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THOUGHT LEADERSHIP BRIEF

Government Officials' Career Incentives and FDI Inflows in China

Danqing Wang

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KEY POINTS

- Political institutions do not only generate risks for foreign investors, they also offer opportunities. One mechanism is through structuring government officials' career incentives by relating their promotion with the volume of FDI attracted.
- In China, we found that cities governed by newly appointed government leaders who have a higher political incentives for further promotion, attracted on average 518.70 million yuan more FDI than cities governed by leaders who continued their term in the same position.
- Among those newly appointed leaders, their incentives further vary, hence influencing their motivation and efforts of attracting FDI. We found that their incentives decrease if they are close to retirement, while the motivation is greater if they are appointed to cities with low prior GDP performance. Taken together, we present an agent-based explanation to account for the intra-country heterogeneities of FDI inflows.

ISSUE

The influence of political institutions on foreign direct investment (FDI) has long been recognized. Political institutions that impose few checks and balances on government officials' discretion can generate high political risk and deter FDI, while changes in political leadership at the national and local government levels can lead to policy discontinuity and volatility, which also negatively affect foreign investors. While the uncertainties and challenges presented by political institutions have been investigated, how they may also produce opportunities for foreign investors is relatively under examined. Specifically, the political career-based incentives and the motivations for officials to attract foreign investment require further attention.

We examine how the political career-based incentives of government officials affect the level of FDI flowing into their administrative areas. Given the importance of FDI for increasing exports, facilitating technological transfer and generating employment, it has been institutionalized in many countries and regarded as a national goal. We argue that if the government designs a predictable internal career advancement system that aligns the behavior of officials with the goal of attracting FDI, officials will be motivated to work towards this goal. We further compare the political incentives between newly appointed leaders, those who serve in the first term, with those who continue their appointment and hence serve the second term in the same position. We argue that although serving in one position over more than one term leads to more experience in that particular position, it slows career progress and reduces the likelihood of promotion due to the mandatory retirement age. Officials who remain at the same level for a second term or more thus have fewer opportunities and incentives for promotion.

China, as the focus of our study, serves as an ideal research context to examine the impact of political incentives. First, the complex bureaucracy of the Chinese government provides a structure for the career trajectories of its officials and the political turnover process. Second, China is a major recipient of FDI, but the inflows of investment have significant regional variations, and as local governments are closely involved in the development of the local economy and link it to the careers of their officials, the incentives for the promotion of officials may influence the FDI inflows into regions.

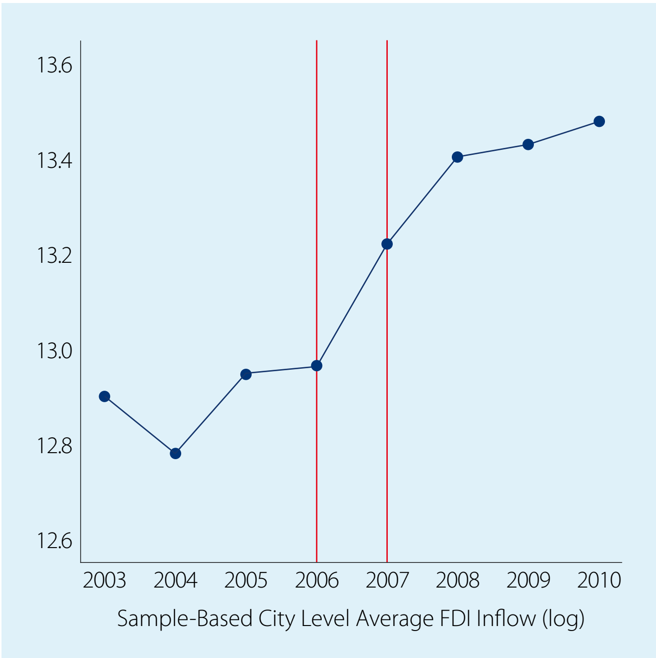
ASSESSMENT

In this study, we focus on the bureaucratic level of city government leaders. The party secretary is at the top of the bureaucracy at each level (including the city) (Yao & Zhang, 2015). Attracting FDI is part of the party-state's strategy, so we focused on the party secretaries of cities as the leaders responsible for devising FDI policies. We manually collected the CVs of all city leaders who served during the observation period.

