

ABSTRACT

Title of Dissertation: FOREIGN DIRECT INVESTMENT IN
AUTHORITARIAN STATES

Chase Coleman Englund
Doctor of Philosophy, 2023

Dissertation directed by: Professor Todd L. Allee
Department of Government and Politics

In this dissertation, I examine autocracies and demonstrate why some autocratic regimes attract considerable investment whereas others do not. I advance two primary claims. The first is that autocratic regimes in which there is political competition actually receive less FDI than those in which there is less competition. Autocratic states tend to have weak institutional protections for investors, which causes greater uncertainty for businesses that fear costly policy changes. Therefore, when political competition in autocracies is greater, investors become more cautious and FDI inflows decline. The second claim is that FDI is more targeted to certain sectors in autocratic states with less political competition. This is because autocratic leaders seek to use FDI as a private good to favor members of their winning coalition. Therefore, autocrats with smaller coalitions (i.e., less political competition) will use policy to steer the benefits of FDI more narrowly. This is important because the use of FDI as a private good in this way tends to entrench authoritarianism. In analyzing both claims, I also examine the relative number of economic elites in a state, which I argue is an important and fundamental indicator of competition over policy (alongside the political measures), because it determines the size of an autocrat's winning coalition.

I find strong support for both of these hypotheses, using a wide range of novel data that I have compiled from several unique sources and various private organizations. I examine the volume

and sectoral concentration of FDI in thousands of cases involving more than 100 non-democratic states over a 42-year period, beginning in 1980. In order to measure foreign investors' perceptions of the policy environment in nondemocratic states, I also utilize data from an automated textual analysis of quarterly earnings calls of publicly traded firms located in authoritarian settings. Even after controlling for other factors, I first find that greater political competition is associated with greater perception of risk by foreign investors and lower FDI inflows. To measure the number of economic elites relative to economic activity, I employ a novel measure of stock market concentration that estimates the degree to which a market is either oligarchic or diversified.

These results are important and timely because many of the largest recipients of FDI globally are now autocratic states. This means that large segments of the global population will depend on authoritarian governance to attract FDI, which is widely considered important to global economic development. Furthermore, understanding whether or not we can expect FDI to have a democratizing impact on autocratic government is crucial to developing expectations about how FDI will shape global politics in the decades to come.

FOREIGN DIRECT INVESTMENT IN AUTHORITARIAN STATES

By

Chase Coleman Englund

Dissertation submitted to the Faculty of the Graduate School of the
University of Maryland, College Park in partial fulfillment
of the requirements for the degree of
Doctor of Philosophy
2023

Advisory Committee:

Professor Todd Allee, Chair
Professor Virginia Haufler
Professor Scott Kastner
Professor Margaret Pearson
Professor Ethan Kaplan, Dean's Representative

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Acknowledgements

To Todd, for your consistent and patient feedback over many months, helping me to carefully communicate ideas and think more clearly. The value of this extends far beyond this work. It goes without saying that without your help this project would not exist, and I am in your debt. To Virginia, and Margaret, and Scott, I cannot thank you enough for your thoughtful feedback, patience, and encouragement in developing this project. To Ethan Kaplan, and to my colleagues at the Federal Reserve, including Nathan Converse and Cindy Vojtech, thank you for your acceptance, your feedback, and your encouragement of my work amidst many other priorities. It is my daily privilege to participate in the work being done at the University of Maryland and at the Federal Reserve in service to the advancement of political and economic science.

To my mother, my thanks for a lifetime of encouragement of my interest in academic science through all manner of books, chemistry sets, documentaries, and summer camps. From you I learned that to follow God is to follow truth, and to have the courage to speak it. To my father, for providing me with the priceless gift of a liberal education, and with it the ideal of independent thought, even at great financial cost to yourself.

To the Soldiers I served with, yours is the truest measure of humility and devotion to a nation which knows little of your sacrifices. While they may be ill understood, they are not made in vain. I count myself the least among you, and if our republic has any virtue, surely it must be found in you. Whatever ends my education serves, may they be served with you in mind.

“To receive wisdom is better than gold, to receive knowledge is more valuable than silver.”

Proverbs 16:16

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1 – Introduction to FDI in Authoritarian States

States, through the actions of their political leaders, set policies that impact investment. Whether it is the level of taxation, the availability of credit, the approval of mergers or joint partnerships, or some other means, states have a variety of ways to increase or decrease the attractiveness of foreign investment. The aim of this dissertation, at some fundamental level, is to demonstrate that the policies toward investment that states implement matter in determining how those states fare in attracting investment inflows, and to explore the reasons why some states end up implementing "better" policies than others in this regard. While foreign direct investment is still only one part (albeit an important one) of the overall picture of global economic activity and development, it serves as a particularly helpful vehicle through which to explore political incentives that are more widely applicable to other types of economic policy behavior.

This research comes at a time when many of the conventional assumptions around this topic are becoming subject to increased scrutiny. Some argue that policy choices do not matter much to investment or development, and that states are merely victims (or benefactors) of their exogenous circumstances such as economic endowments, colonial history, or some other factor (see for recent example Korsah, Amanamah, & Gyimah 2022). Others concede that policy indeed matters, but claim that democratic or politically competitive states are unsuited to navigate the complexities of 21st century markets, and that state-directed models are the future in an era of waning democracy (Park 2004). Given the fact that most of the world's population lives in a non-democratic state, this is an urgent question. By focusing on authoritarian states, we can unpack and examine concepts that are at the root of this debate over the relationship between policies, political competition, authoritarianism, and economic development, in this case through the lens of FDI.

The premise of the theory that I develop and test in the following chapters is that variation in outcomes among authoritarian states in attracting FDI is closely related to the degree to which there is consensus and ultimately consistency in policymaking among elites in these states. I argue that in authoritarian states, this consistency depends to a large degree on limiting the presence of political competition. However, I also explore what I demonstrate to be a more fundamental cause of policy change, which is the presence of dissatisfied economic elites. The relative consolidation of economic influence in a state has huge ramifications for the functioning of that state's politics and the resulting policy decisions. As I will demonstrate, the findings have implications that carry beyond FDI (to other types of investment, development, and economic performance) and outside of only authoritarian states (to democratizing and democratic states).

This introductory chapter will address each of these themes in turn, and provide a summary of the theory of foreign direct investment under authoritarian states which I use to explore the themes more thoroughly.

1.1 – Why study FDI under authoritarianism?

The first motivating fact for this work is that FDI inflows matter, because they are an important source of economic development and growth (see Wang 2009, Chang & Lee 2009, Narula & Driffield 2012). While there is debate around the pathways through which this process occurs, the stylized fact that *FDI is a potential cause of economic growth* is more or less established. This being the case, understanding variation in FDI is important to understanding variation in economic growth.

The second motivating assumption on which this work rests is that *policies towards FDI matter*, because they significantly impact how much and what type of FDI a state receives. While not all would concede this claim, I will demonstrate that policy choices are indeed meaningful,

and just as meaningful as many economic factors. A number of scholars have similarly argued that policy choices are indeed important to attracting FDI (see Ali, Fiess, & MacDonald 2010).

The third and final motivating condition for this research is that authoritarianism is both prevalent and on the rise, not to mention the historical norm for most of human history.

According to the Freedom House Index, roughly 70% of the global population lives under authoritarian or non-democratic governance (Freedom House 2022). Conventional arguments have maintained that democratization (or at least liberalization) would occur as either a prerequisite to or a cause of the economic growth and development that FDI brings.

Unfortunately, these arguments appear to have been wrong, or at least partially wrong. Many of today's largest FDI recipients are already deeply authoritarian or in many cases becoming more so.

The success of states like China and Vietnam in attracting FDI have made it increasingly clear that authoritarian states can in fact be attractive destinations for such investment, and much of global foreign investment now occurs in authoritarian contexts. However, it is also clear that authoritarian states are often economically backwards or outright hostile towards foreign investors, and perform very poorly in attracting FDI. This variation between such states in FDI, both in inflow levels and in type, is arguably greater than it is for their democratic peers.

Combining these assumptions, one is left with the conclusion that FDI matters, policymaking matters to FDI, and most of the world relies on some form of non-democratic government to make those policies. It is also clear that liberalization and democratization cannot be taken for granted. Interestingly, authoritarian states also exhibit huge variation in patterns of FDI. Therefore, understanding how and why authoritarian states vary with regard to FDI, and

how this interacts with political competition, is critically important to understanding global development and growth, as well as the future of global democracy.

However, despite all of these facts, the majority of past literature on the political economy of foreign investment has been content to emphasize the advantages that democratic regimes have in attracting foreign investment (i.e., Jensen 2003). Despite some important exceptions that I will examine, the study of this subject has rarely focused on authoritarian states independently. As a result, we have a limited understanding of how investors see authoritarian states as destinations for possible investment, and why investment outcomes vary considerably between different authoritarian states. Improving our understanding of this subject is critically important not just to the economic prospects of billions of people, but also to the future of democratic governance at a time when these values appear to be in retreat in many parts of the world.

1.2 – A Brief Summary of My Theoretical Approach

All of this leads us to an important and understudied question: How do foreign direct investment inflows vary between authoritarian states due to political causes?

Autocratic leaders do not want or value all FDI equally. Far from being free to choose the FDI policies that encourage the most growth or even the most stability, I argue that non-democratic political leaders are constrained in their choices by their need to limit political competition and reward allies. In the era of globalized markets beginning in earnest after 1980, FDI has come to represent an important and indeed critical source of capital that autocrats wield as a private good in order to retain and strengthen their hold on power. I conceive of a framework under which patterns of FDI are determined by the degree to which foreign investors feel confident about investing in a particular market. This confidence stems from information the

investors receive about risk, which indicates how profitable a particular market is likely to be. When the range of possible outcomes has greater downside, the mean expected return for an investor is lower. The signals that help investors form the range of their expectations are dictated in large part by policy decisions. The term “policy” can encompass a broad range of politically determined rules or decisions, such as partnership or merger approvals, nationalizations, contract awards, grants, or levels of taxation. In authoritarian states, political incumbents and political opposition are the direct, formal determinants of policy rulings. However, these rulings are also strongly influenced by interested parties that have the means to indirectly influence outcomes, namely significant stakeholders which I refer to as “economic elites”.

I explore two important aspects of FDI that vary across states, as well as within them over time. The first is FDI inflows, which is the amount of incoming FDI a state receives. The second is the degree to which those inflows are broad or more narrowly directed. I refer to this measure of concentration as “FDI targeting”. Variation in both of these variables is caused by the degree to which authoritarian leaders are compelled to make changes to policies governing FDI. These variables serve as the primary dependent variables of study.

I argue that the volume of FDI inflows is determined primarily by *policy uncertainty*. Policy uncertainty refers to the degree to which policies governing FDI are stable enough that investors and potential investors can reasonably predict what the policy environment will look like in the near- and medium-term future. As stated above, the term “policies” can encompass a broad range of government actions that make the country in question more or less desirable to foreign investors. Because authoritarian states lack the legal guardrails and property protections of institutional democracies, the potential impacts to business as the result of policy changes are quite large. The level of policy uncertainty is therefore quite important to investors attempting to

estimate returns in authoritarian states, and becomes a determinant of equilibrium investment. When policy is less predictable, FDI inflows decline.

Second, I examine FDI targeting - the degree to which FDI is concentrated in particular areas of activity - and argue that its primary cause is found in *policy favoritism*. Policy favoritism refers to the degree to which policies governing FDI are designed to favor one type of investment over another in order to benefit the incumbent regime. For example, allowing permits for manufacturing-related FDI but withholding permits for financial services FDI would be considered policy favoritism. Again, the relatively greater ability of authoritarian states to choose economic winners and losers makes the favorability of policy quite important to foreign investors' success, as unfavorable policies can severely harm business prospects in authoritarian states where legal protections are limited. The result of higher levels of policy favoritism is more targeted FDI inflows. The degree to which FDI inflows are concentrated ("targeted") also has important implications for economic development and how the benefits of such development are distributed. As I will demonstrate, FDI inflow concentration tends to follow specific, measurable patterns in autocratic regimes, because certain types of FDI are more easily used to provide private benefits to supporters.

Thus far, I have laid out two dependent variables of interest: FDI inflows (a function of policy uncertainty) and FDI targeting (a function of policy favoritism). I explore these variables by examining the role of two primary independent variables in regulating their outcomes, which are *political competition* and *the number of economic elites*. Both of these independent variables provide an indication of how likely changes or inconsistencies in policy will be. I argue that policy uncertainty decreases with less political competition, and with fewer competing economic elites. This results in greater FDI inflows. Second, I argue that policy favoritism is less effective

at steering investment inflows when political competition is present, or when there are more economic elites with competing interests. As a result, FDI becomes less concentrated (“targeted”) to specific favored interests under these conditions. These two independent variables, which are political competition and the number of economic elites, are described in more detail below.

The first primary independent variable I explore is the degree of political competition. Significant political competition indicates a greater likelihood that political opposition, inherently not part of the winning coalition, will be able to secure policy concessions to increase their share (or their benefactors’ share) of private benefits. These policy changes can and often do relate to the way FDI is regulated (and thus which parties benefit). Thus, the presence of *political competition increases policy uncertainty*, and is therefore associated with lower FDI inflows. The presence of political competition also reduces the degree to which autocrats are able to successfully (and consistently) favor specific types of FDI, and so therefore is also associated with less-targeted FDI inflows. In other words, it is more difficult to attract FDI by using tools such as approvals, grants, incentives, etc., when these measures are being directly opposed by a viable political opposition. This fact reduces FDI inflows and reduces the degree to which they can be targeted exclusively towards allies of the regime. In this way, *political competition decreases policy favoritism*.

The other independent variable I examine is the number of dissatisfied economic elites. Economic elites are the owners or beneficiaries of large economic enterprises. In authoritarian states, economic elites, like all actors whose complicity is required to maintain power, receive private benefits from political leaders. In this case, these private benefits relate to the policies regulating FDI mentioned above. When the number of economic elites increases, these private

benefits become diluted or certain elites are left out. This leads to dissatisfaction and the dissatisfied economic elites in turn use their influence to compel policy changes, either by co-opting existing political incumbents or supporting political opposition. By contrast, when states have few economic elites, dissatisfaction is less likely and there is less pressure towards policy change. As a result, *a greater number of economic elites increases policy uncertainty*. In a manner similar to having less political competition, the presence of fewer economic elites makes it more politically viable to consistently adopt special policy measures aimed at rewarding economic elites who support the regime. This has the effect of both increasing overall FDI inflows and resulting in FDI inflows that are more targeted towards benefiting these elites. Therefore, *a greater number of economic elites decreases policy favoritism*.

This variable, the number of economic elites, represents a novel way to differentiate between regimes outside of traditional measures of political competition. The measures I use to estimate this variable provide a supplement to traditional political measures, which often miss important differences between regimes that display similar characteristics on the surface, making variation in FDI outcomes harder to understand. This technique ultimately proves fruitful in predicting variation between regimes that otherwise look politically similar. This approach is particularly novel and forms one of the key takeaways of this work.

In sum, through the course of this work, I demonstrate clearly that political competition is negatively associated with FDI inflows but also predictive of less-targeted FDI. I also use novel measures to demonstrate that the number of economic elites is also negatively associated with FDI inflows and predictive of less-targeted FDI. Importantly, I test the interaction between these variables, and find that they are mutually reinforcing. In particular, the impact of political competition depends heavily on the concurrent presence of dissatisfied economic elites. In turn,

dissatisfied economic elites are more disruptive to the policy status quo when they are able to act through an existing political opposition to channel their demands for policy change.

This study also examines the concepts of policy uncertainty and policy favoritism directly, a test of the theoretical mechanism that is made possible through the use of textual analysis data that examines foreign investor sentiment. I find that the linkages between political competition, economic elites, and FDI variation clearly occur through political processes.

1.3 – Two Brief Illustrative Examples

The term "policy" is somewhat ambiguous by necessity in order to be generally applicable across states. However, a brief vignette helps to provide a more concrete picture of what is meant by the term "policy" and the theoretical concepts I describe above. For this example, I turn to Turkey. Turkey is generally considered to be a competitive authoritarian state. The incumbent party, known as the Justice and Development Party (AKP), controls most of the political life in the country, and decides most economic policy. However, they face some opposition from parties such as the Republican People's Party (CHP). Occasionally, these opposition parties are able to extract concessions from the regime. One such example occurred in 2019, when the Republican People's Party secured a majority in several large cities during regional elections. As a result, several cities newly under control of the opposition cancelled municipal development contracts with ties to the AKP, and invited other firms to bid the contracts. The AKP tried to annul these actions by stripping executive powers from the involved mayors. These actions resulted in uncertainty for municipal bondholders as well as companies with potential ties to these contracts. The result was that many of these investors withdrew their bids and municipal bond prices declined. This provides one example of how political competition reduces FDI.

Turkey is economically diversified, with significant manufacturing interests as well as a large financial services sector. A number of large financial services firms have supported the CHP due to dissatisfaction with AKP economic policies which have resulted in a devaluation of the currency. These currency devaluations have harmed financial firms in Turkey and alarmed international investors. By contrast, many large manufacturers have supported the AKP, seeing a weakened currency as a way to boost exports. This provides one example of how diverse economic interests among economic elites often translate to competing policy preferences among elites. Competition among these dissatisfied economic elites creates policy uncertainty. When policy is uncertain, investors are often wary of entering a market. AKP policies tend to favor manufacturers, but competition over policy makes this favoritism inconsistent.

By contrast, Vietnam is a consolidated authoritarian state. Political competition is nonexistent. Almost all economic activity is controlled by the Communist Party, and private economic activity is also consolidated under a few large conglomerates with single majority owners with ties to the regime. Vietnam has been remarkably consistent in promoting FDI into its manufacturing sector. Despite few credible property rights protections and low political freedom, investors have been comfortable with these consistent policies, and as a result Vietnam has experienced massive foreign investment inflows. However, these flows have gone almost exclusively to certain sectors and firms promoted by the state.

In Turkey, the AKP party would prefer if it did not have to deal with CHP opposition. Insofar as they can favor elites which support the AKP, and harm elites who support the CHP, they will do so, even if the net economic result to investment is negative. Ideally, the AKP would like to emulate the Vietnamese Communist Party, in which a few allied economic elites support the party, and in turn receive consistently favorable policies. When it does occur, this

consistency tends to increase investment interest. In Vietnam, the Communist Party is supportive of investment, but only because such investment serves the interests of incumbent elites.

Vietnam has done relatively little to encourage investment into non-state-owned enterprises or sectors in which investment would not serve incumbent elite interests.

These examples highlight the primary dynamics I intend to study. In Turkey, political competition and competing economic elites who are often dissatisfied with policy results in an investment environment fraught with risk. By contrast, in Vietnam, political consolidation and a limited number of economic elites results in policy that is quite reliable despite limited legal protections, encouraging investment. In both states, leaders favor certain investments over alternatives that empower rivals or do not benefit allies. Through this dissertation, I will explore a number of examples such as these in greater detail.

1.4 – Implications

The theory and findings presented here have several important implications. The first and most obvious implication is that politically liberalizing states (referred to synonymously as anocracies or competitive authoritarian states) face a high risk of experiencing policy instability¹ that gravely harms economic growth and development and as a result often threatens to derail further liberalization. While Turkey appears at risk of this outcome, similar trends have played out in a number of states (for example, Argentina or Venezuela). While other similar states may not experience this sort of acute economic crises, economic underperformance due to

¹ While the scope of discussion here is constrained to *nonviolent* policy instability, there is well-known evidence regarding more severe conflict-related instability in anocratic (i.e., nondemocratic but politically competitive) settings (see Bremmer 2006).

unpredictable politics remains a risk that threatens to validate the curtailment of political and legal freedoms.

The second primary implication of this research relates to economic elites. Firstly, economic diversification in authoritarian states that results in an increase in the relative number of economic elites carries with it the same destabilizing threat as political competition. This is a problem for developing states and (similarly to measures to control political competition) likely encourages non-democratic states to pursue concentrated growth strategies that are less widely beneficial but politically safer. In short, having fewer economic elites erodes political competition, but in authoritarian settings also results in more consistent policy and higher FDI inflows.

While the focus of this work is on impacts to investment, this finding about economic elites also implies that the concentration of economic elites is dangerous to democracy and democratization (including for *democratic* states). When there are fewer economic elites that hold the preponderance of economic influence in a state, political leaders will be more inclined (and in fact obligated) to use private benefits to secure power. This is because when the size of the coalition necessary to hold power becomes smaller, the mean value of private benefits to each member increases. Put more simply, significant declines in the number of economic elites relative to economic activity threatens to erode institutional commitment to public goods like impartial legal protections or ready access to credit in favor of competition over private goods. Therefore, democracies with few economic elites are more likely to backslide into competitive authoritarianism. As I demonstrate, the competition over private goods that occurs in these states is economically disastrous due to the policy unpredictability it creates. This is observed clearly through examining its impact on FDI. This indicates that the current environment of democratic

erosion is likely to have significant consequences to global investment and growth. Therefore, while democratic states are not the focus of this work, the findings have important implications for how we might think about the consequences of democratic erosion.

Lastly, this research demonstrates the limitations to exclusively using measures of formal political institutions to predict policy outcomes. I present a measure for the number of economic elites that proves more effective in predicting policy outcomes than traditional political measures. While economic elites are not the only elites that matter (namely, military elites seem equally relevant in many cases), it is clear that utilizing these alternative measures is important to understanding variation that occurs in seemingly politically similar states. This is not only relevant to authoritarian states, but also applicable to democratic states, especially in the current environment where insight into the causes of democratic erosion is an increasingly imperative research agenda.

1.5 – Chapter Outline

Over the following chapters, I will establish the theoretical approach to my examination of foreign direct investment in authoritarian states, which blends the existing IPE literature on investor uncertainty with a comparative politics approach based on selectorate theory. Following this, I formally test the propositions in the theory through the use of three primary hypotheses. I examine these using a mixed-methods combination of large-n empirical analysis and qualitative case studies.

Chapter 2 examines the existing literature on the political economy of foreign direct investment. I first explore existing research on the interrelationship between regime type and FDI, and establish the central theoretical concepts I plan to study, which are policy uncertainty and FDI inflows, as well as the degree to which FDI inflows are concentrated (“targeted”) and

policy favoritism. This chapter also draws on comparative literature to establish the central independent variables, which are domestic actors that impact policy outcomes in non-democratic states. These are the political opposition and dissatisfied economic elites.

Chapter 3 uses this literature to establish a general theoretical approach that informs the analysis of FDI throughout the rest of the dissertation. I argue that the authoritarian states with more political competition or a greater number of economic elites exhibit more policy uncertainty, and as a result attract less FDI inflows. I also propose that authoritarian states with less political competition or fewer economic elites are more successful at designing policies to favor FDI inflows to certain sectors, and as a result such states exhibit less diversified, more “targeted” FDI inflows. I generate three primary testable hypotheses based on these propositions.

Following from this, Chapter 4 begins the empirical analysis by examining the relationship between political competition and the level of FDI inflows in authoritarian states. The tested hypothesis proposes that increased levels of political competition will be associated with lower FDI inflows in autocratic settings, because it creates greater uncertainty for investors over policy outcomes related to investment. In the weak institutional setting of an authoritarian state, policy shifts can have large impacts to business prospects, and thus political competition is damaging to business. The empirical analysis illustrates that the level of political competition as measured by commonly used measures of political regime type are negatively associated with FDI inflows in non-democratic states. This chapter also explores a key case study relating to FDI in Venezuela.

Chapter 5 explores the relationship between the number of economic elites and the level of FDI inflows in authoritarian states. The tested hypotheses rely upon the proposition that a greater number of economic elites in a non-democratic state will result in more competition over

policies governing investment. This is because non-democratic leaders rely on private benefits to secure support and retain power. When there are more economic elites required to retain power securely, the share of private benefits per elite is reduced. This leads to dissatisfaction and greater competition over policy between elites seeking greater private benefits. The result of this competition is greater policy uncertainty for investors, which reduces the net level of FDI inflows. In line with the central claim, the relative number of economic elites is shown to be negatively associated with several measures of FDI inflows in non-democratic states. Notably, this chapter also establishes the relative number of economic elites, and the measure used to estimate it (the share of equity market capitalization held by top firms, a proxy measure of how many large firms are in a state) as a measure which is equally suitable to many political variables at predicting FDI inflows. Lastly, this chapter explores a key case study of FDI in Kazakhstan.

Chapter 5 also examines an interactive effect between the number of economic elites and the level of political competition. Political competition is proposed to increase the marginal effect of having relatively more economic elites, because it provides economic elites with a channel through which to easily seek policy concessions. Likewise, when there are more dissatisfied economic elites to serve as patrons, political opposition is more likely to survive and have the ability to wield influence. The analysis of the data demonstrates that these two variables, political competition and the relative number of economic elites, reinforce one another, interacting to create a larger marginal effect on the level of FDI inflows in authoritarian states.

Chapter 6 serves as a mechanism test for Chapters 4 and 5. The chapter employs textual analysis data gauging the political risk sentiment of foreign investors on quarterly earnings calls. This data is used to test the mechanism of policy uncertainty by using more negative political

risk sentiment as a proxy for more policy uncertainty. The first portion of the chapter examines the difference in sentiment relating to politics between firms located in states with relatively more political competition compared to states with less. This creates a test of the policy uncertainty mechanism by which greater political competition reduces foreign direct investment inflows (tested in Chapter 4). Foreign firms located in politically competitive authoritarian states are found to express higher risk sentiment surrounding politics. By conducting a similar test comparing the difference between states with relatively more or less economic elites, the chapter also provides a test of the policy uncertainty mechanism linking the level of FDI inflows with the measures for the number of economic elites tested in Chapter 5. Firms located in states with relatively more economic elites are found to express higher risk sentiment surrounding politics. Lastly, Chapter 6 also uses a two-stage regression to examine the impact of policy uncertainty on FDI inflows, and establishes a test of the full casual chain.

Chapter 7 examines the linkage between the independent variables tested in the prior chapters (the level of political competition and the relative number of economic elites) with a new dependent variable, which is the degree to which foreign direct investment inflows are targeted to specific sectors of the economy. It examines the hypothesis that firms associated with the secondary sector seeking to pursue FDI in autocratic states would tend on average to be favored over firms seeking to pursue FDI in the tertiary sector in the same states, resulting in FDI inflows being more targeted to the secondary sector. This is because secondary sector investment is easier to control and use as a private benefit compared with tertiary sector investment, which also carries more political risks. However, in autocratic states where policy competition is high, such as when political competition is higher or where there are relatively more economic elites, such policy favoritism is harder to implement and FDI inflows will be less targeted as a result.

Following from this, having more political competition or a greater number of economic elites is shown to reduce the degree to which FDI inflows are targeted in non-democratic states.

Chapter 8 forms the conclusion of the preceding work. There I focus on summarizing key theoretical and analytical contributions, as well as discussing the implications of the findings. Among these are the use of novel measures to capture the number of economic elites in a state, as well as the finding that politically competitive (“anocratic”) states are most at risk for adverse economic outcomes.

2 – Theoretical Foundations for Understanding Autocratic FDI

By turning to the literature that has attempted to uncover the political causes of foreign investment, we can begin to construct some theoretical intuitions as well as highlight the existing gaps. The existing literature provides a foundation for the theoretical approach I will develop in the following section in two key ways. First, it provides an understanding of the political conditions under which investment is most likely. Second, it establishes a framework for understanding when these political conditions are most likely to prevail, and towards which entities favorable policies are likely to be directed.

2.1 – Regime Type and FDI

Most previous studies have examined FDI variation through the lens of whether and how democratic states attract more FDI than their authoritarian counterparts. Jensen (2008) argues that legal constraints often present in democratic states serve to reduce “political risk” by creating a “status quo bias”, whereby the executive is unable to enact sweeping policy changes. This provides investing firms with an assurance that policy changes are less likely to cause a severe disruption to their business. This is supported by previous work such as Tsebelis (1995, 2012) who argues similarly that a greater number of veto players acts as a constraint to sweeping policy changes that would otherwise harm investment confidence.

Other common explanations for the democratic advantage also relate to this concept of more predictable policy outcomes. One argument centers around transparency, which argues that democratic regimes are more politically transparent, allowing investors to observe the legislative process and thus anticipate changes in policy (Rosendorff and Vreeland 2006). Democratic transparency also provides firms the ability to lobby in advance of negative changes (Jensen

2006, Jensen 2008). Another argument focuses on how leader reputation costs enforce certainty in democratic regimes (Hershman 2005).

In sum, arguments that democracy is associated with greater FDI inflows are widespread in the literature. Among the variety of explanations, the point most germane to our discussion here centers around policy uncertainty. While the above work focuses mostly on examining the association between democracy and investment, the negative relationship between investment and policy uncertainty itself has also been studied directly in its own right, and is also quite well-established. For example, Julio and Yook (2016) examine the effects of political uncertainty on cross-border capital flows using election timing as a source of fluctuations in “political uncertainty”. They find that FDI flows from US companies to foreign affiliates drop significantly during the period just before an election, consistent with the view that political uncertainty deters foreign investment. A number of similar studies have also produced results that support this view about uncertainty deterring investment. For example, both White & Fan (2006) and Khan & Akbar (2013) associate various political risk indicators with lower FDI across regime types. Leblang & Satyanath (2006) and Busse & Hefeker (2007) look for institutional causes of political uncertainty and also associate it with lower investment or FDI. Zheng (2011) draws similar conclusions by looking at policy uncertainty and FDI specifically within China. Authors such as Canh et al (2020) examine uncertainty specifically over economic policy and again find it associated with lower investment.

Despite all this, it is clear that a number of autocratic states have been successful at attracting investment. In a 2003 study, Li and Resnick provide a more nuanced account in which foreign investment is driven by a number of political factors that may be more easily produced by democratic states, such as strong property rights protections and reduced political risk.

However, other factors are more easily generated by authoritarian governments in their accounting, such as the ability to target investment with financial and fiscal incentives. This study is important due to its nuanced approach, explaining how increased political competition can reduce certainty and the ability of the state to offer incentives.

Others have focused on authoritarian states specifically, with some maintaining that autocratic states are in fact, on average, more attractive than democracies as investment destinations. This has been explained by some as a product of economic circumstance (i.e., O'Neal 1994). In contrast, others (O'Donnell 1988, Olson 1993, Bornschier and Chase-Dunn 1985, Becker 1983) point to features of authoritarian governance itself, such as the ability to suppress popular demand for wage increases or higher corporate taxation. Roberts (2006) argues that authoritarian states are most successful at attracting foreign inflows when they provide predictable policies and certain public goods conducive to private investment, and further argues that these guarantees may be more important than democratic institutions. Li and Resnick (2003) speak to this argument as well, pointing to the ability of the authoritarian state to more easily offer conducive goods in the form of "financial and fiscal incentives". They argue that democratic institutions often limit the degree to which these "sweeteners" can be offered, giving autocrats an advantage.

Others have focused more on policy predictability itself, arguing that authoritarian states often have more stable policy environments. Rodrik (1991) centers his argument around policy uncertainty. When autocratic regimes can reduce policy uncertainty to a degree greater than comparable democracies, they will fare better in the market for FDI. Zheng (2013) also argues that democracy is not a prerequisite to strong investment performance. He examined several instances of "special economic zones" in states such as Taiwan, India and China, and found that

when autocratic states can use “flexible governance” to offer credible protections to investors (i.e., greater policy certainty), they are likely to exhibit stronger performance than democratic states that do not offer such guarantees. Wu (2012) also echoes these sentiments about autocratic markets outperforming democratic ones under certain conditions that limit investor uncertainty.

Another important element of measuring FDI inflows is the degree to which they are targeted to particular sectors of the economy. The sectors towards which FDI inflows are allocated has important ramifications for growth and development. While the specific growth impacts vary widely with context, scholars have generally argued that the sectoral diversity of FDI inflows are positively related to growth, particularly diversity in the secondary sector (see Aykut & Sayek 2007, Chakraborty & Nunnenkamp 2008, Mhlanga et al 2019, or Ullah et al 2022 for some examples). For these reasons, FDI inflows which are more heavily concentrated to particular economic areas can be considered suboptimal in comparison with less targeted inflows, all else equal.

The sectors towards which FDI inflows are allocated can also be expected to vary by regime type. In this area scholarship has indicated that autocratic regimes tend to attract FDI disproportionately to particular sectors (Bastiaens 2016). Others have examined examples of how autocratic states tend to use targeting strategies to attract particular types of FDI (Sachs 2007). Both of these concepts will become important to the theoretical setup that follows.

Overall, the literature on FDI seems to indicate that both democratic and autocratic regimes can be attractive (unattractive) investment destinations under the right (wrong) circumstances. However, the most important takeaways for the purpose here of examining autocratic regimes come from findings about the characteristics within these regimes that make them more or less successful. Firstly, authoritarian states that are most able to offer financial and

fiscal incentives to potential investors are most likely to experience high levels of foreign investment. Secondly, those states which are most able to control investor perceptions of risks stemming from political uncertainty (such as business unfriendly political movements or political instability in general) are also well-positioned to engender greater levels of investment. Both of these observations will also play a key role in constructing a theory of foreign investment under authoritarianism.

2.2 – Political Competition and Policy Uncertainty

Here I explore the literature on political competition and policy uncertainty, which broadly asserts that policy uncertainty comes from political opposition that can change policies.

Selectorate theory (Bueno de Mesquita 2005) argues that when authoritarian leaders exist in environments where elite influence is more widely dispersed (i.e., the “winning coalition” is larger), they will be forced to provide more public goods and face greater political competition. This type of “competitive authoritarianism” has been discussed widely in the literature as a sort of “hybrid regime” which features characteristics of both autocratic states (such as a permanent executive) and democratic states (such as a legislature and some form of elections). These regimes have become the subject of a number of in-depth studies (see Levitsky & Way 2002, Gandhi 2008, Levitsky & Way 2010, etc.).

One of the primary observations coming from the study of these regimes is that political leaders are often forced into making political concessions (these may be particular policies, or ceded political positions such as cabinet posts, regional positions, etc.) and policy positions are generally less consistent (Gandhi 2008). So, it follows from these findings that authoritarian elites in competitive regimes may end up with foreign investment policy that satisfies a greater range of elite stakeholders, but is also less consistent in nature. In other words, when the

landscape of political competition includes more diverse interests, the range of potential policy outcomes will be wider and more difficult to predict as a larger number of actors can either veto decisions or influence changes. This difference between competitive and consolidated authoritarian regimes is crucial to understanding how states shape policy and why some states are able to craft more stable and accommodative policy than others.

Research by Pepinski (2009) also supports this view. Pepinski supports these claims in a study of monetary policy during crises, arguing that regime decisions are a function of their political makeup, regardless of overall effect. His comparative work on currency crisis in Malaysia and Indonesia highlights that regimes with divided politics produce less decisive policy paths. This observation about competing coalition interests and policy uncertainty towards capital investment has also been repeated in a number of literatures (Leblang & Satyanath 2006, Saiegh 2008). Vasilyeva & Libman (2020) examine elite fragmentation between regional and national political elites, and find that “unconsolidated” political elites underperform in economic development due to resultant policy uncertainty.

A number of economic studies have examined policy uncertainty directly, and findings suggest support for the conceptualization I develop here. For example, Kenyon & Naoi (2010) examine firm-level surveys to gauge policy uncertainty, and explicitly find that anocratic regimes underperform both democracies and consolidated authoritarian states. This supports the idea that increased political competition under authoritarian settings is damaging to investor confidence.

All of this work helps form the basis of an expectation that competitive authoritarian regimes will display greater political risk due to lower policy predictability, and therefore will, all else equal, experience less investment.

2.3 – Economic Elites and Policy Uncertainty

Here I explore the literature on economic elites and policy uncertainty, which broadly asserts that policy uncertainty comes from dissatisfied economic elites who work through political actors to achieve policy changes.

Thus far, we have reviewed evidence that authoritarian states will generate the most foreign investment interest when they offered targeted benefits and consistent policies, and that politically competitive authoritarian regimes will have a more difficult time creating that environment than consolidated authoritarian regimes. However, questions remain about how economic elites factor into this story, and which economic actors are most likely to receive favorable policy treatment. Pepinsky's (2009) work on Indonesia highlights the close relationship often present between political competition and competing factions of economic elites. So, what type of economic activity and what type of economic elites are most likely to lead to this outcome of policy uncertainty? Here I turn to some comparative literature which examines the economic conditions under which authoritarian leaders make political concessions.

Several works have addressed this question. One promising source on this dynamic is provided by Ansell and Samuels (2014). In *Inequality and Democratization*, Ansell and Samuels develop a model of "elite competition", where economic elites outside the incumbent coalition are able to impose political constraints on incumbent authoritarians, representing a potential threat to regime interests. Similar work has been undertaken by Cox (2015), who underscores these points with his model of "sovereign promises" in which incumbent regimes are forced to make broad concessions in order to raise revenue when they face many economic competitors. Another recent source that employs a similar logic is found in Paniagua & Vogler (2020). In their study *Economic Elites and the Emergence of Power-Sharing Institutions*, they argue that

the “balance of power between competing economic elite factions” is what produces institutional constraints and policy concessions. Each of these approaches highlights how the emergence of economic elites outside the incumbent coalition can force political leaders to make policy concessions. I argue that the emergence of these types of economic elites is related to how widely economic interests are dispersed.

Whether described as the dispersion of economic influence, the widening of the base of power, or in some other fashion, the idea that a larger number of economic entities per capita is conducive to political competition is not necessarily a new one. Authors such as Vanhanen (2000) or Boix (2003) examine one type of economic consolidation, land ownership inequality, as a decisive factor in democratization. They argue that consolidation in the agricultural sector reduces the likelihood of political competition. They operationalize this by measuring family farm market share as a percentage of total agricultural output. Ansell & Samuels pick up on this agricultural consolidation argument as well. While much of this literature has focused on early industrialization and democratization, the concepts are applicable more widely, beyond agrarian economies. As Ansell & Samuels themselves state; “the logic of our model extends beyond early industrializers...[the model] can be applied to any economy with competing political elites - insiders and outsiders - who tend to derive their income from sectors with differential growth rates.” They specifically cite a number of authoritarian states with sectorally distinct insiders and outsiders as being potential theatres for the dynamics they describe to play out. It follows that consolidation in other sectors, such as manufacturing or resource extraction, would have the same suffocating effect on political competition that land consolidation does.

Each of these sources highlights a similar cause to the emergence of political concessions (and eventually institutional constraints), which is the dispersion of economic power to a greater

number of actors. A greater number of economic elites leads to dissatisfaction with private benefits shares. A greater number of economic elites relative to economic activity is therefore a potential source of policy uncertainty due to the tendency of economic elites not favored by the incumbent coalition to support policy change by coopting political elites. Political leaders often find the source of their power in support from economic elites, and therefore, when there are fewer economic elites and greater consensus among them on economic policy preferences, this often translates to political consensus on economic policy. Therefore, we can establish the concept economic elites as being important to FDI outcomes, and although related, distinct from the concept of political competition discussed in the prior section. This will be discussed in greater detail in the succeeding pages.

2.4 – Policy Favoritism

The previous section described that the dispersion of economic influence in authoritarian regimes typically leads to political constraints on incumbent leaders. This dynamic is tied to policy favoritism, whereby incumbent elites use policy to favor particular types of investment as a means to benefit allied parties. This section examines literature related to this concept.

Incumbent political elites set policy to preserve existing institutional arrangements which benefit them (Przeworski 2004, Acemoglu & Robinson 2006, Acemoglu & Robinson 2012). Selectorate theory posits that authoritarian leaders care chiefly about remaining in power and maximizing rents. In order to remain in power, authoritarian leaders must also prevent the emergence of new elites whose influence could destabilize the regime or cause benefits to be more widely dispersed (Bueno de Mesquita 2005). Along these lines, using a logic of political behavior rooted in selectorate theory, Bueno de Mesquita (2005) and his coauthors develop a conceptualization of political incentives whereby authoritarian political leaders remain in power

by providing private benefits to the “winning coalition”, the minimum-sized group of key supporters needed to retain power. Applying this concept to foreign investment, we should expect policy towards foreign investment to be geared towards benefiting members of the winning coalition, regardless of aggregate economic effect.

When leaders are able to “capture” (i.e., closely control and profit from) economic activity, it both bolsters their hold on power by providing revenue with which to pay key supporters and fund security measures. Another key concept of selectorate theory is that leaders who do not pursue such revenue risk being replaced by those who will (Bueno de Mesquita 2005), meaning that leaders generally cannot afford to pass up opportunities to raise revenue. However, when such revenue can be raised without needing to risk the destabilizing consequences of broad-based economic growth² (which could empower rivals), even better. This is the basic logic of autocratic economic consolidation (“rentierism”), discussed most notably by Ross (2001), but also by others (some interesting examples are found in Arezki and Bruckner 2012, Wright, Frantz, and Geddes 2013, and Caselli and Tesei 2016). Autocrats coopt economic activity to entrench the regime and reward the economic elites who facilitate this arrangement (Greene 2010). In the literature, autocracy is commonly characterized as being organized to provide private spoil to a narrow set of economic elites. For example, authors like Acemoglu and his coauthors are well-known for their conception of the “oligarchic autocracy” (see Acemoglu 2008).

² It is important to clarify what is meant here by the term “broad-based”. The term broad-based growth here refers to growth which creates a larger number of economic actors that hold meaningful economic influence in a state. This poses a political threat to autocratic leaders by potentially increasing the size of the economic coalition needed to hold power. The term does not necessarily refer to other definitions of “broad-based” growth which do not impact the distribution of economic influence, such as growth in mean incomes, productivity growth, growth in the middle class, or growth that affects multiple sectors, although these other sorts of “broad-based” growth may often coincide with the kind I examine here.

FDI can provide an important, and indeed often necessary source of capital through which these revenue channels can be developed. This is in essence the key insight of Bak and Moon (2016), discussed further below, which presents foreign investment as essentially a private good. Li (2006) has also developed interesting work in this vein in examining FDI-related tax incentives, arguing that “some autocracies may welcome foreign capital that can strengthen their own domestic interests”, providing as an example joint ventures in a ruling-elite-controlled industry. He predicts that autocracies will offer incentives when regime economic interests are aligned with foreign investment inflows. Shirk (1993) also provides an important perspective on the political economy of FDI allocation in China, arguing that FDI was used to reward political allies.

Wang (2015) also provides an analysis of FDI policy to support this view. He argues that authoritarian states provide rule of law in “partial form” to support capital inflows, but only to help develop “valuable and mobile assets”. Wu (2012) provides similar support in arguing that autocracies have superior economic performance relative to democracies, but only when narrow structural factors provide strong performance incentives to the state. He argues that in the absence of these factors, democracies are superior, because they provide broad, non-targeted legal protections that support broad-based growth.

Bak and Moon (2016) examine the incentives of authoritarian leaders to seek FDI inflows. They argue that authoritarian regimes use FDI to shore up support and strengthen regime interests. While they do not differentiate among types of FDI or among authoritarian regime type, this logic also supports an overall view of foreign investment policymaking as essentially rent seeking, and something that autocratic states can excel at. This work is distinctive

because of its view of foreign investment as a type of private good, as opposed to how it is often viewed, which is as a public good.

There is also a widespread view in the literature that FDI often supports concentration in host economies (see Dunning 1993, Caves 1996, Sun 2012). This nests well with the Acemoglu concept of oligarchic autocracy and contributes to arguments in the literature that FDI often strengthens autocrats (Escribà-Folch 2017) because autocrats use FDI to distribute private goods (Bak & Moon 2016, Escribà-Folch 2017).

Again, while much of the work discussed above is focused on domestic political institutions or other types of economic or social policy, it is clear that the findings have implications for policy towards foreign investment as well. Autocrats will pursue FDI, but in a way designed to benefit supporters and avoid empowering rivals. This inherently creates dissatisfaction among outsiders, so outside parties seeking concessions (described above as political competition and dissatisfied economic elites) will not only increase policy uncertainty, but will often attempt to gain concessions that make FDI less targeted.

In summary, to form the basis of the following theory, I rely on several propositions supported by the literature. First, autocrats can and do attract FDI. Their incentive for attracting FDI is to reward regime insiders as a means to retain their political support. Therefore, autocrats will use policy favoritism to incentivize certain types of FDI over others in a targeted fashion.

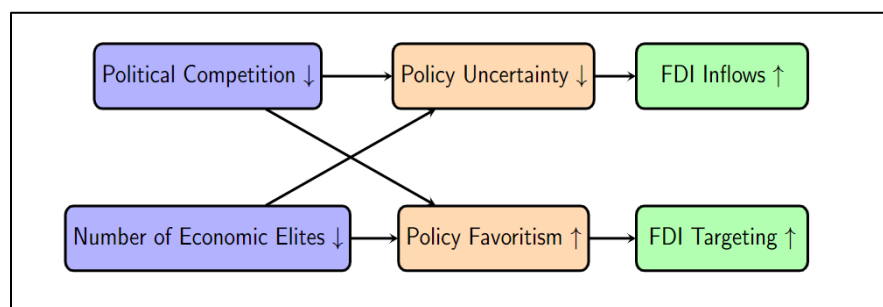
Next, investors care about policy uncertainty. Greater predictability can be provided by institutional constraints on the behavior of the state towards private enterprise (such as is the case in an institutional democracy), or, in the case of authoritarian states, it can be provided by the lack of political competition itself, where politics plays a greater role in business, but a stable,

politically consolidated incumbent regime results in higher certainty about future policy outcomes.

Policy certainty tends to come from two sources. Firstly, the absence of political competition. Perhaps more fundamentally, however, it comes from consensus among economic elites. Consensus is threatened by dissatisfied economic elites who do not benefit from the highly targeted, rent seeking status quo policies present in most authoritarian states. When these dissatisfied economic elites are present, they often influence political leaders to make policy changes. While the existing literature on the economic roots of political institutions has grown quite rich in recent years, this literature has yet to be closely linked with literature related to political incentives and the resulting economic policy outcomes. Establishing this linkage allows us to paint a more interesting picture of variation in foreign investment outcomes.

Figure 1 below provides a visual summary of the theory that will be described in detail in the following chapter, using the foundations established in this chapter. The purple blocks represent the independent variables described in 2.2 and 2.3. The green blocks represent the dependent variables of study. The orange blocks represent the transmission mechanisms, which are discussed in more detail below and finally tested in Chapters 6 and 7.

Figure 1: Visual Summary of Theoretical Approach



3 – Understanding FDI under Autocracy: Theoretical Approach

The theoretical approach espoused here seeks to explain variation in foreign investment between authoritarian regimes, both in the level of inflows and to which sectors they are targeted. I argue that policy uncertainty is a primary political driver of investment inflows in these states, and policy uncertainty stems from both the level of political competition present and number of dissatisfied economic elites. I also seek to explain the sectoral distribution of FDI as a product of policy favoritism, which is also governed by the same independent variables, the level of political competition present and number of dissatisfied economic elites.

When a firm considers investment, in addition to economic factors, it examines the political environment, particularly in authoritarian settings. When policy is predictable, investment becomes more attractive because downside risk is reduced and thus expected returns become greater. In authoritarian contexts, unpredictable policy is particularly damaging to investor confidence, because fewer legal constraints mean that arbitrary taxation, harassment, or even expropriation are more probable outcomes. However, in the same vein, autocratic states also have greater policy flexibility in providing incentives when investment is favored. Therefore, when quo status policies are stable, foreign investors may also consider investment incentives that the state has in place to encourage investment. These could include state partnerships, tax exemptions, or other incentives. The formalized statement of this theory can be found in Appendix 1.

While democracies are not the focus on this theory,³ it is worth mentioning why, in the context of policy predictability, they receive relatively high foreign investment. To reiterate the point made previously, democracies are predictable due to institutional constraints that result in less chance of significant policy changes and encourage strong property rights (Li & Resnick 2003, Jensen 2008). These property protections are typically broad and not targeted to any particular type of investment. This alternate “path to predictability” is what creates growth in investment, but is quite dissimilar from consolidated authoritarian predictability, which is political in nature (as opposed to institutional), and targeted to benefit regime insiders. The “path to predictability” in autocratic regimes is a sort of “predictable corruption” in which rule of law is weak or noncredible, but policy consistency results in foreign investors feeling confident about the policy risks to investment.

My theoretical model contains five primary actors. These are Foreign Investors, Political Incumbents, Political Opposition, Satisfied Economic Elites and Dissatisfied Economic Elites. The political actors can also be referred to as “political elites”. Among these, the two primary independent variables of study are Political Opposition and Dissatisfied Economic Elites.

Before describing these actors and their incentives, it is worth clarifying who “elites” are, both political and economic, and why they are important in the context of this theory.

Economic elites are individuals who hold an outsized proportion of influence over economic affairs in a state. In most cases, this would include owners, board members, or executives of large firms, whether they are privately held or state owned. Depending on the

³ The theoretical model developed here can plausibly be extended into a study of expected observations for FDI in democratic states. However, I will not pursue this comparison here because an adequate treatment of this would require too much additional space and the expected observations would differ significantly from what we expect to see for autocratic states. However, I touch upon the potential for future work in this area in the concluding chapter.

economy, this could also include persons who hold controlling interests in large, informal enterprises, such as land estates or illicit activities. These are special cases that I will discuss later. Economic elites are important because their access to financial resources allows them to wield significant influence over political outcomes through the sponsorship of political elites.

Political incumbents and opposition, together "political elites", are individuals in senior-level positions impacting economic policy in a state. When in power, these are senior elected or appointed officials (including legislative officials) who make, implement, or block policy governing investments. This may also include senior advisors or other influential experts. Political elites are important because they decide on which economic policies are selected, including those that govern foreign direct investment. In some cases, these two categories, economic elites and political elites, may have some overlap, particularly (but not only) in authoritarian states. For example, the owner of a large company may simultaneously serve in a senior government role.

Political Incumbents seek to maximize rents and to remain in power. Rents are maximized by attracting foreign investment for allied enterprises, either state-owned or private firms, from which they may also receive kickbacks or other indirect support. Satisfied Economic Elites seek to maximize rents. Rents are maximized by attracting foreign investment for allied enterprises, either state-owned or private firms, from which they benefit directly. Political Incumbents and Satisfied Economic Elites prevent disruption to this arrangement by preventing the emergence of new elites who might be dissatisfied with the status quo and seek policy change, an outcome that would reduce rents for both parties. In an extreme situation, the emergence of such dissatisfied elites may even result in the loss of power for Political Incumbents, which is obviously something they seek to avoid. The primary incentive with regard

to FDI for Political Incumbents and their Economic Elite patrons is to seek targeted FDI, aimed at benefiting those economic elites whose support is necessary for the regime to retain power. They achieve this targeted FDI by pursuing policy favoritism.

The Political Opposition, to the extent it exists, seeks to change existing economic policies to support allied economic interests or other interests. Dissatisfied Economic Elites seek to change existing economic policies to support their own economic interests. Both parties are motivated to maximize their rents. Rents are maximized by attracting foreign investment for allied enterprises, which then provide Political Opposition with donations or kickbacks and Dissatisfied Economic Elites with a direct financial benefit. In order to maximize rents, the Political Opposition and Dissatisfied Economic Elite will both seek changes to the policies that favor incumbents, seeking to replace them with policies that favor their own interests. When they are able to extract these concessions, it creates uncertainty on the part of investors about which policies will prevail (i.e., policy uncertainty). As a result, they invest less and FDI inflows fall.

