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The Political Economy of Democracy and FDI Inflows in Oil Countries

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Foreign direct investment, or FDI, is a type of investment from a private or public institution of one country into an institution of another and it has defining two characteristics: firstly, it is an investment that gives 10% or greater ownership of the invested company, secondly, it usually gives the investor a participation of management, joint-venture, or the transfer of technology, labor and capital. In political economy literature, there has been an ongoing debate over the role of democracy in encouraging FDI inflows, or what I shall call the 'democracy-FDI relationship'. This debate began a few decades ago and a summary of contributions will be discussed below. This paper will contribute to the debate in some way by examining the democracy-FDI relationship for oil-exporting countries. This paper will be structured as follows. Firstly we will look at the broad motivations for FDI and then the theories behind the democracy-FDI relationship. Secondly, we will define what countries are oil-exporting and why, and utilize the theories and specific real-world examples that support the theories to generate some expectations on the relationship between democracy and FDI inflows for this pool of countries.

I. Theory – Introduction

Why does FDI occur? What are the general motivations for a company or government to make an FDI into another company of another country? Very generally speaking there are some common motivations. A company may make an FDI to expand horizontally (for example, buying another competitor company in another country to enter that country's market) or vertically (buying a supplier to lock in prices). A company may make an FDI to expand knowledge, skills or capital in another area of business. A company may make an FDI to cheapen labor costs or move management overseas again to cut costs. Whatever strategic motivations there may be, the core motivations hardly change: to increase revenue and profitability and to lower costs. If economic growth is correlative with globalization, then one would therefore expect FDI to grow in line with economic, or GDP, growth. For the past nineteen years, world FDI inflows, that is, the *net inflow* of FDI into all countries around the world, have steadily increased by a net total of 719%.[1] GDP growth alone does not seem to explain these inflows. We then need to look at patterns of FDI inflows for oil-exporting countries and check if these can simply be explained by world FDI inflows: if the former simply follows the latter, other variables affecting the former may be difficult or not meaningful for the purposes of this paper. As one would expect, patterns of FDI inflows for oil-exporting countries do not seem to coincide with those of world FDI inflows. Whilst from 1990 to 1991 there was a 25% pullback in world FDI inflows, oil-exporting FDI inflows experienced a 132% increase. Then, from 1993 to 1998, there was a steady increase of world FDI inflows whilst oil-exporting countries suffered pullbacks of 12% in 1993 and 19% in 1999. Most recently, the world experienced a pullback in FDI inflows from US$1.98 trillion in 2007 to US$1.70 trillion in 2008 (a 5% decline in FDI stock), all the while inflows to oil-

[1] All FDI inflows data from *United Nations Conference on Trade and Development*.

exporting countries continued to increase. Therefore, since GDP growth alone does not seem to sufficiently account for the growth in world FDI inflows, and patterns in world FDI inflows does not seem to sufficiently explain the patterns of FDI inflows into oil-exporting countries, we can look for other variables by which to account for patterns in oil-exporting countries.

Discussions on democracy and FDI took place more than thirty years ago. On one side of the discussion, O'Donnell argues that investors share better, more intimate, relationships with autocrats than with democratic leaders (I will discuss relevant cases below). Whilst both autocrats and democratic leaders may receive economic benefits from FDI, autocrats face lower constraints than democratic leaders if they choose to protect foreign investors and investments from pressures such as higher wages, labor protection and unfriendly taxation schemes. [2] According to O'Donnell, autocracy is more attractive to FDI than democracy. On the other end of the spectrum, Olson argues that established democracies, through executive constraint and judicial independence, guarantee property rights which create a safer and more stable and attractive environment for foreign investors to invest.[3] According to Olson, democracy is more attractive to FDI than autocracy.

Li and Resnick explain the effect of property rights and the level of democracy on FDI inflows into developing countries (52 countries from 1982 to 1995).[4] They conclude that when democracy and non-democracy-related property rights are accounted for, democracy has a negative effect on FDI inflows. They also explain how democracy has both negative and positive effects on FDI. The negative effect takes place in three ways. Firstly, executive constraints weaken oligopolistic or monopolistic positions of multinational corporations (MC). Secondly,

[2] O'Donnell 1978 and 1988.
[3] Olson 1993.
[4] Li and Resnick 2003.

such constraints prevent host governments (that is, governments of countries receiving FDI) from proposing financial and fiscal incentives to foreign investors. Lastly, pluralism of businesses encouraged and protected by democracies hinders the growth prospects and profitability of MCs seeking for market dominance, and this positive effect comes from democracy's association with property rights protection. In direct contrast to Li and Resnick, Jensen examines the effect of the level of democracy on inflows into both 114 developing and developed countries from 1970 to 1997, *without* extracting the property rights variable from democracy, and concludes that more democratic countries clearly attract more FDI inflows than less democratic ones.[5] The critical explanation for the positive effect of democracy on FDI lies in democracy's credibility to foreign investors. This credibility is established in two ways. Firstly, following Tsebelis and Henisz, the number of veto players in government – for example, chambers in legislation, judicial-executive-legislative independence, and federal actors – can increase policy stability.[6] Secondly, democratic leaders are held accountable to both the domestic and international public. Such leaders' commitments with MCs are transparent to the public. Reneging on such commitments, promises or contracts with MCs detracts from the credibility of the country. Thus there is a prohibitive reason to why democracies have credibility. Respectively, these are called the 'veto-player' and 'audience-cost' arguments within political economy literature.

Somewhat outside of the debate is Dunning's *ownership*, *locational*, and *internalization* framework (also known as OLI framework) that can be used by MCs when considering making an FDI into a host country.[7] Ownership advantages relate to MCs' access to assets or processes

[5] Jensen 2003.
[6] Tsebelis 1995; Henisz 2000.
[7] Dunning 1991.

that host country firms do not have. Because of high costs of transport, or the physical nature of the good, there are locational reasons to why MCs must invest directly into the host country. Finally, internalization advantages cover the firm-specific and highly variable advantages to keeping full control of the vertical integration (a type of management control wherein all the products of the supply chain are under the control of one management or company) or horizontal integration (wherein a particular product of the supply chain is under the control of one management or company across multiple markets) of the firm.

