THE MODERATING EFFECTS OF BUSINESS ENVIRONMENT ON THE RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH IN CHINA

WANG JIECHEN

UNIVERSITI SAINS MALAYSIA

2024

THE MODERATING EFFECTS OF BUSINESS ENVIRONMENT ON THE RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH IN CHINA

by

WANG JIECHEN

Thesis submitted in fulfilment of the requirements
for the degree of
Master of Social Science

October 2024

ACKNOWLEDGEMENT

Firstly, I would like to express my gratitude to my supervisor, Associate Professor Dr. Tang Chor Foon. Professor Tang's patient guidance and encouragement were of great help to my research. His guidance has helped me overcome various challenges, benefiting me for a lifetime. Secondly, I would like to express my gratitude to my family and friends. The companionship of classmates and friends has given me courage on life's journey. Thanks to my parents, my growth and progress are a testament to their strong support, and I appreciate their selfless contributions without expecting anything in return. Last but not least, I would like to extend special thanks to the staff of the Centre for Policy Research and the librarians of Universiti Sains Malaysia for their support and assistance during my research period.

TABLE OF CONTENTS

LIST OF TABLES

Page

LIST OF FIGURES

Page

LIST OF ABBREVIATIONS

ADF	Augmented Dickey-Fuller
ARDL	Autoregressive Distributed Lag Model
AIC	Akaike Information Criteria
BE	Business Environment
DI	Domestic Investment
ECM	Error Correction Model
EIP	Eurostat Entrepreneurship Indicators Program
EIU	Economist Intelligence Unit
FDI	Foreign Direct Investment
FIN	Financial Development
GDP	Gross Domestic Product
GMM	Generalized Method of Moments
GNP	Gross National Product
HQIC	Hannan-Quinn Information Criterion
ICT	Information and Communications Technology
IMF	International Monetary Fund
INF	Infrastructure
INN	Human Capital and Innovation
INS	Institutional Quality
OECD	Organisation for Economic Cooperation and Development
OLS	Ordinary Least Square Method
PG	Population Growth
PP	Phillips-Perron
R&D	Research and Development
SEZs	Special Economic Zones
SIC	Schwarz Information Criterion
TNCs	Transnational Corporations
UNCTAD	United Nations Conference on Trade and Development
VAR	Vector Autoregression model
VECM	Vector Error Correction Model
WTO	World Trade Organisation

LIST OF APPENDICES

KESAN PENYEDERHANAAN PERSEKITARAN PERNIAGAAN TERHADAP HUBUNGAN PELABURAN LANGSUNG ASING DAN PERTUMBUHAN EKONOMI DI CHINA

ABSTRAK

Dalam tempoh 30 tahun yang lalu, China telah mengalami pertumbuhan ekonomi yang cemerlang dan muncul sebagai destinasi utama untuk pelaburan langsung asing (FDI) yang besar. Walau bagaimanapun, kadar aliran masuk FDI telah merosot dalam beberapa tahun kebelakangan ini. Justeru, kerajaan China telah memperkenalkan dasar untuk meningkatkan persekitaran perniagaan. Berdasarkan senario ekonomi ini, kajian ini menumpukan kepada peranan aliran masuk FDI dan persekitaran perniagaan dalam menjana pertumbuhan ekonomi China dari tahun 1985 hingga 2020. Kajian ini menggunakan kaedah pemberat entropi untuk membina petunjuk persekitaran perniagaan berkaitan dengan kualiti institusi, pembangunan sektor kewangan, infrastruktur, dan inovasi. Seterusnya, kajian ini menggunakan kaedah ekonometrik siri masa seperti ujian punca unit dan ujian kointegrasi Johansen-Juselius untuk menentukan darjah kepegunan pembolehubah dan kewujudan hubungan jangka panjang. Selain itu, kajian ini bukan sahaja menumpukan kepada hubungan langsung, tetapi turut mendalami kesan FDI terhadap pertumbuhan ekonomi China dengan mengambil kira peranan persekitaran perniagaan sebagai faktor penyederhana. Tambahan pula, setiap sub-elemen dalam persekitaran perniagaan juga diterokai secara berasingan untuk memahami impak masing-masing dengan lebih terperinci. Kajian ini mengesahkan bahawa terdapat hubungan jangka panjang antara FDI dan pertumbuhan ekonomi, di mana kedua-dua FDI dan persekitaran perniagaan menyumbang secara langsung kepada pertumbuhan ekonomi. Lebih penting lagi,

dapatan kajian ini menunjukkan bahawa persekitaran perniagaan serta sub-elemennya mempunyai kesan penyederhana dan mampu berinteraksi dengan FDI untuk merangsang pertumbuhan ekonomi. Berdasarkan penemuan ini, kerajaan China disarankan untuk memberi penekanan kepada usaha menarik FDI serta mengoptimumkan persekitaran perniagaan. Selain itu, langkah-langkah untuk memperkukuh pertumbuhan ekonomi jangka panjang boleh diambil dengan menambah baik persekitaran perniagaan, meningkatkan kualiti institusi, membangunkan infrastruktur, memperkasakan inovasi dan memacu pembangunan kewangan.

