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國際學碩士學位論文

**The effect of China's new tax rate policy on FDI:
Would increase of tax rate decrease China's FDI
inflow and economic growth?**

중국의 신 세율정책이 FDI에 미치는 영향

2012年 8月

서울大學校 國際大學院

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Master's Thesis

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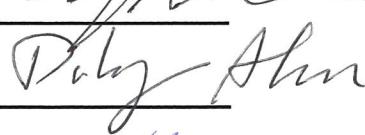
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ABSTRACT

The effect of China's new tax rate policy on FDI: Would increase of tax rate decrease China's FDI inflow and economic growth?

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According to the review on existing study on the relationship between FDI and economic growth and the relationship between corporate income tax rate for FDI and FDI inflow, lower tax rate which can affect multinational corporations' decisions on investment locations has a positive effect on attracting more FDI inflow in a country. However, its effect is less than other factors such as labor cost and market size. From 1984 to 2007, China has operated a dual tax system, with different tax rate for Chinese domestic companies and for foreign companies who have enjoyed more favorable tax treatment than their domestic counterparts. In 2008, Chinese government increased the tax rate for foreign companies by unifying the tax rate for foreign companies and domestic firms. Will this kind of increase decrease China's FDI inflow and economic growth? This paper will answer this question from a more comprehensive method. Using the generalized double diamond model, this research has proved that this increase of tax rate will have no influence on China's FDI and economic growth because Chinese national competitiveness and investment climate has improved a lot. In today's China, there are some other more significant factors for multinational corporations comparing to tax rate.

Key words: *FDI, Economic development, Tax rate, National competitiveness, Generalized double diamond model*

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1. Introduction

One of the main economic policies that economists, researchers and governments all over the world have often encouraged, from time immemorial, has been the issue of achieving high rates of economic growth. Economists have long argued that countries pursuing externally oriented development are more likely to achieve higher rates of economic growth than those that are internally focused. Among those efficient external oriented motivating factors, foreign direct investment (FDI) has been generally accepted as the most significant factor in promoting economic development in host countries (de Mello and Luiz, 1997; Alfaro and Charlton, 2007). During the past four decades, the totality of world economy has increased a lot while the FDI also has increased substantially in the world. According to statistics from UNCTAD, the world inward stock of FDI was \$0.7 trillion in 1980, \$2.0 trillion in 1990, \$7.4 trillion in 2000, and \$19.14 trillion in 2010. Corresponding figures for the totality of world economy was \$10.9 trillion in 1980, \$21.9 trillion in 1990, \$32.2 trillion, and \$63.1 trillion in 2010.

Solow (1957) showed that the growth in output was due to capital accumulation and technological progress. Multinational corporations have brought a lot of capital that needed by the host country in a direct way. Besides bringing capital, it facilitates the transfer of technology, organizational and managerial skills as well as access to international markets. More and more countries are striving to create a favorable and enabling climate by providing some incentives to attract FDI as a policy priority. Even

though the efficiency of some incentives is always questioned a lot, countries have increasingly resorted to such measures since 1990s. Among all those kinds of incentives, fiscal incentive which is the easiest measure to take has been utilized a lot. In terms of all the types of fiscal incentives granted, there is clearly an increasing trend towards offering lower corporate income tax rate for foreign firms for specific types of activities.

The role of tax rate in promoting FDI has been the subject of many studies, but the result about this research cannot be united. The relationship between tax rate and FDI inflow is a controversy issue. There have been some spectacular empirical studies which have showed the role of tax rate as facilitators of FDI is very successful. According to OECD, FDI decreases by 3.7% following a 1% increase in the tax rate on FDI (OECD, 2008). While there are also some theoretical research have improved that tax rate almost has no influence on FDI inflow since multinational corporation will take some other more important factors such as labor cost, market size, and access to raw materials into consideration. As a result, a generally accepted opinion is that tax rate has an influence on attracting FDI but its effect is less than some other main factors.

China has experienced a fast economic growth pace and high FDI inflow for the past twenty years since it opened the door to foreign investors especially after the early 1990s. Attracting FDI is an important part of the 'opening up' and economic reform process which has been included into the basic state policies since 1978. From their commencement in the 1980s, FDI in China have flourished a lot. In the last 30 years,

FDI inflow in China have expanded from almost nil in the late 1970s to \$10.6 billion in the year of 2010. Most of the FDI inflow occurred after 1992 which account for about 95% of the total FDI volume between 1979 and 2010. As a result, China has become the second largest recipient of FDI in the world. With more and more FDI inflow in China, China has also experienced dramatic changes in its economy and society. Consequently, China has transformed from a 'planned economy' to 'market-oriented economy' gradually and at the same time, its real GDP has exceeded Japan and become the second largest economic entity in the world.

Since the open-up policy implemented, the Chinese Government has established a legal framework for FDI step by step and the Chinese taxation system also began a new era of development. Accordingly, the policies on FDI have changed overtime. Those changes companied with the development of FDI inflow. From 1980s to 2007, China has operated a dual tax system, with different tax laws and tax rate, for Chinese domestic companies and for foreign companies. Foreign companies have enjoyed more favorable tax treatment than their domestic counterparts, enjoying preferential tax rates.

This kind of preferential tax rate for FDI has changed in 2007. The enactment of the *Income Tax Law of People's Republic of China for Foreign Invested Enterprises Foreign Enterprises* (Law 2007) (National People's Congress, 2007) on 26 March 2007 has brought foreign enterprises to the same tax regime as domestic enterprises. The aim for the increase of tax rate is to solve China's current problems with their enterprise income tax systems such as unfairness arising from the dual tax system,

inefficiency and lack of practical benefit, disparities between regions and tax chaos. It is necessary to unify domestic and foreign invested enterprise tax policies. Chinese government has expected that unifying the two income tax rates will not only decrease FDI inflow in China and promote improvement in China's economic structure but also will have positive effect on upgrading of its industries and help to foster a legal environment that supports fair competition.

On one hand, a lot of previous research has proved that lower tax rate for foreign firms in China have contributed a lot to China's large amount of FDI inflow. On the other hand, some scholars have stated that since China's economic strength has changed a lot and foreign firms pay more attention to other factors, this kind of increase will have no influence on FDI inflow. As a result, whether the increase of tax rate will have the expected result of Chinese government is unknown. Will this kind of change bring negative influence on China's FDI inflow? Did Chinese government make a right decision? What is the exact effect of the new tax rate policy on FDI and economic growth? Will foreign firms not care the increase due to the improvement of China's economic environment and other more significant factors? The purpose of this paper is to find the real effect of the increase of tax rate on FDI inflow and economic growth in China to answer these questions.

Most previous research has used financial approach to see the relationship among tax rate, FDI inflow and economic growth. Since Chinese government made the decision on increasing tax rate depending on the improvement of China's economic environment, it is better to use a more comprehensive approach to research this

problem. This paper will analyze the research question from the perspective of national competitiveness.

This paper is divided into four sections. In order to finish this paper better, there is the literature review in the following section. In this section, first it will review some research on the theories of FDI determinants to show how low tax rate will influence multinational corporations' decisions. Second, there will be the review about research on the relationship between tax rate and FDI inflow, and the relationship between FDI and economic growth. Thirdly, research on the Chinese case will be reviewed. Finally, there will be a literature review for the model to measure a country's competitiveness.

Following the literature review section, there will be two case studies which consist of Ireland as a successful case and Argentina as a lost case so that the relationship among tax rate, FDI inflow and economic growth in the real world can be realized more clearly.

After case study, the analysis section of this paper will be talked. In this section, the hypothesis will be developed very first. In order to prove the hypothesis, this section will be divided into two parts. The first part will focus on the development process of Chinese tax rate policies for the past over 30 years and the situation of FDI and economic growth during this period. In the second part, the generalized double diamond model which has incorporated tax rate as a factor will be used to measure how China's national competitiveness has changed from 1978 to 2010. Based on this double diamond model, the effect of tax rate will be analyzed more clearly. In order to emphasize the change of China's national competitiveness, there will be a comparison

between China and India in this part. Depending on the analysis, the result analysis and suggestion to Chinese government is followed.

The last section of this paper is the conclusion part which focuses on the conclusion and further study.

2. Literature Review

2.1 Determinants for FDI-OLI paradigm and imbalance theory

Corporations often prefer FDI to other international entry modes such as exporting and licensing. In the world of traditional economics, where competition is perfect and transaction cost is zero, there is no room for FDI. Multinational corporations (MNCs) prefer FDI when they find the external markets are not efficient. If the external markets of exporting and licensing are costly, firms would internalize the transactions within their organizations. So, internalization is the key to explain the determinants for FDI.

With respect of the determinants of FDI, the most fundamental question is what motivates MNCs to invest overseas. The grandfather of FDI theories is Hymer (1976) but his theory is incomplete. Hymer articulates the importance of market imperfections but does not develop his argument into a theory of MNCs. Furthermore, Markusen (1984) and Helpman (1984) suggested that the motivations for FDI can be divided into two types: *market seeking FDI* (also called horizontal FDI) in order to seek market in the host country and avoid trade frictions and *resource seeking FDI* (also called vertical FDI) with the purpose of accessing low resource such as low labor costs, infrastructure or natural resources in the host country.

Other scholars (Buckley and Casson, 1976; Rugman, 1981; Hennart, 1982) extend Hymer's theory of market imperfections into a formal theory, i.e., the

internalization theory. Dunning (1988) advances the internalization theory further by incorporating two other variables—ownership advantages and locational advantages. Dunning's eclectic or OLI paradigm is now the most popular modern theory of FDI. It was first put forward in 1976 during a presentation at a Nobel Symposium in Stockholm. Dunning said that his intention was to offer a holistic framework by which it was possible to identify and evaluate the significance of factors influencing FDI.

