Partnering with the State: Historical Legacies, the Local State Sector, and Foreign Direct Investment in China

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Partnering with the State: Historical Legacies, the Local State Sector, and Foreign Direct Investment in China

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ABSTRACT

How does the size of local state-owned sector affect the flow of foreign direct investment (FDI) to that region? Using an original county-level dataset for China's Yangtze Delta Region, this article finds that counties inheriting a larger state-owned sector from the planned-economy era have attracted more FDI since the outset of the market reform. The article argues that early foreign investors tended to invest in locales with a robust state sector to build joint ventures with local state-owned firms, as doing so helped them satisfy state regulations and reduce various political and market risks. The legacies of the planned economy also shaped local states' preferences, leading to persistent variations in local economic structure. An instrumental variable analysis suggests that the association is likely causal.

Introduction

Foreign direct investment (FDI) plays an important role in China's economic development. While Chinese legal protection of private business is far from perfect, China has been among the top host countries for foreign investment since its accession to the World Trade Organization (WTO) in 2001, surpassing many developing or developed countries with comparable market size. In 2012, China became the greatest recipient country of FDI, surpassing the United States. Many scholarly works have focused on the impact on China's social and political institutions. Few, however, have discussed how local conditions shaped the ways in which foreign investment entered China in the first place.

In fact, huge geographic variations exist in terms of the distribution of foreign investment within China. The most striking variation is between Jiangsu and Zhejiang, two adjacent coastal provinces that are to the north and the south of Shanghai, respectively. As Yasheng Huang writes, the two countries are the most important destinations for FDI in China. The Yangtze Delta Region, which includes these two provinces, accounts for approximately 35% of China's FDI inflows. In contrast, the inland provinces such as Henan and Anhui, which lack a strong state-owned sector, have received much less FDI. This suggests that local state-owned firms played a crucial role in attracting foreign investment to China.

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provinces present an opportunity to conduct the ‘most similar case’ comparison.⁵ The two provinces share a common regional history and culture, an equivalent level of per capita GDP, income, and infrastructure, and the same proximity to Shanghai. Jiangsu however attracted US$ 35.8 billion FDI in 2012, while Zhejiang attracted US$ 13 billion.⁶ Why would a locality attract 2.8 times as much FDI as another so nearby and so similar? What local conditions contribute to such difference?

This article develops an argument that a historical legacy from the socialist era drives the difference. The root of the regional gap lies in the fact that Jiangsu inherited a much larger state sector than Zhejiang at the outset of market reform. The robust state sector in Jiangsu provided a fertile ground for foreign investment in the 1980s, when the Chinese state required foreign investors to form equity joint ventures with Chinese firms. Partnership with local state-owned firms also helped reduce market and political risks for foreign investors. The gap in the size of state sector also contributed to differential official incentives in the two provinces, cultivating a friendlier environment for domestic private business in Zhejiang than that in Jiangsu, forcing private business in Jiangsu to seek foreign partners to improve their market status. The initial difference in ownership structure launched the two provinces into divergent paths of development, and the initial differences in policy practices regarding firms of various ownership forms have been institutionalized, such that they persist today.

To test this argument, the author constructed an original dataset of 136 counties in China’s Yangtze Delta Region (YDR). YDR is a nationally planned economic zone on the east coast, including the southern part of Jiangsu, the northern part of Zhejiang, and Shanghai. While the region only accounts for 2.1% of China’s land area, it generates over 20% of China’s GDP and hosts more than 50% of finalized FDI in China. The analysis shows that YDR counties with a larger state sector in the late 1980s attracted more FDI in the early 1990s and that this pattern has remained largely unchanged three decades later.

To further identify the causal relationship, the author instruments the size of each county’s state sector at the beginning of the reform by each county’s distance to Taipei, the capital city of Taiwan. Counties located closer to Taiwan faced imminent threat of military conflict during the cross-strait standoff between China and Taiwan before 1979, and therefore received little state-directed investment under the centrally planned economic system. The result of the instrumental variable analysis suggests that the relationship between the size of the local state sector and foreign investment is likely causal.

This is not the first paper that examines the determinants of FDI’s locational choice in China or other countries. Yasheng Huang, for example, argues that ownership bias against the domestic private sector explains the regional concentration of FDI in China; in localities where the state discriminates against the private sector, private entrepreneurs seek alliance with foreign investors to increase their bargaining power.⁷ This article builds on Huang’s argument in two ways. First, it suggests that the ownership bias in certain places was a legacy of state investment during the socialist, planned-economy era. Officials in places that inherited a strong state sector did not have the same incentives as officials elsewhere, who depended on the domestic private sector to generate growth and revenue to fulfill evaluation targets.⁸ The second way in which this article builds on Huang’s argument is that it highlights the important role of state regulation in shaping regional distribution of FDI. Because the Chinese state wanted to reap the benefits of foreign investment while retaining control of the economy, the central government required foreign investors to form equity joint ventures with local firms.⁹ As shown in the article, this regulation

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⁵ Huang, ‘Ownership biases and FDI in China’.
⁶ Jiangsu’s 2012 per capita FDI is about 1.9 times of that of Zhejiang (author’s data).
⁷ Huang, ‘Ownership biases and FDI in China’.
⁹ Pearson, Joint Ventures in the People’s Republic of China.
propelled foreign investors to enter regions with a more robust manufacturing sector, which was overwhelmingly state owned during the early days of market reform.

More broadly, this article contributes to the discussion on investment and development in the environment with weak property rights protection. Scholars in the institutionalist tradition posit that securing property rights protection is a prerequisite for economic growth.10 Employing cross-country data, scholars of international political economy also find that foreign investment tends to thrive in countries with well-specified property rights and inclusive institutions.11 But scholars of developmental states argue that authoritarian states can also be conducive to growth, as authoritarian rulers make pro-growth policies without being subject to redistributive pressure from the population.12 Yet the developmental state model does not provide much leverage in explaining within-country variations. This article addresses this gap by showing that a locality’s historical endowment in ownership structure shapes territorial administrations’ ability to promote foreign investment. By doing so, this article contributes to the comparative discussion on how various local arrangements support economic prosperity in states with weak rule of law or contract enforcement.13 More broadly, it also contributes a large body of comparative scholarship that looks at the effect of socialist legacies in former communist or transitional states.14 Finally, it also joins an emerging literature that explores the contemporary consequences of historical legacies in China.15

The remainder of the paper is organized as follows. Section 2 introduces background information, including China’s policy on equity joint venture when it began to open its economy. Section 3 introduces data and baseline analysis. Section 4 describes the instrumental analysis, and Section 5 concludes the paper.

