



Spatial inequality of foreign direct investment in China: Institutional change, agglomeration economies, and market access



Hao Huang ^{a, *}, Yehua Dennis Wei ^b

^a Department of Social Sciences, Illinois Institute of Technology, Siegel Hall 3301 South Dearborn, Suite 116, Chicago, Illinois, 60616, USA

^b Department of Geography, University of Utah, 260 S. Central Campus Dr. Rm. 270, Salt Lake City, UT 84112-9155, USA

ARTICLE INFO

Article history:

Available online 23 March 2015

Keywords:

Foreign direct investment
Spatial inequality
Location determinants
Institutional change
Agglomeration economies
China

ABSTRACT

The spatial inequality of foreign direct investment (FDI) can intensify uneven economic development. As globalization and economic transition proceeds, foreign investors are changing their behaviors in FDI location, based on institutional change and agglomeration effects. In order to reduce the inequality, this research employs spatial statistics and analyses to examine the change in the spatial inequality of FDI among regions and among prefectural cities, and uses regression models and spatial regime analyses to investigate factors influencing the inequality from 1990 to 2010. The spatial diffusion of FDI clusters from the eastern/coastal region to the interior shows the trend of FDI convergence among regions. However, increasing numbers of FDI clusters and hot spots show the increasing divergence among cities within three regions. Agglomeration effects have replaced institutional factors to become one of the most significant factors influencing the FDI inequality among cities. Additionally, special economic zones, coastal open cities, provincial capital cities, and development zones lost their advantages in FDI as more reforms set in. The spatial regime analyses further indicate the significance of market size in FDI in prefecture-level cities and the significance of agglomeration economies in FDI in capitals and municipalities.

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1. Introduction

Foreign direct investment (FDI) can advance economic growth through financial and technological utilization, but the harmful distributional influence of FDI on the inequality of economy has been criticized by divergence schools (Amin, 1976; Frank, 1979). Dependency theory maintains that FDI tends to intensify uneven economic development in developing countries because of the spatial inequality of FDI and its uneven impact (Kentor, 2001; Wallerstein, 1984). Since FDI played a significant role in economic inequality, examining the pattern, trajectory, and mechanisms in the spatial inequality of FDI can help clarify the dynamics and mechanisms behind the economic inequality, and thus provide policy implications on the reduction of inequality.

Since China's reform in the late 1970s, FDI has become a major force promoting economic growth and globalization of China's cities and regions. China ¹ is the second largest recipient of FDI in

the world, behind the United States (UNCTAD, 2013). In 2010, its FDI reached \$105.7 billion, a 17.4 percent increase from 2009 (MCC, 2011). FDI in China, however, has been unevenly distributed across space and time. This uneven distribution is deeply influenced by China's regional differences in economy and politics. China's reform has been a gradual and exploratory process. The early reform stage of the late 1970s and 1980s was characterized by limited scope and space for opening up; only in the early 1990s, with the initiation of rapid market reform, were more cities opened for foreign investment. China's entrance into the World Trade Organization (WTO) in 2001 signaled a new stage of development and globalization. The recent global financial crisis has also prompted the Chinese government to promote domestic investment and interior development to reduce the impact of the crisis. Changing institutional frameworks and policies should have had profound impacts on FDI growth and its spatial distribution. These institutional impacts, however, have not been thoroughly studied.

There is a list of existing studies examining the spatial inequality of FDI among cities in China, but most of these studies focuses on FDI in the 1980s and early and mid-1990s (Gong, 1995; He, 2002; Leung, 1990). These studies examined the institutional effects and found the significance of cities with investment incentives in the 1980s and early and mid-1990s, especially for special economic

* Corresponding author.

E-mail addresses: hhuang48@iit.edu (H. Huang), wei@geog.utah.edu (Y. Dennis Wei).

¹ Based on UNCTAD statistics, Hong Kong, Macao, and Taiwan are measured separately from China. Hong Kong, Taiwan, and Macao rank the 3rd, the 53rd, and the 82nd, respectively, in 2012.

zones (SEZs), open coastal cities (OCCs), and provincial capital cities. However, there are no studies examining the change in institutional effects of the procession of globalization and economic transition in the late 1990s and 2000s. There remains a lack of understanding of the change in patterns, trajectories, and mechanisms of FDI inequality, especially institutional effects. Would SEZs, OCCs, and provincial capital cities still have advantages to attract FDI as they did in the 1980s and early and mid-1990s? Would the role of national development zones in FDI location change in the 2000s compared to that in the 1980s and 1990s? Would effects of agglomeration and market size effects, and comparative advantages strengthen, weaken, or disappear along with these as globalization and economic transition proceeds?

This study uses all prefectural cities² of China between 1990 and 2010 to fill these gaps in the research. We identify changes in spatial clusters of FDI and investigate the change in forces shaping FDI inequality from 1990 to 2010. This paper examines the shift in the scale and nature of FDI at different stages, paying special attention to the effects of government policies, including foreign capital policies and regional development policies. We explain the main trends of FDI inequality at the inter-city level in China in terms of comparative advantages, market access, agglomeration, and institutional perspectives. This article highlights substantial differences existing among Chinese cities, and considers FDI an important manifestation of urban economic reform in China.

