

UNIVERSITY OF CALIFORNIA, SAN DIEGO

**Credibility and Flexibility:  
Political Institutions and Foreign Direct Investment**

A dissertation submitted in partial satisfaction of the  
requirements for the degree Doctor of Philosophy

in

Political Science and International Studies

by

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2007

iii

## DEDICATION

To Xiaowei and Nanxi, with all my love.

## TABLE OF CONTENTS

SIGNATURE PAGE -----	iii
DEDICATION -----	iv
TABLE OF CONTENTS -----	v
LIST OF TABLES -----	vii
LIST OF FIGURES -----	viii
LIST OF APPENDICES -----	ix
VITA -----	xii
ABSTRACT OF THE DISSERTATION -----	xiii
<b>CHAPTER 1: INTRODUCTION -----</b>	<b>1</b>
I. Existing Literature on Institutions and Investment -----	2
II. Theoretical Foundations -----	6
<i>Nonlinear Relationship between Political Institutions and FDI</i> -----	7
<i>Political Institutions and Foreign Firms</i> -----	8
III. Why Study China? -----	11
<i>Why Study Local Institutions?</i> -----	16
IV. Contributions -----	18
V. Outline of the Dissertation -----	19
<b>CHAPTER 2: CREDIBILITY AND FLEXIBILITY: COMPARATIVE INSTITUTIONAL ADVANTAGE AND FOREIGN DIRECT INVESTMENT -----</b>	<b>21</b>
I. Introduction -----	21
II. A Debate on the Relationship between Political Institutions and Investment -----	24
<i>Dispersed Authority</i> -----	24
<i>Concentrated Authority</i> -----	27
III. Theory and Hypotheses -----	31
IV. Empirical Analysis: Political Institutions and FDI -----	37
<i>Dependent Variable</i> -----	38
<i>Independent Variable</i> -----	39
<i>Control Variables</i> -----	40
<i>Findings</i> -----	43
V. Empirical Analysis: Tests of Causal Mechanism -----	48
<i>Political Institutions and Policy certainty</i> -----	48
<i>Political Institutions and Investment Incentives</i> -----	51
<i>Findings</i> -----	52
VI. Conclusion -----	56
<b>CHAPTER 3: POLITICAL INSTITUTIONS AND THE COMPOSITION OF FDI -----</b>	<b>62</b>
I. Introduction -----	62
II. Bargaining Relationship between MNCs and Host Governments -----	64
<i>Obsolescing Bargain Model (OBM)</i> -----	64
<i>Critics of OBM and Political Bargaining Model (PBM)</i> -----	66
III. Theory and Hypotheses -----	70
1. <i>Production Strategy</i> -----	73
2. <i>Asset Specificity</i> -----	75
IV. Data and Models -----	81
<i>Dependent variables</i> -----	83
<i>Independent variables</i> -----	83
<i>Interaction Terms</i> -----	85
<i>Control Variables</i> -----	86
V. Findings -----	89
VI. Conclusion -----	95
<b>CHAPTER 4: FDI AND SPECIAL ZONE POLICY IN CHINA -----</b>	<b>97</b>

I. Introduction	97
II. Flexible Arrangements in Special Zones	100
III. The Political Logic of the Special Zone Policy	110
<i>The Central Government</i>	112
<i>Local Governments</i>	127
IV. The Composition of Foreign Investment in China	133
<i>Evolution of the Composition of FDI</i>	133
<i>Rival Theories</i>	139
V. Conclusion	141
<b>CHAPTER 5: NOT A MAGIC BULLET: HOW DO LOCAL INSTITUTIONS AFFECT FDI IN CHINA?</b>	<b>144</b>
I. Introduction	144
II. Research Design	148
III. Central-Local Relations	150
IV. Governance Structure	156
V. Legal Environment	162
VI. Statistical Evidence	167
<i>Dependent Variables and Explanatory Variables</i>	169
<i>Control Variables</i>	172
<i>Findings</i>	173
VII. Conclusion	179
<b>CHAPTER 6: CONCLUSION</b>	<b>188</b>
I. Questions and Answers	189
<i>Question 1: Why Do Multinational Firms Invest in Autocracies as well as Democracies?</i>	189
<i>Question 2: What Explains the Variation in the Composition of FDI among Countries?</i>	190
<i>Question 3: What Explains the Change in FDI Composition in China?</i>	192
<i>Question 4: What Explains the Inequality of FDI Distribution within China?</i>	195
II. Implications and Future Research Plans	196
<i>Fiscal Federalism and Local Governments' Accountability</i>	196
<i>Legal System, Property Rights, and Foreign Investment in China</i>	197
<i>China and India: Varieties of Capitalism in Developing Countries</i>	199
III. Conclusion	201
<b>BIBLIOGRAPHY</b>	<b>203</b>

## LIST OF TABLES

Table 1-1: Regional Distribution of Actual FDI Inflows in China (1985-2003)-----	13
Table 2-1: Relationship between Political Institutions and FDI in Developing Countries-----	44
Table 2-2: Relationship between Political Institutions and FDI in Developed Countries-----	46
Table 2-3: Inclusion of Policy Certainty Variables (Developing Countries) -----	50
Table 2-4: Ordered Probit Results: Relationship between Institutions and Tax Incentives ----	54
Table 2-5: Effect of Change in Institutional Strength on Investment Incentives -----	55
Table 3-1: Summary Statistics-----	88
Table 3-2: Political Institutions ( <i>POLCON</i> ) and the Composition of FDI-----	91
Table 3-3: Political Institutions ( <i>CHECKS</i> ) and the Composition of FDI-----	93
Table 4-1: Realized Foreign Investment in SEZs and ETDZs 1985-2004-----	102
Table 4-2: Duration of Central Subsidies for ETDZs-----	104
Table 4-3: Major Preferential Tax Policies for Foreign Invested Enterprises in China-----	107
Table 4-4: Central leaders' Remarks on Special Zones-----	115
Table 4-5: Market Entry Modes of FDI (1979-2005)-----	134
Table 4-6: Geographical Sourcing of FDI in China, 1985-2005 -----	136
Table 4-7: Average Size of Investment FIEs, 1993-2005 (million US dollars)-----	137
Table 4-8: The Composition of Foreign Investments in Manufacturing (1995-2005)-----	138
Table 5-1: Key Economic Indicators for National-level ETDZs (2003)-----	145
Table 5-2: OLS Regression Result: Provincial level-----	174
Table 5-3: Provincial Level: Two-stage Least Squares Regression-----	175
Table 5-4: OLS Regression Result: Zone level -----	176
Table 5-5: Major Indicators of Dalian ETDZ and Nantong ETDZ (2003) -----	179



## LIST OF FIGURES

Figure 1-1: FDI Inflows in China 1980-2005-----	13
Figure 2-1: Average FDI Inflows between Democracies and Autocracies 1982-2004 -----	22
Figure 2-2: Simulation of Effect of Checks and Balances on FDI-----	47
Figure 5-1: National-level Economic and Technological Development Zones (ETDZs): GDP and Accumulated FDI Inflows (2003)-----	146
Figure 5-2: Governance Structures of Special Zones -----	157

## LIST OF APPENDICES

Appendix 2-1: Variable Descriptions and Sources .....	58
Appendix 2-2: Investment Incentive Scale Coding Rule.....	59
Appendix 3-1: Variable Descriptions and Sources .....	96
Appendix 5-1: Number of Special Zones at Different Levels of Government.....	181
Appendix 5-2: Institutional Variables of National-level ETDZs.....	183
Appendix 5-3: Variable Descriptions and Sources: Provincial Level .....	186
Appendix 5-4: Variable Descriptions and Sources: Zone Level .....	187

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## ABSTRACT OF THE DISSERTATION

Credibility and Flexibility:

Political Institutions and Foreign Direct Investment

by

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Doctor of Philosophy in Political Science and International Studies

University of California, San Diego, 2007

Professor Susan Shirk, Co-Chair

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Why does a substantial portion of FDI flow into authoritarian regimes despite their weak political institutions? I argue that foreign investors invest in autocracies and democracies in pursuit of different institutional advantages. They invest in some authoritarian countries not despite the lack of credibility, but because of the availability of flexibility. Strong institutions create a credible investment environment that protects property rights better. Weak institutions create a flexible investment environment that provides more preferential treatment and selective protection of property rights. Foreign investors' preferences toward a more credible or more flexible investment environment depend on their firm-specific features which determine whether their bargaining power diminishes relative to host governments after their investment is made.

I conduct quantitative analyses of the effect of political institutions on both the

quantity and the composition of FDI. The results indicate a significant nonlinear relationship between political institutions and FDI in developing countries. Increase in the number of veto players enhances countries' ability to attract FDI at low level of credibility but decreases countries' ability to attract FDI when a moderate level of credibility has been attained. In particular, strong institutions tend to attract foreign firms that are engaged in capital-intensive and domestic market-seeking production.

These quantitative findings are buttressed by an extensive case study of China based on fieldwork. I argue that China attracts massive amounts of FDI partly because of the authoritarian system that gave political elites the flexibility and capacity to initiate a set of institutional innovations, notably the special zone policy, to attract FDI. But China's continuing success in attracting higher quality FDI owes much to the government's credibility that has been gradually built up in the process of maintaining the special zone policy. At the sub-national level, the effect of special zones depends on how they are implemented by local governments. Local institutional factors including central-local relations, governance structure, and legal environment can explain much of the residual regional variation in FDI beyond the geography and policy effects.

This dissertation helps us understand the varieties of capitalism in developing countries and how the variation in socio-economic institutions may lead to various development patterns and policy outcomes. In particular, it suggests that authoritarian governments have the flexibility to use their discretionary authority to play a "helping hand" to promote economic growth, but whether the policy outcome is developmental or predatory largely depends on the credibility of local policy implementation.

## Chapter 1

### Introduction

Foreign direct investment (FDI) is widely believed to have beneficial effects on developing countries, both as a source of long-term finance that complements domestic financial sources and for the skill and technology transfers associated with it. Policymakers in all developing countries have an interest in attracting foreign investment, but not all of them are successful.<sup>1</sup> In 2004, FDI inflows to the developing countries were distributed very unequally with 20 countries receiving 76 percent of total FDI flows to the developing world.<sup>2</sup>

What makes a country attractive to foreign investors? A long list of factors encourages foreign investments into developing countries. On top of the list are big market size, strong economic growth, plentiful natural resources, and low labor costs. Despite their attractions, developing countries pose severe challenges to foreign investors because of the uncertainty in the investment environment. The institutional context in the host countries is particularly important for firms to decide where and how to establish FDI. While the conventional wisdom suggests that democratic countries have more advantages in attracting foreign investment, remarkable stories of foreign investment actually happened in some autocracies and hybrid regimes. China's reputation as a star economic performer, whose economy has been growing at an average rate of 10 percent for nearly three decades, owes much to its dramatic success at attracting foreign investment. Countries like Indonesia, Malaysia, and Vietnam also had similar success under authoritarian governments. Other

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<sup>1</sup> In 2004, 87% of the total of 269 FDI-related regulatory changes introduced in 102 countries were designed to make host countries more attractive to FDI. UNCTAD 2005.

<sup>2</sup> Moran 2006.



authoritarian countries, notably in Africa, have received negligible share of foreign investment and remained marginalized. Why does a substantial portion of FDI flow into authoritarian regimes despite their weak political institutions? Why do some authoritarian countries perform extraordinarily well while others languish?

In an effort to better understand the critical role of political institutions in shaping foreign investors' decisions and strategies, this dissertation has two broad analytical objectives. First, I develop a theoretical model identifying comparative advantages of different political institutions and specifying the sources of investors' preferences toward different political institutions in host countries at the international level. Second, I examine the role played by institutions, both at the national and local level, in influencing foreign investments in China. In particular, I investigate the development of special zones, a broadly implemented institutional innovation, and the variation in their effects on FDI in different areas in China.

The objective of this chapter is to situate the analysis of my dissertation within the existing debate over the institutional determinants of FDI. After identifying some of the theoretical assumptions on which existing literature has been premised, I will preview the argument developed in this dissertation.

## **I. Existing Literature on Institutions and Investment**

The relationship between political institutions and private investment has been extensively debated. The central theoretical debate concerns the importance of state capability to maintain and change policy directions. The empirical literature can be roughly divided into two groups. One emphasizes policy sustainability influenced by limits placed by institutional checks such as legislatures, coalition partners within the

executive branch, judiciary and federal sub-units. The other one emphasizes the importance of state autonomy to mitigate collective action problems and initiate policy innovations.

The first group of literature maintains that to achieve economic development leaders must bind themselves to a set of rules which limit their discretionary powers to intervene in the economy. Governments' commitments are made credible by the self-enforcing institutions that underlie limited governments rather than relying on politicians' good faith. Foreign investors will be reassured about political risk because the political institutions prevent the government from arbitrarily confiscating their assets or changing policies. Potential risk of expropriation makes returns uncertain and discourages investment for risk-averse decision makers. When property rights are insecure, potentially less efficient investments may also be undertaken as a means to strengthen the security of property rights. The predominant view is that democratic regimes are superior to authoritarian regimes for attracting private investment because they have strong institutions that protect property rights and solve credibility problems that discourage private investment.<sup>3</sup>

All these studies agree that existence of credible governance is the key factor that attracts FDI. While some scholars argue that countries lacking strong checks and balances could rely on other "commitment institutions" such as granting independent authority to regulators, adopting specific and substantive rules, signing a bilateral investment treaty with investors' home countries, joining international organizations, or negotiating investment-cost sharing schemes to mitigate the institutional weakness

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<sup>3</sup> Levi 1988, North & Weingast 1989, North 1990, Williamson 1996, Dixit 1996

to a certain extent, they also indicate that these countries cannot completely overcome the institutional disadvantage of weak governance.<sup>4</sup>

Some cross-national studies find positive correlations between strong institutions and private investment,<sup>5</sup> while others find ambiguous evidence.<sup>6</sup> One reason, as suggested by Przeworski and Limongi, is that the hypothesized correlation between democracy and the security of property rights does not in fact exist.<sup>7</sup> This may help explain why there is no consistent empirical evidence that democracy contributes to FDI inflows and economic growth.

The other group of literature suggests that governments with concentrated authority are better able to attract private investment because they can more easily initiate institutional innovations to perform a developmental role or impose political repression to facilitate a positive political business climate. By contrast, dispersed decision-making authority can hinder the ability of governments to undertake necessary economic reforms in response to economic shocks.<sup>8</sup>

The developmental state, initially and forcefully articulated by Chalmers Johnson with specific reference to Japan, has been one of the most compelling explanations for the economic success of some authoritarian countries. It argues that the authoritarian system in some East Asian countries gave the bureaucracy sufficient scope to provide a “helping hand” to private agents and facilitate a positive political business climate.<sup>9</sup> The developmental state underscores the way in which authoritarian governments, if wielded astutely, can contribute positively to economic development. Intensive case

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4 Levy and Spiller 1996, Fine 2003, Buthe & Milner 2005, Jensen 2006.

5 Keefer and Knack 1995, Henisz 2000, Feng 2001, Jensen 2003, Acemoglu and Johnson 2005

6 Przeworski et al. 2000, Li & Resnick 2003

7 Przeworski and Limongi 1993.

8 Haggard 2000, McIntyre 2003.

9 Japan was highly authoritarian in the 1930s when its developmental aspect emerged. South Korea was highly authoritarian during the postwar period till 1993. Taiwan was under martial law from 1947 to 1989. See Johnson 1982, Amsden 1989, Wade 1990, Haggard 1990, Evans 1995.

studies show that most of the East Asian countries began an investment-driven high growth path under authoritarian regimes, although foreign investment did not play a particularly dominant role.<sup>10</sup> Bruce Cumings names the East Asian countries “bureaucratic-authoritarian industrializing regimes” in which strong states rely on some coercive but not fully legitimated means to fulfill the task of industrialization.<sup>11</sup>

East Asia is not the only region in which authoritarian governments have played a positive role in promoting economy. In the 1960s and 1970s, some authoritarian governments in Latin America and the Middle East attracted FDI by building a coalition with multinational corporations (MNCs) through the use of political repression and favoritism against domestic private economic power.<sup>12</sup>

In all these explanations, a powerful, competent, and insulated state bureaucracy is necessary to the emergence of a developmental state. No matter whether they are “developmental state” or “bureaucratic authoritarianism”, successful authoritarian countries share the same experience that governments do not need to be credible to all citizens and secure property rights broadly. Instead, governments can offer selective property rights protection in exchange for some type of economic benefit from a particular group of asset holders.<sup>13</sup>

However, a strong state may be its own worst enemy. Weingast states this problem succinctly: “A government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens.”<sup>14</sup>

Private investors have no way of knowing with certainty whether the state is really developmental due to lack of institutional constraints. While Chalmers Johnson

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10 Gold 1986, Haggard & Kaufman 1995, Naughton 1995, Malesky 2004

11 Cumings 1999.

12 Evans 1979, Gilpin 1987, and O’Donnell 1988.

13 Haber et al. 2003.

14 Weingast 1993, 287.

acknowledges that authoritarian regimes have the capacity of political mobilization to achieve developmental goals, he denies any necessary connection between authoritarianism and the developmental state.<sup>15</sup> Indeed, not all authoritarian governments have the same capacities. It is evident that many authoritarian governments, despite their announced developmental objectives, turned out to be weak states.<sup>16</sup>

While both perspectives provide good reasons why dispersed or concentrated decision-making authority might be more attractive to private investment, their empirical applications have not produced compelling evidence to favor one perspective over the other. Although it may be clear that institutions matter, it has been difficult to identify causal links between particular institutions and good economic performance including attracting FDI that withstand cross-national and inter-temporal comparison.

## II. Theoretical Foundations

The lack of fit between theoretical predictions and empirical results suggests a need to explore the nuanced relationship between political institutions and investment. In this dissertation, I take an initial step at developing an integrated theory of how transnational and sub-national variations in institutions affect foreign investment. The cross-national study is built on the veto player theory while the sub-national study within China looks beyond the veto player framework and examines the effects of some micro institutional variables.

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<sup>15</sup> Johnson 1999.

<sup>16</sup> See, for example, Bates 1981.

### ***Nonlinear Relationship between Political Institutions and FDI***

A key feature of political institutions is the distribution of policymaking power within a government. It depends on the number of institutional actors (veto players) whose agreement is necessary to change existing policies or initiate new policies. In countries marked by a greater number of veto players, it is difficult to change existing policies because any veto player can block such change. Maintaining the status quo is most likely where a large number of veto players exist. A reduction in the number of veto players thus allows governments to more easily change the status quo.<sup>17</sup>

To be sure, all good things do not go together. All governments desire to have the capability of maintaining a good status quo (credibility) and changing a bad status quo (flexibility), but institutional constraints make it impossible for governments to achieve both goals. Governments highly credible to a large number of citizens may lack the ability to respond flexibly to certain small groups. Maximizing the accountability of a government by increasing competition (horizontal accountability) and public participation (vertical accountability) can come at the expense of flexibility and responsiveness. Conversely, maximizing flexibility of a government will generate more credibility problems. If the government is strong enough to take initiatives and change unfavorable policies, it is also strong enough to abrogate these policies for its own benefit.

Governments vary in their ability to make credible commitment. They range from pure clientelism in which dictators can make a credible promise to a small group of elites with the power to choose leaders (called selectorates by Shirk and Bueno de

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<sup>17</sup> Cox and McCubbins 2001, Tsebelis 2002, MacIntyre 2003

Masquita et al.<sup>18</sup>) to democracies in which multiple candidates can make credible promises to basically all voters.<sup>19</sup>

How does this tradeoff between credibility and flexibility of host governments impact foreign investors? Both institutional dimensions influence investors in both positive and negative ways. A more credible government is attractive to foreign investors because of its ability to maintain a long-term stable policy environment and protect property rights, but some inefficient policies could become difficult to change when the institutions are rigid. A more flexible government is attractive to foreign investors because it has more capacity to reduce the burdens of regulation and provide preferential treatment to foreign investors, but may create a higher risk of government changes in policy.

Therefore, this theory predicts an inverted U-shape relationship between political institutions and FDI. A high-performance country is not infinitely strong in the dimension of policy credibility. The best performing political systems have a balance between policy credibility and flexibility. Governments with too strong or too weak institutions are not favored by foreign investors in general. This hypothesis echoes Robert Barro's robust finding that more democracy enhances economic growth at low levels of political freedom but depresses growth when a moderate level of political freedom has been attained.<sup>20</sup>

### ***Political Institutions and Foreign Firms***

A nonlinear correlation between political institutions and FDI would suggest that

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18 Shirk 1993; Bueno de Masquita et al. 2003.

19 Keefer 2007.

20 Barro 1996.

political institutions have more impact on foreign investment under certain conditions than others. This theory generates expectations that political institutions may affect not only the quantity of FDI, but also the composition of FDI.

Foreign investment is a firm-level decision. All firms are not the same, indeed. A foreign firm decides whether and how to enter a new country and or undertake expansion of an ongoing business based on assessments of potential risk and return. While some firms prefer a long-standing democracy, others are more interested in emerging markets where the potential returns are more promising. What type of firms will invest in a country that has more credible institutions but is less likely to offer generous inducements? What type of firms will invest in a country that commits to provide more upfront incentives but is less able to commit to a long-term stable policy?

Foreign firms' preferences toward a more credible or more flexible political environment depend on their post-entry bargaining power—whether their bargaining power diminishes relative to host governments after their investment is made. If a foreign firm's post-entry bargaining power is weak, it will prefer strong political institutions that facilitate policy stability and property rights protection. Alternatively, it will be more prone to lobby the government for more protection or ask for higher ex ante risk premium.<sup>21</sup> But a demand for more favorable conditions at the start may only hasten a later backlash if the foreign firm's bargaining power diminishes rapidly.<sup>22</sup> Therefore, a credible host government is crucial for this type of foreign firms to engage in strategic bargaining.

If a foreign firm has strong post-entry bargaining power relative to the host government, the government's credibility or lack of it will not matter too much. Firms

<sup>21</sup> Alt et al. 2003. Doyle and van Wijnbergen 1994.

<sup>22</sup> Moran 2006.



taking a chance in unstable political environments normally demand a higher return on investment than they would in more stable situations. For them, a host government's flexible policies to foreign investment can offset flaws in political institutions.

What factors affect the post-entry bargaining power of foreign investors? Much of the literature has viewed the investor-host government relations through the lens of the obsolescing bargain model which was originally proposed by Raymond Vernon.<sup>23</sup> The fundamental assumption is: foreign firms will be vulnerable to expropriation risk because their bargaining power will shift in favor of the host government once foreign firms' assets turn into hostages. But this assumption has been undermined by the increasing empirical evidence that foreign firms' bargaining power may not easily become obsolete after their assets are sunk, because networks of suppliers, distributors, consumers, joint-venture partners, and labor provide a political base of support for the foreign firms.<sup>24</sup> In particular, two firm-specific factors have important influences on foreign firms' post-entry bargaining power and thus their preferences toward institutions in host countries.

The first factor is the production strategy, which is normally classified into vertical and horizontal organization of production. Horizontal FDI undertakes production primarily for the local market, so it tends to be import-substituting. Vertical FDI sets up different segments of production in various locations to take advantage of factor price differences, so it is more likely to be export oriented. Horizontal FDI is less footloose than vertical FDI because it is less likely to move into or out of a country in response to policy changes. Given its higher level of

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<sup>23</sup> Vernon 1971.

<sup>24</sup> Kobrin 1987, Eden et al. 2005.

commitment to local market, horizontal FDI seeks a more sustainable investment environment in host countries than vertical FDI.

The second factor is asset specificity, referring to the extent to which the assets have relatively little use beyond their use in the context of a specific transaction. This factor is well understood for explaining the politics of social welfare and trade.<sup>25</sup> When the level of political risk is high, foreign firms tend to hold their wealth in liquid assets that can be quickly moved from one location to another. The more specific the asset, the more it would cost for a foreign firm facing unfavorable policy change to “exit” into another location, and the more incentive the foreign firm will have to avert this unfavorable policy change. Therefore, foreign firms holding highly specific assets will be particularly attracted by countries that could credibly maintain long-term policy and secure their assets.

### **III. Why Study China?**

The credibility-flexibility model suggests that authoritarian countries are not all bad for all foreign investors if they can compensate for weak credibility with the ability to offer attractive inducements. This model partly explains the economic successes of developmental states. But it does not explain why some authoritarian countries are attractive destinations for FDI while others are not. A big problem of the cross-national study is that the veto-player framework treats all authoritarian regimes as if they are the same. Authoritarian regimes, by definition, which have a single veto player, have little capacity to credibly commit on any long-term policy. However, it is evident that wide differences exist in the manner in which different authoritarian

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<sup>25</sup> See, for example, Isabela 2003, Hiscox 2004.

institutions function.<sup>26</sup> If we assume that credibility is a major channel through which political institutions affect economic outcomes, the huge variation in economic performance indicates that some authoritarian countries have institutional arrangements other than veto players to create credibility. Therefore, testing this theory requires an exploration of a real-world case that relies not only on veto players, but also on other institutional arrangements to create credibility.

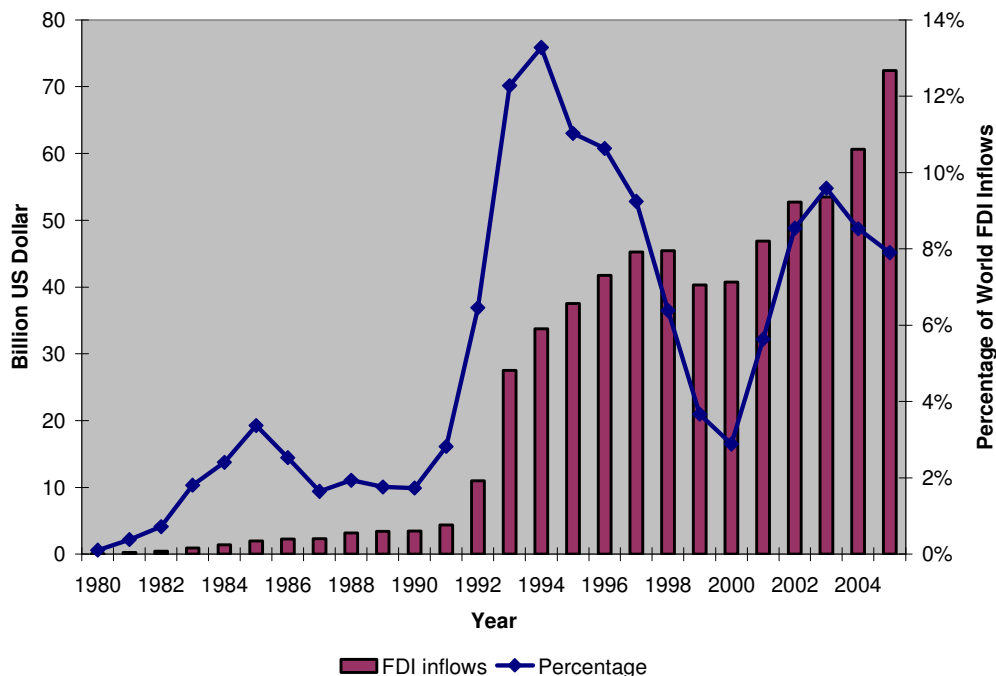
China's stupendous economic performance is at once amazing and puzzling. As shown in Figure 1.1, by almost all accounts, FDI in China has been one of the most successful stories in the world economy. Its FDI inflows, in terms of a share of world total, increased from less than 0.1 percent in 1980 (US\$57 million) to over 8 percent in 2005 (US\$72 billion).<sup>27</sup> How could a poor authoritarian government with little political and legal credibility succeed in attracting a huge amount of FDI?

The regional distribution of FDI within China is equally astonishing. Almost 90 percent of FDI inflows are concentrated in the coastal areas. (Table 1.1) Why was the geographic distribution of FDI extremely uneven within this politically-centralized country?

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<sup>26</sup> Geddes 1999.

<sup>27</sup> China's FDI inflows increased 20 percent from 2004 to 2005. Part of this increase is due to the changes in the methodology underlining China's FDI statistics. Data released by the Chinese government previously did not include FDI in financial sector. Non-financial FDI was \$60 billion in 2005, a slight decline from \$60.6 billion in 2004. UNCTAD 2006.



Source: World Development Indicators 2006

**Figure 1-1: FDI Inflows in China 1980-2005**

**Table 1-1: Regional Distribution of Actual FDI Inflows in China (1985-2003)**

Year	Coast	Middle	West
1985	92%	4%	4%
1986	86%	5%	8%
1987	87%	3%	10%
1988	88%	6%	7%
1989	91%	4%	5%
1990	93%	3%	3%
1991	94%	4%	2%
1992	90%	7%	4%
1993	85%	9%	7%
1994	86%	8%	6%
1995	87%	9%	5%
1996	86%	9%	4%
1997	84%	10%	5%
1998	85%	9%	5%
1999	87%	10%	4%
2000	87%	9%	4%
2001	87%	9%	4%
2002	86%	10%	4%
2003	87%	10%	3%

Source: China Statistical Yearbooks, various years.

Several popular explanations focus on how China has overcome its institutional deficiencies and made credible commitments to foreign investors. First, the formal institutional deficiencies were partially made up for by informal relations. Networks of personal contacts (*guanxi*) or flexible commercial clientelism have been used to complement legal protection and secure business opportunities for foreign investors.<sup>28</sup> Second, fiscal federalism has created an incentive for local governments to act as a counterbalance to the central government, limiting the state's ability to abuse its authority; meanwhile, in the competition to attract and retain capital, local governments have an incentive to demonstrate credible commitment to maintaining an institutional environment favorable to economic growth.<sup>29</sup> Another influential explanation, held by Yasheng Huang, attributes China's high FDI to institutional inefficiencies and market fragmentation that depressed the competitiveness of domestic firms while increasing FDI.<sup>30</sup>

My answer is different. I argue that China has attracted massive amounts of FDI not despite its political institutions, but partly because of them. While the authoritarian system is a big minus for potential investors who are concerned about political risk, it gave political elites the independence to initiate a set of institutional innovations to attract FDI. China's initial FDI boom was primarily due to the special zone policy—an institutional innovation that was characterized by flexible policy arrangements. At the initial stage of the open-door policy, credibility problems were paramount for foreign investors. But the flexible arrangements—tax incentives, fiscal subsidies, cheap or free land, and flexible labor regulations—created huge upfront benefits to offset the risks.

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28 Wank 1999, Wang 2002, Tsai 2002.

29 See Weingast 1995, Qian and Weingast 1997.

30 Huang 2003a.

It makes perfect sense to use attractive deals to solicit foreign firms when there was barely anything else the government could offer. But the Chinese government still faces a commitment problem. How do investors know that the Chinese government will honor its promises once their assets are sunk? After all, there is no constitutional or institutional mechanism to guarantee the existence of special zones and the preferential treatment attached to them. The government seems to have a dilemma: it would like to promise that no onerous changes will be imposed in the future, but has no way to commit itself credibly.<sup>31</sup> Under the circumstances, foreign firms only invested in short-term projects to take advantage of the preferential policies.

However, political considerations in both the central and local governments have constructed relatively stable political support to foreign investment, which appears to facilitate a self-enforcing solution to this commitment problem. First, the central government counts heavily on special zones to attract foreign investment and maintain the momentum of economic growth. Keeping a high-growth economy is considered a political imperative to prevent the widespread unemployment that could lead to social instability.<sup>32</sup> The Chinese government has been seriously concerned about losing foreign investment if the preferential treatment were no longer offered to foreign firms, as indicated by the delayed passage of an enterprise income tax law that equalizes foreign and domestic firms by the National People's Congress. Second, local governments have a strong interest in maintaining and expanding special zones within their territories, because special zones will not only provide showcases to polish their political performance and boost their political careers, but also generate lucrative revenues to local governments through zone-related land acquisition and

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31 Rodrik and Zeckhauser 1988.

32 Shirk 2007.

sales. Expecting that the special zone policy is unlikely to be reversed, foreign firms began to engage in long-term investment that requires higher degree of commitment. They invested in large-scale operations in the technology-intensive sectors aimed at penetrating the domestic market.

### ***Why Study Local Institutions?***

Special zones, as crucial institutional innovations in China, are ideal units for the sub-national analysis of how foreign investors respond to different institutional arrangements in non-democratic countries. The idea behind special zones was to use some special policy incentives to attract foreign investors to certain areas. The experiment of special zones is not unique in China. But no country has relied so heavily on special zones to attract FDI as China has.

In China, operations of foreign firms are embedded in dense local institutions that shape the day-to-day interactions between local governments and foreign firms. While the central government has essentially ruled out the major political risk, local governments emerge as a major source of uncertainty for foreign firms. Whether local governments play “grabbing hands” (predatory government), “helping hands” (developmental government) or “steady hands” (stable and credible government) depends on the specific local institutional setups. Without an effective institutional mechanism to tie local governments’ hands, foreign investors would be worried that once their investments are in place, their bargaining power will dissolve, and local governments will not stick to the promised preferential treatment. Local governments with special zones are particularly worrisome because they have more autonomous authority to pursue their own political goals.

Assuming that foreign firms are fully aware of the quality of local governance, I argue that local governments' ability to attract FDI is substantially determined by three institutional factors. The first factor is central-local relationship, which determines local governments' political authority to deliver the central policies. While more than 6000 special zones are spread out all over China, over 70 percent of them actually exist outside the central plan. Those unauthorized special zones are less favored by foreign firms because: 1) they are vulnerable to closure by the central government; 2) the lack of financial sources makes them unable to keep the promised subsidies to foreign firms.

The second factor is the governance structure, which determines special zones' capacity to maintain consistent policies. Centrally designated special zones (so called "economic and technological development zones" or ETDZ) are governed in two different ways—the autonomous structure and the integrated structure. Under the autonomous structure, the zone government has the autonomous authority but its administrative capacity is limited. Under the integrated structure, the zone government shares authority with the local government over a variety of economic, administrative, and land decisions. While an autonomous governance structure is more able to facilitate flexible policy implementation, an integrated governance structure has more ability to maintain consistent policies.

The third factor is the local legal environment, which determines to what degree foreign firms' property rights will be protected. No constitutional guarantee of property rights was available under the Chinese socialist system until very recently. The security of property rests less on formal legal and institutional constraints on state power at the central level than on informal institutions or some other mechanisms initiated by local governments. Local governments can signal their credibility to



foreign firms through two major channels: 1) clear and consistent local regulations to show their willingness to follow the rule of law; 2) courts within the zone to improve local governments' ability to settle disputes.

#### **IV. Contributions**

My findings—both quantitative and in the case study—offer insight into a number of important debates that contribute to the existing literature in international political economy and comparative politics.

First, this dissertation expands the credible commitment literature by stressing the combination of credibility and flexibility in economic policymaking. In particular, it explains why different economic outcomes can be produced in authoritarian countries: authoritarian governments have the capacity to use their discretionary authority to play a “helping hand” to promote economic growth, but whether the policy outcome is developmental or predatory largely depends on the credibility of local policy implementation. It also suggests that authoritarian governments can signal their credibility through different institutional arrangements, not necessarily the number of “veto players”.

Second, previous IPE literature assumed that all investors are essentially the same. This dissertation analytically disaggregates FDI and initiates a more nuanced understanding of the relationship between institutions and foreign investors. Instead of imposing a “one best way” conducive to all foreign investors, the findings illustrate that investors have systematically different preferences about institutions, conditioned upon their firm- or industry-specific characteristics.

Third, this dissertation contributes to the fiscal federalism literature. While the

market-preserving federalism literature suggests that economic decentralization may create incentives for local governments to make credible commitments and pursue similar developmental models, my study illustrates that under decentralization the various institutional characteristics of localities are likely to reinforce rather than dissolve policy divergence.

## **V. Outline of the Dissertation**

The dissertation is organized into six chapters. After this introduction, I begin with a cross-national analysis, then drill down to the specific case of China, and descend even further to sub-national level in China as I test the logic of my theory at both macro and micro levels. Finally, I conclude by setting out the research agenda that follows from the findings.

*Chapter 2* sets forth the important theoretical issues and specifies the research design. This chapter conducts a statistical analysis for 172 countries during 1982-2004 to test the hypothesized relationship between political institutions and FDI. An increase in institutional strength has the positive impact on FDI when the policy environment is flexible, but the positive effect turns to negative when institutions are too strong and policy environment becomes rigid. Using a cross-sectional dataset, I also test the hypothesized causal channels through which political institutions affect FDI: strong institutions are associated with high political safety while weak institutions are associated with more foreign-specific investment incentives.

*Chapter 3* relaxes the assumption that all foreign investors have the same preference toward investment environment and explores the more nuanced effect of political institutions on different types of firms. I disaggregate FDI by its production

strategy (vertical FDI vs. horizontal FDI) and three types of asset specificity (physical, human, and dedicated asset specificity). The hypothesis is that whether foreign investors prefer stronger institutions depends on their production strategy and various types of asset specificity: Horizontal and highly-asset specific FDI is more vulnerable to the obsolescing bargain and therefore prefers a more credible policy environment.

*Chapter 4* sketches the evolution of China's institutional framework for foreign investment policy, with a particular emphasis on the special zone policy. It suggests that the change in FDI patterns over time seems to reflect foreign investors' response to the shift of policy flexibility and credibility. At the initial stage of the open-door policy, foreign investments were mostly small, labor-intensive, and low-tech. When the Chinese government gradually built up credibility on the special zone policy, foreign investors were more likely to enter the market with a high degree of commitment. They were involved in large-scale operations in the technology-intensive sectors aimed at penetrating the domestic market.

*Chapter 5* drills down to the sub-national level in China and demonstrates how local institutional features shape FDI activities in special zones. In particular, I argue that three institutional factors are particularly important in affecting the credibility of local investment environment. Central-local relations determine the credibility of local governments to deliver the central policies; the governance structure determines local governments' capacity to maintain consistent policies; local legal environment determines to what degree local governments can protect property rights. I test these hypotheses using a unique zone-level dataset.

*Chapter 6* summarizes the important points and sets out the research agenda that follows from the findings.

## Chapter 2

### Credibility and Flexibility:

#### Comparative Institutional Advantage and Foreign Direct Investment

##### I. Introduction

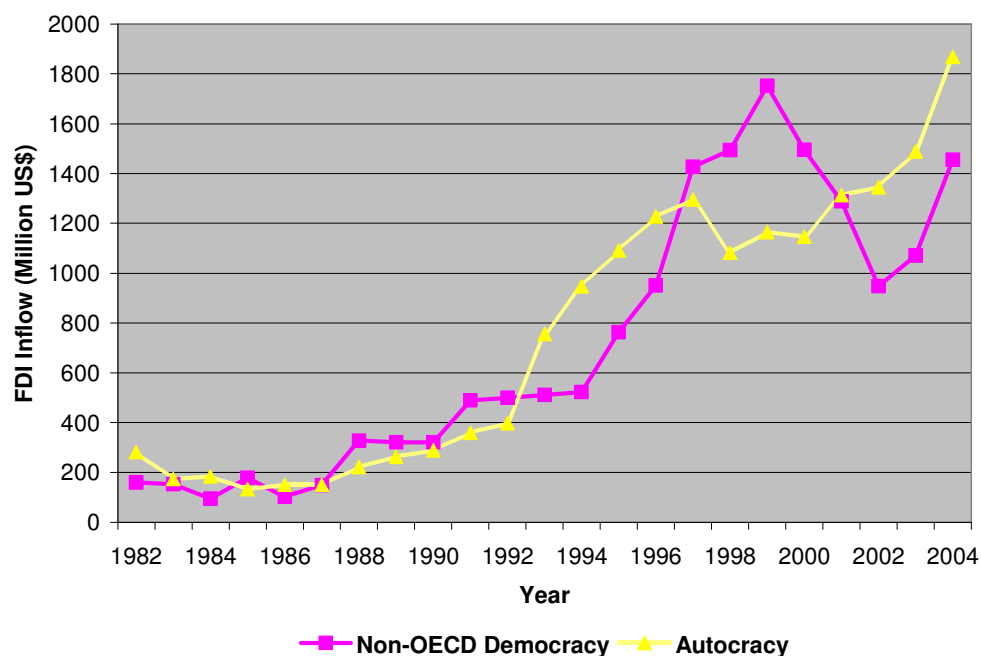
Many developing countries have moved from state-led growth strategies to more market-friendly policy regimes since the 1980s. All the developing countries are advised to “get the fundamentals right”, that is, to build democratic institutions and pursue stable macroeconomic policies. But many developing countries faced the problem of “governance dilemma” when they compete for foreign direct investment (FDI). On the one hand, countries in democratic transition find that FDI does not come automatically as the reward for their political achievements; on the other hand, countries that rely heavily on policy incentives to attract FDI find that competition has sometimes led to a “race to the bottom” not only in the more static sense of forgone fiscal earnings, but also in terms of giving up policy options necessary to organize a more dynamic long-term growth path.