Socialist Legacies, Local Environment, and Foreign Direct Investment in China

State and State Regulations in the Early Reform Period

When China opened its market to foreign investors in the late 1970s and early 1980s, there were debates about whether the influx of foreign capital would erode the economic

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foundation of the socialist state and threaten the power of the Chinese Communist Party (CCP).\textsuperscript{16} Until then, the Chinese economy had been under tight control of the state, through a centrally planned economic system.\textsuperscript{17} State employment was almost universal in the cities, and through it, the CCP controlled various segments of society. Enterprises run by foreigners were not only inconsistent with the then dominant Marxist ideology; it would also crack a hole in the tightly knit party-state system. Pearson points out a dilemma Chinese leaders faced at the time: on the one hand, they wanted to utilize foreign capital and technology to restore and rejuvenate the national economy; on the other hand, the party did not want to give up its control over the economy and the society.\textsuperscript{18} The Party adopted an equity joint venture between foreign investors and domestic firms as a solution to this dilemma.

In July 1979, the Chinese government implemented the Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures.\textsuperscript{19} The law gave legal recognition to foreign investment in China. Its first article required foreign investors in China to form equity joint ventures with ‘Chinese firms, enterprises, or other economic organizations.’ Article 5 elaborated that foreign investors would provide capital and technology, while the Chinese partners’ share in the joint venture could take the form of labor or use right of sites. The law also wrote that the managerial personnel of the joint venture should come from both Chinese and foreign sides, and the chairperson of the board must be Chinese (Article 6). Despite these stringent requirements, foreign investment began to flow into China under the law. Scholars argue that the sheer size of the potential market increased the bargaining power of the Chinese government, allowing such strict regulations on foreign capital that would otherwise be rejected by investors elsewhere.\textsuperscript{20}

The requirement for equity joint venture was loosened in 1986, when the Chinese government implemented the Law on Foreign-Capital Enterprises, allowing firms wholly owned by foreign investors into China.\textsuperscript{21} But equity joint ventures remained the major form by which foreign investment entered China. The number of wholly owned foreign firms operating in China did not surpass the number of equity joint ventures until 1998, and the amount of finalized investment by wholly owned foreign firms did not surpass the amount by equity joint ventures until two years later, in 2000.\textsuperscript{22}

Early investors were forced to seek local partners when entering China. Private firms were not an option as the domestic private sector was essentially nonexistent before the market reform.\textsuperscript{23} The CCP only officially recognized the need to develop and protect domestic private business with the thirteenth party congress, in 1987, and private business did not become constitutionally legal in China until 1988.\textsuperscript{24} Even after that, the ideological debates following the Tiananmen incident in 1989 shed considerable uncertainty on the fate of private business. Such uncertainty did not fully dissipate until 1992, with Deng’s Southern Tour and the fourteenth party congress. In the early days of the reform, most domestic private business took the form of small-scale, self-employed entrepreneurs (i.e. getihu, entities with no more than seven employees).\textsuperscript{25} These small-scale private


\textsuperscript{18}Pearson, \textit{Joint Ventures in the People’s Republic of China}.

\textsuperscript{19}See the Ministry of Commerce’s online archive for the original text of the Law of the People’s Republic of China on Chinese-Foreign Equity Joint Ventures (in Chinese), accessed December 28, 2017, http://history.mofcom.gov.cn/?newchina=%E7%AC%AC%E4%B8%80%E9%83%A8%E5%88%A9%E7%94%A8%E5%A4%96%E8%B5%84%E6%B3%95%E5%BE%B8.

\textsuperscript{20}Pearson, \textit{Joint Ventures in the People’s Republic of China}, p. 20.


\textsuperscript{22}Statistics of Ministry of Commerce, People’s Republic of China.

\textsuperscript{23}Zhang, Liu and Shih argue that private business existed even during the heyday of the planned economy under the informal protection of local officials, but mostly in underground form. See Zhang, Liu and Shih, ‘Guerrilla Capitalism.’

\textsuperscript{24}Clarke, Murrell and Whiting, ‘The role of law in China’s economic development’.

\textsuperscript{25}Huang, ‘Ownership biases and FDI in China’, p. 31.
entities were limited in their capacity to mobilize capital and resources. Their existence relied heavily on the protection and patronage of local state actors.\textsuperscript{26}

Local state-owned enterprises possessed more resources than private entities. Having received state support during the planned-era, they often had well-equipped production sites and experienced workers and managers. More importantly, they also had preferred access to production materials, many of which the state continued to ration even in the early 1990s.\textsuperscript{27} Scholars have noted that the early waves of foreign investors mostly chose to invest in the manufacturing sector.\textsuperscript{28} Setting up construction facilities often required substantial effort in mobilizing capital, labor, and other resources. In addition, foreign firms who had few local connections had difficulty accessing upstream suppliers and downstream customers.\textsuperscript{29} Partnering with local state-owned enterprises provided a solution to these problems. In an interview, a Renmin University professor who conducted fieldwork in southern Jiangsu in the early 1990s recalled that foreign investors encountered various difficulties in getting permissions to do business in China, finding the appropriate sites (or land) for their operations, assembling factories, and recruiting workers, and that local state-owned firms provided invaluable assistance in these aspects.\textsuperscript{30}

**The Role of Local State Firms in Reducing Market and Political Risks**

Forming equity joint ventures with local state firms not only helped foreign investors bypass state regulation and overcome difficulties in starting businesses in China, but it also helped reduce market and political risks. Weak rule of law and lack of contract enforcement posed a significant market risk. Corrupt local government also posed a significant political risk, and the changing policies of the central government did as well.

