



# Do political systems affect economic outcomes? The geography of inward FDI and its relationships with growth and inequality

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## Abstract

This paper explores the complex interplay between political systems, foreign direct investment (FDI), and income inequality. Building on Acemoglu and Robinson's Nobel Prize-winning work on institutions, we develop a framework to analyze governments' political incentives to attract FDI. We argue that highly entrenched autocracies, facing little internal competition for rents, and democracies with strong political competition, eager to secure growth for electoral advantage, exhibit strong incentives to attract FDI. In contrast, weaker autocracies with internal competition for rents and entrenched democracies, where rulers face less pressure to deliver growth, have lower incentives to do so. Rising inequality introduces an additional layer of complexity: while democracies may encounter public resistance to FDI when its benefits are perceived as unevenly distributed, autocracies remain less constrained by public opinion. We analyze data from 144 countries spanning 1990–2018, assessing how political incentives shape FDI inflows and their subsequent impact on economic growth. Our findings suggest that in democracies, robust political competition underpins a country's incentive to remain attractive to investors, while autocracies require regulatory stability and credible long-term commitments to achieve this outcome. Ultimately, our research underscores a paradox—democratic freedoms, though vital, may at times hinder economic competitiveness relative to autocratic regimes.

**Keywords** Foreign direct investment · Political competition · Democracy · Authoritarian regime

## Introduction

Governments today recognize foreign direct investment (FDI) as a potent engine of economic growth (Kumaraswamy et al., 2012; Lorenzen & Mudambi, 2013). It injects capital, fosters innovation, and creates jobs (Mudambi, 2008). Consequently, virtually all countries devote considerable

resources to attracting foreign firms. However, their success varies greatly, and scholars have identified the political system as a key factor influencing their effectiveness.

Within this realm of research, the interplay between political power and international business is a complex and multifaceted topic that has been extensively studied by both political scientists and economists (Holmes et al., 2025). This perspective explores how the pursuit of power by governments, both democratic and authoritarian, is inextricably linked to their strategies for engaging with the global economy through foreign direct investment (FDI).

Existing research has traditionally taken a simplistic linear approach to examining how political environments affect FDI, typically concluding that democracies attract more FDI inflows than autocracies despite electoral uncertainty. However, recent international business (IB) scholarship argues this approach overlooks the complex bargaining dynamics between governments and multinational enterprises (Cuervo-Cazurra et al., 2017; Vernon, 1971) and calls for more sophisticated analysis of state objectives regarding citizen welfare (Bhaumik et al., 2024). Building on the Nobel

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Prize-winning work of Daron Acemoglu and James Robinson, this paper argues that policy implementation depends crucially on how it affects the fortunes of ruling elites, as demonstrated by contrasting innovation policies in 19th-century Western Europe versus Eastern Europe (Acemoglu, 2025; Acemoglu & Robinson, 2006). We propose that FDI policy effectiveness varies systematically based on the underlying political system, moving beyond the democracy–autocracy dichotomy to examine how different political structures influence economic outcomes.

In democracies, the maintenance of political power is primarily focused on securing re-election. This objective necessitates delivering tangible economic benefits to the electorate, such as increased prosperity and improved living standards. Consequently, democratic governments often prioritize policies that promote economic growth and development (Acemoglu et al., 2019).

In contrast, authoritarian regimes maintain power through a combination of coercion and economic performance. While force is a key tool for suppressing dissent and maintaining control, the regime's ability to deliver economic prosperity can significantly reduce the need for excessive repression. This is because a growing economy generates economic opportunities and benefits that can help diffuse social discontent and maintain public support (Letsa & Wilfahrt, 2018; Li, 2021).

Moreover, in countries governed by authoritarian political regimes, the prosperity associated with economic growth often translates into increased rent-seeking opportunities for the ruling elites. As the economy expands, new economic activities and sectors emerge, creating the potential for the capture of rents through corruption, patronage, and other forms of clientelism. These rent-seeking activities can further consolidate the power of the ruling elite and reinforce their control over the political system (Guriev & Treisman, 2022).

International economists have long recognized the positive relationship between economic prosperity and engagement with the global economy. Adam Smith and David Ricardo, among others, demonstrated how free trade and international specialization can lead to increased economic growth and efficiency. In today's globalized world, a key modality of economic engagement is FDI. Inflows of FDI and the associated spillovers, such as technology transfer and knowledge diffusion, have been shown to have a significant positive impact on economic growth, productivity, and overall national development (Awate & Mudambi, 2018; Jha et al., 2024; Kano et al., 2020).

Given the substantial economic benefits associated with FDI, it is not surprising that governments, both democratic and authoritarian, are eager to attract foreign investment (Bueno de Mesquita et al., 2003). They implement a variety of policies and incentives, such as tax breaks, infrastructure

development, and regulatory reforms, to make their countries more attractive to foreign investors. These efforts reflect the recognition that FDI can play a crucial role in driving economic growth, creating jobs, and enhancing a country's competitiveness in the global marketplace. These are all aspects that are expected to provide political benefits to both incumbent elected governments in democracies and ruling elites in authoritarian countries.

In this perspective, the theory proposed by Acemoglu and Robinson (2006) offers a better understanding of a systematic relationship between political systems and the motivations behind government policies to attract FDI inflows. They argue that both democracies and autocracies desire economic growth but for fundamentally different reasons. In democracies, incumbents seek policies that lead to re-election, which economic prosperity can facilitate. Autocrats, however, are more concerned with consolidating power and generating personal wealth through the 'rents' they extract from increased flows of local outputs.

Therefore, while both systems have an incentive to attract FDI as a driver of growth, the intensity of that incentive differs. Autocratic regimes, especially those deeply entrenched, face minimal risk of losing power. This increases their incentives to prioritize growth strategies like FDI attraction as they are confident of retaining control of the associated rents. In contrast, democracies with robust political competition place a significant premium on maintaining economic performance to secure re-election. This creates a stronger incentive to actively court foreign investors.

Synthesizing these arguments suggests a U-shaped relationship between political competition and FDI. At one end of the spectrum, highly entrenched autocracies with minimal risk of regime change have stronger motivations to promote FDI. At the other end, incumbents in democracies, where power regularly shifts hands, are strongly inclined to attract FDI to boost economic performance and re-election prospects.

The middle ground, however, presents a less favorable environment for FDI. Weaker autocracies, still vulnerable to power struggles, may prioritize short-term political gains over economic strategies like FDI attraction since they may not survive to receive the attendant rents. Similarly, entrenched democracies where the same party holds power for extended periods can become complacent, neglecting policies that attract foreign investors.

This framework offers a more nuanced understanding of the relationship between political systems and FDI. While democracies might excel at attracting FDI in principle, their effectiveness depends on the level of political competition. Similarly, the incentives of autocracies to attract FDI depend on the ruling elites' perception of their likelihood of retaining power and, hence, the rents associated with economic growth.



Beyond the political dynamics, the globalization of the world economy has profound implications for the distribution of economic gains (Lang & Tavares, 2024). The rise of the knowledge economy has disproportionately benefited high-knowledge workers, while low-knowledge workers have experienced relatively smaller gains (von Borries et al., 2024). While globalization has increased overall wealth and income, it has also contributed to rising income inequality (Ravallion, 2018).

This trend may negatively affect voter sentiment in democracies, potentially moderating the relationship between political competition and FDI. In autocracies, however, public opinion is less likely to influence government policies, and therefore, the impact of inequality on FDI inflows may be less pronounced. Putting these arguments together, it is likely that liberal democracies will face stronger resistance to the income and wealth-generating forces of globalization as compared with autocratic regimes.

This paper will explore these theoretical arguments and provide empirical evidence to support our hypotheses. By examining the interplay between political systems, FDI, and income inequality in 144 countries over the 1990–2018 period, we aim to shed light on the complex factors that shape economic outcomes in the contemporary global landscape.

Our findings reconcile the contrasting evidence as well as its theoretical underpinnings in the literature examining the relationship between political regimes and FDI inflows. The existing research on this topic, indeed, paints a complex picture. Some studies suggest democracies with transparent institutions and predictable policies offer a more attractive environment for foreign investors, leading to higher FDI inflows (Lacroix et al., 2021; Li, 2021). Conversely, autocratic regimes might be perceived as unstable and unpredictable, deterring investment. However, other studies present a different perspective, highlighting cases where autocracies make policy decisions more rapidly and implement them more effectively (Moon, 2019; Wright, 2008). Although these findings may suggest the plausibility of a non-linear relationship between regime type and FDI inflows, some other research finds no clear correlation between the nature of the political system and FDI levels (Asiedu & Lien, 2011).

Our study offers both a theoretical basis and a strong empirical support to explain and interpret within a more complex, but coherent scenario, these apparently contradictory results. Our findings, drawn along the theoretical lines suggested by Acemoglu and Robinson (2006), indicate that both democracies and autocracies attract greater FDI inflows as drivers for growth, since they help incumbent governments to consolidate their political power and raise their expected ruling prospects. In contrast to the existing literature, where the impact of the political system on the

attraction of foreign investments is analyzed by focusing on either democracies or autocracies, in this paper, we provide a unitary framework that sheds light and gives a complete picture to examine and understand the relationship between competing political systems and FDI inflows. The study, therefore, do not focus on either democracies or autocracies, but takes into consideration, over a time span of about 30 years, a complete set of worldwide political regimes on a continuous spectrum ranging from strong autocracies to highly competitive democracies to examine how and to what extent political dynamics, in such a broad array of political systems, impact on the investment decisions by MNEs.

Understanding the political dynamics examined in our study is crucial for governments seeking to leverage FDI for economic development. Democracies should strive to maintain a healthy level of political competition to ensure a strong focus on sustained economic growth. Autocratic regimes, on the other hand, may need to prioritize policies that create a stable regulatory environment and demonstrate a commitment to long-term economic development to attract foreign investors and achieve sustainable growth. Ironically, democracies may find that their freedom-based political institutions are an inhibiting factor in global economic competition with autocratic regimes.

The paper is organized as follows. In the next section, we develop our theory and formulate the main testable theoretical hypotheses. In the third and fourth sections, we describe the methodology used in the empirical investigation and present the data. In the fifth section, we present the results of our econometric analysis, including sensitivity tests that validate our results within the established framework of institutional distance and its impact on FDI inflows. In the sixth section, we analyze the moderating effect of inequality on the nexus between political competition and FDI inflows. In the seventh section, we focus on the relationship between FDI and economic growth. Finally, the last section, we comment on our findings and draw some concluding remarks.

## The two faces of political competition: How political systems shape FDI attraction

Foreign direct investment (FDI) has long been recognized as a driver of economic prosperity in host countries. It propels them forward on the path of rising growth, serving as the conduit for the inflow of capital, technology, and expertise. Before we proceed further, it is crucial to recognize that macroeconomic FDI flows are simply agglomerations of the decisions of multinational enterprises (MNEs). These MNEs decide to set up and run operating units in host (foreign) countries for numerous reasons that are well documented in the international business (IB) literature. Perhaps the



best-known summarization of MNE strategies driving FDI is the Dunning typology (Dunning & Lundan, 2008).

MNEs establish operating units in foreign countries for two very general reasons that may be related to their value chains. At the upstream (input) end of their value chains, they seek to obtain access to assets, i.e., resources like raw materials. In today's knowledge economy, the most important asset that MNEs access is high-knowledge human capital (Lewin et al., 2009). At the downstream (output) end of their value chains, their objective is access to markets (Luo & Park, 2001). Most asset-seeking FDI is driven by human and natural resources, i.e., the firm establishes a presence in host countries to access complementary skills as well as fossil fuel, mineral, timber, and fresh water to buttress its global capabilities (Cohen, 2007). Most market-seeking FDI is driven by the MNE's marketing knowledge, i.e., the firm leverages resources like its global brand recognition and logistics network to serve local customers (Mudambi, 2008). It is clear to see that both forms of FDI bring valuable capital and knowledge into the host economy.

However, the landscape for attracting FDI is not uniform. Political systems play a crucial role in shaping the incentives and strategies governments adopt when enticing foreign firms. This section delves into the existing literature on FDI spillovers and political systems to explore the contrasting dynamics of FDI attraction in democracies and autocracies.

