CHAPTER 1. INTRODUCTION

1.1 Research Background

Since the implementation of opening policies in 1979, China has increasingly utilized overseas funds actively to accelerate industrialization and industrial promotion. From the beginning of the "Open Door" policy in 1979 to 2006, China has received US$73.52 billion in foreign direct investment (FDI). Indeed, China is the largest developing country of FDI.

In addition, China has maintained one of the highest growth rates since its opening up. Even after the 1997 Asian financial crisis, China's annual growth rate has been over 7%. Today, China's economic growth rate is over 10%. Its high growth rate results from a good deal of overseas funds and foreign technology progress. Thus, FDI has played a key role in the integration of China into a market-oriented economy. Although China's attraction of FDI is impressive, potential problems exist. The distribution of FDI is an unequal development among regions in China, especially between the coastal and inland provinces. In 1999, the amount of actually used FDI declined in China for the first time since the implementation of the open-door policy. Accordingly, the Chinese government gradually attaches great importance to this inequality.

According to Figure 1, actually utilized FDI in China has been accelerating since 1985. In fact, there were few amounts of FDI in China before 1992. Since 1992 Deng Xiaoping's Southern Tour, FDI in China has entered a higher degree of growth. In 1992, the actually utilized foreign capital jumped to US$ 11 billion, while in 1993, the actual investment as compared to that of 1992 more than tripled to US$ 25.7 billion.

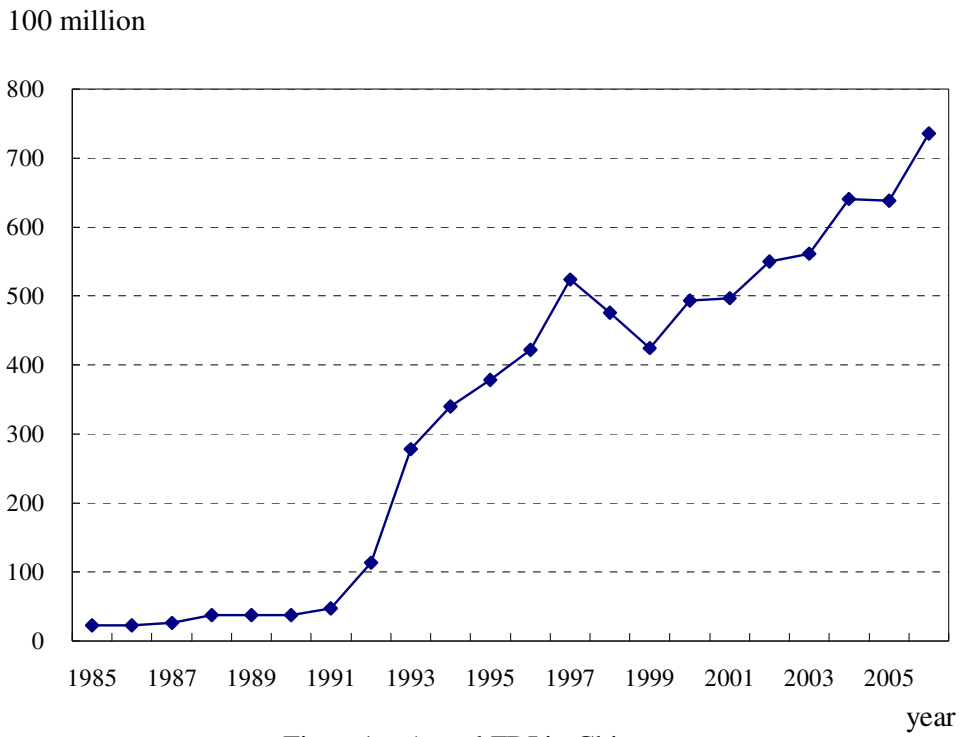

Figure1：Actual FDI in China

Source: *China Statistical Yearbook* (State Statistical Bureau, SSB).

It is obvious that after 1992 Deng Xiaoping's Southern Tour, the Chinese government kept enforcing the "Open Door" policy to increase the amount of FDI. China has become the second largest recipient country of foreign capital, behind the United States, in the world since 1993.Although the inflow of FDI lagged even declined in the 1997 Asian financial crisis, the amount of actually utilized FDI in 2001 achieved US$49.67 billion, surpassing the peak point of 1998 seeing that Chinese government worked out lots of policies. In 2002, China became the largest recipient country of FDI at one time. China has kept being the largest developing country of FDI since 2006.

However, as indicated by Huang, Kao and Yu (2004), the inequality between provinces in China results primarily from the unequal distribution among seven

economic areas. The concentration of FDI inflows in the coastal and inland regions is seen clearly from Table 1. Among the coastal regions, Fujian, Shanghai, Jiangsu and Guangdong have all been hosts to the significant amounts of FDI. Guangdong has consistently been the leading coastal province and, in recent years, the gap between FDI inflows of Guangdong and all of other provinces has been enlarging except for Jiangsu.