II. Theory – Detail

What is the importance of the democracy-FDI relationship for oil countries?

I will define *qualitatively* oil countries as countries with *proven oil and natural gas reserves* and that are net exporters of oil and natural gas – both of which overlap significantly. The democracy-FDI relationship is interesting and important in the case of oil countries for a few reasons.

Firstly, the export revenues of oil countries depend heavily on the sale of oil. The sale of oil in turn depends strategically on the price of oil. Because oil and its physical derivatives are publicly traded in the financial markets, the price of oil is interrelated with the price movements of other asset classes of the financial markets, for example the US dollar. Oil countries depend heavily on oil exports: 90% of Saudi Arabia's export revenue comes from oil, for United Arab Emirates this

is 60%, 80% for Iran, 66% for Algeria, and 95% for Libya.[8] These countries seek to protect and maximize returns based on a precaution that if oil is not selling well and margins are low, government revenues would dramatically fall. The most recent 2008 financial crisis is a timely example. This crisis had three broad effects on the financial markets. Firstly, global equity and property markets plunged. Secondly, there was an immediate 'flight-to-quality' to US Treasury bonds and the US dollar which, for a lack of a better alternative, is the international reserve currency. And thirdly, commodities prices plunged. Crude oil almost reached US$140 per barrel in July 2008 before falling to below US$40 per barrel by November 2008. With respect to crude oil and natural gas, the downfall was an immediate effect of the rising US dollar coupled with an expectation of lower global demand. This severely damaged the foreign currency reserves and the fiscal health of oil countries such as Russia, in which case the political economic consequences trickled down to social instability. Because the financial markets affect oil prices that in turn affect government earnings, the volatility of the financial markets translates into the volatility of the oil country's fiscal and macroeconomic conditions. Moreover, decreased government earnings can lead to increased government debt-to-GDP ratio (a macroeconomic measurement on the ability of a country to pay back its debt to other countries, the higher the number the greater the burden on the country to repay its debt) which puts further negative pressure on the government's fiscal strength and its country's local currency. Needless to say, these scenarios create an unstable and insecure investment environment. Therefore we should expect that, from an investor's perspective, oil countries are less conducive to FDI.

Secondly, as financial markets affect the oil prices that in turn affect the country's fiscal and macroeconomic health, the bargaining power of oil countries with respect to restrictive policies

[8] Data from internet resource *Index Mundi* and *CIA Factbook*.

on FDI is affected. The bargaining power of oil countries may in some ways run in tandem with oil prices in the following manner. Oil countries are net sellers of oil and non-oil countries are net buyers. During the oil bull market, which began as early as 2002 until the 2008 financial crisis, oil countries had been accumulating record amounts of foreign currency reserves from its oil export revenues which are denominated in US dollar. The demand for oil began to outstrip supply and coupled with speculative plays by non-physical traders and investors, prices were favoring net oil sellers. Within this period a few cases of government-led 'repossession' of stakes from foreign MCs in oil projects occurred. One case was in December 2006 when the Russian Kremlin forced Royal Dutch Shell to surrender 25% of the 55% stake in Sakhalin-2, one of the world's largest oil and gas development, to Russian's state-controlled Gazprom. The reasons for this repossession were reported to be environmental and cost-related, for Shell increased the project cost from US$10bn to US$21bn and thus adversely affected the profitability of the project. However, most media sources believe that the cost-related reason was merely ostensible, and presented the real reason as one relating to the increased bargaining power of Russia due to increased oil prices and global demand.[9] At current, since oil prices have fallen dramatically post-2008 financial crisis, Russia is looking outward again. In October 2009, Gazprom and China National Petroleum Corporation (CNPC) reached a preliminary long-term deal to provide natural gas to China, and Rosneft and CNPC collaborated to construct an oil refinery in Tianjin to facilitate China's persistent demand for oil.[10] Another case took place in June 2007 when President Hugo Chavez of Venezuela effectively pushed out US oil companies Exxon Mobil Corporation and ConocoPhillips from multi-billion dollar oil projects. The two companies quit their deals as Venezuela demanded a repossession of stakes. Other companies,

[9] http://www.telegraph.co.uk/finance/2952775/After-Shell-Russia-now-turns-on-BP.html
[10] http://www.hindustantimes.com/rssfeed/restofasia/China-Russia-inch-forward-on-energy-deals-analysts/Article1-465320.aspx

such as Chevron, Statoil, BP and Total all complied with Venezuela's demands by signing pacts that allowed the country to reclaim stakes to as much as 83% in projects worth as much as US$30bn.[11] Over the next few years and up until the financial crisis, Venezuela extended partnerships with national oil companies in Iran, China and Belarus. However, post-2008, after oil prices fell dramatically, in as early as January 2009 Venezuela began soliciting bids from US private companies again.[12] The volatility of the oil price leads to the volatility of an oil country's openness to investment and investment policies. This adds to the instability of an investment environment. Therefore we should expect that, from an investor's perspective, oil countries are less conducive to FDI.

Thirdly, the economic-physical nature of oil and natural gas causes an oil country to have a greater defensive stance towards foreign investment policy. Applying Dunning's OLI framework, the location-specificity of oil is one reason for engaging in FDI. Another is that oil countries such as Iraq, Russia, Angola, Algeria, Libya usually want not only capital but also technology from capital-abundant and technologically-advanced countries. Oil exploration, production and refinery are now extremely dependent on capital and technology, therefore the ownership-specificity of the discovery, recovery and production of crude oil and natural gas (upstream industry) and the refinery, selling and distribution of these resources (downstream industry) is another reason for engaging in FDI. According to Frieden, overseas investments in the primary production for export will more likely be associated with the use of force, from either host or home countries.[13] The exploration and production of oil is one such 'primary production' where expropriation is relatively easier. In short, since there are location-specific and

[11] http://www.usatoday.com/money/economy/2007-06-26-2141258034_x.htm
[12] http://www.nytimes.com/2009/01/15/world/americas/15venez.html?_r=2&scp=2&sq=venezuela&st=nyt
[13] Frieden 1994.

ownership-specific advantages and since the primary production of oil can be more easily expropriated, foreign investments in the oil sector will likely be in the form of FDI. Under these circumstances, both hypothetical and real, with the increasingly globalized demand for oil due to global population and economic growth and the increasingly inflation-adjusted oil price over the past 20 years (also proving that oil demand is increasing), it should not be hard to believe that oil countries should be protective of this increasingly valuable and strategic natural resource. We should therefore expect that, from an oil country's point of view, such countries will have a more defensive stance in their foreign investment policies.