THE MODERATING EFFECTS OF BUSINESS ENVIRONMENT ON THE RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH IN CHINA

ABSTRACT

Over the last 30 years, China has experienced outstanding economic growth and has emerged as a key destination for substantial foreign direct investment (FDI). However, the pace of FDI inflows has decelerated in recent years. In response, the Chinese government has introduced a policy to enhance the business environment. Motivated by this economic scenario, this study focuses on the role of FDI inflows and the business environment in promoting China's economic growth from 1985 to 2020. This study constructs business-environment indicators concerning institutional quality, financial development, infrastructure, and innovation using the entropy weight method. Subsequently, this study employed econometric techniques such as unit root tests and Johansen-Juselius cointegration tests to determine the order of integration of the variables and the presence of long-run relationships. This study not only focuses on the direct relationship but also profoundly explores the impact of FDI on China's economic growth by considering the role of the business environment as a moderating factor. Furthermore, each sub-element of the business environment is explored separately to understand their respective impacts better. This study confirms that FDI and economic growth in China have a long-run relationship. Moreover, findings suggest that both FDI and the business environment directly affect economic growth. More importantly, this study finds that the business environment and its sub-elements effectively moderate the contribution of FDI to economic growth. Given these findings, the Chinese government should focus on attracting FDI and optimising the business

environment and further promote long-term economic growth by improving the business environment, improving the quality of institutions, developing infrastructure, improving innovation capabilities, and promoting financial sector development.

CHAPTER 1

INTRODUCTION

1.1 Background of the Study

Foreign direct investment (FDI) is one of the primary forms of modern capital internationalisation. As defined by the International Monetary Fund (IMF), "FDI is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy" (IMF, 2009). A foreign entity or group of related entities that invests is known as a foreign direct investor. According to the Organisation for Economic Co-operation and Development (OECD), "FDI reflects the objective of establishing a lasting interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor. The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the enterprise" (OECD, 2009). FDI is defined by the United Nations Conference on Trade and Development (UNCTAD) "as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)" (UNCTAD, 2020).

In general, an investor's investment in another country or region is a manifestation of FDI, and its purpose is to obtain control and an interest in, for example, an enterprise. As a result, FDI typically occurs in more open economies and involves

both capital investment and management or technology investment (Kerner, 2014; Gherghina et al., 2019).

Global FDI has grown dramatically over the past few decades. Economic globalisation has made the role of FDI in economic growth even more critical (Al-Shawaf and Almsafir, 2016). FDI can bridge the gap between domestic savings and the investments needed for economic growth, filling the foreign exchange or trade gaps and creating tax revenue and job opportunities for the host country (Todaro, 1992). In addition, FDI can improve the management and technology of host country firms through, for example, technology transfer and workforce training, generating positive spillover effects and, in turn, increased productivity (Gherghina et al., 2019; Stamatiou and Dritsakis, 2014). FDI operates in an increasingly complex environment and is important to economic growth.

1.1.1 Economic Growth

Economic growth is commonly defined as the increase in the output of a country or region over a specified period, encompassing the growth in products and services. This includes factors such as capital, technology, and the labour force. Two pivotal aggregate indicators are used to assess a country or region's economic growth and development level: Gross Domestic Product (GDP) and Gross National Product (GNP).

GDP refers to the total value of final products and services produced and sold by all factors of production within a country's territorial boundaries over a specific period. GNP refers to the total value of final products and services produced and sold by the production factors owned by a country's nationals within a given period.

GDP per capita is often used to gauge a country's economic growth more scientifically and reasonably. It is calculated by dividing the GDP realised during an

accounting period by the population. This metric allows researchers to consider the influence of economic scale and population, providing a more nuanced picture of a country's economic growth. The economic growth rate is a crucial measure of the economy's growth during a specific period; it represents the speed of expansion in overall economic strength within that timeframe.

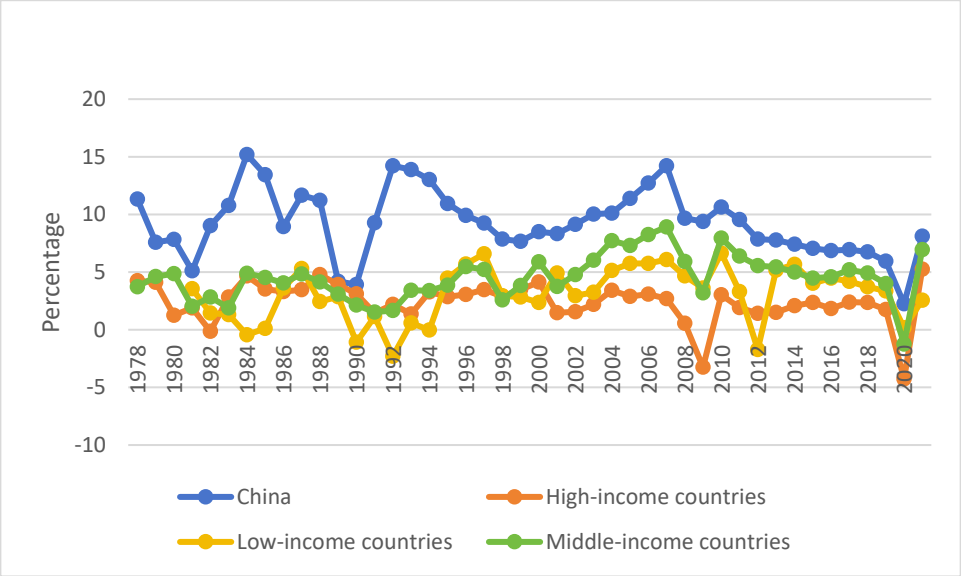

Figure 1.1: GDP Growth Rates in Comparable Economy
Source: *World Bank* (2021), *World Development Indicators*

As can be seen from Figure 1.1, China's GDP growth rate is remarkable and ahead of most countries; it has been above average for developing countries since the reform and opening in 1978. The country's economic growth fluctuated significantly in the early days of reform and opening. Around 2000, China's economy entered a period of steady growth; by 2007, its growth rate had reached 14.23 per cent. In 2008, due to the global financial crisis and other factors, there was a drop in global GDP growth. Despite this, China maintained a growth rate of 9.65 per cent. However, after 2012, China's GDP growth slowed, fluctuating around 7 per cent. In 2020, the COVID-19

epidemic and other factors impacted the GDP growth rate, which dropped to only 2.23 per cent.

