

Institutional Impact of Foreign Direct Investment in China

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Summary. — We provide firm level empirical evidence that the presence of foreign direct investment (FDI) has positively affected the institutional quality of the host regions in China. Specifically, Chinese domestic firms located in regions with a higher level of FDI tend to enjoy a lower level of tax and fee burdens, less arbitrariness in such burdens, as well as better legal protection. To address the potential issue of endogeneity, we adopt the instrumental variable approach. In addition, we explore the specific mechanisms through which the institutional impact is materialized and provide various extensions of the empirical findings that offer further support for the FDI-induced institutional improvement argument.

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1. INTRODUCTION

China's success in attracting high levels of foreign direct investment (FDI) has drawn a lot of attention from around the world, and so has the fast growth of Chinese regions that have enjoyed the lion's share of the FDI inflow. The specific mechanisms through which FDI has benefited the country's economic development, however, are less clear than the spectacular growth in both the capital flow and the economy.

While the conventional wisdom in FDI research explains FDI's contribution to the host country's economic development through increased financial resources and advanced technological or managerial expertise embodied in foreign investment, these two channels may not capture the full story in the context of China. In this paper, we propose a new channel through which foreign direct investment affects the local economy, namely, the inflow of FDI helps improve the quality of local institutions, which are crucial to local economic growth (Acemoglu & Johnson, 2005). In particular, we explore how the presence of FDI affects two types of local institutions for Chinese domestic firms: their tax and fee burdens, as well as the quality of legal protection they experience.

To preview the results, we find that a higher level of FDI inflow is significantly correlated with lower tax and fee burdens, less arbitrariness in such burdens, as well as a higher level of legal protection for domestic firms in the same region. Given that these findings are not only consistent with the causality from FDI to institutional improvement but could also reflect reverse causality or merely simultaneity, we address the potential endogeneity issue by instrumenting FDI level and obtain similar results. We also explore additional extensions and robustness tests, with findings consistent with the causality going from FDI to institutional improvement. These findings thus provide support for the argument that FDI inflow has led to institutional improvement in the host region (referred to as the FDI-induced institutional improvement argument henceforth).

Our study is closely related to several strands of literature that study economic effects of FDI on the host economy. It is argued that the advantages embodied by multinational firms such as superior technologies, management techniques, and marketing strategies can benefit the host country by generating

spillover effects to domestic firms, in addition to bringing in capital. The first relevant body of literature concentrates on the productivity spillover effects of FDI on domestic firms, which have been studied extensively.¹ Although economic theory suggests that FDI can enhance the productivity of domestic firms through a number of channels, for instance, labor mobility (Fosfuri, Motta, & Rønde, 2001), technology transfer (Liu, 2008; Wang & Blomström, 1992), and competition (Markusen & Venables, 1999), the recent empirical literature has provided mixed results (Görg & Greenaway, 2004). Some studies provide evidence that FDI benefits domestic firms by providing easier export marketing access (Greenaway, Sousa, & Wakelin, 2004), enhancing innovation (Cheung & Lin, 2004), transmitting technological information (Branstetter, 2006), and ultimately boosting productivity (Blomström and Sjöholm, 1999; Haskel, Pereira, & Slaughter, 2007), while others have found that there is no evidence that multinational firms have a positive effect on the productivity growth of local firms in general (Harrison & Aitken, 1999; Haddad & Harrison, 1993; Hale & Long, 2012). The positive productivity spillovers, if any, are only enjoyed by a very small group of domestic firms in specific sectors or regions (Keller & Yeaple, 2009; Kokko, Tansini, & Zejan, 1996; Sinani & Meyer, 2004).

A related but distinct strand of literature attempts to identify how FDI affects economic growth both at the regional level and the national level. As in the case of productivity spillover effects, the impact of FDI on economic growth remains contentious in empirical studies. While some studies find that FDI has a positive impact on economic growth (Blomström, Lipsey, & Zejan, 1996; Li & Liu, 2005), other studies fail to detect a positive relationship between FDI and economic growth (Carkovic & Levine, 2005; Durham, 2004). Empirical studies also suggest that the impact of FDI on economic growth depends on the absorptive capacity of the host country such as economic development level (Xu, 2000), human capital (Bengoa &

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Sanchez-Robles, 2003; Borensztein, De Gregorio, & Lee, 1998), financial development (Hermes & Lensink, 2003), and economic liberalization (Balasubramanyam, Salisu, & Sapsford, 1996; Basu, Chakraborty, & Reagle, 2003).

Compared to the large number of studies on productivity and growth spillovers of foreign direct investment, there is a smaller literature attempting to understand the interactive relationship between FDI and local institutions, with the existing studies mostly focusing on how local institutions, for example, property right protection (Coe, Helpman, & Hoffmaister, 2009) and the efficiency of financial markets (Alfaro, Chanda, Kalemli-Ozcan, & Sayek, 2004), affect the degree of FDI spillovers.