While the conventional wisdom maintains that democracies should be more attractive to multinational corporations (MNCs) because they have a more credible policy environment and better property rights, empirical studies do not show a clear relationship. Ajit Ranade, an Indian economist, has an insightful depiction of the relationship between democracy and FDI:

The vast majority of global FDI, both in terms of flows and stocks, is by the investments of multinational companies from one advanced, democratic country to another. In that sense, FDI seems to prefer developed democracies. But when it comes to emerging (read “poor developing”) economies, is FDI discouraged by democracy? Most studies find no link between democracy and FDI, but some have found a U-shaped relationship, holding other things

as equal. That is, either FDI likes a full quota of guarantee of rights and freedoms, or none at all. Not half-way disorderly, muddling, coalitional democracies!<sup>33</sup>

As can be seen from Figure 2.1, while the average FDI inflows increased sharply over time in both non-OECD democratic countries (with Polity score of 4 or higher) and authoritarian countries (with Polity score below 4) in the last two decades, it is unclear whether the democracies attracted more FDI than the autocracies. How should we understand the relationship between political institutions and FDI?



Source: Polity IV database and UNCTAD FDI online database

Note: 1. Non-OECD democracies include countries with Polity score as 4 or higher; Autocracies include countries with Polity score below 4. The cutoff point is based on the widely-accepted criteria that countries with polity score as 4 or higher are normally considered as electoral democracies.  
2. The average FDI inflows are total FDI flowed into autocracies or democracies divided by the number of countries (unweighted).

**Figure 2-1: Average FDI Inflows between Democracies and Autocracies 1982-2004**

This chapter aims to develop a new framework for understanding the relationship between political institutions and FDI. I argue that the relative capacity of different

<sup>33</sup> Ranade 2002.

types of regimes to attract FDI is a function of institutional constraints that underlie policy credibility and flexibility. Both policy features provide foreign investors with some advantages for engaging in specific types of activities in host countries. Foreign investors exploit this institutional support to derive competitive advantages that cumulate into comparative institutional advantages at the national level.<sup>34</sup> Democratic regimes attract FDI because multiple veto players facilitate a more credible policy environment, which enhances the level of policy sustainability and property rights protection. Authoritarian regimes attract FDI not despite the lack of policy credibility, but because of the availability of flexibility. Fewer veto players facilitate a more flexible policy environment, which gives governments more capacity to offer incentives to investors.

My theory predicts a nonlinear relationship between political institutions and FDI. The panel data statistical analysis during 1982-2004 demonstrates an inverted U-shape relationship between political institutions and FDI in developing countries. FDI should be high in countries where institutional strength is moderate but lower in countries with either extremely weak or strong institutions. Increase in the number of veto players enhances FDI at low level of credibility but depresses FDI when a moderate level of credibility has been attained. But this nonlinear relationship between political institutions and FDI does not hold for developed countries, suggesting that the overall political institutions may not be a major factor that influences FDI in consolidated democracies.

I also find that the number of veto players is positively associated with level of policy certainty but negatively associated with the provision of investment incentives to foreign firms. This finding implies that the causal chains between political

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<sup>34</sup> Hall and Soskice 2001.

institutions and FDI are plausible.

This chapter proceeds as follows. The second section reviews the debate on the relationship between political institutions and private investment. The third section illustrates the theoretical framework and presents testable hypotheses. The fourth section discusses the research design and present statistical results of the relationship between political institutions and FDI. The fifth section presents the statistical results of the hypothesized causal mechanism. The last section is the conclusion.

## **II. A Debate on the Relationship between Political Institutions and Investment**

The relationship between political institutions and private investment has been examined extensively. Two perspectives—the advantages of dispersed authority and concentrated authority—stand out as a pair of compelling and competing arguments. Dispersed authority refers to the situation in which governments are subject to strong institutional checks and balances. Concentrated authority refer to the situations in which the state has the capacity to tax and regulate, and consequently, to play an intervening role. While both perspectives concur that political institutions are of pivotal concern to foreign investors in the long run, they emphasize on the effect of different institutional features.

### ***Dispersed Authority***

The dispersed authority argument emphasizes that policy credibility and property rights protection are the key factors affecting foreign investors' decisions. Foreign investors have to assess the degree of political risk before placing their investment.

The major political risk stems from the nature of the “obsolescing bargain” between foreign firms and host governments, which refers to the fact that foreign firms with large irreversible investments are vulnerable to host governments’ opportunistic expropriation *ex post*.<sup>35</sup> Expropriation could take different forms: it could be direct where an investment is nationalized or expropriated through formal transfer of title or outright physical seizure; it could also occur through interference by a state in the use of that property or with the enjoyment of the benefits even where the property is not seized and the legal title to the property is not affected.<sup>36</sup>

A solution to the credibility problem is to impose effective checks and balances on governments, raising the hurdles to arbitrary policy change. The credible commitment literature emphasizes that well-developed political institutions that promote credible policy are of primary importance in the process of economic development.<sup>37</sup> Political institutions determine the constraints and the distribution of *de jure* political power, which in turn affects policy choices and then economic outcomes.<sup>38</sup> Tsebelis argues that institutional configurations with multiple veto points require agreement across a broad range of political actors to endorse a shift in policy, increasing the effort of any given political actor to change the status quo, and thus will be more able to credibly commit their policy choices.<sup>39</sup>

A modified perspective suggests that a formal checks-and-balances mechanism is neither a sufficient nor a necessary precondition of credible policies. Stasavage argues that the presence of checks and balances mechanisms in developing countries may not

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<sup>35</sup> Vernon 1971.

<sup>36</sup> It is worth noting that customary international law does not preclude host states from expropriating foreign investments provided certain conditions are met. These conditions are: the taking of investment for a public purpose, as provided by law, in a non-discriminatory manner and with compensation. (OECD 2004, 3-4)

<sup>37</sup> North & Weingast 1989, North 1990, Levi 1988, Williamson 1996, Dixit 1996.

<sup>38</sup> Acemoglu et al 2005.

<sup>39</sup> Tsebelis 2002.



ensure the credibility of policy commitment to private investors. Credibility cannot be obtained even with multiple veto players if owners of that asset are not represented by any veto player. In contrast, credibility can be ensured even with only one veto point, as long as owners of that asset form a majority in a representative assembly with veto power.<sup>40</sup> Keefer and Knack argue that a nation's creditworthiness is determined by both institutional credibility (number of institutional veto players) and social polarization (income inequality and socio-linguistic inequality). Given multiple veto players, social polarization reduces the ability of countries to respond to shocks, and therefore reduces creditworthiness. The more contentious the social interests are, the higher the potential for a reversing of government policies.<sup>41</sup>

Some cross-national econometric studies find that various effects of political institutions such as political risk,<sup>42</sup> political stability,<sup>43</sup> bureaucratic quality,<sup>44</sup> property rights protection,<sup>45</sup> and political capital,<sup>46</sup> are significantly associated with private investment and economic growth, indicating that foreign investors tend to favor democratic regimes over authoritarian regimes.

All these studies agree that existence of credible political institutions is the key factor that attracts FDI. While some scholars argue that countries lacking strong checks and balances could rely on some "commitment institutions" such as granting independent authority to regulators, adopting specific and substantive rules, signing a bilateral investment treaty with investors' home countries, joining international organizations, or negotiating investment-cost sharing schemes, to mitigate the

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<sup>40</sup> Stasavage 2002.

<sup>41</sup> Keefer and Knack 2002.

<sup>42</sup> Henisz 2000b, Jensen 2003.

<sup>43</sup> Feng 2001.

<sup>44</sup> Evans and Rauch 1999.

<sup>45</sup> Acemoglu and Johnson 2005.

<sup>46</sup> Gerring et al. 2005.

institutional weakness to a certain extent, they also indicate that these countries cannot completely overcome the institutional disadvantage.<sup>47</sup> These countries can only implement ad hoc policy instruments to promote growth and these policies only have minor effect on economic development in the long run.

However, empirical studies have generally failed to provide consistent evidence to support a positive relationship between democratic institutions and foreign investment. Wells highlights fledging democracy's double-edged sword for investors: on the one hand, the government has greater accountability to foreign firms; on the other hand, opposition parties have more freedom to criticize foreign firms as a means to attack incumbent governments. Some democratic governments also have a compelling political need to demonstrate to a domestic constituency their resoluteness and their independence in negotiations with foreign investors.<sup>48</sup> A negative association between democracy and FDI inflows found by Li and Resnick suggests that democracy may reduce the propensity for host governments to offer incentive packages to foreign investors at the expense of taxpayers, thus reducing the incentives for foreign investors to pick democratic investment locations.<sup>49</sup>

### ***Concentrated Authority***

Why do some countries without credible political institutions still attract private investment and promote economic growth? A second theory argues that concentrated political authority is a crucial element of the story. The model of the "developmental state" sketched by Chalmers Johnson 25 years ago maintains that a centralized state

<sup>47</sup> Levy and Spiller 1996, Fine 2003, Buthe & Milner 2005, Jensen 2006.

<sup>48</sup> Wells 1998.

<sup>49</sup> Li and Resnick 2003.

interacting with the private sector contributed to the East Asian industrial success.<sup>50</sup> A crucial component of developmental state is a political system in which the bureaucracy is given sufficient scope to take initiatives and provide a “helping hand” to private agents. By contrast, “predatory states” in which the political institutions allow the minority in power to use its power to play a “grabbing hand”, reduce private agents’ incentives to invest and produce.<sup>51</sup>

Subsequent studies of East Asian economies reinforced the picture of developmental states. Most of these studies focus primarily on the role of states play in eliciting higher rate of private investment.<sup>52</sup> Especially when political institutions are inefficient for promoting economic growth, strong ruling elites have more capacity to change the status quo and initiate economic reforms. Haggard and Kaufman argue that entrenched powers can contribute to the successful initiation and consolidation of politically difficult economic reform measures.<sup>53</sup> Using incentives, subsidies, controls, and mechanisms to deliberately get some prices wrong, governments in South Korea and Taiwan were able to change the inefficient institutions and stimulate economic activity.<sup>54</sup> In particular, Haggard argues that host governments can use three levels of policy to affect foreign investment: environment of property rights protection, structure of macroeconomic incentives, and industry-specific incentives. The ability of governments to use these policy tools depends on

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<sup>50</sup> Johnson 1982.

<sup>51</sup> The terms “grabbing hand” and “helping hand” were initially used by Frye and Shleifer (1997). While both models assume that government (usually, although not necessarily, under a dictatorship) is above law, they differ significantly in how government use its power. The helping hand model means that government uses its power to help business and state officials enforce contract. The grabbing hand model means that government uses its power to extract rent, and mafia replaces state as enforcer. See Frye and Shleifer 1997.

<sup>52</sup> See, for example, Amsden 1989, Wade 1990, Haggard 1990, and Evans 1995.

<sup>53</sup> Haggard and Kaufman 1995.

<sup>54</sup> Amsden 1989, Wade 1990.

their specific institutional features in different issue areas.<sup>55</sup>

These findings actually suggest a major weakness of the credible commitment literature. A credible commitment is only good when the status quo is efficient. If the status quo is inefficient, concentrated authority is better to facilitate an efficient change.

With respect to the credibility problem in authoritarian regimes, the concentrated authority perspective suggests that institutional checks and balances may not be necessary because alternative mechanisms are possible to create safeguards for private investors. These safeguards could be self-enforced. Olson argues that repeated games could discourage a predatory government from maximizing short-term payoffs by expropriating private investors and thus enhance the credibility of government commitment as long as the shadow of the future is sufficiently long.<sup>56</sup> Weingast and others employ the idea of de facto federalism (market-preserving federalism) to explain the unusual success of a Chinese economy in which formal legal property rights protections are lacking.<sup>57</sup> For them, fiscal decentralization can partly overcome credible commitment problem by creating incentives to limit state predation and reduce soft budget constraint problem.

The alternative safeguards could also be purposively designed policy instruments. The use of political repression to minimize uncertainty and risk while offering generous treatment indicates that an alliance between governments and MNCs is in the best interest of the latter. As stated by Robert Gilpin, “because the corporations require a stable host government sympathetic to capitalism, dependent development encourages the emergence of authoritarian regimes in the host country and the

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<sup>55</sup> Haggard 1990.

<sup>56</sup> Olson 2000.

<sup>57</sup> Weingast 1995, Montinola et al. 1995, Qian and Weingast 1997.

creation of alliances between international capitalism and domestic reactionary elites.”<sup>58</sup> Evans also notes that dependent industrialization requires the use of repression to calm the fears of foreign investors and ensure them a certain level of profit.<sup>59</sup> Haggard argues that authoritarian governments could establish their credentials with foreign investors through other commitment technologies such as industrial policies, subsidies, rents, corruption, and particularistic ties.<sup>60</sup>

Indeed, pro-capital developmental policy has created some appealing stories of investment-led economic growth in East Asian economies. The use of political repression has led to increased FDI in some Latin American countries who have experienced the process of dependent development.<sup>61</sup> However, empirical evidence from large number of countries has yet to confirm consistent and stable relationships between specific institutional arrangements and private investment.

Given their theoretical tension and inconclusive empirical findings, neither the dispersed authority nor the concentrated authority perspective alone provides a satisfactory explanation to the relationship between political institutions and FDI. The tension can be related to the dilemma of state power, that is, a state powerful enough to use coercion toward positive ends such as property rights protection or contracts enforcement can also use it predatorily.<sup>62</sup> This tension, suggests the need for a way to bridge the gulf between these competing hypotheses that would specify the conditions under which one is more appropriate than the other.

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<sup>58</sup> Gilpin 1987, 247.

<sup>59</sup> Evans 1979.

<sup>60</sup> Haggard 2004, 62-63.

<sup>61</sup> Collier 1979, O'Donnell 1988.

<sup>62</sup> Weingast 1997.

### III. Theory and Hypotheses

A central assumption of this paper is that all bureaucratic systems are confronted with an inherent tension between credibility and flexibility: institutional frameworks that fragment decision-making power are likely to promote policy credibility while those that concentrate decision-making power are likely to promote policy flexibility. The situation is labeled by Andrew MacIntyre as “the power concentration paradox.”<sup>63</sup> Both characteristics have important implications for economic policy. Economic development hinges on the conditions under which governments can commit themselves credibly to policy promises and respond flexibly to external shocks (e.g., financial crisis) or distribute benefits to various groups within society. On the one hand, credible commitment could ensure prospective private investors a reasonable return on investment and avoid the possibility of arbitrary governmental discretion, but it may entail the risk of policy rigidity, slowing pro-competitive reforms over time. On the other hand, flexibility could overcome collective action problems and facilitate quick decision-making, but it could also make policy less accountable in the absence of external checks and balances on bureaucratic power.<sup>64</sup> Whether policy credibility or flexibility is more beneficial depends on whether the status quo is efficient.<sup>65</sup> If positive action will be required to change an unpopular status quo or maintain an announced policy (e.g., pro-capital economic reforms),

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<sup>63</sup> MacIntyre 2003.

<sup>64</sup> Murtha and Lenway (1994) apply a similar framework to explain states’ industrial strategies. They argue that policy credibility and target specificity combine to determine states’ industrial strategy implementation capabilities. Target specificity, defined as the degree to which a state can disaggregate and isolate component activities of the national economy as objectives of policy intervention, is negatively associated with policy credibility. For example, command economies have high target-specific and low credible industrial policy whereas pluralist regimes have high credible and low target-specific industrial policy.

<sup>65</sup> Haggard and Kaufman 1992, Rogowski 1999.

concentrated authorities are superior. If the status quo suffices (e.g., property rights protection), multiple-veto arrangements are more effective.

How do we know whether a government is more credible or more flexible? In analyzing the policy outcomes of political institutions, researchers focus on the way institutions define the capacity to block or to pass legislation, thus to exercise a veto. Governments' ability to commit policy flexibility or policy credibility is shaped by the number of institutional veto players. States that have more veto players tend to be more able to commit to maintain a given policy whereas states that have fewer veto players tend to be more likely to enact and initiate policy change. Therefore, other things being equal, the more veto players, the stronger the political institutions, and the more stable the policy, and vice versa.<sup>66</sup>

On the one hand, strong institutions encourage credible governance and produce high level of policy certainty, which attracts FDI.<sup>67</sup> Acemoglu and Johnson separate the effects of contracting institutions from property rights institutions and find that the former has less impact on economic development than the latter, suggesting that “economies can function in the face of weak contracting institutions without disastrous consequences, but not in the presence of a significant risk of expropriation from the government or other powerful groups.”<sup>68</sup> Moreover, strong institutions may reduce the “hassle” costs of doing business, moral hazards, and incompleteness in commercial dealings (i.e., search, negotiation, and enforcement costs).<sup>69</sup>

<sup>66</sup> Cox and McCubbins 2001.

<sup>67</sup> A vivid example illustrates the importance of policy certainty to foreign investors. Brazilian President Lula was named as *Personality of the Year 2004* winners by FDI Magazine because of his pro-active stance to promote FDI: “We want to show to investors that we have stability and democracy and assure them that the rules are well defined and that no-one will be taken by surprise by a sudden new regulation.” FDI Magazine 2004.

<sup>68</sup> Acemoglu and Johnson 2005, 953. They use expropriation risk index to measure broad property rights institutions and legal formalism indices to measure narrow contracting institutions.

<sup>69</sup> Bevan et al. 2004.

On the other hand, strong institutions may also inhibit institutional capacity to enforce cooperative political exchanges, and thus undermine governance efficiency and increase transaction costs. For example, Spiller and Tommasi argue that large number of key political players in Argentine policy-making process has moved away politics from institutional arenas, increasing the difficulty to reach cooperative outcomes among policy decision makers.<sup>70</sup>

In contrast, weak institutions experience bigger swings of control over policy and facilitate flexible governance, which produces efficiency and adaptability in policy management. Governments can attract FDI through specific policy instruments, investment incentives in particular.

While investment incentives were conventionally seen as a relatively minor determinant of FDI decisions, a stream of literature has found out that foreign investment is actually sensitive to tax rates.<sup>71</sup> As a matter of fact, investment incentives have become increasingly prominent in governments' investment policy worldwide. An empirical study finds that nearly 95 percent of the 1,086 changes in national FDI legislation in 1992-2001 were favorable to foreign investors. The single most important share of these changes focused on incentives and FDI promotion, accounting for 31 percent of the liberalizing changes.<sup>72</sup>

Critics argue that investment incentives increase the net return to mobile capital while shifting tax burden to labor and other immobile factors, especially when economic integration advances.<sup>73</sup> Increased competition for international capital will prompt countries to reduce their public spending and lower regulatory standards, thus

<sup>70</sup> Spiller and Tommasi 2003.

<sup>71</sup> See Guisinger 1985, Desai et al. 2004, and Garretsen and Peeters 2006.

<sup>72</sup> Kobrin 2005.

<sup>73</sup> Rodrik 1997.



resulting in an inefficient provision of public goods.<sup>74</sup> These problems may be particularly severe if the incentives discriminate against local firms and cause losses of local market shares and employment.<sup>75</sup>

If investment incentives are not welfare-enhancing, why do governments still rush to enter a “race to the bottom”, a game when countries lower their tax rates to compete for foreign investment? An important reason is that governments always have incentives to pursue policy objectives that are easily observable in the short term (e.g., job creation, economic growth) while the costs are distributed over long periods of time and hard to measure.<sup>76</sup> However, if there is a “race to the bottom”, it seems more likely to be found in countries with weak institutions for two reasons.

First, governments with weak institutions have a strong capability to impose their redistribution biases and provide private goods to a certain interest groups. Every government, irrespective of its political make up, performs two economic functions. One is redistributive: governments transfer private goods to powerful interest groups. The other is allocative: governments use taxes to invest in their economies.<sup>77</sup> However, governments’ redistribution biases are shaped by their specific political institutions. A pro-capital regime would minimize redistribution and maximize growth, while a populist regime would do the opposite.<sup>78</sup>

I assume that any government must compete against challengers over the provision of public goods and governments have redistribution biases in favor of their supporting groups—the winning coalition. As the institutions become stronger, the winning coalition grows relative to the size of the selectorate, governments face

<sup>74</sup> Oates 1972, Gordon and Hines 2002, Charlton 2003.

<sup>75</sup> Oman 2000.

<sup>76</sup> Blomström and Kokko 2003.

<sup>77</sup> McGuire and Olson 1996.

<sup>78</sup> Alesina and Rodrik 1994.

increasing pressure to provide public rather than private goods, because it is less efficient to use private transfers to satisfy specific clients.<sup>79</sup>

Politicians may get political credit by attracting more FDI. Some domestic firms may receive the privilege of being the major recipients of foreign capital and technology transfers. These pro-capital politicians and interest groups would have strong incentives to pursue a more capital-friendly policy and provide incentives to foreign firms. In a small winning coalition system, the preferences of these small interest groups are likely to dominate government policy making. In a large winning coalition system, by contrast, the politicians—to maximize electoral success—have a greater incentive to appropriate income from foreign firms because the majority of domestic residents do not benefit from the equity holdings held by foreign firms. Therefore, countries with weaker political institutions will be more likely to offer investment incentives to please their pro-capital supporters and shift tax burdens to the rest of the society. For example, China and Vietnam, despite their autocratic policy-making regimes, have created entrepreneurial and capital-friendly policy environments that are attractive to foreign investors.<sup>80</sup>

Secondly, governments with weak institutions should face strong competing pressure to adjust their domestic policies, because they are subject to a more careful and broad scrutiny by international investors.<sup>81</sup> They would be more willing to make upfront payments to compensate foreign investors' expected loss ex post. Doyle and van Wijnbergen argue that the arrangement of tax incentives is a solution to a time consistency problem created in the bargaining game between a foreign firm and a host

<sup>79</sup> Bueno de Mesquita et al. 2002.

<sup>80</sup> Huang 2003; Meyer and Hung 2005.

<sup>81</sup> Mosley 2003, Wibbels 2006.

government.<sup>82</sup> The premise is that irreversible investment combined with a host government's inability to commit to future tax rates allows the host government to extract a greater share of foreign firm profits through increasing tax rates. If the host government lacks the means to commit itself to fulfilling its promises, forward-looking foreign investors would discount its pledges and instead focus on the upfront benefits they can get. Since a country with weak political institutions is more likely to renege on its commitment ex post, it has an incentive to make more upfront concessions to the foreign firm to reach a deal. Otherwise foreign investors will walk away.

Based on these discussions, I expect that tradeoff of investment determinant posited by levels of institutional strength exists between policy certainty and pro-capital incentive. Two hypotheses emerge to capture the effects of institutional strength on policy outcomes.

*H1: Stronger institutions facilitate higher level of policy certainty, other things being equal.*

*H2: Weaker institutions enable governments to provide more incentives for foreign investors, other things being equal.*

What motivates or inhibits foreign investors to enter a new country or undertake a major expansion of an ongoing business? While foreign investors normally prefer a long-standing stable environment, they do not rule out investing in markets where stable environment is absent. Investors taking a chance in unstable political

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<sup>82</sup> Doyle and van Wijnbergen 1994.

environments normally demand a higher return on investment than they would in more stable situations. For them, a host government's preferential policies to foreign investment (i.e., low tax, subsidy, market monopoly opportunity) can offset flaws in overall environment. Foreign investors are most likely to be attracted to institutions that are able to maintain a sufficient level of policy certainty while offering enough flexibility to meet investors' demands. Therefore, a modest level of institutional strength should be most attractive to foreign investors. Countries with too strong or too weak institutions can still attract FDI, but either extremely rigid or extremely volatile policy environment would undermine host countries' attractiveness to foreign investors.

Therefore, I expect a diminishing marginal effect of political institutions on FDI. Increase in institutional strength has a positive impact on FDI when the policy environment is volatile, but the positive effect turns to negative when institutions are too strong and policy environment becomes too rigid. At very high or low levels of institutional strength, governments suffer from either rigidity or instability problems. These arguments yield a proposition.

*H3: FDI will be higher in countries where institutional strengths are moderate but lower in countries where institutional strengths are too high or too low.*

#### **IV. Empirical Analysis: Political Institutions and FDI**

Using a time-series cross-section (TSCS) dataset, this section tests the relationship between political institutions and FDI. The dataset includes 172 countries and territories from 1982 to 2004. The central hypothesis is that political institutions

have a nonlinear effect on FDI. I expect to see that political institutions are positively associated with FDI when the level of institutional strength is low and political institutions have negative effect on FDI when the level of institutional strength is high. However, some studies strongly suggest that FDI decisions are driven by different considerations in developed countries and developing countries, so it may not be appropriate to pool developed and developing countries in the same regression equation.<sup>83</sup> To address this concern, I apply the same regression specification to non-OECD countries and OECD countries respectively, expecting to see a systematic variation between developing and developed countries.

### *Dependent Variable*

The dependent variable is FDI between 1982 and 2004, both in terms of net inward flows and stock.<sup>84</sup> The data are obtained from the United Nations Conference on Trade and Development (UNCTAD) website.<sup>85</sup> Data on FDI flows are on a net basis (capital transactions' credits less debits between direct investors and their foreign affiliates). For a large number of economies, FDI stocks are estimated by either cumulating FDI flows over a period of time or adding flows to an FDI stock that has been obtained for a particular year.<sup>86</sup> Both variables are logged to reduce skewness.

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<sup>83</sup> See, for example, Mosley 2003, Buthe and Milner 2005.

<sup>84</sup> Market prices are the basis for valuation of both FDI flows and stocks. FDI stock is measured as the market value of subsidiary (or associated) companies' share capital plus (or minus) loans, trade credit, and debt securities (liabilities). FDI flow is measured as the direct investor's increased share of the subsidiary (or associated) companies. See OECD 1996.

<sup>85</sup> There is a slight difference between UNCTAD and WDI data on FDI flows due to their different data sources. Since WDI database does not have information for FDI stock, I use UNCTAD data of both FDI inflows and inward stocks.

<sup>86</sup> Both FDI measures have their advantages and drawbacks. On one hand, FDI stock reflects a long-term trend of FDI activities, reducing the concern that abnormal factors may significantly contribute to

### ***Independent Variable***

The central independent variable measures the level of institutional strength. To increase the robustness of the analysis, I use two measures, both of which are constructed based on the veto-player framework. Henisz's political constraints index *polcon* is theoretically derived from a spatial model of veto players.<sup>87</sup> The more veto points a country has, the higher its *polcon* score and the less likely are unanticipated policy changes. Yet as the number of veto points increases, so too does the number of political players involved in the investment process. He incorporates information covering 1) the number of formal constitutional veto points in a political system (executive, number of house of legislature, federal sub-units, and judiciary), 2) whether these veto points are controlled by different parties, and 3) the cohesiveness of the majority which controls each veto point. The *polcon* index ranges from 0 (least constrained) to 1 (most constrained). Each additional veto point provides a positive but diminishing effect on the total level of constraints on policy change. High level of political constraints is associated with high policy credibility and low flexibility. Low level of political constraints is associated with low policy credibility and high flexibility.

An alternative measure of institutional strength *checks*, developed by Keefer, is also derived from a model of veto players, based on whether the executive and legislative chambers are controlled by different parties in presidential systems and on

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a short-term drastic change in FDI inflows. On the other hand, it may be difficult to identify the empirical factors affecting FDI stock values given relatively small variation in the FDI stocks on a year-to-year basis.

<sup>87</sup> Henisz 2000a.

the number of parties in the government coalition for parliamentary systems.<sup>88</sup> The *checks* index also takes account of the fact that certain electoral rules (closed list vs. open list) affect the cohesiveness of governing coalitions. In addition, the index is explicitly incremented when a party in the government has an economic policy orientation closer to that of the main opposition party than to that of the party of the executive.<sup>89</sup> The *checks* index ranges from 1 to 18. High score of *checks* is associated with high policy credibility and low flexibility. Low score indicates low policy credibility and high flexibility. Since my theory predicts a nonlinear relationship between institutional strength and FDI, I include a quadratic term of the independent variable (*polcon* and *checks*). If the relationship between institutional strength and FDI is an inverted U-shape, the linear term of the independent variable should be positive and the quadratic term negative.

### ***Control Variables***

Conventional wisdom as well as scholarly work suggests that FDI may be primarily affected by location-specific economic factors. Following some baseline econometric models on FDI locations, I include a number of control variables in order to capture key factors that may impact FDI.<sup>90</sup> These factors include level of economic development, country size, economic growth, openness to trade, level of industrialization, and domestic saving rate. The likely impacts of all these control variables on FDI are discussed below.

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<sup>88</sup> Keefer 2002.

<sup>89</sup> Keefer and Stasavage 2003.

<sup>90</sup> Blonigen 2005.

A host country's size and level of economic development are most likely to affect foreign investors' decisions. More developed countries and larger countries tend to attract more FDI. I thus use per capital real GDP (*lgdpper*) and population (*lpop*) to measure economic development and size respectively. Both variables are logged to reduce skewness. I expect that both control variables have positive effects on FDI.

I also include real growth rate (*growth*) as a control. Since firms in countries with high economic growth tend to have high rate of return, the net impact of growth on FDI should be positive.

Another factor that is likely to have an impact on FDI is openness to trade (*trade*), measured by the ratio of imports and exports to GDP. It is also expected to be positively associated with FDI.

Degree of industrialization (*industry*) and domestic saving rate (*saving*) are also included. Degree of industrialization, measured as percentage of industrial added value to GDP, may have an ambiguous effect on FDI. On one hand, economies at an early stage of industrialization cannot offer the sophisticated providers of input that most foreign investors need to be competitive; on the other hand, foreign investors may find these economies more attractive because they are more likely to have first-mover advantage.

The conventional wisdom suggests that FDI comes as the expense of domestic investment. However, Desai et al find that FDI and domestic investment are complements as greater foreign investment is associated with higher level of domestic investment.<sup>91</sup> Therefore, a country with high domestic saving rate tends to have higher demand for external investment. I thus expect a positive association between domestic saving rate and FDI.

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<sup>91</sup> Desai et al. 2005.



I also include capital control dummy (*capcontrol*). The impact of capital account control on FDI has been examined in some studies.<sup>92</sup> I use the IMF capital control dummy that is designed to capture restrictions on capital transactions. It takes 0 when there is no restriction on capital account and 1 otherwise. Capital controls signal an unfriendly investment environment and may discourage potential investors from establishing affiliates in the first place. Therefore, I expect that capital control dummy has a negative impact on FDI. The data descriptions are presented in Appendix 2-A.

Heteroskedasticity, contemporaneous correlation, and serial correlation are potential concerns in TSCS data. Following Beck and Katz's (1995) suggestion, I use a panel-corrected standard-errors (PCSEs) model to capture the unbiased effects of political institutions on FDI. The major difference between OLS and PCSE models is that the latter assumes the existence of heteroskedasticity and cross sectional contemporary correlation. Since I am also concerned about serial correlation, I use AR (1) correction to get refined outcomes. All the right-hand-side variables are lagged by one period to reduce the concern of endogeneity.<sup>93</sup>

However, the coefficients generated by this estimation procedure may be biased by country-specific fixed effects. But using a fixed-effects regression would make it difficult to estimate coefficients for the time-invariant independent variables.<sup>94</sup>

Therefore, I use a random-effect model to check the robustness of the results.

<sup>92</sup> See, for example, Desai et al. 2006; Buthe and Milner 2005.

<sup>93</sup> Reverse causality is also a concern when we examine the causality between governance and FDI. It is possible that FDI affect the quality of governance. More FDI inflows can generate incentives to reform and improve property rights. Moreover, the governance quality measures are constructed ex post, analysts might have a natural bias toward assigning better institutions to countries with higher capital inflows. One solution is to find variables not subject to reverse causality that can account for the institutional variation. However, since I do not have appropriate instrumental variables, I lag all of the independent and control variables by one period of time to reduce the concern of reverse causality.

<sup>94</sup> There are 13 authoritarian countries where the values of *polcon* and *checks* remain constant during the period of time, which make both variables perfectly collinear with country dummy.

### *Findings*

As shown in Table 2.1, the regression outcomes in both the PCSE and the random-effect models show an inverted U-shape relationship between political institutions and FDI in developing countries. For both measures of institutional strength (*checks* and *polcon*), the coefficients are positive on the linear term and negative on the quadratic term and their effects are statistically significant in all models. This implies a diminishing marginal effect of institutional strength on FDI. Therefore, the relationship between institutional strength and FDI is non-linear: for low levels of institutional strength the investment-institution relationship is positive while for high levels of institutional strength it is negative.

With respect to the control variables, the coefficients on the economic determinants of FDI such as GDP per capital, population, and trade openness have the expected positive signs and their effects are statistically significant, suggesting that developing countries with higher level of economic development, larger size, and more connections with international market tend to attract more FDI. The significance and negative sign of the coefficients on *capcontrol* suggest that countries with liberalized capital account tend to attract more FDI. *Growth* has significant and positive effects on FDI flows but not on FDI stock, indicating that economic growth may only have short-term influence on foreign investors' decision. In contrast, *industry* has highly significant and negative effects on FDI stock but not on FDI flows, suggesting that degree of industrialization has long-term effect on foreign investor's decision. Foreign investors are more likely to enter countries in the early stages of industrialization in order to benefit more from their first-mover advantage. Domestic saving rate, however, does not have significant effect on FDI.

**Table 2-1: Relationship between Political Institutions and FDI in Developing Countries**

Dependent Variable	lfdif (Ln FDI Flow)				lfdis (Ln FDI Stock)			
	Model 1 (PCSE)	Model 2 (PCSE)	Model 3 (RE)	Model 4 (RE)	Model 5 (PCSE)	Model 6 (PCSE)	Model 7 (RE)	Model 8 (RE)
checks	0.238 (5.12)***		0.212 (3.77)***		0.065 (3.47)***		0.063 (3.43)***	
checks <sup>2</sup>	<b>-0.012</b> <b>(-2.76)***</b>		<b>-0.010</b> <b>(-2.05)**</b>		<b>-0.003</b> <b>(-2.02)**</b>		<b>-0.003</b> <b>(-1.92)*</b>	
polcon		2.423 (3.46)***		2.339 (2.98)***		0.714 (2.51)**		0.639 (2.47)**
polcon <sup>2</sup>		<b>-2.436</b> <b>(-1.95)*</b>		<b>-2.369</b> <b>(-1.66)*</b>		<b>-0.794</b> <b>(-1.61)</b>		<b>-0.703</b> <b>(-1.54)</b>
lgdpper	0.968 (16.61)***	0.909 (16.31)***	0.996 (10.65)***	0.959 (10.91)***	0.976 (17.01)***	1.012 (18.40)***	1.035 (14.42)***	1.073 (15.72)***
lpop	0.942 (21.31)***	0.863 (24.61)***	0.945 (14.77)***	0.875 (15.77)***	0.926 (27.98)***	0.881 (31.29)***	0.983 (18.31)***	0.930 (19.65)***
growth	0.019 (2.77)***	0.016 (2.32)**	0.019 (4.00)***	0.016 (3.69)***	-0.0002 (-0.01)	-0.001 (-0.28)	-0.0001 (-0.11)	-0.001 (-1.01)
industry	-0.001 (-0.09)	0.001 (0.12)	-0.004 (-0.52)	-0.003 (-0.45)	-0.010 (-2.64)***	-0.009 (-2.77)***	-0.011 (-3.65)***	-0.009 (-3.28)***
saving	-0.004 (-0.85)	-0.001 (-0.27)	-0.003 (-0.60)	-0.001 (-0.19)	0.003 (1.41)	0.002 (1.00)	0.002 (1.30)*	0.001 (0.87)
trade	0.014 (8.31)***	0.012 (7.68)***	0.012 (5.98)***	0.010 (5.74)***	0.005 (5.03)***	0.004 (4.59)***	0.004 (5.15)***	0.003 (4.07)***
capcontrol	-0.074 (-0.60)	-0.183 (-1.62)	-0.183 (-1.26)	-0.262 (-2.01)**	-0.133 (-2.85)***	-0.180 (-3.06)***	-0.123 (-2.41)**	-0.184 (-4.13)***
cons	-18.812 (-21.47)***	-16.834 (-24.89)***	-18.651 (-13.64)***	-16.966 (-13.87)***	-14.977 (-18.32)***	-14.298 (-19.18)***	-16.106 (-14.74)***	-15.378 (-15.43)***
rho	0.63	0.63	0.61	0.61	0.89	0.89	0.89	0.90
R <sup>2</sup>	0.26	0.24	0.69	0.70	0.66	0.62	0.64	0.65
No. of countries	123	131	123	131	123	131	123	131
Obs.	1732	1924	1732	1924	1865	2061	1865	2061

Note: Model 1, 2, 5, 6 use OLS with panel-corrected standard errors (PCSEs) and AR1 correction. Model 3, 4, 7, 8 use random-effect model and AR1 correction. z scores are in parentheses. All right-hand-side variables are lagged one period.

\*\*\* significant at 1%; \*\* significant at 5%; \* significant at 10%.

However, when the same regression specification is applied to OECD countries, both linear and quadratic terms of institutional strength have no significant effect on FDI, indicating that the nonlinear relationship between institutions and FDI does not hold for developed countries. (Table 2.2) This finding confirms the expectation that political institutions are not a major factor that affects FDI inflows in consolidated democracies.

With respect to the effects of control variables on FDI, however, there is no considerable variation between developed and developing countries. Per capita GDP, population, trade openness, and domestic saving rate are positively associated with FDI. The negative signs of the coefficients on *industry* and *capcontrol* imply that FDI prefer countries with liberalized capital market or with relatively low degree of industrialization.

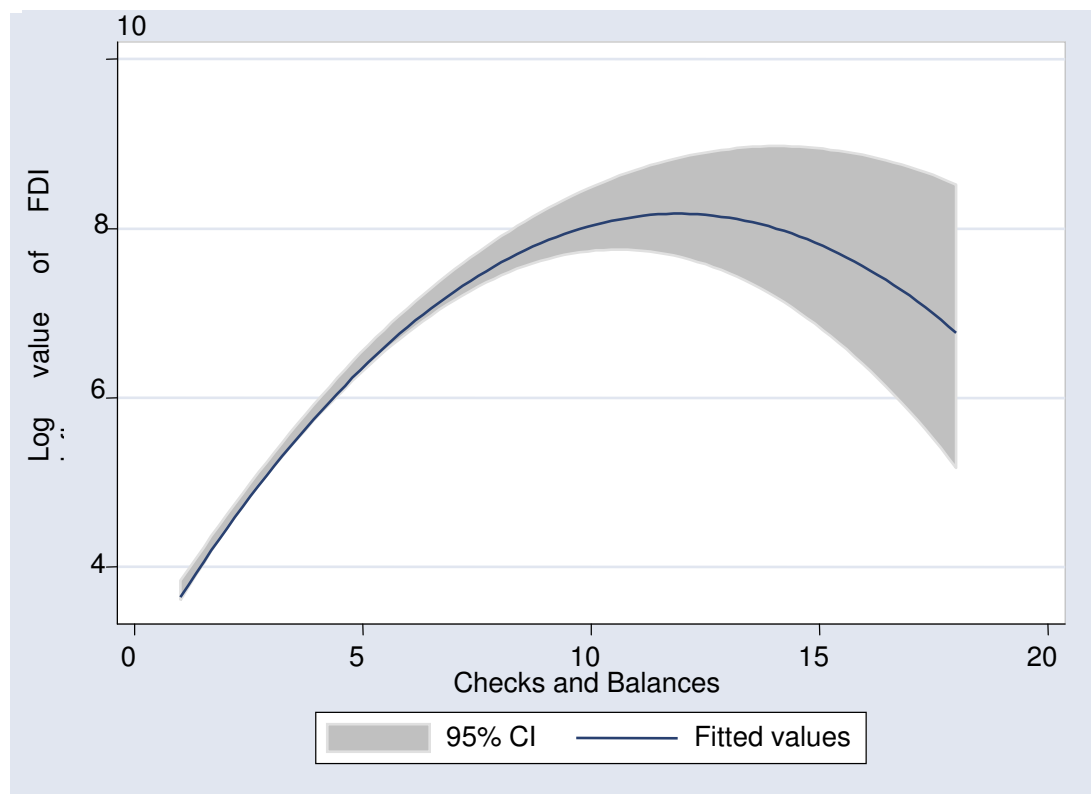
**Table 2-2: Relationship between Political Institutions and FDI in Developed Countries**

Dependent Variable	lfdif (Ln FDI Flow)				lfdis (Ln FDI Stock)			
	Model 1 (PCSE)	Model 2 (PCSE)	Model 3 (RE)	Model 4 (RE)	Model 5 (PCSE)	Model 6 (PCSE)	Model 7 (RE)	Model 8 (RE)
checks	-0.049 (-0.52)		-0.068 (-0.63)		0.054 (1.45)		0.023 (0.82)	
<b>checks<sup>2</sup></b>	<b>-0.0004 (-0.09)</b>		<b>0.001 (0.12)</b>		<b>-0.003 (-1.49)</b>		<b>-0.001 (-0.64)</b>	
polcon		0.379 (0.12)		-1.328 (-0.24)		1.159 (0.91)		-2.124 (-1.41)
<b>polcon<sup>2</sup></b>		<b>-0.66 (-0.66)</b>		<b>-0.031 (-0.00)</b>		<b>1.069 (0.68)</b>		<b>2.611 (1.51)</b>
lgdpper	2.480 (1.33)	0.294 (1.71)*	0.471 (1.90)*	0.475 (1.94)**	0.619 (4.91)***	0.655 (5.37)***	1.575 (8.50)***	1.592 (8.55)***
lpop	1.103 (13.94)***	1.094 (14.57)***	1.104 (10.02)***	1.091 (10.06)***	1.054 (26.07)***	1.053 (25.04)***	1.073 (10.56)***	1.078 (10.51)***
growth	0.017 (0.81)	0.016 (0.76)	0.020 (1.08)	0.019 (1.05)	0.006 (0.91)	0.005 (0.75)	-0.001 (-0.28)	-0.001 (-0.43)
industry	-0.116 (-4.76)***	-0.119 (-4.90)***	-0.137 (-6.14)***	-0.139 (-6.31)***	-0.068 (-5.66)***	-0.066 (-5.56)***	-0.061 (-6.86)***	-0.059 (-6.77)***
saving	0.037 (1.64)	0.041 (1.90)**	0.069 (2.85)***	0.072 (2.96)***	0.009 (0.78)	0.009 (0.78)	0.018 (2.17)**	0.018 (2.15)**
trade	0.022 (6.98)***	0.023 (7.43)***	0.020 (5.21)***	0.020 (5.28)***	0.061 (6.21)***	0.016 (5.87)***	0.010 (5.38)***	0.010 (5.38)***
capcontrol	-0.458 (-2.58)**	-0.452 (-2.59)***	-0.466 (-3.12)***	-0.448 (-3.00)***	-0.159 (-2.34)**	-0.155 (-2.30)**	-0.087 (-2.01)**	-0.087 (-2.04)**
cons	-11.051 (-4.04)***	-11.267 (-4.51)***	-13.014 (-3.91)***	-12.526 (-3.54)***	-12.440 (-9.63)***	-12.356 (-9.39)***	-21.879 (-8.77)***	-21.682 (-8.56)***
rho	0.66	0.65	0.57	0.57	0.85	0.85	0.91	0.91
R <sup>2</sup>	0.53	0.53	0.48	0.47	0.90	0.90	0.59	0.59
No. of countries	28	28	28	28	28	28	28	28
Obs.	438	438	438	438	455	455	455	455

Note: Model 1, 2, 5, 6 use OLS with panel-corrected standard errors (PCSEs) and AR1 correction. Model 3, 4, 7, 8 use random-effect model and AR1 correction. z scores are in parentheses. All right-hand-side variables are lagged one period.