Figure 1.2 shows that China's GDP has grown by leaps and bounds in the past four decades. In 1978, China's GDP was US$148 billion, accounting for only 6.3 per cent of the US GDP. By 2010, China had become a newly industrialised country, with a GDP reaching US$10.36 trillion. Its total GDP exceeded that of Japan, accounting for 40.45 per cent of the GDP of the US. In 2021, China's GDP surpassed the European Union's, becoming the world's second-largest economy. However, in terms of per capita GDP, there is still a huge gap between China and developed countries.

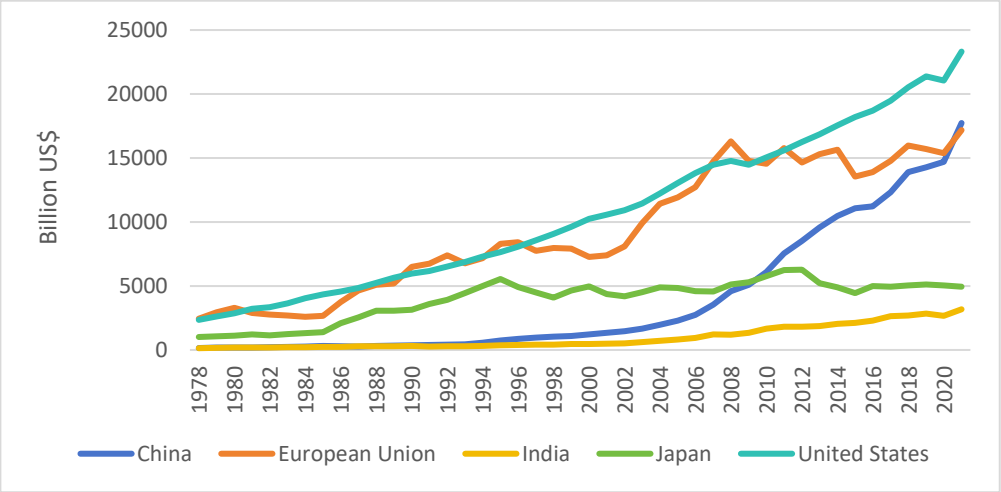

Figure 1.2: GDP in Comparable Economy

Source: *World Bank* (2021), *World Development Indicators*

There is no doubt that China's GDP performance is excellent. However, as is the case for most developing countries, while its GDP growth rate is higher than that of most developed countries over the period, its per capita GDP performance is relatively poor. As shown in Figure 1.3, the per capita GDP of high-income countries is much higher than that of low-income and middle-income countries, and this gap is gradually

widening. Although China's per capita GDP is far lower than that of high-income countries, it is slightly higher than the average for middle-income countries. Studying China's economic growth may enrich our thinking concerning the development of other developing countries. In addition, China's economic development is far from sufficient. Exploring how China's economic growth can be stimulated is still necessary.

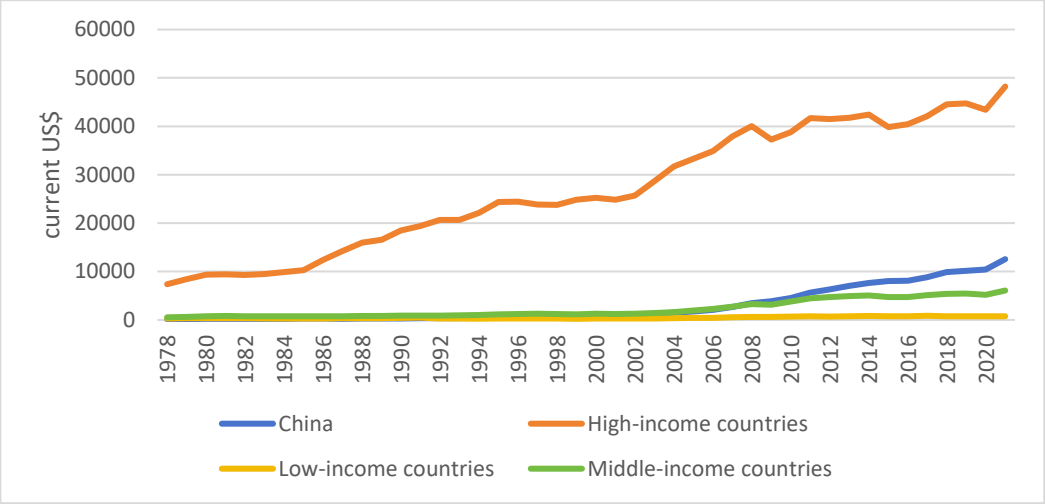

Figure 1.3: Per Capita Real GDP in Comparable Economy

Source: *World Bank* (2021), *World Development Indicators*

1.1.2 FDI and Economic Growth in China

In 1978, China initiated the Reform and Opening-up Policy, with the earliest available data on China's FDI dating back to 1979. Since then, China has proactively cultivated the conditions to attract FDI, propelling its economic growth. After decades of development, China has transitioned from being an impoverished and agriculturally centred nation to emerging as an industrial powerhouse, boasting the world's second-largest GDP and achieving extraordinary economic growth.