I make the assumption that the interests of economic elites are transferred easily to political leaders, and thus political leaders are representative of their underlying patrons. Political elites (regime or opposition) set policy directly, when in power. Economic elites must act through political elites as their proxy. Satisfied Economic Elites generally support Political Incumbents. While satisfied economic elites are more or less functionally identical to incumbent political elites for the purposes of this model, *dissatisfied economic elites* face a choice. They can either choose to support the Political Opposition (if any exists), or attempt to coopt Political Incumbents, swaying them away from the status quo.⁴ In either case, the fundamental story is

⁴ Economic elites may also support opposition and incumbent parties simultaneously as a way to “hedge” against the loss of a political patron. See Heerwig & Murray 2019.

similar: The presence of dissatisfied elites makes the probability of policy changes more likely, lowering policy predictability.

Of course, political leaders can secure power by other means aside from the support of firm owners, and a single party state can still contain a more varied landscape of economic elites. This means that while political and economic competition may covary (and do in most cases), they are not necessarily identical. This will be discussed further in later chapters.

Foreign Investors seek to maximize their returns, and are risk averse. They seek stable markets where economic policies are predictable. In authoritarian contexts, there are less constraints on state interference with business. This environment of degraded property rights can create a relatively high level of downside risk for foreign investors when there is policy uncertainty. Foreign Investors respond to incentives, and will increase equilibrium investment in the face of favorable policies. Foreign investors are assumed here to have no ability to independently influence domestic leaders. While in reality these definitions may occasionally have some overlap, for simplification purposes here we consider “foreign investors” and domestic “economic elites” to be distinct entities. Foreign investors merely observe the domestic policy environment and react. When policies change frequently, or are less internally consistent within a state, future policy conditions become harder for investors to predict, a condition which we call “policy uncertainty”. When there is more policy uncertainty, investors will invest less (resulting in lower FDI inflows). Foreign Investor incentives are also impacted by policy favoritism. When there is policy favoritism, expected returns will vary at the individual foreign investor level depending on the characteristics of the foreign firm in question, meaning that some types of foreign investor will invest less, and others will invest *more*. This variation in effect depending on the type of Foreign Investor in question is what creates *targeted* FDI inflows.

The basic elements of this theory are summarized in Table 1.

Table 1: Actors and Incentives

Actor	FDI policy preference⁵	Means of influence
Political incumbent	Status quo (maintain favoritism)	Direct
Satisfied economic elite	Status quo (maintain favoritism)	Indirect
Political opposition	Change (change favoritism)	Direct
Dissatisfied economic elite	Change (change favoritism)	Indirect
Foreign investors	Consistency	None ⁶

“Policy” can cover a range of outcomes (from something as severe as expropriation to something as mundane as losing a government procurement contract). Beyond the risk of adverse government actions, policy incentives also play an important role in determining Foreign Investor interest. Authoritarian states may offer investment incentives to make up for other comparative disadvantages. Li and Resnick (2003) examine various forms of policy incentive. They include a number of examples; “tax holidays, exemptions from import duties, deductions from social security contributions, accelerated depreciation allowances, investment grants, subsidized loans, donations of land or site facilities, and wage subsidies”.

In democracies, policy is generally predictable due to constraints on the government (strong “property rights”). In consolidated autocratic regimes, policy is predictable due to consensus among incumbent elites, and will favor incumbent elite interests. In competitive autocratic regimes, policy is less predictable due to greater political uncertainty combined with

⁵ This table assumes that the status quo policies are favoring satisfied economic elites. In the case that a policy change occurs, these policy preferences are reversed.

⁶ This setup assumes that foreign investors are not able to influence policy outcomes in a foreign state. While some large foreign firms or trade organizations may in fact be able to successfully lobby foreign governments, for the purposes of this setup we can consider entities of this size to be a form of *economic elite* when acting in this capacity to influence policy. This simplifying assumption allows us to frame economic elites as being economic entities that seek to influence policy to maximize private benefits, and foreign investors as being entities which allocate investment based on expected profitability as a function of policy outcomes. While the actors themselves may occasionally play both roles, the distinction serves to clarify the theoretical setup.

weaker legal constraints. Stated another way, when considering a market, Foreign Investors assess expected returns under current regulations, and then consider the probability of those regulations changing. For consolidated regimes, existing policies toward investment will be more stable over time. Therefore, (holding economic factors constant) when returns are positive in the present, investment is more attractive in consolidated regimes, because future returns are also more certain due to stable policy (see Appendix 1 for a formalized description).

Taking these concepts together, we can describe in more detail what “policy uncertainty” may look like. Drawing from the example from Turkey discussed in the introduction, we see a number of these concepts at play. In this case, the “policy” was the assignment of contracts for a municipal project in Ankara. Where a democratic state may provide a public request for bids and choose the winner based on their bid quality (at least ostensibly), authoritarian states often assign contracts for developing infrastructure or industry in a way that is more purely political. When a foreign firm seeking to partner with the state on such an investment feels secure that once their bid is accepted, the investment will be safe, they are more likely to pursue such an opportunity. In a democratic setting, it would generally be illegal for the municipality to cancel a contract for overtly political reasons. In an authoritarian setting, these guardrails do not exist. However, if the regime is stable, this factor might not concern investors. Unfortunately, this was not the case in Turkey. The CHP (“dissatisfied elites”) were in control of assigning the contract, and the AKP (“incumbent elites”) wanted to see the project discontinued and funds allocated elsewhere. If the AKP managed to wrest control of the contract away from the CHP, the foreign firm could see their contract cancelled for any trumped-up reason (or no reason at all). If the AKP was assigning a contract, the same risk would exist for investors if the CHP gained control. In either case, beginning an expensive investment process begins to look too risky to the foreign investor.

When authoritarian leaders are both willing and able to provide a predictable investment environment, international investment will generally follow.⁷

It bears emphasizing here that FDI is conceptualized in this model as a potential, and indeed important, source of private benefit and economic competitiveness. This assumption is reflective of how FDI is viewed by the leaders of most authoritarian states today. However, FDI was not always as important to economic development strategies as it has been in the contemporary era. For example, while modern manufacturing methods often require FDI partnerships to maintain technological competitiveness through access to intellectual property, a number of pre-1980 economies pursued export-led development strategies while remaining hostile to FDI. Due to the increasing importance of FDI, most developing countries have now “liberalized” their investment policies. Here I rely on the assumption that in the contemporary period, by not pursuing FDI autocrats are forgoing an important source of capital that is necessary to develop a competitive economy. This assumption becomes particularly important when considering investment targeting as a strategy to develop competitive export industries, which is common in authoritarian states. This will be discussed in more detail later in this chapter.

It is also important to discuss here some development-related points of nuance to this theoretical setup. When a consolidated regime is dominated by non-economic elites (for

⁷ I have thus far focused my attention on FDI, excluding FPI, which can often be even more significant economically. Subject to many of the same concerns about growth potential and predictable returns, it is plausible that both forms of investment will behave in similar patterns based off these incentives. The distinction between FDI and FPI is important to the academic literature. For Foreign Investors, however, the differences are often less significant. As an example, the reasons for an investor to invest in real estate through an exchange-traded intermediary such as a REIT, as opposed to purchasing foreign real estate assets directly, will often be predicated on factors such as the sophistication of the investor and the size of the investment, as well as considerations about governance and liquidity. However, in terms of expected returns, the risk exposure should be largely similar. Despite these similarities, there is also important divergence to consider (Wellhausen 2015). I do not formally test these hypotheses for FPI.

example, military elites) or by “unconventional” economic elites, the policy choices made by political leaders are much less likely to be targeted towards supporting FDI inflows.

Unconventional economic elites are economic elites whose economic enterprises are not reliant upon liberal policy choices, such as those involved in certain types of agriculture or resource extraction, or those involved in illicit activities.

When economic elites that benefit from conventional economic policies are less influential relative to political, military, or other elites, this results in a political leadership that is relatively freer of economic concerns, about FDI or otherwise. For example, in North Korea, illicit economic activity is hugely significant, leading to a lack of concern about conventional economic policy by those elites benefitting from the status quo. States in which the military is dominant may also subordinate concerns about economic growth to actions that will benefit the military. These scenarios may result in long-term economic “mismanagement”. However, all leaders need to maintain some form of revenue in the long term in order to retain power.

In states with a large number of influential elites, the likelihood that many or most of them will be negatively impacted by unconventional economic policy is greater. While a state with an economy that is extremely concentrated in primary sector activity (i.e., agrarian or resource-rich) may have only a few influential economic elites dominating the political landscape, and they may be somewhat immune to “unconventional” economic policies, this condition is far less likely when the economy is more diversified. Autocratic states with primary sector oligarchies have been associated in the literature with poor FDI performance (see Akerman et al 2016). Therefore, the situation described in the examples above is far more likely to occur in highly concentrated authoritarian states with underdeveloped economies. Most of these regimes are considered “military regimes” or “personalist regimes”.

It is also worth mentioning that in any state, leaders are also prone to make “mistakes” that result in poor outcomes. In autocratic states where decisions rely on fewer deciders, or competent deciders are not present, these mistakes are likely to be more numerous (relative to say, democracies). Highly concentrated regimes may be even more prone to host poorly performing decision-making bodies. This is roughly correspondent with “veto player” arguments made in past literature (see Kastner & Rector 2003, or MacIntyre 2001). However, leaders who make mistakes (i.e., decisions that harm key supporters) are vulnerable to removal from power, especially in economically high performing regimes (see Besley & Kudamatsu 2007). Therefore, in the long term, the “average” of policy outcomes will support the incumbent elites, regardless of consolidation.

In sum, dissatisfied economic elites and political opposition both represent potential sources of policy uncertainty for investors, because they seek changes to prevailing policy governing investment. This is because in authoritarian states where such changes can have significant impacts to business, this volatility creates greater downside risk for investors. The tendency of autocrats to use FDI as a private good (“favoritism”) results in a condition where both emerging or excluded economic elites (not part of the winning coalition) and political opposition can benefit from changes to policy governing investment. Political opposition acts through the formal political sphere to create such changes, and dissatisfied economic elites can use either formal political channel or informal channels to influence changes. While the actors that make up the political and economic spheres may oftentimes overlap, the presence of dissatisfied economic elites and the presence of political competition represent two distinct conceptual ways to think about the likelihood of policy uncertainty. The next sections will explore each concept in greater detail.

3.1 - Investment Inflows and Authoritarian Regime Type

The first condition under which we would expect policy to be predictable is when the regime is not politically “competitive”. There are a number of ways to conceptualize political competitiveness, but for the purposes of this work I define political competition as the presence of some visible, politically distinct opposition to the incumbent regime. The presence of political competition indicates that there is political opposition dissatisfied with the status quo. As has been demonstrated by a number of scholars, these opposition movements or parties often extract real concessions from the incumbent regime (Ghandi 2008, Levitsky & Way 2010). Conversely, politically consolidated authoritarian regimes (those without viable political competition) are less likely to be forced into policy concessions, because they do not face a viable opposition.

The policy consistency present in consolidated regimes due to a lack of political competition results in a net increase in investment relative to politically competitive regimes. Policy unpredictability can stem from political competition in a variety of ways. In broad terms, this happens in two channels. In one scenario, the political opposition is able to make headway by gaining control of particular regional or cabinet posts, or obtain some other political gain that forces the incumbent elites to make policy concessions. In a more extreme scenario, the opposition takes full control of the government. These types of political concessions often represent a shift in patronage or another policy change that is bad for pre-existing investors. When these changes occur, Foreign Investors often suffer losses from cancelled contracts, rule changes, or any other number of factors tied to the previously prevailing policies. Thus, when investors observe this type of uncertainty, their interest in investing is reduced and FDI inflows are lower. This reduction in FDI inflows can stem either from existing investors divesting or from reductions in new investment.

Therefore, competitive authoritarian regimes will be less successful at attracting investment. Owing to their more uncertain policies, they will be less able to provide consistent favoritism towards particular types of FDI in order to benefit incumbent firms. As a result, FDI may be more diverse, but overall investment will be lower. It is important to emphasize that while these states are not necessarily more corrupt or less institutionally sound than their consolidated counterparts, they are much less predictable. It is this lack of predictability that generates the biggest encumbrance to investment.

H1: Authoritarian states with greater political competition will exhibit less FDI inflows than authoritarian states with less political competition, all else equal.

Bearing in mind the factors discussed previously about extremely politically uncompetitive regimes and their greater tendency to host poor decision-making institutions and elite coalitions less committed to conventional economic policies, the empirical analysis will demonstrate a “diminishing return” from political consolidation, whereby the effect to FDI inflows will plateau or fall beyond a certain point of extreme political consolidation. We also observe an increase in the standard deviation of FDI inflows among these very uncompetitive regimes. This is discussed in more detail in the following chapters.

3.2 - Investment Inflows and Economic Elites

States with a greater number of economic elites relative to economic activity should exhibit less policy predictability. Political Incumbents craft policy to promote investment that benefits allied economic elites. Therefore, as the number of economic elites relative to economic activity increases, so does the probability that some of these elites will be outside of this favoritism or their shares will be smaller, and therefore they will be dissatisfied with the status quo policies.

Let us consider an example to illustrate this dynamic. In a simple economy with only a few economic elites, FDI policy deliberately benefits those elites, and they are satisfied. An example of this policy might be the approval of joint ventures for FDI. Many authoritarian states require foreign investors to partner with a domestic firm to operate, and these partnerships must be approved. In this case favoritism might look like fast-tracking permits for politically favored domestic firms. However, as the number of eligible firms (domestic economic elites) increases, dissatisfaction with this favoritism grows. By definition, favoritism picks winners and losers, and there can only be a limited number of winners. When there are only a few players in the game, everyone can be a winner. However, as the number of economic elites per dollar of FDI inflows increases, some will inevitably be left out of the favoritism and become dissatisfied. Favoritism is a private benefit, as it becomes dispersed, the value diminishes.

Therefore, dissatisfied economic elites will seek to change the policy status quo. If dissatisfied economic elites are successful at changing the policy status quo, pending permits may be cancelled or delayed. This creates uncertainty for investors.

Another example might relate to sectoral favoritism. Assuming that incumbents favor particular sectors for FDI over others, the emergence of more economic elites increases the probability that these elites will have interests in other sectors, and thus will want more favoritism for FDI into non-favored sectors. This also results in dissatisfaction with the status quo.

These sorts of examples will be illustrated in more detail, using tangible case studies, in Chapter 5. By definition, private benefits are scarce, and thus a greater number of economic elites inevitably leads to more competition over those benefits. This competition leads to greater policy uncertainty.

Economic elites influence policy through political elites. In the case that dissatisfied economic elites choose to coopt incumbent political elites to change policy, this essentially means using influence (donations, bribes, or other means) to convince existing incumbents to advocate for a policy change. Or, in the case of particularly principled political incumbents, it may mean using the same means to support the promotion of new, more sympathetic members of the incumbent party to positions of influence.

Alternatively, economic elites may choose to support political opposition leaders. This choice is riskier, as it entails provoking the ire of political incumbents, but the payoffs can be greater if successful. The political opposition is likely to have fewer suitors, so in the case that the political opposition is able to take control of particular cities, regions, cabinets, or legislative committees, the policy rewards to loyal friends may be greater than those provided by coopted incumbent regime elites. In the extreme event that there is a regime change in favor of the opposition, the rewards may be greater still. The means by which economic elites support a political opposition are mostly the same as those they might use to find patrons in the incumbent regime, such as donations, bribes, and other financial rewards derived from their economic status.

In sum, as the number of economic elites expands relative to the size of the economy, political leaders face demands to satisfy competing policy preferences, either directly or from political opposition. Just as political competition results in less predictable policy, a greater number of (large) economic elites in the state should result in less focused policy making and leaders beholden to more interests. The result is less predictable policy.

H2a: Authoritarian states with relatively fewer economic elites will receive higher FDI inflows than authoritarian states with relatively more economic elites, all else equal.

These tests, similar to H1, examine the level of foreign investment inflows at varying levels of economic elite consolidation. When the number of dissatisfied economic elites is smaller, policy will be more predictable, and investment will be higher as a result.

It is also possible that the fullest impact of dissatisfied economic elites on policy predictability is at least partly *conditional* on the presence of a political competition through which they can act. In this case, the presence of dissatisfied economic elites alone (or the presence of political competition alone) would be less impactful than the combination of both dissatisfied economic elites and political competition. It may be the case that Political Incumbents are less willing to be coopted by Dissatisfied Economic Elites than members of a Political Opposition. In that case, Dissatisfied Economic Elites would be more easily able to change the policy status quo when there is a more willing partner in the political opposition. Additionally, from a political standpoint, the presence of an opposition alone may not necessarily indicate a desire to change economic policies. The political opposition may be ineffective, or be interested in other causes, and only when coopted by dissatisfied economic elites will they choose to push for economic policy change. This conditional argument is an alternative hypothesis that I can test.

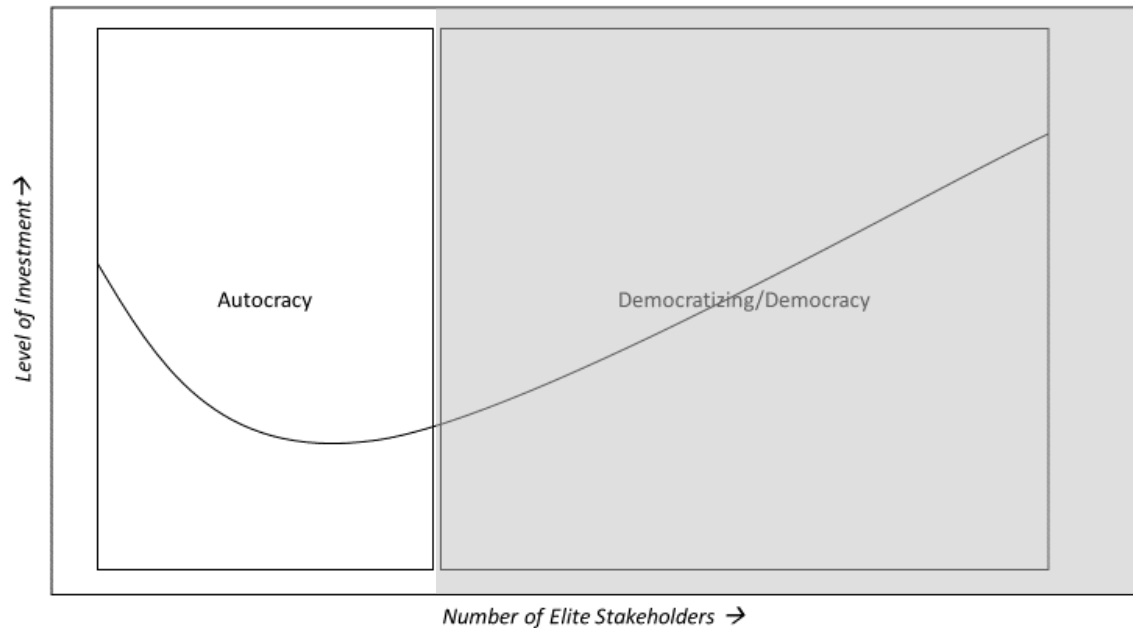
H2b: Among authoritarian states with relatively more economic elites, those with greater levels of formal political competition will receive lower FDI inflows than similar authoritarian states without formal political competition, all else equal.

This interrelationship between political and economic elites is an important one that we will return to in several places throughout the following chapters. As discussed in the prior chapter, states with oligarchic economies can more readily suppress political competition because political leaders in those states can retain power with the consent of fewer stakeholders.

This translates easily to those political leaders opting to provide private goods to economic elites in exchange for their political support. However, when an autocratic state is less oligarchic, these private goods become a source of dissatisfaction for economic elites that are left out or receive smaller shares, and these dissatisfied elites become a source of political competition that leads to destructive policy uncertainty and less FDI inflows. However, the number of economic elites is distinct from measures of political competition, and many states that have nominally consolidated political environments still feature intense competition between competing factions of economic elites.

There are a number of examples of this. In Venezuela, Hugo Chavez came quite close to eliminating opposition parties in the legislature in 2001. However, despite this seemingly acute political consolidation, Venezuela still had a large number of economic elites, many of whom were dissatisfied with his policies governing FDI. Others were aligned with Chavez and benefited from his expropriations. However, some of these dissatisfied economic elites were nearly able to remove Chavez from power in 2002, and this inaugurated a period of intense policy uncertainty. This will be discussed in greater detail in the following chapters, but I will suffice it to say here that the number of economic elites is a distinct and critically important element of the political economy.

Figure 2: Levels of Investment Across Economic Elites



The above figure provides an illustration of the dynamics described in H2a. In the left, unshaded panel, we see that the level of foreign direct investment declines as autocracies gain more economic elites, due to greater policy uncertainty. While predictions for democratic states are not extensively developed here, it is useful to sketch the entire theoretical curve to provide context. The entire curve takes the form of a “j-curve”. In the shaded panel on the right, we see that as the number of economic elites increases past a certain point, political leaders are forced to transition to providing more public goods and instituting impartial legal systems to resolve disputes. This democratization process supports governance quality and rule of law, and results in higher levels policy predictability and therefore higher levels of investment, and states in which this takes place ultimately outpace their less competitive autocratic peers.

H2a focuses only on the left half of Figure 2, which describes how a greater number of economic elites operating under an *autocratic* legal framework results in greater competition over limited private goods, which in turn results in policy uncertainty and ultimately lower investment.

As discussed in the previous section, highly consolidated authoritarian states that are relatively underdeveloped underperform in attracting FDI. These states will occupy the far left of this trendline, and as a result we observe another “dip” on the far left side of the trendline when these states remain in the sample. This is discussed further in the empirical analysis.

3.3 – Targeted Investment

In the introduction, I discussed the Turkish AKP party and their competition with the CHP. The implication was that if the AKP were able to establish consolidated control, and were able to eliminate the sources of economic support for the CHP, the level of investment to the country might actually increase. An entrenched AKP could focus solely on supporting the enterprise of incumbent elites and their allies. However, in this hypothetical scenario, although investment levels might eventually increase, the increase would be targeted to particular sectors favored by the incumbent elite, as opposed to a more broad-based increase.

This concept of investment targeting is an important element of the theory that needs to be examined. Namely, do authoritarians really favor particular sectors over others for FDI investment? If so, which sectors, and why? Examining this concept is important, because it helps us understand the practical implications of policy uncertainty, as well as the source of dissatisfaction with the status quo among unfavored actors. Favoritism is a key source of dissatisfaction. If such sectoral favoritism is not present, and authoritarians value all foreign investment equally, then we might expect a consolidated regime to promote all foreign investment instead of just some. If this were the case, consolidated authoritarian states would be perhaps no different than (and perhaps even superior to) democratic states in this aim, and a greater number of economic elites would have little political impact. I argue that this is not the case.

As discussed previously, the degree to which FDI inflows are targeted to specific sectors has important ramifications for growth and development, as well as important ramifications for the ability of autocrats to entrench themselves by using targeted investment to reward key supporters. Therefore, measuring and predicting the degree to which FDI is targeted is an important element of the analysis here and forms the basis for the third set of hypotheses. I conceive of “targeted FDI” as being a condition where FDI inflows in nondemocratic states are concentrated to the primary and secondary sector (particularly the secondary sector) and away from the tertiary sector.

Selectorate theory posits that authoritarian leaders care chiefly about remaining in power and maximizing rents. In order to remain in power, authoritarian leaders must prevent the emergence of new elites whose influence could destabilize the regime or cause benefits to be more widely dispersed. As Bueno de Mesquita (2005, page 86) states it; “[A political leader who] picks a smaller coalition [than necessary] can never gain enough support. In contrast, if he increases his coalition size by adding surplus supporters, he only reduces the level of rewards he can supply to his existing coalition.” A leader must appease the number of parties necessary to claim power, but would prefer to keep this number as small as possible. Secondly, these leaders must satisfy existing elites so as to avoid being replaced. So, assuming the validity of this model, it follows that authoritarian elites will encourage foreign investment only when it provides benefits to existing elites and most preferably when it does not threaten to lead to the emergence of new elites with whom power must then be shared.

One implication of this is that incumbent authoritarian leaders seeking to prevent this dispersion of economic power are unlikely to favor foreign investment into specific sectors or subsectors for which such investment is more likely to engender this broad-based growth. One

solution to this problem might be to simply stop all foreign investment. However, despite the risks of empowering potential rivals, foreign investment of the right type can provide significant benefits to regimes that court it. In addition, the prospect of potential economic activity that is not strictly controlled by the regime also presents an opening to challengers who might promise to claim this untapped resource for existing elites, meaning that a lack of favoritism towards certain types of investment to benefit incumbent economic elites could create political risk for an incumbent leader.

Therefore, rent-seeking authoritarians are most likely to favor investment into sectors which they can easily control, and target such investment to benefit firms that they or their allies control. Through their policy choices, incumbent political leaders are likely to steer investment dollars towards a small coalition of existing allies, and away from existing or potential future rivals. In particular the goods and material export sectors make attractive candidates for this targeted development of FDI. This leads to the general expectation that autocrats will favor investment into the primary and secondary sectors. While favoritism of certain firms over others is quite likely for domestic investment (and FPI), this type of favoritism should be less prevalent with regard to FDI. This is because foreign firms are not likely to be part of the autocratic regime's winning coalition, and thus favoritism to particular firms is less likely. They are likely to encourage investment by whichever firms provide the greatest benefit to domestic economic elites that are part of the winning coalition. Thus, the appearance of favoritism with regard to FDI is more likely to feature preferences towards particular sectors of FDI rather than for or against particular foreign firms. I examine these patterns in greater detail in Chapter 7.

Export performance is an important factor that drives autocratic preference for secondary sector FDI in particular. Authoritarian states, particularly consolidated ones, only favor foreign

investment that will benefit incumbent elites. For FDI (which is foreign-owned), this means investment into sectors that the state can easily monetize, track, and otherwise control, such as comparative advantage sectors, particularly in goods and raw materials production and export.⁸ Export performance has clear benefits to incumbent authoritarian leaders. Promoting exports provides a clear financial benefit, especially when revenues accrue to the state. Exports are also easy to keep track of because they must move through ports, and therefore, if necessary, easy to shut down. It also means, when possible, using FDI to narrowly favor firms aligned with the incumbent elite, such as through investment partnerships. Generally, secondary sector activities are more dependent on technology and intermediary goods that require higher levels of FDI. As a result, using secondary sector FDI to advance export-led development is a common strategy in contemporary authoritarian states. Consequently, autocratic states are particularly likely to seek secondary sector FDI through policy favoritism towards investment in this sector.

Aside from the incentive of rents gained from promoting these interests, incumbents also have an interest in using policy to protect less competitive sectors, and to prevent investment activity that could empower potential rivals. This leads to an aversion by autocrats to investment in the tertiary sector. Tertiary sector investment into industries like media, technology, or banking threatens to disrupt local monopolies and empower entities outside of the regime. This leads to the expectation that autocracies will use policy favoritism to discourage tertiary sector FDI.

⁸ For FPI, this means investment only into firms that they and their allies control, and only of a type and to a level where they retain this control. Therefore, variation will occur by firm instead of sector. With regard to joint partnerships, we can also expect to see variation by firm (i.e., FDI joint partnerships being approved for favored domestic firms and denied for unfavored domestic firms).

An illustrative example of this is found in Vietnam. The largest textile manufacturing conglomerate in Vietnam, called Vinatex, is majority-owned by the state. In 2014 and 2015, the state passed a series of laws designed to “promote Vietnamese enterprises’ direct participation in foreign distribution systems” (Deloitte 2020). In April of 2015, one of the largest resulting FDI agreements was struck between Vinatex and Japanese textile conglomerate Itochu, a large joint partnership aimed at “the construction of the factories in the industrial zone, which is located in Hai Lang District in the central province of Quang Tri”. Japan is a significant importer of Vietnamese goods. Therefore, the joint venture was arranged with the express purpose to provide Vinatex with the opportunity to boost its textile export turnover to Japan. The agreement also included FPI provisions, allowing Itochu an initial 5% equity stake in Vinatex, providing Vinatex with capital for further expansion.

This scenario provides a useful example of how states use targeted FDI to increase revenue to favored parties, in this case to the secondary sector. While this example focused on a state-owned enterprise, we could just as easily locate similar examples where the relevant firms had less-formal ties to the state. Vingroup, the largest private firm in Vietnam (focused in real estate, manufacturing, and domestic retail) also has close ties with the Vietnamese Communist Party. This cozy relationship has occasionally attracted the protest of corruption activists, but these voices have generally been silenced. Vingroup has been another significant beneficiary of foreign investment inflows.

Vietnam promotes FDI into the manufacturing sector, because most of the largest state-owned or state-aligned firms operate in this sector. Therefore, the FDI increases the revenue of these firms, and thus indirectly support the revenues of incumbent elites. By contrast, FDI into other industries and sectors does not provide this benefit, and thus the government does not have

an interest in supporting it. While the state clearly has incentivized a certain type of foreign investment, the laws surrounding activity in other sectors remain opaque and prohibitory. In contrast, democratic states with a similar development profile, such as the Philippines, attract significant manufacturing FDI, as well as investment in other non-manufacturing industries (such as call center support). This is because clear, impartial legal structures provide an even playing field, as opposed to the state-directed approach in Vietnam.

In sum, the result of favoritism is that FDI becomes *targeted*. Autocrats target investment from foreign investors in particular sectors or subsectors in order to suit their interests. Because policy is crafted to favor particular interests, certain types of investment become relatively more attractive, and thus FDI takes on a more targeted nature, disproportionately flowing to particular activities. This could mean investment targeted at particular industries, or targeted at particular domestic firms (such as through joint partnerships). However, I will focus here on sectoral favoritism. In this theoretical context, targeted FDI refers to a condition where FDI inflows flow disproportionately to the primary and secondary sector (particularly the secondary sector) and away from the tertiary sector. I argue that when incumbent authoritarians are able to decide policy with little opposition, they will reliably engage in policy favoritism, because it serves their interests (and the interests of their allies) to do so. This favoritism results in FDI inflows targeted to particular sectors.

Before positing formal hypotheses relating to how targeted FDI varies between different types of nondemocratic states, we must clearly define the general conceptualization of what “targeted FDI” looks like in all nondemocratic states. When I say that FDI in nondemocratic states is targeted, this means specifically that it *flows disproportionately to the secondary sector and away from the tertiary sector*. In the empirical analysis of targeted FDI in Chapter 7, I

demonstrate this targeted FDI using my data on FDI inflows to nondemocratic states, before examining variation in the degree to which FDI is targeted between different types of nondemocratic state.

Extending the theory from this general claim, I predict that when political competition is present in an authoritarian state, it disrupts the degree to which incumbent autocrats can use policy to favor specific types of FDI. This occurs either by forcing the autocrat to make concessions to allow for or incentivize other types of investment, or simply by blocking the ability of the autocrat to offer reliable incentives for preferred foreign investors. As a result, when political competition is present, the degree to which FDI inflows are targeted (towards the secondary sector and away from the tertiary sector) is reduced. When political competition is reduced, the autocrat will more consistently and successfully target secondary sector FDI to provide private benefits to supporters, creating targeted FDI inflows. This leads to the third hypothesis.

H3a: Authoritarian states with less political competition will exhibit more targeted FDI inflows (concentrated towards the secondary sector and away from the tertiary sector) than authoritarian states with more political competition, all else equal.

Likewise, when there are a greater number of economic elites, they are likely to have varied economic interests and are thus likely to lobby for more varied types of FDI inflows. Policy favoritism inherently creates dissatisfaction among those firms which are not benefiting from the policy. These dissatisfied economic elites will either influence political leaders directly or support opposition political elites to lobby for changes. Conversely, when there are fewer economic elites to please, it is easier for autocrats to use policy favoritism to hold power. This results in FDI inflows that are targeted to the secondary sector (and away from the tertiary sector). This leads to an additional prediction as part of the third hypothesis.

H3b: Authoritarian states with relatively fewer economic elites will exhibit more targeted FDI inflows (concentrated towards the secondary sector and away from the tertiary sector) than authoritarian states with relatively more economic elites, all else equal.

As discussed earlier, the most economically “unconventional” states should tend to be highly concentrated states, especially where major sources of state and elite revenue are not wholly dependent on sound economic management. In order to account for this in considering economic elite consolidation and FDI targeting, I tag certain cases in the sample as being states significantly underdeveloped or comprised of elites with low economic vulnerability. It is plausible that in some cases, such as in some primary sector economies, economic elites may not rely on FDI in the same way that diversified economies do. This aligns with the arguments about secondary sector non-obsolescing made by Kobrin (1987), discussed above. I discuss this issue further in the succeeding sections.

4 – Political Competition and FDI Inflows: Empirical Findings

The following chapters use several data sources to develop quantitative tests of the theoretical claims made in the previous section. This analysis is also interspersed with illustrations and case vignettes to provide further clarity on various dynamics. A summary table of hypotheses and data can be found in Appendix 2.

The first portion of this analysis deals with the first hypothesis, which is that politically uncompetitive authoritarian states will exhibit greater total foreign direct investment inflows than their more politically competitive authoritarian counterparts. The purpose of H1 is to investigate the most straightforward cause of political uncertainty in authoritarian states, which is political competition, and the dampening effect that this uncertainty has on FDI inflows. This section seeks to substantiate this assertion by examining a number of measures for political competition in authoritarian states against their impact on FDI inflows.

Political competition in authoritarian states is damaging to FDI inflows because it results in changes to prevailing policies that govern such investment. These changes have a large impact in authoritarian states, where the regime typically plays an important role in choosing economic winners and losers. Therefore, a lack of consensus among policy making elites can be expected to turn off investors who rely on a predictable policy environment for consistent returns.

4.1 – Approach to Testing H1

H1 is tested using a combined state-level sample. The state-level FDI data is drawn from the World Bank, and is used in combination with economic and political control variables also drawn from the World Bank as well as from various other sources. Overall, the set covers 123 nondemocratic states, which is to say, states which were classified as nondemocratic for at least

one year during the sample period, for the years in which they were nondemocratic.⁹ The data ranges from 1971 to the present, but as discussed in Chapter 3, I focus on the period after 1980. A preliminary construction of this combined data yields a state-level data sample of approximately 4100 observations, which contains state-level figures for FDI.

The H1 hypotheses rely on a measure of state-level FDI as the dependent variable. Among several choices, I opt to use the World Bank Open Data, an open-access source for global development data. This data contains information on foreign direct investment inflows and outflows at the state level. Data is presented in a state-year format as constant dollar figures, and as a percentage of GDP. The primary measure I use for FDI is net FDI inflows, which refers to gross FDI inflows minus gross FDI outflows. This is the primary measure available from the World Bank, based on balance of payments data reported by the International Monetary Fund (IMF) and supplemented by World Bank staff. It provides an accurate estimation of foreign direct investment interest in a particular state. A summary of the FDI data over time and by regime type can be found in Appendix 2.

Statistics on total foreign direct investment capture an aggregation of several types of investment. The three primary components as defined by the World Bank are greenfield investment (direct investment to originate a new enterprise), equity investment (purchase of an existing enterprise in whole or part greater than 10% by a single or “related group” of foreign investors), and reinvestment of earnings (which includes retained earnings on existing foreign-owned enterprises). FDI is not based on the nationality or citizenship of the direct investor but

⁹ In order to retain a balanced panel, states which appeared for less than five nonconsecutive years were removed. This only applied to two states, which were Moldova and Latvia. A sample selection test confirms that remaining missingness is random.

rather is based on residency. It is also not inclusive of borrowing if loans are guaranteed by domestic investors (IMF 2022).

The primary independent variable for H1 is political competition. In order to operationalize this measure, we must distinguish among non-democratic states, dividing competitive authoritarian states (sometimes called “anocracies”) from consolidated authoritarian states.

There are several sources of detailed data on authoritarian states available in open formats, including Polity IV and V-Dem. V-Dem in particular provides the most detailed data, including high-level measures such as overall regime-type as well as more granular measures such as the presence of an opposition party in the legislature. This data allows for both the division of the overall universe of cases (authoritarian states), as well as designation of variation among these cases (political competitiveness).

Regime type is typically measured on an ordinal scale, such as the Polity scale with ranges from negative ten (very authoritarian) to ten (fully democratic). I use Polity Score to categorize authoritarian states and define my universe of cases. I also employ the use of V-Dem data. The V-Dem data consists of several continuous measures of regime type which span from “0” to “1”, with “1” being the most democratic. I use the V-Dem electoral democracy index to define political competition, also in combination with the Polity designations as a robustness mechanism. Therefore, the two primary political measures used in the following analysis are Polity Score and Electoral Democracy Index. However, I also employ the use of component measures for both of these indices. These component measures are Political Competition (a component of Polity Score) along with Legislature Opposition Parties, Opposition Party

Autonomy, and Multiparty Elections, which are component measures of the Electoral Democracy Index.

Together, these measures constitute a well-rounded and rigorous measurement of the political conditions within a state. Below is a summary of the measures I use for political competition.

Table 2: Measures of Political Competition

Variable	Source	Range
Electoral Democracy Index	V-Dem	0-1 (continuous)
Multiparty Elections	V-Dem	0-4
Legislature Opposition Parties	V-Dem	0-2
Opposition Party Autonomy	V-Dem	0-4
Political Competition	Polity IV	1-10
Combined Polity Score	Polity IV	(-10)-10

In all cases, a higher value indicates more political competition. In order to examine political variation in a robust manner, I will conduct tests using a number of different cutoff methods to determine regime type.¹⁰ As explained above, I use these measures to distinguish between politically competitive and consolidated authoritarian states, as well as to measure levels of political competition. For most of the succeeding analysis I rely on the continuous scales described above, but in some cases I use specific cutoffs along the range of each variable to separate cases into categories of “politically competitive authoritarian states” and “politically uncompetitive authoritarian states”.

¹⁰ A conventional measure of a non-democratic state is a state with a combined Polity score below 6. This threshold is used both in scholarship and by Polity itself in defining nondemocracies. Therefore, the set of states below 6 becomes my primary universe of cases. However, by using the alternate measures and differing cutoff points, I test the robustness of observations using this definition.

The models in this chapter also utilize a number of control variables. Controlling for factors that may covary with both political makeup and FDI inflows is most important. One example of this is the presence of oil, for which it has been argued that oil resources have a strong effect on the makeup of political institutions (Ross 2001), and attract significant foreign investment (Mina 2007). Therefore, controls for variables such as this help determine that the results are not driven by these particular oil states. An additional economic control variable accounts for underdeveloped states. In some agrarian or undeveloped economies, there may not be a significant market for FDI. These types of economies also tend to be disproportionately authoritarian (Robinson 2006). It is also plausible that in some cases, primary sector or subsistence economies may not rely on FDI in the same way that diversified economies do, meaning that leaders may not focus as much on directing FDI to economic elites engaged in these industries in the same way they do for secondary-sector economic elites. I discuss this issue in more detail later, but I also account for this by tagging specific cases as “underdeveloped” where GDP per capita is less than \$1000 USD.¹¹ This issue should be relatively minor in most modern states, although this condition was prevalent historically. In addition to these, I also include a battery of other standard economic controls, such as market size, exchange rate, and GDP growth.

As discussed earlier, highly consolidated authoritarian states are more likely to feature concentrations of “unconventional” or non-economic elites, resulting in leaders without the incentive towards economic policies that would support FDI. This issue should be relatively minor in most modern states. However, we might expect a wider standard deviation from the

¹¹ GDP per capita below this level is generally considered “underdeveloped” by a number of authoritative sources. See UNCTAD (2021).

mean trendline when examining a graph of average FDI over political concentration as we approach the states with the lowest Polity Scores, reflecting both the probability of these states not having conventional economic elites and to have poorly performing leaders in general (due to the lack of veto players). This is discussed further below (see Figure 3).

4.2 - Analysis of H1

This section utilizes the data discussed in the prior section, first by examining observable trends within the dataset, before moving on to a more thorough regression analysis in the latter portion.

H1 argues that politically consolidated authoritarian states will exhibit greater total foreign direct investment inflows than their competitive authoritarian counterparts. Examining some summary statistics from the sample, we find the mean FDI inflows as a percentage of GDP at 3.27%. For the most uncompetitive states, this figure was 3.4%, and for more competitive states, the figure was 2.68%.

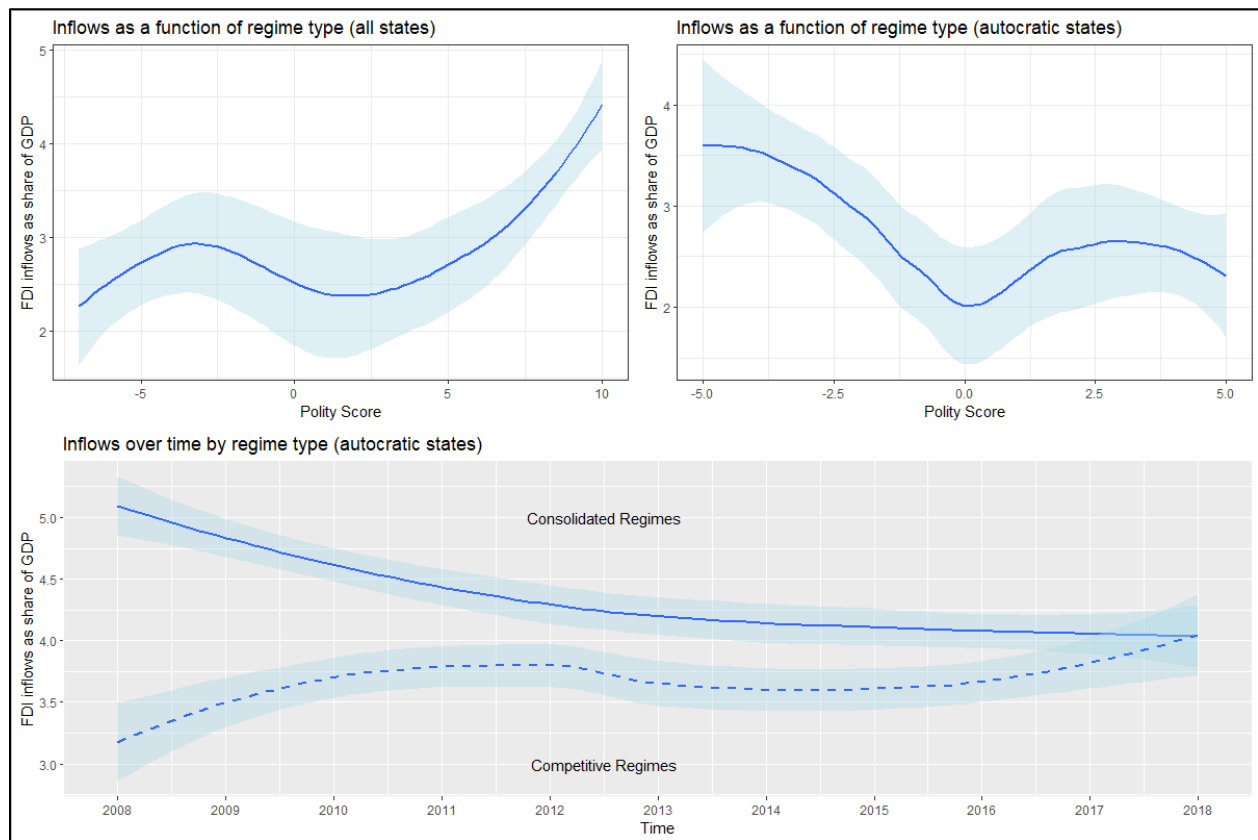
We can visualize these trends in Figure 3 shown below. The figure shows the LOESS moving average¹² values of a ten-year sample of the full data (including the democratic states) for which the coverage was best. The state Polity Score is shown on the x-axis, and FDI inflows as a percentage of GDP is shown on the y-axis. A distinctive “J-Curve” is visible, with consolidated authoritarian regimes displaying greater average FDI inflows relative to competitive regimes (democratic regimes receive the most), conforming to the expected outcome for H1. The top left panel illustrate the entire range of scores, including democracies, and depicts middle-score “anocracies” (around 0-5) as being the worst performing, democracies (6-10) being the

¹² LOESS, or locally estimated scatterplot smoothing, is a localized regression or generalized moving average for a set of datapoints.

best performing, and consolidated autocracies (-5-0) as being second-best performers. The top right panel shows a similar view, but of autocracies and anocracies only, showing a steady decline in FDI inflows performance from -5 through 5. Interestingly, performance among extreme autocracies (-10 through -5) was also poor. This is indicative of the highly consolidated underperformers that were discussed earlier, and is a trend which we will later return to.

The bottom panel depicts average inflows over the sample period, with the sample bifurcated by regime type. The dark line is the LOESS moving average value of consolidated authoritarian states (-10 to 0 on the Polity scale), and the dashed line depicts the same values for the most competitive authoritarian states (0 to 5 on the Polity scale). The mean line is distinctly and consistently higher for more consolidated authoritarian states, indicating that these states attract more FDI across the full range of sample years.

Figure 3: FDI Inflows and Regime Type



Source: World Bank, Center for Systemic Peace.

4.2.1 – Regression Analysis

In order to test Hypothesis 1, I specify the following basic models of state-level FDI inflows to include all six measures of political competition:

$$FDI\ Net\ Inflows_{it} = B_0 + B_1 Political\ Competition_{it} + B_2 \log(GDP)_{it} + B_3 Oil\ Rents\ Share\ of\ GDP_{it} + B_5 Underdevelopment\ dummy_{it} + C_t + e_{it}$$

My standard specification approach for all models is to use ordinary-least-squares (OLS) regression models with fixed effects for time (by year). I employ a state-level model of FDI inflow levels, similar to the model used by Li and Resnick (2003) and others. As in their standard model, I include control variables for regime characteristics, market size, and development level. They include some additional variables such as exchange rate, economic

growth, and labor cost which I do not estimate in my primary models, because I do not expect them to covary significantly with the political variables I am studying, meaning their exclusion should not create bias in the marginal effect of the primary independent variables (political competition). In addition, their inclusion with my data creates limitations in the number of complete observations, which hampers the analysis. However, I do estimate the larger model as a robustness test (see Appendix 3), and the results are similar. These results are also discussed in the succeeding section.

Table 3 provides a regression analysis of these variables in the sample. In Table 3, the various political competition measures are regressed against state-level FDI inflows (H1). Four of the six political measures (used to measure political competitiveness) are negatively associated with FDI inflows at a statistically significant level, indicating lower FDI inflow values in competitive regimes.

The first measure of political competition is the state's corresponding Polity Score for that year. A one-point increase in the state's Polity Score along the 20-point ordinal scale (meaning the state was more democratic) is associated with a decrease in FDI inflows of roughly \$400 million USD (model 1). The other primary measure of political competition is the Electoral Democracy Index, which is a measure taken from V-Dem. This measure, which ranges from 0 to 1 along a continuous scale, exhibits a full movement along the scale as being associated with a decrease in FDI inflows of over \$8 billion USD (model 3).

The substantive significance of these amounts varies by state and time. The mean value for FDI inflows among the sample is approximately \$2 billion USD. The standard deviation for Polity Score is roughly 4.5, corresponding to a \$1.8 billion USD decline in FDI. The result for the Electoral Democracy Index is quite similar. The index has a standard deviation of 0.20 in the

sample, which corresponds to a \$1.6 billion USD decrease in FDI in this model. For most states in most years in the sample, these values represent substantively significant declines in foreign direct investment. The use of a logged dependent variable allows for the interpretation of results in terms of a percentage increase in FDI inflows. These results can be found in Appendix 3.

Among the component measures of the Electoral Democracy Index that are included, both the presence of opposition parties in the legislature (as measured by a three-point ordinal scale), and the autonomy of those opposition parties (as measured by a five-point ordinal scale) both see a one-point move towards greater political competition as being associated with declines in FDI inflows of over \$1 billion USD. These moves also represent significant changes in the level of FDI inflows. The standard deviation for opposition parties in the legislature was 1.2, corresponding to a \$1.6 billion dollar change in the level of FDI inflows using this model (model 5). The same calculation for opposition party autonomy corresponds to a \$2.8 billion dollar change in the level of FDI inflows (model 6). These figures are substantively similar to the composite measure, but provide additional robustness to the result, as well as providing insight into some of the political factors that are creating policy uncertainty in nondemocratic states (namely, robust opposition party activity).

Among the two variables that did not perform as expected, the coefficient on multiparty elections is directionally consistent with the other variables but not statistically significant, while the Polity Political Competition measure is directionally positive but effectively zero when considering the standard deviation. The reason for this latter result is related to the measurement methodology of the Political Competition measure by Polity, which allows for repressive states to receive a high ranking if they exhibit certain characteristics, such as a peaceful transfer of power. The overall Polity variable is strongly correlated with the other measures (such as the V-

Dem Electoral Democracy Index), but the Polity Political Competition variable is not correlated with these measures at all. There were a number of states in the data in which the other political competition measures were low, and the Polity Political Competition measure was high.

The control variables in the primary model are state GDP and a measure of oil income as a share of overall GDP. GDP, as a measure of the relative size of the economy, provides the primary economic determinant of FDI inflows and is important for overall model fit. Oil income as a share of GDP is also an important economic and political measure. States which are dominated by the oil industry often see smaller gains to other sectors, known to economists as the “Dutch Disease” (Corden & Neary 1982). Therefore, high relative oil rents can be expected to have negative implications for overall FDI.

Among the control variables, the coefficient for GDP exhibits an expected significant and positive effect on FDI. The marginal effect of the logged value is roughly \$3.5 billion USD across all six models. The impact of having a greater share of GDP devoted to oil revenues is negatively associated with FDI. This could indicate a number of dynamics. Again, one likely explanation is the “Dutch Disease”; states with larger oil markets tend to underinvest in other sectors. This is partly an economic phenomenon, but largely an effect of the political economy, whereby economic and political elites can derive significant revenue from the relatively less FDI-intensive oil sector and are less incentivized to drive FDI towards other sectors. A one percent increase in oil rents expressed as a share of overall GDP is associated in this model with a decline of roughly \$300 million USD in expected FDI inflows.

Together, these results provide reasonable indication that political competition is negatively associated with FDI inflows. These findings are robust to additional specifications of the data, such as with outliers removed and using alternate measures of FDI. Specifically, the

results hold when measuring FDI as a share of GDP (these results can be viewed in Appendix 3).

These robustness checks are also further described in the following section. The model fit for these models is also within an acceptable range.