Table 1：Chinese FDI Inflows by Region ($US Million)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Coastal	39936.50	41334.17	36491.31	37028.25	42437.34	47922.88	48210.93	63901.97	70555.22	79038.31
Guangdong	12634.95	13031.60	12892.38	12834.94	13634.66	13311.32	10093.35	12899.58	15173.58	14511.00
Fujian	4197.10	4212.11	4024.03	3431.91	3918.04	3838.37	2599.03	2221.20	2607.75	3220.00
Jiangsu	5435.11	6631.79	6077.56	6425.50	6914.82	10189.60	10563.65	12137.83	13183.39	17431.40
Beijing	1592.86	2168.00	1975.25	1683.68	1768.18	1724.64	2191.26	3083.54	3526.38	4551.91
Shanghai	4225.36	3667.74	2836.65	3160.14	4291.59	4272.29	5468.49	6541.00	6850.00	7107.00
Shandong	2775.56	2731.00	2465.47	3027.55	3520.93	4800.10	6016.17	9820.64	11014.41	10000.00
Liaoning	2366.35	2406.24	1061.73	2044.46	2516.12	3411.68	2824.10	5406.79	3590.42	5990.00
Hainan	705.54	717.15	484.49	430.80	466.91	511.96	421.25	643.43	684.01	749.00
Tianjin	2511.35	2113.61	1763.99	1166.01	2133.48	1581.95	1534.73	2472.43	3328.85	4131.00
Zhejiang	1503.45	1340.12	1232.62	1612.66	2211.62	3076.10	4980.55	6759.74	8117.77	8890.00
Guangxi	885.79	886.13	635.12	527.66	384.16	417.26	418.56	295.79	378.66	447.00
Hebei	1103.08	1428.68	1042.02	682.94	676.83	787.61	1099.79	1620.00	2100.00	2010.00

Table 1(Continued)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Inland	6019.87	5426.25	4720.41	4769.82	5618.39	6619.60	7102.39	11769.65	15384.60	19453.20
Shaanxi	268.93	244.51	391.29	224.72	233.93	211.64	213.61	90.22	275.16	471.99
Hubei	848.66	1036.49	989.14	1036.12	1424.25	1645.35	1796.58	2356.42	2649.55	3084.00
Sichuan	248.46	372.48	341.01	436.94	581.88	555.83	412.31	738.25	907.01	1258.01
Heilongjiang	734.85	526.39	318.28	300.86	341.14	355.11	321.80	1236.39	1446.90	1710.00
Hunan	917.02	818.16	653.74	678.33	810.11	900.22	1018.35	1418.06	2072.35	2593.00
Henan	692.04	616.54	521.35	564.03	457.29	404.63	539.03	873.67	1229.60	1845.00
Jilin	402.27	409.17	301.20	337.01	337.66	244.68	190.59	453.00	768.76	761.00
Jiangxi	481.03	464.96	320.80	227.24	395.75	1081.97	1612.02	2052.38	2422.58	2806.57
Anhui	434.43	276.73	261.31	318.47	336.72	383.75	367.20	816.74	1115.73	1390.00
Guizhou	49.77	45.35	40.90	25.01	28.29	38.21	45.21	65.33	107.68	93.84
Shanxi	628.16	300.10	241.97	288.42	351.74	360.05	331.90	526.64	628.39	925.00
Yunnan	165.66	145.68	153.85	128.12	64.57	111.69	83.84	141.52	173.52	302.00
Xinjiang	24.72	21.67	24.04	19.11	20.35	18.99	15.34	45.86	47.49	104.00
Inner Mongolia	73.25	90.82	64.56	105.68	107.03	177.01	88.54	627.43	1185.77	1741.00
Gansu	41.44	38.64	41.04	62.35	74.39	61.21	23.42	35.39	20.00	30.00
Qinghai	2.47	0.00	4.59	0.00	36.49	47.26	25.22	225.00	266.00	275.00
Ningxia	6.71	18.56	51.34	17.41	16.80	22.00	17.43	67.35	68.11	62.79
Total	45956.37	46760.42	41211.72	41798.07	48055.73	54542.48	55313.32	75671.62	85939.82	98491.51

Source: *China Statistical Yearbooks* (State Statistical Bureau, SSB).

Note: Chongqing was separated from Sichuan in 1997. This paper combined Chongqing and Sichuan into one province for consistency.