Due to the lack of contract enforcement, it was normal during the early days of the reform for buyers to make a purchase and then refuse to pay or for borrowers to take out loans and then default on the loan. Such opportunistic behaviors, which were often left unpunished, significantly reduced private entrepreneurs’ incentive to invest.\textsuperscript{31} Domestic private firms could turn to connected local officials for protection, but foreign investors did not have the personal connections this would require.\textsuperscript{32} Partnering with state-owned enterprises provided these needed connections. Leaders of state-owned firms are members of the nomenklatura and are directly appointed by the party.\textsuperscript{33} They enjoy high rank within the local bureaucracy and many have worked in the local state apparatus.\textsuperscript{34} Thus they could deter opportunists from taking advantage of the firms and gain selective protection of property rights.\textsuperscript{35} When commercial disputes arose, investors could mobilize their state connections to navigate the legal system and push for a favorable outcome.\textsuperscript{36}

Partnering with state-owned ventures also provided protection from rent seeking officials, who may demand bribes, ad hoc taxes, informal payments, and sometimes even outright confiscate the

\begin{flushright}
\textsuperscript{26}Qi Zhang and Mingxing Liu, *Revolutionary Legacy, Power Structure, and Grassroots Capitalism Under the Red Flag in China* (New York: Cambridge University Press, 2019).
\textsuperscript{29}Steinfeld, ‘China’s shallow integration’, p. 1975.
\textsuperscript{30}Interview, Renmin University professor, Beijing, December 2, 2017.
\textsuperscript{32}Wang, *Tying the Autocrat’s Hands*.
\textsuperscript{34}The leader of a city-owned enterprise hold the rank of department chief (chuji), which is equivalent to the rank of the head of a city bureau.
\textsuperscript{35}Hou, *Participatory Autocracy*.
\end{flushright}
assets of private businesses. Private entrepreneurs adopt various strategies to avoid state predation, such as seeking office in the local legislature or developing informal ties with high-level leaders. But foreign investors are not eligible for local legislative seats and often lack access to leaders in power. Partnering with local state-owned firms could help deter predation. The equity joint venture turns the state-owned firms (and in turn, the local state) into stakeholders, who would benefit, in the forms of profits and taxes, from the prosperity of the joint ventures with foreign investors. This arrangement creates a ‘veto point’ within the local government that can deter potential predatory actions by local officials. Scholars have long noted the fact that the Chinese bureaucracy is far from monolithic. Forming an alliance with one segment of the local bureaucracy reduces the risk of being expropriated by the rest.

Forging a partnership with the local state also reduces policy risks. China’s reform and opening-up have been marked by policy experimentation, and the rise and fall of central leaders affect the country’s economic policies. Sudden and frequent policy shifts create uncertainties, and are not conducive to the thriving of private business. The brief move towards conservatism after the Tiananmen incident is one example of such a shift. Regional governments who are given enough autonomy in local economic issues sometimes would resist the central government’s policies if they believe they could harm local interests. They devise local policies or practices to offset the impact of central policy change. Such protection can be crucial to the survival of private business.

These factors not only explain why foreign investors chose to partner with local state-owned firms in the first place, but also help explain why the practice persisted even after the Chinese government allowed wholly foreign-owned enterprises into China. Having local state-owned firms (and in turn, the local state) as a business partner helps foreign investors survive and succeed in a country with substantial market and political risks.

The Initial Local Endowment Shapes Official Strategies

As China’s market reform deepened in the early 21st century, the state sector in the coastal provinces gradually shrank and the private sector became dominant. This poses the question as to why have the regional variations of foreign investment persisted even after the local state sector declined. A simple economic explanation is path dependence: latecomers tend to go to places that already have many foreign firms, where amenities and foreign communities that make life and investment easier in China are already established. More subtly, the variations in the local ownership structure may have helped reinforce the initial local policy preferences.

The initial size of the local state sector led to the creation of different business environment across localities. Huang documents that Zhejiang officials are more attentive to the domestic private sector than Jiangsu officials. In Jiangsu, local state offered better service and protection to foreign private business than domestic private business, and private business owners in Jiangsu actually turned to foreign capital for some measure of such protection and advantage. An important cause for such different, as documented in Whiting’s careful comparative case studies,

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37 Hou, Participatory Autocracy.
42 Naughton, Growing out of the Plan; Whiting, Power and Wealth in Rural China.
43 Huang, ‘Ownership biases and FDI in China’.
44 Huang, ‘One country, two systems’.

is that Zhejiang officials had very few local state-owned firms from which to extract revenue in the 1980s.\textsuperscript{45} To fulfill the cadre evaluation targets, Zhejiang officials worked hard to develop the local private sector, which resulted in an environment more conducive to the growth of domestic private business. In contrast, Jiangsu officials, who enjoyed a rich tax base through state and collective-owned firms, paid less attention to promoting private domestic businesses. When the banking and state sector reform led to the decline of local public and collective-owned firms in the mid-1990s, the local tax base in Jiangsu shifted to foreign investment. The cadre evaluation system pushed revenue-starved officials to become more attentive to foreign investors. These local officials make preferential industrial policies, handout subsidies, streamline the regulatory process, and build cleaner courts to attract foreign investors.\textsuperscript{46} The opening of the China-Singapore Suzhou Industrial Park in 1994 further enhanced foreign capital’s dominant role in the local economy in Jiangsu, institutionalizing local policy preference for foreign investment through the creation of the national special policy zone.

The initial difference in the two provinces’ economic policies stemmed from local officials’ expedient responses to the cadre evaluation system based on the different economic endowment they inherited from the socialist era. This difference gradually deepened and institutionalized, and in turn, affected the growth of domestic and foreign firms in the two provinces throughout the reform era. This has created a wide distinction in each locality’s ability to attract FDI.

