Boon, Curse, Fortune or Evil?

The Political Consequences of Inward Foreign Direct Investment

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Introduction

1.1 Motivation

Cross-border flows of foreign direct investment (FDI) are a defining feature of the contemporary global economy. Over the last four decades, global FDI rose from roughly $55 billion in 1980 to a peak of about $2 trillion in 2015 before fluctuating thereafter. Multinational corporations (MNCs)—the principal channel through which FDI occurs—have become prominent actors in the world economy. They allocate resources, capital, and technology across borders, coordinate and reshape global value chains and production networks, and promote international economic integration (Antràs and Chor, 2022; Caves, 1996; Markusen, 1995; Osgood, 2018). For example, in 2023, the production of MNCs and their foreign affiliates accounted for more than 6% of world output, while the global production networks orchestrated by MNCs governed nearly 80% of international trade (UNCTAD, 2024).

For developing countries, these inflows have long been viewed as a potential engine of growth (UNCTAD, 1999, 2023; World Bank, 1993). FDI can bring scarce capital, advanced technology, and access to international markets; it can integrate domestic firms into global supply chains and generate employment. Since the 1980s, many states in the Global South have liberalized their investment regimes, strengthened investment promotion agencies, and expanded international investment treaty commitments, fueling a substantial increase in

inward FDI.

Yet despite this dramatic expansion, the political and economic consequences of FDI remain hotly contested.[1] On the one hand, optimistic accounts depict MNCs as catalysts for development and modernization: creating employment, spreading productive technologies, and diffusing norms, values, and practices to host countries (UNCTAD, 1999; World Bank, 1993). Scholarly works have further linked FDI to democratization, improved governance, strengthened rule of law, and enhanced labor protections (e.g., Gallagher, 2009; Kwok and Tadesse, 2006; Li and Reuveny, 2003; Mosley, 2011; Sandholtz and Gray, 2003).

On the other hand, more skeptical views portray MNCs as exploitative actors that can erode sovereignty, exacerbate inequality, and distort or corrupt institutions. Earlier works in world-systems and dependency traditions advanced normative critiques of foreign corporate power (Evans, 1979; Evans and Gereffi, 1982; Kobrin, 1987; Moran, 1975, 1978). More recent research in positive political economy has documented adverse and often unintended consequences. For example, competition for mobile capital can spur fiscal giveaways and facilitate profit shifting, undermining the domestic tax base and fueling a "race to the bottom" in regulatory standards (Davies and Vadlamannati, 2013; Frankel, 2003; Gallagher, 2009; Rodrik, 1997; Rudra, Alkon and Joshi, 2018). In resource-rich contexts, foreign investment can heighten the risk of violent conflict (Berman, Couttenier, Rohner and Thoenig, 2017; Ross, 2004).

This debate is not merely academic: policymakers face starkly divergent assessments of whether FDI should be embraced as a catalyst for development or regarded with caution as a Trojan horse for vulnerability. These debates raise a central question that this book seeks to address: *How do FDI inflows and MNC activity shape domestic politics in the Global South, and how can we reconcile the divergent accounts of their political consequences?* Our argument is that both perspectives capture important elements of reality, but neither is sufficient on its own.

[1] For contrasting perspectives, see Baldwin (2016) and Rodrik (2018*a*).

In this book, we develop a unified framework to bridge these competing views. We argue that the varied economic and political outcomes of FDI inflows and MNC activity in the Global South can be traced to a single latent mechanism: the creation of economic rents.[2]

Our theory proceeds in two steps. First, the entry of highly productive MNCs often crowds out local firms, resulting in market concentration and the creation of rents. These rents, in turn, incentivize actors at various levels to appropriate, control, and compete for them. Second, the political consequences of rent contestation depend on the strength of domestic institutions. Where fiscal, legal, and political institutions are robust, rents can be taxed, redistributed, and converted into public goods, dampening distributive conflict. Where institutions are weak, rents become prizes over which firms, officials, elites, and even rebel groups compete, heightening the risks of corruption, civil violence, and leadership turnover.

1.2 Theoretical Framework: A Preview

Our theoretical framework builds on two components to account for the divergent political consequences of FDI inflows and MNC activity in the Global South: (1) the rent-creation effect of FDI, which is a function of the productivity gap between foreign entrants and domestic incumbents, and (2) the political ramifications of high rent extraction, shaped by the host country's state capacity and institutional development.

First, the entry and presence of MNCs affect market conditions and contribute to rent creation or dissipation in host countries. MNCs play a transformative role in host economies not only by bringing in capital and technology but also by altering the structure of local markets and the distribution of economic rents. Their entry is rarely neutral: it affects sectoral and aggregate output, reshapes residual demand, introduces new competitive pressures, and can generate or dissipate rents across different sectors. The direction of these effects depends

[2]In economic theory, "rents" denote earnings from a factor of production that exceed the minimum compensation needed to retain it in its current use—that is, income above opportunity cost. Modern political economy emphasizes rents as excess profits generated by monopoly power, natural resource endowments, or regulatory privilege, and highlights their political salience as objects of rent-seeking and contestation (Krueger, 1974; Tullock, 1967).

on the productivity differential between foreign entrants and incumbent firms operating in the host country. MNCs are able to charge higher markups and increase rent creation when their productivity advantage over incumbents is large, as their entry tends to crowd out less productive domestic firms. Conversely, when the productivity gap is small, foreign entry may intensify competition and erode rents.

These dynamics are particularly pronounced in developing countries, where the productivity gap between foreign entrants and domestic firms is often substantial. Theoretical and empirical work in trade and firm heterogeneity shows that only highly productive firms are able to overcome the fixed costs of establishing foreign affiliates (e.g., Helpman, Melitz and Yeaple, 2004; Melitz, 2003; Yeaple, 2009). By contrast, domestic firms in developing countries are frequently smaller, less productive, and resource-constrained. When the productivity gap is large, MNC entry can displace domestic producers, reduce their profitability, and in some cases force them to exit the market altogether. These effects are often described as *market-stealing* or *negative productivity spillovers* (Aitken and Harrison, 1999).

Moreover, a defining feature of many underdeveloped markets is the prevalence of high entry barriers—arising from economies of scale, capital intensity, product differentiation, or technological requirements. Paradoxically, these barriers that constrain local firms create opportunities for foreign investors with the resources and capabilities to overcome them (Caves, 1996; Dunning, 1992). MNCs typically possess proprietary assets—ranging from advanced production technologies and organizational know-how to brand recognition and financial capital—that allow them to enter these markets and quickly establish a dominant position. In doing so, they often reinforce the very barriers they initially overcame, further entrenching market concentration and amplifying the rent-creation effect of FDI (Zhu, 2017).

Second, we embed this market mechanism in a political-economy model of rent contestation. The consequences of FDI-induced rents are not purely economic. As MNCs consolidate market power and local firms retreat, the distribution of rents—and, with it, political influence—shifts. High rents incentivize actors at various levels (firms, elites, officials, and

rebel groups) to appropriate and control them, sometimes through illicit or violent means. This struggle over rents can lead to unintended and adverse political outcomes. Understanding how these transformations affect both economic and political actors is a central concern of this book.

We focus on three political outcomes: corruption, intrastate armed conflict, and leadership turnover. First, when foreign entry increases rents, elites and politicians face stronger incentives to engage in rent-seeking (Krueger, 1974; Shleifer and Vishny, 1993), thereby fueling corruption. This effect is mitigated by robust political and legal institutions, which raise the risks of detection and punishment and thereby increase the costs of corruption (Treisman, 2007).

Second, FDI-induced rents enlarge the stakes of political control (Acemoglu and Robinson, 2006; Powell, 2006). Elites, outsiders, or opposition groups become more motivated to challenge incumbents, whether violently (through armed conflict) or nonviolently (through leadership turnover). Thus, FDI inflows and MNC activity can increase the probability of civil conflict and executive instability. Strong state capacity and effective public goods provision can dampen these risks by enabling governments to control and redistribute rents through taxation, royalties, and fees; by using rents to enhance deterrence capabilities; and by addressing the credible commitment problem in rent-sharing arrangements. These mechanisms reduce grievances and facilitate the peaceful resolution of distributive conflicts.

Our theoretical framework makes three conceptual innovations. First, it develops a simple model of oligopolistic competition among heterogeneous firms to show how the entry of highly productive multinationals raises equilibrium markups, displaces less efficient domestic producers, and thereby increases rents. The key insight is that rent creation is a monotonic function of the productivity gap between foreign entrants and local incumbents: when that gap exceeds a threshold $\theta^{\star}$, markups rise and markets concentrate; when it does not, competition intensifies and rents dissipate. This mechanism is formally derived and illustrated in Chapter 3, which generalizes the monopoly markup rule to heterogeneous-firm settings.

Second, the book embeds this market logic in a political-economy model of rent contestation. Rents are politically inert until actors struggle to control them. Thus, the same FDI inflow that generates high markups can also trigger corruption, conflict, or leadership turnover in institutional environments too weak to tax and redistribute the surplus. By contrast, strong states can channel rents into public goods, neutralizing distributive conflict. The framework therefore predicts conditional effects: inward FDI should increase corruption, conflict, and executive instability in low-capacity polities but have neutral or beneficial effects in high-capacity states.

Finally, the theory provides a unified lens on phenomena often analyzed in isolation. It links market concentration, governance quality, armed conflict, and political turnover to a single latent variable—FDI-induced rents—thereby reconciling conflicting empirical findings in the globalization literature. In doing so, it extends rent-seeking models beyond the natural-resource domain, highlights productivity differentials as a root cause of rent creation, and generates a suite of cross-equation hypotheses that subsequent chapters test using a consistent identification strategy.

1.3 Mechanisms Illustrated

Two brief vignettes preview the logic of our argument and findings: Wal-Mart's bribery scandal in Mexico and Firestone's entanglement in Liberia's civil war.[3] In both cases, the entry and presence of giant MNCs generated market dominance and contributed to high rent extraction. These economic rents became a source of contestation, contributing to adverse political outcomes such as corruption in Mexico and armed conflict in Liberia. The cases also highlight the permissive role of domestic conditions: weak legal oversight in Mexico and a fragile central government in Liberia shaped the way rents were contested and the political consequences that followed.

[3]We provide a more detailed account of these two cases in Chapters 5 and 6, respectively.

Wal-Mart in Mexico

In 2012, the *New York Times* revealed that Wal-Mart de México had orchestrated an extensive bribery scheme to accelerate store openings and secure market dominance after Mexico's 2000 liberalization.[4] Executives authorized payments to mayors, city council members, urban planners, and bureaucrats in exchange for zoning approvals, fee reductions, and political support from neighborhood leaders. Trusted lawyers delivered envelopes stuffed with cash.[5]

The U.S. Department of Justice (DOJ) and Securities and Exchange Commission (SEC) launched wide-ranging investigations under the Foreign Corrupt Practices Act (FCPA). After seven years, Walmart settled in 2019, paying $282 million—$144 million to the SEC and $138 million to the DOJ.[6] While the company did not admit wrongdoing, the case remains one of the most publicized corporate corruption probes in recent history.

This episode illustrates how MNCs, faced with opaque regulatory systems, may use illicit payments to accelerate market entry and entrench market dominance. It also highlights a broader concern: that FDI can exacerbate corruption by increasing the value of state-issued permits and approvals. In weak institutional contexts, economic rents generated by foreign investment provide fertile ground for rent-seeking.

Firestone in Liberia

A very different but equally telling episode unfolded during Liberia's First Civil War. Firestone's longstanding operations became deeply entangled with Charles Taylor's insurgency. Established in 1926, the Firestone Plantations Company grew to become the world's leading rubber producer and a dominant force in Liberia's economy, operating factories, hospitals, and schools, and serving as one of the country's largest employers (Anderson, 1998).

[4]David Barstow, "Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle," *The New York Times*, April 21, 2012.

[5]David Barstow and Alejandra Xanic von Bertrab, "The Bribery Aisle: How Wal-Mart Used Payoffs to Get Its Way in Mexico," *The New York Times*, December 17, 2012.

[6]Nandita Bose, "Walmart to Pay $282 Million to Settle Seven-Year Global Corruption Probe," *Reuters*, June 21, 2019.

Its profits were immense—by 1951, post-tax earnings were roughly three times the total revenue of the Liberian government (Jones and Miller, 2014).

Recognizing this economic centrality, Charles Taylor's National Patriotic Front of Liberia (NPFL) targeted Firestone's facilities in the early 1990s as a means to finance rebellion (Miller and Jones, 2014). In June 1990, NPFL forces seized the plantation, committing atrocities and halting production. Yet Firestone did not fully withdraw. By 1992, the company had struck an agreement with Taylor's rebel government, paying more than $2.3 million in taxes and recognizing him as president. Taylor himself acknowledged that Firestone provided "some semblance of legitimacy" to his movement (Jones and Miller, 2014).

The Firestone case demonstrates that the large rents generated by an MNC can become targets in civil war. Unlike Wal-Mart's bribery case, here rents were captured not through illicit exchange but through coercion. Where states are weak and armed groups powerful, foreign firms can be drawn directly into conflict dynamics. Greater state capacity, on the other hand, allows governments to mitigate these negative consequences, as they are often able to convert rents into public goods and improved services, thereby reducing the incentives to fight over or control access to the benefits created by the foreign firm.

1.4 Empirical Strategy

We subject our argument to more systematic empirical testing using country–year panel data covering roughly 100–160 developing economies from 1970 onward. We examine the impact of FDI inflows on market concentration, corruption, intrastate armed conflict, and leadership turnover in Chapters 4–7, respectively. In each chapter, the key explanatory variable is inward FDI, measured as net inflows per capita in constant dollars (PPP-adjusted) from UNCTAD. Outcome measures are drawn from specialized datasets that map directly onto the theoretical constructs.[7]

A primary challenge in the empirical analysis is endogeneity and selection bias, since

[7]See detailed discussions in each corresponding chapter.

foreign entry is an endogenous process in which firms internalize expected benefits and costs when making investment decisions.[8] We address this issue with an instrumental variable (IV) strategy. The instrument, Geographic Closeness, is defined as the weighted geographic distance between a host country and the twenty wealthiest economies in the world. It is based on the gravity model of FDI flows (Carr, Markusen and Maskus, 2001; Loungani, Mody and Razin, 2002; Markusen, 1995). This instrument was originally developed by Pinto and Zhu (2016) for a cross-national setting and extended in Pinto and Zhu (2022) for a panel setting.[9]

We supplement the large-N analysis with anecdotal evidence in the chapters on corruption, civil conflict, and leadership turnover. For corruption, we examine scandals involving giant MNCs such as Wal-Mart, Rolls-Royce, and Skanska. For civil conflict, we provide detailed accounts of Bralima—a brewing company wholly owned by Heineken International—in the Democratic Republic of Congo, and Firestone's involvement in Liberia. For political instability and leadership turnover, we analyze the International Telephone and Telegraph Company's (ITT) efforts to prevent Allende's electoral victory and its subsequent role in the overthrow of the Allende government in Chile.

1.5 Roadmap

The ensuing chapters situate FDI within broader globalization trends, documenting the empirical heterogeneity that motivates our theory. Next, we develop the formal model and derive testable hypotheses. The subsequent chapters provide the empirical core, showing, respectively, that inward FDI increases market concentration, raises corruption conditional on institutional quality, elevates the risk of civil conflict when state capacity is weak, and links rents to political instability and executive turnover. The concluding chapter places the theoretical and empirical contributions in perspective and highlights the implications for managing FDI-generated rents in an era of fragmented globalization. The roadmap of the manuscript is as follows:

[8] See detailed discussions in Chapter 3.

[9] We discuss the validity and exclusion restriction assumptions of the IV in the substantive chapters of the manuscript.

Chapter 2: Globalization of Markets

This chapter examines the evolution, components, and consequences of economic globalization, with particular attention to FDI and MNCs. It situates globalization in historical perspective, tracing earlier waves of integration in the late nineteenth and early twentieth centuries, their collapse during the interwar years, and the post–World War II resurgence under the Bretton Woods framework and institutions such as the IMF, World Bank, and GATT/WTO.

The chapter then documents the expansion of the main components of globalization—international trade, FDI, portfolio investment, foreign aid, and remittances—along with their benefits and costs, especially for developing countries. It emphasizes the transformative role of FDI and MNCs in configuring the global economy and reshaping the market structures in host economies. While trade, portfolio flows, aid, and remittances all matter, FDI is distinctive for its long-term commitments, managerial control, and ability to reorganize production globally. In doing so, the chapter underscores the centrality of FDI and MNCs to globalization and sets the stage for the book's broader inquiry into how foreign investment shapes domestic politics in the Global South.

Chapter 3: Theory

This chapter builds our argument on a simple model of foreign firm entry and its impact on market structure and rent creation or dissipation in the host country. We illustrate the logic with a Cournot model with heterogeneous incumbent domestic firms ("high-" and "low-productivity") and a potential foreign entrant with marginal cost c_f. A firm's price–cost margin equals its market share divided by the (absolute) demand elasticity, $\mu_i \equiv \frac{P-c_i}{P} = \frac{s_i}{\varepsilon(Q)}$, so equilibrium markups and industry profits can be expressed in terms of market concentration and demand schedules. Comparative statics under linear demand yield two regimes. With entry but no exit, the foreign firm's output expansion lowers individual shares and concentration, compressing markups and rents. With endogenous exit, however, sufficiently

large cost advantages ($c_f \ll c_h$) can force out the least productive incumbents, raising concentration and markups even as technological efficiency improves. Hence, the relationship between MNC entry and market power is non-monotonic: when the entrant's productivity just exceeds the most efficient domestic firms, competition intensifies and rents fall; once the advantage is large enough, the entrant consolidates market power and can extract larger rents (Alfaro, Antràs, Chor and Conconi, 2019; Antràs and Chor, 2013; Hanson, Mataloni and Slaughter, 2005; Helpman, 2014; Melitz and Ottaviano, 2008). This derives the conditions for the predictions to hold and states testable hypotheses linking productivity gaps, exit, post-entry concentration, and consequently markups and rents.

This chapter then synthesizes heterogeneous-firm trade models with a political-economy theory of rent contestation, thereby endogenizing both market structure and political outcomes. It argues that a single latent variable–FDI-induced rents–links three political outcomes often studied in isolation: corruption, civil conflict, and leadership turnover. Finally, it posits that it reconciles apparently inconsistent findings by specifying under which the sign of FDI's effects reverses.

Chapter 4: Market Concentration

Chapter 4 investigates the relationship between FDI inflows and market concentration in developing countries. Using granular firm-level data from the Orbis database (1997–2022) and following Bajgar, Berlingieri, Calligaris, Criscuolo and Timmis's (2020) best-practice coverage guidelines, we construct two alternative measures of concentration: the Herfindahl–Hirschman Index (HHI) and the four-firm concentration ratio (CR4). The analysis shows that the competitive consequences of FDI depend on domestic capabilities. In less developed economies, FDI inflows increase concentration, while in more developed economies FDI reduces it. This pattern holds across both HHI and CR4 and is robust to an alternative specification based on market-structure indicators from the World Bank Enterprise Survey (WBES).

These findings align with the theory's core mechanism. When highly productive MNCs

enter settings where domestic firms are comparatively weak, the exit of low-productivity incumbents and subsequent reallocation of market shares can raise concentration even as technical efficiency improves. By contrast, where domestic capabilities are strong, foreign entry primarily intensifies competition and compresses markups. In terms of the Chapter 3 model, the data support a non-monotonic mapping from foreign–domestic productivity gaps to post-entry concentration: modest gaps discipline market power, whereas sufficiently large gaps trigger exit and potential dominance, raising concentration (Antràs and Chor, 2013; Melitz and Ottaviano, 2008). The fact that the sign of FDI's marginal effect flips with development is precisely what the theory predicts when the equilibrium shifts between "entry-without-exit" and "entry-with-exit" regimes, helping reconcile mixed findings in earlier country-level studies of FDI and concentration (e.g., Blomström, 1986; Lall, 1979*b*).

Our results unveil a positive and significant association between FDI inflows and market concentration in less developed economies, consistent with our proposed causal mechanism. To our knowledge, this chapter presents the first *cross-national* study of FDI's impact on market concentration. Prior research has relied primarily on single-country analyses due to data limitations.

Chapter 5: Governance and Corruption

In Chapter 5, which builds on Pinto and Zhu (2016), we examine the relationship between FDI inflows and corruption in developing countries. We argue that the rents generated by FDI inflows and MNC activity increase incentives for both government officials and firms to engage in corrupt practices. On the one hand, substantial rents enhance the value of government officials' "control rights" over the provision of public goods and services (Ades and Di Tella, 1999), encouraging them to demand higher bribes. On the other hand, high rents increase firms' ability to absorb the additional costs of bribery and raise the returns to those willing to pay. Consequently, FDI inflows and MNC activity may fuel higher levels of corruption in developing countries.

At the same time, strong political and legal institutions—such as democratic compe-

tition and an independent judiciary—can mitigate this effect. Effective legal systems and checks and balances increase both the risks of engaging in corrupt transactions and the likelihood of punishment. Using data from 160 developing countries spanning 1970–2018, we find that inward FDI is associated with higher corruption, but that this effect diminishes as democratic and legal institutions strengthen in the host country. We also provide anecdotal evidence that economic rents accruing from market dominance create incentives for giant MNCs such as Wal-Mart, Rolls-Royce and Skanska to engage in corruption in contexts where political institutions and legal oversight are weak.

This chapter also introduces the instrumental variable Geographic Closeness for inward FDI and provides a detailed discussion of its construct validity and the exclusion restriction assumption.

Chapter 6: Civil Conflict and Political Violence

Chapter 6 examines the impact of inward FDI and MNC activity on intrastate armed conflict in developing countries.[10] We argue that the substantial rents generated by FDI inflows and multinational activity increase incentives for rebel groups to challenge incumbents by enlarging the size of the spoils and raising the value of state capture. Although both governments and rebels may prefer settlement to costly conflict, negotiations often break down because each side is concerned with controlling and distributing rents that could alter their relative power, thereby raising the likelihood of civil war.

We further propose that strong state capacity and effective public goods provision mitigate this conflict-inducing effect of FDI. States with robust capacity are better able to harness rents to strengthen coercive power and deter rebellion. At the same time, capable states are more likely to resolve disputes through institutionalized mechanisms and to convert resources into public goods that alleviate citizen grievances, thus lowering the risk of intrastate conflict.

[10]This chapter draws on Pinto and Zhu (2022), winner of the *2022 Bruce Russett Award for Best Paper* published in the *Journal of Conflict Resolution*.

Our empirical analysis supports these hypotheses. After accounting for endogeneity, reverse causality, and selection bias, we find a significant positive relationship between inward FDI and the onset of intrastate conflict in developing countries. This association is not limited to resource-seeking FDI but holds across primary, secondary, and tertiary sectors. Crucially, FDI has no discernible effect on conflict in states with strong capacity and high public goods provision. The cross-national evidence is supplemented with two case studies—Bralima in the DRC and Firestone in Liberia—which illustrate the causal mechanisms in depth.

Chapter 7: Political Instability and Leadership Turnover

Building on Chapter 6, Chapter 7 examines how foreign investment affects political instability and leadership turnover in host countries. High rents enlarge the spoils of office, deepen elite divisions, and intensify competition for their control. These conflicts may escalate into violent forms, as seen in the intrastate conflicts analyzed in the previous chapter. In other cases, political factions attempt to oust rivals and gain access to these spoils by capturing office. We therefore expect more frequent leadership turnover and shorter tenures, particularly in countries with weak extractive capacity and low levels of public goods provision. By contrast, strong extractive capacity enables incumbents to manage rents through taxation, royalties, and regulatory mechanisms, and to invest them both in deterrence capacity to fend off challengers and in public goods that sustain economic productivity and alleviate citizen grievances.

Our empirical results align with these theoretical expectations. Inward FDI increases the probability of leadership turnover and shortens leaders' tenures after accounting for endogeneity, regime-specific factors, and country fixed effects. This positive association is not driven by natural resource endowments or great-power strategic interests. Moreover, the results show that strong extractive capacity and robust public goods provision dampen the effect of FDI on leadership turnover. A case study of ITT in Chile further illustrates how disputes over the distribution of FDI-induced rents can fuel political instability.

Chapter 8: Conclusion and Implications

This chapter first summarizes our argument and main empirical findings. A central theme of the book is that the political effects of FDI inflows and MNC activity in the Global South are conditional rather than uniform. Productivity gaps between foreign entrants and incumbent firms generate rents, and state capacity and domestic institutions determine whether these rents produce adverse political consequences or yield developmental benefits. By integrating models of firm heterogeneity with theories of political contestation and foregrounding one latent variable—FDI-induced rents—the book develops a unified theoretical framework that links inward FDI to various political outcomes that are often studied in isolation in the literature. By emphasizing the moderating role of state capacity and domestic institutions, our framework helps reconcile the diverging arguments and findings that have long portrayed FDI as either a boon or a curse in developing countries.

In closing the chapter discusses the policy implications of our findings. To maximize the benefits and minimize the costs of FDI inflows and MNC activity, governments in the Global South should adopt robust competition policies, strengthen legal and regulatory institutions, and build state capacity to capture and redistribute rents through transparent fiscal mechanisms. At the same time, openness must be paired with active developmental statecraft: governments can strategically leverage FDI to build domestic capabilities, foster linkages, and promote technology transfer. Safeguarding political stability further requires inclusive and accountable institutions that prevent FDI-induced rents from fueling elite rivalry or civil conflict, ensuring that the gains from foreign investment are broadly shared.

We acknowledge the limitations of our macro-level analysis of FDI's political consequences. The next frontier lies in uncovering the micro-level mechanisms that drive these dynamics. Future research should investigate the localized effects of geographically concentrated investment, disaggregate the consequences of different types of FDI by sector, ownership, and entry mode, and examine how firms adapt their strategies in the face of political and regulatory risks. Scholars should revisit the role of fixed assets in shaping

bargaining power, vulnerability, and rent capture, and expand the scope to include the understudied politics of exit and divestment. Together, these directions point to a broader research agenda for the political economy of FDI—one that incorporates firm-level data, spatially disaggregated outcomes, and dynamic models of entry, engagement, and exit to capture the full lifecycle of global capital and its interaction with domestic institutions and political contestation.

1.6 Positioning Theory and Findings in the Literature

Our account of FDI speaks to several literatures that remain only loosely integrated. The first, rooted in international economics, explains multinational activity in terms of ownership-specific advantages and locational fundamentals. Early canonical work portrayed the multinational as a rational optimizer that arbitrages factor-price differences while internalizing cross-border market failures (Caves, 1996; Dunning, 1992; Hymer, 1976; Vernon, 1971). The heterogeneous-firm revolution sharpened this intuition by showing that trade and investment liberalization reallocate market shares toward the most productive exporters and multinationals, thereby raising aggregate productivity (Bernard, Jensen, Redding and Schott, 2007; Melitz, 2003). Carr, Markusen and Maskus (2001) extend the argument by embedding firm heterogeneity in a general-equilibrium framework in which knowledge-capital motives shape location choice. We retain these micro-foundations but diverge on one critical point: when the productivity gap between multinationals and local incumbents exceeds a threshold, the resulting rise in equilibrium markups generates rents of an order of magnitude ignored in canonical models. By endogenizing rent creation—and demonstrating that it is monotonic in the productivity differential—we open the door to questions about how such rents are politically contested and with what consequences.

Second, our research speaks to two disjoint literatures on the effect of foreign investment and MNCs in developing countries. Our theoretical framework and analyses help reconcile the divergent arguments in these traditions. Early work in comparative political economy portrayed multinational capital as uniformly corrosive. Dependency, “triple-alliance,” and

world-systems theories posited that foreign firms, local elites, and the state coalesced into coalitions that extracted surplus from host economies, deepened underdevelopment, and undermined democratic accountability (Cardoso and Faletto, 1979; Evans, 1979; Evans and Gereffi, 1982; Moran, 1975, 1978; Newfarmer, 1979). Scholars in these traditions argued that reliance on core economies perpetuates inequality and facilitates exploitation in peripheral countries (Cardoso and Faletto, 1979; Hopkins and Wallerstein, 1996; Wallerstein, 2004).[11]

By the late 1990s, the pendulum had swung toward unalloyed optimism. Research grounded in new trade theory and the knowledge-capital model treated FDI as an unambiguous engine of efficiency, institutional upgrading, and welfare gains (Bernard et al., 2007; Brainard, 1997; Carr, Markusen and Maskus, 2001; Caves, 1996; Feenstra, 1998; Melitz, 2003). We argue that both universalist positions rest on partial-equilibrium logics: dependency scholars held market structure constant and overlooked productivity spillovers, while globalists posited costless rent reallocation and ignored distributional politics. Our theoretical framework reconciles these views by showing that FDI amplifies market power and political contestation only when productivity gaps are large and institutional constraints weak.

Third, a growing post-2008 literature on the backlash against globalization documents electoral realignments, populism, and selective protectionism in response to trade and capital-market shocks (Kahler and Lake, 2013; Rodrik, 2018*b*, 2021; Schneider, 2014; Stiglitz, 2002; Walter, 2021). Chapters 5–7 situate our findings within this debate, showing that contestation over FDI-generated rents is most acute where social insurance and fiscal capacity lag behind the pace of integration. Unlike broad critiques that bundle all forms of globalization together, our evidence identifies inward investment as the pivotal channel through which distributive tensions translate into corruption, conflict, and leadership turnover under specific institutional conditions.

A fourth body of work—the resource-curse literature—links exogenous windfall rents

[11] See Vernon (1971) and Frank (1980) for reviews and discussions of the mixed empirical record.

from oil and minerals to corruption, conflict, weak governance, and underdevelopment (Brooks and Kurtz, 2016; Kurtz and Brooks, 2011; Robinson, Torvik and Verdier, 2006; Ross, 2004, 2015; Snyder and Bhavnani, 2005). We show that similar political pathologies emerge when rents are *endogenously* created through the interaction of firm heterogeneity and market entry, rather than bestowed by geological luck. Whereas natural resources are location-fixed by definition, rents arising from productivity gaps are mobile *before* investment and become immobile only after capital is sunk, generating a distinct time-inconsistency problem for host governments (Broner and Ventura, 2016; Caselli and Tesei, 2016). By modeling this sequence explicitly, our framework explains why the same polity can experience both beneficial technology transfer and deleterious rent-seeking across sectors and over time—a pattern resource-centric theories cannot accommodate. Because FDI rents are immobile, they can become focal points for protracted political conflict. The hazard of executive turnover and instability escalates with cumulative, not merely contemporaneous, inward investment. Analogous specifications using cumulative trade shares produce either a null or negative relationship, reinforcing the argument's FDI-specific scope. Thus, the book generalizes the logic of rent creation from extractive industries to the broader universe of multinational production, offering a comprehensive account of how surplus distribution shapes political order.

A fifth strand links capital inflows to security outcomes and elite politics. Earlier research showed that economic interdependence can pacify interstate relations (Russett and Oneal, 2001), yet evidence on internal conflict remains mixed (Bussmann and Schneider, 2007; Gleditsch, 2007; Hegre, Gissinger and Gleditsch, 2003). Some studies argue that FDI raises opportunity costs for rebellion and thus dampens conflict (Barbieri and Reuveny, 2005; Blanton and Apodaca, 2007; Hegre, Gissinger and Gleditsch, 2003), while others find that the same inflows intensify fighting by exacerbating grievances and raising inequality (London and Robinson, 1989; Wegenast and Schneider, 2017). Recent contributions extend the analysis to leadership survival and regime transition, debating whether incumbents gain or lose from

foreign investment (Bak and Moon, 2016; Escribà-Folch, 2017; Owen, 2019). By tracing corruption, conflict, and executive turnover to the same underlying mechanism—contestation over FDI-generated rents in weak institutional environments—our empirical chapters supply a unified explanation for this mixed record. In doing so, the book bridges economics of firm heterogeneity and political theories of rent contestation, offering a parsimonious account of why FDI can appear alternately as development panacea or political poison.

Finally, our framework underscores the analytical distinction between FDI and other components of global integration in two respects. First, while trade liberalization erodes rents by boosting competition and lowering prices (Pavcnik, 2002; Rodrik, 2018*b*; Trefler, 2004), FDI generates residual control rights over tangible assets, producing rents that are larger and more visible than the effects of trade in goods or cross-border labor mobility (Dunning, 1992; Hymer, 1976). Second, FDI also differs from portfolio investment, aid, and remittances. Because FDI entails managerial control and is sunk ex post, it invites appropriation through bribery, taxation, or violence (Kobrin, 1984, 1987). Portfolio flows and loans, by contrast, can exit at low cost and thus discipline governments through the threat of withdrawal (Ghosh, Ostry and Qureshi, 2017; Obstfeld and Rogoff, 1995). Aid is often driven by donor countries' strategic interests (Alesina and Dollar, 2000), while remittances are typically counter-cyclical (Chami, Fullenkamp and Jahjah, 2005; Ratha, 2005). These flows rarely restructure market power unless invested directly in production. Our framework thus highlights that the conditional hazards we identify are specific to the sunk-capital nature of multinational investment.

Chapter 2

Globalization of Markets

2.1 Overview

Globalization is a multifaceted process with economic, political, social, and cultural dimensions. We focus on economic globalization, which refers to the increasing integration of economic activities across national borders. Global economic integration has profoundly transformed the world economy over the past century, but its historical roots run deep. Although the rapid acceleration of globalization since the mid-20^{th} century has made it a defining feature of the contemporary era, earlier waves of globalization laid the groundwork for today's interconnected world (Morrison, 2012; O'Rourke and Williamson, 1999). Economic globalization over the past century has been driven by a variety of factors, including advances in communication and transportation technologies, trade liberalization, and the deregulation of financial markets (Baldwin, 2016; Estevadeordal, Frantz and Taylor, 2003; Feenstra, 1998; O'Rourke and Williamson, 1999).

Economic globalization encompasses several key and interrelated components, including international trade—the exchange of goods and services across borders; international finance—the integration of capital markets enabling the flow of savings and investments across countries; foreign direct investment (FDI)—the movement of investment capital and the formation of global value chains and production networks; technological diffusion—the

transfer of technology either at arm's length or through spillovers; and migration—the movement of people and labor across borders. Global economic integration has increased interdependence among countries, rendering national economies more susceptible to global economic trends such as the convergence of commodity and factor prices, output fluctuations, price and currency volatility, and capital flight (O'Rourke and Williamson, 1999; Rodrik, 1997; Stiglitz, 2002).

Economic globalization has brought significant benefits, including—but not limited to—higher economic growth and efficiency, job creation and employment opportunities, poverty reduction, and enhanced access to goods, services, and technology (Alfaro, Chanda, Kalemli-Ozcan and Sayek, 2010; Borensztein, De Gregorio and Lee, 1998; Theodore Moran, 2005). Yet it has also faced considerable criticism. Commonly cited shortcomings include rising inequality, environmental degradation, and labor market distortions (Flanagan, 2006; Lee, 1997; Mosley and Uno, 2007), as well as the so-called "race to the bottom" in regulations (Davies and Vadlamannati, 2013; Frankel, 2003; Gallagher, 2009; Rodrik, 1997).

MNCs have been criticized for exploiting differences in regulatory standards across countries, maximizing profits for internationally mobile capital owners at the expense of workers, environmental protections, and government revenues in both home and host countries. In many cases, governments are pressured to lower labor, environmental, or tax standards to attract investment (Frankel, 2003; Frankel and Rose, 2005; Gallagher, 2009; Rodrik, 1997). Relatedly, the expansion of global trade and production has led to increased resource consumption, pollution, and environmental degradation. Critics argue that the relentless pursuit of economic growth has come at the expense of the planet's ecological balance (Antweiler, Copeland and Taylor, 2001; Copeland and Taylor, 1994, 1995; Grossman and Krueger, 1993, 1995).

One of the main indictments of globalization—and a key driver of the backlash against it—is that its benefits and costs have not been evenly distributed, potentially exacerbating income inequality both within and between countries. While some nations and regions

have prospered, others have been left behind, particularly in sub-Saharan Africa, Latin America, and parts of East and Southeast Asia (Goldberg and Pavcnik, 2004, 2007; Hanson, 2012; Pavcnik, 2017). The shift of manufacturing and production to low-cost countries has contributed to job losses in certain sectors of developed economies, fueling social unrest and political backlash in parts of the global North (Autor, Dorn and Hanson, 2013, 2016).

In this chapter, we document the evolution of economic globalization and its key components. Our focus is on the exchange of goods and services (i.e., international trade), as well as global flows of FDI, portfolio investment, foreign aid, and remittances. Particular attention is given to FDI, as it is the central subject of this book. We examine the growth of FDI over time, its global distribution, the benefits and costs associated with FDI inflows and MNC activity, and, finally, how FDI differs from other economic flows in its impact on domestic market structures and the processes of rent creation and dissipation.

2.2 Historical Context of Globalization

While globalization is often viewed as a modern phenomenon, it is important to recognize that earlier periods of integration have shaped the current phase of global economic interdependence. The first significant wave of globalization occurred during the late 19$^{\text{th}}$ and early 20$^{\text{th}}$ centuries, a period often referred to as the "Golden Era" of globalization. This era was marked by a surge in international trade, the expansion of colonial empires, and advances in transportation technologies—particularly the steam engine and railroads—and communication systems such as the telegraph and telephone. These innovations reduced the costs of moving goods and people across borders, facilitating an unprecedented level of economic integration (Anderson and van Wincoop, 2004; O'Rourke and Williamson, 1999).

However, this first wave of globalization came to an abrupt end with the outbreak of World War I, the subsequent Great Depression, and the onset of World War II. The interwar period was marked by protectionist policies, exemplified by the Smoot–Hawley Tariff Act, which significantly raised U.S. tariffs on imported goods (Bailey, Goldstein and Weingast,

1997). These measures triggered retaliatory actions by other nations and precipitated a sharp decline in global trade (Irwin, 2017). The collapse of global economic cooperation during this period exposed the fragility of international economic systems and ultimately set the stage for the institutionalization of economic collaboration that characterized the postwar era of globalization (Eichengreen, 1992; Eichengreen and Irwin, 2010; O'Rourke and Williamson, 1999).

The post-World War II era witnessed a resurgence of globalization, this time underpinned by new international institutions such as the International Monetary Fund (IMF), the World Bank, and the General Agreement on Tariffs and Trade (GATT), which later evolved into the World Trade Organization (WTO). These institutions were designed to promote economic stability, facilitate trade, and encourage investment flows between nations (Bagwell and Staiger, 1999, 2002; Goldstein, Rivers and Tomz, 2007). The Bretton Woods system, established in 1944, aimed to create a stable international monetary framework to prevent the kind of economic disruptions that led to the Great Depression (Eichengreen, 1985; Eichengreen and Irwin, 2010). A defining feature of this wave of globalization was the growing integration of national markets, the incorporation of developing countries into the global economy, and the emergence of new economic powerhouses such as China and India.

This process of deep economic integration has been driven by the reduction of trade barriers, such as tariffs, quotas, and subsidies, as well as the harmonization of regulations and standards across borders. As markets become more integrated, businesses gain access to larger consumer bases, benefit from economies of scale, and increase efficiency by locating different stages of production in countries with comparative advantages, such as lower labor costs or better access to raw materials and other resources.

In the contemporary era, MNCs have become central actors in the global economy, serving as key vehicles for investment and the integration of production processes across national borders. This transformation is evident in the rise of global value chains (GVCs), which have expanded rapidly alongside FDI and advances in information technology. Breakthroughs in

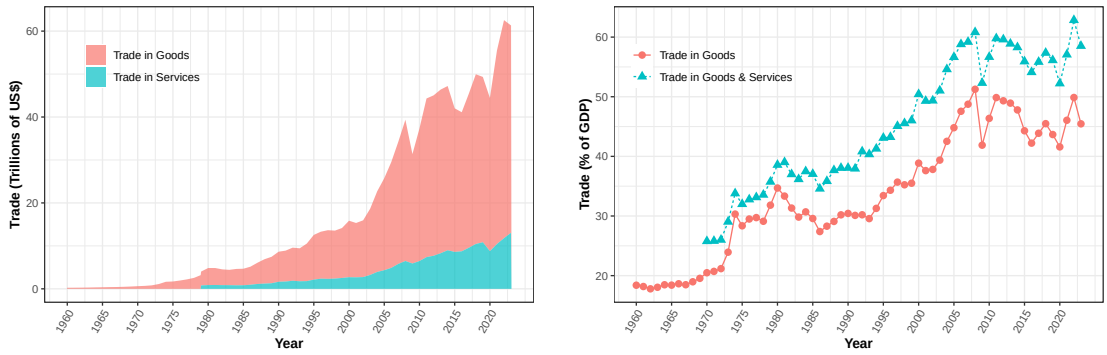
communication and transportation technologies have further accelerated this trend, allowing firms to coordinate complex GVCs and manage production networks spanning multiple countries.

2.3 Key Components of Economic Globalization

2.3.1 International Trade

Economic globalization is driven by several interrelated components, each contributing to the growing integration of national economies. At the heart of globalization lies international trade, which involves the exchange of goods and services across borders. Over the past several decades, the volume of global trade has expanded dramatically. This growth has been facilitated by the reduction of trade barriers, such as tariffs and quotas, as well as advances in transportation and communication technologies, which have significantly lowered the costs of cross-border transactions (Anderson and van Wincoop, 2004; Hanson, 2012; Hummels, 2007).

Figure 2.1: Growth of Global Trade (1960–2023)



Note: Data come from the World Bank's *World Development Indicators.*

As shown in the left panel of Figure 2.1, global trade in goods grew from $0.25 trillion in 1960 to $3.23 trillion by the end of the 1970s—an increase of nearly 1,300% over two decades. Between 1980 and 1999, global goods trade nearly tripled again, rising from $3.97 trillion to $11.63 trillion. Since the turn of the century, however, global trade in goods has exhibited greater volatility. Trade volumes declined sharply in 2009 following the 2007–2008

Great Recession and experienced further slowdowns in 2015–2016 and during the COVID-19 pandemic. Nevertheless, global trade in goods rebounded after each downturn, reaching $48.26 trillion in 2023.

The growth of global trade is particularly striking when measured relative to GDP. Trade as a percentage of GDP is a commonly used indicator of trade openness. The right panel of Figure 2.1 shows that trade openness increased rapidly from the mid-1980s, peaking in 2008 when global trade in goods and services accounted for 60.8% of world GDP. This period is often referred to as the era of "hyper-globalization" (Baldwin, 2016; Subramanian and Kessler, 2014). Three main factors are believed to have driven this phase: (1) the information and communication technology (ICT) revolution, (2) a substantial reduction in trade costs and barriers, and (3) improvements in the security environment, particularly following the end of the Cold War (Antràs, 2020*b*).

Since the global financial crisis of 2007–2008, trade as a share of GDP has leveled off, even though trade volume continues to grow. This suggests that global trade has expanded more slowly than world GDP. In 2022, the trade-to-GDP ratio surpassed its pre-crisis peak, reaching 62.8%, but declined again to 58.5% in 2023. Many observers believe the world may have entered a phase of "slowbalization" or even de-globalization.[1]

The stagnation in trade openness over the past 15 years can be attributed to a growing backlash against globalization, accompanied by the rise of populism and protectionism, particularly in advanced Western economies (Rodrik, 2018*a*; Walter, 2021). Economically, critics argue that globalization has contributed to the deindustrialization of advanced economies, as the "giant sucking sound" of outsourcing has shifted manufacturing jobs to countries with lower labor costs. At the same time, developing countries risk becoming overly dependent on low-value-added production activities, limiting their potential for economic diversification and technological upgrading. Mounting frustration with globalization has fueled public

[1] *The Economist*, "The Steam Has Gone Out of Globalisation," January 24, 2019. `https://www.economist.com/leaders/2019/01/24/the-steam-has-gone-out-of-globalisation`, Accessed June 8, 2025.

support for populist leaders and increasing demands for protectionist policies (Rodrik, 2021).

Despite the lack of progress in trade openness, two significant structural changes have reshaped global trade: the rise of trade in services, and the growing importance of GVC trade. Enabled by digitization and the revolution in ICT, services have become increasingly tradable. The growth of services trade has also been facilitated by the fragmentation of production, as trade in goods increasingly requires service inputs (Deardorff, 2001). Moreover, the expansion of MNCs and their foreign affiliates—major players in goods trade—has further boosted demand for cross-border services. MNCs themselves are also major suppliers of these services (Weymouth, 2017). Trade in services has grown from less than $1 trillion in the 1980s to $13 trillion in 2023, accounting for approximately 21% of total trade.

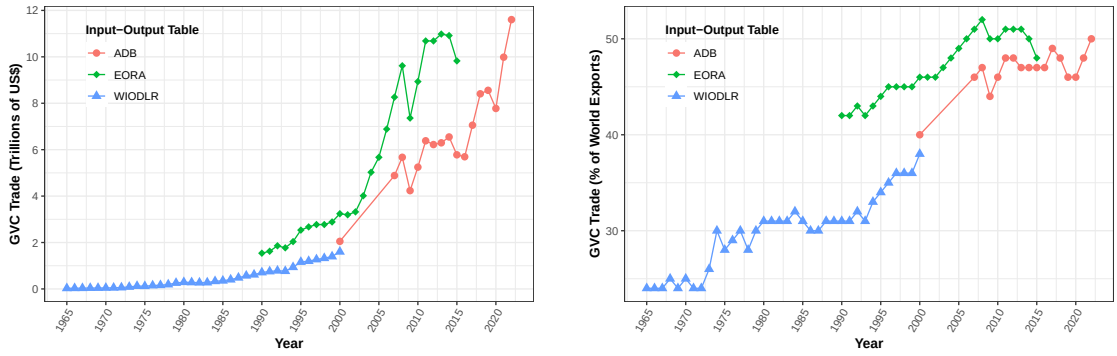
The rapid expansion of GVC trade represents another major structural shift in global trade since the mid-1990s. A GVC refers to the sequence of production stages that add value to a product or service ultimately sold to consumers, with at least two of these stages located in different countries (Antràs, 2020*a*, 553).[2]

With advancements in ICT, a lead firm—often an MNC—can share proprietary knowledge with offshore producers in low-wage countries to ensure high quality and compatibility (Baldwin and Freeman, 2022, 154). These capabilities have enabled firms to further fragment production in order to capitalize on differences in factor endowments and input costs across countries, thereby maximizing efficiency and profitability. Each production stage is typically coordinated by the lead firm, giving rise to complex global production networks (Osgood, 2018; Schoeneman, Zhu and Desmarais, 2020; UNCTAD, 2013). Notably, the expansion of services trade is closely linked to the development of GVCs, as services constitute

[2]GVCs are closely related to another concept—global supply chains (GSCs). While GSCs refer to the logistical movement of goods and materials across countries, focusing on physical flows and supplier networks, GVCs emphasize the entire sequence of activities that add value to a product or service, including design, production, marketing, and services. GVCs highlight how firms strategically organize and coordinate these stages across borders to maximize value creation, whereas GSCs focus more narrowly on procurement, transportation, and distribution. GSCs are commonly used in the business and management literature, while GVCs have been more widely adopted across various academic fields. See Antràs and Chor (2022) and Gereffi and Lee (2012).

an integral component of the value chain that delivers the final product.

Figure 2.2: GVC Trade (1965–2022)



Notes: GVC trade involves the value-added incorporated in exports that cross two or more countries. Data come from the World Bank's *World Integrated Trade Solution*. The three lines (dots, diamonds, and triangles) represent estimates using the inter-country input-output table from the Asian Development Bank (ADB), Eora Global Supply Chain Database (EORA), and World Input-Output Database Long Run series (WIODLR), respectively.

GVC trade differs from traditional trade in important ways. It is characterized by "relational value chains," where products are highly customized and require relation-specific investments. These exchanges often involve tacit knowledge shared between buyers and suppliers, with trust built over time through repeated interactions. Such features create high switching costs and mutual dependence, making GVC trade particularly sticky and resilient to shocks (Antràs and Chor, 2022; Gereffi, Humphrey and Sturgeon, 2005; Martin, Mejean and Parenti, 2023).

Figure 2.2 illustrates the growth of GVC trade over time.[3] We see that GVC trade has risen rapidly since the mid-1990s. The volume of GVC trade—measured as value-added exports that cross two or more countries—increased from $2 trillion in the mid-1990s to $11.6 trillion in 2022, according to ADB estimates (see the left panel of Figure 2.2). GVC trade now accounts for about half of world exports (see the right panel of Figure 2.2).

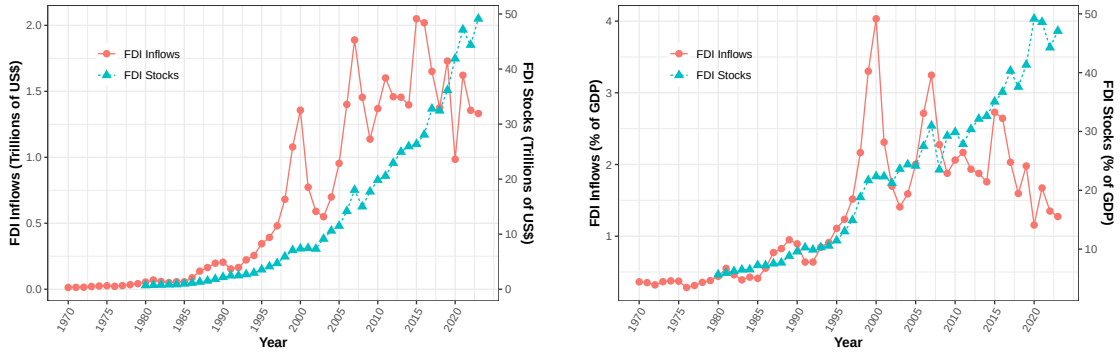
[3]GVC trade is not measured directly, as collecting comprehensive data on the exchange of goods and services at the firm level across countries poses an immense challenge. Instead, GVC trade is typically estimated at an aggregate level (e.g., by industry) using inter-country input-output (ICIO) tables, which combine customs transaction data with national production data. See Borin, Mancini and Taglioni (2021).