## Political regimes and FDI

A substantial body of research underscores the positive link between FDI inflows and economic growth (see Jha et al., 2024 for a review). These benefits flow through various channels. Technology spillovers occupy a prominent position. Multinational corporations (MNCs) bring cutting-edge technology to their host countries. This know-how diffuses through supplier networks and the labor market as skilled workers move between firms. Local firms can learn and adopt these technologies, enhancing their own productivity and competitiveness (Awate et al., 2015). Additionally, FDI acts as a source of resource inflows. Foreign firms alleviate domestic shortages of financial capital, allowing local businesses to access funding for expansion and innovation (Perri & Peruffo, 2016). They also introduce advanced equipment, boosting the host country's productive capacity and potentially leading to the creation of new industries (Kogut & Zander, 2003).

The political context surrounding FDI attraction is equally significant. At its core, the objective of incumbents in all political systems is to maintain power. This manifests differently in democracies and autocracies. Democracies rely on free and fair elections, where incumbents seek re-election by demonstrating strong economic performance. FDI is viewed as a tool to foster economic growth, thereby

bolstering re-election prospects (Svolik, 2013). Furthermore, the intensity of electoral competition plays a crucial role. In highly competitive environments, incumbents have a strong incentive to attract FDI, recognizing its potential to improve their electoral chances. They are likely to implement policies that promote a stable and predictable business environment, reduce regulatory burdens, and offer tax incentives for foreign investors (Acemoglu & Robinson, 2006; Besley et al., 2010).

In contrast, the calculus surrounding FDI in autocracies is fundamentally different. Here, the ruling elite perceives FDI as a means of generating rents, which can be appropriated for their own benefit (Rommel, 2024). These rents can include profits from controlling access to resources, manipulating markets, or extracting bribes from foreign firms. To maintain the status quo, these rents must be shared amongst competing factions within the elite (Wright, 2008). This can include military officers, powerful bureaucrats, or different ethnic or religious groups. When the level of political competition within an autocracy increases, a larger share of the rent from FDI needs to be diverted towards maintaining internal cohesion. This reduces the incentive for the ruling elite to actively attract FDI, as the potential for rent capture diminishes (Acemoglu & Robinson, 2006; Wright, 2008).

Based on these contrasting logics, we can arrive at several key implications. In democracies, economic growth increases the likelihood of re-election for incumbents. As incumbents face greater pressure from electoral competitors, they are more likely to adopt policies to attract foreign investors. This translates into a positive relationship between political competition and the level of FDI inflows. Conversely, in autocracies, a rise in political competition leads to a negative relationship with FDI inflows. As competition intensifies, the ruling elite becomes less motivated to attract FDI, given the need to share the associated rents with other factions.

This framework highlights the multifaceted nature of FDI attraction. In democracies, with their focus on re-election, stronger political competition strengthens the incentive of incumbents to create a business-friendly environment that attracts FDI. Conversely, autocracies emphasize rent-sharing and internal cohesion. In our analysis, political competition is viewed as a threat to incumbents' rents accrued by the ruling elite. One aspect of this threat is the rising risks to these rents from FDI, which lowers their expected value. Hence, stronger political competition causes leaders to court foreign investors less actively.

This leads us to formulate the following testable theoretical hypothesis:

**Hypothesis 1:** The relationship between political competition and FDI inflows is U-shaped, with a significant negative slope at the lower bound and a significant positive slope



at the upper bound. This implies that high FDI inflows are associated with both low and high levels of political competition, with a turning point within the political competition range.

From Hypothesis 1, another reason that motivates MNEs' investment decisions emerges. Following the reasoning of Acemoglu and Robinson (2006), the political risks that might be associated with nationalization, capital controls, and/or commitment problems in autocracies become pronounced as autocratic political power increases. By definition, the stronger the autocratic regime's grip on power, the fewer/weaker its political competitors, and the lower its chance of replacement. This implies it expects a longer future of high rent extraction from MNE FDI. Two logical implications directly flow from this line of argument: (a) stronger autocracies are more likely to implement policies aimed at attracting inward FDI by MNEs; and (b) stronger autocracies are less likely to pursue policies that risk losing this source of rents.

Our approach is based on rational MNE managers adopting a choice-theoretic approach to FDI. In making their FDI decisions, managers evaluate country characteristics, assess them relative to the characteristics of other countries, and match them to the MNE's resources and capabilities. This is the essence of the country-specific advantages (CSA)/firm-specific advantages (FSA) matrix that is one of the building-block theories of IB. Within this framework, managers making FDI decisions consider the CSAs of a focal country, implicitly holding those of all other countries in their choice set constant.

This CSA-based framework underpins the large IB literature on FDI attraction and inward FDI flows (Cui & Moon, 2020). Despite this large body of research, the results of a recent meta-analysis (Bailey, 2018) indicate considerable heterogeneity in extant empirical results linking country institutions and inward FDI. We suggest that one step toward resolving these heterogeneities is to use the political-economy approach of Nobel Laureates Acemoglu and Robinson. Leveraging this approach, we predict that aggregating managerial decisions should generate the U-shaped relationship between the extent of host country political competition and inward FDI that we theorize and test.

### The moderating role of inequality

Concomitant with its positive effect on economic growth, FDI inflows have a concomitant effect on inequality. This relationship between FDI and income inequality has been a subject of extensive academic inquiry (Chintrakarn et al., 2012). The literature generally acknowledges the potential for the uneven distribution of the gains from FDI inflows. High-skilled workers often benefit disproportionately from

FDI inflows, while low-skilled workers may experience relatively smaller increases in their income (Dix-Carneiro & Kovak, 2015). As a consequence, this differential impact can exacerbate existing income inequality.

A separate body of research connects income and wealth inequality to voter dissatisfaction. Studies have consistently shown that rising inequality can lead to increased public discontent and a decline in trust in government institutions (Kurer & van Staalduinen, 2022). This link is particularly relevant in the context of globalization, as international trade can also contribute to income inequality. Empirical evidence suggests that electoral districts more exposed to international trade have experienced greater voter dissatisfaction with globalization (Autor et al., 2020; Carballo Perez & Corina, 2024; Colantone & Stanig, 2018).

By integrating these two strands of literature, we expect that rising inequality in the distribution of income is likely to moderate the positive effect of political competition on FDI inflows over the entire range of political regimes under investigation in this study. This would imply the following testable hypothesis:

**Hypothesis 2:** Rising levels of income inequality shift downward the U-shaped relationship between political competition and FDI inflows across political regimes.

However, different political systems are likely to react differently to the inequality-enhancing aspect of FDI based on the extent to which they are responsive to voter preferences. In democracies, where governments are more accountable to their citizens, rising inequality may temper their enthusiasm for FDI. As voters become increasingly dissatisfied with the perceived unfairness of economic globalization, there is a greater likelihood that democratic governments will implement policies to mitigate the negative distributional effects of FDI.

This leads us to formulate our second testable hypothesis:

**Hypothesis 3:** In democracies, higher levels of income inequality moderate the positive impact of rising levels of political competition on FDI inflows.

In contrast, autocratic regimes, where voter preferences have less influence on government policies, may be less sensitive to the inequality-enhancing effects of FDI. These regimes may prioritize economic growth and foreign investment without giving significant consideration to the distributional consequences. As a result, the potential for FDI to exacerbate income inequality may be less of a concern in autocratic contexts. Therefore, in autocracies, we do not expect income inequality to have a significant effect.

This theoretical framework suggests that the relationship between FDI and inequality is mediated by the nature





of the political regime. Democratic governments are more likely to be influenced by voter dissatisfaction with rising inequality, leading to a potential dampening effect on FDI inflows. Autocratic regimes, on the other hand, may be less constrained by public opinion and may pursue FDI policies without as much regard for the distributional consequences Rommel et al., 2025).

## Measuring the effects of FDI

The magnitude and nature of FDI spillovers are not uniform across all inflows. They depend significantly on the quality and diversity of FDI. However, much of the prior literature is based on bilateral measures of FDI within which these aspects cannot be fully incorporated. Doing so requires a multilateral approach (Jha et al., 2024).

The quality of FDI, often proxied by the identity of the source country, plays a crucial role in determining the extent of spillovers. FDI inflows from more developed economies, such as those in Western Europe, the United States, and Canada, are generally considered to be of higher quality due to their knowledge-intensive nature. These economies host a population of firms that are often at the forefront of technological advancement and possess significant research and development capabilities (Awate & Mudambi, 2018). Consequently, FDI from these countries is more likely to introduce cutting-edge technologies and management practices to the host economy, leading to larger and more beneficial spillovers (Jha et al., 2024). In contrast, FDI from less developed countries may be less knowledge-intensive, resulting in smaller and less impactful spillovers (Awate et al., 2015; Buckley et al., 2007).

Another critical factor influencing FDI spillovers is diversity. A greater diversity of FDI inflows, measured by the range of investing source countries, can enhance the potential for knowledge diffusion and value creation (Zhang et al., 2010). Each source country represents a unique national system of innovation characterized by distinct cultural, institutional, and technological contexts (Stallkamp et al., 2018). By attracting FDI from a wider range of countries, a host economy can benefit from exposure to diverse knowledge and resources (Wasserman & Faust, 1994). This increased diversity can foster greater learning opportunities, stimulate innovation, and enhance the absorptive capacity of domestic firms (Perri et al., 2017). Moreover, multiple FDI ties can create a more stable and resilient economic environment, thereby reducing the host economy's vulnerability to shocks and fluctuations in global markets (Mudambi & Santangelo, 2016).

The quality and diversity of FDI inflows also have implications for the preferences of different political regimes. Democratic governments tend to prioritize FDI that generates higher-paying jobs and a wider variety of employment

opportunities (Alfaro et al., 2004). Such FDI is often perceived as more valuable to society and can contribute to improved living standards and social equity (Bengoa et al., 2003). Additionally, higher-quality FDI inflows are typically associated with larger flows of rents, which can provide economic benefits to the government and the broader population. On the other hand, autocratic regimes may prefer FDI that is more stable and predictable, as this can help to maintain political stability and control (Moon, 2019). More diverse FDI inflows can provide a more reliable source of rents and reduce the risk of economic disruptions (Li, 2021; Rommel, 2024).

Summarizing, the extent and nature of FDI spillovers are contingent on both the quality and diversity of FDI inflows. Higher-quality FDI from developed economies is more likely to generate larger and more beneficial spillovers due to its knowledge-intensive nature. A greater diversity of FDI can also enhance the potential for knowledge diffusion and value creation. Understanding these determinants is essential for policymakers seeking to maximize the benefits of FDI and promote economic development. By implementing policies that attract higher-quality and more diverse FDI, governments can foster innovation, create jobs, and improve the overall well-being of their citizens.

Understanding these dynamics is crucial for policymakers and multinational corporations alike, as it informs their strategies for attracting and engaging in FDI in different political environments.

## Methodology

FDI has become a cornerstone of global economic integration. While its impact on host economies is well documented, the relationship between FDI and political regimes remains a complex and multifaceted issue. Traditional research often focuses on the quantitative aspects of FDI inflows, overlooking the equally important dimensions of quality and diversity. In this paper, we adopt a network-theoretical approach to examine how political regimes affect FDI quality and diversity rather than merely its quantity.

The traditional bilateral analysis of FDI often limits our understanding of its complex interactions within the global investment landscape. A multilateral perspective, grounded in network theory, offers a more comprehensive framework. This approach recognizes that interconnected investments among multiple countries create a web of relationships, where the spillovers and benefits of FDI are influenced not only by the individual characteristics of the host and source countries but also by the overall structure of the investment network.

To assess the impact of political competition on FDI, we employ a comparative analysis of bilateral and multilateral



approaches. By examining the outcomes of both perspectives, we aim to test the effects of the dynamics of political competition on FDI.

$$FDI_{it} = \alpha + \beta_1 PC_{it-1} + \beta_2 PC_{it-1}^2 + \gamma' X + \eta_i + \eta_t + \varepsilon_{it} \quad (1)$$

where the dependent variable is the natural log of per-capita FDI inflow in country  $i$  at time  $t$  at constant prices,  $PC$  is the level of political competition and  $X$  is a vector of control variables, suggested by the literature. All the variables are in logs except the degree of political competition. Finally,  $\eta_i$  captures time-invariant specific country effects and  $\eta_t$  is a set of period dummies controlling for time shocks.

Equation (1) is estimated using a random-effects panel data estimator. We choose this specification rather than a fixed effects model due to the presence of time-invariant covariates in the set of regressors. Nonetheless, we use a Hausman test to check the appropriateness of our choice. Our empirical estimates support our model choice.

When we estimate Eq. (1), we are particularly interested in the parameters  $\beta_1$  and  $\beta_2$ , since they are relevant for testing our hypotheses. Observing that the parameter associated with the linear term is negative and significant, while the one for the quadratic term is positive and significant, is necessary to establish the presence of a U-shaped relationship between FDI and the extent of political competition. However, these conditions are not sufficient. In fact, such evidence is also consistent with an upward concave function.

