

***Straight Ahead on Red:***  
**The Impact of Foreign Direct Investment on Local Autonomy  
in Vietnam**

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**Abstract:** Previous work has hinted that stocks of foreign direct investment (FDI) have played a prominent role in empowering certain local leaders *vis a vis* the center in transition countries, thereby allowing them the policy space to pursue economic reforms outside of central law. While during strict central planning, the central government could use its monopoly to control scarce resources and expenditure distribution; with high stocks of FDI, the bargaining power of regions has improved. This paper tests the above speculation despite the obvious problem of endogeneity. The methodology is a simultaneous equation model measuring the mutually reinforcing impact of FDI and provincial autonomy (in regard to economic reform) of Vietnamese provinces between 1990 and 2000. Stocks of FDI per capita are tested against a measure of autonomy derived from an innovative content analysis of Vietnamese state owned newspapers. Every time a province is cited for violating central laws on economic policy by engaging in reform experimentation, it is coded as a case of autonomy. Using this approach, I find strong preliminary evidence for the influence of FDI on local autonomous economic reform experiments.

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## ***1. Introduction:***

Chen Yun, a leading Chinese economic policy maker, once famously described the leaders of the coastal province of Guangdong as adhering to a “traffic light philosophy.” Leaders respond to the center’s policies in one of three ways. “When the red light is on, they make a detour and proceed as they were going; when the yellow light is on, they ignore it and keep going at the same speed; and when the green light is on, they rush head at full throttle.”<sup>1</sup> According to Jiang Zemin, it wasn’t just Guangdong; at repeated internal meetings in 1995, Jiang complained that eight provinces were virtually “running their own show” in regard to economic policy.<sup>2</sup>

The traffic light offers a vivid depiction of a concept scholars studying local-central relations have termed *de facto decentralization* or *local autonomy*, the notion that even in a unified state, sub-national leaders can wrestle some decision-making authority, especially in regard to economic policy, from the central government.<sup>3</sup> According to some, eventually *de facto* decentralization will be codified into formal rules and institutions, nominally granting to sub-national leaders the autonomy they had long ago seized.<sup>4</sup> Alternatively, it is possible that the policy experiments attempted by newly emancipated local leaders are part of a grand plan of central governments. If the experiments work, the central government can claim credit for their foresight and work to legislate the experiments nationally; and if the experiments turn out to be duds, the central government can always punish local leaders for usurping authority.

Both of these arguments are fascinating and deserve further exploration, but rush ahead of two fundamental questions. First, where did the traffic light come from? That is, why did

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<sup>1</sup> Pye 1991; Wo-Lap 1999

<sup>2</sup> Wo-Lap 1999

<sup>3</sup> Jones-Luong 2003; Herrera 2005; Mitchneck 1995

<sup>4</sup> Jones-Luong 2003; Zweig 2002

coastal provinces like Guangdong and not others in China have the authority to both experiment within the confines of existing Chinese law *and* even break central law when its red lights were deemed to impede their progress? Second, when those provinces approached a traffic light of whatever color, how did they know where they were going? Where did these leaders garner ideas for their economic experiments?

These apparently distinct questions are actually intertwined and their answers grant important insights into both modes of decentralization and the trajectories of states in economic transition. As I argue over the course of the paper, a large explanatory role can be ascribed to the role of foreign investment, especially export oriented investors, in simultaneously providing information and empowering local leaders in their bargaining with the central government. I hypothesize and test the proposition that the greater the stock of FDI, the more likely a province is to engage in autonomous economic reform experiments outside the parameters set by the central government. I use Vietnam's 61 provinces for my test on methodological grounds, but the theory can certainly be applied more generally.<sup>5</sup>

Specifically, my theory, takes place in three stages. In the first stage, stocks of foreign direct investment begin to concentrate in a particular set of provinces, often where the local vested interests are weakest and initial conditions such as infrastructure and proximity to markets are the highest. Eventually, FDI supplants the importance of the local vested interest in that province. In the second stage, investors begin to agitate for policies that will aid the competitiveness of their businesses, particularly in the international arena if they are exporters. Investors lobby provincial officials both individually and within groups, providing information from other countries in which they operate as to what reforms will enhance their business

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<sup>5</sup> Actually, the number of Vietnamese provinces has increased from a starting point of 40 at the beginning of the time period, increasing to 44 in 1991, 53 in 1992, and 61 in 1997. I use sets of unbalanced panel over the time series to account for provincial separations. When a province is split, its panel ends in the data set and the two new provinces begin anew in that year.

performance. Finally in stage three, provincial leaders empowered by the revenue and jobs that stocks of FDI have produced, as well as motivated to continue these achievements, began to pursue innovative economic reforms that either take advantage of the ambiguity of central laws (yellow lights) or violate central laws outright (red lights). These so-called fence-breaking reforms need not be positive in a normative sense or even in their economic impact.<sup>6</sup> While many reforms, such as granting property rights may have positive effects on national economic performance, others such as special investment incentives may have had deleterious results for national welfare. The important issue is that these were reforms intended to assist investors and are not sanctioned by central authorities.

While the first two stages are intuitive, it is the third stage that is the most controversial and therefore the focus of this paper. There are five causal mechanisms that under-gird the decision of provincial officials to violate central law by pursuing local economic reforms to assist foreign investors; all of them related to the increased bargaining power which FDI generates for provincial leaders. These will be discussed in more detail below, but are outlined briefly here. First, provinces with high stocks of FDI provide the bulk of revenue to the central government, which is then distributed to poorer provinces, granting these high-flyers a great deal of leverage. Second, leaders in these provinces have higher local legitimacy than other provincial leaders and central government officials, insulating them to some extent from central pressure. Third, FDI changes the traditional government career calculus, as it becomes profitable (due to higher prestige and pecuniary benefits) for provincial leaders to choose to stay within their provinces rather than attempt to achieve higher office in the capital. Fourth, FDI alters the political bargaining space, thereby providing an alternative voice to the state owned enterprises, who were the winners in the early stages of the Vietnamese *Doi Moi* “reform” process. The fifth

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<sup>6</sup> The term *fence-breaking* (*pha bo rao*) was popularized by Adam Fforde. See Fforde and de Vylder, 1996; Fforde 1989.

is a revenue targeting mechanism that returns to provinces all revenue they generate above an annually negotiated upon target.<sup>7</sup> Because provinces are not dependent on the central government for resources, they are much more likely to challenge the center. Moreover, because their surplus revenue is heavily dependent on the success of foreign investments, they are more likely to find common ground with investors. The five mechanisms reinforce one another making it difficult to separate them analytically; therefore I leave disaggregating those mechanisms to further research.

There is certainly the possibility of endogeneity in the above theory, as investors may have been attracted by what they perceived as a potential for autonomous actions in provinces at the start of the reform process, or later investors may have been attracted to a province with a history of such reforms. As a result, the methodology is a simultaneous equation model measuring the mutually reinforcing impact of FDI and provincial autonomy (in regard to economic reform) of Vietnamese provinces between 1990 and 2000. Stocks of FDI per capita are tested against a measure of fence-breaking derived from Malesky's content analysis of Vietnamese state owned newspapers. Every time a province is cited for violating central laws on economic policy by engaging in reform experimentation, it is coded as a case of de facto decentralization.<sup>8</sup> Using this approach, I find strong preliminary evidence for the impact of FDI on local autonomous economic reform experiments.

Before discussing the test, however; I must challenge two streams of prevailing wisdom in political economy. The first is the tendency to focus on the factors that *attract* foreign direct investment into transition states and their specific provinces, while ignoring the *influence* that investors have once they are on the ground; creating jobs, buying inputs from local enterprises,

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<sup>7</sup> World Bank 1996

<sup>8</sup> Malesky 2004

and providing revenue for local leaders. For my theory of the subnational influence of foreign investors, it is important that we resurrect the notion that investors can act as “agents of change” in developing economies. The second tendency springs from the decentralization debate, which has thus far failed to pin down the micro-logic of how economic openness may impact bargaining.

## ***2. Re-thinking the obsolescing bargain: Embracing the endogeneity of FDI***

Thinking of foreign investors as agents of change in political economy sounds radical, but it is in fact not new at all. Over the past four decades, work on the political economy of FDI has shifted 180°. The shift occurred for logical reasons, but changing focus analysts have abandoned important insights that had been gleaned from the *dependencia* debates. The most important finding was that investors were as likely to lobby and push for changes in a host country’s economic laws as they were to be attracted to that host country by earlier legal changes. An earlier generation of scholars was explicitly interested in *influence* theories of how FDI that was already on the ground affected local institutions and policy making processes.<sup>9</sup> Present work on FDI proceeds entirely from the assumption that investors are pulled into host country by institutions and policy determinants. Political constraints and political risk came to be seen as two more factors to be added to economists’ existing economic models of foreign direct investment determinants, which included infrastructure, market size, proximity to export markets, labor and other input costs, and taxes in the decisions of foreign investors.

A shift in thinking about investors as “agents of change” occurred in the early eighties due to the argument that the bargaining advantage of foreign investors was ephemeral.<sup>10</sup> Once

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<sup>9</sup> Diebold 1974; Biersteker 1978; Moran 1974, 1978; Evans 1979; Kobrin 1976

<sup>10</sup> Vernon 1980

factories were built and equipment purchased, fixed capital became “sunk” and hostage to a host country’s whims -- the bargaining advantage now rested with the host country.<sup>11</sup> Because later researchers assumed the *obsolescing bargain* to be fact, changes were made in the way analysts studied investment decisions. Bargaining over investment contracts was considered a one-shot game, so foreigners could only hope to influence the specific details of the contract; they would have little impact on local institutions or policies. As a result, foreign investors were assumed to invest in countries where they believed the political institutions offered little risk for nationalization of their property and the most profitable opportunities.<sup>12</sup> Analysts became less interested in studying what happened after direct investment had taken place, but rather focused on how investors chose where they were going to invest in the first place. Foreign investors did not lose all bargaining power in this new conception, but through the lens of strategic interaction their power was *ex ante*. If host countries wanted to attract foreign investment, they would need to make the institutional changes that investors wanted or risk being left out in the cold.<sup>13</sup>

Thinking of the political factors that attract FDI into a host country has led to a robust research agenda. Economic and foreign policies have been identified as key determinants of investment, as have political stability, and corruption.<sup>14</sup> Other scholars have identified the effect of political constraints or veto players (in the rational choice vernacular) as positively influencing investor decisions, because investors are less likely to suffer rapid changes in policies that affect them.<sup>15</sup> Recently, a great deal of scholarship has highlighted democracy as influential, though the evidence is mixed.<sup>16</sup>

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<sup>11</sup> Kobrin 1987

<sup>12</sup> Kobrin 1984

<sup>13</sup> Schneider and Frey 1985; World Bank 1997; Henisz and Williamson, 1999. The extreme version of attraction theories is the so-called “race to the bottom.” See Rodrik 1999.

<sup>14</sup> Gastanaga, Nugent, and Pashamova 1998; Schneider and Frey 1985; Jensen 2003; Wei 2000.

<sup>15</sup> Henisz 2000

<sup>16</sup> Li and Resnick, 2002; Jensen 2003

There is no doubt that these studies have made important contributions to scholarship, but nearly all of them have been unable to overcome two important methodological issues. First, the substantive effect of the political variables is always tiny when compared to the traditional economic variables, even in the very best models. The small substantive effect quite accurately reflects our understanding of investment into developing countries.<sup>17</sup> Many investors discount political factors heavily in their location choices. The *Economist* (2004) might mock the political naiveté of investors in an article entitled “Fools Rush In,” but the fact remains that they did rush in despite the well-known bureaucratic mazes and corruption into countries such as Kazakhstan, Azerbaijan, and China; a process that represented the very antithesis of the predictions of *attraction* theories. These regimes had very high discretionary power and offered very little in property rights protection. *Ad hoc* explanations based on economic variables can certainly be derived for these states, such as cheap labor, large domestic markets, or oil lubricating firm decision-making. Nevertheless, these *ad hoc* explanations confirm the fact that business opportunities rather than economic reform drive the decision making of investors. FDI was willing to assume a certain degree of political risk based on the expected returns of their investment and investors felt they could even ameliorate that risk by finding common ground with local government actors.<sup>18</sup>

The second and more important problem is that recent scholarship is rife with endogeneity, specifically because scholars adopted the lessons of the obsolescing bargain too quickly without thinking hard about the conditions under which it was applicable. Stephen Kobrin showed that FDI in the manufacturing industry and export oriented investment was less

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<sup>17</sup> Buthe and Milner make this point quite clearly in their analysis of determinants of FDI (Buthe and Milner 2004). Also see Delios and Henisz, 2003.