Ownership (O) advantage

In order for the MNC to compete with local firms, the MNC must possess firm-specific advantages to compensate for the costs of foreignness. In 1976, Dunning identified three types of ownership advantages: (1) those which stem from the exclusive privileged possession of, or access to, particular income generation assets; (2) those which are normally enjoyed by a branch plant compared with a *de novo* firm; and (3) those which are a consequence of geographical diversification or multi-nationality *per se*. In a later typology, Dunning (1988) distinguished between the *asset (Oa)* and *transaction (Ot)* advantages of the MNC. Dunning (1988) then argues that the most successful MNCs are those that are best able to nurture and exploit both asset and transactional ownership advantages.

Locational (L) advantage

MNCs possessing common ownership advantages can have different investment decisions depending on where they invest. The locational advantages are immobile

factor endowments, or other intermediate products, in host countries. Once more, a distinction needs to be drawn between different kinds of market imperfections. Structural market imperfections including those arising from government intervention may either encourage or discourage inward FDI. On the other hand, even without such distortions, FDI would still occur where there are transaction gains resulting from enhances arbitrage opportunities, the reduction of exchange risks, better coordination of strategic activities, and so on.

Internalization (I) advantage

The great the perceived costs of transactional market failure, the more MNCs are likely to exploit their competitive advantages through international production, rather than by contractual agreements with foreign firms. In contrast, the higher the administrative costs of hierarchies and/or the external diseconomies of operating a foreign venture, the more probable it is that the latter vehicle, or at least a jointly shared equity stake, will be preferred. Dunning claims that it is not only useful, but also logically correct to distinguish between the capability of MNCs to internalize the market, and their willingness to do so. However, the easiest answer to this question is that the ownership advantage is a result of structural market imperfections and the internalization advantage is a response to transactional market imperfections.

As discussed, Dunning's OLI paradigm is very comprehensive and eclectic in analyzing the determinants of FDI. Dunning (1995) reappraises the eclectic paradigm in an age of alliance capitalism. In his later work, Dunning (2000) classifies three main

kinds of traditional ownership advantages: (1) monopoly powers (Bain, 1956; Hymer, 1976; Porter, 1980, 1985), which are barriers to entry to final product markets; (2) non-transferable resources (i.e., resources-based view of the firm), which are barriers to entry to factor, or intermediate, product markets; (3) competencies of the managers (Prahalad and Doz, 1987; Bartlett and Ghoshal, 1989), which may vary widely even within the same corporation. To these three kinds Dunning (2000) adds the fourth kind: asset-augmenting or dynamic ownership advantage. According to Dunning, static ownership advantages are income generating resources and capabilities; and dynamic ownership advantages are to sustain and increase the income generating assets over time.

Actually, FDI has two directions. One is the investment from a more developed country to a less developed country, which can be termed ‘downward’ FDI. The other is the investment from a less developed country to a more developed country, which can be termed ‘upward’ FDI. Including Dunning’s eclectic paradigm, most of the FDI theories have been developed to explain downward FDI. How can we explain the upward FDI?

The first systematic attempt was made by Moon (1988), where he explained FDI by firms from developing countries, as well as FDI by firms from developed countries, with a combined concept of ownership advantages and disadvantages. Moon and Roehl (1993, 2001) then developed this approach to the imbalance theory to explain various types of FDI. The imbalance theory treats the imbalances of ownership advantages and disadvantages, while the eclectic paradigm treats only ownership advantages.

A firm has two different motivations for going abroad: one is to exploit its existing advantages and the other is to seek new advantages. The former is well explained by the existing theories but the latter can be explained only by the imbalance theory. When the firm cannot get critically important assets such as technology and other resources, the firm will search for a balance of its asset portfolio, which will be a powerful force in going abroad to compensate for these disadvantages in foreign countries. Firms are becoming more active in investing in global markets for different strategic reasons and these unconventional FDI activities have become more important than ever before. Thus, both advantages and disadvantages, or their balance, should be considered in the FDI decisions.

2.2 The relationship between tax rate and FDI

There has been plenty of research done by economists all over the world to examine the relationship between FDI and economic growth. So far, the study about the relationship between FDI and economic growth mainly focus on the opinion that FDI will bring the economic growth factors that are needed to develop economy according to the new economic growth theory to the host country.

A generally accepted conclusion is that FDI has played a significant role in promoting economic growth in host countries because FDI represents the transmission to the host country of a package of capital, more efficient labor skills and managerial skills, and higher technology. The FDI by multinational corporations is considered to play an important role for the access of advanced technologies by developing countries

(Borenszteina, Gregoriob, and Lee, 1998). It is possible to identify a number of positive welfare effects of FDI in the host economy: effects of capital inflows on the economy's output potential, through the economy's productive capacity, that is supply-side effects, technology transfer through foreign firms who bring superior technology, the know-how in the domestic market, managerial skills, increase in competition in the host country, the establishment of foreign firms leads to advantages in terms of foreign market access, augmenting domestic savings and investment, increasing exports and thereby earning foreign exchange and employee training (Alfaro and Charlton, 2007).

Some other scholars have researched about the relationship between FDI and economic growth from the perspective of host countries. From a theoretical point of view, existing evidence show that FDI contributes to development but the extent of this contribution depends on the host countries' ability to reap the fruits of FDI. Borenszteina et al. (1998) postulate that FDI would have a greater impact on economic development when the labor force in the host country is educated enough to be able to absorb the spillover effects from FDI. They used human capital as a proxy for absorptive capacity and stress that the higher productivity of FDI only holds when there is a minimum threshold stock of human capital in the host country to diffuse the advanced technology from FDI. Alfaro and Charlton (2007) also assert that FDI conveys greater knowledge spillover but the ability of a country to take advantage of this externality may be limited by local conditions.

Most literature on taxation and FDI is originated from Hartman (1984). He is the

first one to point out the difference between FDI financed by retained earnings and transfer of funds so that certain types of FDI may not be related to taxation. He has proved that FDI financed by retained earnings responds significantly to host country tax rates while FDI from transfer of new funds does not significantly respond to host country tax rates.

After Hartman's research, many subsequent studies have emerged based on Hartman's paper. Boskin and Gale (1987) re-estimated Hartman's model using the updated tax rate and rate of return series. Their study concludes that although the results are somewhat sensitive to sample period and empirical specification, the findings by Hartman are fairly robust.

Papke (1987) investigated the effect of interstate tax differentials on the location of capital investment but used a different measure of relative business tax burdens (the after-tax rate of return on a marginal investment) in the empirical model. His conclusion is that investment location decisions among states are affected by state-local tax cost differentials. However, there are some questions left unsolved in this study such as whether or not specific industry investment is responsive to the state tax incentives aimed at lowering the cost of capital.

Moore, Steece, and Swenson (1987) examined the influence of both the state corporate income tax rate and the form of income tax base structure on foreign investment in manufacturing assets. It is found that business climate, agglomeration economics and unitary tax structures are all important determinants of foreign manufacturers' investment decisions.

A lot of studies have found the conclusion that tax incentives such as tax rates can be a major factor in their investment location decision (UNCTAD, 2000). In one of the IMF working paper (Lim, 2001), the conclusion is that tax rate as fiscal incentives in the host country can increase the country's locational advantage for FDI. Some studies (Young, 1988; Grubert and Mutti, 1991; He and Guisinger, 1993; Hines, 1996) have found tax incentives to be an important factor in attracting FDI and in the making of regional investment decisions.

In 2000, UNCTAD has conducted a survey around the world. The main purpose of that survey is to prove that FDI is increasingly being recognized as an important factor in the economic development of countries and tax incentives such as tax rate can be a major factor in their investment location decisions. The conclusion of that survey is that countries often employ a mix of incentives to channel investment for development of a particular area or region and countries employ tax incentives in order to promote sectors of industry or activities considered crucial for development. A longer period of low tax rates may produce a windfall gain for certain (if not most) qualifying investment projects. That is to say, a longer period would result in qualifying firms benefiting from a reduced rate of tax on 'old' capital already installed in the host country.

Similarly, in 2008, OECD has also conducted a report to examine tax rate effect on FDI. It found that FDI decreases by 3.7% following a 1% increase in the tax rate on FDI. The sensitivity of FDI to tax depends on the host country and the mobility of business activities underlying the tax base. Taxes are likely to matter more in choosing

an investment location.

Based on the above, a number of studies and scholars have proved that tax rate as a kind of tax incentive has positive influence on FDI inflow. That is, keeping a country's lower tax rate for foreign company's income will attract more FDI in this country. However, some other scholars and studies have held an opposite opinion on the relationship between tax rate and FDI inflow. According to previous empirical studies in this opposition camp, some evidence shows that compared to factors such as labor costs, infrastructure and market size, tax rates have limited effects on the initial foreign investment decisions (Forsyth, 1972; Carlton, 1983; Lim, 1983; Moore et al., 1987). Here the interesting point is that these scholars have agreed with that tax rate has significant impact on the decision of regional choice in a country or area after market entry (Forsyth, 1972).

Several investigators, including Hartman (1984), Boskin and Gale (1987), and Young (1988) measured the effect of the effective tax rate on FDI. Grubert and Mutti's (1991) empirical estimates show that the statutory tax rate is a better determinant of income shifting than the effective tax rate.

2.3 Research on Chinese case

A lot of scholars have researched FDI in China. As mentioned above, Chinese tax rate for foreign companies has kept in a relative low level from 1980s to 2007. And China increased the tax rate from 2008. So, it is better to review the studies about FDI in China separately for these two periods.

Before 2008

Due to the ‘reform and opening up’ policy, China’s economy has changed a lot. China has successfully transformed from a planned economy to a market-oriented economy and has achieved economic growth at double-digit for many years. Some scholars have examined the relationship between FDI inflow in China and Chinese economic development.