Lind and Melhum (2010) suggest a procedure to check whether the relationship between two variables actually takes a U-shape. Specifically, they note that a U-shape requires the slope of the function linking the dependent variable and the regressor to be negative at the beginning and positive at the end of the range of data in the sample. Furthermore, the turning point should lie within this data range. If it occurs outside this range, the function is not locally U-shaped. Specifically, both the following inequalities must be satisfied:

$$\beta_1 + 2\beta_2 PC_{min} < 0$$

and

$$\beta_1 + 2\beta_2 PC_{max} > 0$$

where  $PC_{min}$  and  $PC_{max}$  are the lowest and the highest values of the degree of political competition in the sample range of data.

If at least one of the above inequalities is not satisfied, we have evidence against the presence of a U-shaped relationship; it could be either a monotone or an inverted U-shape.

Furthermore, Lind and Melhum (2010) suggest constructing the confidence interval for the extreme point, which is given by the ratio of two estimated parameters, using the

Fieller (1954) method in preference to the delta method, which could be severely biased in finite samples.

## Data

We collected data for 144 countries over a time period spanning from 1990 to 2018. We use three different metrics for FDI inflows, resulting in three dependent variables used in our empirical analysis. The data to construct our three dependent variables are drawn from UNCTAD archives spanning the period 1990–2018 (UNCTAD, 2024).

We capture the quantitative aspects implied by the bilateral analysis of MNEs' foreign investments by FDI inflows per capita in 2015 US\$. We denominate this variable *FDI Inflow*.

We use two metrics of a country's structural position in the global FDI network to capture the qualitative aspects implied by the multilateral analysis of MNEs' foreign investments: in-eigenvector centrality of FDI and in-degree centrality of FDI, respectively (Jha et al., 2024).

The in-eigenvector captures the heterogeneity in inward FDI ties. High values of in-eigenvector centrality in our network indicate that the focal country receives FDI from investor countries, which are destinations of FDI inflows from multiple investors. Therefore, host countries receiving MNEs' foreign investments from more connected countries should be considered more valuable in terms of quality in the FDI inflows (Bonacich, 1987). We denominate this variable *FDI Inflow Quality*.

The in-degree centrality measures the number of incoming ties of a host country associated with FDI inflows. It captures the number of investing countries weighted by the FDI quantities received by the focal country from the investor countries. Higher values of in-degree centrality of FDI indicate greater diversity in the resource and knowledge contexts (the variety of national systems of innovation) accessible to the host country, weighted by the magnitude of exchange through each FDI dyad. We denominate this variable *FDI Inflow Diversity*.

Our main independent variable is the country's political regime, which is captured by the level of *Political Competition (PC)* (Acemoglu & Robinson, 2006; Leonida et al., 2013). It is calculated as a composite measure based on two sub-components drawn from the POLITY V database (Marshall & Gurr, 2020). The first component considers the existence of binding rules on when, whether, and how political actors can express preferences. It, therefore, captures the extent to which political competition is regulated: the more binding the rules, the lower the political competition. The second component refers to the degree to which political actors can pursue alternative preferences for policy and leadership in the political arena: the greater such a degree, the

higher the level of political competition. The resulting index ranges from 1 to 10, with low and high values indicating low and high levels of political competition, respectively.

We add a set of control variables based on the relevant literature on the determinants of FDI.

We noted previously that a typical MNE undertakes FDI with two generic strategic objectives: asset-seeking and market-seeking. While the former is attracted by the host country's resources in terms of knowledge and human capital, the latter is driven by the wealth and the size of the host country's market. Human capital is captured by the expected years of schooling at birth provided by the Human Development Indicators (United Nations, 2024). The wealth of the market is measured by both the growth rate of real GDP and by a dummy variable for low-income countries that takes the value of 1 if the country is classified as a low-income economy and 0 otherwise (Bolívar et al., 2019). The size of a country's market is captured by the growth rate of the population (%) (Baiashvili & Gattini, 2020). Both variables are drawn from the World Bank development indicators (World Bank, 2025).

The country's trade exposure is another important driver for incoming FDI flows (Egger & Pfaffermayr, 2004; Li & Liu, 2005). We capture such a variable by both a *de facto* and a *de jure* openness measure. Both measures are drawn from the KOF database (Gygli et al., 2019). The country's socio-institutional environment is captured by the growth rate of corruption in the executive, legislative, and judiciary (Coppedge et al., 2024), its legal system and its global political network (La Porta et al., 2008).

The summary statistics of all the data used in the empirical analysis, the description of all the variables as well as their data sources will be provided in Tables A1 and A2 of the supplementary material.

## Results

The results from our main regression analysis are presented in Table 1. We estimate the impact of political competition on our three different measures of FDI inflows: per capita, quality, and diversity. The estimates are reported in three different panels. In each panel, we display results for two different models: a control model including only the variables suggested by the literature and a full model augmented by the degree of political competition to test the validity of our theoretical hypothesis H1.

Estimation results provide strong evidence of a non-linear association between the political competition of inward FDI. More specifically, the estimated parameters associated with the linear and the quadratic terms of political competition are both significant. Their signs are negative and positive,

respectively. This finding is consistent across all the estimated models from panel A to C.

However, this result is only a necessary but not a sufficient condition to establish a U-shaped relationship between political competition and FDI inflows. We, therefore, carry out the test for non-monotonicity suggested by Lind and Melhum (2010) reported at the bottom of the table. This analysis provides statistical support for a U-shaped relationship with a significant negative slope at the lower bound and a significant positive slope at the upper bound. As depicted in Fig. 1, FDI inflows are associated with both low and high levels of political competition with a turning point at about the center the political competition range.

These findings strongly support our theoretical hypothesis H1. Democratic governments as well as authoritarian regimes are more likely to be associated with higher FDI inflows, although for different motivations. In democracies, higher political competition strengthens the incentives to attract FDI. Since FDI inflows play a crucial role in promoting economic development, competitive elections force elected governments to attract foreign investors. Thus, the higher the political competition, the more the incentives to carry out policies to attract FDI. In authoritarian regimes, on the other end, rising political competition reduces the incentives to attract FDI. The growth-enhancing effects associated to FDI inflows are an important source of rents for incumbent autocrats. As competition intensifies, however, the ruling elite becomes less motivated to attract FDI since the need to share the associated rents with other political factions rises.

Observing the parameter estimates of the effect of political competition on FDI inflows across the three panels we note that both higher quality and greater diversity of FDI inflows seem to be more sensitive to the political calculus of incumbent rulers in different political regimes. This effect might be explained by the expected larger and more beneficial spillovers associated to both quality and diversity FDI inflows.

Considering the effect of the control variables on inward FDI, their impact is, by and large, in line with the related literature already mentioned in the data description section. GDP growth rate and the dummy for low-income countries, representing the wealth of a country's market, are both statistically significant and show the expected sign across all three panels: while greater GDP per capita leads to higher FDI, lower-income countries are less attractive for foreign investors. A country's trade exposure, in terms of both export and imports of goods as a % of GDP and in terms of pro-trade regulation, affects FDI inflows. Estimates indicate that both *de facto* e *de jure* measures of openness to trade are positively and significantly related to FDI inflows in all our estimated models. While higher levels of human capital raise inward FDI, a country's population growth rate reduces