2.3.2 FDI Flows and MNCs

The growth of international capital flows—including FDI and portfolio investment—has been another key feature of postwar globalization. This section focuses on FDI, as it is the central subject of this book, while other forms of financial flows are discussed in the following section.

FDI refers to investments made by a company or individual in one country to acquire a lasting business interest in another country.[4] According to international standards, an investment is classified as FDI when a foreign investor acquires at least a 10% ownership stake in a foreign enterprise. FDI typically involves long-term commitments, with foreign investors actively participating in the management and operations of their foreign affiliates.

Figure 2.3: World FDI (1970–2023)



Note: Data come from UNCTAD. Dots and diamonds represent FDI inflows and stocks, respectively.

Figure 2.3 plots FDI inflows and stocks over time from 1970 to 2023. The former refers to net inflows during a reference year—that is, total annual inflows minus divestments, which occur when existing investments are withdrawn from a country. The latter captures the cumulative value of FDI held at the end of each reference year. FDI inflows consist of three components: (1) equity capital transactions, including acquisitions and disposals; (2) reinvested earnings; and (3) inter-company loans.[5]

[4]UNCTAD's definition of FDI can be found here: `https://unctadstat.unctad.org/datacentre/reportInfo/US.FdiFlowsStock`. Accessed June 12, 2025.

[5]Ibid.

As shown in the left panel, FDI inflows (dots) began to accelerate in the 1980s and grew exponentially throughout the 1990s. Global annual FDI inflows rose from $54.5 billion in 1980 to $1.4 trillion in 2000—representing nearly a 25-fold increase over two decades. Inflows declined sharply following the burst of the IT bubble in the early 2000s but reached a peak of $1.9 trillion in 2007, just before the Great Recession. Since then, global FDI flows have largely stagnated or declined, although they briefly surpassed the 2007 peak, reaching $2 trillion in 2015. In 2023, global FDI inflows fell to $1.33 trillion, approximately 34% below their 2015 peak. The Great Recession, the COVID-19 pandemic, the Russia–Ukraine war, ongoing trade tensions, and escalating strategic rivalries among major powers have all contributed to declining investor confidence, and MNCs have become increasingly cautious about overseas expansion in this evolving economic and security landscape (UNCTAD, 2024, 5).

Global FDI stocks (triangles in Figure 2.3) exhibit a different pattern. As stocks represent the cumulative value of FDI, they have shown strong and sustained growth—particularly since the early 2000s—and have continued on an upward trajectory. In 2023, global FDI stocks amounted to $49 trillion. This trend suggests that large-scale divestment has not occurred.

The right panel of Figure 2.3 plots global FDI inflows and stocks as a percentage of world GDP. Relative to world GDP, FDI inflows (dots) experienced a sharp increase from the early 1990s to 2000, peaking at 4%. This suggests that during this period, the growth of FDI inflows significantly outpaced that of global GDP. Since then, the share of FDI inflows relative to GDP has declined, falling to 1.4% in 2023. By contrast, FDI stocks as a percentage of world GDP have steadily increased over time, peaking at 49% in 2020. A slight downward trend has emerged since then, consistent with the left panel's depiction of weak growth in FDI inflows in recent years.

FDI plays a central role in globalization by enabling firms to establish operations in foreign markets, build production facilities, and engage in joint ventures with local firms

(Caves, 1996; Markusen, 1995; Markusen and Venables, 1999). MNCs are the primary vector through which FDI occurs. These large firms, which operate in multiple countries, account for a substantial share of global trade, investment, and production. For example, in 2023, FDI inflows represented 5% of global gross fixed capital formation; MNCs and their affiliates contributed over 6% of global GDP; and their production networks accounted for 80% of global trade (UNCTAD, 2024, 34). MNCs are also central to the two structural transformations in international trade discussed earlier—the rise of services trade and the expansion of GVCs.

MNCs are powerful actors in the global economy, with the ability to allocate resources, capital, and technology across borders (Caves, 1996; Markusen, 1995). Motivated by the pursuit of new markets, raw materials, cost reduction, and operational efficiency, MNCs structure their activities strategically across countries. For instance, they often locate labor-intensive production processes in low-wage economies while retaining high-value functions such as research and development (R&D) in capital-abundant advanced economies (Caves, 1996; Dunning, 1992).

MNCs operate through subsidiaries, affiliates, or strategic partnerships, enabling them to access local markets, procure inputs, realize economies of scale, and maximize returns on proprietary assets (Helpman, 2006, 2014; Markusen and Venables, 1999). Their cross-border flexibility allows them to respond quickly to shifts in labor costs, regulatory environments, and global demand. MNCs are typically highly productive firms with a global footprint. In 2023, the top 100 non-financial MNCs held $20.9 trillion in assets—49% of which were located outside their home countries—generated $13.6 trillion in sales, and employed 20.2 million workers worldwide (UNCTAD, 2024, 36). Although MNCs have traditionally been headquartered in developed countries, recent years have seen a growing number emerge from the Global South (UNCTAD, 2016).

Global Distribution of FDI

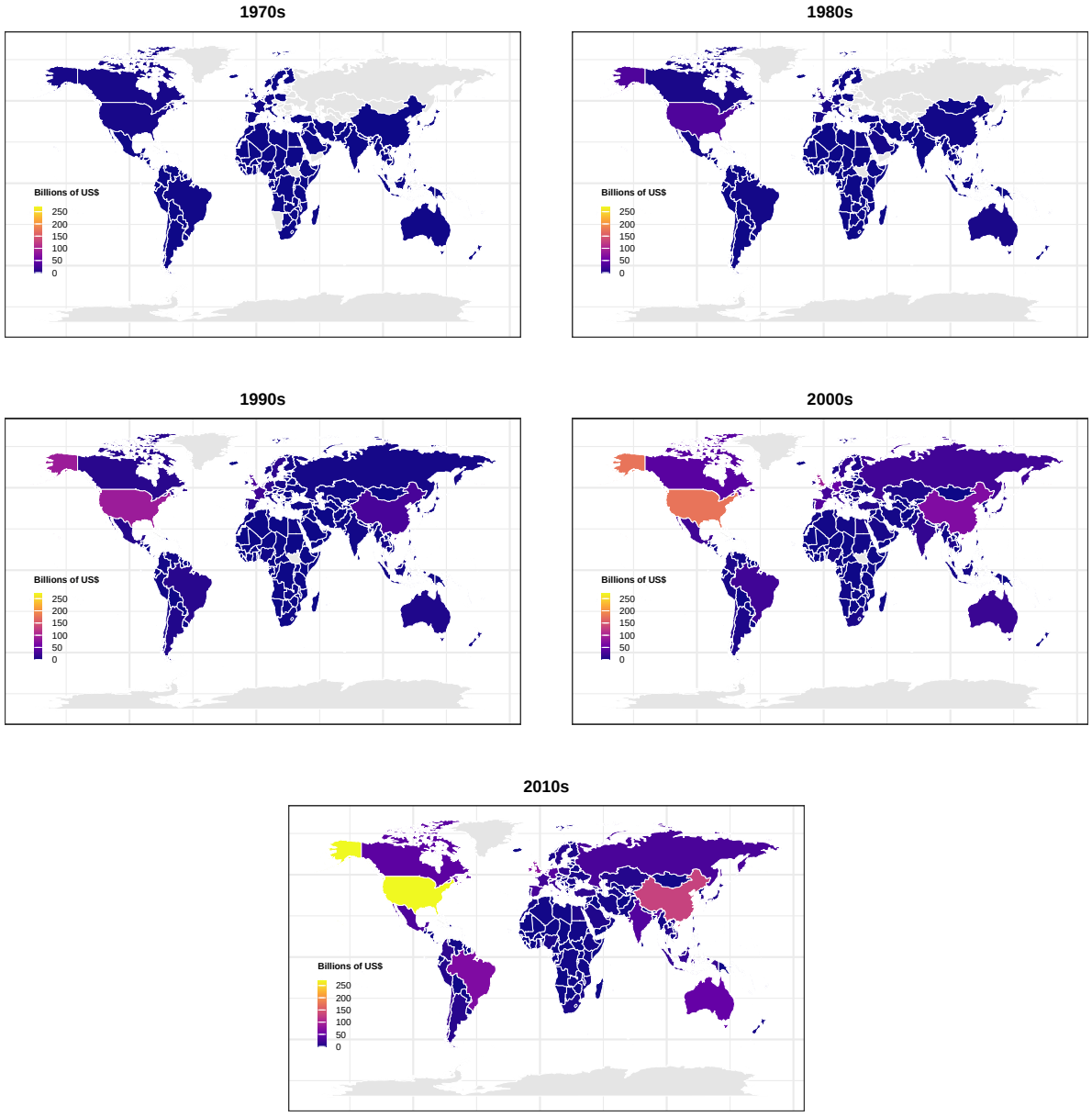
One key question is where FDI goes. Historically, global investment has been largely driven by MNCs based in developed countries and characterized by a pattern of reciprocal capital flows (Julius, 1990, 22). In other words, the Global North has served as both the primary source and principal destination of global FDI flows. This pattern is clearly illustrated in Figure 2.4, which shows the global distribution of FDI inflows by decade. During the 1970s and 1980s, FDI inflows were concentrated primarily in developed economies, although foreign investment had reached nearly every region of the world.

This trend, however, began to shift in the 1990s, as the Global South emerged as an increasingly important destination for FDI. In 2012, for the first time, developing countries (excluding transition economies) collectively received more FDI than developed countries (UNCTAD, 2013). Figure 2.4 captures this transformation. During the 1990s, 2000s, and 2010s, a growing number of developing countries attracted substantial FDI—especially large and emerging economies such as Argentina, Brazil, Chile, China, India, Mexico, Russia, and South Africa. Notably, FDI into Africa increased from $2.8 billion in 1990 to a record $82.2 billion in 2021.

Figure 2.5 presents the global distribution of per capita FDI inflows by decade. A different pattern emerges compared to total FDI inflows. On a per capita basis, although the Global North still receives more FDI overall than the Global South, many countries in the Global South stand out, especially in the 2000s and 2010s. These include not only large and emerging developing economies such as the BRICS countries (Brazil, Russia, India, China, and South Africa), along with Argentina, Chile, and Mexico, but also a diverse set of other countries.

In Sub-Saharan Africa, notable recipients include Botswana, Congo, Equatorial Guinea, Gabon, Libya, and Namibia. In East Asia, Malaysia, Mongolia, and Singapore stand out. In Central Asia, Kazakhstan and Turkmenistan have received high levels of per capita FDI. The Middle East and North Africa also include several oil-rich countries such as Libya,

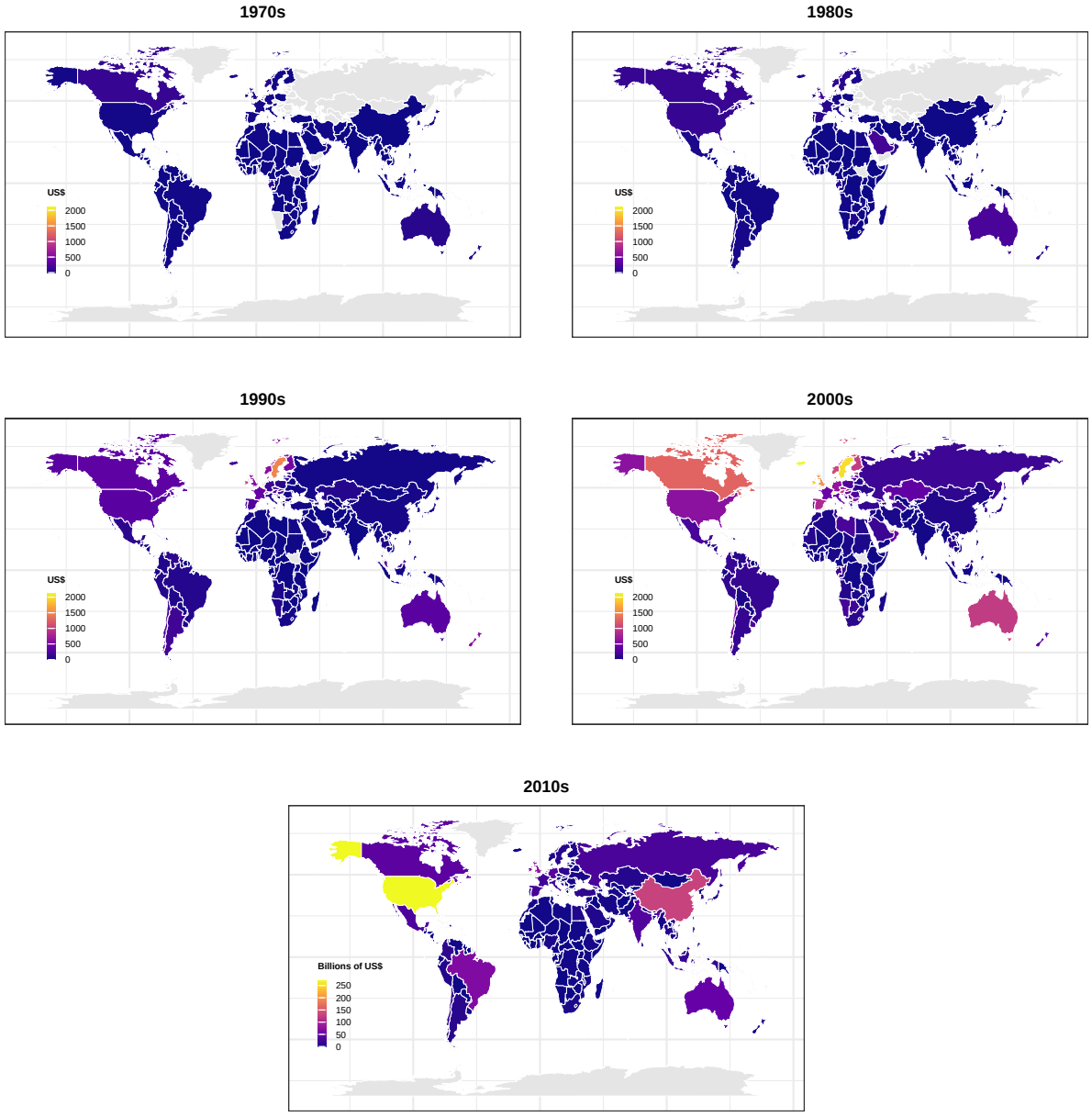
Figure 2.4: Global Distribution of FDI Inflows by Decade



Notes: Data come from UNCTAD. The values of FDI inflows shown in the heat maps represent decadal averages. Grey areas on the map indicate countries or territories for which data are not available.

Oman, Saudi Arabia, and the United Arab Emirates. In Latin America and the Caribbean, countries such as Colombia, Costa Rica, Dominica, Jamaica, Peru, and Uruguay rank highly. In Eastern Europe, prominent cases include Belarus, the Czech Republic, Estonia, Georgia, Romania, Serbia, and Slovenia.

Figure 2.5: Global Distribution of FDI Inflows per Capita by Decade



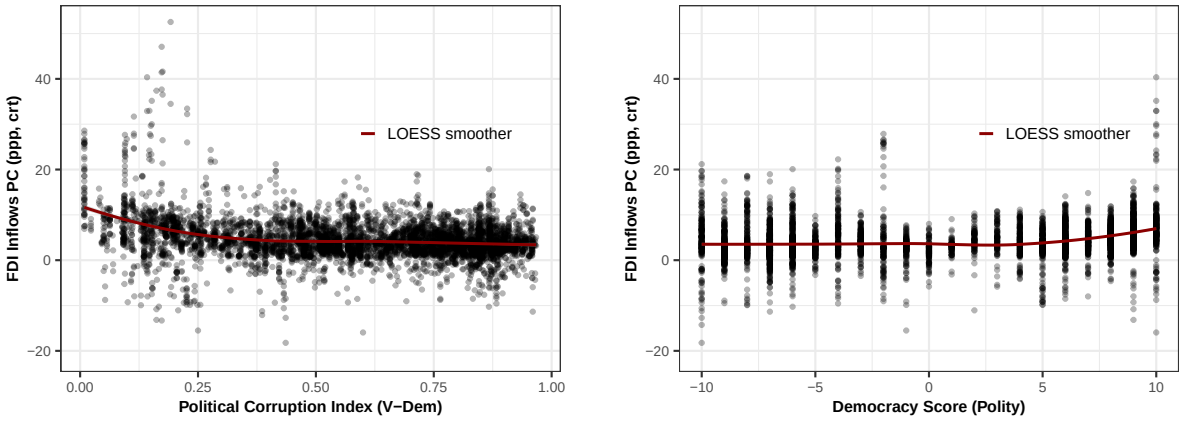
Notes: Data come from UNCTAD. The values of FDI inflows shown in the heat maps represent decadal averages. Grey areas on the map indicate countries or territories for which data are not available.

These countries vary significantly in their political and economic environments. The pattern shown in Figure 2.5 suggests that FDI and MNCs are not necessarily deterred by armed conflict, weak institutions, limited rule of law, or political and economic instability. Instead, they behave as strategic actors that actively pursue market opportunities to

maximize profits (Wright and Zhu, 2018; Zhu and Shi, 2019).

Distribution of FDI in the Global South

Figure 2.6: Corruption, Democracy and FDI Inflows



Notes: Plots show real FDI inflows per capita (cubic root) against levels of corruption and democracy, respectively. The dark red lines represent LOESS smoothers.

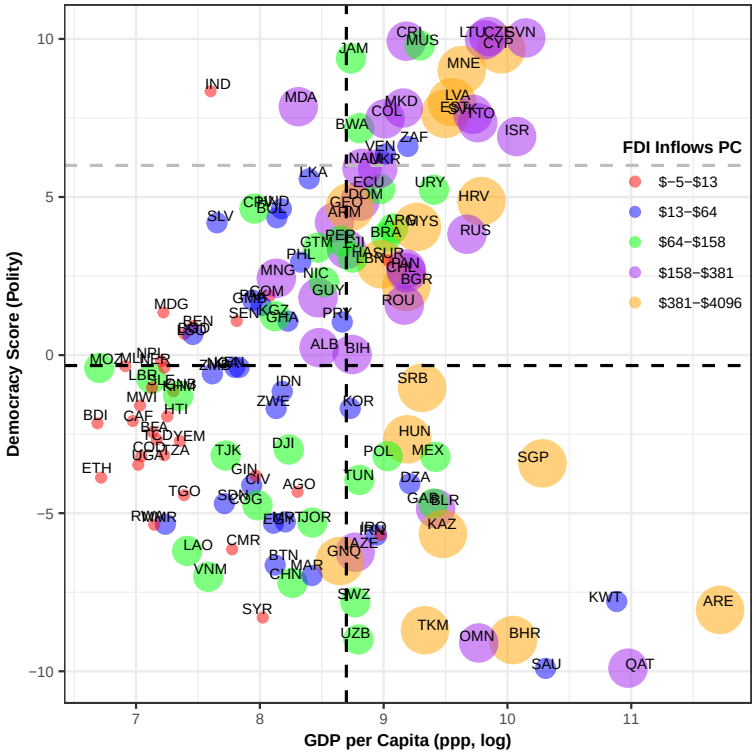
We further examine where FDI goes within the Global South by analyzing the correlation between FDI inflows and a set of political and economic risk indicators for a sample of non-OECD countries. Figure 2.6 plots real per capita FDI inflows[6] against political corruption[7] and democracy (Polity score). The left panel suggests a slightly negative correlation between corruption and per capita FDI inflows. Importantly, there is substantial variation in FDI inflows across all levels of corruption. The right panel shows a similar pattern: while there is a slightly positive correlation between democracy scores and per capita FDI inflows, considerable variation persists across all regime types.

Figure 2.7 categorizes developing countries into four groups based on two dimensions: level of development (real GDP per capita) and regime type (Polity score). Overall, there is a positive correlation between economic development and per capita FDI inflows. In contrast, the relationship between democracy and FDI is less consistent. Both democratic and authoritarian countries with higher levels of development tend to attract more FDI

[6]The distribution of per capita FDI inflows (PPP-adjusted) is highly skewed. We apply the cubic root transformation to reduce the influence of extreme values.

[7]We use the political corruption index from V-Dem.

Figure 2.7: Development, Democracy, and FDI



Notes: The x-axis represents real GDP per capita (PPP-adjusted, logged), and the y-axis shows the democracy score. The size of each bubble is proportional to per capita FDI inflows. Real GDP per capita, democracy score, and FDI inflows per capita are all country means over the study period 1970–2019. The dark vertical and horizontal dashed lines represent the median values of real GDP per capita and democracy score in the sample, respectively. The light horizontal line marks the conventional threshold of 6 on the Polity score, above which countries are classified as democracies.

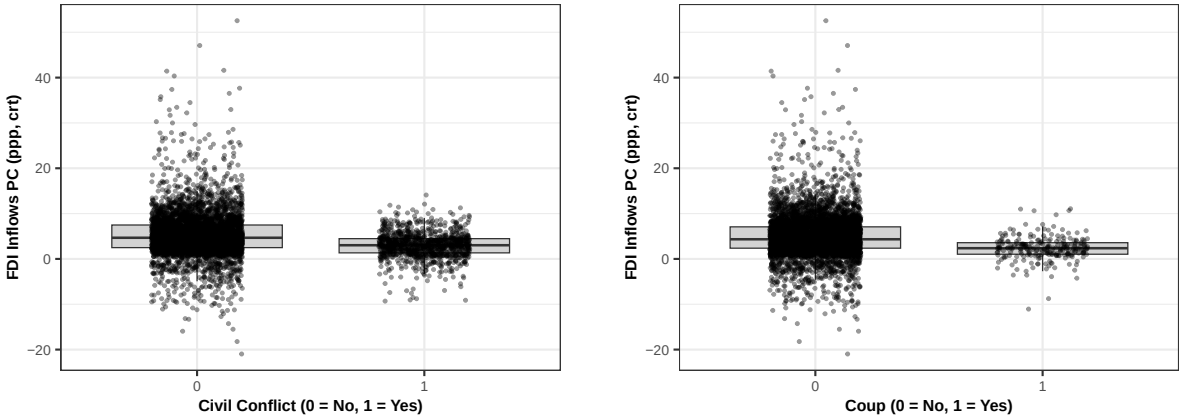
than their less developed counterparts. At any given level of economic development, the level of democracy does not appear to have a strong correlation with per capita FDI inflows. Moreover, substantial variation in per capita FDI inflows is evident across all four groups in the plot.

Figure 2.8 plots per capita FDI inflows against the incidence of civil conflict[8] (left panel) and coup d'état[9] (right panel). Both panels indicate that, on average, countries experiencing civil conflict or coups receive slightly lower levels of per capita FDI. However, there is substantial variation in FDI inflows within each group.

[8]Data on civil conflict are from UCDP/PRIO.

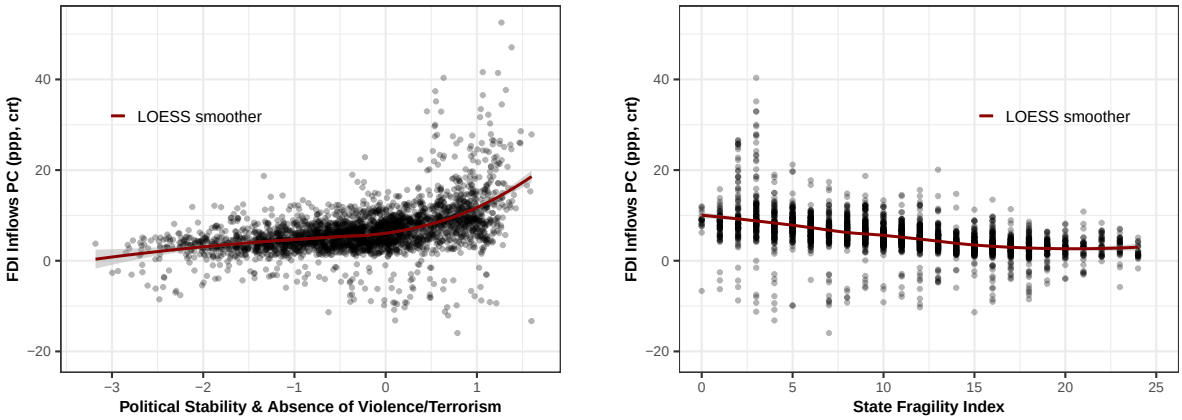
[9]Data are from the Colpus Dataset (Chin, Carter and Wright, 2021).

Figure 2.8: Civil Conflict, Coup, and FDI



Notes: Data are real FDI inflows per capita (cubic root) plotted against the incidence of civil conflict and coups d'état. Thick horizontal bars denote median FDI inflows per capita for each group; box edges denote the 25$^{\text{th}}$ and 75$^{\text{th}}$ percentiles.

Figure 2.9: Stability, Fragility, and FDI



Notes: Plots show real FDI inflows per capita (cubic root) against political stability and state fragility, respectively. The dark red lines represent LOESS smoothers.

Figure 2.9 further explores the relationship between FDI and broader measures of political stability. The left panel plots FDI against a composite index of political stability,[10] while the right panel uses a measure of state fragility.[11] As expected, political stability—defined as the absence of violence and terrorism—is positively correlated with per capita FDI inflows,

[10]Data are from the World Bank's *World Governance Indicators*.

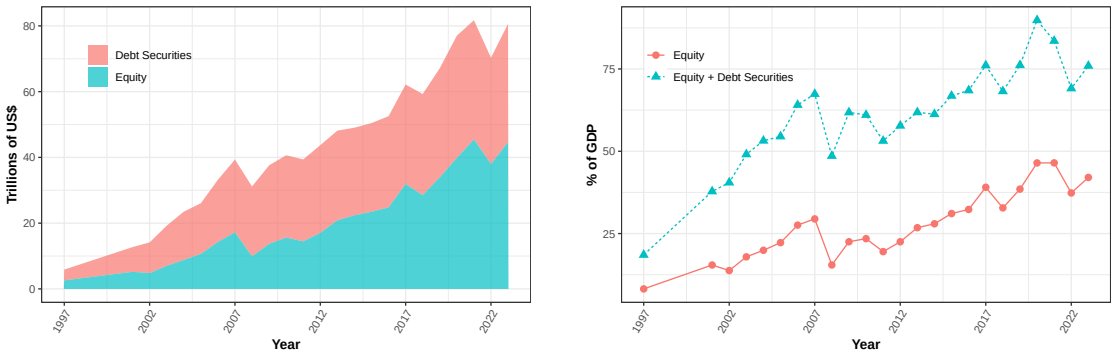
[11]This is a composite measure based on eight component indicators: effectiveness (security, political, economic, and social effectiveness) and legitimacy (security, political, economic, and social legitimacy). See Marshall and Elzinga-Marshall (2018).

whereas state fragility is negatively correlated. Yet, at all levels of political instability or fragility, considerable variation in FDI inflows persists.

In sum, several key takeaways emerge regarding the growth and distribution of global FDI. First, global FDI flows grew exponentially during the 1990s and early 2000s, though they declined sharply following the burst of the IT bubble in the early 2000s. In recent years, however, FDI growth has stagnated and even shown signs of decline—particularly when measured as a share of world GDP. Second, while FDI historically circulated primarily among countries in the Global North, the Global South has become an equally important destination in recent decades. Finally, the descriptive statistics presented in this section suggest that FDI and MNCs are not necessarily deterred by weak institutions, corruption, armed conflict, or political instability. Across all levels of institutional quality and political risk, the volume of FDI inflows varies considerably.[12]

2.3.3 Portfolio Investment

Figure 2.10: Portfolio Investment: 1997–2023



Notes: Data come from the International Monetary Fund's Portfolio Investment Positions (PIP) by Counterpart Economy dataset (formerly Coordinated Portfolio Investment Survey).

The integration of financial markets has been another major driver of globalization. In the 1990s, the IMF, OECD, and EU began actively promoting capital account liberalization, largely reversing the earlier emphasis on capital controls aimed at mitigating currency

[12]There is a large literature on the relationship between institutional quality and FDI inflows. See, e.g., Daude and Stein (2007), Jensen (2015), Li and Resnick (2003), Li, Owen and Mitchell (2018), and Wright and Zhu (2018); see also Pandya (2016) for a review.

volatility and preserving macroeconomic policy autonomy (Rodrik, 2018*a*, 20). Over the past few decades, financial markets have become increasingly interconnected, with capital flowing more freely across borders. This trend has been facilitated by deregulation, the liberalization of capital controls, and advances in financial technologies.

Figure 2.10 illustrates the growth of global portfolio investment from 1997 to 2023.[13] Portfolio investment consists of two components: equity and debt securities. The former refers to cross-border investments in ownership shares (e.g., stocks) that do not confer significant control over the company—typically defined as holdings of less than 10% of voting stock, distinguishing them from FDI discussed earlier. The latter refers to cross-border investments in fixed-income instruments issued by foreign governments or corporations, including bonds, notes, and money market instruments.

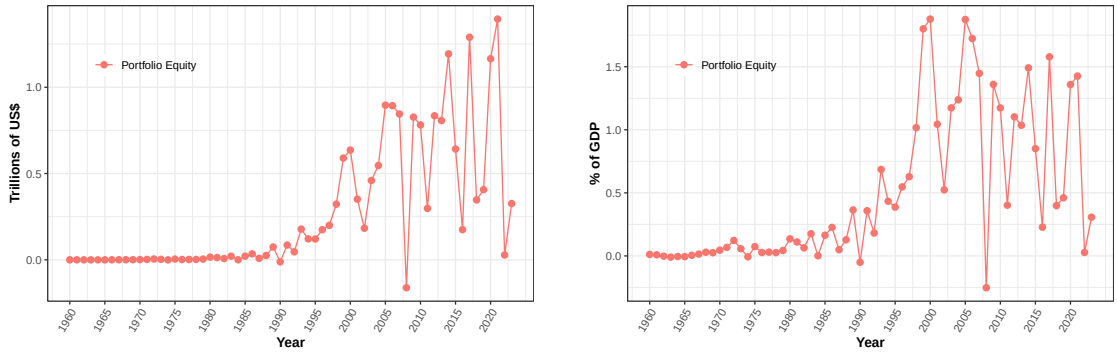
As shown in the left panel of Figure 2.10, the volume of both portfolio equity and debt securities has expanded rapidly over the past few decades. Total global portfolio investment holdings reached $80.6 trillion in 2023, following a significant decline from their peak in 2021. This figure represents 75.9% of world GDP (see the right panel).

The development and integration of global financial markets are expected to improve the efficiency of capital allocation, increase capital endowments in capital-scarce countries, and enhance the functioning of domestic financial systems, thereby promoting long-term economic growth. However, empirical evidence on the relationship between financial liberalization and growth remains mixed (Kose, Prasad and Taylor, 2011; Levine, 2001; Schularick and Steger, 2010). Due to governments' opportunistic behavior and weak domestic institutions, financial liberalization has often resulted in financial instability or even crises (Broner and Ventura, 2016). Historically, there has been a strong association between financial globalization and the occurrence of financial crises (Reinhart and Rogoff, 2009).

[13]The data represent holdings of portfolio investment assets in the form of equity and investment fund shares, as well as long-term and short-term debt securities (IMF, 2017, 1). These data are recorded semi-annually in the PIP dataset. From 1997 to 2008, data are available only for the second half of each year. To ensure consistency, all data points in Figure 2.10 reflect holdings as of the second half of the reference year.

Financial globalization has also increased economies' vulnerability to external shocks. In highly integrated global financial markets, events in one region can produce ripple effects across the world. The Asian Financial Crisis of 1997 and the Global Financial Crisis of 2008 underscored the risks associated with the rapid movement of capital across borders (Kahler and Lake, 2013; Pinto, 2013*b*). Sudden shifts in investor sentiment can trigger capital flight, currency devaluations, and macroeconomic instability. In response, many countries have adopted measures to mitigate the risks of financial globalization, such as maintaining large foreign exchange reserves and implementing prudent macroeconomic policies.

Figure 2.11: Portfolio Equity Net Inflows: 1960–2023



Note: Data come from the World Bank's *World Development Indicators*.

Figure 2.11 presents annual net inflows of portfolio equity from 1960 to 2023, shown in both absolute terms (left panel) and as a percentage of world GDP (right panel). Two patterns stand out. First, the volume of portfolio equity inflows began to rise sharply in the 1990s following capital account liberalization. Second, the figure highlights the high volatility that characterizes global financial markets. For example, global portfolio equity inflows reached \$0.84 trillion in 2007, just before the Global Financial Crisis, but fell to –\$0.16 trillion in 2008 during the crisis. These fluctuations closely mirror global macroeconomic boom-and-bust cycles.

By contrast, global FDI inflows—shown in Figure 2.4—have exhibited greater stability over time and tend to be less sensitive to shifts in the global economic environment. For this reason, FDI is often preferred by host countries—particularly developing economies—as a

more stable and long-term source of external capital (Lipsey, 2001).

2.3.4 Foreign Aid and Remittances

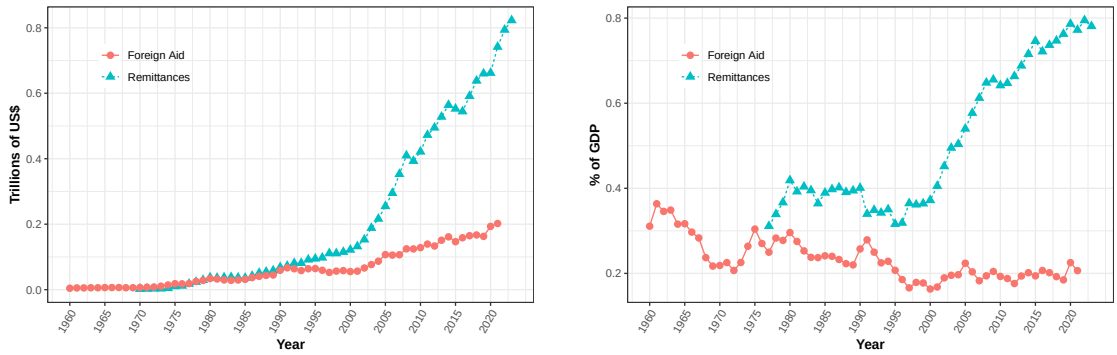
Two other important international economic flows—foreign aid and remittances—also play a critical role in globalization. Foreign aid, often referred to as official development assistance (ODA), consists of concessional loans and grants provided by governments and multilateral institutions to promote economic development and welfare in recipient countries and territories. Remittances are financial or in-kind transfers sent by migrants to their home countries. Both foreign aid and remittances are recorded in a country's current account, whereas FDI and portfolio investment flows are recorded in the capital account.

Figure 2.12 plots global annual flows of foreign aid and remittances, shown in both absolute terms (left panel) and as a percentage of world GDP (right panel). Both flows have increased steadily over time, with remittances exhibiting particularly rapid growth since the 1990s. In the latest year for which data are available, foreign aid amounted to $0.20 trillion in 2021, and remittances reached $0.82 trillion in 2023. Unlike the high volatility observed in portfolio investment, global flows of foreign aid and remittances tend to be more stable and counter-cyclical. Scholars have documented this counter-cyclical characteristic, noting that both aid and remittance flows often increase during times of economic hardship in recipient countries, thereby helping to cushion external shocks and support household consumption (Frankel, 2011; Singer, 2010; Yang and Choi, 2007).

The right panel of Figure 2.12 shows the growth of foreign aid and remittances relative to world GDP. These two flows exhibit markedly different trajectories. Global flows of foreign aid as a percentage of world GDP declined after the end of the Cold War and have remained relatively stable, leveling off around 0.2% for several decades. This stagnation can be attributed to the diminished stategic incentives for large-scale aid following the Cold War (Lancaster, 2007), as well as the persistent failure of many major donors to fulfill their development assistance commitments (United Nations, 2024, Chapter III.C).

In contrast, remittances as a share of world GDP have steadily increased since the mid-

Figure 2.12: Foreign Aid and Remittances: 1960–2023



Notes: Data come from the World Bank's *World Development Indicators*. Dots and triangles represent foreign aid and remittances, respectively.

1990s, reaching a peak of 0.79% in 2022. This trend has been driven by rising demand for migrant labor in high-income countries—many of which face rapid population aging and shrinking labor forces (OECD, 2023; World Bank, 2018).

2.4 Globalization and Domestic Market Structures

FDI differs from other international financial flows in that it constitutes a physical presence of operations in the host country. Furthermore, foreign investors are directly involved in the operations of businesses and exercise managerial control (Hymer, 1976). MNCs are instrumental in transferring technology and management expertise, bringing in best practices to the countries in which they operate, and helping to modernize industries and raise productivity levels. When MNCs invest in a foreign country, they often bring advanced technologies and innovative business models that can boost productivity and competitiveness in the host economy. FDI can create jobs, increase the procurement of business services, improve infrastructure, and contribute to the development of the local economy (Aitken, Harrison and Lipsey, 1996; Lipsey, 2003; Pinto, 2013*a*).

However, FDI can also generate negative consequences. The entry of foreign firms may crowd out domestic companies, particularly in industries where local firms are less competitive (Pinto and Zhu, 2016, 2022). FDI may also exacerbate income inequality, as the benefits of foreign investment are often concentrated in certain sectors or regions within the

host country (Graham, 2000). Moreover, FDI and MNCs have been criticized for generating downward pressure on government regulations, contributing to a "race to the bottom" in labor standards, environmental protections, and taxation (Davies and Vadlamannati, 2013; Frankel, 2003; Gallagher, 2009; Rodrik, 1997; Urpelainen, 2010).

One of our central arguments throughout this book is that FDI inflows and MNC activity can generate a rent creation effect in developing countries. While all components of globalization discussed above can influence economic outcomes, FDI plays a uniquely transformative role in shaping industrial structures and transferring capabilities in host countries. When highly productive foreign firms enter domestic markets—especially in developing countries where incumbent firms often lack scale, efficiency, or technological capability—they can displace local competitors and cause market concentration, thereby generating substantial economic rents. In contrast, in developed markets where incumbent firms are already efficient, foreign entry likely intensifies competition and erodes profit margins, reducing excess rents while potentially improving aggregate productivity.

Trade liberalization operates through different mechanisms. Restrictive trade regimes tend to generate rents for domestic firms by shielding them from international competition (Krueger, 1974). These rents often arise through higher markups and reduced incentives to innovate. Liberalizing trade removes these protections, fostering greater competition, reducing rents, and reallocating market shares toward more productive firms (Pavcnik, 2002; Trefler, 2004). At the same time, liberalization can expand opportunities for rent generation among exporters who benefit from scale economies and access to larger foreign markets (de Loecker and Warzynski, 2012). For example, following the implementation of NAFTA, many previously sheltered Mexican firms, especially in low-productivity sectors such as textiles and footwear, experienced declining profitability due to heightened foreign competition. However, more productive firms in sectors like automotive and electronics—particularly those integrated into North American GVCs—saw rising exports, markups, and profits (Brugués, Kikkawa, Mei and Robles, 2025).

Beyond trade and FDI, other international financial flows—including portfolio investment, foreign aid, and remittances—have their own distinctive dynamics and development implications. Portfolio investment, which includes short-term capital inflows such as equity and bond purchases, plays a limited role in restructuring domestic markets. These flows are typically not for production. Instead, they are driven by risk-return arbitrage and are highly sensitive to macroeconomic volatility and investor sentiment (De Long, Shleifer, Summers and Waldmann, 1990; Lee, Jiang and Indro, 2002). While portfolio investment can deepen capital markets and improve liquidity, it rarely involves managerial control or technology transfer. Moreover, its pro-cyclical and volatile nature can destabilize emerging markets, as seen during the Mexican peso crisis (1994), the Asian financial crisis (1997–1998), and the sudden stops in capital flows during the COVID-19 pandemic (Calvo, 1998; Forbes and Warnock, 2012).

Foreign aid constitutes another important category of financial flows, generally aimed at poverty alleviation, capacity building, or infrastructure development. Although aid can support critical development goals, its effectiveness is heavily contingent on governance structures and institutional quality within recipient countries (Burnside and Dollar, 2000; Easterly, 2003; Kosack and Tobin, 2006; Wright and Winters, 2010). Unlike FDI, foreign aid is not market-driven, and thus lacks the competitive pressures, technological spillovers, and productivity incentives that accompany private investment. Additionally, aid flows may be distorted by security and strategic considerations or conditionalities that limit their developmental impact (Alesina and Dollar, 2000).

Remittances are a more and counter-cyclical source of income. They often increase during periods of domestic economic distress, helping to stabilize consumption and alleviate poverty (Chami, Fullenkamp and Jahjah, 2005; Ratha, 2005). However, the developmental impact of remittances is mixed (Mosley and Singer, 2015). While they improve household welfare and can indirectly support local economies through consumption, their contribution to long-term productivity growth is limited unless channeled into investment in education,

small businesses, or housing (Giuliano and Ruiz-Arranz, 2009; Rapoport and Docquier, 2006). Unlike FDI, remittances do not entail cross-border control of productive assets or integration into global production systems.

FDI stands apart from these other financial flows in several important ways. First, it is typically long-term in nature and accompanied by direct managerial involvement. Second, FDI is a key channel for the transmission of technology, management expertise, and international best practices, which can raise host-country productivity, especially when domestic firms have the absorptive capacity to learn and adapt (Alfaro, Chanda, Kalemli-Ozcan and Sayek, 2004; Borensztein, De Gregorio and Lee, 1998). Third, FDI fosters the formation of linkages with local firms, which can create spillovers through supplier networks, labor mobility, and demonstration effects (Blalock and Gertler, 2008; Javorcik, 2004). These structural features make FDI a more potent engine of sustained economic transformation compared to more volatile or consumption-oriented capital flows.

That said, the benefits of FDI are not automatic. In developing countries, weak institutional environments in particular, FDI may exacerbate market concentration, crowd out local firms, and contribute to rising inequality (Blomström, 1986; Graham, 2000; Pinto and Zhu, 2016). Moreover, in the absence of effective labor or environmental regulation, MNCs may engage in regulatory arbitrage, prioritizing cost savings over social or ecological outcomes (Mosley and Uno, 2007; Urpelainen, 2010). Thus, the developmental impact of FDI ultimately depends on complementary domestic policies, including investment in human capital, legal and regulatory frameworks, and industrial strategies that strengthen local firms' capacity to benefit from foreign presence.

In summary, while all forms of international capital flows can influence economic outcomes, FDI is more directly tied to the reorganization of production and the configuration of market structures, and hence the creation or dissipation of rents within domestic economies. The control over, and contestation of, these rents carry significant economic and political ramifications. In the next chapter, we elaborate on these arguments in detail. As a preview,

we argue that FDI inflows and the entry of highly productive MNCs into developing countries can lead to market concentration and generate substantial economic rents. The struggle to control these rents can fuel corruption, civil conflict, and high leadership turnover—especially in countries with weak institutions and limited state capacity.

Chapter 3

Theoretical Framework

3.1 Overview

To understand the implications of foreign investment in developing nations, it is essential to examine the factors that drive FDI. MNCs—the primary agents of FDI—play a pivotal role in the global economy by deploying substantial capital and advanced technologies across borders. MNCs undertake FDI to safeguard intangible assets such as brand recognition, managerial expertise, and proprietary production technologies, which are difficult to license or subcontract effectively in arm's length markets and that often yield higher returns when managed directly by the parent company (Caves, 1996; Lipsey, 2003; Markusen, 1995).

However, establishing and operating overseas affiliates entails significant additional fixed costs, including identifying suitable foreign locations, setting up subsidiaries, building supply chains, and navigating complex local business and political environments. Only the largest and most efficient firms can afford these additional costs to engage in FDI (e.g., Helpman, Melitz and Yeaple, 2004; Melitz, 2003; Yeaple, 2009). As such, MNCs are often the largest and most productive firms in the global economy.

The entry and presence of these large and highly productive firms can have a profound impact on host countries—both positive and negative.[1] On the one hand, FDI in-

[1]See Theodore Moran (2005) for a collection of essays on the economic impacts of FDI in host countries.

flows and MNC activity can catalyze domestic investment, facilitate technology transfer, generate spillovers in managerial know-how, and integrate domestic firms into GVCs (Baldwin, Braconier and Forslid, 2005; Blomström, Globerman and Kokko, 2001; Javorcik, 2004). MNCs often introduce stronger codes of conduct and contribute to improved labor standards (Malesky and Mosley, 2018; Mosley, 2011; Mosley and Uno, 2007). Foreign entrants may also enhance market competition and promote more efficient resource allocation (Markusen and Venables, 1999). All of these often stimulate local economic development, drive technological advancement, and contribute to long-term growth in host countries.

On the other hand, the entry and presence of MNCs may crowd out local firms and investment and stifle market competition (Agosin and Machado, 2005; Aitken and Harrison, 1999). These developments may negatively affect domestic industries, exploit labor and other local resources, and exacerbate economic inequalities. Such adverse effects are often described as multinationals "skimming the cream" of local markets—extracting the most valuable resources or opportunities while leaving local populations with little benefit (Cardoso and Faletto, 1979; London and Robinson, 1989).

The realization of these effects—whether positive or negative—often depends on local conditions in the host country, including absorptive capacity, human capital, financial infrastructure, and institutional quality (see, e.g., Alfaro et al., 2010; Borensztein, De Gregorio and Lee, 1998).

We focus on the creation and dissipation of rents resulting from the entry and presence of MNCs in host economies and their political consequences. Analytically, the entry and activity of MNCs can be characterized as a process that alters residual demand and reshapes market structures, leading to the generation or erosion of economic rents for both foreign and domestic actors. We argue that the extent to which foreign investment creates or dissipates rents hinges on the productivity gap between foreign entrants and incumbent local firms.

Establishing subsidiaries and operating overseas involves substantial fixed costs, and thus, only the largest and most productive firms are able to bear the costs required to

engage in FDI (e.g., Helpman, Melitz and Yeaple, 2004; Melitz, 2003; Yeaple, 2009). Consequently, MNCs tend to be among the most productive and globally competitive firms in the world economy. In developing countries, indigenous firms are usually smaller and less technologically advanced than their multinational counterparts: The productivity differential between local firms and entering MNCs is significant in these cases. When there is a large productivity gap, the entry of a foreign investor will push local firms out, leading to market concentration and the potential for monopoly or oligopoly rents. As domestic firms lose market share, their average production costs tend to rise, leading to reduced profitability and forcing the least productive firms to exit the market. This dynamic has been conceptualized as either the *market-stealing effect* or the *negative productivity spillover* from MNCs (Aitken and Harrison, 1999).

Furthermore, many market opportunities remain underutilized or untapped in developing countries, particularly in industries characterized by high entry barriers arising from economies of scale, technological and capital requirements, and product differentiation. Paradoxically, it is precisely these entry barriers that create opportunities for MNCs to enter such markets (Caves, 1996; Dunning, 1992). The proprietary assets held by MNCs—such as advanced technologies, managerial expertise, and brand recognition—enable them to overcome these barriers. After entry, MNCs may further raise entry barriers by increasing capital requirements and reinforcing technological intensity, thereby contributing to the formation of monopolistic or oligopolistic market structures (Zhu, 2017). Empirical studies have shown that FDI inflows and the presence of MNCs often lead to increased market concentration and contribute to imperfect competition in developing countries (Blomström, 1986; Blomström and Kokko, 1996; Lall, 1979*a*; Newfarmer, 1979; Willmore, 1989).

Note that both the determinants of foreign entry and the consequences of foreign presence are conditioned by local factors such as state capacity, political development, and governance in the host country. These conditions shape the costs and risks faced by foreign investors. Institutional uncertainty, political instability, policy volatility, and opportunistic

government behavior constitute key sources of non-market risk, all of which add to investment costs (Graham, Johnston and Kingsley, 2017). Such risks must be provisioned for and thereby lower the expected returns on investment, raising the productivity threshold required for firms to profitably enter foreign markets. Under these circumstances, only the most productive firms are likely to engage in FDI. Accordingly, the higher the political risks and costs of investing in a developing country, the greater the expected productivity differential between foreign investors and incumbent firms.

High economic rents incentivize actors to engage in rent-seeking activities, which may take illicit or even violent forms and carry diverse political ramifications. This book examines the effects of economic rents generated by FDI inflows and MNC activity on corruption, civil conflict, and leadership turnover in developing countries. High rents increase the value of government goods and services, motivating officials to trade their "control rights" for bribes, thereby fostering high levels of corruption (Ades and Di Tella, 1999). Likewise, high rents raise the size of spoils and the value of state capture, incentivizing rebel groups to challenge the government and thus heightening the likelihood of civil conflict onset (see, e.g., Collier and Hoeffler, 1998; Fearon and Laitin, 2003; Grossman, 1991; Olsson and Fors, 2004). Finally, the prospect of appropriating these rents can intensify political contestation and spark struggles for control of the government, leading to leadership change through nonviolent means, whether constitutional or otherwise.

Political and institutional development and state capacity building in host countries, are essential for mitigating the adverse effects of FDI inflows and MNC activity while enhancing their positive contributions. Political competition and strong legal institutions increase the likelihood that corrupt behavior is detected and punished, thereby weakening incentives for corruption. Likewise, robust state capacity and institutional development strengthen the state's coercive and administrative capabilities, improve public goods provision, mitigate grievances, and facilitate conflict resolution, thereby reducing the risks of civil conflict and leadership turnover. We elaborate on these mechanisms in detail in the corresponding

chapters.

The remainder of this chapter presents a formal model illustrating how foreign entry can lead to market concentration and high rent extraction. This rent-creation effect of FDI and MNC activity hinges on the productivity differential between foreign entrants and incumbent firms, regardless of whether foreign firms are market-, efficiency-, or resource-seeking. We conclude the chapter with a preview of our argument concerning the impact of FDI and MNC activity on corruption, civil conflict, and leadership turnover.

3.2 MNCs and Host Country Market Dynamics

MNCs tend to be larger and more profitable than other firms, primarily because they are more productive. Empirical research shows that firms with higher productivity and lower costs are typically larger and able to charge higher markups (Autor, Dorn, Katz, Patterson and Van Reenen, 2020; Baqaee and Farhi, 2020; Edmond, Midrigan and Xu, 2023; Kehrig and Vincent, 2021); more productive firms select output levels to maximize profits and set higher markups at any given level of demand (Bernard and Jensen, 1999; Bernard, Jensen and Schott, 2009; Bernard et al., 2007; Bernard, Eaton, Jensen and Kortum, 2003; Helpman, 2006; Helpman, Melitz and Yeaple, 2004; Melitz, 2003; Yeaple, 2009). In competitive markets, more productive incumbent firms are better positioned to withstand competition from high-productivity entrants, while the least productive firms may be driven out. This relationship between productivity differences and economic rents is central to understanding the heterogeneous impact of MNC entry in host countries.