**Testable Hypotheses**

The purpose of this article is to explain the variations of FDI across different localities (and in particular, within the Yangtze Delta Region). The regional differences suggest that the socialist legacy of local state sector played an important role in shaping the distribution of FDI in China. The size of the local state sector inherited from the socialist era influences inflow of FDI through regulatory and local institutional mechanisms. With respect to regulation, having a robust state sector provided fertile ground for forming equity joint ventures, which helped foreign investors circumvent state regulations making market entry difficult and to gain access to assistance and protection from the local state. With respect to local institution environment, the size of the local state sector at the beginning of the reform also structured officials’ attitude and behavior toward business of different ownership forms. Localities that inherited a strong state sector are less friendly to the domestic private sector, prompting private entrepreneurs to rely on foreign partners to improve their market status. Such policy differences gradually deepen, reinforce, and institutionalize, causing long-term differences in local developmental patterns.

The author derives two testable hypotheses from this argument:

**Hypothesis 1:** Places that inherited a strong state sector tended to attract more FDI at the beginning of the market reform.

**Hypothesis 2:** The effect of state sector on FDI persists even after the decline of the state sector.

**Empirical Setting**

To test the hypotheses, this study explores the variations in FDI distribution within China’s Yangtze Delta Region. The region is located on China’s east coast where the Yangtze River flows into the

\textsuperscript{45}Whiting, *Power and Wealth in Rural China.*

Pacific Ocean, with Shanghai being at the center. It is one of China’s most developed and
globalized regions. Despite only accounting for 2.1% of China’s land area, the region produces
more than 20% of the country’s GDP, participates in 48% of international trade,\(^{47}\) and hosts 51% of
all FDI flows into China.\(^{48}\)

This article draws on an original dataset that includes 136 counties and districts from 17 cities in
the region: eight in the northern Jiangsu Province (Nanjing, Suzhou, Wuxi, Yangzhou, Taizhou,
Nantong, Changzhou and Zhenjiang) and nine in the southern Zhejiang Province (Hangzhou,
Ningbo, Huzhou, Jiaxing, Shaoxing, Taizhou, Zhoushan, Jinhua, and Wenzhou). Shanghai is
excluded from the sample because unlike the other cities, it has a provincial-level administrative
status and this status brings unparalleled advantages in attracting foreign investment.

This sample has several advantages. First, it is a relatively small region that attracts more than half of
FDI flow into China. Such geographical proximity allows the author to make controlled comparisons:
localities close to each other share similarities in various dimensions that one might consider to be
crucial determinants of foreign investment, ranging from obvious factors such as the level of economic
development, supply of labor, infrastructure, and distance to the international market to less obvious
ones such as climate, dialects, and local culture.\(^{49}\) Testing the hypotheses with a national sample of
counties would face the challenge of holding these less measurable factors constant across regions. In
addition, the use of this subnational sample automatically holds constant numerous country-level
factors that would affect FDI, such as trade agreements, investment barriers, and currency exchange
rate.\(^{50}\) Besides, the sample counties are all located in the Yangtze Delta metropolitan area, the
boundary of which was clearly stipulated by the Chinese State Council in the Yangtze Delta
Economic Zone Development Plan.\(^{51}\) The shared memberships in a nationally recognized economic
zone hold equal two other important factors among the units: the preferential policies from the central
government and the overall visibility of the locale to foreign investors.

Second, the localities within the YDR have demonstrated enormous variations in their ability to
attract FDI. In 2012, for example, Kunshan (a county within the city of Suzhou) attracted $1.8 billion
USD of FDI (or $1077 USD per capita), whereas Yongkang (a county 300 km south of Kunshan) only
attracted $8.1 million USD (or $11 USD per capita).\(^{52}\)

Finally, the local state sector in different localities in YDR varied significantly at the outset of the
market reform. Scholars have noted the prominence of public and collective-owned firms in
southern Jiangsu and the lack thereof in Zhejiang, particularly in its southern part.\(^{53}\) Such dramatic
variations within a small and otherwise homogenous region provide a rare opportunity to test the
hypotheses.

**Empirical Strategy**

**Dependent Variable**

The main dependent variable is the per capita finalized FDI of YDR counties in the early years of
reform. This article uses the average of per capita FDI from 1991 to 1992, taking a two-year average

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\(^{49}\)All counties in the sample are within a 5-h drive of Shanghai.


\(^{51}\)See, Chinese State Council, ‘Yangtze Delta Economic Zone Development Plan (in Chinese)’, China.com, June 22, 2010, accessed August 8, 2015, [http://www.china.com.cn/policy/txt/2010-06/22/content_20320273.htm](http://www.china.com.cn/policy/txt/2010-06/22/content_20320273.htm). Wenzhou was not listed as a member city in the 2010 document, but I include it in the sample because of its geographic proximity to the region and of its economic importance. The later wave of national plan also included Wenzhou as a member city of the region.

\(^{52}\)All FDI measures in this study are the finalized amount, not the contractual amount.

\(^{53}\)For example, Whiting, *Power and Wealth in Rural China*; Huang, ‘Ownership biases and FDI in China’.
to further smooth out potential noises introduced by a large investment (or lack thereof) in a single year. The author chooses these 2 years for three reasons. First, although FDI entered China as early as the 1980s, the initial investors included a small group of overseas Chinese. These early investors chose the location of their investment mostly based on idiosyncratic personal ties or hometown favoritism. The amount of investment for localities, therefore, demonstrated huge year-to-year fluctuation because of these ad hoc incidents of investment. The Tiananmen incident in 1989 and the foreign sanctions following the incident also significantly lowered foreign investment in 1989 and 1990, making these 2-years atypical. Second, many cities did not report their FDI receipt in the 1980s; the first year that all the counties and districts in the sample reported was 1991. Finally, as mentioned earlier, there were ideological debates within the CCP elites on the course of the reform prior to 1992. The debate was settled only after Deng Xiaoping’s Southern Tour and local governments became fervent in attracting foreign investment (including the opening of the China-Singapore Suzhou Industrial Park in 1994). Before that, most local officials were observing central signals and were less proactive in promoting private or foreign investment. Therefore, the variations in FDI in 1991–2 reflect the intention of foreign investors, whereas data from the years that immediately follow would reflect the effort by local governments in attracting investment.