If oil countries are less conducive to FDI due to their inherently unstable environment and the defensive stance, then the domestic institution can play a role in either increasing the levels of instability and defensiveness, or decreasing them. Whilst we can say this for every type of country, oil or non-oil, the volatility of the financial markets and oil countries that destabilizes government earnings and investment policies should lead one to believe that the power of the domestic institution on the attractiveness of FDI inflows is *greater* in oil countries than in non-oil countries. This paper can therefore be considered as a geopolitical and regional application of the democracy-FDI relationship debate and would hopefully be both interesting and important for any such further study in this topic.

What is the democracy-FDI relationship for oil countries?

The relationship between government-controlled sellers and government-controlled and private buyers is not easily generalizable. O'Donnell's observation that autocratic governments and interested foreign investors enjoy cozy relationships may be valid, but this is only meaningful if

such relationships are sought after in the first place. Similarly, democratic governments can provide the security of private property rights (Olson, Li and Resnick) as well as credibility (Jensen), but security and credibility are meaningful if there are reasons to consider these in the first place. What are the conditions that *initiate* such relationships and considerations? I propose, but I do not set to prove in this paper, a rough dichotomy. Firstly, on the one hand, let us assume that financial and economic conditions initiate such relationships and considerations. Political environment, on the other hand, help maintain and develop these relationships and extend these considerations. Secondly, there is a logical priority between the demand for oil and natural gas and their supply. Without demand, who would think about supply? We will do well to consider again the perspective of the investors. Investors want a reasonable risk-to-reward ratio in their investments. No investor ever simply looks at a potential reward without weighing this against potential risk. Reward, or profitability, is thus a function of demand for oil and oil price and financial economic conditions (e.g. Dunning's OLI framework). Reward is what primarily drives demand. Risk, or the measure of safety, is thus a function of also the financial economic, macroeconomic (monetary and fiscal), and political economic (domestic institutional) environment. Risk is primarily informed by supply. This paper therefore makes a crude distinction between reward being primarily a demand-side, financial-economic concern and risk being a supply-side, financial-economic and *political* concern.

Before focusing on the aspects of risk and protection from risk related to the political concern of domestic institutions, there are clearly reward-based incentives offered by domestic institutions. Taxation schemes are such incentives. Venezuela introduced the Hydrocarbons Law in 2001 which doubled royalties whilst lowered income tax. Media sources report the negative reaction to this law and FDI inflows to the country declined by 79% from 2001 to 2002. As a counter

example, however, Saudi Arabia has a corporate income tax of over 80%, which came into legislation in 2001, yet FDI inflows have not decreased between 2002 and 2008. The relationship between taxation scheme and FDI inflows is far beyond the scope of this paper, but I merely point out, albeit all too briefly, the probability of this relationship and its ambiguity at this current level of research. Apart of taxation schemes, there are other reward-based incentives offered by domestic institutions: tax-holidays, repatriation of capital and profits, exemption from import duties and currency restrictions, company laws allowing complete control of local firms, and so on. UAE's foreign investment policies provide prime examples of how a set of policies can be aimed at drawing in foreign investors.

Since the financial-economic reward-based incentives are in place, we have now established the demand for oil and natural gas investments. We can now turn to the supply of these investments and make risk-based considerations that specifically relate to domestic institutions. What considerations would a rational investor consider?

From an investor's point of view, since oil is in constant demand and affects the fortunes of governments, there are serious political risks in their investment. In light of events that have occurred, some of which mentioned above, these risks may include the following. One: sudden adverse changes in taxation schemes or incentives-related policies that affect bottom-line earnings. Two: sudden adverse changes in ownership laws (for example a maximum of 15% ownership by a foreign MC of a host company is reduced to less than 10%, which by definition would no longer be FDI) that affect the assets and top line growth of the MC. Three: sudden adverse changes from (or to) sector-based privatization to (or from) nationalization that affect – even more critically than the second risk – the operations, management and top line growth of the MC. Four: general domestic institutional changes that can affect all the above changes. Five:

general social and ideological shifts that can affect the above changes. Note that the first three risks directly affect the earnings and revenues of foreign MCs. Though the conditions that can spark off these risks are political, the outcome is financial, as far as an investor's point of view is concerned. The foundation to ensuring that the above risks can be minimized therefore depends on a combination of both *real and perceived* institutional, legal, legislative and social stability:

- Institutional stability – the expectation that the system of government is stable – requires that the domestic institution has durability (that is long-lasting and is measured in years of continued, uninterrupted governance) and a history of gradual transformation as opposed to sudden changes.
- Legal stability – that decisions to settle legal disputes follow procedural fairness and are objectively made – weighs on judicial independence and access to international arbitration. An example of this is Russia's Subsoil Law which provided the legal framework for production sharing agreements, a type of right handed over by the country to the foreign MC to conduct exploration and production activities. The foreign MC acts as a contractor to develop oil and gas resources and receives a share of production to recoup costs and make a profit. Initially the Subsoil Law did not allow for international arbitration. Investors pressured the Russian government to change this, and this change was eventually implemented two years later. According to Bradshaw, investors favored this as a way of insulating their investments from the oil country's legislative instability (discussed below).[14]
- Legislative stability – that investment policies are not subject to sudden changes – depends also on domestic institutional durability as well as on internal institutional

[14] www.geog.le.ac.uk/staff/mjb41/publications/MJB_**Sakhalin_Lessons**.pdf

constraint. Indeed, institutional durability does not guarantee legislative stability but the lack of durability does certainly remove legislative stability.

- Social stability – that there are minimum social unrest, riots and disturbances. This clearly relates to institutional stability and affects the investment environment. An example is in Nigeria where in February 2006 militants, upset with the distribution of oil profits, attacked oil facilities and kidnapped oil workers, leading to a damage of one of Shell's export terminals and a 25% reduction in Nigeria's oil exports. Such instability is negatively associated with FDI attractiveness.

