

**Boon, Curse, Fortune or Evil?**  
The Political Consequences of Inward Foreign Direct  
Investment

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# Chapter 1

## Introduction

### 1.1 Motivation

Cross-border flows of foreign direct investment (FDI) are among the defining features 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 entering a period of sustained fluctuation. Multinational corporations (MNCs), the principal conduit for FDI flows, have emerged as prominent actors in the world economy. They allocate resources, capital, and technology across borders, coordinate and reshape global value chains (GVCs) and production networks, and promote international economic integration ([Antràs and Chor, 2022](#); [Caves, 1996](#); [Markusen, 1995](#); [Osgood, 2018](#)). The scale of their footprint is striking: in 2023, MNCs and their foreign affiliates accounted for more than 6% of world output, while the global production networks they coordinate account for nearly 80% of international trade ([UNCTAD, 2024](#)).

For developing countries, these inflows of capital have long been viewed as a potential engine of economic growth ([UNCTAD, 1999, 2023](#); [World Bank, 1993](#)). FDI can bring scarce capital, advanced technology, and managerial expertise; it can integrate domestic firms into GVCs and international markets, while generating income and employment. Since the 1980s, many states in the Global South have liberalized their investment regimes, strength-

ened investment promotion agencies, and expanded their international investment treaty commitments, fueling a substantial increase in inward FDI ([Jensen, Biglaiser, Li, Malesky, Pinto, Pinto and Staats, 2012](#); [Pandya, 2014](#)).

Yet despite this dramatic expansion, the political and economic consequences of FDI remain deeply contested.<sup>1</sup> Optimistic accounts depict MNCs as catalysts for development and modernization: creating employment, diffusing productive technologies, and transmitting norms, values, and institutional practices to host countries ([UNCTAD, 1999](#); [World Bank, 1993](#)). Scholarly work has further linked FDI to democratization, improved governance, stronger 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](#)).

More skeptical accounts, by contrast, portray MNCs as exploitative actors that erode sovereignty, exacerbate inequality, and distort or corrupt domestic governance practices and institutions. Earlier works in the 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 a range of adverse, and often unintended, consequences. Competition for mobile capital, for instance, 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 Vadlamanati, 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 espouse starkly divergent assessments of whether FDI should be embraced as a catalyst for development or treated with caution as a source of economic and political vulnerability ([Moran, 1998, 2011](#)). These competing assessments about the benefits and costs of FDI raise a central question that this book seeks to address: *How do foreign investment inflows and the expansion of MNC activities affect*

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<sup>1</sup>For contrasting perspectives, see [Baldwin \(2016\)](#) and [Rodrik \(2018\)](#).

*domestic politics in developing countries, and how can we reconcile the divergent accounts of these political consequences?* We argue that while each perspective captures a distinct mechanism, but neither is sufficient to explain the varying effects of FDI and MNC activity on economic and political outcomes in host countries.

Throughout the book, we develop a unified framework connecting FDI, market structure, rents, and political contestation. The analysis focuses on countries in the Global South, where variation in underlying economic conditions and institutional environments is greater and where the effects of FDI are correspondingly more heterogeneous. This variation provides a useful setting for identifying the mechanisms emphasized in the book. Before presenting the framework, however, it is useful to clarify several key concepts that play a central role in both the theoretical model and the empirical analyses.

Throughout, we use the term *FDI-induced rents* to refer to the markups, excess returns, or economic rents resulting from the entry and expansion of activities of MNC subsidiaries in host countries. FDI may increase or decrease aggregate rents in the host economy, depending on whether foreign entry raises concentration, intensifies competition, or displaces less productive firms. Our focus is therefore not only on the creation of new rents, but also on the reallocation of rents among firms that remain active after foreign entry. These extra rents or excess returns can arise through several distinct mechanisms: in some settings, foreign entry reallocates sales toward a smaller number of firms, increases market concentration, and, under variable markups, widens price-cost margins. In others, where markups are relatively fixed or output prices are largely determined in world markets, foreign entry can nonetheless generate substantial operating profits, rents, or quasi-rents through scale economies, cost advantages, firm selection, access to scarce inputs, regulatory privilege, or control over sunk and location-bound assets.

The book's central argument about the impact of FDI on political conditions in the host country follows directly from this economic foundation. FDI-induced rents create powerful incentives for a range of actors, including firms, public officials, economic elites, and

opposition groups, to appropriate, bargain over, or contest them. Whether and how such contestation results in adverse political consequences depends critically on the host country's institutional environment. Where state capacity is strong and institutions are well developed, rent contestation can be channeled through formal political and fiscal mechanisms, limiting its disruptive potential. Where state capacity is weak and institutions are fragile, rent contestation is more likely to generate adverse political consequences such as corruption, political instability, and conflict. It is this conditional relationship between FDI-induced rents, institutional capacity, and political outcomes that constitutes the analytical core of the book.

Importantly, this argument is not an indictment of FDI per se. We echo the optimistic literature that foreign investment can expand output, generate employment, transfer technology and business practices, and integrate domestic firms into global markets. These benefits are most likely to materialize when foreign entry disciplines incumbents rather than displacing them, when supplier markets can absorb and adjust to new competitive pressures, when domestic firms possess the absorptive capacity to learn from multinationals, and when states can tax and regulate the resulting rents through transparent and accountable institutions.

The book's central claim is that FDI may increase the risk of adverse political consequences not because firms are foreign per se, but because large productivity gaps, entry barriers, and weak institutions can together transform foreign entry into concentrated excess returns and, in turn, make those excess returns objects of political contestation. In other words, it is the resulting concentrated market structure and rent extraction, coupled with weak institutions, that heighten the risk of adverse political consequences in the Global South.

## **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: first, the effect

of foreign entry on the creation or dissipation of economic rents; and, second, the political ramifications that result from the creation or dissipation of those rents, which are shaped by host-country state capacity and institutional development.

First, the entry and presence of MNCs affect market conditions and the creation or dissipation of economic rents. The benchmark formalization in Chapter 3 illustrating the mechanism is based on a variable-markup model which provides a transparent mapping from productivity differences to revenue shares, market concentration, and markups. In this framework, when productivity differentials between foreign and domestic firms are large, foreign entry can generate economic rents through the sequence: reallocation  $\rightarrow$  concentration  $\rightarrow$  markups  $\rightarrow$  operating profits  $\rightarrow$  economic profits  $\rightarrow$  rents.

Markup is the ratio of price to marginal cost of production (or, equivalently, the gap between them expressed relative to marginal cost). Higher markups reflect greater pricing power. Profits denote the difference between total revenue and total costs. In general, higher markups contribute to higher profits by increasing price-cost margins. Economic 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). Markups are a key mechanism through which firms generate profits: higher price-cost margins increase operating profits. When such profits persist above competitive levels after accounting for opportunity costs, they constitute economic rents.

The broader argument of the book, however, is not limited to the variable markup environment. When markups are fixed, more productive firms can still earn larger operating and economic profits through lower costs, larger sales, and firm selection. When prices are externally set or assets are location-bound, rents and quasi-rents can arise from world-price minus cost wedges, input bottlenecks, access rights, and sunk investments. Across all these

environments, the key question is whether foreign entry generates excess returns that become concentrated and politically contestable within the host economy.

These dynamics are particularly pronounced in developing countries, where domestic firms are typically smaller, less productive, and more resource-constrained than their foreign counterparts. Theoretical and empirical work on trade and firm heterogeneity shows that only the most productive firms are able to bear the fixed costs of establishing foreign affiliates (Helpman, Melitz and Yeaple, 2004; Melitz, 2003; Yeaple, 2009). As a result, productivity gaps between MNCs and indigenous firms in the Global South tend to be substantial. Moreover, many markets in emerging and less developed economies are characterized by high entry barriers arising from economies of scale, capital intensity, product differentiation, or demanding technological requirements. Paradoxically, the very barriers that constrain local firms create opportunities for foreign investors, who possess the resources and proprietary assets needed to overcome them (Caves, 1996; Dunning, 1992). After entry, MNCs may actively reinforce the barriers they initially surmounted through strategic investment and pricing, vertical integration, preferential regulatory access, or control over key inputs, thereby further entrenching market concentration and amplifying the rent-creation effects of foreign entry (Baccini, Pinto and Weymouth, 2017; Motta, 2004; Newfarmer, 1979; Zhu, 2017). These effects are often described as *market-stealing* or *negative productivity spillovers* (Aitken and Harrison, 1999).

The consequences of FDI-induced rents are not purely economic. As MNCs expand production, increase their share of output, consolidate market power, and force local firms to confront intensified competition and potential retreat, the distribution of FDI-induced rents, and, with it, political influence, becomes increasingly contested. Higher rents create stronger incentives for firms, political elites, state officials, and opposition groups to appropriate and control these resources, at times through illicit or violent means. Such struggles over rents can generate unintended and adverse political consequences. Understanding how these transformations reshape the incentives and behavior of 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. When foreign entry contributes to rent creation, 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 ([Rose-Ackerman, 1999](#); [Treisman, 2007](#)).

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 the frequency of executive changes. 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 inherent in rent-sharing arrangements ([Meng, Paine and Powell, 2023](#); [Powell, 2024](#)). These mechanisms reduce grievances and facilitate the peaceful resolution of distributive conflicts.

Our theoretical framework makes three conceptual innovations. First, it develops a benchmark oligopoly model of heterogeneous firms that formalizes a key mechanism through which foreign entry can lead to the creation or dissipation of economic rents through changes in prices and market shares under different productivity differentials between entrant and incumbent firms. Larger productivity differences shift sales toward more efficient, lower-cost firms. When markups are variable, the entry of more productive firms affects price-cost margins and profits through changes in market shares, effects that are reflected in measures of market concentration. We extend this framework beyond the variable-markup benchmark to show that, even when markups are fixed or prices are externally determined, foreign entry can still generate operating profits, economic profits, rents, and quasi-rents through

scale economies, cost advantages, firm selection, and control over scarce or location-specific assets. These mechanisms are formally derived and illustrated in Chapter 3.

Importantly, this logic applies across different forms of multinational activity. In horizontal FDI, increased competition may lower prices and dissipate rents, but large productivity gaps can also shift market shares toward more productive firms, increase market concentration, and contribute to rent creation. In GVC-related and export-platform FDI, final prices are often determined in global markets; rents instead emerge through sales expansion, supplier selection, and input-market bottlenecks. In resource-seeking FDI, rents arise directly from the wedge between world prices and production costs, and indirectly through linked input sectors. Thus, FDI is neither inherently rent-creating nor rent-dissipating; its effects depend on productivity gaps, market structure, input constraints, and institutional conditions.

Second, the book embeds this market logic within a political-economy framework of rent contestation. Rents are not politically inert; rather, they become politically consequential when actors compete to appropriate and control them. Accordingly, the same FDI inflows that generate high markups and concentrated rents may also trigger corruption, conflict, or leadership turnover in institutional environments that lack the capacity to tax, regulate, and redistribute economic surplus. By contrast, strong states can channel rents into public goods and thereby mitigate distributive conflict. The framework therefore predicts conditional effects: inward FDI is more likely to contribute to adverse political consequences in low-capacity, weak-institution polities, but to generate neutral or beneficial outcomes in high-capacity, strong-institution states.

Our framework therefore also identifies the conditions under which FDI is more likely to produce benign outcomes. When foreign entry intensifies competition rather than concentrating market shares, rents are dissipated and consumers benefit from lower prices, greater output, and increased product variety. When domestic firms possess sufficient absorptive capacity, MNC activity can promote supplier upgrading, learning, and productivity growth.

When states possess strong fiscal and legal capacity, rents that do emerge can be taxed, regulated, and transformed into public goods. Under these conditions, FDI may reduce, rather than intensify, incentives for predation and political contestation. This conditional logic constitutes the book’s central contribution to policy debates: the relevant question is not whether governments should welcome or restrict FDI, but how they can shape the market and institutional environments into which foreign firms enter.

Finally, the theory provides a unified lens through which to analyze phenomena that are often studied in isolation. It links governance quality, armed conflict, and political turnover to a common mechanism—FDI-induced rents—thereby helping reconcile conflicting theoretical arguments and empirical findings in the globalization literature. In doing so, the framework extends rent-seeking models beyond the natural-resource domain, highlights productivity differentials as a fundamental source of rent creation, and generates a coherent set of cross-equation hypotheses that the subsequent chapters test using a consistent identification strategy.

## **1.3 Globalization, Foreign Entry, Market Structure, and Rent Creation**

### **Globalization of Markets**

The book begins by situating our argument within the broader transformation of the world economy under economic globalization. Over time, the expansion of cross-border trade, investment, and financial flows has reorganized production, deepened interdependence among national economies, and altered the opportunities and constraints facing states, firms, and societal actors. Chapter 2 reviews the historical evolution of globalization. In particular, it documents the growth of international trade and cross-border FDI flows, as well as recent structural changes in the global economy, including the rise of services trade and GVC-related trade and investment.

What matters for our argument is that globalization is not politically neutral. Trade,

FDI, portfolio flows, and other forms of international capital movement can all shape domestic politics, but they do so through distinct mechanisms and with different implications for market structure, rent extraction, and political contestation. In some settings, economic integration promotes competition, expands economic opportunities, and supports institutional reform. In others, it contributes to regulatory capture, distributive conflict, and political instability. The political consequences of globalization are therefore conditional both on the specific form of integration and on the institutional and economic environments into which it enters.

FDI is distinctive because it entails long-term commitments, managerial control, and the cross-border reorganization of production. FDI and MNC activity can reshape domestic markets, reallocate sales and profits across firms, and generate economic rents within host economies. This does not make FDI inherently harmful; under many conditions, it expands output, facilitates technology transfer, and connects domestic producers to global markets. However, the same features that make FDI economically important also make it politically consequential. Political risk, policy uncertainty, and instability in the Global South may deter some investors, but not all. When expected returns are sufficiently high, some firms remain willing and able to operate in risky environments. Under these conditions, foreign entry can contribute to market concentration and the creation of economic profits, rents, and quasi-rents that become objects of political contestation.

## **Foreign Entry, Market Structure, and Rent Creation**

Throughout the book, we develop a theoretical framework linking FDI to the creation or dissipation of excess returns and rents, and, in turn, to political outcomes. In Chapter 3, the mechanism is first illustrated using a variable-markup model of oligopolistic competition in which heterogeneous firms compete in quantities, firm-level markups depend on revenue shares and residual demand elasticities, and foreign entry alters the distribution of sales, costs, and input demand across firms. In this setting, entry by a more productive multinational can either intensify or weaken competition depending on the productivity

differential with incumbent firms and the resulting changes in residual demand. When productivity differences are small, foreign entry intensifies competition, lowers concentration, and compresses markups. When productivity differentials are large, foreign entry induces sales reallocation, contraction, or exit among less productive firms, potentially increasing sectoral concentration and markups. The baseline model therefore provides a transparent mechanism linking foreign entry to excess returns and rents: sales reallocation affects market concentration; market concentration shapes markups; and markups, together with scale, determine operating profits and economic rents.

We extend this logic beyond the assumptions of the baseline model. Even when markups are fixed, foreign entry can still concentrate profits through lower costs, larger sales volumes, and firm selection effects, mechanisms emphasized in models of trade and investment with heterogeneous firms ([Antràs and Chor, 2013](#); [Melitz, 2003](#); [Melitz and Ottaviano, 2008](#)). Moreover, when prices are externally determined or assets are location-specific, rents and quasi-rents can arise from wedges between world prices and production costs, control over scarce inputs, sunk investments, and privileged regulatory access. Across horizontal, GVC-related, export-platform, and resource-seeking FDI, political outcomes are therefore shaped not by markups alone, but by a broader set of excess returns generated through the entry and activities of more productive MNCs within the host economy.

## Productivity Differentials and Market Concentration

Chapter 4 investigates the relationship between FDI inflows and market concentration in a sample of both developed and developing countries. Using granular firm-level data from Bureau van Dijk’s *Orbis Historical Database* (1997–2022) ([Bureau van Dijk, N.D.](#)) and following [Bajgar, Berlingieri, Calligaris, Criscuolo and Timmis’s \(2020\)](#) best-practice coverage guidelines, we construct two alternative measures of market concentration: the Herfindahl–Hirschman Index (HHI) and the four-firm concentration ratio (CR4). We use host-country real GDP per capita as a proxy for productivity differentials between multinational firms and domestic incumbents ([Meyer and Sinani, 2009](#)).

The analysis shows that the pro- or anti-competitive effects of FDI depend critically on domestic capabilities. In less developed economies, FDI inflows are more likely to increase market concentration, whereas in more developed economies they are more likely to reduce concentration. These findings identify the first empirical building block in the book’s broader argument: foreign entry reallocates sales and can concentrate economic activity among a smaller number of firms when productivity gaps between foreign entrants and incumbent domestic firms are large. In a variable-markup environment, this mechanism contributes to higher markups as productivity differentials widen. Even in fixed-markup settings or in sectors where prices are determined in world markets, FDI-induced rents may still become concentrated among fewer, larger, and more productive firms. This empirical pattern holds across both HHI and CR4 measures of concentration and remains robust when using alternative concentration measures constructed from the World Bank Enterprise Surveys (WBES) in a cross-sectional setting.

Our findings are consistent with the core theoretical mechanism developed in Chapter 3. When highly productive MNCs enter environments in which domestic firms are relatively weak, the contraction or exit of low-productivity incumbents and the subsequent reallocation of market shares can increase concentration even as technical efficiency improves. By contrast, where domestic capabilities are stronger, foreign entry primarily intensifies competition and compresses markups. In terms of the model developed in Chapter 3, the evidence supports a non-monotonic relationship between foreign-domestic productivity gaps and post-entry concentration: modest productivity gaps discipline market power, whereas sufficiently large gaps trigger firm exit and potential dominance, thereby increasing concentration ([Antràs and Chor, 2013](#); [Melitz and Ottaviano, 2008](#)). The fact that the marginal effect of FDI changes sign across levels of development is precisely what the theory predicts when equilibrium outcomes shift between “entry-without-exit” and “entry-with-exit” regimes. In this way, the analysis helps reconcile mixed findings in earlier country-level studies of FDI and market concentration (see, e.g., [Blomström, 1986](#); [Forte, 2016](#); [Lall, 1979](#); see

Chapter 4 for a more detailed review).

Overall, our results reveal a positive and statistically significant association between FDI inflows and market concentration in less developed economies, consistent with the proposed causal mechanism. This relationship holds when FDI is disaggregated into horizontal versus vertical flows and into manufacturing versus non-manufacturing sectors. To our knowledge, this chapter presents the first *cross-national* study of the relationship between FDI and market concentration. Prior research has relied primarily on single-country analyses because of data limitations.

## 1.4 FDI-Induced Rents and Politics

### Mechanisms Illustrated

Two brief vignettes preview the logic of our argument linking FDI-induced rents to adverse political consequences in the Global South: Wal-Mart’s bribery scandal in Mexico and Firestone’s entanglement in Liberia’s civil war.<sup>2</sup> In both cases, the entry and presence of large MNCs generated market dominance and contributed to substantial rent extraction. These rents, in turn, became objects of political 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 both the ways in which rents were contested and the political consequences that followed.

### Wal-Mart in Mexico

In 2012, the *New York Times* revealed that Wal-Mart de México (Walmex) had orchestrated an extensive bribery scheme to accelerate store openings and secure market dominance after Mexico’s 2000 liberalization.<sup>3</sup> Executives authorized payments to mayors, city council members, urban planners, and bureaucrats in exchange for zoning approvals, fee reduc-

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<sup>2</sup>We provide more detailed discussions of these two cases in Chapters 5 and 6, respectively.

<sup>3</sup>David Barstow, “Vast Mexico Bribery Case Hushed Up by Wal-Mart After Top-Level Struggle,” *The New York Times*, April 21, 2012.

tions, and political support from neighborhood leaders. Trusted lawyers delivered envelopes stuffed with cash.<sup>4</sup> Meanwhile, Walmex’s expansion and operations increase the value of bureaucrats’ regulatory authority and incentivize them to make explicit bribe demands and negotiate payments.<sup>5</sup>

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.<sup>6</sup> 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-induced rents 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). Its profits were immense: by 1951, post-tax earnings were roughly three times the total revenue of the Liberian government (Jones and Miller, 2014).

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<sup>4</sup>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.

<sup>5</sup>U.S. House Committee on Oversight, “Reps. Cummings and Waxman Release Documents Showing That Wal-Mart’s CEO Was Informed of Mexican Bribery Allegations in 2005,” January 11, 2013, <https://oversightdemocrats.house.gov/news/press-releases/rep-cummings-and-waxman-release-documents-showing-that-wal-mart-s-ceo-was>.

<sup>6</sup>Nandita Bose, “Walmart to Pay \$282 Million to Settle Seven-Year Global Corruption Probe,” *Reuters*, June 21, 2019.

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.

## 1.5 Empirical Strategy and Cross-National Evidence

We subject the hypotheses derived from our theoretical framework linking FDI to changes in market structure, corruption, civil conflict, and leadership turnover to systematic empirical tests using a sample of developing countries from 1970 onward. In each of the substantive chapters covering one outcome at a time, the key explanatory variable is inward FDI, measured as net inflows per capita in constant dollars (PPP-adjusted) from UNCTAD. We use FDI stocks per capita (PPP-adjusted) for robustness checks. Measures of market concentration, corruption, civil conflict and leadership turnover are drawn from specialized datasets that map directly onto the theoretical constructs as discussed in the substantive chapters. A primary challenge in the empirical analysis is endogeneity and selection bias, since foreign entry is an endogenous process in which firms internalize expected benefits and costs when making investment decisions.<sup>7</sup> We address this issue with an instrumen-

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<sup>7</sup>See detailed discussions in Chapter 3.

tal 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.<sup>8</sup>

We supplement the large-N analysis with comparative cases illustrating the connection between changes in rents induced by FDI and MNC activity on corruption, civil conflict, and leadership turnover. For corruption, we examine scandals involving Wal-Mart and Rolls-Royce. For civil conflict, we provide detailed accounts of Bralima, a brewing company wholly owned by Heineken International, in the Democratic Republic of Congo (DRC), 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.

### 1.5.1 FDI, Governance, and Corruption

In Chapter 5, which builds on Pinto and Zhu (2016), we examine the implications of FDI-induced rents for corruption in the Global South. High economic rents accruing from FDI inflows and MNC activity increase the value of government regulatory authority over licenses, permits, zoning decisions, and other public goods and services (Ades and Di Tella, 1999), thereby incentivizing officials to exchange discretionary authority for bribes. At the same time, firms earning excessive returns or rents are better able to absorb the additional costs of doing business. 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 competition

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<sup>8</sup>We discuss the rationale, validity and exclusion restriction assumptions of the IV strategy in the substantive chapters of the manuscript.

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 ([Rose-Ackerman, 1999](#)). Using data covering developing countries from 1970 to 2019, 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.

Our case studies of high-profile corruption scandals involving major MNCs such as Wal-Mart and Rolls-Royce help shed light on the causal mechanisms. These multinationals' expansion and operations create opportunities for government officials to extract bribes. In some cases, bribe payments were explicitly demanded and negotiated in exchange for regulatory approval and the awarding of business contracts. These firms also developed sophisticated corruption schemes involving third-party intermediaries (TPIs) to facilitate illicit transactions.

### 1.5.2 Foreign Investors, Civil Conflict, and Political Violence

FDI-induced rents can also increase the risk of intrastate armed conflict in developing countries. We explore this relationship in Chapter 6.<sup>9</sup> High rent extraction increases the size of the spoils and, consequently, the expected returns to governments and rebels appropriating those rents ([Collier and Hoeffler, 2004](#); [Fearon and Laitin, 2003](#); [Grossman, 1991](#)). As a result, rebel groups have stronger incentives to challenge the government. High levels of rent extraction also exacerbate the credible commitment problem inherent in rent-sharing agreements ([Powell, 2006](#); [Walter, 1997, 2002](#)), as control over these rents can shift the relative power over time. Such agreements are therefore more likely to break down in the presence of large economic rents, increasing the probability of armed civil conflict.

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 capabilities and deter rebellion. At the same time, capable states are more likely to resolve disputes through institutionalized mechanisms and

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<sup>9</sup>This chapter is a revised version of [Pinto and Zhu \(2022\)](#).

to convert resources into public goods that alleviate citizen grievances, thereby reducing the risk of intrastate conflict (Gates, Graham, Lupu, Strand and Strøm, 2016; Sobek, 2010; Taydas and Peksen, 2012).

Our empirical analysis supports these hypotheses. After accounting for endogeneity and selection bias using an IV approach, we find a significant positive relationship between inward FDI and the onset of intrastate conflict in the Global South. 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 levels of public goods provision. The cross-national evidence is supplemented by two case studies: Bralima in the DRC and Firestone in Liberia, which illustrate the causal mechanisms in depth.

### 1.5.3 MNC Activity, Political Instability, and Leadership Turnover

Foreign investment can also affect political instability and leadership turnover in the Global South. High rents increase the value of political office by enlarging the fiscal and distributive stakes associated with controlling the state (Acemoglu and Robinson, 2006; Powell, 2006). Consequently, opposition groups have stronger incentives to seek power, contributing to elite fragmentation. Competition over these rents can manifest in leadership turnover, even in the absence of armed conflict. 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 (Kugler and Tammen, 2012), and to invest them in both deterrence capacity to fend off challengers (Caselli and Tesei, 2016) and public goods that sustain economic productivity and alleviate citizen grievances (Brender and Drazen, 2008; Bueno de Mesquita, Smith, Siverson and Morrow, 2005).

Our empirical results presented in Chapter 7 align with these theoretical expectations. Using a sample of developing countries from 1970 to 2018, we find that 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 attenuate the effect of FDI on leadership turnover. We further conduct a detailed case study of ITT's involvement in Chile. The case illustrates how disputes over the distribution of FDI-induced rents can shape the political landscape and fuel political instability.

## 1.6 Theoretical and Empirical Contributions in Context

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 firm 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 demonstrating that trade and investment liberalization reallocates market shares toward the most productive exporters and multinationals, thereby increasing aggregate productivity (Bernard, Jensen, Redding and Schott, 2007; Melitz, 2003). Carr, Markusen and Maskus (2001) further extend this argument by embedding firm heterogeneity within a general-equilibrium framework in which knowledge-capital motives shape location decisions. We retain these micro-foundations but depart from the existing literature on one critical point: when the productivity gap between multinationals and domestic incumbent firms exceeds a certain threshold, the resulting increase in equilibrium markups or excess returns can generate economic rents that canonical models largely overlook. By endogenizing rent creation and demonstrating how it depends on productivity differentials and the resulting changes in market concentration, our framework opens the door to questions about how such rents become politically contested and

with what consequences.

Second, our research speaks to two largely disconnected literatures on the effects of foreign investment and MNC activity in the Global South. Our theoretical framework and empirical analyses help reconcile the divergent arguments advanced within these traditions. Early structural approaches portrayed multinational capital as uniformly corrosive. Dependency, “triple-alliance,” and world-systems theories argued that foreign firms, domestic elites, and the state could form coalitions that extracted surplus from host economies, reinforced underdevelopment, and weakened democratic accountability (Evans, 1979; Evans and Gereffi, 1982; Moran, 1975, 1978). Scholars in these traditions further contended that dependence on core economies perpetuates inequality and facilitates exploitation in peripheral countries (Cardoso and Faletto, 1979; Hopkins and Wallerstein, 1996; Wallerstein, 2004).<sup>10</sup>

By the late 1990s, however, the pendulum had shifted toward a much more optimistic view of FDI. Research grounded in new trade theory and the knowledge-capital framework increasingly treated FDI as a source of efficiency gains, institutional upgrading, technology transfer, and welfare improvement (Bernard et al., 2007; Brainard, 1997; Carr, Markusen and Maskus, 2001; Caves, 1996; Feenstra, 1998; Melitz, 2003). At the same time, scholars also recognized that competition for footloose capital can place downward pressure on governance quality and regulatory standards in host countries (Davies and Vadlamannati, 2013; Gallagher, 2009; Rodrik, 1997; Rudra, Alkon and Joshi, 2018).

We argue that both pessimistic and optimistic perspectives rely on partial logics. Our theoretical framework reconciles these competing views by showing that FDI is most likely to amplify market power and political contestation when productivity gaps between multinationals and domestic firms are large and institutional constraints are weak. In contrast, when productivity gaps are small and institutions are robust, FDI is more likely to generate positive economic and political outcomes.

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

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<sup>10</sup>See Vernon (1971) and Frank (1980) for reviews and discussions of the mixed empirical record.

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 can arise when rents are *endogenously* generated through the entry and expansion of the activities of more productive firms, rather than bestowed by geological endowments. Whereas natural resources are, by definition, location-fixed, rents arising from productivity gaps become location-specific once capital is sunk. As a result, they can serve as focal points for sustained political contestation, undermine governance and instigate conflict. The book therefore generalizes the logic of rent creation from extractive industries to the broader phenomenon of multinational production, offering a more comprehensive account of how the distribution of surplus shapes political order. Recognition of the negative impacts of concentrated economic rents can lead to several mechanisms that affect political change within the host country analyzed in the book. In line with the resource curse logic, the manuscript shows that political and institutional development can mitigate the negative consequences associated with windfalls, rent creation and appropriation. Governments may respond with increased taxation, provision of public goods, implementing social programs funded by these taxes, converting the FDI-induced rents into a potential boon to the host country.

A fourth strand of research links capital inflows to security outcomes and elite politics. Earlier work shows that economic interdependence can pacify interstate relations (Russett and Oneal, 2001), yet evidence on intrastate conflict remains mixed (Bussmann and Schneider, 2007; Gleditsch, 2007; Hegre, Gissinger and Gleditsch, 2003). Some studies argue that FDI raises the opportunity costs of 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 conflict by exacerbating grievances and increasing inequality (London and Robinson, 1989; Wegenast and Schneider, 2017). Recent contributions extend this debate to leadership survival and regime transitions, examining whether incumbents benefit from or are undermined by foreign investment (Bak and Moon, 2016;

[Escribà-Folch, 2017](#); [Owen, 2019](#)). By tracing corruption, conflict, and executive turnover to a common underlying mechanism—contestation over FDI-induced rents in weak institutional environments—our empirical chapters provide a unified explanation for these mixed findings. In doing so, the book bridges the economics of firm heterogeneity with political theories of rent contestation, offering a parsimonious account of why FDI can appear alternately as a development panacea or a source of political instability.

Finally, our framework underscores the analytical distinction between FDI and other components of global integration along two dimensions. First, trade liberalization does not operate through a single mechanism. Lower barriers to imports typically erode protection rents by exposing domestic firms to foreign competition and compressing the markups and profits sustained by tariffs, quotas, and licensing restrictions ([Krueger, 1974](#); [Pavcnik, 2002](#); [Trefler, 2004](#)). At the same time, lower trade costs expand export opportunities for more productive firms, allowing them to increase sales, operating profits, and, in some settings, market power-based rents ([de Loecker and Warzynski, 2012](#); [Melitz, 2003](#)). Aggregate measures of trade openness therefore combine channels that may have offsetting effects on rents. FDI differs because it relocates production within the host economy. Foreign affiliates do not compete solely through arm’s-length trade; they also reshape domestic market structure, input demand, supplier access, and the value of sunk and location-specific assets, making the resulting excess returns larger, more localized, and more politically salient than those generated by trade in goods alone ([Dunning, 1992](#); [Hymer, 1976](#)). Second, FDI also differs from portfolio investment, foreign aid, and remittances. Because FDI entails managerial control and is sunk ex post, it is more susceptible to appropriation through bribery, taxation, or violence ([Kobrin, 1984, 1987](#)). Portfolio flows and loans, by contrast, can exit at relatively low cost and thus discipline governments through the threat of withdrawal ([Ghosh, Ostry and Qureshi, 2017](#); [Obstfeld and Rogoff, 1995](#)). Foreign aid is often driven by donor countries’ strategic interests ([Alesina and Dollar, 2000](#)), while remittances are typically countercyclical ([Chami, Fullenkamp and Jahjah, 2005](#); [Ratha, 2005](#)). These flows rarely restructure market

power unless they are directly invested in production. Our framework thus highlights that the conditional risks we identify are specific to the nature of multinational investment.

## 1.7 Implications for Academics and Practitioners

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 can generate economic rents through several channels: higher markups when concentration raises price-cost wedges, larger profits when more productive firms expand under fixed markups, and rents or quasi-rents tied to world-price wedges, scarce inputs, regulatory access, and sunk assets. State capacity and domestic institutions then determine whether these excess returns produce adverse political consequences or yield developmental benefits. By integrating models of firm heterogeneity with theories of political contestation and placing FDI-induced rents at the center of the analysis, our framework helps reconcile the divergent arguments and findings that have long portrayed FDI as either a boon or a curse in developing countries.

The central lesson from the theory and findings is not that governments in the Global South should retreat from FDI, but that they should avoid treating aggregate inflows as an end in themselves. Because the effects of FDI depend on market structure and the governance of rents, investment policy must be paired with competition and antitrust enforcement, stronger legal and regulatory capacity, transparent governance, and fiscal institutions capable of taxing rents through rule-bound public instruments and converting the resulting revenue into public goods rather than private or targeted benefits. At the same time, openness has to be connected to concrete investments in domestic capabilities: infrastructure, research and development, upstream and downstream linkages, human capital development, worker training, and access to finance. Safeguarding political stability further requires inclusive and accountable institutions that prevent FDI-induced rents from fueling elite rivalry, corruption, or civil conflict.

We must, however, acknowledge the limitations of our analysis of the political consequences of FDI. Our macro-level approach has the advantage of shedding light on higher-level, aggregate outcomes, such as grand corruption, state capture, elite fragmentation, and leadership turnover. By design, more granular, micro-level studies are less well suited to examining these dynamics. Nonetheless, an important next frontier lies in uncovering the micro-level mechanisms and processes that generate these outcomes, offering fruitful opportunities for future research. Future work can 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 response to political and regulatory risks. Scholars should also 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. Taken 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 life cycle of global capital and its interaction with domestic institutions and political contestation.

# 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<sup>th</sup> 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 that enables the cross-border flow of savings and investment; FDI—the movement of capital across borders for the purpose of production; technological diffusion—the transfer of technology through both arm's-length transactions

and spillovers; and migration—the cross-border movement of people and labor. Global economic integration has increased interdependence among countries, rendering national economies more susceptible to global economic forces, such as the convergence of commodity and factor prices, output fluctuations, price and exchange-rate 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; UNCTAD, 2023). 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).

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) and global FDI flows. 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<sup>th</sup> and early 20<sup>th</sup> 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, the World Bank, and the General Agreement on Tariffs and Trade, which later evolved into the World Trade Organization. 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 ([Antràs and Chor, 2022](#); [Baldwin, 2016](#); [UNCTAD, 2013](#)). This transformation is evident in the rise of 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

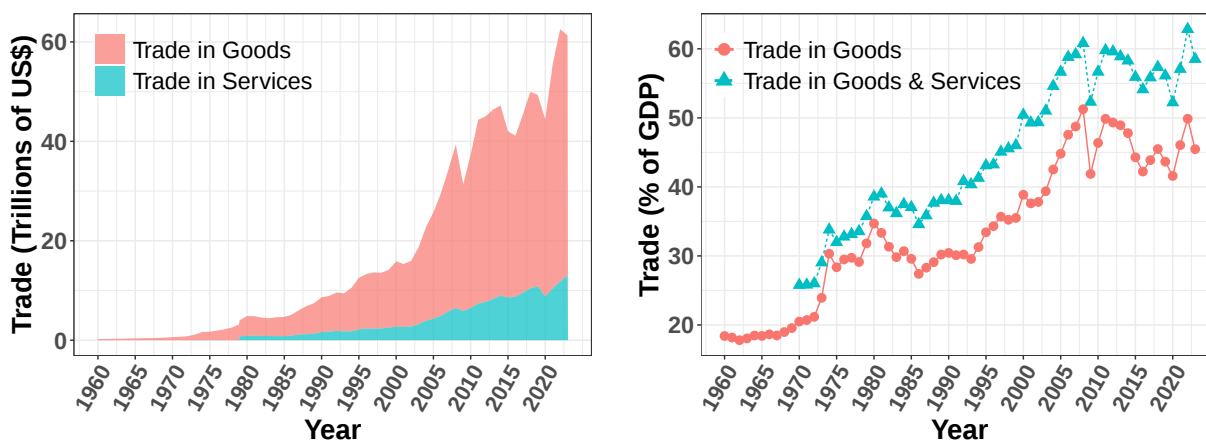
production networks spanning multiple countries.

Conceptually, international trade and FDI are distinct forms of international economic integration: the former primarily reflects arm's-length exchange, whereas the latter involves direct ownership and internal control over foreign productive activities. However, with the fragmentation of global production and the rise of GVCs, trade and FDI have become deeply interconnected. A substantial share of international trade now takes place through related-party transactions within multinational firms and across production networks and value chains coordinated by MNCs.

## 2.3 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, 2020b).

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.<sup>1</sup>

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; Walter, 2021). Economically, critics

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<sup>1</sup>*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>.

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 support for populist leaders and increasing demands for protectionist policies ([Broz, Frieden and Weymouth, 2021](#); [Lake, Martin and Risse, 2021](#); [Walter, 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, 2020a](#), 553).<sup>2</sup>

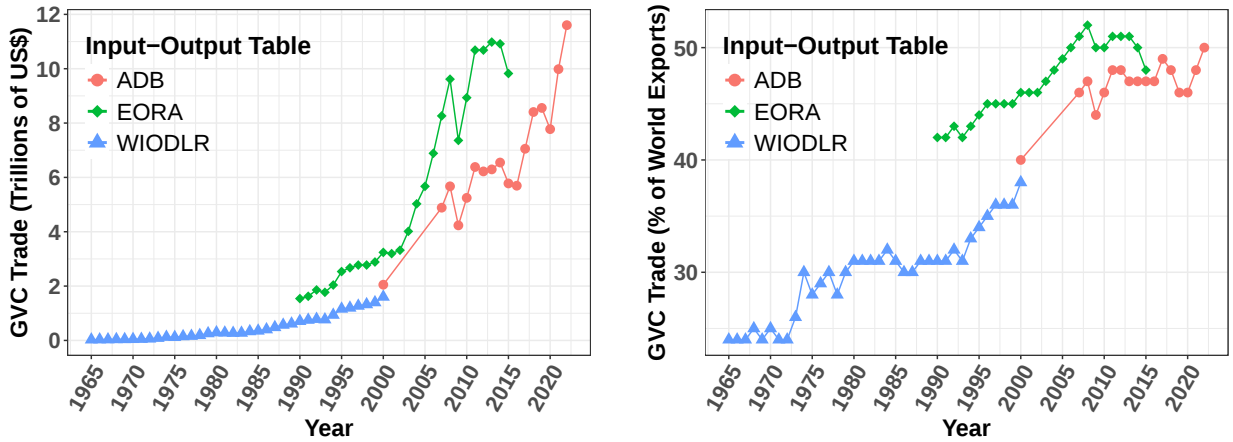
With advancements in ICT, a lead firm, often an MNC, can share proprietary knowledge with offshore producers in low-wage countries to ensure high quality and compatibility

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<sup>2</sup>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 \(2012\)](#).

(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 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.<sup>3</sup> 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).

## 2.4 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.

FDI refers to investments made by a company or individual in one country to acquire a lasting business interest in another country.<sup>4</sup> 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 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.<sup>5</sup>

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

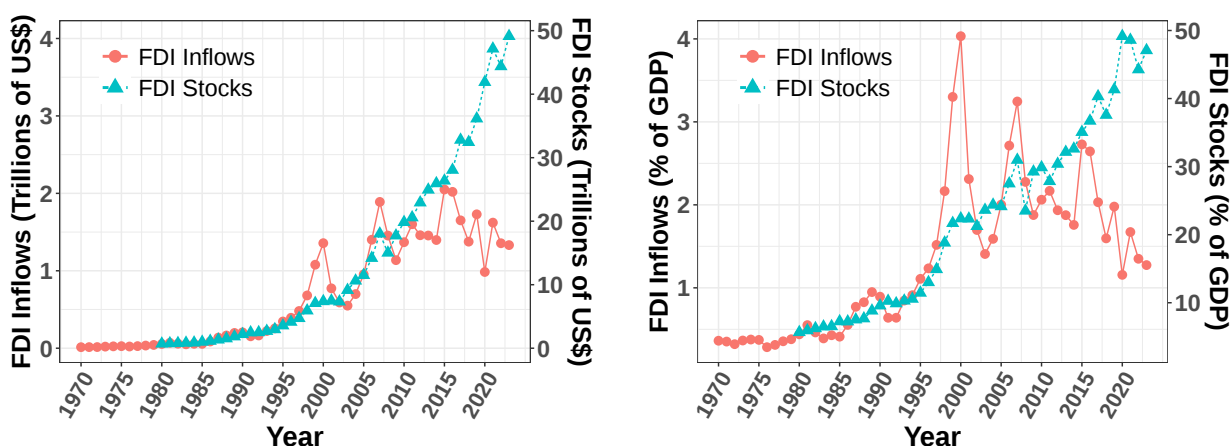
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<sup>3</sup>GVC trade is not measured directly, as collecting comprehensive data on the exchange of goods and services at the firm level across countries poses an immense challenge. Instead, GVC trade is typically estimated at an aggregate level (e.g.,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

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

<sup>5</sup>Ibid.