Buckley, Clegg, and Wang (2002) have tested the impact of inward FDI on the performance of Chinese domestic firms for the manufacturing sector. Their research result has indicated that FDI improves the performance of Chinese indigenous firms. This empirical findings point to the collective importance of the elements in the package of resources associated with FDI. Bo (2006) empirically examined the displacement effect of FDI in China using a panel data set of 29 provinces from 1985 to 2003. The empirical results suggest that FDI has a significant role in effect on domestic investment in China.

Many scholars believe that FDI in China has developed as a result of the ‘opening-up’ policy, the economic reform, as well as the changes in the Chinese tax system. Fung, Lizaka, and Tong (2002) traced the development of China’s economic policy regarding FDI and the resulting changes in FDI inflow from 1980s to 2000s. This paper has also investigated the relationship between FDI inflow and the development of the Chinese economy. The conclusion is that increase in FDI volume in China has positively impacted Chinese GNP changes, international trade, and the progress of advanced technologies. Meanwhile, Huang (2003) reviewed the dual tax

system in China, which is mentioned above that foreign companies and domestic companies apply to different tax rate. He showed that in many important aspects, tax preferential has stimulated foreign companies to invest in China.

Many previous empirical studies have provided evidence that China's tax incentive policies have positive effects on FDI. Tung and Cho (2000) have tested whether tax rates influence foreign investment decisions and the particular forms of FDI in China. They have reached the conclusion that relative low tax rate are effective in attracting FDI to China. Furthermore, they have found that low tax rate can influence the organizational form of FDI. Tung and Cho (2001) further investigated whether tax rates as a kind of tax incentives can attract FDI into certain designated areas in China. In this study, they controlled for other related non-tax variables such as infrastructure, unemployment rate and wage rate to do empirical study. The results have stated that both tax and non-tax variables (infrastructure) are important determinants of regional investment decisions in China.

After 2008

Research on the effect of the increase of tax rate for foreign companies in 2008 mainly have reached the conclusion that this tax rate increase will have no effect on FDI inflow in China. Wang and He (2008) have analyzed the impact of the change for tax rate by comparing the shortcomings of the policy for keeping a relative low tax rate for foreign companies and the advantages of the increase of tax rate. Their conclusion is that this change will have no major influence on FDI inflow in China. They have

strongly stated that the increased tax burden for foreign companies is not likely to slow down FDI inflow in China while it will help foreign companies to revise its organizational structures in China so that they can adapt to new Chinese economic structure. Li (2008) has reached the conclusion that the focus of Chinese tax incentives for foreign companies has shifted from special regions to the entire country, from a regional development orientation to an industry orientation, from an export oriented to a domestically-driven economy. This focus will facilitate overall planning for coordinated economic, social and regional development; promote improvement in China's economic structure, and the upgrade its industries.

2.4 Research on national competitiveness

Porter (1990) introduced the diamond model in his book, *The Competitive Advantage of Nations*. This model is comprehensive because it creates a single model by incorporating the production factor conditions that most traditional theorists have employed with other important variables to explain national competitiveness. Porter's single diamond model consists of two parts: endogenous variables and exogenous variables. The endogenous variables are composed of factor conditions, firm strategy, structure, and rivalry, related and supporting industry and demand conditions, while the exogenous variables consist of government and chances. Even though Porter's single diamond model has created a comprehensive way to measure or analyze national competitiveness, it has been extended in two directions since this model has not taken some other factors into consideration such as internationalization. With the trend of

economic globalization become stronger and faster, the first extension about the diamond model was the incorporation of multinational activities through the introduction of the generalized double diamond model (Rugman, 1991; Rugman and D'Cruz, 1993; Moon et al., 1998; Dunning, 2003).

The generalized double diamond model was introduced as an extension to Porter's single diamond model by incorporation an international diamond into the single diamond model. In the generalized double diamond model, national competitiveness is defined as the capability of firms engaged in value added activities in a specific industry in a particular country to sustain this value added over long periods of time in spite of international competition. Theoretically, two methodological differences between Porter and this new model are important. First, sustainable value added in a specific country may result from both domestically owned and foreign owned firms. Second, sustainability may require a geographic configuration spanning many countries, whereby firm specific and location advantages present in several nations may complement each other. Porter's global firm is just an exporter and his methodology does not take into account the organizational complexities of true global operations by multinational firms (Moon, 1994). This paper will use the double diamond model to examine China's national competitiveness.

Actually, some countries have made very fast economic progress through inviting FDI by providing foreign companies with a low level of tax rate just like China from 1980s to 2007, such as Singapore and Ireland. However, some countries also have increased their tax rate for some economic and political purposes just like China in

2008, such as Argentina. Nevertheless, their choices have been proved to be wrong. Increased tax burden on foreign companies not only has not brought the upgrading of economic and industrial structure but has reduced the FDI inflow. The following section will talk about those two kinds of cases more specifically. The successful case is Ireland while the case of failure is Argentina in order to see the relationship between tax rate and FDI inflow and economic growth in real world.

3. Case Study

3.1 Ireland case

Ireland is an island to the northwest of continental Europe. It is the third-largest island in Europe and the twentieth-largest island in the world.

Ireland is the most FDI-intensive economy in Europe. Foreign-owned firms account for almost 50% of Irish manufacturing employment. The most typical feature of the country's development strategy over the last four decades of outward orientation has been the emphasis on attracting FDI. Ireland has been remarkably successful in inviting FDI in the country even before the 'Celtic Tiger era' of the 1990s and beyond (Buckley and Ruane, 2006).

Ireland remained protectionist for about a decade after most of the rest of Western Europe had moved towards freer trade which resulted at keeping Ireland stagnated with a growth rate of less than 2%. What's more serious is that the depressed economy of the 1950s had made more than 400,000 Irish people emigrate. By the end of the 1950s it was clear that economic policy would need to be completely changed. So it began its trade integration with Continental Europe began in the late 1950s. The First Program for Economic Expansion, which removed protectionism, has encouraged FDI and promoted exports, was introduced in 1958. The move towards openness was accompanied by the introduction of a zero tax rate on profits derived from manufactured exports and a liberalization of the law on foreign ownership of

companies. From 1958 to 1973, the FDI inflow had led Ireland GDP increase from less \$1,900 million to over \$7,200 million. The growth rate is over 300%.

In 1973, Ireland became a number of EU. This brought a substantial increase in FDI inflow which began to locate in higher-technology sectors because the upgrading of the Irish tertiary educational system. The major expansions were in computing equipment, electronic components, and pharmaceuticals and medical and optical devices, and these expansions continued into the ‘Celtic Tiger’ era. From 1973 to 1987, the Irish government not only guided FDI into high technology parts and kept the tax rate in a low level. During this period, FDI inflow has increased from \$52 million to \$332.5 million. The economic average annual growth rate has kept at 5%.

After 1987, with the outlawing of restrictive public procurement practices under the Single European Market initiative, the attractiveness of Ireland as a destination for FDI increased. At that time, Ireland had the lowest rate of corporate tax in the EU. This kind of low corporate tax environment which proved especially beneficial to high-technology multinational corporations who are better able to exploit its benefits was very attractive.

Combined with the increase of manufacturing FDI, Ireland also began to attract increasing services-sector FDI inflow. Ireland’s capacity to attract FDI in service industry was facilitated by substantial reductions in the rate of corporate tax on services during the period from 1980s to 1990s, The Irish government decided in 1998 on a harmonized rate of 12.5% which was expected to produce substantial benefits to most services sectors in order to utilize the impact on manufacturing.

Given the growth in offshoring of R&D, along with Ireland's convergence on average Western European living standards by the early years of 2000s, science, technology and innovation policy has moved to the heart of the Irish policy agenda. This can be treated as a kind of preparation to become a real 'Celtic Tiger' for Ireland. From 1987, Ireland has kept its annual economic growth rate in a level of 5% very stably. Its FDI inflow has broken through \$10,000 million in 1999 and kept increased until 2003. Due to the high economic performance, Ireland has become a world-recognized, 'Celtic Tiger.'

Based on the discussion above, Ireland economic growth cannot be separated with its FDI inflow. Furthermore, the FDI in Ireland has been attracted by its low tax rate compared to other European countries. The development process of Ireland's corporate tax regime can be concluded as the following table.