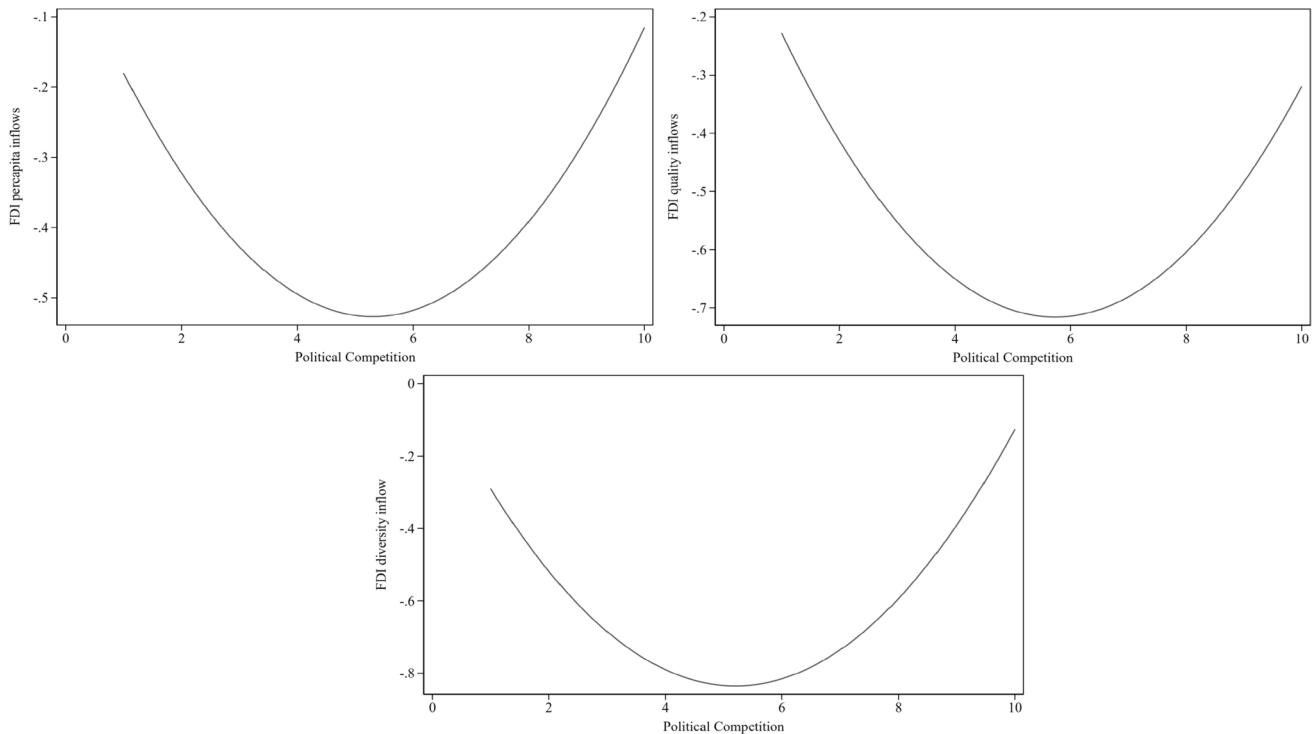


**Table 1** Testing the U-shape relationship between political competition and FDI inflows

|                                                   | Panel A                        |                       | Panel B                     |                       | Panel C                       |                       |
|---------------------------------------------------|--------------------------------|-----------------------|-----------------------------|-----------------------|-------------------------------|-----------------------|
|                                                   | Dep var FDI per-capita inflows |                       | Dep var FDI quality inflows |                       | Dep var FDI diversity inflows |                       |
|                                                   | Control model                  | Full model            | Control model               | Full model            | Control model                 | Full model            |
|                                                   | (a)                            | (b)                   | (c)                         | (d)                   | (e)                           | (f)                   |
| Political Competition <sub>t-1</sub>              |                                | – 0.198***<br>(0.067) |                             | – 0.250***<br>(0.087) |                               | – 0.321***<br>(0.089) |
| Political Competition <sup>2</sup> <sub>t-1</sub> |                                | 0.019***<br>(0.006)   |                             | 0.022***<br>(0.008)   |                               | 0.031***<br>(0.008)   |
| Low-income countries                              | – 1.216***<br>(0.240)          | – 1.145***<br>(0.244) | – 1.282***<br>(0.281)       | – 1.243***<br>(0.275) | – 1.846***<br>(0.312)         | – 1.748***<br>(0.316) |
| Corruption <sub>t-1</sub>                         | – 0.001<br>(0.001)             | – 0.002<br>(0.001)    | – 0.002<br>(0.002)          | – 0.003*<br>(0.002)   | – 0.001<br>(0.002)            | – 0.002<br>(0.002)    |
| British legal system                              | 0.983***<br>(0.275)            | 0.997***<br>(0.264)   | 1.171***<br>(0.333)         | 1.277***<br>(0.316)   | 1.618***<br>(0.371)           | 1.624***<br>(0.351)   |
| French legal system                               | 0.903***<br>(0.191)            | 0.914***<br>(0.190)   | 1.069***<br>(0.285)         | 1.192***<br>(0.275)   | 1.360***<br>(0.279)           | 1.361***<br>(0.270)   |
| Scandinavian legal system                         | 1.872***<br>(0.310)            | 1.690***<br>(0.319)   | 1.770***<br>(0.443)         | 1.724***<br>(0.440)   | 3.122***<br>(0.440)           | 2.814***<br>(0.448)   |
| German legal system                               | 0.992***<br>(0.292)            | 0.956***<br>(0.286)   | 0.880**<br>(0.433)          | 0.954**<br>(0.423)    | 1.844***<br>(0.449)           | 1.769***<br>(0.436)   |
| Political network <sub>t-1</sub>                  | 0.436***<br>(0.147)            | 0.459***<br>(0.145)   | 0.844***<br>(0.271)         | 0.868***<br>(0.268)   | 0.932***<br>(0.227)           | 0.955***<br>(0.220)   |
| Trade exposure <sub>t-1</sub>                     | 0.308**<br>(0.126)             | 0.323**<br>(0.128)    | 0.271*<br>(0.160)           | 0.276*<br>(0.155)     | 0.358**<br>(0.165)            | 0.373**<br>(0.168)    |
| Trade regulation <sub>t-1</sub>                   | 0.590***<br>(0.139)            | 0.545***<br>(0.146)   | 0.481**<br>(0.188)          | 0.423**<br>(0.199)    | 0.760***<br>(0.195)           | 0.685***<br>(0.203)   |
| Population growth rate <sub>t-1</sub>             | – 0.279***<br>(0.073)          | – 0.268***<br>(0.071) | – 0.397***<br>(0.086)       | – 0.391***<br>(0.082) | – 0.078<br>(0.103)            | – 0.061<br>(0.098)    |
| GDP growth rate <sub>t-1</sub>                    | 0.020***<br>(0.004)            | 0.020***<br>(0.005)   | 0.019***<br>(0.006)         | 0.021***<br>(0.007)   | 0.030***<br>(0.006)           | 0.033***<br>(0.007)   |
| Human capital <sub>t-1</sub>                      | 1.232***<br>(0.228)            | 1.271***<br>(0.244)   | 1.167***<br>(0.341)         | 1.198***<br>(0.358)   | 2.022***<br>(0.332)           | 2.045***<br>(0.352)   |
| <i>U-shape test</i>                               |                                |                       |                             |                       |                               |                       |
| Min                                               |                                | – 2.90<br>[0.002]     |                             | – 2.84<br>[0.002]     |                               | – 3.53<br>[0.000]     |
| Max                                               |                                | 2.98<br>[0.001]       |                             | 2.70<br>[0.003]       |                               | 3.53<br>[0.000]       |
| Overall                                           |                                | 2.90<br>[0.002]       |                             | 2.70<br>[0.003]       |                               | 3.53<br>[0.000]       |
| Extreme Point                                     |                                | 5.31                  |                             | 5.73                  |                               | 5.20                  |
| Fieller Interval                                  |                                | [4.12; 6.43]          |                             | [4.57; 7.06]          |                               | [4.28; 6.15]          |
| Observations                                      | 3555                           | 3463                  | 3460                        | 3371                  | 3487                          | 3398                  |
| Overall significance test                         | 4104.675                       | 4720.500              | 5785.665                    | 6483.191              | 20,127.058                    | 22,355.887            |
| R <sup>2</sup>                                    | 0.582                          | 0.607                 | 0.528                       | 0.552                 | 0.677                         | 0.704                 |

Models have been estimated using a random effects panel data estimator. Time dummies included but not reported. The panel U-shape test reports the t-statistic for the hypothesis that the slope of the function is negative at the minimum and positive at the maximum. Overall is the one-side test statistic for the (joint) null hypothesis that the slope of the function is positive at the minimum and negative at the maximum. Fieller interval reported. Clustered standard errors in ( ). p-values in [ ].





**Fig. 1** Political competition and FDI: U-shaped relationship

its attractiveness to foreign investors. This last effect is no longer significant when diversity FDI inflows are used as the dependent variable. As far as the characteristics of the judicial system operating in the host countries are concerned, foreign investors are more attracted by those economies with Western-style legal origins as compared to countries characterized by socialist-style legal origins. Finally, corruption, although negative, does not seem to affect FDI decisions by multinational enterprises.

In Table 2, we run a piecewise regression model to test the robustness of the U-shaped relationship between political competition and FDI inflows. We present the results of the full models only. The three specifications in the table refer to the three different dependent variables we adopted to measure FDI inflows: per capita, quality, and diversity.

$T_1$  and  $T_2$  are two variables constructed from *Political Competition* to be used in the estimation. According to the U-shape tests in Table 1, we carried out models with the turning point of political competition placed at 6 as follows:

$$T_1 = \begin{cases} PC - 6 & \text{if } PC < 6 \\ 0 & \text{if } PC \geq 6 \end{cases}$$

$$T_2 = \begin{cases} PC - 6 & \text{if } PC \geq 6 \\ 0 & \text{if } PC < 6 \end{cases}$$

Once more, regression estimates empirically validate our theoretical hypothesis H1, confirming the existence of a non-linear association between political competition and FDI inflows across all model specifications. The effects of the control variables on FDI inflows are not dissimilar from what we obtained in Table 1.

We have run a further set of estimations with the cutoff of *Political Competition* at 5 and estimates are qualitatively unaffected (estimates are available from the authors, upon request).

In Table 3, we check for the robustness of our findings by changing our main independent variable. The autocracy-democracy spectrum is now measured by the extent of political rights guaranteed by the political system operating in the different countries of our sample. Again, the theoretical hypothesis H1 is confirmed by the data. The U-shape tests are significant across all model specifications, and the parameters associated to political competition are also statistically significant and display the expected signs. Furthermore, parameter estimates seem to indicate that higher quality and greater diversity of FDI inflows are more sensitive to the political calculus of incumbent rulers in different political regimes.

Drawing from the literature examining the effect of institutional similarity on foreign investments by multinational enterprises, we examine whether the political calculus of incumbent rulers to attract foreign investors may be affected

**Table 2** Testing the U-shape relationship between political competition and FDI inflows: Piecewise regressions

|                                       | FDI per-capita inflows<br>Full model<br>(a) | FDI inflows quality<br>Full model<br>(b) | FDI inflows diversity<br>Full model<br>(c) |
|---------------------------------------|---------------------------------------------|------------------------------------------|--------------------------------------------|
| $T_{1,t-1}$                           | − 0.054**<br>(0.026)                        | − 0.082**<br>(0.034)                     | − 0.083**<br>(0.035)                       |
| $T_{2,t-1}$                           | 0.091**<br>(0.036)                          | 0.088**<br>(0.041)                       | 0.156***<br>(0.054)                        |
| Low-income countries                  | − 1.158***<br>(0.245)                       | − 1.255***<br>(0.276)                    | − 1.773***<br>(0.317)                      |
| Corruption <sub>t-1</sub>             | − 0.002<br>(0.001)                          | − 0.003*<br>(0.002)                      | − 0.002<br>(0.002)                         |
| British legal system                  | 1.011***<br>(0.267)                         | 1.291***<br>(0.321)                      | 1.647***<br>(0.359)                        |
| French legal system                   | 0.928***<br>(0.191)                         | 1.205***<br>(0.279)                      | 1.382***<br>(0.274)                        |
| Scandinavian legal system             | 1.751***<br>(0.315)                         | 1.790***<br>(0.437)                      | 2.918***<br>(0.446)                        |
| German legal system                   | 0.986***<br>(0.286)                         | 0.985**<br>(0.425)                       | 1.819***<br>(0.442)                        |
| Political network <sub>t-1</sub>      | 0.456***<br>(0.147)                         | 0.865***<br>(0.271)                      | 0.950***<br>(0.223)                        |
| Trade exposure <sub>t-1</sub>         | 0.329**<br>(0.128)                          | 0.284*<br>(0.155)                        | 0.383**<br>(0.168)                         |
| Trade regulation <sub>t-1</sub>       | 0.554***<br>(0.145)                         | 0.434**<br>(0.197)                       | 0.696***<br>(0.202)                        |
| Population growth rate <sub>t-1</sub> | − 0.267***<br>(0.072)                       | − 0.391***<br>(0.083)                    | − 0.060<br>(0.100)                         |
| GDP growth rate <sub>t-1</sub>        | 0.020***<br>(0.005)                         | 0.021***<br>(0.007)                      | 0.033***<br>(0.007)                        |
| Human capital <sub>t-1</sub>          | 1.260***<br>(0.244)                         | 1.188***<br>(0.356)                      | 2.024***<br>(0.351)                        |
| Observations                          | 3463                                        | 3371                                     | 3398                                       |
| Overall significance test             | 4658.177                                    | 6426.170                                 | 22,224.586                                 |
| $R^2$                                 | 0.602                                       | 0.547                                    | 0.698                                      |

by differences in the political systems between the countries of origin and destination of FDI inflows (Cezar & Escobar, 2015; El-Shagi & Muhammad, 2024). The quality of political institutions is measured by the World Bank's Worldwide Governance Indicators (WGI) that distinguish five different dimensions of governance quality (Kaufmann & Kraay, 2024): voice and accountability, government effectiveness, rule of law, regulation quality, and political stability.

We use network analysis to compute the institutional distance for each of the five WGI indicators. We take the difference, in absolute value, of the institutional quality between country  $j$  and all other countries included in the database. High values of country  $j$ 's index indicate greater institutional distance between country  $j$ 's institutional quality as compared with the institutional quality of all other countries included in the database. Low values of country  $j$ 's index

indicate greater institutional similarity between country  $j$ 's institutional quality as compared with the institutional quality of all other countries included in the database.

In Tables 4, 5, and 6, we add institutional similarity in the set of controls and display regression estimates for FDI per capita, FDI quality, and FDI diversity inflows, respectively. The results obtained indicate that the U-shaped relationship between political competition and FDI inflows keeps statistical significance, regardless of the WGI indicator used and regardless of the measure of FDI taken into consideration. This indicates that the inclusion of institutional distance amongst the regressors does not affect the impact of the political calculus of incumbent rulers on the decision to attract foreign investments, as suggested by Acemoglu and Robinson (2006). As far as the effect of similarity in the quality of political institutions is concerned, by and large, it

**Table 3** Testing the U-shape relationship between political rights and FDI inflows

|                                             | FDI per-capita inflows<br>Full model<br>(a) | FDI inflows quality<br>Full model<br>(b) | FDI inflows diversity<br>Full model<br>(c) |
|---------------------------------------------|---------------------------------------------|------------------------------------------|--------------------------------------------|
| Political Rights <sub>t-1</sub>             | − 0.163**<br>(0.074)                        | − 0.200**<br>(0.089)                     | − 0.265***<br>(0.093)                      |
| Political Right <sup>2</sup> <sub>t-1</sub> | 0.017***<br>(0.006)                         | 0.019**<br>(0.008)                       | 0.027***<br>(0.008)                        |
| Low-income countries                        | − 1.146***<br>(0.236)                       | − 1.234***<br>(0.277)                    | − 1.743***<br>(0.309)                      |
| Corruption <sub>t-1</sub>                   | − 0.001<br>(0.001)                          | − 0.003*<br>(0.002)                      | − 0.002<br>(0.002)                         |
| British legal system                        | 1.021***<br>(0.284)                         | 1.293***<br>(0.332)                      | 1.724***<br>(0.377)                        |
| French legal system                         | 0.956***<br>(0.200)                         | 1.199***<br>(0.283)                      | 1.483***<br>(0.289)                        |
| Scandinavian legal system                   | 1.689***<br>(0.331)                         | 1.686***<br>(0.451)                      | 2.900***<br>(0.459)                        |
| German legal system                         | 0.923***<br>(0.289)                         | 0.899**<br>(0.415)                       | 1.789***<br>(0.435)                        |
| Political network <sub>t-1</sub>            | 0.420***<br>(0.144)                         | 0.834***<br>(0.267)                      | 0.920***<br>(0.221)                        |
| Trade exposure <sub>t-1</sub>               | 0.300**<br>(0.122)                          | 0.259*<br>(0.155)                        | 0.343**<br>(0.161)                         |
| Trade regulation <sub>t-1</sub>             | 0.582***<br>(0.137)                         | 0.478**<br>(0.186)                       | 0.769***<br>(0.194)                        |
| Population growth rate <sub>t-1</sub>       | − 0.266***<br>(0.069)                       | − 0.388***<br>(0.081)                    | − 0.066<br>(0.096)                         |
| GDP growth rate <sub>t-1</sub>              | 0.020***<br>(0.004)                         | 0.020***<br>(0.006)                      | 0.031***<br>(0.006)                        |
| Human capital <sub>t-1</sub>                | 1.187***<br>(0.222)                         | 1.111***<br>(0.334)                      | 1.955***<br>(0.326)                        |
| <i>U-shape test</i>                         |                                             |                                          |                                            |
| Min                                         | − 2.08<br>[0.019]                           | − 2.19<br>[0.014]                        | − 2.71<br>[0.003]                          |
| Max                                         | 2.95<br>[0.002]                             | 2.64<br>[0.004]                          | 3.50<br>[0.000]                            |
| Overall                                     | 2.80<br>[0.019]                             | 2.19<br>[0.014]                          | 2.71<br>[0.003]                            |
| Extreme Point                               | 4.77                                        | 5.19                                     | 5.00                                       |
| Fieller Interval                            | [1.72; 5.89]                                | [2.61; 6.43]                             | [3.34; 6.03]                               |
| Observations                                | 3555                                        | 3460                                     | 3487                                       |
| Overall significance test                   | 4521.745                                    | 6310.297                                 | 21,612.555                                 |
| R <sup>2</sup>                              | 0.613                                       | 0.555                                    | 0.709                                      |

Models have been estimated using a random effects panel data estimator. Time dummies included but not reported. The panel U-shape test reports the t-statistic for the hypothesis that the slope of the function is negative at the minimum and positive at the maximum. Overall is the one-side test statistic for the (joint) null hypothesis that the slope of the function is positive at the minimum and negative at the maximum. Fieller interval reported. Clustered standard errors in ( ). p-values in [ ].

does not seem to affect FDI inflows. The only exception is the effect of government effectiveness, which is statistically significant and displays a negative sign across all model specifications in Tables 4 to 6. These results indicate that

greater similarity in institutional quality is associated with higher inflows of foreign investments (El-Shagi & Muhammad, 2024).