\*\*\* significant at 1%; \*\* significant at 5%; \* significant at 10%.

In order to gain a clearer insight of the substantive importance of the results, Figure 2.2 provides a simulation of the effects of political institutions on FDI. The horizontal axis represents the variation in political institutions (in terms of the score of *checks*) actually observed in the data, keeping all the other control variables in Table 2.1 at their mean values. The vertical axis shows the predicted value of log FDI inflows. The inverted U curve suggests a nonlinear association between political institutions and FDI. For the most part the relationship is positive. It takes a down turn only at relatively high level of checks and balances, indicating that foreign investors tend to prefer stronger institutions in general, but their preference changes when institutions become too strong.



**Figure 2-2: Simulation of Effect of Checks and Balances on FDI**

## V. Empirical Analysis: Tests of Causal Mechanism

While the statistical evidence suggests a nonlinear correlation between institutional strength and FDI in developing countries, it is not clear whether political institutions affect FDI for the hypothesized reasons (H1 and H2). This section tests two causal paths—policy certainty and investment incentive—through which political institutions affect FDI. If the effects are channeled, political institutions should have an effect on both policy certainty and investment incentive and its effect on FDI should attenuate after the two variables are included in the model.

### *Political Institutions and Policy certainty*

The first causal channel is between institutional strength and policy certainty. To test it, I use the same TSCS dataset and same regression models in Table 1 but add two indicators—rule of law and expropriation risk—into the baseline specification to reflect a country's level of policy certainty. These two indicators are from International Country Risk Group (ICRG).<sup>95</sup>

The dependent variable is logged value of FDI inflows. Again, I use both PCSE and random-effect models. The results are presented in Table 2.3. Both indicators have the expected positive effects on FDI flows and stock in all models and the

<sup>95</sup> ICRG variables include six indicators, including corruption, rule of law, bureaucratic quality, ethnic tension, repudiation of contracts by government, and expropriation risk. Level of corruption reflects the degree of government transparency. Rule of law reflects the degree to which the citizens of a country are willing to accept the established institutions to make and implement laws and adjudicate disputes. High scores of bureaucratic quality indicate an established mechanism for recruitment and training. Ethnic tension measures the degree of tension within a country attributable to racial, nationality, or language divisions. Risk of expropriation measures the risk of confiscation and forced nationalization of foreign enterprises. Risk of repudiation of contracts by government is a measure of the risk that the governments will repudiate or unilaterally change the terms of contracts with foreign investors. The first four variables range from 0 to 6 and the last two ranges from 0 to 10, with higher values indicating better ratings, e.g., less corruption, low risk of expropriation, etc. The variables cover the largest number of countries between 1982 and 1997. See Knack and Keefer 1995.

coefficient of *expro\_risk* is statistically significant. More importantly, the inclusion of two indicators of political risks results in smaller coefficients and declining significance of both the linear and quadratic terms of *checks* and *polcon*, indicating that it is plausible that political institutions shape foreign investors' decisions by affecting the level of policy certainty.



Table 2-3: Inclusion of Policy Certainty Variables (Developing Countries)

Dependent Variable	lfdif (Ln FDI flow)				lfdis (Ln FDI stock)			
	Model 1 (PCSE)	Model 2 (PCSE)	Model 3 (RE)	Model 4 (RE)	Model 5 (PCSE)	Model 6 (PCSE)	Model 7 (RE)	Model 8 (RE)
checks	0.193 (3.54)***		0.163 (2.35)**		0.040 (1.64)		0.031 (1.45)	
checks <sup>2</sup>	-0.010 (-1.90)*		-0.007 (-1.21)		-0.001 (-0.71)		-0.0004 (-0.22)	
polcon		1.689 (2.14)**		1.298 (1.28)		0.378 (0.99)		0.401 (1.30)
polcon <sup>2</sup>		-1.815 (-1.35)		-1.182 (-0.64)		-0.455 (-0.66)		-0.504 (-0.92)
<b>rule_of_law</b>	<b>0.111 (1.63)</b>	<b>0.086 (1.30)</b>	<b>1.118 (1.66)*</b>	<b>0.087 (1.26)</b>	<b>0.056 (1.85)*</b>	<b>0.059 (1.90)*</b>	<b>0.067 (2.84)***</b>	<b>0.063 (2.75)***</b>
<b>expro_risk</b>	<b>0.235 (4.67)***</b>	<b>0.254 (5.26)***</b>	<b>0.233 (5.37)***</b>	<b>0.249 (5.84)***</b>	<b>0.076 (3.57)***</b>	<b>0.079 (3.63)***</b>	<b>0.084 (5.66)***</b>	<b>0.079 (5.47)***</b>
lgdpper	0.845 (10.49)***	0.771 (9.96)***	0.889 (7.80)***	0.818 (7.48)***	0.908 (10.95)***	0.898 (12.24)***	0.972 (11.26)***	0.949 (11.16)***
lpop	0.883 (19.13)***	0.859 (20.72)***	0.913 (10.64)***	0.881 (10.53)***	0.959 (18.73)***	0.936 (20.16)***	0.987 (13.35)***	0.973 (13.08)***
growth	0.017 (1.93)*	0.019 (2.15)**	0.017 (2.33)**	0.020 (2.78)***	-0.004 (-1.27)	-0.002 (-0.59)	-0.004 (-2.08)**	-0.002 (-1.44)
industry	-0.010 (-1.13)	-0.004 (-0.43)	-0.017 (-1.70)*	-0.010 (-1.11)	-0.013 (-2.87)***	-0.012 (-2.72)***	-0.015 (-4.30)***	-0.014 (-4.06)***
saving	0.012 (1.44)	0.012 (1.45)	0.012 (1.47)	0.010 (1.44)	0.006 (2.03)**	0.004 (1.51)	0.003 (1.16)	0.002 (0.83)
trade	0.013 (7.33)***	0.012 (7.71)***	0.015 (5.26)***	0.012 (4.86)***	0.008 (5.96)***	0.007 (6.73)***	0.006 (6.45)***	0.005 (5.57)***
capcontrol	0.241 (1.77)*	0.125 (0.96)	0.180 (1.00)	0.085 (0.48)	-0.073 (-1.93)*	-0.095 (-2.36)**	-0.078 (-1.40)	-0.103 (-1.92)*
cons	-19.114 (-18.27)***	-18.114 (-20.33)***	-19.620 (-11.00)***	-18.439 (-10.78)***	-15.930 (-12.31)***	-15.453 (-13.31)***	-16.724 (-11.22)***	-16.183 (-10.87)***
rho	0.61	0.60	0.53	0.53	0.88	0.86	0.86	0.87
R <sup>2</sup>	0.33	0.33	0.71	0.71	0.77	0.76	0.64	0.64
No of countries	89	89	89	89	88	89	88	89
Obs.	1006	1048	1006	1048	1106	1151	1106	1151

Note: Model 1, 2, 5, 6 use OLS with panel-corrected standard errors (PCSEs) and AR1 correction. Model 3, 4, 7, 8 use random-effect model and AR1 correction. z scores are in parentheses. All right-hand-side variables are lagged one period.

\*\*\* significant at 1%; \*\* significant at 5%; \* significant at 10%.

### ***Political Institutions and Investment Incentives***

The second causal channel is between political institutions and investment incentives. Investment incentives can be roughly categorized into three groups: fiscal, financial, and regulatory.<sup>96</sup> Due to the lack of reliable data on the form and amount of investment incentives, it is difficult to make explicit comparisons worldwide.<sup>97</sup> To examine the effect of political institutions on investment incentives, I construct an indicator to capture the level of investment incentives in different countries.

The information of investment incentives is collected from *Corporate Taxes: World Summaries 2002-2003* by PricewaterhouseCoopers (PwC).<sup>98</sup> The Guide provides a summary of basic information about corporate taxes in 125 countries and territories. The tax rates and rules in effect at January 1, 2002 have been used in this

<sup>96</sup> Fiscal incentives include a reduction in the base income tax rate a particular category or categories of investors must pay (e.g., foreign investors, investors in certain types of activity); tax holidays (on income tax, on national or local sales taxes, on other taxes collected by national or sub-national governments); exemptions from import duties or duty drawbacks; accelerated depreciation allowances; investment and re-investment allowances; specific deductions from gross earnings for income-tax purposes; and deductions from social security contributions. See Oman 2000. The most important financial incentives are outright grants and subsidized loans. Regulatory incentives are a broad group of policies, including subsidized infrastructure or services, market preferences and regulatory concessions (e.g., exemptions from labor and environmental standards).

<sup>97</sup> In some other studies, investment incentives are measured by statutory, effective marginal, or effective average tax rates on foreign firms by using firm-level data. Statutory rates are the most obvious and readily available measure, but they can be misleading since low statutory rates can be offset by a broader definition of taxable income. See, for example, Li 2006; Desai et al. 2004.

<sup>98</sup> Shang-jin Wei also uses PwC's country descriptions on legal and regulatory issues to measure government policies toward FDI. His FDI incentive measure includes two categories: FDI restrictions and FDI incentives, each of which consists of four aspects. FDI restrictions include 1) controls on foreign exchange transactions, 2) exclusion from certain strategic sectors, 3) exclusion from non-strategic sectors, and 4) restrictions on the share of foreign ownership. FDI incentives include 1) regional or sectoral incentives, 2) tax concessions, 3) non-tax concessions, and 4) export incentives. The net incentives are defined as the difference between FDI restrictions and FDI incentives. See Wei 2000.

Guide. For each country or territory, the Guide has a section on tax incentives. The coding of tax incentives is primarily based on an analysis of each entry of tax incentive in the Guide. The alternative source is *Tax Incentives and Foreign Direct Investment: a Global Survey*, published by UNCTAD in 2000. The survey includes reviews of tax incentives for 53 countries. I use this source to check and reinforce the consistency of incentive information. Based on these two sources, I construct three variables: general incentive (*incentive*), foreign-special incentive (*fincentive*), and non-foreign-specific incentive (*nfincentive*). See Appendix 2-B for the detailed coding rule.

I use a cross-sectional dataset to test whether political institutions have the hypothesized effect on investment incentive. There are three dependent variables: *incentive*, *fincentive*, and *nfincentive*. Since these variables are categorical and ordinal, ordered probit regression is the appropriate model to use. While the tax incentive indicator is created based on detailed descriptions of tax policies and regulations in a single year (2001), it is almost time-invariant, which means it may actually reflect the nature of investment policy for a long period of time. Therefore, I use the average values of institutional strength (*checks* and *polcon*) for 1991-2000 as the independent variables. I also include the same group of control variables in Table 4. Similarly, I use the average values for all of the control variables for 1991-2000 to reduce the effect of temporal fluctuation.

### ***Findings***

The regression results are presented in Table 2.4. Both *checks* and *polcon* are positively correlated with *incentive*, though the effects are not always statistically

significant. But when we disaggregate *incentive* into foreign-specific incentive (*fincentive*) and non-foreign-specific incentive (*nfincentive*), the findings are consistent with my prediction. Both *checks* and *polcon* are significantly and negatively associated with *fincentive*, indicating that countries with weak political institutions are more likely to offer exclusive tax incentives to foreign firms, other things being equal. In contrast, both *checks* and *polcon* are significantly and positively associated with *nfincentive*, suggesting that countries with strong institutions are more likely to offer incentives to attract investment in specific sectors, areas, and export-oriented activities, regardless of investors' ownership structure.

With respect to the control variables, only *capcontrol* is positively associated with both *incentive* and *nfincentive* and the coefficients are statistically significant. It suggests that countries with more restriction on capital flows are more likely to offer investment incentives. It is consistent with an empirical finding that lots of developing countries use both capital controls and investment incentives in order to selectively attract FDI.<sup>99</sup>

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<sup>99</sup> Wei 2000.

Table 2-4: Ordered Probit Results: Relationship between Institutions and Tax Incentives

Variable	Incentive		Foreign		Non-Foreign	
	<b>0.099</b>		<b>-0.438</b>		<b>0.204</b>	
<b>Checks</b>	<b>(0.97)</b>		<b>(-2.77)***</b>		<b>(1.97)**</b>	
		<b>1.722</b>		<b>-1.948</b>		<b>2.317</b>
<b>Polcon</b>		<b>(2.06)**</b>		<b>(-2.08)**</b>		<b>(2.81)***</b>
Lgdpper	-0.356	-0.489	-0.236	-0.251	-0.345	-0.441
	<b>(-2.61)***</b>	<b>(-3.27)***</b>	<b>(-1.20)</b>	<b>(-1.32)</b>	<b>(-2.45)**</b>	<b>(-3.00)***</b>
Lpop	0.131	0.052	-0.194	-0.211	0.184	0.156
	<b>(1.09)</b>	<b>(0.47)</b>	<b>(-1.24)</b>	<b>(-1.57)</b>	<b>(1.56)</b>	<b>(1.47)</b>
Growth	0.100	0.101	-0.047	-0.026	0.096	0.089
	<b>(2.16)**</b>	<b>(2.19)**</b>	<b>(-0.89)</b>	<b>(-0.51)</b>	<b>(2.09)**</b>	<b>(1.95)*</b>
Industry	-0.009	-0.004	-0.029	-0.026	-0.006	-0.005
	<b>(-0.48)</b>	<b>(-0.24)</b>	<b>(-1.06)</b>	<b>(-1.17)</b>	<b>(-0.32)</b>	<b>(-0.29)</b>
Saving	0.028	0.041	0.052	0.038	0.014	0.027
	<b>(1.29)</b>	<b>(1.95)*</b>	<b>(1.84)*</b>	<b>(1.57)</b>	<b>(0.66)</b>	<b>(1.29)</b>
Trade	0.004	0.001	-0.005	-0.005	0.006	0.005
	<b>(0.82)</b>	<b>(0.15)</b>	<b>(-0.81)</b>	<b>(-0.92)</b>	<b>(1.25)</b>	<b>(1.26)</b>
Capcontrol	1.320	1.334	1.023	0.901	0.779	0.759
	<b>(3.31)***</b>	<b>(3.34)***</b>	<b>(1.95)*</b>	<b>(1.76)*</b>	<b>(1.94)**</b>	<b>(1.88)*</b>
Wald Chi2	47.45	53.37	31.40	26.98	33.67	37.16
Log likelihood	-82.04	-82.40	-47.78	-53.45	-75.17	-75.26
Obs.	97	100	96	99	97	100
Pseudo R <sup>2</sup>	0.22	0.24	0.25	0.20	0.18	0.20

Note: Ordered probit model. z scores are in parentheses.

\*\*\* significant at 1%; \*\* significant at 5%; \* significant at 10%;

Coefficients in ordered probit models cannot be interpreted directly. Following King et al.'s suggestion, I use CLARIFY to examine how these probabilities change as each explanatory variable is increased by one standard deviation above its mean.<sup>100</sup> As can be seen from Table 2.5, other things being equal, one standard deviation increase in *checks* from the mean values will reduce the probability of offering any type of foreign-specific incentives by 12 percent but increase the probability of offering non-foreign-specific incentives by 3 percent. Similarly, other things being equal, one standard deviation increase in *polcon* from the mean value will reduce the probability of offering foreign-specific incentives by 10 percent but increase the

<sup>100</sup> King, Tomz, and Wittenberg 2000.

probability of offering other incentives by 5 percent. These findings suggest that where political institutions are stronger, governments are less likely to offer foreign-specific investment incentives but more likely to offer non-foreign-specific incentives.

**Table 2-5: Effect of Change in Institutional Strength on Investment Incentives**

Variable	Increase of one standard deviation from mean values	Category	Change in probability	95% Confidence Interval	
				lower bound	upper bound
<b>checks</b>	from 3 to 4.5	f incentive = 1	12%	5%	21%
		f incentive = 2	-3%	-7%	0%
		f incentive = 3	-9%	-16%	-4%
		n incentive = 1	-3%	-7%	1%
		n incentive = 2	-8%	-18%	0%
		n incentive = 3	11%	0%	23%
<b>polcon</b>	from 0.27 to 0.47	f incentive = 1	10%	1%	18%
		f incentive = 2	-2%	-4%	0%
		f incentive = 3	-8%	-17%	-1%
		n incentive = 1	-5%	-10%	-1%
		n incentive = 2	-11%	-22%	-3%
		n incentive = 3	16%	5%	27%

Note: Based on an ordered probit model with first differences drawn from 1000 simulations performed by CLARIFY.

Why do political institutions have opposite effects on foreign-specific investment incentives and other incentives? A possible explanation is that various investment incentives may have different distributive effects. On one hand, foreign-specific incentives give foreign firms privileged status over domestic firms despite the fact that foreign firms may be more competitive in the first place. The evidence is consistent with Yasheng Huang's finding that foreign privilege also appears to be greater in more corrupt countries, although it is not absent in countries with strong

institutions.<sup>101</sup>

On the other hand, sectoral, regional, and export-oriented incentives generally aim at promoting economic growth in disadvantaged sectors and areas. Therefore, they may be relatively beneficial to a larger domestic supporting group. The characteristics of distributive policy depend on the scope of political coalition between government agencies and private sector groups that dominate strategic sectors of economy. Where political institutions are weak, the winning coalition is small, and the government will be more likely to provide narrowly-targeted incentives. Where political institutions are stronger, the winning coalition is larger, and the government will be more likely to provide broadly-targeted incentives that benefit larger supporting groups.

## VI. Conclusion

The conventional wisdom suggests a linear relationship between political regimes and FDI with democracy being superior to autocracy in attracting FDI, other things being equal. My theory challenges it by arguing that both strong and weak institutions can provide foreign investors with advantages for engaging in specific types of activities.

In general, foreign investors are most likely to be attracted by countries that are able to create credible policy environments while maintaining some latitude to adjust policy. Countries with very weak or very strong institutions are likely to suffer from either rigidity or instability problems that discourage potential investors.

Instead of confirming Ajit Ranade's observation that "either FDI likes a full quota

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<sup>101</sup> Huang 2004.

of guarantee of rights and freedoms, or none at all,” the statistical findings suggest the opposite. I have found robust statistical evidence to support an inverted U-shape relationship between political institutions and FDI in developing countries. For low levels of institutional strength the FDI-institutions relationship is positive, while for high levels of institutional strength the effect of institutions on FDI becomes negative. However, the statistical findings also suggest that political institutions are not a major factor that affects FDI inflows in developed countries, largely because almost all developed countries are consolidated democracies with relative high level of policy certainty. I have also found that strong institutions are associated with high level of policy certainty while weak institutions are associated with more foreign-specific investment incentives, suggesting that political institutions may affect FDI through two main channels: increasing policy certainty or providing more pro-capital incentive.

These findings help explain why foreign investors do not always prefer democratic developing countries. While foreign investors in long-standing stable democracy can enjoy more policy certainty, those taking a chance in unstable political environments can expect to be compensated by more pro-capital incentives. For them, a host government’s flexible policies to foreign investment can offset flaws in political institutions.



## Appendix 2-1: Variable Descriptions and Sources

Type of Variable	Variable	Description	Source
Dependent Variable	lfdif	Log value of net FDI inflows	UNCTAD
	lfdis	Log value of FDI stocks	UNCTAD
	incentive	Degree of total investment incentives, with higher scores indicate more incentive	PricewaterhouseCoopers (2002) and UNCTAD (2000)
	fincentive	Degree of foreign-specific investment incentives, with higher scores indicate more incentives	PricewaterhouseCoopers (2002) and UNCTAD (2000)
	nfincentive	Degree of non-foreign-specific investment incentives, with higher scores indicate more incentives	PricewaterhouseCoopers (2002) and UNCTAD (2000)
Explanatory Variable	polcon	Level of political constraints, with higher scores indicate better ratings (polcon III)	Henisz (2000)
	checks	Level of checks and balances	Beck et al. (2001)
Control Variable	lgdpper	Log value of per capita GDP (constant 2000 US\$)	WDI 2005
	lpop	Log value of total population	WDI 2005
	growth	Annual growth rate %	WDI 2005
	industry	Industrial output as a percentage of total GDP	WDI 2005
	saving	Total domestic savings as a percentage of GDP	WDI 2005
	trade	Total export and import as a percentage of GDP	WDI 2005
	capcontrol	Binary index of capital account liberalization (0 capital account liberalization, 1 otherwise)	IMF
	rule_of_law	Range from 0-6, with higher values indicating better ratings	ICRG data
	Expro_risk	Range from 0-10, with higher values indicating lower expropriation risk	ICRG data

## Appendix 2-2: Investment Incentive Scale Coding Rule

The investment incentive scale was created based on two factors: incentive category ( $C_i$ ) and incentive type ( $T_j$ ).

PricewaterhouseCoopers' (PwC) report distinguishes four categories of investment incentives: foreign-specific, export, regional, and sectoral incentives.

- $C_1$ : *Foreign-specific incentives* specifically to encourage foreign investment.
- $C_2$ : *Export incentives* to promote the export of goods manufactured, assembled, or processed domestically, including the existence of export processing zones and special economic zones.
- $C_3$ : *Sectoral incentives* to promote sectors of industry or activities which are considered crucial for development.
- $C_4$ : *Regional incentives* to channel investment for development of a particular area or region (i.e. rural development or industrial centers).

Each of these categories is represented by a dummy variable that takes the value of one in the presence of the incentive and zero in its absence.

According to UNCTAD's global survey, six major types of incentives are commonly used in many countries.

- $T_1$ : *Tax holiday or exemption*: Under a tax holiday, qualifying "newly-established firms" are exempted from paying corporate income tax and/or other tax liabilities for a specific time period.
- $T_2$ : *Reduced tax rate*: Governments may set a lower corporate income tax rate as an exception to the general tax regime to target investors who meet specified criteria.

- *T<sub>3</sub>: Investment allowances or credit:* Under an investment allowance, investors are provided with faster or more generous write-offs for qualifying capital costs. They tend to lower the effective price of acquiring capital.
- *T<sub>4</sub>: Duty or VAT exemption:* exemption from import duties or value-added taxes on capital goods, equipment or raw materials, parts and inputs related to the production process.
- *T<sub>5</sub>: Deduction for qualifying expenses*
- *T<sub>6</sub>: R&D allowance*

Again, each of these incentive types is represented by a dummy variable that takes the value of one in the presence of incentive and zero in its absence. The incentive type index is the sum of the six variables, ranging from zero if the country does not offer any of these tax incentives to six if the country can offer all of them. The overall tax incentive score  $Incentive_s$  is the product of incentive category and incentive type, ranging from 0 to 24. The higher the score, the more generous the incentive is.

$$incentive_s = \sum_{i=1}^4 C_i * \sum_{j=1}^6 T_j$$

From foreign investors' perspective, the more exclusive benefit they can get from the incentives, the more attractive the investment opportunity is. Of the four incentive categories, foreign-specific incentive appears to have the highest degree of exclusivity for foreign investors. With its existence, foreign investors will have exclusive tax advantages over local investors, regardless of the characteristics of their investment. While foreign firms can benefit from other incentives, by law they are not exclusive recipients of these special tax arrangements. Export incentives are special promotion for firms with high export ratio. Regional and sectoral incentives are exclusive to

investors located in certain industries or certain geographic areas. To address the special effect of ownership incentive, I create a new variable foreign-specific incentive  $incentive_F$  as the product of ownership category and incentive types. Similarly, a non-foreign-specific incentive score  $incentive_{NF}$  is created as the product of other incentive categories and incentive types. Therefore, the overall tax incentive score  $incentive_S$  is the sum of  $finc incentive_S$  and  $nfincentive_S$ .

$$finc incentive_S = C_1 * \sum_{j=1}^6 T_i$$

$$incentive_S = finc incentive_S + nfincentive_S$$

In order to make more meaningful interpretation, I collapse these scores into three categories to roughly capture different levels of investment incentive as low medium, and high. The formula to collapse is:

<i>incentive</i>	<i>finc incentive</i>	<i>nfincentive</i>
=1 if $incentive_S$ is 0	=1 if $finc incentive_S$ is 0	=1 if $nfincentive_S$ is 0
=2 if $incentive_S$ is [1, 10]	=2 if $finc incentive_S$ is [1, 2]	=2 if $nfincentive_S$ is [1, 9]
=3 if $incentive_S$ is [11, 20]	=3 if $finc incentive_S$ is [3, 5]	=3 if $nfincentive_S$ is [10, 15]

One advantage of using this categorical measure instead of tax rates is that different tax bases in different countries may make the comparison of tax rates less meaningful, especially if I only compare statutory corporate income tax rates across countries.

## Chapter 3

### Political Institutions and the Composition of FDI

#### I. Introduction

Despite the growing literature on the relationship between political institutions and the amount of FDI, the impact of political institutions on the composition of FDI hasn't received much attention. FDI is a firm-level decision. Global investors decide whether to enter a new country or undertake an expansion of an ongoing business based on their own assessment of investment opportunities. What makes a country attractive? Multinational corporations (MNCs) consider two separate sets of variables. The first group is directly related to a country's supply of economic and human resources, such as market size, economic growth, natural resources, and qualified labor supply. The second group is the institutional context of an attractive investment climate, including political and macroeconomic stability, legal and regulatory environment, and bureaucratic procedures. If the first set of variables fits with what the MNC is looking for according to its strategy, and as long as the institutional context is fine, the country might be put on the short list.

It is naïve to assume that all global investors make decisions based on the same set of criteria. The institutional background may shift the playing field favoring some investors while disadvantaging others.<sup>102</sup> MNCs respond strategically when facing the restrictions and incentives created by the institutional context given their sector- or firm-specific features. They may particularly favor or dislike certain investment locations in which they are less likely to be harmed by political instability or more

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<sup>102</sup> Bevan et al. 2004

likely to receive preferential treatment from the host government.

In an effort to better understand the impact of institutions on FDI at the micro level, I relax the assumption that all investors have the same preference on investment environment and explore how different types of MNCs respond differently to certain political institutions in host countries. Building upon the existing economics, business, and political science literature, I argue that the MNC-host government relationship is different from what the classic obsolescing bargain model has described. While investors in general are deterred by risk, they do not necessarily choose more credible host governments. MNCs' choices between a more credible or more flexible policy environment depend on their firm-specific features.

Using the industry-level data of U.S. investment abroad from the Bureau of Economic Analysis from 1983-2004, I conduct time-series-cross-sectional regressions to examine the relationship between political institutions and compositions of FDI. I disaggregate FDI by the production strategy (vertical FDI vs. horizontal FDI) and three types of asset specificity (physical, human, and dedicated asset specificity). I find that the impacts of political institutions on FDI inflows are conditioned on three firm-specific features: export ratio, capital intensity, and firm size. MNCs are likely to invest in small, capital-intensive, and market-oriented projects in countries with strong institutions; MNCs are likely to invest in large, labor-intensive and export-oriented projects in countries with weak institutions. These findings suggest that whether MNCs are vulnerable to the obsolescing bargain depends on their production strategy and special types of asset specificity: Horizontal FDI is more vulnerable to the obsolescing bargain the vertical FDI; FDI with highly specific physical assets is more vulnerable to the obsolescing bargain than FDI with large dedicated assets.

The organization of this chapter is as follows. The second section reviews the

debate over the obsolescing bargain model in international business to show that MNCs have various preferences toward investment environment. The third section develops specific hypotheses that predict the joint effects of political institutions and firm-specific features on FDI inflows. The fourth section discusses data and measurements. The fifth section provides a series of panel data regressions to test the hypotheses. The last section concludes with implications for the study of government-business relationship.

## **II. Bargaining Relationship between MNCs and Host Governments**

How to explain the variation in the composition of FDI across countries?

Economic and business literature maintains that the possession of firm-specific advantages not only provides the reason for MNCs to exist, but also explains MNCs' investment strategies in different host countries. The investment strategy MNCs pursue in a developing country depends, very simply, on two things: the rate of return on the investment and the risk associated with it. While the former is affected by many economic factors such as market size, relative endowment differences, factor prices, as well as trade and investment costs,<sup>103</sup> the latter primarily depends on the institutional background of an investment climate including political and macroeconomic stability, legal and regulatory environment, and bureaucratic procedures.

### ***Obsolescing Bargain Model (OBM)***

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<sup>103</sup> Helpman 1984, Markusen 2002, Hansen et al. 2004.

The major political risk stems from the classic obsolescing bargain model (OBM) developed by Raymond Vernon. At the outset, a MNC's bargaining power is posited to be at a maximum prior to investment since the government needs access to scarce capital or technology. As time elapses, a MNC's ex ante strategic advantage may become its disadvantage ex post. "Yet, almost from the moment that signatures have dried on the document, powerful forces go to work that quickly render the agreements obsolete in the eye of governments."<sup>104</sup> The initial bargain favors the foreign investor, but relative bargaining power shifts to the host government over time as MNCs' assets are transformed into hostages. The host governments have incentives to expropriate MNCs or squeeze their profits by changing policies at any time. The possibility of expropriation and creeping expropriation consists of the major political risk for MNCs.<sup>105</sup>

The OBM suggests that MNCs' investment decisions and strategies are largely contingent upon their specific bargaining power relative to host governments. Indeed, market and competitive opportunities vary according to the type of industry, and risks also affect them differently. Vernon carefully argued that the OBM may only be applied to some specific raw material ventures that require large fixed investments that use stable technology and produce output without a large degree of brand identification (i.e. copper mining). Robert Gilpin also maintains that in the natural resources sector, the advantage shifts from the investment supplier to the investment

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<sup>104</sup> Vernon 1971, 47.

<sup>105</sup> Expropriation and creeping expropriation refer to direct and indirect taking of property respectively. Direct taking of property can take various forms, ranging from outright nationalizations in all economic sectors or on an industry-wide basis, to large-scale takings of land by the State, or specific takings. Creeping expropriations involve an incremental but cumulative encroachment on one or more of the range of recognized ownership rights until the measures involved lead to the effective negation of the owner's interest in the property. It also includes regulatory takings, in which the exercise of governmental regulatory power diminishes the economic value of the owners' property without depriving them of formal ownership. (UNCTAD 2003)



recipient once the investment is in place.<sup>106</sup> Charles Lipson confirmed Vernon's hypothesis that in the oil industry, the "routinization of knowledge" and the growing competition in the industry have significantly eroded the oligopolistic power of multinational oil company.<sup>107</sup>

With respect to manufacturing industries, Vernon suggested that they may be less vulnerable to the risk of expropriation because of their ability to blend into the local environment more effectively and renew production technologies to offset the erosion of time. Kobrin applies the OBM to manufacturing industries. Using share of ownership as a measure of bargaining success, he finds that MNC-host country bargain did not obsolesce for high technology sector.<sup>108</sup> Moreover, in some capital-intensive manufacturing such as automobile industry, Bennett and Sharpe suggest that once the firm had established itself in the market, its linkage to other industry stakeholders and its technological assets may enhance its bargaining power.<sup>109</sup>

### ***Critics of OBM and Political Bargaining Model (PBM)***

Despite its consistent popularity since its first elaboration, the OBM has been criticized for its two problematic assumptions. The first one is the bargaining relationship between MNCs and host government is one-shot bargain over the initial firm-specific entry decision. MNCs' strategies focus on preventing opportunistic behavior by the host government. The political bargaining model (PBM) elaborated by Eden et al., by contrast, takes into account post-entry political strategies by illustrating that MNCs can affect government policies toward their industries through

<sup>106</sup> Gilpin 1975.

<sup>107</sup> Lipson 1985.

<sup>108</sup> Kobrin 1987.

<sup>109</sup> Bennett and Sharpe 1979.

iterative bargaining.<sup>110</sup> MNCs' sunk costs may not necessarily become hostages. Hillman and Wan argue that foreign subsidiaries, host country and parent factors reflecting these dual institutional pressures will significantly affect the choice of political strategies used by MNC subsidiaries in host countries.<sup>111</sup>

The second assumption of the OBM is that the MNCs and the host government bargain with each other in order to pursue relative gains. Therefore, MNCs and the host government necessarily have conflicting goals, which makes MNCs intrinsically vulnerable to expropriation. The PBM, by contrast, assumes that the both MNCs and the host government bargain to achieve absolute gains. Jenkins argues that domestic politics could either impede or reinforce the dynamics of the OBM, depending on whether prominent interest groups ally with MNCs or with the government.<sup>112</sup> Grosse and Behrman argue that the relationship between MNCs and host government could be both conflictual and cooperative in which clashes of interest can arise over various regulatory issues, such as local content regulations and environmental standards.<sup>113</sup> Similarly, Luo's study of China reveals that relations between a MNC and a host country government have progressively become less confrontational and more cooperative because both actors recognize that their interests are compatible and that their resources are complementary.<sup>114</sup> Eden et al. argue that there is scope for MNCs and the host government each to achieve its own goals through cooperation. The more similar the goals of each party, the more likely a successful bargain will result from their interactions. The more divergent their goals, the more difficult the bargaining process and the more likely that governmental constraints will be imposed on MNC

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<sup>110</sup> Eden et al. 2005.

<sup>111</sup> Hillman and Wan, 2005.

<sup>112</sup> Jenkins 1986.

<sup>113</sup> Grosse and Behrman 1992.

<sup>114</sup> Luo 2001.

activities.<sup>115</sup>

Empirically, a big challenge to the OBM is that the risk of expropriation has changed considerably in nature since the 1970s, when it was not unusual for governments to seize assets without compensation.<sup>116</sup> Investors might instead be faced with some forms of “creeping expropriation”, whereby a series of acts could deprive them of their fundamental rights in their investment. Even many cases of “creeping expropriation” may be different from the traditional political risk, which is defined in terms of deliberate acts by host country authorities motivated by an intention to change the treatment of a foreign investor. In fact, more than 90 percent of political losses paid by Lloyd’s syndicates in recent years have occurred when a public sector buyer or supplier was unable to meet all of its obligations on time and in full. The resulting default could be attributed more often to economic misjudgment or over-commitment on the part of host country actors than to bad faith with regard to contractual obligations.<sup>117</sup>

Because of these reasons, critics claimed that the OBM often overestimates the power of the state to dictate policy and underestimates MNCs’ ability to reduce political risk. MNCs’ bargaining power relative to the host government may not be easily obsolesced once the investment is sunk, because networks of suppliers, distributors, consumers, joint-venture partners, and labor provide a political base of support for the foreign investor.<sup>118</sup> Continued innovation by MNCs, control of export markets, multi-lateral financing arrangements, alliances with host country elites, and the dependence of host countries on private sources for future investment, would

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<sup>115</sup> Eden et al. 2005, 261

<sup>116</sup> UNCTAD 1999.

<sup>117</sup> Moran 2006, 82.

<sup>118</sup> Kobrin 1987, Haggard 1990.

constrain and even diminish host country autonomy and power.<sup>119</sup>

In addition to the possession of unique assets, market access, and technologies, organizational structures and capacity serve as a critical resource of MNCs' bargaining power. Henisz and Williamson argue that partnering with a host-country firm is a possible means to increase MNCs' bargaining power relative to the host government by loading a greater fraction of the costs of expropriation onto domestic firms.<sup>120</sup> It is because expropriation of a joint venture will generate higher political costs such as unemployment, reduced tax revenue, political contribution and vote than the expropriation of an entirely foreign firm. Therefore, MNCs are more likely to offer a share of equity ownership to local partners in countries with high political risk.<sup>121</sup> Meyer and Jensen argue that "Greenfield" investors have stronger bargaining positions vis-à-vis host governments than merge & acquisition (M&A) investors. It is because investors involved in M&A are more concerned with privatization policies and with the regulation of markets for corporate equity. They often face the bargaining situation in which multiple potential investors are bidding for the same asset. Greenfield investors, in contrast, can often choose between many alternative sites for investment.<sup>122</sup> Moreover, Malesky states that although an individual foreign investor may be weak relative to a host government, coalitions of MNCs could use their aggregate bargaining strength to fend off expropriation or unfavorable policy changes.<sup>123</sup>

In short, both the OBM and its critics would agree that MNCs are not all the same with respect to their vulnerability to host governments' opportunistic expropriation.

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<sup>119</sup> Levy and Prakash 2003.

<sup>120</sup> Henisz and Williamson 1999.

<sup>121</sup> Henisz 2000b

<sup>122</sup> Meyer and Jensen 2005.

<sup>123</sup> Malesky 2006.

They all agree that MNCs' bargaining power vary across issues and sectors, so do their preferences toward policy environment in host countries. While the OBM maintains that firms with large fixed investment and "routinization of knowledge" are more vulnerable to political risk, the PBM suggests that foreign firms could actually increase their bargaining power relative to the host government in the post-entry stage. Domestic politics, the international economy, home government pressure, and the bargaining tactics of investors all acted as intervening variables between the "inevitable" trend of the OBM and the execution of government control.<sup>124</sup>

### III. Theory and Hypotheses

The mechanism through which foreign investment decisions are formed depends on the interaction between microeconomic—firm and industry attributes—and macroeconomic conditions—host country characteristics.

Countries compete for investment along two dimensions: costs and credibility.<sup>125</sup> As argued in the previous chapter, different political institutions demonstrate unique strengths and weaknesses: essentially they are good at doing different things, and they all have weaknesses. Countries with strong institutions (defined as institutions with a large number of veto players) tend to have a credible policy environment that facilitates policy certainty and property rights protections. The downside is that strong institutions may inhibit institutional capacity to enforce cooperative political exchanges, and thus undermine governance efficiency. On the other hand, countries with weak institutions (institutions with a small number of veto players) tend to have a flexible policy environment in which governments are more likely to offer

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<sup>124</sup> Jenkins 1986, 165.

<sup>125</sup> Janeba 2002.

incentives or change regulations to attract MNCs. But their lack of institutional credibility poses a big threat to MNCs' assets. Both institutional features provide MNCs with some incentives for engaging in specific types of activities in host countries, but the tradeoff between them makes no country have the absolute advantage to attract all investors. MNCs exploit this institutional support to derive competitive advantages that cumulate into comparative institutional advantages at the national level.

Assessments of potential risk and return are inextricably intertwined in the MNCs' decision whether to enter a new country and or undertake an expansion of an ongoing business. MNCs always face a tradeoff between high-return high-risk opportunities and low-return low-risk ones. The tradeoff between costs and credibility may lead to a variety of investment strategies by MNCs. Under what conditions will they invest in a country that has more credible institutions but is less likely to offer generous inducements? Under what conditions will they invest in a country that commits to provide more upfront incentives but is less able to commit a long-term stable policy?

I argue that MNCs' preference toward a more credible or more flexible policy environment is conditioned on their bargaining position relative to host governments. If a MNC's relative bargaining power is weak, it will prefer strong political institutions that facilitate policy stability and property rights protection. Alternatively, the MNC could respond high political risk by insisting upon a higher risk premium in the initial terms of project. But a demand for more favorable conditions at the start may only hasten a later backlash along obsolescing bargain lines.<sup>126</sup> The host government may be more likely to renege on its promise to foreign firms because

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<sup>126</sup> Moran 2006.

local interest groups will impose more pressure on the government to change unfavorable policies. Therefore, credible commitment is the centerpiece of being able to engage in strategic bargain.

If the MNC has strong bargaining power relative to the host government, it will prefer a flexible government that provides more generous incentives and targeted protections. The government's credibility or lack of it will not matter too much.

