

Foreign Direct Investment Liberalization in Communist Regimes: A Theoretical Model Based on the Comparison Among China, Cuba, North Korea, and Vietnam

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Abstract

What are the driving factors for foreign direct investment liberalization in formerly communist countries? Previous research explains foreign direct investment liberalization as a function of the intensification of international commerce and democratization; however, the likes of China, Cuba, North Korea, and Vietnam hardly fit into this narrative. The following contribution makes a theoretical argument about the causes of foreign direct investment liberalization in communist authoritarian regimes with highly centralized and closed economies. We argue that foreign direct investment liberalization is caused by external shocks materializing in policy adaptations. The degree of foreign direct investment liberalization depends on the balance of power between actors who favor liberalization and actors who stand to profit from rent-seeking economies. The relative power of both factions determines the magnitude and type of foreign direct investment liberalization. We test this theoretical argument using case studies, which include China and Vietnam as representatives of gradual transitions and Cuba and North Korea as representatives of traditional rent-seeking economies.

Keywords

Communist regimes, economic liberalization, economic reform, FDI

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Introduction

The recent wave of globalization, which began in the 1980s and continued until the financial crisis of 2007, was largely driven by the economic integration of developing

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countries into the global economy, among them many former centralized economies, such as China and Vietnam. In 2017, the Chinese economy accounted for 30% of global economic growth, dwarfing the contribution of Western countries to the growth of the world's economy (International Monetary Fund, 2018). Foreign direct investment (FDI) liberalization and joint ventures with foreign companies played a crucial role in this context, as they contributed significantly to the Chinese and Vietnamese economic miracles (cf. Chen et al., 1995; Hoang et al., 2010).

However, the introduction of property rights into centralized economies and the subsequent decentralization of economic and political decisions (Acemoglu and Robinson, 2012; Coase, 1960) entails high risks for authoritarian leaders (Treisman, 1999). As a result, we have only limited knowledge as to why and how some countries were able to implement policies conducive to a full-fledged transformation while others, such as North Korea and Cuba, remained stuck in heavily centralized economic systems. To gain more insight into the matter, we develop a theoretical argument derived from previous literature on FDI and capital flow liberalization to explain why and how formerly communist countries liberalized their legal frameworks regarding FDI. Although literature has already covered major aspects of FDI liberalization (e.g. Acemoglu and Robinson, 2012; North et al., 2009; Pandya, 2013; Pepinsky, 2008, 2009, 2013; Quinn and Inclan, 1997), we argue that these approaches need to be tailored to the power constellations prevailing in centralized economies and the dimension of foreign affairs. To validate our argument, we examine case studies based on the historical cases of China, Cuba, North Korea, and Vietnam, as the comparison of the countries within this group tells much about the institutional preconditions and constraints of FDI liberalization. Furthermore, we find that socioeconomic shocks determine the timing of FDI liberalization, whereas the constellation of a domestic coalition dictates the pace and depth of socioeconomic reforms. Both aspects relate to each other, as shocks might not only necessitate the adaptation of liberalization policies but can also alter the preferences and constellation within the supporting coalition of the regime.

Literature Review

Previous theoretical work and empirical studies on FDI liberalization and capital openness (cf. Chwioroth, 2010; Eichengreen and Leblang, 2008; Pandya, 2013; Quinn and Inclan, 1997; Vadlamannati and Cooray, 2014) concentrated on democratization, spillover effects, and domestic power constellations as drivers of economic liberalization. According to quantitative research (Pandya, 2013; Quinn, 2003), FDI liberalization and financial openness seem to be tied to democratization, reflecting the viewpoint that the enhancement of political liberties goes along with improvements of economic rights (cf. Eichengreen and Leblang, 2008). In addition, the process of FDI liberalization seems to be driven by competition among nations to attract foreign companies, as FDI liberalization in one country seems to increase the likelihood of regulatory changes in the immediate neighborhood (cf. Oman, 1999; Vadlamannati and Cooray, 2014). According to Quinn and Inclan (1997), the groups supporting ruling political parties, such as organized labor or owners of capital, determine the degree of participation in globalization. Pinto (2004) draws similar conclusions, attributing the variance of FDI liberalization to the business- or labor-friendliness of the government. However, what about FDI liberalization in dictatorships? The narrower size of the support group notwithstanding (Bueno de Mesquita, 2003), the connection between policy design and the interest of domestic interest groups

seems to matter for non-democratic countries as well. The Indonesian New Order (Chwieroth, 2010) and Malaysia's and Indonesia's reactions to the Asian financial crisis of 1997–1999 (Pepinsky, 2008) illustrate the relevance of socioeconomic power structures and the distributional implications of macroeconomic shocks: While trade intermediaries stand to profit from participation in globalization, the interests of producers depend on their position vis-à-vis the world market (Pepinsky, 2013).