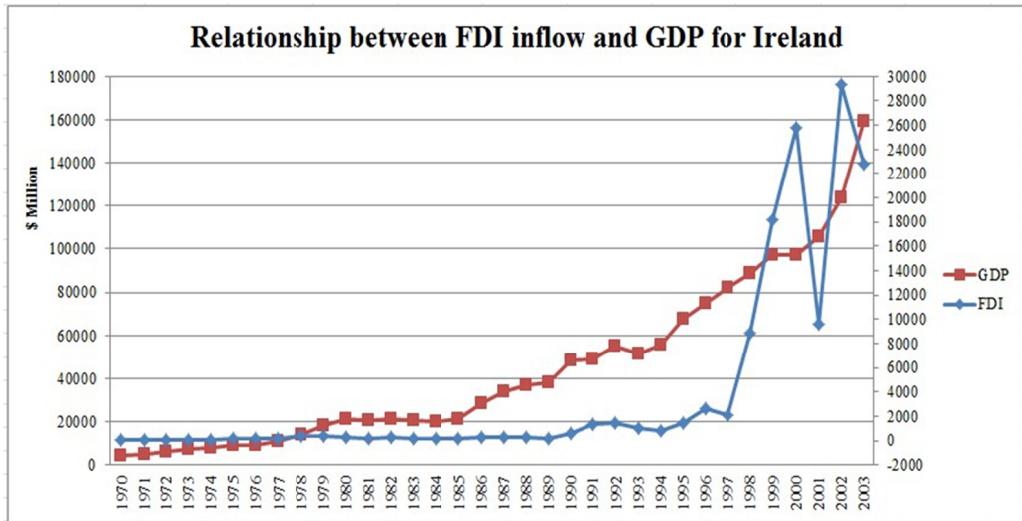
Table 1. Ireland's corporation tax regime

1956: Finance Act introduces Export Profits Tax Relief (EPTR), mainly for manufacturing industry, with 50% tax forgiveness on profits. This measure provided full relief for fifteen years and tapering relief for a further five years.
1958: The tax forgiveness decided in 1956 increased to 100%
1969: EPTR extended to 1989-1990.
1978: Government abolishes EPTR and replaces it with a special 10% rate of corporation profits tax for all manufacturing industry from 1981-2000. In addition, those qualifying for export-tax relief before 1981 continue to benefit until 1990.
1987: Profits of qualifying activities carried out from the Centre are taxed at 10% until 2005.
1990: Government extends the 10% corporation profits tax rate to 2010.
1990: Government extends the 10% corporation profits tax rate to 2010.
1998: Agreement with European Commission on universal 12.5% corporation tax for all trading companies from 2003. However, all existing commitments to the 10% tax rates for manufacturing industry to the year 2010 to be honored. The current 28% standard rate applying to most Services to be reduced by 4% annually in 2000, 2001 and 2002, and by 3.5% in 2003, giving a 12.5% rate at that date.

Source: MacSharry and White (2000)

A lower tax rate for foreign companies has helped Ireland to invent FDI, and the increasing FDI inflow has influenced Irish economic growth positively. This kind of relationship can be realized more clearly according to Figure 1.

Figure 1. Relationship between FDI inflow and GDP in Ireland.



Source: UNCTAD statistic database (2011a)

3.2 Argentina case

Argentina, officially the Argentine Republic, is a country in South America. It is constituted as a federation of 23 provinces and an autonomous city, Buenos Aires. It is the eighth-largest country in the world by land area.

Like other Latin American countries, Argentina has experienced a big economic reform since 1990s. After coming into office in 1989, the administration of Carlos Menem was very unsuccessful to make policies to stabilize the hyperinflation, which has led Cavallo to become the Minister of the Economy in early 1991. Cavallo launched a currency-board scheme in order to stop inflation. Furthermore, he had launched the structural reform for Argentinean economy and taken measures to stabilize price.

Thanks to his structural reforms and price stabilization, the Argentine economy

began to develop into a stabilization and growth period that lasted until 1998. Between 1991 and 1998, GDP grew at an annual average rate of 5.9%. The consumer price index dropped to 84 in 1991 and 17 in 1992. One-digit inflation rates were registered by 1993 and 1994, and there was practically no inflation during the rest of the 1990s.

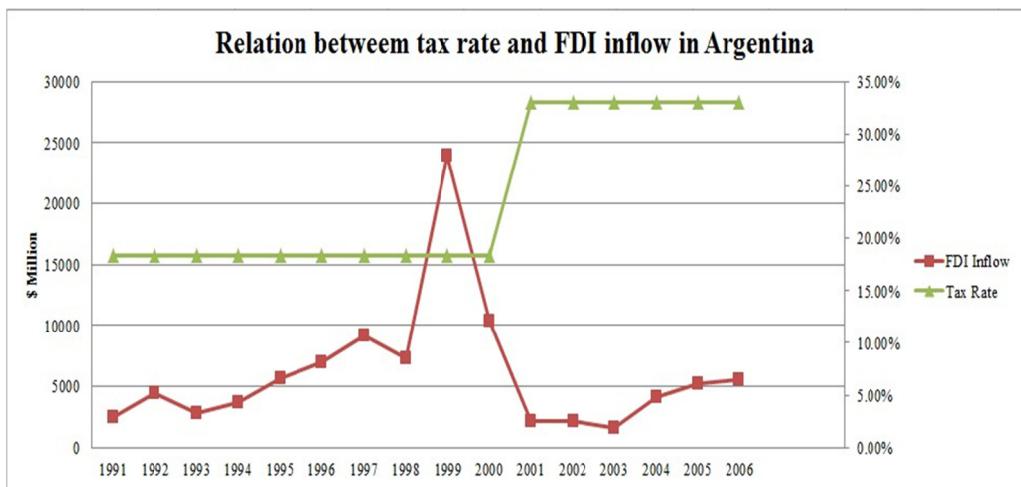
What other thing has contributed to Argentine economic growth was FDI. Argentina has made some attractive policies to invite FDI from other countries. Structural reforms created an FDI-friendly environment for foreign companies. Privatization has also played an important role on attracting FDI. Trade liberalization also helped to attract FDI, given the change in MNCs' strategies worldwide. Investor-friendly approach was accompanied with a lower level of corporate income tax rate which had been kept in a low level of average 18.3% from 1990 to 2000 for FDI. As a result, while FDI inflow reached an annual average of \$7 billion during the 1990-2000 periods. Growing foreign investments were reflected in an expanding FDI stock that reached \$80 billion in 2001.

Unfortunately, Inward FDI flow declined sharply in 2001 due to domestic and international developments. The effects of the global decline on FDI flow were magnified locally by the convertibility crisis in Argentina to a level of 79% dropped, which means there was a severely impact on FDI inflow to the country. What makes worse was that the Argentina government decided to increase its corporate income tax rate on FDI to a high level of 33%.

From 2002 to 2008, foreign companies began to undergo a phase of reorganization and restructuring after the local crisis, with FDI inflow contracting at

the domestic level as well as globally. With the fast economic growth, increased demand, and renewed competitiveness, there was a vigorous expansion of FDI inflow. However, the preferential corporate income tax rate for FDI was disappeared. The high level tax rate of 33% was kept. As a result, the growth rate of FDI inflow has decreased comparing with the period before 2001 crisis. The relationship between FDI inflow and corporate income tax rate in Argentina has been showed by Figure 2.

Figure 2. Relationship between tax rate and FDI inflow in Argentina



Source: Chudnovsky and López (2008)

Through the case study of Ireland and Argentina, the impact of tax rate as a kind of tax incentives to attract FDI is very obvious. Low tax rate has helped Ireland become the ‘Celtic Tiger’ during the past decades. A relatively low tax rate also has made Argentina economy grow a lot. Unfortunately, Argentina government increased its tax rate for foreign company in 2000, the FDI inflow in Argentina has dropped a lot.

However, it's hard to exclude some other FDI determinants from 2001 to 2004 has influenced Argentina a lot so that the FDI inflow decreased very drastically. Having looked at Argentina's case, it seems like that China will become another Argentina since it has increased its tax rate and experienced the 2008 global finance crisis. Will this happen?

4. Analysis Part

4.1 Hypothesis development

As mentioned in the literature review section, Dunning' eclectic paradigm further asserts that the precise configuration of the OLI parameters facing any particular firm, and the response of the firm to that configuration is strongly contextual (Dunning, 2000). In particular, it will reflect the economic and political features of the country or region of the investing firms, and of the country or region in which they are seeking to invest; the industry and the nature of the value added activity in which the firms are engaged; the characteristics of the individual investing firms, including their objectives and strategies in pursuing these objectives. Scholars have identified four main types of foreign based MNC's activities:

- i: That designed to satisfy a particular foreign market, or set of foreign markets, namely, market seeking, or demand oriented FDI.
- ii: That designed to gain access to natural resources, such as minerals, agricultural products, unskilled labor, namely, resources seeking, or supply oriented FDI.
- iii: That designed to promote a more efficient division of labor or specialization of an existing portfolio of foreign and domestic assets by multinational corporation, i.e. rationalized or efficiency seeking FDI.
- iv: That designed to protect or augment the existing O specific advantages of

the investing firms and/or to reduce those of their competitors, namely strategic asset seeking FDI.

According to previous research, tax rate in host country has been proved to be a kind of determinants for MNC's FDI decision on the location factor. Without exception, FDI in China also belongs to those four types mentioned above. The entire foreign firms who come to China can be concluded in one type of FDI or plural types of FDI mentioned above. They are attracted by China's market, resources, and circumstances which can improve their efficiency and augment their existing advantages. Different attractions in China will make foreign firms have different reaction toward the change of tax rate. For example, foreign firms who belong to market seeking maybe do not care the increase of tax rate since the Chinese market size is big enough for them to offset increasing cost brought by increased tax rate. A resource seeking company may not care about the change in tax rate since China's resources are more significant for its investment instead of tax rate. Strategy seeking company may also pay no attention on the change of tax rate. In sum, all the foreign corporations in China can be divided into two camps. The first one is those who really care about the increase of tax rate. And the other one is those who enjoy other FDI attractions in China such as labor cost, natural resources and market than tax rate resulting in they do not care the increase of tax rate. The influence of the increase tax rate on FDI will depend on the balance of power for these two camps.

On the other hand, Chinese economic and business environment has changed a lot compared with 30 years ago. At that time, China did not have enough basic

infrastructures that are useful for FDI such as transportation facilities and telecommunication facilities; China's internationalization is not good enough for FDI to transfer their products produced in China to other places; and China's financial system is not perfect for foreign firms to invest in China. As a result, tax rate might be a kind of big attraction for foreign firms to invest in China. However, China is different nowadays. A wide range of supporting facilities, systems, and services has improved a lot. In other words, business environment has made the role of tax rate in attracting FDI smaller than before.

Furthermore, based on the research above, most scholars have proved that a lower tax rate has a positive influence on attracting FDI. According to OECD (2008), the increase of tax rate will make FDI inflow decrease. Besides, Argentina has experienced a lower FDI inflow since it increased tax rate. It is very possible for China to undergo a decrease of FDI inflow after increasing the tax rate. Combing all the factors discussed above, the hypothesis for the effect of Chinese increased tax rate in 2008 on China's FDI inflow and economic growth in this paper will be developed as following.