Relative bargaining power is the key that determines the firm's investment decisions. The more a foreign investor is exposed to expropriation risk, the weaker its bargaining power, the less likely it will invest in the first place. In general, the relative bargaining powers depend on lots of factors: the resources controlled by one party and demanded by the other, the similarity of interests and relative stakes attached to the negotiation, the constraints on each party, and the ability of either party to limit the behavior of the other party directly through economic or political coercion.<sup>127</sup> For foreign firms, their bargaining power resources are firm-specific, including capital, technology, managerial skills, and access to markets. For host countries, their major resources of bargaining power are economic performance and access to the domestic market.<sup>128</sup>

Specifically, two firm-specific factors—production strategy and asset

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<sup>127</sup> Kobrin 1987.

<sup>128</sup> Encarnation and Wells (1985) find that a host government's bargaining power relative to the foreign investor is likely to increase if: 1) the investment is designed to service the domestic market that may be controlled by the investor downstream from the production site; 2) the investment employs factors of production that are not easily substitutable across countries; 3) the investment is actively sought by competing firms; 4) the investment requires a relatively low technology with multiple substitute sources; 5) the investment produces largely undifferentiated goods that do not require large marketing or R&D expenditures; 6) the investment requires large capital investments that once in place are not easily liquidated or moved; 7) the investment requires the involvement of government as a principal financier, a principal consumer, a principal distributor of outputs, a principal supplier of inputs, or a principal regulator of either inputs or outputs; and 8) the investment is negotiated by a centralized body. Similarly, Tarzi (1991) argues that the host government's bargaining power is affected by four factors: 1) the level of expertise in the host country; 2) the degree of competition among MNCs; 3) economic uncertainty; and 4) the type of FDI.

specificity—are important for affecting a foreign firm’s relative bargaining power and its preferences toward the policy environment in host countries.

### ***1. Production Strategy***

In general, MNCs invest in specific locations in pursuit of three distinct types of advantage, which is labeled as the OLI paradigm by John Dunning. A firm must own a unique asset it wishes to exploit the ownership advantage (O); to get the location advantage (L), the firm must be cost efficient to exploit the asset abroad; and to get the internalization advantage (I), the firm must control the asset’s exploitation rather than outsourcing the production of inputs.<sup>129</sup>

Various types of firms have different preferences for these advantages, however. Their preferences may be shaped by the production strategy. FDI is normally classified into vertical and horizontal forms. Horizontal FDI, motivated by the intention to supply a market with locally produced goods, undertakes similar production activities in both home and abroad. It thus tends to be import-substituting. Vertical FDI, driven by motivation to take advantage of factor price differences for production, locates different production processes in different locations. It is normally export-oriented.

How would host country’s political institutions affect MNCs’ production strategy? The OBM perspective would argue that vertical FDI is less vulnerable to political risk than horizontal FDI for three major reasons. First, export-oriented firms are more likely to be “footloose” than import-substituting firms.<sup>130</sup> Export-oriented firms are

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<sup>129</sup> Dunning 1988.

<sup>130</sup> Encarnation and Wells 1985



relatively free to locate in a wide range of low-wage countries. By contrast, most of import-substituting firms must locate and retain facilities inside the market they hope to supply. Second, export-oriented firms' control of access to international markets increases their leverage to bargain with host governments, especially when the host country pursues a development strategy based on export-led growth.<sup>131</sup> Third, import-substituting firms are more likely to compete with domestic firms for market share, which is likely to trigger nationalistic opposition and governments' arbitrary intervention. Therefore, given their higher vulnerability to political risk, horizontal FDI should prefer strong institutions that facilitate policy certainty than vertical FDI.

*H1a: Host countries with strong institutions are more likely to attract horizontal FDI than vertical FDI.*

However, the PBM perspective would suggest the opposite. Once entering the host market and engaging production, MNCs involved in vertical production will be more likely to interact with domestic firms and local workers through backward linkages. This may give MNCs more political leverage to influence the host government. Policies will be more likely to favor the group with greater lobbying abilities. Moreover, Aizenman and Marion argue that increase in policy risks in host countries should encourage horizontal FDI but discourage vertical FDI. It is because vertical production network gives MNCs less substitutability than horizontal production network. Therefore, host government's opportunistic behavior will be more costly to MNCs engaged in vertical FDI than horizontal FDI.<sup>132</sup> This discussion

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<sup>131</sup> Lecraw 1984.

<sup>132</sup> Aizenman and Marion 2004.

suggests a different hypothesis.

H1b: *Host countries with strong institutions will be more likely to attract vertical FDI than horizontal FDI.*

## **2. Asset Specificity**

Asset specificity is an important factor affecting foreign firms' vulnerability to political risk. Assets are considered has reference to the degree to which an asset can be redeployed to alternative uses and by alternative users without sacrifice of productive value. According to Williamson, asset specificity can take the form of site specificity (specialization by proximity), physical asset specificity (production-specific investments in equipment and machinery), human asset specificity (firm-specific training or learning by doing), dedicated assets (large discrete investment made in expectation of continuing business), brand name capital, or temporal specificity.<sup>133</sup>

On the one hand, some empirical studies have found evidence to support a negative association between asset specificity and investors' bargaining power. Frieden argues that primary productions for export are quite vulnerable to expropriation since they are tied to their location and can be operated after being seized. By contrast, local subsidiaries of transnational corporations which require expertise and international connections to produce goods are generally less vulnerable to expropriation.<sup>134</sup> Lipson suggests that MNCs' reluctance to invest in public utilities

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<sup>133</sup> Williamson 1996, 105-106.

<sup>134</sup> Frieden 1994.

in developing countries stems from the vulnerability of being expropriated and difficulty of being financed.<sup>135</sup> Infrastructure investments are particularly vulnerable when their projects require heavy initial expenditures but are relatively straightforward and profitable to run.

On the other hand, some other studies suggest that high asset specificity would give investors more incentives to lobby the host government for more targeted protection or subsidies after their assets were sunk. Joskow finds that when relationship-specific investments are more important, coal firms tend to make longer commitments to the terms of future trade at the contract execution stage, and rely less on repeated bargaining.<sup>136</sup> Alt et al. find that Norwegian firms with more specific physical assets (measured by R&D intensity) and human asset (measured by job immobility) have greater incentive to lobby for protecting themselves, because they face potentially greater losses from adjusting to new activities in the face of competitive pressure.<sup>137</sup> Zahariadis suggests that asset specificity not only provides incentives for firms to lobby for more subsidies, but also affects the level of subsidies they might get.<sup>138</sup> Isabela Mares argues that firms that are highly exposed to risks will favor a social insurance system where costs and risks are shared, leading these employers to push universalistic unemployment and accident insurance.<sup>139</sup> Similarly, Hiscox argues that firms with highly industry-specific capital have a greater incentive to lobby for a policy change when owners of capital in other industries are more footloose.<sup>140</sup>

The OBM would agree that the more specific the asset, the more costly a foreign

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<sup>135</sup> Lipson 1985.

<sup>136</sup> Joskow 1987.

<sup>137</sup> Alt et al. 1999.

<sup>138</sup> Zahariadis 2001.

<sup>139</sup> Mares 2003.

<sup>140</sup> Hiscox 2004

firm facing unfavorable policy change would find “exit” into another location, and the more incentive the foreign firm will have to avert this unfavorable policy change. Therefore, MNCs holding highly specific assets will be particularly attracted by countries that could credibly maintain long-term policy and secure their assets. However, the political bargain model would argue that foreign firms with high asset specificity are more likely to bend host government’s policies in their favor. With respect to the relationship between political institutions and different types of asset specificity, three pairs of opposite hypotheses can be derived from these two different bargain models.

### *2.1 Physical Asset Specificity*

The first is physical asset specificity. FDI in infrastructure projects (e.g., electricity, telecommunication) has physical asset specificity: the massive up-front capital costs, a long payback period, non-deployable assets, and the highly politicized nature of pricing decisions.<sup>141</sup> Since these MNCs are highly sensitive to political risks and vulnerable to host governments’ opportunistic policies, the OBM would predict that they favor the host country with strong institutions to maintain long-term policy stability and secure their assets. Therefore, MNCs with high asset specificity will prefer countries with strong institutions. Since physical asset specificity is highly associated with capital intensity, a positive correlation between institutional strength and capital intensity also is expected.

*H2a: Strong institutions tend to attract FDI with high physical asset specificity (more capital-intensive FDI), other things being equal.*

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<sup>141</sup> Henisz 2000b.

However, the PBM suggests that capital-intensive MNCs are more likely to build up their political influence after entering the host country. They would have more incentive and capability to ward off expropriation by forming strategic alliances with local firms, diversifying activities outside the host country, and offering more benefits to the host government such as involving the government in the business venture.<sup>142</sup> Therefore, capital-intensive FDI should favor weak institutions or be indifferent to institutional strength once the MNC is engaging in production.

*H2b: Strong institutions tend to attract FDI with low physical asset specificity (less capital-intensive FDI), other things being equal.*

## 2.2 Dedicated Asset Specificity

According to Williamson, dedicated asset specificity refers to a large discrete investment made by a supplier in expectation of continuing business with a particular customer. Therefore, firm size could be a rough indicator to measure the degree of dedicated asset specificity. At the pre-entry stage, large firms may be more concerned about the policy credibility than small firms because they incur more sunk costs. The relatively immovable nature of fixed assets may make MNCs with larger subsidiaries more vulnerable to host governments' opportunistic behaviors.<sup>143</sup> Second, MNCs may suffer from policy liability of foreignness. Vernon argued that larger organizations, as a result of their visibility, may easily be targeted by host governments that are against foreign operations. Issues such as anti-globalization and protectionism, as well as

<sup>142</sup> Grosse and Behrman 1992.

<sup>143</sup> Vachani 1995.

concerns about tax manipulation and profit repatriation, represent some of the thorny issues likely to plague larger foreign firms.<sup>144</sup> Therefore, large foreign operations will be influenced by changes in government policy to greater degree than small operations. Moreover, large firms endowed with technological superiority may be less sensitive to upfront subsidies because their strategies for long-term profitability are more dominant in their investment decisions.

*H3a: Countries with strong institutions are more likely to attract FDI with large dedicated assets, other things being equal.*

However, the PBM would suggest the opposite for the same logic. Williamson's hostage theory claims that reciprocal long-term exchange agreement (hostage) would provide a mutual safeguard against expropriation risk of the dedicated assets.<sup>145</sup> Once entering the host country, large firms may be able to exert more political influence on the host government, not only because they may be seen as bigger contributors to economic growth and job creation, but also because they may derive sufficient political power from their extensive backward linkages to shift government regulations to their preference. Therefore, MNCs with large dedicated assets will be less concerned about political risk given their stronger bargaining power in the post-entry stage. They should favor weak institutions or be indifferent to political institutions.

*H3b: Countries with weak institutions are more likely to attract FDI with large*

<sup>144</sup> Hillman and Wan 2005, 326.

<sup>145</sup> Williamson 1996.

*dedicated assets, other things being equal.*

### 2.3 Human Asset Specificity

Since human asset specificity arises in learning by doing, firms with more input on specific technology and R&D will have high degree of human asset specificity. Technology is an important firm-specific advantage and MNCs diverge systematically in their approach to conducting R&D and the location of core R&D facilities.<sup>146</sup> But it is unclear whether possession of advanced technology would increase or decrease the bargaining position of a MNC over the host government.

On the one hand, the OBM would suggest that since R&D investments normally have large sunk costs and long pay-back period, a long-term credible policy environment is crucial for potential R&D-intensive investors. Many empirical studies have found that strong protections of intellectual property rights in the host country increase R&D investments by MNCs, as the risk of imitation is low. Therefore, R&D intensive MNCs should prefer a credible policy environment that is originated from strong political institutions.

*H4a: Countries with strong institutions attract more R&D intensive FDI, other things being equal.*

On the other hand, in the post-entry stage, the more an industry is characterized by rapid innovation, the more difficult for a host country to enter the industry without the help of an established firm from a developed country.<sup>147</sup> Kobrin finds that the

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<sup>146</sup> Pauly and Reich 1997.

<sup>147</sup> Fagre and Wells 1982.

bargaining relationship will shift in favor of host governments in relatively low technology and management industries.<sup>148</sup> The incentives for the host governments to squeeze the MNC through adverse policy change are much lower than they would have been had the firm used less advanced technology that the host country would be able to operate even in its absence. Therefore, R&D-intensive MNCs, which possess advanced technology or have a rapid rate of technological change, tend to be less vulnerable to political risks than those with lower level of technology or slower technological change. This discussion yields an opposite prediction.

*H4b: Countries with strong institutions attract less R&D intensive FDI, other things being equal.*

#### **IV. Data and Models**

The data for this chapter are obtained from a cross-section of countries over the period 1983-2004. The Bureau of Economic Analysis (BEA) provides country-by-industry tabulations of US direct investment in various numbers of countries from 1983 to 2004. It collected detailed information on the financial structure and overall operations of the foreign affiliates and their U.S. parent companies as well as on transactions and positions between the foreign affiliates and their non-bank U.S. parents. A "foreign affiliate" is a foreign business enterprise in which there is U.S. direct investment, that is, in which a U.S. person owns or controls 10 percent of the voting securities or the equivalent.<sup>149</sup> Its benchmark surveys (1989, 1994, and 1999) provide more detailed information on FDI-related economic activities of US

<sup>148</sup> Koblin 1987.

<sup>149</sup> Bureau of Economic Analysis. 1994. U.S. Direct Investment Abroad: 1994 Benchmark Survey.



affiliates.<sup>150</sup> The variables and their sources are summarized in Appendix 3-A, and are discussed in more detail below.

The BEA industry-level dataset is superior in recording very detailed information on investment outflows from the U.S., but we have to be aware of the weaknesses. First, the hypotheses focus on firm-specific features, so firm-level data would be ideal to examine the impact of political institutions at the micro level. Since the BEA firm-level data are unavailable due to the confidentiality requirement, I can only use the industry-level data to roughly capture firm-specific features. Using the industry-level data will inevitably lose some degree of rigorousness in capturing the relationship between political institutions and individual firms. Because the indicators (size, export ratio, capital intensity, and technological intensity) are measured as unweighted average, they overlook the possible unbalanced distribution problem. Second, this study assumes that MNCs are subject to the same home country influence. But in practice MNCs' investment strategies may be shaped by some home country-specific factors, so it may be biased to draw a general conclusion on the impact of political institutions on FDI using the statistical finding from the US-based FDI data.<sup>151</sup>

<sup>150</sup> Beginning in 1994, the BEA data differed slightly from those shown in prior annual survey publications due to the reclassification of some industries. Specifically, the “communications and public utilities” group was disaggregated and the “metal” and “nonmetallic minerals” mining groups were aggregated in the industry table stub. This change, however, had no material effect on comparisons of the data over time.

<sup>151</sup> It is arguable that the analytical methods for investment evaluation employed by US firms are similar to that applied in MNCs in other home countries. On the one hand, it is possible that MNCs from different home countries may enjoy similar locational advantages, and thus lead to similar investment concerns and opportunities. On the other hand, it is conceivable that different ownership advantages and the oligopolistic competition between MNCs from different countries may lead to different assessments of investment opportunities. The industry that attracts the most Japanese FDI in a certain country may not be the one that attracts the most US FDI in that country. For example, empirical evidence shows that the nature of FDI activities by US firms are different from that of Japanese firms to a great extent. US FDI tends to be market-seeking while Japanese FDI is export-oriented; US MNCs tend to invest in high-tech industries whereas Japanese MNCs tend to invest in low-tech industries; US FDI is more uniformly distributed across industries and over time while Japanese FDI varies considerably. (Huang 1997)

### ***Dependent variables***

The dependent variable is log value of U.S. direct investment flows abroad. It includes investments flow from non-bank U.S. parent firms into foreign affiliates, detailed by industry and by country. The data are available for 56 countries.

### ***Independent variables***

The primary independent variable is the level of institutional constraints. Henisz's (2000a) political constraints index *POLCON* is a measure of political risk or the predictability of policy change. The more veto points a country has, the higher its *POLCON* score and the less likely are unanticipated policy change. Yet as the number of veto points increases, so too does the number of political players involved in the investment process. He incorporates information covering 1) the number of formal constitutional veto points in a political system (executive, number of house of legislature, federal sub-units, and judiciary), 2) whether these veto points are controlled by different parties, and 3) the cohesiveness of the majority which controls each veto point. The *POLCON* index ranges from 0 (least constrained) to 1 (most constrained). High level of political constraints is associated with high policy credibility and low flexibility. Low level of political constraints is associated with low policy credibility and high flexibility.

An alternative measure of the level of institutional constraints *CHECKS*, developed by Keefer, is also based on the formula that counts the number of institutional veto players, based on whether the executive and legislative chambers are controlled by different parties in presidential systems and on the number of parties in

the government coalition for parliamentary systems.<sup>152</sup> The *CHECKS* index also takes account of the fact that certain electoral rules (closed list vs. open list) affect the cohesiveness of governing coalitions. In addition, the index is explicitly incremented when a party in the government has an economic policy orientation closer to that of the main opposition party than to that of the party of the executive.<sup>153</sup> The *CHECKS* index ranges from 1 to 18. High score of *CHECKS* is associated with high policy credibility and low flexibility. Low score indicates low policy credibility and high flexibility.

As discussed earlier, the choice of production strategy determines MNCs' export orientation. Following Aizeman and Marion, I define the output of vertical investment as affiliate exports to the U.S. and to other foreign countries. The assumption is that these affiliate exports represent intermediate goods requiring further processing in the parent country or some third country. I define the output of horizontal investment by affiliate sales in the local market where the affiliate resides. The assumption is that these are sales of final goods. Therefore, export ratio, measured by non-local sales divided by total sales, is an indicator to reflect the degree of vertical production. The higher the export ratio, the more vertical the investment is.

Some empirical studies have tried to measure different categories of asset specificity defined by Williamson.<sup>154</sup> Following Joskow's interpretation of different types of asset specificity, I use three indicators to measure dedicated, physical, and human asset specificity respectively.

First, since investment with high dedicated specificity refers to projects that require large discrete investment in expectation of continuing business, firm size

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<sup>152</sup> Keefer 2002.

<sup>153</sup> Keefer and Stasavage, 2003

<sup>154</sup> See, for example, Joskow 1988, Alt et al. 1999, Zahariadis 2001.

would be a reasonable measure of dedicated specificity. However, there is no way to measure individual firm size because the available dataset is at industry level.

Therefore, I use total assets of foreign affiliates divided by total number of foreign affiliates to measure the average firm size.

Second, the key feature of physical asset specificity is that investments in equipment and machinery that involves design characteristics specific to the transaction and have lower values in alternative uses. So capital intensity would be a reasonable indicator of physical asset specificity. I use total capital expenses divided by total number of employees to measure capital intensity. The more the per capita capital expenses, the higher the level of capital intensity.

Finally, since human asset specificity arises through a learning-by-doing process, I use R&D intensity as an indicator.<sup>155</sup> R&D intensity creates asset specificity because firms that sell products with close substitutes are likely to do less research and development. The R&D intensity is measured as the ratio of R&D expenses in total sales of foreign affiliates.<sup>156</sup>

### *Interaction Terms*

Since I argue that the effect of political institutions on FDI inflows is conditioned on these industry-specific or firm-specific features, I include interaction variables to capture the joint effect of political institutions and industry-specific features. These

<sup>155</sup> It is worthy noting that Alt et al. use R&D intensity as an indicator of physical asset specificity, but they note that R&D spending could also be associated with human asset specificity if the R&D produces learning by doing effect. See Alt et al. 1999.

<sup>156</sup> The BEA 1999 benchmark survey collected data on two technology-related items—R&D expenditures and the number of employees engaged in R&D-related activities. The data on R&D expenditures were collected on two bases: R&D that was performed by the parent or affiliate (whether the R&D was for its own use or for use by others) and R&D that was funded by the parent or affiliate (whether the R&D was performed internally or by others). See BEA 1999 Benchmark Survey, 62.

interaction variables include: *checks\*export*, *checks\*size*, *checks\*kintensity*, *checks\*rndratio*, *polcon\*export*, *polcon\*size*, *polcon\*kintensity*, and *polcon\*rndratio*.

### ***Control Variables***

Conventional wisdom as well as scholarly work suggests that FDI may be primarily affected by location-specific economic factors. Following some baseline econometric models on FDI locations, I include a number of control variables in order to capture key factors that may impact FDI.<sup>157</sup> These factors include level of economic development, country size, economic growth, openness to trade, level of industrialization, and domestic saving rate. The likely impacts of all these control variables on FDI are discussed below.

A host country's size and level of economic development are most likely to affect MNCs' decisions. More developed countries and larger countries tend to attract more FDI. I thus use per capital real GDP (*lgdpper*) and population (*lpop*) to measure economic development and size respectively. Both variables are logged to reduce skewness. I expect that both control variables have positive effects on FDI.

Other factors that are likely to have an impact on FDI is openness to trade (*trade*) and existing FDI inward stocks, both of which reflect the level of internationalization of a specific country. Both variables are expected to be positively associated with FDI.

Degree of industrialization (*industry*) and domestic saving rate (*saving*) are also included. Degree of industrialization, measured as percentage of industrial added value to GDP, may have an ambiguous effect on FDI. On the one hand, economies at an early stage of industrialization cannot offer the sophisticated providers of input that

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<sup>157</sup> Blonigen 2005.

most MNCs need to be competitive; on the other hand, MNCs may find these economies more attractive because they are more likely to have first-mover advantage.

The conventional wisdom suggests that FDI comes as the expense of domestic investment. However, Desai et al find that FDI and domestic investment are complements as greater foreign investment is associated with higher level of domestic investment.<sup>158</sup> Therefore, a country with high domestic saving rate tends to have higher demand for foreign investment. I thus expect a positive association between domestic saving rate and FDI.

Some country-specific factors are more important for MNCs from some countries than the others to make their investment decisions. MNCs may be more likely to invest in countries that have strong economic ties with their home countries or geographically close to their home countries. For example, it appears that market size is more important as a determinant of FDI in China from Europe and the U.S. than for FDI from Hong Kong and Taiwan.<sup>159</sup> Since the database only includes U.S.-based MNCs, these country-specific factors are important in influencing MNCs' investment decisions. I include two variables to control the influence of country-specific factors. One is geographical distance between the U.S. and host countries; the other is bilateral trade between the US and host countries.<sup>160</sup> The opportunity to exchange and cooperate tends to decline the greater is the distance between countries. Therefore, distance between the home and host countries should be negatively associated with FDI inflows. High bilateral trade turnout indicates strong economic ties and high mutual trust between the home and host countries. So I expect the bilateral trade

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<sup>158</sup> Desai et al. 2005.

<sup>159</sup> Tseng and Zebregs 2002

<sup>160</sup> In addition, US export control policy may also affect the export and R&D expenditures of US firms in some countries to a large extent. Its effect should also be controlled if the data of export control is available.

turnout to be positively associated with FDI inflows. The summary statistics are presented in Table 3.1.

**Table 3-1: Summary Statistics**

Variable	Obs	Mean	Std. Dev.	Min	Max
lusfdi	2124	3.65	2.93	-0.69	10.76
polcon3	3677	0.24	0.22	0	0.71
checks	3380	2.63	1.75	1	18
size	2294	547.02	1851.06	0	35505
kintensity	1012	0.48	0.52	0	10.67
expratio	895	0.34	0.23	0	0.90
rndratio	648	0.005	0.009	0	0.09
lgdpper	3510	7.59	1.54	3.81	10.78
lpop	3880	15.63	1.89	10.43	20.99
industry	3169	30.26	11.14	0	88.92
saving	3337	17.11	14.47	-92.76	63.03
trade	3293	78.53	44.49	1.53	330.60
lfdis	3530	7.19	2.60	-4.61	14.20
bitrade	2589	0.08	0.10	0	1.32
ldistance	3861	8.95	0.53	6.59	9.70

Heteroskedasticity, contemporaneous correlation, and serial correlation are potential concerns in TSCS data. Following Beck and Katz's suggestion, I use a panel-corrected standard-errors (PCSEs) model to capture the unbiased effects of political institutions on FDI.<sup>161</sup> The major difference between OLS and PCSE models is that the latter assumes the existence of heteroskedasticity and cross sectional contemporary correlation. Since I am also concerned about serial correlation, I use AR (1) correction to get refined outcomes. All the right-hand-side variables are lagged by one period to reduce the concern of endogeneity.<sup>162</sup>

<sup>161</sup> Beck and Katz 1995.

<sup>162</sup> Reverse causality is also a concern when we examine the causality between governance and FDI. It is possible that FDI affect the quality of governance. More FDI inflows can generate incentives to reform and improve property rights. Moreover, the governance quality measures are constructed ex post, analysts might have a natural bias toward assigning better institutions to countries with higher capital inflows. One solution is to find variables not subject to reverse causality that can account for the institutional variation. However, since I do not have appropriate instrumental variables, I lag all of the independent and control variables by one period of time to reduce the concern of reverse causality.

## V. Findings

In order to examine whether firm-specific features have significant impact on firms' preferences on political institutions, I use a model with interaction terms that allows the marginal effect of industry-specific features on FDI to vary across political institutions. Since I argue that political institutions have different impacts on FDI given their industry-specific features, I expect to see that the marginal effect of political institutions on U.S. investment abroad is sensitive to the distribution of the industry-specific factors such as export ratio, firm size, capital intensity, and R&D intensity.

Therefore, of central interest are the coefficients on the interaction terms. As Braumoeller suggests, lower-order coefficients may not be meaningful if the other variables in the interaction never take on a value of zero.<sup>163</sup> Since it is rarely that capital intensity, export ratio, and R&D ratio take on a value of zero, it is appropriate to focus my interpretation on the interaction terms.

Table 3.2 is the regression results when the institutional variable is *polcon*. Regression 1.1 does not include variable of industrial features and interaction term. It shows that the coefficient on *polcon*, while negative, is statistically insignificant after controlling for some general economic variables and some country-specific factors. It suggests that the impact of political institutions on FDI may depend on some other factors.

Regressions 1.2-1.5 include variables of industrial features and interaction terms. The coefficients on *polcon* are all significant but one model. The statistically

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<sup>163</sup> Braumoeller 2004.



significant interaction term *polcon\_expratio* in regression 1.2 shows that the impact of political institutions on FDI depends on the production strategy of investment. The negative sign on the interaction term indicates that the more vertical is the investments, the higher is the negative effect of political institutions on FDI. This finding is consistent with my hypothesis that strong political institutions are more attractive to horizontal FDI than vertical FDI.

Similarly, in regression 1.3 the negative sign on the interaction term *polcon\_size* suggests that political institutions have negative impact on FDI when the size of foreign affiliates increases. This finding indicates that larger firms may care less about potential risk of expropriation because they may have strong political clout to deal with the host government. It seems to reject the OBM prediction that foreign firms with larger fixed investment are more vulnerable to expropriation. Instead, it provides evidence to support the prediction of political bargain model that the relative bargaining power of large foreign firms may not be easily obsolescing because it is more likely to establish cooperative relations between larger foreign firms and the host government.

In regression 1.4, the interaction term *polcon\_kintensity* is positively associated with FDI, suggesting that the impact of strong institutions on FDI will be amplified if those foreign firms invest in capital-intensive industries. Again, this finding is consistent with my hypothesis that strong institutions attract more capital-intensive FDI than labor-intensive FDI.

In regression 1.5, the coefficient on the interaction term *polcon\_rndratio* is negative but not statistically significant. It indicates that R&D capacity may not be an important factor to shape foreign firms' preference toward political institutions. However, the information for R&D expenses is unavailable for a large number of

developing countries, so adding them produces large amounts of missing data and estimates based on fewer cases. This could also be a possible reason why R&D intensity is not a major factor that affects foreign firms' investment decisions.

**Table 3-2: Political Institutions (*POLCON*) and the Composition of FDI**

Dependent Variable	Log value of US investment abroad flows				
	1.1	1.2	1.3	1.4	1.5
polcon3	-0.140 (-0.52)	2.350 (3.62)***	0.811 (2.84)***	-1.681 (-7.01)***	-0.206 (-0.33)
expratio		3.936 (7.13)***			
<b>polcon_expratio</b>		<b>-5.552</b> <b>(-4.17)***</b>			
size			0.008 (6.08)***		
<b>polcon_size</b>			<b>-0.019</b> <b>(-5.34)***</b>		
kintensity				0.001 (4.44)***	
<b>polcon_kintensity</b>				<b>0.019</b> <b>(2.80)***</b>	
rndratio					18.083 (0.51)
<b>polcon_rndratio</b>					<b>-45.565</b> <b>(-0.60)</b>
lgdpper	0.688 (8.11)***	0.682 (5.62)***	0.620 (7.95)***	0.979 (8.12)***	0.816 (5.90)***
lpop	0.601 (10.55)***	0.316 (3.85)***	0.551 (9.03)***	0.777 (8.11)***	0.405 (4.30)***
industry	0.007 (1.27)	-0.040 (-4.28)***	-0.001 (-0.29)	-0.031 (-4.01)***	-0.032 (-2.50)**
saving	0.002 (0.51)	0.024 (2.22)**	0.005 (1.04)	0.016 (1.94)*	0.012 (0.98)
trade	0.002 (1.37)	-0.001 (-0.54)	0.002 (1.13)	0.005 (2.16)**	0.006 (2.68)***
lfdis	0.410 (9.31)***	0.654 (9.86)***	0.481 (12.02)***	0.337 (4.15)***	0.479 (5.38)***
bitrade	4.277 (6.30)***	2.595 (3.74)***	3.732 (6.11)***	2.759 (3.74)***	1.559 (2.23)**
ldistance	-0.299 (-2.11)**	-0.289 (-1.99)**	-0.319 (-2.63)***	-0.544 (-3.23)***	-0.298 (-1.74)*
OECD dummy	0.015 (0.10)	-0.917 (-3.67)***	-0.192 (-1.48)	-0.549 (-2.85)***	-0.971 (-4.34)***
Cons	-12.488 (-6.69)***	-9.465 (-4.09)**	-11.511 (-6.34)***	-13.127 (-4.49)***	-8.972 (-3.78)***
R <sup>2</sup>	0.59	0.44	0.62	0.65	0.49
No. of obs.	1339	585	1153	496	442

Note: All models use OLS with panel-corrected standard errors (PCSEs) with AR1 correction.

z values in parentheses. \* significance at the 10% level; \*\* significance at the 5% level; and \*\*\* significance at the 1% level.

- Capital intensity is captured by capital expenses divided by number of employees.
- Size is the average log value of assets divided by total number of foreign affiliates
- Export intensity is captured by non-local sales divided by total sales by foreign affiliates
- R&D intensity is captured by R&D spending divided by total sales by foreign affiliates

When I replace the institution variable from *polcon* to *checks*, the results are largely consistent. (Table 3-3) The coefficients on the interaction terms have the same signs in all regressions but one. It reinforces the findings that the impact of political institutions on FDI depends on some industry-specific features including export ratio, firm size, and capital intensity.

With respect to the control variables, the coefficients on the economic determinants of FDI such as GDP per capita, population, and existing FDI stocks have the expected positive signs and their effects are statistically significant in all regressions, suggesting that countries with higher level of economic development, larger size, and good record of hosting FDI tend to attract more FDI from the U.S. firms. In contrast, *industry* has highly significant and negative effects on FDI, suggesting that U.S. firms are more likely to enter countries in the early stages of industrialization in order to benefit more from their first-mover advantage. The coefficients on domestic saving rate, while positive in most regressions, are not statistically significant.

The coefficients on the two country-specific control variables have the expected signs and are statistically significant. Bilateral trade turnout has positive impact on U.S. investment and geographic distance between the U.S. and the host country has negative impact on U.S. investment in that country.

Table 3-3: Political Institutions (*CHECKS*) and the Composition of FDI

Dependent Variable	Log value of US investment abroad flows				
	2.1	2.2	2.3	2.4	2.5
checks	0.041 (1.72)*	0.050 (1.60)	0.130 (4.43)***	-0.102 (-7.05)***	0.022 (0.43)
expratio		2.276 (4.62)***			
<b>checks_expratio</b>		<b>0.016</b> <b>(0.18)</b>			
size			0.008 (4.39)***		
<b>checks_size</b>			<b>0.002</b> <b>(-4.46)***</b>		
kintensity				-0.003 (-5.00)***	
<b>checks_kintensity</b>				<b>0.004</b> <b>(7.72)***</b>	
rndratio					-7.827 (-0.23)
<b>checks_rndratio</b>					<b>0.922</b> <b>(0.15)</b>
lgdpper	0.668 (7.78)***	0.703 (5.68)***	0.584 (7.43)***	0.927 (7.20)***	0.779 (6.02)***
lpop	0.549 (7.93)***	0.319 (3.74)***	0.454 (7.28)***	0.740 (7.15)***	0.379 (3.92)***
industry	0.003 (0.55)	-0.042 (-4.67)***	-0.002 (-0.58)	-0.026 (-2.67)***	-0.028 (-2.40)**
saving	0.009 (1.55)	0.031 (2.82)***	0.004 (0.92)	0.010 (1.23)	0.012 (1.06)
trade	0.002 (1.37)	-0.005 (-1.67)*	0.002 (0.97)	0.005 (1.97)**	0.006 (2.39)**
lfdis	0.420 (8.35)***	0.610 (9.00)***	0.512 (10.55)***	0.347 (4.14)***	0.499 (5.72)***
bitrade	4.043 (5.63)***	2.696 (3.71)***	3.856 (6.03)***	2.909 (3.64)***	1.600 (2.35)**
ldistance	-0.378 (-2.43)**	-0.238 (-1.55)	-0.319 (-2.55)**	-0.525 (-3.08)***	-0.300 (-1.78)*
OECD dummy	-0.159 (-1.04)	-0.928 (-3.62)***	-0.313 (-2.18)**	-0.523 (-2.15)**	-0.967 (-4.56)***
Cons	-10.910 (-5.43)***	-8.994 (-3.67)***	-10.001 (-5.28)***	-12.703 (-4.32)***	-8.677 (-3.70)***
R <sup>2</sup>	0.58	0.43	0.60	0.65	0.49
No. of obs.	1256	584	1103	480	439

Note: All models use OLS with panel-corrected standard errors (PCSEs) with AR1 correction.

z values in parentheses. \* significance at the 10% level; \*\* significance at the 5% level; and \*\*\* significance at the 1% level.

- Capital intensity is captured by capital expenses divided by number of employees.
- Size is the average log value of assets divided by total number of foreign affiliates
- Export intensity is captured by non-local sales divided by total sales by foreign affiliates
- R&D intensity is captured by R&D spending divided by total sales by foreign affiliates

The further issue is that the coefficients generated by this estimation procedure may be biased by country-specific fixed effects. But using a fixed-effects regression would make it difficult to estimate coefficients for the time-invariant independent variables.<sup>164</sup> Therefore, I use a random-effect model to check the robustness of the results. The statistical outcomes are largely consistent with the PCSE regression outcomes. (Results not shown)

In short, production strategy and asset specificity are important in explaining the impact of political institutions in host governments on MNCs, but their role is not always the same as what the OBM would predict. Of all the statistically significant effects, the interaction term of political institutions and export ratio (as a measure of vertical production) has negative effect on FDI, indicating that countries with strong institutions are likely to attract horizontal FDI. The interaction term of political institutions and capital intensity (as a measure of physical asset specificity) is positively associated with FDI, indicating that countries with strong institutions are more likely to attract FDI with high physical asset specificity. The negative coefficient on the interaction term of political institutions and size indicates that countries with strong institutions tend to attract FDI with low dedicated asset specificity.

It seems puzzling that different types of asset specificity have different effects on MNCs' investment preferences. A possible explanation is that a MNC with large operation scale will be more likely to establish backward linkages with local suppliers and customers, which could become the supporters for pro-MNC policy environment. A MNC with highly specific physical asset, however, may not be able to receive enough political support in the host country to ease its concern of expropriation.

<sup>164</sup> There are 13 authoritarian countries where the values of polcon and checks remain constant during the period of time, which make both variables perfectly collinear with country dummy.

## VI. Conclusion

This chapter examines the nuanced relationship between political institutions and FDI by disaggregating FDI based on the production strategy and three types of asset specificity. The central message is that the effect of political institutions on FDI may be conditioned upon some firm-specific features. The regression results show that strong institutions, given their ability to make long-term credible policy, will be more likely to attract FDI that concentrates on horizontal production and has highly specific physical assets, all other things being equal. In contrast, weak institutions, given their ability to make more flexible policy, tend to attract FDI that focuses on vertical production and has large dedicated asset, all other things being equal.

This chapter has two main contributions. First, it provides new evidence to the debate over the firm-government bargaining relationship. The statistical results suggest that while the OBM is still useful for understanding the firm-government relationship, it cannot fully capture the dynamic reality of their interactions.

Second, a focus on the ways in which MNCs interact with the state has important implications for our understanding of the dynamics of FDI. The rising integration of world markets through trade has brought with it a disintegration of multinational firms, which indicates that FDI could take very various forms in different countries. The same U. S. firm might choose to operate in India an integrated plant to produce for the domestic market and choose to operate in China a specific factory to assemble components and ship the end products to other countries. By disaggregating composites of FDI flows, this paper suggests that the variation of FDI distribution is more complex than conventional wisdom would predict.

### Appendix 3-1: Variable Descriptions and Sources

Type of Variable	Variable	Description	Source
Dependent Variable	lusfdi	US Investment Abroad flows million US\$ (log value)	BEA survey (1983-2004)
	polcon3	Level of political constraints, with higher scores indicate better ratings (polcon III)	Henisz (2000a)
Explanatory Variable	checks	Level of checks and balances	Beck et al. (2001)
	expratio	Total non-local sales as a percentage of total sales by foreign affiliates	BEA survey data (1983-2004)
	kintensity	1. Capital expenses divided by number of employees. 2. Investment stocks of capital intensive industries (food, chemicals, and metals) as a share of total investment stocks of total manufacturing	BEA survey data (1983-2004)
	size	Total assets divided by total number of affiliates	BEA survey (1983-2004)
	rndratio	Total R&D expenses as a percentage of total sales by foreign affiliates	BEA survey data (1983-2004)
	lpop	Total population (log value)	WDI 2005
Control Variable	lgdpper	Per capita GDP constant 2000 US\$ (log value)	WDI 2005
	trade	Total export and import as a percentage of GDP	WDI 2005
	saving	Total domestic savings as a percentage of GDP	WDI 2005
	industry	Industrial output as a percentage of total GDP	WDI 2005
	lfdi	FDI stock at the end of previous year	UNCTAD
	bitrade	Trade volume between US and a host country as a percentage of GDP	Expanded Trade and GDP Database (Gleditsch 2002)
	ldistance	The shortest distance between the US and host countries	Minimum Distance Database (Gleditsch and Ward 2001)
	OECD dummy	1 if OECD country, 0 otherwise	

## Chapter 4

### FDI and Special Zone Policy in China

#### I. Introduction

China's striking performance in attracting foreign direct investment (FDI) presents a puzzle: Why have large volumes of FDI streamed into China even though its political institutions seem not able to credibly commit on any long-term policy? An illusory premise is shared among many foreign firms in China, as pointed out by James Ku:

...performing a risk/return analysis in the Chinese business environment often shows that the risks are impossible to ascertain while the possibilities for return seem boundless. Many investors just decide to not think about it and others get completely caught up in the returns.<sup>165</sup>

This view might be familiar for some foreign firms that invest in a booming economy with little concern of expropriation. But how did an authoritarian government of a poor country with little credible track record nonetheless succeed in attracting foreign investment in the first place? Political institutions were always regarded as a big minus for China's ability to attract foreign investment. Several popular explanations focus on how China has overcome its institutional deficiencies and made credible commitments to foreign investors. First, the weakness of political institutions—their inability to make long term credible commitments and secure property rights—was partially made up for by the informal institutional framework. The network of personal contacts (*guanxi*) or flexible commercial clientelism has

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<sup>165</sup> Ku 2006 .



been used to complement legal protections for foreign investors.<sup>166</sup> Second, decentralization has created an incentive for local governments to facilitate rather than obstruct economic reforms, providing credible commitments to the development of collective and private business.<sup>167</sup> This decentralized central-local relationship also facilitates a dynamic of “competitive liberalization” or “segmented internationalization.”<sup>168</sup> Local governments compete fiercely with each other for more resources and favorable policies, leading to an abnormally high demand for FDI.<sup>169</sup>

An alternative perspective held by Yasheng Huang is that China’s huge FDI inflows can be interpreted as an institutional inefficiency rather than an economic success. On the one hand, the systematic policy privileges for foreign-invested enterprises (FIEs) motivate both state-owned enterprises (SOEs) and private Chinese firms to pursue FDI not only for more efficient operating structure, but also for better legal protection and some guarantee of long-term financing. On the other hand, regional fragmentation limits the abilities of Chinese firms to expand and distorts local demand for FDI to an abnormally high level. The combination of two mechanisms creates a strong pull effect on FDI.<sup>170</sup>

In order to shed some light on why China became an attractive destination for foreign investors, this chapter sketches the evolutionary process of China’s foreign investment policy, with a particular emphasis on the special zone policy. I argue that China has attracted massive amounts of FDI not despite its political institutions, but partly because of them. The authoritarian political system gave political elites the independence to initiate a set of institutional innovations to selectively enforce

<sup>166</sup> Wank 1999, Wang 2002, Tsai 2002.