Previous literature bears several implications for our case study. The first is that FDI liberalization in the 1980s occurred against the backdrop of a wave of globalization. The level of globalization constitutes an important precondition for legislation changes in communist countries, as the rationale for FDI liberalization is based on the assumption that foreign enterprises are willing and able to invest overseas. Although democratization and spillover effects seem to explain the overall tendency toward countries' increasing participation in global trade, the countries we observe do not fit into the typical pattern of FDI liberalization for three reasons. The integration of China and Vietnam in the global economy proceeded without significant democratization, while Cuba and North Korea embarked on neither economic liberalization nor democratization. Moreover, the actors typically categorized as drivers of liberalization, such as owners of private businesses (Quinn and Incan, 1997) or financial intermediaries (Pepinsky, 2013) did not exist in centralized economies. Finally, the role of foreign affairs appears to be underestimated in the previous literature, which has been mainly concentrated on countries with positive (OECD) or stable (Malaysia, Indonesia, Mexico) relations with the West (Pepinsky, 2008, 2013; Quinn and Incan, 1997).

Theoretical Considerations

Power Preservation and Rationality

According to Bueno de Mesquita (2002, 2003), decisions of political leaders can be understood as rational cost-benefit calculations, ultimately aimed at gaining or preserving political power. The intensive debate surrounding the term “rationality” requires a deeper reflection on the concept of instrumental rationality used here. In our view, rational choice does not mean that political leaders are acting sustainably (cf. Kahneman and Tversky, 1979; Loewenstein and Prelec, 1992) or on behalf of the national interest (cf. Allison, 1969; Nuechterlein, 1976), as the constant struggle of individuals and groups—in democracies and dictatorships alike—forces policymakers to sacrifice long-term benefits to survive politically in the short run. To satisfy the demands of domestic supporters and foreign powers (Bueno de Mesquita, 2002, 2003), leaders have to consider formal and informal restrictions imposed by political groups that support the leadership and strive to enforce their special interests on a regulatory level (cf. Pepinsky, 2008). This “institutional matrix,” resulting from the relative power of groups separated by different interests, constitutes an equilibrium that changes and evolves over time (cf. North, 1991). Based on these considerations, we derive the following broad assumptions about political decision making:

- Political decisions are based on the cost–benefit calculations of rational actors, who strive to preserve their power (cf. Bueno de Mesquita, 2002, 2003);
- Domestic power constellations and foreign relations determine the way leaders can realize power preservation (cf. Bueno de Mesquita, 2003; North, 1991);

- Leaders are aware of the impact of their decisions on their support group. Otherwise, they would be replaced by other candidates (cf. North, 1991; Pepinsky, 2008).

Support Coalition and FDI Liberalization in Centralized Economies

Given the absence of private enterprises, the support coalitions of the regimes, which we understand in the tradition of Pepinsky (2008, 2013), consist of the military, state sector, and local decision makers, who try to enforce their interests on the regulatory level.

The Military and the State Sector. Given its access to personnel, resources, and weapons, maintaining the loyalty of the military is crucial for realizing regime stability (cf. North et al., 1999, 2009). Its preferences in terms of closer integration with foreign countries hinge on its involvement in the economy: If the military has a vested interest in the economy and in the state sector, pursuing privatization and inducing competition would reduce its economic rents (cf. Acemoglu et al., 2010; North, 1991; Pepinsky, 2008). Moreover, the prioritization of the economy might come at the expense of the military due to cuts to the military budget following a more peaceful foreign policy approach (cf. McDonald, 2004).

Local Decision Makers. Whereas country-specific starting conditions of local leaders might depend on more general variables such as population size and geographical features (cf. Campbell, 2003), economic decentralization is likely to increase the freedom of decision makers on the local level, as the central government is unable to regulate all details of national FDI policies (Malesky, 2008). Local decision makers including subnational officials such as governors, state legislators, mayors, party bureaucrats, and city council members possess political authority and fiscal autonomy on the local level and are able to reap political and economic benefits from commercial exchange, if they expect increased revenues from liberalized foreign trade and investment (cf. Weingast, 2014). Opening to the world, however, does not automatically translate into growth, and local decision makers are more inclined to opt for liberalization if their constituencies have a comparative advantage in the global economy (cf. Pepinsky, 2013; Quinn and Inclan, 1997).

External Shocks as Triggers of Policy Changes

External shocks are developments that are beyond the control of policy makers and are followed by subsequent domestic political alignment processes in reaction to these shocks. Shocks can range from financial crises (Pepinsky, 2009, 2013) or the death of political leaders (Dukalskis and Gerschewski, 2020) to a changing environment in international relations or suddenly increasing economic competition (cf. Vadlamannati and Cooray, 2014). Leadership transitions appear to be critical when combined with other shocks: Dukalskis and Gerschewski (2020) argue that second-generation leaders in China and Vietnam could make ideological changes after the death of the first generation of leaders and within a friendlier external environment (cf. North et al., 1999).