<sup>18</sup> Hahn 1999

vulnerable to the obsolescing bargain, but its lessons have been largely ignored.<sup>19</sup> While most scholars are aware of the endogeneity problem, they generally tend to wave their hands at the dilemma rather than dealing with it directly. Hand waving, however, is just not enough when the problem of endogeneity is more than just a theoretical exercise. Often the endogeneity affects the very operationalization of authors' key causal variables. Lankes and Stern (1999), for instance, rely heavily on a survey of enterprises performed by the World Bank in 1997, which led them to believe that investment decisions were influenced by major institutional changes in the transition countries.<sup>20</sup> But the survey probed only foreign investors who already had significant business operations in the region; their frustration had not deterred them from taking the investment risk in the first place.

By neglecting to think seriously about endogeneity, scholars have overlooked a vital piece of the economic transition puzzle. But even more important than that, scholars have not listened to the story the investors themselves are telling. As the lawyer John Hewko (2001) thundered,

Most foreign investors who have committed resources to a country have probably accepted the fact that in general terms, the legislative and legal systems are inadequate...The immediate focus of committed investors tends to center around a succinct list of specific complaints about that one piece of legislation or regulation that, if rectified, would greatly facilitate the success and continued viability of their investment.

In the rare case in which scholars *do* think seriously about the circular relationship between investment and governance, the results can be fascinating. Henisz and Delios (2004) found that Japanese investors will be less likely to exit from a host country with a politically

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<sup>19</sup> Kobrin 1987

<sup>20</sup> They are not the only ones, the Global Competitiveness Rankings, the World Enterprise Performance Survey, the Business Environment and Enterprise Performance survey, and Kaufman and Kray all build their indicators from surveys of already-invested firms. Even the International Country Risk Group, which is often described as less vulnerable to such endogeneity originally coded its variables using survey data from Knack and Keefer 1995.

hazardous environment if they have significant experience in that country. They surmise that this is because the firms' relationships with local institutions give them an actual or perceived influence over a political regime and thereby an advantage over their counterparts. In short, investors can reap dividends by influencing short-term political decisions and lower level institutions in politically hazardous environments.

The prevalence of models of FDI attraction without taking due consideration of endogeneity also applies to the multiple studies of subnational determinants of FDI. A number of scholars have looked carefully into the determinants of sub-national patterns of FDI attraction.<sup>21</sup> Scholars in this vein often show that particular local institutions are instrumental in attracting FDI but pay too little attention to the factors that led to those institutions in the first place, specifically whether existing stocks of FDI had anything to do with their development. For instance, a test of whether the presence of industrial zones (as a proxy for local economic policies) attracts foreign investors in Vietnam<sup>22</sup> completely overlooks the fact that the zones themselves resulted from discussions between provincial leaders and existing foreign investors about how to provide adequate land for investment expansion when Vietnam law still deemed foreign ownership of land illegal.<sup>23</sup>

If we take seriously the notion that investors will lobby and agitate for reforms that benefit their businesses, we must also consider that they will be lobbying at the subnational level as well. Moreover, because the impact of their investment makes a larger proportional contribution to the local economy than it ever could for the national as a whole, it follows that local authorities may be more receptive to investor demands. One promising strand of research has demonstrated that globalization broadly defined may lead to political disintegration of larger

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<sup>21</sup> Fox 1996; Broadman and Recanatini 2002; Changhui, Delios, Yang 2001

<sup>22</sup> Meyer and Vo 2003

<sup>23</sup> SGGP 1996

nations by creating regional income disparities and consequently a motive for subnational secession movements.<sup>24</sup> This research program, by the authors' own admission, has thus far failed to clarify the micro-logic of how globalization may have this impact. To improve on the tests raised in those articles, it is necessary to spell out how the causal logic of each particular channel of globalization may affect local-central relations.

In doing so, we need to tap into the rich literature on local-central relations. Originally, scholars tended to cut into the question of decentralization from a very top-down perspective, analyzing the impact of constitutional rules of local-central relations, rather than viewing the decentralization process as a bargaining game between subnational units and the central government.<sup>25</sup> Recently, however, scholars have become more sophisticated in the way they study local-central relations by moving away from the coarse institutional measures of federalism and decentralization and beginning to probe in detail the multi-faceted bargaining game between subnational units and the central government. They have shown that, at times, subnational leaders have been able to eke out more autonomy in regard to economic policies and law making,<sup>26</sup> while at other times the central government have been able to strengthen its hand over local leaders through manipulation of personnel management or local perquisites.<sup>27</sup> The fierce debate is most intense among students of China.<sup>28</sup> Thus far, however, these studies have focused primarily on tax revenue or natural resources as key determinants of bargaining power, while spending little time testing global economic forces impact this bargaining game. Recent work, however, in China, Kazakstan, and Russia has shown evidence of foreign investment both

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<sup>24</sup> Gourevitch 1979; Hiscox 2000

<sup>25</sup> Rodden 2004

<sup>26</sup> Solnick 1998; Mitchnek 1995; Herrera 2005

<sup>27</sup> Treisman 1999; Landry 2002; Sheng 2003

<sup>28</sup> Shirk 1993; Oi 1992; Montinola, Qian, and 1995; Whiting 2001; Solinger 1996; Landry, 2002.

empowering local leaders and joining forces with them on local initiatives.<sup>29</sup> These rich case studies provide evidence that a rigorous test of a subnational push hypothesis is possible.

### **3. The micro-logic of FDI and provincial autonomy in the case of Vietnam**

#### *3.1. Why study Vietnam?*

A cross-national test of my theory is presently undesirable due to the lack of comparable measures of autonomy or de facto decentralization across transition states. Most work on the issue has taken the constitutionally enshrined structures of subnational governments as given, rather than acknowledging that institutions are simply the reflection of the bargaining strength and expected payoffs for actors at the time of institution's creation. The nuance needed to code such a variable for cross-national datasets is certainly a distant dream. What variable do we use if we want to understand *de facto* decentralization – autonomy not granted but taken by local governments who wish to pursue their own reform policies and create their own local economic institutions outside of centrally legislated practices? Helmke and Levitsky's call for political scientists to take seriously the role of informal institutions requires that an analyst understand a case intimately enough to be able to understand the informal mechanisms at play in a particularly country and deduce logical predictions from those mechanisms.<sup>30</sup> This cannot be done with any degree of accuracy in a cross-national test. Furthermore, most variance in such test would be cross-national rather than longitudinal, granting analysts little insight into how FDI can impact policies in any one country over time. Scholars must seek ways to expand the number of observations within a setting where the informal institutions share similar traits and can be

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<sup>29</sup> Zweig 2002, Jones-Luong 2003, Orttung 2004

<sup>30</sup> Helmke and Levitsky 2005

properly compared. Only then can we understand the political mechanisms which are unleashed by the entry of international economic actors.

I resolve this problem by testing the results within the single country of Vietnam, where a metric exists to compare autonomy across all of Vietnam's 61 provinces. In doing so, I keep in mind that the observable implication of the above argument is that not only should we find a high correlation between concentrated FDI and subnational autonomy in transition states, but that such autonomy should manifest itself in a series of local reforms beneficial to foreign investors. Furthermore, there should be evidence that FDI can actually spur provincial economic reform programs - even if the central law does not provide for such activity.

Vietnam is a particularly appropriate test for two key methodological reasons. First, the large number of provinces and high variance of both FDI and local autonomy in Vietnam across those provinces, despite relatively even starting points, offers an ideal quasi-experimental setting. Provinces differed in initial structural conditions, such as geography and proximity to markets, but all faced the decision to open up to a market economy in 1986 with very similar institutions and relationships with the central government in Hanoi. Second, studying economic transition in Vietnam allows me to disentangle the forces of the FDI from the tricky problem of the European Union, which offers an independent external incentive for reform in transition states in Eastern Europe and much of the Former Soviet Union.<sup>31</sup>

If anything, evidence seems to suggest that Vietnam should be an extremely difficult case for my theory of FDI's influence at the provincial level. The country has an explicit fear of the negative impacts of a foreign economic presence in their society, generated by over a millennium of negative experience with foreign imperialism. Despite the fact that the country has been

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<sup>31</sup> Vachudova, Milada 2005

among the world's leading recipients of FDI over the nineties<sup>32</sup> with over \$17 billion of implemented investment, a number of Vietnamese leaders have warned of the need to prevent the pernicious influence of capitalist countries on Vietnamese domestic politics through constructive engagement; a term the Vietnamese ironically refer to with the benign sounding "peaceful evolution."<sup>33</sup> According to former Secretary General of the Communist Party Do Moui, however, peaceful evolution was nothing less than the gradual destabilization of Vietnamese society through the support of political pluralism by Western Imperialist forces.<sup>34</sup> Proud of their independence after a number of long and painful wars, many war heroes turned politicians were unlikely to allow their internal politics to be dictated by outsiders. Because of these very real fears, demonstrating that a "push" theory of FDI can work in Vietnam, even if through regional agents, should be very persuasive evidence for my theory.

And yet the same time, Vietnam has received an astounding level of plaudits for its transition choices and rapid growth in international development circles: choices that include rigorous price reform, granting of property rights, and trade liberalization, which at first blush would seem unlikely from a communist government.<sup>35</sup> These steps are especially puzzling in a country where the early winners of initial reform were the dominant state owned enterprises that benefited from price and trade liberalization prior to privatization. Rather than acting as a reformer and high growth economy, Vietnam would seem a better candidate for Hellman's partial reform equilibrium, where further reform would be continually blocked by the state sector.<sup>36</sup> The impetus for many of these reforms remains a mystery to many, but the FDI influence theory outlined above offers an answer.

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<sup>32</sup> Massina 2002

<sup>33</sup> *Diễn biến hoà bình* in Vietnamese. Ky 1996; Lamb 2002; Anonymous 1995.

<sup>34</sup> Schwarz 1996; Bolton 1999

<sup>35</sup> Pritchett 2003

<sup>36</sup> Hellman 1998

### *3.2. Preferences of provincial and central actors*

Why might FDI simultaneously influence the choice sets available to provincial officials and empower them to engage in reform experiments? While the broad argument is relatively intuitive, it is important that we understand the micro-logic as it applies to the Vietnam case. With a little abstraction it may be possible to derive similar mechanisms to these five in other transition countries. All five mechanisms are derived from my assumption that provincial officials (specifically provincial People's Committee Chairman and Party Secretaries) have three sets of incentives: prestige and power, pecuniary benefits for themselves and related family businesses, and community interests in providing employment and better living conditions for citizens in their provinces. Increasing provincial revenue in whatever way possible is the primary means provincial People's Committee officials use to achieve these goals. One high ranking official put it this way, "Provincial revenue is the important indicator of success and power of all provinces. It is their primary target."<sup>37</sup> As a result, when FDI becomes the dominant source of revenue in a province, People's Committee officials are likely to take steps to align their policy preferences with those of the investor. One is likely to expect similar behavior toward the state sector in if SOEs are the primary bread winners.

Simplifying considerably to consider central officials as one actor when clearly many preferences were represented in the Communist Party of Hanoi is a bit risky, but not wholly inaccurate. Abrami (2004) has argued that a norm of consensus in Vietnamese politics often means that Central Committee members horse-trade quietly among themselves before announcing what appear to be unified national policy positions. Over the course of the nineties, the central government had one primary incentive, which was to remain in power. This incentive

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<sup>37</sup> Interview at Central Institute for Economic Management in Hanoi, Vietnam.

manifested itself in three ordered preferences. First, power could only be maintained by focusing on economic growth and poverty alleviation. Emerging from the devastating economic crisis of the mid-eighties, the primary goal was economic growth and poverty alleviation for the citizens of one of the world's poorest countries.<sup>38</sup> There was more than just altruism at work; with growth and redistribution to the most impoverished regions, the central officials hoped to maintain social order and thereby their grip on power. This task was made more difficult by a booming population that introduced nearly a million new entrants to the workforce every year. Second, an emphasis was placed on central control over the reform process – growth was important, but officials in Hanoi wanted decision making to be in their hands, not propelled by autonomous local reformers. Thaveporn Vaskavul has argued,

In the era of renovation, there was an attempt to re-centralize the power of the central government through the redefinition of tasks and operation jurisdiction of local government.<sup>39</sup> The 1992 constitution does not mince words in proclaiming that the national administration is a centralized and unified system from the center to the local level, and the central government presides over that system.

Because initial growth after the 1986 reforms was contributed to a large extent by the state sector, large SOEs held increasing sway over central laws. Indeed, the 1992 Constitution that formally recognized the private sector enshrined in law that the state sector was the core (*nen tang*) of the economy and should assume a “leading role in the national economy.”<sup>40</sup> Thus, the third preference of central officials was to preserve the state sector. There were also ideological reasons why the central government favored SOEs and the important role of local SOEs sustaining the populace during the war with the U.S.A. offered some historical nostalgia.