Key Explanatory Variable

The main explanatory variable is the size of the local state sector. This article uses two measures for this variable. The first is the per capita industrial output by the local state-owned enterprises (LSOEs). This includes the output by the public-owned enterprises (全民所有制企业), and the output by the collective-owned enterprises (集体所有制企业). Extant studies suggest a close connection between the collective-owned enterprises and the Chinese local government. The article uses the sum of the public-owned and collective-owned enterprises in the baseline models, and presents additional results when they are coded independently.

The second measure is the share of industrial output by LSOEs in total industrial output. If the per capita measure reflects the level of LSOEs’ activities, then this measure captures the overall influence of the state sector in the local economy. It is possible that a locale with a high level of per capita LSOE output also has a vibrant domestic private sector, and therefore the state sector might only account for a small share of the total industrial output. The other concern is that the sum of production for public and collective owned firms might represent the overall industrial capacity of a county, and foreign firms would naturally choose places with a stronger industrial base. Accounting for the share of output by LSOEs addresses these two concerns. Figure 1 shows that the two measures are highly correlated: places where LSOEs dominate the local economy also tend to have a higher per capita LSOE output. The two measures therefore should yield similar results when estimated in separate models.

For both the per capita and the share measures, the author uses a three-year average of the data from 1988 to 1990. The author purposefully chooses data from the years that predated the outcome variable (1991–92) in order to mitigate concerns about endogeneity.

Control Variables

The analysis also includes a battery of control variables. The first few are local socio-economic indicators that might affect foreign investors’ decision to enter a locale, including per capita GDP

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(1990), per capita fiscal expenditure (1990), per capita trade volume (1990), and per capita volume of cargo transportation (1990). Because all the variables so far are measured in per capita, the author also includes the size of population (1990) to control for the potential effect of economic scale, which also serves as a proxy for labor supply. For all the continuous variables, the author takes the natural logarithm on the original values to ensure the normality of the data distribution.

Two variables account for policy factors from higher levels of government. The first is a dummy variable indicating whether the county is located under a sub-provincial city (副省级城市). The sample has three sub-provincial cities: Nanjing, Hangzhou, and Ningbo. These cities enjoy legislative and regulatory power that other Chinese cities do not have. The second is a dummy variable indicating whether the county is one of the 14 ‘coastal open cities (沿海开放城市)’ designated by the Chinese State Council in 1984. These cities have more policy freedom in experimenting with business and trade practices with foreign countries than other cities. In the sample, three cities, Nantong, Ningbo, and Wenzhou, have this designation and are given a value of 1. Finally, the author also includes a provincial dummy that accounts for unobserved heterogeneities between Zhejiang and Jiangsu, such as provincial policies or provincial leader’s individual capabilities.

**Baseline Results**

Table 1 uses the first measure of the key explanatory variable—the per capita output by LSOEs—in all model specifications. Column 1 reports the model with only the key variable, and columns 2 and 3 report models that include the economic and the policy control variables, respectively. Columns 4 and 5 replicate the full model specification in column 3, and replace the key explanatory variable with the independent measures of output by public-owned enterprises and collective-owned enterprises, respectively.

The coefficient for the per capita output by LSOE is positive and statistically significant across all model specifications (columns 1 to 3). Results from columns 4 and 5 further suggest that this association holds among the two subgroups of LSOEs: a higher level of per capita output by public-owned enterprises or by collective-owned enterprises is also associated with a higher volume of per capita FDI, and this positive association is more salient in the case of collective-owned enterprises, which was the predominant form of local economy in Jiangsu.56

Table 2 uses the share of output by LSOEs in total industrial output as the key explanatory variable. Like Table 1, columns 1 to 3 each report the model with only the key variable and the models with the economic and policy control included. In all three models, the coefficient for the share of LSOE output is positive and statistically significant.

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56 *Whiting, Power and Wealth in Rural China.*
In Tables 1 and 2, the coefficients for population size and coastal open cities are consistently positive and significant in most model specifications. This suggests that early foreign investors...
tended to invest in counties and districts with relatively large population size and those under the designated open cities by the central government.

Because the 136 sample counties are in two provinces (Jiangsu and Zhejiang), one might question whether provincial-level factors, such as provincial policies or provincial leader’s individual capabilities might affect the FDI distribution. To account for such factors, the author includes a provincial dummy in the full model specification for both measures of LSOEs, and the results are presented in Table 3. The coefficients for both measures remain positive and statistically significant, and the coefficient for the per capita output barely changes from the original one in Model 3 Table 1. While Jiangsu and Zhejiang demonstrate substantial difference in their overall policy preference on foreign and domestic private investment today, this difference did not emerge until the late stages of the reform, when the local governments began to make systematic economic policies to strengthen the existing comparative advantages. This result is consistent with our first hypothesis that a robust state sector helped attract FDI at the outset of the market reform.

The Persistence of the Initial Pattern

The second hypothesis is that the initial variation in local conditions has a persistent effect over subsequent inflow of FDI through changing the local institutional environment. Figure 2 shows that the counties that attracted the most FDI in the early 1990s continued to attract the most in 2012, and no counties that were not top performers in the earlier period rose by 2012. This persistence was expected even though state-owned enterprises have mostly retreated from economic activities in the region.57