In the context of FDI liberalization, shocks might play a twofold role: First, potential external shocks happen frequently, but they do not all result in FDI liberalization. Enhancing foreign investment must be seen as the remedy to resolve economic problems

created by a shock. This happens when a crisis interrupts the traditional business model of a regime and forces it to seek alternative forms of rent creation. Examples would be a sharp decline in resource prices, the economic collapse of a key ally, or a military conflict. Likewise, a sudden improvement of political relations allows a government to engage in economic relations without compromising too much on foreign policy. A major transformation is even more likely if negative and positive shocks coincide, forcing decision makers to speed up FDI liberalization. Second, economic and political shocks might unleash changes within the coalition supporting the authoritarian regime (cf. Pepinsky, 2009), which can—depending on the prevailing conditions—materialize in the adjustment of economic policies. Outside factors, such as political tensions (Bueno de Mesquita, 2002), an economic crisis (cf. Pepinsky, 2013), or even the death of a leader of a personalistic regime, might tip the power balance toward a specific group within the support coalition of the regime, imposing its preferences on foreign trade and investment legislation.

FDI Liberalization and Domestic Reforms

After a significant shock, FDI liberalization follows the form of the prevailing incentive structure, which determines the power preservation strategy of the regime in the moment of the crisis. Oksan Bayulgen (2010) distinguishes between types of capital flow according to their destinations and impact on democratization in the post-Soviet area. Based on her classification of capital flow supporting the prevailing structure as opposed to FDI in the private sector, we differentiate between two types of policies aimed at attracting foreign investment.

FDI Attraction without Domestic Reforms. The first type of policy describes the existence of isolated interactions between the regime and the foreign enterprises, tailored to the way the regime generates power. The design of the interaction here functions to generate stability by rent extraction—particularly in rentier states (cf. Bayulgen, 2010; Croissant and Wurster, 2013; Von Soest and Grauvogel, 2017). The role of foreign companies here is to raise the productivity of local mines and factories through superior technology and facilitate the export of resources abroad (cf. Alfaro and et al, 2004; Bayulgen, 2010; Koizumi and Kopecky, 1980). Economic growth generated by these joint ventures increases the capacities of regimes and bolsters the legitimacy of authoritarian regimes without major economic or political liberalization (cf. Feng, 1997).

FDI Liberalization Embedded within Domestic Reforms. The second type of policy applies to transformation to a more market-oriented economic structure, represented by the cases of China and Vietnam, which have gradually embarked on substantial liberalization of international capital flows. Here, FDI liberalization serves as a tool for opening the economy, as the policies are intended to change the socioeconomic system and encourage participation in globalization. In contrast to the first type, the legitimacy of a regime is based on socioeconomic performance (cf. Croissant and Wurster, 2013; Feng, 1997; Von Soest and Grauvogel, 2017). Spillover effects play a crucial role here, as foreign enterprises provide technologies to countries with low levels of development, which in turn raises the productivity of the economy (cf. Alfaro and et al, 2004; Borensztein et al., 1998).

Methodology

Due to the limited number of centralized economies falling into the category of former communist regimes, missing statistical data of the observed period (1970s–1990s), and difficulties in quantifying some of the variables observed, such as international relations or the structure of domestic coalitions, we favored the design of a case study (cf. Collier and Mahon, 1993; Lijphart, 1971). The advantage of this research methodology is its strength in the identification of omitted variables and the development of a historical explanation that considers path dependency and causal mechanisms, which are hard to examine through mere statistical analysis (cf. Eckstein, 1975; Lijphart, 1971).

The total population consists of authoritarian regimes that share the characteristics of a high degree of economic centralization and an economy closed to foreign investors. These countries have, in most cases, been governed by nominally communist or socialist parties.¹

We follow earlier research (including Dukalskis and Gerschewski, 2020) that compared processes of political change in communist and post-communist countries and decided to focus on North Korea and Cuba as typical cases of a low degree of FDI liberalization and on China and Vietnam as representatives of economies that engaged in liberalization of foreign trade and privatization of large parts of the economy. The selection of the countries therefore constitutes a mostly similar case scenario (Seawright and Gerring, 2008). In spite of different outcomes, all four cases have major commonalities: The high degree of economic planning in the respective economies during the 1950s to 1960s, for example, resulted in the virtual absence of FDI for decades (cf. Pérez-López, 1986).² Moreover, the economies only gradually transformed their economic policies, as the socioeconomic transformation processes were neither interrupted nor triggered by revolutions or wars. The focus on North Korea, China, Vietnam, and Cuba allowed us to focus on the decisive elements of the theory, namely the power constellations among the various socioeconomic groups, the role of the military in the society, and the changes in the geopolitical situation, depicting the “crucial differentiating” causes (Epstein, 1964) that resulted in different adaptations to FDI policy. As the representativeness of the studied countries Cuba, China, North Korea, and Vietnam for the processes in other post-communist countries is fairly limited, the theory tested here does not provide a universal explanation for FDI liberalization in all centralized economies. Instead, it tests the validity of our argument in authoritarian regimes that survived the end of the USSR without regime change or democratization.