Support for the state sector, however, has often taken a back seat to social order brought about by economic growth. Whenever SOEs could not adequately supply revenue, either due to

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<sup>38</sup> Fforde 1996; Van Arkadie and Mallon, 2004

<sup>39</sup> Vaskavul, Thaveporn, 2003, p. 27

<sup>40</sup> Article 15 and 19 of the 1992 Vietnamese 1992 Constitution; Tonneson 2000.

inefficiency or corruption, their capture of the central government diminished and voices rose calling for switching allegiance to economic sectors that could better deliver economic growth. One of these voices was Prime Minister and Politburo member Vo Van Kiet, who argued passionately that socialist orientation was not synonymous with state orientation.<sup>41</sup>

Ideally, central officials would have preferred a fast growing state sector over the nineties allowing them ability to maintain social order and their tight control over the economy. But as FDI began to blossom in certain areas of the country and beneficiary provinces began to push against the confines of central laws in terms of economic policy, central officials came to the conclusion that a preference for growth must take precedence over their continued support for the state sector. But preserving power through central control constrained their activities, so provincial officials were reluctant to embrace provincial experiments wholly. Instead, they allowed local fence-breaking experiments to continue in strong provinces, but simultaneously used state owned newspapers to condemn those experiments and ward off weaker provinces from following suit – a fact Malesky exploits to construct his dependent variable of local autonomy. The result was de facto decentralization and autonomy in a few lucky provinces, but very little in the way of a national policy of decentralization.

### *3.3. Five causal mechanisms for the FDI influence theory*

In broad strokes, Section 3.2 is story of economic reform over the courses of the nineties in Vietnam. Specifically, the shift to de facto decentralization brought about by FDI operated through five reinforcing causal mechanisms.

*1. Redistribution:* High FDI inflows led to high tax revenues, which the central government relied upon to redistribute to poorer provinces and for the provision of social

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<sup>41</sup> Vaskavul 1987

benefits. Consequently, central authorities were more likely to accede to the demands of provincial-level reformers if they had high FDI revenue. A large portion of Vietnamese provinces simply did not have the requisite initial conditions to attract labor and or investment. These poorly endowed provinces looked to the central government for transfers, rather than exploring independent reform strategies or attempting to converge to the successful strategies of the high-flying provinces as market preserving federalists would predict.<sup>42</sup> Indeed, Vietnam has managed to transfer a great deal of wealth from the most developed provinces to the least open provinces over the course of the reform era.

Only six provinces have routinely run fiscal surpluses over the nineties. Together they account for about 70% of national revenue. On the other hand, 41 provinces have been frequent recipients of cash transfers from the central government, allowing a higher level of service delivery than poor provinces could finance out of their own available revenue. In addition to block grants for national health and education programs, these cash transfers have played an increasingly important role in leveling per capita expenditures nationally and played no small role in reducing the country's poverty rate by 60%<sup>43</sup> While the average per capita GDP of rich provinces has been three times that of low-income provinces since 1996, per capita expenditure has been only 57% higher.<sup>44</sup> FDI-recipient provinces cannot credibly commit to halt these transfers, but their leaders' cooperation is needed to help tax authorities placed in the province by Hanoi efficiently collect taxes and transfer that money to the central treasury. More importantly, however, they have argued effectively that it is experimentation that sustains the bonanza and the transfer payments the Vietnamese government relies upon to sustain its power.<sup>45</sup>

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<sup>42</sup> Weingast 1995; Montinola, Qian, and Weingast 1995; Jin, Qian, and Weingast, 1999; Tiebut 1956

<sup>43</sup> Government of Vietnam-Donor Working Group 2000; Vietnam State Budget, Final Accounts for 2000 & Plan for 2002

<sup>44</sup> World Bank 1996.

<sup>45</sup> Vietnam Investment Review 1996

2. *Legitimacy*: A second reason that FDI may lead to *de facto* decentralization is that FDI improves the living standards of citizens in recipient provinces, augmenting the local legitimacy of the provincial government relative to central institutions. In this environment, it is easier to proceed with experimentation without riling up the local populace and drawing the attention of central-level officials. Friedman, for instance, found that foreign firms tended to pay higher wages and had led compressed wage structures in the high FDI recipient Ho Chi Minh City (HCMC).<sup>46</sup> Accountability is gauged directly by competition for the locally elected seats on Provincial People's Councils, from whose ranks the People's Committees are appointed. Of course, the elections of the People's Council can potentially be circumvented, as candidates are nominated by an arm of the Vietnamese Communist Party. Yet there is room for self-nomination and independent (non-Party) nominations by mass organizations, demanding a certain degree of local accountability.<sup>47</sup>

Though far from an ideal test, the World Values Survey conducted in households across Vietnam in 2001 gives us an indication of how well the legitimacy mechanism is functioning.<sup>48</sup> The World Values Survey was designed to create a nationally representative sample and was not intended for provincial comparisons like this study. Nevertheless, all eight of the major regions of Vietnam were surveyed, covering twenty provinces. By taking the average FDI per capita of each region, weighted by the number of districts in each province surveyed, it is possible to construct a measure of how important FDI was in each region surveyed.<sup>49</sup> This can be compared to the confidence in governance questions from the survey. As can be seen in Figure 1, there is a strong negative correlation (-.74) between confidence in the national government and FDI per

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<sup>46</sup> Friedman 2004

<sup>47</sup> Dung 2001; Vaskavul 1997

<sup>48</sup> For details on the methodology of the World Values Survey in Vietnam, please see Dalton and Ong 2001

<sup>49</sup> The survey does not report how many individuals from each province were surveyed

capita. By stark contrast, the percentage of households with expenditures below the poverty line correlates negatively with FDI (-.76) and positively with confidence in government (.66).<sup>50</sup> Though no question allows us to measure it directly, it is likely that relationship is due to a shift in confidence from the national government to provincial officials in provinces not dependent on central transfers for their well-being.

**(Figure 1 about Here)**

3. *Altering the Political Space and Creating New Winners:* In a version of Riker's classic *heresthetic*, foreign investors became the new winners in the altered policy space in recipient provinces, thereby allowing them to unlock the partial reform equilibrium.<sup>51</sup> (Hellman 1998). The early winners of economic reform in Vietnam were Central and Provincial State Owned Enterprises (SOEs), which benefited from the market prices that price liberalization in 1986 allowed them to charge, rather than artificially suppressed prices they were forced to charge under socialism. In provinces where SOEs provided the vast amount of revenue and jobs, they used their political influence to block or hamper reform that benefited the local private and foreign sectors. As FDI built up in particular provinces, it altered the dependence and subsequently the need to cater to the demands of SOEs in the provinces. For instance, state sector contribution to industry in Binh Duong declined from 65% in 1990 to 10.10% in 2000.<sup>52</sup>

4. *Career Incentives:* FDI alters the career incentives of provincial leaders. Albert Hirschman (1958) famously made this argument regarding elites, "the poorer sections of the country, where careers in industry and trade are not promising, often produce for this very

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<sup>50</sup> Joint Donor Report to the Vietnam Consultative Group Meeting, 2003.

<sup>51</sup> For more on Riker's *heresthetics* see Shepsle, Kenneth A. 2003

<sup>52</sup> General Statistical Office 2003

reason, a majority of the country's successful politicians and thereby acquire influential spokesman in the council's of government." In a purely centralized and autarkic state, the career trajectory of provincial leaders is promotion to higher positions in the central government. FDI changes this calculus, as it becomes profitable for provincial leaders to choose to stay within their regions. The benefits from staying at home include heightened prestige as living standards improve. But there are also pecuniary benefits, such as the heightened performance of the provincial economy and the new opportunities provided for friends and family members.

While it is often asserted that the apparent victory of reformers in 2000 was due to the presence of more reformers from fence breaking provinces in the government apparatus, this is a misconception based on the fact that the Prime Minister has tended to be from HCMC. In fact, provincial reformers (especially from the South) are underrepresented in government. Over the past three administrations, only 11.9% ministers came from the South, but even northern reformers are underrepresented in government.<sup>53</sup> So while reformers captured the overall reform agenda in 2001, it is not because of they have managed to place their own leaders into authority positions—their leaders are staying home. If we agree for the sake of argument that all leaders are not angels and will engage in either short-term roving or long-term stationary “banditry,”<sup>54</sup> FDI offers incentives for provincial leaders to employ the more beneficial long term rent-seeking over their tenure and makes them less responsive to the demands places on them by central officials.

5. *Revenue Targeting:* Despite the transfers discussed in mechanism one, rich provinces do not distribute all of their revenue to central coffers. Due to a peculiarity of the financial system, Hanoi sets national taxes through the Ministry of Finance but returns to provinces all

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<sup>53</sup> Nien Giam Hanh Chinh 1998-2000

<sup>54</sup> Olson 1993

revenue they generate above a biannually negotiated target.<sup>55</sup> While only six provinces routinely bring in more revenue than expenditures, close to two-thirds meet their targets on a regular basis.<sup>56</sup> For the highest revenue earners, Hanoi negotiates percentage return rates. HCMC, for example, can keep 29% of its revenue, while Binh Duong can keep 44%.<sup>57</sup> Given the amount of revenue collected in these provinces, however, the return can be substantial -- HCMC and Binh Duong were able to retain about \$870 million and \$20 million respectively in 2000. Localities can also receive additional revenue through extra fees on land transfers and energy usage, which tend to be higher in FDI recipient provinces. Many recipient provinces have been able to retain a great deal of revenue. In fact, the gap between target and actual revenue in the highest income provinces on a per capita basis in 1995 was higher than the total planned expenditure per capita in low-income provinces.<sup>58</sup> This extra revenue can be pumped back into infrastructure spending, social spending, and can be used to off-set provincial tax incentives, thus enlarging the policy space available to experiment with innovative economic policies.

The political implication of this financial mechanism is two-fold. First, provincial officials have an important incentive to accede to the policy demands of foreign investors if they are the dominant source of revenue in the province. If the central government is not willing to grant permission for their policy requests, provincial officials are likely to fence-break in order to retain the revenue flows. Provinces with revenue above the targets are also much less dependent on the central government for resources and therefore harder to reign-in.

It is worth noting that there is a common misunderstanding among recent observers of Vietnam that this targeting system was transplanted to Vietnam in the mid-nineties with the

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<sup>55</sup> World Bank 1996; Vietnam is not the only country: Kazakhstan, Ukraine, and China have all used this mechanism for periods of time ((Norris, Martizes-Vazquez, and Norregard 2001).

<sup>56</sup> Bird et al 1995; Rao, Bird, and Litvack 2001; Vasavakul, 2002; Government of Vietnam-Donor Working Group, 2000

<sup>57</sup> Before its request was granted in 2001, Ho Chi Minh City was only able to keep 15% of its revenue.

<sup>58</sup> World Bank 1996

Budget Law of 1996. Detailed lists of provincial revenue targets are available from the Ministry of Finance as far back as 1992 and probably extend further back. The 1996 Budget Law was in fact an attempt by the central government to codify a method of intergovernmental transfers that had been taking place since the eighties without a concrete legal framework. Some have argued that provincial targeting in Vietnam actually dates back to the very origins of the socialist model, when substantial gaps were left in central plans to be made up by local sourcing of provincially managed state owned enterprises.<sup>59</sup> The most important contribution of the 1996 Budget Law was not the fiscal targeting, but the fact that provinces now had a greater incentive to look toward other forms of enterprises rather than the state sector to beat their revenue targets. As FDI began to replace SOEs as the dominant revenue earners in some provinces, they began to have more influence over local economic policy.

#### ***4. FDI in Vietnam***

In the four years after the Foreign Investment Law in 1987, \$168 million dollars flowed into Vietnam, mostly into off shore oil and gas projects. After 1991, FDI formed with joint ventures in hotel and tourism projects, as well as export-oriented products such as garments, food processing, and automobiles that were thought to be easily managed.<sup>60</sup> FDI became increasingly important in Vietnam's economy. By 2000, although foreign-invested companies employed less than 1% of the total workforce in Vietnam, they cumulatively accounted for around 27% of the country's (non-oil) exports, 35% of the country's total industrial output, almost 13% of

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<sup>59</sup> Naughton 1995; Abrami 2003

<sup>60</sup> Mai 1998

Vietnam's GDP (FDI stock was equal to 50% of GDP), and contributed around 25% of total tax revenues.<sup>61</sup>

There was a high regional concentration of FDI in Vietnam from the very onset. 60% of approved projects between 1990 and 1994 were in HCMC and three neighboring provinces. Hanoi also was an early winner in the FDI attraction race, but its important status proved an exception to the fact that investors were primarily looking south.<sup>62</sup> From a political perspective, the southern concentration was odd. Until 1996, all final approval on FDI decisions had to be made in Hanoi and a province's primary hope of attracting investment rested in a warm and informative greeting for investors, who could then lobby officials at the The State Committee for Cooperation and Investment (SCCI) about where they wanted to set up shop. Similarly, provincial People's Committees were allowed to send letters to the SCCI, preparing documents for investors, and providing their evaluation of a particular investment project. Southern provinces excelled in this early system for reasons that will be discussed in the statistical test below.