Table 3. Local State Sector and FDI Inflow: Including Provincial Effect

<table>
<thead>
<tr>
<th>Dependent variable: Per Capita FDI (1991 and 92 average)</th>
<th>(1)</th>
<th>(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per Capita Output by LSOE</td>
<td>1.413***</td>
<td>1.775*</td>
</tr>
<tr>
<td>(0.324)</td>
<td>(0.980)</td>
<td></td>
</tr>
<tr>
<td>LSOE Output/Total Output</td>
<td>0.878</td>
<td>0.2871***</td>
</tr>
<tr>
<td>(0.650)</td>
<td>(0.499)</td>
<td></td>
</tr>
<tr>
<td>GDP Per Capita</td>
<td>0.878</td>
<td>0.2871***</td>
</tr>
<tr>
<td>(0.650)</td>
<td>(0.499)</td>
<td></td>
</tr>
<tr>
<td>Fiscal Expenditure Per Capita</td>
<td>-0.385</td>
<td>-0.167</td>
</tr>
<tr>
<td>(0.386)</td>
<td>(0.406)</td>
<td></td>
</tr>
<tr>
<td>Cargo Transportation Volume Per Capita</td>
<td>0.189</td>
<td>0.174</td>
</tr>
<tr>
<td>(0.131)</td>
<td>(0.140)</td>
<td></td>
</tr>
<tr>
<td>Population Size</td>
<td>0.588**</td>
<td>0.628**</td>
</tr>
<tr>
<td>(0.264)</td>
<td>(0.280)</td>
<td></td>
</tr>
<tr>
<td>Export Per Capita</td>
<td>-0.132</td>
<td>0.177</td>
</tr>
<tr>
<td>(0.209)</td>
<td>(0.205)</td>
<td></td>
</tr>
<tr>
<td>Coastal Open Cities</td>
<td>0.581**</td>
<td>0.731**</td>
</tr>
<tr>
<td>(0.266)</td>
<td>(0.280)</td>
<td></td>
</tr>
<tr>
<td>Sub-Provincial Cities</td>
<td>0.488**</td>
<td>0.332</td>
</tr>
<tr>
<td>(0.234)</td>
<td>(0.253)</td>
<td></td>
</tr>
<tr>
<td>Jiangsu Provincial Dummy</td>
<td>0.768***</td>
<td>0.728**</td>
</tr>
<tr>
<td>(0.240)</td>
<td>(0.338)</td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>-16.804***</td>
<td>-23.183***</td>
</tr>
<tr>
<td>(2.750)</td>
<td>(2.729)</td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>136</td>
<td>136</td>
</tr>
<tr>
<td>R2</td>
<td>0.758</td>
<td>0.729</td>
</tr>
<tr>
<td>Adjusted R2</td>
<td>0.741</td>
<td>0.709</td>
</tr>
<tr>
<td>Residual Std. Error (df = 126)</td>
<td>1.084</td>
<td>1.148</td>
</tr>
</tbody>
</table>

Note: *p < 0.1; **p < 0.05; ***p < 0.01

The reason the pattern persists is that FDI inflow is increasingly dependent on the past FDI stocks, and less on the LSOEs. There are various explanations that might account for this transition. The first is simply the scale effect, that places already with many foreign investors enjoy certain advantages (such as networks, reputations, and business opportunities) in bringing in new investors. The second is the role of local institutions. FDI tends to transform local institutions, because its incentivizes local officials to undertake market-oriented reforms, to build more effective courts, to adopt preferential industrial policies, and to reduce local corruptions, among many others. Localities that became dependent on foreign investment therefore adapt their local institutions in a way that allows them to retain or to attract more foreign investment.

In Table 4, the author runs the same specification as in Tables 1 and 2 using Model 3, but replace the outcome variable with the per capita FDI data from 2012. In columns 2 and 4, the author includes the provincial dummy into the specification to capture the institutional difference between the two provinces that are not captured in other control variables.

The results show that the coefficients for the LSOEs not only reduce in sizes, but also in their significant levels (i.e. the coefficient for the share of LSOEs is no longer significant at the 10% level), especially after including the provincial dummy (columns 2 and 4). This contrasts sharply with the results in Table 3, where the inclusion of the provincial dummy does not change the results to the same extent.

The comparison between this result and the baseline provides suggestive evidence that institutionalized factors captured by the provincial dummy played a more prominent role in determining the variations of FDI in 2012, whereas in the early 1990s the size of local state sector played a more important role (as shown by results in Table 3).

**Causal Identification: an Instrumental Variable Approach**

So far, this article has documented a positive association between the concentration of LSOEs and the FDI inflow in the initial stage of China’s market reform, and this association is robust to different ways of measuring the size of the local state sector and after accounting for various alternative explanations. This study also pays attention to the chronological order of the data for the outcome and explanatory variables, such that concerns about endogeneity would be minimal. Yet a cautious reader might still not be fully convinced, as unobservable factors may drive the association.

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An instrumental variable approach allows the author to further examine the causal relationship. A valid instrument should capture an exogenous variation that only affects the dependent variable through the endogenous regressor, not through other omitted variables or directly affect the dependent variable.\textsuperscript{59}

Valid instruments are often derived from natural or quasi-natural experiments in human history, such as the use of settler mortality rate as the instrument for the quality of early colonial institutions, or the use of distance to the ocean as an instrument for the historical intensity of slave trade in Africa.\textsuperscript{60}

In this study, the author instruments the explanatory variable — the size of the local state sector — by the sample counties’ distance to Taipei. This instrument captures the degree to which a locale in YDR was under military threat from Taiwan during the pre-reform era (1949–1978).

Taiwan is located about 600 km south to the YDR. In 1949, the Nationalist government lost the civil war to the Communists and retreated to the island. The two sides of the Taiwan Strait belonged to the different, hostile camps during the subsequent Cold War. The Nationalist government in Taiwan made the recovery of the Chinese mainland a top political priority. In the early 1950s, when mainland China’s air force was still in its nascence, the Taiwanese air force conducted numerous aerial bombings along the Chinese coastline. Beginning in the late 1950s, it began to intrude through flyover surveillance. The United States, which formed an official alliance with Taiwan and stationed military forces in Taiwan, played an important role in these activities. From 1949 to 1969, the Chinese mainland government issued 469 formal diplomatic protests to the United States regarding the latter’s intrusion into the Chinese air.\textsuperscript{61}