With regards to this instability, it is worth noting the geographic effects of instability. A country's instability, whether it is institutional or social, may destabilize a neighboring country or at least produce a negative perception on the neighboring country's stability. It is considerable and noteworthy, but not something which this paper will attempt to model. The risk-reward system for each country will be considered, politically and economically, and independently for each country. This paper will assume that such neighborhood effects of instability will be accounted for in the independent variables that measure the political and economic dynamics of each individual country. On top these four 'dimensions of stability' is the criteria of how well the central government can delegate and coordinate the implementation of investment policies through periphery governments. The better the delegation and coordination, the more protection there is from the abovementioned risks. An example of poor central-to-peripheral coordination is the case of Russia's Sakhalin-1, where ExxonMobil oversees its exploration and production development, wherein the main challenges and resistance to the management and work of the US oil company come from local, not central, authorities.

In summary, an evaluation of risk is an evaluation of the level of uncertainty. In the case of FDI risks, the uncertainties pertaining to FDI directly depend on the dimensions of stability in the institutional, legal, legislative and social arenas. (These arenas will be operationalized in the next section.) Because democratic systems should have higher durability, greater association with judicial independence and international arbitration, higher internal institutional constraint than autocratic systems, lower social unrest, we should expect that more democratic systems ensure greater stability. With regards to property rights protection and expropriation, following Jensen, I believe that there is no strong reason to why democratic regimes are more likely to expropriate than autocratic regimes, since in both cases the appeasement of those who have the power to select leaders of such regimes, or the 'selectorate', is critical to their survival.[15] The security of property rights overlaps with the abovementioned risk minimization mechanisms. Finally, the protection of risk necessarily requires the *perception* of the protection of risk. It is here that Jensen's credibility is important. As mentioned, veto-player and audience-cost arguments provide credibility to democratic systems. Though credibility does not ensure stability, it ensures the perception of stability from the investor's point of view. Therefore we should expect that more democratic systems in oil countries attract greater levels of FDI inflows.

[15] Jensen 2003.

III. Empirics – Design

The empirical analysis covers 143 countries (see Appendix) from 1990 to 2008. The countries display variation across FDI inflows and levels of democracy. A pooled panel data design is applied producing six models.

Dependent Variable

The dependent variable is FDI Inflows as measured in millions of current US dollar. FDI inflows are investments in at least 10% of voting stock. This is not inflation-adjusted, but neither are the relevant independent variables (such as World FDI Inflows, see below) so the net effect of inflation should theoretically be cancelled out. Data comes from *United Nations Conference on Trade and Development*.

Independent Variables

The first independent variable is Polity IV. This is a measurement of the level of democracy, and is operationalized on: competitiveness and regulation of political participation, competitiveness and openness of executive recruitment, and internal constraints on executive decision-makers. The variable is measured from -10 (strongly autocratic) to +10 (strongly democratic). It is expected that the higher the variable score (the more democratic) the higher the FDI inflows. Data comes from internet resource on *Polity IV*. This is an oft-used variable in political economy literature, and is used in Li and Resnick, in Jensen and in other political economy literature

outside of the democracy-FDI debate. As we shall see below, *Polity IV* resource has many other indices that correlate with the democracy index of Polity IV.

The second independent variable is Oil and Exporter, a dummy variable for oil countries selected through two criteria: i) the country has proven oil reserves as a percentage of world proven oil reserves, ii) the country is a net exporter of oil. This ensures that those with proven oil reserves but are net importers, and therefore net buyers of oil, are not in the list. The reason is obvious. Net exporters of oil will receive net export earnings in oil and net importers will not. Net exporters will play the role of the supplier. The demand-supply divide is to stay consistent with my theoretical dichotomous approach to investment analysis. The interaction of Oil and Exporter and Polity IV is of primary interest. It is expected that being an oil country will receive lower FDI inflows but a higher Polity IV score (being more democratic) will help bring back FDI inflows in a strong way. Data comes from *OPEC* and *Index Mundi*.

The third independent variable is Durability. This is a measurement of the number of years that a regime has been in power. Any regime change, interruption or break will reset the number to zero. I use this as a proxy for institutional, legislative and social stability. Following Li and Resnick, it is expected that the greater the durability increases perceived stability and decreases investors' sense of risk, thereby increasing FDI inflows. Data comes from *Polity IV*.

An interceding note on Li and Resnick's property rights is in order. When we weigh the attractiveness of democracy against the attractiveness of autocracy on cross-border investments, extracting property rights from democracy seems problematic for the reason that it has an asymmetrical consequence on the variable of the level of democracy. If there is an association between democracy and property rights protection, then extracting property rights from the level

of democracy takes away from democracy but not from autocracy. The scale is therefore shifted. Li and Resnick's conclusion might not contradict Jensen's conclusion because Jensen nets the effect of democracy. This paper does not extract property rights, but instead nets the effect in the variable of Polity IV. I therefore assume that the level of property rights protection to be associated with *some* level of democracy, though I do not assume that this association is precise or that its direction is clearly positive with higher levels of democracy.

Control Variables

The first control variable is Economic Size measured in GDP in international currency in purchasing power parity. It is expected that greater economic size will attract higher FDI inflows.

The second control variable is Economic Growth measured in annual percentage change in GDP growth. It makes intuitive sense that economic growth generally accompanies increased economic return on investment. Investors will be attracted to countries with economic growth, therefore it is expected that economic growth will be positively related to FDI inflows.

The third control variable is Trade Size measured in exports plus imports as a percentage of total GDP. Following Jensen, it is expected that the greater the trade size the higher the level of FDI inflows since it is likely that economic conditions for a better investment environment may overlap with conditions for a better international trade environment, or simply that trade flows correlate with investment flows. Data for the first three control variables comes from World Bank's *World Development Indicators*.

The fourth control variable is Current Account Balance. This is a proxy for the macroeconomic health of the country. A persistently negative current account balance equates to a persistently positive capital and financial account. This sometimes entails public debt (positive financial account in the form of government debt to fund negative account balance) which, beyond a certain percentage level over GDP, reveals poor macroeconomic health. This in turns lowers the public's confidence in the country's local currency and bonds, and possibly leading to the weakening of the currency and the increase of government bond yields. A weakening currency may deter investors when investments when certain receipts are contracted and made in the local currency which will return a lower US dollar-denominated value and therefore real returns on investments suffer. It is expected that a negative current account balance reduces FDI inflows. Data comes from the *IMF*.