For FDI flows, crucial legal changes were made in Decree 852 of January 1996 and the amended Foreign Investment Law. Decree 852 placed FDI coordination and planning under the direct control of the provincial People's Committee's Department of Planning and Investment (DPI). The Foreign Investment Law allowed provinces to sign smaller FDI projects (below \$10 million) directly.<sup>63</sup> Not coincidentally, the average size of individual FDI projects has dropped considerably since 1996 despite the fact that the absolute number of projects increased.<sup>64</sup>

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<sup>61</sup> Freeman and Nestor 2004

<sup>62</sup> At this time, FDI came primarily in the form of joint ventures with state owned enterprises, accounting for over 70% of approved projects and 75% of total registered capital between 1988-1994.

<sup>63</sup> Vietnam Investment Review 1997

<sup>64</sup> VIR 2002; Folkmanis 2002

Investors have opted to invest just below the investment limits and avoid dealing with Hanoi bureaucrats.

Reliance on FDI tapered off in 1997 with the on-set of the Asian Financial Crisis, where Vietnam was impacted indirectly by the loss of investment from its East Asian neighbor (roughly 70% of its inflows at that time).<sup>65</sup> Nevertheless, the stock of FDI as a percentage of GDP continues to be fifth among all transition states.<sup>66</sup> In 1999, the Foreign Investment Advisory Service (FIAS) reported that Vietnam was the number one recipient of FDI among all developing and countries in transition in proportion to size of its economy.

It is important to remember that most of the investors over the course of the nineties were fellow Asian firms from, who were primarily interested in using Vietnam as an export platform.<sup>67</sup> These countries accounted for 64% of total capital and 59.7% of licensed projects. Primarily due to their influence, foreign investors' share of exports rapidly grew to 27% in 1995 and 45% by 2001. Most of the Asian investors in Vietnam already had significant operations elsewhere in Asia. They were familiar with investing in the Asian context and conscious of their needs. Indeed, some have found that investment from Asian countries significantly less likely to fail than their European and American counterparts.<sup>68</sup>

### ***5. Testing the simultaneous impact of FDI and provincial autonomy***

In this section, I develop a statistical test of the proposition that the larger the stock of FDI, the more likely a province is to engage in fence-breaking economic reforms. To deal with the endogeneity, I use a simultaneous equation model of autonomy in the Vietnamese provinces

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<sup>65</sup> Fforde 2002

<sup>66</sup> UNCTAD 2001

<sup>67</sup> Anh 2004, Mai 1998

<sup>68</sup> Kokko, Ari, Kotoglu, Krohwinkel-Karlsson 2003

between 1990 and 2000.<sup>69</sup> Recently, these models have become quite popular in political science.<sup>70</sup> The model begins with two equations:

$$y_1 = \gamma_1 y_2^* + \beta'_1 \mathbf{X}_1 + \varepsilon_1 \quad (1)$$

$$y_2 = \gamma_2 y_1^* + \beta'_2 \mathbf{X}_2 + \varepsilon_2 \quad (2)$$

Where,

- $y_1$  is the stock of FDI per capita within each province every year, a continuous endogenous variable,
- $y_2$  is a dichotomous endogenous variable capturing whether one or more cases of fence breaking was observed in a given year in a given province. The variable receives a scores of 1 if  $y_2 > 0$ , and 0 otherwise,
- $\mathbf{X}_1$  and  $\mathbf{X}_2$  are matrices of exogenous variables in (1) and (2) of which more will be said below.
- $\beta'_1$  and  $\beta'_2$  are vectors of parameters in (1) and (2),
- $\gamma_1$  and  $\gamma_2$  are the parameters of the endogenous variables in (1) and (2),
- $\varepsilon_1$  and  $\varepsilon_2$  are the error terms of (1) and (2).<sup>71</sup>

### 5.1. The Dichotomous Dependent Variable – Content analysis of Autonomy

The dichotomous dependant variable in this analysis is whether the province has engaged in an autonomous action in a given year favorable to foreign investors, measured by a content analysis of state-owned Vietnamese newspapers. Measuring whether provinces have engaged in fence breaking activity and the total level of *de facto* decentralization is a difficult task. No standard Freedom House-type measure exists that can adequately capture this process. As a proxy, Malesky (2004) exploits one of the interesting elements of the Vietnamese polity. Because the Vietnamese Government uses its state owned press as a forum to denounce provinces which push beyond their central tenets and brags about the successes of “sanctioned

<sup>69</sup> I base my model on the CDSIMEQ program (Keshk, Omar M.G. 2003).

<sup>70</sup> Alvarez and Glasgow 1999

<sup>71</sup> Readers interested in derivation of the model should refer to Appendix 5. To confirm that the pooled time series nature of the data does not affect the results, I offer separate pooled time series tests of the bivariate measure in Appendix 4 and the imputed measure of FDI in Robustness Test 1.

experiments,” a content of analysis of a variety of these newspapers offers an ideal measure to capture the amount of broken fences that each provinces has accumulated over the course of the nineties. Malesky tracks six daily newspapers from 1990-2000 and records every time a province was cited for willfully pushing beyond central economic or administrative policy (red lights), such as allowing land to be used as collateral in receiving bank loans,<sup>72</sup> and every time provinces took advantage of ambiguity in central law to enact their own reforms (yellow lights).<sup>73</sup>

Finally, his analysis captures every time province receives special rights to engage in experiments or pilot projects that are not granted to other provinces (green lights), such as constructing industrial zones. As these green-lighted experiments often duplicate early fence-breaking reforms, I drop them for this analysis. For instance, the one-stop-shop policy for investment licensing instead of negotiating with multiple regulatory agencies began as fence-breaking by Binh Duong and Ho Chi Minh (HCM) City to improve government efficiency and was criticized roundly in the papers as dangerous. By 1994, HCM city was given permission to pilot the program in a few areas while Binh Duong continued to do it without official permission. After success in those areas, the experiment was extended to all of HCM City.<sup>74</sup>

The content analysis uses a wide variety of newspapers representing the widest provincial coverage possible, different government factions, interests, and geographical reach were chosen

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<sup>72</sup> This reform was first initiated in 1993 by Ba Ria-Vung Tau. Initially, provincial leaders were criticized for the activity, but eventually the Prime Minister gave them special permission to experiment. After a few months, it was determined that the province had gone too far and the experiment was supposed to be stopped (SGGP, 1993a). While there was a brief stoppage, eventually the reform gained support in other provinces (LD, 1993).

<sup>73</sup> In Ho Chi Minh City, the Department of External Economic Relations actually began putting limits on the amount of export taxes placed on products produced within its boundaries (SGGP, 1991). They also violated central customs laws by clearing goods from inspection before assessing import taxes (SGGP, 1993b).

<sup>74</sup> SGGP 1995

to maximize variance in this variable.<sup>75</sup> Overall, 550 articles were chosen that span every one of Vietnamese provinces, though many provinces did have any cases in a particular year. Thirteen economic policy and legal categories were delineated.<sup>76</sup> The most frequent of these were land, housing, trade, legal, administrative, and micro-economic reforms.

Of course, there are several limitations to such an approach. First, the two major metropolises of HCMC and Hanoi tended to be cited more than other provinces, simply because of their special importance to the country. We might expect that smaller, less endowed provinces may receive less attention from newspapers for the same reason they might be ignored by investors. To control for this, I include a dummy variable to account for the special importance of these two cities in the economy. I also control for overall size of the provincial GDP in robustness tests, which was never significant in fully-specified models.<sup>77</sup>

Secondly, it is often not clear whether a provincial leader has simply broken a fence or is actually engaging in corruption, as he is often accused by the papers. Many reform endeavors clearly offer some personal gain to the provincial leaders or their families as discussed above. For instance, a leader that allows inputs to be imported below the tariff price, but whose family is heavily invested in the recipient industry. Authors have noted that trumped up corruption cases are often used to reign in autonomous provinces, so one cannot simply rule these out.<sup>78</sup> To account for this dilemma, I subdivide the dataset into cases of pure economic reform and those in which members of the People's Committee benefited monetarily from the initiative, such as

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<sup>75</sup> The five Vietnamese and one English language paper are: *Nhan Dan* (People's Daily), *Lao Dong* (Labor), *Sai Gon Giai Phong* (Liberated Saigon), *Tuoi Tre* (Youth), *Thanh Nien* (Young People), and the *Vietnam Investment Review*, the newspaper of record for the foreign investment community in Viet Nam.

<sup>76</sup> These include investment incentives, land use rights, legal reform, administrative policies, micro-economic policies, infrastructure, trade policies, environmental policies, labor policies, taxes, investment zones, credit funds, treatment of foreigners, and cultural policies.

<sup>77</sup> Data set received from Vietnamese General Statistical Office by way of World Bank Hanoi. The data is available only from 1995 until 2000. Data prior to this compilation overestimates provincial data so much that the sum of provincial GDPs was greater than national GDP.

<sup>78</sup> Gainsborough 2003; Gainsborough 2001

through the sale of houses, land, or imported goods. These cases of tentative “corruption” account for about one third of the entire sample of cases. Results did not vary significantly between the cumulative dataset and a dataset only including cases where no individual gain was recorded.

Third, some analysts of Vietnam have noted that the central government may not bark at a particular reformist province for fear that its innovations will become popular and spread.<sup>79</sup> My data set simply misses these occasions, as provinces must be cited to appear, necessitating further qualitative case studies of a subset of provinces. As unrecognized cases of fence-breaking bias against a positive finding for my theory, positive confirmation should be considered an indication that actual cases of fence-breaking are even higher.

I use a dummy of whether a province has engaged in such activity in a given year as my dependent variable for the first test. There are two primary reasons why I use a dichotomous variable as opposed to a count variable. First, severe non-stationarity in both the count variable (provinces are becoming more autonomous over time) and stocks of FDI may lead to spurious regression. Appendix 3 provides the result of the Hadri Langrange Multiplier test of stationarity.<sup>80</sup> As can be seen, the null hypothesis of stationarity cannot be rejected in the dichotomous measure (*cases of autonomy*), but can be rejected in the count measures of *number of autonomy* (in a given year) and *stock of autonomy* (over the entire data set), where the test statistics are not significantly different from zero.<sup>81</sup> Secondly, cases of autonomy in a given year are not independent of each other. A series of fence-breaking incidents in a given province are likely to be related to some underlying and unobservable need of foreign investors or even an

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<sup>79</sup> Gareth Porter noticed that it took years for the government to acknowledge Long An province’s violation of central pricing policies. When it finally did, it trumpeted them as its own ideas, Porter 1993.

<sup>80</sup> Hadri, Kaddour 2000

<sup>81</sup> To avoid spurious regression, I must use the first difference of all variables where a null of hypothesis of stationarity is rejected.

idiosyncratic factor such as a particularly audacious provincial official. Newspaper coverage of these incidents is also not an independent draw; it is not uncommon to see clusters of articles on different violations of the Land Law cited in local newspapers because journalists were primed to seek out those stories. Third, clusters of cases are found most often in the biggest provinces leading to severely skewed data. By reducing the measure to a dichotomous variable of whether autonomy was observed or not, I am able to skirt these issues and focus on the central question - how much FDI is needed for a province to believe it has the bargaining power to challenge central authority for the first time in a given year.<sup>82</sup>

The data set for this test includes pooled time series data of three sets of unbalanced panels (see footnote 2). 1990 is chosen as the starting date, because reliable data on implemented FDI as opposed to merely contracted does not exist before that date. 2000 is chosen as the end point, because it represents to many scholars the final year of SOE capture of the central government. Not only was this the year of the Enterprise Law and the initiation of a competition policy task force, but 2000 also saw the rise of Nong Duc Manh to Vietnam's Party Secretary. Rather than the conservative leaders of the past, Manh is a pragmatic with reformist credentials.<sup>83</sup>

## 5.2. Continuous Dependent Variable: FDI in Vietnam – Implemented FDI per Capita

The continuous dependent variable for the simultaneous equation model is the stock of implemented FDI per capita in every province for each year between 1990 and 2000, allowing for depreciation assuming a ten-year lifespan of each new investment (MPI 2001).<sup>84</sup>

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<sup>82</sup> For interested readers, I provide a robustness test of the count measure using a pooled time series model with panel corrected standard errors on the first difference of the *count of autonomy*.