Table 3: Political Competition and FDI Inflows

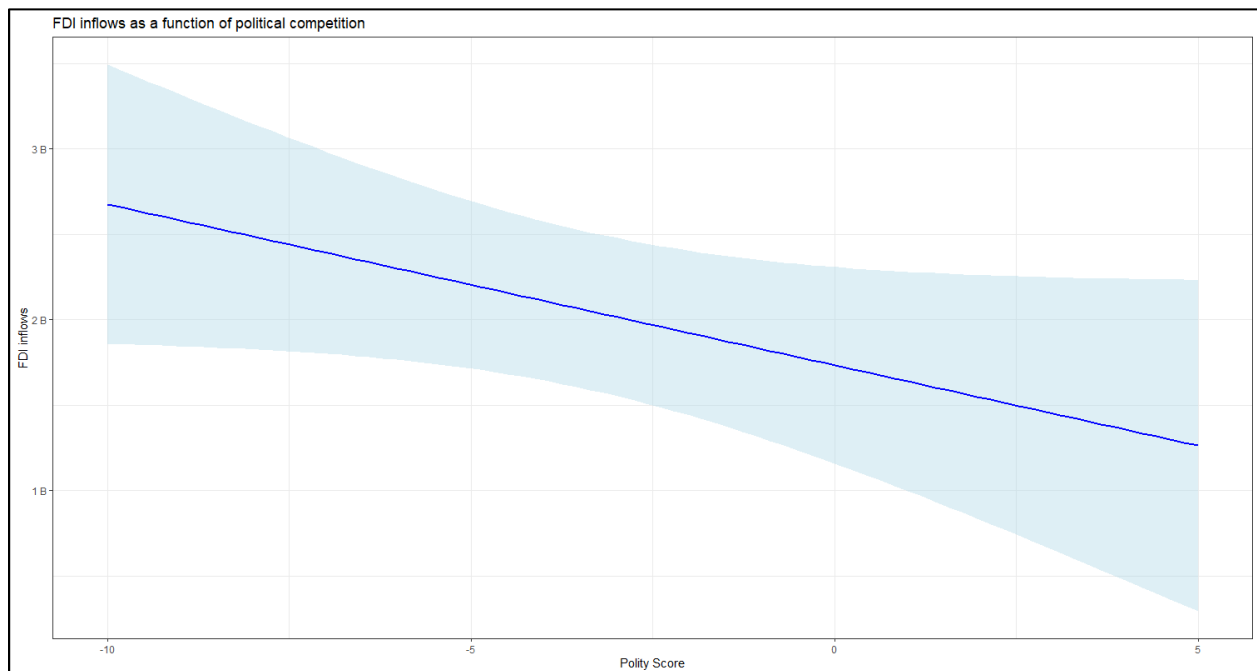
	<i>Dependent variable:</i>					
	Foreign direct investment net inflows (millions of usd)					
	(1)	(2)	(3)	(4)	(5)	(6)
Polity Score	-401.97*** (76.10)					
Political Competition		-11.42 (16.90)				
Electoral Democracy Index			-8,142*** (1,766)			
Multiparty Election				-301.21 (460.21)		
Legislature Opposition Parties					-1,375*** (460.21)	
Opposition Party Autonomy						-1,770*** (226.60)
log(GDP)	3,740*** (184.08)	3,855*** (185.34)	3,661*** (188.80)	3,845*** (184.16)	3,676*** (186.66)	3,749*** (183.83)
Oil rents	-321.83*** (31.09)	-274.22*** (29.04)	-319.02*** (31.19)	-275.07*** (30.11)	-307.18*** (30.33)	-335.51*** (30.60)
Underdeveloped	-1,097 (709.12)	-706.64 (708.99)	-1,651** (735.61)	-728.27 (710.01)	-1,013 (707.47)	-2,345*** (731.34)
Observations	2,654	2,654	2,654	2,654	2,654	2,654
R ²	0.161	0.152	0.159	0.152	0.161	0.171
Adjusted R ²	0.147	0.138	0.145	0.138	0.148	0.158
F Statistic (df = 4; 2611)	124.958***	116.870***	122.999***	116.862***	125.465***	134.723***

Note:

*p<0.1; **p<0.05; ***p<0.01

The figures below illustrate the findings from Table 3 using Polity Score as a measure of political competition. Figure 4 uses a linear estimation between the two variables, and illustrates a decrease in FDI of roughly \$1.75 billion USD across the range of Polity values in the sample.

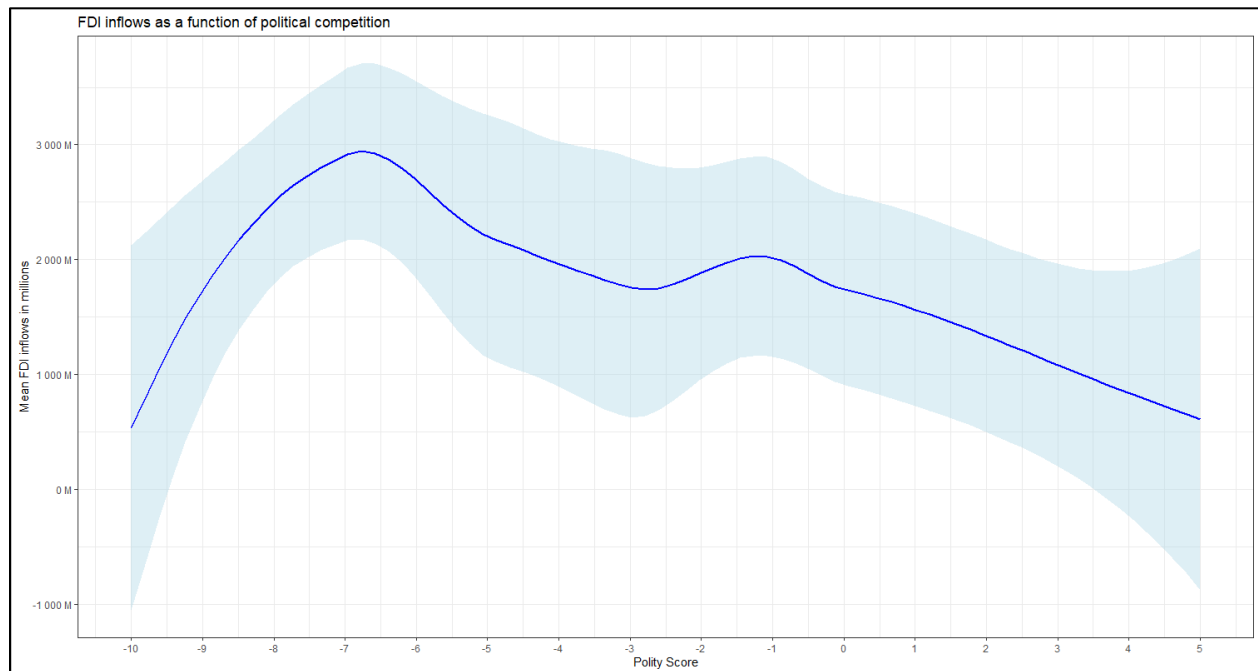
Figure 4: FDI Inflows and Political Competition



Source: World Bank, Center for Systemic Peace

Figure 5 provides a LOESS estimation of the same variable, and provides greater context into how the curve varies across the range of Polity Score. As the figure illustrates, the positive effect of less political consolidation on FDI diminishes after a state reaches roughly negative seven. This is indicative of the dynamic hypothesized earlier, whereby we see a “diminishing return” from greater political consolidation past a certain point. This trend is partly driven by China, which account for a large amount of FDI at an average Polity value of negative seven. When China is removed from the sample, the point of diminishing returns from consolidation begins closer to negative four.

Figure 5: FDI Inflows and Political Competition (LOESS)



Source: World Bank, Center for Systemic Peace

Together with the findings from the regression analysis, these data provide reasonable indication of support for H1, whereby politically consolidated authoritarian states will exhibit greater total foreign direct investment inflows than their competitive authoritarian counterparts.

4.2.2 - Robustness Checks

In order to examine the robustness of these findings, I made a series of adjustments to the models to determine whether or not the results would hold if incremental changes were made to some of the underlying assumptions and variables, such as the cutoff for inclusion as a “non-democratic” state or the length of time that political competition takes to impact FDI. I also examined the model using different control variables and even different measures of the dependent variable.

As a first robustness check, I run models 1 and 3 (which tested the primary measures of overall political competition in my data) using a one year lagged variable for political

competition. In both cases, the marginal negative effect of political competition on FDI inflows is slightly larger. This result indicates that a lagged independent variable may better capture the time between changes in political competition, investors changing their perceptions of risk, and subsequently making changes to existing investment plans.

In addition, I run the models using a different cut point for the universe of cases. The primary models presented here used a Polity Score of 5 or below to define the set of non-democratic states. I also tested the models using a universe of cases using both 4 and 6 as the cut point and the results are statistically and substantively robust to this change. In both cases the marginal effects are within approximately one standard deviation of the primary models. I also run models that excluded a key case, China. In these models the size of the marginal negative effect on FDI observed for political competition is reduced,¹³ but the substantive and statistical significance of the results holds. Lastly, I run the models using the full timespan captured by the data (beginning in 1971). The marginal effect for most of the political competition measures is slightly smaller, but substantively similar to the primary models presented here with data beginning in 1980. This makes sense when we consider the growth in the international market for FDI between 1970 and 1980.

Tests were also conducted using an additional dataset on FDI from the International Trade Centre. This data includes gross FDI inflows, providing an alternative to the net FDI inflows measure taken from the World Bank. These results are presented fully in Chapters 5 and 7, but the findings were consistent with the data used in this chapter.

¹³ The results for model 1 in Table 3, with China excluded, saw a negative marginal effect of approximately 54 million USD within a 95% confidence interval.

Finally, these models were tested using different controls variables, including the exchange rate index and economic growth. The model was also tested with two-way fixed effects (for time and country). The results were robust to the inclusion of these additional variables. These results can be found in Appendix 3.

I also examined autocorrelation in the data. The model used by Li and Resnick (2003) uses an autoregressive technique (AR1) to control for autocorrelation of the dependent variable (FDI inflows) by accounting for previous values in the regression. Techniques such as these are necessary when autocorrelation in the model residuals is high. Using a Durbin-Watson test to measure the level of modeled serial autocorrelation in the data I employ, the models shown in Table 3 return results around 2.01, indicating that serial autocorrelation is within an acceptable range. This makes sense theoretically, as FDI in authoritarian states tends to be episodic and based on variable flows rather than previous levels, causing it to differ from heavily autocorrelated economic measures like GDP.

4.3 – H1 Case Study

The preceding empirical analysis provides a compelling validation of the theoretical intuitions around the connection between political competition and foreign direct investment. However, given the degree to which “policy uncertainty” is abstracted, a case study is helpful to further clarify how the mechanism between these variables operates. This section will examine such a case study as a means to further illustrate a tangible example of the empirical findings discussed above.

Among a number of examples of the negative impact of political competition on FDI in authoritarian settings, one that is both well-known and particularly illustrative of how political competition in these settings creates policy uncertainty (which in turn reduces investment

inflows) is the case of Venezuela. In Venezuela the rise of the Chavez Regime in the late 1990s inaugurated a period of democratic backsliding, increasing political uncertainty, and volatile FDI performance despite the presence of some of the largest gas fields in South America.

Venezuela is an economically attractive destination for FDI. Aside from the presence of massive oil reserves, the country also benefits from a relatively educated population and close proximity to the United States market for energy and goods exports. However, Venezuela is also a politically competitive authoritarian state. When Hugo Chavez assumed power in 1999, Venezuela saw a dramatic reduction in FDI inflows. Ostensibly, at the outset, this was due largely to the antibusiness rhetoric from Chavez's Socialist Party. However, at a deeper level, the more enduring damage came from the uncertainty introduced by continuous rounds of destructive political competition which eroded the institutional protections for investment and left investors with unclear expectations about which laws would prevail and whether or not expropriation would continue or not. Poor FDI performance in 1999 was followed by a number of years of volatile performance. By 2002, FDI inflows had plunged by roughly 90% from 1997 highs and turned net negative for the first time (World Bank 2022).

The reasons for this reduction are multifaceted, but almost certainly rooted in the fear by investors of expropriation or other punitive measures against investment threatened by Chavez as a means to consolidate his power. After coming to power, the Socialist Party took a number of measures to weaken economic elites in the opposition and to consolidate power. These measures included actions such as doubling the royalty payments by oil companies to the government, restricting corporate ownership on key oil projects to a minority share, and replacing long-serving professionals in the state-owned oil firm Petroleos de Venezuela (PDVSA) with political supporters (even going to the outrageous length of televising their firings) (Washington Times

2002). These measures had the combined effect of choking off foreign investment. Declines in FDI inflows can often be temporary and may recover once investors adjust to the new policy environment. However, recovery from this reduction in Venezuela was inhibited by the continuous political competition over FDI policy which followed this initial shock.

In 1999, Chavez used his legislative majority to secure changes to election laws and executive oversight. Elections that July saw the opposition reduced to only six seats. Constitutional changes resulted in expansions in executive power, including powers of censorship, the ability to eliminate government institutions or unilaterally dismiss officials, as well as to overrule the judicial system. This resulted in the politicization of the judiciary and its de facto subordination to the executive branch (Diaz Reus 2022). Investors seeking to resolve disputes were thus at the mercy of whether they were politically favored.

This impacted investors because they could no longer bring investment disputes directly to the courts. Fortunately, the Commercial Arbitration Law of 1998, passed before Chavez took power, eliminated the prior requirement for judicial approval of arbitration disputes, meaning that arbitration could be binding and provide an alternative means of dispute resolution outside of the politicized courts. The result was that many investors sought to bring such disputes before the International Centre for the Settlement of Investment Disputes (“ICSID”). However, uncertainty around the degree to which the regime would respect ICSID rulings remained uncertain for years, as the state argued that such rulings were only valid with explicit and narrowly defined “prior consent” which it had not provided (Diaz Reus 2022).

Political opposition to measures such as these grew increasingly aggressive. By 2002, political competition in Venezuela had come to a head. The opposition party, known as “Coordinadora Democrática” (CD), launched an attempted coup with members of the military in

April of 2002. This action saw Hugo Chavez removed from power for roughly 48 hours before the coup was reversed. One of their principal goals was to roll back constitutional changes made after 1999. Despite the failure of the coup, the CD Party, along with its influential backers comprised of members of the business elite in Venezuela, still held significant sway over politics in Venezuela for years after. Following the coup attempt, they organized a series of crippling oil strikes in 2003 which further harmed economic prospects. In early 2003, Chavez created an Exchange Administration Board (CADIVI) to restrict the purchase and sale of foreign currency. Following elections in 2004, the opposition lobbied the regime to roll back legislative changes that were harmful to business, threatening additional strikes if demands were not met (Ellsworth and Forero 2004). All of this had a damaging effect on foreign investment inflows. Investors often operate in authoritarian markets where the state can easily disrupt markets, and are comfortable as long as they feel they can make money and the policy situation is likely to remain stable. However, bouts of policy instability such as this are poisonous to investment when legal protections are weak, because investors have little recourse if events turn against them.

In high profile ICSID investment dispute cases involving expropriation, such as one involving Mobil¹⁴ that was in arbitration from 2007 until 2010, the Venezuelan government argued that state companies were only subject to ICSID ruling with explicit “prior consent”. In this case ICSID held that any state-based companies in Venezuela must indeed formally consent to ICSID jurisdiction. This decision provides de facto cover from arbitration for almost all important Venezuelan firms when operating with foreign investors, because almost all important firms are state-owned or state-controlled. As is common in authoritarian states, in important or

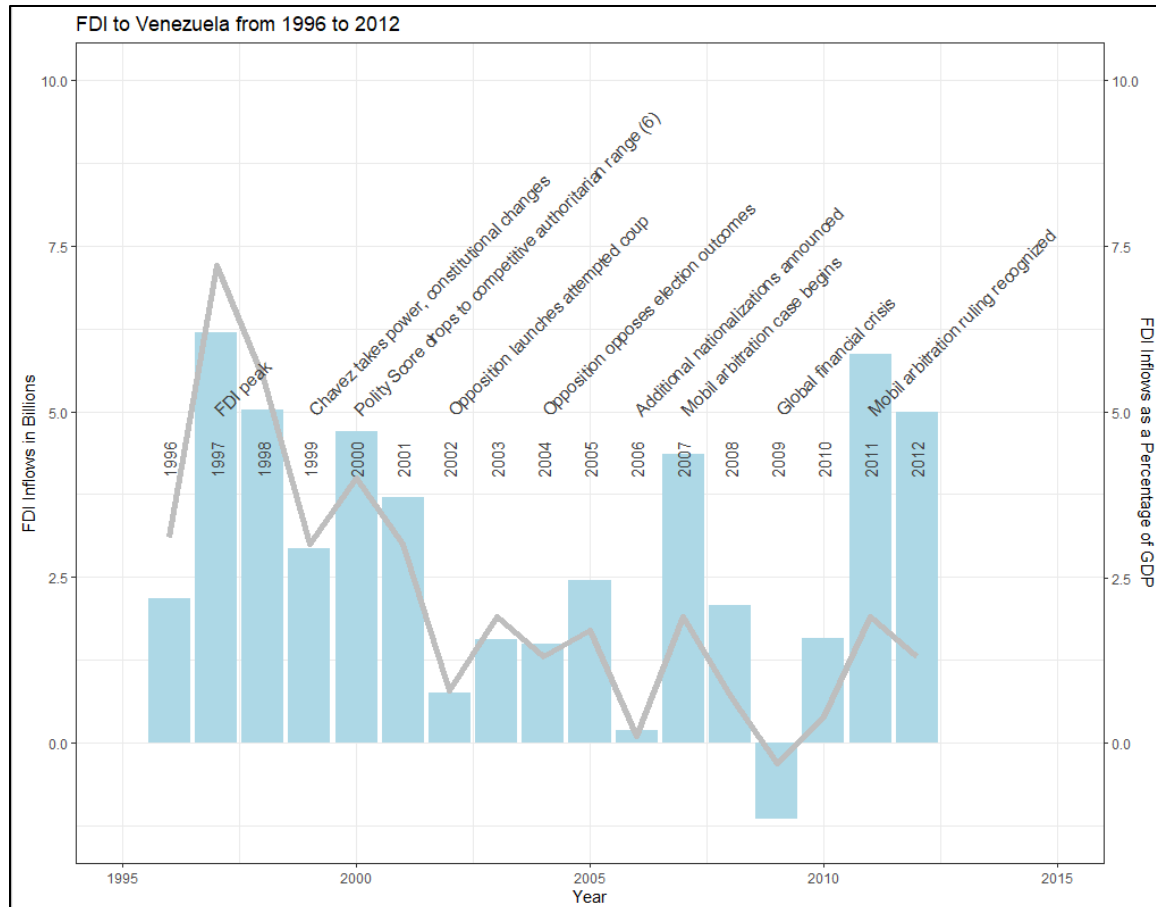
¹⁴ The Mobil case was actually the second largest case from 2007. The larger case, involving Conoco Phillips, was not decided until several years after the Mobil case. It was also found in favor of the investor.

sensitive sectors such as energy and media, Venezuelan law requires that either the Venezuelan state or nationals be majority owners. To further enforce this, in 2010, Venezuela enacted the “2010 Insurance Activity Law” requiring half of the board of directors of any Venezuelan company to be Venezuelan nationals or residents (Diaz Reus 2022). Nevertheless, this provided only partial coverage, and Venezuela was still found liable for damages stemming from violation of a bilateral investment treaty. Mobil was awarded \$1.6 billion in damages, a landmark finding.

The 2010 ICSID decision had a positive effect on investment in Venezuela because it reduced uncertainty around whether or not the Venezuelan state would respect ICSID rulings and provided some precedent for investor protection (Diaz Reus 2022). Investors could now stipulate consent to arbitration as a condition of a deal and have reasonable confidence that this would grant greater legal protection from ICSID. 2011 saw a resulting spike in foreign investment (further uncertainty in other areas quickly eroded these gains). The uncertainty around investment policy in Venezuela in the decade following Chavez’s rise to power are good examples of how weak institutions in authoritarian states create uncertainty for investors when political competition is present. The ability of the opposition to extract some concessions from the regime or even to seize power resulted in uncertainty on the part of investors as to how investment would be governed. The presence of a robust opposition that was more or less openly supported by many private investors and economic elites incentivized the regime to embark on further nationalizations and crackdowns. When institutional rules are uncertain or unprotected, changes in political fortunes will greatly impact investment, because the incumbent regime is incentivized to attack opposition businesses to punish enemies and reward allies. When political control is consolidated, policies, even if restrictive, are more predictable and thus investment is more viable. The counterfactual in this case would be a situation where Chavez faced little

resistance to his consolidation of power. This scenario may have actually resulted in greater FDI inflows, because foreign investors would have more certainty about the terms of investment, even if they were unfavorable. This is illustrated by the increase in investment following the Mobil ICSID case despite the unfavorable ruling.

Figure 6: Timeline of FDI Inflows to Venezuela



Source: World Bank

One crucial element of this saga is the role played by economic elites. The success of the CD Party was due almost entirely to its sponsorship by Fedecámaras, a business group which represents many of Venezuela's largest firms, many of whom were harmed by Socialist Party policies. Without the economic influence of Fedecámaras, the CD Party would not have been

able to extract concessions from political incumbents. Targeting these rival economic elites was a key priority for the Socialist Party. After gaining control of PDVSA, they consolidated control of the wholesale fuel sector, forcing full nationalization by 2008. They also targeted other key industries such as telecoms, electricity, and steel production. The Venezuelan firm Sidor Steel, majority owned by domestic economic elites and foreign investment from Argentina through a firm known as Techint, was nationalized in 2007, despite the lack of a purchase agreement with Techint and the threat of ICSID arbitration (Perez 2021). The presence of dissatisfied economic elites such as these was a key component of the policy uncertainty that was present in Venezuela during these nationalizations, because most of the viable political opposition to the regime was sponsored by these economic elites. These dissatisfied economic elites were also a source of uncertainty by virtue of the fact that they represented an attractive target for the Chavez Regime seeking to consolidate power and reward allies, meaning that they would pursue continual efforts to restructure the control of key economic assets in Venezuela, creating waves of disruption and uncertainty.

This role of economic elites is therefore crucial to this story about policy uncertainty. Following the conclusion to Chapter 4, Chapter 5 will examine this dynamic in greater detail, focusing specifically on the role of economic elites in determining policy uncertainty and FDI inflows by extension.

4.4 – Conclusion

Based on these results, it seems reasonable to conclude that political competition in authoritarian states has a dampening effect on FDI inflows, due to the uncertainty it creates in the minds of existing and potential investors. This finding is important for several reasons. Firstly, it helps us parse prior findings about the advantages and disadvantages of democratic governance

in relation to attracting FDI. When political competition occurs in weak institutional settings, it is likely to reduce investment as investors have less certainty over how politics will affect their prospects. The “democratic advantage” is not the result merely of increased political competition, but rather the constraint of such competition by strong institutions. Secondly, these findings highlight the economic danger faced by democratizing states (anocracies) that combine political competition with weaker institutions.

However, as I will demonstrate in the succeeding chapter, this variable (political competition) by itself is insufficient to provide a complete picture of what drives policy uncertainty in authoritarian states. Economic elites are a crucial part of the investment picture, and provide both a supplement and potentially a substitute for an examination of policy dynamics based on purely political measures. The role of dissatisfied economic elites in driving policy changes, both in isolation and as a multiplier to existing political opposition, is the focus of the succeeding chapter.

5 – Economic Elites and FDI Inflows: Empirical Findings

As the previous section established, the level of political competition is an important factor in predicting levels of FDI inflows. However, one of the key propositions of this dissertation is that this measure is insufficient to understand the phenomenon fully. The impact of political competition on FDI inflows can't be fully understood without accounting for the relative number of economic elites in the state. As I will demonstrate, this variable, which is typically excluded from similar models, is important both independently and in conjunction with political competition. There are two primary reasons that excluding this variable becomes problematic.

First, the exclusion of this measure leaves unexplained important variation in the level of policy uncertainty among states with nominally similar political systems. While measures of political competition can often adequately capture the presence of non-consensus among policy makers, oftentimes these dynamics are non-public in nature. As discussed in the previous chapter, the number of economic elites is an important factor in determining how many dissatisfied economic elites are likely to be present, and therefore in determining the level of policy predictability states that are otherwise politically similar. As this section will demonstrate, the inclusion of economic elites increases the fit of the model significantly, and the substantive effect on FDI inflows is comparable (if not greater) than that of political competition.

In addition to this, the number of (dissatisfied) economic elites and the degree of political competition are likely to exhibit conditional effects. In other words, when there are a relatively greater number of economic elites in a state, the presence of visible political competition is likely to amplify the effect that these elites will have on policy uncertainty. By contrast, when the state has a more concentrated, oligarchic character, formal political competition is less likely to

impact uncertainty around policies governing foreign investment. Phrased another way, political opposition provides a channel through which dissatisfied elites can seek to change policy.

5.1 – Approach to Testing H2

Similarly to H1, the H2 hypotheses also rely on foreign direct investment inflows as the primary dependent variable. The measures employed to estimate this are mostly identical to the measures used for H1. In this manner, the regression models presented in this chapter will essentially serve as a *re-testing* of the models in the previous chapter, but this time including a new independent variable in the model, aimed at estimating the number of dissatisfied economic elites. I argue that this variable is critically important to a full understanding of policy uncertainty and thus FDI inflows in non-democratic settings.

The primary explanatory variable explored in this chapter is the *number of dissatisfied economic elites*. The analysis of H2 relies upon measures of market consolidation to proxy for the relative number of dissatisfied economic elites in a state. Like many concepts in political science, measuring the number of economic elites in a particular state is quite challenging, and perhaps even more challenging than some political measures. Similar to trying to measure the size of a “winning coalition”, it is often easier by comparison to get a rough sense of whether a state has a large or small number of economic elites, as the symptoms of either such condition are often clear. Nevertheless, it is rather challenging to come up with an exact number. This is due to a number of factors, such as the private nature of such information about elite circles and variation between states in how economic elites may act or appear. By nature, the idea of an “economic elite” is somewhat nebulous in order to be sufficiently generalizable across states.

Despite this being the case, I propose that we can in fact get a reasonable estimate of this variable in many modern authoritarian states by examining the market share of the *largest* firms

in that state. As previously discussed, most economic elites are individuals in control of large firms, public or private. This raises the question of whether the raw number of firms is a valid substitute for the number of economic elites. Because individual firms vary significantly in size and significance to the overall economy, it would be incorrect to think of *every* firm in a state as being identified with an economic elite. Therefore, a better approximation of the relationship between these two concepts is to specifically consider the *largest* firms in the state as being associated with economic elites.

While not a perfect proxy, examining the relative share of stock market capitalization for top listed firms allows us to construct a rough measure of the number of economic elites in a state relative to its economic size. In authoritarian states, the number of economic elites relative to the size of the state's economic activity should correlate with the number of dissatisfied economic elites, because when a state has relatively more economic elites, their individual share of private benefits (benefits which in this case are derived from FDI) is diminished. By contrast, when most of the capital is concentrated with fewer firms in an authoritarian state, it is reasonable to expect that there will be fewer dissatisfied economic elites. This consolidation allows incumbent political leaders to focus on specific, narrow interests, thereby raising the individual share of private benefit for each economic elite. More satisfied economic elites results in more consistent policy, which in turn yields higher FDI inflows.

On average, listed firms are larger than non-listed firms, because most exchanges have listing requirements that remove small firms. This measure of top firm market (capitalization) share therefore provides a rough estimate of the relative distribution of large, conventional (i.e., concerned with FDI-related policy) enterprises in a state, which should be correlated with the relative number of conventional economic elites. For example, when a state has a market in

which the top five firms hold most of the capital, we can expect that such a state will have fewer actors that are considered economic elites than a state where the top five firms hold only a small share of overall capital. It stands to reason that markets that are dominated by top firms would have fewer top firms overall relative to markets where capitalization is spread more evenly. Using market share concentration to determine the relative number of firms in a market is also well-substantiated by literature on this subject. There is substantial literature using concepts such as the Herfindahl Concentration Index to identify oligopoly markets (see Appelbaum 1982, Farrell & Shapiro 1990, or Ukav 2017, among others).

Some types of economic elites are inherently more difficult to capture in a measure which looks solely at the number of large public firms. Aside from the obvious exclusion of private companies, large land enterprises may not have formal corporate structures. However, the number of private companies should be roughly correlated with the number of public companies in most modern states.¹⁵ An important exception is that in lesser-developed states, landowning enterprises may be an important gap in the data. I will account for this by splitting the sample along the lines of development and introducing a control variable as discussed earlier. Underdeveloped states with fewer conventional economic elites may not behave in the same way that developed states with fewer economic elites do. Regardless, this should be a minor issue in the succeeding analysis, as most states with functioning exchanges captured by this dataset are not underdeveloped.

¹⁵ This is largely substantiated by the economic literature on this subject. The number of listed companies in a state is well-understood as a development indicator which is correlated with the number of private companies (see Demirgüç-Kunt & Levine 1996). While there are few studies that look specifically at the correlation between *large public firms* and *large private firms*, it seems justifiable based on existing data to suspect that such a correlation exists.

I use stock market data to measure this concept. This data is available through the World Federation of Exchanges (WFE). The WFE is a trade association of publicly regulated stock, futures, and options exchanges. The WFE maintains publicly available data on firms which are traded on an exchange. Because many of these exchanges are located in authoritarian states, this data provides a good source of insight into the firm characteristics present in these environments. For equities, the WFE data contains information on the number and average size of listed firms. Similarly, data on debt markets contains state-level information on the number and listed value of debt-issuing firms and entities, as well as distinguishing between public- and private- sector issuers. The WFE data covers 33 nondemocratic states since 1980. While data was not available for all nondemocratic states present during the period studied, this subset contains a representative sample that covers states from a wide range of developmental stages, income levels, and geographic regions. My analysis also incorporates a battery of economic controls that help address any residual bias. A full listing of the states contained in the sample can be found in Appendix 3.

The first measure I use, Market Cap Share of the Top 5 Percent, measures the percentage of total market cap accounted for by top five largest firms by market cap percentage. The second measure, Market Cap Share of the Top 10 Firms, measures the percentage of total market cap accounted for by top ten largest firms by market cap size. Both measures range from 0 to 1, with 1 representing the respective group covering 100 percent of market share. States with more concentrated market cap should have fewer economic elites. A low percentage figure (less than

0.60) indicates many economic elites, while a high figure (greater than 0.70) indicates fewer economic elites.¹⁶

Control variables are also crucial for these tests. I include a standard battery of economic and political control variables taken from the World Bank in a manner similar to the previous chapter. Following the Li & Resnick (2003) model, I include GDP as a measure of market size, level of development, population size, exchange rate, and growth. Control variables will be discussed in greater detail along with regression results.

In sum, I use the relative market share of the top firms in a country's exchange as a proxy for the number of economic elites. This is a somewhat novel measurement approach. However, while not a perfect substitute, there is sufficient reason to expect that this measure is sufficiently correlated with the number of economic elites to serve in this capacity. Put simply, I propose that concentrated oligopoly markets are more likely to have small cliques of economic elites that are satisfied under an authoritarian system, where more diversified, competitive markets are more likely to host dissatisfied economic elites who would prefer policy changes. Because of the novelty to this approach, I use the following vignette to more fully illustrate the relationship between the concept of economic elites and the measurement I propose to employ.

5.1.1 – The Example of Kazakhstan

One case example which helps substantiate the association between large firm market share concentration and the number of economic elites that I discuss in the prior section is Kazakhstan. After achieving independence in 1990, the state has embarked on a more or less continuous journey of economic centralization. The result of this has been the formation of a

¹⁶ A histogram of the data can be viewed in Appendix 3.

tight clique of economic elites and political incumbents. Despite this, the country has been remarkably successful in attracting foreign investment, particularly to those sectors favored by elites. In fact, it is one of the best performing FDI destinations in central Asia.

The presence of a functioning stock exchange in Kazakhstan allows us to quantify this reduction in the number of economic elites through the market share variable. Beginning in 1990, the top five percent of firms in the exchange held approximately 57% market share, a value relatively close to the mean in the dataset. Over the course of the last thirty years, this share has consistently grown (excluding a brief interruption following the 2014 collapse in oil prices), and now sits near 75%, representing a significant concentration of economic power. This change has corresponded with a reduction in the number of economic elites in the state.

As reported by the Wall Street Journal following recent unrest in the country, Kazakhstan has been characterized by “businessmen close to the government amass[ing] huge wealth through privatization and ownership of natural resources” (Kantchev 2022). This cycle of investment and political favoritism has led to a concentration of economic elites in the state.

As of 2022, only 162 people account for 55% of total wealth in the country, according to a recent report by KPMG (KPMG 2022). The country has five billionaires in Forbes’s World’s Billionaires list, stemming from the oil, mining and banking sectors.

A quote from researchers Simon Commander and Ruta Prieskienyte from a recent paper at the IZA Institute of Labor Economics further illustrates this dynamic; “This system of decision-making continues to reflect the interests of a relatively small group of players, whether counted in terms of individuals or their business vehicles or holdings” (Commander & Prieskienyte 2021).

Kazakhstan offers a wide range of generous tax incentives particularly targeted towards foreign firms wishing to invest alongside domestic firms in industries like uranium mining and gas extraction. Many of these incentives involving joint partnerships are approved by a central committee under the Ministry of Industry and New Technologies (Consulate General of the Republic of Kazakhstan 2022). One example is the joint partnership between Kazakh firm Kazatomprom and foreign enterprises such as Orano SA centered around uranium extraction (Orano 2022). The former CEO of Kazatomprom, Galymzhan Pirmatov, is a close ally of Kazakh President Kassym-Jomart Tokayev, and was appointed head of the national bank after his tenure as CEO concluded. Prior CEOs, such as Kazakh billionaire Mukhtar Dzhakishev, are also well-known to have been closely tied in with the country's political elite (Reuters 2020).

This case provides a particularly helpful example of how relatively high market share of top firms in a state are often reflective of that state having relatively fewer, more influential economic elites. It also provides a good example of how those remaining economic elites wield political influence to incentivize investment into enterprises they control. Following the empirical analysis, I will return to this case to provide additional qualitative context to the outcomes observed in the data.

5.2 – Analysis of H2

The fundamental claim of H2 is that authoritarian states with fewer economic elites exhibit greater FDI inflows, because policy is more predictable (H2a). However, it is also clear that the primary independent variable, the number of economic elites, may share a conditional relationship with the primary independent variable for H1, the level of political competition (H2b). Before examining these claims directly, I develop a preliminary exploration of the data to more fully exhibit the measures I propose to use.

5.2.1 - Exploration of the Data relating to H2

As a measure for the number of economic elites in a state, I used the WFE measure for the total market capitalization share of the top 10, or top 5 percent, largest firms in an exchange. Because large states with large exchanges have more firms, the top five percent will vary in whether it is more or less than the top 10 firms as an absolute number. In cases where it was greater than 10, I defaulted to this figure. Among the sample, the values ranged from 15 percent, which occurred in Mexico, (indicating a very egalitarian market with relatively more economic elites) to 95 percent, which occurred in Zambia (indicating a very consolidated market with relatively few economic elites). The mean for the sample was approximately 62 percent.

Initial examination of the WFE data supports the proposition that the top firm market share measure provides a good estimate of the relative number of large firms. Another measure included in the data I use is the total number of domestic firms listed on local exchanges. This provides an alternative rough estimate of the number of large firms within the state (due to the size-based listing requirements discussed earlier). Examining this measure against the market capitalization share of top firms, a clear negative relationship is observed, both through a basic correlation measure and a simple linear regression.¹⁷ This indicates that states where top firms dominate the market tend to have fewer large firms in general, and therefore fewer economic elites.

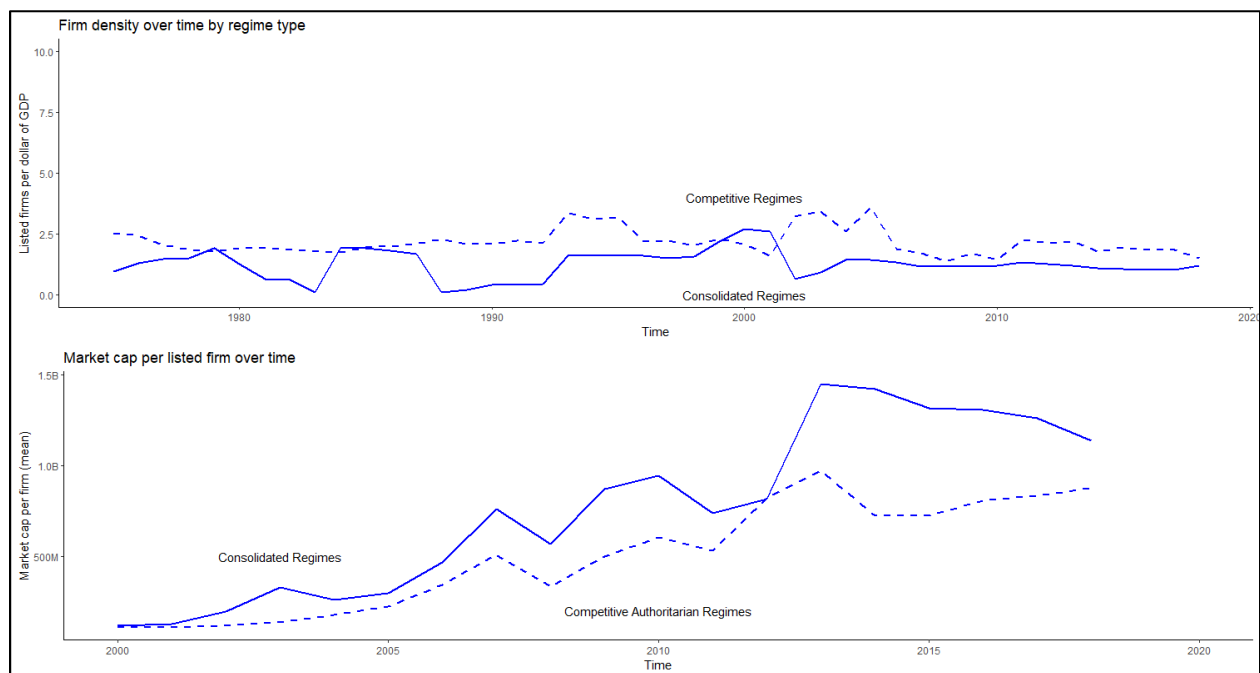
Examining the data also shows a clear pattern between political competition and the relative number of economic elites, and thus helps build support for the idea that the number of economic elites is not only associated with the level of political competition, but may also be

¹⁷ The correlation between the number of listed domestic firms per dollar of GDP and Large Firm Market Share was negative 0.14.

useful as an independent measure of the elite dynamics that produce policy uncertainty (as proposed by H2).

Figure 7 illustrate observations across a period of ten years (2008-2018) of 39 authoritarian states.¹⁸ This period represented the largest number of observations in the overall data. The states are bifurcated by regime type. The dark lines are the LOESS moving average values of consolidated authoritarian states (-10 to -5 on the Polity scale), and the dashed lines are the same values for competitive authoritarian states (-4 to 5 on the Polity scale). The top panel depicts the average listed firms per dollar of GDP over the sample period, and the bottom panel depicts the average market capitalization over the sample period.

Figure 7: Firm Concentration and Regime Type



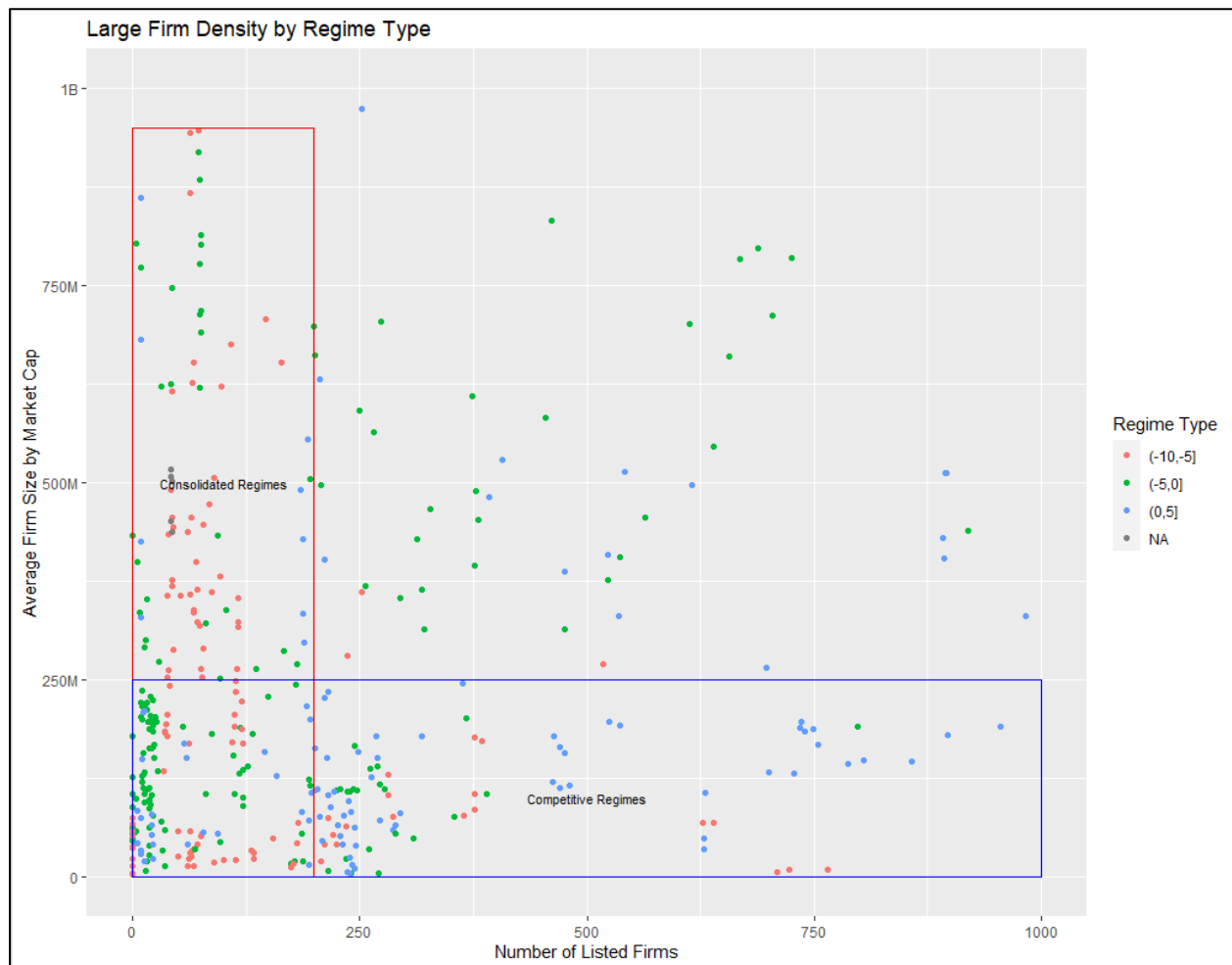
Source: World Bank, World Federation of Exchanges, Center for Systemic Peace

¹⁸ The data used for Figures 7 and 8 contains six additional authoritarian states for which there was listed firms and market capitalization data, but did not have data on top firm shares.

As the figure illustrates, the consolidated authoritarian regime has fewer firms that are larger on average. In contrast, the competitive regime features a greater number of firms that are smaller on average.

This is illustrated differently in Figure 8, which shows the mean clusters of state cases (for example, “Vietnam 1999”) in the sample. The x-axis depicts the average firm size by market cap for that case, and the y-axis depicts the number of listed domestic firms for the same case. The colors represent the regime type as coded by Polity Score. The orange plots represent the most consolidated state cases in the sample, and the blue plots represent the most competitive state cases in the sample (green plots are cases with mid-range scores). By bounding the mean cluster within a box of the same color, we observe that the consolidated cases have fewer, larger firms, similar to what was found in the earlier figures.

Figure 8: Large Firm Density by Regime Type

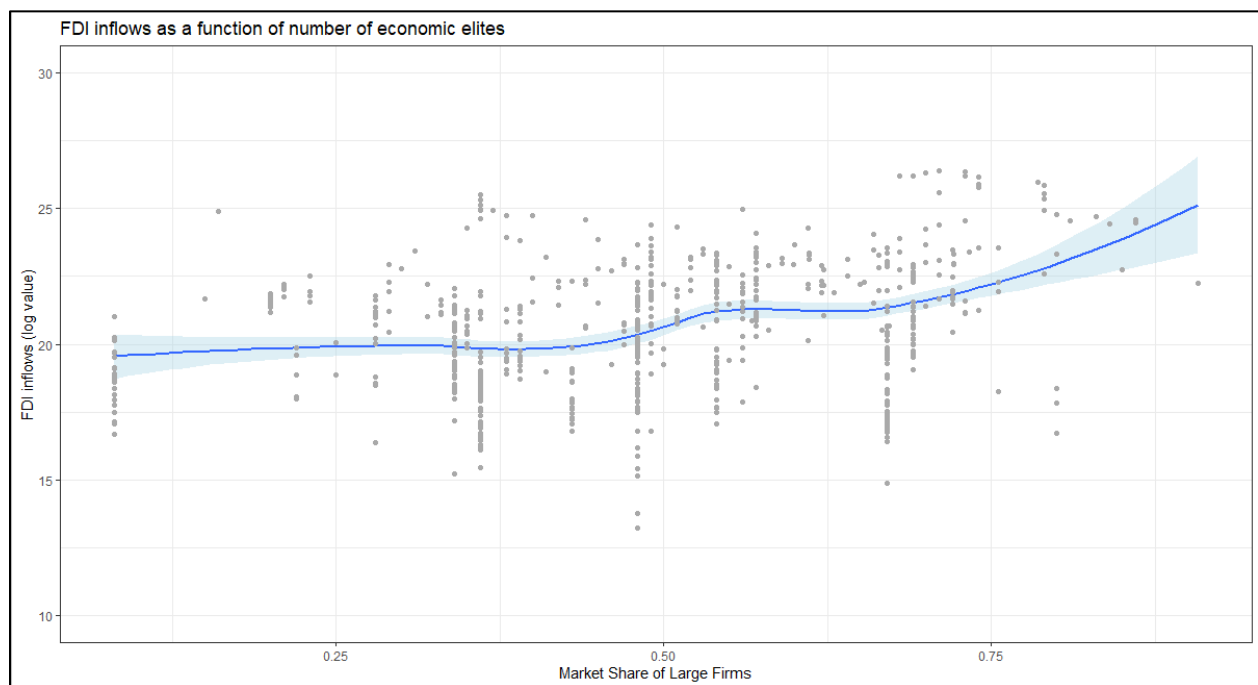


Source: World Bank, World Federation of Exchanges, Center for Systemic Peace

Both of these figures support the idea that consolidated states have fewer economic elites that will take a larger share of private benefits, and that generally speaking, the firms in consolidated states grow larger. They build support for the idea that the number of economic elites is useful as its own independent measure of the elite dynamics that produce policy uncertainty (H2a). Because the largest mean firm sizes tended to be observed in politically consolidated states with few economic elites, the figures also suggest a conditional relationship between political competition and the number of economic elites (H2b).

In Figures 9 and 10, I examine the relationship between the number of economic elites and FDI inflows directly, and indeed find that it is comparable to measures of political competition in its usefulness at predicting the level of policy uncertainty and resulting impact to FDI inflows. Figure 9 below provides an illustration of the relationship between the market share of large exchange-listed firms in a state, which is a proxy measure for the number of economic elites, and the logged level of FDI inflows. As the figure shows, a distinct positive relationship is present, and is most pronounced when elite firm consolidation is greater than 0.40. This indicates support for H2a.

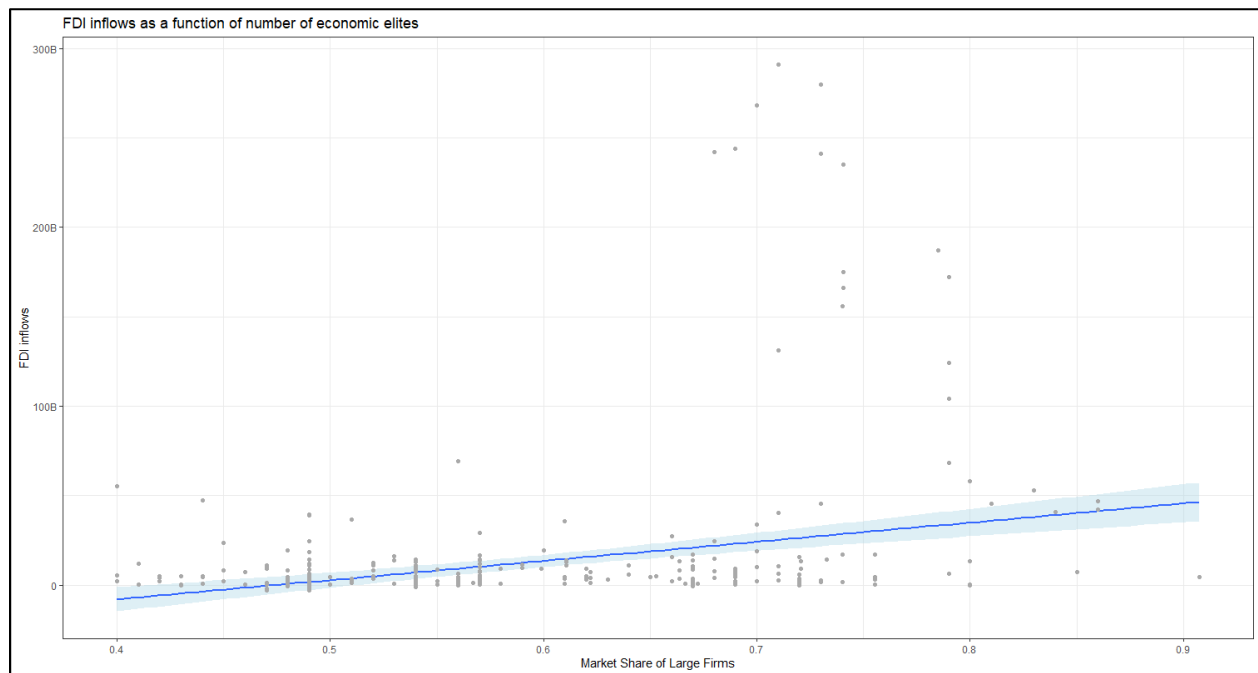
Figure 9: FDI Inflows and Economic Elites (LOESS)



Source: World Bank, World Federation of Exchanges

Figure 10 uses a linear estimation method and non-logged FDI inflows and shows a subset of the sample between the values of 0.40 and 1. Some of the larger values around the 0.70 range represent China case years, but with these values removed, the overall trend still holds, albeit at a slightly lower level of statistical and substantive significance.

Figure 10: FDI Inflows and Economic Elites



Source: World Bank, World Federation of Exchanges

Together, this preliminary analysis of the data provides validation of the measurement approach for H2, as well as initial support for the claims made in H2a and H2b. The next sections will provide rigorous examination of both hypotheses using regression analysis.

5.2.2 – Regression Analysis for H2a

My specification approach for H2a models is to use ordinary-least-squares (OLS) regression models with fixed effects for time (by year). I employ a state-level model of FDI inflow levels, similar to the model used in H1.

I specify the following basic models of state-level FDI inflows to include my primary measure of the number of economic elites, which is large firm market share. When a few large firms dominate a market, we can expect that there will be fewer economic elites. As with the prior models in Chapter 4, I rely on a model specification similar to that in Li and Resnick

(2003). The full replication of their model to include exchange rate and growth can be found in Appendix 3. The specification for the primary model (model 3) is:

$$FDI\ Net\ Inflows_{it} = B_0 + B_1 Large\ firm\ market\ share_{it} + B_2 \log(GDP)_{it} + B_3 Oil\ Rents\ Share\ of\ GDP_{it} + B_4 \log(population)_{it} + B_5 Underdevelopment\ dummy_{it} + B_6 Polity\ Score_{it} + C_t + e_{it}$$

Table 4 demonstrates the positive relationship between the market cap share of the top ten firms in country's exchange (which serves as a proxy for the relative number of economic elites in that state), and FDI inflows. In the primary model, a positive move across the range of values for Large Firm Market Share produces an increase in FDI inflows of approximately \$18.6 billion USD (model 4). Using the standard deviation for Large Firm Market Share to construct a more plausible expected change, the standard deviation of 0.20 produces an expected increase of approximately \$3.75 billion USD. As discussed in the previous chapter, this represents a substantively significant movement for most states in most years. Notably, the model fit is improved from the Polity Score model in the previous chapter. In the two simpler models (models 1 and 2), the effect is also statistically and substantively significant, to an even greater degree than in the full model. The results here are shown using raw dollar figures for FDI net inflows, for ease of interpretation. However, it is important to note that these results are similar when normalizing FDI inflows through the use of the logged value. These alternative results can be found in Appendix 3.