Their size, profitability, and productivity enable MNCs to navigate the complexities of both home and host country environments and to serve global markets. The decision to invest abroad depends on a range of factors, including host market potential, labor costs, political stability, and regulatory conditions. Such investments are often aimed at exploiting the comparative advantages offered by host countries relative to home or third-country markets. We elaborate on this logic within the analytical framework presented below.

3.2.1 Entry, Productivity Differential, and Market Concentration

A foreign firm, hereafter F, weighs entry into a host market after assessing market size, resource access, labour costs, growth potential, regulation, and—crucially—the productivity of local incumbents. Host-country firms are heterogeneous, so the marginal-cost edge that F enjoys is destination-specific; we document this differences in the ensuing chapters. For tractability we clasify local firms into two types, $i \in \{H, L\}$: high-productivity incumbents with marginal cost c_h and low-productivity firms with cost c_l. Consider a market under oligopoly facing an inverse demand schedule $P(Q)$ that satisfies $P'(Q) < 0$. Total output is given by $Q = \sum_j q_j$, and firms are heterogeneous in their marginal costs c_i. The cost ordering of F, H and L firms is: $c_f \leq c_h < c_l$. Entry by F therefore *heightens competition* among efficient firms while threatening the survival of the least productive ones.

An individual firm i seeks to maximize profit, taking demand and the quantities of its competitors as given. The maximization problem is:

$$\max \pi_i = \Big(P(Q) - c_i\Big)q_i - F \tag{3.1}$$

The first-order condition (FOC) is:

$$\frac{\partial P(Q)}{\partial Q} \cdot \frac{\partial Q}{\partial q_i} q_i + P(Q) = c_i \tag{3.2}$$

Since $\partial Q/\partial q_i = 1$, this simplifies to:

$$P(Q) - c_i = -P'(Q)q_i \tag{3.3}$$

Dividing both sides by $P(Q)$:

$$\frac{P(Q) - c_i}{P(Q)} = -\frac{P'(Q)q_i}{P(Q)} \tag{3.4}$$

Multiplying and dividing by Q, it is possible to express the markup of firm i as a function of its market share:[2]

$$\mu_i = \frac{P - c_i}{P} = \frac{s_i}{\varepsilon(Q)} \tag{3.5}$$

where s_i is the market share of firm i and is given by

$$s_i = \frac{q_i}{\sum_{j=1}^{n} q_j} \tag{3.6}$$

and $\varepsilon(Q)$ is the market-wide elasticity of demand, defined as

$$\varepsilon(Q) := \frac{-P(Q)}{P'(Q)Q} \tag{3.7}$$

Hence, the more efficient the firm is, the higher its market share and the markup that it can charge. Besides, given the definition of the Herfindahl-Hirschman Index (HHI).

$$HHI = \sum s_j^2 \tag{3.8}$$

We can write the total profit of the industry as a function of concentration, as

$$\Pi := \sum \pi_j = \sum (P - c_j)P = \sum \frac{P - c_j}{P} P q_j = \sum \frac{s_j^2}{\varepsilon(Q)} PQ = HHI \frac{P}{Q} \varepsilon(Q) \tag{3.9}$$

Linear Demand

Assume a linear inverse demand function:

$$P(Q) = a - Q \tag{3.10}$$

The market is composed of L low-productivity firms and H high-productivity firms. All firms of the same type share the same marginal cost: $c_l > c_h$.

[2]The results are substantively similar when modeling markups as multiplicative.

The FOCs are given by:

$$q_h = \frac{a - Lq_l - c_h}{H + 1} \tag{3.11}$$

$$q_l = \frac{a - Hq_h - c_l}{L + 1} \tag{3.12}$$

In equilibrium, the optimal quantities are given by

$$q_h^* = \frac{a + Lc_l - (L + 1)c_h}{L + H + 1} \tag{3.13}$$

$$q_l^* = \frac{a + Hc_h - (H + 1)c_l}{L + H + 1} \tag{3.14}$$

Which yield to a total quantity and price of equilibrium equal to

$$Q^* = \frac{(L + H)a - C}{L + H + 1} \tag{3.15}$$

$$P^* = \frac{a + C}{L + H + 1} \tag{3.16}$$

where $C = Lc_l + Hc_h$.

Besides, the market shares for individual firms are given by

$$s_h = \frac{q_h^*}{Q^*} \tag{3.17}$$

$$s_l = \frac{q_l^*}{Q^*} \tag{3.18}$$

And the elasticity of demand evaluated at the optimal total quantity (Q^*) is equal to:

$$\varepsilon(Q^*) = \frac{a}{Q^*} - 1 \tag{3.19}$$

We can now evaluate the impact of entry of more productive F foreign firms with marginal cost $c_f < c_h$ under two conditions: i) when incumbent firms remain in the market; and ii)

when less productive incumbent firms are forced out of the market.

Entry of F without exit

If there is no exit, the entry of a foreign firm makes total quantities produced to increase and individual share to decrease, lowering the concentration of the market.

$$q_f = \frac{a - Lq_l - Hq_h - c_f}{F+1} \tag{3.20}$$

$$q_h = \frac{a - Lq_l - Fq_f - c_h}{H+1} \tag{3.21}$$

$$q_l = \frac{a - Hq_h - Fq_f - c_l}{L+1} \tag{3.22}$$

In equilibrium, the optimal quantities are given by

$$q_f^* = \frac{a + Lc_l + Hc_h - (L+H+1)c_f}{L+H+F+1} \tag{3.23}$$

$$q_h^* = \frac{a + Lc_l + Fc_f - (L+F+1)c_h}{L+H+F+1} \tag{3.24}$$

$$q_l^* = \frac{a + Hc_h + Fc_f - (H+F+1)c_l}{L+H+F+1} \tag{3.25}$$

Which yield to a total quantity and price of equilibrium equal to

$$Q^{*'} = \frac{(L+H+F)a - C'}{L+H+F+1} \tag{3.26}$$

$$P^{*'} = \frac{a + C'}{L+H+F+1} \tag{3.27}$$

where $C' = Lc_l + Hc_h + Fc_f$ is the total cost of the industry.

Entry of F with exit of L firms

If low-productivity firms exit as foreign firms F enter the market the FOC are given by

$$q_f = \frac{a - Hq_h - c_f}{F + 1} \tag{3.28}$$

$$q_h = \frac{a - Fq_f - c_h}{H + 1} \tag{3.29}$$

In this equilibrium with exit, the optimal quantities are given by

$$q_f^* = \frac{a + Hc_h - (H + 1)c_f}{H + F + 1} \tag{3.30}$$

$$q_h^* = \frac{a + Fc_f - (F + 1)c_h}{H + F + 1} \tag{3.31}$$

Which yield to a total quantity and price of equilibrium equal to

$$Q^{*\prime\prime} = \frac{(H + F)a - C^{\prime\prime}}{H + F + 1} \tag{3.32}$$

$$P^{*\prime\prime} = \frac{a + C^{\prime\prime}}{H + F + 1} \tag{3.33}$$

where $C^{\prime\prime} = Hc_h + Fc_f$ is the total cost of the industry.

However, the entry of foreign firms can cause total quantity to either increase or decrease. This depends on two competing forces: increased competition among high-productivity firms, and the exercise of market power due to a reduced number of firms operating, as illustrated in the figures below.[3]

[3]For the numerical examples we use the following parameters: $a = 100$ (intercept of linear inverse demand); $c_l = 5$ (marginal cost of low-productivity firms); $c_h = 3$ (marginal cost of high-productivity firms). $\frac{c_h}{c_f} \in [0.75, 3]$ (range of ration of cost differential of H and F); $L = 80$ (number of low-productivity firms); $H = 30$ (number of high-productivity firms); $F = 1$ (mumber of foreign entrants).

Figure 3.1: Total Output vs. Relative Productivity

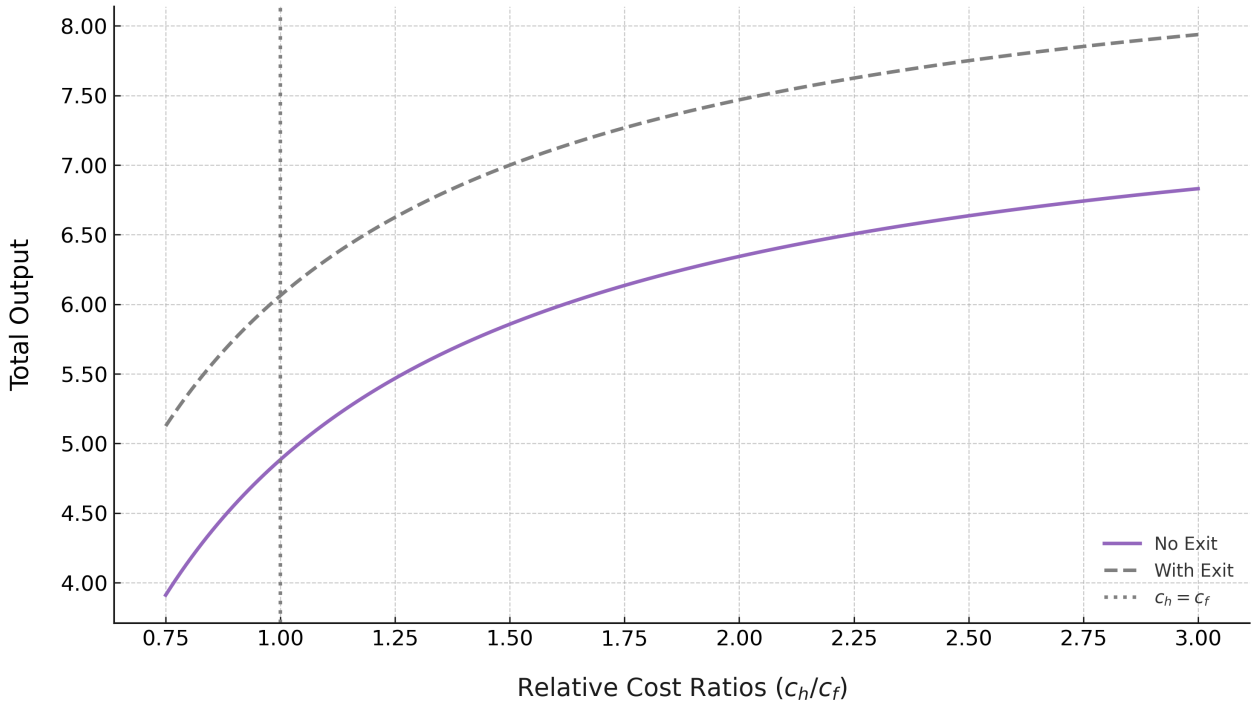
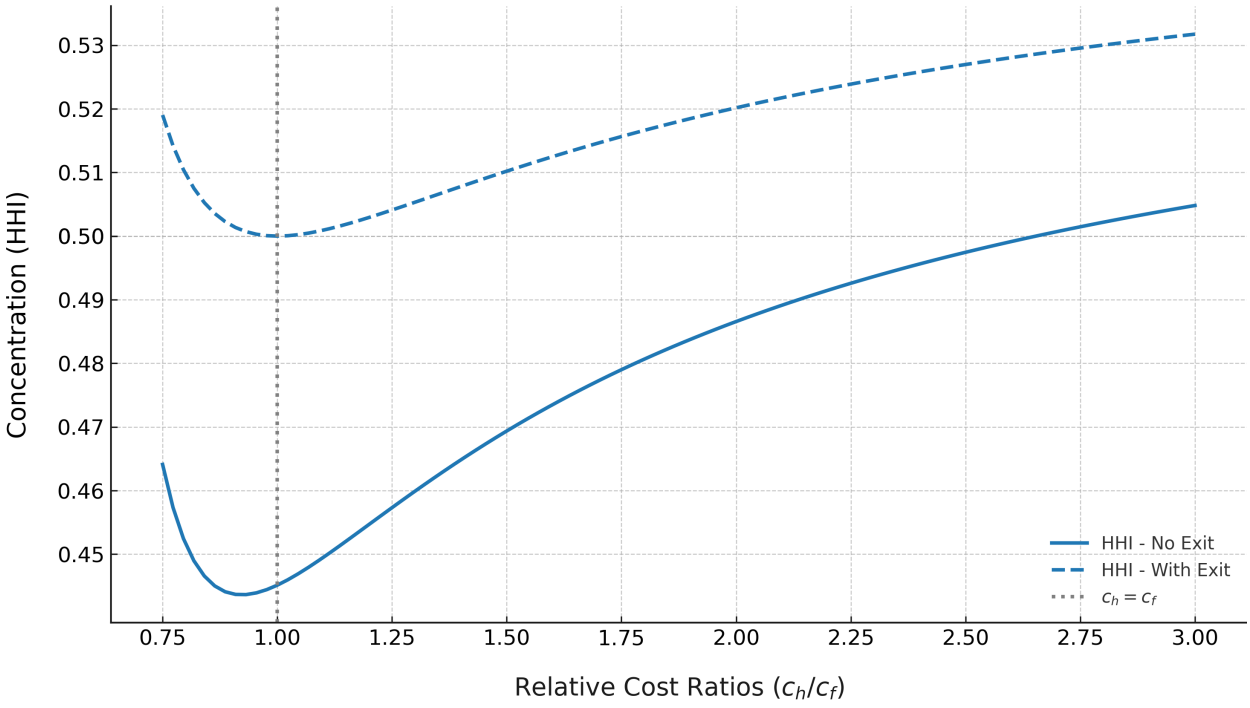


Figure 3.1 shows output as the productivity differential c_h/c_f between the foreign entrant and incumbent firms increases. Output increases when a more productive foreign firm enters the market; the output gains scale with foreign firm productivity, and are more pronounced when less productive domestic firms exit the market. When F is only *slightly* more or less efficient than H aggregate production rises modestly because market share is simply reallocated. As the gap widens, total output increases monotonically, and the boost is nearly *twice as large* under the exit regime: as low productivity L firms withdraw, demand is met at a lower marginal cost, and consumer surplus peaks.

Figures 3.2 and 3.3 compare market concentration and total markups as a function of varying productivity differentials between entrant and incumbent firms. For small cost differentials, the presence of a single F makes the industry *more competitive*; mark-ups fall and concentration dips. Once c_h/c_f crosses parity, however, the entrant's efficiency advantage dominates: both markups (μ) and market concentration—measured as the Herfindahl-Hirschman Index (HHI)—rise, especially when L firms exit the market. The market now

Figure 3.2: Market Concentration (HHI) vs. Relative Productivity

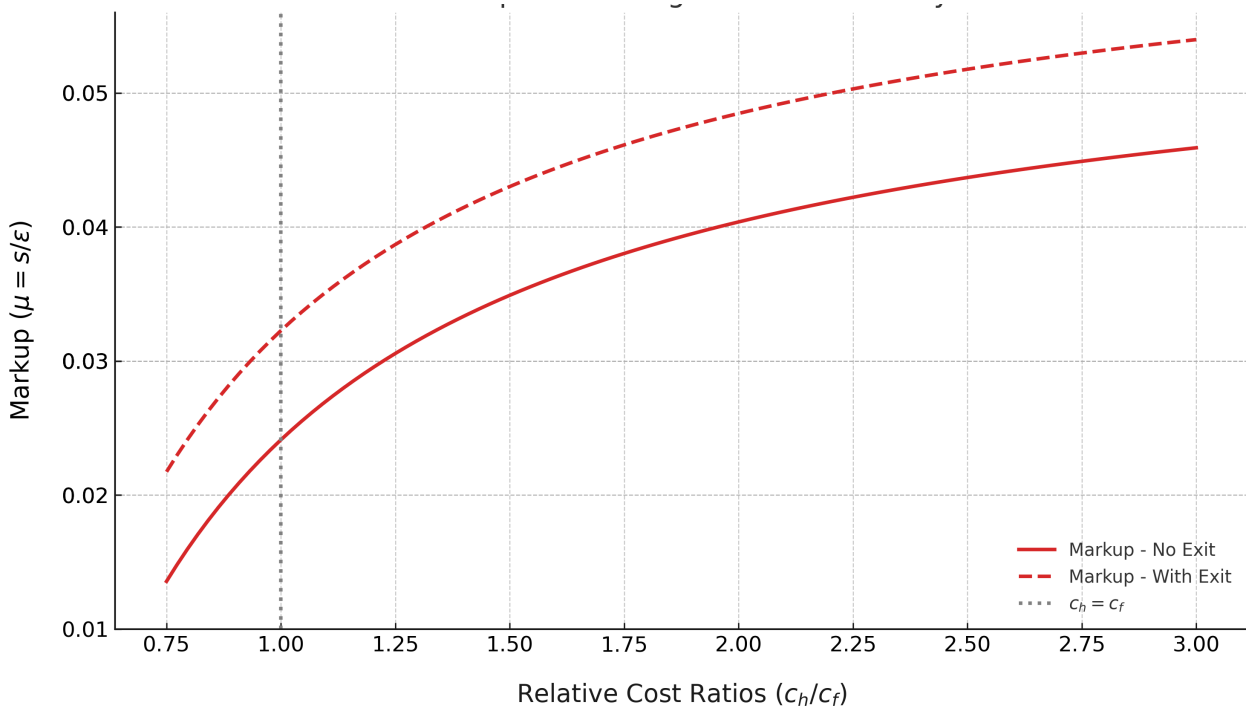


resembles an oligopoly of strong players—F plus surviving H firms—able to sustain higher prices and capture larger economic rents.

The results suggest that, in the absence of firm exit—that is, when incumbent firms, more or less productive, are able to compete with the foreign entrant—market concentration falls when the productivity differential is small. Market concentration increases when the productivity differential becomes sufficiently large. When less productive firms exit—that is, when the foreign entrant drives incumbent firms out of the market—a more productive foreign entrant (to the right of the line $c_h = c_f$) is able to capture a larger market share and, consequently, command a higher markup.

In sum, the entry of a more productive firm leads to the exit of less productive firms, and market concentration scales with productivity differentials. The results also hold as the number of highly productive entrants increases and less productive firms continue to exit the market: concentration rises because the more productive firms—both domestic survivors and foreign entrants—expand their market shares and, consequently, their markups.

Figure 3.3: Markups vs. Relative Productivity



Average firm productivity is typically lower in developing economies, while firms that manage to invest abroad sit in the *upper tail* of their home-country distribution—since crossing borders entails extra fixed costs and risk (Edmond, Midrigan and Xu, 2023, and subsequent work). The model therefore predicts that the foreign-domestic cost gap c_h/c_f is widest in poorer countries and narrows with development. As we show below, wider gaps translate into higher mark-ups and larger rents; hence the distributional stakes of MNC entry are greatest where domestic industry is weakest.

Greater output, higher average productivity, and lower prices benefit consumers, while potential technology transfers from F can spur innovation by H firms, upgrade skills, and raise long-run productivity. Yet these gains may be accompanied by job losses among L firms, a concentration of market power, and higher markups or rents when productivity differentials are large. Because productivity gaps tend to be widest in developing countries, markups and rents are correspondingly larger there; they decline as the gap narrows in richer economies where incumbents can match F's competitive challenge. The subsequent sections

trace how the effects of foreign entry on economic and political outcomes vary across the development spectrum.

3.3 Risk and Endogenous MNC entry

We may characterize a foreign investor's decision to enter and operate in a foreign market as the outcome of a strategic interaction between an MNC and the host government. The MNC—regardless of its investment motivation, whether to procure inputs, serve domestic consumers, or establish a platform for exports to third countries—identifies a potential target location abroad. Entry decisions are influenced by both economic and political conditions in the host country, as well as by the host government's realized and anticipated behavior.

Foreign investors typically consider the availability of resources and complementary endowments, local demand for the firm's products, supplier networks, infrastructure, and related factors (Markusen, 1995). The costs of entering and doing business in a foreign jurisdiction include protecting proprietary assets, managing a foreign workforce, learning about consumer preferences, and suffering potential scale inefficiencies at the plant level (Caves, 1996; Helpman, 2006; Lipsey, 2003; Markusen, 1995).

Politics in the host country can further raise the costs of doing business. These are typically referred to as non-market political risks, and include political and policy instability, outright expropriation, or more subtle forms of creeping expropriation such as tax increases or regulatory changes (Graham, Johnston and Kingsley, 2017; Kobrin, 1984). Investors also face contractual risks arising from their relationships with workers, buyers, clients, suppliers, and partners (Antràs, 2003; Antràs and Helpman, 2004; Antràs, Desai and Foley, 2009; Bernard, Jensen, Redding and Schott, 2010; Henisz, 2002; Pinto and Weymouth, 2016).

These politically induced costs can be conceptualized as the wedge between the expected market return on investment and the risk-adjusted rate of return in the foreign market. An MNC will choose to incur these entry costs if the risk-adjusted expected returns from investing abroad exceed the opportunity cost of investing at home or in third countries—that

is, its reservation value. Consequently, these additional costs raise the productivity threshold required for market entry.

Introducing a temporal component adds another source of uncertainty and risk to the foreign investment decision by an MNC. When the cost of redeploying assets is high, host governments may become more tempted to act opportunistically. This is the core of the obsolescing bargain theory, which holds that the bargaining power of foreign investors erodes over time as their investments become increasingly embedded in the host economy, creating incentives for governments to extract greater value post-entry (Vernon, 1971).[4]

In a dynamic setting, compensatory mechanisms often emerge in equilibrium, conditioning on the circumstances under which governments exhibit opportunistic behavior when investors face high asset redeployment costs. Foreign investors and host governments may bargain over how to share the rents generated by the investment—for instance, by converting part of those rents into taxes or public services. Establishing a rent-sharing mechanism can mitigate the commitment problem and generate significant economic and political benefits for the host country (Jensen et al., 2012; Pinto and Pinto, 2008, 2011).

In summary, MNC entry is an endogenous process shaped by complex strategic interactions between investors and host governments. The outcome is contingent on prevailing economic and political contexts. All else being equal, firms with higher productivity, greater patience, risk neutrality (or risk tolerance), and superior risk-mitigation capabilities (e.g., experience in uncertain environments or access to local knowledge) are more likely to enter politically risky environments. Although firms generally prefer to minimize exposure to political and policy risks, such risks can serve as entry barriers that deter less capable competitors. In such settings, the opportunity for rent creation and extraction may outweigh the costs, justifying entry for some investors—though not all.

[4]In addition to political instability and uncertainty, the political orientation of the incumbent government can also affect investment decisions. See Jensen, Biglaiser, Li, Malesky, Pinto, Pinto and Staats (2012); Pandya (2014*a*,*b*); Pinto (2013*a*); Pinto and Pinto (2008, 2011); Pinto and Weymouth (2016); Pinto (2004), among others.

Descriptive statistics presented in Chapter 2 support the view that MNC entry is endogenous. Multinationals are not uniformly deterred by weak institutions or high political risk. As the data show, FDI inflows vary significantly across countries with similar levels of institutional quality and political risk.

3.4 Investment Motivation, Market Concentration, and Rent Extraction

FDI is commonly classified by motivation into three categories: resource-seeking, market-seeking, and efficiency-seeking. While each type of FDI can have distinct economic effects, the entry and expansion of highly productive MNCs into developing countries can reshape market structures and influence the dynamics of rent creation—regardless of their underlying motivation.

Resource-seeking FDI is primarily motivated by access to natural resources in the host country, such as Shell and Chevron's investments in Nigeria. The literature frequently associates rent creation with this type of FDI. Resource-extractive sectors are typically characterized by high capital intensity, steep upfront costs, economies of scale, and asset specificity—factors that act as barriers to entry and lead to concentrated markets (UNCTAD, 2007; Wright and Zhu, 2018). For instance, three firms control 74% of global iron ore production for export, while the ten largest companies produce roughly 41% of global oil and gas output (UNCTAD, 2007). Most developing countries lack the financial resources, technology, and managerial expertise necessary to fully exploit their natural resource endowments (Shafer, 1994; UNCTAD, 2007). MNCs fill this gap by bringing capital, advanced technologies, and operational know-how, thereby enabling host countries to more effectively extract and monetize resource rents.

Trade liberalization further facilitates resource-seeking FDI by lowering barriers to exporting raw materials and intermediate commodities. When highly productive foreign firms with superior extraction technologies enter resource-rich economies, they are better equipped

to exploit local resources for export or domestic sale, often increasing the overall volume of rents. Mining firms such as Glencore and Freeport-McMoRan, for example, have developed extensive operations in the Democratic Republic of Congo, capturing substantial rents from cobalt and copper extraction despite persistent corruption, political instability, and conflict-related violence (Ross, 2004).

A distinctive feature of extractive industries lies in the structure of ownership and control over natural resources: states typically retain subsoil rights, regulate the granting of concessions, and oversee national companies responsible for extracting and marketing oil, gas, and minerals. When more productive firms enter the sector, the rents generated through resource extraction—including export revenues—are often appropriated by those firms and by government elites, rather than being distributed broadly to the citizenry. In countries such as Angola, Nigeria, and Venezuela, resource revenues can constitute more than half of total government income. This centralized and non-tax-based revenue stream heightens rent-seeking behavior and undermines incentives to develop transparent and accountable institutions.

This rent creation dynamic associated with foreign investment is likely to happen in other economic activities beyond resource-seeking FDI and the natural resource sector. Market-seeking FDI—also known as horizontal FDI—is driven by the desire to serve consumers in the host country. Such investments typically arise when trade costs are high or protectionist policies limit imports. Multinationals establish local production facilities to bypass tariffs, quotas, or other barriers to market access (Blonigen, 1997; Brainard, 1997). Automotive companies like Volkswagen and General Motors, for instance, established plants in Brazil and Argentina in response to high import tariffs and industrial policy incentives. Firms in this category often exploit factor-cost advantages, productivity differentials, or product specialization to establish dominant market positions and secure economic rents (Helpman, 2014; Markusen, 1995; Melitz and Ottaviano, 2008). Pharmaceutical MNCs exemplify this dynamic, using patent protections and strong brand recognition to insulate

themselves from competitive and governance-related risks in emerging markets (Kyle, 2007).

Efficiency-seeking FDI—often referred to as vertical or export-platform FDI—involves establishing production in one country primarily to serve third-country markets. These investments exploit comparative advantages, favorable trade policies, and proximity to key markets (Ekholm, Forslid and Markusen, 2007; Markusen, 1995). Vertical FDI is particularly attractive when wage differentials lower the cost of producing intermediate goods (see Helpman, 2014, 10). Relatedly, GVC-oriented FDI fragments production across multiple locations to optimize comparative advantages, cost efficiencies, regulatory conditions, and technological capacities (Alfaro et al., 2019; Antràs and Chor, 2013; Gereffi, 2011). Electronics manufacturers such as Samsung and Intel, for example, have invested heavily in Vietnam, using it as a low-cost export platform benefitting from favorable trade agreements and strategic proximity to regional and global markets. Firms engaged in these forms of FDI tend to be highly productive and globally competitive relative to domestic firms in host countries. Through specialization, economies of scale, and access to global markets, they can raise markups and capture substantial rents (Hanson, Mataloni and Slaughter, 2005).

In summary, when productivity differentials between foreign and domestic firms are substantial, the entry and presence of MNCs—whether resource-seeking, market-seeking, or efficiency-seeking—can displace indigenous firms, resulting in varying degrees of market concentration and rent creation.

3.5 MNCs, Rent Extraction, and Political Ramifications

In the preceding sections, we introduced a theoretical framework identifying the conditions under which the entry and presence of highly efficient MNCs can crowd out domestic firms, increase market concentration, and contribute to rent creation. In developing countries the productivity differential between MNCs and domestic firms is large, we are likely to observe a rent generation effect. High rents due to rising markups and reduced competition

incentivize actors at various levels to appropriate, control, and compete over them, which may result in bad political outcomes.

In this book, we embed the rent-creation effect of FDI into a political economy model of rent contestation, and examine three political outcomes: corruption, civil conflict, and leadership turnover. We choose these three political outcomes because each of them represents a direct consequence of different forms of appropriating, controlling, and competing over economic rents. High rents induce rent-seeking activities that can take an illicit form. One direct outcome is corruption, because high rents, on the one hand, increase the value of government goods and services and thus the incentives of government officials who are in charge of regulating and delivering these goods and services to demand bribes, and on the other hand, increase the ability of firms to internalize the extra of doing business. High rents also increase the size of spoils and the value of capturing the state. Outsiders or opposition groups are thus motivated to launch a challenge to the incumbent, which may take a violent form such as armed conflict or nonviolent form such as a leadership turnover. As a result, we should expect FDI inflows to increase corruption, civil conflict, and leadership turnover in developing countries.

Nonetheless, the extent of these effects is likely to be moderated by the host countries' economic, political, and institutional conditions. For corruption, the risk of detection and punishment is vital to reduce corruption. Therefore, we focus on the quality of political and legal institutions in host countries. For conflict and leadership turnover, we argue that state capacity and public goods provision serve to reduce the risk. States with strong capacity are able to collect and control the rents through taxation, royalties, and other regulatory mechanisms. Furthermore, when the economic rents are in the government's control, strong states are able to invest them to strengthen their deterrence capacity to fend off challengers. Finally, strong states are able to channel the rents into public goods that relief citizens' grievances and promote a productive economy. Consequently, outsiders and opposition groups have less incentive to challenge the incumbent, either violently or

nonviolently.

In successive chapters of the book, we further elaborate the theoretical framework as it applies to different economic and political consequences of foreign investment in developing countries, and subject our conjectures to systematic empirical tests: In particular, we first evaluate whether FDI inflows and MNC activity contribute to market concentration and high rent extraction in developing countries. We then aim to corroborate whether increased inward FDI is linked to rising corruption, the onset of civil conflict, and high leadership turnover in developing economies and examine the economic, political, and institutional factors that mitigate these adverse effects.

Chapter 4

Foreign Direct Investment and Market Concentration

4.1 Introduction

In this chapter, we empirically examine the relationship between inward FDI and market concentration in host countries. In Chapter 3, our formal model demonstrates that the impact of foreign entrants on market dynamics hinges on the productivity differential between foreign entrants and indigenous firms. In developing countries, where this differential tends to be large, the entry and presence of MNCs often drive domestic firms out of business, thereby increasing market concentration and contributing to rent creation. In contrast, in advanced economies, where domestic firms are better able to compete with foreign entrants, the entry and presence of foreign firms are more likely to enhance competition and dissipate rents. To the extent that economic development serves as a proxy for the competitiveness of domestic firms, we expect higher inward FDI to lead to more concentrated markets in less developed countries.

A central empirical challenge is constructing a measure of market concentration across a large number of countries. This is a daunting task because it requires detailed firm-level data, which are not readily accessible for most economies. We address this challenge by

leveraging firm-level financial data from the Bureau van Dijk's Orbis database (now Moody's) and the World Bank's Enterprise Survey (WBES) to construct two alternative measures of market concentration in a panel and cross-sectional setting, respectively. The results provide strong support for our argument that inward FDI contributes to market concentration in developing countries, and that this positive relationship weakens—or even turns negative—as host countries' levels of development increase.

The remainder of the chapter is organized as follows. The next section reviews the existing literature on FDI, market structures, and firm- or industry-level markups in host countries. We then describe in detail the construction of our market concentration measures. This is followed by a systematic empirical analysis of the relationship between FDI inflows and market concentration. The chapter concludes by summarizing the findings and discussing their implications.

4.2 Related Research

Existing empirical research on FDI and market concentration primarily relies on single-country studies, largely due to the lack of cross-national measures of market concentration. Constructing such measures requires detailed firm-level financial data across a large number of countries. However, these data, especially for non-listed firms, are often confidential and not readily accessible. This poses a significant obstacle to the empirical cross-national examination of FDI and market concentration.

In an earlier study, Lall (1979*b*) argues that the presence of MNCs increases market concentration in less developed countries by raising entry barriers for potential entrants and by adopting tactics such as takeovers and lobbying for favorable policies. Using industry-level data from Malaysia, he shows that MNC presence is strongly correlated with market concentration, measured by the four-firm concentration ratio (CR4).

Forte (2016) reviews 13 studies published between 1979 and 2014.[1] These include Lall

[1]See Forte (2016) for details.

(1979*b*) on Malaysia, Blomström (1986) on Mexico, Bourlakis (1987) on Greece, Willmore (1989) on Brazil, Cho (1990) on Indonesia, Driffield (2001*a*,*b*) on the United Kingdom, Yun (2001) on Korea, Amess and Roberts (2005) on Poland, Rutkowski (2006) on 13 Central and Eastern European Countries (CEECs), Singh (2011) on India, Adam and Khalifah (2012) on Malaysia, and Forte and Sarmento (2014) on Portugal.

Most of these studies adopt a within-country research design, examining variation in market concentration across industries. Concentration is typically measured using either the N-firm concentration ratio (e.g., CR3, CR4, or CR5) or the Herfindahl-Hirschman Index (HHI). The independent variable is commonly operationalized as the foreign share of employment, gross output, sales, or assets. Among the 13 studies reviewed, seven find a positive relationship between foreign presence and market concentration—all based on data from developing countries. Three studies, focusing on developed countries (the United Kingdom and Portugal), report a negative relationship. Amess and Roberts (2005), using Polish manufacturing firm data from 1989 to 1993, identify a U-shaped relationship between the foreign share of industry output and concentration.

In addition to the aforementioned studies, Ratnayake (1999) finds that foreign ownership increased market concentration in New Zealand following substantial liberalization in the mid-1980s. A more recent study by Zhu (2017) on China demonstrates a significant positive effect of MNC presence on market concentration.

Other studies have examined the impact of FDI on firm or industry markups, which serve as indicators of firms' market power and the level of competition. For instance, Chung (2001) analyzes U.S. manufacturing firms from 1987 to 1991 and finds that foreign presence significantly decreases incumbent firms' price-cost markups—especially for those located further away from foreign investments.[2] Sembenelli and Siotis (2008) utilize data from Spanish firms from 1983 to 1996 and reveal that foreign presence has a short-term negative

[2]One speculative explanation offered in the article suggests that stronger firms choose to locate further away from investments to take advantage of lower input prices, enabling them to charge lower prices, while weaker firms choose to be closer to benefit from positive spillovers.

effect on firms' markups in non-R&D-intensive sectors, while it has a dominant positive effect in R&D-intensive sectors. In another study, Weche (2018) analyzes both imports and FDI in six European countries (Croatia, France, Hungary, Ireland, Slovenia, and the UK), finding that imports dampen firms' markups, but FDI does not exhibit a clear effect on markups in the pooled sample. The effect of FDI shows strong heterogeneity across countries. A recent study by Yang (2023) illustrates that firms in industries with a higher level of foreign presence enjoy higher markups in China.

Evidence from existing single-country studies suggests that the entry and presence of MNCs contribute to market concentration and high firm markups—particularly in developing countries—although the evidence is not conclusive. To date, there has been a lack of systematic *cross-national* research on this topic, however. The study most closely related to ours is Rutkowski (2006). Rutkowski leverages the Business Environment and Enterprise Performance Survey (BEEPS) and uses responses to a survey question—"Thinking of your firm's major product line or main line of services in the domestic market, how many competitors do you face?"—to construct two measures of market concentration at the sector level.[3] He finds that sectors with a higher level of FDI stocks are associated with a lower level of market concentration in these countries. Note that Rutkowski's (2006) measures of market concentration are based on survey responses—a noticeable difference from other studies that rely on firm-level financial data.

We contribute to this literature by examining the relationship between FDI and market concentration in a much larger set of countries—including both developed and developing countries—and utilizing the most fine-grained firm-level financial data available.

4.3 Constructing Market Concentration Measures

Constructing a cross-national time-series measure of market concentration is a daunting task. To address this challenge, we rely on the Orbis database, which is widely regarded as

[3]These measures, labeled *CONCEN* and *CONCEN2*, are coded as follows: *CONCEN* is coded as 1 if the respondent answered four or fewer players and 0 otherwise, while *CONCEN2* is coded as 2 if the answer was 0 (indicating a monopoly), 1 if there were 1 to 4 competitors, and 0 if there were more than four competitors.

the industry standard for firm registry data. Orbis compiles information primarily from official sources and private vendors and supplements it with data from annual reports, company websites, private correspondence, and press releases. The database includes approximately 200 million firms globally and provides detailed financial and ownership data whenever available (Bajgar et al., 2020).

We query annual operating revenue data for all firms with a BvD number (a unique firm identifier) from Orbis's historical archive. After excluding observations with missing revenue data, we obtain roughly 180 million firm-year records covering the period from 1979 to 2022. The number of firm-level observations varies widely across country-years—ranging from 0 to 4.4 million. This wide range reflects both the size of national economies—smaller and developing countries naturally host fewer firms—and differences in data reporting quality across countries and over time.

It is important to emphasize the limitations of the Orbis data. While it covers a vast number of firms worldwide, the representativeness of the data for any given country is uncertain. Bajgar et al. (2020) assess Orbis coverage and representativeness using the OECD STAN dataset as a benchmark. They find that Orbis is skewed toward larger, older, and more productive firms. Moreover, coverage varies both across countries and over time. When restricting the sample to country-years with at least 5,000 observations, representativeness improves substantially. Nonetheless, they conclude that Orbis remains the best available option for cross-national research.

Following Bajgar et al.'s (2020) assessment, we implement two thresholds—1,000 and 5,000 firms per country-year—to define sufficient coverage. The lower threshold is chosen given our focus on non-OECD countries, which typically have smaller firm populations. The 5,000-firm threshold is used in robustness checks.[4] We also drop any country-year observations where the market concentration value lies more than three standard deviations from

[4]Applying the 5,000 threshold reduces the sample size by about one-fourth and the number of countries from 63 to 52.

the country-specific mean. This step mitigates the risk that abrupt changes in concentration reflect data irregularities or shifts in reporting coverage rather than actual market dynamics.

Table 4.1: List of Countries in the Orbis Sample

Counry	N	Start Year	End Year	Counry	N	Start Year	End Year
Albania	4	2014	2018	Lebanon	2	2016	2017
Algeria	8	2010	2017	Lithuania	17	2002	2018
Argentina	3	2016	2018	Luxembourg	15	2004	2018
Australia	12	2004	2018	Macedonia	8	2007	2018
Austria	15	2004	2018	Malaysia	20	1999	2018
Belarus	13	2001	2018	Mauritius	2	2017	2018
Belgium	28	1991	2018	Mexico	12	2006	2018
Brazil	11	2008	2018	Moldova	6	2012	2018
Bulgaria	24	1995	2018	Montenegro	6	2013	2018
Cameroon	1	2016	2016	Morocco	8	2011	2018
Canada	18	2001	2018	Netherlands	26	1993	2018
Chile	6	2013	2018	New Zealand	8	2011	2018
China	20	1999	2018	Norway	24	1995	2018
Colombia	14	2005	2018	Philippines	13	2005	2018
Croatia	21	1998	2018	Poland	23	1996	2018
Cyprus	13	2006	2018	Portugal	22	1997	2018
Czech Republic	22	1997	2018	Romania	24	1995	2018
Denmark	19	2000	2018	Russia	22	1997	2018
Egypt	11	2003	2018	Saudi Arabia	10	2009	2018
Estonia	7	2012	2018	Serbia	11	2008	2018
Finland	24	1995	2018	Singapore	19	2000	2018
France	24	1995	2018	Slovakia	20	1999	2018
Georgia	3	2013	2018	Slovenia	17	2002	2018
Germay	26	1993	2018	Spain	28	1991	2018
Greece	24	1995	2018	Sweden	22	1997	2018
Hungary	22	1997	2018	Thailand	18	2001	2018
India	1	2014	2014	Turkey	15	2004	2018
Indonesia	14	2005	2018	Ukraine	20	1999	2018
Ireland	13	2006	2018	United Arab Emirates	8	2011	2018
Israel	12	2006	2017	United Kingdom	36	1983	2018
Italy	28	1991	2018	United States	33	1986	2018
Japan	28	1991	2018	Uruguay	4	2013	2018
Kazakhstan	9	2010	2018	Uzbekistan	2	2017	2018
Korea, Republic of	26	1993	2018	Vietnam	12	2007	2018
Latvia	16	2003	2018				

We construct two widely used measures of market concentration: the Herfindahl–Hirschman

Index (HHI)[5] and the four-firm concentration ratio (CR4).[6] For each country-year, we first compute HHI and CR4 at the three-digit industry level and then aggregate them to the national level using each industry's share of total operating revenue as weights.

Table 4.1 lists the countries included in our sample for which reliable market concentration measures are available. The sample is skewed toward developed and more industrialized developing countries, reflecting the uneven coverage and quality of firm-level data across countries in the Orbis database.

4.4 Empirical Analysis

To empirically examine the relationship between FDI and market concentration, we estimate the following model:

$$\begin{aligned} Concentration_{i,t} &= \beta_1 \cdot FDI_{i,t} + \beta_2 \cdot (FDI_{i,t} \times GDP\ PC_{i,t}) \\ &\quad + \beta_3 \cdot GDP\ PC_{i,t} + X_{i,t} \cdot \xi + \varepsilon_{i,t} \end{aligned} \tag{4.1}$$

$Concentration_{i,t}$ is a measure of market concentration in country i in year t. $FDI_{i,t}$ is the main explanatory variable, and $GDP\ PC_{i,t}$ is the moderator. β_1, β_2, and β_3 are the coefficients to be estimated for the FDI variable, the interaction term, and the moderator, respectively. $X_{i,t}$ is a matrix of control variables derived from the empirical literature on the determinants of market concentration, and ξ is a vector of coefficients to be estimated. $\varepsilon_{i,t}$ is the error term.

Independent and Control Variables

Our main independent variable is annual net FDI inflows per capita, adjusted for purchasing power parity (PPP) to facilitate meaningful cross-country and time-series compar-

[5]HHI is calculated as follows: $HHI = \sum_{i=1}^{n} s_i^2$, where s_i is the market share of firm i, and n is the number of firms in the market.

[6]CR4 is calculated as CR4 $= \frac{s_1+s_2+s_3+s_4}{\sum_{i=1}^{n} s_i}$, where s_i is the market share of firm i, and n is the total number of firms in the market.

isons. Net FDI inflows represent the total amount of foreign investment received by a country in a given year, minus divestments (i.e., when foreign firms withdraw capital). It is important to note that net FDI inflows are not the difference between inward and outward FDI flows. Net inflows can take negative values if divestments exceed new investments in a given year.

An alternative measure commonly used in the literature is FDI stocks, which capture the cumulative value of foreign investment in a host country at a given point in time. We opt to use FDI inflows rather than FDI stocks as our primary explanatory variable for both theoretical and practical reasons. Theoretically, FDI inflows reflect year-to-year changes in foreign investment activity, allowing us to better capture the entry or exit of foreign firms as well as the expansion or contraction of MNC operations. By contrast, FDI stocks are more reflective of the overall presence of MNCs in the host country (Kerner, 2014).

From a data perspective, FDI inflows are available over a longer time span, beginning in 1970, whereas data on FDI stocks begin only in 1980. Nevertheless, our core findings remain robust when we substitute FDI stocks for inflows as the main independent variable.[7]

To address the highly skewed distribution of FDI inflows, which includes both very large positive values and negative observations, we apply a cubic root transformation to the variable.[8] FDI data come from United Nations Conference on Trade and Development's (UNCTAD) Data Hub.

We use the level of GDP per capita (PPP-adjusted) as a proxy for the competitiveness of incumbent firms and expect a negative coefficient for the interaction term between FDI and GDP per capita.[9] We control for state capacity using two proxies: relative political ex-

[7]Throughout this book, we use real FDI inflows per capita as the primary independent variable, with real FDI stocks per capita used for robustness checks.

[8]Because the distribution of FDI inflows is highly skewed and contains negative values, a log transformation is not appropriate. One common workaround is to add a small positive constant before applying a logarithmic transformation. However, this approach alters the meaning of the FDI variable by rendering all values artificially positive and introduces arbitrariness in the choice of constant. We therefore adopt a cubic root transformation, which accommodates both positive and negative values while preserving the relative spacing of the data (see Wright and Zhu, 2018).

[9]Data come from the Penn World Table 10.01.

traction (RPE)[10] and infant mortality (Esty, Goldstone, Gurr, Harff, Levy, Dabelko, Surko and Unger, 1998; Hanson, 2015). We expect stronger states to possess greater administrative and legal capacity to enforce antitrust laws, making them more effective in curbing monopolistic or oligopolistic practices and fostering market competition. Similarly, more democratic governments are expected to be better positioned to constrain market concentration, as monopolies and oligopolies reduce consumer welfare and may jeopardize the electoral prospects of incumbent politicians (Li and Resnick, 2003, 182).

In addition, we control for the size of the economy, measured by GDP (PPP-adjusted), and the economic growth rate.[11] Larger economies and faster growth are expected to diminish the influence of a few dominant players by fostering greater market entry and competition. Unlike FDI, exposure to international trade is expected to promote market competition and reduce firm markups (Edmond, Midrigan and Xu, 2015; Pavcnik, 2002; Trefler, 2004). In contrast, countries endowed with natural resources are more likely to exhibit monopolistic or oligopolistic market structures due to the inherent characteristics of natural monopolies—high capital intensity, technological barriers to entry, and large fixed costs—as well as the negative spillover effects of the resource sector on the rest of the economy (Robinson, Torvik and Verdier, 2006).[12] To mitigate concerns of endogeneity, all right-hand-side variables in all model specifications are lagged by one year.

Results

We start with the HHI measure.[13] Model 1 in Table 4.2 presents results from a random-effects model with standard errors clustered at the country level.[14]

[10]Data from Arbetman-Rabinowitz, Fisunoglu, Kugler, Abdollahian, Johnson, Kang and Yang (2013). This variable is discussed in detail in Chapters 6 and 7.

[11]Real GDP data come from the Penn World Table 10.01, and annual GDP growth rate data come from the World Bank's *World Development Indicators*. We take the natural logarithm and cubic root of these two variables, respectively, to address their skewed distributions.

[12]Trade openness is measured by the sum of exports and imports divided by GDP. Natural resource endowments are measured by total natural resource rents as a percentage of GDP (including oil, natural gas, coal, minerals, and forests). Both indicators are from the *World Development Indicators*.

[13]We multiply HHI by a factor of 100 to improve the readability of the estimated coefficients.

[14]A Portmanteau test for panel serial correlation cannot reject the null hypothesis that there is no autocorrelation of any order.

Table 4.2: FDI Inflows and Market Concentration

	HHI			CR4		
	(1)	(2)	(3)	(4)	(5)	(6)
FDI Inflows PC	0.14	0.81**	0.66**	0.05	0.83**	0.65**
	(0.08)	(0.34)	(0.32)	(0.09)	(0.35)	(0.31)
FDI × GDP PC		-0.31**	-0.27**		-0.36**	-0.29**
		(0.14)	(0.12)		(0.15)	(0.12)
GDP PC	22.27***	24.27***	74.60***	23.59***	25.75***	83.43***
	(4.72)	(4.37)	(12.91)	(6.15)	(5.79)	(14.06)
RPE	-0.70	-1.86	-4.37	-4.25	-5.40	-8.83
	(6.39)	(6.42)	(7.24)	(8.08)	(8.14)	(8.73)
Infant Mortality	28.24***	28.33***	26.43***	32.59***	32.66***	30.30***
	(4.13)	(4.09)	(5.15)	(5.29)	(5.28)	(6.00)
Democracy	0.14	0.12	-0.18	0.48	0.46	0.05
	(0.24)	(0.24)	(0.18)	(0.31)	(0.30)	(0.28)
GDP	-10.17***	-10.11***	-64.74***	-11.11***	-10.93***	-75.13***
	(1.41)	(1.40)	(11.91)	(1.54)	(1.51)	(12.47)
Growth Rate	-0.40	-0.51*	-0.49	-0.36	-0.50	-0.49
	(0.32)	(0.31)	(0.33)	(0.37)	(0.35)	(0.39)
Trade Openness	-15.08***	-15.06***	-18.02***	-15.52***	-15.36***	-17.84***
	(3.93)	(3.88)	(4.94)	(5.17)	(5.14)	(6.18)
Resource Rents	-3.92	-3.78	0.42	-4.52	-4.40	1.82
	(2.58)	(2.57)	(2.83)	(3.19)	(3.17)	(3.13)
Constant	150.06***	144.52***	814.98***	184.31***	176.28***	961.86***
	(30.65)	(29.30)	(144.04)	(38.52)	(37.33)	(147.36)
N	907	907	907	921	921	921
Number of Countries	63	63	63	63	63	63
R^2 (within)	0.46	0.47	0.52	0.47	0.47	0.54
R^2 (between)	0.00	0.00	0.04	0.01	0.01	0.02
R^2 (overall)	0.06	0.06	0.05	0.04	0.04	0.03
Country FEs	No	No	Yes	No	No	Yes

Notes: Clustered standard errors in parentheses;
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

The coefficient of FDI is positive but not statistically significant. This linear specification overlooks the heterogeneous effect of FDI on market concentration in developing and developed countries, however. Our argument suggests that FDI is more likely to increase market concentration in developing countries, where domestic firms are small and technologically backward. Conversely, it is more likely to foster market competition in developed

countries, where domestic firms are large and technologically advanced.