Figure 2.3: World FDI (1970–2023)



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

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, and 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 rapidly to changes in labor costs, regulatory environments, and global demand. MNCs are typically highly productive firms with extensive global oper-

ations. 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 economies, recent decades have witnessed the growing emergence of multinational firms from the Global South (UNCTAD, 2016).

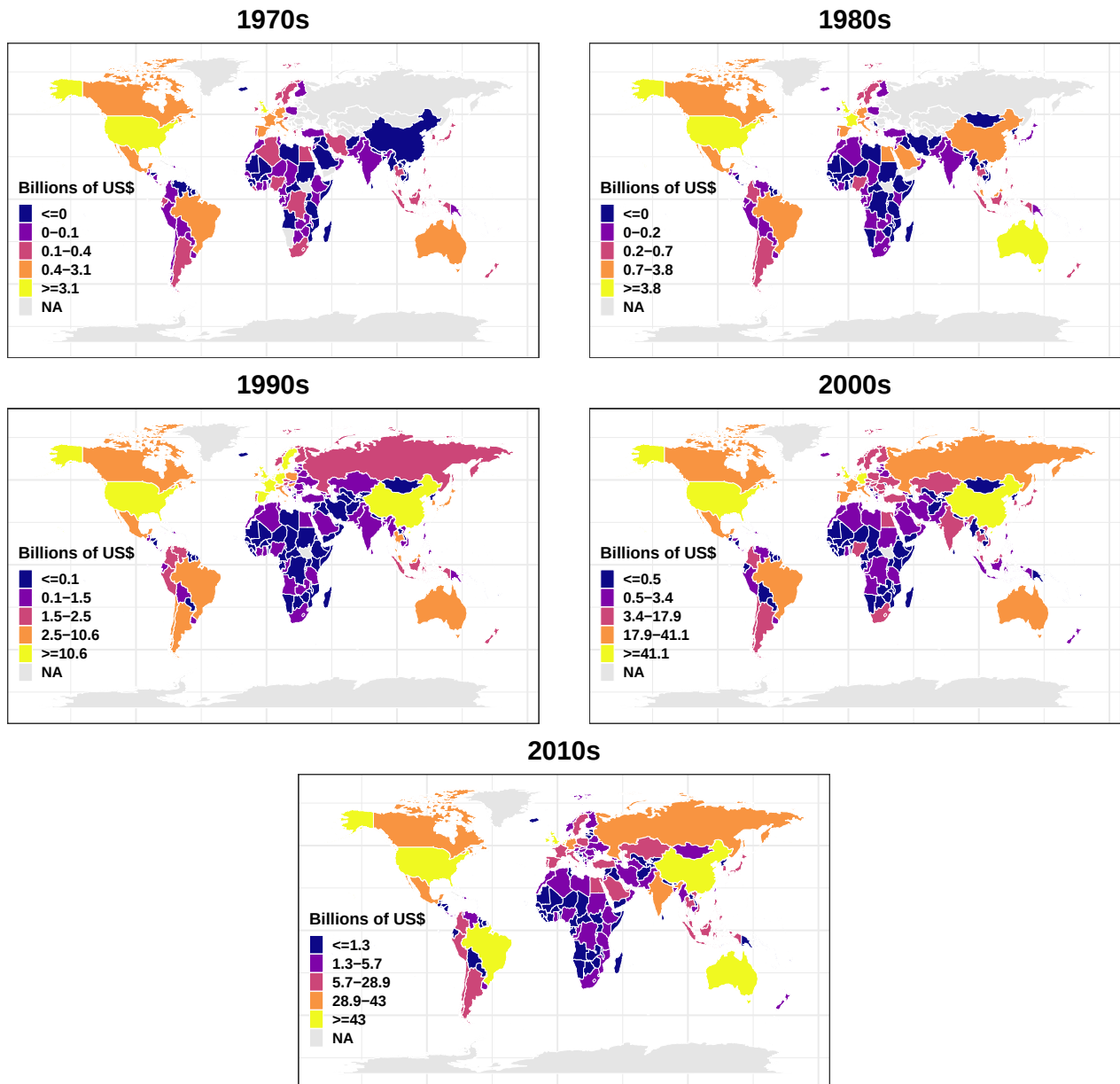
### **Global Distribution of FDI**

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

Figure 2.4: Global Distribution of FDI Inflows by Decade

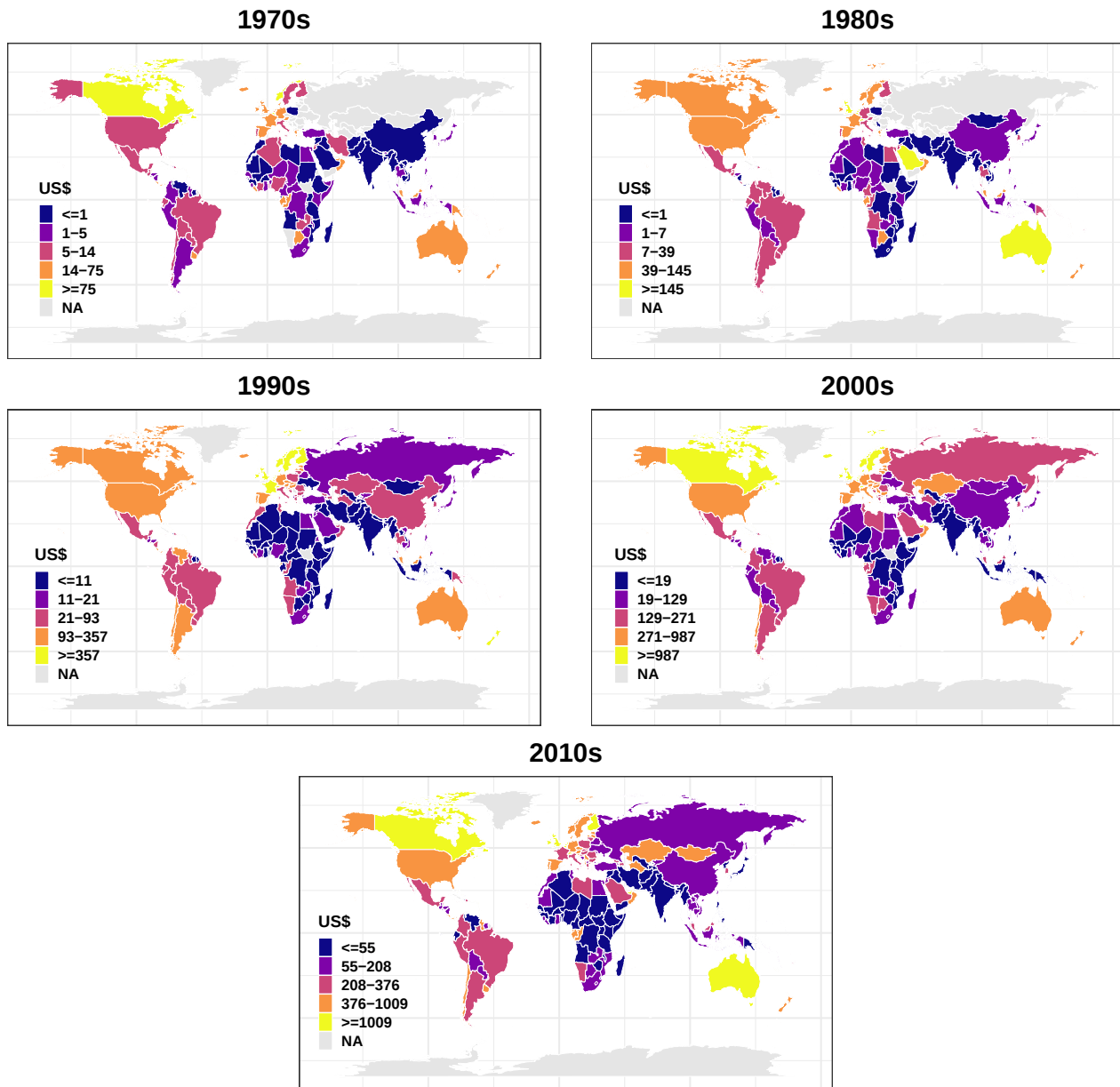


*Notes:* Data come from UNCTAD. The values of FDI inflows shown in the heat maps represent decadal averages. Grey areas on the map indicate countries or territories for which data are not available.

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.

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.

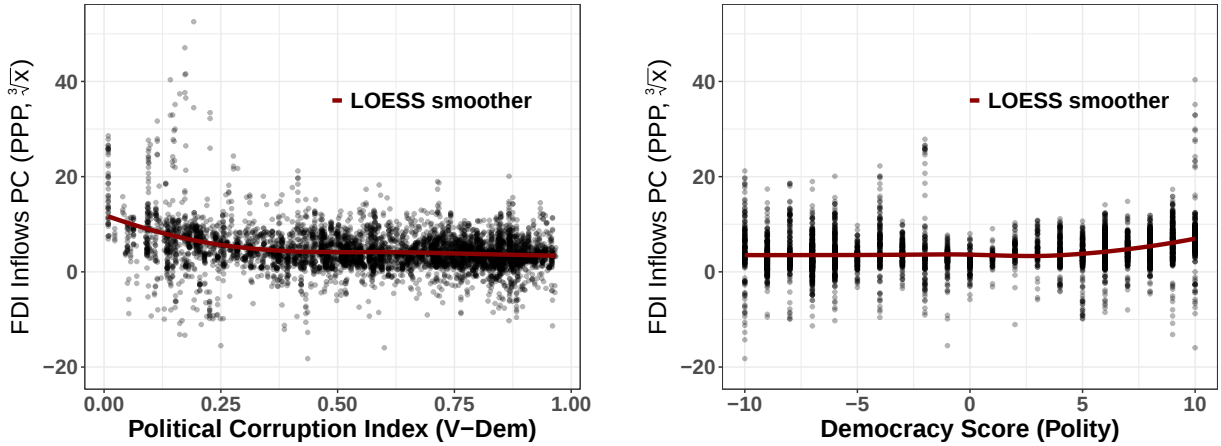
The Middle East and North Africa also include several oil-rich countries such as Libya, Oman, Saudi Arabia, and the United Arab Emirates. In Latin America and the Caribbean, countries such as Colombia, Costa Rica, Dominica, Jamaica, Peru, and Uruguay rank highly. In Eastern Europe, prominent cases include Belarus, the Czech Republic, Estonia, Georgia,

Romania, Serbia, and Slovenia.

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<sup>6</sup> against political corruption<sup>7</sup> 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<sup>8</sup>,

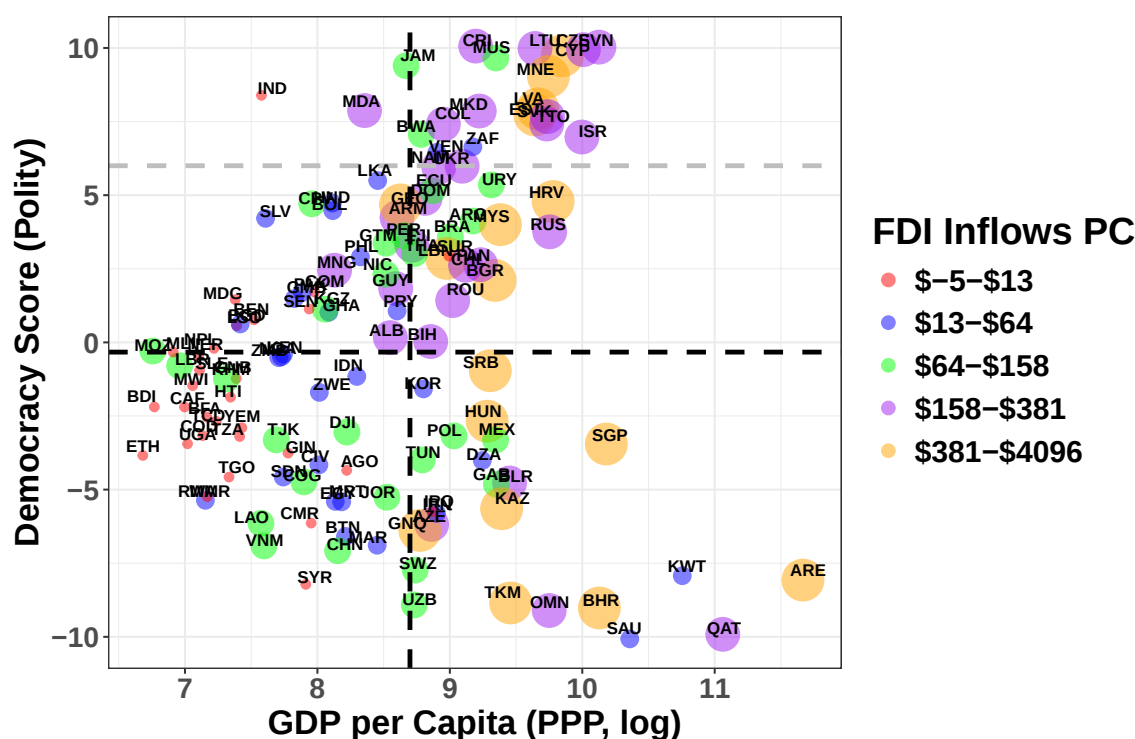
<sup>6</sup>The distribution of per capita FDI inflows (PPP-adjusted) is highly skewed. We apply the cubic root transformation to reduce the influence of extreme values.

<sup>7</sup>We use the political corruption index from V-Dem.

<sup>8</sup>The Pearson correlation between FDI inflows per capita and polity scores is 0.20 in the sample.

considerable variation persists across all regime types.

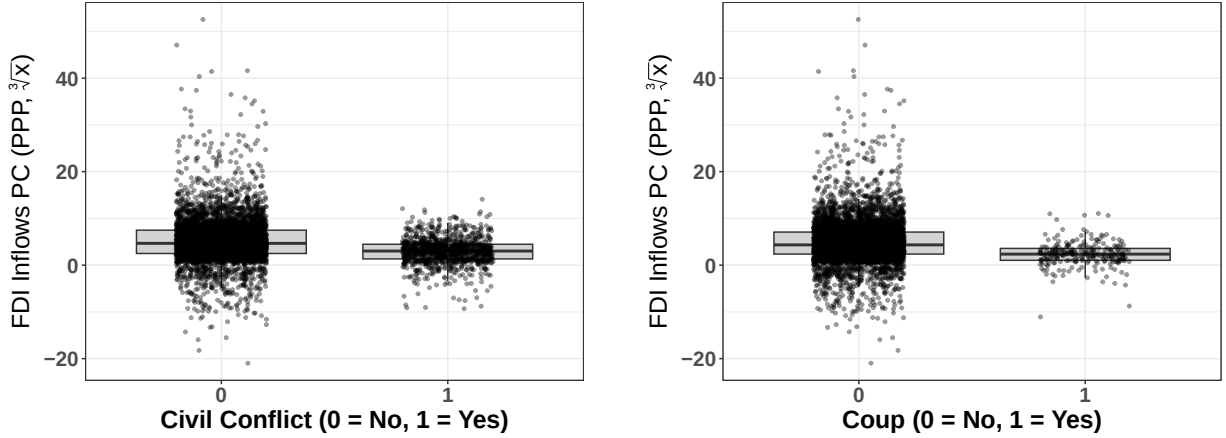
Figure 2.7: Development, Democracy, and FDI



*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.

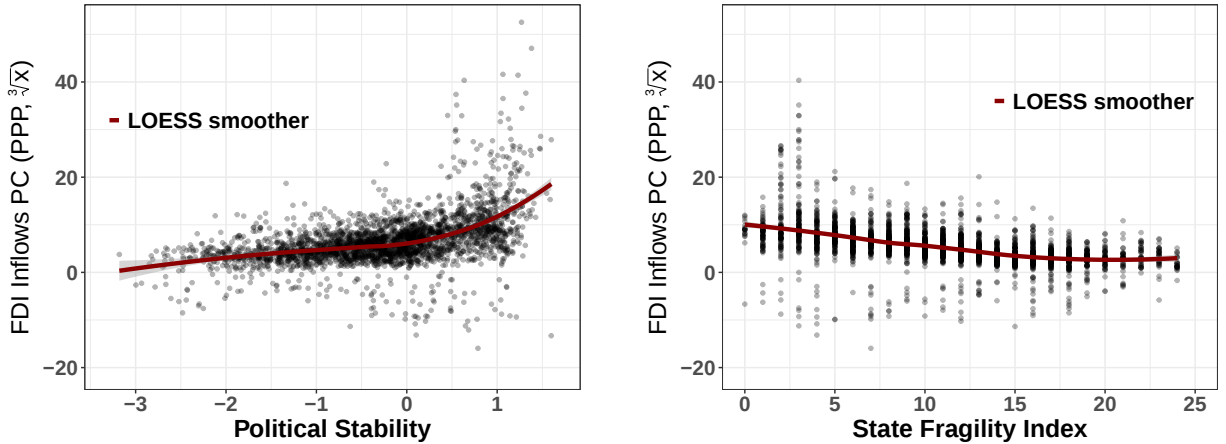
Figure 2.7 categorizes developing countries into four groups based on two dimensions: level of development (real GDP per capita) and regime type (Polity score). Overall, there is a positive correlation between economic development and per capita FDI inflows. In contrast, the relationship between democracy and FDI is less consistent. Both democratic and authoritarian countries with higher levels of development tend to attract more FDI 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: 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<sup>th</sup> and 75<sup>th</sup> 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 2.8 plots per capita FDI inflows against the incidence of civil conflict<sup>9</sup> (left panel) and coup d'état<sup>10</sup> (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.

Figure 2.9 further explores the relationship between FDI and broader measures of po-

<sup>9</sup>Data on civil conflict are from UCDP/PRIO.

<sup>10</sup>Data are from the Colpus Dataset (Chin, Carter and Wright, 2021).

litical stability. The left panel plots FDI against a composite index of political stability and absence of violence/terrorism,<sup>11</sup> while the right panel uses a measure of state fragility.<sup>12</sup> As expected, political stability, defined as the absence of violence and terrorism, is positively correlated with per capita FDI inflows, 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.<sup>13</sup>

## 2.5 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 potentially boost productivity and

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<sup>11</sup>Data are from the World Bank's *World Governance Indicators*.

<sup>12</sup>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).

<sup>13</sup>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.

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). In addition, research suggests that FDI may contribute to improved governance, stronger rule of law, and enhanced labor protections (Kwok and Tadesse, 2006; Mosley, 2011; Sandholtz and Gray, 2003).

At the same time, FDI can also generate unintended economic and political consequences. The entry of foreign firms may crowd out domestic companies, particularly in sectors where local firms are less competitive (Pinto and Zhu, 2016, 2022). The benefits of foreign investment may also be unevenly distributed, contributing to rising inequality across sectors, regions, and social groups within host countries (Graham, 2000). Moreover, scholars have argued that competition for foreign investment can place 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 the Global South. While all components of globalization 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 or cause them to contract, thereby increasing market concentration and contributing to rent generation. In contrast, in developed markets where incumbent firms are already efficient, foreign entry likely intensifies competition and erodes profit margins, reducing excess returns while potentially improving aggregate productivity. Chapter 3 discusses these mechanisms in detail.

Trade liberalization operates through distinct channels, and its distributive consequences are not uniform. Restrictions on imports such as tariffs, quotas, and licensing requirements

often generate rents for domestic incumbents by sheltering them from foreign competition (Krueger, 1974). Lowering those barriers usually erodes these protection rents, compresses domestic markups, and reallocates market shares toward more efficient producers (Pavcnik, 2002; Trefler, 2004). At the same time, lower trade costs expand export opportunities for the most productive firms. In heterogeneous-firm settings, those firms can increase sales and profits through scale and selection, and in some differentiated-product markets they may also sustain higher markups (de Loecker and Warzynski, 2012; Melitz, 2003). For example, after entering the North American Free Trade Agreement, many previously sheltered Mexican firms in low-productivity sectors faced declining profitability as foreign competition intensified, while more competitive firms integrated into North American value chains expanded exports and improved performance (Brugués, Kikkawa, Mei and Robles, 2025). FDI builds on but also departs from this logic. Because foreign affiliates produce within the host economy, they affect not only trade flows but also domestic market concentration, supplier access, input demand, and the value of firm- and location-specific assets. As a result, FDI can generate excess returns that are more localized and more politically salient than those arising from arm's-length trade alone.

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 tied to direct control over 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, often referred to as official development assistance, constitutes another important category of international financial flows. It consists of concessional loans and grants provided by governments and multilateral institutions to promote economic development and welfare in recipient countries and territories. Aid is generally directed toward poverty alleviation, capacity building, and infrastructure development. Although it can support critical development objectives, its effectiveness is highly contingent on governance structures and institutional quality in recipient countries ([Burnside and Dollar, 2000](#); [Easterly, 2003](#); [Kosack and Tobin, 2006](#); [Sexton, 2016](#); [Wright and Winters, 2010](#)). Unlike FDI, foreign aid is not market-driven and therefore lacks the competitive pressures, technological spillovers, and productivity incentives associated with private investment. Moreover, aid flows may be shaped by security and strategic considerations, as well as by donor-imposed conditionalities that can constrain their developmental impact ([Alesina and Dollar, 2000](#)).

Remittances, which refer to financial or in-kind transfers sent by migrants to their home countries, constitute a relatively stable and countercyclical 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 increased consumption, their contribution to long-term productivity growth is limited unless they are channeled into investments 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 networks.

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 (Ahn, Kim, Li and Manera, 2026; 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, particularly those with weak institutional environments, 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 rent creation. The struggle to control these rents can increase the risk of adverse political consequences such as corruption, civil conflict, and high leadership turnover, especially in countries with weak institutions and limited state capacity.

# Chapter 3

## FDI, Markups, Rents, and Politics

### 3.1 A General Framework: Overview

Our theoretical framework builds on two components: (1) the effect of foreign entry on the creation or dissipation of economic rents; and (2) the political ramifications of those rents, shaped by host-country state capacity and institutional development.

MNCs are typically among the most productive firms in the global economy and tend to be much larger than firms in developing countries. More generally, when firms enter a market and begin production, their activities can affect output prices, market shares, and production costs, both within the sector and through linked input markets and, potentially, the broader economy.

In perfectly competitive markets, entry occurs until economic profits are driven to zero. At the other extreme, when entry leads to the exit of incumbent firms or when only a small number of firms remain active, production may become highly concentrated, allowing surviving firms to charge markups above marginal cost. Under monopolistic competition, entry increases product variety and alters residual demand for imperfect substitutes. In oligopolistic settings, the distribution of market shares determines market concentration, which in turn affects equilibrium markups. These markups generate operating profits; net of fixed and opportunity costs, they become economic profits, and when they exceed the

normal return required to sustain production or investment, they constitute economic rents.

Across these settings, foreign entry tends to reallocate production toward more productive firms, with less productive firms contracting or exiting the market. The theoretical framework developed in this chapter emphasizes the excess returns associated with this reallocation. In some settings, these excess returns arise through variable markups. In others, they arise through scale economies, world-price-cost wedges, access to scarce inputs, or control over sunk and location-specific assets. Throughout the chapter, we refer to this broader class of excess returns as FDI-induced rents.

## Productivity Differences and Rent Creation

The extent to which foreign investment creates or dissipates rents hinges on the productivity gap between foreign entrants and incumbent local firms. Because establishing and operating foreign affiliates entails substantial fixed costs, MNCs tend to be drawn from the upper tail of the global productivity distribution (Helpman, Melitz and Yeaple, 2004; Melitz, 2003; Yeaple, 2009). In developing countries, where domestic firms are often smaller and less technologically advanced, the productivity gap between foreign entrants and local incumbents can be especially large. When that gap is modest, foreign entry may intensify competition and dissipate rents. When it is large, entry can induce domestic contraction or exit, raise concentration, and generate rents for the surviving firms. As domestic firms lose market share, their average production costs may 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, in developing countries many market opportunities remain underutilized or untapped, particularly in industries characterized by high entry barriers arising from economies of scale, technological and capital requirements, and product differentiation. Paradoxically, these entry barriers create opportunities for MNCs to enter such markets (Caves, 1996; Dunning, 1992). The proprietary assets held by MNCs, such as advanced technolo-

gies, 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 (Motta, 2004; Newfarmer, 1979; Zhu, 2017), thereby contributing to the formation of concentrated market structures. 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; Forte, 2016; Willmore, 1989).

Note that both the determinants of foreign entry and the consequences of foreign presence are conditioned by local conditions, which 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.

## Rents and Political Outcomes

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 arising from FDI inflows and MNC activity on corruption, civil conflict, and leadership turnover in the Global South. High rents increase the value of government-controlled goods and services, motivating officials to exchange regulatory authority over these resources for bribes, thereby fostering corruption (Ades and Di Tella, 1999; Pinto and Zhu, 2016). Likewise, high rents increase the value of political control and the spoils associated with state capture, incentivizing rebel groups to challenge incumbent governments and thereby heightening the likelihood of civil conflict onset (Collier and Hoeffler,

1998; Fearon and Laitin, 2003; Grossman, 1991). Finally, the prospect of appropriating these rents can intensify political contestation and generate struggles over control of the government, leading to leadership turnover 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 strengthens the state’s coercive and administrative capabilities, improves public goods provision, mitigates grievances, and facilitates conflict resolution, thereby reducing the risks of civil conflict and leadership turnover.

For the remainder of this chapter, we build on insights from a formal model to examine the mechanisms through which foreign entry can generate high markups and economic rents across a range of settings, as well as the political consequences of rent extraction.

## 3.2 Model Overview and Predictions

A companion working paper by Pinto and Rueda (2026) develops the formal model that underpins the argument in this chapter and extends Edmond, Midrigan and Xu (2015) to allow for FDI. The appendix reproduces the benchmark model for readers who want the full derivations. Here, the goal is different: to explain clearly what the model implies and why it matters for the broader argument of the book.

The central insight is straightforward. Foreign entry changes who sells, who survives, and who controls scarce inputs inside the host economy. Those changes alter the distribution of sales across firms. In some market environments, that reallocation changes markups directly. In others, it changes profits and rents through scale, firm selection, and control over local assets even when markups themselves do not vary.<sup>1</sup>

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<sup>1</sup>The technical reason why reallocation toward larger firms can raise markups in the baseline case in the variable-markup model is because buyers find it easier to switch among firms in the same line of business

The benchmark result is non-monotonic. When the productivity gap between the foreign entrant and domestic incumbents is small, entry tends to spread sales across more firms, intensify competition, and lower markups. When the productivity gap is large, however, entry can shift sales toward a smaller number of highly productive firms, induce contraction or exit among weaker incumbents, and increase concentration.<sup>2</sup> In that case, higher markups, together with larger scale, raise profits and rents.

The broader argument of the chapter is not limited to this benchmark variable-markup environment. When markups are fixed, more productive firms can still earn larger operating profits and economic profits because they sell more at lower cost. When prices are determined externally, as in some export-platform and resource sectors, rents may arise from the gap between world prices and local costs rather than from higher domestic markups. What matters throughout is whether foreign entry creates or concentrates excess returns within the host economy.

This mechanism is especially relevant in developing countries. Average firm productivity is typically lower in poorer economies, while firms that undertake FDI are drawn from the upper tail of the global productivity distribution. Wider productivity gaps therefore make it more likely that foreign entry will generate concentrated profits and rents rather than simply intensify competition. As domestic firms catch up, these effects should weaken.

Greater sales, higher productivity, and lower prices can benefit consumers and improve efficiency. But those gains may be accompanied by firm exit, higher concentration, and greater rents when productivity differences are large. The remainder of this section explains that logic in intuitive terms and then shows how it changes across different market

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than to substitute away from that sector altogether. Intuitively, a small firm mainly competes against close rivals within the sector, while a very large firm becomes harder to replace because buyers would need to substitute across sectors, which is more difficult. This will be reflected in changes in firms' revenue shares.

<sup>2</sup>This follows from footnote 1: Let  $\omega_{ij}$ , denote the fraction of all sales in sector  $j$  accounted for by firm  $i$ . We can summarize sectoral concentration by the Herfindahl-Hirschman Index,  $HHI_j = \sum_i \omega_{ij}^2$ , which adds up each firm's squared sales share. Squaring each  $\omega_{ij}$  gives extra weight to large firms, so the index is low when sales are spread across many similarly sized firms and high when one or a few firms dominate the market. The sectoral markup,  $\mu_j$ , is the average price-cost wedge in sector  $j$ . Hence, a higher  $HHI_j$  raises  $\mu_j$  because concentration shifts demand toward the larger, more productive, and less substitutable seller.

environments.

## Baseline Mechanism

Consider an industry populated by domestic firms producing differentiated goods. These firms differ in productivity and therefore in their production costs. More productive firms can serve the market more cheaply, sell more, and capture larger shares of industry sales.

Now introduce a foreign firm that is considering entry. Because producing abroad requires the firm to overcome fixed costs that domestic incumbents do not face to the same extent, the entrant is assumed to be more productive than at least some local firms (Bernard and Jensen, 1999; Helpman, Melitz and Yeaple, 2004; Yeaple, 2009). Once it enters, it competes directly with domestic producers for customers, workers, suppliers, and other inputs. The result is a reallocation of sales and production across firms.

That reallocation matters because market power depends not only on the number of firms in the market, but also on how sales are distributed among them. A market with many firms can still be dominated by a few very large producers. Conversely, a market with fewer firms can remain competitive if sales are broadly dispersed. The effect of FDI therefore depends on whether foreign entry fragments sales or concentrates them.

The benchmark model in the appendix formalizes this point using a demand structure in which buyers can more easily substitute across firms within the same sector than across broader sectors of activity. The practical implication is intuitive: a very small firm can be replaced relatively easily by close competitors, but a very large firm becomes harder to discipline because replacing it requires buyers to move farther away from their preferred bundle of goods. Larger firms therefore face less elastic residual demand and can sustain higher markups.<sup>3</sup>

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<sup>3</sup>Formally, we can connect market share to pricing power in the following terms:  $\sigma_{ij}$  is the residual demand elasticity faced by firm  $i$  in sector  $j$ , and  $\omega_{ij}$  is that firm's share of sectoral sales. When  $\omega_{ij}$  is small, the firm is one of many close substitutes and the elasticity it faces is close to the higher within-sector elasticity. When  $\omega_{ij}$  is large, the firm becomes harder to replace and the elasticity it faces moves toward the lower across-sector elasticity.

## Core intuition

When the productivity advantage of the foreign entrant is modest, entry often makes the market more competitive. Domestic firms remain active, the entrant takes only a limited share of sales, and the number of meaningful competitors increases. In that case, sales remain relatively dispersed and markups tend to fall. The consumer gains from foreign entry are clearest in this environment: prices decline, output rises, and no single firm becomes dominant.

The outcome changes when the entrant's productivity advantage is large. A much more efficient foreign firm can expand rapidly because it is able to produce at lower cost than many incumbents. Less productive domestic firms lose sales, contract, and in some cases exit altogether. Production then becomes concentrated among a smaller number of larger and more efficient firms. In the benchmark variable-markup setting, this raises equilibrium markups. More generally, it raises profits and rents by shifting scale toward firms with lower costs and stronger market positions.

This is the core reason the effect of foreign entry is non-monotonic. The same shock can have pro-competitive effects when it adds one more efficient rival to an otherwise viable market, and rent-creating effects when it tips the market toward dominance by a few highly productive firms. The difference lies in the size of the productivity gap and in the ability of domestic firms to absorb the competitive shock.

The same logic applies when more than one multinational enters. Multiple entrants do not automatically eliminate rents. If all of them are much more productive than the average domestic firm, and if fixed costs or input bottlenecks limit broader entry, production can still become concentrated among a relatively small number of high-productivity firms. In that case, competition may increase on one margin while rents remain concentrated on another.

The benchmark model captures this by showing that a foreign entrant with a small sales share may initially disperse activity and lower concentration, whereas a much more produc-

tive entrant can capture enough sales to increase concentration, especially once domestic firms begin to contract or exit. The political and distributive consequences follow from that reallocation.

## Baseline predictions

The benchmark argument yields three baseline predictions. First, foreign entry increases total sales and productivity because production is reallocated toward more efficient firms. Second, the effect on concentration is conditional. When productivity gaps are small, entry increases competition and concentration falls. When productivity gaps are large, entry induces contraction or exit and concentration rises. Third, the effect on markups follows the effect on concentration: markups fall when competition intensifies and rise when production becomes more concentrated.

These predictions imply a broader expectation about profits and rents. Foreign entry is most likely to generate concentrated excess returns when foreign firms are much more productive than domestic incumbents, when fixed costs limit entry, and when domestic adjustment is weak. These conditions are more likely to hold in less developed economies, where domestic firms are often smaller, less productive, and more resource-constrained.

The benchmark also clarifies why foreign entry can enhance efficiency while simultaneously generating politically consequential rents. Reallocation toward more productive firms reduces costs and can improve consumer welfare, yet it may also increase market concentration and expand the pool of profits and rents accruing to surviving firms. Thus, efficiency gains and rent creation can coexist.

## 3.3 Extensions to the Baseline Mechanism

The benchmark model identifies a clear mechanism through which foreign entry can generate rents: reallocation increases market concentration, higher concentration raises markups, and higher markups increase profits and rents. However, the strength and composition of this effect depend on the broader economic environment. Three dimensions are

particularly important: how demand conditions shape markups, how input markets respond to foreign expansion, and how output prices are determined.

These extensions do not overturn the baseline mechanism. Rather, they clarify the conditions under which foreign entry affects rents through different channels. In some settings, the primary adjustment occurs through markups. In others, it operates through profits, cost pressures, or quasi-rents associated with world prices and sunk assets. The broader framework developed in this book therefore applies across different forms of FDI, even though the benchmark formalization emphasizes a particular market structure.

## Demand Structure and Markup Determination

In the benchmark case, larger firms can charge higher markups because their customers have fewer close substitutes. But not all industries behave this way.

In some settings, firms face a more fixed demand elasticity and therefore charge roughly constant markups. In those environments, the markup channel is muted. Yet the broader argument does not disappear. More productive firms still produce at lower cost, expand sales more rapidly, and are better able to survive fixed costs. As a result, foreign entry can still concentrate profits and rents even if markups do not rise with market share.<sup>4</sup>

## Input-Market Adjustments

Foreign entry can also reshape the market through its effects on inputs. A highly productive foreign affiliate does not compete only for customers. It also competes for labor, land, logistics, energy, infrastructure, and intermediate goods. When these inputs are in limited supply, expansion by the affiliate can push up their prices.

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<sup>4</sup>The key point is that, when markups are fixed, productivity matters through scale rather than through differential pricing. More productive firms do not charge a higher markup than their rivals; instead, they sell more, generate more revenue, and spread fixed costs over a larger sales base. More technically, under constant-markup monopolistic competition,  $\bar{\sigma}$  is the common elasticity of demand faced by all firms, so the markup is fixed at  $\mu = \bar{\sigma}/(\bar{\sigma} - 1)$ . Let  $r_{ij}$  denote the total revenue of firm  $i$  in sector  $j$ , equal to price times quantity sold. Let  $\tilde{\pi}_{ij}$  denote operating profits before fixed costs, that is, the surplus remaining after variable production costs are paid. Let  $F_{ij}$  denote the fixed cost of operating, and let  $\pi_{ij}$  denote profits after that fixed cost is paid. The expression  $\tilde{\pi}_{ij} = r_{ij}/\bar{\sigma}$  means that, with a common markup, a constant share of revenue becomes operating profit. The expression  $\pi_{ij} = r_{ij}/\bar{\sigma} - F_{ij}$  then shows whether that operating surplus is large enough to cover the fixed cost and leave the firm with positive net profits.

These cost increases do not affect all firms equally. More productive firms are usually better able to absorb higher wages, transport costs, or input prices because they begin from a lower cost base. Less productive domestic firms, by contrast, are hit harder. Input-market pressure can therefore accelerate contraction or exit among weaker firms even if competition in output markets is strong and product prices do not rise much.

This means that concentration can rise through a channel other than consumer prices. A foreign entrant may not dramatically raise prices in the final-goods market, yet it may still increase rents indirectly by changing who can profitably operate in the host economy. In this way, input bottlenecks magnify the selection effect of FDI and reinforce the concentration of production among fewer, more productive firms.

This extension is especially important for developing countries, where infrastructure, skilled labor, transport, and specialized intermediates are often in short supply. Under those conditions, foreign entry can reshape the domestic economy not only by taking sales from incumbents but also by changing the cost structure faced by everyone else.

## Inelastic Prices and World-Market Pricing

In other settings, output prices are not determined mainly by domestic market structure. This is especially true in export-platform industries, GVCs, and resource sectors where prices are set in world markets or negotiated externally. In such cases, the relevant rents need not come from higher domestic markups.

Instead, the key source of surplus is the gap between the externally given price and the firm's local cost of production. A highly productive foreign affiliate can earn substantial profits because it can produce more cheaply than local rivals at a price it largely takes as given. Once the investment is sunk, part of that surplus becomes quasi-rents tied to the location, the assets, and the surrounding network of suppliers, infrastructure, and permits.<sup>5</sup>

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<sup>5</sup>Intuitively, when output prices are externally given the firm earns surplus when it can produce below the external price and sell enough output to cover its fixed costs. Once those fixed costs are sunk, the ex post surplus is more precisely a quasi-rent tied to the location and the assets in place. Technically, the relevant surplus can be written as  $\Pi_{ij} = (P^* - c_{ij})q_{ij} - F_{ij}$ . Here  $P^*$  is the world price or other externally determined output price,  $c_{ij}$  is the firm's marginal cost of production,  $q_{ij}$  is the quantity sold, and  $F_{ij}$  is the fixed cost

This is particularly important for export-oriented and resource-seeking FDI. In such settings, foreign entry may not raise domestic consumer prices, yet it can still create large and politically salient rents. Productive affiliates expand, local suppliers reorganize around them, scarce inputs become more valuable, and host governments gain leverage over immobile assets. The political significance of these rents may be as large as, or larger than, the rents generated through markups in domestic consumer markets.

What matters is not whether the surplus takes the form of markups in domestic product markets, but whether foreign activity generates excess returns tied to economic assets and decisions located within the host economy. Once created, these returns can become objects of taxation, bargaining, corruption, and political contestation.

## Corollary

Taken together, the benchmark mechanism and its extensions suggest that the effects of foreign entry depend on how sales reallocation interacts with demand conditions, input markets, and the broader pricing environment. The benchmark model highlights one particularly transparent mechanism through which foreign entry may generate rents: sales reallocation can increase concentration, higher concentration may raise markups, and higher markups can contribute to increased profits and rents. However, this is only one of several channels through which multinational activity may generate economically and politically consequential excess returns.

When markup variation is limited or absent, foreign entry can still contribute to concentrated profits and rents through scale economies, firm selection, input-market pressures, and control over sunk and location-specific assets. The broader argument developed in this book therefore applies across different forms of FDI, although the specific channels through which excess returns emerge vary across contexts.

These mechanisms provide the foundation for the discussion that follows. Different types of FDI or different modes of foreign entry place varying weight on product-market of operating.

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competition, supplier linkages, exposure to world prices, and input bottlenecks. As we elaborate below, all of these channels can potentially reshape the distribution of production and the concentration of excess returns within the host economy.