2. Theoretical framework and research context

In the neoclassical analysis of locational factors of FDI, the focus has been on the role of comparative advantages (Kojima, 1982). New economic geography (NEG) emphasizes market access and agglomeration economies as driving forces behind FDI concentration (Baldwin, Forslid, Martin, Ottaviano, & Robert-Nicoud, 2003; Fujita, Krugman, & Venables, 1999; Hymer, 1976; Krugman, 1991). More recent work on institutional economies has uncovered institutional effects in FDI location decisions (Dicken, 2007; Phelps and Raines, 2003). We hold that these perspectives are complementary in explaining distribution patterns and dynamic processes of FDI.

The neoclassical theory's comparative advantages are based on profit maximization in terms of costs (Kojima, 1982; Santiago, 1987). Kojima (1982) identifies low labor costs as comparative advantages of vertical investments, which largely account for determinants and dynamic processes of FDI. Santiago (1987) explains FDI activities in terms of conditions in host countries. This line of research has identified the significance of accessibility of the central business district, transportation, and infrastructure, such as airports and highways (Guimera, Mossa, Turttschi, & Nunes Amaral, 2005; Knox and Taylor, 1995; Wei, Luo, & Zhou, 2010). Research in China has also identified cheap labor costs as important drivers for MNEs to invest among cities in the early 1990s (Head and Ries, 1996). After China's entry into the WTO, MNEs were changing from export-oriented investments to domestic market-oriented investments, but there is no research investigating the changes in the impact of comparative advantages on FDI location. Our empirical analysis will contribute to the FDI theories in understanding the evolutionary process of the investment landscape.

New economic geography, pioneered by Hymer (1976) and Krugman (1991), identifies agglomeration economies as one of the driving forces behind FDI location decisions. Hymer (1976) identifies large market sizes as a determinant of FDI. This strand of

literature also investigates how agglomeration influences MNEs' location choices and the concentration of foreign direct investments (FDIs) in particular places due to increasing returns at the level of the individual firms (Coughlin & Segev, 2000; Coughlin, Terza, & Arromdee, 1991; Shaver & Flyer, 2000). Agglomeration economies help to reduce transaction costs for investors (Guimaraes, Figueirido, & Woodward, 2000). However, when a city's FDI concentration reaches a certain level, the city may exhibit agglomeration diseconomies and a loss of comparative advantages due to negative externalities, such as rising labor costs, transportation bottle necks, and so on (Chan, Henderson, & Tsui, 2008). FDIs may move to cities with comparative advantages (Fan & Scott, 2003). Studies have indicated a strong agglomeration effect in China at the inter-city level in the late 1980s and early 1990s (Gong, 1995; He, 2002; Head & Ries, 1996; Leung, 1990). The debate on agglomeration economies concerns the relative importance of localization and urbanization economies, which has not been examined in reference to China. Localization economies are related to the industrial concentration while urbanization economies are related to the size of a city (Rosenthal & Strange, 2004). Therefore, dynamic processes and movement of FDI are unclear without understanding the relative importance of localization and urbanization economies. This research will expand FDI theories by distinguishing different types of agglomeration economies.

Institutional analysis has been increasingly used in FDI research. These works have uncovered the significance of transnational state apparatus (Robinson, 2003, 2004), nation-states (Dicken, 2007; Liu & Dicken, 2006) and local institutions (Wei, Leung, Li, & Pan, 2008; Wei et al., 2010) in firm location and business organization. Furthermore, the institutional approach emphasizes that differences in institutional capacities of regional and local economies play an important role in attracting FDI when many nation-states are decentralizing and devolving their institutional structures (Martin, 2000). In China, foreign capital policy and regional and local development policy affect FDI location. However, these policies are location-specific and vary across regions and cities (Wei et al., 2010). Current studies only focus on cities with investment incentives in the 1980s and early and mid-1990s (Gong, 1995; He, 2002; Head & Ries, 1996; Leung, 1990). There are no sufficient studies on impacts of central and western policies, local and regional development policies, or transnational policies in the 1990s and 2000s.

China's foreign capital policy was initiated in the 1980s. In 1980, the central government designated four cities in the southern coastal region – Shenzhen, Zhuhai, Shantou, and Xiamen-as special economic zones (SEZs) for opening up to foreign investment with fiscal incentives. These incentives included reductions and exemptions on taxes and land use fees. In 1984, 14 coastal cities were announced as open coastal cities (OCCs) and they offered similar incentives to foreign investors. In 1985, the central government expanded preferential policies to three open delta economic areas: the Yangtze River Delta (YRD), the Pearl River Delta (PRD), and the Minnan Golden Triangle. In 1988, the Bohai Rim Region (BRR) was added as another open coastal area. With the rapid economic growth of the coastal region in the 1980s, the central government decided to extend its open door policy to the central and western areas. In 1992, five cities along the Yangtze River in the central and western areas were opened to foreign capital, and soon all provincial capital cities in the central and western areas were designated as open cities. However, existing studies are still limited to the significance of cities with investment incentives in the 1980s and early and mid-1990s, especially for SEZs, OCCs, and provincial capital cities (Gong, 1995; He, 2002; Head & Ries, 1996). There are no studies examining the change in institutional effects of the procession of globalization and economic transition in the late 1990s and 2000s. Whether these cities with investment incentives

² A prefectural-level city is an administrative division of China, ranking below a province, and typically comprises a main urbanized area and a much larger surrounding rural area.

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