The fifth control variable is Government Consumption measured as government expenditure as a percentage of GDP. Following Jensen and Barro, who claim that government intervention dampens economic growth rates, government consumption may be related to political regime.[16] Therefore some directional effect of government consumption on FDI inflows may be witnessed here. Data comes from World Bank's *World Development Indicators*.

Finally, the control variable of World FDI Inflows as measured in millions of current US dollars is used. This should be positive with FDI inflows across individual countries. Data comes from *United Nations Conference on Trade and Development*.

Because of time constraint and the inability to obtain data with sufficient time coverage, the following variables are not included. 1) Oil price, annualized and adjusted for inflation. This

[16] Barro 1993 and 1996.

would be a good indicator of oil demand and would aid in studying the variation in the bargaining power of net exporters versus net importers. 2) Political stability. This is not only a political index, but also a social index as it measures social unrest. It would be a good indicator of institutional and social stability and may correlate with durability. 3) Government deficit. The government deficit would be an even stronger proxy than current account balance for the perceived strength and safety of local currency and government bonds and therefore the expected returns on investment.

IV. Empirics – Findings

Table 1: FDI Inflows (millions current USD)

Variables	*Model 1*	*Model 2*	*Model 3*	*Model 4*
Polity IV	107.599**	96.781*	82.619*	65.74
	(35.929)	(40.507)	(35.762)	(40.360)
Oil and Exporter		-610.547		-1054.817
		(1230.857)		(1220.571)
Durability			61.941***	62.189***
			(8.892)	(8.915)
Economic Size	0.0122***	0.001***	0.001***	0.001***
	(0.0003)	(0.000)	(0.000)	(0.000)
Trade Size	24.463***	24.873***	21.335***	21.736***
	(6.320)	(6.340)	(6.275)	(6.295)
Economic Growth	14.611	14.374	8.863	8.472
	(42.585)	(42.598)	(42.181)	(42.193)
Current Account Balance	0.054	-0.005***	-0.005***	-0.052***
	(0.0071)	(0.001)	(0.001)	(0.001)
Government Expenditure	-40.611	-41.496	-15.179	-18.017
	(24.889)	(25.306)	(24.917)	(25.285)
World FDI Inflows	0.001**	0.001**	0.001**	0.001**
	(0.000)	(0.000)	(0.000)	(0.000)**
Polity IV * Oil and Exporter		76.648		89.301
		(96.549)		(95.629)
Constant	-2480.627**	-2377.631*	-3557.137***	-3293.867***
	(924.688)	(999.677)	(928.693)	(997.952)
N	2574	2574	2574	2574
R^2	0.53	0.54	0.55	0.55

Table 1 is the result of the following cross-sectional regression equation:

$$\text{FDI Inflows}_{it} = \alpha + \beta_{it}(\text{Independent Variables}) + \varepsilon_{it} \text{ where } i = 1,2 \ldots 143 \text{ and}$$

$$t = 1990, 1992 \ldots 2007$$

Table 1 above shows the results on the dependent variable FDI Inflows. Model 1 is a baseline model, without Oil and Exporter and Durability, and shows that a 1-point increase in Polity IV

(that is a 1-point increase toward democratic system) increases the FDI inflows to the country by US$108Mn. Polity IV is positive and significant in three of the four models. This falls in line with expectation. In Models 3 and 4, a 1-year increase in Durability increases FDI inflows to the country by US$62Mn. In Models 2 and 4, the variable Oil and Exporter is negative but insignificant. Being an oil country is expected to decrease FDI inflows, as theorized above. Looking at the interaction variable Polity IV * Oil and Exporter in Models 2 and 4, a 1-point increase toward democracy for an oil country is related to an increase in FDI of US$77Mn and US$89Mn respectively. In Model 4, this increase is larger than an increase of FDI for non-oil countries. The general direction falls in line with expectation, albeit the non-significance of coefficients.

Moving to the control variables, we have results that mostly fall in line with expectation for all of them. Economic Size is highly significant and positively associated with FDI inflows, as is Trade Size. Economic Growth is not significant but it is also positively associated with higher levels of FDI. Current Account Balance for Models 2 to 4 is highly significant and negatively related to FDI inflows and is not in line with expectation. Government Expenditure is negatively associated with FDI inflows in the country.

Table 2: Lagged Independent Variables on FDI Inflows

Variables	*Model 5*	*Model 6*
FDIInflows	0.004	0.002
	(0.002)	(0.002)
Polity IV	79.953*	59.063
	(38.593)	(43.608)
Oil and Exporter		-1200.640
		(1323.742)
Durability	81.544***	81.495***
	(9.504)	(9.530)
Economic Size	0.013***	0.013***
	(0.000)	(0.001)
Trade Size	21.342**	22.123**
	(6.727)	(6.746)
Economic Growth	33.736	32.891
	(44.569)	(44.577)
Current Account Balance	-0.048***	-0.048***
	(0.001)	(0.001)
Government Expenditure	-5.363	-7.366
	(26.815)	(27.183)
World FDI Inflows	0.002***	0.002***
	(0.000)	(0.000)
Polity IV * Oil and Exporter		138.891
		(103.058)
Constant	-4518.316***	-4285.452***
	(1014.611)	(1087.602)
N	2574	2574
R^2	0.60	0.60

Table 2 shows a lagged regression:

$$\text{FDI Inflows}_{it} = \alpha + \beta_{i(t-1)}(\text{FDI Inflows} + \text{Independent Variables}) + \varepsilon_{i(t-1)}$$

$i = 1,2 \ldots 143$ and $t = 1990, 1992 \ldots 2007$

Table 2 results show that if we lag the independent variables by one unit of time, and include in the equation FDI inflows of the previous year into the independent variable set, similar results

emerge. Polity IV is positive and significant in Model 5 on FDI inflows, Oil and Exporter is negative but not significant on FDI inflows, and Durability remains significant and positive on inflows. In Models 5 and 6, the interaction variable Polity IV * Oil and Exporter shows a slightly stronger coefficient with a lower standard deviation than those in Models 2 and 4. The direction is as expected, a 1-point increase toward democracy for an oil country increases FDI inflows to the country by US$139Mn. For non-oil country a 1-point increase leads to US$59Mn, less than half the amount that it would give to an oil country. The control variables behave in a predictable manner given Models 1 to 4.[17]