### 3.4 FDI Types: Horizontal, Vertical, Export-Platform, and GVC-Related

***Horizontal/market-seeking FDI.*** In product markets, the effects of entry depend on demand elasticity. When residual demand is elastic, a more productive entrant passes through its cost advantage and output prices fall. When demand is less elastic, price adjustments are more limited, and if entry induces exit and raises concentration, prices among surviving firms may stabilize or increase. In terms of quantities, the entrant expands its sales while less productive incumbents contract or exit, reallocating production toward more efficient firms.

In input markets, outcomes depend on supply elasticity. With elastic supply, expansion generates limited cost pressure. With inelastic supply, increased demand raises wages and input costs, disproportionately affecting less productive firms and accelerating exit. These dynamics determine market structure: concentration falls when productivity differences are modest and incumbents survive, but rises when entry induces contraction or exit. Rents are dissipated under strong competition, but are re-created and reallocated toward larger surviving firms when concentration increases and residual demand becomes less elastic.

***Vertical/efficiency-seeking, export-oriented, and GVC-related FDI.*** In product markets, prices are largely determined by global demand, so domestic price effects are limited. The main adjustment occurs through quantities and linked sectors: affiliate sales expand, and capable suppliers grow, while less productive firms lose share or exit.

Input-market conditions are central. With elastic supply, expansion generates broader spillovers across sectors. With inelastic supply, increased demand for skilled labor, logistics, land, and specialized intermediates raises costs and induces crowd-out. Reallocation occurs

primarily in upstream, downstream, and non-tradable sectors linked to the affiliate. Concentration rises in these sectors when bottlenecks bind, and rents emerge in input-constrained segments. These rents remain diffuse when supplier entry keeps pace, but become concentrated when input constraints limit adjustment.

***Resource-seeking/extractive FDI.*** In product markets, output prices are largely exogenous and determined in world markets, so domestic price adjustments are minimal. Rents arise directly from the wedge between the world price and marginal cost. In terms of quantities, extraction expands with the foreign firm's productivity advantage, subject to geological and infrastructural constraints.

Input-market effects again depend on supply elasticity. With elastic supply, expansion entails limited displacement. With inelastic supply, increased demand for labor, land, energy, and transport raises input prices and crowds out higher-cost firms in related sectors. Reallocation and market structure reflect these constraints: extraction is typically highly concentrated due to scale and access rights, and linked sectors may also become more concentrated when bottlenecks bind. Even under price-taking conditions, rents are amplified through input-market pressures and reallocation toward more productive firms in connected sectors.

## Illustrating the Mechanisms

The types of FDI differ in which margin carries most of the adjustment. In market-seeking FDI, the central margin is product-market competition. In export-oriented and GVC-related FDI, the main effects often run through quantities, supplier networks, and factor and input markets. In resource-seeking FDI, output prices are frequently determined in world markets, so rents arise directly from the wedge between world prices and local marginal costs, and indirectly through pressure on scarce inputs. These differences map onto the model. Entry by more productive firms changes revenue shares  $\omega_{ij}$ ; revenue shares determine concentration,  $HHI_j$ ; and concentration affects sectoral markups  $\mu_j$ . At the same time, foreign affiliates that produce locally affect marginal costs through their demand for

labor, land, logistics, energy, infrastructure, and intermediate inputs.

Market-seeking FDI illustrates both the competitive and rent-creating sides of the mechanism. Separate from the corruption episode discussed in Chapter 5, Walmart's expansion in Mexico altered the retail environment faced by Mexican consumer-goods producers. Studies of the Mexican wholesale and retail sectors show that Walmex forced suppliers to reduce margins, improve product appeal, and innovate; firms unable to adjust lost market share or exited ([Iacovone, Javorcik, Keller and Tybout, 2015](#); [Javorcik, Keller and Tybout, 2008](#)). This is the pro-competitive version of the mechanism: foreign entry increases pressure on incumbents, compresses their markups, and reallocates sales toward firms able to meet the entrant's price, quality, and logistics requirements. Yet the same process also generates selection. If only a subset of firms can satisfy the multinational's scale and quality demands, sales become concentrated among those suppliers. When markups are variable, the dominant firm's markup can rise with its revenue share, and the size of the rent-creation effect scales with the productivity advantage of the MNC relative to incumbent firms.

Bralima, the Congolese brewer historically associated with Heineken, illustrates a different market-seeking case. As discussed in Chapter 6, Bralima held a dominant position in the DRC beverage sector, and its distribution network became a target for armed groups seeking to extract rents from commercial activity ([Miklian and Schouten, 2013](#), 73; see also [Schouten, 2013](#)). Brewing and soft-drink production depend not only on consumer demand but also on brands, bottling capacity, distribution networks, security arrangements, and regulatory permissions. Rents in such sectors need not arise only from high final-good prices. They may also reflect control over local production facilities, logistics, marketing assets, and access to retail channels. Where these assets are concentrated, the foreign affiliate can become a central node in the domestic market even when production is formally local.

Export-platform FDI shows how the mechanism operates even when the affiliate does not mainly serve the host-country consumer market. Intel's investment in Costa Rica is a useful example. Intel entered a sector in which Costa Rica had limited prior domestic

production, bringing proprietary technology, managerial capabilities, and access to global electronics markets ([Spar, 1998](#)). The investment transformed Costa Rica's export structure and created new demand for skilled labor, infrastructure, services, and specialized suppliers. In this case, the concentration effect does not necessarily come from displacing many domestic semiconductor producers, since few existed before entry. Rather, the foreign affiliate creates a new high-productivity activity whose sales are concentrated from the outset. Rents are tied to the productivity advantage, proprietary assets, and location-specific investments that make production viable within the host economy. Whether those rents diffuse through learning and supplier upgrading depends on local absorptive capacity and policy support ([Paus and Gallagher, 2008](#)).

Samsung's expansion in Vietnam provides a related GVC example. Samsung became a major export-platform investor in Vietnamese electronics, employing large numbers of workers and accounting for a substantial share of Vietnam's merchandise exports ([Sheldon and Kwon, 2023](#)). Its operations generated demand for labor, industrial parks, logistics, and suppliers, while also attracting foreign suppliers linked to Samsung's global production network. The mechanism is not primarily that Samsung raises domestic consumer prices. Rather, its expansion reallocates labor, infrastructure, and supplier opportunities toward firms capable of meeting the technical and scale requirements of the multinational. Domestic firms that cannot enter these supply chains may face higher costs or lose relative position, while capable suppliers grow rapidly. The result can be higher concentration in export activities and linked input sectors, even when final output is sold abroad.

Resource-seeking FDI is the clearest case in which prices are largely external to the host economy. Foreign investment in Chilean copper, including the historically important role of multinational firms such as Anaconda and Kennecott, illustrates this logic ([Moran, 1975](#)). As discussed in Chapter 7, foreign control over major Chilean industries became politically salient because these sectors generated large, location-bound rents. Copper is sold into world markets, so the relevant rent at the extraction stage comes from the wedge between the world

price and the marginal cost of extraction. But the affiliate's operations also require skilled labor, transport, energy, engineering services, equipment, and infrastructure access. As the foreign firm expands, it may bid up the prices of these inputs and alter the organization of linked sectors. Lower-productivity firms that use similar inputs may contract or exit, while suppliers able to meet the multinational's requirements may expand and become dominant in their own markets.

The resulting surplus takes several forms. At the extraction stage, rents arise from resource ownership, world prices, and low marginal extraction costs. In linked sectors, rents arise when input-market pressures and supplier selection concentrate activity among a smaller number of firms. These rents are tied to local assets: mineral rights, production facilities, infrastructure, permits, and relationships with public authorities. Transfer pricing may affect where accounting profits are recorded, but it does not eliminate the underlying rents associated with location-bound assets and host-country production ([Kobrin, 1987](#); [OECD, 2022](#)).

Table [3.1](#) summarizes how foreign entry affects prices, quantities, input costs, market structure, and rents across different types of FDI. The effects in each case can be understood through three dimensions emphasized above: the elasticity of demand and the resulting markup determination, the elasticity of input supply and resulting cost pressures, and the extent to which output prices adjust. Across all modes, the common mechanism is the reallocation of production toward more productive firms; what differs is how this reallocation translates into prices, costs, concentration, and rents.

### **3.5 Entry Modes, Trade, Multiple Entrants, and Dynamic Effects**

The preceding sections treat foreign entry as a shock to the distribution of productivity, marginal costs, and market shares. The same logic extends beyond the baseline case, but different forms of integration affect the set of active firms in distinct ways. Greenfield

Table 3.1: Markup Regimes, Productivity, and Rent Creation and Dissipation across FDI Types

| FDI Type                           | Markup Regime                                                                                                                                                             | High- $z$ Channel                                                                                                                                         | Rent Dissipation                                                                                                                                         | Rents and Concentration                                                                                                                                                                             |
|------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Horizontal FDI (domestic market)   | Variable markups when residual demand depends on firm sales shares; fixed markups under monopolistic competition                                                          | If markups are variable, high- $z$ entrants have lower costs, larger $\omega_{ij}$ , less elastic residual demand, and higher $\mu_{ij}$                  | Competition dissipates rents when entry expands the active set, keeps sales shares dispersed, lowers $HHI_j$ , and forces pass-through into lower prices | Rents rise when productivity gaps induce exit or dominance, increasing $HHI_j$ and sectoral markups                                                                                                 |
| Vertical/GVC FDI (export platform) | Product prices often set in world markets; local markups matter mainly in supplier, logistics, and non-tradable input sectors, while labor-market tightness affects costs | High- $z$ affiliates expand sales and input demand; markups scale with productivity, especially where linked sectors have variable markups or bottlenecks | Rents dissipate when labor mobility, infrastructure expansion, spillovers and learning broaden the set of firms able to serve the affiliate              | Rents concentrate when scarce inputs or supplier requirements shift activity toward a small number of high- $z$ firms, raising linked-sector $HHI_j$                                                |
| Resource-seeking FDI (extractive)  | Output price often exogenous; extraction rents arise mainly from $P^* - c_{ij}$ rather than endogenous product-market markups                                             | High- $z$ lowers extraction cost and raises the price-cost wedge; linked-sector markups may rise, especially when input markets are constrained           | Competition dissipates rents when productivity differentials are low, entry into linked activities is feasible, and input markets are not constrained    | Rents higher for high- $z$ firms when scale economies, access rights, political and legal risk, infrastructure control, or geology limit entry; concentrate in linked sectors when bottlenecks bind |

*Note:* FDI-induced rents can arise through three broad channels. Under variable markups, high-productivity firms charge higher markups because lower costs raise their revenue shares and reduce residual demand elasticity. Under fixed markups, productivity affects sales, operating profits, economic profits, and survival rather than markups directly. Under world-market pricing or location-bound assets, rents and quasi-rents arise primarily from price-cost wedges, scarce inputs, access rights, and sunk investments, with markup variation concentrated mainly in linked non-tradable sectors.

investment introduces a new producer prior to selection; mergers and acquisitions (M&As) consolidate ownership and may immediately reduce the number of active firms; trade liberalization alters the intensity of foreign competitive pressure; and dynamic spillovers determine whether productivity gaps persist or narrow over time. These cases do not overturn the baseline mechanism; rather, they clarify the channels through which foreign entry affects costs, quantities, firm survival, and market concentration.

## Greenfield Investment and M&As

Greenfield entry adds production capacity of a more productive firm which, in order to operate in the host country, needs to pay a fixed cost. If the foreign investor's marginal cost is sufficiently low, equilibrium sales reallocate toward the entrant and some higher-cost

domestic firms may exit. M&As, by contrast, remove an incumbent from the active set while potentially lowering the effective marginal cost of the combined entity. Concentration may increase through consolidation, higher productivity, and effects in factor and input markets.

In both cases, the key comparative statics derive from changes in the distribution of marginal costs and the size of the active set of firms. When productivity advantages are large and fixed costs limit entry, reallocation toward more productive and hence lower-cost producers can increase concentration and equilibrium markups (Nocke and Yeaple, 2007). The relevant condition is not domestic consumer-market competition per se, but whether entry alters the allocation of production and costs within host-country jurisdiction.

When input supply is inelastic, expansion by more productive firms raises input demand, increasing costs for remaining firms and reinforcing selection effects. When prices are relatively inelastic, the distinction between the two modes becomes primarily one of how quickly concentration rises: greenfield entry induces gradual reallocation, whereas mergers and acquisitions generate discrete shifts in market structure.

In sum, these different modes of entry vary in how they affect the active set of firms, but not in the underlying logic established by the model and extensions: both greenfield investment and M&As can shift the distribution of costs, reallocate sales, and alter market shares. In both cases, rents emerge from the interaction of productivity differences, cost pressures, and the resulting concentration of production.

## Trade Liberalization

Trade liberalization should not be treated as a single shock. Its effects differ depending on whether integration operates through imports or exports. Lower barriers to imports usually dissipate rents created by protection. Tariffs, quotas, licensing regimes, and related restrictions shield incumbents from foreign competition and allow them to sustain markups and profits that would not survive in more contestable markets (Krueger, 1974; Pavcnik, 2002; Trefler, 2004). Reducing those barriers exposes domestic firms to foreign rivals and compresses protected markups and rents.

The export side works differently. In heterogeneous-firm models, lower trade costs allow the most productive firms to serve foreign markets while less productive firms contract or exit (Melitz, 2003). Under constant markups, exporters' operating profits and economic profits rise because sales expand and fixed export costs are spread over larger volumes. Under variable markups, changes in revenue shares and the active set may also support higher markups for the most productive firms. Trade liberalization therefore does not mechanically eliminate rents: it often dissipates protection rents in domestic markets while raising profits, and in some settings rents, for selected high-productivity exporters.

This distinction clarifies how our mechanism differs from a purely trade-driven account. Arm's-length trade reallocates demand across firms and locations through import competition and export access. FDI goes further by relocating production inside the host economy. Foreign affiliates affect not only sales but also local input demand, supplier access, infrastructure use, and the value of sunk and location-bound assets. For that reason, FDI can magnify and localize excess returns even in settings where imports discipline incumbents or export growth alone would generate narrower gains. Empirically, aggregate measures of trade openness combine an import-disciplining channel and an export-expansion channel that may work in opposite directions, whereas inward FDI more directly captures the presence of foreign-controlled production inside the host economy.

## Multiple Entrants

The presence of multiple multinational entrants similarly does not guarantee competitive outcomes. When productivity dispersion is large, fixed costs remain high, or input bottlenecks limit adjustment, additional entrants compress rents at the margin but need not eliminate them. Equilibrium rents then depend on the joint distribution of productivity, marginal costs, fixed costs, strategic interaction with suppliers and buyers, and the extent to which foreign production reshapes input markets and the active set of firms. Ex-ante competition among governments to attract mobile capital does not preclude rent creation ex-post. Subsidies or tax concessions may affect expected returns prior to entry, which is

often magnified by rent-seeking behavior, but once fixed costs are sunk and assets are embedded within the jurisdiction, operating profits, economic profits, rents, and quasi-rents are determined by the cost structure and market allocation characterized above.

## Dynamic Effects

The comparative statics derived above describe the short- to medium-run effects of foreign entry on concentration and markups. Over time, however, foreign investment may generate productivity spillovers to domestic firms ([Javorcik, 2004](#); [Mercer-Blackman, Xiang and Khan, 2021](#)). The magnitude of such spillovers depends on absorptive capacity, human capital, and institutional development ([Blomström, Globerman and Kokko, 2001](#); [Havranek and Irsova, 2011](#); [Marcin, 2008](#); [Meyer and Sinani, 2009](#)).

If domestic firms upgrade and productivity dispersion narrows, competitive pressures may intensify and concentration may decline. If productivity gaps persist, fixed costs and strategic interaction can sustain concentrated rents. The dynamic path therefore depends on how entry affects the distribution of costs across firms and whether domestic producers can converge toward the technological frontier.

## 3.6 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 ([Jensen, 2006](#); [Kobrin, 1979](#); [Pinto and Pinto, 2008, 2011](#); [Pinto and Weymouth, 2016](#); [Pinto, 2004](#)). 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 (Helpman, 2006; 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; Jensen, 2003; Kobrin, 1984; Li and Resnick, 2003; Wright and Zhu, 2018). Investors also face contractual risks arising from their relationships with workers, buyers, clients, suppliers, and partners (Antràs and Helpman, 2004; Bernard, Jensen, Redding and Schott, 2010; Henisz, 2002).

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.<sup>6</sup> Political risk therefore has two effects. It may deter some foreign firms from entering, but conditional on entry it selects especially productive firms. This strengthens the expected productivity gap between foreign entrants and domestic incumbents, which is precisely the gap that drives reallocation, concentration, and rent creation in the model.

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

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<sup>6</sup>In the notation of the model, political risk can be represented as an additional fixed cost or risk premium attached to FDI. A foreign firm enters when  $E[\pi^{F,D}(z^F)] - Wf_D - \kappa(\rho) \geq \bar{V}$ , where  $f_D$  is the fixed cost of operating domestically through FDI,  $\rho$  denotes political or policy risk,  $\kappa(\rho)$  is the associated risk cost, and  $\bar{V}$  is the firm's outside option. This condition defines a productivity threshold  $z^{F*}$  for foreign entry. If political risk raises the cost of entry, then  $\frac{\partial z^{F*}}{\partial \rho} > 0$ .

over time as their investments become increasingly embedded in the host economy, creating incentives for governments to extract greater value post-entry ([Vernon, 1971](#)).<sup>7</sup>

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 ([Wright and Zhu, 2018](#)). 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, with outcomes contingent on prevailing economic and political conditions. All else equal, firms with higher productivity, greater patience, higher risk tolerance (or risk neutrality), and superior risk-mitigation capabilities—for example, experience in uncertain environments or access to local knowledge—are more likely to enter politically risky environments. Although firms generally seek to minimize exposure to political and policy risks, such risks can also function as entry barriers that deter less capable competitors. In these settings, the potential for rent creation and extraction may outweigh the associated costs, thereby justifying entry for some investors, though not all ([Wright and Zhu, 2018](#)).

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.

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<sup>7</sup>In addition to political instability and uncertainty, the political orientation of the incumbent government can also affect investment decisions. See [Jensen et al. \(2012\)](#); [Pandya \(2014\)](#); [Pinto and Weymouth \(2016\)](#); [Pinto \(2004\)](#).

### 3.7 Rent Extraction and Political Ramifications

The second component of our theoretical framework examines the political ramifications of economic rents arising from FDI inflows and MNC activity in the Global South. The model developed in this chapter identifies clear mechanisms linking FDI to economic rents in host economies and highlights that the rent-creation effect of FDI depends on the productivity gap between foreign entrants and incumbent domestic firms. In the Global South, domestic firms are typically smaller, less productive, and more resource-constrained than their foreign counterparts. In these settings, the productivity gaps between foreign entrants and domestic firms are substantial. Consequently, foreign entry is likely to reallocate production, induce less productive firms to contract or exit, increase market concentration, and raise markups and rents.

The second component of our theoretical framework examines the political consequences of economic rents arising from FDI inflows and MNC activity in the Global South. The model developed in this chapter identifies clear mechanisms linking foreign entry to rent creation in host economies and highlights that these effects depend critically on the productivity gap between foreign entrants and incumbent domestic firms. In the Global South, domestic firms are typically smaller, less productive, and more resource-constrained than their foreign counterparts. Under these conditions, foreign entry is more likely to reallocate production and sales, induce less productive domestic firms to contract or exit, and increase market concentration and rent extraction.

These rents, in turn, reshape the incentives of political actors. When economic activity generates substantial excess returns tied to assets, infrastructure, and production located within the host economy, those returns become objects of political contestation. Governments may seek to capture them through taxation, regulation, licensing, or discretionary policy intervention. Political elites, bureaucrats, and private actors may attempt to appropriate them through corruption, favoritism, or preferential access. In environments where

state authority is weak or contested, armed groups and rival political factions may also compete for control over the economic activities that generate these rents.

The central political implication of the model is therefore straightforward: when foreign entry generates concentrated rents within host economies, it increases incentives for political actors to compete for access to and control over those rents. The form this competition takes depends on institutional constraints. Where institutions are strong, rent extraction is more likely to occur through formal and legal channels such as taxation, regulation, and lobbying. Where institutions are weak, contestation over rents may instead take the form of corruption, political instability, or violent conflict. The next section develops this political logic further and derives a set of testable implications.

## MNCs, Rents and Politics: Empirical Implications

We embed the rent-creation effect of FDI and MNC activity into a political economy framework of rent seeking and contestation and examine three outcomes: corruption, civil conflict, and leadership turnover. Each corresponds to a distinct channel through which actors seek to appropriate, control, or compete over economic rents.

### Corruption

Higher rents increase incentives for corruption ([Ades and Di Tella, 1999](#); [Rose-Ackerman, 1999](#)). When firms earn large rents, the value of public officials' regulatory discretion rises. Officials who control licenses, permits, procurement contracts, taxation, or enforcement possess greater leverage over rent-generating firms, thereby increasing the potential gains from exchanging these rights for illicit payments ([Ades and Di Tella, 1999](#)). Moreover, public officials may respond proactively to market conditions by strategically adjusting the quantity and quality of government goods and services in ways that maximize bribe revenues ([Bardhan, 1997](#); [Kaufmann and Wei, 1999](#)). Corruption constitutes an additional cost of doing business, which may deter foreign entry. However, firms earning high rents have a greater capacity to absorb informal payments as a cost of maintaining favorable treatment. The combination of stronger bribe extraction incentives and an enhanced ability to pay therefore

increases the risk of corruption.

Political development and strong legal institutions play a key role in mitigating these incentives for illicit exchange between firms and public officials in the presence of economic rents. Political competition and effective legal institutions increase the probability of corruption exposure and detection, as well as the likelihood of punishment (Brunetti and Weder, 2003; Lederman, Loayza and Soares, 2005; Treisman, 2007), thereby reshaping the risk-return calculus faced by public officials when attempting to appropriate rents for personal benefit. We therefore expect strong political and legal institutions to dampen the effect of FDI on corruption in developing countries.

### **Civil Conflict**

FDI-induced rents can increase the risk of intrastate armed conflict in the Global South. First, greater rent creation enlarges the size of the spoils and increases the expected returns to appropriating those rents, thereby strengthening incentives for rebel groups to challenge the government (Collier and Hoeffler, 2004; Fearon and Laitin, 2003; Grossman, 1991; Olsson and Fors, 2004). Second, control over rents enhances rebels' fighting capacity relative to the state: groups that capture rents through extortion, coercion, or taxation are better able to sustain insurgency and are more likely to prevail in military confrontation. Although both governments and rebels have incentives to avoid costly conflict and may attempt to bargain over the distribution of rents (Dal Bó and Powell, 2009), higher rents exacerbate commitment problems by altering the future balance of power (Bell and Wolford, 2015; Powell, 2006; Walter, 2002). Anticipating that control over rents today may enable future renegeing, both sides may be unwilling to agree to or uphold negotiated settlements. As a result, in the presence of large economic rents, agreements are more difficult to sustain and more likely to break down, increasing the likelihood of conflict. We therefore expect FDI inflows into developing countries to increase the probability of intrastate armed conflict.

In the presence of economic rents, states with strong capacity are able to capture and regulate these rents through taxation, royalties, and fees, and to convert them into de-

terrence capabilities or public goods that address grievances (Snyder and Bhavnani, 2005; Sobek, 2010; Taydas and Peksen, 2012). This reduces rebel groups' incentives to challenge the government and raises the opportunity cost of rebellion, making conflict less attractive to potential insurgents. Furthermore, strong institutions help mitigate credible commitment problems in rent-sharing arrangements and facilitate the peaceful resolution of conflict (DeRouen, Ferguson, Norton, Park, Lea and Streat-Bartlett, 2010; Gates et al., 2016; Skaperdas, 2008). As a result, the effect of FDI on civil conflict is attenuated and may even disappear in states with strong capacity and robust institutions.

### **Leadership Turnover**

Rents generated by foreign investment can be captured by the state through royalties, taxes, and dividends, increasing both the size of the spoils and the value of political power. Higher rents incentivize incumbent leaders to prolong their tenure to retain access to these resources (Bueno de Mesquita et al., 2005), while simultaneously motivating opposition groups and rival elites to compete for control over them (Andersen and Aslaksen, 2013; Besley and Persson, 2011; Caselli and Cunningham, 2009). Although incumbents may attempt to deter or co-opt challengers through distributing rents, such arrangements are undermined by credible commitment problems, as neither incumbents nor challengers can credibly commit to honoring agreements over time (Meng, Paine and Powell, 2023; Powell, 2024). Consequently, bargaining over the distribution of rents is prone to breakdown, leading to intensified political contestation and a higher likelihood of leadership turnover, whether through institutional or extra-institutional means. We therefore hypothesize that FDI inflows are positively associated with leadership turnover in developing countries.

State capacity, particularly extractive capacity and the provision of public goods, plays a central role in moderating the effect of FDI on leadership turnover. Extractive capacity determines the extent to which governments can capture rents generated by foreign investment (Arbetman-Rabinowitz and Kugler, 1997; Kugler and Tammen, 2012). In its absence, a substantial share of these rents may remain with MNCs or domestic actors, limiting incum-

bents' control over resources. When leaders are able to capture these rents, they can deploy them strategically to maintain power through vote buying, surveillance, repression, and military expansion (Caselli and Tesei, 2016). Rents can also be channeled into the provision of public goods, fostering a more productive and diversified economy that provides potential challengers with alternative income opportunities (Gallego and Pitchik, 2004), while also improving public welfare and bolstering political support (Brender and Drazen, 2008; Bueno de Mesquita et al., 2005; Nunn, Qian and Wen, 2018). Both channels reduce the likelihood of successful challenges to incumbent leaders. Accordingly, we expect higher levels of state capacity to attenuate the positive effect of FDI inflows on leadership turnover.

In summary, our theoretical framework consists of two components: (1) the rent-creation effect of FDI, which depends on the productivity gap between foreign entrants and domestic incumbent firms; and (2) the political ramifications of FDI-induced rents. In the Global South, where productivity gaps between multinationals and domestic firms are substantial, FDI inflows and MNC activity tend to induce sales and production reallocation and generate higher markups and rents. These economic rents arise across different types of FDI and modes of entry. High rents, in turn, create strong incentives for stakeholders, including political leaders, public officials, economic elites, firms, and opposition groups, to compete for access to and control over these rents, thereby increasing the likelihood of adverse political outcomes. At the same time, the framework highlights the critical mitigating role of state capacity and institutions. Strong state capacity and robust institutions enable governments to effectively capture and regulate rents, discipline rent-seeking behavior, convert rents into coercive capacity or public goods, and facilitate credible rent-sharing arrangements and the peaceful resolution of conflict. Under these conditions, FDI inflows and MNC activity are more likely to enhance consumer welfare, promote efficiency gains, and support economic growth, while minimizing the risk of adverse political consequences.

In the next chapter, we subject the first component of the theoretical framework to empirical testing. In the subsequent three chapters, we further elaborate the second compo-

ment by examining the relationship between FDI and three political outcomes: corruption (Chapter 5), civil conflict (Chapter 6), and leadership turnover (Chapter 7), derive testable hypotheses, and present both quantitative and qualitative evidence.

## Appendix 3.1: Model

Pinto and Rueda (2026) extend Edmond, Midrigan and Xu (2015) to allow for FDI. In that model, reproduced in this appendix, perfectly competitive producers assemble a homogeneous final consumption good using inputs from a continuum of sectors

$$Y = \left( \int_0^1 y_j^{\frac{\theta-1}{\theta}} dj \right)^{\frac{\theta}{\theta-1}} \quad (3.1)$$

In each sector  $j$ , output is produced using  $n_j^H$  domestic inputs,  $n_j^{F,M}$  imported inputs, and  $n_j^{F,D}$  inputs from foreign firms producing domestically (FDI).

$$y_j = \left[ \sum_{i=1}^{n_j^H} y_{ij}^H \frac{\gamma-1}{\gamma} + \sum_{i=1}^{n_j^{F,M}} y_{ij}^{F,M} \frac{\gamma-1}{\gamma} + \sum_{i=1}^{n_j^{F,D}} y_{ij}^{F,D} \frac{\gamma-1}{\gamma} \right]^{\frac{\gamma}{\gamma-1}} \quad (3.2)$$

where  $\theta$  denotes the elasticity of substitution *across* sectors and  $\gamma$  the elasticity of substitution *within* sector. It is assumed that  $\gamma > \theta$ , implying that it is harder to substitute goods across than within sectors.

**Technology.** Intermediate good producer  $i$  in sector  $j$  uses a technology that is linear in labor ( $l$ ):

$$y_{ij} = z_{ij} l_{ij} \quad (3.3)$$

where  $z_{ij}$  is the productivity of firm  $i$ .

**Demand for intermediate goods:** Final good producers choose intermediate inputs  $y_{ij}^H$ ,  $y_{ij}^{F,M}$ , and  $y_{ij}^{F,D}$  to maximize profits

$$PY - \int_0^1 \left( \sum_{i=1}^{n_j^H} p_{ij}^H y_{ij}^H + \tau \sum_{i=1}^{n_j^{F,M}} p_{ij}^{F,M} y_{ij}^{F,M} + \sum_{i=1}^{n_j^{F,D}} p_{ij}^{F,D} y_{ij}^{F,D} \right) dj \quad (3.4)$$

subject to (3.1) and (3.2). The solution to this problem gives the following demand functions

$$y_{ij}^H = \left( \frac{p_{ij}^H}{p_j} \right)^{-\gamma} \left( \frac{p_j}{P} \right)^{-\theta} Y \quad (3.5)$$

$$y_{ij}^{F,M} = \left( \frac{\tau p_{ij}^{F,M}}{p_j} \right)^{-\gamma} \left( \frac{p_j}{P} \right)^{-\theta} Y \quad (3.6)$$

$$y_{ij}^{F,D} = \left( \frac{p_{ij}^{F,D}}{p_j} \right)^{-\gamma} \left( \frac{p_j}{P} \right)^{-\theta} Y \quad (3.7)$$

where the aggregate and sectoral price indexes are

$$P = \left( \int_0^1 p_j^{1-\theta} dj \right)^{\frac{1}{1-\theta}} \quad (3.8)$$

and

$$p_j = \left( \sum_{i=1}^{n_j^H} \phi_{ij}^H p_{ij}^{H1-\gamma} + \tau^{1-\gamma} \sum_{i=1}^{n_j^{F,M}} \phi_{ij}^{F,M} p_{ij}^{F,M1-\gamma} + \sum_{i=1}^{n_j^{F,D}} \phi_{ij}^{F,D} p_{ij}^{F,D1-\gamma} \right)^{\frac{1}{1-\gamma}} \quad (3.9)$$

where  $\phi_{ij}^H$ ,  $\phi_{ij}^{F,M}$ , and  $\phi_{ij}^{F,D}$  are equal to 1 if the firm operates in the home market, zero otherwise.

**Competition:** Individual firms produce a differentiated variety and engage in Cournot competition. The maximization problem of a home firm in its domestic market is

$$\pi_{ij}^H := \max_{y_{ij}^H, \phi_{ij}^H} \left[ \left( p_{ij}^H - \frac{W}{z_{ij}} \right) y_{ij}^H - W f_d \right] \phi_{ij}^H \quad (3.10)$$

and in its export market

$$\pi_{ij}^{*H} := \max_{y_{ij}^{*H}, \phi_{ij}^{*H}} \left[ \left( p_{ij}^{*H} - \frac{\tau W}{z_{ij}} \right) y_{ij}^{*H} - W f_x \right] \phi_{ij}^{*H} \quad (3.11)$$

For an importing foreign firm (produces abroad, sells at home):

$$\pi_{ij}^{F,M} := \max_{y_{ij}^{F,M}, \phi_{ij}^{F,M}} \left[ \left( p_{ij}^{F,M} - \frac{\tau W^*}{z_{ij}^F} \right) y_{ij}^{F,M} - W^* f_M \right] \phi_{ij}^{F,M} \quad (3.12)$$

For a foreign firm producing domestically (FDI):

$$\pi_{ij}^{F,D} := \max_{y_{ij}^{F,D}, \phi_{ij}^{F,D}} \left[ \left( p_{ij}^{F,D} - \frac{W}{z_{ij}^F} \right) y_{ij}^{F,D} - W f_D \right] \phi_{ij}^{F,D} \quad (3.13)$$

The pricing equations follow the usual Lerner index. For domestic home firms:

$$p_{ij}^H = \frac{\sigma_{ij}^H}{\sigma_{ij}^H - 1} \frac{W}{z_{ij}} \quad (3.14)$$

for importing foreign firms:

$$p_{ij}^{F,M} = \frac{\sigma_{ij}^{F,M}}{\sigma_{ij}^{F,M} - 1} \frac{\tau W^*}{z_{ij}^F} \quad (3.15)$$

and for FDI foreign firms:

$$p_{ij}^{F,D} = \frac{\sigma_{ij}^{F,D}}{\sigma_{ij}^{F,D} - 1} \frac{W}{z_{ij}^F} \quad (3.16)$$

The elasticity of demand faced by each firm is given by

$$\sigma_{ij}^H = \left( \omega_{ij}^H \frac{1}{\theta} + (1 - \omega_{ij}^H) \frac{1}{\gamma} \right)^{-1} \quad (3.17)$$

where  $\omega_{ij}^H \in [0, 1]$  is the home firm's share of sectoral revenue:

$$\omega_{ij}^H = \left( \frac{p_{ij}^H}{p_j} \right)^{1-\gamma} \quad (3.18)$$

and analogously for importing and FDI foreign firms:

$$\omega_{ij}^{F,M} = \left( \frac{\tau p_{ij}^{F,M}}{p_j} \right)^{1-\gamma}, \quad \omega_{ij}^{F,D} = \left( \frac{p_{ij}^{F,D}}{p_j} \right)^{1-\gamma} \quad (3.19)$$

Analogous expressions define  $\sigma_{ij}^{F,M}$  and  $\sigma_{ij}^{F,D}$  using the corresponding revenue shares  $\omega_{ij}^{F,M}$  and  $\omega_{ij}^{F,D}$ . Note that shares sum to one:  $\sum_i \omega_{ij}^H + \sum_i \omega_{ij}^{F,M} + \sum_i \omega_{ij}^{F,D} = 1$ . Conditional on operating, operating profits gross of fixed costs can be written as a function of markups:

$$\tilde{\pi}_{ij}^H = (\mu_{ij}^H - 1) \frac{W}{z_{ij}} y_{ij}^H \quad (3.20)$$

These expressions clarify the sequence connecting the model to the broader argument of the book. A higher markup,  $\mu_{ij}$ , raises operating profits through the price–cost wedge and the scale of sales, as shown by  $\tilde{\pi}_{ij}$ . Net economic profits,  $\pi_{ij}$ , then depend on whether those operating profits are sufficient to cover fixed costs. In the text, we use rents to refer to the portion of these profits that exceeds the normal return required to keep the firm active, as well as to analogous excess returns tied to scarce resources, bottlenecks, regulatory access, or location-bound assets. The variable-markup model is the benchmark formalization of this mechanism, but the broader argument of the chapter also encompasses fixed-markup and world-price environments in which foreign entry changes profits and quasi-rents even when markups do not vary. The sectoral markup is the revenue-share-weighted harmonic mean of individual markups:

$$\frac{1}{\mu_j} = \sum_i \omega_{ij}^H \frac{1}{\mu_{ij}^H} + \sum_i \omega_{ij}^{F,M} \frac{1}{\mu_{ij}^{F,M}} + \sum_i \omega_{ij}^{F,D} \frac{1}{\mu_{ij}^{F,D}} \quad (3.21)$$

### Some useful relationships

From (3.17) it is possible to write the sectoral markup as a function of the concentration index:

$$\mu_j = \left[ 1 - \frac{1}{\gamma} + \left( \frac{1}{\gamma} - \frac{1}{\theta} \right) \text{hhi}_j \right]^{-1} \quad (3.22)$$

where

$$\text{hhi}_j = \sum_{i=1}^{n_j^H} (\omega_{ij}^H)^2 + \sum_{i=1}^{n_j^{F,M}} (\omega_{ij}^{F,M})^2 + \sum_{i=1}^{n_j^{F,D}} (\omega_{ij}^{F,D})^2,$$

which aggregates revenue shares across domestic firms, importing foreign firms, and foreign firms producing domestically. As usual in these kinds of models, the firm-level markup equals the inverse labor share:

$$ls_{ij}^H := \frac{W l_{ij}}{p_{ij}^H y_{ij}^H} = \frac{1}{\mu_{ij}^H} \quad (3.23)$$

## Partial equilibrium analysis

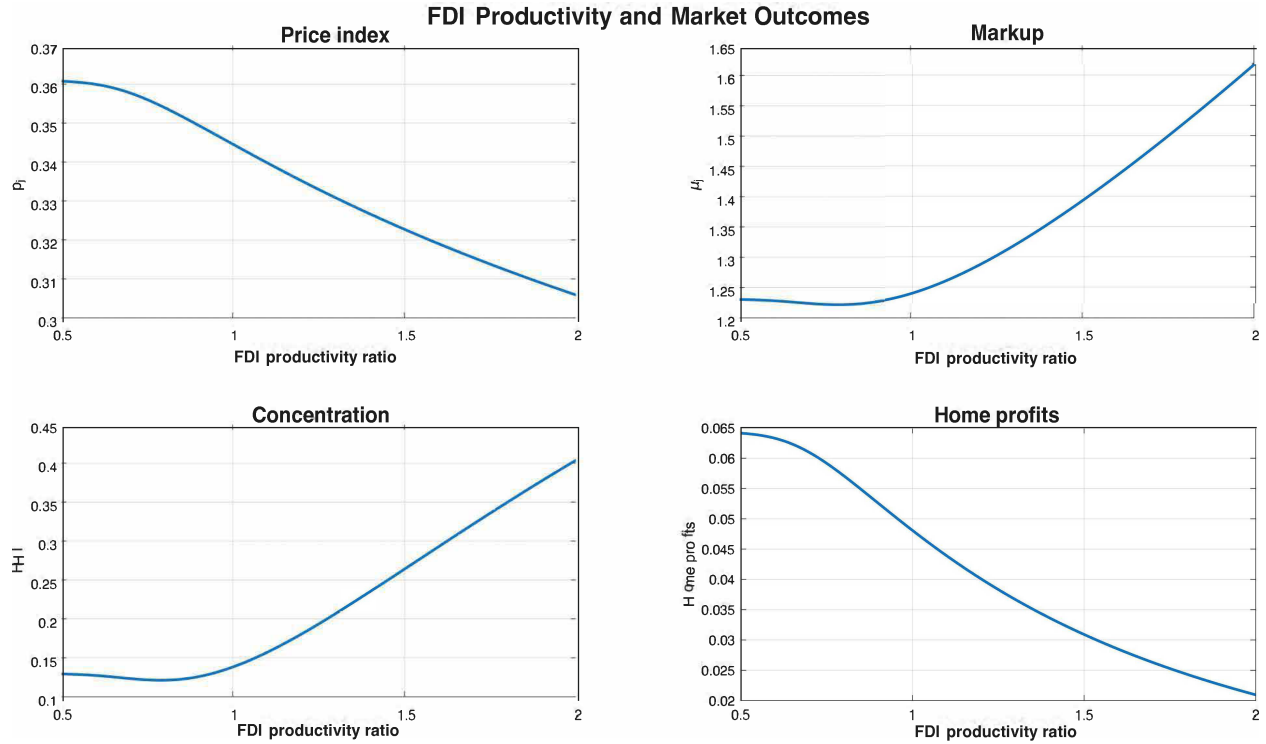


Figure 3.1: Partial Equilibrium Analysis

*Notes:* This figure shows the effects of foreign direct investment (FDI) entry on key sectoral outcomes, including the price index, average markup, market concentration (HHI), and total home profits. The x-axis represents partial equilibrium outcomes evaluated across a range of FDI productivity levels, normalized by the productivity of the most productive home firm prior to entry.