When the number of economic elites is greater, here measured by a lower figure for the market cap share of the top ten firms, there is a decrease in FDI. This indicates that oligarchic states, or those with relatively fewer economic elites relative to economic activity, have greater FDI inflows. This finding indicates that a greater number of economic elites increases policy uncertainty. When there are more economic elites competing over scarcer private benefits from

FDI inflows, there is more likely to be competition over policy and thus changes to policy, which increases investor uncertainty.

This relationship is likely to hold regardless of what sector the elites are in. For example, in two hypothetical authoritarian economies where all firms are part of the secondary sector, the state with fewer economic elites should outperform the state with more, as the latter will have greater policy uncertainty. In other words, this is not merely the effect of industry concentration.

The models incorporate several control variables. As before, the logged value for GDP serves as a measure of the primary economic determinant of FDI inflows in the model. Notably, the effect is several times larger in this model than in the H1 models. I also include a control variable for underdevelopment, defined as extremely low GDP per capita (below \$1000 USD). These undeveloped states are likely to receive less FDI simply because poor infrastructure and levels of human capital prohibit much investment. Furthermore, as discussed in the theory section, these states are both more likely to be highly autocratic and more likely to have incentives towards investment that are nonconventional. The observed effect of this variable is indeed negative in each model where it appears, but not quite statistically significant at the 90% confidence interval threshold. I also include a control variable for the size of the population. States with large populations are likely to have both more economic elites and also more FDI. Interestingly, the effect of this variable is found to be negative after controlling for GDP, indicating that (all else equal) larger states received *less* FDI. However, this effect was not significant in the full model.

The last control variable is political competition (as measured by Polity Score), included from the first model. Due to the negative covariance¹⁹ between these variables (i.e., on average, states that are politically competitive also have relatively more economic elites as measured by smaller large firm market share), including this measure is important. Models 1 and 2 show effects without the political competition variable, and Models 3 and 4 include the variable. As in the H1 models, the measured effect for Polity Score is statistically and substantively negative, in this instance to a greater degree than in the H1 models. The effect of oil rents as a share of GDP is also consistent from the prior chapter, again with a larger effect. I also substituted Polity Score with the Electoral Democracy Index, and the effect for Large Firm Market Share was roughly the same (slightly larger in substantiveness), and the effect of the Electoral Democracy Index was statistically and substantively negative as in the H1 models. The last model, Model 4, shows the results using the Electoral Democracy Index instead of Polity Score as the measure of political competition. The results are similar for both Large Firm Market Share and political competition.

The reason for the control variables from H1 having larger effects in these models is likely due to the fact that the number of observations were limited by the states for which there were Large Firm Market Share observations, which tended to be larger, more developed states, leading to the average values being larger.

¹⁹ This value was approximately negative 0.10.

Table 4: Economic Elites and FDI Inflows

	<i>Dependent variable:</i>			
	Foreign direct investment net inflows (millions)			
	(1)	(2)	(3)	(4)
Large Firm Market Share	19,189*** (5,803)	16,813*** (5,958)	12,373** (5,979)	18,638*** (6,008)
log(GDP)	14,088*** (1,384)	13,704*** (1,429)	12,699*** (1,431)	13,130*** (1,452)
log(population)	-3,229*** (1,040)	-2,429** (1,114)	-1,617 (1,117)	-2,412** (1,111)
Oil rents	-535*** (90)	-620*** (95)	-813*** (105)	-730*** (109)
Underdeveloped		-8,499 (6,536)	-10,078 (6,463)	-9,030 (6,524)
Polity Score			-1,118*** (273)	
Electoral Democracy Index				-14,857** (7,199)
Observations	660	640	640	640
R ²	0.279	0.294	0.313	0.299
Adjusted R ²	0.229	0.242	0.261	0.246
F Statistic	59.613*** (df = 4; 616)	49.537*** (df = 5; 595)	45.184*** (df = 6; 594)	42.217*** (df = 6; 594)

Note:

*p<0.1; **p<0.05; ***p<0.01

The next table, Table 5, provides another illustration of the relationship using an alternative measure of FDI taken from the International Trade Centre instead of the World Bank. This data includes gross FDI inflows, as well as annual outward FDI flows and FDI stock. I examine gross inflows, which provides an alternative to the net inflows measure from the World Bank. While the number of observations is reduced by the limitations of this smaller dataset, the basic relationship holds. The substantive effect of a move across the range of large firm market share values is larger, equating to a roughly \$20 billion USD increase in gross FDI inflows.

In these models, the performance of the control variables is similar to their performance in the previous models. Notably, the effect of the underdevelopment variable is reversed. In the final model, which uses Electoral Democracy Index as the measure of political competition, statistical significance was reduced.

Table 5: Economic Elites and FDI Inflows (Alternate Measure)

	<i>Dependent variable:</i>			
	Total FDI (alternate measure, millions USD)			
	(1)	(2)	(3)	(4)
Large Firm Market Share	22,044* (12,689)	24,541* (12,440)	23,482* (12,159)	9,399 (14,340)
log(GDP)	20,555*** (2,640)	23,186*** (2,755)	22,448*** (2,705)	22,115*** (2,774)
log(population)	-6,033*** (2,065)	-7,839*** (2,124)	-8,427*** (2,086)	-3,579 (2,952)
Oil rents	-259 (174)	-209 (171)	-519** (201)	139 (240)
Underdeveloped		39,617*** (14,511)	46,023*** (14,365)	36,907** (14,406)
Polity Score			-1,593*** (576)	
Electoral Democracy Index				45,345** (22,086)
Observations	164	164	164	164
R ²	0.600	0.620	0.640	0.632
Adjusted R ²	0.534	0.555	0.575	0.565
F Statistic	52.482*** (df = 4; 140)	45.412*** (df = 5; 139)	40.923*** (df = 6; 138)	39.421*** (df = 6; 138)

Note:

*p<0.1; **p<0.05; ***p<0.01

The final table, Table 6, shows the relationship with a third measure of the dependent variable, FDI as a percentage of GDP. Once again, a negative relationship between FDI and the number of economic elites is indicated. Here, a move across the range of values predicts an increase of roughly 17-19% in FDI inflows as a percentage of GDP. Using the standard deviation of 0.2, this figure was a roughly 4% increase in FDI inflows as a percentage of GDP. Again, this indicates that more-oligarchic markets were associated with higher FDI inflows for autocratic states.

Using this measure as the dependent variable helps reduce the selection effect of having fewer observations and provides a better estimate of the substantive effect. The performance for all of the control variables was similar, aside from Polity Score, which saw a reversal in marginal effect. Interestingly, this indicates that after controlling for the other variables, this measure of political competition was associated with higher FDI inflows when measured as a percentage of GDP. This effect was also found using the Electoral Democracy Index in place of Polity Score. This may indicate that lower income states played a larger role in determining the overall effect of this variable in these models, and that the negative effects of political competition, after controlling for these other variables, are felt most significantly in higher-income states.

Table 6: Economic Elites and FDI Inflows as a Share of GDP

	<i>Dependent variable:</i>			
	Foreign direct investment net inflows % of GDP			
	(1)	(2)	(3)	(4)
Large Firm Market Share	17.568*** (5.633)	17.469*** (5.835)	19.583*** (5.918)	12.846** (5.761)
log(GDP)	2.357* (1.344)	2.740* (1.399)	3.218** (1.416)	4.195*** (1.392)
log(population)	-4.348*** (1.010)	-4.862*** (1.091)	-5.249*** (1.106)	-4.905*** (1.066)
Oil rents	-0.412*** (0.087)	-0.407*** (0.093)	-0.315*** (0.104)	-0.127 (0.105)
Underdeveloped		7.691 (6.401)	8.442 (6.397)	9.034 (6.256)
Polity Score			0.532** (0.270)	
Electoral Democracy Index				37.642*** (6.904)
Observations	660	640	640	640
R ²	0.083	0.086	0.092	0.130
Adjusted R ²	0.019	0.019	0.023	0.064
F Statistic	13.944*** (df = 4; 616)	11.231*** (df = 5; 595)	10.054*** (df = 6; 594)	14.766*** (df = 6; 594)

Note:

*p<0.1; **p<0.05; ***p<0.01

One possible alternative explanation for the findings for Large Firm Market Share in this set of models using FDI as a percentage of GDP as a dependent variable measure, is that the presence of a market concentrated to just a few large firms and foreign investment comprising a large share of GDP could both be signs of economic underdevelopment and not indicative of a political dynamic. However, as described previously, economic underdevelopment is not necessarily always accompanied by highly concentrated markets dominated by a few economic elites. The association between this arrangement and authoritarianism illustrated earlier is an indication rather that this phenomenon is in fact caused by political favoritism, or a “state-directed” approach to development in which political elites steer foreign capital towards allies. Significant underdevelopment is also controlled for in this regression in part to mitigate this effect. This is discussed further in the alternative explanations section (5.2.4).

5.2.3 – Regression Analysis for H2b

The next regressions presented here are a test of H2b, the interactive effect between the number of economic elites and the presence of political competition. These tables illustrate a negative interactive relationship between the number of economic elites and the level of political competition, where states in which the number of economic elites is smaller show a greater negative marginal effect of political competition on FDI. Stated another way, the negative marginal effect on FDI of have more economic elites becomes greater as states become politically competitive. In less technical terms, this means that for authoritarian states, more political competition and a greater number of economic elites have a larger negative impact on FDI inflows when they occur simultaneously than when they occur separately.

My specification approach for H2b models is to use ordinary-least-squares (OLS) regression models with fixed effects for time (by year). I employ a state-level model of FDI

inflow levels, similar to the model used in H1 and H2a. The measure for market share of large firms is inverted for ease of interpretation (an inverted variable means that *lower* values now indicate a more oligarchic market).

I specify the following basic models of state-level FDI inflows to include my primary measure of the number of economic elites, which is large firm market share, as well as a measure of political competition.²⁰ The primary intuition is that when states have relatively more economic elites (now represented by a higher value using the inverted Large Firm Market Share scale), political competition will be more damaging to FDI inflows. The specification for the primary model shown below is:

$$FDI\ Net\ Inflows_{it} = B_0 + B_1 Large\ firm\ market\ share\ (inverted)_{it} * Political\ Competition_{it} + B_2 Large\ firm\ market\ share\ (inverted)_{it} + B_3 Political\ Competition_{it} + B_4 \log(GDP)_{it} + B_5 Oil\ Rents\ Share\ of\ GDP_{it} + B_6 \log(population)_{it} + B_7 Underdevelopment\ dummy_{it} + C_t + e_{it}$$

The results of this model, using all six measures of political competition, are presented in Table 7 below.

²⁰ The Polity Score Variable contains negative values, but can be rescaled by adding 10 to each value. This makes no difference to the reported results.

Table 7: Economic Elites and FDI Inflows Conditional on Political Competition

	<i>Dependent variable:</i>					
	Foreign direct investment net inflows (millions)					
	(1)	(2)	(3)	(4)	(5)	(6)
Mktshare(inverse)*Polity Score	-2,071* (1,222)					
Mktshare(inverse)*Political Competition		-100 (1,097)				
Mktshare(inverse)*Electoral Democracy Index			-97,848*** (29,254)			
Mktshare(inverse)*Multiparty Elections				-6,958 (10,173)		
Mktshare(inverse)*Legislature Opp. Parties					-3,420 (4,711)	
Mktshare(inverse)*Opp. Party Autonomy						-2,899 (4,168)
Mktshare(inverse)	-22,286*** (7,235)	-18,560*** (6,204)	8,594 (10,554)	-19,535*** (5,832)	-21,593*** (6,224)	-15,642*** (5,889)
Polity Score	-182 (578)					
Political Competition		-127 (513)				
Electoral Democracy Index			9,228 (10,279)			
Multiparty Elections				2,160 (4,459)		
Legislature Opp. Parties					-2,901 (1,876)	
Opp. Party Autonomy						-5,439*** (1,637)
log(GDP)	13,728*** (1,418)	13,948*** (1,405)	13,821*** (1,396)	14,068*** (1,386)	12,007*** (1,507)	15,310*** (1,354)
log(pop. ages 15 to 64)	-2,603** (1,042)	-3,120*** (1,054)	-2,666** (1,042)	-3,179*** (1,044)	-2,172** (1,068)	-5,635*** (1,075)
Oil rents % of GDP	-713*** (100)	-538*** (90)	-694*** (104)	-536*** (90)	-670*** (96)	-826*** (98)
Observations	660	660	660	660	660	660
R ²	0.300	0.280	0.298	0.280	0.295	0.328
Adjusted R ²	0.248	0.228	0.246	0.227	0.244	0.279
F Statistic (df = 6; 614)	43.795***	39.855***	43.388***	39.732***	42.900***	50.021***

Note:

* p<0.1; ** p<0.05; *** p<0.01

The measure for the number of economic elites, Large Firm Market Share, is used here with its inverse values. As such, states with a value of 1 would be scored 0, and vice versa. This creates the expectation of a *negative* relationship between the variable, which now measures the degree to which a market is *not concentrated* to the largest firms, and FDI inflows. The reason for this is to orient the marginal effect in the same direction as the political competition measures, which eases the interpretation of the results. If the effects are multiplicative, the marginal effects of the interaction terms should be negative, which indeed they are.

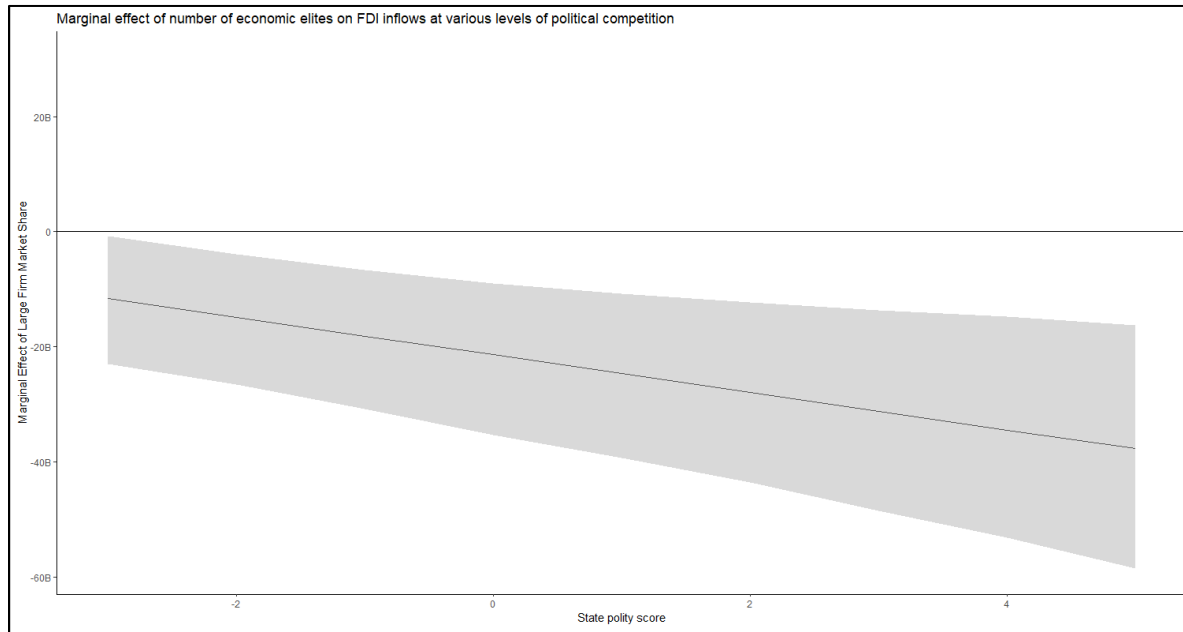
In each of the models (five out of six) where the independent marginal effect of Large Firm Market Share is statistically significant, the effect on FDI inflows is negative, indicating that less-oligarchic markets are associated with less FDI inflows. The interaction terms associated with the primary measures of political competition, Polity Score and Electoral Democracy Index, are also statistically significant in the expected direction, while the other variables are outside the margin of significance. This indicates that these variables are multiplicative of each other's marginal effects. The independent marginal effects of the measures of political competition all lose their statistical significance, aside from the ordinal variable measuring opposition parties' presence in the legislature.

The results for the control variables in these models are in line with the expectations taken from previous models. For robustness, I also generated alternative models using a dummy variable for the level of Large Firm Market Share. These results are similar to the results using a continuous variable and can be viewed in Appendix 3.

The figures below provide an illustration of these interactive effects. Figure 11 illustrates the effect of having a relatively greater number of economic elites (cases where Large Firm Market Share was below 0.75) across the range of Polity Score values in the sample. As the

figure illustrates, greater political competition increases the size of the negative effect. The highest value for political competition corresponded with a negative marginal effect on FDI inflows of roughly \$20 billion USD expected from a move across the range of market share values (\$4 billion USD using the standard deviation).

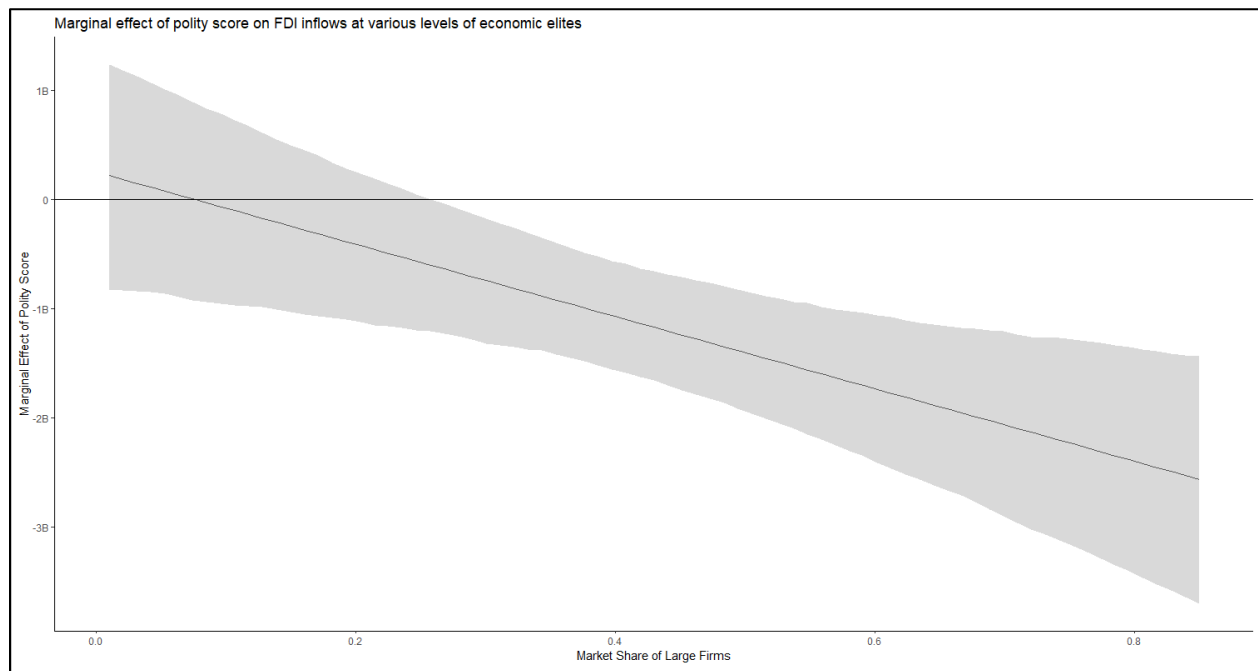
Figure 11: FDI Inflows and Economic Elites Conditional on Political Competition



Source: World Bank, World Federation of Exchanges, Center for Systemic Peace

Figure 12 shows the other side of the interactive effect. When the state has very few economic elites, as measured by a high market share for elite firms, the marginal effect of increases in political competition as measured by Polity Score is nonsignificant. At a greater number of economic elites, however, this effect becomes decidedly negative. This is important because it illustrates clearly that the impact of political competition on FDI inflows is moderated to a large degree by whether or not there are also dissatisfied economic elites seeking policy change. The findings in H1 of an independent effect for political competition likely occurs at least in part because many states with low political competition also tend to have oligarchic market structures.

Figure 12: FDI Inflows and Political Competition Conditional on Economic Elites



Source: World Bank, World Federation of Exchanges, Center for Systemic Peace

Together with the table, these findings provide support for the hypothesis that the marginal effect of having a greater number of economic elites is more negative when political competition is present. Stated another way, authoritarian states with more economic elites will exhibit less total foreign direct investment inflows when more political competition is present.

What these findings make clear is that the concentration of economic activity to fewer elite actors reinforces political consolidation as political leaders need the support of fewer parties to retain influence and political competitors are less relevant without economic elite allies. This explains why the effect of political competition is more disruptive to investment inflows when it is combined with the influence of a greater number of economic elites who can support their aims.

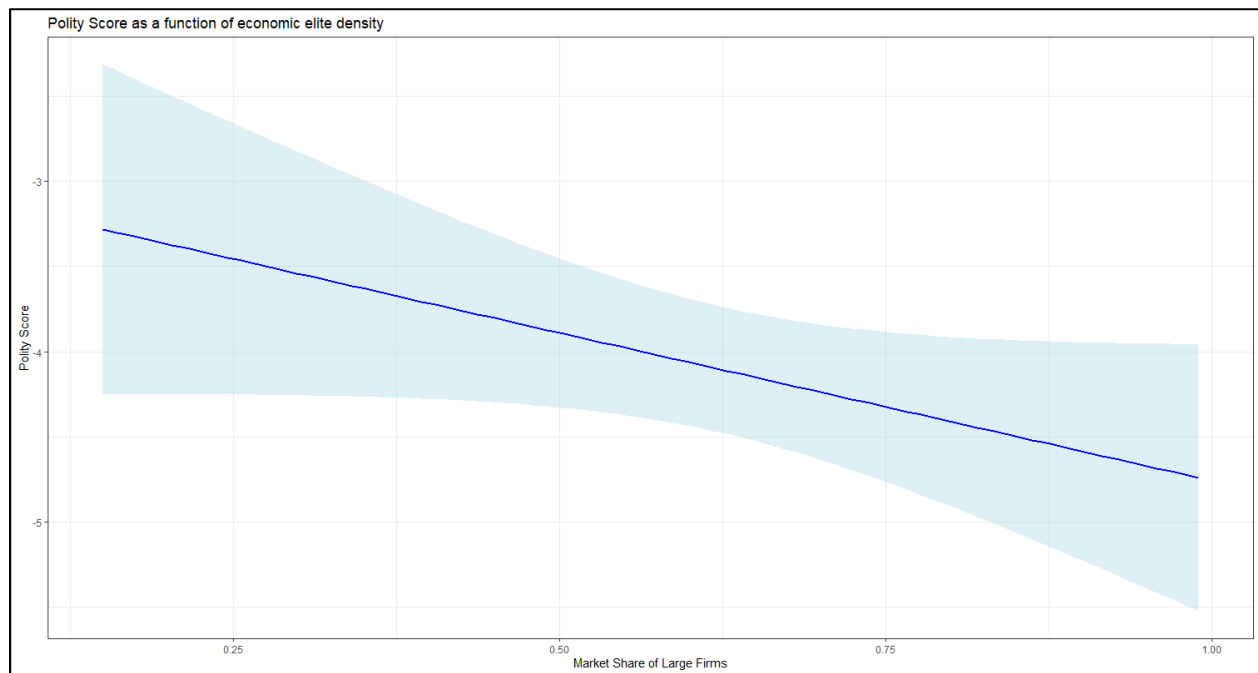
Similarly, political consolidation likewise appears to support the consolidation of economic elites. When political leaders are more enabled to direct favors towards economic elite

allies, these allies can grow to dominate markets more easily and sideline competitors who have no political patron. This helps explain why a greater number of economic stakeholders is more disruptive to investment inflows when the competing elites are more easily able to find political patrons (i.e., when there is greater political competition). However, it should be said that economic elites are more easily able to conjure up political allies than the reverse case, where political leaders will be hard pressed to create more economic elites.

In these ways, the interaction between economic elites and political competition is not just multiplicative in the way that H2b describes, but the two sets of actors actually reinforce one another in a way that could be causal, particularly economic elites leading to more political competition. In other words, the number of economic elites is a leading indicator of political competition, and when there are more economic elites, it will lead to greater political competition. Fully exploring this relationship between the two independent variables is beyond the scope of this dissertation, but it bears emphasis here as a point for future study. An analysis of my data finds that while the two variable measures are correlated (the measure for political competition is positively correlated with the measure for the number of economic elites), this correlation is weak (less than 0.1).

The illustration in Figure 13 below provides a measure of the association between political competition and the number of economic elites. In Figure 13, the x-axis displays the market share of the top 10 listed firms, and the y-axis depicts the average corresponding Polity score of the state. The figure provides a clear indication of a negative relationship. This supports the idea that greater political competition in authoritarian states often coincides with a larger number of economic elites jockeying for a share of limited private benefits.

Figure 13: Political Competition and Economic Elites



Source: World Federation of Exchanges, Center for Systemic Peace

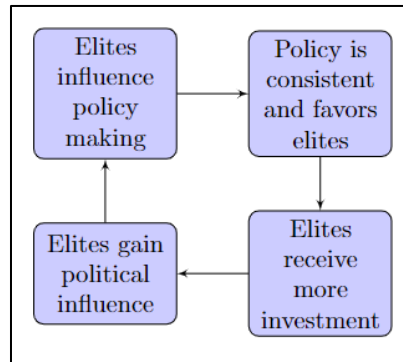
5.2.4 – Alternative Explanations

Here I will discuss in greater detail some possible alternative explanations for the findings in this chapter. After explaining these issues conceptually, I will develop some additional tests which help bolster the explanations I propose above.

First, FDI inflows can drive the growth of certain firms, leading to them gaining a larger relative share of market cap. This suggests a reverse causality between the dependent and independent variables, where high FDI increases the market share of large firms. In truth, this is part of a feedback loop that begins with political favoritism towards economic elites, which is what is further examined in H3. Figure 14 below summarizes this feedback loop. While this is an interesting observation, it should be distinctly understood that in the theoretical framework posited here, the original cause of higher FDI inflows is the *policy consistency* that results from a consolidation in elite interests, not merely the presence of a few large firms. FDI inflows create

economic consolidation primarily when they are politically directed to provide private benefits. The idea of FDI being the sole driver of economic consolidation has limited theoretical support in the literature. In addition, the use of a lagged independent variable helps to address this concern from an empirical standpoint (see Appendix 3).

Figure 14: Alternative Explanation for H2



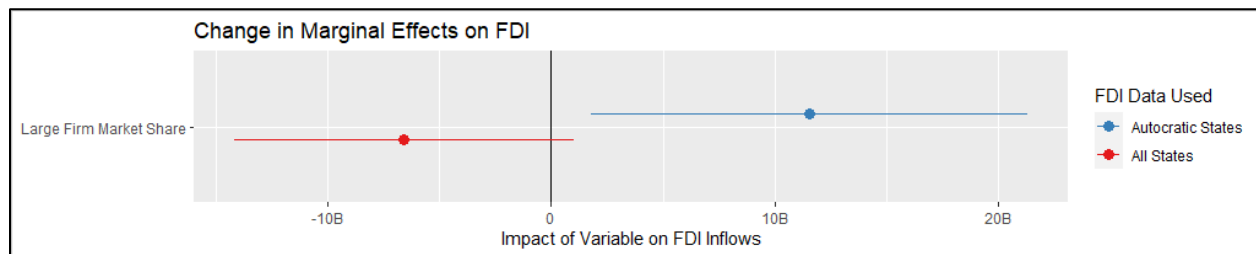
Another alternative explanation is that comparative advantage due to endogenous economic endowments results in more FDI to a small subset of firms, which then come to dominate the market. In this case, states with concentrated economies would be inherently more attractive as investment destinations because such concentration indicates economic success. While this is an interesting idea, it falls into question when we consider the number of similarly endowed democratic states in which there is a particularly competitive sector and yet the market is still quite diverse. Among typical examples of states with dominant sectors are Taiwan and South Korea, in which the top 5% of firms have roughly 40% and 58% market share on average over the sample period, respectively, which are relatively low figures. This diversification does not seem the result simply of economic development either. Less developed democratic states are often similarly diverse, such as the Philippines with 55% market share on average for top firms. Meanwhile, states like Vietnam have top firm market shares closer to 70%. Similar highly

authoritarian states tend to have similarly high measures, for example Kazakhstan at roughly 80% and Saudi Arabia at roughly 90%.

A final alternative explanation worth addressing is related to export performance and the structure of demand for intermediary goods. In this case, states with larger secondary sector firms require more FDI as intermediary goods to production of goods for export. This is closely related to the points made previously about why competitive secondary sector performance typically requires more FDI. However, this observation is similar to the previous alternative explanations discussed in that it describes a reason why states with large (secondary sector) firms would attract more FDI, but fails to explain why the presence of these large firms would crowd out the presence of large firms in other sectors.

Another way to assess whether these alternative explanations are likely to be true is to examine a dataset with democratic states included. If the first alternative explanation is correct, we should see FDI inflows as being generally predictive of Large Firm Market Share. If the second alternative explanation is correct, we should see Large Firm Market Share as being positively associated with FDI inflows (as it was for H2a) for *all states including democratic ones*. This would indicate a more general economic association between these two variables less indicative of a political cause. We can examine both of these possible alternative explanations by adding democratic states into the sample and re-estimating a simple model to determine if indeed the association is more generalized. The WFE data discussed earlier contains additional data on an additional 42 democratic states covering the same time period. This roughly doubles the sample size.

Figure 15: FDI and Economic Elites in Autocratic States Versus Full Dataset



Indeed, when these states are added to the sample and the model is reproduced using the full sample, the positive association between Large Firm Market Share and FDI inflows is diminished to statistical insignificance. The effect is also markedly more negative. This is illustrated in Figure 15 above. Using this combined data to test for reverse Granger-causality, by testing the effect of a lagged FDI variable on Large Firm Market Share as the dependent variable, also yields an insignificant result.²¹ While additional testing can be done, this provides at least some basis to suspect that these variables are indeed related in autocratic states specifically for political reasons. For democratic states, the association between the variables is closer to being reversed. There are theoretical reasons to suspect this that go beyond the scope of the discussion at hand, but it is suffice to say here that the relationship functions quite differently for democratic states than it does for autocratic states.

The relationship being illustrated here is distinctly different from a comparative advantage story. In authoritarian states, we should expect that a greater number of economic elites, measured here by the degree to which the equities market is dominated by a small number of large firms, should result in less FDI, *even if these additional elites are all part of the same sector*. As political leaders decide on policies governing foreign investment, they will favor

²¹ The graphic model in Figure 15 uses the model form specified on page 104. The reverse causality test also used the full dataset, including democratic states, and switched the positions of FDI inflows and Large Firm Market Share in the model form specified on page 104, as well as applying a one-year lag to the FDI variable. The coefficient for FDI inflow was statistically indistinguishable from zero.

elites. When those elites are few, policies will be consistent and encourage investment as a private good. When the number of elites is greater, policy favoritism will be less consistent as elites jockey over favors, and investors will be more wary of an unpredictable policy environment with weak or noncredible legal protections.

5.2.5 – Additional Robustness Checks

Similar to the robustness checks in the previous section, I tested the primary models using a one year lagged value for the measure of top firm market share. The performance of these lagged models is substantively the same as the original models. There are two likely reasons for this. Firstly, the number of complete observations in the data is quite limited. The second contributing factor is that most states do not see large changes in the market share variables across time, with the exception of a few. These two features in combination results in statistically similar results for both model types. These models are shown in Appendix 3.

The models were also tested using two way fixed effects (country and year). These models lose statistical significance. The most likely reason for this is that within-country variation in large firm market share tends to be low, so this factor in combination with the relatively low number of observations is enough to reduce statistical significance. Small panels such as this one are typically limited by the overspecification of fixed effects (see Hill et al. 2020).

Including a control variable for market capitalization also removes the statistical significance of the effect for both models. This is likely because market capitalization is correlated with both FDI and large firm market share. While foreign portfolio investment (FPI) is not in the scope of the hypotheses being tested here, it is quite likely that states that perform well in attracting FDI are also strong performers in attracting FPI. Market capitalization is also

correlated with large firm market share, for the same reason that large firm market share is correlated with FDI. The correlation between large firm market share and market capitalization is weakly positive (around 0.1). FDI and market capitalization (a measure of FPI) are highly correlated (0.89).

As an additional robustness check, I sought to examine the Hirschman Herfindahl index (HHI) for the countries in the dataset. Unfortunately, for most of the states in the data, there is limited HHI information for domestic industries. Some data is available from the World Bank World Integrated Trade (WIT) dataset. However, this data proved to be a poor match for the concepts being measured here. The WIT HHI data is a measure of the dispersion of trade value across an exporter's *partners*. A country with trade (export or import) that is concentrated in a very few markets will have an index value close to 1. Similarly, a country with a perfectly diversified trade portfolio will have an index close to zero. While this provides an interesting look at trading partner diversification, it does not indicate the concentration of the domestic market or even the sectoral concentration of exports. The measure was negatively correlated with large firm market share, indicating that states with more concentrated domestic markets tended to have more trading partners, likely a proxy for them being more successful at trade in general.

As discussed in the previous chapter, the Li and Resnick (2003) standard model of FDI uses autoregressive correction (AR1) to control for autocorrelation in their residuals. However, as with the models shown in Table 3, the results of a Durbin-Watson test for Table 4 are within an acceptable range, returning a result of approximately 2.21.

5.3 – H2 Case Studies

In this section, I explore two key case studies. First, I return to the example of Kazakhstan discussed earlier in this chapter. Next, as a way to better examine the consolidation process as well as to examine a non-oil state, I examine the example of Singapore.

5.3.1 - Kazakhstan

The first case study will be a continuation of the example discussed earlier, Kazakhstan. Kazakhstan is one of the top destinations for FDI in Central Asia, despite numerous other states with similar economic endowments. This is causally related to the degree to which the consolidation of economic elites fosters policy consistency that increases FDI inflows (H2a). As previously discussed, Kazakhstan offers a wide range of generous tax incentives particularly targeted towards foreign firms wishing to invest alongside domestic firms in industries like uranium mining and gas extraction. Many of these incentives involving joint partnerships are approved by a central committee under the Ministry of Industry and New Technologies (Consulate General of the Republic of Kazakhstan 2022).

Obviously, large influential economic elites seek to influence the decisions of the central committee to benefit their economic interests. This being the case, the presence of fewer economic elites has made decision-making by the central committee remarkably consistent. Incentives for investment into the oil and gas industry, as well as other extractive industries such as uranium mining, are robust and have remained consistent despite political challenges as the state has undergone a concentration of economic elites following independence from the Soviet Union. These include measures such as targeted tax rates and adjustable royalties for partner firms. One example of how economic elites have shaped this process is found in the negotiation

of the Kashagan Oil Field Project Sharing Agreement (PSA), which was the country's most significant foreign investment agreement since independence.

The Kashagan Oil Field is unique for a number of reasons. Being one of the largest oil fields in the region, it provides an invaluable source of potential economic development for Kazakhstan. However, due to its location in the Caspian Sea, development of the field and maintenance of the extraction equipment is more technically challenging than most onshore fields (Reich 2010). This has created an incentive for the state to encourage *continual* FDI as a means to develop and maintain the resource, because the technology involved means that one-time investments that can later be nationalized (the model for many primary-sector FDI schemes) are less desirable. As a result, the government has had an incentive to create stable and predictable rules and incentives governing FDI, because these arrangements will not obsolesce quickly over time (Kobrin 1987).²²

The situation is made apparent by the renegotiation of the Kashagan Oil Field PSA in 2008. The negotiation was aimed at resetting the terms of an earlier arrangement reached in 1998. The terms of this earlier deal were considered by the state to be suboptimal, and the state had a number of reasons to consider nationalization of the field. However, despite this condition and initial friction with the involved foreign firms, due to the technical challenges involved the Kazakh regime maintained a level of cooperation with large international investors like ExxonMobil and Royal Dutch Shell. Key benefits for firms investing in crude oil extraction,

²² While not as relevant here, the other situation in which this type of non-obsolescing FDI scheme is desirable is for secondary sector FDI related to technical manufacturing. This is a key driver of results we will observe in later chapters.

such as a reduction of the standard export tax rate and reduced royalty payments, were maintained (Reich 2010).

The primary beneficiary of the deal was KazMunayGas, the Kazakh state-owned oil and gas firm. KazMunayGas controls virtually the entire domestic gas market and Kazakhstan, and thus FDI negotiation can be largely dictated by what is most beneficial to that firm specifically. This consolidation removes any dissenting influences (such as competitors upset over being left out or parties pushing for higher tax rates to pay for other priorities) and results in a stable negotiating process and stable arrangement. The result of this condition was the conclusion of a deal over the Kashagan Field in 2008 that set out a framework of general terms and incentives for FDI investment in Kazakhstan for the next decade or more, such as tax relief and floating royalties, that were later replicated in other areas such as the Orano uranium extraction deal inked in 2022.²³ This sort of policy consistency drives foreign investor confidence.

This case is also useful for illustrating how the number of economic elites and the presence of political opposition interact in a multiplicative way (H2b). In the period since independence, Kazakhstan has experienced a consistent decline in political competition. This trend has occurred in the form of greater executive power (for example, the lengthening of presidential terms beginning in 1998), as well as in the legislature. While the Otan Party has remained dominant throughout this period, the emergence and ultimate failure of opposition parties in the late 1990s and early 2000s is illustrative of the dynamics described quantitatively

²³ In contrast to the approach taken with such primary sector industry, like many autocratic states, Kazakhstan restricts FDI related to media and telecommunications, as well as other tertiary sector services such as air travel. Other tertiary sector industries such as banking are also heavily consolidated and controlled by economic elites linked to the regime. This policy of restrictiveness towards related FDI specifically protects economic elite interests in these sectors, which are heavily consolidated and uncompetitive. A Kazakh banking crisis from 2016-2018 was characterized by further consolidation, and notably by the bailout of one of the country's largest banks, owned by the family of the president's chief of staff (Bertelsmann Foundation 2022). This sort of favoritism towards non-tertiary investment will be discussed in more detail in Chapter 7, which examines H3.

above. Details on this period are captured in literature on this period such as Bremmer & Welt (1996), Bowyer (2008), and Commander & Prieskienyte (2021). These accounts provide greater insight into how opposition parties relied on economic elites to become viable, and in turn were able to amplify the voices of dissatisfied economic elites. By contrast, when elites were homogenous in their preferences, political opposition languished. Speaking about the failure of formal political opposition parties like Azamat and the United Democratic Party in the mid-2000s, Bowyer (2008) summarizes this dynamic thusly:

“In fact, neither the first nor second generation of political opposition could effectively overcome the general problem of disorganization and lack of resources. A key commonality that these opposition movements shared is that, during their emergence, Kazakhstan's elite base had not yet undergone the process of division and conflict that later arose as a result of diversifying economic interests... Until economic interests caused a split, elites of this generation were more or less homogenous. Their political movements thus did not represent intra-elite competition, which is important to party leadership development.”

This provides an illustration of why political competition has been ineffective at producing policy change in an oligarchic Kazakhstan. When political competition cannot channel competing economic elite preferences, it becomes less relevant to economic policy. This leads to less of an effect (or even a positive effect) on FDI inflows in the (somewhat rare) cases in which political competition appears in states with few economic elites. Perhaps unsurprisingly, near the conclusion of the Kashagan field PSA in 2008, the Kazakh regime was able to introduce additional measures aimed at political centralization and the sidelining of political opposition. In May 2007, presidential term limits were abolished and the legislature was restructured to give the Otan Party more consolidated control and decision-making power (Bertelsmann Foundation

2022). The effect on investor perceptions was positive, as this indicated to investors that the deal they were about to secure was unlikely to change.

5.3.2 – Singapore

Singapore is a consolidated authoritarian state, and also one of the world's top recipients of FDI (as well as a top recipient of FPI). It is also an example of how political and economic consolidation both contribute to a reduction in policy uncertainty. As a non-oil state, it is a helpful supplementary example to those cases discussed already.

More or less a city-state on the south coast of Malaysia, Singapore became fully independent in 1965. Initially democratic, the state has experienced several decades of political consolidation that has effectively made it a one party state under the center-right "People's Action Party" or "PAP". Initially ranked as a 7 on the Polity Scale, the state has experienced a long period of consolidation under the PAP, mostly headed by the Lee family and their allies. Through a series of legal changes to the electoral system, such as the "Societies Act" first introduced in 1967, the PAP has established itself as the only viable party with the ability to approve or otherwise illegitimate any political opposition (Bailey 2015). By the mid-2000s, the state was ranked a -2 on the scale, and declined further to a -4 by 2021. This classifies the country as a consolidated authoritarian state (technically a "closed anocracy" using Polity definitions).

In addition, this period was also marked by a consolidation of economic influence. Led by the growth of semiconductor manufacturing, large technology firms came to dominate the market with the help of a targeted industrial growth strategy by the state. Using the Large Firm Market Share measure used in this chapter, we see that top firms held a mean equity market share of approximately 50% between 1980 and 1995. Between 1995 and 2005, however, this

figure surged to roughly 67%. However, during this period of economic and political consolidation, FDI inflows to Singapore have surged as the state has taken a deliberate focus on attracting secondary-sector FDI.

Most of the FDI to Singapore is associated with the technology manufacturing sector, and Singapore is a top global producer of semiconductors and other electronic components. However, in contrast with some similarly endowed states such as Taiwan, Singapore's growth has left it economically consolidated. The largest economic enterprises in Singapore are Temasek Holdings, a state-owned technology conglomerate, and the Government of Singapore Investment Corporation or "GIC", the state-owned sovereign wealth fund. Together, the state controls over 1 trillion in assets, making it the largest economic stakeholder in Singapore by far (Forbes 2020).

Until 2006, the third largest enterprise was known as Chartered Semiconductor Manufacturing Corp. ("CSMC"). The Chair of CSMC was Ho Ching, the wife of high-ranking party official Lee Hsien Loong, who is now Prime Minister of Singapore. Loong is also the son of Lee Kuan Yew, the first Prime Minister of Singapore, who came to power after independence. In 2006 CSMC was sold to a joint venture controlled by the Emirati state-owned sovereign wealth fund (Reuters 2004).²⁴ Subsequently, Ho Ching became CEO of Temasek Holdings.

The key to much of the successful semiconductor-related FDI investment in Singapore has been to achieve government approval to develop wafer fabrication facilities, in what is known as a "wafer fab park". CSMC received a number of such approvals before their acquisition in 2006, partnering on fabrication facilities for IBM, Samsung, and Agere Systems

²⁴ This contrasts with the sale of Taiwan-based TSMC, which is owned by a diversified group of foreign investors.

(another American company based in Pennsylvania), among others (SEC 2005). This concept provides a good example of how authoritarian states can use investment-related policy decisions to provide private benefits to key supporters. The administration of Goh Chok Tong (the Prime Minister immediately preceding the sale of CSMC) could affect the approval of development projects for wafer fabrication plants. Because there were only a limited number of "economic elites" involved in semiconductor or other large-scale manufacturing, it was relatively easy to ensure that the approvals were given to these firms (such as CSMC). In exchange, these firms support the incumbent regime. In this case, one of the primary beneficiaries of this FDI linked to CSMC was the Lee family, which were key supporters of the Goh administration. In an alternative scenario where the landscape of economic elites was more diverse, the awarding of development permits for a limited amount of space would become more competitive, and the regime would have a more difficult time keeping all stakeholders satisfied. It is easy to see how such a scenario could lead to less predictable decision-making around the award of permits, which is a factor that would plausibly make potential foreign investors more cautious about entering joint ventures.

The lack of political competition in Singapore likewise acts as a conditioning factor to tamp down on this type of policy uncertainty. For example, when the proposed development of integrated resorts (casino hotels) in partnership with foreign hotel chains was met with popular disapproval in 2004, the regime was able to fairly easily sideline these concerns to continue with the project. The regime leaders did not need to concern themselves with dissatisfaction leading to their removal or other political costs, because their clique of key supporters wanted the project to continue (Joshua 2013). While Singapore technically has elections, the candidates are selected and approved by the PAP, meaning the popular dissatisfaction does not really pose a threat to

party leaders as long as economic elites are satisfied with their performance (Lai 2020). In a more politically competitive state, it is easy to imagine how a similar scenario could result in greater uncertainty over the viability of the project, and the potential dampening effect this would have on investment interest on the part of relevant foreign firms seeking FDI opportunities. The consolidation of political authority thus has supported the government's ability to maintain consistent investment-focused policy in Singapore, leading to greater confidence on the part of foreign investors and more FDI inflows.

In these ways, the political economy of Singapore helps to illustrate how the lack of political competition and consolidation in the number of economic elites in nondemocratic states can lead to greater FDI inflows. It also helps to illustrate how leaders in authoritarian states use FDI as a source of private benefits that keep their supporters satisfied, and thus reinforce their political authority. When these benefits become more diffuse, competition over benefits increases, which in turn increases policy uncertainty and lowers FDI.

It is important to note that while economic elite consolidation has led to less policy uncertainty and more FDI in Singapore, the dynamic should also work in reverse. In other words, when there are more competing economic elites, policy uncertainty will increase and FDI inflows will decrease, all else equal. While economic elite dissatisfaction often coincides with political competition for reasons already discussed, the effect is also possible independent of political competition. In the case of Singapore, the period from 1980 until 1987 is the best example of this dynamic. During this period, Singapore was rapidly modernizing and experienced an increase in the number of competing economic elites. Many of these emerging elites began pushing for policies that would attract more skilled labor, while other firms supported policies aimed at developing low-wage industry. As a result of this condition, it was

more difficult for the state to select industry-specific investment incentives, and they were more inclined to select broad-based “public goods” policies. One of these was to introduce large, compulsory wage increases, which were supported by some industries and opposed by other businesses. This increase in the cost of capital and uncertainty about labor policy had the unintended effect of reducing international investment interest and ultimately causing a recession. However, somewhat ironically, this event actually led to the elimination of many firms in low-wage industries, which eventually allowed Singapore to concentrate policy on favoring the industry it is known for today: semiconductor manufacturing. This episode provides an example of how competition between economic elites over policy creates uncertainty for investors and reduces FDI inflows.²⁵

5.4 – Conclusion

The primary claim being tested in this section is that the number of economic elites in a state is an important factor in predicting policy uncertainty, because all else equal, a greater number of economic elites in an authoritarian system leads to *dissatisfaction* with the policy status quo. This variable, the number of economic elites, is arguably more important than the presence of political competition by itself. This is because competition over policy is often hidden, and therefore not measured by traditional measures of political competition. The presence of dissatisfied economic elites also appears to be a precondition to the manifestation of the full FDI-reducing effect of political competition. Political competition without economic elite actors seeking competing policy outcomes is less likely to lead to inconsistent policy, and therefore less likely to create policy uncertainty on the part of investors.

²⁵ An extended discussion of this period can be found in Appendix 5.

This finding is also significant for several additional reasons. Despite being an important variable in determining policy outcomes in a state, the number of economic elites has received less academic attention. The findings presented here also imply that as states diversify their economies, competition between a larger number of economic elites, when not constrained by strong institutions, may in fact lead to greater uncertainty on the part of investors and as a result create net reductions in investment. This “competition trap” is an important finding for both political economy and developmental economics. While the measurements available for the number of economics elites are limited, the importance of the topic merits additional development of such measures in order to capture economic elites in states where exchange data is not available or does not provide a complete picture of the economic environment.

6 – Testing the Mechanism of Policy Uncertainty

The previous chapters have laid out and tested a theory of foreign direct investment that asserts the importance of political competition and the number of economic elites in predicting the size and the character of investment inflows. The primary mechanism through which these variables impact FDI is policy uncertainty. Policy uncertainty is the degree to which foreign investors feel unsure about which policies will prevail in a certain country, specifically policies that will impact their business. This uncertainty creates risk for their business enterprise, and reduces their equilibrium investment amount.

This type of investor sentiment stemming from policy decisions is often referred to as “political risk” in other contexts. The focus of this chapter will be on developing and testing several hypotheses to examine this mechanism more closely, specifically by examining a novel dataset on “political risk” which I use to measure the degree to which investor anxiety over policy varies by country. By examining the association between the variables discussed in the previous chapters (political competition and economic elites) and investing firm executives’ perceptions of political risk to their business, we can confirm that the findings about FDI inflows in the previous chapters are resultant of the political dynamics which I describe. I also examine and confirm that connection between perceptions of political risk and FDI inflows, confirming that greater risk is indeed associated with less investment.

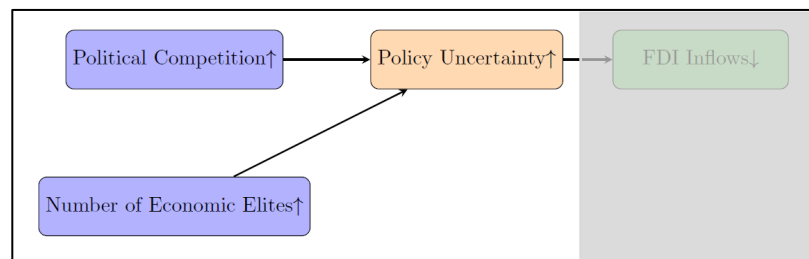
6.1 - Policy Uncertainty

As previous chapters substantiated, when the landscape of influential elites includes more diverse interests, the range of potential policy outcomes will be wider and more difficult to predict as a larger number of actors can either veto decisions or influence changes. This policy

uncertainty is the mechanism that reduces FDI, as foreign investors are wary of investing in a state where the prevailing policy status quo is more likely to change unfavorably.

Thus far, I have tested the connection between FDI inflows and my primary independent variables, but have argued that their connection relies upon a middle mechanism, policy uncertainty. Because relevant policies can vary so widely between states and are not catalogued in any accessible way, we have no systematic way to measure policy change across many states. However, by utilizing some new relevant data, I aim to provide more credibility to my primary arguments by testing the connection between my primary independent variables and a proxy for policy uncertainty. The unshaded area of Figure 16 illustrates the first part of the mechanism test presented here.

Figure 16: Visual Depiction of Mechanism Test Part 1



The first source of policy uncertainty that I discuss in Chapter 3 is the presence of political competition. The presence of political competition raises the probability of changes to the policy status quo that governs investment. In authoritarian states, where these policies can have a great impact on the viability of investment, this uncertainty reduces foreign direct investment inflows from foreign investors. Political competition can induce policy concessions either by securing concessions from the incumbent or through capturing local or regional offices. Alternatively, in more severe scenarios, such political opposition may overtake the incumbent for

control of the national government. In any case, the presence of higher levels of political competition reduces FDI inflows because it creates *policy uncertainty* for foreign investors.

Policies can include a variety of rules or decisions that govern the way foreign investment inflows are channeled. These can include mergers, grants, expropriations, taxes, or a broad number of other actions discussed previously. We can expect that foreign investors will observe the consistency of such policies and form opinions about their stability before deciding whether or not to invest. The first hypothesis (H1) found that the presence of greater levels of political competition is therefore associated with lower FDI inflows due to this uncertainty.

Therefore, examining investors' policy uncertainty *directly* allows us to test the mechanism that generates the first hypothesis, which is the connection between my primary independent variables and the level of policy uncertainty:

M1: Foreign firms investing in authoritarian states with greater political competition will perceive more policy uncertainty than those in authoritarian states with less political competition, all else equal.