**Table 4** Testing the U-shape relationship between political competition and FDI per-capita inflows: Institutional distance

|                                                   | (a)                   | (b)                   | (c)                   | (d)                   | (e)                   |
|---------------------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| Political Competition <sub>t-1</sub>              | - 0.186**<br>(0.076)  | - 0.226***<br>(0.068) | - 0.227***<br>(0.067) | - 0.226***<br>(0.067) | - 0.220***<br>(0.065) |
| Political Competition <sub>t-1</sub> <sup>2</sup> | 0.018***<br>(0.006)   | 0.020***<br>(0.006)   | 0.020***<br>(0.006)   | 0.020***<br>(0.006)   | 0.019***<br>(0.006)   |
| Low-income countries                              | - 0.939***<br>(0.280) | - 0.941***<br>(0.281) | - 0.859***<br>(0.277) | - 0.864***<br>(0.279) | - 0.844***<br>(0.283) |
| Corruption <sub>t-1</sub>                         | - 0.001<br>(0.002)    | - 0.001<br>(0.002)    | - 0.001<br>(0.002)    | - 0.001<br>(0.002)    | - 0.001<br>(0.002)    |
| British legal system                              | 1.394***<br>(0.336)   | 1.232***<br>(0.281)   | 1.033***<br>(0.296)   | 1.010***<br>(0.357)   | 1.125***<br>(0.264)   |
| French legal system                               | 1.285***<br>(0.294)   | 1.162***<br>(0.246)   | 0.916***<br>(0.237)   | 0.885***<br>(0.336)   | 1.007***<br>(0.205)   |
| Scandinavian legal system                         | 1.443***<br>(0.342)   | 1.254***<br>(0.343)   | 1.524***<br>(0.384)   | 1.362***<br>(0.348)   | 1.480***<br>(0.350)   |
| German legal system                               | 1.225***<br>(0.344)   | 1.099***<br>(0.315)   | 0.923***<br>(0.311)   | 0.883***<br>(0.375)   | 0.986***<br>(0.299)   |
| Political network <sub>t-1</sub>                  | 0.358**<br>(0.152)    | 0.370**<br>(0.152)    | 0.366**<br>(0.148)    | 0.367**<br>(0.147)    | 0.353**<br>(0.149)    |
| Trade exposure <sub>t-1</sub>                     | 0.173<br>(0.152)      | 0.188<br>(0.152)      | 0.169<br>(0.152)      | 0.170<br>(0.152)      | 0.171<br>(0.150)      |
| Trade regulation <sub>t-1</sub>                   | 0.731***<br>(0.159)   | 0.713***<br>(0.152)   | 0.740***<br>(0.156)   | 0.746***<br>(0.156)   | 0.750***<br>(0.155)   |
| Population growth rate <sub>t-1</sub>             | - 0.300***<br>(0.070) | - 0.296***<br>(0.070) | - 0.292***<br>(0.073) | - 0.294***<br>(0.072) | - 0.281***<br>(0.072) |
| GDP growth rate <sub>t-1</sub>                    | 0.020***<br>(0.006)   | 0.019***<br>(0.006)   | 0.019***<br>(0.006)   | 0.020***<br>(0.006)   | 0.020***<br>(0.006)   |
| Human capital <sub>t-1</sub>                      | 1.738***<br>(0.279)   | 1.749***<br>(0.270)   | 1.780***<br>(0.279)   | 1.788***<br>(0.280)   | 1.786***<br>(0.281)   |
| Voice and accountability                          | - 1.738<br>(1.288)    |                       |                       |                       |                       |
| Government effectiveness                          |                       | - 1.339*<br>(0.814)   |                       |                       |                       |
| Rule of law                                       |                       |                       | 1.095<br>(1.202)      |                       |                       |
| Regulation quality                                |                       |                       |                       | 0.639<br>(1.099)      |                       |
| Political stability                               |                       |                       |                       |                       | 0.904*<br>(0.548)     |
| <i>U-shape test</i>                               |                       |                       |                       |                       |                       |
| Min                                               | - 2.35<br>[0.009]     | - 3.26<br>[0.000]     | - 3.36<br>[0.000]     | - 3.34<br>[0.000]     | - 3.33<br>[0.000]     |
| Max                                               | 2.95<br>[0.002]       | 3.14<br>[0.001]       | 3.17<br>[0.001]       | 3.18<br>[0.001]       | 3.04<br>[0.001]       |
| Overall                                           | 2.35<br>[0.009]       | 3.14<br>[0.001]       | 3.18<br>[0.001]       | 3.18<br>[0.001]       | 3.04<br>[0.001]       |
| Extreme Point                                     | 5.28                  | 5.60                  | 5.66                  | 5.63                  | 5.7                   |
| Fieller Interval                                  | [2.96; 6.55]          | [4.50; 6.77]          | [4.57; 6.86]          | [4.55; 6.81]          | [4.59; 7.00]          |
| Observations                                      | 2579                  | 2579                  | 2579                  | 2579                  | 2579                  |
| Overall significance test                         | 3865.005              | 3708.820              | 3855.653              | 3842.628              | 3631.215              |
| R <sup>2</sup>                                    | 0.609                 | 0.618                 | 0.584                 | 0.591                 | 0.593                 |

Models have been estimated using a random effects panel data estimator. Time dummies included but not reported. The panel U-shape test reports the *t*-statistic for the hypothesis that the slope of the function is negative at the minimum and positive at the maximum. Overall is the one-side test statistic for the (joint) null hypothesis that the slope of the function is positive at the minimum and negative at the maximum. Fieller interval reported. Clustered standard errors in ( ). *p* values in [ ].



**Table 5** Testing the U-shape relationship between political competition and FDI quality inflows: Institutional distance

|                                                   | (a)                   | (b)                   | (c)                   | (d)                   | (e)                   |
|---------------------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| Political Competition <sub>t-1</sub>              | - 0.309***<br>(0.085) | - 0.333***<br>(0.078) | - 0.333***<br>(0.077) | - 0.331***<br>(0.076) | - 0.325***<br>(0.075) |
| Political Competition <sub>t-1</sub> <sup>2</sup> | 0.026***<br>(0.007)   | 0.028***<br>(0.007)   | 0.027***<br>(0.007)   | 0.027***<br>(0.007)   | 0.027***<br>(0.006)   |
| Low-income countries                              | - 1.026***<br>(0.278) | - 1.063***<br>(0.268) | - 0.980***<br>(0.268) | - 0.964***<br>(0.272) | - 0.944***<br>(0.274) |
| Corruption <sub>t-1</sub>                         | - 0.002<br>(0.002)    | - 0.002<br>(0.002)    | - 0.002<br>(0.002)    | - 0.002<br>(0.002)    | - 0.002<br>(0.002)    |
| British legal system                              | 1.440***<br>(0.396)   | 1.411***<br>(0.305)   | 1.258***<br>(0.321)   | 1.110***<br>(0.402)   | 1.260***<br>(0.290)   |
| French legal system                               | 1.322***<br>(0.370)   | 1.334***<br>(0.292)   | 1.139***<br>(0.291)   | 0.966**<br>(0.402)    | 1.129***<br>(0.252)   |
| Scandinavian legal system                         | 1.382***<br>(0.409)   | 1.219***<br>(0.398)   | 1.363***<br>(0.433)   | 1.295***<br>(0.417)   | 1.403***<br>(0.412)   |
| German legal system                               | 1.070**<br>(0.436)    | 1.062***<br>(0.380)   | 0.909**<br>(0.380)    | 0.764*<br>(0.459)     | 0.895**<br>(0.363)    |
| Political network <sub>t-1</sub>                  | 0.671***<br>(0.240)   | 0.669***<br>(0.239)   | 0.681***<br>(0.236)   | 0.674***<br>(0.235)   | 0.671***<br>(0.237)   |
| Trade exposure <sub>t-1</sub>                     | 0.145<br>(0.164)      | 0.162<br>(0.162)      | 0.146<br>(0.163)      | 0.145<br>(0.163)      | 0.149<br>(0.162)      |
| Trade regulation <sub>t-1</sub>                   | 0.474**<br>(0.201)    | 0.452**<br>(0.194)    | 0.481**<br>(0.199)    | 0.495**<br>(0.198)    | 0.495**<br>(0.197)    |
| Population growth rate <sub>t-1</sub>             | - 0.410***<br>(0.080) | - 0.404***<br>(0.079) | - 0.405***<br>(0.081) | - 0.405***<br>(0.081) | - 0.395***<br>(0.082) |
| GDP growth rate <sub>t-1</sub>                    | 0.020***<br>(0.007)   | 0.019***<br>(0.007)   | 0.020***<br>(0.007)   | 0.020***<br>(0.007)   | 0.020***<br>(0.007)   |
| Human capital <sub>t-1</sub>                      | 1.777***<br>(0.384)   | 1.763***<br>(0.361)   | 1.805***<br>(0.371)   | 1.823***<br>(0.379)   | 1.823***<br>(0.372)   |
| Voice and accountability                          | - 1.052<br>(1.562)    |                       |                       |                       |                       |
| Government effectiveness                          |                       | - 1.481*<br>(0.882)   |                       |                       |                       |
| Rule of law                                       |                       |                       | 0.171<br>(1.396)      |                       |                       |
| Regulation quality                                |                       |                       |                       | 0.913<br>(1.239)      |                       |
| Political stability                               |                       |                       |                       |                       | 0.916<br>(0.612)      |
| <i>U-shape test</i>                               |                       |                       |                       |                       |                       |
| Min                                               | - 3.59<br>[0.000]     | - 4.28<br>[0.000]     | - 4.31<br>[0.000]     | - 4.34<br>[0.000]     | - 4.33<br>[0.000]     |
| Max                                               | 3.30<br>[0.000]       | 3.42<br>[0.000]       | 3.48<br>[0.000]       | 3.46<br>[0.000]       | 3.37<br>[0.000]       |
| Overall                                           | 3.30<br>[0.000]       | 3.42<br>[0.000]       | 3.48<br>[0.000]       | 3.46<br>[0.000]       | 3.37<br>[0.000]       |
| Extreme Point                                     | 5.95                  | 6.04                  | 6.05                  | 6.06                  | 6.12                  |
| Fieller Interval                                  | [4.90; 7.10]          | [5.22; 7.14]          | [5.23; 7.14]          | [5.24; 7.17]          | [5.27; 7.28]          |
| Observations                                      | 2541                  | 2541                  | 2541                  | 2541                  | 2541                  |
| Overall significance test                         | 3988.584              | 3920.801              | 3871.490              | 3898.993              | 3650.467              |
| R <sup>2</sup>                                    | 0.564                 | 0.576                 | 0.558                 | 0.550                 | 0.554                 |

Models have been estimated using a random effects panel data estimator. Time dummies included but not reported. The panel U-shape test reports the *t*-statistic for the hypothesis that the slope of the function is negative at the minimum and positive at the maximum. Overall is the one-side test statistic for the (joint) null hypothesis that the slope of the function is positive at the minimum and negative at the maximum. Fieller interval reported. Clustered standard errors in ( ). *p* values in [ ].