Hypothesis

Since China's investment environment and national competitiveness has improved a lot, and other attractive factors have promoted as well, in spite of the increased tax rate in 2008, FDI inflow in China will not decrease. The increased tax rate in 2008 will have no influence on China's FDI inflow and economic growth because of more perfect investment and business environment in China.

Explanation for hypothesis:

The increase of tax rate has made foreign firm's cost increase. However, comparing with the increased cost, the benefit brought by the improved investment and business environment and national competitiveness in China is larger. As a result, foreign firms do not care whether the tax rate will increase or decrease. Business environment has attracted them to select China as their investment location and they will come to China. The increase of tax rate will have no influence on China's FDI inflow. Since there is no change in FDI inflow, there will be no change in the contribution of FDI to China's economic growth. In other words, increased tax rate also has no influence on China's economic growth. Furthermore, foreign firms want to enjoy other attractions in China such as cheap labor, larger market size, and abundant natural resources. Foreign firms come to China to find more market for the demand of their products and more resources such as minerals and labors for the supply of their products. Since those kinds of attractions will bring more benefit to foreign firms compared to low tax rate. The increase of tax rate will have no influence on China's FDI inflow and economic growth. The following part will talk about China's tax rate from 1980s to 2011 first and China's national competitiveness secondly so that the hypothesis can be proved.

4.2 China's tax rate from 1980s to 2011

Since the open-up policy implemented, the Chinese Government has established a legal framework for FDI step by step and the Chinese taxation system also began a

new era of development. Accordingly, the policies on FDI have changed overtime. Those changes companied with the development of FDI inflow and economic growth.

During 1980s

In the early 1980s, China was very poor in investment environment. This included backward infrastructure, very weak industrial fundamental conditions, low level demand markets, and an ineffective legal system. In addition, China hardly understood how to open markets, which became an obstacle for foreign investors to be involved in China. To attract large scale foreign investment, China chose a policy of ‘concessions to promote the opening of the market.’ Preferential tax rate for foreign investors was seen as one means to compensate a poor investment environment.

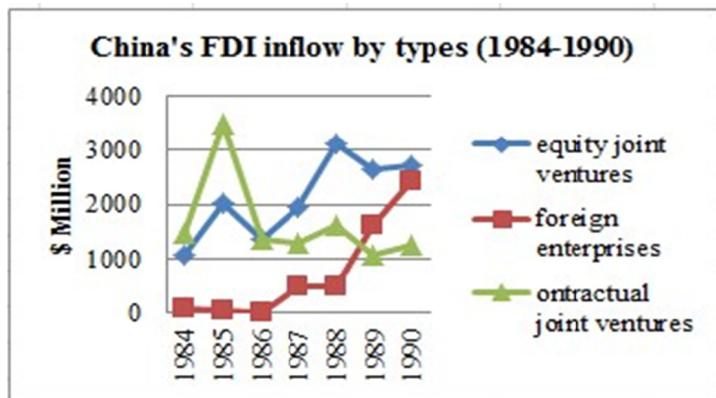
Since 1980s, the Chinese Government has established a number of open economic zones which offered a more liberal investment and trade regime for FDI than other areas in addition to lower tax rates. As more regions become more opened to the outside world and reformed deepened, foreign investment steadily increased in equity joint ventures, contractual joint ventures and wholly foreign-owned enterprises. To meet the tax demands of emerging joint ventures of FDI, China promulgated the *Income Tax Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures* (National People's Congress, 1980) and its rules of implementation. The *Income Tax Law of the People's Republic of China Concerning Foreign Enterprises* (National People's Congress, 1981) and its rules of implementation were also successfully introduced in the next two years. This law applies to foreign enterprises

with establishments in China engaged in independent business operations, or in cooperative production or cooperative business operations with Chinese enterprises. These two laws had an extremely significant effect on foreign firms by providing preferential tax rates and encouraging investment in China.

What's more interesting is that during this period, compared with the contractual joint ventures and wholly-owned foreign enterprises, equity joint ventures enjoyed greater preferential tax treatment. For example, the income tax rate on equity joint ventures was 30% with a local income tax of 10% of assessed income tax (that is a further 3% on taxable income). However, the tax rate for foreign enterprises was computed progressively on taxable income in excess of specified amounts. The result is a tax rate for foreign enterprises ranging from 20% to 40%, with a 10% local income tax levy. Furthermore, all equity joint ventures, regardless of their nature, enjoyed a full two years tax holiday, followed by a three years reduction at 50% of the applicable tax rate. This kind of discrimination had a great negative effect on the enthusiasm of foreign investors.

As mentioned above, in this period, Chinese government has applied different income tax rate on different types of FDI. In other words, compared with the contractual joint ventures and foreign enterprises, equity joint ventures enjoyed greater preferential tax treatment. Corporate tax rate was lower than other two types of FDI. The volume of FDI inflow in those three different types from 1984 to 1990 can be seen in Figure 3.

Figure 3. China's FDI inflow by types (1984-1990)



Source: China annual statistical database (2012)

From the figure above, it is obvious that the volume of equity joint ventures in this period is far more than other two types of FDI except the 1985. Actually, the contract signed in this year was almost same to 1984. Since some contracts had involved large amount of money, the volume in this year as increased. In sum, this period has proved that lower tax rate can attract more FDI into China. In order to examine the relationship among FDI inflow and economic growth, the following examination will combine those three types of FDI together. During this period, the volume and growth rates of China's FDI inflow and GDP can be seen in Table 2.

Table 2. China's FDI inflow and GDP (1984-1990)

	FDI Inflow \$ Million	GDP \$ Million	FDI growth rate	GDP growth rate
1984	1,419.0	317,352.1	50.0%	0.8%
1985	1,956.0	309,082.6	37.8%	-1.5%
1986	2,243.7	304,347.9	14.7%	8.4%
1987	2,313.5	329,851.4	3.1%	25.3%
1988	3,193.7	413,438.7	38.0%	11.2%
1989	3,392.6	459,782.3	6.2%	-12.0%
1990	3,487.1	404,494.2	2.8%	4.9%
Average	2,572.2	362,621.3	21.8%	5.3%

Source: UNCTAD statistic database (2011a)

Based on the table above, China's FDI inflow and GDP has increased since China began to take 'opening-up' policy from 1978. FDI inflow almost had kept the same trend with the increase of GDP. The lower tax rate for equity joint venture type FDI was more than other two types.

From 1991 to 2007

As more regions began to be opened to the world and the economic reform turned to be more deepened, FDI had been steadily increased in equity joint ventures, as well as contractual joint ventures and wholly-owned foreign companies. On 9 April 1991, the Seventh National People's Congress adopted the *Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises*

(Law 1991) (National People's Congress, 1991), implemented a unified income tax law for equity joint ventures, contractual joint ventures and wholly foreign-owned enterprises. Law 1991 went into effect from 1st July, 1991.

There are three policy principles formed in the new Law 1991: first, to implement the policy of opening the Chinese economy to the outside world and the strategy of developing the economy to improve the investment environment as well as promote foreign economic and technological development; second, to continue to implement lower tax rates, more preferences and facilitated procedures on the basis of safeguarding national interests, and to focus preferential tax treatment measures on guiding the orientation of foreign investment towards encouraged industries; third, to combine the continuity, stability and adaptability of the tax law on the basis of China's actual situation and international practice.

The unified tax rate was 30%. For foreign enterprises, although the nominal tax rate was 30% (with a further local income tax computed on the taxable income at a rate of 3%), a reduced rate can be applied to those located in regions specially related with specific projects. Law 1991 and subsequent legislation pointed out that:

i: A 15% income tax rate would apply to the following foreign invested enterprises (FIEs):

- FIEs located in Special Economic Zones (SEZ), FIEs with establishments or business offices in SEZs engaged in production and business operations, as well as those FIEs engaged in production which had establishments in Economic and Technological Development Zones

- FIEs engaged in production which were located in the old urban districts of cities within the SEZs, the Coastal Economic Open Zones, the Economic Technological Development Zones, and which were engaged in technologically intensive or knowledge intensive projects, or foreign invested projects with an amount of investment of more than \$30 million and a long capital recovery time, or engaged in energy sources, transportation and port constructions;
- Foreign - Chinese Equity Joint Ventures engaged in the construction of ports and docks;
- Foreign capital banks and Foreign-Chinese Joint Invested Banks and other financial institutions located in the SEZs or other areas approved by the State Council, where the capital provided by foreign investors or the funds for business activities allocated by the head office bank to the branch bank exceeds \$10 million; And at the same time with an operational period of ten years or more;
- FIEs engaged in production set up in the Pudong New District of Shanghai, and FIEs engaged in energy exploitation and transportation construction projects such as airports, ports, railways, highways, and electricity power stations;
- Accredited high technological FIEs set up in New and High-technology Industrial Development Zones identified by the State Council; or accredited new technological FIEs situated in Beijing New Technology Development and

Experiment Zones;

- FIEs established in other places specified by the State council and engaged in such projects as encouraged by the State;
- FIEs engaged in encouraged projects established in western regions of China during 2001–2010

ii: The following enterprises and projects will be eligible for taxation on enterprise income at 24%:

- FIEs engaged in production situated in Coastal Economic Open Zones or in the old urban districts of cities in the SEZs or the Economic and Technological Development Zones
- FIEs engaged in production situated in coastal port cities, provincial capitals cities, open riparian cities, the border economic cooperation zones and the border cities of China;
- FIEs situated in national tourist vacation areas which approved by the State Council.

