Foreign Direct Investment flows to countries where the most prominent political parties are national, rather than regional

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What is the relationship between Foreign Direct Investment (FDI) and political party organisation? ***Joel W. Simmons, Allen Hicken, Ken Kollman*** *and* ***Irfan Nooruddin*** *share evidence which shows that countries with a higher number of regionalised political parties will have more difficulty attracting FDI than those countries with national political parties in positions of greater prominence.*

Narendra Modi Credit: Global Panorama, CC BY SA 2.0

Foreign direct investment (FDI) is big business. A recent report from the Organisation for Economic Co-operation and Development (OECD) shows that in 2015, total global FDI flows amounted to USD 1.7 trillion, the highest level since 2007. The huge amount of FDI flowing through the global economy is important because decades of social science research shows that the countries able to attract it stand to reap large economic benefits. Luring FDI stimulates capital accumulation, increases employment and exports, and generates gains in worker productivity by introducing new technologies into the economy.

Given these economic benefits, it is no surprise that countries around the world are locked in a fierce battle to attract all that foreign investment. But which countries win and which lose? What determines where all that capital is likely to locate? Existing research draws attention to the fact that once sunk, FDI is difficult to reverse. Because of this, once an investment is made, revenue-seeking governments may be tempted to renegotiate the business-friendly incentives and policies that attracted the investment to the country in the first place.

In the extreme, states might nationalize the firm altogether, but the more common situation is a subtler form of expropriation, wherein the state raises tax rates on investment returns or imposes new regulations that make doing business less profitable than originally anticipated. Obviously, investors prefer to allocate their capital to countries where the government is unlikely to engage in this sort of behavior.

In new research, we advance this perspective by highlighting a new determinant of expropriation risk. Specifically, we argue that FDI will tend to flow to countries where the most prominent political parties are national rather than regional organizations. A simple comparison of the United States and India illustrates the key distinction we highlight. In the United States, elections from the Presidency to local mayors and everything in-between are contested by Democrats and Republicans. The hegemony of these two party labels over the political process is so complete that even a longtime independent like Senator Bernie Sanders is forced to contest the 2016 Presidential race as a Democrat. In India, however, Sanders could have chosen from any of several hundred viable alternative party labels with which to align himself.

Even in 2014, when Narendra Modi's *Bharatiya Janata Party* formed the first majority government in thirty years, over two out of every three voters in that election voted for some other party. The bulk of these non-BJP votes went to regional parties around the country, most of which are relevant only in individual states and rely on elaborate coalition dynamics for policy influence. The practical consequence of this difference is that in the United States, both parties have national constituencies, while in India, most parties have constituencies that are regionally narrow and specific.

Why should the geographic dispersion or parties' political support affect investment? The crux of the issue is that whatever investment does enter the country will almost certainly cluster in some regions of the country and avoid others. In virtually any country, even the most casual observation reveals regions where economic activity clusters and other regions trapped in comparatively high poverty – witness the stark differences in income between the northeastern and western coasts of the United States compared to the Mississippi River Delta, or northern Italy compared to the south, eastern China compared to inland, or Gujarat and Maharashtra states in India compared to the northeastern states in that country.

This clustering, in turn, creates visible inequalities within the country and generates demands for geographic-based income redistribution. Unchecked, such redistributive pressures can dissuade investors from entering the country altogether.

Importantly, countries with regionalized party systems are especially susceptible to these redistribution demands. When a party drawing support from relatively poor regions of the country comes to power, it has strong incentives to raise taxes on existing difficult-to-reverse capital and spend the increased revenues on its supporters. Such geographic-based income redistribution is optimal for the party precisely because the capital it taxes resides in regions of the country from which it does not draw much political support anyway. Politically speaking, a party from an FDI-poor region loses nothing from expropriating the returns to FDI in more attractive regions.

On the other hand, national parties are essentially coalitions between the citizens residing in FDI-rich and those in FDI-poor regions. Thus, maintaining political support obliges these parties to strike a delicate balance – engage in some redistribution to maintain support in the poor regions, but refrain from raising taxes too high in order to keep support in the relatively richer parts of the country. In the end, even if national parties pursue some geographic-based income redistribution, that they must appeal simultaneously to the residents most likely to gain from FDI and those residents unlikely to gain from FDI obliges them to moderate the taxes levied on capital.

The upshot is that countries with regionalised party systems are much less attractive to capital owners than countries with nationalized party systems. How big is the difference? We sampled about sixty democratic countries, gathering data on each for every available year between 1975 and 2007. Our analysis shows that a standard deviation increase in our measure of party system regionalism reduces FDI's share of GDP by about 0.5 points. If that sounds like a small amount, consider that, on average, FDI accounts for a little over two percent of GDP. Thus, that 0.5-point reduction amounts to a twenty-five percent decline in FDI's share of GDP. From this perspective, the effect of regionalism is large indeed.

Amidst the rhetoric about the importance of national competitiveness in attracting valuable foreign investment, it is easy to lose sight of a critical truth: like politics, all investment is local. In the long run, building a new manufacturing plant might benefit the whole country, but in the short run the benefits accrue disproportionately to the region where the plant is located. Politicians facing election cycles have limited time horizons, and are unlikely to view the benefits of FDI elsewhere generously. Where they share party labels with the lucky representatives from FDI-attractive regions, they will play the good soldier and emphasize the shared benefits of such investment, but when party labels cover less territory and regional identities dominate, the temptation to seize the benefits of others' good fortunes can prove too hard to resist.

This dynamic is detrimental to investment. The challenge therefore for leaders is to convince their colleagues in power that the prosperity generated by FDI will be shared, quickly. Otherwise, to borrow a line, things fall apart.

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