**Table 6** Testing the U-shape relationship between political competition and FDI diversity inflows: Institutional distance

|                                                   | (a)                   | (b)                   | (c)                   | (d)                   | (e)                   |
|---------------------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| Political Competition <sub>t-1</sub>              | - 0.205**<br>(0.098)  | - 0.271***<br>(0.090) | - 0.265***<br>(0.087) | - 0.265***<br>(0.087) | - 0.258***<br>(0.086) |
| Political Competition <sub>t-1</sub> <sup>2</sup> | 0.022***<br>(0.008)   | 0.026***<br>(0.008)   | 0.025***<br>(0.008)   | 0.025***<br>(0.008)   | 0.024***<br>(0.008)   |
| Low-income countries                              | - 1.366***<br>(0.368) | - 1.355***<br>(0.362) | - 1.239***<br>(0.364) | - 1.248***<br>(0.365) | - 1.230***<br>(0.368) |
| Corruption <sub>t-1</sub>                         | - 0.002<br>(0.002)    | - 0.001<br>(0.002)    | - 0.002<br>(0.002)    | - 0.002<br>(0.002)    | - 0.002<br>(0.002)    |
| British legal system                              | 2.190***<br>(0.447)   | 1.867***<br>(0.371)   | 1.551***<br>(0.374)   | 1.548***<br>(0.453)   | 1.723***<br>(0.354)   |
| French legal system                               | 1.893***<br>(0.408)   | 1.624***<br>(0.343)   | 1.237***<br>(0.323)   | 1.227***<br>(0.439)   | 1.418***<br>(0.299)   |
| Scandinavian legal system                         | 2.561***<br>(0.482)   | 2.278***<br>(0.482)   | 2.741***<br>(0.534)   | 2.431***<br>(0.487)   | 2.565***<br>(0.492)   |
| German legal system                               | 2.124***<br>(0.496)   | 1.866***<br>(0.456)   | 1.597***<br>(0.458)   | 1.557***<br>(0.521)   | 1.715***<br>(0.445)   |
| Political network <sub>t-1</sub>                  | 0.744***<br>(0.233)   | 0.762***<br>(0.237)   | 0.753***<br>(0.228)   | 0.758***<br>(0.230)   | 0.750***<br>(0.232)   |
| Trade exposure <sub>t-1</sub>                     | 0.235<br>(0.192)      | 0.252<br>(0.192)      | 0.233<br>(0.191)      | 0.233<br>(0.192)      | 0.233<br>(0.190)      |
| Trade regulation <sub>t-1</sub>                   | 1.009***<br>(0.220)   | 0.988***<br>(0.209)   | 1.019***<br>(0.217)   | 1.032***<br>(0.217)   | 1.029***<br>(0.215)   |
| Population growth rate <sub>t-1</sub>             | - 0.056<br>(0.091)    | - 0.060<br>(0.091)    | - 0.042<br>(0.096)    | - 0.050<br>(0.094)    | - 0.031<br>(0.095)    |
| GDP growth rate <sub>t-1</sub>                    | 0.027***<br>(0.006)   | 0.026***<br>(0.006)   | 0.026***<br>(0.006)   | 0.027***<br>(0.006)   | 0.027***<br>(0.006)   |
| Human capital <sub>t-1</sub>                      | 2.853***<br>(0.390)   | 2.875***<br>(0.370)   | 2.932***<br>(0.390)   | 2.942***<br>(0.388)   | 2.953***<br>(0.391)   |
| Voice and accountability                          | - 2.995*<br>(1.602)   |                       |                       |                       |                       |
| Government effectiveness                          |                       | - 1.847*<br>(1.027)   |                       |                       |                       |
| Rule of law                                       |                       |                       | 2.110<br>(1.393)      |                       |                       |
| Regulation quality                                |                       |                       |                       | 0.967<br>(1.296)      |                       |
| Political stability                               |                       |                       |                       |                       | 0.890<br>(0.720)      |
| <i>U-shape test</i>                               |                       |                       |                       |                       |                       |
| Min                                               | - 1.98<br>[0.024]     | - 2.94<br>[0.002]     | - 2.96<br>[0.002]     | - 2.98<br>[0.001]     | - 2.93<br>[0.002]     |
| Max                                               | 2.87<br>[0.002]       | 3.04<br>[0.001]       | 2.95<br>[0.002]       | 3.01<br>[0.001]       | 2.89<br>[0.002]       |
| Overall                                           | 1.98<br>[0.024]       | 2.94<br>[0.002]       | 2.95<br>[0.002]       | 2.98<br>[0.001]       | 2.89<br>[0.002]       |
| Extreme Point                                     | 4.77                  | 5.28                  | 5.38                  | 5.32                  | 5.36                  |
| Fieller Interval                                  | [1.12; 6.17]          | [3.96; 6.54]          | [4.03; 6.78]          | [3.99; 6.65]          | [3.99; 6.80]          |
| Observations                                      | 2554                  | 2554                  | 2554                  | 2554                  | 2554                  |
| Overall significance test                         | 9093.360              | 7272.913              | 7942.416              | 9605.562              | 7699.730              |
| R <sup>2</sup>                                    | 0.707                 | 0.713                 | 0.673                 | 0.686                 | 0.690                 |

Models have been estimated using a random effects panel data estimator. Time dummies included but not reported. The panel U-shape test reports the *t*-statistic for the hypothesis that the slope of the function is negative at the minimum and positive at the maximum. Overall is the one-side test statistic for the (joint) null hypothesis that the slope of the function is positive at the minimum and negative at the maximum. Fieller interval reported. Clustered standard errors in ( ). *p* values in [ ].

## Income inequality and the effect of political competition on FDI inflows

In Table 7, we test the effect of inequality in the distribution of income on the relationship between political competition and FDI inflows. The results are aimed at testing the validity of the theoretical hypothesis H2. We follow the empirical procedure suggested Haans, Pieters and He (2015) to run the U-shape test when the non-linear effect is interacted with a mediator variable.

Similar to Table 1, they are organized in three different panels, according to our three measures of FDI inflows. In each panel, we display estimates for both the control and the full model. Empirical estimates across all model specifications confirm the U-shaped relationship between political competition and FDI inflows. However, the influence of political competition on FDI is moderated by the effect of income inequality. This implies a downward shift of the curve, indicating that in both well-established democracies enjoying high levels of competition and in authoritarian regimes with low levels of political competition, the attraction of FDI inflows is less pronounced as inequality in the distribution of income rises. These findings empirically support our theoretical hypothesis H2.

In Fig. 2, we compare the U-shaped relationship between political competition and FDI inflows resulting from the estimation exercises reported in Table 2 (solid line) and in Table 7 (dashed line). We note that when inequality in the distribution of income is included in the regression, the curve keeps the same non-linear shape, but it shifts downwards. This result is confirmed regardless of the dependent variable used for measuring FDI inflows. This emphasizes the moderating effect of inequality on the political calculus of incumbent rulers associated with the policies enacted to attract foreign investors.

What the results in Table 7 tell us is that the introduction of inequality in the distribution of income moderates the positive association between political competition and FDI inflows, but what they do not tell us is whether income inequality provides different effects in democracies and autocracies. To check this eventuality and, therefore, the validity of our theoretical hypotheses H3, we look at Table 8, where we split our sample of countries according to whether the level of political competition is  $< 4$  (i.e., strongly authoritarian countries) or  $> 7$  (i.e., well-established competitive democracies).

We note that while the association between political competition and FDI inflows is positive and significant in democracies—the only exception is the case of FDI per-capita inflows—such an effect fades away in the case of countries governed by authoritarian regimes—the only exception is the case of FDI diversity inflows. More relevant for our purposes, political regimes seem to react differently to

the inequality-enhancing aspect of FDI based on the extent to which they are responsive to voter preferences. While greater inequality in the income distribution moderates the favor of democratically elected governments to foreign investors, in authoritarian regimes, the cross-effect between political competition and the Gini coefficient is generally not statistically significant, indicating that such a tempering effect of income inequality disappears.

These results support our theoretical hypothesis H3 with regard to democracies. The findings are also in line with our expectations with regard to autocracies. While in democracies, elected governments are more likely to carry out policies to mitigate the negative distributional effect of FDI to please dissatisfied voters, in authoritarian regimes, the governing elites are not electorally accountable to citizens, and rulers' policy decisions are scarcely affected by public preferences.

It is interesting to note that the empirical validation of hypotheses 2 and 3 emphasizes the documented dichotomy between 'liberal meritocratic capitalism', rooted in democratic institutions, and 'political capitalism', characteristic of autocratic countries (Milanovic, 2019). After the triumph of the combination of capitalism and democracy at the turn of the 20th century, it seems that the socio-economic consequences of the former resulted in rising insecurity and economic inequality. This is one of the factors underlying the current crisis of liberal democracies around the world (Wolf, 2024). This crisis is associated with what has been claimed to be the failure of liberal democratic governments to face and tackle the challenges associated with the structural socio-economic transformations that characterize modern global capitalism (Milner, 2021). In this context, economic inequality has been largely recognized as the main challenge of globally connected economies. FDI inflows are one of the key distinguishing characteristics of global connectivity (Jha et al., 2024).

In democracies, rising inequality erodes the electoral consensus toward globalization and, therefore, openness toward FDI inflows likely affects the policy choices of incumbent elected governments. This leads scholars to argue for a turning point in the beneficial relationship between democracy and capitalism operating in the core economies of the West, of which the United States can be considered the most paradigmatic example (Milanovic, 2019; Wolf, 2024). In contrast, in autocracies, incumbent rulers are not elected and are better equipped to control the socio-economic drawbacks associated with globalization and openness to FDI inflows. This may lead to a novel institutional combination between capitalism and authoritarian governments, with China as the prime exemplar.



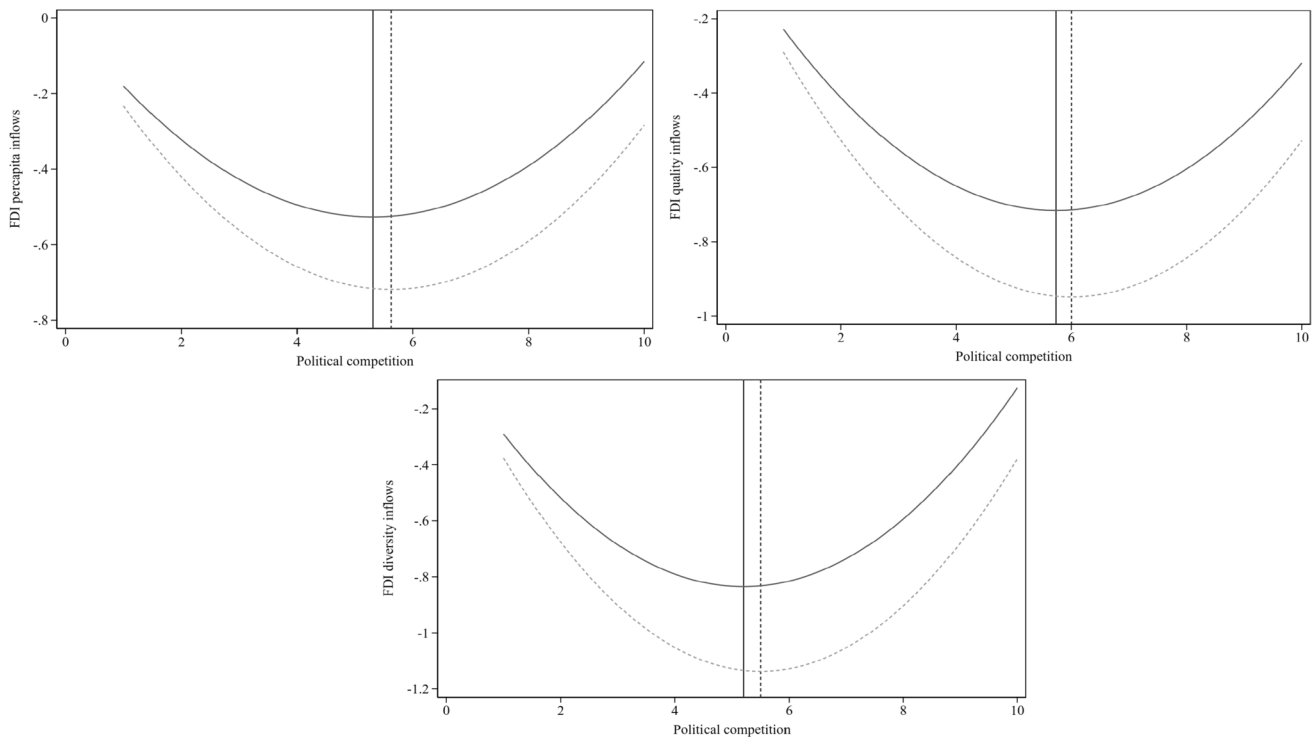
**Table 7** Testing the U-shape relationship between political competition and FDI inflows: The effect of income inequality