In conclusion, during this period, the tax rates are widespread as long as they are foreign-related enterprises regardless of regions, industries and technical sophistication. In addition, regionally based benefits are more accepted than industrial and technical benefits, and are more concentrated on the coastal regions such as Guangdong Province.

In sum, from 1991, China began to take a lower unified tax rate for all types of FDI who invested in economic special zones. During this period, the volume and growth rates of China's FDI inflow and GDP can be seen in Table 3.

Table 3. China's FDI inflow and GDP (1991-2007)

	FDI Inflow \$ Million	GDP \$ Million	FDI growth rate	GDP growth rate
1991	4,366.3	424,116.8	25.2%	4.8%
1992	11,007.5	499,859.3	152.1%	17.9%
1993	27,515.0	641,068.5	150.0%	28.2%
1994	33,766.5	582,653.4	22.7%	-9.1%
1995	37,520.5	756,960.2	11.1%	29.9%
1996	41,725.5	892,013.9	11.2%	17.8%
1997	45,257.0	985,045.9	8.5%	10.4%
1998	45,462.8	1,045,199.1	0.5%	6.1%
1999	40,318.7	1,100,776.1	-11.3%	5.3%
2000	40,714.8	1,192,836.3	1.0%	8.4%
2001	46,877.6	1,317,229.7	15.1%	10.4%
2002	52,742.9	1,455,554.2	12.5%	10.5%
2003	53,504.7	1,650,769.5	1.4%	13.4%
2004	60,630.0	1,942,780.8	13.3%	17.7%
2005	72,406.0	2,283,670.6	19.4%	17.5%
2006	72,715.0	2,787,254.3	0.4%	22.1%
2007	83,521.0	3,494,351.2	14.9%	25.4%
Average	14,762.7	644,509.6	26.4%	13.9%

Source: UNCTAD, statistic database (2011a)

Based on the table above, keeping preferential tax rate in this period for foreign firms, although China's economic environment and other attractions for FDI was a little weak, FDI inflow in China has increased a lot. Previous research has improved that during this period, lower tax rate has a positive influence on FDI inflow in China. Although the average increase rate during this period is only a little higher than the

previous period, the average volume of FDI inflow is almost six times. This large amount of FDI inflow has injected vitality into China's economic growth. As a result, the average growth rate of GDP during this period is two times of the previous one. During this time period, China's economy and society environment has changed a lot. This is the most significant period in which the outcome of open up policy and economic reform has been recognized by the whole world.

After 2007

Even though the dual tax rate system has brought a lot of FDI inflow to China from 1991, it also has brought some problems to China's economy such as unfairness arising from the dual tax system, inefficiency and lack of practical benefit, disparities between regions and tax chaos. To solve those kinds of problems with this income tax system, the preferential tax rate for FDI has changed in 2007. Due to the enactment of the Law 2007 on 26 March 2007, foreign enterprises are brought under the same tax regime as local enterprises. This regulation, taking effect on 1st January 2008 represents a milestone in China's taxation history, and indicates a fundamental change in China's tax incentive policy. Law 2007 establishes a standardized tax rate of 25% of taxable income which applies to both domestic and foreign-funded enterprises. A lower tax rate of 20% is available for qualified small and low-profit enterprises, and 15% for qualified State-encouraged high/new technological enterprises without geographical limitation.

For industrial enterprises, the concessionary 20% rate will only apply where

taxable income is ¥300,000 or less, the number of employees is 100 or less and total assets are ¥30 million or less. For non-industrial enterprises, the relevant ceilings are taxable income of ¥300,000, 80 employees, and total assets of ¥10 million.

As the principal remaining incentive, the criteria defining ‘high/new technological enterprises’ which qualify for the 15% tax rate are:

- Holding independent ownership of ‘core IP rights; ’
- The product/service is included in the State Encouraged High and New Technology Catalogue. (This catalogue is to be released by the State Council and the Science, Tax and Finance bureaus);
- R&D expenditure exceeds a minimum required percentage of annual sales revenue.

Based on the main content of Law 2007, it seems that Chinese government wants to attract more high/new technology FDI into China to affect Chinese economic structure upgrading while the FDI inflow keeps increasing and contributing to Chinese economic development. In sum, from 2008, China began to apply a new unified corporate income tax rate to all companies, including foreign companies and domestic companies. This is the main focus for this paper. The new tax rate is 25%. On one hand, this is 10% larger than the preferential tax rate for FDI during the period from 1991 to 2007. On the other hand, this is a little lower than the tax rate for FDI during the period from 1984 to 1990. Now, it’s time to see the change of FDI inflow and GDP after the increase of tax rate since 2008 to 2011.

Table 4. China's FDI inflow and GDP (2008-2011)

	FDI Inflow \$ Million	GDP \$ Million	FDI Growth Rate	GDP Growth Rate
2008	108,312.0	4,531,831.0	29.6%	29.6%
2009	95,000.0	5,050,542.9	-12.3%	11.4%
2010	105,735.0	5,739,358.3	11.3%	13.6%
2011	116,000.0	6,711,487.9	9.7%	16.9%
Average	106,261.8	5,508,305.0	9.6%	17.9%

Source: UNCTAD statistic database (2011a)

According to the table above, both the volume of FDI inflow and GDP are far higher than that of the two previous times though the growth rate for FDI is less than the half of previous ones while the GDP growth rate has also kept in a high level. Decreased FDI inflow in 2009 can contribute to the lower average growth rate of FDI. In 2009, the whole world has been panicked by the 2008 financial crisis. A lot of multinational corporations have to adjust their investment decisions because of this crisis. The whole world FDI inflow has decreased 37% in 2009 (UNCTAD, 2010a). Comparing to the world's decrease rate, China has kept a better performance. Furthermore, turmoil in the financial markets and the worldwide economic downturn progressively affected global FDI in 2008 and in the first half of 2009 while developing and transition economies saw FDI inflow raises in 2008 to record levels for both. In 2008, FDI inflow into developing countries including China was less affected than those into developed countries (UNCTAD, 2009a). In the first half of 2008 developing countries seemed better able to weather the global financial crisis, as their

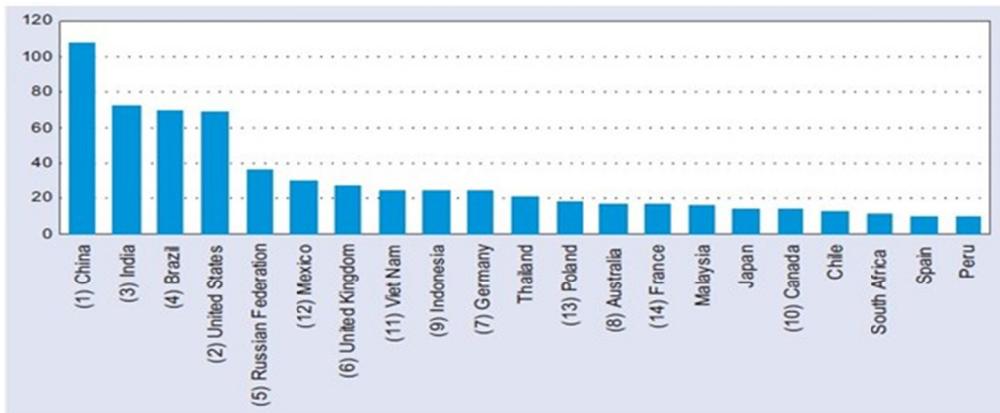
financial systems were less closely interlinked with the hard-hit banking systems of the United States and Europe. Their economic growth remained robust, supported by rising commodity prices.

In 2009, while inflow is likely to decline overall, FDI seeking to tap the large Chinese market is expected to remain strong. In China, proactive fiscal policy responses to sustain economic growth, such as the \$580 billion stimulus package, as well as the expansionist monetary policy, may help maintain foreign investors' confidence and FDI inflow at relatively high levels. What's more important is that China has ranked number one, as the most preferred FDI locations in UNCTAD's World Investment Prospects Survey 2009–2011 (UNCTAD, 2009b). China's strong performance has reshaped the landscape of FDI flow to the region as well as to the world at large. In other words, FDI inflow in China has been affected little due to the financial crisis. In sum, during this period, a higher tax rate have not decreased the volume of FDI inflow but slowed down the increase rate of FDI inflow.

According to UNCTAD (2011b), China's role in Asia has expanded. China has played a multifaceted role in the current process of industrial restructuring and upgrading in Asia: (a) it continues to be attractive to market-seeking FDI, but the coastal region becomes less attractive to labor-intensive, efficiency-seeking FDI due to the rising costs of production; (b) it has become an important source of capital and technology for neighboring, low-income countries; (c) within China, a new round of industrial upgrading is taking place, with significant implications for the development trajectories of both China and other countries in the region. Some low-end,

export-oriented manufacturing activities have been shifting from coastal China to a number of neighboring countries, while efficiency-seeking FDI in coastal provinces of China has been upgrading to high-end products, and market-seeking FDI has been increasingly targeting the inland regions (Zhang, 2011). Due to its economy's size and growth potential, China is becoming a key force that could shape the region's production landscape in the years to come. In World Investment Prospects Survey 2010-2012, China has ranked as the first one as the priority of host economies for FDI (See Figure 4).

Figure 4. Top priority host economies for FDI for the 2010-2012



Source: UNCTAD (2010b)

According to the result of World Investment Prospects Survey, it is necessary to examine China's national competitiveness to see why China can rank as the first one as the priority of host economies for FDI in this period. Based on the above analysis, the increase of tax rate after 2008 has not made both China's FDI inflow and economic

growth decrease. The first half of the hypothesis has been proved. The following part will focus on the other half of the hypothesis, namely, the improvement of China's national competitiveness.