We consider the political cycle of China's Communist Party (large-scale leadership turnover coincides with the Party's National Congress every five years) and identify two groups of city government leaders: first-term leaders, who are newly appointed after the congress, and continuing leaders, who remain in the same position to serve a second term after the congress. As FDI volume is as an evaluation and promotion criterion for government officials, first-term city leaders due to their stronger promotion incentives are more prone to designing and implementing policies to attract FDI. This results in a higher level of FDI flow into their cities than into those governed by continuing leaders.

Our sample consisted of panel data on the FDI inflows into 224 Chinese cities at the prefecture level from 2003 to 2010. The average city inflows within this period is 2715.707 million yuan. Figure 1 plots the growth trend in annual FDI inflows to the cities in our sample from 2003 to 2010. The 17th National Congress occurred during this period, in 2007, and we compared the cities' average FDI inflows before and after the congress. Our sample consists of 114 cities with first-term leaders and 110 with continuing leaders after the congress. And we conducted several measures to ensure that the two types of leaders and cities did not differ along significant dimensions before the congress.

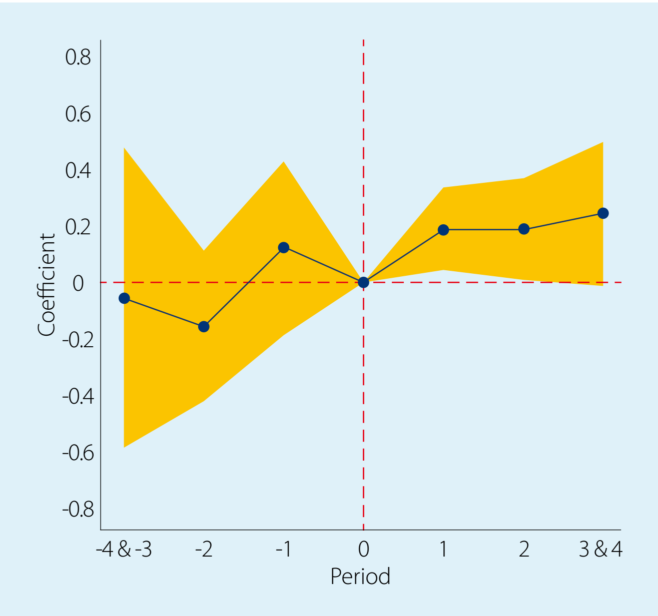
Figure 1: Annual FDI Inflows in China (Average at the City Level)



Using a rigorous difference-in-differences design, we find that first-term leaders were on average associated with a 19.1% increase in FDI inflows to their cities compared with continuing leaders, after controlling for the characteristics of the cities and the general influence of the party congress on FDI. Figure 2 presents the results. The x-axis represents the years, with 0 referring to the year of the local party congress and -1 and 1 the years before and after the congress, respectively. The y-axis represents the estimated coefficients for the difference in FDI inflows under the two types of leaders. The shaded areas show the confidence intervals for the coefficients, which contained 0 before the congress. This means that the estimated difference was not statistically significant, whereas the difference was significantly greater than 0 after the congress. This result further supported our premise that cities with different types of leaders did not differ before the congress, and the difference in FDI inflows after the congress can be explained by their different political incentives.

Figure 2. FDI Difference between First Term Leaders and Continuing Leaders before and after the Congress

Note: 0 on the X-axis refers to the year of the party congress. The graph shows that the FDI difference between first term leaders and continuing leaders is not different from 0 before the congress (the left section), while the difference is always bigger than 0 after the congress (the right section).



We further find that the difference between the first term leaders and continuing leaders is 31% less if they are close to retirement than the difference for non-retiring leaders, which is equivalent to 357.90 million yuan. However, for cities with poor prior GDP performance, the difference between first-term leaders and continuing leaders was 34% greater, which is equivalent to 695.06 million yuan.