|                                                                         | Panel A                        |                       | Panel B                     |                       | Panel C                       |                        |
|-------------------------------------------------------------------------|--------------------------------|-----------------------|-----------------------------|-----------------------|-------------------------------|------------------------|
|                                                                         | Dep var FDI per-capita inflows |                       | Dep var FDI quality inflows |                       | Dep var FDI diversity inflows |                        |
|                                                                         | Control model                  | Full model            | Control model               | Full model            | Control model                 | Full model             |
|                                                                         | (a)                            | (b)                   | (c)                         | (d)                   | (e)                           | (f)                    |
| Political Competition <sub>t-1</sub>                                    |                                | - 1.794***<br>(0.490) |                             | - 2.101***<br>(0.679) |                               | - 2.788***<br>(0.758)  |
| Political Competition <sup>2</sup> <sub>t-1</sub>                       |                                | 0.147***<br>(0.040)   |                             | 0.169***<br>(0.052)   |                               | 0.233***<br>(0.063)    |
| Political Competition <sub>t-1</sub> × Gini <sub>t-1</sub>              |                                | 2.669***<br>(0.815)   |                             | 3.098***<br>(1.099)   |                               | 4.120***<br>(1.230)    |
| Political Competition <sup>2</sup> <sub>t-1</sub> × Gini <sub>t-1</sub> |                                | - 0.215***<br>(0.068) |                             | - 0.247***<br>(0.086) |                               | - 0.340***<br>(0.104)  |
| Gini <sub>t-1</sub>                                                     | - 0.747<br>(0.895)             | - 7.318***<br>(2.324) | - 0.131<br>(0.973)          | - 7.923**<br>(3.339)  | - 0.710<br>(1.243)            | - 10.447***<br>(3.361) |
| Low-income countries                                                    | - 1.226***<br>(0.240)          | - 1.170***<br>(0.247) | - 1.286***<br>(0.281)       | - 1.258***<br>(0.276) | - 1.857***<br>(0.311)         | - 1.783***<br>(0.317)  |
| Corruption <sub>t-1</sub>                                               | - 0.001<br>(0.001)             | - 0.001<br>(0.001)    | - 0.002<br>(0.002)          | - 0.003<br>(0.002)    | - 0.001<br>(0.002)            | - 0.001<br>(0.002)     |
| British legal system                                                    | 0.976***<br>(0.276)            | 0.976***<br>(0.265)   | 1.167***<br>(0.333)         | 1.251***<br>(0.315)   | 1.612***<br>(0.371)           | 1.599***<br>(0.347)    |
| French legal system                                                     | 0.885***<br>(0.193)            | 0.887***<br>(0.195)   | 1.048***<br>(0.287)         | 1.154***<br>(0.280)   | 1.328***<br>(0.280)           | 1.318***<br>(0.274)    |
| Scandinavian legal system                                               | 1.719***<br>(0.353)            | 1.302***<br>(0.357)   | 1.721***<br>(0.477)         | 1.397***<br>(0.470)   | 2.955***<br>(0.519)           | 2.207***<br>(0.503)    |
| German legal system                                                     | 0.892***<br>(0.304)            | 0.775***<br>(0.292)   | 0.845*<br>(0.438)           | 0.812*<br>(0.426)     | 1.733***<br>(0.477)           | 1.506***<br>(0.439)    |
| Political network <sub>t-1</sub>                                        | 0.433***<br>(0.149)            | 0.425***<br>(0.147)   | 0.852***<br>(0.274)         | 0.846***<br>(0.270)   | 0.936***<br>(0.227)           | 0.911***<br>(0.220)    |
| Trade exposure <sub>t-1</sub>                                           | 0.315**<br>(0.126)             | 0.326***<br>(0.125)   | 0.276*<br>(0.159)           | 0.282*<br>(0.150)     | 0.367**<br>(0.164)            | 0.375**<br>(0.164)     |
| Trade regulation <sub>t-1</sub>                                         | 0.567***<br>(0.138)            | 0.516***<br>(0.142)   | 0.457**<br>(0.187)          | 0.394**<br>(0.196)    | 0.739***<br>(0.193)           | 0.644***<br>(0.200)    |
| Population growth rate <sub>t-1</sub>                                   | - 0.286***<br>(0.074)          | - 0.278***<br>(0.070) | - 0.403***<br>(0.087)       | - 0.401***<br>(0.081) | - 0.091<br>(0.104)            | - 0.080<br>(0.095)     |
| GDP growth rate <sub>t-1</sub>                                          | 0.021***<br>(0.004)            | 0.021***<br>(0.005)   | 0.020***<br>(0.006)         | 0.021***<br>(0.008)   | 0.031***<br>(0.006)           | 0.034***<br>(0.008)    |
| Human capital <sub>t-1</sub>                                            | 1.214***<br>(0.234)            | 1.245***<br>(0.244)   | 1.187***<br>(0.347)         | 1.211***<br>(0.362)   | 2.004***<br>(0.339)           | 2.019***<br>(0.351)    |
| <i>U-shape test</i>                                                     |                                |                       |                             |                       |                               |                        |
| Min                                                                     |                                | - 3.65<br>[0.000]     |                             | - 3.28<br>[0.001]     |                               | - 4.02<br>[0.000]      |
| Max                                                                     |                                | 3.41<br>[0.000]       |                             | 3.01<br>[0.001]       |                               | 3.86<br>[0.000]        |
| Overall                                                                 |                                | 3.41<br>[0.000]       |                             | 3.01<br>[0.001]       |                               | 3.86<br>[0.000]        |
| Test for shift of the turning point                                     |                                | - 1.26<br>[0.208]     |                             | - 0.48<br>[0.630]     |                               | - 1.29<br>[0.196]      |
| Extreme Point                                                           |                                | 5.62                  |                             | 6.00                  |                               | 5.50                   |
| Fieller Interval                                                        |                                | [4.67; 6.70]          |                             | [5.03; 7.15]          |                               | [4.64; 6.43]           |
| Observations                                                            | 3527                           | 3436                  | 3432                        | 3344                  | 3459                          | 3371                   |
| Overall significance test                                               | 4194.842                       | 5040.761              | 5743.017                    | 6708.915              | 21,441.717                    | 29,441.444             |
| R <sup>2</sup>                                                          | 0.586                          | 0.621                 | 0.530                       | 0.564                 | 0.682                         | 0.722                  |



**Table 7** (continued)

Models have been estimated using a random effects panel data estimator. Time dummies included but not reported. The panel U-shape test reports the  $t$ -statistic for the hypothesis that the slope of the function is negative at the minimum and positive at the maximum. Overall is the one-side test statistic for the (joint) null hypothesis that the slope of the function is positive at the minimum and negative at the maximum. Fiel-ler interval reported. Clustered standard errors in ( ).  $p$  values in [ ].

**Fig. 2** Political competition, FDI, and inequality: downward shift of the U-shaped relationship

### Political regimes, FDI inflows, and economic growth

We discussed and empirically demonstrated that greater FDI inflows are associated with both strong autocracies and well-established democracies. However, incumbent governments in different political regimes are not interested in foreign investments per se. FDI inflows are means to an end, which is economic prosperity. As already mentioned, there is a vast literature, both theoretical and applied, that suggests the positive impact of FDI inflows on economic growth (Jha et al., 2024; Kumaraswamy et al., 2012; Lorenzen & Mudambi, 2013). However, in this section, we want to complete the circle in our reasoning and provide empirical evidence on the growth-effect generated by the calculus of incumbent governments in different political regimes concerning the decision to attract FDI inflows—i.e., the political replacement effect of foreign investments.

In this section, therefore, we empirically assess whether FDI inflows, modeled as a non-monotonic U-shaped function of political competition, affect per-capita GDP. We estimate a standard Solow growth model, augmenting

traditional regressors with the fitted values of FDI inflows generated from the baseline models shown in Table 2.

Specifically, we estimate the following equation:

$$Growth_{i,t} = \phi_0 + \phi_1 s_{i,t} + (n + \delta + g)_{i,t} + \widehat{FDI}_{i,t} + y_{i,t-1} + \eta_i + \eta_t + \omega_{i,t} \quad (2)$$

where  $Growth_{i,t}$  is the average per-capita GDP growth rate over a 5-year period,  $s_{i,t}$  is the gross capital formation in percentage of GDP, which is here use as proxy for savings,  $(n + \delta + g)_{i,t}$  is the sum of population growth rate ( $n$ ), capital depreciation rate ( $\delta$ ) and technological advancement ( $g$ ),  $\widehat{FDI}_{i,t}$  are the fitted values of FDI inflows as estimated in Table 2,  $y_{i,t-1}$  is the level of initial per-capita GDP,  $\eta_i$  is a random term capturing cross-country heterogeneity,  $\eta_t$  controls for period shocks common to countries in the sample, and  $\omega_{i,t}$  is the idiosyncratic error term. Data for analysis is sourced from the World Development Indicators (World Bank, 2024), and variables are in logs.

Following standard growth empirics, we average the variables over a 5-year period and use the initial value of the period ( $y_{i,t-1}$ ) to control for inertia in the convergence process of economies (Islam, 1995).



**Table 8** Democracies vs. autocracies: The effect of inequality on FDI

|                                                            | Panel A                |                       |                       | Panel B                |                      |                        |
|------------------------------------------------------------|------------------------|-----------------------|-----------------------|------------------------|----------------------|------------------------|
|                                                            | Democratic countries   |                       |                       | Autocratic countries   |                      |                        |
|                                                            | FDI per-capita inflows | FDI quality inflows   | FDI diversity inflows | FDI per-capita inflows | FDI quality inflows  | FDI diversity inflows  |
|                                                            | (a)                    | (b)                   | (c)                   | (d)                    | (e)                  | (f)                    |
| Political Competition <sub>t-1</sub>                       | 0.557<br>(0.341)       | 0.740*<br>(0.407)     | 1.003**<br>(0.401)    | - 0.506<br>(0.369)     | - 0.116<br>(0.451)   | - 1.051**<br>(0.480)   |
| Political Competition <sub>t-1</sub> × Gini <sub>t-1</sub> | - 0.930*<br>(0.533)    | - 1.261**<br>(0.637)  | - 1.686***<br>(0.623) | 0.820<br>(0.608)       | 0.089<br>(0.720)     | 1.697**<br>(0.793)     |
| Gini <sub>t-1</sub>                                        | 7.654<br>(4.945)       | 11.872**<br>(5.962)   | 14.143**<br>(5.904)   | - 5.800**<br>(2.414)   | - 4.623<br>(3.192)   | - 12.081***<br>(3.052) |
| Low-income countries                                       | - 0.828*<br>(0.451)    | - 0.784*<br>(0.462)   | - 1.052<br>(0.664)    | - 0.999**<br>(0.400)   | - 1.330**<br>(0.534) | - 1.848***<br>(0.459)  |
| Corruption <sub>t-1</sub>                                  | 0.000<br>(0.002)       | 0.001<br>(0.002)      | 0.002<br>(0.002)      | - 0.004<br>(0.005)     | - 0.016**<br>(0.007) | - 0.007<br>(0.007)     |
| British legal system                                       | 0.191<br>(0.328)       | - 0.064<br>(0.377)    | 0.981**<br>(0.416)    | 0.609<br>(0.428)       | 1.263***<br>(0.445)  | 1.303***<br>(0.454)    |
| French legal system                                        | 0.130<br>(0.250)       | - 0.119<br>(0.336)    | 0.732**<br>(0.340)    | 0.789**<br>(0.333)     | 1.422***<br>(0.403)  | 1.342***<br>(0.457)    |
| Scandinavian legal system                                  | 0.440<br>(0.443)       | 0.065<br>(0.599)      | 1.460**<br>(0.591)    |                        |                      |                        |
| German legal system                                        | 0.019<br>(0.352)       | - 0.364<br>(0.498)    | 0.958*<br>(0.508)     | 0.726<br>(0.504)       | 0.715<br>(0.647)     | 0.808<br>(0.838)       |
| Political network <sub>t-1</sub>                           | 0.304<br>(0.239)       | 0.769*<br>(0.451)     | 0.691**<br>(0.324)    | 0.104<br>(0.273)       | 0.452<br>(0.377)     | 0.330<br>(0.342)       |
| Trade exposure <sub>t-1</sub>                              | 0.164<br>(0.222)       | 0.090<br>(0.233)      | 0.016<br>(0.287)      | 0.629***<br>(0.238)    | 0.513*<br>(0.276)    | 0.868***<br>(0.267)    |
| Trade regulation <sub>t-1</sub>                            | 0.895***<br>(0.244)    | 0.853**<br>(0.345)    | 1.198***<br>(0.331)   | - 0.084<br>(0.240)     | - 0.047<br>(0.328)   | 0.071<br>(0.301)       |
| Population growth rate <sub>t-1</sub>                      | - 0.279***<br>(0.098)  | - 0.403***<br>(0.110) | - 0.076<br>(0.125)    | - 0.274**<br>(0.128)   | - 0.330**<br>(0.140) | - 0.098<br>(0.166)     |
| GDP growth rate <sub>t-1</sub>                             | 0.032***<br>(0.006)    | 0.034***<br>(0.010)   | 0.045***<br>(0.009)   | 0.002<br>(0.009)       | 0.003<br>(0.011)     | 0.008<br>(0.010)       |
| Human capital <sub>t-1</sub>                               | 1.826***<br>(0.387)    | 1.819***<br>(0.595)   | 3.083***<br>(0.533)   | 0.594<br>(0.416)       | 0.591<br>(0.583)     | 0.913*<br>(0.514)      |
| Observations                                               | 1976                   | 1940                  | 1947                  | 666                    | 644                  | 647                    |
| R <sup>2</sup>                                             | 0.599                  | 0.544                 | 0.696                 | 0.533                  | 0.495                | 0.672                  |