Case Study: FDI Liberalization in Communist Regimes

The following case study concentrates on two pivotal aspects of FDI liberalization. The first part addresses the time frame of FDI liberalization and examines whether and which external shocks translate into significant legal changes, while the second is devoted to the impact of the shock on the support coalition and the question of how shocks influence the degree of FDI liberalization.

Time Frame of FDI Liberalization

In the following, we test our argument on the cases of Cuba, China, North Korea, and Vietnam. Based on the assumption of policy makers’ cost–benefit calculations, we argue

Table 1. Shocks and Policy Adaptions.

Dimension	Time period	Major event	Legislative impact
China	1976–1986	Sino–Soviet split (1959–1989) Cultural Revolution (1966–1976) Death of Mao Zedong (1974)	Joint Venture Law (1979) Chinese Agricultural Reform (1979) Special Economic Zone in South China (1980)
Vietnam	1986–1996	Reunification (1976) Cambodia campaign (1978–1989) Death of Le Duan (1984)	Reform of the collective farm system (1981) Law on Foreign Investment (1987)
DPRK (1)	1984	North Korean debt crisis (1980)	Joint Venture Law (1984)
DPRK (2)	1992–1998	Breakdown of the USSR (1990)	Law on Foreign Investment (1992) Rason SEZ Law (1993)
Cuba (1)	1982	Debt crisis (1982)	Joint Venture Law (1982)
Cuba (2)	1995–2000	Breakdown of the USSR (1990)	IV. Communist Party Congress (1991); Export Processing Zones (1995); Amendment of the Foreign Investment Law (1995)

This compilation is based on laws concerning joint ventures and wholly owned foreign enterprises in the respective countries; DPRK: Democratic People's Republic of Korea.

that FDI liberalization follows an external shock that disrupts the business model of the regime.

China. In the case of China, the timing of economic liberalization coincided with severe socioeconomic shocks (Table 1) and the transition of power from the first to the second generation of leaders. Previous events that were partly policy choices of the Chinese government and earlier socioeconomic shocks such as the Sino–Soviet split had shaped the circumstances of the transition from Mao Zedong to Deng Xiaoping (Vogel, 2011; Zhang, 2016). China was in the midst of a severe socioeconomic crisis triggered by the failed Great Leap Forward (Memorandum of Conversation, 1987), and the aftermath of the Cultural Revolution posed a difficult political challenge for the new leadership. Orchestrated by Mao Zedong, the revolution had destabilized the country, dividing it between modernizers calling for economic liberalization and conservatives carrying on the Maoist heritage (cf. East German Report, 1974). Unlike other communist countries, China could not rely on technological or economic support from the USSR, as the geopolitical tensions between the communist superpowers reached their pinnacle in the 1970s (Gorbachev, 1995; Memorandum of Conversation, 1987). As a result, the Chinese government was forced to search for alternatives in light of the standoff between Moscow and Beijing. Legal measures taken in this period were intended to enhance “the development of the productivity forces”³ and included, for example, the Chinese-Foreign Equity Joint Ventures Law of 1979, adopted by the 5th National People’s Congress, or the Regulations on the Special Economic Zones (SEZs) in Guangdong Province of 1980, which allowed for stronger economic exchange with Western countries as well as rapprochement with the United States and Japan (Vogel, 2011).

Vietnam. The Vietnamese open-door policy proceeded in a similar environment and shares many characteristics with the Chinese case. After the death of Le Duan, who represented the hardliner camp, the new leadership under Nguyen Van Lin needed to stabilize the socioeconomic situation (Shenon, 1998). After reunification in 1975, Vietnam experienced severe economic crisis due to the inability of central planners in Hanoi to overcome economic struggles and recession resulting from reunification. (Boothroyd and Pham, 2000; Pham, 2016; Vasavakul, 1995). Moreover, the transformation of South Vietnam into a centralized economy discouraged private efforts to rebuild the war-torn country, resulting in a comprehensive social and economic crisis (Pham, 2016). The situation was aggravated by mass emigration (Beresford, 1989), a soaring inflation rate peaking at 700% from September 1985 to September 1986 (cf. Alpert, 2005), civic unrest (Kolko, 1997), the Sino–Vietnamese Border War, and the financial burden of Vietnam’s Cambodia campaign.⁴ As a result, stabilizing Vietnam’s ailing economy demanded gradual liberalization and trade diversification, as Soviet aid proved insufficient to rebuild the entire country (Hoan, 1991).