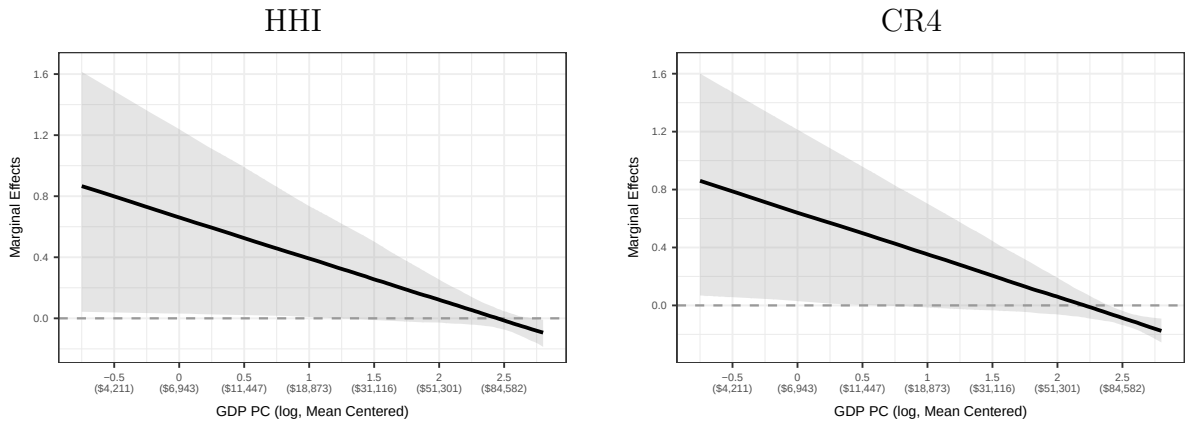
To examine this nonlinear hypothesis, Model 2 introduces an interaction term between FDI and per capita GDP—our proxy for the competitiveness of a country's domestic firms. The results yield a positive coefficient for FDI and a negative coefficient for the interaction term, both statistically significant. These findings support our argument that the effect of FDI on market concentration varies with the level of economic development. Model 3 includes country fixed effects to account for unobserved heterogeneity across countries, and the results remain consistent.

In models with interaction terms, the marginal effect of FDI depends on the level of GDP per capita. For ease of interpretation, we visualize the marginal effects of FDI on market concentration in the left panel of Figure 4.1. These effects are simulated based on the coefficients estimated in Model 3. The figure clearly demonstrates that FDI has a significant positive effect on market concentration in less developed countries and that this effect diminishes and eventually turns negative as GDP per capita increases.

Substantively, if real per capita GDP (mean-centered) is held at -0.01 ($6,861, corresponding to Syria in 1993)—the median value below the threshold at which the marginal effect of FDI turns negative—a one standard deviation increase in real per capita FDI ($109) increases market concentration by 3.14 units. This effect represents approximately 20% of the standard deviation of the HHI variable, indicating a substantively large impact. The marginal effect is statistically significant at the 95% level. Conversely, when real per capita GDP is set at 2.70 ($103,778, corresponding approximately to Ireland in 2020), the same increase in real per capita FDI is associated with a 0.32-unit decrease in market concentration, equivalent to about 2% of the standard deviation of the HHI variable. This latter effect is statistically significant at the 90% level.

In Models 4–6, we replicate the specifications from Models 1–3 using an alternative measure of market concentration—the four-firm concentration ratio (CR4). The results remain consistent: the coefficient for FDI is positive, while the coefficient for the interaction

Figure 4.1: Marginal Effects of FDI Inflows on Market Concentration



Notes: Plots show the marginal effects of real FDI inflows per capita on market concentration across levels of real GDP per capita, based on estimates from Models 3 and 6 in Table 4.2. Shaded areas indicate 95% confidence intervals, derived from 1,000 simulations.

term is negative, and both are statistically significant. The right panel of Figure 4.1 displays the simulated marginal effects of FDI based on the estimates from Model 6. The pattern closely resembles that shown in the left panel. When measured by CR4, FDI appears to have an even stronger negative effect on market concentration in developed countries.

Regarding the results of other control variables in Models 3 and 6 with country fixed effects (our preferred model specification),[15] real GDP per capita is positively and significantly associated with market concentration. This result contrasts with the findings of Mitton (2008), whose cross-country analysis reports a negative correlation between GDP per capita and market concentration. It is important to note that our results are primarily driven by within-country variation. Moreover, the broader empirical evidence on the relationship between economic development and market concentration remains mixed. Recent studies suggest that industries in advanced economies have become increasingly concentrated, partly due to rising investments in intangible assets that disproportionately benefit large firms, allowing them to expand their market shares and entrench their dominance (Bajgar, Criscuolo and Timmis, 2025).

[15] As shown in the table, our models explain more within-country than between-country variation in market concentration.

In contrast, large economies and trade openness are associated with lower market concentration. High economic growth also shows a negative relationship, although its coefficient is not statistically significant. These results are consistent with theoretical expectations. Larger economies tend to support a greater number of firms, thereby fostering competition and reducing the dominance of any single firm. Trade liberalization, by lowering trade barriers and regulatory constraints, intensifies product market competition, erodes the market power of incumbent firms, and improves resource allocation and efficiency (Edmond, Midrigan and Xu, 2015; Pavcnik, 2002; Trefler, 2004). This highlights a key difference between trade openness and FDI, as discussed in Chapter 2. Finally, democracy and natural resource endowments do not appear to have a significant effect on market concentration.

In the Appendix, we re-estimate the models using real FDI stocks per capita as the independent variable. Overall, the results are consistent with our expectations, although they are somewhat weaker when market concentration is measured by CR4 (see Table 4.3 and Figure 4.3). In Tables 4.5 and 4.6, we present results that exclude country-years with fewer than 5,000 firms recorded in the Orbis database. Using this higher threshold improves the representativeness of the Orbis data (Bajgar et al., 2020) and thereby enhances the validity of the concentration measures. The tradeoff, however, is a reduction in sample size by approximately one-fourth. Nonetheless, we actually obtain stronger results, particularly when FDI stocks per capita is used as the independent variable.

World Bank Enterprise Survey Sample

In this section, we further evaluate the relationship between inward FDI and market concentration using an alternative sample constructed from the World Bank Enterprise Survey (WBES).[16] We reproduce the empirical analysis presented in Pinto and Zhu (2022) using the most recent version of the dataset. The WBES project has conducted establishment-level surveys in 148 countries since 2002. It employs a standardized sampling methodology designed to generate representative samples of national economies and to minimize measure-

[16]This section is adapted from Pinto and Zhu (2022).

ment error, allowing for cross-country comparability. The World Bank does not implement the survey annually in each country, and the number of completed surveys varies across countries. We use the standardized dataset compiled by the World Bank, which includes surveys conducted between 2006 and 2016.[17]

To construct measures of market concentration using the WBES data, we rely on data on firms' full-time employees.[18] For each survey, we classify firms into three broad sectors: manufacturing; retail and wholesale; and other sectors (predominantly services). We then compute two concentration metrics for each sector: the HHI of employment and the employment share of the top four firms (CR4).[19] Finally, we weight sectoral concentration ratios by each sector's share of national employment and aggregate them to obtain national-level measures of market concentration.

We rely on cross-sectional variation in the WBES data to examine the relationship between inward FDI and market concentration by averaging the measures for each country when multiple surveys are available. Since the World Bank surveys firms in different years across countries, we average all covariates over a 20-year period prior to the latest survey year in each country.[20]

The dataset primarily consists of non-OECD countries,[21] and we therefore focus on developing countries and estimate a linear model. As we have argued, the entry and presence of MNCs in developing countries are likely to crowd domestic firms out of the market, thereby

[17]We use this version to maintain consistency with our previous study (Pinto and Zhu, 2022). The standardized version aligns all variables with the latest standardized questionnaire. Results remain consistent if surveys conducted before 2006 are included.

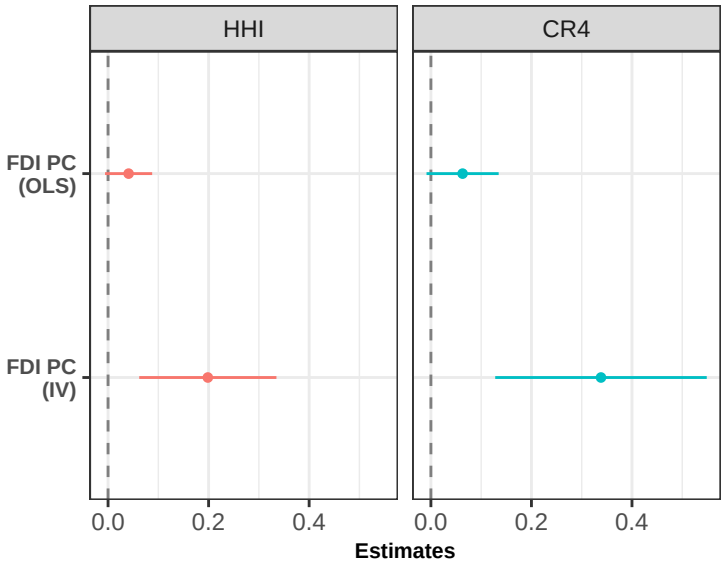
[18]The WBES also reports sales data, but we use employment because its coverage is significantly better. Of the 117,480 observations, 15,532 (13%) have missing sales data, whereas only 817 (0.7%) are missing employment data.

[19]Ideally, we would calculate concentration at the two-digit industry level. However, the number of observations at that level is too small to allow meaningful estimation. The broad sectoral classification follows the WBES sampling strategy, which stratifies all industries into several manufacturing subgroups, two service sectors (retail and wholesale), and a residual category. See the WBES implementation notes.

[20]The number of completed surveys per country ranges from one to three. The maximum time span between the earliest and latest survey within a country is 11 years. Averaging covariates over a 20-year period maximizes the number of observations included in the regression analysis.

[21]Turkey and Sweden are the only two OECD countries included.

Figure 4.2: FDI Inflows and Market Concentration (WBES)



Notes: The plots show point estimates and 95% confidence intervals for FDI per capita. Full regression results are reported in Table 4.4 in the Appendix.

contributing to market concentration. Accordingly, we expect a positive coefficient for the FDI PC variable. To maintain consistency with the model specification presented in Pinto and Zhu (2022), we estimate both an OLS model and an instrumental variable (IV) model for each of the two dependent variables: HHI and CR4.[22]

Figure 4.2 presents the point estimates and 95% confidence intervals for FDI per capita across the four model specifications. The coefficient on FDI is positive and statistically significant at the 10% level in the two OLS models, where HHI and CR4 are used as the dependent variables, respectively. After accounting for endogeneity in the IV models, the magnitude of the FDI PC coefficient increases substantially and becomes highly statistically significant. These results are consistent with our expectation that FDI inflows into developing countries lead to increased market concentration.

Substantively, all else being equal, a one standard deviation increase in real FDI inflows per capita ($18) raises market concentration by 0.52 units, which corresponds to 75.4% of

[22]The instrumental variable, which we discuss in detail in the next chapter, is the weighted geographic distance between a host country and the world's richest 20 economies, measured by GDP per capita. See Pinto and Zhu (2016, 2022).

the standard deviation of the HHI measure in the sample. In the model where concentration is measured by CR4, the same increase in FDI per capita leads to a 0.89-unit increase in CR4—approximately 82.5% of its sample standard deviation. These marginal effects are substantively large.

4.5 Conclusion

In this chapter, we empirically assess the relationship between inward FDI and market concentration using measures of market concentration constructed from two alternative sources—the Orbis database and the WBES. We find robust evidence that the impact of inward FDI on market concentration in host countries varies by the level of GDP per capita—our proxy for the productivity differential between foreign and domestic firms. In developed countries, where indigenous firms are able to sustain competition with MNCs, FDI inflows are negatively associated with market concentration. In contrast, in developing countries, where domestic firms are typically smaller and technologically less advanced, FDI inflows are strongly and positively correlated with market concentration. These findings seem to support the our argument presented in the previous chapter about the consequences of foreign investment: the results suggest that FDI inflows—and consequently the presence of MNC affiliates—contribute to rent creation in developing countries by reinforcing market concentration.

In the following chapters, we examine the political implications of this rent-creation effect. Specifically, we show that FDI inflows can foster corruption, civil violence, and political instability in developing countries by generating high rents that incentivize actors at various levels to appropriate, control, and compete over them. The ultimate outcomes of such predation and competition, however, depend critically on state capacity and the quality of political and legal institutions.

4.6 Appendix

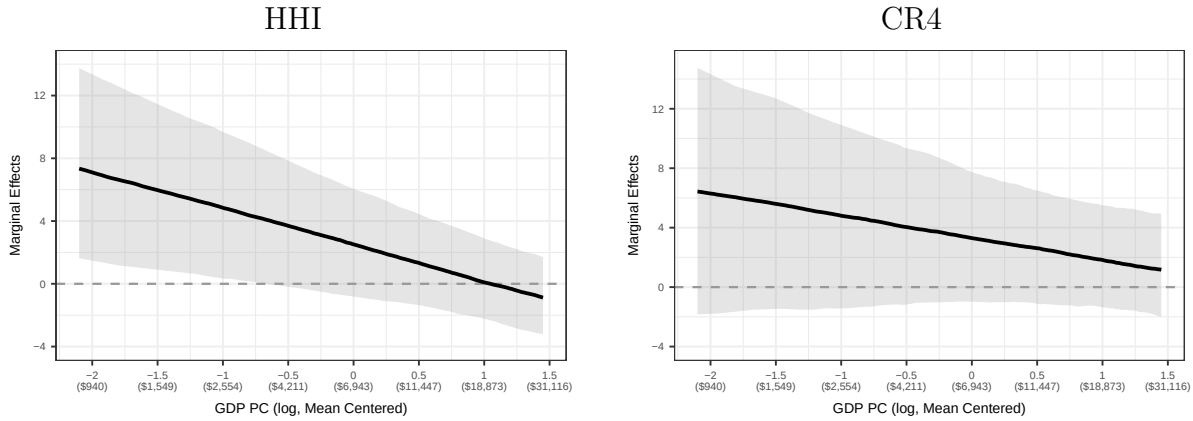
Table 4.3: FDI Stocks and Market Concentration

	HHI			CR4		
	(1)	(2)	(3)	(4)	(5)	(6)
FDI Stocks PC	-3.79***	0.06	2.60	-3.70**	-0.15	3.35
	(1.34)	(1.25)	(1.73)	(1.82)	(1.71)	(2.23)
FDI × GDP PC		-3.12***	-2.36***		-2.78**	-1.42
		(0.70)	(0.86)		(1.10)	(1.17)
GDP PC	27.89***	54.38***	77.39***	29.01***	52.42***	84.90***
	(5.03)	(8.25)	(12.16)	(6.43)	(12.31)	(13.64)
RPE	-3.42	-4.44	-5.54	-7.90	-8.56	-8.55
	(6.44)	(5.97)	(6.88)	(8.62)	(8.27)	(9.01)
Infant Mortality	26.70***	27.93***	27.16***	31.07***	32.36***	32.05***
	(4.00)	(4.16)	(5.01)	(5.26)	(5.40)	(5.85)
Democracy	0.19	0.14	-0.14	0.54*	0.49*	0.03
	(0.22)	(0.21)	(0.20)	(0.29)	(0.28)	(0.28)
GDP	-10.42***	-10.10***	-49.95***	-11.35***	-10.96***	-69.05***
	(1.39)	(1.48)	(13.45)	(1.51)	(1.53)	(14.90)
Growth Rate	-0.50	-0.55	-0.42	-0.50	-0.55	-0.41
	(0.36)	(0.34)	(0.36)	(0.41)	(0.39)	(0.41)
Trade Openness	-11.74***	-8.85**	-15.36***	-12.49**	-9.68*	-17.34***
	(4.33)	(4.32)	(5.14)	(5.68)	(5.84)	(6.43)
Resource Rents	-3.34	-3.41	1.36	-3.82	-4.19	2.29
	(2.55)	(2.51)	(2.90)	(3.16)	(3.14)	(3.11)
Constant	169.27***	120.07***	610.74***	203.30***	156.42***	863.74***
	(30.52)	(32.73)	(165.89)	(38.18)	(40.09)	(180.34)
N	901	901	901	915	915	915
Number of Countries	63	63	63	63	63	63
R^2 (within)	0.45	0.49	0.53	0.46	0.48	0.54
R^2 (between)	0.01	0.00	0.03	0.00	0.01	0.01
R^2 (overall)	0.08	0.06	0.05	0.06	0.05	0.02
Year FEs	No	No	Yes	No	No	Yes

Notes: Robust standard errors in parentheses;

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Figure 4.3: Marginal Effects of FDI Stocks on Market Concentration



Notes: Plots show the marginal effects of real FDI stocks per capita on market concentration across levels of real GDP per capita, based on estimates from Models 3 and 6 in Table 4.3. Shaded areas indicate 95% confidence intervals, derived from 1,000 simulations.

Table 4.4: FDI Inflows and Market Concentration (WBES)

	HHI		CR4	
	(1) OLS	(2) IV	(3) OLS	(4) IV
FDI Inflows PC	0.04*	0.20***	0.06*	0.34***
	(0.02)	(0.07)	(0.04)	(0.11)
State Capacity (RPE)	0.08	-0.11	0.23	-0.08
	(0.19)	(0.20)	(0.27)	(0.30)
GDP	-0.19***	-0.23***	-0.32***	-0.40***
	(0.03)	(0.04)	(0.04)	(0.06)
Democracy	-0.02*	-0.04**	-0.02	-0.06**
	(0.01)	(0.02)	(0.02)	(0.03)
Growth Rate	-0.55***	-0.54***	-0.73***	-0.71***
	(0.18)	(0.19)	(0.24)	(0.26)
Resource Rents	-0.18*	-0.00	-0.26*	0.04
	(0.09)	(0.13)	(0.14)	(0.20)
Constant	4.37***	3.98***	7.68***	6.99***
	(0.58)	(0.61)	(0.73)	(0.84)
N	110	110	110	110
R^2	0.34	0.08	0.36	0.04
F-stat (Excluded Instr)		14.94		14.94
$P > F$		0.00		0.00

Notes: Robust standard errors in parentheses;

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Table 4.5: FDI Inflows and Market Concentration (High Threshold)

	HHI			CR4		
	(1)	(2)	(3)	(4)	(5)	(6)
FDI Inflows PC	0.12	0.83**	0.82**	0.07	0.77**	0.77**
	(0.11)	(0.35)	(0.33)	(0.10)	(0.33)	(0.31)
FDI × GDP PC		-0.32**	-0.34**		-0.32**	-0.34***
		(0.14)	(0.13)		(0.13)	(0.12)
GDP PC	17.17***	18.69***	72.54***	18.07**	19.44***	82.28***
	(4.87)	(4.63)	(17.52)	(7.16)	(6.90)	(17.14)
RPE	-3.42	-5.04	-12.11	-8.46	-10.19	-14.88
	(7.23)	(7.18)	(8.74)	(8.66)	(8.63)	(9.90)
Infant Mortality	23.34***	23.06***	20.99***	26.19***	25.78***	20.80***
	(4.06)	(4.02)	(5.61)	(5.37)	(5.38)	(6.68)
Democracy	0.35	0.30	-0.35	0.71**	0.66**	-0.10
	(0.22)	(0.21)	(0.22)	(0.30)	(0.29)	(0.34)
GDP	-6.93***	-6.81***	-67.68***	-9.00***	-8.91***	-81.26***
	(1.33)	(1.33)	(17.50)	(1.74)	(1.75)	(18.16)
Growth Rate	-0.10	-0.25	-0.32	-0.19	-0.35	-0.41
	(0.35)	(0.34)	(0.41)	(0.45)	(0.44)	(0.53)
Trade Openness	-14.01***	-13.98***	-18.10***	-18.74***	-18.74***	-22.19***
	(3.88)	(3.86)	(5.90)	(5.43)	(5.42)	(7.10)
Resource Rents	-8.03***	-8.11***	-3.25	-6.32	-6.39	0.48
	(3.03)	(2.98)	(3.20)	(4.09)	(4.04)	(3.54)
Constant	116.64***	111.99***	872.35***	184.51***	180.81***	1083.64***
	(28.77)	(28.25)	(210.60)	(38.34)	(37.84)	(216.79)
N	694	694	694	698	698	698
Number of Countries	52	52	52	52	52	52
R^2 (within)	0.44	0.45	0.54	0.44	0.44	0.54
R^2 (between)	0.01	0.01	0.01	0.00	0.01	0.00
R^2 (overall)	0.07	0.07	0.04	0.04	0.04	0.02
Country FEs	No	No	Yes	No	No	Yes

Notes: Clustered standard errors in parentheses;

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Table 4.6: FDI Stocks and Market Concentration (High Threshold)

	HHI			CR4		
	(1)	(2)	(3)	(4)	(5)	(6)
FDI Stocks PC	-4.14***	-1.48	3.68*	-3.81*	-0.37	4.85*
	(1.45)	(1.46)	(1.84)	(2.01)	(2.02)	(2.46)
FDI × GDP PC		-2.50***	-2.92***		-3.19***	-2.57**
		(0.91)	(0.91)		(1.22)	(1.28)
GDP PC	24.38***	46.62***	76.19***	24.74***	51.90***	84.53***
	(5.10)	(8.86)	(16.26)	(7.09)	(10.54)	(15.73)
RPE	-5.88	-6.60	-12.55	-11.80	-13.10	-15.07
	(7.30)	(6.63)	(7.88)	(9.18)	(8.35)	(9.21)
Infant Mortality	22.96***	24.06***	22.08***	25.59***	26.29***	22.72***
	(3.92)	(3.98)	(5.31)	(5.38)	(5.41)	(6.41)
Democracy	0.35*	0.27	-0.33	0.75***	0.65**	-0.11
	(0.18)	(0.19)	(0.26)	(0.28)	(0.28)	(0.35)
GDP	-7.23***	-7.00***	-50.31***	-9.22***	-8.92***	-67.57***
	(1.19)	(1.25)	(17.26)	(1.62)	(1.70)	(19.14)
Growth Rate	-0.19	-0.26	-0.17	-0.32	-0.39	-0.28
	(0.40)	(0.39)	(0.43)	(0.50)	(0.49)	(0.53)
Trade Openness	-10.48**	-7.34*	-14.91**	-15.62***	-11.85**	-20.14***
	(4.14)	(4.22)	(6.09)	(5.96)	(6.04)	(7.26)
Resource Rents	-7.20**	-7.74***	-2.28	-5.43	-5.88	1.35
	(3.04)	(2.92)	(3.15)	(4.16)	(3.88)	(3.45)
Constant	134.69***	95.31***	626.26***	200.64***	153.50***	876.76***
	(26.44)	(29.35)	(210.96)	(36.46)	(36.97)	(231.64)
N	688	688	688	692	692	692
Number of Countries	52	52	52	52	52	52
R^2 (within)	0.43	0.46	0.54	0.43	0.46	0.54
R^2 (between)	0.03	0.01	0.00	0.00	0.00	0.00
R^2 (overall)	0.09	0.08	0.03	0.06	0.04	0.01
Year FEs	No	No	Yes	No	No	Yes

Notes: Robust standard errors in parentheses;

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Chapter 5

Foreign Direct Investment and Corruption

5.1 Introduction

In April 2012, the *New York Times* published an investigative report revealing that Wal-Mart de Mexico had systematically bribed government officials to secure permits and licenses, accelerating store openings and establishing market dominance in the country.[1] The report also detailed efforts by Walmart's leadership to conceal the misconduct. According to interviews conducted by the *Times*, a former executive described personally dispatching two trusted outside lawyers to deliver envelopes of cash to public officials. He explained, "They targeted mayors and city council members, obscure urban planners, low-level bureaucrats who issued permits—anyone with the power to thwart Wal-Mart's growth. The bribes, he said, bought zoning approvals, reductions in environmental impact fees, and the allegiance of neighborhood leaders."

The *Times* series on Wal-Mart's foreign bribery prompted investigations by the U.S. Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) into the

[1]David Barstow, "Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle," *The New York Times*, April 21, 2012.

conduct of Wal-Mart subsidiaries around the world, including in Mexico, Brazil, China, and India.[2] In 2019, Walmart announced that it would pay $282 million as a "global settlement" to resolve all investigations related to the Foreign Corrupt Practices Act (FCPA)—more than $144 million to settle civil charges brought by the SEC and approximately $138 million to resolve parallel criminal charges by the DOJ.[3]

This is not an isolated incident. Corruption scandals involving MNCs in developing countries have frequently made headlines, with notable cases including Carrefour, GlaxoSmithKline, Rolls-Royce, and Skanska.[4] Yet while these global firms operate in different environments around the world, the corruption scandals associated with their activities varies across time and spaces. These cases raise an important question: Is there a systematic connection between FDI inflows—and the activity of MNC affiliates—and corruption in host countries?

We argue that foreign investment may exacerbate corruption if foreign MNC entrants are more productive than the incumbent firms, resulting in higher rent extraction, and contributing to market concentration by driving local firms out of the market. High rents increase the value of government goods and services, thereby heightening public officials' incentives to demand bribes. At the same time, firms enjoying significant market power in a less competitive environment are more capable of paying bribes and absorbing the additional costs of corruption. We further posit that a country's level of economic and institutional development can mitigate the corrupting influence of FDI. Economic development reflects the increasing competitiveness of indigenous firms, while political and legal development raises the likelihood of corruption detection and enforcement, thereby reducing both the incentives and opportunities to engage in corrupt practices.

The remainder of this chapter proceeds as follows. We begin with a brief review of

[2]David Barstow and Alejandra Xanic von Bertrab, "The Bribery Aisle: How Wal-Mart Used Payoffs to Get Its Way in Mexico," *The New York Times*, December 17, 2012.

[3]Nandita Bose, "Walmart to Pay $282 Million to Settle Seven-Year Global Corruption Probe," *Reuters*, June 21, 2019.

[4]We provide a more detailed account of these cases later in the chapter.

the existing literature, followed by the development of our theoretical argument on the relationship between FDI and corruption in developing countries, with particular attention to the moderating role of economic development and political and legal institutions. We then empirically test our hypotheses using data from a sample of non-OECD countries. The chapter concludes with a discussion of the findings and their broader implications.[5]

5.2 Related Literature

Academic research offers competing arguments regarding how inward FDI may affect corruption in host countries. On the one hand, scholars have suggested that FDI inflows and the presence of MNCs help decrease corruption in host countries. Broadly speaking, three main mechanisms have been proposed. First, the entry of foreign firms increases market competition and reduces the rents enjoyed by firms, thereby dampening their incentives to engage in corruption (Ades and Di Tella, 1999; Sandholtz and Gray, 2003; Treisman, 2007). Second, MNCs act as agents for transmitting norms and values from home to host countries (Gerring and Thacker, 2005; Kwok and Tadesse, 2006; Sandholtz and Gray, 2003). The underlying assumption is that most MNCs originate in Western advanced economies, where norms such as economic neoliberalism, democratic governance, the rule of law, and property rights protection are well-established and are diffused to host countries through MNC activity, thereby reducing corruption. Third, MNCs may leverage their bargaining power—stemming from their exit option—to pressure host governments to strengthen the rule of law and improve governance (Kwok and Tadesse, 2006; Malesky, 2004; Wang, 2015).

Other scholars contest this broad generalization and argue that MNC activities and FDI inflows are more likely to contribute to corruption in host countries. Only large and highly productive firms can afford the additional costs of engaging in FDI (Helpman, Melitz and Yeaple, 2004). The entry of these highly productive firms can reshape the economic landscape in host countries. This rent creation effect is particularly pronounced in less developed countries where indigenous firms are small and of low productivity. Hence, Pinto

[5]The rest of the chapter builds upon and extends Pinto and Zhu (2016).

and Zhu (2016) on which this chapter builds, contend that the entry of MNCs can result in higher rent creation by driving less productive firms out of the market and increasing market concentration. By focusing on China and leveraging subnational variation, Zhu (2017) shows that FDI inflows and MNC activities correlate strongly with corruption, and that market concentration mediates the positive relationship between FDI and corruption.

Other, more micro-level studies also paint a complex relationship between FDI and corruption. Utilizing firm survey data, Hellman, Jones and Kaufmann (2000) and Søreide (2006) show that MNCs are just as prone to engaging in corruption as their domestic counterparts in host countries. Transparency International (2006) finds that MNCs have a significant tendency to pay bribes, particularly in low-income countries. Malesky, Gueorguiev and Jensen (2015), leveraging a list experiment to address the social desirability issue in measuring corruption, find that foreign firms in Vietnam are more likely to pay bribes than local firms when entering restrictive industries. Subsequent studies also indicate that the propensity of MNCs to bribe varies depending on whether they are from the OECD Anti-Bribery Convention (ABC) signatory states (Chapman, Jensen, Malesky and Wolford, 2021; Jensen and Malesky, 2018).

More recent studies have examined the localized impact of FDI on corruption using geo-referenced data. Again, the findings are rather mixed. For example, Brazys and Kotsadam (2020) combine geo-referenced FDI project data from *fDi Markets* with survey data from Afrobarometer. They find that FDI projects, particularly from non-signatories of the OECD Anti-Bribery Convention (ABC), decrease local citizens' experiences of corruption.[6] They attribute this counterintuitive finding to a selection effect, suggesting that FDI projects from signatory countries tend to locate in less corrupt areas, leaving little room for improvement. In contrast, Donaubauer, Kannen and Steglich (2022) show that citizens living in localities with a foreign firm presence are more likely to report having paid bribes than those living

[6]However, a reduction in local citizens' bribery experiences does not necessarily imply overall improvement in corruption. As noted by the authors, FDI-induced economic growth or rent-seeking opportunities may provide government officials with alternative income sources, reducing their propensity to engage in petty corruption.

in similar localities anticipating future foreign firm presence.

We note several shortcomings in existing cross-national studies of corruption. First, earlier research relies primarily on perception-based corruption indices constructed by organizations such as Transparency International (TI), the World Bank, or the PRS Group. As we will discuss later in this chapter, these measures suffer from issues including anchoring bias, limited construct validity, and inconsistencies due to changes in survey sources and aggregation methods. We turn to corruption indices from the V-Dem project,[7] which are arguably better designed to address these methodological concerns. Second, as we will argue later, the effect of FDI on corruption is likely conditional on a country's domestic economic, political, and legal environment. This potential non-linear relationship is often overlooked in the existing literature. Third, foreign entry is an endogenous process. MNCs internalize the expected benefits and costs of entry when making investment decisions and choose destinations accordingly. Most existing studies give insufficient attention to this issue of endogeneity and the resulting selection bias.

5.3 Our Argument

Corruption refers to the misuse of public office for private gains (Bardhan, 1997; Rose-Ackerman, 1999). In Chapters 3 and 4, we have established both theoretically and empirically that MNC activity and FDI inflows lead to a more concentrated market in developing countries, as large and highly productive foreign firms compete their domestic counterparts out of the market. A more concentrated market is characterized by less competition and more opportunities for firms to extract monopoly rents. It is widely documented that high rents nurture corruption (Ades and Di Tella, 1999; Rose-Ackerman, 1999).

To the extent that bribe payments constitute an additional cost of doing business (Wei, 2000), firms' ability to pay bribes depends in part on the level of rents they are able to

[7]Coppedge, Gerring, Knutsen, Lindberg, Teorell, Altman, Bernhard, Cornell, Fish, Gastaldi, Gjerlow, Glynn, Good God, Grahn, Hicken, Kinzelbach, Krusell, Marquardt, McMann, Mechkova, Medzihorsky, Paxton, Pemstein, Pernes, Rydén, von Römer, Seim, Sigman, Skaaning, Staton, Sundström, Tzelgov, Wang, Wig, Wilson and Ziblatt (2024).

extract. In markets with limited competition, firms enjoy substantial pricing power and can charge higher markups. These rents provide them with the financial capacity to internalize the cost of corruption. That is, firms operating in less competitive markets are more able to afford paying bribes without significantly undermining their profit margins.

On the supply side of corruption, bureaucrats responsible for allocating government goods and services have strong incentives to demand bribes when market rents are high. Elevated rent levels raise the value of bureaucrats' "control rights" over licenses, permits, and regulatory approvals, thereby increasing the potential gains from exchanging these control rights for illicit payments (Ades and Di Tella, 1999). In such environments, corruption can become institutionalized as a form of quid pro quo between rent-seeking firms and rent-extracting officials.

Moreover, bureaucrats may not passively respond to market conditions but instead strategically adjust the quantity and quality of government goods and services in ways that maximize their bribe revenues (Bardhan, 1997; Kaufmann and Wei, 1999). For instance, by creating artificial bottlenecks, adding red tape, or selectively enforcing regulations, officials can heighten firms' dependence on government intervention and thereby enhance opportunities for bribe extraction. In this sense, both the demand and supply sides of corruption are shaped by the extent of rent creation and market concentration. Therefore, we hypothesize that, all else being equal, higher levels of inward FDI lead to more corruption in developing countries.

Development and Corruption

The rent creation effect of FDI revolves around the productivity differentials between foreign firms and their domestic counterparts. Inward FDI is more likely to crowd out domestic investment and lead to market concentration in developing countries. In these countries, domestic firms are typically small, weak, and technologically backward, resulting in a large productivity differential between MNCs and domestic firms. In contrast, in developed countries, where domestic firms are large, strong, and technologically advanced, they are

capable of withstanding competition from MNCs. In such cases, inward FDI is more likely to enhance market competition, leading to a rent dissipation effect. By examining a cross-national sample of both developed and developing countries and using host countries' GDP per capita as a proxy for the competitiveness of indigenous firms, Pinto and Zhu (2016) find that inward FDI contributes to corruption in developing countries. However, this positive effect disappears in developed countries.

We re-examine this conditional argument using a panel dataset of developing countries. Developing countries exhibit strong heterogeneity in the level of economic development, resulting in widely varying levels of competitiveness of indigenous firms. Furthermore, firms in developing countries become more competitive as they accumulate more capital, technological know-how, managerial skills, etc., over time. To the extent that levels of economic development serve as a proxy for the productivity of indigenous firms, productivity differentials between MNCs and domestic firms decrease in more developed developing countries, weakening the rent creation effect of FDI. Thus, we expect the positive effect of FDI on corruption diminishes as the level of economic development in host countries increases.

Democracy and Corruption

The quid pro quo exchange associated with corruption is an illicit activity and subject to penalties in law once detected. Our argument connecting rent creation to corruption, focuses on the benefits or opportunities of engaging in these illicit exchanges. However, the costs of corruption, including the probability of detection, the severity of punishment, and the potential payoffs from alternative options, also influence the calculus of economic agents and government officials to engage in corruption (Becker, 1968; Treisman, 2000). We posit that political and judicial institutions in host countries likely shape the risk and cost calculus for government officials when seeking to pocket rents for personal benefits.

Institutions encompass a set of formal and informal rules that govern human interaction across political, social, and economic domains (North, 1990). Scholars have paid considerable attention to the role of political institutions such as regime type, electoral system, checks

and balances in determining the incidence of corruption (e.g., Chang and Golden, 2006; Kunicová and Rose-Ackerman, 2005; Lederman, Loayza and Soares, 2005; Persson, Tabellini and Trebbi, 2003). Political institutions determine "the environment in which the relations between individuals and the state take place," and shape "the incentives for those in office to be honest and to police and punish misbehavior of people inside and outside the government bureaucracy" (Lederman, Loayza and Soares, 2005, 27). In a democracy, political competition for executive and legislative office likely increases the probability that corrupt practices will be discovered and exposed, and the officials involved can suffer from being voted out of office (Rose-Ackerman, 1999). Furthermore, freedom of association and a free press are often present in democracies, empowering public interests to voice their concerns and uncover government malfeasance (Brunetti and Weder, 2003; Treisman, 2007).

In contrast, authoritarian countries lack the same electoral mechanisms to punish politicians for their illicit behavior. Freedom of association and the free press are often suppressed. Consequently, the costs of engaging in corruption are lower. When the risk of detection and punishment is low, high rents accruing from the entry and presence of MNCs provide fertile ground for the quid pro quo of public power for personal benefits. Therefore, we hypothesize that the positive effect of FDI on corruption weakens in more democratic countries.

Note that political competition can potentially induce corruption, as politicians may resort to unlawful methods to gain advantages over their rivals (see e.g., Chang and Golden, 2006; Nyblade and Reed, 2008). We believe this is more likely in fragile or new democracies where institutions and norms are not yet fully developed or are often ignored. We subject this question to empirical examination.

Judicial Independence and Corruption

The detection and prosecution of corruption depend crucially on the performance of a country's legal institutions. Existing studies have examined the relationship between different legal systems and corruption. Common law originated in England to defend against the expropriation from the King, while civil law evolved in France as a tool for the purpose of

state building and regulating the economy (La Porta, Lopez-de Silanes, Shleifer and Vishny, 1999). Common law systems may therefore be better suited to protect against the misuse of public office (Treisman, 2000). However, empirical studies do not provide consistent evidence that common law systems are associated with lower corruption than civil law systems (see e.g., La Porta et al., 1999; Treisman, 2000).

The focus on the broad distinction of legal systems overlooks one critical aspect of legal institutions—the enforcement of the law (Zhu and Deng, 2022). Typically, the enforcement of institutions is imperfect due to the high costs associated with acquiring comprehensive information about contract compliance, as well as the potential influence of enforcement agents' personal interests on outcomes (North, 1990, 54). The risk of being caught and punished for corruption depends crucially on the impartial and effective enforcement of the law. Yet, "[l]aw enforcement cannot be an effective anti-corruption tool unless the judiciary is independent both of the rest of the state and the private sector" (Rose-Ackerman, 2007, 15).

Judicial independence refers to the principle that a judge's decision is in accordance with the law and is free from interference by political and private actors (Rosenn, 1987; Kornhauser, 2002, 49–50). This conceptualization emphasizes the autonomy of judiciaries. Others conceptualize judicial independence as "power," indicating that a judge's decisions are expected to be properly implemented and effectively constrain other actors (Cameron, 2002). We believe that both the autonomy and power of judiciaries are crucial for deterring government officials from engaging in corruption. The former ensures that judges are not subject to influence from corrupt officials, while the latter ensures that punishments for corrupt acts are effectively carried out. Therefore, we adopt Linzer and Staton's (2015) approach and focus on *de facto* judicial independence ("independent judging in practice") instead of *de jure* independence ("a set of formal institutions"). Furthermore, well-performing judiciaries bolster citizens' and businesses' faith in using courts to protect their property rights against predatory government behavior, such as corruption (Frye and Zhuravskaya, 2000).

Essentially, what really matters to corruption is the performance of judiciaries rather than parchment barriers. Our fourth hypothesis connects judicial independence as a moderating factor on the impact of foreign investment on corruption: *de facto* judicial independence attenuates the positive effect of FDI on corruption.

5.4 Multinationals and Corruption in Developing Countries

Before turning to a systematic evaluation of our hypotheses, we examine several high-profile corruption scandals involving MNCs. These case studies illustrate the mechanisms by which FDI and MNC activity may exacerbate corruption in host countries.

Wal-Mart in Mexico

In the early 2000s, Wal-Mart aggressively expanded into emerging markets, including Mexico, India, Brazil, and China. This rapid growth was accompanied by widespread allegations of corruption involving the company's foreign subsidiaries and third party intermediaries (TPIs). The company failed to establish and enforce adequate internal anti-corruption controls, violating the U.S. FCPA, which makes foreign bribery a criminal case. TPIs working on behalf of Wal-Mart subsidiaries allegedly made improper payments to government officials to secure permits and licenses, using falsified records and coded invoices to conceal the transactions. These payments were intended to bypass regulations, gain access to privileged information, and eliminate penalties.[8]

In Mexico, Wal-Mart holds a dominant position in the retail market. As of 2012, approximately 20% of all Wal-Mart stores worldwide were located in Mexico. With 2,275 stores and a workforce of 221,000 employees, Wal-Mart was the largest private employer in the country.[9] Wal-Mart de Mexico's rapid expansion—fueled in part by illicit payments—

[8]Department of Justice. 2019. "Walmart Inc. and Brazil-Based Subsidiary Agree to Pay $137 Million to Resolve Foreign Corrupt Practices Act Case," Available at `https://www.justice.gov/archives/opa/pr/walmart-inc-and-brazil-based-subsidiary-agree-pay-137-million-resolve-foreign-corrupt`, Accessed July 21, 2025.

[9]David Barstow and Alejandra Xanic von Bertrab, "The Bribery Aisle: How Wal-Mart Used Payoffs to

helped the company achieve exponential growth and solidify its market dominance in the country.

The *New York Times* investigation revealed that Wal-Mart de Mexico was not simply navigating a corrupt business environment, nor were its bribes limited to accelerating standard bureaucratic approvals. Instead, the subsidiary proactively and systematically engaged in corruption, deploying substantial illicit payments to obtain advantages that would otherwise have been denied under the law. These actions allowed the company to undermine democratic institutions—such as public deliberations, voting procedures, and regulatory oversight—and to sidestep rules intended to safeguard public welfare. Through these means, Wal-Mart de Mexico was able to suppress competition and entrench its market dominance.[10]

The DOJ's investigation further revealed that Wal-Mart employed a similar bribery strategy to accelerate its expansion in other developing markets, including India, Brazil, and China. In each of these countries, Wal-Mart's operations suffered from serious internal control failures related to anti-corruption, which enabled TPIs to make improper payments to government officials in order to obtain permits and licenses. In India, from 2009 to 2011, Wal-Mart's joint venture retained TPIs who made illicit payments to secure store operating permits. These payments were falsely recorded in company books using vague descriptions such as "miscellaneous," "professional fees," and "government fee." In Brazil, despite repeated warnings from internal audit reports, Wal-Mart Brazil continued to contract TPIs and made improper payments in connection with store construction. One such TPI, known internally as the "sorceress" or "genie" for her ability to quickly obtain permits, was retained indirectly despite numerous red flags acknowledged by Wal-Mart Brazil employees. In China, from 2003 to 2011, Wal-Mart's internal audit team repeatedly flagged substantial weaknesses in anti-corruption controls at its local subsidiary. However, many of these deficiencies—particularly those identified between 2007 and 2010—were never addressed,

Get Its Way in Mexico," *The New York Times*, December 17, 2012.

[10]Ibid.

allowing systemic risks to persist.[11]

Rolls-Royce in the Global South

In 2017, Rolls-Royce reached a landmark settlement of over $800 million with enforcement authorities in the United States, United Kingdom, and Brazil to resolve extensive investigations into systemic corruption and violations of anti-bribery laws, including the U.S. FCPA and the UK Bribery Act.[12] The resolution followed coordinated investigations by the U.S. DOJ, the UK Serious Fraud Office (SFO), and Brazilian Ministerio Publico Federal, and was among the largest anti-corruption settlements ever secured by the UK.

Between 2000 and 2013, Rolls-Royce repeatedly used TPIs to funnel more than $35 million in bribes to officials across at least seven countries: China, India, Indonesia, Thailand, Russia, Nigeria, and Malaysia.[13] These payments were intended to secure confidential bidding information, influence procurement decisions, and win government contracts in civil aerospace, defense, and energy sectors. The bribes took various forms—including cash transfers, luxury items, inflated commissions, and misrepresented consultancy fees.

In Indonesia, Rolls-Royce paid approximately $2.25 million and gifted a luxury vehicle to an intermediary to secure a contract for T700 engines. In Thailand, the company routed $18.8 million through intermediaries—including Thai Airways employees—to secure engine sales. In China, a $5 million payment was partially used to fund an executive's MBA trip with lavish accommodations when the company was negotiating the sale of T700 engines with China Eastern Airlines. In India, despite regulations prohibiting the use of intermediaries in defense deals, Rolls-Royce used one anyway and disguised the payment as a consultancy

[11]Department of Justice. 2019. "Walmart Inc. and Brazil-Based Subsidiary Agree to Pay $137 Million to Resolve Foreign Corrupt Practices Act Case." Available at `https://www.justice.gov/archives/opa/pr/walmart-inc-and-brazil-based-subsidiary-agree-pay-137-million-resolve-foreign-corrupt`. Accessed July 21, 2025.

[12]U.S. Department of Justice. 2017. "Rolls-Royce plc Agrees to Pay $170 Million Criminal Penalty to Resolve Foreign Corrupt Practices Act Case." Available at: `https://www.justice.gov/archives/opa/pr/rolls-royce-plc-agrees-pay-170-million-criminal-penalty-resolve-foreign-corrupt-practices-act`. Accessed July 21, 2025.

[13]Ibid.

fee.[14]

Despite repeated internal warnings and audit findings, the company failed to take corrective action for over a decade. Critics noted that the British government had long held a close relationship with Rolls-Royce—often praised as "a jewel in the UK's industrial crown"—raising concerns over regulatory capture and the reluctance to pursue enforcement actions against politically connected firms.[15]

Ultimately, Rolls-Royce was charged with conspiracy to corrupt, false accounting, and failure to prevent bribery under the UK Bribery Act.[16] The company entered into a Deferred Prosecution Agreement (DPA) with the SFO and its U.S. and Brazilian counterparts, agreeing to enhanced compliance monitoring and corporate reforms. This case remains one of the most significant corporate corruption prosecutions in UK history and highlights the global reach of anti-bribery enforcement.

Skanska in the Southern Cone

Founded in Sweden in 1887, Skanska is one of the world's largest construction and development firms, with major operations across Europe and North America. While the company has built prominent infrastructure—including hospitals, airports, and energy facilities—it has also faced serious corruption allegations in Latin America.

In 2007, Skanska was implicated in a major bribery scandal in Argentina involving the expansion of the national gas pipeline network. The company allegedly paid over $5.5 million in bribes to Argentine officials through fraudulent invoices and inflated project costs in order to secure the contract.[17] Several senior Skanska executives were arrested, and

[14]"Rolls-Royce Apologises After £671M Bribery Settlement" BBC, January 18, 2017. Avaiable at `https://www.bbc.com/news/business-38644114`, Accessed July 21, 2025.

[15]Ibid. Rob Evans, David Pegg, and Holly Watt. "Rolls-Royce to Pay £671M over Bribery Claims," *The Guardian*, January 16, 2017. Available at: `https://www.theguardian.com/business/2017/jan/16/rolls-royce-to-pay-671m-over-bribery-claims`. Accessed July 21, 2025.

[16]Serious Fraud Office. 2017. "Deferred Prosecution Agreement: Rolls-Royce plc." Available at: `https://assets.publishing.service.gov.uk/media/67c061c4750837d7604dbc66/DPA_-_Rolls_Royce_-_170117.pdf`. Accessed July 21, 2025.

[17]"Skanska's Bribes Scandal Shakes Kirchner Government," *MercoPress*, May 24, 2007. Available at: `https://en.mercopress.com/2007/05/24/skanska-s-bribes-scandal-shakes-kirchner-government`. Accessed July 21, 2025.

multiple government officials—including the head of Argentina's Natural Gas Regulatory Agency—were dismissed as a result.[18]

In 2016, Skanska Brasil was banned from bidding on public contracts for at least two years following corruption allegations related to Brazil's Petrobras scandal, known as Operation Car Wash. Brazilian authorities accused Skanska of paying $890,000 in bribes—channeled through a shell company called Energex—to secure a $360 million oil terminal expansion contract.[19] Skanska was part of a cartel of 21 companies accused of bid-rigging and bribery in exchange for public works contracts. The company began withdrawing from Latin America in 2014 and completed its exit by early 2016.[20]

Other Cases

Carrefour Brasil was implicated in a corruption scandal involving its Atacadão subsidiary, accused of paying $280,000 in bribes to operate stores in São Paulo without proper licenses.[21] GlaxoSmithKline faced similar allegations in China, where payments were funneled through travel agencies and industry associations.[22] A 2006 survey by Transparency International of over 11,000 business executives in 125 countries found that firms from major exporting nations were particularly prone to paying bribes in low-income countries (International, 2006).

These case studies collectively demonstrate that MNC activity can exacerbate corruption in developing countries, particularly in environments with limited competition, high rents, and weak institutions. Although MNCs face legal consequences, enforcement is often

[18]"Argentina fires two in tax evasion, bribery probe." *Reuters*, May 17, 2007. Available at: `https://www.reuters.com/article/markets/oil/argentina-fires-two-in-tax-evasion-bribery-probe-idUSN17281916/`. Accessed July 21, 2025.

[19]Anthony Boadle. "Brazil bars Skanska Unit from Public Tenders in Petrobras Probe," *Reuters*, June 9, 2016. Available at: `https://www.reuters.com/article/world/europe/brazil-bars-skanska-unit-from-public-tenders-in-petrobras-probe-idUSL1N1910UD/`. Accessed July 21, 2025.

[20]Skanska. 2016. "Skanska Divests Latin American Operations." Available at: `https://group.skanska.com/media/press-releases-articles/162408/Skanska-divests-Latin-American-operations/`. Accessed July 21, 2025.

[21]Gabriela Mello, 'Carrefour Brasil Targeted in São Paulo Bribery Probe," *Reuters*, May 28, 2020.

[22]"GlaxoSmithKline Fined $490M by China for Bribery," *BBC*.

weak, and home governments may hesitate to impose harsh penalties that could undermine global competitiveness.

Importantly, our argument centers on the rent creation effects of MNCs and their implications for corruption. We *do not* claim that MNCs are categorically more corrupt than domestic firms. As Zhu (2017) notes, rents may be shared with local firms through procurement, subcontracting, and vertical linkages (Fuller, 2013; Javorcik, 2004; Liu, Wang and Wei, 2009). Furthermore, both domestic and foreign firms in oligopolistic markets may enjoy considerable market power and are able to charge high markups (Lall, 1979*a*).

Whether foreign firms are more likely to engage in bribery or pay higher bribes than domestic firms remains an open empirical question. Existing studies offer mixed evidence (see Chapman et al., 2021; Helpman, Melitz and Yeaple, 2004; Jensen and Malesky, 2018; Malesky, Gueorguiev and Jensen, 2015; Søreide, 2006). While this question is beyond the scope of our current analysis, the cases reviewed here underscore the need to examine how market structure, firm power, and institutional strength shape the corruption risks associated with FDI.

5.5 Empirical Strategy

To test our hypotheses, we construct a panel dataset of all developing countries from 1970 to 2019.[23] We estimate the following model:

$$Corruption_{i,t} = \beta_1 \cdot FDI_{i,t} + \beta_2 \cdot (FDI_{i,t} \times M_{i,t}) + \beta_3 \cdot M_{i,t} + X_{i,t} \cdot \xi + \varepsilon_{i,t} \quad (5.1)$$

$Corruption_{i,t}$ is an indicator of national-level corruption in country i in year t. $M_{i,t}$ is the moderator. β_1, β_2, and β_3 are the coefficients to be estimated for FDI, the interaction term, and the moderator, respectively. $X_{i,t}$ is a matrix of covariates derived from the empirical

[23]Developing countries are defined as non-OECD countries. Countries drop out of our sample once they become OECD member states. Australia and New Zealand became OECD member states in 1971 and 1973, respectively, but we exclude them from our sample for the entire time period.

literature on the determinants of corruption, and ξ is a vector of coefficients to be estimated. $\varepsilon_{i,t}$ is the error term.