Of the total amount of FDI that China has received since 1989, the coastal areas' share has been over 90%. In contrast, the inland provinces, which are considerably less developed and poorer, and in greater need of capital investment, have not played hosts to FDI to any significant degree. Within the context of opening the economy, the earliest reform experiments focused on developing four initial Special Economic Zones (SEZs),[1] which have embodied preferential tax policies to attract foreign capital and technology, and promoted exports. Subsequently, the Chinese government designated fourteen open coastal cities and development zones.[2] Therefore, preferential policies actually have some kind of effect on determining FDI in these areas.[3]

In fact, numerous political and economic reasons will attract regional distribution of FDI. Chen (1996) concluded that the location of FDI seems to have been influenced by the existence of good transportation linkages, technological filtering and, to some extent, by the potential for market-share extension. Cheng and Kwan (2000) pointed out that the size of a region's market as measured by regional income, key policy designations and good infrastructure have a positive effect, but wage cost has a negative effect on FDI. In addition, Sun et al. (2002) mentioned that the degree of openness and agglomeration have a positive influence on regional distribution of FDI. Since both political and economic factors are determinants of FDI, there is almost none study to discuss about the political effect. Thus, this paper primarily points out the political power do have effect on the location of FDI.

[1] Shenzhen, Zhuhai, Shantou and Xiamen.
[2] From north to south: Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai. Development zones are Hainan Special Economic Zone and the Pudong New Area in Shanghai.
[3] See Huang,(1995), Yingoi et al. (1999), and Cheng and Kwan(2000).

1.2 Research Purpose

This paper uses political power as a new variable that no one has considered it as a political factor of determining FDI before. Under above-mentioned, there are many factors that could affect the determinants of FDI distribution. For instance, wage cost has a negative effect on FDI. Preferential policy, the size of a region's market, the degree of openness and good transportation both affect regional distribution of FDI positively. The economic factor is regarded as the most important variable in recent studies. However, there are not only economic reasons but also political factors acting on the determinants of FDI distribution. Most of the previous studies focus on economic activities but ignore political affairs. Thus, this paper concentrates on how region's political power in the central government affects regional distribution of FDI.

First of all, the purpose of this paper is to construct an empirical model to investigate how region's political power in the central government affects regional distribution of FDI. Panel data analysis is adopted because this paper aims to examine the determinants of FDI distribution across provinces and over time. Second, most of the data used in this paper are acquired from the *China Statistical Yearbooks*. The Yearbooks provide two figures of FDI, "Signed Agreement" FDI and "Actually Utilized" FDI. This paper uses the latter one, which is the actual amount of FDI invested in China. Third, this study compresses the distribution of provincial FDI and investigates what factors would influence the determinants of FDI distribution from political and economic angles. Finally, this study attempts to obtain a conclusion and a rule with which the Chinese authority may follow.

Since that the inflow of FDI declined in the 1997 Asian financial crisis, this paper adopts the official panel data for 30 provinces/cities during the 1997-2006 period. However, the data of Tibet are incomplete to be used thoroughly so this paper

neglects Tibet. This paper uses the panel data from the *China Statistical Yearbooks* and the *Chongqing Statistical Yearbooks* to analyze this issue. This paper expects to completely examine how region's political power in the central government influences regional distribution of FDI. Moreover, this paper considers the time-specific effect in order to investigate the change each year. Finally, the ultimate results are based on several econometric tests for accuracy so these conclusions are reliable.

1.3 Research Framework and Process

1.3.1 Expected Research Results

According to the purpose of this research, this paper hopes to accomplish the following results:

(1) This paper will completely generalize the influence of region's political power in the central government on regional foreign direct investment (FDI) in China after 1997.

(2) This paper attempts to establish a structure including theory as well as an empirical model. In addition, this paper uses the data to investigate regional FDI of each province/city. Based on the conclusions, this paper attempts to examine the situation of region's political power and regional FDI of each province in China.

(3) This paper regards the political power as a factor affecting regional distribution of FDI that no studies adopted before so this paper uses a strategic decision mechanism to measure the political power.

(4) In the empirical model, this paper will adopt the panel data analysis to capture regional-specific and time-specific effects. Thus, this paper uses an empirical model in order to evaluate. In addition, this paper considers the time-specific effect in order to investigate the change each year.

(5) Finally, this paper adopts various statistical tests to check the accuracy. And those tests will offer strong evidence for the conclusion.

The conclusion is not only an international academic discussion and practical application, but also offers Taiwanese businessmen main information for investments in China. The Taiwanese businessmen can take into consideration the conclusions of this paper to choose their investment locations in China. Moreover, this paper also contributes a new factor, the political power, to investigate the determinants of regional FDI of each province in China that no one has considered it before.

1.3.2 Research Framework

The primary issue of this paper is how region's political power in the central government affects on regional FDI in China after the Asian financial crisis in 1997. This paper calculates the political power of 30 provinces from 1997-2006 and constructs an empirical model in order to examine the role of the political power playing in the local government's FDI in China.