4.3 Examination of China's national competitiveness

Variables selection

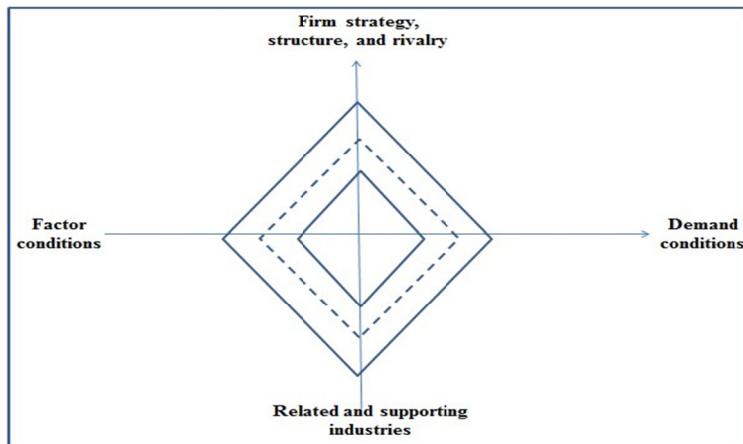
China began to take 'opening-up' policy in 1978. After over 30 years, China has integrated into the world very well. The international factor has contributed a lot to China's national competitiveness. Therefore, this study will use generalized double diamond model to examine China's national competitiveness.

As we can see in Figure 5, there are four aspects of generalized double diamond model: factor conditions, demand conditions, related and supporting industries and firm strategy, structure and rivalry. Each aspect has domestic and international factors, additionally; this research will divide all the factors in more detail scope in order to measure China's national competitiveness more precisely, such as basic and advanced in factor conditions, size and sophistication in demand conditions, transportation and communication in related and supporting industries and rivalry in firm strategy, structure and rivalry.

This study is about the effect of the increase tax rate for foreign firms after 2008. From 1980s to 2007, foreign firms in China have enjoyed a kind of preferential tax rate compared to domestic firms. As mentioned above, tax rate has been proved to have influence on firms' investment decision on locations. So the tax rate can be treated as a

factor of firm strategy, structure and rivalry. To compare the difference of national competitiveness in different tax rate time period, this study will choose 1992 in which year foreign firms enjoyed a lower tax rate and 2010 to make a generalized double diamond for China.

Figure 5. Generalized Double Diamond Model



Source: Moon et al. (1995)

Table 5 has listed the domestic independent variables and Table 6 has listed the international independent variables. These variables do not constitute a full set of all relevant parameters but represent acceptable proxies to illustrate the ‘value added’ of incorporating international elements in the diamond model.

Table5. Domestic independent variables of double diamond model for China

	1992	2010
FACTOR CONDITION		
Basic	Workforce (10,000 persons)	
	59,432	76,105
Advanced	Higher education entrance rate (%)	
	51.2	83.3
DEMAND CONDITION		
Size	Population (10,000 persons)	
	117,171	133,972
Sophistication	GDP per Capita (\$)	
	363	3,687
RELATED AND SUPPORTING INDUSTRIES		
Transportation	Length of Transportation(10,000Km)	
	5.4	9.1
Communication	Telephone users (10,000 persons)	
	1,146	115,338.6
FRIM STRATEGY, STRUCTURE AND RIVALRY		
Rivalry	Number of domestic firms	
	520,000	3,700,000
	Tax Rate	
	15.0%	25.0%

Source: China annual statistical database (2012)

Table 6. International independent variables of double diamond model for China

	1992	2010
FACTOR CONDITION		
Basic	Inward FDI (\$ billion)	
	11	106
Advanced	Outward FDI (\$ billion)	
	4	68.8
DEMAND CONDITION		
Size	Exports (\$ billion)	
	84.9	1,579.9
Sophistication	Growth rate of Exports (%)	
	18.1	31.4
RELATED AND SUPPORTING INDUSTRIES		
Transportation	Air Transport System (10,000km)	
	50.7	276.5
Communication	Internet Users (10,000 persons)	
	NA	45,730
FRIM STRATEGY, STRUCTURE AND RIVALRY		
Rivalry	Number of Foreign firms	
	84,371	445,244

Source: China annual statistical database (2012)

Factor conditions

Basic

Based on World Investment Report, Chinese large size of workforce and lower labor cost are very attractive to FDI. In the past decade, China's emergence as the workshop of the world and as the largest receiver of FDI has profoundly influenced global trade patterns and the competitive landscape.

Advanced

In China, in terms of education, which implies labor quality, higher education enrolment has risen very fast. Nowadays, the rate of skilled labor in China is increasing. This is the main reason why many multinational corporations begin to invest capital-intensive products in China while move labor-intensive products to other neighboring countries such as Vietnam and Laos.

Demand conditions

Size

Population is the basic factor for demand conditions with purchasing power and characteristics and level of domestic demand. In term of population, China has huge potential for the biggest market over the world. However, China's population growth has been somewhat slowed by the one child policy. In terms of expanding market approach, 'foreign trade,' especially, 'exports' is very important factor in demand conditions. Even though China has a lot of population, however, their purchasing

power was too weak to lead national economic development. Thus, they need to expand their market outside China.

Sophistication

China's per capita GDP growth is faster than that during the 1978-2000 periods, which enabled China to fulfill the plan of \$3,000 per capita GDP growth by 2020 and in fact reaching \$4,000 in 2010. And this China's rapid growth of per capita GDP is not only due to its fast economic growth, but because of the lower birth rate, and the appreciation of the yuan. Furthermore, since the 2008 global financial crisis, Chinese government who has realized that the real engine for economic growth is domestic demand has made a lot of positive policies to encourage Chinese people spend their money

Related and supporting industries

Transportation

China's sustained high economic growth and increased competitiveness has been underpinned by a massive development of infrastructure. Additionally, the organizational structure for infrastructure development in China is very systematic and dynamic. Due to these reasons, China has been successful in developing its infrastructure to improve the competitiveness of its economy in general, particularly in the manufacturing sector and attract huge FDI. Air transportation services and economic development interact with each other through a series of mutual causality feedback relationships.

Communication

In terms of overall communication of China, it has improved a lot during three decades. The information and communications technology (ICT) industry in China is large and complex, covering a wide range of products. The overall industry and its sub-sectors are enormous in size and China is universally considered the manufacturing hub for most of the world's electronics. China is currently the world's fourth largest information technology (IT) market by spent after the United States, Japan and Germany. And this developed ICT industry well support the related and supporting industries of China.

Firm strategy, structure and rivalry

Rivalry

Porter argues that domestic rivalry and the search for competitive advantage within a nation can help provide organizations with bases for achieving such advantage on a more global scale. That is, domestic rivalry has a positive and significant relationship with trade performance measured by world export share, particularly when R&D intensity reveals opportunities for dynamic improvement and innovation. Since 1978, China adopted its open-up policy and allowed its economy to be exposed to the international market. Before the economic reform in 1978, there are many state ownership enterprise (SOE) in China. Under a system of state ownership, assets will not be transferred on the open market even to the highest bidder. Privatization of the state sector is therefore necessary to reallocate resources on a more efficient basis. In

terms of the number of foreign firms, the growth rate is much larger than that of domestic firms.

Tax Rate

From 1992, China began to take a lower unified tax rate for all types of FDI who invested in economic special zones. Actually, the average income tax burden on FDI is 15%, while that on domestic enterprises is 25% (Zhang, 2011). This lower tax rate has been proved to be very attractive to foreign firms since Chinese investment climate was not very good at that time. Chinese government has increased this tax rate to 25% from 2008.

Government policy

1978: Economic reform

The Chinese economic reform (Gaige Kaifang, 改革開放), also called ‘Socialism with Chinese characteristics,’ were started in December 1978 by reformist within the China led by Deng, Xiaoping. In this period, the Chinese government introduced economic reforms, introducing elements of a free-market economy. The government also encouraged foreign investment. That laid the groundwork for the modern China we see today.

2011: 12th five-year plan

In October 2010, the Communist Party of China’s (CPC) Central Committee approved the guiding principles of China’s 12th Five-Year Plan for National Economic and Social Development (FYP). And on 14th March 2011, CPC approved a new

national development program for the next five years from 2011 to 2015. The 12th FYP is distinctive in its heightened focus on economic restructuring, the environment and energy efficiency, and scientific development. Differences between key targets and how these key targets are categorized in the 11th and 12th FYP reflect changing government priorities. 12th FYP emphasizes ‘higher quality growth’ as the country’s rapid development during the past 30 years has lifted millions of citizens out of poverty. What Chinese government pursuing in this plain is ‘changing,’ especially in industry structure, from labor-intensive to high-technology industry. The change of tax rate policy for foreign firms also has reflected this kind of policy bias.

Making the generalized double diamond for China

The data for domestic independent variable in Table 5 and international independent variables in Table 6 are transformed into ‘competitiveness indices’ in Table 7. To calculate the competitiveness index, for each variable, a maximum value ‘100’ is given to the period which has the higher value and a relative ratio in terms of percentage is given to the other period which has the lower value among the year 1992 and the year 2010. If a variable is measured by two elements, half weight is given to each element. For example, in Table 5, both of the year 2010’s size and sophistication in demand conditions have higher values than those of the year 1992. Therefore, maximum value ‘100’ is given to each of the two demand conditions of 2010 of China. Therefore, the competitive index of 2010’s domestic demand conditions is

$$100/2 + 100/2 = 100.0$$

The year 1992's size demand conditions has the lower value than that of the year 2010, thus, the value represents 87.46% of that of the year 2010. 1992's sophistication in demand conditions also has the lower value than that of 2010, which represents only 9.85% of that of the year 2010. Thus, the competitive index of the year 1992's demand conditions is

$$87.46/2 + 9.85/2 = 43.75$$

For the variable of tax rate, since a lot of research has proved that lower tax rate has a positive influence on investment climate, a minus competitiveness index has been given to the percentage of tax rate. Table 7 shows that for all four determinant of the diamond model, the year 2010 has higher competitive indices for both of domestic and international variable. Especially the gap between international variables is much larger than that of domestic variables. It implies that during three decades, Chinese 'international' factor has improved a lot, furthermore, this also leaded Chinese rapid economic growth. This difference is clearly visualized in Figure 5 and Figure 6. What's more important is that China's national competitiveness has improved a lot and China is more attractive than ever before.