The key factor contributing to China's rapid economic growth and industrialisation appears to be its constant adjustment of policies around the use of foreign investment and attracting FDI (Wei and Liu, 2001). Strategic implementation

and utilisation of FDI have been crucial in propelling China's economic transformation; China has made great strides in utilising foreign investment, especially since reform and opening up (Buckley et al., 2010).

China has become a global leader in attracting FDI, particularly following its accession to the World Trade Organisation (WTO) in December 2001. China has experienced a staggering increase in FDI inflows, which have grown from US$348.7 million in 1990 to approximately US$14.9 billion in 2020. At the same time, the economy achieved impressive growth rates, surging from US$36.09 billion to approximately US$1,468.77 billion during the same period—an extraordinary increase of over 40 times.

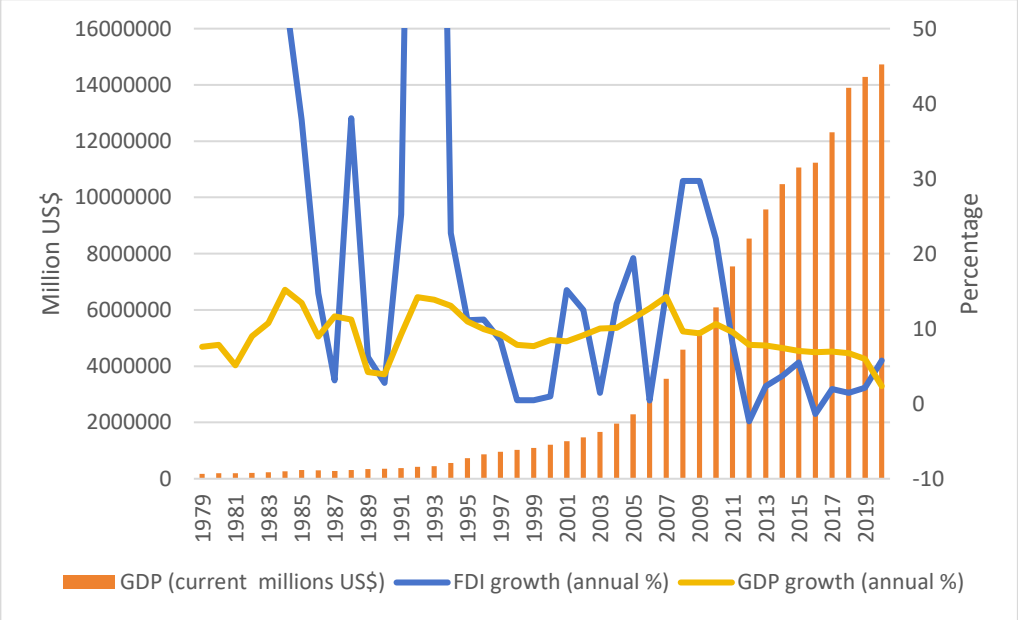

Figure 1.4: China's Economic Growth and FDI Growth

Source: *World Bank* (2021), *World Development Indicators*

To provide a more nuanced understanding of FDI and its impact on China's economic growth, this study considers the relationship between FDI and economic

growth in three distinct periods: Starting and shock development (1978–1991), rapid growth (1992–2011), slowing growth and quality improvement (2012–2020).

1.1.2(a) Starting and Shock Development Stage (1978–1991)

In December 1978, China declared that it would carry out a 'Reform and Opening-up' policy. Before this pivotal moment, it was a highly closed planned economic system, and foreign investment, much like other components of the private economy, lacked legitimacy, and there was no place for such inflows.

In 1979, China established its Foreign Investment Management Committee, which was entrusted with implementing the opening-up policy and fortifying the management of foreign economic and trade affairs. In the same year, the first foreign investment law, the Sino-Foreign Joint Venture Enterprise Law, was promulgated, recognising that a market economy is possible under socialism; opening the economy and introducing foreign investment gained institutional legitimacy (Kuntner, 2020).

China's opening to the world did not happen abruptly but involved a gradual expansion. In 1980, China established four Special Economic Zones (SEZs).[1] The economic policies applicable to these zones were more flexible than those applied to the rest of the country, allowing them to experiment with market-oriented reforms. The success of these initial SEZs led to the decision in 1984 to expand the economic reforms to 14 coastal cities,[2] not just limited to the original SEZs. In 1985, China introduced coastal economic open zones in key regions, including the Yangtze River Delta,[3] Pearl River Delta,[4] and the Southern Fujian Triangle.[5] These areas have played a crucial role

[1] Shenzhen, Zhuhai, Shantou and Xiamen Special Economic Zones.
[2] Beihai, Dalian, Fuzhou, Guangzhou, Lianyungang, Nantong, Ningbo, Qingdao, Qinhuangdao, Shanghai, Tianjin, Wenzhou, Yantai, Zhanjiang,
[3] Including Shanghai City, Jiangsu Province, Zhejiang Province, and Anhui Province, a total of 41 cities
[4] Foshan, Guangzhou, Shenzhen, Zhuhai, Dongguan
[5] Quanzhou, Xiamen, Zhangzhou

in driving economic growth, attracting foreign investment, and being hubs for manufacturing and export-oriented industries. This continuous expansion of openness to the global community laid the groundwork for accelerating economic growth and fostering international cooperation. Furthermore, these initiatives served as valuable experiments, allowing the country to refine the relevant policies and prepare for the opening up (Heilmann, 2008).