V. Conclusion and Criticism

There is reason to believe that the empirics support the theory. Firstly, higher levels of democracy lead to higher levels of FDI into the country. This result accords with Jensen's reasons and findings. Secondly, given the nature of oil as an expropriable good, as a good whose price is determined by world demand and other price movements of the financial markets, and as a good that in turn determines the financial economic fortunes of oil countries, investors are expected to be cautious about oil investments and oil countries are expected to be defensive about their natural resources and hence by nature will be less open to FDI than non-oil countries. Weakly, the result accords with this expectation. Thirdly, higher levels of democracy that bring

[17] A fixed effects model with year effects was run for the lagged independent variables. The resulting summary of the coefficient estimates of intercepts based on years showed that only 2 of 18 estimates (years 2000 and 2007) were significantly different from the overall average intercept at $p = 0.05$. A fixed effects model with country effects was run for the same set of variables, and only 11 of 143 countries show significantly different estimates. These results can be accessed through the R-code and Data provided by the author and separate from this paper.

in higher levels of FDI for countries in general, bring in *even higher* levels of FDI for oil countries also, thus it does not conflict with the view that the power of regime type on FDI inflows is quite notable for oil countries compared to non-oil countries. In models that include regime durability, the increase in the level of democracy on the increase in FDI is larger for oil countries than for non-oil countries. Fourthly, greater regime durability, as a proxy for institutional, legislative and social stability, is clearly important to attracting greater FDI inflows.

Now I wish to highlight some deficiencies to the paper.

The first criticism is that the statistical model can be improved. Robustness tests need to be better regarded, standard deviations for key independent variables are high and residuals can be corrected and remodeled.

The second criticism is that taxation on FDI inflows is important and not enough regard has been given to this. The rough dichotomy drawn between reward as a demand-related phenomenon and supply as a risk-related phenomenon does not accommodate to the role of taxation because that is both a supply and a reward-related phenomenon.

The third criticism is that oil countries, though many of them depend on export revenues from oil, also receive FDI in non-oil sectors. How would one control for FDI in the non-oil sectors so the focus is on oil-related FDI only, rather than an aggregate FDI? Sufficient and comprehensive data is not available as yet, but what proxies could one use to abstract oil-related FDI only?

This fourth criticism is that this paper is not about the political economy of democracy and FDI across the world, but only to oil countries. The difference between oil countries and other types of countries (say manufacturing-dependent countries) hinges on the argument that the prices of oil and natural gas stand inescapably between movements in the financial markets and the fate of

government revenues. The immediate attention one would then give is how such prices affect FDI inflows. I have not included oil prices in the model, though the data was gathered, because the problems are technical: How does one annualize oil prices that change by the minute? How much lag should be given to this annualized amount? What about the real local price of oil, accounting for subsidies implemented to guard local consumers from oil price fluctuations? Should futures or spot prices be used? Should a commodity index be used? How to abstract the other commodities from oil and natural gas (which are the two main goods that control for the selection of oil countries)?

Because oil as an asset and as a source of government revenue is volatile, oil countries' policies are unpredictable and the investment environment is unstable. Therefore one of the key independent variables and ideas is the role of 'multi-dimensional stability' required to bring about a more attractive investment environment. The final criticism here is that without political instability index or other measures, durability as the only proxy for the dimensions of stability is oversubscribed. Too much explanatory expectation is assigned to durability. Durability is a control variable in Li and Resnick and not even included in Jensen. So this idea of multi-dimensional stability is outside of the democracy-FDI debate, but nonetheless it shows promise and much more can be done to clarify what aspects of stability can be tested against FDI inflows, and how that stability affects oil countries in particular.

Appendix

Appendix 1: Country, * = oil countries

Country	Data	FDI Inflow (millions of current USD)			PolityIV		
	Coverage	Mean	Min	Max	Mean	Min	Max
Albania	1993-2007	214.40	20.00	956.20	6.00	0.00	9.00
Algeria*	1990-2007	680.93	0.01	2646.00	-2.21	-7.00	2.00
Angola*	1990-2007	3388.98	-334.80	15547.74	-3.21	-7.00	-2.00
Argentina*	1990-2007	6040.49	1652.01	23987.70	7.53	7.00	8.00
Armenia	1993-2007	211.14	0.80	1132.40	3.94	-6.00	7.00
Australia	1990-2007	13028.14	-32080.15	46773.98	10.00	10.00	10.00
Austria	1990-2007	5799.03	356.32	29586.47	10.00	10.00	10.00
Azerbaijan	1993-2007	458.77	-4817.00	3535.00	-5.88	-7.00	1.00
Bahrain	1990-2007	749.27	-275.00	2914.89	-8.37	-10.00	-7.00
Bangladesh	1990-2007	383.20	1.39	1086.30	4.16	-6.00	6.00
Belarus	1994-2007	385.45	7.00	2158.10	-4.12	-7.00	7.00
Benin	1990-2005	57.40	1.41	255.24	5.84	0.00	7.00
Bhutan	1990-2007	6.87	-0.70	73.30	-8.68	-10.00	3.00
Bolivia	1990-2006	395.07	-287.80	1026.05	8.68	8.00	9.00
Botswana	1990-2007	142.87	-287.40	494.59	7.63	7.00	8.00
Brazil	1990-2007	16466.54	988.80	45058.16	8.00	8.00	8.00
Bulgaria	1990-2007	2267.70	4.00	11716.09	8.42	8.00	9.00
BurkinaFaso	1990-2006	37.37	0.46	343.54	-2.74	-7.00	0.00
Burundi	1990-2006	1.09	-0.57	11.68	-0.89	-7.00	6.00
Cambodia	1994-2007	261.70	33.00	867.28	1.12	-7.00	2.00
Cameroon	1990-2007	152.55	-112.83	601.75	-4.42	-8.00	-4.00
Canada*	1990-2007	24648.16	-445.04	108414.49	10.00	10.00	10.00
CentralAfricanRep	1990-2007	16.64	-10.68	121.11	1.32	-7.00	5.00
Chad	1990-2007	263.52	-99.34	924.12	-2.92	-7.00	-2.00
Chile	1991-2007	5221.20	661.20	16786.86	8.63	8.00	10.00
China	1990-2007	46413.21	3487.11	108312.00	-7.00	-7.00	-7.00
Colombia*	1991-2007	3496.79	456.90	10563.87	7.47	7.00	9.00
Comoros	1990-2007	1.25	-1.45	8.06	4.21	-2.00	9.00
CongoRepublic	1990-2007	458.80	-13.06	2621.68	-2.16	-8.00	5.00
CongoDemocratic	1990-2007	103.14	-107.72	1000.00	-2.16	-8.00	5.00
CostaRica	1990-2007	666.18	162.40	2021.00	10.00	10.00	10.00
Croatia	1993-2007	1490.32	13.00	4982.00	2.88	-5.00	9.00
Cyprus	1990-9,2003-7	801.23	75.20	2181.03	10.00	10.00	10.00
CzechRepublic	1993-2007	5075.07	653.47	11602.80	9.63	8.00	10.00
Denmark	1990-2007	5253.61	-932.16	16458.20	10.00	10.00	10.00
Djibouti	1991-2007	38.89	0.06	234.00	-2.21	-8.00	2.00
DominicanRep	1990-2007	810.95	96.50	2884.70	7.26	5.00	8.00
Ecuador*	1991-2007	588.55	126.18	1329.82	7.47	5.00	9.00