In addition to political competition by itself, the previous chapters illustrated the importance of economic elites in determining the pressure on policy stability. A greater number of dissatisfied economic elites is a source of policy uncertainty due to the tendency of economic elites outside the coalition to support policy change.

Chapter 3 explored how economic elites are a key determinant of policy uncertainty outside of formal political competition. Economic elites are those actors who control or own large economic enterprises within the states. In authoritarian states, the complicity of some majority of economic influence is necessary for the incumbent to retain power. Therefore, he uses FDI inflows as a private good in order to achieve this. When there are a greater number of

economic elites, the mean share of benefit from FDI inflows becomes diminished, and certain economic elites, if left out of the spoils, become dissatisfied. These dissatisfied economic elites push for policy changes in order to capture a greater share of benefit from FDI inflows.

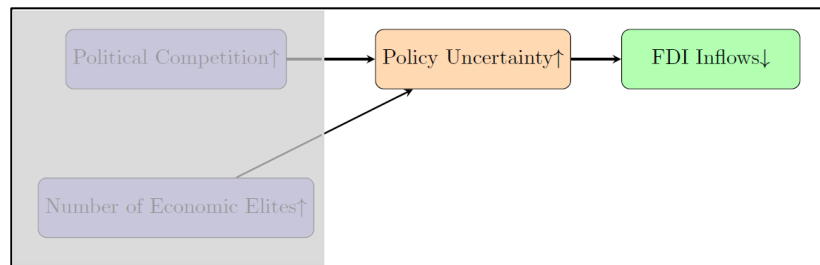
The push for policy changes by dissatisfied economic elites results in uncertainty on the part of foreign investors over the viability of investment. H2 explored the hypothesis that a greater number of economic elites therefore reduces the level of overall FDI inflows. This chapter will also seek to explore the mechanism behind this result directly, which is the connection between economic elites and policy uncertainty.

When there are a greater number of economic elites, policy uncertainty will be greater. Thus, firms investing in states with greater economic elite consolidation should also exhibit less policy uncertainty, and this feature is what increases investment.

M2: Foreign firms investing in authoritarian states with relatively fewer economic elites will perceive less policy uncertainty than firms in authoritarian states with relatively more economic elites, all else equal.

For both of these mechanism tests, there is an implied assumption that greater policy uncertainty reduces the level of FDI inflows. When foreign investors are more uncertain about the policy environment in a particular market, their level of equilibrium investment declines. M1 and M2 explore the association between sources of policy change and how this creates policy uncertainty for investors. M3 will explore how this policy uncertainty is translated into lower aggregate FDI inflows. The unshaded area of Figure 17 illustrates the second part of the mechanism test presented here.

Figure 17: Visual Depiction of Mechanism Test Part 2



When investors are uncertain about which policies will prevail in the future, and these changes potentially have significant (negative) impacts to their investment, their *expected minimum return* is lowered. As many risk-averse investors make investment decisions based on this expected minimum return, this results in less investment. This second part of the transmission mechanism is fairly-well established empirically in existing literature (see Howell & Chaddick 1994, Brink 2004, Gonchar & Greve 2022). However, I also recreate this finding using my own data in a two-stage instrumental variable regression model. This portion of the mechanism test will be presented at the end of this chapter. This concept can be expressed in the following way:

M3: Authoritarian states with greater levels of aggregate foreign investor policy uncertainty will receive less FDI inflows, all else equal.

This chapter will proceed by describing my methodology for testing these claims, which is done by using data on policy uncertainty expressed by businesses investing in nondemocratic states during earnings calls.

6.2 – Approach to Testing the Mechanisms

The first two mechanism tests here (M1, M2) use foreign investor policy *uncertainty* as the primary dependent variable. The third test (M3) uses it as the primary independent variable. I measure an operational version of this variable in novel ways using unique data on the political

“risk” environment in the country. The risk data is drawn from a dataset developed by the Department of Economics at Boston University. Known as the Firm-Level Risk Dataset, this data aggregates firm-specific measures of exposure, risk, and sentiment constructed using textual analysis of quarterly earnings conference calls (Hassan et al 2019). The risk data sample contains 16428 quarterly observations that capture a foreign firms’ perception of risk in a country in which they invest, in combination with political and economic control variables described in the succeeding sections. In total, the data covers 1082 firms investing in 36 nondemocratic states, with cases beginning in 2002 and ranging to the present. The cases are in firm-quarter-country format, allowing for temporal analysis by country. Although an investing firm may operate in multiple countries, earning calls occur on a country-specific basis, where executives in charge of operations for a country discuss earnings factors pertinent to that country.

These observations of investor-risk perception represent the views of executives from *foreign firms* (i.e., foreign investors) about the “political risk” (policy uncertainty) to their firm associated with a particular market in a nondemocratic state. In other words, the dataset provides information about the policy uncertainty of all foreign investor firms within a particular state. By looking at the mean level of “political risk” expressed by firms investing within a particular state, we also can generate a proxy for aggregate policy uncertainty in that state.

The dataset’s variable for “political risk” is developed using computational linguistics to quantify the share of the earnings call devoted to discussing uncertainties to firm earnings associated with politics in a particular nondemocratic state. A higher value is associated with more *mentions* of political risk, which the data uses as a synonym for “uncertainty” on the part of firm executives about investment in a state. The dataset also includes a similar sentiment analysis, which looks for positive and negative tone words associated with politics (meaning

discussions of elections, regulations, or other political keywords). For this index, a lower score means more negative *sentiment* about the policy environment in a state. The risk values found in the data range from 0 to over 3500, but the majority of values occur between 0 and 100. The sentiment data ranges from (16,000) to 14,000, with the majority of values occurring between (1,000) and 1,000. Both scores rely on a counting methodology and are thus theoretically unbounded continuous variables. For the political risk score, a greater number of mentions of risk paired with mentions of political topics increases the score. For political sentiment, a greater number of mentions of political topics paired with either negative or positive tone words lowers or raises the score, respectively. Additional information about how the scores are calculated by the index authors can be found in Appendix 6.

The measurement of “political risk” and “political sentiment” in this data are both used as co-equal, alternate measurements for the concept of *policy uncertainty*. In this dataset, the compilers refer to the concept of policy uncertainty as “political risk”. Specifically, when a particular state has more unpredictable FDI policy, we should expect the earnings calls for foreign firms located in that state to contain more discussions of risk associated with politics and more discussions of politics featuring negative tone words. The measure methodology for the political risk score explicitly measures the word “uncertainty” and synonyms for uncertainty in scoring particular firms as experiencing more “risk”. This makes this measure (“political risk score”) particularly appropriate for this application. Unpredictable policy will lead to more changes in regulations, and more discussion about election results in the context of business risk and uncertainty. Therefore, when policy is less predictable, the earnings calls in the dataset will contain more discussion of these keywords. If policy was predictable, business leaders would not view these factors as significant to their earnings. In this way, by observing all the investor calls

in a particular country, we measure policy uncertainty using both of the political risk indices described above.

The key assumption here is that “political risk” and “political sentiment” serve as proxy measurements for the concept of policy uncertainty. In this way they are both used to estimate policy uncertainty as the dependent variable.

It is also important to note that all the firms in this dataset are not necessarily foreign-owned. They could be the local corporate entities of foreign firms, but they could also be domestic firms. While this reduces the degree to which the analysis in this chapter is testing policy uncertainty specific to *foreign* investors, there is little reason to suspect that the inclusion of domestic firms would greatly bias the results. Domestic investment should be subject to the same incentives that apply to foreign investment. Political competition and a greater number of economic elites should produce policy uncertainty that applies to both foreign and domestic firms. Similarly, autocrats should favor the same type of firms for domestic investment as for foreign investment.²⁶

The independent variables for H1 and H2 mechanism tests are the same as the IVs for the primary hypotheses (political competition and economic elites), and taken from the same sources described above.

Because these tests are examining political dependent variables, political control variables are important. I incorporate controls for factors that are likely to substantially impact perceptions of uncertainty on the part of investors, such as recent elections or institutional factors

²⁶ There may be some exceptions to this for large, established domestic firms that are part of the tertiary sector, such as media or banking. However, this difference, to the extent that it exists, should bias the marginal effect of sectoral affiliation *downwards*, providing a more conservative estimate. See Appendix 4.

such as the strength of property rights. A recent election should increase the amount of discussion on an earnings call that is devoted to discussing political risk factors, and is thus an important control variable. Likewise, perceptions around the strength of property rights should affect the degree to which political factors are discussed in relationship to earnings, and will also covary with political measures. Lastly, I also control for firm-level *nonpolitical* uncertainty, which should be positively associated with how foreign investors view other types of risk. Nonpolitical uncertainty values are calculated using a similar textual analysis methodology to what is described above for the policy uncertainty values, but provides an index for discussions of risks *not* associated with political discussion.²⁷ Countries with greater aggregate nonpolitical uncertainty, such as uncertainty related to economic factors, are also more likely to have greater political uncertainty. As such, this is an important control variable.

Table 8 below provides a summary of the hypotheses, variables, and data used in this chapter.

Table 8: Summary of Chapter 6 Mechanism Tests

Hypothesis	DV	DV Measure (source)	IV	IV Measure (source)
M1	Policy uncertainty	Political risk (BU)	Political consolidation	Political competition (V-Dem)
M2	Policy uncertainty	Political risk (BU)	Economic consolidation	Number of economic elites (WFE)
M3	FDI inflows	FDI inflows (World Bank)	Policy uncertainty	Political risk (BU)

²⁷ More information on the calculation of this variable can be found in Hassan et al. (2019).

6.2.1 – Mechanism Test for H1

An initial description of the data helps illustrate how this data will be employed. We can illustrate this by highlighting the mean “political risk score” by regime type. The overall mean score for the data for firms investing in autocratic states was 143. Segregating the set of autocratic states for which there are observations, we see that for the most authoritarian states (Polity Score of less than 0), the mean political risk score for firms in those states was 142. Among firms located in the more competitive regimes (Polity Score equal to or greater than 0) the mean score was 214. This mean comparison provides a simple support for the overall idea that states with more political competition experience more policy uncertainty, expressed here by the “political risk score” of the firms investing in them. When a particular state has a greater level of policy uncertainty, the firms considering investment in those states will express greater levels of policy uncertainty. This is the fundamental premise of the empirical analysis in this chapter.

The model approach I use follows from similar studies on country-level determinants of firm-level policy uncertainty (see Kenyon & Naoi 2010). I used a two-tiered multilevel model that includes both country-level and firm-level independent variables to explain variation measured at the firm-level. The dependent variable, policy uncertainty, represents the policy uncertainty expressed by a particular foreign investor in a particular state at a particular time. Like many firm outcomes (such as credit scores, debt, or capital expenditures), the risk perceptions of a firm are impacted by both country-level variables (factors like a recent election) and firm-level variables (such as how the firm feels about other types of risk). The use of the nonpolitical risk measure, which (like the dependent variable) is measured at the firm-level, allows for a more accurate model specification than would otherwise be possible with only

country-level measures. This multilevel approach allows for the examination of the effects of both firm- and state- level variables on foreign investors' perceptions of policy uncertainty within nondemocratic states across time. Here, I use this approach to isolate the effect of the country-level variable examined in Chapter 4, which is political competition.

The models presented in this section to test M1 resemble those presented in Chapter 4 to test H1, albeit now using a firm-level dependent variable. In order to formally test the mechanism for Hypothesis 1, I specify the following basic models of foreign investor firms' policy uncertainty (for firm j investing in country i), using the BU dataset's "political risk" and "political sentiment" as proxy variables, and to include all six measures of state-level political competition (in country i):

$$\text{Policy Uncertainty}_{jt} = B_0 + B_1\text{Political Competition}_{it} + B_2\text{Property rights}_{it} + B_3\text{Recent election}_{it} + B_4\text{Nonpolitical risk}_{jt} + C_t + e_{it}$$

Table 9 presents the results of this model using all six measures of political competition and the first BU political uncertainty measure, which measures *mentions* of risk. As the first table indicates, an increase in political competition is associated with increased mentioning of political risk in five out of six variables measured. Basic control variables for the property rights environment and the occurrence of a recent election are also included. The regressions are linear with fixed effects for time (by year). Model fit was on the lower end, but within an acceptable range.

Both primary measures of political competition, Polity Score and the Electoral Democracy Index, are positively associated with mentions of political uncertainty. A one-point increase in Polity Score is associated with an increase in the risk index score of roughly 6.5. A standard deviation increase in the Electoral Democracy Index of 0.20 is associated with an

increase in the risk index score of roughly 37. Given the mean for the dataset (143), these values represent substantive changes in the overall level of investor uncertainty. This result provides the primary evidence of the proposed theoretical relationship between political competition and foreign investor uncertainty.

Among the control variables, a better score on the Property Rights Index,²⁸ a measure of how robust legal protections for business are in a particular state at a particular time, is negatively associated with the risk index score, which is an intuitive result. The occurrence of a recent presidential election, as measured by a dummy variable, is associated with an increase in the risk index score, which is also expected. A similar dummy variable measure for the occurrence of a parliamentary election was not significant. I also included a measure for nonpolitical risk, which is a measure from the BU dataset that captures mentions of uncertainty in a similar way to the political risk index, but instead captures mentions paired with nonpolitical topics. As expected, these two risk indices are positively associated with one another. The regressions also included a firm-level measure of nonpolitical risk or nonpolitical sentiment. Nonpolitical risk should be associated with perceptions of political risk, as managers that are more risk sensitive in one area are more likely to be risk sensitive in another. The inclusion of this variable in the model is necessary to strengthen model fit and ensure enough case variation to improve statistical robustness.

In sum, this result indicates that as political competition increases, policy uncertainty also increases. This leads to a reduction in FDI inflows, which is the result we observed in Chapter 4.

²⁸ The Property Rights Index is taken from V-Dem, defined as a 0-1 score indicating the strength of the legal right to acquire, possess, inherit, and sell private property, including land. A higher score indicates stronger property rights.

Table 9: Political Competition and Policy Uncertainty

	<i>Dependent variable:</i>					
	Political Risk					
	(1)	(2)	(3)	(4)	(5)	(6)
Polity Score	6.496*** (1.629)					
Political Competition		3.465 (3.817)				
Electoral Democracy Index			188.661*** (29.788)			
Multiparty Elections				8.619 (7.374)		
Legislature Opp. Parties					16.341*** (4.015)	
Opp. Party Autonomy						14.253*** (3.831)
Nonpolitical Risk	0.056*** (0.002)	0.057*** (0.002)	0.056*** (0.002)	0.057*** (0.002)	0.056*** (0.002)	0.056*** (0.002)
Property Rights Index	-88.136*** (24.325)	-42.285* (21.808)	-241.649*** (38.424)	-35.642* (20.420)	-134.878*** (31.852)	-147.551*** (36.419)
Recent parl. Election	-2.839 (8.760)	-2.864 (8.768)	11.193 (9.021)	-9.315 (10.421)	-1.798 (8.763)	-5.514 (8.793)
Recent pres. Election	36.667** (15.388)	44.454*** (15.338)	28.205* (15.445)	46.733*** (15.217)	39.069** (15.301)	37.459** (15.384)
Observations	9,611	9,611	9,611	9,611	9,611	9,611
R ²	0.064	0.063	0.067	0.063	0.065	0.064
Adjusted R ²	0.062	0.061	0.065	0.061	0.062	0.062
F Statistic (df = 5; 9588)	132.118***	128.901***	137.286***	129.017***	132.260***	131.679***

Note:

*p<0.1; **p<0.05; ***p<0.01

Table 10 provides another look at this relationship, this time using political risk *sentiment* (the alternative measure of policy uncertainty) as the dependent variable. In this instance five of six measures of political competition are associated with more negative sentiments about political risk. In this set of models, a one-point increase in Polity Score is associated with a lower score on the Political Sentiment index of roughly 37 points, indicating discussions of political topics paired with more negative tone words. The standard deviation increase of 0.20 for the Electoral Democracy Index is associated here with a decrease of about 80 points on the Political Sentiment Index. The mean value on the Political Sentiment index was around 1200, making these findings smaller in terms of substantive significance, but still supportive of the proposed theoretical relationship.

Among the control variables, each performed in line with expectations, similar to the previous set of models. Parliamentary election occurrence saw a more significant effect, and the significance of the presidential election variable is reduced. In both cases, a recent election is negatively related to risk sentiment, which is an intuitive outcome. Similarly, nonpolitical risk was positively associated with political risk sentiment across all models. The property rights index was negatively associated with risk sentiment, a counterintuitive result. Overall model fit was stronger for these models.

Both of these findings seem to suggest that increases in political competition in authoritarian states lead to negative sentiments about political risk to investment. In other words, it contributes to policy uncertainty. This provides evidence to support the claim that politically competitive authoritarian states perform more poorly in attracting FDI because they feature greater policy uncertainty for investors.

Table 10: Political Competition and Policy Uncertainty (Alternate Measure)

	<i>Dependent variable:</i>					
	Political Sentiment					
	(1)	(2)	(3)	(4)	(5)	(6)
Polity Score	-37.053*** (8.771)					
Political Competition		-188.338*** (20.463)				
Electoral Democracy Index			-415.596** (161.462)			
Multiparty Elections				-7.078 (39.771)		
Legislature Opp. Parties					-112.360*** (21.669)	
Opp. Party Autonomy						-217.233*** (20.582)
Nonpolitical Sentiment	0.034*** (0.001)	0.034*** (0.001)	0.035*** (0.001)	0.034*** (0.001)	0.035*** (0.001)	0.035*** (0.001)
Property Rights Index	-1,683.509*** (131.125)	-1,605.603*** (117.196)	-1,532.185*** (207.328)	-1,983.900*** (110.238)	-1,303.369*** (171.339)	-282.369 (194.959)
Recent parl. Election	-507.339*** (47.352)	-501.540*** (47.193)	-537.568*** (48.753)	-502.629*** (56.171)	-512.739*** (47.338)	-462.038*** (47.324)
Recent pres. Election	-97.108 (82.818)	-54.845 (82.190)	-111.637 (83.329)	-152.424* (81.903)	-101.824 (82.325)	-15.643 (82.416)
Observations	9,611	9,611	9,611	9,611	9,611	9,611
R ²	0.172	0.178	0.171	0.171	0.173	0.180
Adjusted R ²	0.170	0.176	0.170	0.169	0.171	0.178
F Statistic (df = 5; 9588)	399.436***	415.564***	396.729***	395.139***	401.617***	422.002***

Note:

*p<0.1; **p<0.05; ***p<0.01

6.2.2 – Mechanism Test for H2

The models presented in the previous section mirror those used in Chapter 4 to test H1. This section will likewise develop models similar to those presented in Chapter 5 to test H2. As before, I use a two-tiered multilevel model that includes both country-level and firm-level independent variables. In this case, I seek to study the impact of the country-level variable examined in Chapter 5 (the number of economic elites) on the firm-mean of policy uncertainty expressed by foreign investor in a particular nondemocratic state.

The following set of models uses measures of the number of economic elites as the primary independent variable. In order to test the mechanism for Hypothesis 2, I specify the following basic models of firm-level policy uncertainty (for firm j investing in country i) to include the primary state-level measure for the relative number of economic elites (in country i); large firm market share:

$$\text{Policy Uncertainty}_{jt} = B_0 + B_1 \text{Large firm market share}_{it} + B_2 \text{Property rights}_{it} + B_3 \text{Recent election}_{it} + B_4 \text{Political competition}_{it} + B_5 \text{Nonpolitical risk}_{jt} + C_t + e_{it}$$

In Table 11 below, Political Sentiment Index score serves as the proxy for policy uncertainty. The results of the model, using two measures of political competition, shows Large Firm Market Share, a measure of the number of economic elites, associated with a significant and positive effect to the Political Sentiment Index score. This indicates that a standard deviation increase in the Large Firm Market Share measure of 0.20 is associated with a 160 point increase in the Political Sentiment Index Score. In other words, autocratic states that were more oligarchic (i.e., had fewer economic elites) saw foreign investors expressing less policy uncertainty. Substantively, given the mean value (143), this represents an even larger effect than the result found for political competition in the previous section.

The results using the Electoral Democracy Index in place of Polity Score are substantively similar. In this model the marginal effect of Large Firm Market Share decreases slightly, by approximately 22%. The negative marginal effect of political competition is retained, with a 0.20 increase on the Electoral Democracy Index representing a predicted decrease in firm sentiment score of approximately 298. This alternative model provides confirmation of the finding regarding the positive relationship between the number of economic elites and the level of policy uncertainty, and also provides additional confirmation of the positive relationship between political competition and policy uncertainty, in this case using an alternative measure for political competition. Overall, this provides further robustness to the findings.

In sum, the results for political sentiment are in line with the expectations inherent from H2. When there are fewer economic elites, discussion of political risk during earnings calls took on a more positive tone. This seems to indicate that foreign investors in states with fewer economic elites experience less investment-reducing policy uncertainty. This supports the idea that the results observed in H2 flow from this increased policy uncertainty in environments with many competing economic elites. Importantly, this finding about political risk also helps to refute the alternative explanation that H2 results are merely reflecting the FDI-increasing impact of having a competitive advantage in some sector.

Table 11: Economic Elites and Policy Uncertainty

	<i>Dependent variable:</i>	
	Political Sentiment	
	(1)	(2)
Large Firm Market Share	799.229*** (225.569)	618.627*** (228.335)
Polity Score	-79.276*** (9.386)	
Electoral Democracy Index		-1,491.772*** (158.730)
Nonpolitical Sentiment	0.036*** (0.001)	0.036*** (0.001)
Property Rights Index	-296.266** (130.408)	-33.634 (137.626)
Recent Parl. Election	-536.417*** (80.346)	-553.171*** (80.118)
Recent Pres. Election	-50.336 (107.195)	-56.890 (106.566)
Observations	7,408	7,408
R ²	0.162	0.163
Adjusted R ²	0.159	0.161
F Statistic (df = 6; 7384)	237.046***	240.390***

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

Also notable was that among the control variables, the property rights index was less statistically significant in model 1, and not significant in model 2. The finding seems to suggest that in authoritarian settings, the relationship between codified rule of law and the direction of political sentiment among investors is weaker than often suggested. This finding was consistent across several measures of this variable.²⁹

²⁹ I also ran the same model using the alternative measure for policy uncertainty, the Political Risk Index score, as the dependent variable. Interestingly, for these models, having fewer economic elites was positively associated with mentions of risk (the other BU risk measurement variable). This result was unexpected. One possible explanation for this is that it is the result of environments where a few elites dominate featuring closer ties between economic and political elites. When political and economic elites are closely tied, we can expect executives to discuss political dynamics with greater interest in regard to company earnings.

The results using political risk in place of political sentiment were not significant. There are some reasons to expect this result. When a particular state is more oligarchic, firms seeking to do business in that state may make a more natural association between politics and business. As a result, the methodology used to score the Political Risk Index may pick up more instances of political topics being discussed in conjunction with synonyms for risk or uncertainty. However, this may not necessarily indicate that policy uncertainty is greater, but merely that the uncertainty that is present is more clearly linked to politics. Either way, the results for this test were not supportive of the hypothesis.

I also applied an additional model employing fixed effects for country in addition to time, and the results for Large Firm Market Share were somewhat diminished in significance. However, model fit was weaker in this alternative specification. In addition, I tested the robustness of these findings using a logged dependent variable. The results were substantively identical, but model fit was slightly reduced.

6.2.3 – Mechanism Test for Policy Uncertainty and FDI

This section focuses on drawing the empirical connection between the proxy measures of policy uncertainty, which are Political Sentiment score and Political Risk score, and the measure of FDI used in the prior chapters. This is important because whereas the preceding sections examined the connection between political competition and economic elites with policy uncertainty, this section provides the connection between this transmission mechanism (policy uncertainty) and the primary outcome variable being examined in the prior chapters (foreign direct investment inflows). Greater policy uncertainty should lead to reduced FDI inflows, all else equal. As discussed in detail in Chapter 3, this is because risk-averse foreign investors base their expected returns at least partly on expected policy outcomes.

In order to examine this relationship using the firm-level data employed in this section, the index scores for Political Risk and Political Sentiment were aggregated by mean for each country-year group in the data. These aggregated scores provide the basis for examining their effect on a country-level dependent variable, FDI inflows.

The model employed to predict country-level FDI is a standard OLS regression with fixed effects for time, similar to those used in the prior chapters.

$$FDI\ Net\ Inflows_{it} = B_0 + B_1 Policy\ uncertainty_{it} + B_2 \log(GDP)_{it} + B_3 Oil\ Rents\ Share\ of\ GDP_{it} + B_4 Real\ exchange\ rate\ index_{it} + C_t + e_{it}$$

Table 12 presents the results of this model. As the model indicates, both measures of policy uncertainty are associated with FDI inflows in the expected manner. For Political Sentiment, a one-point increase in the score (indicating more positive sentiment) is associated with an increase in FDI inflows of roughly \$8 million USD. For the Political Risk score, the outcome is similar. This indicates that more positive investor sentiment related to politics was indeed associated with greater investment. Meanwhile, a one-point increase in this score (indicating more mentions of political risk) is associated with an \$18 million USD expected decline in FDI inflows. Similarly, this result indicates a tight relationship between investor sentiment and FDI inflows. When investors perceive more political risk, they invest less.

The control variables also performed along the lines expected from prior studies on this subject, and model fit was within an acceptable range. The findings of this model, while not particularly surprising, provide the connection needed to validate the mechanism test presented in this chapter. As mentioned previously, this finding has been replicated by a variety of past studies using similar data (see Howell & Chaddick 1994, Brink 2004, Gonchar & Greve 2022).

Table 12: Policy Uncertainty and FDI Inflows

	<i>Dependent variable:</i>	
	Foreign direct investment net inflows (millions)	
	(1)	(2)
Political Sentiment	8.4** (3.5)	
Political Risk		-18.0* (10.0)
log(GDP)	26,714*** (1,230)	26,810*** (1,235)
Real exchange rate	644.3*** (157.6)	873.9*** (157.8)
Oil rents	-2,445*** (402.4)	-2,708*** (395.4)
Observations	274	274
R ²	0.678	0.674
Adjusted R ²	0.651	0.647
F Statistic (df = 4; 252)	132.374***	130.548***

Note:

*p<0.1; **p<0.05; ***p<0.01

We can more formally link this model with the measures for economic elites and political competition explored in the earlier sections of this chapter by employing a two-stage least squares instrumental variable regression model. Here we use the prior measures of economic elites and political competition directly as instrumental variables for political sentiment and political risk in predicting policy uncertainty. The model form follows the same country-level FDI model, derived from Li & Resnick (2003), used in the earlier chapters. The model specifications are as follows³⁰:

$$FDI\ Net\ Inflows_{it} = B_0 + B_1 Policy\ uncertainty_{it} + B_2 log(GDP)_{it} + B_3 Oil\ Rents\ Share\ of\ GDP_{it} + C_t + e_{it} \mid B_0 + B_1 Large\ Firm\ Market\ Share_{it} + B_2 log(GDP)_{it} + B_3 Oil\ Rents\ Share\ of\ GDP_{it} + C_t + e_{it}$$

³⁰ The exchange rate variable is dropped for this model due to missingness in the data when used in combination with the large firm market share variable.

$$FDI\ Net\ Inflows_{it} = B_0 + B_1 Policy\ uncertainty_{it} + B_2 \log(GDP)_{it} + B_3 Oil\ Rents\ Share\ of\ GDP_{it} + C_t + e_{it} \mid B_0 + B_1 Political\ Competition_{it} + B_2 \log(GDP)_{it} + B_3 Oil\ Rents\ Share\ of\ GDP_{it} + C_t + e_{it}$$

The results of this model confirm the causal links of the mechanism test, finding that the instrumental variables are a statistically valid estimator for the model connecting policy uncertainty with FDI inflows. The size of the marginal effect for both measures of policy uncertainty on FDI is substantially larger than the estimated values in the simple OLS model. Table 13 provides the results of the model using both measures of policy uncertainty tested using the number of economic elites as the instrumental variable. The results confirm that the measures of policy uncertainty are negatively associated with FDI inflows, and that the measure of economic elites serves as a valid instrument to predict variation in these measures. Model 1 shows that states containing foreign investors with more positive sentiments about politics (measured by Political Sentiment) exhibit significantly greater FDI inflows. Model 2 illustrates that states containing foreign investors with higher perceptions of risk associated with politics (measured by Political Risk) exhibit the opposite effect. The fit and substantive significance of both models is strong. Appendix 3 contains similar results which use the prior measures of political competition as the instrumental variable for measuring policy uncertainty. Those results are similarly supportive of the use of political competition as an instrumental variable to predict variation in FDI.

Table 13: Policy Uncertainty and FDI Inflows (Two Stage Model)

<i>Dependent variable:</i>		
Foreign direct investment net inflows (millions usd)		
	(1)	(2)
Political Sentiment	77.50*** (22.71)	
Political Risk		-317.88*** (97.25)
log(GDP)	19,568*** (3,906)	31,826*** (2,253)
Oil rents	-1,106*** (333.14)	-1,510*** (344.31)
Observations	270	270
R ²	0.538	0.471
Adjusted R ²	0.501	0.428
F Statistic	275.462***	252.808***

Note:

*p<0.1; **p<0.05; ***p<0.01

These results are important for a number of reasons. Firstly, they establish a clear linkage between greater policy uncertainty and lower FDI inflows, which confirms the theoretical intuition and the findings from prior literature discussed in Chapter 2. Secondly, they confirm that the two primary variables we use to explain variation in FDI inflows in nondemocratic states (political competition and the relative number of economic elites) reliably predict this policy uncertainty, measured here through two different indices capturing the way foreign investors in a particular state feel about the policy environment.

The purpose of this chapter is to help trace the causal pathway that links political competition and the number of economic elites with decisions by investors about how much FDI to allocate to a particular market. This bridging concept, “policy uncertainty”, is the sum of investors’ expectations about how the policy environment will impact the profitability of their

investment. As discussed in Chapter 3, investors examine the number of policy changes over the previous period, and use that to form expectations about the range of policy outcomes in the future. The lower range of this expected outcome forms the basis for minimum expected returns, meaning that risk averse investors or those with small margins for profitability are less likely to invest. Most investors do not observe measures of political competition or the number of economics elites directly, but rather form their expectations based on intuition or data on past policy changes related to their area of investment. As the degree of political competition or the number of competing economic elites causes greater volatility in policymaking, minimum expected returns fall in the aggregate, and in turn the aggregate level of investment declines.

The best way to understand this concept is not by describing it, but rather by reading commentary from the investors themselves. Following significant policy developments in large markets, financial media reports frequently capture investor sentiments in their own words. Providing excerpts of this commentary is illustrative. Building from an example discussed earlier, erratic policy moves in Turkey since the election of Recep Erogan in 2014 have prompted a number of investors to reconsider investments in the country. A CNBC interview with one foreign investor was helpful in highlighting investor thinking (Smith 2021).

“Investors, we like nothing less, if you will, than an unpredictable monetary and fiscal policy,” said Ozan Ozkural, the managing partner of boutique investment firm Tanto Capital Partners. Tanto, among other things, consults for merger and acquisition deals in Turkey and other near-east markets. “In this context, I just cannot imagine any investor coming into the country in the short term until this changes... In this current climate, until we shift to a fundamentally credible reformist stance — within either this government or, whenever the

elections take place, the next one — it is very difficult to invest long term in the country right now.”

While some may consider recent events in Turkey to be an extreme example, similar commentary is common from investors in a variety of other contexts. Drawing from the Venezuela example discussed earlier, we can find similar reports from investors following bouts of uncertainty in the late 1990s. The *Wall Street Journal* provided extensive reporting during this period and captured relevant remarks from a number of foreign investors (Vogel 1999). One of those was Thomas Smith, then-president of PSEG Americas, a New Jersey-based private utilities provider that was investing in a number of South American markets at the time. One of the primary concerns that PSEG held in investing in competitive authoritarian contexts was the unstable regulatory environment. We know this from the firm’s public statements as well as legal filings. Speaking about the prospects of the company’s multimillion-dollar acquisition and development deal to provide electricity in Venezuela, Smith remarked,

“Although [Chavez] has the opportunity and desire to reform the electrical sector... To be honest, not very many international companies are making these types of investment in Venezuela [right now due to the uncertainty].”

PSEG is a large, experienced investor in international markets with a high risk tolerance. Unfortunately, this particular investment met with ill fortune, as Venezuela nationalized all electricity utilities in 2007. Ironically, PSEG is also an investor in Turkey, and was involved in a high-profile investment dispute there as well. The details of this dispute are particularly relevant to highlighting how policy uncertainty represents a threat to investment. ICSID ruled in PSEG’s favor in 2004 (long before the particularly unorthodox policy agenda inaugurated by Erdogan), citing the Turkish government’s “failure to create a stable and predictable legal framework” for

foreign investment (Ripinsky & Williams 2008). The language of the finding is particularly explicit.

“The ‘roller-coaster effect’ of Turkey’s continuing legislative changes is found to be a breach of the fair and equitable treatment obligation, as the investor’s basic expectations of stability cannot be met in a situation where the law is changing continuously and endlessly”

Examples like these help to highlight the fundamental point that investors form their “basic expectations” of profitability at least partly based on the volatility of the policy environment. In markets where weak legal protections are combined with political uncertainty, investment is riskier. Large foreign firms like PSEG that have experience dealing with risky investment markets may still make investments, but aggregate inflows must decline with mean expected profitability. Greater uncertainty around the range of policy outcomes leads risk-averse investors to expect lower returns, and as such lowers equilibrium investment.

In summary, when policy uncertainty among foreign investors is higher with regard to a particular state (measured in this chapter with two indicators of investing firm sentiment) they are likely to invest less, and the result is lower aggregate FDI inflows to the state in question. The preceding sections in this chapter have established that our primary explanatory variables (political competition and the number of economic elites) are empirically linked with greater policy uncertainty as defined by these measures. When investor firms consider investment in authoritarian states with more political competition or more economic elites, they tend to experience greater policy uncertainty, which leads them to invest less.

6.3 – Conclusion on mechanism tests

These mechanism tests provide an important contribution to advancing the theory espoused here. Economic outcomes are not purely, and perhaps not even mostly, the result of economic endowments. They are the result of political policy choices that enhance or reduce the existing economic incentives.

In order to test the other side of the mechanism, I use an OLS and two-stage least squares model to confirm the relationship between the Political Sentiment and Political Risk measures against FDI inflows. The relationship with both variables performed as expected. These models provide a test of the full causal chain.

This chapter also provides further substantiation of the theory by testing the critical mechanisms linking political competition and the number of economic elites with outcomes to the level of FDI inflows. The level of FDI inflows is determined by uncertainty over policy on the part of investors, which lowers the equilibrium level of investment.

By examining state level characteristics and linking these to the level of political risk expressed by foreign firms investing in those states, we can conduct a mechanism test that helps to further validate the findings presented in Chapters 4 and 5. Those chapters left open the question of whether and to what degree the results were indicative of economic forces rather than political ones. Examining the political mechanisms for those results directly helps us more confidently reject those alternative explanations.

7 – Targeted FDI in Nondemocratic States: Empirical Findings

The previous chapters laid out dynamics which create policy uncertainty, and in turn lead to reductions in FDI inflows. When there are economic elites who are unsatisfied with their share of benefits under current policy, and particularly when there is also political opposition through which they can easily channel their demands for change, the policy environment with regard to foreign investment is more likely to be unstable. This creates uncertainty on the part of investors, who pull back on their investment. The result is a lower level of equilibrium FDI.

The converse implication is that when non-democratic states have limited political competition and the economic landscape is characterized by a limited number of (FDI-seeking) economic elites, policy is likely to remain stable and the state will attract more FDI, all else equal. By itself, this finding is somewhat depressing; more-oligarchic, more-autocratic regimes are more successful at attracting investment than their more politically competitive and economically decentralized peers. This is also concerning because it suggests an alternative path to economic success that runs contrary to the conventional expectation that states should first liberalize to become attractive investment destinations.

However, this is only part of the story. While these regimes may attract more FDI, it should not be confused with broad-based investment that occurs when states provide institutionalized property rights and other impartial legal protections. By contrast, FDI inflows to these illiberal regimes are highly targeted to benefit incumbent elites. Therefore, the third dynamic I examine is how elites target *specific types* of foreign investment that will benefit their interests. This targeting is the focus of this chapter. As discussed earlier, this concept is important for several reasons. The sectors towards which FDI inflows are allocated has important

ramifications for growth and development, and also important implications for how FDI inflows impact dynamics like wage growth and the formation of a middle class in developing countries.

As I will demonstrate, incumbent economic elites favor foreign investment under two conditions. Firstly, such investment should not threaten to empower rivals or primarily benefit regime outsiders. Secondly, such investment should provide a tangible benefit for regime elites and insiders. This benefit could come directly, such as by providing capital (including intellectual capital) or business for elite-owned or elite-controlled firms, or indirectly by providing revenues to elites through taxation or fees on the economic activity stimulated by the investment.

As discussed in Chapter 3, this sort of favoritism results in concentrated, or “targeted”, FDI often along predictable sectoral lines. Economists generally divide the economy into three sectors. The primary sector refers to resource extractive industries, such as agriculture, mining, forestry, and oil extraction. The secondary sector refers to economic activities relating to primary industry, such as manufacturing, construction, and processing intermediary goods. The tertiary sector, also called the “service sector”, refers to industry focused on media, banking, entertainment, and other services. Thus, favoritism is a country-level concept, but is measured by examining sectoral concentration. For example, when we say that investment into a state is “targeted”, we mean that such investment is flowing disproportionately to particular sectors of that state’s economy.

Because FDI into the secondary sector is necessary to maintain performance in that sector (generally more so than for the primary sector), and secondary sector growth is attractive to

autocrats for a variety of reasons,³¹ I will demonstrate that FDI in authoritarian states tends to be targeted towards the secondary sector. Further, FDI into the tertiary sector is often unattractive to autocrats because it often conflicts with state controls over key sectors like media and banking and requires relatively free information flows and an educated population. Therefore, I will demonstrate that FDI in authoritarian states tends not to be targeted towards the tertiary sector. I employ two unique datasets to examine this claim. The first looks at FDI inflows in dollars by sector. The second looks at cases of FDI investment by foreign firms, measured as inflows in number of employees, segregated by sector. Both of these datasets will help us examine the claim that FDI is targeted in nondemocratic states along sectoral lines, as well as the claim that it becomes *more* targeted when there are fewer economic elites or less political competition.

The ability of autocrats to employ favoritism and achieve targeted FDI inflows varies depending on how much competition there is over policy governing FDI. When political competition or dissatisfied economic elites are able to secure policy concessions or changes as discussed in the previous chapters, this will result in autocrats being generally less able to favor particular types of FDI. This is because political opposition is likely to target policies that are benefiting incumbent elites, and these elites are precisely the ones the incumbent autocrat is trying to favor with targeted FDI inflows. This favoritism is in fact often the *source* of dissatisfaction among economic elites who are excluded from it. As a result, FDI inflows will be less targeted when greater policy uncertainty is present due to political competition or a greater number of competing economic elites.

³¹ These reasons relate to the relative ease with which secondary sector activity can be controlled and taxed, and the degree to which domestic firms (often controlled by domestic economic elites) benefit from activity in this sector. The secondary sector supply chain provides financial opportunities that are less applicable to the tertiary (or even the primary) sector.

Recall that this line of reasoning led to the proposition of two hypotheses in Chapter 3. The first of these dealt with the effect of political competition on the degree to which FDI is targeted. When political competition is reduced, autocrats can more reliably use favoritism towards the secondary sector to produce targeted FDI inflows. These leads to the following prediction:

H3a: Authoritarian states with less political competition will exhibit more targeted FDI inflows (concentrated towards the secondary sector and away from the tertiary sector) than authoritarian states with more political competition, all else equal.

Likewise, when there are few economics elites in a particular state, it produces the same outcome. Autocrats can more reliably use favoritism towards the secondary sector to produce targeted FDI inflows. This leads to the second part of H3:

H3b: Authoritarian states with relatively fewer economic elites will exhibit more targeted FDI inflows (concentrated towards the secondary sector and away from the tertiary sector) than authoritarian states with relatively more economic elites, all else equal.

Examining these claims will require the testing of two propositions. The first is that secondary-sector concentration in FDI inflows (“targeted FDI”) is indeed present in nondemocratic states. The first part of this chapter examines this general claim, and defines “targeted FDI” as FDI inflows which are concentrated towards the secondary sector and away from the tertiary sector. While some nondemocratic states target FDI inflows to the primary sector, this is less observable in the aggregate and is instead discussed in more detail as part of the case study at the end of this chapter.

The second component of this chapter deals with testing that this targeted nature of FDI increases as political competition and the number of economic elites declines. In order to do this,

I examine how the concentration of FDI inflows to the secondary and tertiary sector change across different types of nondemocratic states.

Due to the diverse nature of foreign investment and the variety of ways in which it can benefit regime insiders and allies, large-n style analysis can be challenging. Therefore, I follow my quantitative analysis in this chapter with a case study that provides more insight into the dynamics at play.

7.1 – Approach to Testing H3

Because FDI targeting must be measured by sectoral concentration, testing this concept requires more-granular FDI inflows data that can be differentiated by sector. The approach to testing H3 relies upon a two-step analysis. The first part of the analysis, beginning in section 7.2.1, summarizes the data and focuses on substantiating the claim that FDI in authoritarian states is indeed targeted, primarily to the secondary sector. The second part of the analysis, beginning in 7.2.2, then builds upon this idea to analyze whether FDI becomes *more* targeted in states with less political competition or fewer economic elites. This latter portion of the analysis relies on two techniques. First, I look at the “concentration” of FDI to particular sectors, and how the political variables effect this. Next, I look at how the marginal effect of the political variables change depending on the type of FDI in question (i.e., what sector it is in).

The H3 hypotheses rely on foreign investment targeting as the primary dependent variable. Here I employ FDI data from the International Trade Centre (ITC) to compare the degree to which FDI is targeted in consolidated regimes versus competitive regimes. The data contains two subsets, both of which I use to test the effect of state-level political variables on the degree to which FDI is targeted by sector. The first set contains individual cases of foreign direct investment, and the second set records inflows by sector. Crucially, both datasets contain

information on FDI differentiated by sector. This unique feature allows for disaggregating FDI inflows by sector and subsector, and thus makes it possible to examine the claims of H3a and H3b.

The full ITC Investment Map data (“case data”) contains over 142,000 individual cases of investment across roughly 200 countries in the set, including investment year, investing firm sector, host and parent state, and the size of the investment. The ITC case data provides investment cases measured by the size of the project in *number of employees*. While not a perfect measure, it seems reasonable to suspect that the investment size measured in number of employees should be correlated with the investment size measured in USD.³² The investment size variable ranges from 0 to over 300,000 in some cases, but most cases are between 50 and 500. The mean value is 467. The full ITC dataset with control variables contains 40447 observations. The set covers over 38,000 private firms across 115 authoritarian and competitive authoritarian states, with cases beginning in 1971 and ranging to the present.³³

This ITC case dataset also contains subsector information, allowing us to identify investment patterns with more granularity. Some examples of potentially interesting subsector designations are association with the oil industry, involvement in manufacturing, and association with exporting. Classifications are taken from the National Industrial Classification Code, or “NICC”, framework.

The ITC database also contains country-level FDI inflows data (“inflows data”). This data provides foreign investment inflows segregated by primary, secondary, and tertiary sector in

³² FDI inflows are argued to be positively correlated with employment (see Bekhet 2013), and the employment measure is positively correlated with total FDI inflows at the country level in my data.

³³ As with prior analyses, I restrict my observations to cases occurring after 1980.

a time-series fashion. The unit of measurement for this series is FDI in USD. This dataset is an important supplement to the case data because it provides an alternate measure of FDI as measured in USD (as opposed to using the number of employees). However, unlike most FDI data (such as the World Bank data employed earlier), this dataset also has the rare feature including FDI inflows by investing firm sector. This makes it an important source of information for examining the concept of targeted FDI.

By examining how much FDI into a state is concentrated to a particular sector or subsector, we can estimate a value for how “targeted” FDI inflows are. I construct broad measures for FDI targeting by examining how concentrated FDI inflows are to a particular sector relative to the overall total. These measures can be constructed using either the ITC inflows data or the case data. Generally, the best way to conceptualize “targeted FDI” is at the broad sector level (i.e., primary, secondary, or tertiary). This is because these categories appear in most countries in most years. Subsectors, by contrast, are often country or time specific and therefore more difficult to generalize. For example, while “equipment manufacturing” may be important in some states and FDI may indeed be targeted to that subsector, many other states may not have a market for equipment manufacturing. However, the subsector data is still a useful supplement to the broader sectoral data. This will be discussed in more detail in the following sections.

The primary independent variables used in this chapter are the level of political competition and the number of economic elites. The measurements for these variables are taken from the independent variable measures for H1 and H2. Once again, economic control variables are important to these tests. Controlling for economic factors that might explain targeted FDI is important to distinguish the impact of policy favoritism from economic endowments. Similar to H1 and H2, I plan to utilize data from the World Bank to develop these economic control

variables. These include factors such as market size and development, as well as measures of important economic endowments that may skew sectoral inflows, such as the presence of oil and gas. Other variables that have been found to impact sectoral concentration, such as exchange rate are also included (Walsh & Yu 2010). Each of these are derived from the World Bank data in a manner similar to the previous chapters.

7.2 – Analysis of H3

H3 focuses on the degree to which FDI is targeted in authoritarian regimes, and how this condition varies between different types of regimes. In order to measure this, I utilize both subsets of the ITC data on FDI in authoritarian states described in the previous section. As discussed above, the data are coded according to the sector and subsector in which the FDI occurred, making the data useful for distinguishing how targeted FDI is towards a particular sector. As discussed previously, the primary sector refers to extractive economic activity, such as agriculture, forestry, drilling, mining, or fishing. The secondary sector comprises economic activity centered on production of physical goods and refined products, such as manufacturing of consumer, intermediary, or industrial goods, chemical production, textiles, or construction. The tertiary sector, otherwise called the “service sector”, is focused on the provision of services, such as finance, banking, and accounting, tourism, communications and marketing, software, and any other intangible service. “Subsector” is a further categorization of any activity within these three main categories, and includes any of the examples I have listed here. An examination of the data provides support for both the proposition that FDI in nondemocratic states is targeted (towards the secondary sector and away from the tertiary sector), as well as for the claim that the degree to which FDI is targeted meaningfully varies across nondemocratic states depending on the degree

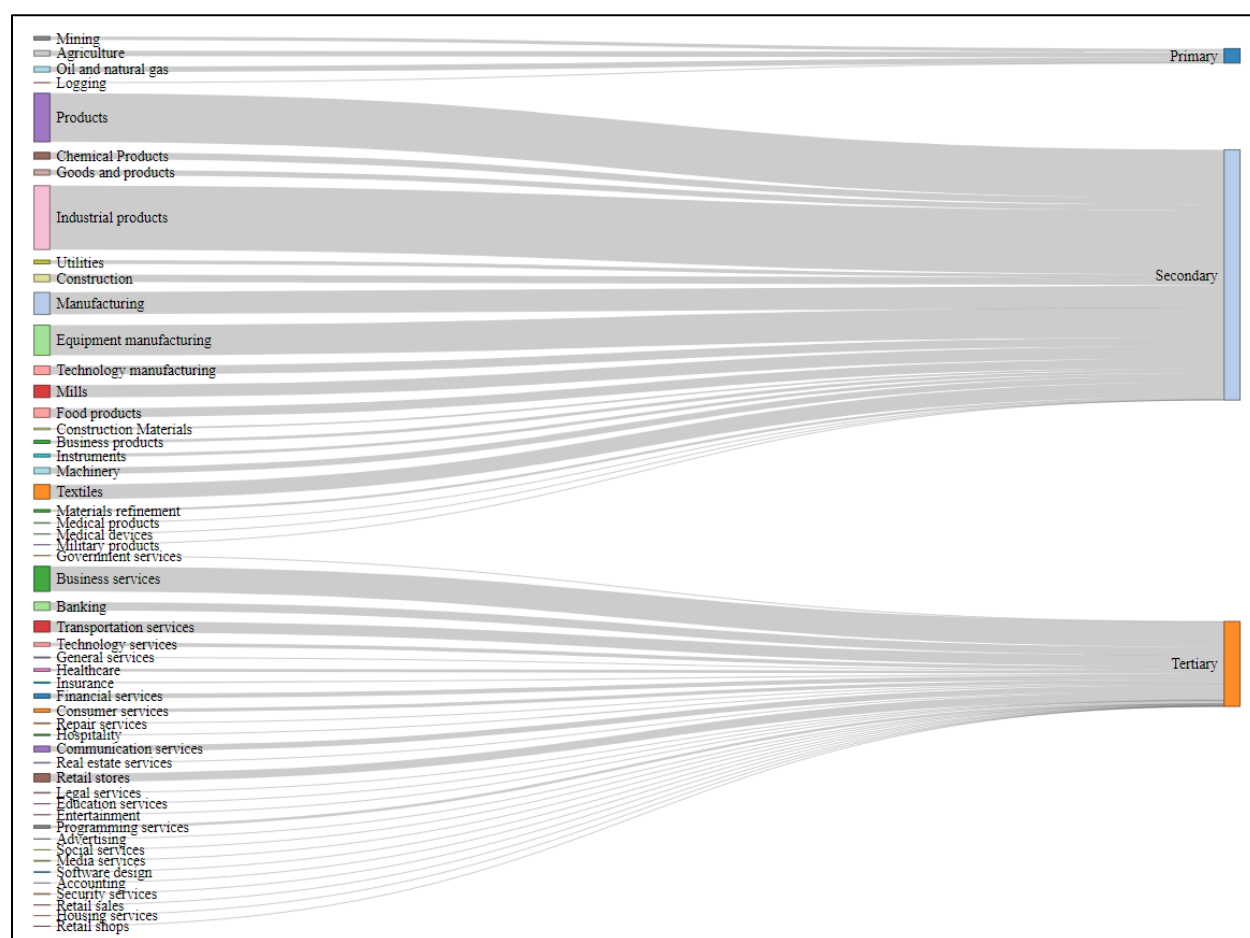
of political competition or the number of economic elites (H3a and H3b). The succeeding sections examine each of these claims in turn.

7.2.1 – The Appearance of Targeted FDI in Nondemocratic States

This section will examine the general form of FDI in nondemocratic states, illustrating specifically that it is targeted away from the tertiary sector and towards the secondary sector. A high-level examination of the ITC case data indicates support for this claim. Among this case data, for which the investment size is measured in the number of positions hired, the mean was 538. For the most authoritarian states, this mean was 562, and for competitive regimes the mean investment size was 413. Among sectors, the largest mean was in the secondary sector, with 576 employees on average, and the lowest value was for the tertiary sector, with a mean of 469. This provides a general picture of FDI inflows being targeted towards the secondary sector and away from the tertiary sector in authoritarian states.

Figure 18 provides a visual representation of the ITC case data (i.e., the ITC dataset of individual cases of foreign direct investment by individual firms). The nodes on the left side indicate the subcategories of the larger categories on the right side. The size of the nodes and the link paths are determined by the volume of that type of investment in the sample. The figure provides a helpful and intuitive summary of the types of FDI observed in the sample of authoritarian states. The most popular form of FDI in this sample of authoritarian states was in the secondary sector, particularly in industrial products. In other words, among all the individual cases of firms pursuing foreign direct investment in an authoritarian state recorded in the ITC dataset, the largest sector by volume (as measured in number of positions created) was the secondary sector, and the largest subsector by volume was industrial products.