In 1986, China's 'Regulations on Encouraging Foreign Investment' were promulgated. This legal framework granted foreign investors preference in key areas such as taxation, land use fees, credit, foreign exchange, and import-export procedures. The subsequent promulgation of laws, including the Law on Enterprises with Foreign Investment (1986) and the Law on Joint Ventures with Foreign Investors (1988), played a vital role in providing essential legal protection for foreign-invested enterprises (Yuqing, 1987). These measures cultivated an institutional environment that actively encouraged foreign investment, playing a significant role in the gradual growth of FDI in China.

The early introduction of foreign investment was an indispensable catalyst for China's economic growth. In the initial phase of reform and opening, China's production capacity was especially low. The imperative to expand production was a prerequisite for augmenting residents' income and establishing a market characterised by high purchasing power (Hu and Khan, 1997). Enhancing production capacity required the infusion of advanced foreign equipment (Kim, 1980). However, in 1978, China's foreign exchange reserves amounted to a meagre US$167 million; this severe shortage of foreign currency presented a significant challenge. The introduction of export-oriented foreign investment emerged as a solution to this predicament (Yu, 1994).

FDI played a dual role—it not only directly increased investment but also had a pronounced impact on economic growth due to the generally higher production efficiency of FDI enterprises compared to those supported by domestic funding (Kueh, 1992). For instance, in 1991, despite FDI industrial enterprises accounting for only one-tenth of the total industrial assets in China, they contributed over a quarter of the total value of industrial output, nearly one-third of industrial profits, and one-fifth of value-added tax (Liu, 2019). This illustrates the significant and outsized contribution of FDI to China's economic landscape during the early stages of its development.

1.1.2(b) Rapid Growth Stage (1992–2011)

The inflow of foreign capital has brought significant changes to China's economy and society, and the socialist society has taken on some characteristics of a capitalist society, triggering controversy and doubts about foreign investment. It was not until Deng Xiaoping's 1992 South Tour speech, which emphasised the need to focus on economic construction and clarified the importance of development and reform that some controversies and doubts about the introduction of foreign investment gradually subsided, and foreign investor's confidence in continuing to invest in China became unprecedentedly strong (Zhao, 1993).

In 1992, economic openness began to expand inland from the coast, and the preferential opening-up policy was extended to five cities along the Yangtze River,[6] 13 border cities,[7] and 11 provincial capital cities in inland areas.[8] While further expanding its policy of opening up, China also began exploring the introduction of foreign

[6] Chongqing, Jiujiang, Wuhan, Wuhu, Yueyang
[7] Bole, Dandong, Dongxing, Hekou, Heihe, Hunchun, Manzhouli, Pingxiang, Erenhot, Ruili, Suifenhe, Tacheng, Wanding, Yining
[8] Changsha, Chengdu, Guiyang, Hefei, Lanzhou, Nanchang,Taiyuan, Xi'an, Xining, Yinchuan, Zhengzhou

investment through equity mergers and acquisitions, attaching great importance to high-tech investment.

In 1995, China promulgated the "Guidance Catalogue for Industries for Foreign Investment", which listed high-tech investment projects as encouraged investments and continuously adjusted the guidance catalogue based on actual conditions. The door for foreign capital to acquire listed companies through the securities market was opened by the promulgation of the ‘Interim Regulations on the Acquisition of State-owned Enterprises by Foreign Investors’ (1999) and the ‘Notice on Issues Concerning the Transfer of State-owned Shares and Legal Person Shares of Listed Companies to Overseas Investors’ (2003).

In December 2001, China officially joined the WTO, which required the country to open its market further, continuously expand areas for foreign investment, and improve policy transparency. Under this framework, China’s investment environment has strengthened, freeing its massive domestic demand potential. China has gradually become the most attractive investment destination in the world.

This period is marked by the rapid surge in FDI. Since 1992, China has progressively evolved into a developing country that attracts the lion’s share of FDI (Zhang, 2005). The increase in FDI has been remarkable, surging from US$4.366 billion in 1991 to an impressive US$116.011 billion in 2011. This influx of significant foreign capital has had profound implications, intensifying market competition within China and significantly augmenting the overall strength of its enterprises (Gaur et al., 2018).

FDI has catalysed the economic landscape. Compared to their foreign-funded counterparts, Chinese enterprises lack experience in market competition, often facing disadvantages in several key areas, including technical proficiency, marketing

capabilities, and brand awareness (Fan, 2008). To bolster their competitiveness, Chinese enterprises need to elevate their technological innovation and refine their commercial operations. Domestic-funded enterprises are compelled to augment their scale and strengthen their competitive position through mergers and reorganisations, optimising industrial organisational structures, and enhancing the industry's operational efficiency (Bonaglia et al., 2007).

Human resource flows are the mechanism for the technology spillover from foreign investments to domestic enterprises. Foreign-invested enterprises cultivated technical and business talents, laying the foundation for China's independent industrial production (Zhu, 2010). The use of foreign investment and the policy of opening has significantly enhanced the competitiveness of Chinese enterprises. China has cultivated its world-class advanced manufacturing in the fields of home appliances, communication equipment, and communication electronics. FDI has also created many job opportunities (Karlsson et al., 2009). According to statistical data from 1992 to 2011, enterprises backed by foreign funding contributed to the creation of 19.28 million new urban jobs, accounting for 10.68 per cent of all such jobs in the same period; nationally, the proportion of individuals employed in foreign-funded enterprises as a share of total urban employment increased from 1.2 per cent to 6 per cent.