<sup>167</sup> See Weingast 1995, Qian and Weingast 1997, Oi 1999.

<sup>168</sup> Yang 1997, Zweig 2002.

<sup>169</sup> Fu 2000.

<sup>170</sup> Huang 2003a

property rights and entice foreign investors. But authoritarian rule would have been a drawback without continuing commitment to institutional reform, particularly the special zone policy.

China's political system obviously lacks the capability to prevent the government from overturning the special zone policy, but political considerations in both the central and local governments seems to provide a self-fulfilling solution to this credibility problem. On the one hand, the central government considers that keeping a high-growth economy is a political imperative to prevent the widespread unemployment that could lead to social instability.<sup>171</sup> It counts heavily on special zones to attract foreign investment and maintain the momentum of economic growth. Therefore, it allowed the expansion of special zones despite the rise in inefficient investment, corruption, and violation of law coming along with zones. On the other hand, local governments also have a strong interest to maintain and expand special zones within their territories. For them, special zones not only provide showcases to polish their political performance and boost their political careers, but also bring forth an access for them to benefit from land acquisition and sales. The equilibrium between the central and local governments fosters the stability of special zones and alleviates foreign investors' concern of the major political risk.

The change in FDI patterns over time seems to reflect foreign investors' response to the shift of policy flexibility and credibility. At the initial stage of the economic reforms, credibility problems were paramount for foreign investors to deal with an authoritarian government that was inherently hostile toward capitalism. But the flexible arrangement of the special zone policy created huge upfront benefits, which were particularly attractive to foreign investors with short time horizon. As a result,

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<sup>171</sup> Shirk 2007.

FDI inflows were dominated by small, labor-intensive, and export-oriented investors, who used the loosely bound joint ventures as the major market entry mode. As the economic reforms unfolded, the benefits of preferential policies gradually diminished, but at the same time the government slowly established its credibility by maintaining the special zone policy. This increase in credibility was particularly welcome by long-term foreign investors. As a result, more investors were involved in large-scale operations in the high-tech sectors and aimed at penetrating the domestic market. The dominant market entry mode became equity joint ventures (EJVs), which were later replaced by wholly foreign owned enterprises (WFOEs).

This chapter proceeds as follows. The second section discusses the major features that contribute to special zones' flexible investment environment. The third section discusses the political logic of the special zone policy and explores how the central and local governments manage to maintain the special zone policy. The fourth section analyzes the change in FDI activities over time and compares explanations of different theories. The fifth section is a conclusion.

## II. Flexible Arrangements in Special Zones

The World Bank defines a special zone as a geographic area within the territory of a country where economic activities of certain kinds are promoted by a set of policy instruments that are not generally applicable to the rest of the country.<sup>172</sup> In China, the special zone concept has been broadly implemented at every level of local government. According to an official estimation, there were over 6000 special zones

<sup>172</sup> In practice, the types of SZs activities vary from bonded warehouse, export processing & assembling to high-tech R&D. The most common type of special zone is export-processing zone (EPZ), which is defined as "an industrial estate, usually a fenced-in area of 10 to 300 hectares, that specializes in manufacturing for export. It offers firms free trade conditions and liberal regulatory environment." See Madani 1999.

all over the country by 2004.<sup>173</sup> Of them, 227 were designated by the central government (the State Council), including 5 special economic zones (SEZs), 54 economic and technological development zones (ETDZs), 53 high-tech industrial development zones (HTIDZs), 15 free trade zones (FTZs), 58 export-processing zones (EPZs), 14 border economic and cooperative zones (BECZs), and 28 tourism and holiday zones (THZs).<sup>174</sup> While these special zones have different “bosses” within the central government, they share a common goal of attracting foreign investments and promoting local economy.<sup>175</sup> 1346 zones were designated by provincial governments. The rest of them were established by prefectural, county, or even township governments and never got approved by the central or provincial governments.<sup>176</sup>

Despite their tiny size, special zones have left an astonishingly large footprint of FDI activities. Together, the five SEZs and the 54 ETDZs accounted less than 1 percent of total land area, but they contributed over 30 percent of total foreign capital in China in 2004, as shown in Table 4.1. Although the official data for other types of special zones are unavailable, it is likely that special zones are hosting the majority of the FDI in China.

Table 4.1 also indicates the divergent trends between the older SEZs and newer ETDZs in terms of the share of national foreign capital over time.<sup>177</sup> From 1985 to

<sup>173</sup> The Ministry of Land and Resources, Nov. 26, 2004.

<sup>174</sup> There are five special zones that enjoy the same preferential policies as ETDZs but do not have the same name. They are Suzhou Industrial Park, Hainan Yangpu development zone, Shanghai Jinqiao export processing zone, Ningbo Daxie development zone, and Xiamen Haicang investment zone.

<sup>175</sup> ETDZs and BECZs are governed by the Ministry of Commerce, HTIDZs are governed by the Ministry of Science and Technology, EPZs and FTZs are governed by the Customs General Administration, and THZs are governed by China Tourism Administration.

<sup>176</sup> The Ministry of Land and Resources, Nov. 26, 2004.

<sup>177</sup> Although both SEZs and ETDZs enjoy the similar privileged status in attracting FDI, they were very set up in pursuit of different policy goals. First, SEZs were created in places that were previously underdeveloped, with poor infrastructure and shortage of skilled labor, but had close ties to overseas Chinese communities; ETDZs were established in the open coastal cities that had relatively well-developed infrastructure and human capital. Second, the primary purpose of SEZs was to promote export while ETDZs aimed to create import substitution capacity. Third, ETDZs reflected a desire to promote foreign investment in some of the major centers of the domestic economy, rather than allowing it to concentrate in showcase peripheral zones with weak linkages to the interior areas.

2004, the share in the five SEZs fluctuated between 10 percent and 14 percent, but it moved slowly downward since 1994. In contrast, the ETDZs have become increasingly important in attracting FDI. Their share increased 20 times from 0.9 percent in 1985 to 22 percent in 2004.

**Table 4-1: Realized Foreign Investment in SEZs and ETDZs 1985-2004**

Year	Total Realized Foreign Investment (US\$ billion)	SEZ		ETDZ	
		Amount	Percentage	Amount	Percentage
1985	4.65	0.60	12.8	0.04	0.9
1988	10.23	1.02	10.0	0.16	1.5
1992	19.20	2.47	12.9	0.79	4.1
1994	43.21	6.13	14.2	2.61	6.0
2000	59.36	5.80	9.8	4.55	7.7
2003	56.14	6.00	10.7	10.33	18.4
2004	60.63	5.36	8.8	13.61	22.4

Note: SEZs include Shenzhen, Zhuhai, Shantou, Xiamen, and Hainan; The number of ETDZs varies over time: 13 in 1985; 14 in 1988 and 1992; 32 in 1994; 45 in 2000; 54 in 2003.

Source: SEZs' foreign investment data from Wang Guanyi 2004 and Provincial Statistical Yearbooks of Guangdong, Fujian, and Hainan.

ETDZs' foreign investment data from Yearbook of Special Economic Zones and Development Zones, various years;

National foreign investment data from China Statistical Yearbook, various years

How did special zones come to play such an important role in China's FDI miracle? As Naughton argues, the special zone policy was a policy of "disarticulation, in which successive sections of the economy are separated from the planned core, which persists."<sup>178</sup> Indeed, using a special policy arrangement to attract foreign investment was a catalyst for economic transition. Otherwise, China would be likely to fall in a vicious equilibrium trap of continual budgetary pressures, high and unstable taxation, significant tax evasion, and low incentives for investment in the

<sup>178</sup> Naughton 1995, 11.

economy, given the lack of strong institutional constraints.<sup>179</sup>

At the first glimpse, China's special zones resemble Taiwan's export processing zones (EPZs), an important driving force behind Taiwan's economic takeoff, in many aspects. They were established based on an innovative idea of combining in one place the advantages of a free trade zone, an industrial estate, and all the relevant administrative offices of the government. They offer preferential treatment to firms located in the zones. Infrastructural support needed for export businesses, such as industrial land, customs clearance, banks, and telecommunications are made readily available within the zones.

China's special zones differ from Taiwan's EPZs, however. Special zones are characterized by a deeper set of institutional changes and have been established in a much broader scope in the national economy. Three institutional features—privileged political and fiscal status, decentralized decision-making authority, and streamlined organizational structure—enable special zones to create capital-friendly investment environments.

First, special zones have privileged political and fiscal status, which grants them exceptional authority and resources in implementing economic policies. Take ETDZs as an example. Although ETDZs are created not as fully-functioning local governments, the head of an ETDZ normally has a higher position in the bureaucratic hierarchy than the head of a comparable local district government (i.e., district government in the urban area or county government in the rural area). The zones are normally placed under the direct control of the mayor or vice mayor.<sup>180</sup> This not only

<sup>179</sup> Litwack and Qian 1998.

<sup>180</sup> Actually, there is some variation with respect to the bureaucratic rank of ETDZs in different places. For ETDZs set up in the provincial-level municipalities (*zhi xia shi*) and vice-provincial level municipalities [*jihua danlie shi*], the head of the administrative commission has the same rank as the head of prefectures. There are some exceptions. The head of administrative commission in Kunshan ETDZ has higher bureaucratic rank than the mayor of

guarantees the zone a favorable distribution of government resources, but also facilitates quick decision-making at the municipal level.<sup>181</sup>

**Table 4-2: Duration of Central Subsidies for ETDZs**

Group	Special Zone	Charter year	Start of Additional Subsidy	Term	State Council Extension of Additional Subsidy
<b>I</b>	14 ETDZs	1984-98	1984	15 Years (gradually phased out in last 5 years)	Terminated 1/1/99
	Pudong New Area	1990	1991	10 years	Maintained until 1/1/2002
<b>II</b>	14 Border Open Cities	1992	1993	6 years (gradually phased out in last 3 years)	Terminated 1/1/99
	Suzhou Industrial Park	1993	1994	5 years	Extended to 1/1/2003
<b>III</b>	10 ETDZs	1993	1994	5 years	Terminated 1/1/99
<b>IV</b>	10 ETDZs	1994	1995	5 years	Extended to 1/1/2004

Note:

Group I: Dalian, Tianjin, Qinhuangdao, Yantai, Qingdao, Lianyungang, Nantong, Ningbo, Guangzhou, Zhanjiang, Fuzhou, Shanghai Minhang, Shanghai Hongqiao, Shanghai Caohejing.

Group II: Heihe, Suifenhe, Hunchun, Dandong, Manchuria, Erlianhaote, Yining, Tacheng, Bole, Wanting, Ruili, Hekou, Pingxiang, Dongxing.

Group III: Wuhan, Wuhu, Chongqing, Hangzhou, Shenyang, Changchun, Harbin, Beijing, Urumqi, Ningbo Daxie.

Group IV: Beijing, Urumqi, Shanghai Minhang, Shanghai Hongqiao, Shanghai Caohejing and five other cities.

Source: China Law and Practice (2000), "Local governments lure FIEs with outlawed tax incentives," April 1, 2000

Special zones are also granted an independent fiscal authority (*yiji caizeng*), which enables them to collect tax revenues and assume fiscal responsibility.<sup>182</sup>

Through special fiscal arrangements, the central government allowed the first 14 ETDZs to keep all of their fiscal revenues for five years without any obligation of

Kunshan, which is a county-level city under Suzhou municipal government. See Bao 2002, 75-78.

<sup>181</sup> Conventionally, such kind of economic unit would be put under the supervision of a functional bureau such as bureau of foreign economy and trade or bureau of industry.

<sup>182</sup> Administratively, there are four levels of local government that have different degrees of autonomy of fiscal decision: provinces and municipalities at the provincial level, prefectures and municipalities at the prefecture level, counties and cities at the county level, and townships.

remittance. The exemption period was later extended to the end of 1995.<sup>183</sup> After the exemption was over, the 14 ETDZs were offered three more years of transition period, during which they were required to remit an increasing share of revenues to the central government. Therefore, the new tax system adopted in the rest of country from 1994 was not applied to ETDZs until 1999.<sup>184</sup> The ETDZs designated later have also received tax exemptions for various periods of time. The duration of the incentives is based on the respective charter document of a group of ETDZs of the same category. Table 4.2 shows the phase-out information for certain zones released by the Ministry of Finance in January 1999. The special fiscal arrangements gave ETDZs opportunities to accumulate financial resources and pursue a self-reliant developmental mode.<sup>185</sup>

Second, unlike Taiwan's EPZs that were under the direct control of the central government, China's special zones enjoy a certain amount of leeway to pursue their own investment objectives, thanks to economic decentralization. ETDZs have the authority to approve FDI projects up to \$30 million, which is the same authority the central government grants to provincial governments.<sup>186</sup> They also have the same authority as municipal governments in managing fixed investment, urban planning, land development, and price-setting for land lease.

The central government sets up a package of preferential policies exclusively for foreign investors. According to the *Corporate Income Tax Law for Foreign-Invested*

<sup>183</sup> Ministry of Finance, China, Notice 177, October 9 1994

<sup>184</sup> Pi and Wang 2004

<sup>185</sup> Typically, revenues of the first 14 ETDZs came from four major sources in the 1980s: 1) discounted loans from the central government; 2) fiscal transfers from local governments; 3) revenue from land usage fees; and 4) tax and tariff rebates.

<sup>186</sup> The cut-off point between approval by central and local authorities is a project size of US\$30 million. Projects valued at more than US\$30 million must be submitted for approval to Ministry of Commerce and they will then be considered by the National Development and Reform Commission (NDRC). Projects with a value exceeding US\$100 million must also be submitted to the State Council for approval. Projects below US\$30 million may be approved by government departments at provincial level. See OECD 2003.



*Enterprises*, FIEs enjoy a preferential tax regime that consists of tax holiday and tax concession for five years, and exemption (or concession) on payment of import/export duties. Manufacturing companies with a contract for ten years or more are eligible for a two-year tax holiday followed by 50 percent reduction during the next three years (*liang mian san jian ban*). On top of that, a further tax concession may be applicable for particular types of FIEs, such as technologically advanced or export-oriented companies, or investments in port and wharf development. For example, a technologically advanced FIE may qualify to be taxed at 50 percent of usual rate after the five years have expired. Moreover, as part of a package of preferential treatment, the Joint-Venture Labor Regulations granted foreign investors significant flexibility and reduced burdens related to the employment of Chinese workers.<sup>187</sup>

In addition to having these ownership-specific tax incentives, FIEs located in special zones enjoy additional benefits. The 30 percent corporate income tax rate for FIEs may be reduced to 15 or 24 percent, depending on the geographic location and the type of investment.

The central government also grants local governments some discretion to offer their own incentives.<sup>188</sup> As shown in Table 4.3, local governments are empowered to directly exempt or reduce 10 percent surtax payable by FIEs on the income tax and various other local taxes and fees. They can also provide other incentives such as tax reward, accelerated depreciation, profit rollover, and subsidies for FIEs that are important to them.

<sup>187</sup> Gallagher 2005.

<sup>188</sup> Before 1994, corporate income tax revenues collected from FIEs were shared by the central and local governments. The tax-sharing system (*fenshui zhi*) introduced in 1994 has assigned the corporate income tax revenue collected from most FIEs to local governments (including those in special zones). Arguably, local governments would have less incentive to offer tax breaks to FIEs, because it has become a more costly policy for local governments. Starting 2002, all the corporate income tax revenues are shared 50-50 between the central and local governments. Lu and Tang 1997.

**Table 4-3: Major Preferential Tax Policies for Foreign Invested Enterprises in China**

National Policies								
Content	General	Special Economic Zone	National Special Zone				Open city & area and provincial development zone*	
			Economic and technology development zone (including EPZ)	High-tech industrial development zone	Free trade zone	Border economic and cooperative zone		
Income Tax Rates	Manufacturing	30%	15%	15%	15%	15%	24%	24%
	Non-manufacturing	30%	15%	30%	30%	30%	30%	30%
	Technology-advanced	30%	15%	15%	15%	15%	15%	15%
	Enterprise exporting 70 percent of production	15%	10%	10%	10%	10%	12%	12%
	Financial institutions	30%	15%	15% (with State Council's approval)				
	Specially approved encouraged projects	15%						
Tax Break/Exemption	<ul style="list-style-type: none"> <li>Exemption for two years from the first profit-making year followed by a 50 percent reduction in the three following years for manufacturing enterprises with a contract life of ten years or longer;</li> <li>A 50 percent reduction will be extended for three more years when enterprises continue to be technologically advanced; or set up in middle or western areas.</li> <li>Exemption for the first profit-making year followed by a 50 percent reduction in the two following years for: service enterprises set up in SZs with \$5 million registered assets; or financial institutions set up in SZs with at least \$10 million registered assets and a contract life of ten years or longer.</li> <li>Enterprises operating in agriculture, forestry and husbandry are levied tax at a concessional rate of 15 to 30 percent thereafter for ten years.</li> <li>Exemption for five years from the first profit-making year followed by a 50 percent reduction in the five following years for enterprises investing in seaport or harbor construction with a contract life of 15 years or longer.</li> <li>Rebate of 40 percent of income tax if the profit is reinvested for joint ventures; full refund of income tax for export-oriented or technologically advanced enterprises.</li> </ul>							

**Table 4-3 Continued**

Import-Export Duties	Refund or reduction of import duties for production inputs and export goods.
Value-added tax	Exemption or reduction for products sold in SEZs and EPZs
Tax exemption for investment in fixed assets	
<b>Provincial Policies</b>	
Local Income Tax Rates	Up to 10 percent, exemption or reduction subject to provincial governments' regulations
Tax Reward	Local governments determine the amount of rewards for enterprises that pay taxes on time
Depreciation	Local governments determine whether to apply accelerated depreciation accounting principle to specific enterprises
Property tax, urban construction tax, tax for occupation of arable land	Local governments determine the term and proportion of tax reduction
Charges for usage of land, power, water, telecommunication, and other services	Local governments determine the discount rates
Tax loss carry-forward	Local governments determine whether to allow enterprises to use present operating losses to reduce taxes due in the next five years.

\* Open cities & areas include those in coastal, river, inland, border areas that were granted preferential policies

Source: China Yearbook of Investment 2002 (*zhongguo touzi nianjian*) 418-420

Thirdly, special zones have a streamlined organizational structure, which means red tape is less entangling than in areas outside the zones. Compared with Taiwan's EPZs, which were primarily aimed at promoting exports, China's special zones have more complex functions, but they share the same feature of integrated and simplified administrations. A typical special zone government has both Communist Party organs and government institutions: the Party working commission (*dang gong wei*) on the Party side and the administrative commission (*guan wei hui*) on the government side. However, the two sets of institutions only have nominal difference. Almost all the members on the Party working committee hold posts on the administrative commission. In other words, the two commissions are one organization with two different names (*yi tao banzi, liang kuai paizi*).

Technically, a zone government is not a fully-functioning local government. The administrative commission is created by the municipal government to attract foreign investment and govern the zone. It has a simplified set of bureaucratic organizations with one core department in charge of investment promotion.<sup>189</sup> The other key department is to manage land development and infrastructure construction.<sup>190</sup>

The municipal governments also set up some administrative agencies including customs, taxation, and business licensing within the zone to speed up the investment approval process. While the zone government has no official authority over these agencies, it is responsible for "supervising and coordinating" these agencies.<sup>191</sup> The

<sup>189</sup> The organization has different names in different periods of time. In the 1980s, its typical name was department of trade and investment promotion (*zhaoshang yinzi ju*). Currently it is more commonly called department of economic development. The change of name indicates the functional change from an investment-oriented organization to development-oriented one.

<sup>190</sup> Lacking financial support from the government, special zones normally use a "cumulative development approach" (*gundong shi kaifa*) to finance the land development, which featured a rationale of "developing a stretch of land, making a rational return on it and then using the return to develop new stretches of land". That is, a small stretch of land area was initially developed under the criteria of "seven connections and one leveling" (*qitong yiping*) for industrial development. Developed land was leased to foreign investors and the revenues were raised for developing a new stretch of land.

<sup>191</sup> The relationship between the administrative commissions and those dispatched agencies is clearly stated in

zone government is not obliged to provide public services such as schools, hospitals, utilities, and police. These obligations are taken over by the local governments adjacent to the zone. The zone government does not have legislative authority, which means no presence of local People's Congress in the zones. Some special zones have judicial institutions (Court and Procuratorate), but they arguably violate the formal legal procedure.<sup>192</sup>

Because of the streamlined organizational structure, a typical zone government is much smaller in size. For example, the average number of staff for a high-tech industrial development zone (HTIDZ) is only one fourth that of a fully-functioned local government with the same size of land area and population.<sup>193</sup>

Thanks to these special institutional arrangements, foreign firms located in the special zones can enjoy tax benefits and have access to well-developed infrastructure and facilities at very low cost. Red tape associated with applications for and licensing of investment, plant establishment, import and export was reduced so that foreign firms can start and run their projects with minimal bureaucratic fuss. These benefits, together with the abundant low-cost labor supply, created a very attractive investment environment for foreign firms.

### III. The Political Logic of the Special Zone Policy

Successful economic reform requires political actors who can actually keep reform-related promise. For a country with a strong rule of law, establishing the legal

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some provincial regulations of ETIDZ as that the administrative commission supervises and coordinates these institutions.

<sup>192</sup> The Superior Court has approved twenty courts set up in special zones to handle specifically foreign-related economic disputes. According to the deputy head of the Superior Court, no court will be established in other special zones in the light of the WTO accession. See Xu 2002. However, these institutions are criticized as violating the Constitution. Most of the special zones are non-administrative districts that do not have the authority to have their own legislative and justice institutions. Liu 2005.

<sup>193</sup> Ministry of Science and Technology, Torch Center 2004.

status of special zones would be an effective way to make a credible commitment to assure foreign investors. But China, in the early 1980s having been isolated from the rest the world for three decades, did not take this step. The Chinese government actually realized that establishing the legal status for special zones is crucial to reassure foreign investors. For instance, Vice Premier Gu Mu admitted in 1985 that the weak legal environment was a key concern for foreign investors and suggested that the “National Regulations of Development Zones” was in preparation along with the “Wholly Foreign-Owned Enterprise Law” and the “Sino-Foreign Cooperative Joint Venture Law”.<sup>194</sup> The latter two laws were established in 1986 and 1988 respectively, but the former has never been formally submitted to the NPC for approval.

If the government cannot be held accountable, the benefit of the flexible arrangement will not last long. Investors will be hesitant to increase the investment scale when they realize that they will be vulnerable to future policy change once their capital is sunk. As a result, the country may fall into a commitment trap: the government’s inability to restrict its own future opportunistic behavior may hurt the government.<sup>195</sup> In China, the question uppermost in the minds of foreign investors was how long the door will remain open and whether future political shifts would adversely affect the profitability of their businesses. Indeed, since its inception in the early 1980s, the preferential policy arrangement in special zones has sparked intense controversy.<sup>196</sup> Foreign firms might find themselves expropriated or expelled should a new wave of xenophobia spread through the country.<sup>197</sup>

This commitment trap did not materialize, however. As shown in Table 4.1,

<sup>194</sup> Gu Mu 1985.

<sup>195</sup> Rodrik and Zeckhauser 1988.

<sup>196</sup> For a detailed review of the political debates over the SEZs, see Crane 1990.

<sup>197</sup> Osborne 1986.

special zones have played a crucial role in attracting FDI. This finding is not particularly amazing, because China, to a large extent, just reproduced the successful development strategy adopted in Korea and Taiwan. A distinguishing feature of China's special zones, however, is that they haven't been fading with the promotion of the whole investment climate nationwide. Special zones' share of FDI inflows in national total, have actually increased 25 times from 1985 to 2004.<sup>198</sup> Why have special zones proved so enduringly popular among foreign investors? How did the Chinese government manage to keep its promise for a long time?

Political considerations in both the central and local governments create a self-enforcing solution to this commitment problem. First, the central government has a strong political motivation to keep foreign investment flowing in order to maintain the economic momentum and prevent the widespread unemployment. It has a serious concern of losing foreign investment once the preferential treatment is no long available for foreign firms, as indicated by the debate over preferential tax rates which I will discuss later. Second, local governments have a strong incentive to maintain and expand special zones in their domain because 1) it is a convenient choice for local officials to quickly boost their political achievement during their terms; 2) zone-related land acquisitions and sales generate huge benefits for local governments. Since neither the central nor local governments have the incentive to change the status quo, special zones prevail even after the overall investment environment has been fundamentally improved.

### ***The Central Government***

<sup>198</sup> In contrast, Taiwan' EPZs played a comparably important role in attracting FDI in its early stage. They received 23 percent of foreign investment between 1966 and 1970, but the importance of EPZs declined significantly as the benefits of being in the zones were eroded by liberalization of the remainder of the economy. See Haggard 1990.

At the initial stage of the open-door policy, the central government was clear that the special zone policy was crucial in attracting foreign investment because there was basically nothing else the government could offer. Instead of institutionalizing this policy, the central government relied on some informal means to keep this policy irreversible. First, the top leaders used their personal commitments to defend the policy from the opposition within the ruling coalition and to reassure foreign investors. Second, the central government wielded particularistic arrangement to ensure that local governments will not collectively oppose this policy. Third, the central government created powerful economic agencies to maintain the ultimate control over the overall shape of the investment policies.

#### *Top Leaders' Personal Commitments*

The open-door policy flourished in China after Deng Xiaoping took power in 1978. Four SEZs—Shenzhen, Zhuhai, Shantou, and Xiamen—were created as an integral part of this strategy. In 1979, the CCP Central Committee and the State Council authorized the Guangdong and Fujian leaderships to use “special policies and flexible measures” to implement an experimental development strategy.<sup>199</sup> The exceptionalist interpretation of “special things must be fulfilled in SEZs” defined a certain license for experimentation of the SEZs.<sup>200</sup> These special policies and flexible measures included 1) special tax incentives for foreign investment, 2) greater independence on financial planning and international trade activities, 3) province-

<sup>199</sup> Reardon 1998

<sup>200</sup> This slogan came from then Party Secretary Hu Yaobang in 1983. The full quote was: “New things must be dealt with in new ways, special things in special ways; adopting completely new methods while not changing position [of opening to the outside].” The special things are represented as “four primary objectives” (*sige weizhu*): 1) development should primarily rely on attracting and utilizing foreign investments; 2) the primary economic forms should be joint ventures and partnerships as well as wholly foreign-owned enterprises; 3) the products should primarily be export-oriented; 4) the economic activities should primarily be driven by market. See Crane 1996.



level authority on economic administration, and 4) local legislative authority.

Deng Xiaoping himself had underwritten the essentially political features of the SEZs. He reportedly used the argument that “foreign interests must serve national Chinese interests” to defend the privileged role given to the SEZs in adapting more flexible economic policies, and extending many of the reforms of the SEZs to the zones in the interior.<sup>201</sup>

Deng Xiaoping assumed direct responsibility for the SEZs, stating in 1984 that “the running of the SEZs was my initiative and the CCP Central Committee approved it...”<sup>202</sup> Because this policy was so closely tied with his political authority, he could not afford any failure. He visited Tianjin economic development zone (TEDA) in August 1986 and reportedly said firmly: “No open-up no life. (*bufang jiu buhuo*) There is no option of closing down.”<sup>203</sup> This statement seemed to target two groups of audience. For foreign investors, it was a strong commitment from the highest level of state power to assure them that the preferential treatments for foreign investors would not be reversed under any circumstance. For the conservatives, it was a warning to prevent them from challenging his decision. As shown in Table 4.2, when the latent opposition periodically burst forth into active disapproval of the SEZs policy, the top leaders’ well-publicized visits to the SEZs (i.e., Deng Xiaoping in 1984 and 1992, Zhao Ziyang in 1987, and Jiang Zemin in 1994, 1995 and 2000) have bolstered strong political supports of maintaining the special policy arrangement.<sup>204</sup>

<sup>201</sup> Ho and Huenemann 1984.

<sup>202</sup> Reardon 1998

<sup>203</sup> Li, Yuanpu. 1986. “Deng Xiaoping says ‘no open-up no life’ in Tianjin.” *People’s Daily*, Aug. 22, 1986.

<sup>204</sup> In 1984, Deng’s key slogan in Shenzhen turned aside charges of spiritual pollution: “The development and experience of Shenzhen prove that our policy of establishing Special Economic Zones is correct.” The decision to open fourteen coastal cities to foreign investment was made after Deng Xiaoping’s approving visit to the SEZs in 1984. See Crane 1990.

**Table 4-4: Central leaders' Remarks on Special Zones**

Leader	Time	Location	Key Remarks	Source
Deng Xiaoping	Jan. 26, 1984	Shenzhen	Shenzhen's development and achievement have proved that our SEZ policy is correct.	PB, 2/2/1984
Deng Xiaoping	Aug. 19, 1986	Tianjin	No open-up no life. There is no option of closing down.	PB, 8/22/1986
Zhao Ziyang	Nov. 1987	Shanghai, Jiangsu, Zhejiang, Fujian	Great international cycle ( <i>guoji da xunhuan</i> )	PB, 1/23/1988
Jiang Zemin	Nov. 26, 1990	Shenzhen	The practice of SEZ policy is successful and the guideline of the reform and open policy is absolutely correct.	PB, 11/27/1990
Deng Xiaoping	Jan. 22, 1992	Shenzhen	Be braver, be faster.	PB, 3/31/1992
Jiang Zemin	Apr. 13, 1993	Hainan	SEZs' "pioneering" role will shine through history.	PB, 4/14/1993
Jiang Zemin	Jun., 1994	Guangzhou, Shenzhen, Zhuhai	The center's resolve of developing SEZs will not change; the SEZ policy will not change; SEZs' position in the open-up policy will not change.	PB, 8/28/2000
Jiang Zemin	Dec., 1995	Shenzhen	Create new advantages and ascend another story.	PB, 12/9/1995
Jiang Zemin	Nov. 2000	Shenzhen	SEZs should continue their pioneering role in the open-up policy.	PB, 11/15/2000

From the outset the SEZs received opposition from within the central government and local governments. On the one hand, the initial economic boom in the SEZs didn't convince some conservative officials in the center (e.g., Chen Yun and Yao Yilin) that the reforms were desirable. Instead, they worried about that the SEZs might annihilate the socialist economic system and become conduits of capitalist exploitation and decadence.<sup>205</sup> On the other hand, local governments have both raised some opposition to the SEZs and lobbied for extending the privilege. For example, officials in Shanghai, feeling threatened by the prospect of competing centers of international economic activity in the SEZs, asked for participation in the zone

<sup>205</sup> Crane 1990; Shirk 1994.

policy.<sup>206</sup>

While Deng Xiaoping was generally on the side of the liberal reformers, he also actively accommodated the concerns of the conservatives by warning the party to guard against decadent influence from abroad. Therefore, the setting up of SEZs and ETDZs was shaped by the balanced strategy: by confining the experimentation to a limited geographic area, those benefiting from the myriad of restrictions that existed would not feel threatened. To avoid strong opposition from other local governments, the central government only invested a small amount of “seed money” to initiate this particularistic policy. By 1985, Shenzhen received 4.5 billion RMB investments in infrastructural construction. Of them, only 3.8 percent came directly from the central government as earmark transfers, 38 percent from discounted loans, and 20 percent from SEZ revenues which would otherwise have been remitted to the center. Foreign investment accounted for 27 percent of the basic construction.<sup>207</sup>

Compared with the five SEZs, the first group of ETDZs had a low-key start. Almost all the 14 ETDZs were set up on the outskirts of big cities. They had much smaller area, less financial support from the central government, and no legislative guarantee. The total industrial area of these ETDZs was about 20km<sup>2</sup>, much smaller than the Shenzhen SEZ alone (243 km<sup>2</sup>). The breakthrough policy that designated ETDZs in 14 Open Coastal Cities (OCCs) was released in the State Council’s “Minutes of Some Coastal Cities Seminar” (*yanhai bufen chengshi zuotanhui jiyao*) in 1984, a surprisingly informal and vague way. The central government decided to use preferential policies rather than financial resources to promote these special zones, as stated in the Minutes:

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<sup>206</sup> Crane 1990, 39.

<sup>207</sup> Wu 1985.

To further open up coastal cities and develop special economic zones, the central government should not be expected to invest lots of money. Instead, the central government will give (these areas) policies. One is to give foreign investors preferential policies and lower tax rates, and allow them to sell a portion of their products on the domestic market. The second is to give these cities more autonomy to carry out outward-looking activities.

The first national ETDZ was set up in Dalian on September 25, 1984. In the following two years, 14 ETDZs were established along China's eastern seaboard from Dalian to Zhanjiang. As indicated in the Minutes, the central government was reluctant to make a large investment. It only offered RMB 2.2 billion discounted loans to the 14 ETDZs for the first three years to launch their initial infrastructural construction.<sup>208</sup> In 1985, larger territorial units—the open deltas of the Yangtze and Pearl rivers and southern Fujian—were included in the category of special zones.

#### *Particularistic Arrangements*

While Deng Xiaoping's prominence turned aside opposition from the conservatives within the central government, he had to provide some incentives to reinforce regional political support for the particularistic arrangement.<sup>209</sup> The incentives were generated through selectively offering "scarce, profitable reform opportunities" to some coastal provinces.<sup>210</sup> The decision to open fourteen coastal cities to foreign investment was made after Deng's approving visit to the SEZs in 1984. He reportedly articulated the "guiding ideology... to open wide and not to restrict," and proposed steps to add some coastal cities and to apply them the similar

<sup>208</sup> The total amount of discounted loans was calculated based on the start-up size of 14 ETDZs. The central government gave RMB 100 million discounted loans per km<sup>2</sup> and the total start-up size of 14 ETDZs were 22 km<sup>2</sup>. See Pi and Wang 2004.

<sup>209</sup> Shirk 1993.

<sup>210</sup> Shirk 1994.

policies implemented in the SEZs.<sup>211</sup>

After the central government granted preferential treatment to 14 coastal cities, 24 inland cities reportedly lobbied for the same privileges.<sup>212</sup> This policy met some serious challenges in 1985-87. Mounting economic costs, especially foreign exchange imbalances and infrastructural spending, led to a reassertion of central control and a diminution of preferential status for special zones. More importantly, the demotion of the reformist Party Secretary Hu Yaobang in the anti-bourgeois liberalization campaign dramatically changed the political climate and brought reconstituted special zone policy under intense scrutiny. To assure the confidence of foreign investors and gain support from more local governments, the newly-selected Party Secretary Zhao Ziyang made a whirlwind visit to some coastal provinces in 1987. He reiterated that zone policy was a crucial element of China's economic strategy and articulated a broader coastal development plan.<sup>213</sup> In 1988, the State Council announced that the number of open coastal cities and counties was being expanded from 148 to 284 and would embrace a population of 160 million.<sup>214</sup> However, these new policies were held off after the Tiananmen Incident in 1989.

The second round of special zone expansion was promoted by Deng Xiaoping's south tour in 1992, where he urged an intensification and speed-up of economic transformation. The speech sparked a "zone fever" among local governments all over the country. An official survey among 106 counties in 1992 showed that 75 percent of them had established or planned to establish development zones, accounting for over 50 percent of total agricultural land.<sup>215</sup>

<sup>211</sup> Deng Xiaoping 1984, 51-52; also Barnett 1985.

<sup>212</sup> Yang 1997.

<sup>213</sup> Crane 1990.

<sup>214</sup> Kleinberg 1990, 91.

<sup>215</sup> National Agricultural Planning Committee 1993.

In order to rein in the rampant expansion of local special zones, the State Council promulgated a circular stating that only those special zones designated by the central and provincial governments could legally operate.<sup>216</sup> A two-level approval system was established based on this circular. The central government granted a more privileged status to the newly established Pudong new district in Shanghai and approved 18 national ETDZs, including Beijing, Shenyang, Hangzhou, and Chongqing. Meanwhile, it shut down as many as 1000 zones set up without the proper approval by the central and provincial governments.<sup>217</sup> Thanks to the economic boom after 1992, ETDZs had a tremendous performance between 1992 and 1996. By 1996, the total amount of industrial outputs and FDI stocks of the 14 ETDZs were more than ten times and three times those of 1991 respectively.<sup>218</sup>

In the mid of 1990s, there was a widespread speculation that the central government would change the favorable climate that had nurtured the special zones' spectacular transformation as some officials and scholars argued that the system gave foreign investors an unfair advantage over domestic investors.<sup>219</sup> In particular, scholars like Hu Angang argued that the preferential policies exacerbated regional inequality and created "privileged cliques and groups with vested interests" who opposed dismantling these preferential policies.<sup>220</sup> Moreover, evidence of "round-tripping" FDI, that is, domestic capital cycling out of the country and back in order to take advantage of such incentives, bolstered the perception among authorities that the preferential policy had been abused.<sup>221</sup> Such concern prompted Beijing to revoke tariff and duty exemptions for all capital imports of FIEs approved on or after April 1,

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<sup>216</sup> The State Council, 1993.

<sup>217</sup> Coopers & Lybrand 1996.

<sup>218</sup> The Ministry of Commerce 2004.

<sup>219</sup> Florcruz 1995.

<sup>220</sup> Zweig 2002.

<sup>221</sup> Rosen 1999.

1996. The effects of removing the tariff exemptions were apparent. The contracted FDI inflows dropped more than a quarter in 1997.<sup>222</sup> The central government, realizing that already slowing FDI inflows would likely drop further as a result of the Asian financial crisis, responded by restoring the tariff exemptions, effective January 1, 1998.

Although there was increasing pressure from the interior provinces against the preferential policies for the coastal provinces, the central government managed not to revoke the special zone policy. Instead, it decided to open more interior cities to foreign investors while allowing the existing national special zones to keep the original preferential policies for a limited time period.<sup>223</sup> However, by the end of the 1990s when the grace period was about to expire, the central government decided to extend special zones' privileged lease for unlimited period of time. This policy was publicly confirmed by President Jiang Zemin at the 20<sup>th</sup> anniversary of Shenzhen SEZ in November 2000, "China will develop SEZs all through the process of the country's reform, opening up and modernization drive."<sup>224</sup> This time, the central government's "defection" did not generate a strong backlash from the interior provinces, mainly because of the launching of the "Western Development Strategy" (WDS) campaign in 1999, through which the center committed to grant more resources and preferential policies to promote economic development in interior provinces.<sup>225</sup> Although the long list of FDI-related policies was more like a statement of intent, at least it officially offered the same preferential policies to the interior provinces to attract foreign

<sup>222</sup> Chang, K.T. 1998.

<sup>223</sup> Yang 1997.

<sup>224</sup> People's Daily, Nov. 15, 2000.

<sup>225</sup> In 2000 alone, the central government transferred 70 billion RMB to promote the WDS. By February 2002, the total government investment reached over 400 billion RMB. See Tian 2004.

investment.<sup>226</sup>

The WDS triggered the third round of zone expansion. 16 national ETDZs were approved by the State Council, most of which were in poor inland regions.<sup>227</sup> In mid-2003, the central government decided to refocus its regional economic policy towards rejuvenating the old industrial areas in Northeast China, while retaining policies aimed at developing the western and central regions. The central government's particularistic economic promotion arrangement has eventually spread to the whole country.<sup>228</sup>

With the spread of special zones, the central government finally began to consider the proposal of enacting the national legislation on special zones. The Ministry of Commerce (MOFCOM)—the primary advocate for the national legislation—has prepared several drafts of Regulations for National ETDZs and has been actively lobbying other organs of the central government to initiate the regulations.<sup>229</sup> However, the debate over special zones and the privileged status of foreign investors once again denied passage of the national legislation. But the focal point has shifted from fierce ideological debate to socioeconomic issues, particularly land grab and tax losses. To establish special zones, local governments often procured farmland in coercive ways, at prices well below the prevailing market rates, and handed it over to developers or foreign investors. Coupled with rapidly rising inequality between rural and urban incomes and corruption, the land seizures have sparked social unrest. In

<sup>226</sup> The Circular of the State Council's General Office on the Distribution of "Suggestions on the Implementation of Policies and Measures Pertaining to the Development of the Western Region" submitted by the Western Regional Development Office of the State Council consisted of 18 specific preferential policies, such as relaxing control on a number of manufacturing and service sectors for foreign investment, broadening the scope for these regions to enjoy various preferential policies, developing an export-oriented economy and increasing foreign cooperation. See Asian Development Bank.

<sup>227</sup> The 16 national ETDZs in central and western regions are Hefei, Xi'an, Changsha, Huhhot, Nanchang, Chengdu, Kunming, Guiyang, Zhengzhou, Nanning, Shihezi, Yinchuan, Taiyuan, and Xining.

<sup>228</sup> Shirk 1993.

