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Institutions and Foreign Direct Investment: China *versus* the Rest of the World

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Summary. — Weak institutions impede foreign direction investment (FDI), yet China attracts massive FDI despite global media spotlighting its institutional infirmities. Standard institutional quality variables poorly track rapid transformations, like China' regime shift following Den Xiaoping's 1993 Southern Tour. Economy track record usefully augments these variables in such cases. Cross-country regressions controlling for institutional quality and economy track record reveal China's FDI inflow unexceptional. Rather, China's FDI inundation resembles analogous post-reform East Bloc events. Arguments that China's FDI inflow is inefficiently large because weak institutions deter domestic investment while special initiatives attract FDI are thus either unsupported or not unique to China.

Key words — institution, FDI, cross-country, China

1. INTRODUCTION

China now receives more foreign capital in the form of foreign direct investment (FDI) than any other country, despite ongoing, and sometimes vociferous criticism of the quality of its government in the foreign media. This is curious because FDI involves much irreversible fixed investment, which is sensitive to investors' perceptions of public policies and property rights. Does the quality of China's government explain its FDI allure, or is China's inflow of FDI in some sense "exceptional" given the quality of its government?

This question has broad implications. The development literature shows financial development, investment, and thus growth depending critically on the construction and maintenance of sound institutions—fundamental tasks of government and defining norms of "good government." FDI can be less affected by institutional deficiencies than domestic investment if foreign investors have better access to capital, or backing from their home governments in protecting their property rights. In such situations, FDI can serve a critical development role. Of course, arguments to the contrary are also plausible, for foreign investors can confront information asymmetries and discriminatory sentiments. Hence this paper has multiple objectives. On a broad level, it explores the relationships between various aspects of government quality and inward FDI. On a country-specific level, it explores, within the context of such relationships, possible differences between FDI inflows to China and other countries at similar levels of development (as captured by *per capita* GDP).

We first show how FDI inflows correlate across countries with three key dimensions of "good government." These are

1. *The general quality of government*. To measure this, we use appraisals of official respect for private property rights and freedom from official corruption.
2. *The strength of constraints on executive power*. Here again we use appraisals, but focusing specifically on the freedom of action the country's institutions accord its head of government. Intuitively, constraints on executive power prevent a country's head of government from ruling by decree, arbitrarily nullifying or modifying contracts or property rights, and capriciously altering the rules of the economic game in other ways. If executive actions hinge on legislatures being consulted and court rulings being sought amid an open competition for the right to govern, a country's future policy direction is less likely to be arbitrary and opportunistic.
3. *The government's track record*. A government that has overseen more impressive economic growth in the past is likely to draw more FDI than other countries with similarly

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appraised institutions. We therefore consider past economic growth as an implicit measure of government track record.

Within this framework, we show that FDI inflow correlates with a country's economic growth track record, both its magnitude and stability, and with its general institutional quality, as captured by the "rule of law." We find no China effect, for China dummies are insignificant—as both intercept adjusters and slop shifters for institutional quality variables. We confirm an FDI inflow surge into China following a marked regime change in 1993, but the effect readily fades with time, and a similar pattern is evident in Eastern Bloc transition economies. Any apparently anomalous "China effect" is readily explained by conditioning FDI inflow on track record in sustaining past growth, as well as obvious controls for log population size, adults as a fraction of total population, trade over GDP, exchange rates, and time dummies.

We surmise three conclusions from our findings:

1. High quality government attracts FDI. The most significant such qualities are respect for the "rule of law" and a solid track record in overseeing strong and stable economic growth. We find that "limits" on "executive power" matter less clearly, perhaps reflecting difficulties in quantifying that variable or an unstable relationship with FDI.
2. China's large FDI inflow is not mysterious. Its high level is concordant with its growth track record and its size, demographic appeal, openness, *etc*. The institutional variables are not important in explaining China's high FDI inflow, because China's institutions are rated only slightly higher than those of other countries at similar *per capita* GDP levels.
3. These results suggest that China's FDI inflow is not abnormally large. In particular, it does not accord with China's pro-inward FDI policies letting foreigners grab excessive shares of China's investment opportunities while China's poor institutions discourage domestic capital formation. Or, if such a phenomenon is present, it is also present in enough other countries to render Chinese data non-anomalous.