The main purpose of this paper is to investigate the comprehensive impact of region's political power in the central government on regional FDI. Hence, after discussing the research background, purpose and structure, this paper generalizes the FDI theory and the determinants of FDI. In addition, this paper will compress those literatures and introduce a strategic decision mechanism to measure the political

power. Moreover, this paper will interpret the relationship between region's political power and regional FDI in China.

Subsequently, this paper collects research data and constructs an empirical model in terms of previous literature. This paper uses a regressive method and attempts to explain the estimate result in order to examine the role of the political power playing in the local government's FDI in China. Furthermore, this paper uses regional- and time- specific effect to observe whether regional FDI is influenced by time and regional characteristics. Meanwhile, the conclusion will be tested by several statistical methods.

Finally, this paper uses the conclusion to provide several policy implications. Hence, this offers Taiwanese businessman a guide to better evaluate their strategies. Moreover, the Chinese authority could draw up policies in terms of the conclusions. The research steps are illustrated in Figure 2.

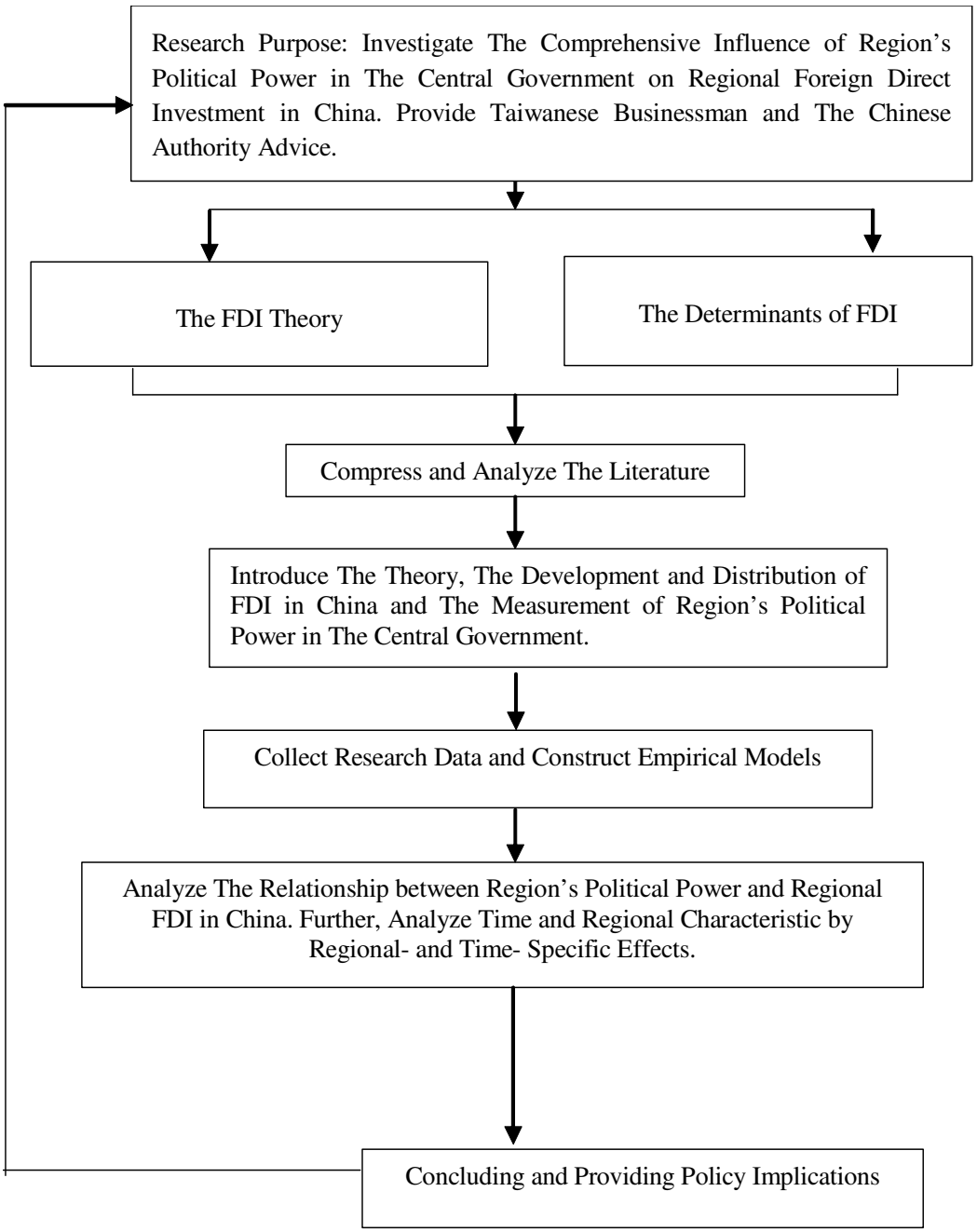

Figure 2：Research Framework