## Parametrization

Table 3.2: Parameter Values

| Symbol                       | Value | Description                |
|------------------------------|-------|----------------------------|
| <i>Production Technology</i> |       |                            |
| $\theta$                     | 1.24  | Across-sector elasticity   |
| $\gamma$                     | 10.24 | Within-sector elasticity   |
| $\tau$                       | 1.24  | Gross trade cost           |
| $\kappa$                     | 4.5   | Pareto shape               |
| $J$                          | 1000  | Number of sectors          |
| $N_j^H, N_j^{F,M}$           | 200   | Number of firms per sector |
| $N_j^{F,D}$                  | 1     | FDI firms                  |

# 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, we argue that market concentration is one observable step in a broader mechanism linking foreign entry to FDI-induced rents. When productivity gaps between foreign entrants and indigenous firms are large, the entry and presence of MNCs can induce contraction or exit among less productive domestic firms and reallocate sales toward a smaller number of producers. In variable-markup environments, this can raise markups and the profits and rents associated with them. In fixed-markup or world-price environments, concentration still matters because it captures the reallocation of sales, profits, supplier access, and other excess returns among fewer and more productive firms. In advanced economies, where domestic firms are better able to compete, foreign entry is more likely to intensify competition and dissipate those excess returns. 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 leverage firm-level financial data from the Bureau van Dijk's Orbis database ([Bureau van Dijk, N.D.](#)) and the World Bank's Enterprise Survey (WBES) to construct 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.

We further disaggregate FDI into horizontal versus vertical and manufacturing versus non-manufacturing. The results indicate that both horizontal and vertical FDI are associated with higher market concentration in less developed countries. As the level of development increases, however, the effect of horizontal FDI remains positive, whereas the effect of vertical FDI weakens and eventually turns negative. These findings suggest that horizontal FDI tends to reduce market competition in both developing and developed economies. This pattern is consistent with the expectation that horizontal FDI, which often involves M&As, can immediately reduce the number of market participants.<sup>1</sup> With respect to manufacturing versus non-manufacturing FDI, both are associated with greater market concentration in developing countries. This effect diminishes and becomes negative in more developed economies.

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

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<sup>1</sup>Market competition may intensify in the long run if incumbent firms are able to sustain competitive pressure.

## 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, particularly for non-listed firms, are often confidential and not readily accessible. This limitation poses a significant obstacle to cross-national empirical research of the relationship between FDI and market concentration.

In an earlier study, [Lall \(1979\)](#) 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.<sup>2</sup> These include [Lall \(1979\)](#) on Malaysia, [Blomström \(1986\)](#) on Mexico, [Bourlakis \(1987\)](#) on Greece, [Willmore \(1989\)](#) on Brazil, [Cho \(1990\)](#) on Indonesia, [Driffield \(2001a,b\)](#) 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 Sarmiento \(2014\)](#) 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

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<sup>2</sup>See [Forte \(2016\)](#) for details.

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. Using firm-level data from Belgian manufacturing industries, [De Backer and Sleuwaegen \(2003\)](#) report that foreign entry discourages domestic entry and increases domestic exit, while foreign presence has the opposite effect on domestic entry and exit. They suggest that the former likely reflects the short-term effects of FDI inflows, whereas the latter captures their longer-term effects. A more recent study by [Zhu \(2017\)](#) on China shows that FDI inflows and MNC presence has a strong positive effect on market concentration.

Other studies have examined the impact of FDI on firm- or industry-level 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.<sup>3</sup> [Sembenelli and Siotis \(2008\)](#) utilize data from Spanish firms from 1983 to 1996 and reveal that foreign presence has a short-term negative 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 tend to contribute to market concentration and high firm markups, particularly in

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<sup>3</sup>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.

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.<sup>4</sup> 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, which is a noticeable difference from other studies that rely on firm-level financial data.

Finally, there is a vast literature examining the spillover effects of FDI in host countries, and the empirical evidence remains mixed.<sup>5</sup> Taken together, many studies fail to find strong evidence that FDI inflows and the presence of foreign firms generate positive spillovers for the average domestic firm.

The evidence becomes more nuanced when spillovers are disaggregated into horizontal and vertical channels. Horizontal spillovers—those occurring within the same industry—are often found to be weak or negative, as domestic firms face intensified competition from more productive multinational firms ([Konings, 2001](#); [Lu, Tao and Zhu, 2017](#)). In contrast, vertical spillovers—those transmitted through upstream and downstream linkages between multinational affiliates and local suppliers or buyers—tend to be positive ([Javorcik, 2004](#); [Mercer-Blackman, Xiang and Khan, 2021](#)).

Importantly, the literature suggests that the magnitude and direction of spillover effects depend on host-country conditions. A positive spillover effect is more likely when the technology gap between multinationals and domestic firms is relatively small, when domestic

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<sup>4</sup>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.

<sup>5</sup>See [Blomström, Globerman and Kokko \(2001\)](#) and [Görg and Greenaway \(2004\)](#) for comprehensive reviews of the early literature, and [Ahn, Aiyar and Presbitero \(2025, 2487–88\)](#) for a more recent overview.

firms possess sufficient absorptive capacity to learn from and adapt the technologies and practices introduced by multinational firms, and when host countries are more developed and have stronger institutions ([Aghion, Blundell, Griffith, Howitt and Prantl, 2009](#); [Ahn et al., 2026](#); [Havranek and Irsova, 2011](#); [Marcin, 2008](#); [Meyer and Sinani, 2009](#)).

Note that spillovers and market structure are related but analytically distinct concepts. Negative productivity spillovers from multinationals to domestic firms can increase market concentration through a market-stealing effect ([Aitken and Harrison, 1999](#)), whereby more productive foreign firms capture market share and force less productive domestic firms to contract or exit. Positive productivity spillovers, however, do not necessarily imply a decline in market concentration. The two can coexist when the least productive domestic firms contract or exit and markets become consolidated among multinational firms and a smaller number of surviving domestic firms. In such cases, the productivity of surviving domestic firms may increase due to positive spillover effects, such as learning through imitation, adaptation, and innovation, or through scale economies and resource reallocation toward more efficient firms.

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

### 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 Bureau van Dijk’s Orbis database ([Bureau van Dijk, N.D.](#)), which is widely regarded as 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 that our sample includes both OECD and non-OECD countries. The latter typically have smaller firm populations. We report results from both samples. We also drop any country-year observations where the market concentration value lies more than three standard deviations from 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.

We construct two widely used measures of market concentration: the Herfindahl–Hirschman Index (HHI)<sup>6</sup> and the four-firm concentration ratio (CR4).<sup>7</sup> For each country-year, we first

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<sup>6</sup>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 total number of firms in the market.

<sup>7</sup>CR4 is calculated as  $CR4 = s_1 + s_2 + s_3 + s_4$ , where firms are ranked by market share and  $s_i$  is the

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       | 2019     | Luxembourg           | 8   | 2009       | 2019     |
| Algeria        | 7   | 2011       | 2017     | Macedonia            | 8   | 2012       | 2019     |
| Argentina      | 1   | 2018       | 2018     | Malaysia             | 15  | 2005       | 2019     |
| Australia      | 8   | 2012       | 2019     | Mexico               | 9   | 2011       | 2019     |
| Austria        | 2   | 2008       | 2010     | Moldova              | 7   | 2012       | 2019     |
| Belarus        | 9   | 2011       | 2019     | Montenegro           | 6   | 2014       | 2019     |
| Belgium        | 24  | 1993       | 2019     | Morocco              | 9   | 2011       | 2019     |
| Brazil         | 8   | 2012       | 2019     | Netherlands          | 26  | 1994       | 2019     |
| Bulgaria       | 23  | 1996       | 2019     | New Zealand          | 6   | 2012       | 2019     |
| Cameroon       | 1   | 2016       | 2016     | Norway               | 25  | 1995       | 2019     |
| Canada         | 13  | 2006       | 2019     | Philippines          | 12  | 2008       | 2019     |
| China          | 18  | 2002       | 2019     | Poland               | 21  | 1998       | 2019     |
| Colombia       | 13  | 2005       | 2019     | Portugal             | 22  | 1997       | 2019     |
| Croatia        | 22  | 1998       | 2019     | Romania              | 23  | 1997       | 2019     |
| Cyprus         | 8   | 2012       | 2019     | Russia               | 19  | 1999       | 2019     |
| Czech Republic | 21  | 1999       | 2019     | Saudi Arabia         | 6   | 2013       | 2019     |
| Denmark        | 10  | 2002       | 2019     | Serbia               | 13  | 2007       | 2019     |
| Egypt          | 7   | 2011       | 2019     | Singapore            | 16  | 2002       | 2019     |
| Estonia        | 7   | 2013       | 2019     | Slovakia             | 18  | 2002       | 2019     |
| Finland        | 23  | 1996       | 2018     | Slovenia             | 18  | 2002       | 2019     |
| France         | 25  | 1995       | 2019     | Spain                | 27  | 1991       | 2019     |
| Georgia        | 3   | 2013       | 2019     | Sweden               | 23  | 1997       | 2019     |
| Germany        | 19  | 1997       | 2019     | Switzerland          | 13  | 2006       | 2019     |
| Greece         | 23  | 1997       | 2019     | Thailand             | 18  | 2002       | 2019     |
| Hungary        | 20  | 1998       | 2019     | Turkey               | 14  | 2006       | 2019     |
| Ireland        | 8   | 2012       | 2019     | Ukraine              | 19  | 2001       | 2019     |
| Italy          | 27  | 1993       | 2019     | United Arab Emirates | 4   | 2016       | 2019     |
| Japan          | 23  | 1997       | 2019     | United Kingdom       | 33  | 1987       | 2019     |
| Kazakhstan     | 7   | 2013       | 2019     | United States        | 27  | 1993       | 2019     |
| Korea          | 19  | 2001       | 2019     | Uruguay              | 2   | 2017       | 2018     |
| Latvia         | 16  | 2003       | 2019     | Vietnam              | 11  | 2008       | 2019     |
| Lithuania      | 8   | 2007       | 2019     |                      |     |            |          |

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 low-threshold sample for which 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 market share of firm  $i$ .

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:

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

$\text{Concentration}_{i,t}$  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.  $\beta_1$ ,  $\beta_2$ , and  $\beta_3$  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  $\xi$  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 allow meaningful cross-country and time-series comparisons. 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.<sup>8</sup> 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.<sup>9</sup> 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 (see also Meyer and Sinani, 2009) and expect a negative coefficient for the interaction term between FDI and GDP per capita.<sup>10</sup> We control for state capacity using two proxies: relative political extraction (RPE)<sup>11</sup> 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).

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<sup>8</sup>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.

<sup>9</sup>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).

<sup>10</sup>Data come from the Penn World Table 10.01.

<sup>11</sup>Data from Arbetman-Rabinowitz, Fisunoglu, Kugler, Abdollahian, Johnson, Kang and Yang (2013). This variable is discussed in detail in Chapters 6 and 7.

In addition, we control for the size of the economy, measured by GDP (PPP-adjusted), and the economic growth rate.<sup>12</sup> 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, import exposure is expected to intensify product-market competition and erode rents sustained by protection, thereby reducing incumbents' markups and limiting concentration (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 such as 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).<sup>13</sup> To mitigate concerns of endogeneity, all right-hand-side variables in all model specifications are lagged by one year.<sup>14</sup>

In all model specifications, we include country fixed effects to account for unobserved, time-invariant country-specific heterogeneity. Standard errors are clustered at the country level to account for potential within-country correlation in the error terms.

## Results

Table 4.2 presents the results from two alternative measures of market concentration: HHI<sup>15</sup> and CR4. We first fit a baseline model without an interaction term (Model 1).<sup>16</sup>

<sup>12</sup>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.

<sup>13</sup>Import Exposure is measured by total imports as a percentage of 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 Bank's *World Development Indicators*.

<sup>14</sup>In subsequent chapters, we employ an instrumental variable (IV) approach to address endogeneity concerns. However, the instrument used in this study (discussed in detail in Chapter 5) performs poorly for the present sample, as the first-stage F-statistics fall below conventional thresholds for instrument strength. In such cases, IV estimates can be more biased than ordinary least squares (OLS) estimates (Bound, Jaeger and Baker, 1995; Staiger and Stock, 1997). While OLS estimates may still be subject to endogeneity concerns, our empirical specifications incorporate a rich set of controls and fixed effects to mitigate potential omitted-variable bias. Moreover, the results are robust across alternative model specifications, which increases confidence in the main findings.

<sup>15</sup>We multiply HHI by a factor of 100 to improve the readability of the estimated coefficients.

<sup>16</sup>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 (1K Threshold)

|                        | HHI                   |                       |                       |                       |                       | CR4                   |                       |
|------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                        | (1)                   | (2)                   | (3)                   | (4)                   | (5)                   | (6)                   | (7)                   |
| FDI PC                 | 0.08<br>(0.08)        | 0.73**<br>(0.32)      | 0.57*<br>(0.28)       | 0.59**<br>(0.28)      | 0.73**<br>(0.33)      | -0.00<br>(0.07)       | 0.68**<br>(0.33)      |
| FDI PC $\times$ GDP PC |                       | -0.30**<br>(0.13)     | -0.23**<br>(0.11)     | -0.24**<br>(0.11)     | -0.30**<br>(0.13)     |                       | -0.31**<br>(0.13)     |
| GDP PC                 | 68.47***<br>(13.64)   | 69.83***<br>(13.03)   | 55.80***<br>(15.39)   | 56.97***<br>(15.52)   | 70.10***<br>(13.46)   | 76.17***<br>(15.77)   | 77.59***<br>(15.10)   |
| RPE                    | -3.16<br>(7.72)       | -4.44<br>(7.77)       | 1.31<br>(7.42)        | 0.95<br>(7.42)        | -6.27<br>(7.75)       | -8.86<br>(9.62)       | -9.99<br>(9.69)       |
| Infant Mortality       | 28.56***<br>(5.26)    | 28.33***<br>(5.23)    | 25.78***<br>(5.40)    | 26.19***<br>(5.51)    | 28.30***<br>(5.18)    | 32.91***<br>(6.24)    | 32.82***<br>(6.23)    |
| Democracy              | -0.16<br>(0.18)       | -0.18<br>(0.18)       | -0.06<br>(0.17)       | 0.09<br>(0.26)        | -0.17<br>(0.25)       | -0.19<br>(0.37)       | -0.15<br>(0.36)       |
| GDP                    | -60.40***<br>(11.93)  | -59.82***<br>(11.83)  | -51.61***<br>(12.33)  | -52.53***<br>(12.25)  | -59.02***<br>(11.68)  | -68.93***<br>(13.22)  | -68.37***<br>(12.81)  |
| Growth Rate            | -0.46<br>(0.34)       | -0.54<br>(0.33)       | -0.68**<br>(0.32)     | -0.69**<br>(0.32)     | -0.63*<br>(0.34)      | -0.54<br>(0.43)       | -0.64<br>(0.40)       |
| Import Exposure        | -13.87***<br>(4.70)   | -14.26***<br>(4.63)   | -14.73***<br>(4.57)   | -14.76***<br>(4.56)   | -15.23***<br>(4.40)   | -13.09**<br>(5.94)    | -13.15**<br>(5.87)    |
| Resource Rents         | -1.18<br>(2.65)       | -1.05<br>(2.65)       | -1.74<br>(2.72)       | -1.99<br>(2.71)       | -2.24<br>(2.93)       | -0.51<br>(3.26)       | -0.45<br>(3.24)       |
| Value Added (Agr)      |                       |                       | -8.47<br>(7.59)       | -9.08<br>(7.67)       |                       |                       |                       |
| Value Added (Ind)      |                       |                       | 21.06**<br>(9.21)     | 20.24**<br>(9.10)     |                       |                       |                       |
| Value Added (Ser)      |                       |                       | 15.49<br>(14.98)      | 14.81<br>(14.78)      |                       |                       |                       |
| Rule of Law            |                       |                       |                       | -7.07<br>(8.15)       | -4.49<br>(7.89)       | 7.26<br>(8.36)        | 4.89<br>(8.21)        |
| Output (HFA)           |                       |                       |                       |                       | 13.87*<br>(7.67)      | 12.38<br>(8.66)       | 11.38<br>(8.52)       |
| Constant               | 737.53***<br>(142.26) | 728.19***<br>(141.77) | 533.54***<br>(173.76) | 554.07***<br>(170.27) | 716.47***<br>(139.06) | 847.48***<br>(153.57) | 838.85***<br>(148.53) |
| $N$                    | 907                   | 907                   | 894                   | 894                   | 904                   | 918                   | 918                   |
| Countries              | 63                    | 63                    | 63                    | 63                    | 62                    | 62                    | 62                    |
| $R^2$ (within)         | 0.51                  | 0.51                  | 0.52                  | 0.52                  | 0.52                  | 0.52                  | 0.53                  |
| $R^2$ (between)        | 0.04                  | 0.04                  | 0.04                  | 0.04                  | 0.04                  | 0.02                  | 0.02                  |
| $R^2$ (overall)        | 0.05                  | 0.05                  | 0.06                  | 0.06                  | 0.05                  | 0.03                  | 0.03                  |
| Country FEs            | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | 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 results support our argument that the effect of FDI on market concentration varies with the level of economic development.

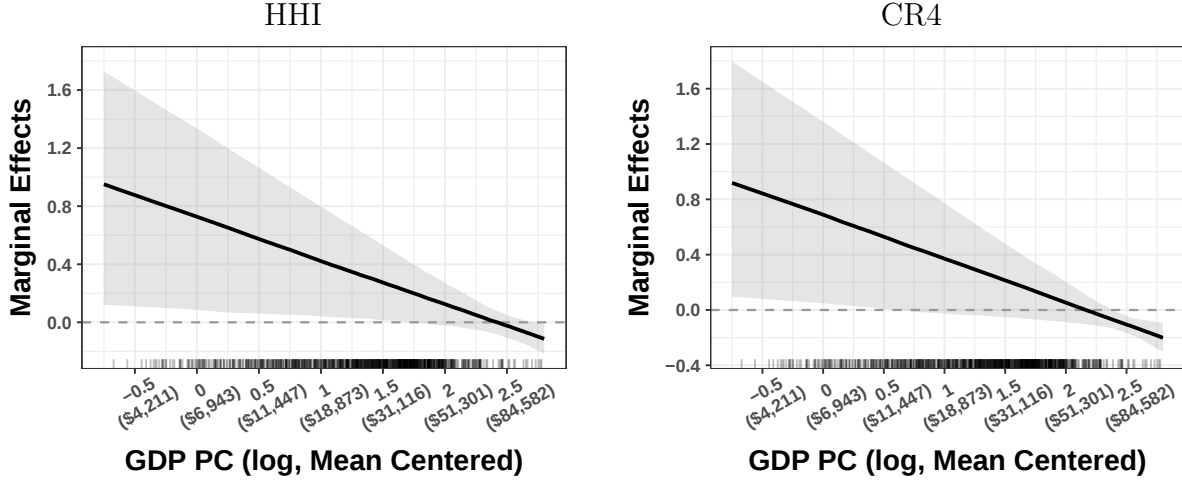
In Models 3 and 4, we further control for country-level factors that may influence market competition, including industry structure and legal institutions. We capture industry structure using the shares of value added in agriculture, industry, and services as a percentage of GDP,<sup>17</sup> and measure legal institutions using the rule-of-law indicator from V-Dem. The results suggest that countries with a larger industrial (secondary) sector tend to exhibit higher levels of market concentration. The rule-of-law variable does not appear to have a statistically significant effect. In Model 5, we employ an alternative measure of industry structure—the share of gross output accounted for by high fixed-asset industries. Industries characterized by high fixed costs can create natural barriers to entry and thereby limit market competition (Wright and Zhu, 2018; Zhu and Deng, 2022). As such, countries with a greater concentration of activity in high fixed-asset industries are expected to exhibit higher levels of market concentration. Consistent with this expectation, the coefficient on this variable is positive and statistically significant at the 10% level. In Models 6 and 7, we re-estimate Models 1 and 5 using the CR4 measure of market concentration, and obtain the same results.

Figure 4.1 presents the marginal effects of inward FDI on market concentration, based

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<sup>17</sup>The data come from the World Bank’s *World Development Indicators*.

Figure 4.1: Marginal Effects of FDI Inflows on Market Concentration (1K Threshold)



*Notes:* Plots show the marginal effects of real FDI inflows per capita (cubic root) on market concentration across levels of real GDP per capita, based on estimates from Models 5 and 7 in Table 4.2. Shaded areas indicate 95% confidence intervals, derived from 1,000 simulations. The rug plots at the bottom of each panel show the distribution of the moderator.

on 1,000 simulations of the estimated coefficients from Models 5 and 7 in Table 4.2. The results indicate that inward FDI has a strong positive effect on market concentration in less developed countries; however, this effect attenuates as the level of economic development increases and eventually becomes negative at higher levels of GDP per capita.

Substantively, consider the left panel. When real GDP per capita is held at the 25<sup>th</sup> percentile (approximately \$17,268, corresponding to Turkey in 2009), a one standard deviation increase in real per capita FDI (\$486) is associated with a 2.79-unit increase in market concentration. This effect amounts to approximately 18% of the standard deviation of the HHI measure, which represents a substantively large impact. The marginal effect is statistically significant at the 95% confidence level. In contrast, when real GDP per capita reaches \$40,355 (approximately Sweden in 2005), the marginal effect of FDI inflows on market concentration is no longer statistically distinguishable from zero.

In Table 4.3, we use a higher threshold by excluding country-year observations with fewer than 5,000 firms recorded in the Orbis database. Using this higher threshold improves the coverage and representativeness of the Orbis data and thereby enhances the validity of

Table 4.3: FDI Inflows and Market Concentration (5K Threshold)

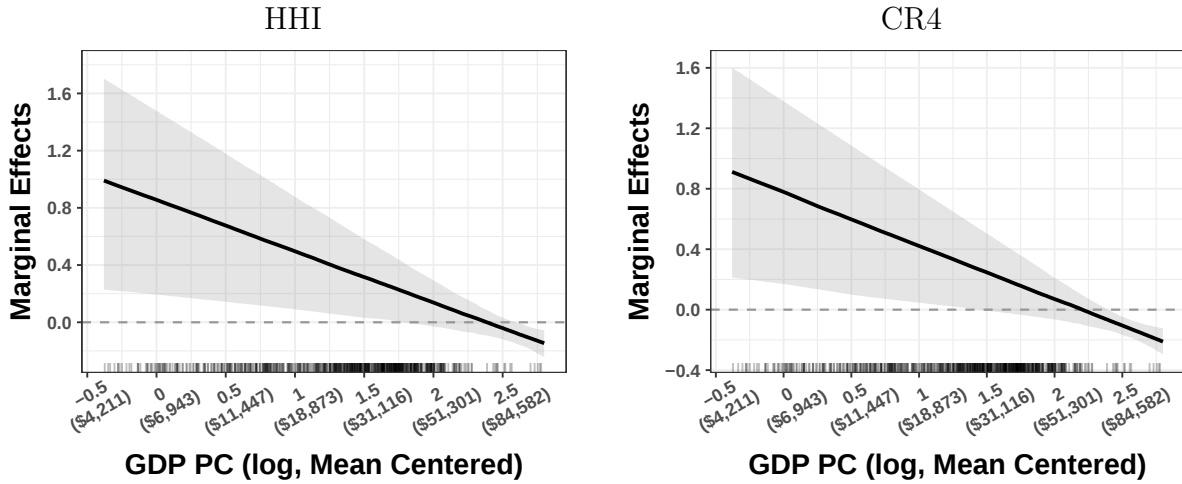
|                        | HHI                   |                       | CR4                   |                       |
|------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                        | (1)                   | (2)                   | (3)                   | (4)                   |
| FDI PC                 | 0.06<br>(0.09)        | 0.84**<br>(0.33)      | -0.01<br>(0.09)       | 0.76**<br>(0.32)      |
| FDI PC $\times$ GDP PC |                       | -0.35***<br>(0.13)    |                       | -0.35***<br>(0.13)    |
| GDP PC                 | 64.49***<br>(17.86)   | 67.06***<br>(17.27)   | 73.02***<br>(18.32)   | 75.58***<br>(17.77)   |
| RPE                    | -11.21<br>(9.62)      | -13.51<br>(9.71)      | -13.47<br>(11.29)     | -15.73<br>(11.39)     |
| Infant Mortality       | 24.90***<br>(5.69)    | 23.83***<br>(5.66)    | 25.44***<br>(7.14)    | 24.42***<br>(7.18)    |
| Democracy              | -0.42<br>(0.26)       | -0.41<br>(0.25)       | -0.41<br>(0.40)       | -0.39<br>(0.39)       |
| GDP                    | -58.84***<br>(17.34)  | -60.15***<br>(17.01)  | -71.61***<br>(18.77)  | -72.90***<br>(18.47)  |
| Growth Rate            | -0.31<br>(0.44)       | -0.45<br>(0.42)       | -0.41<br>(0.55)       | -0.57<br>(0.55)       |
| Import Exposure        | -13.65**<br>(5.43)    | -13.88**<br>(5.35)    | -15.14**<br>(7.12)    | -15.39**<br>(7.03)    |
| Resource Rents         | -5.57*<br>(3.17)      | -5.87*<br>(3.08)      | -2.01<br>(3.70)       | -2.34<br>(3.61)       |
| Output (HFA)           | 13.04**<br>(6.30)     | 12.32**<br>(6.00)     | 13.70<br>(8.19)       | 13.05<br>(7.91)       |
| Rule of Law            | 1.98<br>(6.91)        | -0.63<br>(6.64)       | 12.43<br>(8.63)       | 9.73<br>(8.21)        |
| Constant               | 724.96***<br>(207.85) | 742.08***<br>(204.18) | 906.80***<br>(223.15) | 923.82***<br>(219.64) |
| $N$                    | 691                   | 691                   | 695                   | 695                   |
| Countries              | 51                    | 51                    | 51                    | 51                    |
| $R^2$ (within)         | 0.51                  | 0.53                  | 0.51                  | 0.52                  |
| $R^2$ (between)        | 0.01                  | 0.01                  | 0.00                  | 0.00                  |
| $R^2$ (overall)        | 0.03                  | 0.03                  | 0.01                  | 0.01                  |
| Country FEs            | Yes                   | Yes                   | Yes                   | Yes                   |

Notes: Clustered standard errors in parentheses;

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

the concentration measures (Bajgar et al., 2020). The trade-off is a reduction in the sample size, with approximately 25% fewer observations and about 20% fewer countries. Despite this more restrictive sample, our main findings remain robust, with the estimated effects becoming slightly stronger. Figure 4.2 plots the simulated marginal effects based on the estimated coefficients from Models 2 and 4. Again, we see that FDI inflows have a strong positive effect on market concentration at lower levels of economic development, and this effect attenuates and turns negative at higher levels of economic development.

Figure 4.2: Marginal Effects of FDI Inflows on Market Concentration (5K Threshold)



*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 2 and 4 in Table 4.3. Shaded areas indicate 95% confidence intervals, derived from 1,000 simulations. The rug plots at the bottom of each panel show the distribution of the moderator.

Regarding the results of other control variables in Tables 4.2 and 4.3, real GDP per capita is positively and significantly associated with market concentration. This result contrasts with the findings in 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 dispropo-

portionately benefit large firms, allowing them to expand their market shares and entrench their dominance (Autor, Dorn, Katz, Patterson and Van Reenen, 2020; Bajgar, Criscuolo and Timmis, 2025).

In contrast, large economies and import exposure are consistently associated with lower market concentration. These results are sensible. Larger economies tend to support a greater number of firms, thereby fostering competition and reducing the dominance of any single firm. Import competition, by lowering protection and increasing contestability, intensifies product-market competition, erodes rents enjoyed by domestic incumbents, and improves resource allocation and efficiency (Edmond, Midrigan and Xu, 2015; Pavcnik, 2002; Trefler, 2004). This highlights a key difference between import competition and inward FDI. Imports discipline firms through foreign competitive pressure, whereas FDI can also reallocate sales, reshape supplier access, and alter input demand within the host economy. Finally, weak state capacity is strongly associated with higher market concentration.

In the Appendix, we re-estimate the models using real FDI stocks per capita as the main explanatory variable. Table 4.6 reports the results for both the 1K and 5K threshold samples, while Figures 4.4 and 4.5 present the corresponding marginal effects. Overall, the results are consistent with those reported in the main text. Inward FDI stocks are positively associated with market concentration at lower levels of economic development; however, this effect attenuates as real GDP per capita increases and becomes statistically indistinguishable from zero at higher levels of development.

## 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). We reproduce the empirical analysis reported in Pinto and Zhu (2022). The WBES project has conducted nationally representative firm-level surveys in 160 countries since 2002.<sup>18</sup> It employs a standardized sampling methodology designed to generate rep-

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<sup>18</sup>World Bank. “Enterprise Surveys,” <https://www.enterprisesurveys.org/en/enterprisesurveys>.

representative samples of the non-agricultural, non-extractive formal private economy, and to minimize measurement error, allowing for cross-country comparability.

The WBES are administered to business owners and top managers. The sample consists of firms with at least five employees and a minimum of 1% private ownership. It covers firms in manufacturing, construction, wholesale and retail trade, hotels and restaurants, transportation and storage, communications, professional services, and information technology. In a small number of economies, additional sectors such as education and health are also surveyed. The surveys are stratified by sector,<sup>19</sup> firm size,<sup>20</sup> and geographic location.<sup>21</sup> For detailed information, see the WBES’s sampling methodology notes.<sup>22</sup>

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.<sup>23</sup>

To construct measures of market concentration using the WBES data, we rely on data on firms’ full-time employees.<sup>24</sup> 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).<sup>25</sup> Finally, we weight sectoral concentration ratios

<sup>19</sup>Sectoral stratification depends on the size of the economy. In general, the WBES classifies firms into manufacturing, retail, and other services. In larger economies, manufacturing and services are further divided into subsectors for stratification purposes.

<sup>20</sup>Three size strata are used: small (5–19 employees), medium (20–99), and large ( $\geq 100$ ). A fourth stratum (top 1%) is included for very large economies.

<sup>21</sup>Geographic stratification is designed to cover major urban areas in order to reflect the distribution of non-agricultural economic activity.

<sup>22</sup>World Bank, 2022, “Enterprise Surveys: Sampling Methodology,” [https://www.enterprisesurveys.org/content/dam/enterprisesurveys/documents/methodology/Sampling\\_Note-Consolidated-2-16-22.pdf](https://www.enterprisesurveys.org/content/dam/enterprisesurveys/documents/methodology/Sampling_Note-Consolidated-2-16-22.pdf).

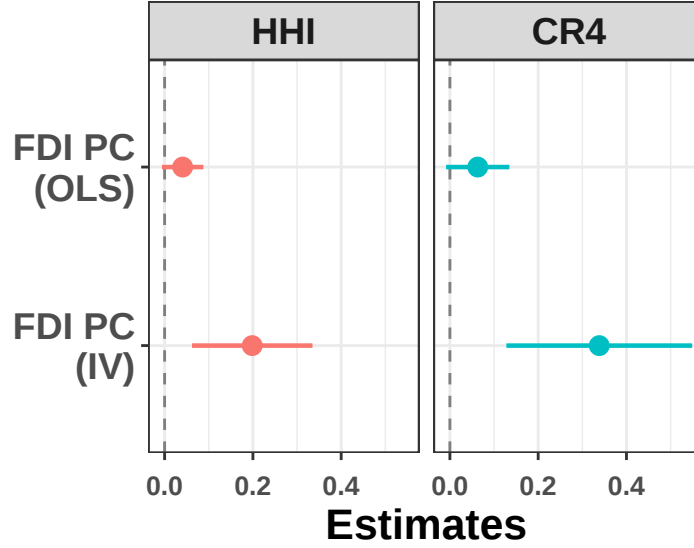
<sup>23</sup>We use this version to maintain consistency with our previous study (Pinto and Zhu, 2022). The standardized version aligns all variables with the latest standardized questionnaire. Results remain consistent if surveys conducted before 2006 are included.

<sup>24</sup>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.

<sup>25</sup>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

by each sector's share of national employment and aggregate them to obtain national-level measures of market concentration.

Figure 4.3: 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 4.7 in the Appendix.

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.<sup>26</sup>

The dataset primarily consists of non-OECD countries,<sup>27</sup> 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 reallocate production and sales toward more productive firms, causing less productive domestic firms to contract or exit and thereby contributing to increased market concentration. Accordingly, we expect a positive coefficient

sectors (retail and wholesale), and a residual category. See the WBES implementation notes.

<sup>26</sup>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.

<sup>27</sup>Turkey and Sweden are the only two OECD countries included.

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.<sup>28</sup>

Figure 4.3 presents the point estimates and 95% confidence intervals for FDI per capita across the four model specifications (see Table 4.7 in the Appendix for full results). 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 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.

### Horizontal versus Vertical FDI

In this section, we explore potential heterogeneity between horizontal and vertical FDI. However, existing FDI statistics compiled by organizations such as UNCTAD, the World Bank, and the IMF primarily report aggregate directional flows at the sector or country level, as recorded in countries' balance of payments. These data do not distinguish between horizontal and vertical FDI. UNCTAD also provides country-level data on cross-border M&As, sourced from a private vendor (Refinitiv), with coverage beginning in 1990. M&A transactions can involve both horizontal FDI when firms acquire or merge with foreign competitors

<sup>28</sup>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 \(2016, 2022\)](#).

producing similar final goods, and vertical FDI when firms acquire foreign suppliers or firms operating at different stages of the production process.

To address this data limitation, we use a country's level of participation in global GVCs to decompose total FDI inflows into horizontal and vertical components. The underlying assumption is that GVC trade reflects the international fragmentation of production, whereby firms located in different countries contribute to distinct stages of the production process, often coordinated by lead firms ([Antràs, 2020a](#); [Antràs and Chor, 2013](#); [Baldwin, 2016](#)). Such cross-border production networks are closely associated with vertical FDI, which involves the geographic separation of production stages across countries.

Building on this insight, we proxy vertical FDI by multiplying total FDI inflows and the share of GVC trade in a country's total trade.<sup>29</sup> The remaining portion of FDI is interpreted as horizontal FDI. This approach captures the idea that MNCs engaged in GVC activities are more likely to undertake vertically integrated production across borders. We acknowledge that this proxy is an approximation and does not perfectly distinguish between vertical and horizontal FDI.

Table 4.4 presents the results using two alternative measures of market concentration constructed from the Orbis database with FDI decomposed into horizontal and vertical components. Overall, the results suggest that horizontal FDI is positively associated with market concentration in both developing and developed countries. By contrast, the effect of vertical FDI on market concentration is moderated by the level of economic development. In particular, vertical FDI has a strong positive effect on market concentration in less developed countries, but this effect attenuates as the level of development increases. These findings are sensible. Horizontal FDI, which often involves the acquisition of foreign competitors, tends to increase firms' market shares in final goods markets and thereby raise market concentration. The results for vertical FDI are in line with the FDI spillover literature: negative spillovers are more likely when the technological gap between multinational and domestic firms is large

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<sup>29</sup>The data are from [World Bank \(2020\)](#).

Table 4.4: Horizontal and Vertical FDI

| <b>Panel A: 1K Threshold</b>   |                  |                 |                |                    |                  |                 |                 |                   |
|--------------------------------|------------------|-----------------|----------------|--------------------|------------------|-----------------|-----------------|-------------------|
|                                | HHI              |                 |                |                    | CR4              |                 |                 |                   |
|                                | (1)              | (2)             | (3)            | (4)                | (5)              | (6)             | (7)             | (8)               |
| Horizontal FDI                 | 0.27**<br>(0.12) | -0.02<br>(0.37) |                |                    | 0.13<br>(0.11)   | -0.05<br>(0.40) |                 |                   |
| Horizontal FDI $\times$ GDP PC |                  | 0.17<br>(0.20)  |                |                    |                  | 0.10<br>(0.21)  |                 |                   |
| Vertical FDI                   |                  |                 | 0.06<br>(0.08) | 0.90**<br>(0.38)   |                  |                 | -0.01<br>(0.08) | 0.88**<br>(0.38)  |
| Vertical FDI $\times$ GDP PC   |                  |                 |                | -0.38**<br>(0.15)  |                  |                 |                 | -0.40**<br>(0.15) |
| <i>N</i>                       | 904              | 904             | 904            | 904                | 918              | 918             | 918             | 918               |
| Countries                      | 62               | 62              | 62             | 62                 | 62               | 62              | 62              | 62                |
| $R^2$ (within)                 | 0.52             | 0.52            | 0.51           | 0.52               | 0.52             | 0.53            | 0.52            | 0.53              |
| $R^2$ (between)                | 0.04             | 0.04            | 0.04           | 0.04               | 0.02             | 0.02            | 0.02            | 0.02              |
| $R^2$ (overall)                | 0.05             | 0.05            | 0.05           | 0.05               | 0.03             | 0.03            | 0.03            | 0.02              |
| Covariates                     | Yes              | Yes             | Yes            | Yes                | Yes              | Yes             | Yes             | Yes               |
| Country FEs                    | Yes              | Yes             | Yes            | Yes                | Yes              | Yes             | Yes             | Yes               |
| <b>Panel B: 5K Threshold</b>   |                  |                 |                |                    |                  |                 |                 |                   |
|                                | HHI              |                 |                |                    | CR4              |                 |                 |                   |
|                                | (1)              | (2)             | (3)            | (4)                | (5)              | (6)             | (7)             | (8)               |
| Horizontal FDI                 | 0.34**<br>(0.14) | 0.46<br>(0.38)  |                |                    | 0.30**<br>(0.14) | 0.51<br>(0.41)  |                 |                   |
| Horizontal FDI $\times$ GDP PC |                  | -0.07<br>(0.20) |                |                    |                  | -0.12<br>(0.23) |                 |                   |
| Vertical FDI                   |                  |                 | 0.04<br>(0.09) | 0.92**<br>(0.37)   |                  |                 | -0.04<br>(0.09) | 0.80**<br>(0.35)  |
| Vertical FDI $\times$ GDP PC   |                  |                 |                | -0.39***<br>(0.14) |                  |                 |                 | -0.37**<br>(0.14) |
| <i>N</i>                       | 691              | 691             | 691            | 691                | 695              | 695             | 695             | 695               |
| Countries                      | 51               | 51              | 51             | 51                 | 51               | 51              | 51              | 51                |
| $R^2$ (within)                 | 0.53             | 0.53            | 0.51           | 0.53               | 0.52             | 0.52            | 0.51            | 0.52              |
| $R^2$ (between)                | 0.01             | 0.01            | 0.01           | 0.01               | 0.00             | 0.00            | 0.00            | 0.00              |
| $R^2$ (overall)                | 0.04             | 0.04            | 0.03           | 0.03               | 0.02             | 0.02            | 0.01            | 0.01              |
| Covariates                     | Yes              | Yes             | Yes            | Yes                | Yes              | Yes             | Yes             | Yes               |
| Country FEs                    | Yes              | Yes             | Yes            | Yes                | Yes              | Yes             | Yes             | Yes               |

Notes: Estimates for covariates are omitted; full results are reported in Tables 4.4 and 4.8 in the Appendix. Clustered standard errors are in parentheses; \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

and when host countries are less developed ([Aghion et al., 2009](#); [Ahn et al., 2026](#); [Havranek and Irsova, 2011](#); [Marcin, 2008](#); [Meyer and Sinani, 2009](#)).

### **Manufacturing versus Non-Manufacturing FDI**

In this section, we further explore heterogeneity between manufacturing and non-manufacturing FDI. Sectoral FDI data are available from UNCTAD; however, their coverage varies significantly across countries, with particularly high levels of missingness in developing countries ([Wright and Zhu, 2018](#)). To address this limitation, we adopt a similar decomposition strategy and partition total FDI inflows into manufacturing and non-manufacturing components. Specifically, we proxy manufacturing FDI using the product of total FDI inflows and the share of manufacturing value added in a country's GDP, with the remaining portion interpreted as non-manufacturing FDI.

Table 4.5 presents the results. They do not show a significant difference between manufacturing and non-manufacturing FDI. Both are associated with higher market concentration in less developed countries, and this relationship is moderated by the host country's level of economic development.

Taken together, the results in Tables 4.4 and 4.5 indicate that the impact of FDI inflows on market concentration depends primarily on the productivity differential between multinational and domestic firms. In developing countries, where this productivity gap is relatively large, foreign entry tends to cause low-productivity domestic firms to contract or exit and thereby increases market concentration. This pattern holds across different types of FDI, including both horizontal and vertical, as well as manufacturing and non-manufacturing FDI.