The next section motivates our research question. Section three describes our general views on inward FDI and the quality of governments and institutions. Section 4 reports the empirical tests that educe our conclusions. Section 5 uses these results to understand China's high FDI inflows relative to those into countries with comparable incomes. Section 6 discusses the issues regarding the institutional variables and their effects on regression explaining inward FDI. Section 7 concludes that "too much" FDI is not flowing into China.

2. ISSUES

The importance of sound institutions to economic development has now received wisdom. Solid property rights protection and respect for the rule of the law are viewed as the basic factors that determine macroeconomic stability, capital market development, business sector development, and investment in innovation—see La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997, 1998, Acemoglu, Johnson, Robinson,& Thaicharoen, 2003, Durnev, Li, Morck,& Yeung, 2004, Acemoglu, Johnsn, & Robinson, 2005, and many others. The successful development and maintenance of sound institutions are therefore now seen as a critical function of government; indeed, as a fundamental test of "good government."

From this perspective China's economic growth seems a puzzle. China features a one party political monopoly. By most reckoning, democracy, and political transparency are not integral to the Chinese polity. Stories of corruption, scandals, and embezzlement starring government bureaucrats, bank executives, and corporate insiders contribute to a general perception of weak property rights. More formal evaluations of the quality of Chinese institutions concur with these impressions.

Table 1 shows China's "rule of law" exceeding levels in both the former Eastern Bloc and Latin America, though its score on corruption is weaker. But China's growth outpaces both these regions. This success understandably draws economists, such as Allen, Qian, and Qian (2005), and others, to envision a "Chinese model" of development that permits vigorous growth despite feeble institutions.

But Table 1 also sounds a note of caution. China's *per capita* GDP is markedly lower than the averages for either the Eastern

Table 1. *Key statistics for China, the Former Eastern Bloc, and Latin America. Figures are averages over 1993 through 2003, and across all countries in Latin American or the former Eastern Bloc*

	China	Former Eastern Bloc	Latin American
Economic performance			
Per capita GDP (US$)	761.8	2251.9	2923.8
Average annual GDP growth	8.4%	2.7%	0.7%
Foreign investment			
Inward FDI *per capita* (US$)	$34.4	$89.6	$87.3
FDI/GDP	4.7%	4.3%	3.1%
Institutional development			
Respect for the rule of law	4.9	4.5	3.1
Freedom from corruption	2.5	3.3	2.9
Responsible government	−7.0	3.0	7.6
Constraints on executive power	3.0	4.4	6.1

"*Respect for the rule of law*" is an ICRG survey result gauging the state of law and order in each country. It ranges from 1 to 6, with higher values connoting greater general respect for the rule of law. It contains a law component, which captures the strength and impartiality of the legal and political establishment in judicial matters, and an order component, which captures the extent to which residents of a country accept established legal and political institutions as the sole legitimate way to make and implement laws and to adjudicate disputes. We report the average of the variable from 1993 to 2002.

We also adopt International Country Risk Guide's corruption index as our "*freedom from corruption*" index; this measure is most commonly used in the related economics literature, and also has the widest coverage among standard corruption indices. This variable captures the likelihood that high government officials demand special payments, and the extent to which illegal payments are expected throughout low levels of government. In addition to bringing consistency with the previous studies, the broad coverage of countries preserves our sample size. The index takes values ranging from zero (most corrupt) to six (least corrupt); and so falls with rising corruption.

"*Responsible government*" is constructed from the Polity IV database and rates each country on a democracy–autocracy scale. The database has an autocracy variable ranging from 0 to 10, with a larger number indicating a more autocratic government. It also has analogous democracy index ranges from 0 to 10, but with a larger number indicating more democratic government. Our *responsible government* variable is the democracy index minus the autocracy index, a measure called *polity2* in the database. It captures the extent to which a political regime is responsible to its people, the larger the number the stronger the democratic checks on the political system.

"*Constraints on executive power*" is also from the Polity IV database, and ranges from 1 to 7 with higher values indicating stronger barriers to political entry (monarchy to dictatorship to open entry), the nature of political transitions (orderly or military), and the selection of successors (genetics to appointment to open election).