Cuba and North Korea in the 1980s and 1990s. In the cases of North Korea and Cuba, it is necessary to distinguish between different waves of FDI liberalization. Both countries were exposed to several external shocks beyond their immediate reach, including the Chruschev’s secret speech and the subsequent de-Stalinization of the USSR (Lankov, 2006), the Cuban missile crisis (Fardella, 2015), and Nixon’s visit to China (Xia and Shen, 2014). Although these events had sizable impacts on ideological questions and bilateral relations, they did not cause major economic turbulence (Fardella, 2015). North Korea and Cuba rather sought to rebalance economic relations by diversifying trade with nonaligned nations (Fardella, 2015; Lankov, 2006).⁵ The first wave of FDI liberalization in Cuba (1982) and North Korea (1984) was triggered by the declining economic performance in both countries. The Cuban economy of the 1980s was characterized by a recession (Lopez and Garea, 2015) and a severe debt crisis (Turits, 1987) that coincided with the first law on joint ventures. Two years before, North Korea had defaulted on Japanese loans, but lukewarm efforts to transform the economy in 1984 through joint ventures with overseas Koreans loyal to Pyongyang (cf. Soble, 1985) and cosmetic changes to the regulatory framework did not yield fundamental changes. It took the collapse of the USSR for North Korean and Cuban leaders to ultimately engage in the second wave of FDI liberalization (cf. Vargas, 1996; Zakharova, 2016). In the absence of political allies willing to provide both regimes with developmental aid, garnering foreign investment was the only solution remaining for overcoming the crisis. Legal changes that indicated that FDI attraction was an immediate response to this shock were the North Korean Foreigner Investment Act of 1991 and the Cuban Foreign Investment Act of 1995 (cf. Lopez and Garea, 2015; Park, 2007; Vargas, 1996; Zook, 2012).

FDI Liberalization and the Support Groups

While the shock argument explains the timing of FDI liberalization, it does not explain why Cuba and North Korea evaded the extent of domestic reforms enacted in China and Vietnam. To illustrate how FDI liberalization proceeds in countries dominated by the interests of rent seekers, we begin with descriptions of the North Korean and Cuban cases. We then shift our attention to how and the reasons why China and Vietnam departed from centralized economies and evolved into market-oriented economies.

Cuba and North Korea. In Cuba and North Korea, socioeconomic structures characterized by monopolies with strong ties to the military and governmental institutions impeded economic liberalization. Prior to the dissolution of the USSR, the Cuban regime generated rents in the sugar industry and in barter trade with the USSR (cf. Mesa-Lago, 2008, 2009; Piccone and Trikunas, 2014; Turits, 1987). The breakup of the USSR and the decline in sugar prices in the 1990s (cf. Radell, 1991; Turits, 1987) disrupted this business model and hit state-owned enterprises in the nonsugar manufacturing industry, which declined by 85% from 1989 to 2007 (cf. Johns, 2003; Mesa-Lago, 2008). As a result, the economy gravitated toward the exploitation of natural resources and the tourism industry, both controlled by regime-affiliated companies (cf. Mesa-Lago, 2008; Piccone and Trikunas, 2014; Rampton and Marsh, 2017; Werlau, 2005). The downfall of the USSR had similar ramifications on the North Korean economy. The people's economy, consisting of various state-owned enterprises in the manufacturing sector, withered away due to the scarcity of resources and lack of trade partners (Habib, 2011; Kim, 2011; Lankov, 2008) and was replaced by a growing mining sector, which increased its share from 5% of the gross domestic product in 1995 to 50% in 2012 (cf. Kim, 2016; Sin, 2013).

In both cases, these developments resulted in the emergence of rent-seeking economies: Arms sales, forced labor (Kim, 2011, 2016), and export of labor forces—ranging from Cuban doctors in Venezuela to North Korean construction workers in the Middle East—played a crucial role in stabilizing the distribution mechanisms of both regimes (Feinberg, 2013; Kim, 2011, 2016). Concurrently, the military gradually gained a more prominent role within the socioeconomic structure, and Moscow's retrenchment from Cuba and the Korean peninsula accelerated this tendency (Féron, 2017; Lankov, 2017; Reuters, 2009; Seliger and Pascha, 2011). In Cuba, the seeds of military domination were already laid in the 1960s and 1970s (Dominguez, 1978), driven by efforts to reorganize the economy with military support⁶ (cf. Féron, 2017; Gershman and Gutierrez, 2009). A major step toward the current system was the establishment of the military-owned enterprise GAESA, which gradually expanded its influence over the Cuban economy. At the end of this process, military control rose to more than 60% of the economy (Gershman and Gutierrez, 2009). Although we know little about the exact economic role of the North Korean military, several indicators suggest parallels to Cuba. The centralization of power in the 1960s under Kim Il Sung, who tried to limit the influence of party wings challenging the legitimacy of hereditary succession (Lankov, 2006), resulted in an incremental fusion of military, governmental, and party functions (Armstrong, 2004; Collins, 2012; Kim, 2016; Myers, 2015). As a consequence, military actors gained control over the sale of natural resources and products from military-controlled production units (Seliger and Pascha, 2011; Simons and White, 1984), became heavily involved in the manufacturing, agriculture and mining sectors, and began to receive financial resources from state-owned enterprises tailored to the acquisition of hard currency (Kim, 2011, 2016; Park, 2013; Seliger and Pascha, 2011).