Models have been estimated using a random effects panel data estimator. Time dummies included but not reported. Clustered standard errors in ( ). *p* values in [ ].

A key issue in estimating equation (2) is that  $\widehat{FDI}_{i,t}$  is a generated regressor. The use of generated regressors is well documented since it can lead to underestimated standard

errors, causing type I error (Murphy & Topel, 1985). To solve this problem and obtain correct standard errors, we use a commonly accepted methodology consisting of bootstrapping the entire procedure. Thus, we re-estimate the baseline



**Table 9** The politics of FDI and economic growth

| Dependent variable        | Panel A                      |                       | Panel B                   |                       | Panel C                     |                       |
|---------------------------|------------------------------|-----------------------|---------------------------|-----------------------|-----------------------------|-----------------------|
|                           | Using FDI per-capita inflows |                       | Using FDI quality inflows |                       | Using FDI diversity inflows |                       |
| Per-capita GDP growth     | Control model                | Full model            | Control model             | Full model            | Control model               | Full model            |
|                           | (a)                          | (b)                   | (c)                       | (d)                   | (e)                         | (f)                   |
| $S_{i,t}$                 | 3.409***<br>(0.430)          | 3.350***<br>(0.425)   | 3.655***<br>(0.458)       | 3.581***<br>(0.424)   | 3.420***<br>(0.448)         | 3.352***<br>(0.456)   |
| $(n + \delta + g)_{i,t}$  | - 1.687<br>(1.052)           | - 1.677*<br>(1.011)   | - 2.102**<br>(0.887)      | - 2.134***<br>(0.817) | - 1.544<br>(0.970)          | - 1.506<br>(0.937)    |
| (fitted) $FDI_{i,t}$      | 0.841***<br>(0.271)          | 0.855***<br>(0.220)   | 0.658***<br>(0.235)       | 0.669***<br>(0.212)   | 0.622***<br>(0.179)         | 0.647***<br>(0.158)   |
| $Y_{i,t-1}$               | - 0.916***<br>(0.195)        | - 0.954***<br>(0.159) | - 0.802***<br>(0.178)     | - 0.831***<br>(0.167) | - 0.966***<br>(0.188)       | - 1.026***<br>(0.177) |
| Observations              | 742                          | 733                   | 735                       | 726                   | 736                         | 727                   |
| Overall significance test | 190.690                      | 199.038               | 184.261                   | 180.160               | 176.019                     | 193.274               |
| $R^2$                     | 0.253                        | 0.259                 | 0.253                     | 0.258                 | 0.265                       | 0.272                 |

Models have been estimated using a random effects panel data estimator. The dependent variable is the average growth rate of per-capita GDP over a 5-year period. All variables are in logs. Time dummies included but not reported. Bootstrap standard errors in ( ) are obtained using 500 replications.

models in Table 2 using the bootstrap technique. We calculated the fitted values of FDI inflows and included them amongst the regressors of equation (2). Bootstrap is, again, used to obtain correct standard errors for the growth equation parameters. The entire procedure is conducted using both 500 and 1000 replications. Regardless of the number of replications, the standard errors remained largely unchanged. Therefore, we chose to only show the empirical results obtained with 500 replications.

The findings of our analysis are reported in Table 9, where we estimate the effect of FDI per capita, FDI quality, and FDI diversity inflows on per-capita GDP growth rate. As in Table 2, we present six different model specifications distributed in three panels. In each panel, we show estimation results for either a control model or a full model, according to whether our three measures of FDI inflows are (models a, c, and e) or are not (models b, d, and f) determined by the political calculus of incumbent rulers in different political regimes, respectively.

We note that FDI inflows are positive and statistically significant across all model specifications. This indicates that foreign investments are associated with higher levels of per-capita GDP growth rate, regardless of whether we use FDI per-capita inflows, FDI quality inflows, or FDI diversity inflows. However, the effects of quality and diversity FDI inflows on per-capita GDP growth rate display greater magnitude in the full models as compared to the control models. The opposite applies if we look at the growth effect of FDI per-capita inflows. These findings suggest that the impact of

FDI inflows on a country's per-capita growth rate is stronger when they are characterized by better quality and greater diversity. This should enter into the political calculus of all incumbent rulers.

These results suggest that the nature of FDI inflows makes a difference for incumbent policy makers through their effects on income. Both autocrats and democratically elected rulers prefer better quality and more diverse FDI inflows, although for different reasons: power and rents for the former and higher re-election prospects for the latter.

As far as the control variables are concerned, they are generally statistically significant and display the expected signs. These findings are consistent with growth empirics.

## Conclusions

Foreign direct investment (FDI) has emerged as a critical driver of economic growth and development worldwide. Governments around the globe recognize the positive spillovers associated with FDI, such as job creation, technology transfer, and market access. As a result, they have implemented various policies to attract inward FDI from multinational enterprises (MNEs). However, the extant literature on FDI and FDI attraction has largely focused on the business and economic factors and institutions (like tax concessions) in the host countries (Castellani et al., 2022). Thus far nature and extent of political competition in the host country have received relatively less attention.

Extant research examining the host country's political environment has taken a linear or monotone approach, asking whether it is democracies or autocracies that attract more FDI (Dutta & Osei-Yeboah, 2013). Most of this research concludes that, despite the uncertainty produced by electoral outcomes, FDI inflows are higher in democracies. However, recent research in IB argues that this approach is overly simplistic (Li et al., 2018) and ignores the bargaining process between governments in MNEs (Vernon, 1971). Our paper answers the call in the pages of *JIBS* for IB researchers to adopt a more sophisticated approach to the objectives of the state, especially with regard to the welfare of the citizenry (Bhaumik, et al., 2024).

Our approach to the objectives of the state is anchored in the work of Daron Acemoglu and James Robinson, winners of the 2024 Nobel Prize in Economics. They highlight the crucial role of the political perspective in explaining business and economic outcomes (Acemoglu, 2025). They have persuasively argued that even when policies are welfare-enhancing, whether or not they are implemented depends crucially on how they affect the fortunes of the country's rulers. For instance, innovation is unambiguously good for a nation. It was encouraged and implemented in 19th-century Western Europe, where the ruling elite was embedded in industry. In contrast, it languished in Austria-Hungary and Russia in Eastern Europe, where the ruling elites were primarily landowning aristocrats (Acemoglu & Robinson, 2006). This view forms the basis of our paper. We draw on this Nobel Prize-winning work to argue that the effectiveness of inward FDI policy is likely to vary systematically depending on the underlying political system in which it operates.

Democracies and autocracies represent two distinct political systems. Nonetheless, governments, whether democratic or authoritarian, are motivated by a desire to maintain their political power, and they recognize that economic prosperity is a key factor in achieving this goal. By engaging with the global economy through FDI, governments can access the resources and opportunities necessary to drive economic growth, create jobs, and enhance their political legitimacy. However, the relationship between power and international business is not always straightforward since different political regimes are characterized by differing motivations and priorities. In democracies, governments are accountable to their citizens through electoral processes. Their primary concern is to enact policies that benefit the electorate and enhance their chances of re-election. Conversely, autocratic regimes are not subject to the same democratic constraints. Their primary goal is to extract rents for the benefit of the ruling elite.

The differing political concerns of democracies and autocracies have significant implications for their approach to FDI. In democracies with high levels of political

competition, incumbent governments face significant pressure to deliver tangible benefits to their constituents. This can incentivize them to implement more pro-FDI policies to attract investment and stimulate economic growth. On the other hand, in democracies with low levels of political competition, incumbent governments may have less incentive to pursue FDI-friendly policies, as they face minimal electoral challenges.

In contrast, in autocracies, the relationship between political competition and FDI is more complex. While these regimes may also recognize the economic benefits of FDI, their primary motivation is maintaining their political power to extract rents from foreign investors. Increased political competition can weaken the grip of the ruling elite on rents extracted from FDI. It can also lead to greater uncertainty and instability. This may deter foreign investors and reduce FDI inflows.

Overall, our analysis suggests a U-shaped relationship between political competition and FDI inflows. Both very high and very low levels of political competition are associated with favorable treatment of FDI and large FDI inflows. Intermediate levels of political competition are likely to witness less favorable policy treatment of FDI and lower FDI inflows. Our empirical analyses support these expectations.

Beyond the quantity of FDI inflows, the quality and diversity of FDI also play a crucial role. Higher-quality FDI, such as investments in research and development or advanced manufacturing, can generate more valuable spillovers for the host economy. Similarly, more diverse FDI portfolios can reduce the risk of economic shocks and promote sustainable development. Our findings suggest that the association between political competition and MNEs foreign investment decisions is stronger on FDI quality and diversity than on FDI quantity. This implies that political actors in both democracies and autocracies value higher-quality and more diverse FDI, albeit for different reasons.

In addition to the political factors discussed above, concerns about inequality can also influence FDI policies. While FDI can generate economic growth and create jobs, it may also exacerbate inequality. This can lead to public discontent and political backlash, particularly in democracies where citizens have a stronger voice. Our empirical evidence supports these hypotheses, suggesting that democracies may offer fewer incentives for inward FDI than autocracies due to concerns about inequality. This ironic outcome highlights the importance of considering both economic and social factors when evaluating FDI policies.

Since FDI inflows should be considered as means to an end, it should be noted that incumbent rulers are not interested in foreign investments per se, but rather because of their income-enhancing effects. Therefore, in the last section of the paper, we empirically investigated the growth-impact of FDI inflows generated by the policy decisions of



incumbent governments in different political regimes. Our estimations reveal that the political calculus of incumbent rulers associated to greater FDI inflows in both autocracies and democracies leads to higher per-capita growth rates. This relationship is stronger if the FDI inflows are of better quality and more diverse, since those types of foreign investments grant incumbent rulers higher expected per-capita growth rates, which, in turn, are combined with greater power and rents in autocracies and higher probability of re-election in democracies.

This research demonstrates that the relationship between political competition and FDI is complex and multifaceted. It highlights the differing motivations and priorities of governments in democracies and autocracies, as well as the impact of political competition on FDI policies. Our findings will offer several notable insights to better understand the relationship between the process of gaining and maintaining political power in both democracies and authoritarian regimes and international business in today's global economy.

**Supplementary Information** The online version contains supplementary material available at <https://doi.org/10.1057/s41267-026-00849-8>.

**Data availability** Data were obtained from publicly available sources. Replication materials, including data files and routines, are accessible through the Figshare repository. <https://doi.org/10.6084/m9.figshare.31048825>.

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