China's economy experienced a significant boom in this period. In 2006, the level of China's foreign exchange reserves surpassed that of Japan, securing the top position globally, and its savings rate became one of the highest in the world. The pinnacle of this economic surge was reached in 2007, when China's GDP growth rate reached 14.23 per cent, marking the fastest growth since the reform and opening up was initiated.

China subsequently adopted measures to align its foreign investment practices with international standards. In 2006, it enhanced approval procedures and anti-monopoly investigations by adopting the ‘Measures for the Administration of Mergers and Acquisitions of Domestic Enterprises by Foreign Investors’. The supranational treatment of foreign investment was gradually phased out and replaced by an investment promotion mechanism conforming to global norms. In 2007, China intensified the review and supervision of foreign mergers and acquisitions of companies in sensitive industries and those concerned with national security.

In 2008, China adopted an Anti-Monopoly Law, learning from common practices around the world and using legislation to create a market and regulatory environment that supports fair competition. As of December 1, 2010, China had cancelled the last two preferential tax policies for foreign companies.

1.1.2(c) FDI Growth Rate Slowing Down Stage (2012–2020)

The allure of FDI waned amidst the removal of preferential treatment for foreign investment and the impact of factors such as an ageing population and increasing production costs diminishing traditional competitive advantages. Since 2012, the rates of growth of GDP and FDI flows have experienced a decline compared to earlier periods. To foster the development of a new open economic system, China has introduced strategic changes to its foreign investment policies. In 2014, the ‘Measures for the Administration of Approval and Registration of Foreign Investment Projects’ were enacted, marking a shift from a comprehensive approval system to a system of universal filing with limited approval. Simultaneously, the types of industries that are prohibited and restricted for foreign investment were reduced through the ‘Foreign Investment Industry Guidance Catalogue’.

While relaxing foreign investment access, China began paying more attention to the quality of foreign investment. China's foreign investment focus shifted from scale, short-term efficiency and innovation to the improvement of its high-tech sector and industrial supply chain with the 2016 adoption of the 'National Innovation-Driven Development Strategy Outline' promulgated. Since 2018, China's foreign investment management and service system has transformed from reliance on preferential policies to developing a business environment that attracts foreign investment.

Since 2012, the growth of China's FDI flows has slowed. From 2001 to 2011, the average annual growth rate of FDI flows was more than 20 per cent; this dropped to an average yearly growth rate of only 7 per cent after 2012. Foreign investment, nevertheless, remains an important part of economic growth. Data from the Ministry of Commerce reveal that in 2020, China established 38,570 new foreign-invested enterprises, with the actual use of foreign investment amounting to US$149.342 billion. While the number of foreign-funded enterprises accounts for less than 3 per cent of the total number of Chinese enterprises, their impact is substantial. These entities generate nearly half of the foreign trade volume, contribute a quarter of the profits of industrial enterprises, and account for a fifth of corporate tax revenue. Notably, the economic benefits derived from foreign-funded enterprises surpass the national average by a significant margin. This underscores the enduring and vital contribution of foreign investment to China's economy despite its slowed growth.

1.1.3 Business Environment

The business environment can be defined as the set of conditions outside a firm's control that have a significant influence on how businesses behave throughout their life cycle (World Bank, 2022). This is relatively broad, and no more specific definition is

currently available. The concept of business environment can be understood from some internationally influential business environment evaluation index systems.

The World Bank's *Global Doing Business* report selects representative large cities in each country as the evaluation object, weights each indicator through the simple average method, and calculates the score ranking of each economy. In this report, released annually from 2002 to 2020, the World Bank evaluated 190 countries. The main indicators considered are the following: time, procedures and costs required to perform activities related to the life cycle of the company. These activities specifically include starting a business, dealing with construction permits, obtaining electricity, registering property, securing credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency (World Bank, 2020). Before 2015, China's ranking in the report was around 90, and in 2016 it was 78. In 2019, China proposed the policy of 'optimising the business environment', and its ranking increased to 46. In 2020, it rose to 31st in the ranking (World Bank, 2020). The rapid improvement in this ranking reflects China's emphasis on the business environment and how the government's efficiency and service quality have improved.

There are also various macro-level indicators used to evaluate the business environment. The Economist Intelligence Unit (EIU) has developed a business environment assessment system comprising ten primary indicators covering the political, economic, and social spheres. These cover market mechanisms, free international competition, foreign investment, international trade and exchange rate control, taxation, finance, the labour market, infrastructure, and other relevant fields (EIU, 2023). The entrepreneurial determinants in the OECD-Eurostat Entrepreneurship Indicators Program (EIP) cover six categories: regulatory framework, market

conditions, access to finance, knowledge creation and dissemination, entrepreneurial capacity, and entrepreneurial culture (OECD, 2017). The World Economic Forum's *Global Competitiveness Report* features 12 primary evaluation indicators at the first level for assessing the business environment. These indicators encompass institutions, infrastructure, the adoption of information and communications technology (ICT), macroeconomic stability, health, skills, product markets, labour markets, market value, market size, start-up costs, and innovation capacity (WEF, 2020).

Assessment indicators pertaining to the business environment show that it has undergone significant transformation since the reform and opening. In the 1980s, China was still in the era of ticket supply, with severe shortages of material and a lack of robust infrastructure, particularly in areas such as energy and transportation. It was unable to provide sufficient momentum for production and circulation and unable to innovate independently. Furthermore, in the absence of private enterprise as a planned economy period, China lacked a financial system commensurate with commercial development; it did not even have a commercial bank.