Cooperation between foreign investors and regimes appears to mirror North Korea's and Cuba's economic structure. The collaboration of state-owned enterprises and foreign investors primarily concerned the Cuban tourism sector—in the form of GAESA's exclusive collaboration with Marriott or Western Union—and in North Korea's mining business. Although the number of resources devoted to the military or the regime in North Korean SEZs remains contentious (Brown, 2016), they appear to be closely embedded in the system of the regime and to function as rent-seeking mechanisms with few actual competencies (Kim, 2016; Tertitskiy, 2017). According to some reports (cf. Frank, 2016;

Zook, 2012), North Korean workers in the Kaesong Industrial Complex received only a marginal part of the real wages determined by negotiations between state and foreign investors. Further research (Feinberg, 2013) has shown that government agencies in Cuba receive up to 90% of the salaries of the labor force employed in joint ventures and that both regimes offer jobs in joint ventures to individuals loyal to the regime (cf. Chang, 2016; Johns, 2003).

The rent-seeking character of North Korea's FDI policy manifests in the regime's approach toward proponents of economic reforms and private markets. According to defectors (Kim, 2016), the purge of Jang Son-Thaek in 2013 was motivated by the interests of the Ministry of People's Security to secure and export its own coal. The 2002 arrest of the Chinese businessman Yang Bin, the renationalization of Xiyang (Reuters, 2012), or the devaluation of the North Korean currency targeting the income basis of North Korea's new bourgeoisie (Green, 2013; Toloraya, 2016; Yoshihiro, 2018) might point at similar distributional conflicts (Green, 2013; Hanke, 2013). The Cuban government shares Pyongyang's distaste for new social classes enacting policies against dollarization⁷ and private wealth accumulation in the tourism sector. As long as military-affiliated institutions profited from taxing privately owned accommodations for tourists, Havana tolerated the coexistence of private and state-owned actors (Johns, 2003). Soon after the United States imposed sanctions on Cuba's military, the distribution conflict between *casas particulares* and GAESA intensified again, and the government initiated tougher measures against the private markets (cf. Reuters, 2019; United States Department of the Treasury, 2019).

China and Vietnam. In contrast to North Korea and Cuba, the socioeconomic structures of China and Vietnam have been supportive of the economic liberalization since the onset of FDI liberalization. Due to the more diversified structures of China's and Vietnam's economies—divided into provincial enterprises, an informal private economy, state-owned enterprises, and the military-controlled sector—a single actor did not gain a dominating role (Nguyen, 2016). Moreover, the division of Vietnam and China into provinces with higher degrees of autonomy provided representation for local decision makers in the Chinese and Vietnamese Communist Parties (Malesky et al., 2011; Riedel and Turley, 1999). The socioeconomic shocks preceding FDI liberalization in both countries reinforced these tendencies.

Falkenheim (1980) and Schurmann (1968) found that the Great Leap Forward (1958–1962) and the Cultural Revolution (1966–1976) accelerated decentralization and shifted competencies to local decision makers. These interest groups gained momentum following the deaths of Mao and were capable of garnering enough political support (Zhang, 2016). After the coup of 1976, Deng removed the pro-Maoist Gang of Four and strengthened the role of local decision makers by introducing township and village enterprises in rural areas and by changing incentives for cooperation with foreign enterprises (Lin and Wang, 2008; Vogel, 2011; Zhang, 2016). The Regulations on Special Economic Zones in Guangdong Province in 1980 sparked the establishment of the Guangdong Provincial Committee for the Administration of Special Economic Zones (Montinola et al., 1995) and reduced the role of the responsible central government in foreign trade matters (Huan, 1986). Subsequent legal changes allowed local decision makers, such as Ren Zhongyi, Guangdong's first party secretary, or Wan Li, the first party secretary of Anhui province, to undertake individual liberalization efforts, leading to an extraordinarily high level of

fiscal decentralization (Landry, 2008; Yeung and Chu, 1998) and to a concentration of FDI in China's Southern provinces (Dorn, 2016; State Statistical Bureau, 1992).