But as the profitability of foreign firms largely depends on the local business environment, they may behave strategically to influence local institutions and policy making processes in their favor (Hillman & Hitt, 1999; Malesky, 2009). Prior studies, for example, suggest that FDI can directly influence the level of trade barriers in host countries through lobbying (Blonigen & Figlio, 1998; Gawande, Krishna, & Robbins, 2006; Grossman & Helpman, 1994; Hillman & Ursprung, 1993), significantly lower corruption level by bringing in competition (Ades & Di Tella, 1999; Larrain & Tavares, 2004). Prior studies also find that FDI has a positive and highly significant impact on property right protection in the host country (Ali, Fiess, & Macdonald, 2011), gives local firms more confidence in contracts enforcement (Ahlquist, 2008), and even exerts a positive effect on reform choices in transition countries through lobbying and information provision (Hewko, 2003; Lewis, 2005; Malesky, 2009). In a recent empirical study, Dang (2013) investigates the effects of a rising level of foreign direct investment on economic institutions across the provinces of Vietnam and finds that more FDI inflow is associated with better institutional outcomes including provincial competitiveness index, regulation in business environment, property rights, and accountability.

The following patterns thus summarize the related literature: First of all, there lacks unambiguous evidence for FDI's positive spillovers in influencing indigenous firms' productivity both in China and in other developing countries. Secondly, there is evidence of foreign investment's impact on local institutions in the host country, but additional supporting evidence is still needed. In particular, only a few studies address the impact of FDI in China from this perspective. Tuan and Ng (2004) document that the introduction of FDI plays an important role in reshaping the local institutional settings in the host country. And in a pioneering paper, Héricourt and Poncet (2009) provide evidence that FDI presence helps domestic private firms in China to bypass the financial obstacles that they face at home. Finally, the continued trend to provide preferential policies to foreign investors around the world begs for more theoretical justifications.

To help address the gap in the literature and to shed light on the important issue of evaluating and improving the role of FDI in the host country's economic development, we empirically study how the presence of FDI influences the quality of institutional environment experienced by Chinese domestic firms. This is particularly relevant in the context of China, given the criticisms raised by commentators against China's FDI policies. For example, Huang (2005) has argued that policy preferences toward foreign firms have negative implications for indigenous firms in the host economy, because domestic firms lose both market share as well as access to finances and other material and policy resources in competing with foreign firms.

The structure of the paper is as follows: In Section 2, we provide background information on FDI and FDI policies in China, with a focus on those impacting the business

environment. Section 3 describes the data sets used in the paper and provides some preliminary patterns. The main empirical findings are presented in Section 4, with a focus on the strategy for addressing the issue of endogeneity. Section 5 offers results regarding potential mechanisms through which FDI impacts institutional quality and provides additional findings based on alternative data sources. The final section concludes and discusses directions for future research.

2. BACKGROUND INFORMATION ON FDI AND FDI POLICIES IN CHINA

Since 1993, China has become the largest recipient of FDI inflow among developing countries, and since 2009 it has been ranked second (after the U.S.) in the annual amount of foreign capital attracted into the country. The two conventional mechanisms that link FDI and economic growth in developing countries, increased capital stock and advanced technology and managerial expertise, however, do not seem as relevant in China.

First of all, China has been running a trade surplus with the rest of the world since 1994 comparable to the annual amount of FDI inflow, implying that at the same time of attracting a large amount of foreign capital inflow, the country is sending a similar amount of capital out in the form of foreign sovereign debt (Ju & Wei, 2010). Furthermore, although empirical studies generally find supporting evidence for foreign invested firms' superior performance, results are mixed regarding the spillover effects of FDI presence on Chinese domestic firms. Hale and Long (2012) explore multiple data sets and investigate FDI spillovers in China from various aspects in a book-long project, finding no convincing evidence that FDI presence has uniformly positive spillover effects on Chinese domestic firms' performance, whether measured in labor productivity, total factor productivity, exports, or new product development.²

As the large inflow of FDI in China is generally accompanied by rapid economic growth in the host region, these findings are puzzling. Figure 1 shows a clear positive correlation between the regional GDP (in logs) and the percentage of total industrial asset owned by foreign invested firms in the same region, which is statistically significant and numerically substantial at 0.523.³ Although the correlation is not conclusive evidence for causality, the commonly held belief that FDI inflow has made positive contributions to regional development warrants additional investigations into the various impacts of FDI on its regions in China.

To help reconcile the seemingly contradictory facts discussed above, the current paper looks at the impact of FDI in China from a new perspective, i.e., how foreign direct investment inflow affects the institutional environment for Chinese indigenous firms. By helping improve the business environment for domestic firms in China, FDI may have produced positive spillovers for its host country in a potentially more important way. If empirically supported, these spillover effects will provide justifications along a different dimension for the numerous policy preferences awarded to foreign investors in China, which would not have been warranted if no positive externalities have resulted from their investment.

A brief review of China's FDI policies is in order at this point to provide background information for the later analysis. In terms of geographic regions and sectors open to foreign direct investment, China's FDI policies changed from restrictive before 1978 to tolerating in the early 1980s, then to encouraging between the mid-1980s and the mid-1990s, and finally

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