5.5.1 Measuring Corruption

Scholars have long studied corruption. However, measuring corruption is challenging, especially in a cross-national setting. Broadly speaking, researchers have utilized two types of corruption measures: "subjective" and "objective."[24] Both measures have their advantages and disadvantages. "Subjective" measures, such as Transparency International's (TI) Corruption Perception Index (CPI), the World Bank's (WB) Control of Corruption index, and the International Country Risk Guide's (ICRG) Corruption Index, are mainly perception-based. TI's CPI is primarily aggregated from different experts' ratings. The WB's Control of Corruption Index is aggregated from surveys of residents, international and local business-people, and country experts, while the ICRG's corruption index is based on ratings mainly from experts in the financial sector (Ko and Samajdar, 2010). These measures are available for the majority of countries worldwide over a relatively long time span.

However, perceptions of corruption may be deeply rooted in respondents' cultural backgrounds, identity, and social norms, which vary significantly across countries (Andersson and Heywood, 2009), and most experts are not local residents and are based in Western countries (Ko and Samajdar, 2010). These measures are also likely to suffer from an anchoring problem, as residents in different countries may have different understandings of what constitutes corruption (Andersson and Heywood, 2009; Malesky and Samphantharak, 2008). Furthermore, perceptions may not accurately reflect reality due to the secretive nature of corruption (Olken 2009; Seligson 2002; c.f. Charron 2016). In addition to these issues related to perception-based measures, the World Bank's World Governance Indicators have been criticized for a lack of construct validity (Arndt and Oman, 2006; Kurtz and Schrank, 2007; Thomas, 2010).

[24]See, for example, Treisman (2007) for a detailed discussion of the advantages and disadvantages of "subjective" vs. "objective" measures of corruption.

"Objective" measures of corruption are typically constructed using reported corruption cases, prosecutions, or convictions. However, one primary problem of such measures is that they are jointly determined by the underlying levels of corruption and the efficacy of law enforcement. In countries with weak legal institutions, the number of corruption cases, prosecutions, or convictions may not provide an accurate indicator of true corruption levels. Additionally, such measures are not well-suited for cross-national analyses.

To address these drawbacks, researchers have turned to surveys of residents' or businesses' experiences of corruption, which arguably more accurately reflect the prevalence of corruption. For example, the Afrobarometer survey asks respondents about the frequency of bribing government officials to get things done.[25] Similarly, the World Bank Enterprise Survey asks firms whether an informal gift or payment was expected or requested in public transactions dealing with utilities, permits, licenses, and taxes.[26]

Arguably, these experience-based measures are designed to address the shortcomings in the "subjective" measures and those "objective" measures using corruption cases, prosecutions, or convictions. Nonetheless, there are at least two shortcomings to using surveys of residents' or businesses' experiences. First, these surveys are more likely to capture petty corruption, which involves low-level bureaucrats and small bribes, rather than grand corruption, which involves high-level government officials, large-scale embezzlement and bribery, or even state capture. Second, responses may suffer from a social desirability bias, as respondents may choose not to report or may misreport due to the sensitivity of such questions (Jensen, Li and Rahman, 2010).

The more recent Varieties of Democracy (V-Dem) project attempts to address the drawbacks in perception-based corruption measures.[27] V-Dem relies on coders from a pool of over

[25]The Afrobarometer survey includes questions such as "How often, if ever, did you have to pay a bribe, give a gift, or do a favor for a government official in order to get the document you needed?"

[26]These questions are worded as follows: "In reference to that application [e.g., to obtain an electrical connection], was an informal gift or payment expected or requested?"

[27]See Coppedge, Gerring, Knutsen, Lindberg, Teorell, Marquardt, Medzihorsky, Pemstein, Gastaldi, Grahn, Pernes, Rydén, von Römer, Tzelgov, Wang and Wilson (2024) for a detailed discussion of its methodology.

3700 experts and typically collect data from five experts for each country-year observation. It uses item response theory modeling to generate a latent score for each indicator from their expert ratings. To address the anchoring problem common in cross-national ratings, V-Dem utilizes vignettes (hypothetical cases) to generate bridging data across different expert coders, which helps to identify unqualified experts and to ensure consistency in their assessment. V-Dem has also made great efforts to generate historical data. Most of its indicators cover the time span from 1900 to the present and some of them also cover the time span from 1789 to 1900.

We believe the V-Dem corruption indices represent a significant improvement over other perception-based corruption measures, and thus, they serve as our dependent variables. We utilize two corruption indices from V-Dem: political corruption and regime corruption.[28] The political corruption index (*v2x_corr*, "How pervasive is political corruption?") is the average of four corruption indices: (1) public sector corruption index,[29] (2) executive corruption index,[30] (3) legislative corruption,[31] and (4) judicial corruption.[32]

The Regime corruption index (*v2xnp_regcorr*, "To what extent do political actors use political office for private or political gain?") is a factor score from a Bayesian factor analysis model of four indices: executive embezzlement,[33] executive bribes,[34] legislative corruption,

[28]See Coppedge, Gerring, Knutsen, Lindberg, Teorell, Altman, Bernhard, Cornell, Fish, Gastaldi, Gjerlow, Glynn, Grahn, Hicken, Kinzelbach, Marquardt, McMann, Mechkova, Neundorf, Paxton, Pemstein, Rydén, von Römer, Seim, Sigman, Skaaning, Staton, Sundström, Tzelgov, Uberti, Wang, Wig and Ziblatt (2024) for the coding details.

[29]*v2x_pubcorr*: "To what extent do public sector employees grant favors in exchange for bribes, kickbacks,or other material inducements, and how often do they steal, embezzle, or misappropriate publicfunds or other state resources for personal or family use?"

[30]*v2x_execorr*: "How routinely do members of the executive, or their agents grant favors in exchange forbribes, kickbacks, or other material inducements, and how often do they steal, embezzle, ormisappropriate public funds or other state resources for personal or family use?"

[31]*v2lgcrrpt*. "Do members of the legislature abuse their position for financial gain?"

[32]*v2jucorrdc*. "How often do individuals or businesses make undocumented extra payments or bribes in order to speed up or delay the process or to obtain a favorable judicial decision?"

[33]*v2exembez*: "How often do members of the executive (the head of state, the head of government, and cabinet ministers), or their agents, steal, embezzle, or misappropriate public funds or other state resources for personal or family use?"

[34]*v2exbribe*: "How routinely do members of the executive (the head of state, the head of government,and cabinet ministers), or their agents, grant favors in exchange for bribes, kickbacks, or othermaterial inducements?"

and judicial corruption.

Table 5.1: Pairwise Correlation of Corruption Indices

	Pol Corr (V-Dem)	Reg Corr (V-Dem)	CPI (TI)	Corruption (WB)	Corruption (ICRG)
Political Corruption (V-Dem)	1.00				
	(7244)				
Regime Corruption (V-Dem)	0.97	1.00			
	(7244)	(7280)			
CPI (TI)	0.80	0.77	1.00		
	(3057)	(3059)	(3160)		
Corruption (WB)	0.85	0.82	0.95	1.00	
	(3352)	(3358)	(2963)	(3795)	
Corruption (ICRG)	0.52	0.52	0.74	0.75	1.00
	(3954)	(3975)	(2426)	(2516)	(4053)

Note: Number of observations in parentheses.

Table 5.1 presents the pairwise correlation of V-Dem corruption indices and other perception-based measures in our sample of developing countries. Political and regime corruption indices are highly correlated, but they are less so with other measures, including TI's CPI, the World Bank's, and ICRG's corruption indices.[35] The correlation is lowest for the ICRG's corruption index. TI's CPI and the World Bank's corruption indices appear to be highly correlated with each other, which is partially explained by overlapped sources used to construct these measures.

Independent and Control Variables

As in the previous chapter, our independent variable is the real FDI inflows per capita. We take the cubic root of this variable to address skewed distribution. In the Appendix, we present the results using real FDI stocks per capita as alternative independent variable.

In the regression analysis, we use host countries' GDP per capita (PPP-adjusted) as a proxy for the competitiveness of indigenous firms. GDP per capita is also the most significant predictor of corruption identified in the empirical literature (Treisman, 2007). To capture

[35]For easy interpretation, we have reversed the values of other corruption measures so that a higher value indicates more corruption.

democratic competition in host countries, we employ the standard Polity score as well as the indices of political competition and competitiveness of participation (Marshall, Gurr and Jaggers, 2019). Data on judicial independence are drawn from Linzer and Staton (2015).

We also control for a range of covariates, including economic growth, trade openness, natural resource endowments, religious composition (percentages of Protestants, Catholics, and Muslims), and legal system origin (British, French, or other). High economic growth is expected to expand the economy and foster competition, thereby reducing rents and lowering incentives for corruption. Similarly, trade openness is supposed to promote market competition and limit rent extraction, which should also correlate negatively with corruption. In contrast, countries with abundant natural resources are generally more vulnerable to corruption. Resource windfalls can weaken government accountability and foster clientelistic networks (Ross, 2015).

Scholars have long debated whether religious and legal traditions play a role in shaping corruption and government performance. Some have argued that Catholicism and Islam are more prone to corruption and associated with inferior government outcomes than Protestantism (La Porta et al., 1999; La Porta, Florencio, Shleifer and Vishny, 1997; Lipset and Lenz, 2000). Protestantism is linked to greater individualism, a weaker centralized church, and stronger support for pluralism and education. In contrast, Catholicism—historically characterized by a centralized and hierarchical church structure—is associated with greater state control and weaker civic institutions. Islam tends to promote strong community norms but also greater state involvement in religion and law, which may hinder the development of independent institutions and foster clientelism.

Legal origins are also thought to matter. Civil law, which originated as an instrument to expand state authority and codify centralized power, tends to be more bureaucratic, grant greater discretion to government officials, and impose fewer institutional constraints on the executive. These features are believed to make civil law systems more vulnerable to rent-seeking and corruption. In contrast, common law evolved to constrain the power of the

Crown and protect private property rights, emphasizing judicial independence and limiting government discretion—features thought to support better governance and lower corruption levels (La Porta et al., 1999; Treisman, 2000).[36]

Some scholars argue that it is not religious affiliation but religiosity—that is, the intensity of individual religious belief and practice—that matters more for corruption (Gokcekus and Ekici, 2020). Similarly, others contend that the functioning and quality of legal systems, rather than their formal origins, better explain variation in corruption outcomes. For example, the adaptability and legitimacy of transplanted legal systems are shown to be more consequential than whether a country follows common or civil law traditions (Berkowitz, Pistor and Richard, 2003).

Moreover, several studies caution against overly deterministic interpretations of religious and legal traditions, noting that institutional, economic, and political factors—such as income level, democratic history, and state capacity—are more robust predictors of corruption (Haggard, MacIntyre and Tiede, 2008; Lederman, Loayza and Soares, 2005; Treisman, 2000; Voigt, 2008). Empirical findings on the effects of religious and legal traditions are also mixed, with results often contingent on model specifications and the inclusion of control variables.

To maintain consistency with previous studies, we control for both religious and legal traditions in our analysis. Religious composition is measured by the population percentages of Protestants, Catholics, and Muslims, using data from the Religious Characteristics of States Dataset Project (Brown and James, 2019). Legal origin is captured by a set of dummy variables—British, French, and Other, and we obtain the data from Djankov, La Porta, Lopez-de Silanes and Shleifer (2008).

[36]There is a substantial literature on the link between legal origins and economic and political outcomes. The literature is controversial and has generated numerous critiques. See Beck, Demirgüç-Kunt and Levine (2001) and Haggard, MacIntyre and Tiede (2008) for critical reviews.

5.6 Endogeneity, Selection Bias, and Instrumental Variable

One empirical challenge to examine FDI's political consequences in host countries is endogeneity and selection bias. The insights from the obsolescing bargain model suggests that foreign capital is footloose ex ante; however, once foreign investment takes place, MNCs put their physical assets in a foreign country and thus become ex post immobile. This ex post immobility gives rise to host governments' opportunistic behavior to take advantage of MNCs (Vernon, 1971, 1977). Therefore, entry is an endogenous process in which MNCs internalize the cost and risk associated with governments' opportunism, as we discussed in Chapter 3. MNCs choose to enter the foreign market when expected benefits outweigh costs. Consequently, we may observe less FDI and fewer foreign entrants in countries with weak governance and high political risk as it requires even higher productivity and markups to compensate these risks of entering and operating in these countries. This leads to a downward bias in the estimates.

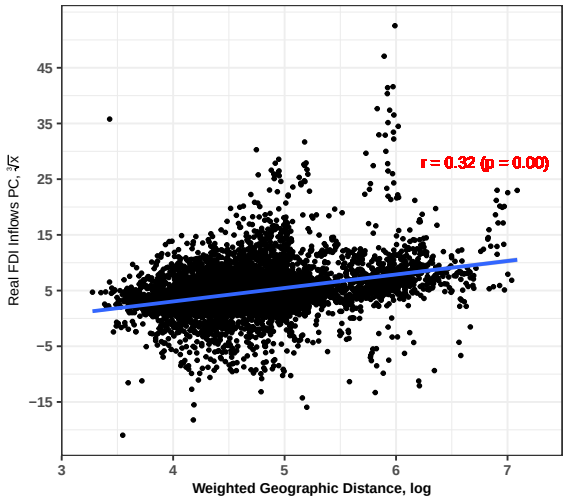
Instrumental variable (IV) estimation offers a general solution to address endogeneity and selection biases. The basic strategy in IV estimation involves finding an instrument that is contemporaneously uncorrelated with the error term in the original model, but correlated with the endogenous variable for which it serves as an instrument; additionally, the IV should not have a direct effect on the dependent variable (i.e., the exclusion restriction assumption) (Wooldridge, 2010, , 89-90). Pinto and Zhu (2016) construct an IV—Geographic Closeness—for inward FDI using the weighted geographic distance between a host country and the 20 wealthiest countries in the world in a cross-sectional setting and Pinto and Zhu (2022) extends it to a cross-sectional time-series setting. The construct of this IV is based on the empirical literature on the gravity model of foreign investment (Carr, Markusen and Maskus, 2001; Loungani, Mody and Razin, 2002; Markusen, 1995). On the one hand, investors prefer a closer destination to save costs; on the other hand, richer and more advanced economies

are more likely to be the suppliers of capital and their importance is closely related to capital endowments. The IV is constructed as the summation of 20 weighted bilateral distances:

$$Z_{i,t} = \sum_{j=1}^{20} \frac{1}{dist_{i,j,t}} \times \ GDP\ per\ capita_{j,t} \tag{5.2}$$

where $i = 1, 2, 3, ..., N$, $j = 1, 2, 3, ..., 20$, and $t = 1, 2, 3, ..., T$, indexing host countries, the 20 wealthiest economies, and year, respectively. The reciprocal of geographic distance is used such that the constructed IV correlates positively with inward FDI.[37] This IV varies both cross-sectionally and temporally. The former is determined by a country's geographic location relative the 20 wealthiest economies and the latter by the changes of the list of the 20 wealthiest economies and their capital endowments, proxied by their GDP per capita. We use the same instrument to address the reverse causality issue.

Figure 5.1: Weighted Geographic Distance and Inward FDI



Notes: Plot of weighted geographic distance (log) against real FDI inflows per capita (cubic root) with a fitted linear regression line. The shaded area around the line represents the 95% confidence interval.

Figure 5.1 presents a plot of the IV—Geographic Closeness—against real per capita

[37]The inter-capital geographic distance data is from the CEPII Gravity Database (Conte, Cotterlaz and Mayer, 2022).

FDI inflows. As expected, the IV is positively and significantly correlated with FDI inflows per capita. The Pearson correlation between the IV and FDI inflows per capita is 0.32 ($p = 0.00$).[38] The figure also shows several outliers, primarily due to the highly skewed distribution of the FDI inflows data.

Pinto and Zhu (2016) discuss several potential violations of the exclusion restriction assumption in studying corruption. First, the instrument may capture trade openness, as bilateral distance is a key component in gravity models of international trade. However, the weighted distance to the 20 wealthiest economies is not a strong instrument for trade openness.[39] That said, all of our models explicitly control for trade openness. Second, geographic distance may correlate with the likelihood of diffusing norms and values through cross-border economic exchanges. MNCs are one of the main channels through which such norms and values are transmitted (Kwok and Tadesse, 2006). Even if distance captures some of these diffusion mechanisms, the resulting bias would likely be downward, as norms and values from advanced economies are generally associated with reductions in corruption (see Gerring and Thacker, 2005; Kwok and Tadesse, 2006; Sandholtz and Gray, 2003). Finally, distance may influence how country experts and businesspeople rate corruption, which is a greater concern for perception-based corruption measures. Observers may provide more accurate ratings for countries geographically closer to advanced economies. The V-Dem methodology is explicitly designed to mitigate this issue. It relies on a minimum of three out of five coders who are nationals or permanent residents of the country being rated, and employs anchoring vignettes to screen out unqualified coders and ensure inter-coder consistency (Coppedge, Gerring, Knutsen, Lindberg, Teorell, Marquardt, Medzihorsky, Pemstein, Gastaldi, Grahn, Pernes, Rydén, von Römer, Tzelgov, Wang and Wilson, 2024). Overall, we are confident that the weighted distance measure provides a valid instrument for inward

[38]The Pearson correlation between Geographic Closeness and real FDI stocks per capita is 0.36 ($p = 0.00$).

[39]When using weighted distance to predict trade openness while controlling for FDI inflows or stocks per capita, the F-statistics of the excluded instrument are 6.93 and 2.87, respectively—well below the conventional threshold of 10 (Bound, Jaeger and Baker, 1995; Staiger and Stock, 1997). See Table 5.8 in the appendix.

FDI.

5.7 Results

We begin by estimating a simple random effects (REs) model, regressing the political corruption index on real FDI inflows per capita, GDP per capita, democracy, economic growth, and trade openness (Model 1 in Table 5.2). The coefficient on FDI is positive but not statistically significant at conventional levels. In Model 2, we estimate a fixed effects (FEs) model to account for potential unobserved heterogeneity across countries. The results are largely consistent with those from the RE model. A Hausman test fails to reject the null hypothesis of no systematic differences between the two estimators, suggesting that the RE model may be appropriate.

Both models explain very little within-group variation, as indicated by a low within-group R^2. One possible explanation is that corruption is persistent and changes little over time. Given that the results are primarily driven by between-group variation, we adopt the REs specification as our preferred model.

One concern with the results in Models 1 and 2 is endogeneity. As discussed in Chapter 3, foreign entry is an endogenous process in which firms internalize the expected benefits and costs conditional on the risks in the host market. It is well documented that corruption and poor governance reduce FDI inflows and deter the entry of MNCs (see, e.g., Habib and Zurawicki, 2002; Uhlenbruck, Rodriguez, Doh and Eden, 2006; Wei, 2000; Zhu and Shi, 2019). If this is the case, FDI is less likely to flow into countries with higher levels of corruption, which would bias our estimates downward. To address this concern, we employ an instrumental variables (IV) approach.

In Model 3 of Table 5.2, we re-estimate Model 1 by instrumenting FDI inflows using Geographic Closeness. The F-statistic of the excluded instrument in the first-stage regression is 38.74, well above the conventional threshold of 10, indicating that the instrument is strong (Bound, Jaeger and Baker, 1995; Staiger and Stock, 1997). The second-stage

Table 5.2: FDI Inflows and Political Corruption (V-Dem)

	(1)	(2)	(3)	(4)	(5)
FDI Inflows PC	0.02	0.02	4.19***	3.62***	3.66***
	(0.02)	(0.02)	(1.03)	(0.84)	(0.86)
GDP PC	-1.73***	2.09***	-11.66***	-10.45***	-10.42***
	(0.54)	(0.51)	(2.60)	(2.30)	(2.31)
Democracy	-0.09***	-0.08**	-0.49***	-0.47***	-0.47***
	(0.03)	(0.03)	(0.16)	(0.15)	(0.16)
Growth Rate	0.03	-0.03	-0.81	-0.57	-0.57
	(0.04)	(0.04)	(0.53)	(0.45)	(0.46)
Trade Openness	-0.32	-0.11	-3.10*	-2.04	-2.05
	(0.29)	(0.29)	(1.60)	(1.40)	(1.40)
Resource Rents	0.28	-0.09	2.55*	1.84	1.72
	(0.27)	(0.27)	(1.50)	(1.56)	(1.57)
% of Protestants				0.17	0.17
				(0.21)	(0.21)
% of Catholics				0.23**	0.21**
				(0.09)	(0.10)
% of Muslims				0.22**	0.17*
				(0.09)	(0.10)
British Legal Origin					7.16
					(7.51)
French Legal Origin					23.80***
					(6.40)
Constant	73.89***	43.13***	149.16***	124.54***	109.00***
	(5.09)	(0.37)	(21.06)	(18.07)	(19.22)
N	4467	4343	4467	3977	3969
Number of Countries	124	123	124	123	122
R^2 (within)	0.02	0.01	0.00	0.01	0.00
R^2 (between)	0.27	0.15	0.05	0.11	0.26
R^2 (overall)	0.19	0.11	0.01	0.05	0.12
Country FEs	No	Yes	No	No	No
F-stat (Excluded Instr)			38.74	47.64	46.39
$P > F$			0.00	0.00	0.00

Notes: Clustered standard errors in parentheses;
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

regression shows that the magnitude of the FDI coefficient increases to 4.19, compared to 0.02 in Model 1, and becomes statistically significant beyond conventional levels. This result suggests that endogeneity does indeed bias the OLS estimates downward. Substantively,

holding other factors constant, a one standard deviation increase in per capita FDI inflows (approximately 4.07 units or $67.42) raises corruption levels by 17.04 units, which corresponds to approximately 0.70 standard deviations on the political corruption index (ranging from 0 to 100).[40]

Regarding other control variables, GDP per capita, democracy, and trade openness appear to exert a negative effect on corruption, whereas natural resource rents are positively associated with corruption.[41] Overall, these results are sensible and align with findings in the existing literature (see Treisman, 2007).

In Models 4 and 5, we further control for religious traditions and legal system origins. The results suggest that countries with larger Catholic or Muslim populations, as well as those with civil law systems, tend to exhibit higher levels of corruption. We interpret these results as suggestive and caution against overly deterministic interpretations. Importantly, our main finding remains robust to the inclusion of these additional controls: FDI continues to have a strong positive effect on corruption.

To ensure that our results are not driven by a specific measure of corruption, we use alternative indices as dependent variables. In Model 1 of Table 5.3, we employ the regime corruption index from V-Dem and replicate Model 5 from Table 5.2. Our main finding remains essentially unchanged: FDI continues to have a strong positive effect on corruption. However, some noticeable differences emerge. Specifically, the coefficients for trade openness and the Catholic population are no longer statistically significant, though their signs remain consistent with those in Table 5.2.

We further explore corruption indices from the World Bank and the ICRG in Models 2 and 3, respectively.[42] One caveat when using these indices in panel analysis is that changes

[40]The original scale of the corruption index ranges from 0 to 1. We have rescaled it to 0–100 for ease of interpretation of regression coefficients.

[41]These results also contribute to the debate on whether democratic competition increases or reduces corruption. Our findings suggest that democratic competition may enhance the likelihood of detecting and exposing corrupt behavior, rather than incentivizing politicians to engage in corruption to gain an advantage over opponents.

[42]We do not use TI's CPI, as the methodology and information sources have changed significantly since its

Table 5.3: FDI Inflows and Corruption (V-Dem, WB and ICRG)

	V-Dem	WB	ICRG
	(1)	(2)	(3)
FDI Inflows PC	3.52***	0.84**	2.83***
	(0.93)	(0.36)	(0.86)
GDP PC	-10.76***	-1.99**	-4.65*
	(2.71)	(0.84)	(2.48)
Democracy	-0.72***	-0.14***	-0.40**
	(0.17)	(0.05)	(0.16)
Growth Rate	-0.56	-0.17	-0.31
	(0.47)	(0.14)	(0.52)
Trade Openness	-1.41	-0.37	-0.15
	(1.47)	(0.32)	(0.91)
Resource Rents	2.13	0.16	-0.39
	(1.73)	(0.53)	(1.31)
% of Protestants	0.04	-0.19**	0.04
	(0.22)	(0.08)	(0.19)
% of Catholics	0.13	-0.04	-0.01
	(0.09)	(0.05)	(0.08)
% of Muslims	0.16*	-0.02	0.02
	(0.10)	(0.05)	(0.06)
British Legal Origin	6.13	1.49	3.77
	(7.54)	(2.73)	(4.51)
French Legal Origin	21.13***	7.40***	10.26***
	(6.64)	(2.70)	(3.64)
Constant	114.28***	41.13***	55.22***
	(22.04)	(6.84)	(18.93)
N	3993	1851	2529
Number of Countries	122	118	98
Country FEs	51.04	7.65	22.77
F-stat (Excluded Instr)	0.00	0.01	0.00

Notes: Clustered standard errors in parentheses;
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

in aggregation methods, coverage, and data sources over time may introduce artificial temporal variation (see Ko and Samajdar, 2010; Thomas, 2010; Treisman, 2007). Despite these concerns, the results in Table 5.3 consistently suggest that FDI inflows are associated with

launch in 1995. In particular, the pre-2012 data are not constructed to allow meaningful comparisons over time (Lambsdorff, 2006; Saisana and Saltelli, 2012). See Pinto and Zhu (2016) for a cross-sectional study that uses the CPI alongside the World Bank and ICRG indices.

higher levels of corruption in developing countries.[43]

The Moderating Effect of Development, Democracy, and Judicial Independence

In this section, we empirically examine the conditional effect of FDI on corruption by introducing a series of interaction terms. We have argued that economic development, democratic competition, and judicial independence can moderate the relationship between FDI and corruption, potentially mitigating the positive effect of FDI inflows. In Model 1 of Table 5.4, we include an interaction term between FDI and GDP per capita—our proxy for the competitiveness of indigenous firms.[44] The results show that the coefficient on FDI is positive, while the coefficient on the interaction term is negative; both are statistically significant at conventional levels.

Figure 5.2 plots the simulated marginal effects of FDI across varying levels of economic development. The figure shows that FDI inflows have a strong positive effect on corruption in less developed countries. However, this marginal effect diminishes as the level of development increases, and eventually turns negative at very high levels of development. These results are consistent with our theoretical expectation: as domestic firms become more competitive, the rent-creation effect of FDI weakens, while the rent-dissipation effect may prevail when local firms are capable of effectively competing with foreign entrants.

In our sample, the direction of the marginal effect of FDI changes when GDP per capita reaches approximately $41,830 (roughly the level of Singapore in 2001). When real GDP per capita is held at $4,639—the level of Côte d'Ivoire in 1995, and the median among countries below the threshold—a one standard deviation increase in per capita FDI is associated with a 14.72-unit increase (0.75 standard deviations) in the political corruption index. This

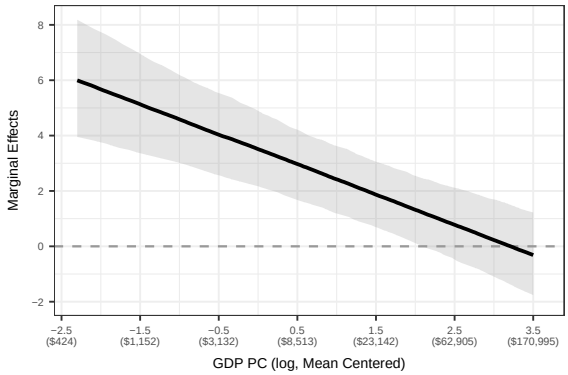
[43]Note that the F-statistic of the excluded instrument in Model 2, where the World Bank's corruption index is used as the dependent variable, does not exceed the threshold of 10. These results should therefore be interpreted with caution.

[44]Since FDI is endogenous, its interaction term with a moderator is also endogenous. We address this by purging the interaction term using the product of the moderator with both the included and excluded instruments from the first-stage equation predicting FDI (Achen, 1986; Kelejian, 1971). All interaction terms in the analysis are purged in this manner.

marginal effect is statistically significant at the 95% confidence level. In contrast, when GDP per capita is held at $69,521—the median among countries above the threshold—the same increase in per capita FDI is associated with a 2.76-unit decrease (0.11 standard deviations) in corruption, although this effect is not statistically significant.

One key takeaway from the simulated marginal effects in Figure 5.2 is that economic development mitigates the positive effect of FDI on corruption. However, this positive effect persists in most developing countries, as the level of development required for the effect to dissipate is relatively high. This finding aligns with our theoretical argument: in many developing countries, indigenous firms are small and technologically backward, making them unable to sustain competition with MNCs.

Figure 5.2: Marginal Effects of FDI on Corruption—Development



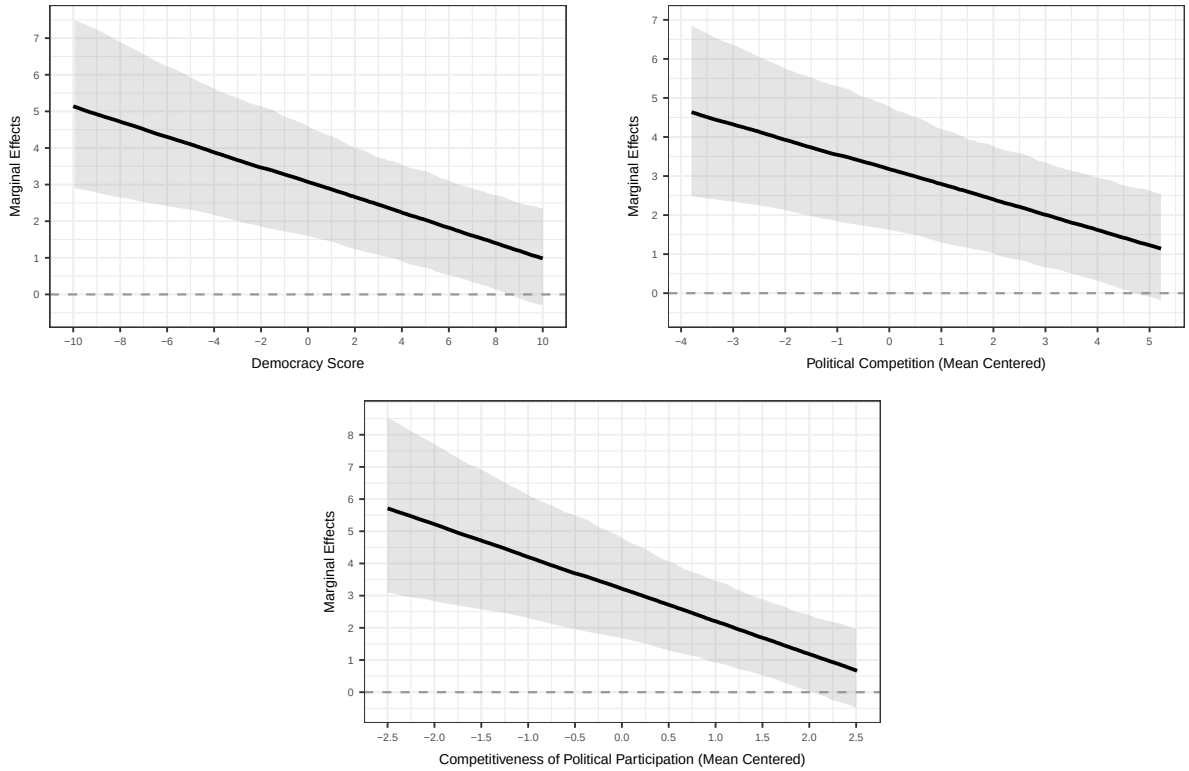
Notes: Plot of marginal effects of FDI on corruption from Model 1 in Table 5.4. Shaded areas represent 95% confidence intervals based on 1,000 simulations.

We further examine the hypothesis that democratic competition moderates the relationship between FDI and corruption. Model 2 in Table 5.4 introduces an interaction term between FDI and host countries' democracy scores. A positive coefficient on FDI and a negative coefficient on the interaction term indicate that the impact of FDI on corruption declines as the level of democracy increases. Our theoretical argument suggests that political competition functions as a mechanism for exposing corrupt behavior by government officials, thereby deterring them from engaging in corruption. We test this mechanism further in Models 3 and 4, where we incorporate two measures of political competition from

the Polity Project: political competition (POLCOM) and competitiveness of participation (PARCOMP), each interacted with FDI. The results from these models are consistent with our expectation that greater political competition mitigates the positive effect of FDI on corruption in developing countries.

Figure 5.3 visualizes the simulated marginal effects of FDI from Models 2, 3, and 4. Across all three panels, a clear pattern emerges: the effect of FDI on corruption weakens as a host country becomes more democratic and politically competitive. However, similar to the results in Figure 5.2, the positive effect of FDI tends to persist in most developing countries, as it only dissipates when host countries reach very high levels of democracy and political competition.

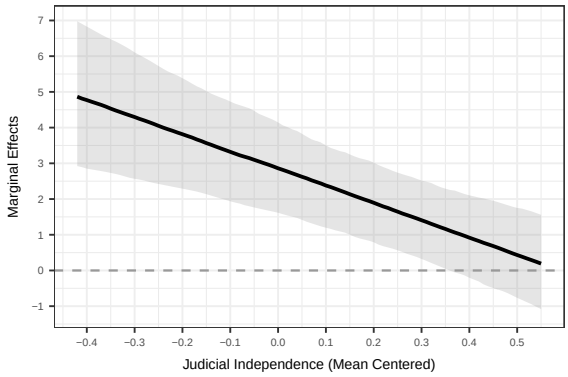
Figure 5.3: Marginal Effects of FDI on Corruption—Political Competition



Notes: Plots of marginal effects of FDI on corruption from Model 2, 3, and 4 of Table 5.4, respectively. Shaded areas represent 95% confidence intervals based on 1,000 simulations.

Finally, Model 5 tests the hypothesis regarding the moderating effect of the legal system. We introduce a measure of *de facto* judicial independence from Linzer and Staton (2015)

Figure 5.4: Marginal Effects of FDI on Corruption—Judicial Independence



Notes: Plots of marginal effects of FDI on corruption from Model 6 of Table 5.4. Shaded areas represent 95% confidence intervals based on 1,000 simulations.

and interact it with FDI. The results support our hypothesis that judicial independence mitigates the positive effect of FDI on corruption. The marginal effects plot in Figure 5.4 shows that while FDI has a strong positive effect on corruption in countries with low judicial independence, it no longer has a statistically significant effect in countries with high judicial independence.

FDI Stocks and Corruption

In our main analysis, we use real FDI inflows per capita as the primary independent variable. In the appendix, we report results using real FDI stocks per capita as the independent variable. These results, presented in Tables 5.5, 5.6, and 5.7, consistently show that FDI into developing countries increases corruption, while economic, political, and legal developments in host countries help mitigate this positive effect.

5.8 Conclusion

In this chapter, we examine the relationship between inward FDI and corruption in developing countries. We argue that the entry and presence of MNCs in these economies are likely to generate a rent-creation effect. As larger and more advanced MNCs crowd out smaller and less competitive domestic firms, market concentration increases, resulting in the creation of high economic rents. These rents, in turn, foster corruption by both

increasing the value of government officials' "control rights"—and hence their incentives to demand bribes—and enabling firms to absorb the additional costs of doing business in corrupt environments.

We further posit that economic development, political competition, and judicial independence can moderate this relationship and help mitigate the positive effect of FDI on corruption. Economic development reflects the capacity of domestic firms to compete with MNCs; political competition increases the likelihood that corruption will be exposed; and an independent judiciary raises the probability that corrupt behavior will be punished.

To test these arguments, we conduct an empirical analysis using a panel dataset covering all developing countries from 1970 to 2019. We employ an IV approach to address potential concerns about endogeneity. The empirical findings provide strong support for our hypotheses: inward FDI increases corruption in developing countries, but this effect diminishes in countries with higher levels of economic development, political competition, and judicial independence.

The findings underscore the importance of understanding how external economic forces influence market dynamics and rent-seeking behavior in host countries. It is well established that high rents nuture corruption (Ades and Di Tella, 1999; Krueger, 1974; Rose-Ackerman, 1999). While economic rents often arise from natural resource extraction or government-imposed or natural barriers to market competition, we demonstrate that the entry and presence of highly productive MNCs can also contribute to rent creation in developing economies. Previous studies on economic integration and corruption frequently rely on composite measures of globalization, thereby overlooking the heterogeneous effects of its distinct components.

Our results also have important policy implications: developing countries often compete to attract FDI, expecting MNCs to provide scarce capital, advanced technology, managerial expertise, and marketing capabilities, as well as to generate spillovers and integrate host economies into GVCs (Baldwin, Braconier and Forslid, 2005; Blomström and Kokko, 1996;

Blomströmm and Kokko, 1998; Caves, 1996; UNCTAD, 2013). However, our results indicate that the entry and presence of MNCs can also foster market structures conducive to corruption. To mitigate this risk and maximize the benefits of FDI inflows, host governments and international organizations should prioritize strengthening antitrust enforcement, building independent judicial institutions, and enhancing the competitiveness of domestic firms. We discuss the broader policy implications of our study in Chapter 8.

Table 5.4: Development, Democracy, Judicial Independence and Corruption

	(1)	(2)	(3)	(4)	(5)
FDI Inflows PC	3.49***	3.04***	3.15***	3.19***	2.84***
	(0.68)	(0.75)	(0.78)	(0.77)	(0.63)
FDI × GDP PC	-1.08***				
	(0.24)				
FDI × Democracy		-0.21***			
		(0.06)			
FDI × Pol Comp			-0.38***		
			(0.12)		
FDI × Par Comp				-1.00***	
				(0.29)	
FDI × Judicial Indep					-4.79***
					(1.31)
GDP PC	-2.42	-8.05***	-8.51***	-7.93***	-7.27***
	(1.87)	(2.21)	(2.40)	(2.29)	(1.83)
Democracy	-0.52***	0.26			-0.03
	(0.15)	(0.24)			(0.17)
Political Competition			0.64		
			(0.46)		
Comp of Participation				1.90*	
				(1.10)	
Judicial Independence					-10.34
					(9.73)
Growth Rate	-0.69**	-0.48	-0.44	-0.48	-0.63*
	(0.33)	(0.36)	(0.38)	(0.37)	(0.33)
Trade Openness	-3.29**	-1.51	-2.04	-2.48*	-1.55
	(1.44)	(1.30)	(1.36)	(1.44)	(1.22)
Resource Rents	2.06	1.08	1.25	1.26	0.81
	(1.62)	(1.39)	(1.37)	(1.39)	(1.36)
% of Protestants	0.17	0.20	0.17	0.17	0.06
	(0.20)	(0.19)	(0.19)	(0.19)	(0.17)
% of Catholics	0.19**	0.08	0.10	0.11	0.12
	(0.09)	(0.08)	(0.08)	(0.08)	(0.08)
% of Muslims	0.14	0.15	0.16*	0.15*	0.09
	(0.09)	(0.09)	(0.09)	(0.09)	(0.08)
British Legal Origin	10.62	1.28	2.38	3.30	4.78
	(6.83)	(7.03)	(6.94)	(6.98)	(5.65)
French Legal Origin	25.06***	21.10***	22.06***	22.62***	18.70***
	(5.85)	(5.39)	(5.39)	(5.45)	(4.22)
Constant	27.85***	29.78***	29.55***	30.85***	32.79***
	(8.19)	(8.03)	(7.99)	(7.99)	(6.92)
N	3969	3969	3870	3870	3962
Number of Countries	122	122	122	122	121

Notes: Clustered standard errors in parentheses;
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

5.9 Appendix

Table 5.5: FDI Stocks and Political Corruption (V-Dem)

	(1)	(2)	(3)	(4)	(5)
FDI Stocks PC	0.29*	0.28	6.55***	6.28***	6.36***
	(0.16)	(0.19)	(1.51)	(1.57)	(1.56)
GDP PC	-3.17***	2.23***	-13.81***	-12.12***	-12.27***
	(0.60)	(0.52)	(3.23)	(3.33)	(3.27)
Democracy	-0.06*	-0.04	-0.52***	-0.45***	-0.45***
	(0.03)	(0.04)	(0.15)	(0.16)	(0.16)
Growth Rate	0.07*	-0.01	-0.05	-0.05	-0.05
	(0.04)	(0.04)	(0.26)	(0.27)	(0.27)
Trade Openness	-0.83*	0.62	-7.01***	-6.57***	-6.67***
	(0.44)	(0.43)	(2.22)	(2.40)	(2.37)
Resource Rents	0.34	-0.26	1.59	1.03	1.05
	(0.31)	(0.31)	(1.43)	(1.65)	(1.63)
% of Protestants				-0.10	-0.10
				(0.30)	(0.28)
% of Catholics				0.04	0.04
				(0.14)	(0.12)
% of Muslims				0.16	0.14
				(0.14)	(0.11)
British Legal Origin					2.19
					(6.92)
French Legal Origin					18.81***
					(5.97)
Constant	86.89***	36.85***	161.78***	143.23***	132.28***
	(5.61)	(0.42)	(25.26)	(27.49)	(28.17)
N	3823	3700	3823	3347	3341
Number of Countries	123	121	123	122	121
R^2 (within)	0.03	0.01	0.05	0.05	0.05
R^2 (between)	0.24	0.20	0.17	0.23	0.34
R^2 (overall)	0.20	0.16	0.13	0.16	0.25
Country Fixed Effects	No	Yes	No	No	No
F-stat (Excluded Instr)			55.67	53.50	54.35
$P > F$			0.00	0.00	0.00

Notes: Clustered standard errors in parentheses;
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Table 5.6: FDI Stocks and Corruption (V-Dem, WB and ICRG)

	V-Dem		WB
	(1)	(2)	(3)
FDI Stocks PC	6.82***	2.19***	7.67***
	(1.83)	(0.83)	(2.03)
GDP PC	-13.97***	-3.73***	-8.47**
	(3.82)	(1.20)	(3.53)
Democracy	-0.65***	-0.15**	-0.35**
	(0.17)	(0.06)	(0.15)
Growth Rate	-0.12	0.05	0.18
	(0.31)	(0.09)	(0.25)
Trade Openness	-6.72**	-2.40**	-6.46**
	(2.75)	(0.96)	(2.81)
Resource Rents	1.54	0.64	-2.09
	(1.88)	(0.42)	(1.62)
% of Protestants	-0.24	-0.13*	-0.06
	(0.27)	(0.08)	(0.34)
% of Catholics	-0.09	-0.01	-0.01
	(0.13)	(0.03)	(0.14)
% of Muslims	0.07	-0.01	0.11
	(0.08)	(0.03)	(0.08)
British Legal Origin	1.10	0.51	-2.17
	(7.22)	(1.91)	(4.78)
French Legal Origin	17.34***	4.96***	2.65
	(6.69)	(1.90)	(4.33)
Constant	150.58***	53.63***	83.52***
	(31.97)	(8.87)	(28.75)
N	3365	1829	2479
Number of Countries	121	117	98
F-stat (Excluded Instr)	58.73	18.43	34.69
$P > F$	0.00	0.00	0.00

Notes: Clustered standard errors in parentheses;
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Table 5.7: Development, Democracy, Judicial Independence and Corruption

	(1)	(2)	(3)	(4)	(5)
FDI Stocks PC	3.82***	5.20***	4.74***	4.05***	4.68***
	(1.19)	(1.35)	(1.36)	(1.49)	(1.16)
FDI × GDP PC	-0.63**				
	(0.31)				
FDI × Democracy		-0.22***			
		(0.07)			
FDI × Pol Comp			-0.43***		
			(0.14)		
FDI × Par Comp				-1.04***	
				(0.35)	
FDI × Judicial Independence					-3.69*
					(1.91)
GDP PC	-3.65	-9.94***	-9.05***	-7.68***	-9.41***
	(3.30)	(2.53)	(2.52)	(2.58)	(2.14)
Democracy	-0.37**	0.87*			-0.02
	(0.15)	(0.46)			(0.17)
Political Competition			1.92**		
			(0.91)		
Comp of Participation				4.80**	
				(2.36)	
Judicial Independence					-4.79
					(16.39)
Growth Rate	0.12	0.04	0.15	0.18	-0.05
	(0.22)	(0.26)	(0.27)	(0.26)	(0.25)
Trade Openness	-4.97**	-5.35**	-5.98***	-5.43**	-5.07***
	(2.09)	(2.13)	(2.05)	(2.19)	(1.95)
Resource Rents	1.71	0.87	1.09	1.27	0.58
	(1.56)	(1.46)	(1.44)	(1.41)	(1.42)
% of Protestants	-0.01	-0.07	-0.12	-0.08	-0.17
	(0.24)	(0.22)	(0.20)	(0.21)	(0.18)
% of Catholics	0.03	-0.08	-0.11	-0.09	-0.02
	(0.10)	(0.11)	(0.11)	(0.11)	(0.09)
% of Muslims	0.13*	0.09	0.09	0.09	0.05
	(0.08)	(0.08)	(0.08)	(0.08)	(0.07)
British Legal Origin	4.64	0.18	1.24	1.87	2.93
	(6.06)	(6.30)	(6.28)	(6.16)	(5.19)
French Legal Origin	21.23***	19.86***	21.64***	22.02***	17.37***
	(5.06)	(5.12)	(5.15)	(5.08)	(4.28)
Constant	34.17***	34.76***	39.46***	40.13***	37.44***
	(7.92)	(8.14)	(7.96)	(7.74)	(7.09)
N	3341	3341	3251	3251	3335
Number of Countries	121	121	121	121	121

Notes: Clustered standard errors in parentheses;
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Table 5.8: Geographic Closeness, FDI, and Trade Openness

	FDI	Trade	FDI	Trade
	(1)	(2)	(3)	(4)
Geographic Closeness	2.77***	0.17***	1.38***	0.10*
	(0.41)	(0.06)	(0.17)	(0.06)
Trade Openness	0.32*		0.86***	
	(0.19)		(0.14)	
FDI Inflows PC (lag)		0.00**		
		(0.00)		
FDI Stocks PC (lag)				0.07***
				(0.01)
GDP PC	1.39***	0.09**	0.99***	-0.03
	(0.25)	(0.04)	(0.11)	(0.04)
Democracy	0.00	0.00	0.01	0.00
	(0.02)	(0.00)	(0.01)	(0.00)
Growth Rate	0.24***	0.01*	0.06**	0.00
	(0.07)	(0.01)	(0.02)	(0.01)
Resource Rents	-0.16	0.15***	-0.01	0.15***
	(0.22)	(0.03)	(0.16)	(0.03)
% of Protestants	-0.00	0.00	0.03**	0.01
	(0.02)	(0.00)	(0.02)	(0.00)
% of Catholics	-0.01	-0.01***	0.00	-0.01***
	(0.01)	(0.00)	(0.01)	(0.00)
% of Muslims	-0.02***	-0.01**	-0.00	-0.00***
	(0.01)	(0.00)	(0.00)	(0.00)
British Legal Origin	2.74***	0.04	1.86***	-0.10
	(1.04)	(0.16)	(0.44)	(0.16)
French Legal Origin	1.79**	0.06	1.58***	-0.07
	(0.85)	(0.14)	(0.41)	(0.14)
Constant	-23.07***	2.58***	-14.06***	3.55***
	(3.01)	(0.40)	(1.04)	(0.35)
N	3993	3987	3365	3297
R^2	0.35	0.20	0.64	0.22
Number of Countries	122	123	121	121
F-stat (Excluded Instr)	46.37	6.93	65.21	2.87
$P > F$	0.00	0.01	0.00	0.09

Notes: Robust standard errors in parentheses; clustered at the country level; * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Chapter 6

Foreign Direct Investment and Civil Conflict

6.1 Introduction

As discussed earlier the formation of global production networks built around MNCs is prominent feature of the international economy in the post-war era. Over the same period there has been a dramatic increase in the number of countries experiencing political violence and intrastate armed conflict. The percentage of conflict-affected countries increased steadily during the second half of the twentieth century, to a peak of 20% in the early 1990s (Blattman and Miguel, 2010, 4).[1]

The relationship between globalization and conflict has become a source of contention among scholars and practitioners. Theories of commercial liberalism assert that economic integration promotes peace between states as governments internalize the losses resulting from the disruptive effect of violent conflict (e.g., Oneal and Russet, 1997; Russett and Oneal, 2001). Likewise, economic integration increases the opportunity costs of resorting to violence to resolve intrastate conflicts and disputes. Governments and rebel groups have

[1]This chapter is largely a reprint of Pinto and Zhu (2022), with revisions and modifications. Pinto and Zhu (2022) received the 2022 Bruce Russett Best Article Award from the *Journal of Conflict Resolution*.

incentives to avoid violence because intrastate wars disrupt cross-border economic exchanges that bring wealth and prosperity (e.g., Barbieri and Reuveny, 2005; Blanton and Apodaca, 2007; Bussmann and Schneider, 2007; Gleditsch, 2007; Hegre, Gissinger and Gleditsch, 2003).

Yet, the propositions from commercial liberalism on the relationship between economic integration and intrastate conflict overlook some important features of global integration. First, commercial liberalism assumes that globalization generates benefits to the economy, and that those benefits are uniformly distributed across societal groups (Schneider, 2014, 176). Global integration, however, creates winners and losers within countries; the uneven distribution of benefits and costs has the potential to exacerbate grievances, increasing incentives to rebel and fight (Bussmann and Schneider, 2007; Hartzell, Hoddie and Bauer, 2010; Olzak, 2011). Second, there is an underlying assumption that by promoting economic development, global integration *in general* reduces rebels' incentives to fight. A body of critical scholarship, however, suggests that "war is not development in reverse" and conflict and violence can be instrumental in development (e.g., Cramer, 2006; Gómez, Sánchez-Ayala and Vargas, 2015; Maher, 2015; Thomson, 2011). Finally, different forms of globalization, such as trade and FDI, may affect domestic conflict through different mechanisms. The debate is not only theoretical but also empirical. Researchers have reported positive, negative, or no relationships between global integration and civil conflict (see e.g., Barbieri and Reuveny, 2005; Blanton and Apodaca, 2007; Bussmann and Schneider, 2007; de Soysa and Fjelde, 2010; Hegre, Gissinger and Gleditsch, 2003).