Similarly to China, the shock sparked by the country's unification had a strong effect on political equilibrium of forced (Beresford, 1989) and manifested in the change of power following the 6th National Congress of the Communist Party of Vietnam. The new setting not only did not prevent the emergence of a hereditary succession, but also favored the reformers, as the power of the provincial party secretaries grew significantly (Beresford, 1989; Elliott, 1992; Vuving, 2006). Article 115.2 of the 1980 constitution and the establishment of departments of planning and investment on the provincial level (Elliott, 1992; Hoa and Lin, 2016; Vuving, 2006) provided the provinces with significant abilities in terms of their own budgets and planning mechanisms. Moreover, provincial delegates earned full status in the 7th National Congress of the Communist Party of Vietnam, coinciding with an increase in the number of voters endorsing reforms (Pham, 2016; Vuving, 2006). One prominent supporter of liberalization was Phan Van Khai, the mayor of Ho Chi Minh City (Freeman, 1996; Vuving, 2006), which eventually became one of the main beneficiaries of Vietnam's FDI liberalization (United Nations Conference on Trade and Development, 2008).

Along with processes strengthening local decision makers, leadership transitions in China and Vietnam undermined the role of the military as a stumbling block for liberalization. The war against Vietnam allowed Deng to distract the military, still weakened by the purges during the Cultural Revolution, from domestic issues and to rally the CCP around his strategy of economic development (Wilson Center Digital Archive, 2020; Zhang, 2016). Moreover, Deng redefined the role of the military as a stabilizing factor by outlawing "unofficial organizations" that continued to pledge allegiance to the Cultural Revolution (Zhang, 2016). The Vietnamese military, which remained affiliated to the traditionalists, was occupied with the Sino-Vietnamese Border War and the conflict in Cambodia (Riedel and Turley, 1999; Thayer, 1997). As a result, the military's warning calls to prevent economic liberalization passed widely unnoticed (Bolton, 1999; Pham, 2016; Thayer, 1997), while its decline manifested in budget cuts (Thayer, 1997) and constitutional changes formalizing the new equilibrium of forces (e.g. Art. 21 and Art. 25, 1992 Constitution of Vietnam).

Nevertheless, military actors profited from economic growth, which stemmed from the comparative advantages of the Chinese and Vietnamese economies in terms of labor (Johns, 2003). The dismantlement of the collectives in 1978 in the wake of China's Rural Reform or redistribution of land in Vietnam in 1987 increased the power of local decision makers without compromising military interests directly (Dorn, 2016; Malesky, 2008; Naughton, 2008; Zhang, 2016). Instead, the People's Liberation Army (PLA) went into business on a massive scale to compensate for losses from the reduction of military spending—for instance, by opening military hospitals to civilians and participating in the mining and construction sectors (Bickford, 1994; Saunders and Scobell, 2015). To defuse distribution conflicts, the new Chinese constitution of 1982, following the first wave of reforms, softened the state's leading force in the economy, and allowed for the coexistence of private and state-owned sectors (Gardner, 1976; Goodman, 2014; Naughton, 2008; Ngo, 1993). The integration of the Vietnamese military, which accounted for 3% of Vietnam's economy, proceeded in a similar way and military- and state-owned enterprises were able to engage in joint ventures with foreign enterprises to compensate for the declining military budget (Nguyen and Mayer, 2004; Thayer, 1997). Nevertheless, distribution conflicts persisted in the years following liberalization (Garver, 1993; Grevatt,

2018; Nguyen, 2017).) and resulted in the emergence of a two-tier structure balancing the interests of the military, state-owned enterprises, provincial leaders, and a rising middle class (Li, 2003). Whereas vague constitutional norms, such as “socialist orientation,” provided a legal basis for the interests of vested monopolies, the Law on Enterprise supported the emergence of market forces (Pham, 2016). The new Vietnamese constitution of 1992 therefore depicted a framework that safeguarded the interests of all members of the dominating coalition (Malesky et al., 2011) and divided the roles among the military, state-owned sector, and liberal reformers.

Finally, the international situation imposed comparably few costs on Vietnam and China to transform their economies, as access to foreign joint ventures was not tied to concessions impacting parts of the support coalition. China’s opening policy went along with the improvement of bilateral ties with the United States and began with Nixon’s 1972 visit to China (Burr, 1999; Huan, 1986; Liu and Yan, 2015; Watson and Luolin, 1986). In contrast to those on Cuba and North Korea, sanctions did not prevent cooperation with military or state-owned Chinese enterprises and did not entail clauses such as disarmament or diplomatic concessions. In contrast to China, Vietnam had to make more significant concessions to the international community. However, many of these can be considered sunken costs, as the breakdown of the USSR made retrenchment from Cambodia and rapprochement with China inevitable (Riedel and Turley, 1999).

Summary of the Case Study Findings

The discussion of the case study has centered on two pivotal aspects of our argument: the temporal linkage between external shocks and subsequent policy adaptations and the connection between the magnitude of policy adaptations and the constellation of interest groups. In the first part, we examined the effects of external shocks on the course of FDI liberalization and found that major policy changes follow external shocks disrupting the regime’s traditional business model. Phases of power transition make policy changes more likely, as the new leadership needs to demonstrate its ability to safeguard the support coalition’s interests. The absence of economic shocks in the magnitude of China’s Cultural Revolution or Vietnam’s reunification combined with a relatively late transition from the first to the second generation of political leaders appears to explain the earlier starting point for reforms in those countries compared to that in North Korea and Cuba.