IMPLICATIONS

Most research has focused on how political institutions give rise to risks and uncertainties for foreign investors. The power structure of political institutions, i.e., a lack of checks and balances, and changes in leadership result in instability and policy discontinuity, negatively impacting FDI. However, political opportunities are as important as political risks for multinational enterprises (MNEs). In our research, we demonstrate how political institutions can create opportunities for investors and positively impact FDI, through the state goal of FDI attraction and government officials' career incentives. Our study complements research on the risks of political institutions, reveals the multifaceted role of such institutions.

Our study offers a new explanation for the heterogeneity in intra-country FDI inflows. Previous studies have mainly focused on regional characteristics, such as the abundance of resources and the quality of formal and informal institutions, as the main drivers for the disparities in regional FDI inflows and the performance of subsidiaries. However, the role of political agents who devise FDI policies has been underexplored. We show that variations in intra-country FDI inflows can be due to the political incentives of leaders. Differences in these incentives can lead to different levels of FDI in cities administered by such leaders, despite similarities in their resource endowments and institutional environments.

Our study also has implications to understand the consequences of political turnover. Normally it is perceived that incumbent leaders can maintain policy continuity, which decreases uncertainty for foreign investments. We nevertheless highlight the importance of reduced incentives for continuing leaders. Conversely, leaders serving their first term (i.e., new leaders coming to power after political turnover) can have stronger political incentives to climb the career ladder and are thus more motivated to attract FDI, if doing so is linked to their future promotion opportunities.

Our findings also offer practical implications for multinationals' entry and investing decisions. Current research has cautioned multinationals to consider political risks and uncertainties and has suggested various ways to mitigate these risks. However, our study indicates that the level of political uncertainty depends on the new leaders' characteristics. A new leader might provide lucrative investment packages or create a better investment environment if his/her career advancement is closely associated with FDI attraction. Multinationals can then leverage the leaders' incentives and negotiate better entry deals. As such, knowing the new leaders' political incentives can help multinationals move faster and improve their entry decisions.

The context of China provides a unique setting to explore the role of political incentives under a strong party-state and a well-structured bureaucracy. However, the theory concerning political incentives can also be applied to other political institutions. For example, government officials in Japan, South Korea, and Taiwan have well-structured career paths with clearly defined evaluation criteria based on state goals. They are often highly motivated and successful in terms of achieving such goals. Research on Eastern European countries also shows that those with a bureaucracy that facilitates and legitimizes FDI attract more FDI. In contrast, if career paths and state goals are less well defined or subject to change, such as in Brazil or India, government officials are less likely to be motivated to work towards state-defined goals and are more likely to seek personal gain.

The mechanism of political incentives can also be found in Western democracies, where politicians are under pressure from voters and election cycles. The incentive of winning elections can motivate politicians to pursue the concerns of voters. For example, elected mayors of U.S. cities provide larger incentive packages for investors than nonelected city managers. In newly democratic countries, such as those in the former Soviet bloc, politicians are likely to liberalize trade soon after elections, so they can gain the benefits of economic growth before the next round of voting.

In conclusion, by focusing on how political terms shape the career incentives of government officials, we propose a new perspective on FDI inflows in this study. We present a novel account of the regional disparity of FDI inflows and extend the focus on uncertainty and risks generated by political institutions by examining how government officials' political incentives can provide opportunities for foreign investment.

Danqing Wang is an assistant professor in the department of management at the Hong Kong University of Science and Technology. She obtained her Ph.D. in management from INSEAD, France. Her research focuses on state-firm interactions and firms' non-market strategies in emerging economies. Her work has appeared at Administrative Science Quarterly and Academy of Management Journal, and will appear at Journal of International Business Studies and Journal of Business Ethics. She is currently serving on the editorial board of Administrative Science Quarterly and Management and Organization Review. She is the recipient of the WAIB emerging woman scholar award for 2018 and has also received the Faculty Outstanding Teacher award in 2018 when working at the University of Hong Kong.

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INSTITUTE FOR EMERGING MARKET STUDIES

T: (852) 3469 2215
E: iems@ust.hk
W: http://iems.ust.hk
A: Lo Ka Chung Building, The Hong Kong University of Science and Technology, Clear Water Bay, Kowloon

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