<sup>83</sup> Van Arkardie and Mallon 2003; Thayer 2002

<sup>84</sup> Using FDI as a percentage of GDP in the years when GDP is available makes little difference in the 1995-2000 results. Interested reviewers should see Robustness Test 3.

To better understand the influence dynamic, we need to understand that different types of investors have different goals. While export oriented investors need improvements in institutional quality to lower their transactions costs and facilitate the competitiveness of their products on international markets, investors interested only in accessing the domestic market might actually push for more opaque governance. Such negative pressure is particularly the case when investors with headquarters in the transition country look for protection of their market share from imported goods.<sup>85</sup> I account for this differentiation, in two ways. First, I provide two control variables for the *percentage of FDI projects involved in manufacturing and natural resource exploitation*, as opposed to service provision, commerce, or retail sales.<sup>86</sup> Secondly, I use the stock of FDI weighted by provincial exports as a percentage of GDP between 1995 and 2000, the only years for which data exists. Obviously, the amount of exports accounted for by foreign investment would be ideal, but such a number does not exist across all provinces. It would also have been interesting to study investment by nationality, but the data does not exist at the provincial-level.

## 5.2. Exogenous Control Variables

*Initial conditions:* The most crucial variable for the simultaneous equation analysis is favorable *infrastructure*, because it is theoretically correlated with investment and not with provincial autonomy. Contrary to the market preserving federalists, I argue that some provinces simply do not have the requisite initial conditions to attract labor or investment.<sup>87</sup> Therefore, copycatting strategies are unlikely to work and are unlikely to be attempted. These poorly

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<sup>85</sup> Fung et al, 2002.

<sup>86</sup> Unfortunately, this data is only available in the Vietnamese Enterprise Census for the year 2000, forcing me to assume that the same distribution of enterprises existed throughout the time period. This is a dangerous assumption, but the only one that is possible given the data.

<sup>87</sup> Montinola, Qian, and Weingast 1995.

endowed provinces will look to the central government for transfers or international aid (generally contracted centrally) rather than exploring independent reform strategies to attract FDI.

To account for these factors, I create a measure of initial conditions. I employ a factor analysis with a varimax rotation to create a composite measure of five different measures of initial conditions. These include the number of telephones in the province and the amount of transported material (in millions of tons) per kilometer to gauge the quality of infrastructure throughout the period,<sup>88</sup> the percentage of population in urban versus rural settings to measure the size of the internal market, and human capital measured by the number of students who enrolled in secondary school and graduated (there is almost no variance on primary school).

The rotation yielded one component, which I label “*Infrastructure*.” Table 1 below includes the factor loadings and eigenvalues for these measures.

**(Table 1 about Here)**

The important assumption that infrastructure is very likely to pull investment into a province, but is unlikely to have any impact on autonomy unless it is through investment is upheld by the table of bivariate correlations in Appendix 1. *Infrastructure* correlates with cases of autonomy only at .29 but correlates with the stock of FDI per capita at .63. Even if we only look at infrastructure in the very first year of a province’s creation, the correlation is .43. This *first year infrastructure* is very important, because it does not trend upward, giving us a measure of infrastructure quality independent of local government actions (especially the use of surplus revenue to improve roads and ports). More importantly, having an extra variable uncorrelated

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<sup>88</sup> In other settings, I have used percentage of communes with roads connecting them to the city center, but it correlates at the .70 level with transported material. Transported material is more suitable because it measures more than just road coverage, but also the quality of the roads.

with autonomy makes the simultaneous model soluble, much like an instrument in two-stage least squares. Models are also run with the infrastructure increasing over time for comparison.

Four other control variables for structural conditions are used and can be seen in Appendix 2. These are the *share of agriculture in provincial output*, the *percentage of secondary school graduates* in each province as a measure of human capital, *distance from Hanoi* in kilometers to gauge whether proximity to the central government limits the ability to experiment, and *distance from major markets* (Hanoi or HCMC) as a measure of whether foreign investors are interested in accessing large urban markets for sales, purchase of intermediate goods, and softer factors such as the presence of other foreigners and services catering to their needs.<sup>89</sup> Interestingly, there is a (-0.50) correlation between distance from Hanoi and secondary school graduates, which makes sense because Northern provinces were favored by the communist regime. It goes without saying that this education was likely to be highly tinged with Marxist-Leninist thought and not a very good predictor of economic governance or FDI attraction.

*Cabinet Member from Province:* As in the China literature, there is much debate in Vietnam about the role of connections in the central government in shielding provinces from serious punishment when they experiment with reforms.<sup>90</sup> For China, Pierre Landry tested the validity of these statements by measuring whether promotions to central positions results from informal networks at the central level, finding little support for the conjecture.<sup>91</sup> Similarly, I control for the number of *cabinet positions* in each year held by provincial compatriots. The number ranges from 0 in the case of most provinces, to 8 for Nghe An (the birth place of Ho Chi Minh) in 1997.

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<sup>89</sup> All variables except distance trend upward over time (Appendix 3), necessitating the use of the first difference).

<sup>90</sup> Vasavakul 2003; Turley and Womack 1998; Kerkvliet, 2001

<sup>91</sup> Landry 2004

*Strength of Party Control:* Yumin Sheng has argued convincingly that those Chinese provinces more exposed to global economic forces may have a tendency to pursue a different economic reform trajectory, but that the central government is not a passive actor, rather it maneuvers to maintain control of subnational governments through the personnel appointment process -- shifting centrally connected Party Secretaries to lead more open provinces. Sheng (2004) measures this impact by using a variable pioneered by Yasheng Huang to measure Party Control over provincial governments.<sup>92</sup> I duplicate this measure of *Party Control* by coding a province: 0) if the Party Secretary is from the province, but does not serve on the Central Committee; 1) if the Party Secretary is from province and serves on the Central Committee; 2) if the Party Secretary was transferred from another province; 3) if the Party Secretary was transferred from a central government position in Hanoi; and 4) if the Party Secretary is concurrently a member of the Vietnamese Politburo. An equivalent measure for the provincial executive or People's Committee Chairmen is also created. This measure should be negatively associated with autonomy.

*Share of the State Sector in Industry:* As discussed above in the “unlocked PRE mechanism,” the strength of state owned enterprises in a province might affect both sides of the simultaneous model. First, high state presence may crowd out FDI , but second, SOEs may work to undermine local reforms that they see as harming their economic interests. I use a measure of the share of the state owned state sector in provincial industry. Once again, share in revenue would have been most appropriate, but such data does not exist.

*City Dummy:* This variable simply captures whether the province is Hanoi or HCMC to account for possible biased coverage in newspapers to the country's two biggest metropolises.

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<sup>92</sup> Huang 1996

*Southern Dummy:* It is open debate whether Southern provinces had a special advantage in leading the reform agenda early on in the nineties. They benefited from a Southern legacy and affinity with a market mechanism. Because southern provinces were only under a centrally planned system for 11 years (between 1975 and 1986), many of the entrepreneurs under the old regime reemerged after the beginning of economic reforms. They were able to profit from their old expertise and, in some cases, also from their international and domestic connections. They may even have benefited from the presence of an ethnic Chinese population, however small after 1979. This accumulated stock of knowledge may be similar to the notion of social capital.<sup>93</sup> To capture the impact of the South, I create a dummy variable based on whether a province was north or south of the 1954 Geneva Armistice's border declaration at the 17<sup>th</sup> Parallel.

*Average Regional Autonomy:* Market Preserving Federalism theorists believe that other provinces should imitate successful reforms. Following the recent work on policy diffusion, however, this will be tempered by province's knowledge of provincial reforms in its neighboring provinces.<sup>94</sup> We should expect that policy ideas should diffuse to neighboring provinces and should diffuse more rapidly across provinces of similar geography, climate, and topology. A province with mostly mountainous terrain would have less agricultural land to re-zone for manufacturing -- one of the major Southern reforms. Following the General Statistical Office, I divide Vietnam into eight regions based on geographic and climate characteristics. To measure whether there has been a diffusion of reforms, I measure the mean number of autonomous actions of provinces within the region of the tested province.<sup>95</sup> The assumption is that the higher the number of regional reforms, the more likely diffusion into a neighboring province.

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<sup>93</sup> Putnam 1994

<sup>94</sup> Simmons, 2004; Kopstein and Reilly, 2000

<sup>95</sup> Simmons and Elkins, 2004; Kopstein and Reilly, 2000

## 6. Results

Table 2 illustrates the results of the simultaneous model. As can be immediately seen, the original speculation about the mutually reinforcing impact of FDI and cases of provincial autonomy proves not to be the case. FDI has a significant impact on instances of autonomy in every specification, but the inverse does not prove to be true. All else equal, provincial fence-breaking reforms are insignificant in their attraction of FDI and actually have a slightly negative substantive effect in a given year. This is true whether the model captures flows of FDI by including a lagged stock of FDI variable, as I do in models 1, 2, 4, and 5, or whether predict the growth in stocks of FDI, as I do in model 3. When testing for FDI flows in the most recent year, the most important predictor is always the existing stock of FDI (differenced to avoid upward trending). This is a clear example of economies of agglomeration or the notion that investors will tend to cluster near other investors to benefit from vertical linkages as well as the fact that the presence of other successful investors can be used as an information short-cut.<sup>96</sup> Two other predictors of flows are secondary education, which correlates negatively and could be interpreted as the more exposure to Marxist-Leninist education in Hanoi; the more unlikely a province is to attract investment.<sup>97</sup> The city dummy is significant and positive, indicating that Ha Noi and HCMC were likely to receive about \$18 more per capita than other locations.

### (Table 2 about Here)

Focusing on factors leading to the increase of FDI stocks yields more interesting results in the anticipated directions. A one standard deviation increase in the improvement in the quality of infrastructure of a province in its first year will lead to a \$30 per capita increase in the stock of FDI. Each 100 km increase in distance from the major markets of Ha Noi and HCMC costs a

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<sup>96</sup> Krugman 1993

<sup>97</sup> Though not shown due to space consideration, a dummy for the years after the Asian Financial Crisis (1998 and 1999) has significant negative impact on investment.

province roughly \$3 in FDI per capita. Increases in the size of agriculture and the strength of the SOE sector in a given province will lead to significant decreases in stocks of FDI. Secondary education is once again negative, while location in Ha Noi or HCMC is strongly positively associated with FDI increases. Also highly significant is location in the South, which leads to increase of FDI stocks about \$11 per capita. Cases of autonomy in the previous year, however, while inching closer to significance continue to have a negative impact of stocks of FDI per capita. Clearly, autonomy is not a major source of attraction for investors.<sup>98</sup>

In the second set of equations, however, we learn that on FDI has a positive and significant impact on autonomy. Although in model 3 when the lagged stock of FDI is dropped from the first equation, this impact is less pronounced. In the most fully specified equation Model 5, the overall probability of autonomous action is about 40% with all variables set to their mean. An increase in the imputed stock of investment vary from the minimum score in the data set to the maximum, increases the probability of autonomous action by an astounding 71%.<sup>99</sup> Increasing the stock of FDI from the 50<sup>th</sup> percentile (\$7 per capita) to the 75<sup>th</sup> percentile (\$46 per capita) on the other hand raises the probability of autonomous action by about 4%.

Figure 2 extends the analysis of the probability of autonomy. Holding all other variables at their mean value, I allow the stock of FDI per capita to vary from the 1<sup>st</sup> percentile (\$0 per capita) to the 90<sup>th</sup> percentile (about \$180 per capita). By doing this, we can see that FDI has a steady effect on the probability of autonomous actions. The probability of autonomy increases gradually until it crosses a tipping point at about the 60<sup>th</sup> percentile (\$13.7). Once that threshold is crossed, the probability of autonomous actions shoots up rapidly, crossing 70% when the top

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<sup>98</sup> Reviewers may be interested in whether the absolute number of autonomous incidents or the stock of autonomous incidents may have an impact on FDI attraction. These results are shown using a pooled time series model in Robustness Test 1. Indeed, there is a positive substantive effect (though insignificant) between the number of cases of autonomy (and the stock of autonomy) on both stocks and flows of FDI.

<sup>99</sup> Readers interested in confirming that effects do not change when using a pooled time series model with panel corrected standard errors to deal with the time series properties of the model, please see Appendix 3.

five percent of provinces are reached (\$567 per capita). This confirms my theory that stocks of FDI can act as a spur to provincial reform among its lucky recipients. The steady upward slope indicates that while the effect is highest in the top FDI-recipient provinces, it is not driven by them.<sup>100</sup>

**(Figure 2 about here)**

The diffusion hypothesis is clearly upheld, as provinces in highly autonomous regions are much more likely to experiment. Holding all other variables at their mean, an increase of one standard deviation (about 6 cases of autonomy) in the stock of regional autonomy increases the probability of provincial autonomy by 5.6%. By contrast, most other factors have very little impact on autonomy: the size of the state sector, percentage of secondary school graduates, southern proximity, number of cabinet members, and control of the local Party Secretary have effects that are not significantly different from zero.