In the second part, we examined how shocks interact with the interests and preferences of the support groups behind the regime, as well as the constraints that international relations impose on authoritarian regimes. The economic structures of North Korea and Cuba, which are characterized by a dominance of regime-affiliated groups, such as the military—coupled with the fusion among party, military, and state functions—have been major stumbling blocks for liberalization, as the regimes and their support coalitions would lose their tight grips on the economy by allowing economic competition. The shock hitting both countries in the 1990s—the dissolution of the USSR—reinforced this structure due to the decline of the non-rent-seeking parts of the economy. As a result, the support coalition used FDI liberalization as a tool to enhance the efficiency of the rent-seeking economy and sought to prevent the emergence of new social forces.

In contrast to North Korea and Cuba, China and Vietnam were significantly more decentralized from the beginning, so that local decision makers were able to influence decision making at the national level and not the other way around. In addition, events such as the Cultural Revolution, the Unification of Vietnam, and the Sino–Vietnamese

War distracted military leaders in China and Vietnam from their domestic interests and gave rise to a faction of local decision makers who stood to profit from domestic liberalization.

The international situation strengthened the prevailing tendencies. The Sino–Soviet split sparked Beijing’s need for Western trade partners, whereas the later rapprochement between the United States and China made it easier for Deng to engage in commercial ties to Western countries. The breakdown of the USSR and the withdrawal from Cambodia allowed Vietnam to profit from the post-Cold War peace dividend. The situations in North Korea and Cuba were different, rendering policy adaptations more difficult. In the absence of a powerful ally, and in light of economic turmoil, both regimes could not utilize their geopolitical weight to enter globalization without existential political concessions.

Conclusion

Based on the assumption of cost–benefit-calculating decision makers, we argue that successful FDI liberalization requires a combination of time and country-specific factors that incentivize the introduction of property rights and, to a different extent, FDI-friendly policy. This argument is supported by the comparison between FDI liberalization practices in Cuba, China, North Korea, and Vietnam, where regulatory changes coincided with macroeconomic shocks. These crises, however, do not necessarily translate into full-fledged economic transformations, as FDI liberalization follows the form of the prevailing incentive structure. The outcome of the shock depends on the number of losers and their positions within the regime’s power architecture. The existence of an oversized military with stakes in the economy and representation in the political architecture deters economic liberalization, as the military itself would lose influence and access to rent creation. By contrast, economic decentralization and the power of local decision makers within the power architecture are both factors that are conducive to FDI liberalization. This explains why both North Korea and Cuba have not evolved into market economies and have opted to remain centralized, whereas China and Vietnam have undergone successful liberalization. In addition, the realization of economic liberalization and of FDI in particular depends on foreign policy, which imposes high costs on specific players within the coalitions that are supportive of the regimes.

Further proof of the validity of the presented theoretical framework would require quantitative assessments and a systematic review of FDI liberalization attempts in the USSR in the 1920s, when Lenin experimented with domestic and foreign trade reforms, as well as other phases of open-door policies in the pre-1990 socialist world. Hence, additional research could strengthen the application of the presented theoretical argument beyond the discussed cases.

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Notes

1. As a result, the total population of the case study includes, for instance, Angola, Cuba, Cambodia, China, the Democratic People's Republic of Korea, Ethiopia, Laos, Libya, Vietnam, and the USSR. Potentially, Venezuela and Syria could be contemporary examples. Angola and Laos, which would be other candidates for former communist regimes, are excluded from this analysis for reasons of space and data availability.
2. Vietnam constitutes a special case, as investment in South Vietnam was possible prior to the fall of Saigon in 1975. Nevertheless, the North Vietnamese leadership enacted a strict collectivization policy immediately after the reunification, which resulted in an absence of FDI in South Vietnam.
3. "The main task on the way to socialism is the development of the productivity forces. That is why we adopted a policy toward socialist modernization, a policy of reforms and of open doors to the foreign countries" (Memorandum of Conversation, 1987).
4. Although the Cambodia campaign was not an exogenous event outside the control of decision makers, it was embedded in a larger series of events beyond the control of the strategic planners in Hanoi, namely an international constellation that drove the interests of Moscow and Beijing apart and forced political decision makers to pick sides between both communist powers.
5. Pyongyang was, in fact, able to reap benefits from reconfiguring its foreign policy by exploiting competition between the USSR and China (Lankov, 1985; Zakharova, 2016), whereas the Cuban leadership lacked the means to delink from the USSR, given the more imminent threat posed by Washington, D.C. (Fardella, 2014; Morris, 2007).
6. The Ejercito Juvenil de Trabajo, which was established and commanded by Raúl Castro, was founded in 1973 to cultivate Cuba's remote areas.
7. The most evident step in this direction was the establishment of the convertible peso in the 1990s (Villegas, 1996).

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