Table 7. Competitiveness index of the double diamond model for China

	1992	2010
FACTOR CONDITIONS		
Domestic Variables	69.8	100
International Variables	5.2	100
DEMAND CONDITIONS		
Domestic Variables	43.8	100
International Variables	28.8	100
RELATED AND SUPPORTING INDUSTRIES		
Domestic Variables	29.4	100
International Variables	9.2	100
FIRM STRATEGY, STRUCTURE, AND RIVALRY		
Domestic Variables	57.1	16.7
International Variables	18.9	100

The year 1992's domestic diamond consisting of solid lines and its international diamond consisting of dotted lines are shown in Figure 6. Similarly, the year 2010's domestic and international diamonds are shown in Figure 7. It can thus be said that the difference between the international diamond and domestic diamond is the international or multinational determinants of the nation's competitiveness.

Figure 6. The Competitiveness of China in 1992

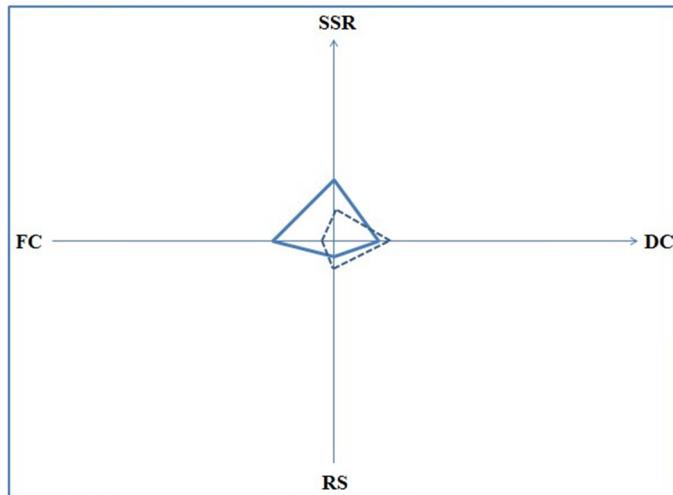
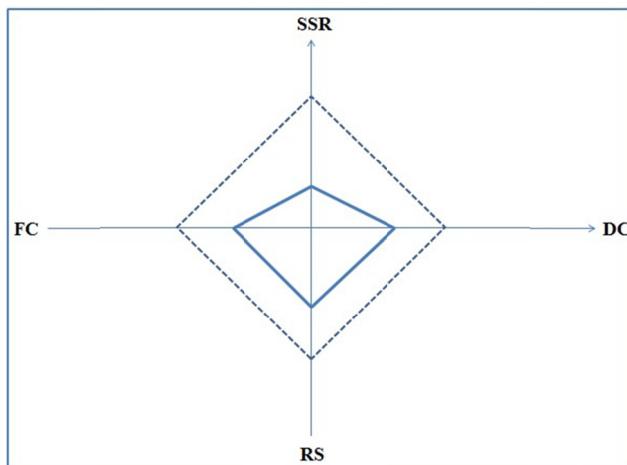


Figure 7. The Competitiveness of China in 2010



Combining the two figures above, we can sagely draw the conclusion that China's national competitiveness has increased a lot even though the tax rate for foreign firms has increased. Due to this reason, China is becoming more and more attractive to FDI. That's the main reason why China can rank first as the priority for FDI destination. In

order to understand the improvement of China's national competitiveness more clearly, there will be a comparison between China and India in the following part.

Comparison between China and India

China and India had similar development strategies prior to their breaking out of their deliberate insulation from the world economy and the ushering in market-oriented economic reforms and liberalization. China began reforming its closed and planned economy in 1978. India always had a large private sector and functioning markets which were subject to rigid state controls until the hesitant and piecemeal reforms of the 1980s. These two countries look very same to each other.

However, there are a number of factors that has made China has a better economic environment and national competitiveness than India. First of all, India was under the colonial rule of the British for around 190 years. This has drained the country's resources to a great extent and led to huge economic loss.

Secondly, China started towards the liberalization of its market economy much before India. This has strengthened Chinese economy to a great extent. While India was a little slow in embracing globalization and open market economies. While India's liberalization policies started in the 1990s, China welcomed FDI and private investment in the mid-1980s. This made a significant change in its economy and the GDP increased considerably (Wolf and Montoya, 2011).

In addition, Compared to India, China has a much well developed infrastructure. Some of the important factors that have created a stark difference between the

economies of the two countries are manpower and labor development, communication, civic amenities and so on. All these aspects are well developed in China which has put a positive impact in its economy to make it one of the best in the world.

Last but not least, China and India are the world's two most populous countries. However, China's population is healthier than India's, and China's population also has higher average levels of literacy and education than India's.

In terms of tax rate policy for foreign firms, while China did away with preferential tax incentives largely available to foreign investors in free trade zones, with unification of tax base in 2008; India has shored-up tax incentives in SEZs to give its infrastructure sector a much-needed boost.

Based on the analysis above, Chinese economic environment is better than India since China began to take open-up policy and involve into global economy which has made China's national competitiveness increase a lot. India should make more effort to catch up with China.

4.4 Result explanation

Based on the analysis of China's tax rate and generalized double diamond model analysis, we can safely draw the conclusion that the higher tax rate from 2008 has not decrease either the volume of FDI inflow into China or China's economic growth since China's national competitiveness has improved a lot which means that China becomes more attractive than before. As a result, FDI who plans to invest in China pay less attention on the increasing tax rate. This result has supported the hypothesis that the

increase of tax rate will have no influence on FDI inflow and economic growth in China thanks to the improvement of Chinese business and investment environment. In sum, the improvement of investment climate and national competitiveness of China as well as other attractions to FDI has contributed to the result that the increase of tax rate in 2008 has no influence on FDI inflow and economic growth for China.

5. Conclusion and Further study

Based on the previous research, both the advantages and disadvantages of a multinational company can be determinants of FDI. Lower corporate income tax rate for foreign firms in the host country will affect FDI's decisions on location as a kind of determinant for FDI. A lot of research has proved that lower tax rate will encourage more FDI inflow in a country. Since the relationship between FDI and economic growth has also been proved to be positive, lower tax rate can contribute to economic growth.

After the implementation of 'opening-up' policy, China has taken three kinds of corporate income tax rate policies for FDI. However, those three are very different.

From 1980s to 1990, Chinese government provided preferential tax rate only to equity joint-venture FDI while other two types of FDI, namely wholly-owned foreign firms and contractual joint-venture FDI, had to afford a higher tax rate. As a result, during this period, equity joint-venture FDI has increased a lot than other two types. This has showed that tax rate has influence on FDI in China.

From 1991 to 2007, China has operated a dual tax system, with different tax laws and a unified tax rate for all types of FDI, for Chinese domestic companies and for foreign companies. Foreign companies have enjoyed more favorable tax treatment than their domestic counterparts, enjoying preferential tax rates. As a result, during this period, not only FDI but also GDP in China has increased a lot. The lower tax rate for

FDI has encouraged multinational firms to make a decision on investing in China instead of other locations.

Even though the lower tax rate has contributed to FDI inflow and economic growth to China, thinking about China's current problems with their enterprise income tax systems such as unfairness arising from the dual tax system, inefficiency and lack of practical benefit, disparities between regions and tax chaos, Chinese government decided to increase the tax rate for FDI and unify the tax rate for both foreign firms and domestic firms. The statistic data has proved that the increase of tax rate has not decreases China's FDI inflow since 2008. Using the generalized double diamond model, the improvement of China's national competitiveness can be realized more clearly. Thanks to the improvement of economic environment and investment climate, the volume of FDI has kept increasing in China, so as the GDP. However, this cannot guarantee that Chinese government can get what they expect. That is the upgrading of Chinese economic growth mode and industrial structure. Chinese government should make more effort to provide a better and better economic environment for FDI such as more sophisticated and larger demand market, better skilled labors, and more available natural resources so that higher level FDI will come to China.

As mentioned above, in Law 2007, Chinese government has provided a lower tax rate as 15% to high/new technology enterprises. Actually, the qualification for such a high/new technology enterprise is so strict that the number of qualified enterprises is very small, not to mention foreign firms. This is the main reason why the number of high/new technology enterprises is so small. However, a lot of multinational

corporations have begun to adjust corporation structure to be a member of high/new technology enterprises so that they can enjoy the lower income tax rate. If a great number of FDI become the real high/new technology enterprises a few years later, what will happen in China at that time? And Chinese government expectation of promoting China's economic structure and upgrading of its industries will come true?

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KOREAN ABSTRACT

자국의 기업과 자국내 외국기업에게 적용되던 세금율을 통합하려는 중국정부의 정책 변화에 따라 외국기업의 세금율이 상승하게 되었다. 기존의 연구사례들에 따르면 세금의 상승은 FDI 의 감소를 기인한다. 하지만 이것이 중국에도 적용되는 것일까.

이번 연구에서는 중국의 높아진 국가경쟁력과 개선된 투자환경이 중국에 투자하고 있는 다국적기업에게 세금보다 더 중요한 요인이라는 것을 Double diamond model 을 통하여 입증하려고 한다.

주제어: 해외직접투자, 경제발전, 세금율, 국가경쟁력, Generalized double diamond model

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