In this chapter, we show that when applying our theoretical framework to the link between inward FDI and civil conflict we can reconcile the diverging results in prior research. We build on the insights from scholarship on conflict which has established that civil wars are more likely to break out when the opportunities for appropriating rents are high and the opportunity costs of engaging in violence are low (Collier and Hoeffler, 1998; Fearon, 2008; Olsson and Fors, 2004). Recall our argument that when MNCs expand their activities into host countries, they affect market dynamics and the opportunities for rent creation. As we

have established in previous chapters, the effect of foreign investment on market dynamics depends on the ability of local firms to endure competition with multinationals. In developing countries where indigenous firms are typically smaller, less productive and have lower access to cutting-edge technology than their multinational counterparts, the entry of multinationals is likely to crowd out domestic firms, increase market concentration, and contribute to the creation of economic rents. Conflict over the control and distribution of those rents increases the incentives for rebel groups and incumbent governments to fight. Since fighting is costly, governments and rebels would prefer to bargain a settlement which they both prefer over fighting. However, concerns over the distribution of rents which potentially alter relative power dynamics could lead to fighting due to commitment problems. Rebels and governments are more likely to clash today to avoid having to relinquish resources or face a stronger opponent tomorrow, as neither party can guarantee not to take advantage of the potential shifts in relative power (Fearon, 1995; Powell, 2006; Walter, 1997, 2002).

We further contend that strong state capacity alleviates this positive association between foreign investment and conflict. Governments in strong states are able to sustain their residual claims over rents created by the change in market dynamics effected by the entry of multinationals. Moreover, controlling a share of these rents further reinforce governments' fighting capabilities. Strong states are also capable of addressing citizens' demands and grievances through other channels such as provision of public goods and institutionalized mechanisms for dispute resolution, which lower citizens' incentives to join rebel groups and raise the opportunity costs of rebellion. Moreover, strong states are equipped with well-functioning political and legal institutions, which enable the government to credibly adhere to negotiated agreements and thus alleviate the commitment problem. We therefore expect the positive effect of inward investment on conflict to scale down with state capacity.

Empirically, our identification strategy relies on an IV approach which helps address potential endogeneity concerns, threats from unobserved confounders, and selection bias introduced in previous chapters. Our analyses, based on a sample of developing countries,

provide strong support for our hypotheses that inward FDI has a strong positive effect on the likelihood of civil conflict.[2] The positive association between FDI and conflict is not solely driven by resource-seeking investment: it holds for foreign investment in the secondary and tertiary sector as well.[3] We further examine our proposed causal mechanism and provide evidence that inward FDI causes market concentration, and that concentration increases the probability of conflict. Finally, our results suggest that state capacity plays a mitigating role; that is, the positive effect of foreign investment on civil conflict diminishes as state capacity strengthens.

This chapter makes several important contributions to the literature on globalization and intrastate conflict. First, we highlight the importance of understanding the impact of global economic forces on market dynamics and rent creation in host countries and their implications for intrastate conflict.[4] This link has been overlooked in earlier work. To the extent that high economic rents fuel armed violence, globalization can contribute to civil conflict by creating a concentrated market environment conducive to rent creation.

Second, our findings suggest that global integration does not always have a pacifying effect, and that different forms of globalization affect civil violence differently. The presence of the large and highly productive MNCs is likely to alter market structure and contribute to rent creation, particularly in developing countries. This, in turn, increases the likelihood of civil conflict, especially when states are weak. Opening up to trade, in contrast, is likely to intensify market competition and dissipate the economic rents enjoyed by incumbent firms.[5] Therefore, globalization through trade liberalization should lower the incentive to fight. Our results indeed suggest that foreign investment and trade openness have distinct effects on intrastate conflict.

[2]We focus on civil conflict onset as the main outcome of interest. Appendix 6.7 shows that inward investment also prolongs civil conflict and increases the number of conflicts within a country.

[3]In Appendix 6.7, we disaggregate FDI into the primary, secondary, and tertiary sectors; we find that all types of investment have a strong positive effect on civil conflict.

[4]In a classic work, Krueger (1974) shows that economic rents accruing from government restrictions on imports (e.g., licensing) induce rent-seeking activities, which can take illegal forms.

[5]Some scholars suggest that international trade may increase the likelihood of domestic conflict in certain circumstances. See discussion in the next section.

Finally, we emphasize the importance of addressing potential identification threats arising from reverse causality and selection bias when studying the relationship between FDI and conflict. The interactions between global economic forces and domestic politics are simultaneous. On the one hand, cross-border economic exchanges alter the motivations and behaviors of societal actors, shaping political outcomes within countries. On the other hand, domestic politics influences a country's degree of integration into the global economy and channels the influence of external economic forces. As demonstrated by our empirical results, overlooking endogeneity and selection issues can lead to biased estimates or even invalid inferences.

This chapter proceeds as follows. The next section reviews the literature on economic interdependence and civil conflict. We then present our argument that inward FDI can increase the likelihood of civil conflict in developing countries by causing market concentration and contributing to rent creation, and that strong state capacity and high levels of public goods provision help to mitigate this effect. Following that, we discuss the research design and conduct a systematic empirical analysis. Finally, the chapter concludes with a discussion of the limitations of this study and possible future research direction.

6.2 Economic Interdependence and Intrastate Conflict

Commercial liberalism asserts that economic interdependence promotes peace between states (e.g., Oneal and Russet, 1997; Russett and Oneal, 2001). Economic integration contributes to a nation's economic growth and wealth; thus, states have the incentive to avoid conflict with a trading partner for fear of losing economic benefits (Polachek, 1980). Scholars have extended this argument to intrastate conflict and contended that benefits stemming from economic integration incentivize both governments and domestic groups to refrain from using violence, lowering the risk of armed conflict (e.g., Barbieri and Reuveny, 2005; Blanton and Apodaca, 2007; Bussmann and Schneider, 2007; Gleditsch, 2007; Hegre, Gissinger and Gleditsch, 2003).

Empirical studies have produced considerable support for a pacifying effect of trade on intrastate conflict.[6] Yet some scholars have also pointed out that trade shocks could lead to intrastate war. Bussmann and Schneider (2007) suggest that high trade openness reduces the risk of civil war but trade liberalization—changes in trade openness—is a destabilizing factor because it decreases the opportunity cost of using violence for losers suffering from economic reforms. Dal Bó and Dal Bó (2011) formally show that an increase in the price of capital-intensive output via trade can increase conflict by shrinking the labor-intensive sector and lowering wages—the main opportunity cost of rebellion. Garfinkel, Skaperdas and Syropoulos's (2008) model illustrates that trade openness can induce conflict by raising the value of contested natural resources when property rights are not secure. Dube and Vargas (2013) provide empirical evidence that the rise in oil prices contributes to violence in Colombia. Martin, Mayer and Thoenig (2008) suggest that international trade can be a substitute to internal trade and thus weaken economic ties between groups within a country, which increases the likelihood of conflict.

Most empirical studies operationalize economic interdependence in terms of trade openness. The relationship between foreign investment and intrastate conflict is relatively underexplored, and the empirical record is much more mixed. Barbieri and Reuveny (2005) report a strong negative relationship between FDI and civil war. Blanton and Apodaca (2007) find no negative association between FDI inflows and the probability of intrastate conflict, but report a significant drop in the intensity of conflict with higher investment inflows. Hegre, Gissinger and Gleditsch (2003) suggest that economic openness, including FDI, does not have a direct effect on the onset or duration of civil conflict; rather, openness plays an indirect pacifying role by contributing to income and political stability.

On the other hand, Olzak (2011) finds that economic globalization significantly increases fatalities from ethnic conflicts. Wegenast and Schneider (2017) shows that resource extraction by foreign firms in sub-Saharan Africa exacerbates grievances in local communities and

[6]See Schneider (2014) for a review of the literature.

increases conflict. Structuralist scholars maintain that, by raising income inequality, the influx of foreign investment causes political violence (e.g., London and Robinson, 1989). Finally, critical scholars have challenged the capitalist peace thesis and contend that violence and conflict are actually central to capitalist development (Cramer, 2006). A group of scholars, mainly drawing on the case of Colombia, show that violence and conflict accompany liberalization and deregulation, and can be instrumental in development (e.g., Gómez, Sánchez-Ayala and Vargas, 2015; Grajales, 2011; Gutiérrez-Sanín, 2009; Maher, 2015; Thomson, 2011).

The literature, we argue, overlooks one important mechanism through which inward FDI can be linked to internal conflict: FDI inflows affect market dynamics and rent creation in host countries, which in turn shapes the opportunity environment for rebellion. We elaborate on this mechanism in the next section.

6.3 FDI, Rents, and Civil Conflict

In previous chapters, we have established both theoretically and empirically that FDI inflows and MNC activity increase market concentration, which in turn facilitates high rent extraction in developing countries. High rents accruing from FDI inflows have direct implications for intrastate conflict. First, higher rent creation increases the size of the spoils and thus the expected returns to appropriating those rents (see Collier and Hoeffler, 2004; Fearon and Laitin, 2003; Grossman, 1991; Olsson and Fors, 2004). As potential gains increase rebels will have greater incentives to challenge the government. Garfinkel, Skaperdas and Syropoulos's (2008) model illustrates a similar logic in the case of international trade: free trade may intensify domestic conflict by increasing the value of contested natural resources when property rights are imperfectly enforced. Second, irrespective of the underlying motivations for rebellion, controlling rents enhances rebel groups' fighting capabilities relative to the government. Rebel groups who capture the rents created by foreign investors through extortion or taxation are better able to sustain their challenges, and more likely to prevail in a military confrontation with the government.

Since fighting is costly, both the government and rebels have incentives to reach a bargain they both would prefer over fighting. The government, for example, could potentially buy off their opposition by sharing the rents (Dal Bó and Powell, 2009). However, when economic rents increase, conflict over the control of those rents can exacerbate the commitment problem faced by the government (and rebel groups), because controlling these rents is likely to shift the future balance of power (Bell and Wolford, 2015). Rebels could accept concessions today that they believe to be equivalent to the expected value of fighting; yet rebel groups may worry that the rents accruing to the incumbent would result in future power shifts in favor of the government. It would then be easier for the government to renege on the settlement, keeping those rents to itself and fending off future attacks from the rebels. A similar calculation likely makes the government reluctant to transfer resources to the rebels as rents go up. In the presence of high economic rents, it is more difficult to arrange the distribution of rents and agree upon concessions, or such arrangements and agreements are more likely to break down, which results in conflict because of commitment problems (Fearon, 1995; Powell, 2006; Walter, 1997, 2002). Therefore, we expect FDI inflows into developing countries to increase the probability of intrastate armed conflict.

Note that the effect of FDI on conflict does not depend on the motivation behind the investment (e.g., resource-seeking, market-seeking, or export-oriented) or the sector in which the investment occurs (e.g., primary, manufacturing, or services). As long as the productivity differential between foreign and domestic firms is substantial, FDI inflows into the resource, manufacturing, or service sectors can lead to market concentration and rent creation to varying degrees. Even for export-oriented firms, access to foreign markets allows them to increase their markups through gains from economies of scale.[7] In the next section, we provide anecdotal evidence that FDI inflows and MNC activity can be linked to civil conflict by contributing to rent creation not only in the natural resource sector but also in manufacturing and other sectors.

[7]See Chapter 3 for a more detailed discussion on this point.

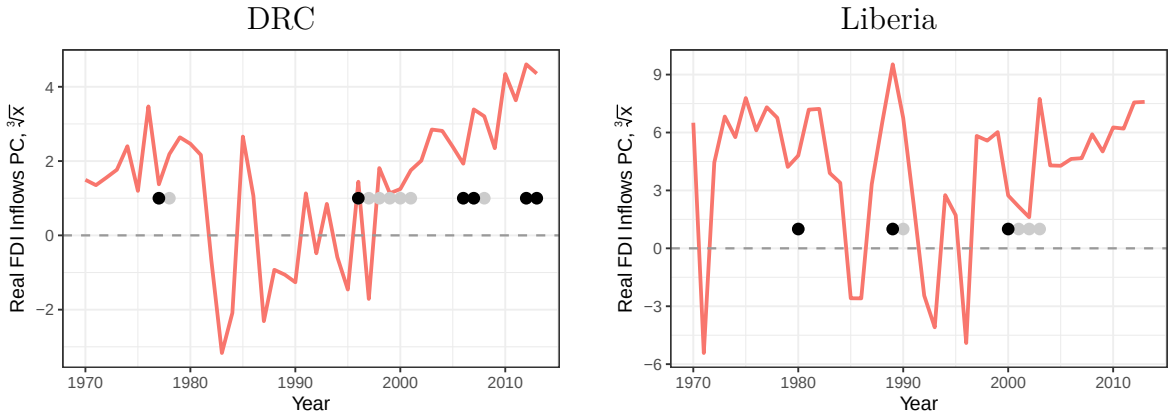
6.3.1 Multinationals and Conflict in Natural Resources and Beyond

The natural resource sector would be a *representative* case of the proposed mechanism. This sector is characterized by large capital requirements, steep upfront costs, economies of scale in production, and high costs of redeployment, which are barriers to entry that result in concentrated markets and rent creation. To illustrate, 74% of world iron ore production for export is controlled by the three largest companies, and approximately 41% of global oil and gas is produced by the largest 10 companies in the sector (UNCTAD, 2007). Yet most developing countries lack financial resources, technology, and management skills to exploit the endowments of natural resources to their full extent (Shafer, 1994; UNCTAD, 2007, 92). MNCs bring the financial resources, technology, and know-how that allow developing countries to further extract natural resource rents. High rents accruing from resource extraction have direct implications for civil conflict. As Skaperdas (2008, 31) notes, "[t]hough foreign investments in natural resources ... are typically meant to contribute to economic development, sometimes when there are serious problems of stability they can have the unintended consequences of intensifying conflict for the capture of the resultant rents." For example, in Indonesia, the rebel group Aceh Merdeka which emerged shortly before the opening of Aceh's first major natural gas facility—a joint venture between state-owned Pertamina, Mobil, and a consortium of Japanese companies (Robinson, 1998, 138). "With the start of LNG [liquid natural gas] production in the mid-1970s, however, Aceh became a magnet for the greedy and the powerful, and therefore a site of economic and political contention" (Robinson, 1998, 139).

The link between foreign investment and conflict is not limited to the natural resource sector. FDI into other sectors can also reshape market structures and generate higher rents, thereby increasing the incentives of rebel groups to capture those rents, enhance their relative strength, and challenge the government. To illustrate the connections between foreign

investment and conflict, we present two vignettes from the Democratic Republic of Congo (DRC) and Liberia, both of which are included in our dataset. In Figure 6.1, we plot the patterns of inward FDI and civil conflict in the DRC and Liberia, respectively. The figures suggest that outbreaks of civil conflict tend to follow upward movements in FDI activity in both countries. They also indicate that foreign investors remain engaged despite persistent violence. These patterns are consistent with our theoretical expectations. We further examine the involvement of MNCs' foreign affiliates across different sectors of the economy in these two countries and document their links to rebel activity in greater detail.

Figure 6.1: FDI and Civil Conflict in DRC and Liberia (1970–2013)



Notes: Solid red lines indicate the levels of real FDI inflows per capita (PPP-adjusted). Black dots indicate the onset of civil conflict, while gray dots represent the incidence of ongoing conflict.

Beer and Conflict in the DRC

It is widely accepted that the economic stakes of controlling valuable natural resources are among the main motivations behind rebel movements in the DRC (Olsson and Fors, 2004; UN Panel of Experts, 2001). "Elite networks"—consisting of political and military leaders, domestic and foreign businesses, and rebel leaders in occupied areas—have coalesced in various ways to monopolize the exploitation of natural resources (UN Panel of Experts, 2002). A report by a UN panel identifies a long list of domestic and MNCs engaged in the illegal exploitation of national resources in the DRC, particularly oil and other minerals. The activities of these companies can be linked to violence by directly or indirectly contributing

to the revenues of rebel groups (RAID, 2004). As stated in the report, "In fact, no coltan exists from the eastern DRC without benefiting either the rebel group or foreign armies" (UN Panel of Experts, 2002, 16). A quote in the *New York Times* further illustrates the point: "Just by controlling the borders and diminishing fraud, the rebellion can expect to start receiving large sums of money. The foreign investment will certainly follow."[8]

In the DRC the link between foreign investment and violence is not restricted to the extraction of oil and minerals. Foreign investment in other sectors, such as manufacturing and wholesale distribution, also resulted in rent creation. Controlling those rents has allowed rebel groups to sustain their challenge against the government. The activities of Bralima—an affiliate of Heineken International in the DRC—is a case in point.[9] Bralima is a brewing company, founded in 1923. It has been fully owned by Heineken International since 1987. Bralima holds a dominant position in the DRC's beverage sector, with over 60% market share (Miklian and Schouten, 2013, 73). Given its market dominance, Bralima enjoys high economic rents.

Despite the ongoing civil war in the DRC, Bralima maintained its operations and even increased its dominant position. There is now persuasive evidence suggesting that Bralima's activities have contributed to violent conflict. M23—a rebel group based in the eastern DRC, and mainly operating in the province of North Kivu, generated revenue for its activities by forcefully charging fees to truckers at the checkpoints under its control (Schouten, 2013, 9).[10] Given the opportunity to extort money, new rebel groups emerged (Schouten, 2013, 8). It is estimated that trucks that deliver bottles of Bralima beer paid up to $1 million a year to rebel groups (Miklian and Schouten, 2013, 73). In addition to contributing to checkpoint fees, it has been reported that Bralima was levied heavy taxes by the Rally for Congolese Democracy–Goma (RCD-Goma), a rebel group based in Goma during the second

[8]Howard W. French. 1997. "The Great Gold Rush in Zaire." *New York Times*, April 18.

[9]This case on Bralima and civil violence in the DRC draws heavily on Miklian and Schouten (2013) and Schouten (2013).

[10]According to Miklian and Schouten's conversation with a "tax collector" for M23, the three checkpoint stations in Bunagana, Kibati, and Kiwanja are M23's main funding sources (Miklian and Schouten, 2013, , 73).

Congo War (1998-2003).[11] Rebel groups in the DRC have been able to forcefully extract rents from economic operations outside of the resource sector, by setting up border posts and self-declared road checkpoints that collect fees from trucks passing through (Schouten, 2013, 8).

Rubber and Rebel Activity in Liberia

A related example of the connection between MNC operations and violent conflict is found in the First Liberian Civil War. A recent investigation reveals that Firestone's involvement in Liberia contributed to Charles Taylor's uprising (Miller and Jones, 2014).[12] The Firestone Plantations Company was established in Liberia in 1926 and soon became the world's leading rubber producer. Firestone played a dominant role in the Liberian economy; it was one of the country's largest employers and operated not only factories but also hospitals and schools (Anderson, 1998). By 1951, Firestone's post-tax profits were approximately three times the total revenue of the Nigerian government (Jones and Miller, 2014). As one interviewee noted, "Firestone was huge in every way, and the revenues were absolutely crucial. So what would happen would be that the government, when it ran out of money, would anticipate the revenues" (Miller and Jones, 2014).

Charles Taylor, the leader of the rebel group National Patriotic Front of Liberia, acknowledged the significance of capturing Firestone's facilities: "Oh, you had immediately a means that would provide the needed financial assistance that we needed for the revolution" (Miller and Jones, 2014). Controlling the rents generated by Firestone's operations was critical for both the government and the rebels.

In 1989, Charles Taylor returned to Liberia and began building his army using financial resources—partly derived from Firestone (Miller and Jones, 2014). On June 5, 1990, the rebels invaded Firestone's plantation and committed atrocities, forcing the company to halt

[11] *IRIN News*. 2000. "Protests against Bukavu 'Deportations'," September 8. Available at `http://www.irinnews.org/report/1978/drc-protests-against-bukavu-\%E2\%80\%9Cdeportations\%E2\%80\%9D`. Accessed March 8, 2016.

[12] The discussion of the Firestone case draws from ProPublica and PBS Frontline's documentary, *Firestone and the Warlord*, and Jones and Miller (2014).

operations. However, the violence did not drive Firestone out. Instead, in 1992, the company reached an agreement with Charles Taylor to recognize him as president and agreed to pay his rebel government more than $2.3 million in taxes (Jones and Miller, 2014). The company also provided a base of operations for the rebels, along with much-needed financial resources and foreign exchange for the insurrection (Jones and Miller, 2014).[13] Firestone was not only a source of funding and employment for the rebels but also, as Taylor emphasized, a provider of "some semblance of legitimacy" (Jones and Miller, 2014).

MNCs and Conflict: Lessons from the DRC and Liberia

The cases of the DRC and Liberia illustrate several important points. First, foreign investment and conflict are interconnected: while conflict can deter inward FDI, not all investors avoid violent areas. Some MNCs are risk-acceptant and would not pass on opportunities for extracting rents (Driffield, Jones and Crotty, 2013; Maher, 2015; Skovoroda, Goldfinch, DeRouen and Buck, 2019). For example, Maher (2015) shows that violence perpetrated by the Colombian government and paramilitary groups served the interests of transnational oil investors by creating favorable conditions, such as improved security and infrastructure. In Colombia during the 1990s, inward FDI grew at an average annual rate of 55%, despite high levels of political and criminal violence. Multinationals in the extractive, security, financial, and service sectors were motivated by the favorable contracts and concessions they could obtain "from a beleaguered state badly in need of extra income to sustain its war against a growing armed insurgency" (Richani, 2005, 115).

Second, these cases suggest that MNC activity across various sectors of the economy can contribute to rent creation, thereby fueling civil violence. Third, they highlight how the problem is compounded by a weak and failing government unable to control its territory, collect taxes, deliver basic public goods, or marshal the resources necessary to deter rebel groups. These vignettes do not constitute a formal test of our argument. Rather, we present them as anecdotal evidence to illustrate that the connection between MNC activity and

[13]Chris Morran, "Firestone Made Deal With The Devil, Paid Millions To Help Fund Genocidal Warlord."

rebels' ability to challenge the state extends beyond the natural resource sector and does not depend solely on the motivations behind rebellion. In the next sections, we further examine how state capacity moderates the conflict-enhancing effect of inward investment in developing countries.

6.4 Rents, State Capacity, and Civil Conflict

The vignettes from the DRC and Liberia underscore a potential mitigating role of state capacity on the relationship between foreign investment and intrastate conflict. State capacity shapes the opportunity environment faced by rebel groups when deciding to engage in violence (Tilly, 1978). Fragile and weak states favor insurgency and increase the risk of civil conflict (Fearon and Laitin, 2003). The governments in the DRC and Liberia have been fragile and weak, providing rebels an opportunity to appropriate rents generated by MNCs, and enhancing rebels' capabilities to mount a challenge.

One attribute of state capacity is the government's ability to collect taxes, royalties, and fees. Extractive capacity helps strengthen a government's fighting capabilities relative to other groups in the polity. States with stronger extractive capacity are in better positions to capture the rents generated from the activity of foreign firms in their territories, further bolstering state capacity. In addition, strong states are likely to be sufficiently powerful to deter rebellions. As the odds of defeating the government decrease, rebels lose incentives to fight. Conversely, when the government weakens, rebels are tempted to fight.

A well-functioning state is also capable of addressing the demands of its citizens through institutionalized channels such as public goods provision or redistribution, thereby lowering incentives to fight (Snyder and Bhavnani, 2005; Sobek, 2010; Taydas and Peksen, 2012). When the government is able to convert its share over the rents generated by MNCs into public goods to address citizens' demands, incentives to rebel drop: Public goods provision increases the opportunity cost of rebellion as fighting becomes less attractive to would be rebels. Furthermore, state capacity is associated with institutional development. States

with strong political and legal institutions are capable of enforcing negotiated rent-sharing contracts with opposition factions and thus alleviate the credible commitment problem often associated with the outbreak of civil conflict (DeRouen, Ferguson, Norton, Park, Lea and Streat-Bartlett, 2010; Gates, Graham, Lupu, Strand and Strøm, 2016; Skaperdas, 2008). We can, thus, derive the following hypothesis: The positive effect of inward FDI on civil conflict diminishes when levels of state capacity increase.

6.5 Empirical Analysis

To examine the empirical content of the hypothesis that inward foreign investment increases the risk of civil conflict in developing countries, we estimate the following model:

$$\begin{aligned} Prob(Conflict_{i,t} = 1) &= \beta_1 \cdot FDI_{i,t} + \beta_2 \cdot (FDI_{i,t} \times M_{i,t}) \\ &\quad + \beta_3 \cdot M_{i,t} + X_{i,t} \cdot \xi + \varepsilon_{i,t} \end{aligned} \tag{6.1}$$

$Conflict_{i,t}$ is an indicator of civil conflict in country i in year t. $M_{i,t}$ is the moderator. β_1, β_2, and β_3 are the coefficients to be estimated for FDI, the interaction term, and the moderator, respectively. $X_{i,t}$ is a matrix of covariates derived from the empirical literature on the determinants of intrastate armed conflict, and ξ is a vector of coefficients to be estimated. $\varepsilon_{i,t}$ is the error term.

Data

The dependent variable is the onset of civil conflicts with at least 25 battle deaths, obtained from the UCPD/PRIO Armed Conflict Dataset (Gleditsch, Wallensteen, Eriksson, Sollenberg and Strand, 2002; Themnér and Wallensteen, 2014). The variable is coded 1, if there is a new onset of conflict between government forces and at least one rebel group or it has been more than two years since the last observation of the conflict. To model onset and address temporal correlation, we drop the subsequent years of an ongoing conflict. Our

main results focus on conflict onset as the outcome variable. Appendix 6.7 shows that FDI inflows also have a strong positive effect on the presence/duration and the number of internal conflicts within a country.

As in the previous chapters, the main explanatory variable is real FDI per capita, adjusted for purchasing power. In the main specifications we use FDI inflow per capita as the independent variable. Results are substantively and statistically the same if we use real FDI stock per capita as the independent variable.

State capacity is a multidimensional concept, and scholars operationalize it in different ways. We focus on the revenue-extracting aspect of state capacity and use the Relative Political Extraction (RPE) index (Arbetman-Rabinowitz et al., 2013; Kugler and Tammen, 2012). This variable measures the ratio of actual tax revenue to expected tax revenue estimated from a linear function of the economy's structure and size. It is closely related to the mechanism discussed in the theory: the extent to which the government is able to control the rents accruing from MNC activity. We use tax revenue as a percentage of GDP for robustness checks.

In the baseline model, we include a battery of standard controls identified in the civil war literature: real GDP per capita, economic growth rate,[14] population (log), level of democracy, natural resource endowments, ethnolinguistic and religious fractionalization, percentage of mountainous area, and two indicator variables for states possessing noncontiguous territories, and for the Cold War period. We obtain real GDP per capita data from *Penn World Table 9.0*. The data on population and annual economic growth rates are from the World Bank's *World Development Indicators*. Democracy is measured by standard Polity scores, ranging from –10 to 10 (Marshall and Jaggers, 2010).[15] We use the per capita value of oil and gas production as a measure of natural resource endowments (Ross and Mahdavi, 2015). The data for ethnolinguistic and religious fractionalization, mountainous areas, and noncon-

[14]We take the cube root of this variable to deal with its skewed distribution.
[15]This variable is rescaled to vary from –1 to 1.

tiguous states come from Fearon and Laitin (2003). Finally, we include a time polynomial to account for time dependence (Carter and Signorino, 2010). Our time-series cross-sectional data set includes 118 developing countries from 1970 to 2013.

First Cut: A Naive Probit Model

Model 1 in Table 6.1 presents the results from a "naive" probit model. All time-varying covariates are lagged one year. We observe that the coefficient of FDI per capita is negative but does not achieve statistical significance. One concern is that this result may suffer from an endogeneity and selection bias. It is possible that armed conflict deters foreign investors, so we are less likely to observe FDI in violent places. This leads to a downward bias in estimates. Further, scholars have documented firms' heterogeneous preferences for entering conflict zones. For example, Barry (2018) suggests that MNCs favor peaceful places when entering a new market but are pretty resilient to conflict when the costs of entry have been sunk. Mihalache-O'keef and Vashchilko (2010) show that primary and service sector FDI are less sensitive to political violence than manufacturing FDI. Driffield, Jones and Crotty (2013) suggest that MNCs from countries with weaker institutions are more likely to invest in conflict zones. Skovoroda et al. (2019) demonstrate a positive correlation between civil war and U.S. investment in the oil and gas industry. To address these potential endogeneity and selection biases, our identification strategy relies on an IV estimation. The IV model also helps address potential measurement errors.[16]

IV Estimation

We utilize Geographic Closeness as an IV for inward FDI.[17] However, concerns may arise regarding the potential violation of the exclusion restriction assumption. In our case, we have grounds to believe that weighted geographic distance primarily influences civil conflict through cross-border flows of foreign investment. One possible violation of the exclusion restriction is that geographic distance may correlate with the diffusion of norms

[16]See Kerner (2014) for a detailed discussion of the measurement issues in existing FDI data.
[17]See Section 5.6 in Chapter 5.

and values such as democratic governance and neoliberal economic ideas, which likely have a pacifying effect on civil conflict. MNCs actually serve as an important vehicle for the diffusion of such norms and values (Kwok and Tadesse, 2006; Sandholtz and Gray, 2003). Even if the diffusion happens through other channels such as access to foreign media or cross-border personnel movements which tend to correlate with geographic distance, it is less of a concern for our identification strategy. This diffusion mechanism implies that geographic closeness to developed countries has a negative effect on conflict, which will result in an *underestimate* of the true coefficient of FDI. Similarly, if geographic closeness affects conflict through trade, it will bias the coefficient of FDI *downward*, because increasing trade is expected to intensify market competition and reduce opportunities for rent creation, thereby decreasing the likelihood of conflict.

Another possibility is that the IV may capture major powers' strategic interests that are likely to influence civil conflict. Support from these major powers is supposed to strengthen the government and dampen the incentives for rebellion (Fearon and Laitin, 2003).[18] Furthermore, most capital exporting countries included in the construction of the instrument are advanced democracies. A country that is neighbored by more democratic countries should have a lower risk of civil conflict (Gleditsch, 2007). If our instrument captures major powers' strategic security interests, we would *underestimate* the positive effect of FDI on civil conflict. In any event, to block this channel in our regression models we explicitly control for the strategic and security interests of the countries sourcing the investment capital.

In Model 2, we re-estimate Model 1 by instrumenting FDI per capita using geographic closeness. The F-statistic of the (excluded) instrument in the first-stag regression is 35.79, which suggests that the IV is strong. Compared with the results in Model 1, one noteworthy change is that the coefficient of FDI per capita turns positive and statistically significant at the 1% level. Substantively, when all other variables are held at their medians, a one standard

[18]For instance, the "Brezhnev doctrine" and French support for its former African colonies are two examples of great powers' security and strategic interests helping to lower the likelihood of civil conflict onset (Fearon and Laitin, 2003, 86)

Table 6.1: FDI and Civil Conflict Onset (Probit)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
FDI Inflows PC	-0.01	0.27***	0.31***	0.30***	0.27***	0.29***	
	(0.02)	(0.04)	(0.03)	(0.03)	(0.04)	(0.06)	
Nonprimary FDI PC							0.41***
							(0.03)
State Capacity (RPE)	0.03	0.07	0.20***	0.10	0.07	-0.01	0.71***
	(0.10)	(0.08)	(0.07)	(0.07)	(0.08)	(0.09)	(0.21)
GDP PC	-0.18***	-0.56***	-0.57***	-0.58***	-0.56***	-0.71***	-1.24***
	(0.06)	(0.06)	(0.05)	(0.06)	(0.06)	(0.11)	(0.08)
Population	0.13***	0.09***	-0.03	0.07***	0.09***	0.12***	-0.04
	(0.03)	(0.03)	(0.04)	(0.02)	(0.03)	(0.03)	(0.04)
Growth Rate	0.01	-0.08***	-0.09***	-0.10***	-0.08***	-0.05	-0.07
	(0.03)	(0.03)	(0.02)	(0.02)	(0.03)	(0.04)	(0.04)
Polity IV	0.09	-0.03	-0.08*	-0.02	-0.03	0.11	0.33***
	(0.07)	(0.06)	(0.05)	(0.05)	(0.05)	(0.07)	(0.11)
Natural Resources	0.03	0.06***	0.05***	0.05***	0.06***	0.02	0.22***
	(0.02)	(0.01)	(0.01)	(0.01)	(0.01)	(0.02)	(0.02)
Ethnic Frac.	0.49***	0.39***	0.34***	0.36***	0.39***	0.30**	-0.78***
	(0.17)	(0.12)	(0.12)	(0.12)	(0.12)	(0.15)	(0.28)
Religious Frac.	-0.53**	-0.57***	-0.57***	-0.53***	-0.57***	-0.49***	-0.29
	(0.21)	(0.14)	(0.14)	(0.15)	(0.14)	(0.17)	(0.25)
% Mountains	0.00	0.03	0.03	0.02	0.03	0.03	0.07
	(0.03)	(0.02)	(0.02)	(0.02)	(0.02)	(0.03)	(0.05)
Noncontiguous	0.65***	0.43***	0.51***	0.34***	0.43***	0.47***	0.75***
	(0.12)	(0.12)	(0.11)	(0.12)	(0.12)	(0.13)	(0.16)
Cold War	0.04	0.49***	0.33***	0.57***	0.49***	0.45***	0.67***
	(0.09)	(0.09)	(0.07)	(0.07)	(0.09)	(0.12)	(0.13)
Trade Openness			-0.56***				
			(0.09)				
UN Voting Similarity				-0.99***			
				(0.22)			
Aid				-0.03			
				(0.03)			
Alliance				0.45			
				(0.68)			
Colonial Ties				-2.78**			
				(1.31)			
Military Interventions					0.43		
					(1.16)		
Constant	-0.31	2.34***	5.05***	3.10***	2.33***	3.22***	7.90***
	(0.51)	(0.55)	(0.75)	(0.49)	(0.55)	(0.88)	(0.72)
N	3451	3451	3328	3451	3451	2964	908
F-stat (Excluded Instr)		35.79	14.16	18.20	35.61	45.67	35.32
P> F		0.00	0.00	0.00	0.00	0.00	0.00

Notes: All models include a time polynomial to account for time dependence and their coefficients are not reported. Robust standard errors in parentheses. * significant at 10%, ** significant at 5%, *** significant at 1%. Models 1-5 are estimated with the full sample. Model 6 excludes observations with more than one-third of their export revenues from fuels. Model 7 utilizes nonprimary FDI only.

deviation increase in inward FDI per capita from its median will increase the probability of civil conflict onset by 21 percentage points. The marginal effect is significant at the 1% level. This result provides support for our hypothesis that in developing countries, inward FDI increases the likelihood of civil conflict.

Regarding the estimated coefficients on the control variables, economic development and economic growth have a strong negative effect on civil conflict onset. By contrast, countries with larger populations and noncontiguous territory, abundant natural resources, and higher levels of ethnolinguistic fractionalization are significantly more likely to experience civil conflict onset. State capacity measured by Relative Political Extraction does not seem to have an independent effect on civil conflict onset. Religious fractionalization and the post-Cold War period correlate with lower probability of violence onset.

In Model 3, we control for trade openness (imports and exports as a percentage of GDP).[19] The results show that trade openness has a strong negative effect on civil conflict onset. This is consistent with the expectation that trade, unlike inward FDI, increases market competition and dissipates economic rents, thereby reducing the risk of conflict. The association between FDI and conflict increases slightly compared to Model 2.

In model 4 we address the concern that our instrument may capture major powers' security interests, which can directly affect civil conflict. We include four different measures of source countries' security interests: the host's UNGA voting similarity to the twenty capital sources, total foreign aid received from those countries, and alliance relationships and colonial ties.[20] The results show that two of the four measures—UNGA voting similarity and colonial ties—correlate negatively and significantly with civil conflict onset. Consistent with our expectation, after controlling for major powers' strategic interests, the coefficient of FDI becomes slightly larger compared with the one in Model 2. It remains significant beyond

[19]The data come from the World Bank's *World Development Indicators*.

[20]The UNGA voting similarity scores, alliance relationships, and colonial ties between a host and the capital source countries are weighted by the latter's share of real GDP per capita among the top twenty countries.

conventional levels. In Model 5, we use an alternative measure of international military intervention to capture major powers' influence on civil conflict.[21] We lag this variable one time period to address endogeneity. Again, our main results hold. In robustness checks, we differentiate the direction of intervention and further control for U.S. covert operations during the Cold War and obtain the same results (see Appendix 6.7).

Another potential concern about the results in Model 2 is that the positive relationship between FDI inflows and civil conflict onset could be driven by resource-rich countries. Our theory suggests that the positive effect of FDI on internal conflict exists in non-resource sectors as well. To check whether the results are solely driven by resource-rich countries, we re-estimate Model 2 by excluding countries with large resource endowments. We classify resource-rich countries as those receiving more than one-third of their export revenues from fuels (Fearon and Laitin, 2003). As shown in Model 6, after dropping resource-rich countries, we still find a positive and significant effect of inward FDI on civil conflict onset.

One may still be concerned that even in resource-poor countries, FDI into the primary sector could be the driving force. To address this concern, we experiment with sectoral FDI data obtained from UNCTAD. We focus on FDI in the manufacturing and service sector only, excluding investment in the agricultural and extractive industries.[22] We normalize non-primary FDI by population and take the cube root of the variable to deal with the skewed distribution. Model 7 shows that non-primary FDI has a strong positive effect on civil conflict onset. The results in Models 6 and 7 give us confidence that the positive relationship between FDI and conflict is not driven solely by foreign investment in the primary sector. In Appendix 6.7, we further disaggregate FDI in the primary, secondary, and tertiary sector and find that all have a strong positive effect on intrastate conflict.

[21] The data come from Pickering and Kisangani (2009).

[22] One caveat with this strategy is that the coverage of sectoral FDI data is fairly poor. The sample contains 61 developing countries for the period 1980 to 2013. The number of observations within each country varies from 1 to 33.

FDI, Market Concentration, and Civil Conflict

Our theory suggests that inward FDI causes market concentration and results in rent creation, thereby increasing the probability of conflict onset. In this section, we examine the underlying causal mechanism. Two critical questions we need to address: Does inward FDI indeed increase market concentration in developing countries, and does market concentration correlate with a high probability of conflict onset? Chapter 4 systematically examines the first question and demonstrates that inward FDI contributes to market concentration in developing countries.

Table 6.2: Market Concentration and Civil Conflict Onset (OLS)

	(1) CR4	(2) HHI
Concentration	15.83*	2.02*
	(8.25)	(1.18)
GDP PC	-1.53*	-1.66*
	(0.92)	(0.92)
State Capacity (PRE)	-3.56*	-3.23*
	(1.95)	(1.80)
Population	0.58	0.42
	(0.41)	(0.40)
Growth Rate	1.30	1.42
	(1.24)	(1.26)
Natural Resources	0.71**	0.68**
	(0.28)	(0.27)
Constant	5.72	18.41**
	(9.49)	(8.96)
N	103	103
R^2	0.21	0.19

Notes: Robust standard errors in parentheses. * significant at 10%, ** significant at 5%; *** significant at 1%.

To address the second question whether market concentration increases the odds of conflict onset, we leverage the cross-sectional variation and use the frequency of conflict onset over the period 2000–2013 as the dependent variable. Market concentration is measured by the Herfindahl-Hirschman Index (HHI) and four-firm concentration ratio (CR4) constructed

from the World Bank Enterprise Survey (WBES).[23] All time-variant covariates are averaged over the same period.[24] We estimate an OLS model and present the results in Table 6.2.[25] We see that both measures of market concentration correlate positively with a high rate of conflict onset and their coefficients are significant at the 10% level.[26] Take Model 1 for example. Substantively, all else being equal, a one standard division increase of market concentration will raise the frequency of conflict onset by 1.64 (approximately 57% of the mean level in the sample). This marginal effect is substantially large. Altogether results in this section provide evidence supportive of the proposed mechanisms.

State Capacity and Conflict Onset

This section examines the role of state capacity in mitigating the positive effect of FDI on conflict onset. We again use geographic closeness to instrument FDI so as to deal with the endogeneity and selection bias. Given the strong assumption of the jointly normal distribution of the error terms from the two stages of regression in an IV probit model (Wooldridge, 2010, 585) and the complexity of interpreting an interaction term in binary probit models (Ai and Norton, 2003; Berry, DeMeritt and Esarey, 2010), we estimate a linear probability model (LPM), which provides a good estimate of the average effect (Wooldridge, 2010, 585).

Model 1 in Table 6.3 shows the results where FDI interacts with Relative Political Extraction (RPE). The coefficient of FDI is positive and that of the interaction term is negative. Both coefficients are statistically significant at the 1% level. These results lend

[23] See detailed discussions in Chapter 4.

[24] We estimate a paired-down version of the model to maximize the sample size. The results are consistent if we introduce other covariates included the baseline model.

[25] Two countries, India and Myanmar, have the highest number of conflict onsets over the 14-year period (five and six onsets, respectively), and exert a large influence on the results. India's FDI per capita and market concentration are both well below the sample means. India's frequent civil conflict onsets in this period were driven by secessionist movements in Assam, Bodoland, and Kashmir. Myanmar also experienced frequent separatist wars, and its FDI per capita and market concentration are far below the sample means. Funding for rebels groups in Myanmar comes from looting of timber and gemstones and from opium production (see Ross, 2004). We exclude these two observations in the regression.

[26] The results are consistent if we use the total number of onsets over the time period as the dependent variable and estimate a negative binomial model.

Table 6.3: FDI, State Capacity, and Civil Conflict Onset (LPM)

	(1) RPE	(2) Tax/GDP	(3) Enroll.
FDI Inflows PC	0.04***	0.05***	0.03***
	(0.01)	(0.01)	(0.01)
FDI*State Capacity	-0.01***	-0.01**	-0.02*
	(0.00)	(0.00)	(0.01)
State Capacity	0.05**	0.02*	-0.01
	(0.02)	(0.01)	(0.03)
GDP PC	-0.07***	-0.09***	-0.06***
	(0.02)	(0.02)	(0.02)
Population	0.02***	0.02***	0.02***
	(0.00)	(0.00)	(0.00)
Growth Rate	-0.01***	-0.01***	-0.01***
	(0.00)	(0.00)	(0.00)
Democracy	-0.00	-0.01	-0.00
	(0.01)	(0.01)	(0.01)
Natural Resources	0.01***	0.01***	0.00***
	(0.00)	(0.00)	(0.00)
Ethnic Frac.	0.08***	0.08***	0.06***
	(0.02)	(0.02)	(0.02)
Religious Frac.	-0.11***	-0.10***	-0.08***
	(0.02)	(0.02)	(0.02)
% Mountains	0.00	0.00	0.00
	(0.00)	(0.00)	(0.00)
Noncontiguous	0.14***	0.14***	0.13***
	(0.02)	(0.02)	(0.02)
Cold War	0.07***	0.08***	0.06***
	(0.02)	(0.02)	(0.02)
Constant	0.50***	0.55***	0.39***
	(0.09)	(0.10)	(0.09)
N	3451	3472	3050
R^2	0.09	0.09	0.09

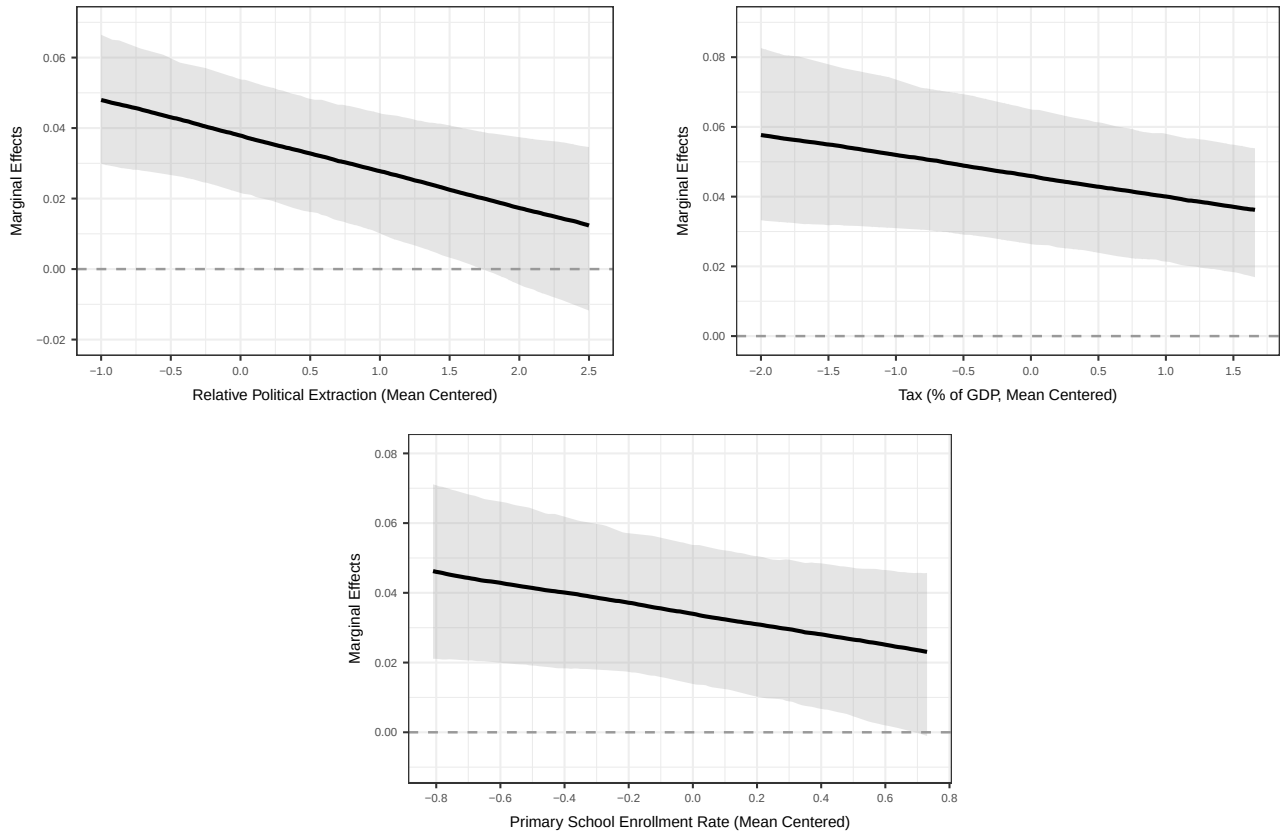
Notes: All models include a time polynomial to account for time dependence and their coefficients are not reported. Bootstrapped standard errors in parentheses. * significant at 10%, ** significant at 5%; *** significant at 1%.

support to our hypothesis that state capacity attenuates the positive effect of FDI on conflict onset. The top-left panel of Figure 6.2 visualizes the marginal effects of FDI on civil conflict onset along the level of RPE. When RPE reaches 1.73 (approximately Belarus's in 1991 in our sample), FDI no longer has a significant impact on civil conflict onset. In Model 2, we utilize an alternative measure—tax revenue as a percentage of GDP. We take the natural logarithm of this variable to address skewed distribution.[27] The results are consistent. The top-right panel of Figure 6.2 shows that the marginal effect of FDI remains positive and

[27]It is lagged one year to deal with potential endogeneity.

significant within the range of the tax revenue variable in the sample.

Figure 6.2: Marginal Effects of FDI per Capita on Civil Conflict Onset



Notes: Plots of marginal effects of FDI on civil conflict onset. The shadowed areas indicate the 95% confidence intervals, obtained from 1,000 simulations.

In Model 3, we examine one of the proposed functions of state capacity in our argument: the ability to deliver public goods. To measure public goods provision, we use primary school enrollment rate as a proxy. Enrollment rates are an outcome variable and serve as a good proxy for the government's ability to deliver the public goods (Thyne, 2006, 736). The results in Model 3 are consistent with our expectation: the coefficient of FDI is positive whereas the interaction term between FDI and primary school enrollment rate is negative, and both are statistically significant. In the bottom panel of Figure 6.2, we graph the simulated marginal effects of FDI on conflict onset from Model 3. It indicates that the positive effect of FDI diminishes along the level of primary school enrollment. Note that, in both Models 1 and 2, the coefficient of state capacity is positive, which suggests that when the level of FDI inflows

is low, high extraction capacity of the state increases the probability of civil conflict. It may be because the grievances generated by the state's excessive revenue extraction outweigh the deterrence power that the state acquires from the extracted revenue when total rents are low and the economy is poor as indicated by low FDI inflows. When we use school enrollment rate as a proxy for state capacity, its coefficient becomes negative.

In sum, the results in Table 6.3 support our hypothesis that state capacity attenuates the positive effect of FDI on internal conflict.[28]

Conflict Duration and Additional Robustness Checks

So far, we have focused on civil conflict onset as the outcome variable. According to our argument, rents accruing from MNC activity should also increase the duration of conflict and the number of conflicts within a country. High rents generated by FDI inflows increase the incentive of different groups to rebel. If economic rents persist, the incentive for rebellion will continue. Moreover, capturing the rents through extortion or taxation contributes to rebel groups' financial viability, which alters the relative strength in favor of rebel groups and enables them to keep challenging the government, regardless of their motivations for rebellion. Thus, we should expect inward FDI to increase conflict incidence and total number of conflicts. Results in Appendix 6.7 show that FDI inflows indeed have a strong positive effect on the presence/duration of conflict as well as the number of armed conflicts within a country.

We also perform a series of additional robustness checks. First, we examine whether our results are sensitive to how we code civil conflict onset (Appendix 6.7). Second, we experiment with disaggregating internal conflict and the results show that inward FDI correlates positively with both conflict over the control of territory and conflict over the control of

[28]We experimented with the composite index of national capability (CINC) from the National Material Capabilities Data Set v5.0 (Singer, Bremer and Stuckey, 1972) to capture a nation's coercive power and a measure of political constraints (polcon) from Henisz (2002) to proxy a government's credible commitments. Consistent with our expectation, the results show that the interaction term between FDI and CINC and the one between FDI and Henisz's measure are both negative and statistically significant. Yet the marginal effects of FDI remain positive and significant within the range of the CINC and polcon variable in the sample.

government (Appendix 6.7).