## **4.5 Conclusion**

In this chapter, we examine the relationship between inward FDI and market concentration using measures constructed from two alternative data sources: the Orbis database and the WBES. We find consistent evidence that the effect of inward FDI on market concentra-

Table 4.5: Manufacturing and Non-Manufacturing FDI

| <b>Panel A: 1K Threshold</b>  |                |                    |                |                    |                |                    |                 |                    |
|-------------------------------|----------------|--------------------|----------------|--------------------|----------------|--------------------|-----------------|--------------------|
|                               | HHI            |                    |                |                    | CR4            |                    |                 |                    |
|                               | (1)            | (2)                | (3)            | (4)                | (5)            | (6)                | (7)             | (8)                |
| Manuf FDI                     | 0.21<br>(0.17) | 1.68**<br>(0.70)   |                |                    | 0.06<br>(0.16) | 1.73**<br>(0.70)   |                 |                    |
| Manuf FDI $\times$ GDP PC     |                | -0.70**<br>(0.29)  |                |                    |                | -0.79***<br>(0.29) |                 |                    |
| Non-Manuf FDI                 |                |                    | 0.07<br>(0.08) | 0.77**<br>(0.34)   |                |                    | -0.00<br>(0.07) | 0.75**<br>(0.34)   |
| Non-Manuf FDI $\times$ GDP PC |                |                    |                | -0.32**<br>(0.13)  |                |                    |                 | -0.34**<br>(0.14)  |
| <i>N</i>                      | 863            | 863                | 863            | 863                | 872            | 872                | 872             | 872                |
| Number of Countries           | 61             | 61                 | 61             | 61                 | 61             | 61                 | 61              | 61                 |
| $R^2$ (within)                | 0.50           | 0.51               | 0.50           | 0.51               | 0.50           | 0.51               | 0.50            | 0.51               |
| $R^2$ (between)               | 0.05           | 0.05               | 0.05           | 0.05               | 0.04           | 0.04               | 0.04            | 0.04               |
| $R^2$ (overall)               | 0.06           | 0.06               | 0.06           | 0.06               | 0.04           | 0.04               | 0.04            | 0.04               |
| Covariates                    | Yes            | Yes                | Yes            | Yes                | Yes            | Yes                | Yes             | Yes                |
| Country FEs                   | Yes            | Yes                | Yes            | Yes                | Yes            | Yes                | Yes             | Yes                |
| <b>Panel B: 5K Threshold</b>  |                |                    |                |                    |                |                    |                 |                    |
|                               | HHI            |                    |                |                    | CR4            |                    |                 |                    |
|                               | (1)            | (2)                | (3)            | (4)                | (5)            | (6)                | (7)             | (8)                |
| Manuf FDI                     | 0.18<br>(0.19) | 1.90***<br>(0.69)  |                |                    | 0.06<br>(0.19) | 1.83***<br>(0.64)  |                 |                    |
| Manuf FDI $\times$ GDP PC     |                | -0.82***<br>(0.28) |                |                    |                | -0.85***<br>(0.27) |                 |                    |
| Non-Manuf FDI                 |                |                    | 0.04<br>(0.09) | 0.91**<br>(0.36)   |                |                    | -0.02<br>(0.09) | 0.84**<br>(0.33)   |
| Non-Manuf FDI $\times$ GDP PC |                |                    |                | -0.38***<br>(0.14) |                |                    |                 | -0.38***<br>(0.13) |
| <i>N</i>                      | 659            | 659                | 659            | 659                | 659            | 659                | 659             | 659                |
| Number of Countries           | 50             | 50                 | 50             | 50                 | 50             | 50                 | 50              | 50                 |
| $R^2$ (within)                | 0.52           | 0.53               | 0.52           | 0.53               | 0.50           | 0.51               | 0.50            | 0.51               |
| $R^2$ (between)               | 0.02           | 0.02               | 0.02           | 0.02               | 0.00           | 0.00               | 0.00            | 0.00               |
| $R^2$ (overall)               | 0.05           | 0.05               | 0.05           | 0.05               | 0.03           | 0.03               | 0.03            | 0.03               |
| Covariates                    | Yes            | Yes                | Yes            | Yes                | Yes            | Yes                | Yes             | Yes                |
| Country FEs                   | Yes            | Yes                | Yes            | Yes                | Yes            | Yes                | Yes             | Yes                |

Notes: Estimates for covariates are omitted; full results are reported in Tables 4.10 and 4.11 in the Appendix. Clustered standard errors are in parentheses; \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

tion depends on a country's level of economic development, which we interpret as a proxy for the productivity differential between multinationals and domestic firms. In more developed economies, where domestic firms are better able to compete with MNCs, FDI inflows have no effect or are associated with reductions in market concentration. By contrast, in developing countries, where domestic firms tend to be smaller and less technologically advanced, FDI inflows are strongly associated with higher levels of market concentration. This positive relationship remains robust when we decompose FDI into horizontal and vertical components, as well as into manufacturing and non-manufacturing sectors.

These findings constitute the first empirical step in the book's broader argument. FDI reallocates production and sales and can concentrate economic activity among a smaller number of firms when productivity gaps are large. In variable-markup environments, such concentration is one pathway to higher markups, operating profits, economic profits, and rents. In fixed-markup or world-price environments, the same pattern suggests that profits, supplier access, and other FDI-induced rents become more concentrated, even if domestic markups do not increase proportionally. The results therefore support the broader claim that foreign entry can generate politically salient excess returns through multiple channels.

The broader implications of these findings extend beyond market outcomes to the domestic politics of host countries. If inward FDI contributes to the creation of economic rents, it may reshape the incentives of firms, political actors, and other societal stakeholders. In developing countries with weak state capacity and limited institutional constraints, these rents can become targets of appropriation, fostering rent-seeking behavior, corruption, and political contestation. In subsequent chapters, we examine these political consequences in detail, showing how FDI-induced rents can increase the risk of corruption, civil conflict, and political instability in the Global South. Importantly, the extent to which these outcomes materialize depends on the strength of state capacity and the quality of political and legal institutions, which shape how rents are distributed, regulated, and contested.

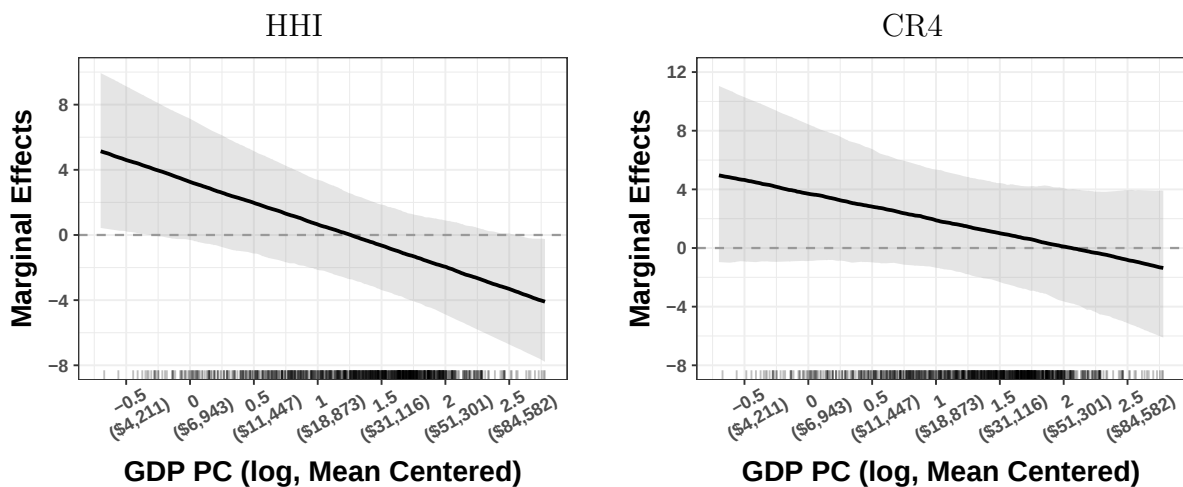
## 4.6 Appendix

Table 4.6: FDI Stocks and Market Concentration

|                    | 1K Threshold          |                       |                       |                       | 5K Threshold          |                      |                       |                       |
|--------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|----------------------|-----------------------|-----------------------|
|                    | (1)<br>HHI            | (2)<br>HHI            | (3)<br>CR4            | (4)<br>CR4            | (5)<br>HHI            | (6)<br>HHI           | (7)<br>CR4            | (8)<br>CR4            |
| FDI PC             | 0.36<br>(1.34)        | 3.29*<br>(1.89)       | 1.67<br>(1.74)        | 3.80<br>(2.38)        | 1.09<br>(1.60)        | 4.10**<br>(2.01)     | 2.48<br>(1.98)        | 5.35**<br>(2.55)      |
| FDI PC ×<br>GDP PC |                       | -2.68***<br>(0.95)    |                       | -1.87<br>(1.29)       |                       | -3.28***<br>(1.03)   |                       | -3.18**<br>(1.46)     |
| GDP PC             | 69.71***<br>(14.04)   | 73.68***<br>(12.34)   | 76.75***<br>(15.58)   | 80.07***<br>(14.43)   | 65.49***<br>(17.39)   | 72.31***<br>(15.58)  | 73.34***<br>(17.31)   | 79.48***<br>(15.75)   |
| RPE                | -5.62<br>(7.84)       | -7.10<br>(7.35)       | -9.07<br>(10.02)      | -9.96<br>(9.77)       | -11.93<br>(9.70)      | -14.11<br>(8.44)     | -14.23<br>(11.40)     | -16.46<br>(10.24)     |
| Infant Mortality   | 28.99***<br>(5.12)    | 28.93***<br>(4.98)    | 34.26***<br>(6.08)    | 34.36***<br>(6.02)    | 25.98***<br>(5.46)    | 24.28***<br>(5.43)   | 27.24***<br>(6.93)    | 25.45***<br>(6.97)    |
| Democracy          | -0.19<br>(0.26)       | -0.13<br>(0.26)       | -0.17<br>(0.37)       | -0.14<br>(0.37)       | -0.43<br>(0.27)       | -0.34<br>(0.27)      | -0.41<br>(0.39)       | -0.33<br>(0.39)       |
| GDP                | -60.53***<br>(11.76)  | -43.25***<br>(13.67)  | -71.14***<br>(12.88)  | -59.80***<br>(15.48)  | -60.78***<br>(17.23)  | -41.95**<br>(17.12)  | -74.94***<br>(18.30)  | -56.21***<br>(20.13)  |
| Growth Rate        | -0.55<br>(0.38)       | -0.52<br>(0.38)       | -0.56<br>(0.44)       | -0.55<br>(0.44)       | -0.32<br>(0.44)       | -0.26<br>(0.44)      | -0.46<br>(0.54)       | -0.41<br>(0.54)       |
| Import Exposure    | -15.27***<br>(5.07)   | -13.10***<br>(4.54)   | -14.42**<br>(6.60)    | -12.65**<br>(6.11)    | -14.18**<br>(5.77)    | -11.50**<br>(5.36)   | -16.58**<br>(7.56)    | -14.13**<br>(6.93)    |
| Resource Rents     | -2.18<br>(2.98)       | -0.71<br>(3.05)       | -0.50<br>(3.25)       | 0.38<br>(3.20)        | -5.59*<br>(3.18)      | -4.28<br>(3.03)      | -2.00<br>(3.68)       | -0.85<br>(3.41)       |
| Output (HFA)       | 14.57*<br>(7.73)      | 11.89<br>(7.72)       | 12.42<br>(8.50)       | 10.25<br>(8.69)       | 13.26**<br>(6.19)     | 10.16<br>(6.28)      | 13.42*<br>(7.97)      | 10.98<br>(8.11)       |
| Rule of Law        | -3.05<br>(7.99)       | -4.03<br>(8.35)       | 4.87<br>(8.25)        | 4.20<br>(8.42)        | 0.94<br>(6.75)        | -2.01<br>(6.55)      | 9.91<br>(8.30)        | 7.16<br>(7.97)        |
| Constant           | 733.82***<br>(139.38) | 500.69***<br>(164.30) | 865.37***<br>(149.65) | 709.75***<br>(183.79) | 741.13***<br>(205.81) | 491.70**<br>(206.33) | 932.76***<br>(216.46) | 686.02***<br>(241.47) |
| <i>N</i>           | 898                   | 898                   | 912                   | 912                   | 685                   | 685                  | 689                   | 689                   |
| Countries          | 62                    | 62                    | 62                    | 62                    | 51                    | 51                   | 51                    | 51                    |
| $R^2$ (within)     | 0.51                  | 0.52                  | 0.53                  | 0.53                  | 0.52                  | 0.54                 | 0.52                  | 0.53                  |
| $R^2$ (between)    | 0.04                  | 0.02                  | 0.02                  | 0.01                  | 0.01                  | 0.00                 | 0.00                  | 0.00                  |
| $R^2$ (overall)    | 0.05                  | 0.04                  | 0.02                  | 0.02                  | 0.03                  | 0.02                 | 0.01                  | 0.01                  |
| Country FEs        | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                  | Yes                   | Yes                   |

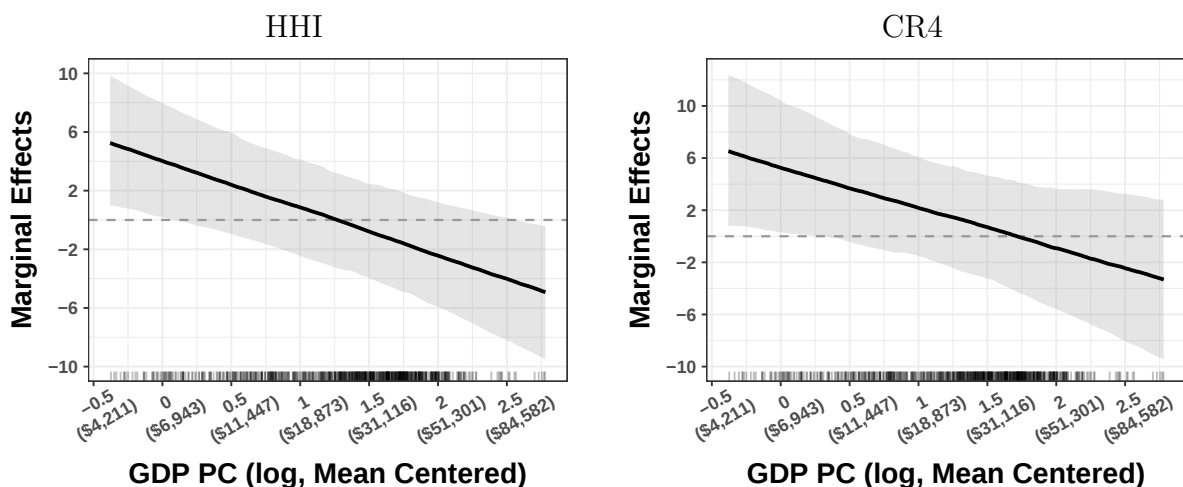
Notes: Clustered standard errors in parentheses; \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

Figure 4.4: Marginal Effects of FDI Stocks on Market Concentration (1K Threshold)



*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 4.6. Shaded areas indicate 95% confidence intervals, derived from 1,000 simulations.

Figure 4.5: Marginal Effects of FDI Stocks on Market Concentration (5K Threshold)



*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 4.6. Shaded areas indicate 95% confidence intervals, derived from 1,000 simulations.

Table 4.7: FDI Inflows and Market Concentration (WBES)

|                            | HHI                |                    | CR4                |                    |
|----------------------------|--------------------|--------------------|--------------------|--------------------|
|                            | (1)<br>OLS         | (2)<br>IV          | (3)<br>OLS         | (4)<br>IV          |
| FDI Inflows PC             | 0.04*<br>(0.02)    | 0.20***<br>(0.07)  | 0.06*<br>(0.04)    | 0.34***<br>(0.11)  |
| State Capacity (RPE)       | 0.08<br>(0.19)     | -0.11<br>(0.20)    | 0.23<br>(0.27)     | -0.08<br>(0.30)    |
| GDP                        | -0.19***<br>(0.03) | -0.23***<br>(0.04) | -0.32***<br>(0.04) | -0.40***<br>(0.06) |
| Democracy                  | -0.02*<br>(0.01)   | -0.04**<br>(0.02)  | -0.02<br>(0.02)    | -0.06**<br>(0.03)  |
| Growth Rate                | -0.55***<br>(0.18) | -0.54***<br>(0.19) | -0.73***<br>(0.24) | -0.71***<br>(0.26) |
| Resource Rents             | -0.18*<br>(0.09)   | -0.00<br>(0.13)    | -0.26*<br>(0.14)   | 0.04<br>(0.20)     |
| Constant                   | 4.37***<br>(0.58)  | 3.98***<br>(0.61)  | 7.68***<br>(0.73)  | 6.99***<br>(0.84)  |
| $N$                        | 110                | 110                | 110                | 110                |
| $R^2$                      | 0.34               | 0.08               | 0.36               | 0.04               |
| $F$ -stat (Excluded Instr) |                    | 19.81              |                    | 19.81              |
| $P > F$                    |                    | 0.00               |                    | 0.00               |

Notes: Robust standard errors in parentheses;

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

Table 4.8: Horizontal and Vertical FDI (1K Threshold)

|                                   | HHI                   |                       |                       |                       | CR4                   |                       |                       |                       |
|-----------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                   | (1)                   | (2)                   | (3)                   | (4)                   | (5)                   | (6)                   | (7)                   | (8)                   |
| Horizontal FDI                    | 0.27**<br>(0.12)      | -0.02<br>(0.37)       |                       |                       | 0.13<br>(0.11)        | -0.05<br>(0.40)       |                       |                       |
| Horizontal FDI $\times$<br>GDP PC |                       | 0.17<br>(0.20)        |                       |                       |                       | 0.10<br>(0.21)        |                       |                       |
| Vertical FDI                      |                       |                       | 0.06<br>(0.08)        | 0.90**<br>(0.38)      |                       |                       | -0.01<br>(0.08)       | 0.88**<br>(0.38)      |
| Vertical FDI $\times$<br>GDP PC   |                       |                       |                       | -0.38**<br>(0.15)     |                       |                       |                       | -0.40**<br>(0.15)     |
| GDP PC                            | 66.16***<br>(13.91)   | 64.20***<br>(13.53)   | 68.67***<br>(14.11)   | 70.04***<br>(13.48)   | 75.53***<br>(15.65)   | 74.62***<br>(15.05)   | 76.16***<br>(15.75)   | 77.25***<br>(15.06)   |
| RPE                               | -4.78<br>(7.59)       | -4.55<br>(7.53)       | -4.92<br>(7.70)       | -6.56<br>(7.70)       | -8.90<br>(9.59)       | -8.85<br>(9.53)       | -8.84<br>(9.62)       | -10.36<br>(9.63)      |
| Infant Mortality                  | 27.43***<br>(5.30)    | 27.60***<br>(5.35)    | 28.53***<br>(5.19)    | 28.69***<br>(5.07)    | 32.41***<br>(6.35)    | 32.52***<br>(6.43)    | 32.91***<br>(6.21)    | 33.14***<br>(6.13)    |
| Democracy                         | -0.20<br>(0.26)       | -0.20<br>(0.26)       | -0.21<br>(0.25)       | -0.17<br>(0.25)       | -0.19<br>(0.37)       | -0.20<br>(0.38)       | -0.20<br>(0.37)       | -0.15<br>(0.36)       |
| GDP                               | -56.99***<br>(11.54)  | -56.06***<br>(11.41)  | -59.54***<br>(11.83)  | -59.00***<br>(11.72)  | -68.28***<br>(13.01)  | -67.95***<br>(12.89)  | -68.91***<br>(13.22)  | -68.07***<br>(12.74)  |
| Growth Rate                       | -0.44<br>(0.37)       | -0.43<br>(0.37)       | -0.54<br>(0.36)       | -0.67*<br>(0.33)      | -0.50<br>(0.44)       | -0.49<br>(0.44)       | -0.53<br>(0.43)       | -0.68*<br>(0.40)      |
| Import Exposure                   | -14.72***<br>(4.25)   | -14.65***<br>(4.26)   | -14.92***<br>(4.48)   | -15.30***<br>(4.38)   | -13.01**<br>(5.85)    | -13.05**<br>(5.83)    | -13.10**<br>(5.94)    | -13.18**<br>(5.84)    |
| Resource Rents                    | -3.38<br>(2.82)       | -2.98<br>(2.80)       | -2.26<br>(2.97)       | -1.74<br>(3.00)       | -1.07<br>(3.19)       | -0.83<br>(3.12)       | -0.51<br>(3.27)       | -0.01<br>(3.30)       |
| Output (HFA)                      | 12.57<br>(7.65)       | 12.70<br>(7.72)       | 14.55*<br>(7.91)      | 14.29*<br>(7.60)      | 11.54<br>(8.60)       | 11.84<br>(8.88)       | 12.39<br>(8.64)       | 11.62<br>(8.45)       |
| Rule of Law                       | -3.61<br>(7.87)       | -2.62<br>(7.88)       | -2.09<br>(7.96)       | -4.16<br>(8.02)       | 6.38<br>(8.27)        | 6.99<br>(8.16)        | 7.29<br>(8.38)        | 5.04<br>(8.33)        |
| Constant                          | 696.93***<br>(135.33) | 685.83***<br>(134.08) | 723.66***<br>(140.41) | 714.90***<br>(139.85) | 841.34***<br>(150.39) | 837.59***<br>(149.61) | 847.35***<br>(153.64) | 833.97***<br>(147.75) |
| <i>N</i>                          | 904                   | 904                   | 904                   | 904                   | 918                   | 918                   | 918                   | 918                   |
| Countries                         | 62                    | 62                    | 62                    | 62                    | 62                    | 62                    | 62                    | 62                    |
| $R^2$ (within)                    | 0.52                  | 0.52                  | 0.51                  | 0.52                  | 0.52                  | 0.53                  | 0.52                  | 0.53                  |
| $R^2$ (between)                   | 0.04                  | 0.04                  | 0.04                  | 0.04                  | 0.02                  | 0.02                  | 0.02                  | 0.02                  |
| $R^2$ (overall)                   | 0.05                  | 0.05                  | 0.05                  | 0.05                  | 0.03                  | 0.03                  | 0.03                  | 0.02                  |
| Covariates                        | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   |
| Country FEs                       | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   |

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

Table 4.9: Horizontal and Vertical FDI (5K Threshold)

|                                   | HHI                   |                       |                       |                       | CR4                   |                       |                       |                       |
|-----------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                   | (1)                   | (2)                   | (3)                   | (4)                   | (5)                   | (6)                   | (7)                   | (8)                   |
| Horizontal FDI                    | 0.34**<br>(0.14)      | 0.46<br>(0.38)        |                       |                       | 0.30**<br>(0.14)      | 0.51<br>(0.41)        |                       |                       |
| Horizontal FDI $\times$<br>GDP PC |                       | -0.07<br>(0.20)       |                       |                       |                       | -0.12<br>(0.23)       |                       |                       |
| Vertical FDI                      |                       |                       | 0.04<br>(0.09)        | 0.92**<br>(0.37)      |                       |                       | -0.04<br>(0.09)       | 0.80**<br>(0.35)      |
| Vertical FDI $\times$<br>GDP PC   |                       |                       |                       | -0.39***<br>(0.14)    |                       |                       |                       | -0.37**<br>(0.14)     |
| GDP PC                            | 62.12***<br>(16.84)   | 62.88***<br>(16.55)   | 64.83***<br>(17.89)   | 66.92***<br>(17.39)   | 71.10***<br>(17.70)   | 72.53***<br>(17.26)   | 73.26***<br>(18.27)   | 75.14***<br>(17.86)   |
| RPE                               | -11.35<br>(9.33)      | -11.49<br>(9.44)      | -11.09<br>(9.61)      | -13.45<br>(9.65)      | -13.85<br>(11.11)     | -14.10<br>(11.27)     | -13.37<br>(11.27)     | -15.59<br>(11.27)     |
| Infant Mortality                  | 23.17***<br>(5.58)    | 22.98***<br>(5.64)    | 25.01***<br>(5.66)    | 24.41***<br>(5.58)    | 23.81***<br>(7.14)    | 23.47***<br>(7.21)    | 25.45***<br>(7.10)    | 24.90***<br>(7.09)    |
| Democracy                         | -0.41<br>(0.26)       | -0.41<br>(0.26)       | -0.42<br>(0.26)       | -0.41<br>(0.25)       | -0.39<br>(0.40)       | -0.39<br>(0.40)       | -0.41<br>(0.40)       | -0.39<br>(0.39)       |
| GDP                               | -56.51***<br>(16.36)  | -56.98***<br>(16.25)  | -59.10***<br>(17.39)  | -60.22***<br>(17.12)  | -69.83***<br>(18.18)  | -70.72***<br>(18.02)  | -71.79***<br>(18.75)  | -72.72***<br>(18.53)  |
| Growth Rate                       | -0.22<br>(0.43)       | -0.23<br>(0.43)       | -0.30<br>(0.44)       | -0.47<br>(0.42)       | -0.37<br>(0.55)       | -0.39<br>(0.55)       | -0.40<br>(0.55)       | -0.57<br>(0.55)       |
| Import Exposure                   | -13.72***<br>(5.10)   | -13.72***<br>(5.11)   | -13.62**<br>(5.44)    | -13.80**<br>(5.35)    | -15.42**<br>(6.83)    | -15.43**<br>(6.83)    | -15.11**<br>(7.12)    | -15.30**<br>(7.02)    |
| Resource Rents                    | -6.81**<br>(3.05)     | -7.03**<br>(3.04)     | -5.55*<br>(3.18)      | -5.41*<br>(3.12)      | -3.11<br>(3.59)       | -3.52<br>(3.59)       | -2.04<br>(3.70)       | -1.95<br>(3.65)       |
| Output (HFA)                      | 10.89*<br>(5.82)      | 10.79*<br>(5.84)      | 13.19**<br>(6.32)     | 12.87**<br>(6.02)     | 11.43<br>(7.70)       | 11.23<br>(7.68)       | 13.78*<br>(8.17)      | 13.56*<br>(7.96)      |
| Rule of Law                       | -0.21<br>(6.64)       | -0.56<br>(6.64)       | 2.16<br>(6.92)        | -0.03<br>(6.81)       | 9.95<br>(8.30)        | 9.28<br>(8.21)        | 12.56<br>(8.65)       | 10.37<br>(8.32)       |
| Constant                          | 703.32***<br>(195.49) | 709.28***<br>(194.56) | 727.65***<br>(208.62) | 740.93***<br>(205.48) | 892.28***<br>(214.79) | 903.67***<br>(213.23) | 908.74***<br>(223.07) | 920.00***<br>(220.37) |
| <i>N</i>                          | 691                   | 691                   | 691                   | 691                   | 695                   | 695                   | 695                   | 695                   |
| Countries                         | 51                    | 51                    | 51                    | 51                    | 51                    | 51                    | 51                    | 51                    |
| $R^2$ (within)                    | 0.53                  | 0.53                  | 0.51                  | 0.53                  | 0.52                  | 0.52                  | 0.51                  | 0.52                  |
| $R^2$ (between)                   | 0.01                  | 0.01                  | 0.01                  | 0.01                  | 0.00                  | 0.00                  | 0.00                  | 0.00                  |
| $R^2$ (overall)                   | 0.04                  | 0.04                  | 0.03                  | 0.03                  | 0.02                  | 0.02                  | 0.01                  | 0.01                  |
| Covariates                        | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   |
| Country FEs                       | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   |

Clustered standard errors are in parentheses; \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

Table 4.10: Manufacturing and Non-Manufacturing FDI (1K Threshold)

|                                 | HHI                   |                       |                       |                       | CR4                   |                       |                       |                       |
|---------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                 | (1)                   | (2)                   | (3)                   | (4)                   | (5)                   | (6)                   | (7)                   | (8)                   |
| Manuf FDI                       | 0.21<br>(0.17)        | 1.68**<br>(0.70)      |                       |                       | 0.06<br>(0.16)        | 1.73**<br>(0.70)      |                       |                       |
| Manuf FDI ×<br>GDP PC           |                       | -0.70**<br>(0.29)     |                       |                       |                       | -0.79***<br>(0.29)    |                       |                       |
| Non-Manuf FDI                   |                       |                       | 0.07<br>(0.08)        | 0.77**<br>(0.34)      |                       |                       | -0.00<br>(0.07)       | 0.75**<br>(0.34)      |
| Non-Manuf FDI ×<br>GDP PC       |                       |                       |                       | -0.32**<br>(0.13)     |                       |                       |                       | -0.34**<br>(0.14)     |
| GDP PC                          | 65.64***<br>(14.97)   | 68.19***<br>(14.05)   | 66.26***<br>(14.93)   | 68.20***<br>(14.26)   | 73.24***<br>(17.62)   | 75.26***<br>(16.56)   | 73.41***<br>(17.54)   | 74.84***<br>(16.84)   |
| RPE                             | -5.57<br>(8.27)       | -6.32<br>(8.28)       | -5.47<br>(8.27)       | -6.42<br>(8.26)       | -9.48<br>(10.69)      | -10.22<br>(10.76)     | -9.37<br>(10.66)      | -10.28<br>(10.71)     |
| Infant Mortality                | 28.32***<br>(5.16)    | 28.11***<br>(5.13)    | 28.45***<br>(5.13)    | 28.37***<br>(5.09)    | 33.26***<br>(6.38)    | 33.04***<br>(6.41)    | 33.30***<br>(6.34)    | 33.23***<br>(6.35)    |
| Democracy                       | -0.25<br>(0.27)       | -0.19<br>(0.26)       | -0.25<br>(0.27)       | -0.22<br>(0.26)       | -0.22<br>(0.38)       | -0.15<br>(0.37)       | -0.22<br>(0.38)       | -0.17<br>(0.37)       |
| GDP                             | -58.26***<br>(12.02)  | -57.80***<br>(11.99)  | -58.79***<br>(12.03)  | -58.61***<br>(11.96)  | -67.68***<br>(14.74)  | -66.39***<br>(14.14)  | -67.81***<br>(14.71)  | -67.07***<br>(14.27)  |
| Growth Rate                     | -0.62*<br>(0.37)      | -0.75**<br>(0.35)     | -0.59<br>(0.38)       | -0.68*<br>(0.36)      | -0.70<br>(0.44)       | -0.86**<br>(0.41)     | -0.68<br>(0.45)       | -0.79*<br>(0.43)      |
| Import Exposure                 | -16.17***<br>(4.82)   | -16.32***<br>(4.76)   | -16.21***<br>(4.82)   | -16.18***<br>(4.74)   | -13.38**<br>(6.67)    | -13.44**<br>(6.63)    | -13.44**<br>(6.68)    | -13.31**<br>(6.61)    |
| Resource Rents                  | -2.04<br>(3.12)       | -1.92<br>(3.11)       | -2.12<br>(3.12)       | -2.00<br>(3.10)       | -0.65<br>(3.43)       | -0.50<br>(3.43)       | -0.63<br>(3.42)       | -0.51<br>(3.41)       |
| Output (HFA)                    | 10.57<br>(7.42)       | 10.38<br>(7.18)       | 10.91<br>(7.45)       | 10.63<br>(7.21)       | 8.37<br>(8.25)        | 7.61<br>(8.06)        | 8.50<br>(8.22)        | 7.77<br>(8.07)        |
| Rule of Law                     | 0.09<br>(8.43)        | -2.45<br>(8.33)       | 0.32<br>(8.44)        | -1.80<br>(8.33)       | 9.39<br>(8.59)        | 6.49<br>(8.48)        | 9.59<br>(8.63)        | 7.30<br>(8.47)        |
| Constant                        | 716.35***<br>(138.57) | 707.59***<br>(139.54) | 722.56***<br>(139.10) | 717.28***<br>(138.92) | 835.66***<br>(170.81) | 816.43***<br>(163.73) | 837.40***<br>(170.85) | 825.11***<br>(165.27) |
| <i>N</i>                        | 863                   | 863                   | 863                   | 863                   | 872                   | 872                   | 872                   | 872                   |
| Countries                       | 61                    | 61                    | 61                    | 61                    | 61                    | 61                    | 61                    | 61                    |
| <i>R</i> <sup>2</sup> (within)  | 0.50                  | 0.51                  | 0.50                  | 0.51                  | 0.50                  | 0.51                  | 0.50                  | 0.51                  |
| <i>R</i> <sup>2</sup> (between) | 0.05                  | 0.05                  | 0.05                  | 0.05                  | 0.04                  | 0.04                  | 0.04                  | 0.04                  |
| <i>R</i> <sup>2</sup> (overall) | 0.06                  | 0.06                  | 0.06                  | 0.06                  | 0.04                  | 0.04                  | 0.04                  | 0.04                  |
| Covariates                      | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   |
| Country FEs                     | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   |

Notes: Estimates for covariates are omitted; full results are reported in the Appendix. Clustered standard errors are in parentheses; \*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

Table 4.11: Manufacturing and Non-Manufacturing FDI (5K Threshold)

|                                  | HHI                   |                       |                       |                       | CR4                   |                       |                       |                       |
|----------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                  | (1)                   | (2)                   | (3)                   | (4)                   | (5)                   | (6)                   | (7)                   | (8)                   |
| Manuf FDI                        | 0.18<br>(0.19)        | 1.90***<br>(0.69)     |                       |                       | 0.06<br>(0.19)        | 1.83***<br>(0.64)     |                       |                       |
| Manuf FDI $\times$<br>GDP PC     |                       | -0.82***<br>(0.28)    |                       |                       |                       | -0.85***<br>(0.27)    |                       |                       |
| Non-Manuf FDI                    |                       |                       | 0.04<br>(0.09)        | 0.91**<br>(0.36)      |                       |                       | -0.02<br>(0.09)       | 0.84**<br>(0.33)      |
| Non-Manuf FDI $\times$<br>GDP PC |                       |                       |                       | -0.38***<br>(0.14)    |                       |                       |                       | -0.38***<br>(0.13)    |
| GDP PC                           | 63.61***<br>(19.90)   | 68.37***<br>(19.11)   | 64.49***<br>(19.96)   | 67.43***<br>(19.45)   | 71.37***<br>(22.57)   | 76.34***<br>(21.82)   | 72.09***<br>(22.52)   | 75.10***<br>(22.14)   |
| RPE                              | -10.47<br>(10.46)     | -12.39<br>(10.47)     | -10.23<br>(10.46)     | -12.46<br>(10.48)     | -13.64<br>(12.43)     | -15.62<br>(12.53)     | -13.45<br>(12.41)     | -15.64<br>(12.46)     |
| Infant Mortality                 | 24.75***<br>(5.85)    | 23.64***<br>(5.72)    | 24.97***<br>(5.82)    | 23.96***<br>(5.77)    | 26.33***<br>(7.43)    | 25.19***<br>(7.40)    | 26.44***<br>(7.39)    | 25.48***<br>(7.41)    |
| Democracy                        | -0.45<br>(0.27)       | -0.43<br>(0.26)       | -0.46<br>(0.27)       | -0.45<br>(0.27)       | -0.47<br>(0.41)       | -0.44<br>(0.39)       | -0.47<br>(0.41)       | -0.46<br>(0.40)       |
| GDP                              | -59.51***<br>(19.04)  | -61.88***<br>(18.60)  | -60.24***<br>(19.14)  | -61.83***<br>(18.87)  | -72.01***<br>(23.05)  | -74.51***<br>(22.52)  | -72.64***<br>(23.06)  | -74.25***<br>(22.81)  |
| Growth Rate                      | -0.42<br>(0.47)       | -0.60<br>(0.45)       | -0.38<br>(0.47)       | -0.54<br>(0.46)       | -0.62<br>(0.60)       | -0.84<br>(0.59)       | -0.59<br>(0.60)       | -0.77<br>(0.60)       |
| Import Exposure                  | -15.24**<br>(6.01)    | -15.01**<br>(5.93)    | -15.22**<br>(6.00)    | -14.97**<br>(5.93)    | -15.49*<br>(8.25)     | -15.29*<br>(8.17)     | -15.51*<br>(8.25)     | -15.28*<br>(8.16)     |
| Resource Rents                   | -5.70*<br>(3.28)      | -6.16*<br>(3.19)      | -5.79*<br>(3.30)      | -6.03*<br>(3.21)      | -2.61<br>(3.81)       | -3.14<br>(3.68)       | -2.62<br>(3.80)       | -2.91<br>(3.70)       |
| Output (HFA)                     | 10.11*<br>(5.75)      | 9.60*<br>(5.53)       | 10.34*<br>(5.78)      | 9.87*<br>(5.55)       | 9.39<br>(7.32)        | 9.03<br>(7.09)        | 9.61<br>(7.28)        | 9.19<br>(7.09)        |
| Rule of Law                      | 4.39<br>(7.85)        | 1.32<br>(7.57)        | 4.71<br>(7.84)        | 2.20<br>(7.69)        | 16.19*<br>(9.52)      | 12.88<br>(9.23)       | 16.49*<br>(9.53)      | 13.84<br>(9.29)       |
| Constant                         | 742.64***<br>(226.22) | 769.51***<br>(220.91) | 750.88***<br>(227.61) | 769.00***<br>(224.02) | 915.86***<br>(273.99) | 944.38***<br>(267.49) | 923.10***<br>(274.38) | 941.66***<br>(270.84) |
| <i>N</i>                         | 659                   | 659                   | 659                   | 659                   | 659                   | 659                   | 659                   | 659                   |
| Countries                        | 50                    | 50                    | 50                    | 50                    | 50                    | 50                    | 50                    | 50                    |
| $R^2$ (within)                   | 0.52                  | 0.53                  | 0.52                  | 0.53                  | 0.50                  | 0.51                  | 0.50                  | 0.51                  |
| $R^2$ (between)                  | 0.02                  | 0.02                  | 0.02                  | 0.02                  | 0.00                  | 0.00                  | 0.00                  | 0.00                  |
| $R^2$ (overall)                  | 0.05                  | 0.05                  | 0.05                  | 0.05                  | 0.03                  | 0.03                  | 0.03                  | 0.03                  |
| Covariates                       | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   |
| Country FEs                      | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   | Yes                   |

Notes: Estimates for covariates are omitted; full results are reported in the Appendix. Clustered standard errors are 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.<sup>1</sup> 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

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<sup>1</sup>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.<sup>2</sup> 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.<sup>3</sup>

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

We argue that foreign investment may exacerbate corruption when foreign entrants are more productive than incumbent firms and contribute to the creation of economic rents. As discussed in Chapter 3, in some settings these excess returns arise because foreign entry induces the contraction or exit of less productive local firms, increases market concentration, and raises markups; in other settings, they arise because more productive firms earn higher operating and economic profits through scale economies, lower costs, preferential regulatory access, or control over valuable location-specific assets. High rents and quasi-rents increase the value of licenses, permits, contracts, zoning decisions, and other government goods and services, thereby heightening public officials' incentives to use their authority for private gain.

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<sup>2</sup>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.

<sup>3</sup>Nandita Bose, "Walmart to Pay \$282 Million to Settle Seven-Year Global Corruption Probe," *Reuters*, June 21, 2019, <https://www.reuters.com/article/business/walmart-to-pay-282-million-to-settle-seven-year-global-corruption-probe-idUSKCN1TL27I/>.

<sup>4</sup>Gabriela Mello, "Carrefour Brasil Targeted in São Paulo Bribery Probe," *Reuters*, May 28, 2020, <https://www.reuters.com/article/business/carrefour-brasil-targeted-in-sao-paulo-bribery-probe-may-face-heavy-fine-idUSKBN234259/>. "GlaxoSmithKline Fined \$490M by China for Bribery," *BBC*, September 19, 2014, <https://www.bbc.com/news/business-29274822>. "Skanska's Bribes Scandal Shakes Kirchner Government," *Mercopress*, May 24, 2007, <https://en.mercopress.com/2007/05/24/skanska-s-bribes-scandal-shakes-kirchner-government>. We provide a detailed account of the Rolls-Royce case later in the chapter.

At the same time, firms earning substantial profits or quasi-rents are better able to pay bribes and absorb the additional costs of doing business. We further posit that a country's level of political and institutional development can mitigate this effect. Strong political and legal institutions increase the likelihood of detection and enforcement, thereby reducing both the incentives and the opportunities for engaging in corrupt practices.

The remainder of this chapter proceeds as follows. We begin with a brief review of 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 political and legal institutions. We then discuss our identification strategy based on an instrumental variable approach and empirically test our hypotheses using data from a sample of developing countries. The chapter concludes with a discussion of the findings and their broader theoretical implications.<sup>5</sup>

## 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

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<sup>5</sup>The rest of the chapter builds upon and extends [Pinto and Zhu \(2016\)](#).