\begin{table}[h]
\centering
\caption{Local State Sector and FDI Inflow: Using the 2012 Data}
\begin{tabular}{lcccc}
\hline
 & \multicolumn{4}{c}{Dependent variable: Per Capita FDI (2012)} \\
 & (1) & (2) & (3) & (4) \\
\hline
Per Capita Output by LSOE & 1.621\textsuperscript{***} & 1.090\textsuperscript{***} &  & \\
 & (0.306) & (0.320) &  & \\
LSOE Output/Total Output &  & 3.332\textsuperscript{***} & 1.419 & \\
 &  & (0.674) & (0.927) & \\
GDP Per Capita & −0.165 & 0.023 & 1.908\textsuperscript{***} & 1.534\textsuperscript{***} \\
 & (0.662) & (0.626) & (0.468) & (0.471) \\
Fiscal Expenditure Per Capita & −0.821\textsuperscript{**} & −0.703* & −1.056\textsuperscript{**} & −0.896\textsuperscript{**} \\
 & (0.407) & (0.385) & (0.407) & (0.398) \\
Cargo Transportation Volume Per Capita & −0.077 & 0.089 & 0.045 & 0.105 \\
 & (0.133) & (0.133) & (0.143) & (0.140) \\
Population Size & 0.091 & 0.082 & 0.136 & 0.107 \\
 & (0.276) & (0.260) & (0.280) & (0.271) \\
Export Per Capita & −0.296 & −0.138 & 0.014 & 0.104 \\
 & (0.214) & (0.206) & (0.201) & (0.197) \\
Coastal Open Cities & −0.744\textsuperscript{***} & −0.682\textsuperscript{**} & −0.549 & −0.558\textsuperscript{**} \\
 & (0.278) & (0.263) & (0.280) & (0.271) \\
Sub-Provincial Cities & 1.085\textsuperscript{***} & 1.176\textsuperscript{***} & 0.927\textsuperscript{***} & 1.089\textsuperscript{***} \\
 & (0.252) & (0.239) & (0.255) & (0.253) \\
Jiangsu Provincial Dummy &  & 0.964\textsuperscript{***} &  & 0.969\textsuperscript{***} \\
 &  & (0.250) &  & (0.333) \\
Constant & −0.913 & −0.353 & −7.774\textsuperscript{***} & −5.109* \\
 & (2.906) & (2.743) & (2.575) & (2.656) \\
Observations & 120 & 120 & 120 & 120 \\
R2 & 0.604 & 0.651 & 0.593 & 0.622 \\
Adjusted R2 & 0.576 & 0.623 & 0.564 & 0.592 \\
Residual Std. Error & 1.064 & 1.003 & 1.079 & 1.044 \\
 & (df = 111) & (df = 110) & (df = 111) & (df = 110) \\
\hline
\end{tabular}
\textsuperscript{Note: *p < 0.1; **p < 0.05; ***p < 0.01}
\end{table}


\textsuperscript{61}How many invading aircrafts were taken down since the founding of PRC? (in Chinese), Tencent History, December 3, 2013, accessed August 27, 2015, \url{http://view.news.qq.com/a/20131203/011527.htm}. 

\[14\] X. MA
The counties close to Taiwan therefore became the frontier of national defense. They were under constant threat of bombing or aerial surveillance, and were also mobilized to prepare for direct military confrontation with the Nationalists. Before 1979, the official rhetoric of the mainland government was that the Chinese people were determined to ‘liberate Taiwan,’ whereas the Nationalist government in Taiwan also claimed to prepare for ‘recovering the mainland.’ Tensions eased in the 1980s.

The distance to Taipei measure captures the overall intensity of war threat a locality experienced during the cross-strait military standoff before the 1980s. The basic understanding is that those places that are closer to Taipei were under more imminent threats of military conflicts, and therefore had received little state investment during the planned-economy era (i.e. before the 1980s). Consequently, these places were endowed with a smaller state sector at the beginning with which foreign investors could form joint ventures when China opened its door to the outside world.

China scholars have documented that the cross-strait conflicts had significant economic implications. For example, during her fieldwork in the early 1990s, Whiting found that local officials in Southern Zhejiang (Wenzhou) were more incentivized to protect and encourage domestic private investment, whereas officials in Southern Jiangsu showed little motivation in promoting private business. She attributes such contrast to the fact that the two places had very different endowment at the beginning of the economic reform. Zhejiang, unlike Jiangsu, lacked state investment during the Maoist era because of the military threats from Taiwan, and the local officials who were under the pressure of cadre evaluation to fulfill the growth targets had no other choice but to develop the local private sector. Whiting’s meticulous case studies provide strong validity to the causal story behind the instrument.

Figure 3 shows the scatterplots of the instrument (county’s distance to Taipei) against the two measurements of the local state sector. As shown in the plots, both the per capita and the share measures steadily increase with each county’s distance to Taipei. The distance measure however does not demonstrate a similarly robust association with any other control variables in the model specification (see Figure 4). These results suggest that the instrument likely meets the exclusive restriction requirement. That is, the threat of military conflict with Taiwan, as proxied by the distance, should only affect the outcome of interest (distribution of FDI) through the channel of the size of local state sector, instead of other channels.

Tables 5 and 6 present the results of the instrumental variable analysis by using the two-stage least-squares (2SLS) regression. In the first stage (Table 6), the author uses the size of the local state sector as the outcome and estimates the outcome using logged distance to Taipei and all other control variables. In the second stage, the author estimates the average of per capita FDI in 1991 and 1992 (same with the baseline model) using the instrumented local state sector size and other controls. The author reports the results from the second stage in Table 5. The coefficients for the size of local state sector, instrumented by county’s distance to Taipei, remain positive and statistically significant. This pattern is consistent across two different measures of the local state sector. The instrument easily passes the test for weak instrument. The F-statistics in both models are much higher than the rule-of-thumb standard of 10. This result lends strong support for the claim that the relationship between the size of local state sector and FDI inflow is causal.