6.6 Conclusion

The current era of globalization is characterized by the formation of global production networks built around multinationals. Global integration through foreign investment is believed to be a boon: foreign investment is expected to generate positive economic outcomes, such as employment, exports, and economic growth. Yet foreign investment may also generate unintended economic and political consequences. In this chapter, we examine the relationship between inward investment and intrastate armed conflict. We argue that the entry and presence of highly productive foreign firms in developing countries causes market concentration and leads to high rent creation; high rents, in turn, increase rebel groups' incentives to challenge the government or to control these rents for instrumental purposes, thereby increasing the probability of internal conflict.

Testing the empirical content of this link is complicated by endogeneity and selection biases concerns. We use an instrumental variable for FDI—geographic closeness, which is derived from the gravity model of investment—to address the endogeneity and selection issue. We find that inward FDI correlates positively and strongly with a high probability of civil conflict. This relationship holds for FDI in the primary, secondary, and tertiary sector. In addition, we show that inward FDI increases the probability of civil conflict through causing market concentration and leading to high rent extraction. State capacity, on the other hand, attenuates the positive effect of FDI on internal conflict.

It should be noted that one limitation of our study is that we do not explore the relationship between FDI and conflict at a more disaggregated level. The advantage of a country-level study is that we are able to cover a large number of countries over a long time period. Further, such a research design allows us to directly examine the underlying mechanism that FDI inflows lead to market concentration and rent creation, which in turn increases the likelihood of civil conflict. Yet, civil conflicts are often region-specific and

foreign investment can be geographically concentrated. Our research is thus not able to explore how international businesses interact with local communities and the implications of these interactions for violence and conflict. This remains a fruitful area for future research especially given that geo-coded FDI project data has become increasingly available (e.g., the *fDi Markets* data).

Future studies can also explore further the heterogeneity of MNCs and its impact on intrastate armed conflict. For example, capital-intensive foreign investment may have a stronger effect on internal conflict than labor-intensive foreign investment. This is because the former is more likely than the latter to cause market concentration and lead to monopoly rent extraction due to large capital requirements and high sunk costs associated with these investments; further, the immobility of capital-intensive investment makes it a relatively easy target for rebel groups to extract resources.

6.7 Appendix

Sectoral FDI and Conflict

To explore the heterogeneity of foreign investment, we disaggregate FDI into the primary, secondary, and tertiary sector. Models 1-3 of Table 6.4 show the results from a probit model for each type of FDI. We see that primary and tertiary FDI are positively while secondary FDI is negatively associated with civil conflict onset. None of the coefficients achieves statistical significance. Models 4-6 re-estimate Models 1-3 by using geographic closeness as an instrument for sectoral FDI. After accounting for the endogeneity bias, we see that all three types of FDI have a strong positive effect on civil conflict. One caveat is that our instrument variable—geographic closeness—is a much stronger predictor of secondary and tertiary FDI than primary FDI, as indicated by the F-statistics in Models 4-6. This also suggests that the results from the IV estimator reported in the main text are mainly driven by FDI in the secondary and tertiary sectors.

Table 6.4: Sectoral FDI and Civil Conflict Onset (Probit)

	Probit			IV Probit		
	(1) Pri.	(2) Sec.	(3) Ter.	(4) Pri.	(5) Sec.	(6) Ter.
FDI Inflows PC	0.06	-0.05	0.03	0.45***	0.45***	0.42***
	(0.04)	(0.04)	(0.06)	(0.02)	(0.03)	(0.03)
State Capacity (RPE)	0.99***	1.03***	0.98***	-0.59***	0.16	0.77***
	(0.34)	(0.34)	(0.34)	(0.16)	(0.19)	(0.21)
GDP PC	-0.30**	-0.27*	-0.35**	0.20***	-0.64***	-1.16***
	(0.15)	(0.15)	(0.17)	(0.05)	(0.12)	(0.09)
Population	0.27***	0.22***	0.21***	0.27***	-0.09***	-0.01
	(0.07)	(0.07)	(0.07)	(0.03)	(0.03)	(0.04)
Growth Rate	-0.01	0.01	-0.00	-0.09**	0.02	-0.11**
	(0.08)	(0.08)	(0.08)	(0.04)	(0.04)	(0.04)
Democracy	0.21	0.19	0.18	-0.12*	0.18*	0.31***
	(0.17)	(0.18)	(0.18)	(0.07)	(0.11)	(0.12)
Natural Resources (log)	0.07	0.10**	0.11**	-0.23***	0.10***	0.23***
	(0.05)	(0.05)	(0.04)	(0.02)	(0.03)	(0.02)
Ethnic Frac.	0.28	0.27	0.24	0.10	-0.10	-0.91***
	(0.54)	(0.55)	(0.55)	(0.15)	(0.24)	(0.28)
Religious Frac.	-0.23	-0.18	-0.24	0.02	-0.11	-0.21
	(0.51)	(0.51)	(0.51)	(0.21)	(0.19)	(0.25)
% Mountains	0.04	0.03	0.02	0.05	0.04	0.07
	(0.09)	(0.09)	(0.09)	(0.03)	(0.05)	(0.05)
Noncontiguous	0.66***	0.76***	0.77***	-0.41***	0.20	0.79***
	(0.24)	(0.24)	(0.24)	(0.14)	(0.13)	(0.16)
Cold War	0.19	0.04	0.14	0.54***	0.27***	0.76***
	(0.26)	(0.25)	(0.28)	(0.10)	(0.10)	(0.13)
Constant	-0.55	-0.45	0.11	-3.37***	3.84***	7.39***
	(1.31)	(1.29)	(1.38)	(0.46)	(0.87)	(0.72)
N	908	908	908	908	908	908
Pseudo R^2	0.28	0.28	0.28			
F-stat (Excluded Instr)				0.27	10.59	34.97
$P > F$				0.60	0.00	0.00

Standard errors in parentheses

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Notes: All models include a time polynomial to account for time dependence and their coefficients are not reported. Robust standard errors in parentheses. * significant at 10%, ** significant at 5%; *** significant at 1%.

FDI and Conflict Type

In this section, we report results on FDI and different types of internal conflict. We have argued that in developing countries inward FDI results in market concentration and high rents, which in turn increase rebels' incentive to challenge the government or to capture the rents to enhance their fighting capabilities, regardless of their motivations. Therefore, we expect the positive effect of FDI to hold for different types of intrastate armed conflict. The UCDP/PRIO armed conflict data set reports three types of incompatibility between a government and rebels: incompatible concerns about government, territory, or both. We code an onset of conflict as a government conflict if the only conflict in a country-year is over government or both government and territory are contested, and as a territory conflict if all conflicts are over territory or both government and territory are contested. We use two intermittent peace years to treat a reoccurrence of the conflict as a new onset and drop the subsequent years of an ongoing conflict in the regression. Models 1 and 2 in Table 6.5 present the results on the onset of conflict over government and territory, respectively. Consistent with our expectation, both coefficients of FDI per capita are positive and statistically significant.

Table 6.5: FDI and Civil Conflict Type (IV Probit)

	(1) Govt.	(2) Terr.
FDI per Capita (cube)	0.22***	0.31***
	(0.07)	(0.02)
State Capacity (RPE)	0.06	0.08
	(0.09)	(0.08)
GDP per Capita (log)	-0.56***	-0.57***
	(0.10)	(0.06)
Population (log)	0.09***	0.12***
	(0.03)	(0.03)
Growth Rate	-0.09***	-0.10***
	(0.03)	(0.02)
Polity IV	-0.01	-0.02
	(0.07)	(0.05)
Nat. Resources (log)	0.07***	0.06***
	(0.02)	(0.02)
Ethnic Frac.	0.54***	0.45***
	(0.17)	(0.14)
Religious Frac.	-0.45***	-0.68***
	(0.17)	(0.15)
% Mountains (log)	0.04	0.02
	(0.02)	(0.02)
Noncontiguous	0.43***	0.35***
	(0.14)	(0.13)
Cold War	0.43***	0.43***
	(0.14)	(0.09)
Constant	1.70*	2.40***
	(0.87)	(0.56)
N	3401	3375
F-stat (Excluded Instr)	34.45	40.50
$P > F$	0.00	0.00

Notes: All models include a time polynomial to account for time dependence and their coefficients are not reported. Robust standard errors in parentheses. * significant at 10%, ** significant at 5%; *** significant at 1%.

Conflict Duration and Total Number of Conflicts

This section examines the effect of FDI on the presence/duration of civil conflict and the number of conflicts within a country. To model the presence/duration of civil conflict, we use conflict incidence as the dependent variable, which is coded 1 if there is at least one active conflict in a country-year and 0 if otherwise. Model 1 in Table 6.6 presents results from an IV probit model. FDI per capita has a strong positive effect on conflict incidence. Model 2 estimates an IV logit model with time dependence, which is equivalent to a duration model (Beck, Katz and Tucker, 1998). We use the two-stage residual inclusion (2SRI) estimator in which the first-stage residuals are included as additional regressors as opposed to the two-stage predictor substitution (2SPS) estimator, because for nonlinear models the former produces consistent estimates but the latter does not (Terza, Basu and Rathouz, 2008). Standard errors are bootstrapped. Model 2 shows that the coefficient of FDI is positive and significant at the 5% level, which suggests that inward FDI prolongs the duration of conflict. Model 3 uses the number of active conflicts in a country-year as the dependent variable and estimates a 2SLS model. The results show that FDI inflows increase the number of conflicts as well.

Table 6.6: Conflict Presence/Duration and Number of Conflicts

	Conflict Duration		Total Conflicts
	(1) Probit	(2) Logit	(3) 2SLS
FDI Inflows PC	0.25***	0.59**	0.16***
	(0.05)	(0.23)	(0.04)
State Capacity (RPE)	-0.05	-0.17	0.01
	(0.07)	(0.16)	(0.03)
GDP PC	-0.42***	-0.95**	-0.22***
	(0.09)	(0.38)	(0.06)
Population	0.11***	0.27***	0.09***
	(0.02)	(0.05)	(0.01)
Growth Rate	-0.07**	-0.15*	-0.04***
	(0.03)	(0.08)	(0.01)
Democracy	-0.03	-0.08	-0.03*
	(0.05)	(0.14)	(0.02)
Natural Resources	0.02	0.04	0.00
	(0.01)	(0.04)	(0.01)
Ethnic Frac.	0.20*	0.48*	0.32***
	(0.11)	(0.25)	(0.04)
Religious Frac.	-0.28**	-0.58	-0.28***
	(0.14)	(0.38)	(0.06)
% Mountains	0.06***	0.15***	0.01
	(0.02)	(0.05)	(0.01)
Noncontiguous	0.10	0.26	0.32***
	(0.08)	(0.18)	(0.05)
Cold War	0.61***	1.47***	0.33***
	(0.08)	(0.41)	(0.07)
First-Stage Residual		-0.61***	
		(0.23)	
Constant	2.34***	5.15**	1.56***
	(0.55)	(2.22)	(0.37)
N	4114	4114	4114
F-stat (Excluded Instr)	35.35	35.35	35.35
$P > F$	0.00	0.00	0.00

Notes: All models include a time polynomial to account for time dependence and their coefficients are not reported. Robust standard errors in Models 1 and 3 and bootstrapped standard errors in Model 2. * significant at 10%, ** significant at 5%; *** significant at 1%.

Coding Civil Conflict Onset

In the main text, the civil conflict onset variable is coded 1 if this is a new onset or it has been at least two years since the last observation of the conflict, and the subsequent years of an ongoing conflict are dropped to model onset. In this section, we examine whether our results are sensitive to how the civil conflict onset variable is coded. In Model 1 of Table 6.7, we include the subsequent years of an ongoing conflict. In Models 2–5, we use different numbers of intermittent years—2, 5, 8, and 20—to treat a reoccurrence of the conflict as a new onset and drop the subsequent years of an ongoing conflict. Finally, Model 6 utilizes only completely new onsets of civil conflict. We see from Table 6.7 that the empirical results are robust and consistent. FDI inflows correlate positively and strongly with civil conflict onset regardless of how we code it.

Table 6.7: FDI and Civil Conflict Onset: Different Intermittent Years (IV Probit)

	(1) Onset2	(2) Onset1	(3) Onset5	(4) Onset8	(5) Onset20	(6) New
FDI Inflows PC	0.26***	0.25***	0.27***	0.27***	0.26***	0.27***
	(0.06)	(0.04)	(0.04)	(0.04)	(0.04)	(0.04)
State Capacity (RPE)	0.09	0.02	0.13	0.13	0.15*	0.16*
	(0.07)	(0.08)	(0.08)	(0.08)	(0.09)	(0.09)
GDP PC	-0.56***	-0.54***	-0.58***	-0.59***	-0.55***	-0.54***
	(0.07)	(0.07)	(0.06)	(0.06)	(0.07)	(0.07)
Population	0.08***	0.10***	0.10***	0.10***	0.10***	0.09***
	(0.02)	(0.03)	(0.03)	(0.03)	(0.03)	(0.03)
Growth Rate	-0.07**	-0.07**	-0.11***	-0.11***	-0.11***	-0.12***
	(0.03)	(0.03)	(0.02)	(0.02)	(0.02)	(0.02)
Democracy	-0.04	-0.04	0.02	0.02	-0.01	-0.00
	(0.06)	(0.06)	(0.06)	(0.06)	(0.06)	(0.07)
Natural Resources (log)	0.06***	0.05***	0.06***	0.06***	0.05***	0.05***
	(0.01)	(0.02)	(0.01)	(0.02)	(0.02)	(0.02)
Ethnic Frac.	0.27**	0.47***	0.23**	0.24**	0.30**	0.28**
	(0.12)	(0.13)	(0.12)	(0.12)	(0.13)	(0.13)
Religious Frac.	-0.45***	-0.52***	-0.55***	-0.49***	-0.62***	-0.66***
	(0.14)	(0.14)	(0.15)	(0.15)	(0.17)	(0.17)
% Mountains	0.02	0.03	0.02	0.02	0.01	-0.01
	(0.02)	(0.02)	(0.02)	(0.02)	(0.03)	(0.03)
Noncontiguous	0.26**	0.41***	0.44***	0.40***	0.48***	0.49***
	(0.11)	(0.12)	(0.13)	(0.12)	(0.15)	(0.15)
Cold War	0.46***	0.43***	0.56***	0.58***	0.56***	0.61***
	(0.11)	(0.10)	(0.07)	(0.07)	(0.08)	(0.07)
Constant	2.14***	2.25***	2.29***	2.34***	2.09***	2.10***
	(0.67)	(0.58)	(0.57)	(0.56)	(0.64)	(0.65)
N	4114	3485	3406	3396	3375	3364
F-stat (Excluded Instr)	33.50	36.68	36.56	36.44	41.21	40.76
$P > F$	0.00	0.00	0.00	0.00	0.00	0.00

Notes: All models include a time polynomial to account for time dependence and their coefficients are not reported. Robust standard errors in parentheses. * significant at 10%, ** significant at 5%; *** significant at 1%.

Military Interventions and U.S. Covert Operations

In the main text, we control for international military interventions to address the concern that our instrumental variable may capture major powers' strategic interests. The correlation between our instrument and the weighted military intervention variable is –0.02 in the sample. As shown in Model 5 of Table 6.1, our main findings remain robust and consistent when we add this variable to the model. In that model, we treat all military interventions the same and do not distinguish the direction of intervention. To further check the robustness of our findings, in Models 1–3 of Table 6.8, we consider different types of military interventions from the 20 capital source countries in a given year: non-neutral, favoring the government, or favoring rebels. We weight the interventions by the capital source countries' share of GDP per capita among the 20 economies and lag the intervention variables one year to address endogeneity. Adding these variables does not substantively affect the results of the first-state stage regression. The second-stage results show that the military intervention variables do not have a significant effect on the onset of civil conflict. The coefficient of real FDI per capita remains positive and significant.

In Model 4, we further control for U.S. covert operations during the Cold War.[29] The data are from Berger, Corvalan and Satyanath (2013). This variable is lagged to deal with endogeneity. The correlation between U.S. covert operations and the instrument is –0.22 in our sample, significant at the 1% level. The results show that U.S. covert operations do not significantly affect conflict onset, though the coefficient is positive. Our main finding regarding inward FDI remains the same.

[29]The Soviet Union is not among the 20 wealthiest economies included in the construction of the instrumental variable.

Table 6.8: Interventions and Civil Conflict Onset (IV Probit)

	(1)	(2)	(3)	(4)
FDI Inflows PC	0.27***	0.27***	0.27***	0.27***
	(0.04)	(0.04)	(0.04)	(0.04)
State Capacity (RPE)	0.07	0.07	0.08	0.08
	(0.08)	(0.08)	(0.08)	(0.08)
GDP PC	-0.56***	-0.56***	-0.56***	-0.57***
	(0.06)	(0.06)	(0.06)	(0.06)
Population	0.09***	0.09***	0.09***	0.09***
	(0.03)	(0.03)	(0.03)	(0.03)
Growth Rate	-0.08***	-0.08***	-0.08***	-0.08***
	(0.03)	(0.03)	(0.03)	(0.03)
Democracy	-0.03	-0.03	-0.03	-0.03
	(0.06)	(0.06)	(0.06)	(0.06)
Natural Resources (	0.06***	0.06***	0.06***	0.06***
	(0.01)	(0.01)	(0.01)	(0.01)
Ethnic Frac.	0.39***	0.39***	0.41***	0.41***
	(0.12)	(0.12)	(0.13)	(0.12)
Religious Frac.	-0.57***	-0.57***	-0.57***	-0.54***
	(0.14)	(0.14)	(0.14)	(0.14)
% Mountains	0.03	0.03	0.03	0.03
	(0.02)	(0.02)	(0.02)	(0.02)
Noncontiguous	0.43***	0.43***	0.43***	0.41***
	(0.12)	(0.12)	(0.12)	(0.12)
Cold War	0.49***	0.49***	0.49***	0.46***
	(0.09)	(0.09)	(0.09)	(0.09)
Interventions (Nonneutral)	0.88			
	(1.06)			
Interventions (Favor Gov.)		0.19		
		(1.31)		
Interventions (Favor Reb.)			7.77	
			(5.39)	
U.S. Covert Operations				0.20
				(0.13)
Constant	2.34***	2.34***	2.31***	2.38***
	(0.55)	(0.55)	(0.56)	(0.52)
N	3451	3451	3451	3394
F-stat (Excluded Instr)	35.68	35.67	35.96	35.90
$P > F$	0.00	0.00	0.00	0.00

Notes: All models include a time polynomial to account for time dependence and their coefficients are not reported. Robust standard errors in parentheses. * significant at 10%, ** significant at 5%; *** significant at 1%.

Chapter 7

Foreign Direct Investment and Leadership Turnover

7.1 Introduction

On September 11, 1973, the Chilean military staged a coup d'état that overthrew President Salvador Allende and brought an end to Chile's 46-year tradition of electoral democracy. The coup marked a pivotal moment in Cold War politics and drew significant attention to the role of foreign influence in domestic political transitions. One major MNC, the International Telephone and Telegraph Corporation (ITT), was widely believed to have played an active role in supporting U.S. covert operations aimed at destabilizing Allende's government. Declassified documents and U.S. Senate hearings later revealed that ITT had lobbied the U.S. government and offered up to $1 million to the Central Intelligence Agency (CIA) to fund efforts either to prevent Allende's inauguration or to orchestrate his removal—primarily to protect the company's business interests from nationalization (U.S. Senate, 1975).[1]

This case exemplifies how FDI and corporate interests can have a profound impact on domestic politics in host countries. It also raises a critical question: How might FDI inflows and MNC activity influence political instability and leadership turnover in developing

[1]We provide a more detailed account of ITT's involvement in Chile later in this chapter.

countries? We argue that FDI inflows and MNC activity can exacerbate political contestation and instability in host countries when they contribute to market concentration and rent creation. High rents create strong incentives for actors at various levels to capture, appropriate, and compete over those rents—often through illicit or violent means. In the previous two chapters, we demonstrated that FDI inflows and MNC activity in developing countries increase both corruption and the likelihood of armed conflict.

Yet, competition over the control of economic rents may also manifest in leadership turnover, short of military conflict. High rents increase the value of political office by enlarging the potential spoils, thereby incentivizing opposition groups to seek power and contributing to elite fragmentation (Acemoglu, Ticchi and Vindigni, 2010; Andersen and Aslaksen, 2013; Besley and Persson, 2011; Caselli and Cunningham, 2009). Rent-sharing agreements are prone to breakdown due to the inherently conflictual nature of rent distribution (Acemoglu and Robinson, 2008*a*; Meng, Paine and Powell, 2023; Powell, 2024). Consequently, we expect a higher likelihood of leadership turnover when economic rents are elevated.

We further contend that state capacity mitigates the positive relationship between FDI and leadership turnover. Strong states—endowed with high extractive capacity—enable incumbent governments to more effectively collect and control economic rents. These resources can be deployed either to strengthen deterrence capacity or to provide public goods that enhance economic productivity and alleviate public grievances, thereby prolonging the incumbent's tenure in office.

We subject these arguments to empirical testing using data from the Changes in the Sources of Leadership Support (CHISOL) Dataset for the period 1970 to 2018 (Mattes, Leeds and Matsumura, 2016). Our results show that FDI inflows are associated with a higher probability of leadership turnover after accounting for endogeneity and unobserved country heterogeneity. This positive relationship holds for both primary and non-primary FDI, as well as in non-resource-dependent countries, suggesting that the effect is general and not merely a manifestation of the resource curse. Moreover, our findings indicate that the

positive effect of FDI on leadership turnover weakens—and eventually turns negative—as a state's extractive capacity and ability to provide public goods increase.

The chapter is organized as follows. Next section reviews the literature. After that, we present our argument, testable hypotheses, and a case study of the ITT in Chile. We then evaluate our hypotheses in a cross-national time-series setting. Finally, the chapter concludes.

7.2 Related Literature

The political economy of FDI literature has examined leadership turnover as both an explanatory and an outcome variable. One strand of this literature explores leadership turnover within the broader framework of political risk, treating it as a potential deterrent to foreign investors: as the ex-post costs of redeployment increase, firms become more exposed to government discretion and policy uncertainty, raising the likelihood of expropriation over time (Pinto and Pinto, 2008, 2011; Vernon, 1971). Frequent government turnover shortens leaders' time horizons, incentivizing them to expropriate foreign investments for political survival (Li, 2009). Leadership turnover also leads to shifts in government preferences, resulting in policy volatility and undermining government credibility (Bak, 2016; Gray and Kucik, 2017). This negative effect of leadership turnover on FDI inflows is likely more pronounced in authoritarian regimes, where political constraints on leaders are weaker (Fails, 2014; Rooney and DiLorenzo, 2021).

A second strand of the literature examines the impact of FDI and MNC activity on leadership turnover and political instability more broadly. This line of inquiry has a longer intellectual history. Earlier works rooted in the World Systems, Dependencia, Triple Alliance, and structuralist traditions portray foreign investors as exploitative actors that disrupt domestic political and economic processes in host countries (Evans, 1979; Evans and Gereffi, 1982; Kobrin, 1987; Moran, 1975, 1978).

More recent research has focused on the consequences of FDI inflows for political sur-

vival. FDI can enhance a leader's ability to deliver private benefits to elites, thereby creating a pro-FDI coalition that prolongs authoritarian incumbents' tenure (Bak and Moon, 2016). Foreign investors may also act strategically, increasing FDI flows to reduce the risk of coups in authoritarian regimes (Tomashevskiy, 2017). In democracies, FDI-driven job creation and local economic growth can bolster a leader's electoral prospects and chances of reelection (Garriga, 2022; Kim, 2022; Owen, 2019).

The political economy literature on FDI and leadership turnover, however, remains relatively thin. A broader, related literature examines the relationship between natural resource rents—and more generally unearned income—and political survival. Scholars offer competing arguments as to whether, how, and under what conditions unearned income, such as resource rents or foreign aid, affects a leader's ability to retain power. The empirical evidence on this question remains mixed.

One influential strand of the literature argues that unearned income can help prolong a leader's tenure in office. These financial windfalls, such as natural resource revenues and foreign aid, relax fiscal constraints and provide incumbent leaders with discretionary resources to maintain political support. Specifically, they enable rulers to finance patronage networks, co-opt opposition elites, and bolster the state's coercive apparatus (e.g., Acemoglu, Johnson and Robinson, 2005; Ahmed, 2012; Andersen and Aslaksen, 2013; Robinson, Torvik and Verdier, 2006; Wright, Frantz and Geddes, 2015). In addition, leaders may spend strategically to reduce popular demand for political accountability—for instance, by offering tax cuts or targeted public goods to key constituencies (McGuirk, 2013; Morrison, 2009).

Conversely, another strand of the literature suggests that unearned income generates political instability and shortens leaders' tenure. These financial flows increase the value of holding office, tempting the elites with the winning coalition or opposition groups to oust the leader (Acemoglu, Ticchi and Vindigni, 2010; Caselli, 2006; Caselli and Tesei, 2016; Caselli and Cunningham, 2009). They may also induce moral hazard in the sense that the leader over-extract rents and under-invest in public goods, thereby jeopardizing long-run

economic growth and leading to political instability (Cabrales and Hauk, 2010; Ravetti, Sarr and Swanson, 2018).

We note several important gaps in the existing literature. First, the relationship between FDI and leadership turnover has received limited scholarly attention. The few existing studies focus primarily on the effect of inward FDI on political survival in authoritarian regimes. We extend this line of inquiry by developing a general theoretical framework that accounts for the relationship between FDI and leadership turnover across different regime types.

Second, while the literature on unearned income offers nuanced insights into how easily appropriated rents can influence political dynamics—either as a source of stability or instability—it largely overlooks other forms of rent creation. As noted earlier, natural resource rents represent an extreme case of a broader phenomenon: rent creation arising from market concentration and entry barriers. In a perfectly competitive market, the price of natural resources should equal the marginal cost of extraction. However, when high entry barriers—whether natural or government-imposed—exist, they foster market concentration and generate economic rents. These rents can become deeply politicized, shaping elite competition and influencing leadership outcomes.

Third, the literature often assumes an oversimplified, monotonic relationship between economic rents and leadership turnover, whether positive or negative. Yet, whether economic rents prolong or shorten a leader's tenure likely depends on who controls these rents and how they are allocated. These moderating factors have received scant attention in the existing research.

7.3 FDI, Rents, and Leadership Turnover

In Chapters 3 and 4, we demonstrated that the rent-creation effect of FDI is a function of the productivity differential between foreign entrants and domestic firms. In developing countries, where domestic firms are typically smaller and less technologically advanced, this

productivity differential tends to be large. As a result, FDI inflows and MNC activity in these countries are more likely to crowd out domestic firms, leading to increased market concentration and the creation of economic rents.

These rents can be captured by the state through royalties, taxes, and dividends. High rents increase both the size of the spoils and the value of holding political power. On the one hand, incumbent leaders are incentivized to prolong their tenure in order to maintain access to these rents, as such access is typically lost upon leaving office (Bueno de Mesquita, Smith, Siverson and Morrow, 2005). On the other hand, high levels of rent extraction motivate opposition groups to seek power (Andersen and Aslaksen, 2013; Besley and Persson, 2011; Caselli and Cunningham, 2009) and contribute to elite fragmentation, as rival factions compete to control the rents associated with political office (Acemoglu, Ticchi and Vindigni, 2010; Caselli, 2006). The incentives to capture and appropriate these rents can give rise to political contestation and conflict over control of the state, either through direct violence—as discussed in Chapter 6—or through leadership turnover, whether by constitutional or unconstitutional means.

When facing a political challenge, incumbent leaders may attempt to discourage or co-opt challengers by redistributing rents. Authoritarian leaders, in particular, often employ monetary payoffs, perks, and privileges to co-opt opposition figures and consolidate political support (Gandhi and Przeworski, 2006; Svolik, 2012; Wright, Frantz and Geddes, 2015). In both authoritarian and democratic systems, cabinet appointments and legislative seats are frequently allocated as part of elite-level rent-sharing arrangements aimed at preserving regime stability (Arriola, Devaro and Meng, 2021; Francois, Rainer and Trebbi, 2015). Rent-sharing may also take the form of preferential access to government contracts and other state-disbursed economic opportunities (Reuter, 2017).

However, any rent-sharing arrangement is subject to a fundamental credible commitment problem (Meng, Paine and Powell, 2023; Powell, 2024). Because control over economic resources translates into political power, the distribution of rents is inherently conflictual

(Acemoglu and Robinson, 2008*a*). The incumbent leader cannot credibly commit not to renege on the agreement by reallocating rents in their favor at a later stage. Similarly, opposition groups or rival elites cannot credibly commit to refraining from using their enhanced political position—gained through increased access to rents—to mount a future challenge to the incumbent's authority.

Due to these commitment problems, bargaining over the allocation of rents generated by FDI inflows and MNC activity is prone to failure. As a result, we expect heightened political contestation and, consequently, a greater likelihood of leadership turnover in contexts characterized by substantial rent extraction from foreign investment. Hence, we hypothesize that FDI inflows will be positively associated with the likelihood of leadership turnover in developing countries.

7.3.1 Rents, State Capacity, and Leadership Turnover

State capacity plays a significant role in mitigating the positive effect of FDI inflows and MNC activity on leadership turnover. State capacity is a multidimensional concept that generally refers to a government's ability to collect taxes, enforce law and order, and deliver public goods (Arbetman-Rabinowitz and Kugler, 1997; Besley and Persson, 2010; Hendrix, 2010; Suryanarayan, 2024). We posit that two dimensions of state capacity—extractive capacity and the provision of public goods—are key moderators in the relationship between FDI inflows, MNC activity, and leadership turnover.

Leaders' political survival hinges on the resources under their control (Bueno de Mesquita et al., 2005). These resources may originate from non-tax sources such as natural resource rents and foreign aid, or from tax revenues. Extractive capacity determines the extent to which a government can generate revenue from the domestic economy (Arbetman-Rabinowitz and Kugler, 1997; Kugler and Tammen, 2012). Natural resource rents typically require minimal extractive capacity, as leaders can generate income through upfront payments from the sale of extraction rights and continue to benefit from royalties, dividends, and related taxes (Ross, 2004).

In contrast, extracting rents from non-resource sectors—such as those generated by FDI inflows and MNC activity—relies more heavily on the state's ability to effectively tax and regulate economic activity. In states with high extractive capacity, governments can capture these rents through corporate taxation, royalties, and other regulatory mechanisms (Arbetman-Rabinowitz and Kugler, 1997; Kugler and Tammen, 2012). However, in states with weak extractive capacity, much of the economic rents may remain with MNCs or domestic actors capable of appropriating them outside the reach of the state. Thus, the ability of the state to tax and regulate FDI-driven rents plays a central role in shaping their political consequences.

When an incumbent leader captures the economic rents, they face at least two strategic options for consolidating their hold on power. First, they can allocate resources to what Caselli and Tesei (2016) term "self-preservation activities," including vote-buying, surveillance, repression, and military expansion. These measures enhance the regime's coercive capacity and deter opposition by increasing the costs and reducing the likelihood of a successful political challenge.

Second, the leader can channel a portion of these rents into the provision of public goods. By investing in infrastructure, education, healthcare, and other public services, the leader fosters a more productive and diversified economy, thereby improving societal well-being. This strategy has two important implications. First, a productive and diversified economy provides alternative income opportunities for potential challengers, reducing their incentive to seek political power (Gallego and Pitchik, 2004). Second, effective public goods provision alleviates public grievances, bolsters support for the incumbent (Brender and Drazen, 2008; Bueno de Mesquita et al., 2005; Fiorina, 1978; Nunn, Qian and Wen, 2018), and undermines opposition cohesion by exacerbating coordination problems and weakening collective action (Acemoglu and Robinson, 2008*a*,*b*). Thus, by addressing public discontent and improving material conditions, leaders can secure popular legitimacy while mitigating the risks of rebellion or political unrest.

Accordingly, we expect that higher levels of state capacity—particularly the ability to extract revenues from the economy and to convert resources into public goods—will moderate the positive effect of FDI inflows on leadership turnover. We thus hypothesize that, all else being equal, the positive effect of inward FDI on leadership turnover in developing countries weakens as state capacity increases.

7.4 ITT in Chile

In this section, we examine the case of ITT in Chile to illustrate how concerns over the distribution of rents from FDI inflows and MNC activity can lead to political instability, even in a country like Chile, which had a long tradition of democracy until 1973.

Founded in 1920, ITT had grown into a sprawling business conglomerate by the late 1960s and early 1970s. At that time, ITT's worldwide assets totaled $6.6 billion, making it one of the ten largest American corporations on *Fortune* magazine's list.[2]

ITT entered Chile in 1927 by acquiring the Chilean Telephone Company during a period in which it was purchasing telecommunications firms across Latin America (Melo, 1998, 205). Following the acquisition, the company was renamed Compañía de Teléfonos de Chile (CTC). In Chile, ITT operated six affiliates, including two hotels, an Avis car rental company, a small telex service, and a phone equipment plant,[3] employing approximately 8,000 workers.[4] Its total assets in Chile were valued at approximately $200 million, making it the third-largest foreign investor in the country—surpassed only by the copper holdings of Anaconda and Kennecott.[5] ITT's most valuable asset in Chile was its stake in CTC, estimated at around $153 million.

[2]Karnow, Stanley. "ITT's Chile Caper: A 'Good Corporate Citizen' Or Economic Imperialist?" *Washington Post*, March 27, 1972. Available at `https://www.cia.gov/readingroom/docs/CIA-RDP74B00415R000300020010-2.pdf`. Accessed February 2, 2025.

[3]Rubin, Barry. "Chile Cancels Talks: Expose ITT, CIA Role in Chile." *National Guardian*, April 11, 1973. Available at `https://www.cia.gov/readingroom/docs/CIA-RDP91-00901R000600100004-0.pdf`. Accessed February 15, 2025.

[4]Karnow, Stanley. "ITT's Chile Caper: A 'Good Corporate Citizen' Or Economic Imperialist?" *Washington Post*, March 27, 1972. Available at `https://www.cia.gov/readingroom/docs/CIA-RDP74B00415R000300020010-2.pdf`. Accessed February 2, 2025.

[5]"ITT in Chile." *North American Congress on Latin America* (NACLA), September 25, 2007. Available at `https://nacla.org/article/itt-chile`. Accessed March 6, 2025.

CTC quickly became the dominant force in Chile's telecommunications market. In 1930, the company signed a special agreement with the government, securing a 50-year concession with an option for renewal every 30 years. Moreover, it was not required to interconnect with other networks (Melo, 1998, 206). This agreement reinforced ITT's privileges and consolidated its monopolistic position in Chile's telecommunications sector. By 1953, CTC managed 371 million local calls and 23 million interurban calls annually, whereas the country's second-largest telecommunications provider, Compañía Nacional de Teléfonos de Valdivia, handled only 6.2 million local calls and 470,000 interurban calls in the mid-1950s (Melo, 1998, 207).

The Chilean government sought to regulate the public utilities sector, which was largely controlled by domestic economic elites and multinationals. Decree-Law No. 4 (DL-4), enacted on July 24, 1959, established a legal framework for regulating electric services, with certain provisions extended to telecommunications. Under DL-4, concessionaires were required to pay the government an initial tax followed by an annual tax for establishing and operating their systems. They were also obligated to interconnect with other providers. Tariffs were set to ensure a guaranteed annual return of 10 percent on fixed assets (Melo, 1998, 207).

In the same year, Chile enacted its first competition law, Law No. 13,305, and established the Antitrust Commission. However, the law had limited impact on curbing monopolistic practices, and the National Economic Prosecutor remained largely inactive during its early years (Agüero, 2016).

Despite these legal reforms, CTC retained its privileges under the terms of its 1930 agreement, including the right to maintain its own accounting records (Melo, 1998, 206). Even during the 1950s, as Chile grappled with high inflation, CTC remained profitable and retained its legitimacy, despite growing public dissatisfaction. It did so by leveraging its close relationship with the Chilean government, which repeatedly approved tariff increases (Bucheli and Salvaj, 2013, 740). Nonetheless, CTC's service remained both poor in quality and expensive, consistently failing to meet consumer demand (Melo, 1998, 208). CTC's

monopolistic position and privileged status reflected Chile's pro-elite, foreign investment-friendly economic environment, which was characterized by persistent concentration and limited competition.

The economic and political clout of industrial monopolies and demands for redistribution became central issues of political contestation in Chile. Two new parties emerged: a coalition of leftist and Marxist groups formed the Frente de Acción Popular (FRAP) in 1956 and a group of centrist and social-Christian parties merged into the Partido Demócrata Cristiano (DC, Christian Democratic Party) in 1957. Both parties depicted then-President Jorge Alessandri, who run as an independent candidate but was supported by the conservative Partido Conservador and the right-leaning Partido Liberal, as a defender of the elites and foreign interests (Bucheli and Salvaj, 2013, 740). These developments contributed to the emergence of a three-bloc party system in Chile's political landscape, a structure that persisted until the military coup of 1973.

The 1964 election marked a significant shift in Chile's political landscape. During the campaign, Eduardo Frei, the DC candidate, advocated for land redistribution, government participation in the mining sector, and the empowerment of the lower classes. Salvador Allende, the FRAP candidate, proposed a more radical approach, calling for the expropriation of foreign businesses and state control over monopolies (Bucheli and Salvaj, 2013, 740).

ITT and the CIA covertly provided millions of dollars in financial support to Frei to block Allende's election, viewing Frei as the "lesser evil" (Sigmund, 1976, 12; see also Bucheli and Salvaj, 2013, 740–9). With backing from the Conservatives and Liberals, Frei won the 1964 election with 56 percent of the vote, while FRAP's Allende secured 38.9 percent.

During his presidency from 1964 to 1970, Eduardo Frei implemented the "Revolution in Liberty" program, which prioritized agrarian reform and the "Chileanization" of the copper industry. At the time, land ownership in Chile was highly concentrated under the hacienda system, with 65 percent of the land controlled by just 7 percent of landowners (Sigmund, 1976, 20). Under the 1967 land reform law, the Chilean government expropriated large

estates and redistributed the land to peasant families; however, the primary beneficiaries were wealthier peasants (Winn, 1974, 136–7).

The "Chileanization" of the copper industry aimed to expand government control and redistribute resource rents (Sands, 1982). Natural resource rents were a major source of government revenue, but resource extraction was predominantly controlled by foreign companies (Frieden, 1991, 146). The Frei administration negotiated agreements with Anaconda and Kennecott—two U.S. companies that dominated Chile's copper industry—and gradually acquired majority ownership (Sigmund, 1977). However, neither the left nor the right was satisfied with Frei's "Revolution in Liberty." The left viewed his approach as too gradualist and his goals too modest, while the right saw his "creeping socialism" as a threat to traditional elite interests (Sands, 1982).

The 1970 election once again centered on issues such as wealth redistribution, foreign control of Chilean industries, and the extent of government involvement in the economy. Salvador Allende ran for a fourth time as the candidate of Unidad Popular (UP, Popular Unity), a leftist coalition of social democrats, Christian socialists, and Marxists that had replaced FRAP. Allende's platform included the nationalization of the copper mines, accelerated agrarian reform, socialization of major sectors of the economy, wage increases, and improved relations with socialist and communist countries (U.S. Senate, 1975, 20). Jorge Alessandri ran as an independent candidate but was backed by the National Party. His campaign emphasized private sector development, economic growth over income redistribution, and reduced government expenditures (Sigmund, 1976, 95). Radomiro Tomic, the DC candidate, advocated continuing and expanding Frei's "Revolution in Liberty" program, including the nationalization of major industries such as copper and accelerated land redistribution to peasants (U.S. Department of State, 2015).

Viewing Allende's presidency as a significant threat to their interests in Chile, American firms expressed concerns to U.S. government officials (U.S. Senate, 1975, 12). ITT again approached the CIA, offering to fund the Alessandri campaign. Although the CIA rejected

the proposal, ITT, following the agency's advice, channeled approximately $350,000 to the Alessandri campaign and the National Party, while other U.S. businesses contributed a similar amount (U.S. Senate, 1975, 13). Meanwhile, the U.S. government orchestrated "spoiling" operations, including an extensive propaganda campaign and other covert actions, to prevent Allende from winning the election (U.S. Senate, 1975, 21–22).

However, these efforts failed to achieve the desired outcome. On September 4, 1970, Salvador Allende won a plurality in the Chilean presidential election, securing 36.3 percent of the popular vote. He was closely followed by Jorge Alessandri, who received 35.5 percent, while Radomiro Tomic finished third with 28.1 percent. According to Chile's 1925 constitution, when no candidate wins an absolute majority, Congress was responsible for selecting the president from the top two candidates. During the interim period between the election and the Congressional proceedings to elect a president, ITT, the CIA, and other US businesses actively sought to prevent Allende from assuming office, viewing him as a threat to both US business interests in Chile and national security amid Cold War tensions.

The US's anti-Allende efforts operated on two tracks (U.S. Senate, 1975, 23–6): Under Track I the CIA engaged in interconnected political, economic, and propaganda efforts aimed at influencing the congressional vote. The National Security Decision Memorandum 40 (NSDM 40, or Forty Committee) approved efforts to enlist American businesses in exerting economic pressure on Chile, and an interagency working group was formed to coordinate covert economic measures.[6] Under Track II the CIA was directed to provoke a military coup in Chile.

It was reported at the time that ITT had made an offer of $1 million to fund US government efforts to prevent Allende from assuming the presidency, but the CIA rejected the offer.[7] ITT also proposed to the US government to take measures against Chile, such as

[6]Established under National Security Decision Memorandum 40, the Forty Committee was a sub-Cabinet body within the Executive Branch responsible for reviewing and approving major covert operations. It oversaw the planning and coordination of clandestine activities–primarily conducted by the CIA–intended to advance U.S. foreign policy objectives, including covert actions in Chile during the early 1970s.

[7]Shanahan, Eileen. "I.T.T. Officials in Conflict on Purpose of Chile Fund." *New York*

halting US aid, but no further action or discussions took place (U.S. Senate, 1973, 11).

Yet, these efforts failed to achieve their intended outcome. On October 24, 1970, the Chilean Congress elected Mr. Allende as president. After taking office, Allende moved to nationalize major industries. On July 11, 1971, Congress passed a nationalization amendment to the constitution. It included a clause of "excess-profit taking," allowing the government to deduct excess profits, which meant that companies could receive little to no compensation.[8]

In response to Allende's electoral victory and the prospect of nationalization, ITT and other major US companies with investments in Chile formed an ad-hoc committee. Its objective was to pressure the US government to block Chile's access to loans from international financial institutions, forcing Allende to negotiate under more favorable terms (U.S. Senate, 1973, 12–3).

Under the constitutional amendment, the Allende government nationalized the copper mines owned by Anaconda and Kennecott, deducting $7.74 million in excess profits that exceeded the book value of these assets.[9] Initially, Allende informed ITT that government had not yet decided whether to nationalize the telephone company or form a joint venture with the firm. However, the Chilean government later opted for nationalization and offered $24 million in compensation, while ITT demanded the full book value of its 70 percent stake in CTC. On September 29, the Chilean government took over CTC's management. Shortly after, ITT proposed an 18-point action plan to the US government, aimed at crippling Chile's economy to ensure Allende would not remain in power for more than six months (Subcommittee on Multinational Corporations, 1973, 15). However, the proposal was ignored

Times. Mar 23, 1973, p.77. Available at `https://www.nytimes.com/1973/03/23/archives/itt-officials-in-conflict-on-purpose-of-chile-fund.html`. Accessed March 12, 2025. "ITT: A Small Whale." *The Nation*, April 16, 1973. Available at `https://www.cia.gov/readingroom/docs/CIA-RDP91-00901R000600100004-0.pdf`. Accessed February 15, 2025.

[8]Office of the Historian. "The Allende Years and the Pinochet Coup, 1969–1973." Available at `https://history.state.gov/milestones/1969-1976/allende`. Accessed March 13, 2025.

[9]Novitski, Joseph. "Chile Nullifies Payments For Seized Copper Mines." *New York Times*. September 29, 1971. Page 1. Available at `https://www.nytimes.com/1971/09/29/archives/chile-nullifies-payments-for-seized-copper-mines-chile-nullifies.html`. Accessed March 12, 2025.

by the Nixon administration.[10]

Negotiations between ITT and the Chilean government resumed in December, but the publication of Anderson's columns sparked a political uproar. The columns exposed ITT's collaboration with the CIA and its proposed covert actions to interfere in the 1970 election.[11] In response, the Allende government swiftly moved to nationalize CTC without providing adequate compensation under the "excess profit" ruling.

Throughout Allende's presidency, the US publicly stated that "Chile's problem was a Chilean problem, to be settled by Chile" (U.S. Senate, 1975, 27). However, the US actively worked to forge a united opposition to his government by funding opposition parties, conducting an anti-Allende propaganda campaign, and sustaining economic warfare against Chile (Senate Select Committee 1975). The US also enlisted international financial institutions and private companies to participate in economic warfare aimed at destabilizing Chile's economy. These efforts played a crucial role in setting the stage for the military coup on September 11, 1973, though there is little evidence indicating that the US government was directly involved in covertly supporting the coup.[12] The military coup ended Chile's 46-years history of democracy.[13] From its independence in 1818 to1973, there were only three brief interruptions to Chile's democratic tradition.[14]

Although the ITT-Chile case was complicated by Cold War tensions, it clearly illustrated that the control and distribution of monopoly rents generated by MNCs can be a source of political contestation, which may, in turn, lead to political instability and leadership turnover. For years, ITT maintained its privileges and monopoly in Chile but failed to provide the quality service residents demanded, exacerbating public grievances. The ITT case was merely

[10]"I.T.T. Against Chile." *New York Times*, July 4, 1972, p. 16. `https://www.nytimes.com/1972/07/04/archives/itt-against-chile.html`. Accessed March 12, 2025.

[11]See Anderson, Jack. "The Washington Merry-Go-Round: Memos Bare ITT Try for Chile Coup." *The Washington Post* March 21, 1972, B13.

[12]Office of the Historian. "The Allende Years and the Pinochet Coup, 1969–1973." `https://history.state.gov/milestones/1969-1976/allende`, Accessed March 6, 2025.

[13]Ibid.

[14]Sobran, M.J. JR. "ITT and Allende: Looking Back on What Happened." *National Review.* 13 April, 1973.

a reflection of Chile's monopolistic economy at the time, which was dominated by large private companies and foreign businesses.

The influence of consolidated industrial conglomerates and demands for wealth distribution became central issues in Chile's electoral politics in the 1960s. New parties including the PDC and FRAP emerged to challenge the government for control over major industries and economic rents, particularly in sectors dominated by foreign firms. Grievances over unequal wealth distribution and monopolistic business practices helped push the Chilean electorate to the left, ultimately leading to Allende's electoral victory in 1970. The dominant position of major industries in Chile, particularly foreign owned companies in the copper and telecommunications sectors, sparked demands for nationalization even before Allende was elected president. Allende's more radical approach, the so-called democratic road to socialism, consolidated government control over economic rents but alienated domestic elites and foreign businesses. ITT and other American firms instigated CIA's efforts to create chaos (Track I actions) to prevent the Chilean Congress from electing Allende (Kornbluh, 2013: 21-3). While this effort failed, it helped sow the seeds that ultimately led to the military coup of 1973.

7.5 Empirical Analysis

In this section, we subject our hypotheses to systematic empirical analyses using a sample of non-OECD countries from 1970 to 2018. The dependent variable is leadership turnover, coded as 1 if at least one leader transition occurs in a given country-year, and 0 otherwise. The data is from the Changes in the Sources of Leadership Support (CHISOLS) Dataset (Mattes, Leeds and Matsumura, 2016). Leadership turnover data in CHISOLS is based on the ARCHIGOS political leaders database (Goemans, Gleditsch and Chiozza, 2009) and is updated through 2018.

Our main independent variable is measured using data on real per capita FDI inflows (PPP-adjusted). As in previous chapters, we apply a cubic root transformation to address

the variable's skewed distribution. To account for endogeneity, we adopt the same empirical strategy as before, instrumenting inward FDI with a weighted geographic distance between the host country and the world's 20 wealthiest economies.[15]

State capacity is a multidimensional concept. As argued in the theoretical section, high extractive capacity and public goods provision serve as critical moderators in the relationship between inward FDI and leadership turnover. Following the previous chapter, we use Arbetman-Rabinowitz et al.'s (2013) Relative Political Extraction dataset to measure extractive capacity. We use two alternative measures from the dataset, including Absolute Political Capacity (APE) and Tax/GDP, for robustness checks.

We construct a composite measure of public goods provision based on a factor score derived from a principal factor analysis of the primary school enrollment rate,[16] measles immunization rate (% of children ages 12–23 months), and infant mortality rates (per 1,000 live births).[17]

In addition, we control for real GDP per capita (PPP-adjusted, log), population (log), economic growth rates, trade openness, and resource rents (% of GDP). The Chile case illustrates that great powers' interests, influence and intervention may lead to political instability and leadership turnover. We use real aid per capita received as a proxy for great power strategic influence, as most donors are Western developed countries and aid allocation is primarily driven by security considerations (Alesina and Dollar, 2000). We also control for covert operations conducted by the United States and the Soviet Union during the Cold War (Berger, Corvalan and Satyanath, 2013).[18]

We further control for a full set of regime types: presidential, parliamentary, single-

[15]See Section 5.6 in Chapter 5.

[16]The primary school enrollment rate is calculated by dividing the total number of students enrolled in primary school by the population aged 5 to 14. Enrollment data are from UNESCO's education statistics; population data are from the World Bank's *World Development Indicators*.

[17]Data for both the measles immunization rate and the infant mortality rate come from the World Bank's *World Development Indicators*. For ease of interpretation, we reverse the values of the infant mortality rate so that higher values indicate better public goods provision.

[18]In robustness checks, we further control of great powers' influence using a weighted measure of the host country's UNGA voting similarity score with the top 20 wealthiest countries and US military aid received.

party, personal, monarchy, and other regimes.[19] The data come from the Rulers, Elections, and Irregular Governance (REIGN) dataset (Bell, Besaw and Frank, 2021). REIGN's regime classification builds on Marshall, Gurr and Jaggers (2019) and Geddes, Wright and Frantz (2014). Single-party regimes are excluded as the reference category. Finally, all model specifications include a time polynomial to account for time dependence.