Figure 18: FDI to Authoritarian States by Sector and Subsector



Source: International Trade Centre

Similar trends are also observed in the ITC country-level inflows data. Mean secondary sector yearly inflows were roughly constant across the sample at approximately \$550 million. However, in the most authoritarian states (those ranked below negative 4 on the Polity scale), mean tertiary sector yearly inflows saw a precipitous drop from the overall mean (from roughly \$2 billion to roughly \$1 billion).³⁴ This indicates that tertiary sector FDI underperforms in more-authoritarian settings.

³⁴ While mean tertiary sector yearly inflows were larger than mean secondary sector yearly inflows in this sample, this was driven primarily by a few outliers. With these removed, the tertiary sector mean dropped below the mean for secondary sector inflows.

This is an indication of two trends. Firstly, authoritarian states, on average, tend to be most successful at attracting secondary sector investment. This aligns with the expectation that the secondary sector is more attractive to autocrats due to the degree to which it can be monetized, controlled, and undertaken without the need for an educated workforce or loosening of information controls. In economic terms, autocratic states generally underperform in developing human capital that attracts tertiary sector investment (see Pinto et al 2005). Secondly, in comparison with the primary sector (which has many of these same “benefits”), this figure also illustrates that the secondary sector requires a greater degree of initial and continuing investment to attain and remain in function (as discussed earlier in context with Kobrin 1987). As discussed previously, there is reason to suspect that primary sector dominated autocracies are less likely to attract FDI (i.e., Akerman et al 2016).

These observations are also observed statistically, where we find that an association with the secondary sector is predictive of larger FDI investments. We can illustrate this using a simple multilevel regression which includes a dummy variable indicating the sector in which a particular firm-level case of FDI occurred. For this I employ an OLS model using fixed effects for time and for firm. I specify a basic model of firm-level investment size (for firm j) to include measures of firm sector location, as well as country-level (country i) control variables for GDP, exchange rate, and political competition.³⁵ This is not a direct hypothesis test of our primary explanatory variables (political competition and the number of economic elites), but rather the premise is to examine whether certain firms are, on average, likely to make larger or smaller

³⁵ Exchange rate index has been found to be an important economic variable in sectoral concentration. See Walsh & Yu 2010.

investments based on their sectoral affiliation (i.e. to determine whether favoritism is indeed occurring). The model used is specified as:

$$FDI\ Investment_{jt} = B_0 + B_1 Firm\ sector\ location_{jt} + B_2 log(GDP)_{it} + B_3 Real\ exchange\ rate\ index_{it} + B_4 Political\ competition_{it} + C_{jt} + e_{it}$$

Table 14 presents the results of this modeling of the impact of a firms' sectoral affiliation and the size of investment. It found a strong positive association between secondary sector firms and investment size, and a negative association with tertiary sector affiliation. This shows that cases of FDI that took place in the secondary sector tended to be larger by roughly 1800 employees, and cases occurring in the tertiary sector tended to be smaller by roughly the same amount. Primary sector affiliation had no significant effect. This indicates that foreign investors seeking to invest in the secondary sector in nondemocratic states typically make larger investments, and those investing in the tertiary sector typically make smaller investments. I argue that this is because autocrats pursue policies of favoritism towards secondary sector investment, which makes investment in that sector more profitable and therefore leads to more inflows. These results provide evidence towards that claim.

Among the control variables, the exchange rate index saw a negative association with investment size, indicating that cases of investment in states with stronger currencies were typically smaller. Polity Score also saw a negative association with investment size, consistent with the results developed in Chapter 4. Oil rents were positively associated with investment size, an intuitive result. Lesser developed states also saw larger investment, indicating that foreign investment in those states tended to involve more employees.

Table 14: Investing Firm Sector Location and Size of Investment in Authoritarian States

	<i>Dependent variable:</i>		
	Investment Size		
	(1)	(2)	(3)
Firm in secondary sector	1,229.455*** (389.385)		
Firm in primary sector		25.806 (523.876)	
Firm in tertiary sector			-1,383.964*** (410.522)
log(GDP)	-40,710.690*** (5,461.707)	-39,787.850*** (5,474.666)	-41,004.760*** (5,462.986)
Exchange rate index	-739.411*** (59.068)	-731.840*** (59.241)	-741.261*** (59.055)
Polity Score	-480.840* (271.341)	-498.371* (272.305)	-474.139* (271.238)
Oil rents	581.196*** (140.964)	560.744*** (141.348)	587.453*** (140.965)
Underdeveloped	46,766.430*** (3,891.156)	48,073.960*** (3,883.647)	46,510.120*** (3,894.767)
Observations	31,487	31,487	31,487
R ²	0.324	0.319	0.325
Adjusted R ²	-15.018	-15.138	-15.001
F Statistic (df = 6; 1328)	106.277***	103.836***	106.619***
<i>Note:</i>		*p<0.1; **p<0.05; ***p<0.01	

All of these observations support a general picture of authoritarian states as being inclined to encourage targeted investment, particularly in lucrative and easily controlled sectors such as industrial manufacturing or textiles (i.e. in the secondary sector). The lack of investment in the primary sector is supportive of the expectation that FDI often plays a less important role in primary sector development relative to the secondary sector. The measure of FDI shown in the first two figures is measured in the size of the investment by persons hired. Secondary sector

operations are more human capital-intensive. However, as we will see, these findings also extend to the size of the investment in dollars.

The relatively poor performance of the tertiary sector industries is even more telling of a political trend. While the tertiary sector can be just as human capital intensive, the tertiary (service) sector is more difficult to prop up using a state-directed approach, and the types of industries it contains are less likely to produce taxable exports. The industrial strategy that is easier for most autocrats to execute is simply to focus on manufacturing and commodity export as a revenue strategy, and this is more or less what has characterized most autocratic states in the postwar global economy (see Shapiro & Taylor 1990). More than any other sector, service sector success depends on educated populations and the free exchange of information, which are both more difficult to produce in authoritarian settings. All of these factors make investment into the service sector less lucrative to incumbent political and economic elites, especially relative to the secondary sector. To the extent that an authoritarian state contains significant service sector economic elites (such as state media or banking), it is less likely that such enterprises will be globally competitive, and so incumbent leaders also have an incentive to prevent the inflow of service sector investment that could compete with domestic firms.

All of this trend analysis is suggestive that if autocrats do engage in targeted FDI strategies, they are likely to target FDI for secondary sector enterprise, and target FDI away from the tertiary sector. The next section will focus on examining how political competition and the number of economic elites impact the *degree* to which FDI is targeted in such ways in nondemocratic states.

7.2.2 – Regression Analysis for H3a

The previous section was focused mostly on demonstrating that FDI is indeed targeted in authoritarian states, and examining the nature of this targeting. The primary conclusion is that autocrats seek to target FDI to the secondary sector, for a variety of reasons. This provides a basis on which we can examine how political variables affect these trends. This section will extend the analysis to examine how the degree to which FDI is targeted varies across various levels of political competition and with various relative numbers of economic elites present in the state. As the hypotheses suggest, as policy becomes more consistent (i.e., with less political competition or fewer economic elites), the degree to which FDI is targeted (to the secondary sector) should increase.

A review of the ITC case data on FDI indeed indicates greater diversity for competitive regimes. Examining the cases of FDI from the standpoint of which major sector they took place in (primary, secondary, or tertiary), the data shows that competitive regimes tend to have investment that is more diversified across sectors, potentially indicating a less targeted approach from elites in steering investment into particular sectors. Secondary sector investment comprises almost 70% of cases (unweighted) for consolidated regimes, and roughly 55% for competitive regimes. The difference when weighted (by investment size) is even greater; 75% and 53%. The standard deviation between primary, secondary, and tertiary shares (weighted) is 25% for competitive regimes, and 37% for consolidated regimes, reflecting greater concentration for consolidated regimes. This supports the general view that FDI inflows tended to be more targeted in consolidated authoritarian states because they are able to employ favoritism more reliably. An illustration of mean FDI by sector can be found in Appendix 3. These distinctions provide an indication of support for H3a (and H3b).

In keeping with the trend analysis above, in order to measure the degree to which foreign direct investment is targeted in a particular state, I develop a formal analysis in which I rely upon measures of how concentrated foreign investment is into each of the three primary sectors. As mentioned previously, the ITC data contains sector differentiated figures for FDI inflows measured in dollars. To capture the degree of investment concentration for each primary sector, I divide the dollar amount of foreign direct investment for a particular sector by the total dollar amount of foreign direct investment for each state-year case.³⁶ The resulting value is expressed as a percentage. For example, a value of 25% for the secondary sector would indicate that 25% of total FDI occurred in the secondary sector. A higher value indicates more concentration, and thus more targeted FDI. The mean concentration values for the primary, secondary, and tertiary sectors were 29%, 21% and 34%, respectively. Across the sample, values range from roughly negative 100% (where a particular sector had significant net divestment) to around 120% (where sector inflows were larger than total inflows due to divestment in other sectors).

Again, my specification approach is to use ordinary-least-squares (OLS) regression models with fixed effects for time (by year). As discussed in the introduction, hypothesis 3a predicts that greater political competition will result in a state receiving FDI inflows that are less targeted (to the secondary sector). In order to test Hypothesis 3a, I specify the following basic model of state-level FDI targeting to include all six measures of political competition. The model examines the degree of sectoral concentration in FDI inflows as the dependent variable.

$$\text{Sector Share of FDI Net Inflows}_{it} = B_0 + B_1 \text{Political Competition}_{it} + B_2 \log(\text{GDP})_{it} + B_3 \text{Oil Rents Share of GDP}_{it} + C_t + e_{it}$$

³⁶ Breaking down the measure into subsectors was also possible, but impractical for testing across a wide range of states with diverse economies.

If hypothesis 3a is correct, then we should expect to see FDI more targeted by sector when political competition is low. As we established in the previous section, we should expect that policy favoritism should result in FDI inflow targeted to the secondary sector and away from the tertiary sector. Therefore, political competition should be positively associated with tertiary sector FDI inflow concentration, and negatively associated with FDI inflow concentration from foreign firms in the secondary sector.

In Table 15, we observe that our measures of political competition, where significant, are positively associated with relatively more investment in the tertiary sector. While the number of observations is limited by the data, the effect is robust across a number of model specifications.³⁷ The most important result here is seen in model 3. There we find that one of the primary measures of political competition, the Electoral Democracy Index, is significantly and positively associated with higher concentration in the tertiary sector.

A move across the range of Electoral Democracy Index values is associated with a 65% increase in tertiary sector concentration (model 1). The standard deviation for the index was 0.20, equivalent to a 13% increase. This seems to imply that as states feature less political competition, they will pursue investment policies that tend not to favor investment by foreign firms associated with the tertiary sector. The results of model 6 using Opposition Party Autonomy as the measure of political competition also yielded statistically significant results. This indicates that states with greater political competition as measured by the independence of their opposition parties saw significantly more inflows to the tertiary sector. Again, I argue that

³⁷ The significant model (model 3 in Table 15) is robust to the inclusion of the full battery of standard economic control variables, including population, exchange rate, and development level, however, the number of observations becomes limited when these controls are added due to missingness in the data. These results can be viewed in Appendix 3.6.

this is due to the diminished ability of the autocrat to pursue investment policies that discriminate against the tertiary sector. So overall, two of six measures of political competition are strongly supportive of the hypothesized effect, and two others (models 4 and 5) are indicative of the expected (positive) effect but not quite statistically significant. The effects of the remaining two measures were less discernable from zero.

Testing of these variables for the other two sectors did not yield statistically significant results. For brevity, these results are omitted here, but can be viewed in Appendix 3.6. This finding indicates that the negative relationship between political competition and FDI being targeted away from the tertiary sector was stronger than the expected negative relationship between political competition and FDI being targeted towards the primary or secondary sectors. In order to address this gap, the relationship between these variables is explored in more detail in Section 7.2.4.

Table 15: Political Competition and Targeted FDI (Tertiary Concentration)

	<i>Dependent variable:</i>					
	Tertiary concentration					
	(1)	(2)	(3)	(4)	(5)	(6)
Polity Score	-0.002 (0.011)					
Political Competition		-0.004 (0.007)				
Electoral Democracy Index			0.657** (0.272)			
Multiparty Elections				0.069 (0.067)		
Legislature Opp. Parties					0.058 (0.038)	
Opp. Party Autonomy						0.092*** (0.035)
log(GDP)	-0.044* (0.025)	-0.044* (0.023)	-0.014 (0.025)	-0.040* (0.023)	-0.026 (0.025)	-0.019 (0.024)
Oil rents % of GDP	-0.023*** (0.006)	-0.022*** (0.006)	-0.021*** (0.006)	-0.022*** (0.006)	-0.021*** (0.006)	-0.021*** (0.006)
Observations	226	226	226	226	226	226
R ²	0.085	0.087	0.111	0.090	0.095	0.116
Adjusted R ²	-0.014	-0.012	0.014	-0.009	-0.003	0.020
F Statistic (df = 3; 203)	6.312***	6.445***	8.426***	6.681***	7.131***	8.855***

Note:

*p<0.1; **p<0.05; ***p<0.01

Among the control variables, higher GDP is associated with a slightly lower concentration in the tertiary sector. This is likely not a result of GDP itself, but rather an artifact of the association between autocratic states with lower political competition having both higher GDP and less tertiary sector concentration. Where the effect of political competition is significant, the marginal effect of GDP is removed. With oil rents, the small negative association makes sense, as states with higher oil rents can be expected to have less tertiary sector investment concentration specifically due to the larger relative size of the primary sector. In

sum, these findings are suggestive, but not conclusive, that increased political competition decreases the effectiveness of policy bias against the tertiary sector.

7.2.3 – Regression Analysis for H3b

Following from how the tests of H2 expanded the models developed to test H1, the models used to test H3a and H3b here are largely the same model with the variable measure for the number of economic elites being included in H3b.

As discussed in the introduction, hypothesis 3b predicts that a greater number of economic elites will result in a state receiving FDI inflows that are less targeted (to the secondary sector). In order to test Hypothesis 3b, I specify the following basic model of state-level FDI targeting to include the primary measure of the relative number of economic elites; large firm market share. This model also uses the sectoral concentration of FDI inflows as the dependent variable.

$$\text{Sector Share of FDI Net Inflows}_{it} = B_0 + B_1 \text{Large firm market share}_{it} + B_2 \log(\text{GDP})_{it} + B_3 \text{Oil Rents Share of GDP}_{it} + B_4 \log(\text{population})_{it} + B_5 \text{Underdevelopment dummy}_{it} + B_6 \text{Political Competition}_{it} + C_t + e_{it}$$

If hypothesis 3b is correct, then we should expect to see more targeted FDI when there are few economic elites. Specifically, we should expect that policy favoritism should result in FDI inflows targeted to the secondary sector and away from the tertiary sector. Therefore, fewer economic elites (i.e., higher large firm market share) should be negatively associated with tertiary sector FDI inflow concentration, and positively associated with secondary sector FDI inflow concentration.

The control variables are taken from the standard model used in Chapter 4, and include common sectoral predictors such as labor pool size (population), oil rents, and level of

development. The model used by Walsh & Yu (2010) also includes an exchange rate variable. This variable does not meaningfully change the results, although the size of the marginal effect for the economic elites variable is reduced and model fit is improved. For brevity, results using this additional full model are provided in Appendix 3. Overall, these variables help control for structural economic factors that predict sectoral concentration.

Table 16 provides a look at the results of this model for concentration in each sector of the economy. In this case I find that having a greater number of economic elites is positively associated with relatively more investment in the tertiary sector. The first table illustrates the results of the models using Polity Score as the measure of political competition, while the second table illustrates the same results using the Electoral Democracy Index as the primary measure of this variable. Interestingly, the Large Firm Market Share variable is more significant than the political competition measure in both instances.

Shown in the second table, Table 17, a move across the range of large firm market share is modeled to a reduction in tertiary sector concentration of over 100%. Using a standard deviation of 0.20 for the independent variable, the expected change is 22%. This indicates that having a more oligarchic economy is associated with a decline in the degree to which FDI inflows are concentrated to the tertiary sector.³⁸ I propose that this finding is the result of policy favoritism. When states have less political competition (i.e., H3a) or fewer economic elites (i.e., H3b), they pursue FDI policy strategies to benefit the state and key supporters. This typically

³⁸ The results in both tables were robust to the inclusion of an exchange rate variable. However, the inclusion of this variable further reduced the number of observations, and exchange rate should not covary strongly with any of the other independent variables. For this reason, the variable is not included in these tables. These results can be viewed in Appendix 3.

results in less relative FDI inflows to the tertiary sector, particularly in favor of the secondary sector.

Similar to the models used for H3a in the previous section, these models were not able to establish a clear statistical relationship with the secondary sector. As in that section, this outcome is likely related to the low number of observations, and indicates that the negative relationship between the number of economic elites and FDI being targeted away from the tertiary sector was stronger than the relationship between economic elites and the other two concentration variables. However, in order to address this gap, I explore the connection with the secondary sector in greater detail in the following sections.

Table 16: Economic Elites and Targeted FDI

	<i>Dependent variable:</i>		
	Primary concentration	Secondary concentration	Tertiary concentration
	(1)	(2)	(3)
Large Firm Market Share	2.754 (2.110)	-1.260 (0.846)	-1.038* (0.619)
log(GDP)	-0.010 (0.640)	-0.215 (0.228)	-0.186 (0.167)
Oil rents	0.100** (0.045)	-0.033* (0.018)	-0.042*** (0.013)
log(population)	0.187 (0.578)	0.149 (0.169)	0.025 (0.124)
Underdeveloped	0.195 (2.018)	-0.152 (0.984)	0.111 (0.721)
Polity Score	0.065 (0.089)	-0.003 (0.040)	-0.017 (0.029)
Observations	87	106	106
R ²	0.098	0.072	0.186
Adjusted R ²	0.272	0.218	0.068
F Statistic	1.102 (df = 6; 61)	1.036 (df = 6; 80)	3.045*** (df = 6; 80)
<i>Note:</i>			
*p<0.1; **p<0.05; ***p<0.01			

Table 17: Economic Elites and Targeted FDI (Alternate Political Competition Measure)

	<i>Dependent variable:</i>		
	Primary concentration	Secondary concentration	Tertiary concentration
	(1)	(2)	(3)
Large Firm Market Share	2.485 (2.081)	-1.255 (0.889)	-1.099* (0.651)
log(GDP)	0.169 (0.645)	-0.211 (0.224)	-0.165 (0.164)
Oil rents	0.067 (0.045)	-0.032* (0.019)	-0.034** (0.014)
log(population)	-0.131 (0.647)	0.150 (0.193)	0.057 (0.142)
Underdeveloped	-0.031 (1.997)	-0.139 (0.974)	0.163 (0.713)
Electoral Democracy Index	-1.124 (3.017)	0.009 (1.415)	0.477 (1.036)
Observations	87	106	106
R ²	0.092	0.072	0.185
Adjusted R ²	0.280	0.218	0.070
F Statistic	1.029 (df = 6; 61)	1.034 (df = 6; 80)	3.019** (df = 6; 80)
<i>Note:</i>			*p<0.1; **p<0.05; ***p<0.01

Among the control variables, oil rents is again associated with less concentration in the secondary and tertiary sectors, and positively associated with concentration of FDI to the primary sector, an intuitive result. GDP is again negatively associated with tertiary sector concentration. One likely reason for this could be the fact that many states in which tourism is the primary industry (i.e., tertiary sector dominated) are small, lesser developed states. The low number of observations in the ITC country-level FDI data also makes finding significant results more challenging.

7.2.4 – Additional Testing Using Subsector Data

The previous section illustrated relatively clear findings with regard to the tertiary sector. However, the models in the previous section were not able to establish a clear relationship between political competition, economic elites, and FDI targeting in favor of the *secondary sector* specifically. Here I seek to probe this question further by examining the second ITC dataset, which covers individual cases of FDI, exploring bifurcation in the marginal effects of political variables on FDI between the various sectors of FDI inflows. These results help to further evaluate my claims about secondary sector favoritism. In order to do this, I replicate the models of FDI used in Chapters 4 and 5, but use the ITC data in place of the World Bank data so that I can disaggregate the dependent variable (FDI inflows) by what sector it occurred in. If autocrats indeed value some types of FDI inflows (i.e., secondary sector) over other types, we should see the marginal effect of the political variables *increase* for these favored subtypes.

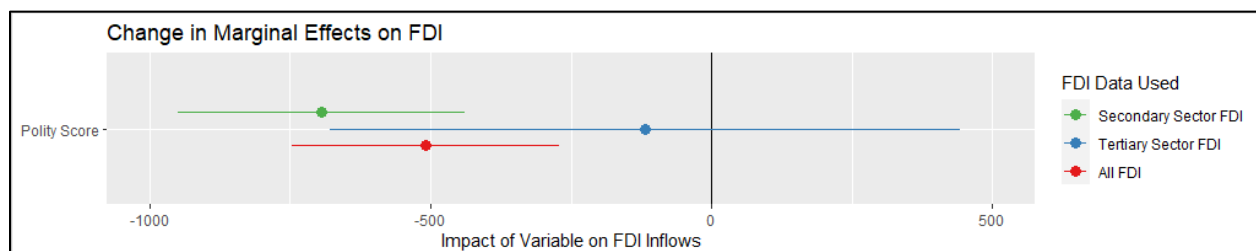
One of the issues with the country-level ITC FDI data used in the previous section is the lack of observations. A method to get around this is to aggregate the firm-level ITC data, which contains more countries and years. Following this, here I develop models using the firm-level data to test the degree to which secondary sector FDI was favored over tertiary sector FDI. The model specification used here uses the ITC firm-level data, aggregated to country-level mean of FDI inflows as measured in terms of employees, and the same model specification used for the prior country-level models of FDI. The models are replicated using different subsets of the data disaggregated by FDI type (the original model results using aggregate FDI data can be found in Tables 3 and 4). The full specified model form is:

$$FDI\ Inflows_{it} = B_0 + B_1 Large\ firm\ market\ share_{it} + B_2 \log(GDP)_{it} + B_3 Oil\ Rents\ Share\ of\ GDP_{it} + B_4 Political\ Competition_{it} + B_5 Real\ exchange\ rate\ index_{it} + C_t + e_{it}$$

For the first tests, I drop the economic elites measure (*Large firm market share* in the above model) in order to test the results for political competition in the same manner done in Chapter 4 (Table 3). The only difference is that FDI inflows are now disaggregated by sector. The results of testing this model using FDI disaggregated by sector indicate that the negative marginal effect of political competition on FDI is stronger for secondary sector FDI, indicating that this sector is particularly sensitive to the effect hypothesized in Chapter 4. If autocrats tend to favor investment to secondary sector enterprises such as textiles, industrials, or other types of manufactured products, the impact to this type of FDI can be expected to be greater when political competition disrupts the use of this FDI to reward insiders.

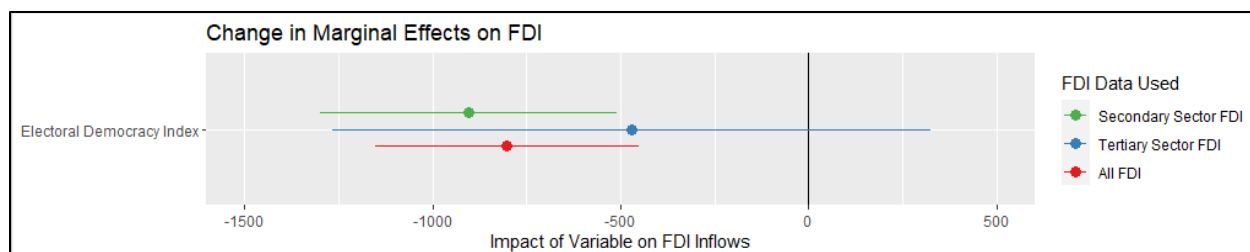
Figure 19 illustrates this effect, showing an increase in the size of the negative marginal effect of political competition when examining solely secondary sector inflows. While there is a fair degree of overlap between the marginal effects, the overall indication is that the negative effect of political competition on FDI inflows is larger for the secondary sector than it is over FDI inflows overall. This is consistent with the findings in the previous section, which suggest that greater political competition increases the proportion of FDI investment flowing towards the tertiary sector. By contrast, the marginal effect for tertiary sector FDI was insignificant, indicating that tertiary sector FDI does not meaningfully increase when states become more autocratic.

Figure 19: Political Competition and FDI Inflows by Sector



To reiterate the theoretical point, the reason this result is expected is because when policy is more consistent (i.e., there is less competition over policy), we can expect that autocrats will favor investment into the secondary sector, for all the reasons explained previously. As a result, FDI will be more targeted towards the secondary sector. This finding of an increase in the negative marginal effect of political competition for secondary sector inflows is also similar when using the Electoral Democracy Index as the political competition measure (Figure 20).

Figure 20: Political Competition and FDI Inflows by Sector (Alternate Measure)

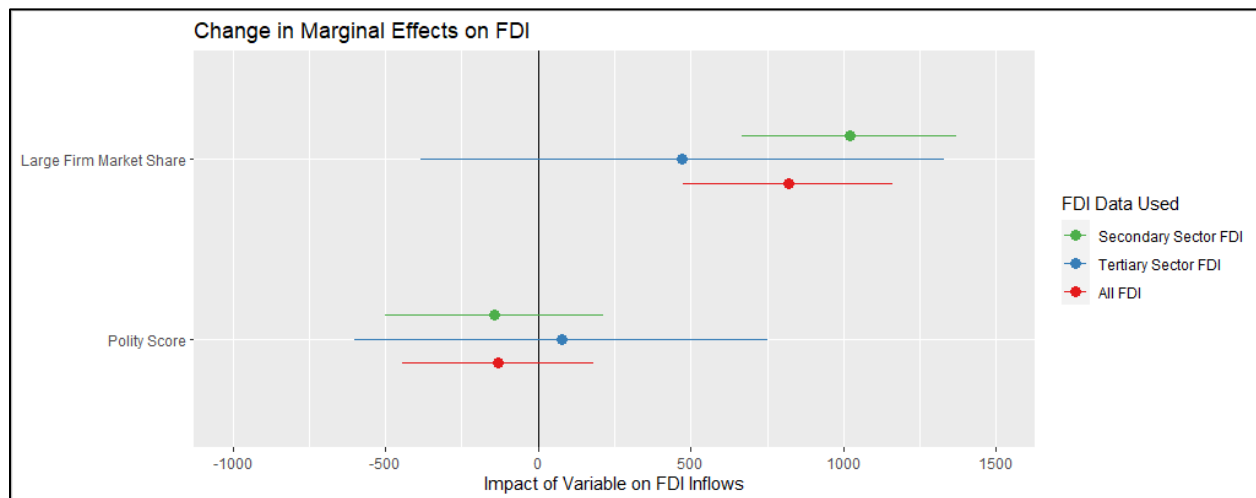


Next, I develop a similar test using the full model, which includes the large firm market share value to measure the number of economic elites. This is parallel to the models shown in Chapter 5 (Table 4), but now using FDI inflows disaggregated by sector. The results are similar. Secondary sector FDI is more sensitive to changes in the number of economic elites, and tertiary sector FDI is less sensitive. When economic elites are fewer, policy towards FDI is more consistent, and tends to favor secondary sector enterprise in particular. This is illustrated in Figure 22, which also includes the political competition variable, included in the model as a control variable. The change in marginal effect for political competition is still present, although weaker and the marginal effect of the variable is not statistically significant from zero.

This is further confirmation of the theoretical intuition. When there are fewer economic elites (as measured in Figure 21 by the equity market share of large firms), we can expect that

policy will be more consistent and favored towards secondary sector FDI. As a result, FDI will become more targeted to the secondary sector, and the increase in FDI inflows will go disproportionately to the secondary sector.³⁹

Figure 21: Economic Elites and FDI Inflows by Sector



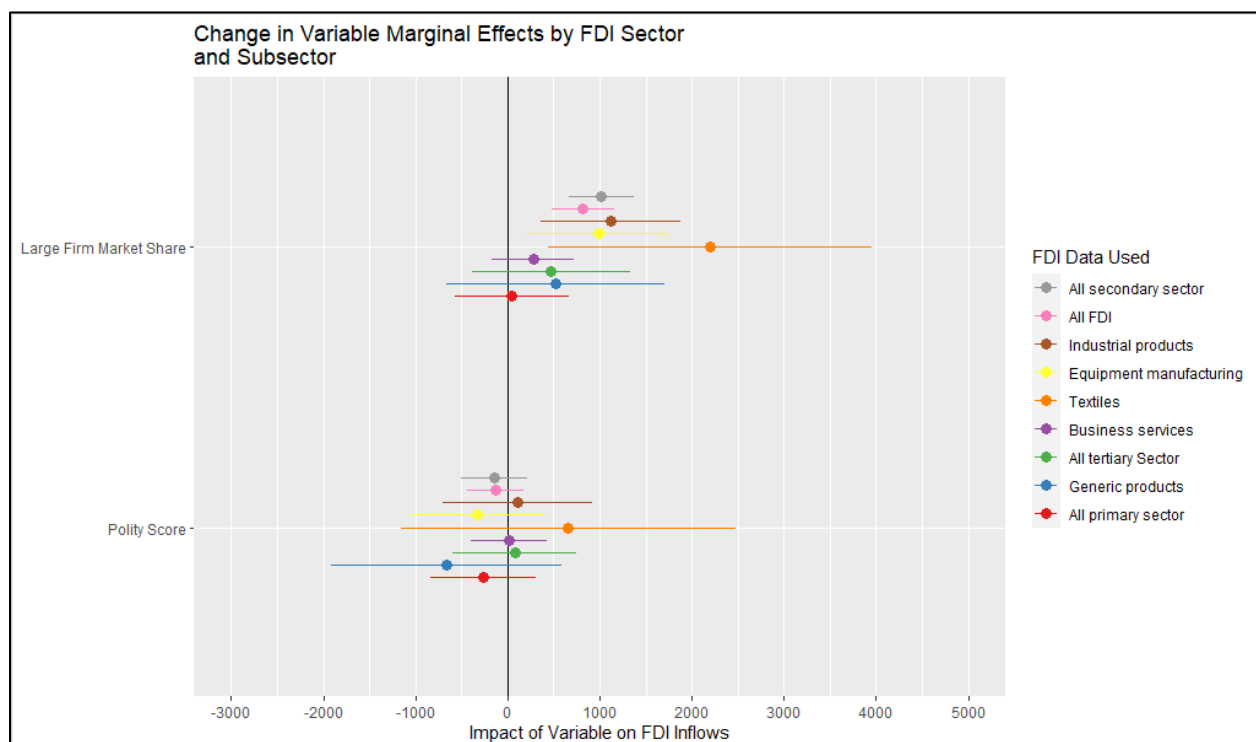
We can take this a step further by breaking down FDI into its smaller subsectors. Figure 22 provides additional granularity on the various types of FDI in the dataset. The largest effects are observed for textiles, industrial products, and equipment manufacturing. The weakest marginal effects are observed for tertiary sector FDI (overall), business services, and primary sector FDI (overall). This further confirms the intuition that secondary sector FDI is more politically favored by autocrats, and thus disruptions to policy have a relatively greater impact on those sectors. Interestingly, two of these sectors (industrial products and equipment manufacturing) are particularly technology intensive. This helps to strengthen the earlier

³⁹ It is important to note that results similar to these can also be produced using the country-level ITC data on FDI inflows in USD, albeit with weaker statistical significance due to the issues discussed earlier. That data also does not contain the more granular sectoral distinctions included with the firm-level data. These alternative results can be viewed in Appendix 3.

argument that autocrats are seeking secondary sector FDI primarily as a means to boost export performance and development in technologically intensive industries.

Again, the statistical significance of the differences between sectors and subsectors are hampered by the relatively small number of observations for each subsector when compared to the whole set. However, we do observe statistically distinct effects between various effects. For example, the difference between the effect of Large Firm Market Share on secondary sector FDI inflows versus primary sector FDI inflows is statistically distinct. Once again, this is because we should expect that, on average, policy consistency will result in autocrats pursuing FDI targeted at the secondary sector versus the other sectors. The marginal effects were statistically significant for nearly every subsector of the secondary sector, again, with the largest effects found for textiles and industrial products FDI.

Figure 22: Economic Elites and FDI Inflows by Subsector



In sum, these findings imply that as states have fewer economic elites, they are more successful at compelling political leaders to pursue targeted investment policies that produce less FDI inflows in the tertiary sector, and more in the secondary sector. Economic elites seek FDI as a private good.

7.2.5 – Alternative Explanations

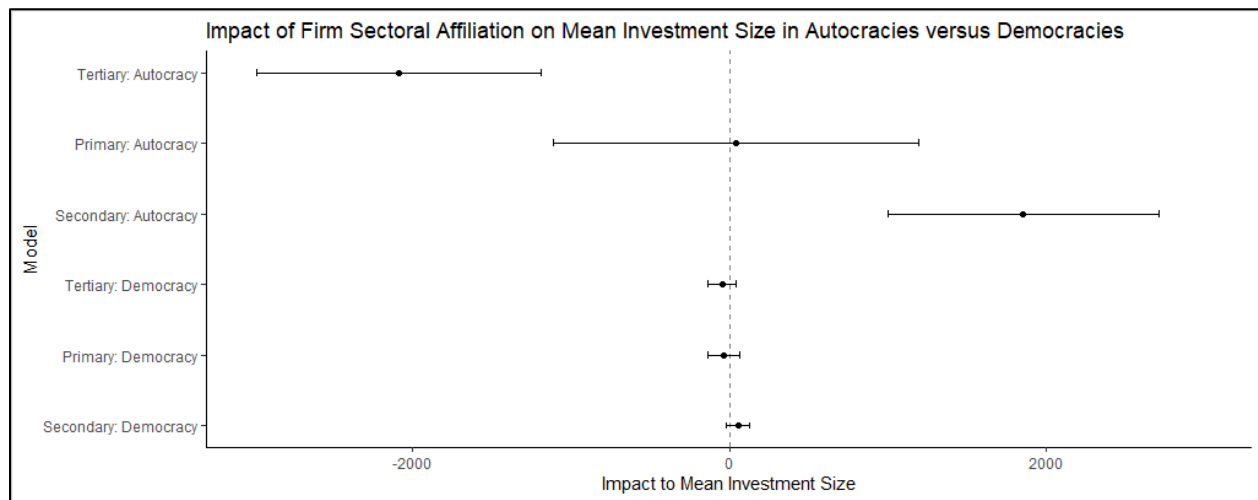
One important alternative explanation for the finding in H3b is that both targeted FDI and a small clique of dominant firms are a symptom of a state having a competitive advantage in one particular industry and being relatively undeveloped in other areas. In other words, when there are fewer key sectors, FDI will be more concentrated (i.e., “targeted”) to those sectors, and there will also be fewer economic elites. It is crucial here to address this possible critique, and to emphasize that this is a political story, not a story about economic endowments. As discussed in Chapter 5, democratic states with competitive secondary sector industries often also have large, globally competitive service sector industries. The implication is that many states with competitive key sectors still manage to attract diverse FDI and develop diverse markets (i.e., many economic elites). This occurs across the development spectrum.

While it is difficult (if not impossible) to totally disentangle the political effect from the economic effects in this regression, it seems clear that authoritarian states which pursue politically-directed development will develop more asymmetrically (where one sector dominates) than politically competitive states which do not undertake such a targeted approach. The fact that we observe significant effects for the political variables in the analyses of H3a and H3b also provides indication that there is a political story behind the presence of targeted FDI inflows.

This dynamic is also subject to the same sort of feedback loop or reverse causality discussed as part of H2, with some slight differences. Instead of large companies tending to get larger, here we can expect sector dominance expecting to get more dominant. If a state is dominated by a small clique of one type of industry, we can expect that policy may favor investment to support that industry, thus further increasing its existing advantage. In other words, targeted FDI should likely increase the market share of existing large firms, which is the reason they seek the targeting in the first place (for the financial benefit). Again, it is difficult to disentangle whether the targeting of FDI is the cause of fewer economic elites dominating the state, or whether those elites dominate the state because FDI is concentrated to begin with. I argue that the former is the root cause and the reason that states stay in this pattern over the long term instead of diversifying. The theoretical assertion here is that FDI being concentrated to particular sectors of the economy originates from the autocrat pursuing targeted FDI as a way of providing private goods to supporters (economic elites).

The robustness test from Chapter 5 that incorporated data including democratic states helped strengthen the case for the result there being a political one. We can conduct the same sort of comparative analysis using the ITC data. The table below displays a visual representation of the result from the first portion of this chapter, 7.2, shown in the first three marginal effects plot points, which showed the impact of sectoral affiliation on the mean investment size for a firm as measured in number of employees. The second three plot points provide the same result using the ITC firm-level data on democratic states. As Figure 23 shows, the sectoral bias we observe for autocracies is not present. This indicates that this sectoral “favoritism” is not the statistical result of a comparative advantage, but a political effect unique to autocratic states.

Figure 23: Sectoral Affiliation and FDI Inflows in Authoritarian States Versus Democratic States

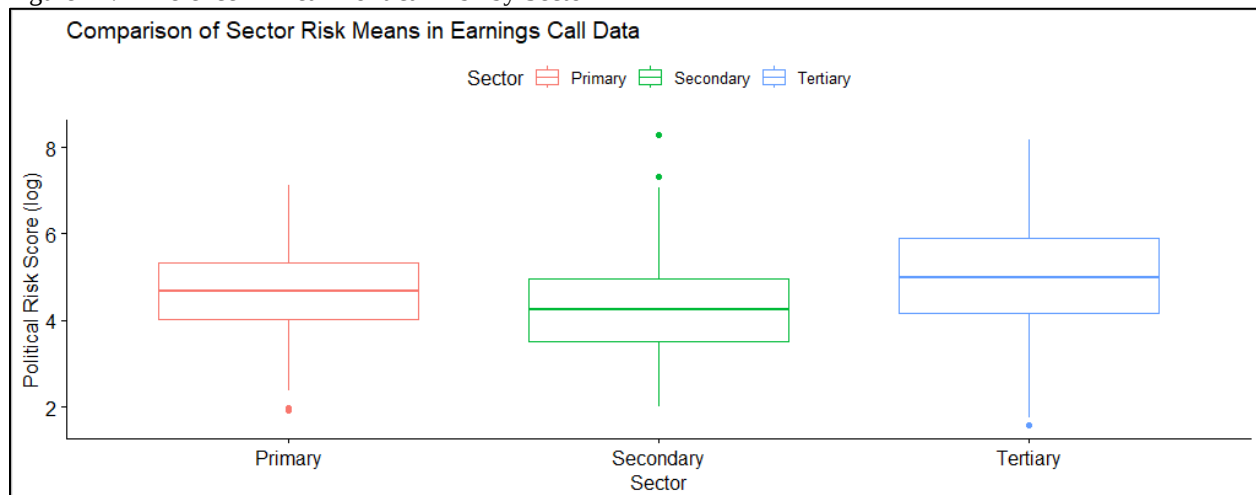


However, the need to further illustrate this dynamic, as well as the low number of observations for the state-level regressions as a result of limited data, call for a greater examination of this hypothesis in a qualitative format. To this end, I develop a case study in the next section to further highlight the political causes of these statistical observations. However, this issue also produces the need for a test of the mechanism directly. In this case, the mechanism that links fewer economic elites to targeted FDI inflows is the presence of policy favoritism.

In order to examine this mechanism, policy favoritism, I devise a mechanism test using the data on foreign investors' political risk sentiment introduced in Chapter 6. However, instead of examining variation in investors' political risk sentiment based on the characteristics of the country they are in, I examine variation between investors' political risk sentiment based on what sector they are investing in. I demonstrate that secondary-sector investors experience less risk overall than investors in other sectors (particularly tertiary-sector investors), indicating that autocrats favor secondary-sector FDI. Importantly, I also show that this variation (which is evidence that policy favoritism exists in nondemocratic states) *increases* in states with fewer economic elites and less political competition. In other words, these states have *more favoritism*.

Figure 24 below illustrates this finding in a succinct way. What the graphic shows is that the political risk perceptions of foreign investors in the secondary sector are lower in nondemocratic states. This illustrates that FDI inflows are targeted towards the secondary sector (and away from the tertiary sector) in nondemocratic states because policy favoritism towards secondary sector investment is present in nondemocratic states. In Appendix 4, I fully substantiate this observation using a battery of tests. I also develop additional tests to illustrate that this variation in sectoral risk perception *increases* as the state has less political competition or fewer economic elites to contend with.

Figure 24: Difference in Mean Political Risk by Sector



Source: Hassan 2019

The results of this mechanism test, which are presented fully in Appendix 4, are important in building support for the claim that the observations discussed so far in Chapter 7 have a political, rather than an economic, cause. They establish that the targeted FDI we observe in autocratic states, in the form of greater inflows to the secondary sector, are a result of policies in nondemocratic states which favor this type of investment. These results are also important in establishing that fewer economic elites leads to more targeted FDI due to policy favoritism rather

than an economic cause. This is evidenced by the fact that states with fewer economic elites saw greater variation in investor political risk sentiment by sector, particularly that secondary sector investors expressed less concern with political risk.

7.3 – H3 Case Study

One interesting case study that helps illustrate both targeted FDI and favoritism towards certain types of foreign investment in the politics of FDI is found in Madagascar.

Underdeveloped and notoriously hard to do business in, the country has still managed to attract several billion dollars in FDI since the early 2000s. Over the course of this period, there have been large variations in both the amount and type of FDI that provide a useful vignette for exploring the political economy of FDI. This case study will demonstrate how the leaders of nondemocratic states are incentivized to discourage investment into the tertiary sector, and encourage investment into the primary and secondary sector.

In the previous chapter, primary sector FDI was less focused on. As discussed there, the primary sector generally requires less FDI in order to remain competitive, and thus we see less empirical evidence for targeted FDI inflows to the primary sector. However, as this case study will demonstrate, when an autocrat needs primary-sector foreign investors in order to fully utilize primary sector resources or reward supporters, the incentives with regard to primary sector and secondary sector FDI look similar. This case study helps to develop our understanding of this nuance.

Politically, Madagascar can be categorized as an anocracy, or a competitive authoritarian regime. In 2009, a cohort of several economic and military elites, led by Andry Rajoelina, deposed sitting President Marc Ravalomanana, in what was widely viewed as a coup. Following

this, FDI inflows to the country collapsed, a product of both increased policy uncertainty and the de facto blacklisting of the country by many western states.

A period of political uncertainty followed, but was largely resolved by 2014. Following this, FDI inflows began to rise again until disruptions resulting from the Covid-19 Pandemic. However, the type of FDI inflows to the country look quite different than they did in 2009, and President Rajoelina has achieved a de facto consolidation of power in the state.

The nature of Rajoelina's wealth was from tertiary sector growth. By the early 2000's he had become a media mogul of significant influence, and one of the wealthiest people in the country. He transitioned successfully into politics, becoming the mayor of Madagascar's largest city. One of his chief supporters, Mamy Ravatomanga, was another economic elite, Chairman of the Sodiat Groupe, a large industrial conglomerate. Together representing a rising class of dissatisfied elites, they were able to unite the political opposition to overcome President Ravalomanana and establish a new provisional government under what is known as the TGV party. Ironically, since taking power, one of Rajoelina's signature policies has been to restrict investment into media enterprises, and has consolidated control of the nation's media under his own media conglomerate called *Viva* (Freedom House 2012). This policy provides one example of how and why FDI targeting occurs in autocratic states. Investment by outside (or inside) entities into alternative media in Madagascar does nothing to reward supporters of the regime, and in fact threatens to both destabilize the regime and reduce the market dominance of *Viva*. Therefore, the regime has a strong incentive to restrict such tertiary sector FDI, or at least not to encourage it. This would be expressed in the data we looked at earlier as a lower concentration of FDI inflows from foreign firms in the tertiary sector.

In contrast to this, while overall FDI to the country was reduced during this bout of instability, the economic rewards to key supporters such as Mamy Ravatomanga have been lucrative. In addition to its offshore oil reserves, Madagascar has some of the world's largest reserves of rare earth metals, as well as large stocks of rosewood, which is a valuable commodity for luxury furniture. All of these features made the country particularly attractive to China, which is the world's largest consumer of both rare earth metals and rosewood. With a willing source of FDI investment in China, and a way to utilize such investment to reward supporters, the regime has gone about targeting this type of primary sector investment. In a manner similar to why many nondemocratic state leaders seek secondary sector FDI, the Rajoelina government was able to use Chinese primary sector FDI to develop key resources and reward supporters of the regime.

Since 2009, the TGV party has maintained “interventionalist” policies to promote the mining and energy sectors and reward key supporters such as the Sodiat Group (i.e., economic elites such as Mamy Ravatomanga). Among its many subsidiary functions, the Sodiat Groupe specializes in the leasing and sale of industrial equipment used for mining and drilling. Since 2009, Chinese FDI in these sectors has increased steadily, and Sodiat has been a prime beneficiary. In 2014, around the time that the political situation stabilized, Sodiat went into partnership with another firm, Malagasy Malaysian Equipment Rentals (MMER), to become a key facilitator of Chinese drilling investment⁴⁰ (Africa Intelligence 2014). Chinese firms involved in drilling, such as the Madagascar Southern Petroleum Company (MSPC), have also been key supports of TGV politicians, such as Hery Rajaonarimampianina (S&P Global 2014).

⁴⁰ Chinese firms have also invested in similar primary sector activities such as mining operations. China Nonferrous Metal Mining Group (CNMC) agreed in 2019 to make significant investments in the country to facilitate the mining of rare earths used in the manufacture of electronic components. See Daly & Evans (2019).

The state has also been able to benefit from this activity directly, increasing mineral royalties gradually over the last decade from 2 percent to between 5 and 10 percent (Rabary 2019).

The rosewood trade has also expanded greatly, further benefiting key economic elites. One of the first actions of Rajoelina's government after taking power in 2009 was to issue "exemptions" to the ban on rosewood exports. Even after reinstating the ban, it has been widely reported that the trade has continued by illicit means. Ravatomanga, Sodiat, and even Rajoelina himself have been linked to the rosewood trade through various subsidiaries and affiliates (Sharife & Maintikely 2018). Again, while overall FDI has declined, FDI targeted to these particular subsectors has increased dramatically, because the state has incentivized it to reward key supporters of the coup. In this case, Rajoelina used primary sector FDI to reward key supporters.

The Rajoelina government has also used secondary sector FDI to benefit other key economic elites in some cases. One of the largest companies in Madagascar is the Socota Groupe, which is a textile conglomerate. While the initial coup reduced growth dramatically, the boost in trade with China has lifted the textile industry as Madagascar has become a key link in a supply chain that links east Asian textile production with markets in Europe. This presented an opportunity to provide lucrative benefits to a potential supporter with significant influence in the state. Salim Ismail, the Chairman of Socota group, is one of the wealthiest people in the country and a key figure whose support is critical to the regime. The Rajoelina government has therefore supported targeted investment in this sector and has partnered with several conglomerates in Asia to facilitate this trade. Such Asian firms have invested in Madagascar as a mid-to-late stage production area for textiles, otherwise known as "cut-make-trim" or "CMT" (Calabrese & Balchin 2022). CMT investment helps advance or maintain productivity in states with emerging

textile industries. Pursuing this sort of CMT investment is a typical strategy for states seeking to develop or expand textile exports, and is consistent with the type of FDI often favored by autocratic states. We can find the textile industry playing a significant role in export-led development strategies in a number of autocratic states, including the example of Vietnam discussed earlier. As we saw in section 7.2, textiles was one of the most common subsectors among the cases of secondary-sector FDI observed in the ITC case data.

This case provides a clear example of how political leaders use FDI to benefit their key supporters, not by pursuing FDI broadly, but rather by using policy favoritism to encourage FDI from investors in certain sectors, which results in FDI inflows that are targeted to those sectors. In this case, the state encouraged both primary and secondary sector FDI inflows. In most nondemocratic states, secondary sector FDI represents a more important source of continued investment due to the technological demands of secondary sector production. For this reason, in the aggregate, we tend to see FDI inflows targeted to the secondary sector. However, in this case, both primary and secondary sector investment provided opportunities to develop key resources and reward supporters.

As is typical in many nondemocratic states, Rajoelina's government has taken few real steps to promote FDI into the tertiary sector, but has focused heavily on incentives for various primary and secondary sector investment that stands to benefit key supporters. The regime will focus on specific subsectors when it is necessary to secure support, such as with Salim Ismail and textiles. Therefore, it follows that when a regime is consolidated via having less political competition and/or fewer economic elites to please, policy governing investment will pursue policy favoritism focused on benefiting insiders and FDI inflows will be more targeted. When regimes are very competitive, such as in Madagascar in 2009, political leaders may be more

inclined to make concessions or broad-based policies to stave off political threats, and as a result FDI policy will be less tightly controlled and FDI inflows less targeted.

Worth mentioning is that this case also provides several indicators that are relevant to the other hypotheses presented in earlier chapters. Firstly, the collapse in FDI following the collapse of the Ravalomanana presidency provides a clear example of how competitive authoritarian states exhibit less total foreign direct investment than consolidated peers as a result of policy uncertainty. It also provides a useful example of how the presence of dissatisfied economic elites (such as Rajoelina and Ravatomanga in 2009) can amplify political competition and thus increase this uncertainty. A rising number of economic elites can in fact provide a leading indicator of future political competition.

While the specifics of FDI in Madagascar is certainly shaped by economic endowments, the broad strokes seem clearly determined by politics. A different policy mix could see significantly more focus on the secondary sector, in this case on textiles manufacture. Additionally, less restrictions on media would result in much growth and more investment in the tertiary sector, which is in fact how the now TGV-controlled *Viva* media grew. The aggregate data clearly shows the bias against tertiary sector investment, while the ambiguity between primary and secondary sector favoritism in the data is a result of the state-by-state variation in which economic elites are in power and what resource endowments are present. Madagascar provides a nice example where endowments are essentially controlled for, as it holds a comparative advantage in both the primary and secondary sectors.

7.4 – Conclusion

This chapter examined a critical part of the story of how and why authoritarian regimes attract FDI. Far from being impartial moderators seeking as much investment as possible, regime

elites intentionally steer foreign investment into sectors and enterprises where they and their allies will benefit. This is known as targeted FDI.

The data afforded us some ability to make generalizations about this targeting. For example, investment into the primary and particularly the secondary sector appears to be favored, and investment activity in the tertiary sector is less popular. There are a variety of reasons for this, including the ease and anonymity with which raw materials and manufactured products can be tracked, controlled, and sold. By contrast, encouraging investment into the service sector is more complex and often requires concessions that autocrats are unwilling to make, such as releasing control over information flows.

The first part of this chapter also built upon these observations by examining in detail the hypotheses around how political competition and the number of economic elites determine the level to which this targeting of FDI is present. This is supplemented in Appendix 4 by an analysis of the mechanism which creates targeted FDI outcomes, which is policy favoritism towards particular types of FDI.

Beyond this, the details are largely dependent on the economic endowments and specific circumstances of the state in question. Case studies, such as the one presented in this chapter, allow us to examine the specific ways in which autocratic leaders use foreign investment to enrich themselves and their allies, and to punish existing rivals or prevent new ones from emerging. While many of these states are “successful” or “competitive” as destinations for foreign investment, the character of their success differs fundamentally from the success of democratic states which encourage investment through liberalization measures such as impartial legal protections and property rights. While these successful autocrats can be formidable economic competitors in some areas, and many are able to leverage their economic success

towards improving state capacity, it is important to understand the limitations of their strategy as a vehicle for overall development and liberalization.