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 may contribute to corruption in developing 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 and induce contraction or exit among less productive firms, resulting in market concentration and rent creation. This rent-creation effect is particularly pronounced in less developed countries, where indigenous firms are small and have low productivity. In a cross-sectional study, [Pinto and Zhu \(2016\)](#), on which this chapter builds, show that inward FDI is associated with higher corruption in developing countries, and that this marginal effect turns negative in developed countries. By focusing on China and leveraging subnational variation, [Zhu \(2017\)](#) shows that FDI inflows and MNC activity are strongly correlated 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 Kot-](#)

sadam (2020) combine geo-referenced FDI project data from *fDi Markets* with survey data from Afrobarometer. They find that FDI projects, particularly those originating from non-signatories to OECD ABC, are associated with lower levels of local citizens' experiences of corruption.<sup>6</sup> They attribute this counterintuitive result 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 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,<sup>7</sup> 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 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.

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<sup>6</sup>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.

<sup>7</sup>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).

### 5.3 Our Argument

Corruption refers to the misuse of public office for private gain ([Bardhan, 1997](#); [Rose-Ackerman, 1999](#)). In Chapters 3 and 4, we have established both theoretically and empirically that FDI inflows and MNC activity can lead to the creation of economic rents in developing countries, as large and highly productive foreign firms induce contraction or exit among less productive domestic counterparts. 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 rents they are able to extract. These rents provide the financial capacity to internalize the costs of corruption. In other words, firms with high markups and substantial rents are better able to absorb bribe payments without significantly reducing their profit margins.

On the supply side of corruption, public officials 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 officials' "control rights"—discretionary authority that public officials have over the allocation, approval, or enforcement of government policies, resources, and regulations, thereby increasing the potential gains from exchanging these 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, public officials 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 increase 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. Therefore, we hypothesize that, all else being equal, higher levels of inward FDI lead to more corruption in developing countries.

## 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 ([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 next 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 empirical evaluation of our hypotheses, we examine several high-profile corruption scandals involving MNCs. These cases illustrate how dominant MNCs use bribery to navigate regulatory environments and to expand their businesses in developing countries; at the same time, MNC activity creates opportunities for local officials with regulatory authority to extract bribes.

## Wal-Mart in Mexico and Beyond

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). Reports show that 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.<sup>8</sup>

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, supermarkets and restaurants and a workforce of 221,000 employees, Wal-Mart was the largest private employer in the country.<sup>9</sup> Wal-Mart's rapid expansion in Mexico, which was fueled in part by illicit payments, 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 (Walmex) 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, Walmex was able to suppress competition and entrench its market dominance.<sup>10</sup>

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<sup>8</sup>U.S. Department of Justice, "Walmart Inc. and Brazil-Based Subsidiary Agree to Pay \$137 Million to Resolve Foreign Corrupt Practices Act Case," June 20, 2019, <https://www.justice.gov/archives/opa/pr/walmart-inc-and-brazil-based-subsidiary-agree-pay-137-million-resolve-foreign-corrupt>.

<sup>9</sup>Barstow and Xanic von Bertrab, "The Bribery Aisle."

<sup>10</sup>Barstow and Xanic von Bertrab, "The Bribery Aisle."

The Walmex corruption scandal provides a revealing case of how a large multinational with dominant market power uses bribery to navigate regulatory environments in which public officials possess significant discretionary authority. The Teotihuacán project, in particular, offers unusually detailed evidence, drawn from internal company documents, investigative reporting, and regulatory findings, of how bribery can be embedded within formal permitting processes.

The Teotihuacán project emerged as a strategically valuable but highly constrained opportunity. The proposed site, located near the entrance to the town and close to the pyramids, was attractive for retail traffic and market positioning. However, a 2003 zoning plan explicitly prohibited commercial development on the site in order to protect the archaeological zone.<sup>11</sup> This restriction constituted a binding legal barrier. Under normal circumstances, Walmex would not have been permitted to build on the site.

Rather than abandoning the project, Walmex executives sought to reverse the regulatory outcome. Investigative evidence shows that the company arranged to bribe a government official to alter the zoning map before its official publication, which was the final step required for it to become law.<sup>12</sup> By intervening at this stage, Walmex effectively changed the legal classification of the land. When the zoning map was published, the site had been reclassified to permit commercial development. Construction proceeded shortly thereafter, and the store opened in late 2004 despite sustained public protests.<sup>13</sup>

The zoning change alone was insufficient to complete the project. Additional approvals were required from municipal authorities and federal agencies, including the National Institute of Anthropology and History (INAH). Internal Wal-Mart documents later reviewed by the U.S. House Committee on Oversight indicate that:

*“The payments at the Teotihuacán site were made to the majority of the Municipal Council for 1.2 million pesos; and The National Institute of Anthropology and*

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<sup>11</sup>Barstow and Xanic von Bertrab, “The Bribery Aisle.”

<sup>12</sup>Barstow and Xanic von Bertrab, “The Bribery Aisle.”

<sup>13</sup>Barstow and Xanic von Bertrab, “The Bribery Aisle.”

*History (INAH) required an official donation of 500,000 pesos and a ‘personal irregular gift of \$400,000 for the INAH’s Director.’ ”<sup>14</sup>*

These payments were directly tied to regulatory decisions, including archaeological clearance and construction authorization.<sup>15</sup> Additional records show that payments were requested for specific administrative steps, such as obtaining a highway ruling and certification of excavation work.<sup>16</sup>

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, allowing systemic risks to persist.<sup>17</sup>

The Wal-Mart corruption scandal provides striking evidence of how a giant multinational

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<sup>14</sup>U.S. House Committee on Oversight, “Reps. Cummings and Waxman Release Documents Showing That Wal-Mart’s CEO Was Informed of Mexican Bribery Allegations in 2005,” January 11, 2013, <https://oversightdemocrats.house.gov/news/press-releases/rep-cummings-and-waxman-release-documents-showing-that-wal-mart-s-ceo-was>.

<sup>15</sup>U.S. House Committee on Oversight, “Reps. Cummings and Waxman Release Documents.”

<sup>16</sup>U.S. House Committee on Oversight, “Reps. Cummings and Waxman Release Documents.”

<sup>17</sup>U.S. Department of Justice, “Walmart Inc. and Brazil-Based Subsidiary.”

can use bribery to facilitate the approval of licenses and permits, and even to obtain outcomes otherwise prohibited by law. At the same time, Wal-Mart's operations created opportunities for local officials with regulatory authority to extract bribes. One internal report noted that, in India, Wal-Mart would be "targeted by corrupt individuals and organizations seeking bribes or kickbacks in exchange for favorable business relationships or the relaxation of bureaucratic constraints."<sup>18</sup>

In Mexico, when issues arose, Walmex typically negotiated payments with relevant officials to secure administrative approvals and move projects forward.<sup>19</sup> When interviewed by *The Times*, a former real estate executive and in-house lawyer who resigned in September 2004 recounted the persistent "pressure and stress" of engaging in long-term corrupt practices, particularly in dealing with "greedy" officials who escalated their demands for bribes.<sup>20</sup> In the Teotihuacán project, internal Wal-Mart documents indicate that INAH requested both a donation and a personal gift to its director in exchange for approving the construction permit.<sup>21</sup>

## 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.<sup>22</sup> 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

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<sup>18</sup>U.S. Securities and Exchange Commission, *In the Matter of Walmart Inc.*, Securities Exchange Act of 1934 Release No. 86159, June 20, 2019, <https://www.sec.gov/files/litigation/admin/2019/34-86159.pdf>.

<sup>19</sup>U.S. Securities and Exchange Commission, *In the Matter of Walmart Inc.*.

<sup>20</sup>Barstow, "Vast Mexico Bribery Case."

<sup>21</sup>U.S. House Committee on Oversight, "Reps. Cummings and Waxman Release Documents."

<sup>22</sup>U.S. Department of Justice, "Rolls-Royce plc Agrees to Pay \$170 Million Criminal Penalty to Resolve Foreign Corrupt Practices Act Case," January 17, 2017, <https://www.justice.gov/archives/opa/pr/rolls-royce-plc-agrees-pay-170-million-criminal-penalty-resolve-foreign-corrupt-practices-act>.

million in bribes to officials across at least seven countries: China, India, Indonesia, Thailand, Russia, Nigeria, and Malaysia.<sup>23</sup> 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 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 fee.<sup>24</sup>

The Rolls-Royce corruption case in Russia clearly illustrates how lucrative contracts can tempt both MNCs and government officials into quid pro quo arrangements. The case involves a Rolls-Royce subsidiary, Rolls-Royce Energy Systems, Inc. (RRESI), on a 2008 contract to supply gas compression equipment to Gazprom (a Russian state-owned company) for the Portovaya liquefied natural gas project. Evidence from enforcement proceedings indicates that the contract was secured through a bribery scheme involving senior company employees, intermediaries, and a key official within Gazprom. Prior to and during the tender process, Rolls-Royce personnel cultivated relationships with Gazprom officials, including one official whose influence proved critical. During the bidding process, the key Gazprom official explicitly requested payment in exchange for supporting Rolls-Royce's bid during the tender process.<sup>25</sup>

In response, senior Rolls-Royce employees coordinated with intermediaries to structure commission payments, with the understanding that a portion would be transferred to the

<sup>23</sup>U.S. Department of Justice, "Rolls-Royce plc."

<sup>24</sup>"Rolls-Royce Apologises After £671M Bribery Settlement," *BBC News*, January 18, 2017, <https://www.bbc.com/news/business-38644114>.

<sup>25</sup>SFO v Rolls-Royce plc & anor., Judgment (UK Serious Fraud Office), paras. 76–82.

official. These arrangements were deliberately kept within a small circle of employees, and internal communications reveal efforts to avoid documenting sensitive discussions. The total commissions paid to intermediaries amounted to approximately £8 million.<sup>26</sup> Rolls-Royce was subsequently selected as the preferred bidder in June 2008, with internal correspondence acknowledging that the Gazprom official had been “instrumental” in securing the contract. The contract was finalized later that year, generating substantial profits for the firm.<sup>27</sup>

Likewise, the Rolls-Royce corruption case involving Thailand’s state-owned energy firm, PTT Public Company Ltd. (PTT), and its subsidiary, PTT Exploration and Production Public Company (PTTEP), reveals a sustained bribery scheme spanning roughly 2000 to 2012. Rolls-Royce and its subsidiary RRESI engaged intermediaries with the understanding that commission payments would be used, at least in part, to bribe foreign officials responsible for awarding contracts.<sup>28</sup>

In the case of the GSP-5 gas separator project, internal communications indicate that intermediaries had already committed substantial portions of these commissions to officials to secure favorable treatment. This created pressure on Rolls-Royce to honor these arrangements even after the firm introduced internal limits on commission payments. Employees expressed concern that intermediaries would be “out of pocket” or unable to maintain relationships with key “players” if payments were reduced. To manage these constraints, Rolls-Royce employees actively sought ways to meet intermediaries’ and officials’ expectations. While formally complying with corporate policies, they managed to circumvent commission caps by disguising excess payments as separate contractual expenses, such as fictitious engineering or coordination services. These arrangements allowed total compensation to exceed official limits while preserving the flow of funds to intermediaries and, ultimately, to public officials.<sup>29</sup>

<sup>26</sup>SFO v Rolls-Royce plc & anor., paras. 78–79.

<sup>27</sup>SFO v Rolls-Royce plc & anor., paras. 79–81.

<sup>28</sup>*United States v. Rolls-Royce PLC*, No. 2:16-cr-247 (S.D. Ohio 2016), Attachment A, para. 18.

<sup>29</sup>*United States v. Rolls-Royce PLC*, Attachment A, paras. 26–35.

Similar dynamics are evident in the Kazakhstan case involving contracts with Asia Gas Pipeline (AGP), a joint venture between Kazakh and Chinese state-owned firms. In 2009, representatives of Rolls-Royce and RRESI met in Zurich with an intermediary and a representative of a foreign official. During this meeting, the official's representative demanded a substantial commission in exchange for providing access to decision-makers and the ability to "fix" problems. Subsequent communications emphasized that higher commission payments were considered the minimum necessary from the Kazakh side.<sup>30</sup> In the months that followed, Rolls-Royce employees worked closely with the intermediary to structure payments that would meet these expectations. Internal communications explicitly acknowledged that portions of the commissions would be used to bribe a foreign official associated with AGP. Senior employees met repeatedly in London and Istanbul to negotiate increased commission levels while minimizing internal scrutiny. RRESI was ultimately awarded contracts to supply 11 gas turbine units, valued at approximately \$145 million.<sup>31</sup>

Despite repeated internal warnings and audit findings, Rolls-Royce 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.<sup>32</sup>

Ultimately, Rolls-Royce was charged with conspiracy to corrupt, false accounting, and failure to prevent bribery under the UK Bribery Act.<sup>33</sup> 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

<sup>30</sup> *United States v. Rolls-Royce PLC*, Attachment A, para. 48.

<sup>31</sup> *United States v. Rolls-Royce PLC*, Attachment A, paras. 50–53.

<sup>32</sup> Rob Evans, David Pegg, and Holly Watt. "Rolls-Royce to Pay £671M over Bribery Claims," *The Guardian*, January 16, 2017, <https://www.theguardian.com/business/2017/jan/16/rolls-royce-to-pay-671m-over-bribery-claims>.

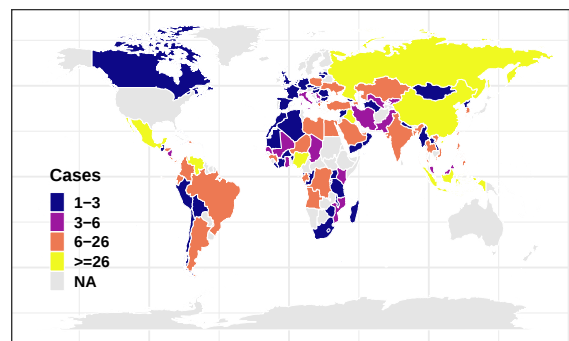
<sup>33</sup> Serious Fraud Office, "Deferred Prosecution Agreement: Rolls-Royce plc," January 28, 2022, [https://assets.publishing.service.gov.uk/media/67c061c4750837d7604dbc66/DPA\\_-\\_Rolls\\_Royce\\_-\\_170117.pdf](https://assets.publishing.service.gov.uk/media/67c061c4750837d7604dbc66/DPA_-_Rolls_Royce_-_170117.pdf).

global reach of anti-bribery enforcement.

## FCPA Cases

Bribery is not uncommon in MNCs' overseas operations. To illustrate, Figures 5.1 and 5.2 present the geographic distribution of bribery cases and the industry composition of enforcement actions under the Foreign Corrupt Practices Act (FCPA).<sup>34</sup> We can see that most bribery occurs in developing countries, especially those with high rent-extraction opportunities and weak institutions (Figures 5.1). The top 10 countries are China, Nigeria, Mexico, Iraq, Indonesia, Venezuela, Russia, India, Argentina, and Saudi Arabia. These bribery cases occur not only in resource sectors, but also frequently in other manufacturing and service industries (Figure 5.2).

Figure 5.1: Geographic Distribution of Bribery in FCPA Cases (1978–2017)

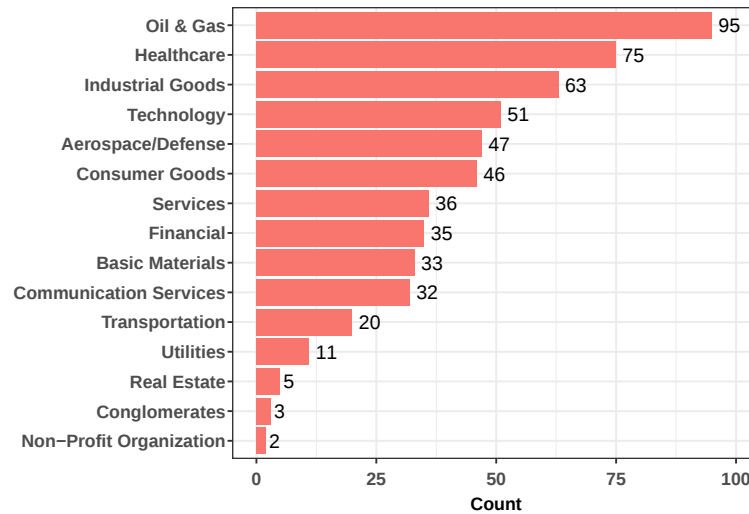


*Notes:* Locations where bribes were offered or paid across all FCPA cases from 1978 to 2017. NA indicates that no cases are reported. Data are from Xu (2025).

Our case studies collectively show that MNC activity can exacerbate corruption in developing countries, particularly in environments characterized by limited competition, high rent extraction, and weak institutions. The Wal-Mart and Rolls-Royce cases illustrate how

<sup>34</sup>Enacted in 1977, the U.S. FCPA bars firms and individuals from offering or providing payments or other benefits to foreign public officials in order to secure or maintain business advantages. The statute applies not only to U.S. corporations and citizens but also to foreign companies listed on U.S. exchanges, as well as to conduct that occurs within U.S. jurisdiction. In addition to its anti-bribery provisions, the FCPA requires firms to maintain accurate financial records and implement internal controls designed to prevent illicit payments. Violations may result in substantial criminal and civil penalties. See U.S. Department of Justice, Criminal Division, and U.S. Securities and Exchange Commission, Enforcement Division, 2020, *A Resource Guide to the U.S. Foreign Corrupt Practices Act*, 2nd ed, <https://www.justice.gov/criminal/criminal-fraud/file/1292051/dl?inline>.

Figure 5.2: Industry Distribution of FCPA Cases (1978–2024)



*Notes:* Bars represent the total number of cases. Data are from Stanford Law School’s Foreign Corrupt Practices Act Clearinghouse (<https://fcpa.stanford.edu>). Classification is based on the industry of the company defendants or other involved parties.

high levels of rent extraction can enable firms to offer lucrative bribes in order to navigate regulatory environments and further strengthen their market positions. Although MNCs may face legal consequences for such behavior, enforcement is often weak or politically selective (Tomashevskiy, 2021), and home governments may hesitate to impose severe penalties that could undermine the global competitiveness of domestic firms (Crippa, Malesky and Picci, 2025). At the same time, these cases also demonstrate that local government officials are not merely passive recipients of bribes. Rather, they actively exploit their regulatory authority over licenses and permits, access to confidential information, and influence over contract allocation to extract private gains.

Importantly, our argument centers on the rent-creation effects of MNC activity and their implications for corruption. We *do not* claim that MNCs are categorically more prone to corruption than domestic firms. As discussed in Chapter 3, rents may be shared with local firms through procurement relationships, subcontracting, and vertical linkages (Davis, Kaplinsky and Morris, 2018; Milberg and Winkler, 2013; Zhu, 2017). Moreover, when production and sales become concentrated among a smaller number of firms, both domestic and

foreign firms may be able to extract economic rents.

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.<sup>35</sup> 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.  $\beta_1$ ,  $\beta_2$ , and  $\beta_3$  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 corruption, and  $\xi$  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

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<sup>35</sup>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.

of corruption measures: “subjective” and “objective.”<sup>36</sup> 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 businesspeople, 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).

“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 (Zhu, 2017). 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.

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<sup>36</sup>See, for example, Treisman (2007) for a detailed discussion of the advantages and disadvantages of “subjective” vs. “objective” measures of corruption.

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.<sup>37</sup> Similarly, the WBES asks firms whether an informal gift or payment was expected or requested in public transactions dealing with utilities, permits, licenses, and taxes.<sup>38</sup>

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.<sup>39</sup> V-Dem relies on coders from a pool of over 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 in-

<sup>37</sup>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?”

<sup>38</sup>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?”

<sup>39</sup>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.

dicators cover the time span from 1900 to the present and some of them also cover the time span from 1789 to 1900.

The V-Dem corruption indices arguably 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.<sup>40</sup> The political corruption index (*v2x\_corr*, “How pervasive is political corruption?”) is the average of four corruption indices: (1) public sector corruption index,<sup>41</sup> (2) executive corruption index,<sup>42</sup> (3) legislative corruption,<sup>43</sup> and (4) judicial corruption.<sup>44</sup>

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,<sup>45</sup> executive bribes,<sup>46</sup> legislative corruption, and judicial corruption.

Table 5.1 presents the pairwise correlations 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.<sup>47</sup> The correlation is lowest for the

<sup>40</sup>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.

<sup>41</sup>*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 public funds or other state resources for personal or family use?”

<sup>42</sup>*v2x\_execorr*: “How routinely do members of the executive, or their agents grant favors in exchange for bribes, kickbacks, or other material inducements, and how often do they steal, embezzle, or misappropriate public funds or other state resources for personal or family use?”

<sup>43</sup>*v2lgcrrpt*. “Do members of the legislature abuse their position for financial gain?”

<sup>44</sup>*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?”

<sup>45</sup>*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?”

<sup>46</sup>*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 other material inducements?”

<sup>47</sup>For easy interpretation, we have reversed the values of other corruption measures so that a higher value indicates more corruption.

Table 5.1: Pairwise Correlation of Corruption Indices

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

*Note:* Number of observations in parentheses.

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 overlapping 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 (PPP-adjusted). 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 control for host countries' GDP per capita (PPP-adjusted), which is the most significant predictor of corruption identified in the empirical literature (Treisman, 2007). To capture 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 Jagers, 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, FCPA enforcement, religious composition (the shares

of Protestants, Catholics, and Muslims), and legal system origin (British, French, or other). Higher economic growth is expected to expand economic activity and intensify competition, thereby reducing rents and lowering incentives for corruption. Trade openness is also expected, on average, to be negatively associated with corruption, as greater import competition can erode protection rents and limit opportunities for rent extraction. At the same time, aggregate trade openness combines import-disciplining and export-expansion channels that may operate in opposite directions, making its overall effect less direct than that of inward FDI. In contrast, countries with abundant natural resources are generally more vulnerable to corruption, as resource windfalls can weaken government accountability and foster clientelistic networks (Ross, 2015). Finally, enforcement of the U.S. FCPA is extraterritorial, serving as a proxy for the strengthening of international anticorruption norms and thereby increasing both the risks and costs associated with overseas bribery by MNCs (Crippa, Malesky and Picci, 2025; Xu, 2025).<sup>48</sup>

Scholars have long debated whether religious traditions and legal origins shape corruption and government performance. Some argue that Catholicism and Islam are associated with higher corruption and weaker governance than Protestantism, which is linked to individualism, pluralism, and stronger civic institutions (La Porta et al., 1999; La Porta, Florencio, Shleifer and Vishny, 1997; Lipset and Lenz, 2000). Similarly, legal origins are thought to matter: civil law systems, historically tied to centralized state authority, are seen as more bureaucratic and prone to discretion and rent-seeking, whereas common law systems emphasize judicial independence and constraints on executive power, which may support better governance (La Porta et al., 1999; Treisman, 2000). However, this literature remains contested (Beck, Demirgüç-Kunt and Levine, 2001; Haggard, MacIntyre and Tiede, 2008).

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

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<sup>48</sup>We use the annual number of U.S. FCPA enforcement cases to capture temporal variation in extraterritorial legal intervention. The data are drawn from the Stanford Law School Foreign Corrupt Practices Act Clearinghouse (<https://fcpa.stanford.edu>).

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 \(2008\)](#).

## 5.6 Endogeneity, Selection Bias, and Instrumental Variable

One empirical challenge to examining FDI's political consequences in host countries is endogeneity and selection bias. The insights from the obsolescing bargain model suggest that foreign capital is footloose *ex ante*; however, once foreign investment takes place, MNCs place physical assets in a foreign country and thus become *ex post* immobile ([Vernon, 1971, 1977](#)). This *ex post* immobility gives rise to host governments' opportunistic behavior to take advantage of MNCs. 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 because investors require higher expected returns, supported by productivity advantages and rents, to compensate for the risks of entering and operating in these countries. This likely 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:

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

where  $i = 1, 2, 3, \dots, N$ ,  $j = 1, 2, 3, \dots, 20$ , and  $t = 1, 2, 3, \dots, T$ , 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.<sup>49</sup> This IV varies both cross-sectionally and temporally. The former is determined by a country's geographic location relative to 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.

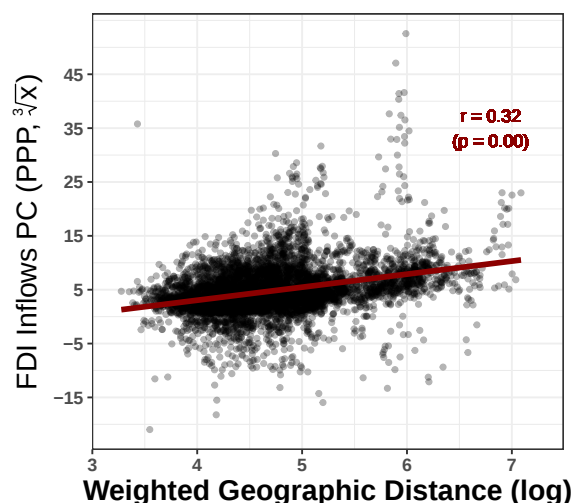
Figure 5.3 presents a plot of the IV (GEOGRAPHIC CLOSENESS) against real per capita FDI inflows. As expected, the IV is positively and significantly correlated with FDI inflows per capita. The Pearson correlation between the IV and FDI inflows per capita is 0.32 ( $p = 0.00$ ).<sup>50</sup> The figure also shows several outliers, primarily due to the highly skewed distribution of the FDI inflows data.

Pinto and Zhu (2016) discuss in detail 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,

<sup>49</sup>The inter-capital geographic distance data are from the CEPII Gravity Database (Conte, Cotterlaz and Mayer, 2022).

<sup>50</sup>The Pearson correlation between GEOGRAPHIC CLOSENESS and real FDI stocks per capita is 0.36 ( $p = 0.00$ ).

Figure 5.3: 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.

the weighted distance to the 20 wealthiest economies is not a strong instrument for trade openness.<sup>51</sup> 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,

<sup>51</sup>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.

and employs anchoring vignettes to screen out unqualified coders and ensure inter-coder consistency.<sup>52</sup> Overall, we are confident that the weighted distance measure provides a valid instrument for inward 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.

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 (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 IV approach.

In Models 3 and 4 of Table 5.2, we re-estimate Models 1 and 2 by instrumenting FDI inflows using GEOGRAPHIC CLOSENESS. The  $F$ -statistic of the excluded instrument in the first-stage regressions for both models is 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 regression results in both models show that the magnitude of the FDI coefficient increases substantially and becomes statistically significant at conventional levels. Evidently, endogeneity biases the OLS estimates downward.

Substantively, take Model 3 as an example, holding other factors constant, a one stan-

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<sup>52</sup>Coppedge, Gerring, Knutsen, Lindberg, Teorell, Marquardt, Medzihorsky, Pemstein, Gastaldi, Grahn, Pernes, Rydén, von Römer, Tzelgov, Wang and Wilson (2024).

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

|                                | (1)                | (2)                | (3)                  | (4)                  | (5)                  | (6)                  |
|--------------------------------|--------------------|--------------------|----------------------|----------------------|----------------------|----------------------|
| FDI Inflows PC                 | 0.02<br>(0.02)     | 0.02<br>(0.02)     | 5.01***<br>(1.28)    | 4.90***<br>(1.33)    | 4.43***<br>(1.09)    | 4.56***<br>(1.14)    |
| GDP PC                         | -1.67***<br>(0.55) | 2.13***<br>(0.51)  | -12.34***<br>(2.79)  | -11.30***<br>(2.94)  | -11.27***<br>(2.49)  | -11.20***<br>(2.52)  |
| Democracy                      | -0.09***<br>(0.03) | -0.08**<br>(0.03)  | -0.49***<br>(0.17)   | -0.47***<br>(0.17)   | -0.47***<br>(0.16)   | -0.47***<br>(0.17)   |
| Growth Rate                    | 0.03<br>(0.04)     | -0.03<br>(0.04)    | -1.02<br>(0.63)      | -0.98<br>(0.64)      | -0.76<br>(0.54)      | -0.78<br>(0.56)      |
| Trade Openness                 | -0.32<br>(0.29)    | -0.12<br>(0.29)    | -3.75**<br>(1.80)    | -3.23*<br>(1.79)     | -2.45<br>(1.52)      | -2.47<br>(1.54)      |
| Resource Rents                 | 0.25<br>(0.27)     | -0.13<br>(0.27)    | 3.04*<br>(1.59)      | 2.34<br>(1.68)       | 2.41<br>(1.62)       | 2.26<br>(1.65)       |
| FCPA Enforcement               | -0.01<br>(0.01)    | -0.01*<br>(0.01)   | -0.07*<br>(0.04)     | -0.08**<br>(0.04)    | -0.09**<br>(0.04)    | -0.10**<br>(0.04)    |
| % of Protestants               |                    |                    |                      |                      | 0.20<br>(0.22)       | 0.21<br>(0.22)       |
| % of Catholics                 |                    |                    |                      |                      | 0.24***<br>(0.09)    | 0.21**<br>(0.10)     |
| % of Muslims                   |                    |                    |                      |                      | 0.24***<br>(0.09)    | 0.19**<br>(0.09)     |
| British Legal Origin           |                    |                    |                      |                      |                      | 7.68<br>(8.12)       |
| French Legal Origin            |                    |                    |                      |                      |                      | 25.02***<br>(6.80)   |
| Constant                       | 73.59***<br>(5.10) | 43.19***<br>(0.37) | 154.35***<br>(22.64) | 146.32***<br>(23.72) | 128.69***<br>(19.36) | 112.15***<br>(20.90) |
| <i>N</i>                       | 4467               | 4343               | 4467                 | 4467                 | 3977                 | 3969                 |
| Countries                      | 124                | 123                | 124                  | 124                  | 123                  | 122                  |
| Country FEs                    | No                 | Yes                | No                   | Yes                  | No                   | No                   |
| <i>F-stat</i> (Excluded Instr) |                    |                    | 28.36                | 25.57                | 33.33                | 31.37                |
| <i>P &gt; F</i>                |                    |                    | 0.00                 | 0.00                 | 0.00                 | 0.00                 |

Notes: Clustered standard errors in parentheses;

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

dard deviation increase in per capita FDI inflows (approximately 4.07 units or \$67.42) raises corruption levels by 20.37 units, which corresponds to approximately 0.83 standard deviations on the political corruption index (ranging from 0 to 100).<sup>53</sup> Regarding other control

<sup>53</sup>The original scale of the corruption index ranges from 0 to 1. We have rescaled it to 0–100 for ease of

variables, GDP per capita, democracy, trade openness, and FCPA enforcement appear to exert a negative effect on corruption, whereas natural resource rents are positively associated with corruption.<sup>54</sup> Overall, these results are sensible and align with findings in the existing literature (see Treisman, 2007).

The 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 RE specification as our preferred 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. The RE model also allows us to estimate coefficients for time-invariant covariates.

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 6 in Table 5.2. Our main finding remains essentially unchanged: FDI continues to have a strong positive effect on corruption.

We further explore corruption indices from the World Bank and the ICRG in Models 2 and 3, respectively.<sup>55</sup> One caveat when using these indices in panel analysis is that changes

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interpretation of regression coefficients.

<sup>54</sup>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.

<sup>55</sup>We do not use TI's CPI, as the methodology and information sources have changed significantly since its launch in 1995. In particular, the pre-2012 data are not constructed to allow meaningful comparisons over

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

|                                | V-Dem                | WB                 | ICRG                |
|--------------------------------|----------------------|--------------------|---------------------|
|                                | (1)                  | (2)                | (3)                 |
| FDI Inflows PC                 | 4.20***<br>(1.17)    | 0.90**<br>(0.45)   | 2.56***<br>(0.84)   |
| GDP PC                         | -11.23***<br>(2.85)  | -1.96**<br>(0.87)  | -5.74***<br>(1.99)  |
| Democracy                      | -0.72***<br>(0.18)   | -0.14**<br>(0.05)  | -0.38***<br>(0.14)  |
| Growth Rate                    | -0.72<br>(0.55)      | -0.18<br>(0.16)    | -0.24<br>(0.49)     |
| Trade Openness                 | -1.69<br>(1.57)      | -0.35<br>(0.32)    | -0.95<br>(0.97)     |
| Resource Rents                 | 2.59<br>(1.75)       | 0.15<br>(0.54)     | 0.57<br>(1.10)      |
| FCPA Enforcement               | -0.08*<br>(0.04)     | -0.00<br>(0.01)    | 0.06**<br>(0.03)    |
| % of Protestants               | 0.08<br>(0.22)       | -0.19**<br>(0.08)  | 0.03<br>(0.11)      |
| % of Catholics                 | 0.14<br>(0.09)       | -0.05<br>(0.05)    | 0.00<br>(0.04)      |
| % of Muslims                   | 0.17*<br>(0.09)      | -0.02<br>(0.06)    | 0.01<br>(0.03)      |
| British Legal Origin           | 6.76<br>(8.05)       | 1.62<br>(3.03)     | 1.87<br>(3.86)      |
| French Legal Origin            | 22.19***<br>(6.96)   | 7.73**<br>(3.03)   | 7.02**<br>(3.10)    |
| Constant                       | 115.14***<br>(23.09) | 40.64***<br>(6.91) | 69.18***<br>(15.69) |
| <i>N</i>                       | 3993                 | 1851               | 2529                |
| Countries                      | 122                  | 118                | 98                  |
| <i>F-stat</i> (Excluded Instr) | 34.89                | 4.72               | 20.05               |
| <i>P &gt; F</i>                | 0.00                 | 0.04               | 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

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.

concerns, the results in Table 5.3 consistently suggest that FDI inflows are associated with higher levels of corruption in developing countries.<sup>56</sup>

## The Moderating Effect of 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 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 introduce an interaction term between FDI and host countries' democracy scores.<sup>57</sup> A positive coefficient on FDI and a negative coefficient on the interaction term indicate that the effect 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 2 and 3, 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.

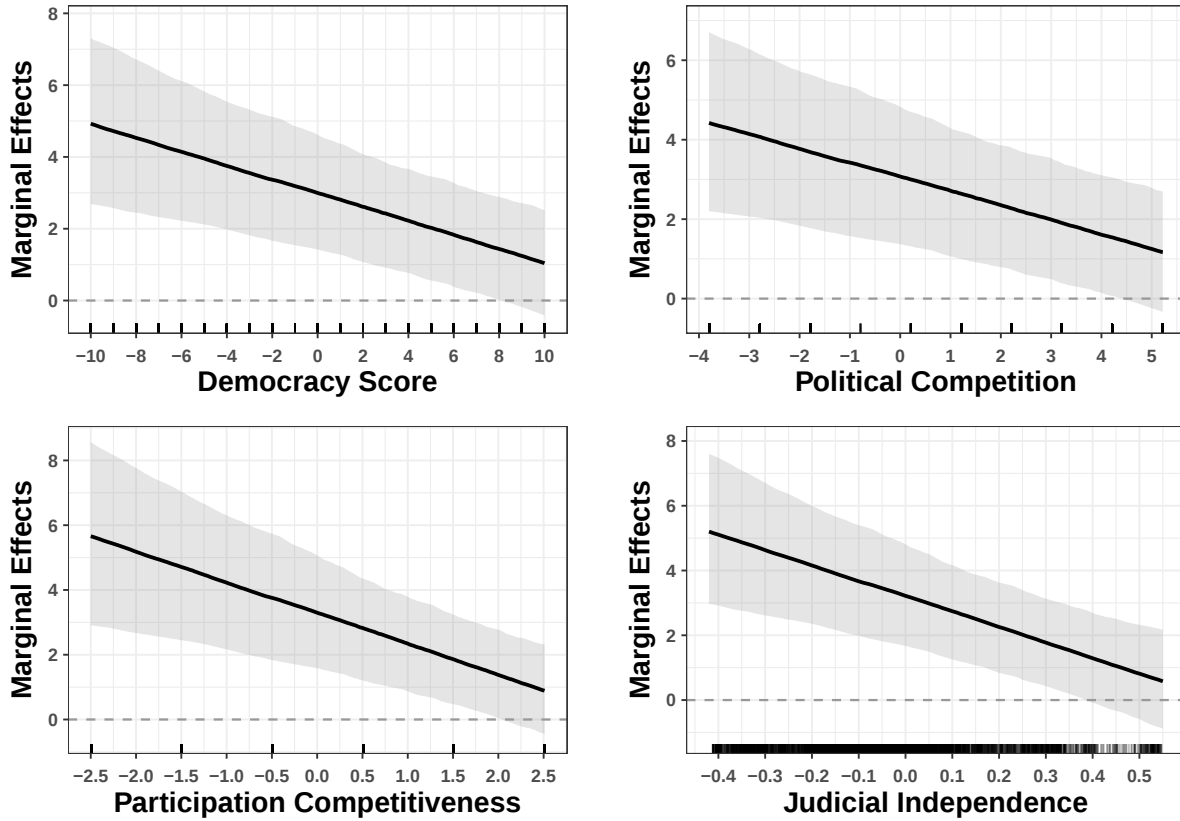
Figure 5.4 visualizes the simulated marginal effects of FDI from Models 1, 2, and 3. Across all three panels, a clear pattern emerges: the effect of FDI on corruption weakens as a host country becomes more democratic and politically competitive. However, the positive effect of FDI seems to persist in most developing countries, as it only dissipates when host countries reach very high levels of democracy and political competition.

Finally, Model 4 tests the hypothesis regarding the moderating effect of the legal system.

<sup>56</sup>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.

<sup>57</sup>Since FDI is endogenous, its interaction term with a moderator is also endogenous. We address this by purging the interaction term using the products 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.

Figure 5.4: Marginal Effects of FDI on Corruption: Political Competition and Judicial Independence



*Notes:* Plots show the marginal effects of real FDI inflows per capita on corruption across levels of the moderator, based on estimates from the four models in Table 5.4, respectively. Shaded areas indicate 95% confidence intervals, derived from 1,000 simulations. The rug plots at the bottom of each panel show the distribution of the moderator.

We introduce a measure of *de facto* judicial independence from [Linzer and Staton \(2015\)](#) 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 (bottom-right panel 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 indepen-

dent variable. These results, presented in Tables 5.5, 5.6, and 5.7, consistently show that FDI into developing countries increases corruption, while 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 highly productive MNCs in these economies can result in the creation of economic rents. These excess returns foster corruption by increasing the value of government officials' control rights and by enabling firms to absorb the additional costs of doing business in corrupt environments. We further posit that political competition and judicial independence can moderate this relationship and help mitigate the positive effect of FDI on corruption.

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 political competition and judicial independence.

These findings underscore the importance of understanding how external economic forces shape the creation of excess returns in host countries. It is well established that high rents foster corruption (Ades and Di Tella, 1999; Krueger, 1974; Rose-Ackerman, 1999). Our contribution is to demonstrate that foreign investment can itself be a source of rent creation and to highlight the mitigating role of political development and legal institutions. Existing studies on economic integration and corruption often rely on composite measures of globalization, thereby overlooking the heterogeneous channels through which different forms of foreign investment generate politically salient excess returns and adopting overly monotonic characterizations of the relationship between globalization and corruption.