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62 Whiting, Power and Wealth in Rural China.
63 Whiting, Power and Wealth in Rural China, chapter 2.
64 The provincial dummy is not included in the model specification, because the distance to Taipei is also a time-invariant component captured by the provincial dummy (i.e. Jiangsu is further away from Taipei than Zhejiang), and the inclusion of the dummy would absorb much of the variation in the instrument.
Concluding Remarks

Why and how does foreign investment grow in transitioning economies with substantial market and political risks? Why does it flow to some locations over others? Economists and political scientists have offered various explanations, ranging from macroeconomic fundamentals to political institutions. This article argues that the legacies of the socialist, planned economy in China plays an important role in

Figure 3. Distance of Counties to Taipei and the Size of Local State Sector.

Figure 4. Distance of Counties to Taipei and the Other Control Variables.

Concluding Remarks

Why and how does foreign investment grow in transitioning economies with substantial market and political risks? Why does it flow to some locations over others? Economists and political scientists have offered various explanations, ranging from macroeconomic fundamentals to political institutions. This article argues that the legacies of the socialist, planned economy in China plays an important role in
shaping the locational choices of foreign investment in the country. *Ceteris paribus*, localities that inherited a large local state sector, tended to attract more foreign investment. Forming joint ventures at the beginning of the market reform helped foreign investors satisfy the regulatory requirement of the host country, and shielded them from various political and market risks. The ownership structure at the early stage of the reform also shaped local officials’ preferences for different types of investment under the cadre evaluation system, creating a self-reinforcing local business environment that perpetuates regional gaps in ownership structure.

This article also has limitations. First, the study relies mostly on aggregated, district-level data for inferential analyses. Further data at the firm or individual level could be used to substantiate the behavioral logic suggested in the argument. Second, the empirical analysis is limited to the Yangtze delta counties. While using data beyond the region might risk introducing unmeasurable confounders,

### Table 5. Two-Stage Least-Squares Regression (Second Stage)

<table>
<thead>
<tr>
<th>DV: Per Capita FDI (1991 and 92 average)</th>
<th>(1)</th>
<th>(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Per Capita Output by LSOE</td>
<td>2.639***</td>
<td>2.639***</td>
</tr>
<tr>
<td>(0.667)</td>
<td>(0.667)</td>
<td></td>
</tr>
<tr>
<td>LSOE Output/Total Output</td>
<td>3.693***</td>
<td>3.693***</td>
</tr>
<tr>
<td>(0.944)</td>
<td>(0.944)</td>
<td></td>
</tr>
<tr>
<td>GDP Per Capita</td>
<td>−0.516</td>
<td>3.094***</td>
</tr>
<tr>
<td>(1.158)</td>
<td>(0.499)</td>
<td></td>
</tr>
<tr>
<td>Fiscal Expenditure Per Capita</td>
<td>−0.279</td>
<td>−0.676</td>
</tr>
<tr>
<td>(0.431)</td>
<td>(0.411)</td>
<td></td>
</tr>
<tr>
<td>Cargo Transportation Volume Per Capita</td>
<td>0.165</td>
<td>0.175</td>
</tr>
<tr>
<td>(0.145)</td>
<td>(0.148)</td>
<td></td>
</tr>
<tr>
<td>Population Size</td>
<td>0.635**</td>
<td>0.701**</td>
</tr>
<tr>
<td>(0.280)</td>
<td>(0.283)</td>
<td></td>
</tr>
<tr>
<td>Export Per Capita</td>
<td>−0.487*</td>
<td>0.081</td>
</tr>
<tr>
<td>(0.267)</td>
<td>(0.205)</td>
<td></td>
</tr>
<tr>
<td>Coastal Open Cities</td>
<td>0.445</td>
<td>0.731**</td>
</tr>
<tr>
<td>(0.288)</td>
<td>(0.285)</td>
<td></td>
</tr>
<tr>
<td>Sub-Provincial Cities</td>
<td>0.481*</td>
<td>0.195</td>
</tr>
<tr>
<td>(0.253)</td>
<td>(0.250)</td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>−13.997***</td>
<td>−25.536***</td>
</tr>
<tr>
<td>(3.999)</td>
<td>(2.524)</td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>136</td>
<td>136</td>
</tr>
<tr>
<td>R2</td>
<td>0.724</td>
<td>0.718</td>
</tr>
<tr>
<td>Adjusted R2</td>
<td>0.706</td>
<td>0.700</td>
</tr>
<tr>
<td>Residual Std. Error (df = 127)</td>
<td>1.154</td>
<td>1.166</td>
</tr>
<tr>
<td>Wu-Hausman Test (p-value)</td>
<td>0.206</td>
<td>0.467</td>
</tr>
</tbody>
</table>

Note: *p < 0.1; **p < 0.05; ***p < 0.01

### Table 6. Two-Stage Least-Squares Regression (First Stage)

<table>
<thead>
<tr>
<th>DV: Prominence of Local State Sector</th>
<th>Per Capita Output by LSOE</th>
<th>LSOE Output/Total Output</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distance to Taipei (logged)</td>
<td>0.711***</td>
<td>0.707***</td>
</tr>
<tr>
<td>Other Control Variables</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>Observations</td>
<td>136</td>
<td>136</td>
</tr>
<tr>
<td>R2</td>
<td>0.724</td>
<td>0.6034</td>
</tr>
<tr>
<td>Adjusted R2</td>
<td>0.706</td>
<td>0.5785</td>
</tr>
<tr>
<td>F Statistic for Weak Instruments Test (df = 127)</td>
<td>43.955***</td>
<td>125.151***</td>
</tr>
</tbody>
</table>

Note: *p < 0.1; **p < 0.05; ***p < 0.01

66 For example, in post-soviet Central Asia and the Caucasus, most foreign capitals have flown into the state sector. See Oksan Bayulgen, ‘Foreign capital in Central Asia and the Caucasus: curse or blessing?’ *Communist and Post-Communist Studies* 38(1), (2005), pp. 49–69.
such exercises would bolster the external validity of the findings. Case studies of other post-communist states suggest that the empirical pattern uncovered in this article exist elsewhere, even though these countries did not necessarily demand that foreign investors form joint partnerships. Future studies using data within and outside China to test the argument would further enhance our understanding on the role of the local state in promoting foreign investment in transitional economies.

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Disclosure statement

No potential conflict of interest was reported by the author.

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