8 – FDI in Authoritarian States: Conclusions

This dissertation has provided insights into a number of the key dynamics which govern foreign direct investment in authoritarian states. In doing so, this research has also produced theory and empirical findings which have wider application to the study of portfolio investment, democracy, and the political economy of economic policymaking in general. This chapter will summarize the key findings of this research, discuss the implications for policy, and discuss the application of these findings to other areas of research.

8.1 – Summary of key theoretical contributions

Several fundamental claims have been made in this dissertation. This section will summarize these theoretical contributions, which were used to inform the follow-on analysis.

The first theoretical contribution of this work is to provide additional nuance to our understanding of why investment inflows vary so widely in nondemocratic states. The mechanism I propose here for this variation is uncertainty over policy on the part of foreign investors. I argue that this policy uncertainty stems from two primary and distinct sources. First, it can come from formal political competition, which extracts concessions or diversifies policymaking authority away from regime incumbents. Secondly, it can come from dissatisfied economic elites, actors with significant financial influence that are dissatisfied with the policy status quo. They can empower political competition or influence policy changes directly with incumbents. The number of dissatisfied economic elites is a function of the overall number of economic elites, as a greater number of economic elites reduces the mean share of private benefits per elite and therefore leads to dissatisfaction.

When policy uncertainty is reduced, investors are more optimistic and investment inflows increase. However, investment success in nondemocratic settings is typically more narrow than in democratic settings. This is because regime incumbents, with their smaller winning coalitions, primarily seek to use FDI as a private good to reward key economic elites and consolidate their hold on power. They use favoritism in policymaking to achieve targeted FDI inflows to particular sectors of the economy. Typically, FDI from foreign firms involved in secondary sector activity represents the most attractive form of FDI to nondemocratic leaders, because it is easy to distribute as a private benefit and represents relatively little political threat. Furthermore, the secondary sector is typically more technologically demanding than the primary sector, meaning that FDI is important to maintain strong performance in this sector.

While both autocratic states and policy uncertainty have been examined before in FDI-related literature, the most important contribution of this work is to propose a unique understanding of what causes policy uncertainty. In particular, dissatisfied economic elites are an often overlooked actor that represent a fundamental driver of the political economy in nondemocratic settings. The concept of targeted FDI is also an important contribution, as it highlights fundamental differences in the character of FDI inflows between nondemocratic and democratic states, helping us rethink what a “successful” FDI strategy really looks like.

8.2 – Summary of key analytical contributions

Following from these theoretical innovations, the analysis contained in this work also provides important contributions to the study of FDI in nondemocratic settings.

The first hypothesis was that authoritarian states with more political competition would have lower FDI inflows than authoritarian states with less political competition, all else equal. I used six individual measures of political competition to determine whether in fact greater levels

of political competition were associated with less FDI inflows in authoritarian states. In most cases, and across multiple measures of FDI, this was in fact the case. This chapter provided the theoretical basis upon which the rest of the analytical approach was based.

Chapter 5 examined the second hypothesis, which was that authoritarian states with more economic elites would have lower FDI inflows than authoritarian states with fewer economic elites, all else equal. In order to measure this concept, the number of economic elites in a state, I developed a novel analytical approach based on equity market share concentration. States in which fewer firms held a larger proportion of market capitalization were proposed to be more “oligarchic” and with fewer economic elites. The analysis found that this measure of large firm market share was robustly and positively associated with FDI inflows across a variety of model specifications. I argue that this effect observed because states with fewer economic elites tended to have more consistent policymaking.

The second hypothesis also had an additional variant, which was that authoritarian states with a greater number of economic elites that also had high political competition would have lower FDI inflows than similar authoritarian states with less political competition, all else equal. In other words, I argue that these two variables have a multiplicative relationship in their effect on FDI inflows. In order to test this, I modeled several variations of an interaction effect between large firm market share and the political competition measures. The results were clear: The presence of political competition amplifies the effect of having a greater number of economic elites, and vice versa.

These are important analytical contributions for several reasons. Firstly, there are few existing measures for the concept of “economic elites”. While the use of this measure requires the adoption of certain controls, I argue it provides a solid starting point for further analysis of

this important subject. Secondly, the analysis demonstrated through the use of a unified model that this measure for economic elites was often more predictive, both statistically and substantively, than the traditional political competition measures. This requires a reappraisal of the FDI literature to determine the degree to which the number of economic elites is in fact a fundamental structural factor from which more superficial political observations emerge.

Using a novel dataset on firm-level risk perceptions, I illustrated the degree to which the number of economic elites was in fact associated with greater perceptions of policy uncertainty on the part of foreign investors. The measure (along with the political competition measures) was in fact robustly associated with these perceptions of uncertainty. This provides a more solid analytical footing on which to claim that the performance of nondemocratic states in attracting FDI inflows is largely dependent on investors' policy uncertainty, and this policy uncertainty is governed in large part by political competition and the number of dissatisfied economic elites. The use of earnings call data provides an important contribution on how such data can be used to proxy difficult-to-measure concepts such as the degree to which policy changes are creating investor uncertainty across a panel of unique states.

I also examined a third primary hypothesis related to FDI inflows being targeted in nondemocratic states, primarily towards secondary sector activities and away from tertiary sector activities. I tested the claim that authoritarian states with less political competition or fewer economic elites would also have *more targeted* FDI inflows than authoritarian states with higher levels of these variables. To operationalize this test, I developed a two-part setup. The first analytical component established the empirical presence of FDI that was targeted towards the secondary sector and away from the tertiary sector in nondemocratic states. The second stage of

the analysis examined the change (increase or decrease) in this observed favoritism associated with levels of political competition and economic elites.

The results showed clearly that less political competition and fewer economic elites were associated with FDI inflows being more targeted towards the secondary sector and away from the tertiary sector. An additional subsector analysis confirmed the finding and was strongly suggestive that the association with secondary sector favoritism was related to the level of technology required for a particular enterprise. This finding established one of the more important empirical implications of this work, namely the somewhat paradoxical finding that competitive authoritarian states, while receiving less overall FDI inflows, receive FDI inflows that are more diverse. As discussed earlier, the diversity of FDI inflows has important implications for income and economic growth, as well as middle class development.

Additionally, I tested the claim that this observation of “targeted FDI” was related primarily to *policy favoritism*, rather than structural economic factors. I tested this by again examining firm-level perceptions of political risk among foreign investors, finding that these perceptions increased with tertiary sector association and decreased with secondary and primary sector association. This helps to rule out economic explanations for the earlier findings about FDI inflows.

These findings provide several important contributions. Firstly, they provide a novel and measurable definition of targeted FDI inflows, distinguishing FDI inflows in authoritarian states from more broad-based FDI inflows more commonly found in democratic settings. Secondly, they establish a meaningful way to examine the source of this phenomenon; political favoritism towards certain types of FDI in authoritarian states, and addresses the alternative explanation that these trends are related to structural economic factors rather than political ones.

8.3 – Avenues for future research

This section will outline possible areas for future research and feature brief discussion about how the concepts would apply. There are several important and readily applicable extensions which lend themselves to further research. These areas are foreign portfolio investment, domestic investment, democratic states, and the relationship between political competition and economic elites. Each of these topics have important theoretical overlaps with the work presented here, but also important differences.

8.3.1 – Foreign Portfolio Investment

One clear area for future applications of this theory is to the study of foreign portfolio investment (FPI). When policy uncertainty is high in a nondemocratic setting, this should carry ramifications for portfolio as well as direct investment. Many of the case examples discussed in this work could be expanded to include a discussion of portfolio investment, and in most cases, states saw a positive correlation in the performance of these two types of investment.

The distinction between FDI and FPI is important to the academic literature. For actual foreign investors, however, the differences are often less significant. As an example, the reasons for an investor to invest in real estate through an exchange-traded intermediary such as a REIT, as opposed to purchasing foreign real estate assets directly, will often be predicated on factors such as the sophistication of the investor and the size of the investment, as well as considerations about governance and liquidity (discussed below). However, in terms of expected returns, the risk exposure should be largely similar. However, despite the similarities, there are still important differences between FDI and FPI that should be considered in future research.

One of the key differences between these two types of investment is in the level of liquidity. Direct investment, as the less liquid form of investment, can be expected to behave in a

relatively more risk averse fashion, but also react more slowly to political changes. Exiting a direct investment is time consuming, relatively costly, and potentially fraught with risk. Before going through considerable efforts to set up a foreign enterprise, investors of this type are more likely to seek assurances that the political environment will allow for predictable operations. If things go wrong, however, these investors may choose to “ride it out” instead of pulling the plug on an enterprise. In contrast, portfolio investing can often be done over the phone or on the computer, and an investment can be unwound in a matter of minutes or hours. As such, it is subject to the reverse dynamic, where investors will be less wary about entering a market, but will unwind their investment more quickly at signs of trouble. This leads to significant variations in volatility (Goldstein & Razin 2005). When being measured by the year, however, these variations will be less apparent.

An additional distinction between these two forms of investment is in their typical governance structure. While foreign firms can list on a country’s stock exchange, the majority of the firms are typically domestically owned and operated. Firms listed on a country’s stock exchange can also be wholly owned by the state. In contrast, most foreign direct investment enterprises will retain foreign ownership (although they are often operated by domestic proxies). This difference carries significance for the theoretical treatment of FPI. For example, where autocratic leaders may be wary of FPI in the tertiary sector that will disrupt state control of things like banking or media, they are likely to be more receptive to FPI directed at domestic enterprises of this sort (so long as a controlling stake is maintained).

Lastly, foreign portfolio investment provides the opportunity to lend to firms, as opposed to owning them. For this reason, it is a critical source of capital for those domestic entities which are unable or unwilling to divest equity. The international market for FDI, at its peak in 2007,

was over 3 trillion USD in size. In contrast, the international capital market for bonds alone is over 123 trillion USD, over 41 times larger (international equity markets are valued at about 70 trillion USD). This underscores why FPI is so critical to understanding international investment, and more specifically why lending markets are particularly important.

There are reasons to suspect that favoritism and targeting should function differently for FDI and FPI. A primary distinction between FDI and FPI is that FDI by nature does not as easily empower domestic elites. For that reason, the primary incumbent elite incentive towards FDI is to generate rents through taxable exports, or to indirectly support domestic industry elites. Factors such as the size of the investing firm or the size of the investment are less relevant than the particular type of investment, chiefly whether it provides efficient rents to incumbent elites. Conversely, FPI by nature provides capital to domestic elites, and therefore the primary incentive of incumbent elites is to steer this capital towards regime allies and away from outsiders and potential rivals. In this case, incumbent elites are likely to favor investment into fewer, larger firms associated with the winning coalition.

In sum, FPI is both critically important to development and economic performance, and is significantly larger than the market for FDI. It is also likely to be subject to many of the same theoretical considerations as FDI, although there are likely to be important differences. As a result, it provides fertile ground for future study.

8.3.2 – Domestic economic policy and economic growth

There is reason to suspect that the incentives governing policy towards FDI explored in this theory should also apply to other types of economic policy, such as that governing domestic investment and growth. While many authoritarian states have levels of domestic capital formation that are lower than foreign investment, it is still a critical source for economic

development in most states. As such, authoritarian leaders will be equally invested in ensuring that capital does not flow to potential rivals and rewards political allies, incentives which could be expected to result in the same sort of favoritism present in policy towards FDI. As such, domestic capital formation and development should display the same targeted characteristics as FDI inflows. However, similar to FPI, there may also be some important differences between the incentives governing FDI and those governing domestic investment, for largely the same reasons discussed with regard to FPI above.

The presence of political competition and a greater number of economic elites can also be expected to have the same disruptive effects on domestic capital markets and growth as it does on foreign investment. Economic elite dissatisfaction with shares of private benefits extends to domestic capital in the same manner it relates to FDI. In other words, incumbent elites use domestic capital to provide private benefits in a manner similar to how they use foreign capital. Therefore, we should expect that the presence of more economic elites should encourage greater competition over policies governing the beneficiaries of domestic capital flows, creating uncertainty. Similarly, political competition will have an amplifying effect and also reduce the predictability of policy. We should expect that domestic investors behave in a similar fashion to international investors, and the presence of greater uncertainty over policies impacting their profitability should have a negative effect on equilibrium investment.

In summary, there is ample reason to suspect that policy uncertainty and policy favoritism function much the same in their impact to domestic capital as to foreign investment. When there are more economic elites and greater political competition, overall domestic capital formation and growth should be lower and less targeted. Because domestic capital formation and growth is a significant factor in development, and is also likely subject to many of the same

theoretical dynamics with regard to policy uncertainty and policy favoritism, it also provides a promising area for future research.

8.3.3 – Democratic States

Another area with a promising avenue for future research is democratic states. While this work focused on authoritarian states, there is also reason to suspect that the concepts should be applicable to democratic states as well. However, there are likely to be important differences in how the theoretical concepts apply to democratic states.

Contrary to the negative relationship between economic elites and FDI inflows described in this work, the relationship between these variables in democratic states is likely to be *positive*. As described in previous chapters, an increase in the number of economic elites diversifies the demand for private goods from politicians, and the private goods share per recipient decreases. Eventually, if this increase in the number of economic elites continues, their preference will switch from seeking a small share of private goods to preferring the provision of public goods, such as an impartial legal system, transparent tax code, and ready access to credit. The economic benefits of a predictable and democratic public goods system outweigh a small share of private goods in a poorly performing anocracy. In other words, once private benefits become small and uncertain enough, utility is greater under a public goods system. This is essentially the argument of Cox (2015) and others like Paniagua & Vogler (2020, 2022).

Under settings where formal political competition is already at a high level, a greater number of economic elites *increases* FDI inflows (and likely FPI inflows and capital formation as well), because it incentivizes high governance quality and the provision of public goods more widely. Rather than creating instability, legal protections ensure that changes in political power do not greatly impact business outcomes. Conversely, when the number of economic elites is

significantly fewer or political competition is significantly reduced in nonauthoritarian states, this incentivizes leaders to bend rules to provide private benefits to insiders, because influence is concentrated enough that power can be secured by appealing to fewer elites. This has the same dampening effect on investment interest that political competition does in authoritarian states. Unlike consolidated authoritarian states where politics are stable, or fully democratic states where legal protections prevent political outcomes from greatly damaging business, being on the wrong side of politics in an anocratic state can be disastrous for business outcomes. For this reason, doing business in such states becomes riskier and equilibrium investment declines.

It is less clear how political competition measures would perform in predicting FDI in democratic states. Because political competition is already present in anocratic states, it is unclear whether more competition would increase or decrease FDI. However, it is likely the case that increases in competition would provide the same sort of incentive towards institutional strengthening that having more economic elites is likely to cause. Furthermore, many of the political competition measures used here also capture institutional strength variables such as property rights in their scoring. For that reason, they are likely to see a positive association with FDI (and other types of investment) in democratic states.

Examining these variables in a democratic context would complete the full picture on how they impact the political economy of investment and growth, and provide valuable insight into variation between nonauthoritarian states. Examining the number of economic elites would be particularly useful in providing a way to examine democratic states outside of traditional measures of political competition. It would also provide insight into democratization and democratic decline (which I address in the following section). For all of these reasons, it provides an important and promising route for future study.

8.3.4 – Causality between economic elites and political competition

As discussed in Chapter 5, there is reason to suspect that the number of economic elites and the presence of political competition are mutually reinforcing in authoritarian states. The findings in that chapter suggested that an increase in the number of economic elite actors reinforces political competition as dissatisfied economic elites search for political patrons and utilize political competition to secure concessions. As discussed using the Kazakhstan case as an example, political competition without the backing of economic elites often struggles to gain influence.

This provides insights into how the democratization process occurs. When economic elites increase in number, this creates more competition and dissatisfaction over private goods. Eventually, if the number becomes great enough, the private goods system breaks down and it is better for elites to agree to an open, public goods system. Each player is too small to benefit greatly from a private goods system. This creates the incentive for institution building, including democratization.

This same process also works in reverse, providing insight into democratic decline. When the number of economic elites decreases, elites become *less* committed to an open, impartial system because bending the rules can provide them with lucrative private benefits and the players are large enough to benefit under this system more than a public goods system. Leaders can more easily retain power by providing such private benefits to a few key stakeholders. Under this model, oligarchic states will tend to be less democratic.

Much of the literature from which I have drawn elements of the theory presented here was related to democratization. The process by which competitive economic elites codify legal protections and push for public goods is closely related to the incentives I discuss in this work.

Future study should analyze the connection between increases and decreases in the number of economic elites, and how this impacts measures of political competition. Because political leaders rely on financial influence to gain, hold, and exert power, the distribution of economic elites in a state is critical to determining what the pressures on political leaders will be. This factor determines whether an opposition is viable, and whether political leaders will be more interested in public or private goods (i.e., the quality of governance). A greater number of economic elites should be associated with more political competition, and fewer economic elites with less political competition. Again, oligarchic states can be expected to be less democratic and exhibit weaker rule of law. While this work is mostly focused on governance quality as it relates to economic policy, it is also reasonable to suspect better or worse governance quality in the economic sphere is closely associated with other types of governance quality as well.

The number of economic elites therefore becomes a potentially important predictor of overall governance quality, and perhaps a better predictor in many cases than political competition. While greater political competition (i.e., democracy) is associated with a number of positive economic and social outcomes, the findings here strongly suggest that it is less effective and even less enduring without the supporting patronage and buy-in of economic elites. Therefore, the number of economic elites is potentially an incredibly important variable in predicting governance outcomes, particularly related to economic policy, but yet is rarely considered in such analysis. In short, measuring the relative number of economic elites gives us an indicator of the policy environment outside of traditional (overt) political measures.

As a general principle, my findings indicate that when the base of economic influence is more widely dispersed, the result is typically that private goods systems become less attractive to influential elites and pressures towards political competition and rule of law increase. Given the

importance of democratization and democratic decline in the contemporary environment, this is a subject that merits significant further study.

8.4 – Policy implications

One clear policy implication for authoritarian states derived from these findings is that nondemocratic states with a greater number of economic elites or greater political competition risk entering an “anocratic trap” of policy uncertainty, which will ultimately limit their development, as well as discourage other nondemocratic states from liberalization. These competitive authoritarian states need support and incentives to keep their political competition over economic policy within certain guardrails to avoid deleterious economic consequences of unrestrained competition over the levers of power.

Additionally, authoritarian states should be given incentives to open up growth opportunities to non-insiders, and allow for an increase in the number of economic elites. However, there is no straightforward way of convincing incumbent economic elites to support measures that would cause a reduction in lucrative private benefits. One possibility is conditioning FDI or foreign aid on the host state adopting certain openness provisions which allow for the formation and growth of small and medium-sized enterprises, investment into the tertiary sector, and to include the competition guardrails mentioned above. By widening the base of economic influence, such measures serve to encourage greater policy competition (and eventually formal political competition) in nondemocratic states.

In democracies, the policy implication implied by these findings is to keep the number of economic stakeholders as great as possible, as this will ensure support for an open, public-goods oriented system and promote better governance quality outcomes. When the base of economic influence becomes too concentrated, this makes private benefits more attractive, because

political leaders can retain power by appealing to fewer stakeholders. This condition leads to the bending of norms to provide private benefits and is the path to institutional decay and anocracy. While we should exercise humility with regard to our ability to change the course of economic trends, this outcome can best be avoided by promoting the formation and growth of small- and medium-sized enterprises, and pursuing policies that prevent oligopoly and monopoly markets before large actors are able to hijack the political process.

8.5 – Global investment and the future of authoritarianism

As the trends of globalization continue, the importance of FDI to development and economic performance will continue to increase. This inevitability represents both a threat and a potential opportunity. If autocratic states are able to continue to leverage FDI to entrench incumbent elites and consolidate power, while at the same time using the fruits of FDI inflows to provide standard of living increases for their citizenry, autocratic governance in many regions will continue to strengthen, and the appeal of the state-led autocratic approach to development as a viable alternative to traditional liberalism will continue to grow. Rather than face the economic and political uncertainty associated with anocracy and democratization, many states will opt to restrain political freedoms. The likely result of this will be an increasingly assertive network of entrenched global autocracies, and an increasing pressure for democratic states to abandon democratic norms in an attempt to remain competitive.

However, we need not resign ourselves to this outcome. The autocratic model of FDI carries within it critical weaknesses that offer an opportunity for democratic states to offer a more attractive alternative to investors, which would both strengthen the position of global democratic states as well as offer an attractive incentive for states to adopt liberal institutions and allow political and economic competition. While autocratic states pursue more narrowly targeted

FDI strategies to empower incumbent elites and avoid empowering political competition, democratic states have the ability to adopt a wider appeal. This appeal, properly capitalized on, allows for the simultaneous growth of FDI across all sectors and for the benefit of many economic actors, not just central elites. Greater diversification in FDI inflows, both horizontally across sectors and vertically across different size firms, ultimately results in greater innovation, creative destruction, and ultimately higher output. Democracies can accelerate these strengths by fostering competitive environments for small- and medium-sized enterprises and strengthening the institutions, legal frameworks, and property rights protections that allow them to thrive.

Incumbent leaders in authoritarian states will always seek to limit political competition and retain unbalanced access to capital that favors existing elites. However, like all leaders, they are subject to the structural realities of the political economy. Democratic states can thereby encourage liberalization by incentivizing autocratic states to receive FDI that widens the base of economic influence, such as FDI that empowers small and mid-sized firms and tertiary sector FDI that encourages education and the free flow of information. By doing this, democratic states can use FDI to weaken autocratic consolidation and encourage greater competition over policy. In anocratic states where such conditions already exist, the focus should be on incentivizing such states to adopt impartial legal frameworks and property rights protections that will reduce destructive unrestrained policy competition, and by doing so further encourage democratic consolidation.

While the 21st century is still young, the patterns which manifest themselves now will become harder and harder to correct as global institutions and norms become increasingly contested by rising autocratic powers. Therefore, the time to understand the choices before us and react accordingly is now, while the course is still being set.

Appendix 1: Formal Theory Statement

FDI inflows to an economy are a function of aggregate planned investment by foreign firms. For an individual foreign firm, planned investment (I_p) is a function of the expected cost of capital, which is itself determined by expected profitability, the expected real interest rate (at home and in the host market), and the expected rate of government tax (at home and in the host market). Profitability is determined both by *economic* and *policy* factors. Economic factors such as the structure of demand, as well as supply factors like the market price for local labor, the presence of resources, and the cost of materials form the baseline of investor expectations about profitability. Policy factors, as discussed throughout this work, alter this baseline positively or negatively. This condition is expressed concisely as;

$$I_p = f(c_e) = f(\Pi_e, r_e, T_e)$$

It follows that the expected cost of capital is itself a function of the current cost of capital at time t , policy uncertainty (U_p), as well as uncertainty over nonpolicy factors (U_n), because such uncertainty impacts the expected values of profitability, real rates, and government tax. Uncertainty can be conceptualized as a range of possible values for the political and economic variables that determine the cost of capital. Investors are assumed to be risk averse, meaning that they use the most conservative value for these expectations in allocating planned investment. If we conceive of policy uncertainty as primarily expanding the lower range of expected outcomes without expanding the upper range, this assumption can be relaxed, and we can also assume that investors merely take the mean value of policy expectations, and the result is the same. Greater policy uncertainty thus raises the expected cost of capital;

$$\Pi_e, r_e, T_e = f(U_p, U_n, \Pi_t, r_t, T_t)$$

Finally, the theory I present in Chapter 3 asserts that for nondemocratic states, policy uncertainty is a function of the number of economic elites and the presence of political competition, namely that these variables are positively related. Policy uncertainty is a recent-value weighted function of the sum of policy volatility over some period of time n . In more colloquial terms, investors observe the degree of policy volatility over the recent past to form an estimation of the range of policy outcomes that could occur in the future, which is “policy uncertainty”. This policy volatility is itself determined by the presence of political competition and the number of economic elites, because they induce more frequent policy changes. In other words, when there are more economic elites or greater political competition, policy changes are more likely. This increases investors perceived level of volatility in policymaking, which they use to form expectations about the future. I express this here as;

$$U_p = f\left(\sum_{i=t}^{t-n}(\sigma_p)\right) = f(EE, PC)$$

While non-policy uncertainty is not the focus of this work, we can summarize it briefly by saying that we can expect that this variable to be determined by an assessment of recent relevant economic and market conditions. Profitability can be a function of a number of variables that may or may not covary with political variables, such as GDP, exchange rates, or the presence of resources or infrastructure. These variables must be controlled for in an empirical analysis insofar as they interact in meaningful ways with the political variables I examine (political competition and the number of economic elites). For example, I control for GDP and

oil rents in most models, because these have covariance with the political variables I examine. This is discussed in greater detail in the sections discussing measurement.

Appendix 2: Summary of Hypotheses and Measurements

The table below provides a concise summary of all hypotheses, variables and data.

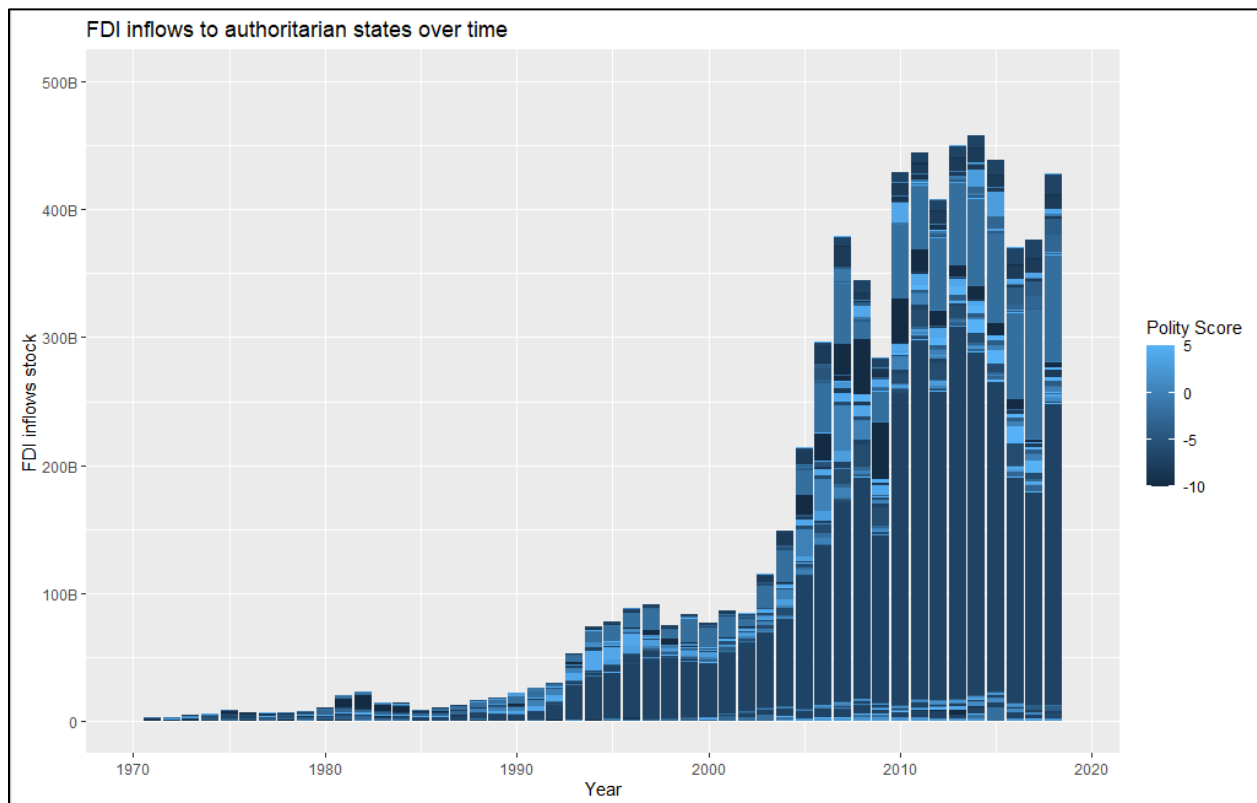
Table 18: Hypotheses and Data

Hypothesis	DV	DV Measure (source)	IV	IV Measure (source)
H1	FDI level	FDI (WB)	Political consolidation	Political competition (V-Dem)
H2a	FDI level	FDI (WB)	Economic consolidation	Number of economic elites (WFE)
H2b	FDI level	FDI (WB)	Economic consolidation * Political consolidation	Number of economic elites (WFE), Political competition (V-Dem)
H3a	Targeted FDI	FDI (ITC)	Political consolidation	Political competition (V-Dem)
H3b	Targeted FDI	FDI (ITC)	Economic consolidation	Number of economic elites (WFE)

Appendix 2.1: Supplemental Data Summary

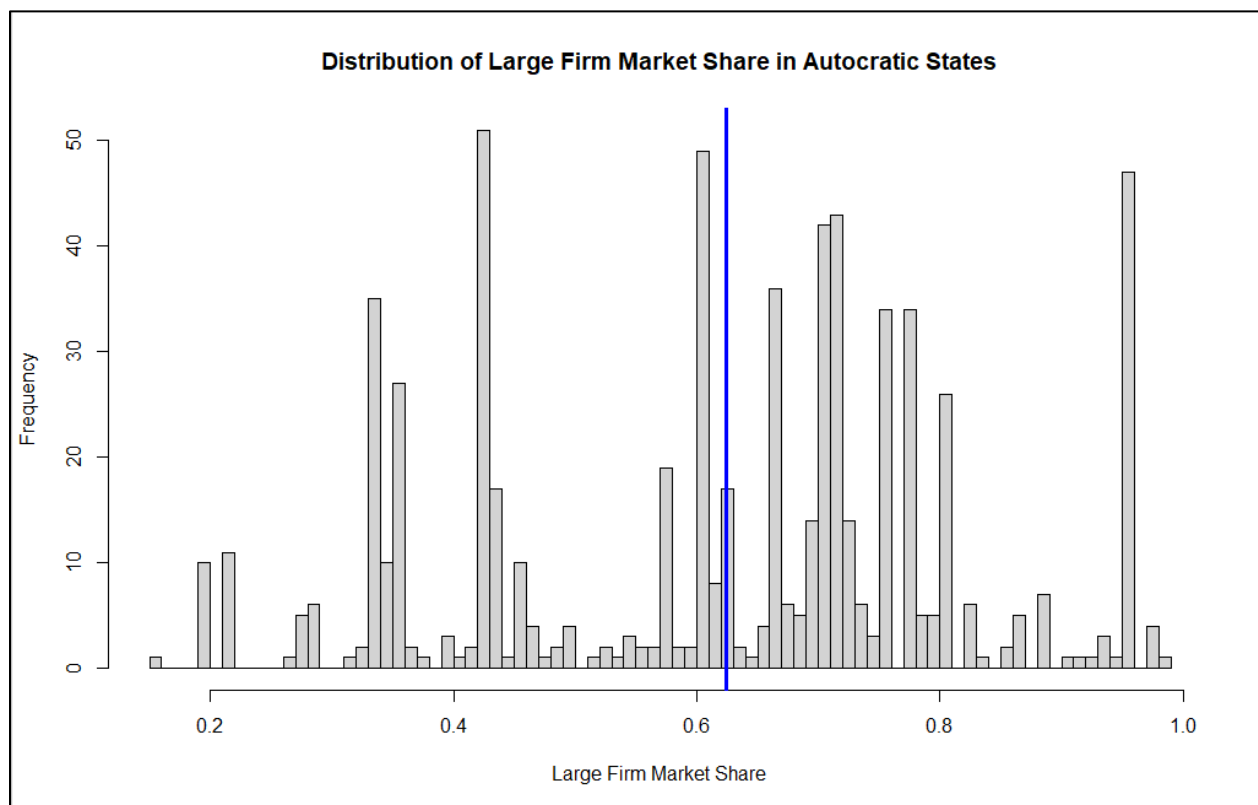
Figure 25 below provides a summary of the global stock of net FDI inflows to nondemocratic states over time in the period since 1970. The figure depicts a significant increase in global stock beginning to accelerate during the 1980s.

Figure 25: FDI Inflows to Nondemocratic States



I use the equity market share of the top 10 or top 5 percent of firms (“Large Firm Market Share”) as a measure of the number of economic elites in a state. Figure 26 provides a histogram representation of the distribution of Large Firm Market Share values among the sample of nondemocratic states.

Figure 26: Histogram for Measure of Economic Elites



The table below provides a listing of states contained in the World Federation of Exchanges data.

Table 19: States Contained in World Federation of Exchanges Data

State	Income Group	Region
Algeria	Low	ME
Argentina	Mid	SA
Azerbaijan	Mid	EU
Bahrain	High	ME
Bangladesh	High	AS
China	High	AS
Croatia	High	EU
Ghana	Mid	AF
Indonesia	Low	AS
Iran, Islamic Rep.	High	ME
Jordan	Mid	ME
Kazakhstan	High	ME
Kenya	Low	AF
Korea, Rep.	High	AS

Kuwait	High	ME
Lebanon	Mid	ME
Malaysia	Mid	AS
Mexico	Mid	SA
Morocco	Low	AF
Nigeria	Mid	AF
Oman	High	ME
Pakistan	Mid	ME
Papua New Guinea	Mid	AS
Peru	Mid	SA
Qatar	High	ME
Russian Federation	High	EU
Saudi Arabia	High	ME
Singapore	High	AS
South Africa	High	AF
Sri Lanka	High	AS
Tanzania	Low	AF
Thailand	High	AS
Tunisia	Low	AF
Turkey	High	ME
Ukraine	High	EU
United Arab Emirates	High	ME
Vietnam	High	AS
Zambia	Mid	
Zimbabwe	Low	

Appendix 3: Supplemental Analyses

Appendix 3.1: Supplemental Analysis for H1

Table 20 below displays the H1 models from Chapter 4 with the use of country fixed effects. The results are similar to those presented in the body of the text, but model fit was inhibited. From a theory standpoint, the use of country fixed effects should not be necessary with strong country-level institutional variables included. The use of country fixed effects therefore represents the most conservative method of estimation (see Li and Resnick 2003).

Table 20: Political Competition and FDI Inflows (Alternative Models with Country Fixed Effects)

	<i>Dependent variable:</i>					
	Foreign direct investment net inflows (millions usd)					
	(1)	(2)	(3)	(4)	(5)	(6)
Polity Score	-235.97*** (81.73)					
Political Competition		-15.26 (13.66)				
Electoral Democracy Index			-8,743*** (2,481)			
Multiparty Elections				-197.29 (342.84)		
Legislature Opp. Parties					-118.91 (300.14)	
Opp. Party Autonomy						-820.78*** (258.05)
log(GDP)	6,162*** (613)	6,451*** (610)	6,221*** (609)	6,377*** (610)	6,363*** (616)	6,131*** (613)
Oil rents	-205.58*** (43.43)	-212.38*** (43.42)	-200.85*** (43.46)	-211.18*** (43.46)	-210.81*** (43.56)	-199.99*** (43.52)
Underdeveloped	-9,031*** (1,295)	-8,999*** (1,297)	-8,785*** (1,296)	-9,042*** (1,297)	-9,007*** (1,299)	-8,905*** (1,295)
Observations	3,123	3,123	3,123	3,123	3,123	3,123
R ²	0.076	0.073	0.077	0.073	0.073	0.076
Adjusted R ²	0.011	0.009	0.012	0.008	0.008	0.012
F Statistic (df = 4; 2918)	59.616***	57.705***	60.716***	57.458***	57.411***	60.097***

Note:

*p<0.1; **p<0.05; ***p<0.01

Table 21 displays the results of the H1 models from Chapter 4 with the use of FDI as a share of total GDP as the dependent variable. Model fit was poor, but the overall result was consistent with the results shown in Chapter 4. The model here employs the use of time and country fixed effects. Without country fixed effects, the significance of the results is weakened.

Table 21: FDI Inflows and Political Competition (Alternative Measure of FDI Inflows)

	<i>Dependent variable:</i>					
	Foreign direct investment net inflows (as share of GDP)					
	(1)	(2)	(3)	(4)	(5)	(6)
Polity Score	-0.230** (0.095)					
Political Competition		0.003 (0.016)				
Electoral Democracy Index			-3.579 (2.877)			
Multiparty Elections				-0.397 (0.397)		
Legislature Opp. Parties					-0.212 (0.347)	
Opp. Party Autonomy						-0.637** (0.299)
log(GDP)	-1.374* (0.710)	-1.153 (0.706)	-1.215* (0.706)	-1.189* (0.705)	-1.209* (0.713)	-1.350* (0.710)
Oil rents	-0.059 (0.050)	-0.066 (0.050)	-0.061 (0.050)	-0.064 (0.050)	-0.063 (0.050)	-0.056 (0.050)
Underdeveloped	-1.139 (1.499)	-1.156 (1.501)	-1.043 (1.503)	-1.152 (1.500)	-1.090 (1.503)	-1.043 (1.500)
Observations	3,123	3,123	3,123	3,123	3,123	3,123
R ²	0.004	0.002	0.002	0.002	0.002	0.003
Adjusted R ²	-0.066	-0.068	-0.068	-0.068	-0.068	-0.067
F Statistic (df = 4; 2918)	2.644**	1.181	1.557	1.420	1.263	2.306*

Note:

*p<0.1; **p<0.05; ***p<0.01

Table 22 below displays the results of model 1 from Table 3 in Chapter 4, now using the logged value of FDI inflows. This result helps confirm the findings of the overall model, as well as allowing the interpretation of the marginal effect coefficient in terms of a percentage change in FDI inflows. The results here illustrate a one-point increase in Polity Score as being associated with a 65% increase in net FDI inflows.

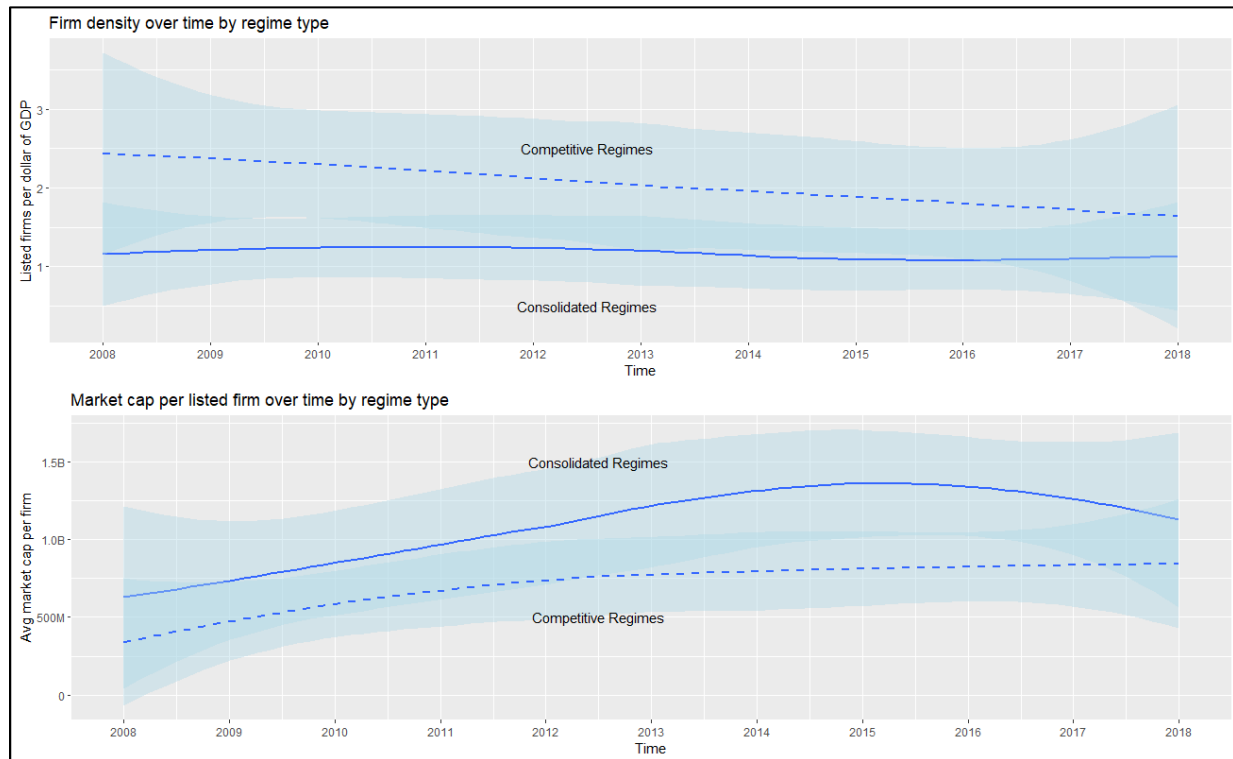
Table 22: Political Competition and FDI Inflows (Alternative Models, Logged DV)

<i>Dependent variable:</i>	
	log(FDI)
log(Polity Score)	-0.131* (0.071)
log(GDP)	0.502*** (0.088)
Oil rents	0.011* (0.007)
Underdeveloped	-0.627*** (0.177)
Observations	2,212
R ²	0.041
Adjusted R ²	-0.029
F Statistic	21.969*** (df = 4; 2060)
<i>Note:</i> *p<0.1; **p<0.05; ***p<0.01	

Appendix 3.2: Additional Visualization of Firm Concentration and Regime Type (H2)

This figure provides an illustration of the regression version of the figures presented in Chapter 5.2. The figure depicts competitive authoritarian regimes as having more firms relative to GDP, but with a smaller mean market capitalization. This indicates that consolidated authoritarian states tend to be economically consolidated, or more “oligarchic”, lending support to H2.

Figure 27: Firm Concentration and Regime Type (LOESS)



Appendix 3.3: Supplemental Analysis for H2a and H2b

Here I present a larger model that is more closely based on the model used by Li and Resnick (2003), to include growth and exchange rates. I also include a lagged independent variable for the number of economic elites. The number of observations is more constrained due to limitations of the data, but the primary results are consistent with what was presented in Chapter 5 (Table 4). This represents a more conservative estimation, but features variables that should not covary with the political measures I study at the cost of additional observed cases.

Table 23: Economic Elites and FDI Inflows (Alternative Models, Additional Controls)

<i>Dependent variable:</i>		
	Foreign direct investment net inflows (millions usd)	
	(1)	(2)
Large Firm Market Share (lag)	57,947 *** (9,479)	78,362 *** (10,550)
log(GDP)	24,759 *** (2,594)	26,342 *** (2,586)
log(population)	-7,838 *** (1,923)	-10,746 *** (1,983)
Oil rents	-1,517 *** (176.64)	-1,627 *** (185.70)
Underdeveloped	-9,993 (8,616)	-7,385 (8,566)
Exchange rate	35.79 (52.16)	9.29 (53.53)
GDP Growth	449.86 (421.39)	346.97 (421.04)
Polity Score	-1,691 *** (391.78)	
Electoral Democracy Index		-51,024 *** (11,588)
Observations	346	346
R ²	0.488	0.489
Adjusted R ²	0.409	0.411
F Statistic (df = 8; 299)	35.654***	35.827***

Note:

*p<0.1; **p<0.05; ***p<0.01

In the table below, I present models similar to the table above, but without the lagged primary independent variable. I also utilize a logged dependent variable. The results are similar to those shown in Chapter 5 in substantive and statistical significance. Most notably, the political competition measures generally lost statistical significance in the logged dependent variable models.

Table 24: Economic Elites and FDI Inflows (Alternative Models, Logged DV)

	<i>Dependent variable:</i>	
	log(FDI net inflows)	FDI net inflows (millions usd)
	(1)	(2)
Large Firm Market Share	0.949*** (0.334)	56,613*** (9,541)
log(GDP)	1.508*** (0.089)	24,534*** (2,608)
log(population)	-0.571*** (0.066)	-7,895*** (1,926)
Oil rents	-0.023*** (0.006)	-1,445*** (170.95)
Underdeveloped	0.426 (0.287)	-9,908 (8,502)
Exchange rate	-0.004*** (0.002)	15.98 (43.97)
GDP growth	0.023 (0.015)	515.69 (424.08)
Polity Score	0.025* (0.014)	-1,655*** (391.62)
Observations	330	352
R ²	0.712	0.475
Adjusted R ²	0.664	0.394
F Statistic	87.094*** (df = 8; 282)	34.346*** (df = 8; 304)
<i>Note:</i>		*p<0.1; **p<0.05; ***p<0.01

The interpretation of the results using a logged dependent variable is made easier by logging the Large Firm Market Share variable. The resulting coefficient is 0.526, at the same level of statistical significance. Using this value, a one percent increase in Large Firm Market Share is associated with a 52% increase in FDI inflows.

I also conducted additional testing of H2b. Another approach is to use a dummy variable in place of the continuous variable used in the previous regressions to measure economic elite consolidation. In order to produce the next table and the following figures, the variable measuring market share of elite firms was converted into a dummy variable, where 0 represents cases in which the market share of elite firms is equal to or above 0.75, and 1 represents cases where it is below this threshold (1 indicates states with relatively more economic elites). Transforming the large firm market share variable into a dummy variable provides additional support for the hypothesis, and is also instructive in providing a comparison of the effect of political competition in states with relatively more economic elites versus more oligarchic states.

The model employed here is specified by the following terms:

$$FDI\ Net\ Inflows_{it} = B_0 + B_1 Large\ firm\ market\ share\ dummy_{it} * Political\ Competition_{it} + B_2 Large\ firm\ market\ share\ dummy_{it} + B_3 Political\ Competition_{it} + B_4 \log(GDP)_{it} + B_5 Oil\ Rents\ Share\ of\ GDP_{it} + B_6 \log(population)_{it} + B_7 Underdevelopment\ dummy_{it} + C_t + e_{it}$$

Table 25 below provides a summary of the regressions results using this modeling approach with all six measures of political competition.

Table 25: Economic Elites and FDI Inflows Conditional on Political Competition (Dummy Variable)

	<i>Dependent variable:</i>					
	Foreign direct investment net inflows (millions usd)					
	(1)	(2)	(3)	(4)	(5)	(6)
Mktsharedummy*Polity Score	-3,016 *** (627.46)					
Mktsharedummy*Political Competition		112.68 (1,128)				
Mktsharedummy*Electoral Democracy Index			-80,532 *** (11,960)			
Mktsharedummy*Multi-party Elections				-8,087 * (4,727)		
Mktsharedummy*Legislature Opp. Parties					-9,078 *** (1,830)	
Mktsharedummy*Opp. Party Autonomy						-6,797 *** (1,678)
Mktsharedummy	-18,043 *** (3,737)	-5,576 (3,386)	15,081 *** (4,182)	-5,885 ** (2,690)	-11,188 *** (2,871)	-1,921 (2,604)
Polity Score	1,411 ** (595.08)					
Political Competition		-308.20 (1,116)				
Electoral Democracy Index			19,704 ** (8,778)			
Multi-party Elections				5,505 (3,837)		
Legislature Opp. Parties					2,335 (1,640)	
Opp. Party Autonomy						-2,194 (1,407)
log(GDP)	14,112 *** (1,376)	13,092 *** (1,442)	13,948 *** (1,362)	13,222 *** (1,368)	11,831 *** (1,465)	14,941 *** (1,323)
log(pop. Ages 15 to 64)	-2,229 ** (1,023)	-2,471 ** (1,119)	-2,160 ** (1,008)	-2,438 ** (1,051)	-1,323 (1,054)	-5,176 *** (1,070)
Oil rents % of GDP	-727.79 *** (98.75)	-509.09 *** (92.46)	-781.21 *** (103.80)	-494.42 *** (91.41)	-662.43 *** (95.69)	-842.09 *** (97.43)
Observations	660	660	660	660	660	660
R ²	0.319	0.273	0.327	0.275	0.313	0.338
Adjusted R ²	0.269	0.220	0.278	0.222	0.263	0.289
F Statistic (df = 6; 614)	47.882 ***	38.397 ***	49.701 ***	38.751 ***	46.631 ***	52.151 ***

Note:

* p<0.1; ** p<0.05; *** p<0.01

Once again, the interactive terms for Large Firm Market Share and the two primary measures of political competition, Polity Score and the Electoral Democracy Index, are both statistically significant and substantively negative in effect. In the primary model (model 1), the independent effect of the Large Firm Market Share dummy variable is also negative as expected. The independent effects of the dummy variable and the political competition measures are positive in several other cases, but these positive marginal effects were overwhelmed by the marginal effect of the interactive term.

The figure below illustrates the results visually.

Figure 28: Marginal Effect of Political Competition Conditional on Economic Elites (Dummy Variable)



Appendix 3.4: Instrumental Variable Tests Using Political Competition (M3)

The table below displays results of the instrumental variable test developed in Chapter 6, now using the measures of political competition as the instrument to predict changes in policy uncertainty (as measured by the Political Risk and Political Sentiment measures). The results are slightly weaker using these instruments, but substantively similar (the negative marginal effect of

political risk on FDI inflows presented in the Chapter 6 model was approximately 317 million USD). This indicates that the measures of political competition serve as a valid instrument to predict variation in these measures.

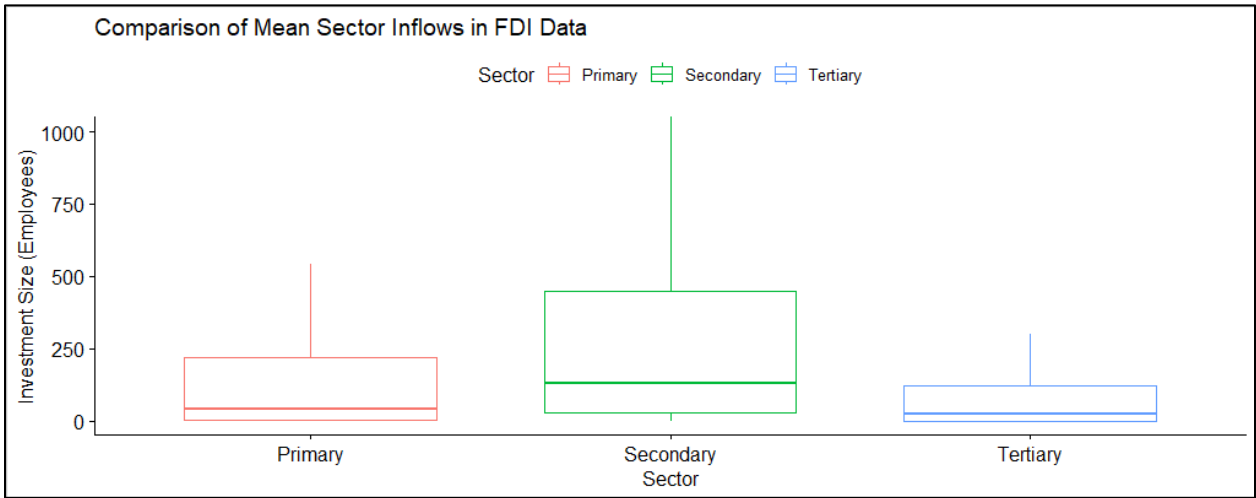
Table 26: Policy Uncertainty and FDI Inflows (Two Stage Model, Alternative Measures)

	<i>Dependent variable:</i>	
	Foreign direct investment net inflows (millions usd)	
	(Polity Score Inst.Var.)	(Electoral Democracy Index Inst.Var.)
Political Risk	-206.33** (91.37)	-87.04** (33.92)
log(GDP)	27,979 *** (1,742)	20,521 *** (1,524)
Oil rents	-1,610 *** (311.19)	-1,529 *** (250.46)
Observations	262	406
R ²	0.553	0.449
Adjusted R ²	0.518	0.421
F Statistic	324.184***	369.306***
<i>Note:</i>		*p<0.1; **p<0.05; ***p<0.01

Appendix 3.5: Illustration of Secondary Sector Firm Advantage in Attractive FDI (H3)

The figure below provides an illustration of the secondary sector advantage (and tertiary sector disadvantage) in FDI in authoritarian states. As discussed in Chapter 7.2, authoritarian states tend to favor secondary sector affiliated FDI. The secondary sector is more attractive to autocrats due to the degree to which it can be monetized, controlled, and undertaken without the need for an educated workforce or loosening of information controls. In economic terms, autocratic states generally underperform in developing human capital that attracts tertiary sector investment (see Pinto et al 2005). This figure is a companion to the figure in 7.2.5, which illustrates the same effect, but with regard to the level of risk sensitivity (i.e. political uncertainty) that dictates investment appetite, instead of FDI itself.