Egypt*	1990-2007	2595.96	237.40	11578.10	-5.37	-6.00	-3.00
ElSalvador	1990-2007	312.90	-4.80	1508.50	6.95	6.00	7.00
EquatorialGuinea	1990-2007	632.64	6.02	1873.10	-5.32	-7.00	-5.00
Ethiopia	1990-2007	187.80	0.17	545.26	-0.32	-8.00	1.00
Fiji	1990-2005	105.27	3.43	373.66	3.82	-4.00	6.00
Finland	1990-2007	3775.85	-4199.38	12351.36	10.00	10.00	10.00
France	1990-2007	46499.50	15187.99	157972.89	9.00	9.00	9.00
Gabon*	1990-2007	-4.69	-498.62	319.51	-4.16	-7.00	-4.00
Gambia	1990,1993-2007	32.78	8.03	76.46	-2.53	-7.00	8.00
Georgia	1994-2007	401.41	0.00	1750.24	5.29	4.00	7.00
Germany	1990-2007	32154.69	-10188.35	198276.51	10.00	10.00	10.00
Ghana	1990-2007	286.86	14.80	2120.41	2.79	-7.00	8.00
Greece	1990-2007	1477.62	50.30	5363.67	10.00	10.00	10.00
Guatemala	1990-2007	299.52	59.30	837.80	6.42	3.00	8.00
Guinea	1990-2007	125.80	0.21	1349.59	-2.16	-7.00	-1.00
GuineaBissau	1990-2007	5.35	0.04	18.51	2.16	-8.00	6.00
Guyana	1990-2005	72.88	7.90	178.00	4.63	-7.00	6.00
Haiti	1990-2007	20.78	-2.80	160.00	1.76	-7.00	7.00
Honduras	1990-2007	301.71	41.50	876.99	6.53	6.00	7.00
Hungary	1990-2007	3709.49	553.81	7705.79	10.00	10.00	10.00
India	1990-2007	7082.46	75.00	41554.00	8.74	8.00	9.00
Indonesia	1990-2007	2335.19	-4495.00	8336.00	0.47	-7.00	8.00
Iran*	1990-2007	968.92	-361.95	3657.07	-2.68	-6.00	3.00
Ireland	1990-2007	4369.54	-31689.30	29323.80	10.00	10.00	10.00
Israel	1990-2007	3584.67	49.56	14762.88	9.53	9.00	10.00
Italy	1990-2007	12367.91	2235.95	40201.85	10.00	10.00	10.00
Japan	1990-2006	5658.31	-6505.64	24425.55	10.00	10.00	10.00
Jordan	1990-2007	642.82	-33.55	3267.56	-2.32	-4.00	-2.00
Kazakhstan*	1992-2007	3232.51	100.00	14543.43	-4.65	-6.00	-3.00
Kenya	1990-2007	72.46	2.00	728.01	0.37	-7.00	8.00
KoreaRep	1990-9,2001-7	4037.75	546.27	9882.93	7.16	6.00	8.00
Kuwait*	1993-2006	47.15	-175.00	347.34	-7.24	-9.50	-7.00
Kyrgyzstan	1993-2007	82.58	-2.36	232.67	-1.44	-3.00	4.00
LaoDemRep	1990-2007	73.74	6.00	323.50	-7.00	-7.00	-7.00
Latvia	1992-2007	580.39	31.50	2247.10	8.00	8.00	8.00
Lebanon	1990-2007	1269.64	1.63	3606.40	6.21	6.00	7.00
Lesotho	1990-2007	45.64	7.24	198.86	5.63	-7.00	8.00
Libya*	2000-2002	648.17	-148.00	4689.00	-7.00	-7.00	-7.00
Lithuania	1993-2007	663.37	10.00	2016.98	10.00	10.00	10.00
MacedoniaTFYR	1994-2007	224.59	9.49	699.09	7.40	6.00	9.00
Madagascar	1990-2007	170.98	5.73	1476.76	6.61	-6.00	9.00
Malawi	1990-2007	28.76	-28.70	107.71	2.63	-9.00	6.00
Malaysia*	1990-2007	4704.11	553.95	8401.20	3.42	3.00	6.00