However, in 2020, after decades of development, China had 4,608 financial institutions, the balance of broad money supply (M2) was US$33.52 trillion, the stock of social financing scale at the end of the year is US$43.65 trillion, the national foreign exchange reserves are US$3.2165 billion, and the power generation capacity is 7.62 trillion kilowatt hours, the cargo transportation turnover is 196,618 billion ton-kilometres, the mobile phone penetration rate is 113.9 units per 100 people, there are 8.74 million college graduates annually, the research and experimental development (R&D) expenditure is US$374.345 billion, and the National Natural Science Foundation of China funds 45,700 research projects. These advances demonstrate the

dramatic changes in China's business environment and support the development of the business economy.

1.2 Problem Statement

The relationship between FDI and economic growth has sparked a long-standing debate, and there is no consensus in studies on whether FDI can promote economic growth. On the surface, China's economic success seems to be closely related to attracting and utilising FDI. However, some studies disagree. For example, some scholars have suggested in meta-analysis that FDI's role in China's economic growth has been exaggerated and that the Chinese government's efforts to stimulate further economic growth by encouraging FDI are unlikely to succeed (Gunby et al., 2017). In fact, one of the goals of China's policy to optimise the business environment is to improve the environment for investment and increase its attractiveness for FDI to drive economic growth. It is thus necessary to further clarify the role of FDI in economic growth and the role of the business environment in that relationship.

A problem that cannot be ignored is that China's economic growth and FDI have slowed down significantly in recent years. It is necessary to take action to attract FDI and develop the economy. In the early days of reform and opening, China's main advantages in attracting FDI were its low costs and supra-national treatment.[9] However, as the problem of China's ageing population intensifies and labour costs rise, the advantage it had based on cheap labour has been overtaken by other countries (Li et al., 2012). The supra-national treatment for foreign investment established in the early days of reform and opening up has also been gradually abolished.

[9] Supra-national treatment: It refers to the treatment of FDI that is higher than the investment of the country's nationals, such as tax reduction, foreign exchange incentives, etc

Some foreign companies are frustrated by unclear laws, inconsistent regulatory interpretations, and difficulties in obtaining licenses for foreign companies (AmCham, 2016). Over the same period, the re-industrialisation strategy of developed countries has begun to attract outsiders, and these countries have also restricted outflows; the global competition for investment is becoming increasingly fierce. For example, the European Commission aims to expand the share of European manufacturing in GDP from 14 per cent to 20 per cent by 2020 (Moczadlo, 2020). The United States' re-industrialisation will also reduce the export competitiveness of China's manufacturing industry and weaken the technological spillover effect of FDI (Pan and Zhu, 2019). China faces huge difficulties in further improving the quantity and quality of foreign investment. Economic growth has also slowed, from 14.23 per cent in 2007 to about 6 per cent in 2019. It is necessary to cultivate new advantages to develop the economy and attract FDI.

In recent years, under the impact of factors such as the Sino–U.S. trade war and the perception that China poses a threat, China’s FDI inflows have been severely challenged, and its economic growth has also slowed (Lee, 2023). Affected by de-Sinicization and supply chain decoupling, the US, Japan, Korea, and countries in Europe are trying to replace Chinese manufacturers with enterprises in Vietnam, India, Southeast Asia, South America, and other regions. For example, Apple has moved substantial production capacity to India and Vietnam.

FDI in high-tech industries also faces enormous threats. US President Joe Biden signed an executive order restricting US entities from investing in the following fields in China: semiconductors and microelectronics, quantum information technology and artificial intelligence (Spiegelman,2023). Some European, Japanese, and Korean

companies have also followed the US and withdrawn investment from China. China's economic growth is thus facing more severe difficulties. With reduced production capacity and employment difficulties, China's imports and exports are also under threat. The country urgently needs to respond to changes in the external environment and promote economic growth by optimising the business environment. Given this, optimising the business environment and increasing efforts to attract FDI are important policies for economic growth.

However, there is currently little research on the relationship between the business environment and economic growth. The intricate relationship between FDI, the business environment and economic growth remains unclear and necessitates further exploration and analysis.

1.3 Research Questions

Based on the problem statement, this study explores the impact of FDI and the business environment on economic growth. Specifically, the research questions of this study are as follows:

(i) What impact does FDI have on economic growth?

(ii) What impact does the business environment have on economic growth?

(iii) What role does the business environment play in moderating the impact of FDI on economic growth?

1.4 Research Objectives

This study examines the role of FDI and the business environment in promoting China's economic growth. Based on this overall goal, the specific objectives of this study are the following:

(i) To determine the influence of inward FDI on economic growth.

(ii) To investigate the impact of the business environment on economic growth.

(iii) To examine the role of the business environment in moderating the impact of FDI on economic growth.

1.5 Significance of the Study

This study makes some significant contributions to the existing literature. Existing studies are focused on the relationship between economic growth and FDI but ignore the effect of the business environment on economic growth. This study fills this gap in the literature. Unlike previous studies that only focused on the direct effects of FDI on economic growth, this study explores the impact of FDI on economic growth under the moderating effect of the business environment. In addition, there is no consensus on the relationship between FDI and economic growth, and the results of this study support that FDI can promote economic growth. Moreover, there are few studies on the business environment and economic growth, and this study explores the relationship between the business environment and economic growth, enriching the research on economic growth.

Furthermore, the results of this study offer a point of reference for formulating business environment policies and put forward countermeasures and suggestions for optimising the business environment to promote the inflow of foreign capital and economic development. In the context of the gradual disappearance of traditional advantages such as labour costs, exploring the moderating effect of the business environment on foreign direct investment can further clarify the factors that attract foreign investment to China and provide empirical support for improving the business environment and expanding the scale of foreign investment. It offers valuable insights for policymakers in formulating FDI and business environment policies, which is of

great practical significance for further expanding the scale of investment attraction and maintaining economic development.

