden Appearance of the Peak of Foreign Acquisition,"Chinese Academy of International Trade and Economic Cooperation of Ministry of Commerce, Sep.11, 2006. See: http://caitec.mofcom.gov.cn/aarticle/a/m/200609/20060903116014.html
[2] "FIEs Push Forward the Wave of Acquisition," *Global Business and Finance*, Apr. 6, 2007. See: http://www.baolai123.cn/FinanceNews/economist/jingjiguancha/20070406/19293480436.shtml
[3] "Beheading Purchase by Foreign Capital Threatens China's Economic Security," *China Political Affairs Information Network*, March 2006
[4] Han Deqiang, "China's Economic Security Has Come to the Most Dangerous Period," *China and World Observer,* Issue No. 3, 2006
[5] Wang Zhile, "foreign merger and economic security in China," *China and World Observer,* Issue No. 3, 2006
[6] Besides exempting foreign-invested enterprises from corporate income tax for two years and allowing them to pay tax at half the standing rate for three years thereafter, Chinese government exempts 15-24 percent income tax from FIEs while a full 30 percent from domestic-funded enterprises.
[7] National Bureau of Statistics of China, See: http://www.stats.gov.cn/tjsj/ndsj/
[8] Zuo Dapei, "Remove Foreign Capital Myth and Prohibit Foreign Acquisitions of State-owned Enterprises," *China and World Observer,* Issue No. 3, 2006
[9] Ye Fujing, "Financial Open with the Governmental Protection Mechanisms," *China and World Observer,* Issue No. 3, 2006
[10] Shi Jiansan and Shi Yubin, "The Difficulties Chinese Enterprises Face in Oversea Acquisition," Dec. 19, 2005. See: http://www.g-view.com.cn/nei.asp?ID=777
[11] Robert·Gilpin, *War and Change in World Politics*, trans. People's University Press, 1994.
[12] Joseph J. Romm, *Defining National Security: The Nonmilitary Aspects*, Council on Foreign Relations, 1993, p.76
[13] "Newest Fortune 500 List, 18 Chinese Companies Listed," *Xinhua News Agency*, July, 14, 2005. See: http://news.xinhuanet.com/fortune/2005-07/14/content_3218087.htm
[14] Wang Zhile, "FIEs Are Part of China's Enterprises," *People's Daily*, Aug. 8, 2006. See: http://mnc.people.com.cn/GB/54828/4678316.html
[15] According to *World Competitiveness Yearbook (from1995 to 2006)* by the International Institute for Management Development.
[16] "The Emergence of China and India," See: http://www.weforum.org/pdf/summitreports/am2006/emergence.htm
[17] Ministry of Commerce of People's Republic of China, See: http://www.mofcom.gov.cn/
[18] "Foreign Acquisition Must Pass the Test of Anti-monopoly," *Nanfang Daily*, Aug. 11, 2006. See: http://www.nanfangdaily.com.cn/southnews/tszk/nfdsb/ttcf/yw/200608110572.asp
[19] According to the report of Development and Research Center of State Council, FIEs hold a dominant position in 21 of 27 China's industries. In the past 15 years, FIEs' percentage in the total national gross industrial output values rose from 2.28 percent to 35 prcent. In industries such as light industry, chemical industry, medicine, machinery and electronics, products by FIEs make up 1/3 of the national market share; See: "Reexamine the Role of FIEs, 21 among China's

28 Industries Are Under the Control of FIEs," *People's Daily,* Sept. 2, 2006. See: http://mnc.people.com.cn/BIG5/54823/4772811.html

[20] Zhang Shixian, *A Research of China's Development Strategy of Attracting FDI*, 2000.

[21] The first round of globalization, which lasted from the great geographical discoveries around 1500 to the end of the industrial revolution, was a globalization of trade. The second round of globalization, which lasted from the direct overseas investment at the end of the 19th century to the end of the Second World War, was a globalization of funds. The third round of globalization, which started after 1973 when the petroleum crisis led to the end of the gold standard, was a globalization of currency and finance.

[22] "FIEs Income Is 7 Times Higher than that of Domestic-Funded Enterprises," *Sina*, Jan. 23, 2006.
See: http://finance.sina.com.cn/g/20060123/11442298934.shtml; "Enterprise Income of Chinese Private Enterprises," *Xinhua New Agency*, Feb. 3, 2005. See: http://news.xinhuanet.com/fortune/2005-02/03/content_2542198.htm; "The Impact of the Release of Enterprise Income Tax Law of the People's Republic of China," *People's Daily*, Mar. 20, 2007. See: http://finance.people.com.cn/GB/8215/79833/5491577.html;

[23] Under the Guidelines on Promoting Adjustment of Sate-owned Capital and Reorganization of State-owned Enterprises, the seven industries of war industry, power grid and power, petrochemical, telecommunications, coal, civil aviation and shipping are defined as "vital industrial and crucial fields that relate to national security and the life line of national economy", where State capital should keep "absolute control."