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ScienceDirect
The Social Science Journal 48 (2011) 52–71
The SOCIAL SCIENCE JOURNAL
www.elsevier.com/locate/soscij

A political economy approach to foreign investment and local welfare

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Received 8 October 2009; received in revised form 1 June 2010; accepted 22 July 2010

Abstract

A number of papers in the economics and urban literature observe several positive impacts of foreign investment on urban development and urge cities to actively pursue foreign investors. The author conducts a political-economy analysis illustrating that an economic boom stimulated by a massive inflow of international capital may bring about serious social–environmental side effects for tourist cities. If foreign investors dominate a city's policymaking, this foreign-driven expansion may come at the expense of declining local welfare, which can lead to serious social conflicts and political instability. Macao is adopted as a case study.

1. Introduction

A large volume of economics literature encourages cities to create market conditions that attract foreign investors to invest and exploit local competitive advantages. According to these studies, international capital has various advantages, such as promoting growth (Sheng, 2010; Xafa, 2008), fostering competition (Edwards, 2001), transferring technology and management skill (Lopez-Mejia, 1999), enhancing policy transparency and market discipline (Moreno, 2001), strengthening efficiency in financial institutions (Claessens, Demirguc-Kunt, & Huizinga, 2001), and smoothing intertemporal consumption across cities (Eichengreen et al.,

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0362-3319/$ – see front matter
doi:10.1016/j.soscij.2010.07.013

1999). Vast urban literature also finds that foreign investment enhances urban development. Sit and Yang (1997) find that foreign investors have been playing a significant and positive role in transforming the Pearl River Delta from a closed, self-reliant agrarian region into an industrialized and urbanized area, enabling it to integrate with the international division of labor. Turnock (1997) argues that foreign investors help to accelerate urban restructuring, exploit comparative advantages, and situate Eastern European cities within the global division of labor. Foreign investment also stimulates competition by pushing domestic enterprises to innovate. Wu (2001) finds that foreign investors account for a significant portion of China's development finance. This made large-scale infrastructure and prestigious, high-profile projects possible and helps to transform Chinese cities from a mixed, cellular pattern to a highly differentiated pattern of land uses. Wei, Leung, and Luo (2006) find significant contributions by foreign investors to the increase in external trade, global city and financial center formation, as well as overall rapid economic growth in the city of Shanghai. Positive evaluations of foreign investment in urban context are also provided by Wu (2000, 2003), Dick and Rimmer (1998), Bullard, Bello, and Mallhotra (1998), and Shi and Hamnett (2002).

However, in the context of tourist cities, a number of studies find serious side effects accompanying an overgrowth of tourism, which is driven by foreign investment. Economic side effects, such as leakages, increased costs of living, and asset bubbles, are documented in Copeland (1991), Wilkinson (1999), Scheyvens and Momsen (2008), Potter (1993, p. 102), Hoti, McAleer, and Shareef (2005), Harrison (2003, p. 7), Chand (2003), Sheng and Tsui (2009a,c), Mowforth and Munt (2003, p. 273), and Croes (2006). Environmental side effects, such as air pollution, noise pollution, and overuse of natural resources, are analyzed in Briassoulis (2002), Wilkinson (1999), Sheng and Tsui (2010), Liu and Jenkins (1996, p. 113), and Gössling (2001). Social side effects, such as increased crime, social polarization, and cultural alienation are illustrated in Shaw and Shaw (1999), Carbone (2005), Sheng (in press-a,b), Scheyvens and Momsen (2008), Ghosh, Siddique, and Gabbay (2003), Williams and Hall (2000, 2002), Gössling and Schulz (2005), and Stonich (2003).

To address the side effects from foreign investment at its root, the author, by focusing on the different preferences of foreign investors and host communities, conducts a political-economic analysis of tourist cities to illustrate how massive inflows of foreign capital may cause serious social–environmental side effects, in addition to the economic boom, and how the interests of foreign investors and host communities might diverge in the presence of significant side effects. The author focuses specifically on a city's degree of openness and shows, in detail, the rational preferences of host communities and foreign investors. In this paper, 'tourist city' refers to a city in which the tourism sector has a large or dominant share in the local economy, and where the host community is mainly a provider, but not a consumer, of tourism services. After theoretical modeling, the author presents a case study of Macao, a booming tourist city, which has experienced spectacular growth since its gaming sector was liberalized to foreign investors, but has also suffered from serious socio-environmental side effects. By critically reevaluating the negative impacts of massive foreign capital inflow in the case study, this paper tries to balance the prevailing views in the existing literature and to inspire city planners to formulate more comprehensive foreign investment policies.