Table 5.4: Democracy, Judicial Independence, and Corruption

|                             | (1)                 | (2)                 | (3)                 | (4)                 |
|-----------------------------|---------------------|---------------------|---------------------|---------------------|
| FDI Inflows PC              | 2.97***<br>(0.80)   | 3.04***<br>(0.86)   | 3.26***<br>(0.87)   | 3.19***<br>(0.78)   |
| FDI $\times$ Democracy      | -0.19***<br>(0.06)  |                     |                     |                     |
| FDI $\times$ Pol Comp       |                     | -0.36***<br>(0.12)  |                     |                     |
| FDI $\times$ Par Comp       |                     |                     | -0.95***<br>(0.28)  |                     |
| FDI $\times$ Judicial Indep |                     |                     |                     | -4.74***<br>(1.35)  |
| GDP PC                      | -7.81***<br>(2.17)  | -8.21***<br>(2.36)  | -7.89***<br>(2.29)  | -7.16***<br>(1.92)  |
| Democracy                   | 0.22<br>(0.23)      |                     |                     | 0.01<br>(0.17)      |
| Political Competition       |                     | 0.58<br>(0.45)      |                     |                     |
| Comp of Participation       |                     |                     | 1.74<br>(1.07)      |                     |
| Judicial Independence       |                     |                     |                     | -12.30<br>(9.75)    |
| Growth Rate                 | -0.46<br>(0.37)     | -0.41<br>(0.39)     | -0.49<br>(0.39)     | -0.70*<br>(0.37)    |
| Trade Openness              | -1.48<br>(1.29)     | -2.00<br>(1.34)     | -2.50*<br>(1.45)    | -1.67<br>(1.24)     |
| Resource Rents              | 1.18<br>(1.38)      | 1.33<br>(1.36)      | 1.40<br>(1.39)      | 1.10<br>(1.38)      |
| FCPA Enforcement            | -0.01<br>(0.03)     | -0.01<br>(0.03)     | -0.02<br>(0.03)     | -0.06*<br>(0.04)    |
| % of Protestants            | 0.21<br>(0.19)      | 0.18<br>(0.19)      | 0.19<br>(0.19)      | 0.10<br>(0.17)      |
| % of Catholics              | 0.09<br>(0.08)      | 0.10<br>(0.08)      | 0.12<br>(0.08)      | 0.12<br>(0.08)      |
| % of Muslims                | 0.15*<br>(0.09)     | 0.17**<br>(0.08)    | 0.16*<br>(0.09)     | 0.10<br>(0.08)      |
| British Legal Origin        | 1.62<br>(7.08)      | 2.67<br>(6.98)      | 3.64<br>(7.10)      | 5.21<br>(5.90)      |
| French Legal Origin         | 21.24***<br>(5.47)  | 22.14***<br>(5.48)  | 22.89***<br>(5.61)  | 19.24***<br>(4.37)  |
| Constant                    | 96.03***<br>(19.09) | 99.39***<br>(20.54) | 97.17***<br>(20.32) | 92.06***<br>(16.43) |
| <i>N</i>                    | 3969                | 3870                | 3870                | 3962                |
| Countries                   | 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)       | (6)       |
|--------------------------------|----------|----------|-----------|-----------|-----------|-----------|
| FDI Stocks PC                  | 0.30*    | 0.28     | 8.82***   | 8.48***   | 7.49***   | 7.35***   |
|                                | (0.16)   | (0.19)   | (1.93)    | (1.92)    | (1.77)    | (1.77)    |
| GDP PC                         | -3.11*** | 2.29***  | -15.23*** | -14.56*** | -13.02*** | -12.62*** |
|                                | (0.60)   | (0.53)   | (3.48)    | (3.62)    | (3.36)    | (3.48)    |
| Democracy                      | -0.06*   | -0.04    | -0.54***  | -0.52***  | -0.46***  | -0.45***  |
|                                | (0.03)   | (0.04)   | (0.16)    | (0.16)    | (0.16)    | (0.17)    |
| Growth Rate                    | 0.07     | -0.01    | -0.21     | -0.19     | -0.14     | -0.13     |
|                                | (0.04)   | (0.04)   | (0.30)    | (0.29)    | (0.30)    | (0.29)    |
| Trade Openness                 | -0.85*   | 0.58     | -9.39***  | -8.86***  | -7.81***  | -7.62***  |
|                                | (0.44)   | (0.43)   | (2.65)    | (2.66)    | (2.56)    | (2.58)    |
| Resource Rents                 | 0.31     | -0.30    | 2.17      | 1.93      | 1.49      | 1.40      |
|                                | (0.31)   | (0.32)   | (1.62)    | (1.63)    | (1.68)    | (1.72)    |
| FCPA Enforcement               | -0.01    | -0.01*   | -0.11***  | -0.10***  | -0.06**   | -0.06**   |
|                                | (0.01)   | (0.01)   | (0.03)    | (0.03)    | (0.03)    | (0.03)    |
| % of Protestants               |          |          |           |           | -0.09     | -0.07     |
|                                |          |          |           |           | (0.26)    | (0.31)    |
| % of Catholics                 |          |          |           |           | 0.06      | 0.05      |
|                                |          |          |           |           | (0.11)    | (0.14)    |
| % of Muslims                   |          |          |           |           | 0.16**    | 0.16      |
|                                |          |          |           |           | (0.08)    | (0.13)    |
| British Legal Origin           |          |          |           |           |           | 1.95      |
|                                |          |          |           |           |           | (7.65)    |
| French Legal Origin            |          |          |           |           |           | 18.48***  |
|                                |          |          |           |           |           | (6.56)    |
| Constant                       | 86.58*** | 36.91*** | 169.86*** | 164.73*** | 147.65*** | 132.08*** |
|                                | (5.62)   | (0.42)   | (26.53)   | (27.70)   | (26.67)   | (29.56)   |
| <i>N</i>                       | 3823     | 3700     | 3823      | 3823      | 3347      | 3341      |
| Countries                      | 123      | 121      | 123       | 123       | 122       | 121       |
| Country FEs                    | No       | Yes      | No        | Yes       | No        | No        |
| <i>F-stat</i> (Excluded Instr) |          |          | 35.11     | 33.50     | 37.79     | 36.46     |
| <i>P &gt; F</i>                |          |          | 0.00      | 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                 | ICRG                |
|--------------------------------|----------------------|--------------------|---------------------|
|                                | (1)                  | (2)                | (3)                 |
| FDI Stocks PC                  | 7.66***<br>(2.10)    | 2.54**<br>(1.20)   | 7.03***<br>(2.24)   |
| GDP PC                         | -14.34***<br>(4.07)  | -4.01***<br>(1.47) | -8.04**<br>(3.67)   |
| Democracy                      | -0.66***<br>(0.18)   | -0.15**<br>(0.06)  | -0.36**<br>(0.14)   |
| Growth Rate                    | -0.18<br>(0.33)      | 0.06<br>(0.09)     | 0.20<br>(0.25)      |
| Trade Openness                 | -7.52**<br>(3.01)    | -2.65**<br>(1.20)  | -5.66*<br>(2.99)    |
| Resource Rents                 | 1.81<br>(1.98)       | 0.68<br>(0.42)     | -2.33<br>(1.60)     |
| FCPA Enforcement               | -0.05<br>(0.03)      | -0.01<br>(0.01)    | 0.03<br>(0.03)      |
| % of Protestants               | -0.23<br>(0.31)      | -0.13<br>(0.08)    | -0.10<br>(0.40)     |
| % of Catholics                 | -0.10<br>(0.15)      | -0.02<br>(0.04)    | -0.03<br>(0.19)     |
| % of Muslims                   | 0.09<br>(0.10)       | -0.01<br>(0.03)    | 0.16<br>(0.11)      |
| British Legal Origin           | 0.37<br>(7.67)       | 0.54<br>(1.98)     | -3.94<br>(6.46)     |
| French Legal Origin            | 16.79**<br>(7.06)    | 5.10**<br>(1.99)   | 0.99<br>(5.16)      |
| Constant                       | 151.79***<br>(33.65) | 54.73***<br>(9.86) | 81.32***<br>(30.45) |
| <i>N</i>                       | 3365                 | 1829               | 2479                |
| Countries                      | 121                  | 117                | 98                  |
| <i>F-stat</i> (Excluded Instr) | 37.86                | 11.50              | 22.30               |
| <i>P &gt; F</i>                | 0.00                 | 0.00               | 0.00                |

Notes: Clustered standard errors in parentheses;

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

Table 5.7: Democracy, Judicial Independence, and Corruption

|                                    | (1)                  | (2)                  | (3)                  | (4)                  |
|------------------------------------|----------------------|----------------------|----------------------|----------------------|
| FDI Stocks PC                      | 5.40***<br>(1.51)    | 4.58***<br>(1.55)    | 3.81**<br>(1.86)     | 5.11***<br>(1.28)    |
| FDI $\times$ Democracy             | -0.22***<br>(0.07)   |                      |                      |                      |
| FDI $\times$ Pol Comp              |                      | -0.43***<br>(0.14)   |                      |                      |
| FDI $\times$ Par Comp              |                      |                      | -1.01***<br>(0.34)   |                      |
| FDI $\times$ Judicial Independence |                      |                      |                      | -3.69**<br>(1.87)    |
| GDP PC                             | -10.06***<br>(2.53)  | -8.98***<br>(2.51)   | -7.65***<br>(2.64)   | -9.33***<br>(2.05)   |
| Democracy                          | 0.84*<br>(0.46)      |                      |                      | -0.01<br>(0.17)      |
| Political Competition              |                      | 1.93**<br>(0.90)     |                      |                      |
| Comp of Participation              |                      |                      | 4.60**<br>(2.27)     |                      |
| Judicial Independence              |                      |                      |                      | -5.62<br>(16.16)     |
| Growth Rate                        | 0.02<br>(0.27)       | 0.16<br>(0.28)       | 0.20<br>(0.27)       | -0.08<br>(0.26)      |
| Trade Openness                     | -5.55**<br>(2.25)    | -5.82***<br>(2.17)   | -5.17**<br>(2.49)    | -5.45***<br>(2.02)   |
| Resource Rents                     | 0.95<br>(1.44)       | 1.04<br>(1.41)       | 1.19<br>(1.41)       | 0.81<br>(1.44)       |
| FCPA Enforcement                   | -0.01<br>(0.03)      | 0.01<br>(0.03)       | 0.02<br>(0.04)       | -0.04<br>(0.03)      |
| % of Protestants                   | -0.07<br>(0.22)      | -0.12<br>(0.19)      | -0.09<br>(0.20)      | -0.15<br>(0.19)      |
| % of Catholics                     | -0.08<br>(0.11)      | -0.10<br>(0.11)      | -0.08<br>(0.11)      | -0.01<br>(0.09)      |
| % of Muslims                       | 0.09<br>(0.08)       | 0.08<br>(0.08)       | 0.09<br>(0.08)       | 0.05<br>(0.07)       |
| British Legal Origin               | 0.29<br>(6.30)       | 1.36<br>(6.22)       | 2.05<br>(6.06)       | 2.98<br>(5.27)       |
| French Legal Origin                | 19.91***<br>(5.11)   | 21.72***<br>(5.11)   | 22.07***<br>(5.03)   | 17.42***<br>(4.28)   |
| Constant                           | 120.11***<br>(22.32) | 116.55***<br>(21.65) | 105.83***<br>(22.29) | 115.73***<br>(17.48) |
| <i>N</i>                           | 3341                 | 3251                 | 3251                 | 3335                 |
| Countries                          | 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       | 2.35***<br>(0.41)   | 0.19***<br>(0.07)  | 1.16***<br>(0.18)   | 0.14**<br>(0.07)   |
| Trade Openness             | 0.34*<br>(0.19)     |                    | 0.88***<br>(0.14)   |                    |
| FDI Inflows PC (lag)       |                     | 0.00**<br>(0.00)   |                     |                    |
| FDI Stocks PC (lag)        |                     |                    |                     | 0.07***<br>(0.01)  |
| GDP PC                     | 1.30***<br>(0.26)   | 0.09**<br>(0.04)   | 0.93***<br>(0.11)   | -0.02<br>(0.04)    |
| Democracy                  | 0.00<br>(0.02)      | 0.00<br>(0.00)     | 0.01<br>(0.01)      | 0.00<br>(0.00)     |
| Growth Rate                | 0.23***<br>(0.07)   | 0.01*<br>(0.01)    | 0.06**<br>(0.02)    | 0.00<br>(0.01)     |
| Resource Rents             | -0.24<br>(0.22)     | 0.16***<br>(0.03)  | -0.06<br>(0.17)     | 0.16***<br>(0.03)  |
| FCPA Enforcement           | 0.02***<br>(0.01)   | -0.00<br>(0.00)    | 0.01***<br>(0.00)   | -0.00*<br>(0.00)   |
| % of Protestants           | -0.01<br>(0.02)     | 0.00<br>(0.00)     | 0.03*<br>(0.01)     | 0.01<br>(0.00)     |
| % of Catholics             | -0.01<br>(0.01)     | -0.01***<br>(0.00) | 0.00<br>(0.00)      | -0.01***<br>(0.00) |
| % of Muslims               | -0.02***<br>(0.01)  | -0.00**<br>(0.00)  | -0.00<br>(0.00)     | -0.00***<br>(0.00) |
| British Legal Origin       | 2.22**<br>(1.04)    | 0.08<br>(0.16)     | 1.59***<br>(0.40)   | -0.06<br>(0.16)    |
| French Legal Origin        | 1.31<br>(0.81)      | 0.09<br>(0.15)     | 1.34***<br>(0.36)   | -0.04<br>(0.14)    |
| Constant                   | -20.01***<br>(3.24) | 2.36***<br>(0.48)  | -12.39***<br>(1.16) | 3.28***<br>(0.41)  |
| $N$                        | 3993                | 3987               | 3365                | 3297               |
| $R^2$                      | 0.37                | 0.20               | 0.66                | 0.23               |
| Countries                  | 122                 | 123                | 121                 | 121                |
| $F$ -stat (Excluded Instr) | 33.11               | 7.49               | 41.28               | 4.08               |
| $P > F$                    | 0.00                | 0.01               | 0.00                | 0.04               |

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

A prominent feature of the postwar international economy is the rise in cross-border FDI flows and the rapid expansion of MNCs and their affiliates. 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).<sup>1</sup>

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 Russett, 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

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<sup>1</sup>This chapter is 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 apply our theoretical framework to the link between inward FDI and civil conflict and show how it 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 highly productive MNCs expand their activities into developing countries, they can reallocate production and sales, resulting

in more concentrated markets and the generation of economic rents (Chapters 3 and 4). Conflict over the control and distribution of those excess returns 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 attenuates 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 reinforces 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 commit to negotiated agreements and thus alleviate the commitment problem. We therefore expect the positive effect of inward investment on conflict to decline 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, as discussed 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.<sup>2</sup> The positive association between FDI and conflict is not solely driven by resource-seeking investment: it holds for foreign investment in the secondary and

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<sup>2</sup>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.

tertiary sectors as well.<sup>3</sup> We further examine our proposed causal mechanism and provide evidence that inward FDI causes market concentration (Chapter 4), 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 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 and that strong state capacity and high levels of public goods provision help to mitigate this effect. We conduct two case studies to illustrate the mechanism: Bralima, a subsidiary of Heineken International, and Firestone's involvement in civil conflicts in the DRC and Liberia, respectively. Following that, we discuss the research design and conduct a systematic empirical analysis. Finally, the chapter concludes with a caution against a deterministic interpretation of the argument and empirical results.

## 6.2 Economic Interdependence and Intrastate Conflict

Commercial liberalism asserts that economic interdependence promotes peace between states (e.g., [Oneal and Russett, 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

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<sup>3</sup>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.

intrastate conflict.<sup>4</sup> Yet some scholars have also pointed out that trade shocks could lead to intrastate war. [Busmann 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 increases conflict. [Kishi, Maggio and Raleigh \(2017\)](#) show that in African states, dependence

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<sup>4</sup>See [Schneider \(2014\)](#) for a review of the literature.

on FDI as a source of income incentivizes governments, especially those with weak civil liberties and high budget deficits, to use securitization violence to maintain political stability, serve investors' interests, and retain power.

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](#)).

Others highlight a more complex relationship between FDI and civil conflict. By examining sectoral FDI from a sample of 70 developing and transitioning economies from 1980 to 2013, [Mihalache-O'Keef \(2018\)](#) finds that primary FDI stocks are positively while tertiary FDI stocks are negatively associated with conflict onset, and no strong correlation for secondary FDI stocks. Using a general equilibrium model, [Kibria, Oladi and Akhundjanov \(2020\)](#) illustrate that FDI in skilled labor-intensive resource sectors reduces the risk of civil violence by raising skilled wages and drawing labor into security enforcement, whereas FDI in unskilled labor-intensive sectors increases the risk by raising unskilled wages and pulling labor away from enforcement. Empirically, they show that in Sub-Saharan Africa, FDI inflows reduce violence in countries rich in skilled labor-intensive resources (e.g., fossil fuels) but increase it in countries abundant in unskilled labor-intensive, non-fuel resources (e.g., ores and metals).

With the increasing availability of geo-coded FDI project data (e.g., *Financial Times's* fDi Markets), more recent literature has examined the localized effects of FDI projects on civil conflict. For example, [Christensen \(2019\)](#) investigates the relationship between mining-related FDI and both social and armed conflict in Africa, finding that mining investment increases the likelihood of protests, especially during commodity price booms, but has no

significant effect on armed conflict. He attributes the positive association between mining investment and social conflict to information problems, as price booms raise expectations among local communities. Similarly, [Brazys, de Soysa and Vadlamannati \(2025\)](#) find that FDI across all sectors increases the risk of localized conflict short of civil war. In contrast, [Shim \(2025\)](#), using a global sample, shows that foreign ownership of mines decreases armed conflict, as rebel groups anticipate potential intervention from firms' home states, particularly those with greater military capabilities.

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 Chapters [3](#) and [4](#), 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-induced rents 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 can generate rents through scale economies, supplier selection, input bottlenecks, and sales reallocation, even when final prices are largely determined outside the domestic market.<sup>5</sup>

Armed conflict can dissipate rents by disrupting production, damaging assets, and raising operating costs through insecurity and logistical frictions. However, our argument does

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<sup>5</sup>See Chapter 3 for a more detailed discussion on this point.

not hinge on rents remaining unchanged; it requires only that they are not fully dissipated. Even in conflict settings, valuable assets such as fixed capital, production facilities, inventories, and transport networks as well as fiscal and quasi-fiscal revenue streams (e.g., taxes, royalties, and informal payments) often persist and continue to generate surplus value. Although reduced, these rents remain sufficiently attractive to armed groups seeking to capture them. Conflict may therefore reallocate or transform rents by shifting control over production sites, trade routes, or resource extraction, creating opportunities for appropriation despite overall economic decline. As long as the expected gains from capturing these assets or revenue streams exceed the costs of contestation, the persistence of such rents may be sufficient to sustain conflict dynamics.

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.

### **6.3.1 Multinationals and Conflict in Natural Resources and Beyond**

The natural resource sector is a *canonical* 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

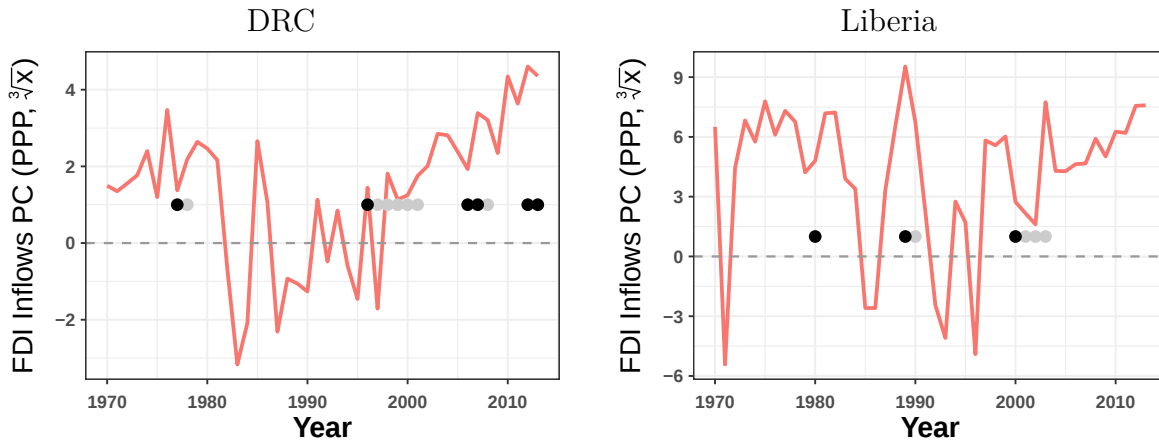
investments in natural resources ... are typically meant to contribute to economic development, sometimes when there are serious problems of stability they can have the unintended consequences of intensifying conflict for the capture of the resultant rents.” For example, in Indonesia, the rebel group Aceh Merdeka 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 [liquefied 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 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.

### 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,” which consist 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,

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 grey dots represent the incidence of ongoing conflict.

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.”<sup>6</sup>

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.<sup>7</sup> 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

<sup>6</sup>Howard W. French, “The Great Gold Rush in Zaire,” *New York Times*, April 18, 1997.

<sup>7</sup>This case on Bralima and civil violence in the DRC draws heavily on Miklian and Schouten (2013) and Schouten (2013).

share (Miklian and Schouten, 2013, 73).

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).<sup>8</sup> 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 Congo War (1998-2003).<sup>9</sup> Rebel groups in the DRC were 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).<sup>10</sup> 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 Liberian government (Jones and Miller, 2014). A former

<sup>8</sup>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).

<sup>9</sup>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.

<sup>10</sup>The discussion of the Firestone case draws from ProPublica and PBS Frontline's documentary, *Firestone and the Warlord*, and Jones and Miller (2014).

BBC West Africa correspondent put it, “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 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).<sup>11</sup> 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

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<sup>11</sup>Chris Morran, “Firestone Made Deal With The Devil, Paid Millions To Help Fund Genocidal Warlord.”

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 a wide range of economic sectors can contribute to rent creation and that these rents, in turn, increase the risk of 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 rebels’ ability to challenge the state extends beyond the natural resource sector and does not depend solely on the motivations behind rebellion.

## 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 et al., 2010; Gates et al., 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 hypotheses, we estimate the following model:

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

$Conflict_{i,t}$  is an indicator of civil conflict in country  $i$  in year  $t$ .  $M_{i,t}$  is the moderator.  $\beta_1$ ,  $\beta_2$ , and  $\beta_3$  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  $\xi$  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 if 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 (PPP-adjusted). 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,<sup>12</sup> population (log), level of democracy, natural resource endowments, ethnolinguistic and religious fractionalization, percentage of mountainous area, and two indicator variables for states possessing noncontiguous territo-

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<sup>12</sup>We take the cube root of this variable to deal with its skewed distribution.

ries, 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).<sup>13</sup> 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 noncontiguous 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.<sup>14</sup>

<sup>13</sup>This variable is rescaled to vary from  $-1$  to  $1$ .

<sup>14</sup>See Kerner (2014) for a detailed discussion of the measurement issues in existing FDI data.

## IV Estimation

We utilize GEOGRAPHIC CLOSENESS as an IV for inward FDI.<sup>15</sup> 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 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).<sup>16</sup> 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

<sup>15</sup>See Section 5.6 in Chapter 5.

<sup>16</sup>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)

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-stage 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 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).<sup>17</sup> The results show that trade openness has a strong negative effect on civil conflict onset. This is consistent with the expectation that, on average, trade openness reflects an important import-competition channel that dissipates protection rents and lowers incentives for conflict, even though trade can also expand profits for some exporters. 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

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<sup>17</sup>The data come from the World Bank's *World Development Indicators*.

Table 6.1: FDI and Civil Conflict Onset (Probit)

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

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.<sup>18</sup> 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 conventional levels. In Model 5, we use an alternative measure of international military intervention to capture major powers' influence on civil conflict.<sup>19</sup> 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.<sup>20</sup> We normalize

<sup>18</sup>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.

<sup>19</sup>The data come from Pickering and Kisangani (2009).

<sup>20</sup>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.

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.

## 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 shows that inward FDI contributes to market concentration in developing countries.

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

|                      | (1)<br>CR4       | (2)<br>HHI        |
|----------------------|------------------|-------------------|
| Concentration        | 15.83*<br>(8.25) | 2.02*<br>(1.18)   |
| GDP PC               | -1.53*<br>(0.92) | -1.66*<br>(0.92)  |
| State Capacity (PRE) | -3.56*<br>(1.95) | -3.23*<br>(1.80)  |
| Population           | 0.58<br>(0.41)   | 0.42<br>(0.40)    |
| Growth Rate          | 1.30<br>(1.24)   | 1.42<br>(1.26)    |
| Natural Resources    | 0.71**<br>(0.28) | 0.68**<br>(0.27)  |
| Constant             | 5.72<br>(9.49)   | 18.41**<br>(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).<sup>21</sup> All time-variant covariates are averaged over the same period.<sup>22</sup> We estimate an OLS model and present the results in Table 6.2.<sup>23</sup> 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.<sup>24</sup> Take Model 1 for example. Substantively, all else being equal, a one standard deviation 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

<sup>21</sup>See detailed discussions in Chapter 4.

<sup>22</sup>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.

<sup>23</sup>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.

<sup>24</sup>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.

(Wooldridge, 2010, 585).

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

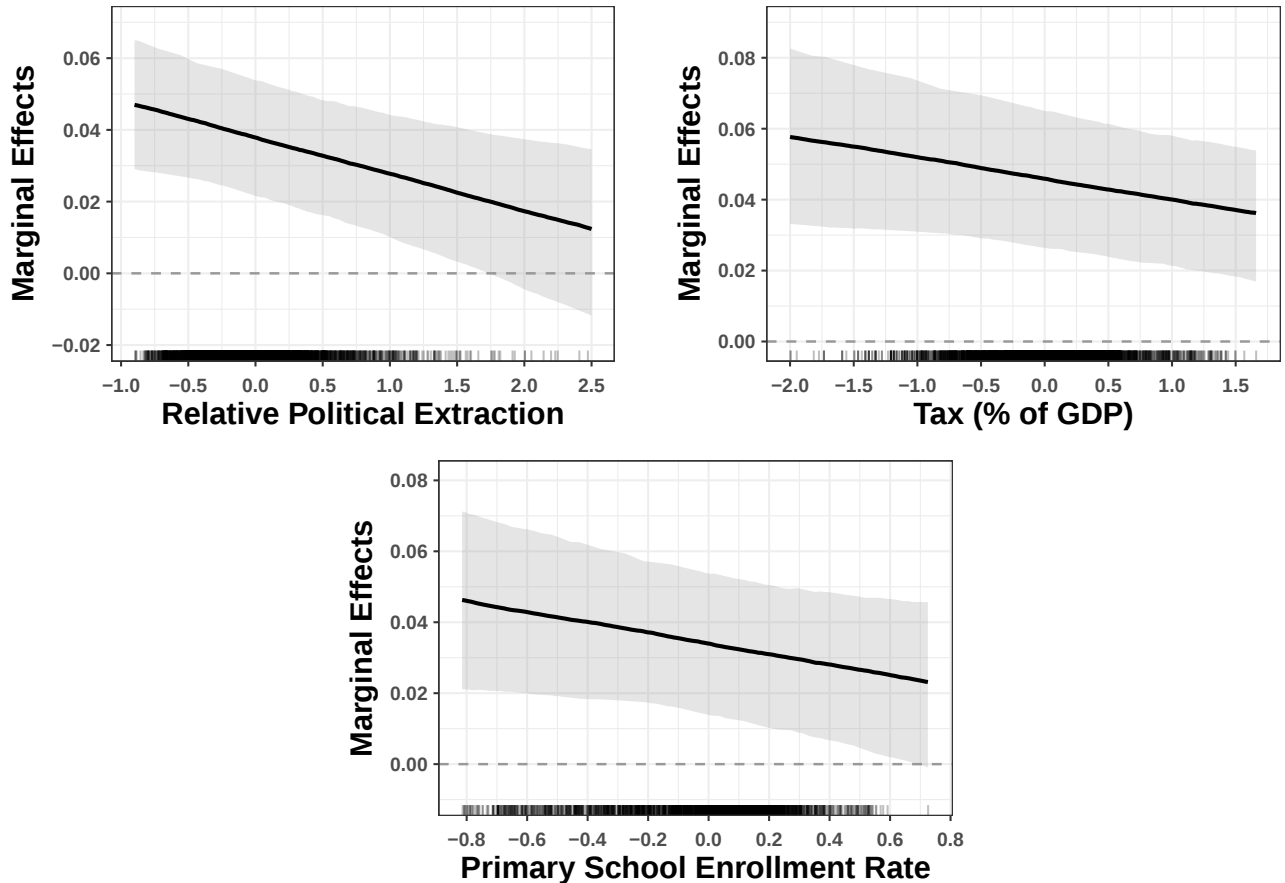
|                       | (1)<br>RPE         | (2)<br>Tax/GDP     | (3)<br>Enroll.     |
|-----------------------|--------------------|--------------------|--------------------|
| FDI Inflows PC        | 0.04***<br>(0.01)  | 0.05***<br>(0.01)  | 0.03***<br>(0.01)  |
| FDI*State Capacity    | -0.01***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

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 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.<sup>25</sup> The results are consistent. The top-right panel of Figure 6.2 shows that the marginal effect of FDI remains positive and 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 show the marginal effects of real FDI inflows per capita on conflict onset across levels of the three moderators (RELATIVE POLITICAL EXTRACTION, TAX (% OF GDP), and PRIMARY SCHOOL ENROLLMENT RATE, all mean-centered), based on estimates from the three models in Table 6.3, respectively. Shaded areas indicate 95% confidence intervals, derived from 1,000 simulations. The rug plots at the bottom of each panel show the distribution of the moderator.

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

<sup>25</sup>It is lagged one year to deal with potential endogeneity.

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.<sup>26</sup>

## 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

<sup>26</sup>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.

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 alternative codings of civil conflict onset (Appendix 6.7). Second, we disaggregate internal conflict and find that inward FDI is positively associated with both conflict over territorial control and conflict over control of the government (Appendix 6.7). Third, we explore the effect of FDI on conflict incidence and the total number of civil conflicts (Appendix 6.7), finding that FDI inflows are positively associated with both outcomes. Finally, we examine further the influence of great powers' geopolitical interests by controlling for different types of military interventions and U.S. covert operations during the Cold War (Appendix 6.7). Our main findings remain consistent and robust.

## 6.6 Conclusion

The current era of globalization is characterized by the expansion of global production networks centered on MNCs. Integration through foreign investment is often viewed as beneficial because it can generate positive economic outcomes such as employment, exports, and economic growth. Yet foreign investment may also produce 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 can reshape market structures and contribute to the creation of economic rents. These rents, in turn, increase incentives for rebel groups to challenge the government or to capture these excess returns for instrumental purposes, thereby raising the likelihood of internal conflict.

Our case studies provide insight into the underlying mechanisms. Empirically testing this relationship, however, is complicated by concerns about endogeneity and selection bias.

To address these issues, we instrument FDI using geographic proximity. We find that inward FDI is positively and strongly associated with a higher probability of civil conflict. This relationship holds across the primary, secondary, and tertiary sectors. By contrast, state capacity and the provision of public goods attenuate the positive effect of FDI on internal conflict.

Finally, we caution that these findings should *not* be interpreted deterministically, as if foreign investment mechanically produces civil conflict. Rather, FDI-induced rents create incentives for rebel groups to appropriate these rents in order to alter the balance of power or challenge the government, thereby increasing the *probability* of civil conflict. Moreover, as we have argued and demonstrated, the effect of FDI on conflict is conditional on the market and institutional environments into which foreign firms enter. When foreign entry disperses sales, strengthens domestic suppliers, and generates broad-based employment and learning, it can contribute to economic development and raise the opportunity costs of rebellion. Likewise, when states possess the capacity to tax and regulate rents, provide public goods, and enforce political bargains, the surplus generated by foreign investment is less likely to become an object of violent contestation.

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

## 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 6.5, 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 6.5 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 6.5: FDI and Civil Conflict Onset: Different Intermittent Years (IV Probit)

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

## 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 6.6 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 6.6: FDI and Civil Conflict Type (IV Probit)

|                                | (1)<br>Govt.       | (2)<br>Terr.       |
|--------------------------------|--------------------|--------------------|
| FDI per Capita (cube)          | 0.22***<br>(0.07)  | 0.31***<br>(0.02)  |
| State Capacity (RPE)           | 0.06<br>(0.09)     | 0.08<br>(0.08)     |
| GDP per Capita (log)           | -0.56***<br>(0.10) | -0.57***<br>(0.06) |
| Population (log)               | 0.09***<br>(0.03)  | 0.12***<br>(0.03)  |
| Growth Rate                    | -0.09***<br>(0.03) | -0.10***<br>(0.02) |
| Polity IV                      | -0.01<br>(0.07)    | -0.02<br>(0.05)    |
| Nat. Resources (log)           | 0.07***<br>(0.02)  | 0.06***<br>(0.02)  |
| Ethnic Frac.                   | 0.54***<br>(0.17)  | 0.45***<br>(0.14)  |
| Religious Frac.                | -0.45***<br>(0.17) | -0.68***<br>(0.15) |
| % Mountains (log)              | 0.04<br>(0.02)     | 0.02<br>(0.02)     |
| Noncontiguous                  | 0.43***<br>(0.14)  | 0.35***<br>(0.13)  |
| Cold War                       | 0.43***<br>(0.14)  | 0.43***<br>(0.09)  |
| Constant                       | 1.70*<br>(0.87)    | 2.40***<br>(0.56)  |
| <i>N</i>                       | 3401               | 3375               |
| <i>F-stat</i> (Excluded Instr) | 34.45              | 40.50              |
| <i>P &gt; F</i>                | 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 6.7 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 6.7: Conflict Presence/Duration and Number of Conflicts

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

## 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-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.<sup>27</sup> 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.

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<sup>27</sup>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***<br>(0.04)  | 0.27***<br>(0.04)  | 0.27***<br>(0.04)  | 0.27***<br>(0.04)  |
| State Capacity (RPE)           | 0.07<br>(0.08)     | 0.07<br>(0.08)     | 0.08<br>(0.08)     | 0.08<br>(0.08)     |
| GDP PC                         | -0.56***<br>(0.06) | -0.56***<br>(0.06) | -0.56***<br>(0.06) | -0.57***<br>(0.06) |
| Population                     | 0.09***<br>(0.03)  | 0.09***<br>(0.03)  | 0.09***<br>(0.03)  | 0.09***<br>(0.03)  |
| Growth Rate                    | -0.08***<br>(0.03) | -0.08***<br>(0.03) | -0.08***<br>(0.03) | -0.08***<br>(0.03) |
| Democracy                      | -0.03<br>(0.06)    | -0.03<br>(0.06)    | -0.03<br>(0.06)    | -0.03<br>(0.06)    |
| Natural Resources (            | 0.06***<br>(0.01)  | 0.06***<br>(0.01)  | 0.06***<br>(0.01)  | 0.06***<br>(0.01)  |
| Ethnic Frac.                   | 0.39***<br>(0.12)  | 0.39***<br>(0.12)  | 0.41***<br>(0.13)  | 0.41***<br>(0.12)  |
| Religious Frac.                | -0.57***<br>(0.14) | -0.57***<br>(0.14) | -0.57***<br>(0.14) | -0.54***<br>(0.14) |
| % Mountains                    | 0.03<br>(0.02)     | 0.03<br>(0.02)     | 0.03<br>(0.02)     | 0.03<br>(0.02)     |
| Noncontiguous                  | 0.43***<br>(0.12)  | 0.43***<br>(0.12)  | 0.43***<br>(0.12)  | 0.41***<br>(0.12)  |
| Cold War                       | 0.49***<br>(0.09)  | 0.49***<br>(0.09)  | 0.49***<br>(0.09)  | 0.46***<br>(0.09)  |
| Interventions (Nonneutral)     | 0.88<br>(1.06)     |                    |                    |                    |
| Interventions (Favor Gov.)     |                    | 0.19<br>(1.31)     |                    |                    |
| Interventions (Favor Reb.)     |                    |                    | 7.77<br>(5.39)     |                    |
| U.S. Covert Operations         |                    |                    |                    | 0.20<br>(0.13)     |
| Constant                       | 2.34***<br>(0.55)  | 2.34***<br>(0.55)  | 2.31***<br>(0.56)  | 2.38***<br>(0.52)  |
| <i>N</i>                       | 3451               | 3451               | 3451               | 3394               |
| <i>F-stat</i> (Excluded Instr) | 35.68              | 35.67              | 35.96              | 35.90              |
| <i>P &gt; F</i>                | 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](#)).<sup>1</sup>

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

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<sup>1</sup>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 the creation of economic rents. In the previous chapter, we have shown that FDI inflows and MNC activity in developing countries increase 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, 2008a](#); [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 ([Mattes, Leeds and Matsumura, 2016](#)) for the period 1970 to 2018. 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. The next section reviews the literature. After that, we present our argument, testable hypotheses, and a case study of 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 survival. 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, 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 provides nuanced insights into how easily appropriable rents can shape 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 one manifestation 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 can foster market concentration and generate economic rents. These rents may become highly 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**

Recall again in Chapters 3 and 4, we have shown 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 induce contraction or exit among less productive

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 et al., 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, 2008a](#)). 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 resulting from FDI inflows. Hence, we hypothesize that FDI inflows increase the likelihood of leadership turnover in developing countries.

## **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 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-induced 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, 2008a,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.<sup>2</sup>

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,<sup>3</sup> employing approximately 8,000 workers.<sup>4</sup> 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.<sup>5</sup> ITT's most valuable asset in Chile was its stake in CTC, estimated at around \$153 million.

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 inter-

<sup>2</sup>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.

<sup>3</sup>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.

<sup>4</sup>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.

<sup>5</sup>"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.

connect 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 ran 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.<sup>6</sup> 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.<sup>7</sup> ITT also proposed to the US government to take measures against Chile, such as halting US aid, but no further action or discussions took place (U.S. Senate, 1973, 11).

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<sup>6</sup>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.

<sup>7</sup>Shanahan, Eileen. “I.T.T. Officials in Conflict on Purpose of Chile Fund.” *New York 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.

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.<sup>8</sup>

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.<sup>9</sup> 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 ([U.S. Senate, 1973, 15](#)). However, the proposal was ignored by the Nixon administration.<sup>10</sup>

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

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<sup>8</sup>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.

<sup>9</sup>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.

<sup>10</sup>“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.

collaboration with the CIA and its proposed covert actions to interfere in the 1970 election.<sup>11</sup> 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 (U.S. Senate, 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.<sup>12</sup> The military coup ended Chile’s 46-year history of democracy.<sup>13</sup> From its independence in 1818 to 1973, there were only three brief interruptions to Chile’s democratic tradition.<sup>14</sup>

Although the ITT-Chile case was complicated by Cold War tensions, it clearly illustrated that the control and distribution of economic 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 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

<sup>11</sup>See Anderson, Jack. “The Washington Merry-Go-Round: Memos Bare ITT Try for Chile Coup.” *The Washington Post* March 21, 1972, B13.

<sup>12</sup>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.

<sup>13</sup>Ibid.

<sup>14</sup>Sobran, M.J. JR. “ITT and Allende: Looking Back on What Happened.” *National Review*. 13 April, 1973.

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, 21–23). 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 developing countries from 1970 to 2018. We estimate the following model:

$$\begin{aligned} Prob(Turnover_{i,t} = 1) = & \beta_1 \cdot FDI_{i,t} + \beta_2 \cdot (FDI_{i,t} \times M_{i,t}) \\ & + \beta_3 \cdot M_{i,t} + X_{i,t} \cdot \xi + \varepsilon_{i,t} \end{aligned} \quad (7.1)$$

$Turnover_{i,t}$  is an indicator of leader transition in country  $i$  in year  $t$ .  $M_{i,t}$  is the moderator.  $\beta_1$ ,  $\beta_2$ , and  $\beta_3$  are the coefficients to be estimated for FDI, the interaction term, and the moderator, respectively.  $X_{i,t}$  is a matrix of covariates, and  $\xi$  is a vector of coefficients to be estimated.  $\varepsilon_{i,t}$  is the error term.

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 are 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.<sup>15</sup>

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,<sup>16</sup> measles immunization rate (% of children ages 12–23 months), and infant mortality rates (per 1,000 live births).<sup>17</sup>

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 geopolitical considerations (Alesina and Dollar, 2000). We also control

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<sup>15</sup>See Section 5.6 in Chapter 5.

<sup>16</sup>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*.

<sup>17</sup>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.

for covert operations conducted by the United States and the Soviet Union during the Cold War (Berger, Corvalan and Satyanath, 2013).<sup>18</sup>

We further control for a full set of regime types: presidential, parliamentary, single-party, personal, monarchy, and other regimes.<sup>19</sup> 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 Jagers (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

<sup>18</sup>In robustness checks, we further control for 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.

<sup>19</sup>We classify foreign-occupied and provisional regimes as other regimes.