Results

We begin by evaluating the linear hypothesis concerning the effect of inward FDI on leadership turnover, and results are presented in Table 7.1. Model 1 is a simple pooled probit model and Model 2 adds country fixed effects (FEs). The coefficients for FDI Inflows PC in both models are slightly positive but do not achieve statistical significance.

One concern with these results is endogeneity, as frequent leadership turnover signals political instability, which discourages FDI inflows and may even lead to divestment (Li, 2009). This introduces a downward bias in the estimates. To address this issue, Models 3 and 4 respectively re-estimate Models 1 and 2 using an IV estimator, where Geographic Closeness is used as an instrument for FDI inflows. As expected, the magnitude of the coefficient on FDI Inflows PC increases when endogeneity is accounted for. The coefficient becomes statistically significant when country fixed effects are further included (our preferred specification). A positive and significant coefficient on FDI Inflows PC supports our hypothesis that FDI inflows and MNC activity contribute to higher leadership turnover by creating more opportunities for rent extraction.

Substantively, take the reference category (single-party regimes) as an example. Holding all other variables at their means, a one standard deviation increase in real FDI inflows per capita in its cubic root from from its mean—roughly corresponding to the change from Armenia's real FDI inflows per capita in 2001 ($112.8) to Estonia's in 2000 ($899.1) in the sample—increases the probability of leadership turnover by 9.8 percentage points. This marginal effect is substantively large, given that the mean leadership turnover rate in the

[19] We classify foreign-occupied and provisional regimes as other regimes.

Table 7.1: FDI Inflows and Leadership Turnover

	(1)	(2)	(3) IV	(4) IV
FDI Inflows PC	0.01	0.01	0.04	0.12**
	(0.01)	(0.01)	(0.06)	(0.06)
State Capacity (RPE)	-0.25***	-0.38***	-0.25***	-0.43***
	(0.08)	(0.13)	(0.08)	(0.13)
GDP PC	-0.01	0.02	-0.06	-0.19
	(0.05)	(0.09)	(0.11)	(0.15)
Population	0.01	0.04	0.00	-0.21
	(0.02)	(0.15)	(0.02)	(0.18)
Growth Rate	-0.07***	-0.08***	-0.08***	-0.11***
	(0.02)	(0.02)	(0.03)	(0.03)
Trade Openness	-0.14**	-0.07	-0.19*	-0.16
	(0.06)	(0.10)	(0.11)	(0.12)
Resource Rents	-0.06	-0.02	-0.04	-0.01
	(0.05)	(0.11)	(0.05)	(0.11)
Aid PC	0.02	0.02	0.02	0.03
	(0.02)	(0.03)	(0.02)	(0.03)
Covert Ops (US)	0.14	-0.06	0.17	-0.07
	(0.13)	(0.17)	(0.15)	(0.19)
Covert Ops (SU)	0.02	0.16	0.09	0.46
	(0.15)	(0.23)	(0.19)	(0.35)
Presidential	0.37***	0.02	0.36***	-0.01
	(0.08)	(0.18)	(0.09)	(0.18)
Parliamentary	0.77***	0.45	0.77***	0.43
	(0.13)	(0.30)	(0.13)	(0.30)
Personal	-0.27***	-0.53***	-0.28***	-0.55***
	(0.10)	(0.18)	(0.10)	(0.18)
Military	0.40***	0.17	0.40***	0.16
	(0.11)	(0.18)	(0.11)	(0.19)
Monarchy	0.02	-0.16	0.06	-0.34
	(0.26)	(0.73)	(0.28)	(0.68)
Other Regimes	1.15***	1.04***	1.14***	0.95***
	(0.33)	(0.27)	(0.32)	(0.25)
Constant	-0.85	-3.94	-0.27	2.72
	(0.68)	(2.43)	(1.20)	(3.85)
N	4161	4035	4161	4035
R^2	122	115	122	115
F-stat (Excluded Instr)			18.31	34.83
P> F			0.00	0.00
Fixed Effects	No	Yes	No	Yes

Notes: Clustered standard errors in parentheses;

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

sample is 14.7%.

The results on the control variables are all sensible. Strong state capacity, measured by Relative Political Extraction, is strongly and negatively associated with leadership turnover. High economic growth rates also significantly reduce the likelihood of leader transition, which aligns with findings in the literature that economic growth is a strong predictor of leader survival in both democratic and authoritarian countries (De Mesquita and Smith, 2010; Gasiorowski, 1995; Haggard and Kaufman, 1995). The results also reveal heterogeneity across regime types. Compared to single-party regimes, leaders in personalist regimes have significantly longer tenures, while their counterparts in other regimes (foreign-occupied and provisional) have shorter tenures. Leaders in military regimes and monarchies do not experience significantly higher turnover than those in single-party regimes, nor do leaders in democratic regimes with presidential or parliamentary systems, once country fixed effects are accounted for. All other control variables appear to have little effect on leadership turnover in the fully specified model (Model 4).

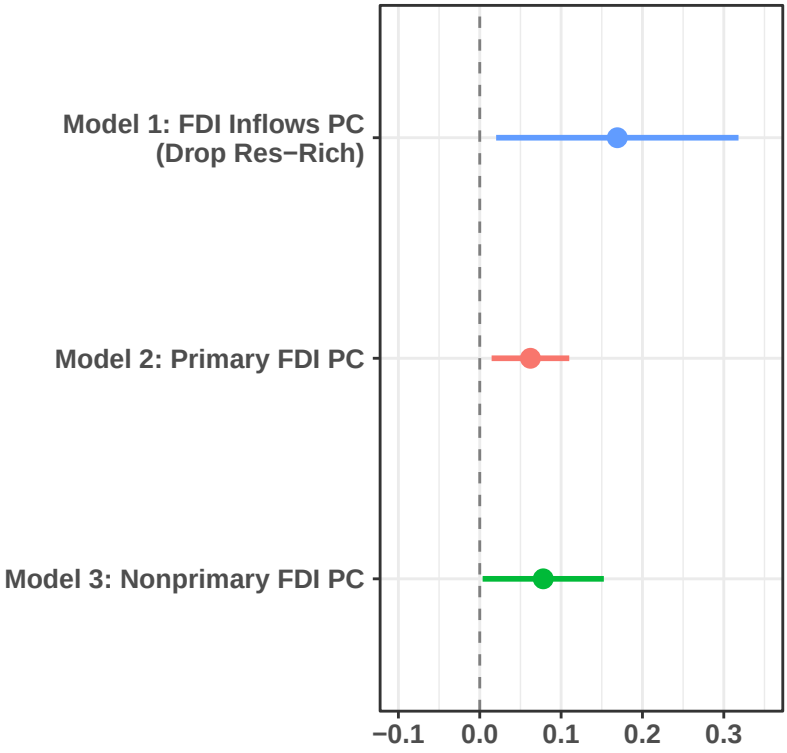
FDI, Natural Resources, and Leadership Turnover

A large body of literature has examined the political economy of the resource curse, showing that windfalls from natural resources undermine governance and development, bolster corruption, and fuel violence and political instability.[20] As we argued in Chapter 3, rents accruing from FDI inflows and MNC activity can generate similar consequences. This rent-creation effect can occur beyond the natural resource sector, as long as the productivity differentials between MNCs and domestic firms are sufficiently large. In other words, if FDI inflows lead to market concentration and high rent extraction in developing countries, then the positive relationship between inward FDI and leadership turnover should also hold in non-resource countries and for non-resource FDI. We examine this argument in several ways and present the results in Figure 7.1.

First, we exclude resource-rich countries from our sample and estimate the fully specified

[20]See Ross (2015) for a detailed review.

Figure 7.1: Estimated Coefficients: FDI, Natural Resources, and Leadership Turnover



Notes: Dots represent point estimates, and horizontal lines indicate 95% confidence intervals. Model 1 uses FDI inflows per capita as the independent variable, excluding resource-rich countries. Models 2 and 3 use primary and non-primary FDI per capita, respectively, as the independent variable. All results are based on the fully specified model. Estimates for covariates, time polynomials, and country fixed effects are not plotted. See Table 7.4 in the Appendix for full results.

model. Countries are classified as resource-rich if fuel exports constitute more than one-third of their total exports Fearon and Laitin (2003). As shown in Figure 7.1, the results remain consistent and robust after removing resource-rich countries from the sample.

Second, we utilize sectoral FDI data obtained from UNCTAD, disaggregating FDI into the primary and non-primary sectors. As noted in the previous chapter, these data are not systematically reported, and a significant portion of observations in our sample is missing. Moreover, coverage varies considerably across countries. Our sample of non-OECD countries contains only 1,198 country-year observations with available sectoral FDI data. It turns out that our instrument—weighted geographic distance—is not a strong predictor of sectoral FDI inflows for this particular sample. Accordingly, we estimate a simple probit model with

country fixed effects. To address endogeneity, we lag the primary and non-primary FDI per capita variables by one year. The results, plotted in Figure 7.1, show that both types of FDI have a strong and positive effect on leadership turnover.

Taken together, these results reveal that the positive relationship between inward FDI and leadership turnover is not confined to the natural resource sector; it also holds in the non-resource sector. All types of FDI can lead to market concentration and high rent extraction when foreign firms are significantly more productive than domestic firms. The resulting contestation over control of these rents can generate political instability and elevate the risk of leadership turnover.

Great Powers' Strategic Influence

Table 7.2: FDI Inflows, Geopolitical Influence, and Leadership Turnover

	(1)	(2)	(3)	(4)	(5)	(6)
FDI Inflows PC	0.155**	0.115*	0.102*	0.218***	0.131*	0.124**
	(0.061)	(0.061)	(0.062)	(0.076)	(0.069)	(0.061)
UNGA Voting Sim (Top 20)	0.743					
	(0.739)					
Alliances (Total)		0.002				
		(0.008)				
Alliances (Top 20)			0.114			
			(0.074)			
Military Intervention				0.220**		
				(0.112)		
US Military Aid PC					-0.021	
					(0.066)	
Colonial Ties (Top 20)						-0.008
						(0.223)
Constant	2.034	3.325	1.389	6.872	2.755	2.722
	(4.253)	(3.956)	(4.283)	(5.592)	(3.872)	(3.845)
Covariates	Yes	Yes	Yes	Yes	Yes	Yes
N	3971	3560	3560	2769	4035	4035
R^2	115	113	113	107	115	115
F-stat (Excluded IV)	33.91	32.4	30.52	22.01	25.43	34.79
P> F	0.00	0.00	0.00	0.00	0.00	0.00
Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes

Notes: Estimates for covariates are excluded to save space. Clustered standard errors in parentheses;

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Our case study of Chile illustrates that great powers' strategic interests and their interference in the domestic affairs of other countries can contribute to political instability and leadership turnover. The case also suggests that the economic interests of MNCs may overlap with the security interests of their home countries in the host country.

In our model, we explicitly control for total aid received—a proxy for great powers' security interests—as well as covert operations by the United States and the Soviet Union during the Cold War. To further ensure that our results are not driven by great power influence, we include multiple alternative measures of great powers' security interests and engagement. These variables include: a host country's UNGA voting similarity score with the top 20 wealthiest economies, the total number of alliances, the number of alliances with the top 20 wealthiest economies, a dummy variable indicating any military intervention, US military aid per capita, and the total number of colonial ties with the top 20 wealthiest economies.

The regression results are presented in Table 7.2. Our main finding that inward FDI increases the probability of leadership turnover remains robust even after accounting for various measures of great power influence. Among these variables, MILITARY INTERVENTION stands out as having a particularly strong effect on leadership turnover. In contrast, the other variables variables measuring security motivations do not appear to have a statistically significant impact.

State Capacity, Public Goods Provision, and Leadership Turnover

Table 7.3: FDI Inflows, State Capacity and Leadership Turnover

	(1) RPE	(2) APE	(3) Tax/GDP	(4) Pub Goods
FDI Inflows PC	0.03***	0.02*	0.03***	0.03**
	(0.01)	(0.01)	(0.01)	(0.01)
FDI × State Capacity	-0.01	-0.07**	-0.15***	-0.02***
	(0.01)	(0.03)	(0.05)	(0.01)
State Capacity	-0.07**	0.11	0.11	0.04
	(0.03)	(0.15)	(0.22)	(0.03)
GDP PC	-0.05*	-0.02	-0.04	-0.04
	(0.03)	(0.03)	(0.03)	(0.03)
Population	-0.05	-0.01	-0.04	-0.00
	(0.03)	(0.04)	(0.04)	(0.06)
Growth Rate	-0.02***	-0.02***	-0.02***	-0.03***
	(0.01)	(0.01)	(0.01)	(0.01)
Trade Openness	-0.03	-0.02	-0.03	-0.04
	(0.02)	(0.02)	(0.02)	(0.03)
Resource Rents	-0.00	-0.00	0.01	0.00
	(0.02)	(0.02)	(0.02)	(0.02)
Aid PC	0.01	0.00	0.01	-0.00
	(0.00)	(0.00)	(0.00)	(0.01)
Covert Ops (SU)	0.11	0.07	0.12	-0.07
	(0.09)	(0.09)	(0.09)	(0.15)
Covert Ops (US)	-0.00	-0.01	-0.00	-0.03
	(0.03)	(0.03)	(0.03)	(0.05)
Presidential	-0.01	0.00	-0.01	-0.06
	(0.03)	(0.03)	(0.03)	(0.04)
Parliamentary	0.12***	0.13***	0.12***	0.11*
	(0.04)	(0.04)	(0.04)	(0.06)
Personal	-0.11***	-0.10***	-0.10***	-0.16***
	(0.03)	(0.03)	(0.03)	(0.04)
Military	0.03	0.05	0.06*	0.05
	(0.03)	(0.03)	(0.03)	(0.04)
Monarchy	-0.12	-0.10	-0.12	0.05
	(0.08)	(0.08)	(0.08)	(0.12)
Other Regimes	0.28***	0.29***	0.32***	0.23***
	(0.05)	(0.05)	(0.05)	(0.07)
Constant	1.06	0.48	0.93	0.58
	(0.73)	(0.71)	(0.77)	(1.34)
N	4161	4131	4181	3022
R^2	0.10	0.10	0.09	0.11
Fixed Effects	Yes	Yes	Yes	Yes

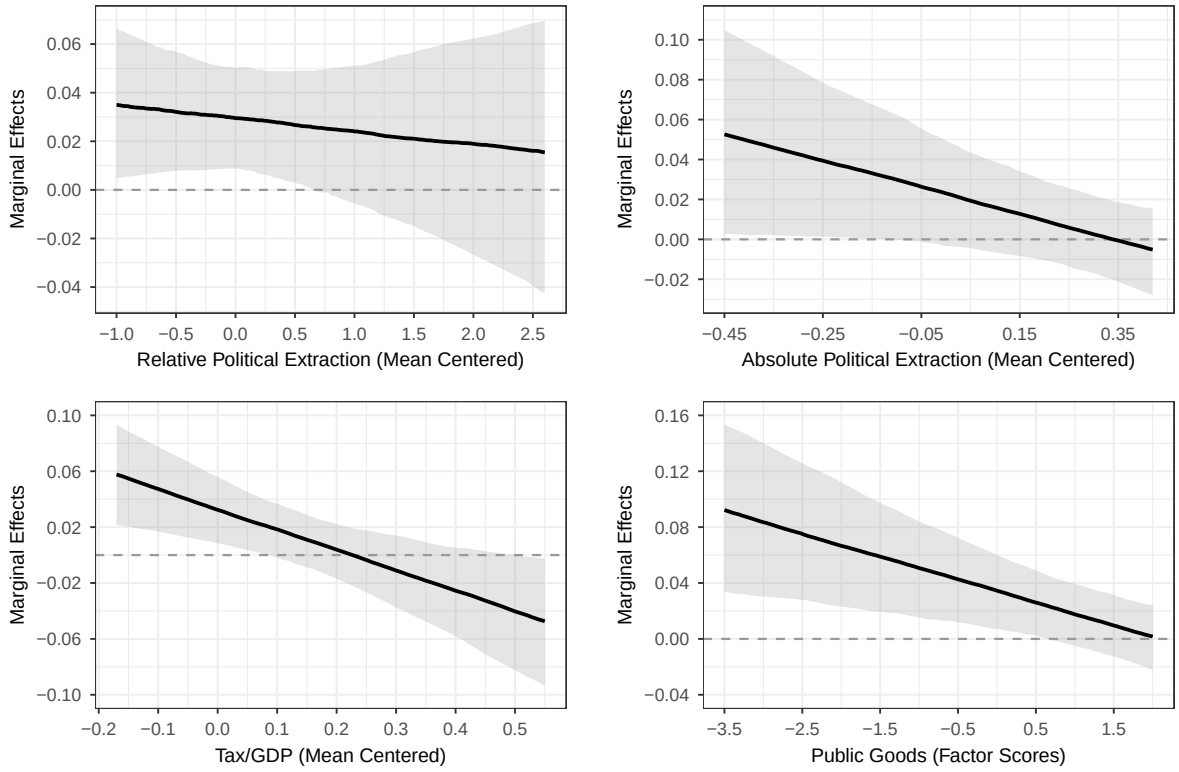
Notes: Robust standard errors in parentheses;
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

In Section 7.3.1, we argued that strong state capacity and effective public goods provision mitigate the positive effect of FDI on leadership turnover. When the state can control the rents generated by FDI and MNC activity and use them to enhance surveillance and deterrence capabilities, incumbents are less likely to face challengers. Alternatively, if incumbents can convert these rents into public goods, this fuels a productive economy, alleviates grievances, and bolsters political support, thereby helping to prolong their tenures. In other words, the effect of FDI on leadership turnover is conditional on the levels of state capacity and public goods provision.

To evaluate this nonlinear relationship, we introduce interaction terms between FDI and, respectively, state capacity and public goods provision into the fully specified model. For ease of interpretation, we estimate a linear probability model in which both FDI and the interaction terms are instrumented. Our primary interest lies in interpreting the conditional marginal effects of FDI on leadership turnover. Table 7.3 presents the full regression results, and Figure 7.2 visualizes the simulated marginal effects across alternative measures of state capacity and public goods provision. Note that introducing these interaction terms does not significantly alter the estimates of the other control variables.

In the top two panels, Relative Political Extraction (RPE) and Absolute Political Extraction (APE) are included as moderators, respectively. RPE captures the ratio of actual tax revenue to expected tax revenue, with the latter estimated from a linear function of structural characteristics such as income level, trade openness, and resource endowments. Arguably, it capture a state's effort in revenue collection. APE, by contrast, estimates tax capacity using stochastic frontier analysis. It reflects the maximum achievable level of tax revenue given a country's economic structure. The gap between this frontier and actual performance is interpreted as tax inefficiency, allowing us to assess how effectively a government mobilizes its fiscal resources. Data for both RPE and APE are from Arbetman-Rabinowitz et al. (2013). Both figures show that FDI increases the probability of leadership

Figure 7.2: Marginal Effects of FDI Flows on Leadership Turnover



Notes: Plots of marginal effects of FDI inflows on government turnover at different levels of public goods provision (top row) and state capacity (bottom row). The shadowed areas indicate the 95% confidence intervals, obtained from 1,000 simulations.

turnover when a country's extractive capacity is low, while the marginal effect diminishes as extractive capacity increases. At high levels of extractive capacity, FDI no longer has a statistically significant effect on leadership turnover.

To interpret the substantive effects, take the top-left panel as an example. The figure shows that when RPE reaches a level of 0.75 (approximately Benin's in 1983), FDI no longer has a significant effect on leadership turnover. If we set RPE one standard deviation below 0.75 (approximately Zimbabwe's in 1981), a one standard deviation increase in real FDI per capita increases leadership turnover by 10.8 percentage points. This marginal effect is statistically significant at the 95% level. Conversely, if RPE is one standard deviation above 0.75 (approximately Côte d'Ivoire's in 1973), the same increase in real FDI per capita increases leadership turnover by 7.9 percentage points, but the marginal effect is not statistically

significant.

The bottom-left panel uses Tax/GDP as a moderator. Tax revenue is a direct indicator of how much revenue—including rents accruing from FDI and MNC activities—are under government control. The results reveal a stronger moderating effect of Tax/GDP compared to RPE or APE. We see that FDI has a strong positive effect on leadership turnover when tax revenue is low, and its effect turns negative when tax revenue reaches the level of 38.2% of GDP (approximately Angola's in 2013) or beyond.

The bottom-right panel plots the marginal effects from a model where public goods provision is included as an moderator. Recall that this is a composite measure based on primary school enrollment rates, measles immunization rates, and infant mortality rates (reversed). The results indicate that the marginal effect of FDI on leadership turnover is conditional on the level of public goods provision. Inward FDI increases the risk of leadership turnover when public goods provision is low, but has no significant effect on leader tenure when public goods provision is high.

Overall, the results presented in Figure 7.2 provide strong support for our argument that robust state capacity and effective public goods provision mitigate the positive effect of FDI on leadership turnover. We also observe that the strength of the moderating effect varies across different moderators.

FDI Stocks and Leadership Turnover

Our main results are based on FDI inflows as the explanatory variable. Recall that we chose FDI inflows over stocks for two chief reasons. First, inflows capture the short-term impact of investment on rent creation, which directly affects the strategic calculus of relevant actors. Second, the choice is practical: data on FDI inflows are available for a longer time period, whereas data on FDI stocks are unavailable for the 1970s. To ensure our results are not driven by the choice of our main explanatory variable, we repeat the above exercise using real FDI stock per capita (FDI Stocks PC) as the independent variable. Results are presented in Tables 7.6 and 7.7 in the Appendix.

Our results remain consistent and robust. FDI stock per capita have a strong and positive effect on leadership turnover when endogeneity and country-specific characteristics are accounted for and that high extractive capacity and public goods provision alleviate the positive effect of . We refer readers to the appendix for the full regression results (Tables 7.6 and 7.7) and visualization of the marginal effects across the four alternative moderators (Figure 7.3).

7.6 Conclusion

In this chapter, we extend our theoretical framework to examine the relationship between inward FDI and leadership turnover. As argued throughout this book, when more productive foreign firms expand their operations into developing countries, they alter the structure of domestic markets, leading to higher markups and the creation of economic rents. We contend that competition over the control of these rents can generate political instability and, ultimately, greater leadership turnover. Furthermore, we argue that state capacity and the provision of public goods moderate this relationship. Strong state capacity—particularly extractive capacity—enhances the government's surveillance and deterrence capabilities, discouraging potential challengers. Meanwhile, the effective delivery of public goods mitigates citizen grievances and bolsters political support for incumbents, thereby extending their tenure.

Our case study of Chile clearly illustrates that the distribution of rents accruing from FDI inflows and MNC activity was a central issue of political contestation that contributed to instability. Admittedly, the Chilean case was further complicated by CIA involvement and the broader US–Soviet rivalry for influence in Latin America during the Cold War. To systematically evaluate our hypotheses, we analyze the determinants of leadership turnover in a sample of non-OECD countries from 1970 to 2018. Our regression results show that inward FDI significantly increases the probability of leadership turnover after accounting for endogeneity and country-specific characteristics. This relationship remains robust when controlling for potential confounders, including natural resource endowments and great power

influence. Moreover, the results indicate that strong state capacity and public goods provision significantly moderate this effect: the positive impact of FDI on leadership turnover diminishes as these institutional capacities strengthen.

The findings presented in this chapter further underscore the central argument of this book: global integration through foreign investment can profoundly reshape the economic and political dynamics of developing host countries. While some of these consequences—such as corruption, civil violence, and political instability—are undesirable, they can be mitigated by robust domestic institutions, effective fiscal extraction, and the provision of public goods.

7.7 Appendix

Table 7.4: FDI Inflows, Resources and Leadership Turnover

	(1) Primary	(2) Nonprimary	(3) Drop Res-Rich
Primary FDI PC	0.06**		
	(0.02)		
Nonprimary FDI PC		0.08**	
		(0.04)	
FDI Inflows PC			0.17**
			(0.08)
State Capacity (RPE)	-0.52	-0.44	-0.47***
	(0.39)	(0.39)	(0.18)
GDP PC	-0.42	-0.48	-0.27
	(0.27)	(0.29)	(0.19)
Population	0.36	0.13	-0.20
	(0.59)	(0.61)	(0.19)
Growth Rate	-0.07	-0.08	-0.12***
	(0.06)	(0.06)	(0.03)
Trade Openness	-0.19	-0.21	-0.41***
	(0.43)	(0.43)	(0.14)
Resource Rents	-0.07	0.00	0.22
	(0.27)	(0.28)	(0.15)
Aid PC	-0.01	0.00	0.00
	(0.04)	(0.05)	(0.04)
Covert Ops (US)	-1.35	-1.41	0.00
	(0.89)	(0.88)	(0.14)
Covert Ops (SU)			0.58
			(0.47)
Presidential	0.43	0.44	-0.39**
	(0.58)	(0.65)	(0.19)
Parliamentary	2.41***	2.37***	0.08
	(0.81)	(0.82)	(0.34)
Personal	-0.48	-0.46	-0.86***
	(0.63)	(0.65)	(0.22)
Military	1.62**	1.61**	-0.17
	(0.77)	(0.77)	(0.20)
Monarchy	8.57***	9.31***	-1.91***
	(0.90)	(1.09)	(0.35)
Other Regimes	1.74***	1.68***	0.55**
	(0.50)	(0.55)	(0.26)
Constant	-4.37	-1.09	4.94
	(7.19)	(7.73)	(3.59)
N	954	952	2444
R^2	52	52	72
F-stat (Excluded IV)			23.2
$P > F$			0.00
Fixed Effects	Yes	Yes	Yes

Notes: Clustered standard errors in parentheses;
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Table 7.5: FDI Inflows, Geopolitical Influence, and Leadership Turnover (Full Results)

	(1)	(2)	(3)	(4)	(5)	(6)
FDI Inflows PC	0.155**	0.115*	0.102*	0.218***	0.131*	0.124**
	(0.061)	(0.061)	(0.062)	(0.076)	(0.069)	(0.061)
UNGA Voting Sim (Top 20)	0.743					
	(0.739)					
Alliances (Total)		0.002				
		(0.008)				
Alliances (Top 20)			0.114			
			(0.074)			
Military Intervention				0.220**		
				(0.112)		
US Military Aid PC					-0.021	
					(0.066)	
Colonial Ties (Top 20)						-0.008
						(0.223)
State Capacity (RPE)	-0.467***	-0.443***	-0.432***	-0.456***	-0.435***	-0.434***
	(0.128)	(0.133)	(0.134)	(0.141)	(0.129)	(0.129)
GDP PC	-0.255*	-0.169	-0.152	-0.142	-0.191	-0.190
	(0.142)	(0.162)	(0.162)	(0.201)	(0.145)	(0.145)
Population	-0.150	-0.253	-0.142	-0.502*	-0.207	-0.208
	(0.198)	(0.220)	(0.239)	(0.283)	(0.184)	(0.183)
Growth Rate	-0.107***	-0.099***	-0.099***	-0.108***	-0.111***	-0.110***
	(0.027)	(0.027)	(0.027)	(0.028)	(0.026)	(0.026)
Trade Openness	-0.285**	-0.108	-0.098	-0.062	-0.163	-0.157
	(0.145)	(0.121)	(0.124)	(0.130)	(0.120)	(0.118)
Resource Rents	-0.012	-0.023	-0.036	0.139	-0.003	-0.007
	(0.121)	(0.119)	(0.118)	(0.144)	(0.115)	(0.114)
Aid PC	0.048*	0.020	0.020	0.024	0.026	0.025
	(0.027)	(0.028)	(0.027)	(0.035)	(0.027)	(0.027)
Covert Ops (US)	-0.067	-0.045	-0.100	-0.009	-0.068	-0.067
	(0.203)	(0.189)	(0.201)	(0.193)	(0.186)	(0.186)
Covert Ops (SU)	0.569	0.452	0.371	0.669	0.478	0.464
	(0.360)	(0.343)	(0.332)	(0.455)	(0.364)	(0.348)
Presidential	-0.064	0.030	0.018	0.054	-0.010	-0.008
	(0.182)	(0.190)	(0.190)	(0.213)	(0.179)	(0.179)
Parliamentary	0.459	0.241	0.231	0.204	0.433	0.429
	(0.302)	(0.279)	(0.281)	(0.317)	(0.301)	(0.299)
Personal	-0.580***	-0.585***	-0.597***	-0.503**	-0.548***	-0.546***
	(0.192)	(0.195)	(0.189)	(0.210)	(0.179)	(0.180)
Military	0.167	0.196	0.172	0.194	0.164	0.163
	(0.194)	(0.192)	(0.187)	(0.207)	(0.187)	(0.187)
Monarchy	-0.337	-0.479	-0.485	-1.468***	-0.340	-0.344
	(0.666)	(0.591)	(0.584)	(0.387)	(0.680)	(0.682)
Other Regimes	0.814***	0.991***	0.976***	1.266***	0.955***	0.954***
	(0.238)	(0.254)	(0.254)	(0.286)	(0.252)	(0.253)
Constant	2.034	3.325	1.389	6.872	2.755	2.722
	(4.253)	(3.956)	(4.283)	(5.592)	(3.872)	(3.845)
N	3971	3560	3560	2769	4035	4035
R^2	115	113	113	107	115	115
F-stat (Excluded IV)	33.91	32.4	30.52	22.01	25.43	34.79
$P > F$	0.00	0.00	0.00	0.00	0.00	0.00
Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes

Notes: Clustered standard errors in parentheses;
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Table 7.6: FDI Stocks and Leadership Turnover

	(1)	(2)	(3) IV	(4) IV
FDI Stocks PC	-0.02	0.03	0.02	0.39**
	(0.02)	(0.04)	(0.16)	(0.17)
State Capacity (RPE)	-0.27***	-0.32**	-0.26**	-0.28*
	(0.08)	(0.14)	(0.10)	(0.16)
GDP PC	0.03	-0.08	-0.03	-0.58**
	(0.05)	(0.13)	(0.21)	(0.26)
Population	0.01	0.12	0.00	-0.41
	(0.02)	(0.21)	(0.02)	(0.33)
Growth Rate	-0.06**	-0.09***	-0.06**	-0.11***
	(0.02)	(0.03)	(0.03)	(0.03)
Trade Openness	-0.09	-0.06	-0.14	-0.44*
	(0.07)	(0.16)	(0.20)	(0.25)
Resource Rents	-0.08*	-0.02	-0.07	0.00
	(0.05)	(0.15)	(0.05)	(0.17)
Aid PC	0.02	0.01	0.02	-0.00
	(0.02)	(0.03)	(0.02)	(0.03)
Covert Ops (US)	0.10	-0.19	0.10	-0.26
	(0.14)	(0.25)	(0.14)	(0.27)
Presidential	0.35***	-0.01	0.33***	-0.02
	(0.08)	(0.21)	(0.11)	(0.22)
Parliamentary	0.76***	0.49	0.76***	0.44
	(0.13)	(0.40)	(0.13)	(0.42)
Personal	-0.30***	-0.49**	-0.31***	-0.53**
	(0.11)	(0.25)	(0.11)	(0.26)
Military	0.44***	0.33	0.44***	0.28
	(0.13)	(0.22)	(0.13)	(0.25)
Monarchy	-0.06	-0.20	-0.01	0.30
	(0.25)	(0.80)	(0.33)	(1.04)
Other Regimes	1.23***	0.96***	1.23***	0.79**
	(0.36)	(0.31)	(0.35)	(0.34)
Constant	-1.14*	-4.60	-0.58	7.88
	(0.64)	(3.47)	(1.81)	(6.81)
N	3515	3402	3515	3402
Number of Countries	121	115	121	115
F-stat (Excluded IV)			7.37	17.64
P> F			0.01	0.00
Fixed Effects	No	Yes	No	Yes

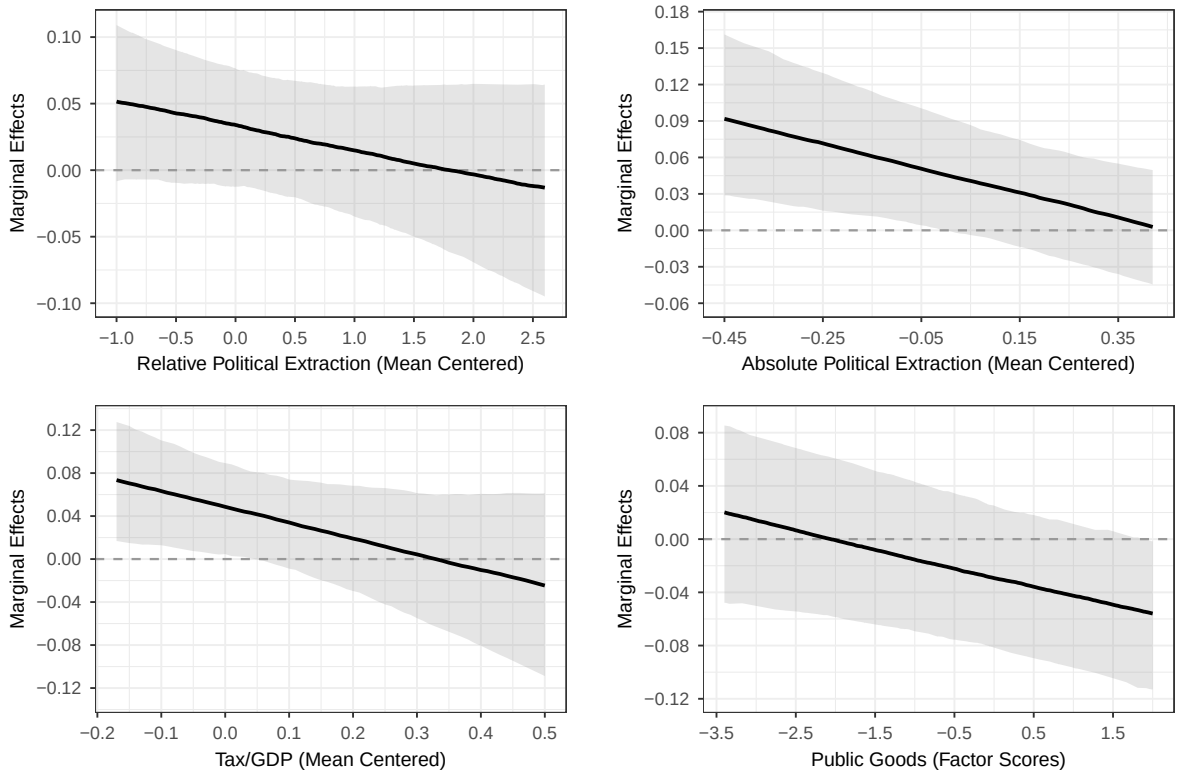
Notes: Robust standard errors in parentheses;
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Table 7.7: FDI Stocks, State Capacity and Leadership Turnover

	(1) RPE	(2) APE	(3) Tax/GDP	(4) Pub Goods
FDI Stocks PC	0.03	0.05*	0.05**	-0.03
	(0.02)	(0.02)	(0.02)	(0.03)
FDI × State Capacity	-0.02	-0.10**	-0.15*	-0.01**
	(0.02)	(0.04)	(0.08)	(0.01)
State Capacity	0.05	0.58**	0.59	0.11***
	(0.09)	(0.27)	(0.56)	(0.04)
GDP PC	-0.06	-0.06*	-0.07*	0.03
	(0.04)	(0.04)	(0.04)	(0.04)
Population	-0.01	-0.04	-0.04	0.06
	(0.05)	(0.05)	(0.05)	(0.06)
Growth Rate	-0.02***	-0.02***	-0.02***	-0.01**
	(0.01)	(0.01)	(0.01)	(0.01)
Trade Openness	-0.05	-0.07*	-0.06*	-0.01
	(0.04)	(0.04)	(0.03)	(0.03)
Resource Rents	0.00	0.01	0.01	-0.01
	(0.02)	(0.02)	(0.02)	(0.02)
Aid PC	0.00	-0.00	-0.00	0.00
	(0.01)	(0.01)	(0.01)	(0.01)
Covert Ops (SU)	-0.10	-0.08	-0.04	-0.19
	(0.12)	(0.12)	(0.11)	(0.13)
Covert Ops (US)	-0.03	-0.04	-0.03	-0.03
	(0.04)	(0.04)	(0.04)	(0.05)
Presidential	-0.02	-0.01	-0.02	-0.03
	(0.03)	(0.03)	(0.03)	(0.04)
Parliamentary	0.12**	0.14**	0.11**	0.16**
	(0.05)	(0.05)	(0.05)	(0.06)
Personal	-0.11***	-0.10***	-0.11***	-0.12***
	(0.04)	(0.04)	(0.04)	(0.04)
Military	0.06*	0.08**	0.07*	0.08*
	(0.04)	(0.04)	(0.04)	(0.04)
Monarchy	-0.09	0.03	-0.03	0.03
	(0.11)	(0.12)	(0.11)	(0.11)
Other Regimes	0.25***	0.25***	0.25***	0.19***
	(0.06)	(0.06)	(0.06)	(0.07)
Constant	0.96	1.33	1.14	-1.22
	(0.95)	(0.96)	(1.01)	(1.25)
N	3527	3500	3547	2969
R^2	0.14	0.13	0.14	0.14
Fixed Effects	Yes	Yes	Yes	Yes

Notes: Robust standard errors in parentheses;
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$.

Figure 7.3: Marginal Effects of FDI Stocks on Leadership Turnover



Notes: Plots of marginal effects of FDI stocks on leadership turnover at different levels of public goods provision (top row) and state capacity (bottom row). The shadowed areas indicate the 95% confidence intervals, obtained from 1,000 simulations.

Chapter 8

Conclusion

8.1 Summary

Cross-border flows of FDI are a defining feature of the contemporary global economy, profoundly influencing patterns of production, trade, and development across both advanced and developing countries. In particular, FDI is widely regarded as a critical driver of economic growth in capital-scarce developing economies. Beyond providing financial capital, FDI can facilitate the transfer of advanced technology, managerial expertise, and access to international markets (UNCTAD, 1992). It can also promote the integration of domestic firms into global value chains and generate positive productivity spillovers through backward and forward linkages (Alfaro et al., 2010; Blalock and Gertler, 2008; Javorcik, 2004). Furthermore, FDI may stimulate job creation, support infrastructure development, and contribute to the diffusion of best practices in corporate governance, environmental standards, and production processes (Caves, 1996; Kwok and Tadesse, 2006; Mosley, 2011). These multifaceted benefits have positioned FDI as a central component of development strategies in many emerging economies.

These perceived benefits underpin one of the core policy prescriptions of the Washington Consensus, which urged developing countries to liberalize their investment regimes in order to attract FDI (Williamson, 1990). In practice, FDI has played a significant role in several

widely cited development success stories. The rapid industrialization of the Asian Tigers—South Korea, Taiwan, Hong Kong, and Singapore—was facilitated, in part, by their strategic integration into global production networks led by MNCs (Wade, 1990; World Bank, 1993). More recently, members of the BRICS group have also leveraged foreign investment to spur growth, promote industrial upgrading, and diversify export structures (UNCTAD, 2023).

Yet these developmental gains are neither automatic nor universally guaranteed. The number of successful FDI-led development experiences in the Global South remains limited. While FDI can serve as a catalyst for growth, its developmental impact is highly contingent upon host-country institutional quality, absorptive capacity, and policy frameworks (Alfaro et al., 2004; Borensztein, De Gregorio and Lee, 1998; OECD, 2002). In many contexts, foreign investment has also been associated with adverse outcomes, including rising income inequality, crowding out of domestic firms, and weak or even negative productivity spillovers (Aitken and Harrison, 1999; OECD, 2002). Critics further point to a regulatory "race to the bottom," whereby governments deliberately weaken labor protections and environmental standards to attract or retain foreign capital (Davies and Vadlamannati, 2013; Frankel, 2003; Gallagher, 2009; Rodrik, 1997). Moreover, dependency theorists and world-systems scholars have long warned of the structural power of MNCs, arguing that FDI can reinforce patterns of underdevelopment by subordinating domestic economies to the imperatives of global capital. This dynamic is captured in the notion of the "triple alliance" among local elites, foreign investors, and the state (Cardoso and Faletto, 1979; Evans, 1979; Moran, 1975).

In this book, we seek to reconcile these divergent accounts by developing a theoretical framework that foregrounds an often-overlooked mechanism through which FDI inflows and MNC activity can produce negative—and often unintended—political consequences in the Global South. The entry of highly productive foreign firms can crowd out domestic competitors, leading to greater market concentration and the creation of economic rents. These rents, in turn, generate strong incentives for political and economic actors at multiple levels to capture, control, and compete over them. Such competition can manifest in destabilizing

ways, including higher levels of corruption, an increased likelihood of armed conflict, and more frequent turnover of political leadership.

Crucially, these outcomes are not deterministic. The political consequences of FDI and MNC activity are conditioned by domestic political and institutional contexts. Countries with effective legal systems, robust political competition, strong extractive capacity, and high levels of public goods provision are better equipped to mitigate the negative effects of rent creation. In such settings, foreign investment is more likely to generate developmental benefits rather than reinforce rent-seeking behavior. Conversely, where institutional capacity is weak, the same inflows may exacerbate governance failures and political instability. The broader impact of FDI is therefore contingent, shaped by the interaction between global capital and domestic political and institutional structures.

One key takeaway from the book is that the political consequences of FDI inflows and MNC activity are conditional rather than uniform. Our theoretical framework helps reconcile diverging arguments and findings on the positive and negative impacts of FDI in developing countries, and sheds light on why the existing literature has alternately portrayed FDI as a boon or a curse.

The book also contributes to the broader literature on the consequences of globalization, which often emphasizes the institutional features of countries participating in global markets. We show that, even holding institutions and enforcement constant, the capacity of global forces to generate or dissipate rents plays a central role in shaping the political consequences of globalization.

In sum, by integrating models of firm heterogeneity with a theory of rent contestation, the book offers a unified explanation for why inward investment can appear as a boon, a curse, a fortune, or an evil—sometimes within the same country and even within the same decade. This argument is particularly salient in the current era of globalization, where MNCs and the integrated production networks they coordinate play a central role.

8.2 Policy Implications for the Global South

The findings of this book carry several important policy implications for developing countries seeking to harness the benefits of FDI while minimizing its potential risks. While FDI can stimulate economic growth, transfer technology, and generate employment, the entry of highly productive MNCs can also contribute to market concentration and the creation of economic rents—particularly in weak institutional environments. These rents can distort political incentives, encourage corruption, and provoke distributional conflicts. A more strategic, institutionally grounded approach to managing FDI is therefore essential. We highlight the following policy recommendations:

Promoting Competitive Domestic Markets: Our findings indicate that FDI-induced market concentration and rent creation can stimulate rent-seeking behaviors and exacerbate distributional conflicts. To counter these risks, governments should adopt competition policies that prevent excessive market concentration and ensure a level playing field for all firms. Policy measures may include the enforcement of antitrust regulations, targeted support for small and medium-sized enterprises, and initiatives to enhance the technological capabilities of local firms. Such measures can help domestic enterprises integrate into global value chains.

Strengthening Institutional Capacity: Countries in the Global South should prioritize investments in legal and regulatory capacity to manage the political economy consequences of FDI. An independent judiciary, effective enforcement of property rights, and comprehensive anti-corruption frameworks are essential to ensuring that the rents generated by foreign investment are not captured by narrow elites or diverted through patronage networks. Strong institutions can mitigate the risks of rent-seeking and help channel FDI-related gains toward broad-based development.

Enhancing State Capacity: In sectors where rents are inevitable—particularly those with high entry barriers—governments should establish institutional mechanisms to capture these rents through taxation, royalties, or other regulatory instruments, and allocate them toward

public goods and national development objectives. Transparent fiscal management, well-designed redistributive policies, and strategic public investment in health, education, and infrastructure can help ensure that the gains from FDI are broadly shared across society.

Balancing Openness with Developmental Statecraft: While openness to global capital is important, countries should avoid a strategy of passive liberalization. Instead, they can pursue a form of developmental statecraft—engaging in active industrial policy, regulating entry modes, and strategically leveraging FDI to build domestic capacity. Policy tools may include fostering backward and forward linkages, setting performance requirements, and negotiating technology transfer agreements where feasible, so that FDI inflows enhance the growth and competitiveness of domestic firms.

Safeguarding Political Stability: Because FDI-induced rent creation can intensify political contestation, heighten elite rivalries, and in some cases contribute to armed conflict, governments should strengthen institutions of political inclusion and conflict resolution. Priority measures include fostering transparent and accountable political institutions, establishing credible power-sharing arrangements, and depoliticizing access to economic resources. Such institutional safeguards can lower the risk that competition over FDI-generated rents escalates into governance crises or violent conflict.

In sum, the developmental impact of FDI in the Global South depends critically on how effectively states manage the economic rents and structural tensions it generates. Rather than pursuing FDI at all costs, governments should adopt an approach to foreign investment that is politically informed, institutionally grounded, and explicitly oriented toward long-term development objectives.

8.3 Limitations and Directions for Future Research

We conclude by acknowledging the limitations of our study and identifying promising avenues for future research. First, our study is, by design, a macro-level examination of the economic and political consequences of FDI inflows and MNC activity in developing coun-

tries. This approach enables us to identify broad patterns across a large number of countries and over an extended time period. However, the reliance on aggregate-level data necessarily conceals important variation and dynamics at the micro level. Both our explanatory and outcome variables are aggregated at the country level, which limits our ability to capture localized effects and firm-level heterogeneity.

Future research can fruitfully explore micro-level dynamics in two directions. One promising avenue is to examine the localized impact of foreign investment. FDI is often geographically concentrated, and its effects on host communities may be more pronounced when spillover effects are limited. Investigating how international businesses interact with local institutions, labor markets, and communities could yield valuable insights. With the growing availability of geo-coded FDI data—such as the *fDi Markets* database—scholars have begun exploring these spatially disaggregated impacts of foreign investment (e.g., Blair, Christensen and Wirtschafter, 2022; Brazys and Kotsadam, 2020; Donaubauer, Kannen and Steglich, 2022; Owen, 2019; Wang, Pearson and McCauley, 2022).

Another important direction is to further unpack the heterogeneity of FDI. Not all foreign investment is alike—differences in sector, capital intensity, ownership structure, and entry mode may yield divergent political and economic effects. For example, capital-intensive FDI is more likely to generate economic rents and distort market competition due to the large fixed costs and high barriers to entry. Zhu and Deng (2022), for instance, show that corruption tends to be more prevalent in capital-intensive sectors, where opportunities for monopoly rent extraction are higher. Future work should systematically investigate which types of FDI are most likely to contribute to rent creation and under what conditions such rents are captured or dissipated.

Second, while our study focuses on corruption, civil conflict, and leadership turnover as key outcomes of rent creation, the implications of FDI and MNC activity are likely far broader. The political economy literature has long examined the effects of unearned income such as windfalls from natural resources and foreign aid on governance and institutional

development.[1] Our argument is that economic rents generated by FDI can have similar consequences—particularly when domestic institutional conditions facilitate rent-seeking behavior. Future research should build upon this framework to explore how foreign investment shapes a wider array of political and economic outcomes, including electoral dynamics, bureaucratic quality, social conflict, and citizen attitudes. Such extensions would contribute to a more holistic understanding of the impact of global capital flows on developing country governance.

Third, as we argued in Chapter 3, foreign entry is inherently endogenous. Firms make location and entry decisions based on their expectations of host country risks and returns. Thus, the political and economic characteristics of host countries influence not only the quantity and quality of FDI inflows but also the mode of entry—such as joint ventures, greenfield investments, or mergers and acquisitions. These entry modes, in turn, may have distinct implications for rent creation and political engagement. In theory, more productive firms with higher markups are better equipped to enter high-risk environments, we still know relatively little about how firms adapt their strategies to mitigate political and regulatory risk. Recent studies using observational and experimental firm-level data have begun to shed light on these issues, examining how MNCs engage in lobbying, cultivate political connections, or resort to bribery as risk mitigation strategies (Henisz, 2000; Malesky, Gueorguiev and Jensen, 2015; Zhu and Shi, 2019). Further empirical work—especially with detailed firm-level data—is needed to deepen our understanding of how political risk shapes corporate behavior on the ground.

Fourth, the implications of fixed assets merit renewed attention. The classic obsolescing bargain model posits that foreign investors with immobile assets become vulnerable to ex post policy reversals or expropriation by host governments (Vernon, 1971). While large-scale expropriations have become rare since the 1980s (Wright and Zhu, 2018), governments now more commonly employ subtle forms of creeping expropriation, including regulatory

[1] Again, see Ross (2015) for a review.

harassment and adverse tax policy changes (Graham, Johnston and Kingsley, 2017). At the same time, investor protections embedded in bilateral investment treaties and trade agreements have empowered firms to challenge host governments through international arbitration mechanisms (Simmons, 2014). Although some investors may be deterred by the risk of creeping expropriation, others—particularly those able to capture substantial monopoly rents—may be undeterred, or even find such environments attractive. Beyond the immobility of fixed assets, future research should explore additional dimensions, such as their replaceability (Johns and Wellhausen, 2021) and the opportunities they provide for monopoly rent extraction (Wright and Zhu, 2018), and assess how these factors shape firm behavior.

Lastly, the political economy literature on FDI has predominantly focused on entry and its determinants, while giving relatively little attention to exit dynamics.[2] Yet exit, like entry, is endogenous. Although the withdrawal of foreign firms has historically been understudied, the recent wave of divestment following international shocks—such as the Russia–Ukraine war—underscores the importance of understanding MNC exit decisions. If FDI inflows generate rents that erode governance or competition, the resulting political and economic deterioration may eventually precipitate exit. A dynamic framework is therefore needed to capture the full lifecycle of foreign investment: entry, market engagement, political interaction, and exit. Critical questions remain: When and why do MNCs exit? What are the consequences of exit for market structure, employment, and governance—both at the local and national levels? These questions have become increasingly salient amid intensifying trade tensions, industrial policy interventions, and global investment reconfiguration. Understanding exit is thus essential for advancing both theory and policy.

[2]See Pandya (2016) for a comprehensive review.

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