Mali	1990-2007	75.27	-21.87	243.80	5.63	-7.00	7.00
Mauritania	1990-2007	102.95	-3.33	814.10	-5.26	-7.00	4.00
Mauritius	1990-2007	79.21	-25.64	382.77	10.00	10.00	10.00
Mexico*	1990-2007	15117.17	2633.24	29801.63	5.37	0.00	8.00
Moldova	1992-2007	141.25	12.02	712.76	7.35	5.00	8.00
Mongolia	1991-2007	108.08	2.00	682.50	9.33	2.00	10.00
Morocco	1990-2007	1146.77	165.00	2807.73	-6.53	-8.00	-6.00
Mozambique	1990-2007	185.35	9.20	586.99	3.42	-7.00	6.00
Namibia	1990-2007	221.35	19.64	746.37	6.00	6.00	6.00
Nepal	1990-1,1996-2007	6.55	-6.55	23.06	3.00	-6.00	6.00
Netherlands	1990-2007	25836.68	-3492.10	118376.00	10.00	10.00	10.00
NewZealand	1990-2007	2228.47	-113.08	7757.80	10.00	10.00	10.00
Nicaragua	1990-2007	190.08	0.67	626.10	7.58	6.00	9.00
Niger	1990-2005	27.42	-34.35	146.94	3.29	-7.00	8.00
Nigeria*	1990-2007	3975.44	1002.50	20278.50	-0.42	-7.00	4.00
Norway*	1990-2007	3025.10	-668.11	7090.45	10.00	10.00	10.00
Oman*	1990-2006	554.69	5.20	3124.58	-8.68	-10.00	-8.00
Pakistan	1990-2007	1339.41	271.92	5590.00	1.79	-6.00	8.00
Panama	1990-2007	825.87	77.90	2497.90	8.79	8.00	9.00
PapuaNewGuinea	1990-2007	161.31	-30.41	654.25	4.00	4.00	4.00
Paraguay	1990-2007	125.34	10.00	341.90	6.74	2.00	8.00
Peru	1990-2007	2060.25	-79.00	5490.96	5.11	-3.00	9.00
Philippines	1990-2007	1384.47	195.00	2921.00	8.00	8.00	8.00
Poland	1990-2007	7221.79	88.00	22612.00	8.95	5.00	10.00
Portugal	1990-2007	3378.59	689.70	10901.96	10.00	10.00	10.00
Qatar*	2003-5	1157.74	4.88	6700.00	-10.00	-10.00	-10.00
Romania	1990-2007	3082.73	0.01	13305.01	7.32	5.00	9.00
Russia*	1992-2007	12879.32	689.57	70320.00	4.47	3.00	6.00
Rwanda	1990-2007	14.80	0.00	103.35	-4.95	-7.00	-3.00
SaudiArabia*	1990-2007	5226.55	57.00	38222.50	-10.00	-10.00	-10.00
SierraLeone	1990-2007	22.59	-7.46	94.49	1.29	-7.00	7.00
Slovakia	1993-2006	1963.93	179.14	4692.65	8.56	7.00	10.00
Slovenia	1990-2007	533.08	106.56	1814.77	10.00	10.00	10.00
SolomonIslands	1990-2007	14.55	-18.56	75.51	8.00	8.00	8.00
SouthAfrica	1990-2007	2110.45	-527.10	9009.17	8.37	5.00	9.00
Spain	1990-2007	22724.17	8070.48	65539.45	10.00	10.00	10.00
SriLanka	1990-2007	246.65	43.35	752.20	5.26	5.00	6.00
Sudan*	1990-2007	860.09	-31.13	3541.36	-6.21	-7.00	-4.00
Swaziland	1990-2007	47.78	-60.90	152.72	-9.16	-10.00	-9.00
Sweden	1990-2007	15567.56	-41.04	60960.57	10.00	10.00	10.00
Switzerland	1990-2006	10146.77	-951.19	49245.23	10.00	10.00	10.00
Syria	1990-2007	352.67	18.03	2116.00	-8.05	-9.00	-7.00
Tajikistan	1993-2007	94.95	6.70	375.80	-3.41	-6.00	-1.00

Tanzania	1990-2006	287.62	0.01	744.00	-2.16	-6.00	-1.00
Thailand	1990-2007	4921.17	1369.00	11238.09	6.63	-5.00	9.00
Togo	1990-2007	34.89	-13.11	77.34	-2.95	-7.00	-2.00
TrinidadTobago	1990-2007	745.21	109.40	3047.00	9.63	9.00	10.00
Tunisia	1990-2007	841.06	88.70	3311.80	-3.68	-5.00	-3.00
Turkey	1990-2007	4855.33	608.00	22046.00	7.44	7.00	9.00
Turkmenistan	1996-2007	296.75	62.30	820.00	-9.00	-9.00	-9.00
Uganda	1990-2007	225.20	-5.91	787.38	-3.84	-7.00	-1.00
Ukraine	1993-2007	2495.53	159.00	10693.00	6.47	5.00	7.00
UAE*	1990-2007	3608.05	-985.34	14186.52	-8.00	-8.00	-8.00
UnitedKingdom	1990-2007	63444.39	9252.76	183385.62	10.00	10.00	10.00
UnitedStates	1990-2006	134586.86	19222.00	316112.00	10.00	10.00	10.00
Uruguay	1990-2007	447.77	11.30	2205.10	10.00	10.00	10.00
Uzbekistan	1992-2007	179.02	-24.00	918.00	-9.00	-9.00	-9.00
Venezuela*	1990-2007	2024.86	-590.00	6202.00	7.00	5.00	9.00
Vietnam	1990-2007	2069.16	180.00	8049.97	-7.00	-7.00	-7.00
Yemen	1991-2003	180.89	-307.60	1121.00	-2.00	-2.00	-2.00
Zambia	1990-2007	307.09	34.34	1323.90	3.58	-9.00	7.00
Zimbabwe	1990-2005	67.30	2.80	444.30	-4.84	-6.00	-3.00

Appendix 2: Descriptives on Variables

Variables	N	Mean	S.D.	Minimum	Maximum
FDIInflows	2663	4679.25	18754.77	-32080.15	316112.00
PolityIV	2696	3.00	6.73	-10.00	10.00
Durability	2696	23.02	30.70	0.00	199.00
Economic Size	2678	290448.12	987478.64	95.00	14441425.00
Economic Growth	2661	3.64	6.04	-50.00	71.00
Trade Size	2604	77.87	38.70	11.00	281.00
Current Account Balance	2669	-585.14	43273.65	-803546.00	426107.00
Government Expenditure	2537	19.38	9.75	3.06	82.78
Oil and Exporter	2717	0.16	0.37	0.00	1.00
WFDIInflows	2717	679476.76	580184.62	50267.77	1978837.91

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