<sup>229</sup> The most recent action was carried out in February 2005, when the MOFCOM invited officials from NPC Judiciary committee, the State Council Legal Office, and 10 ETDZs to set an agenda to draft the ETDZ regulations. People's Daily, Mar. 28, 2005.



recent years, disputes over land procurement accounted for 65 percent of mass protests in rural China.<sup>230</sup> Special zones have become controversial not only because of the land issue. They may also inflict enormous losses through tax breaks and forgone duties.<sup>231</sup>

### *Governance Institutions*

Since the initiation of the open-door policy, the top leaders have established a number of high level institutions that give them ultimate control over the overall shape of the investment policies. These supra-ministerial agencies, though had little public accountability or transparency, were relatively free from political meddling. These institutions established that preferential policies are offered to foreign investors primarily through the platform of special zones. While it is true that those policies were interpreted flexibly along with the decentralization of policymaking authority, the central government still has the capacity to maintain the consistency of the special policy framework and coordinate the provision of government investment services, which is an important factor behind of China's FDI performance.

The first supra-ministerial institution in charge of investment policy was the Foreign Investment Control Commission (FICC), which was created in 1979 along with the promulgation of the Sino-Foreign Equity Joint Ventures Law, the landmark legislation for foreign investment.<sup>232</sup> The role of the FICC was to coordinate and to

<sup>230</sup> Wang Hongru 2006.

<sup>231</sup> A report by the National Auditing Bureau reveals that the local governments' illegal tax efforts have caused 6.5 billion RMB tax losses beyond the authorized tax deductions in 80 development zones. These tax losses are primarily caused by two factors. First, firms within the development zones have enjoyed more preferential tax treatment than what the dual tax systems would allow. The average actual income tax rates for firms within and outside development zones are 11% and 27.9% respectively. Second, the preferential tax rate has been enjoyed by many firms outside the development zones because of the increasing expansion of special zones. *China Youth Daily*. Oct. 23, 2006.

<sup>232</sup> The FICC shared the same set of organization and personnel with the Import-Export Commission (IEC), which

approve contracts between Chinese and foreign partners, a vital function in a centralized economy. The FICC reported directly to the State Council, supervised by Vice-Premier Gu Mu, an ardent reformer and a key patron of the SEZ policy. Consisting of representatives from the concerned ministries, the FICC was designed to centralize and streamline both the application and screening process for foreign investors. The FICC had the power to approve or refuse any FDI contract above \$3 million. However, the SEZs were not subject to the FICC, but rather had their own investment approval bodies and had no real upper limit on investment.<sup>233</sup> The FICC was merged into Ministry of Foreign Economic Relations and Trade (MOFERT) in 1982.<sup>234</sup>

Upon the establishment of the four SEZs, the central government created new institutions—Special Economic Zone Leading Group in 1980 and Special Economic Zone Office (SEZO) in 1982—to govern the SEZs and ETDZs. Vice-Premier Gu Mu was placed at the head of Leading Group of SEZs. This concurrent appointment allowed him to serve coordinating role in the government. Governing special zones imply a separate objective and separate rules and regulations which were outside the jurisdiction of line ministries in the areas of commerce, industry, labor, customs, banking, and taxation. The very nature of special zones created conflict among relevant interests. Without a clear-cut and powerful management structure, zone authorities are likely to be involved in conflicts with different levels of government and with line ministries which try to use the economic freedom of the zones to further

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was created at the same time.

<sup>233</sup> Osborne 1986.

<sup>234</sup> In 1982, the newly-established Ministry of Foreign Economic Trade and Relations (MOFERT) took over the functions of the FICC, the IEC, the Ministry of Foreign Trade, and the Ministry of Economic Relations with Foreign Countries (essentially an aid agency).

their own interests.<sup>235</sup> SEZO was created outside of the formal bureaucratic structure. Its establishment, change, or abolishment depended upon the State Council and did not need to be approved by the NPC. Although the SEZO was only a ministry-rank agency and had no independent executive authority, it has the capability to coordinate policies between ministries over foreign investment issues. As an ad hoc organ which assists the Premier in the administration of special zones issues, SEZO maintained direct links with the top political leadership, which gave key economic officials political backing and operate amid the confusion created by potential rivals in other line ministries.<sup>236</sup> This special status of SEZO had guaranteed it a good deal of political autonomy and speeded up the process of attracting foreign investments to the zones.

Despite its ad hoc nature, the SEZO had been functioning for 16 years until 1998, when it was merged into another newly-created ad hoc organization—the Economic Reform Office (ERO).<sup>237</sup> Accordingly, special zones were transferred under the jurisdiction of ERO in 1998 for a short period of time. In October 1999, the MOFTEC finally took over the authority of governing special zones. The specific governing body under the MOFCOM was downgraded to a division (Division of Development Zones, or *kaifa qu chu*). The downgrade and eventual abolishment of the SEZO was related to a decision to streamline and increase the efficiency of the state bureaucracy. It also indicated that the central government began to attach less importance to this specific arrangement in the light of WTO accession.

The third supra-ministerial institution was the National Leading Group for Foreign Investment, a joint party-state organization of top officials in a given sector. It

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<sup>235</sup> Wall 1991.

<sup>236</sup> Crane 1990.

<sup>237</sup> The predecessor of ERO was National Economic Reform Commission, which became an informal advisory organization to the State Council after 1998.

was established in 1994 primarily as a response to the “zone fever” and fierce competition between local governments for foreign capital. Realizing the difficulties of eliciting local compliance with its policy, the central government had to recentralize the policymaking of foreign investment issues. The Leading Group, directed by the Vice Premier Li Lanqing, included top-level representatives from 16 concerned ministries.<sup>238</sup> It was the peak coordinating body between the various parts of the government. This arrangement encouraged investment policies to be assessed in terms of national rather than a ministry-specific interest. Again, as a consequence of organizational restructuring, it was abolished in 1998 and all its functions were transferred to the Ministry of Foreign Trade and Economic Cooperation (MOFTEC).

After the bureaucratic restructuring in 1998, the MOFTEC (Ministry of Commerce, or MOFCOM since 2003) became the primary institution responsible for foreign investment policymaking. It drafts legislation and regulations governing the establishment, operation, and treatment of FIEs as well as collects and publishes statistics on FDI in China. The most recent round of bureaucratic restructuring in March 2003 strengthened the central government’s efforts to maintain authority over the overall shape of foreign investment policy. The National Development and Reform Commission (NDRC) is deeply involved in key regulatory decisions and industrial policies.<sup>239</sup> Any major foreign investment policy initiated by the MOFCOM must necessarily be approved by the NDRC if they are related to property rights and sovereignty.<sup>240</sup>

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<sup>238</sup> State Council Administrative Office 1994.

<sup>239</sup> Pearson 2005.

<sup>240</sup> OECD 2005.

### *Tax Incentive Debate*

The tax incentives to foreign firms, institutionalized through the promulgation of the income tax law for foreign-invested enterprises in 1991, did not generate much debate in the 1980s and the early 1990s. Since the tax reform in 1994, a growing number of government officials have openly criticized the tax policies as being unfair to domestic firms.<sup>241</sup> In 1998, the Ministry of Finance and the Bureau of Taxation began to work on a planned unification of tax treatment for foreign and domestic firms. Since then, this issue has been the subject of an intense debate with the Ministry of Finance (MOF) and the Bureau of Taxation supporting the abolition of tax incentives for foreign firms and the Ministry of Commerce (MOFCOM) and local governments opposing it. On some occasions in recent years, some senior officials of the MOF announced the imminent reunification of tax rates in between the current domestic and foreign rates.<sup>242</sup> However, this proposal was postponed at the NPC Conferences three years in a row from 2004-2006, generating a speculation that preferential tax incentive for foreign firms would become permanent.<sup>243</sup>

An important reason, as Financial Minister Jin Renqing revealed, is that “there were way too much more people lobbying for foreign firms than for domestic firms.”<sup>244</sup> For example, facing the imminent threat of losing tax benefits, 54 MNCs reportedly submitted a petition to the State Council Legislative Affairs Office, asking for a grace period of five to ten years before withdrawal of tax benefits in January

<sup>241</sup> The 1994 tax reform introduced the tax sharing system (*fenshui zhi*) in all provinces. There are two major changes in this reform. One is the designation of the value-added tax (VAT) as a centrally collected tax that will be shared 75–25 between the center and the provinces. The other is the separation of taxation authorities between the national tax bureau and local tax bureaus. The local tax bureaus collected local taxes, while the national tax bureau collected national taxes and shared taxes. Local revenue has been redefined as revenues from local taxes and the local portion of the shared taxes.

<sup>242</sup> Li Meng 2005.

<sup>243</sup> Stakelbeck 2006.

<sup>244</sup> Deng Jin 2005.

2005.<sup>245</sup> In response to MNCs' concern, the central government had to clarify its ambiguous attitude. In a commentary in the People's Daily, the MOFCOM vows to "uphold firmly the policy of using foreign investment," promising that the Chinese government will continue its policy to welcome foreign investors even though the tax incentives for them will not be available any more.<sup>246</sup>

With this reassurance message, the Chinese government finally decided to push forward the passage of the new tax policy. In March 2007, the NPC ratified the new Enterprise Income Tax Law with a big margin that unifies the income tax levied on domestic and foreign enterprises by introducing a single tax rate of 25 percent. The focus of incentives has shifted from special regions to the entire country and from a regional development orientation to an industry orientation. Further, the new tax law signals a move away from an export-oriented to a domestically-driven economy.<sup>247</sup> While the new tax law will eventually eliminate all preferential policies attached to special zones, it grants a five-year transition period for FIEs in special zones qualified to enjoy the tax incentive under the existing tax systems. At the same time, the enactment of Property Law which gives equal protection in law to both private and public property indicates that reliance on preferential treatment and selective enforcement of property rights are no longer a viable policy choice for the Chinese government to maintain a long-term economic growth.

### ***Local Governments***

Although the central government has a strong incentive to keep its promise on

<sup>245</sup> China Business Times Jan. 13, 2005.

<sup>246</sup> Ministry of Commerce 2006.

<sup>247</sup> Xinhua, Mar. 8, 2007.

special zone policy, it won't be easy to fulfill the task without local governments' compliance. In particular, the particularistic strategy was actually a dangerous policy that could backfire on the center. Increase in distribution inequality between the wealthy coast and the poor inland might generate backlash from local governments that did not benefit from the special zone policy in the first place. In a hierarchical nomenklatura system in which promotion is the ultimate career goal, local officials would be more interested in relative gain, that is, whether they could perform better than their competitors, than absolute gain. Since the inland provinces were distant from the overseas market and poorly-endowed, it is impossible for them to catch up with their coastal counterparts even they were offered the same policy. Why didn't those local governments attempt to block the special zone policy altogether?

Local governments have strong incentives to embrace special zones for both political and economic reasons. First, they can use special zones as a showcase to polish their political achievement (*zheng ji*). Second, they can use special zones as an access to grab benefits from land acquisition and sales.

#### *The Mechanism of Political Achievement*

Although local officials have more "exit" options, they are essentially careerists: their primary interest is to stay in power and advance with the party-state hierarchy. Since the mid-1980s, the CCP Organization Department has provided highly specific guidelines for the annual evaluation of local party and government leaders.<sup>248</sup> The principal criteria of evaluation consist of four aspects: political integrity (*de*), competence (*neng*), diligence (*qin*) and achievements (*ji*). Work achievement targets,

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<sup>248</sup> Whiting 2004.

primarily measured by some key economic indicators such as industrial output, agriculture procurement, and realized investment in infrastructure, account for 60 to 70 per cent of the evaluation.<sup>249</sup> Many interviewees in special zones also admit that foreign investment is an important, if not the most important, criterion for evaluating local officials' political achievements, which eventually determines their salaries and political careers.<sup>250</sup>

The evaluation system motivates local officials to launch projects which have easily conceivable outcomes in a short term to polish their political achievements. Establishing special zones obviously is a good choice because it would improve infrastructure, create job opportunities, spur property price, and most importantly, attract foreign investment. At the same time, the costs of establishing special zones—infrastructure investment, fiscal subsidies, forgone tax revenue and land rental—could be easily left for future governments to defray. Of course not all the benefits could materialize, but local officials still have strong incentives to gamble on building up special zones, expecting that, once they succeed, the showcase of special zones (i.e., new plants, better infrastructure, and more employment) could improve their promotion prospects.

The case of Suzhou provides a role model that exactly matches local officials' political calculation. Suzhou, a city in the Jiangsu Province, became the largest recipient city of foreign investment in the country with \$8.7 billion in recorded foreign investment in 2004. Its remarkable success in attracting foreign investment, primarily due to two national-level special zones—Suzhou industrial park and high-tech development zone, has brought big political rewards to some chief local officials.

<sup>249</sup> Edin 2003.

<sup>250</sup> Almost all ETDZs interviewed have annual quantified FDI goals set by the superior municipal governments. Amount of FDI inflows is the primary indicator while some zones have multiple indicators such as contracted and realized FDI inflows, share of high-tech products, and GDP growth rate.



Three former Suzhou municipal party heads have been promoted as provincial governors in Jiangsu, Jilin, and Shaanxi. The apparently strong ties between foreign investment and political career have been called the “Suzhou phenomenon” by the Chinese media.<sup>251</sup>

### *The Land Business*

While the political achievement mechanism may not be sufficient to drive all local governments into the competition for special zones, the zone-related land transactions create a strong economic motivation for them to join the zone chase. China’s land system is managed under two segments: urban land solely owned by the state and rural land collectively owned by rural residents. The passage of the Land Administrative Law in 1986 (and later revised in 1999) introduced a market mechanism for urban land management. While urban land is still owned by the state, its use rights now can be transferred to commercial use. Initially, both the ownerships and geographic restrictions were set for the commercialization of land use rights. Initially, commercial land use rights could be transferred only to foreign firms within special zones at a market price. SOEs got their land allocated by the government at a fixed allocation price and land in the old cities was prohibited to be leased.<sup>252</sup> This dual-track arrangement was to accommodate the interests of foreign investors without challenging the overarching socialist principle. Beginning in 1989, the central government gave local governments more authority to approve land use rights, especially the authority to convert farmland to industrial or business uses. Meanwhile, the central government exerted its control through a hierarchical review system that

<sup>251</sup> Southern Weekend Nov. 18, 2004.

<sup>252</sup> Cartier 2001.

requires upper-level governments to oversee and approve land expropriation and conversion decisions made at lower levels.<sup>253</sup> Revenue from land usage was initially divided between the central and local government in the ratio of 40:60. However, the central government actually got less because it cannot effectively oversee the transactions between local governments and developers. Since 1994, the central government allows local governments to keep all the revenues from land transactions.<sup>254</sup>

The lift of ban on public land leasing and decentralization of land authority created a new revenue source for local governments at their disposal. In some localities, land use sales account for as much as 60 percent of local revenue.<sup>255</sup> Under current rules, requisition compensation for farmland is calculated only according to the land's agricultural value, which is much lower than its industrial or commercial value.<sup>256</sup> The extremely profitable land business not only gives local governments strong incentives to convert the farmland for industrial or commercial use, but also enables them to use cheap land as a major sweetener to attract foreign investors.<sup>257</sup> In some places, the low land-use fee is the most important incentive local governments use to attract foreign investors.<sup>258</sup> This phenomenon is vividly summarized by this

<sup>253</sup> For example, construction projects using up to 3 *mu* of farmland required approval by the county level governments; those using between 3 and 10 *mu* of farmland required approval at the prefecture level; those using between 10 and 1,000 *mu* of farmland required approval at the provincial level; and those using more than 1,000 *mu* of farmland required approval by the State Council. See Ho and Lin 2003.

<sup>254</sup> Chang 2006.

<sup>255</sup> Subrahmanyam 2005.

<sup>256</sup> Per Article 47 of the Land Administration Law, compensation is divided into three areas in the case of farmland: compensation for the land; compensation for resettlement; and compensation for young crops and attachments. The land compensation fee is defined as six to ten times the average annual yield value of the arable land over the prior three years. Compensation for resettlement depends on the number of residents involved. The standard resettlement allowance for each person to be settled is four to six times the average annual yield referred to above. Compensation for young crops and attachments is left up to the discretion of provincial-level governments, "with reference" to the other two standards. See Subrahmanyam 2005.

<sup>257</sup> The success of Kunshan ETDZ, as an interviewee indicated, is at least partly due to the reduced land use fee policy. (Interview in Guangzhou, 12/04/04) The average cost of land development and compensation is RMB 120,000 per *mu* (667 m<sup>2</sup>) in Kunshan, but the average rent for investors is RMB 80,000 per *mu*. See Luo and Lin 2003

<sup>258</sup> A survey result conducted by Zhejiang Provincial Statistics Bureau shows that the average development cost of land in the development zones is RMB 98,800 per *mu* (667 m<sup>2</sup>) and the average industrial land use fee is only

saying: “local governments treat guests, ordinary people pay the bill.” (*difang zhengfu qingke, laobaixing maidan*)<sup>259</sup>

Establishing development zones is the most popular channel for local governments to access the land business. Because profits from land transactions were shared among local governments at different levels, it is difficult to rely on upper-level governments to hold back the land expropriation activities at lower levels. Local governments can also bypass the land conversion cap by dividing larger projects into smaller ones (*hua zheng wei ling*) and multi-year projects into independent annual projects.<sup>260</sup> Realizing the ineffectiveness of the hierarchical review and approval system, the central government decided to recentralize the land authority in 2004. All expropriation of agricultural land and most conversions of farmland for urban development now require state approval at the provincial level or higher.<sup>261</sup> This policy has been aimed to reduce local governments’ incentive of establishing and expanding special zones, but it is still subject to local governments’ manipulation. For example, many local governments have tried to get around this new policy by using the method “replacing expropriation with lease” (*yi zu dai zeng*), arguing that lease contracts do not need approval by the central government.<sup>262</sup>

Thanks to their desires to polish political achievement and grab lucrative profits from land transactions, local governments are strong supporters of the special zone policy. Although the interests of the central government and local governments sometimes conflict, their common interest on the special zone policy has created a self-fulfilling mechanism that reassures foreign investors, which explains why special

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RMB 88,300 per mu. About a quarter of the industrial land areas in the development zones have been leased at prices lower than the cost. Chang 2006.

<sup>259</sup> People’s Daily. Apr. 23, 2004.

<sup>260</sup> Ho and Lin 2003.

<sup>261</sup> Huang 2005.

<sup>262</sup> Xinhua Sep 5, 2006.

zones are enduringly popular among foreign investors.

#### **IV. The Composition of Foreign Investment in China**

Looking at special zones, we should realize that they are costly efforts: in terms of transaction costs of setting them up, foregone tax revenues, and political effort to maintain the policy. Therefore, the existence and lasting of special zones became an important mechanism through which the Chinese government enhances the credibility of its commitment to foreign investors. The evolution of FDI composition in China seems to reflect that foreign investors were responsive to the change in policy credibility over time.

##### ***Evolution of the Composition of FDI***

In the early phase of economic reforms, foreign investors, mostly from Taiwan and Hong Kong, had low expectations about the investment environment and adopted a strategy called “two ends remain outside” (*liangtou zaiwai*) for export processing and assembly.<sup>263</sup> They imported materials, components, machinery, and equipment to China and exported the end products to the world market. The export-processing enterprises had the advantage of being flexible and easy to establish. Moreover, they did not require high technology or large amounts of capital, making them less exposed to risk of expropriation. Equity joint venture was clearly the most preferred mode by the government for two major reasons. First, foreign partners would presumably be more committed to transferring proprietary technology and management skills.

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<sup>263</sup> Hsing 1998.

Second, it allowed the government to control more directly the activities of foreign investors, which help preserve the symbolic nationalistic values.<sup>264</sup>

**Table 4-5: Market Entry Modes of FDI (1979-2005)**

Year	Realized FDI (billion US\$)	WFOE (%)	EJV (%)	CJY & JDP (%)	Others (%)
1979-82	1.77	0.0	5.8	57.4	36.7
1983	0.92	4.7	8.0	56.6	30.6
1984	1.42	1.1	18.0	69.7	11.3
1985	1.96	0.7	29.6	54.5	15.2
1986	2.24	0.7	35.9	47.0	16.5
1987	2.65	0.9	56.1	30.3	12.6
1988	3.73	6.1	52.9	26.6	14.4
1989	3.77	9.8	54.0	26.1	10.1
1990	3.75	18.2	50.2	24.4	7.1
1991	4.67	24.3	49.3	20.0	6.5
1992	11.29	22.3	54.2	21.0	2.5
1993	27.77	23.4	55.3	20.4	0.9
1994	33.95	23.7	52.8	23.0	0.6
1995	37.81	27.3	50.5	21.5	0.8
1996	42.14	29.9	49.3	19.8	1.0
1997	46.73	34.6	41.7	19.9	3.8
1998	45.46	36.2	40.4	21.8	1.6
1999	40.32	38.6	39.3	21.4	0.7
2000	40.72	47.3	35.2	17.1	0.3
2001	46.88	50.9	33.6	14.4	1.1
2002	52.74	60.2	28.4	10.9	0.5
2003	53.51	62.4	28.8	7.3	1.6
2004	60.63	66.3	27.0	5.3	1.3
2005	60.32	71.2	24.2	3.0	1.6

Source: China Statistical Yearbook, various years

Note:

- WFOE stands for wholly foreign-owned enterprise (*duzi jingying*). It is defined as a limited liability company established in China with capital solely contributed by the foreign investor.
- EJV stands for equity joint venture (*hezi jingying*). It is defined as limited liability companies incorporated and registered in China with capital contributions from both Chinese and foreign parties. The minimum requirement of equity contribution by the foreign partners is 25 percent.
- CJV stands for contractual joint venture (*hezuo jingying*) and. It is organized as business partnership in which both parties operate as separate entities and bear liabilities independently. There is no minimum requirement of equity contribution by the foreign partners.
- JDP stands for joint development (*hezuo kaifa*). It is a special type of cooperative efforts between Chinese and foreign parties to explore and develop natural resources such as mineral, gas, and, most noticeably offshore oil.<sup>265</sup>
- Others include foreign share-holding enterprises, compensation trade, processing & assembly, and international leasing.

<sup>264</sup> Pearson 1991, 82

<sup>265</sup> Fu 2000

- The realized FDI inflows do not include the financial sector. If FDI in financial sector was included, the total realized FDI inflows would be US\$72 billion in 2005.

As shown in Table 4.5, the dominant modes of FDI in the early 1980s were contractual joint ventures (CJVs) and joint developments (JDPs), both of which allowed foreign investors to minimize investment risk by using flexible arrangements in resource sharing and management commitment. Equity joint ventures (EJVs), which required a higher resource and management commitment from foreign firms, contributed the majority of total FDI between 1987 and 1995. Wholly foreign-owned enterprises (WFOEs), which required the highest degree of commitment but allowed foreign investors to have a complete control over corporate management, have become the most important entry mode of FDI in China since 2000. Joint ventures would help foreign firms circumvent unfavorable local government regulations by tapping into the knowledge expertise and *guanxi* connections of their local partners. WFOEs, by contrast, would have to bear more political risks since they tend to have more problems with host government regulations. Wholly-owned subsidiary became the primary market entry mode despite the government's strict performance requirements.<sup>266</sup>

The geographic sources of FDI inflows also show a significant change. Most of the early investment in the SEZs came from small and labor-intensive overseas Chinese firms located in Hong Kong and Taiwan. Their interest in the special zones was strongly influenced by their proximity to export markets and the preferential policies they were granted. Investments from ethnic Chinese have been gradually

<sup>266</sup> The government initially did not allow establishment of WFOEs in China outside the SEZs till 1986 when the government promulgated the "Wholly Foreign-Owned Enterprise Law." The government requires applicant companies to satisfy at least one of the following performance criteria: 1) the company must use advanced technology and equipment, develop new products, be economical with respect to energy and raw materials, and upgrade and replace existing products; 2) the company must export more than 50 percent of its total production and it must balance foreign exchange receipts and payments. See Van Den Bulcke et al. 2003, 30.

subsiding as a share of total FDI. They only accounted for one third of total FDI inflows in 2005. The combined relative share of FDI from the U.S., EU, and Japan was around 30 percent for most of the time in the last two decades. The remaining one third of FDI came mainly from some offshore tax havens (i.e. Cayman Islands and Virgin Islands) and Asian newly industrial economies (NIEs) such as Korea and Singapore.

**Table 4-6: Geographical Sourcing of FDI in China, 1985-2005**  
(% of total realized FDI inflows)

Year	HK & Macao	Taiwan	EU	US	Japan	Others
1985	48.8	..	8.9	18.2	16.1	8.0
1986	59.2	..	8.0	14.5	11.7	6.6
1987	69.1	..	2.3	11.4	9.5	7.7
1988	65.6	..	4.9	7.4	16.1	6.0
1989	61.2	4.6	5.5	8.4	10.5	9.8
1990	54.9	6.4	4.2	13.1	14.4	7.0
1991	57.0	10.7	5.6	7.4	12.2	7.1
1992	70.0	9.5	2.2	4.6	6.5	7.2
1993	64.9	11.4	2.4	7.5	4.8	9.0
1994	59.8	10	4.6	7.4	6.2	12.0
1995	54.6	8.4	5.7	8.2	8.3	14.8
1996	51.0	8.3	6.6	8.3	8.8	17.0
1997	46.5	7.3	9.2	7.2	9.6	20.2
1998	41.6	6.4	8.8	8.6	7.5	27.1
1999	41.4	6.5	11.1	10.5	7.4	23.1
2000	38.9	5.6	11	10.8	7.2	26.5
2001	36.4	6.4	9.6	9.5	9.3	28.8
2002	34.8	7.5	7.7	10.3	7.9	31.8
2003	33.9	6.3	8.0	7.8	9.4	34.6
2004	32.2	5.1	7.9	6.5	9.0	39.3
2005	30.7	3.6	9.4	5.1	10.8	40.4

Source: China Statistical Yearbook, various years

FDI from different origins has distinctive features with respect to the sectoral distribution. Some empirical studies have found that FDI from Hong Kong and Taiwan is mainly labor-intensive and tends to use China as a low-cost hub to

manufacture goods for export to industrialized countries.<sup>267</sup> In contrast, FIEs from the EU, U.S., and Japan are largely concentrated in industries characterized by a high degree of technology and are capital intensive, such as telecommunications, chemicals, pharmaceuticals and the automotive sector.<sup>268</sup> They mainly invest in China to penetrate the large and rapidly growing domestic market, as indicated by the fact that they locate primarily where local income per capita and wage rates are both high.<sup>269</sup>

The stable share of FDI from U.S., Europe, and Japan in the last two decades seems to indicate that the composition of FDI has barely changed much, but Table 4.7 and 4.8 suggest a different picture. As shown in Table 4.7, the average size of FIE (in terms of investment) increased around 150 percent from US\$2.3 million in 1993 to US\$5.6 million 2005. The increase in size is more evident in the manufacturing with an average-sized FIE in 2005 being three times larger than that in 1993.

**Table 4-7: Average Size of Investment FIEs, 1993-2005 (million US dollars)**

Year	Total Sectors	Manufacturing	Ratio of Manufacturing
1993	2.3	1.7	55%
1994	2.4	1.8	55%
1995	2.7	2.1	54%
1996	3.0	2.3	54%
1997	3.2	2.4	53%
1998	3.4	2.5	53%
1999	3.7	2.7	53%
2000	4.1	3.2	55%
2001	4.3	3.5	56%
2002	4.7	3.9	58%
2003	4.9	4.2	60%
2004	5.4	4.6	60%
2005	5.6	5.0	61%

Source: China Statistics Yearbooks 1999-2006 and China Economic Yearbooks 1994-1998.

<sup>267</sup> Fung et al. 2002.

<sup>268</sup> Van Den Bulcke et al. 2003

<sup>269</sup> Fung et al. 2004.



Note: Average size of investment is total investment divided by total number of FIEs. Ratio of manufacturing is total investment by FIEs in manufacturing divided by total investment by FIEs in all industries.

**Table 4-8: The Composition of Foreign Investments in Manufacturing (1995-2005)**

Year	Labor-intensive & low tech (%)	Labor-intensive & high tech (%)	Capital-intensive & low tech (%)	Capital-intensive & high tech (%)
1995	35.7%	25.1%	23.7%	15.5%
1996	33.8%	26.6%	23.1%	16.5%
1997	33.1%	27.5%	22.8%	16.0%
1998	n.a.	n.a.	n.a.	n.a.
1999	30.3%	29.0%	21.0%	18.4%
2000	29.6%	30.3%	20.8%	17.9%
2001	29.0%	30.9%	21.1%	17.7%
2002	28.6%	32.0%	20.3%	17.8%
2003	27.7%	35.3%	18.5%	18.5%
2004	26.4%	37.1%	17.9%	18.6%
2005	26.3%	35.6%	19.4%	18.8%

Source: China Statistical Yearbooks 1996-2006.

Note:

1. For any specific industry, the ratio is calculated as: the total assets of FIEs in any specific industry divided by the total assets of FIEs in all manufacturing.
2. The classification follows Van Den Bulcke et al. 2003 and is carried out by using four-digit SIC.
  - Labor-intensive & low-tech industries (LI-LT) include food, beverage, tobacco, textiles, apparel products, leather products, wood products, furniture, paper products, rubber and plastics, etc.
  - Labor-intensive & high-tech industries (LI-HT) include non-electric machinery, electrical and electronic products, measuring equipment, education and sports activity, and recycling and disposal waste;
  - Capital-intensive & low-tech industries (KI-LT) consist of extraction of petroleum and gas, mining and processing of ores, manufacture of non-metal mineral products and primary metal industries, production and distribution of electricity, heat, gas, and water;
  - Capital-intensive & high-tech industries (KI-HT) include chemical products, petroleum products, pharmaceuticals, manufacture of transportation equipment, etc.

With respect to the composition of foreign investment in the manufacturing industries, Table 4.8 shows that labor-intensive low-tech FIEs accounted for more than a third of total assets in 1995, but their share dropped to around a quarter in 2005. In contrast, the share of labor-intensive high-tech FIEs increased more than 10 percent

points and accounted for 36 percent of total manufacturing assets in 2005. The share of capital-intensive low-tech FIEs lost about 4 percent points, which was roughly the same level gained by capital-intensive high-tech FIEs. Overall, labor-intensive FIEs consistently accounted for 60 percent of total manufacturing assets while high-tech FIEs increased their share from 40 percent to 55 percent between 1995 and 2005.

All these data suggest that, in addition to the rapid increase in FDI, the composition of FDI has experienced a notable change over time. In the early stage, FDI was dominated by small, labor-intensive and low-tech firms aiming to use China as an export platform. With the gradual improvement of the investment environment, these features have become less salient. Labor-intensive FDI still dominates the Chinese market, but investors are increasingly engaged in large-scale operations and high-tech sectors.

### ***Rival Theories***

I have argued that the existence and endurance of special zones was crucial for the China to attract foreign investors. How would the rival theories explain the role of special zones?

The informal institutions perspective argues that guanxi enables well-connected investors to take advantage of the weakness of law. Under this theory, the existence and endurance of special zones is largely unnecessary (or even undesirable because they lower the value of informal network). But special zones are not window-dressing. Their role in attracting FDI tells us a lot about what informal network cannot do. The more direct evidence is the change of FDI sources in China over time. The informal institutions perspective predicts that ethnic Chinese investment dominates FDI

inflows in China, but it cannot explain the continuing decline in the share of ethnic Chinese investment.

The market-preserving federalism perspective gives lots of credit to local governments in promoting FDI inflows. Under this theory, special zones should exist, but their performance should primarily depend on local governments' effort rather than their relationship with the central government. An increased economic decentralization should be accompanied by a rising FDI inflows. In fact, the most successful special zones are those which have closer ties with the central government and received more central support (shown in Chapter 5). The fluctuation of FDI inflows over time did not match the market-preserving federalism hypothesis, suggesting that economic decentralization could not be the primary factor at work. As shown in Table 4.5, FDI inflows increased slowly in the 1980s when economic decentralization picked up its speed. The biggest surge in FDI inflows occurred in 1993, after the central government tightened its control over the economy and shut down lots of local special zones. Similarly, the latest campaign launched in 2003 to rein in excessive expansion of special zones did not adversely affect FDI inflows.

Finally, the institutional inefficiency hypothesis suggests that high level of FDI dependency in China was an unintended outcome of institutional distortions. Under this theory, special zones are the key culprit because they not only create an unlevel playing field in favor of foreign investors, but also entice local competition that accelerates regional fragmentation. However, this hypothesis cannot explain special zones' enduring popularity among foreign investors despite their diminishing political privilege.

Empirically, while this hypothesis is convincing to explain the general characteristics of FDI inflows in China, its assertion of FDI patterns is inaccurate in

reflecting the change over time.<sup>270</sup> It is true that in the 1980s and early 1990s, a high proportion of FDI inflows consisted of efficiency-seeking FDI that was normally small, labor-intensive and export-oriented. But market-seeking FDI has gradually replaced efficiency-seeking FDI to become the leading type of FDI in China as indicated by the alteration in geographic sourcing in the 1990s.<sup>271</sup> As a result, more FDI flows into high-tech sectors and aims to penetrate the domestic market. It suggests that foreign investors may have attached less importance to the preferential policies in special zones and more on their appreciation of the evolution of the institutional situation and the overall economic system.

## V. Conclusion

Special zones, as the primary platform to attract FDI, have played a crucial role in China's economic reform. But it appears puzzling that special zones were not phased out with the improvement of investment environment in the remainder of the economy. Rather, the Chinese government has extended the special zone policy to a very broad scope. The conventional wisdom suggests that in order for preferential policies to maintain their specific characteristics, either the total number of their targets should be limited or the scope of their application be restricted. Otherwise, the very attraction and effectiveness of preferential policies would simply evaporate and the central government would be worse off because of the high costs of special zone policy.

However, special zones, initially as a flexible arrangement to bypass the rigid political environment, have gradually become a mechanism that helps the Chinese

<sup>270</sup> According to Yasheng Huang, FDI in China has five distinct patterns compared with other developing countries: the high FDI/capital formation ratio, the demise of contractual alliances (e.g., export-processing and assembly), the dominance of FIEs in labor-intensive and export-oriented industries, the pervasive presence of FIEs across industries, and the small size of FIEs. See Huang 2003a.

<sup>271</sup> OECD 2003

government keep its promise to foreign investors. To be sure, given its authoritarian system, the Chinese government would lack the capability to make credible commitments. But both the central and local governments have strong political interests on special zones. Neither side has an incentive to overturn the special zone policy.

The equilibrium between the central and local governments sent a signal to foreign investors that the Chinese government's commitment on the special zone policy is unlikely to be reversed. Foreign investors were continually frustrated by the inadequacy of the regulatory regime, the impenetrability of the bureaucracy, and a multitude of practical obstacles, but the big political risk seems not a primary concern for them. Although the benefits of preferential policies have diminished over time, special zones, because of their political endurance and economic advantage, have become even more attractive destinations for foreign investors. For many of them, remaining in the zone could be considered an important factor still required for success in China.<sup>272</sup> After all, just as Haber et al. point out, investors do not require the government to protect property rights as a public good in order for investment to take place. Rather they only care about the sanctity of their own property rights.<sup>273</sup>

The change in China's FDI patterns over time appears to reflect foreign investors' response to the shift of policy flexibility and credibility. At the initial stage of the open-door policy, foreign investors with short time frames rushed in to take advantage of preferential policies. They were mostly small, labor-intensive, and low-tech. Since partnering with Chinese firms would help foreign investors mitigate political risk, loosely-bound joint-venture was the primary market entry mode. As the institutional

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<sup>272</sup> EIU 2006.

<sup>273</sup> Haber et al. 2003.

reforms unfolded, the government gradually established credibility by continuously extending the scope of special arrangement. Foreign investors with long time horizons began to put down bricks and mortar. They were involved in large-scale operations in the technology-intensive sectors aimed at penetrating the domestic market. As the concern of political risk decreased, foreign investors were more likely to enter the market with a high degree of commitment. Therefore, wholly foreign owned enterprises (WFOEs) gradually surpassed equity joint ventures (EJVs) and became the primary market entry mode in China.

## Chapter 5

### Not a Magic Bullet: How Do Local Institutions Affect FDI in China?

#### I. Introduction

As a country lacking strong institutions for making credible commitment, China depends heavily on special zones to attract foreign investment. The idea behind special zones was to allow foreign investors into a handful of closed and controllable locations and offer them preferential treatment. The setup of special zones, initially as a flexible institutional innovation, has created a certain degree of credibility that would otherwise be lacking for an authoritarian government. More than two decades after they were first established, special zones remain the primary location for the most FDI in China. In 2004, 54 special zones (economic and technological development zones, or ETDZs) designated by the central government contributed a quarter of total FDI inflows in China while they accounted for less than 0.1% of total territory.<sup>274</sup>

Risk of expropriation which would be a major concern for potential investors has been essentially ruled out in special zones by the central government. But this does not guarantee a success for special zones in attracting foreign investment. Although special zones offer advantages to the foreign firms looking to enter or expand in China, they are not magic bullets. Even among the 54 national-level special zones, only a few can truly be called runaway successes. As can be seen in Figure 5.1, Tianjin (tj), Suzhou (sz), Guangzhou (gz), Dalian (dl), and Kunshan (ks) are frontrunners, in terms of both FDI and GDP. The majority of the ETDZs lag far

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<sup>274</sup> Ministry of Commerce 2005a.

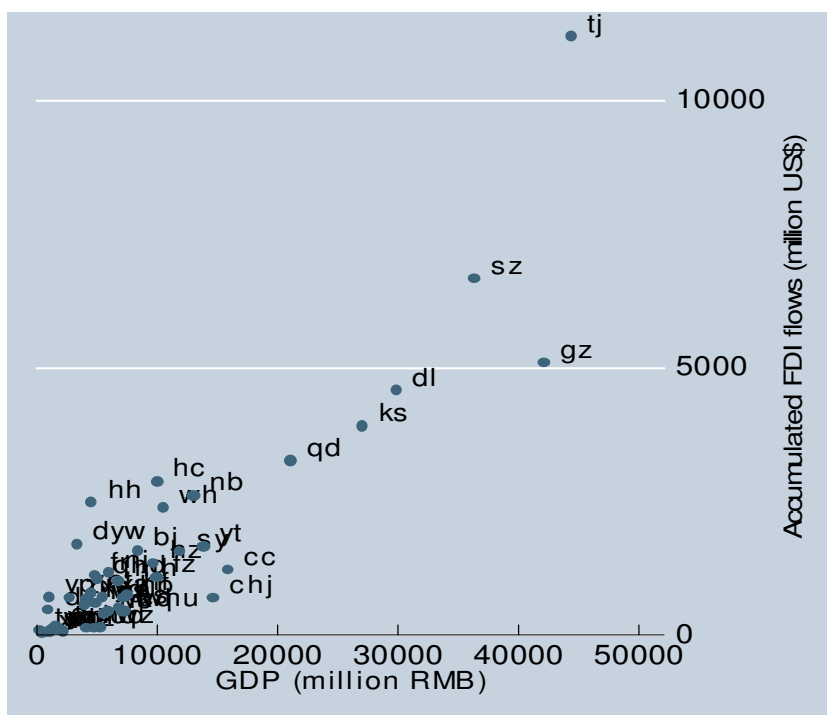
behind. Tianjin attracted US\$ 11.2 billion accumulated FDI inflows while Xining only received US\$ 3 million in 2003. As Table 5.1 shows, other aspects of economic performance also range widely among the special zones. For the top-level zones, foreign-invested enterprises (FIEs) accounted for almost all of the industrial output while in some other zones FIEs have only made marginal contributions to industrial output. Some zones are highly outward-oriented as they sold three quarters of their products to overseas markets while the most inward-looking zone has all the products sold on domestic market.

**Table 5-1: Key Economic Indicators for National-level ETDZs (2003)**

Indicator	Description	Highest	Lowest	Mean	Standard Deviation
GDP	RMB million	44523	348	9234	10267
Accumulated realized FDI flows	US\$ million	11167	3	1393	1995
FIEs share of industrial output	FIE industrial output divided by total industrial output (%)	100	2	57	28
Hi-tech share of industrial output	Hi-tech industrial output divided by total industrial output (%)	90	0	38	24
Export ratio	Total exports divided by total sales (%)	74	1	23	19
Average size of FIE	Realized FDI flows divided by number of new FIEs (US\$ million)	36	0.3	5.2	6.0

Source: *China Yearbook of Special Economic Zones and Development Zones 2004* (Zhongguo jingji tequ kaifa qu nianjian 2004)





Source: *China Yearbook of Special Economic Zones and Development Zones 2004 (Zhongguo jingji tequ kaifa qu nianjian 2004)*

**Figure 5-1: National-level Economic and Technological Development Zones (ETDZs): GDP and Accumulated FDI Inflows (2003)**

Local governments, given their day-to-day interactions with foreign firms, emerge as a major source of uncertainty for foreign firms. This uncertainty is particularly salient with respect to special zones, in which local governments have more autonomy to pursue their own development goals. Without an effective institutional mechanism to tie local governments' hands, foreign investors would be worried that once their investments are in place, their bargaining power will diminish, and local governments will not stick to the preferential treatment they had promised. This chapter is to explore how local institutions shape special zones' ability to attract foreign investment.