Table 7.1: FDI Inflows and Leadership Turnover

|                            | (1)                | (2)                | (3)<br>IV          | (4)<br>IV          |
|----------------------------|--------------------|--------------------|--------------------|--------------------|
| FDI Inflows PC             | 0.01<br>(0.01)     | 0.01<br>(0.01)     | 0.04<br>(0.06)     | 0.12**<br>(0.06)   |
| State Capacity (RPE)       | -0.25***<br>(0.08) | -0.38***<br>(0.13) | -0.25***<br>(0.08) | -0.43***<br>(0.13) |
| GDP PC                     | -0.01<br>(0.05)    | 0.02<br>(0.09)     | -0.06<br>(0.11)    | -0.19<br>(0.15)    |
| Population                 | 0.01<br>(0.02)     | 0.04<br>(0.15)     | 0.00<br>(0.02)     | -0.21<br>(0.18)    |
| Growth Rate                | -0.07***<br>(0.02) | -0.08***<br>(0.02) | -0.08***<br>(0.03) | -0.11***<br>(0.03) |
| Trade Openness             | -0.14**<br>(0.06)  | -0.07<br>(0.10)    | -0.19*<br>(0.11)   | -0.16<br>(0.12)    |
| Resource Rents             | -0.06<br>(0.05)    | -0.02<br>(0.11)    | -0.04<br>(0.05)    | -0.01<br>(0.11)    |
| Aid PC                     | 0.02<br>(0.02)     | 0.02<br>(0.03)     | 0.02<br>(0.02)     | 0.03<br>(0.03)     |
| Covert Ops (US)            | 0.14<br>(0.13)     | -0.06<br>(0.17)    | 0.17<br>(0.15)     | -0.07<br>(0.19)    |
| Covert Ops (SU)            | 0.02<br>(0.15)     | 0.16<br>(0.23)     | 0.09<br>(0.19)     | 0.46<br>(0.35)     |
| Presidential               | 0.37***<br>(0.08)  | 0.02<br>(0.18)     | 0.36***<br>(0.09)  | -0.01<br>(0.18)    |
| Parliamentary              | 0.77***<br>(0.13)  | 0.45<br>(0.30)     | 0.77***<br>(0.13)  | 0.43<br>(0.30)     |
| Personal                   | -0.27***<br>(0.10) | -0.53***<br>(0.18) | -0.28***<br>(0.10) | -0.55***<br>(0.18) |
| Military                   | 0.40***<br>(0.11)  | 0.17<br>(0.18)     | 0.40***<br>(0.11)  | 0.16<br>(0.19)     |
| Monarchy                   | 0.02<br>(0.26)     | -0.16<br>(0.73)    | 0.06<br>(0.28)     | -0.34<br>(0.68)    |
| Other Regimes              | 1.15***<br>(0.33)  | 1.04***<br>(0.27)  | 1.14***<br>(0.32)  | 0.95***<br>(0.25)  |
| Constant                   | -0.85<br>(0.68)    | -3.94<br>(2.43)    | -0.27<br>(1.20)    | 2.72<br>(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;

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

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 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

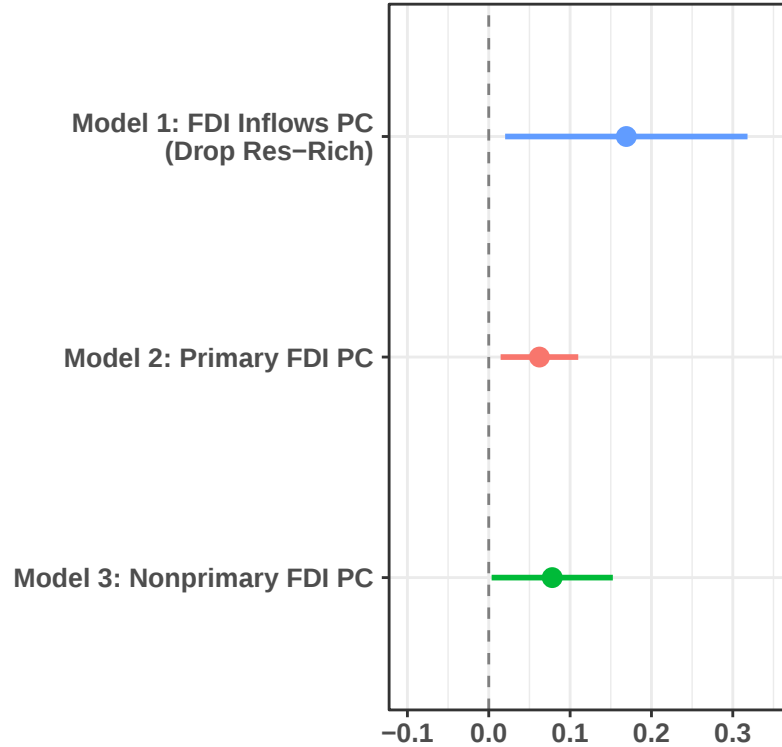
A large body of literature has examined the political economy of the resource curse, showing that windfalls from natural resources undermine governance and development, bolster corruption, and fuel violence and political instability.<sup>20</sup> As we argued in Chapter 3, rents accruing from FDI inflows 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

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<sup>20</sup>See Ross (2015) for a detailed review.

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.

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.

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

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 baseline model, we explicitly control for total foreign aid received, a proxy for great powers' security interests, as well as covert operations conducted by the United States and the Soviet Union during the Cold War. To further ensure that our findings are not driven by broader patterns of great power influence and geopolitical engagement, we incorporate several additional measures. These include a host country's UNGA voting similarity with the top 20 wealthiest economies,<sup>21</sup> the total number of military alliances with other states, the number of alliances with the top 20 wealthiest economies,<sup>22</sup> a dummy variable indicating

<sup>21</sup>Data are from Bailey, Strezhnev and Voeten (2017). The final score is constructed as a weighted average using the same set of weights employed in the construction of the instrumental variable.

<sup>22</sup>Data are from Gibler (2009).

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

|                          | (1)              | (2)             | (3)             | (4)               | (5)             | (6)              |
|--------------------------|------------------|-----------------|-----------------|-------------------|-----------------|------------------|
| FDI Inflows PC           | 0.16**<br>(0.06) | 0.12*<br>(0.06) | 0.10*<br>(0.06) | 0.22***<br>(0.08) | 0.13*<br>(0.07) | 0.12**<br>(0.06) |
| UNGA Voting Sim (Top 20) | 0.74<br>(0.74)   |                 |                 |                   |                 |                  |
| Alliances (Total)        |                  | 0.00<br>(0.01)  |                 |                   |                 |                  |
| Alliances (Top 20)       |                  |                 | 0.11<br>(0.07)  |                   |                 |                  |
| Military Intervention    |                  |                 |                 | 0.22**<br>(0.11)  |                 |                  |
| US Military Aid PC       |                  |                 |                 |                   | -0.02<br>(0.07) |                  |
| Colonial Ties (Top 20)   |                  |                 |                 |                   |                 | -0.01<br>(0.22)  |
| Constant                 | 2.03<br>(4.25)   | 3.33<br>(3.96)  | 1.39<br>(4.28)  | 6.87<br>(5.59)    | 2.75<br>(3.87)  | 2.72<br>(3.85)   |
| 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.

Full results presented in Table 7.5 in the appendix.

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

whether the country experienced any military intervention,<sup>23</sup> U.S. military aid per capita,<sup>24</sup> and the total number of colonial ties with the top 20 wealthiest economies.<sup>25</sup>

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 measuring security motivations do not appear to have a statistically significant

<sup>23</sup>Data are from Pickering and Kisangani (2009).

<sup>24</sup>U.S. military aid data are obtained from <https://foreignassistance.gov>.

<sup>25</sup>Data are from Conte, Cotterlaz and Mayer (2022).

impact.

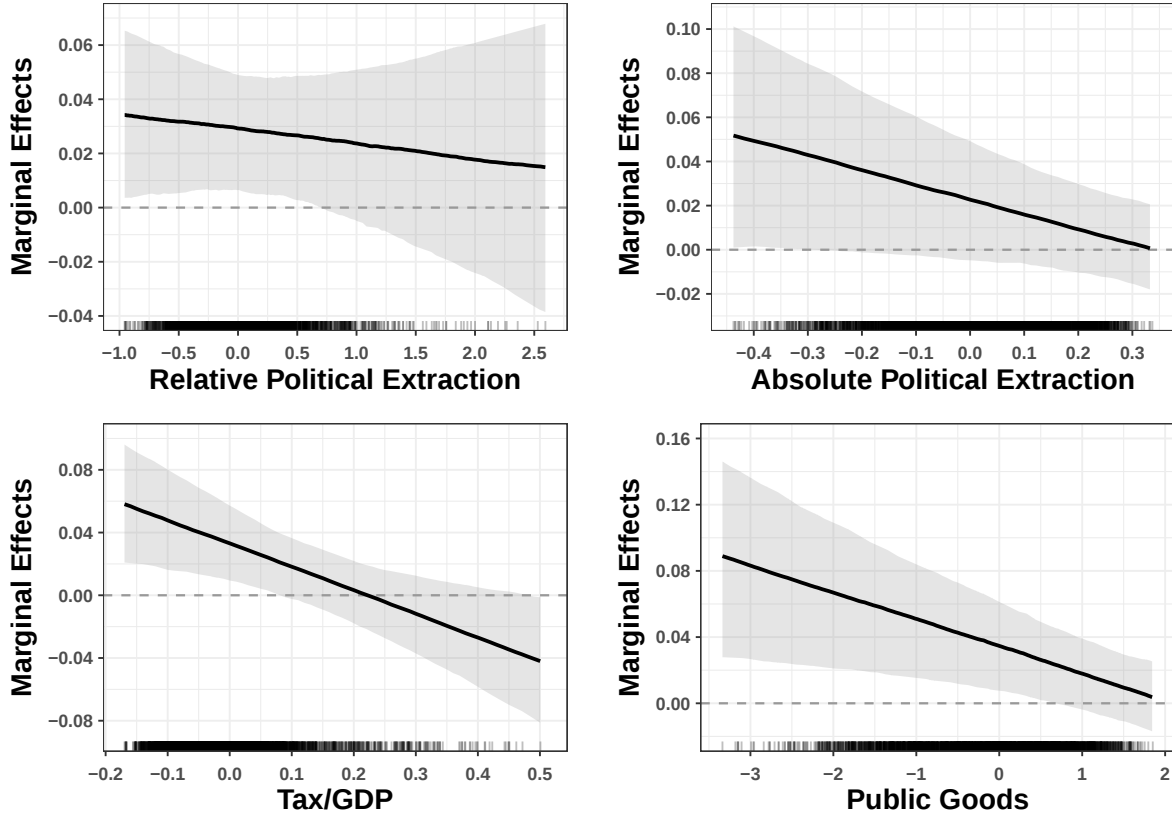
## **State Capacity, Public Goods Provision, and Leadership Turnover**

We have 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 captures 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

Figure 7.2: Marginal Effects of FDI Flows on Leadership Turnover



*Notes:* Plots show the marginal effects of real FDI inflows per capita on leadership turnover across levels of the four moderators (RELATIVE POLITICAL EXTRACTION, ABSOLUTE POLITICAL EXTRACTION, TAX/GDP, and PUBLIC GOODS PROVISION, all mean-centered), based on estimates from the four models in Table 7.3, respectively. Shaded areas indicate 95% confidence intervals, derived from 1,000 simulations. The rug plots at the bottom of each panel show the distribution of the moderator.

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 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. Real FDI stocks per capita have a strong positive effect on leadership turnover when endogeneity and country-specific characteristics are accounted for, and high extractive capacity and public goods provision mitigate this positive effect. 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 into developing countries, they can generate economic rents through higher markups, larger operating and economic profits, and quasi-rents associated with fixed and location-specific assets. Competition over access to and distribution of these returns can intensify political contestation and ultimately increase the likelihood of leadership turnover. We further argue that state capacity and the provision of public goods moderate this relationship. Strong state capacity enhances the government's surveillance and deterrence capabilities, thereby discouraging potential challengers. At the same time, the effective provision of public goods can mitigate citizen grievances and strengthen political support for incumbent leaders.

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 developing 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. It can increase the risk of adverse political outcomes, such as corruption, civil violence, and political instability. Importantly, these effects can be mitigated by strong domestic institutions, effective fiscal capacity, and the provision of public goods.

Table 7.3: FDI Inflows, State Capacity and Leadership Turnover

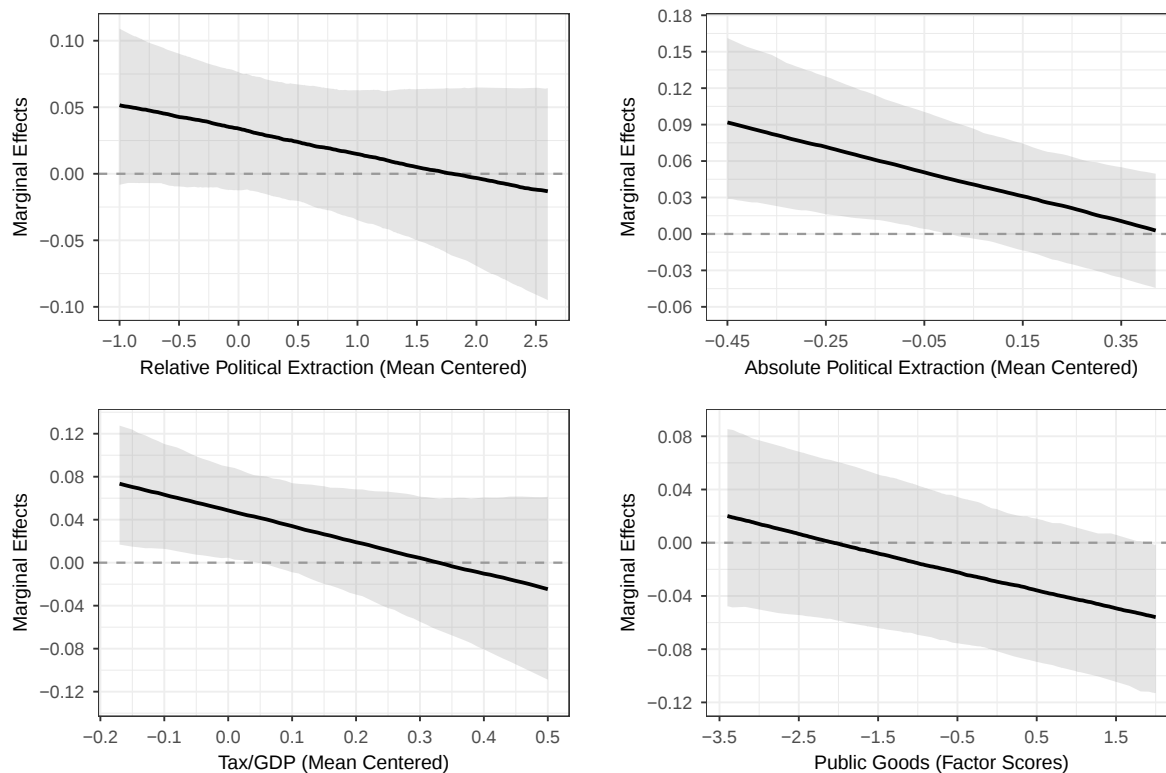
|                             | (1)<br>RPE         | (2)<br>APE         | (3)<br>Tax/GDP     | (4)<br>Pub Goods   |
|-----------------------------|--------------------|--------------------|--------------------|--------------------|
| FDI Inflows PC              | 0.03***<br>(0.01)  | 0.02*<br>(0.01)    | 0.03***<br>(0.01)  | 0.03**<br>(0.01)   |
| FDI $\times$ State Capacity | -0.01<br>(0.01)    | -0.07**<br>(0.03)  | -0.15***<br>(0.05) | -0.02***<br>(0.01) |
| State Capacity              | -0.07**<br>(0.03)  | 0.11<br>(0.15)     | 0.11<br>(0.22)     | 0.04<br>(0.03)     |
| GDP PC                      | -0.05*<br>(0.03)   | -0.02<br>(0.03)    | -0.04<br>(0.03)    | -0.04<br>(0.03)    |
| Population                  | -0.05<br>(0.03)    | -0.01<br>(0.04)    | -0.04<br>(0.04)    | -0.00<br>(0.06)    |
| Growth Rate                 | -0.02***<br>(0.01) | -0.02***<br>(0.01) | -0.02***<br>(0.01) | -0.03***<br>(0.01) |
| Trade Openness              | -0.03<br>(0.02)    | -0.02<br>(0.02)    | -0.03<br>(0.02)    | -0.04<br>(0.03)    |
| Resource Rents              | -0.00<br>(0.02)    | -0.00<br>(0.02)    | 0.01<br>(0.02)     | 0.00<br>(0.02)     |
| Aid PC                      | 0.01<br>(0.00)     | 0.00<br>(0.00)     | 0.01<br>(0.00)     | -0.00<br>(0.01)    |
| Covert Ops (SU)             | 0.11<br>(0.09)     | 0.07<br>(0.09)     | 0.12<br>(0.09)     | -0.07<br>(0.15)    |
| Covert Ops (US)             | -0.00<br>(0.03)    | -0.01<br>(0.03)    | -0.00<br>(0.03)    | -0.03<br>(0.05)    |
| Presidential                | -0.01<br>(0.03)    | 0.00<br>(0.03)     | -0.01<br>(0.03)    | -0.06<br>(0.04)    |
| Parliamentary               | 0.12***<br>(0.04)  | 0.13***<br>(0.04)  | 0.12***<br>(0.04)  | 0.11*<br>(0.06)    |
| Personal                    | -0.11***<br>(0.03) | -0.10***<br>(0.03) | -0.10***<br>(0.03) | -0.16***<br>(0.04) |
| Military                    | 0.03<br>(0.03)     | 0.05<br>(0.03)     | 0.06*<br>(0.03)    | 0.05<br>(0.04)     |
| Monarchy                    | -0.12<br>(0.08)    | -0.10<br>(0.08)    | -0.12<br>(0.08)    | 0.05<br>(0.12)     |
| Other Regimes               | 0.28***<br>(0.05)  | 0.29***<br>(0.05)  | 0.32***<br>(0.05)  | 0.23***<br>(0.07)  |
| Constant                    | 1.06<br>(0.73)     | 0.48<br>(0.71)     | 0.93<br>(0.77)     | 0.58<br>(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;

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

## 7.7 Appendix

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.

Table 7.4: FDI Inflows, Resources and Leadership Turnover

|                              | (1)<br>Primary    | (2)<br>Nonprimary | (3)<br>Drop Res-Rich |
|------------------------------|-------------------|-------------------|----------------------|
| Primary FDI PC               | 0.06**<br>(0.02)  |                   |                      |
| Nonprimary FDI PC            |                   | 0.08**<br>(0.04)  |                      |
| FDI Inflows PC               |                   |                   | 0.17**<br>(0.08)     |
| State Capacity (RPE)         | -0.52<br>(0.39)   | -0.44<br>(0.39)   | -0.47***<br>(0.18)   |
| GDP PC                       | -0.42<br>(0.27)   | -0.48<br>(0.29)   | -0.27<br>(0.19)      |
| Population                   | 0.36<br>(0.59)    | 0.13<br>(0.61)    | -0.20<br>(0.19)      |
| Growth Rate                  | -0.07<br>(0.06)   | -0.08<br>(0.06)   | -0.12***<br>(0.03)   |
| Trade Openness               | -0.19<br>(0.43)   | -0.21<br>(0.43)   | -0.41***<br>(0.14)   |
| Resource Rents               | -0.07<br>(0.27)   | 0.00<br>(0.28)    | 0.22<br>(0.15)       |
| Aid PC                       | -0.01<br>(0.04)   | 0.00<br>(0.05)    | 0.00<br>(0.04)       |
| Covert Ops (US)              | -1.35<br>(0.89)   | -1.41<br>(0.88)   | 0.00<br>(0.14)       |
| Covert Ops (SU)              |                   |                   | 0.58<br>(0.47)       |
| Presidential                 | 0.43<br>(0.58)    | 0.44<br>(0.65)    | -0.39**<br>(0.19)    |
| Parliamentary                | 2.41***<br>(0.81) | 2.37***<br>(0.82) | 0.08<br>(0.34)       |
| Personal                     | -0.48<br>(0.63)   | -0.46<br>(0.65)   | -0.86***<br>(0.22)   |
| Military                     | 1.62**<br>(0.77)  | 1.61**<br>(0.77)  | -0.17<br>(0.20)      |
| Monarchy                     | 8.57***<br>(0.90) | 9.31***<br>(1.09) | -1.91***<br>(0.35)   |
| Other Regimes                | 1.74***<br>(0.50) | 1.68***<br>(0.55) | 0.55**<br>(0.26)     |
| Constant                     | -4.37<br>(7.19)   | -1.09<br>(7.73)   | 4.94<br>(3.59)       |
| <i>N</i>                     | 954               | 952               | 2444                 |
| <i>R</i> <sup>2</sup>        | 52                | 52                | 72                   |
| <i>F</i> -stat (Excluded IV) |                   |                   | 23.2                 |
| <i>P</i> > <i>F</i>          |                   |                   | 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              | 0.16**<br>(0.06)   | 0.12*<br>(0.06)    | 0.10*<br>(0.06)    | 0.22***<br>(0.08)  | 0.13*<br>(0.07)    | 0.12**<br>(0.06)   |
| UNGA Voting Sim (Top 20)    | 0.74<br>(0.74)     |                    |                    |                    |                    |                    |
| Alliances (Total)           |                    | 0.00<br>(0.01)     |                    |                    |                    |                    |
| Alliances (Top 20)          |                    |                    | 0.11<br>(0.07)     |                    |                    |                    |
| Military Intervention       |                    |                    |                    | 0.22**<br>(0.11)   |                    |                    |
| US Military Aid PC          |                    |                    |                    |                    | -0.02<br>(0.07)    |                    |
| Colonial Ties (Top 20)      |                    |                    |                    |                    |                    | -0.01<br>(0.22)    |
| State Capacity (RPE)        | -0.47***<br>(0.13) | -0.44***<br>(0.13) | -0.43***<br>(0.13) | -0.46***<br>(0.14) | -0.44***<br>(0.13) | -0.43***<br>(0.13) |
| GDP PC                      | -0.25*<br>(0.14)   | -0.17<br>(0.16)    | -0.15<br>(0.16)    | -0.14<br>(0.20)    | -0.19<br>(0.15)    | -0.19<br>(0.15)    |
| Population                  | -0.15<br>(0.20)    | -0.25<br>(0.22)    | -0.14<br>(0.24)    | -0.50*<br>(0.28)   | -0.21<br>(0.18)    | -0.21<br>(0.18)    |
| Growth Rate                 | -0.11***<br>(0.03) | -0.10***<br>(0.03) | -0.10***<br>(0.03) | -0.11***<br>(0.03) | -0.11***<br>(0.03) | -0.11***<br>(0.03) |
| Trade Openness              | -0.28**<br>(0.14)  | -0.11<br>(0.12)    | -0.10<br>(0.12)    | -0.06<br>(0.13)    | -0.16<br>(0.12)    | -0.16<br>(0.12)    |
| Resource Rents              | -0.01<br>(0.12)    | -0.02<br>(0.12)    | -0.04<br>(0.12)    | 0.14<br>(0.14)     | -0.00<br>(0.12)    | -0.01<br>(0.11)    |
| Aid PC                      | 0.05*<br>(0.03)    | 0.02<br>(0.03)     | 0.02<br>(0.03)     | 0.02<br>(0.04)     | 0.03<br>(0.03)     | 0.03<br>(0.03)     |
| Covert Ops (US)             | -0.07<br>(0.20)    | -0.04<br>(0.19)    | -0.10<br>(0.20)    | -0.01<br>(0.19)    | -0.07<br>(0.19)    | -0.07<br>(0.19)    |
| Covert Ops (SU)             | 0.57<br>(0.36)     | 0.45<br>(0.34)     | 0.37<br>(0.33)     | 0.67<br>(0.45)     | 0.48<br>(0.36)     | 0.46<br>(0.35)     |
| Presidential                | -0.06<br>(0.18)    | 0.03<br>(0.19)     | 0.02<br>(0.19)     | 0.05<br>(0.21)     | -0.01<br>(0.18)    | -0.01<br>(0.18)    |
| Parliamentary               | 0.46<br>(0.30)     | 0.24<br>(0.28)     | 0.23<br>(0.28)     | 0.20<br>(0.32)     | 0.43<br>(0.30)     | 0.43<br>(0.30)     |
| Personal                    | -0.58***<br>(0.19) | -0.59***<br>(0.20) | -0.60***<br>(0.19) | -0.50**<br>(0.21)  | -0.55***<br>(0.18) | -0.55***<br>(0.18) |
| Military                    | 0.17<br>(0.19)     | 0.20<br>(0.19)     | 0.17<br>(0.19)     | 0.19<br>(0.21)     | 0.16<br>(0.19)     | 0.16<br>(0.19)     |
| Monarchy                    | -0.34<br>(0.67)    | -0.48<br>(0.59)    | -0.49<br>(0.58)    | -1.47***<br>(0.39) | -0.34<br>(0.68)    | -0.34<br>(0.68)    |
| Other Regimes               | 0.81***<br>(0.24)  | 0.99***<br>(0.25)  | 0.98***<br>(0.25)  | 1.27***<br>(0.29)  | 0.96***<br>(0.25)  | 0.95***<br>(0.25)  |
| Constant                    | 2.03<br>(4.25)     | 3.33<br>(3.96)     | 1.39<br>(4.28)     | 6.87<br>(5.59)     | 2.75<br>(3.87)     | 2.72<br>(3.85)     |
| <i>N</i>                    | 3971               | 3560               | 3560               | 2769               | 4035               | 4035               |
| <i>R</i> <sup>2</sup>       | 115                | 113                | 113                | 107                | 115                | 115                |
| <i>F-stat</i> (Excluded IV) | 33.91              | 32.4               | 30.52              | 22.01              | 25.43              | 34.79              |
| <i>P</i> > <i>F</i>         | 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)<br>IV          | (4)<br>IV          |
|-----------------------------|--------------------|--------------------|--------------------|--------------------|
| FDI Stocks PC               | -0.02<br>(0.02)    | 0.03<br>(0.04)     | 0.02<br>(0.16)     | 0.39**<br>(0.17)   |
| State Capacity (RPE)        | -0.27***<br>(0.08) | -0.32**<br>(0.14)  | -0.26**<br>(0.10)  | -0.28*<br>(0.16)   |
| GDP PC                      | 0.03<br>(0.05)     | -0.08<br>(0.13)    | -0.03<br>(0.21)    | -0.58**<br>(0.26)  |
| Population                  | 0.01<br>(0.02)     | 0.12<br>(0.21)     | 0.00<br>(0.02)     | -0.41<br>(0.33)    |
| Growth Rate                 | -0.06**<br>(0.02)  | -0.09***<br>(0.03) | -0.06**<br>(0.03)  | -0.11***<br>(0.03) |
| Trade Openness              | -0.09<br>(0.07)    | -0.06<br>(0.16)    | -0.14<br>(0.20)    | -0.44*<br>(0.25)   |
| Resource Rents              | -0.08*<br>(0.05)   | -0.02<br>(0.15)    | -0.07<br>(0.05)    | 0.00<br>(0.17)     |
| Aid PC                      | 0.02<br>(0.02)     | 0.01<br>(0.03)     | 0.02<br>(0.02)     | -0.00<br>(0.03)    |
| Covert Ops (US)             | 0.10<br>(0.14)     | -0.19<br>(0.25)    | 0.10<br>(0.14)     | -0.26<br>(0.27)    |
| Presidential                | 0.35***<br>(0.08)  | -0.01<br>(0.21)    | 0.33***<br>(0.11)  | -0.02<br>(0.22)    |
| Parliamentary               | 0.76***<br>(0.13)  | 0.49<br>(0.40)     | 0.76***<br>(0.13)  | 0.44<br>(0.42)     |
| Personal                    | -0.30***<br>(0.11) | -0.49**<br>(0.25)  | -0.31***<br>(0.11) | -0.53**<br>(0.26)  |
| Military                    | 0.44***<br>(0.13)  | 0.33<br>(0.22)     | 0.44***<br>(0.13)  | 0.28<br>(0.25)     |
| Monarchy                    | -0.06<br>(0.25)    | -0.20<br>(0.80)    | -0.01<br>(0.33)    | 0.30<br>(1.04)     |
| Other Regimes               | 1.23***<br>(0.36)  | 0.96***<br>(0.31)  | 1.23***<br>(0.35)  | 0.79**<br>(0.34)   |
| Constant                    | -1.14*<br>(0.64)   | -4.60<br>(3.47)    | -0.58<br>(1.81)    | 7.88<br>(6.81)     |
| <i>N</i>                    | 3515               | 3402               | 3515               | 3402               |
| Number of Countries         | 121                | 115                | 121                | 115                |
| <i>F-stat</i> (Excluded IV) |                    |                    | 7.37               | 17.64              |
| <i>P &gt; F</i>             |                    |                    | 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)<br>RPE         | (2)<br>APE         | (3)<br>Tax/GDP     | (4)<br>Pub Goods   |
|-----------------------------|--------------------|--------------------|--------------------|--------------------|
| FDI Stocks PC               | 0.03<br>(0.02)     | 0.05*<br>(0.02)    | 0.05**<br>(0.02)   | -0.03<br>(0.03)    |
| FDI $\times$ State Capacity | -0.02<br>(0.02)    | -0.10**<br>(0.04)  | -0.15*<br>(0.08)   | -0.01**<br>(0.01)  |
| State Capacity              | 0.05<br>(0.09)     | 0.58**<br>(0.27)   | 0.59<br>(0.56)     | 0.11***<br>(0.04)  |
| GDP PC                      | -0.06<br>(0.04)    | -0.06*<br>(0.04)   | -0.07*<br>(0.04)   | 0.03<br>(0.04)     |
| Population                  | -0.01<br>(0.05)    | -0.04<br>(0.05)    | -0.04<br>(0.05)    | 0.06<br>(0.06)     |
| Growth Rate                 | -0.02***<br>(0.01) | -0.02***<br>(0.01) | -0.02***<br>(0.01) | -0.01**<br>(0.01)  |
| Trade Openness              | -0.05<br>(0.04)    | -0.07*<br>(0.04)   | -0.06*<br>(0.03)   | -0.01<br>(0.03)    |
| Resource Rents              | 0.00<br>(0.02)     | 0.01<br>(0.02)     | 0.01<br>(0.02)     | -0.01<br>(0.02)    |
| Aid PC                      | 0.00<br>(0.01)     | -0.00<br>(0.01)    | -0.00<br>(0.01)    | 0.00<br>(0.01)     |
| Covert Ops (SU)             | -0.10<br>(0.12)    | -0.08<br>(0.12)    | -0.04<br>(0.11)    | -0.19<br>(0.13)    |
| Covert Ops (US)             | -0.03<br>(0.04)    | -0.04<br>(0.04)    | -0.03<br>(0.04)    | -0.03<br>(0.05)    |
| Presidential                | -0.02<br>(0.03)    | -0.01<br>(0.03)    | -0.02<br>(0.03)    | -0.03<br>(0.04)    |
| Parliamentary               | 0.12**<br>(0.05)   | 0.14**<br>(0.05)   | 0.11**<br>(0.05)   | 0.16**<br>(0.06)   |
| Personal                    | -0.11***<br>(0.04) | -0.10***<br>(0.04) | -0.11***<br>(0.04) | -0.12***<br>(0.04) |
| Military                    | 0.06*<br>(0.04)    | 0.08**<br>(0.04)   | 0.07*<br>(0.04)    | 0.08*<br>(0.04)    |
| Monarchy                    | -0.09<br>(0.11)    | 0.03<br>(0.12)     | -0.03<br>(0.11)    | 0.03<br>(0.11)     |
| Other Regimes               | 0.25***<br>(0.06)  | 0.25***<br>(0.06)  | 0.25***<br>(0.06)  | 0.19***<br>(0.07)  |
| Constant                    | 0.96<br>(0.95)     | 1.33<br>(0.96)     | 1.14<br>(1.01)     | -1.22<br>(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;

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

# Chapter 8

## Conclusion

### 8.1 Foreign Investment, Rents, and Politics

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, 2013](#)). It can also promote the integration of domestic firms into GVCs 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 generate negative, and often unintended, political consequences in the Global South. The entry and presence of highly productive foreign firms can contribute to the creation of economic rents through multiple channels. When foreign entry induces the contraction or exit of less productive domestic competitors, market concentration may increase and, in variable-markup environments, markups increase. When markups are fixed,

more productive firms can still earn larger operating and economic profits through lower costs, greater sales, and firm selection effects. When prices are externally determined or assets are location-bound, rents and quasi-rents can arise from wedges between world prices and production costs, access to scarce inputs, regulatory privileges, and sunk investments. These excess returns, in turn, create strong incentives for political and economic actors at multiple levels to capture, control, and compete over them. Such competition may manifest in destabilizing ways, including higher levels of corruption, an increased likelihood of armed conflict, and more frequent turnover of political leadership.

The relationship between FDI and adverse political consequences identified in this book should not be interpreted as *deterministic*. Instead, it suggests that FDI-induced rents increase the *probability* of such negative outcomes. Crucially, the political consequences of FDI and MNC activity are conditional on 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 FDI-induced rents. 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.

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, in which 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. The central implication is *not* that governments should restrict foreign investment, but rather that the governance of FDI inflows and MNC activity is critically important. We emphasize that FDI can stimulate growth, generate employment, facilitate technology transfer, and integrate domestic firms into global production networks (Caves, 1996; Markusen, 1995; Theodore Moran, 2005). Rather, the central lesson is that the benefits of FDI are not automatic. As the literature on spillovers and absorptive capacity has long emphasized, the gains from foreign investment depend on domestic capabilities, supplier linkages, human capital, financial development, and institutional quality (Alfaro et al., 2010; Blomström, Globerman and Kokko, 2001; Borensztein, De Gregorio and Lee, 1998; Havranek and Irsova, 2011; Marcin, 2008; Meyer and Sinani, 2009). This book adds a political economy mechanism to this insight: when foreign entry creates concentrated rents, those rents become objects of appropriation and contestation. Policy should therefore focus not simply on attracting more FDI, but on shaping the market and institutional conditions under which it operates: preserving competition through antitrust enforcement, taxing rents through transparent public institutions, and channeling the resulting revenues into public goods rather than private or targeted benefits.

*Promoting Competitive Domestic Markets:* Our findings indicate that FDI-induced market concentration and rent creation can stimulate rent-seeking behavior and exacerbate distributional conflicts. This does not mean that foreign entry is undesirable; indeed, when domestic firms remain viable and new entrants face low barriers to entry, FDI can intensify competition, lower prices, and dissipate rents. The policy challenge is to preserve this pro-competitive channel. Governments should therefore adopt competition and antitrust policies that prevent excessive concentration and ensure a level playing field for foreign and domestic firms. Policy measures may include antitrust enforcement, access to finance for small and

medium-sized enterprises, and initiatives to enhance the technological capabilities of local firms. Such measures help domestic enterprises integrate into GVCs and make the positive spillover effects emphasized in the FDI literature more likely to materialize ([Ahn et al., 2026](#); [Markusen and Venables, 1999](#); [Meyer and Sinani, 2009](#)).

*Strengthening Institutional Capacity:* Governments in the Global South should prioritize investments in legal and regulatory capacity to manage the political economy consequences of FDI. A central implication of our analysis is that FDI-induced rents do not inherently produce adverse outcomes; rather, their political effects depend on how they are governed. The rent-seeking literature has long emphasized that rents invite costly efforts to obtain, protect, and redistribute them ([Acemoglu and Robinson, 2006](#); [Krueger, 1974](#); [Shleifer and Vishny, 1993](#)). We extend this insight by showing how FDI can generate such rents when productivity differentials, entry barriers, and market concentration are substantial. In weak institutional environments, these rents are more likely to be contested through informal bargaining, bribery, and political competition over control of economic assets and regulatory authority. Strengthening institutional capacity through an independent judiciary, credible enforcement of property rights, transparent regulatory procedures, and effective anti-corruption frameworks can shift these dynamics. Strong institutions do not eliminate rents, but they can channel them into formal mechanisms such as taxation, regulation, and public accountability, thereby reducing incentives for corruption, conflict, and elite instability. Domestic institutional reforms can be complemented by extraterritorial enforcement, such as the U.S. FCPA and EU anti-bribery regimes, which raise the expected costs of illicit payments by multinational firms. By increasing the risks associated with foreign bribery, such enforcement can weaken the link between FDI-induced rents and corruption.

*Enhancing State Capacity:* In sectors where rents are inevitable, particularly those with high entry barriers, scarce resources, or large fixed assets, governments should establish institutional mechanisms to tax a share of those rents through transparent, rule-bound fiscal instruments, including royalties, licensing fees, and other public revenue mechanisms, and

allocate the proceeds toward public goods and national development objectives. This implication follows directly from the findings on civil conflict and leadership turnover. Rents are most politically destabilizing when states cannot tax and govern them, convert the resulting revenue into public goods, or credibly enforce bargains over their distribution. Transparent fiscal management, well-designed redistributive policies, and strategic public investment in health, education, infrastructure, and enforcement capacity can help ensure that the gains from FDI are broadly shared across society rather than becoming private benefits, targeted favors, or prizes for officials, armed actors, or political challengers.

*Building Domestic Capabilities:* While openness to global capital is important, countries should avoid a strategy of passive liberalization. Investment promotion agencies often evaluate success by the volume of inflows they attract. The results in this book suggest that governments should also ask what kind of investment is entering, how it affects market structure, whether it strengthens domestic suppliers, and whether the rents it generates are transparent and governable. FDI is more likely to generate broad-based gains when governments invest in infrastructure and human capital, promote research and development, expand worker training and access to finance, and foster upstream and downstream linkages between foreign affiliates and domestic firms. The aim is not to insulate domestic firms from competition, but to ensure that openness expands productive capacity rather than simply concentrating rents in a small number of firms or sectors.

*Safeguarding Political Stability:* Because FDI-induced rents 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. The political consequences documented in this book are not driven by foreign ownership per se; they arise when valuable rents are concentrated, weakly governed, and tied to assets or sectors that political actors can target. Transparent and accountable political institutions, credible power-sharing arrangements, and depoliticized rules governing access to economic resources can lower the risk that competition over FDI-induced rents escalates into adverse political

consequences. In this sense, the policy implications of the book connect the literature on FDI and development to the broader literature on rents, state capacity, and political order (Besley and Persson, 2010; Bueno de Mesquita et al., 2005; Ross, 2015).

In sum, the developmental impact of FDI in the Global South depends critically on how effectively states manage the economic rents and structural tensions generated by foreign investment. 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. The goal is not less openness, but better governed openness: foreign investment that expands domestic capabilities, preserves competition through antitrust enforcement where possible, and taxes rents through transparent fiscal institutions so that revenues are converted into public goods rather than private gain, targeted favors, or political predation.

### **8.3 Limitations and Future Research**

We conclude by acknowledging the limitations of our study and identifying promising avenues for future research. First, our analysis is, by design, a macro-level examination of the economic and political consequences of FDI inflows and MNC activity in the Global South. This approach enables us to assess the political ramifications of broad macroeconomic conditions such as market structure and rent creation, and to identify general patterns across a large number of countries over an extended period. It also allows us to examine political outcomes at a high level of aggregation that would be difficult to capture in micro-level studies. These include grand corruption involving senior government officials, embezzlement, and state capture; intrastate armed conflicts over control of the government; and executive turnover at the highest level of office. At the same time, reliance on aggregate data necessarily obscures important variation and dynamics at the micro level. Both our explanatory and outcome variables are measured at the country level, limiting 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.<sup>1</sup> Our argument is that economic rents generated by FDI inflows and MNC activity can produce similar consequences, particularly when domestic institutional conditions facilitate rent-seeking behavior. Future research should build on this framework to examine how foreign investment shapes a wider range of political and economic outcomes, including

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<sup>1</sup>Again, see [Ross \(2015\)](#) for a review.

electoral dynamics, bureaucratic quality, public goods provision, social conflict, and citizen attitudes. Such extensions would contribute to a more comprehensive understanding of the impact of global capital flows on governance in developing countries.

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 M&As. In theory, more productive firms with higher markups are better equipped to enter high-risk environments, but 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 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 subtler forms of creeping expropriation, including regulatory 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 may even find such environments attractive. Beyond the immobility of fixed assets, future research should examine 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 foreign entry decisions and the dynamics between firms and host governments.

Lastly, the political economy literature on FDI has predominantly focused on entry and its determinants,<sup>2</sup> while giving relatively little attention to exit dynamics. 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 ([Wellhausen and Zhu, 2026](#)). 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, at both the local and national levels? These questions have become increasingly salient amid intensifying trade tensions, policy uncertainty, and the reconfiguration of global investment. Understanding exit is thus essential for advancing both theory and policy.

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<sup>2</sup>See [Pandya \(2016\)](#) for a comprehensive review.

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