The two variables that are most important in the autonomy specifications are the types of investment. The percentage of FDI projects in manufacturing has a positive impact on FDI, as was suspected due to the fact that these enterprises tend to be the most likely to export and therefore require reforms that allow them to better compete internationally. On the other hand, the percentage of projects involved in natural resource exploitation has a negative impact on autonomy, as these projects require permission of the central government and are more likely to be interested in provincial activities which protect their investment rather than improve the economy generally.

Appendix 2 captures the impact of different types of FDI more effectively by studying the interactions effects between manufacturing, natural resources, and exports with the imputed

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<sup>100</sup> Readers interested in confirming that high-FDI provinces alone are not solely responsible for the relationship should observe the scatter plot of imputed FDI and imputed autonomy in Robustness Test 2.

FDI per capita in a pooled time series mode on the probability of cases of autonomy. Dummies were created for each of these variables, indicating whether a province was above the 50<sup>th</sup> percentile. While only the interaction with natural resources proved statistically significant, the fascinating substantive effects are explored further in Figure 3 below. Figure 3a illustrates that possessing above average percentage of manufacturing projects leads to a shift upward in the probability of autonomy though the two lines possess similar slopes, indicating that investment will lead to autonomy at about the same rate in the two provinces. Figure 3b demonstrates a similar effect for provinces with a high percentage of exports. The two lines are not exactly parallel, however, as there are too few provinces with low exports and very high FDI, demonstrating poignantly that FDI in Vietnam is predominantly export-oriented. In other countries, the effects may differ. Considering exports and manufacturing at the same time in Figure 3c, it is clear that both effects continue to operate. The highest probability of autonomous actions is in provinces characterized by high exports and high manufacturing. Figure 3d sheds some light on why the relationship between natural resource investment and FDI is positive even though the impact of natural resources overall is negative. While the slope of high resource based provinces is very steep, none of these provinces even reaches the lowest quartile of FDI per capita. Most likely, they are dominated by SOE, with foreign investment playing a minor role in the form of joint-venture partners. As a result, no natural resource-dominated investment location is likely to participate in an autonomous action.

**(Figure 3 about here)**

## ***7. Conclusion***

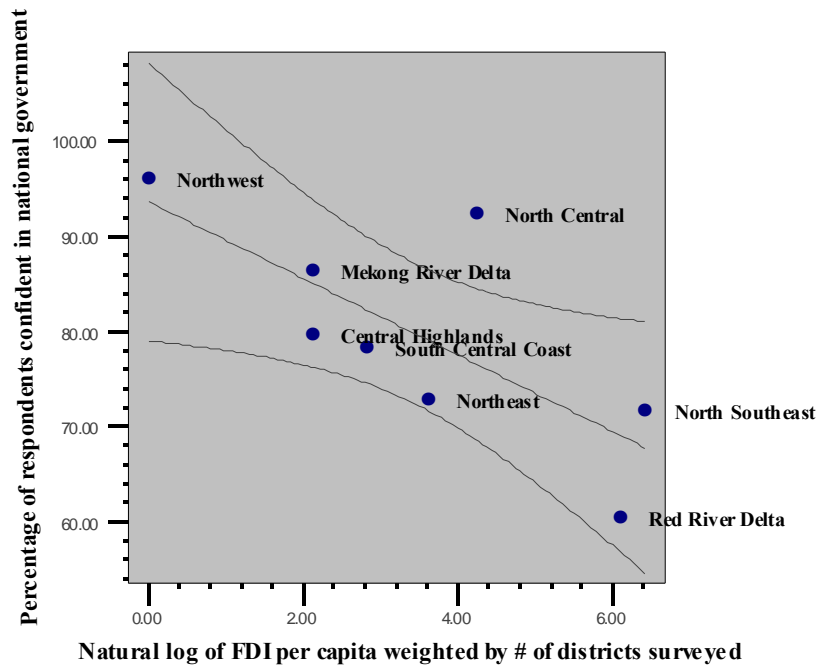
In this paper, I have demonstrated persuasively that the influence of existing investors has a stronger impact on the probability of provincial autonomy than the hope of attracting future

investment. Locational determinants in Vietnam are still primarily structural in terms of better infrastructure and proximity to markets with economies of agglomeration playing the predominant role in year-to-year flows, as the presence of other investors signals relatively cheaply these other factors. This is an important corrective to both the present literature on the political economy of FDI, which has tended to concentrate too heavily on the political determinants of investment attraction, while neglecting the role existing investors have in shaping domestic institutions and policy.

Similarly, this article adds to the decentralization literature, by presenting one example of the micro-processes by which international factors affect local-central relations. By understanding this mechanism, we can make better predictions about the exact form decentralization and subnational institutions will eventually take in transition economies, and eventually how these relationships will impact overall progress toward economic reform.

A final critical finding is that not all investors are the same; export-oriented investors (particularly in manufacturing industries), have the most pronounced effect on provincial autonomy. These investors benefit the most from provinces' fence-breaking policies, as such actions lower their transaction costs locally and allow them to better compete in international markets. Other investors may be less concerned with fence-breaking economic reforms and more concerned with protecting access to lucrative domestic markets. While natural-resource-oriented foreign investment still plays too small a role in most provinces to derive clear predictions, its presence appears to have a negative impact on local autonomy.

**Figure 1: Relationship between Regional Foreign Direct Investment and Confidence in National Government (World Values Survey, 2001)**



<b>Table 1: Factor analysis using varimax rotation to create measures of infrastructure<sup>101</sup></b>		
<b>Variable</b>	<b>Factor 1</b>	<b>Uniqueness</b>
Percentage of population urban	0.761	0.421
Telephones per capita	0.628	0.606
Mill. Tons of cargo transported on provincial roads per km	0.742	0.450
Eigenvalues	1.52	
Cumulative variance explained	79%	

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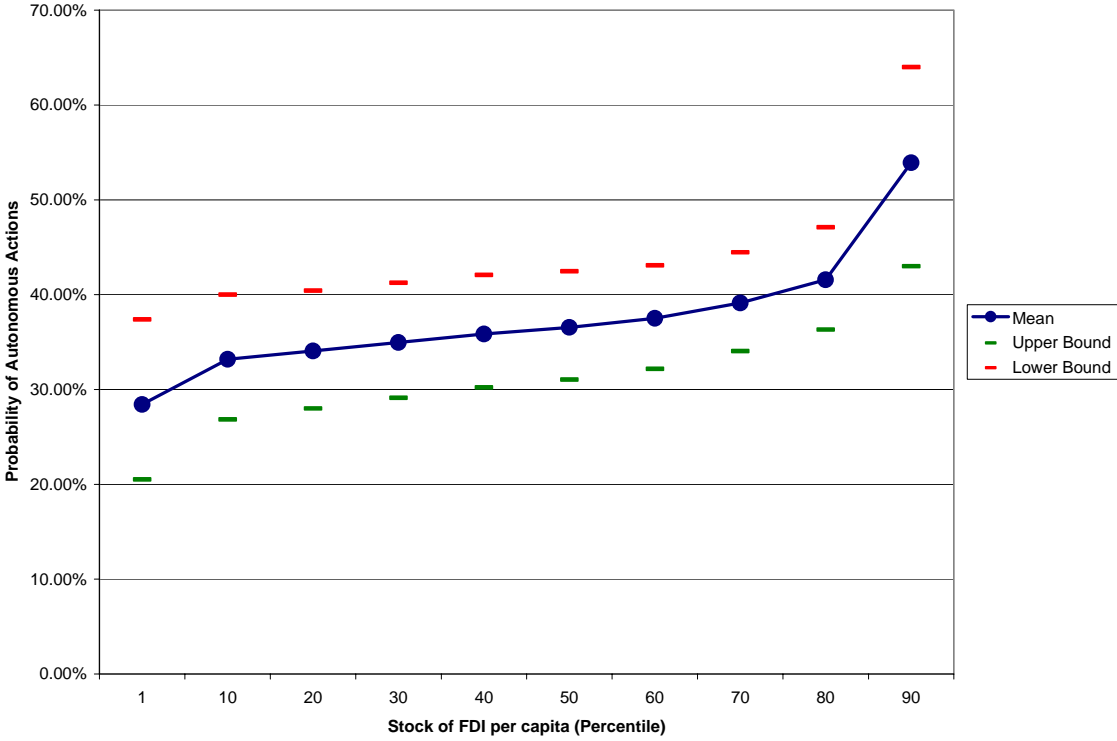
<sup>101</sup> Data was obtained from *10 Cuoc Dieu Tra Quy Mo Lon 1998-2000*. 2001. [10 Large Scale Surveys 1998-2000. Hanoi: *Nha Xuat Ban Thong Ke* [Statistical Publishing House]; *Nien Giam Thong Ke* [Statistical Yearbook of the General Statistical Office] 1995-2002 (multiple volumes).. Hanoi: *Nha Xuat Ban Thong Ke* [Statistical Publishing House].

**Table 2: Simultaneous Equation Model of Foreign Direct Investment and Provincial Autonomy**

<b>Equation 1 Dependent Variable Stock of FDI per Capita - Coefficient with t-value in parentheses</b>					
<i>Independent Variables</i>	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5</i>
Imputed case of autonomy	-29.39 (-.86)	-7.69 (-0.93)	-16.12 (-1.85)*	-0.97 (-.18)	-1.723 (-.26)
First difference of lagged stock of FDI per capita	0.79 (3.38)***	0.64 (9.57)***		0.61(10.28)***	0.592 (10.35)**
Infrastructure in province's first year	32.22 (.9)	11.80 (1.13)	30.17 (2.51)**		4.401 (.54)
Distance from metropolis	-0.03 (-1.05)	-0.01 (-1.43)	-0.03 (-4.58)***	-0.01 (-1.05)	-0.004 (-.46)
First difference of agricultural share of provincial output	-1.97 (-.10)	-1.52 (-0.13)	-17.74 (1.88)*	-2.25 (-.20)	-3.217 (-.28)
First difference in SOE share of industrial output	-0.64 (-1.15)	-0.27 (-1.44)	-0.78 (-4.51)***	-0.20 (-1.17)	-0.144 (-.84)
First difference of % of secondary school graduates	-0.40 (-1.51)	-0.36 (-2.38)**	-0.25 (2.04)**	-0.34 (-2.38)**	-0.353 (-2.38)**
Southern Dummy	6.62 (1.08)	3.89 (1.24)	10.36 (4.22)***	3.70 (1.18)	0.842(.27)
City Dummy	7.43 (.32)	17.73 (1.67)*	42.12 (5.41)***	28.40 (3.79)***	21.464
First difference of infrastructure 1990-2000				-3.01(-.32)	4.026 (2.11)**
First difference mean autonomy of region					1.395(2.12)**
Constant	9.93	6.25 (1.57)	18.31 (4.83)***	2.93 (.91)	-1.723 (.34)
N	416	379	440	379	379
R <sup>2</sup>	.55	.55	.30	.54	.56
F Test	56.09***	49.99**	22.87***	49.64***	33.46**
<b>Equation 2 Dichotomous Measure of Autonomy - Coefficient and z-scores in parentheses</b>					
<i>Independent Variables</i>	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5</i>
Imputed Stock of FDI per capita	0.015 (3.79)***	0.01 (3.22)***	0.03 (1.64)*	0.01 (3.28)***	0.013 (3.51)***
First difference in SOE share of industrial output	-0.009 (-1.01)	-0.01 (-.68)	0.00 (.24)	-0.01 (-.73)	-0.002 (-.19)
First difference of % of secondary school graduates	0.005 (.63)	0.01 (1.09)	0.01 (.95)	0.01 (.25)	0.007 (1.06)
Southern Dummy	0.130 (.89)	0.10 (.59)	0.00 (-.01)	0.11 (.53)	0.074 (.46)
No. of Provincial compatriots in cabinet	0.083 (1.28)	0.04 (.52)	0.04 (.44)	0.04 (.59)	0.025 (.38)
Provincial party control	-0.024 (-.21)	0.02 (.15)	-0.11 (-.53)	0.02 (.86)	-0.045 (-.41)
Percentage of FDI projects in manufacturing		0.00 (1.85)**	0.00 (1.27)	0.00 (1.96)**	0.003 (-1.91)***
Percentage of FDI projects in natural resource exploitation		-0.01 (-1.95)**	0.00 (-0.78)	-0.01 (-2.03)**	-0.005 (-2.49)***
City Dummy	0.263 (.60)	0.25 (.54)	-0.47 (-0.42)	0.26 (.54)	0.299 (.75)
First difference mean autonomy of region					0.130 (1.90)*
Constant	-0.510 (-3.49)	-1.35 (-2.05)**	-1.53(-1.58)*	-1.35 (-2.17)**	-1.568(-2.65)***
N	416	379	440	379	379
Pseudo R <sup>2</sup>	.803	.112	.083	.112	.125
Chi squared	45.45***	57.42***	49.18***	57.02***	64.1***

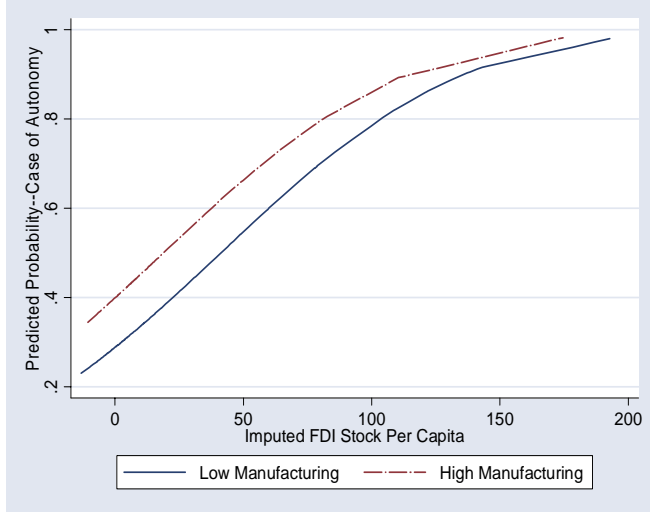
\* Significant at the .1 level; \*\* Significant at the .05 level; \*\*\*Significant at the .01 level.