Taking economic decentralization as a starting point, I argue that while the innovative institutional framework of special zones was created at the national level,

micro-institutional features vary across regions and influence the implementation of local policy-making. Operations of foreign firms were embedded in dense local institutions that shape the interactions between local governments and foreign firms. Therefore, whether local governments play “grabbing hands” (predatory government), “helping hands” (developmental government) or “steady hands” (stable and credible government) depends on the specific local institutional setups, which may create extra-market advantage (or disadvantage) affecting the location and patterns of FDI.<sup>275</sup>

With respect to the investment environment in special zones, I argue that three institutional factors are important in affecting the credibility of local policy implementation: central-local relations, governance structure, and regulatory environment. Central-local relations determine local governments’ political authority to deliver the central policies; the governance structure (autonomy vs. integration) determines special zones’ capacity to maintain consistent policies; legal environment determines to what degree foreign firms’ property rights will be protected. I argue that special zones with closer ties with the central government, integrated governance structure, and strong legal environment tend to attract more foreign investments, other things being equal.

This chapter proceeds as follows. The second section discusses the research design. The following three sections discuss three institutional factors that affect the credibility of local governance in special zones: central-local relations, governance structure, and legal environment. The sixth section presents the hypotheses, data and statistical results. The last section is the conclusion.

<sup>275</sup> The terms “grabbing hand” and “helping hand” were initially used by Frye and Shleifer (1997). The helping hand model means that government is above law but uses power to help business and state officials enforce contract. The grabbing hand model means that government is above law and uses power to extract rent, and mafia replaces state as enforcer. See Frye and Shleifer 1997.

## II. Research Design

Special zones in China provide an ideal setting to examine the factors that affect the quality of local governance because of the huge variation in the performance of special zones in attracting foreign investment despite the same institutional setup at the national level. Location-specific factors such as economic development, infrastructure, natural and human resources, and access to international market have clearly played a big role in the successes of the top-level zones in the coastal areas. Indeed, the latecomers in the hinterland are in a disadvantaged position. They are far removed from international markets, burdened with the inefficient state owned industry, and handicapped by an open door policy that has discriminated against them for at least 15 years. The initial locational advantages created path dependencies that reinforce the attractiveness of coastal special zones to foreign investors as time unfolds. Incumbency advantages in these zones persist even after their initial policy advantages diminished.<sup>276</sup> Therefore, the huge discrepancy in economic performance reflects the interaction of locational advantage and the forces of agglomeration.

Such an explanation, however, overlooks the role played by local governments in policy implementation, which is also a crucial factor for economic development in a country with strong elements of fiscal federalism.<sup>277</sup> Economic decentralization increases the incentive for local governments to adapt development models that are perceived to be successful in other places. But the different institutional

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<sup>276</sup> Graham 2004.

<sup>277</sup> For the discussion of fiscal federalism in China, see Montinola, Qian, and Weingast 1994.

characteristics of the localities are likely to reinforce rather than dissolve economic inequality.<sup>278</sup>

To examine the impact of local institutions on foreign investment, I visited 14 national-level ETDZs (out of 54 in total) and constructed a unique dataset based on interview records, news reports, and official statistical information. Most of these ETDZs are located in coastal provinces and have similar economic and geographic characteristics. Their performance in attracting foreign investment, however, varies a lot. This personal observation also suggests that some unobservable institutional factors may matter.

The first objective is to identify the local institutional factors that affect the location of foreign firms. Consistent with the credibility-flexibility framework illustrated in Chapter 2, I assume that a foreign firm decides to invest in a specific location based on assessments of potential risk and return. The major risk stems from the nature of the “obsolescing bargain” between foreign firms and host governments.<sup>279</sup> Once bargaining power shifts from foreign firms to the host government, the government may opportunistically impose more conditions on foreign firms, ranging from higher taxes to complete expropriation, to maximize their payoffs ex post. Other things being equal, foreign firms prefer local governments with high level of credibility. Three key institutional factors—central-local relations, governance structure, and legal environment—emerge to be important in affecting the credibility of local governance.

However, not all foreign investors are the same. Foreign investors can perform some types of activities more efficiently than others because of the institutional

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<sup>278</sup> Thun 2006, 17.

<sup>279</sup> Vernon 1971.

support they can receive, conditioned on their bargaining powers relative to the host government.<sup>280</sup> Likewise, institutions do not function equally well. A flexible institutional arrangement facilitates decisive policymaking that could reduce the burdens of regulation and provide preferential treatment to foreign investors. A credible institutional setup is more capable to maintain a long-term stable policy environment and protect property rights. Foreign firms' investment strategies will accordingly differ in response to different local institutional setups. In general, foreign firms that have long time horizons and high level of commitment desire local governments that are more able to make long-term credible policy, whereas those that have short time horizons and low level of commitment tend to prefer local governments that are more able to bypass red tape and respond swiftly. Therefore, the second objective is to examine the impact of local institutional factors on the composition of foreign investment. Consistently with the framework in Chapter 3, I choose three firm-specific characteristics: firm size, export orientation (production strategy), and technological intensity. Ideally, these variables should be measured using firm-level data. Due to the data limitation, I can only use aggregated zone-level data to roughly measure these three characteristics. I will come back to discuss the data measurements later.

### III. Central-Local Relations

The first institutional factor is central-local relations. Ever since the designation of the first 14 ETDZs in 1984, local governments began to lobby the central

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<sup>280</sup> A very rich literature examines how firm-specific characteristics affect foreign investors' bargaining power relative to host government, which thus shapes their preferences on political risk. See, for example, Encarnation and Wells 1985, Kobrin 1987, and Henisz 2000.

government for the same development opportunity. The central government held a tight control over the designation authority at the national level until 1993, when the State Council promulgated a circular allowing provincial governments to designate new special zones. However, the circular stated that zones designated by provincial governments cannot have the same privileged policies enjoyed by national-level special zones.<sup>281</sup> A two-level approval system was established based on this circular. The standard procedure for designating a national-level special zone is as follows. A prefecture government first submits a project proposal to the provincial government above it, and upon approval, the proposal is submitted to the State Council. The State Council then authorizes the Ministry of Commerce, along with the Ministry of National Land and Resources and the Ministry of Construction, to review the proposal. If these line ministries all agree that it is appropriate to proceed, they will indicate it in the reviewing report, which is finally subject to approval at the premier's working meeting.<sup>282</sup> Given the complicated approval procedure, national-level special zones are subject to careful scrutiny by multiple veto players at both central and provincial levels.

Provincial-level special zones, by contrast, are only required to be approved by provincial governments and reported to the central government. While the central government has the final authority over the policy framework of special zones, it is the provincial governments that play the pivotal role in granting authority and supervising provincial-level zones.

While provincial-level approval is the minimum requirement for officially designating any special zone, a large number of special zones were set up by

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<sup>281</sup> The State Council 1993.

<sup>282</sup> Ye and Liu, Aug. 27 2003.

governments at the prefecture, county, or even township levels without any official authorization. By July 2004, there were 6899 various special zones around the country, covering 38,600 square kilometers of land area.<sup>283</sup> Only 227 national-level zones and 1346 provincial-level zones were identified by the central government by the end of 2006.<sup>284</sup> In other words, some 70 percent of local special zones actually grew up out of the central plan.

Compared with national-level special zones, those designated by provincial or sub-provincial governments are less appealing to most foreign investors. Those zones usually have smaller land of area, lower development level, less reliable infrastructure, and shorter operating records. More importantly, there is a big concern among foreign investors whether the preferential treatment committed by these zones would be revoked in the future. Two key factors affect the credibility of local zones.

First, local special zones are vulnerable to a credibility problem because they were born with “original sin”. While the purpose of the two-level approval system was to reaffirm the central government’s authority and rein in the rampant proliferation of special zones, it actually encouraged local governments to play a risky game of chicken with the central government. There was speculation that the central government would have to devolve the designation authority to a lower level if more special zones become *fait accompli*. The best example was Kunshan ETDZ, which was set up by the Kunshan county government in 1985 and promoted as a national-level ETDZ in 1992 because of its outstanding performance. The success of Kunshan encouraged lots of followers to use the strategy of “building nests to attract birds” (*zhu cao yin niao*) to develop their own special zones, hoping that these unauthorized

<sup>283</sup> The Ministry of Land and Resources, Nov. 26, 2004. An interviewee said that a more realistic estimation of total number of special zones all around the country might be much more than 6,000. Interview in Kunshan, Oct. 28, 2004.

<sup>284</sup> National Development and Reform Commission 2007.

zones would be legalized as long as they were too big to be ignored. Otherwise, they would be forced out of the competition.<sup>285</sup> Indeed, except for the 14 national ETDZs, the central government approves new national special zones only if they have reached a certain level of development.<sup>286</sup> All the ETDZs designated by the State Council between 1992 and 2000 were initiated, on average, four years earlier than their official designation dates.<sup>287</sup>

Competitive proliferation of special zones at local levels of government followed by central crackdowns emerged in a cyclical pattern. Thanks to the “zone fever” in the wake of Deng Xiaoping’s South Tour in 1992, the total number of development zones increased over 20 times from 117 in 1991 to over 1,800 by the end of 1992.<sup>288</sup> The central government subsequently shut down as many as 1000 zones set up without the proper approval by the central and provincial governments.<sup>289</sup> In spite of repeated attempts from the central government to shut down unauthorized local zones, they nevertheless grew rampantly across the country. In the latest attempt to cool down beginning in late 2003, some 4,800 various development zones were canceled, covering a total of 24,900 km<sup>2</sup> planned land area.<sup>290</sup> By the end of 2006, there were only 1,568 special zones left and the total area has shrunk to about 10,000 km<sup>2</sup>.<sup>291</sup>

Appendix 5-A lists the number of special zones at different levels of government in 31

<sup>285</sup> See Yang 1997 and Zweig 2002.

<sup>286</sup> In 2005, the Ministry of Commerce promulgated that any new national-level special zone has to meet at least one of the five preconditions: 1) the major economic indicators should have grown for at least two consecutive years prior to the application; 2) annual industrial output should be 4 billion RMB per km<sup>2</sup> or higher; 3) annual tax revenue should be no less than 1 billion RMB; 4) annual export volume should be no less than 500 million RMB; and 5) accumulated realized FDI should be US\$ 1 billion or higher. Ministry of Commerce 2005b.

<sup>287</sup> Bao 2002, 62.

<sup>288</sup> The number of 1800 was estimated by the Special Economic Zones Office (SEZO). Actually the exact number of zones was unclear because there were at least four versions from different government agencies. The estimated number of development zones was 1700 according to the National Planning Commission, 2700 according to the Bureau of Land Management, and 9000 according to the Ministry of Agriculture. Jiang, Jan. 30, 1993.

<sup>289</sup> Coopers & Lybrand 1996.

<sup>290</sup> China Daily, Aug. 24 2005.

<sup>291</sup> Xinhua, Apr. 19, 2007.



provinces as of August 2004.

The second factor that undermines local special zones' credibility is their financial capacity. While the central government allows provincial-level special zones to use preferential policies to attract foreign investment, only the national-level special zones can treat foreign investors well at the expense of the central government.<sup>292</sup> While local special zones promise to offer the same preferential tax treatment as the bigger zones, there are fewer guarantees that they can continue to offer them. Since the preferential tax rate and tax reductions are pre-approved by the central government, the national taxation bureau will collect tax revenues from special zones based on this arrangement. For local special zones, the tax obligation is based on the regular income tax rate (30 percent) and local governments are responsible for subsidizing any preferential tax rate and tax reductions. Therefore, local special zones have to subsidize foreign investors out of their own pockets.

However, local governments, as the agents of the central government, always use their informational advantage to circumvent the center's control and pursue their own ends.<sup>293</sup> In practice, it is quite common for local special zones to offer incentives that they do not have authority and capacity to grant. In some areas, the standard "two-year tax holiday followed by 50 percent reduction during the next three years" (*liang mian san jian ban*) was replaced by "five-year tax holiday followed by 50 percent reduction during the next ten years" (*wu mian shi jian ban*).<sup>294</sup> For many local governments, the only resource they have is land, which they offer with very low or even zero fees. Unauthorized special zones are believed to be the major form of

<sup>292</sup> In 1994, the central government allowed the first 14 coastal ETDZs and 9 inland ETDZs to keep all their fiscal revenues when the tax-sharing system was applied to all other areas. See China Public Finance Yearbook 1994 (*Zhongguo caizheng nianjian 1994*).

<sup>293</sup> Miller 1992.

<sup>294</sup> Economic Daily, Jan. 6, 2004.

illegal land use around China. One survey of 24 provincial units found that in 1987 and 1988, there were 97,000 cases (8.7 percent of the total) in which the local government exceeded its property authority, such as offering land-use rights to investors at below-market prices.<sup>295</sup>

Fierce competition over preferential policies creates serious problems between the central and local governments. On the one hand, if locally negotiated arrangements are subsequently reviewed at a higher level of authority, concessions may be rescinded if thought too generous—whether they are technically permissible or not. On the other hand, localities offer incentives they know higher authorities will reject so that they might appear more investor-friendly.<sup>296</sup>

Moreover, local governments also have strong incentives to collude with FIEs to avoid paying centrally-imposed taxes.<sup>297</sup> By manipulating the effective tax rates on FIEs, local governments can divert tax revenues that otherwise would have to be shared with the central government to local extra-budgetary account. The lower the probability of detection by the central government, the more likely local governments are to offer generous tax incentives to foreign investors. Perceiving local governments' incentive for cheating in advance, the central government will devote more effort to detect and punish local officials for their unauthorized commitments to foreign investors.

Between 1993 and 2000, the central government promulgated three circulars to prevent overreaching incentives offered by local special zones. The first circular, promulgated in July 1993, declared that all preferential tax policies created at will and

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<sup>295</sup> Yang and Wei 1996.

<sup>296</sup> Rosen 1999.

<sup>297</sup> It is very similar to the model of corruption with theft described by Shleifer and Vishny (1993) Corruption with theft model suggests that corruption aligns the interests of local officials and foreign investors, since both of them will be better off by avoiding paying taxes to the central government. See Shleifer and Vishny 1993.

beyond the scope of a local government's power are null and void. The second one, released in March 1998, added a greater level of specificity to the first Circular. All taxes except for the slaughter tax, banquet tax and animal husbandry tax were off limits to interpretation or manipulation by local governments. The third circular, released in January 2000, identified and outlawed the technique of collect-first-refund-later (*xian zhen hou fan*) that was broadly used by local governments to bypass the central government's tax regulations.<sup>298</sup> In the first three months of 2004, the National Taxation General Bureau found more than 1,000 cases of unauthorized tax incentives in various special zones nationwide and the total amount was about RMB 430 million.<sup>299</sup>

In short, lack of political authority creates a big credibility problem for local special zones. Foreign investors were understandably very cautious about locating big investments in local special zones for fear that these zones might not be able to keep their promises of providing overly generous incentives. Their concerns were repeatedly reinforced when the central government periodically cracked down on unauthorized zones.

#### **IV. Governance Structure**

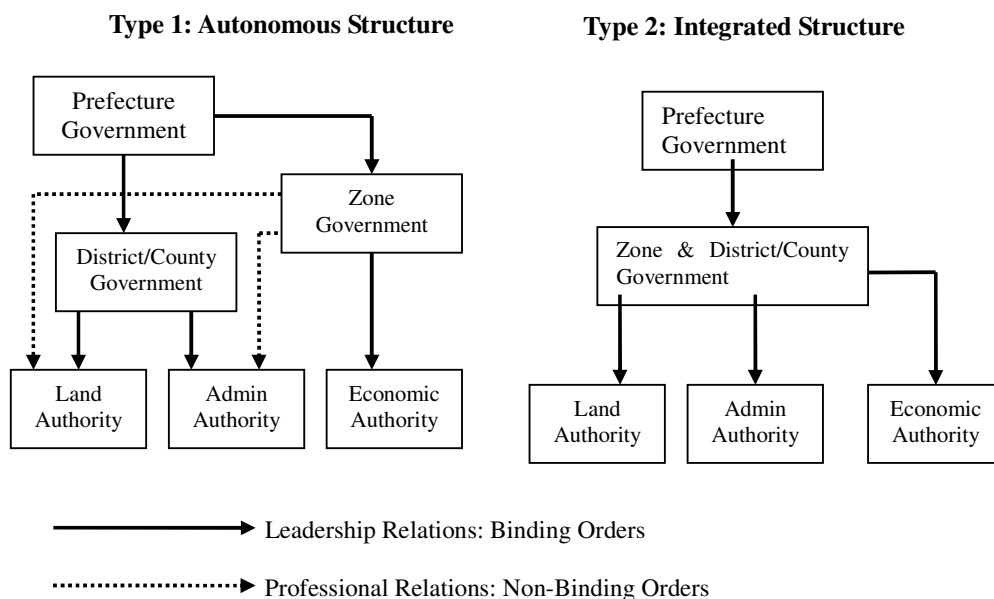
The second institutional factor is the governance structure, which determines special zones' capacity to maintain consistent policies. As discussed in Chapter 4, special zones have a streamlined organization designed to attract foreign investment and promote the local economy. To enact a special zone, a prefecture government first encircles a land plot on the territory of a subordinate district/county and provides

<sup>298</sup> China Law and Practice, Apr. 1, 2000.

<sup>299</sup> Zhou Yang, Aug. 23, 2004.

fiscal resources and bank loans for the initial infrastructural buildup. The prefecture government then circumvents the urban district government or rural county government (*qu/xian zhengfu*) subordinate to it and directly delegates the governing authority to an integrated administrative commission (*guan wei hui*) for the zone.

As can be seen in Figure 5.2, there are two ways that zones can be governed. Type 1 is the autonomous governance structure. Type 2 is the integrated governance structure. The key difference between the autonomous and integrated structures is who has control over economic, administrative, and land authorities.



**Figure 5-2: Governance Structures of Special Zones**

In the autonomous governance structure, the special zone is independent from the district/county government and has highly autonomous economic authorities, but they are not self-sufficient economies. The district/county government controls the administrative and land authorities, which may be transferred to the zone government (administrative commission) through case-by-case negotiation. An autonomous

governance structure is characterized by individual government agencies each pursuing its own development objectives with little coordination. This structure was not a big problem when special zones were small and functioned only as the venue for foreign firms. However, the two separate bureaucratic structures have become increasingly incompatible as special zones are getting larger and more complex. The need for expansion is more urgent in some old special zones, because they do not have sufficient developed land areas to accommodate a fast growing demand. The primary hurdle is land authority. According to China's Land Administration Law, only administrative governments at prefecture or county levels have the authority over the land usage right. Special zones have no authority over land usage right, nor can they requisition farmland for industrial or commercial use.<sup>300</sup> It is very difficult for a special zone to expand without the cooperation from the district/county government.<sup>301</sup> From foreign firms' perspective, dealing with fragmented government agencies under different umbrellas is not only time-consuming, but also confusing and costly.

For prefecture governments, having well-developed zones in their jurisdictions is in their best interest. Those zones will not only increase potential for more foreign investment, but also will become showcases of local officials' political performance. District/county officials do not necessarily share this perspective, however. For some of them, special zones on their territories are liabilities rather than assets. On the one

<sup>300</sup> In June 2005, the Supreme People's Court promulgated a justice interpretation, explicitly stating that any land usage contract between administrative commission of special zones and developers is illegal. (People's Daily, Jun. 24, 2005)

<sup>301</sup> The conflicting interest has actually set barriers even for the establishment of some national SZs. For example, when Hangzhou municipal government decided to set up its ETDZ on a plot which belongs to Yuhang district government, it had to coordinate with Yuhang district government and get the latter's support. Otherwise, the State Council would not approve the proposed ETDZ without receiving the formal approval from the Yuhang district government. (Interview in Hangzhou, Oct. 29, 2004)

hand, district/county officials cannot directly claim much benefit from the development of special zones. Special zones remit their tax revenues directly to or receive subsidies from the prefecture government. On the other hand, district/county officials are required to hand off the governance of special zones while continuously providing some public services, seizing new farmland for industrial or commercial use, and compensating and relocating rural residents whose land is taken for use within zones.<sup>302</sup> Lack of principal-agent relationship in the bureaucratic hierarchy gives many district/county officials little incentive to support special zones. Rather they may have a strong incentive to prevent special zones from expanding and encroaching on their own territories.

The conflicting interests between zones and district/county governments create a tough situation for the prefecture government. Although the prefecture governments can order district/county governments to be cooperative with special zones, the latter can shirk their duties easily. They can even use special zones as hostages to bargain with prefecture governments for more fiscal subsidies or privileged policies.

Widespread negotiations between officials representing prefecture, district/county, and special zones have to be carried out continuously, increasing the transaction costs for all zone-related activities. Lacking effective means to deal with the conflict between district/county governments and special zones, some prefecture governments have come up with an integrated governance structure that binds special zones and district/county governments together.

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<sup>302</sup> Under current rules, requisition compensation for farmland is calculated by local governments only according to the land's agricultural value, which is much lower than its industrial or commercial value. The policy not only gives local governments strong incentives to reap huge profits when converting the farmland for commercial use, but also becomes a significant source of social tension and violent protest. In March 2006, the National Development and Reform Commission (NDRC) proposed a market-based compensation payment for farmland seized for non-agricultural use, but it did not lay out a timetable for its implementation. Beijing News (*Xin Jing Bao*), Mar. 9, 2006.

As can be seen in Figure 5.2, in the integrated governance structure, the special zone is merged with the district/county government. The zone governing body shares the economic, administrative, and land authorities with the district/county government. Currently, 16 national-level ETDZs have been merged with their neighboring district governments and use the integrated governance structure, including the Qingdao ETDZ with the Huangdao district government, the Shenyang ETDZ with the Tiexi district government, and the Fuzhou ETDZ with the Mawei district government. (See Appendix 5-B)

The transformation of the governance structure of special zones has triggered a policy debate nationwide. “It is a reverse of the ongoing institutional innovation”, warned by a local official in Tianjin ETDZ (TEDA), “The achievement of institutional innovation in the last twenty years would be destroyed if all of the national special zones were swallowed by local governments. It would be a big tragedy.”<sup>303</sup>

No consensus has yet been reached within the central government regarding the two governance structures. The National Development and Reform Commission (NDRC) argues that special zones should be abolished altogether since there is no need to use special institutional arrangements to attract foreign investments any more. The merger of special zones with district/county governments has reinforced this perspective. By contrast, the Ministry of Commerce insists on the necessity to maintain the privileged status of the special zones. On its criteria list for assessing performance of ETDZs, an integrated governance structure is treated as a minus. The performance of an ETDZ will be marked down when it has been merged into a

<sup>303</sup> Interview in Tianjin, Dec. 21, 2004.

district/county government and uses an integrated governance structure.<sup>304</sup> In March 2005, a circular jointly promulgated by the Ministry of Commerce, the Ministry of Construction, and the Ministry of State Land and Resources reiterated that special zones should maintain their autonomous governance structure and “not be merged with neighboring district/county governments.”<sup>305</sup>

How would different governance structures affect investment policy outcomes in special zones? Under the autonomous structure, zone government is the single authority over zone governance and the local government controls the administrative and land authorities. The special zone is very flexible in providing services to foreign firms within the zones because the zone government is like a one-stop agency. However, when foreign firms need more land to build new plants or expand their businesses, the zone government has to negotiate with the local government to deal with issues like land acquisition and residents relocation. The negotiation could be time-consuming and costly, because local governments often time do not share the benefits of zone development. This feature makes policy implementation inconsistent and less predictable, especially for large investment projects.

Under an integrated governance structure, the zone government shares the economic, administrative, and land authorities with the local government, which means special zones have dual-governments that check each other. While the zone government has less leeway in policy implementation, which reduces the flexibility of zone governance, it has more administrative capacity and lower coordination cost in dealing with land acquisition and residents relocation issues. So the zone governance should be more consistent.

<sup>304</sup> Interview in Tianjin, Dec. 21, 2004.

<sup>305</sup> The State Council Administrative Office, Mar. 21, 2005.



## V. Legal Environment

While foreign investors are profiting from special zones' improved business environment, they continue to wrestle with China's legal environment. A survey of American firms conducted by the American Chamber of Commerce in 2005 shows that the list of top-ranking operating challenges in China—unclear regulations (75 percent), bureaucracy (74 percent), lack of transparency (71 percent), and inconsistent regulatory interpretation (67 percent)—has barely changed since 1999.<sup>306</sup>

Special zones were *ad hoc* institutional arrangement from the very beginning and were never recognized in any national laws approved by the legislature (National People's Congress). Through some administrative regulations, the State Council and several line ministries such as the Ministry of Commerce (MOFCOM), Ministry of Construction, and Ministry of State Land and Resources (MLR) authorized some areas as special zones that could offer preferential policies to attract FDI. The MOFCOM—the primary advocate for a national law—has prepared several drafts of Regulations for National ETDZs and has been actively lobbying other parts of the central government to achieve it.<sup>307</sup> Local governments also strongly support a national law to ensure the legal status of special zones, which was confirmed by almost all the local officials interviewed.<sup>308</sup> There are two major reasons that local officials favor a national law. First, enacting a national law will send a strong signal to foreign investors that the special institutional arrangement and preferential policies

<sup>306</sup> The American Chamber of Commerce-PRC 2006.

<sup>307</sup> The most recent action was carried out in February 2005, when the MOFCOM invited officials from NPC Judiciary committee, the State Council Legal Office, and 10 ETDZs to set an agenda to draft the ETDZ regulations. People's Daily, Mar. 28, 2005.

<sup>308</sup> Interviews in Suzhou (Oct. 27, 2004), Kunshan (Oct. 28, 2004), Hangzhou (Oct. 29, 2004), Shanghai (Nov. 2, 2004), Beijing (Nov. 25, 2004), Guangzhou (Dec. 4, 2004), and Tianjin (Dec. 21, 2004).

could not easily be reversed. Second, it will simplify the principal-agent relationship within the bureaucratic hierarchy and prevent multiple government interventions in special zones. However, the MOFCOM was very cautious about submitting its proposal to the NPC, worrying that once the NPC turns down the proposal, it has to wait for at least five years to submit it again.<sup>309</sup>

From the perspective of foreign investors, the lack of legal status is a big minus that undermines the credibility of investment policies at the national level. Without a national legal framework for special zones, all the local legal environments are flawed, but foreign investors have to live with the reality. They have to use some second-best indicators to assess local legal environment. Provincial regulations become an important indicator. While the central government is ambiguous in enacting a national law for special zones, it actually allowed or even encouraged local governments to establish legal regulations for special zones at provincial level (*shengji kaifa qu tiaoli*) and respond to foreign investors' concern in their own ways.

The first provincial regulation for special zones was passed by the Tianjin municipal NPC in 1985. Early establishment of provincial regulations helped Tianjin ETDZ (TEDA) differentiate itself from other special zones in creating a more credible legal environment, which contributed significantly to its success in attracting FDI.<sup>310</sup> By 2003, of 54 national ETDZs, 38 have provincial NPC approved regulations to assure their legal status.<sup>311</sup> (See Table 5.3)

These provincial regulations have similar provisions, which normally have four key points. First, the regulations grant administrative commissions, the sole governing

<sup>309</sup> Interview in Tianjin, Dec. 21, 2004.

<sup>310</sup> Pi and Wang 2004.

<sup>311</sup> The majority of the provincial regulations were applied exclusively to specific national ETDZs. Some provinces have passed regulations of development zones which are applied to all special zones in their domains. These provinces include Jiangsu, Shangdong, Shanghai, Hebei, Shaanxi, Henan, Jilin, Hubei, Sichuan, and Anhui.

body of special zones, the authority to govern zones and specify the scope of their administrative authority. Second, the regulations authorize administrative commissions to provide certain preferential policies to foreign investors which meet some minimum requirements. Thirdly, they give foreign investors a guideline how to set up plants and employ workers in zones. Finally, they constrain other bureaucratic organizations from intervening in the governance of zones.<sup>312</sup>

While the enactment of local regulations of special zones is an important indicator of the local legal environment, whether these regulations will be effectively implemented is a key factor for foreign investors to assess a specific legal environment. These provincial regulations are intended, in large part, to convince potential investors that their capital and interests would be protected, but they do not necessarily or even commonly translate into their unambiguous and consistent application. According to the results of a survey conducted in 2005 by the American Chamber of Commerce in China, unclear regulations, rather than no regulation, are the top challenge for foreign investors, because “it does not matter much what the law says but how the person sitting in the [local] government office who interprets the law would say”.<sup>313</sup>

A strictly enforced provincial regulation gives foreign investors more confidence in local governments’ commitment to a rule-based investment environment. In practice, however, these regulations often leave considerable room for interpretation and administrative discretion by local officials. Local officials have strong incentives to manipulate preferential policies to meet their specific needs. Many interviewees

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<sup>312</sup> Indeed, many provincial regulations for development zones require that “other government organizations should not go to development zones to supervise or intervene in their administrative affairs at their own will. If the supervision or intervention is necessary, it should be permitted by the provincial government in advance.”

<sup>313</sup> Lu and Tang, 1997, 86.

report that FDI performance is an important, if not the most important, criterion for evaluating local officials' political achievements (*zheng ji*), which eventually determines their salaries and political careers. Almost all ETDZs where I interviewed have annual quantified FDI goals set by the superior municipal governments. Amount of FDI inflows is the primary indicator while some zones have multiple indicators such as contracted and realized FDI inflows, share of high-tech products, and GDP growth rate. The evaluation system motivates local officials to adopt policies intended to improve their economic performance relative to others.<sup>314</sup> Therefore, "the officials have single-mindedly embraced growth to finance the enormous government bureaucracy, absorb huge unemployment, and help state-run banks avoid collapse. Worker rights and environmental protection are seen as threats to investment."<sup>315</sup>

While conducting business in China, foreign firms occasionally find themselves embroiled in disputes with Chinese individuals, companies, or local governments. Given the ambiguity of the legal setup in special zones, how these disputes are handled by local governments is also a critical concern for foreign firms when making their investment decisions. Prior to 2001, cases involving foreign interests could be filed in either the primary-level courts or intermediate courts, depending on their nature.<sup>316</sup> However, since courts are funded by local governments, foreign firms have complained that poorly trained court officials are susceptible to local favoritism. The Supreme People's Court also set up courts in 20 special zones to specifically handle those cases.<sup>317</sup> These courts are not only generally more experienced in adjudicating

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<sup>314</sup> Whiting 2004.

<sup>315</sup> Kahn, Jan. 25, 2004.

<sup>316</sup> There are four levels of courts in China. Every major city has primary courts and intermediate courts. Supervising these courts are the provincial high courts. The Supreme People's Court, located in Beijing, has appellate jurisdiction over all courts in China.

<sup>317</sup> These 20 special zones include 14 ETDZs (Tianjin, Qinhuangdao, Dalian, Shenyang, Changchun, Yantai, Guangzhou, Zhanjiang, Dayawan, Hainan Yangpu (2), Langfang, and Maoming) and 6 HTIDZs

such cases, but also tend to be more sympathetic to foreign firms' needs. In the wake of China's WTO accession, the Supreme People's Court issued "Provisions concerning jurisdiction over foreign-related civil and commercial cases", limiting the number of courts allowed by law to hear cases under this category. While most of the grassroots courts are no longer allowed to handle these cases, the courts located in the 20 special zones are.<sup>318</sup> The centralization of the judicial powers in this regard was aimed at directing cases to those courts which are most qualified to handle them. Moreover, as courts in special zones and intermediate courts are in most cases less exposed to the otherwise powerful local authorities, local protectionism is likely to be curtailed.

As far as foreign firms are concerned, the local legal environment includes a long list of issues such as market entry and exit, labor relations and flexibility in labor use, ownership transformation, transparency of financing and taxation, and dispute resolution. A World Bank report finds that legal efficiency varies widely across regions in China as firms (domestic and foreign) in more advanced regions tend to experience lower legal burden.<sup>319</sup> This finding suggests that local legal environment is an important factor to determine whether local governments play "helping hands" or "grabbing hands" with respect to foreign investors.

In short, special zones tend to have a more credible policy environment when they have higher level of political authority, stronger administrative capacity, and

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(Wuxi, Hefei, Luoyang, Xiangfan, Chengdu, and Mianyang). Langfang and Maoming are the only provincial-level ETZs. Hainan Yangpu has both primary and intermediate courts. See China Court Network, [www.chinacourt.org](http://www.chinacourt.org).

<sup>318</sup> Only those courts located in provincial capitals, municipalities, SEZs and some independently planned cities, or those specially appointed by the Supreme People's Court, may hear such cases under the Provisions. See *Fashi* (2002), No. 5.

<sup>319</sup> See Dollar et al. 2003. The report uses three measures—informal payment, regulatory burden, and shipment loss—to capture regulatory efficiency. Of the five important FDI destinations, Guangzhou and Shanghai are clearly leaders in regulatory efficiency, while Chengdu and Tianjin lag the farthest. Beijing is in the middle of the pack.

stronger legal environment. Perceiving variation in policy credibility in special zones, foreign investors will respond differently with respect to their entry decisions and strategies. Foreign investors with long time horizons and low tolerance for political risk will particularly prefer a more credible institutional environment.

## **VI. Statistical Evidence**

As argued in chapter 2 and 3, institutional flexibility and credibility influence both the locations and compositions of FDI. A more credible government is attractive to foreign investors because of its ability to maintain a long-term stable policy and protect property rights whereas a more flexible government is attractive to foreign investors because of its ability to provide preferential treatment to foreign investors. For foreign investors with long time horizons or low tolerance of political risk, institutional credibility is crucial. For those with short time horizons or high tolerance of political risk, institutional flexibility plays a more important role. I have found cross-national evidence to support my theory.

To examine whether these institutional features matter at the sub-national level, I use the statistical method to test how they affect various aspects of FDI performance in special zones. In particular, I focus on four dependent variables: FDI inflows, size of FDI projects, export orientation, and technological intensity.

I argue that special zones with closer ties with the central government have more credible policy environment, and thus tend to attract more FDI. So special zones designated by higher level of government should attract more FDI than those designated by lower level of government. It yields a testable hypothesis.

H1: *Holding other things equal, national and provincial-level special zones are more effective in attracting FDI than local special zones.*

I also argue that special zones with integrated governance structure and stronger legal environment tend to have more credible policy environment, which makes them more attractive destinations for foreign firms.

H2: *Special zones with an integrated governance structure tend to attract more FDI, other things being equal.*

H3: *Special zones with stronger legal environment tend to attract more FDI, other things being equal.*

In particular, foreign firms with longer time horizons or low tolerance for political risk would prefer special zones with more credible policy environments. This type of foreign firms normally is large-scale, more technology-intensive, and less export-oriented. Therefore, I have two additional hypotheses.

H4: *Foreign firms tend to be larger, more technology-intensive, and less export-oriented in special zones with an integrated governance structure, other things being equal.*

H5: *Foreign firms tend to be larger, more technology-intensive, and less export-oriented in special zones with stronger legal environment, other things being equal.*

### *Dependent Variables and Explanatory Variables*

To test H1, I run a cross-sectional OLS regression of provincial FDI inflows on the number of different special zones. The dependent variable is average realized provincial FDI flows in each province in 1999-2003, which are collected from the China Statistics Yearbooks. The explanatory variables are the number of zones at different levels of government. The total numbers of zones in each province were collected by the Ministry of Land and Resources (MLR) from the recent campaign of investigating and development zones in early 2004. The ratios of national, provincial, and local zones in total zones are calculated based on data collected from various news resources, mainly from recent provincial governments' official reports.<sup>320</sup>

I include a number of control variables, including per capita GDP, labor cost and quality, and geographic location. Per capita GDP captures the fundamental economic conditions of a province. The indicators for labor quality and cost are percentage of population enrolled in higher educational level and average wage costs respectively. The geographic location variable is defined as the distance of between the provincial capital and the nearest ocean harbor. It is expected that the provinces with higher per capita GDP, higher educational level, lower labor cost, and closer to the coast will have some comparative advantages in attracting foreign investors over other provinces. Since I expect that these indicators have a lagged effect on foreign investors' decision, I use average values of per capita GDP, wage, and educational level between 1994 and 1998. The variable descriptions and sources are presented in

<sup>320</sup> While the MLR information does not distinguish authorized (national-level and provincial-level) special zones from unauthorized zones, it has the number of cancelled or merged zones for many provinces (except Inner Mongolia, Jilin, Shanghai, Guizhou, and Xijiang) by August 2004. However, we cannot simply assume the number of cancelled zones as the total number of local zones for two reasons. First, the released number of cancelled zones was only preliminary and incomplete effort; second, some local zones have found a way to become authorized zones. Therefore, it is reasonable to calculate the number of local zones based on the information of total, national, and provincial zones.



### Appendix 5-C.

I have constructed a unique ETDZ-level dataset to test H2-H5. The primary dependent variables are four indicators of FDI performance in national ETDZs, including FDI inflows, average size of FDI projects, export ratio, and high-tech ratio. The data are from the yearbooks of special economic zones and development zones 1997, 1998, 2002, 2003, and 2004.<sup>321</sup>

I use the log value of realized FDI utilization (*shiji liyong waizi*) to capture FDI inflows. The average FDI size (*size*) is measured by the amount of realized FDI inflows divided by number of new FDI projects. The export ratio (*export*) is captured by total export divided by total sales. The technology ratio (*technology*) is measured by total high-tech industrial output divided by total industrial output. It is worth noting that export ratio and technology ratio do not distinguish FIEs from domestic companies given the limited data availability. However, we can reasonably assume that these indicators approximately reflect the activities of FIEs since both FIEs and domestic companies might have similar activities in the same zone.

The two independent variables—governance structure and legal environment—are hard to measure, however. As discussed earlier, special zones' governance structures vary between autonomous and integrated modes. On the one hand, the autonomous governance structure has a streamlined authority focusing on investment policy, which would facilitate a more flexible policy environment. On the other hand, the integrated governance structure has greater capacity to implement economic, administrative, and land policies, which would facilitate a more credible policy

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<sup>321</sup> The yearbook of special economic zones and development zones is published annually since 1991. However, the statistical part of the yearbook varies considerably from year to year. The data of ETDZs only cover a few indicators in many years. Only in five years (1996, 1997, 2001, 2002, and 2003), the data have all the necessary information for this study. However, lack of annual data for a longer period makes a time-series analysis impossible.

environment.

I create a binary dummy to measure the difference in administrative capacity (*governance*). I code a zone 1 when it is categorized as an integrated governance structure and 0 when it is categorized as an autonomous structure. For example, I code Qingdao ETDZ as 1 because it was merged with Huangdao district government in 1994. Beijing ETDZ is coded as 0 because it is consistently independent as an economic zone. It is worthy noting that some ETDZs (i.e., Dalian, Qinhuangdao, Weihai, and Yantai) have much broader jurisdictions and more complex functions than what a typical economic zone should be although they haven't officially become administrative districts.<sup>322</sup> In those cases, I treat them as *de facto* integrated governance structure and code them 1.

The other independent variable is the local legal environment. To capture the credibility with which local governments implement laws and regulations, I construct two measures. The first is a measure of basic legal setup, constructed as the duration of provincial regulations of special zones (*duration*). While the majority of national ETDZs have established provincial regulations approved by provincial NPC, they differ significantly in the period of duration. An early established regulation would help an ETDZ signal its sincerity of maintaining a capital-friendly environment to foreign investors. The longer the regulation lasts, the more audience cost it will create, the more credible its signal would be. In contrast, a late established regulation would not generate much signaling effect to foreign investors. The other measure is the capacity of legal enforcement, indicated as the presence of courts (*court*). As discussed earlier, courts set up in the ETDZs not only have more judicial capability to handle foreign-related commercial cases, but also tend to be less susceptible to local

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<sup>322</sup> Pi and Wang 2004.

protectionism. Therefore, the presence of courts in the zone is likely to increase foreign investors' confidence on legal enforcement. Of the 54 ETDZs, 12 have courts approved by the Supreme People's Court. I code these zones 1 and 0 for the rest of them.

### ***Control Variables***

It is certainly likely that FDI flows and patterns in special zones will be affected by some locational factors. Since special zones are affiliated with either the capital cities or major cities in each province, it is reasonable to assume that locational factors in their parent cities will influence foreign investors' decisions in special zones.<sup>323</sup> I include five control variables: per capita GDP as a measure of economic development level, average wage (*wage*) as a measure of labor cost, number of enrolled college students (*education*) as a measure of labor skill, length of paved road (*road*) as a measure of infrastructure, and distance from provincial capitals to seaports (*distance*) as a measure of geographic proximity.

The age of ETDZ may also matter. It is plausible that an earlier-designated special zone has some advantages over a newer one not only because it has better economic conditions, but also because it has gained reputation in attracting FDI. In addition, old zones are more likely to establish local regulations earlier. Therefore, I include a timing dummy (*zoneage*) to control the effect of central policy. I code 14 ETDZs designated before 1989 as 1, those established between 1989 and 1994 as 2, and the rest as 3. The variable descriptions and sources are presented in Appendix 5-D.

<sup>323</sup> I realize that the endogeneity problem is likely as FDI inflows will sequentially affect the parent cities' economic development, labor costs, and educational level. However, these effects may vary across cities due to the different share of special zones' contribution to the economy of parent cities.

### *Findings*

As can be seen in Table 5.2, the number of special zones in a province has significant positive effect on FDI inflows after controlling some locational effects. This finding is consistent with the empirical observation that special zones are important in attracting FDI. However, there are some systematic differences with respect to the designating levels of government. The coefficient on the ratio of national zones is positive and statistically significant, suggesting that the increase in national zones has substantively positive effect on FDI inflows. The ratio of provincial zones is also positively associated with the dependent variable, but the coefficient is statistically insignificant. By contrast, the coefficient on the ratio of local zones is negative indicating that increase in the share of local zones tends to discourage FDI inflows. This result would appear to confirm H1. Unauthorized local zones, due to their low political authority and poor infrastructure, have barely produced any positive effect to attract foreign investors.