1.6 Scope of the Study

The primary focus of this study is the relationship between FDI, the business environment, and China's economic growth. The study utilises annual data for China spanning from 1985 to 2020. China was selected as the focus because, over the past four decades, its economy has demonstrated the best performance and fastest economic growth in utilising FDI. It is also a country that has been severely challenged in attracting FDI and economic growth in recent years due to dual pressures from internal factors and the external environment. In addition, China has clearly proposed optimising the business environment.

The period of 1985 to 2020 was selected in light of the availability and reliability of data. Although China initiated its reform and opening policy in 1978, the initial years of development were marked by turbulence, and the process of opening unfolded gradually. It was only around 1985 that reform and opening gained traction, signifying a pivotal juncture. It was at this point that China's economic growth began to yield tangible results.

1.7 Organisation of the Study

Chapter 1 provides background to the research, articulates the problem statement, and outlines the research questions and objectives, the significance and scope of the study, and details of its organisation. The remainder of this study is structured as follows. Chapter 2 reviews the theoretical and empirical literature relevant to the research. Chapter 3 focuses on the research methodology, detailing the variables, explaining the data sources, and outlining the econometric methods employed. The

findings are presented and discussed in Chapter 4. Chapter 5 summarises the study, offering concluding remarks, policy recommendations, an acknowledgement of the study's limitations and suggestions for future research.

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

This chapter will review the relevant theories and literature used in this study. First, the theoretical basis of economic growth and FDI (the variables considered in this study) are reviewed. The chapter then considers the empirical literature on the relationships among FDI, economic growth, and the business environment.

2.2 Theoretical Review

This section introduces neoclassical economic growth theory (Solow, 1956) and endogenous economic growth theory (Romer, 1986, 1990). This chapter also introduces other theories related to FDI and the business environment, including the theory of the eclectic paradigm of international production (Dunning, 1977), which is proposed based on the theories of absorbing monopoly advantage (Hymer, 1960) and internalisation (Buckley and Casson, 1976).

2.2.1 The Eclectic Paradigm of International Production

This study finds theoretical support in the theory of international production compromise. The internalisation theory explains why multinational corporations choose to invest across borders, giving rise to FDI. The theory of ownership advantage explains the potential impact of FDI on the economic growth of the host country. The theory of location advantage links the investment environment of the host country with FDI, providing theoretical support for the relationship between the business environment, FDI and economic growth.

In the 1970s, the economist Dunning introduced the theory of international production eclecticism, building on theories concerning the absorption of monopoly advantage and internalisation. This theory, which has been continuously refined and enhanced, holds that the mode, scope, and pattern of international production are influenced by three firm-specific advantages: the ownership advantage, the internalisation advantage, and the location advantage (Dunning, 1977, 1979, 1988, 2001, 2014).

Ownership or monopoly advantage, initially proposed by Hymer (1960), posits that a crucial prerequisite for firms wishing to invest overseas is possessing an advantage that can offset the additional costs associated with such investment. Kindleberger (1969) further elucidates this advantage as the benefits multinational corporations enjoy in terms of scale, market, and factors of production. The monopoly advantage is made manifest through the possession and use of knowledge assets (Johnson, 1970), currency strength (Aliber, 1971), product heterogeneity, core assets such as knowledge and technology (Caves, 1971), and economies of scale (Ball and Pearson, 1976).

Dunning categorises ownership advantage into three distinct types: asset, transaction, and institutional ownership advantages (Dunning, 1979, 1988; Dunning and Lundan, 2008). The assets advantage arises from a multinational enterprise's control of tangible and intangible assets, while the transaction advantage stems from the company's ability to coordinate and utilise assets. The institutional advantages are manifest in the governance structure of a multinational corporation.

Buckley and Casson (1976) think that FDI directly results from enterprises internalising international transactions. Due to the incompleteness of the market, maximising profits is difficult if intermediate products, such as technology, marketing

know-how and management experience, are traded through the external market. Rugman (1981) analyses the corporate and national factors associated with the activities of transnational corporations (TNCs) and argues that internationalisation is the result of a failure of the information market; TNCs are forced to establish internal markets to overcome the failure of external markets because there is no suitable market on which to sell their products.

Dunning's eclectic theory of international production is a rich development of the theory of internalisation. Dunning (1988) sees internalisation as the internal use of the assets owned by multinational enterprises to avoid the adverse effects of incomplete external markets. In addition, internationalisation allows these corporations to realise the advantages of optimal allocation of resources and to maintain and make full use of their monopoly ownership advantages (Dunning, 1988).

Location advantage refers to the host country's favourable investment environment, which includes factors such as market size, level of economic growth, infrastructure, transportation, and labour costs. TNCs typically seek cost advantages by investing in regions with lower labour costs, high market potential, fewer access restrictions, and favourable government policies (Dunning, 1977, 1988, 1998). Belderbos (2003) takes an institutional perspective in their analysis of the impact of host countries' political, economic, legal, and transition regimes on attracting FDI. Ellison et al. (2010) argue that industrial spatial agglomeration provides natural advantages and external benefits, such as technology spillovers, ultimately enhancing the location advantages of agglomeration areas. Cross-border production can become a driving force for FDI if it proves more profitable than domestic production. Therefore, investing in a favourable location becomes the optimal choice for multinational enterprises.