Figure 29: Difference in Mean FDI Inflows by Sector in Authoritarian States



Appendix 3.6: Supplemental Analysis of H3a and H3b

The table below presents the insignificant results for the H3a models of the marginal effect of political competition on primary and secondary sector concentration in FDI inflows. As with the results for H3b for these concentration measures, the results were hampered by the limited number of observations in the data for the dependent variables.

Table 27: Political Competition and Targeted FDI (Primary and Secondary Sector)

	<i>Dependent variable:</i>			
	Secondary concentration		Primary concentration	
	(1)	(2)	(3)	(4)
Electoral Democracy Index	0.152 (0.361)		-0.233 (0.653)	
Polity Score		0.013 (0.014)		0.016 (0.025)
log(GDP)	0.014 (0.039)	0.020 (0.036)	-0.022 (0.070)	0.008 (0.065)
Oil rents	-0.019** (0.008)	-0.017** (0.008)	0.043*** (0.015)	0.047*** (0.016)
Underdeveloped	0.004 (0.154)	-0.002 (0.149)	0.271 (0.284)	0.314 (0.276)
Observations	226	226	207	207
R ²	0.033	0.036	0.048	0.049
Adjusted R ²	-0.077	-0.073	-0.072	-0.070
F Statistic	1.730 (df = 4; 202)	1.902 (df = 4; 202)	2.298* (df = 4; 183)	2.366* (df = 4; 183)

Note:

*p<0.1; **p<0.05; ***p<0.01

The models presented in Chapter 7, sections 7.2.2 and 7.2.3, were robust to the inclusion of exchange rate as a control variable, although this reduced the number of observations. The model fit was improved. This follows the findings of Walsh & Yu (2010) regarding the importance of exchange rate in sectoral concentration for FDI. For brevity, the results are given here rather than in Chapter 7. Model 1 gives the H3a results with all control variables and Model 2 gives the H3b results with all control variables.

Table 28: Targeted FDI, Alternative Tertiary Sector Models

	<i>Dependent variable:</i>	
	Tertiary concentration	
	(1)	(2)
Large Firm Market Share		-0.656* (0.371)
Electoral Democracy Index	0.545* (0.321)	0.340 (0.672)
log(GDP)	0.080** (0.033)	-0.046 (0.075)
Oil rents	-0.061*** (0.021)	-0.076*** (0.021)
Exchange rate	-0.003 (0.003)	-0.008 (0.005)
Underdeveloped	0.012 (0.109)	0.024 (0.246)
log(population)	-0.103** (0.040)	-0.015 (0.084)
Observations	107	63
R ²	0.515	0.711
Adjusted R ²	0.366	0.502
F Statistic	14.346*** (df = 6; 81)	12.660*** (df = 7; 36)
<i>Note:</i> *p<0.1; **p<0.05; ***p<0.01		

These figures accompany the figures in 7.2.4, and use the ITC state level data in place of the firm level data. As discussed in that section, the results are clearest for the tertiary sector, but are hampered overall by the limited number of observations. The first illustration shows how the negative marginal effect of increased political competition is diminished for tertiary sector FDI, indicating that the negative impact to FDI felt from greater political competition is mostly resultant of decreased favoritism toward the primary and secondary sectors, resulting in less targeted FDI inflows there. The second illustration is similar, exhibiting how the positive marginal effect of fewer economic elites on FDI inflows is not found for the tertiary sector, indicating that increased favoritism serves to increase FDI inflows targeted primarily towards the primary and secondary sectors.

Figure 30: Political Competition and FDI Inflows by Sector (Supplemental)

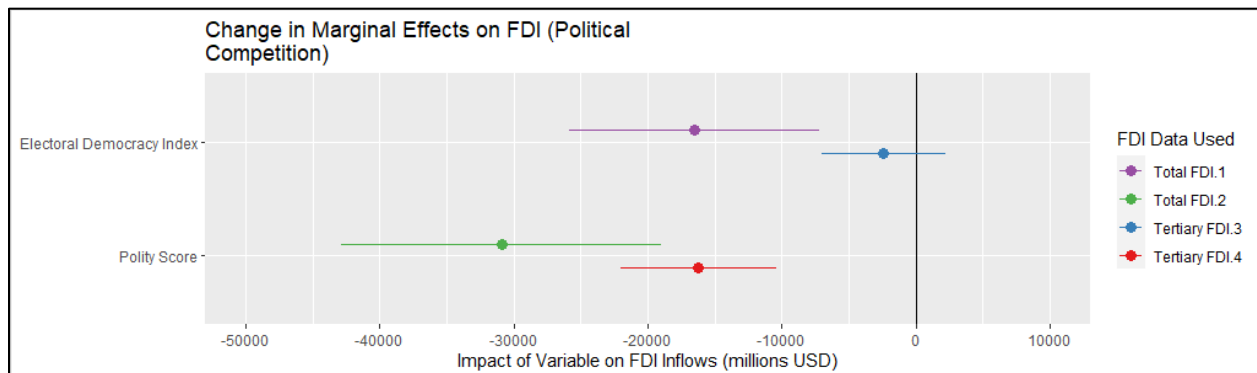
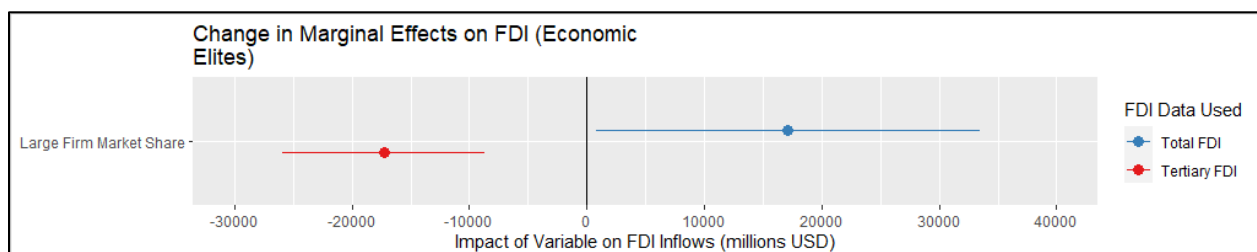


Figure 31: Economic Elites and FDI Inflows by Sector (Supplemental)

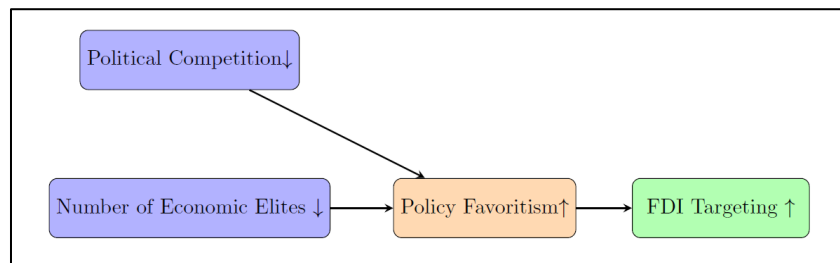


Appendix 4: Testing Policy Favoritism as a Mechanism

In Chapter 6, I examined the mechanism linking political competition and the number of economic elites with FDI inflows, which was policy uncertainty. In this appendix, I extend this analysis, using the same data, to examine the concept linking these variables to FDI targeting, which is *policy favoritism* towards foreign direct investment into the secondary sector. Here I develop several hypotheses which I use to examine using the BU dataset on political risk and political sentiment that was employed in Chapter 6.

FDI *policy favoritism* describes the process by which autocratic leaders tend to favor foreign direct investment into particular sectors, which appears as more favorable policy towards investors operating in those sectors. When investors are in industries that tend to be favored by autocrats for FDI, they will feel more confident about how political policies will impact their business. This increases their equilibrium investment amount. As a result, autocracies tend to overperform in FDI inflows to certain sectors. This creates “targeted” FDI inflows which are more heavily concentrated to particular sectors (i.e., the secondary sector). Figure 32 provides a visual illustration of the mechanism test presented in this appendix.

Figure 32: Visual Depiction of Mechanism Test for H3



In Chapter 6, we saw that executives from foreign firms experienced differing perceptions of risk (policy uncertainty) based on the characteristics of the state they were

investing in. In this appendix, we will examine how these perceptions differ based on characteristics of the investing firm itself (i.e., what sector the investing firm is in), and how these differing perceptions become more pronounced based on the degree to which the state is politically consolidated or has fewer economic elites. As discussed in Chapter 7, autocrats favor FDI in the secondary sector, because this type of FDI is both often necessary for a competitive secondary sector, and is easily utilized as private good. Those sections examined sectoral concentration in FDI inflows (“targeted FDI”). This appendix will examine sectoral concentration in foreign investor sentiment (“favoritism”), which is the source of targeted FDI. Secondary sector firms should experience reduced levels of policy risk, a condition which we called “policy favoritism”, because it implies that certain foreign investors’ FDI is favored over others. In Chapter 6, we examined how foreign investors’ aggregate risk sentiment varied based on our country-level variables of interest (political competition and the number of economic elites). In this appendix chapter, I will establish that these risk sentiments also vary by which sector the foreign investor is located in, and that this sectoral variation in risk sentiment (a proxy for “favoritism”) increases in significance in states with less political competition and fewer economic elites.

This appendix is important in addressing alternative explanations for the H3 results presented earlier. As discussed in Chapter 7, conclusive analysis of H3 is prevented by the alternative explanation that the observed effects are stemming from economic explanations rather than political ones, particularly for the measure of economic elites. In order to rule out purely economic explanations for FDI inflows being more targeted, we also need this direct measure of policy favoritism, and to determine if there is a difference in such favoritism between foreign firms seeking to invest along the lines I suggest. By aggregating investor risk sentiment

by sector and then examining the variation between sectors, I devise a means to measure favoritism directly.

The implication of this favoritism is that consolidated authoritarian states will successfully attract foreign investment, but mostly into particular, narrow interests. Autocrats use policy measures (tax breaks, royalties, and other incentives) to encourage FDI from certain types of foreign investors, namely those in the secondary sector. Therefore, the risk perceptions of foreign investors should vary meaningfully between sectors, holding other factors constant. There are often economic reasons for concentration in investment inflows we see in states with particular comparative advantages, but this differs from the specific targeting of certain FDI we see in authoritarian states.⁴¹ I seek to examine this favoritism more directly by examining the connection between my primary independent variables and a measure of policy favoritism itself.

As with the previous mechanism tests, analysis at the firm level is productive, because it is necessary to differentiate between different sectoral affiliations of firms to detect favoritism (which is variation in uncertainty between investors from different sectors). I propose two hypotheses to test the mechanisms behind the results of H3a and H3b.

⁴¹ An example from Chapter 7, a comparison of Vietnam and the Philippines, illustrated how political factors still create divergence in outcomes to FDI inflows in states that have similar economic endowments. Another illustration of this difference is found between Vietnam and Taiwan. Both states have a comparative advantage in electronics manufacturing, and as expected, both states perform well in this regard. However, in Taiwan, the largest publicly traded firm, TSMC, is majority foreign owned, and the state has a robust service sector. In Vietnam, all the largest firms are all controlled by the state or top elites, and there is little service sector to speak of. This represents the result of policy favoritism because investment in Taiwan, including FDI, flows freely to a variety of firm types and industries (i.e., investment is not targeted), facilitating economic growth outside of just domestic incumbent elites and favored industries. In Vietnam, policy favoritism results in targeted FDI inflows, leading to growth mostly just for the secondary sector and thus for state-owned or aligned firms. Thus, the degree to which sectoral concentration varies between Taiwan and Vietnam is largely due to targeted FDI inflows. The reason that FDI inflows are more targeted (to the secondary sector) in Vietnam is because Vietnam hosts an autocratic government which pursues policy favoritism towards this type of investment as a way to reward supporters (economic elites). Therefore, we can expect foreign investors to feel more confident about investing in Vietnam when they are associated with the secondary sector than when they are associated with other sectors. By contrast, this difference should be less pronounced in states like Taiwan.

M4a: Firms investing in authoritarian states with greater political competition will experience less policy favoritism (less variation in risk sentiment between firms in different sectors) than those in authoritarian states with less political competition, all else equal.

M4b: Firms investing in authoritarian states with relatively fewer economic elites will experience more policy favoritism (less variation in risk sentiment between firms in different sectors) than those in authoritarian states with relatively more economic elites, all else equal.

In sum, in Chapter 7, I examined the sectoral (and sub-sectoral) concentration of FDI inflows. Here I propose to examine the policy favoritism that produces this targeted FDI. In Chapter 6, I tested a hypothesis that when firms experienced greater perceptions of risk, they invested less (M3). The findings for that concept apply here as well. When investors experience less favorable policy based on what sector they are investing in, this appears as higher political risk, and they invest less (and vice versa). Investors expressing more political risk sentiment invest less. This was substantiated in Chapter 6. Therefore, this appendix will focus exclusively on substantiating the first part of the causal chain, where greater policy consolidation (less political competition, fewer economic elites) leads to more significant differentiation between the treatment of foreign investors based on their sectoral affiliation (“policy favoritism”). If the sector-targeted nature of FDI observed in Chapter 7 stems mostly or purely from structural *economic* factors, we should not necessarily expect there to be any difference in the perception of *political* risk by different types of foreign investors along those same sectoral lines. The next section will describe in detail the data I propose to use to test these mechanism hypotheses.

Appendix 4.1: Mechanism Test for H3

In a manner similar to Section 7.2, this appendix necessarily consists of a two-part analysis. The first part focuses on substantiating the claim that foreign investors associated with different sectors experience varying levels of political risk simply based on whether or not they

are politically favored by autocrats. In other words, it substantiates whether or not policy favoritism is indeed occurring in nondemocratic settings. In the second part, I build on this to examine whether this favoritism becomes *greater* with less political competition or fewer economics elites. I do this by replicating the models of political risk used in Chapter 6, this time segregating the dependent variable (firm-level perceptions of political risk) by what sector the foreign investors' firm is associated with.

In order to test these claims, I return to the Firm-Level Risk Dataset described in detail in Chapter 6. Again, this data aggregates firm-level measures of exposure, risk, and sentiment constructed using textual analysis of quarterly earnings conference calls held by more than 1000 firms investing in 36 nondemocratic states, with cases beginning in 2002 and ranging to the present. The cases are in firm-quarter-country format. Using techniques I describe below, I assign sectoral affiliations to each firm, allowing for analysis of sectoral differences. (Hassan et al 2019).

Like policy uncertainty, *Policy favoritism* is also a country-level concept. However, the expression of policy favoritism is that investment into particular sectors will receive more favorable policy incentives. The most important variations in *policy favorability* therefore inherently occurs at the sector level. Therefore, measuring this concept will require a slightly different approach than the analysis used for policy uncertainty. Specifically, when a particular state has more policy favoritism, we should expect to observe higher variance *between sectors* in the level of expressed “political risk” or “political sentiment” expressed during associated firms' earning calls. Firms located in sectors that are likely to make them favored (i.e., secondary sector investors) should express significantly less concern about political factors on average than firms

in other sectors. Stated another way, I argue that in dealing with autocratic states, foreign investors vary in the degree to which the state favors them as partners for FDI.

The Boston University dataset that I employ in this appendix allows me to examine these differences in mean risk sentiment by sector, as measured by the variance in risk and sentiment scores for associated investors. That is, if some foreign investors in a particular country experience higher risk, but other foreign investors in the same country do not, and this variation occurs along predictable sectoral patterns, that suggests that there is policy favoritism (for FDI) by the state toward some types of foreign investment but not others.

Based on findings from the analysis in 7.2, I operationalize this by assuming that firms associated with particular sectors or subsectors will be favored. As outlined in 7.2, autocrats favor targeted FDI into sectors that produce reliable returns that can be used to reward key supporters (generally speaking, primary or secondary sector investment), and disfavor FDI that is hard to control or threatens to destabilize the regime or harm domestic industries (generally speaking, most tertiary sector investment). Secondary sector FDI is particularly sought-after because of the fact that consistent investment is often required to maintain the systems and technology to produce reliable secondary-sector returns relative to many primary-sector industries. It should be expressly noted however, that this is a generalized tendency, and complex primary sector production (such as the Kazakhstan example discussed earlier) often indeed requires consistent capital renewal and as a result incentivizes states to encourage FDI.

When foreign investors located in unfavored sectors show a significantly higher level of expressed risk, this indicates that FDI-related policies are less favorable to them. Favored investors that do not face as many policy-related costs (such as taxes, restrictions, special permitting, etc.), can be expected to discuss this form of risk less. Therefore, affiliation with the

secondary sector should be associated with a lower political risk score and a higher political sentiment score. In contrast, affiliation with the tertiary sector should produce the opposite result. In particular, the “political sentiment score” is a useful measure here, because it scores specifically based on the sentiment of a particular firm. Firms that are favored (i.e., investing in a favored sector) should exhibit higher sentiment. Again, the indices of “political risk” and “political sentiment” are used as proxies to measure differences in the favorability of policy between different types of investors.

For H3, I use the BU risk data to construct the independent variables. Broadly, I assume that firms in the primary or secondary sectors will be favored, because industries in these sectors are easy to monetize and control, and typically represent the most lucrative opportunities. In particular, policy will favor FDI into relatively capital-intensive enterprises, such as manufacturing, which are more reliant on FDI.

This risk data includes data on which country and sector a foreign investor is located in. I use firm naming conventions to measure investing firm characteristics, which serve as the independent variables for the H3 mechanism test. Firms’ names often contain indications of their activity (such as ABC Gas Company). I use these characteristics (the firm’s legal name) to make informed assumptions about firm sectoral affiliation.⁴² Firm names were used to sort cases by industry and sector. This method resulted in the categorization of roughly 1000 tertiary sector firms, 153 firms for the secondary sector, and 155 firms for the primary sector.

Table 29 summarizes the variable measures and sources of data used to construct the tests.

⁴² See Appendix 7 for a coding methodology.

Table 29: Summary of Appendix 4 Mechanism Tests

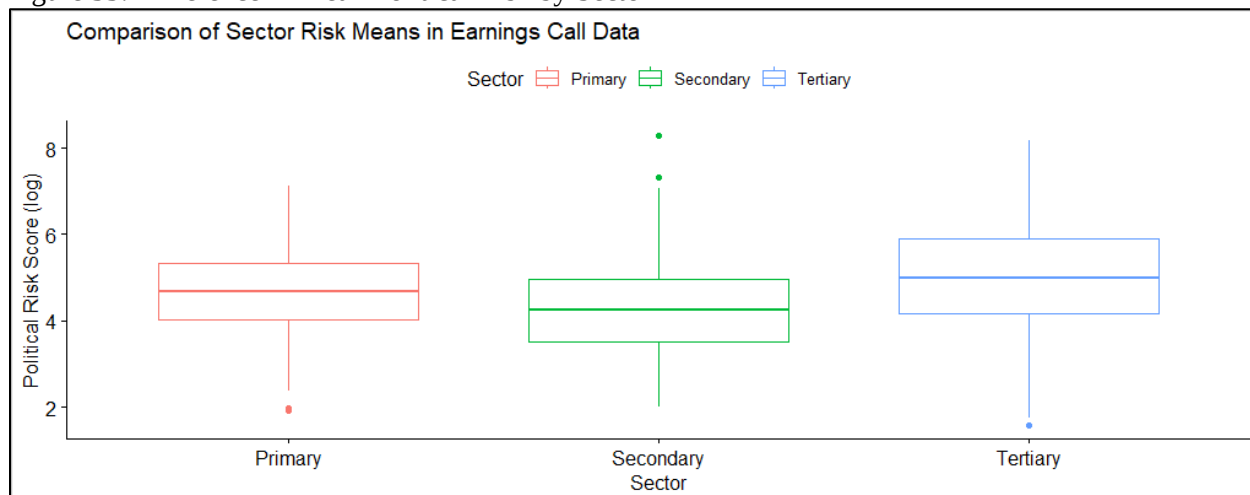
Hypothesis	DV	DV Measure (source)	IV	IV Measure (source)
M4a	Policy favoritism	Level of sectoral variation in expressed political risk (BU)	Political consolidation	Political competition (V-Dem)
M4b	Policy favoritism	Level of sectoral variation in expressed political risk (BU)	Economic consolidation	Number of economic elites (WFE)

For the measure of “political risk”, the overall observed mean score among the firms sampled was 143. When we break this data out by segregating firms based on their sector, the measure was lowest among secondary sector firms, at a mean of 122, and highest among tertiary sector firms, at a mean of 224. This indicates that foreign investors from secondary sector firms tended to express less concern with risk, and those from tertiary sector firms tended to express more concern with risk. This provides an example of how we might go about designating firms from particular sectors as experiencing more or less policy risk based on favoritism in policymaking. This simple analysis seems to support the overall trend that tertiary sector firms are less favored for FDI into autocratic states.

These patterns can also be illustrated with a simple boxplot which compares the mean political risk values for each type of firm. Figure 33 provides a visual representation of the data. The figure illustrates secondary sector firms experiencing less overall risk sensitivity, particularly in comparison with tertiary sector firms. This is evidence of the secondary sector advantage discussed earlier in this chapter. A complimentary means comparison figure, which

illustrates the secondary sector advantage in terms of FDI inflows using the data from H3, can be found in Appendix 3.

Figure 33: Difference in Mean Political Risk by Sector



Source: Hassan 2019

In order to formally test the mechanism for Hypothesis 3, I specify the following multilevel models of firm-level policy sentiment (for firm j) to include measures of firm sector location and firm nonpolitical risk sentiment, as well as country-level (country i) control variables associated with greater political risk, such as the occurrence of a recent election and the legal environment. The setup is similar to the multilevel model presented in Chapter 6. The premise is to examine whether certain firms are, on average, more or less subject to policy favoritism based on their sectoral affiliation:

$$Policy\ Favorability_{jt} = B_0 + B_1 Firm\ sector\ location_{jt} + B_2 Property\ rights_{it} + B_3 Recent\ election_{it} + B_4 Nonpolitical\ risk_{jt} + B_5 Oil\ rents_{it} + C_t + e_{it}$$

The following two tables (Table 30 and Table 31) present the results of this model, examining how sectoral affiliation impacts the political risk score and the political sentiment score. Sectoral affiliation was measured using a dummy variable indicator. In the tables, tertiary sector affiliation is positively associated with perceptions of political risk and negatively

associated with political sentiment. Affiliation with the tertiary sector is associated with a 94-point increase in the political risk score (indicating that these firms had more mentionings of risk associated with politics in their earnings calls), and a 189-point decrease in the political sentiment score (indicating that tertiary sector firms had more negative tone words associated with discussions of political topics). As with many of the results for Chapter 7.2, while the results for secondary and primary sector affiliation performed directionally as expected, the results had relatively low statistical significance. This is likely due to the fact that most of the firms in the dataset that could be categorized based on their naming convention were tertiary sector firms, meaning the low number of observations for other types of firms hampered the statistical significance of the results.

Among the control variables, performance is again as expected based on theory and prior results. Interestingly, the most nonconforming result was with the property rights index and political sentiment, where the relationship was reported as negative. Again, this seems to suggest that in authoritarian settings, the relationship between codified rule of law and the direction of political sentiment among investors is weaker than often suggested. The regressions also included a firm-level measure of nonpolitical risk or nonpolitical sentiment. Nonpolitical risk should be associated with perceptions of political risk, as managers that are more risk sensitive in one area are more likely to be risk sensitive in another. Oil rents were also included as a control variable in these regressions due to potential covariance with sectoral variation and generally saw a negative association with political sentiment.

Table 30: Investing Firm Sector Location and Policy Favorability

	<i>Dependent variable:</i>		
	Political Risk		
	(1)	(2)	(3)
Firm in secondary sector	7.146 (23.509)		
Firm in primary sector		11.018 (23.381)	
Firm in tertiary sector			94.958*** (9.798)
Nonpolitical Risk	0.057*** (0.002)	0.057*** (0.002)	0.053*** (0.002)
Property Rights Index	-34.029* (20.559)	-34.858* (20.569)	-38.436* (20.442)
Recent Parl. Election	-2.911 (8.774)	-2.935 (8.773)	-9.789 (8.758)
Recent Pres. Election	46.397*** (15.217)	46.498*** (15.219)	40.330*** (15.152)
Oil rents	0.297 (0.630)	0.270 (0.632)	-1.293** (0.648)
Observations	9,611	9,611	9,611
R ²	0.063	0.063	0.072
Adjusted R ²	0.061	0.061	0.070
F Statistic (df = 6; 9587)	107.315***	107.338***	124.003***
<i>Note:</i> *p<0.1; **p<0.05; ***p<0.01			

Table 31: Firm Sector Location and Policy Favorability (Alternate Measure)

	<i>Dependent variable:</i>		
	Political Sentiment		
	(1)	(2)	(3)
Firm in secondary sector	125.688 (126.073)		
Firm in primary sector		644.667*** (125.298)	
Firm in tertiary sector			-189.800*** (52.069)
Nonpolitical Sentiment	0.034*** (0.001)	0.034*** (0.001)	0.034*** (0.001)
Property Rights Index	-2,079.461*** (110.558)	-2,114.953*** (110.454)	-2,077.045*** (110.390)
Recent Parl. Election	-496.058*** (47.252)	-500.161*** (47.190)	-482.050*** (47.348)
Recent Pres. Election	-156.484* (81.584)	-146.893* (81.487)	-144.595* (81.599)
Oil rents	-28.636*** (3.380)	-30.052*** (3.385)	-25.520*** (3.489)
Observations	9,611	9,611	9,611
R ²	0.177	0.179	0.178
Adjusted R ²	0.175	0.177	0.176
F Statistic (df = 6; 9587)	343.955***	349.115***	346.445***
<i>Note:</i>		*p<0.1; **p<0.05; ***p<0.01	

This finding implies that there is a political bias in authoritarian countries against tertiary sector investment. This is important, because it helps establish a firmer ground on which to claim causality for the H3 findings regarding FDI targeting. In other words, if there is a political bias against the tertiary sector (which it appears from these results that there is), we can attribute more targeted FDI (i.e., the finding that more-autocratic states have relatively less tertiary sector FDI inflows) to a political cause rather than an economic one. This political cause is political

consolidation (the premise of H1) and/or there being fewer economic elites to please (the premise of H2). The primary claim being made here is that autocrats prefer to pursue FDI targeted at the secondary sector, and specifically not the tertiary sector. When competition over policy decreases, autocrats are therefore more easily able to pursue this line of policy, and FDI inflows become more targeted as a result.

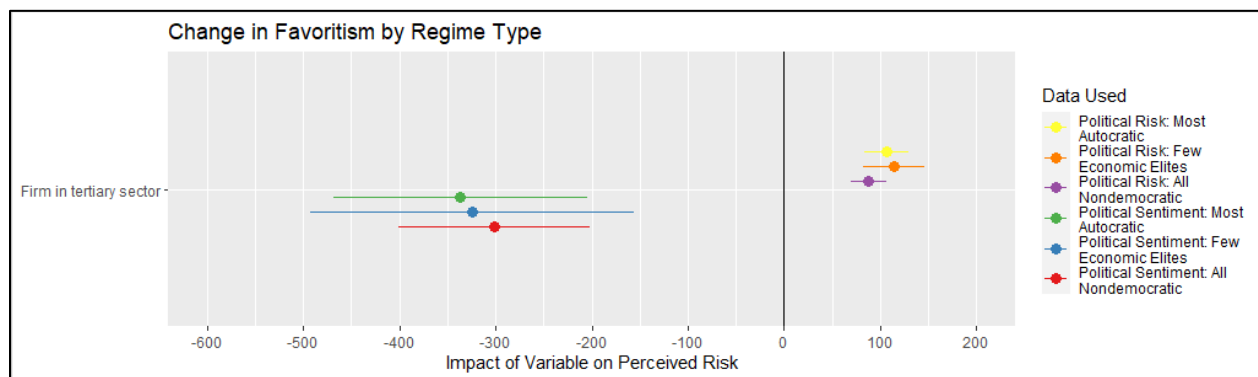
The finding for risk-sensitivity of foreign investors in the primary sector is also interesting. Clearly, growth in the primary sector is favored by autocrats, as evidenced by several of the case studies we have examined. The finding in Model 2 of Table 31 confirms that foreign investors associated with this sector indeed experience less negative policy uncertainty. However, interestingly, this does not directly translate into increased FDI inflows to this sector, as evidenced empirically in the prior section. Again, this is likely due to the fact that secondary sector FDI is more technologically challenging, and *requires* more secondary sector FDI in order to remain competitive.

The primary focus of the analysis in this appendix, to this point, has been to provide substantiation for the claim that the targeted nature of FDI in authoritarian states is related to political causes (i.e., policy favoritism) rather than economic factors. The next portion of the analysis will focus on the degree to which our primary independent variables (the level of political competition and the relative number of economic elites) impact the degree to which this policy favoritism occurs. This provides the actual test of the claims M4a and M4b.

The first way this can be done is simply by reproducing the models used in Tables 30 and 31 above, this time disaggregating the sample data by regime type. The purple and red plots on the marginal effects plot in Figure 34 below represent the original results from Model 3 in Table 30 and Model 3 in Table 31. What the figure illustrates is that the size of the marginal effect (of

sectoral affiliation) tends to increase as states become less politically competitive (under 0 on the Polity scale, yellow and green plots) and have fewer economic elites (over 0.70 on the Large Firm Market Share scale, orange and blue plots). What this means is that foreign investors affiliated with the tertiary sector experience more negative bias in these consolidated regimes. I argue that this is because these less-competitive regimes are more effective at implementing favoritism towards (or against) certain types of FDI inflows. The result is that FDI inflows become more targeted in these consolidated states.

Figure 34: Marginal Effects Changes by Regime Type



More-autocratic states discriminate more effectively against tertiary sector investment. Following from this, the implication is that a decrease in the number of economic elites, or a decrease in political competition, should result in smaller decreases in policy uncertainty for tertiary sector firms than for other firms. In order to further examine this claim, I conducted a test of the difference in the marginal effect of both political competition and the number of economic elites on the political risk and sentiment scores, comparing between the various sectoral categories of foreign investor in the dataset. We should expect that the positive marginal effect of these variables on risk sentiment observed in Chapter 6 should be strongest for secondary sector investors, because these investors are treated most favorably by autocrats as competition over policy is reduced. Conversely, it should be weakest for tertiary sector investors.

In order to conduct this test, I replicate the multilevel model used in Chapter 6 to test M2. In order to test the mechanism there, I specified the following basic models of firm-level policy uncertainty (in firm j) to include the primary state-level measure for the relative number of economic elites (in country i); large firm market share, as well as measures of political competition:

$$\text{Policy Uncertainty}_{jt} = B_0 + B_1 \text{Large firm market share}_{it} + B_2 \text{Property rights}_{it} + B_3 \text{Recent election}_{it} + B_4 \text{Political competition}_{it} + B_5 \text{Nonpolitical risk}_{jt} + C_t + e_{it}$$

I employ this model on observations disaggregated by firm sector location, and examine whether the observed marginal effect varies between firms situated in different sectors.

The figures below provide a summary of this comparison test using the same model used for H2a. Figure 35 shows the results using Polity Score as the political competition measure, and Figure 36 uses Electoral Democracy Index for this variable. As the model illustrates, the expected marginal effect of having fewer economic elites is that the Political Sentiment score for that state will increase (this was shown in the models in the previous section). This confirms the finding from M2 in Chapter 6. However, the effects of this result are not uniform. When we filter the data for only the tertiary sector firms, we see the positive effect diminished and lose statistical significance from zero. This is a critically important result, because it illustrates that the greater certainty over policy that occurs with fewer economic elites does not apply equally to all types of firms. Specifically, tertiary sector firms do not realize gains in policy certainty. This indicates that states with fewer economic elites exhibit greater policy favoritism (against FDI from tertiary sector firms) and this results in the secondary sector targeted FDI that we observed in Chapter 7.2. This result therefore supports the claim described in Mechanism Test 3b.

The results comparison for the political competition variable used in Figure 35 (Polity Score) did not result in a statistically significant difference from one another, although the negative effect on sentiment (observed in the Chapter 6 tests of M1 and M2) is retained. Therefore, the prediction of Mechanism Test 3a is not fully supported by this model. However, the result found when using the Electoral Democracy Index as the variable for measuring political competition does indicate that the negative marginal effect of political competition on policy uncertainty is *more negative* for tertiary sector firms. This model (Figure 36) indicates support for Mechanism Test 3a.

Figure 35: Economic Elites, Political Competition, and Policy Uncertainty by Sector

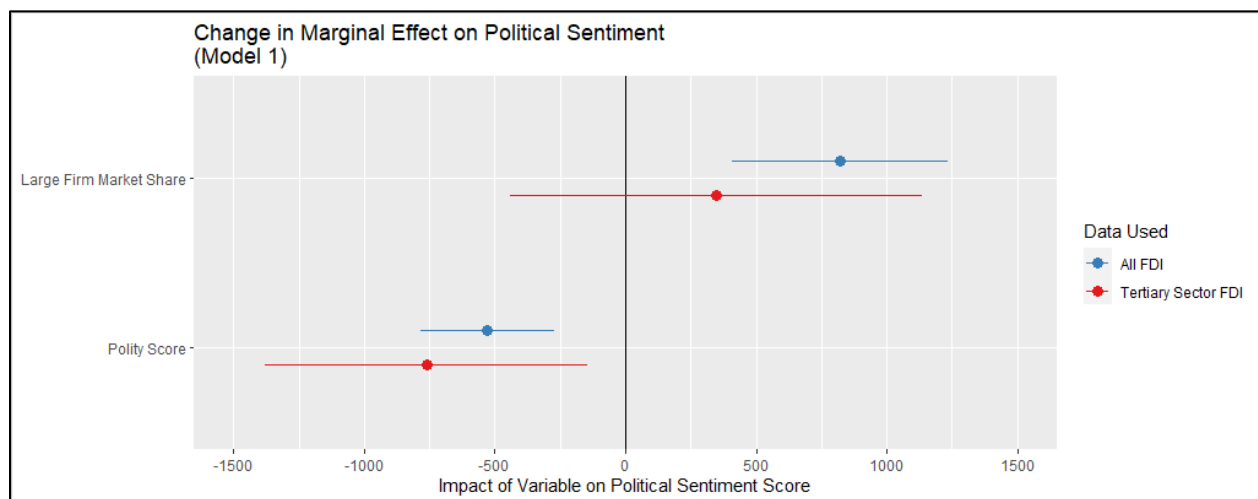
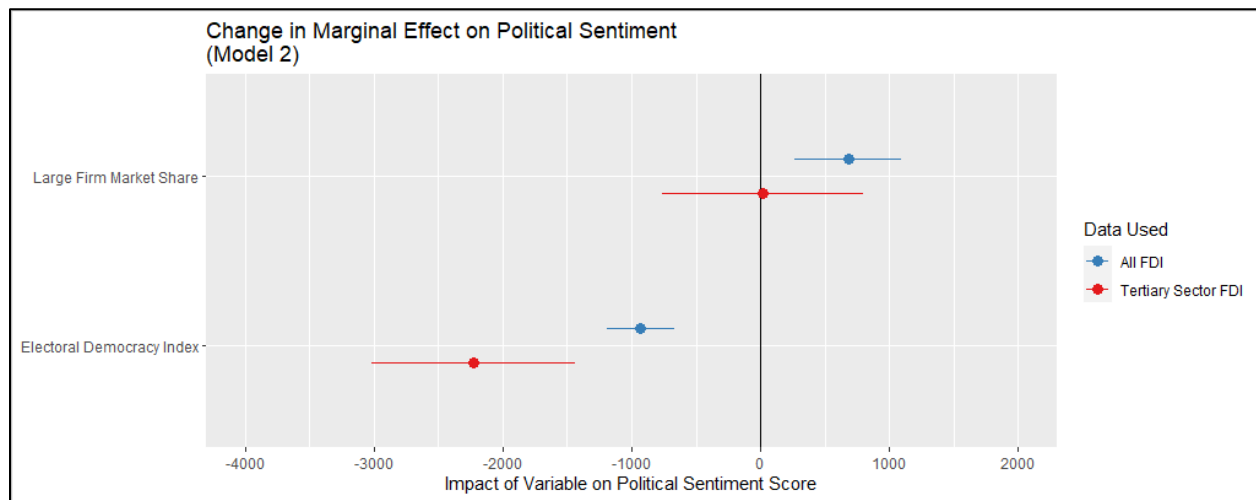


Figure 36: Economic Elites, Political Competition, and Policy Uncertainty by Sector (Alternative Measure)



In sum, when political competition is greater, it appears to more negatively impact policy uncertainty for tertiary sector firms than other firms. There are a number of possible explanations for this result. The most likely explanation within the context of the other findings is that the reduction in policy favoritism against tertiary sector firms that results from greater political competition is outweighed by the negative impact that increased overall policy uncertainty has for these firms. In other words, tertiary sector firms are particularly sensitive to the impact of policy uncertainty created by greater political competition in authoritarian settings (resulting either from political competition or dissatisfied economic elites).

This appendix has sought to use the Political Risk Dataset employed in Chapter 6 to provide a test of the policy favoritism mechanism. The type of FDI inflows, namely the degree to which they are targeted to certain sectors, is determined by the level of favoritism towards FDI into certain sectors on the part of policymakers. The analysis in this appendix provides validation of this claim and attempts to dispel alternative explanations.

Appendix 5: Economic Elite Competition and Policy Uncertainty in Singapore during the 1980s

Despite the lack of real political competition during most of its modern history, Singapore has seen periods of uncertainty over economic policy stemming from competition between economic elites, most notably during the 1980s. This condition led to a lack of policy focus by the state, more policy uncertainty, and ultimately less foreign investment interest. It was only once this changed that the nation became a top FDI recipient.

During this period, Singapore was quickly becoming a hub for electronics manufacturing and finance, but also had a greater number of economic elites from other significant industries. Importantly, some of these elites had policy preferences which were at odds with preferences held by the large semiconductor manufacturers. Alongside still-developing high-tech manufacturing firms, there were a large number of state-owned entities involved in a variety of activities including chemical manufacturing, food production, and textiles. Many of these were oriented around low-skill labor. A good embodiment of this type of firm in the private sector was Pan-Electric Industries. The large conglomerate was primarily involved in refrigerator manufacturing, marine salvage, as well as hotel and real estate development, among a variety of other interests.

During this period, Singapore was attempting to transition from a low-wage developing economy into a more modern developed state with a larger technology and services sector. However, with a number of competing interests to balance, the state did not take a deliberate focus on promoting any particular industry in order to achieve this. Put differently, incumbent leaders could not easily use private goods to satisfy all key supporters. Instead, with this goal of

development in mind, the incumbent regime in Singapore attempted a new ‘public goods’ type policy in 1981: large, compulsory wage increases. However, these wage increases had a highly counterproductive effect, reducing the economic competitiveness of a number of critical industries. As a result, dissatisfied elites quickly pushed for changes to this policy (Huff 1987). This turned off international investors by introducing greater uncertainty over how the regulatory environment might impact the cost of capital. This contributed to the weakening of the overall economy. The early 1980s saw more limited economic growth in Singapore and FDI was largely stagnant. Partly due to the weak economic conditions and partly due to a poorly structured debt portfolio, Pan-Electric Industries experienced a financial collapse in 1985 and helped contribute to a country-wide recession that year. A number of state-owned enterprises were insolvent. FDI inflows reached the lowest levels since the 1970s (Chee 1986).

However, the recession and the collapse of Pan-Electric had the unintended, secondary effect of reducing policy competition by increasing industry consolidation around semiconductor manufacturing. Up to this point, Singapore was involved primarily in low-tech manufacturing, which was more labor intensive. The collapse of Pan-Electric gave momentum to economic elites at the head of high-tech firms who argued that high-tech manufacturing was the surest path to ease labor condition and achieve development success, and successfully lobbied the state for significant policy reforms that would focus on promoting this sector, and on divesting or privatizing uncompetitive state-owned firms (Yuen 1989). In order to develop a technology-focused manufacturing sector, FDI would be critical. However, Singapore was not particularly attractive to foreign investors due to uncertainty over costs and a lack of clear incentives to invest. In order to change this, the state would need to deliberately favor this type of FDI.

The following year, the PAP introduced significant reforms and Prime Minister Lee Kuan Yew initiated a cabinet reorganization, replacing key economic and trade ministers with younger party members. A series of policy changes and reversals sharpened the focus of the state on promoting the emerging semiconductor industry and making Singapore a top destination for FDI inflows (Chee 1986). Such technology would be the key to overcoming labor shortages related to manufacturing. These reforms were followed by a robust economic recovery in 1987 and a large increase in FDI inflows (Low 1988).

Most of the land in Singapore was and still is state-owned, making the leasing of scarce land a highly political issue. Firms such as Pan-Electric competed with a number of others for the right to lease highly valuable land. The award of such leases was highly dependent on the state's priorities. The state began to use land leases after this period to focus on incentivizing industrial upgrading to allow for more high-tech manufacturing development. These measures were largely successful, leading Singapore to develop its current status as a destination for microchip wafer production.

Appendix 6: Scoring Methodology for Political Risk and Political Sentiment

Political Risk is calculated by pairing “political bigrams” with a count of the number of synonyms for risk or uncertainty found in the transcript. Political topics are summarized in the first table below. Frequently used uncertainty synonyms are included in the second table below. All tables are taken from Hassan et al (2019).

Political Sentiment is scored by pairing political bigrams with positive or negative words. Frequently used positive and negative words are included in the third table below. All tables are taken from Hassan et al (2019).

Figure 37: Tables Taken from Hasson et al. (2019) which depict scoring methodologies

Appendix Table 1: Mapping of political topics to Center for Responsive Politics (CRP) lobbying issues

Political topic	Lobbying issues
Economic Policy & Budget	Accounting; Advertising; Apparel, Clothing, & Textiles; Arts & Entertainment; Automotive Industry; Aviation, Airlines & Airports; Banking; Bankruptcy; Beverage Industry; Chemical Industry; Consumer Product Safety; Copyright, Patent & Trademark; District of Columbia; Economics & Economic Development; Federal Budget & Appropriations; Finance; Food Industry; Gaming, Gambling & Casinos; Manufacturing, Insurance; Labor, Antitrust & Workplace; Marine, Boats & Fisheries; Media Information & Publishing; Minting/Money/Gold Standard; Radio & TV Broadcasting; Railroads; Roads & Highways; Small Business; Telecommunications; Tobacco; Transportation; Travel & Tourism; Trucking & Shipping; Unemployment
Environment	Agriculture; Animals; Clean Air & Water; Environment & Superfund; Fuel, Gas & Oil; Hazardous & Solid Waste; Natural Resources; Real Estate & Land Use; Utilities
Trade	Commodities; Foreign Relations; Postal; Tariffs; Trade
Institutions & Political Process	Government Issues; Torts
Health	Health Issues; Medicare & Medicaid; Medical Research & Clinical Labs; Pharmacy
Security & Defense	Defense; Disaster & Emergency Planning; Homeland Security; Intelligence; Veterans Affairs
Tax Policy	Taxes
Technology & Infrastructure	Aerospace; Computers & Information Technology; Science & Technology

Notes: This table shows our manual mapping between our eight political topics (left column) and lobbying issues as given in the lobbying data from the Center for Responsive Politics (CRP) (right column). Note that the lobbying issues in the CRP lobbying data are the same as in the original Senate's Office of Public Records (SOPR) data.

Figure 38: Tables Taken from Hasson et al. (2019) which depict scoring methodologies

Appendix Table 2: Top 100 positive and negative sentiment words in $PSentiment_{i,t}$							
word	frequency	word	frequency	word	frequency	word	frequency
good	2,641,408	exciting	125,149	loss	467,845	negatively	58,012
strong	1,722,126	achieving	124,735	decline	429,914	unemployment	56,743
great	1,062,140	enable	120,768	difficult	389,060	worse	56,076
better	1,044,778	successfully	116,105	against	317,498	lag	55,132
opportunities	943,258	efficiencies	110,269	negative	310,768	wrong	55,089
able	828,658	easy	102,912	restructuring	268,455	bridge	54,903
positive	801,637	strengthen	98,139	challenges	251,140	delayed	54,439
progress	767,047	enhanced	88,684	force	214,267	severe	53,619
opportunity	761,564	encouraging	80,381	late	208,239	dropped	51,672
best	586,648	strengthening	79,861	closing	201,021	volatile	50,101
improvement	578,902	innovative	78,270	declined	190,489	lose	49,996
benefit	545,925	stability	74,459	losses	186,988	disclosed	49,461
improve	491,591	excellence	72,222	critical	176,951	shut	48,688
pleased	472,508	satisfaction	70,475	challenging	172,838	complicated	46,154
improved	399,832	pleasure	69,950	weak	147,742	breakdown	45,190
improving	393,062	winning	69,761	closed	141,847	slowing	44,031
success	372,656	superior	68,689	problem	141,206	serious	43,591
effective	337,530	gaining	68,179	claims	140,602	difficulties	42,743
profitability	326,058	perfect	66,669	break	126,092	disclose	42,695
successful	305,358	easier	65,672	slow	121,636	losing	41,206
greater	304,344	alliance	60,327	recall	119,959	slowed	40,555
stronger	301,302	collaboration	60,090	challenge	118,675	stress	40,184
strength	299,641	enabled	59,525	delay	114,017	caution	39,621
advantage	281,246	advantages	54,330	concerned	113,522	disruption	39,382
leadership	273,733	exceptional	53,971	bad	113,416	discontinued	38,879
achieve	259,392	stabilize	51,977	cut	109,198	failure	38,639
despite	250,814	gained	51,765	concern	108,700	challenged	37,776
confident	246,215	strongest	49,524	problems	108,547	downward	37,597
improvements	244,112	accomplished	48,676	litigation	105,754	poor	36,464
achieved	241,412	enhancing	47,817	weakness	103,443	deficit	34,792
excited	236,622	enables	47,758	volatility	103,236	suspect	34,719
favorable	229,367	valuable	47,491	difficulty	99,148	slowly	33,622
stable	226,222	impressive	46,205	lost	98,587	nonperforming	33,240
leading	220,624	progressing	45,966	crisis	97,581	unfavorable	33,165
efficiency	219,873	strengthened	44,440	concerns	93,580	deterioration	30,689
gain	215,827	enjoy	43,041	declines	91,712	opportunistic	30,593
happy	212,745	positively	42,027	weaker	89,910	termination	29,859
optimistic	184,364	efficiently	41,960	delays	87,772	miss	29,821
gains	182,624	exclusive	41,163	impairment	83,706	investigation	29,702
profitable	168,303	achievement	41,120	opposed	81,317	breaking	29,454
innovation	163,060	strengths	41,004	recession	75,221	shortage	29,249
excellent	161,468	enabling	39,380	slowdown	74,771	attrition	28,658
encouraged	153,800	easily	38,297	downturn	74,492	damage	28,519
attractive	151,848	stabilized	38,076	slower	68,496	chargeoffs	28,456
win	147,404	satisfied	37,099	closure	67,907	worst	28,432
efficient	146,568	accomplish	36,791	lack	67,044	drag	28,308
benefited	132,346	benefiting	36,606	unfortunately	65,115	hurt	27,999
highest	131,666	accomplishments	36,427	missed	64,440	disappointed	27,415
tremendous	130,119	transparency	35,139	declining	62,109	bankruptcy	26,730
enhance	126,034	diligently	33,363	adverse	58,552	shutdown	26,657
Total sentiment words found: 40,207,559							
This table shows the frequency across all transcripts of all positive and negative sentiment words from Loughran and McDonald (2011), excluding “question,” “questions,” and “ill” that appear within 10 words of a political but not non-political bigram.							

Figure 39: Tables Taken from Hasson et al. (2019) which depict scoring methodologies

Appendix Table 3: All synonyms of “risk,” “risky,” “uncertain,” and “uncertainty” found when measuring $PRisk_{i,t}$					
word	frequency	word	frequency	word	frequency
risk	413,925	jeopardize	1,821	riskiness	135
risks	106,858	unsettled	1,664	treacherous	130
uncertainty	91,775	unpredictability	1,563	oscillating	112
variable	68,138	dilemma	1,547	perilous	92
chance	60,863	skepticism	1,502	tentativeness	85
possibility	57,599	hesitancy	1,491	unreliability	72
pending	53,318	riskier	1,352	wariness	70
uncertainties	51,092	unresolved	1,214	vagueness	59
uncertain	39,191	unsure	1,151	dodgy	58
doubt	39,022	irregular	1,123	equivocation	55
prospect	30,926	jeopardy	1,077	indecisive	43
bet	21,279	suspicion	1,027	chancy	40
variability	21,215	risking	863	menace	38
exposed	19,553	peril	660	qualm	35
likelihood	19,280	hesitating	628	vacillating	33
threat	19,021	risked	577	gnarly	32
probability	15,791	unreliable	550	disquiet	30
unknown	12,050	unsafe	486	ambivalence	30
varying	9,442	hazy	472	imperil	28
unclear	9,036	apprehension	466	vacillation	22
unpredictable	8,467	unforeseeable	466	incalculable	17
speculative	8,132	halting	453	untrustworthy	17
fear	7,939	wager	446	equivocating	15
reservation	7,026	torn	437	diffident	15
hesitant	6,275	precarious	362	fickleness	11
gamble	6,065	undetermined	349	misgiving	11
risky	5,227	insecurity	348	changeability	11
instability	4,762	debatable	346	undependable	9
doubtful	4,736	undecided	341	incertitude	8
hazard	4,626	dicey	330	fitful	8
tricky	4,359	indecision	324	parlous	8
sticky	4,325	wavering	266	unconfident	6
dangerous	4,297	iffy	235	defenseless	5
tentative	4,018	faltering	212	unsureness	3
hazardous	3,155	endanger	205	fluctuant	3
queries	2,676	quandary	204	niggle	3
danger	2,465	insecure	189	diffidence	3
fluctuating	2,462	changeable	189	precariousness	1
unstable	2,440	riskiest	183	doubtfulness	1
vague	2,427	hairy	177		
erratic	1,876	ambivalent	169		
query	1,826	dubious	158		
Total synonyms found: 1,287,932					
This table shows the frequency across all transcripts of all single-word synonyms of “risk,” “risky,” “uncertain,” and “uncertainty” as given in the Oxford Dictionary (excluding “question,” “questions,” and “venture”) that appear within 10 words of a political but not non-political bigram.					

Appendix 7: Coding Methodology for Foreign Firms

The following table presents the code words used to code the sector of firms within the earnings call data. When a code word appeared in the firm's name, the firm was coded to the corresponding sector. Firm names with code words from multiple sectors were designated on a case-by-case basis, and represented less than 10 total cases.

Table 32: Coding Methodology for Foreign Firm Sector

Primary Sector Code Words	Secondary Sector Code Words	Tertiary Sector Code Words
Oil, gas	Manufacturing	Bank
Mining, minerals	Rubber	Airlines, transportation
Agriculture, farming	Steel, iron	Health
Timber, lumber	Chemical	Hotel
Coal	Semiconductor	Services, utilities
	Appliances, products	Finance, financial, investing, insurance
		Real Estate, properties, offices
		Communications, media
		Retail

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