**Figure 2:  
 Predicted Probabilities of Simultaneous Equation 2  
 The Impact of FDI on Provincial Autonomy**

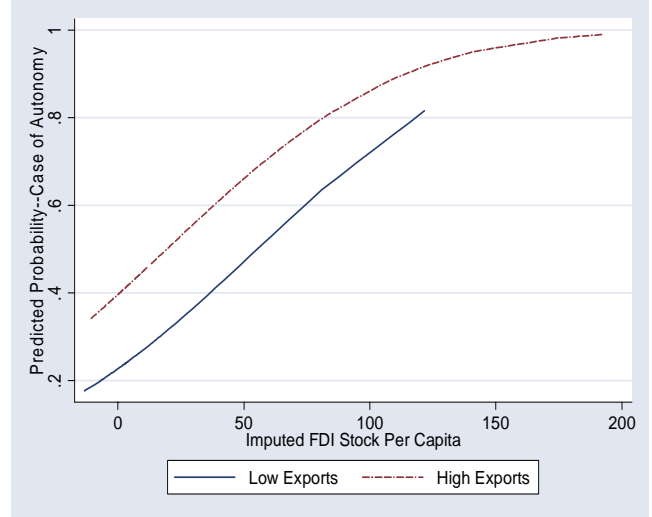


**Figure 3**  
**Interactions between Types of Investment and Imputed Foreign Direct Investment**

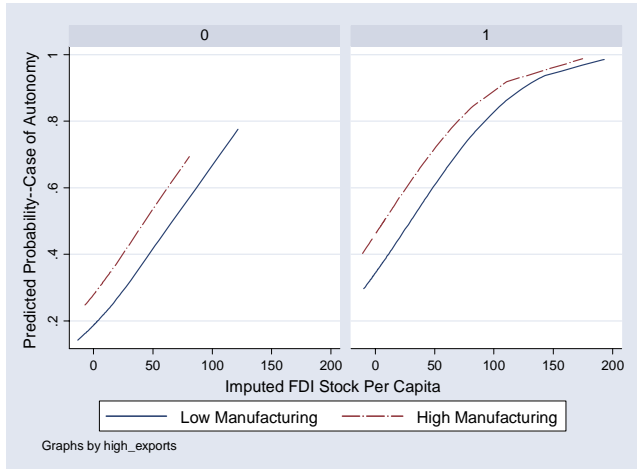
**Figure 3a**  
**Interaction of FDI with Level of Manufacturing Projects in Province**



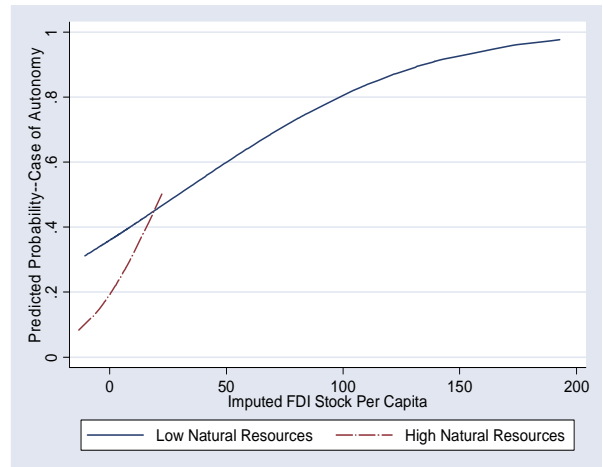
**Figure 3b**  
**Interaction of FDI with High and Low Exporting Provinces**



**Figure 3c**  
**Interaction of FDI with Level of Manufacturing Projects (by High (1) or Low Exports (0))**



**Figure 3d**  
**Interaction of FDI with Level of Natural Resource Projects in Province**



**Interaction of FDI with High**

**and Low**

## Appendices

<b>Appendix 1: Descriptive Statistics of Key Dependent and Independent Variables</b>				
<b>Variable</b>	<b>Mean</b>	<b>Std. Dev.</b>	<b>Min</b>	<b>Max</b>
Stock of FDI per capita	86.56	233.65	0.00	1646.60
Number of actions in one year	0.89	2.30	0.00	25.00
Stock of autonomous actions over time	6.20	14.07	0.00	147.00
SOE share of industrial output	48.07	21.24	0.00	99.33
Infrastructure in year 1	-0.42	0.52	-0.95	2.49
Infrastructure overall	0.000	1.00	-0.95	8.24
Mean stock of autonomy in region	6.19	6.18	0.00	26.11
Agriculture percentage of output	0.38	0.18	0.01	1.91
Percentage of secondary school graduates	86.14	10.37	46.26	99.56
Distance from Hanoi	897.45	749.02	0.00	2066.00
Distance from Hanoi or HCMC	249.41	217.60	0.10	835.00
Percentage of FDI projects in manufacturing	57.25	41.70	0.00	100.00
Percentage of FDI projects in natural resources	6.39	20.75	0.00	100.00
Exports as a percentage of GDP	15.98	17.94	0.00	102.23
Number of provincial compatriots in cabinet	0.70	1.17	0.00	7.00
Central control of party secretary	0.98	0.87	0.00	4.00

<b>Appendix 2: Bivariate Correlations of Initial Conditions Variables</b>										
<b>Variable</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	<b>9</b>	<b>10</b>
1. Case of Autonomy	1									
2. Stock of FDI per capita	0.27	1								
3. First Difference FDI Stock per capita	0.25	0.60	1							
4. Infrastructure	0.29	0.63	0.43	1						
5. First Difference Infrastructure	0.13	0.32	0.24	0.47	1					
6. Infrastructure in first year of panel	0.27	0.49	0.43	0.91	0.34	1				
7. First Difference of share of agriculture in economy	-0.01	-0.06	-0.09	0.00	-0.02	-0.05	1			
8. First Difference of secondary school graduates	0.00	0.07	-0.06	0.05	0.02	0.02	0.20	1		
9. Distance from Hanoi	0.04	0.08	0.08	0.11	0.05	0.12	0.04	0.03	1	
10. Distance from metropolitan area	-0.15	-0.24	-0.23	-0.19	-0.07	-0.20	0.00	-0.03	0.01	1

### Appendix 3: Hadri Lagrange Multiplier Test of Stationarity

<i>Balanced Panel Data with 61 Provinces Constructed from District-Level Data</i>					
	Test-Statistic	P-Value	N	T	Years
FDI stock per capita	12.7	0.000	61	11	1990-2000
SOE share of industry	.762	0.000	61	10	1990-2000
Case of Autonomy	-.055	0.478	61	11	1990-2000
Number of Autonomy	2.649	0.040	61	11	1990-2000
Stock of Autonomy	15.0	0.000	61	11	1990-2000
<i>Unbalanced Panel Data with Varying Numbers of Provinces</i>					
	Test-Statistic	P-Value	N	T	
FDI stock per capita	7.5	0.000	53	4	1992-1997
D1.FDI stock per capita	-.0037	0.515	53	3	1993-1997
FDI stock per capita	-.308	0.6211	61	3	1998-2000
SOE share of industry	4.937	0.000	53	4	1992-1997
SOE share of industry	1.81	0.03	61	3	1998-2000
Case of Autonomy	-.78	0.782	53	4	1992-1997
Case of Autonomy	-1.084	0.8609	61	3	1998-2000
Number of Autonomy	1.093	0.137	53	4	1992-1997
Number of Autonomy	-1.511	0.935	61	3	1998-2000
Stock of Autonomy	6.356	0.000	53	4	1993-1997
Stock of Autonomy	2.577	0.005	61	3	1998-2000
Infrastructure	4.60	0.000	53	4	1993-1997
Infrastructure	2.522	0.012	61	4	1998-2000
Agriculture	25.0	0	53	4	1993-1997
Agriculture	.970	0.166	61	4	1998-2000
Secondary school graduates	2.54	0.0055	53	4	1993-1997
Secondary school graduates	0.961	0.168	61	4	1998-2000

A test of stationarity was conducted using the Hadri Lagrange Multiplier. The null hypothesis is the variable exhibits a stationary process. Rows shaded in gray indicate that we cannot reject the null hypothesis of stationary. Unshaded rows indicate that that we must reject the null hypothesis of stationarity, requiring differencing these variables in multivariate testing.

### Appendix 4: Pooled Time Series Probit Model on Imputed FDI from Simultaneous Equations

<i>Independent Variables</i>	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5</i>	<i>Model 6</i>
Imputed Stock of FDI per capita	0.010 (2.16)**	0.009 (2.00)**	0.010 (2.37)**	0.016 (2.05)**	0.007 (1.55)	0.025 (1.99)**
First difference in SOE share of industrial output	-0.009 (-0.91)	-0.006 (-.64)	-0.043 (-2.13)**	-0.005 (-.52)	-0.005 (-.43)	-0.006 (-.64)
First difference of % of secondary school graduates	0.003 (.32)	0.002 (.23)	0.004 (.47)	0.003 (.35)	0.003 (.40)	0.006 (.69)
Southern Dummy	0.091 (.46)	0.012 (.06)	-0.124 (-.58)	0.064 (.33)	-0.021 (-.11)	-0.204 (-.96)
No. of Provincial compatriots in cabinet	0.070 (.86)	0.060 (.73)	0.064 (.79)	0.072 (.88)	0.062 (.77)	0.083 (1.03)
Provincial party control	-0.008 (-.06)	0.031 (.24)	0.080 (.47)	0.011 (.09)	-0.008 (-.07)	0.041 (.33)
City Dummy	0.648 (1.19)	0.563 (1.04)	0.167 (.29)	0.331 (.50)	0.772 (1.42)	0.312 (.57)
Percentage of FDI projects in manufacturing	0.004 (1.71)*	0.004 (1.57)	0.003 (1.36)	0.335 (1.65)*	0.005 (2.14)**	0.004 (1.58)*
Percentage of FDI projects in natural resource exploitation	-0.009(-1.81)*	-0.010 (-1.96)**	-0.009 (-1.52)	-0.010 (-1.97)**	-0.333 (-1.22)	-0.008 (-1.60)*
Mean autonomy of region		0.205 (2.63)**	0.167 (1.99)**	0.213 (2.72)***	0.195 (2.49)***	0.200 (2.61) ***
Exports as a percentage of GDP 95-2000			0.007 (1.24)			0.565 (2.61) ***
Interaction: High manufacturing and imputed FDI				-0.010 (-1.16)		
Interaction: High natural resource and imputed FDI					0.028 (1.82)*	
Interaction: High exports and imputed FDI						-0.017 (-1.33)
Constant	-0.701 (-3.47)***	-0.846 (-4.03)***	-0.985 (-4.08)***	-0.835 (-4.04)***	-0.8883 (-4.22)***	-1.144 (-4.92)***
N	379	379	257	379		
Chi squared	31.43***	37.03***	41.81***	37.4*		
AR 1 Model with Prais Winsten estimates and heteroskedastic panel corrected standard errors.						
* Significant at the .1 level, ** Significant at the .05 level; ***Significant at the .01 level.						