The control variables—per capita GDP, education, and distance—have the expected significant effects on the dependent variable in every model. Provinces with higher level of economic development, better labor quality, and in close geographic proximity tend to attract more FDI. Wage level is positively associated with FDI, indicating that foreign investors may not take low labor cost as a positive factor as it is associated with low development level and labor quality. Even taken these location-specific factors into account, special zones still play an important role in affecting provincial FDI inflows.

**Table 5-2: OLS Regression Result: Provincial level**

Variable	Log value of FDI flows 5-year mean (1999-2003)			
<b>Total zone (number)</b>	0.002 (3.76)***	0.003 (3.91)***	0.002 (3.09)***	0.003 (3.79)***
<b>National zone (ratio)</b>		2.023 (1.72)*		
<b>Provincial zone (ratio)</b>			1.252 (0.16)	
<b>Local zone (ratio)</b>				-1.596 (-1.34)
Log gdpper (1994-98)	0.448 (1.52)	0.245 (0.97)	0.406 (1.56)	0.234 (0.98)
Log wage (1994-98)	0.185 (0.17)	-0.146 (-0.17)	0.072 (0.08)	-0.220 (-0.27)
Log education (1994-98)	1.005 (3.27)***	1.221 (5.34)***	1.035 (3.98)***	1.213 (5.69)***
Log distance	-0.243 (-2.44)**	-0.322 (-3.83)***	-0.255 (-3.53)***	-0.320 (-4.34)***
Cons.	4.537 (0.42)	8.460 (0.93)	5.791 (0.64)	10.825 (1.34)
Obs.	30	30	30	30
R-square	0.82	0.84	0.82	0.84

Note: Robust OLS regression model, t values in parentheses.

\* significance at the 10% level; \*\* significance at the 5% level; and \*\*\* significance at the 1% level.

A further issue is that the ratios of special zones at different level are to some extent endogenous with FDI inflows. The establishment of special zones in a province may be driven by the demand of foreign firms. To mitigate the endogenous concern, I use the ratio of provincial administrative expenses in total provincial government expenditure (*govexp*) as an instrumental variable. It is based on the assumption that provincial governments with more administrative money at disposal are more likely to use them to establish more special zones, but provincial administrative spending has no independent effect on FDI inflows beyond any effect working through special zones. The 2SLS regression results in Table 5.3 show that the coefficients on the three

explanatory variables still have the same signs and statistical significance, but their impacts increase dramatically after I have controlled the endogeneity problem.

**Table 5-3: Provincial Level: Two-stage Least Squares Regression**

Instrumental Variable: Ratio of administrative spending in total provincial expenditure

Variable	Log value of FDI flows 5-year mean (1999-2003)		
	<b>Total zone (number)</b>	0.004 (2.57)**	0.005 (1.89)*
<b>National zone (ratio)</b>	21.401 (2.05)**		
<b>Provincial zone (ratio)</b>		11.519 (1.20)	
<b>Local zone (ratio)</b>			-7.489 (-1.80)*
Log gdpper (1994-98)	-0.267 (0.41)	-0.706 (-0.61)	-0.553 (-0.73)
Log wage (1994-98)	-1.745 (-1.10)	-1.701 (-0.68)	-1.717 (-0.95)
Log education (1994-98)	1.515 (4.32)***	2.234 (1.67)	1.983 (2.74)**
Log distance	-0.448 (-2.21)**	-0.690 (-1.51)	-0.605 (-2.11)**
Cons.	25.976 (1.39)	26.875 (0.96)	34.049 (1.45)
Obs.	30	30	30
R-square	0.65	0.40	0.61

Note: Robust 2SLS regression model, t values in parentheses. The instrumental variable is ratio of administrative spending in total provincial expenditure

\* significance at the 10% level; \*\* significance at the 5% level; and \*\*\* significance at the 1% level

The second test suggests that local institutional environment does have significant influence on some aspects of FDI activities. All three independent variables are significantly and positively associated with FDI, indicating that ETDZs with an integrated governance structure, long-term stable regulations, and presence of local courts tend to attract more FDI. This finding appears to support the hypothesis that more credible policy environment would make ETDZs more attractive to foreign

investors.

**Table 5-4: OLS Regression Result: Zone level**

Variable	Log FDI	Size	Export	Technology
	0.334	-1.436	-0.007	0.037
<b>governance</b>	(1.74)*	(-1.7)*	(-2.19)**	(0.94)
	0.064	-0.257	-0.001	-0.006
<b>duration</b>	(2.48)**	(-2.08)**	(-1.25)	(-1.13)
	0.585	1.969	0.002	-0.079
<b>court</b>	(2.92)***	(1.48)	(0.62)	(-1.88)*
	-0.351	-1.530	-0.005	-0.080
<b>zoneage</b>	(-1.51)	(-1.44)	(-1.09)	(-1.85)*
	0.971	4.281	0.022	0.055
<b>lgdpper</b>	(3.29)***	(2.78)***	(3.41)***	(1.11)
	-1.364	-5.169	0.005	-0.173
<b>lwage</b>	(-3.28)***	(-1.84)*	(0.38)	(-1.96)*
	0.094	-0.056	-0.010	0.022
<b>leducation</b>	(0.66)	(-0.08)	(-4.48)***	(0.74)
	0.354	2.142	0.002	0.089
<b>lroad</b>	(2.13)**	(2.38)**	(0.65)	(2.51)**
	-0.036	0.106	-0.001	0.002
<b>ldistance</b>	(-0.93)	(0.43)	(-1.43)	(0.29)
	-0.255	-2.637	0.010	
<b>y1996</b>	(-0.64)	(-1.11)	(0.87)	
	-0.190	0.920	-0.002	
<b>y1997</b>	(-0.52)	(0.29)	(-0.19)	
	-0.581	-1.161	0.002	-0.034
<b>y2001</b>	(-1.93)*	(-0.92)	(0.37)	(-0.69)
	-0.294	-1.109	0.001	0.022
<b>y2002</b>	(-1.18)	(-1.01)	(0.35)	(0.47)
	3.798	2.379	-0.115	0.741
<b>_cons</b>	(1.14)	(0.12)	(-1.39)	(0.85)
<b>Obs.</b>	190	188	180	137
<b>R-square</b>	0.46	0.17	0.42	0.18

Note: Robust OLS regression model, t values in parentheses.

\* significance at the 10% level; \*\* significance at the 5% level; and \*\*\* significance at the 1% level.

With respect to other aspects of FDI performance, these institutional variables have different effects. Both *governance* and *duration* have significantly negative effects on size, suggesting that investments in ETDZs with an integrated governance structure and stronger legal environment tend to be smaller in size, all other things being equal. This finding appears surprising, but it is practically reasonable. On the

one hand, while ETDZs with more credible policy environment are attractive to large foreign investors, they also host many relatively small foreign investors, which could reduce the average size of investment scale. On the other hand, for ETDZs with only a few foreign firms, a large-scale project could produce a skewing effect that increases the average size of foreign firms.

*Governance* is also significantly and negatively associated with export, suggesting that foreign investors in ETDZs with an integrated governance structure tend to target more at domestic market. *Court* has significant but negative effect on technology, indicating that the presence of courts may discourage foreign firms to invest in high-tech industries, which seems counter-intuitive.

The *age* of ETDZs has the expected negative effect on FDI, size, export, and technology, but its effect is only statistically significant in one model. It still suggests that the earlier-designated ETDZs had a first-mover advantage in attracting FDI. Those ETDZs are also more likely to attract more large-scale, export-oriented and high-tech FDI.

Locational factors in parent cities also have significant influence on FDI performance. Their effects are largely consistent with what international business theories would predict. Locations with higher development level, low labor cost, and better infrastructure not only tend to attract more FDI, but also are likely to attract large-scale FDI projects. Export-oriented foreign firms are more likely to be attracted by locations with higher development level but lower educational level, indicating that labor skill is a less important factor for export-oriented firms. Infrastructure is always a significant factor in affecting foreign firms' locations, particularly large-scale and high-tech foreign firms.

In short, all three institutional variables have significant effects on FDI locations,



strongly supporting H2 and H3 that special zones with an integrated governance structure and stronger legal environment are more attractive to FDI in general. However, their effects on various aspects of FDI composition do not show a clear trend that supports H4 and H5, indicating that foreign firms' investment activities may be conditioned on more specific factors.

To get a substantive idea of the actual impact of those local institutional factors, we can compare the performance of two ETDZs with similar natural endowments and established time. (Table 5.5) Located in coastal industrial cities, both the Dalian zone (of Liaoning province) and the Nantong zone (of Jiangsu province) were designated by the central government in 1984 and established provincial regulations in 1987. Despite its smaller size, the Dalian zone significantly outperformed the Nantong zone in attracting foreign investment. The Dalian zone attracted five times of foreign investment more than the Nantong zone did up to 2003. Meanwhile, the Dalian zone is governed under the integrated structure while the Nantong zone is governed under the autonomous structure. A court has been functioning in the Dalian zone since 1993 while it was not exist in the Nantong zone before 2005. This substantive evidence is also consistently with the hypothesis that zones with integrated structure and functioning courts tend to attract more foreign investment. In terms of the composition of foreign investment, firms in Dalian are smaller in size, more export-oriented and less technological intensive. The differences in these features, while perceivable, seem not enough to indicate any firm conclusion.

**Table 5-5: Major Indicators of Dalian ETDZ and Nantong ETDZ (2003)**

Major Indicator	Dalian	Nantong
Zone Size	20 km <sup>2</sup>	24.3 km <sup>2</sup>
Established time	1984	1984
Regulation time	1987	1987
<b>Governance structure</b>	<b>Integrated</b>	<b>Autonomous</b>
<b>Court</b>	<b>Yes</b>	<b>No</b>
GDP (billion RMB)	30	4.6
FDI inflows (million US\$)	600	200
FDI stock (million US\$)	4500	750
Average size of foreign firm (million US\$)	4.5	5.3
Export ratio	49%	43%
High-tech ratio	11%	23%

## VII. Conclusion

Economic decentralization increases the incentive for local governments to pursue their development objectives. The diffusion of special zones in local governments at all levels in China indicates that local officials strongly believe that the ability to offer preferential policy treatment to foreign investors is a magic bullet to attract FDI and promote their local economy. Indeed, the success of economic reform is “to have allowed a substantial degree of flexibility in an otherwise rigid and statist economic system.”<sup>324</sup> The ability to strike a deal at local level is important because the overall framework is rather restrictive and entrepreneurially minded local officials may use their leverage to improve the business climate.<sup>325</sup> For foreign investors, complex and regionally divergent regulation creates obstacles to FDI, increases the costs of information gathering and negotiations and increases the need

<sup>324</sup> Huang 2003, 308.

<sup>325</sup> Estrin and Meyer 2004.

for local partners to help with these tasks. Therefore, local government taking a progressive approach to reform may thus facilitate foreign investment.

Economic decentralization also heightens the importance of local institutional setup in shaping the outcomes of local policy making. The unbalanced economic performance of special zones in China indicates that center-initiated policy innovation will not function well without a local institutional mechanism to guarantee its implementation. Three local institutional factors are important for special zones' performance: the central-local relations determine local governments' political authority to deliver central policies; the governance structure determines local governments' capacity to maintain policy consistency; local legal environment determines to what degree foreign firms' property rights will be protected.

The statistical results show that while special zones in general are useful to attract FDI inflows, national-level special zones are much more effective than provincial and sub-provincial special zones, mainly because of their political authority and more credible policy environment. Special zones with an integrated governance structure and strong legal environment tend to attract more FDI, other things being equal. However, the institutional variables do not show clear effects on specific patterns of FDI, indicating that the effect of institutional factors may not be salient when more micro-foundational factors need to be taken into account.

### Appendix 5-1: Number of Special Zones at Different Levels of Government

Province	I Total Number of Zones	II Number of National Zones	III Number of Provincial Zones	IV Number of Local Zones
Anhui	194	4	85	105
Beijing	470	3	16	451
Chongqing	176	3	34	139
Fujian	269	20	65	184
Gansu	93	2	34	57
Guangdong	420	26	69	325
Guangxi	77	7	23	47
Guizhou	41	2	13	26
Hainan	92	5	5	82
Hebei	63	5	45	13
Heilongjiang	100	6	29	65
Henan	69	4	23	42
Hubei	114	4	89	21
Hunan	179	4	73	102
Inner Mongolia	101	6	39	56
Jiangsu	475	27	109	339
Jiangxi	137	3	88	46
Jilin	73	5	35	33
Liaoning	113	13	42	58
Ningxia	36	1	15	20
Qinghai	5	1	3	1
Shaanxi	77	5	17	55
Shangdong	947	16	155	776
Shanghai	157	15	26	116
Shanxi	32	2	22	8
Sichuan	137	5	38	94
Tianjin	143	5	25	113
Tibet	1	1	0	0
Xinjiang	28	7	11	10
Yunnan	81	7	15	59
Zhejiang	758	13	103	642
<b>Total</b>	<b>5658</b>	<b>227</b>	<b>1346</b>	<b>4090</b>

Source:

1. Numbers of total zones in each province are from the Ministry of Land and Resources (Aug. 2004).
2. Numbers of national and provincial zones are from the National Development and Reform Commission 2007.
3. Numbers of local zones are the numbers of total zones minus the numbers of national and provincial zones. ( $V = I - III - IV$ )

Note: National special zones include special economic zones, economic and technological development zones, high-tech industrial zones, free trade zones, border economic cooperative zones, export processing zones, and tourism & holiday zones designated by the state council.

## Appendix 5-2: Institutional Variables of National-level ETDZs

ETDZ	Designated Time	Court	Provincial Regulation	Govern Structure	Note
Dalian	Sep-84	Yes	1987	0/1	Integrated (de facto)
Ningbo	Oct-84	No	1988	1	Integrated (Co-established with Beilun district government in 1984)
Qingdao	Oct-84	No	1988	0/1	Integrated (merged into Huangdao district government in 1992)
Qinhuangdao	Oct-84	Yes (1995)	1993	0/1	Integrated (de facto)
Yantai	Oct-84	Yes (1992)	1988	0/1	Integrated (de facto)
Zhanjiang	Nov-84	Yes	1993	0	Autonomous
Guangzhou	Dec-84	Yes (1997)	1987	0/1	Integrated (merged with other zones in 2002; became a new administrative district in 2005)
Lianyungang	Dec-84	No	1987	0	Autonomous
Nantong	Dec-84	Yes (2005)	1987	0	Autonomous
Tianjin	Dec-84	Yes	1985	0	Autonomous (new administrative district proposal pending)
Fuzhou	Jan-85	No	1987	1	Integrated (merged with Mawei district government in 1992)
Shanghai Hongqiao	Aug-86	No	1988	0	Autonomous (State-owned Corporation)
Shanghai Minhang	Aug-86	No	1988	0	Autonomous (State-owned Corporation)
Shanghai Caohejing	Jun-88	No	1998	0	Autonomous (State-owned Corporation)
Xiamen Haicang	May-89	No	n.a.	0/1	Integrated (became Haicang district government in 2003)
Shanghai Jinqiao	Mar-90	No	1988	0	Autonomous (State-owned Corporation)
Wenzhou	Mar-92	No	1992	0	Autonomous
Hainan Yangpu	Mar-92	Yes (1994)	1993	0	Autonomous
Fujian Rongqiao	Oct-92	No	1997	0	Autonomous
Weihai	Oct-92	No	1988	0/1	Integrated (de facto)
Yingkou	Oct-92	No	n.a.	0/1	Integrated (Merged with Bayuquan district government in 1998)

### Appendix 5-2 Continued

ETDZ	Designated Time	Court	Provincial Regulation	Govern Structure	Note
Changchun	Apr-93	Yes	1995	0	Autonomous
Chongqing	Apr-93	No	2000	0/1	Integrated (Merged with a new administrative district in 2001)
Fujian Dongshan	Apr-93	No	1996	0/1	Integrated (Merged with Dongshan county government)
Hangzhou	Apr-93	No	1994	0/1	Integrated (Merged with Xiasha district government in 1999)
Harbin	Apr-93	No	1993	0	Autonomous
Shenyang	Apr-93	Yes	1994	0/1	Integrated (Merged with Tiexi district government)
Wuhan	Apr-93	Yes	1996	0	Autonomous
Wuhu	Apr-93	No	1994	0	Autonomous
Dayawan	May-93	Yes	n.a.	0	Autonomous
Kunshan	May-93	No	1987	0/1	Integrated (Merged with Kunshan city government )
Guangzhou Nansha	May-93	No	n.a.	0	Autonomous (Became a new administrative district in 2005)
Xiaoshan	May-93	No	1994	0	Autonomous
Ninbo Daxie	May-93	No	1994	0	Autonomous (State-owned Corporation)
Suzhou	Feb-94	No	1987	0	Autonomous (Joint-venture with Singapore)
Beijing	Aug-94	No	1995	0	Autonomous
Urumuqi	Aug-94	No	2001	0	Autonomous
Changsha	Feb-00	No	n.a.	0/1	Integrated (Merged with Changsha County government)
Chengdu	Feb-00	No	1997	0/1	Integrated (Merged with Longquan district government)
Guiyang	Feb-00	Yes	n.a.	0/1	Integrated (Merged with Xiaohe district government)
Hefei	Feb-00	No	1997	0	Autonomous
Kunming	Feb-00	No	n.a.	0	Autonomous
Xi'an	Feb-00	No	2002	0	Autonomous
Zhengzhou	Feb-00	No	1995	0	Autonomous
Nanchang	Apr-00	No	n.a.	0	Autonomous
Shihezi	Apr-00	No	n.a.	0	Autonomous
Hohhot	Jul-00	No	n.a.	0	Autonomous

### Appendix 5-2 Continued

ETDZ	Designated Time	Court	Provincial Regulation	Govern Structure	Note
Xining	Jul-00	No	n.a.	0	Autonomous
Nanning	May-01	No	n.a.	0	Autonomous
Taiyuan	Jun-01	No	n.a.	0	Autonomous
Yinchuan	Jul-01	No	n.a.	1/0	Separated from local district government in Nov. 2002
Nanjing	Mar-02	No	1987	0/1	Integrated (Merged with Xixia district government in 1995)
Lanzhou	Mar-02	No	n.a.	0/1	Integrated (Merged with Anning district government in 2003)

Note:

1. Information of ETDZ designated time is from *China Yearbook of Special Economic Zones and Development Zones* 2003
2. Information of courts are from China Court Network [www.chinacourt.org](http://www.chinacourt.org), access on June 3, 2006
3. Information of enactments and changes of local regulations is collected from China Laws and Regulations Database [www.chinalawinfo.com](http://www.chinalawinfo.com), access on November 28, 2004
4. Information of governance structure is collected from various news resources and personal interviews.
5. Governance structure equals 0 when it is a autonomous governance structure and 1 when it is a integrated governance structure; 0/1 means change from autonomous to integrated governance structure.



### Appendix 5-3: Variable Descriptions and Sources: Provincial Level

	Variable	Description	Source
Dependent variable	FDI flows	Average amount of FDI inflows 1999-2003	China Statistical Yearbook
Independent variable	Total Zone	Total number of SZs (authorized and unauthorized)	Ministry of Land and Resources
	National Zone (ratio)	Ratio of national zones in total zones	China Association of Development Zones
	Provincial Zone (ratio)	Ratio of provincial zones in total zones	Various news resources
	Local Zone (ratio)	Ratio of local zones in total zones	
Control variable	GDP Per Capita (log value)	Average GDP Per capita (yuan) 1994-1998	China Statistical Yearbook (China Data Online)
	Wage (log value)	Average wages of staff and workers (yuan) 1994-1998	China Statistical Yearbook (China Data Online)
	Education (log value)	Percentage of population with at least high school education, 1994-1998	China Statistical Yearbook (China Data Online)
	Distance	Railway distance between the provincial capital to the nearest harbor (1,000 km)	Jin and Chen 1996

#### Appendix 5-4: Variable Descriptions and Sources: Zone Level

	Variable	Description	Source
Dependent variable	FDI flow (log value)	Total amount of FDI flows	China Yearbook of Special Economic Zones and Development Zones (1997, 1998, 2002, 2003, 2004)
	Size	Total new realized FDI inflows divided by number of new FDI projects	
	Export	Total export as a percentage of total sales	
	Technology	Total high-tech output as a percentage of total industrial output	
Independent variable	Governance	Governance structure: 1 if ETDZ uses an integrated governance structure; 0 otherwise	Interviews and various news sources
	Duration	Years since the establishment of provincial regulation	China Laws and Regulations Database
	Court	1 if ETDZ has courts set up; 0 otherwise	<a href="http://www.chinacourt.org">www.chinacourt.org</a>
Control variable	Zone age	Timing of ETDZ designation Dummy variable: 1 if designated before 1988; 2 if designated between 1989 and 1994; 3 if designated after 1994	Yearbook of Special Economic Zones and Development Zones
	GDP Per capita (Log value)	GDP Per capita in parent city (yuan)	China Statistical Yearbook (China Data Online)
	Wage (Log value)	Average wages of staff and workers in parent city (yuan)	China Statistical Yearbook (China Data Online)
	Education (Log value)	Number of enrolled university students in parent city	China Statistical Yearbook (China Data Online)
	Road (log value)	Length of paved road (km <sup>2</sup> )	China Statistical Yearbook (China Data Online)
	Distance (log value)	Railway distance between the provincial capital to the nearest harbor (1,000 km)	Jin and Chen 1996

## Chapter 6

### Conclusion

Where do foreign investors prefer to locate their projects? The conventional wisdom suggests that democratic countries are more attractive because they can credibly commit that they will not arbitrarily take predatory actions against foreign investors. But why do foreign firms invest in authoritarian regimes even when they are aware of the high level of political risk and inadequate protection of property rights? Let me quote Guillermo O'Donnell, who has convincingly analyzed the motivations of foreign firms in investing in bureaucratic-authoritarian states in Latin America.

Of course, these first investors run greater risks, know how much they are needed, and bill the recipient accordingly. . . . . Second, they require particularly favorable conditions—which may be on the verge of a pseudo-investment-for their entry.<sup>326</sup>

An authoritarian regime to attract foreign capital must offer foreign firms handsome incentives at the outset of the investment. This ability, ironically, is derived from the political institutions that appear too weak to constrain the governments from exerting their discretionary authority.

This dissertation has challenged the theoretical and empirical claims that strong institutions are the prerequisite for countries to attract foreign investment. An alternative model, developed in this dissertation, suggests that policy credibility is desirable for foreign investment, but it cannot be assumed that more credibility is always better for all investors. Foreign investors can have common and diverging

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<sup>326</sup> O'Donnell 1978, 18.

preferences over political institutions in host countries. A key theoretical objective has been to specify the conditions under which profit-maximizing foreign investors are prone to invest in countries with more credible or more flexible policy environment.

This conclusion chapter summarizes my answers to four core questions listed below. It then draws some implications and proposes some tentative ideas for future research.

## **I. Questions and Answers**

### ***Question 1: Why Do Multinational Firms Invest in Autocracies as well as Democracies?***

Multinational firms invest in autocracies and democracies in pursuit of different institutional advantages. Strong institutions encourage a credible political environment that protects property rights better. Weaker institutions facilitate a flexible political environment that provides more preferential treatment to foreign investors. I have examined the relationship between political institutions and FDI using a variety of statistical models and data from a large number of countries. The time-series cross-national results indicate a significant nonlinear relationship between political institutions and FDI in developing countries. Increase in institutional strength, in terms of the number of veto players, enhances countries' ability to attract FDI at low level of credibility but decreases countries' ability to attract FDI when a moderate level of policy credibility has been attained.

Some people may be skeptical about the tradeoff assumption between policy credibility and flexibility under any political institutions. It is true that authoritarian regimes can make credible commitment because the dictators may behave like

stationary bandits as long as they anticipate a long life-span. However, stationary bandits are less efficient than limited governments in making credible commitments.<sup>327</sup> If the dictator realizes that his reign is about to end, he will have a strong incentive to become predatory. Authoritarian regimes may be more inclined to pursue particularistic policy goals by providing incentives or selectively enforce property rights. Fewer veto players within the decision-making body enables the government to move more swiftly.<sup>328</sup> Small size of winning coalition within the selectorate creates an incentive for the government to provide private benefits to a certain group.<sup>329</sup> These two factors make less credible governments more flexible in providing private goods.

I have also examined how political institutions affect FDI. The statistical results provide strong support to the hypothesized mechanisms through which political institutions affect FDI. On the one hand, more veto players increase the level of policy certainty and rule of law, both of which independently have strong positive effects on FDI. On the other hand, the number of veto players is negatively associated with provision of investment incentives to foreigners, suggesting that countries with weak political institutions are more likely to offer selective incentives particularly to foreign investors. It provides empirical evidence that authoritarian regimes have more latitude to bend domestic policies to attract foreign investors.

***Question 2: What Explains the Variation in the Composition of FDI among Countries?***

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<sup>327</sup> Haber et al. 2003.

<sup>328</sup> Tsebelis 2002.

<sup>329</sup> Bueno de Mesquita et al. 2003.

Even if the host government promises to offer very generous incentives, why should foreign firms believe that the government will honor that promise once their investment is sunk, when their bargaining power will diminish rapidly. The host government would then be in a position to impose new requirements on the firm, which might more than offset the original incentives.

What keeps the government from renegeing on its promise? If the government would earn more from taxing foreign firms than expropriating their assets, it will keep its promise.<sup>330</sup> Whether the credibility problem matters depends on foreign firms' specific post-entry bargaining power. For some firms, control over technology, management skills and access to export markets will provide sufficient protection, because host governments have the incentive to maintain a collaborative rather than conflictual relationship with those firms. In this situation, the government's commitment is self-enforcing. For investors with rapidly obsolescing post-entry bargaining power, however, there is no self-enforcing commitment. Investors may require strong institutions to constrain the government or simply avoid going to politically risky countries altogether. Therefore, simply looking at the aggregate number of foreign investment does not provide an accurate gauge of the effect of the political institutions on individual foreign firms.

I have attempted to explore multiple facets of the investor-state bargaining relationship. The basic idea is: strong institutions generate policy stability, which reassures foreign firms, who then are more likely to invest in relation-specific assets. Weak institutions produce greater swings in policy, which reward investment in more flexible strategies. To gauge what specific features are important in affecting foreign investors' preferences, I disaggregate FDI by the production strategy (horizontal and

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<sup>330</sup> Haber et al. 2003.

vertical production) and different aspects of asset specificity.

The regression results have shown that countries with strong institutions, given their ability to make long-term credible policy, will be more likely to attract horizontal FDI in which MNCs produce and sell products in host countries. In contrast, countries with weak institutions, given their ability to make more flexible policy, tend to attract FDI that focuses on the vertical production. In other words, multinational firms tend to set up affiliates to process imported inputs and sell products to foreign markets in countries with weaker institutions. They tend to invest on production for local customers in countries with more credible governments.

The effects of political institutions on different types of asset specificity vary. Multinational firms are likely to invest in capital-intensive production (as a measure of physical asset specificity) in countries with more credible governments. They tend to set up large-size affiliates (as a measure of dedicated asset specificity) in countries with more flexible governments. It is because foreign firms with large operation scale will be more likely to establish backward linkages with local suppliers and customers, which could gain political support to secure their property rights. Increases in the number of veto players are not significantly associated with foreign firms' R&D spending (as a measure of human asset specificity).

These findings suggest that the essential insight of the obsolescing bargain model that foreign investors' bargaining powers depend on their firm-specific features remains accurate, but how these features play in the bargaining process is more complex than what the obsolescing bargain model would predict.

***Question 3: What Explains the Change in FDI Composition in China?***

The cross-national theoretical framework offers a simple institutional explanation of why authoritarian regimes like China can attract foreign investment. The Chinese government wielded its largely unchecked authority to set up a favorable business environment conducive to foreign investment outside the poorly managed centrally planned economy. Since the early 1980s, the Chinese government has approved numerous special zones in which foreign firms can enjoy very generous treatments including tax break, cheap land, streamlined approval and licensing process, and flexible labor regulations. These preferential arrangements initially only attracted short-term investments from foreign firms that focused on small-scale, labor-intensive, and export-oriented production. Loosely-bound joint-venture was the primary market entry mode in the early stage.

Authoritarian rule still would have been a big concern for foreign investors if the government lacks the capability to credibly commit to continually welcome foreign investment. Political considerations in both the central and local governments create a self-enforcing solution to this commitment problem. On the one hand, the central government has a strong political motivation in keeping foreign investment flowing into China. Keeping the momentum of economy growth is considered a political imperative to avoid large-scale social unrest.<sup>331</sup> Instead of institutionalizing the special zone policy, the central government relied on some informal means to keep this policy irreversible. First, the top leaders from Deng Xiaoping to Jiang Zemin used their personal commitments to defend the policy from the opposition within the ruling coalition and to reassure foreign investors. Second, the central government wielded particularistic arrangement to prevent local governments from collectively opposing this policy. Third, the central government created powerful economic agencies to

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<sup>331</sup> Shirk 2007.



maintain the ultimate control over the overall shape of the investment policies.

On the other hand, local governments also have a strong incentive to maintain and expand special zones within their territories, because 1) it is a convenient choice for local officials to polish their political achievement in a relatively short term; 2) zone-related land acquisition and sales generate huge benefits for local governments. Since neither the central nor local governments have the incentive to change the status quo, special zones prevail even after the overall investment environment has been fundamentally improved.

Over time, the Chinese government has gradually built up its reputation through its continuing commitment to special zone policy and the implementation of more rule-based FDI policy. Thanks to the political guarantee and the agglomeration effects resulting from the clustering of industrial activities, infrastructural facilities and labor pool, special zones have strengthened their dominant role in attracting foreign capital. In 2004, over 30 percent of foreign investments are located in five special economic zones (SEZs) and 54 economic and technological development zones (ETDZs), which account for less than 1 percent of total land area. The rest of the country, however, has received a smaller share of foreign capital.

For foreign investors, although the benefits of preferential policies have diminished over time, political risks have also reduced. The change in benefit-risk combination has made the Chinese market more attractive to firms with a high degree of commitment. They are engaged in large-scale, high-tech production for the domestic market. Wholly foreign owned enterprises (WFOEs) have gradually surpassed equity joint ventures (EJVs) and become the primary market entry mode in China.

***Question 4: What Explains the Inequality of FDI Distribution within China?***

Despite special zones' pivotal role in attracting foreign investment, there is a huge variation in investment inflows and economic performance among special zones. Even among the national-level special zones, the discrepancy is astonishing. The largest zone attracted as many as 1000 times of foreign capital more than what the smallest one got.<sup>332</sup> The most common explanations for regional divergence are “geography effects” and “preferential-policy effects”, which have been found almost equally important to the coast-inland disparity.<sup>333</sup> This dissertation, however, argues that local institutional factors can explain much of the residual regional variation in FDI beyond the geography and policy effects.

Why do local institutions matter? As China's political institutions are weak and China's constitution affords no guarantee for special zones' existence, the institutional guarantee must come from the local level. Local institutions will shape governments' credibility and thus affect their ability to attract FDI. In particular, three local institutional factors have affected the credibility of local governance: central-local relationship, governance structure, and local legal environment.

The statistical results have shown that national-level special zones are significantly more effective in attracting FDI than local special zones. Of the 54 national-level special zones, those with integrated governance structure (in which zone governments are merged with local governments) attract more FDI than those with autonomous structure (in which zone governments are independent from local governments). Special zones with better legal environment, which is indicated by more durable provincial regulations and functioning courts, also attract more FDI.

<sup>332</sup> China Yearbook of Development Zones 2004.

<sup>333</sup> Demurger et al. 2002.

I have also examined whether these local institutional factors have systematic effects on the composition of FDI. The results, however, only have ambiguous evidence, suggesting that the effect of local institutional factors may not be prominent when more micro-foundational factors need to be taken into account.

## II. Implications and Future Research Plans

### *Fiscal Federalism and Local Governments' Accountability*

What implications can we draw from these findings? The China case has significant implications for the fiscal federalism literature. The theory of “market-preserving federalism” maintains that competition for investment among local governments, and between local governments and central government, ensures against egregious restrictions on property rights.<sup>334</sup> A case study of development zones in Shanghai by Steven Lewis shows that foreign investment flows to localities that are both economically more competitive and more centralized, an evidence seeming to support the market-preserving federalism theory.<sup>335</sup> However, although competitive pressure among local governments may limit predatory behavior by local governments, this in itself does not give rise to secure property rights and credible commitment, because local governments may have an incentive to expand their spending beyond their means.<sup>336</sup> In particular, poorly endowed local governments, meaning those with disadvantaged natural resources, infrastructure, and human capital, may become even more predatory.<sup>337</sup> It is evident from Chapter 4 and 5 that local

<sup>334</sup> Qian and Weingast 1997.

<sup>335</sup> Lewis 1997.

<sup>336</sup> Rodden 2002.

<sup>337</sup> Cai and Treisman 2005.

governments are likely to bypass the central guidelines and offer more generous incentives to foreign firms, which actually undermines the credibility of their commitments.

This dissertation illustrates that special zones with closer ties with the central government are likely to attract more FDI. Special zones at a lower level that have more preferential treatments are less popular destinations to foreign firms. This finding suggests that local governments will lose accountability to foreign investors when the system is too decentralized. Indeed, fiscal decentralization, in order to be effective, may itself require a reasonably strong central government to restrain debilitating practices by local governments.<sup>338</sup> In a country with multiple levels of local governments, to simply view local governments as a whole will overlook the variation in the effect of fiscal federalism on the quality of local governance. Therefore, it is worthwhile to explore how fiscal federalism shapes local policy outcomes at different administrative levels. This topic is currently of major importance in light of the proposed reform of streamlining local governments by reducing the administrative levels from five to three (provincial, county, village) in China.<sup>339</sup>

### ***Legal System, Property Rights, and Foreign Investment in China***

The China case also suggests the necessity to reconsider the role of the legal system and property rights in China. The empirical finding that special zones with

<sup>338</sup> Blanchard and Shleifer 2001; Oates 2005; Cai and Treisman 2006.

<sup>339</sup> This proposal was first experimented in the establishment of Hainan province in 1988 and Chongqing municipality in 1996. Some other provinces such as Zhejiang, Henan, and Hubei have initiated a number of administrative reforms, giving counties a wide range of authorities currently held by prefectures. *Outlook News Weekly (Liaowang)* 2003. *Oriental Morning Post (Dongfang Zaobao)* 2004.

functioning local courts will attract more foreign investments seems to challenge the general impression that China has managed to achieve high investment growth despite the lack of rule of law and unenforceable property rights.<sup>340</sup>

The security of property rights involves both facilitating private contracting and limiting government coercion and expropriation.<sup>341</sup> While courts can increase the security of property rights by resolving disputes among private agents, it is widely assumed that the key of a legal system to protecting property is placing constraints on state agents.<sup>342</sup> Empirical evidence from cross-national and comparative studies is largely consistent with this hypothesis. Acemoglu and Johnson find that “economies can function in the face of weak contracting institutions without disastrous consequences, but not in the presence of a significant risk of expropriation from the government or other powerful groups.”<sup>343</sup> Similarly, Frye’s study on Russia reveals that investors valued legal constraints on state agents over strong state capacity to enforce private contracting when making investment decisions.<sup>344</sup>

While China’s legal system is in the midst of a transition to a more law-based system, it remains structurally flawed and ineffective because the government is fundamentally unwilling to allow real judicial constraints on the exercise of its power.<sup>345</sup> Why do foreign investors still value the legal system despite its inability to tie the hands of state agents?

My hunch is that while courts are ineffective in checking state agents in China, they may be relatively effective in enforcing private contracting and protecting property from private trespass, which explains why legal considerations still matter

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<sup>340</sup> Peerenboom 2002

<sup>341</sup> Levine 2005

<sup>342</sup> Weingast 1993.

<sup>343</sup> Acemoglu and Johnson 2005, 953.

<sup>344</sup> Frye 2004.

<sup>345</sup> Pei 2005.

for foreign firms to make investment decisions. Foreign firms' property will be more secure even if courts are effective only in facilitating private contracting. Moreover, foreign firms' legal considerations may vary depending on their industry- or firm-specific attributes such as firm size. One hypothesis is that a weak legal system is more likely to adversely influence mid-sized foreign firms than either large or small firms. It is because mid-sized firms are generally too large to use the informal networks of individual entrepreneurs to bypass the legal barriers, yet too small to muster the resources needed to withstand the inadequate legal system.

My future research plan is to conduct an intensive study to explore which aspects of property rights are especially important for different foreign firms investing in China and whether the legal system is able to deliver them. I argue that while an adequate legal system is not a decisive factor in attracting FDI in the first place, the lack of it is a significant barrier to retaining such investment. In other words, the strong state discretion in China, not necessarily a bad thing for potential foreign investors, would constitute a big concern for existing foreign firms.

### ***China and India: Varieties of Capitalism in Developing Countries***

This dissertation also helps us understand the varieties of capitalism in developing countries and how the variation in socio-economic institutions may lead to various development patterns and policy outcomes. A report by Goldman Sachs predicts that Brazil, Russia, India, and China—the BRICs economies—may surpass the six largest developed economies (G6) by 2050.<sup>346</sup> These four countries, however, have pursued different development paths under the pressures of competition for

<sup>346</sup> Goldman Sachs 2003; Jain 2006.

international capital. Brazil and Russia have liberalized and deregulated their economies rapidly. China and India, by contrast, have adopted a more coordinated model by retaining control over important parts of the economies while gradually integrating into the global economy.

Nevertheless, global investors view China and India as distinctly different markets, although they are two of the most attractive FDI destinations among all emerging markets. Investors favor China over India for its market size, government incentives, and tax regime. India's rule of law, transparency, and legal environment are more favorable than what China presents.<sup>347</sup> Which type of foreign firms prefers one over the other? It is important to understand the underlying institutional characteristics that result in different policy outcomes.

The type of political institutions influences the content of policy. India's democratic institutions provide more policy certainty to foreign investors, but India lacks a strong government commitment to attracting FDI. It has problems about delivering attractive incentives to foreign investors. China's authoritarian system gives the government greater capacity to produce greater swings in investment policy, but it is more difficult to constrain the Chinese government from abusing their discretion. As a result, India has more liberalized policy whereas China has "more business-oriented" and more FDI-friendly policies.

In particular, the special zones policy highlights the influence of political institutions. Special zones in China were initiated by the strong and highly committed top leaders and their rapid expansion was mainly driven by local governments' competitive liberalization. Special economic zones are not new in India, but their progress has been frustrated by strong institutional gridlocks. Opposition from the

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<sup>347</sup> A.T. Kearney 2004.

multiparty coalition partners and local governments wield effective vetoes over generous tax incentives, flexible labor laws and land acquisition and represent a significant brake on the liberal agenda.<sup>348</sup>

Different policy environments may shape the composition of foreign capital. Foreign firms pick institutional forms according to what suits their preferences. In general, China attracts capital-intensive firms via an export-oriented manufacturing framework that uses special zones. India attracts more technology-oriented firms that concentrate on selling on the domestic market. Foreign firms contributed about 50% of exports in China but hardly 5% in India in 2001.<sup>349</sup> Foreign firms seem more footloose in China while more relation-specific in India, but we need more rigorous comparison before drawing a firm conclusion.

### III. Conclusion

High growth rates in some developing countries, most prominently China, and to a lesser extent in India, Malaysia, Chile, and most recently Vietnam, have transformed the way political scientists think about the relationship between economic development and political institutions. Through the cross-national studies and an extensive case study of China, this dissertation has suggested that the institutional environment of a host country will influence FDI inflows, but not in a way suggested by the conventional wisdom that democratic institutions are a necessary condition to attract foreign investment. Some foreign firms invest in some authoritarian regimes not despite the lack of credibility, but because of the availability of flexibility. Authoritarian governments have the capacity to provide more preferential treatment

<sup>348</sup> Yee 2006; *The Economist* 2006.

<sup>349</sup> UNCTAD 2002, 154.



and selective protection of property rights to attract foreign investment.

I wish to be particularly clear, however, that I am not arguing that authoritarian regimes are never bad for economic development. Rather, I am arguing that there are conditions under which weak institutions are bad for economic development, and conditions under which they might actually be good for economic development.

As the pace of globalization intensified, the motivations of foreign investment became more complex. The market integration and production disintegration have produced a mixed effect on the bargaining relationship between MNCs and host governments. On the one hand, pressures of competition for international capital and the spread of backward linkages from foreign affiliates to local suppliers shift the investor-state relations from conflict to cooperation; on the other hand, increased interaction between MNCs and host governments amplifies the effect of investment environment on firms' activities. Important economic, cultural, and institutional differences between countries shape MNCs' investment decisions and strategies. It is important to remember there is no single "one size fits all" approach to attracting and retaining foreign investment which works for all countries at all times in all conditions. Exploring the new relationship between MNCs and host governments will require the careful analysis of firm-level data and extensive case studies.

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