## Appendix 5: The Simultaneous Equation Model

Because  $y_2$  is a simple dichotomous measure that is not observed directly, the structural equations (1) and (2) are rewritten with  $\sigma_2$  the standard deviation of the autonomy measure. This is because it is a latent variable that can only be measured when it crosses a given threshold, after a violation of central law.

$$y_1 = \gamma_1 \sigma_2 y_2^{**} + \boldsymbol{\beta}'_1 \mathbf{X}_1 + \varepsilon_1 \quad (3)$$

$$y_2^{**} = (\gamma_2 / \sigma_2) y_1 + (\boldsymbol{\beta}'_2 / \sigma_2 \mathbf{X}_2) + \varepsilon_2 / \sigma_2 \quad (4)$$

Now, estimation follows the typical two-stage estimation process. In the first stage, the following two models are fitted using all of the exogenous variables (i.e., the exogenous variables in both (3) and (4)),

$$y_1 = \boldsymbol{\Pi}'_1 \mathbf{X} + v_1 \quad (5)$$

$$y_2^{**} = \boldsymbol{\Pi}'_2 \mathbf{X} + v_2 \quad (6)$$

Where,

- $\mathbf{X}$  is a matrix of all the exogenous variables in (5) and (6),
- $\boldsymbol{\Pi}'_1$  and  $\boldsymbol{\Pi}'_2$  are vectors of parameters to be estimated,
- $v_1$  and  $v_2$  are error terms.

Equation (5) is estimated via OLS and (6) via probit. From these reduced-form estimates, the predicted values from each model are obtained for use in the second stage.

$$\hat{y}_1 = \hat{\boldsymbol{\Pi}}'_1 \mathbf{X} \quad (7)$$

$$\hat{y}_2^{**} = \hat{\boldsymbol{\Pi}}'_2 \mathbf{X} \quad (8)$$

In the second stage, the original endogenous variables (stock of FDI per capita and cases of autonomy) in (3) and (4) are replaced by their respective fitted values in (7) and (8). Thus, in the second stage, the following two models are fitted:

$$y_1 = \gamma_1 \hat{y}_2^{**} + \boldsymbol{\beta}_1 \mathbf{X}_1 + \varepsilon_1 \quad (9)$$

$$y_2^{**} = \gamma_2 \hat{y}_1 + \boldsymbol{\beta}_2 \mathbf{X}_2 + \varepsilon_2 \quad (10)$$

Again, (9) is estimated using ordinary least squares (OLS) and (10) is estimated via probit. The model relies upon the imputation of two endogenous regressors, using the estimate of two associated reduced-form equations. Nevertheless, the two imputed regressors are measured with sampling error. Without correction, this sampling error will bias the estimate of the standard errors in the second-stage equations. This procedure corrects for this bias using an asymptotically correct covariance matrix.<sup>102</sup>

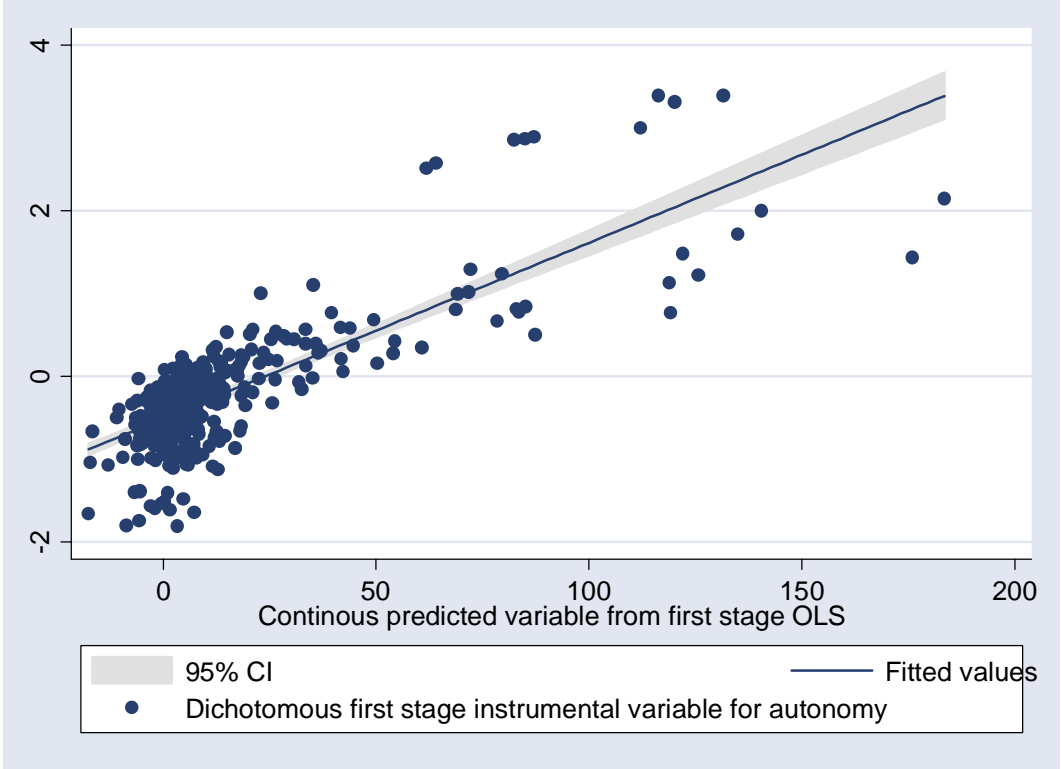
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<sup>102</sup> Maddala 2003

<b>Robustness Test 1: Pooled Time Series Model with Panel Corrected Standard Errors</b>						
<b>(Dependent Variable: Stock Foreign Direct Investment per Capita)</b>						
	<i>Stock of FDI per capita</i>		<i>Flows of FDI per capita</i>		<i>Stock of Autonomy</i>	
<i>Independent Variables</i>	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5 (stock)</i>	<i>Model 6 (flow)</i>
First difference of number of autonomous actions in year i.	1.117 (.14)	0.901 (1.07)	0.701 (1.04)	0.418 (0.57)		
First difference of lagged stock of autonomous actions					2.22 (1.14)	2.21 (1.14)
First difference of lagged stock of FDI per capita	0.543 (4.67)***	0.539 (4.77)***				-0.01 (-0.04)
Infrastructure in province's first year	3.102 (.44)	3.518 (.53)	12.486 (2.36)**	9.692 (1.45)	-3.46 (-.23)	-3.46 (-.23)
Distance from metropolis	-0.012 (-1.95)**	-0.003 (-.75)	-0.021 (-2.29)**	-0.016 (-1.92)*	-0.04 (-1.06)	-0.04 (-1.09)
First difference of agricultural share of provincial output	-2.438 (-.32)	-3.208 (-.42)	-6.917 (-.97)	-9.112 (-1.24)	-20.57 (-1.58)	-21.02 (-1.61)
First difference in SOE share of industrial output	-0.229 (-.92)	-0.135 (-.56)	-0.206 (-.98)	-0.189 (-.93)**	-0.26 (-.28)	-0.26 (-.28)
First difference of % of secondary school graduates	-0.377 (-3.72)***	-0.391 (-3.83)***	-0.194 (-2.24)**	-0.227 (-2.48)***	-0.13 (-.68)	-0.13 (-.64)
Southern Dummy	5.042 (1.68)*	1.756 (.74)	8.374 (1.77)*	6.433 (1.51)	38.47 (1.99)*	38.70 (2.09)**
City Dummy	18.021 (1.11)	18.128 (1.11)	23.303 (1.13)	27.512 (1.32)	61.62 (1.70)*	62.04 (1.69)
Mean autonomy of region		4.618 (3.05)***		4.104(2.79)***		
Constant	6.551 (1.40)	1.716 (.38)	16.990 (3.78)***	10.927(2.19)**	10.00 (.80)	10.14 (.82)
N	416	416	487	487	416	416
R <sup>2</sup>	.45	.46	.10	.11		.08

\* Significant at the .1 level, \*\* Significant at the .05 level; \*\*\*Significant at the .01 level.  
AR 1 Model with Prais Winsten estimates and heteroskedastic panel corrected standard errors.

**Robustness 2:  
Scatter Plot of Imputed Stock of FDI per capita and Imputed Autonomy from  
Simultaneous Equation Model.**



### Robustness Test 3

#### Simultaneous Equation Model of Foreign Direct Investment/GDP and Provincial Autonomy

**Equation 1 Dependent Variable: Stock of FDI as a percentage of GDP (1995-2000)- -Coefficient with t-value in parentheses**

<i>Independent Variables</i>	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5</i>
Imputed cases of Autonomy	0.211 (.08)	0.639 (.27)	1.904 (.47)	-0.822 (-.36)	4.782 (1.72)*
First difference of lagged stock of FDI per capita	0.284 (4.17)***	0.281 (4.23)***		0.303 (4.54)***	0.221 (2.86)**
Infrastructure in province's first year	1.498 (.63)	1.125 (.36)	-2.316 (-0.41)	2.783 (.90)	-3.603 (-.93)
Distance from metropolis	-0.001 (.71)	0.001 (.22)	-0.003 (-0.54)	0.000 (.09)	0.002 (.50)
First difference of agricultural share of provincial output	-3.206 (.39)	-3.569 (.99)	-7.528 (-1.27)	-3.355 (-.92)	-4.118 (-.98)
First difference in SOE share of industrial output	0.030 (.84)	0.056 (.40)	-0.142 (-0.56)	0.006 (.04)	0.198 (1.17)
First difference of % of secondary school graduates	-0.121 (.11)	-0.111 (-1.52)	-0.081 (-1.11)	-0.123 (-1.68)*	-0.077 (-0.88)
Southern Dummy	0.463 (.73)	-0.106 (-.08)	1.594 (.85)	0.051 (.97)	-0.536 (-.36)
City Dummy	-7.165 (.08)*	-7.528 (-1.89)*	6.792 (1.19)	-8.265 (-2.06)**	-5.334 (-1.17)
Mean autonomy of region		0.893 (1.31)	0.301 (.25)	1.107 (1.62)*	0.269 (.32)
Constant	2.504 (.11)	1.48 (.93)	1.955 (.83)	1.546 (.96)	1.295 (.67)
N	212	212	273	212	212
R <sup>2</sup>	.15	.12	.05	.12	.18
F Test	4.04***	3.95***	2.72***	3.96***	4.51***

**Equation 2 Dichotomous Measure of Autonomy -- Coefficient and z-scores in parentheses**

<i>Independent Variables</i>	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>	<i>Model 5</i>
Imputed Stock of FDI per capita	0.058 (1.80)*	0.059 (1.97)**	-0.033 (-.81)	0.064 (2.16)**	0.110 (1.70)*
First difference in SOE share of industrial output	-0.034 (-1.49)	-0.033 (-1.53)	-0.053 (-3.43)***	-0.034 (-1.62)*	-0.037 (-1.49)
First difference of % of secondary school graduates	-0.002 (-.12)	-0.001 (-.05)	-0.005 (-.73)	-0.001 (-.05)	-0.001 (-.07)
Southern Dummy	0.243 (1.09)	0.227 (1.06)	0.066 (.58)	0.090 (.40)	0.151(-.55)
No. of Provincial compatriots in cabinet	0.093 (1.01)	0.091 (1.03)	0.014 (.29)	0.110 (1.30)	0.074 (.71)
Provincial party control	0.066 (.35)	0.086 (.47)	0.167 (1.60)*	0.096 (.56)	0.133 (.62)
Percentage of FDI projects in manufacturing	0.004 (1.60)*	0.004 (1.62)*	0.004 (2.84)***	0.003 (1.28)	0.003 (1.02)
Percentage of FDI projects in natural resource exploitation	-0.010 (-1.54)	-0.010 (-1.61)*	-0.013 (-2.58)***	-0.008 (-1.34)	-0.009 (-1.19)
City Dummy	1.123 (1.97)**	1.083 (1.98)**	1.228 (2.79)***	0.915 (1.75)*	1.062 (1.58)*
Mean autonomy of region		0.062 (.64)	0.213 (3.59)***	0.067 (.73)	0.050 (.42)
Exports as a percentage of GDP				0.010 (1.52)	0.006 (.82)
Interaction of Exports and FDI as a percentage of GDP					-0.003 (-1.44)
Constant	-0.924 (-3.34)***	-0.987 (-3.57)***	-0.954 (-6.43)***	-1.962 (-3.95)***	-1.064 (-3.20)
N	212	212.00	273.00	212.00	212.00
Pseudo R <sup>2</sup>	.13	0.14	0.13	0.14	0.14
Chi squared	37.46***	39.23***	46.62***	39.95***	40.85***

\* Significant at the .1 level, \*\* Significant at the .05 level; \*\*\*Significant at the .01 level.

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